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TAX RESEARCH TECHNIQUES

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STUDIES IN FEDERAL TAXATION

TAX RESEARCH TECHNIQUES

BY RAY M. SOMMERFELD, CPA and
G. FRED STREULING, CPA

AICPA American Institute of Certified Public Accountants

Tax
Research
Techniques

Tax Research Techniques

TAX STUDY
NO. 5

Tax Research Techniques

By Ray M. Sommerfeld, CPA and
G. Fred Streuling, CPA

University of Texas at Austin

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To our wives,
BARBARA and MAURINE

Foreword

Tax Research Techniques is directed to non-tax specialists to aid them in the development of their research skills. Using specific examples and step-by-step techniques, the book explains how to approach and research tax problems.

It is with sincere gratitude that I acknowledge the work of the authors, Professors Ray M. Sommerfeld, CPA and G. Fred Streuling, CPA, of the University of Texas at Austin. Their combined efforts have made this book an outstanding addition to our Studies in Federal Taxation.

Working very closely with the authors was a task force composed of Donald H. Skadden, CPA; Bernard Barnett, CPA; and J. Fred Kubik, CPA. The following members of the Tax Publications Subcommittee assisted in an advisory capacity: Donald H. Skadden, CPA, Chairman; Stanley H. Beckerman, CPA; Mortimer Berl, CPA; Irwin Dubin, CPA; Sol J. Meyer, CPA; Dominic A. Tarantino, CPA; and G. George Varady, CPA.

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JOEL M. FORSTER, *Director*
Federal Tax Division

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1

. . . scientific method, like science itself, defies definition. It is made up of a number of operations, some mental, some manual. Each of these, in its time, has been found useful, first in the formulation of questions that seem urgent . . . and then in the finding, testing, and using the answers to them.

J. D. BERNAL

Tax Research in Perspective

This study is designed to provide a working knowledge of tax research methodology for the certified public accountant who is not already a tax specialist. It introduces its readers to the research process utilized in the tax-related work commonly performed by accountants in public practice and it notes, in passing, the kind of research used to determine tax policy recommendations.[1] After a careful reading of this study and many hours of experience in implementing the procedures suggested here, the reader should be capable of solving most of the tax problems encountered in a public accounting practice.

[1] Accountants generally have not ventured far into the realm of tax policy. Because of their practical experience in tax matters, accountants could play an important role in improving our tax system. If they were to assume an active role in policy deliberations in the future, many of the research procedures simply noted in passing later in this chapter would have to be investigated at length.

This study also introduces the reference volumes necessary for a tax library. It suggests both minimal library requirements and methods of utilizing the more important tax reference works. This study is not primarily intended to increase knowledge of specific substantive tax provisions *per se,* but, as a secondary benefit, it may teach readers more than they previously knew about some tax provisions as they study the examples offered as problem-solving illustrations. When solving a similar problem of their own, however, readers should not rely upon the conclusions reached in these examples without updating them. Although some of the AICPA tax studies are periodically revised, they were never intended as a substitute for a current tax-reference service.

Meaning of Research in General

Ideally, a book devoted to tax research would begin with an unambiguous definition of the word *research.* Unfortunately, no such definition has come to the authors' attention; therefore, we will have to be satisfied with a general description rather than a precise definition. This general description should adequately reveal the nature of the process envisioned within the phrase *tax research* as it is used here.

The word *research* is used to describe a wide variety of diverse activities. For example, at one extreme it can include the search for anything not presently known by the person making the search. In that context, looking up an unknown telephone number in a directory would constitute research. At the other extreme, a scientist might restrict his use of the word *research* to exhaustive experimentation under tightly controlled conditions solely for the purpose of revising previously accepted conclusions in light of recently determined facts. Between the extremes lie infinite alternative definitions.

Thus, this tax study does not purport to deal with all forms of tax research; except for a few introductory comments in this chapter, this study is restricted to a description of the procedures commonly utilized by a diverse group of professionals—including certified public accountants, lawyers, enrolled agents, and Internal Revenue Service personnel—to determine a defensibly "correct" (and in some instances an optimal) conclusion to a tax question. Totally different kinds of work undertaken by these individuals or by other persons might be properly included within the meaning of

the phrase *tax research,* but our objective is neither to define nor to reconcile conflicting definitions. We desire only to place the general characteristics of the different types of tax research in perspective. Very few persons become expert in each of the research methodologies noted. Nevertheless, anyone deeply engaged in any facet of tax work should at least be generally aware of what other individuals working in the same field are doing. With increasing frequency, those expert in one facet of taxation are asked to express an informed opinion on a wholly different aspect of taxation. In these circumstances it is especially desirable that the expert be aware of what others have done so that he might move with appropriate caution in dealing with tax matters with which he is not intimately familiar.

Perhaps the easiest and most desirable way to place the different types of tax research in meaningful perspective is to create a general classification system based on the purpose of the inquiry. Although other possible classification systems are evident—for example, one could easily construct a classification scheme based on the character of the methodology employed—one based upon the purpose behind the research effort seems to be most useful for this statement of perspective. At least three distinct purposes for tax research come immediately to mind: implementation of rules, policy determination, and advancement of knowledge.

Research for Implementation of Rules

Much tax research is undertaken to determine the applicability of general tax laws to specific fact situations. After a tax law is enacted, implementation of the law is the responsibility of the taxpayer. Although we have what purports to be a self-assessment tax system in this country, both tax rules and business practices have become so complex that many taxpayers seek the assistance of specially trained individuals to assure not only their compliance with the tax rules, but also their achievement of that compliance at minimal tax cost.

Five elementary steps constitute a total research effort: (1) establishing the facts, (2) from the facts, determining the question, (3) searching for an authoritative solution to that question, (4) determining the import of the frequently incomplete and sometimes conflicting tax authorities located, and (5) communicating the conclu-

sion to the interested party. Although a thorough examination of what each of these five steps involves must be deferred to later chapters, we can briefly describe each step at this juncture.

Establishing the Facts. Most tax laws and related administrative regulations are necessarily written in general terms. Effective rules must be stated in terms that adequately describe the vast majority of factual circumstances envisioned by those who determine the rules. Rules stated too broadly invite conflicting interpretation; those stated too narrowly often fail to achieve their intended objective. However, no matter how carefully the words of a statute are selected, general rules cannot possibly describe every conceivable factual variation that might be subject to the intended rules. Consequently, the first step in implementation-oriented research necessarily involves the process of obtaining all of the facts so that the researcher can determine which tax rule or rules might apply to those particular events.

Determining the Questions. Questions arise when specific fact situations are examined in light of general rules or laws. Complex tax questions frequently evolve through several stages of development. Based on his prior knowledge of tax rules, a researcher usually can state the pertinent questions in terms of very general rules. For example, he may ask whether the facts necessitate the recognition of gross income by the taxpayer. Or he may ask whether the facts permit the taxpayer to claim a deduction in his determination of taxable income. Or he may ask whether a gain should be reported as ordinary income or as capital gain. After making an initial search of the authorities to answer his general question, the researcher often discovers that he must answer one or more specific technical questions of interpretation before he can answer his general question. These secondary questions frequently involve the need to determine the exact meaning of certain words and/or phrases as they are used in particular tax rules. For example, the tax researcher may have to determine if the fact situation he has under consideration is "ordinary," "necessary," or "reasonable" as those words are used in various sections of the code. Alternatively he may have to determine the meaning of the word "primarily" or, perhaps, the meaning of the phrase "trade or business." Once he has restated his

general question in this more specific way, the researcher often must return briefly to the process of collecting more facts. From his study of the authorities, he learns that facts he initially did not consider important may be critical to the resolution of his now revised question. After obtaining all necessary facts and resolving the more technical questions, the tax researcher may discover that he has also resolved his general question. If, however, the answer to his general question is negative, he very often must seek an answer to a related question before he can proceed to a conclusion. For example, even if the tax researcher determines that a particular expenditure is not tax deductible, he may have to determine whether or not the expenditure can be capitalized (that is, added to the tax basis of an asset) or whether it must simply be ignored in the tax determination procedure.[2] In effect, raising collateral questions returns the researcher to the beginning of the second step in the research process. This procedure continues until all pertinent questions have been satisfactorily answered.

Searching for Authority. Authority in tax matters is legion. It nearly always begins with the Internal Revenue Code of 1954, as amended, but it quickly expands to include Treasury regulations, judicial decisions, administrative pronouncements, and sometimes, congressional committee reports. Judicial decisions in federal tax disputes are rendered by U.S. district courts, the Tax Court, the Court of Claims, the several circuit courts of appeals, and the Supreme Court. Administrative pronouncements are issued as revenue rulings, revenue procedures, technical information releases, and general counsel memoranda. Reports of the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee may be pertinent to the resolution of a tax question. Obviously the task of locating all of the potential authority before reaching a conclusion can be a very demanding and time-consuming task. As previously explained, the search for authority often raises additional questions that can only be answered after the determination of additional facts. Thus the research process often moves back from

[2] In a tax-planning situation, of course, the tax adviser may recommend an alternative way of structuring the transaction so as to achieve the most desirable tax result.

step three to step one before it proceeds to a resolution of the general question.

Resolving the Question. After locating, reading, and interpreting all of the pertinent authority, a tax adviser must be prepared to resolve the many questions he has raised. His client (the taxpayer) must make the final decision on what course of action to take, but, in most circumstances, the taxpayer's decision is guided by and even dependent upon the conclusions reached by the adviser. The taxpayer looks to his adviser for guidance. Even when working with questions to which there appear to be no ready answers, a tax adviser must be prepared to say to his client, "If I were you, I would do this." Thus a tax adviser really must resolve the questions to his own satisfaction before he can recommend action to anyone else.

Communicating the Conclusion. Having thoroughly researched the tax problem and having reached a conclusion, a tax adviser must communicate all pertinent factors to the interested parties. Drafting tax communications is unusually difficult. Very often, highly technical questions must be phrased in layman's language. Positions sometimes must be carefully hedged without omitting or misstating any critical fact or any applicable rule. At the same time, a tax adviser must take sufficient care to protect his own rights and professional integrity. These considerations sometimes are conflicting constraints in drafting an appropriate communication; therefore, great care must be exercised in this final step of the implementation-oriented research procedure.

The arrangement of the material in this tax study follows the sequence of steps suggested above. That is, chapter 2 is concerned with the search for facts; chapter 3 is a discussion of the process by which a tax researcher prepares his statement of the pertinent questions. Chapter 4 explains how a researcher can systematically go about locating possible authority; chapter 5 suggests what he might do if the authority he finds is incomplete or conflicting. Chapter 6 describes the many factors that must be considered in drafting the communication that will convey the results of the research effort to the concerned persons. Finally, chapters 7 and 8 each give a detailed example of this tax research process under two different

circumstances: chapter 7 illustrates the research process in a compliance setting, chapter 8, in a planning situation.

Research for Policy Determination

Our tax laws are enacted by Congress to produce federal revenues and to achieve designated economic and social objectives. For example, the general objectives of the investment credit and the rapid depreciation provisions include stimulating investment spending and economic growth. The domestic international sales corporation provisions are intended to stimulate foreign sales of domestically produced goods and thus to aid in the solution of U.S. balance of payments (currency) problems. These and many other tax provisions should be investigated thoroughly to determine whether they are efficiently achieving the intended objectives. The research methodology common to such investigations draws heavily from the discipline of economics. Econometric models must be constructed and much data obtained to formulate tax policy.

Similarly, our government representatives should have factual information about voter preferences. They should know, for example, whether a majority of the voters prefer to deal with problems of pollution through fines and penalty taxes, through incentive provisions in the tax laws, or through wholly non-tax legislation. Similarly, those who enact laws should know how the voters feel about funding public medical care, employee retirement programs, mass transit systems, interstate highways, and a host of other government projects. The research methodology common to determining voter preferences draws heavily on survey techniques best understood by sociologists, demographers, and other social scientists.

Every change in tax law has a direct impact on the federal budget and on monetary policies, the magnitude and direction of which should be determined as accurately as possible before the law is finalized. Operations research techniques and computer technology are most useful in making such determinations. Some of the research techniques used to make these predictions are similar to those used by the econometrician in building models that tell us whether or not a law can achieve its intended objectives; in other ways the techniques utilized are quite different. The point is simply that, even within the confines of the work which must be undertaken to provide tax policy prescriptions, the procedures that must be utilized

to make those determinations vary substantially. Yet all of these diverse procedures are commonly referred to as tax research.

Research for Advancement of Knowledge

Another purpose for undertaking tax research is the advancement of knowledge in general. Research undertaken to determine a preferable tax policy, as well as that undertaken to implement tax rules, has a pragmatic objective. The researcher in each instance has a very practical reason for wanting to know the answer he seeks. Some research, on the other hand, is undertaken solely for the purpose of disseminating general knowledge. There is, however, no single common methodology for such research. Rather, the methodology selected depends entirely upon the nature of the investigation being undertaken. If it involves economic predictions, economic modeling is necessary. If it involves taxpayer attitudes and/or preferences, surveys based on carefully selected statistical samples are equally mandatory. And if it involves compliance consideration, a studied opinion of pertinent authority is just as essential.

Tax practitioners, as well as academicians, government employees, and foundation personnel, often engage in tax research work intended solely for the advancement of knowledge. The results are published in journals and presented in proceedings that appeal to two fundamentally different audiences. Policy-oriented journals and proceedings primarily attract persons who are economists by education and training. Implementation-oriented journals and proceedings primarily attract those who are either accountants or lawyers by education and training. Academicians are found in both camps.

Examples of Tax Research

Chapter 7 is an example of implementation-oriented tax research. The objective of chapter 7 is simply to illustrate how a tax researcher might determine the "correct" tax treatment of the act of incorporating a sole proprietorship under stated fact conditions. Chapter 8 demonstrates how tax planning can be utilized to minimize the tax dangers and maximize the tax opportunities implicit in a different fact setting. Before we turn all of our attention to the details of this form of research in subsequent chapters, however, let us pause very briefly to note a few examples of policy-oriented tax

research. Some knowledge of this literature should be helpful to any certified public accountant undertaking a policy-oriented research project. Although individual CPA firms tend to do little of this work, a few accountants may be in for a new adventure because of the expansion of the AICPA's role in tax policy, approved by the executive committee in the fall of 1969. Several task forces have been appointed and research begun. The first Statement of Tax Policy was issued by the AICPA in 1974.[3]

A relatively recent example of a policy-oriented tax study is the report of the Advisory Commission on Intergovernmental Relations entitled *Financing Schools and Property Tax Relief—A State Responsibility.*[4] Their report is an interesting compilation of statistical data, position papers, and a survey of taxpayer attitudes. It demonstrates well the multidimensional quality common to most tax policy issues.

An example of a more theoretical study is found in the recent work of Joseph Pechman and Benjamin Okner entitled *Who Bears the Tax Burden?*[5] This effort is one of a long and distinguished series of studies in government finance. It attempts to determine the distribution of all taxes combined by income classes. It demonstrates nicely the complexity of tax policy studies by presenting its results under eight different assumptions of tax incidence. Further, the authors do not express a preference for any one result, in recognition of the fact that no conclusive empirical evidence has been found which would justify making a single selection.

A third example of policy-oriented research can be found in Stanley Surrey's recent book, *Pathways to Tax Reform,* which introduces the notion of a "tax expenditures" budget.[6] In it the author attempts to demonstrate, in terms of lost revenues, the cost of many

[3] See *Taxation of Capital Gains* (New York: American Institute of Certified Public Accountants, 1974), 28 pages. Further policy statements by the AICPA are expected in the areas of estate and gift tax reform and the value-added tax, in the near future.

[4] The 261-page report (No. A-40, January 1973) is available from the Advisory Commission on Intergovernmental Relations, Washington, D.C. 20575, for $2.50.

[5] This 119-page booklet, published in 1974, is available from The Brookings Institution, 1775 Massachusetts Avenue, Washington, D.C. 20036, for $2.50 in paperback and $5.95 in clothbound editions.

[6] Stanley S. Surrey, *Pathways to Tax Reform* (Cambridge, Mass: Harvard University Press, 1973).

exemption, exclusion, and deduction provisions in the income tax law. Based on these estimates, the author points to what he sees as the preferred route to tax reform.

A thorough review of an important segment of tax research was made by Carl Shoup in "Quantitative Research in Taxation and Government Expenditure."[7] In this work, Shoup appraises the need for further quantitative research and suggests outlets for such work. Literally hundreds of other excellent examples of tax research could be cited here, although to do so would lead far afield from the objectives of this study.

In summary, the phrase *tax research* is commonly used to refer to widely divergent processes. All are legitimate, socially productive endeavors that may be included in a definition of tax research. A broad outline of the different processes are mentioned in this perspectives chapter for two reasons: first, to give the reader some idea of what is and what is not to be described in the study and second, to suggest to accountants and others, who by their own inclination are implementation-oriented, the kinds of efforts that should be included in policy-oriented projects they might undertake.

In closing this chapter, the authors join many others who have called for a broader participation of tax-interested persons in the determination of tax policy. In the past, the tax research efforts of theoreticians have all too often wholly ignored all practical consequences, including the behavioral adaptation of those most directly affected by their recommendations. On the other hand, the policy prescriptions rendered by the implementation-oriented groups have often overlooked important empirical evidence accumulated in the more theoretical studies. Stanley Surrey, a Harvard law professor interested in taxation and a former assistant secretary of the treasury for tax policy, made these observations in 1966:

> We must be aware that the apparent certitude offered by the mass of numbers computers can generate or the conclusions that the ranks of econometric equations can produce do not lull us into a false security. There is still room, as the computer technology develops, for a constructive two-way dialogue between the computer

[7] Shoup's paper was published as "Public Expenditures and Taxation" (Colloquium IV), (New York: National Bureau of Economic Research, 1972), 16 pages.

> technologists and those whose insights come from experience and accumulated wisdom. Working together they can offer great hope and promise for an improved tax system capable of fully bearing its share of responsibility for achieving the Great Society we are seeking.[8]

An important first step in this hoped-for working together is the acquaintance of each with the aims and the methodologies of the other. This volume should help to describe the tax research methodology commonly utilized by the more implementation-oriented group.

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[8] Stanley S. Surrey, "Computer Technology and Federal Tax Policy," *National Tax Journal,* September 1966, pp. 257-58.

2

The Moving Finger writes; and having writ,
Moves on; nor all your Piety nor Wit
Shall lure it back to cancel half a Line,
Nor all your Tears wash out a Word of it.

OMAR KHAYYAM

The Critical Role of Facts

A tax result is dependent upon three variables: facts, applicable law, and an administrative (and occasionally judicial) process. An accountant not trained in the practice of law is apt to underestimate the significance of facts to the resolution of a tax question. Most layman's study of law, including an accountant's study of business law, tends to concentrate on general rules. For the accountant turned tax adviser, however, general rules will not suffice. It is essential that every tax adviser understand why a thorough knowledge of *all* the facts is critical to the resolution of any tax question.

The Importance of Facts to Tax Questions

As used here, the word *fact* means an actual occurrence or an event, a thing having real existence; facts are the who, what, when, why, where, and how of daily existence. From the facts, questions arise. A tax adviser must be able to distinguish a conclusion from a fact. For example, a statement that an individual is married really is a conclusion rather than a fact. The facts that support such a conclusion may include such real-world events as these:

• On June 9, 1956, that person appeared with a member of the opposite sex before a third person duly authorized to perform marriages.
• That person exchanged certain oral vows with the specified member of the opposite sex.
• The person authorized to perform marriages made certain declaratory statements to those persons present.
• The exchange of vows and the declaratory statements were made in the presence of a designated number of witnesses.
• Certain documents were signed by designated parties to this ceremony and those documents were filed in a specified repository.
• No events which might change this relationship have subsequently transpired.

Change any one of the above facts and the conclusion—that is, that a person is married—may no longer be valid. A statement of pertinent facts is virtually always much longer and clumsier than is a simple statement of the conclusion drawn from them. Consequently most of the time we tend to converse in words, sentences, and thoughts based on conclusions rather than on elementary facts.

In tax work it often is necessary to pursue facts at length to be certain of the validity of a particular tax conclusion. To continue the foregoing illustration, a person cannot file a "joint income tax return" unless he or she is married. Obviously, most people know if they are married or not, and most tax advisers accept their client's word on this important conclusion. If, in the course of a conversation or in an investigation related to the preparation of a tax return, it becomes apparent that there is reason to doubt the validity of the client's conclusion, then a full-scale investigation of all of the facts is necessary. For example, a client may state that he has recently gotten a divorce. This simple statement should be sufficient to cause an alert tax adviser to make further investigations, because a person may be deemed to be married for tax purposes even after he believes that he once again is single. By the same token, the tax adviser must know that persons who never in their life have exchanged marriage vows may be deemed to be married for tax and other purposes by virtue of their actions (that is, by virtue of "the facts") and the law of the state in which they reside. The tax adviser also knows that persons married to nonresident aliens are not eligible to file joint income tax returns even though they are obviously married.

One of the things that makes tax work both difficult and risky is the fact that the taxpayer often does not understand the significance of the pertinent facts, and a tax adviser often cannot take the time to determine each of these facts or to investigate their significance if he is to perform his consultative role without charging an exorbitant fee. When the tax adviser is alerted to the possibility that a further investigation of the facts may lead to a significantly different conclusion in a tax determination, however, it is his professional obligation to investigate those facts in sufficient depth to permit a correct determination of their tax import. In situations involving aspects of the law beyond the confines of taxation—as in the marriage example—the accountant will find it necessary for his client to obtain a related legal opinion from a qualified attorney before he can proceed with his client's tax problem.

No one engaged in tax practice should ever underestimate the importance of factual detail. Virtually every authoritative reference on tax practice stresses this important conclusion. Bickford says, "It would be impossible . . . to overemphasize the importance of knowing *all* the facts of a case, down to the last detail, figure and date."[1] Freeman and Freeman put it this way: "Facts determine the law. Law is really facts. Shape the facts and you have planned the law. Facts have to be found. Be a detective. Find not some of the facts but all of the facts."[2] Implied in the latter quotation is the important distinction between events that have already taken place and those that are yet to occur. Tax planning is based on this critical distinction.

Facts—Established and Anticipated

Taxpayer compliance and tax planning constitute two major portions of any successful tax adviser's work. The initial and critical difference between these two phases of tax practice is simply a difference in the state of the facts. In compliance work, all of the facts have already transpired and the tax adviser's only task—assuming that he already knows what the facts are—is the determination of

[1] Hugh C. Bickford, *Successful Tax Practice*, 4th ed. (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1967), p. 14.

[2] Harrop A. Freeman and Norman D. Freeman, *The Tax Practice Deskbook* (Boston: Warren, Gorham & Lamont, 1973), p. 2-1.

the tax result implicit in those facts. In planning work, the tax adviser researches alternative ways of achieving established goals and recommends to his client those actions that will—considering all operational constraints, personal and financial objectives, and personal and business history—minimize the resulting tax liability. In other words, the tax planner must determine an optimal set of facts from the standpoint of tax results, given certain personal and financial constraints. The operational procedures applied in these two phases of tax practice are quite different.

After-the-Facts Compliance

The first step in taxpayer compliance work is a determination of the facts that have already taken place. The procedures used to determine facts differ significantly depending upon the relationship existing between the tax adviser and the taxpayer. The less personal the relationship, the greater the amount of time that must be devoted to a discovery of facts. In most instances, the fact discovery process can be divided into at least four distinct steps: initial inquiry, independent investigation, additional inquiry, and substantiation.

Initial Inquiry. At one extreme, the tax adviser will not have known the taxpayer prior to the request for services. In that event, if the initial request is for tax return preparation services, it is common for the tax adviser to complete a predetermined checklist of facts during (or immediately following) an initial interview. Many firms have devised their own forms to facilitate this information gathering process; others utilize standard forms prepared by tax return computer services or other agencies. If the initial request is for assistance in an administrative proceeding, a less structured interview is typically used. In every instance the objective of the inquiry is the same: To establish all of the facts essential to an accurate determination of the tax liability.

Tax advisers who are intimately familiar with their client's affairs often are able to extract sufficient factual information from existing files and personal knowledge to allow them to avoid extended personal contact with the taxpayer while making an investigation comparable to the initial inquiry. For example, the certified public accountant who regularly maintains and/or audits all of a client's fi-

nancial records will require only minimal additional contact with the client to establish the information necessary to determine the correct tax liability.

Independent Investigation. Regardless of the extent of personal contact involved in the initial inquiry, all but the simplest taxpayer compliance engagements require some independent investigation on the part of the tax adviser. The specific reason for undertaking such an independent investigation varies from one situation to another, but all stem from the need for additional facts to determine a tax result. Sometimes the impetus for getting more facts comes from something the client said; at other times, from what he did not say. At still other times, the need for further facts becomes apparent when the tax adviser begins to examine the client's financial records. For example, a canceled check made payable to an unknown Dr. Jones may or may not be tax deductible. The return preparer must determine what kind of doctor Jones is and what service was rendered to the taxpayer before he can determine whether or not the payment can be deducted.

Whatever the cause, the tax adviser frequently engages in what might be described as detective work to determine necessary facts. An independent investigation may involve a detailed review of financial records, old files, correspondence, corporate minutes, sales agreements, bank statements, and so forth; it may involve interviews with friends, family, employees, business associates, or others; and, in some cases, that search may extend to reviews of general business conditions and practices. Because of the relatively high cost of some investigations, it is common to defer incurring those costs until such time as they are absolutely necessary. Usually this means deferring them from the time of the initial act of taxpayer compliance to the time of a dispute, that is, from the time of filing the tax return to the time at which the Internal Revenue Service challenges a tax conclusion previously reported by the taxpayer on the basis of rather tenuous facts. Because less than 3 percent of all tax returns filed are challenged in an average year, the reason for delaying a costly in-depth investigation is obvious. Nevertheless, the competent tax adviser should always be alert for situations that are apt to require further investigation later. Often it is easier and cheaper to obtain facts and to assemble related evidence at the time events transpire than it is to construct them at a later date; occasionally facts may

become impossible to determine if too much time has elapsed between the events and the inquiry. A tax adviser's services are often more efficient and less costly if the client himself collects much of the necessary evidence to support the facts. Again, the probability of the client's doing this successfully is much greater if facts relate to recent events. Deferring an investigation of pertinent facts nearly always increases the costs. The trade-off is clear: Incur a smaller cost now at the risk of its being unnecessary, or incur greater cost later in the unlikely event that it is needed.

Additional Inquiry. Even in those situations in which an in-depth investigation of the facts has been completed, the tax adviser frequently will need to make further factual inquiries after he begins his search of the law. A search for the tax law applicable to a given set of facts often uncovers the need for information not originally deemed relevant by the taxpayer or the tax adviser. By reading revenue rulings and judicial decisions in situations similar to that of his client, the adviser may become aware of fact considerations he or his client originally failed to consider. Being alerted to their possible importance, the tax adviser must return to the fact determination process once again. In highly complex situations, this process of moving between fact finding and law determination may repeat itself several times before the tax question is finally resolved.

Substantiation of Facts. Determining what the facts are and proving those facts are two entirely different things. The nature and quality of proof required varies significantly depending upon who is receiving proof. In tax matters, the person who must be convinced of the authenticity of the facts can be anyone from an Internal Revenue Service agent to a Supreme Court justice. The methods used to substantiate facts vary tremendously. Generally, fact substantiation procedures are much less formal in dealings with an administrative agency such as the IRS than in dealings with a court, and even within the judicial system, the rules of evidence vary from one court to another. Obviously, the closer one moves to formal litigation the greater the need for the opinion and the assistance of a qualified trial attorney. Only such a professional can adequately assess the hazards of the litigation procedure, including the rules of evidence and the burden-of-proof problems.

The certified public accountant engaged in tax practice should not lose sight of the fact that the vast majority of all tax disputes

are settled at the administrative level.[3] Therefore it is necessary for him to be fully prepared to determine, present, and substantiate all of the facts critical to the resolution of a tax dispute in any administrative proceeding. In doing this, the CPA must exercise due caution to avoid stipulation of any fact that might prove to be detrimental to his client in the unlikely event that the dispute should move beyond administrative hearings and into the courts. Because of this ever-present danger, the CPA should consult with a trial attorney at the first sign of significant litigation potential.

Before-the-Facts Planning

If events have not yet transpired, the facts have not yet been established and there is opportunity to plan anticipated facts carefully. As noted earlier, tax planning is nothing more than determining an optimal set of facts from the standpoint of tax results. The procedures followed in making such a determination differ significantly from the procedures utilized in taxpayer compliance work.

Determination of the Preferred Alternative. The first step in the determination of the tax-preferred alternative involves a client interview. In this instance, however, the purpose of the interview is not to determine exactly what has happened in the past but, rather, to determine (1) the future economic objectives of the client and (2) any operative constraints in achieving those objectives. If he is to perform his task successfully, the tax planner must be privy to *all* of his client's hopes, dreams, ambitions, and prejudices, his present circumstances, and his history. That kind of information can seldom be obtained in a single interview. Ideally, it is derived through a long, open, and trusting relationship between client and tax adviser. When tax planning is based on such an on-going relationship, any particular client interview may be brief and directly to the point. Even relatively major plans can sometimes be developed, at least initially, with no more than a simple telephone conversation.

When the tax adviser fully understands his client's objectives and constraints, he should spend a considerable amount of time simply thinking about alternative ways of achieving the objectives specified by the client before beginning his research. Generally there are

[3] Government publications fail to provide precise data on the percentage of settlements at different levels. However, according to the *1973 Annual Report of the Commissioner of Internal Revenue*, approximately 99 percent of all proposed adjustments are settled outside the courtroom.

diverse ways to achieve a single goal; failure to spend enough time and effort in creative thinking about that goal usually results in taking the most obvious route to the solution. In many instances the most obvious route is not the preferred alternative. A vivid imagination and creative ability have their greatest payoff in this "thinking step."

Although in all probability no one can do much to increase his native imagination or creative ability, many people simply do not take advantage of that which they already possess. By far the most common cause of unimaginative tax planning is the failure of the adviser to spend sufficient time *thinking about* alternative ways to achieve a client's objectives. A common tendency is to rush far too quickly from the initial inquiry to a search of the law for an answer. By rushing to a solution, we very often completely overlook the preferred alternative.

An example of creative imagination appears in *John J. Sexton,* 42 TC 1094 (1964), where the taxpayer successfully defended his right to depreciate a hole in the ground. The facts of the case are both interesting and instructive. The taxpayer was an operator of refuse dumps. He acquired land with major excavations primarily to use in his dumping business, and he allocated a substantial portion of his purchase price of the land to the holes. As the holes were filled, he depreciated the value so allocated. Because the taxpayer carefully documented all the pertinent facts in his case, the court allowed his deduction. Many less imaginative persons might have totally overlooked this major tax advantage simply because it is unusual and because they did not spend enough time just thinking about the facts of the case.

After a tax adviser has determined a client's objectives, and after he has thought about alternative ways of achieving those objectives, he should systematically go about researching the tax rules and calculating the tax result of each viable alternative. The preparation of a "decision tree" often is very helpful in determining which of several alternatives is the tax-preferred one (see chapter 8, page 217). It forces the adviser to think through each alternative carefully, and it demonstrates vividly the dollar significance of the tax savings in the preferred set of facts. Obviously, however, it is up to the client to implement the plan successfully.

Substantiation of Subsequent Events. The client and the tax adviser, working together, must take every precaution to accumu-

late and preserve sufficient documentation of the facts to support the tax plan selected. In relatively extreme circumstances, a court will not hesitate to apply any one of several judicial doctrines—most notably the doctrine of substance-over-form—to find that an overly ambitious tax plan is not a valid interpretation of the law. If, however, the tax adviser exercises reasonable caution against plans that lack substance, and if he takes sufficient care to document each step of the plans, the chance of succeeding is considerably improved. Of course, the process of substantiating carefully selected facts is primarily the responsibility of the taxpayer. The tax adviser, however, should supervise the process of implementation to make certain that the intended events actually transpire in the sequence intended, and that the proof of these events will be available when and if it is needed.

Some Common Fact Questions

Most tax disputes involve questions of fact, not questions of law. In working with fact questions, a tax adviser's job is to assemble, clarify, and present the facts in such a way that any reasonable person would conclude that they conform to the requirements outlined in the tax law. Demonstrating that degree of fact clarity is often next to impossible. Some fact questions are necessarily much more involved and difficult to prove than others. Following are brief examples of common but difficult questions of fact.

Fair Market Value. The determination of the fair market value of a property is probably the most commonly encountered fact question in all of taxation. It arises in connection with income, estate, and gift taxes. The applicable law common to many of these situations is relatively simple if we could but determine the fair market value of the properties involved. For example, Section 61 of the code provides that ". . . gross income means all income from whatever source derived," and Treasury Regulations Section 1.61-2(d)(1) goes on to state that ". . . the fair market value of the property or services taken in payment (for services rendered) must be included in income." Generally, the application of this law is simple enough once the valuation question is settled.

The legal definition of fair market value stated concisely in Estate Tax Regulations Section 20.2031-1(b) follows.

> The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.

Fact problems are involved in making that brief definition operational. What is a willing buyer? A willing seller? A compulsion to buy? A compulsion to sell? Reasonable knowledge? A relevant fact? Only in the case of comparatively small blocks of listed securities and in the case of selected commodities do we have access to an organized market which will supply us with ready answers to those questions. In all other instances we must look to all of the surrounding facts and circumstances to find an answer.

Books have been written in attempts to delineate the fact circumstances which must be considered in determining fair market value. Unfortunately, even a cursory review of those books must remain outside the scope of this tax study.[4] Suffice it to observe here that valuation is a fact question and that, ordinarily, the party to any tax valuation dispute who does the best job of determining, clarifying, and presenting all of the pertinent facts is the party who wins that dispute.

Reasonable Salaries. The fact determination of what constitutes a reasonable salary has long been a troublesome tax problem. With the recent introduction of the maximum tax on earned income, this question promises to become of even more critical significance in the immediate future.[5] Once again, in many cases the applicable law is relatively simple if we could but determine what is reasonable within a particular fact setting.

In determining reasonableness, the Internal Revenue Service agent and the judge often look, for comparison, to such obvious facts as salaries paid to other employees performing similar tasks for other

[4] See G. D. McCarthy and R. E. Healy, *Valuing a Company* (New York: Ronald Press, 1971) and J. R. Krahmer and T. D. Henderer, *Valuation of Shares of Closely Held Corporations*, 221 Tax Management Portfolio, 1973.

[5] The increase in the effective marginal tax rate to 48 percent on owner-managed corporations, previously conducted in multiple corporate entities, should serve to encourage the owner-managers to distribute a larger proportion of the corporate income in the form of salaries, paid to the owner-managers, because there is very little extra tax cost associated with such a distribution and it provides the owner with a maximum degree of financial flexibility.

employers, any unique attributes of a particular employee, the employee's education, the availability of other persons with similar skills, and prior compensation paid to the employee. In addition, tax authorities trying to determine the reasonableness of salaries also look to the dividend history of the employer corporation, the relation between salaries and equity ownership, the time and method of making the compensation decision, the state of the economy, and many other facts. Again, we cannot examine here all of the detailed facts which have been important to reasonable salary decisions in the past.[6] We need only observe that the question of reasonableness is a fact question. The taxpayer who marshals all of the pertinent facts and presents them in a favorable light stands a better chance of winning an IRS challenge of unreasonable salaries than does the taxpayer who ignores any one or more critical facts. The best reason for carefully studying regulations, rulings, and cases in such a circumstance is to make certain not to overlook the opportunity to determine and prove a fact that could be important to the desired conclusion.

Casualty and Theft Losses. Noncorporate taxpayers frequently lose their right to claim a casualty or theft loss deduction for income tax purposes because they did not take sufficient care to establish the facts surrounding that loss. The law authorizes a tax deduction for losses sustained on property held for personal use only if such property is damaged or destroyed by a casualty or theft. Thus, the loss sustained because of the disappearance of a diamond ring will not give rise to a tax deduction unless the taxpayer can prove that the disappearance is attributable to a casualty or theft, rather than to carelessness on the part of the owner. If the taxpayer has photographs, newspaper accounts, police reports, testimony of impartial persons, and/or other evidence that a casualty or theft has occurred, he will have relatively little trouble in convincing a skeptical Internal Revenue agent or a judge of his right to that deduc-

[6] See C. C. Halsey and M. E. Peloubet, *Federal Taxation and Unreasonable Compensation* (New York: Ronald Press, 1964) for an excellent survey of nearly 200 cases on this topic. See also H. Steutzer, Jr., "Reasonable Compensation," *New York University Twenty-Fifth Annual Institute on Federal Taxation* (New York: N.Y.U., 1967), pp. 49-508; E. L. Kellett, "Reasonableness of Compensation Paid to Officers or Employees, so as to Warrant Reduction Thereof in Computing Employer's Income Tax," 10 ALR 3d 125 (1966).

tion. It is the facts that count, and the taxpayer generally has the burden of proving the facts in a tax dispute.

Gifts. Section 102 provides that receipt of a gift does not constitute taxable income. In many situations, however, it is difficult to determine whether a particular property transfer really is a gift or compensation for either a past or a contemplated future event. Once again it is the facts surrounding the transfer that will control that determination. Facts that demonstrate the intent of the transferor to make a gratuitous transfer—that is, one without any expectation of something in return—are necessary to the determination that the transfer was a gift. Relationships existing between the transferor and the transferee may be important; for example, it generally will be easier to establish the fact that a gift was made if the two involved persons are closely related individuals (for example, father and son). On the other hand, if the two are related in an employer-employee relationship, it will be especially difficult to establish the presence of a gift. Although the broad outline of many other abstract but common fact questions could be noted here, let us consider in somewhat greater detail a few examples of some real-world tax disputes that were based on fact questions.

Illustrative Fact Cases

In an attempt to better illustrate the critical role of facts in the resolution of tax questions, an examination of four previously litigated tax cases follow. The four cases can be divided into two sets of two cases each. One set deals with the question of distinguishing between a gift and income for services rendered; the other set deals with the propriety of deducting payments made by a taxpayer to his parent. None of the four cases is particularly important in its own right, but together they serve to illustrate several important conclusions common to tax research and fact questions. The court decisions in these cases are relatively brief, and the facts involved are easy to comprehend.

Gift or Income?

Both the 1939 and 1954 Internal Revenue Codes include a rule providing that gifts do not constitute an element of taxable income. The present rule is stated in Section 102 of the 1954 code as follows: "(a) General Rule.—Gross income does not include the value

of property acquired by gift, bequest, devise, or inheritance." The first two cases to be examined consist largely of a judicial review of the facts necessary to determine whether or not particular transfers or property constitute gifts or taxable income for services rendered.

The first case involves a taxpayer named Margaret D. Brizendine and her husband, Everett. The case was heard by the Tax Court in 1957 and the decision, rendered by Judge Rice, reads in part as follows.

Everett W. Brizendine,

Findings of Fact

Petitioners were married in 1945 and throughout the years in issue were husband and wife and residents of Roanoke, Virginia. They filed no returns for the years 1945 through 1949, inclusive, but did file returns for 1950 and 1951 with the former collector of internal revenue in Richmond.

Prior to the years in issue, petitioner, Margaret D. Brizendine, was convicted and fined on five separate occasions for operating a house of prostitution, or for working in such a house. Petitioner, Everett W. Brizendine, prior to the years in issue, had served a term in the penitentiary. During the years in issue, he was convicted and fined seven times for violation of the Roanoke City Gambling Code, for operating a gambling house, and for disorderly conduct.

Prior to the years in issue, petitioner Margaret D. Brizendine, met an individual in a Roanoke, Virginia, restaurant with whom she became friendly. The individual promised her that if she would discontinue her activities as a prostitute he would buy her a home and provide for her support. In 1945, the individual paid Margaret $2,000 with which sum she made the down payment on a house; he also arranged for her to secure a loan to pay the balance of the purchase price. From 1945 and until the time of his death in March 1950, the individual provided money with which Margaret made payments on such loan. In addition, he paid her approximately $25 per week in cash and also paid her money to provide for utilities, insurance, furniture, and clothing. In 1946, he paid her $500 which she used to buy a fur coat.

In determining the deficiencies herein, the respondent arrived at petitioners' adjusted gross income by adding annual estimated living expenses in the amount of $2,000 to the known expenditures made by them. The amounts of adjusted gross income so determined

were as follows:

1945	$4,784.80
1946	3,300.70
1947	2,645.00
1948	2,978.62
1949	2,763.37
1950	4,812.82
1951	3,641.57

Petitioners' living expenses did not exceed $1,200 in addition to the known personal expenditures made by them during each of the years in issue.

Petitioners' failure to file returns for the years 1945 through 1949 inclusive, was not due to reasonable cause. The deficiencies in issue were due to petitioners' negligence or intentional disregard of rules and regulations. The petitioners' failure to file declarations of estimated tax was not due to reasonable cause and resulted in an underestimate of estimated tax.

Opinion

Petitioners contended that the amount received by Margaret from the individual, with which she made a down payment on a house, as well as all other amounts received from him until the time of his death in 1950, were gifts to her and, therefore, did not constitute taxable income. The respondent, while accepting petitioner's testimony as to the source of the sums, argues that she has not established that the amounts received from the individual were really gifts. He further points out that Margaret testified that the payments received from the individual were in consideration of her forbearance to refrain from engaging in prostitution, and to grant him her companionship, and argues that her promise constituted valid consideration for the payments which causes them to be taxable as ordinary income.

Both petitioners testified at the hearing in this case. Their demeanor on the stand, coupled with their long criminal records, leaves considerable doubt in our mind that the payments from the individual to Margaret were the only source of petitioner's income during the years in question, or that such amounts as the individual paid to Margaret were gifts. Since petitioners thus failed to establish that those amounts were in fact gifts, we conclude that such amounts were correctly determined by respondent to be taxable income which petitioners received during the years in issue. We further

think that there is considerable merit to the respondent's argument that Margaret's promise to the individual to forbear from engaging in prostitution, and to grant him her companionship, constituted sufficient consideration for the money received from him to make it taxable to her.

We think, on the basis of the whole record, that respondent's estimate of personal living expenses in the amount of $2,000 was excessive. Many of the known expenditures which petitioners made during the years in issue were for living expenses, and pursuant to our findings we are satisfied that an additional $1,200 adequately covers all of their personal living expenses.

