

SOLUTIONS MANUAL



**TAX
RESEARCH**
FOURTH EDITION

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TAX RESEARCH
By Barbara Karlin
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INSTRUCTOR'S GUIDE

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PREFACE

This guide is intended to help the instructor address the research questions that follow each chapter. Much effort has been made to ensure that the answers are as complete and accurate as possible. However, due to the dynamic nature of tax law, as time passes, Congress amends the Code, the Treasury issues new Regulations and the courts continue producing cases. Please use this guide as a starting point with that fact in mind.

Those seeking additional instructor tools such as PowerPoint slides and exams may wish to go to the following Web address where such tools can be found:
<http://www.prenhall.com/karlin>.

**KEY CONCEPTS
AND
PRACTICAL APPLICATIONS**

CHAPTER 1 - OVERVIEW OF TAX RESEARCH

KEY CONCEPTS (1-21)

1. Definitions:
 - a. **Tax planning** occurs when a tax question arises before all the facts are established. In this case, research results may play a significant role in planning a future transaction. In a tax planning situation, it is important for the researcher to determine precisely what the taxpayer wishes to accomplish. The researcher can then examine the law and provide the taxpayer with useful information about whether it is possible to attain these goals, and if possible, how they might be achieved.
 - b. A **fact** is something that is real or actual. A fact is different from an opinion. (See pages 7-9)
 - c. A **conclusion** is an opinion. A conclusion may result from reviewing facts or the law. It is important to distinguish a conclusion from a fact. (See pages 7-9)
 - d. A **fact** is **relevant** when it affects the application of the tax laws. An irrelevant fact is one that, even if altered, would have no impact on the application of the tax laws. (See pages 7-9)
 - e. A **primary source** is the most authoritative form of tax resource. Usually, researchers should base their conclusions only on primary sources. Only authorized governmental bodies such as Congress (the Internal Revenue Code), the Treasury Department and the judiciary generate primary sources. (See pages 11-13)
 - f. A **secondary source** may be very useful in the research process, but it is not authoritative. Examples of secondary sources include reference services, treatises, textbooks and journal articles.
 - g. **IRC** stands for the Internal Revenue Code. It is the central primary source in tax research. Most of the tax laws are found in the Internal Revenue Code.
 - h. A **reference service** is a type of secondary source of information for the tax researcher. A reference service, among other things, provides references to potentially relevant primary authority.

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- i. Employers often use **time budgets** to indicate the approximate amount of time the researcher should expect to spend on a research project. Unfortunately, because they are guesstimates, they are often not as accurate as one would like. However, they may provide a helpful guide regarding how exhaustive the research effort should be. If the researcher finds she will likely exceed the allotted time budget, it is advisable to consult with the person who prepared the budget before performing more research.
2. The purpose of tax research is to determine the tax implications of a certain set of facts, or to answer a tax question.
3. The four basic steps in the tax research process are:
 - Step One - Gathering Relevant Facts
 - *determine the relevant tax question
 - *identify all the material facts
 - Step Two -Researching
 - *identify and read the pertinent resources
 - *define the question if necessary and/or obtain additional facts
 - Step Three - Analyzing
 - *synthesize the information gathered
 - *ponder what you have learned
 - *determine whether there is enough information and authority to render a conclusion
 - *conclude
 - Step Four - Communicating
 - *determine the appropriate form of communication
 - *communicate your conclusions.
4. It is important to determine and remain focused on the research question throughout the research process. Because there is so much information available to the researcher, it is easy to go astray and waste time material irrelevant to the research question. When the researcher determines the initial research question, he can review the material efficiently with an eye towards information that may help answer the question. By staying focused, the researcher can carefully eliminate that material not useful to the question. The researcher must also recognize the potential to amend the initial research question as he gains more information through the research process.
5. It is important to determine whether you have been asked to act in a planning role when gathering facts and determining the research question for a variety of reasons. The expectations placed upon the researcher in a planning role may substantially differ from those expected of the researcher when asked to react to an established set of facts. In the

planning role, the researcher may be expected to provide creative suggestions as to how the taxpayer might accomplish his objectives. In addition, when planning, the researcher is in a potentially more vulnerable situation because the research results may directly impact the taxpayer's actions. (See page 17)

6. A fact is something real, whereas a conclusion is an opinion which may or may not be based on the facts or the law. It is important to recognize the difference between the two because the tax research must be based on the facts and the law only.
7. The research question often changes as the research process progresses. As the researcher learns more about the relevant provisions in the Internal Revenue Code, it is likely that he will need to refine the research question. This may continue to occur with each step of the research process. (See pages 4-7)
8. The researcher may miss critical information and fail to identify a critical tax question if she frames the research question too narrowly. While it is important to stay focused, it is also necessary to recognize that the initial research question may need to be expanded to cover additional issues identified through the research process.
9. A tax researcher's role is varied. It may simply be to determine the appropriate way to report a completed transaction on a tax return. Or, the researcher may be asked to justify a taxpayer's position taken in a previously filed tax return. Another potential role for the research involves helping a taxpayer plan a future transaction. The researcher may be a creative advisor and educator. Ultimately, the researcher must also communicate the research results in the taxpayer.

Tax research of some sort is necessary whenever someone (client, employer or researcher) identifies a tax question requiring an answer. As a taxpayer's advisor, sometimes the researcher is able to provide the taxpayer with a clear and definitive answer about the tax question, e.g., "Yes, the position taken on a previous return was correct," or, "You must report the salary income on your return." However, in a planning mode, such straightforward results are not often possible. In the planning mode, although the taxpayer may expect the tax advisor to make the decision as to what the taxpayer should do, it is important that the tax advisor only educate the taxpayer so that the taxpayer can make the decision.

