

CCH FEDERAL TAXATION COMPREHENSIVE TOPICS



SMITH | HARMELINK | HASSELBACK

2019 Tax Rates and Amounts

Tax Rate Schedules for 2019

Schedule X: Single Individuals

Taxable Income		Pay	+	% on Excess	of the amount over
Over	But Not Over				
\$0	\$9,700	\$0.00		10%	\$0
9,700	39,475	970.00		12	9,700
39,475	84,200	4,543.00		22	39,475
84,200	160,725	14,382.50		24	84,200
160,725	204,100	32,748.50		32	160,725
204,100	510,300	46,628.50		35	204,100
510,300	—	153,798.50		37	510,300

SCHEDULE Y-1: Married Filing Jointly and Surviving Spouses

Taxable Income		Pay	+	% on Excess	of the amount over
Over	But Not Over				
\$0	\$19,400	\$0.00		10%	\$0
19,400	78,950	1,940.00		12	19,400
78,950	168,400	9,086.00		22	78,950
168,400	321,450	28,765.00		24	168,400
321,450	408,200	65,497.00		32	321,450
408,200	612,350	93,257.00		35	408,200
612,350	—	164,709.50		37	612,350

SCHEDULE Y-2: Married Individuals Filing Separately

Taxable Income		Pay	+	% on Excess	of the amount over
Over	But Not Over				
\$0	\$9,700	\$0.00		10%	\$0
9,700	39,475	970.00		12	9,700
39,475	84,200	4,543.00		22	39,475
84,200	160,725	14,382.50		24	84,200
160,725	204,100	32,748.50		32	160,725
204,100	306,175	46,628.50		35	204,100
306,175	—	82,354.75		37	306,175

SCHEDULE Z: Heads of Households

Taxable Income		Pay	+	% on Excess	of the amount over
Over	But Not Over				
\$0	\$13,850	\$0.00		10%	\$0
13,850	52,850	1,385.00		12	13,850
52,850	84,200	6,065.00		22	52,850
84,200	160,700	12,962.00		24	84,200
160,700	204,100	31,322.00		32	160,700
204,100	510,300	45,210.00		35	204,100
510,300	—	152,380.00		37	510,300

Tax Rate Schedules for 2019

The Tax Cuts and Jobs Act provides for a flat 21-percent corporate tax rate beginning in 2018. Also, the 80-percent and 70-percent dividends-received deduction prior to 2018 is reduced to 65 percent and 50 percent, respectively. Further, the TCJA repealed the corporate alternative minimum tax.

Tax Rate for Estates and Trusts					
Taxable Income		Pay	+	% on Excess	of the amount over
Over	But Not Over				
\$0	\$2,600	\$0.00		10%	\$0
2,600	9,300	260.00		24	2,600
9,300	12,750	1,868.00		35	9,300
12,750	—	3,075.50		37	12,750

Filing Requirements

For 2019, Code Sec. 6012 requires a tax return to be filed if gross income for the year is at least as much as the amount shown for the categories in the table below.

Filing Status	Gross Income 2019	
Single	Under 65	\$12,200
	65 or older	13,850
	Dependent with unearned income	1,100
	Dependent with no unearned income	12,200
Married Filing Joint Return	Both spouses under 65	\$24,400
	One spouse 65 or older	25,700
	Both spouses 65 or older	27,000
Married Filing Separate Return	All	5
Head of Household	Under 65	\$18,350
	65 or older	20,000
Surviving Spouse	Under 65	\$24,400
	65 or older	25,700

Standard Deduction

The standard deduction is based on the filing status of the taxpayer and is made up of the “basic standard deduction” plus any “additional standard deduction.” The standard deduction is adjusted annually, if necessary, for inflation.

Filing Status	Basic Standard Deduction 2019
Single	\$12,200
Married Filing Joint Return	24,400
Married Filing Separate Return	12,200
Head of Household	18,350
Surviving Spouse	24,400

Additional Standard Deduction for Age and Blindness. An additional standard deduction is allowed for those age 65 or over and for those who are blind. The additional standard deduction is the total of the additional amounts allowed for both age and blindness. The dollar value of each additional amount will depend on the taxpayer’s filing status.

Filing Status	Additional Standard Deduction 2019
Single	\$1,650
Married Filing Joint Return	1,300
Married Filing Separate Return	1,300
Head of Household	1,650
Surviving Spouse	1,300

Taxpayers receive an additional standard deduction for being both aged and blind. Thus, a married couple, both of whom are aged and blind, is allowed an additional standard deduction of \$5,200 ($\$1,300 \times 4$).

2020

CCH FEDERAL TAXATION Comprehensive Topics

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Preface

CCH Federal Taxation—Comprehensive Topics introduces students of accounting to the complex and absorbing study of federal taxation. *Comprehensive Topics* covers a broad range of subjects from the definition of income to corporate reorganizations.

The order in which topics are introduced in this book represents a simple and clear division among the basic taxable entities. The initial chapters deal with topics affecting individual taxpayers. As the cornerstone for the foundation of federal taxation, these topics constitute an extensive outline of the basics. This book distills the major ideas and operational techniques for dealing with problems encountered in these areas. The second major focus of the book is on corporations and partnerships. Eight chapters examine the tax complexities of these entities. In addition, three chapters cover the taxation of estates, gifts, and trusts and the techniques for retirement and estate planning. The final chapter covers multijurisdictional taxation. Chapter 2, “Tax Research, Practice, and Procedure,” is pertinent to all tax entities and acquaints the student with the fundamentals necessary for understanding complex tax issues. Also, it gives students an introduction to doing tax research online.

The twenty-eighth edition of *CCH Federal Taxation—Comprehensive Topics* has been prepared to ensure that all material presented is complete and reflects all tax acts, issued regulations, and case developments through March 2019. The Tax Cuts and Jobs Act has been fully integrated into the textbook. *Comprehensive Topics* is designed to be used either in a one-semester class or in a two-semester sequence. This book was not prepared as a restatement of the Internal Revenue Code and related tax law. Many such works currently exist. It was designed as a learning device to present federal tax information in a way that will stimulate thought and planning as well as mastery of the difficult, tightly interwoven intricacies of federal tax law in a sequence different from that presented in the Code. This was done so that common ideas and underlying similarities could be linked in the mind of the student and unifying characteristics could be drawn together to present a clearer and more functional picture of the whole.

This edition continues the practice of using Tax Return Problems. The problems are highlighted as such in the Problems section of the following chapters: 4-7, 10-12, 14, 19, 22, 23, and 25. For faculty teaching the course in the fall semester of 2019, draft copies of Form 1040 and accompanying schedules are usually available in September.

The contributing authors of this volume wish to thank many of their colleagues for helpful suggestions and for the time and energy they have given to improving the manuscript.

March 2019

Ephraim P. Smith

How to Use This Book

CCH Federal Taxation—Comprehensive Topics has been organized to make it easy to study the fundamental concepts of federal tax laws affecting individuals. Special features, end-of-chapter materials, an appendix, and supplementary materials are provided to further assist in the learning process.

CHAPTER OPENINGS

All chapters begin with the same elements: a list of the learning objectives and an overview. This information provides a framework for understanding the material that will be studied in the chapter.

SPECIAL FEATURES

Special features—Keystone Problems, Planning Pointers, and Tax Blunders—appear throughout the book. Their purpose is to make familiar the specific applications of the tax law, suggest tax-saving strategies, and illustrate methods of avoiding undesired tax consequences. Additionally, vivid and realistic examples to illustrate salient points are included within the chapters to show application of the law and accounting techniques.

END-OF-CHAPTER MATERIALS

Every chapter ends with a summary of the material covered. Questions and Problems follow for applying the principles learned and allowing the instructor to evaluate and recall the main ideas discussed in the chapter. The problems are sequenced in the order in which the topics are presented in the chapter. Also included are Comprehensive Problems and Research Problems. Comprehensive Problems are designed to develop computational skills, while the purpose of the Research Problems is to provide an opportunity to learn and utilize the methodology of tax research.

END-OF-BOOK MATERIALS

In addition to the Topical Index, other useful research materials are found at the end of the book. The Appendix covers various Tax Rate Schedules, and the Glossary of Tax Terms contains over 200 definitions. In addition, the Finding Lists and Table of Cases detail the textbook's citations by Internal Revenue Code Sections, Regulation Sections, Revenue Procedures, Revenue Rulings, and court cases.

SUPPLEMENTARY MATERIALS

A *Study Manual*, sold separately, outlines and highlights the in-depth textbook presentation and contains Objective Questions (and Answers) for self-evaluation. It also includes a series of Tax Return Problems designed to complement conceptual study of federal taxation and to provide exposure to various aspects of tax return preparation.

To order the *Study Manual* for this volume (*CCH Federal Tax Study Manual, 2020*), contact your bookstore or write or call: Wolters Kluwer, 2700 Lake Cook Road, Riverwoods, Illinois 60015 (800-344-3734; CCHCPELink.com).

ACCESS UPDATES

CCH has created a special webpage to keep you up to date with changing tax laws and new developments. This page will also hold any revised content that may be created before the next edition is released.

Visit CCHCPELink.com/Resources to find information on updates to the book and latest developments!

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Chapter

1

Introduction to Federal Taxation and Understanding the Federal Tax Law

OBJECTIVES

After completing Chapter 1, you should be able to:

1. Identify types of taxes used by federal and state governments to raise revenues.
2. Understand the methods of tax collection and the trends shown by tax collection statistics.
3. Differentiate between tax avoidance and tax evasion.
4. Recall the underlying rationale of the federal income tax and its historical development.
5. Describe the route a tax bill takes until enacted into law.
6. Define the basic tax concepts and terms of federal income taxation.

INTRODUCTION

Federal taxation is the fuel by which Americans power their “Ship of State.” The tax structure which supports our federal government has gone from quill and ink records of revolutionary assessments to lightning speed computers which calculate and validate millions of income tax returns submitted by individuals and corporations. Federal taxes, in addition to the income tax, include a variety of other taxes covering estates, gifts, and customs, as well as excise taxes, and other minor categories of tax. Our governments can thus select among a variety of tax alternatives to produce the revenues required to operate national programs and carry out national policies.

Taxes are big business. Unfortunately, many business decisions are made in the United States today without regard to federal tax consequences. Individuals are concerned with personal income tax decisions and gift and estate tax decisions, while corporations concern themselves with corporate taxes, personal holding company taxes, and accumulated earnings tax decisions. Further, businesspersons must concern themselves with the choice of business entity: corporation, partnership, or S corporation. Differences in tax costs can be considerable. Advantages and disadvantages are virtually unlimited. This book presents information which is required knowledge if you make business decisions.

While most businesspersons (and many advisors) think about how to make decisions in nontax terms, the tax accountant bears the burden of introducing tax considerations. The topics presented in this book must be viewed in terms of decision-making—therefore, tax planning and tax research are of the utmost importance. Tax decisions are not made in a vacuum. Lawyers, accountants, financial managers, and a host of other experts work as a team in the decision-making process. This book is intended to serve as a guide for accounting students and for MBA students interested in gaining insight into and expertise in the tax complexities of business decision-making.

OVERVIEW

This chapter presents information on the magnitude of federal taxes collected and on taxpayer obligations. Then, a brief historical account is presented of federal tax collections prior to and after the adoption of the Sixteenth Amendment to the Constitution, which enabled Congress to levy “taxes on incomes, from whatever source derived.” Following this is an introductory discussion of the federal legislative process and an analysis of the social, political, and economic rationale underlying the federal tax law. Finally, basic tax concepts are explained.

Fundamental Aspects of Federal Taxation

¶1101

SOURCES OF REVENUE

Types of Taxes

From the very beginning, with the ratification of the Sixteenth Amendment to the Constitution, through various Revenue Acts and many court cases, a set of tax laws has evolved that raised \$2.980 trillion, net of refunds, on over 245 million tax returns processed by the IRS in 2017. This was higher than the \$2.907 trillion raised in 2016. The federal government uses a number of different types of taxes to generate the cash flow it needs for operating the government. The following is a listing of the various types of federal taxes:

Income taxes	Corporations, individuals, fiduciaries
Employment taxes	Old age, survivors, disability, and hospital insurance (federal insurance contributions, self-employment insurance contributions), unemployment insurance, railroad retirement
Estate and gift taxes	Estate, gift, and generation-skipping transfers
Excise and customs taxes	Alcohol, tobacco, gasoline, other

Over the years individuals have borne the burden in the arena of tax payments. Individual taxes account for approximately 49.72 percent of total tax collections. Corporate income tax collections account for approximately 9.85 percent of total tax receipts.

Historically, Americans have been staunch supporters of the federal government's tax efforts. The rate of participation and compliance is one of the highest in the world. Realistically, the impact of estimating withholding provisions and the threat of government audits have aided in the outstanding record of the Internal Revenue Service.

Individual Income Taxes

Presently the United States government taxes income, transfers, and several transaction-type items (excise, customs, etc.). The major source of revenues is the tax on individuals (see Table 2). In 2017, individuals contributed 49.72 percent of the gross internal revenue collected. Since 1943, the U.S. has been on a pay-as-you-go system. Income taxes withheld by employers increased from \$1.01 trillion in 2016 to \$1.06 trillion in 2017. In 2017, 122 million individual taxpayers received a tax refund which totaled almost \$437 billion.

Corporate Income Taxes

Corporate income taxes accounted for 9.85 percent of the total revenue collected by the U.S. government in 2017. The Tax Reform Act of 1986 reduced the top corporate income tax rate from 46 percent to 34 percent. The Revenue Reconciliation Act of 1993 raised the corporate income tax rate to 35 percent. The American Jobs Creation Act of 2004 created many business incentives. The corporate tax rate has changed from 1 percent in 1913 to a high of 52 percent between 1952 and 1962. The Tax Cuts and Jobs Act reduced the corporate rate from 35 percent to a flat 21 percent. Generally, corporations are subject to tax based on net income without regard to dividends distributed to their shareholders.

Estate and Gift Taxes

Estate and gift taxes accounted for only 0.76 percent of the total revenue collected by the government in 2017. The estate tax, as we know it today, was enacted on September 8, 1916, and is levied on the transfer of property. The gift tax was originally enacted in 1924, was repealed in 1926, and then was restored in 1932.

Excise and Customs Taxes

Excise and customs taxes are levied on transactions, not on income or wealth. Examples of excise taxes are the taxes on alcohol, tobacco, and gasoline. The government collects the tax, usually at an early stage of production. In 2017, 2.08 percent of the government's revenue, or \$61.9 billion, came from excise taxes.

Customs taxes are levied on certain goods entering the country. There are several reasons why the government levies this tax but by far the most important reason is the protection of U.S. industry from foreign competition.

State and Local Taxes

Just as the federal government needs an ever-increasing amount of dollars to satisfy its requirements, so do the states and local communities. State and local taxes are also big business. The major source of revenue for state governments is the income tax and the sales tax. For local communities, the property tax is a major source of revenue. Approximately 31.1% of state revenues are generated by the property tax. State governments raised \$1,313.2 billion in 2016, up from \$1,067.7 billion in 2015. California collected the most in state taxes followed by New York and Texas.

Value-Added Tax

The value-added tax (VAT) is of fairly recent origin and much more popular overseas than in the United States. The concept of a VAT was first proposed by a German industrialist and government consultant, Dr. Wilhelm von Siemens, in 1918. In the next three decades much discussion took place. France was the first major country to adopt the VAT. In 1919, France instituted a general sales tax. This stayed in place until 1948, when it was replaced with a tax on production at each stage of the manufacturing process.

There are many forms of taxation, but basically all taxes can be categorized as direct taxes or indirect taxes. The federal income tax on individuals and corporations is a direct tax. Indirect taxes are those levied on producers or distributors with the expectation that these taxes will be passed on to the ultimate consumer. The VAT is an example of an indirect tax. It is merely a sales tax assessed at any or all levels of production and distribution. It is applied only on the value added to the product in an early stage of production or distribution. Notice that the VAT is a tax on products, not on business entities. The major drawback of the VAT is that it is extremely regressive.

EXAMPLE 1.1

A sweater is produced at a cost of \$10. If the VAT is 5 percent, then each taxpayer, regardless of income level or ability to pay, must pay the fifty cents for VAT.

The VAT continues to be discussed as an attractive source of revenue in the United States. Each 1 percent of VAT would be expected to raise \$12 billion. Even with the exclusions for food and medicine, \$7.6 billion would be raised per percentage point of tax. Despite these attractions, the VAT worries many Americans. First, it is a very regressive tax. Second, there is some concern that ultimately the VAT will partially replace the personal income tax. Proponents of the VAT, however, maintain that its use would help shrink the “tax gap” (discussed at ¶1121). That is, the element of the population not currently paying taxes would have to pay a VAT tax, since it is a layered sales tax.

Flat Tax

The past several years have seen heated discussions about using a flat tax. Proponents of a flat tax point to the lower cost of administration and the ease of preparation by Americans as the major benefits. A flat tax would take an individual’s total income minus an allowance for family size and apply one tax rate. This rate would apply to all individuals. There would be no deductions.

Various senators and representatives have presented proposals for consideration. A flat tax has been proposed composed of two tax forms—one for individuals and one for businesses. Their proposal would tax individuals on total income minus an allowance based on family size and then apply a 17 percent tax rate. For businesses, the tax rate would be the same 17 percent, but it would be applied against the firm’s gross revenue minus costs of purchases, wages, salaries, capital equipment, structures, land, and pensions. To date, none of these proposals has been successful.

Fair Tax

The Fair Tax is a consumption tax. The proponents of the fair tax would replace the Internal Revenue Code with a consumption tax. In many respects it would resemble the sales tax that many states now collect. Proponents suggest that low income individuals would receive a rebate from the government as a way to reduce the regressive nature of the tax.

KEYSTONE PROBLEM

The federal government currently uses many forms of taxation, both direct and indirect, to raise revenue. Would it not be more effective and less burdensome just to employ a single tax? What would you consider to be a more effective and efficient system of raising revenue?

¶1121

TAX COLLECTION AND PENALTIES

Returns

The Internal Revenue Service processed over 245 million federal tax returns and supplementary documents in 2017—a slight increase from 2016. This is in comparison to 143 million tax returns processed in 1980. It collected \$2.980 trillion in 2017, slightly more than it collected in 2016. Taxes and tax collections are indeed big business. Table 1, derived from the 1980 Annual Report of the Commissioner of the Internal Revenue Service and the 2017 Internal Revenue Service Data Book, details the magnitude of work required to support our government. Approximately 61.4 percent of all returns are filed by individuals. In 2017, individuals filed 150.7 million returns, for a total of approximately \$1.48 trillion. In 2017, corporate collections decreased to \$293.6 billion.

Table 1. NUMBER OF RETURNS FILED BY PRINCIPAL TYPE OF RETURN
(Figures in Thousands)

Type of Return	1980	2016	2017	Increase or Decrease Between 1980 and 2017	
				Amount	Percent
Grand Total	143,446	244,246	245,412	101,966	71.08
Income tax, total	107,827	188,711	187,407	79,580	73.80
Individual	93,143	150,711	150,691	57,548	61.78
Declaration of estimated tax	8,699	23,101	22,230	13,531	155.55
Fiduciary	1,877	4,006	4,046	2,169	115.56
Estate and Trust	1,390	3,207	2,995	1,605	115.47
Corporation	2,718	7,039	6,893	4,175	153.61
Estate tax	148	36	34	(114)	(77.03)
Gift tax	216	249	245	29	13.43
Employment tax	26,499	30,460	30,680	4,181	15.78
Exempt organizations	444	1,500	1,528	1,084	244.14
Excise tax	909	1,015	1,018	109	11.99
Supplemental documents	6,064	22,445	22,275	16,211	267.33

Sources: 1980 Annual Report of the Commissioner of the Internal Revenue Service and Internal Revenue Service Data Books 2016 and 2017.

Tax Collections

Tax collections have increased dramatically between 1980 and 2017. This was due in part to the growth in the economy. Table 2 gives data on tax collections from 1980, 2016, and 2017. Obviously, the increase in tax collections from 1980 to 2017 is staggering—\$2,460,366,993,000. Now, notice the detail. Corporate taxes have increased 305.7 percent between 1980 and 2017, while individual income taxes have increased 415.2 percent. Estate and gift taxes have increased 250 percent in the same period. Keep these figures in mind as you read the chapters that follow.

Just as the dollar amounts have increased in tax collections, so has the number of returns filed. From 1980 to 2017, the number of corporate income tax returns increased by 153.6 percent. During the same time period, the number of individual income tax returns increased by 61.8 percent. The number of individuals requesting an individual income tax refund decreased slightly in 2017 to 119.9 million.

Table 2. GROSS INTERNAL REVENUE COLLECTIONS (net of refunds)
(Figures in Thousands)

Source	Percent of 2017 Collections	1980	2016	2017	Increase or Decrease Between 1980 and 2017	
					Amount	Percent
Grand total	100.00	519,375,273	2,907,303,017	2,979,742,266	2,460,366,993	473.72
Income taxes, total	59.57	359,927,392	1,740,855,666	1,775,102,989	1,415,175,597	393.18
Corporation	9.85	72,379,610	294,271,001	293,634,315	221,254,705	305.69
Individual	49.72	287,547,782	1,444,729,327	1,481,468,674	1,193,920,892	415.21
Employment taxes, total	35.62	128,330,480	1,014,673,637	1,061,451,074	933,120,594	727.12
Old-age, survivors, disability, and hospital insurance	35.15	122,486,499	1,000,491,731	1,047,371,143	924,884,644	755.09
Unemployment insurance	0.27	3,309,000	8,243,916	8,124,886	4,815,886	145.54
Railroad retirement	0.20	2,534,981	5,937,990	5,955,045	3,420,064	134.91
Estate and gift taxes, total	0.76	6,498,381	21,337,157	22,732,968	16,234,587	249.83
Excise taxes, total	2.08	24,619,021	76,457,302	61,856,711	37,237,690	151.26

Sources: 1980 Annual Report of the Commissioner of the Internal Revenue Service and Internal Revenue Service Data Books 2016 and 2017.

Tax Audits and Penalties

The U.S. tax system is a voluntary compliance tax system. The total number of federal tax returns filed in 2017 was 245,412,000, of which 150,691,000 were filed by individual taxpayers. The IRS conducted examinations of 1,059,924 returns, and on the basis of these examinations, it recommended additional tax and penalties of almost \$29 billion.

