South Western Federal Taxation 2023 Essentials of Taxation Individuals and Business Entities 26th edition Nellen Solutions Manual

SKU: 9780357720103-SOLUTIONS

Instructor's Guide

Nellen/Cuccia/Persellin/Young, SWFT 2023 Volume 4: Essentials of Taxation: Individuals and Business Entities, 9780357720103; Chapter 2: Working with the Tax Law

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Chapter Objectives

The following objectives are addressed in this chapter:

2.1 Describe the statutory, administrative, and judicial sources of the tax law and the purpose of each source.

2.2 Locate and work with the tax law and explain the tax research process.

2.3 Communicate the results of the tax research process in a client letter and a tax file memorandum.

2.4 Employ a strategy for applying tax research skills in taking the CPA exam.

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Chapter Outline

In the outline below, each element includes references (in parentheses) to related content. "CO CH.##" refers to the chapter objective; "PPT Slide #" refers to the slide number in the PowerPoint deck for this chapter (provided in the PowerPoints section of the Instructor Resource Center); and, as applicable for each discipline, accreditation or certification standards ("BL 1.3.3"). Introduce the chapter and use the Ice Breaker in the PPT if desired, and if one is provided for this chapter. Review learning objectives for Chapter 2. (PPT Slide 2).

I. Tax Law Sources (2.1, PPT Slides 5–39)

   a. Statutory Sources of the Tax Law
      i. Statutory sources of law include the Constitution (Article I, Sections 7, 8, and 10), tax treaties, and the Internal Revenue Code.
      ii. Origin of the Internal Revenue Code.
         1. Known as the Internal Revenue Code of 1939, the codification arranged all Federal tax provisions in a logical sequence and placed them in a separate part of the Federal statutes.
         2. Major amendments to this codification took place in 1954, 1986, and 2017.
         3. Congress usually passes one or more laws each year that have tax provisions and become part of the Internal Revenue Code of 1986.
      iii. The Legislative Process.
         1. Exhibit 2.1 in the text illustrates the usual legislative process for enacting changes to the Internal Revenue Code.
         2. Federal tax legislation normally originates in the House Ways and Means Committee of the House of Representatives because the U.S. Constitution mandates that revenue raising bills begin in the House. A tax bill might originate in the Senate if it is attached as a rider to other legislative proposals.

3. Tax legislation is referred from the Senate Finance Committee to the entire Senate. If the House and Senate tax bills disagree, the Joint Conference Committee resolves the differences. (See Exhibit 2.2 in the text for an illustration of what happened with amendments to the child tax credit in the drafting of the Tax Cuts and Jobs Act of 2017.)
4. The Committee Reports explain the provisions of the proposed legislation and are a valuable source for ascertaining the intent of Congress. What Congress had in mind when it considered and enacted tax legislation can be a key to interpreting the legislation by taxpayers, the IRS, and the courts.

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

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

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

1. These treaties affect transactions involving U.S. persons and entities operating or investing in a foreign country, as well as persons and entities of a foreign country operating or investing in the United States.
2. Neither a tax law nor a tax treaty automatically takes legal precedence. When there is a direct conflict between the Code and a treaty, the most recently adopted item prevails.

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

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

1. Regulations, which carry considerable authority as the official interpretation of tax law, may be issued in proposed, temporary, or final form.
    (a) New Regulations and changes in existing Regulations usually are issued in proposed form before they are finalized. The interval between the proposal of a Regulation and its finalization permits taxpayers and other interested parties to comment on the propriety of the proposal. Proposed Regulations carry little weight.
    (b) Final Regulations have the force and effect of law. They carry considerable authority as the official interpretation of tax statutes.

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

2. Proposed, Temporary, and Final Regulations are published in the *Federal Register*, the *Internal Revenue Bulletin*, and major tax services.
3. Regulations also may be classified as legislative, interpretive, or procedural.

ii. Revenue Rulings, Revenue Procedures, and Notices.