10. The researcher can gather relevant facts by questioning the taxpayer and reviewing relevant documents. It is important to be aware of all the facts because the application of the law may change if any of the relevant facts change. Sometimes it is difficult for the researcher to gather all the relevant facts because the researcher may not know what are the relevant questions to ask and the taxpayer may not know what are the relevant facts to explain.

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11. The two sources of primary authority that provide interpretations of the Internal Revenue Code are Treasury interpretations and judicial interpretations.
12. Reference services may help direct the researcher to relevant primary authority.
13. The researcher may base his research conclusion only on primary sources, not secondary sources. In determining whether something is a primary source, it is helpful to consider the originator of the source. If either Congress, the Treasury Department or the courts authored the source, it is likely a primary source. Otherwise, the source is likely a secondary source.
14. Each research step requires the use of critical thinking.
15. The researcher may communicate research results either internally or externally. Internal communications include letters to the file or office memos. External communications include letter to the taxpayer and letters to a taxing authority. Communication can take either oral or written form.
16. Sometimes, there is only one correct answer to a tax research question. However, many times, there is no one correct answer. Instead, there may be a variety of potentially correct answers. This is because the tax law is complex and frequently subject to a variety of interpretations.
17. The tax researcher takes on the role of tax advocate in a variety of situations, the key one being when representing the taxpayer before a taxing authority during an audit.
18. The researcher is typically in a tax planning situation when the facts can still be altered. Tax planning typically does not occur when the facts are established and the researcher is asked to determine the appropriate reporting position. However, any possible change in the future actions of the taxpayer may trigger the research to become involved in tax planning. As a tax planner, the researcher must provide the taxpayer with guidance regarding the taxpayer's options. Particularly because of the increased vulnerability to the tax researcher, it is important to recognize when tax planning is involved.
19. The standard required when signing a return or recommending a tax return position to a taxpayer is that the position have a "realistic possibility of being sustained on its merits." To satisfy this standard, the researcher must be able to show that after performing a reasonable and well-informed analysis, a knowledgeable person in tax law would conclude there is at least a one in three chance that the position will be upheld.
20. The tax researcher should be aware of the practical considerations of the need to be accurate and time efficient, while considering the various standards of authority and the

amount of tax involved. The researcher must also create a proper record of the research performed.

21. Client files help refresh the researcher's memory regarding the facts and research results and reasoning. In addition, they help provide for continuity in the service provided to the taxpayer. A client file should include all relevant tax documents (tax returns, supporting documents, etc.), summaries of written and oral communications regarding client issues, office memos, supporting documentation for each research project, and any carryover schedules.

PRACTICAL APPLICATIONS (22-26)

22.
 - a. If taxpayer purchased a ticket for the New Jersey lottery and won \$1,000, an initial question arises regarding whether the \$1,000 will be considered income for federal income tax purposes and also state tax purposes. Potentially helpful additional information includes: when and if the taxpayer collected the cash, type of taxpayer (individual or something else), and method of accounting the taxpayer uses.
 - b. Taxpayer's payment of \$5,000 to his former wife triggers the initial tax question as to whether the taxpayer is entitled to a deduction for the \$5,000 payment for either federal or state tax purposes. It would be helpful to know more about what generated the payment (e.g., was it required under a divorce decree or was it voluntary), and the specific terms controlling the payment.
 - c. Taxpayer's payment of \$1,000 to a lawyer for advice triggers the initial question as to whether the payment might qualify as a tax deduction for either federal or state tax purposes. Necessary additional information includes the nature of the services performed by the lawyer for the taxpayer and the date of payment.
23.
 - a. Although this set of facts seems at first to be rather complete, there is still a good deal of relevant information missing: the date of the divorce; number of children; children's ages; divorce decree and specific wording requiring the \$10,000 payment; if it is determined by the researcher that a portion of the \$10,000 is actually child support, another relevant piece of necessary information is Mr. K's history of payments - has he kept up with them or is he behind? [§71(c)(3)] In addition, if the payments are made within the first three years of the divorce, there may be a frontloading issue which requires a knowledge of the history of payments made. [§71(f)]
 - b. Additional potential sources of information or documents include: prior tax returns and any divorce documents available.

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- c. Relevant facts include the amount of payments and the fact they are made monthly.
Irrelevant facts include Mr. K's occupation and age.
 - d. Unless the student is very familiar with the rules under §71, the student will not yet be able to identify all the facts necessary to fully address the research question. Not until the law is examined will the student be able to appreciate all the relevant facts and know all the relevant questions to ask.
 - e. The students most likely will identify the initial question as "Is the \$10,000 income to Mrs. K?" That's the first step in identifying the question. But as the student begins to discover more about the law, for example that there is a different tax impact depending on whether the amounts are alimony or child support, the question begins to be more refined. One of the first refinements would be to determine what portion of the \$10,000 is alimony and what part is "child support." There are several additional layers of refinements as the student digs deeper into the Code Section.
 - f. The taxpayer's desired result is to avoid being required to recognize as income the \$10,000. Clearly the researcher should be aware of this. However, since the facts are already set, the desired result is not quite as important as in a planning setting.
 - g. The students should recognize that this is not a planning research problem. The facts are already entirely set. It could turn into a planning situation if, as a result of the information the researcher provides to Mrs. K, she decides she wants to change the facts by, for instance, revisiting in court how the amounts are to be structured.
 - h. The same laws apply and in the same manner if the dollar amount is reduced, except perhaps for the frontloading rules in §71(f). However, the need to be quick about the research is underscored because the researcher is looking at a maximum taxable income amount of \$1200. It doesn't make practical sense to research the question so thoroughly that the research bill is as high as the income.
- 24.
- a. The researcher's role in this situation is to determine the tax treatment, then educate the client and report the appropriate tax treatment of the free parking. Planning may occur for future parking arrangements, but the central role at this juncture is to accurately determine the tax impact of the current arrangement.
 - b. The researcher will need to ascertain all the relevant facts as they exist, research the status of the current law on the subject, determine the appropriate tax

treatment in this situation, and communicate the results to the taxpayer.

