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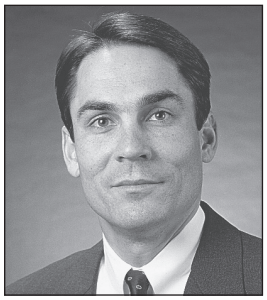

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PREFACE

New to this Edition

INDIVIDUALS

- Complete updating of the chapter material for the provisions in the Tax Cuts and Jobs Act of 2017 and the subsequent guidance affecting individual taxpayers
- Complete updating of significant court cases and IRS rulings and procedures during 2018 and early 2019
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2019
- Whenever new updates become available, they will be accessible via MyLab Accounting
- Focus on critical thinking skills with additional Tax Strategy and Critical Thinking Problems
- Updating of the end-of-chapter tax return problems to 2018 (2018 tax forms are included because the 2019 tax forms were not available when this edition went to print)
- Addition of shorter tax form problems, focusing on single forms or schedules

CORPORATIONS

- Complete updating of the chapter material for the provisions in the Tax Cuts and Jobs Act of 2017 and the subsequent guidance affecting corporations and other entities
- The comprehensive corporate tax return, Problem C:3-66, has all new numbers for the 2018 forms
- The comprehensive partnership tax return, Problem C:9-58, has all new numbers for the 2018 forms
- The comprehensive S corporation tax return, Problem C:11-62, has all new numbers for the 2018 forms
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2019
- Whenever new updates become available, they will be accessible via MyLab Accounting
- Focus on critical thinking skills with additional Tax Strategy and Critical Thinking Problems
- Addition of shorter tax form problems, focusing on single forms or schedules

SOLVING TEACHING AND LEARNING CHALLENGES

The Rupert/Anderson/Hulse 2020 Series in Federal Taxation is appropriate for use in any first course in federal taxation, and comes in a choice of three volumes:

- Federal Taxation 2020: Individuals
- Federal Taxation 2020: Corporations, Partnerships, Estates & Trusts (the companion book to Individuals)
- Federal Taxation 2020: Comprehensive (14 chapters from Individuals and 15 chapters from Corporations)

** For a customized edition of any of the chapters for these texts, contact your Pearson representative and he or she can create a custom text for you

- The *Individuals* volume covers *all* entities, although the treatment is often briefer than in the *Corporations* and *Comprehensive* volumes. The Individuals volume, therefore, is appropriate for colleges and universities that require only one semester of taxation as well as those that require more than one semester of taxation. Further, this volume adapts the suggestions of the Model Tax Curriculum as promulgated by the American Institute of Certified Public Accountants
- The *Corporations, Partnerships, Estates & Trusts* and *Comprehensive* volumes contain three comprehensive tax return problems whose data change with each edition, thereby keeping the problems fresh. Problem C:3-66 contains the comprehensive corporate tax return, Problem C:9-58 contains the comprehensive partnership tax return, and Problem C:11-62 contains the comprehensive S corporation tax return, which is based on the same facts as Problem C:9-58 so that students can compare the returns for these two entities
- The *Corporations, Partnerships, Estates & Trusts* and *Comprehensive* volumes contain sections called Financial Statement Implications, which discuss the implications of Accounting Standards Codification (ASC) 740. The main discussion of accounting for income taxes appears in Chapter C:3. The financial statement implications of other transactions appear in Chapters C:7, C:8, and C:16 (Corporations volume only)

Rupert/Anderson/Hulse 2020 Series in Federal Taxation has an appropriate blend of technical content of the tax law with a high level of readability for students. It is focused on enabling students to apply tax principles within the chapter to real-life situations using many strong pedagogical aids:

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These comments relate the text material to events, cases, and statistics occurring in the tax and business environment. The statistical data presented in some of these comments are taken from the IRS's Statistics of Income at www.irs.gov.

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These comments compare the tax discussion in the text to the accounting and/or financial statement treatment of this material. Also, the last section of Chapter C:3 discusses the financial statement implications of federal income taxes.

What Would You Do in This Situation?

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These "speed bumps" encourage students to pause and apply what they have just learned. Solutions for each issue are provided in the box.

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These comments provide the ethical implications of material discussed in the adjoining text. Apply what they have just learned.

Tax Strategy Tip

These comments suggest tax planning ideas related to material in the adjoining text.

Additional Comment

These comments provide supplemental information pertaining to the adjacent text.

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Instructor's Solutions Manual authored by Kenneth Anderson from University of Tennessee, David Hulse from University of Kentucky, and Timothy Rupert from Northeastern University	• Solutions to discussion questions • Solutions to problems • Solutions to comprehensive and tax strategy problems
Test Bank authored by Anthony Masino from East Tennessee State University and Ann Burstein Cohen from SUNY at Buffalo	Over 1,500 multiple-choice, true/false, short-answer, essays, and worked problems. • Type (Multiple-choice, true/false, short-answer, essay) • Page references to where content is found in the text
Computerized TestGen	TestGen allows instructors to: • Customize, save, and generate classroom tests • Edit, add, or delete questions from the Test Item Files • Analyze test results • Organize a database of tests and student results.
PowerPoint Presentations authored by Allison McLeod from University of North Texas	Slides include key graphs, tables, and equations in the textbook. PowerPoints meet accessibility standards for students with disabilities. Features include, but not limited to: • Keyboard and Screen Reader access • Alternative text for images • High color contrast between background and foreground colors
Multistate Tax Chapter authored by Michael Schadewald from University of Florida	An entire chapter, complete with problems (and solutions) dedicated to multi-state tax practices.
TaxAct 2018 Professional Software	Available online with Individuals, Corporations, and Comprehensive Texts—please contact your Pearson representative for assistance with the registration process. This user-friendly tax preparation program includes more than 80 tax forms, schedules, and worksheets. TaxAct calculates returns and alerts the user to possible errors or entries. Consists of Forms 990, 1040, 1041, 1065, 1120 and 1120S.

Acknowledgments

Our policy is to provide annual editions and to prepare timely updated supplements when major tax revisions occur. We are most appreciative of the suggestions made by outside reviewers because these extensive review procedures have been valuable to the authors and editors during the revision process.

We also are grateful to the various graduate assistants, doctoral students, and colleagues who have reviewed the text and supplementary materials and checked solutions to maintain a high level of technical accuracy. In particular, we would like to acknowledge the following colleagues who assisted in the preparation of supplemental materials for this text: Ann Burstein Cohen, SUNY at Buffalo; Joshua G. Coyne, University of Memphis; Kate Demarest, Carroll Community College; Allison McLeod, University of North Texas; Mitchell Franklin, LeMoyne College; and Anthony Masino, East Tennessee State University.

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Please send any comments to Kenneth E. Anderson, David S. Hulse, or Timothy J. Rupert.

CHAPTER

1

TAX RESEARCH

LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Distinguish between closed fact and open fact tax situations
2. Describe the steps in the tax research process
3. Explain how the facts influence tax consequences
4. Identify the sources of tax law and assess the authoritative value of each
5. Consult tax services to research an issue
6. Apply the basics of Internet-based tax research
7. Use a citator to assess tax authorities
8. Describe the professional guidelines that CPAs in tax practice should follow
9. Prepare work papers and communicate to clients

CHAPTER OUTLINE

This chapter introduces the reader to the tax research process. Its major focus is the sources of the tax law (i.e., the Internal Revenue Code and other tax authorities) and the relative weight given to each source. The chapter describes the steps in the tax research process and places particular emphasis on the importance of the facts to the tax consequences. It also describes the features of frequently used tax services and computer-based tax research resources. Finally, it explains how to use a citator.

The end product of the tax research process—the communication of results to the client—also is discussed. This text uses a hypothetical set of facts to provide a comprehensive illustration of the process. Sample work papers demonstrating how to document the results of research are included in Appendix A. The text also discusses two types of professional guidelines for CPAs in tax practice: the American Institute of Certified Public Accountants' (AICPA's) *Statements on Standards for Tax Services* (reproduced in Appendix E) and Treasury Department *Circular 230*.

OVERVIEW OF TAX RESEARCH

OBJECTIVE 1

Distinguish between closed fact and open fact tax situations

Tax research is the process of solving tax-related problems by applying tax law to specific sets of facts. Sometimes it involves researching several issues and often is conducted to formulate tax policy. For example, policy-oriented research would determine how far the level of charitable contributions might decline if such contributions were no longer deductible. Economists usually conduct this type of tax research to assess the effects of government policy.

Tax research also is conducted to determine the tax consequences of transactions to specific taxpayers. For example, client-oriented research would determine whether Smith Corporation could deduct a particular expenditure as a trade or business expense. Accounting and law firms generally engage in this type of research on behalf of their clients.

This chapter deals only with client-oriented tax research, which occurs in two contexts:

ADDITIONAL COMMENT

Closed-fact situations afford the tax advisor the least amount of flexibility. Because the facts are already established, the tax advisor must develop the best solution possible within certain predetermined constraints.

1. **Closed fact or tax compliance situations:** The client contacts the tax advisor after completing a transaction or while preparing a tax return. In such situations, the tax consequences are fairly straightforward because the facts cannot be modified to obtain different results. Consequently, tax saving opportunities may be lost.

EXAMPLE C:1-1 ▶ Tom informs Carol, his tax advisor, that on November 4 of the current year, he sold land held as an investment for $500,000 cash. His basis in the land was $50,000. On November 9, Tom reinvested the sales proceeds in another plot of investment property costing $500,000. This is a closed fact situation. Tom wants to know the amount and the character of the gain (if any) he must recognize. Because Tom solicits the tax advisor's advice after the sale and reinvestment, the opportunity for tax planning is limited. For example, the possibility of deferring taxes by using a like-kind exchange or an installment sale is lost. ◀

ADDITIONAL COMMENT

Open-fact or tax-planning situations give a tax advisor flexibility to structure transactions to accomplish the client's objectives. In this type of situation, a creative tax advisor can save taxpayers dollars through effective tax planning.

2. **Open fact or tax planning situations:** Before structuring or concluding a transaction, the client contacts the tax advisor to discuss tax planning opportunities. Tax-planning situations generally are more difficult and challenging because the tax advisor must consider the client's tax and nontax objectives. Most clients will not engage in a transaction if it is inconsistent with their nontax objectives, even though it produces tax savings.

EXAMPLE C:1-2 ▶ Diane is a widow with three children and five grandchildren and at present owns property valued at $30 million. She seeks advice from Carol, her tax advisor, about how to minimize her estate taxes and convey the greatest value of property to her descendants. This is an open-fact situation. Carol could advise Diane to leave all but $11.4 million of her property to a charitable organization so that her estate would owe no estate taxes. Although this recommendation would eliminate Diane's estate taxes, Diane is likely to reject it because she wants her children or grandchildren to be her primary beneficiaries. Thus, reducing estate

taxes to zero is inconsistent with her objective of allowing her descendants to receive as much after-tax wealth as possible. ◀

TAX STRATEGY TIP

Taxpayers should make investment decisions based on after-tax rates of return or after-tax cash flows.

When conducting research in a tax planning context, the tax professional should keep a number of points in mind. First, the objective is not to minimize taxes per se but rather to maximize a taxpayer's after-tax return. For example, if the federal income tax rate is a constant 30%, an investor should not buy a tax-exempt bond yielding 5% when he or she could buy a corporate bond of equal risk that yields 9% before tax and 6.3% after tax. This is the case even though his or her explicit taxes (actual tax liability) would be minimized by investing in the tax-exempt bond.[1] Second, taxpayers typically do not engage in unilateral or self-dealing transactions; thus, the tax ramifications for all parties to the transaction should be considered. For example, in the executive compensation context, employees may prefer to receive incentive stock options (because they will not recognize income until they sell the stock), but the employer may prefer to grant a different type of option (because the employer cannot deduct the value of incentive stock options upon issuance). Thus, the employer might grant a different number of options if it uses one type of stock option versus another type as compensation. Third, taxes are but one cost of doing business. In deciding where to locate a manufacturing plant, for example, factors more important to some businesses than the amount of state and local taxes paid might be the proximity to raw materials, good transportation systems, the cost of labor, the quantity of available skilled labor, and the quality of life in the area. Fourth, the time for tax planning is not restricted to the beginning date of an investment, contract, or other arrangement. Instead, the time extends throughout the duration of the activity. As tax rules change or as business and economic environments change, the tax advisor must reevaluate whether the taxpayer should hold onto an investment and must consider the transaction costs of any alternatives.

ADDITIONAL COMMENT

It is important to consider nontax as well as tax objectives. In many situations, the nontax considerations outweigh the tax considerations. Thus, the plan eventually adopted by a taxpayer may not always be the best when viewed strictly from a tax perspective.

One final note: the tax advisor should always bear in mind the financial accounting implications of proposed transactions. An answer that may be desirable from a tax perspective may not always be desirable from a financial accounting perspective. Though interrelated, the two fields of accounting have different orientations and different objectives. Tax accounting is oriented primarily to the Internal Revenue Service (IRS). Its objectives include calculating, reporting, and predicting one's tax liability according to legal principles. Financial accounting is oriented primarily to shareholders, creditors, managers, and employees. Its objectives include determining, reporting, and predicting a business's financial position and operating results according to Generally Accepted Accounting Principles. Because tax and financial accounting objectives may differ, planning conflicts could arise. For example, management might be reluctant to engage in tax reduction strategies that also reduce book income and reported earnings per share. Success in any tax practice, especially at the managerial level, requires consideration of both sets of objectives and orientations.

STEPS IN THE TAX RESEARCH PROCESS

OBJECTIVE 2

Describe the steps in the tax research process

In both open- and closed-fact situations, the tax research process involves six basic steps:

1. Determine the facts.
2. Identify the issues (questions).
3. Locate the applicable authorities.
4. Evaluate the authorities and choose those to follow where the authorities conflict.
5. Analyze the facts in terms of the applicable authorities.
6. Communicate conclusions and recommendations to the client.

[1] For an excellent discussion of explicit and implicit taxes and tax planning see M. S. Scholes, M. A. Wolfson, M. Erickson, M. Hanlon, L. Maydew, and T. Shevlin, *Taxes and Business Strategy: A Planning Approach,* fifth edition (Upper Saddle River, NJ: Pearson Prentice Hall, 2015). Also see Chapter I:18 of the *Individuals* volume. An example of an implicit tax is the excess of the before-tax earnings on a taxable bond over the risk-adjusted before-tax earnings on a tax-favored investment (e.g., a municipal bond).

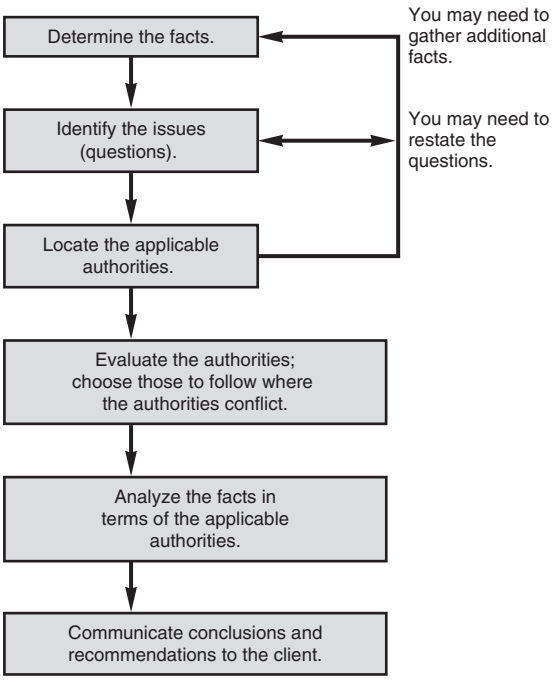


FIGURE C:1-1 ▶ STEPS IN THE TAX RESEARCH PROCESS

ADDITIONAL COMMENT

The steps of tax research provide an excellent format for a written tax communication. For example, a good format for a client memo includes (1) statement of facts, (2) list of issues, (3) discussion of relevant authority, (4) analysis, and (5) recommendations to the client of appropriate actions based on the research results.

Although the above outline suggests a linear approach, the tax research process often is circular. That is, it does not always proceed step-by-step. Figure C:1-1 illustrates a more accurate process, and Appendix A provides a comprehensive example of this process.

In a closed-fact situation, the facts have already occurred, and the tax advisor's task is to analyze them to determine the appropriate tax treatment. In an open-fact situation, by contrast, the facts have not yet occurred, and the tax advisor's task is to plan for them or shape them so as to produce a favorable tax result. The tax advisor performs the latter task by reviewing the relevant legal authorities, particularly court cases and IRS rulings, all the while bearing in mind the facts of those cases or rulings that produced favorable results compared with those that produced unfavorable results. For example, if a client wants to realize an ordinary loss (as opposed to a capital loss) on the sale of several plots of land, the tax advisor might consult cases involving similar land sales. The advisor might attempt to distinguish the facts of those cases in which the taxpayer realized an ordinary loss from the facts of those cases in which the taxpayer realized a capital loss. The advisor then might recommend that the client structure the transaction based on the fact pattern in the ordinary loss cases.

TYPICAL MISCONCEPTION

Many taxpayers think the tax law is all black and white. However, most tax research deals with gray areas. Ultimately, when confronted with tough issues, the ability to develop strategies that favor the taxpayer and then to find relevant authority to support those strategies will make a successful tax advisor. Thus, recognizing planning opportunities and avoiding potential traps is often the real value added by a tax advisor.

Often, tax research involves a question to which no clearcut, unequivocally correct answer exists. In such situations, probing a related issue might lead to a solution pertinent to the central question. For example, in researching whether the taxpayer may deduct a loss as ordinary instead of capital, the tax advisor might research the related issue of whether the presence of an investment motive precludes classifying a loss as ordinary. The solution to that issue might be relevant to the central question of whether the taxpayer may deduct the loss as ordinary.

Identifying the issue(s) to be researched often is the most difficult step in the tax research process. In some instances, the client defines the issue(s) for the tax advisor, such as where the client asks, "May I deduct the costs of a winter trip to Florida recommended by my physician?" In other instances, the tax advisor, after reviewing the documents submitted to him or her by the client, identifies and defines the issue(s) himself or herself. Doing so presupposes a firm grounding in tax law.[2]

[2] Often, in an employment context, supervisors define the questions to be researched and the authorities that might be relevant to the tax consequences.

Once the tax advisor locates the applicable legal authorities, he or she might have to obtain additional information from the client. Example C:1-3 illustrates the point. The example assumes that all relevant tax authorities are in agreement.

EXAMPLE C:1-3 ▶ Mark calls his tax advisor, Al, and states that he (1) incurred a loss on renting his beach cottage during the current year and (2) wonders whether he may deduct the loss. He also states that he, his wife, and their minor child occupied the cottage only eight days during the current year.

This is the first time Al has dealt with the Sec. 280A vacation home rules. On reading Sec. 280A(d), Al learns that a loss is *not* deductible if the taxpayer used the residence for personal purposes for longer than the greater of (1) 14 days or (2) 10% of the number of days the unit was rented at a fair rental value. He also learns that the property is *deemed* to be used by the taxpayer for personal purposes on any days on which it is used by any member of his or her family (as defined in Sec. 267(c)(4)). The Sec. 267(c)(4) definition of family members includes brothers, sisters, spouse, ancestors (e.g., parents and grandparents), or lineal descendants (e.g., children and grandchildren).

Mark's eight-day use is not long enough to make the rental loss nondeductible. However, Al must inquire about the number of days, if any, Mark's brothers, sisters, or parents used the property. (He already knows about use by Mark, his spouse, and his lineal descendants.) In addition, Al must find out how many days the cottage was rented to other persons at a fair rental value. Upon obtaining the additional information, Al proceeds to determine how to calculate the deductible expenses. Al then derives his conclusion concerning the deductible loss, if any, and communicates it to Mark. (This example assumes the passive activity and at-risk rules restricting a taxpayer's ability to deduct losses from real estate activities will not pose a problem for Mark. See Chapter I:9 for a comprehensive discussion of these topics.) ◀

Many firms require that a researcher's conclusions be communicated to the client in writing. Members or employees of such firms may answer questions orally, but their oral conclusions should be followed by a written communication. According to the AICPA's *Statements on Standards for Tax Services* (reproduced in Appendix E),

> Although oral advice may serve a taxpayer's needs appropriately in routine matters or in well-defined areas, written communications are recommended in important, unusual, substantial dollar value, or complicated transactions. The member may use professional judgment about whether, subsequently, to document oral advice.[3]

In addition, Treasury Department *Circular 230* covers all written advice communicated to clients. These requirements are more fully discussed at the end of this chapter and in Chapter C:15.

Importance of the Facts to the Tax Consequences

OBJECTIVE 3

Explain how the facts influence tax consequences

Many terms and phrases used in the Internal Revenue Code (IRC) and other tax authorities are vague or ambiguous. Some provisions conflict with others or are difficult to reconcile, creating for the researcher the dilemma of deciding which rules are applicable and which tax results are proper. For example, as a condition to claiming another person as a dependent, the taxpayer must provide a certain level of support for such person.[4] Neither the IRC nor the Treasury Regulations define "support." This lack of definition could be problematic. For example, if the taxpayer purchased a used automobile costing $8,000 for an elderly parent whose only source of income is $7,800 in Social Security benefits, the question of whether the expenditure constitutes support would arise. The tax advisor would have to consult court opinions, revenue rulings, and other IRS pronouncements to ascertain the legal meaning of the term "support." Only after thorough research would the meaning of the term become clear.

[3] AICPA, *Statement on Standards for Tax Services*, No. 7, "Form and Content of Advice to Taxpayers," 2010 (2018 to include required citations), Para. 6.

[4] Sec. 152(e)(1)(A) and Sec. 152(d)(1)(C).

In other instances, the legal language is quite clear, but a question arises as to whether the taxpayer's transaction conforms to a specific pattern of facts that gives rise to a particular tax result. Ultimately, the peculiar facts of a transaction or event determine its tax consequences. A change in the facts can significantly change the consequences. Consider the following illustrations:

Illustration One
Facts: A holds stock, a capital asset, that he purchased two years ago at a cost of $1,000. He sells the stock to B for $920. What are the tax consequences to A?
Result: Under Sec. 1001, A realizes an $80 capital loss. He recognizes this loss in the current year. A must offset the loss against any capital gains recognized during the year. Any excess loss is deductible from ordinary income up to a $3,000 annual limit.
Change of Facts: A is B's son.
New Result: Under Sec. 267, A and B are related parties. Therefore, A may not recognize the realized loss. However, B may use the loss if she subsequently sells the stock at a gain.

Illustration Two
Facts: C donates to State University ten acres of land that she purchased two years ago for $10,000. The fair market value (FMV) of the land on the date of the donation is $25,000. C's adjusted gross income is $100,000. What is C's charitable contribution deduction?
Result: Under Sec. 170, C is entitled to a $25,000 charitable contribution deduction (i.e., the FMV of the property unreduced by the unrealized long-term gain).
Change of Facts: C purchased the land 11 months ago.
New Result: Under the same IRC section, C is entitled to only a $10,000 charitable contribution deduction (i.e., the FMV of the property reduced by the unrealized short-term gain).

Illustration Three
Facts: Acquiring Corporation pays Target Corporation's shareholders one million shares of Acquiring voting stock. In return, Target's shareholders tender 98% of their Target voting stock. The acquisition is for a bona fide business purpose. Acquiring continues Target's business. What are the tax consequences of the exchange to Target's shareholders?
Result: Because the transaction qualifies as a reorganization under Sec. 368(a)(1)(B), Target's shareholders are not taxed on the exchange, which is solely for Acquiring voting stock.
Change of Facts: In the transaction, Acquiring purchases the remaining 2% of Target's shares with cash.
New Result: Under the same IRC provision, Target's shareholders are now taxed on the exchange, which is not solely for Acquiring voting stock.

CREATING A FACTUAL SITUATION FAVORABLE TO THE TAXPAYER

TYPICAL MISCONCEPTION

Many taxpayers believe tax practitioners spend most of their time preparing tax returns. In reality, providing tax advice that accomplishes the taxpayer's objectives is one of the most important responsibilities of a tax advisor. This latter activity is tax consulting as compared to tax compliance.

Based on his or her research, a tax advisor might recommend to a taxpayer how to structure a transaction or plan an event so as to increase the likelihood that related expenses will be deductible. For example, suppose a taxpayer is assigned a temporary task in a location (City Y) different from the location (City X) of his or her permanent employment. Suppose also that the taxpayer wants to deduct the meal and lodging expenses incurred in City Y as well as the cost of transportation thereto. To do so, the taxpayer must establish that City X is his or her tax home and that he or she temporarily works in City Y. (Section 162 provides that a taxpayer may deduct travel expenses while "away from home" on business. A taxpayer is deemed to be "away from home" if his or her employment at the new location does not exceed one year, i.e., it is "temporary.") Suppose the taxpayer wants to know the tax consequences of his or her working in City Y for ten months and then, within that ten-month period, finding permanent employment in City Y. What is tax research likely to reveal?

Tax research will lead to an IRS ruling stating that, in such circumstances, the employment will be deemed to be temporary until the date on which the realistic expectation about the temporary nature of the assignment changes.[5] After this date, the employment

[5] Rev. Rul. 93-86, 1993-2 C.B. 71.

will be deemed to be permanent, and travel expenses relating to it will be nondeductible. Based on this finding, the tax advisor might advise the taxpayer to postpone his or her permanent job search in City Y until the end of the ten-month period and simply treat his or her assignment as temporary. So doing would lengthen the time he or she is deemed to be "away from home" on business and thus increase the amount of meal, lodging, and transportation costs deductible as travel expenses. The taxpayer should compare the tax savings to any additional personal costs of maintaining two residences.

THE SOURCES OF TAX LAW

OBJECTIVE 4

Identify the sources of tax law and assess the authoritative value of each

The language of the IRC is general; that is, it prescribes the tax treatment of broad categories of transactions and events. The reason for the generality is that Congress can neither foresee nor provide for every conceivable transaction or event. Even if it could, doing so would render the statute narrow in scope and inflexible in application. Accordingly, interpretations of the IRC—both administrative and judicial—are necessary. Administrative interpretations are provided in Treasury Regulations, revenue rulings, revenue procedures, and several other pronouncements discussed later in this chapter. Judicial interpretations are presented in court opinions. The term *tax law* as used by most tax advisors encompasses administrative and judicial interpretations in addition to the IRC. It also includes the meaning conveyed in reports issued by Congressional committees involved in the legislative process.

THE LEGISLATIVE PROCESS

Tax legislation begins in the House of Representatives. Initially, a tax proposal is incorporated in a bill. The bill is referred to the House Ways and Means Committee, which is charged with reviewing all tax legislation. The Ways and Means Committee holds hearings in which interested parties, such as the Treasury Secretary and IRS Commissioner, testify. At the conclusion of the hearings, the Ways and Means Committee votes to approve or reject the measure. If approved, the bill goes to the House floor where it is debated by the full membership. If the House approves the measure, the bill moves to the Senate where it is taken up by the Senate Finance Committee. Like Ways and Means, the Finance Committee holds hearings in which Treasury officials, tax experts, and other interested parties testify. If the committee approves the measure, the bill goes to the Senate floor where it is debated by the full membership. Upon approval by the Senate, it is submitted to the President for his or her signature. If the President signs the measure, the bill becomes public law. If the President vetoes it, Congress can override the veto by at least a two-thirds majority vote in each chamber.

Generally, at each stage of the legislative process, the bill is subject to amendment. If amended, and if the House version differs from the Senate version, the bill is referred to a House-Senate conference committee.[6] This committee attempts to resolve the differences between the House and Senate versions. Ultimately, it submits a compromise version of the measure to each chamber for its approval. Such referrals are common. For example, in 1998 the House and Senate disagreed over what the taxpayer must do to shift the burden of proof to the IRS. The House proposed that the taxpayer assert a "reasonable dispute" regarding a taxable item. The Senate proposed that the taxpayer introduce "credible evidence" regarding the item. A conference committee was appointed to resolve the differences. This committee ultimately adopted the Senate proposal, which was later approved by both chambers.

ADDITIONAL COMMENT

Committee reports can be helpful in interpreting new legislation because they indicate the intent of Congress. With the proliferation of tax legislation, committee reports have become especially important because the Treasury Department often is unable to draft the needed regulations in a timely manner.

After approving major legislation, the Ways and Means Committee and Senate Finance Committee usually issue official reports. These reports, published by the U.S. Government Printing Office (GPO) as part of the *Cumulative Bulletin* and as separate documents, explain the committees' reasoning for approving (and/or amending) the legislation.[7] In addition, the GPO publishes records of both the committee hearings and transcripts of the floor debates. The records are published as separate House or Senate documents. The transcripts are incorporated in the *Congressional Record* for the day of the

[6] The size of a conference committee can vary. It is made up of an equal number of members from the House and the Senate.

[7] The *Cumulative Bulletin* is described in the discussion of revenue rulings on page C:1-12.

debate. In tax research, these records, reports, and transcripts are useful in deciphering the meaning of the statutory language. Where this language is ambiguous or vague, and the courts have not interpreted it, the documents can shed light on **Congressional intent**, i.e., what Congress *intended* by a particular term, phrase, or provision.

EXAMPLE C:1-4 ▶ In 1998, Congress passed legislation concerning shifting the burden of proof to the IRS. This legislation was codified in Sec. 7491. The question arises as to what constitutes "credible evidence" because the taxpayer must introduce such evidence to shift the burden of proof to the IRS. Section 7491 does not define the term. Because the provision was relatively new, few courts had an opportunity to interpret what "credible evidence" means. In the absence of relevant statutory or judicial authority, the researcher might have looked to the committee reports to ascertain what Congress intended by the term. Senate Report No. 105-174 states that "credible evidence" means evidence of a quality, which, "after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted."[8] This language suggests that Congress intended the term to mean evidence of a kind sufficient to withstand judicial scrutiny. Such a meaning should be regarded as conclusive in the absence of other authority. ◀

THE INTERNAL REVENUE CODE

The IRC, which comprises Title 26 of the United States Code, is the foundation of all tax law. First codified (i.e., organized into a single compilation of revenue statutes) in 1939, the tax law was recodified in 1954. The IRC was known as the Internal Revenue Code of 1954 until 1986, when its name was changed to the Internal Revenue Code of 1986. Whenever changes to the IRC are approved, the old language is deleted and new language added. Thus, the IRC is organized as an integrated document, and a researcher need not read through the relevant parts of all previous tax bills to find the current version of the law. Nevertheless, a researcher must be sure that he or she is working with the law in effect when a particular transaction occurred.

ADDITIONAL COMMENT

The various tax services, discussed later in this chapter, provide IRC histories for researchers who need to work with prior years' tax law.

The IRC contains provisions dealing with income taxes, estate and gift taxes, employment taxes, alcohol and tobacco taxes, and other excise taxes. Organizationally, the IRC is divided into subtitles, chapters, subchapters, parts, subparts, sections, subsections, paragraphs, subparagraphs, and clauses. Subtitle A contains rules relating to income taxes, and Subtitle B deals with estate and gift taxes. A set of provisions concerned with one general area constitutes a subchapter. For example, the topics of corporate distributions and adjustments appear in Subchapter C, and topics relating to partners and partnerships appear in Subchapter K. Figure C:1-2 presents the organizational scheme of the IRC.