The second case involved a taxpayer named Greta Starks. The case was heard by the Tax Court in 1966 and the decision, rendered by Judge Mulroney, reads in part as follows.

Greta Starks, TC Memo 1966-134

Findings of Fact

Petitioner, who was unmarried during the years in question, lives at 16900 Parkside, Detroit, Michigan. She filed no Federal income tax returns for the years 1954 through 1958. She was 24 years old in 1954 and during that year and throughout the years 1955, 1956, 1957 and 1958 she received from one certain man, amounts of money for living expenses, and a house (he gave her the cash to buy it in her name), furniture, an automobile, jewelry, fur coats, and other clothing. This man was married and about 55 years old in 1954.

Respondent in his notice of deficiency stated that he determined that the property and money petitioner received each year constituted income received by petitioner "for services rendered" and in his computation he held her subject to self-employment tax. He explained his computation of the deficiency for each year by reference to Exhibit A which was attached to the notice of the deficiency. Page 13 of this Exhibit A is as follows:

Analysis of Living Expenses and Assets Received for Services Rendered

Year 1954	
1955 Oldsmobile automobile	$ 3,000.00
Weekly allowance ($150.00 x 20 weeks)	3,000.00
Total	$ 6,000.00

Year 1955	
16900 Parkside	$22,211.08
Roberts Furs	5,038.00
Saks Fifth Avenue	828.18
Piano and furniture	6,000.00
Weekly allowance ($150.00 x 52 weeks)	7,800.00
Total	$41,877.26
Year 1956	
Roberts Furs	$1,570.00
Saks Fifth Avenue	3,543.17
Miscellaneous household expense	1,500.00
Total	$ 6,613.17
Year 1957	
Furs by Roberts	$ 121.00
Saks Fifth Avenue	1,353.19
Living expenses	4,000.00
Total	$ 5,474.19
Year 1958	
Furs by Roberts	$ 35.00
Saks Fifth Avenue	978.79
Living expenses	4,000.00
Total	$ 5,013.79

The money and property received by petitioner during the years in question were all gifts from the above described man with whom she had a very close personal relationship during all of the years here involved.

Opinion

The question in this case is whether the advancements made by respondent's witness were gifts under section 102, Internal Revenue Code of 1954, or in some manner payments that would constitute taxable income. The question is one of fact.

There were two witnesses in this case. Petitioner took the stand and testified she was not gainfully employed during the years here involved except for an occasional modeling job in 1954 for which her total receipts did not exceed $600. She said she had no occupation and was not engaged in any business or practicing any profession and had no investments that yielded her income during the

years in question. She in effect admitted the receipt of the items of money and property recited in respondent's notice of deficiency but said they were all gifts made to her by the man she identified as sitting in the front row in the courtroom. She testified that this man gave her money to defray her living expenses, and about $20,000 cash to buy the house at 16900 Parkside in 1955. She testified that she mortgaged this house for about $9,000 and she and this man lived for a time off of the proceeds of this loan. She said that this man gave her the furniture, jewelry, and clothing but she never considered the money and property turned over to her by this man as earnings. She said she had during the years in question, love and affection for this man and a very personal relationship.

The only other witness in the case was the alleged donor who sat in the courtroom during all of petitioner's testimony. He was called to the stand by respondent. He admitted on direct examination (there was no cross-examination) that he had advanced petitioner funds for the purchase of a house, clothes, fur coat, and furniture for the house. He was asked the purpose of the payments and he replied: "To insure the companionship of Greta Starks, more or less of a personal investment in the future on my part." The only other portion of his testimony that might be said to have any bearing on whether the advancements were gifts or not is the following:

Q. In advancing Greta Starks monies to purchase the properties I previously mentioned, what factors did you take into consideration pertaining to your wish or desire of securing the permanent companionship of Greta Starks?

A. The monies were advanced as I considered necessary. The purchase of a house was considered a permanent basis to last ten, twenty years not for a short while.

Respondent, of course, asks us to believe the testimony of his witness for respondent's counsel stated he was not to be considered a hostile witness. The witness was only asked a few questions. He had heard all of petitioner's testimony to the effect that the money, home, car, furniture, clothing, etc. were gifts by him to her. It is somewhat significant that he was not asked the direct question as to whether the advancement of money and property, which he admits he made, were gifts by him to her. We have quoted the only two statements he made that throw any light at all on the issue of whether the advancements were gifts or earnings. Such passages in his answers to the effect that he was making a "personal investment in the future" or the house purchase was "considered a permanent basis" are in-

comprehensive and rather absurd as statements of purpose. His testimony, in so far as it can be understood at all, tends to corroborate petitioner. He gives as his purpose for making the advancements "to insure the companionship" of petitioner. This can well be his purpose for making the gifts. It certainly serves no basis for the argument advanced by respondent on brief to the effect that her "companionship" was a service she rendered in return for the money and property she received. Evidently respondent would argue the man paid her over $41,000 for her companionship in 1955 and $5,000 or $6,000 for her companionship in the other years.

We are not called upon to determine the propriety of the relations that existed between petitioner and her admirer during the five years in question. He testified he had not seen her for five or six years. Petitioner was married in 1961 and is now living with her husband and mother. It is enough to say that all of the circumstances and the testimony of petitioner and even of respondent's witness support her statement that she received gifts of money and property during the five years in question and no taxable income.

A Comparison of Facts. Even a cursory examination of these two Tax Court memorandum decisions reveals that the two cases have many facts in common. In both instances a female taxpayer received substantial sums of money and other valuable property each year for several years, from a specific male person, in exchange for the taxpayer's companionship.

On the other hand, the two decisions also suggest several fact differences between the two cases. For example:

1. The names, dates, and places of residence of the principal parties differed in each instance.
2. The woman involved in the one case was, throughout the years in question, married; the other woman was single.
3. One of the male companion/transferors had died prior to the legal action; the other was alive and testified at the trial.
4. One of the taxpayer/transferees had a criminal record as a prostitute prior to the years in question; the other had no such record.

Because the pertinent tax issue is the same in both cases, the question is whether the facts common to the two cases are sufficiently alike to demand a common result or whether facts are sufficiently dissimilar to justify opposite results in each case. Ms. Brizendine had

to report taxable income; Ms. Starks was found to have received only gifts and, therefore, had no taxable income to report. The law was the same in both instances; therefore, the different results must be explained either by the differences in the facts or by differences in the judicial process. Theoretically, the judicial process should work equally well in every case; if so, the different results can only be explained by different facts.

An Analysis of the Divergent Results. The published decision rendered by any court is, quite obviously, much less than a complete transcript of judicial proceeding. It is, at best, a brief synopsis of those elements of the case deemed to be most important to the judge who has the responsibility of explaining why and how the court reached its decision. A review of the two judicial decisions under consideration here suggests at least two hypotheses that might explain adequately the divergent results reached in these two cases.

On the one hand, the fact that Margaret Brizendine was found to have received taxable income rather than gifts may be attributable primarily to the fact that she had a record of prior prostitution. The fact that during the years 1945 through 1951 she elected to "discontinue her activities as a prostitute" may suggest that the taxable status of her receipts really had not changed all that significantly. Prior to 1945 her receipts apparently were derived from numerous parties; thereafter, from one individual. If the same explanation for the receipts is common to both time periods, the tax results should not differ simply because of the number of transferors involved. If, however, the explanation for those transfers differed materially during the two time periods, a history of prostitution should have no material impact on the present decision.

An alternative hypothesis that might also adequately explain the divergent results in these two cases would emphasize the differences in the judicial process rather than the differences in the facts. In most tax litigation the taxpayer has the burden of proving that the tax liability determined by the Commissioner of Internal Revenue is incorrect. If the taxpayer fails to present such proof, the contentions of the IRS are deemed to be correct. Perhaps the attorney for Ms. Brizendine simply failed to *prove* his client's case.

Two adjacent statements in *Brizendine* support each of the above hypotheses. Judge Rice first says, ". . . since petitioners thus failed to establish that those amounts were in fact gifts, we conclude that

such amounts were correctly determined by respondent to be taxable income which petitioners received during the years in issue." This sentence clearly suggests that Ms. Brizendine's primary problem was one of inadequate proof. In the next sentence, however, the judge suggests the alternative hypothesis in the following words: "We further think that there is considerable merit to the respondents' argument that Margaret's promise to the individual to forebear from engaging in prostitution, and to grant him her companionship, constituted sufficient consideration for the money received from him to make it taxable to her."

The ultimate basis for a judicial decision often is not known with much certainty. Any impartial reading of *Brizendine* could not pass lightly over the judge's observation that the taxpayers' ". . . demeanor on the stand, coupled with their long criminal records, leaves considerable doubt in our mind that the payments from the individual to Margaret . . . were gifts." Although initially it may be difficult to understand how courtroom behavior or criminal records relate to the presence or absence of a gift, those facts may help to establish the credibility of any statements made by a witness. The process of taxation is, after all, not a laboratory procedure but a very human process from beginning to end. Any attempt to minimize the significance of the human element at any level of the taxing process runs the risk of missing a critical ingredient.

Starks may be viewed as further evidence of the importance of the human element in the taxing process. This time, however, the record suggests that human sympathies were running with the taxpayer and against the IRS. Judge Mulroney seems to have been less than pleased with the performance of the government's attorney. The judge, commenting on the government's interrogation of the male transferor, observes that ". . . he was not asked the direct question as to whether the advancements of money and property, which he admits he made, were gifts by him to her. We have quoted the only two statements he made that throw any light at all on the issue of whether the advancements were gifts or earnings. Such passages in his answers to the effect that he was making a 'personal investment in the future' or the house purchase was 'considered a permanent basis' are incomprehensive and rather absurd as statements of purpose. His testimony, in so far as it can be understood at all, tends to corroborate petitioner." In summary, even though the taxpayer technically once again had the burden of proving the IRS

wrong, the failure of the government's attorney to ask the obvious question and to pursue related questions when a witness gave "incomprehensive" answers seems to have influenced the judge in this instance. At any event, the court did conclude that "all of the circumstances and the testimony of petitioner and even of respondent's witness support her statement that she received gifts of money and property during the five years in question and no taxable income."

Lessons for Tax Research. Even though the specific technical tax content of these two cases is trivial, a tax adviser can learn several things from these two cases. History—that is, facts that took place well before the events deemed to be critical in a given tax dispute—may significantly influence the outcome of the decision. Therefore, in gathering the facts in a tax problem, the tax adviser can never be too thorough in getting all of the facts of his case.

A study of these two cases also reveals the intricate balance between facts and conclusions. If the trier of facts—IRS agent, conferee, appellate conferee, or judge—can be convinced of the authenticity or even the reasonableness of the facts presented for his consideration, he has ample opportunity to reach the conclusion desired by the taxpayer. If those facts are not presented to him, or are presented inadequately, the decision-maker cannot be blamed for failing to give them full consideration. Disputes are often lost by the party who fails to capitalize on the opportunity to know and present all pertinent facts in the best light.

Finally, some further reflections on these two cases are instructive for tax planning generally. If the parties to this litigation had correctly anticipated their subsequent tax problems, what might they have done to reduce the probabilities of an unfavorable result? For example, would the results have differed if neither party had included "weekly allowance" in their financial arrangements? Or all transfers had been made on such special occasions as a birthday, an anniversary, Christmas, Saint Valentine's Day, or some other holiday? If gift cards had accompanied each transfer and those cards saved and "treasured" in a scrapbook? If gift tax returns had been filed by the transferor? Obviously, each of the additional facts suggested here would lend credence to the conclusion that the transfers were indeed gifts. At some point the evidence—perhaps the filing of the gift tax return—would be so overwhelming that no one would question the conclusion in anything but the most unusual circumstances.

The important point of this review is, of course, that the tax adviser often plays a critical role in settings very remote from the courtroom. If he correctly anticipates potential tax problems that might arise, he is in an excellent position to recommend actions for accumulation of supporting proof that will almost assure the conclusion his client is interested in reaching, without going to court. Even when the tax adviser has been consulted only after all of the facts are "carved in stone," the thoroughness with which he presents those facts is often critical to the resolution of the tax question. And no one can make a good presentation of the facts until he knows precisely what they are, down to the very last detail. A study of two more cases can yield additional insight into the critical role which facts play in tax questions.

Deductible or Not?

In general, we know that income earned from the rendering of a service must be reported by the person who rendered the service and that income from property must be reported by the person who owns the property. If a taxpayer arranges for someone else to pay to one of his parents a part of the value that was originally owed to him for services rendered, generally that payment would still be taxed to the individual rendering the service, and the payment would not ordinarily be deductible by him. Payments made to parents, like payments made to anyone else, would be deductible for income tax purposes only if the parent had rendered a business-related service to the child and the payment made for such a service were reasonable in amount. But what exactly do those words mean?

The third case to be reviewed here involves a professional baseball player named Cecil Randolph Hundley, Jr. The case was heard by the Tax Court in 1967 and the decision, rendered by Judge Hoyt, reads in part as follows.

Cecil Randolph Hundley, Jr. 48 TC 339 (1967)

Findings of Fact

The stipulated facts are found accordingly and adopted as our findings.

Cecil Randolph Hundley, Jr. (hereinafter referred to as petitioner), filed his 1960 income tax return with the district director of internal revenue, Richmond, Va. Martinsville, Va., was his legal residence at the time petitioner filed the petition herein. Petitioner is a professional baseball player and at the time of trial was a catcher for the Chicago Cubs of the National League.

Petitioner's father, Cecil Randolph Hundley, Sr. (hereinafter referred to as Cecil), is a former semiprofessional baseball player, and he has also been a baseball coach. Cecil played as a catcher throughout his baseball career, and received numerous injuries to his throwing hand while using the traditional two-handed method of catching. This is a common problem of catchers. A few years before Cecil retired from active participation in baseball as a player, he developed a one-handed method of catching which was unique and unorthodox. This technique was beneficial because injuries to the catcher's throwing hand were avoided. Cecil became actively engaged in the construction and excavation business in 1947 and was still engaged in that business at time of trial.

Petitioner attended Bassett High School near Martinsville, Va., from which he graduated in June of 1960. During 1958 petitioner was a member of his high school baseball team and the local American Legion team. He played catcher for both teams and was an outstanding player. In the spring of 1958, while a sophomore in high school, petitioner decided that he wanted to become a good major league professional ball player. Petitioner believed that Cecil was best qualified to coach and train him for the attainment of this goal. After discussing his ambition with Cecil, an oral agreement was reached between petitioner and Cecil. Cecil agreed to devote his efforts to a program of intensive training of petitioner in the skills of baseball, to act as petitioner's coach, business agent, manager, publicity director, and sales agent in negotiating with professional baseball teams for a contract. His role may best be described in petitioner's own words when he first asked Cecil to handle things for him in 1958: "Daddy, do the business part and let me play the ball."

As compensation for Cecil's services, it was agreed that Cecil would receive 50 percent of any bonus that might be received under the terms of a professional baseball contract if one should later be signed. This contingent payment agreement was thought to be fair and reasonable by the parties since it was unknown at that time whether petitioner would ever develop into a player with major league potential or sign a professional baseball contract or receive

a bonus for signing. Moreover, petitioner could not sign a baseball contract while still a minor without his parent's consent or until he graduated from high school. The size of baseball bonuses obtainable at some unknown time, years in the future, was extremely conjectural. A rule limiting bonuses to $4,000 for signing baseball contracts had been suspended in 1958 and its reinstatement was a definite possibility before 1960. It was not expected by petitioner or Cecil at that time that an exceptionally large bonus would ever be received. Later on they estimated that at most $25,000 might be paid to petitioner as a bonus.

Between the spring of 1958 and petitioner's graduation from high school in 1960, Cecil devoted a great deal of time to petitioner's development into the best baseball player possible. Cecil became petitioner's coach and taught petitioner the skill of being a one-handed catcher. While this method is advantageous, it is difficult to master because it is contrary to natural instincts. The perfection of this unorthodox technique therefore required an inordinate amount of time and effort by the teacher and the pupil. Cecil also taught petitioner to be a power hitter in order to enhance petitioner's appeal to professional baseball teams. Petitioner weighed only 155 pounds during his high school days which was a decided handicap for him both as a hitter and a catcher hoping to break into the big leagues.

Cecil attended every baseball practice session and every home and away game in which petitioner participated between 1958 and 1960. On many of these occasions he met with scouts for big league teams. By mutual agreement, Cecil relieved petitioner's high school and American Legion coach from any duties with respect to petitioner. It was agreed between the coach and Cecil that it would be in the petitioner's interest for Cecil to be in complete charge of the training program. Cecil supplied petitioner with baseball equipment at his own expense during this period.

In order to obtain the best possible professional baseball contract for petitioner, Cecil had many meetings with members of the press during the 2-year period from the spring of 1958 to June 16, 1960, to publicize petitioner's skill as a baseball player. Cecil handled all the negotiations with representatives of the many professional baseball teams that became interested in petitioner. This undertaking involved numerous meetings at home and out of town. Cecil left Sundays open for such negotiations for the entire 2-year period

but negotiations often occurred on other days of the week. Cecil was never paid anything for the considerable expenses he incurred over the 2-year period.

The amount of compensation to be received by Cecil was contingent on the obtainment and size of a bonus to be paid petitioner for signing a professional baseball contract. In determining the percentage of the possible bonus to be received by Cecil, the parties also gave consideration to Cecil's increased expenses and the anticipated loss of time and income from his construction business. Cecil had to neglect his business and he lost several substantial contracts during the period of petitioner's intensive training. The amount of time he devoted to his grading and excavating business was substantialy reduced during 1958, 1959, and 1960 with corresponding loss of business income.

Petitioner developed into an outstanding high school baseball player under Cecil's tutorage and by 1960 many major league clubs had become interested in signing him. Due to the rule requiring high school graduation before signing a baseball contract, extensive final negotiation sessions with representatives of the various major league baseball teams did not begin until after petitioner's graduation in 1960.

The final negotiation sessions were held at Cecil's home and after 2 weeks resulted in a professional baseball contract signed by petitioner on June 16, 1960. All of the negotiations with the many major league clubs bidding for petitioner's contract were handled by Cecil in such a way that the bidding for petitioner's signature was extremely competitive. Representatives of the various baseball teams were allowed to make as many offers as they wanted during the 2-week period, but the terms of any offer were not revealed to representatives of other teams. Cecil's expert and shrewd handling of the negotiations was instrumental in obtaining a most favorable contract and an extraordinarily large bonus for the petitioner.

The baseball contract finally signed by petitioner was with a minor league affiliate of the San Francisco Giants of the National League. The contract provided for a bonus of $110,000 to be paid over a 5-year period at the rate of $22,000 per year, $11,000 to petitioner and $11,000 to Cecil, and a guaranteed salary to petitioner of not less than $1,000 per month during the baseball playing season for a period of 5 years. Cecil bargained for and insisted upon the minimum salary provision in addition to the large bonus because of his expectation that petitioner would be playing in the

relatively low paying minor leagues for at least 5 years. Cecil also signed the contract because under the rules of professional baseball the signature of a minor was not accepted without the signature of his parent.

The baseball contract contained the following pertinent provisions:

1. The Club hereby employs the Player to render, and the Player agrees to render, skilled services as a baseball player in connection with all games of the Club during the year 1960, including the Club's training season, the Club's exhibition games, the Club's playing season, any official series in which the Club may participate, and in any game or games in the receipts of which the Player may be entitled to share. The Player convenants that at the time he signs this contract he is not under contract or contractual obligation to any baseball club other than the one party to this contract and that he is capable of and will perform with expertness, diligence and fidelity the service stated and such other duties as may be required of him in such employment.

2. For the service aforesaid subsequent to the training season the Club will pay the Player at the rate of one thousand dollars ($1,000) per month . . . after the commencement of the playing season . . . and end with the termination of the Club's scheduled playing season and any official league playoff series in which the Club participates.

• • • •

14. Player is to receive cash bonus of one hundred and ten thousand dollars ($110,000) payable as follows:

Eleven thousand dollars ($11,000) upon approval of this contract by the National Association of Professional Baseball Leagues. Also eleven thousand dollars ($11,000) on Sept. 15, 1961; Sept. 15, 1962; Sept. 15, 1963; Sept. 15, 1964.

The father, Cecil R. Hundley, is to receive eleven thousand dollars ($11,000) upon approval of contract by the National Association of Professional Baseball Leagues. Also eleven thousand dollars ($11,000) on Sept. 15, 1961; Sept 15, 1962; Sept. 15, 1963; and Sept. 15, 1964.

• • • •

The designation of $11,000 to be paid annually to Cecil for 5 years was a consequence of the agreement between Cecil and petitioner to divide equally any bonus received by petitioner for signing

a professional baseball contract. The scout for the San Francisco Giants who negotiated the contract was aware of the aforementioned agreement before the contract was written, and the terms of the contract reflected the prior understanding of the contracting parties with respect to the division of the bonus payments. Petitioner's high school coach also knew of the 50-50 bonus agreement between petitioner and Cecil and had been aware of it since its inception in 1958.

During the 1960 taxable year which is in issue, petitioner and Cecil each received $11,000 of the bonus from the National Exhibition Co. pursuant to the terms of the contract. Petitioner did not include the $11,000 payment received by Cecil in his gross income reported in his income tax return for 1960. Cecil duly reported it in his income tax return for that year.

The notice of deficiency received by petitioner stated that income reported as received from the National Exhibition Co. was understated by the amount of $11,000. The parties are apparently in agreement that petitioner understated his income for 1960 in the determined amount, but petitioner contends that an offsetting expense deducion of $11,000 should have been allowed for the payment received by Cecil as partial compensation for services rendered under the 1958 agreement between petitioner and Cecil. Respondent's position on brief is that only a $2,200 expense deduction, 10 percent of the total bonus payment in 1960, is allowable to petitioner in 1960 as the reasonable value of services performed by Cecil.

The contract between Cecil and petitioner was made in 1958; it was bona fide and at arm's length, reasonable in light of the circumstances existing when made and in the taxable year before us. The payment of 50 percent of petitioner's bonus thereunder to Cecil in 1960 was compensation to him for services actually rendered to petitioner. He received and kept the $11,000 of the bonus paid directly to him by the ball club.

Opinion

Respondent's determination that an additional $11,000 should have been included in petitioner's income for 1960 is based upon section 61(a) which provides that gross income includes compensation for services and section 73(a) which provides that amounts received in respect of the services of a child shall be included in the child's gross income even though such amounts are not received by the child.

It is beyond question and on brief the parties agree that the

$11,000 received by Cecil actually represented an amount paid in consideration of obtaining petitioner's services as a professional baseball player. Petitioner, while agreeing with the foregoing conclusion, argues that a deduction in the amount of $11,000 should be allowed for 1960 under section 162 or 212. Respondent has conceded that such a deduction should be allowed but only in the amount of $2,200.

Section 162 provides that a deduction shall be allowed for an ordinary and necessary expense paid during the taxable year in carrying on any trade or business including a reasonable allowance for compensation for personal services actually rendered. Section 212 provides that an individual may deduct all ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income.

Respondent argues there is insufficient evidence to establish an agreement in 1958 to share any bonus equally and that even if there were such an agreement no portion paid for Cecil's services to petitioner prior to 1960 is deductible because prior to his graduation, petitioner was not in the trade or business of being a baseball player. He contends that the only service performed by Cecil for which petitioner is entitled to a deduction was the actual negotiation of the June 16, 1960, contract. He concedes on brief that a reasonable value for the services rendered by Cecil during the 2-week period from graduation to signing the contract is $2,200, 10 percent of the total bonus paid in 1960.

Petitioner has introduced persuasive and convincing evidence that the agreement was in fact reached in the spring of 1958, and we have so found. This finding is essential to petitioner's position that a deduction for an ordinary and necessary business expense deduction in the amount of $11,000 should be allowed in 1960. He argues that a contingent right to 50 percent of any bonus obtained was a reasonable value for services rendered by Cecil between the spring of 1958 and the signing of the contract in 1960, and that payment for such services was therefore an ordinary and necessary expense associated with his business of professional baseball.

We agree that the 50 percent contingent compensation agreement was reasonable in amount. Section 1.162-7(b)(2) of the regulations sets forth a test for the deductibility of contingent compensation which we have accepted as correct in *Roy Marilyn Stone Trust*, 44 T.C. 349 (1965). We apply the test here.

The primary elements considered by petitioner and Cecil in de-

termining Cecil's contingent compensation were the amount of time that would be spent in coaching, training, and representing petitioner during the uncertain period between 1958 and an eventual contract. Cecil's exclusive handling of all publicity and contract negotiations and the income that would probably be lost due to less time spent on Cecil's construction business were also important factors. In addition to the foregoing considerations, emphasis should be placed on the fact that the ultimate receipt of a bonus of any kind was uncertain and indefinite. The amount was indeterminable and in 1958 neither petitioner, Cecil, nor the high school coach who was aware of the agreement had any notion that an exceptionally large bonus would be paid 2 years hence. Petitioner might well never have become a professional ballplayer, nor was it at all certain that he would be paid a bonus in the future. Viewing the circumstances at the time the agreement was made in the light of all of the evidence before us we conclude and hold that the test of resonableness has been met even though the contingent compensation may be greater than the amount which might be ordinarily paid.

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While it is true that an agreement of this sort between a father and his minor son cannot possess the arm's-length character of transactions between independent, knowledgeable businessmen and must be most carefully scrutinized, the agreement here stands every searching test. Independent and trustworthy witnesses verified its existence since 1958. It was in our judgement and in the opinion of both petitioner and Cecil, then and at trial, fair to both parties. See *Olivia de Havilland Goodrich,* 20 T.C. 323 (1953).

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Respondent contends further, however, that even if the bonus splitting agreement arose in 1958 and was intended to ultimately result in a reasonable amount of compensation for services rendered throughout the 2-year period, the full amount received by Cecil is still not deductible because petitioner was not engaged in a trade or business or any other income-producing activity until graduation from high school when he became eligible to sign a professional baseball contract. In order for an expenditure to qualify for deductibility under section 162 or 212, it must have been paid or incurred in carrying on any trade or business or for any other income producing or collecting activity. . . .

The contingent compensation agreement was so closely bound up with the existence of the petitioner's business activity of professional

baseball that payments made thereunder must be considered as paid in carrying on a trade or business. If petitioner had never entered the business of professional baseball or had not been paid a bonus therefor, no payments would have been made to or received by Cecil. The whole basis of the agreement was the ultimate existence and establishment of the contemplated business activity and the collection of a bonus. We therefore conclude that payments made under the terms of the agreement were paid for services actually rendered in carrying on a business. The obligation to make the payments to Cecil was an obligation of the business since there would be no obligation without the business. If the business were entered without payment of a bonus there also would be no obligation to share it with Cecil. The unique relationship of Cecil's compensation to the professional baseball contract and petitioner's income derived therefrom in 1960 is most persuasive of the deductible nature of the compensation payment made that year.

Respondent's final argument, raised herein for the first time on brief, is based on the premise that the services rendered prior to high school graduation were basically educational in nature, and that educational expenditures are personal and nondeductible if undertaken primarily for the purpose of obtaining a new position or substantial advancement in position. See sec. 1.162-5(b), Income Tax Regs. We have previously held that claimed deductions for educational expenditures of the foregoing type are not allowable. *Mary O. Furner*, 47 T.C. 165 (1966); *Joseph T. Booth III*, 35 T.C. 1144 (1961); and *Arnold Namrow*, 33 T.C. 419 (1959), aff'd. 288 F.2d 648 (C.A. 4, 1961).

However, petitioner is not claiming a deduction in the amount of $11,000 for educational expenditures, and indeed he could not. It is clear that a significant portion of Cecil's compensation was not for coaching and training petitioner in the skills of baseball, if that be deemed education, but for other services rendered throughout the 2-year period.

• • • •

We hold, therefore, that whereas respondent acted correctly in including the entire $22,000 bonus in petitioner's taxable income, petitioner should be nevertheless allowed a deduction in the amount of $11,000 in 1960 as a business expense for the portion of the bonus paid directly to Cecil for his personal services actually rendered with such rewarding financial results for both petitioner and his father.

The last case to be reviewed in this chapter involves another professional baseball player named Richard A. Allen. His case was heard by the Tax Court in 1968 and the decision, rendered by Judge Raum, reads in part as follows.

Richard A. Allen, 50 TC 466 (1968)

Findings of Fact

Some of the facts have been stipulated and, as stipulated, are incorporated herein by this reference along with accompanying exhibits.

Petitioners Richard A. and Barbara Allen are husband and wife, who at the time of the filing of the petitions and amended petitions herein resided in Philadelphia, Pa. Richard A. Allen filed his individual returns for the calendar years 1960, 1961, and 1962, and a joint return with his wife Barbara Allen for 1963, on the cash receipts and disbursements method of accounting, with the district director of internal revenue, Pittsburgh, Pa. Barbara Allen is a party to this proceeding solely by virtue of the joint return filed for 1963, and the term 'petitioner' will hereinafter refer solely to Richard A. Allen.

Petitioner was born on March 8, 1942. In the spring of 1960 petitioner, then age 18, was living with his mother, Mrs. Era Allen, in Wampum, Pa., and was a senior at a local high school. Mrs. Allen had been separated from her husband since 1957. She had eight children, of whom three, including petitioner, were dependent upon her for support during 1960. She received no funds from her husband, and supported her family by doing housework, sewing, or laundry work.

In the course of his high school years, petitioner acquired a reputation as an outstanding baseball and basketball player. He was anxious to play professional baseball, and had even expressed a desire to leave high school for that purpose before graduation, but was not permitted to do so by his mother. During the petitioner's junior year in high school, word of his athletic talents reached John Ogden (hereinafter "Ogden"), a baseball "scout" for the Philadelphia National League Club, commonly known and hereinafter referred to as the Phillies. Ogden's attention was drawn to petitioner through a newspaper article about petitioner which, while primarily describing him as a great basketball player, also

mentioned that he had hit 22 "home runs" playing with a men's semiprofessional baseball team the summer before his junior year in high school, and that the player who had come closest to his total on this team, which otherwise comprised only grown men, had hit only 15 home runs. Ogden's function as a scout for the Phillies was to select baseball talent capable of playing in the major leagues, i.e., with the Phillies, and after reading this article he made up his mind to see petitioner.

Ogden had himself played baseball for around 16 to 18 years, was general manager of one baseball club and owner of another for 7 or 8 years, and at the time of the trial herein had been a baseball scout for the preceding 28 years—a total of about 52 years in professional baseball. After interviewing petitioner and watching him play basketball and baseball, Ogden determined that petitioner was the greatest prospect he had ever seen. He conveyed this impression to John Joseph Quinn (hereinafter "Quinn"), vice president and general manager of the Phillies, and told Quinn that petitioner was worth "whatever it takes to get him." Quinn thereupon gave Ogden authority to "go and get" petitioner, i.e., to sign him to a contract to play baseball for the Phillies.

From this point on, Ogden became very friendly with petitioner's family. He hired Coy Allen, petitioner's older brother of about 36 or 37 who had played some semiprofessional baseball in the past, as a scout for the Phillies. He also signed Harold Allen, another brother of petitioner to a contract to play baseball in the Phillies organization. He visited the Allen home often, and talked to petitioner about playing baseball. He did not, however, attempt immediately to sign petitioner to a contract because of a rule adhered to by the Phillies and other baseball teams prohibiting the signing of any boy attending high school to a baseball contract until after his graduation.

Ogden, as well as representatives of a dozen or more other baseball teams that also desired petitioner's services, discussed petitioner's prospects with his mother, Era Allen. She was the head of the family, and she made all the family decisions. Although petitioner discussed baseball with the various scouts, he referred them to his mother in connection with any proposed financial arrangements, and he felt "bound" to play for whichever club his mother might select.

Era Allen conducted all negotiations with Ogden in respect of the financial arrangements that might be made for petitioner if it should be determined that he would play for the Phillies. However, she knew nothing about baseball, particularly the financial aspects of

baseball, and she relied almost entirely upon advice from her son Coy Allen. After petitioner had entered into a contract to play for the Phillies organization, as hereinafter more fully set forth, Era Allen paid Coy $2,000 in 1960 for his services out of the funds which she received under that contract, and she deducted that amount from her gross income on her 1960 individual income tax return.

One of the principal items of negotiation with Ogden was the amount of "bonus" to be paid for petitioner's agreement to play for the Phillies organization. Such bonus was in addition to the monthly or periodic compensation to be paid petitioner for services actually rendered as a ballplayer. The purpose of the bonus was to assure the Phillies of the right to the player's services, if he were to play at all, and to prevent him from playing for any other club except with permission of the Phillies. Scouts for other teams had made offers of a bonus of at least $20,000 or $25,000. During the course of the negotiations Ogden made successive offers of a bonus in the amounts of $35,000, $50,000, and finally $70,000. The $70,000 offer was satisfactory to petitioner's mother, but she wanted $40,000 of that amount paid to her and $30,000 to petitioner. She thought that she was entitled to a portion of the bonus because she was responsible for his coming into baseball by her hard work, perseverance, taking care of petitioner, and seeing that he "did the right thing." Although it had been informally agreed prior to petitioner's graduation that he would go with the Phillies, the contract was presented to and signed by petitioner some 30 or 40 minutes after he had received his high school diploma on June 2, 1960.

The contract was formally between petitioner and the Williamsport Baseball Club, one of six or seven minor league teams affiliated with the Phillies through a contractual arrangement known as a "working agreement" whereby, in general, the Phillies were entitled, in exchange for a stated consideration, to "select" the contracts of any of the players on the Williamsport Club for their own purposes and under which the Phillies further agreed, among other things, to reimburse the Williamsport Club for any bonus paid to a player for signing a contract with that club. The Williamsport Club was under the substantial control of the Phillies, and the contract between petitioner and the Williamsport Club was signed on behalf of the latter by an official of the Phillies, who was in charge of all the Phillies' minor league clubs, or what was called their "farm system," and who was authorized to sign on behalf of the Williamsport Club. The contract was on the standard form

prescribed by the National Association of Professional Baseball Leagues. Since petitioner was a minor, his mother gave her consent to his execution of the contract by signing her name under a printed paragraph at the end of the form contract entitled "Consent of Parent or Guardian." Such consent was given explicity [*sic*] "to the execution of this contract by the minor player party hereto," and was stated to be effective as to any assignment or renewal of the contract as therein specified. She was not a party to the contract. The Phillies, in accordance with their usual practice, would not have entered into any such contract, through the Williamsport Club or otherwise, without having obtained the consent of a parent or guardian of the minor player.

In addition to providing for a salary of $850 per month for petitioner's services as a ballplayer, the contract provided for the $70,000 bonus payable over a 5-year period, of which $40,000 was to be paid directly to petitioner's mother and $30,000 to petitioner. The contract provided in part as follows:

1. The Club hereby employs the Player to render, and the Player agrees to render, skilled services as a baseball player in connection with all games of the Club during the year 1960. . . . The Player convenants that at the time he signs this contract he is not under contract or contractual obligation to any baseball club other than the one party to this contract and that he is capable of and will perform with expertness, diligence and fidelity the service stated and such other duties as may be required of him in such employment.

2. For the service aforesaid subsequent to the training season the Club will pay the Player at the rate of eight hundred fifty dollars per month.

• • • •

5. (a) The Player agrees that, while under contract and prior to expiration of the Club's right to renew the contract, and until he reports to his club for spring training, if this contract is renewed, for the purpose of avoiding injuries he will not play baseball otherwise than for the Club except that he may participate in post-season games as prescribed in the National Association Agreement.

(b) The Player and the Club recognize and agree that the Player's participation in other sports may impair or destroy his ability and skill as a baseball player. Accordingly, the Player agrees he will not engage in professional boxing or wrestling and that,

except with the written consent of the Club, he will not play professional football, basketball, hockey or other contact sport.

• • • •

Player is to receive bonus of	$6,000	payable	June 2, 1960
Do.	$8,000	..do..	June 1, 1961
Do.	$8,000	..do..	June 1, 1962
Do.	$4,000	..do..	June 1, 1963
Do.	$4,000	..do..	June 1, 1964

Mother Mrs. Era Allen is to receive bonus of $16,000 payable June 2, 1960
Mother Mrs. Era Allen is to receive bonus of $10,000 payable June 1, 1961
Mother Mrs. Era Allen is to receive bonus of $6,000 payable June 2, 1962
Mother Mrs. Era Allen is to receive bonus of $4,000 payable June 2, 1963
Mother Mrs. Era Allen is to receive bonus of $4,000 payable June 2, 1964

Total bonus seventy thousand dollars guaranteed.

• • • •

It was generally the practice in baseball to have the signature of a parent or guardian when signing a player under the age of 21 to a contract, and a contract lacking such signature would probably not have been approved by the president of the National Association of Professional Baseball Leagues.

The installments of the $70,000 bonus agreed to by the Williamsport Baseball Club in its contract with petitioner were actually paid by the Phillies under their "working agreement" with the Williamsport Club. The Phillies viewed such bonus arrangements as consideration to induce a player to sign a contract which thus tied him to the Phillies and prevented his playing baseball for any other club without the consent of the Phillies. These bonus arrangements represented a gamble on the part of the Phillies, for a player might not actually have the ability to play in the major leagues, or might decide on his own that he no longer wanted to play baseball. The Phillies could not recover bonus money already paid, and as a matter of baseball practice felt obligated to pay a bonus, once agreed to, in all events, even if some part of the bonus still remained unpaid when the player left or was given his unconditional release by the club. Nevertheless, in light of petitioner's

future potential and ability, Ogden, who negotiated petitioner's bonus, and Quinn, who had the final say in these matters, felt that $70,000 was a fair price to pay to "get" the right to petitioner's services as a professional baseball player. It was a matter of indifference to them as to whom the bonus was paid or what division was made of the money. The previous year, in 1959, the Phillies had paid a bonus of approximately $100,000 to one Ted Kazanski and in 1960, at about the same time they signed petitioner, the Phillies paid a bonus of approximately $40,000 to one Bruce Gruber.

Following the execution of the foregoing contract in June 1960 with the Williamsport Club, petitioner performed services as a professional baseball player under annual contracts for various minor league teams affiliated with the Phillies until sometime in 1963. From that time, he has performed his services directly for the Phillies, and in 1967 his annual salary as a baseball player was approximately $65,000.

Petitioner (and his wife Barbara Allen in the taxable year 1963) reported as taxable ordinary income in his (their) Federal income tax returns for the taxable years 1960, 1961, 1962, and 1963 the bonus payments received by petitioner in each of said years, as follows:

Year	Amount
1960	$ 6,000
1961	8,000
1962	8,000
1963	4,000

Petitioner's mother, Era Allen, reported as taxable ordinary income in her Federal income tax returns for the taxable years 1960, 1961, 1962, and 1963 the payments received by her in each of said years, as follows:

Year	Amount
1960	$16,000
1961	10,000
1962	6,000
1963	4,000

In his notice of deficiency to petitioner in respect of the taxable years 1961 and 1962, and his notice of deficiency to petitioner Richard and his wife Barbara Allen in respect of the taxable year 1963, the Commissioner determined that the bonus payments received by petitioner's mother in 1961, 1962, and 1963 represented amounts received in respect of a minor child and were taxable to petitioner under sections 61 and 73 of the Internal Revenue

Code of 1954; he increased petitioner's taxable income in each of those years accordingly.

Opinion

1. *Inclusion of Bonus in Petitioner's Gross Income.* (a) Petitioner was only 18 years old when the events giving rise to the bonus payments in controversy took place. Accordingly, if the payments made during the years in issue (1961–63) by the Phillies to Era Allen, petitioner's mother, constitute "amounts received in respect of the services" of petitioner within the meaning of section 73(a), I.R.C. 1954, then plainly they must be included in petitioner's gross income rather than in that of his mother. Although petitioner contends that the statute does not cover the present situation, we hold that the payments made to his mother during the years in issue were received solely in respect of petitioner's services, and that all such amounts were therefore includable in his income.

Petitioner argues that the payments received by his mother, totaling $40,000 over a 5-year period, were not part of his bonus for signing a contract to play baseball for the Phillies organization, but rather represented compensation for services performed by her, paid by the Phillies in return for her influencing petitioner to sign the contract and giving her written consent thereto. But there was no evidence of any written or oral agreement between the Phillies and Era Allen in which she agreed to further the Phillies' interests in this manner, and we shall not lightly infer the existence of an agreement by a mother dealing on behalf of her minor child which would or could have the effect of consigning her child's interests to a secondary position so that she might act for her own profit. Moreover, we think the evidence in the record consistently points to the conclusion that the payments received from the Phillies by Era Allen were considered and treated by the parties as part of petitioner's total bonus of $70,000. This sum was paid by the Phillies solely to obtain the exclusive right to petitioner's services as a professional baseball player; no portion thereof was in fact paid for his mother's consent.

We note, first of all, that there was no separate written agreement between the Phillies and Era Allen concerning the payment of $40,000 to her, and that in fact the sole provision of which we are aware for the payment of this sum appears in the contract between petitioner and the Williamsport Baseball Club, a minor league baseball club affiliated with the Phillies under a "working agreement" which entitled the Phillies to claim the contract and

the services of any player on the club at any time. Petitioner's contract, a uniform player's contract standard in professional baseball, contained a paragraph requiring the parties to set forth any "additional compensation" (aside from the regular payment of salary) received or to be received from the club "in connection with this contract" and it is in the space provided for such "additional compensation" that all the annual installments of petitioner's bonus, both those payable to petitioner and those payable to his mother, are set forth. After a description of all such installments, identifying the payee (petitioner or his mother), the amount and the date due, appear the words: "Total bonus seventy thousand dollars guaranteed." Moreover, if further proof be needed that the Phillies did not consider any part of the $70,000 bonus as compensation for Era Allen's services it is provided by the testimony of John Ogden, the baseball scout responsible for petitioner's signing a contract with the Phillies' organization. Although Ogden resisted being pinned down, the clear import of his testimony was that the total bonus paid was determined solely by petitioner's ability to play baseball and his future prospects as a player, that the Phillies considered $70,000 a fair price to pay for the right to petitioner's services, and that it made little difference to them whether petitioner's mother received any part of the bonus so determined.

Era Allen herself did not claim to be entitled to $40,000 by virtue of any services performed for or on behalf of the Phillies, and in fact made clear in her testimony that she bargained, as one would expect, "for whatever was best for my son." Rather, she insisted upon a large portion of petitioner's bonus because she felt that petitioner would never have reached the point at which he was able to sign a lucrative contract with a professional baseball team had it not been for her hard work and perseverance in supporting him. And indeed, as the mother of a minor child, one who by the fruits of her own labor had contributed to the support of her minor child without the help of the child's father, she appears to have been entitled to *all* petitioner's earnings under Pennsylvania law. Pa. Stat. tit. 48, sec. 91 (1965).