Although audits of individual returns made up the bulk of the examinations (933,785 returns), they resulted in only \$9.03 billion of the total recommended collections, while audits of corporate returns yielded \$17.7 billion. Of course, audits do not always favor the IRS, as evidenced by the fact that, of the individual returns examined, almost 34,000 resulted in additional refunds; this amount was down from 37,000 in 2016.

Until recently, there had been an upsurge in the number of taxpayers who illegally sought, either openly or covertly, to reduce or eliminate their tax obligation. However, the IRS has responded to the challenge by taking advantage of the developing computer technology. Computers already scrutinize tax returns, check errors, and perform a number of routine, repetitive tasks with speed, efficiency, and great accuracy. The IRS continues to match almost all information returns that businesses are required to submit on magnetic media to verify that correct amounts are reported on taxpayers' returns. Information returns include W-2 Forms listing salary and 1099 Forms listing other income.

In 2017, the IRS audited almost one million individual income tax returns or 0.6 percent of all individual tax returns. The percentage of returns audited was slightly lower than the previous year. Table 3 presents information on the percentage of returns audited by type of return.

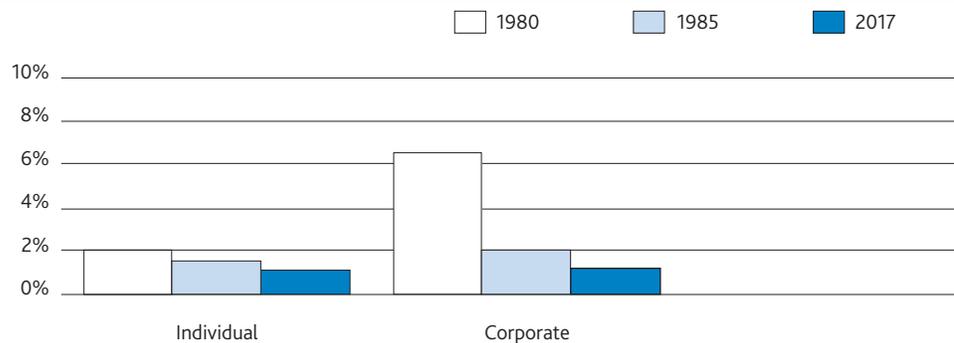
For years, the audit rate for individual returns had been declining. For fiscal year 2017, the audit rate for individual returns was 0.6 percent. In FY 1997 it was 1.28 percent, and in FY 1995 it was 1.67 percent.

Table 3. PERCENTAGE OF RETURNS AUDITED

Type of Return	Percentage Audited	
	2016	2017
Individual	0.7	0.6
Partnership	0.4	0.4
Corporation	1.1	1.0
Estate	8.8	8.2
Gift	0.8	0.8
Excise	1.4	1.4
Employment	0.2	0.2

Sources: Internal Revenue Service Data Books 2016 and 2017.

Because of severe budget deficits during the late 1980s and 1990s, the personnel needed to audit the growing number of returns filed have not been added. A major reason for the decline in audit rates has been staff reduction at the IRS and the movement of IRS personnel to focus on customer service. Since the late 1980's, staff in the examinations division was reduced by over 30 percent. Table 4 graphically depicts the percentage of returns audited by the Internal Revenue Service. The IRS budget in FY 2017 was \$11.5 billion. This is down from FY 2016 when it was \$11.7 billion.

Table 4. PERCENTAGE OF RETURNS AUDITED—1980—2017

Sources: 1980 Annual Report of the Commissioner of the Internal Revenue Service and Internal Revenue Service Data Book 2017.

Naturally, for certain types of taxpayers and those with higher incomes, the probability of audit is much greater. Individuals with income of over \$100,000 were most likely to be audited.

The Internal Revenue Service has acknowledged that the problem of tax evasion is indeed a serious one. The “tax gap,” that is, the total revenue lost through tax evasion, has increased from \$81 billion in 1981 to \$345 billion in 2001 and to \$450 billion in 2006. IRS officials estimate that enforcement activities along with late payments have recovered \$65 billion of the tax gap for 2006 resulting in a net tax gap in 2006 of \$385 billion. The IRS updated the study and the average annual tax gap for 2008–2010 was \$458 million. Enforcement activities recovered \$52 billion for a net annual tax gap of \$406 billion. The IRS estimated that 61 percent of the tax gap was caused by individuals and the remainder by corporations. Today, the voluntary compliance rate is estimated by the Commissioner of Internal Revenue to be 83 to 85 percent. Each percentage point of noncompliance costs the government \$26 billion in lost revenue.

The Tax Reform Act of 1986 closed many of the loopholes associated with tax shelters. Since 1988 the IRS has been using a revised audit-selection formula that is aimed at high-income returns. Further, the Tax Acts of 1986 and 1987, the Technical and Miscellaneous Revenue Act of 1988, and the Revenue Reconciliation Acts of 1989, 1990, and 1993 changed the penalties imposed on taxpayers for not complying with the tax laws.

The Improved Penalty and Compliance Act, which was incorporated into the Revenue Reconciliation Act of 1989, revamped the civil tax penalty provisions of the Internal Revenue Code. The goal was to create a fairer, less complex, and more effective penalty system. The Act made changes in the following broad areas:

1. Document and information return penalties
2. Accuracy-related penalties
3. Preparer, promoter, and protestor penalties
4. Penalties for failures to file or pay tax

¶1131

TAXPAYER OBLIGATIONS

Tax accountants, lawyers, and businesspersons, since the inception of the first federal income tax law, have concerned themselves with choosing among the various forms a transaction may take. There is an acute awareness among tax accountants that tax consequences of an action may differ depending upon procedural variations and alternative approaches to a business decision. The increasing complexity of the modern tax laws serves only to accentuate the problem.

Because of the extreme difficulty experienced in trying to differentiate between tax avoidance and tax evasion, Congress enacted, in the 1954 Internal Revenue Code, a provision which illustrates circumstances that constitute prima facie evidence of the tainted purpose. The 1986 Code contends with the problem of criminal tax evasion in Section 7201, entitled “Attempt to Evade or Defeat Tax.” It reads:

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$100,000 (\$500,000 in the case of a corporation), or imprisoned not more than five years, or both, together with the costs of prosecution.

The goal of every businessperson should be profit maximization. The government endorses this goal. Tax avoidance is legal and a legitimate pursuit of a business entity.

Tax Avoidance

All citizens have the prerogative to arrange their transactions and affairs in such a manner as to reduce their tax liabilities. A good businessperson is obligated to search out those transactions and to time those events which will lower the tax liability. Judge Learned Hand, in *S.R. Newman*, declared many years ago:

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. CA-2, 47-1 USTC ¶9175, 159 F.2d 848.

There is a clear demarcation between tax avoidance and tax evasion. The saving of tax dollars requires specific actions so as to avoid the tax liability prior to the time it would have occurred according to law. It requires the proper handling of affairs so that items of income are subjected to a lower tax rate than would apply if no action had been taken. In some instances, it requires the postponing of income which is subject to taxation until a time when the individual's tax bracket would be lower.

Tax Evasion

To be guilty of evading taxes, the individual must already have a tax liability. All actions must be definitely complete, and in spite of this liability, the taxpayer does not report income. The courts have ruled that it is not wrong to find a form of a transaction that does not lead to any tax liability. However, there is a legal obligation to disclose a tax liability based on completed transactions, and the refusal to report the tax liability is illegal.

The Tax Court in *Berland's Inc. of South Bend* (16 TC 182, acq., 1951-2 CB 1, Dec. 18,057) said that the purpose of tax evasion must be the “principal” purpose, and the taxpayer is not guilty of tax evasion merely because the tax consequences of the particular transaction are considered. Furthermore, the Tax Court said:

The consideration of the tax aspects of the plan was no more than should be expected of any business bent on survival under the tax rates then current. Such consideration is only part of ordinary business prudence.

What frequently distinguishes tax avoidance from tax evasion is the intent of the taxpayer. The intent to evade tax occurs when a taxpayer knowingly misrepresents the facts. Intent is a mental process, a state of mind. A taxpayer's intent is judged by his or her actions. The taxpayer who knowingly understates income leaves evidence in the form of identifying earmarks, referred to as “badges” of fraud. Internal revenue agents are on the lookout for these badges of fraud. The more common badges are:

1. Understatement of income. The IRS considers the failure to report entire sources of income, such as tips, or specific items where similar items are included in income, such as dividends received, as an indication that there may have been an understatement of income. Other such indications include the unexplained failure to report substantial amounts of income determined by the IRS to have been received, the concealment of bank accounts or other property, and the failure to deposit receipts to a business account contrary to normal practices.
2. Claiming of fictitious or improper deductions. To the IRS, a substantial overstatement of deductions is a badge of fraud that could warrant a further look at the taxpayer's books. Other indications of improper deductions are the inclusion of obviously unallowable items in unrelated accounts and the claiming of fictitious deductions or dependency deductions for nonexistent, deceased, or self-supporting persons.
3. Accounting irregularities. Accounting practices that are considered a badge of fraud include the keeping of two sets of books or no books, false entries, backdated or postdated documents, inadequate records, and discrepancies between book and return amounts.
4. Allocation of income. The distribution of profits to fictitious partners and the inclusion of income or deductions in the return of a related taxpayer with a lower tax rate than that of the taxpayer are indications of an intentional misstatement of taxable income.
5. Acts and conduct of the taxpayer. Aside from the improper reporting of income or deductions, a taxpayer's conduct can give the IRS reason to question the propriety of a return. For example, false statements, attempts to hinder an examination of a return, the destruction of books or records, the transfer of assets for purposes of concealment, or the consistent underreporting of income over a period of years are badges of fraud.

The presence of one or more of these badges of fraud does not in itself mean that the return is fraudulent. However, it should alert an examiner that additional probing and inquiry are necessary. Internal Revenue Manual, Sec. 4.10.

Corporate Tax Avoidance

Normally, the Commissioner and the courts accept a corporation as being distinct from its shareholders. However, if it appears that a sham transaction has taken place, then the Commissioner has grounds for taking action. Judge Learned Hand, in summarizing many cases on the subject of tax avoidance v. tax evasion, stated in *National Investors Corp. v. Hoey*:

To be a separate jurial person for purposes of taxation, a corporation must engage in some industrial, commercial, or other activity besides avoiding taxation: in other words, that the term "corporation" will be interpreted to mean a corporation which does some "business" in the ordinary meaning; and that escaping taxation is not "business" in the ordinary meaning. 44-2 USTC ¶9407, 144 F.2d 466, 467-68 (CA-2 1944).

Section 269 of the Internal Revenue Code provides the Commissioner with a very important tool in judging whether or not a corporate acquisition is tax avoidance or merely a sham. If the Commissioner feels that there is no principal purpose for the tax-free acquisition, "such deduction, credit, or other allowance" may be disallowed. The key defense by the taxpayer is to substantiate that there was indeed a "principal purpose." If there is a principal purpose, nothing stops the taxpayer from having other purposes, such as the saving of taxes. *Kershaw Mfg. Co., Inc.*, 24 TCM 228, TC Memo. 1965-44, Dec. 27, 268(M).

Taxpayer's Assessment of Tax Liability

In order to decrease potential tax liability, the taxpayer must choose the action that will allow the greatest tax savings. An example of a tax savings device is investment in municipal bonds instead of corporate bonds. The interest derived from corporate bonds is taxable income, whereas the interest received from municipal bonds is tax free. In the above example, the taxpayer does not have to hide the fact that there is a lower tax liability on the profit.

When contemplating a transaction, the taxpayer makes an assessment of the tax liability. Naturally, any doubtful issues are resolved in the taxpayer's own favor. Certainly, there is nothing fraudulent about using this procedure. On the other hand, if the taxpayer knowingly overstates expenses, thereby reducing the tax liability, then the taxpayer is guilty of tax evasion.

¶1151

BRIEF HISTORY OF THE FEDERAL INCOME TAX

The origin of taxation in the United States dates back to the Constitution and, therefore, the Constitution is the ultimate source of the power to tax. Originally, the Constitution empowered Congress "to lay

and collect taxes, duties, imports and excises, to pay the debts and provide for the common defense and general welfare of the United States.” In granting this power, Congress also limited the power of taxation in that “all duties, imports, and excises shall be uniform throughout the United States, that direct taxes should be laid in proportion to the population.” It was within these confinements that many cases tested the constitutionality of the early tax laws—a test many of the taxes did not pass. During the late 1800s, the terms “uniform” and “direct taxes” were very important concepts.

Income Tax Law of 1894

In the late 1880s, support was mounting at the state level for an income tax. In Ohio, the State Democratic Convention approved a graduated income tax in the summer of 1891. Reflecting on the mood of the country at that time, William Jennings Bryan supported an income tax as preferential to a tax on tobacco and beer which he felt would put an unfair hardship on the poor. Although this proposed tax and others like it were never passed, they encouraged others to investigate the possibilities of a federal income tax. Ultimately this led to the actual passage of the Wilson Tariff Bill of 1894. This bill was not an income tax bill; however, an amendment was attached to the bill which allowed for an income tax. The provisions of this income tax law stated that the tax would commence on January 1, 1895, and continue until January 1, 1900. It was a 2 percent tax on all “gains, profits, and income” over \$4,000 “derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation.” Income was defined to include interest on all securities except federal bonds which were exempt by law of their issuance from any federal taxation. The Act also imposed a 2 percent tax on net profits of corporations but not on partnerships.

There was much criticism of this law. Concerns arose that provisions such as the \$4,000 exemption made the law discriminatory against certain groups. Consequently, many cases were brought before the courts. The major point raised by opponents of the Act was whether or not such a tax on income derived from property was a “direct tax” in the sense commonly understood in the Constitution. A direct tax was held to be a tax on the land and, therefore, had to be apportioned among the states.

The Supreme Court declared the law unconstitutional in the famous *Pollock v. Farmers’ Loan & Trust Co.* case, 157 U.S. 429, 15 S.Ct. 673 (1895). It characterized the income tax as a “direct tax” and stated that the Constitution provides that “no direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken.” Therefore, the Court invalidated a significant portion of the law and rendered income tax apportionment impossible. Further, the Court considered the property tax a direct tax and excise and duties taxes as indirect taxes. The Court stated, in a five-to-four decision, that a tax on real estate and on personal property is a direct tax and, therefore:

unconstitutional and void, because not apportioned according to representation, all these sections constituting one entire scheme of taxation, are necessarily invalid.

The Court expressed, in one of its longest opinions, no opinion on whether or not the income tax provisions were unconstitutional. Thus, with this decision, the first federal income tax law since the Civil War in the United States was declared to be unconstitutional.

Corporation Excise Tax of 1909

Support for an income tax was growing even though the courts had voided all attempts made by Congress. Government was becoming more costly and new sources of revenue were essential. The Spanish American War produced a great need for funds, and many believed that an income tax was the only solution. In the Pollock decision, the Supreme Court voted five to four that the tax was unconstitutional. By late 1908, it was abundantly clear that only by passage of a constitutional amendment would the government receive the power needed to impose a federal income tax. Therefore, an amendment was passed by Congress in 1909. However, because of the length of time required to ratify a constitutional amendment, Congress simultaneously passed the Corporation Excise Tax of 1909. The Supreme Court had ruled in the Pollock case that an “excise tax” was not required to be apportioned. Further, the Court indicated in several cases that an income tax on corporations would be upheld if it were deemed an excise tax levied on corporations for the privilege of carrying on or doing business as a corporation, granted the amount of tax due was based upon the net income of the corporation.

The Tax Act of 1909 was the first Act to be upheld by the courts that taxed corporate profits. Prior to this time, corporate profits were tax free except for a short period of time during the Civil War. The 1909 Act provided that corporations would pay an annual special excise tax. This tax amounted to 1 percent on net income over \$5,000 exclusive of dividends from other corporations.

As can be imagined, many influential people objected to the 1909 Act. By 1910, fifteen cases challenging the Act had reached the Supreme Court. In a unanimous decision, the Supreme Court upheld that the Tax Act of 1909 was not a direct tax, but an indirect tax and “an excise upon the particular privilege of doing business as a corporate entity.”

The Revenue Act of 1909 was a tax for the privilege of doing business as a corporation, even though the assessment was on the net income of the corporation. A unanimous Supreme Court upheld the law in *Flint v. Stone Tracy Co.*, 220 U.S. 107, 31 S.Ct. 342 (1911).

When examining the differences between the 1895 law which was held to be unconstitutional and the 1909 law which was upheld as constitutional, the difference is indeed in only a few words, changing a tax upon income to a tax measured by income. Justice Day wrote the opinion for the Supreme Court and stated that the difference was “not merely nominal, but rests upon substantial difference between the mere ownership of property and the actual doing of business in a certain way.”

Sixteenth Amendment and the Revenue Act of 1913

Taxation laws as we know them today derive their authority from the Sixteenth Amendment as passed by Congress on July 12, 1909. The amendment stated:

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Alabama became the first state to ratify the amendment in the same year that it was passed—1909. On February 25, 1913, the final vote for ratification was received.

Congress now was given the clear authority to enact a tax on income from whatever source derived. Taxes could be either direct or indirect and could be imposed without regard to any census or enumeration.

On October 3, 1913, pursuant to the power granted by the Sixteenth Amendment, Congress enacted the Revenue Act of 1913 which imposed a tax on the net income of individuals and corporations. The Revenue Act of 1913 was retroactive to March 1, 1913. This date is important for tax purposes because this is the date which is sometimes used as a basis for computing gains and losses. Simultaneous to the enactment of the Revenue Act, the Corporation Excise Tax was repealed.

The Revenue Act of 1913 serves as the basis for the income tax laws of the United States. However, it would never have been passed without its two precedents, the Income Tax Law of 1894 and the Corporation Excise Tax of 1909. These two laws laid the foundation and framework for an income tax. The Supreme Court ruling in the Pollock case made it mandatory that an amendment to the Constitution be passed to allow for a direct tax on income.

1913 to Date

Following the passage of the Sixteenth Amendment, there have been many changes in the tax law. Many of the more important changes in our federal taxing system are outlined below. Some of the data for 1916–1962 came from *World Tax Series: Taxation in the United States*, CCH (Commerce Clearing House), 1963, pp. 117–118.

- 1913** The Revenue Act of 1913—Normal tax and surtax approved. Personal exemptions established.
- 1916** The Revenue Act of 1916—Established the estate tax.
- 1917** Charitable contributions granted tax deductible status. Federal income taxes were disallowed as a tax deduction. Credit for dependents allowed for first time.
- 1918** Tax preferences and exemptions established. Tax credit was granted for foreign income taxes paid. Carryforward provisions adopted for net operating losses. Depletion deductions for mines and oil and gas wells were instituted. Tax-free corporate mergers and other reorganizations permitted.
- 1921** Capital gains rates established. Profit-sharing and pension trusts exempted from tax.
- 1924** Gift tax enacted to prevent avoidance of the estate tax.
- 1926** January 1, 1926—Gift tax repealed.
- 1932** Gift tax restored in more effective form.

- 1934** The personal exemption and exemption for dependents were made deductible in determining net income for the purpose of surtax as well as normal tax.
- 1935** Federal Social Security Act enacted.
- 1936** Mutual investment companies allowed deduction for dividends distributed by them.
- 1938** LIFO adopted as an acceptable inventory method.
- 1939** Internal Revenue Code of 1939—Set out to codify separately the Internal Revenue laws.
- 1942** Net operating losses were allowed to be carried back. Provisions were made or changed for medical expenses, alimony, capital gains, and a standard deduction in lieu of itemized deductions.
- 1943** Current Tax Payment Act—Pay-as-you-go system adopted.
- 1948** Marital deduction originated for estate and gift tax. Split-income treatment approved for married couples.
- 1950** Self-employment tax enacted.
- 1954** Internal Revenue Code of 1954—Successor to the 1939 Code. Completely overhauled federal tax laws. Largest piece of federal legislation enacted to date. Broad changes were made in an attempt to codify income, estate, gift, and excise tax laws along with administration and procedure rules into one document.
- 1962** The Revenue Act of 1962—Granted a tax credit of 7 percent for investment in Section 38 Property. Further, the concept of “depreciation recapture” was introduced.
- 1964** The Revenue Act of 1964—Intended to stimulate sagging economy. Largest corporate and individual tax rate reduction since the Act of 1913.
The Act extended depreciation recapture to business realty. Foreign investment income subjected to increased taxation.
- 1966** The Tax Adjustment Act of 1966—Suspended the 7 percent investment credit. It was reinstated six months later.
Graduated withholding replaced flat-rate. Corporations required to pay estimated tax more quickly.
- 1969** The Tax Reform Act of 1969—Investments in commercial and industrial buildings were significantly affected when depreciation allowances were reduced and the recapture rules changed. Investment tax credit repealed.
- 1971** The Revenue Act of 1971—Restored investment credit at 7 percent.
- 1974** Employee Retirement Income Security Act of 1974 (ERISA)—Major changes to the entire private pension system.
- 1975** The Tax Reduction Act of 1975—Reduced taxes for both individuals and corporations. Changed the investment tax credit from seven to 10 percent for a two-year period.
- 1976** The Tax Reform Act of 1976—Established at-risk rules for tax shelters and eliminated many tax shelters. Also, the Act made extensive changes in the treatment of foreign income.
- 1977** The Tax Reduction and Simplification Act of 1977—Attempted to simplify the system. Established zero-bracket amount exemption deductions.
- 1978** The Revenue Act of 1978—Revised corporate rate structures. New structure taxes the first \$100,000 of income on a graduated scale, ranging from 17 to 40 percent, and at a 46 percent rate on all taxable income over \$100,000. The Act made the 10 percent investment credit permanent.
The Act also made changes to capital gains, tax shelter rules, employee benefits, and estate and gift taxes.
- 1978** The Energy Tax Act of 1978—Instituted a tax credit for residential energy savings.
- 1980** The Bankruptcy Act of 1980—Added a seventh type of tax-free reorganization, the “G” type. Clarified rules for tax treatment of bad debts.