An IRC section contains the operative provisions to which tax advisors most often refer. For example, they speak of "Sec. 351 transactions," "Sec. 306 stock," and "Sec. 1231 gains and losses." Although a tax advisor need not know all the IRC sections, paragraphs, and parts, he or she must be familiar with the IRC's organizational scheme to read and interpret it correctly. The language of the IRC is replete with cross-references to titles, paragraphs, subparagraphs, and so on.

EXAMPLE C:1-5 ▶ Section 7701, a definitional section, begins, "When used in this title. . ." and then provides a series of definitions. Because of this broad reference, a Sec. 7701 definition applies for all of Title 26; that is, it applies for purposes of the income tax, estate and gift tax, excise tax, and other taxes governed by Title 26. ◀

EXAMPLE C:1-6 ▶ Section 302(b)(3) allows taxpayers whose stock holdings are completely terminated in a redemption (a corporation's purchase of its stock from one or more of its shareholders) to receive capital gain treatment on the excess of the redemption proceeds over the stock's basis instead of ordinary income treatment on the entire proceeds. Section 302(c)(2)(A) states, "In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if. . . ." Further, Sec. 302(c)(2)(C)(i) indicates "Subparagraph (A) shall not apply to a distribution to any entity unless. . . ." Thus, in determining whether a taxpayer will receive capital gain treatment in a stock redemption, a tax advisor must be able to locate and interpret various cross-referenced IRC sections, subsections, paragraphs, subparagraphs, and clauses. ◀

[8] S. Rept. No. 105-174, 105th Cong., 1st Sess. (unpaginated) (1998).

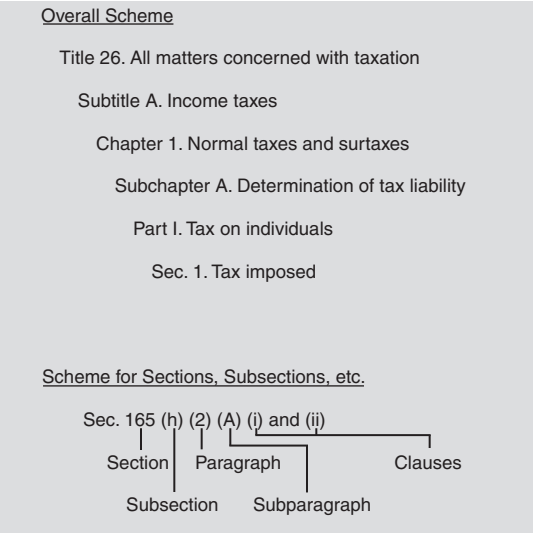


FIGURE C:1-2 ▶ ORGANIZATIONAL SCHEME OF THE INTERNAL REVENUE CODE

TREASURY REGULATIONS

The Treasury Department issues regulations that expound upon the IRC. Treasury Regulations often provide examples with computations that assist the reader in understanding how IRC provisions apply. Treasury Regulations are formulated on the basis of Treasury Decisions (T.D.s). The numbers of the Treasury Decisions that form the basis of a Treasury Regulation usually are found in the notes at the end of the regulation.

Because of frequent IRC changes, the Treasury Department does not always update the regulations in a timely manner. Consequently, when consulting a regulation, a tax advisor should check its introductory or end note to determine when the regulation was adopted. If the regulation was adopted before the most recent revision of the applicable IRC section, the regulation should be treated as authoritative to the extent consistent with the revision. Thus, for example, if a regulation issued before the passage of an IRC amendment specifies a dollar amount, and the amendment changed the dollar amount, the regulation should be regarded as authoritative in all respects except for the dollar amount.

Proposed, Temporary, and Final Regulations. A Treasury Regulation is first issued in proposed form to the public, which is given an opportunity to comment on it. Parties most likely to comment are individual tax practitioners and representatives of organizations such as the American Bar Association, the Tax Division of the AICPA, and the American Taxation Association. The comments may suggest that the proposed rules could affect taxpayers more adversely than Congress had anticipated. In drafting a final regulation, the Treasury Department generally considers the comments and may modify the rules accordingly. If the comments are favorable, the Treasury Department usually finalizes the regulation with minor revisions. If the comments are unfavorable, it usually finalizes the regulation with major revisions or allows the proposed regulation to expire.

Proposed regulations are just that—proposed. Consequently, they carry no more authoritative weight than do the arguments of the IRS in a court brief. Nevertheless, they represent the Treasury Department's official interpretation of the IRC. By contrast, **temporary regulations** are binding on the taxpayer. Effective as of the date of their publication, they often are issued immediately after passage of a major tax act to guide taxpayers and their advisors on procedural or computational matters. Regulations issued as temporary are concurrently issued as proposed. Because their issuance is not preceded by a public comment period, they are regarded as somewhat less authoritative than final regulations.

Once finalized, regulations can be effective the earliest of (1) the date they were filed with the *Federal Register,* a daily publication that contains federal government pronouncements; (2) the date temporary regulations preceding them were first published in the *Federal Register*; or (3) the date on which a notice describing the expected contents of the regulation was issued to the public.[9] For changes to the IRC enacted after July 29, 1996, the Treasury Department generally cannot issue regulations with retroactive effect.

Interpretative and Legislative Regulations. In addition to being officially classified as proposed, temporary, or final, Treasury Regulations are unofficially classified as interpretative or legislative. **Interpretative regulations** are issued under the general authority of Sec. 7805 and, as the name implies, merely make the IRC's statutory language easier to understand and apply. In addition, they often illustrate various computations. **Legislative regulations**, by contrast, arise where Congress delegates its rule-making authority to the Treasury Department. When Congress believes it lacks the expertise necessary to deal with a highly technical matter, it instructs the Treasury Department to set forth substantive tax rules relating to the matter.

Whenever the IRC contains language such as "The Secretary shall prescribe such regulations as he may deem necessary" or "under regulations prescribed by the Secretary," the regulations interpreting the IRC provision are legislative. The consolidated tax return regulations are an example of legislative regulations. In Sec. 1502, Congress delegated to the Treasury Department authority to issue regulations that determine the tax liability of a group of affiliated corporations filing a consolidated tax return. As a precondition to filing such a return, the corporations must consent to follow the consolidated return regulations.[10] Such consent generally precludes the corporations from later arguing in court that the regulatory provisions are invalid.

Authoritative Weight. Final Treasury Regulations are presumed to be valid and have almost the same authoritative weight as the IRC. Despite this presumption, taxpayers occasionally argue that a regulation is invalid and, consequently, should not be followed.

Prior to 2011, courts held interpretive and legislative regulations to different standards, giving more authority to legislative regulations that Congress specifically delegated to the Treasury Department to draft. The difference in authoritative weight largely disappeared, however, in 2011 with the Supreme Court decision in *Mayo Foundation.* [11] Going forward, both types of regulations will have the same authoritative weight and will be overturned only in very limited cases such as when, in the Court's opinion, the regulations exceed the scope of power delegated to the Treasury Department,[12] are contrary to the IRC,[13] or are unreasonable.[14]

KEY POINT

The older a Treasury Regulation becomes, the less likely a court is to invalidate the regulation. The legislative reenactment doctrine holds that if a regulation did not reflect the intent of Congress, lawmakers would have changed the statute in subsequent legislation to obtain their desired objectives.

In assessing the validity of long-standing Treasury Regulations, some courts apply the **legislative reenactment doctrine**. Under this doctrine, a regulation is deemed to receive congressional approval whenever the IRC provision under which the regulation was issued is reenacted without amendment.[15] Underlying this doctrine is the rationale that, if Congress believed that the regulation offered an erroneous interpretation of the IRC, it would have amended the IRC to conform to its belief. Congress's failure to amend the IRC signifies approval of the regulation.[16] This doctrine is predicated on Congress's constitutional authority to levy taxes. This authority implies that, if Congress is dissatisfied with the manner in which either the executive or the judiciary has interpreted the IRC, it can invalidate these interpretations through new legislation.

STOP & THINK

Question: You are researching the manner in which a deduction is calculated. You consult Treasury Regulations for guidance because the IRC states that the calculation is to be done "in a manner prescribed by the Secretary." After reviewing these authorities, you

[9] Sec. 7805(b).
[10] Sec. 1501.
[11] *Mayo Foundation for Medical Education & Research, et al. v. U.S.,* 107 AFTR 2d 2011-341, 131 S.Ct. 704 (2011).
[12] *McDonald v. CIR,* 56 AFTR 2d 85-5318, 85-2 USTC ¶9494 (5th Cir., 1985).
[13] *Jeanese, Inc. v. U.S.,* 15 AFTR 2d 429, 65-1 USTC ¶9259 (9th Cir., 1965).
[14] *United States v. Vogel Fertilizer Co.,* 49 AFTR 2d 82-491, 82-1 USTC ¶9134 (USSC, 1982).
[15] *United States v. Homer O. Correll,* 20 AFTR 2d 5845, 68-1 USTC ¶9101 (USSC, 1967).
[16] One can rebut the presumption that Congress approved of the regulation by showing that Congress was unaware of the regulation when it reenacted the statute.

conclude that another way of doing the calculation arguably is correct under an intuitive approach. This approach would result in a lower tax liability for the client. Should you follow the Treasury Regulations, or should you use the intuitive approach and argue that the regulations are invalid?

Solution: Because of the language "in a manner prescribed by the Secretary," the Treasury Regulations dealing with the calculation are legislative. Whenever Congress calls for legislative regulations, it explicitly authorizes (directs) the Treasury Department to write the "rules." Thus, a challenge based on the existence of a reasonable alternative method is unlikely to succeed in court. Under the *Mayo Foundation* decision, you should reach the same conclusion even if dealing with an interpretive Treasury Regulation.

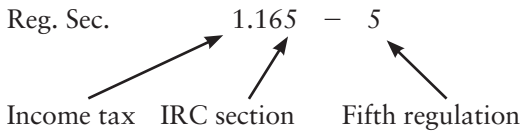
ADDITIONAL COMMENT

Citations serve two purposes in tax research: first, they substantiate propositions; second, they enable the reader to locate underlying authority.

Citations. Citations to Treasury Regulations are relatively easy to understand. One or more numbers appear before a decimal place, and several numbers follow the decimal place. The numbers immediately following the decimal place indicate the IRC section being interpreted. The numbers preceding the decimal place indicate the general subject of the regulation. Numbers that often appear before the decimal place and their general subjects are as follows:

Number	*General Subject Matter*
1	Income tax
20	Estate tax
25	Gift tax
301	Administrative and procedural matters
601	Procedural rules

The number following the IRC section number indicates the numerical sequence of the regulation, such as the fifth regulation. No relationship exists between this number and the subsection of the IRC being interpreted. An example of a citation to a final regulation is as follows:



Citations to proposed or temporary regulations follow the same format. They are referenced as Prop. Reg. Sec. or Temp. Reg. Sec. For temporary regulations the numbering system following the IRC section number always begins with the number of the regulation and an upper case T (e.g., -1T).

Section 165 addresses the broad topic of losses and is interpreted by several regulations. According to its caption, the topic of Reg. Sec. 1.165-5 is worthless securities, which also is addressed in subsection (g) of IRC Sec. 165. Parenthetical information following the text of the Treasury Regulation indicates that the regulation was last revised on March 11, 2008, by Treasury Decision (T.D.) 9386. Section 165(g) was last amended in 2000. A researcher must always check when the regulations were last amended and be aware that an IRC change may have occurred after the most recent regulation amendment, potentially making the regulation inapplicable.

When referencing a regulation, the researcher should fine-tune the citation to indicate the precise passage that supports his or her conclusion. An example of such a detailed citation is Reg. Sec. 1.165-5(j), Ex. 2(i), which refers to paragraph (i) of Example 2, found in paragraph (j) of the fifth regulation interpreting Sec. 165.

ADMINISTRATIVE PRONOUNCEMENTS

The IRS interprets the IRC through **administrative pronouncements**, the most important of which are discussed below. After consulting the IRC and Treasury Regulations, tax advisors are likely next to consult these pronouncements.

TYPICAL MISCONCEPTION

Even though revenue rulings do not have the same weight as Treasury Regulations or court cases, one should not underestimate their importance. Because a revenue ruling is the official published position of the IRS, in audits the examining agent will place considerable weight on any applicable revenue rulings.

Revenue Rulings. In **revenue rulings**, the IRS indicates the tax consequences of specific transactions encountered in practice. For example, in a revenue ruling, the IRS might indicate whether the exchange of stock for stock derivatives in a corporate acquisition is tax-free.

The IRS issues more than 50 revenue rulings a year. These rulings do not rank as high in the hierarchy of authorities as do Treasury Regulations or federal court cases. They simply represent the IRS's view of the tax law. Taxpayers who do not follow a revenue ruling will not incur a substantial understatement penalty if they have substantial authority for different treatment.[17] Nonetheless, the IRS presumes that the tax treatment specified in a revenue ruling is correct. Consequently, if an examining agent discovers in an audit that a taxpayer did not adopt the position prescribed in a revenue ruling, the agent will contend that the taxpayer's tax liability should be adjusted to reflect that position.

A revenue ruling appears in the weekly *Internal Revenue Bulletin* (cited as I.R.B.), published by the U.S. Government Printing Office (GPO). Prior to 2009, revenue rulings appeared in the *Cumulative Bulletin* (cited as C.B.), a bound volume issued semiannually by the GPO. An example of a citation to a revenue ruling appearing in the *Cumulative Bulletin* is as follows:

Rev. Rul. 97-4, 1997-1 C.B. 5.

This is the fourth ruling issued in 1997, and it appears on page 5 of Volume 1 of the 1997 *Cumulative Bulletin*. For rulings after 2008, researchers should use citations to the *Internal Revenue Bulletin*. An example of such a citation follows:

Rev. Rul. 2013-8, 2013-15 I.R.B. 763.

For revenue rulings (and other IRS pronouncements) issued after 1999, the full four digits of the year of issuance are set forth in the title. For revenue rulings (and other IRS pronouncements) issued before 2000, only the last two digits of the year of issuance are set forth in the title. The above citation represents the eighth ruling for 2013. This ruling is located on page 763 of the *Internal Revenue Bulletin* for the fifteenth week of 2013. Once a revenue ruling is published in the *Cumulative Bulletin,* only the citation to the *Cumulative Bulletin* should be used. Thus, a citation to the I.R.B. is temporary.

Revenue Procedures. As the name suggests, **revenue procedures** are IRS pronouncements that usually deal with the procedural aspects of tax practice. For example, one revenue procedure deals with the manner in which tip income should be reported. Another revenue procedure describes the requirements for reproducing paper substitutes for informational returns such as Form 1099.

As with revenue rulings, revenue procedures are published in the *Internal Revenue Bulletin* and, prior to 2009, in the *Cumulative Bulletin*. For revenue procedures issued after 2008, the I.R.B. is the final reference. An example of a citation to a revenue procedure appearing in the *Internal Revenue Bulletin* is as follows:

SELF-STUDY QUESTION

Are letter rulings of precedential value for third parties?

ANSWER

No. A letter ruling is binding only on the taxpayer to whom the ruling was issued. Nevertheless, letter rulings can be very useful to third parties because they provide insight as to the IRS's opinion about the tax consequences of various transactions.

Rev. Proc. 2017-4, 2017-1 I.R.B. 146.

This pronouncement is found in the first issue of the *Internal Revenue Bulletin* on page 146. It is the fourth revenue procedure issued in 2017.

In addition to revenue rulings and revenue procedures, the *Cumulative Bulletin* contains IRS notices, as well as the texts of proposed regulations, tax treaties, committee reports, and U.S. Supreme Court decisions.

Letter Rulings. **Letter rulings** are initiated by taxpayers who ask the IRS to explain the tax consequences of a particular transaction.[18] The IRS provides its explanation in the form of a letter ruling, a response personal to the taxpayer requesting an answer. Only the

[17] Chapter C:15 discusses the authoritative support taxpayers and tax advisors should have for positions they adopt on a tax return.

[18] Chapter C:15 further discusses letter rulings.

taxpayer to whom the ruling is addressed may rely on it as authority. Nevertheless, letter rulings are relevant for other taxpayers and tax advisors because they offer insight into the IRS's position on the tax treatment of particular transactions.

Originally the public did not have access to letter rulings issued to other taxpayers. As a result of Sec. 6110, enacted in 1976, letter rulings (with confidential information deleted) are accessible to the general public and have been reproduced by major tax services. An example of a citation to a letter ruling appears below:

Ltr. Rul. 200130006 (July 30, 2001).

The first four digits (two if issued before 2000) indicate the year in which the ruling was made public, in this case, 2001.[19] The next two digits denote the week in which the ruling was made public, here the thirtieth. The last three numbers indicate the numerical sequence of the ruling for the week, here the sixth. The date in parentheses denotes the date of the ruling.

ADDITIONAL COMMENT

A technical advice memorandum is published as a letter ruling. Whereas a taxpayer-requested letter ruling deals with prospective transactions, a technical advice memorandum deals with past or consummated transactions.

Other Interpretations

Technical Advice Memoranda. When the IRS audits a taxpayer's return, the IRS agent might ask the IRS national office for advice on a complicated, technical matter. The national office will provide its advice in a **technical advice memorandum**, released to the public in the form of a letter ruling.[20] Researchers can identify which letter rulings are technical advice memoranda by introductory language such as, "In response to a request for technical advice. . . ." An example of a citation to a technical advice memorandum is as follows:

T.A.M. 9801001 (January 2, 1998).

This citation refers to the first technical advice memorandum issued in the first week of 1998. The memorandum is dated January 2, 1998.

News Releases. If the IRS wants to disseminate information to the general public, it will issue a **news release**. News releases are written in lay terms and are dispatched to thousands of newspapers throughout the country. The IRS, for example, may issue a news release to announce the standard mileage rate for business travel. An example of a citation to a news release is as follows:

I.R. News Release 2012-25 (February 17, 2012).

This citation is to the twenty-fifth news release issued in 2012. The release is dated February 17, 2012.

ADDITIONAL COMMENT

Announcements are used to summarize new tax legislation or publicize procedural matters. Announcements generally are aimed at tax practitioners and are considered to be "substantial authority" [Rev. Rul. 90-91, 1990-2 C.B. 262].

Announcements and Notices. The IRS also disseminates information to tax practitioners in the form of **announcements** and **notices**. These pronouncements generally are more technical than information releases and frequently address current tax developments. After passage of a major tax act, and before the Treasury Department has had an opportunity to issue proposed or temporary regulations, the IRS may issue an announcement or notice to clarify the legislation. The IRS is bound to follow the announcement or notice just as it is bound to follow a revenue procedure or revenue ruling. Examples of citations to announcements and notices are as follows:

Announcement 2007-3, 2007-1 C.B. 376.
Notice 2007-9, 2007-1 C.B. 401.

The first citation is to the third announcement issued in 2007. It can be found on page 376 of the first *Cumulative Bulletin* for 2007. The second citation is to the ninth

[19] Sometimes a letter ruling is cited as PLR (private letter ruling) instead of Ltr. Rul.

[20] Technical advice memoranda are discussed further in Chapter C:15.

notice issued in 2007. It can be found on page 401 of the first *Cumulative Bulletin* for 2007. Notices and announcements issued prior to 2009 appear in both the *Internal Revenue Bulletin* and the *Cumulative Bulletin,* but after 2008 they appear only in the *Internal Revenue Bulletin*.

JUDICIAL DECISIONS

Judicial decisions are an important source of tax law. Judges are reputed to be unbiased individuals who decide questions of fact (the existence of a fact or the occurrence of an event) or questions of law (the applicability of a legal principle or the proper interpretation of a legal term or provision). Judges do not always agree on the tax consequences of a particular transaction or event. Therefore, tax advisors often must derive conclusions against a background of conflicting judicial authorities. For example, a U.S. district court might disagree with the Tax Court on the deductibility of an expense. Likewise, one circuit court might disagree with another circuit court on the same issue.

Overview of the Court System. A taxpayer may begin tax litigation in any of three courts: the U.S. Tax Court, the U.S. Court of Federal Claims (formerly the U.S. Claims Court), or U.S. district courts. Court precedents are important in deciding where to begin such litigation (see page C:1-21 for a discussion of precedent). Also important is when the taxpayer must pay the deficiency the IRS contends is due. A taxpayer who wants to litigate either in a U.S. district court or in the U.S. Court of Federal Claims must first pay the deficiency. The taxpayer then files a claim for refund, which the IRS is likely to deny. Following this denial, the taxpayer must petition the court for a refund. If the court grants the taxpayer's petition, he or she receives a refund of the taxes in question plus accrued interest. If the taxpayer begins litigation in the Tax Court, on the other hand, he or she need not pay the deficiency unless and until the court decides the case against him or her. In that event, the taxpayer also must pay interest and penalties.[21] A taxpayer who believes that a jury would be sympathetic to his or her case should litigate in a U.S. district court, the only forum where a jury trial is possible.

SELF-STUDY QUESTION

What are some of the factors that a taxpayer should consider when deciding in which court to file a tax-related claim?

ANSWER

(1) Each court's published precedent pertaining to the issue, (2) desirability of a jury trial, (3) tax expertise of each court, and (4) when the deficiency must be paid.

If a party loses at the trial court level, it can appeal the decision to a higher court. Appeals of Tax Court and U.S. district court decisions are made to the court of appeals for the taxpayer's circuit. The appeals court system is comprised of 11 geographical circuits designated by numbers, the District of Columbia Circuit, and the Federal Circuit.[22] Table C:1-1 shows the states that lie in the various circuits. California, for example, lies in the Ninth Circuit. When referring to these appellate courts, instead of saying, for example, "the Court of Appeals for the Ninth Circuit," one generally says "the Ninth Circuit." All decisions of the U.S. Court of Federal Claims are appealable to one court—the Court of Appeals for the Federal Circuit—irrespective of where the taxpayer resides or does business.[23] The only cases the Federal Circuit hears are those that originate in the U.S. Court of Federal Claims.

ADDITIONAL COMMENT

Because the Tax Court deals only with tax cases, it presumably has a higher level of tax expertise than do other courts. Tax Court judges are appointed by the President, in part, due to their considerable tax experience. The Tax Court typically maintains a large backlog of tax cases, sometimes numbering in the tens of thousands.

The party losing at the appellate level can petition the U.S. Supreme Court to review the case under a **writ of certiorari**. If the Supreme Court agrees to hear the case, it grants certiorari.[24] If it refuses to hear the case, it denies certiorari. In recent years, the Court has granted certiorari in only about six to ten tax cases per year. Figure C:1-3 and Table C:1-2 provide an overview and summary of the court system with respect to tax matters.

The U.S. Tax Court. The U.S. Tax Court was created in 1942 as a successor to the Board of Tax Appeals. It is a court of national jurisdiction that hears only tax-related cases. All taxpayers, regardless of their state of residence or place of business, may litigate in the Tax Court. It has 19 judges, including one chief judge.[25] The President, with the consent of the Senate, appoints the judges for a 15-year term and may reappoint them for an additional

[21] Revenue Procedure 2005-18, 2005-1 C.B. 798, provides procedures for taxpayers to make remittances or apply overpayments to stop the accrual of interest on deficiencies.

[22] The Federal Circuit has nationwide jurisdiction to hear appeals in specialized cases, such as those involving patent laws.

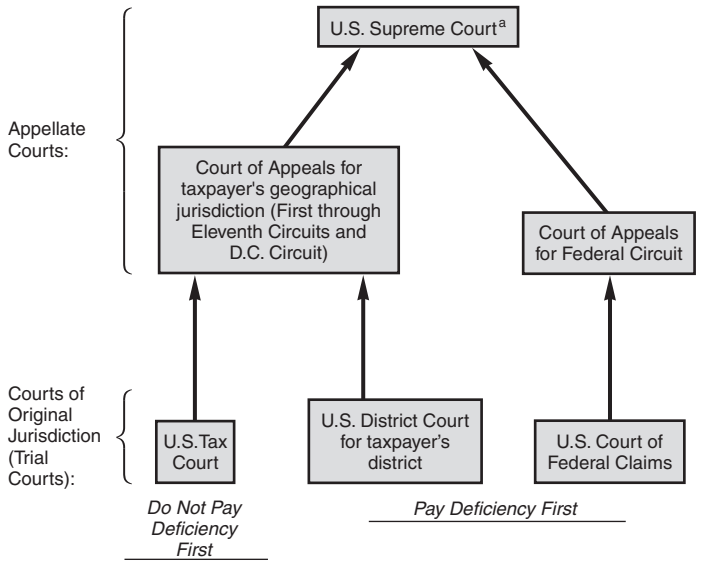
[23] The Court of Claims was reconstituted as the United States Court of Claims in 1982. In 1992, this court was renamed the U.S. Court of Federal Claims.

[24] The granting of certiorari signifies that the Supreme Court is granting an appellate review. The denial of certiorari does not necessarily mean that the Supreme Court endorses the lower court's decision. It simply means the court has decided not to hear the case.

[25] The Tax Court also periodically appoints, depending on budgetary constraints, a number of trial judges and senior judges who hear cases and render decisions with the same authority as the regular Tax Court judges.

▼ **TABLE C:1-1**
Federal Judicial Circuits

Circuit	States Included in Circuit
First	Maine, Massachusetts, New Hampshire, Rhode Island, Puerto Rico
Second	Connecticut, New York, Vermont
Third	Delaware, New Jersey, Pennsylvania, Virgin Islands
Fourth	Maryland, North Carolina, South Carolina, Virginia, West Virginia
Fifth	Louisiana, Mississippi, Texas
Sixth	Kentucky, Michigan, Ohio, Tennessee
Seventh	Illinois, Indiana, Wisconsin
Eighth	Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
Ninth	Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington, Guam, Northern Marina Islands
Tenth	Colorado, Kansas, New Mexico, Oklahoma, Utah, Wyoming
Eleventh	Alabama, Florida, Georgia
D.C.	District of Columbia
Federal	All jurisdictions (for taxpayers appealing from the U.S. Court of Federal Claims)



[a] Cases are heard only if the Supreme Court grants certiorari.

FIGURE C:1-3 ▶ OVERVIEW OF COURT SYSTEM—TAX MATTERS

term. The judges, specialists in tax-related matters, periodically travel to roughly 100 cities throughout the country to hear cases. In most instances, only one judge hears a case.

The Tax Court issues both regular and memorandum (memo) decisions. Generally, the first time the Tax Court decides a legal issue, its decision appears as a **regular decision**. **Memo decisions**, on the other hand, usually deal with factual variations of previously decided cases. Nevertheless, regular and memo decisions carry the same authoritative weight.

At times, the chief judge determines that a particular case concerns an important issue that the entire Tax Court should consider. In such a situation, the words *reviewed by the court* appear at the end of the majority opinion. Any concurring or dissenting opinions follow the majority opinion. A judge who issues a concurring opinion agrees with the basic outcome of the majority's decision but not with its rationale. A judge who issues a dissenting opinion believes the majority reached an erroneous conclusion.

▼ **TABLE C:1-2**
Summary of Court System—Tax Matters

Court(s) (Number of)	Number of Judges on Each	Personal Jurisdiction	Subject Matter Jurisdiction	Determines Questions of Fact	Trial by Jury	Precedents Followed	Where Opinions Published
U.S. district courts (over 95)	1–28*	Local	General	Yes	Yes	Same court Court for circuit where situated U.S. Supreme Court	*Federal Supplement* *American Federal Tax Reports* *United States Tax Cases*
U.S. Tax Court (1)	19	National	Tax	Yes	No	Same court Court for taxpayer's circuit U.S. Supreme Court	*Tax Court of the U.S. Reports* *CCH Tax Court Memorandum Decisions* *RIA Tax Court Memorandum Decisions*
U.S. Court of Federal Claims (1)	16	National	Claims against U.S. Government	Yes	No	Same court Federal Circuit Court U.S. Supreme Court	*Federal Reporter (pre-1982)* *U.S. Court of Federal Claims* *American Federal Tax Reports* *United States Tax Cases*
U.S. Courts of Appeals (13)	About 20	Regional	General	No	No	Same court U.S. Supreme Court	*Federal Reporter* *American Federal Tax Reports* *United States Tax Cases*
U.S. Supreme Court (1)	9	National	General	No	No	Same court	*U.S. Supreme Court Reports* *Supreme Court Reporter* *United States Reports, Lawyers' Edition* *American Federal Tax Reports* *United States Tax Cases*

*Although the number of judges assigned to each court varies, only one judge hears a case.

Another phrase sometimes appearing at the end of a Tax Court opinion is *Entered under Rule 155*. This phrase signifies that the court has reached a decision concerning the tax treatment of an item but has left computation of the deficiency to the two litigating parties.

SELF-STUDY QUESTION

What are some of the considerations for litigating under the small cases procedure of the Tax Court?

ANSWER

The small cases procedure gives the taxpayer the advantage of having his or her "day in court" without the expense of an attorney. But if the taxpayer loses, the decision cannot be appealed. On the other hand, the IRS also cannot appeal if *it* loses.

Small Cases Procedure. Taxpayers have the option of having their cases heard under the **small cases procedure** of the Tax Court if the amount in controversy on an annual basis does not exceed $50,000.[26] This procedure is less formal than the regular Tax Court procedure, and taxpayers can represent themselves without an attorney.[27] The cases are heard by special commissioners instead of by one of the 19 Tax Court judges. A disadvantage of the small cases procedure for the losing party is that the decision cannot be appealed. The opinions of the commissioners generally are not published and have no precedential value.

Acquiescence Policy. The IRS has adopted a policy of announcing whether, in future cases involving similar facts and similar issues, it will follow federal court decisions that are adverse to it. This policy is known as the IRS **acquiescence policy**. If the IRS wants taxpayers to know that it will follow an adverse decision in future cases involving similar facts and issues, it will announce its "acquiescence" in the decision. Conversely, if it wants taxpayers to know that it will not follow the decision in such future cases, it will announce its "nonacquiescence." The IRS does not announce its acquiescence or nonacquiescence in every decision it loses.

ADDITIONAL COMMENT

The only cases with respect to which the IRS will acquiesce or nonacquiesce are decisions that the government loses. Because the majority of cases, particularly Tax Court cases, are won by the government, the IRS will potentially acquiesce in only a small number of cases.

The IRS publishes its acquiescences and nonacquiescences as "Actions on Decision" first in the *Internal Revenue Bulletin,* then in the *Cumulative Bulletin.* Before 1991, the IRS acquiesced or nonacquiesced in regular Tax Court decisions only. In 1991, it broadened the scope of its policy to include adverse U.S. Claims Court, U.S. district court, and U.S. circuit court decisions.

In cases involving multiple issues, the IRS may acquiesce in some issues but not others. In decisions supported by extensive reasoning, it may acquiesce in the result but not the rationale (*acq. in result*). Furthermore, it may retroactively revoke an acquiescence or nonacquiescence. The footnotes to the relevant announcement in the *Internal Revenue Bulletin* and *Cumulative Bulletin* indicate the nature and extent of IRS acquiescences and nonacquiescences.

These acquiescences and nonacquiescences have important implications for taxpayers. If a taxpayer bases his or her position on a decision in which the IRS has nonacquiesced, he or she can expect an IRS challenge in the event of an audit. In such circumstances, the taxpayer's only recourse may be litigation. On the other hand, if the taxpayer bases his or her position on a decision in which the IRS has acquiesced, he or she can expect little or no challenge. In either case, the examining agent will be bound by the IRS position.

