Chapter 1

UNDERSTANDING AND WORKING

WITH THE FEDERAL TAX LAW

Lecture Notes

**SUMMARY OF CHANGES IN THE CHAPTER**

The following are notable changes in the chapter from the 2012 Edition. For major changes, see the Preface to the Instructor’s Edition of the text.

* A Tax in the News item that illustrates a recent application of the whistleblower program that netted the IRS and the individual informant a considerable reward from evaded taxes.
* Amplification of the current status of Cumulative Bulletins (C.B.s) issued by the IRS.
* Updated online addresses of various tax periodicals and tax-related Websites.

**INITIAL OBSERVATIONS**

Former IRS Commissioner Sheldon Cohen indicates that “taxes are dry, arcane and difficult, but tell me a person’s philosophy of taxes, and I will tell you his or her philosophy of life.”

As required by § 8022(3)(B), the Joint Committee on Taxation released its study in April 2001, entitled *Study of the Overall State of the Federal Tax System and Recommendations for Simplification*. An instructor may wish to acquire this three volume report.

The tax law is complex and some of its provisions sometimes defy logic. The IRS publishes more than 649 tax forms, schedules, and separate instructions, totaling more than 16,000 lines. The Internal Revenue Code has sections numbered from 1 to 9833, although there is not a section for each number. For example, there are no Code sections numbered 6 through 10 or 200 through 210 but some numbers have more than one section such as § 280A to 280H. There are over 151,000 regulations supporting these code sections as well as court cases, rulings and other pronouncements interpreting the code.

Most often, there are reasons for the tax rules. One may not agree with the reasons but, nonetheless, they exist. Knowing these reasons can go a long way in helping to understand the tax law. This knowledge is what Chapter 1 conveys. Chapter 1 also provides an instructor with the opportunity to review some of the concepts covered in the first course in taxation.

**1.1 THE WHYS OF THE TAX LAW**

1. While the major objective of Federal tax law is raising revenue, this is not the sole objective of tax laws.

a. Important in explaining various provisions found in the law are economic, social, equity, and political considerations.

b. Influence of the IRS and the courts also has its impact.

**Revenue Needs**

2. Foundation of a taxing system is to raise revenue to cover the cost of government operations.

3. Many states require that they have balanced budgets, thus precluding deficit spending. The Federal government does not have this requirement.

a. National deficit was more than $14.7 trillion near the end of 2011.

b. This is more than $47,000 per citizen.

4. When enacting legislation, Congress considers revenue neutrality.

a. Changes in the tax law should not increase or decrease the net revenues collected.

b. However, individual taxpayers may have their taxes increase or decrease.

**Economic Considerations**

5. Tax law is often used to accomplish economic objectives and encouraging certain activities.

1. Control of the Economy and Encourage Certain Activities.

* Congress has used depreciation and tax rates to control the economy.
* Technological progress is encouraged by allowing the immediate expensing of research and development costs. Incremental R & D expenditures also are allowed a special credit.
* Ecology is encouraged by allowing pollution control facilities to be amortized over 60 months. Also there are various tax credits for home energy conservation and the purchase of hybrid energy vehicles.
* Low-income housing tax credits stimulate the construction of these dwellings.
* Saving which leads to capital formation is stimulated by incentives to increase private retirement plans. The encouragement of private-sector pension plans can be justified under social considerations as well.

7. Encouragement of Certain Industries.

* Tax laws favor farming by allowing expensing of soil and water conservation and fertilizers. Also farmers defer the gain recognition on crop insurance proceeds.
* Natural resource exploration and development is encouraged by allowing expensing of intangible drilling and development costs. Also, percentage depletion often allows a larger write-off for mineral interests that qualify.
* Publishing industry is aided by immediately expensing certain circulation expenditures.
* Railroad industry benefits from amortization procedures allowed with regards to railroad rolling stock.
* Manufacturing industry currently receives the benefit of the domestic production activities deduction.

8. Encouragement of Small Business.

a. Congressional favoritism for small business is based on the notion that what is good from small businesses is good for the economy as a whole.