- c. Some of the questions include the dollar amount involved, the location of the parking lot, the employment relationship of the taxpayer, the law firm's policies regarding the provision of this benefit to its employees, etc.
 - d. The initial research question is "What is the tax impact of free parking provided by a law firm to its employee (if the facts bear this out) or partner (if these are the facts)?"
 - e. The students will not understand at this junction the impact that this has on the tax treatment. However, because the Code provisions in Section 132 treat parking benefits differently depending upon whether someone is a partner or an employee, this underlines the importance of finding out all potentially relevant facts in the initial client interview. (IRC Section 132(f)(1)(C) and (5)(C) provide that parking reimbursements or free parking up to \$175 per month provided by an employer to an employee will be excluded from taxable income.) Thus to accurately answer the research question, the researcher will need to understand the employment relationship of the taxpayer to the law firm. If the taxpayer, upon hearing that the parking benefits represent taxable income, pretends that she did not inform the researcher of the information, ethical issues now arise. Chapter 6 explores this in more detail, but suffice it to say that in this situation, the researcher is obligated under various regulatory rules and guidelines to honestly report the benefits as income.
25. This question provides a good opportunity for the student to explore the subject of managing their work through files. There is no one right answer here. However, some possible files include a tax return file, a working paper file (that includes all the supporting analysis), an important documents file (that includes company bylaws, etc.), and perhaps a correspondence file. Page 22 of the text lists some of the documents that the student might consider including in the files.
26. The initial role of the researcher is to determine the tax treatment of the specific sale. However, the role may quickly change into more of a planning role as the researcher addresses potential future tax strategies regarding future stock transactions. Facts necessary to address the initial question regarding tax treatment of the sale include purchase dates and prices of the shares sold as well as the sales price. Broker statements will need to be gathered.

INTEGRATED CASE STUDIES - see solutions at page 140

CHAPTER 2 – THE INTERNAL REVENUE CODE

KEY CONCEPTS (1-17)

1. Definitions
 - a. **Legislative Committee Reports** provide a record of the decisions made in each legislative committee. They can be helpful in providing guidance regarding legislative intent.
 - b. **The Joint Committee on Taxation** is a nonlegislative committee whose staff help draft bills and committee reports. It also writes the “Blue Book.”
 - c. **The “Blue Book”** is an explanation of new law prepared by the Joint Committee on Taxation. It is considered primary authority.
 - d. **USC** stands for “United States Code.” It embodies all the statutory law passed by Congress.
 - e. **Title 26** of the United States Code is also known as the Internal Revenue Code.
 - f. **Flush language** is language that appears to not clearly belong to the Code provision directly preceding it. Its margins are to the far left.
 - g. **Sunset provisions** are typically found at the end of a Code Section and provide for the section’s termination at a specific date. If Congress wishes to continue the provision, it must do so through legislation.
 - h. **Terms of art** are words that have a special meaning when used in the IRC. Most tax research involves determining the meaning of a “term of art” in the context of a particular factual situation.
 - i. **IRC Section 7701** is the definitional section of the IRC. It provides definitions for a wide variety of terms used.
 - j. **Limiting language** is language that limits the application of a Code provision to a particular portion of the Code. For example, the language “For purposes of this Part,” is limiting language.
 - k. **Transition provisions** are provisions within the Code indicating the application date and terms of a particular Code provision. This occurs whenever a new Code provision is passed.
2. New tax bills must first begin in the House Ways and Means committee. The Senate Finance is the second Congressional committee to examine a potential tax bill. The

Conference Committee is a committee made up of members of the other two committees and is called into action when the Senate bill differs from that produced by the House of Representatives.

3. The legislative process generates committee reports from the three legislative committees. These reports can be useful in helping the researcher determine the Congressional intent behind a particular Code provision.
4. Students can keep informed about current tax legislative activities through review of publications that discuss this topic (BNA daily journals, newspapers, etc.).
5. Committee Reports of new legislation are easiest to locate through the publications made available by the primary tax publishers. Finding Committee Reports reflecting older legislation is more challenging. The major tax reference services also provide excerpts of the committee reports. For legislative history prior to the 1954 Code, *Siedman's Legislative History of the Federal Income Tax Laws* includes committee reports, hearings, and debates for selected legislation from 1861 to 1954. To find legislative history of enacted legislation after 1954, a service published by the Bureau of National Affairs called *Primary Sources* may be helpful. The table of contents is arranged by Code Section. Tax Analysts' web-based Federal Tax Library also provides committee reports for all tax acts since 1981. The major tax services (CCH and RIA) provide selected portions of committee reports through their multi-volumed reference services. These are available in paper and electronically
6. The Internal Revenue Code is divided into many divisions. The largest division is a subtitle, followed by Chapters, Subchapters, Parts, Subparts, and finally Sections. Each major topic has its own Subchapter. Understanding the organization of the Code helps make research more efficient and increases the researcher's confidence that he has found all possible applicable Code Sections.
7. Three possible methods of citing the Internal Revenue Code include: IRC Section; The Internal Revenue Code of 1986 as amended; Code §.
8.
 - a. Information returns and records
 - b. Employment taxes; Federal Insurance Contributions; Deduction of tax from wages
 - c. Financing of Presidential Election Campaigns; Presidential Election Campaign
 - d. Income taxes; Accounting Periods and Methods of Accounting, Methods of Accounting, Taxable year for which deductions taken
9. Through the table of contents, index or by knowing the relevant Code Section.
10. The connecting word is *or*. This means that if any of the listed items are satisfied, the expenditure is considered political lobbying and is not deductible. If the items were

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connected with an *and*, each of the items would need to be fulfilled in order to be penalized under these provisions.