Published Opinions and Citations. Regular Tax Court decisions are published by the U.S. Government Printing Office in a bound volume known as the *Tax Court of the United States Reports*. Soon after a decision is made public, Research Institute of America (RIA) and Commerce Clearing House (CCH) each publish the decision in its respective reporter of Tax Court decisions. An official citation to a Tax Court decision is as follows:[28]

ADDITIONAL COMMENT

If a particular case is important, the chief judge will instruct the other judges to review the case. If a case is reviewed by the entire court, the phrase *reviewed by the court* is inserted immediately after the text of the majority opinion. A reviewed decision provides an opportunity for Tax Court judges to express their dissenting opinions.

MedChem Products, Inc., 116 T.C. 308 (2001).

The citation indicates that this case appears on page 308 in Volume 116 of *Tax Court of the United States Reports* and that the case was decided in 2001.

[26] Sec. 7463. The $50,000 amount includes penalties and additional taxes but excludes interest.

[27] Taxpayers also can represent themselves in regular Tax Court proceedings even though they are not attorneys. Where taxpayers represent themselves, the words *pro se* appear in the opinion after the taxpayer's name. The Tax Court is the only federal court before which non-attorneys, including CPAs, may practice.

[28] In a citation to a case decided by the Tax Court, only the name of the plaintiff (taxpayer) is listed. The defendant is understood to be the Commissioner of Internal Revenue whose name usually is not shown in the citation. In cases decided by other courts, the name of the plaintiff is listed first and the name of the defendant second. For non-Tax Court cases, the Commissioner of Internal Revenue is referred to as *CIR* in our footnotes and text.

From 1924 to 1942, regular decisions of the Board of Tax Appeals (predecessor of the Tax Court) were published by the U.S. Government Printing Office in the *United States Board of Tax Appeals Reports*. An example of a citation to a Board of Tax Appeals case is as follows:

J.W. Wells Lumber Co. Trust A., 44 B.T.A. 551 (1941).

This case is found in Volume 44 of the *United States Board of Tax Appeals Reports* on page 551. It is a 1941 decision.

ADDITIONAL COMMENT

Once the IRS has acquiesced in a federal court decision, other taxpayers generally will not need to litigate the same issue. However, the IRS can change its mind and revoke a previous acquiescence or nonacquiescence. References to acquiescences or nonacquiescences in federal court decisions can be found in the citators.

If the IRS has acquiesced or nonacquiesced in a federal court decision, the IRS's action should be denoted in the citation. At times, the IRS will not announce its acquiescence or nonacquiescence until several years after the date of the decision. An example of a citation to a decision in which the IRS has acquiesced is as follows:

Security State Bank, 85 AFTR 2d 2000-1980, *acq*. 2001-001.

The case appears on page 2000-1980 of Volume 85 of the AFTR, Second Series. In 2001, the IRS acquiesced in this decision. A citation to a decision in which the IRS has nonacquiesced is as follows:

Estate of Algerine Allen Smith, 108 T.C. 412 (1997), *nonacq*. A.O.D. 2000-1.

KEY POINT

To access all Tax Court cases, a tax advisor must refer to two different publications. The regular opinions appear in the *Tax Court of the United States Reports,* published by the U.S. Government Printing Office, and the memo decisions are published by both RIA (formerly PH) and CCH in their own court reporters.

The case appears on page 412 of Volume 108 of the *Tax Court of the United States Reports*. In 2000, the IRS nonacquiesced in this 1997 decision.

Tax Court memo decisions are not published by the U.S. Government Printing Office. They are, however, published by RIA in *RIA T.C. Memorandum Decisions* and by CCH in *CCH Tax Court Memorandum Decisions*. In addition, shortly after its issuance, an opinion is made available electronically and in loose-leaf form by RIA and CCH in their respective tax services. The following citation is to a Tax Court memo decision:

Edith G. McKinney, 1981 PH T.C. Memo ¶81,181 (T.C. Memo 1981-181), 41 TCM 1272.

ADDITIONAL COMMENT

In its Internet-based tax service (see Page C:1-26), RIA uses a different format for its Tax Court Memorandum Decisions, which in this textbook appear in parentheses after the "official" RIA citation.

McKinney is found at Paragraph 81,181 of Prentice Hall's (now RIA's)[29] 1981 *PH T.C. Memorandum Decisions* reporter, and in Volume 41, page 1272, of CCH's *Tax Court Memorandum Decisions*. The 181 in the PH citation indicates that the case is the Tax Court's 181st memo decision of the year. A more recent citation is formatted in the same way but refers to RIA memo decisions.

Paul F. Belloff, 1992 RIA T.C. Memo ¶92,346 (T.C. Memo 1992-346), 63 TCM 3150.

U.S. District Courts. Each state has at least one U.S. district court, and more populous states have more than one. Each district court is independent of the others and is thus free to issue its own decisions, subject to the precedential constraints discussed later in this chapter. Different types of cases—not just tax-related—are adjudicated in this forum. A district court is the only forum in which the taxpayer may have a jury decide questions of fact. Depending on the circumstances, a jury trial might be advantageous for the taxpayer.[30]

District court decisions are officially reported in the *Federal Supplement* (cited as F. Supp.) published by West®. Some decisions are not officially reported and are referred

[29] Several ownership changes have occurred for publishers of tax service materials. Thomson Reuters added the former Prentice Hall tax materials to the product line of its RIA tax publishing division. RIA and West® are members of Thomson Reuters, Tax and Accounting Division, and CCH is a member of the Wolters Kluwer Tax, Accounting and Legal Division.

[30] Taxpayers might prefer to have a jury trial if they believe a jury will be sympathetic to their case.

to as **unreported decisions**. Decisions by U.S. district courts on the topic of taxation also are published by RIA and CCH in secondary reporters that contain only tax-related opinions. RIA's reporter is *American Federal Tax Reports* (cited as AFTR).[31] CCH's reporter is *U.S. Tax Cases* (cited as USTC). A case not officially reported nevertheless might be published in the AFTR and USTC. An example of a complete citation to a U.S. district court decision is as follows:

> *Alfred Abdo, Jr. v. IRS,* 234 F. Supp. 2d 533, 90 AFTR 2d 2002-7484, 2003-1 USTC ¶50,107 (DC North Carolina, 2002).

ADDITIONAL COMMENT

A citation, at a minimum, should contain the following information: (1) the name of the case, (2) the reporter that publishes the case along with both a volume and page (or paragraph) number, (3) the year the case was decided, and (4) the court that decided the case.

In the example above, the **primary citation** is to the *Federal Supplement*. The case appears on page 533 of Volume 234 of the second series of this reporter. **Secondary citations** are to *American Federal Tax Reports* and *U.S. Tax Cases*. The same case is found in Volume 90 of the second series of the AFTR, page 2002-7484 (meaning page 7484 in the volume containing 2002 cases) and in Volume 1 of the 2003 USTC at Paragraph 50,107. The parenthetical information indicates that the case was decided in 2002 by the U.S. District Court for North Carolina. Because some judicial decisions have greater precedential weight than others (e.g., a Supreme Court decision versus a district court decision), information relating to the identity of the adjudicating court is useful in evaluating the authoritative value of the decision.

ADDITIONAL COMMENT

The U.S. Court of Federal Claims adjudicates claims (including suits to recover federal income taxes) against the U.S. Government. This court usually hears cases in Washington, D.C., but will hold sessions in other locations as the court deems necessary.

U.S. Court of Federal Claims. The U.S. Court of Federal Claims, another court of first instance that addresses tax matters, has nationwide jurisdiction. Originally, this court was called the U.S. Court of Claims (cited as Ct. Cl.), and its decisions were appealable to the U.S. Supreme Court only. In a reorganization, effective October 1, 1982, the reconstituted court was named the U.S. Claims Court (cited as Cl. Ct.), and its decisions became appealable to the Circuit Court of Appeals for the Federal Circuit. In October 1992, the court's name was again changed to the U.S. Court of Federal Claims (cited as Fed. Cl.).

Beginning in 1982, U.S. Claims Court decisions were reported officially in the *Claims Court Reporter,* published by West® from 1982 to 1992.[32] An example of a citation to a U.S. Claims Court decision appears below:

> *Benjamin Raphan v. U.S.,* 3 Cl. Ct. 457, 52 AFTR 2d 83-5987, 83-2 USTC ¶9613 (1983).

The *Raphan* case appears on page 457 of Volume 3 of the *Claims Court Reporter*. Secondary citations are to Volume 52, page 83-5987 of the AFTR, Second Series, and to Volume 2 of the 1983 USTC at Paragraph 9613.

Effective with the 1992 reorganization, decisions of the U.S. Court of Federal Claims are now reported in the *Federal Claims Reporter.* An example of a citation to an opinion published in this reporter is presented below:

> *Jeffrey G. Sharp v. U.S.,* 27 Fed. Cl. 52, 70 AFTR 2d 92-6040, 92-2 USTC ¶50,561 (1992).

The *Sharp* case appears on page 52 of Volume 27 of the *Federal Claims Reporter,* on page 6040 of the 70th volume of the AFTR, Second Series, and at Paragraph 50,561 of Volume 2 of the 1992 USTC reporter. Note that, even though the name of the reporter published by West® has changed, the volume numbers continue in sequence as if no name change had occurred.

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[31] The *American Federal Tax Reports* (AFTR) is published in two series. The first series, which includes opinions issued up to 1957, is cited as AFTR. The second series, which includes opinions issued after 1957, is cited as AFTR 2d. The *Alfred Abdo, Jr.* decision cited as an illustration of a U.S. district court decision appears in the second *American Federal Tax Reports* series.

[32] Before the creation in 1982 of the U.S. Claims Court (and the *Claims Court Reporter*), the opinions of the U.S. Court of Claims were reported in either the *Federal Supplement* (F. Supp.) or the *Federal Reporter, Second Series* (F.2d). The *Federal Supplement* is the primary source of U.S. Court of Claims opinions from 1932 through January 19, 1960. Opinions issued from January 20, 1960, to October 1982 are reported in the *Federal Reporter, Second Series*.

Circuit Courts of Appeals. Lower court decisions are appealable by the losing party to the court of appeals for the circuit in which the litigation originated. Generally, if the case began in the Tax Court or a U.S. district court, the case is appealable to the circuit for the individual's residence as of the appeal date. For a corporation, the case is appealable to the circuit for the corporation's principal place of business. The Federal Circuit hears all appeals of cases originating in the U.S. Court of Federal Claims.

As mentioned earlier, there are 11 geographical circuits designated by numbers, the District of Columbia Circuit, and the Federal Circuit. In October 1981, the Eleventh Circuit was created by moving Alabama, Georgia, and Florida from the Fifth to a new geographical circuit. The Eleventh Circuit has adopted the policy of following as precedent all decisions of the Fifth Circuit during the time the states currently constituting the Eleventh Circuit were part of the Fifth Circuit.[33]

EXAMPLE C:1-7 ▶ In the current year, the Eleventh Circuit first considered an issue in a case involving a Florida taxpayer. In 1980, the Fifth Circuit had ruled on the same issue in a case involving a Louisiana taxpayer. Because Florida was part of the Fifth Circuit in 1980, under the policy adopted by the Eleventh Circuit, it will follow the Fifth Circuit's earlier decision. Had the Fifth Circuit's decision been rendered in 1982—after the creation of the Eleventh Circuit—the Eleventh Circuit would not have been bound by the Fifth Circuit's decision. ◀

As the later discussion of precedent points out, different circuits may reach different conclusions concerning similar facts and issues.

Circuit court decisions—regardless of topic (e.g., civil rights, securities law, and taxation)—are now reported officially in the *Federal Reporter, Third Series* (cited as F.3d), published by West®. The third series was created in October 1993 after the volume number for the second series reached 999. The primary citation to a circuit court opinion should be to the *Federal Reporter*. Tax decisions of the circuit courts also appear in the *American Federal Tax Reports* and *U.S. Tax Cases*. Below is an example of a citation to a 1994 circuit court decision:

> *Greene v. U.S.*, 185 F. 3d 67, 84 AFTR 2d 99-5415, 99-2 USTC ¶50,701 (3rd Cir., 1999).

The *Greene* case appears on page 67 of Volume 185 of the *Federal Reporter, Third Series*. It also is published in Volume 84, page 99-5415 of the AFTR, Second Series, and in Volume 2, Paragraph 50,701, of the 1999 USTC. The parenthetical information indicates that the Third Circuit decided the case in 1999. (A *Federal Reporter, Second Series* reference is found in footnote 33 of this chapter.)

ADDITIONAL COMMENT

A judge is not required to follow judicial precedent beyond his or her jurisdiction. Thus, the Tax Court, the U.S. district courts, and the U.S. Court of Federal Claims are not required to follow the others' decisions, nor is a circuit court required to follow the decision of a different circuit court.

U.S. Supreme Court. Whichever party loses at the appellate level can request that the U.S. Supreme Court hear the case. The Supreme Court, however, hears very few tax cases. Unless the circuits are divided on the tax treatment of an item, or the issue is deemed to be of great significance, the Supreme Court probably will not hear the case.[34] Supreme Court decisions are the law of the land and take precedence over all other court decisions, including the Supreme Court's earlier decisions. As a practical matter, a Supreme Court interpretation of the IRC is almost as authoritative as an act of Congress. If Congress does not agree with the Court's interpretation, it can amend the IRC to achieve a different result and has in fact done so on a number of occasions. If the Supreme Court declares a tax statute to be unconstitutional, the statute is invalid.

All Supreme Court decisions, regardless of subject, are published in the *United States Supreme Court Reports* (cited as U.S.) by the U.S. Government Printing Office, the *Supreme Court Reporter* (cited as S. Ct.) by West®, and the *United States Reports, Lawyers' Edition* (cited as L. Ed.) by LexisNexis®. In addition, the AFTR and USTC

[33] *Bonner v. City of Prichard*, 661 F.2d 1206 (11th Cir., 1981).

[34] *Vogel Fertilizer Co. v. U.S.*, 49 AFTR 2d 82-491, 82-1 USTC ¶9134 (USSC, 1982), is an example of a case the Supreme Court heard to settle a split in judicial authority. The Fifth Circuit, the Tax Court, and the Court of Claims had reached one conclusion on an issue, while the Second, Fourth, and Eighth Circuits had reached another.

reporters published by RIA and CCH, respectively, contain Supreme Court decisions concerned with taxation. An example of a citation to a Supreme Court opinion appears below:

> *Boeing Company v. U.S.*, 537 U.S. 437, 91 AFTR 2d 2003-1088, 2003-1 USTC ¶50,273 (USSC, 2003).

According to the primary citation, this case appears in Volume 537, page 437, of the *United States Supreme Court Reports*. According to the secondary citation, it also appears in Volume 91, page 2003-1088, of the AFTR, Second Series, and in Volume 1, Paragraph 50,273, of the 2003 USTC.

SELF-STUDY QUESTION

Is it possible for the Tax Court to intentionally issue conflicting decisions?

ANSWER

Yes. If the Tax Court issues two decisions that are appealable to different circuit courts and these courts have previously reached different conclusions on the issue, the Tax Court follows the respective precedent in each circuit and issues conflicting decisions. This is a result of the *Golsen* Rule.

Table C:1-3 provides a summary of how the IRC, court decisions, revenue rulings, revenue procedures, and other administrative pronouncements should be cited. Primary citations are to the reporters published by West® or the U.S. Government Printing Office, and secondary citations are to the AFTR and USTC.

Precedential Value of Various Decisions.

Tax Court. The Tax Court is a court of national jurisdiction. Consequently, it generally rules uniformly for all taxpayers, regardless of their residence or place of business. It follows U.S. Supreme Court decisions and its own earlier decisions. It is not bound by cases decided by the U.S. Court of Federal Claims or a U.S. district court, even if the district court has jurisdiction over the taxpayer.

In 1970, the Tax Court adopted what is known as the *Golsen* Rule.[35] Under this rule, the Tax Court departs from its general policy of adjudicating uniformly for all taxpayers and instead follows the decisions of the court of appeals to which the case in question is appealable. Stated differently, the *Golsen* Rule mandates that the Tax Court rule consistently with decisions of the court for the circuit where the taxpayer resides or does business.

EXAMPLE C:1-8 ▶ In the year in which an issue was first litigated, the Tax Court decided that an expenditure was deductible. The government appealed the decision to the Tenth Circuit Court of Appeals and won a reversal. This is the only appellate decision regarding the issue. If and when the Tax Court addresses this issue again, it will hold, with one exception, that the expenditure is deductible. The exception applies to taxpayers in the Tenth Circuit. Under the *Golsen* Rule, these taxpayers will be denied the deduction. ◀

U.S. District Court. Because each U.S. district court is independent of the other district courts, the decisions of each have precedential value only within its own jurisdiction (i.e., only with respect to subsequent cases brought before that court). District courts must follow decisions of the U.S. Supreme Court, the circuit court to which the case is appealable, and the district court's own earlier decisions regarding similar facts and issues.

EXAMPLE C:1-9 ▶ The U.S. District Court for Rhode Island, the Tax Court, and the Eleventh Circuit have decided cases involving similar facts and issues. Any U.S. district court within the Eleventh Circuit must follow that circuit's decision in future cases involving similar facts and issues. Likewise, the U.S. District Court for Rhode Island must decide such cases consistently with its previous decision. Tax Court decisions are not binding on the district courts. Thus, all district courts other than the one for Rhode Island and those within the Eleventh Circuit are free to decide such cases independently. ◀

U.S. Court of Federal Claims. In adjudicating a case, the U.S. Court of Federal Claims must rule consistently with U.S. Supreme Court decisions, decisions of the Circuit Court of Appeals for the Federal Circuit, and its own earlier decisions, including those rendered when the court had a different name. It need not follow decisions of other circuit courts, the Tax Court, or U.S. district courts.

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[35] The *Golsen* Rule is based on the decision in *Jack E. Golsen*, 54 T.C. 742 (1970).

▼ **TABLE C:1-3**

Summary of Tax-Related Primary Sources—Statutory and Administrative

Source Name	Publisher	Materials Provided	Citation Example
U.S. Code, Title 26	Government Printing Office	Internal Revenue Code	Sec. 441(b)
Code of Federal Regulations, Title 26	Government Printing Office	Treasury Regulations (final)	Reg. Sec. 1.461-1(c)
		Treasury Regulations (temporary)	Temp. Reg. Sec. 1.62-1T(e)
Internal Revenue Bulletin	Government Printing Office	Treasury Regulations (proposed)	Prop. Reg. Sec. 1.671-1(h)
		Treasury decisions	T.D. 8756 (January 13, 1998)
		Revenue rulings	Rev. Rul. 2009-33, 2009-40 I.R.B. 447
		Revenue procedures	Rev. Proc. 2009-52, 2009-49 I.R.B. 744
		Committee reports	S.Rept. No. 105-33, 105th Cong., 1st Sess., p. 308 (1997)
		Public laws	P.L. 105-34, Sec. 224(a), enacted August 6, 1997
		Announcements	Announcement 2007-3, 2007-4 I.R.B. 376
		Notices	Notice 2009-21, 2009-13 I.R.B. 724
Cumulative Bulletin	Government Printing Office	Treasury Regulations (proposed)	Prop. Reg. Sec. 1.671-1(h)
		Treasury decisions	T.D. 8756 (January 12, 1998)
		Revenue rulings	Rev. Rul. 84-111, 1984-2 C.B. 88
		Revenue procedures	Rev. Proc. 77-28, 1977-2 C.B. 537
		Committee reports	S.Rept. No. 105-33, 105th Cong., 1st Sess., p. 308 (1997)
		Public laws	P.L. 105-34, Sec. 224(a), enacted August 6, 1997
		Announcements	Announcement 2006-8, 2006-1 C.B. 344
		Notices	Notice 88-74, 1988-2 C.B. 385

Summary of Tax-Related Primary and Secondary Sources—Judicial

Reporter Name	Publisher	Decisions Published	Citation Example
U.S. Supreme Court Reports	Government Printing Office	U.S. Supreme Court	*Boeing Company v. U.S.*, 537 U.S. 437 (2003)
Supreme Court Reports	Thomson Reuters/West	U.S. Supreme Court	*Boeing Company v. U.S.*, 123 S. Ct. 1099 (2003)
Federal Reporter (1st–3rd Series)	Thomson Reuters/West	U.S. Court of Appeal Pre-1982 Court of Claims	*Leonard Greene v. U.S.*, 13 F.3d 577 (2nd Cir., 1994)
Federal Supplement Series	Thomson Reuters/West	U.S. District Court	*Alfred Abdo, Jr. v. IRS*, 234 F. Supp. 2d 553 (DC North Carolina, 2002)
U.S. Court of Federal Claims	Thomson Reuters/West	Court of Federal Claims	*Jeffery G. Sharp v. U.S.*, 27 Fed. Cl. 52 (1992)
Tax Court of the U.S. Reports	Government Printing Office	U.S. Tax Court regular	*Security State Bank*, 111 T.C. 210 (1998), acq. 2001-1 C.B. xix
Tax Court Memorandum Decisions	Wolters Kluwer/CCH	U.S. Tax Court memo	*Paul F. Belloff*, 63 TCM 3150 (1992)
RIA Tax Court Memorandum Decisions	Thomson Reuters/RIA	U.S. Tax Court memo	*Paul F. Belloff*, 1992 RIA T.C. Memo ¶92,346 (T.C. Memo 1992-346)
American Federal Tax Reports	Thomson Reuters/RIA	Tax: all federal courts except Tax Court	*Boeing Company v. U.S.*, 91 AFTR 2d 2003-1088 (USSC, 2003)
U.S. Tax Cases	Wolters Kluwer/CCH	Tax: all federal courts except Tax Court	*Ruddick Corp. v. U.S.*, 81-1 USTC ¶9221 (Ct. Cls., 1981)

EXAMPLE C:1-10 ▶ Assume the same facts as in Example C:1-9. In a later year, a case involving similar facts and issues is heard by the U.S. Court of Federal Claims. This court is not bound by precedents set by any of the other courts. Thus, it may reach a conclusion independently of the other courts. ◀

Circuit Courts of Appeals. A circuit court is bound by U.S. Supreme Court decisions and its own earlier decisions. If neither the Supreme Court nor the circuit in question has already decided an issue, the circuit court has no precedent that it must follow, regardless of whether other circuits have ruled on the issue. In such circumstances, the circuit court is said to be writing on a clean slate. In rendering a decision, the judges of that court may adopt another circuit's view, which they are likely to regard as relevant.

EXAMPLE C:1-11 ▶ Assume the same facts as in Example C:1-9. Any circuit other than the Eleventh would be writing on a clean slate if it adjudicated a case involving similar facts and issues. After reviewing the Eleventh Circuit's decision, another circuit might find it relevant and rule in the same way. ◀

In such a case of "first impression," when the court has had no precedent on which to base a decision, a tax practitioner might look at past opinions of the court to see which other judicial authority the court has found to be "persuasive."

Forum Shopping. Not surprisingly, courts often disagree on the tax treatment of the same item. This disagreement gives rise to differing precedents within the various jurisdictions (what is called a "split in judicial authority"). Because taxpayers have the flexibility of choosing where to file a lawsuit, these circumstances afford them the opportunity to **forum shop**. Forum shopping involves choosing where among the courts to file a lawsuit based on differing precedents.

An example of a split in judicial authority concerned the issue of when it became too late for the IRS to question the tax treatment of items that "flowed through" an S corporation's return to a shareholder's return. The key question was this: if the time for assessing a deficiency (limitations period) with respect to the corporation's, but not the shareholder's, return had expired, was the IRS precluded from collecting additional taxes from the shareholder? In *Kelley,*[36] the Ninth Circuit Court of Appeals ruled that the IRS would be barred from collecting additional taxes from the shareholder if the limitations period for the *S corporation's* return had expired. In *Bufferd,*[37] *Fehlhaber,*[38] and *Green,*[39] three other circuit courts ruled that the IRS would be barred from collecting additional taxes from the shareholder if the limitations period for the *shareholder's* return had expired. The Supreme Court affirmed the *Bufferd* decision,[40] establishing that the statute of limitations for the shareholder's return governed. This action brought about certainty and uniformity within the judicial system.

Dictum. At times, a court may comment on an issue or a set of facts not central to the case under review. A court's remark not essential to the determination of a disputed issue, and therefore not binding authority, is called *dictum*. An example of dictum is found in *Central Illinois Public Service Co.*[41] In this case, the U.S. Supreme Court addressed whether lunch reimbursements received by employees constitute wages subject to withholding. Justice Blackman remarked in passing that earnings in the form of interest, rents, and dividends are not wages. This remark is dictum because it is not essential to the determination of whether lunch reimbursements are wages subject to withholding. Although not authoritative, dictum may be cited by taxpayers to bolster an argument in favor of a particular tax result.

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[36] *Daniel M. Kelley v. CIR,* 64 AFTR 2d 89-5025, 89-1 USTC ¶9360 (9th Cir., 1989).

[37] *Sheldon B. Bufferd v. CIR,* 69 AFTR 2d 92-465, 92-1 USTC ¶50,031 (2nd Cir., 1992).

[38] *Robert Fehlhaber v. CIR,* 69 AFTR 2d 92-850, 92-1 USTC ¶50,131 (11th Cir., 1992).

[39] *Charles T. Green v. CIR,* 70 AFTR 2d 92-5077, 92-2 USTC ¶50,340 (5th Cir., 1992).

[40] *Sheldon B. Bufferd v. CIR,* 71 AFTR 2d 93-573, 93-1 USTC ¶50,038 (USSC, 1993).

[41] *Central Illinois Public Service Co. v. CIR,* 41 AFTR 2d 78-718, 78-1 USTC ¶9254 (USSC, 1978).

STOP & THINK

Question: You have been researching whether an amount received by your new client can be excluded from her gross income. The IRS is auditing the client's prior year tax return, which another firm prepared. In a similar case decided a few years ago, the Tax Court allowed an exclusion, but the IRS nonacquiesced in the decision. The case involved a taxpayer in the Fourth Circuit. Your client is a resident of Maine, which is in the First Circuit. Twelve years ago, in a case involving another taxpayer, the federal court for the client's district ruled that this type of receipt is not excludable. No other precedent exists. To sustain an exclusion, must your client litigate? Explain. If your client litigates, in which court of first instance should she begin her litigation?

Solution: Because of its nonacquiescence, the IRS is likely to challenge your client's tax treatment. Thus, she may be compelled to litigate. She would not want to litigate in her U.S. district court because it would be bound by its earlier decision, which is unfavorable to taxpayers generally. A good place to begin would be the Tax Court because it is bound by appellate court, but not district court, decisions and because of its earlier pro-taxpayer position. No one can predict how the U.S. Court of Federal Claims would rule because no precedent that it must follow exists.

ADDITIONAL COMMENT

A tax treaty carries the same authoritative weight as a federal statute (IRC). A tax advisor should be aware of provisions in tax treaties that will affect a taxpayer's worldwide tax liability.

TAX TREATIES

The United States has concluded **tax treaties** with numerous foreign countries. These treaties address the alleviation of double taxation and other matters. A tax advisor exploring the U.S. tax consequences of a U.S. corporation's operations in another country should determine whether a treaty between that country and the United States exists. If one does, the tax advisor should ascertain the applicable provisions of the treaty. (See Chapter C:16 for a more extensive discussion of treaties.)

KEY POINT

Tax articles can be used to help *find* answers to tax questions. Where possible, the underlying statutory, administrative, or judicial sources referenced in the tax article should be cited as authority and not the author of the article. The courts and the IRS will place little, if any, reliance on mere editorial opinion.

TAX PERIODICALS

Tax periodicals assist the researcher in tracing the development of, and analyzing tax law. These periodicals are especially useful when they discuss the legislative history of a recently enacted IRC statute that has little or no administrative or judicial authority on point.

Tax experts write articles on landmark court decisions, proposed regulations, new tax legislation, and other matters. Frequently, those who write articles of a highly technical nature are attorneys, accountants, or professors. Among the periodicals that provide in-depth coverage of tax-related matters are the following:

The Journal of Taxation
The Tax Adviser
Practical Tax Strategies
Taxes—The Tax Magazine
Tax Law Review
Tax Notes
The Journal of Corporate Taxation
PPC's Guide to Choice of Business Entity
PPC's Guide to Real Estate Taxation
Estate Planning

The first six journals are generalized; that is, they deal with a variety of topics. As their titles suggest, the next four are specialized; they deal with specific subjects. All these publications (other than *Tax Notes,* which is published weekly) are published monthly, bi-monthly, or quarterly. Daily newsletters, such as the *Daily Tax Report,* published by Bloomberg BNA in print and electronic formats, are used by tax professionals when they need updates more timely than can be provided by monthly or quarterly publications.

Tax periodicals and tax services are secondary authorities. The IRC, Treasury Regulations, IRS pronouncements, and court opinions are primary authorities. In presenting research results, the tax advisor should always cite primary authorities.

Tax services

OBJECTIVE 5

Consult tax services to research an issue

Various publishers provide multivolume commentaries on the tax law in what are familiarly referred to as **tax services**. Researchers often consult tax services at the beginning of the research process because a tax service helps identify the tax authorities pertaining to a particular tax issue. The actual tax authorities (e.g., IRC, Treasury Regulations, IRS pronouncements, and court cases), and not the tax services, are generally cited as support for a particular tax position. The services are available in print form via the publishers and electronic form via the Internet. (See further discussion at "The Internet as a Research Tool" later in this chapter). Although each major tax service is an outstanding resource, significant differences exist in the content and organizational scheme from one publisher to the next. For example, each service has its own special features and editorial approach to tax issues along with a great deal of proprietary content. The best way to acquaint oneself with the various tax services and the advantages and disadvantages of each is to use them in researching hypothetical or actual problems.

Organizationally, tax services fall into two types: annotated and topical (although this distinction has become somewhat blurred in the Internet version of these services). An **annotated tax service** is organized by IRC section. The IRC-arranged subdivisions of this service are likely to encompass several topics. The annotations accompany editorial commentaries and include digests or summaries of IRS pronouncements and court opinions that interpret a particular IRC section. They are classified by subtopic and cite pertinent primary authorities. A **topical tax service**, on the other hand, is organized by broad topic, including income taxes, estate and gift taxes, and excise taxes. The topically arranged subdivisions of this service are likely to encompass several IRC sections.

Annotated tax services include the *United States Tax Reporter* and the *Standard Federal Income Tax Reporter* services, both of which are organized by IRC section. Many tax advisors find these reporters easy to use because of their extensive indexing system. Topical tax services include RIA's *Federal Tax Coordinator 2d* and Bloomberg BNA's *Tax Management Portfolios*. *Tax Management Portfolios* are popular with many tax advisors because they are very readable yet still provide a comprehensive discussion of a broad range of tax issues. Each portfolio (e.g., Passive Loss Rules, Portfolio 549) covers a particular topic in great detail. However, because the published portfolios do not cover all areas of the tax law, another service may be necessary to supplement the gaps in a portfolio's coverage. Table C:1-4 summarizes the organization and key features of the major tax services.