- 1980** The Windfall Profit Tax Act—Excise tax levied on domestic oil.
- 1980** The Installment Sales Revision Act of 1980—Revised installment sales rules.
- 1981** Economic Recovery Tax Act (ERTA)—Largest tax cut bill ever passed. Top individual tax rates decreased from 70 to 50 percent. All property placed in service after December 31, 1980, eligible for the Accelerated Cost Recovery System (ACRS). Increased allowable contributions to Keoghs, SEPs, and other retirement systems. Permitted two-earner married couples a deduction to reduce the inequity of the “marriage penalty.” Extended the investment credit to include a wider array of investments.
- 1982** Tax Equity and Fiscal Responsibility Act (TEFRA)—Largest revenue-raising bill ever passed. Tightened up on itemized deductions. New rules on partial liquidations and for the taxation of distributed appreciated property. Tightened up pension rules. Corporate deductions for certain tax preferences cut by 15 percent. Required that basis of depreciated property must be reduced by 50 percent of investment credit. ACRS modified for 1985 and 1986 and Federal Unemployment Tax Act (FUTA) notes increased.
- 1982** Technical Corrections Act of 1982—Made changes to: ACRS, the investment credit, targeted jobs credit, the credit for research costs, and incentive stock options. Made changes to the Windfall Profit Tax Act.
- 1982** Subchapter S Revision Act of 1982—Enacted many new provisions for S corporations.
- 1983** Social Security Act Amendments of 1983—Bailed out the Social Security System.
- 1984** Deficit Reduction Act of 1984—Composed of two parts: first, the Tax Reform Act of 1984 and second, the Spending Reduction Act of 1984. The Tax Reform Act of 1984 provided for reducing the holding period on capital gains from more than one year to more than six months, extending the ACRS recovery period for 15-year real property to 18 years, taxing interest-free loans between family members, and drastically slashing the income-averaging provisions.
- 1986** The Tax Reform Act of 1986—The most significant and complex tax revision in the history of this country. The scope of the changes was so comprehensive that the tax law was redesignated the Internal Revenue Code of 1986.
- 1987** Revenue Act of 1987—Focused primarily on business tax rules. Areas affected included accounting for long-term contracts, limitations on the use of the installment method, application of corporate tax rates to master limited partnerships, and changes in the estimated tax rules for corporations. The Act postponed for five years the reduction to 50 percent of the top estate and gift tax rate.
- 1988** Family Support Act of 1988—Provided for major reform in the area of modifying the principal welfare program, Aid to Families with Dependent Children (AFDC). Also included in the Act was the modification of employee business expense reimbursement rules. Beginning in 1989 additional amounts will have to be deducted as miscellaneous itemized deductions.
- 1988** Technical and Miscellaneous Revenue Act of 1988—TAMRA contained a number of substantive provisions. Included in the Act were the taxpayer’s bill of rights, limitations on the completed-contract accounting method, and extension of the exclusions for employee-provided educational assistance and the business energy credits.
- 1989** P.L. 101-140. Repealed Code Sec. 89. The nondiscrimination and qualification rules for employee benefit plans were repealed. Prior law nondiscrimination rules were reinstated.
- 1989** Medicare Catastrophic Coverage Repeal Act of 1989—Repealed the medicare surtax retroactively.
- 1989** Revenue Reconciliation Act of 1989—The Act achieved a deficit reduction of about \$17.8 billion and accelerated the rate of collection of withholding and payroll tax. The Act also changed the partial interest exclusion on ESOPs. Modifications were also made to the like-kind exchange rules.

- 1990** Revenue Reconciliation Act of 1990—The Act contained a number of significant changes, including a deficit reduction of about \$40 billion in 1991. The Act also increased from two to three the number of statutory rates, 15 percent, 28 percent, and 31 percent. Also, a maximum capital gain rate of 28 percent was established.
- 1991** Tax Extension Act of 1991—The Act extended, for six months only, 11 tax provisions that were to expire on December 31, 1991.
- 1992** Energy Policy Act of 1992—The Act greatly increased the amount of employer-provided transportation benefits excludable by employees.
- 1993** Revenue Reconciliation Act of 1993—The Act raised the tax rates for high-income earners. Changes also were made to the AMT, passive losses, and Section 179. Corporate tax rates increased by 1 percent.
- 1994** Social Security Domestic Employment Reform Act of 1994—The Act raised the threshold for paying Social Security and federal unemployment taxes on domestic workers from \$50 per quarter to \$1,000 annually, retroactive to the beginning of 1994.
- 1994** General Agreement on Tariffs and Trade (GATT)—To offset the loss of revenue from the reduction in tariffs, Congress passed several tax and revenue provisions. The major revenue items were: estimated tax treatment for Code Sec. 936 and subpart F income; increased premiums for employers with underfunded pension plans; and reduced interest rates on large corporate tax refunds.
- 1996** Taxpayer Bill of Rights 2—The Act included more than 40 separate provisions, many of which provided useful tools for tax practitioners representing clients before the IRS.
- 1996** Small Business Job Protection Act—The major portion of tax law changes passed in 1996 was contained in this Act. It also contained many technical corrections. The balance of the Act was divided into four major categories: small business provisions, S corporation reform, pension simplification, and revenue-raising offsets.
- 1996** Health Insurance Portability and Accountability Act—The focus of this Act was on portability of health insurance. However, this Act contained tax provisions that focus on a variety of health-related issues, as well as several revenue-raising provisions unrelated to health care.
- 1996** Personal Responsibility and Work Opportunity Reconciliation Act—The tax impact of this Act was primarily limited to the earned income tax credit.
- 1997** Taxpayer Relief Act of 1997—The Act provided significant tax cuts for many taxpayers. Major features included a reduction in capital gains tax rates, expanded IRAs, educational tax incentives, estate tax relief, and a child tax credit.
- 1998** IRS Restructuring and Reform Act of 1998—The major intent of the Act was to rein in the Internal Revenue Service. Two of the most important provisions of the Act dealt with changing the holding period for a capital asset to be classified as long-term so as to receive the most favored capital gain rate from more than 18 months down to more than 12 months. The second important area of the Act was the “technical corrections” section, which clarified many of the key provisions in the Taxpayer Relief Act of 1997. There were over seventy technical corrections contained in the Act.
- 1998** Tax and Trade Relief Extension Act of 1998—This Act included extensions of several expiring tax credits through June 30, 2000. The major extensions provided for in this legislation include the research tax credit, the work opportunity credit, and the welfare-to-work credit.
- 1999** Tax Relief Extension Act of 1999—This Act extended the time period for which tax credits and exclusions continued to be available.
- 2000** FSC Repeal and Extraterritorial Income Exclusion Act of 2000; the Consolidated Appropriations Act, 2001; the Installment Tax Correction Act of 2000—The year 2000 saw the passage of three important tax bills that contain many provisions impacting taxpayers. The Community Renewal Tax Relief Act of 2000 was contained in the

Consolidated Appropriations Act, 2000. This Act renewed provisions designed to enhance investment in low and moderate-income, rural and urban communities. The Act also extended for two years medical savings accounts (MSAs). Also included was a provision expanding innocent spouse relief. The Installment Tax Correction Act of 2000 reinstated the availability of the installment method of accounting for accrual basis taxpayers.

- 2001** Economic Growth and Tax Relief Reconciliation Act of 2001—The largest tax cut since 1981. The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) was estimated to provide tax savings of \$1.35 trillion over the next 10 years. The Act contained over 440 Code changes and numerous phase-in and transitional rules. The wide range of changes primarily affected individuals, from cuts in marginal income tax rates to changes in contribution limits for retirement plans.
- 2002** The Job Creation and Worker Assistance Act of 2002 was passed in March 2002. This Act contained a number of general business incentives, special relief for New York City, individual incentives, extenders, and some technical corrections.
- 2003** Jobs and Growth Tax Relief Reconciliation Act of 2003—The third largest tax cut in U.S. history. The purpose of the tax bill was to jump-start the U.S. economy. The bill contained ten major provisions. Half of the provisions accelerated tax cuts originally scheduled not to take effect until 2006.
- 2004** Working Families Tax Relief Act of 2004—The primary focus of this \$146 billion package was on offering the middle class tax relief.
- 2004** American Jobs Creation Act of 2004—The primary focus of this \$145 billion package was on business incentives.
- 2005** Energy Policy Act of 2005—The \$14.5 billion energy package contained incentives for oil, gas, electric, nuclear and alternative fuel industries.
- 2005** The Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users—This \$286.5 billion, six-year, highway and mass transit bill authorized funds for federal-aid highways, highway safety programs and transit programs.
- 2005** The Katrina Emergency Tax Relief Act of 2005 (KETRA)—Signed into law by President Bush on September 23, 2005. KETRA provided \$6.1 billion in emergency tax relief for victims of Hurricane Katrina. Another major provision of the bill was that it provided tax incentives for charitable giving.
- 2005** Gulf Opportunity Zone Act of 2005—The hurricane relief act is an \$8.6 billion package of tax incentives primarily aimed at the gulf region. Major provisions included creation of Gulf Opportunity (GO) Zones, fifty percent bonus depreciation related to rebuilding in the zones, expansion of Code Sec. 179 expensing for investments in the GO Zone, enhancements of low-income housing and rehabilitation credits within the zones, and expanded tax-exempt bond limits within the zones.
- 2006** Pension Protection Act of 2006—Provided for significant strengthening of traditional pension plans. Specific focus was on the funding rules for defined benefit plans and strengthening the reporting rules for plan administrators. Further, the Act made permanent the retirement savings enacted under the Economic Growth and Tax Relief Act of 2001.
- 2006** Tax Relief and Health Care Act of 2006—The Act extended a number of provisions including the higher education tuition deduction, state and local sales tax deduction, welfare to work tax credit, teacher classroom expenses and tax credits for research and development.
- 2007** Small Business and Work Opportunity Tax Act of 2007—Provided for incentives for small businesses together with an increase in the federal minimum wage. The Act extended the work opportunity tax credit through August 31, 2011. Further, the Act enhanced the Section 179 deduction, extending it through 2010 and indexing it for inflation.
- 2007** Mortgage Forgiveness Debt Relief Act of 2007—The Mortgage Forgiveness Debt Relief Act was a way of giving tax relief for debt forgiveness on mortgages and continuing the deduction for mortgage insurance payments.

- 2008** Economic Stimulus Act of 2008—The Act was designed to jump start the U.S. economy. The centerpiece of the Act provided for rebates to individuals reaching as high as \$600 and \$1,200 for married couples. Beyond the rebates to individuals, the Act also provided for \$44.8 billion in business incentives. The major business incentive was the enhanced Code Section 179 expensing. It raised Code Section 179 expensing from \$128,000 in 2008 to \$250,000 and increased the threshold for reducing the deduction from \$510,000 to \$800,000.
- 2008** Farm and Military Acts of 2008—The Food, Conservation and Energy Act of 2008 provided benefits to farmers, ranchers and timber producers. The Military Tax Relief Bill provided benefits to members of the armed forces who are receiving combat pay, saving for retirement, or purchasing a new home.
- 2008** Housing Assistance Act of 2008—This Act provided first-time homebuyers with a refundable credit of 10% of the purchase of a new home up to \$7,500, subject to certain phase-out rules. Furthermore, it provided taxpayers who claim the standard deduction an additional deduction up to \$500 or \$1,000 on a joint return for state and local property taxes. It also provided an increase for low-income housing tax credits.
- 2008** Emergency Economic Stabilization Act of 2008—The centerpiece of the legislation was the \$700 billion which was made available to stabilize the economy. The Act also included AMT (alternative minimum tax) relief along with the extension of numerous tax provisions that were set to expire.
- 2009** The American Recovery and Reinvestment Act of 2009—The \$789 billion new law contained nearly \$300 billion in tax relief. Major provisions included: Making Work Pay Credit, enhancements to the child tax credit, a 2009 Alternative Minimum Tax (AMT) patch, many energy incentives, and extension of bonus depreciation and Section 179 expensing.
- 2009** Worker, Homeownership, and Business Assistance Act of 2009—The major provisions of the Act were that it extended and expanded the first-time homebuyer credit, it allowed for up to \$2,400 in unemployment benefits to be tax-free in 2009, and it allowed for enhanced credits for the years 2009 and 2010 for the earned income credit and the child tax credit.
- 2010** The Patient Protection and Affordable Care Act—This Act usually referred to as the Affordable Care Act or "Obamacare" was signed into law on March 23, 2010. The Act has two parts, the Patient Protection and Affordable Care Act and the Health Care and Reconciliation Act. PPACA is a law intended to ensure that all Americans have access to affordable health care.
- 2010** The Hiring Incentives to Restore Employment Act—This bill is referred to as the HIRE Act. The HIRE Act greatly expanded Code Section 179 expensing, COBRA premium assistance extended through March 31, 2010, and an employer's payroll tax holiday and retention credit for employers hiring workers who were unemployed.
- 2010** Small Business Jobs Act of 2010—The bill contained several important tax provisions. The Act significantly increased the maximum expensing under Section 179 to \$500,000 and increased the beginning of the phase-out range to \$2 million for tax years beginning in 2010 and 2011. Also, the Act extended the 50 percent bonus first year depreciation for one year.
- 2010** Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010—The 2010 Tax Relief Act extended for two years the Bush-era tax cuts including the capital gains and dividend tax cuts. Further it cut payroll taxes two percentage points in 2011, placed a two-year patch on the alternative minimum tax and revived the estate tax.
- 2012** American Taxpayer Relief Act of 2012—The Act allows all Bush-era tax cuts to sunset after 2012 for individuals with income over \$400,000 and \$450,000 for couples. Also, the Act permanently patches the alternative minimum tax, increased capital gains rates to 20 percent for those individuals making over \$400,000 and extended for five years the American Opportunity Tax Credit.

- 2014** The Tax Increase Prevention Act of 2014 was signed into law by President Obama on December 19, 2014. H.R. 5771 extends temporarily over 50 expired provisions. The law also creates Achieving a Better Life Experience (ABLE) which affords benefits for persons with disabilities.
- 2015** Bipartisan Budget Act of 2015—President Obama signed into law the Act on November 2, 2015. It contains several important tax provisions especially with respect to partnership audit rules. It eliminates TEFRA, after December 31, 2017, unified partnership audit rules together with protocols for electing large partnership rules. In its place will be a more streamlined audit regime. The Act also makes changes to the Patient Protection and Affordability Care Act (ACA) with respect to employers with over 200 employees automatically enrolling full-time employees into an employer health plan.
- 2015** Protecting Americans from Tax Hikes (PATH) Act of 2015—The PATH Act of 2015 did much more than just extend the 50-plus provisions that expired at the end of 2014. Some provisions were made permanent, others extended for five years (through 2019) and others extended for two years (through 2016). Among the more notable extensions for individuals are: the American Opportunity Tax Credit, deduction for certain expenses for elementary and secondary school teachers, increases in the earned income credit and transit benefits parity. For businesses the more notable extensions are: enhanced expensing under Section 179, and the research tax credit.
- 2017** An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal 2018. The tax act is more commonly referred to as The Tax Cuts and Jobs Act. It is a massive tax act with as its centerpiece a drop in the corporate tax rate from 35 percent to 21 percent. Its impact on both business and individual taxpayers is huge. From changes in the tax rates and thresholds to the elimination of personal exemptions, The Tax Cuts and Jobs Act changed many items on individuals' tax returns. The Tax Cuts and Jobs Act is a reconciliation bill. Therefore, the longer title and the Act had to comply with stricter rules with respect to deficits. Many of the changes to corporations are permanent but changes to individual tax provisions are for 8 years only. They will sunset after 2025. The goal of The Tax Cuts and Jobs Act was to reduce taxes on both corporations and individuals and to stimulate economic growth.
- 2018** Bipartisan Budget Act of 2018 contained several tax provisions. The Act retroactively extended approximately thirty-three tax provisions. Among the more notable is it excludes from gross income discharge of qualified principal residence indebtedness.

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FEDERAL TAX LEGISLATIVE PROCESS

When reviewing the tax acts since the mid to late 1970s, it becomes obvious that tax reform is a yearly event. Tax bills are passed for numerous reasons (i.e., revenue needs, incentive for economic development, or to affect the economy). Tax bills in this country have not followed a uniform path. Normally, major tax legislation originates with the President sending a message to Congress. An alternative approach is for congressional initiative on a tax bill.

The Constitution requires that revenue legislation originate in the House of Representatives. Therefore, the first step is for hearings before the House of Representatives Ways and Means Committee. Many influential bodies present recommendations to this Committee—the Secretary of the Treasury, the Office of Management and Budget, etc. After meeting with various bodies, the Committee meets in executive session, and a tax bill is transmitted by means of a Committee report to the House.

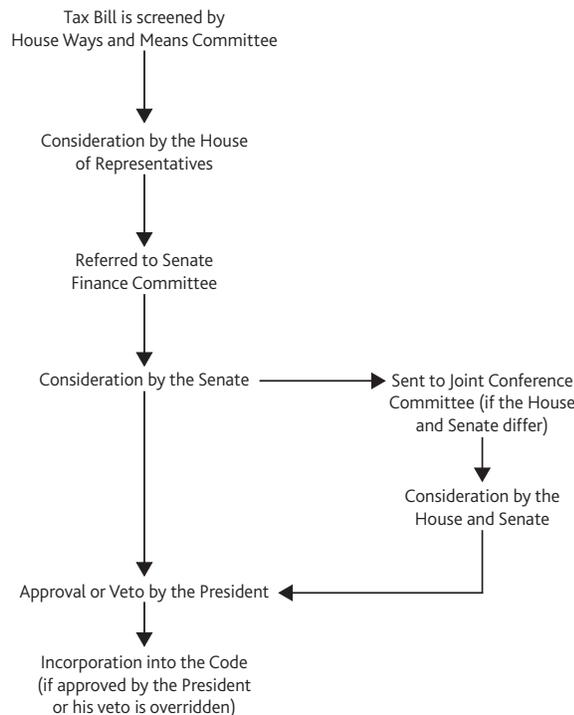
The House of Representatives debates the bill usually under a “closed rule” procedure, which permits amendments to come only if approved by the Ways and Means Committee. If the bill is defeated it may be referred back to committee; if it passes, it is sent to the Senate where it is first discussed in the Senate Finance Committee.

Hearings are held by the Finance Committee which might result in amendments to the House bill. The amendments may range from insignificant to totally changing the bill. The bill is then transmitted to the whole Senate. One significant difference between the House and the Senate is that, in the Senate, any Senator may offer amendments from the floor of the Senate. After passage, if there are any differences

between the House and Senate versions of the bill, it goes to the Joint Conference Committee, which is composed of ranking members of the House Ways and Means Committee (seven members) and the Senate Finance Committee (five members) for resolution. The Conference Committee version of the bill must be accepted or rejected—it cannot be changed by either the House or the Senate. Assuming passage by the House and the Senate, the bill becomes law when approved by the President. If it is vetoed, both the Senate and the House must vote affirmatively by a two-thirds majority to override the President's veto.

Exhibit 1 illustrates the sequence of events whereby a tax bill is introduced before the House Ways and Means Committee, passes through the House of Representatives, the Senate Finance Committee, and the Senate. As indicated in the final portion of Exhibit 1, if approved by the President, the tax bill will be incorporated into the Internal Revenue Code.

Exhibit 1. THE LEGISLATIVE PROCESS



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TAX REFORM

Tax reform acts are passed by Congress and signed into law by the President quite regularly. Several tax reform acts stand out because of the magnitude of the act. The year 1986 was a most interesting year for tax legislation. Both political parties, Democrats and Republicans, were “demanding” tax reform. The Treasury Department presented to President Reagan a massive tax reform plan that would impact the tax liability of most individuals and corporations. President Reagan, in his 1986 budget, called for a tax system that would be “simpler, more neutral, and more conducive to economic growth.”

Tax Reform Act of 1986

The Senate passed a bill with only two rate brackets, 15 and 27 percent (28 percent was the final figure approved). Like that of the House of Representatives, their bill called for the removal of many tax deductions. One new feature added in the Senate bill was the drastic reduction in the number of people eligible for Individual Retirement Accounts (IRAs). After much debate, compromising, and political maneuvering, the Tax Reform Act of 1986 was passed and signed into law by President Reagan on October 22, 1986. The Tax Reform Act of 1986 carries the label of the most extensive overhaul of the U.S. tax code in almost 40 years, as well as the most fundamental reform of the U.S. tax structure. The scope of the changes was so comprehensive that the tax code was renamed the Internal Revenue Code of 1986.

Table 5 presents comparative data for the inflation-indexed items for 2018 and 2019.

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Table 5. 2018-2019 PARTIAL COMPARISON OF TAX CHANGES FOR INDIVIDUALS

Item		2018	2019
Filing requirements			
If filing status is:		A return is required if gross income was at least:	A return is required if gross income was at least:
Single	Under 65	\$12,000	\$12,200
	65 or older	13,600	13,850
Head of Household	Under 65	\$18,000	\$18,350
	65 or older	19,600	20,000
Married Filing Jointly	Both under 65	\$24,000	\$24,400
	One spouse 65 or older	25,300	25,700
	Both 65 or older	26,600	27,000
	Not living with spouse at end of year (or on date spouse died)	\$0	0
Married Filing Separately	All	0	0
Qualifying Widow(er)	Under 65	\$24,000	\$24,400
	65 or older	25,300	25,700

Note: Children and other dependents should see Chapter 3 for special rules.

