**CHAPTER 2**

**WORKING WITH THE TAX LAW**

***LECTURE NOTES***

**OVERVIEW**

Federal tax law is a mixture of laws passed by Congress, explanations provided by the Treasury Department and the Internal Revenue Service (IRS), and court decisions. This chapter introduces the statutory, administrative, and judicial sources of the tax law *and* explains how the law is applied to business and individual transactions. It further explains how to apply tax research techniques effectively. Tax research is of critical importance in properly characterizing completed events as well as in planning proposed transactions.

**SUMMARY OF CHANGES IN THE CHAPTER**

The following are notable changes in the chapter from the 2020 Edition.

* Clarified the relevance of guidance that is published in the Internal Revenue Bulletin (Exhibit 2.3).
* Expanded coverage of IRS notices and placed its discussion with Revenue Rulings and Procedures.
* Added a Bridge Discipline question on AI and tax research.

### **THE BIG PICTURE**

The Big Picture discussion in Chapter 2 introduces the introductory tax student to the idea that answers to tax questions will not always be found in the tax textbook and that research often needs to be undertaken to answer the question.

The discussion in text Section 2-2 takes the student through the answer to the research questions posed. Depending on the research services available, the instructor might ask the students to formulate keyword searches and then demonstrate what happens when those searches are undertaken in the research service. The instructor could also ask the students to see if they could verify the correctness of the textbook conclusion or change one of the key facts and to determine how the conclusion would change, if at all.

**TAX LAW SOURCES**

**Statutory Sources of the Tax Law**

1. Statutory sources of law include the Constitution (Article I, Sections 7, 8, and 10), tax treaties, and the Internal Revenue Code.

2. Origin of the Internal Revenue Code.

a. Known as the Internal Revenue Code of 1939, the codification arranged all Federal tax provisions in a logical sequence and placed them in a separate part of the Federal statutes.

b. Major amendments to this codification took place in 1954, 1986, and 2017.

c. Congress usually passes one or more laws each year that have tax provisions and become part of the Internal Revenue Code of 1986.

3.The Legislative Process.

a. Exhibit 2.1 in the text illustrates the usual legislative process for enacting changes to the Internal Revenue Code.

b. Federal tax legislation normally originates in the House Ways and Means Committee of the House of Representatives because the U.S. Constitution mandates that revenue raising bills begin in the House. A tax bill might originate in the Senate if it is attached as a rider to other legislative proposals.

c. Tax legislation is referred from the Senate Finance Committee to the entire Senate. If the House and Senate tax bills disagree, the Joint Conference Committee resolves the differences. (See Exhibit 2.2 in the text for an illustration of what happened with amendments to the child tax credit in the drafting of the Tax Cuts and Jobs Act of 2017.)

d. The Committee Reports explain the provisions of the proposed legislation and are a valuable source for ascertaining the intent of Congress. What Congress had in mind when it considered and enacted tax legislation is, of course, the key to interpreting the legislation by taxpayers, the IRS, and the courts.

4. Arrangement of the Internal Revenue Code. The Internal Revenue Code is found in Title 26 of the U.S. Code. In working with the Code, it helps to understand the format. The key is usually the Section number. For example, in citing Section 2(a), it is unnecessary to include Subtitle A, Chapter 1, Subchapter A, Part I. Mentioning Section 2(a) is sufficient.

5. Citing the Code. See the description on page 2-5 in the text for the format used to reference Code Sections.

6. Effect of Treaties. The United States signs certain tax treaties (sometimes called tax conventions) with foreign countries to render mutual assistance in tax enforcement and to avoid double taxation.

a. These treaties affect transactions involving U.S. persons and entities operating or investing in a foreign country, as well as persons and entities of a foreign country operating or investing in the United States.

b. Neither a tax law nor a tax treaty automatically takes legal precedence. When there is a direct conflict between the Code and a treaty, the most recently adopted item prevails.

**Administrative Sources of the Tax Law** (See Exhibit 2.3 in the text.)

7. Treasury Department Regulations. The Treasury Department has a duty to issue rules and Regulations to explain and interpret the Code.

a. Regulations, which carry considerable authority as the official interpretation of tax law, may be issued in proposed, temporary, or final form.