▼ TABLE C:1-4
Summary of Key Features of Tax Services

Name	Publisher	Organization	Key Features
United States Tax Reporter	Thomson Reuters/RIA	IRC section number	• Editorial commentary • Index and findings list • Annotations
Standard Federal Income Tax Reporter	Wolters Kluwer/CCH	IRC section number	• Editorial commentary • Index and findings list • Annotations
Federal Tax Coordinator 2d	Thomson Reuters/RIA	Tax topic (income tax by topic, estate and gift taxes, excise taxes)	• Commentary organized by topic with references to primary authority and tabbed access to IRC and Treasury Regulations.
Tax Management Portfolios	Bloomberg BNA	U.S. income, foreign income, state tax, estate and gift tax	• Over 400 specialized booklets with extensive commentary by topic, heavily footnoted and referenced to primary authority.

THE INTERNET AS A RESEARCH TOOL

OBJECTIVE 6

Apply the basics of Internet-based tax research

Internet databases are rapidly replacing print-based services as the principal source of tax related information. These databases encompass not only the IRC, Treasury Regulations, court cases, state laws, and other primary authorities, but also citators and secondary sources such as tax service reporters, treatises, journals, and newsletters. The principal advantages of using Internet-based tax services are ease and speed of access. These services eliminate the need for searching through several volumes of text, the need for consulting numerous cumulative supplements, and the time required to regularly update a print-based library. In addition, Internet based research tools put a vast amount of information in the hands of a tax practitioner without the cost and space requirements of a well equipped print-based tax library.

ADDITIONAL COMMENT

To apply the online research tools discussed in this chapter, textbook users must have access to the described Internet-based tax services at their institution.

Because of these advantages, the Internet has become the principal medium for conveying tax related information to professionals. The most widely used Internet-based research services are RIA's Checkpoint™ (hereafter CHECKPOINT) and CCH IntelliConnect™. Westlaw®[42] and LexisNexus are online legal research services that are predominately used by legal professionals.[43] This chapter discusses the use of internet-based tax services in general and uses CHECKPOINT for illustrative purposes. Similar features will exist for other major tax services.

The tax services include a variety of libraries that will vary by vendor (e.g., CCH or RIA) and by subscription type (limited or comprehensive). The core of any tax service covers federal taxes but also can cover state and local taxes, estate planning, payroll taxes, pensions, international tax, and financial planning. The federal libraries will include text of the IRC, Treasury Regulations, IRS pronouncements, court opinions, and other primary sources. In addition, the Internet services will include a section containing daily updates for important tax developments in the subscribed practice areas as well as the annotated and/or topical tax services discussed previously, such as the *United States Tax Reporter* (CCH) and the *Federal Tax Coordinator 2d* (RIA). State and local libraries will include tax reporters for all 50 states as well as various multi-state tax guides that provide useful state-by-state comparisons for selected state tax topics (e.g., combined reporting and apportionment methods). Other libraries, such as those covering estate and gift taxes, pensions, and payroll taxes, provide detailed information for professionals heavily engaged in these specialized areas of tax practice.

Libraries and databases in Internet services can be searched in three basic ways:

- By keyword
- By citation
- By index

EXAMPLE C:1-12 ▶

Rhonda Researcher's client is a real estate developer and wants to exchange an office building for a residential condominium in the same town. The client wants to know if he can structure the transaction in a tax advantaged way. Rhonda immediately recognizes the situation as a potential like-kind exchange of real property. Therefore, she undertakes a keyword search using the term *like-kind exchange* to quickly uncover potentially applicable documents. She also knows that Sec. 1031 is the relevant IRC section and can search the IRC or Treasury Regulations by citation. On the other hand, if she were unfamiliar with the topic, she could employ several other options. For example, she may browse the index, which is arranged alphabetically by topic. The index entries under "like-kind exchange" direct Rhonda to a number of entries potentially applicable to the transaction. ◀

Most tax professionals conduct tax research using the keyword and citation methods. We discuss these two methods in more detail below.

[42] Westlaw® is owned by Thomson Reuters.

[43] The research products discussed in this section (e.g., RIA Checkpoint, CCH IntelliConnect™, Westlaw®, and LexisNexus) generally are available only to paid subscribers.

KEYWORD SEARCHES

Searching tax services by keyword is relatively simple, particularly if the researcher is familiar with the Internet. The first step is to select which source (e.g., IRC or editorial materials) to search, perform an initial keyword search, and refine the results after the initial query. The researcher can choose to search across any combination of the available databases. The CHECKPOINT Federal databases include primary sources such as the Internal Revenue Code, Treasury Regulations, and Federal Tax Cases along with editorial databases such as RIA's *Federal Tax Coordinator 2d*. Deciding which database to include in the search depends partly on the expected complexity of the research question and on the researcher's familiarity with the topic.

The search engines within the services look for the terms selected and many variations of the terms. For example, the search for *auto* will return documents with auto, car, automobile, motor vehicle, passenger vehicle, sedan, and others.[44] Searches will include both singular and plural variations. Any document with the term or terms is returned and ranked by best match according to the search. If two terms are used, the best matches generally are documents where the terms are close together. Choosing effective search terms is critical to success. The search must be broad enough to include relevant documents but not so broad to include hundreds or thousands of documents unlikely to be on point.

For example, if the researcher selects the database containing court cases, the term *property exchange* returns thousands of results that have both the words *property* and *exchange* somewhere in the document. Clearly, this outcome is too broad for a researcher just beginning his or her research. Fortunately, several methods of narrowing the search exist. For example, the keyword search "property exchange" that uses quotation marks around the search phrase will return documents only with that exact phrase. Thus, quotation marks should be used sparingly and only when the researcher knows the precise phrase. Using Boolean connectors is helpful as well. These connectors force the search engine to narrow the search based on the parameters set. Table C:1-5 provides a partial list of connectors available in CHECKPOINT.

Another way to narrow a search is to focus on terms unique to the research question at hand. The goal is to identify tax related terms likely to appear only in relevant tax

▼ TABLE C:1-5
Connectors Used in CHECKPOINT

Connector	Description	Examples
&, and	Retrieves documents with both terms.	property & exchange
|, or	Retrieves documents with either term.	property | exchange
^, not	Retrieves documents with one term but not the other.	property ^ exchange
/n	Retrieves documents in which the first term is separated from the second term by no more than n number of words.	property /5 exchange Locates property within 5 words of exchange
/s	Retrieves documents that contain the first term within 20 words of the second term (or within the same sentence for RIA).	property /s exchange
/p	Retrieves documents that contain the first term within 80 words of the second term (or within the same paragraph for RIA).	property /p exchange
" "	Exact phrase.	"property exchange"
*	Keyword variation.	Deprecia* returns depreciation, depreciate, depreciated, depreciating
?	Keyword variation.	Advis?r returns advisor and adviser

[44] Tax services provide a thesaurus tool, which can identify synonyms and suggest alternative terms related to search terms used by the researcher. The search engine automatically searches for synonyms unless the researcher restricts the search to specific terms using Boolean connectors or quotation marks. For example, a search for the specific phrase "automobile depreciation" will not return documents that refer to *auto*, *car*, or *vehicle*.

authorities. For example, stamps are a type of collectible, but the term also will appear in documents discussing taxation of distilled spirits, food stamps, and store stamps and coupons. The researcher should begin the search with limiting terms such as *collectible* rather than the broader term *stamps*. Also, researchers with a good working knowledge of the IRC quickly learn that using IRC sections in search terms is a great way to obtain relevant documents. Browsing the index containing editorial content can identify helpful keywords.

Searching using key words is a skill that improves with practice. Researchers becoming familiar with using the databases will learn to craft search terms that include the most relevant elements of the question at hand. Once the researcher finds a document on point, the information within that document often can be used to narrow future searches. The search can be repeated by adding terms, or the documents returned originally can be searched using a new set of terms. Also, the "search within results" feature offered by major tax services is helpful when the search returns too many documents. However, if searches by keyword search do not return the desired results, other options exist.

SEARCH BY CITATION

Often the desired document is a specific IRC section, Treasury Regulation, court case, IRS pronouncement, or other document. If so, tax services offer searches by specific citation. Researchers must be careful to use exact citations using this tool because close matches will not return the desired document.

Within tax services, the citation search tools provide dedicated boxes in which to type the specific type of document requested. For example, to search for IRC Sec. 267, the researcher simply types 267 in the box labeled Current Code in CHECKPOINT under the "Find by Citation" link. Specific boxes also exist for various Treasury Regulations, court decisions, revenue rulings, revenue procedures, and other IRS pronouncements.

NONCOMMERCIAL INTERNET SERVICES

Many noncommercial institutions, such as governments and universities, allow access to their tax-related databases via the Internet. In "tax-surfing" the Internet, the researcher might first visit the IRS site located at *www.irs.gov*. Although oriented to the layman, this site contains a wealth of information useful to the tax professional. Such information includes guidelines for electronic filing, IRS forms and instructions, the full text of Treasury Regulations, and recent issues of the *Internal Revenue Bulletin*. Other useful sites include those maintained by the Library of Congress at *www.loc.gov* and the U.S. Government Publishing Office Federal Digital System at *www.govinfo.gov*. From these sites, the researcher can retrieve the text of recent court opinions, tax legislation, committee reports, state and federal tax laws, and much more.

An excellent gateway for starting tax related research is the Tax, Accounting, and Payroll Sites Directory at *www.taxsites.com*, maintained by AccountantsWorld, LLC. This site provides hundreds of hyperlinks to federal, state, and international tax law and tax form databases. Instrumental in financial accounting searches is the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) site at *www.sec.gov/edgar.shtml*. EDGAR is a document filing and retrieval service sponsored by the U.S. Securities and Exchange Commission (SEC). It provides access to the full text of documents filed with the SEC by publicly traded companies. These documents include annual financial statements on Form 10-K, quarterly financial statements on Form 10-Q, proxy statements, and prospectuses. The EDGAR database extends from January 1994 to the present and is accessible by company name, central index key, document file number, and keyword.

CITATORS

OBJECTIVE 7

Use a citator to assess tax authorities

Citators serve two functions. First, they trace the judicial history of a particular case (e.g., if the case under analysis is an appeals court decision, the citator indicates the lower court that heard the case and whether the Supreme Court reviewed the case). Second, they list

other authorities (e.g., cases and IRS pronouncements) that cite the case or authority in question. These listed authorities are called *citing cases* or *citing rulings*. The judicial history also indicates whether the case is affirmed, reversed or remanded.[45]

Because tax law relies heavily on precedent, the citator provides an index of citing cases and rulings that help the researcher determine the strength of the case or ruling he or she is evaluating. The citator gives full citations for the citing case and lists where the citing cases can be found. It is important to note that the same case may have as many as three decisions (i.e., lower court, court of appeals, and Supreme Court) with each listing having its own list of citing cases. Therefore, if a citing case cites only the Supreme Court decision, the citator will list it only under the Supreme Court cite. The citator allows the researcher to enter case names or case citations. The discussion in this section focuses on the electronic version of the citators, although print versions also exist.

The basic function of a citator is to provide the history of each authority and list cases and pronouncements that have cited the authority. Also, the citator often provides additional information about the citing case, showing whether the citing authorities comment favorably or unfavorably on the cited case or whether they can be distinguished from the cited case.[46]

In addition to tax cases, the citator evaluates revenue rulings and other IRS pronouncements and lists any status changes. Before relying on a revenue ruling or pronouncement, a researcher must confirm that the pronouncement reflects the current position of the IRS. For example, a revoked ruling is one in which the ruling is no longer correct and the correct position is being stated in the new ruling. The IRS does not remove the old ruling from the *Internal Revenue Bulletin* or *Cumulative Bulletin*, but the old ruling does not have authority regarding a transaction occurring after the revocation. Thus, failure to confirm its status could result in an incorrect conclusion. Table C:1-6 provides a list of terms the IRS uses to describe changes in the status of a ruling.

▼ TABLE C:1-6
Terms to Describe Status Changes to IRS Rulings

Term	Description of Term
Amplified	No change in the prior published position has occurred, but the prior position is extended to cover a variation of the fact situation previously addressed.
Clarified	Language used in a prior published position is being made clear because the previous language has caused or could cause confusion.
Distinguished	The ruling mentions a prior ruling but points out an essential difference between the two rulings.
Modified	The substance of a previously published ruling is being changed, but the prior ruling remains in effect.
Obsoleted	A previously published ruling is no longer determinative with respect to future transactions, e.g., because laws or regulations have changed, or the substance of the ruling has been adopted into regulations.
Revoked	A previously published ruling has been determined to be incorrect, and the correct position is being stated in the new ruling.
Superseded	The new ruling merely restates the substance of a previously published ruling or series of rulings.
Supplemented	The ruling expands a previous ruling, e.g., by adding items to a list.
Suspended	The previously published ruling will not be applied pending some future action, such as the issuance of new or amended regulations.

Source: Appendices in IRS Internal Revenue Bulletins.

[45] If a case is *affirmed*, the decision of the lower court is upheld. *Reversed* means the higher court invalidated the decision of the lower court because it reached a conclusion different from that derived by the lower court. *Remanded* signifies that the higher court sent the case back to the lower court with instructions to address matters consistent with the higher court's ruling.

[46] When a court distinguishes the facts of one case from those of an earlier case, it suggests that its departure from the earlier decision is justified because the facts of the two cases are different.

USING THE CITATOR

Internet-based versions of the citators are easier to use than print-based citators. For example, assume the researcher is currently reading *Leonarda C. Diaz v. Commissioner of Internal Revenue*, 70 TC 1067 (1978). The researcher can click on the citator, and the service opens up a new tab with a summary of activity of the case. The information provided indicates that the *Diaz* case was first decided by the Tax Court (i.e., TC), and then by the Second Circuit Court of Appeals (i.e., CA-2). It shows that the Second Circuit affirmed (upheld) the Tax Court's decision. Cases underneath the Second Circuit decision cite the *Diaz* decision and might be useful for the researcher to better understand the impact of the case. Cases listed beneath the Tax Court decision cite the Tax Court's opinion.

PROFESSIONAL GUIDELINES FOR TAX SERVICES

OBJECTIVE 8

Describe the professional guidelines that CPAs in tax practice should follow

Professional guidelines for tax services are contained in both government-imposed and professional-imposed tax standards. The following sections briefly describe two types of guidelines—Treasury Department ***Circular 230*** (Rev. 6-2014) and the American Institute of Certified Public Accountants (AICPA) ***Statements on Standards for Tax Services (SSTSs)***. A fuller discussion of these standards appears in Chapter C:15.

TREASURY DEPARTMENT *CIRCULAR 230*

Circular 230 sets forth rules to practice before the Internal Revenue Service and pertains to certified public accountants, attorneys, enrolled agents, and other persons representing taxpayers before the IRS. It presents the duties and restrictions relating to such practice and prescribes sanctions and disciplinary proceedings for violating these regulations.

Circular 230 rules, however, are not ethical standards. Instead, the document focuses on the right to represent clients before the IRS. These standards differ from the AICPA's SSTSs in the following ways:

- They apply only to federal tax issues and not state authorities.
- They generally apply only to federal income tax practice.
- They do not provide the depth of guidance found in the SSTSs.
- They give the government the authority to impose monetary penalties for violations of the rules.

Circular 230 provides guidelines for written advice to taxpayers. In June 2014, the IRS substantially revised and simplified the rules and eliminated the distinction between covered opinions and other written advice. Under the new rules, all written advice is held to a "reasonable practitioner standard" that will vary based on the nature and extent of the advice. An email to a client answering a routine tax question will be held to a different standard than will an opinion on the tax effects of a complex transaction. The written advice rules do not apply to training or educational presentations but do apply to marketing and sales presentations.

For all written advice, the practitioner is expected to base the advice on reasonable assumptions, consider relevant facts and circumstances, identify the facts relevant to the advice, be properly skeptical of representations by the taxpayer and others, relate applicable law and authority to the facts, and not base an opinion on the chances that a transaction will or will not be identified by IRS and subject to audit. The revised Section 10.37 of *Circular 230* does note that the IRS representative will consider the "additional risk" associated with opinions related to tax shelters.

AICPA'S STATEMENTS ON TAX STANDARDS

Tax advisors confronted with ethical issues frequently turn to a professional organization for guidance. Although the guidelines set forth by such organizations are not *legally* enforceable, they carry significant moral weight, and may be cited in a negligence lawsuit as the proper "standard of care" for tax practitioners. They also may provide grounds for the termination or suspension of one's professional license. One such set of guidelines is the *Statements on Standards for Tax Services* (SSTSs),[47] issued by the American Institute of Certified Public Accountants (AICPA) and reproduced in Appendix E.

The SSTSs provide an ethical framework to govern the normative relationship between a tax advisor and his or her client, where, unlike an auditor, a tax advisor acts as the client's advocate. Thus, his or her primary duty is to the client, not the IRS. In fulfilling this duty, the advisor is bound by the highest standards of care. The most recent version of the SSTSs includes seven standards that provide guidance for AICPA members in their professional tax practice.

ADDITIONAL COMMENT

SSTS No. 1 states that tax advisors have both the "right and responsibility" to be an advocate for the taxpayer with respect to any position that otherwise meets the standard.

SSTS No. 1—Tax Return Positions. Tax professionals often provide tax advice in situations where the authority is unclear or evolving. Frequently this advice involves recommending positions that could be reversed upon audit. This statement describes the minimum level of confidence a CPA must achieve to recommend a tax return position to a taxpayer. Members first must determine and comply with all standards imposed by the various taxing authorities. Regardless of those standards, a member should not recommend a position unless he or she has a good faith belief that the position has a "realistic possibility" of being sustained administratively or judicially on its merits if challenged. Members are not permitted to take the probability of audit into account.

If the position does not meet the realistic probability standard, a member still may recommend a tax return position if he or she concludes that the position has a "reasonable basis" and the position is properly disclosed. When recommending a tax return position and when preparing or signing a return on which a tax return position is taken, a member should, when relevant, advise the taxpayer regarding potential penalty consequences of such tax return position and the opportunity, if any, to avoid such penalties through disclosure. The member also may consider any GAAP requirements to disclose aggressive tax positions under the portion of Accounting Standards Codification 740 formerly known as FIN 48.

The standard highlights the dual responsibility of the member. The U.S. tax system can function only when taxpayers file "true, correct, and complete" returns, but taxpayers also have no obligation to pay more in tax than they legally owe. The tax professional's duty is to meet his or her responsibilities to both the tax system and the taxpayer client.

SSTS No. 2—Answers to Questions on Returns. Return preparers often must sign a declaration that the return is "true, correct, and complete." A member should make a reasonable effort to obtain from the taxpayer the information necessary to provide appropriate answers to all questions on a tax return before signing as preparer. However, in certain circumstances, questions or information applicable to the taxpayer may be omitted. Reasonable grounds include the following situations:

- The omitted information is not readily available or is immaterial and has little effect on taxable income or loss or the tax liability.
- The meaning of the question as it relates to the taxpayer is uncertain.
- The requested information is voluminous, in which case the taxpayer can attach a statement indicating that the requested information will be supplied upon request.

[47] AICPA, *Statements on Standards for Tax Services*, 2009, effective January 1, 2010.

SSTS No. 3—Certain Procedural Aspects of Preparing Returns. Tax returns are based on information provided by the client. This statement sets forth the applicable standards for members concerning this information. Specifically, in preparing or signing a return, members are not required to examine or verify a client's supporting data. A member may rely on information supplied by the taxpayer unless the information appears to be incorrect, incomplete, inconsistent, or unreasonable under the circumstances. However, if the applicable law or regulations impose a specific record keeping requirement to claim a deduction, the member should inquire and satisfy himself or herself that the required records do exist.

Members are specifically encouraged to make use of a taxpayer's returns for one or more prior years in preparing the current return, whenever feasible. The practice should help avoid the omission or duplication of items and provide a basis for the treatment of similar or related transactions.

SSTS No. 4—Use of Estimates. For various reasons, precise information about an amount required on a tax return might not be available at the time the tax return is prepared. For example, the taxpayer might not have a record of small transactions or might be missing certain records. In such cases, a member may advise on estimates used in the preparation of the tax return, but the taxpayer has the responsibility to provide the estimated data. Appraisals and valuations are not considered estimates.

If estimates are used, they generally need not be labeled as estimates, but they should not be presented in a manner that provides a misleading impression about the degree of factual accuracy. However, disclosure that estimates were used should be made in some unusual situations, including:

- A taxpayer has died or is ill at the time the return is prepared.
- A taxpayer has not received a schedule K-1 at the time the tax return is to be filed.
- Litigation is pending that affects the return.
- Fire, computer failure, or a natural disaster has destroyed the relevant records.

Notwithstanding this statement, the tax practitioner may not use estimates when such use is implicitly prohibited by the IRC. For example, Sec. 274(d) disallows deductions for certain expenses (e.g., meals and entertainment) unless the taxpayer can substantiate the expenses with adequate records or sufficient corroborating information. The documentation requirement effectively precludes the taxpayer from estimating such expenses and the practitioner from using such estimates.

SSTS No. 5—Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decisions. Members can take positions that differ from a position determined in an administrative proceeding with respect to the taxpayer's prior return (such as an IRS audit, IRS appeals conference, or a court decision.) Departure might be warranted because of a change in the law or regulations, or favorable court decisions. In any event, if the member can otherwise meet the standards of SSTS No. 1, departure from previous positions is permissible.

SSTS No. 6—Knowledge of Error: Return Preparation and Administrative Proceedings. For purposes of this standard, the definition of an error has the common meaning, including a mathematical error, but the definition also encompasses any position that does not meet the standards of SSTS No. 1. A position also qualifies as an error if it met the standard when a return was originally filed but no longer does because of a retroactive legislative or legal proceeding. An error for this purpose does not include immaterial items.

A member should inform the taxpayer promptly upon becoming aware of (1) an error in a previously filed return, (2) an error in a return that is the subject of an administrative proceeding (e.g., an IRS audit or appeals conference), or (3) a taxpayer's failure to file a required return. A member should advise the taxpayer of the potential consequences of the error and recommend corrective measures to be taken. This advice can be given orally.

The member is not obligated to inform the taxing authority of an error and, in fact, may not do so without the taxpayer's permission except when required by law.

However, if the taxpayer requests that a member prepare the current year's return and the taxpayer has not taken appropriate action to correct an error in a prior year's return, the member should consider whether to withdraw from preparing the return and whether to continue a professional or employment relationship with the taxpayer.

The standard recognizes that conflicts can arise between the member's interests and those of the client. For example, withdrawal from an engagement could have an adverse impact on the taxpayer. In some situations, the member should consult his or her own legal counsel before deciding on recommendations to the taxpayer and whether to continue the engagement. In situations involving potential fraud or criminal charges, the member should advise the client to consult with an attorney before taking any action.

SSTS No. 7—Form and Content of Advice to Taxpayers. A member should use professional judgment to ensure that tax advice provided to a taxpayer reflects competence and appropriately serves the taxpayer's needs. The advice can be communicated in writing or orally. When communicating tax advice to a taxpayer in writing, a member should comply with relevant taxing authorities' standards applicable to written tax advice. A member should use professional judgment about any need to document oral advice.

In deciding on the form of advice provided to a taxpayer, a member should consider factors such as:

- The importance of the transaction and the amounts involved
- The technical complexity involved
- The existence of authorities and precedents
- The tax sophistication of the taxpayer
- The need to seek other professional advice
- The potential penalty consequences of a tax return position and whether any penalties can be avoided through disclosure

This statement implies that practitioner-taxpayer dealings should not be casual, nonconsensual, or open ended. Rather, they should be professional, contractual, and definite. Oral advice may be appropriate in routine matters, but written communications are recommended in important, complicated, or significant dollar value transactions.

In addition to these obligations, the tax advisor has a strict duty of confidentiality to the client. Although not encompassed under the SSTSs, this duty is implied in the accountant client privilege. (For a discussion of this privilege, see Chapter C:15.)

STOP & THINK

Question: As described in the Stop & Think box on pages C:1-10 and C:1-11, you are researching the manner in which a deduction is calculated. The IRC states that the calculation is to be made "in a manner prescribed by the Secretary." After studying the IRC, Treasury Regulations, and committee reports, you conclude that another way of doing the calculation is arguably correct under an intuitive approach. This approach would result in a lower tax liability for the client. According to the *Statements on Standards for Tax Services,* may you take a position contrary to final Treasury Regulations based on the argument that the regulations are not valid?

Solution: You should not take a position contrary to the Treasury Regulations unless you have a "good-faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits." However, you can take a position that does not meet the above standard, provided you adequately disclose the position, and the position has a reasonable basis. Whether or not you have met the standard depends on all the facts and circumstances. Chapter C:15 discusses tax return preparer positions contrary to Treasury Regulations.

WHAT WOULD YOU DO IN THIS SITUATION?

Regal Enterprises and Macon Industries, unaffiliated corporations, have hired you to prepare their respective income tax returns. In preparing Regal's return, you notice that Regal has claimed a depreciation deduction for equipment purchased from Macon on February 22 at a cost of $2 million. In preparing Macon's return, you notice that Macon has reported sales proceeds of $1.5 million from the sale of equipment to Regal on February 22. One of the two figures must be incorrect. How do you proceed to correct it? Hint: See SSTS No. 3 in Appendix E.

SAMPLE WORK PAPERS AND CLIENT LETTER

OBJECTIVE 9

Prepare work papers and communicate to clients

Appendix A presents a set of sample work papers, including a draft of a client letter and a memo to the file. The work papers indicate the issues to be researched, the authorities addressing the issues, and the researcher's conclusions concerning the appropriate tax treatment, with rationale therefor.

The format and other details of work papers differ from firm to firm. The sample in this text offers general guidance concerning the content of work papers. In practice, work papers may include less detail.

PROBLEM MATERIALS

Note: To complete the online research problems for this chapter, textbook users must have access to an Internet-based service.

DISCUSSION QUESTIONS

C:1-1 Explain the difference between closed-fact and open-fact situations.

C:1-2 According to the AICPA's *Statements on Standards for Tax Services,* what duties does the tax practitioner owe the client?

C:1-3 Explain what is encompassed by the term **tax law** as used by tax advisors.

C:1-4 The U.S. Government Printing Office publishes both hearings on proposed legislation and committee reports. Distinguish between the two.

C:1-5 Explain how committee reports can be used in tax research. What do they indicate?

C:1-6 A friend notices that you are reading the Internal Revenue Code of 1986. Your friend inquires why you are consulting a 1986 publication, especially when tax laws change so frequently. What is your response?

C:1-7 Does Title 26 contain statutory provisions dealing only with income taxation? Explain.

C:1-8 Refer to IRC Sec. 301.
- **a.** Which subsection discusses the general rule for the tax treatment of a property distribution?
- **b.** Where should one look for exceptions to the general rule?
- **c.** What type of Treasury Regulations would relate to subsection (e)?

C:1-9 Why should tax researchers note the date on which a Treasury Regulation was adopted?

C:1-10
- **a.** Distinguish between proposed, temporary, and final Treasury Regulations.
- **b.** Distinguish between interpretative and legislative Treasury Regulations.

C:1-11 In 2011, there was a change in the authoritative weight of interpretive versus legislative regulations. Briefly explain what changed and why.

C:1-12 Explain the legislative reenactment doctrine.

C:1-13
- **a.** Discuss the authoritative weight of revenue rulings.

b. As a practical matter, what consequences are likely to ensue if a taxpayer does not follow a revenue ruling and the IRS audits his or her return?

C:1-14 **a.** In which courts may litigation dealing with tax matters begin?
b. Discuss the factors that might be considered in deciding where to litigate.
c. Describe the appeals process in tax litigation.

C:1-15 May a taxpayer appeal a case litigated under the Small Cases Procedure of the Tax Court?

C:1-16 Explain whether the following decisions are of the same precedential value: (1) Tax Court regular decisions, (2) Tax Court memo decisions, and (3) decisions under the Small Cases Procedures of the Tax Court.

C:1-17 Does the IRS acquiesce in decisions of U.S. district courts?

C:1-18 The decisions of which courts are reported in the AFTR? In the USTC?

C:1-19 Why do some revenue ruling citations refer to the *Internal Revenue Bulletin* (I.R.B.) and others to a *Cumulative Bulletin* (C.B.)?

C:1-20 Explain the *Golsen* Rule. Give an example of its application.

C:1-21 Assume that the only precedents relating to a particular issue are as follows:

Tax Court—decided for the taxpayer
Eighth Circuit Court of Appeals—decided for the taxpayer (affirming the Tax Court)
U.S. District Court for Eastern Louisiana—decided for the taxpayer
Fifth Circuit Court of Appeals—decided for the government (reversing the U.S. District Court of Eastern Louisiana)

a. Discuss the precedential value of the foregoing decisions for your client, who is a California resident.
b. If your client, a Texas resident, litigates in the Tax Court, how will the court rule? Explain.

C:1-22 Which official publication(s) contain(s) the following:
a. Transcripts of Senate floor debates
b. IRS announcements
c. Tax Court regular opinions
d. Treasury decisions
e. U.S. district court opinions
f. Technical advice memoranda

C:1-23 Under what circumstances might a tax advisor find the provisions of a tax treaty useful?

C:1-24 What two functions does a citator serve?

C:1-25 Name three primary sources of authority that tax professionals should check against the citator before relying on those sources for important matters.

C:1-26 List three methods of searching the major tax service databases.

C:1-27 Use any major tax service to answer the following questions:
a. What are the principal primary sources?
b. What are the principal secondary sources?

C:1-28 Compare the features of the computerized tax services with those of Internet sites maintained by noncommercial institutions. What are the relative advantages and disadvantages of each? Could the latter sites serve as a substitute for a commercial tax service?

C:1-29 According to the *Statements on Standards for Tax Services,* what belief should a CPA have before taking a pro-taxpayer position on a tax return?

C:1-30 List an advisor's duties that are excluded under the AICPA's *Statements on Standards for Tax Services*.

C:1-31 List three requirements that apply to written advice under Treasury Department *Circular 230*.

C:1-32 Explain how Treasury Department *Circular 230* differs from the AICPA's *Statements on Standards for Tax Services*.

PROBLEMS

C:1-33 ***Interpreting the IRC.*** Under a divorce agreement executed in the current year, an ex-wife receives from her former husband cash of $25,000 per year for eight years. The agreement does not explicitly state that the payments are excludable from gross income.
a. Does the ex-wife have gross income? If so, how much?
b. Is the former husband entitled to a deduction? If so, is it for or from AGI? Refer only to the IRC in answering this question. Start with Sec. 71.
c. How did the Tax Cuts and Jobs Act of 2017 change the alimony rules?

C:1-34 ***Interpreting the IRC.*** Refer to Sec. 385 and answer the questions below.
a. Whenever Treasury Regulations are issued under this section, what type are they likely to be: legislative or interpretative? Explain.
b. Assume Treasury Regulations under Sec. 385 have been finalized. Will they be relevant to estate tax matters? Explain.

C:1-35 ***Using IRS Rulings.*** Locate PLR 8733007 and Rev. Rul. 81-219.
a. Briefly summarize the tax issue and conclusion of each ruling.
b. Under what circumstances can a researcher rely on the private letter ruling?
c. Under what circumstances can a researcher rely on the revenue ruling?

C:1-36 ***Using Treasury pronouncements.*** Which IRC section(s) does Rev. Rul. 2001-29 interpret? Hint: consult the official pronouncement of the IRS.

C:1-37 ***Using a Major Tax Service for a Keyword Search.*** The objective is to locate a general overview of available home office deductions. On the main research tab, select the *United States Tax Reporter—Explanations database*. How many results does the search return for each search term if the terms and connectors option is selected?
a. Search term: home office deduction.
b. Search term: "home office" deduction.
c. Search term: "home office" /5 deduction.