1. Special provisions illus­trating this positive bias for small business include the following.

* Special treatment of small business corporation stock leading to ordinary (rather than capital) loss treatment (§ 1244 stock).
* S corporation elections allow the avoidance of corporate income tax and the pass-through of losses to the shareholders.

**Social Considerations**

9. Many of the tax provisions passed by Congress can be explained by social desirability. These provisions encourage individuals to work, give to charities, obtain educations, and adoption. Employers are encouraged to provide accident, health, and group-term life insurance as well as retirement plans for employees.

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| **ADDITIONAL LECTURE RESOURCE** |

Discuss the following items not listed in the text and explain their justification on social grounds.

1. Credit for the elderly. This credit was designed to provide a measure of relief for certain senior citizens with low incomes and small or no Social Security bene­fits. Congress believed it was socially and economi­cally desirable to provide a modest tax benefit for this type of taxpayer.
2. Abandoned spouse provisions permit certain married persons living apart from their spouses to be treated as unmarried for tax purposes.
3. This treatment may enable persons with dependents to be taxed under the more favorable head of household standard deduction and tax rates (when compared to the rates applicable to married persons filing separately). These special rules are not only socially desirable but also equitable.
4. Due to reducing the marriage penalty in recent years, those without dependents are similarly placed when filing single or married filing separately.

**Equity Considerations**

10. Equity is a relative concept and people often disagree as to what is equitable. For tax purposes, equity is equal application of what the tax law recognizes.

11. Alleviate the effect of multiple taxation.

a. Taxpayers are allowed a deduction for state and local income taxes and a deduction or credit for foreign income taxes. Also, some state income tax laws allow a deduction for Federal income taxes.

b. Triple taxation relief for corporations is provided by dividends received deduction. In the case of individual shareholders, qualified dividends are taxed at a maximum rate of 15% (Beginning in 2013, dividends will be taxed as ordinary income for individuals if Congress does not act to extend the reduced tax rate).

12. Wherewithal to Pay Concept.

a. This concept is based on equity. It recognizes that it is inequitable to tax transactions when the taxpayer has no ability to pay the tax.

(1) Applies only where Congress specifically provides, thus, one cannot conclude that a transaction is nontaxable just because no cash results from the exchange.

(2) Most wherewithal to pay provisions in the tax law do not permanently avoid gain or loss but operate on a deferral principle. Because of the basis carryover rules, gain or loss merely is postponed to the future disposition. The following are examples of this deferral concept.

* Like-kind exchanges (§ 1031).
* Involuntary conversions (§ 1033).
* A transfer of property to a controlled corporation (§ 351).
* A transfer to a partnership (§ 721).
* Transfers of lessee made improvements on the leased property to the lessor upon termination of the lease (§ 109).

13. Mitigating the Effect of the Annual Accounting Period Concept.

a. For administrative ease, all taxpayers have to file tax returns yearly. However, all taxpayers do not have a one year business cycle. To mitigate the effect of annual accounting period concepts, taxpayers are allowed the following.

* Deductions for net operating losses that occur in other tax years.
* Installment treatment.
* Deduction determination after the year-end when it is difficult to accurately assess the proper amount by year-end. Examples are contributions to IRA and H.R. 10 (Keogh) retirement plans.

14. Coping with Inflation. To overcome the impact of inflation in many areas of the tax law, Congress has included an indexing procedure.

**Political Considerations**

15. Special Interest Legislation provides benefits to limited groups of taxpayers. However, this legislation should not be condemned if justified on economic or social grounds.

16. Political Expediency. Congress is sensitive to the general public’s sentiment regarding taxes. The AMT is a response to the general public’s disapproval of large profitable corporations paying little or no income taxes.

17. State and Local Influences on Federal taxation may be less apparent. The community property system is an example.

**Influence of the Internal Revenue Service**

18. IRS as Protector of the Revenue. IRS is influential in many areas beyond its role in issuing administrative pronouncements. It is proactive in closing “loopholes” in tax laws.

