4TH EDITION

CONTEMPORARY TAX PRACTICE

Research, Planning and Strategies

CCH® PUBLICATIONS

John O. Everett
Cherie Hennig
Nancy Nichols

Wolters Kluwer

4th
EDITION

CONTEMPORARY TAX PRACTICE

Research, Planning and Strategies

JOHN O. EVERETT
CHERIE HENNIG
NANCY NICHOLS

Wolters Kluwer

EDITORIAL STAFF
Production: Jennifer Schencker
Design: Craig Arritola

2700 Lake Cook Road
Riverwoods, IL 60015
800 248 3248
CCHGroup.com

Preface

This is not your parents' tax textbook.

This was the first sentence in the Preface to the first edition of this textbook, and continues to be a guiding principle in this fourth edition.

Our purpose in writing this text was to provide a comprehensive resource for a second course in taxation that touches all bases of contemporary tax practice: research, planning, and compliance. As a result, this text looks quite a bit different from other second-course tax textbooks in the market.

The combination of the 150-hour accounting program and increasing student interest in a tax specialty has created somewhat of a quandary in planning for a second or advanced course in the tax sequence. Historically, a second undergraduate course in taxation has been devoted to comprehensive coverage of corporations, along with an overview of other tax entities and a brief introduction to federal transfer taxes. If these two courses were required, then a follow-up, general-purpose graduate tax course was usually devoted to tax research, or perhaps to a more theoretical transactional approach to tax planning.

With the advent of the 150-hour program, many accounting programs limit tax coverage to just two courses for the non-tax specialist. Then the question becomes exactly what should be in this second course? This inevitably leads to a push and pull between a comprehensive corporate course using a legal treatise, or some variation of the typical tax research course plus limited coverage of special topics. As a result, some basic coverage of other entities in current second undergraduate courses falls through the cracks.

Contemporary Tax Practice: Research and Planning Strategies is designed to close the gap between these two approaches for a second course, and at the same time provide a solid tax foundation for beginning an accounting career. Our text provides comprehensive coverage of tax research and tax planning strategies, as well as special topics such as the financial accounting tax accrual and tax reform proposals. And for those basic tax topics that might fall by the wayside due to the constraints of a two-semester sequence, we offer a number of comprehensive tax tutorials on our webpage.

When developing this text, our vision was a simple one: *This will be a research text, and much, much more.* First of all, we have included all the features that you would expect in a tax research text:

- A comprehensive introduction to tax authorities, with separate chapters examining legislative, administrative and judicial authorities in detail (Chapters 1, 2, and 3).
- A thorough discussion of locating tax authority with various online tax services, and assessing the relative value of such authority (Chapter 4).
- Numerous research questions that test the research skills of the user; every chapter includes sets of research questions.
- An informative introduction to tax procedures, administration, and sanctions, including current reporting and disclosure controversies (Chapter 9).
- An overview of a typical tax engagement, with a special emphasis on written tax communications (Chapter 10).

But *Contemporary Tax Practice: Research and Planning Strategies* includes much, much more. By moving some of the basic coverage of various tax entities to the web tutorials, we are able to shift gears and provide a much deeper understanding of the legal underpinnings of our tax law and related planning strategies. This coverage includes a number of topics you would *not* expect in the typical tax research text:

- A thorough review and analysis of the leading judicial decisions involving gross income, deductions, property transactions, and accounting periods and methods, including a review of tax principles applicable to each topic and commentary on the importance of each decision and events subsequent to each decision (Chapters 5, 6, 7, and 8).
- An extensive discussion of tax planning opportunities related to individuals, retirement planning, closely-held businesses, and gift and estate taxes (Chapters 11, 12, 13, 14, and 16).
- A unique chapter devoted solely to the choice of business entity decision, from both a tax and a non-tax perspective, with a comprehensive Case Study and Excel model that brings to life the tax factors involved in such a decision (Chapter 15).
- A concise and insightful introduction to the tax accrual for financial accounting purposes, including coverage of ASC Topic 740, formerly FASB 109 and FIN 48, and book-tax reconciliations on Schedule M-3 (Chapter 17).
- An introduction to current proposals for reforming the tax laws, including the Fair Tax, the flat tax, the USA tax, and the value-added tax (Chapter 18).

To quote a Chinese proverb, *"I hear and I forget. I see and I remember. I do and I understand."* In order for students to gain a full understanding of the tax research, planning, and compliance processes in today's practice, they must work with examples, case studies, and planning techniques that incorporate the tax law in a meaningful way. And in this regard, *Contemporary Tax Practice: Research and Planning Strategies* offers five significant supplemental benefits. Specifically, adopters will be provided access to:

- ***RESEARCH:*** **CCH's IntelliConnect®**—the professional research package with fully integrated full-text primary source documents, analysis, and current tax news, including federal, state, and international tax. Users learn how to do tax research on the CCH industry-leading platform and are also able to answer the research questions found in each chapter.

- ***COMPLIANCE:*** **ProSystem *fx* Tax,** the award-winning tax compliance and preparation software package from CCH—one of the leading tax return preparation packages in the industry.

- ***PLANNING:*** The text **Website** (*CCHGroup.com/ContemporaryTax*) contains numerous tax planning case studies, with comprehensive Excel spreadsheet models that analyze such topics as the individual alternative minimum tax, choice of business entity, retirement plan projections, fringe benefits, grantor retained annuity trusts, and other planning scenarios discussed in Chapters 11 through 16. Also included are spreadsheet cases examining C to LLC conversions and estate executor elections. Most chapters also include supplemental tax planning questions for assignment. In addition, **CCH's IntelliConnect®** offers a number of valuable planning aids, including the *Tax Tools* and *Financial and Estate Planning* sections of the website.

- ***INTERACTIVE TAX TOPIC TUTORIALS:*** The text **Website** (*CCHGroup.com/ContemporaryTax*) includes interactive tutorials for the basic tax laws applicable to individuals, corporations, and other entities, as well as the gift and estate tax, designed to bring students of various

tax backgrounds up to speed with current tax law. These interactive tutorials flesh out the fundamentals of various topics covered in the planning chapters of the text, such as corporate formations, corporate distributions, partnership formations, S corporation requirements, and fiduciary income tax issues. These tutorials help ensure that students who take the CPA Examination are exposed to all topics listed in the specified examination content outlines.

- ***STUDENT LEARNING AIDS:*** The text includes access to a dedicated product **Website** that features online interactive quizzes, tax news updates, and more. The organization of this text is flexible enough so that individual segments can stand alone.

Please visit *cchgroup.com/Resources* for any periodic updates or clarifications that may become available for Contemporary Tax Practice 4th Edition as well as Tax Briefings and other valuable resources.

This marks the fourth edition of this text, and the authors are delighted with the response to the first three editions. We wish to thank many of our colleagues and students for their suggestions in designing and improving the presentation of the material. As always, we welcome any comments on the text and ancillaries.

September 2016

John O. Everett
Cherie J. Hennig
Nancy N. Nichols

About the Author

John O. Everett, Ph.D., CPA, is Professor Emeritus of Accounting at Virginia Commonwealth University in Richmond, VA. John began his career as an IRS agent, and he has served as a speaker and instructor for numerous professional education programs, including the national training courses of Ernst & Young and McGladrey & Pullen. A graduate of Oklahoma State University, he has authored or coauthored a number of articles in academic and professional journals, including The *Journal of the American Taxation Association*, *Journal of Legal Tax Research*, *Accounting Horizons*, *Issues in Accounting Education*, *Journal of Accounting Education, Advances in Accounting*, *The Journal of Accountancy*, *The CPA Journal*, *The Journal of Taxation*, *Taxes*, *Tax Notes*, and *The Tax Adviser*. He is the coauthor of several books, including *Tax Point* with Cherie Hennig, the first interactive tax textbook on the Web, and CCH's *Practical Guide to Schedule M-3 Compliance* with Cherie Hennig and William Raabe, a comprehensive reference source. John was the 2007 awardee of the Ray M. Sommerfeld ATA/E&Y Tax Educator of the Year, and is a previous recipient of the American Taxation Association Outstanding Service Award.

Cherie J. Hennig, Ph.D., M.B.A., began her career as an IRS Revenue Agent in Denver, CO. She has taught undergraduate and graduate tax courses at University of North Carolina, Wilmington, Florida International University, Colorado State University, the University of South Florida, and Virginia Tech. She has published articles in leading tax journals, co-authored two tax texts and written and taught numerous continuing professional education courses. Her articles have appeared in such journals as *The National Tax Journal*, *The Journal of the American Taxation Association*, *Advances in Taxation*, *Issues in Accounting Education*, *Journal of Legal Tax Research*, *Journal of Accountancy*, *Advances in Accounting Behavioral Research, Tax Notes*, *Accounting Horizons*, *Journal of Taxation*, *Taxes*, *Journal of International Taxation,* and *The Tax Adviser*. She is a member of the American Taxation Association and the American Institute of CPAs. She co-authored with John Everett and Nancy Nichols the text, *Contemporary Tax Practice: Research, Planning and Strategies*, published by Wolters Kluwer. She also co-authored with John Everett and William Raabe the text, *Practical Guide to Schedule M-3 Compliance,* published by Wolters Kluwer. Cherie also coauthored with John Everett, *Tax Point*, the first interactive tax textbook on the Web. She has taught numerous CPE courses for professional organizations. Cherie received the American Taxation Association, 2007 Outstanding Service Award. She served on the Tax Executive Committee of the AICPA and the Editorial Board of the ATA Journal of Legal Tax Research.

Nancy Nichols, Ph.D., CPA, is the Journal of Accounting Education Research Professor at James Madison University. She also serves as the Director of the Masters in Accounting program. Prior to obtaining her Ph.D. at the University of North Texas, Nancy was a tax partner at Deloitte and Touche. She teaches graduate and undergraduate courses in taxation. With primary research interests in the areas of taxation and segment reporting, she has published numerous articles in such journals as the *Journal of the American Taxation Association, Journal of Legal Tax Research, Accounting Horizons, Journal of Accountancy, Journal of International Accounting, Auditing and Taxation, Issues in Accounting Education, Journal of Accountancy, The CPA Journal, Tax Notes,* and *Journal of Taxation*. Nancy is an active member of American Taxation Association and serves on the Editorial Board of the ATA Journal of Legal Tax Research.

Acknowledgments

Special thanks to Jennifer Schencker, Associate Editor and Coordinator, and Craig Arritola, Senior Graphic Designer, at Wolters Kluwer for their outstanding work in this new-look edition, from editing to modifying the appearance of the book. Thanks also to Kurt Diefenbach, Managing Editor at Wolters Kluwer, for his support, encouragement and invaluable advice in overseeing this project to completion.

Contents

		Page
Chapter 1	Legislative Sources of Authority	1-1
Chapter 2	Administrative Sources of Authority	2-1
Chapter 3	Judicial Sources of Authority	3-1
Chapter 4	Tax Research—Locating and Assessing Tax Authority	4-1
Chapter 5	Landmark Judicial Decisions—Income	5-1
Chapter 6	Landmark Judicial Decisions—Deductions	6-1
Chapter 7	Landmark Judicial Decisions—Property Transactions	7-1
Chapter 8	Landmark Judicial Decisions—Accounting Records, Accounting Methods and Income Allocations	8-1
Chapter 9	Tax Practice—Procedures, Administration and Sanctions	9-1
Chapter 10	Tax Communications Between the Client, Tax Preparer and the IRS	10-1
Chapter 11	Tax Planning for Individuals	11-1
Chapter 12	Tax Planning for Compensation and Retirement	12-1
Chapter 13	Gift and Estate Tax Planning I—The Basics	13-1
Chapter 14	Gift and Estate Tax Planning II—Trusts and Closely-Held Business Strategies	14-1
Chapter 15	Business Planning—Choice of Entity	15-1
Chapter 16	Tax Planning Strategies—Business Entities	16-1
Chapter 17	The Tax Accrual: An Introduction to Financial Accounting Issues	17-1
Chapter 18	Tax Reform Proposals	18-1
	Glossary	G-1
	Topical Index	I-1

Table of Contents

Paragraph

CHAPTER 1 Legislative Sources of Authority

Introduction 1001
An Introduction to Tax Authority 1003
Legislative Authority: A Historical Perspective 1005
The Legislative Process 1007
The Internal Revenue Code: A Closer Look 1009
Evaluating and Locating Legislative Authority 1011
"Substantial Authority" in Tax Controversies 1013
Summary 1015

CHAPTER 2 Administrative Sources of Authority

Introduction 2001
An Introduction to Administrative Authority 2003
Regulations 2005
Revunue Rulings 2007
Revenue Procedures 2009
Private Letter Rulings (PLRs) 2011
Other Forms of Letter Rulings: Technical Advice Memoranda (TAMs), Field Service Advices (FSAs), and Determination Letters 2013
Miscellaneous Technical Guidance 2015
Informational Releases of the IRS 2017
Audit-Related Releases 2019
Compliance-Related Releases 2021
Summary 2023

CHAPTER 3 Judicial Sources of Authority

Introduction 3001
The Court's Authority 3003
The U.S. Tax Court 3005
The U.S. District Court 3007
The U.S. Court of Federal Claims 3009
The Courts of Appeal 3011
The U.S. Supreme Court 3013
Locating and Citing Judicial Authority 3015
Reading and Assessing Court Opinions 3017
Factors to Consider in Choosing a Court 3019
Summary 3023

CHAPTER 4 Tax Research—Locating and Assessing Tax Authority

Introduction 4001
Types of Tax Research 4003
Steps in Tax Research 4005
The Research Memo 4007
The Client Letter 4009
Electronic Tax Services—An Introduction 4011
Print Services—Code-Based Versus Topic-Based 4013
The Current Players—An Historical Perspective 4015
Exercise 1: Going Directly to a Particular Code Section 4017
Formulating a Search Expression 4019
Performing a Citator Search with the Standard Federal Income Tax Reporter 4023
Checkpoint 4025
Performing a Menu-Walk Search with Checkpoint's Federal Tax Coordinator 2nd 4027
Performing a Citation Search with Checkpoint's Federal Tax Coordinator 2nd 4029
Summary 4031

