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PEARSON'S

Federal Taxation 2017

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2016

TAX RATE SCHEDULES

INDIVIDUAL TAXPAYERS

Single [§1(c)]:

If taxable income is:	The tax is:
Not over $9,275	10% of taxable income.
Over $9,275 but not over $37,650	$927.50, plus 15% of the excess over $9,275.
Over $37,650 but not over $91,150	$5,183.75, plus 25% of the excess over $37,650.
Over $91,150 but not over $190,150	$18,558.75, plus 28% of the excess over $91,150.
Over $190,150 but not over $413,350	$46,278.75, plus 33% of the excess over $190,150.
Over $413,350 but not over $415,050	$119,934.75, plus 35% of the excess over $413,350.
Over $415,050	$120,529.75, plus 39.6% of the excess over $415,050.

Head of Household [§1(b)]:

If taxable income is:	The tax is:
Not over $13,250	10% of taxable income.
Over $13,250 but not over $50,400	$1,325.00, plus 15% of the excess over $13,250.
Over $50,400 but not over $130,150	$6,897.50, plus 25% of the excess over $50,400.
Over $130,150 but not over $210,800	$26,835.00, plus 28% of the excess over $130,150.
Over $210,800 but not over $413,350	$49,417.00, plus 33% of the excess over $210,800.
Over $413,350 but not over $441,000	$116,258.50, plus 35% of the excess over $413,350.
Over $441,000	$125,936.00, plus 39.6% of the excess over $441,000.

Married, Filing Joint and Surviving Spouse [§1(a)]:

If taxable income is:	The tax is:
Not over $18,550	10% of taxable income.
Over $18,550 but not over $75,300	$1,855.00, plus 15% of the excess over $18,550.
Over $75,300 but not over $151,900	$10,367.50, plus 25% of the excess over $75,300.
Over $151,900 but not over $231,450	$29,517.50, plus 28% of the excess over $151,900.
Over $231,450 but not over $413,350	$51,791.50, plus 33% of the excess over $231,450.
Over $413,350 but not over $466,950	$111,818.50, plus 35% of the excess over $413,350.
Over $466,950	$130,578.50, plus 39.6% of the excess over $466,950.

Married, Filing Separate [§1(d)]:

If taxable income is:	The tax is:
Not over $9,275	10% of taxable income.
Over $9,275 but not over $37,650	$927.50, plus 15% of the excess over $9,275.
Over $37,650 but not over $75,950	$5,183.75, plus 25% of the excess over $37,650.
Over $75,950 but not over $115,725	$14,758.75, plus 28% of the excess over $75,950.
Over $115,725 but not over $206,675	$25,895.75, plus 33% of the excess over $115,725.
Over $206,675 but not over $233,475	$55,909.25, plus 35% of the excess over $206,675.
Over $233,475	$65,289.25, plus 39.6% of the excess over $233,475.

Capital Gains and Dividends

Capital gains and losses are assigned to baskets. Five possible tax rates will apply to most capital gains and losses:

- Ordinary income tax rates (up to 39.6% in 2016) for gains on assets held one year or less
- 28% rate on collectibles gains and includible Sec. 1202 gains
- 20% rate on gains on assets held for more than one year and qualified dividends (for taxpayers whose regular tax bracket is 39.6%)
- 15% rate on gains on assets held for more than one year and qualified dividends (for taxpayers whose regular tax bracket is higher than 15% and less than 39.6%)
- 0% rate on gains on assets held for more than one year and qualified dividends (for taxpayers whose regular tax bracket is not higher than 15%)

Note: The net investment income of higher income taxpayers (modified AGI greater than $200,000 for single and $250,000 for married filing jointly) also may be subject to an additional tax of 3.8%. Net investment income includes dividends and capital gains, along with other types of investment income.

Social Security Tax—2016

Category	Rate	Dollar Limit
OASDI	6.2%	$118,500
Medicare*	1.45%	First $200,000 of wages ($250,000 for joint returns)
	2.35%	Wages greater than $200,000 ($250,000 for joint returns)

*Only the employee is required to pay the additional Medicare tax on wages above $200,000 ($250,000 for joint returns). The employer pays Medicare tax of 1.45% on all wages.