(1) New Regulations and changes in existing Regulations usually are issued in proposed form before they are finalized. The interval between the proposal of a Regulation and its finalization permits taxpayers and other interested parties to comment on the propriety of the proposal. Proposed Regulations carry little weight.

(2) Final Regulations have the force and effect of law. They carry considerable authority as the official interpretation of tax statutes.

(3) Temporary Regulations are issued where immediate guidance is important. They have the same authority as Final Regulations but expire within three years after the date of their issuance.

b. Proposed, Temporary, and Final Regulations are published in the *Federal Register*, the *Internal Revenue Bulletin*, and major tax services.

c. Regulations may also be classified as legislative, interpretive, or procedural.

8. Revenue Rulings, Revenue Procedures, and Notices.

a. Revenue Rulings are official pronouncements of the National Office of the IRS and provide guidance to both IRS personnel and taxpayers in handling routine tax matters. They usually deal with more restricted problems than Regulations and do not carry the same legal force and effect as Regulations.

b. Both Revenue Rulings and Revenue Procedures serve an important function in providing guidance to IRS personnel and taxpayers in handling routine tax matters. They generally apply retroactively and may be revoked or modified by subsequent rulings or procedures, Regulations, legislation, or court decisions.

c. Revenue Procedures are issued in the same manner as Revenue Rulings, but they deal with the internal management practices and procedures of the IRS. Revenue Procedures do not carry the same legal force and effect as Regulations.

d. Notices are issued when immediate guidance is needed by taxpayers. Typically, this guidance is transitional while the IRS works on permanent guidance on the particular topic.

e. Revenue Rulings, Revenue Procedures, and Notices are published weekly by the U.S. Government in the *Internal Revenue Bulletin* (I.R.B.). *Internal Revenue Bulletins* are listed at **irs.gov/irb**.

9. Letter Rulings. A letter ruling is a statement issued by the National Office of the IRS in response to a taxpayer’s request, which applies the tax law to a proposed transaction. Revenue rulings can result from a taxpayer request for a letter ruling.

10. Other Administrative Pronouncements.

a. *Treasury Decisions* (TDs) are issued by the Treasury Department to announce new Regulations, amend or change existing Regulations, or announce the position of the Government on selected court decisions. TDs are published in the *Internal Revenue Bulletin*.

b. The IRS publishes other administrative communications in the *Internal Revenue Bulletin*, such as Announcements, Proposed Regulations, and Practitioner Disciplinary Actions.

c. A determination letter is a statement issued by the Area Director in response to a taxpayer and provides guidance on the application of the tax law.

d. Technical Advice Memoranda (TAMs) are furnished by the National Office as needed. TAMs deal with completed rather than proposed transactions. TAMs are issued in response to questions raised by IRS field personnel during audits.

**Judicial Sources of the Tax Law**

11. Five Federal courts have jurisdiction over tax disputes between the IRS and taxpayers: the U.S. Tax Court, the U.S. District Court, the U.S. Court of Federal Claims, the U.S. Court of Appeals, and the U.S. Supreme Court. (See Figure 2-1 at the end of these Lecture Notes for the location of judicial sources.)

12. After a taxpayer has exhausted the remedies available within the IRS, the dispute can be taken to the Federal courts. The trial and appellate court system for Federal tax litigation is illustrated in Exhibit 2.4 in the text.

a. A court of original jurisdiction initially hears the case.

b. Appeals (either by the taxpayer or the IRS) are heard by the appropriate appellate court.

c. To commence litigation the taxpayer chooses among the pertinent U.S. District Court, the U.S. Court of Federal Claims, the U.S. Tax Court, or the Small Cases Division of the U.S. Tax Court.

d. At the trial court level, a taxpayer usually is the plaintiff (or petitioner), and the government is the defendant (or respondent). If the taxpayer wins and the government appeals as the new petitioner (or appellant), the taxpayer now is the respondent.

13. Trial Courts. See Concept Summary 2.1 in the text for a summary of various attributes of the Federal trial courts. The differences among the various trial courts can be summarized as follows.