19. Administrative Feasibility.

a. Some tax laws are justified on the grounds that they simplify the collecting the revenue and administering the law. Such items as the pay-as-you-go basis for collecting taxes and the imposition of interest and penalties on taxpayers for noncompliance with the tax law help ease revenue collection.

b. Laws to aid in the audit process conducted by the IRS.

(1) Standard deduction reduces the number of taxpayers claiming itemized deductions. Fewer deductions to check simplifies the audit function.

(2) The $1,730,800 unified gift tax credit providing an exclusion amount of $5 million and the annual $13,000 gift exclusion.

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| **ADDITIONAL LECTURE RESOURCE** |

The Code provides civil and fraud penalties.

1. For documents and information returns, the penalty varies by the length of time within which the taxpayer corrects the failure to file or furnish correct information returns.
2. A substantial understatement penalty and valuation penalties exist.
3. Fraud and negligence penalties do not apply to failures to file returns. Fraudulent failure to file returns penalty is 15% of the net tax due per month, up to a maximum of 5 months or 75%.
4. Preparer penalties and a penalty for directly or indirectly promoting abusive tax shelters.

**Influence of the Courts**

20. Judicial Concepts Relating to Tax Law.

a. Substance over form is one of the most important tax concepts developed by the courts.

b. Step transaction approach (also called telescoping or collapsing) allows the tax law to disregard any step in a transaction involving many steps, if the results would be the same.

c. Statutory relief provisions that operate to benefit taxpayers are narrowly construed.

d. Arm’s-length transaction concept. Transactions should be constructed such that unrelated parties would have handled the transaction in the same manner.

e. Continuity of interest, which applies primarily to corporation restructuring, has been incorporated into statutory provisions.

f. Business purpose concepts principally apply to corporations. Tax avoidance is not considered to be a sound business purpose.

21. Judicial Influence on Statutory Provisions. Courts interpret the tax law and may have substantial impact on statutory provisions.

a. Congress generally accepts the decisions of the courts, and those decisions become part of the tax law. In some cases, Congress may see fit to incorporate the result of a decision and make it part of the tax law.

b. On occasion, a decision leads to uncertainty by failing to provide guidelines for similar but not identical factual situations. To clarify the matter, Congress may amend the tax law to establish such guidelines.

c. If Congress does not choose to accept a judicial decision, it can change the tax law to neutralize the result. Congress has the last word on what the Federal tax law should be barring certain exceptions (e.g., constitutional issues).

**1.2 SUMMARY**

22. In addition to revenue-raising, the Federal tax law is influenced by other considerations, such as, economic, social, equity, and political. Influence of the IRS and the courts are also instrumental in the development of tax laws.

**1.3 WORKING WITH THE TAX LAW—TAX SOURCES**

**General Observations**

Coverage of Tax Research. This section of Chapter 1 is designed to familiarize students with tax research methods, sources, and proper citations for primary sources. The depth of coverage given to this material depends upon the objectives that the instructor establishes for the course. If research problems are assigned, this section will facilitate the student’s ability to perform the research.

* Some instructors may prefer to not discussing this material in class.
* Light coverage of materials would cover where Code, Regulations, Revenue Rulings, Revenue Procedures, and judicial decisions fit into the scheme of the tax law. Further, the citations for these various sources should be illustrated because the rest of the text attempts to provide sources for the rules making up the tax law.

* Initial hurdles that students may encounter when coping with the tax research process is the location of the sources. Providing instructions on how to access library and internet sources is generally helpful to the students.

**Statutory Sources of the Tax Law**

23. Origin of the Internal Revenue Code.

a. Before 1939, the tax law provisions were not codified.

b. The first codification was in 1939 and then was recodified in 1954.

c. The Internal Revenue Code of 1986 was not a recodification of the tax law. Apparently Congress felt that the changes made by the Tax Reform Act of 1986 were so substantial that a change in the Code title was in order.

24. Legislative Process. For a diagram of the legislative process, see text page 1-18.

a. Committee reports are an important source for ascertaining the intent of Congress when passing new tax laws. These are key for interpreting legislation, especially before regulations have been issued.