C:1-38 ***Using a Major Tax Service for a Citation Search.*** The objective is to locate a general overview of available home office deductions. You have previously researched the issue and know that Sec. 280A is the primary authority for this issue. In the Keyword Search box, enter 280A and check the IRS Rulings and Releases database and answer the following questions.
a. How many results for Revenue Rulings does the search return for the search term: 280A?
b. Using the search within results function, use the new term: home office. How many results does the search return?
c. Does using the search within results function improve your results? Explain why.

C:1-39 ***Determining Acquiescence.***
a. What official action (acquiescence or nonacquiescence) did the IRS Commissioner take regarding the 1985 Tax Court decision in *John McIntosh,* 85 T.C. 31 (1985)? Hint: Consult Actions on Decisions (AOD).
b. Did this action concern *all* issues in the case? If not, explain. (Before answering this question, consult the headnote to the court opinion.)

C:1-40 ***Determining Acquiescence.***
a. What 2015 action (acquiescence or nonacquiescence) did the IRS Commissioner take regarding the 9th Circuit decision in *Voss v. Commissioner,* 116 AFTR 2d 2015-5529? Hint: Consult Actions on Decisions (AOD).
b. What issue did the AOD address?

C:1-41 ***Determining Acquiescence.***
a. What original action (acquiescence or nonacquiescence) did the IRS Commissioner take regarding the 1982 Tax Court decision in *Doyle, Dane, Bernbach, Inc.*, 79 T.C. 101 (1982)? Hint: Consult Actions on Decisions (AOD).
b. Did the IRS Commissioner subsequently change his mind? If so, when?

C:1-42 ***Evaluating a Case.*** Look up *James E. Threlkeld,* 87 T.C. 1294 (1988) and answer the questions below.
a. Was the case reviewed by the court? If so, was the decision unanimous? Explain.
b. Was the decision entered under Rule 155?
c. Consult a citator. Was the case reviewed by an appellate court? If so, which one?

C:1-43 ***Evaluating a Case.*** Look up *Bush Brothers & Co.,* 73 T.C. 424 (1979) and answer the questions below.
a. Was the case reviewed by the court? If so, was the decision unanimous? Explain.
b. Was the decision entered under Rule 155?
c. Consult a citator. Was the case reviewed by an appellate court? If so, which one?

C:1-44 ***Writing Citations.*** Provide the proper citations (including both primary and secondary citations where applicable) for the authorities listed below. (For secondary citations, reference both the AFTR and USTC.)
a. *National Cash Register Co.,* a 6th Circuit Court decision
b. *Thomas M. Dragoun v. CIR,* a Tax Court memo decision
c. *John M. Grabinski v. U.S.,* a U.S. district court decision
d. *John M. Grabinski v. U.S.,* an Eighth Circuit Court decision
e. *Rebekah Harkness,* a 1972 Court of Claims decision
f. *Hillsboro National Bank v. CIR,* a Supreme Court decision
g. Rev. Rul. 78-129

C:1-45 ***Writing Citations.*** Provide the proper citations (including both primary and secondary citations where applicable) for the authorities listed below. (For secondary citations, reference both the AFTR and USTC.)

a. Rev. Rul. 99-7
b. *Frank H. Sullivan,* a Board of Tax Appeals decision
c. *Tate & Lyle, Inc.,* a 1994 Tax Court decision
d. *Ralph L. Rogers v. U.S.,* a U.S. district court decision
e. *Norman Rodman v. CIR,* a Second Circuit Court decision

C:1-46 ***Interpreting Citations.*** Indicate which courts decided the cases cited below. Also indicate on which pages and in which publications the authority is reported.

a. *Lloyd M. Shumaker v. CIR,* 648 F.2d 1198, 48 AFTR 2d 81-5353 (9th Cir., 1981)
b. *Xerox Corp. v. U.S.,* 14 Cl. Ct. 455, 88-1 USTC ¶9231 (1988)
c. *Real Estate Land Title & Trust Co. v. U.S.,* 309 U.S. 13, 23 AFTR 816 (USSC, 1940)
d. *J. B. Morris v. U.S.,* 441 F. Supp. 76, 41 AFTR 2d 78-335 (DC TX, 1977)
e. Rev. Rul. 83-3, 1983-1 C.B. 72
f. *Malone & Hyde, Inc. v. U.S.,* 568 F.2d 474, 78-1 USTC ¶9199 (6th Cir., 1978)

C:1-47 ***Using a Tax Service.*** Use the index of any tax service to locate authorities dealing with the deductibility of the cost of a facelift.

a. Cite the authority you find.
b. List the primary IRC section cited as authority.
c. May a taxpayer deduct the cost of a facelift paid in the current year? Explain.

C:1-48 ***Using a Tax Service.*** Using any tax service, locate Reg. Sec. 1.302-1. Does this Treasury Regulation reflect recent amendments to the IRC? Explain.

C:1-49 ***Using a Tax Service.*** Using the index of any tax service, search the editorial materials to locate authorities addressing whether termite damage constitutes a casualty loss.

a. Cite the authority you found.
b. Cite at least two primary authorities.

C:1-50 ***Using a Tax Service.***

a. Using any tax service, locate Sec. 303. This section states that Sec. 303(a) applies only if the stock in question meets a certain percentage test. What is the applicable percentage?
b. Locate Reg. Sec. 1.303-2(a) in the same service. Does this Treasury Regulation reflect recent amendments to the IRC with respect to the percentage test addressed in Part a? Explain.

C:1-51 ***Using a Tax Service.*** Using the BNA tax service, identify the number of the BNA portfolio for the following subjects.

a. Innocent spouse relief.
b. Accounting methods.
c. Involuntary conversions.
d. IRAs.
e. Deductibility of legal and accounting fees, bribes, and illegal payments.

C:1-52 ***Using a Keyword Search.*** Using a keyword search of editorial materials in any tax service, locate authorities dealing with the deductibility of the cost of work clothing by a firefighter. List a revenue ruling addressing this question.

C:1-53 ***Using a Citator.*** Trace *Biltmore Homes, Inc.,* a 1960 Tax Court memo decision, in the citator.

a. According to the citator, how many times has the Tax Court decision been cited by other courts?
b. How many issues did the lower court address in its opinion? Hint: Refer to the case headnote numbers.
c. Did an appellate court review the case? If so, which one?

C:1-54 ***Using a Citator.*** Trace *Stephen Bolaris,* 776 F.2d 1428, in the citator.

a. According to the citator, how many times has the Ninth Circuit's decision been cited?
b. Did the decision address more than one issue? Explain.
c. Was the decision ever cited unfavorably? Explain.

C:1-55 ***Interpreting a Case.*** Using any tax service, refer to the *Holden Fuel Oil Company,* RIA T.C. Memo ¶72,045 (T.C. Memo 1972-45), 31 TCM 184.
a. In which year was the case decided?
b. What controversy was litigated?
c. Who won the case?
d. Was the decision reviewed at the lower court level?
e. Was the decision appealed?
f. Has the decision been cited in other cases?

C:1-56 ***Internet Research.*** Access the IRS Internet site at *www.irs.gov* and answer the following questions:
a. How does one file a tax return electronically?
b. How can the taxpayer transmit funds electronically?
c. What are the advantages of electronic filing?

C:1-57 ***Internet Research.*** Access the IRS Internet site at *www.irs.gov* and indicate the titles of the following IRS forms:
a. Form 4506
b. Form 973
c. Form 8725

C:1-58 ***Internet Research.*** Access the Federation of Tax Administrators Internet site at *www.taxadmin.org/state-tax-forms* and indicate the titles of the following state tax forms and publications:
a. Minnesota Form M-100
b. Oklahoma Form 512 2-D
c. North Carolina Form D-403

C:1-59 ***Internet Research.*** Access the Urban Institute and Brookings Institution Tax Policy Center at *taxpolicycenter.org*. On the home page, search for *state individual income tax rates* and locate the Tax Policy Center's latest summary of each state's rates. Researchers also can locate the file by looking under the TAX FACTS tab and then the *State* tab, *Main Features of State Tax Systems*.
a. How many states do not have a state individual income tax?
b. How many states tax only interest and dividends for individuals?
c. What is the top marginal individual income tax rate in Oregon?
d. Of those that do impose an income tax, which state's top marginal rate is lowest?

COMPREHENSIVE PROBLEM

C:1-60 Your client, a physician, recently purchased a yacht on which he flies a pennant with a medical emblem on it. He recently informed you that he purchased the yacht and flies the pennant to advertise his occupation and thus attract new patients. He has asked you if he may deduct as ordinary and necessary business expenses the costs of insuring and maintaining the yacht. In search of an answer, consult the editorial materials in any tax service. Explain the steps taken to find your answer.

TAX STRATEGY AND CRITICAL THINKING PROBLEM

C:1-61 Your client, Home Products Universal (HPU), distributes home improvement products to independent retailers throughout the country. Its management wants to explore the possibility of opening its own home improvement centers. Accordingly, it commissions a consulting firm to conduct a feasibility study, which ultimately persuades HPU to expand into retail sales. The consulting firm bills HPU $150,000, which HPU deducts on its current year tax return. The IRS disputes the deduction, contending that, because the cost relates to entering a new business, it should be capitalized. HPU's management, on the other hand, firmly believes that, because the cost relates to expanding HPU's existing business, it should be deducted. In contemplating legal action against the IRS, HPU's management considers the state of judicial precedent: The federal court for HPU's district has ruled that the cost of expanding from distribution into retail sales should be capitalized. The appellate court for HPU's circuit has stated in *dictum* that, although in some circumstances switching from product distribution to product sales entails entering a new trade or business, improving customer access to one's existing products generally does not. The

Federal Circuit Court has ruled that wholesale distribution and retail sales, even of the same product, constitute distinct businesses. In a case involving a taxpayer from another circuit, the Tax Court has ruled that such costs invariably should be capitalized. HPU's Chief Financial Officer approaches you with the question, "In which judicial forum should HPU file a lawsuit against the IRS: (1) U.S. district court, (2) the Tax Court, or (3) the U.S. Court of Federal Claims?" What do you tell her?

CASE STUDY PROBLEM

C:1-62 A client, Mal Manley, fills out his client questionnaire for the previous year and on it provides information for the preparation of his individual income tax return. The IRS has never audited Mal's returns. Mal reports that he made over 100 relatively small cash contributions totaling $24,785 to charitable organizations. In the last few years, Mal's charitable contributions have averaged about $15,000 per year. For the previous year, Mal's adjusted gross income was roughly $350,000, about a 10% increase from the year before.

Required: Applying *Statements on Standards for Tax Services* No. 3, determine whether you can accept at face value Mal's information concerning his charitable contributions. Now assume that the IRS recently audited Mal's tax return for two years ago and denied 75% of that year's charitable contribution deduction because the deduction was not substantiated. Assume also that Mal indicates that, in the previous year, he contributed $25,000 (instead of $24,785). How do these changes of fact affect your earlier decision?

TAX RESEARCH PROBLEMS

C:1-63 The purpose of this problem is to enhance your skills in interpreting the authorities that you locate in your research. In answering the questions that follow, refer only to *Thomas A. Curtis, M.D., Inc.,* 1994 RIA TC Memo ¶94,015 (T.C. Memo 1994-15), 67 TCM 1958.

a. What was the principal controversy litigated in this case?
b. Which party—the taxpayer or the IRS—won?
c. Why is the corporation instead of Dr. and/or Ms. Curtis listed as the plaintiff?
d. What is the relationship between Ellen Barnert Curtis and Dr. Thomas A. Curtis?
e. Approximately how many hours a week did Ms. Curtis work, and what were her credentials?
f. For the fiscal year ending in 1989, what salary did the corporation pay Ms. Curtis? What amount did the court decide was reasonable?
g. What dividends did the corporation pay for its fiscal years ending in 1988 and 1989?
h. To which circuit would this decision be appealable?
i. According to *Curtis*, what five factors did the Ninth Circuit mention in *Elliotts, Inc.* as relevant in determining reasonable compensation?

C:1-64 Josh contributes $5,000 toward the support of his widowed mother, aged 69, a U.S. citizen and resident. She earns gross income of $2,000 and spends it all for her own support. In addition, Medicare pays $3,200 of her medical expenses. She does not receive financial support from sources other than those described above. Must the Medicare payments be included in the support that Josh's mother is deemed to provide for herself?

Prepare work papers and a client letter (to Josh) dealing with the issue.

C:1-65 Amy owns a vacation cottage in Maine. She predicts that the time during which the cottage will be used in the current year is as follows:

By Amy, solely for vacation	12 days
By Amy, making repairs ten hours per day and vacationing the rest of the day	2 days
By her sister, who paid fair rental value	8 days
By her cousin, who paid fair rental value	4 days
By her friend, who paid a token amount of rent	2 days
By three families from the Northeast, who paid fair rental value for 40 days each	120 days
Not used	217 days

Calculate the ratio for allocating the following expenses to the rental income expected to be received from the cottage: interest, taxes, repairs, insurance, and depreciation. The ratio will be used to determine the amount of expenses that are deductible and, thus, Amy's taxable income for the year.

For the tax manager to whom you report, prepare work papers in which you discuss the calculation method. Also, draft a memo to the file dealing with the results of your research.

C:1-66 Look up *Summit Publishing Company,* 1990 PH T.C. Memo ¶90,288 (T.C. Memo 1990-288), 59 TCM 833, and *J.B.S. Enterprises,* 1991 PH T.C. Memo ¶91,254 (T.C. Memo 1991-254), 61 TCM 2829, and answer the following questions:

a. What was the principal issue in these cases?
b. What factors did the Tax Court consider in resolving the central issue?
c. How are the facts of these cases similar? How are they dissimilar?

C:1-67 Your supervisor would like to set up a single Sec. 401(k) plan exclusively for the managers of your organization. Concerned that this arrangement might not meet the requirements for a qualified plan, he has asked you to request a determination letter from the IRS. In a brief memorandum, address the following issues:

a. What IRS pronouncements govern requests for determination letters?
b. What IRS forms must be filed with the request?
c. What information must be provided in the request?
d. What actions must accompany the filing?

CHAPTER

2

CORPORATE FORMATIONS AND CAPITAL STRUCTURE

LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Discuss the tax advantages and disadvantages of alternative business forms
2. Apply the check-the-box regulations to partnerships, corporations, and trusts
3. Recognize the legal requirements and tax considerations related to forming a corporation
4. Discuss the requirements for deferring gain or loss upon incorporation
5. Explain the tax implications of alternative capital structures
6. Determine the tax consequences of worthless stock or debt obligations
7. Identify tax planning opportunities in corporate formations
8. Comply with procedural rules for corporate formations

CHAPTER OUTLINE

When starting a business, entrepreneurs must decide whether to organize it as a sole proprietorship, partnership, corporation, limited liability company, or limited liability partnership. This chapter discusses the advantages and disadvantages of each form of business association. Because many entrepreneurs find organizing their business as a corporation advantageous, the chapter looks at the definition of a corporation for federal income tax purposes. It also discusses the tax consequences of incorporating a business. The chapter closes by examining the tax implications of capitalizing a corporation with equity and/or debt and describing the advantages and disadvantages of alternative capital structures.

This textbook takes a life-cycle approach to corporate taxation. The corporate life cycle starts with corporate formation, discussed in this chapter. Once formed and operating, the corporation generates taxable income (or loss), incurs federal income tax and other liabilities, and makes distributions to its shareholders. Finally, at some point, the corporation might outlive its usefulness and be liquidated and dissolved. The corporate life cycle is too complex to discuss in one chapter. Therefore, additional coverage follows in Chapters C:3 through C:8.

ORGANIZATION FORMS AVAILABLE

OBJECTIVE 1

Discuss the tax advantages and disadvantages of alternative business forms

Businesses can be organized in several forms including

- Sole proprietorships
- Partnerships
- Corporations
- Limited liability companies
- Limited liability partnerships

A discussion of the tax implications of each form is presented below.

ADDITIONAL COMMENT

The income/loss of a sole proprietorship reported on Schedule C carries to page 1 of Form 1040 and is included in the computation of the individual's taxable income. Net income, if any, also carries to Schedule SE of Form 1040 for computation of the sole proprietor's self-employment tax.

ADDITIONAL COMMENT

The Tax Cuts and Jobs Act of 2017 added a deduction for qualified business income, effective for tax years beginning after 2017. The deduction is 20% of qualified business income from a partnership, S corporation, or sole proprietorship (also REIT dividends). See Chapter C:9 for additional details.

SOLE PROPRIETORSHIPS

A **sole proprietorship** is an unincorporated business owned by one individual. It often is selected by entrepreneurs who are beginning a new business with a modest amount of capital. From a tax and legal perspective, a sole proprietorship is not a separate entity. Rather, it is a legal extension of its individual owner. Thus, the individual owns all the business assets and reports income or loss from the sole proprietorship directly on his or her individual tax return. Specifically, the individual owner (proprietor) reports all the business's income and expenses for the year on Schedule C (Profit or Loss from Business) or Schedule C-EZ (Net Profit from Business) of Form 1040. A completed Schedule C is included in Appendix B, where a common set of facts (with minor modifications) illustrates the similarities and differences in sole proprietorship, C corporation, partnership, and S corporation tax reporting.

If the business is profitable, the profit is included in the proprietor's other income.

EXAMPLE C:2-1 ▶ John, a single taxpayer, starts a new computer store, which he operates as a sole proprietorship. John reports a $15,000 profit from the business in its first year of operation. In addition, John is allowed a $3,000 (0.20 × $15,000) qualified business income deduction, so only $12,000 of his profits is taxable. Assuming his marginal tax rate is 24%, John's tax on the $12,000 of taxable profit from the business is $2,880 (0.24 × $12,000).[1] ◀

If the business is unprofitable, the loss reduces the proprietor's total taxable income, thereby generating tax savings.

EXAMPLE C:2-2 ▶ Assume the same facts as in Example C:2-1 except John reports a $15,000 loss instead of a $15,000 profit in the first year of operation. Assuming he still is taxed at a 24% marginal tax rate, the $15,000 loss produces tax savings of $3,600 (0.24 × $15,000). ◀

[1] The $15,000 Schedule C profit in Example C:2-1 will increase adjusted gross income (AGI). The qualified business income deduction, however, does not reduce AGI. The AGI level affects certain deduction calculations (e.g., medical, charitable contributions, and miscellaneous itemized) and, because of limitations, may result in a taxable income increase different from the $15,000 AGI increase.

ADDITIONAL COMMENT

Although this chapter emphasizes the tax consequences of selecting the entity in which a business will be conducted, other issues also are important in making such a decision. For example, the amount of legal liability assumed by an owner is important and can vary substantially among the different business entities.

Tax Advantages. The tax advantages of conducting business as a sole proprietorship are as follows:

- The sole proprietorship is not subject to taxation as a separate entity. Rather, the sole proprietor, as an individual, is taxed at his or her marginal rate on income earned by the business.
- Profits may qualify for the 20% qualified business income deduction.
- The proprietor's marginal tax rate may be lower than the marginal tax rate that would have applied had the business been organized as a corporation.
- The owner may contribute cash to, or withdraw profits from, the business without tax consequences.
- Although the owner usually maintains separate books, records, and bank accounts for the business, the money in these accounts belongs to the owner personally.
- The owner may contribute property to, or withdraw property from, the business without recognizing gain or loss.
- Business losses may offset nonbusiness income, such as interest, dividends, and any salary earned by the sole proprietor or his or her spouse, subject to the passive activity loss rules.

Tax Disadvantages. The tax disadvantages of conducting business as a sole proprietorship are as follows:

- The profits of a sole proprietorship are currently taxed to the individual owner, whether or not the profits are retained in the business or withdrawn for personal use. By contrast, the profits of a corporation are taxed to its shareholders only if and when the corporation distributes the earnings as dividends.
- At times, corporate tax rates have been lower than individual tax rates. In such times, businesses conducted as sole proprietorships have been taxed more heavily than businesses organized as corporations.
- A sole proprietor must pay the full amount of Social Security taxes because he or she is not considered to be an employee of the business. By contrast, shareholder-employees must pay only half their Social Security taxes; the corporate employer pays the other half. (The employer, however, might pass this half onto employees in the form of lower wages or fewer employees hired.)
- Sole proprietorships may not deduct compensation paid to owner-employees. By contrast, corporations may deduct compensation paid to shareholder-employees.
- Certain tax-exempt benefits (e.g., premiums for group term life insurance) available to shareholder-employees are not available to owner-employees.[2]
- A sole proprietor must use the same accounting period for business and personal purposes. Thus, he or she cannot defer income by choosing a business fiscal year that differs from the individual's calendar year. By contrast, a corporation may choose a fiscal year that differs from the shareholders' calendar years.

ADDITIONAL COMMENT

In 2017 and 2018, the employee's half of Social Security taxes is 6.2%, and the employee's half of the Medicare tax is 1.45%, for a total of 7.65%. The employer pays the same percentages for its half of these items. In addition, the employee (but not the employer) is subject to an additional 0.9% Medicare tax if the employee's wages exceed a threshold amount ($200,000 unmarried; $250,000 for married filing jointly; $125,000 for married filing separately).

PARTNERSHIPS

A **partnership** is an unincorporated business carried on by two or more individuals or entities for profit. The partnership form often is used by friends or relatives who engage in a business and by groups of investors who want to share the profits, losses, and expenses of an investment such as a real estate project.

A partnership is a tax reporting, but not taxpaying, entity. The partnership acts as a conduit for its owners. Its income, expenses, losses, credits, and other tax-related items pass through to the partners who report these items on their separate tax returns.

Each year a partnership must file a tax return (Form 1065—U.S. Partnership Return of Income) to report the results of its operations. When the partnership return is filed, the preparer must send each partner a statement (Schedule K-1, Form 1065) that reports the

REAL-WORLD EXAMPLE

Entities filed the following number of tax returns in 2017:

Entity	Number
Partnership	4.01 million
C corporation	2.01 million
S corporation	4.84 million

[2] Section 162(l) permits self-employed individuals to deduct as a trade or business expense all of the health insurance costs incurred on behalf of themselves, their spouses, and their dependents.

partner's allocable share of partnership income, expenses, losses, credits, and other tax-related items. The partner then must report these items on his or her separate tax return. As with a sole proprietorship, the partner's allocable share of business profits is added to the partner's other income and taxed at that partner's marginal tax rate. A completed Form 1065 appears in Appendix B.

EXAMPLE C:2-3 ▶ Bob, a single taxpayer, owns a 50% interest in the BT Partnership, a calendar year entity. The BT Partnership reports a $30,000 profit in its first year of operation. Bob's $15,000 share passes through from the partnership level to Bob's individual tax return. In addition, Bob is allowed a $3,000 (0.20 × $15,000) qualified business income deduction on his share of pass-through income, so only $12,000 of it is taxable. Assuming Bob is taxed at a 24% marginal rate, his tax on the $12,000 is $2,880 (0.24 × $12,000). Bob must pay the $2,880 tax whether or not the BT Partnership distributes any of its profits to him. ◀

If a partnership reports a loss, the partner's allocable share of the loss reduces that partner's other income and provides tax savings based on the partner's marginal tax rate. The passive activity loss rules, however, may limit the amount of any loss deduction available to the partner. (For a discussion of these rules, see Chapter C:9 of this textbook.)

EXAMPLE C:2-4 ▶ Assume the same facts as in Example C:2-3 except that, instead of a profit, the BT Partnership sustains a $30,000 loss in its first year of operation. Assuming Bob is taxed at a 24% marginal rate, his $15,000 share of the first year loss produces a tax savings of $3,600 (0.24 × $15,000). ◀

TAX STRATEGY TIP

In a limited partnership, the general partner could be a corporation, thereby affording the general owners (shareholders) of the corporation added liability protection.

Organizationally, a partnership can be either general or limited. In a general partnership, the liability of each partner for partnership debts is unlimited. Thus, these partners are at risk for more than the amount of their capital investment in the partnership. In a limited partnership, at least one partner must be a general partner, and at least one partner must be a limited partner. As in a general partnership, the general partners are liable for all partnership debts, and the limited partners are liable only to the extent of their capital investment in the partnership, plus any amount they are obligated to contribute under their partnership agreement. Unless specified in that agreement, limited partners generally may not participate in the management of the partnership business.

Tax Advantages. The tax advantages of doing business as a partnership are as follows:

- The partnership as an entity pays no tax. Rather, the income of the partnership passes through to the separate returns of the partners and is taxed directly to them.
- Pass-through income may qualify for the 20% qualified business income deduction.
- A partner's tax rate may be lower than a corporation's tax rate for the same level of taxable income.
- Partnership income is not subject to double taxation. Although partnership profits are accounted for at the partnership level, they are taxed only at the partner level.
- Additional taxes generally are not imposed on distributions to the partners. With limited exceptions, partners can contribute money or property to, or withdraw money or property from, the partnership without recognizing gain or loss.
- Subject to limitations, partners can use losses to offset income from other sources.
- A partner's basis in a partnership interest is increased by his or her share of partnership income. This basis adjustment reduces the amount of gain recognized when the partner sells his or her partnership interest, thereby avoiding double taxation.

ADDITIONAL COMMENT

If two or more owners exist, a business cannot be conducted as a sole proprietorship. From a tax compliance and recordkeeping perspective, conducting a business as a partnership is more complicated than conducting the business as a sole proprietorship.

Tax Disadvantages. The tax disadvantages of doing business as a partnership are as follows:

- All the partnership's profits are taxed to the partners when earned, even if not distributed.
- A partner's tax rate could be higher than a corporation's tax rate for the same level of taxable income.
- A partner is not considered to be an employee of the partnership. Therefore, he or she must pay the full amount of self-employment taxes on his or her share of partnership

income. Some tax-exempt fringe benefits (e.g., premiums for group term life insurance) are not available to partners.[3]

- Partners generally cannot defer income by choosing a fiscal year for the partnership that differs from the tax year of the principal partner(s). However, if the partnership demonstrates a business purpose, or if it makes a special election, it may use a fiscal year in general.

Chapters C:9 and C:10 of this volume discuss partnerships in greater detail.

CORPORATIONS

Corporations fall into two categories: C corporations and S corporations. Both have limited liability. A C corporation is subject to double taxation. Its earnings are taxed first at the corporate level when earned, then again at the shareholder level when distributed as dividends. An S corporation, by contrast, is subject to single-level taxation, much like a partnership. Its earnings are accounted for at the corporate level but are taxed only at the shareholder level.

ADDITIONAL COMMENT

Unlike a sole proprietorship and a partnership, a C corporation is a separate taxpaying entity. This form can be advantageous because the corporate rate is 21%, which may be much lower than an individual shareholder's rate, which might be as high as 37%.

C Corporations. A **C corporation** is a separate entity that, for tax years beginning after December 31, 2017, is taxed at 21% on taxable income. A C corporation must report all its income and expenses and compute its tax liability on Form 1120 (U.S. Corporation Income Tax Return). A completed Form 1120 appears in Appendix B. Shareholders are not taxed on the corporation's earnings unless these earnings are distributed as dividends, and qualified dividends are taxed at the shareholder's tax rate for long-term capital gains, which can be 0%, 15% or 20 % depending on the individual's tax status and level of taxable income.[4] In addition, an incremental 3.8% tax rate applies to net investment income for taxpayers whose modified AGI exceeds $200,000 ($250,000 for married filing jointly). Net investment income includes, among other things, interest, dividends, annuities, royalties, rents, and net gains from the disposition of property not used in a trade or business, all reduced by deductions allocable to such income or gains. In contrast, a C corporation's capital gains are taxed at the same 21% tax rate as its other income.

EXAMPLE C:2-5 ▶

TAX STRATEGY TIP

If a shareholder is also an employee of the corporation, the corporation can avoid double taxation by paying a deductible salary instead of a dividend. The salary, however, must be reasonable in amount. See Tax Planning Considerations in Chapter C:3 for further discussion of this technique along with an example demonstrating how the lower tax rate on dividends reduces the difference between salary and dividend payments.

Jane owns 100% of York Corporation stock. York reports taxable income of $50,000 for the current year, so York pays a corporate income tax of $10,500 (0.21 × $50,000). If the corporation distributes none of its earnings to Jane during the year, she pays no tax currently on York's earnings. However, if York distributes its after-tax earnings to Jane, she must pay tax on $39,500 ($50,000 − $10,500) of dividend income. Assuming Jane's marginal tax rate on capital gains and qualified dividends is 15%, her tax on the dividend income is $5,925 (0.15 × $39,500). The total tax on York's $50,000 of profits, therefore, is $16,425 ($10,500 paid by York + $5,925 paid by Jane). This total tax produces an effective tax rate of 32.85% ($16,425 ÷ $50,000) on the corporate profit. ◀

Even when a corporation does not distribute its profits, double taxation may result. The profits are taxed to the corporation when they are earned. Then, effectively, they may be taxed a second time (as capital gains) when the shareholder sells appreciated stock or when the corporation liquidates.

EXAMPLE C:2-6 ▶

TAX STRATEGY TIP

By having a corporation retain earnings instead of paying dividends, the shareholder converts current ordinary income into deferred capital gains. The corporation, however, must avoid the accumulated earnings tax (see Chapter C:5).

On January 2 of the current year, Carl purchases 100% of York Corporation stock for $60,000. In the same year, York reports taxable income of $50,000, on which it pays tax of $10,500. The corporation distributes none of the remaining $39,500 to Carl. On January 3 of the next year, Carl sells his stock to Mary for $99,500 (his initial investment plus the current year's accumulated earnings). Carl must report a capital gain of $39,500 ($99,500 − $60,000). Thus, York's profit is effectively taxed twice—first at the corporate level when earned and again at the shareholder level when Carl sells the appreciated stock at a gain. ◀

Tax Advantages. The tax advantages of doing business as a C corporation are as follows:

- A C corporation is an entity separate and distinct from its owners. Its tax rate may be lower than its owners' marginal tax rates. So long as these earnings are not distributed and taxed to both the shareholders and the corporation, aggregate tax savings may result. If retained in the business, the earnings may be used for reinvestment and the retirement of debt. This advantage, however, may be limited by the accumulated earnings tax and the personal holding company tax. (See Chapter C:5 for a discussion of these two taxes.)

[3] Partners are eligible to deduct their health insurance costs in the same manner as a sole proprietor. See footnote 2 for details.

[4] Taxable income breakpoints for tax rates for capital gains and qualified dividends are indexed using the Chained Consumer Price Index for All Urban Consumers (C-CPI-U) in tax years beginning after 2017. See the Quick Reference section of the text for these breakpoints.

- Shareholders employed by the corporation are considered to be employees for tax purposes. Consequently, they are liable for only half their Social Security taxes, while their corporate employer is liable for the other half.
- Shareholder-employees are entitled to nontaxable fringe benefits (e.g., premiums paid on group term life insurance and accident and health insurance). The corporation can provide these benefits with before-tax dollars (instead of after-tax dollars). By contrast, because sole proprietors and partners are not considered to be employees for tax purposes, they are ineligible for certain tax-free fringe benefits, although they are permitted to deduct their health insurance premiums.
- A corporation may deduct as an ordinary and necessary business expense compensation and certain benefits paid to shareholder-employees. Within reasonable limits, it may adjust this compensation and these benefits upward to shelter corporate taxable income.
- A C corporation can use a fiscal instead of a calendar year as its reporting period. A fiscal year could permit a corporation to defer income to a later reporting period. (A personal service corporation, however, generally must use a calendar year as its tax year.[5])
- Special rules allow a shareholder to exclude 50% of the gain realized on the sale or exchange of stock held more than five years, provided the corporation meets certain requirements.