1. Revenue Rulings are official pronouncements of the National Office of the IRS. They usually deal with more restricted problems than Regulations and do not carry the same legal force and effect as Regulations.
2. Both Revenue Rulings and Revenue Procedures serve an important function in providing guidance to IRS personnel and taxpayers in handling routine tax matters. They generally apply retroactively and may be revoked or modified by subsequent rulings or procedures, Regulations, legislation, or court decisions.
3. Revenue Procedures are issued in the same manner as Revenue Rulings, but they deal with the internal management practices and procedures of the IRS. Revenue Procedures do not carry the same legal force and effect as Regulations.
4. Notices are issued when immediate guidance is needed by taxpayers. Typically, this guidance is transitional while the IRS works on permanent guidance on the particular topic.
5. Revenue Rulings, Revenue Procedures, and Notices are published weekly by the U.S. Government in the *Internal Revenue Bulletin* (I.R.B.). *Internal Revenue Bulletins* are listed at **irs.gov/irb**.

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

iv. Other Administrative Pronouncements.

1. *Treasury Decisions* (TDs) are issued by the Treasury Department to announce new Regulations, amend or change existing Regulations, or announce the position of the Government on selected court decisions. TDs are published in the *Internal Revenue Bulletin*.
2. The IRS also publishes various administrative communications on its website, such as IRs (News Releases), Chief Counsel Advice (CCA), Chief Counsel Notices (CCN), and frequently asked questions (FAQs).
3. A determination letter is a statement issued by the Area Director in response to a taxpayer and provides guidance on the application of the tax law.

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

c. Judicial Sources of the Tax Law

i. Five Federal courts have jurisdiction over tax disputes between the IRS and taxpayers: the U.S. Tax Court, the U.S. District Court, the U.S. Court of Federal Claims, the U.S. Court of Appeals, and the U.S. Supreme Court.

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

1. A court of original jurisdiction initially hears the case.
2. Appeals (either by the taxpayer or the IRS) are heard by the appropriate appellate court.
3. To commence litigation, the taxpayer chooses among the pertinent U.S. District Court, the U.S. Court of Federal Claims, the U.S. Tax Court, or the Small Cases Division of the U.S. Tax Court.
4. At the trial court level, a taxpayer usually is the plaintiff (or petitioner), and the government is the defendant (or respondent). If the taxpayer wins and the government appeals as the new petitioner (or appellant), the taxpayer now is the respondent.

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

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

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

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

(a) The fact that the IRS does not appeal does not mean that the IRS agrees with the result.
(b) The role of appellate courts is limited to a review of the record of the case that was compiled by the trial courts. As a result, the appellate process usually involves a determination of whether the trial court applied the proper law in arriving at its decision.
(c) The appellate court may approve (affirm) or disapprove (reverse) the lower court's findings, or it may send the case back to the trial court for further consideration (remand).

2. Other Rules and Strategies. The Federal Circuit at the appellate level provides a taxpayer with an alternative forum to the Court of Appeals of their home circuit.
(a) District Courts, the Tax Court, and the Court of Federal Claims must abide by the precedents set by the Court of Appeals of their jurisdiction.
(b) All courts must follow decisions of the U.S. Supreme Court.
(c) As a result of *Golsen* [*Jack E. Golsen*, 54 T.C. 742 (1970)], the Tax Court will not follow its own precedents in a subsequent case if the Court of Appeals with jurisdiction over the taxpayer previously reversed the Tax Court on the issue at hand.

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

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

1. Judicial Citations—The Tax Court. The Tax Court issues two types of decisions: Regular and Memorandum, based on the Chief Judge's determination. They differ in both substance and form.
(a) Memorandum decisions deal with cases that involve only the application of already established principles of law.
(b) Regular decisions involve novel issues not previously resolved by the Tax Court.
(c) In actual practice, both Regular and Memorandum decisions represent the position of the Tax Court and, as such, can be relied on.
(d) Regular Tax Court decisions are published by the U.S. Government Printing Office as the *Tax Court of the United States Reports*. Memorandum decisions are published by both CCH and Thomson Reuters.

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

2. Judicial Citations—The District Courts, Court of Federal Claims, and Courts of Appeals. Decisions dealing with Federal tax matters are reported in both the CCH *U.S. Tax Cases* (USTC) and the *American Federal Tax Reports* (AFTR) series. Federal District Court decisions, dealing with both tax and nontax issues, also are published by West in its *Federal Supplement Series* (F.Supp.).
3. Judicial Citations—Supreme Court. Decisions are published by CCH in the USTCs and in the AFTRs. The U.S. Government Printing Office also publishes these decisions in the *United States Supreme Court Reports* (U.S.), as does West in the *Supreme Court Reporter* (S.Ct.) and the *United States Reports, Lawyer's Edition* (L.Ed.).