(1) For major tax legislation, the staff of the Joint Committee may prepare a General Explanation of the Act. Commonly known as the “bluebook” because of the color of its cover. These detailed explanations can provide valuable guidance to tax advisers and taxpayers.

(2) IRS will not accept “bluebook” explanations as having legal effect but they are substantial authority for purposes of the accuracy-related penalty.

1. On occasions, Congress enacts “deadwood” bills to “clean up” the Code by eliminating provisions that are obsolete and possess no continuing validity.

25. Internal Revenue Code is supreme Federal tax law, except in the following situations.

a. When in direct conflict with a tax treaty, the law provides which ever was most recently passed will take precedence.

b. Supreme Court determines a statute is unconstitutional. In cases not involving constitutionality issues, Congress may override the Supreme Court by amending the Code. Taxpayers often have the impression that the Supreme Court always is the final word but this is not the case with the Internal Revenue Code.

26. Arrangement of Code.

a. Organization and parts of a Code section are presented on text page 1-20 and in Figure 1.1 in the Instructor’s Guide on page 1-18.

b. Proper citation formats are presented on text page 1-20.

c. Some Code section citations contain a capital letter (e.g., § 280A to § 280H). This is because certain Code numerical sequences have no space for expansion.

**Administrative Sources of the Tax Law**

Administrative sources are either issued by the Treasury Department or the IRS.

27. Treasury Department Regulations. Under § 7805(a) Treasury has a duty to issue rules and regulations to explain and interpret the Code.

a. Regulations do carry considerable weight and are important in complying with the tax law.

b. Since they interpret the Code, regulations are arranged in the same manner as the Code but have a prefix indicating the type of tax to which they apply.

c. Several types of regulations are issued.

* Final, Proposed, and Temporary (expire at the end of 3 years).
* Legislative regulations.
* Interpretative regulations.
* Procedural regulations.

d. Proper citation formats are presented on text page 1-21.

28. Revenue Rulings and Revenue Procedures. Official pronouncements of the National Office of the IRS.

a. Revenue Rulings (Rev. Rul.): Provide specific interpretations of the tax law and therefore do not carry the same legal force and effect as Regulations.

b. Revenue Procedures (Rev. Proc.): Concern the internal management practices and procedures of the IRS.

c. Both serve to provide guidance to both IRS personnel and taxpayers in handling routine tax matters.

d. Both are published weekly by the U.S. Government in the Internal Revenue Bulletin (IRB). Semiannually, the bulletins for a six-month period are gathered together and published in a bound volume called the Cumulative Bulletin (CB).

e. Proper citation formats are presented on text page 1-22.

29. Other Administrative Pronouncements.

a. Treasury Decision (TD): Issued by the Treasury Department to promulgate new Regulations, amend existing Regulations, or to announce Government positions on court decisions. Published in the IRB transferred to the CB.

b. Technical Information Release (TIR): Issued to announce the publication of various IRS pronouncements (e.g., Revenue Rulings, Revenue Procedures).

c. Letter Ruling (Ltr Rul or PLR): Issued by National Office of IRS upon a taxpayer’s request and describe how the IRS will treat a proposed transaction for tax purposes.

(1) In general, they apply only to taxpayers making the request but post-1984 rulings may be substantial authority for purposes of avoiding accuracy-related penalties.

(2) IRS must make letter rulings available for public inspection.

d. Technical Advice Memorandum (TAM): Issued by National Office of IRS. TAMs resemble letter rulings however, they are issued in response to questions raised during audits. TAMs deal with completed rather than proposed.

e. Proper citation format for Ltr Rul and TAM with explanations are presented on text page 1-23.

**Judicial Sources of the Tax Law**

30. Judicial Process in General.

a. After a taxpayer has exhausted remedies available within the IRS the dispute can be taken to the Federal courts.

(1) First considered by a court of original jurisdiction (trial court).

(2) Appeals taken to the appropriate appellate court.

(3) Federal trial and appellate court system is found in text Figure 1.1.

b. Precedential Value. American law, following English common law, is frequently “made” by judicial decisions. Under the doctrine of stare decisis, each decision has precedential value for future decisions with the same controlling set of facts.