* Number of courts.
* Number of judges.
* Location.
* Jurisdiction of the Court of Federal Claims.
* Jurisdiction of the Tax Court and District Courts.
* Jury trial.
* Payment of deficiency.
* Appeals.
* Bankruptcy.
* Gray areas.

14. Appellate Courts. A trial court decision can be appealed to the appropriate Circuit Court of Appeals. The 11 geographic circuits, the circuit for the District of Columbia, and the Federal Circuit appear in Exhibit 2.5 in the text.

a. *Process and Outcomes.* If the government loses at the trial court level (District Court, Tax Court, or Court of Federal Claims), it need not appeal.

(1) The fact that the IRS does not appeal does not mean that the IRS agrees with the result.

(2) The role of appellate courts is limited to a review of the record of the case that was compiled by the trial courts. As a result, the appellate process usually involves a determination of whether the trial court applied the proper law in arriving at its decision.

(3) The appellate court may approve (affirm) or disapprove (reverse) the lower court’s findings, or it may send the case back for further consideration (remand).

b. *Other Rules and Strategies.* The Federal Circuit at the appellate level provides a taxpayer with an alternative forum to the Court of Appeals of his or her home circuit.

(1) District Courts, the Tax Court, and the Court of Federal Claims must abide by the precedents set by the Court of Appeals of their jurisdiction.

(2) All courts must follow decisions of the U.S. Supreme Court.

(3) As a result of *Golsen* [*Jack E. Golsen*, 54 T.C. 742 (1970)], the Tax Court will not follow its own precedents in a subsequent case if the Court of Appeals with jurisdiction over the taxpayer previously reversed the Tax Court on the issue at hand.

15. U.S. Supreme Court. The U.S. Supreme Court grants certiorari to resolve a conflict among the Courts of Appeals or where the tax issue is extremely important. The granting of a Writ of Certiorari indicates that at least four of the nine members of the Supreme Court believe that the issue is of sufficient importance to be heard by the full Court.

16. Judicial Citations. Judicial citations usually follow a standard pattern: case name, volume number, reporter series, page or paragraph number, court, and year of the decision.

a. *Judicial Citations—The Tax Court*. The Tax Court issues two types of decisions: Regular and Memorandum, based on the Chief Judge’s determination. They differ in both substance and form.

(1) Memorandum decisions deal with cases that involve only the application of already established principles of law.

(2) Regular decisions involve novel issues not previously resolved by the Tax Court.

(3) In actual practice, both Regular and Memorandum decisions represent the position of the Tax Court and, as such, can be relied on.

(4) Regular Tax Court decisions are published by the U.S. Government Printing Office as the *Tax Court of the United States Reports*. Memorandum decisions are published by both CCH and RIA.

(5) If the IRS loses a decision, it may indicate whether it agrees or disagrees with the results reached by the court by publishing an acquiescence (“A” or “*acq.*”) or nonacquiescence (“NA” or “*nonacq.*”), respectively. The acquiescence or nonacquiescence result is published in the *Internal Revenue Bulletin* as an *Action on Decision*.

b. *Judicial Citations—The District Courts, Court of Federal Claims, and Courts of Appeals*. Decisions dealing with Federal tax matters are reported in both the CCH *U.S. Tax Cases* (USTC) and the RIA *American Federal Tax Reports* (AFTR) series. Federal District Court decisions, dealing with both tax and nontax issues, also are published by West in its *Federal Supplement Second Series*.

c. *Judicial Citations—Supreme Court*. Decisions are published by CCH in the USTCs and by RIA in the AFTRs. The U.S. Government Printing Office also publishes these decisions in the *United States Supreme Court Reports* (U.S.), as does West in its *Supreme Court Reporter* (S.Ct.), and the Lawyer’s Co-operative Publishing Company in its *United States Reports, Lawyer’s Edition* (L.Ed.).

**WORKING WITH THE TAX LAW—TAX RESEARCH**

17. Tax research is the process of finding a professional conclusion to a tax problem. The problem might originate either from completed or proposed transactions.