SELF-STUDY QUESTION

How are corporate earnings subject to double taxation?

ANSWER

Corporate earnings initially are taxed to the corporation. In addition, once these earnings are distributed to the shareholders as dividends, they are taxed again. Because the corporation does not receive a deduction for the distribution, these earnings have been taxed twice. Also, double taxation can occur when a shareholder sells his or her stock at a gain. In either case, the dividends or capital gains are taxed at the applicable capital gains rate.

Tax Disadvantages. The tax disadvantages of doing business as a C corporation are as follows:

- Double taxation of income results when the corporation distributes its earnings as dividends to shareholders or, effectively, when shareholders sell or exchange appreciated stock.
- Shareholders generally cannot withdraw money or property from the corporation without recognizing income. A distribution of cash or property to a shareholder generally is taxable as a dividend if the corporation has sufficient earnings and profits (E&P). (See Chapter C:4 for a discussion of E&P.)
- Net operating losses confer no tax benefit to the owners in the year the corporation incurs them. They can be carried back (if incurred before 2018) or carried over to offset the corporation's income in future years. For start-up corporations, these losses provide no tax benefit until the corporation earns a profit in a subsequent year. Shareholders cannot use these losses to offset income from other sources. (See Chapter C:3 for a discussion of corporate NOLs.)
- Capital losses confer no tax benefit to the owners in the year the corporation incurs them. They cannot offset the ordinary income of either the corporation or its shareholders. These losses must be carried back or carried over to offset corporate capital gains realized in other years. (See Chapter C:3 for a discussion of corporate capital gains and losses.)

S Corporations. An **S corporation** is so designated because special rules governing its tax treatment are found in Subchapter S of the IRC. Nevertheless, the general corporate tax rules apply unless overridden by the Subchapter S provisions. Like a partnership, an S corporation is a pass-through entity. Income, deductions, losses, and credits are accounted for by the S corporation, which generally is not subject to taxation. They pass through to the separate returns of its owners, who generally are subject to taxation. An S corporation offers its owners less planning flexibility than does a partnership. For example, the number and type of S corporation shareholders are limited, and the shareholders cannot allocate income, deductions, losses, and credits in a way that differs from their proportionate ownership. As mentioned before, like C corporation shareholders, S corporation shareholders enjoy limited liability.

To obtain S corporation status, a corporation must make a special election, and its shareholders must consent to that election. Each year, an S corporation files an information return, Form 1120S (U.S. Income Tax Return for an S Corporation), which reports the results of its operations and indicates the items of income, deduction, loss, and credit that pass through to the separate returns of its shareholders.

[5] Sec. 441. See Chapter C:3 for the special tax year restrictions applying to personal service corporations.

TAX STRATEGY TIP

If a corporation anticipates losses in its early years, it might consider operating as an S corporation so that the losses pass through to the shareholders. When the corporation becomes profitable, it can revoke the S election if it wishes to accumulate earnings for growth.

Tax Advantages. The tax advantages of doing business as an S corporation are as follows:

- S corporations generally pay no tax. Instead, corporate income passes through and is taxed to the shareholders.
- Pass-through income may qualify for the 20% qualified business income deduction.
- The shareholders' marginal tax rates may be lower than a C corporation's tax rate, thereby producing overall tax savings.
- Corporate losses pass through to the separate returns of the shareholders and may be used to offset income earned from other sources. (Passive loss and basis rules, however, may limit loss deductions to shareholders. See Chapter C:11.) This treatment can be beneficial to owners of start-up corporations that generate losses in their early years of operation.
- Because capital gains, as well as other tax-related items, retain their character when they pass through to the separate returns of shareholders, the shareholders are taxed on these gains as though they directly realized them. Consequently, they can offset the gains against capital losses from other sources. Furthermore, they are taxed on these gains at their own capital gains rates.
- Shareholders generally can contribute money to or withdraw money from an S corporation without recognizing gain.
- Corporate profits are taxed only at the shareholder level in the year earned. Generally, the shareholders incur no additional tax liability when the corporation distributes the profits.
- A shareholder's basis in S corporation stock is increased by his or her share of corporate income. This basis adjustment reduces the shareholder's gain when he or she later sells the stock, thereby avoiding double taxation.

EXAMPLE C:2-7 ▶ Chuck owns 50% of the stock in Maine, an S corporation that uses the calendar year as its tax year. In its first year of operation, Maine reports $30,000 of taxable income, all ordinary in character. Maine pays no corporate income tax. Chuck, however, must recognize his $15,000 share of Maine's income whether or not the corporation distributes this income to him. However, Chuck is allowed a $3,000 (0.20 × $15,000) qualified business income deduction on his share of pass-through income, so only $12,000 of it is taxable. If his marginal rate is 24%, Chuck pays a tax of $2,880 (0.24 × $12,000) on this share. If Maine instead reports a $30,000 loss, Chuck's $15,000 share of the loss reduces his tax liability by $3,600 (0.24 × $15,000). ◀

TAX STRATEGY TIP

Relatively low individual tax rates may increase the attractiveness of an S corporation relative to the C corporation form of doing business.

Tax Disadvantages. The tax disadvantages of doing business as an S corporation are as follows:

- Shareholders are taxed on all of an S corporation's current year profits whether or not the corporation distributes these profits and whether or not the shareholders have the wherewithal to pay the tax on these profits.
- If the shareholders' marginal tax rates exceed that for a C corporation, the overall tax burden may be heavier, and the after-tax earnings available for reinvestment and debt retirement may be reduced.
- Nontaxable fringe benefits generally are not available to S corporation shareholder-employees.[6] Ordinarily, fringe benefits provided by an S corporation are deductible by the corporation and taxable to the shareholder. On the other hand, S corporation shareholder-employees pay half of Social Security taxes while the S corporation employer pays the other half.
- S corporations generally cannot defer income by choosing a fiscal year other than a calendar year unless the S corporation can establish a legitimate business purpose for a fiscal year or unless it makes a special election.

Chapter C:11 discusses S corporations in greater detail. In addition, Appendix F compares the tax treatment of C corporations, partnerships, and S corporations.

[6] S corporation shareholders may deduct their health insurance costs in the same manner as sole proprietors and partners. See footnotes 2 and 3 for details.

ADDITIONAL COMMENT

All 50 states have adopted statutes providing for LLCs.

LIMITED LIABILITY COMPANIES

A **limited liability company** (LLC) combines the best features of a partnership with those of a corporation even though, from a legal perspective, it is neither. While offering its owners the limited liability of a corporation, an LLC with more than one owner generally is treated as a partnership for tax purposes. This limited liability extends to all the LLC's owners. In this respect, the LLC is analogous to a limited partnership with no general partners. Unlike an S corporation, an LLC may have an unlimited number of owners who can be individuals, corporations, estates, and trusts. As discussed below, under the check-the-box regulations, the LLC may elect to be taxed as a corporation or be treated by default as a partnership. If treated as a partnership, the LLC files Form 1065 (U.S. Partnership Return of Income) with the IRS.

REAL-WORLD EXAMPLE

All the Big 4 accounting firms operate in some form of LLP.

LIMITED LIABILITY PARTNERSHIPS

The **limited liability partnership** (LLP) business form is attractive to owners of professional service organizations, such as public accounting firms, that adopt LLP status primarily to limit their legal liability. Under state LLP laws, partners are liable for their own acts and omissions as well as the acts and omissions of individuals under their direction. On the other hand, LLP partners are not liable for the negligence or misconduct of the other partners. Thus, from a legal liability perspective, an LLP partner is like a limited partner with respect to other partners' acts but like a general partner with respect to his or her own acts, as well as the acts of his or her agents. Like a general partnership or LLC with more than one owner, an LLP can elect to be taxed as a corporation under the check-the-box regulations. If treated as a partnership by default, the LLP files Form 1065 (U.S. Partnership Return of Income) with the IRS.

CHECK-THE-BOX REGULATIONS

OBJECTIVE 2

Apply the check-the-box regulations to partnerships, corporations, and trusts

Most unincorporated businesses may choose to be taxed as a partnership or a corporation under rules commonly referred to as the **check-the-box regulations**. According to these regulations, an unincorporated business with two or more owners is treated by default as a partnership for tax purposes unless it elects to be taxed as a corporation. An unincorporated business with one owner is disregarded as a separate entity and thus treated as a sole proprietorship by default unless it elects to be taxed as a corporation.[7]

An eligible entity (i.e., an unincorporated business) may elect its classification by filing Form 8832 (Entity Classification Election) with the IRS. The form must be signed by each owner of the entity, or any officer, manager, or owner of the entity authorized to make the election. The signatures must specify the date on which the election will be effective. The effective date cannot be more than 75 days before or 12 months after the date the entity files Form 8832. A copy of the form must be attached to the entity's tax return for the election year.

TAX STRATEGY TIP

When applying the federal check-the-box regulations, taxpayers also must check to see whether or not their state will treat the entity in a consistent manner for state tax purposes.

EXAMPLE C:2-8 ▶ On January 10 of the current year, a group of ten individuals organizes an LLC to conduct a bookbinding business in Texas. In the current year, the LLC is an eligible entity under the check-the-box regulations and thus may elect (with the owners' consent) to be taxed as a corporation. If the LLC does not make the election, the LLC, for tax purposes, will be treated as a partnership by default. ◀

EXAMPLE C:2-9 ▶ Assume the same facts as in Example C:2-8 except only one individual organized the LLC. Unless the LLC elects to be taxed as a corporation, the LLC, For tax purposes, will be disregarded by default. Consequently, its income will be taxed directly to the owner as if it were a sole proprietorship. ◀

[7] This rule does not apply to corporations, trusts, or certain special entities such as real estate investment trusts, real estate mortgage investment conduits, or publicly traded partnerships. Reg. Sec. 301.7701-2(b)(8). Publicly traded partnerships are discussed in Chapter C:10. Special check-the-box rules apply to foreign corporations. These rules are beyond the scope of this text.

If an entity elects to change its tax classification, it cannot make another election until 60 months after the effective date of the initial election. Following the election, certain tax consequences ensue. For example, following a partnership's election to be taxed as a corporation, the partnership is deemed to distribute its assets to the partners, who are then deemed to contribute the assets to a new corporation in a nontaxable exchange for stock. If an eligible entity that previously elected to be taxed as a corporation subsequently elects to be treated as a partnership or a disregarded entity, it is deemed to have distributed its assets and liabilities to its owner(s) in a liquidation as described in Chapter C:6. In the case of a partnership, the deemed distribution is followed by a deemed contribution of assets and liabilities to a newly formed partnership.[8]

LEGAL REQUIREMENTS AND TAX CONSIDERATIONS RELATED TO FORMING A CORPORATION

OBJECTIVE 3

Recognize the legal requirements and tax considerations related to forming a corporation

LEGAL REQUIREMENTS

State or jurisdictional laws dictate the legal requirements for forming a corporation. These requirements usually include

- Investing a minimum amount of capital
- Filing articles of incorporation
- Issuing stock
- Paying incorporation fees to the state or other jurisdiction

One of the first decisions an entrepreneur must make when organizing a corporation is choosing a state of incorporation. Although most entrepreneurs incorporate in the state where they conduct business, many incorporate in other states with more favorable corporation laws. Such laws might provide for little or no income, sales, or use taxes; low minimum capital requirements; and modest incorporation fees. Regardless of the state of incorporation, the entrepreneur must follow the incorporation procedure set forth in the applicable state statute. Typically, under this procedure, the entrepreneur must file articles of incorporation with the appropriate state agency. The articles must specify certain information, such as the formal name of the corporation; its purpose; the par value, number of shares, and classes of stock it is authorized to issue; and the names of the individuals who will initially serve on the corporation's board of directors. The state usually charges a fee for incorporation or filing. In addition, it periodically may assess a franchise tax for the privilege of doing business in the state. These fees and taxes could be substantial.

ADDITIONAL COMMENT

States are not consistent in how they tax corporations. Certain states have no state income taxes. Other states do not recognize an S corporation election, thereby taxing an S corporation as a C corporation.

TAX CONSIDERATIONS

Once the entrepreneur decides on the corporate form, he or she must transfer cash, property (e.g., equipment, furniture, inventory, and receivables), or services (e.g., accounting, legal, or architectural services) to the corporation in exchange for its debt or equity. These transfers may have tax consequences for both the transferor investor and the transferee corporation. For instance, the sale of property for stock usually is taxable to the transferor.[9] However, if Sec. 351(a) (which treats an investor's interest in certain transferred business assets to be "changed in form" rather than "disposed of") applies, any gain or loss realized on the exchange may be deferred. In determining the tax consequences of incorporation, one must answer the following questions:

- What property should be transferred to the corporation?
- What services should the transferors or third parties provide for the corporation?

[8] Reg. Sec. 301.7701-3(g). An alternative way for a corporation to be taxed as a pass-through entity is to make an election to be taxed as an S corporation. See Chapter C:11.

[9] Sec. 1001.

- What liabilities, in addition to property, should be transferred?
- Do the transferor shareholders have control of the corporation after the transfers?

Example C:2-10 and Table C:2-1 compare the tax consequences of taxable and nontaxable property transfers.

EXAMPLE C:2-10 ▶ For several years Brad has operated a successful manufacturing business as a sole proprietorship. To limit his liability, he decides to incorporate his business as Block Corporation. Immediately preceding the incorporation, he reports the following balance sheet for his sole proprietorship, which uses the accrual method of accounting:

		Adjusted Basis	*Fair Market Value*
Assets:			
Cash		$ 10,000	$ 10,000
Accounts receivable		15,000	15,000
Inventory		20,000	25,000
Equipment	$120,000		
Minus: Depreciation	(35,000)	85,000	100,000
Total		$130,000	$150,000
Liabilities and owner's equity:			
Accounts payable		$ 30,000	$ 30,000
Note payable on equipment		50,000	50,000
Owner's equity		50,000	70,000
Total		$130,000	$150,000

When Brad transfers the assets to Block in exchange for its stock, he realizes a gain because the value of the stock received exceeds his basis in the assets. If the exchange is taxable, Brad recognizes $5,000 of ordinary income on the transfer of the inventory ($25,000 FMV − $20,000 basis) and, because of depreciation recapture, $15,000 of ordinary income on the transfer of the equipment ($100,000 FMV − $85,000 basis). However, if the exchange meets the requirements of Sec. 351(a), it is nontaxable. In other words, Brad recognizes none of the income or gain realized on the transfer of assets and liabilities to Block. ◀

STOP & THINK

Question: Joyce has conducted a business as a sole proprietorship for several years. She needs additional capital and wants to incorporate her business. The assets of her business (building, land, inventory, etc.) have a $400,000 adjusted basis and a $1.5 million FMV. Joyce is willing to exchange the assets for 1,500 shares of Ace Corporation stock, each having a $1,000 fair market value. Bill and John each are willing to invest $500,000 cash in Joyce's business for 500 shares of stock. Why is Sec. 351 relevant to Joyce? Does it matter to Bill and John?

Solution: If not for Sec. 351, Joyce would recognize gain on the incorporation of her business. She realizes a gain of $1.1 million ($1,500,000 – $400,000) on her contribution of proprietorship assets to a new corporation in exchange for 60% of its outstanding shares (1,500 ÷ [1,500 + 500 + 500] = 0.60). However, she recognizes none of this gain because she meets the requirements of Sec. 351. Section 351 does not affect Bill or John because each is simply purchasing 20% of the new corporation's stock for $500,000 cash. Nevertheless, their contribution of cash, which counts as property, allows the three shareholders to have 100% control after the transfer. They will not realize or recognize gain or loss unless they subsequently sell their stock at a price above or below the $500,000 cost.

If all exchanges of property for corporate stock were taxable, many entrepreneurs would find the tax cost of incorporating their business prohibitively high. In Example C:2-10, for example, Brad would recognize a $20,000 gain on the exchange of his assets for the corporate stock. Moreover, because losses also are realized in an exchange, without special rules, taxpayers could exchange loss property for stock and recognize the loss while maintaining an equity interest in the property transferred.

▼ **TABLE C:2-1**
Overview of Corporate Formation Rules

Tax Treatment for:	Taxable Property Transfer	Nontaxable Property Transfer
Transferors: 1. Gain realized	FMV of stock received Money received FMV of noncash boot property (including securities) received Amount of liabilities assumed by transferee corporation Minus: Adjusted basis of property transferred Realized gain (Sec. 1001(a))	Same as in a taxable transaction
2. Gain recognized	Transferors recognize the entire amount of realized gain (Sec. 1001(c)) Losses may be disallowed under related party rules (Sec. 267(a)(1)) Installment sale rules may apply to the realized gain (Sec. 453)	Transferors recognize none of the realized gain unless one of the following exceptions applies (Sec. 351(a)): a. Boot property is received (Sec. 351(b)) b. Liabilities are transferred to the corporation for a nonbusiness or tax avoidance purpose (Sec. 357(b)) c. Liabilities exceeding basis are transferred to the corporation (Sec. 357(c)) d. Services, certain corporate indebtedness, and interest claims are transferred to the corporation (Sec. 351(d)) The installment method may defer recognition of gain when a shareholder receives a corporate note as boot (Sec. 453)
3. Basis of qualified stock and other property received	FMV (Cost) (Sec. 1012)	Basis of property transferred to the corporation Plus: Gain recognized Minus: Money received (including liabilities treated as money) FMV of noncash boot property Total basis of qualified stock received (Sec. 358(a)) Allocation of total qualified stock basis is based on relative FMVs Basis of noncash boot property is its FMV (Sec. 358(a))
4. Holding period of property received	Day after the exchange date	Holding period of qualified stock received includes holding period of Sec. 1231 property or capital assets transferred; otherwise it begins the day after the exchange date
Transferee Corporation: 1. Gain recognized	The corporation recognizes no gain or loss on the receipt of money or other property in exchange for its stock (including treasury stock) (Sec. 1032)	Same as taxable transaction except the corporation may recognize gain under Sec. 311 if it transfers appreciated noncash boot property (Sec. 351(f))
2. Basis	FMV (Cost) (Sec. 1012)	Generally, same as in transferor's hands plus any gain recognized by transferor (Sec. 362) If the total adjusted basis of all transferred property exceeds the total FMV of the property, the total basis to the transferor is limited to the property's total FMV
3. Holding period	Day after the exchange date	Transferor's carryover holding period for the property transferred regardless of the property's character (Sec. 1223(2))

To allow taxpayers to incorporate without incurring a high tax cost and to prevent taxpayers from recognizing losses while maintaining an equity claim to the loss assets, Congress enacted Sec. 351.

SECTION 351: DEFERRING GAIN OR LOSS UPON INCORPORATION

OBJECTIVE 4

Discuss the requirements for deferring gain or loss upon incorporation

Section 351(a) provides that transferors recognize no gain or loss when they transfer property to a corporation solely in exchange for the corporation's stock if immediately after the exchange, the transferors are in control of the corporation. Section 351 does not apply to a transfer of property to an investment company, nor does it apply in certain bankruptcy cases.

This rule is based on the premise that, when property is transferred to a controlled corporation, the transferors merely exchange direct ownership for indirect ownership through stock in the transferee corporation, which gives them an equity interest in the underlying assets. In other words, the transferors maintain a continuity of interest in the transferred property. Furthermore, if the only consideration the shareholders receive is stock, they have not generated cash with which to pay their taxes. If the transferors of property receive other consideration in addition to stock, such as cash or debt instruments, they will have the wherewithal to pay taxes and, under Sec. 351(b), may have to recognize some or all of their realized gain.

TAX STRATEGY TIP

A transferor who wishes to recognize gain or loss must take steps to avoid Sec. 351 by deliberately failing at least one of its requirements or by engaging in sales transactions. See Tax Planning Considerations at the end of this chapter for details.

A transferor's realized gain or loss that is unrecognized for tax purposes is not exempt from taxation. It is only *deferred* until the shareholder sells or exchanges the stock received in the Sec. 351 exchange. Shareholders who receive stock in such an exchange take a stock basis that reflects the deferred gain or loss. For example, if a shareholder receives stock in exchange for property and recognizes no gain or loss, the stock basis equals the basis of property transferred less liabilities assumed by the corporation (see Table C:2-1). This tax treatment is discussed later in this chapter. Under an alternative approach, the stock basis can be calculated as follows: FMV of qualified stock received, minus any deferred gain (or plus any deferred loss). This latter approach highlights the deferral aspect of this type of transaction. If the shareholder later sells the stock, he or she will recognize the deferred gain or loss inherent in the basis adjustment.

EXAMPLE C:2-11 ▶

Assume the same facts as in Example C:2-10. If Brad satisfies the conditions of Sec. 351, he will not recognize the $20,000 realized gain ($15,000 gain on equipment + $5,000 gain on inventory) when he transfers the assets and liabilities of his sole proprietorship to Block Corporation. Under the alternative approach, Brad's basis in the Block stock is its FMV decreased to reflect the deferred gain. Thus, Brad's basis in the Block stock is $50,000 ($70,000 FMV − $20,000 deferred gain). If Brad later sells his stock for its $70,000 FMV, he will recognize the $20,000 gain at the time of sale. ◀

ADDITIONAL COMMENT

As will be discussed later in this chapter, the statutory method for arriving at Brad's stock basis is the adjusted basis of property transferred ($130,000) minus liabilities assumed by the corporation ($80,000), again $50,000.

The specific requirements for deferral of gain and loss under Sec. 351(a) are

- The transferors must transfer property to the corporation.
- They must receive stock of the transferee corporation in exchange for their property.
- They must be in control of the corporation immediately after the exchange.

Each of these requirements is explained below.

THE PROPERTY REQUIREMENT

The rule of gain or loss nonrecognition applies only to transfers of property to a corporation in exchange for the corporation's stock. Section 351 does not define the term *property*. However, the courts and the IRS have defined *property* to include cash and almost any other asset, including installment obligations, accounts receivable, inventory,

equipment, patents and other intangibles representing know-how, trademarks, trade names, and computer software.[10]

Excluded from the statutory definition of property are[11]

- Services (such as legal or accounting services) rendered to the corporation in exchange for its stock
- Indebtedness of the transferee corporation not evidenced by a security
- Interest on transferee corporation debt that accrued on or after the beginning of the transferor's holding period for the debt

The first of these exclusions perhaps is the most important. A person receiving stock in compensation for services must recognize the stock's FMV as ordinary income for tax purposes. In other words, an exchange of services for stock is a taxable transaction even where concurrent transfers of property for stock are nontaxable under Sec. 351.[12] A shareholder's basis in the stock received in compensation for services is the stock's FMV (not necessarily the FMV of the services).

EXAMPLE C:2-12 ▶ Amy and Bill form West Corporation. Amy exchanges property for 90 shares (90% of the outstanding shares) of West stock. Amy's exchange is nontaxable because Amy has exchanged property for stock and controls West immediately after the exchange. Bill performs accounting services that he normally bills for $12,000 in exchange for ten shares of West stock worth $10,000. Bill's exchange is taxable because he has provided services in exchange for stock. Thus, Bill recognizes $10,000 of ordinary income—the FMV of the stock—as compensation for his services. Bill's basis in the stock is its $10,000 FMV. ◀

THE CONTROL REQUIREMENT

Section 351 requires the transferors, as a group, to be in control of the transferee corporation immediately after the exchange. A transferor may be an individual or any type of entity (such as a partnership, another corporation, or a trust). Section 368(c) defines *control* as ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock (e.g., nonvoting preferred stock).[13] The minimum ownership levels for nonvoting stock apply to each class of stock rather than to the nonvoting stock in total.[14]

EXAMPLE C:2-13 ▶ Dan exchanges property having a $22,000 adjusted basis and a $30,000 FMV for 60% of newly created Sun Corporation's single class of stock. Ed exchanges $20,000 cash for the remaining 40% of Sun stock. The transaction qualifies as a nontaxable exchange under Sec. 351 because the transferors, Dan and Ed, together own at least 80% of the Sun stock immediately after the exchange. Therefore, Dan defers recognition of his $8,000 ($30,000 − $22,000) realized gain. (Ed realizes no gain because he contributes cash.) ◀

Because services do not qualify as property, stock received by a person who exclusively provides services does not count toward the 80% control threshold. Unless transferors of property own at least 80% of the corporation's stock immediately after the exchange, the control requirement will not be met, and the entire transaction will be taxable.

EXAMPLE C:2-14 ▶ Dana transfers property having an $18,000 adjusted basis and a $35,000 FMV to newly created York Corporation for 70 shares of York stock. Ellen provides legal services for the remaining 30 York shares valued at $15,000. Because Ellen does not transfer property to York, her stock is not counted toward the 80% ownership threshold. On the other hand, because Dana transfers property to York, his stock is counted toward this threshold. However, Dana is not in control of York immediately after the exchange because he owns only 70% of York stock. Therefore, Dana recognizes all $17,000 ($35,000 − $18,000) of his gain realized on the exchange. Dana's basis in his York stock is its $35,000 FMV. Ellen recognizes $15,000 of ordinary income, the FMV of stock received for her services. Ellen's basis in her York stock is $15,000. The tax consequences to Ellen are the same whether or not Dana meets the control requirement. ◀

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[10] For an excellent discussion of the definition of *property*, see footnote 6 of *D.N. Stafford v. U.S.*, 45 AFTR 2d 80-785, 80-1 USTC ¶9218 (5th Cir., 1980).

[11] Sec. 351(d).

[12] Secs. 61 and 83.

[13] In determining whether the 80% requirements are satisfied, the constructive ownership rules of Sec. 318 do not apply (see Rev. Rul. 56-613, 1956-2 C.B. 212). See Chapter C:4 for an explanation of Sec. 318.

[14] Rev. Rul. 59-259, 1959-2 C.B. 115, as modified by Rev. Rul. 81–17, 1981-1 C.B. 75.

If the property transferors own at least 80% of the stock immediately after the exchange, they, but not the provider of services, will be in control of the transferee corporation.

EXAMPLE C:2-15 ▶ Assume the same facts as in Example C:2-14, except a third individual, Fred, contributes $35,000 in cash for 70 shares of York stock. Now Dana and Fred together own more than 80% of the York stock (140 ÷ 170 = 0.82) immediately after the exchange. Therefore, the transaction meets the Sec. 351 control requirement, and neither Dana nor Fred recognizes gain on the exchange. Ellen still must recognize $15,000 of ordinary income, the FMV of the stock she receives for her services. ◀

Transferors of Both Property and Services. If a person transfers both services *and* property to a corporation in exchange for the corporation's stock, all the stock received by that person, including stock received in exchange for services, is counted toward the 80% control threshold.[15]

EXAMPLE C:2-16 ▶ Assume the same facts as in Example C:2-14 except that, in addition to providing legal services in exchange for stock worth $15,000, Ellen contributes property worth at least $1,500. In this case, all of Ellen's stock counts toward the 80% ownership threshold. Because Dana and Ellen together own 100% of the York stock, the exchange meets the Sec. 351 control requirement. Therefore, Dana recognizes no gain on his property exchange. However, Ellen still must recognize $15,000 of ordinary income, the FMV of the stock received as compensation for services. ◀

When a person transfers both property and services in exchange for a corporation's stock, the property must have more than nominal value for that person's stock to count toward the 80% control threshold.[16] The IRS generally requires that the FMV of the stock received for transferred property be at least 10% of the value of the stock received for services provided. If the value of the stock received for the property is less than 10% of the value of the stock received for the services, the IRS will not issue an advance ruling to the effect that the transaction meets the requirements of Sec. 351.[17]

EXAMPLE C:2-17 ▶ Assume the same facts as in Example C:2-16 except that Ellen contributes only $1,000 worth of property in addition to the legal services. In this case, the IRS will not issue an advance ruling that the transaction meets the Sec. 351 requirements because the FMV of stock received for the property ($1,000) is less than 10% of the value of the stock received for the services ($1,500 = 0.10 × $15,000). Consequently, if the IRS audits Ellen's tax return for the year of transfer, it probably will challenge Dana's and Ellen's position that the transfer is nontaxable under Sec. 351. ◀

Transfers to Existing Corporations. Section 351 applies to transfers to an existing corporation as well as transfers to a newly created corporation. The same requirements must be met in both cases. Property must be transferred in exchange for stock, and the property transferors must be in control of the corporation immediately after the exchange.

EXAMPLE C:2-18 ▶ Jack and Karen own 75 and 25 shares, respectively, of Texas Corporation stock. Jack transfers property with a $15,000 adjusted basis and a $25,000 FMV to the corporation in exchange for an additional 25 shares of Texas stock. The transaction meets the Sec. 351 control requirement because, immediately after the exchange, Jack owns 80% (100 ÷ 125 = 0.80) of Texas stock. Therefore, Jack recognizes no gain. ◀

If a shareholder transfers property to an existing corporation for additional stock but does not own at least 80% of the stock immediately after the exchange, the control requirement is not met. Thus, Sec. 351 denies tax-free treatment for many transfers of property to an existing corporation by a new shareholder. A new shareholder's transfer of property to an existing corporation is nontaxable only if that shareholder acquires at least 80% of the corporation's stock, or if enough existing shareholders also transfer additional property so that the transferors as a group, including the new shareholder, control the corporation immediately after the exchange.

[15] Reg. Sec. 1.351-1(a)(2), Ex. (3).
[16] Reg. Sec. 1.351-1(a)(1)(ii).
[17] Rev. Proc. 77-37, 1977-2 C.B. 568, Sec. 3.07, as modified by T.D. 8761, 1998-1 C.B. 812.

EXAMPLE C:2-19 ▶ Alice owns all 100 shares of Local Corporation stock, valued at $100,000. Beth owns property with a $15,000 adjusted basis and a $100,000 FMV. Beth contributes the property to Local in exchange for 100 shares of newly issued Local stock. The transaction does not meet the Sec. 351 control requirement because Beth owns only 50% of Local stock immediately after the exchange. Consequently, Beth recognizes an $85,000 ($100,000 − $15,000) gain. ◀

If an existing shareholder exchanges property for additional stock to enable another shareholder to qualify for tax-free treatment under Sec. 351, the stock received must be of more than nominal value.[18] For advance ruling purposes, the IRS requires that this value be at least 10% of the value of the stock already owned.[19]

EXAMPLE C:2-20 ▶ Assume the same facts as in Example C:2-19 except that Alice transfers additional property worth $10,000 for an additional ten shares of Local stock. Now both Alice and Beth are transferors, thereby satisfying the Sec. 351 control requirement. Consequently, neither Alice nor Beth recognizes gain on the exchange. If Alice receives fewer than ten shares, the IRS will not issue an advance ruling that the exchange is tax-free under Sec. 351. ◀

STOP & THINK

Question: Matthew and Michael each own 50 shares of Main Corporation stock having a $250,000 FMV. Matthew wants to transfer property with a $40,000 adjusted basis and a $100,000 FMV to Main in exchange for an additional 20 shares. Can Matthew avoid recognizing $60,000 ($100,000 − $40,000) of the gain realized on the transfer?

Solution: If Matthew simply exchanges the property for additional stock, he must recognize the gain. The Sec. 351 control requirement will not have been met because Matthew will own only 70 of the 120 outstanding shares (or 58.33%) immediately after the exchange.