Prior to 1944, the Commissioner's rulings and regulations "required a parent to report in his (or her) return the earnings of a minor child, if under the laws of the state where they resided the parent had a right to such earnings," even if none or only part of the child's earnings were actually appropriated by the parent. . . . Because parents were not entitled to the earnings of their minor children in all States, and because even in those States following this

common-law doctrine the parents' right to the earnings of a minor child could be lost if it was found that the child had been emancipated, the result of the Commissioner's policy was that:

> for Federal income tax purposes, opposite results obtain(ed) under the same set of facts depending upon the applicable State law. In addition, such variations in the facts as make applicable the exceptions to the general rule in each jurisdiction tend(ed) to produce additional uncertainty with respect to the tax treatment of the earnings of minor children.

H. Rept. No. 1365, 78th Cong., 2d Sess., p. 21 (1944); S. Rept. No. 885, 78th Cong., 2d Sess., p. 22. To remedy these defects, Congress in 1944 enacted the substantially identical predecessor of section 73 of the Internal Revenue Code of 1954, providing the easily determinable and uniform rule that all amounts received "in respect of the services of a child" shall be included in his income. "Thus, even though the contract of employment is made directly by the parent and the parent receives the compensation for the services, for the purpose of the Federal income tax the amounts would be considered to be taxable to the child because earned by him." H. Rept. No. 885, 78th Cong., 2d Sess., p. 22, 23. We think section 73 reverses what would have been the likely result in this case under pre-1944 law wholly apart from the contract, and that the $70,000 bonus is taxable in full to petitioner.

Petitioner stresses the fact that the $70,000 bonus paid by the Phillies did not constitute a direct payment for his "services" as a professional baseball player, which were to be compensated at an agreed salary of $850 per month, for the $70,000 was to be paid in all events, whether or not petitioner ever performed any services for the Phillies organization. Therefore, it is argued, the bonus payments could not have constituted compensation for *services* which alone are taxed to a minor child under section 73. Cf. Rev. Rul. 58-145, 1958-1 C.B. 360. This argument misreads the statute, which speaks in terms of "amounts received *in respect of* the services of a child," and not merely of compensation for services performed. True, petitioner performed no services in the usual sense for his $70,000 bonus, unless his act of signing the contract be considered such, but the bonus payments here were paid by the Phillies as an inducement to obtain his services as a professional baseball player and to preclude him from rendering those services to other professional baseball teams; they thus certainly constituted amounts received "in respect of" his services.

(b) Even if amounts in issue were not received "in respect of the services" of a child under section 73, we think that the bonus installments paid to petitioner's mother during the tax years 1961–63 are nevertheless chargeable to him under the general provisions of section 61. It has long been established that one who becomes entitled to receive income may not avoid tax thereon by causing it to be paid to another through "anticipatory arrangements however skillfully devised." *Lucas* v. *Earl*, 281 U.S. 111, 114–115; *Helvering* v. *Horst*, 311 U.S. 112; *Helvering* v. *Eubank*, 311 U.S. 122; *Harrison* v. *Schaffner*, 312 U.S. 579.

As indicated above, the entire $70,000 bonus was paid as consideration for petitioner's agreement to play baseball for the Phillies or any team designated by the Phillies. We reject as contrary to fact the argument that part of that amount was paid to his mother for her consent to the contract. It was petitioner, and petitioner alone who was the source of the income and it is a matter of no consequence that his mother thought that she was entitled to some of that income because of her conscientious upbringing of petitioner. . . .

2. *Petitioner's Alternative Contention—Deduction of Bonus Payments From His Gross Income.* Finally petitioner argues alternatively that if his entire $70,000 bonus is includable in his income, he should be allowed to deduct the bonus payments received by his mother as an "ordinary and necessary" expense incurred in carrying on his trade or business as a professional baseball player. He places great reliance in this argument upon *Cecil Randolph Hundley, Jr.*, 48 T.C. 339, acq. 1967–2 C.B. 2, a case recently decided by this Court in which a professional baseball player was allowed to deduct that portion of his bonus for signing a baseball contract which was paid directly to his father, the result of an agreement entered into some 2 years before the contract was signed as a means of compensating the father for his services as a baseball coach and business agent. However, the special facts in *Hundley*, which supported a finding of reasonableness for the amount of the deduction claimed and warranted the conclusion that the amounts paid there in fact represented a bona fide expense incurred in carrying on the taxpayer's trade or business of being a professional baseball player, are almost entirely absent here.

It is unnecessary to determine the exact sum which would have constituted a reasonable payment to Era Allen for her services, though we note that only $2,000 was paid to her son Coy Allen for

the advice she so greatly relied on, for we are certain that in any case it could not have exceeded the $16,000 received by her in 1960. Although the year 1960 is not before us in these proceedings, we can and do take into account the payment made to her in that year in determining whether the deductions now claimed by petitioner for payments made to her in the years 1961, 1962, and 1963 are reasonable in amount and deductible as "ordinary and necessary" business expenses. We think they clearly are not, and hold that petitioner is not entitled to deductions in any amount for payments made to his mother in those years.

A Comparison of the Facts. Once again even a cursory examination of these two Tax Court decisions reveals that the cases have several facts in common. In both instances:

1. A professional baseball player arranged to have a portion of a sizable bonus paid to one of his parents.
2. Both the parent and the ball-playing minor child signed the professional contract.
3. The bonus payments actually were made by the ball club to the parent over several years.
4. The parent reported the amount received as ordinary taxable income and paid the tax liability thereon.

The two cases also differ in several factual respects.

1. The names, dates, amounts, and places of residence of the principal parties differed in each case.
2. The parent involved in one case was the baseball player's father; in the other case it involved his mother.
3. One parent was knowledgeable about and deeply involved in training the child in the skill of ball playing; the other parent knew relatively little about baseball.
4. One parent-child pair had a prior oral agreement about how they would divide any bonus that might eventually be received; the other parent-child pair had no such prior agreement.

Once again, it is pertinent to inquire whether or not the common facts are sufficient to require a common result or whether the

different facts justify a different result. The decisions of the court again were very different. Cecil Hundley, Jr., was allowed to deduct the portion of the bonus paid to his father; Richard Allen was denied the right to deduct the portion of the bonus paid to his mother. Because the law was the same in both cases, and because there is little basis in the reported decisions to conclude that differences in the judicial process had much influence on these results, we must conclude that the different facts adequately explain the divergent results.

An Analysis of the Divergent Results. Judge Hoyt makes it clear that the decision in *Hundley* is critically dependent upon the existence of the oral agreement between the father and the son. He states: "Petitioner has introduced persuasive and convincing evidence that the agreement was in fact reached in the spring of 1958, and we have so found. This finding is essential to petitioner's position. . . ." Judge Raum makes it equally clear in *Allen* that he could find no contractual agreement in that case. He states: "Petitioner argues that the payments received by his mother . . . were not part of his bonus for signing a contract to play baseball for the Phillies organization, but rather represented compensation for services performed by her, paid by the Phillies in return for her influencing petitioner to sign the contract and giving her written consent thereto. But there was no evidence of any written or oral agreement between the Phillies and Era Allen in which she agreed to further the Phillies' interests in this manner, and we shall not lightly infer the existence of an agreement by a mother dealing on behalf of her minor child. . . ."

One cannot help but wonder exactly how it is possible for a person to present convincing evidence of an oral agreement made between a father and his tenth-grade son some nine years prior to the litigation. Two brief statements in the reported decision provide the only clues. One statement notes that the high school coach knew of the oral agreement since its inception; the other statement suggests that the scout for the San Francisco Giants, who negotiated the Hundley contract, also knew of the oral agreement since its inception. We can only conclude, therefore, that these statements are either based on an oral examination of witnesses at the trial or that written depositions were obtained from these persons and submitted as evidence at the trial to substantiate the existence of the oral contract.

Lessons for Tax Research. For the student of tax research, perhaps the most instructive aspect of the last two cases is their demonstration of the importance of favorable testimony by impartial witnesses. Proper preparation of a tax file sometimes may include the need to provide supporting evidence available only from disinterested third parties. The longer one waits to locate such a party, the greater the difficulty in finding one capable of giving the testimony needed. To the maximum extent possible, considering economic constraints, the tax adviser should anticipate the importance of all supporting documents, including sworn statements from third parties. If strong evidence of one or two critical facts can be provided to an IRS agent or to a conferee, the probability of litigation may be significantly reduced.

A careful reading of these two decisions also reveals that very similar fact situations may sometimes be argued on radically different grounds. In other words, even though the facts are similar, the questions raised may be different. Although this observation really is more pertinent to the next chapter of this tax study than it is to the present chapter, and even though the more unusual argument did not prove to be fruitful in this instance, we observe in passing that *Allen* argues for a favorable result in the alternative. First, the taxpayer contends that the payments made to his mother were *not* for his services as a ballplayer. Only later, should the first argument fail, does he argue that the payments to his mother are deductible business expenses. In *Hundley*, on the other hand, the taxpayer never raised the former issue. The fact that both questions deserve consideration stems directly from a careful review of the facts and the law.

In *Allen* the argument is made that a bonus payment really is not a payment for *services rendered.* At least in part, that payment really is to compensate the ballplayer for *not* rendering services (to a competitor club).

The pertinent statutory provisions refer to "amounts received *in respect of the services of a child.*" (Emphasis added.) The question raised, then, deals with whether a ballplayer's bonus properly falls within the meaning of the "in respect of" clause. After reviewing the congressional intent behind those words, the court determined that it did and thus rejected the taxpayer's first line of argument. Nevertheless, this observation should remind the tax adviser to consider the facts of his case in every possible way before resigning

himself to a single line of argument. The next chapter examines in greater detail the subtle relationship between the facts and a statement of the pertinent questions.

For the tax adviser, a knowledge of the statutes alone is insufficient. An adviser must carefully delineate facts important to the tax question and recognize the need to document significant facts in the event they must be retrieved and substantiated during a later audit. The next chapter addresses the task of extracting or anticipating tax questions from the fact situation.

3

. . . there is frequently more to be learn'd from the unexpected Questions of a Child, than the Discourses of Men, who talk in a Road, according to the Notions they have borrowed, and the Prejudices of their Education.

JOHN LOCKE

The Elusive Nature of Tax Questions

Tax questions arise when a unique set of fact circumstances is examined in light of general rules of tax law. Learning to identify and phrase the critical tax questions implicit in any set of facts is no small accomplishment for, in many instances, the most important questions are by no means obvious. The more experienced the tax adviser, the easier it is for him to identify and to ask the right questions. For the beginner, asking the right question is often the most difficult part of tax research. Even the most seasoned tax veteran can easily overlook a very important question, and for this reason successful tax practitioners make it a general practice to require an internal review of all tax research before stating an opinion to anyone outside the firm. This precaution sometimes is extended to include even the preparation of a written record of all oral responses made to informal inquiries received. The probability of overlooking either an important tax question or a part of the law is simply too great to permit any less thorough procedure.

The difficulty experienced in properly identifying and stating the pertinent tax questions is largely attributable to the high degree of interdependence that exists between the facts, questions, and law. If the tax adviser fails to determine all of the pertinent facts, the chance that he will overlook a critical question is greatly increased. Similarly, even if the tax adviser has determined all of the critical facts, he may fail to consider a critical part of the law and thus again over-

look a critical question. Finally, even if the tax adviser knows all of the facts and all of the law pertinent to a case, he still may overlook an obvious question simply because of human error.

Errors in stating questions are often related to either (1) failure to think originally or creatively about tax problems or (2) failure to pay sufficient attention to detail. A veteran tax adviser will seldom fail to heed detail; on the other hand, precisely because of his long experience, he may be prone to overlook new and different ways of viewing recurrent problems.[1] In some instances, therefore, it is desirable to have the most complex tax situations reviewed by inexperienced as well as experienced personnel. The former individuals might ask the obvious question that otherwise would be overlooked, but only the latter individuals can fully appreciate the significance of even the obvious question once it has been asked. Frequently, one good tax question raises two or more related questions, and before long the tax result becomes dependent upon a network of closely related but separate questions.

Initial Statement of the Question

The resolution of a tax problem often evolves through several stages of development. In many instances the initial statement of the question may be only remotely related to the questions that turn out to be critical to its solution. The greater the technical competence of the researcher, the fewer steps in the evolution of an answer. The technical competence of tax researchers is, in all likelihood, normally distributed on a continuum ranging from little or no competence to very great expertise. Any attempt to separate these individuals into discrete groups is obviously unrealistic. Nevertheless, for purposes of discussion of the difficulties encountered in identifying tax questions, tax advisers could be categorized as falling into one of three groups, namely, those with "minimal" technical competence, those with "intermediate" technical competence, and those with "extensive" technical competence relative to the *subject*

[1] For example, in *Allen* (see chapter 2) it would have been very easy to overlook the first of the two alternative arguments considered there; i.e., what exactly was Allen being paid for in the bonus? If it was for *not* rendering a service, a different result might apply. Admittedly, that argument was not successful in that particular case, but it was pertinent and could have been important.

at hand. Technical competence in one area of taxation does not guarantee equal competence in other areas. Individuals who have an extensive technical knowledge in one aspect of taxation must move with a beginner's caution when approaching another area of the law; although the problems are often similar, the applicable rules are sometimes quite different. As was stated earlier, a final tax result depends upon three variables: facts, law, and an administrative (and/or judicial) process. Just as the facts of one case may differ from another, so also may the law.

Minimal Technical Competence

A tax adviser with minimal technical competence usually can state tax questions in only the broadest of terms. After reviewing the facts he typically is prepared to ask such general questions as the following:

1. Must gross income be recognized "in these fact circumstances"?
   a. If so, how much income must be recognized?
   b. If so, in which year should that income be reported?
2. Can a deduction be claimed "in these circumstances"?
   a. If so, how much can be deducted?
   b. If so, in which year can the deduction be claimed?
   c. If not, can something be added to the tax basis of an asset?
3. If income must be recognized, is that income ordinary income or capital gain?
   a. If capital gain, is it long or short-term?
   b. If ordinary income, is it earned income?
4. What is the tax basis of a specific asset?

In any real situation, of course, the actual facts of the case must be substituted for the phrase "in these circumstances" in the hypothetical questions posed above. For example, in the first question suggested above, the facts might be such as to justify this question: "Must gross income be recognized if a taxpayer transfers appreciated property to his ex-wife in settlement of any claims that she might have against him arising from a divorce?" Or, in the second hypothetical question, the facts might justify a question like this: "Can an accrual-basis corporate taxpayer claim an income tax deduction in the current year for an unpaid note given as a bonus to

a cash-basis employee who is also the corporate-employer's sole stockholder?" Observe that even the initial statement of a tax question should be very carefully phrased so as to include what appear to be all of the important facts of the situation.

Because beginning staff members typically enter the tax departments of accounting firms with minimal technical competence, they usually are prepared to ask only broad, general questions. If properly phrased, however, the broad questions posed by the new staffman are ultimately the same questions which the more knowledgeable tax adviser seeks to answer. He tends, however, to phrase his initial questions in somewhat different terms.

Intermediate Technical Competence

The tax adviser with an intermediate level of technical competence often can review a fact situation and state the pertinent questions in terms of specific statutory authority. For example, the first question already considered for the beginning adviser might be verbalized by a person with more experience in words like this: "Has any gross income been realized within the meaning of Section 61 or 1002 if a taxpayer transfers appreciated property to his former spouse as part of a divorce settlement in the state of Maryland?" Or, in the second question previously considered, he may ask: "Does Section 267 disallow the current deduction for a bonus, otherwise deductible under Sections 162 and 461, which is payable by a corporation to a cash-basis employee who is the corporate employer's sole stockholder, if the corporate obligation is evidenced by a note due six months following the end of the employer's tax year?"

A comparison of the same two hypothetical questions, as phrased by the person with minimal competence versus that phrased by the person with an intermediate level of competence, reveals several interesting differences.

First, the more experienced person generally understands the statutory basis of authority which is applicable to the tax questions. Or, to put this same difference in another way, the more experienced person knows that most tax questions have a statutory base, and he knows which code sections are applicable to the facts under consideration. In still other words, the experienced person knows that correct tax results do *not* stem from secondary reference books,

which all too frequently state "rules" ad infinitum without revealing the source of authority for their conclusions.

Second, the tax adviser with intermediate technical competence often phrases his questions in such a way that they imply the answer to a more general question, subject only to the determination of the applicability of one or more "special provisions" to the facts under consideration. For example, the phrasing of the first question suggested earlier for the person with intermediate level skills may really imply something like this: "The stated facts will result in the recognition of income under the general rules of Section 61 and/or 1002, unless some other authority can be found to support a contrary conclusion." Note that questions phrased by the person with greater technical competence frequently suggest where the answers can be located. If a researcher knows which code sections are applicable to a given fact situation, his task in locating pertinent authority for a solution is greatly simplified.

Third, the more competent tax adviser is apt to include more facts in his statement of the question than is the beginning adviser. Thus, for example, he may imply the importance of state law to a federal income tax result by adding a phrase such as "in the state of Maryland." This tendency to add more facts to the statement of the question is the result of experience. The more experienced person often recognizes, in his statement of the question, some of the apparently innocent facts that can so critically modify a tax result.

In daily tax practice, a person with minimal technical tax competence acquires a great deal of his knowledge by answering the specific question posed to him by his more competent colleagues. He saves valuable and expensive time by being directed to look in the right places. Without this assistance, the beginner must spend many hours just locating the general authority which is pertinent to his question. (The various methods of locating authority are described in chapter 4.) We might note, however, that the beginner typically prepares working papers detailing the research steps he undertakes to answer the questions posed by his supervisors. These working papers both permit the supervisor to review the adequacy of the staffman's conclusions and leave a permanent record of the facts and the authorities that were considered in solving any given tax problem. These records may prove to be invaluable should the IRS later question the way the tax adviser handled a particular tax problem.

Extensive Technical Competence

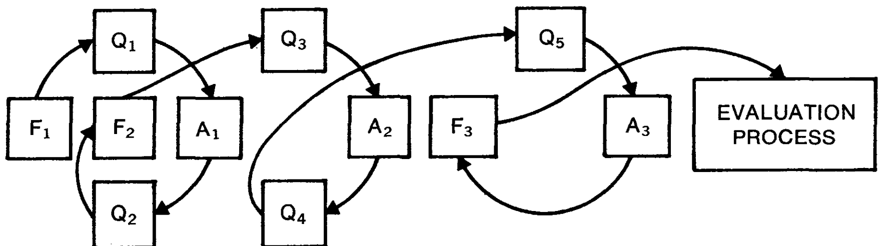
The tax adviser with an extensive level of technical competence in a given area can often review a fact situation and state the pertinent question in a still more refined manner. For example, he may ask a question like this: "Is there any reason why *Davis* would not apply 'to this situation'?" Or he may ask, "Are all of the conditions stipulated in Revenue Ruling 55-608 satisfied 'in this case'?" By stating his question in this way, the expert implies not only that he knows the general statutory authority for an answer, but also that he knows specific interpretative authority that would in all likelihood apply to the facts under consideration. The expert often needs only to determine the most recent events to resolve a tax question. Unless something new has happened, that somehow has managed to avoid his attention or to slip his memory, his phrasing of the question suggests that a very specific answer can be found to the general but unstated question. Thus, the expert's question—"Is there any reason why *Davis* would not apply?"—may in reality be the same question that the beginner phrased this way: "Must gross income be recognized if an ex-husband transfers appreciated property to his ex-wife in settlement of any claims she might have against him arising from a divorce?" The former question implies that the answer to the latter question can be found in the decision of the Supreme Court in *United States* v. *Davis*, 370 US 65 (1962). Similarly, the bonus question may imply that the answer to the current deduction may be found in Revenue Ruling 55-608, 1955-2 CB 546. The phrasing of the expert's question recognizes, however, that there may be ample reason why specific interpretive authority would not apply. For example, the facts of the two cases may differ in some material way—perhaps the taxpayer in the divorce case lived in a community property state, whereas the *Davis* decision involved a taxpayer in a non-community property state—or the *Davis* decision may have been otherwise modified by a regulation, ruling, or judicial decision issued after 1962. If one knows his way around a tax library, it obviously will require even less time to answer the question posed by the expert than it will to answer the question posed by the adviser with "intermediate" competency. Unfortunately, however, not all tax questions are so easily stated or resolved, even by the expert.

Restatement of the Initial Question After Some Research

In some circumstances even an expert must move cautiously from facts, to questions, to authority, and thence back to more facts, more questions, and more authority before he can resolve a tax problem. The search for authority to resolve an initial question sometimes leads to the realization that facts never previously deemed important are critical to the resolution of the problem. In that event the tax adviser returns to the fact determination procedure before looking any further for answers. The initial search suggests considering other tax rules rather than isolating more facts; at other times it suggests the need to determine additional facts as well as the need to consider additional rules. Before reaching the administrative or judicial process the tax adviser has only two raw materials with which to work: facts and rules. He must learn how to identify and phrase pertinent questions by examining facts in light of rules. That microscopic examination is what reveals the need for further facts and/or rules. The tax research process is not complete until all of the facts have been fully examined in light of all of the rules and all pertinent questions have been resolved to the extent possible.

This "research procedure" is illustrated conceptually in figure 3.1. The spiral line shows how the researcher proceeds from an initial statement of the facts (F_1), to an initial statement of the questions (Q_1), to an initial search for authority (A_1). If the initial authority suggests new and different questions (Q_2), as it often does, the researcher continues by making additional fact determinations (F_2) and/or by considering additional authority (A_2). This procedure continues over and over until all the facts are known, all the authorities are considered, and all the questions are answered—at least tentatively. At this juncture the tax adviser evaluates the facts and authorities he has just unearthed and reaches a conclusion.

Figure 3.1



Dangers Inherent in Statements of Questions

The danger of overlooking pertinent alternatives is greatly increased if tax questions are stated too narrowly. This danger is particularly acute for the more experienced tax adviser because, as noted earlier, he generally knows where to begin looking. Once the search for pertinent authority is restricted to a particular segment of the code, for all practical purposes all other alternatives are eliminated.

This danger has been vividly demonstrated to the authors time and time again. While teaching a university course in tax research methodology, it is, of course, necessary to design example cases that will lead students to make important discoveries of their own. A large number of the example cases are drawn from "live" problems suggested by various tax practitioners. In more cases than we care to admit, the very best solutions have been those never considered by either the authors or by those who suggested the problems to us in the first instance. Beginning students, unhampered by predilection and blessed by natural curiosity and intelligence, have managed on more than one occasion to view the problem in an entirely different light. This is mentioned in order to stress the importance of imagination and creativity in tax research and planning. As was noted in chapter 2, the "thinking step," the point at which the practitioner spends time considering facts, alternatives, and options, is an indispensible segment of the research process.

A second danger inherent in the statement of the question is the tendency to phrase the question utilizing conclusions rather than elementary facts. The important distinction between conclusions and facts was noted in the prior chapter. The use of conclusions in stating questions is hazardous because they tend to prejudice the result by subtly influencing the way one searches for pertinent authority. If, for example, one begins to search for authority on the proper way to handle a particular expenditure for tax purposes, his question might ask, Should the expenditure of funds for "this-and-that" be capitalized? The answer probably will be affirmative. On the other hand, if the same question is rephrased in terms something like this—Can the expenditure of funds for "'this-and-that" be deducted?—the answer, once again, will probably be affirmative. Obviously, if the facts are the same (that is, if the "this-and-that" in the two questions are identical) both answers cannot be correct.

The explanation for the conflicting results probably can be traced to the place where the researcher looked for his authority. The prior question would tend to lead the researcher to decisions in which Section 263 was held to be of primary importance, whereas the latter question would lead him to decisions in which Section 162 was found to be of greater importance.[2] Ideally, the index of reference volumes would include citations to both decisions in both places, but the cost of duplication quickly becomes prohibitive, and the human element in any classification system is less than perfect. Consequently, the statement of the question may assume unusual importance. Perhaps the tax adviser's problem is akin to the lawyer's problem in asking a leading question of a witness. To the maximum extent possible, tax questions should be phrased neutrally and without conclusions so as to permit the researcher greater freedom in finding the best possible authority for resolving his question.

A Comprehensive Example

The remainder of this chapter is a detailed review of a relatively simple, yet comprehensive, example that demonstrates the elusive nature of tax questions. In the process of developing this example we will attempt to illustrate the way in which facts, rules, and questions are inextricably entwined, one with the other, in tax problems. In following this example, the reader should not be concerned with the problem of locating pertinent authority. The next chapter will explain how the reader might have found that same authority had he been working alone on this problem. To begin, let us assume the following statement of facts.

> On February 10, 1976, Ima Hitchcock, a long-time client of your CPA firm, sold one-half of her equity interest in General

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[2] Section 263 reads in part as follows: "No deduction shall be allowed for—(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Section 162 reads in part as follows: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." Obviously, reasonable men can and do differ in their application of these rules to specific fact situations.

> Paper Corporation (hereafter, GPC) for $325,000 cash. Ms. Hitchock had owned 60,000 shares (or 20 percent) of the outstanding common stock of GPC since its inception in 1946. During the past 20 years, she had been active in GPC management. Following this sale of stock, however, she planned to retire from active business life. Her records clearly reveal that her tax basis in the 30,000 shares sold was only $25,000 (one-half of her original purchase price).

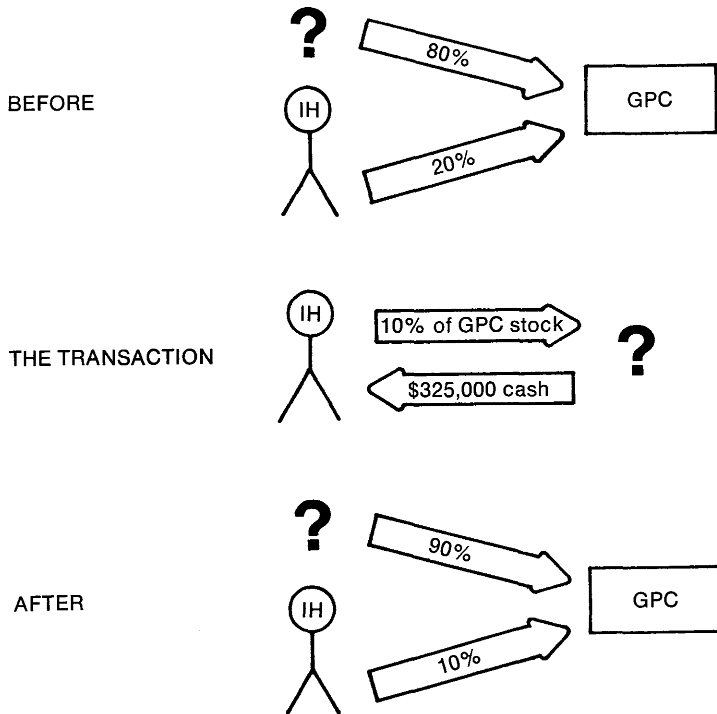
Given no additional facts, both the beginner and the seasoned tax adviser would be likely to conclude that Ms. Hitchcock should report a $300,000 long-term capital gain in 1976 because of her sale of the GPC stock. The case appears to be wholly straightforward and without complication, as long as no one asks any questions or volunteers any additional information. Although few persons would ask for it in this case, the statutory authority for the suggested conclusion would rest upon Sections 1001, 1002, 1012, 1221, 1222, and 1223. Section 1221 would establish that the stock is a capital asset; Sections 1222 and 1223 would determine the long-term status of the capital gain realized; Section 1012 would specify the cost basis of the shares sold; Section 1001 would define the gain realized as the difference between the $325,000 received and the $25,000 cost basis surrendered; and Section 1002 would require that the entire $300,000 realized gain be recognized. If, however, someone happened to ask who purchased Ms. Hitchcock's shares, problems could arise quickly.

Diagraming the Facts

Before beginning to consider this example in more detail, a simple "stick figure" diagram may be made of the transaction just described. In the authors' opinion, every tax adviser should become accustomed to preparing such simple diagrams of the essential facts of any case before he begins to ask any questions or search for any authority. In addition to diagraming the critical transaction itself, the practitioner should diagram a simple portrayal of the fact situation as it existed both before and after the transaction under examination. Each person can create his own set of symbols for any problem; this illustration, however, utilizes only a stick figure to represent an individual taxpayer (Ima Hitchcock) and a square to represent a corporate taxpayer (General Paper Corporation). These

simple symbols are used to diagram the before- and after-fact situation, as well as the transaction under analysis, as follows.

Figure 3.2



The diagram of this deceptively simple tax problem is the first critical step toward asking the necessary questions.

First Questions Call for Additional Facts

As is evident in the diagram, the first two critical questions appear to be (1) Who owns the other 80 percent of GPC stock? and (2) Who purchased the shares from Ms. Hitchcock? The answers to these two questions obviously call for the determination of more facts, not for additional authority.

Suppose that the CPA knew from his prior work with this client that GPC is a closely owned corporation; that is, it has been equally owned by five local residents (including Ms. Hitchcock) since its

inception in 1945. Knowing these facts, one of the two questions suggested above has already been answered. However, the CPA might be curious about who purchased the stock, how the value of $325,000 was determined, and so on. Under these circumstances, we can easily imagine a conversation between Ms. Hitchcock and her CPA as follows:

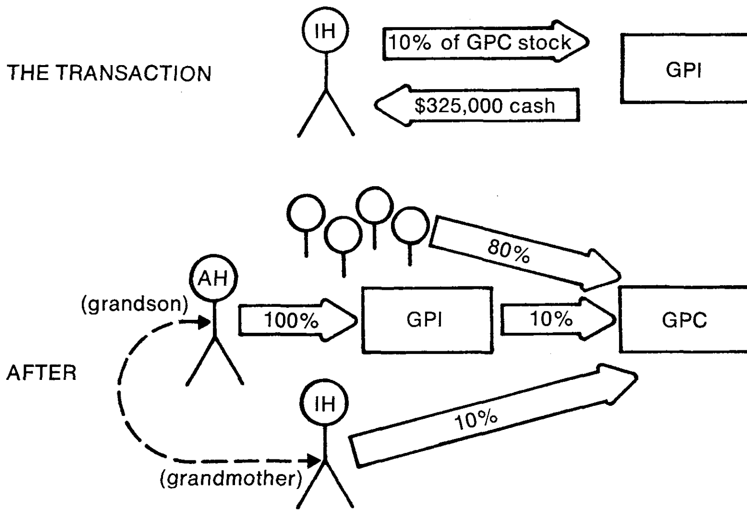
CPA:	Who purchased your stock in GPC, Ms. Hitchcock?
Ms. H:	Ghost Publishing, Incorporated.
CPA:	That is a name that I have not heard before. Is it a local firm?
Ms. H:	Yes, it is my grandson's corporation.

From there this conversation would proceed to establish the facts that Ghost Publishing, Incorporated (hereafter, GPI) was indeed a small but very profitable corporation whose stock was entirely owned by Ms. Hitchcock's favorite grandson, Alvred Hitchcock. GPI decided to purchase the GPC stock both to guarantee its own supply of paper and because Alvred was convinced that GPC was a sound financial investment.

The discovery of these additional facts would begin to separate the beginner from the more experienced tax adviser. In all probability, the beginner quite possibly would not modify his prior conclusion concerning Ms. Hitchcock's need to report a $300,000 long-term capital gain in 1976. The more seasoned tax adviser would know at least that sales between related parties are often subject to special scrutiny, and he would begin to search for possible authority that might modify his prior conclusion.

Before we proceed to examine possible authority, we should stop and observe two apparently innocent facts that have vital importance to the resolution of this tax problem: (1) The GPC shares were purchased from Ms. Hitchcock by GPI and (2) GPI is owned by Ms. Hitchcock's grandson. Unless these two facts are discovered, and their importance fully appreciated, this problem simply could not proceed any further. We might also pause briefly to rediagram both our "transaction" and the after-the-transaction situation to accommodate the new facts which we have just determined. The new diagrams might look as follows, opposite.

Figure 3.3



Once again this diagram should serve to highlight the potential problems which lie ahead of us.

An experienced researcher would realize the danger implicit in sales between related parties and begin to look for some authority which might modify his conclusion. The tax adviser with extensive technical competence in the taxation of corporations and corporate shareholder relations might be able to turn directly to Section 304 to determine the next appropriate question—that is, Does Section 304 apply to Ms. Hitchcock's sale of 30,000 shares of GPC stock to GPI?

The Authority

Understanding Section 304 may be difficult. It reads as follows.

SEC. 304. REDEMPTION THROUGH USE OF RELATED CORPORATIONS.

(a) Treatment of Certain Stock Purchases.—

(1) Acquisition by related corporation (other than subsidiary).—For purposes of sections 302 and 303, if—

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control, then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.

(2) Acquisition by subsidiary.—For purposes of sections 302 and 303, if—

(A) in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and

(B) the issuing corporation controls the acquiring corporation, then such property shall be treated as a distribution in redemption of the stock of the issuing corporation.

(b) Special Rules for Application of Subsection (a).—

(1) Rule for determinations under section 302(b).—In the case of any acquisition of stock to which subsection (a) of this section applies, determinations as to whether the acquisition is, by reason of section 302(b), to be treated as a distribution in part or full payment in exchange for the stock shall be made by reference to the stock of the issuing corporation. In applying section 318(a) (relating to constructive ownership of stock) with respect to section 302(b) for purposes of this paragraph, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.

(2) Amount constituting dividend.—

(A) Where subsection (a)(1) applies.—In the case of any acquisition of stock to which paragraph (1) (and not paragraph (2)) of subsection (a) of this section applies, the determination of the amount which is a dividend shall be made solely by reference to the earnings and profits of the acquiring corporation.

(B) Where subsection (a)(2) applies.—In the case of any acquisition of stock to which subsection (a)(2) of this section applies, the determination of the amount which is a dividend shall be made as if the property were distributed by the acquiring corporation to the issuing corpora-

tion and immediately thereafter distributed by the issuing corporation.

(c) Control.—

(1) In general.—For purposes of this section, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. If a person (or persons) is in control (within the meaning of the preceding sentence) of a corporation which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation, or owns at least 50 percent of the total value of the shares of all classes of stock of another corporation, then such person (or persons) shall be treated as in control of such other corporation.

(2) Constructive ownership.—Section 318(a) (relating to the constructive ownership of stock) shall apply for purposes of determining control under paragraph (1). For purposes of the preceding sentence, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.

Although the beginner might require assistance in interpreting and applying this code section to the facts of Ms. Hitchcock's sale, he must learn how to read and understand the language if he is ever to succeed as a tax adviser. Certainly the beginner might take comfort in knowing that even such a distinguished jurist as Learned Hand found this to be a formidable assignment. He once said,

> In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handles to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.[3]

[3] Learned Hand, "Thomas Walter Swan," *Yale Law Journal*, Vol. 57, December 1947, p. 169.

Perhaps the final line of the quotation is the most telling. Learning how to understand the code is most certainly a time-consuming process. Even a beginner will realize, after any careful reading of Section 304, that certain words and phrases deserve his special attention. He knows that if he is ever to understand Section 304 he must determine the import of Sections 302 and 303, that he will have to distinguish between an acquisition by a "related corporation that is not a subsidiary" and an acquisition by a subsidiary corporation, and that he will have to determine how the constructive ownership rules of Section 318 are applied to determine control. For both the beginner and for the person with an intermediate level of tax skills, these determinations may well constitute the next pertinent set of questions.

The Third Set of Questions

Although this conclusion is not obvious at the outset, the last of the determinations suggested in the preceding paragraph is the one that must be solved first. In reverse order, then, those determinations can be stated as questions like this:

1. After the sale of 30,000 shares of GPC common stock to GPI, what shares does Ms. Hitchcock own, directly or indirectly, for purposes of Section 304, giving full consideration to the constructive ownership rules of Section 318?
2. Can the sale of 30,000 shares of GPC stock to GPI by Ms. Hitchcock be considered, for purposes of Section 304, as either
   (a) an acquisition by a related (but not subsidiary) corporation or
   (b) an acquisition by a subsidiary corporation?
3. If the answer to either question in two, above, is affirmative, what is the tax effect of Section 302 and/or 303 on this disposition of stock?

To solve these three questions we must turn to more authority. Our first stop will be at Section 318, the constructive ownership rules, which are applicable to Section 304 according to paragraph (2) of subsection (c).

More Authority

Fortunately, Section 318 does not, at least at the outset, appear to be as confusing as Section 304. Section 318 reads in part, as follows.

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) General Rule.—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) Members of family.—

(A) In general.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

(ii) his children, grandchildren, and parents.

(B) Effect of adoption.—For purposes of subparagraph (a)(ii), a legally adopted child of an individual shall be treated as a child of such individual by blood.

(2) Attribution from partnerships, estates, trusts, and corporations.—

• • • •

(C) From corporations.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.

(3) Attribution to partnerships, estates, trusts, and corporations.—

• • • •

(C) To corporations.—If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.

• • • •

(5) Operating rules.—

(A) In general.—Except as provided in subparagraphs (B) and (C), stock constructively owned by a person by reason of the application of paragraph (1), (2), (3), or (4),

> shall, for purposes of applying paragraphs (1), (2), (3), and (4), be considered as actually owned by such person.
> (B) Members of family.—Stock constructively owned by an individual by reason of the application of paragraph (1) shall not be considered as owned by him for purposes of again applying paragraph (1) in order to make another the constructive owner of such stock.
> (C) Partnerships, estates, trusts, and corporations.—Stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of paragraph (3) shall not be considered as owned by it for purposes of applying paragraph (2) in order to make another the constructive owner of such stock.

A reexamination of the facts already known about GPC in light of the rules of Section 318 suggests the need to determine some additional facts before proceeding toward a solution.

More Questions and More Facts

A careful reading of Section 318 suggests that we must make absolutely certain who it is that owns the other 80 percent of GPC. Earlier it was stated that GPC was "equally owned by five local residents." After reading the quoted portion of Section 318, it should be obvious that we must ask if any of the other four GPC owners are related to Ms. Hitchcock within any of the family relationships described in paragraph (1) of subsection (a) of Section 318. At the same time, we probably should make certain that none of the other four original owners has sold any of his original stock in GPC. If they have, we would also have to determine who purchased those shares and determine the relationship, if any, between those purchasers and Ms. Hitchcock. To simplify the remaining task just a little, let us assume that we can quickly determine that none of the other four owners of GPC are in any way related to Ms. Hitchcock and that each of the other four original owners continues to own all of his shares in GPC. Having determined this, we can now reach our first tentative conclusions.

First Tentative Conclusions

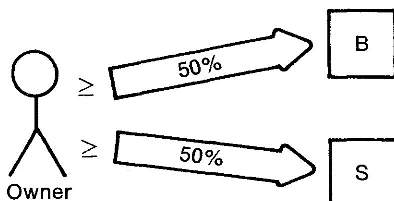
Specifically, we are now prepared to answer the first of the three questions suggested on page 72; that is, After the sale of 30,000

shares of GPC common stock to GPI, what shares does Ms. Hitchcock own, directly or indirectly, for purposes of Section 304, giving full consideration to the constructive ownership rules of Section 318? By operation of Section 318(a)(1)(A)(ii), Ms. Ima Hitchcock constructively owns any shares of stock owned by her grandson, Alvred. Consequently, Ms. Hitchcock is deemed to own 100 percent of GPI, the corporation that purchased the 30,000 shares of GPC stock from her. Furthermore, by operation of Section 318(a)(2)(C), Ms. Hitchcock's grandson Alvred is indirectly deemed to own any stock owned by GPI, and Section 318(a)(1) says that effectively Ms. Hitchcock must pretend that she owns not only what her grandson owns directly, but also that which he owns indirectly.[4] This means, of course, that Ms. Hitchcock is, for purposes of Section 304, deemed to own that which she just sold.

Having made this determination, however, we can now also answer the second of the three questions posed earlier; that is, Does Section 304 apply to this sale of stock? Obviously that question really is two questions and we can separate them for purposes of further investigation. First, we must determine if the acquisition of the 30,000 shares by GPI can be considered to be an acquisition by a related, but non-subsidiary, corporation; second, we must determine if that acquisition can be considered to be an acquisition by a subsidiary corporation. These questions might lead us to ask another tentative question: What is meant by a related but non-subsidiary corporation? Section 304(a)(1)(A) apparently is intended to provide the rules for stock acquisitions where the seller of the stock (that is, the "one or more persons" clause) is "in control of" both the corporation whose stock is sold and the corporation making the purchase. The more experienced tax adviser will immediately recognize this as a brother-sister corporate relationship. That relationship can be diagramed as follows, page 76.

[4] The only exception to this conclusion is stated in the operating rules of Section 318(a)(5)(B) which reads as follows: "Stock constructively owned by an individual by reason of the application of paragraph (1) [that is, by family attribution] shall not be considered as owned by him for purposes of again applying paragraph (1) in order to make another the constructive owner of such stock." Since Alvred's indirect ownership of GPC shares comes about by application of paragraph (2)(C) of Section 318 and not by application of paragraph (1), Section 318(a)(1)(A)(ii) requires that Ms. Ima Hitchcock also include in her indirect ownership any shares which GPI owns.

Figure 3.4



In this ownership arrangement, corporations *B* and *S* are deemed to be related to one another as brother and sister corporations. (The degree of control required to establish this relationship is stated in Section 304(c)(1) as either 50 percent of the voting power or 50 percent of the value of the shares.)

Even giving full consideration to all indirect ownership as well as all direct ownership, Ms. Ima Hitchcock can be said to own only 20 percent of GPC. She owns 10 percent directly and another 10 percent indirectly.[5] Thus, even though Ms. Hitchcock owns 100 percent of GPI (the acquiring corporation) indirectly, she owns only 20 percent of GPC, and therefore the rules of Section 304(a)(1) do *not* apply to her disposition. In other words, Ms. Hitchcock's sale would *not* be deemed to be an acquisition by a related non-subsidiary corporation.

We must return then to the second part of our last question; that is, Can the sale of GPC stock by Ms. Hitchcock to GPI be considered as an acquisition made by a subsidiary corporation? Once again a commonsense answer would seem to be a negative one. The acquirer (GPI) is in no way the subsidiary of GPC (the corporation whose stock Ms. Hitchcock sold). Be careful, however, and look again at the simple diagram on page 69. If one can impute shares one way around an ownership circle, is it possible that the process might work in the reverse direction as well? The answer, of course, must be found in the wording of the code.