Self-Employment Tax—2016

Category	Rate	Dollar Limit
OASDI	12.4%	$118,500
Medicare	2.9%	First $200,000 of self-employment income ($250,000 combined self-employment income for joint returns)
	3.8%	Self-employment income greater than $200,000 ($250,000 for joint returns)

Alternative Minimum Tax—2016

If AMTI minus the exemption amount is:		The tax is:	
Over—	But Not Over—		Of the Amount Over—
$0	$186,300*	26%	$0
$186,300*		$48,438* + 28%	$186,300

*$93,150 and $24,219 for married taxpayers filing separately.

AMT exemption amounts (before phase-outs and other adjustments):

Unmarried individuals (other than surviving spouses and heads of households)	$53,900
Married individuals filing joint returns and surviving spouses	83,800
Married individuals filing separate returns	41,900

STANDARD DEDUCTION

Filing Status	
Married individuals filing joint returns and surviving spouses	$12,600
Heads of households	9,300
Unmarried individuals (other than surviving spouses and heads of households)	6,300
Married individuals filing separate returns	6,300
Additional standard deduction for the aged and the blind	
Individual who is married and surviving spouses	1,250*
Individual who is unmarried and not a surviving spouse	1,550*
Taxpayer claimed as dependent on another taxpayer's return: Greater of (1) earned income plus $350, or (2) $1,050.	

*These amounts are $2,500 and $3,100, respectively, for a taxpayer who is both aged and blind.

PERSONAL AND DEPENDENCY EXEMPTION AND PHASE-OUTS

Personal and dependency exemption	$ 4,050
Phase-outs for high income taxpayers:	
Personal and dependency exemptions are reduced by 2% for each $2,500 increment (or part of increment) for AGI above the threshold amount.	
Itemized deductions are reduced by 3% for each dollar of AGI above the threshold amounts (taxpayers cannot lose more than 80% of their allowable itemized deductions).	
For both provisions, the AGI threshold amounts are:	
Married individuals filing joint returns and surviving spouses	$311,300
Heads of households	285,350
Unmarried individuals (other than surviving spouses and heads of households)	259,400
Married individuals filing separate returns	155,650

2016
TAX RATE SCHEDULES

ESTATES AND TRUSTS [§1 (e)]:

If taxable income is:	The tax is:
Not over $2,550	15% of taxable income.
Over $2,550 but not over $5,950	$382.50 plus 25% of the excess over $2,550.
Over $5,950 but not over $9,050	$1,232.50 plus 28% of the excess over $5,950.
Over $9,050 but not over $12,400	$2,100.50 plus 33% of the excess over $9,050.
Over $12,400	$3,206.00 plus 39.6% of the excess over $12,400.

CORPORATIONS

If Taxable Income Is:		The Tax Is:	
Over—	**But Not Over—**		**Of the Amount Over—**
$ 0	$ 50,000	15%	$ 0
50,000	75,000	$ 7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333		6,416,667 + 35%	18,333,333

UNIFIED CREDIT AMOUNT FOR ESTATE AND GIFT TAX

Year of Gift/Year of Death	Amount of Credit	Basic Exclusion Amount (Exemption Equivalent)
January through June, 1977	$ 30,000 (6,000)[b]	$ 120,666 (30,000)[b]
July through December, 1977	30,000	120,666
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,563
1981	47,000	175,625
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 through 1997	192,800	600,000
1998	202,050	625,000
1999	211,300	650,000
2000 and 2001	220,550	675,000
2002 and 2003	345,800	1,000,000
2004 and 2005	555,800 (345,800)[a]	1,500,000 (1,000,000)[a]
2006, 2007, and 2008	780,800 (345,800)[a]	2,000,000 (1,000,000)[a]
2009	1,455,800 (345,800)[a]	3,500,000 (1,000,000)[a]
2010	1,730,800[b] (330,800)[a]	5,000,000[b] (1,000,000)[a]
2011	1,730,800	5,000,000
2012	1,772,800	5,120,000
2013	2,045,800	5,250,000
2014	2,081,800	5,340,000
2015	2,117,800	5,430,000
2016	2,125,800	5,450,000

[a] The numbers in parentheses represent the credit and exemption equivalent amounts for the gift tax.
[b] This amount applied if the executor opted to have the estate subject to the estate tax and FMV basis rule in 2010.