Gain recognition can be avoided in two ways:

1. Matthew can transfer sufficient property (i.e., $750,000 worth) to Main to receive 150 additional shares so that, immediately after the exchange, he will own 80% (200 out of 250 shares) of Main stock.
2. Alternatively, Michael also can contribute additional property to qualify as a transferor. Specifically, he can contribute to the corporation at least $25,000, or 10% of the $250,000 value of the Main stock that he already owns so that together the two transferors will own 100% of Main stock immediately after the exchange.

Disproportionate Exchanges of Property and Stock. Section 351 does not require that the value of the stock received by the transferors be proportionate to the value of the property transferred. However, if the value of the stock received is *not* proportionate to the value of the property transferred, the exchange may be treated in accordance with its economic effect, that is, a proportional exchange followed by a constructive gift, compensation payment, or extinguishment of a liability owed by one shareholder to another.[20] If the deemed effect of the transaction is a gift from one transferor to another, for example, the "donor" will be treated as though he or she received stock equal in value to that of the property contributed and then gave some of the stock to the "donee."

EXAMPLE C:2-21 ▶ Don and his son John transfer property worth $75,000 (adjusted basis of $42,000 to Don) and $25,000 (adjusted basis of $20,000 to John), respectively, to newly formed Star Corporation in exchange for all 100 shares of Star stock. Don and John receive 25 and 75 Star shares, respectively. Because Don and John are in control of Star immediately after the exchange, they recognize no gain or loss. However, because Don and John did not receive the stock in proportion to the FMV of their respective property contributions, Don might be deemed to have received 75 shares (worth $75,000), then to have given 50 shares (worth $50,000) to John. If the IRS deems such a gift, it might require Don to pay gift taxes. Don's basis in his remaining 25 shares is $14,000 [(25 ÷ 75) × $42,000 basis in the property transferred]. John's basis in the 75 shares is $48,000 [$20,000 basis in the property transferred by John + ($42,000 − $14,000) basis in the shares deemed to have been gifted by Don]. ◀

[18] Reg. Sec. 1.351-1(a)(1)(ii).
[19] Rev. Proc. 77-37, 1977-2 C.B. 568, Sec. 3.07, as modified by T.D. 8761, 1998-1 C.B. 812.
[20] Reg. Sec. 1.351-1(b)(1).

Immediately After the Exchange. Section 351 requires that the transferors be in control of the transferee corporation "immediately after the exchange." This requirement does not mean that all transferors must simultaneously exchange their property for stock. It does mean, however, that all the exchanges must be agreed to beforehand, and the agreement must be executed in an expeditious and orderly manner.[21]

EXAMPLE C:2-22 ▶ Art, Beth, and Carlos form New Corporation. Art and Beth each transfer noncash property worth $25,000 in exchange for one-third of the New stock. Carlos contributes $25,000 cash for another one-third of the New stock. On January 10, Art and Carlos transfer their property and cash, respectively. Beth transfers her property on March 3. Because all three transfers are part of the same prearranged transaction, the transferors are deemed to be in control of the corporation immediately after the exchange. ◀

TAX STRATEGY TIP

If one shareholder has a prearranged plan to dispose of his or her stock, and the disposition reduces the ownership of the transferor shareholders below the required 80% control, such disposition can disqualify the Sec. 351 transaction for all the shareholders. As a precaution, all shareholders should provide a written representation that they do not currently have a plan to dispose of their stock.

Section 351 does not require the transferors to retain control of the transferee corporation for any specific length of time after the exchange. Control is required only "immediately after the exchange." The IRS has interpreted this phrase to mean that the transferors must not have a prearranged plan to dispose of their stock outside the control group. If they do have such a plan, they are not considered to be in control immediately after the exchange.[22]

EXAMPLE C:2-23 ▶ Amir, Bill, and Carl form White Corporation. Each contributes to White appreciated property worth $25,000 in exchange for one-third of White stock. Before the exchange, Amir arranges to sell his stock to Dana as soon as he receives it. This prearranged plan implies that Amir, Bill, and Carl do *not* have control immediately after the exchange because Bill and Carl own only 66.7% of the stock while Amir has disposed of his interest. Therefore, each must recognize gain on the exchange. ◀

THE STOCK REQUIREMENT

Under Sec. 351, transferors who exchange property solely for transferee corporation qualified stock recognize no gain or loss if they control the corporation immediately after the exchange. For this purpose, qualified stock may be voting or nonvoting and may be common stock or qualified preferred stock. On the other hand, *nonqualified* preferred stock is treated as boot. Preferred stock generally has a preferred claim to dividends and liquidating distributions. Such stock, however, is nonqualified if

- The shareholder can require the corporation to redeem it,
- The corporation either is required to redeem the stock or is likely to exercise a right to redeem it, or
- The dividend rate on the stock varies with interest rates, commodity prices, or other similar indices.

These features render the preferred stock more like cash or debt than like equity. Thus, it is treated as boot subject to the rules discussed below. In addition, stock rights or stock warrants are not considered stock for purposes of Sec. 351.[23]

Topic Review C:2-1 summarizes the major requirements for a nontaxable exchange under Sec. 351.

EFFECT OF SEC. 351 ON THE TRANSFERORS

If all Sec. 351 requirements are met, the transferors recognize no gain or loss on the exchange of their property for stock in the transferee corporation. The receipt of property other than stock does not necessarily render the entire transaction taxable. Rather, it could result in the recognition of all or part of the transferors' realized gain.

Receipt of Boot. If a transferor receives any money or property other than stock in the transferee corporation, the additional money or property is considered to be **boot**. Boot may include cash, notes, securities, nonqualified preferred stock, or stock in another corporation. Upon receiving boot, the transferor recognizes gain to the extent of the lesser of the transferor's

[21] Reg. Sec. 1.351-1(a)(1).
[22] Rev. Rul. 79-70, 1979-1 C.B. 144.
[23] Reg. Sec. 1.351-1(a)(1)(ii).

TOPIC REVIEW C:2-1

Major Requirements of Sec. 351

1. The nonrecognition of gain or loss rule applies only to transfers of property in exchange for a corporation's qualified stock. It does not apply to an exchange of services for stock.
2. The property transferors must be in control of the transferee corporation immediately after the exchange. Control means ownership of at least 80% of the voting power and at least 80% of the total number of shares of all other classes of stock. Stock disposed of after the exchange pursuant to a prearranged plan does not meet the "immediately after the exchange" requirement.
3. The nonrecognition rule applies only to the gain realized in an exchange of property for qualified stock. If the transferor receives property other than qualified stock, such property is considered to be boot. The transferor recognizes gain to the extent of the lesser of the FMV of any boot received or the realized gain.

realized gain or the FMV of the boot property received.[24] A transferor never recognizes a loss in an exchange qualifying under Sec. 351 whether or not he or she receives boot.

The character of the recognized gain depends on the type of property transferred. For example, if the shareholder transfers a capital asset such as stock in another corporation, the recognized gain is capital in character. If the shareholder transfers Sec. 1231 property, such as equipment or a building, the recognized gain is ordinary in character to the extent of any depreciation recaptured under Sec. 1245 or 1250.[25] Thus, depreciation is not recaptured unless the transferor receives boot and recognizes a gain on the depreciated property transferred.[26] If the shareholder transfers inventory, the recognized gain is entirely ordinary in character.

EXAMPLE C:2-24 ▶ Pam, Rob, and Sam form East Corporation and transfer the following property:

Transferor	*Asset*	*Transferor's Adj. Basis*	*FMV*	*Consideration Received*
Pam	Machinery	$ 10,000	$ 12,500	25 shares East stock
Rob	Land	18,000	25,000	40 shares East stock and $5,000 East note
Sam	Cash	17,500	17,500	35 shares East stock

The machinery is Sec. 1231 property, and the land is a capital asset. The exchange meets the requirements of Sec. 351 except that, in addition to East stock, Rob receives boot of $5,000 (the FMV of the note). Rob realizes a $7,000 ($25,000 − $18,000) gain, of which he recognizes $5,000—the lesser of the $7,000 realized gain or the $5,000 boot received. The gain is capital in character because the property transferred was a capital asset in Rob's hands. Pam realizes a $2,500 gain on her exchange of machinery. However, even though Pam would have been required to recapture depreciation had she sold or exchanged the machinery, she recognizes no gain because she received no boot. Sam neither realizes nor recognizes gain on his cash purchase of East stock. ◀

ADDITIONAL COMMENT

If multiple assets were aggregated into one computation, any built-in losses would be netted against the gains. Such a result is inappropriate because losses cannot be recognized in a Sec. 351 transaction.

Computing Gain When Several Assets Are Transferred. Revenue Ruling 68-55 adopts a "separate properties approach" for computing gain or loss when a shareholder transfers more than one asset to a corporation.[27] Under this approach, the gain or loss realized and recognized is computed separately for each property transferred. The transferor is deemed to have received a proportionate share of stock, securities, and boot in exchange for each property transferred, based on the assets' relative FMVs.

EXAMPLE C:2-25 ▶ Joan transfers two assets to newly formed North Corporation in a transaction qualifying in part for tax-free treatment under Sec. 351. The total FMV of the assets is $100,000. The consideration

[24] Sec. 351(b).

[25] Section 1239 also may require some gain to be characterized as ordinary income. Section 1250 ordinary depreciation recapture will not apply to real property placed in service after 1986 because MACRS mandates straight-line depreciation.

[26] Secs. 1245(b)(3) and 1250(c)(3).

[27] 1968-1 C.B. 140, as amplified by Rev. Rul. 85-164, 1985-2 C.B. 117.

received by Joan consists of $90,000 of North stock and $10,000 of North notes. The following data illustrate how Joan determines her realized and recognized gain under the procedure set forth in Rev. Rul. 68-55.

	Asset 1	*Asset 2*	*Total*
Asset's FMV	$40,000	$60,000	$100,000
Percent of total FMV	40%	60%	100%
Consideration received in exchange for asset:			
Stock (Stock × percent of total FMV)	$36,000	$54,000	$ 90,000
Notes (Notes × percent of total FMV)	4,000	6,000	10,000
Total proceeds	$40,000	$60,000	$100,000
Minus: Adjusted basis	(65,000)	(25,000)	(90,000)
Realized gain (loss)	($25,000)	$35,000	$ 10,000
Boot received	$ 4,000	$ 6,000	$ 10,000
Recognized gain (loss)	None	$ 6,000	$ 6,000

Under the separate properties approach, the loss realized on the transfer of Asset 1 does not offset the gain realized on the transfer of Asset 2. Therefore, Joan recognizes $6,000 of the total $10,000 realized gain, even though she receives $10,000 of boot. Joan's selling Asset 1 to North so as to recognize the loss might be advisable. However, the Sec. 267 loss limitation rules may apply to Joan if she is a controlling shareholder (see page C:2-35). ◀

Computing a Shareholder's Basis.

Boot Property. A transferor's basis in any boot property received is the property's FMV.[28]

Stock. A shareholder computes his or her adjusted basis in stock received in a Sec. 351 exchange as follows:[29]

	Adjusted basis of property transferred to the corporation
Plus:	Any gain recognized by the transferor
Minus:	FMV of boot received from the corporation
	Money received from the corporation
	Liabilities assumed by the corporation
	Adjusted basis of stock received

EXAMPLE C:2-26 ▶

ADDITIONAL COMMENT

Because Sec. 351 is a deferral provision, any unrecognized gain must be reflected in the basis of the stock received by the transferor shareholder and is accomplished by substituting the shareholder's basis in the property transferred for the basis of the stock received. This substituted (exchanged) basis may be further adjusted by gain recognized and boot received.

Bob transfers a capital asset having a $50,000 adjusted basis and an $80,000 FMV to South Corporation. He acquired the property two years ago. Bob receives all 100 shares of South stock, having a $70,000 FMV, plus a $10,000 90-day South note (boot property). Bob realizes a $30,000 gain on the exchange, computed as follows:

FMV of stock received	$70,000
Plus: FMV of 90-day note	10,000
Amount realized	$80,000
Minus: Adjusted basis of property transferred	(50,000)
Realized gain	$30,000

Bob's recognized gain is $10,000, i.e., the lesser of the $30,000 realized gain or the $10,000 FMV of the boot property. This gain is long-term and capital in character. The Sec. 351 rules effectively require Bob to defer $20,000 ($30,000 − $10,000) of his realized gain. Bob's basis in the South stock is $50,000, computed as follows:

Adjusted basis of property transferred	$50,000
Plus: Gain recognized by Bob	10,000
Minus: FMV of boot received	(10,000)
Adjusted basis of Bob's stock	$50,000 ◀

[28] Sec. 358(a)(2).

[29] Sec. 358(a)(1).

If a transferor receives more than one class of qualified stock, his or her basis must be allocated among the classes according to their relative FMVs.[30]

EXAMPLE C:2-27 ▶ Assume the same facts as in Example C:2-26 except Bob receives 100 shares of South common stock with a $45,000 FMV, 50 shares of South qualified preferred stock with a $25,000 FMV, and a 90-day South note with a $10,000 FMV. The total adjusted basis of the stock is $50,000 ($50,000 basis of property transferred + $10,000 gain recognized − $10,000 FMV of boot received). This basis must be allocated between the common and qualified preferred stock according to their relative FMVs, as follows:

$$\text{Basis of common stock} = \frac{\$45{,}000}{\$45{,}000 + \$25{,}000} \times \$50{,}000 = \$32{,}143$$

$$\text{Basis of preferred stock} = \frac{\$25{,}000}{\$45{,}000 + \$25{,}000} \times \$50{,}000 = \$17{,}857$$

Bob's basis in the note is its $10,000 FMV. ◀

SELF-STUDY QUESTION

What is an alternative method for determining the basis of the assets received by the transferor shareholder? How is this method applied to Bob in Example C:2-26?

ANSWER

The basis of all boot property is its FMV, and the basis of qualified stock received is the stock's FMV minus any deferred gain or plus any deferred loss. Bob's stock basis under the alternative method is $50,000 ($70,000 FMV of stock − $20,000 deferred gain).

Transferor's Holding Period. The transferor's holding period for any stock received in exchange for a capital asset or Sec. 1231 property includes the holding period of the property transferred.[31] If the transferor exchanged any other kind of property (e.g., inventory) for the stock, the transferor's holding period for the stock begins on the day after the exchange. Likewise, the holding period for boot property begins on the day after the exchange.

EXAMPLE C:2-28 ▶ Assume the same facts as in Example C:2-26. Bob's holding period for the stock includes the holding period of the capital asset transferred. His holding period for the note starts on the day after the exchange. ◀

STOP & THINK

Question: The holding period for stock received in exchange for a capital asset or Sec. 1231 property includes the holding period of the transferred item. The holding period for inventory or other assets begins on the day after the exchange. Why the difference?

Solution: Because stock received in a Sec. 351 exchange represents a "continuity of interest" in the property transferred, logically the stock should not only be valued and characterized in the same manner as the asset exchanged for the equity claim, but also accorded the same tax attributes. Because the holding period of a capital asset is relevant in determining the character of gain or loss realized (i.e., long-term or short-term) on the asset's subsequent sale, stock received in a tax-free exchange of the asset should be accorded the same holding period for the purpose of determining the character of gain or loss realized on the stock's subsequent sale. By the same token, because the holding period of a noncapital asset is less relevant in determining the character of gain or loss realized on the asset's subsequent sale, stock received in a tax-free exchange of the asset need not be accorded the same holding period for the purpose of determining the character of gain or loss realized on the stock's subsequent sale. Given the very nature of a noncapital asset, this gain or loss generally is ordinary in character, in any event. Moreover, if stock received in exchange for a noncapital asset were accorded a holding period that includes that of the transferred property, a transferor could sell the stock in a short time to realize a long-term capital gain, thereby converting ordinary income (potentially from the sale of the noncapital asset) into capital gain from the sale of stock.

Topic Review C:2-2 summarizes the tax consequences of a Sec. 351 exchange to the transferor(s) and the transferee corporation.

[30] Sec. 358(b)(1) and Reg. Sec. 1.358-2(b)(2).

[31] Sec. 1223(1). Revenue Ruling 85-164 (1985-2 C.B. 117) provides that a single share of stock may have two holding periods: a carryover holding period for the portion of such share received in exchange for a capital asset or Sec. 1231 property and a holding period that begins on the day after the exchange for the portion of such share received for inventory or other property. The split holding period is relevant only if the transferor sells the stock received within one year of the transfer date.

TOPIC REVIEW C:2-2

Tax Consequences of a Sec. 351 Exchange

To Transferor(s):

1. Transferors recognize no gain or loss when they exchange property for qualified stock. Exception: A transferor recognizes gain equal to the lesser of the realized gain or the sum of any money received plus the FMV of any non-cash property received. The character of the gain depends on the type of property transferred.
2. The basis of the qualified stock received equals the adjusted basis of the property transferred plus any gain recognized by the transferor minus the FMV of any boot property received minus any money received (including liabilities assumed or acquired by the transferee corporation).
3. The holding period of qualified stock received in exchange for capital assets or Sec. 1231 property includes the holding period of the transferred property. The holding period of stock received in exchange for any other property begins on the day after the exchange.

To Transferee Corporation:

1. A corporation recognizes no gain or loss when it exchanges its own stock for property or services.
2. The corporation's basis in property received is the transferor's basis plus any gain recognized by the transferor. However, if the total adjusted basis of all transferred property exceeds the total FMV of the property, the total basis to the transferee is limited to the property's total FMV.
3. The corporation's holding period for property received includes the transferor's holding period.

ADDITIONAL COMMENT

The nonrecognition rule for corporations that issue stock for property applies whether or not the transaction qualifies the transferor shareholder for Sec. 351 treatment.

TAX CONSEQUENCES TO TRANSFEREE CORPORATION

A corporation that issues stock or debt for property or services is subject to various IRC rules for determining the tax consequences of that exchange.

Gain or Loss Recognized by the Transferee Corporation. Corporations recognize no gain or loss when they issue their own stock in exchange for property or services.[32] This result ensues whether or not Sec. 351 governs the exchange and whether or not the corporation issues new stock or treasury stock.

EXAMPLE C:2-29 ▶ West Corporation pays $10,000 to acquire 100 shares of its own stock from existing shareholders. The next year, West reissues these 100 treasury shares in exchange for land having a $15,000 FMV. West realizes a $5,000 ($15,000 − $10,000) gain on the exchange but recognizes none of this gain. ◀

Corporations also recognize no gain or loss when they exchange their own debt instruments for property or services. On the other hand, a corporation recognizes gain (but not loss) if it transfers appreciated property to a transferor as part of a Sec. 351 exchange. The amount and character of the gain are determined as though the property had been sold by the corporation immediately before the transfer.

EXAMPLE C:2-30 ▶ Alice, who owns 100% of Ace Corporation stock, transfers to Ace land having a $100,000 FMV and a $60,000 adjusted basis. In exchange, Alice receives 75 additional shares of Ace common stock having a $75,000 FMV, and Zero Corporation common stock having a $25,000 FMV. Ace's basis in the Zero stock, a capital asset, is $10,000. Alice realizes a $40,000 gain [($75,000 + $25,000) − $60,000] on the land transfer, of which she recognizes $25,000 (i.e., the FMV of the boot property received). In addition, Ace recognizes a $15,000 capital gain ($25,000 − $10,000) upon transferring the Zero stock to Alice. ◀

Transferee Corporation's Basis for Property Received. A corporation that acquires property in exchange for its stock in a transaction that is taxable to the transferor takes a current cost (i.e., its FMV) basis in the property. On the other hand, if

[32] Sec. 1032.

ADDITIONAL COMMENT

If a shareholder transfers built-in gain property in a Sec. 351 transaction, the built-in gain actually is duplicated. This duplication occurs because the transferee corporation assumes the potential gain through its carryover basis in the assets it receives, and the transferor shareholder assumes the potential gain through its substituted basis in the transferee corporation stock. A similar duplication occurs for built-in loss property. This result reflects the double taxation characteristic of C corporations.

the exchange qualifies for nonrecognition treatment under Sec. 351 and is wholly or partially tax-free to the transferor, the corporation's basis in the property is computed under Sec. 362 as follows:

Transferor's adjusted basis in property transferred to the corporation	
Plus: Gain (if any) recognized by transferor	
Minus: Reduction for loss property (if applicable)	
Transferee corporation's basis in property	

The transferee corporation's holding period for property acquired in a transaction satisfying the Sec. 351 requirements includes the period during which the property was held by the transferor.[33] This general rule applies to all types of property without regard to their character in the transferor's hands or the amount of gain recognized by the transferor. This rule also applies if the corporation reduces a property's basis under the loss property limitation discussed below.[34]

EXAMPLE C:2-31 ▶ Top Corporation issues 100 shares of its stock for land having a $15,000 FMV. Tina, who transferred the land, had a $12,000 basis in the property. If the exchange satisfies the Sec. 351 requirements, Tina recognizes no gain on the exchange. Top's basis in the land is $12,000, the same as Tina's. Top's holding period includes Tina's holding period. However, if the exchange does *not* satisfy the Sec. 351 requirements, Tina recognizes $3,000 of gain. Top's basis in the land is its $15,000 acquisition cost, and its holding period begins on the day after the exchange date. ◀

Reduction for Loss Property. Section 362(e)(2) prevents shareholders from generating double losses by transferring loss property to a corporation. The double loss potential exists because the corporation would hold property with a built-in loss, and the shareholders would hold stock with a built-in loss. Accordingly, if a corporation's total adjusted basis (including any increase for gain recognized by the shareholder) for all properties transferred by the shareholder exceeds the properties' total FMV, the basis to the corporation of the properties must be reduced by this excess. The reduction in basis is allocated among the properties in proportion to their respective built-in losses. The limitation applies on a shareholder-by-shareholder basis. In other words, the property values and built-in losses of all shareholders are not aggregated.

EXAMPLE C:2-32 ▶ John transfers the following assets to Pecan Corporation in exchange for all of Pecan's stock worth $26,000.

Assets	*Adjusted Basis to John*	*FMV*
Inventory	$ 5,000	$ 8,000
Equipment	15,000	11,000
Furniture	9,000	7,000
Total	$29,000	$26,000

Although the transaction meets the requirements of Sec. 351, the total basis of the assets transferred ($29,000) exceeds their total FMV. Consequently, the total basis to Pecan is limited to the assets' FMV ($26,000). The $3,000 ($29,000 − $26,000) reduction in basis must be allocated among the assets in proportion to their respective built-in losses as follows:

Assets	*Built-in Losses*	*Allocated Reduction*
Equipment	$4,000	$2,000
Furniture	2,000	1,000
Total	$6,000	$3,000

[33] Sec. 1223(2).

[34] Reg. Sec. 1.362-4(c)(3)(i).

Thus, Pecan's bases for the assets transferred by John are:

Inventory	$ 5,000
Equipment ($15,000 – $2,000)	13,000
Furniture ($9,000 – $1,000)	8,000
Total	$ 26,000

The holding period of each property includes the transferor's holding period. ◀

A corporation subject to the basis reduction rules described above can avoid this result if the corporation and all its shareholders so elect. Under the election, the corporation need not reduce the bases of the assets received, but the affected shareholder's basis in stock received for the property is reduced by the amount by which the corporation would have reduced its basis absent the election.

EXAMPLE C:2-33 ▶ Assume the same facts as in Example C:2-32 except John and Pecan elect not to reduce the bases of the assets Pecan received. Under the election, John's basis in his Pecan stock is reduced to $26,000 ($29,000 – $3,000). ◀

A corporation and its shareholders can avoid the basis reduction rules altogether if each shareholder transfers enough appreciated property to offset any built-in losses of other property transferred. This avoidance opportunity exists because in making the comparison, each shareholder aggregates the adjusted bases and FMVs of his or her property transferred.

EXAMPLE C:2-34 ▶ Assume the same facts as in Example C:2-32 except the inventory's FMV is $12,000. In this case, total basis equals $29,000 and total FMV equals $30,000. Because total basis does not exceed total FMV, the limitation does not apply. Consequently, the corporation takes a carryover basis in each asset even though some assets have built-in losses. ◀

ASSUMPTION OF THE TRANSFEROR'S LIABILITIES

When a shareholder transfers property to a controlled corporation, the corporation often assumes the transferor's liabilities. The question arises as to whether the transferee corporation's assumption of liabilities is equivalent to a cash (boot) payment to the transferor. In certain types of transactions, the transferee's assumption of a transferor's liability is treated as a payment of cash to the transferor. For example, in a like-kind exchange, if a transferee assumes a transferor's liability, the transferor is treated as though he or she received a cash payment equal to the amount of the liability assumed. By contrast, if a transaction satisfies the Sec. 351 requirements, Sec. 357 provides relief from such treatment.

General Rule—Sec. 357(a). For the purpose of determining gain recognition, the transferee corporation's assumption of liabilities in a property transfer qualifying under Sec. 351 is *not* considered equivalent to the transferor's receipt of money. Consequently, the transferee corporation's assumption of liabilities does not result in the transferor's recognizing part or all of his or her realized gain. For the purpose of calculating the transferor's stock basis, however, the transferee corporation's assumption of liabilities *is* treated as money received and thus decreases the transferor's stock basis. Moreover, for the purpose of calculating the transferor's *realized* gain, the transferee corporation's assumption of liabilities is treated as part of the transferor's amount realized.[35]

EXAMPLE C:2-35 ▶ Roy and Eduardo transfer the following assets and liabilities to newly formed Palm Corporation:

[35] Sec. 358(d)(1).

Transferor	Asset/ Liability	Transferor's Adj. Basis	FMV	Consideration Received
Roy	Machinery	$15,000	$32,000	50 shares Palm stock
	Mortgage	8,000	—	Assumed by Palm
Eduardo	Cash	24,000	24,000	50 shares Palm stock

The transaction meets the requirements of Sec. 351. Roy's recognized gain is determined as follows:

FMV of stock received	$24,000
Plus: Palm's assumption of the mortgage liability	8,000
Amount realized	$32,000
Minus: Basis of machinery	(15,000)
Realized gain	$17,000
Boot received	$ –0–
Recognized gain	$ –0–

Although Palm's assumption of the mortgage liability increases Roy's amount realized, Roy recognizes none of his realized gain because the mortgage assumption is not considered to be boot (i.e., a cash equivalent). Eduardo recognizes no gain because he transferred only cash. Roy's stock basis is $7,000 ($15,000 basis of property transferred − $8,000 liability assumed by Palm). Eduardo's stock basis is $24,000. ◀

ADDITIONAL COMMENT

If any of the assumed liabilities are created for tax avoidance purposes, *all* the assumed liabilities are tainted.

The general rule of Sec. 357(a), however, has two exceptions. These exceptions, discussed below, relate to (1) transfers for the purpose of tax avoidance or without a bona fide business purpose and (2) transfers where the liabilities assumed by the corporation exceed the total basis of the property transferred.

ETHICAL POINT

Information about any transferor liabilities assumed by the transferee corporation must be reported with the transferee and transferor's tax returns for the year of transfer (see page C:2-36). Where a client asks a tax practitioner to ignore the fact that tax avoidance is the primary purpose for transferring a liability to a corporation, the tax practitioner must examine the ethical considerations of continuing to prepare returns and provide tax advice for the client.

Tax Avoidance or No Bona Fide Business Purpose—Sec. 357(b). All liabilities assumed by a controlled corporation *are* considered to be money received by the transferor, and therefore boot, if the principal purpose of the transfer of any portion of such liabilities is tax avoidance or if the liability transfer has no bona fide business purpose.

The transfer of liabilities might be considered to be motivated principally by tax avoidance where the transferor incurred the liabilities shortly before the transfer. Thus, the most important factor in determining whether a tax avoidance purpose exists may be the length of time between the incurrence of the liability and its transfer to, or assumption by, the corporation.

The assumption of liabilities normally is considered to have a business purpose if the transferor incurred the liabilities in the normal course of business or in the course of acquiring business property. Examples of liabilities without a bona fide business purpose and whose transfer would cause *all* liabilities transferred to be considered boot are personal obligations of the transferor, including a home mortgage or any other loans of a personal nature.

EXAMPLE C:2-36 ▶ David owns land having a $100,000 FMV and a $60,000 adjusted basis. The land is not encumbered by any liabilities. To obtain cash for his personal use, David transfers the land to his wholly owned corporation in exchange for additional stock and $25,000 cash. Because the cash is considered to be boot, David must recognize $25,000 of gain. Assume instead that David mortgages the land for $25,000 to obtain the needed cash. If shortly thereafter David transfers the land and the mortgage to his corporation for additional stock, the $25,000 mortgage assumed by the corporation will be considered to be boot because the transfer of the mortgage appears to have no bona fide business purpose. David's recognized gain will be $25,000, i.e., the lesser of the boot received ($25,000) or his realized gain ($40,000). This special liability rule prevents David from obtaining cash without boot recognition. ◀

Liabilities in Excess of Basis—Sec. 357(c). Under Sec. 357(c), if the total amount of liabilities transferred to a controlled corporation exceeds the total adjusted basis of all property transferred, the excess liability is taxed as a gain to the transferor. This rule applies

regardless of whether the transferor realizes any gain or loss. The rationale for the rule is that the transferor has received a benefit (in the form of a release from liabilities) that exceeds his or her original investment in the transferred property. Therefore, the transferor should be taxed on this benefit. The character of the recognized gain depends on the type of property transferred to the corporation. The transferor's basis in any stock received is zero.

EXAMPLE C:2-37 ▶ Judy transfers $10,000 cash and land, a capital asset, to Duke Corporation in exchange for all its stock. At the time of the exchange, the land has a $70,000 adjusted basis and a $125,000 FMV. Duke assumes a $100,000 mortgage on the land for a bona fide business purpose. Although Judy receives no boot, Judy must recognize a $20,000 ($100,000 − $80,000) capital gain, the amount by which the liabilities assumed by Duke exceed the basis of the land and the cash. Judy's basis in the Duke stock is zero, computed as follows:

Judy's basis in the land transferred		$ 70,000
Plus:	Cash transferred	10,000
	Gain recognized	20,000
Minus:	Liabilities assumed by Duke	(100,000)
Judy's basis in the Duke stock		$ –0–

Note that, without the recognition of the $20,000 gain, Judy's basis in the Duke stock would be a negative $20,000 ($80,000 − $100,000). ◀

STOP & THINK

Question: What are the fundamental differences between the liability exceptions of Sec. 357(b) and Sec. 357(c)?

Solution: Section 357(b) treats all "tainted" liabilities as boot so that gain recognition is the lesser of gain realized or the amount of boot. Excess liabilities under Sec. 357(c) are not treated as boot; they require gain recognition whether or not the transferor realizes any gain. Section 357(b) tends to be punitive in that the "tax avoidance" liabilities cause all the "offending" shareholder's transferred liabilities to be treated as boot even if the transfer of some liabilities do not have a tax avoidance purpose. Section 357(c) is not intended to be punitive. It recognizes that the shareholder has received an economic benefit to the extent of excess liabilities, and it prevents the occurrence of a negative stock basis. In short, Section 357(b) deters or punishes tax avoidance while Sec. 357(c) taxes an economic gain.