II. Working with the Tax Law—Tax Research (2.2, PPT Slides 40–55)

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

ii. Tax research involves the following procedures (illustrated in Exhibit 2.6 in the text):
   1. Identifying and refining the problem.
   2. Locating the appropriate tax law sources.
   3. Assessing the tax law sources.
   4. Arriving at the solution or at alternative solutions, including consideration of nontax factors.
   5. Effectively communicating the solution to the taxpayer or the taxpayer's representative.
   6. Updating the solution in light of new developments.

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

b. Refining the Problem
   i. Use new facts to refine the tax problem.

c. Locating the Appropriate Tax Law Sources
   i. Once the problem is clearly defined, the researcher does a keyword search using an electronic tax service or references the Internal Revenue Code and the Treasury Regulations.

ii. Tax Services. Several important observations about the use of tax services cannot be overemphasized.
   1. Always check for current developments. Tax services are updated several times a day, and tax newsletters often feature highlights of recent tax law developments.
   2. There is no substitute for the original source. Do not base a conclusion solely on a tax service's commentary. If a Code Section, Regulation, or case is vital to the research, read it.

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

d. Assessing Tax Law Sources
   i. Once a source has been located, the next step is to assess it in light of the problem at hand. Proper assessment involves careful interpretation of the tax law and consideration of its relevance and significance.
   ii. Interpreting the Internal Revenue Code. This is the greatest challenge for the IRS. The language of the Code is difficult to comprehend fully.
   iii. Assessing the Significance of a Treasury Regulation.
      1. Give the Code and any related Regulations equal weight when dealing with taxpayers and their representatives.
      2. Proposed Regulations are not binding.
      3. The burden of proof is on the taxpayer.
      4. Final Regulations can be classified as procedural, interpretive, or legislative. Procedural Regulations are instructions indicating information that taxpayers should provide the IRS.
      5. Interpretive Regulations are hard and solid and almost impossible to overturn unless they do not clearly reflect the intent of Congress.
      6. In some Code Sections, Congress has given the Treasury Secretary or a delegate the specific authority to prescribe Regulations to carry out the details of administration. Regulations issued under this type of authority possess the force and effect of law and often are called Legislative Regulations.
   iv. Assessing the Significance of Other Administrative Sources of the Tax Law. Revenue Rulings carry much less weight than Regulations; however, they are important for the researcher in that they reflect the position of the IRS on tax matters for specified fact patterns.
   v. Assessing the Significance of Judicial Sources of the Tax Law. How much reliance can be placed on a particular decision depends on the following factors:
      1. The level of the court. The higher the level of the court that issued a decision, the greater the weight accorded to that decision.

2. The legal residence of the taxpayer. More reliance is placed on decisions of courts that have jurisdiction in the area where the taxpayer's legal residence is located.
3. The type of decision. A Tax Court Regular decision carries more weight than a Memorandum decision; the Tax Court does not consider Memorandum decisions to have precedential value.
4. The weight of the decision. A decision that is supported by cases from other courts carries more weight than a decision that is not supported by other cases.
5. Subsequent events. Was the decision affirmed or overruled on appeal?
6. In connection with the last two factors, the use of a citator is invaluable to tax research. A citator provides the history of a case, including the authority relied on in reaching the result.

vi. Understanding Judicial Opinions. Reading judicial opinions can be more productive if certain conventions of usage are understood.
1. Some courts, including the Tax Court, apply the terms "petitioner" and "respondent" to the plaintiff and defendant, respectively, particularly when the case does not involve an appellate proceeding.
2. Appellate courts often use the terms "appellant" and "appellee" instead.
3. It also is important to distinguish between a court's final determination, or holding, and passing comments made in the course of its opinion. These latter remarks, examples, and analogies, often collectively termed "dicta," are not part of the court's conclusion and do not have precedential value.

