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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 affecting individual taxpayers, including an explanation of the new rules and the related implications of the following items:
 - Reduction in marginal tax rates
 - Elimination of personal and dependency exemptions
 - Changes in the deductibility of state and local taxes and casualty losses
 - Elimination of miscellaneous itemized deductions
 - Changes to the alternative minimum tax
 - Increase in the child tax credit
- Complete updating of significant court cases and IRS rulings and procedures during 2017 and early 2018
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2018
- Whenever new updates become available, they will be accessible via MyLab Accounting
- Updating of the end-of-chapter tax return problems to 2017 (2017 tax forms are included because the 2018 tax forms were not available when this edition went to print), but also including a supplemental explanation for each tax return problem of how the solution will change for the 2018 tax year given the provisions of the Tax Cuts and Jobs Act.

CORPORATIONS

- Complete updating of the chapter material for the provisions in the Tax Cuts and Jobs Act of 2017 affecting corporations and other entities, including an explanation of the new rules and the related implications of the following items:
 - Reduced corporate tax rate
 - Qualified business income deduction
 - New limitations on interest, business losses, and NOLs
 - New rules for the taxation of international transactions
 - The comprehensive corporate tax return, Problem C:3-65, has all new numbers for the 2017 forms
- The comprehensive partnership tax return, Problem C:9-58, has all new numbers for the 2017 forms
- The comprehensive S corporation tax return, Problem C:11-62, has all new numbers for the 2017 forms
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2018
- Whenever new updates become available, they will be accessible via MyLab Accounting

SOLVING TEACHING AND LEARNING CHALLENGES

The Rupert/Anderson 2019 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 2019: Individuals
- Federal Taxation 2019: Corporations, Partnerships, Estates & Trusts (the companion book to Individuals)
- Federal Taxation 2019: 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:3-65 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 2019 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:

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/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.

MyLab Accounting

Reach Every Student with MyLab Accounting

MyLab is the teaching and learning platform that empowers you to reach every student. By combining trusted author content with digital tools and a flexible platform, MyLab personalizes the learning experience and improves results for each student. Learn more about MyLab Accounting at <https://www.pearsonmylabandmastering.com/>

Powerful Homework and Test Manager Create, import, and manage online homework and media assignments, quizzes, and tests. Create assignments from online questions directly correlated to this and other textbooks. Homework questions include “Help Me Solve This” guided solutions to help students understand and master concepts. You can choose from a wide range of assignment options, including time limits and maximum number of attempts allowed. In addition, you can create your own questions—or copy and edit ours—to customize your students’ learning path.

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This program comes with the following teaching resources.

Supplements available to instructors at www.pearsonhighered.com/pearsontax	Features of the Supplement
Instructor's Resource Manual authored by Mitchell Franklin from LeMoyne College and Joshua Coyne from University of Memphis	<ul style="list-style-type: none"> • Sample syllabi • Instructor outlines • Information regarding problem areas for students • Solutions to the tax form/tax return preparation problems
Instructor's Solutions Manual authored by Kenneth Anderson from University of Tennessee and Timothy Rupert from Northeastern University	<ul style="list-style-type: none"> • 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. <ul style="list-style-type: none"> • Type (Multiple-choice, true/false, short-answer, essay) • Page references to where content is found in the text
Computerized TestGen	TestGen allows instructors to: <ul style="list-style-type: none"> • 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: <ul style="list-style-type: none"> • 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 2017 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.

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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.

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.

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.

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 \$11.18 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.

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.

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.

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).