UNIFIED TRANSFER TAX RATES

For Transfers Made in 1984 Through 2001:*

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over $10,000	18% of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20% of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22% of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24% of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26% of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28% of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30% of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32% of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34% of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37% of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39% of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41% of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43% of the excess of such amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45% of the excess of such amount over $1,500,000.
Over $2,000,000 but not over $2,500,000	$780,800, plus 49% of the excess of such amount over $2,000,000.
Over $2,500,000 but not over $3,000,000	$1,025,800, plus 53% of the excess of such amount over $2,500,000.
Over $3,000,000	$1,290,800, plus 55% of the excess of such amount over $3,000,000.

* For decedents dying after 2001 and gifts made after 2001, the maximum tax rates are as follows:
Note: The rates in the above schedule still apply to amounts less than the amounts in the second column of the below schedule.

Year	If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
2002	Over $2,500,000	$1,025,800, plus 50% of the excess of such amount over $2,500,000.
2003	Over $2,000,000	$780,800, plus 49% of the excess of such amount over $2,000,000.
2004	Over $2,000,000	$780,800, plus 48% of the excess of such amount over $2,000,000.
2005	Over $2,000,000	$780,800, plus 47% of the excess of such amount over $2,000,000.
2006	Over $2,000,000	$780,800, plus 46% of the excess of such amount over $2,000,000.
2007–2009	Over $1,500,000	$555,800, plus 45% of the excess of such amount over $1,500,000.
2010	Over $500,000**	$155,800, plus 35% of the excess of such amount over $500,000.**
2011–2012	Over $500,000	$155,800, plus 35% of the excess of such amount over $500,000.
2013 and after	Over $1,000,000	$345,800, plus 40% of the excess of such amount over $1,000,000.

** Gift tax only unless the executor opted to have the estate subject to the estate tax and FMV basis rule in 2010.

PEARSON'S FEDERAL TAXATION 2017

CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS

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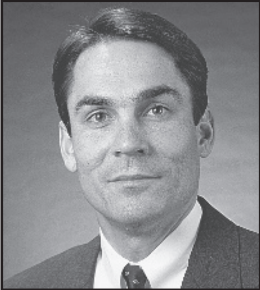

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PREFACE

Why is the Rupert/Pope/Anderson series the best choice for you and your students?

The Rupert/Pope/Anderson 2017 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 2017: Individuals
Federal Taxation 2017: Corporations, Partnerships, Estates & Trusts (the companion book to *Individuals*)
Federal Taxation 2017: 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 they 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:11-64 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:5, C:7, C:8, and C:16 (*Corporations* volume only).

What's New to this Edition?

INDIVIDUALS

- Complete updating of significant court cases and IRS rulings and procedures during 2015 and early 2016.
- Complete updating for the Protecting Americans from Tax Hikes Act of 2015, the Trade Preferences Extension Act of 2015, and the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.
- Discussion of the tax extender deductions and credits in 2016.
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2016.
- Whenever new updates become available, they will be accessible via MyAccountingLab.

CORPORATIONS

- The comprehensive corporate tax return, Problem C:3-66, has all new numbers for the 2015 forms.
- The comprehensive partnership tax return, Problem C:9-58, has all new numbers for the 2015 forms.
- The comprehensive S corporation tax return, Problem C:11-64, has all new numbers for the 2015 forms.
- Changes affecting 2016 tax law have been incorporated into the text where appropriate, including the tax legislation listed in the second Individuals bullet item above.
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2016.
- Whenever new updates become available, they will be accessible via MyAccountingLab.

MyAccountingLab

MyAccountingLab is an online homework, tutorial, and assessment program designed to work with *Pearson's Federal Taxation 2017* to engage students and improve results. MyAccountingLab's homework and practice questions are

correlated to the textbook, they regenerate algorithmically to give students unlimited opportunity for practice and mastery, and they offer helpful feedback when students enter incorrect answers. Combining resources that illuminate content with accessible self-assessment, MyAccountingLab with eText provides students with a complete digital learning experience—all in one place. To register, go to http://www.pearsonmylabandmastering.com.

For Instructors

MyAccountingLab provides instructors with a rich and flexible set of course materials, along with course-management tools that make it easy to deliver all or a portion of your course online.

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Strong Pedagogical Aids

- Appropriate blend of technical content of the tax law with a high level of readability for students.
- Focused on enabling students to apply tax principles within the chapter to real-life situations.

Real-World Example

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.

Book-to-Tax Accounting Comparison

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?