11. "Taxpayer Bill of Rights 2." This was enacted July 30, 1996. This information is located in the back of the CCH softbound IRC volumes and in the front of the RIA softbound volumes.
12. "Economic Growth and Tax Relief Reconciliation Act of 2001." It became law on June 7, 2001. In the back of the CCH Code volumes.
13. Historical notes to a Code Section can be helpful in providing information about historical changes to Code provisions. This information may help the researcher better understand the language used in the current Code provision. The notes often also provide important information about transition dates.
14. The Internal Revenue Code can be found in the following:
 - * Softbound paper version published by both RIA and CCH
 - challenges: must purchase new version regularly to ensure currentness
 - benefits: easy to access
 - * As part of the larger hardbound reference services published by RIA and CCH
 - challenges: fragmented throughout the reporter service; less portable.
 - benefits: updated throughout the year as revisions are made.
 - * On the Internet on publicly accessible addresses
 - challenges: usually outdated; often contains mistakes
 - benefits: free
 - * Electronically either on the Internet or CD-ROM through proprietary fee-based services
 - challenges: cost
 - benefits: easy to cut and paste; current
15. IRC Section 162 is part of Title 26; Subtitle A (Income Taxes); Chapter 1 (normal taxes); Subchapter B (Computation of Taxable Income).
16. IRC Section 162 includes the following:
 - a. 16 Subsections:
 - (a) General
 - (b) Charitable Contributions and Gifts
 - (c) Illegal Bribes and Kickbacks
 - (d) Capital Contributions to Federal National Mortgage Association
 - (e) Denial of deduction for certain lobbying and political expenditures
 - (f) Fines and penalties
 - (g) Treble damage payments under the antitrust laws
 - (h) State legislators' travel expenses away from home
 - (i) Repealed
 - (j) Certain foreign advertising expenses

- (k) Stock redemption expenses
 - (l) Special rules for health insurance costs of self-employed individuals
 - (m) Certain excessive employee remuneration
 - (n) Special rule for certain group health plans
 - (o) Treatment of certain reimbursed expenses of rural mail carriers.
 - (p) Cross references
- b. Paragraphs within subsection (d) include:
- (1) General
 - (2) Carryforward of disallowed interest
 - (3) Investment interest
 - (4) Net investment income
 - (5) Property held for investment
 - (6) Phase-in of disallowance
- c. Subparagraphs within IRC Section 162(d)(3) include:
- (A) General
 - (B) Exceptions
 - (C) Personal property used in short sale
17. IRC Section 7805 provides that the Secretary of the Treasury Department shall prescribe all rules and regulations necessary to enforce the Internal Revenue Code. It also discusses the retroactivity of regulations and the duration of temporary regulations.

PRACTICAL APPLICATIONS (18-55)

18. The correct way to cite the bolded sentence is “IRC Section 280G(b)(2)(C)(ii).”
19. The correct way to cite the bolded sentence is “the flush language of IRC Section 460(b).”
20. a. Corporation’s ability to deduct mining and exploration costs - Section 381(c)(10). [CCH code index topic “mining and exploration costs.”]
- b. Taxation of Social Security benefits of nonresident aliens - Section 871(a)(3). CCH - “Nonresident aliens...then Social Security benefits, taxation of.”]
- c. Definition of “Head of Household” - Section 2(b)(1). [CCH - “Head of Household, defined.”]
- d. Valuation of a gift - Section 2512. [CCH - “Gifts, valuation of” or “Valuation of gifts.”]
- e. Sick pay benefits of employees - Sections 104-106. [CCH – “Employees, sick benefits” or “Sick pay.”]

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- f. Deductibility of face lift - Section 213(d)(9). [CCH - “Cosmetic surgery, medical expenses.”]
 - g. Bad debt reserves - Section 593. [CCH - “Reserves (bad debt)” or “Bad Debt (reserves).”]
 - h. Statute of limitations for filing an amended return - Section 6501(c)(7). [CCH - “Returns” - amended - statute of limitations.”]
 - i. Withholding requirements for tip income - Section 3402(k). [CCH - “Tips” - (Withholding). Or “Withholding of income tax on wages” -(tips)]
 - j. Penalties for tax fraud - Section 6663. [CCH - “Penalties”- fraud.]
21. Subtitle B.
22. Subtitle 1 (Income Taxes); Chapter 1 (Normal Taxes and Surtaxes); Subchapter L (Insurance Companies). Section 816 defines an insurance company.
23. a. Tax on prohibited transactions of pension plan fiduciaries (Sec. 4975)
- b. Definition of the Generation Skipping Tax (Sec. 2611)
- c. Definition of “Adjusted Basis” in determining gain from sale of asset (Sec. 1011-1012)
- d. Taxation of contributions made to a partnership (Sec. 721-724)
- e. Limitations on assessment and collection (Sec. 6501)
24. a. Deduction of interest paid on loans used for education (Sec. 221)
- b. Deduction of corporation’s start-up and organizational expenses (Sec. 248—not to be confused by 195...although table of contents makes it confusing)
- c. Deduction of “qualified tuition” (Section 222)
- d. Definition of a life insurance contract (Section 7702)
- e. Payment of estimated income tax (Sec. 6315)
25. a. IRC §280G - Golden Parachute Payments (nondeductibility)
- b. IRC §3102 - Deduction of federal insurance taxes from wages