[5] Incidentally, the revised diagram of the facts pictured on page 69 really suggests this conclusion with much less confusion than do all of the words of the code. Perhaps one picture can be worth a thousand words. Note that simply following the dotted lines of that diagram back from Alvred to Ms. Hitchcock shows that the conclusion just reached is not really so farfetched after all.

Ordinarily, Section 318(a)(3)(C) attributes ownership from a stockholder to a corporation *only if* the stockholder owns 50 percent or more of the value of that corporation's outstanding stock. The last sentence of Section 304(c)(2), however, says that ". . . sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein." This seems to say, then, that for purposes of Section 304 any acquiring corporation will be deemed to own any stock owned (indirectly or directly) by any of its stockholders. Returning to the facts of the problem, this means that GPC owns any stock that Ms. Hitchcock owns and, you will remember, we just determined that Ms. Hitchcock is deemed to own 100 percent of GPI. In effect, then, GPC owns 100 percent of GPI, making GPI (the acquirer) a wholly owned subsidiary of the corporation whose stock Ms. Hitchcock sold. It appears, therefore, that Section 304(a)(2) does apply to this disposition. Perhaps it would now be useful to paraphrase that paragraph of the code, substituting the facts of our specific situation for the exact words of the code. If we do that, the pertinent paragraph would read something like this:

> Acquisition by subsidiary.—For purposes of sections 302 and 303, if—
>
> (A) in return for $325,000, GPI, acquired from Ms. Hitchcock stock in GPC, and
>
> (B) GPC controls GPI,
>
> then the $325,000 *shall be treated as a distribution in redemption of the stock of GPC.*

The careful reader will have observed that even at this point we have not yet determined the correct tax treatment of Ms. Hitchcock's stock disposition. Before we can make that determination, we must ask still more questions.

More Questions, More Authority

Code Section 304(a)(2) simply provides that Ms. Hitchcock's sale should be treated as a distribution in redemption of stock, and it suggests that we look to two additional code sections to see what that means. Our next question, then, must be this: If Ms. Hitchcock's disposition of GPC stock is to be treated as a stock redemp-

tion under Section 302 and/or 303, what, if anything, do those sections say about the tax treatment of amounts received?

On further searching we could quickly discover that Section 303 deals only with distributions in redemption of stock to pay death taxes. Clearly, the facts of our problem do not suggest anything about Ms. Hitchcock's making this disposition to pay death taxes, thus we may safely conclude that Section 303 is not applicable to our solution. We turn, therefore, to Section 302, which reads in pertinent part as follows.

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) General Rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions Treated as Exchanges.—

(1) Redemptions not equivalent to dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially disproportionate redemption of stock.—

(A) In general.—Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) Limitation.—This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) Definitions.—For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation

(whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) Series of redemptions.—This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) Termination of shareholder's interest.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) Stock issued by railroad corporations in certain reorganization.—

• • • •

(5) Application of paragraphs.—In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

(c) Constructive Ownership of Stock.—

(1) In general.—Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

• • • •

(d) Redemptions Treated as Distributions of Property.—Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

Obviously, this new and relatively lengthy code section simply brings more new questions to mind. The careful reader should observe that Section 302(a) provides a general rule that any redemption will be treated as *"a distribution in part or full payment in ex-*

change for the stock" (emphasis added) if the conditions of any one of four paragraphs are satisfied. This means that *if* the conditions of any one of the four subsections can be satisfied, a taxpayer from whom stock is redeemed can treat the disposition as a sale. In most instances this would result in capital gain treatment. The general rules of subsection (a) say absolutely nothing, however, about the proper tax treatment of the redemption proceeds if those conditions cannot be satisfied. That possibility is treated in subsection (d), which says that "such redemption shall be treated as *a distribution of property to which section 301 applies.*" (Emphasis added.) On further investigation we could discover that Section 301 generally provides a dividend treatment for properties distributed by a corporation to its shareholder. This would mean, of course, that the redeemed shareholder would have to report an ordinary income rather than a capital gain.

If we continued to examine the facts of our illustrative problem in detail against all of the rules of Section 302, we would have to proceed through another relatively complex set of code provisions not unlike those we have just examined in some detail. Because this procedure is no longer new, and because we really are interested only in demonstrating the complex relationship which exists between facts, authorities, and tax questions, we will discontinue our detailed step-by-step approach and state the remainder of this analysis in more general terms. We can begin such a summary treatment of our problem as follows:

1. *Question:* Is Ms. Hitchcock's disposition a redemption within the meaning of Section 317(b), as required by Section 302(a)?

   Authority: Section 317(b) reads as follows:

   > Redemption of stock.—For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

   Conclusion: The intended meaning of this section is not obvious; it seems to suggest only that what the acquiring corporation does with shares it acquires from its shareholders will in no way effect the classification of the stock acquisition as a stock redemption. The section seems initially not to apply

to our case because it refers to a corporation acquiring *its* stock from a shareholder. A more general reflection on how this section is made applicable to related corporations through Section 304 suggests, however, that these words must be stretched to include the stock of a related corporation if the obvious meaning of Section 304 is not to be emasculated. Hence, we would likely conclude that Ms. Hitchcock's disposition probably is a redemption within the meaning of Section 317(b).

2. *Question:* Is Ms. Hitchcock's sale (redemption) of 30,000 shares of GPC stock to GPI a redemption that falls within the meaning of any one of the exceptions of Section 302(b)(1) through (b)(4)?

   Authority: Read again Section 302(b)(1) through (b)(4) as quoted previously.

   Conclusions (in reverse order):

   (a) Clearly the exception of Section 302(b)(4) is not applicable; that is, GPC is not a railroad corporation.

   (b) Clearly the exception of Section 302(b)(3) is not applicable; that is, Ms. Hitchcock continues to own directly 30,000 shares of GPC stock even after her sale of 30,000 shares to GPI.

   (c) Clearly the exception of Section 302(b)(2) is not applicable; that is, considering her indirect ownership as well as her direct ownership, Ms. Hitchcock owns after the sale exactly what she owned before the sale, namely, 20 percent of GPC. (Note that Section 302(c) requires that the attribution rules of Section 318 be applied to stock redemptions.)

The Final Question

Without having carefully examined each of the intermediate questions and authorities suggested above, the reader might have some trouble in stating the final question. If he took the time to do so, however, it would seem that Ms. Hitchcock's final question might be stated thus: Is Ms. Hitchcock's sale of 30,000 shares of GPC to GPI properly treated as a "redemption not essentially equivalent to a dividend" as that phrase is used in Section 302(b)(1)?

The implied conclusion stems importantly from (1) the requirement in Section 304 (with assistance from Section 318) that Ms. Hitchcock's apparent sale be treated not as a sale at all but as a redemption of a parent corporation's stock when that stock is purchased by its subsidiary corporation and (2) the requirement in Section 302 that stock redemptions be treated as a dividend unless one of the four exceptions in Section 302(b) are satisfied.

Any detailed assessment of the authority which is pertinent to an interpretation of Section 302(b)(1) would lead us well into the objective of chapter 5 of this tax study. Consequently, we will not undertake that assessment here. We will note, in passing, some general observations that would become pertinent to a resolution of the problem were we actually to undertake a detailed assessment. First, "the legislative history of Section 302(b)(1) . . . suggests that it is to play a modest role in the scheme of things."[6] Second, in the Treasury regulations the only example of a stock redemption qualifying for exchange treatment under Section 302(b)(1) is stated in Regs. Sec. 1.302-2(a), which reads, in part, as follows: "For example, if a shareholder owns only nonvoting stock of a corporation which is not section 306 stock and which is limited and preferred as to dividends and in liquidation, and one-half of such stock is redeemed, the distribution will ordinarily meet the requirements of paragraph (1) of section 302(b) but will not meet the requirements of paragraphs (2), (3), or (4) of such section." This example obviously lends no support to the case at hand since the facts of Ms. Hitchcock's ownership are radically different from those described in this regulation. Third, in *U.S.* v. *Davis,* 397 US 301 (1970), the Supreme Court held ". . . that neither the absence of a tax-avoidance motive nor the presence of a business purpose for the redemption would protect it against dividend treatment."[7] In summary, the authority for granting Ms. Hitchcock exchange (that is, capital gain) treatment by operation of the exception stated in Section 302(b)(1) appears to be relatively weak. And if the exception of Section 302(b)(1) cannot be made to apply, Ms. Hitch-

[6] Boris I. Bittker and James S. Eustice, *Federal Taxation of Corporations and Shareholders,* 3d ed. (Boston: Warren, Gorham & Lamont, Inc., 1971), pp. 9-24.
[7] Ibid., pp. 9-25.

cock must report a $325,000 dividend income by operation of Section 302(d).[8]

Do We Begin Again?

At this point the difference between the tax adviser with limited technical competence and the more experienced tax adviser is once again apt to become apparent. If the beginner actually had discovered and understood all of the facts and all of the rules considered thus far in our example, he would be very apt to conclude that the correct tax treatment of Ms. Hitchcock's apparent sale is, after all, dividend treatment rather than capital gain. The more experienced tax adviser is more likely to ask one last searching question, Does this conclusion make any common sense? If his answer to this one last question is negative, as it is apt to be in this case, the expert sets off once more on yet another search for authority to justify an apparently more reasonable conclusion.

By rethinking the facts of this illustration, a tax adviser should observe that his tentative conclusion rests largely on the presumption that GPI is a subsidiary of GPC when, in fact, GPC does not directly own a single share of GPI stock. In fact, no "first generation shareholder" of GPC even owns such stock. He might go on to observe, then, that the literal application of the rules just studied could clearly lead to potentially absurd results in some circumstances. For example, if a stockholder owned only a few shares of General Motors Corporation common stock and he should happen to sell some of these shares to his grandson's wholly owned corporation, the tax result would, for the same reasons as those determined here, be held to constitute a dividend. His grandson's little corporation would, by some wild stretch of the imagination and the law of the land, be made into a subsidiary of General Motors. This observation might lead the experienced tax adviser to look into the history of Section 304, where he would discover that it was intended to close an unintended opportunity for owners of closely related corporations to "bail out" the earnings and profits of their corporation as a capital gain, rather than through the payment of

[8]Our conclusion simply assumes a sufficiency of earnings and profits as required by Section 316, which defines the word "dividend." In actual practice, of course, this would constitute another critical fact determination.

dividends. Still further reflection on the intended purpose of Section 304 would suggest clearly that the section was never intended to cover the isolated sale of a few shares of General Motors to a very distantly related corporation and that, in all probability, it was never intended to cover a situation like Ms. Hitchcock's either. A careful study of the constructive ownership provisions required by Section 304 would also yield some obvious ambiguities in statutory construction. For example, given the literal application of the constructive ownership rules of Section 318, every brother-sister pair of corporations is automatically a parent-subsidiary pair as well, although both the code and the Treasury regulations imply that the two situations are separate and must be treated differently. Finally, the experienced tax adviser might locate judicial support that would suggest that courts on rare occasions refuse to apply the code literally if the result is clearly absurd and inconsistent with the intent of Congress.[9] And last but not least, the tax adviser may locate some secondary reference work that points up the very problem encountered.[10] All of these authorities give the experienced tax adviser some comfort, but, at the same time, they leave him in something of a dilemma.

A Moral Dilemma?

Any tax adviser who painstakingly has found his way through the facts and the law of Ms. Hitchcock's sale might be trapped in a moral dilemma. That adviser would understand that, in all likelihood, he could just report the "sale" of Ms. Hitchcock's stock in Part II, Schedule D, Form 1040, as a routine sale and that it would not be questioned further. After all, what is the statistical probabil-

[9] For example, note the following words from the United States Supreme Court: "When . . . [plain] meaning has led to absurd or futile results, this Court has looked beyond the words to the purpose of the Act. Frequently, . . . even when the plain meaning did not produce absurd results but merely an unreasonable one plainly at variance with the policy of the legislation as a whole this court has followed that purpose, rather than the literal whole." U.S. v. American Trucking Association, 310 US 534 (1940).

[10] Relative to the parent-subsidiary relation derived solely from constructive ownership rules see Bittker and Eustice, *Federal Taxation of Corporations and Shareholders,* pp. 9-39/40. See also Jacob Mertens, Jr., *Law of Federal Income Taxation,* Vol. 1 (Chicago: Callaghan and Co.) para. 9.106, pp. 328-29.

ity of an audit that would discover who purchased the shares and reveal who it was that owned the purchasing corporation? Beyond that, what is the chance that an auditor would fully understand all of the intricacies of Sections 301, 302, 304, 317, and 318? Furthermore, there is some authority (admittedly weak) for treating the sale-redemption as an exchange under Section 302(b)(1) anyway. If that authority is applicable, the correct tax result is a $300,000 long-term capital gain. The tax adviser strongly suspects that capital gain treatment really is the treatment intended by Congress (even though no one ever really considered it), but he knows equally well that the Internal Revenue Service might reach a contrary conclusion were it fully aware of all the facts. Certainly, the tax adviser knows that his client intended to enter into a sale that would produce capital gain rather than ordinary dividend income. The real dilemma, then, may concern not the conclusion, but the proper method of reporting all of the facts that have transpired. If the tax adviser reveals all he knows on the tax return, the probability of an audit and the possibility of costly litigation are substantially increased. If he remains silent, reports the disposition as a simple sale, and all the facts are subsequently discovered and the dispute is litigated, the adviser stands to jeopardize his professional reputation and possibly risk the penalties of perjury for filing a false return.

Under the circumstances described here, the tax adviser might seek the opinion of Ms. Hitchcock's legal counsel to obtain another opinion as to the correct treatment of the proceeds from the disposition of the GPC stock and as to the proper method of reporting that event. The latter conclusion is particularly important if legal counsel should state that, in his opinion, the correct treatment of the proceeds is as a capital gain. Although an opinion of legal counsel would not absolve the tax adviser from his own professional responsibility, it would lend credence to the tax treatment he finally reports and, to some extent, demonstrate his desire to perform his duty in a professionally responsible manner.

That foregoing example demonstrates (1) the critical role of facts, (2) the interdependency of facts and rules, and (3) the elusive nature of pertinent tax questions. If all the facts are discovered and all the rules are known and understood, apparently simple transactions have a way of creating relatively complex tax problems in all too many situations. The tax adviser must ask the right ques-

tions, not because he desires to convert a simple situation into a complex problem and a larger fee, but because the correct reporting of a tax result depends so directly upon his asking those questions. Questions often evolve from fact determination to rule application. For example, in our illustration the first critical questions were (1) Who purchased the shares? and (2) Who owned the purchaser? Certainly those are fact questions. Nevertheless, unless a person has some appreciation of the applicable rules, it would be highly unlikely that he would continue to ask the right questions. After the facts were determined, the critical questions concerned the application of rules to known facts, for example, (1) Does Section 304 apply to Ms. Hitchcock's sale of 30,000 shares of GPC to GPI? (2) Does Section 318 apply to make GPI a subsidiary corporation of GPC? and (3) Does the exception of Section 302 (b)(1) apply to this same disposition? Each question appears to be more esoteric than the preceding one. Yet every question depends to an important degree upon the tax adviser's knowledge of the authority that is applicable to the given fact situation.

4

. . . reasons are as two graines of wheate,
hid in two bushels of chaffe;
you shall seeke all day ere you finde them . . .
WILLIAM SHAKESPEARE

Locating Appropriate Authority

In chapters 2 and 3 we discussed the importance of facts and the methodology employed to delineate questions that must be answered to solve tax problems successfully. To determine a technically correct answer to a tax question, the tax adviser may consult statutory, administrative, judicial, and, in some instances, editorial authority. This process consists of two distinct phases: (1) the tax adviser must locate the appropriate authority and (2) he must assess the importance of that authority; augment it if it is found to be incomplete, and, on occasion, choose between conflicting authorities. The following pages will identify the various kinds of tax authorities and ways to locate them, and chapter 5 will concentrate on the assessment of authorities.

The Tax-Legislation Process

Our present income taxing system began with the Tariff Act of October 3, 1913. Since then numerous revenue acts have been enacted into law. Due to their number and increasing complexity, existing revenue acts were codified into a single document called the Internal Revenue Code in 1939. The Internal Revenue Code of 1939 was revised and simplified again in the Internal Revenue Code of 1954. All revenue acts enacted into law after 1939 have been integrated into the extant Internal Revenue Code.

By virtue of Article I, Section 7, of the Constitution, all revenue bills must originate in the House and cannot be sent to the Senate until the House has completed action on the bill. After introduction, most of the actual work on a revenue bill takes place in the House Ways and Means Committee. In the case of major bills, public hearings are scheduled. The first and most prominent witness during these hearings usually is the secretary of the Treasury, representing the executive branch of the government. Upon conclusion of the hearings, the committee goes into executive session and, after tentative conclusions have been reached, prepares the House Ways and Means Committee report, which includes the proposed bill drafted in legislative language, an assessment of its effect on revenue, and a general explanation of the provisions in the bill. The report represents the only written document that details the reasons for the committee's actions and, therefore, it constitutes an important reference source for the courts, the Internal Revenue Service, and practitioners in determining legislative intent in connection with each section of the code. Upon completion of the committee report, the bill is reported to the floor of the House for action. Prior to 1975, revenue legislation usually was considered "privileged" business and, as such, had priority over other matters on the floor. In the past, the approval of the Rules Committee usually was sought before a bill was placed on the floor. This procedure was followed so that a tax bill could be debated under the "closed rule"; thus, amendments from the floor were forbidden unless the Ways and Means Committee approved them. This procedure appears to be changing and it is anticipated that future revenue legislation will be subject to amendments on the floor of the House.

After approval by the House, a tax bill is sent to the Senate where it is immediately referred to the Finance Committee. If it is a major bill, the Senate Finance Committee holds its own hearings and prepares its own committee report. Debate on the floor of the Senate proceeds with few restraints; consequently, Senate amendments to a revenue bill are commonplace. Obviously, the Senate Finance Committee report will not disclose the intent of Congress on the amended portion of a bill. For those portions it becomes necessary to consult the *Congressional Record* to understand the reasons for the amendment.

If the House and Senate pass different versions of the same bill, further congressional action is necessary. After the House adopts

a motion to disagree with the Senate version of a revenue bill, a conference committee is appointed to iron out the differences. Like the House Ways and Means Committee and the Senate Finance Committee, the conference committee may prepare its own committee report, concentrating on the areas of disagreement. Their report usually is rather technical and does not explain how the two bills were reconciled. However, statements made on the floor of either chamber prior to the final vote on the conference report are entered in the *Congressional Record.* These statements often shed light on congressional intent for the amended sections. After approval of the conference bill by both the House and the Senate, the bill is sent to the President for his signature.[1]

To illustrate how the tax adviser might utilize his knowledge of the foregoing process, let us refer to the Revenue Act of 1971, which was signed by the President as Public Law 92-178 on December 10, 1971, amending the Internal Revenue Code of 1954. Among many other changes, the act considerably liberalized Section 214 of the code, which deals with child care expenses. The new child care expense provisions are found in Section 210 of the 1971 act. In addition to numerous other changes incorporated in Section 210, the act requires that married taxpayers who claim a deduction for child care expenses must both be gainfully employed on a "substantially full-time" basis, unless one of the spouses is physically or mentally incapacitated. The tax practitioner who is faced with the question of whether or not his client satisfies the "substantially full-time" employment criterion might, in the absence of other authoritative pronouncements (such as Treasury regulations or revenue rulings), consult the committee reports. The House Ways and Means Committee report for the 1971 act contains no mention of any proposed change to Section 214 of the 1954 code. Following the legislative process of a tax bill, the next logical step is to examine the Senate Finance Committee report, which discloses that changes dealing with the child care expense deduction were added by the Senate Finance Committee. A careful perusal of the Senate report reveals exactly what was meant by the provision that married taxpayers must both satisfy, among other requirements, the "substantially full-time" employment test. The committee report states that

[1] For a more complete discussion of the legislative process, see Joseph A. Peckman, *Federal Tax Policy,* rev. ed. (Washington, D.C.: The Brookings Institution, 1971).

> . . . the term 'employed on a fulltime basis' means employed for three-quarters or more of the normal or customary work week (or the equivalent on the average during the month).[2]

Tracing this Senate Finance Committee amendment to the conference committee report reveals that the liberalized child care deduction provisions were adopted by the conference committee as Amendment No. 49 without further elaboration on the meaning of "substantially full-time" employment.

Accessing Public Documents

Committee reports can be obtained in a number of ways. The official report of each committee (House Ways and Means, Senate Finance, and conference) is published by the Government Printing Office (GPO). These reports are available in the government documents section of any library that has been designated as an official depository. Committee reports are also reprinted in the weekly *Internal Revenue Bulletin* and consequently appear in the *Cumulative Bulletin;* they can also be found in the *U.S. Code Congressional and Administrative News* (USCCAN), published by West Publishing Company. In addition, major revenue acts—such as the Tax Reform Act of 1969 or the Revenue Act of 1971—are published with partial or full texts of the accompanying committee reports by Commerce Clearing House, Inc., and Prentice-Hall, Inc. The editors of the Rabkin and Johnson tax service (*Federal Income, Gift and Estate Taxation*) also typically extract important segments of committee reports and intersperse them among the code sections contained in the four "Code" volumes of the service.

At times it becomes necessary to trace the history of a particular 1954 code section to the 1939 code or to previous revenue acts. Barton's *Federal Tax Laws Correlated* (FTLC), a six-volume reference service, is an extremely useful tool to guide the researcher from the 1954 code to the 1939 code and prior acts. Barton's FTLC gives the researcher citations to the official committee reports, the USCCAN, and *Cumulative Bulletin* where applicable segments of committee reports can be found. A second source for references to

[2] U.S., Congress, Senate, Committee on Finance, S. Rept. 92-553, 92d Cong., 1st sess., 1971, p. 42.

committee reports is *Seidman's Legislative History of Federal Income Tax and Excess Profits Tax Laws.* This three-volume work contains the legislative history of tax statutes enacted from 1861 to 1953, including the original text of revenue acts and 1939 code sections, with excerpts from applicable committee reports. Another source of recent legislative history of the code is Tax Management's *Primary Sources.* This publication is arranged by IRC section number and emphasizes the legislative history of the Tax Reform Act of 1969 and subsequent acts. Selected provisions are traced back to 1954. Documentary materials pertaining to substantive current legislation is forwarded to subscribers on a monthly basis.[3]

The well-informed tax adviser should stay abreast of congressional activities involving tax statutes in order to determine the potential positive and negative tax effects such developments may harbor with respect to his clients. One effective means of keeping in touch with such daily congressional tax activities is through *Tax Notes,* a weekly newsletter published by Tax Analysts and Advocates, Washington, D.C. For a more comprehensive listing of tax newsletters, see page 134 of this chapter.

The Internal Revenue Code

All federal statutes passed by Congress are compiled and published in the *United States Code.* Title 26 of the *United States Code* contains the statutes that authorize the Treasury Department, specifically, the Internal Revenue Service, to collect taxes for the federal government. The present code, commonly known as the Internal Revenue Code of 1954, applies to taxable years beginning after 1953. Prior to 1954, statutory authority for the collection of taxes rested with the Internal Revenue Code of 1939. Although the Internal Revenue Code is amended almost annually, the designation 1954 remains fixed with the present Internal Revenue Code.

[3] Walter E. Barton and Carroll W. Browning, *Federal Tax Laws Correlated* (Boston: Warren, Gorham & Lamont, Inc., 1969).
J. S. Seidman, *Seidman's Legislative History of Federal Income Tax Laws, 1938-1861 and Excess Profits Tax Laws 1953-1939* (Englewood Cliffs, N.J.: Prentice-Hall).
Tax Management, *Primary Sources* (Washington, D.C.: Bureau of National Affairs).

The Internal Revenue Code of 1954 is divided into the following segments:

Subtitles	*Chapters*
A. Income Taxes	1-6
B. Estate and Gift Taxes	11-12
C. Employment Taxes	21-25
D. Miscellaneous Excise Taxes	31-42
E. Alcohol, Tobacco, and Certain Other Excise Taxes	51-53
F. Procedure and Administration	61-80
G. The Joint Committee on Internal Revenue Taxation	91-92
H. Financing the Presidential Election Campaigns	95-96

The bulk of the income tax provisions is found in Chapter 1 of Subtitle A. Chapter 1 is divided into twenty subchapters, A through T. (Effectively, however, Chapter 1 currently consists of only nineteen subchapters since Subchapter R has been repealed.) These subchapter designations are often used by tax practitioners as part of their everyday vocabulary to identify general areas of income taxation. The most frequently used designations are these.

Subchapter	
C	Corporate distributions and adjustments
F	Exempt organizations
J	Estates, trusts, beneficiaries, and decedents
K	Partners and partnerships
N	Taxation of multinational corporations
S	Tax status election of small business operations

Section numbers are additional subdivisions of the Internal Revenue Code and run consecutively through the entire code. For example, Subchapter A, which deals with the determination of an entity's tax liability, includes section numbers 1 through 58. To the extent that section numbers are unassigned, the arrangement is suitable for future expansion of the code. The reader should also note that section numbers give a clue to which general income tax topic is involved. For example, code section numbers in the 300 series indicate that the section will deal with the topic of corporate distributions and adjustments. Each section is further broken down into categories (see exhibit 4.1, opposite).

Exhibit 4.1

SEC. 117. SCHOLARSHIPS AND FELLOWSHIP GRANTS.

(a) GENERAL RULE.—In the case of an individual, gross income does not include—

(1) any amount received—

(A) as a scholarship at an educational institution (as defined in section 151 (e) (4)), or

(B) as a fellowship grant,

including the value of contributed services and accommodations; and

(2) any amount received to cover expenses for—

(A) travel,

(B) research,

(C) clerical help, or

(D) equipment,

which are incident to such a scholarship or to a fellowship grant, but only to the extent that the amount is so expended by the recipient.

(b) LIMITATIONS.—

(1) INDIVIDUALS WHO ARE CANDIDATES FOR DEGREES.—In the case of an individual who is a candidate for a degree at an educational institution (as defined in section 151 (e) (4)), subsection (a) shall not apply to that portion of any amount received which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or the fellowship grant. If teaching, research, or other services are required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree as a condition to receiving such degree, such teaching, research, or other services shall not be regarded as part-time employment within the meaning of this paragraph.

(2) INDIVIDUALS WHO ARE NOT CANDIDATES FOR DEGREES.—In the case of an individual who is not a candidate for a degree at an educational institution (as defined in section 151 (e) (4)), subsection (a) shall apply only if the condition in subparagraph (A) is satisfied and then only within the limitations provided in subparagraph (B).

(A) CONDITIONS FOR EXCLUSION.—The grantor of the scholarship or fellowship grant is—

(i) an organization described in section 501(c)(3) which is exempt from tax under section 501(a),

(ii) a foreign government,

(iii) an international organization, or a binational or multinational educational and cultural foundation or commission created or continued pursuant to the Mutual Educational and Cultural Exchange Act of 1961, or

(iv) the United States, or an instrumentality or agency thereof, or a State, a territory, or a possession of the United States, or any political subdivision thereof, or the District of Columbia.

(B) EXTENT OF EXCLUSION.—The amount of the scholarship or fellowship grant excluded under subsection (a) (1) in any taxable year shall be limited to an amount equal to $300 times the number of months for which the recipient received amounts under the scholarship or fellowship grant during such taxable year, except that no exclusion shall be allowed under subsection (a) after the recipient has been entitled to exclude under this section for a period of 36 months (whether or not consecutive) amounts received as a scholarship or fellowship grant while not a candidate for a degree at an educational institution (as defined in section 151 (e) (4)).

Section 117

Subsection (b)

Paragraph (2)

Subparagraph (A)

Sub-subparagraph (ii)

The Internal Revenue Code is published annually in paperback editions by Commerce Clearing House, Inc. (CCH), Prentice-Hall, Inc. (P-H), and Research Institute of America (RIA). The code is also published in most multivolume tax services, either separately in a loose-leaf volume or serially in several volumes. In the latter case, the volume includes editorial comments arranged on a topical and/or section number basis.

Administrative Interpretations

Within the executive branch, the Treasury Department has the responsibility of implementing the tax statutes passed by Congress. This function is specifically carried out by the Internal Revenue Service division of the Treasury Department. The duties of the Internal Revenue Service are two-fold: First, the statutes must be interpreted according to the intent of Congress, and, second, the statutes must be enforced.

The interpretive duties of the Treasury and the IRS range from the general to the specific. Treasury regulations are written in broad, general terms to explain the provisions of the Internal Revenue Code. Revenue rulings, on the other hand, interpret the code only with respect to specific facts and are inapplicable to fact situations that deviate from those stated in a particular revenue ruling.

Treasury Regulations

Section 7805 of the Internal Revenue Code gives the secretary of the Treasury or his delegate a general power to prescribe necessary rules and regulations to administer the tax laws as passed by Congress. In addition to Section 7805, specific reference is made throughout the code to the effect that the secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purpose of a specific chapter or section.

Treasury regulations may be divided into regulations that are almost "statutory" and those that are interpretive. An example of "statutory regulations" are those promulgated under Section 1502 (formerly Section 141(b), Internal Revenue Code of 1939) dealing with consolidated tax returns. Because of the complexity of the subject, Congress failed to legislate in detail in the area of consolidated tax returns and delegated this responsibility to the secretary of the

Treasury or his delegate. Apparently, in 1954, Congress had second thoughts concerning the delegation of legislative power to the secretary. Had the 1954 code been enacted in the form in which it passed the House of Representatives, the consolidated return regulations actually would have been written into the statute. The Senate Finance Committee disagreed, however, and in the conference committee the view of the Senate prevailed.[4] Due to the complexity and detail involved in the consolidated return regulations, Congress apparently felt that revisions and amendments should be left under the purview of the Treasury.

Taxpayers electing to file consolidated returns must execute a consent form in which they agree to be bound by the provisions of the regulations.[5] Presumably, such an agreement leaves almost no appeal from the provisions of the consolidated return regulations and, in that sense, gives them a position more nearly "statutory" than the interpretive regulations.

The purpose of the interpretive regulations is to clarify the language of the code as passed by Congress. Although the wording of the regulations is sometimes almost identical to the language of the code and of little assistance, in recent years the Treasury has made frequent attempts to add helpful examples to the regulations.

In effect, even the interpretive regulations may come to have the force of law; however, technically, if they contradict the intent of Congress, they can be overturned by the courts.[6] Nevertheless, the odds are very much against the taxpayer or his representative who tries to win a case against the Internal Revenue Service solely by attempting to declare a specific Treasury regulation to be in conflict with the code or the intent of Congress. For a more complete discussion on the status of Treasury regulations, see chapter 5.

According to the Administrative Procedure Act, regulations must be issued in proposed form before they are published in final form. Proposed regulations for a new or existing part of the code may begin with the formation of a special task force that may include representatives of the Internal Revenue Service, the American Bar Association, the American Institute of Certified Public Accountants, and other knowledgeable individuals, as was the case with the

[4] U.S., Congress, Senate, Committee on Finance, S. Rept. 1622, 83d Cong., 2d sess., 1954, p. 120.
[5] Treas. Regs. Sec. 1.1502-75(h)(2)(1966).
[6] See, for example, W. W. Marett, 325 F2d 28 (CA-5, 1963).

regulations under Section 1502. Usually, however, regulations are prepared solely by members of the Treasury Department. Interested parties generally are given thirty days from the date the proposed regulations appear in the *Federal Register* to submit objections or suggestions. Depending upon the controversy surrounding a proposed regulation, it will, after the given time period, be either withdrawn and issued in permanent form or amended and reissued as a new proposed regulation.

Permanent regulations are initially published as official Treasury Decisions (TD) and appear in the *Federal Register.* They subsequently are reprinted by the Government Printing Office in codified form and are officially cited as Title 26 of the *Code of Federal Regulations* (26 CFR . . .). Commerce Clearing House and Prentice-Hall publish paperback editions of the Treasury regulations periodically.

The identifying number of a specific part of the regulations can be divided into three segments, as follows:

Treas. Regs. Sec. 1.1245 – 2 (a)(3)(ii)

Segment I II III

Segment I indicates that the regulation deals either with a specific tax or with a procedural rule. Title 26 of the *Code of Federal Regulations* utilizes the following designations as the identification numbers for what we call "segment I" of a correct citation of a Treasury regulation.

Part 1	Income Tax
Part 20	Estate Tax
Part 25	Gift Tax
Part 31	Employment Tax
Parts 48 and 49	Excise Taxes
Part 301	Administrative and Procedural
Part 601	Statement of Procedural Rules

Segment II simply coincides with the specific code section that the regulation interprets. Thus, in the above example, one can determine that the regulation cited (a) deals with the income tax (because of the prefix 1) and (b) refers specifically to Section 1245 of the Internal Revenue Code. Segment III represents the sequence of the regulation and a breakdown of its content. Thus, segment III in

the example refers to Section 1245, second section, paragraph (a), subparagraph (3), subdivision (ii). Generally, there is no direct correlation between the sequence designation of the Internal Revenue Code and the organization of a Treasury regulation. For instance, Code Section 1245(c) discusses "Adjustment to Basis," while the interpretive discussion of the same topic is found in Treas. Regs. Sec. 1.1245-5.

Frequently, there is a considerable delay between the time a particular section is added to the code and the time when the Treasury issues proposed or permanent regulations. A case in point is found in the child care expense provisions of Code Section 214, which underwent major modification in the Revenue Act of 1971. The new statute became effective for the tax year 1972. Three years later the Treasury regulations for the revised statute had not yet been proposed or issued. Regulations published for Section 214 are applicable only for tax years prior to 1972. The tax researcher must, therefore, be careful to ascertain that the regulations he consults are in fact valid for the current statute.

Occasionally, when a major change of a particular code section has been enacted and the commissioner of internal revenue subsequently issues new regulations, two sets of regulations will appear covering the same code section for a time. The regulations currently published under Section 170, on charitable contributions, are a case in point. Due to the major revisions in the Tax Reform Act of 1969, new regulations were issued in 1972 to govern Section 170. New regulations are distinguishable from those applicable to tax years prior to 1970 through the addition of a capital letter *A*. That is, Treas. Regs. Sec. 1.170A-1 applies to years after 1969, Treas. Regs. Sec. 1.170-1, to years before 1970. Once again, to identify current and noncurrent regulations, the researcher must be aware of this procedure.

Revenue Rulings

Another interpretive tool used by the Internal Revenue Service to apply tax laws to specific situations are letter rulings. These letter rulings generally are official replies given by the IRS to inquiries from taxpayers concerning the tax consequences of a proposed transaction. If, in the opinion of the Internal Revenue Service, the issue is of significant general application, the essence of the reply

will be published in the form of a revenue ruling. In the past, care was taken to protect the identity of the actual taxpayer making the initial request to comply with statutory provisions prohibiting the disclosure of information obtained from the public.

Initially revenue rulings are published in the weekly *Internal Revenue Bulletin.* The same rulings later appear in the permanently bound *Cumulative Bulletin,* a semiannual publication of the Government Printing Office. A typical citation for a revenue ruling would appear in the following forms:

Rev. Rul. 74-101, IRB 13,10
or
Rev. Rul. 74-101, 1974-1 CB 131

The first citation refers to the 101st revenue ruling published in 1974 in the thirteenth weekly *Internal Revenue Bulletin,* on page 10. The second citation refers to the same revenue ruling; however, in this instance its source is the first volume of the 1974 *Cumulative Bulletin,* page 131.

Prior to 1953, rulings by the Internal Revenue Service appeared under various titles such as general counsel's memorandums (GCM), appeals and review memorandums (ARM), internal revenue mimeographs (IR-Mim.), and tax board mtmorandums (TBM), to name just a few. While some of these rulings still have potential value, in Revenue Procedure 67-6, 1967-1 CB 576, the IRS announced a continuing review program of rulings. If the IRS revokes or modifies a prior revenue ruling, open tax years can be retroactively affected for all taxpayers other than the taxpayer who initially requested the ruling. The modification will affect the latter party only if a misstatement or omission of material facts was involved. In researching a problem, the tax practitioner should consult a current status table to avoid the embarrassment of relying on a ruling that has been revoked or modified. The current rulings volume (vol. 7) of the *Mertens' Law of Federal Income Taxation* is particularly helpful for this task.

Published revenue rulings generally have less force than Treasury regulations because they were intended to cover only specific fact situations. Consequently, published rulings provide valid precedent only if a second taxpayer's facts are substantially identical. In dealing with revenue agents and other Internal Revenue Service per-

sonnel, however, one might remember that regulations, revenue rulings, and acquiesced Tax Court decisions constitute the official policy of the service. Thus an agent is often more easily persuaded by a revenue ruling than by a district court or even a circuit court decision. An agent's work must be approved by his supervisor and sometimes by the review staff; these persons tend to minimize litigation hazards.

Revenue Procedures

Revenue procedures announce administrative practices followed by the Internal Revenue Service. The depreciation guidelines announced in Revenue Procedures 62-21 and 65-13 are an example. If a taxpayer will accept the estimated lives recommended in these revenue procedures, as liberalized by the Revenue Act of 1971, the service will not challenge the result of their application if proper procedures were followed.

Publication and identification methods for revenue procedures are identical to those used for revenue rulings. That is, they are initially published in the *Internal Revenue Bulletin* and subsequently in the *Cumulative Bulletin* and are numbered in the sequence of their appearance. Only the prefix "Rev. Proc." is different.

Technical Information Releases

Technical information releases (TIRs) are used by the Internal Revenue Service to disseminate important technical information on specific issues. TIRs are not published in the *Internal Revenue Bulletin* but are distributed via a practitioners' mailing list. In addition, the major tax services publish them in their current-matters volume. If the IRS decides that a TIR has enough general application, it will be reissued as a revenue procedure. In such an instance, of course, the TIR will appear in the *Internal Revenue Bulletin* and subsequently in the *Cumulative Bulletin.* A TIR usually includes a statement indicating the extent to which the practitioner may rely upon the announcement.

Letter Rulings and Technical Advice Memoranda

To further clarify provisions of the code, the Internal Revenue Service has furnished interpretive rulings in the form of private letter rulings and technical advice memorandums. Private letter rulings

are issued to taxpayers who formally request advice about the tax consequences applicable to a specific business transaction. Such ruling requests have been employed frequently by taxpayers to assure themselves of a preplanned tax result before consummating a transaction and as a subsequent aid in the preparation of the tax return. The Internal Revenue Service may refuse a ruling request; but even when rulings are given it is usually understood that such a ruling is limited in application to the taxpayer making the request, and IRS personnel are instructed not to accept private rulings as precedent when offered by taxpayers other than those for whom the rulings were originally rendered. In the past, however, private letter rulings have often inspired the publication of revenue rulings or revenue procedures describing similar fact situations.

The technical advice memorandum, a special after-the-fact ruling, also may be requested from the technical staff of the Internal Revenue Service. For example, if a disagreement arises in the course of an audit between the taxpayer or his representative and the revenue agent, either side may request formal technical advice on the issue(s) through the district director. If the advice is favorable to the taxpayer, IRS personnel usually will comply with the ruling. In some instances, such technical advice also has been used as the basis for the issuance of a revenue ruling.

Recently, the continuation of private rulings has been placed in serious jeopardy. Through legal action brought by various taxpayers against the Internal Revenue Service under the Freedom of Information Act (FOIA), the IRS has been ordered to release unpublished rulings.[7] At this writing, the Administration is planning to introduce legislation that would more specifically indicate documents that would be available for public scrutiny. An issue to be resolved is to what extent such a law would have retroactive application. The commissioner of Internal Revenue has stated, however, that based upon *Tax Analysts,* the Service considers technical advice memorandums not in the same category as private letter rulings and thus does not anticipate the release of technical advice memorandums.[8] Nevertheless, taxpayers who have in the past uti-

[7] Tax Analysts and Advocates, 505 F2d 350 (CA-D.C., 1974); also Fruehauf Corp., 369 F.Supp. 108 (DC Mich., 1974), aff'd CA-6, 6/9/75.

[8] Joel M. Forster, ed., "Washington Report," *The Tax Adviser,* March 1975, pp. 162-65.

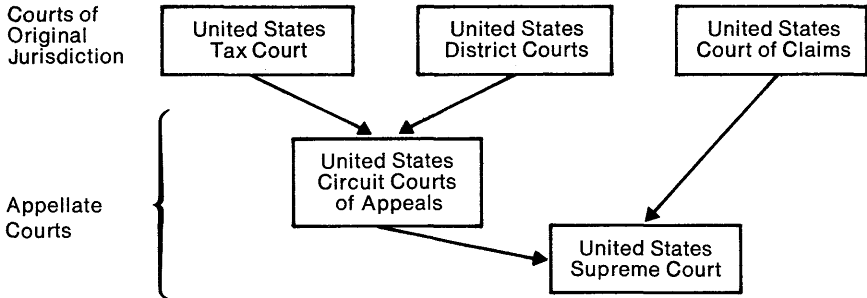
lized the private rulings procedure may now steer away from it because of their desire to keep certain information confidential.

Judicial Interpretations

In situations where statutory authority alone does not provide a clearcut solution for a particular problem, the taxpayer or his adviser must consult judicial as well as administrative authority in forming an opinion. Judicial interpretations provide varying degrees of precedent, depending upon the nature of the conflict and the jurisdictional authority of the court that rendered the opinion.

While a vast majority of all disagreements with the Internal Revenue Service are settled on the administrative level, unsettled disputes may be litigated by filing suit in one of three courts of original jurisdiction: the United States Tax Court, a United States district court, or the United States Court of Claims. Appeals from both the Tax Court and the district courts are heard by the circuit courts of appeals. Appeals from a circuit court or the Court of Claims must be directed to the United States Supreme Court. The judicial alternatives available to a taxpayer can be depicted as in figure 4.1.

Figure 4.1



After receiving a request for *certiorari* from either the government or the taxpayer, the Supreme Court decides whether or not it should review a case. *Certiorari* is most commonly granted in situations where a conflict already exists between two or more circuit courts of appeals and/or the Court of Claims. Sometimes the Supreme Court will grant *certiorari* without a prior conflict if it deems

a case to have special significance. In order to understand fully the weight of a court decision, and the degree to which it sets precedent, an elementary understanding of the jurisdiction of each court is essential.