31. Trial Courts. Courts in which a taxpayer may pursue a tax conflict are as follows.

a. Single U.S. Court of Federal Claims hears tax and other Federal government cases. Has 16 judges.

b. Single U.S. Tax Court hears only tax cases. Has 19 judges.

c. Small Cases Division of U.S. Tax Court. The broken line between the U.S. Tax Court and the Small Cases Division in text Figure 1.1 indicates that there is no appeal from the Small Cases Division. This court involves informal cases of $50,000 or less.

d. There are numerous U.S. District Courts based on geographical locations. Each court has 1 judge and taxpayers can have a jury trial.

e. Concept Summary 1.1 in the text provides a summary of the organization of the tax trial courts.

32. Appellate Courts. Appeal from trial courts are to the U.S. Court of Appeals for the appropriate jurisdiction.

a. Generally, a three-judge panel hears a case, but occasionally the full court will decide more controversial conflicts.

b. If the IRS or taxpayer loses in a trial court level either or both may appeal. When it loses, the IRS may choose not to appeal for a number of reasons.

c. Precedential Value of U.S. Court of Appeals decisions.

(1) Trial courts must follow precedents set by the Court of Appeals within their jurisdiction. Tax Court follows the Golsen rule.

(2) Court of Appeals need not follow decisions of another Court of Appeals because they are geographical court at the same level.

(3) All Courts of Appeals must follow decisions of the U.S. Supreme Court.

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| **ADDITIONAL LECTURE RESOURCE** |

**JURISDICTION OF THE COURTS OF APPEALS**

First Second Third Fourth

Maine Connecticut Delaware Maryland

Massachusetts New York New Jersey North Carolina

New Hampshire Vermont Pennsylvania South Carolina

Rhode Island Virgin Islands Virginia

Puerto Rico West Virginia

Fifth Sixth Seventh Eighth

Louisiana Kentucky Illinois Arkansas

Mississippi Michigan Indiana Iowa

Texas Ohio Wisconsin Minnesota

Tennessee Missouri

Nebraska

Ninth Tenth Eleventh North Dakota

Alaska Colorado Alabama South Dakota

Arizona Kansas Florida

California New Mexico Georgia

Hawaii Oklahoma

Idaho Utah Federal Circuit

Montana Wyoming All jurisdictions: case originating

Nevada in U.S. Court of Federal Claims

Oregon

Washington District of Columbia

Guam Washington, D.C.

33. Supreme Court.

a. Appeal to the U.S. Supreme Court requires a Writ of Certiorari.

b. If the Court agrees to hear the case, it grants the Writ but most often, it will deny.

c. Court grants certiorari to resolve a conflict among the Courts or when the tax issue is extremely important.

d. All individuals and the IRS must follow the decisions of the U.S. Supreme Court.

34. Judicial Citations. Proper judicial citation formats for all court cases are presented on text pages 1-28 through 1-30.

**Other Sources of the Tax Law**

35. Effect of Treaties. Tax conventions (treaties) are signed by the United States and foreign countries to render mutual assistance in tax enforcement and to avoid double taxation. Neither a tax law nor a tax treaty takes general precedence. When there is a conflict, the most recent item will take precedence.

36. Tax Periodicals. Online sources of various periodicals are listed on text page 1-31.

**1.4 WORKING WITH THE TAX LAW– LOCATING TAX SOURCES**

**Electronic Versus Paper Tax Sources**

37. Computerized tax research tools have replaced paper resources in most tax practices. There are two chief ways to conduct tax research using computer resources.

a. Online and CD-ROM subscription services.

b. Online free Internet sites.

38. Accessing tax documents through electronic means offers numerous advantages over a strictly paper-based approach.

a. Materials generally are available faster. Online services are updated daily and can be accessed from remote locations.

b. Some tax documents are available only by electronic means and no longer in print.

c. Commercial subscriptions provide additional tax law sources.

d. With topical indexes users rely on someone else’s organization and judgment to deter-mine relevant words. With a computerized search, users determine their own keywords.

e. Can retrieve documents in order of relevance or by source.

f. Using electronic searches cannot substitute for developing a thorough knowledge of the tax law or for logical and analytical review of tax issues.