KEY POINT

Because of the "liabilities in excess of basis" exception, many cash basis transferor shareholders might inadvertently create recognized gain in a Sec. 351 transaction. However, a special exception exists that protects cash basis taxpayers. This exception provides that liabilities that would give rise to a deduction when paid are not treated as liabilities for purposes of Sec. 357(c).

Liabilities of a Cash Method Taxpayer—Sec. 357(c)(3). In a Sec. 351 tax-free exchange, special problems arise when a taxpayer using the cash or hybrid method of accounting transfers property and liabilities of an ongoing business to a corporation.[36] Often, the principal assets transferred are accounts receivable having a zero basis. Liabilities usually are transferred as well. Consequently, the amount of liabilities transferred may exceed the total basis (but not the FMV) of the property transferred.

Under the general rule of Sec. 357(c), the transferor recognizes gain equal to the amount by which the liabilities assumed exceed the total basis of the property transferred. Section 357(c)(3), however, provides that, in applying the general rule, the term *liabilities* does *not* include any amount that would give rise to a deduction when paid (e.g., accounts payable of a cash basis taxpayer). These amounts also are not considered liabilities for the purpose of determining the shareholder's basis in stock received.[37] Therefore, they generally do not reduce this basis. However, if after all other adjustments the stock's basis exceeds its FMV, these liabilities could reduce stock basis, but not below the stock's FMV.[38]

EXAMPLE C:2-38 ▶ Tracy operates a cash basis accounting practice as a sole proprietorship. She transfers the assets of her practice to Prime Corporation in exchange for all the Prime stock. The balance sheet for the transferred practice is as follows:

[36] Sec. 357(c)(3).
[37] Sec. 358(d)(2).
[38] Sec. 358(h)(1).

Assets and Liabilities	*Adjusted Basis*	*FMV*
Cash	$ 5,000	$ 5,000
Furniture	5,000	8,000
Accounts receivable	–0–	50,000
Total	$10,000	$63,000
Accounts payable (deductible expenses)	$ –0–	$25,000
Note payable (on office furniture)	2,000	2,000
Owner's equity	8,000	36,000
Total	$10,000	$63,000

If, for purposes of Sec. 357(c), the accounts payable were considered liabilities, the $27,000 of liabilities transferred (i.e., the $25,000 of accounts payable and the $2,000 note payable) would exceed the $10,000 total basis of assets transferred, and Troy would recognize a $17,000 gain. Because paying the $25,000 of accounts payable gives rise to a deduction, however, they are not considered liabilities for purposes of Sec. 357(c). On the other hand, the $2,000 note payable *is* considered a liability for this purpose because paying it would not give rise to a deduction. Thus, the total liabilities transferred to Prime amount to only $2,000. Because that amount does not exceed the $10,000 total basis of the assets transferred, Tracy recognizes no gain. Moreover, the accounts payable are not considered liabilities for purposes of computing Tracy's basis in her stock because the stock's basis ($8,000) does not exceed its FMV ($36,000). Thus, her basis in the Prime stock is $8,000 ($10,000 − $2,000). ◀

Topic Review C:2-3 summarizes the liability assumption and acquisition rules of Sec. 357.

OTHER CONSIDERATIONS IN A SEC. 351 EXCHANGE

Recapture of Depreciation. If a Sec. 351 exchange is completely nontaxable (i.e., the transferor receives no boot), no depreciation is recaptured. Instead, the corporation inherits the entire amount of the transferor's recapture potential. Where the transferor recognizes some depreciation recapture as ordinary income (e.g., because of boot recognition), the transferee inherits the remaining recapture potential. If the transferee corporation subsequently disposes of the depreciated property, the corporation is subject to recapture rules on depreciation it claimed subsequent to the transfer, plus the recapture potential it inherited from the transferor.

EXAMPLE C:2-39 ▶ Azeem transfers machinery having a $25,000 original cost, an $18,000 adjusted basis, and a $35,000 FMV for all 100 shares of Wheel Corporation stock. Before the transfer, Azeem used the machinery in his business and claimed $7,000 of depreciation. In the transfer, Azeem recaptures no depreciation, and Wheel inherits the $7,000 recapture potential. After claiming an additional $2,000 of depreciation, Wheel has a $16,000 adjusted basis in the machinery. If Wheel

TOPIC REVIEW C:2-3

Liability Assumption and Acquisition Rules of Sec. 357

1. *General Rule (Sec. 357(a)):* A transferee corporation's assumption of liabilities in a Sec. 351 exchange is not treated as boot by the shareholder for gain recognition purposes. On the other hand, the assumption of liabilities is treated as the receipt of money for purposes of determining the transferor's stock basis and amount realized.
2. *Exception 1 (Sec. 357(b)):* All liabilities assumed by a transferee corporation are considered to be money/boot received by the transferor if the principal purpose of the transfer of any of the liabilities is tax avoidance or if no bona fide business purpose exists for the transfer.
3. *Exception 2 (Sec. 357(c)):* If the total amount of liabilities assumed by a transferee corporation exceeds the total basis of property transferred, the transferor recognizes the excess as gain.
4. *Special Rule (Sec. 357(c)(3)):* For purposes of Exception 2, the term liabilities for a transferor using a cash or hybrid method of accounting does not include any amount that would give rise to a deduction when paid.

now sells the machinery for $33,000, it must recognize a $17,000 ($33,000 − $16,000) gain. Of this gain, $9,000 is ordinary income recaptured under Sec. 1245. The remaining $8,000 is a Sec. 1231 gain. ◀

Computing Depreciation. When a shareholder transfers depreciable property to a corporation in a nontaxable Sec. 351 exchange and the shareholder has not fully depreciated the property, the corporation must use the depreciation method and recovery period used by the transferor.[39] For the year of the transfer, the depreciation must be allocated between the transferor and the transferee corporation according to the number of months each party held the property. The transferee corporation is assumed to have held the property for the entire month in which the property was transferred.[40]

EXAMPLE C:2-40 ▶ On June 10 of Year 1, Carla paid $6,000 for a computer (five-year property for MACRS purposes), which she used in her sole proprietorship business. In Year 1, she claimed $1,200 (0.20 × $6,000) of depreciation. She did not elect Sec. 179 expensing and did not claim any bonus depreciation. On February 10 of Year 2, she transfers the computer and other sole proprietorship assets to King Corporation in exchange for King stock. Because Sec. 351 applies, she recognizes no gain or loss. King must use the same MACRS recovery period and method that Carla used. Depreciation for Year 2 is $1,920 (0.32 × $6,000). That amount must be allocated between Carla and King. The computer is considered to have been held by Carla for one month and by King for 11 months (including the month of transfer). The Year 2 depreciation amounts claimed by Carla and King are calculated as follows:

Carla	$6,000 × 0.32 × 1/12 = $ 160
King Corporation	$6,000 × 0.32 × 11/12 = $1,760

King's basis in the computer is calculated as follows:

Original cost	$6,000
Minus: Year 1 depreciation claimed by Carla	(1,200)
Year 2 depreciation claimed by Carla	(160)
Adjusted basis on transfer date	$4,640

King's depreciation for Year 2 and subsequent years is as follows:

Year 2 (as computed above)	$1,760
Year 3 ($6,000 × 0.1920)	1,152
Year 4 ($6,000 × 0.1152)	691
Year 5 ($6,000 × 0.1152)	691
Year 6 ($6,000 × 0.0576)	346
Total	$4,640 ◀

If the transferee corporation's basis in the depreciable property exceeds the transferor's basis (e.g., as a result of an upward adjustment to reflect gain recognized by the transferor), the corporation treats the excess amount as newly purchased MACRS property and uses the recovery period and method applicable to the class of property transferred.[41]

EXAMPLE C:2-41 ▶ Assume the same facts as in Example C:2-40 except that, in addition to King stock, Carla receives a King note. Consequently, she must recognize $1,000 of gain on the transfer of the computer. King's basis in the computer is calculated as follows:

Original cost	$6,000
Depreciation claimed by Carla	(1,360)
Adjusted basis on transfer date	$4,640
Plus: Gain recognized by Carla	1,000
Basis to King on transfer date	$5,640

The additional $1,000 of basis is depreciated as though it were separate, newly purchased five-year MACRS property. Thus, King claims depreciation of $200 (0.20 × $1,000) on this

[39] Sec. 168(i)(7).
[40] Prop. Reg. Secs. 1.168-5(b)(2)(i)(B), 1.168-5(b)(4)(i), and 1.168-5(b)(8).
[41] Prop. Reg. Sec. 1.168-5(b)(7).

ADDITIONAL COMMENT

Currently, we have no clear guidance on how the corporation depreciates transferred property that has a reduced basis under the loss property limitation rule discussed on page C:2-21. For now, taxpayers probably should rely on Prop. Reg. 1.168-2(d)(3), which provides a method for calculating depreciation when the transferee's basis is less than the transferor's basis.

portion of the basis in addition to the $1,760 of depreciation on the $4,640 carryover basis. Alternatively, King could elect to expense the $1,000 "new" basis under Sec. 179. ◀

Assignment of Income Doctrine. The **assignment of income doctrine** holds that income is taxable to the person who earned it and that it may not be assigned to another person for tax purposes.[42] The question arises as to whether the assignment of income doctrine applies where a cash method taxpayer transfers uncollected accounts receivable to a corporation in a Sec. 351 exchange. Specifically, who must recognize the income when it is collected—the taxpayer who transferred the receivable or the corporation that now owns and collects on the receivable? The IRS has ruled that the doctrine does *not* apply in a Sec. 351 exchange if the taxpayer transfers substantially all the business assets and liabilities, and a bona fide business purpose exists for the transfer. Instead, the accounts receivable take a zero basis in the corporation's hands, and the corporation includes their value in its income when it collects on the receivables.[43]

EXAMPLE C:2-42 ▶ For a bona fide business purpose, Ruth, a cash basis taxpayer, transfers all the assets and liabilities of her legal practice to Legal Services Corporation in exchange for all of Legal Services stock. The assets include $30,000 of accounts receivable that will generate earnings that Ruth has not included in her gross income. Because Ruth transfers substantially all the business assets and liabilities for a bona fide business purpose, the assignment of income doctrine does not apply to the receivables transferred, and Legal Services takes a zero basis in the receivables. Subsequently, Legal Services includes the value of the receivables in its income as it collects on them. ◀

The question of whether a transferee corporation can deduct the accounts payable transferred to it in a nontaxable transfer has frequently been litigated.[44] Most courts have held that ordinarily expenses are deductible only by the party that incurred those liabilities in the course of its trade or business. However, the IRS has ruled that in a nontaxable exchange the transferee corporation may deduct the payments it makes to satisfy the transferred accounts payable even though they arose in the transferor's business.[45]

Choice of capital structure

OBJECTIVE 5

Explain the tax implications of alternative capital structures

When a corporation is formed, the way it is financed will determine its capital structure. The corporation may obtain capital from shareholders, nonshareholders, and creditors. In exchange for their capital, shareholders may receive common or preferred stock; nonshareholders may receive benefits such as employment or special rates on products sold by the corporation; and creditors may receive long- or short-term debt. As explained below, each of these alternatives has tax advantages and disadvantages for the shareholders, creditors, and corporation.

CHARACTERIZATION OF OBLIGATIONS AS DEBT OR EQUITY

The deductibility of interest payments creates an incentive for corporations to incur sufficient debt to maximize the amount of allowable interest deductions. Because debt financing often resembles equity financing (e.g., preferred stock), the IRS and the courts have refused to accept the form of the security as controlling.[46] In some cases, debt obligations that possess equity characteristics have been treated as common or preferred stock for tax purposes. In determining the appropriate tax treatment, the courts have relied on a number of factors.

[42] See, for example, *Lucas v. Guy C. Earl,* 8 AFTR 10287, 2 USTC ¶496 (USSC, 1930).
[43] Rev. Rul. 80-198, 1980-2 C.B. 113.
[44] See, for example, *Wilford E. Thatcher v. CIR,* 37 AFTR 2d 76-1068, 76-1 USTC ¶9324 (9th Cir., 1976), and *John P. Bongiovanni v. CIR,* 31 AFTR 2d 73-409, 73-1 USTC ¶9133 (2nd Cir., 1972).
[45] Rev. Rul. 80-198, 1980-2 C.B. 113.
[46] See, for example, *Aqualane Shores, Inc. v. CIR,* 4 AFTR 2d 5346, 59-2 USTC ¶9632 (5th Cir., 1959) and *Sun Properties, Inc. v. U.S.,* 47 AFTR 273, 55-1 USTC ¶9261 (5th Cir., 1955).

Congress enacted Sec. 385 to establish a standard for determining whether a security is debt or equity. Section 385 provides that the following factors be considered in the determination:

HISTORICAL NOTE

The Treasury Department at one time issued proposed and final regulations covering Sec. 385. These regulations were the subject of so much criticism that the Treasury Department eventually withdrew them. Section 385, however, makes it clear that Congress wants the Treasury Department to make further attempts at clarifying the debt-equity issue. So far, the Treasury Department has issued no "new" proposed or final regulations.

- Whether there is a written unconditional promise to pay on demand or on a specified date a certain sum of money in return for adequate consideration in the form of money or money's worth, in addition to an unconditional promise to pay a fixed rate of interest
- Whether the debt is subordinate to, or preferred over, other indebtedness of the corporation
- The ratio of corporate debt to equity
- Whether the debt is convertible into stock of the corporation
- The relationship between holdings of stock in the corporation and holdings of the interest in question[47]

DEBT CAPITAL

Various provisions govern the tax treatment of (1) the issuance of debt; (2) the payment of interest on debt; and (3) the extinguishment, retirement, or worthlessness of debt. The tax implications of each of these events are examined below.

SELF-STUDY QUESTION

From a tax perspective, why is the distinction between debt and equity important?

ANSWER

Subject to limitations, interest paid with respect to a debt instrument is deductible by the payor corporation. Dividends paid with respect to an equity instrument are not deductible by the payor corporation. Thus, the determination of whether an instrument is debt or equity can provide different results to the payor corporation. Different results apply to the payee as well. Qualified dividends are subject to the applicable capital gains tax rate while interest is taxed as ordinary income.

Issuance of Debt. If a transferor transfers appreciated property in exchange for stock, the transfer will be nontaxable, provided the Sec. 351 requirements have been met. On the other hand, if the transferor transfers appreciated property in exchange for corporate debt as part of a Sec. 351 exchange, the FMV of the debt received will be treated as boot, possibly leading to gain recognition.

Payment of Interest. For tax years beginning after December 31, 2017, C corporations with average gross receipts for the previous three years exceeding $26 million (in 2019) are limited in their interest deduction to the sum of (1) business interest income; (2) 30% of adjusted taxable income, and (3) floor plan financing interest for corporate taxpayers who sell motor vehicles. Interest expense greater than the sum of these three items carries over to the next tax year, subject to the limitation in that year. The carryover period is indefinite. To arrive at adjusted taxable income, a C Corporation calculates its taxable income without regard to (1) any item of income, gain, deduction, or loss not properly allocable to a trade or business; (2) any business interest or business interest income; (3) any net operating loss deduction; and (4) any deduction allowable for depreciation, amortization, or depletion taken in years before 2022. C corporations with average gross receipts of $26 million or less are not limited in their business interest deduction. In contrast to business interest expenses, the corporation cannot deduct dividends paid on equity securities.

If a corporation issues a debt instrument at a discount, Sec. 1272 requires the holder to amortize the original issue discount over the term of the obligation and treat the accrual as interest income. The debtor corporation amortizes the original issue discount over the term of the obligation and treats the accrual as an additional cost of borrowing.[48] If the corporation repurchases the debt instrument for more than the issue price (plus any original issue discount deducted as interest), the corporation deducts the excess of the purchase price over the issue price (adjusted for any amortization of original issue discount) as interest expense.[49]

Under Sec. 171, if a corporation issues a debt instrument at a premium, the holder may elect to amortize the premium over the term of the obligation and treat the accrual as a reduction in interest income earned on the obligation. For the debtor corporation, the premium reduces the amount of deductible interest.[50] If the corporation repurchases the debt instrument at a price greater than the issue price (minus any premium treated as income), the corporation deducts the excess of the purchase price over the issue price (adjusted for any amortization of premium) as interest expense.[51]

[47] See also *O.H. Kruse Grain & Milling v. CIR*, 5 AFTR 2d 1544, 60-2 USTC ¶9490 (9th Cir., 1960), which lists additional factors that the courts might consider.

[48] Sec. 163(e).

[49] Reg. Sec. 1.163-7(c).

[50] Reg. Sec. 1.163-12.

[51] Reg. Sec. 1.163-7(c).

Extinguishment of Debt. Generally, the retirement of debt is not a taxable event. Thus, a debtor corporation's extinguishing an obligation at face value does not result in the creditor's recognizing gain or loss. However, amounts received by the holder of a debt instrument (e.g., note, bond, or debenture) at the time of its retirement are deemed to be "in exchange for" the obligation. Thus, if the obligation is a capital asset in the holder's hands, the holder must recognize a capital gain or loss if the amount received differs from its face value or adjusted basis, unless the difference is due to original issue or market discount.

EXAMPLE C:2-43 ▶ Titan Corporation issues a ten-year note at its $1,000 face amount. On the date of issuance, Rick purchases the note for $1,000. Because of a decline in interest rates, Titan calls the note at a price of $1,050 payable to each note holder. Rick reports the premium as a $50 capital gain, and Titan deducts as interest expense total premiums paid to all its note holders. ◀

ADDITIONAL COMMENT

Even though debt often is thought of as a preferred instrument because of the deductibility of the interest paid, the debt must be repaid at its maturity, whereas stock has no specified maturity date. Also, interest usually must be paid at regular intervals, whereas dividends do not have to be declared if sufficient funds are not available to pay them or if the corporation needs to retain funds for operations or growth.

Table C:2-2 presents a comparison of the tax advantages and disadvantages of a corporation's using debt in its capital structure.

EQUITY CAPITAL

Corporations can raise equity capital through the issuance of various types of stock. Some corporations issue only a single class of stock, whereas others issue numerous classes of stock. Reasons for the use of multiple classes of stock include

- Permitting nonfamily employees of family owned corporations to obtain an equity interest in the business while keeping voting control in the hands of family members.
- Financing a **closely held corporation** through the issuance of preferred stock to an outside investor, while leaving voting control in the hands of existing common stockholders.

Table C:2-3 lists some of the major tax advantages and disadvantages of using common and preferred stock in a corporation's capital structure.

SELF-STUDY QUESTION

Does the transferee corporation recognize gain on the receipt of appreciated property from a shareholder?

ANSWER

No. A corporation does not recognize gain when it receives property from its shareholders, whether or not it exchanges its own stock. However, the transfer must qualify as a Sec. 351 exchange or the transaction will be taxable to the shareholders.

CAPITAL CONTRIBUTIONS BY SHAREHOLDERS

A corporation recognizes no income when it receives cash or noncash property as a capital contribution from a shareholder.[52] If the shareholders make voluntary pro rata payments to a corporation but do not receive any additional stock, the payments are treated as additional consideration for the stock already owned.[53] The shareholders' respective bases in their stock are increased by the amount of cash contributed, plus the basis of any noncash property contributed, plus any gain recognized by the shareholders. The

▼ TABLE C:2-2
Tax Advantages and Disadvantages of Using Debt in a Corporation's Capital Structure

Advantages:

1. A corporation can deduct interest paid on a debt obligation, subject to limitation.
2. Shareholders do not recognize income in a debt retirement as they would in a stock redemption.

Disadvantages:

1. If at the time the corporation is formed or later when a shareholder makes a capital contribution, the shareholder receives a debt instrument in exchange for property, the debt is treated as boot, and the shareholder recognizes gain to the extent of the lesser of the boot's FMV or the realized gain.
2. If debt becomes worthless or is sold at less than its face value, the loss generally is a nonbusiness bad debt (treated as a short-term capital loss) or a capital loss. Section 1244 ordinary loss treatment applies only to stock (see pages C:2-32 and C:2-33).
3. In some circumstances, business interest deductions are limited.

[52] Sec. 118(a).

[53] Reg. Sec. 1.118-1.

▼ **TABLE C:2-3**

Tax Advantages and Disadvantages of Using Equity in a Corporation's Capital Structure

Advantages:

1. A 50%, 65%, or 100% dividends-received deduction is available to a corporate shareholder who receives dividends. A similar deduction is not available for the receipt of interest (see Chapter C:3).
2. A shareholder can receive common and preferred stock in a tax-free corporate formation under Sec. 351 or a nontaxable reorganization under Sec. 368 without recognizing gain (see Chapters C:2 and C:7, respectively). Receipt of debt securities in each of these two types of transactions generally results in the shareholder's recognizing gain.
3. Common and preferred stock can be distributed tax-free to the corporation's shareholders as a stock dividend. Some common and preferred stock distributions, however, may be taxable as dividends under Sec. 305(b). Distributions of debt obligations generally are taxable as a dividend (see Chapter C:4).
4. Under Sec. 1244, common or preferred stock that the shareholder sells or exchanges or that becomes worthless is eligible for ordinary loss treatment, subject to limitations (see pages C:2-32 and C:2-33). The loss recognized on similar transactions involving debt securities generally is treated as capital in character.
5. Section 1202 excludes 50% of capital gains realized on the sale or exchange of qualified small business (C) corporation stock that has been held for more than five years. For qualified stock acquired after February 17, 2009 and before September 28, 2010, the exclusion is 75%, and for qualified stock acquired after September 27, 2010, the exclusion is 100%.
6. Qualified dividends are taxed at the applicable capital gains rate.

Disadvantages:

1. Dividends are not deductible in determining a corporation's taxable income.
2. Redemption of common or preferred stock generally is taxable to the shareholders as a dividend. Under the general rule, none of the redemption distribution offsets the shareholder's basis for the stock investment. Redemption of common and preferred stock is eligible for exchange treatment only in situations specified in Secs. 302 and 303 (see Chapter C:4).
3. Preferred stock issued to a shareholder as a dividend might meet the definition of Sec. 306 stock. Sale, exchange, or redemption of such stock can result in the recognition of ordinary income instead of capital gain (see Chapter C:4). This ordinary income is taxed as a "deemed dividend" at the applicable capital gains rate.

TYPICAL MISCONCEPTION

The characteristics of preferred stock can be similar to those of a debt security. Often, a regular dividend is required at a stated rate, much like what would be required with respect to a debt obligation. The holder of preferred stock, like a debt holder, may have preferred liquidation rights over holders of common stock. Also, preferred stock is not required to possess voting rights. However, differences remain. A corporation can deduct its interest expense but not dividends. Interest income is ordinary income to shareholders, but qualified dividends are subject to the applicable capital gains tax rate.

corporation's basis in any property received as a capital contribution from a shareholder equals the shareholder's basis, plus any gain recognized by the shareholder.[54] Normally, the shareholders recognize no gain when they transfer property to a controlled corporation as a capital contribution.

EXAMPLE C:2-44 ▶ Dot and Fred each own 50% of the stock in Trail Corporation, and each has a $50,000 basis in that stock. Later, as a voluntary contribution to Trail's capital, Dot contributes $40,000 in cash and Fred contributes property having a $25,000 basis and a $40,000 FMV. As a result of the contributions, Trail recognizes no income. Dot's basis in her stock is increased to $90,000 ($50,000 + $40,000), and Fred's basis in his stock is increased to $75,000 ($50,000 + $25,000). Trail's basis in the property contributed by Fred is $25,000—the same as Fred's basis in the property. ◀

If a shareholder-lender gratuitously forgives corporate debt, the debt forgiveness might be treated as a capital contribution equal to the principal amount of the forgiven debt. A determination of whether debt forgiveness is a capital contribution is based on the facts and circumstances surrounding the event.

[54] Sec. 362(a).

WHAT WOULD YOU DO IN THIS SITUATION?

Your corporate client wants to issue 100-year bonds. The corporation's CEO reads *The Wall Street Journal* regularly and has observed that similar bonds have been issued by several companies, including several Fortune 500 companies. He touts the fact that the interest rate on these bonds is slightly more than that for 30-year U.S. Treasury bonds. In addition, he expresses the belief that interest on the bonds would be deductible, whereas dividends on preferred or common stock would be nondeductible. You are concerned that the IRS might treat the bonds as equity because of their extraordinarily long term. If the IRS does treat the bonds as such, it might recharacterize the "interest" as dividends and deny your client an interest deduction.

What advice would you give the client now regarding the bond issue? What advice would you give it when it prepares its tax return after the new bonds have been issued?

CAPITAL CONTRIBUTIONS BY NONSHAREHOLDERS

BOOK-TO-TAX ACCOUNTING COMPARISON

The IRC requires capital contributions of property other than money made by a nonshareholder to be reported at a zero basis. Financial accounting rules, however, require donated capital to be reported at the FMV of the asset on the financial accounting books. Neither set of rules requires the property's value to be included in income.

Nonshareholders sometimes contribute capital to a corporation in the form of cash or other property. For example, a city government might make a "contribution to capital" to a corporation in the form of undeveloped land to induce the corporation to locate within the city and provide jobs for citizens of the municipality. For transfers before December 23, 2017, such "contributions to capital" were excluded from the corporation's gross income if the money or property contributed was neither a payment for goods or services nor a subsidy to induce the corporation to limit production. However, for transfers after December 22, 2017, the term "contribution of capital" no longer includes contributions to the corporation by nonshareholders who are customers, potential customers, governmental entities, or civic groups. Instead, contributions to a corporation made after December, 22, 2017 by nonshareholders who fall into any of these categories will be taxable income to the corporation to the extent of the fair market value of the property contributed. The corporation will then take a fair market value basis in the property received. All other "contributions to capital" by nonshareholders who are not customers, potential customers, governmental entities, or civic groups will continue to be nontaxable. In this case, the corporation will continue to take a zero basis in the property received, which precludes the corporation from claiming depreciation deductions or other capital recovery offsets with respect to the contributed property.

If a nonshareholder, who is not a customer, potential customer, governmental entity, or civic group, contributes cash, the basis of any property acquired with the cash during a 12-month period beginning on the day the corporation received the contribution is reduced by the cash amount use to acquire the property. The amount of any cash received from nonshareholders that the corporation does not use to purchase property during the 12-month period reduces the basis of another noncash property held by the corporation on the last day of the 12-month period. This basis reduction applies to the corporation's other property in the following order:

1. Depreciable property
2. Amortizable property
3. Depletable property
4. All other property

In the sequence of these downward adjustments, however, a property's basis may not be reduced below zero.

EXAMPLE C:2-45 ▶ To induce the company to locate in the municipality, on March 1, 2019, the City of San Antonio contributes to Circle Corporation $100,000 in cash and a tract of land having a $500,000 FMV. Because the City of San Antonio is a governmental entity, Circle recognizes $600,000 of ordinary income as a result of the contribution and takes a $500,000 basis in the land. ◀

EXAMPLE C:2-46 ▶ To induce the company to locate in the municipality, on March 1, 2019, Mr. X, who is not a customer, potential customer, representative of the City of San Antonio, or a representative of a civic organization contributes to Circle Corporation $100,000 in cash and a tract of land having a $500,000 FMV. Because of a downturn in Circle's business, the company invests only $70,000 of

the contributed cash over a 12-month period. Because Mr. X is not a customer, potential customer, a governmental entity, or a civic organization, Circle recognizes no income as a result of the contribution. Circle's basis in the land is zero. Also, the basis of the property purchased with $70,000 of the contributed cash also is zero ($70,000 cost – $70,000 contributed cash used to purchase the property). The basis of Circle's remaining assets, starting with its depreciable property, must be reduced by the $30,000 ($100,000 − $70,000) cash contributed but not invested in property. ◀

WORTHLESSNESS OF STOCK OR DEBT OBLIGATIONS

OBJECTIVE 6

Determine the tax consequences of worthless stock or debt obligations

Investors who purchase stock in, or lend money to, a corporation usually want to earn a profit and recover their investment. Some investments, however, do not offer an adequate return on capital, and an investor may lose part or all of the investment. In this event, the securities evidencing the investment become worthless. This section examines the tax consequences of stock or debt securities becoming worthless.

SECURITIES

A debt or equity **security** that becomes worthless results in a capital loss for the investor as of the last day of the tax year in which the security becomes worthless. For purposes of this rule, the term *security* includes (1) a share of stock in a corporation; (2) a right to subscribe for, or the right to receive, a share of stock in a corporation; or (3) a bond, debenture, note, or other evidence of indebtedness with interest coupons or in registered form issued by a corporation.[55]

TYPICAL MISCONCEPTION

Probably the most difficult aspect of deducting a loss on a worthless security is establishing that the security is actually worthless. A mere decline in value is not sufficient to create a loss. The burden of proof of establishing total worthlessness rests with the taxpayer.

In some situations, investors recognize an ordinary loss when a security becomes worthless. Investors who contribute capital, either in the form of equity or debt to a corporation that later fails, generally prefer ordinary losses because such losses are deductible against ordinary income. Ordinary losses that generate a pre-2018 NOL can be carried back two years or carried over up to 20 years. Post-2017 NOLs, on the other hand, do not carry back but carry over indefinitely subject to an 80% of taxable income limitation in the carryover year. (See Chapter C:3 for further discussion.) In general, ordinary loss treatment is available in the following circumstances:

- *Securities that are noncapital assets.* An ordinary loss occurs when a security that is a noncapital asset in the hands of the taxpayer is sold or exchanged or becomes totally worthless. Securities in this category include those held as inventory by a securities dealer.
- *Affiliated corporations.* A domestic corporation can claim an ordinary loss for any affiliated corporation's security that becomes worthless during the tax year. The domestic corporation must own at least 80% of the total voting power of all classes of stock entitled to vote, and at least 80% of each class of nonvoting stock (other than stock limited and preferred as to dividends). At least 90% of the aggregate gross receipts of the loss corporation for all tax years must have been derived from nonpassive income sources.
- *Section 1244 stock.* Section 1244 permits a shareholder to claim an ordinary loss if qualifying stock issued by a small business corporation is sold or exchanged or becomes worthless. This treatment is available only to an individual who was issued the qualifying stock or who was a partner in a partnership at the time the partnership acquired the qualifying stock. In the latter case, the partner's distributive share of partnership losses includes the loss sustained by the partnership on such stock. Ordinary loss treatment is not available for stock inherited, received as a gift, or purchased from another shareholder. The ordinary loss is limited to $50,000 per year (or $100,000 if the taxpayer is married and files a joint return). Losses exceeding the dollar ceiling in any given year are considered capital in character.

SELF-STUDY QUESTION

Why would a shareholder want his or her stock to qualify as Sec. 1244 stock?

ANSWER

Section 1244 is a provision that may help the taxpayer but that can never hurt. If the Sec. 1244 requirements are satisfied, the individual shareholders of a small business corporation may treat losses from the sale or worthlessness of their stock as ordinary rather than capital in character. If the Sec. 1244 requirements are not satisfied, such losses generally are treated as capital in character.

EXAMPLE C:2-47 ▶

For $175,000, Tammy and her husband Cole purchased 25% of Minor Corporation's initial offering of a single class of stock. Minor is a small business corporation, and the Minor stock satisfies all Sec. 1244 requirements. On September 1 of the current year, Minor filed for bankruptcy. Two years later, the bankruptcy court notifies shareholders that the Minor stock is worthless. In that year, Tammy and Cole can deduct $100,000 of their initial investment as an ordinary loss. The remaining $75,000 loss is treated as capital in character. ◀

[55] Sec. 165(g).