CHAPTER 5 Landmark Judicial Decisions—Income

Introduction 5001
Objectives of Taxation—The Macro View 5003
Considerations in Measuring Taxable Income 5005
Income Recognition and Accounting Methods 5007
Concepts Overriding Accounting Method Elections 5009
Landmark Income Cases—The Realization Concept 5011
Landmark Income Cases—Windfall Gains 5013
Landmark Income Cases—Accounting Methods 5015
Assignment of Income Issues 5017
Summary 5019

CHAPTER 6 Landmark Judicial Decisions—Deductions

Introduction 6001
The Four Positive Criteria of a Deduction 6003
The Four Negative Criteria of a Deduction 6005
Accounting for Expenses Under the Cash Method 6007
Accounting for Expenses Under the Accrual Method 6009
Economic Performance: When Does It Occur? 6011
Landmark Deduction Cases—Testing the Criteria 6013
Landmark Deduction Cases—Business v. Personal 6015
Landmark Deduction Cases—Methods of Accounting 6017
Summary 6019

CHAPTER 7 Landmark Judicial Decisions—Property Transactions

Introduction 7001
The Capital Asset Definition 7003
The Capital Gain and Loss Netting Process for Individuals 7005
Capital Gain and Loss Netting Process—Corporations 7007
The Special Case of Code Sec. 1231 Properties 7009
Nontaxable Exchanges of Property 7011
Landmark Property Cases—The Capital Asset Definition 7013
Landmark Property Cases—The Realization Principle 7015
Landmark Property Cases—Nontaxable Exchanges 7017
Summary 7019

CHAPTER 8 Landmark Judicial Decisions—Accounting Records, Accounting Methods and Income Allocations

Introduction 8001
Accounting Records Cases 8003
Special Accounting Method Cases 8005
Income Allocation Method Cases 8007
Summary 8009
Appendix A: Is the Affordable Care Act's Shared Responsibility Payment a Tax? *The National Federation of Business v. Sebilius Case* 8010

CHAPTER 9 Tax Practice—Procedures, Administration and Sanctions

Introduction 9001
Role and Structure of the Internal Revenue Service 9003
Taxpayer Rights 9005
Selecting a Return for Audit 9007
Types of IRS Examinations 9009
Working with an Auditor 9011
Possible Audit Outcomes 9013
Interest 9015
Statute of Limitations 9017
Penalties 9019
Civil Penalties Applicable to Taxpayers 9021
Criminal Penalties Applicable to Taxpayers 9023
Penalties Applicable to Tax Return Preparers 9025
Civil Penalties Applicable to Preparers 9027
Criminal Penalties Applicable to Preparers 9029
Reportable Transactions 9031
Administrative Constraints: Circular 230 9033
Statements of Standards for Tax Services 9035
Summary 9037

CHAPTER 10 Tax Communications Between the Client, Tax Preparer and the IRS

Introduction 10,001
Why Keep Records? 10,003
Recordkeeping for Individuals 10,005
Recordkeeping for Businesses 10,007
Sample Recordkeeping System 10,009
Tax Preparer Workpapers 10,011
Best Practices for Tax Advisors 10,013
Summary 10,015

CHAPTER 11 Tax Planning for Individuals

Introduction 11,001
Tax Planning Constraints: The Alternative Minimum Tax 11,003
The Individual AMT Computation: A Comprehensive Example 11,005
Tax Planning Constraints: The Passive Activity Limitations 11,007
Tax Planning Constraints: The Investment Interest Limitations 11,009
Tax Planning Constraints: Additional Taxes Under the Affordable Care Act (ACA) 11,011
Tax Planning: Tax-Exempt Income and Fringe Benefits 11,013
Tax Planning: Capital Gains and Losses 11,015
Tax Planning: Rental Investments as Tax Shelters 11,017
Tax Planning: Selected Personal Deductions 11,019
Tax Planning: Vacation Rental Homes 11,021
Tax Planning: College Education Expenses for Children 11,023
Summary 11,025

CHAPTER 12 Tax Planning for Compensation and Retirement

Introduction 12,001
Nontaxable Fringe Benefits: A Brief Review 12,003
Cafeteria Plans, FSAs, HRAs, and HSAs 12,005
Deferred Compensation: Qualified Plans 12,007
Code Sec. 401(k) Cash or Deferred Arrangements (CODAs) 12,009
SEP and SIMPLE Retirement Plans 12,011
Individual Retirement Accounts (IRAs) 12,013
Pension Maximization Strategies 12,015
Other Deferred Compensation Strategies 12,017
Summary 12,019

CHAPTER 13 Gift and Estate Tax Planning I—The Basics

Introduction 13,001
The Unified Transfer Tax System in General 13,003
The Federal Gift Tax 13,005
The Federal Estate Tax 13,007
The Generation-Skipping Transfer Tax 13,009
Planning Basics—Lifetime Gifts 13,011
Planning Basics—Minimizing Probate Costs 13,013

Planning Basics—Optimizing the Estate Marital Deduction 13,015
Summary 13,017

CHAPTER 14 Gift and Estate Tax Planning II—Trusts and Closely-Held Business Strategies
Introduction 14,001
Powers of Appointment—Tax Considerations 14,003
Trusts: Classification as Revocable and Irrevocable 14,005
Irrevocable Transfers with a Retained Life Estate: General Tax Consequences 14,007
Insurance Trusts and Trusts for Minors 14,009
Trusts and Charitable Contributions 14,011
Estate Freezes—An Introduction 14,013
Installment Sales as a Freeze Strategy 14,015
Using Trusts for Estate Freezes 14,017
Minority Discount Strategies for Family-Held Businesses 14,019
The Limited Partnership as an Estate Planning Tool 14,021
Utilizing the Intentionally Defective Irrevocable Trust 14,023
Documenting and Implementing an Estate Plan 14,025
Summary 14,027

CHAPTER 15 Business Planning—Choice of Entity
Introduction 15,001
Business Entities: An Introduction 15,003
Importance of the Choice of Entity Decision 15,005
The Sole Proprietorship as a Business Entity 15,007
The Partnership as a Business Entity 15,009
The S Corporation as a Business Entity 15,011
The C Corporation as a Business Entity 15,013
A Note on Personal Services Corporations (PSCs) 15,015
Limited Liability Companies and Limited Liability Partnerships 15,017
Miscellaneous Considerations in Choice of Entity 15,019
Choice of Entity: Final Summaries 15,021
A Multi-year Spreadsheet Model for Assessing the Tax Consequences of Each Entity Type 15,023
Summary 15,025

CHAPTER 16 Tax Planning Strategies—Business Entities
Introduction 16,001
Adopting and Changing a Method of Accounting 16,003
Inventory Method Issues—Planning Possibilities 16,005
Tax Planning—Acquisition, Use and Disposition of Property 16,007
Corporate Planning Ideas 16,009
Summary 16,011

CHAPTER 17 The Tax Accrual: An Introduction to Financial Accounting Issues

Introduction 17,001
Book-Tax Differences 17,003
Income Taxes in the Financial Statements 17,005
Valuation Allowance 17,007
Earnings of Foreign Subsidiaries 17,009
Uncertain Tax Positions 17,011
Tax Reporting Requirements for Book-Tax Differences and Uncertain Tax Positions 17,013
Concluding Thoughts 17,015
Summary 17,017

CHAPTER 18 Tax Reform Proposals

Introduction 18,001
Perceived Deficiencies of the Current Tax System 18,003
Tax Reform Proposals: The View from 10,000 Feet 18,005
Tax-inclusive and Tax-exclusive Rates 18,007
The Value-Added Tax 18,009
National Retail Sales Tax 18,011
Flat Tax 18,013
Personal Consumption Taxes 18,015
Modifying the Current System: The President's 2010 National Commission on Fiscal Responsibility and Reform Plan 18,017
Concluding Thoughts 18,019
Summary 18,021

GLOSSARY OF TAX TERMS G–1
TOPICAL INDEX I–1

Chapter

1

Legislative Sources of Authority

LEARNING OBJECTIVES

1. Distinguish between primary and secondary tax authority.
2. Understand the historical development of the tax law.
3. Describe the legislative process for a tax bill.
4. Detail the organization of the Internal Revenue Code.
5. Differentiate substantial authority and reasonable basis in tax practice.

¶1001 INTRODUCTION

Traditionally, tax practice is divided into three distinct components: research, planning, and compliance. But these are not mutually exclusive categories, and one of the purposes of this text is to demonstrate the relationships of all three activities.

The first half of this course is devoted to tax research, the process of examining various primary and secondary sources to determine the answer to a tax question. The last half of the course is devoted to tax planning, the orderly process of arranging one's affairs to minimize tax liabilities. But successful tax planning strategies often depend on solid research so that the strategy chosen will withstand judicial scrutiny.

Tax research and planning are also a significant part of the compliance work in contemporary tax practice. For example, changing accounting methods may require extensive research to develop a justification to the IRS for the change, and may require a substantial tax planning effort to determine which change is most tax-benefit efficient. Only after these questions are answered can the complex compliance task of completing Form 3115 (Application for Change in Accounting Method) and accompanying schedules describing the change be completed.

This text is devoted primarily to tax research and tax planning. The first three chapters introduce the major sources of legislative, administrative, and judicial authorities, collec-

tively known as **primary authority**. The first type of tax authority, legislative authority, is discussed in the remainder of this chapter. Chapter 4 introduces the various print and electronic tax services that aid practicing tax professionals in locating the answer to a tax research, planning or compliance question. Chapters 5 through 8 expand the discussion of tax authority, and review quite a bit of tax law as well, by examining the landmark judicial decisions involving income; deductions; property transactions; and accounting records, methods, and income allocations.

The last half of the text is devoted to procedural issues and tax planning strategies. Chapter 9 reviews the maze of administrative and procedural constraints dominating contemporary tax practice, including taxpayer and preparer penalties. Chapter 10 provides an anatomy of a tax engagement, from beginning to end, with a special emphasis on tax communications. Chapters 11 through 16 introduce common and not-so-common tax planning strategies related to individuals, retirement, basic and advanced transfer tax issues, choice of business entity, and small closely-held businesses.

Finally, the last two chapters of the text introduce two broader aspects of contemporary tax practice. First, Chapter 17 introduces the role of taxes in financial accounting issues by reviewing the tax accrual and the impact of ASC 740. And lastly, Chapter 18 examines the debate over tax reform by examining the pros and cons of various tax reform ideas proposed in recent years.

¶1003 AN INTRODUCTION TO TAX AUTHORITY

.01 Primary vs. Secondary Tax Authority

In researching a tax question, it is extremely important to understand the difference between primary tax authority and secondary tax authority. Although both sources may be consulted in attempting to find the answer to a tax question, the actual answer must always relate to a primary authority.

Primary tax authority, the "official" body of tax law, consists of the Internal Revenue Code as drafted by Congress, Regulations and other pronouncements of the Department of the Treasury, and judicial decisions devoted to tax issues. The answer to a tax question must necessarily be traced back to a primary tax authority.

Secondary tax authority refers to various "unofficial" sources of tax information, such as textbooks, journal articles, commentaries, tax service editorial comments, and even this text. Secondary services are primarily devoted to finding, interpreting and explaining primary authority. These sources, while possibly being very informative and technically accurate, do not represent the tax law and should not be used to justify a position taken on a tax return.

.03 Legislative, Administrative and Judicial Authorities

Primary tax authority may be broken into three categories: legislative, administrative, and judicial. **Legislative authority** refers to tax authority enacted by the legislative body, the United States Congress. Tax bills passed by Congress are added to *Title 26* of the U.S. Code and have the force and effect of law, unless they are found to be unconstitutional. As explained later in this chapter, legislative authority also includes the various committee reports issued by the tax-writing committees in Congress, as well as tax treaties involving the United States.

Administrative authority includes all pronouncements of the executive branch of the federal government. Most tax administrative authority is drafted by the Department of Treasury and one of its major divisions, the Internal Revenue Service (IRS). The primary administrative authority is the tax Regulations, the official interpretations of the tax law by the Treasury and the IRS. Other sources of administrative authority, discussed in Chapter 2, are revenue rulings, revenue procedures, letter rulings, and various other notices and announcements.

Judicial authority refers to decisions of the federal courts on tax matters. As discussed in Chapter 3, a number of courts are asked to decide tax controversies, and these interpretations of the tax law are important components of tax authority. One court, the U.S. Tax Court, is devoted solely to tax cases, while other courts, such as the U.S. District Court and the Court of Claims, hear all kinds of civil and criminal cases, including some tax cases. U.S. Circuit Courts of Appeal, and to a lesser extent the U.S. Supreme Court, may hear tax cases as well.

¶1005 LEGISLATIVE AUTHORITY: A HISTORICAL PERSPECTIVE

The power to tax is specifically defined in the Constitution. Article 1, Section 8, Clause 1 states that "*The Congress shall have the power to lay and collect taxes, duties, imports and excises, to pay the debts and provide for the common defense and general welfare of the United States*." But this power has not always been exercised by Congress. The following discussion provides a chronological record of taxation in the United States and highlights several concepts that remain important in contemporary tax practice.

- ***1643.*** The first attempt to tax incomes in the United States was in 1643, when several colonies instituted what was called a *faculties and abilities tax*. This was a modest tax, with tax collectors literally going door to door and asking if the individual had income during the year. If so, the tax was computed on the spot. Needless to say, there were substantial compliance problems with this system.

- ***1700s–1800s.*** In the early 1700s and well into the 1800s, a number of the southern colonies and states adopted an income tax modeled on the tax instituted in England. This was basically a tax on income, and not on property. The British theory was that you tax the income from property, and not the property itself (i.e., "tax the fruit, but not the tree.") Thus, gains or losses on sales of property were not subject to taxation.