United States Tax Court

The United States Tax Court consists of sixteen judges, separate and distinct from the Treasury Department, appointed by the President for fifteen-year terms. Although the principal office of the Tax Court is located in Washington, D.C., the court conducts hearings in most large cities in the United States. The Tax Court is organized by divisions, which usually consist of only one judge, although they may consist of more than one. Commissioners may be assigned to assist a judge. Proceedings before the Tax Court may be conducted with or without trial; if sufficient facts are stipulated, the assigned judge may render an opinion without a formal trial.

After hearing a case, the assigned judge will submit his findings of fact and his opinion, in writing, to the chief judge, who then decides whether or not the case should be reviewed by the full court. Should the chief judge decide that a full review is not necessary, the original decision will stand and be entered either as a "regular" or a "memorandum" decision. Regular decisions are published by the Government Printing Office.

Prior to 1943, the Tax Court was known as the Board of Tax Appeals, the decisions of which were published in forty-seven volumes covering the period from 1924 to 1942. These volumes are cited as the *United States Board of Tax Appeals Reports* (BTA). For example, 39 BTA 13 refers to the thirty-ninth volume of the *Board of Tax Appeals Reports,* page 13. Beginning with the latter part of 1942, when Congress changed the name of the body, the proceedings have been published as *The Tax Court of the United States Reports* (TC). Thus, an illustrative citation would be 12 TC 101. Bound volumes of the Tax Court reports are published only by the United States Government Printing Office.

Tax Court memorandum decisions are reproduced by the government in mimeograph form only. However, Commerce Clearing House publishes memorandum decisions in their *Tax Court Memorandum Decisions* (TCM) series and Prentice-Hall makes them available as the *Prentice-Hall Memorandum Decisions* (PH-TC

Memo). In recent years the Tax Court has handed down more memorandum opinions than regular opinions. Memorandum opinions usually involve conclusions that, in the opinion of the chief judge, have been well established and require only a delineation of facts. Nevertheless, in 1945 Judge Murdock publicly pointed out the precedent value of memorandum decisions and acknowledged that they could be cited in briefs.[9]

If, in the opinion of the chief judge, a case contains an unusual point of law or one on which considerable disagreement exists among the judges of the Tax Court, he may assign the case to the full court. After each judge has had an opportunity to study the case, the court meets for an expression of opinions and a vote. In such instances it is possible that one or more majority and minority opinions will be prepared and that the trial judge—possibly the only one to have actually heard the proceedings—could write the minority opinion. The majority opinion will be entered as the final decision of the Tax Court.

As a general rule, the Tax Court's jurisdiction rests with the determination of *deficiencies* in income, excess profits, self employment, estate, or gift taxes. Specifically excluded are claims for refunds if the commissioner did not first assess a deficiency[10] and matters of administrative policy.[11] Claims for refund must be tried in either a district court or the Court of Claims. Thus, in order to bring suit in the Tax Court of the United States, a taxpayer must have received a notice of deficiency and a so-called ninety-day letter and, subsequently, have refused to pay the deficiency.

Some Tax Court transcripts disclose that a "decision has been entered under Rule 50." This notation signifies that the court has reached a conclusion as to the facts and issues of the case but leaves the computational aspects of the decision to the opposing parties. Both parties will subsequently submit to the court their version of the refund or deficiency computation. If both parties agree on the computation, no further argument is necessary. In the event of disagreement, the court will reach its decision on the basis of the data

[9] J. Edgar Murdock, "What Has the Tax Court of the United States Been Doing?" *American Bar Association Journal,* June 1945, pp. 298-99.

[10] Scaife Company, 47 BTA 964 (1942).

[11] Cleveland House Brewing Company, 1 BTA 87 (1924).

presented by each party. Data submitted or arguments heard under Rule 50 are usually not a part of the trial transcript.

As part of Public Law 91-172, Congress enacted IRC Section 7463, which authorizes the creation of special trial procedures within the Tax Court for disputes involving $1,000 or less (later amended to $1,500 or less).[12] A taxpayer may request trial before the Small Tax Case Division by executing Form 2 of the Tax Court and paying a filing fee of $10. Even this fee may be waived if in the opinion of the court the petitioner is unable to make such payment. Legal counsel is not required; the taxpayer may represent himself. Trial procedures are conducted on an informal basis with the filing of briefs permitted but not required. Only an informal record of the trial proceedings is prepared and every decision is final, making an appeal from a decision of the Small Tax Case Division of the Tax Court impossible. Decisions of this division may not be cited as precedent in other cases.

Acquiescence policy. In some instances the commissioner of internal revenue will publicly announce his "acquiescence" or "nonacquiescence" to a *regular* Tax Court decision. This policy does not encompass Tax Court memorandum decisions or decisions of other courts. In announcing his acquiescence, the commissioner publicly declares his agreement with a conclusion reached by the Tax Court. This does not necessarily mean that the commissioner agrees with the *reasoning* used by the court in reaching the conclusion, but only that in the future, unless otherwise announced, the Internal Revenue Service will dispose of similar disputes in a manner consistent with that established in the acquiesced case. In those situations where the Tax Court has ruled against the government, the commissioner may wish to express nonacquiescence to inform taxpayers that he will continue to contest similar disputes in the future.

Acquiescence and nonacquiescence are announced in the weekly *Internal Revenue Bulletin* and are republished in the semiannual *Cumulative Bulletin*. In addition, citators of the major tax services indicate whether the commissioner has acquiesced or refused to acquiesce in a particular decision, giving specific reference to the *Cumulative Bulletin* in which the commissioner's announcement

[12] The $1,500 limitation includes the initial tax contested, potential additional amounts, and penalties, but excludes interest.

can be found. If the tax adviser plans to rely on a specific acquiesced case, it is important that he check the original announcement, because it is possible that only a partial acquiescence exists. For example, a single Tax Court case may involve multiple issues and the commissioner may acquiesce in only one of those issues. An interesting example of this is found in *The Friedlander Corporation,* 25 TC 70 (1955), in which the Tax Court considered three issues. The commissioner remained silent on the first issue, expressed nonacquiescence to the second, and acquiesced to the third.[13]

The commissioner may also withdraw his acquiescence with retroactive effect. For example, in *Caulkins,* 1 TC 656 (1943), the commissioner initially published his nonacquiescence but later changed this to acquiescence when the court of appeals sustained the Tax Court.[14] Eleven years later another commissioner reinstated the initial nonacquiescence.[15] A taxpayer who claimed that he had relied on *Caulkins* before the acquiescence was retroactively withdrawn found no relief when, in *Dixon,* the Supreme Court upheld the commissioner's right to do so.[16]

United States District Court

The federal judicial system is divided into eleven judicial circuits as illustrated in figure 4.2, page 107. Ten of the circuits are numbered; the eleventh covers Washington, D.C. Each of the eleven circuits is further divided into districts. At least one district judge is assigned to each federal district. Depending upon need, however, two or more federal district judges may hear cases in any district. A taxpayer may bring suit in a federal district court only after he has paid a tax, either with the return or as a deficiency assessment, and has processed a request for refund.[17] A United States district court is the only court in which a taxpayer can request a jury trial in a tax dispute. Published proceedings of the federal district courts can be found in the *Federal Supplement* reporter series, published by West Publishing Company.

[13] Cumulative List of Announcements Relating to Decisions of the Tax Court, 1972-2 CB 2.

[14] See TC 1943-24-11581, 1943-1 CB 28; see TC 1944-24-11907, 1944-1 CB 5.

[15] Rev. Rul. 55-136, 1955-1 CB 7.

[16] W. Palmer Dixon, 381 US 68 (1965).

[17] Int. Rev. Code of 1954, Sec. 7422.

United States Court of Claims

The U.S. Court of Claims was created by Congress in 1855 to dispose of claims against the United States government. The Court of Claims is a single court consisting of a chief judge and four associate judges appointed by the President. By statute, the court is required to hold an annual term in Washington, D.C.[18] Most of the hearings are held by fifteen commissioners who report their findings to the judges. The prerequisites for filing suit in the Court of Claims are identical with those applicable to the district court; that is, the petitioners must have paid a tax and subsequently filed a request for refund that the commissioner rejected. The proceedings of the Court of Claims can be found in the *Court of Claims Reporter* series published by the United States Government Printing Office. In addition, West's *Federal Reporter* includes all Court of Claims cases between 1929 and 1932 and after 1959. From 1932 to 1960 the Court of Claims cases were published in the *Federal Supplement* series (West Publishing Company).

United States Circuit Courts of Appeals

In addition to the District of Columbia Circuit, the states and U.S. territories are geographically partitioned into judicial circuits numbered from one through ten (see figure 4.2). Decisions of the Tax Court and a district court may be appealed by either the taxpayer or the government to the circuit court in which the taxpayer resides. Hearings before a circuit court are conducted by a panel of three judges.

Depending upon need and policies within each particular circuit, federal district judges may be asked to serve on a panel during a session. Upon request by any circuit judge, regardless of whether or not he was a member of the trial panel, the full circuit court (that is, all the judges in that circuit) may review the decision of a trial panel. The proceedings of the circuit courts are published by West Publishing Company in the *Federal Reporter* (1st and 2nd Series).

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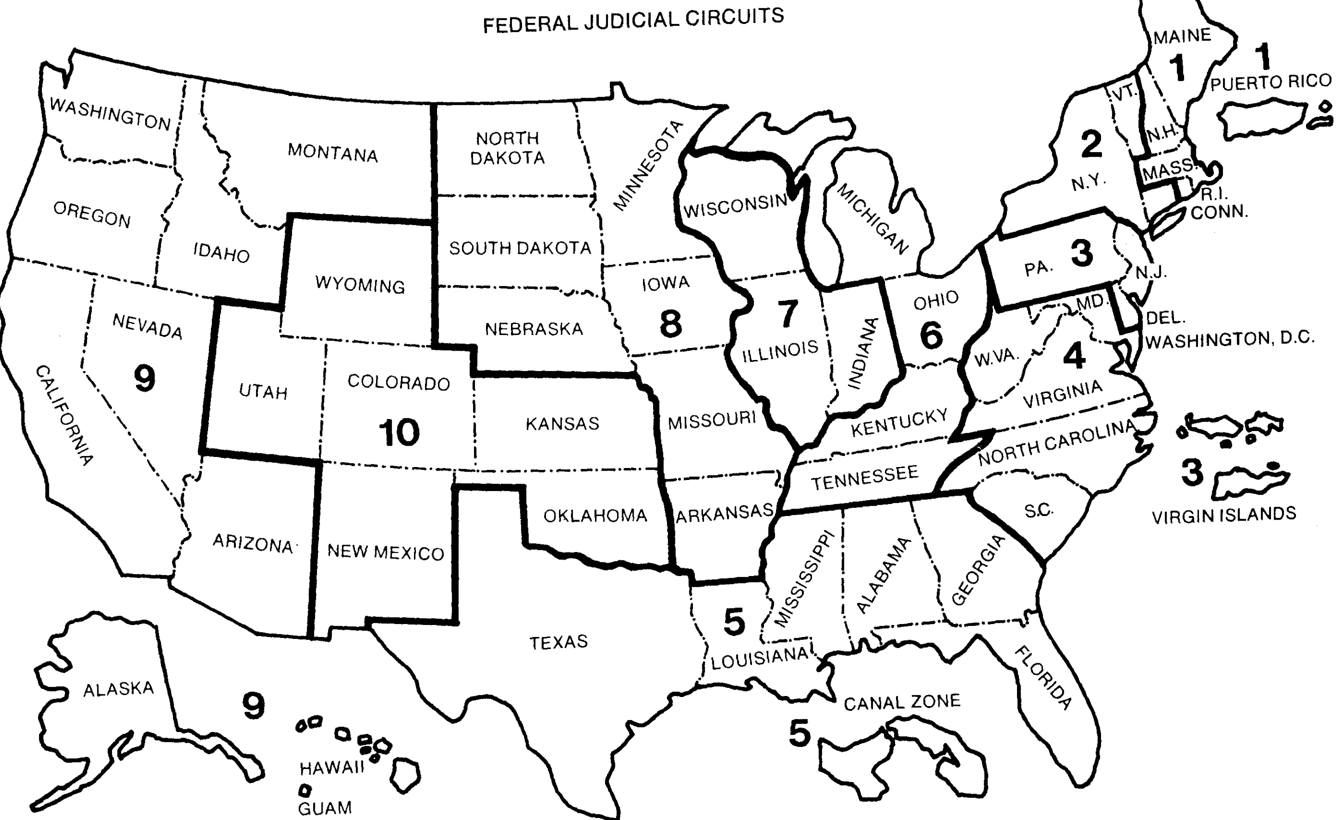
[18] *United States Code Annotated,* Title 28, Sec. 174, (St. Paul, Minn.: West Publishing Co., 1968).

Figure 4.2



United States Supreme Court

Final appeals from the Court of Claims or from a circuit court of appeals rests with the Supreme Court. As previously explained, appeal requires a writ of *certiorari*, which the Supreme Court may or may not grant. Supreme Court decisions are of special importance because they constitute the final judicial authority in tax matters. The Supreme Court decisions can be found in any one of three publications: the *United States Supreme Court Reports* (U.S.), Government Printing Office; *Supreme Court Reporter* (S.Ct.), West Publishing Company; the *United States Reports, Lawyers' Edition* (L.Ed.), Lawyers' Co-Operative Publishing Company.

Special Tax Reporter Series

All *tax* decisions rendered by the Supreme Court, the circuit courts of appeals, the Court of Claims, federal district courts, and some state courts are separately published by Commerce Clearing House in the *United States Tax Cases* (USTC) series and by Prentice-Hall in the *American Federal Tax Reports* (AFTR and AFTR2d) series. These two special judicial reporter series provide a tax practitioner with two major advantages: First, by collecting *only* tax cases in one reporter series, it is economically possible for most tax practitioners to acquire at least one complete set of all judicial authority dealing with tax problems; second, the space required to store one complete tax reporter series is minimal when compared with the many volumes that would otherwise have to be maintained were all judicial tax decisions readily available (tax cases would be mixed among other civil and criminal proceedings).

Tax Court decisions, which comprise a separate volume, are not included in either the USTC or AFTR series. In addition to the Tax Court reporter series published annually by the Government Printing Office, however, both CCH and P-H provide a current loose-leaf service which offers all regular and memorandum Tax Court decisions in an expeditious manner. If these loose-leaf volumes are retained, it is unnecessary to purchase the government (TC) series to obtain a complete set. Most practitioners, however, make that purchase anyway in order to obtain bound volumes of the regular Tax Court decisions. As noted earlier, unlike the government, both Commerce Clearing House and Prentice-Hall publish bound volumes of the Tax Court memorandum decisions.

Although the duplication of a single judicial proceeding in several court reporter series has the advantages noted earlier, that same duplication creates the problem of multiple citations. The extent of the present duplication is shown in exhibits 4.2 and 4.3, pages 110 and 112. In preparing tax communications, a writer can never be certain of which reporter series is most readily available to his reader; therefore, it is difficult to know which series should be cited. In order to standardize citation presentation, most formal publications have accepted the practice of presenting at least an initial reference to the "official" or "standard" reporter series. If other (secondary) citations are also given, they generally follow the standard citation. Thus, one might properly cite the decision in *Harris* as *Harris* v. *Commissioner*, 340 US 106 (1950), 39 AFTR 1002, 50-2 USTC ¶10,786. Obviously additional secondary references could be added to the two in the above illustration.

The Citator

The tax researcher who must consider judicial authority has a most useful tool at his disposal in a citator, which is simply a compilation of cross-references to judicial decisions. Following the initial entry of each judicial proceeding in an alphabetical sequence, a citator includes later cross-references to additional citations—that is, to other cases—which in some way contain a reference to the initial entry. To illustrate, assume that only five judicial decisions have ever been rendered (those being *Able, Baker, Charlie, Daley,* and *Evert,* in chronological order.) Assume further that the court in *Baker* made some mention of the *Able* decision; that the court in *Daley* made some reference to the decisions in *Able* and *Charlie,* but not to that in *Baker;* and that the court in *Evert* made reference only to the decision in *Baker.* Given these assumptions a complete citator could be prepared as follows:

Able (initial citation)
. . . *Baker* (cross-reference to page in *Baker* which "cites" *Able*)
. . . *Daley* (cross-reference to page in *Daley* which "cites" *Able*)
Baker (initial citation)
. . . *Evert* (cross-reference to page in *Evert* which "cites" *Baker*)
Charlie (initial citation)
. . . *Daley* (cross-reference to page in *Daley* which "cites" *Charlie*)
Daley (initial citation only)
Evert (initial citation only)

Exhibit 4.2
Summary of Primary and Secondary Citations

	Primary		Secondary	
	Publisher	Standard Citation	Publisher	Standard Citation
Supreme Court[a]	U.S. Government Printing Office	*Harris* v. *Comm.*, 340 US 106 (1950)	The Lawyers Co-Operative Publishing Company	*Harris* v. *Comm.*, 95 L.Ed. 111
	West Publishing Company	*Harris* v. *Comm.*, 71 S. Ct. 181 (1950)	Prentice-Hall	*Harris* v. *Comm.*, 39 AFTR 1002
			Commerce Clearing House	*Harris* v. *Comm.*, 1950-2 USTC ¶10, 786
Circuit Courts of Appeal	West Publishing Company	*Salome Jr.* v. *U.S.*, 395 F2d 990 (CA-6, 1968)	Prentice-Hall	*Salome Jr.* v. *U.S.*, 22 AFTR2d 5039
			Commerce Clearing House	*Salome Jr.* v. *U.S.*, 1968-2 USTC ¶9440
District Courts	West Publishing Company	*Whittington* v. *Jones*, 96 F. Supp 967 (W.D. Okla., 1951)	Prentice-Hall	*Whittington* v. *Jones*, 40 AFTR 553
			Commerce Clearing House	*Whittington* v. *Jones*, 1951-1 USTC ¶9302
Court of Claims[b]	West Publishing Company	*Scott* v. *U.S.*, 354 F2d 292 (Ct. Cl., 1965)	Prentice-Hall	*Scott* v. *U.S.*, 16 AFTR2d 6087

	U.S. Government Printing Office	*Scott* v. *U.S.*, 173 Ct. Cl. 650 (1965)	Commerce Clearing House	*Scott* v. *U.S.*, 1966-1 USTC ¶9169
Board of Tax Appeals	U.S. Government Printing Office	*Charles F. Long*, 12 BTA 488		
Board of Tax Appeals (memorandum decisions)	Prentice-Hall	*Frank L. Owen*, 40 BTA 1377, Dock 8 7811 (Memo), June 6, 1939, 1939 P-H ¶6530		
Tax Court	U.S. Government Printing Office	*Mae F. Meurel*, 20 TC 614 (1953)	Prentice-Hall[c] Commerce Clearing House[c]	
Tax Court (memorandum decisions)	Prentice-Hall	*Stephen L. & Doris M. Morrow*, 1967 P-H TC Memo 67, 242		
	Commerce Clearing House	*Stephen L. & Doris M. Morrow*, 26 TCM 1222 (1967)		

[a] The *Supreme Court Reporter*, published by West Publishing Company, is considered primary authority during the period prior to the publication of the official report by the U.S. Government Printing Office.

[b] Cases decided in the Court of Claims from 1929 to the present are cited to the West publications. Earlier cases are cited to the *Court of Claims Reports* published by the U.S. Government Printing Office.

[c] Both P-H and CCH publish "advance sheets" on all Tax Court decisions. Even though they are never *bound*, if a person collected and retained all of the loose-leaf (advance) sheets, he would in effect have the TC reports.

Exhibit 4.3
Publication Summary of Judicial Decisions

Court	Publication	1900–1975 (year labels as printed on the bar)
SUPREME COURT	U.S. Supreme Court Reports	
	Supreme Court Reporter	
	U.S. Reports	
	American Federal Tax Reports	
	United States Tax Cases (1)	(1913)
CIRCUIT COURTS OF APPEALS	Federal Reporter (2)	
	American Federal Tax Reports	
	United States Tax Cases (1)	(1913)
DISTRICT COURTS	Federal Reporter (2)	(1932, end)
	Federal Supplement	(1932)
	American Federal Tax Reports	
	United States Tax Cases (1)	(1913)
COURT OF CLAIMS	U.S. Court of Claims Reports	
	Federal Supplement	(1932) (1960)
	Federal Reporter (2)	(1929) (1932) (1960)
	American Federal Tax Reports	
	United States Tax Cases (1)	(1913)
BOARD OF TAX APPEALS and TAX COURT (regular & memo decisions)	U.S. Board of Tax Appeals Reports	(1924) (1942)
	United States Tax Court Reports (3)	(1942)
	Tax Court Memorandum Decisions (P-H)	(1928)
	Tax Court Memorandum Decisions (CCH)	(1942)

(1) From 1913 to 1933 only opinions of genuine precedent value are included from the Circuit Courts of Appeal, District Courts & Court of Claims.
(2) Since 1925 the Federal Reporter is published as the Federal Reporter 2d Series.
(3) Prior to 1970 this publication was known as Tax Court of the United States Reports.

Obviously, there are thousands of judicial decisions and many thousands of cross-references. Were there no citators (or other equivalent data retrieval systems), it would be virtually impossible to locate much of the pertinent judicial authority on most tax questions. With citators available, the task is at least feasible. To illustrate, consider the problem of interpreting what the words "ordinary" and "necessary" mean as they are used in Code Sections 162 and 212. This task was undertaken by the Supreme Court in 1933 in *Welch* v. *Helvering*, 290 US 111 (1933). Since that 1933 decision, *Welch* v. *Helvering* has been "cited" in more than 300 subsequent court decisions. A citator greatly facilitates the task of locating any or all of these decisions, which just may offer additional perspective on the meaning of the words "ordinary" and "necessary," because it identifies a reasonable set of cases to examine further. In most instances, of course, the list of cases suggested by a citator will be much smaller than the 300 noted here.

Using the Citator. To demonstrate the methodology applied in searching for pertinent judicial decisions, assume that a tax researcher has somehow identified a potentially important case with a primary citation. If that practitioner has only the USTC or AFTR reporter series available to him, he must first find an "equivalent" secondary citation before he can read the decision he is interested in reviewing. If he has the AFTR series available, he should begin with the *P-H Citator*; if he has the USTC series available, he should begin with the *CCH Citator*. Each citator will give the secondary citation for its own reporter series only. The case "names" (technically called *styles*) are arranged in alphabetical sequence in both citators. However, the *P-H Citator* consists of five separate volumes, whereas the *CCH Citator* consists of only one. Thus, in working with P-H materials, a tax researcher may have to consult more than one volume *if* he wants to locate all of the subsequent decisions that have cited the initial entry. The number of volumes to be consulted will depend upon the year the initial case was heard. If a case was first tried sometime between 1796 and 1941, the researcher using the P-H series must consult all three volumes of the AFTR series, volume 1 of the AFTR2d series, and the looseleaf volume for current citations. On the other hand, if the case

being examined was first tried sometime between 1948 and 1954, the researcher would consult only volume 3 of the AFTR series, volume 1 of the AFTR2d series, and the current (loose-leaf) volume. Exhibit 4.4, see below, compares the *CCH Citator* with the *P-H Citator;* exhibit 4.5, opposite, cross-references the *P-H Citator* to other judicial reporters.

Exhibit 4.4
Key to Citator Services

Publisher / Year	1796-1941	1941-1948	1948-1954	1954-1967	Since 1967
Prentice-Hall	1st Series Vol. 1	1st Series Vol. 2	1st Series Vol. 3	2nd Series Vol. 1	Loose-leaf
Commerce Clearing House	Only one loose-leaf volume covering all dates				

Any meaningful comparison of these two citator services must go beyond the apparent convenience factor of working with one CCH volume as opposed to five P-H volumes because the usefulness of either citator becomes a function of what the researcher wants to find. Should he desire to obtain a brief judicial history of a case, the *CCH Citator* is a handy research tool. For example, assume that the researcher wants to trace the history of *Germantown Trust Co.* This case came to his attention in a tax periodical, where it was cited as 309 US 304 (1940). A simple check in the one-volume *CCH Citator*, which is arranged in alphabetical order, discloses that *Germantown Trust Co.* was originally tried by the Board of Tax Appeals in 1938 and entered as a memorandum decision; this decision was reversed by the Third Circuit Court of Appeals, and in turn was reversed by the Supreme Court (see exhibit 4.6, page 116). In addition, the *CCH Citator* discloses that *Germantown Trust Co.* has subsequently been cited in over twenty additional cases, most recently in 1972. All of this information may or may not be pertinent to the researcher's tax problem. Finally, of course, the *CCH Citator* gives the cross-reference of the case in the USTC series.

To gather this same information through the use of the *P-H Citator*, the researcher would proceed along the following lines (see exhibits 4.7–4.11, pages 117-121). The original citation, *Germantown Trust Co.*, 309 US 304 (1940), discloses the decision year; thus, the researcher turns to volume 1 of the *P-H Citator* (1796-1941) to learn that the Board of Tax Appeals was the court of

Exhibit 4.5
Extended Key to Prentice-Hall Citator Volumes

Judicial Reporter Volumes[a] / *Prentice-Hall Citator Volume:*	*Volume 1*	*Volume 2*	*Volume 3*	*Volume 1 (2d)*	*Current Volume*
Years covered	1919-1941	1942-1948	1949-1953	1954-1967	1968-to date
American Federal Tax Reports (AFTR)	1-27	28-35	36-43	44-52	—
American Federal Tax Reports—2d Series (AFTR2d)	—	—	—	1-6	7-
U.S. Supreme Court Reports (US)	1-313(450)	313-332(126)	332-345	346-364	365-
Federal Reporter (Fed.)	1-300	—	—	—	—
Federal Reporter—2d Series (F2d)	1-123(746)	123-163(286)	163-205(73)	205-285	286-
Federal Supplement (F. Supp.)	1-41(907)	41-72(925)	72-112	113-188	189-
U.S. Court of Claims Reports (Ct. Cl.)	1-93	94-110	111-127	127-144	145-
Board of Tax Appeals Memorandum Decisions (BTA Memo)	1-629	1934-1942	—	—	—
U.S. Board of Tax Appeals Reports (BTA)	1-45(629)	45 to end	—	—	—
Tax Court Memorandum Decisions (P-H TC Memo)	—	1943-1948 #48, 167	#48, 168-54, 205	#54, 206-76, 253	#67, 254-
United States Tax Court Reports (TC)	—	1-10	11-22(85)	22-35(438)	35(439)-

[a]Where a volume is split, the break-off page number is indicated in brackets (–) if known.
Source: John C. Williams, Golden Gate University.

Exhibit 4.6
CCH Citator Page

——CCH—— 90,887 GER

Gerber Co., John .... ¶ 3379.042, 5861.08
• **BTA**—44 BTA 26; Dec. 11,738; A. 1941-2 CB 6
Ginsberg Est., Dec. 22,994(M), 17 TCM 472, T.C.Memo. 1958-95
Daniels, Dec. 22,648(M), 16 TCM 944, T.C.Memo. 1957-209
Parsons, Dec. 18,590(M), 10 TCM 959
Rhodes-Jennings Furniture Co., Dec. 17,959(M), 9 TCM 1019
Hounsell, Dec. 17,773(M), 9 TCM 611
Kirkpatrick, Dec. 14,293(M), 3 TCM 1312

Gerdel, Cletus H. .... ¶ 6003.28
• **DC**—Mo., 52-1 USTC ¶ 9337; 103 F.Supp. 635
Waldin, 58-1 USTC ¶ 9283, 253 F.2d 551
Waldin, 56-1 USTC ¶ 9347, 138 F.Supp. 791

Gerdes, L. L. (See James, Edward C.)

Gerhard, Erwin v. Carey (See Moll, Ruth v. Carey)

Gerhard, W. Richard .... ¶ 1342.25, 2052.99
• 29 TCM 1153; Dec. 30,334(M); T.C.Memo. 1970-262

Gerhardt, Philip L. (Case, Montgomery B.): Helvering v. .... ¶ 644.42, 644.4201, 5369.06
• **Sup. Ct.**—(rev'g CA-2), 38-2 USTC ¶ 9320; Ct.D. 1343, 1938-2 CB 246; 304 U.S. 405; 58 S.Ct. 969
Wilmette Park Dist., 50-1 USTC ¶ 9105, 338 U.S. 411
Graves, 39-1 USTC ¶ 9411, 306 U.S. 466
Washington Toll Bridge Authority, 62-2 USTC ¶ 15,429, 307 F.2d 330
State Road Dept., Fla., 58-2 USTC ¶ 15,158, 255 F.2d 516
Sims, 58-1 USTC ¶ 9269, 252 F.2d 434
Gunn, 48-2 USTC ¶ 9417, 171 F.2d 36
Shamberg Est., 44-2 USTC ¶ 9446, 144 F.2d 998
State of California, 42-2 USTC ¶ 9483, 129 F.2d 455
La Rochelle, 40-2 USTC ¶ 9792, 115 F.2d 878
Morrissey, 39-1 USTC ¶ 9462, 103 F.2d 234
Stillwell, 39-1 USTC ¶ 9250, 101 F.2d 588
Pickett, 39-1 USTC ¶ 9223, 100 F.2d 909
Washington Toll Bridge Authority, 61-1 USTC ¶ 15,330, 190 F.Supp. 95
Gunn, 47-2 USTC ¶ 9352, 72 F.Supp. 617
Fairbanks, Morse & Co., 46-1 USTC ¶ 9145, 63 F.Supp. 495
State of New York, 43-1 USTC ¶ 9206, 48 F.Supp. 15
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original jurisdiction, which tried the case twice. Furthermore, the *P-H Citator* shows that the BTA decision was reversed by the Third Circuit Court of Appeals and that the text of the Supreme Court decision may be found at 23 AFTR 1084. Whether that decision sustained or reversed the circuit court cannot be determined from the citator. Additional cases in which *Germantown Trust Co.* has been cited are listed but, in order to compile a more complete listing, all five citator volumes must be consulted, that is, volumes 2 and 3 of the AFTR series, volume 1 of the AFTR2d series, and finally the loose-leaf edition covering cases since 1967.

It should be apparent that the *CCH Citator* is the more convenient source for locating a particular case in order to determine its original trial court, to trace its history through the appeals courts, and finally to compile a summary of cases in which the decision was subsequently cited. However, in the case of *Germantown*, the multiple-volume *P-H Citator*, in the aggregate, discloses a larger number of cases in which *Germantown Trust Co.* has been cited than does the one-volume *CCH Citator*. Furthermore, the *P-H Citator* features several other advantages not to be found in the *CCH Citator*, which may be of considerable importance to the careful tax researcher. Most of these advantages will assist the tax adviser in the process of assessing potential tax authority and thus a detailed discussion of these desirable features will be deferred until the following chapter.

Editorial Interpretations

The sheer bulk and complexity of the tax statutes make it humanly impossible for any individual to understand all of the rules and regulations pertinent to a tax practice. Fortunately, the tax practitioner has at his disposal a variety of editorial interpretations ranging from extensive loose-leaf tax services to brief explanations in professional journals and pamphlets, much of which is invaluable to an efficient tax practice.

Tax Services

Perhaps the most significant assistance is available through a subscription to one or more major tax services. Tax services are designed to help quickly locate statutory, administrative, and judicial

authority and to give helpful editorial interpretations of those primary authorities. The various tax services constantly update the information they provide. Subscribers are regularly informed of changes in the statute or regulations, new court decisions and revenue rulings, and other pertinent matters. Nothing is more embarrassing to a practitioner than to plan a tax strategy with an outdated authority. Current subscription tax services are a tremendous timesaving device that the tax practitioner can ill afford to be without.

A practitioner usually begins his research with the service with which he is most familiar. Dependence upon one service, however, can become detrimental. Each service is compiled and maintained by editors with divergent approaches to solving the same tax problem. Consequently, each service develops a distinct interpretive personality. While the salesman representing the publisher may believe that his product is adequate by itself, the experienced researcher will discover that, because of their unique features, most tax services really complement each other.

The key to utilizing each tax service effectively lies in the mastery of its index systems. Access to materials in individual services may be gained through code section numbers, topical references, or both. To demonstrate the individuality of indexes of at least two frequently used tax services, assume the following fact situation. An immediate family member of an important client has become the victim of a political kidnapping. A sizable ransom is demanded and eventually delivered for the release of the victim. Subsequently, a determination must be made as to the deductibility of the ransom payment. If the tax researcher begins his inquiry with the topical index of the Prentice-Hall Tax Service, he will find the entry "ransom money," with a reference to paragraph 7434. However, paragraph 7434 discusses ransom payments only as they constitute income to the extortioner. If the researcher consults the Commerce Clearing House Index, he will find the notation "Ransom payments, theft loss deduction," directing him to paragraph 1571.29 and Revenue Ruling 72-112, which allowed a deduction of ransom payments as a theft loss where the taking of money was illegal under state law and was done with criminal intent.

As one might suspect, Revenue Ruling 72-112 can also be found in the Prentice-Hall Tax Service under the heading "Theft" and a subheading "ransom payments as," with a reference to paragraph 14,407(10). Another key word will bring the same result in the P-H

service. The heading "Extortion" will lead to the subheading "money obtained by" and the reference to paragraph 14,407 (10).

The foregoing example is not designed to recommend one particular index and tax service over another; its purpose is to demonstrate the trial-and-error approach necessary to locate pertinent authority. Furthermore, it also demonstrates the advisability of having more than one tax service available.

To further illustrate this point let us continue with the foregoing example and assume that, instead of representing the family of the kidnapped victim, the tax adviser is representing the kidnapper and must determine the tax aspects of the ransom money that he obtained. In the Commerce Clearing House Index, the heading "ransom" only leads to the deductibility question. In the Prentice-Hall index, the term "Ransom money" refers the researcher to paragraph 7434. This citation gives a synopsis of *James Rutkin*, 343 US 130 (1952), in which the Supreme Court held that money extorted without the victim's consent and through threats of violence is to be included in gross income. In order to locate this authority in the Commerce Clearing House Index, the researcher would have to begin with the key word "extortion," which would lead to the heading "Extortion Payment" and the subheading "income from," paragraph reference 681.242.

In addition to variations in index systems, each tax service is known for specific features that may prove to be helpful, depending upon the research problem in question. A summary of cost, organization, and techniques of supplementation utilized by major tax service publishers can be found in exhibit 4.12, page 126.[19]

The following general comments outline some of the features of each service. Commerce Clearing House and Prentice-Hall publish major tax services annually in loose-leaf binders under the titles *Standard Federal Tax Reporter* and *Federal Taxes*, respectively. In many ways, these two services are similar. Both publications follow the organization of the Internal Revenue Code. Each major division begins with a preliminary discussion introducing the subject in general terms; subdivisions include exact quotations of the

[19] The source for exhibits 4.12, 4.13, and 4.14 is Charles Van Raimond, "CPA Tax Libraries in Texas—Their Content and Use" (master's thesis, the University of Texas at Austin, 1975).

code sections and the related Treasury regulations. In addition, each subdivision contains interpretive explanations by the editorial staff and brief synopses of related court decisions, revenue rulings, and revenue procedures. Each service also features a separate volume containing the most recent developments regarding statutory, administrative, and judicial authority.

Mertens's tax service, entitled *Law of Federal Income Taxation* (Chicago: Callaghan and Co.), is organized on a topical basis and, therefore, does not follow the sequence of the code.[20] The separate loose-leaf volumes of Mertens's service can be divided into two groupings: (1) the treatise volumes, each volume containing scholarly discussions of the various tax topics (statutory, administrative, and judicial authorities are cited in footnote form) and (2) volumes containing the Internal Revenue Code, a code commentary, Treasury regulations, and various rulings and procedures. Although the code commentary volumes do not feature complete texts of the committee reports, the editorial summaries do provide historical background and suggest the apparent congressional intent for many sections. The ruling volumes comprised revenue rulings, revenue procedures, and miscellaneous announcements beginning with 1954. These volumes embody an efficient index system that, in addition to showing the current status of revenue rulings, assists in identifying all rulings issued in connection with a particular Internal Revenue Code section. Because of its encyclopedic approach to the subject matter, the Mertens service is especially helpful to the individual with limited knowledge of the topic to be researched. Due to its scholarly excellence, Mertens is cited in court opinions.

Perhaps one weakness of Mertens is the fact that revised and new material is organized on a cumulative basis and appears in the front of each volume. This makes it somewhat cumbersome to locate the most recent developments on any particular topic. Furthermore, the revision process of Mertens occurs less frequently than that of Commerce Clearing House or Prentice-Hall.

Federal Income, Gift and Estate Taxation (9 vols.), by Jacob Rabkin and Mark H. Johnson (New York: Matthew Bender, Inc.) is a loose-leaf tax service organized by subject rather than by code

[20] See also Jacob Mertens, Jr., *Law of Federal Gift and Estate Taxation* (Chicago: Callaghan and Co., 1969).

Exhibit 4.12
Tax Services

Tax Service	Publisher	Cost*	Index & Organization	Content of Complete Set	Supplementation
Federal Tax Service	Prentice-Hall Englewood Cliffs, New Jersey 07632	[1]$627	Master key-word Index in Volume 1; organized by code section.	16 loose-leaf volumes, including IRC, regs., rulings, and court decisions, editorial analysis and comment, and a citator. [1]Covers income, estate and gift, and excise taxes.	Weekly
Mertens Law of Federal Taxation	Callaghan & Co. 6141 N. Cicero Ave. Chicago, Ill. 60646	$475	Indexed by topic (Vol. 12), and "Tables" (Vol. 11) converting IRC and cases to Mertens paragraph numbers. Sequenced according to Mertens paragraph numbers.	40 volumes; including treatise, IRC, IRC commentary regs; rulings, all as amended. Treatise volume cross-references material to all above-mentioned volumes.	Rulings and regs. supplemented monthly; treatise volumes supplemented quarterly.
Rabkin and Johnson, Federal Income, Gift and Estate Taxation	Matthew Bender & Co. 235 E. 45th St. New York, New York 10017	$195	Indexed by topic, code section, tables of cases and rulings. Organized by topic.	10 volumes; first six deal with tax topics, next four are IRC & legislative history of code sections. Spotlight on commentary, but references included in body of text, rather than as footnotes.	Bi-monthly permanent supplements; other months current matters such as cases, rulings, etc.
Standard Federal Tax Reports	Commerce Clearing House, Inc. 4025 W. Peterson Ave. Chicago, Ill. 60646	[2]$510	Indexed by code section and key-words. Organized by code section.	16 loose-leaf volumes; including IRC, regs., rulings, and court decisions, editorial analysis and comment, and a citator. [2]Covers income, estate and gift, and excise taxes.	Weekly
Tax Coordinator	Research Institute of America 589 Fifth Ave., New York, New York 10017	$417	Indexed by topic and code section. Tables of court decisions, regs., and rulings. Organized by code section.	7 loose-leaf volumes; including statements of law and comments, footnoted to IRC, regs., rulings, and court decisions on each page; managerial approach generally.	Checklist every 2 weeks. Alternate weeks—"Bi-weekly Alert."

Tax Service	Publisher	Cost*	Index & Organization	Content of Complete Set	Supplementation
Tax Management	Bureau of National Affairs 1231 24th St. N.W. Washington, D.C. 20037	[3]$607	Indexed by topic, code section and key-words. Bibliography at the end of each portfolio is referenced to other services & sources.	Series of portfolios dealing with specific code sections and/or procedural matters. Each portfolio includes a detailed analysis, working papers section and bibliography.	26 new or revised portfolios and 26 memorandums issued annually. Updated monthly.
Tax Planning	Institute for Business Planning 2 West 13th St. New York, New York 10017	$156	Indexed by topics, paragraph number; also code section and regs. Tables organized by broad topics.	Oriented toward tax planning. Covers tax strategy, accounting, corporate tax planning, investments, misc. items, research aids.	Updated by monthly memorandums.

[1]Price is for a combination of income, estate and gift, and excise tax services on a one year contract. If purchased on a two year contract, the price would be $564 per year. Each service may be purchased separately at the following prices:

Income	$396 for a one year contract or $360 per year for a two year contract.
Estate and Gift	$102 for a one year contract or $ 84 per year for a two year contract.
Excise	$ 72 for a one year contract—no reduction for a two year contract.

Prentice-Hall also has a three-volume bound citator which may be purchased for an additional $15/volume.

[2]Price is for a combination of income, estate and gift, and excise tax services on a one year contract. If purchased on a two year contract, the price would be $465 per year. Each service may be purchased separately at the following prices:

Income	$385 for a one year contract or $350 per year for a two year contract.
Estate and Gift	$ 85 for a one year contract or $ 75 per year for a two year contract.
Excise	$ 70 for a one year contract or $ 65 per year for a two year contract.

The income and excise tax services may be purchased together for $390 on a two year contract.

[3]Price is for a combination of U.S.-income, estate and gift, and foreign income tax services on a one year contract. If contract is for a renewal, the price would be $552. Each service may be purchased separately at the following prices:

U.S.-Income	$369-new; $337 for a renewal
Estate and Gifts	$138-new; $126 for a renewal
Foreign Income	$255-new; $233 for a renewal

or in various combinations at the following prices:

U.S.-Income and Estate and Gifts	$452-new; $411 for a renewal
U.S.-Income and Foreign Income	$523-new; $476 for a renewal
Estate and Gifts and Foreign Income	$310-new; $284 for a renewal

*Prices shown are accurate as of January 15, 1975 and subject to change without notice. Interested parties should consult publishers.

section. For example, all material dealing with partnerships is found in one cumulative discussion. The Internal Revenue Code and the Treasury regulations are published in separate volumes. One of the outstanding features of the Rabkin and Johnson service is the availability of the legislative committee reports, which are interspersed in the Internal Revenue Code volumes.

The Research Institute of America, Inc., (RIA) publishes *Tax Coordinator,* a compilation of professional tax research. The service is divided into twenty-four separate divisions identified by a lettered tab card. Each division begins with an explanation of all problems in a given area, supported with citations to appropriate authorities. Next is the text of the applicable code section and Treasury regulation. Explanations of latest developments appear immediately following the verbatim reprints of the code and regulations. Editorial explanations include illustrations, planning points, tax traps, and appropriate recommendations.