Table 5. 2018-2019 PARTIAL COMPARISON OF TAX CHANGES FOR INDIVIDUALS—Continued

Item		2018			2019		
Tax rates							
Married filing jointly or surviving spouse	10%	0	\$19,050	10%	0	\$19,400	
	12%	\$19,050	to \$77,400	12%	\$18,650	to \$78,950	
	22%	\$77,400	to \$165,000	22%	\$75,900	to \$168,400	
	24%	\$165,000	to \$315,000	24%	\$153,100	to \$321,450	
	32%	\$315,000	to \$400,000	32%	\$233,350	to \$408,200	
	35%	\$400,000	to \$600,000	35%	\$416,700	to \$612,350	
Single	37%	Over	\$600,000	37%	Over	\$612,350	
	10%	0	to \$9,525	10%	0	to \$9,700	
	12%	\$9,525	to \$38,700	12%	\$9,325	to \$39,475	
	22%	\$38,700	to \$82,500	22%	\$37,950	to \$84,200	
	24%	\$82,500	to \$157,500	24%	\$91,900	to \$160,725	
	32%	\$157,500	to \$200,000	32%	\$191,650	to \$204,100	
Married filing separately	35%	\$200,000	to \$500,000	35%	\$416,700	to \$510,300	
	37%	Over	\$500,000	37%	Over	\$510,300	
	10%	0	to \$9,525	10%	0	to \$9,700	
	12%	\$9,525	to \$38,700	12%	\$9,325	to \$39,475	
	22%	\$38,700	to \$82,500	22%	\$37,950	to \$84,200	
	24%	\$82,500	to \$157,500	24%	\$76,550	to \$160,725	
Head of household	32%	\$157,500	to \$200,000	32%	\$116,675	to \$204,100	
	35%	\$200,000	to \$300,000	35%	\$208,350	to \$306,175	
	37%	Over	\$300,000	37%	Over	\$306,175	
	10%	0	to \$13,600	10%	0	to \$13,850	
	12%	\$13,600	to \$51,800	12%	\$13,350	to \$52,850	
	22%	\$51,800	to \$82,500	22%	\$50,800	to \$84,200	
Social Security wage base	24%	\$82,500	to \$157,500	24%	\$131,200	to \$160,700	
	32%	\$157,500	to \$200,000	32%	\$212,500	to \$204,100	
	35%	\$200,000	to \$500,000	35%	\$416,700	to \$510,300	
	37%	Over	\$500,000	37%	Over	\$510,300	
	The maximum amount for 2018 is \$128,400.			The maximum amount of taxable and creditable annual earnings subject to the Social Security and self-employment income tax is \$132,900.			

Table 5. 2018-2019 PARTIAL COMPARISON OF TAX CHANGES FOR INDIVIDUALS—Continued

Item	2018	2019
Standard deduction		
Basic standard deduction		
Single	\$12,000	\$12,200
Head of household	18,000	18,350
Married filing jointly or qualifying widow(er)	24,000	24,400
Married filing separately	12,000	12,200
Additional standard deduction for blindness or 65		
Married (filing jointly or separately) or qualifying widow(er)	\$1,300	\$1300
Single or head of household	\$1,600	\$1650
Dependent's standard deduction	Cannot exceed the greater of (A) \$1,050 or (B) earned income plus \$350 (limited to \$12,200).	Cannot exceed the greater of (A) \$1,100 or (B) earned income plus \$350 (limited to \$12,200).
Nanny Tax	Wage threshold for paying Social Security and federal unemployment taxes on domestic workers is \$2,100 annually.	Wage threshold for paying Social Security and federal unemployment taxes on domestic workers is \$2,100 annually.

American Taxpayer Relief Act of 2012

The “fiscal cliff” was averted. The Act allowed the Bush-era tax cuts to sunset for taxpayers with incomes over \$400,000 and for couples with income over \$450,000. Many tax breaks that were to expire were extended. It permanently patches the alternative minimum tax and provides for a maximum estate tax of 40 percent with a \$5 million exclusion.

Other highlights of the Act include: raising the tax on incomes over \$400,000 (individuals) and \$450,000 (filing jointly) to 39.6 percent; raising the maximum capital gains tax to 20 percent; five year extension on the American Opportunity Tax Credit; and a two year extension on certain business tax items.

Expired Tax Provisions—Tax Extenders

At the end of 2014, President Obama signed into law the Tax Increase Prevention Act of 2014 which extended 51 tax provisions. These provisions are referred to as extenders. It is the usual procedure of Congress to pass a bill that renews the expired provisions each year. On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes (PATH) Act of 2015. A number of individual and business tax incentives were made permanent.

The Tax Cuts and Jobs Act

One of the measures adopted in the Tax Reform Act of 1986 was that inflation adjustments would be provided annually for several specific items such as the standard deduction, tax brackets, personal exemption amounts, and the earned income credit. Indexing was designed to protect individuals from “bracket creep”—that is, where an individual’s income increases only by the inflationary rate but the taxpayer moves into a higher tax bracket.

After many months of discussion both the House of Representatives and the Senate passed tax bills. A joint House-Senate conference committee reconciled the differences and on December 15, 2017, the conference committee approved the tax reform bill and it was then sent back to both the House and the Senate for approval. On December 20, 2017, both branches of Congress passed the tax act. The House approved the bill 227-203. No Democrats voted for the bill. The Senate’s parliamentarian ruled that three provisions violated the reconciliation rules and had to be eliminated. The Senate then passed the bill 51-48 with no Democrats voting in favor. The President then signed the bill into law on December 22, 2017. It is the most significant tax legislation in the past 30 years. Opponents maintain the deficit will grow uncontrolled. Proponents maintain economic growth will be substantial and will pay for the tax cuts.

Tax Extenders

President Trump signed into law on February 9, 2018 a massive two-year budget deal. It raised the deficit ceiling by \$300 billion. The 652-page document covers a vast array of provisions. Some of the major provi-

sions are: defense spending, higher Medicare premiums for the wealthy, assistance for mental health and the opioid crises and tucked away in the bill is the retroactive renewal of the expired 2016 tax extenders. Approximately 33 provisions were extended retroactively through 2017.

Below is a listing of the most important extenders that we cover in this book.

Extenders retroactively renewed through 2017

- Exclusion from gross income of discharge of principle residence acquisition indebtedness
- Mortgage insurance premiums treated as qualified residence interest
- Deduction for qualified tuition and related expenses of up to \$4,000 for individuals whose adjusted gross income does not exceed \$65,000 (\$130,000 joint return)
- Indian employment tax credit
- Qualified zone academy bonds
- Seven-year recovery period for motorsports entertainment complexes
- Special expensing rules for certain film and television productions
- Energy efficient commercial buildings deduction
- Excise tax credits and payment provisions relating to alternative fuel

Extenders through 2018

- The 7.5 percent floor on medical expense deductions

Extenders through 2019

- The New Markets Tax Credits
- Work Opportunity Tax Credit
- Bonus depreciation
- Look-through treatment of payments between related controlled foreign corporations
- Health coverage excise tax imposed on individuals without health insurance reduced to zero after 2019
- Provisions modifying the rates of taxation of beer, wine, and distilled spirits
- Employer credit for paid family and medical leave

Extenders expiring in 2020 through 2026

There are many other provisions expiring from 2020 through 2026. Most of the changes in The Tax Cuts and Jobs Act affecting individuals take effect after December 31, 2017 and sunset after 2025. One notable exception is the new rules on alimony. Alimony and separate maintenance agreements executed after 2018 or current agreements modified after 2018 will no longer allow for alimony to be tax deductible by the payor and the payments included in gross income of the payee.

Extenders made permanent

- Certain expenses of elementary and secondary school teachers
- Transit benefits parity for employer-provided mass transit and parking benefits
- Tax-free distributions from IRAs for charitable purposes for individuals age 70½ and older
- Reduced earnings threshold for additional child tax credit
- Earned income credit modifications
- State and local general sales tax deduction
- Special rule for qualified conservation contributions
- Enhanced Code Sec. 179 expensing
- Research tax credit
- Tax treatment of certain payments to controlling exempt organizations
- Basis adjustment to stock of S corporations making charitable contributions of property
- Employer wage credit for employees who are active duty members of the uniformed services
- Treatment of certain dividends of regulated investment companies
- Exclusion of 100 percent of gain on certain small business stock
- Reduction in S corporation recognition period for built-in gains tax
- Subpart F exception for active financing income of food inventory
- Temporary minimum low-income housing tax credit rate for non-federally subsidized buildings

Extenders through 2019

- The New Markets Tax Credits
- Work Opportunity Tax Credit

- Bonus depreciation
- Look-through treatment of payments between related controlled foreign corporations

Extenders through 2017

- Exclusion from gross income of discharge of principle residence acquisition indebtedness
- Mortgage insurance premiums treated as qualified residence interest
- Deduction for qualified tuition and related expenses
- Indian employment tax credit
- Qualified zone academy bonds
- Seven-year recovery period for motorsports entertainment complexes
- Special expensing rules for certain film and television productions
- Energy efficient commercial buildings deduction
- Excise tax credits and payment provisions relating to alternative fuel

As of press time no legislation had been enacted to extend the expired provisions. From the list above it can be seen that the extenders fall into three groups: those affecting individuals, those affecting businesses, and those related to energy.

Underlying Rationale of the Federal Income Tax

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OBJECTIVES OF THE TAX LAW

The federal income tax is comprised of a complicated and continually evolving blend of legislative provisions, administrative pronouncements, and judicial decisions. The primary purpose of the tax law is obviously to raise revenue, but social, political, and economic objectives are also extremely important. These various objectives, which frequently work at cross-purposes with the revenue raising objective of the law, must be examined and understood to gain an appreciation of the rationale underlying the immense multipurpose body of law known as the federal income tax.

It is easy to criticize the entire tax law for being too complex. However, any time one law attempts to raise revenue and achieve a variety of social, political, and economic objectives, while simultaneously attempting to be equitable to all income levels and administratively feasible for the government to enforce, it cannot avoid being complex.

Tax loopholes are frequently attacked as being counterproductive to the revenue raising objective of the Treasury because they cost the U.S. government billions of dollars in lost revenue. However, some of these so-called loopholes can be thought of as tax incentives, enacted by Congress to encourage certain types of investment, or to achieve specified social, economic, or political objectives.

For example, the tax law provides that interest from municipal bonds is generally excluded from gross income, while interest received from all other sources, including savings accounts and corporate obligations, is subject to taxation. The municipal bond provision thus offers excellent tax benefits for individuals with available resources to invest, but these bonds typically provide a lower yield than corporate obligations.

Primarily because of this tax benefit, municipal bonds are a popular type of investment for wealthy taxpayers. To better evaluate the criticism that municipal bonds are a tax loophole, the probable tax consequences of this type of investment can be examined in the case of a taxpayer in the 37 percent marginal tax bracket.

EXAMPLE 1.2

Cliff, a 37% bracket taxpayer, has \$50,000 available to invest. After evaluating the pros and cons of stocks, bonds, money market certificates, and other types of investments, his decision is limited to the following two choices:

Freemont Highway municipal bonds, rate of interest		9%
Data-Search Inc., corporate bonds, rate of interest		12%
	Freemont	Data-Search
Interest income (before taxes)	\$4,500	\$6,000
Income taxes	<u>0</u>	<u>2,220</u>
Yield (after taxes)	<u>\$4,500</u>	<u>\$3,780</u>

Result. Cliff will select the Freemont municipal bonds. Even with a lower rate of interest than the corporate obligations, Freemont provides a larger after-tax yield.

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A common but simplistic criticism of this tax provision is that the wealthy individual has used a loophole to avoid \$1,665 of taxes ($\$4,500 \text{ interest} \times 37 \text{ percent tax rate}$), thereby depriving the U.S. government of a corresponding amount of revenue. However, this criticism must be weighed against the underlying purpose of the municipal bond provision which is encouraging taxpayers to invest in state and local obligations and allowing the various municipalities to compete for resources in the bond market at a lower rate of interest than corporate bonds.

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ECONOMIC FACTORS

Over the years, numerous provisions of the tax law have been employed to help stimulate the economy, to encourage capital investment, or to direct resources to selected business activities. Perhaps the most well-known provision of the tax law, designed to serve as a stimulus to the economy, was the investment tax credit. This credit, which served to encourage investment in qualified property, primarily tangible personal property used in a trade or business, had been suspended for a period of time, repealed, reinstated, and again repealed.

Similar to its use of the investment credit, Congress has used depreciation write-offs as a means of controlling the economy. Viewed as a popular stimulus for business investment is the tax benefit resulting from the accelerated cost recovery methods of depreciation. The Tax Cuts and Jobs Act liberalized the expensing rules. Additionally, the related election to expense allows the taxpayer to deduct as much as \$1,020,000 (in 2019) of the cost of qualifying property in the year of purchase. However, where the cost of qualified property placed in service during the year exceeds \$2.55 million, the \$1,020,000 ceiling is reduced by the amount of such excess.

Various other tax provisions have been employed to help stimulate selected industries. Thus, unique tax benefits, such as the provisions for percentage depletion, apply to the mining of natural resources. Correspondingly, farming activities benefit from special elections to expense rather than capitalize soil and water conservation expenditures under an approved conservation plan.

Small business investment has been encouraged by various provisions. For example, certain types of small businesses may elect to file as an S corporation, which essentially provides the limited liability protection of corporate status, while treating most items of income as if the entity were a partnership. Correspondingly, a special rule allows ordinary loss treatment for small business stock.

For year beginning after December 31, 2017 the corporate tax is a flat 21 percent.

¶1181

SOCIAL FACTORS

Numerous tax provisions can best be explained in light of their underlying social objectives. For example, premiums paid by an employer on group-term insurance plans are not treated as additional compensation to the employees. This provision encourages business investment in group-term insurance and provides benefits to the family of a deceased employee. Also, social considerations provide the rationale for excluding employer-paid premiums on accident and health plans or the premiums on medical benefit plans from an employee's gross income.

Deferred compensation plans allow an individual to defer taxation on current income until retirement. The preferential tax treatment is an attempt to encourage private retirement plans to supplement the Social Security benefits. Other socially motivated tax provisions include the deduction for charitable contributions, the child care credit for working parents, and the credit for the elderly.

Frequently, social considerations help to explain a tax provision that discourages certain types of activities. For example, even though an individual may have incurred a fine or a penalty while engaged in a regular business activity, no deduction is allowed for this type of expenditure. The basis underlying this Congressional policy is that by allowing such a deduction, the law would be implicitly condoning and encouraging such activities. Correspondingly, bribes to government officials and illegal kickbacks or rebates are not deductible, even if related to the active conduct of one's trade or business.

¶1185

POLITICAL FACTORS

Since the tax law is created by Congress, and Congress consists of several hundred elected officials, political factors play a major role in the development of tax legislation. Special interest groups frequently seek to influence tax legislation, while Congressmen themselves are often likely to introduce legislation which would be of particular benefit to their own district or, perhaps, to selected constituents. Of course, special interest legislation does invite widespread criticism if it does not also serve a useful economic or social objective.

As with the economic and social objectives, many politically inspired provisions have been designed in a negative context to discourage certain types of activities. Thus, provisions such as the alternative minimum tax, which imposes an alternative tax rate on taxable income increased by tax preference items, the limitation on investment interest expense, or the accumulated earnings restrictions on corporations can be explained on this basis.

¶1187

TAX POLICY AND REFORM MEASURES

If there has been a trend through the years in tax statutes, it has been toward reform. The word “reform” itself first appeared in the popular name of the tax act entitled Tax Reform Act of 1969, but the concept of reform had begun to take shape long before and the enactment of reform measures has continued unabated through the years.

During the later part of the 1980s, various changes in the tax law, especially the passage of the Tax Reform Act of 1986, have resulted in the most dramatic tax modifications in tax policy since the enactment of the Internal Revenue Code of 1913. For the first time in 73 years, Congress attempted to address the broad public-policy implications of the entire tax law. In undertaking the revision of 1986, Congress sorted through a massive panorama of loopholes, inequities, and antiquated provisions and eliminated provisions that had lost much of their original social, political, or economic purpose.

Clearly, the tax policy implications of the 1986 revision will be under examination for some time to come. A major impact can be expected on the manner in which individuals and businesses save, invest, earn, and spend their money. For example, with the curtailment of the deduction for contributions to individual retirement accounts (IRAs), high-yield securities such as dividend-paying blue chip stocks, corporate bonds, and “municipals” might become more attractive investments than growth stocks. In fact, many wage earners may find it advantageous to pay taxes on their entire salary, rather than investing in a deferred compensation plan if they anticipate future increases in their marginal tax rates. Correspondingly, with the elimination of the consumer interest deduction, many individuals may shift to making cash purchases instead of incurring nondeductible obligations. Of course, some homeowners may be tempted to circumvent these restrictive provisions by using home equity loans to finance consumer purchases.

The Taxpayer Relief Act of 1997 cut taxes in a fashion that had not been seen since 1981. The reduction of capital gains tax rates will have a significant impact on investment strategies.

The student of tax law can anticipate frequent if not annual changes to the way individuals and businesses are taxed. The source of tax revenue to finance the operation of the federal government during the next decade will be a hotly debated issue. Some tax policymakers will promote new taxation schemes, such as a consumption tax, while others will advocate a tax policy that is revenue-neutral and neutral as to its impact on various income groups.

Basic Tax Concepts

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ESSENTIAL TAX TERMS DEFINED

When studying federal income taxation, it is important to keep in mind several basic tax concepts. By understanding these basic concepts unique to federal taxation, the course will be more interesting and meaningful. Because some of the terms set out below have definitions peculiar to income taxation, it is advisable that they be carefully examined before proceeding to the discussion of specific topics. Refer to the Glossary of Tax Terms in the back of the book for a comprehensive listing of tax terms discussed throughout the text.

Accrual basis of accounting

The accrual basis is distinguished from the cash basis. On the accrual basis, income is accounted for as and when it is earned, whether or not it has been collected. Expenses are deducted when they are incurred, whether or not paid in the same period. In determining when the expenses of an accrual-basis taxpayer are incurred, the all-events test is applied. Such test provides that the expenses are deductible in the year in which all of the events have occurred that determine the fact of liability and the amount of the liability can be determined with reasonable accuracy. Generally, all of the events that establish liability for an amount, for the purpose of determining whether such amount has been incurred, are treated as not occurring any earlier than the time that economic performance occurs.

¶1187

Assignment of income doctrine

The assignment of income by an individual who retains the right of ownership to the property has generally proved ineffective as a tax-shifting procedure. For the assignment to be effective, a gift of the property would be necessary. For example, Ben is preparing to attend Major State College. As a means of paying for room and board, his father assigns to Ben his salary. This is an invalid assignment of income and Ben's father would be liable for the tax. In *Lucas v. Earl*, 2 USTC ¶496, 281 U.S. 111-115, 50 S.Ct. 241 (1930), the Supreme Court ruled that the government could "tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." Also, in this case the Court stated that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew."

Basis

The basis of property is the cost of such property. It usually means the amount of cash paid for the property and the fair market value of other property provided in the transaction.

EXAMPLE 1.3

An individual paid cash of \$20,000 for an automobile and assumed a \$7,500 loan on the car; thus, the basis in the automobile is \$27,500.

EXAMPLE 1.4

An individual paid \$500,000 for a tract of land and a building. Purchase commissions, legal and recording fees, surveys, transfer taxes, title insurance, and charges for installation of utilities amounted to \$70,000. The basis of the property would be \$570,000. Any amounts owed by the seller and assumed by the buyer are included in the basis of the property.

The definition and the determination of "basis" are of utmost importance because it is that figure which is usually used for depreciation and the determination of gain or loss. If property was acquired by gift, inheritance, or in exchange for other property, special rules for finding its basis apply.

Business purpose

When a transaction occurs it must be grounded in a business purpose other than tax avoidance. Tax avoidance is not a proper motive for being in business. The concept of business purpose was originally set forth in *Gregory v. Helvering*, 35-1 USTC ¶9043, 293 U.S. 465, 55 S.Ct. 266 (1935). In this case, the Supreme Court ruled that a transaction aiming at tax-free status had no business purpose. Further, the Court stated that merely transferring assets from one corporation to another under a plan which can be associated with neither firm was invalid. This was merely a series of legal transactions that when viewed by the Court in its entirety had no business purpose.

Capital asset

Everything owned and used for personal purposes, pleasure, or investment is a capital asset. Examples of capital assets are stocks, bonds, a residence, household furnishings, a pleasure automobile, gems and jewelry, gold, silver, etc. Capital assets do not include inventory, accounts or notes receivable, depreciable property, real property, works created by personal efforts (copyrights), and U.S. publications.

Cash basis

The cash basis is one of the two principal recognized methods of accounting. It must be used by all taxpayers who do not keep books. As to all other taxpayers (except corporations, certain partnerships, and tax-exempt trusts) it is elective, except that it may not be used if inventories are necessary in order to reflect income. On the cash basis, income is reported only as it is received, in money or other property having a fair market value, and expenses are deductible only in the year that they are paid.

Claim of right

The term claim of right asks whether cash or property received by an individual to which the individual does not have full claim and which the individual might have to return in the future must be included in income. The question here is whether the taxpayer must report the income when received or wait until

the taxpayer has full right to it. In *North American Oil Consolidated v. Burnet*, 3 USTC ¶943, 286 U.S. 417 (1932), the Supreme Court resolved the question by stating that amounts received by an individual under a claim of right must be included in gross income even though the individual might have to refund the amount at a later time.

Conduits

Some entities are not tax paying. They pass through their income (loss) to owners (beneficiaries). A partnership is an example of a conduit. Partnerships do not pay taxes; they merely report the partnership's taxable income or losses. The income (loss) flows directly to the partners. However, partnerships do compute partnership taxable income. Other types of conduits are grantor trusts and S corporations.

Constructive-receipt doctrine

When a cash-basis individual receives income, or it is credited to an account the individual may draw upon, or it is set aside for the individual, the courts have ruled that the individual has constructively received the income. This concept was developed to stop taxpayers from choosing the year in which to recognize income. Once an individual has an absolute right to the income, it must be recognized. A good example of the constructive receipt doctrine is interest earned on a bank account. If interest is credited to the taxpayer's account, it is of no consequence that the taxpayer does not withdraw the money. The day the interest is credited to the account is the day the taxpayer must include the amount in income.

Entity

Generally, for tax purposes there are four types of entities: individuals, corporations, trusts, and estates. Each entity determines its own tax and files its own tax return. Each tax entity has its specific rules to follow for the determination of taxable income. Basically the concept of "entity" answers the question "Who is the taxpayer?" Note that partnerships were not in the list of entities. For tax purposes, partnerships are not tax-paying entities. The income (loss) flows directly to the partners.

Gross income

Gross income, for income tax purposes, refers to all income that is taxable. The law enumerates specific items of income that are not to be included in gross income and, therefore, are nontaxable. With these exceptions, all income is includible in gross income.

Holding period

The holding period of property is the length of time that the property has been held by the taxpayer, or the length of time that the taxpayer is treated for income tax purposes as having held it. The term is most important for income tax purposes as it relates to capital gains transactions. Whether capital gain or loss is short or long term depends on whether the asset sold or exchanged has been held by the taxpayer for more than 12 months.