- c. IRC §68 - Limitation on deductibility of certain types of itemized deductions
- 26.
- a. IRC §1223 – First sentence contains the words *For purposes of this subtitle* (limiting language); Section 1223(1) contains numerous terms of art (e.g., *exchange, property, sale*); Section 1223(1)(A) contains pinballing to another Code Section as well as the connecting word *and*; Section 1223(8) provides transitional rules; Section 1223(11) has flush language that uses the measuring words *more than 1 year*; Section 1223(16) provides cross references. It will be helpful to note to the students that the numbering in this Code Section differs from the norm in that the Subsections are numeric rather than alphabetic.
 - b. IRC §117 – The first sentence of Section 117(b) contains the limiting language *For purposes of this section*; Section 117(a) contains several terms of art (e.g., *qualified scholarship, individual, candidate for a degree, educational organization*); Section 117(a) pinballs the student to another Code Section; Section 117(b) contains the connecting word *and*.
 - c. IRC §1239 – Section 1239(b) contains the limiting language *For purposes of subsection (a)*; Section 1239(a) contains several terms of art (e.g., *sale, exchange, property, related persons, etc.*); Section 1239(b) uses the connecting word *and*; Section 1239(b)(2) pinballs the student to another Code Section; Section 1239(c)(A) uses the measuring terms *more than 50 percent*.
- 27.
- a. IRC §179 – Section 179(d)(1) uses the limiting language *For purposes of this section*; Section 179(a) contains several terms of art (e.g., *cost, Section 179 property, expense, etc.*); Section 179(b)(3)(B)(i) contains the connecting word *or*; Section 179(b)(4)(B) contains the measuring language *50 percent (not more than or in excess of)*; Section 179(d)(1) pinballs the student to another Code Section. This is also an opportunity to illustrate that Code Section 179 is an entirely different section than Code Section 179A.
 - b. §280F – Section 280F(a)(1)(B)(iv) provides the limiting language *For purposes of this subtitle*; Section 280F(a) contains several terms of art (e.g., *taxable year, passenger automobile, recovery period*); Section 280F(a)(2) contains the connecting word *and* as well as pinballing the student to another Code Section; Section 280F(b)(3) contains the measuring language *exceeds 50 percent*.
 - c. §168 – Section 168(b) contains the limiting language *For purposes of this section*; Section 168(a) contains several terms of art (e.g., *depreciation, tangible property, applicable depreciation method, etc.*); Section 168(b)(2) contains the connecting term *or* as well as a pinball to another Code Section; Section 168(d)(3) contains the measuring term *exceed*; Section 168(f)(5) contains transitional rules. This is a good Code Section to point out the lengthy historical amendments following the Section.

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28. The IRC is replete with examples literally almost every Code Section contains at least one example of limiting language. The purpose of this exercise is to underline the significance of paying attention to limiting language. Because the language seems so nonsubstantive, students tend to simply ignore the language as unimportant.
29. Same answer as #28.
30. Section 172(c) defined the term *net operating loss*.
31. Code Section 168(e)(2)(A)(i) defines this term as “any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units.” The provisions that follow define some, but not all, of the terms of art in this provision such as *dwelling unit*.
32. This is a challenging question for the student. They should ultimately land on the words “substantial risk of forfeiture” as the key words in the taxpayer’s situation. If the stock is subject to “substantial risk of forfeiture,” Sam has no income in the current year. However if he has no “substantial risk of forfeiture,” he has current income. One of the points in this exercise is for the student to appreciate that although there are numerous other terms of art in this provision, the only one requiring special research in this situation are the words “substantial risk of forfeiture.” It is the set of facts that determines which words in the Code need further analysis. The facts in this situation which cause these words to be critical is the potential loss of the stock should Sam be convicted of a crime. The research question moves from “is the stock income” to “is the stock subject to substantial risk of forfeiture?”
- “Substantial risk of forfeiture” is defined somewhat in IRC Section 83(c)(1). This definition is not really sufficient to enable the student to determine whether the stock is subject to a substantial risk of forfeiture. When we get to Chapter 3, the students will have the opportunity to read the regulations which are clear in explaining that the risk of being convicted of a crime is not substantial enough to be considered a “substantial risk of forfeiture.” Therefore, Sam does have income in the year he receives the stock.
33. Now the key term of art is “property.” Does property include cash? The Code does not clarify the meaning of this term for purposes of this section. The regulations indicate that cash is not considered “property” for purposes of Section 83, although it is considered “property” when that word is used in other Code Sections. (For example Section 1041). This illustrates to the student that the facts drive the determination of what portion of the Code requires focus. In addition, this is an important illustration of the fact that the same word may have two different and conflicting definitions depending on what Code Section it is used in.
34. a. Trust income tax – Subchapter I
b. Partnership tax – Subchapter K

- c. Corporate tax – Subchapter C
 - d. Calculation of individual taxable income – Subchapter B
35. This Code Section was generated by P.L. 105-34, Section 1454(a) (The Taxpayer Relief Act of 1997). All of the Committee Reports offer the same authoritative value regarding this provision because the House and Senate’s reports are the same. The Conference Committee Report simply indicates that the conference agreement follows the House and Senate Bill, with some technical modifications. Students can begin to locate this information after consulting with the historical amendments that follow the Code Section which identify the applicable Public Law and Section number. From there, the easiest method of research is to locate one of the softbound volumes containing the history of the act (given the relative recency of the act, students may be able to find this information in their library). If this is not available, students can locate the reports using the electronic online libraries; however, this is somewhat challenging and will likely lead to some frustration. This is a good lesson in why it is useful to keep those softbound legislative summaries.
 36. Code Section 213 allows a deduction to Sam of \$50 per night [flush language of Code Section 213(d)(2)]. Sam appears to satisfy all the requirements for the deduction set forth in Section 213(d)(2) since the amount paid for the lodging does not appear to be *lavish or extravagant*, was incurred *while away from home primarily for...medical care*, and the medical care was provided by a licensed physician in a hospital (we assume it was licensed) and there was *no significant element of personal pleasure...*
 37. Mary will have to recognize the full \$3,000 as income. Code Section 74(c)(1) seems to provide an exclusion for the award. However, that provision refers to Code Section 274(j) for the definition of an *employee achievement award*. Students who assume that Mary’s award is an employee achievement award will miss this question. Code Section 274(j) provides a very narrow definition of the term to include only awards given for length of service or safety achievement [Section 274(j)(3)(A)].
 38. No, the trust is not entitled to the Section 179 deduction per Section 179(d)(4).
 39. The provision was added to the Code Section in 1993 by P.L. 103-66, Sec. 1343(a). This provision applies to property converted on or after 9/1/91. This question provides the student with the opportunity to research using the Code’s historical amendments.
 40. Students should find researching into the current pending legislation interesting. In addition, this provides an opportunity for a substantive discussion (if desired) on some of the pending tax bills.
 41. Costs incurred in searching for a new residence ceased being deductible as moving expenses beginning after December 31, 1993. This change was as result of P.L. 103-66.