The Bureau of National Affairs publishes a portfolio tax service entitled *Tax Management.* At present the total service consists of some 150 portfolios that range in length from 50 to 200 pages. Each portfolio deals with a specific tax topic. The organization of the material within each portfolio follows a standard pattern. Part (A) contains a detailed analysis of the subject matter. This analysis is written in narrative form, with extensive footnotes to statutory, administrative, and judicial authority. The format of discussion lends itself to research progressing from general backgrounds through specific problems within the topic under consideration. Part (B) provides helpful working papers, appropriate forms, and illustrations and part (C) includes a bibliography of related resource material.

Previously noted were two special judicial reporter series, namely, the Commerce Clearing House USTC series and the Prentice-Hall AFTR series. To some extent, the cases appearing in these series are "selected" by editorial staffs. In addition, the editors prepare "headnotes" for each case published. Headnotes enumerate the issue(s) contained in each case in brief form and give the court's conclusion. Thus, a researcher may gain a quick understanding of the general subject matter of each case included in either series by simply scanning the headnotes. The researcher must remember, however, that the headnotes are in effect editorial comments and not an integral part of any official opinion.

The decision to subscribe to only one tax service or to several must be made on the basis of how many services a practice can support. However, the tax adviser should keep in mind that, just as two heads are better than one, two or more tax services can increase effectiveness. The real benefit of any tax service lies in the time-saving factor which allows the tax practitioner to quickly find a correct answer to his tax question. However, time constraints in a tax practice make it impossible to consult all available services on every problem. Anticipation of which service will most efficiently direct research to an acceptable solution comes only with experience.

Books

The economics of a tax practice demand that the researcher find solutions quickly and without excessive cost to the client. Consequently, a tax adviser cannot afford the luxury of pulling a full-length book from the shelf and spending a day or two pursuing the subject in leisurely fashion. However, a survey of CPA tax libraries in Texas disclosed that practitioners considered some tax reference books to be invaluable in their tax practice. The three most frequently mentioned books are *Federal Income Taxation of Corporations and Shareholders*, third edition (Boston: Warren, Gorham and Lamont, 1971), by Boris I. Bittker and James S. Eustice; *On Partnership Taxation* (New York: McGraw-Hill, 1971) by Arthur B. Willis; and *The Consolidated Tax Return: Principles, Practice, Planning*, second edition (Boston: Warren, Gorham and Lamont, 1973), by Jack Crestol, Kevin M. Hennessey, and Anthony P. Rua.[21] Their special status implies that they contain information discussed and summarized in a fashion not elsewhere available.

Numerous tax institutes and seminars are held annually throughout the United States. At such institutes, tax topics are discussed and papers are presented that usually deal with significant current issues. Three very popular tax institutes—the New York University Tax Institute, the University of Southern California Tax Institute, and the Tulane Tax Institute—publish their proceedings in annual bound volumes. Because of the emphasis on current and complex topics, tax researchers may benefit from consulting such materials.

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[21] Charles Van Raimond, "CPA Tax Libraries," p. 23.

Tax Magazines

More than a dozen magazines are currently published dealing exclusively with taxation and providing valuable assistance to the tax practitioner. Their formats range from those appealing to the general tax practitioner to those specializing in a particular field of taxation. For example, the *Journal of Taxation* features regular departments dealing with corporations, estates, trusts and gifts, exempt institutions, partnerships, and so on. The *Tax Adviser,* published monthly by the American Institute of Certified Public Accountants, is another popular tax journal for the general practitioner. A relatively new periodical, the *Journal of Real Estate Taxation,* would obviously appeal most to the tax practitioner whose practice includes numerous clients with real estate problems.

To locate pertinent articles in the periodical tax literature, a researcher may consult the cumulative indexes provided in the various issues. A more efficient means of locating journal material is through *CCH Tax Articles,* a three-volume service including a topical index, a code section index, and an author's index. The P-H tax service index volume also contains an "Index to Tax Articles" that is organized by topic using the P-H paragraph index system. For a complete list of available tax magazines that may assist the tax researcher see exhibit 4.13, page 132.[22]

Tax Newsletters

Most tax newsletters are published weekly and are, therefore, excellent sources of the most recent developments. They keep the tax adviser in touch with the dynamics of the tax laws. Occasionally, in scanning a newsletter, a practitioner will spot an item that has relevance to a client's problem. More often, however, the newsletter simply provides the practitioner with ideas that may be recalled and used in later work. See exhibit 4.14, page 134, for a comprehensive listing of the available publications.[23]

How many technical publications a tax adviser should purchase is, of course, an individual decision. Many publications duplicate information and reading all of them would demand too much of a tax adviser's valuable time. The decision must, therefore, be based

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[22] Raimond, "CPA Tax Libraries."
[23] *Ibid.*

on the size and nature of the practice. The larger the firm, the more varied the personalities, and the greater the areas of specialization represented, the greater the variety of subscriptions required.

Computer Assisted Tax Research

Mead Data Central, Inc., has developed a computer storage and retrieval system which is likely to have a far-reaching impact upon future tax research. This system, marketed under the trade name LEXIS, is useful in situations where authority is scarce and a manual search could have overlooked appropriate authority. The inherent speed of the computer also makes the LEXIS system invaluable in situations where authority is voluminous and access must be obtained quickly. The system is thorough and accurate when used by a knowledgeable tax practitioner.

The researcher subscribing to the LEXIS data base communicates with the computer through a terminal (possibly installed in his office) that is connected via telephone lines to the central computer in Dayton, Ohio. Access to the information stored in the computer memory is accomplished through "key-words-in-context." The researcher must select the words (or phrases) likely to be found in the original text of any authority that might be pertinent to the problem at hand. The computer scans all of the documents in its file and indicates via the terminal video screen the number of documents it has that include the selected words. The user may then narrow or expand his original key-word selection, depending upon the computer response. If he uses key words that are too common, the computer simply will have too many entries to justify his looking at each of them. If he uses key words that are too restrictive, the computer will overlook authority that may be pertinent to his problem. For example, if the researcher entered only the words "personal residence" and "sale of," the computer would be likely to locate 500 to 1,000 citations which contain those common words. In order to reduce the number of documents to be examined, the researcher might add the specific phrase "taxpayer 65 or over" and may find that this addition reduces the number of available documents substantially. Complementing this request with "primary residence" may bring the number of applicable documents down to an even more manageable size. When the search has been sufficiently narrowed, the complete text of actual documents can then be re-

Exhibit 4.13
Tax Magazines

Magazine	Cost*	Issues Per Year	Publisher	Coverage
Estate Planning	$18	4	Journal of Taxation P.O. Box 2721 Tampa, Florida 33601	coverage. Specialized estate planning
The Journal of Corporate Taxation	28	4	Warren, Gorham and Lamont 89 Beach St. Boston, Mass. 02111	Corporate tax planning articles by tax practitioners.
The Journal of Real Estate Taxation	28	4	Warren, Gorham and Lamont 89 Beach St. Boston, Mass. 02111	Tax planning with emphasis on real estate transactions.
Journal of Taxation	42	12	Journal of Taxation P.O. Box 2721 Tampa, Florida 33601	Comprehensive coverage of current tax developments.
The Monthly Digest of Tax Articles	17	12	Research and Documentation Corp. 14 Plaza Road Greenvale, N.Y. 11548	Digest of tax articles published in various magazines.
National Tax Journal	13	4	National Tax Assn. & Fund for Public Policy Research Suite 805 1730 M St. N.W. Washington, D.C. 20036	Tax policy orientation; frequent theoretical economic analysis.
Oil and Gas Tax Quarterly	41.60	4	Matthew Bender & Co. 1275 Broadway Albany, N.Y. 12201	Specialized coverage of oil and gas taxation topics.
The Practical Accountant	12	12	Institute for Continuing Professional Development 964 3rd Ave. New York, N.Y. 10022	Includes selected articles on taxation for the general practitioner.

The Real Estate Review	28	4	Warren, Gorham and Lamont 89 Beach St. Boston, Mass. 02111	Includes articles dealing with taxation topics in real estate.
The Tax Adviser	36	12	American Institute of CPA's 1211 Ave. of Americas New York, N.Y. 10036	Current tax developments, estate planning techniques, tax practice management.
The Tax Executive	10	4	Tax Executives Institute Suite 812 425 13th St. N.W. Washington, D.C. 20004	In-depth articles of particular interest to corporate tax executives written by tax professionals, scholars, and management executives.
Tax Law Review	13.75	4	Warren, Gorham and Lamont 89 Beach St. Boston, Mass. 02111	Usually contains 2-3 in-depth articles on particularly complex areas of taxation, also has "Selected Tax Readings"—synopsis of 7-9 recently published articles and books.
The Tax Lawyer	15	4	American Bar Assn. Section of Taxation 1705 DeSales St. N.W. Washington, D.C. 20036	In-depth coverage of tax topics for the lawyer in tax practice.
Taxation for Accountants	24	12	Journal of Taxation 125 East 56 St. New York, N.Y. 10022	General coverage of tax topics for the accountant in general tax practice.
Taxation for Lawyers	18	6	Journal of Taxation P.O. Box 2721 Tampa, Florida 33601	General coverage of tax topics for the lawyer in general tax practice.
Taxes—The Tax Magazine	20	12	Commerce Clearing House, Inc. 4025 West Peterson Ave. Chicago, Ill. 60646	Selected articles covering current tax developments, includes section dealing with tax laws.
Trusts and Estates	24	12	Communication Channels, Inc. 461 Eighth Ave. New York, N.Y. 10001	Specialized emphasis on estate and trust taxation and estate planning.

*Prices shown are accurate as of January 15, 1975, and subject to change without notice. Interested parties should consult publishers for latest prices.

Exhibit 4.14
Tax Newsletters

Newsletter	Cost*	Issues Per Year	Publisher	Coverage
Accountant's Weekly Report	$ 60	52	Prentice-Hall Englewood Cliffs, N.J. 07632	Current developments in government regulations, accounting practices, and taxation of businesses.
Acquisitions, Dispositions and Distributions	60	12	Alexander Hamilton Institute 235 East 42nd St. New York, N.Y. 10017	Tax implications of mergers, acquisitions, dispositions, and distributions.
Daily Tax Report	467	365	Bureau of National Affairs, Inc. 1231 25th St. N.W. Washington, D.C. 20037	Summary and analysis of developments in taxation and finance for preceding 24 hours.
Estate Planning Ideas	36	26	Institute for Business Planning 2 New York Plaza New York, N.Y. 10004	Report on tax aspects of estate planning.
Estate, Trust and Gift Taxes Interpreted	27	26	Alexander Hamilton Institute 235 East 42nd St. New York, N.Y. 10017	Report on current developments in estate, trust, and gift taxation.
Federal Taxes Report Bulletin	24	52	Prentice-Hall Englewood Cliffs, N.J. 07632	Weekly reprint of bulletin sent to tax service subscribers; general coverage of weekly developments, some planning ideas.
J. K. Lasser Tax Report	36	24	Business Reports, Inc. 1 West Ave. Larchmont, N.Y.	General coverage of tax developments.
Kess Tax Practice Report	36	24	Warren, Gorham and Lamont 89 Beach St. Boston, Mass. 02111	General coverage of day to day tax problems; emphasis on tax planning.
Kiplinger Tax Letter	28	26	The Kiplinger Washington Editors 1729 H St. N.W. Washington, D.C. 20006	General coverage of major tax developments.
Matthew Bender Tax Letter	28	24	Matthew Bender & Co. 1275 Broadway Albany, N.Y. 12201	General coverage of current developments in taxation.
Non-Profit Organization Tax Letter	45	18	Organization Management Inc. Box 9902 Washington, D.C. 20015	Current developments in taxation as may affect tax exempt organizations.

Real Estate Tax Ideas	36	12	Warren, Gorham and Lamont 89 Beach St. Boston, Mass. 02111	Tax analysis of real estate transactions for real estate professionals.
Tax Barometer	68	26	Federal Publications 1725 K St. N.W. Washington, D.C. 20006	Digest and analysis of current tax developments.
The Tax Consultant	21	12	National Tax Training School Monsey, N.Y. 10952	Emphasis on individual taxation.
Tax Notes	45	52	Tax Analysts and Advocates 732 17th St. N.W. Washington, D.C. 20006	Tax analysis prepared by a public interest firm.
Tax Planning Ideas	60	24	Institute for Business Planning 2 New York Plaza New York, N.Y. 10004	Tax ideas for future business planning.
Tax Report of Banking and Trusts	58	24	Warren, Gorham and Lamont 89 Beach St. Boston, Mass. 02111	Current tax developments concerned with banks and trusts.
Tax Research Institute a) Bi-weekly alert b) Planning Report	60	26 ea. (sent alternately—52 total)	Research Institute of America 509 Fifth Ave. New York, N.Y. 10019	Current tax developments written with emphasis on tax planning. Also tax return guides and opportunity checklists.
Tax Wrap-Up	60	24	Tax Wrap-Up 14 Plaza Road Greenvale, N.Y. 11548	Current developments in taxation.
Taxes Interpreted	38.50	26	Alexander Hamilton Institute 235 E. 42nd St. New York, N.Y. 10017	Interprets and analyzes current developments in taxation.
Taxes on Parade	20	52	Commerce Clearing House 4025 W. Peterson Ave. Chicago, Ill. 60646	Weekly reprint of report sent to tax service subscribers; general coverage of weekly developments.
U.S. Tax Week	75	52	Matthew Bender & Co. 1275 Broadway Albany, N.Y. 12201	Digest and commentary of current tax developments.

*Prices shown are accurate as of January 15, 1975 and subject to change without notice.

trieved on the video screen and, if necessary, printed out in hard copy. The critical difference between a computer search and a manual search is in the key words. Successful retrieval in the computer system depends upon the correct identification of key words actually used in a tax authority; in the manual system it depends upon identification of the key word selected by the preparer of an index.[24] Nevertheless, experience with one system is usually helpful in the other.

At the present time the LEXIS data bank includes the following documents:

The Internal Revenue Code of 1954 (as amended)
Final, temporary, and proposed Treasury regulations pertaining to the code
The *Cumulative Bulletins* beginning in 1954
Tax Court decisions from 1942
Tax Court memorandum decisions from 1968
Tax cases decided by the district courts from 1970
Tax cases decided by the Court of Claims from 1942
Tax cases decided by the courts of appeals from 1945
Tax cases decided by the Supreme Court from 1913
Public laws beginning with the 1954 Internal Revenue Code
House, Senate, and Conference committee reports associated with the 1954 code and amendments to the code

Ultrafiche

Maintaining a complete tax library often requires expensive office space. To partially alleviate the space problem, Commerce Clearing House has employed an ultrafiche technique to reproduce up to 1,700 pages on a single four-by-six-inch transparent plastic card. These cards are read on viewers, similar to those used with

[24] The LEXIS terminal can also access the accounting data banks of the AICPA's National Automated Accounting Retrieval System (NAARS). This system operates through Mead Data Central's research service and gives the user access to a data bank containing complete accounting information on over 6,000 corporate annual reports, Accounting Research Bulletins, Accounting Principles Board Opinions, Statements on Auditing Standards and all future pronouncements of the Financial Accounting Standards Board. Detailed information can be obtained from the Information Retrieval Department of the AICPA.

microfilm, which may be equipped with printing capacity. At the present time the following texts have been reproduced by CCH using this technique:

	Original Publisher
Board of Tax Appeals Report (1924-1942)	GPO
United States Tax Court Reports (1943-present)	GPO
Cumulative Bulletins (1919-present)	GPO
United States Tax Court (1913-present)	CCH
Tax Court Memorandum Decisions (1943-present)	CCH

This entire collection of ultrafiche plastic plates is filed in CCH loose-leaf binders and requires less than one foot of shelf space.

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. . . as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.

JUDGE LEARNED HAND

Assessing and Applying Authority

After a tax researcher has located authority that seems pertinent to his problem, the important task of assessing that material begins. His aim is to arrive at a course of action that he can confidently communicate to his client along with identification of the risks and costs accompanying it.

Locating appropriate authority for a particular tax problem is only half the battle. The technical jargon of many portions of the Internal Revenue Code and Treasury regulations requires the tax adviser to read and comprehend unusually complex sentences in order to determine congressional intent; other portions of the code and regulations hinge upon deceptively simple words or phrases whose definitions may be debatable. Furthermore, while available secondary authorities or such interpretive sources as Treasury regulations, revenue rulings, or court decisions may be more comprehensible than are primary statutory authorities, they are frequently less authoritative.

The researcher faces another, more serious hurdle when authorities conflict. The applicable law may be questionable due to conflicts between statutes or between interpretations of those statutes, between the IRS interpretations and various federal courts, and

among the courts themselves at various levels of jurisdiction. Finally, a researcher may be unable to locate any authority at all on a particular problem.

In attempting to assess authority and apply it to complex practice problems, the researcher may encounter any one of four fundamentally different situations. The first involves clear, concise tax law that could be applied if the researcher were able to gather additional facts from his client. In two other circumstances, the adviser may be in possession of clearly established facts but finds (1) conflicting statutes or (2) conflicting interpretations of those statutes. Finally, a researcher may encounter a fourth situation in which existing tax law is incomplete or inapplicable, requiring him to resolve issues through interpolation from related authorities and application of creative thinking.

The Law Is Clear—the Facts Are Uncertain

A tax adviser frequently finds it difficult to reach a conclusion and to make a recommendation more because of insufficient knowledge of the facts in the case than because of confusion in the applicable rules. In many situations, the biggest single problem is gathering sufficient evidence to support the taxpayer's contention that he be granted the tax treatment clearly authorized in a specific provision of the Internal Revenue Code.

To illustrate this kind of problem, assume that a client, Mr. Jerry Hill, includes what he describes as a "$16,000 casualty loss" with the information he provides for the filing of his income tax return. A cursory line of questioning by his tax adviser reveals that the loss is claimed for a handwoven Indian wall carpet that, the client claims, was chewed and clawed to bits by a stray dog. Mr. Hill explains that while on vacation last summer, he left his residence in the care of his housekeeper. Apparently one day the housekeeper neglected to close a door securely and a stray dog wandered into the house. Upon the Hills' return from vacation, they were told the following story. Attracted by strange noises, the housekeeper entered the study and found a dog gnawing and tearing on the wall rug. As the housekeeper entered the room, the dog turned and ran growling from the house. Although not certain of it the housekeeper reported noticing foam around the dog's mouth. Later a neighbor said that a rabid dog had been seen roaming the neighborhood. The house-

keeper, who cared for Hill's own dogs, stated that the dog discovered in the study was not one of Mr. Hill's. Mr. Hill checked with the city dogcatcher concerning the reported sighting of a mad dog. He was, however, unable to confirm any such report with the dogcatcher. He did not check with the police department.

Through a little research, the tax adviser is convinced that in order for Mr. Hill to qualify for a casualty loss deduction under Section 165(a) he must satisfy the following specific requirements:

1. The loss must have been sudden and unexpected. (*Matheson* v. *Commissioner,* 54 F2d 537 (CA-2, 1931).)
2. The loss could not constitute a mysterious disappearance. (*Paul Bakewell, Jr.,* 23 TC 803 (1955).)
3. The amount of the loss deduction is limited to fair market value (FMV) immediately before the casualty occurred, less the FMV immediately after the casualty, less any insurance recovery, and less a $100 floor. (Treas. Regs. Sec. 1.165-7(b).)
4. The loss could not be attributable to the taxpayer's own dog. (*J. R. Dyer,* 20 TCM 705 (1961).)

At this point a tax adviser would be faced with two alternatives: he could accept his client's statement at face value and claim the deduction, or he might suggest that the client accumulate additional substantiation of the loss if he desires to claim the deduction. If an adviser follows the former alternative he is simply postponing the collection of evidence until a possible audit by the IRS, because the presence of a rather sizable casualty loss on a client's tax return undoubtedly would increase the risk of an audit. Furthermore, it might be self-defeating to defer the collection of evidence because two or three years from now individuals who could render statements on matters now fresh in their minds may be unavailable, or they may not recall necessary details. Furthermore, helpful police records may be destroyed. Since the taxpayer may be unaware of what is needed to substantiate the loss deduction, he may, in the meantime, dispose of important evidence, such as the ruined rug.

If a tax adviser pursues the second alternative, he should present his client with a list of instructions and suggest that the client accumulate the necessary evidence to support the deduction in the event of an audit or eventual litigation. The list could include the following items:

1. Sworn statements from
   (a) the housekeeper and (b) the individual who sighted the apparently rabid dog in the neighborhood.
2. Appraisal by a qualified expert or experts showing the value of the rug before and after the casualty.
3. Color photographs of the rug before and after the casualty.
4. Instructions to retain the damaged rug as evidence, if possible.
5. Statements from, or correspondence with, insurance agents relative to the amount of any insurance recovery.
6. Purchase invoice showing proof of ownership and cost.

A client may ignore an adviser's request or he may be unable to obtain all of the evidence recommended. Nevertheless, the adviser will have informed his client on a timely basis of the requirements necessary to sustain the right to the deduction claimed.

In tax research work involving situations in which tax laws are clear but the facts of the situation are in question, it behooves the tax adviser to establish the facts necessary to reach a conclusion and either to accumulate appropriate supporting evidence or to suggest that his client do so. Then, in the event of an audit, the tax adviser would have only to persuade a revenue agent to accept the mass of overwhelming evidence and, therefore, to reach the conclusion desired.

The Facts Are Clear—the Law Is Questionable

The tax researcher may encounter another kind of problem involving situations where facts are well established but the law is uncertain. Uncertainty may arise either because of conflicting or ambiguous statutes or because of conflicting interpretations of a statute, the latter of which is the more common.

Conflicting Statutes

Although it is rather rare, the facts of a problem sometimes can be analyzed in light of two entirely different provisions of the statute, with each provision furnishing a different tax result. It is reasonable under these circumstances for the tax adviser to report the transactions under that section of the Internal Revenue Code that would produce the lowest tax liability for his client. In this

situation the adviser and his client should be prepared for a possible IRS challenge.

In *Haserot* v. *Commissioner,* 41 TC 562 (1964), the Tax Court was faced with an apparent conflict in statutory authority. The facts of that case reveal that a taxpayer transferred stock in two companies that he owned to a third corporation in exchange for that corporation's stock and "boot" (cash). After the transfer, the taxpayer owned more than 82 percent of the third corporation's stock. Accordingly, the taxpayer treated the transaction as a nontaxable transfer under Section 351, with "boot" received in the transfer taxable as a capital gain. The government, on the other hand, claimed that Section 304 was controlling. Having to choose one of these statutory provisions, the Tax Court said in part:

> Both parties present a multiplicity of arguments as to which section controls. If section 351 controls, the gain is to be taxed as a capital gain. If section 304 controls, then the gain is to be taxed as a capital gain or the $64,850 cash payment is to be taxed as a dividend, depending upon the relevant parts of section 302.
>
> • • • •
>
> We have no reason to believe that Congress had any intent with regard to the fact pattern of this case. However, the statements in sections 301(a) and 302(d), "except as otherwise provided in this chapter [or subchapter]" of the Code, indicate that Congress made the policy decision that dividend treatment will result from the application of section 302 only if no other provision in the relevant parts of the Code requires other treatment. Section 351 has no such limitation. That section is, by its terms, applicable. That section provides for tax treatment of the payment in question in a manner other than and different from the distribution treatment provided for by sections 302(d) and 301. Consequently, the very words of the latter sections preclude dividend treatment in this case.[1]

The rather dubious conclusion reached by the Tax Court rests importantly on a very careful reading of the code. It suggests, in fact, that no statutory conflict exists even though the net result seems clearly to be inconsistent with the general intent of Section 304. Fortunately, conflicting statutory authority is rare; when it is discovered, however, the taxpayer should be prepared to litigate his

[1] Henry McK. Haserot, 41 TC 562 (1964).

right to rely on the more advantageous provision.

In a few instances, the drafters of the Internal Revenue Code anticipated the possible application of two provisions of the statute to the same fact situation and provided a statutory resolution of the conflict. For example, Section 368(a)(2)(A) explicitly provides that a corporate reorganization that satisfies both the rules of a type C and a type D reorganization, shall be treated as a type D reorganization only. Unfortunately, not all conflicts in the statutes are so easily resolved.

Conflicting Interpretations

A tax researcher more frequently encounters conflicting interpretations of tax statutes by various authorities. Conflicts may be found between the Treasury regulations and the code, between the Treasury regulations and the courts, or between two federal courts. In such situations, the tax adviser must consider the alternatives and weigh the risks—including the cost of lengthy administrative battles with the IRS and potential litigation—before recommending a particular conclusion or course of action.[2] While it is the responsibility of the tax adviser to discover conflicting interpretations of the statutes and to advise his client of the risks and alternatives, the client should decide which course of action to pursue. Although only the client can decide whether to incur the costs of an administrative or legal confrontation with the IRS, he generally relies heavily on the recommendation of his tax adviser in reaching that decision. Other pertinent considerations include the general inconvenience associated with such disputes, the risk of exposure to additional audits, and the possibility of adverse publicity.

Regulations Versus Individual Interpretation. During his research efforts, every tax adviser will form a personal opinion concerning the validity of specific regulations. Sometimes a tax adviser may have serious reservations concerning the Treasury's interpretation of a statute and may so inform his client. However, to plan a tax strategy that depends solely on having a particular segment of the Treasury

[2] For additional discussion of factors to be considered by a CPA in giving tax advice, see American Institute of Certified Public Accountants, Statement on Responsibilities in Tax Practice No. 8, "Advice to Clients" (New York: American Institute of Certified Public Accountants, 1970).

regulations declared invalid is certainly a high-risk proposition. Nevertheless, if all other attempts to sustain a client's position fail, legal counsel may advise a taxpayer to challenge the validity of a Treasury regulation.

In analyzing the validity of a specific regulation, a tax researcher should determine, among other things, the "age" of that regulation. Perhaps a life in excess of ten years would categorize a regulation as "old" and anything short of ten years would warrant the designation "new." Old regulations—especially those that have been unsuccessfully challenged in the courts—should be considered as the equivalent of the statute itself. This is especially true if, subsequent to the unsuccessful court action, Congress revised other segments of the statute but left unchanged the provision that had been challenged. An example of a situation in which a regulation was challenged and later upheld by the courts can be found in *Paul J. Ussery*.[3] In this instance the taxpayer took issue with the construction of Treas. Regs. Sec. 1.117-4, which excludes from the terms "fellowship" and "scholarship" any payments granted for academic work performed primarily for the benefit of the grantor. Because Congress amended the Internal Revenue Code subsequent to the *Ussery* decision but did not further clarify Section 117, one might assume that Congress has given its approval to the court's interpretation in *Ussery*. This conclusion is frequently stated by the court; see, for example, *Helvering* v. *Winmill*, 305 US 79 (1938).

Tax advisers should generally consider "old" regulations that have never been challenged to be well established. Most attempts to overturn old regulations through court action would be futile while the possibility of successfully challenging a "new" regulation is significantly greater. Before challenging a new regulation, however, the tax adviser should determine the kind of regulation in question.[4] The likelihood of a successful challenge will be very slim if the regulation has been issued under specifically delegated authority. In the

[3] Paul J. Ussery v. U.S., 296 F2d 582 (CA-5, 1961).

[4] An example of statutory regulations are those under Sec. 1502, where Congress delegated the authority to the Treasury secretary in the consolidated tax return area. Another example of statutory regulations will be forthcoming when the Treasury exercises its authority under Section 385 where the secretary or his delegate has been granted authority to prescribe regulations that would offer guidelines for purposes of determining whether an interest in a corporation is either debt or equity.

event that a tax adviser feels that a new and previously untested interpretive regulation construes a statute contrary to the intent of Congress, he must obtain legal counsel before embarking upon an all-out battle against the regulation.

Regulations Versus Courts. If a regulation has already been challenged, one of three possible outcomes may exist. First, the Internal Revenue Service may have lost the challenge and either revised or withdrawn the contested regulation. Second, the government may have lost one or more specific tests of the regulation but still be unwilling to concede defeat. Third, the IRS may have been able to defend a regulation successfully, and, therefore, further attempts to challenge that regulation would not hold much promise.

During the sixties, an interesting and prolonged conflict developed between certain Treasury regulations and a number of court decisions beginning in 1954 with the *Kintner* decision.[5] Prior to 1962, self-employed professionals, who were unable to incorporate under state law, could not deduct for tax purposes contributions made to profit-sharing or pension plans.[6] At the same time, a tax deduction for contributions to similar plans was available to corporations. In order to obtain the benefits available to corporations, professional partnerships attempted to assume the characteristics of associations, which qualify as corporations for tax purposes. These characteristics were first established in *Morrissey* and later adopted in the Treasury regulations.[7]

In opposing the classification of professional partnerships as "corporate associations," the commissioner lost numerous court battles. In an attempt to strengthen its position, the Treasury amended the regulations barring corporate treatment for unincorporated professional partnerships. This move resulted in the passage of state laws permitting the formation of professional corporations.

In a further move to strengthen the service's position, Subsection

[5] U.S. v. Kintner, 216 F2d 418 (CA-9, 1954).

[6] In 1962 the "H.R. 10" or "Keogh" plan was passed by Congress and allowed self-employed individuals a contribution deduction for retirement plans of up to the lesser of $2,500 or 10 percent of earned income. The amounts were amended in 1974 to read $7,500 and 15 percent, respectively.

[7] See Morrissey v. Commissioner, 296 US 344 (1935), and Treas. Regs. Sec. 301.7701-2.

(h) was added to Treas. Regs. Sec. 301.7701-2 on February 2, 1965. Subsection (h) provided that all professional corporations would be taxed for federal income tax purposes as partnerships, even if incorporated under state professional corporation acts. Interested taxpayers declared war on the so-called Kintner regulations and consistently won one decision after another.[8] The issue was finally settled when, on August 8, 1969, the IRS announced that henceforth organizations formed under state professional corporation acts would be treated for tax purposes as corporations.[9] Unfortunately, however, the Treasury regulations have not yet been fully amended to reflect this change of heart by the IRS.

During the time of controversy, tax advisers and their clients were faced with the options of accepting the Treasury regulations at face value or of casting their lot with court decisions, which time after time proved to be successful for the taxpayer. Many taxpayers were willing to invest time and assume the risk and expense of battling the IRS through administrative appeals procedures and the courts. While in this instance the final result was favorable to the taxpayers, in other conflicts taxpayers have been less successful.[10]

What has been said here concerning conflicting authority between Treasury regulations and judicial opinions is, obviously, equally applicable to conflicting authority between judicial opinions and revenue rulings, revenue procedures, and other official IRS pronouncements. While any dispute between the IRS and the courts is still in progress, taxpayers with similar questions become prime targets for future litigation if they adopt a position contrary to the service's. The service is often looking for a "better" fact case (from its point of view) or for a more favorable circuit in which to litigate further. Any time a tax adviser recommends a position contrary to that of the Internal Revenue Service, even if that contrary position is adequately supported by judicial authority, the adviser should also explain to the client the potential risks and extra costs implicit in taking that position.

[8] See, for example, U.S. v. Empey, 406 F2d 157 (CA-10, 1969); O'Neill v. U.S., 410 F2d 888 (CA-6, 1969); Kurzner v. U.S., 413 F2d 97 (CA-5, 1969).

[9] TIR No. 1019, *Federal Taxes,* (P-H, 1969), par. 55, 334.

[10] See, for example, B. Foreman Co., Inc. v. Commissioner, 453 F2d 1144, (CA-2, 1972), which deals with the creation of income issue under IRC Sec. 482.

As far as revenue agents, district conferees, and appellate conferees are concerned, the IRS position is the law, and they will challenge a departure from this position. A tax adviser should recommend an intentional disregard of the official IRS position only if his client is aware of the potential disagreement and the possible need to litigate.

One Court's Interpretation Versus Another's. Disagreements between courts on similar issues can be characterized as "horizontal" and "vertical." Horizontal differences mean conflicting opinions issued by courts at the same level of jurisdiction; vertical differences refer to conflicts between lower and higher courts. Horizontal differences can occur between federal district courts, between the Tax Court and a district court, and between the several circuit courts. In such conflicts, the service is under no obligation to follow, on a nationwide basis, the precedent set by either court. Thus, a district court opinion favorable to the taxpayer would technically have precedent value only for a taxpayer residing within the jurisdiction of that district court. Similarly, any circuit court opinion technically has precedent value only within the circuit where the decision originated because one circuit court is not bound to follow the precedent of another. If appealed, conflicting district court opinions, from district courts within the same circuit, are settled by the appropriate circuit court. The Supreme Court, if it grants *certiorari,* settles conflicts between circuits. Prior to the time that a circuit court or the Supreme Court disposes of such opposing views, the tax adviser and his client should be fully aware of the risks involved when relying on a court decision that may subsequently be appealed and overturned.

An interesting example of conflict between courts involves employee expenses for transportation of the tools of one's trade. Relying on Rev. Rul. 63-100,[11] which allowed a musician an automobile expense deduction for the transportation of his musical instrument between his personal residence and his place of employment, a taxpayer deducted his driving expenses because he transported a thirty-two-pound bag of tools to work each day. The Tax Court denied the deduction; however, the Second Circuit reversed and remanded the case to the Tax Court. On rehearing, the Tax Court allowed 25 per-

[11] Rev. Rul. 63-100, 1963-1 CB 34.

cent of the total driving expenses claimed by the taxpayer.[12] Subsequently, in *Fausner* and in *Hitt,* two airline pilots, who were required by their employers and by government regulations to carry extensive flight gear, attempted to deduct transportation expenses between their home and the airport. In *Fausner,* the Tax Court felt constrained by the *Sullivan* decision since Fausner resided in the Second Circuit, and it allowed the deduction for the 1965 tax year.[13] However, because Hitt resided in the Fifth Circuit, the Tax Court, ruling on the same day, disregarded *Sullivan* and disallowed the deduction.[14] Fausner's returns for 1966 and 1967 were again challenged by the Internal Revenue Service on the same issue, and Fausner once more petitioned the Tax Court to rule on the matter. Although Fausner had resided in New York during 1966 and 1967, he had moved to Texas in 1968 and was thus petitioning from the Fifth Circuit in the latter years. In this instance, the Tax Court sustained the service as it had done previously in *Hitt,*[15] Fausner appealed to the Fifth Circuit and received an adverse ruling.[16] At this point a conflict between the Second and the Fifth Circuit courts existed and the Supreme Court granted *certiorari* on an appeal from *Fausner.*[17] The Supreme Court finally settled the controversy by ruling against the taxpayer.[18]

The foregoing example demonstrates both horizontal and vertical differences in judicial decisions. In horizontal differences, a taxpayer cannot rely on a decision rendered by another court at the same level of jurisdiction, because courts at the same level of jurisdiction simply are not bound by decisions of other courts at that same level. Vertical differences are harder to explain because lower courts generally are bound by decisions of higher courts. In the case of the Tax Court, however, even vertical differences may exist because the Tax Court has national jurisdiction. The Tax Court con-

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[12] Sullivan v. Commissioner, 368 F2d 1007 (CA-2, 1966) and 27 TCM 620 (1971).

[13] Fausner v. Commissioner, 66 TC 620 (1971).

[14] Hitt v. Commissioner, 55 TC 628 (1971).

[15] Fausner v. Commissioner, P-H TC Memo para. 71,277.

[16] Fausner v. Commissioner, 472 F2d 561 (CA-5, 1973).

[17] Actually the conflict between the circuits involved another decision, in which the court held for the taxpayer (Tyne v. Commissioner, 385 F2d 40 (CA-7, 1967)).

[18] Fausner v. Commissioner, 93 S.Ct. 2820 (1973).

siders itself bound by the decisions of the circuit courts of appeals only to the extent that taxpayers reside in the jurisdiction of a circuit court that has rendered a decision on that issue.

Since the Tax Court is *not* obligated to accept any circuit court opinion on a nationwide basis, it has ample opportunity to express its displeasure with a circuit court opinion by disregarding it in fact cases involving taxpayers from other circuits. Such a result can be demonstrated with two cases, in which the Tax Court arrived at opposing conclusions, involving two "50-50" stockholders in the same Subchapter S corporation where each taxpayer had sued on an identical issue. In both *Doehring*[19] and *Puckett*,[20] the issue to be decided revolved around whether or not the two taxpayers' loan company had lost its Subchapter S status. The IRS had previously disallowed the election on the grounds that more than 20 percent of the corporation's gross revenue was derived from interest (passive income). The taxpayers, relying on *House* v. *Commissioner*, 453 F2d 982 (CA-5, 1972), argued that the ceiling did not apply to loan companies. The Tax Court ruled against the taxpayer in *Doehring*, stating that *House* did not apply since *Doehring* would be appealed to the Eighth Circuit. In *Puckett*, however, the Tax Court upheld the taxpayer's contention, although disagreeing with it, since appeal would be to the Fifth Circuit in which *House* was controlling. The decision leaves both taxpayers in a precarious situation. If Doehring could win his case on appeal to the Eighth Circuit, then two circuit courts will have ruled for the taxpayer, making the government's position relatively weak. On the other hand, if the Eighth Circuit should rule for the government, then two circuit courts' opposing decisions would increase the possibility that the Supreme Court may wish to grant *certiorari* to settle the conflicting opinions. At this point, either both will come out winners or both will end up losers.[21] Thus, before beginning any appeals pro-

[19] K. W. Doehring v. Commissioner, CCH Dec. No. 32, 762 (M), Sept. 10, 1974, TC Memo 1974-234.

[20] P. E. Puckett v. Commissioner, CCH Dec. No. 32, 763 (M), Sept. 10, 1974, TC Memo 1974-235.

[21] In the event that the Supreme Court rules against the taxpayer, the government may wish to appeal the *Puckett* decision provided this can be accomplished on a timely basis. Nevertheless, Puckett's position in future years will have to comply with the Supreme Court decision.

cedures, Doehring must consider the possibility of a loss that would reverse his fellow stockholder's present favorable position.

One taxpayer recently tested the commissioner's right to ignore established judicial precedent. In that case the IRS sent deficiency notices to two taxpayers claiming that certain distributions received from their corporation were dividends. Two stockholders challenged the deficiency assessment in the Tax Court. While taxpayer Divine's suit was pending, the Tax Court ruled against taxpayer Luckman.[22] Upon appeal, however, the Seventh Circuit reversed the Tax Court.[23] The commissioner pressed on with the same position he had taken in *Luckman* and obtained another favorable ruling from the Tax Court in *Divine*.[24] Taxpayer Divine then appealed to the Second Circuit Court, claiming that where the commissioner is relitigating an issue that he has previously lost and the facts are distinguishable only by virtue of the identity of the taxpayer, the commissioner should be barred from again bringing suit. Although the Second Circuit Court held for taxpayer Divine, it struck down his contention that the commissioner was prevented from bringing suit.[25]

The Facts Are Clear—the Law Is Incomplete

As explained earlier, whenever a statute is silent or imprecise on a particular tax question, a tax researcher must consult such other interpretive authorities as Treasury regulations, revenue rulings, or court decisions. In his search for interpretive material, a tax adviser soon discovers that finding authority with facts identical to his own will be the exception rather than the rule. In most circumstances, therefore, the ability to distinguish cases on the basis of facts becomes critical, for many times it is necessary to piece together support for the researcher's position from several authorities.

An illustration of this third class of common tax problems follows. Assume that a client, an Austrian named Werner Hoppe, presents the following facts. Werner visited his brother, Klaus, who had immigrated to the United States six years ago and resides in Dallas, Texas. At the time of the visit, Werner was under contract to an Austrian soccer team and was expected to return to the team to

[22] Sid Luckman, 50 TC 619 (1968).
[23] Luckman v. Commissioner, 418 F2d 381 (CA-7, 1969).
[24] Harold S. Divine, 59 TC 152 (1972).
[25] Divine v. Commissioner, 500 F2d 1041 (CA-2, 1974).

begin play for the fall 1974 season. Werner's brother Klaus had fallen in love with American football and had become an enthusiastic fan of the Dallas Cowboys. The Cowboys had recently lost their regular kicker, Toni Fritsch, to an injury; and a replacement, picked up on waivers, proved to be less than satisfactory. Knowing of Werner's kicking ability, Klaus was convinced that Werner could help the Cowboys if given an opportunity. Klaus, therefore, contacted Toni Fritsch, who is also a former Austrian, and suggested a tryout. Klaus also took Werner to a Cowboy workout and introduced him to the kicking coach. As a result of the contact with Toni Fritsch and the visit with the kicking coach, Werner was given a tryout by the Cowboys, who were desperate for a good kicker. Werner's performance was far superior to others at the tryout, and the Cowboys offered him the kicking job. Werner, however, was reluctant to accept the offer because he had planned to return to Austria in a few weeks to continue his soccer career. Considerable encouragement from Klaus and the Cowboy organization seemed to be in vain until the Cowboys, at Klaus's suggestion, offered Werner a $40,000 bonus. At this point Werner overcame his reluctance and signed a contract, which Klaus cosigned as witness and interpreter. Economically speaking, the regular salary offered by the Cowboys was considerably more attractive than was Werner's salary as a soccer player in Austria. Grateful to his brother for assisting as an interpreter and negotiator, and for encouraging him to stay, Werner instructed the Cowboys to pay $15,000 of the negotiated bonus directly to Klaus. Klaus reported the $15,000 as other income on his 1974 income tax return and paid the appropriate tax. After examining Werner's 1974 tax return, the IRS made a deficiency assessment claiming that the $15,000 paid to Klaus constituted income to Werner and should thus be included in his income under Section 61(a)(1). The IRS agent relied at least in part upon the authority of *Richard A. Allen*, 50 TC 466 (1968).

After determining the foregoing facts, the tax researcher decides that, according to the language of Treas. Regs. Sec. 1.61-2(a)(1), the total bonus payment should be included in Werner's return. The regulations specify that, in general, wages, salaries, and bonuses are income to the recipient unless excluded by law. After additional research, the tax adviser locates the decision in *Cecil Randolph Hundley, Jr.*, which appears to contain a similar fact situation.[26] In

[26] Cecil Randolph Hundley, Jr., 48 TC 339, acq. 1967-2 CB 2.

Hundley, to which the commissioner acquiesced, the taxpayer included the bonus payments in his income, but he was allowed a business expense deduction for that portion of the bonus paid to his father. Before relying solely on the authority of *Hundley*, the tax adviser must be certain that the facts of *Hundley* are in effect substantially similar to Werner's situation and that the expense of further negotiations with the IRS is warranted and based on a sound premise. Thus, the tax adviser will carefully compare the *Allen* and *Hundley* cases with the facts presented by Werner Hoppe. In doing this the adviser might prepare the following list of facts.