- ***1861–1873.*** In 1861, the Union enacted the first federal income tax, designed to help finance the civil war. Tax rates were three percent on income exceeding $600 and less than $10,000, and five percent on income exceeding $10,000. The tax, though modest, did provide substantial funds for the war effort. After the war when the need for federal revenues decreased, Congress let the tax law expire in 1873.

- ***1880.*** During the 1870s, a number of individuals had challenged the validity of the federal income tax. In 1880, one of these cases had worked its way to the U.S. Supreme Court. In *Springer vs.* U.S.,[1] the taxpayer contended that the income tax on his professional earnings and personal property income violated the "direct tax" requirement of the Constitution. At this time, it was hard for the Supreme Court to be interested in a case involving a tax that expired seven years earlier, and perhaps to avoid the chaos that a decision for the taxpayer would generate, the Court unanimously sided with the government. In effect, the Supreme Court concluded that the income tax was an excise tax, and not a capitation tax (based on population) or a property tax.

[1] *Springer vs. U.S.*, 102 US 586.

- ***1894.*** By 1894, Congress's appetite for more revenues had increased, so a new tax law was passed that year. This was a controversial provision, and the law passed with the signature of President Grover Cleveland. The tax, though modest, received much more attention during times of peace.
- ***1895.*** Once again, a taxpayer challenged the legality of the income tax. In *Pollock v. Farmers' Loan and Trust Co.*,[2] a taxpayer sued the corporation in which he owned stock, contending that they should never have paid the income tax because it was unconstitutional. In this case, the tax was paid on income from land, and Pollock argued that since a tax on real estate is a direct tax, a tax on the income from such property must be a direct tax as well. And since the Constitution prohibits a direct tax unless certain conditions are met, the income tax should be declared unconstitutional. The direct tax argument was also used by Springer in 1880, but now the Court focused more closely on the possible conflict with the Constitution. The provision in question was Article 1, Section 9, Clause 4 of the Constitution. This clause stated the following:

  1. "But all duties, imposts, and excises shall be uniform throughout the United States."
  2. "No capitation, or other direct tax shall be laid, unless in proportion to a census or enumeration herein before to be taken."

In effect, this clause required any direct tax to be based on a census. For example, if the government desired to raise $10 million, and New York had 20 percent of the total U.S. population at that time, then New York would be required to raise $2 million. And if New York had 1 million residents, each resident would owe $2 in taxes. Obviously, a tax based on income could not achieve such proportionality, since incomes differed across individuals. This time, in a 5-4 decision, the Supreme Court ruled that the income tax was unconstitutional. A few days after the initial vote, the Court revoted and reached the same result. Thus, the tax law was ruled unconstitutional, and was effectively repealed.

- ***1909.*** Congress took two actions in 1909 to deal with their increasing revenue needs. First, they passed a corporate income tax, but labeled it an excise tax on the privilege of doing business. The tax was set at one percent on all incomes exceeding $5,000. Secondly, Congress passed the 16th Amendment, which would eliminate the apportionment requirement. This amendment reads as follows:

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

- ***1911.*** The U.S. Supreme Court upheld the corporate "excise tax" as constitutional in *Flint v. Stone Tracey*.[3] The court ruled that the tax was a "special excise tax on the privilege of doing business."
- ***1913.*** The required three-fourths of the states ratified the 16th Amendment, thus adding the amendment to the constitution. Congress then immediately enacted the first "constitutional" tax law, the *Revenue Act of 1913*. The tax ranged from one percent on income exceeding $3,000 to seven percent on incomes exceeding $500,000. For the first time, this statute introduced the notion of a **progressive tax rate** structure (i.e., the tax rate increases as the base, income in this case, increases).

[2] *Pollock v. Farmers' Loan and Trust Co.*, 158 US 601.
[3] *Flint v. Stone Tracey*, 220 US 107.

- ***1916.*** The U.S. Supreme Court upheld the progressive income tax as constitutional in *Brushaber v. Union Pacific Railroad Co.*[4]
- ***1916–1939.*** During this period, Congress passed a total of 17 different revenue acts devoted to taxation. These were all independent pieces of legislation, as Congress did not bother to eliminate inconsistencies, deadwood provisions, or modifications contained in prior acts. Thus, a person trying to find the answer to a tax question would need to search all 17 Acts. Congress solved this problem in 1939 by merging all of the acts into one cohesive body of tax law titled the *Internal Revenue Code of 1939*. The term "Code" was used to signify that all prior acts had been "codified" into a single location, with inconsistencies and deadwood provisions eliminated.
- ***1954.*** Following numerous amendments to the Code after 1939, Congress decided to once again reorganize the Code. Amendments were merged into the Code, the organization was changed to flow more logically, and the title was changed to the *Internal Revenue Code of 1954*.
- ***1986.*** Following major changes in the Code as part of the Tax Reform Act of 1986, Congress decided to change the name of the Code to the *Internal Revenue Code of 1986*. However, the organizational pattern of the 1954 re-codification was retained, so in essence the 1986 change was in name only.
- ***1993, 1996, 2001, 2004.*** Major tax legislation was enacted in each of these years, amending the Internal Revenue Code.

This brief historical review provides insight into a number of current Code provisions encountered in tax practice. For example, when determining "earnings and profits" of a corporation for purposes of classifying dividends, no amounts prior to March 1, 1913, are included (this is the date of enactment for the *Revenue Act of 1913*). Similarly, if a taxpayer is forced by the IRS to make an accounting methods change, the cumulative adjustment to income required for such a change will not include any amounts generated prior to 1954 (the date of the second codification of the Code).

Observation

The 1954 re-codification involved an extensive reordering and renumbering of the Code. For example, Sec. 17(j) of the 1939 Code is now Code Sec. 1231 under the 1954 reorganization. Practitioners researching questions involving statutes enacted prior to 1954 need to cross-check Code reference numbers between the two codes. Most major tax services furnish tables providing these cross references.

¶1007 THE LEGISLATIVE PROCESS

.01 Introduction

Benjamin Disraeli, a famous British politician of the 19th century, once commented that "*There are two things one should never watch: sausage-making and tax legislation.*" The process is indeed complicated, and the path to final passage is often torturous and filled with back-room deals

[4] *Brushbaber v. Union Pacific Railroad Co.*, SCt, 1 USTC ¶4, 240 US 1, 36 SCt 236.

and hidden agendas. Nonetheless, taxes are an important part of everyday life today, and, as Justice Oliver Wendell Holmes once said, *"Taxes are the price we pay for a civilized society."*

It is important to understand how the legislative process operates, not only from a historical perspective but also from the need to understand how several by-products of the process are important sources of legislative authority. But before examining the process in detail, perhaps one question should be asked: Exactly what *is* a tax? How is a tax defined?

.03 Definition of a "Tax"

There have been many definitions of a tax over the years, but perhaps the most succinct and accurate definition was coined by Ray Sommerfeld years ago: *A tax is a nonpenal yet compulsory transfer remitted for the public good.*[5]

Each phrase in this definition is important. First of all, a tax is not a penalty; in theory, taxpayers receive something of value in return, such as those elements of a civilized society referred to by Justice Holmes. Secondly, even though we describe our tax system as a "voluntary self-assessment system," in reality the system becomes rather involuntary (fines, jail sentences, etc.) if one does not pay his or her share of taxes. So taxes are indeed compulsory transfers. Finally, the exact use of taxes collected by the government is not specified in advance; rather, such collections are used for the public good. The determination of the public good is made by Congress as part of the separate budget process.

.05 The Legislative Process—Origins of a Tax Bill

Although individual members of Congress sometimes author important pieces of a comprehensive tax bill, as a practical matter the process is usually driven by the Administration currently in power. Generally, the staffs of the Department of Treasury are heavily involved in crafting the wishes of the Administration into tax policy, and the initial draft of the bill is presented by the Secretary of the Treasury to Congress. This large bureaucracy includes a number of highly-skilled economists, attorneys, accountants, statisticians, and other professionals.

There are other important players at the beginning of the legislative process. Perhaps more than any other group, the staffs of the two tax writing committees described below (House Ways and Means and Senate Finance Committees) have a major influence on tax legislation. These are bright, highly-skilled individuals with extensive tax knowledge, though generally not much practical experience. Each of these staffs number in excess of 100. In addition, various think tanks, nonprofit organizations and lobby groups manage to leave their imprints on tax legislation as well.

Another key player in the legislative process is the Joint Committee on Taxation (JCT). This committee has 10 members composed of the 5 ranking members of the House Ways and Means and Senate Finance Committees. But it is really the large and experienced staff of this committee that does the heavy lifting in the tax process. JCT staffers work with the two committees in drafting bills and committee reports. They also draft a final report on the new laws after enactment, generally referred to as the "Blue Book," which is discussed below.

Observation All of these players in the tax process are sometimes referred to as the "kitchen bureau," in that all are trying to serve as cooks in the same kitchen.

[5] Sommerfeld, Ray, M, Hershel M. Anderson, and Horace Brock, *An Introduction to Taxation* (Harcourt Brace Jovanovich, Inc., 1967), 2.

.07 The Legislative Process—The House of Representatives

Article 1, Section 7 of the Constitution requires that all tax bills originate in the House of Representatives. The first stop is the House Ways and Means Committee, the primary group devoted to revenue measures. This committee has had a varying number of members over the years, and (1) the membership is apportioned based on the relative numbers of the two parties in the house, and (2) the chair is from the majority party. **Figure 1** lists the members of the committee for the 114th Session of Congress, which began its two-year session in January, 2015.

Observation

Although the Constitution states that all revenue bills must originate in the House, this did not occur in 1982. In that year House Democrats insisted that if the Reagan Administration wanted to raise taxes that year, then they should start the bill in the Senate, which was controlled by the Republicans. Democrats were still smarting from the publicity given the Republicans for cutting taxes in 1981, and when a desperate need for raising revenues occurred in 1982 due to ballooning deficits, they wanted to make sure that the Republicans received "credit" for raising taxes.

The first order of business for the House Ways and Means Committee upon receiving a tax proposal is to call public hearings. Anyone can submit written testimony, but the Committee decides who will provide oral testimony. By tradition, the Secretary of the Treasury is the first person to testify on the proposed legislation.

Following the public hearings, the Ways and Means Committee "marks up" the bill and begins debate on the merits of the bill. These hearings are open to the public (including the cameras of *C-SPAN* and other organizations), although closed sessions are sometimes called for the real horse-trading phase of the process. Eventually, the Committee will vote on the bill, which at this stage may look very different than the "marker" that was laid down at the start of the process. If a simple majority passes the bill, it is sent on to the floor of the full House of Representatives. If the bill is defeated, it is essentially dead for this session of Congress.

Figure 1

Kevin Brady, Texas (Chair)	Jason Smith, Missouri	Lloyd Doggett, Texas
Sam Johnson, Texas	Lynn Jenkins, Kansas	Mike Thompson, California
Jim Renacci, Ohio	Erik Paulsen, Minnesota	John B. Larson, Connecticut
Pat Meehan, Pennsylvania	Kenny Marchant, Texas	Earl Blumenauer, Oregon
Devin Nunes, California	Tom Reed, New York	Ron Kind, Wisconsin
Pat Tiberi, Ohio	Mike Kelly, Pennsylvania	Bill Pascrell, Jr., New Jersey
Dave G. Reichert, Washington	George Holding, North Carolina	Joseph Crowley, New York
Charles W. Boustany, Jr., Louisiana	Sander Levin, Michigan (Ranking Member)	Tom Rice, South Carolina
Peter J. Roskam, Illinois	Charles B. Rangel, New York	Danny Davis, Illinois
Kristi Noem, South Dakota	Jim McDermott, Washington	Linda Sanchez, California
Tom Price, Georgia	John Lewis, Georgia	Diane Black, Tennessee
Vern Buchanan, Florida	Richard E. Neal, Massachusetts	Todd Young, Indiana
Adrian Smith, Nebraska	Xavier Becerra, California	Bob Dold, Illinois

One important byproduct of the process in the Ways and Means Committee is the *Ways and Means Committee Report*. This detailed report, required of both tax-writing committees in Congress, contains four sections: (1) a draft of the legislation, (2) reasons for the changes, (3) an explanation of the changes, and (4) an estimate of the revenue effects of the change. This report is an important document for purposes of attempting to determine Congressional intent, as it may be years before the IRS gets around to drafting regulations that interpret a particular Code provision.

The full House of Representatives generally debates a bill under a **closed rule**, whereby the only person who may amend the bill is a member of the Ways and Means Committee. If the bill is eventually passed, it is sent on to the Senate; if the bill fails, it is effectively killed for that legislative session.

It is important to recall that the House Ways and Means Committee Report summarizes the activities of the committee up to the point that the bill is sent to the House floor. If a tax researcher wants additional details concerning the debate in the House, reference must be made to the **Congressional Record**. This document has a record of all exchanges on the floor of the House.

.09 The Legislative Process—The Senate

The first stop for legislation in the Senate is the Senate Finance Committee, the major revenue committee in the Senate. Once again, representation of the committee is proportionate to the full Senate membership, and the chair is always from the majority party. The current membership of this committee is disclosed in **Figure 2**.

The Senate Finance Committee more or less follows the same procedures used by the House Ways and Means Committee. However, there is no requirement that the Finance Committee start with the same bill that the House passed; in fact, it is a rare occurrence when they do. Public hearings are followed by a debate about the merits of the bill, and eventually a vote is taken. If the bill is passed by the Committee, it is sent to the floor of the full Senate.