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42. a. No, per Section 121(f) which provides for an election by the taxpayer not to have the Code Section apply.
- b. Yes, per Section 121(d)(5) which refers to Section 1033 for additional rules.
- c. No, per Section 121(b)(3)(A) which states that the exclusion is not allowed if there was any other sale for which the exclusion applied during the prior 2 years ending on the date of the second sale.

43. No. The student must look at the historical amendments which indicate that the provisions only apply to sales AFTER May 6, 1997

There was a \$125,000 exclusion for TP's over 55 years old.

The provision was enacted by P.L. 105-34, Sec. 312(a). This process will enable the students to practice researching legislative history.

44. P.L. 107-16 amended Code Section 2001 to change the rate to 49% in 2003, going down by 1% each year through 2009.

45. a. Relevant facts include: motive for travel, travel expenses, actual travel plans.
- b. The research question is whether she will be able to take a deduction for her travel costs.
- c. Code Section 274(m)(2) specifically disallows this form of educational deduction.

46. This problem illustrates a number of challenges: pinballing, measuring words, and attempting to understand the often-times convoluted way things are written. In addition, it is critical in this problem that the student always keep in mind the research question, otherwise she will end up reading all sorts of provisions that never actually apply!

Students may identify the initial research question as "Do the passive loss rules apply to the C Corporation?" The question at this point has nothing to do with what the actual passive loss rules are. This becomes relevant only if they determine the answer to their initial research question is "yes."

The student first gets to the critical Code Section (§469) using either their knowledge, the index ("passive losses") or the table of contents. The critical language in §469 begins in §469(a)(1) with "If for any taxable year the taxpayer is described in paragraph (2)." The rest of paragraph (1) becomes irrelevant for the moment. It is only relevant if the students decides that Corporation C is a "taxpayer described in paragraph (2)." The word *if* is key.

IRC §469(a)(2) lists three types of taxpayers. If Corporation C is any one of these types of taxpayers, then the passive loss provisions apply and the student must go back to the beginning. So now the hunt is to determine whether Corporation C fits into either of the three categories. Note that the connector in the list is *and*.

The facts do not lead one to believe that Corporation C is an individual, estate or trust [§469(a)(2)(A)]. The facts indicate that Corporation C is definitely not a personal service corporation, thus [§469(a)(2)(C)] also does not apply. But Corporation C might fit into [§469(a)(2)(B)] and be considered a *closely held C corporation*.

Now the research question becomes more refined for the moment: Is Corporation C a *closely held C corporation* for purposes of applying §469? To answer this, the student needs to look for the definition of the term *closely held C corporation*. By skimming through §469, the student should land upon §469(j)(1) as the place which provides the definition of this term. [Note that some students may get waylaid and read other subsections which seem relevant since some do start discussing the passive loss rules for closely held corporations. However, this is a useful learning process...if the student has always at the forefront the research question, the student in the skimming process will skip the information that discusses the passive loss rules for a closely held C corp.]

IRC §469(j)(1) informs the student that a *closely held C corporation* is any C corporation described in Code Section 465(a)(1)(B). Now the student must go read that provision, always remembering the reason why he/she is reading it. IRC §465(a)(1)(B) send the reader to yet another code section for the definition: IRC §542(a)(2)!

§542(a)(2) is a very difficult code section to read. After studying it, the students should conclude their facts are such that Corporation C is NOT a *closely held C corporation* for purposes of §469. (It should be pointed out that there may be different meanings for the term *closely held C corporation* but that this definition applies to the term when used in §469.) Once deciphered, the provision says that in order to meet the stock ownership requirements (which the student has been told by the code is the test for whether an entity is a closely held company for the passive loss rules), the following must exist: more than 50% of the stock is owned by 5 or fewer people (“not more than 5 individuals”). Because in the facts each shareholder owns 10% of the company, 5 people only own 50%. The provision states that more than 50% must be owned by 5 or fewer people. So in no event can Corporation C’s facts fulfill this requirement. Therefore, Corporation C is NOT a closely held corporation for purposes of §469 and therefore the company does not need to worry about the passive loss rules!

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47. Yes, per Code Section 7701(a)(26) which states that a *trade or business* includes the performance of the functions of a public office.
48. The research question is: “Can the company deduct the costs of demolition. If not, can the costs be depreciated in some way?” The student will find the pertinent Code Section [IRC §280B] if the student looks for the word *demolition* in the index. It might be noticed that CCH’s index is a bit misleading here because it refers only to *demolition of historic structures*. Students can also discover the provision by going through the table of contents and finding the disallowance in Part IX of Subchapter B. It is good to note here that whenever researching to determine if something is deductible, the student should first look to see if there is a provision allowing the deduction, but then should always look to see if there is a specific provision that makes the item not deductible. In this case, the table of contents doesn’t lead to a clear allowance for the deduction in the allowing code sections (§161 et seq.), but a disallowance is clearly located in Part IX.

IRC §280B provides clear authority that demolition expenses are not deductible and must be capitalized to the land. This Code Section is fairly easy to read and doesn’t appear to leave any doubt about the correct answer. However, in the next chapter, students will be able to remember the definiteness of this Code Section and be surprised by how outdated the Regulations can be. The Regulations contradict this provision, but were written long before this provision came into effect.