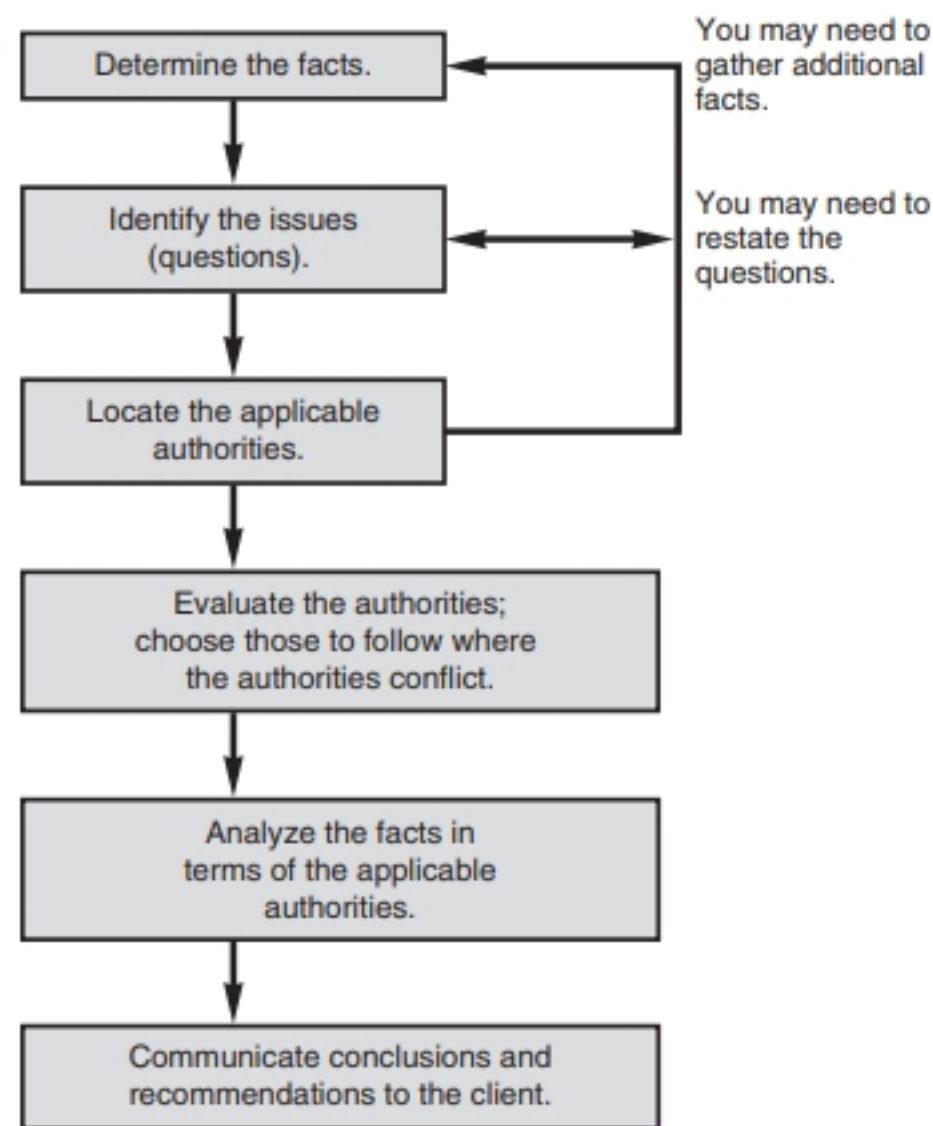


FIGURE C:1-1 ► STEPS IN THE TAX RESEARCH PROCESS

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 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, 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.

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

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.

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).

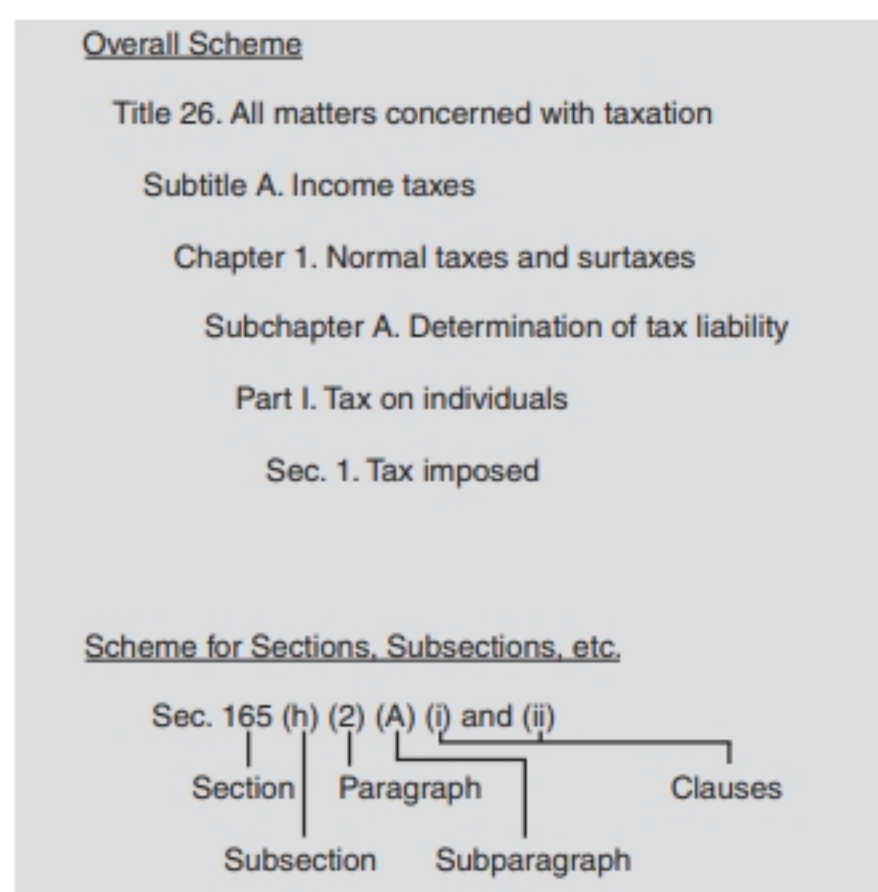


FIGURE C:1-2 ► ORGANIZATIONAL SCHEME OF THE INTERNAL REVENUE CODE

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

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.

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.



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.

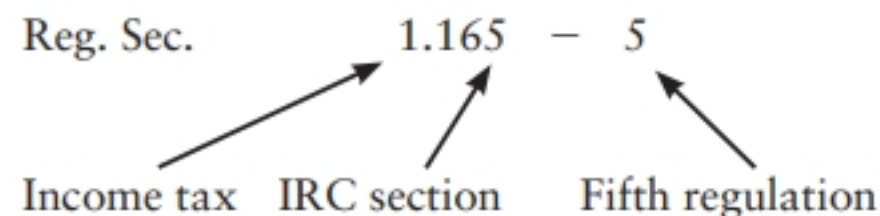
ADDITIONAL COMMENT

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:

<i>Number</i>	<i>General Subject Matter</i>
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:

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

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.

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.