**Conventional Tax Sources**

39. Tax services are either annotated or topical. However, with hypertext linking capabilities, the structure of the services is not as important. Major services available are the following.

a. Research Institute of America: *Federal Tax Coordinator 2d* (Topical); *United States Tax Reporter* (Annotated); and *Analysis of Federal Taxes: Income* (Topical).

b. Commerce Clearing House: *Standard Federal Income Tax Reporter* (Annotated) and *Tax Research Consultant* (Topical).

c. West Group: Merten’s Law of Federal Income Taxation (Topical).

d. Bureau of National Affairs: *Tax Management Portfolios* (Topical).

e*. Warren, Gorham & Lamont:* Federal Income, Gift, and Estate Taxation (Topical).

40. Working with the Tax Services.

a. The best method to learn tax research is by performing tax research. This is because procedural knowledge such tax research is obtained through practice.

b. Tax determinations should not be based solely on a tax service’s commentary. If the primary source is important, it should be read.

c. Checking citators is an important step in tax research because citators indicate whether the primary source is still good tax law.

d. Always check for current developments.

**Electronic Tax Sources**

41. Virtually all major commercial tax publishers and primary tax sources are available electronically. Tax sources are usually found using a Search, Link, or Browse strategy.

42. CD-ROM Services. Can pack a tremendous amount of tax materials on a single CD. At their best these services provide archival data that is a core library of tax documents.

43. Online Systems. Allow practitioners to obtain virtually instantaneous use of tax law sources by accessing the service provider.

44. The Internet. Provides a wealth of tax information generally with no direct cost to the researcher.

**1.5 WORKING WITH THE TAX LAW – TAX RESEARCH**

45. Definition of Research. Tax research is the method used to determine the best available solution to a situation that possesses tax consequences that arise from either a completed or proposed transactions. It is the process of finding a competent and professional conclusion to a tax problem. It involves the six steps, which are the next outline headings.

**Identifying the Problem**

46. Problem identification starts with a compilation of the relevant facts involved. All of the facts that might be relevant must be gathered as omissions could modify the solution reached.

47. Refining the Problem and Further Refinement of the Problem. The problem will be refined and further refined during the research process as research is an iterative rather than a lineal process.

**Locating the Appropriate Tax Law Sources**

48. Tax law sources can be located by using a Keyword, Content (table of content or index) or citation search. Each of these can be performed using online services.

**Assessing the Validity of Tax Law Sources**

49. The tax sources identified as relevant to the tax problem need to be interpreted and assessed as to their legal weight and validity.

50. Interpreting the Internal Revenue Code. Language of the Code is often complex, therefore, it must be read carefully watching particularly for restrictive language and definitions that vary from one Code section to another.

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| **ADDITIONAL LECTURE RESOURCE** |

One author has noted 10 common pitfalls in interpreting the Code.1

1. Determine the limitations and exceptions to a provision. Do not permit the language of the Code Section to carry greater or lesser weight than was intended.

2. Just because a Section fails to mention an item does not mean that the item is excluded.

3. Read definitional clauses carefully. Note, for example, that § 7701(a)(3) defines a corporation as including “associations.” This inclusion (further developed in Chapter 2) becomes essential in determining how professional associations are to be treated for Federal income tax purposes.

4. Do not overlook small words such as “and” and “or.” There is a world of difference between these two words.

5. Read the Code Section completely; do not jump to conclusions.

6. Watch out for cross-referenced and related provisions since many Sections of the Code are interrelated.

7. At times Congress is not careful when reconciling new Code provisions with existing Sections. Conflicts among Sections, therefore, do arise.

8. Be alert for hidden definitions; terms in a particular Code Section may be defined in the same Section or in a separate Section.

9. Some answers may not be found in the Code. Therefore, it may be necessary to consult the Regulations and/or judicial decisions.

10. Take careful note of measuring words such as “less than 50 percent,” “exceeds 35 percent,” “at least 80 percent,” and “more than 80 percent.”