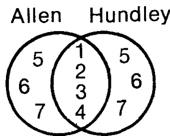
Allen	*Hoppe*	*Hundley*
1. Professional baseball player received sizable bonus.	1. Professional football player received sizable bonus.	1. Professional baseball player received sizable bonus.
2. Taxpayer was amateur prior to signing contract.	2. Taxpayer was professional soccer player prior to signing contract.	2. Taxpayer was amateur player before signing contract.
3. Parent and ball-playing minor child signed professional ball contract.	3. Ballplayer alone signed contract, but brother signed as witness and interpreter.	3. Parent and ball-playing minor child signed professional ball contract.
4. Some bonus payments were actually made to mother.	4. Some bonus payments were actually made to brother.	4. Some bonus payments were actually made to father.
5. Mother knew little about baseball.	5. Brother had average knowledge of football.	5. Father was knowledgeable in baseball and taught his son extensively.
6. Mother was passive participant in negotiations for contract and bonus.	6. Brother was an active participant in negotiations for contract and bonus.	6. Father handled most of the negotiations for a contract and bonus.
7. No oral agreement existed.	7. No oral agreement existed.	7. Oral agreement existed on how to divide the bonus payments.

Because *Allen* was decided for the government and *Hundley* for the taxpayer, it may be important to distinguish the two cases on the basis of facts. Utilizing a simple diagram technique, we begin with seven facts identified in each case.

Figure 5.1

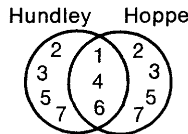
Next the researcher should identify those issues that are very similar in both cases, and those that are more readily distinguishable.

Figure 5.2



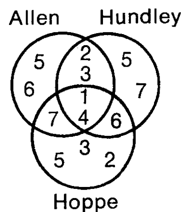
The second diagram shows that facts one through four are "neutral" in that they are nearly identical in both cases, and that the important facts, which perhaps swayed the outcome of the *Hundley* case in favor of the taxpayer, appear to be facts five through seven. Comparing Hundley with Hoppe produces the following result.

Figure 5.3



This diagram shows that *Hoppe* and *Hundley* agree in facts one, four, and six only. The following comparison of all three fact situations might provide additional insight for the tax adviser.

Figure 5.4



This analysis shows that facts one and four are neutral in all three cases and perhaps should not be considered to have an impact upon the final outcome. Fact two, dealing with the professional status of Hoppe, which can be distinguished from both Allen and Hundley, might significantly bolster Hoppe's claim for an ordinary and necessary business expense under Section 162. Hoppe has already established his business as a professional athlete; fact three, the signing of the contract by Hoppe alone (again distinguished from Allen and Hundley), seems to support the fact that Klaus was needed in the negotiations as an interpreter, the capacity in which he signed the contract. Facts five and six, which indicate the degree of expertise exhibited by the respective relatives of each ballplayer and the role played by the relatives in the contract negotiations, seem to be of much greater significance. In Hundley's and Hoppe's cases both relatives took active roles in negotiating final contracts. In *Hundley*, the father was knowledgeable about baseball and contract negotiations. Hoppe's situation is certainly similar. Klaus exhibited an ability to negotiate by recommending that a bonus be offered, and he displayed his expertise as an interpreter. The final fact—number seven—in which *Allen* and *Hoppe* are distinguished from *Hundley*, appears to be a liability to Hoppe's position and weakens his case considerably.

The foregoing analysis demonstrates a situation in which the statute is incomplete and a taxpayer and his adviser must rely on equally incomplete interpretive materials. Careful analysis indicates that previous interpretations appear to apply to some but not all the existing facts. Once a thorough examination of the facts and a review of the applicable authority have been completed, a decision must be made about the course of action. Possible risks must be evaluated and additional expenses must be estimated, before the decision to contest the deficiency assessment is made. Consultation with legal counsel concerning litigation hazards will assist the taxpayer in deciding whether to carry the case beyond administrative procedures into the courts.

The Facts Are Clear—the Law Is Nonexistent

It is possible that a tax researcher may discover that his problem is not clearly covered by any statutory, administrative, or judicial authority. In such circumstances, the tax adviser has an opportunity to utilize whatever powers of creativity, logical reasoning, and per-

suasion he possesses. Since the revenue agent making an examination likewise will have little authority to substantiate any proposed adjustment, it is up to the tax adviser to present a convincing argument in support of his client's position. However, as stressed throughout this chapter, before the tax adviser proceeds with a course of action, the client should be advised of the possible risks and expenses associated with it. In these circumstances, the client may want to ask the IRS for a letter ruling before he reaches a final decision.

We have suggested that in all questionable situations the cost and risk factors be considered before reaching a conclusion. Risk should be interpreted as any possible adverse consequence that might occur as a result of a specific course of action adopted by the taxpayer. One must ask whether the questionable treatment of a particular item on the return will trigger an examination, and whether such an examination is likely to subject other items on the return to scrutiny and a possible proposed adjustment.[27] Furthermore, proposed adjustments on one year's tax return may lead to similar adjustments on a prior year's return. Thus, in addition to developing a strong case against the IRS claims, potential risks must be considered in the final decision process in the treatment of all tax matters. At the same time one should not forget that the cost of disputing a tax liability is generally deductible. For the taxpayer in a high marginal tax bracket, this may be a point in favor of continuing a dispute with the IRS.

Working With the Citator

In addition to its usefulness in locating appropriate authority, the citator can assist in the assessment process. Throughout this chapter we have observed how conflicting interpretations of the code by taxpayers, their tax advisers, the IRS, and the courts result in considerable litigation. In the litigation process, court decisions sometimes are appealed and, subsequently, either affirmed or reversed by the appropriate appellate court. Furthermore, it should be apparent that, while a particular court decision may support a taxpayer's

[27] A questionable treatment should not be confused with an illegal treatment. The former refers to items supported by adequate authority which lend themselves to honest disagreement between taxpayers and IRS.

position, subsequent decisions by the same court or by other courts may reverse a previous decision. It is imperative, therefore, that the researcher carefully investigate the judicial history of any decision before placing much emphasis on it. The citator can assist the researcher in this evaluative process. Verifying the judicial history of a particular case can be accomplished effectively only through the *P-H Citator;* the *CCH Citator* simply does not include the information necessary to make this determination. To illustrate, let us return to exhibit 4.6, page 116. The entry in the *CCH Citator* for the *Germantown Trust Co.* case discloses that *Germantown* was cited in *Automobile Club of Michigan,* 353 US 180 (1957). Because the latter case was decided by the Supreme Court, it would be important to know which issue was involved and whether or not the Supreme Court upheld its earlier decision in *Germantown Trust Co.* Such information cannot be gleaned from the *CCH Citator.* As shown in exhibit 4.10, page 120, the *P-H Citator* lists information similar to that found in the *CCH Citator.* However, the symbol "n-1" precedes the *Automobile Club* citation, and similar symbols precede other cases in which *Germantown* was cited. The P-H symbol explanation sheet (see exhibit 5.1, page 158), discloses that "n" denotes that *Germantown* was cited only in a dissenting opinion. The number "1" in connection with the symbol "n" refers the reader to the corresponding headnote number in the AFTR series, which identifies the issue involved. A further examination of cases in which *Germantown* was cited (exhibit 4.10) indicates that issue "3" is most frequently cited, that in one instance *Germantown* was "explained"; and that in another instance it was "distinguished." (See exhibit 5.1 for an explanation of the terms *explained* and *distinguished,* as well as other interpretive symbols.)

How the *P-H Citator* can assist the researcher can be demonstrated with the decision reached by the Supreme Court in *Wilcox,* 327 US 404 (1946). In this decision the Supreme Court held that embezzled money does not constitute taxable income to the embezzler. The Supreme Court overruled the *Wilcox* decision in *James,* 366 US 213 (1961). The extract from the *P-H Citator* shown in exhibit 5.2, page 159, reveals that *Wilcox* was cited on various issues in *James* and that in *James* the court overruled *Wilcox* on issues three, four, and nine. Thus, reliance on *Wilcox,* simply because it represented a Supreme Court decision, would be ill advised.

Before a researcher relies explicitly upon the authority of any

Exhibit 5.1
Prentice-Hall Citator Symbols

Court Decisions

Judicial History of the Case

a	affirmed (by decision of a higher court)
d	dismissed (appeal to higher court dismissed)
m	modified (decision modified by higher court, or on rehearing)
r	reversed (by a decision of a higher court)
s	same case (e.g. on rehearing)
rc	related case (companion cases and other cases arising out of the same subject matter are so designated)
x	certiorari denied (by Supreme Court of the United States)
(C or G)	The Commissioner or Solicitor General has made the appeal
(T)	Taxpayer has made the appeal
(A)	Tax Court's decision acquiesced in by Commissioner
(NA)	Tax Court's decision nonacquiesced in by Commissioner
sa	same case affirmed (by the cited case)
sd	same case dismissed (by the cited case)
sm	same case modified (by the cited case)
sr	same case reversed (by the cited case)
sx	same case—certiorari denied

Syllabus of the Cited Case

iv	four (on all fours with the cited case)
f	followed (the cited case followed)
e	explained (comment generally favorable, but not to a degree that indicates the cited case is followed)
k	reconciled (the cited case reconciled)
n	dissenting opinion (cited in a dissenting opinion)
g	distinguished (the cited case distinguished either in law or on the facts)
l	limited (the cited case limited to its facts. Used when an appellate court so limits a prior decision, or a lower court states that in its opinion the cited case should be so limited)
c	criticized (adverse comment on the cited case)
q	questioned (the cited case not only criticized, but its correctness questioned)
o	overruled

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Exhibit 5.2
Prentice-Hall Citator Extract

WILBUR—contd
f-1—Meyer, Leon R. & Lucile H., 46 TC 103, 46 P-H TC 72
1—McGah, E. W. & Lucille, 1961 P-H TC Memo 61-862, 863
1—Laidley, Inc., 1961 P-H TC Memo 61-1007
1—Taft, John S. & Virginia M., 1961 P-H TC Memo 61-1241
1—Marin Canalways & Dev. Co., Inc., 1961 P-H TC Memo 61-1870
e-1—Louisquisset Golf Club, Inc., 1962 P-H TC Memo 62-1758
e-1—Evwalt Development Corp., 1963 P-H TC Memo 63-257
1—Esrenco Truck Co., The, 1963 P-H TC Memo 63-334
e-1—Schine Chain Theatres, Inc., 1963 P-H TC Memo 63-565
e-1—Schine Chain Theatres, Inc., 1963 P-H TC Memo 63-567
1—Merlo Builders, Inc., 1964 P-H TC Memo 64-209
1—Gen. Alloy Casting Co., 1964 P-H TC Memo 64-987
f-1—Gardens of Faith, Inc., 1964 P-H TC Memo 64-1161
1—Catalina, Homes, Inc., 1964 P-H TC Memo 64-1496 [See 5 AFTR2d 1556, 279 F2d 661-662]
1—Brahms, James J., 1964 P-H TC Memo 64-1564
e-1—Thomas Machine Mfg. Co., 1964 P-H TC Memo 64-1798, 64-1800
1—Smith, George T. & Clela V., 1964 P-H TC Memo 64-1860
1—Barclay Co., 1964 P-H TC Memo 64-1877
f-1—Rouse, Randolph D., 1964 P-H TC Memo 64-2021 [See 5 AFTR2d 1556, 279 F2d 662]
1—Old Dominion Plywood Corp., 1966 P-H TC Memo 66-784, 66-785
1—Peco Co., 1967 P-H TC Memo 67-230
1—Jaffee, Leon S. & Fern, 1967 P-H TC Memo 67-658
WILCOX, C. B. 27 BTA 580
1—Baltimore, Stuart L. & Glennis M., 1958 P-H TC Memo 58-336
1—Letter Ruling, 3-6-57, 1957 P-H 76,371
WILCOX, CO-EXEC. v U.S., 5 AFTR2d 1949, 185 F Supp 385 (DC Ohio, 5-27-60)
WILCOX; COMM. v, 327 US 404, 34 AFTR 811
James v U.S., 7 AFTR2d 1380, 366 US 257, 81 S Ct 1075, 6 L Ed 2d 275
g—Prokop v Comm., 1 AFTR2d 1430, 254 F2d 555 (USCA 7)
Dixie Machine Welding & Metal Works, Inc. v U.S., 11 AFTR2d 1083, 315 F2d 440 (USCA 5) [See 327 US 408, 34 AFTR 814]
e—Pitoscia; U.S. v, 15 AFTR2d 271, 238 F Supp 140 (DC NJ) [See 327 US 408, 34 AFTR 814]
Stromberg, Isaac, Est. of, 1962 P-H TC Memo 62-1455 [See 327 US 405-407, 34 AFTR 813]
g—Nelson, Frederic A. & Doris R., 1964 P-H TC Memo 64-658
1—Mandel v Comm., 229 F2d 387, 48 AFTR 909 (USCA 7)
1—Smith v U.S., 2 AFTR2d 5525, 257 F2d 134 (USCA 10)
1—Piel v Comm., 15 AFTR2d 256, 340 F2d 890 (USCA 2)
e-1—Buder, Exec. v U.S., 17 AFTR2d 069, 071, 354 F2d 944 (USCA 8)
1—Tunnell, Jr. v U.S., 148 F Supp 696, 50 AFTR 1859 (DC Del)
1—Silverman, Alex and Doris, 28 TC 1068, 28-1957 P-H TC 603
3—James v U.S., 7 AFTR2d 1376, 366 US 249, 81 S Ct 1071, 6 L Ed 2d 270
o-3—James v U.S., 7 AFTR2d 1362, 366 US 257, 81 S Ct 1053, 6 L Ed 2d 251, 1961-2 CB 11
g-3—Briggs v U.S., 214 F2d 700, 45 AFTR 1814 (USCA 4)
g-3—Smith v U.S., 2 AFTR2d 5525, 257 F2d 134 (USCA 10)
3—Beck v U.S., 9 AFTR2d 771, 298 F2d 624 (USCA 9)
3—Miss. Chemical Co.; U.S. v, 13 AFTR2d 445, 326 F2d 573 (USCA 5)
3—McGuire; U.S. v, 15 AFTR2d 597, 347 F2d 101 (USCA 6)
q-3—Geiger, Est. of v Comm., 16 AFTR2d 5808, 352 F2d 225 (USCA 8)
e-3—Peelle; U.S. v, 1 AFTR2d 1447, 159 F Supp 53 (DC NY)
q-3—Parr, In re, 10 AFTR2d 5479, 5482, 205 F Supp 495, 498 (DC WVa)
q-3—Pitoscia; U.S. v, 15 AFTR2d 267, 238 F Supp 136 (DC NJ)

WILCOX—contd
g-3—Fidelity-Phila. Trust Co., 23 TC 532, 23-1954 P-H TC 332
q-3—Muldrow, L. M. & Helen B., 38 TC 912, 38 P-H TC 693
o-3—Rev. Rul. 61-185, 1961-2 CB 9
o-4—James v U.S., 7 AFTR2d 1362, 366 US 249, 81 S Ct 1053, 6 L Ed 2d 251, 1961-2 CB 11
4—James v U.S., 7 AFTR2d 1365, 1371, 366 US 222, 81 S Ct 1057, 6 L Ed 2d 255
4—James v U.S., 7 AFTR2d 1376, 366 US 249, 81 S Ct 1071, 6 L Ed 2d 270
q-4—Macias v Comm., 1 AFTR2d 1664, 255 F2d 26 (USCA 7)
g-4—Smith v U.S., 2 AFTR2d 5525, 257 F2d 134 (USCA 10)
f-4—Adams, Est. of v Comm., 12 AFTR2d 5262, 5263, 320 F2d 813 (USCA 5)
e-4—Peelle; U.S. v, 1 AFTR2d 1447, 159 F Supp 53 (DC NY)
q-4—Parr, In re, 10 AFTR2d 5479, 5482, 205 F Supp 495, 498 (DC WVa)
q-4—Muldrow, L. M. & Helen B., 38 TC 912, 38 P-H TC 693
4—McDaniel, R. D., Est. of, 1961 P-H TC Memo 61-1706
4—Emerson, Newell W. & Collete M., 1965 P-H TC Memo 65-1058, 65-1059
4—Kenny, John C., 1966 P-H TC Memo 66-1026
o-4—Rev. Rul. 61-185, 1961-2 CB 9
5—James v U.S., 7 AFTR2d 1365, 366 US 222, 81 S Ct 1057, 6 L Ed 2d 255
5—James v U.S., 7 AFTR2d 1376, 366 US 249, 81 S Ct 1071, 6 L Ed 2d 272
5—Ward v Comm., 224 F2d 552, 47 AFTR 1477 (USCA 9)
5—Wyss; U.S. v, 239 F2d 660, 50 AFTR 1205 (USCA 7)
5—Miss. Chemical Co.; U.S. v, 13 AFTR2d 443, 326 F2d 571 (USCA 5)
f-5—Midvale Co., The v U.S., 129 Ct Cl 492, 124 F Supp 683, 46 AFTR 815
e-5—Peelle; U.S. v, 1 AFTR2d 1447, 159 F Supp 53 (DC NY)
5—Miss. Valley Portland Cement Co. v U.S., 20 AFTR2d 5798 (DC Miss)
n-5—Caldwell, James E. & Co., 24 TC 615, 24-1955 P-H TC 330
5—Pigman, Luerana, 31 TC 369, 31-1958 P-H TC 215
g-5—Woods, George & Betty, 1958 P-H TC Memo 58-598
5—McDaniel, R. D., Est. of, 1961 P-H TC Memo 61-1706
6—James v U.S., 7 AFTR2d 1365, 1367, 366 US 222, 223, 81 S Ct 1057, 6 L Ed 2d 255
6—James v U.S., 7 AFTR2d 1376, 366 US 249, 81 S Ct 1071, 6 L Ed 2d 272
6—Mandel v Comm., 229 F2d 387, 48 AFTR 909 (USCA 7)
g-6—Smith v U.S., 2 AFTR2d 5525, 257 F2d 134 (USCA 10)
6—Beck v U.S., 9 AFTR2d 771, 298 F2d 624 (USCA 9)
g-6—Wallace; U.S. v, 9 AFTR2d 1118, 1119, 300 F2d 531; 532 (USCA 4)
6—Miss. Chemical Co.; U.S. v, 13 AFTR2d 443, 326 F2d 571 (USCA 5)
6—Piel v Comm., 15 AFTR2d 256, 340 F2d 890 (USCA 2)
g-6—McGuire; U.S. v, 15 AFTR2d 597, 347 F2d 101 (USCA 6)
f-6—Midvale Co., The v U.S., 129 Ct Cl 492, 124 F Supp 683, 46 AFTR 815
e-6—Peelle; U.S. v, 1 AFTR2d 1447, 159 F Supp 53 (DC NY)
f-6—Pittsburgh Milk Co., (Dissolved), The, 26 TC 716, 26-1956 P-H TC 411
f-6—Rosedale Dairy Co., Inc., 1957 P-H TC Memo 57-952
6—Harmony Dairy Co., 1960 P-H TC Memo 60-655
6—Schwartz, Abe M., Est. of, 1960 P-H TC Memo 60-772
7—James v U.S., 7 AFTR2d 1377, 366 US 250, 81 S Ct 1071, 6 L Ed 2d 271
o-9—James v U.S., 7 AFTR2d 1362, 366 US 249, 81 S Ct 1053, 6 L Ed 2d 251, 1961-2 CB 11
9—James v U.S., 7 AFTR2d 1365, 366 US 222, 81 S Ct 1057, 6 L Ed 2d 255
9—James v U.S., 7 AFTR2d 1376, 366 US 249, 81 S Ct 1071, 6 L Ed 2d 272

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particular judicial decision, he should take the few minutes it requires to trace that case through the *P-H Citator* to be sure that subsequent developments did not render the case invalid for his purpose.

In addition to the *P-H Citator*, Shepard's Citations, Inc., publishes a comprehensive legal citator that can assist tax researchers in tracing the history and current status of any case.[28] Since *Shepard's Citations* includes almost all federal and state cases, the publication consists of numerous volumes, requiring extensive space. While it may not be economically feasible to include Shepard's citator in a typical tax library, it can be found in nearly all law libraries and the tax researcher may wish to make use of it in unusual circumstances.

[28] *Shepard's Citations* (Colorado Springs, Colo.: Shepard's Citations, Inc.).

6

True ease in writing comes from art,
not chance,
As those move easiest who have
learned to dance.

ALEXANDER POPE

Communicating Tax Research

Throughout this tax study we have used the terms *tax researcher* and *tax adviser* synonymously. If a distinction could be made between the two forms of practice, it would be based on the tax *adviser's* task of reporting the conclusion that has been so painstakingly pieced together. While some tax conclusions can be communicated orally, much of the information gathered by a tax researcher must eventually be placed in writing as either internal or external documentation. The task of writing introduces two major problems for the practitioner. First, the ability of some to write well is more often than not an acquired trait, the result of practice and more practice. Second, communicating the conclusions of tax research requires the ability to perceive how much or how little to express. This task is complicated by the fact that highly technical solutions frequently must be distilled into layman's language. Also, the tax adviser often must hedge on his solution because, as discussed in chapter 5, a definitive answer simply is not available in every case. In addition, the tax adviser must, to protect his own professional integrity, foresee potential future claims against him. Like writing skill, the ability to determine precisely what needs to be said usually

can be improved through practice. In larger offices, every inexperienced tax researcher should be given an early opportunity to present much of his initial research in written form. A new researcher should also be assigned the responsibility of preparing draft copies of correspondence that will be subsequently reviewed by a supervisor for weaknesses in writing style and technical presentation. Experience and assistance can mold a good researcher into a good advisor with a mastery of writing style and an ability to pinpoint the finer information required in tax documents.

The form in which a written tax communication appears is determined by the audience for which it is intended. Some documents are prepared for internal purposes, or firm use, only. Other documents, such as client letters, protest letters, and requests for rulings, are prepared for an external audience. In the following pages we will illustrate the appropriate formats and contents of some of the more frequently encountered communications. Of course, firm policies often dictate specific formats and procedures; nevertheless, certain basic features are universal to most tax communications.

Internal Communications

Within the accounting firm, the client file is the basic vehicle used to communicate specific client information between the various levels of the professional staff. Pertinent information concerning each client's unique facts is contained in the file in the form of memos and working papers.

Memo to the File

A memo to the file may be initiated as a result of any one of several developments. Often such memos are the result of a client's request—in person, over the telephone, or in a letter—for a solution to a tax problem. The importance of facts in tax research was explained in chapter 2; a memo to the file is commonly used to inform the researcher of the underlying facts needed to identify issues, locate authorities, and reach solutions. In most large offices the initial contact with the client occurs at the partner or manager level, while much of the actual research will be performed by a staffman. It is critical, therefore, that accurate information be communicated be-

tween the various levels of the professional staff. A typical memorandum to the files may appear as follows.

October 30, 1975

TO: Files

FROM: Tom Partner

SUBJECT: Potential exchange of common voting stock for preferred nonvoting stock in Allemania Electronic, Inc.

Today Tim Dietz, financial vice-president of Electric Supply Co., called to request information concerning the tax consequences of a proposed recapitalization in Allemania Electronic, Inc., an 85 percent-owned subsidiary. Allemania was acquired by Electric on June 1, 1971, and has been carried in the financial statements as a temporary investment on the equity basis. The auditors of Electric (Meyerson, Garner, and Leavitt) are now insisting that continued association with Allemania would require the inclusion of the subsidiary in Electric's financial statements on a fully consolidated basis. The directors of Allemania are not in favor of such a disclosure and have suggested that Allemania exchange sufficient common voting stock for preferred nonvoting stock to reduce Electric's ownership in the form of voting stock from 85 percent to 50 percent or below. The board hopes, through the reduction of ownership in voting stock, that inclusion of Allemania on a consolidated financial basis with Electric can be avoided. At the present time Electric and Allemania join in the filing of a consolidated tax return on a May 31, fiscal-year basis. Responsibility for preparation and filing of the return rests with Electric's internal tax department, which we review on an annual basis. Tim Dietz requested that our report reach him prior to Electric's next board meeting, scheduled for November 22, and he requested that we contact him personally for additional information.

The information contained in the above memo should be sufficient for the researcher to begin his work. Furthermore, the memo communicates a specific deadline and indicates that the client is willing to supplement this information with additional facts if necessary.

A less formal procedure is often followed when a long-established client calls the tax adviser for an immediate answer to a routine tax question on a well-defined, uncontroversial topic. If the tax adviser gives an oral reply, he should place the conversation in writing, thus creating a record for the files. Such a record serves as protection

against subsequent confusion or misinterpretation that may jeopardize the tax adviser's professional integrity, and it can serve as a basis for billing the client.[1]

Leaving Tracks

Once the necessary information has been recorded in a memo to the files, the researcher may begin his task of identifying questions and seeking solutions. Supporting documents for his conclusions, such as excerpts from or references to specific portions of the Internal Revenue Code, Treasury regulations, revenue rulings, court decisions, tax service editorial opinions, and periodicals, should be put in the files. All questions and conclusions should be appropriately cross-indexed to facilitate subsequent retrieval of the information. Pertinent information in supporting documents should be highlighted to avoid unnecessary reading. Examples of the content and organization of a client's file are presented in chapter 7.

Because time is the most important commodity any tax adviser has for sale, a well-organized client file is of the utmost importance; it can eliminate duplication of effort. Supervisory review of a staff person's research can be accomplished quickly, and additional time is saved if and when it becomes necessary to refer to a client's file months, or even years, after the initial work was performed. Such a delayed reference to a file may be required because of subsequent IRS audits, preparation of protests, and/or the need to solve another client's similar tax problem. Because promotions, transfers, and staff turnover are common occurrences in accounting firms, well-organized files can be of significant help in familiarizing new staff members with client problems.

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[1] The question of whether oral advice should be confirmed in writing arises frequently. The AICPA subcommittee on responsibilities in tax practice makes the following recommendation: "Although oral advice may serve a client's needs appropriately in routine matters or in well-defined areas, written communications are recommended in important, unusual or complicated transactions. In the judgment of the CPA, oral advice may be followed by a written confirmation to the client. A written record will limit misunderstandings and provide a basis for future discussions, reference, planning and implementation of suggestions." AICPA, Statement on Responsibilities in Tax Practice No. 8, "Advice to Clients" (New York: American Institute of Certified Public Accountants, 1970).

Another time-saving device used by practitioners is the tax subject file. To prepare such a system, members of the practitioner's tax staff contribute tax problems together with documented conclusions, which are then pooled and arranged on a subject basis. In a multioffice firm such files are duplicated, in some instances on microfilm, and made available to each office. A subject file can eliminate many hours of duplicative research.

External Communications

A tax practitioner's written communication to an external audience takes on added significance because it demonstrates professional expertise, renders professional advice, and exposes professional reputation. Perhaps the most frequently encountered external document in a CPA's tax practice is the client letter. Communication with the Internal Revenue Service on behalf of a client to protest a deficiency assessment or to request a ruling for a proposed transaction are also quite common.

Client Letters

In a client letter the tax adviser expresses his professional opinion to those who pay for his services. The significance of a client letter can perhaps best be expressed as follows:

> Tax opinion letters are emerging as a new work product for tax professionals. Anyone who has written such a letter knows why he said what he said and has reasons for discussing certain items in more or less detail. It is no easy task to balance the proper degree of necessary technicality with everyday English, trying all the while to foresee any misunderstanding that could arise and to write only what is meant. The ability to write good tax opinion letters has become one of the finer attributes of the tax practitioner.[2]

The detailed format of client letters may vary from one firm to another. Most good client letters, however, have several things in common.

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[2] W. J. DeFillips, "Developing a Tax Department in a Growing Organization," *Journal of Adviser's Accountancy*, June 1974, p. 64.

Style. Like a good speaker, a good writer must know his audience before he begins. Because tax clients vary greatly in their own tax expertise, it is important to consider the technical sophistication of a client or his staff when composing a tax opinion letter. The style of a letter may range from a highly sophisticated format, which includes numerous technical explanations and citations, to a simple composition that utilizes only laymen's terms. In many situations, of course, the best solution lies somewhere between the two extremes.

Format and Content. Regardless of the degree of technical sophistication, a well-drafted client letter follows a well-planned format. It should begin with an enumeration of the facts upon which the tax adviser's research is based. In conjunction with a statement of the facts, a statement of caution (see "Disclaimer Statements," page 168) should be included to warn the client that the research conclusions stated are valid only for the specified facts. Next, the letter should state the important tax questions implicit in the previously identified facts. Finally, the tax practitioner should list his conclusions and the authority for those conclusions. An example of appropriate form and typical content of a client letter is shown in chapter 7. Additional examples can be examined in the AICPA's Tax Study No. 4, *Tax Practice Management*, by William L. Raby.[3]

A client letter may identify areas of controversy (or questions that are not authoritatively resolved) that might be disputed by the Internal Revenue Service. Some highly qualified tax advisers seriously question the wisdom of including any discussion of disputable points in a client letter because that letter may end up in the possession of a revenue agent at a most inopportune time. Furthermore, by authority of Section 7602, the IRS has the right to examine all relevant books, papers, and records containing information relating to the business of a taxpayer liable for federal taxes. Tax accountants are well aware that documents in their possession, relating to the computation of a client's federal tax liability, are not considered privileged communication. A recent study disclosed that in only fourteen out of thirty-two federal tax cases in which the question

[3] William L. Raby, Tax Study No. 4, *Tax Practice Management* (New York: American Institute of Certified Public Accountants, 1974).

of privileged communication was litigated did the courts grant a privilege to certain tax-related communications. All of those granted were either under an attorney-client or Fifth Amendment privilege—never under an accountant-client privilege.[4] The accountant in tax practice is thus faced with a dilemma. If a client letter discloses both the strengths and weaknesses of the client's tax posture, exposure of the letter to a revenue agent may considerably weaken the client's position and even assist the revenue agent in preparing his case. On the other hand, if the potential weaknesses of the position are not clearly communicated to the client, the tax adviser exposes himself to potential legal liability for inappropriate advice. Although many advisers do not agree, we believe that client letters should contain comprehensive information, including some reference to the more vulnerable factors which could expose the client to potential challenge by the IRS. In our opinion, full disclosure and self-protection against claims by clients, which may endanger the professional reputation of all tax practitioners, is more important than the risk of an IRS challenge. Any disclosure of weaknesses must be carefully worded, and the client should be cautioned in advance to control possession of the letter.

The issue of privileged communication is most frequently raised in connection with tax fraud cases, and, in the long run, a tax practitioner will do his practice more good by preserving his professional reputation than by protecting those few clients who may be guilty of tax fraud. In situations where a CPA suspects that fraud may be involved, he should immediately refer the client to an attorney for all further work. If the attorney believes that the accountant may be of assistance, he may reengage the accountant and thereby possibly extend his privilege to the accountant's workpapers.[5]

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[4] Walter V. Arnold, "Privileged Communications for the Tax Accountant" (unpublished professional report, the University of Texas at Austin, 1974). Although fifteen states plus Puerto Rico have enacted accountant-client privileged communication statutes, they are without authority in federal matters.

[5] See Marvin J. Garbis and William H. Burke, "Fifth Amendment Protection of the Accountant's Workpapers in Tax Fraud Investigations," *Taxes*, January, 1969, p. 20. See also Gaylord A. Jentz, "Accountant Privileged Communications: Is It a Dying Concept Under the New Federal Rules of Evidence?" *American Business Law Journal*, Fall 1973, pp. 149-60.

Disclaimer Statements. Tax advisers deal with two basically different situations. In the case of after-the-fact advice, the tax practitioner must assure himself that he understands all of the facts necessary to reach a valid conclusion. Incomplete or inaccurate facts may lead the adviser to an erroneous conclusion. In planning situations, where many of the facts are still "controllable," the tax adviser must assure himself that he fully understands the client's objective and any operational constraints on achieving that objective. Furthermore, planning situations frequently involve lengthy time periods during which changes in the tax laws may occur, thus possibly changing the recommended course of action. Statement No. 8, issued by the AICPA responsibilities in tax practice subcommittee, noted some of the problems associated with new developments in tax matters.

> The CPA may assist clients in implementing procedures or plans associated with the advice offered. During this active participation, the CPA continues to advise and should review and revise such advice as warranted by new developments and factors affecting the transaction.
>
> Sometimes the CPA is requested to provide tax advice but does not assist in implementing the plans adopted. While developments such as legislative or administrative changes or further judicial interpretations may affect the advice previously provided, the CPA cannot be expected to communicate later developments that affect such advice unless he undertakes this obligation by specific agreement with his client. Thus, the communication of significant developments affecting previous advice should be considered extraordinary service rather than an implied obligation in the normal CPA-client relationship.[6]

On the advisability of including some type of disclaimer statement in a client letter, the same subcommittee stated:

> Experience in the accounting and other professions indicates that clients understand that advice reflects professional judgment based on an existing situation. Experience has also shown that clients

[6] AICPA, Statement on Responsibilities in Tax Practice No. 8.

> customarily realize that subsequent developments could affect previous professional advice. Some CPAs use precautionary language to the effect that their advice is based on facts as stated and authorities which are subject to change. Although routine use of such precautionary language seems unnecessary based on accepted business norms and professional relationships, the CPA may follow this procedure in situations he deems appropriate.[7]

In summary, the AICPA subcommittee concludes that a disclaimer statement is *not* required. The authors of this study, however, are of the opinion that client letters generally should contain disclaimer statements as a matter of policy. In our opinion, the client letter should include a brief restatement of the important facts, a statement to the effect that all conclusions stated in the letter are based on those specific facts, and a warning to the client of the dangers implicit in any changes or inaccuracies in those facts. In the case of tax-planning engagements, we also recommend that the tax practitioner include a warning that future changes in the law could jeopardize the planned end results. An example of such a disclaimer statement in client letters appears in chapter 7.

Protest Letters

Another external document commonly prepared by the tax practitioner is the "protest" of a client's tax deficiency as assessed by the Internal Revenue Service. Although written protests are not required for a district conference if the proposed tax deficiency does not exceed $2,500, prospects of an appeal to the appellate division often dictate the early preparation of a written protest. The Internal Revenue Service suggests that a protest include the following information:

1. A statement that you want to appeal the findings of the examining officer to the District Conference Staff or to the Appellate Division, as the case may be.
2. Your name and address (the residence address of individuals;

[7] *Ibid.*

the address of the principal office or place of business of corporations).

3. The date and symbols on the letter transmitting the proposed adjustments and findings you are protesting.

4. The taxable years, periods, or returns involved.

5. An itemized schedule of adjustments of findings with which you do not agree.

6. A statement of facts supporting your position in contested factual issues. This statement and all major evidence submitted with the protest is to be declared true under penalties of perjury. This may be done by adding to the protest the following declaration, signed by the taxpayer as an individual or by an authorized officer of a corporation:

> Under the penalties of perjury, I declare that I have examined the statement of facts presented in this protest and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete.

7. Instead of the declaration required in 6 above, if your representative prepares or files the protest, he may substitute a declaration stating:
   (a) Whether he prepared the protest and accompanying documents, and
   (b) Whether he knows personally that the statements of fact contained in the protest and accompanying documents are true and correct.

8. A statement outlining the law or other authority upon which you rely. This statement is not required in offer in compromise cases based solely on doubt of collectibility.[8]

In principle, the body of a protest follows the format of a client letter in that the protest specifies important facts, delineates contested findings, and lists the authority supporting the taxpayer's position. An example of a typical protest letter follows.

[8] Internal Revenue Service Publication No. 5, "Right of Appeal and Preparing Protests for Unagreed Cases—Income, Estate, Gift, and Excise and Employment Taxes" (Washington, D.C.: Government Printing Office, 1975).

July 14, 1975

District Director of
Internal Revenue
Federal Building
Salt Lake City, Utah 84101

Re: Intermountain Stove, Inc.
1408 State Street
Moroni, Utah 84646

Corporate income taxes for the year ended 12/31/73

Sir:

Reference is made to your letter of May 23, 1975 (Reference—B:S:59-A:FS:rs), which transmitted a copy of your examining officer's report dated May 8, 1975, covering his examination of Intermountain Stove, Inc.'s corporate income tax return for the year ended December 31, 1973. In the report, the examining officer recommended adjustments to the taxable income (loss) in the following amount:

Tax Year	Amount of Increase in Income Reported
December 31, 1973	$42,000

PROTEST AGAINST ADJUSTMENT

Your letter granted the taxpayer a period of thirty days from the date thereof within which to protest the recommendations of the examining officer, which period was subsequently extended to July 22, 1975, by your letter dated June 6, 1975, a copy of which is attached. This protest is accordingly being filed within such period, as extended.

The taxpayer respectfully protests against the proposed adjustment stated below.

FINDINGS TO WHICH TAXPAYER TAKES EXCEPTION

Exception is now taken to the following item:

Disallowance of the following expenses of Intermountain Stove, Inc.

Description	Year	Amount
Professional Fees	December 31, 1973	$42,000

GROUNDS UPON WHICH TAXPAYER RELIES

The taxpayer submits the following information to support its contentions:

Expenses of Intermountain Stove, Inc.

Your examining officer contends that fees paid in the amount of $42,000 in connection with the employment of certain individuals who were experienced in various phases of the production and sale of cast iron stoves should be considered as the acquisition costs of assets in connection with expansion of operations and establishment of a new cast iron stove division.

Taxpayer contends, for reasons set forth below, that the examining officer's position is untenable on the facts and in law and that such costs are clearly deductible as ordinary and necessary expenses incurred in its trade or business, deductible in accordance with Section 162 of the Internal Revenue Code.

Facts concerning the operations of Intermountain Stove, Inc.

Intermountain Stove, Inc. (ISI) is a manufacturer of campers. As a result of the fuel crisis, orders in 1973 declined and ISI decided, in addition to their camper operation, to again produce wood and coal burning stoves, a product ISI had manufactured until the end of World War II and for which a strong demand suddenly developed. To begin immediate operation in a new stove division, ISI contracted with a consulting firm to locate personnel with experience in the production and marketing of cast iron stoves. The fee paid for such services during 1973 amounted to $42,000.

Discussion of authorities

Section 162(a) of the Internal Revenue Code provides—

> There shall be allowed as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . .

To contend, as the examining officer does, that assets were acquired with the employment of the newly acquired employees is not within the usual interpretation of the Internal Revenue Code.

There were no employment contracts purchased, as may sometimes be found in the hiring of professional athletes; the employees were free to sever their employment relationships at any time, and, in fact, certain of these specific individuals have done so. The ex-

amining officer's position was considered in *David J. Primuth,* 54 TC 374, in which the court stated—

> It might be argued that the payment of an employment fee is capital in nature and hence not currently deductible. Presumably under this view the fee would be deductible when the related employment is terminated. However, the difficulty with this view is to conjure up a capital asset which had been purchased. Certainly the expense was not related to the purchase or sale of a capital asset. . . . Certainly in the ordinary affairs of life common understanding would clearly encompass the fee paid to the employment agency herein as 'ordinary and necessary expenses in carrying on any trade or business' (Section 162) within the usual, ordinary and everyday meaning of the term.

Your examining officer is here attempting to disallow deductions for amounts paid to outside consultants in a situation where the expenses would clearly be deductible if the work had been performed by the company's own staff. No such distinction should be made. The corporation employed the expertise of a knowledgeable consultant to assist in the location of personnel with specific background and experience. The payment of fees for such assistance may be compared with the direct payroll and overhead costs of operating an "in-house" personnel department.

The examining officer apparently believes that such costs should be capitalized primarily because they might be nonrecurring in nature. This is not the test as to whether an expense is ordinary and necessary. As the Supreme Court stated in *Helvering* v. *Welch,* 290 US 111, 3 USTC 1164: "Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer may make them often." The fees are ordinary and necessary because it is the common experience in the business community that payments are made for assistance in the procurement of personnel. This is emphasized by the Court in *Primuth* by the following statement:

> "Fees" must be deemed ordinary and necessary from every realistic point of view in today's marketplace where corporate executives change employers with a notable degree of frequency.

These expenditures, if paid by the individual employees and reimbursed by the employer, would have been clearly deductible by both the employee and employer, with the employee having an offsetting amount of income for the reimbursement. See Rev. Rul. 60-233, 1960-1 CB 57, Rev. Rul. 66-4, 1966-1 CB 233. The expense is no

less deductible when paid directly by the corporation.

It is, therefore, contended that the disallowance made by the examining officer was in error.

REQUEST FOR CONFERENCE

An oral hearing is requested before the conference staff of the district director's office.

STATEMENT WITH RESPECT TO PREPARATION[9]

The attached protest was prepared by the undersigned on the basis of information available to him. All statements contained therein are true and correct to the best of his knowledge and belief.

Signature of Tax Practitioner

Requests for Rulings and Determination Letters

Frequently tax practitioners find it necessary to seek a ruling from the IRS to fix the tax consequences of a client's anticipated business transaction or to settle a disagreement with a revenue agent during an examination. The general procedures with respect to the issuance of advance rulings (before-the-fact) and determination letters (after-the-fact) are outlined in Rev. Proc. 72-3, 1972-1 CB 698, in which the IRS announced that a careful adherence to the specified requirements will minimize needless delays in processing requests for rulings and for determination letters. In addition to Rev. Proc. 72-3, the IRS has on occasion issued procedures that govern ruling requests dealing with specific topics. For example, Rev. Proc. 73-10 suggests specific guidelines for ruling requests involving Section 351. Similarly, Rev. Proc. 74-17 delineates requirements for ruling requests concerning the classification of organizations, for example, partnerships *versus* associations.

Requests for rulings, which are addressed to the national office of the IRS, generally take the following format.

[9] It is assumed that an appropriate power of attorney has been filed with the IRS. Otherwise, a power of attorney must be attached to the protest.

November 15, 1975

Commissioner of Internal Revenue
Washington, D.C. 20224
Attention: T:PS:T

Re: Allemania Electronic, Inc.
(I.D. 73-2113112)
1403 South State Street
Austin, Texas 78712
Request for Ruling under
Section 306 to fix status
of nonvoting preferred
stock to be issued under
Section 368(a)(1)(E) in
exchange for voting common stock.

Dear Sir:

Allemania Electronic, Inc. is a Texas corporation with 10,000 shares of common voting stock issued and outstanding. Of this issue, 8,500 shares are owned by Electric Supply Co., while the remaining shares are owned by several minority interests. Electric and Allemania join in the filing of a consolidated tax return on a calendar year basis. A plan has been proposed under which Allemania will exchange 3,500 shares of its common voting stock now held by Electric for 3,500 shares of preferred nonvoting stock. The proposed exchange should constitute a recapitalization to which Section 368(a)(1)(E) applies. A ruling is respectfully requested as to whether or not the proposed issue of preferred nonvoting stock would constitute "Section 306 stock."