Figure 2 114th Congress — Senate Finance Committee

Democrats	Republicans
Ron Wyde, Oregon	Orrin G. Hatch, Utah (Chair)
Mark Warner, Virginia	John Thune, South Dakota
Benjamin L. Cardin, Maryland	Richard Burr, North Carolina
Sherrod Brown, Ohio	Dan Coats, Indiana
Robert P. Casey, Pennsylvania	Mike Crapo, Indiana
Michael F. Bennet, Colorado	Pat Roberts, Kansas
Charles E. Schumer, New York	Johnny Isakson, Georgia
Debbie Stabenow, Michigan	Mike Enzi, Wyoming
Maria Cantwell, Washington	John Cornyn, Texas
Bill Nelson, Florida	Rob Portman, Ohio
Robert Menendez, New Jersey	Patrick J. Toomey, Pennsylvania
Thomas Carper, Delaware	Dan Heller, Nevada
Charles E. Grassley, Iowa	Tim Scott, South Carolina

The Senate Finance Committee also issues a comprehensive report of its activities, the *Senate Finance Committee Report*. This report includes the same four sections as the *House Ways and Means Committee Report*: (1) a draft of the legislation, (2) reasons for the changes, (3) an explanation of the changes, and (4) an estimate of the revenue effects of the change. Just like the *Ways and Means Committee Report*, the *Senate Finance Committee Report* is an important document for attempting to determine Congressional intent, as it may be several years before regulations are issued.

The Senate debates the bill under an **open rule**, whereby any Senator may propose amendments to the bill. Eventually, the Senate will vote on a bill, and this piece of legislation may have little in common with the bill passed by the House. If the bill is defeated, as a practical matter it is a dead issue for the session. If the bill passes, the next series of events depends on how different the two tax bills are. If there are only minor differences in the two bills, the Senate version of the bill may be sent back to the House for a concurring vote, and if approved, this bill is sent to the President for a signature.

As was true with the House, any details regarding amendments made on the floor of the Senate will not be described in the Senate Finance Committee Report. Once again, the *Congressional Record* must be consulted for details.

Observation

It has sometimes been said the "Representatives represent the people, and Senators represent property." This view is given additional credence when one closely follows the legislative process. Because the Senate operates under an open rule, this may be the first chance for outsiders to influence the bill. Lobbyists are always waiting outside the Senate chamber for a chance to pitch their view of the bill. In fact, this area is sometimes called Gucci Gulch, a reference to the favored footwear of the lobbyists.

.11 The Legislative Process—The Conference Committee

In the vast majority of cases, the House and Senate bills are quite a bit different, necessitating a Conference Committee. The chairs of the House Ways and Means and the Senate Finance Committees each appoint representatives to this committee, which has the simple purpose of trying to draft compromise legislation. The Conference Committee has a varying number of members each year.

Observation

Until the 1986 Act, the chairs of the two tax-writing committees would generally make appointments to the Conference Committee based on seniority on the respective committees. However, when the 1986 Conference Committee was established, both chairs decided to appoint members that they believed would best represent their committee's interests in Conference. For that reason, two prominent names associated with tax policy, Bill Bradley, a senator from New Jersey, and Jack Kemp, a representative from New York, were appointed to the committee even though both were relatively fresh faces in Congress.

If the Conference Committee eventually crafts and passes a compromise tax bill, it is sent back to the House and Senate for a vote; after all, neither chamber of Congress had actually approved the compromise bill. If both houses pass the compromise, it is then sent to the President for a signature.

The Conference Committee also produces a final report of its work, simply called the *Conference Committee Report*. However, this report is not as comprehensive as the reports issued by the House Ways and Means and Senate Finance Committees. In many cases, the Committee adopts either the House or Senate version of a particular provision, and in such a case the *Conference Committee Report* merely refers the reader to the original committee report for details. If a compromise provision is drafted by the committee, the *Conference Committee Report* will include more detailed explanations.

.13 The Legislative Process—The Presidential Signature

Generally, there is a 10-day interval between the time that a bill is delivered to the President's desk and when he or she actually signs the bill. During this interim period, staffers on the Joint Committee of Taxation comb the bill carefully for any errors or inconsistencies, and Congress then votes on a Concurrent Resolution to ratify any needed corrections in the bill. The objective of this process is to make sure the President signs a tax bill that is as clean and error-free as possible.

Observation

The *Tax Reform Act of 1986* made major changes in the tax laws, in some cases upsetting members of Congress who saw provisions that they championed for their constituencies go away. When the Concurrent Resolution came up for a vote, a number of these unhappy members of Congress started proposing amendments to put their pet provisions back in the bill. As a result, the Concurrent Resolution started hemorrhaging revenue, which violated the "revenue neutrality" pledge that was part of the process in 1986. Revenue neutrality essentially required that final tax bill raise the same amount of total revenue as the tax law before the changes. So in the end, the Concurrent Resolution was not passed, President Reagan signed a bill with over 100 errors, and it was not until two years later that most of these errors were corrected.

Once the tax bill reaches the President's desk, he or she can take one of three actions: (1) sign the bill, at which point it becomes part of *Title 26* of the U.S. Code, (2) veto the bill, or (3) choose not to sign the bill, in which case the bill becomes law after ten days. If Congress adjourns within the ten-day period and the President does not sign the bill, the effect is the same as a veto; this occurrence is known as a **pocket veto**. In most cases, the effective date of the new legislation is the date that the President signs the bill, although in some cases retroactive dates are established for certain provisions; this is discussed later in this chapter.

.15 The Legislative Process—The Joint Committee Report and Technical Corrections

As mentioned earlier, The Joint Committee on Taxation issues a final report on the tax legislative process commonly called the "Blue Book" due to the color of the cover on the

paperback edition. The Joint Committee on Taxation Report includes the same four elements that the Ways and Means Committee and Senate Finance Committee reports: (1) a draft of the legislation, (2) reasons for the changes, (3) an explanation of the changes, and (4) an estimate of the revenue effects of the change. All of these elements have changed as the bill moved through the process, so in many respects the Blue Book is the most accurate and comprehensive explanation of the new law. Nonetheless, many courts do not give it much weight as a source for determining Congressional intent, as explained later.

In some cases, major tax legislation is followed in the next year or two with a "Technical Corrections Act." No matter how many times staffers read and review a tax bill, errors will frequently slip through the net. And sometimes legislation has unintended consequences that no one could have foreseen. A technical corrections act is drafted to remedy these deficiencies. For example, the *Technical Corrections Act of 1988* was devoted to cleaning up more than 100 errors in the *Tax Reform Act of 1986* caused primarily by the failure of Congress to pass a Concurring Resolution that year.

¶1009 THE INTERNAL REVENUE CODE: A CLOSER LOOK

.01 Tracking the Stages of a Tax Bill

A tax bill is referred to in various manners as it winds its way through the legislative process. When a bill is first introduced in the House or the Senate, it is assigned a bill number. For example, a 2016 tax proposal when first introduced was referenced as follows in the House:

H.R. 5186 — 114th Congress (2015-2016)

Once the bill passes either house, it can be called an Act and is given an official name. In recent years, the art of naming an Act has become somewhat political, with certain emotionally charged words as Jobs and Tax Relief featured in the title. This was the case in this 2012 legislation:

Middle Class Tax Relief and Job Creation Act of 2012

Observation

Two recent examples of emotionally-charged names of tax acts:

P.L. 113-295 Tax Increase Prevention Act of 2014
P.L. 114-14 Don't Tax Our Fallen Public Safety Heroes Act, 2015

When an act becomes law, it is first published as a "slip law," given a Public Law number, and is then bound into the appropriate volume of the *United States Statutes at Large*.

Observation

The first two digits in a Public Law number represent the session of Congress. These Congressional session numbers may be converted to the second calendar year of the session (each session lasts two years) by multiplying the session number by 2 and subtracting 212. For example, the 114th Session of Congress ended in 2016 [(114 × 2) – 212 = 16]. For sessions of Congress before 2000, the subtraction is only 112, and not 212. Thus, the 99th session ended in 1986 [(99 × 2) – 112 = 86].

Once the tax act is finally codified into the U.S. Code, the "official" full citation of the act can be quite cumbersome. For example, a complete citation of the 2012 Act is:

Middle Class Tax Relief and Job Creation Act of 2012, P.L. No. 112-96, 126 Stat. 156

.03 Organization of the Code

Just as the official title of a tax act can be somewhat cumbersome to remember, so can the Code location of a particular provision. As mentioned earlier, completed tax bills are added to Title 26 of the U.S. Code. But the Code has many titles, subtitles, chapters, subchapters, parts, subparts, etc. to remember. For example, the complete citation for the tax law devoted to computing tax liability for a married couple is disclosed in Figure 3.

Fortunately for tax researchers, there is one unique Code section for each provision of the federal income tax law. So as a practical matter, tax publications generally just refer to a Code section for reference purposes. For example, the provision illustrated in **Figure 3** would simply be Code Section 1.

Figure 3 also provides two examples of short-hand references for a particular Code section. One is simply an abbreviation (*Sec.*), and the other a symbol (§). And as discussed in Chapter 2, tax Regulations, the official interpretations of Code sections, use the Code section number as part of the referencing procedure for this tax authority.

Observation

Although the unique section numbers in the Code provide for ease of reference, it is important to understand the various divisions within the Code. For example, a particular Code section may use the expression "for purposes of this subtitle" or "for purposes of this subpart". In such a case, it is important to know exactly where you are in the Code to know for sure if the provision is applicable to your tax question. It is a good idea to always refer to the Code index to see exactly what Code sections are included in the "subtitle" or "subpart" you are examining.

.05 Guides for Reading and Interpreting the Code

Two cardinal rules should always be followed in attempting to determine the answer to a federal tax question: (1) get the facts (GTF) and (2) read the code (RTC). A tax professional must have a firm grip on the facts of a particular case before beginning the research effort; otherwise, subtle differences or nuances may escape detection and lead to the wrong conclusion.

FIGURE 3 **Organization of the Internal Revenue Code Referencing the Internal Revenue Code and Regulations**

INTERNAL REVENUE CODE:

The Internal Revenue Code is Title 26 of the United States Code. This portion of the Code contains the internal revenue laws as enacted by Congress. An example of a complete reference is the following, related to the tax computation of a married couple:

26. Title (Internal Revenue Title)
    A. Subtitle (Income Taxes)
    1. Chapter (Normal Taxes and Surtaxes)
        A. Subchapter A (Determination of Tax Liability)
            I. Subpart (Tax on Individuals)
                1. Section (Tax Imposed)
                    (a) Subsection (Married individuals . . .)
                        (1) Paragraph
                            (A) Subparagraph
                                (1) Clause

Example of a common reference for citation purposes:

Sec. 1
- *Sec.* — Shorthand reference for "Section" (also the symbol "§")
- *1* — Section number

TREASURY REGULATIONS:

Treasury regulations are the Department of the Treasury's official interpretation of the Internal Revenue Code. Regulations are numbered to correspond to the section of the Code being interpreted. These regulations are found in Title 26 of the Code of Federal Regulations.

Example of a common reference for citation purposes:

Reg. §1.61-5(b)
- *Reg.* — Type of regulation ("1" is an income tax regulation)
- *§1.61* — Code section interpreted
- *-5* — Number of regulation (in chronological order)
- *(b)* — Paragraph

The importance of reading the Code cannot be emphasized enough; every answer to a tax question must somehow relate directly to the ultimate primary authority, the Internal Revenue Code. In tax practice there is a temptation to examine the "easy to read" secondary authorities first when trying to find the answer to a question. But these are only interpretations, and if the answer is in the Code itself, the interpretations are irrelevant. Courts have

consistently emphasized that their purpose is to interpret the law, and not legislate. This view is illustrated in the following case quotes:

- *Huntsberry v. Commissioner*.[6] "Unequivocal evidence of legislative purpose is required before the court will override the plain meaning of the statutory language."
- *Strogoff v. United States*.[7] "The context from which the meaning of a word is taken must be the words of the statute itself."
- *Woods v. Commissioner*.[8] "To glean the meaning of the words used by Congress, we must first look to the ordinary or settled meaning of the words used to convey its intent."
- American Automobile Association.[9] "The validity of the long established policy of the Court in deferring, where possible, to Congressional procedures in the tax field is clearly indicated in this case."
- *Eisner v. MaComber*.[10] "And, as this court has so often said, the high prerogative of declaring an Act of Congress invalid, should never be exercised except in a clear case."

When reading and interpreting the Code, it is important to read the language closely, constantly being on the lookout for definitions, cross references, and connectors. For example, *Code Sec. 280A(c)* addresses the office in the home deduction, and one of the key words in that provision is in subsection (c)(1)(B), the word "or". Thus, a home office will qualify if any one of the three conditions is met. This connector was also used as a justification for modifying Code Sec. 280A in 1997; this will be discussed in Chapter 6.

Observation

Definitions can be extremely important in interpreting the Code. In some cases, the definitions of key terms are contained in the statute; in other cases the researcher may need to check a key word index for the Code to find the definition (e.g., Code Sec. 152 defines a "dependent" for tax purposes). Additionally, Code Sec. 7701 is titled "Definitions" and contains over 50 definitions of common terms used in the Code, such as "person" and "corporation."

In summary, the words used in the Code must be interpreted in their everyday meaning. Furthermore, if the Code is clear on an issue, there is no need to go any further.

.07 Tax Act Provisions That Are Not Codified

A common misperception about the Internal Revenue Code is the notion that every part of a tax act is added to the Internal Revenue Code. In reality, a number of provisions do not make it into the Code; these include transition rules, effective dates, and sunset provisions.

Most of the transition rules affect only a few taxpayers and are of short duration. For example, in order to obtain support from certain members of Congress, special rules may be enacted to "soften" the landing of certain constituents who are losing existing tax benefits because of either new provisions or a repeal of old provisions. This has led to such legislation as the "Gallo Amendment," designed to help the famous vineyard family adjust to a change in the estate tax law.

[6] *Huntsberry*, 83 TC 742 (1984).
[7] *Strogoff*, 86-2 USTC ¶9616, 10 ClsCt 584.
[8] *Woods*, 91 TC 11.
[9] *American Automobile Association*, SCt 61-2 USTC ¶9517, 367 US 687.
[10] *Eisner v. Macomber*, 252 US 159.

Also, the transition rules are also the favorite vehicle for Congress to dole out special political favors to constituents. This is an action that members of Congress would prefer to be shielded from public scrutiny.