18. Tax research involves the following procedures (illustrated in Exhibit 2.6 in the text).

a. Identifying and refining the problem.

b. Locating the appropriate tax law sources.

c. Assessing the tax law sources. (See Table 2-1 at the end of the Lecture Notes for a list of primary and secondary sources.)

d. Arriving at the solution or at alternative solutions, including consideration of nontax factors.

e. Effectively communicating the solution to the taxpayer or the taxpayer’s representative.

f. Updating the solution in light of new developments.

**Identifying the Problem**

19. Problem identification starts with a compilation of the relevant facts involved. In other words, all the facts that may have a bearing on the problem must be gathered.

**Refining the Problem**

20. Use new facts to refine the tax problem.

**Locating the Appropriate Tax Law Sources**

21. Once the problem is clearly defined, the researcher does a keyword search using an electronic tax service or references the Internal Revenue Code and the Treasury Regulations

22. Tax Services. Several important observations about the use of tax services cannot be overemphasized.

a. Always check for current developments. Tax services are updated several times a day, and tax newsletters often feature highlights of recent tax law developments.

b. There is no substitute for the original source. Do not base a conclusion solely on a tax service’s commentary. If a Code Section, Regulation, or case is vital to the research, read it.

23. Tax Commentary. Various tax publications are another source of relevant information. If an article or a posting is relevant to the issue at hand, it may provide the references needed to locate the primary sources of the tax law that apply.

**Assessing Tax Law Sources**

24. Once a source has been located, the next step is to assess it in light of the problem at hand. Proper assessment involves careful interpretation of the tax law and consideration of its relevance and significance.

25. Interpreting the Internal Revenue Code. This is the greatest challenge for the IRS. The language of the Code is difficult to comprehend fully.

26*.* Assessing the Significance of a Treasury Regulation.

a. Give the Code and any related Regulations equal weight when dealing with taxpayers and their representatives.

b. Proposed Regulations are not binding.

c. The burden of proof is on the taxpayer.

d. Final Regulations can be classified as procedural, interpretive, or legislative. Procedural Regulations are instructions indicating information that taxpayers should provide the IRS.

e. Interpretive Regulations are hard and solid and almost impossible to overturn unless they do not clearly reflect the intent of Congress.

f. In some Code Sections, Congress has given the Treasury Secretary or a delegate the specific authority to prescribe Regulations to carry out the details of administration. Regulations issued under this type of authority possess the force and effect of law and are often called Legislative Regulations.

27. Assessing the Significance of Other Administrative Sources of the Tax Law. Revenue Rulings carry much less weight than Regulations; however, they are important for the researcher in that they reflect the position of the IRS on tax matters for specified fact patterns.

28. Assessing the Significance of Judicial Sources of the Tax Law. How much reliance can be placed on a particular decision depends on the following factors.

a. The level of the court. The higher the level of the court that issued a decision, the greater the weight accorded to that decision.

b. The legal residence of the taxpayer. More reliance is placed on decisions of courts that have jurisdiction in the area where the taxpayer’s legal residence is located.

c. The type of decision. A Tax Court Regular decision carries more weight than a Memorandum decision; the Tax Court does not consider Memorandum decisions to have precedential value.

d. The weight of the decision. A decision that is supported by cases from other courts carries more weight than a decision that is not supported by other cases.

e. Subsequent events. Was the decision affirmed or overruled on appeal?

f. In connection with the last two factors, the use of a citator is invaluable to tax research. A citator provides the history of a case, including the authority relied on in reaching the result.

29. Understanding Judicial Opinions. Reading judicial opinions can be more productive if certain conventions of usage are understood.

a. Some courts, including the Tax Court, apply the terms *petitioner* and *respondent* to the plaintiff and defendant, respectively, particularly when the case does not involve an appellate proceeding.

b. Appellate courts often use the terms *appellant* and *appellee* instead.

c. It also is important to distinguish between a court’s final determination, or holding, and passing comments made in the course of its opinion. These latter remarks, examples, and analogies, often collectively termed dicta, are not part of the court’s conclusion and do not have precedential value.