49. The research question is “Can the president exclude the value of the free parking or must he consider the value as taxable income?” In this situation, the students will most likely not find the index to the Code very helpful: neither *parking* or *benefits* or *employee benefits* can be located in the index. Unless the students know to look up the term *fringe benefits*, they will not be able to get far with the index. On the other hand, the table of contents is very useful in this situation. Students will browse through Subchapter B, skimming the specific inclusions portion and then the specific exclusions portion. They should land on IRC §132 as a possible pertinent section.

If the student is accessing the Code using an electronic format, she might very well take advantage of the ability of the computer to search through the Code to find where *parking* is mentioned. Because this word is not used frequently in the IRC, in this case they will be able to quickly arrive at not only the correct Code Section but the specific provision within that Code Section that addresses the issue.

This problem helps illustrate the need to apply the logical skimming technique discussed in the chapter. The student starts by reading carefully §132(a). From this, the student should identify that it is paragraph 5 (*qualified transportation fringe*) that looks most relevant. §132(a)(5) indicates that *qualified transportation fringes* are excluded from gross income. Thus, the new research question is whether the free parking provided to the president is considered a *qualified transportation fringe*. They should have skimmed each of the subsection headings until they find the one on qualified transportation fringes

- §132(f).

§132(f)(1)(C) indicates that *qualified parking* provided by an employer to an employee is a qualified transportation fringe. Because the president is receiving the parking as an *employee* from the company (or *employer*), the next question is whether the parking provided to the president is *qualified parking*. Reading on, the student sees the limitation on any exclusion (should the parking be *qualified*) in §132(f)(2)(B). That provision states that the exclusion *shall not exceed* \$175 per month. [Students will notice several apparently duplicate provisions regarding the dollar limitation. This provides the student with an opportunity to see the importance of the effective date rules contained in these provisions.] It is also important to note here that the IRC frequently has “inflation” provisions hidden somewhere in the Code Section which provides for an adjustment of dollar amounts on an annual basis. Students should be aware that whenever dollar amounts are used in the IRC, they need to determine whether those amounts are to be adjusted for inflation. In this case, further perusal of the Code Section reveals §132(f)(6) which indicates the parking dollar limitation is to be adjusted annually for inflation. Next obvious question of the students - how do you discover what the adjusted amount is? The adjusted amount is never in the IRC. Rather, it is published yearly by the Treasury in announcements which they will learn about in the next chapter.

So the student knows that perhaps the entire amount of the parking will be excluded - if the parking is *qualified parking*. Skimming through §132(f), she should find the definition for “qualified parking” in §132(f)(5)(C). Upon reading the definition, the student will realize that more information is needed to accurately answer the research question since the definition anticipates the parking is provided on or near the business premises of the employer. Assuming this is the case, the value of the free parking is excludable. [Note that some students may have a very hard time reading the definition of qualified parking. It is defined as *parking provided to an employee on or near the business premises of the employer or ...* What follows the *or* are requirements if the employee commutes to work. Sometimes students fail to spot that *or* and believe that the additional requirements (*in a commuter highway vehicle or car pool*) must be satisfied.

50. a. Using either the index or the table of contents, the student should find the applicable IRC section with ease – IRC §163. This section is an excellent example of the bandaging effect that has taken place over the years which results in the poor organization of Code Sections within the section itself. It is also an example of the need to read a Code Section to the end using the logical skimming approach. IRC §163(a) provides a general rule which appears to allow fully the deduction of all the interest. The language does not suggest any exceptions to the general provision allowing deduction for interest paid. However, IRC §163(h) provides much more detailed rules for this type of interest (in addition to destroying the general rule stated in IRC §163(a) by instead indicating that no personal interest is deductible unless). Therefore, the student must skim through each of the subsections until they bump into §163(h).

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Once finding §163(h), the student should see that IRC §163(h)(2)(D) indicates that “qualified residence interest” is still a deductible type of interest. Now the research question becomes more refined and is “is the interest paid by taxpayer ‘qualified residence interest’?”

IRC §163(h)(3) defines this term to include interest paid on “acquisition indebtedness” with respect to any “qualified residence” of the taxpayer. Thus two new questions are whether the interest the taxpayer paid was “acquisition indebtedness” and whether the homes are “qualified residences.”

“Acquisition indebtedness” is defined in IRC §163(h)(3)(B) and after careful reading appears to apply to the debt paid on both homes with the facts given. The remaining question is whether both homes are “qualified residences.” Further skimming reveals that IRC §163(h)(4)(1) defines a qualified residence to include the “principal residence” within the meaning of IRC §121 AND one other residence “which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1).” [Note that in the CCH codes, the cite actually reads “§163(h)(5)[4]”. This is because CCH is reflecting the official number of the Code paragraph (“5”) which is erroneous. The accurate number is “4,” which CCH also reflects. RIA’s code simply reports the paragraph as it should be without noting the formal erroneous numbering.]

Next the student must determine that the first home is indeed the taxpayer’s principal residence by seeing how that term is defined in Section 121. Next, the student must read IRC §280A(d)(1) to determine whether the second home also qualifies. IRC §280A(d)(1) defines use as a residence to include any dwelling unit used for personal purposes (we can assume from the facts that taxpayer’s use is personal) for a period of time “which exceeds the greater of 14 days or 10% of the days rented.” Taxpayer’s personal use is 30 days. He rents the house for 10 days. Thus, 14 days is greater than 10% of the rental days (10% of 10 = 1). Because the taxpayer’s personal use (30 days) exceeds 14 days, the house is considered a residence for purposes of IRC §280A(d). We are able to use this definition for purposes of IRC §163(h) even though there is limiting language because IRC §163(h) directs us to use this definition.