In some cases, new provisions are effective for only a limited period of time, or an old provision is being phased out over a limited period of time. In these cases, Congress may keep these effective dates out of the Code in order to avoid confusion and to keep the Code relatively clean. In such a case, the researcher must refer to the Act, and not the Code, for the details on these effective dates. These transition rules are often difficult to locate.

Effective Dates

Generally, most provisions contained in a new tax act become effective on the date that the President signs the Act into law. For example, President Obama signed the Tax Increase Prevention Act of 2014 on December 19, 2014, and this is the effective date unless stated differently in the Act.

In some cases, the effective date may be prospective; for example, a new provision may not take effect until the following tax year. In other cases, a provision may be retroactive to a date specified by Congress. In many cases, a retroactive date is the first day the provision was discussed in Congress; that way, taxpayers are prevented from "planning around" the new law before it takes effect.

¶1011 EVALUATING AND LOCATING LEGISLATIVE AUTHORITY

.01 Constitution

The Constitution is the ultimate tax authority; if a statute is found to violate the Constitution, it will be declared invalid. Recall the *Pollock* case mentioned earlier in the tax history; this was the only successful challenge to the constitutionality of our tax laws, and this occurred in 1895.

Observation

There are a number of authors and speakers who make a living by selling products and information that "proves" that the tax law is unconstitutional, and if you will just follow their advice, you will not have to pay taxes. Obviously, none of these schemes have ever worked. Interestingly, the IRS recently did a study on these authors and commentators and found that over 95 percent of them actually do file and pay their own taxes; they know better than to follow their own advice.

The 1895 challenge in the *Pollock* case was the *last* successful challenge on the constitutionality of the federal income tax. And yet, there are always gullible individuals who believe various authors and speakers when they assert that the income tax is unconstitutional and does not have to be paid. A recent case in point was the actor Wesley Snipes, who bought into the notorious "861 argument" of a leading tax protestor. *Code Sec. 861* states that foreign-source wages of U.S. citizens are taxable, and the protest movement argues that since this section does not

mention U.S. wages, they must not be taxable! At trial, Mr. Snipes changed his defense to argue that he was "duped" by the tax protestors. Although Mr. Snipes was not found guilty of tax fraud, he was convicted on three counts of failure to file a tax return on income exceeding $10 million (payment for two sequel films in the *Blade* series). The interest and penalties alone on this $10 million deficiency may very well exceed $10 million.

A copy of the Constitution is included in Volume 1 of the U.S. Code. Most tax services, both print and online, also offer copies of the Constitution.

On the Web

The Constitution is available free of charge online at the following locations:

http://www.usconstitution.net

http://www.archives.gov/exhibits/charters/constitution.html

.03 The Internal Revenue Code

As a practical matter, the Internal Revenue Code is the final tax authority for most matters, as long as the Constitution is not violated. As a result, the answer to any tax question must first be tied to a provision of the Code, as statutory authority is always controlling. Interpretations such as Regulations and court cases may help understand how a Code provision is applied, but the ultimate authority is still the Code.

The Internal Revenue Code is available as Title 26 of the United States Code, and is also reprinted in most tax services, both print and online editions. The major publishers also sell hard copy editions as separate volumes, either as one volume by the Thomson Reuters and two volumes by Wolters Kluwer.

On the Web

The Code is available free of charge online at the following locations:

http://uscode.house.gov

http://www.law.cornell.edu/uscode/26

.05 Tax Acts

As mentioned earlier, not all provisions of a Tax Act are eventually codified. For that reason, it is frequently necessary to examine the full Act, especially for effective dates, transition rules, and sunset provisions. The full text of a tax act is published by the Government Printing Office, and is usually offered as a paperback supplement for most paper tax services.

On the Web Most tax acts are offered free of charge at the Congressional website:

https://www.congress.gov/

.07 Tax Treaties

Tax treaties are another source of legislative authority that has not been discussed thus far in this chapter. In general, the President of the United States may enter into a treaty with any other country, and such treaty is considered having the force and effect of law once it is approved with the advice and consent of the Senate (a two-thirds vote is required). Most treaties are designed to eliminate the double taxation of income, either for a U.S. citizen working abroad or for a citizen of another country working in the United States.

The courts generally tend to give equal weight to both the Code and treaties. When the two are in conflict, courts usually assume that the one adopted later controls. In addition, other agreements between the United States and other countries, such as the North American Free Trade Act (NAFTA), though technically not treaties, may have the effect of a treaty for tax purposes.

The full texts of treaties are sometimes difficult to find. Wolters Kluwer and Warren Gorham Lamont offer Tax Treaty Services, and treaties may be found in the United States Code Annotated published by West Publishing Company. The IRS currently provides links to tax treaties at *http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z*.

.09 Committee Reports

As discussed earlier, the committee reports of the various tax committees (House Ways and Means, Senate Finance, and Conference) are useful indicators of Congressional intent. These reports may be the only interpretation until regulations are enacted.

However, at all times, it must be remembered that legislative history may be used to solve Congressional ambiguity, and not create it. Committee reports may not be used to overturn the plain meaning of the words in the statute itself. Of the three documents, the Conference Committee Report is usually accorded greater weight since it summarizes the final product of Congress. But in many cases this document merely refers the reader to one of the other two committee reports if the final provision is close (or the same) in wording to the original proposal in one of the houses.

Earlier it was mentioned that the **Joint Committee on Taxation Report (the Blue Book)** is often regarded as the most comprehensive and lucid explanation of a new tax law. Nonetheless, over the years courts have traditionally accorded this document less weight than other sources, since it is not written "contemporaneously" with the legislative process. Recall that the Joint Committee does not have a legislative function; it serves as an interpretive body only. More importantly, there is no opportunity for Congress or anyone else involved in the legislative process to rebut the Blue Book's conclusions.

However, two recent events have tended to provide more authority to the Blue Book. First, the Blue Book is now listed as "substantial authority" for purposes of avoiding the Code

Sec. 6662 penalty discussed later in the chapter. Second, the U.S. Supreme Court stated the following in *FPC v. Memphis Light,*[11] concerning the Blue Book: "It provides a compelling contemporary indication of the legislation's effect."

Full-text copies of the various committee reports are printed in the weekly Internal Revenue Bulletin after the tax legislation is passed, and are printed again in the Cumulative Bulletin that is compiled at the end of the year. (There is one exception—the IRS chose not to reprint the 888 pages of the committee reports accompanying the 1954 recodification.) Committee reports for years prior to 1939 are reprinted in the 1939 cumulative bulletin. In addition, most tax services provide all committee reports in paperback form with print services and on their websites.

On the Web

Committee reports may be found on the following websites:

http://www.jct.gov

http://waysandmeans.house.gov

http://finance.senate.gov

http://congress.gov

There are two other valuable print services that offer access to selected portions of committee reports for legislation enacted prior to 1954. One is J.S. Seidman, *Legislative History of Federal Income Tax Laws, 1861-1938, 1939-1953* (6 volumes).[12] This service organizes pre-1954 legislation by Code section and/or topic, and provides cross-reference tables for converting 1954 code section numbers to 1939 code section numbers and vice versa. A second source is Walter E. Barton and Carroll W. Browning, *Federal Tax Laws Correlated.*[13]

.11 The Congressional Record

The *Congressional Record* is the only source for determining legislative intent on amendments made on the floor of the House or Senate. The relevant discussion must be located by the day of the debate, no easy task. However, there is no other alternative to locating this information.

An important part of this document in regard to a discussion of tax law changes is the presence of *colloquies* and *floor statements*. These represent discussions between members of Congress and the managers (from the Joint Committee) of a tax bill that are intended to clarify specific provisions. These discussions are inserted into the *Congressional Record*. As a general rule, colloquies and floor statements may be relied on only in the event the statute or Committee reports fail to yield any insight into Congressional intent or actions.

There is some question as to how much weight should be accorded to colloquies and floor statements. As a general rule, the following guidelines apply:

- Similar colloquies in both houses are strong affirmation of Congressional intent.
- A colloquy given affirmation by the tax-writing committee chair (or the author of the bill) is given the greatest weight.

[11] *Federal Power Commission v. Memphis Light*, SCt 73-1 USTC ¶9412, 411 US 458, 93 SCt 1723.
[12] J.S. Seidman, *Legislative History of Federal Income Tax Laws, 1861-1938, 1939-1953.* Prentice-Hall, Inc. (Englewood Cliffs, N.J.: 1954).
[13] Walter E. Barton and Carroll W. Browning, *Federal Tax Laws Correlated.* Warren Gorham & Lamont (Boston: 1969).

- Colloquies and floor statements made *before* a vote are given much greater weight than those given *after* a vote.

Most libraries provide access to the *Congressional Record*, either through print services, microfiche, or online services such as the LEXIS and WESTLAW electronic libraries.

On the Web

The Historical Congressional Record Index may be accessed through the Government Printing Office (GPO) site at the following location:

http://www.gpo.gov

.13 Congressional Hearings

Public hearings of the House Ways and Means Committee and the Senate Finance Committee yield very little in terms of tax authority. Hearings records typically provide insight into the problems, but not necessarily the legislative solutions. For that reason, hearings records tend to be given little if any weight by the Courts.

Most libraries provide access to Congressional hearings, either with print volumes from the Government Printing Office or online with a LEXIS or WESTLAW subscription.

On the Web

The Historical Congressional Record Index may be accessed through the Government Printing Office (GPO) site:

http://www.gpo.gov

.15 Pending Legislation and Unenacted Legislation

Questions inevitably arise concerning the weight given to pending legislation, particularly technical corrections that appear certain to be enacted by Congress. The IRS official position is that no reliance can be made on pending legislation until the provisions have actually been signed into law. However, the IRS has sometimes considered pending legislation when issuing private letter rulings.[14]

Observation

Sometimes the old axiom "No good deed goes unpunished" also applies to tax professionals who try to do the right thing. For example, in 1986 Congress revised the alternative minimum tax (AMT) rules for individuals, and in doing so forgot to continue the required adjustment for personal exemption deductions, since such amounts are not allowed for the AMT. Everyone knew that Congress would eventually correct this oversight and apply the change retroactively, so some firms went

[14] For example, *see* Ltr. Rul. 88020045.

ahead and made the adjustment anyway on 1987 returns. Much to their dismay, the returns were bounced by the IRS, who said that the law does not read that way. So the returns were filed a second time, this time without the adjustment, and, oh yes, then refiled a third time in 1988 after Congress made the technical correction!

Unenacted Legislation

At first blush, it is difficult to understand how legislation that was *not* enacted could have any relevance whatsoever to a tax researcher. The answer is that, if nothing else, unenacted legislation tells one what Congress did not intend to enact. There is some value in knowing that Congress considered such an interpretation and consciously decided not to enact that interpretation.

The concept of unenacted legislation is also relevant in explaining an argument sometimes used by taxpayers and occasionally by the IRS. This defense is termed "legislative reenactment," and describes a situation where the IRS or the courts have issued an interpretation of a particular law and Congress has a chance to change the interpretation (in subsequent legislation) but chooses not to. Thus, the IRS or court interpretation is "legislatively reenacted." Generally, taxpayers have had little success in sustaining such arguments, since silence is not necessarily agreement.

¶1013 "SUBSTANTIAL AUTHORITY" IN TAX CONTROVERSIES

The Internal Revenue Code contains a number of penalties that may be applied to tax professionals for certain actions. However, in some cases these penalties will not apply if the tax professional has "substantial authority" for the position taken on the tax return. This is discussed in detail in Chapter 9.

.01 Substantial Authority

One of the more common penalties potentially applicable to taxpayers is the "substantial understatement" penalty of *Code Sec. 6662*. This penalty is equal to 20 percent of the understatement; however, it may be reduced if there is "substantial authority" for the treatment of the item.

For purposes of reducing the amount of understatement of income tax subject to the "substantial understatement penalty," *Reg. §1.6662-4(d)* and *Notice 90-20* (1990-1 CB 328) define substantial authority to include the following:

1. The Internal Revenue Code and other statutes
2. Regulations (final, temporary, and proposed)
3. Court cases
4. Tax treaties
5. Statements of Congressional intent, including:
   a. House Ways and Means Committee Reports
   b. Senate Finance Committee Reports
   c. Joint Conference Committee Reports
   d. Congressional Record
   e. Joint Committee on Taxation Report (the "Blue Book")

6. Administrative pronouncements, including:
   a. Revenue Rulings
   b. Revenue Procedures
   c. Private Letter Rulings (PLRs)
   d. Technical Advice Memoranda (TAMs)
   e. Actions on Decisions (AODs)
   f. General Counsel Memoranda (GCMs)
   g. Notices, Press Releases, and similar documents

The Internal Revenue Service does have the power to except certain authorities from this list. At least once a year, the IRS must publish in the Federal Register a list of positions it believes lack substantial authority and that affect a significant number of taxpayers. However, this does not mean that substantial authority exists for positions not included on the list.

¶1015 SUMMARY

- A tax bill must work its way through the House Ways and Means Committee, the Senate Finance Committee, the Joint Conference Committee, and passage by both the House and Senate before being sent to the President for his signature.
- The Constitution, Internal Revenue Code, and tax treaties are the three main sources of legislative authority.
- The Internal Revenue Code contains the tax laws passed by Congress and is the highest level of authority in most tax research issues.

REVIEW QUESTIONS FOR CHAPTER 1

True or False

Indicate which of the following statements are true or false by circling the correct answer.

1. An article in the *Journal of Taxation* is an example of secondary authority. T F

2. All answers to a tax question must necessarily be traced back to secondary tax authority. T F

3. A decision of the U.S. Supreme Court is an example of administrative tax authority. T F

4. The Senate Finance Committee Report is an example of legislative authority. T F

5. Under the early British income tax laws that were duplicated in the United States in the 1800s, gains and losses on property were includible in the tax base. T F

6. In *Springer vs. U.S.*, the federal income tax was found to be unconstitutional by the Supreme Court. T F

7. The corporate income tax enacted in 1909, labeled as an "excise tax on the privilege of doing business," was later ruled unconstitutional. T F

8. The U.S. House of Representatives generally debates a tax bill under a "closed rule," allowing amendments only by Ways and Means Committee members. T F

9. A Conference Committee bill must generally be voted on once again by both houses of Congress. T F

10. *Reg. §1.263-4* refers to the fourth section of the first regulation issued on *Code Sec. 263* of the Internal Revenue Code. T F

FILL IN THE BLANKS

Fill in each blank with the appropriate word or phrase that completes each sentence.