30. Assessing the Significance of Other Sources. (See Table 2-1 at the end of these Lecture Notes for a list of primary and secondary tax law sources.)

a. Primary sources of tax law include the Constitution, legislative history materials, statutes, treaties, Treasury Regulations, IRS pronouncements, and judicial decisions.

b. Reference to secondary materials such as tax publications, treatises, legal opinions, and written determinations may be useful. In general, secondary sources do not constitute tax authority.

c. For purposes of the accuracy-related penalty, the IRS expanded the list of substantial authority to include a number of other items (e.g., letter rulings and Proposed Regulations).

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

31. Discuss possible solutions to Example 4 in the text.

**Communicating Tax Research**

32. A good tax research communication should contain the following elements.

* A clear statement of the issue.
* A short review of the fact pattern that raised the issue.
* A review of the pertinent tax law sources.
* Any assumptions made in arriving at the solution.
* The solution recommended and the logic or reasoning supporting it.
* The references consulted in the research process.

33. Exhibits 2.7 and 2.8 in the text present the tax file memorandum (internal to the firm) and the client letter associated with the facts of Example 4 in the text.

**Updates**

34. Because tax research may involve a proposed (as opposed to a completed) transaction, a change in the tax law (legislative, administrative, or judicial) could alter the original conclusion.

**Tax Research Best Practices**

35. The researcher must use the document list that results from a search procedure in a professional manner. Most electronic tax services allow a user to retrieve documents in order of relevance or in the order listed by database sources.

36. Finding Relevant Materials Effectively. Usually, tax professionals use one of the following strategies when performing computer-based tax research.

a. Search various databases using keywords that are likely to be found in the underlying documents, as written by Congress, the judiciary, or administrative sources.

b. Link to tax documents for which all or part of the proper citation is known.

c. Browse the tax databases, examining various tables of contents and indexes in a traditional manner or using cross-references in the documents to jump from one tax law source to another.

d. Sometimes a researcher can begin a search process using materials that are available at no direct cost. Such sources include the following.

* Exhibit 2.9 in the text lists some of the websites that may be most useful to tax researchers and their internet addresses as of press date.
* Blogs and RSS feeds provide a means by which information related to the tax law can be exchanged among taxpayers, tax professionals, and others who subscribe to the group’s services.

**FINANCIAL DISCLOSURE INSIGHTS**

**Where Does GAAP Come From?** In reconciling the tax and financial accounting reporting of a transaction, the tax professional needs to know the hierarchy of authority of accounting principles—in particular, the level of importance to assign to a specific GAAP document. Discuss the diagram presented in the text which shows the sources of GAAP, arranged in a general order of authority from highest to lowest.

**TAX RESEARCH ON THE CPA EXAMINATION**

37. The CPA examination includes tax-oriented questions in the following topical areas.

* Federal tax procedures, ethics, and accounting issues.
* Federal taxation of property transactions.
* Federal taxation—individuals.
* Federal taxation—entities.

38. Questions address issues involving tax compliance and tax planning matters.

39. Each exam section includes multiple-choice questions and case studies called task-based simulations (TBSs).

a. The Regulation section of the exam has 76 multiple choice questions and 8 TBSs.

b. TBSs are small case studies designed to test a candidate’s tax knowledge and skills using real-life work-related situations.

c. The typical TBS requires 15–30 minutes to complete.

40. Candidates can learn more about the CPA examination at **aicpa.org/cpaexam**. This site reviews the exam’s format, navigation functions, and tools. A collection of study materials is available, and a 30- to 60-minute sample exam will familiarize a candidate with the types of questions on the examination.

**RESEARCH PROBLEMS**

Solutions to end-of-chapter Research Problems are located in the Solutions Manual.

**In-class Exercises**

**Q1.** The shareholders of Red Corporation and Green Corporation want assurance that the consolidation of both into a single corporation, Blue Corporation, will be a nontaxable reorganization. Should a letter ruling or a determination letter be requested from the IRS? Explain when each is used.