Therefore, both houses are qualified residences, both debts are acquisition indebtedness and neither debt exceeds the dollar limitations found in IRC §163(h)(3); therefore, all the interest is deductible.

- b. This question requires the student to apply the rule that you must always skim to the end of the applicable section. At first glance, the student will think that the new facts result in a failure of the second home to be considered a qualified

residence because it fails the test in IRC §280A(d)(1) since 14 days of personal use does not exceed 14 days. However, more thorough reading of IRC §163(h)(5) reveals an exception to this rule in IRC §163(h)(5)(A)(iii). This provision states that “for purposes of clause (i)(II)” [limiting language that refers to the second home definition we just discussed], a home will still be considered a residence even if it fails the IRC §280A(d)(1) test if the taxpayer does not rent the house at any time. Therefore, the home remains a qualified residence under these circumstances and the interest on the debt is deductible.

- c. Assume for this question that the current balance on the mortgage is \$1,500,000. Also assume there is no second home. Now the student should discover the provisions in IRC §163(h)(3)(B)(ii) that impose a \$1,000,000 limitation on the total amount of acquisition indebtedness. This would appear to indicate that only a portion of the interest on the first home is deductible. However, further reading uncovers an exception to this dollar limitation when the initial debt was acquired prior to 1987 [IRC §163(h)(3)(D)]. Therefore, all the interest is deductible.

51. At the initial stage, students probably will not be able to closely articulate the research question unless they understand what the vacation home deduction rules provide. So the initial question for most will be “do the vacation rules apply when a cousin uses a home for personal use?” As students learn more about the vacation home deduction rules, the question will be refined further.

If the students were asked to do the previous question, most of them should be able to recognize the code section that is applicable since they just spent some time in it -- §280A. Otherwise, students can arrive at the section by using the index or looking at the table of contents.

The initial question is not what are the vacation home deduction rules, but do they apply in the given factual situation? Thus, the student should not be struggling to determine what the rules are at this point. The general rule states however the general rule and provides important information to the researcher. §280A(a) says that “...no deduction...shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.” The student should eventually determine that §280A(d)(1) is relevant because it discusses what a “residence” is and states that it all depends on the number of days the taxpayer “personally used” the home. Now the student’s research question can be narrowed to “is the personal use of a cousin considered to be personal use by the taxpayer?”

§280A(d)(2) defines “personal use” to include the use of persons other than the taxpayer in three different situations. §280A(d)(2)(A) states that the personal use of “any member of the family (as defined in section 267(c)(4)) of the taxpayer” is considered to be personal use of the taxpayer. Study of §267(c)(4) indicates that a cousin is not a “member of the family.”

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However, this is not the end of the research. It turns out that the personal use of the cousin will be attributed to the taxpayer under §280A(d)(2)(C) because this provision includes the use of “any individual...unless ... the dwelling unit is rented for a rental which...is fair rental.” Because the cousin uses the house for free, such use is considered the personal use of the taxpayer.

52. With the changed facts, the critical provision is §280A(d)(2)(A) which attributes the nephew’s personal use even though he is paying fair rental value is he is considered “a family member” of Sue. Studying §267(c)(4), the student should conclude that the nephew is not a “family member” of Sue’s.
53. a. John has \$20,000 of debt relief which represents potential gross income. Code Section 108(a)(1)(B) provides for the exclusion from income of debt relief if the debtor was “insolvent” immediately prior to the relief of debt. The exclusion cannot exceed the amount of the insolvency. Code Section 108(d)(3) defines insolvency as the amount a person’s liabilities exceed the fair market value of their assets immediately prior to the discharge. John is insolvent by \$15,000 ($300,000 - [235,000 + 50,000]$). John will be able to exclude \$15,000 of the \$20,000 debt relief income. He must recognize \$5,000 as income.
- b. Because John excluded \$15,000 of the debt relief due to insolvency, Code Section 108(b) suggests that he has to reduce his basis by that amount. However, Code Section 1017(b)(2) provides additional limitations on the amount the basis needs to be reduced if after the discharge, liabilities still exceed the basis of the assets. Applying Code Section 1017(b)(2) results in the requirement that John will not have to reduce his basis at all because the basis in his assets after discharge does not exceed the liabilities after discharge [basis of assets after discharge = \$70,000 ($150,000 - 30,000$ cash paid) minus liabilities after discharge = \$250,000 ($300,000 - 50,000$ discharged debt)]. Note that students sometimes need to be reminded that John does not want to have the basis in his assets reduced! So the Code Section 1017(b)(2)’s limitation may provide him with a desired benefit. Also note that students tend not to go to Code Section 1017(b)(2) and instead stop at Code Section 108(b)(2)(E). This provides a good lesson in the need to follow the “pinballing.”
- c. Students should see that Code Section 108(b)(5) allows John the ability to avoid reducing the NOL under the regular Section 108(b) ordering rules, and instead reduce his basis. Here it is critical to point out to the student that by making the Section 108(b)(5) election, the benefits of Code Section 1017(b)(2) are waived [see the last sentence in Section 1017(b)(2)].
54. The applicable Code Section in this situation is IRC §127 which provides for the exclusion of up to \$5,250 in educational benefits resulting from a qualified educational
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assistance program. A few important items to note to the students when examining this Code Section include the sunset provisions now in the historical notes and the frequency of amendments in Subsection (c). It will be useful to have the students examine these historical amendments and discuss them briefly.

55. This question involves the tax treatment of income resulting from the relief of debt. Either through the table of contents or through the index, students should locate IRC §108. After a good deal of careful skimming, students should discover that IRC §108(e)(2) applies in this situation and allows Susan to exclude the \$6,000 in relieved rent, since these payments would have resulted in a tax deduction had she made them.

INTEGRATED CASE STUDIES - see solutions beginning on page 140