Income

The fundamental concept of income is set forth in the Sixteenth Amendment—"incomes, from whatever source derived." It is the gain derived from capital, labor, or both. For tax purposes the term "income" is not used alone. The most common usages are gross income, adjusted gross income, and taxable income.

Income-shifting

Income-shifting is the transfer of income from one family member to another who is subject to a lower tax rate or the selection of a form of business that decreases the tax liability for its owners.

Pay-as-you-go tax system

The American tax system is often referred to as a pay-as-you-go tax system. Much of the federal government's tax collections come from withholdings and estimated taxes. The various types of taxpayers pay tax throughout the year, not just at year-end. The United States has been on a pay-as-you-go system since 1943.

Realized v. recognized gain or loss

A gain or loss is realized when a transaction is completed. However, not all realized gains and losses are taxed (recognized). A recognized gain or loss occurs when a taxpayer is obligated to pay tax on a completed transaction.

Substance v. form

Individuals should arrange their financial transactions in a manner that will minimize their tax liability. If a transaction is all it purports to be and not merely a transaction to avoid taxes, then it is valid. If the transaction is solely to avoid taxes and there is no business purpose to the transaction, then it is invalid. The fact that a taxpayer uses one form of transaction rather than another to minimize taxes does not invalidate the transaction. A good example of when substance v. form is a significant issue is in the area of leases. Payments under a lease are tax deductible. Payments under a purchase agreement are not tax deductible. Therefore, it is of utmost importance to determine the true “substance” of this type of transaction. Questions to be asked might include: Do any equity rights transfer to the lessee at the end of the lease period? May the lessee buy the property at a nominal purchase price? With a lease transaction it is immaterial that the parties refer to the transaction as a lease. The true substance of the transaction controls over the form.

Tax benefit rule

A recovery is includible in income only to the extent that the deduction reduced tax in any prior year by any amount. Therefore, where a deduction reduced taxable income but did not reduce tax, the recovery amount is excludable from income. This rule applies to both corporate and noncorporate taxpayers.

Taxable income

Taxable income for a corporation is gross income minus all deductions allowable, including special deductions such as the one for dividends received. Taxable income for individuals who itemize deductions is equal to adjusted gross income minus the greater of itemized deductions or the standard deduction amount and the qualified business deduction. For taxpayers who do not itemize, taxable income is adjusted gross income minus the standard deduction and the qualified business deduction.

Wherewithal to pay

The concept that the taxpayer should be taxed on a transaction when he or she has the means to pay the tax. For example, a taxpayer owns property that is increasing in value. The IRS does not tax the increased value until the taxpayer sells the property. At the time of sale, the taxpayer has the wherewithal to pay.

SUMMARY

- Taxes are indeed big business. The Internal Revenue Service collected \$2,979,742,266,000 in 2017.
- Individuals contributed 49.72 percent of all taxes raised by the IRS.
- Corporations contributed approximately 9.85 percent of all taxes raised by the IRS.
- A basic understanding of tax terminology will help business leaders run their corporations.

QUESTIONS

1. Clearly, individuals are carrying a much heavier tax burden than corporations. Is this justified?
2. Some economists have argued that corporate taxes should be eliminated and only individuals should be taxed. Explain.
3. Discuss excise tax when used as a measure for social control (i.e., tax on alcohol and gasoline).
4. Why is the value-added tax (VAT) considered regressive?
5. How might the VAT be used to balance the budget?
6. What is the test which distinguishes between tax avoidance and tax evasion?
7. If your interest is in tax avoidance, name several types of investments that will lower your tax liability.
8. “The tax evader is a criminal.” Support or refute this statement.
9. Discuss the badges of fraud.
10. What is meant by the term “tax gap”?
11. Why is income-shifting considered such a major tax planning concept?
12. What was the constitutional impediment to income taxation prior to the Sixteenth Amendment?
13. The federal taxing system has tried to reflect changes in society and lifestyles. Give three examples.
14. What was the purpose of the Sixteenth Amendment?
15. Of what importance is the date March 1, 1913?
16. Where must revenue legislation originate?
17. Which committees of Congress are responsible for revenue legislation?
18. What is the purpose of the Joint Conference Committee?

PROBLEMS

19. The legislative process of a tax bill begins with the:
 - a. House Ways and Means Committee
 - b. President
 - c. Senate Finance Committee
 - d. Any of the above
20. The Sixteenth Amendment granted Congress the right to:
 - a. Create progressive tax rates
 - b. Create a value-added tax
 - c. Tax income from whatever source derived
 - d. Impose a national property tax

21. The value-added tax has great appeal to politicians because:
 - a. It has the potential to raise large sums of money.
 - b. It taxes the rich and not the poor.
 - c. It is progressive in nature.
 - d. All of the above.
22. An attractive characteristic of the personal income tax is:
 - a. It does not tax the poor.
 - b. It is equitable.
 - c. It is free from loopholes.
 - d. It has the ability to raise a considerable amount of money.
23. The Tax Reform Act of 1986:
 - a. Amended the Internal Revenue Code of 1954
 - b. Replaced the Internal Revenue Code of 1954 with the Internal Revenue Code of 1986
 - c. Replaced the Internal Revenue Code of 1954 with the Internal Revenue Code of 1987
 - d. Was found to be unconstitutional by the Supreme Court in 1987
24. The Tax Cuts and Jobs Act did all of the following except:
 - a. Enhanced the child care credit
 - b. Created a homebuyer's credit
 - c. Lowered corporate tax rates
 - d. Extended the 7.5 percent floor on medical expenses
25. When approving a tax bill and there are differences between the House and Senate versions, the differences are resolved by the:
 - a. President
 - b. Speaker of the House
 - c. President of the Senate
 - d. Joint Conference Committee
26. Net capital gains are:
 - a. Taxed at a maximum rate of 31 percent.
 - b. Taxed at a maximum rate of 28 percent.
 - c. Taxed at a maximum rate of 20 percent
 - d. Taxed at a maximum rate of 15 percent.
27. The American Taxpayer Relief Act of 2012 did all of the following except:
 - a. Permanently patched the Alternative Minimum Tax
 - b. Sunset the Bush-era tax cuts
 - c. Installed a maximum 20 percent capital gains tax rate
 - d. Extended the American Opportunity Tax Credit
28. Which item listed below is not a capital asset?
 - a. Stocks
 - b. Pleasure automobile
 - c. Bonds
 - d. Depreciable property
29. Major features of conduits are:
 - a. Pass through their income to owners
 - b. Need not file income tax returns
 - c. Need not pay taxes
 - d. Both (a) and (c) above
30. What are several major provisions of the Tax Cuts and Jobs Act?
31. **Research Problem.** The following case highlights the right of the taxpayer to select among legitimate business alternatives in order to avoid taxes. Read the case and prepare a written brief.

Peterson & Pegau Baking Co., 2 BTA 637 (1925), Dec. 775.

Chapter

2

Tax Research, Practice, and Procedure

OBJECTIVES

After completing Chapter 2, you should be able to:

1. Identify the primary authoritative sources of the tax law and understand the relative weight of these authorities.
2. Explain the role of the court system as a forum for both the taxpayer and the government.
3. Develop a familiarity with the various forms of judicial citations.
4. Understand the general organization of a loose-leaf tax service and the importance of a citator service and other types of secondary reference materials.
5. Describe the organization of the Internal Revenue Service and selected rules relating to practice before the IRS.
6. Discuss the examination of returns, including correspondence examinations, office examinations, and field examinations.
7. Explain the appeals process, both within the IRS and through the court system.
8. Understand the possible communications between the IRS and taxpayers, including private rulings, determination letters, and technical advice.
9. Describe some of the more common penalties to which taxpayers and tax preparers might be subject.
10. Understand ethics as related to the tax practitioner.

OVERVIEW

To the general public, the tax practitioner is often viewed simply as a preparer of tax returns. However, from a broader, more professional perspective, tax practice also involves extensive research, creative tax planning, and effective representation of clients before the audit or appellate divisions of the Internal Revenue Service.

Tax research is the process whereby one systematically searches for the answer to a tax question, using the various primary and secondary sources of tax-related information. This involves reviewing and evaluating appropriate Internal Revenue Code sections, Treasury Regulations, Internal Revenue Service Rulings, and court decisions. Research into this voluminous material is typically facilitated by the use of one of the loose-leaf tax services, which are organized and cross-referenced in such a manner as to assist the researcher in the confusing trek through the overwhelming mass of authoritative data. Also, due to rapid technological advances made in computer-assisted tax research, the researcher may access the most complete and up-to-date authoritative data with online tax research services.

The tax specialist needs to understand the organizational structure of the IRS and its administrative procedures to provide fully informed tax consulting services to taxpayers involved in disputes with the IRS. Thus, this chapter includes a discussion of the internal organization of the IRS and how its various administrative groups function, the rules relating to practice before the IRS, and the procedures for examination of returns, including service center examinations, office examinations, and field examinations.

What actions can a taxpayer take if there is an adverse decision by the tax auditor or revenue agent? To provide an answer to this question, this chapter details and explains the appeals process, both within the IRS and through the court system. Another approach available to the taxpayer is the right to request advice from the IRS on the tax consequences of a particular transaction. This chapter discusses the various communications between the IRS and taxpayers, including private letter rulings, determination letters, and technical advice.

Some of the more common penalties to which taxpayers and tax preparers might be subject are also discussed. Tax practitioners should be familiar with the code of professional ethics of their profession since a violation of these standards might mean that “due care” has not been exercised and the practitioner might be subject to charges of negligence.

Tax Reference Materials

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CLASSIFICATION OF MATERIALS

Tax reference materials are usually classified as primary “authoritative” sources or secondary “reference” sources. Primary source materials include the Internal Revenue Code (Statutory Authority), Treasury Regulations and Internal Revenue Service Rulings (Administrative Authority), and the various decisions of the trial courts and the appellate courts (Judicial Authority).

Secondary reference materials consist primarily of the various loose-leaf tax reference services. Additional secondary materials include periodicals, textbooks and treatises, published papers from tax institutes and symposia, and newsletters.

Reminder. While the editorial opinions included in the secondary reference materials are extremely knowledgeable and comprehensive, neither the IRS nor the courts will afford any authoritative weight to these opinions. One exception is Mertens, *Law of Federal Income Taxation*. This tax service is often quoted in judicial decisions.

Both primary and secondary sources can be accessed through one of the computer-assisted research services. These electronic data bases are updated daily and contain many source documents not normally found in the traditional tax library.

Primary Source Materials

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STATUTORY AUTHORITY

Statutory authority is primarily the Internal Revenue Code, but it also includes the U.S. Constitution and tax treaties. The authority of the U.S. government to raise revenue through a federal income tax is derived from the Sixteenth Amendment to the Constitution. Following ratification of this Amendment, the federal income tax law was enacted on October 3, 1913, and was made retroactive to March 1, 1913. Various other revenue acts were soon enacted. From these provisions, a loose and disconnected body of tax law emerged, making it virtually impossible to systematically engage in tax research. Accordingly, to facilitate a convenient form of organization, the various revenue acts that were legislated between 1913 and 1939 were codified into Title 26 of the United States Code, known as the Internal Revenue Code of 1939.

In subsequent years, with the growing complexity of the tax law, the Code was revised and rewritten as the Internal Revenue Code of 1954. During the next thirty-two years numerous tax laws were incorporated as amendments into the 1954 Code. Accordingly, the Economic Recovery Tax Act of 1981 (ERTA), the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and the Tax Reform Act of 1984 were included as part of the Internal Revenue Code of 1954, as amended. However, in 1986, as a result of the sweeping changes made by the Tax Reform Act of 1986, Congress changed the name of the tax law to the Internal Revenue Code of 1986.

Organization of the Code

The Internal Revenue Code of 1986 is comprised of nine subtitles (A-I), each consisting of individual, consecutively numbered chapters (1-98). The subtitles most commonly encountered by the tax practitioner that form the basis of this book are Subtitle A, “Income Taxes,” including Chapters 1–6, and Subtitle B, “Estate and Gift Taxes,” including Chapters 11–15. The remaining subtitles relate to topics such as employment taxes, excise taxes, alcohol and tobacco taxes, etc. Portions of Subtitle F, “Procedure and Administration,” including Chapters 61–80, are also examined in this text.

The major portion of the Code dealing with federal income tax is located in Chapter 1 of Subtitle A. This extremely important Chapter, entitled “Normal Taxes and Surtaxes,” is further divided into Subchapters (A–Z), and each Subchapter is then generally divided into parts and subparts, which are then divided into sections. These sections are typically referred to as “Code Sections.”

The following exhibit (Exhibit 1) provides a Table of Contents for Chapter 1 of Subtitle A of the Internal Revenue Code of 1986.

Exhibit 1. INTERNAL REVENUE CODE OF 1986—SELECTED TABLE OF CONTENTS

Subtitle A—Income Taxes

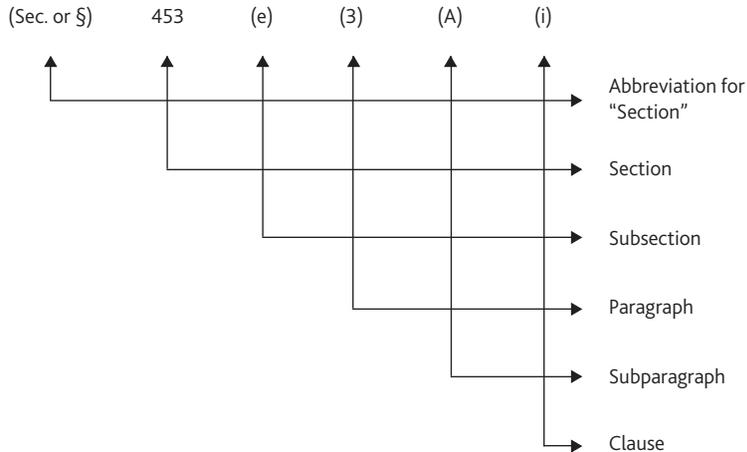
Chapter 1—Normal Taxes and Surtaxes

Subchapter		Beginning Section Number
A	Determination of Tax Liability	1
B	Computation of Taxable Income	61
C	Corporate Distributions and Adjustments	301
D	Deferred Compensation, Etc.	401
E	Accounting Periods and Methods of Accounting	441
F	Exempt Organizations	501
G	Corporations Used to Avoid Income Tax on Shareholders	531
H	Banking Institutions	581
I	Natural Resources	611
J	Estates, Trusts, Beneficiaries, and Decedents	641
K	Partners and Partnerships	701
L	Insurance Companies	801
M	Regulated Investment Companies and Real Estate Investment Trusts	851
N	Tax Based on Income from Sources Within or Without the United States	861
O	Gain or Loss on Disposition of Property	1001
P	Capital Gains and Losses	1201
Q	Readjustment of Tax Between Years and Special Limitations	1301
R	Election to Determine Corporate Tax on Certain International Shipping Activities Using Per Ton Rates	1352
S	Subchapter S: Tax Treatment of S Corporations and Their Shareholders	1361
T	Cooperatives and Their Patrons	1381
U	Designation and Treatment of Empowerment Zones, Enterprise Communities, and Rural Development Investment Areas	1391
V	Title 11 Cases	1398
W	District of Columbia Enterprise Zone [Stricken]	1400
X	Renewal Communities [Stricken]	1400E
Y	Short-Term Regional Benefits	1400L
Z	Opportunity Zones	1401

Citing the Code

Code Sections, particularly those found within Chapter 1 of Subtitle A, are cited by detailed reference to section, subsection, paragraph, and subparagraph. On occasion, the reference is even broken down to inferior subdivisions, such as a clause.

For example, Section 453(e)(3)(A)(i) might serve as an illustration.



Throughout this text, references to Code Sections are in the form explained above. Unless otherwise noted, references to Code Sections relate to the Internal Revenue Code of 1986. References to the 1939 or 1954 Code are specifically noted.

Congressional Committee Reports

Congressional Committee Reports are the minutes or official statements made by members of the House Ways and Means Committee, Senate Finance Committee, and Conference Committee on their intention in passing a specific piece of legislation. Unlike Treasury Regulations, Revenue Rulings, and Revenue Procedures issued by the IRS that are not binding on the courts, congressional intent expressed in Committee Reports very often is binding as these Committee Reports are regarded as very high authority. Committee Reports are published in the *Cumulative Bulletin* and by private publishers, including Wolters Kluwer and Thomson Reuters. Additionally, the *Congressional Record* reports floor debates in the House of Representatives and in the Senate.

Blue Books

As stated in the House Committee Report to the Revenue Reconciliation Act of 1989 (P.L. 101-239), “Blue Books” have been added to the list of authorities on which taxpayers may rely for interpretation of the tax law (see discussion at ¶2035). Blue Books are prepared by the Staff of the Joint Committee on Taxation for major tax acts. Although Blue Books are generally based on Committee Reports for an act, they often contain additional interpretative information. The IRS has used this interpretative information in numerous rulings as the basis for a particular position. Blue Books are published electronically by Wolters Kluwer, CCH.

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ADMINISTRATIVE AUTHORITY

As a result of congressional authority, the Secretary of the Treasury or a delegate, the Commissioner of Internal Revenue, is authorized to provide administrative interpretation of the tax law. As noted in Section 7805(a):

Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary or his delegate shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.

Treasury Regulations

Treasury Regulations have generally been classified into three broad categories: legislative, interpretative, and procedural. Legislative regulations are those which are issued by the Treasury under a specific grant of authority by Congress to prescribe the operating rules for a statute. Generally, legislative regulations have the force and effect of law. Interpretative regulations are issued pursuant to the general rule-making power granted to the Commissioner under Code Sec. 7805(a) and provide taxpayers with guidance in order to comply with a statute. Although interpretative regulations do not have the force and effect of law, the courts customarily accord them substantial weight. Procedural regulations are considered to be directive

rather than mandatory and, thus, do not have the force and effect of law. They explain the IRS's position and provide the mechanics for compliance with the various federal income tax laws, as for example the making and filing of tax elections.

The Regulations are organized in a sequential system consistent with the Code. Additionally, the Regulations are prefixed by a number which designates the applicable area of taxation to which they refer. For example, following are the more important Regulation prefixes:

Part	1.	Final income tax regulations
Part	20.	Estate Tax
Part	25.	Gift Tax
Part	31.	Withholding taxes
Part	301.	Procedure and Administration
Part	601.	Statement of Procedural Rules

Accordingly, an "Income Tax" Regulation relating to Section 453 of the Code would be cited as Reg. §1.453, followed by a dash, then the sequential number of issue, with subparts added for more detailed reference.

Proposed Regulations

New Regulations and changes to existing Regulations usually are issued in proposed form before they are finalized. During the interval between the publication of the Notice of Proposed Rulemaking and finalization of the Regulation, taxpayers and other interested parties are permitted to file objections or suggestions. Proposed Regulations generally do not have the same weight as Temporary Regulations. Tax law publishers, such as Wolters Kluwer and Thomson Reuters, provide a comprehensive listing of these Proposed Regulations, showing the date of their proposal and date of adoption and also publish the text of the Proposed Regulations.

Temporary Regulations

Sometimes Temporary Regulations are issued by the Treasury Department. Their purpose is to provide interim guidance regarding recent tax legislation until final Regulations are adopted. Temporary Regulations (issued after November 20, 1988) must also be issued as Proposed Regulations and must undergo public and administrative scrutiny during a comment period as do Proposed Regulations. Every Temporary Regulation issued after November 20, 1988, will expire three years from the date of issuance. Prior to its expiration, a Temporary Regulation has the same weight as a Final Regulation.

Final Regulations

Finalized Regulations are published in the *Federal Register* as are the Proposed Regulations and Temporary Regulations. All tax Regulations are also published in the *Internal Revenue Bulletin*. Final Regulations and Temporary Regulations are designated as Treasury Decisions (T.D.s) and are assigned a sequential number in order of issuance for the year. The effective date and date of adoption are significant.

Final Regulations as well as Proposed and Temporary Regulations are reproduced in major tax services.

Revenue Rulings and Revenue Procedures

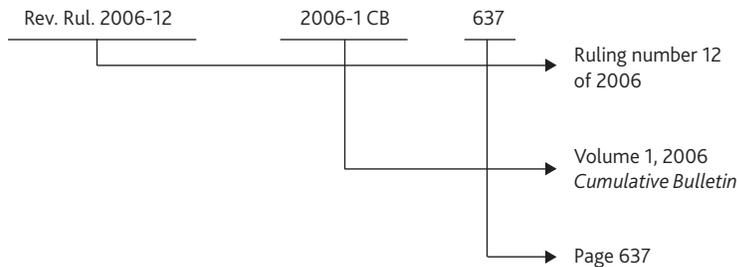
Revenue Rulings, the official pronouncements of the IRS, are similar to Treasury Regulations in that they represent administrative interpretations of the internal revenue laws. Revenue Rulings are issued with respect to a particular issue and insure that this issue will be handled uniformly throughout the United States, both in planning and in auditing. Revenue Rulings, however, do not have the same authoritative weight as regulations. Every issue of the *Internal Revenue Bulletin* includes the following statement:

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

Revenue Procedures are published official statements of procedure issued by the IRS that affect either the rights or the duties of taxpayers or other members of the public under the Internal Revenue Code and

related statutes and regulations. Revenue Procedures usually reflect the contents of internal management documents. A statement of the IRS position on a substantive tax issue will not be included in a Revenue Procedure. Revenue Procedures are directive and not mandatory.

Both Revenue Rulings and Revenue Procedures are originally published in the weekly issues of the *Internal Revenue Bulletin*, printed by the U.S. Government. However, through 2008, on a semiannual basis, the bulletins were compiled, reorganized by Code section classification, and published in a bound volume designated the *Cumulative Bulletin*. Once published in the *Cumulative Bulletin*, a Revenue Ruling or Revenue Procedure received a permanent citation as shown below:



After 2008, a Revenue Ruling, such as Rev. Rul. 2014-12, would be cited as Rev. Rul. 2014-12, 2014-15 I.R.B. 923. This is the 12th Rev. Rul. of 2014 in the 15th weekly issue of the *Internal Revenue Bulletin* on page 923. The citation for a Revenue Procedure is identical, except the abbreviation “Rev. Proc.” is used in place of “Rev. Rul.”