**Solution:**

The proper approach is to request that the National Office of the IRS issue a letter ruling concerning the income tax effect of the proposed transaction. Letter rulings are issued for a fee upon a taxpayer’s request and describe how the IRS will treat a proposedtransaction for tax purposes. They apply only to the taxpayer who asks for and obtains the ruling. Letter rulings can be useful to taxpayers who want to be certain of how a transaction will be taxed before proceeding. Letter rulings also allow taxpayers to avoid unexpected tax costs and may be the most effective way to carry out tax planning. However, the IRS limits the issuance of individual rulings to restricted, preannounced areas of taxation.

Determination letters are issued at the request of taxpayers and provide guidance on the application of the tax law. They differ from letter rulings in that the issuing source is an IRS Area Director (rather than the National Office of the IRS). Also, determination letters usually involve completed(as opposed to proposed) transactions.

**Q2.** Chris operates a barbershop in which he employs eight barbers. To comply with the rules governing income tax and payroll tax withholding, Chris wants to know whether the barbers working for him are employees or independent contractors.

**Solution:**

The proper procedure is to request a determination letter on their status from the appropriate Area Director.

**Table 2-1**

**Primary and Secondary Tax Law Sources**

**Primary Secondary**

Sixteenth Amendment to Constitution X

Tax Treaty X

Internal Revenue Code Section X

U.S. Supreme Court Decision X

U.S. Circuit Court of Appeals Decision X

Tax Court Memorandum Decision X

Tax Court Regular Decision X

U.S. District Court Decision X

U.S. Court of Federal Claims Decision X

Small Cases Division of U.S. Tax Court X\*\*

Final Regulation X

Temporary Regulation X\*

Proposed Regulation X\*\*\*

Revenue Ruling X

Revenue Procedure X

Senate Finance Committee Report X

Bluebook X

Letter Ruling X

Technical Advice Memorandum X

Actions on Decisions X

Determination Letter X

*Harvard Law Review* article X

## Field Service Advice X

General Counsel Memorandum X

\* Can be outstanding for three years at most.

The categorization of a tax law source as a primary or a secondary source is not black and white. All of the sources categorized as primary in the above table are so categorized because all can be relied on to defend against the application of penalties by the IRS. However, note the following.

\*\* The Tax Court indicates that Small Cases Division opinions should not be used or cited as precedent. As such, these decisions could be categorized as secondary sources.

\*\*\* Proposed Regulations are not binding. That is, a taxpayer is not required to follow the guidance in the Proposed Regulation unless (or until) the Regulation becomes final. This could lead to the categorization of a Proposed Regulation as a secondary source.

**Figure 2-1**

**Location of Judicial Sources**

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

Series Series Series Series Series Series**a**

U.S. District

Courts

(tax cases) Yes Yes Yes No No No

U.S. Tax

Court**b**No**c** No**c** No No No No

U.S. Court

of Federal

Claims**d**

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

U.S. Courts of

Appeal

(tax cases) Yes Yes No Yes No No

U.S. Supreme Ct.

(tax cases) Yes Yes No No No Yes

U.S. District

Courts **f**

(all cases) No No Yes No No No

U.S. Courts of

Appeal

(all cases) No No No Yes No No

U.S. Supreme

Court

(all cases) No No No No No Yes

**Notes for Figure 2-1:**

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

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

**c** Both CCH and RIA have separate reporters for Regular, Memorandum, and Small Cases Division decisions of the U.S. Tax Court.

**d** All decisions (both tax and nontax) of the U.S. Court of Federal Claims are published by the U.S. GPO in the *Claims Court Reporter Series*. From 1960 to October 1, 1982, Court of Claims decisions were published in the *Court of* *Claims Reporter Series*.

**e** From 1932 to 1960, the Court of Claims decisions were published in the *F.Supp*. *Series*. Beginning October 1982, the Claims Court decisions are published in the *Claims Court Reporter*. Beginning on October 30, 1992, the Claims Court underwent a further name change. The new designation, U.S. Court of Federal Claims, begins with Volume 27 of the former *Cl.Ct.* (West citation) now abbreviated as *Fed.Cl*.

**f** “All cases” has reference to nontax as well as tax decisions. Thus, it would include such varied issues as interstate transportation of stolen goods, civil rights violations, and anti-trust suits.