11. A decision of the 5th Circuit Court of Appeals is an example of _____ (primary, secondary) tax authority.

12. _____ authority refers to authority as enacted by the U.S. Congress.

13. The first truly national income tax in the U.S. was used to fund the _____.

14. The U.S. income tax was ruled unconstitutional in 1895 because the Supreme Court ruled that it was a _____ tax, requiring apportionment by a census.

15. The _____ Amendment to the Constitution eliminated the apportionment requirement for the federal income tax.

16. The second codification of the U.S. tax laws occurred in _____.

17. The Constitution requires that all revenue bills originate in the _____.

18. For an explanation of changes to a tax bill that occurred on the floor of the Senate, reference must be made to the _____.

19. A(n) _____ occurs if Congress adjourns within the 10-day period that the President is considering a tax bill, and the President does not sign the bill.

20. In the broadest sense, the ultimate tax authority is the _____.

MULTIPLE CHOICE

Circle the best answer for each of the following questions.

21. Which of the following is not a category of primary tax authority?
    a. judicial authority
    b. administrative authority
    c. procedural authority
    d. legislative authority

22. Which of the following is not a traditional component of tax practice?
    a. tax planning
    b. tax research
    c. tax compliance
    d. tax accounting

23. A Revenue Procedure issued by the IRS is an example of:
    a. legislative authority
    b. administrative authority
    c. judicial authority
    d. none of the above

24. The first "codification" of the U.S. income tax laws occurred in:
    a. 1913
    b. 1921
    c. 1939
    d. 1954

25. Which of the following is not a part of the final reports of the Ways and Means Committee or the Senate Finance Committee?
    a. explanation of the changes
    b. transcripts of oral testimony to the committee on proposed law changes
    c. estimate of the revenue effects of the changes
    d. reasons for the changes

26. A Presidential veto may be overridden only by an affirmative vote of:
    a. a simple majority of both houses of Congress
    b. a two-thirds majority of both houses of Congress
    c. a three-fourths majority of both houses of Congress
    d. none of the above

27. The final comprehensive report issued that explains recently-enacted tax legislation is the:
    a. Conference Committee Report
    b. Congressional Record
    c. Senate Finance Committee Report
    d. Joint Committee on Taxation Report

28. P. L. 110-43 would have been enacted in the session of Congress that ended in the year:
    a. 1996
    b. 2000
    c. 2008
    d. 2010

29. The short-hand method of referencing a particular part of the Internal Revenue Code is to cite the:
    a. subtitle number
    b. chapter number
    c. subchapter number
    d. section number

30. Tax Act provisions that may not be added to the Internal Revenue Code itself can include:
    a. effective dates
    b. sunset provisions
    c. transition rules
    d. any of the above

REVIEW PROBLEMS

31. Give two examples of each of the following: (a) primary tax authority and (b) secondary authority.

32. List the three basic types of tax authority, and provide an example of each one.

33. What is the importance of each of the following dates in U.S. tax history: 1861, 1895, 1913, 1939, and 1954?

34. What was the U.S. Supreme Court's rationale for declaring the federal income tax unconstitutional in the *Pollock v. Farmers' Loan and Trust Co*. case of 1895?

35. Explain how Congress "fixed" the apportionment problem with regards to the federal income tax in 1909.

36. Define the term "codification," and list the major codifications of the Internal Revenue Code. Why are these dates sometimes important in researching a federal tax question?

37. Explain the basic steps that a tax bill follows in both the House Ways and Means Committee and the Senate Finance Committee. Do both houses of Congress also follow the same procedures when debating a bill on the floor of the entire legislative body? Explain.

38. Why is the Conference Committee Report typically much smaller in size than either the House Ways and Means Committee Report or the Senate Finance Committee Report? Explain.

39. What are the President's options when a tax bill reaches his or her desk?

40. Why are the courts sometimes hesitant to cite the "Blue Book" (Joint Committee on Taxation Report) as authority? Explain.

41. Explain how to convert the following public law numbers to the last year of the legislative session generating the law: P. L. 98-200 and P. L. 107-420.

42. Since each "section" of the Code has a unique Section number, is it necessary to be concerned about broader subdivisions, such as Subchapter, Chapter, and Part?

43. Do all provisions of a tax act eventually end up in the Internal Revenue Code? Explain.

44. "The role of the courts is to interpret the law, and not make the law." Do you agree? Explain.

45. How much weight should be given to colloquies and floor statements? Explain.

RESEARCH QUESTIONS

46. Which subchapter of the Code contains *Code Sec. 303*?

47. How is a "dependent" defined for purposes of *Code Sec. 119(a)*?

48. *Code Sec. 408* was amended several years ago to allow tax-free distributions from IRAs to charity. Which Act of Congress made this change, and when was the change effective?

49. Refer to Code Sec. 408(d)(8). Is the exclusion from income available for all IRA owners, regardless of their age? What was the initial expiration date for this provision? What is the current expiration date for this exclusion and what most recent Act of Congress made the change to extend the expiration date?

50. *Code Sec. 317* defines the term "property." Is this definition of property to be used for other sections of the Code, such as Code Sec. 1001? Explain.

51. What is the title of Section 111 of *P. L. 113-295*?

52. What was the purpose of *P. L. 110-176*?

53. When was Code Sec. 36B added to the code and what was the Act that added this provision?

54. How did the Technical Corrections Act of 2007 modify Code Sec. 53(e)(2) of the Internal Revenue Code?

Chapter

2

Administrative Sources of Authority

LEARNING OBJECTIVES

1. Identify the sources of administrative authority.
2. Differentiate between the different types of Regulations.
3. Describe the various types of IRS pronouncements.

¶2001 INTRODUCTION

Administrative sources of authority are a second type of primary authority. This authority is derived from the executive branch, the "Administration." In the tax area, the primary administrative authority is the product of the efforts of the Department of Treasury, primarily through one of its divisions, the Internal Revenue Service. The IRS is specifically charged by the Secretary of the Treasury to enforce the regulations.

The Treasury Department is responsible for the enforcement of tax statutes and the collection of tax revenue. Many of the Treasury's administrative functions are delegated to the Internal Revenue Service. To facilitate the administration of tax law, the IRS issues a variety of official pronouncements, the most important of which are discussed in this chapter.

¶2003 AN INTRODUCTION TO ADMINISTRATIVE AUTHORITY

.01 Delegation of Authority

Code Sec. 7805(a) charges the Treasury Department with the overall administration of the Internal Revenue Code:

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

The "Secretary" referred to above is the Secretary of the Treasury, a member of the President's cabinet (and not the Treasurer, another official not connected with tax matters). Although the Secretary is granted this broad authority, as a practical matter, most administrative pronouncements are written by staff of the Internal Revenue Service (a division of the Department of Treasury) or the office of the Chief Counsel of the IRS (the Assistant General Counsel of the Treasury Department). The IRS is headed by a Commissioner, who is appointed by the President.

.03 Sources of Administrative Authority

The primary sources of administrative authority are the Regulations (published by the government). Other important sources of authority published by the government include Revenue Rulings and Revenue Procedures. Several other administrative pronouncements are produced by the IRS but not published by the government. Chief among these documents are the private letter rulings and technical advice memorandums.

¶2005 REGULATIONS

.01 Importance of Regulations

Final Regulations represent the Treasury and the IRS's ultimate interpretation of the Code. As a rule, Regulations are generally more "readable" than the Code. These are issued under the signature of the Secretary of the Treasury. Because these Regulations are issued with the imprimatur of the Secretary of the Treasury, the IRS Commissioner and staff are bound by the Regulations even if they do not agree with them.

As discussed later, Regulations generally have the force and effect of law, as long as they are reasonable and consistent interpretations of the Code. But since most regulations are interpretive in nature, courts occasionally overturn regulations that they believe do not properly interpret Congressional intent.

.03 Classifications of Regulations

Regulations may be grouped by type into one of the three categories:

1. ***Interpretive Regulations.*** These regulations attempt to clarify the provisions of a particular Code section. The bulk of regulations issued are interpretive in nature.
2. ***Legislative Regulations.*** In some cases, Congress directs the IRS to in effect perform a law-making function and to specify the substantive requirements of a particular provision. This is generally done when Congress chooses not to delve into highly technical issues. An example would be the detailed requirements found in the Regulations for filing a consolidated tax return. These regulations tend to be accorded a higher level of authority than interpretive regulations.

3. ***Procedural Regulations.*** These regulations specify detailed procedural rules for various aspects of tax practice, including filing requirements and prerequisites for making certain elections under the Code. Procedural Regulations are generally denoted with a prefix of "15" or "301" in the citation system for Regulations.

.05 Regulations—Proposed and Final Regulations

At the beginning of the year, the Treasury schedules Regulation projects for the year. A task force is formed for each Regulation project, consisting principally of attorneys, economists, and CPAs in the Chief Counsel's office. Regulation projects take several years to bear results in most cases, and there is a large backlog of regulation projects (some going back to the Tax Reform Act of 1986 and even earlier).

Once the task force completes a draft of a regulation, it is published in *The Federal Register* as a Proposed Treasury Decision (TD). Interested parties are given 30 days to comment (in writing or orally) on the **Proposed Regulations**. As long as a Regulation is a Proposed Regulation, it does not have the force and effect of law of a Final Regulation. Nonetheless, the Proposed Regulation provides clues as to the IRS position on an issue, and should be considered when contemplating future transactions.

After the comment period, the IRS may (1) issue a final regulation as a TD and publish such in The *Federal Register*, (2) withdraw the proposed Regulation for further work and then reissue as a Final Regulation, or (3) withdraw the Regulation and suspend work on the project. In many cases, lengthy delays develop in the process in the latter two scenarios.

Observation

Most Regulations include lengthy preambles which "preview" the Regulations and discuss reasons for any changes from the Proposed Regulations. These preambles may provide useful insights, and in some cases have been cited in court cases.

Final Regulations are published in the Federal Register as a Treasury Decision (TD), and then published in the weekly *Internal Revenue Bulletin*. The date of publication in the Federal Register is the release date. An example of a final regulation is illustrated in **Figure 1**.

Observation

The *Internal Revenue Bulletin* is the primary communications vehicle used by the IRS. For example, new Regulations are published in the weekly bulletin as Treasury Decisions (TDs). Prior to 2009, the weekly bulletins were consolidated into a *Cumulative Bulletin*, so that all publications of the same type (e.g., Revenue Rulings, Revenue Procedures, etc.) could be grouped together logically. In terms of print volumes, it usually took two or three volumes to consolidate the weekly bulletins, and for that reason cites to the Cumulative Bulletin for various authorities such as rulings and procedures may read 2007-1 CB, 2007-2 CB, etc. The IRS stopped creating the Cumulative Bulletin after the 2008-2 edition so all the references after 2008 are to the *Internal Revenue Bulletin* (IRB).

.07 Temporary Regulations

Temporary Regulations are Regulations issued by the IRS without the normal comment period and are generally effective on the date of issuance. These Regulations are "fast lane" guidance, in that most are drafted in response to a law change or a judicial decision that requires immediate guidance. Generally, such Regulations are issued when the requirements for public notice are impracticable, unnecessary, or contrary to the public interest.

Code Sec. 7805(e), added in 1998, now requires that Temporary Regulations also be issued as Proposed Regulations at the same time, and the Temporary Regulations automatically expire three years after issuance. Temporary Regulations are considered to be authoritative until they are superceded by Final Regulations. As a rule, Temporary Regulations should be treated with the same authority as final regulations.

Observation

Although there is currently a three-year sunset rule on temporary regulations that are issued as proposed regulations, no such limit applies to old proposed regulations. In some cases, proposed regulations that are more than 20 years old are still around.

Figure 1 Example Regulation

Regulation § 1.61-14. Miscellaneous items of gross income.

(a) In general. In addition to the items enumerated in section 61(a), there are many other kinds of gross income. For example, punitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income. Another person's payment of the taxpayer's income taxes constitutes gross income to the taxpayer unless excluded by law. Illegal gains constitute gross income. Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.

(b) Cross references.

(1) Prizes and awards, see section 74 and regulations thereunder;

(2) Damages for personal injury or sickness, see section 104 and the regulations thereunder;

(3) Income taxes paid by lessee corporation, see section 110 and regulations thereunder;

(4) Scholarships and fellowship grants, see section 117 and regulations thereunder;

(5) Miscellaneous exemptions under other acts of Congress, see section 122;

(6) Tax-free covenant bonds, see section 1451 and regulations thereunder.

(7) Notional principal contracts, see §1.446-3.

(T.D. 6272, 11/25/57 , amend T.D. 6856, 10/19/65, T.D. 8491, 10/8/93)

.09 Precedent Value of Regulations

Generally, Legislative Regulations should be treated as having the force and effect of law, since the law-making function is in effect delegated to the IRS by Congress. Interpretive Regulations should also generally be treated as having the force and effect of law, unless they conflict with the statute. In the latter case, courts have not been hesitant to overturn Regulations if the court believes that the IRS is not correctly interpreting Congressional intent. For example, see *Professional Equities, Inc.*,[1] where the Tax Court overturned Regulations concerning the treatment of wraparound mortgages in determining first-year gain on an installment sale.

In some cases, the IRS may continue to follow a Regulation that has been ruled invalid by a court; since the only decision that the IRS *must* absolutely follow is a U.S. Supreme Court decision. The IRS may continue its interpretation in hopes of winning the issue in another circuit so that perhaps the Supreme Court will consider the issue.