Other Administrative Pronouncements

In addition to substantive rulings (Revenue Rulings and Revenue Procedures) published to promote a uniform application of the tax laws, the IRS issues communications to individual taxpayers and IRS personnel in three primary ways: (1) Private Letter Rulings, (2) Determination Letters, and (3) Technical Advice Memoranda. These documents are part of the IRS rulings program, which is discussed in detail at ¶2225.

Digests of Private Letter Rulings may be found in *Private Letter Rulings* (published by Thomson Reuters), Bloomberg BNA *Daily Tax Reports*, and Tax Analysts *Tax Notes*. *IRS Letter Rulings Reports* (published by Wolters Kluwer) contains both digests and the full texts of all Private Letter Rulings. These documents may also be accessed electronically through Wolters Kluwer's IntelliConnect® or CCH® AnswerConnect. Determination Letters are not published; however, the IRS is now required to make individual rulings available for public inspection. Technical Advice Memoranda are available similar to Private Letter Rulings.

IRS List of Substantial Authority for Taxpayer Reliance

The IRS has provided guidance on (1) adequate disclosure of items and positions taken on tax returns for purposes of avoiding the accuracy related penalty for understatement of tax, Rev. Proc. 94-36, 1994-1 CB 682, and (2) a listing of substantial authority that may be relied on to avoid imposition of that penalty, Reg. §1.6662-4(d)(3). In addition, the IRS issues a list of positions for which there is not substantial authority. This list must be issued by the Secretary of the Treasury (and revised not less frequently than annually) and published in the *Federal Register*. Code Sec. 6662(d)(3).

The purpose of the list is to assist taxpayers in determining whether a position should be disclosed in order to avoid the substantial understatement penalty. House Committee Report, Revenue Reconciliation Act of 1989. Thus, a taxpayer could choose to disclose that position to avoid the imposition of the accuracy-related penalty. However, inclusion of a position on this list is not conclusive as to whether or not substantial authority exists with respect to that position.

Prior to 1990, the list of substantial authority was restricted to: (1) the Internal Revenue Code, (2) final and temporary regulations, (3) court cases, (4) IRS administrative pronouncements, (5) tax treaties, and (6) congressional intent reflected in committee reports accompanying legislation. Reg. §1.6661-3.

The list of substantial authority now includes (1) the Joint Committee on Taxation's General Explanation of tax legislation (i.e., the “Blue Book”); (2) proposed regulations; (3) information or press releases; (4) notices, announcements, and other similar documents published in the *Internal Revenue Bulletin*; (5) private letter rulings; (6) technical advice memoranda; (7) actions on decisions; and (8) general counsel memoranda. Reg. §1.6662-4(d)(3)(iii). “Authority” does not include conclusions reached in treatises, legal periodicals, and opinions rendered by tax professionals.

With respect to the test for “substantial authority,” the IRS continues to apply the principle that there is substantial authority for the tax treatment of an item only if the weight of authorities supporting such treatment is substantial in relation to the weight of authorities supporting contrary tax treatment. The type of document providing the authority affects the weight to be accorded an authority. Reg. §1.6662-4(d)(3)(i) and (ii).

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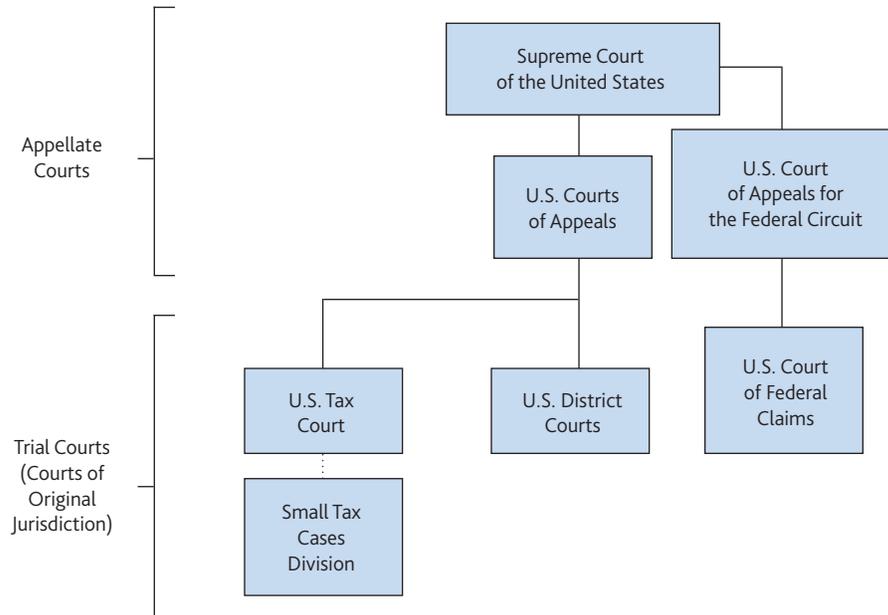
JUDICIAL AUTHORITY

The ultimate test in the interpretation of the Code, in determining the validity of Regulations, and in applying the “law” to the facts of a given case takes place in the courts. The court system provides the taxpayer with the opportunity to test before a neutral forum both the position taken by the taxpayer and that taken by the Commissioner with respect to any issue. The courts historically have played a substantial role in the interpretation, application, and enforcement of the tax law. Exhibit 2 outlines the trial and appellate court alternatives for federal tax litigation.

Trial Court System

There are three tribunals that have original jurisdiction to hear and decide tax cases arising under the Internal Revenue Code. A taxpayer can file a petition with the United States Tax Court, in which event assessment and collection of the deficiency will be stayed until the Tax Court’s decision becomes final. But the taxpayer may, if he or she prefers, pay the deficiency and then sue for a refund in a U.S. District Court or the United States Court of Federal Claims.

Exhibit 2. JUDICIAL APPEALS ALTERNATIVES



U.S. Tax Court

The United States Tax Court’s jurisdiction is limited to cases concerning the Internal Revenue Code, and would include income tax law, estate tax law, excess profits, but not employment taxes. The Tax Court consists of 19 judges appointed by the President for 15-year terms. It is a special court whose jurisdiction is limited almost exclusively to litigation under the Internal Revenue Code. Prior to 1943, the Tax Court was known as the Board of Tax Appeals. Although the Tax Court is a single court located in Washington, D.C., hearings are held in several cities throughout the nation, usually with only a single judge present who submits his opinion to the chief judge. Only rarely does the chief judge decide that a full review is necessary by all 19 judges.

Decisions of the Tax Court are issued as either “regular” or “memorandum” decisions. “Regular” decisions are those which require an interpretation of the law. In theory, “memorandum” decisions concern only well-established principles of law and require only a determination of facts. However, on occasion, the courts have cited “memorandum” decisions. Hence, both kinds of Tax Court decisions should be regarded as having precedent value.

Viewing itself as a national court hearing cases from all parts of the country, for many years the Tax Court had followed a policy of deciding cases on what it thought the result should be. The Tax Court has abandoned its “national law” view, under which it applied its own rule on a nationwide basis without limitation by rules of the circuits in which tax controversies arose. The Tax Court has adopted the position that it will follow precedents of the Circuit Court of Appeals of jurisdiction (known as the *Golsen* rule). As a result, it is entirely possible that the Tax Court will rule differently on identical fact patterns for two taxpayers residing in different circuits in the event of inconsistent holdings between the various Circuit Courts.

The Tax Court is the only court to which a taxpayer may take a case without first paying the tax. Consequently, taxpayers resort to it in many instances; and because it is a court of limited jurisdiction dealing primarily with tax matters, its decisions are accorded considerable weight. This is particularly true of decisions in which the Commissioner of Internal Revenue has acquiesced.

Historically, the policy of the IRS has been to announce in the *Internal Revenue Bulletin* the determination of the Commissioner to acquiesce or not acquiesce in most of the regular decisions of the Tax Court. An announcement of acquiescence (cited Acq.) indicates that the IRS has accepted the conclusion reached in the case but not necessarily the reasons given by the court in its opinion. An announcement of nonacquiescence (cited Nonacq.) usually means that the IRS will continue to litigate the issue if it arises again. Since 1991, the IRS has indicated acquiescences or nonacquiescences for memorandum decisions of the Tax Court as well as for decisions of other courts. An announcement of acquiescence is not legally binding on the IRS and thus can be retroactively withdrawn at any time. If a case is being relied upon, it is important to determine whether it has been acquiesced in by the Commissioner, the extent of the acquiescence (if any), and whether the initial acquiescence may have been withdrawn at a later date.

Additionally, a procedure is used in the Tax Court for cases involving disputes of \$50,000 or less. The taxpayer who uses the “small tax case” procedures should be aware that the decision may not be appealed. The advantage to using this procedure is the fact that the formal procedures of the Tax Court are relaxed and made informal.

Judicial Citations—Tax Court Regular Decisions. Regular and memorandum decisions of the Tax Court are reported separately. The Government Printing Office publishes bound volumes of only the regular decisions under the title *United States Tax Court Reports* (cited TC).

Permanent Citation: *Microsoft Corporation*, 115 TC 228 (2000).

Thus, the decision appears in Volume 115 of the *United States Tax Court Reports*, page 228, issued in 2000.

Because there is usually a time lag between the date a decision is rendered and the date it appears in bound form, a temporary citation is used until a permanent citation can be substituted.

Temporary Citation: *Gilda A. Petrane v. Commissioner*, 129 TC —, No. 1 (July 2007).

Thus, the temporary citation identified that the decision appeared in Volume 129 of the *United States Tax Court Reports*, page left blank, 1st regular decision issued by the Tax Court since Volume 128 was issued. Once Volume 129 was issued, the permanent citation incorporating the page was substituted and the number of the case is not used.

Permanent Citation: *Gilda A. Petrane v. Commissioner*, 129 TC 1 (2007).

Judicial Citations—Tax Court Memorandum Decisions. The government provides only photocopies of the memorandum decisions. However, memorandum decisions are published by both Wolters Kluwer and Thomson Reuters in bound volumes separate from those in which they report other tax cases. The Tax Court memorandum decisions are published by Wolters Kluwer under the title *Tax Court Memorandum Decisions* (cited TCM), while the Thomson Reuters series is called *Thomson Reuters Memorandum Decisions* (cited TC Memo).

Wolters Kluwer Citation: *Harvey D. Perry, Jr. v. Commissioner*, 84 TCM 1, T.C. Memo. 2002-165 (2002).

Thomson Reuters Citation: *Harvey D. Perry, Jr. v. Commissioner*, 2002 TC Memo ¶2002-165.

Although presented in a different way, the reference in both citations indicates that the memorandum decision was the 165th memorandum decision issued by the Tax Court in 2002.

Both regular and memorandum decisions for years prior to 1943 were published by the government under the title *United States Board of Tax Appeals Reports*.

Citation: *J.E. Burke*, 19 BTA 743 (1930).

Thus, the decision appears in Volume 19 of the *United States Board of Tax Appeals Reports*, page 743, issued in 1930.

U.S. District Courts

The U.S. District Courts were the main courts of original jurisdiction for tax cases prior to the establishment of the Board of Tax Appeals which later became the Tax Court. A taxpayer can take a case to the U.S. District Court for the district in which the taxpayer resides only if the taxpayer first pays the tax deficiency assessed by the IRS and then sues for a refund. Each state has at least one District Court in which both tax and nontax litigation are heard. Only in a District Court can one obtain a jury trial, and even there a jury can decide only questions of fact—not those of law.

Judicial Citations—U.S. District Courts Decisions. Published decisions of the U.S. District Courts, including both tax and all other types of litigation, are reported in the *Federal Supplement* (cited F.Supp.) published by West Publishing Company. In addition, the tax decisions of the District Courts are also published in the two special tax reporter series, Wolters Kluwer *United States Tax Cases* (cited USTC) and Thomson Reuters *American Federal Tax Reports* (cited AFTR).

West Citation: *Eugene B. Glick*, 96 F.Supp. 2d 850 (DC Ind., 3/14/00).

The order of citation is volume number, reporter, page number.

Wolters Kluwer Citation: *Eugene B. Glick*, 2000-1 USTC ¶50,372 (DC Ind., 3/14/00).

Paragraph reference rather than a page number gives the location of the case.

Thomson Reuters Citation: *Eugene B. Glick*, 86 AFTR 2d 2000-5083 (DC Ind., 3/14/00).

The prefix “2000” preceding the page number indicates the year the case was decided.

U.S. Court of Federal Claims

The U.S. Court of Federal Claims is a single court consisting of 16 judges appointed by the President. The court resides in Washington, D.C. and the decision to travel is made on a case-by-case basis and is heard by the trial judge to whom the case has been assigned. Prior to October 29, 1992, the court was known as the U.S. Claims Court, and prior to October 1, 1982, the court was known as the U.S. Court of Claims whose decisions were appealed directly to the Supreme Court.

In federal tax matters, the U.S. Court of Federal Claims has concurrent jurisdiction with the U.S. District Courts. The Court of Federal Claims is a constitutional court and has jurisdiction in judgment on any claim against the United States which is:

1. Based on the Constitution
2. Based on any Act of Congress
3. Based on any regulation of an executive department

Judicial Citations—U.S. Court of Federal Claims Decisions. Since 1992, decisions of the Court of Federal Claims have been reported by West Publishing Company in the *Federal Claims Reporter* (cited FedCl). The decisions of the Claims Court from October 1982 until 1992 were reported by West Publishing Company in a series designated the *U.S. Claims Court Reporter* (cited ClCt). Decisions of the predecessor Court of Claims were published by the U.S. Government Printing Office in a separate series of volumes entitled the *U.S. Court of Claims Reports* (cited CtCl). The decisions of the predecessor Court of Claims were also published by West Publishing Company from May 1960 through September 1982 in the *Federal Reporter 2d Series* (cited F.2d), while decisions between 1932 and 1960 were reported in the *Federal Supplement* (cited F.Supp.).

In addition, the tax decisions of the Court of Federal Claims (and the predecessor Claims Court and Court of Claims) are also published in the Wolters Kluwer *United States Tax Cases* (cited USTC) and Thomson Reuters *American Federal Tax Reports* (cited AFTR).

West Citation:	<i>Katz v. U.S.</i> , 22 ClCt 714 (ClCt, 1991). <i>Scott v. U.S.</i> , 354 F.2d 292 (CtCl, 1965). <i>Betz v. U.S.</i> , 40 Fed Cl 286 (Fed Cl, 1998).
Wolters Kluwer Citation:	<i>Katz v. U.S.</i> , 91-1 USTC ¶50,289 (ClCt, 1991). <i>Scott v. U.S.</i> , 66-1 USTC ¶9169 (CtCl, 1965). <i>Betz v. U.S.</i> , 98-1 USTC ¶50,199 (Fed Cl, 1998).
Thomson Reuters Citation:	<i>Katz v. U.S.</i> , 67 AFTR2d 91-733 (ClCt, 1991). <i>Scott v. U.S.</i> , 16 AFTR2d 6087 (CtCl, 1965). <i>Betz v. U.S.</i> , 81 AFTR2d 98-611 (Fed Cl, 1998).

Appeals Court System

If either the taxpayer or the IRS is not satisfied with a trial court decision, an appellate court may be asked to review that decision. There are two levels of courts that handle appeals from the three courts of original jurisdiction. Appeals may be taken to the United States Courts of Appeals of jurisdiction or the U.S. Court of Appeals for the Federal Circuit. As a final step, the controversy may be appealed from the appellate courts to the Supreme Court.

The authority of decisions of all Courts of Appeals stands above that of the Tax Court, a District Court, or the Court of Federal Claims. The United States Supreme Court is, of course, the final authority as to what a statute means or as to any question of federal law.

U.S. Circuit Courts of Appeals

Appeals in tax cases may be taken from the U.S. District Courts or the Tax Court by either the IRS or the taxpayer to the United States Courts of Appeals of jurisdiction. Jurisdiction is based upon the location of the taxpayer's residence. There are eleven numbered circuits and additional unnumbered circuits for the District of Columbia Circuit and the Federal Circuit. See Exhibit 3.

Normally, a Circuit Court's review, made by a panel of three judges is limited to the application of law—not the determination of facts. In this process, the appellate court of any circuit is obligated to follow the findings of the Supreme Court but not those of the other Circuit Courts. When conflicts develop between circuits, District Courts of each individual circuit are required to follow any precedent set by the appellate court of their own circuit (i.e., the Circuit Court to which their decisions may be appealed). Also, as noted earlier, pursuant to the *Golsen* rule, the Tax Court follows the policy of observing precedent set by the appellate court of the circuit in which the taxpayer resides. In this way, consistency in the application of law is maintained between the Tax Court and the District Court of jurisdiction even though there may exist an inconsistency in the law's application to taxpayers residing in various circuits.

Judicial Citations—U.S. Circuit Courts of Appeals Decisions. All decisions, both tax and nontax, of the various Circuit Courts are published by West Publishing Company in the *Federal Reporter* including 2nd and 3rd Series (cited F.2d and F.3d). In addition, tax decisions of the Circuit Courts are also contained in Wolters Kluwer's *United States Tax Cases* (cited USTC) and Thomson Reuters *American Federal Tax Reports* (cited AFTR). Citations indicate not only the volume and page, but also the particular court.

West Citation: *Diane S. Blodgett v. Commissioner*, 394 F.3d 1030 (CA-8, 2005).

Wolters Kluwer Citation: *Diane S. Blodgett v. Commissioner*, 2005-1 USTC ¶50,146 (CA-8, 2005).

Thomson Reuters Citation: *Diane S. Blodgett v. Commissioner*, 95 AFTR2d 2005-448 (CA-8, 2005).

U.S. Court of Appeals for the Federal Circuit

On October 1, 1982, the seven judges of the Court of Claims and the five judges of the Court of Customs and Patent Appeals became the 12 judges of the newly created Court of Appeals for the Federal Circuit (CA-FC). The IRS and taxpayers appeal decisions from the U.S. Court of Federal Claims to this court. The court is empowered to sit in various locations around the country and can be expected to make an effort to hold sessions in the major cities where its business arises.

U.S. Supreme Court

Appeals to the U.S. Supreme Court from the Circuit Courts of Appeals and the Court of Appeals for the Federal Circuit may be made generally by a petition for certiorari. The Supreme Court may grant certiorari at its discretion; further, the Supreme Court is not required to give reasons for its refusal to review. However, past experience has shown that the Court generally grants certiorari only if:

1. The issue has resulted in conflicting decisions in the Circuit Court of Appeals or
2. The issue involved raises an important and continuing problem in the administration of the tax law.

If the Supreme Court declines to review the decision, it will formally deny the petition for certiorari.

Judicial Citations—U.S. Supreme Court Decisions. All Supreme Court decisions are published by the U.S. Government Printing Office in the *United States Supreme Court Reports* (cited U.S.), West Publishing Co. in the *Supreme Court Reporter* (cited S.Ct.), and the Lawyer's Co-Operative Publishing Co. in the *United States Reports, Lawyer's Edition* (cited L.Ed.). Like all other federal tax cases (except those rendered by the U.S. Tax Court), tax-related Supreme Court decisions are reported by Wolters Kluwer in *United States Tax Cases* (cited usTC) and Thomson Reuters in *American Federal Tax Reports* (cited AFTR).

GPO Citation: *Drye, Jr. v. U.S.*, 528 U.S. 49 (1999).

West Citation: *Drye, Jr. v. U.S.*, 120 S.Ct. 474 (1999).

Lawyer's Ed. Citation: *Drye, Jr. v. U.S.*, 145 L.Ed.2d 466 (1999).

Wolters Kluwer Citation: *Drye, Jr. v. U.S.*, 99-2 usTC ¶51,006 (1999).

Thomson Reuters Citation: *Drye, Jr. v. U.S.*, 84 AFTR2d 99-7160 (1999).

Secondary Source Materials

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ANALYSIS OF TAX LAW SOURCES

The voluminous bulk and complexity of our tax law make it extremely difficult to systematically research all of the statutory and administrative provisions associated with a given set of tax issues. The problem is further compounded when one also attempts to analyze, evaluate, and update the leading court cases that impact on these issues. Fortunately, secondary reference materials provide a convenient cross-referenced and continuously updated road map to guide the practitioner in the complicated task of wading through a growing maze of primary tax authority.

Tax Research Services

There are various tax research services that are published with the specific purpose of providing comprehensive reference information on the ever-changing tax law and on-going developments in administrative rulings and case decisions. The use of any particular tax research service is best described in materials made available to users by the representatives of the tax research services. However, there are some general points to be made on the use of these tax research services. First, it is important to check for the latest developments on any topic, issue, or case being researched under a specific statute, regulation, or ruling. Second, editorial analysis, be it a synopsis or digest, provided by the tax research services for case decisions or administrative rulings is an interpretative commentary. Such editorial commentary, no matter how knowledgeable, is not intended to be a substitute for the authoritative primary source document.

Internet Based Research Systems

The role of electronic research systems cannot be overstated. To say that most print materials are also available online does not describe the increasingly integrated and comprehensive search capabilities of online research systems. Users can access computerized tax law data banks with their personal computers by using various tax research publisher's online internet based research systems. Whatever format the researcher uses, all data bases are now integrated with primary and secondary source materials from which the researcher can retrieve full text documents or search for key words or phrases. Publishers' computerized tax research systems can also be used to access citation information to locate all judicial decisions that have cited a particular decision or statute. These online citators are more current than is possible in print format.

Wolters Kluwer Tax Products on the Internet

As an example of an electronic tax research system, Wolters Kluwer's IntelliConnect® offers a completely integrated suite of tax research materials including primary source documents, i.e., the Internal Revenue Code, Treasury Regulations, Revenue Rulings, tax case decisions, administrative guidance and more. In addition to primary source material, Intelliconnect includes editorial analysis and content including fully searchable versions of most Wolters Kluwer products including the *Standard Federal Tax Reporter*. The *Standard Federal Tax Reporter* is a comprehensive Federal tax resource and the organization of this resource is described more fully below, following this discussion of internet-based research systems.