Unique to the Rupert/Pope/Anderson series, these boxes place students in a decision-making role. The boxes include many *controversies* that are as yet unresolved or are currently being considered by the courts. These boxes make extensive use of **Ethical Material** as they represent choices that may put the practitioner at odds with the client.

Stop & Think

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

Ethical Point

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.

Program Components

Materials for the instructor may be accessed at the Instructor's Resource Center (IRC) online, located at **www.pearsonhighered.com/phtax** or within the Instructor Resource section of MyAccountingLab. You may contact your Pearson representative for assistance with the registration process.

- ***TaxAct 2015 Software:*** Available via online purchase with Individuals, Corporations, and Comprehensive Texts. 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.
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- ***Solutions Manual:*** Contains solutions to discussion questions, problems, and comprehensive and tax strategy problems. It also contains all solutions to the case study problems, research problems, and "What Would You Do in This Situation?" boxes.
- ***Test Bank:*** Offers a wealth of true/false, multiple-choice, and calculative problems. A computerized program is available to adopters.
- ***PowerPoint Slides:*** Consists of chapter outlines, featuring images, examples, and problems throughout, to aid in class lectures.
- ***Image Library:*** Figures, tables, and tax forms featured in the book are provided as individual files for the convenience of instructors and students.
- ***Multi-State Tax Chapter:*** An entire chapter, complete with problems (and solutions) dedicated to multi-state tax practices.

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Please send any comments to Kenneth E. Anderson 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

Overview of Tax Research...1-2
Steps in the Tax Research Process...1-3
Importance of the Facts to the Tax Consequences...1-5
The Sources of Tax Law...1-7
Tax Services...1-25
The Internet as a Research Tool...1-26
Citators...1-28
Professional Guidelines for Tax Services...1-30
Sample Work Papers and Client Letter...1-34

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.

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.

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

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 $5.45 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).

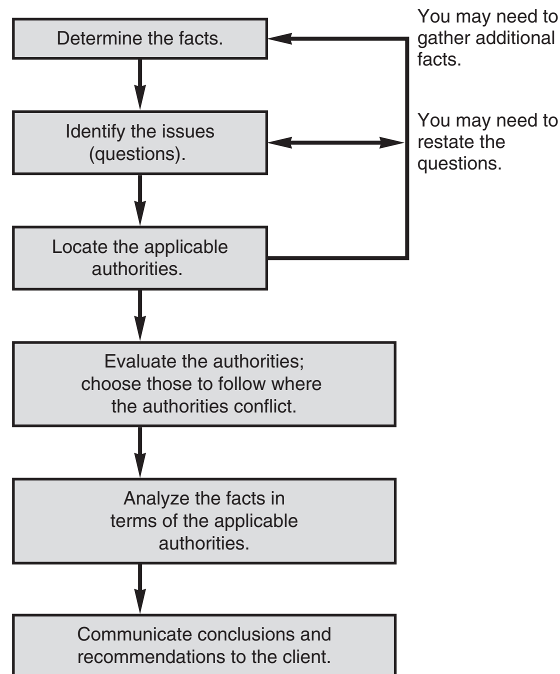

FIGURE C:1-1 ▶ STEPS IN THE TAX RESEARCH PROCESS

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.

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.

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.

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:8 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 client'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, 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 both records of 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).

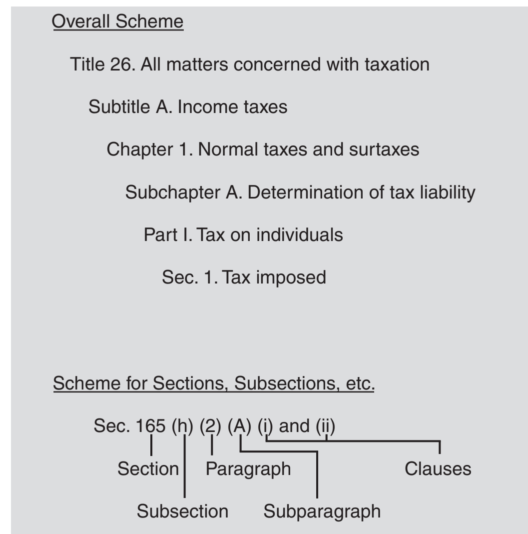

FIGURE C:1-2 ▶ ORGANIZATIONAL SCHEME OF THE INTERNAL REVENUE CODE

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.