Observation

In April and October of each year, the IRS publishes a *Semi-Annual Agenda of Regulations*. This document indicates all Code sections for which new regulations are under development or existing regulations that are to be reviewed. In addition, this summary provides information on the current status of all Regulations projects in progress. This document is published in the Federal Register each year.

.11 Effective Date of Regulations

Generally, Code Sec. 7805(b) states that a Regulation should be effective on the date in which such Regulation is filed with the Federal Register. However, the same statute states that Regulations can be applied *retroactively* in the following situations:

- The Regulation is issued within 18 months of the underlying statute being interpreted.
- The Regulation is designed to prevent taxpayer abuse.
- The Regulation corrects a procedural defect in the issuance of a prior Regulation.
- The Regulation relates to internal Treasury Department policies, practices, or procedures.
- The Regulation may apply retroactively by Congressional directive.
- The Commissioner has the power to allow taxpayers to elect to apply new Regulations retroactively.

.13 Citing a Regulation

In citing a regulation, the first number (to the left of the decimal) represents the type of Regulation. The most common types are:

1. Income Tax
20. Estate Tax
25. Gift Tax
31. Employment Tax
301. Procedural Matters

[1] *Professional Equities*, 89 TC 165.

Generally, a Regulation is cited in the following manner:

Reg. Sec. 1.162-1(b)(3)

where "1" represents the type of regulation (Income Tax, in this case), the "162" represents the Code section being interpreted, the second "1" represents the chronological number of the regulation for this Code section (in this case, the first one), and the (b)(3) represents subdivisions (paragraph and subparagraph) within the Regulation (these do not correspond to subdivisions of the Code section being interpreted).

Proposed Regulation cites usually incorporate the abbreviation "Prop," such as:

Prop. Reg. Sec. 1.263A-3

Temporary Regulations incorporate the abbreviation "Temp." or "T", such as:

Temp. Reg. Sec. 1.263A-3T

.15 Locating Regulations

Most tax services furnish complete sets of Regulations, either separately or incorporated within the codification. Electronic subscription services also provide a Regulations database. Regulations are also available on the Internet at:
http://www.gpo.gov
http://www.irs.gov/Tax-Professionals/Tax-Code,-Regulations-and-Official-Guidance

Observation

A word of warning: Regulations can easily become outdated, and the IRS is slow to amend such Regulations. It is extremely important to check to see if the regulations have been superceded or modified by subsequent regulations, legislation, or court decisions. Most tax services will prominently display cautionary notes at the top of a regulation if it has been affected by later developments.

¶2007 REVENUE RULINGS

The rulings process began in 1955 with the objective of consolidating information concerning the internal practices of the IRS. Prior to this time, such interpretations included such documents as Appeals and Review Memoranda (ARMs), Office Decisions (ODs), General Counsel's Memorandum (GCMs), Income Tax Rulings (Its), Internal Revenue Publication Memographs (IR-Mims), and Treasury Department Circulars (DCs). Some of these older documents may still be applicable to current tax situations.

Revenue Rulings are official IRS interpretations of the tax consequences of the Code's application in a specific unnamed hypothetical taxpayer's situation (i.e., a specific set of facts). Unlike Regulations, they are not general statements of authority. An example of a Revenue Ruling is provided in **Figure 2**.

Figure 2 **Revenue Ruling Example**

Excerpts from: Rev. Rul. 2015-11, 2015-21 IRB 975, 05/07/2015, IRC Sec(s). 167

Depreciation-precious metals used in manufacturing processes.
After stating that more recent court decisions requiring analysis of specific facts surrounding asset's use in taxpayer's trade or business when determining whether and extent to which asset is depreciable are incompatible with its' earlier published guidance, IRS ruled that capitalized cost of unrecoverable precious metals that are used in various manufacturing processes is depreciable under Code Sec. 167; and Code Sec. 168; , but capitalized cost of any recoverable precious metal isn't depreciable. Rev. Rul. 75-491,1975-2 CB 19 and Rev. Rul. 90-65,1990-2 CB 41 are revoked.

Issue
Is the capitalized cost of unrecoverable precious metal that is used in various manufacturing processes depreciable under §167 and §168 of the Internal Revenue Code?

Facts
Situation 1. A is a contract jeweler who fabricates jewelry to customers' specifications using gold supplied by the customers. A does not maintain an inventory of gold or completed jewelry, but to assist customers A fabricates and maintains gold sample jewelry showing currently available styles. A's samples are not held for sale. Every 3 years A melts down the sample jewelry, recovering 100 percent of the gold content of the jewelry. For A 's purposes, the recovered gold is indistinguishable from gold that has not previously been used in sample jewelry and A reuses it in fabricating new sample jewelry. A capitalizes the cost of the gold into the basis of its sample jewelry.

Situations 2 and 3 omitted.

Law
Section 167(a) provides as a depreciation deduction a reasonable allowance for the exhaustion and wear and tear (including a reasonable allowance for obsolescence) of property used in a taxpayer's trade or business.

Paragraphs omitted.

Section 1.167(a)-2 provides that the depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence.

Section 1.168(a)-1(a) provides that §168 determines the depreciation allowance for tangible property that is of a character subject to the allowance for depreciation provided in §167(a) and that is placed in service generally after December 31, 1986. See §1.168(a)-1(b). Accordingly, tangible property to which §1.168(a)-1(a) applies is property that is of a character subject to the allowance for depreciation provided in § 167(a) if the taxpayer shows that the property is subject to exhaustion, wear and tear, or obsolescence, and that the property has a determinable estimated useful life.

¶2007

Analysis

An asset is depreciable for federal income tax purposes to the extent that the taxpayer can show that the asset is subject to exhaustion, wear and tear, or obsolescence, and that the asset has a determinable estimated useful life. See *O'Shaughnessy v. Commissioner*, 332 F.3d 1125 [91 AFTR 2d 2003-2559] (8th Cir. 2003), aff'g in part, rev'g in part, 2002-1 USTC ¶ 50,235, 89 A.F.T.R. 2d 658 (D. Minn. 2001) (allowing depreciation for tin that declined in volume and purity as a result of glass manufacturing process); *Arkla, Inc. v. United States*, 765 F.2d 487 [56 AFTR 2d 85-5446] (5th Cir. 1985), cert. denied, 475 U.S. 1064 (1986) (allowing investment credit and depreciation for unrecoverable cushion gas but not for recoverable cushion gas); Rev. Rul. 97-54, 1997-2 C.B. 23 (adopting the reasoning of *Arkla*, supra).

In *O'Shaughnessy*, the Eighth Circuit allowed the taxpayer to depreciate the initial installation of molten tin used in the float manufacturing process of flat glass. The Eighth Circuit concluded that whether an asset is depreciable for federal income tax purposes depends on the taxpayer's showing that the asset is subject to exhaustion and wear and tear. The Eighth Circuit reasoned that the tin's decline in volume and purity as a result of its use in the glass manufacturing process constituted " exhaustion, wear and tear" within the meaning of § 167, and therefore, the taxpayer appropriately depreciated the tin under §168. In reaching its decision, the court concluded that Rev. Rul. 75-491, 1975-2 C.B. 19 (holding that the initial installation of molten tin used in the float manufacturing process of flat glass is not depreciable), was no longer persuasive insofar as the ruling predated a substantial restructuring of the depreciation rules upon which its holding was based.

Paragraphs omitted.

In Situation 1, the gold used to manufacture sample jewelry can be recovered and reused by A in A's trade or business in a manner that is indistinguishable from other gold that has never been fabricated, used, and recovered. The utility of the gold does not diminish as a result of its having previously been fabricated into sample jewelry. Accordingly, the gold is not subject to exhaustion, wear and tear, or obsolescence and as a result, is not depreciable.

Paragraphs omitted.

Application

Any change in a taxpayer's treatment of the cost of precious metals to conform with this revenue ruling is a change in method of accounting that must be made in accordance with §§446 and 481, the regulations thereunder, and the applicable administrative procedures. See section 6.01 of Rev. Proc. 2015-14, 2015-5 I.R.B. 450 (or successor guidance). The amount of the §481(a) adjustment must account for the proper amount of the depreciation allowable that is required to be capitalized under any provision of the Code (for example, § 263A) as of the beginning of the year of change.

Effect On Other Documents

Rev. Rul. 75-491 is revoked. Rev. Rul. 90-65 is revoked.

Drafting Information

The principal author of this revenue ruling is Douglas H. Kim of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Kim at (202) 317-7005 (not a toll-free call).

.01 Sources of Rulings

Revenue Rulings are issued in response to taxpayer inquiries (usually through Letter Ruling requests discussed below), court decisions (including the announcement of acquiescence or non-acquiescence to specific court decisions), or a perceived need for additional guidance on a specific transaction. Additionally, the IRS will occasionally respond to the requests for technical advice with a ruling.

The IRS intends for its employees and taxpayers alike to follow Revenue Rulings if the facts in the particular case are substantially the same as those in the ruling, and the preface to the Internal Revenue Bulletin states that rulings may be used as precedent. However, in many cases the facts are not the same, and in other cases a ruling may have been revised, revoked or made obsolete by a later ruling, court decision, or legislation.

Since rulings are official interpretations of the Service, they are issued by the National Office and undergo extensive review at the Branch, Division, and Assistant Commissioner levels. Such rulings generally require extensive editing for all possible situations, distinctions, and limitations.

Generally, a Revenue Ruling is limited to one to three pages and is organized in the following manner: (1) issue, (2) facts, (3) law, (4) analysis, and (5) holding. Currently, the IRS issues approximately 60 Revenue Rulings per year.

.03 Precedent Value of Rulings

Although Revenue Rulings are sometimes referred to as "Junior Regulations," they do not have the force and effect of Regulations. Rulings are responsive to and limited by the stated pivotal facts, and they are not intended to be statements of general applicability (as Regulations are). IRS personnel generally will follow published Revenue Rulings, and sometimes the rulings provide clues as to the IRS's litigation strategy on a particular issue.

The precedent value attached to Revenue Rulings in the courts depends on the Court. For example, the U.S. District Court and the U.S. Claims Court tend to give such rulings more weight than the U.S. Tax Court, generally because the former courts do not have tax specialists. Witness the following two quotes:

- *Dunn v. U.S.*—"Rulings have the force and of legal precedence unless unreasonable or inconsistent with the provisions of the Internal Revenue Code."[2]
- *Stubbs, Overbeck & Associates v. U.S.*—"Revenue Rulings are merely the opinion of a lawyer in an agency."[3]

[2] *Dunn*, DC N.Y., 79-1 USTC ¶9295, 468 FSupp 991.
[3] *Stubbs, Overbeck and Associates*, CA-5, 71-2 USTC ¶9520, 445 F2d 1142.

.05 Publication and Citation of Revenue Rulings

As official interpretations of the IRS, Revenue Rulings are published in the weekly *Internal Revenue Bulletin* and, prior to 2009, consolidated into the semi-annual *Cumulative Bulletin* for that particular year. For this reason, there are two different citations for each ruling: one the location in the weekly *Internal Revenue Bulletin*, and the other the location in the annual *Cumulative Bulletin* (prior to 2009).

These two formats may be illustrated as follows:

- *Rev. Rul. 99-40, 1999-48 I.R.B. 5* (temporary citation, the 40th ruling in 1999, found in the 48th weekly issue of the 1999 Internal Revenue Bulletin on page 5)
- *Rev. Rul. 99-40, 1999-2 C.B. 60* (permanent citation, found on page 60 of the 2nd Cumulative Bulletin of 1999)

.07 Locating Revenue Rulings

As mentioned above, Revenue Rulings are found in the IRB and the CB. Most electronic tax services offer full texts of all Revenue Rulings.

Observation

Unfortunately, the IRS does not withdraw revoked or obsolete rulings from publication. Therefore, a tax researcher should be cautious and always ensure that a ruling is current. This is best done by checking a finding list in a tax service *Citator* volume, which will note any modifications or changes by subsequent events.

A useful tax research resource related to Revenue Rulings is the *The IRS Bulletin Index-Digest System*. This publication by the Government Printing Office provides the ability to identify most Revenue Rulings (and Revenue Procedures, discussed below) by Code Section or topic; in fact, all are grouped by Code Section in the publication. Finding lists are provided, and each ruling or procedure is summarized in short paragraph form. Four separate services are provided: (1) Income Tax (Publication 641), (2) Estate and Gift Taxes (Publication 642), Employment Taxes (Publication 643), and Excise Taxes (Publication 644). Cumulative supplements are also provided.

¶2009 REVENUE PROCEDURES

Revenue Procedures are defined in Reg. §601.601 as "statements of procedure affecting the rights or duties of taxpayers or other members of the public under the Code and related tax laws, or of information that should be a matter of public knowledge." These pronouncements essentially describe the internal practices and procedures of the IRS in administering the federal tax laws. These include guidance on filing requirements and special requirements for elections under the Code. For example, the first Revenue Procedure published each year provides detailed requirements for requesting letter rulings (described below), changes of accounting method, or changes of accounting period.

.01 Uses of Revenue Procedures

The National Office of the IRS publishes these official guidelines regarding tax procedural matters. Two popular uses of Revenue Procedures are to describe the requirements for obtaining a Letter Ruling from the IRS and to specify those areas of tax law in which the IRS will decline to issue Letter Rulings. The IRS issues about 60 Revenue Procedures per year. In some cases, important guidance of a general and permanent nature may be upgraded to a Procedural Regulation. A recent Revenue Procedure is displayed in **Figure 3**.

Observation

In recent years, most of the important IRS procedural guidance has been in the form of Revenue Procedures. This is especially true for procedures that tend to change fairly often, such as the steps that must be taken to request a letter ruling or change an accounting method. The Service simply does not want to be constantly changing Regulations for this purpose.