In addition to the *Standard Federal Tax Reporter*, Wolters Kluwer research products online include *Practical Tax Expert*, which provides tax research, focusing on the topics that matter most to the small-firm preparer, such as individual and small business taxation. It provides practical explanations of tax law, including examples, comments, planning notes and compliance notes, as well as a variety of tools and practice aids. It includes discussions of source material including the Internal Revenue Code, Treasury Regulations, Rulings and other IRS material, all properly cited and linked for further research.

Practical Tax Professional provides tax research, focusing on the topics that matter most to the small-firm practitioner, such as individual and small business taxation, while also providing coverage of a full range of federal tax research issues.

IntelliConnect® includes many other tax research resources and is organized by overall category including Federal Tax, State Tax, Financial and Estate Planning, Accounting, etc. Within each category, various resources and products are available for research and practice assistance. The electronic format of the internet-based tax research services provides an opportunity to include automated tools and calculators, which makes the tax research systems ideal not only for tax research but also to find quick answers and practice aids. IntelliConnect® includes Smart Charts on many topics as well as calculators, decision tools and more. In addition to these features, the internet-based research systems provide an opportunity for the most current information that can be updated more frequently than the print resources. IntelliConnect® includes the Wolters Kluwer daily news service, Tax Day, current journals and newsletters, the latest Wolters Kluwer briefings on major tax developments, a Case Citator that is current to date and many other electronic products including Wolters Kluwer's well-regarded Law, Explanation and Analysis books on current legislation. Subscribers to internet-based tax research systems receive log in information providing access to the full array of resources anytime and virtually anyplace.

In addition to the internet-based tax research systems, new applications are being continuously developed by most tax research services. Wolters Kluwer offers tax research information specifically designed for mobile devices including iPhones and iPads. Some of these applications include CCH Mobile, eBooks, current journals, and newsletters.

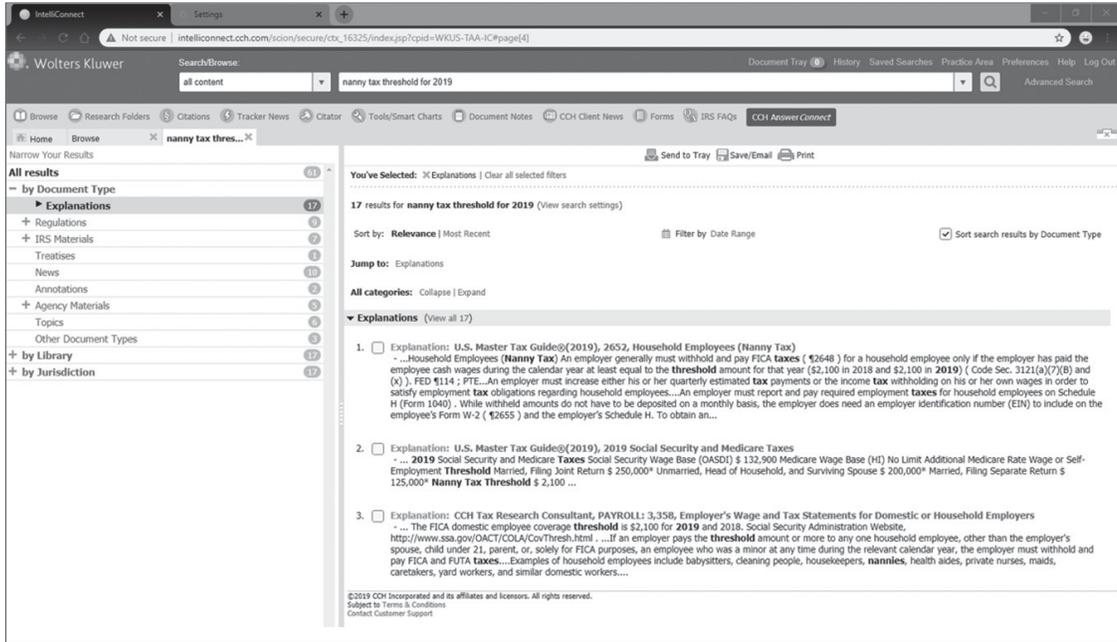
It must be noted here that despite the encompassing nature of electronic research and search methods, students are well advised to have a firm understanding of the nature, basis and authority of the documents they are using to support a tax position and how the various sources of authority are interrelated and linked. Therefore, following the internet screen shots below on the Wolters Kluwer internet-based system, a more detailed description of the organization of various tax research products is included with the understanding that these original research resources are still available in print format and are now also available through the electronic research systems.

Complete, current, and reliable tax information is on the Internet from Wolters Kluwer at <https://taxna.wolterskluwer.com>. Many tax research products are also available on mobile applications.

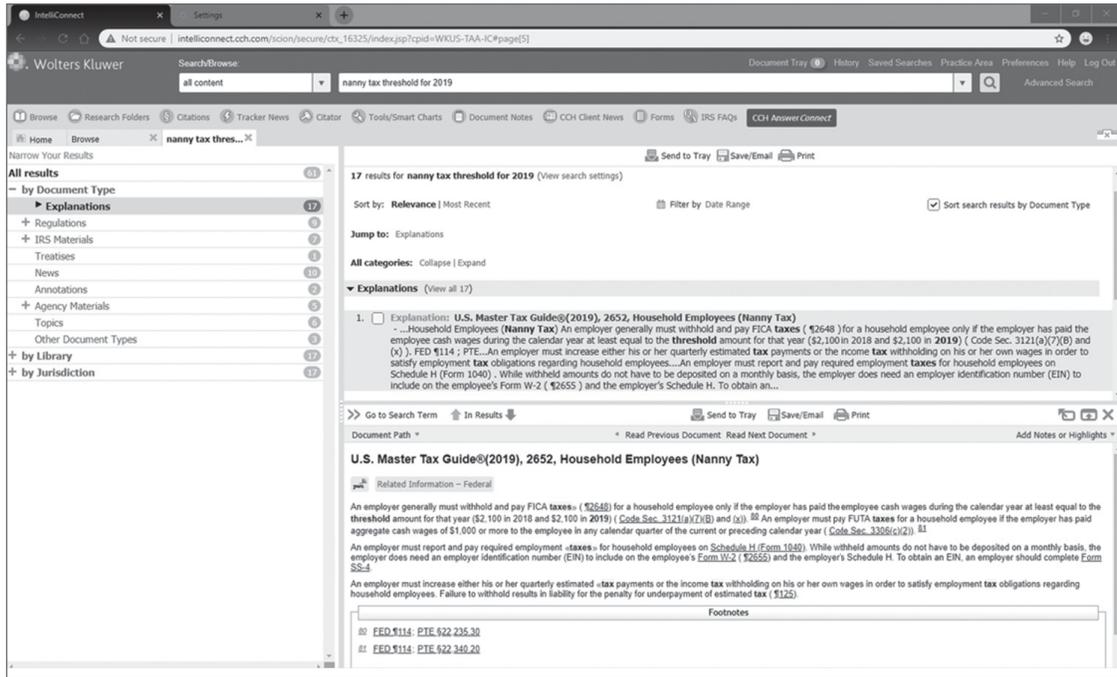
Researching a Topic

In the Internet browser's Address bar, go to <http://intelliconnect.ccb.com>. You will be taken to the Log In page where you can enter your User ID and Password in order to reach the IntelliConnect® home page where you can initiate a search.

Type your search term or phrase in the navigation bar at the top of the screen. For purposes of illustration look for the “nanny tax threshold for 2019” and click Go. On the left side of the screen you can choose to Narrow Your Results. For this example click the plus next to “by Document Type” and when the list expands, click on Explanations.



This screen displays the results that best match your query. Click on the first document and the screen will split so that the document will appear at the bottom.



Review the document to see if it contains the information with respect to the nanny tax threshold for 2018. In this example the first item listed contains information on the nanny tax threshold for 2019. The nanny tax remains at \$2,100 for 2019. Cash amounts paid for a nanny are not subject to FICA taxes if less than \$2,100 during 2019.

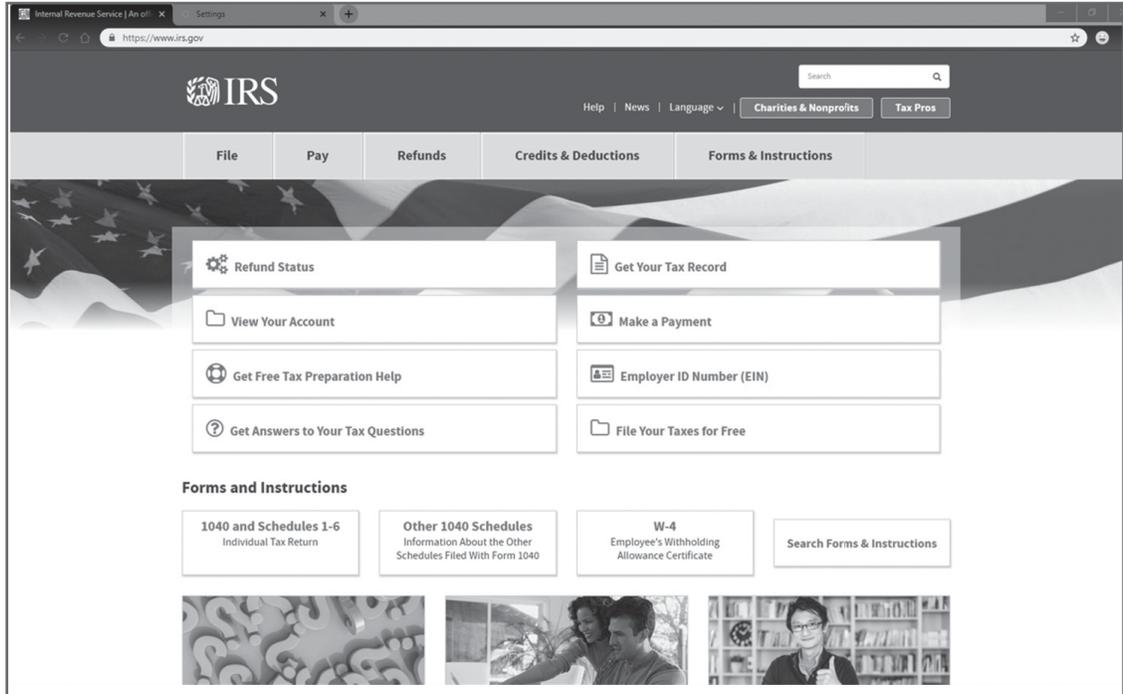
Once you have found the information you were searching for you might want to email it to yourself. There are several options in the middle of the Tri-screen. Click on Save/Email and choose Email document from the drop down list. Enter the required information and click send.

The screenshot shows the Wolters Kluwer online tax research system. The search results for "nanny tax threshold for 2019" are displayed. A modal window titled "Email Document(s)" is open, allowing the user to send the selected document. The modal includes fields for "To", "CC", "Bcc", "Reply To", "From", "Subject", and "Message". The "Send documents as" options are "Attached PDF", "Links", and "Text within body of email". The "Send" button is highlighted.

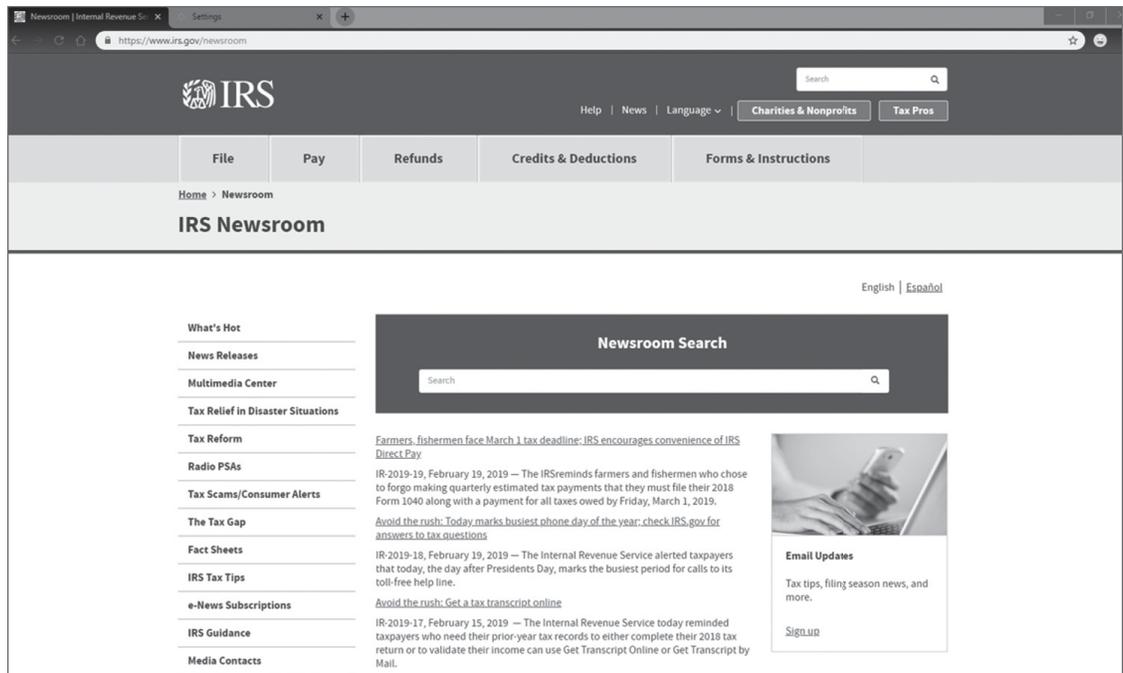
The only way to become proficient at using an electronic data base is through practice and experience. The tax student is encouraged to experiment with Wolters Kluwer's online tax research system by searching for the answer to a tax question. Once the art of electronic searching is mastered, it will be obvious how much more comprehensive and efficient it is than a traditional paper search. For example, what authority can you find to justify a deduction for home office expense by a college professor? What authority can you find that would deny the deduction?

IRS Homepage

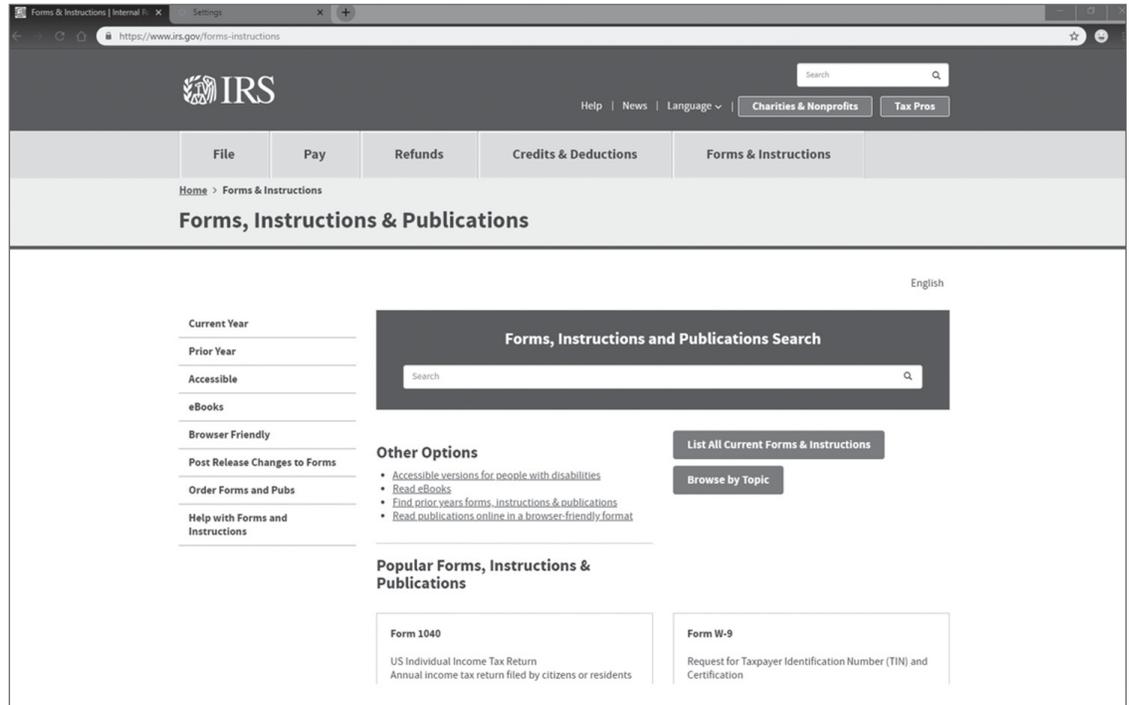
The IRS homepage on the World Wide Web (<http://www.irs.gov>) went online on January 8, 1996. During its first 24 hours of operation, close to one million "hits" were recorded. Features on the IRS homepage include the following: Refund Status, Get Free Tax Preparation Help, Get Your Tax Refund, Make a Payment, Forms and Instructions, News, and Help.



One very useful aspect of the IRS homepage is the ability to retrieve the latest in tax news. In the “search” box type in “newsroom” to access information on important topics (as shown below). From the IRS homepage, click on News.



Across the top of the page the tabs provided are: File, Pay, Refunds, Credits & Deductions, and Forms & Publications. Besides retrieving tax news from the IRS, tax forms and publications may be downloaded. The fifth item listed across the top of the page is Forms and Publications. By clicking on Forms and Publications, the Forms and Publications page appears. All IRS tax forms may be retrieved from this site. Please note that forms and publications from prior years are available back to 1992.

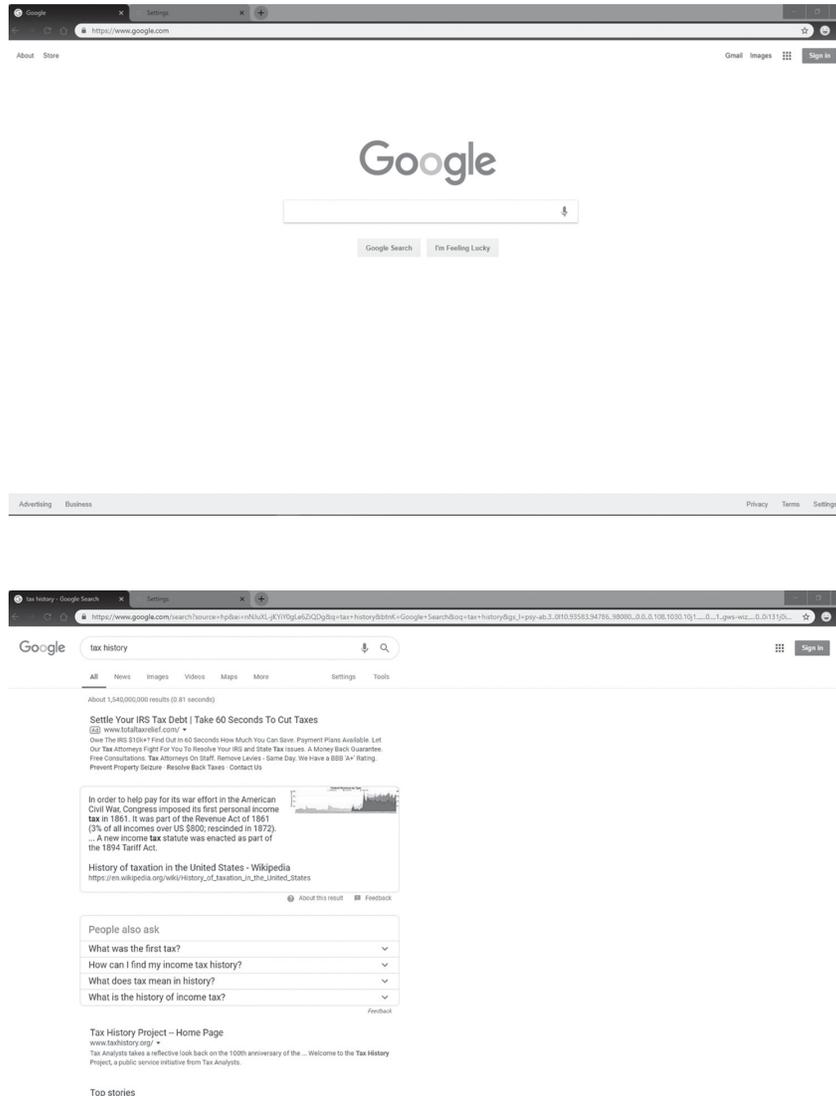


By clicking on the “List All Current Forms & Instructions” link, <http://apps.irs.gov/app/picklist/list/formsPublications.html> appears. All IRS tax forms may be retrieved from this site.



Searching the Internet

A good way to search the Internet is by using search engines. A search engine allows you to type in a term or phrase which describes your area of interest. For example, open your Internet browser's search screen and type in the phrase "tax history." Once the search is complete, all of the finds are listed and linked to millions of useful sources (sample screens shown below).



Standard Federal Tax Reporter, Wolters Kluwer

Wolters Kluwer publishes loose-leaf reporters in all major federal tax areas. These reporters are also available on Wolters Kluwer's tax research system, IntelliConnect®. The most comprehensive of these tax reference services is the *Standard Federal Tax Reporter*, frequently referred to as the *Standard* or *Fed*. Other specialized tax services include the *Federal Excise Tax Reporter* and the *Federal Estate and Gift Tax Reporter*.

The *Standard Reporter* consists of 24 coordinated and cross-referenced loose-leaf volumes that provide comprehensive coverage of the income tax law. The service also provides weekly supplements presenting current federal court decisions, new rulings, and changes in the law or regulations, digests of Tax Court decisions, as well as reviews of the significant legislative changes, and editorial comments which provide tax planning ideas related to current developments.

The major portion of the *Standard*, Volumes 1 through 18, compiles the legislative, administrative, and judicial aspects of the income tax law. The volumes are arranged in Code Section order and reflect the current income tax law and accompanying related regulatory texts (including proposed amendments to the Regulations) as well as legislative Committee Reports, followed by “Explanations” and supplemented with digests of associated administrative rulings and judicial decisions. Volume 19, “New Matters,” is used to retain current developments such as digests of Tax Court decisions, full texts of rulings, current tables of decisions and rulings, and the Supreme Court Docket.

The *Standard* also includes the “U.S. Tax Cases Advance Sheets” Volume in which are reported the full texts of new income tax decisions from the federal courts, including the U.S. Supreme Court and the U.S. Court of Federal Claims. In the three Internal Revenue Code Volumes may be found the current internal revenue statutes. The Index Volume leads to the basic contents by subject through the Topical Index and also features a tax calendar, rate tables and tax rate schedules, tax planning information, checklists, and special tables.