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1 H. G. Wong, “Ten Common Pitfalls in Reading the Internal Revenue Code,” *The Practical* *Accountant* (July-August 1972), pp. 30‑33.

51. Assessing the Validity of a Treasury Regulation.

a. Treasury Regulations may have the force and effect of law, however, courts have held a Regulation or a portion invalid if contrary to the intent of Congress. Burden of proof is on the taxpayer to show that the Regulation should be invalidated.

b. Regulations that merely reprints or rephrases what Congress has stated in its Committee Reports are ‘‘hard and solid’’ and almost impossible to overturn.

c. Through the Code, Congress may give the ‘‘Secretary or his delegate’’ the authority to prescribe Regulations to administer or otherwise provide operating tax rules. Since Congress has delegated its legislative powers to the Treasury Department, these legislative Regulations have the power of law.

52. Assessing the Validity of Other Administrative Sources of the Tax Law. While Revenue Rulings issued by the IRS carry less weight than Regulations, they do reflect the position of the IRS on tax matters.

53. Assessing the Validity of Judicial Sources of the Tax Law. How much reliance can be placed on a particular decision depends upon the level of the court, the legal residence of the taxpayer, and its precedential value.

54. Assessing the Validity of Other Sources.

a. The IRS regards only primary sources as substantial authority. Primary sources include: the Constitution, legislative history materials, statutes, treaties, judicial decisions, regulations, and IRS pronouncements.

b. While secondary sources are not substantial authority, they still may be very useful. Some, such as letter rulings general counsel and technical advice memoranda, can bring protection from accuracy related penalties. The general explanation of tax legislation prepared by the Joint Committee on Taxation (“Blue Book”) can also provide protection from accuracy penalties.

**Arriving at the Solution or at Alternative Solutions**

55. After evaluating the tax law and applying it to the facts of the tax problem, a solution to the tax issues must be developed by applying professional judgment.

a. The research may not result in a clear solution either because the law is not clear on the issue or incomplete knowledge of the tax facts. Thus, alternative treatments may be presented.

b. The personal risk preference and clients desired outcome must also be considered.

**Communicating Tax Research**

56. Once the conclusions have been reached, they must be communicated to the supervisor and the client.

a. Format may be in memo, letter, or spoken presentation

b. Good tax research communication should contain the following elements.

* Clear statement of the issue.
* Short review of the factual pattern that raises the issue.
* Review of pertinent primary tax law.
* Any assumptions made in arriving at the solution.
* Solutions recommended and citations to the law supporting such solutions.

**1.6 WORKING WITH THE TAX LAW– TAX PLANNING**

**Nontax Considerations**

57. Tax considerations can operate to impair sound business judgment. Tax and Nontax considerations should be balanced.

**Components of Tax Planning**

58. The following are components of tax planning.

a. Avoidance: Passing property by death avoids income tax on any built-in appreciation; investment in Roth IRAs avoids post-investment income and appreciation on later distribution.

b. Deferral: Like-kind exchanges (§ 1031) and involuntary conversions (§ 1033) defer gain; installment sales both postpone and spread the recognition of gain.

c. Conversion: converting inventory to investment property may change ordinary income to capital gain; § 1244 converts a stock loss from capital to ordinary.

d. Entity choice: Partnerships allow domestic production activities deduction to be claimed by the partners; C corporations keep entity profits from being taxed to the shareholders.

e. Preserve formalities: Advance from shareholder to corporation treated as a loan rather than as contri­bution to capital; advance from corporation to shareholder treated as loan rather than as a constructive dividend.

f. Consistency: If taxpayer is an investor when selling land for a gain then cannot be a dealer when the sale would yield a loss; if taxpayer making lifetime gifts cannot continue to control the property gifted.

59. Avoidance vs. Evasion. There is a fine line between legal tax planning and illegal tax planning—tax avoidance versus tax evasion. However, the consequences are as vast as the differences between a lightning bug and lightning.

a. Tax avoidance is merely tax minimization through legal techniques. In this sense, tax avoidance becomes the proper objective of all tax planning.

b. Evasion, while also aimed at the elimination or reduction of taxes, connotes the use of subterfuge and fraud as a means to an end.