Figure 3 Revenue Procedure Example

Rev. Proc. 2007-57, I.R.B. 2007-36, 547, September 4, 2007. [Code Sec. 3402]

Withholding of tax at source: Gambling winnings: Poker tournaments. --

The IRS has informed poker tournament sponsors, including casinos, of their withholding and information reporting obligations, under Code Sec. 3402(q), regarding amounts paid to tournament winners. Withholding is required when one or more tournament winners are paid in excess of $5,000 apiece over the entry and "buy-in" fees that participants are charged and that comprise a "wagering pool" from which the winnings are paid. The withholding rate is equal to the third lowest rate applicable to single filers, under Code Sec. 1(c), which currently is 25 percent. A sponsor required to withhold on poker tournament winnings must file a Form W-2G, Certain Gambling Winnings, with the IRS on or before February 28 (March 31 if filed electronically) of the calendar year following the calendar year in which the winnings are paid.

SECTION 1. PURPOSE

This revenue procedure informs taxpayers of their obligations under section 3402(q) pertaining to withholding and information reporting applicable to certain amounts paid to winners of poker tournaments. It further sets forth procedures to be used to comply with the relevant requirements of the Internal Revenue Code and Treasury Regulations thereunder.

SECTION 2. FACTUAL BACKGROUND

A business taxpayer ("poker tournament sponsor") may sponsor a poker tournament, charging an entry fee and a "buy-in" fee for each participant. In exchange for the fees, each participant receives a set of poker chips with a nominal face value for use in the specific poker tournament. The poker tournament sponsor pays amounts, which exceed a participant's fees by $5,000, to a certain number of tournament winner(s), out of a pool comprised of all the participants' fees.

SECTION 3. LEGAL BACKGROUND

.01. *Withholding under section 3402.* Section 3402(q)(1) provides that every person who makes any payment of winnings which are subject to withholding shall deduct and withhold from the payment an amount equal to the product of the third lowest rate of tax applicable under section 1(c) and such payment. Section 3402(q)(3) provides that the term "winnings which are subject to withholding" means, in part, proceeds from a wagering transaction, if the proceeds are more than $5,000 from a wager placed in any sweep-stakes, wagering pool, or lottery. The term "wagering pool" includes "all pari-mutuel betting pools, including on- and off-track racing pools, and similar types of betting pools." H.R. Conf. Rep. No. 94-1515, at 488 (1976) (relating to the enactment of §3402(q)). "In common usage the term 'pool' connotes a particular gambling practice, an arrangement whereby all bets constitute a common fund to be taken by the winner or winners." *United States v. Berent*, 523 F.2d 1360, 1361 (9 th Cir. 1975). Section 3402(q)(4)(A) provides that proceeds from a wager shall be determined by reducing the amount received by the amount of the wager.

.02. *Information reporting under section 31.3402(q)-1(e).* Section 31.3402(q)-1(e) of the Employment Tax Regulations provides that each person who is to receive a payment of winnings subject to withholding shall furnish to the payer a statement on Form W-2G or Form 5754 (whichever is applicable) made under the penalties of perjury containing certain required information, including the name, address, and Taxpayer Identification Number of the winning payee. Section 31.3402(q)-1(f)(1) provides that every person making a payment of winnings for which withholding is required shall file a Form W-2G with the IRS on or before February 28 (March 31 if filed electronically) of the calendar year following the calendar year in which the payment of winnings is made and shall furnish a copy of the Form to the payee.

SECTION 4. APPLICATION

A poker tournament sponsor is required to withhold and report on payments of more than $5,000 made to a winning payee in a taxable year by filing an information return with the IRS as prescribed by section 3402(q). The poker tournament sponsor must furnish a copy of the information return to the IRS on or before February 28 (March 31 if filed electronically) of the calendar year following the calendar year in which the payment is made, as prescribed by section 31.3402(q) of the regulations.

SECTION 5. SCOPE

This revenue procedure applies to poker tournament sposors, including casinos, which pay amounts to winners in a manner substantially similar to that described in section 2 of this revenue procedure.

SECTION 6. WAIVER OF LIABILITY UNDER SECTION 3402 AND WAIVER OF OTHER PENALTIES OR ADDITIONS TO TAX

The IRS will not assert any liability for additional tax or additions to tax for violations of any withholding obligation with respect to amounts paid to winners of poker tournaments under section 3402, provided that the poker tournament sponsor meets all of the requirements for information reporting under section 3402(q) and the regulations thereunder.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for payments made on or after March 4, 2008.

SECTION 8. DRAFTING INFORMATION

The principal author of this revenue procedure is Blaise G. Dusenberry of the Office of Associate Chief Counsel (Procedure and Administration). For further information regarding this revenue procedure, contact Cynthia McGreevy at (202) 622-4910 (not a toll-free call).

.03 Authority of Revenue Procedures

Revenue Procedures generally have the same level of authority as Revenue Rulings. Like Rulings, they may be used as precedent. If nothing else, the tax professional knows that IRS

personnel will definitely following the Procedures. In some cases, Revenue Procedures are mandated in certain areas by Congress, and these tend to be given more deference by the courts.

.05 Locating Revenue Procedures

The citation formats for Revenue Procedures are generally the same as Revenue Rulings. The Procedure is first published in the weekly *Internal Revenue Bulletin*, and then again in the annual *Cumulative Bulletin*. The two citation formats are:

- *Rev. Proc. 99-40, 1999-48 I.R.B. 5* (temporary citation, the 40th ruling in 1999, found in the 48th weekly issue of the 1999 Internal Revenue Bulletin on page 5)
- *Rev. Proc. 99-40, 1999-2 C.B. 60* (permanent citation, found on page 60 of the 2nd Cumulative Bulletin of 1999)

Revenue Procedures may be located with generally the same procedures used for Revenue Rulings described above. Revenue Procedures are also categorized and summarized in the *IRS Bulletin Index-Digest System* mentioned earlier.

¶2011 PRIVATE LETTER RULINGS (PLRs)

Private Letter Rulings are issued by the IRS National Office in response to taxpayers' requests for the IRS's position on a particular tax issue. One example would be a request to evaluate the tax consequences of a proposed merger.

Observation

There are many topics that the IRS will refuse to rule on. This is especially true for areas of the tax law that seem fairly settled. Generally, the first Revenue Procedure issued each year (e.g., Rev. Proc. 2009-1) provides a current list of the areas that may not be the subject of ruling requests. This Revenue Procedure also lists the requirements for submitting a ruling request, the appropriate fees, and other details.

.01 Drafting Procedures for PLRs

The procedures used for drafting PLRs are much the same as Revenue Rulings, except that (1) such requests receive a more limited review by the National Office of the IRS at the Group or Section levels only, and (2) such rulings are not published (in print) by the IRS. In addition, the IRS lists a number of issues each year that it will not rule on. This list, along with the detailed instructions for requesting a ruling (as well as for requesting a change in accounting period or method) are usually printed in the first Revenue Procedure issued for the calendar year.

.03 Precedent Value of PLRs

The PLR is issued only to the requesting taxpayer, and its reliability is high for that particular taxpayer. The taxpayer must attach the ruling to the relevant tax return when filed, although there is no legal requirement that the taxpayer must actually follow the ruling. If the IRS receives a number of ruling requests on the same issue, or the issue is one of emerging importance, they may decide to publish the PLR as a Revenue Ruling.

Although the IRS insists that PLRs may not be relied on as precedents, other factors tend to mitigate this statement. For example, Code Sec. 6110(f) makes such letter rulings available for inspection by the public under the Freedom of Information Act, and PLRs are included on the list of authorities that may be cited as "substantial authority" for avoiding certain statutory penalties. Because of these factors, several tax publishers now offer digests or complete texts of such rulings. A PLR is illustrated in **Figure 4**.

Figure 4 **Private Letter Ruling 201321017, 05/24/2013, IRC Sec(s). 162**

Trade or business expenses-excessive employee remuneration-covered employees.

Corp.'s three employees, two of whom each served as principal financial officer during same taxable year and other who was one of corp.'s three highest compensated officers and whose employment was terminated before end of taxable year, wouldn't be considered "covered employees" under Code Sec. 162(m); for taxable year ending on stated date.

Full Text:
February 20, 2013
Dear [Redacted Text]:

This letter is in response to a letter dated December 11, 2012, submitted by your authorized representative, requesting a ruling under section 162(m) of the Internal Revenue Code (Code). Specifically, Taxpayer requested a ruling that Employee A, Employee B, and Employee C are not "covered employees" under section 162(m) for Taxpayer's taxable year ending on Date 3 (Year 1). The facts, as represented, are as follows.

Taxpayer is a publicly held corporation. Employee A and Employee B each served as the principal financial officer of Taxpayer during a portion of Year 1. During Year 1, Employee A served as the principal financial officer beginning on Date 1 and ending on Date 2, and Employee B served as the principal financial officer beginning on Date 2 and for the remainder of Year 1. Pursuant to the executive compensation disclosure rules under the Securities Exchange Act of 1934 (Exchange Act), Taxpayer is required to disclose the compensation of Employee A and Employee B because each served as the Taxpayer's principal financial officer during Year 1. During Year 1, Employee C was one of the Taxpayer's three highest compensated officers. Employee C's employment with Taxpayer terminated before Date 3. Even though Employee C was not serving as an executive officer of the Taxpayer at the end of Year 1, under the Exchange Act executive compensation disclosure rules Taxpayer is required to disclose the compensation of Employee C for Year 1 because Employee C would have been disclosed as one of the Taxpayer's three highest compensated executive officers (other than the PEO or the PFO) if he was serving as an executive officer at the end of Year 1.

Section 162(a)(1) of the Code allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 162(m)(1) of the Code provides that for any publicly held corporation no deduction shall be allowed for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year exceeds $1 million.

Section 162(m)(2) of the Code defines publicly held corporation to mean any corporation issuing any class of common equity securities required to be registered under section 12 of the Exchange Act.

Section 162(m)(3) of the Code defines covered employee as any employee of the taxpayer if (A) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such capacity, or (B) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Exchange Act by reason of such employee being among the four highest compensated officers for the taxable year (other than the chief executive officer).

Section 1.162-27(c)(2) of the Income Tax Regulations provides that a covered employee is any individual who, on the last day of the taxable year, is (A) the chief executive officer of the corporation or is acting in such capacity; or (B) among the four highest compensated officers (other than the chief executive officer). Whether an individual is the chief executive officer or one of the four highest compensated officers is determined pursuant to the executive compensation disclosure rules under the Exchange Act.The executive compensation disclosure rules are contained in Item 402 of Regulation S-K, 17 CFR 229.402.These rules require disclosure of compensation awarded to, earned by, or paid to certain executive officers.

On September 8, 2006, a final rule amending the Securities and Exchange Commission's executive compensation disclosure rules was published in the Federal Register (71 FR 53158). Among other things, the amended disclosure rules altered the composition of the group of executives who are covered by the disclosure rules. Like the pre-amendment disclosure rules, the amended disclosure rules refer to these executives as "named executive officers." Under the amended disclosure rules, named executive officers consist of, in relevant part, (i) all individuals serving as the registrant's principal executive officer or acting in a similar capacity during the last completed fiscal year, regardless of compensation level; (ii) all individuals serving as the registrant's principal financial officer or acting in a similar capacity during the last completed fiscal year, regardless of compensation level; (iii) the registrant's three most highly compensated executive officers other than the principal executive officer and the principal financial officer who were serving as executive officers at the end of the last completed fiscal year; and (iv) up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year. Prior to amendment, the disclosure rules provided that named executive officers consisted of, in relevant part, (i) all individuals serving as the registrant's chief executive officer or acting in a similar capacity during the last completed fiscal year, regardless of compensation level; and (ii) the registrant's four most highly compensated executive officers other than the chief executive officer who were serving as executive officers at the end of the last completed fiscal year. Companies were required to comply with the amended disclosure rules for fiscal years ending on or after December 15, 2006.

Notice 2007-49, 2007-1 C.B. 1429, provides that the IRS will interpret the term "covered employee" for purposes of section 162(m) to mean any employee of the taxpayer if, as of the close of the taxable year, such employee is the principal executive officer (within the meaning of the amended disclosure rules) of the taxpayer or an individual acting in such a capacity, or if the total compensation of such employee for that taxable year is required to be reported to shareholders under the Exchange Act by reason of such employee being among the three highest compensated officers for the taxable year (other than the principal executive officer or the principal financial officer). The Notice also provides that the term covered employee for purposes of section 162(m) does not include those individuals for whom disclosure is

required under the Exchange Act on account of the individual being the taxpayer's principal financial officer (within the meaning of the amended disclosure rules) or an individual acting in such a capacity.

Therefore, based solely on the facts presented, we rule as follows:

- For purposes of section 162(m) of the Code, Employee A, Employee B, and Employee C will not be considered "covered employees" with respect to Year 1.
- This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.
- A copy of this letter must be attached to any income tax return to which it is relevant.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,
John B. Richards
Senior Technical Reviewer

A number of courts have also cited Private Letter Rulings in some fashion. For example, in *Rowan Companies, Inc. v. U.S.*,[4] the U.S. Supreme Court cited such rulings as evidence of inconsistent IRS positions on the issue of FICA and FUTA tax classifications. There is also evidence that the IRS refers to such prior rulings in order to foster consistent tax administration when dealing with similar issues.

.05 Locating PLRs

Private Letter Rulings are generally cited in either of the following manners:

- *PLR 8651012*
- *PLR 201321017*

In the first cite, 86 is the year, 51 is the 51st week of the year, and 012 represents the 12th ruling issued that week. The second cite is for the years 2000 and later; 9 digits are used for these cites (with the first four used for the year). Most electronic tax services contain complete texts of all Private Letter Rulings.

¶2013 OTHER FORMS OF LETTER RULINGS: TECHNICAL ADVICE MEMORANDA (TAMS), FIELD SERVICE ADVICES (FSAS), AND DETERMINATION LETTERS

.01 Technical Advice Memoranda (TAMs)

A **Technical Advice Memorandum (TAM)** is another type of letter ruling issued by the IRS. A TAM represents the IRS's response to a request by an IRS District Director or Appeals

[4] *Rowan Companies*, SCt, 81-1 USTC ¶9479, 452 US 247, 101 SCt 2288.