United States Tax Reporter, Thomson Reuters

United States Tax Reporter, published by Thomson Reuters, consists of 18 coordinated loose-leaf volumes organized by Code sections and updated on a weekly basis. The service is similar to Wolters Kluwer’s and also includes a two-volume Internal Revenue Code, a seven-volume Citator, a one-volume Index, a one-volume Table of Cases, Rulings, and Tax Tables, a Recent Developments volume, an Advance Sheets volume for AFTR2d cases and a volume of proposed amendments to Federal Tax Regulations. Thomson Reuters also publishes loose-leaf tax services for excise taxes and for estate and gift taxes. This service is included in the Thomson Reuters Checkpoint online service.

Mertens, Law of Federal Income Taxation, Thomson West

Mertens’ *Treatise on the Law of Federal Income Taxation*, published by Thomson West, is an intensive, annotated work, providing excellent in-depth discussions of general concepts of tax law. However, unlike services such as those of Wolters Kluwer and Thomson Reuters, Mertens is not generally used as a comprehensive, self-contained reference service. Rather, it is typically regarded as a useful complement to the traditional reference services.

Tax Management Portfolios, Bloomberg BNA

Tax Management Portfolios, published by Bloomberg BNA, is a useful supplement to a tax library. Each portfolio ranges in length from 50 to 200 pages and deals exclusively with a special tax topic, covering Code, Regulations, reference to primary authorities, and extensive editorial discussion, including numerous tax planning ideas. Bloomberg BNA Portfolios are available online.

Federal Tax Coordinator, Thomson Reuters

The *Federal Tax Coordinator*, published by Thomson Reuters, is somewhat similar in organization to Wolters Kluwer’s *Standard Federal Tax Reporter* and Thomson Reuters’s *United States Tax Reporter*, with compilation volumes and an elaborate cross-reference system of indexation. However, the 26-volume service is organized by topic rather than by Code section. Popular features of the *Tax Coordinator* are the editorial explanations, illustrations, planning ideas, and warnings of potential tax traps. This service is included in the Thomson Reuters Checkpoint online service.

The Citator

Probably the most comprehensive method for evaluating and updating case law is through the use of a citator. The *Wolters Kluwer Citator* contains an alphabetical listing of the Tax Court (formerly the Board of Tax Appeals) and federal court decisions since 1913. It is updated currently online in IntelliConnect®. Additionally, the *Wolters Kluwer Citator* indicates a paragraph reference where each case is digested in the Compilation Volumes of the *Standard Federal Tax Reporter*. More than one paragraph reference will be given if a case involves several tax issues. The *Citator* is available on IntelliConnect® and offers instant linking to the cases cited.

Each listing outlines the judicial history of a selected case beginning with the highest court to have ruled on that issue. Then, in descending order, the actions of lower courts are also cited and described. Finally, under each listing, the *Citator* refers to other court cases, which helps to evaluate a given decision as a precedent.

The *Citator 2nd*, published by Thomson Reuters, is a seven-volume service with monthly and annual cumulative supplements organized in a manner somewhat consistent with that of the *Wolters Kluwer Citator*.

Essentially, Thomson Reuters provides an alphabetical list of court cases followed by a descriptive legislative history of each case. However, in those cases involving more than one issue, the Thomson Reuters citator also cross-references its descriptive system of judicial references according to the various issues. Citators are included in the online services of Wolters Kluwer and Thomson Reuters.

To illustrate the usefulness of the citator to the researcher, the Wolters Kluwer Citator will be explained in greater detail. Refer to Exhibit 4, a sample taken from the Wolters Kluwer Citator and locate the *Atlas Life Insurance Co.* case. The case name is followed by paragraph (¶) references to the Compilation Volumes in which the decision appears as an annotation to the law, regulations, and other cases in point. The black dot preceding each court action in the case permits the researcher to quickly scan the judicial history of the case. *Atlas Life Insurance Co.* was decided on appeal in the Supreme Court in 1965, which reversed the decision of the Court of Appeals for the Tenth Circuit. The Court of Appeals decision reversed the ruling of the District Court of Oklahoma.

Exhibit 4. WOLTERS KLUWER CITATOR—COURT CASES SAMPLE SECTION

Federal Tax Citator, Atlas Life Insurance Co.

Atlas Life Insurance Co.

ANNOTATED AT . . . 2019FED ¶25,736.60, ¶25,913.74

• SCT-- (rev'g CA) 65-1 *ustc* ¶9407, Ct D 1903, 381 US 233, 85 S Ct 1379, 1965-2 CB 220

Consumer Life Ins. Co. SCT, 77-1 *ustc* ¶9364, Ct D 1985, 430 US 725, 97 S Ct 1440, 1977-1 CB 178

Standard Life & Accident Ins. Co. SCT, 77-2 *ustc* ¶9480, Ct D 1986, 433 US 148, 97 S Ct 2523, 1977-2 CB 230

Travelers Ins. Co. CA-FC, 2002-2 *ustc* ¶50,652, 303 F3d 1373

Bankers Life and Casualty Co. CA-7, 98-1 *ustc* ¶50,346, 142 F3d 973

Group Life & Health Ins. Co. CA-5, 70-2 *ustc* ¶9683, 434 F2d 115

Jefferson Standard Life Ins. Co. CA-4, 69-1 *ustc* ¶9278, 408 F2d 842

Franklin Life Ins. Co. CA-7, 68-2 *ustc* ¶9459, 399 F2d 757

Boli CA-FC, 87-2 *ustc* ¶9566, 831 F2d 276

Goldin CA-2, 87-1 *ustc* ¶9128, 809 F2d 187

Union Mutual Life Ins. Co. DC-ME, 76-2 *ustc* ¶9661, 420 FSupp 1181

Franklin Life Ins. Co. DC-IL, 67-2 *ustc* ¶9515

American Mutual Life Ins. Co. FedCl, 2000-1 *ustc* ¶50,314, 46 FedCl 445

Reserve Life Insurance Co. CtCls, 81-1 *ustc* ¶9147, 640 F2d 368

Investors Diversified Services, Inc. CtCls, 78-1 *ustc* ¶9379, 216 CtCls 192, 575 F2d 843

Northwestern Mutual Life Ins. Co. ClsCt, 85-1 *ustc* ¶9233, 7 ClsCt 501

Wells Fargo & Co. TC, Dec. 55 037, 120 TC 69

Union Central Life Ins. Co. TC, Dec. 38 339, 77 TC 845

Ball TC, Dec. 30 153, 54 TC 1200

Allstate Fire Ins. Co. TC, Dec. 28 197, 47 TC 237

• CA-10-- (rev'g DC) 64-2 *ustc* ¶9510, 333 F2d 389

• DC-OK-- 63-1 *ustc* ¶9452, 216 FSupp 457

In addition to the historical record of the case, citations are given for the court actions taken in a particular case which show where the full text of the decision may be found. A citation to *U.S. Tax Cases* (USTC), for example, refers to an expansive series of volumes published by Wolters Kluwer that cover tax-related court opinions issued since 1913. The volumes, published twice a year, cover Supreme Court, Courts of Appeals, District Courts, and Court of Federal Claims cases. The Thomson Reuters citator would refer to the *American Federal Tax Reports* (AFTR), the comparable Thomson Reuters series of federal court cases. Memorandum decisions of the Tax Court are published by Wolters Kluwer under the title *Tax Court Memorandum Decisions* (cited TCM), while the Thomson Reuters series is called *TC Memorandum Decisions* (cited TC Memo).

The Citator typically gives even further research information than already discussed. For each case listed in the Citator there is given the “cited record” of that case. These “cited records” list the names and citations of later cases which discussed and distinguished the main case. Thus, the “cited record” permits the researcher to evaluate the judicial authority of the related case.

For the very latest developments in any case, the researcher using the Wolters Kluwer Citator should also check the “Case Table” (for the current year) in Volume 19, the “New Matters” volume of the *Standard*. Appeals to higher courts, IRS acquiescences or nonacquiescences, and government decisions on whether to appeal federal court cases are shown in the “Case Table” (for the current year) for all cases. (Where Supreme Court action is indicated in the Case Table, more information on the case may be obtained from the Supreme Court Docket located in the New Matters Volume.)

Books

In addition to the loose-leaf reference services and the bound volumes of tax-related court cases published in the special reporter series *U.S. Tax Cases* (USTC) available from Wolters Kluwer or the *American Federal Tax Reports* (AFTR) available from Thomson Reuters, a well-equipped tax library should contain numerous leading tax textbooks.

Following are selected, highly recommended tax books:

Price on Contemporary Estate Planning, John R. Price and Samuel A. Donaldson (Wolters Kluwer)

Federal Tax Practitioner's Guide, Susan Flax Posner (Wolters Kluwer)

Federal Income Taxation of Corporations and Shareholders, Boris I. Bittker and James I. Eustice (Thomson/WG&L)

S Corporation Taxation, Robert W. Jamison (Wolters Kluwer)

Practical Guide to Partnerships and LLCs, Robert Ricketts and Larry Tunnell (Wolters Kluwer)

Practical Guide to U.S. Taxation of International Transactions, Robert J. Misesy, Jr. and Michael S. Schadewald (Wolters Kluwer)

Partnership Taxation, Arthur B. Willis, John S. Pennell, Philip F. Postlewaite, and Richard Lipton (Thomson/WG&L)

Tax Institutes

Current tax topics are discussed and technical papers presented at the various tax institutes and symposia held annually at universities and other locations throughout the United States. The well-known tax institutes such as New York University and the National Tax Association—Tax Institute of America publish their annual proceedings. The papers presented at the annual University of Chicago Federal Tax Conference are published every year in the March issue of *TAXES—The Tax Magazine*. The papers presented at the annual UCLA Tax Controversy Institute and the New York University Tax Controversy Forum are published each year in the December-January and August-September issues of the *Journal of Tax Practice and Procedure*.

Tax Periodicals

Several monthly and quarterly journals contain current articles dealing exclusively with technical tax matters. Some of these magazines cover a broad range of tax topics, while others specialize in a particular area of taxation.

Following are some of the more popular tax periodicals:

Corporate Taxation (Thomson/WG&L)

CPA Journal (New York State Society of Certified Public Accountants)

Estate Planning (Thomson/WG&L)

International Tax Journal (Wolters Kluwer)

Journal of the American Taxation Association (American Taxation Association)

Journal of Passthrough Entities (Wolters Kluwer)

Journal of Tax Practice and Procedure (Wolters Kluwer)

Journal of Taxation (Thomson/WG&L)

Journal of Taxation of Financial Products (Wolters Kluwer)

National Tax Journal (National Tax Association—Tax Institute of America)

Practical Tax Strategies (Thomson/WG&L)

Tax Adviser (American Institute of Certified Public Accountants)

Tax Executive (Tax Executive Institute)

Tax Law Review (New York University School of Law)

Tax Lawyer (American Bar Association)

TAXES—The Tax Magazine (Wolters Kluwer)

Trusts and Estates (Penton Media, Inc.)

Newsletters

The practitioner needs to stay on top of current developments in the tax field and for this purpose finds that weekly and even daily updates of pertinent tax law information is needed. Daily reporting is available both electronically through online computer legal research systems from tax publishers and through the mail. There is the daily *Tax Day News* and *Federal Tax Weekly*, published by Wolters Kluwer; the Bloomberg BNA *Daily Tax Report*, available from the Bureau of National Affairs; and Tax Analysts' *Tax Notes Today*. The most popular weekly newsletters are *Federal Tax Weekly*, published by Wolters Kluwer; the *Federal Taxes Weekly Alert*, published by Thomson Reuters; and Tax Analysts' weekly *Tax Notes*.

Research Methodology

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TYPES OF TAX RESEARCH SITUATIONS

Essentially, there are two types of tax research cases or situations. The “closed-fact” case, sometimes referred to as ex post facto research, involves the legal interpretation of historical events. In such cases, the taxable transactions have already occurred and can no longer be altered, although various tax elections and alternatives might still be available. Two common examples of “closed-fact” situations are preparation of a tax return after the taxable year is completed and representation of a taxpayer before the Audit Division of the IRS on the examination of a previously filed tax return.

In contrast, the “open-fact” case typically involves events that have not yet been finalized (i.e., controllable facts). Thus, this type of research relates primarily to future planning decisions. However, whether the primary focus of a research engagement is for tax compliance or tax planning, the underlying methods and techniques should be systematic, thorough, properly documented, and effectively communicated to the client.

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RESEARCH MODEL

The following research model presents a five-step systematic format that can be applied to a “closed-fact” or an “open-fact” case:

1. Gathering the facts and identifying the tax issues to be researched.
2. Locating and studying the primary and secondary authorities relevant to the enumerated tax issues.
3. Updating and evaluating the weight of the various authorities.
4. Reexamining various facets of the research.
5. Arriving at conclusions and communicating these conclusions to the client.

STEP 1: Gathering the Facts and Identifying the Tax Issues to Be Researched

During this difficult part of the research process it is necessary to elicit a comprehensive, unbiased report from the client. Difficulty stems from the fact that taxpayers often tend to have a simple perspective of the tax issues related to their problem. They fail to see the multiple issues that might be involved in what they perceive as a single, straightforward issue.

EXAMPLE 2.1

Mary Jones, a single taxpayer, moved from New York to Miami in 2019. Accordingly, she sold her residence in New York at a gain well in excess of \$400,000. In preparation of her 2019 tax return, since the gain on the sale of this residence is quite substantial, the researcher must examine the facts and explore the tax-savings elections.

Mary is asked to provide all information related to these events, and she supplies the real estate closing statement reflecting the sale of the New York residence. As far as Mary is concerned, she has supplied “all” information necessary to resolve this issue. However, the following facts must still be ascertained:

1. What was the cost of the New York residence?
2. Should any improvements be capitalized as part of the basis of the New York residence?
3. Were there any selling costs involved with the sale?
4. Over the years, were there any property assessments that should be capitalized as part of the basis of the New York residence?
5. Was any portion of the New York residence depreciated as a home office deduction on prior tax returns?
6. Is Mary eligible for the \$250,000 tax-free exclusion?

STEP 2: Locating and Studying the Secondary and Primary Authorities Relevant to the Enumerated Tax Issues

For each issue enumerated in Step 1, the research might begin with a thorough reading of the compilation materials found in the tax services whether in print format (loose-leaf and books) or electronic format. The editorial explanations and observations provide useful insights and help direct the research process. Additionally, the research should continue with a review of the applicable Code sections, Regulations, and digests of selected judicial decisions. Those cases which seem particularly appropriate to the research should be cited to facilitate reference for subsequent follow-up study. Finally, before leaving the tax services, it is imperative to refer to the “Current Developments” section to examine the impact of recent actions.

STEP 3: Updating and Evaluating the Weight of the Various Authorities

The statutory and administrative authorities selected in Step 2 must now be evaluated to determine relative weight. Additionally, the relevant court cases must be assessed in terms of their value as judicial precedent. Before relying upon a particular decision, it is essential to refer to one of the citator services and review the history and current status of that case.

It is not uncommon to discover conflicting interpretations of similar issues by different courts. In place of a national law policy, the Tax Court has adopted the position that better judicial administration requires it to follow a Court of Appeals decision. Nevertheless, courts at the same level of jurisdiction may issue conflicting opinions; whereas, the Internal Revenue Service is not obligated to adhere to either decision on a nationwide basis. Accordingly, a District or Circuit Court decision favorable to a taxpayer has significant precedent value only within that district or circuit.

STEP 4: Reexamining Various Facets of the Research

After studying and evaluating the various statutory, administrative, and judicial authorities, it often becomes necessary to reexamine the original tax problem. It may even become necessary to seek additional facts and modify or expand the research process.

Additionally, if there are any authorities in conflict with the projected conclusions, it is essential to study them carefully. The researcher must not only be able to support his or her own research conclusions, but also must be prepared to defend these conclusions in light of conflicting authorities.

During this phase of the research, it may sometimes be useful to clarify the meanings of unfamiliar or highly technical words or terms. A standard dictionary may provide some guidance, but if the words are not generally used in a nonlegal context, *Black's Law Dictionary* should be consulted.

STEP 5: Arriving at Conclusions and Communicating the Conclusions to the Client

Communicating the conclusions of the tax research to the client requires professional judgment. The client should be advised of the potential benefits and risks associated with the recommended actions. Since the communication will be in writing, it is essential to determine how much or how little detail should be noted. Additionally, the communication must be expressed at the client's level of sophistication. This sometimes presents a difficult task, especially when the research involves complex issues and highly technical reasoning.

Essentially, the communication should be concise, well-structured, and should follow an organized format that includes:

1. A review of the facts
2. An enumeration of the various tax issues
3. The conclusions
4. A discussion of the reasoning and authorities supporting the conclusions

While the client might be concerned only with the section dealing with conclusions, the professional substance of the communication is contained in the reasoning and authority. It is in this section of the report that the various authorities are discussed and evaluated. Finally, it is in this section that the client is supplied with authoritative support, should it ever become necessary to defend against a challenge by the Internal Revenue Service.

Tax Administration

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ORGANIZATION OF THE IRS

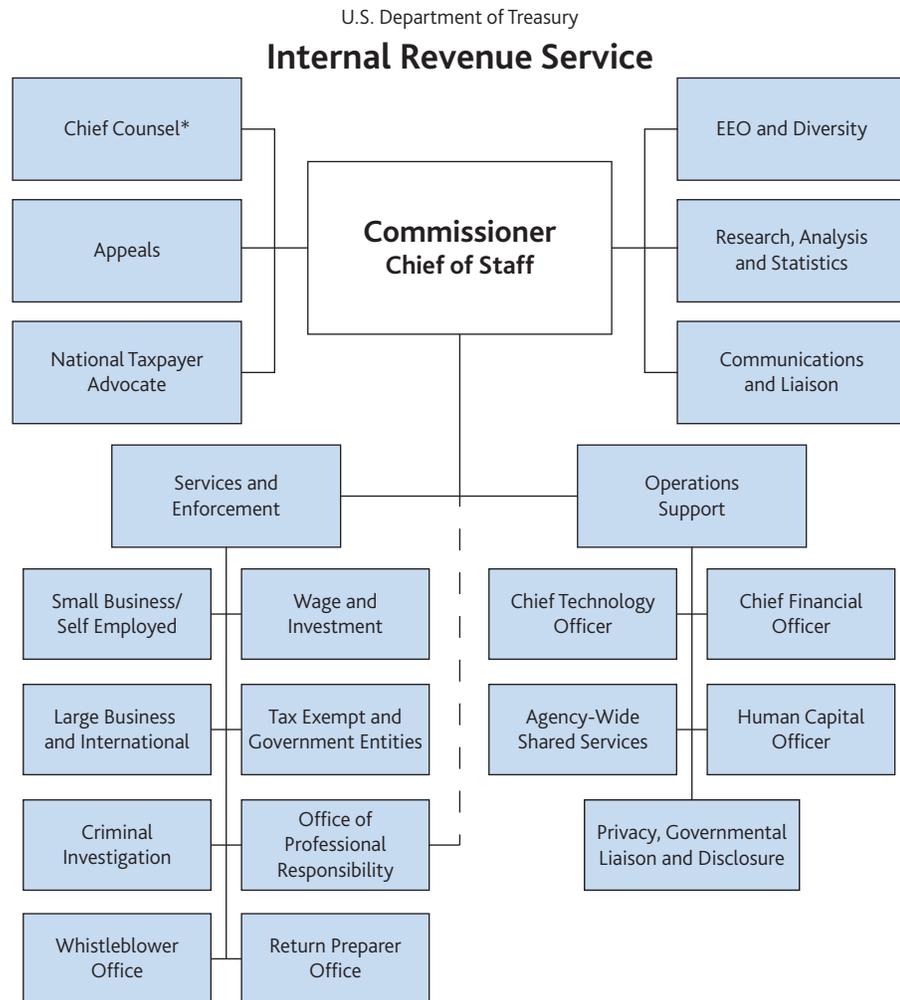
The administration and enforcement of federal internal revenue taxes are required to be performed under the supervision of the Secretary of the Treasury. Code Sec. 7801(a). The Internal Revenue Service, a division of the Department of the Treasury, has been delegated the operational aspects of the determination, assessment, and collection of all internal revenue taxes. The Commissioner of Internal Revenue, the official in charge, is appointed by the President and serves under the Secretary of the Treasury. Code Sec. 7802.

The Internal Revenue Service (IRS) consists of a National Office, headquartered in Washington, D.C., and an extensive field organization composed of over a hundred thousand revenue agents, revenue officers, and support personnel. The main task of the National Office is to develop uniform policies for the nationwide administration of the tax law and coordinate the various operations of the IRS.

Internal Revenue Service Restructuring and Reform Act of 1998

In accordance with the Internal Revenue Service Restructuring and Reform Act of 1998, the IRS modified its entire structure. The structure divides the IRS into four operating divisions. Each operating division is responsible for serving a group of similar taxpayers. The structure is organized to reflect specific types of taxpayers and common issues associated with these taxpayers. See Exhibit 7.

Exhibit 7. IRS ORGANIZATION CHART



* With respect to tax litigation and the legal interpretation of tax law, the Chief Counsel also reports to the General Counsel of the Treasury Department. On matters solely related to tax policy, the Chief Counsel reports to the Treasury General Counsel.

The IRS's mission is to:

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

The four operating divisions are supported by two agency-wide service organizations: (1) Information Systems; and (2) Agency-Wide Shared Services. In addition, the IRS Appeals Office, the Taxpayer Advocate Service, the Office of the Chief Counsel and Criminal Investigation are nationwide organizations that provide separate specialized services.

The Operating Divisions

Wage and Investment Division (W&I)

W&I covers individual taxpayers who only receive wage and/or investment income, which includes approximately 88 million filers. Most of these taxpayers only deal with the IRS when filing their tax returns each year. Compliance matters are limited to such issues as dependency exemption, credits, filing status, and deductions. Much of the income earned by W&I taxpayers is reported by third parties (such as employers, banks, brokerage firms) and the income is generally collected through third-party withholding. Thus, this group is generally highly compliant. Most of these taxpayers earn under \$50,000 a year.