**Tax Planning − A Practical Application**

60. Text Example 20 is used to demonstrate a practical application.

**Follow-up Procedures**

61. Tax planning usually involves proposed as opposed to completed transactions. The tax law can change by the time the transaction is completed, therefore additional research should be performed to check the current status of the tax law.

**1.7 TAXATION ON THE CPA EXAMINATION**

62. The 14 hour computer based CPA examination has increased emphasis on information technology and general business knowledge.

63. Of the four sections, the 3-hour Regulation section includes taxation and covers:

a. Federal tax procedures and accounting issues.

b. Federal taxation of property transactions.

c. Federal taxation—individuals.

d. Federal taxation—entities.

64. CPA exam has both multiple-choice and simulations.

a. Simulations are small case studies designed to test a candidate’s tax knowledge.

b. Simulations may require research of authoritative sources such as Internal Revenue Code and Federal tax forms.

**For additional reinforcement of locating judicial sources, consider using Figure 1.2 on the next page of this outline.**

**Solutions to Research Problems appear separately as a download from the Instructor’s Resource Page and on the Instructor’s CD.**

**Figure 1.1**

**Figure 1.2**

A

**Determination**

**of Tax**

**Liability**

**P**

**Capital Gains**

and Losses

**S**

**Tax Treatment**

**of**

**S Corporations**

**and Their**

**Shareholders**

## A B C D E F G H I J K L M N O P Q R S T

**Chapter 1**

**Normal Taxes**

**and Surtaxes**

**Chapters**

**2-6**

**SUBCHAPTERS**

**SUBTITLE A: INCOME** **TAXES**

**O**

**Gain or Loss**

**on Disposition**

**of Property**

**K**

**Partners**

**and**

**Partnerships**

**J**

**Estates,**

**Trusts,**

**Beneficiaries,**

**and Decedents**

**G**

**Corporations**

**Used to Avoid**

**Income Tax**

**on Shareholders**

**B**

**Computation of**

**Taxable Income**

**C**

**Corporate**

**Distributions**

**and Adjustments**

**LOCATION OF JUDICIAL SOURCES**

USTC AFTR F.Supp. F.3d Cls.Ct. S.Ct.

Series Series Series Series Series Series(a)

U.S. District Courts  
(tax cases) Yes Yes Yes No No No

U.S. Tax Court(b) No(c) No(c) No No No No

U.S. Claims Court(d)

(tax cases) Yes Yes No(e) Yes(e) Yes(e) No

U.S. Courts of Appeals  
(tax cases) Yes Yes No Yes No No

U.S. Supreme Court  
(tax cases) Yes Yes No No No Yes

U.S. District Courts  
(all cases)(f) No No Yes No No No

U.S. Courts of Appeals  
(all cases) No No No Yes No No

U.S. Supreme Court  
(all cases) No No No No No Yes

(a) Answers also apply to the United States Supreme Court Reports (abbreviated U.S.) and to the United States Reports, Lawyer’s Edition (abbreviated L.Ed.).

(b) Regular (not Memorandum) decisions are published by the U.S. Government Printing Office in Tax Court of the United States Reports.

(c) Both CCH and RIA have separate services for reporting the decisions of the U.S. Tax Court (both regular and memorandum).

(d) All decisions (both tax and non-tax) of the U.S. Court of Claims were published by the U.S. Government Printing Office in Court of Claims Reporter Series. Ceased publication September 30, 1982.

1. From 1945 to 1960, the Court of Claims decisions were published by West Publishing Company in the F.Supp. Series; from 1960, to September 30, 1982, in the F.2d Series; from October 1, 1982, to September 30, 1992, in the Claims Court Reporter; and beginning October 1, 1992, in the Federal Claims Reporter.
2. The reference to “all cases” pertains to non-tax as well as tax cases. Thus, it would include such varied issues as interstate transportation of stolen goods, civil rights violations, and antitrust suits.

**NOTES**