vii. Assessing the Significance of Other Sources.
1. Primary sources of tax law include the Constitution, legislative history materials, statutes, treaties, Treasury Regulations, IRS pronouncements, and judicial decisions.
2. Reference to secondary materials such as tax publications, treatises, legal opinions, and written determinations may be useful. In general, secondary sources do not constitute tax authority.
3. For purposes of the accuracy-related penalty, the IRS expanded the list of substantial authority to include a number of other items (e.g., letter rulings and Proposed Regulations).

e. Arriving at the Solution or at Alternative Solutions
   i. Discuss possible solutions to Example 4 in the text.

f. Communicating Tax Research (2.3, PPT Slides 56–57)
   i. A good tax research communication should contain the following elements:
   - A clear statement of the issue.
   - A short review of the fact pattern that raised the issue.
   - A review of the pertinent tax law sources.

- Any assumptions made in arriving at the solution.
- The solution recommended and the logic or reasoning supporting it.
- The references consulted in the research process.

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

g. Updates

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

h. Tax Research Best Practices

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

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

1. Search various databases using keywords that are likely to be found in the underlying documents, as written by Congress, the judiciary, or administrative sources.
2. Link to tax documents for which all or part of the proper citation is known.
3. Browse the tax databases, examining various tables of contents and indexes in a traditional manner or using cross-references in the documents to jump from one tax law source to another.
4. Sometimes a researcher can begin a search process using materials that are available at no direct cost. Such sources include the following:
   - Exhibit 2.9 in the text lists some of the websites that may be most useful to tax researchers and their internet addresses as of press date.
   - Blogs and RSS feeds provide a means by which information related to the tax law can be exchanged among taxpayers, tax professionals, and others who subscribe to the group's services.

III. Tax Research on the CPA Examination (2.4, PPT Slide 58)

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

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

ii. Questions address issues involving tax compliance and tax planning matters.
iii. Each exam section includes multiple-choice questions and case studies called task-based simulations (TBSs).
    1. The Regulation section of the exam has 76 multiple choice questions and 8 TBSs.
    2. TBSs are small case studies designed to test a candidate's tax knowledge and skills using real-life work-related situations.
    3. The typical TBS requires 15 to 20 minutes to complete.
iv. Candidates can learn more about the CPA examination at **aicpa.org/becomeacpa/cpaexam.html**. This site reviews the exam's format, navigation functions, and tools. A collection of study materials is available, and a 30- to 60-minute sample exam will familiarize a candidate with the types of questions on the examination.
v. In 2020, the AICPA and the National Association of State Boards of Accountancy (NASBA) announced the start of a modification to the CPA exam expected for 2024 (see **evolutionofcpa.org**). The change aims to ensure the CPA designation reflects the knowledge and skills expected of a CPA today.
vi. The new approach to the CPA exam (and licensure) is to test core knowledge plus a discipline. The core includes accounting, auditing, tax, and technology; all candidates take this part of the CPA exam. The three disciplines are business analysis and reporting, information systems and controls, and tax compliance and planning, with candidates taking an exam in one of these areas. Regardless of the chosen discipline, this model leads to full CPA licensure, and the CPA is not limited to practice only in the discipline selected for testing on the CPA exam.

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Discussion Questions

You can assign these questions several ways: in a discussion forum in your LMS; as whole-class discussions in person; or as a partner or group activity in class.

1. Discussion 1 (2.2 and 2.4, PPT Slides 40–55 and 58) Duration 15 minutes.
    a. For her tax class, Yvonne is preparing a research paper discussing the tax aspects of qualified stock options. Explain to Yvonne how she can research the provisions on this topic.
        i. Answer: After understanding the relevant facts and the accounting rules related to qualified stock options:
            - A key word search on an online service is appropriate—Thomson Reuters *Checkpoint*, CCH *IntelliConnect* or *AnswerConnect*, LexisNexis, or Westlaw (or WestlawNext).

- Yvonne may browse through IRS publications (available on the IRS website).
- Additional information can be found on the internet. Many CPA and law firms post reliable articles on various tax subjects, often with reference and links to primary authority.

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Video Information

Related Cengage Video Content

- Show Me How video (none applicable)
- Concept Clips/Quick Lessons video (none applicable)

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