FACTS

Electric Supply Co. acquired 85 percent of Allemania's common voting stock on June 1, 1971. Since that time Electric has included Allemania's stock as a temporary investment on its audited financial statements. Considerable pressure is now being exerted by Electric's auditors to include Allemania as a fully consolidated subsidiary on its audited statement or to dispose of the investment. Since Allemania is a supplier of needed components to Electric, divesture is out of the question. On the other hand, inclusion on a fully consolidated basis is out of the question since the board of directors

fears a negative effect upon Electric's stock prices. Allemania has therefore adopted a plan to exchange 3,500 shares of voting common stock for an equal number of nonvoting preferred stock, thus making it possible to continue to show Allemania on Electric's audited financial statements as a line-item investment since ownership in voting stock does not exceed 50 percent.

DISCUSSION OF AUTHORITIES

Internal Revenue Code, Section 306(c)(1)(B)(ii) seems to imply that the preferred stock to be issued would be tainted as Section 306 stock. Similar thoughts are expressed in Rev. Rul. 59-84, Rev. Rul. 66-332, and Rev. Rul. 70-199. However, given the nature of the transaction contemplated by Allemania, there also appears to be substantial authority for arguing that the newly issued preferred stock should not be Section 306 stock. Since, after the proposed exchange of common for preferred, the percentage interest in Electric's voting stock would be substantially reduced, the preferred stock should not be Section 306 stock. This position seems to be supported by Rev. Rul. 59-84, where one of the shareholders reduced his proportionate interest in the common stock of the distributor corporation from 55.8 percent to 0 percent. In that instance the Internal Revenue Service ruled that since the shareholder's percentage interest in the common stock was substantially reduced by the recapitalization, Section 306 did not apply to the newly issued preferred stock.

BUSINESS PURPOSE

Taxpayer also contends that avoidance of income taxes is not a reason for the proposed recapitalization, but that recapitalization is motivated entirely by a valid business purpose. The business purpose in this instance is the avoidance of the negative impact upon stock prices that Electric contends will result if Allemania is included as a fully consolidated subsidiary on Electric's audited financial statements.

REQUEST FOR RULING

It is respectfully requested that the commissioner rule that the proposed issuance of preferred nonvoting stock in exchange for common voting stock under Section 368(a)(1)(E) *does not* qualify the newly issued preferred stock as Section 306 stock.

STATEMENT WITH RESPECT TO CONTENT

The statements contained in this request for ruling are true and correct to the best of the knowledge of the undersigned and are made under the penalties of perjury.

Allemania Electronic, Inc.

By ______________________________

Vice President and Treasurer

STATEMENT WITH RESPECT TO PREPARATION

The attached request for ruling was prepared by the undersigned on the basis of information made available to him. All statements contained therein are true and correct to the best of his knowledge and belief.

____

Signature of Tax Practitioner

7

These examples are the school of mankind,
and they will learn at no other.

EDMUND BURKE

Tax Research in the "Closed-Fact" Case: An Example

The preparation of a well-organized working-paper file cannot be overemphasized because it proves that research efforts have been thorough, are logically correct, and are adequately documented. The elements of this chapter comprise a sample client file. The formats of files utilized in practice vary substantially among firms; the new tax accountant who uses this tax study as a guide for his own research efforts should be prepared to modify this illustration to conform to the format used by his employer. It is hoped that the general format suggested here would be approved by most experienced tax advisers, although any employer might disagree with any of several specifics. The sample is based on a relatively simple incorporation transaction. Because the tax problems illustrated are relatively simple, the supporting file would be considered excessive by most advisers; the cost of preparing such an elaborate file would be too great to justify. In this case, the reader should concentrate more on general working paper content and arrangement than on the substantive tax issues illustrated; although, in more complex problems this kind of detail would be appropriate.

Throughout this chapter it is assumed that the client has contacted the accountant after all aspects of the incorporation trans-

action were completed. In other words, the accountant's task in this engagement is restricted to compliance-related tax research. We have combined the information for two clients into one file; that is, that of the new corporate entity and that of its president and major stockholder. In practice, however, two separate files would be maintained. Finally, in practice a file would very likely include a substantial number of photocopies of excerpts from the Internal Revenue Code, Treasury regulations, revenue rulings, judicial decisions, commercial tax services, and other reference works. We have attempted to simulate a real file by combining script and ordinary type. Anything in script type would be handwritten in a real file. Anything enclosed by a tint block represents material that would be photocopied in a real file.

Red E. Ink/Ready, Inc.

Tax File
December 1975

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R. U. Partner & Company
Certified Public Accountants
2010 Professional Tower
Calum City, USA 00001

December 23, 1975

Mr. Red E. Ink, President
Ready, Incorporated
120 Publisher Lane
Calum City, USA 00002

Dear Mr. Ink:

This letter confirms the oral agreement of December 17, 1975, in which our firm agreed to undertake the preparation of federal income tax returns for you and Ready, Inc., for the next year. The letter also reports the preliminary results of our investigation into the tax consequences of the incorporation of your printing business last March. We are pleased to be of service to you and anticipate that our relationship will prove to be mutually beneficial. Please feel free to call upon me at any time.

Before stating the preliminary results of our investigation into the tax consequences of your incorporation transaction, I would like to restate briefly all of the important facts as we understand them. Please review this statement of facts very carefully. Our conclusions depend upon a complete and accurate understanding of all of the facts. If any of the following statements is either incorrect or incomplete, please call it to my attention immediately, no matter how small or insignificant the difference may appear to be.

Our conclusions are based upon an understanding that on March 1, 1975, you exchanged *all* of the assets and liabilities of the printing business, which you had operated for the prior twelve years as a sole proprietorship, for 1,000 shares of common stock in Ready, Inc., a newly formed corporation. The assets that you transferred to Ready, Inc., consisted of $20,000 cash; $10,000 (estimated market value) supplies on hand; $50,000 (face value) trade receivables; and $60,000 (book value) equipment. The equipment, purchased new in 1971 for $100,000, had been depreciated on a double-declining-balance method for the past four years. An investment credit was claimed in 1971 on the purchase of the equipment. The liabilities assumed by Ready, Inc., consisted of the $40,000 mortgage remaining from the original equipment purchase in 1971 and current trade payables of $10,000. We further understand that Ready, Inc., plans to continue to occupy the building leased by you on October 1, 1973, from Branden Properties, until the expiration of

(draft)
FES
12/23/75

that lease on September 30, 1977. Finally, we understand that Ready, Inc., has issued only 1,000 shares of common stock and that you retain 980 of those shares; that your wife, Neva, holds ten shares; and that Tom Books, the corporate secretary-treasurer, holds the remaining ten shares. The shares held by Mrs. Ink and Mr. Books were given to them by you, as a gift, on March 1, 1975.

Assuming that the preceding paragraph represents a complete and accurate statement of all of the facts pertinent to your incorporation transaction, we anticipate reporting that event as a wholly nontaxable transaction. In other words, neither you (individually) nor your corporation will report any taxable income or loss solely because of your incorporation of the printing business. Furthermore, no amount of investment credit will have to be recaptured. However, in the future Ready, Inc., will be restricted to a 150 percent declining-balance depreciation deduction on the equipment transferred. The trade receivables collected by Ready, Inc., after March 1, 1975, will be reported as the taxable income of the corporate entity; collections made between January 1, 1975, and February 28, 1975, will be considered part of your personal taxable income for 1975.

If Ready, Inc.'s tax return is audited, there is a possibility that the Internal Revenue Service may challenge the corporation's right to deduct the $10,000 in trade payables it assumed from your proprietorship. If you so desire, I would be pleased to explain this matter in detail. Perhaps it would be desirable for Mr. Bent, you, and me to meet and review this potential problem prior to our filing the corporate tax return.*

If you wish to report the first corporate taxable income on a cash-method fiscal-year basis, ending February 29, 1976, it is imperative that you have Mr. Tom Books keep the corporation's regular financial accounts on that same basis. If he desires any help in maintaining those records, we will be happy to assist him. It will be necessary for us to have access to your personal financial records no later than March 1, 1975, and to your corporate records no later than April 15, 1975, if the two federal income tax returns are to be completed and filed on a timely basis.

Finally, may I suggest that we plan to have at least one more meeting in my office sometime prior to February 28, 1976, to discuss possible tax-planning opportunities available to you in the new corporation. Among other consid-

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*Some advisors would delete this paragraph and handle the matter orally.

(draft)
FES
12/23/75

erations, we should jointly review the possibility that you may want to make a Subchapter S election, and that you may need to structure executive compensation arrangements carefully and may wish to institute a pension plan. It may be desirable to discuss these opportunities at the same time that we meet with Mr. Bent to consider the question of deducting the $10,000 in trade payables, as noted earlier. Please telephone me to arrange an appointment if you would like to do this shortly after the holidays.

Thank you again for selecting our firm for tax assistance. It is very important that some of the material in this letter be kept confidential and we strongly recommend that you carefully control access to it at all times. If you have any questions about any of the matters discussed, feel free to request a more detailed explanation or drop by and review the complete files, which are available in my office. If I should not be available, my assistant, Fred Senior, would be happy to help you. We look forward to serving you in the future.

Sincerely yours,

Robert U. Partner

(draft)
FES
12/23/75

R. U. Partner & Company
Certified Public Accountants
2010 Professional Tower
Calum City, USA 00001

December 17, 1975

MEMO TO FILE

FROM: R. U. Partner

SUBJECT: Ready, Inc.—Tax Engagement

Mr. Red E. Ink (President) and Mr. Tom Books (Secretary-Treasurer) this morning engaged our firm to prepare and file annual federal income tax returns for Ready, Inc. In addition, Mr. Ink has requested that we prepare his individual tax returns annually. During an interview in my office, the following information pertinent to the first year's tax returns was obtained.

On March 1, 1975, Red E. Ink incorporated the sole proprietorship printing business that he has for twelve years previously operated as Red's Print Shop. Mr. Ink had two primary business reasons for incorporating: (1) he desired to limit his personal financial liability in his growing business and (2) he wanted access to credit, which is becoming increasingly difficult to obtain as an individual because of the prevailing interest rates and the state usury laws. In the incorporation transaction, Red transferred all of the assets and liabilities of his former proprietorship to Ready, Inc., a newly formed corporation, in exchange for 1,000 shares of common stock. After receiving the 1,000 shares, Red gave ten shares to his wife, Neva, who was named corporate vice president, and another ten shares to Tom Books, an unrelated and long-time employee who was named the corporate secretary-treasurer. Red stated that these two transfers were intended as gifts and not as compensation for any prior services.

Tom Books provided me with a copy of the balance sheet he prepared for Red's Print Shop just prior to the incorporation. It appears as follows:

Red's Print Shop
Balance Sheet
February 28, 1975

Assets	
Cash	$ 20,000
Supplies on hand	10,000
Trade receivables	50,000
Equipment (net)	60,000
Total Assets	$140,000

A-1 (RUP 12/17/75)

Liabilities & Equity

Trade payables	$ 10,000	
Mortgage payable	40,000	
Total liabilities		$50,000
Red E. Ink, capital		90,000
Total Liabilities & Equity		$140,000

The balance sheet was prepared at the request of Mr. Hal Bent, who served as legal counsel to Mr. Ink during the incorporation of his business. Incidentally, Mr. Bent recommended to Mr. Ink that he engage our firm for the preparation and filing of the federal tax returns. Hal Bent is retained as corporate counsel for Ready, Inc., as well as personal attorney for Mr. and Mrs. Red E. Ink.

During our interview Mr. Ink stated that he has always reported his personal income on a calendar-year, cash basis. It is his intention to report the corporation's taxable income on a cash basis in the future. He plans, however, to have the corporate (taxable) fiscal year run from March 1 to February 28/29.

The $40,000 mortgage payable represents the balance payable on equipment that was purchased for $100,000 in 1971. This equipment has been depreciated on a double-declining-balance method since then. Investment credit was claimed when the equipment was purchased (new). The $60,000 shown on the balance sheet is book value. Red and Tom estimate that the fair market value of the equipment transferred was approximately $75,000 at the time of the incorporation transaction. The trade payables represent the unpaid balances for supplies, utilities, employees' wages, etc. as of the end of February 1975. All of these accounts were paid by Ready, Inc., within sixty days following incorporation. Tom has agreed to provide us with Ready, Inc.'s income statement and year-end balance sheet by no later than March 30, 1976. Mr. Ink will provide us with additional details concerning his personal tax return in early February.

I have assigned Fred E. Senior the responsibility of investigating all tax consequences associated with the initial incorporation of Ready, Inc. He is immediately to begin preparation of our file, which will be utilized early next year in connection with the completion of the tax returns for these two new clients. All preliminary research should be completed by Fred and reviewed by me before December 31, 1975. I have also asked Fred to prepare a draft of a client letter confirming this new engagement and stating our preliminary findings on the tax consequences of the incorporation transaction.

A-2 (RUP 12/17/75)

R. U. Partner & Company
Certified Public Accountants
2010 Professional Tower
Calum City, USA 00001

December 19, 1975

MEMO TO FILE

FROM: Fred E. Senior

SUBJECT: Additional Information on Ready, Inc., Tax Engagement

After reviewing Mr. Partner's file memo of December 17, 1975, and subsequently undertaking limited initial research into the tax questions pertinent to filing the Red E. Ink/Ready, Inc., federal income tax returns, I determined that additional information should be obtained. Specifically, I observed that the February 28, 1975, balance sheet included no real property, and I believed that it was necessary for several reasons to confirm all of the facts pertinent to this client's real estate arrangements. Accordingly, with R. U.'s approval, I telephoned Tom Books today and obtained the following additional information.

Tom explained that Red had signed a forty-eight-month lease with Branden Properties, Inc., on October 1, 1973, and that Ready, Inc., had continued to occupy the same premises and had paid all monthly rentals due under this lease ($6,000 per month) since March 1, 1975. It is Tom's opinion that Red probably will construct his own building once this lease expires, but that he probably will not try to get out of the present lease before its expiration on September 30, 1977. Tom said that the lease agreement calls for a two-month penalty payment (i.e., a $12,000 payment) if either party should break the lease prior to its expiration. According to this agreement, whichever party breaks the lease must pay the other the sum stipulated. Tom further stated that the present lease "really is not a particularly good one." In late 1973 it appeared to Red that office space in Calum City was going to be scarce and he thought that the lease then negotiated was a wholly reasonable one. By the spring of 1975, however, the available office space exceeded the demand. Tom suggested (and based on his square-footage estimates, I agree) that this same lease could now be negotiated for about $5,500 per month. The penalty for breaking the lease would just about equal the saving that could be obtained by renegotiating a new lease today. Under the circumstances, Red has elected to continue with the old lease for the present. This option allows him time to decide whether to build or purchase another building sometime prior to 1977.

A-3 (FES 12/19/75)

Red E. Ink (Personal Account)
Summary of Questions Investigated
December 1975

	W.P. Ref.
1. Was Red E. Ink's March 1, 1975, exchange of all of the assets and liabilities of Red's Print Shop for 1,000 shares of common stock of Ready, Inc., a tax-free transfer under Sec. 351?	
<u>Conclusion</u>: Yes; all of the requirements of Sec. 351 were satisfied.	C-1 & 2
<u>Collateral Question</u>: Is there any reasonable possibility that the liabilities assumed by Ready, Inc., might exceed the adjusted basis of the assets transferred so that the exception (to Sec. 351) provided in Sec. 357(c) might demand the recognition of some gain in this incorporation transaction? More specifically, what portion of the building lease (if any) must be deemed to constitute a "liability" for the purpose of applying Sec. 357(c)?	See W.P. A-3
<u>Conclusion</u>: In our opinion the possibility that the IRS could successfully sustain the conclusion that the liabilities assumed by Ready, Inc., exceeded the adjusted basis of the assets transferred is most unlikely. We believe that no part of the lease should be considered as a "liability" for purposes of Sec. 357(c).	C-2 thru C-7
2. Is the portion of the $60,000 in trade receivables transferred by Red E. Ink to Ready, Inc., and collected by the latter, properly considered to be the taxable income of Mr. Ink (individually) or that of Ready, Inc. (the Corporation)?	
<u>Conclusion</u>: Reasonable authority now exists to justify treating the trade receivables collected after incorporation as the taxable income of Ready, Inc.	See C-7 & 8

B-1 (FES 12/18/75)

	W.P. Ref.
3. Must Red E. Ink recapture any portion (or all) of the investment credit claimed in 1971 because of his transfer of the related equipment to Ready, Inc., on 3/1/75?	
Conclusion: No recapture is required.	See C-8 & 9
4. What is Mr. Ink's tax basis in the 980 shares of Ready, Inc., common stock which he retained?	
Conclusion: In our opinion, Mr. Ink's basis in 980 shares is $39,200.	See C-10 thru C-11

Red E. Ink (Personal Account)
Working Papers
December 1975

W.P. Ref.

Question 1: Was the incorporation of Red's Print Shop on 3/1/75 a tax-free transaction?

Conclusion: Yes; all of the conditions of Sec. 351 were satisfied in this transaction. Sec. 351, IRC 1954, reads as follows:

For facts, see W.P. A-1

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation (including, in the case of transfers made on or before June 30, 1967, an investment company) by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

requires 80% (Red got 100%; kept 98%)

the rule

(b) Receipt of Property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

N/A (no boot rec'd by Mr. Ink)

(c) Special Rule.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

N/A

(d) Application of June 30, 1967, Date.—For purposes of this section, if, in connection with the transaction, a registration statement is required to be filed with the Securities and Exchange Commission, a transfer of property to an investment company shall be treated as made on or before June 30, 1967, only if—

N/A

(1) such transfer is made on or before such date,

C-1 (FES 12/18/75)

(2) the registration statement was filed with the Securities and Exchange Commission before January 1, 1967, and the aggregate issue price of the stock and securities of the investment company which are issued in the transaction does not exceed the aggregate amount therefore specified in the registration statement as of the close of December 31, 1966, and — N/A

(3) the transfer of property to the investment company in the transaction includes only property deposited before May 1, 1967.

(e) Cross References.—

(1) For special rule where another party to the exchange assumes a liability, or acquires property subject to a liability, see section 357. — See W.P. C-2 to 7

(2) For the basis of stock, securities, or property received in an exchange to which this section applies, see sections 358 and 362. — See W.P. 10 & 11

(3) For special rule in the case of an exchange described in this section but which results in a gift, see section 2501 and following. — N/A

(4) For special rule in the case of an exchange described in this section but which has the effect of the payment of compensation by the corporation or by a transferor, see section 61(a) (1). — N/A

Because Mr. Ink had 100%-control immediately after the exchange (98% even after gifts), and because no "boot" was received, this is a tax-free exchange. In re liabilities, see #2, below.

Question 2: Could the liabilities assumed by Ready, Inc., exceed the adjusted basis of the assets transferred so that the exception of Sec. 357(c) might require the recognition of some gain?

Conclusion: No; see below for reasons. Sec. 357 reads as follows:

SEC. 357. ASSUMPTION OF LIABILITY.

(a) General Rule.—Except as provided in subsections (b) and (c), if—

W.P. Ref.

(1) the taxpayer receives property which would be permitted to be received under section 351, 361, 371, or 374 without the recognition of gain if it were the sole consideration, and

(2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, or acquires from the taxpayer property subject to a liability,

then such assumption or acquisition shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351, 361, 371, or 374, as the case may be.

☆ the rule

(b) Tax Avoidance Purpose.—

(1) In general.—If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition described in subsection (a)—

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such purpose, was not a bona fide business purpose,

then such assumption or acquisition (in the total amount of the liability assumed or acquired pursuant to such exchange) shall, for purposes of section 351, 361, 371, or 374 (as the case may be), be considered as money received by the taxpayer on the exchange.

N/A

(2) Burden of proof.—In any suit or proceeding where the burden is on the taxpayer to prove such assumption or acquisition is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence.

N/A

See below

(c) Liabilities in Excess of Basis.—

(1) In general.—In the case of an exchange—

(A) to which section 351 applies, or

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a) (1) (D),

if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then

QUESTION: would the lease constitute a "liability" for this purpose?

See below

such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(2) Exceptions.—Paragraph (1) shall not apply to any exchange to which—

(A) subsection (b) (1) of this section applies, or

(B) section 371 or 374 applies.

N/A

Per R. U. Partner's Memo to File (12/17/75), p. 2, the assets transferred to Ready, Inc., by Red E. Ink were as follows:

See W.P. A-1

see notes below

	Asset	FMV	Basis
	Cash	$20,000	$20,000
(1)	Supplies	10,000	-0-
(2)	Trade receivables	50,000	-0-
(3)	Equipment	75,000	60,000
	Total Basis of Assets		$80,000

FOOTNOTES:

(1) In response to my telephone inquiry of today, Tom Books confirmed that Mr. Ink has always expensed all supplies for tax purposes when paid.

(2) Mr. Ink has always reported his taxable income on a cash basis. W.P. A-1

(3) Value estimated; adjusted basis is book value. W.P. A-1

Liabilities assumed by Ready, Inc., were

Mortgage Payable $40,000

NOTE: The IRS is likely to contend that the $10,000 in trade payables also represents a liability assumed by Ready, Inc. We would dispute that conclusion (see below). It is also conceivable, though unlikely, that the IRS would also include

C-4 (FES 12/18/75)

some portion or all of the remainder of the lease payments within the meaning of a "liability" as used in Sec. 357(c). We most certainly would contest that contention if raised by the IRS.

There is no authority which conclusively defines the word "liability" for tax purposes. The Code does not and the several judicial decisions in point conflict. In Testor v. Commissioner, 327 F2d 788 (CA-7, 1964), Peter Raich, 46 TC 604 (1966), and Wilford E. Thatcher, 61 TC 4 (1973), the accounts payable of a cash basis taxpayer were considered to be liabilities for the purpose of applying IRC Sec. 357(c). While the court in Raich never explicitly discussed the definitional problem, the majority opinion in Thatcher assumes "that Congress intended the term liability to have its ordinary meaning." While the "ordinary" meaning of the word was held by that court to include the accounts payable of a cash basis taxpayer, it is not at all apparent that future payments under an unexpired lease are to be so construed. Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 3d ed., pp. 14-136, suggest a contrary conclusion, at least so far as lease payments might be involved in reorganizations.

Furthermore, in Bongiovanni v. Commissioner, 470 F2d 921 (CA-2, 1972) rev'g TC Memo Dec. 31,027, the word "liability" is defined to include only tax liabilities--i.e., "leins in excess of tax costs, particularly mortgages encumbering property transferred in a Section 351 transaction"--and excludes those liabilities which do not fall within that narrow definition. In finding that accounts payable of a cash basis taxpayer were not liabilities for purposes of Sec. 357(c), the court in Bongiovanni relied upon pre-

W.P. Ref.

cisely the same Senate Report as that mentioned in Thatcher, Testor, and Raich, but with an opposite conclusion. Judge Quealy, who wrote the original opinion in Bongiovanni (TC Memo 1971-262) vigorously dissented to the majority opinion in Thatcher, arguing that the Second Circuit Court had correctly reversed his prior opinion. Because the Seventh Circuit opinion in Testor conflicts with that of the Second Circuit in Bongiovanni, the Supreme Court may have to resolve this dispute.

At this date it is clear that the Second Circuit would consider neither Ink's $10,000 in trade payables nor the payments on the unexpired lease as a liability. Neither the Seventh Circuit nor any other court has ruled on the lease-payments issue.

For accounting purposes, two types of leases are distinguished. The operating lease conveys no property rights to the lessee. The lessor retains full title and the lessee merely pays rent for using the property. The financing lease is considered to be the equivalent of a sale. In that kind of lease the lessee can, at the termination of the lease, obtain title to the property by paying a nominal amount.

In this context the obligation of a financing lease might well be considered to be a liability within the congressional intent of Sec. 357(c). Such secured transactions were used in the Committee Reports to illustrate application of the section. (See S. Rept. 1622, to accompany H.R. 8300, P. Law 591, 83d Cong., 2d sess., 1954, p. 270; H. Rept. 1337 (same law), p. A129.) In an operating lease--like Red E. Ink's--the rental pay-

W.P. Ref.

ments can only be considered to be payments for the current use of property. Consequently, we would reject any attempt by the IRS to treat these lease payments as a liability for purposes of Sec. 357(c).

Given the fact that Ink's lease with Branden Properties does call for a mandatory $12,000 payment in the event the lease is broken, and given the fact that this lease could be considered a slightly "unfavorable" one as of 3/1/75, the IRS just might contend that $12,000 (of the remaining $186,000) does represent a liability assumed by Ready, Inc. Note, however, that even if both the trade payables of $10,000 and the lease of $12,000 were considered to be liabilities, the $80,000 in basis transferred would still exceed the sum of any liabilities assumed by Ready, Inc. It is only if the entire balance of the remaining lease payments is deemed to be a liability that Sec. 357(c) can be made to apply. Based on all of the authorities considered here, we would strongly resist any such interpretation if raised by the IRS on audit.

See W.P. A-3

For further discussion of the Sec. 357(c) problem, see "Sec. 357(c) and The Cash Basis Taxpayer," 115 Univ. Penn. Law Rev. 1154 (1967); "The Frustrations in Section 357(c)," 25 Tax Law Review 227 (1970).

Question 3: Are collections of the trade receivables transferred by Mr. Ink to Ready, Inc., on 3/1/75 to be considered the taxable income of Mr. Ink or of Ready, Inc.?

Conclusion: For many years, in reliance on the "assignment-of-income" doctrine, the courts have held that an individual

W.P. Ref.

transferor, rather than the controlled corporate transferee, was taxable on the inchoate income items transferred in a Sec. 351 transaction. Brown v. Commissioner 115 F2d 337 (CA-2, 1940); Clinton Davidson, 43 BTA 576 (1941); and Adolph Weinberg, 44 TC 233 (1965) aff'd per curiam 386 F2d 836 (CA-9, 1967).

The tax court was finally persuaded, however, to allow the cash basis taxpayer to transfer accounts receivable tax free under Sec. 351. Thomas Briggs, TC Memo 1956-086. Since Briggs two additional cases, Hempt Bros. Inc. v. US, 354 F. Supp. 1172 (DC Pa., 1973) and Divine, Jr. v. US, 1962-2 USTC 85,592 (WD Tenn., 1962) have argued that the assignment-of-income doctrine is inapplicable in such situations. Bittker and Eustice (3d ed.) also note that the implicit holding of Peter Raich, 46 TC 604 (1966) is that receivables transferred would not have been recognized but for Sec. 357(c). (Bittker and Eustice, 3d ed., p. 3-59.) Under the fact circumstances of Ink's case, there seems to be sufficient authority to argue that any receivables collected by Ready, Inc., should be treated as the taxable income of the corporation and not that of Mr. Ink individually.

Question 4: Must Mr. Ink recapture any of the investment credit claimed in 1971 because of his transfer of the equipment to Ready, Inc., in 1975?

Conclusion: No--All conditions of Treas. Regs. Sec. 1.47-3(f)(1) are satisfied. The pertinent regulation reads as follows:

(Red E. Ink)

W.P. Ref.

TREAS. REGS. SEC. 1.47–3(f)

(f) Mere change in form of conducting a trade or business.—

(1) General rule.

(i) Notwithstanding the provision of § 1.47–2, relating to "disposition" and "cessation," paragraph (a) of § 1.47–1 shall not apply to section 38 property which is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing the taxpayer's qualified investment by reason of a mere change in the form of conducting the trade or business in which such section 38 property is used provided that the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

☆ the rule

(ii) The conditions referred to in subdivision (i) of this subparagraph are as follows:

(a) The section 38 property described in subdivision (i) of this subparagraph is retained as section 38 property in the same trade or business,

OK here (same bus.)

(b) The transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) of such section 38 property retains a substantial interest in such trade or business.

OK here (98% retained)

(c) Substantially all the assets (whether or not section 38 property) necessary to operate such trade or business are transferred to the transferee to whom such section 38 property is transferred, and

OK here (all prop. transf.)

(d) The basis of such section 38 property in the hands of the transferee is determined in whole or in part by reference to the basis of such section 38 property in the hands of the transferor.

OK here (see W.P. E-3)

This subparagraph shall not apply to the transfer of section 38 property if paragraph (e) of this section, relating to transactions to which section 381 applies, applies with respect to such transfer.

N/A

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(Red E. Ink)

W.P. Ref.

Question 5: What is Mr. Ink's tax basis in the 980 shares of Ready, Inc., stock that he retained after the 3/1/75 incorporation?

Conclusion: IRC Sec. 358 determines the adjusted basis of stocks and securities received in a Sec. 351 transaction. It reads as follows:

SEC. 358. BASIS TO DISTRIBUTEES.

(a) General Rule.—In the case of an exchange to which section 351, 354, 355, 356, 361, or 371 (b) applies—

(1) Nonrecognition property.—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged— [here, $80,000] [See W.P. C-4]

(A) decreased by—

(i) the fair market value of any other property (except money) received by the taxpayer, [NONE]

(ii) the amount of any money received by the taxpayer, and [See Sec. 358(d)] [-40,000]

(iii) The amount of loss to the taxpayer which was recognized on such exchange, and [N/A]

(B) increased by—

(i) the amount which was treated as a dividend, and

(ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend). [N/A] [(but see W.P. C-6 thru C-7 for possible IRS view)]

(2) Other property.—The basis of any other property (except money) received by the taxpayer shall be its fair market value. [N/A]

(b) Allocation of Basis.—

(1) In general.—Under regulations prescribed by the Secretary or his delegate, the basis determined under subsection (a)(1) shall be allocated among the properties permitted to be received without the recognition of gain or loss. [N/A]

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N/A

(2) Special rule for section 355.—In the case of an exchange to which section 355 (or so much of section 356 as relates to section 355) applies, then in making the allocation under paragraph (1) of this subsection, there shall be taken into account not only the property so permitted to be received without the recognition of gain or loss, but also the stock or securities (if any) of the distributing corporation which are retained, and the allocation of basis shall be made among all such properties.

N/A

(c) Section 355 Transactions Which Are Not Exchanges. — For purposes of this section, a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange, and for such purposes the stock and securities of the distributing corporation which are retained shall be treated as surrendered, and received back, in the exchange.

For result refer to Sec. 358(a)(1)(A)(ii), above.

(d) Assumption of Liability.—Where, as part of the consideration to the taxpayer, another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition (in the amount of the liability) shall, for purposes of this section, be treated as money received by the taxpayer on the exchange.

See again W.P. C-4 thru C-7 for meaning of "liab."

N/A

(e) Exception.—This section shall not apply to property acquired by a corporation by the exchange of its stock or securities (or the stock or securities of a corporation which is in control of the acquiring corporation) as consideration in whole or in part for the transfer of the property to it.

According to Sec. 358(a), therefore, Mr. Ink's basis in the 1,000 shares he initially received would be $40,000 (i.e., $80,000 basis transferred less $40,000 liabilities assumed by Ready, Inc.). See again W.P. C-4 thru C-6 for a discussion of the meaning of the word "liabilities."

Because Mr. Ink gave ten shares to Mrs. Ink and ten shares to Mr. Books, the basis in his remaining 980 shares would be $39,200 (i.e., 98% of $40,000). Each donee would have a basis of $400 in the ten shares received per Sec. 1015.

C-11 (FES 12/18/75)

Ready, Inc. (Corporate Acct.)
Summary of Questions Investigated
December 1975

	W.P. Ref.
1. Must Ready, Inc., report any taxable income in its first tax year because of its exchange of previously unissued stock for the assets of Red's Print Shop?	
Conclusion: No. (Sec. 1032.)	See E-1
2. Can Ready, Inc., claim a tax deduction under Sec. 162 for the $10,000 expended within sixty days following incorporation in payment of the trade payables it assumed from Red's Print Shop?	
Conclusion: The officers of Ready, Inc., should be alerted to the possibility that the IRS might successfully challenge the propriety of the corporation's deducting the $10,000 expended in payment of these accounts.	See E-1 & 2
3. Is the portion of the trade receivables transferred by Mr. Ink to Ready, Inc., and collected by the corporation after the incorporation, properly deemed to be the taxable income of the corporation?	
Conclusion: Sufficient authority exists to justify treating the receivables collected as the taxable income of Ready, Inc.	See again C-7 & 8
4. What is Ready, Inc.'s, adjusted tax basis in the various assets it received from Red E. Ink on 3/1/75?	
Conclusion:	

Cash	$20,000	
Supplies	-0-	See E-3
Receivables	-0-	
Equipment	60,000	

D-1 (FES 12/19/75)

W.P. Ref.

5. What is the maximum depreciation method that Ready, Inc., can utilize relative to the equipment acquired from Red E. Ink on 3/1/75?

Conclusion: 150 percent declining-balance depreciation assuming the equipment has a remaining useful life of three years or longer. — See E-3

6. Must Ready, Inc., obtain the commissioner's approval to file its first tax return on a February 28/29 fiscal-year, cash-method basis?

Conclusion: No; no special permission is required so long as the corporate financial records are maintained on this same basis. — See E-4 & 5

Ready, Inc. (Corporate Account)
Working Papers
December 1975

W.P. Ref.

Question 1: Must Ready, Inc., report any taxable income in its first tax year because of its exchange of previously unissued stock for the assets of Red's Print Shop on 3/1/75?

Conclusion: No; see Code Sec. 1032 below.

> SEC. 1032. EXCHANGE OF STOCK FOR PROPERTY.
>
> (a) Nonrecognition of Gain or Loss.—No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.
>
> (b) Basis.—For basis of property acquired by a corporation in certain exchanges for its stock, see section 362.

☆ } the rule

Question 2: Can Ready, Inc., claim a tax deduction under IRC Sec. 162 for the $10,000 it expended within sixty days following incorporation in payment of the trade accounts it assumed from Red's Print Shop?

For facts, see W.P. A-1

Conclusion: Generally the courts have denied a deduction for ordinary (Sec. 162) expenses incurred by the transferor but paid by the corporate transferee following a Sec. 351 incorporation. As recently as 1972 the Tax Court declared:

> It is well settled that an expenditure of a preceding owner of property which has accrued but which is paid by one acquiring that property is a part of the cost of acquiring that property, irrespective of what would be the tax character of the expenditure to the prior owner. Such payment becomes part of the basis of the property acquired and may not be deducted when paid by the acquired of that property.

(M. Buten and Sons, Inc., TC Memo 1972-044.)

E-1 (FES 12/19/75)

Thus the Tax Court in Buten indicates that a definite uniformity of application exists in this area. Despite the significant number of cases supporting that conclusion, however, it may be significant that in Peter Raich, 46 TC 604 (1966), the parties stipulated that the accounts payable were deductible by the transferee corporation. Furthermore, in Bongiovanni, 470 F2d 921 (CA-2, 1972) the Second Circuit Court in 1972 noted that "where the acquiring corporation is on an accrual basis, such accounts are also deductible in its initial period." (Note: Ready, Inc., will be a cash-basis taxpayer.) Perhaps the most significant argument favoring deductibility was presented in US v. Smith, 418 F2d 589 (CA-5, 1969). There the court noted that "If this factual inquiry reveals a primary purpose other than acquisition of property, the court may properly allow a deduction to the corporation if all the requirements of Title 26 USC, Sec. 162, are met...." In Ink's incorporation it is arguable that the liabilities of Red's Print Shop were assumed by Ready, Inc., solely for business convenience reasons and not for the acquisition of property. If Red's decision to transfer these liabilities can be demonstrated to have been motivated by this criterion, the reasoning in Smith might support Ready, Inc.'s, claim for deductibility. Given the weight of contrary authority, however, the officers of Ready, Inc., should be alerted to a possibility of an IRS challenge. See Magruder v. Supplee, 316 US 394 (1942); Holdcraft Transportation Co., 153 F2d 323 (CA-8, 1946); Haden Co. v. Commissioner, 165 F2d 588 (CA-5, 1948) and Athol Mfg. Co., 54 F2d 230 (CA-1, 1931).

W.P. Ref.

Question 3: Are collections from the $50,000 in trade accounts receivable transferred by Mr. Ink to Ready, Inc., on 3/1/75 to be considered the taxable income of Mr. Ink or of Ready, Inc.?

Conclusion: Of Ready, Inc.; see again W.P. C-7 & 8

Question 4: What is Ready, Inc.'s adjusted tax basis in the various assets it received from Mr. Ink on 3/1/75?

Conclusion: The basis of the assets received by a corporate transferee in a Sec. 351 transaction are determined by Sec. 362(a) which reads as follows:

SEC. 362. BASIS TO CORPORATIONS.

(a) Property Acquired by Issuance of Stock or as Paid-In Surplus.—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

☆ the rule

Accordingly, Ready, Inc.'s, adjusted tax basis of assets received is as follows:

See W.P. A-1

Cash	$20,000
Supplies	-0-
Trade receivables	-0-
Equipment	60,000

Question 5: What is the maximum depreciation method that Ready, Inc., can utilize in depreciating the equipment acquired from Mr. Ink on 3/1/75?

W.P. Ref.

Conclusion: Because Sec. 381 does not apply to Sec. 351 transfers, all property received by Ready, Inc., is deemed to be used property. Such property can not be depreciated under any of the rapid methods granted only to original users in Sec. 167(b)(2), (3), or (4). See Rev. Rul. 67-286, 1967-2 CB 101. However, according to Rev. Rul. 57-352, 1957-2 CB 150, as modified by Rev. Rul. 57-248, 1967-2 CB 98, such property can be depreciated by a declining balance method not to exceed 150 percent of the straight-line rate, if the used tangible property has an estimated remaining life of three years or longer.

Confirmed by phone with Tom Books 12/19/75

Question 6: Must Ready, Inc., obtain the commissioner's approval to file its first tax return on a March 1 fiscal-year, cash-basis?

Conclusion: See below Treas. Regs. Sec. 1.441-1(b)(3).

TREAS. REG. SEC. 1.441-1(b)(3)

(3) A new taxpayer in his first return may adopt any taxable year which meets the requirements of section 441 and this section without obtaining prior approval. The first taxable year of a new taxpayer must be adopted on or before the time prescribed by law (not including extensions) for the filing of the return for such taxable year. However, for rules applicable to the adoption of a taxable year by a partnership, see paragraph (b)(2) of § 1.442-1, section 706(b), and paragraph (b) of § 1.706-1. For rules applicable to the taxable year of a member of an affiliated group which makes a consolidated return, see § 1.1502-76 and paragraph (d) of 1.442-1.

See also Treas. Regs. Sec. 1.441-1(e).

W.P. Ref.

TREAS. REG. SEC. 1.441–1(e)

(e) Fiscal year.

(1) The term "fiscal year" means—

(i) A period of 12 months ending on the last day of any month other than December, or

(ii) The 52-53-week annual accounting period, if such period has been elected by the taxpayer.

(2) A fiscal year will be recognized only if it is established as the annual accounting period of the taxpayer and only if the books of the taxpayer are kept in accordance with such fiscal year.

See client letter reminder

The courts have held that a corporate transferee is a separate taxpayer from that of its transferor. Sid v. Ezo Products Co., 37 TC 385 (1961); Akron, Canton, and Youngstown Railroad Co., 22 TC 648 (1955); and Textile Apron Co. 21 TC 147 (1953). Consequently, if Ready, Inc., will keep its financial books on the same basis as it desires to report its taxable income, no special permission is required.

Red E. Ink/Ready, Inc.
Suggestions for Client's Future Consideration
December 1975

If Mr. Ink desires any assistance in future tax planning we should discuss with him, in the near future, the following matters:

1. Subchapter S Election--

   a. The circumstances under which this would be desirable/undesirable.

   b. When the decision must be made. (Between 2/1 and 3/31.)

   c. Need for every shareholder's approval. (Possibly get buy-out agreements.)

2. Executive compensation possibilities--

   a. Group-term life insurance (Sec. 79(a)).

   b. Health and accident insurance (Sec. 106).

   c. Death benefits (Sec. 101).

   d. Travel and entertainment (requirements and advantages).

3. Pension Plans (costs and benefits).

4. Future Contributions to Capital.

   a. Consider advantages of securities.

   b. Sec. 1244 if additional stock is issued.

5. Could 85 percent dividend-received deduction be used effectively?

F-1 (FES 12/23/75)

8

It is too well settled to need citation of authorities that it is no offense nor is it reprehensible to avoid the attachment of taxes. One may employ all lawful means to minimize taxes.

JUDGE WALTER A. HUXMAN

Research Methodology for Tax Planning

This final chapter examines the research methodology appropriate to tax planning. It considers (1) the general role of tax planning in the CPA firm and (2) the technical differences between research methodologies for tax planning and tax compliance.

A recent survey by an AICPA committee contains several implications about the role of tax practice in the CPA firm.[1] First, the survey clearly establishes the fact that tax practice represents an important source of revenue for the CPA (tax work accounts for between 21 and 40 percent of the total billings in nearly 46 percent of the responding firms). Second, although return preparation accounts for the largest portion of the tax work revenues, consultation and planning ranks second—ahead of representation before government bodies. Third, the larger practice units tend to generate a larger proportion of their total tax work revenues from consultation and planning than do the smaller practice units. Fourth, most of the respondents anticipated that consultation and planning would account for a greater proportion of future tax work fees. All of this suggests, of course, that the CPA who limits his tax practice to

[1] Jerome P. Solari and Don J. Summa, "Profile of the CPA in Tax Practice," *Tax Adviser*, June 1972, pp. 324-28.

compliance work is not taking full advantage of his opportunities. An expansion-oriented CPA is likely to discover that tax-planning work is a latent source of major growth. The continuing relationship that a CPA has with his client ordinarily provides him with sufficient knowledge of facts to make tax-planning proposals with minimal additional input from the client.

As we noted in chapter 2, a final tax liability depends upon three variables: the facts, the law, and an administrative process. A change in any one of those variables is likely to change a client's tax liability. To devise a tax plan which relies for its success upon an amendment to the Internal Revenue Code is usually unrealistic. Very few taxpayers wield that much influence and, even if they did, the response of Congress in tax matters typically is unpredictable and slow. Attempts to change the administrative process would be equally ineffective and for similar reasons. Good tax planning always gives adequate consideration to the administrative process, but it does not rely upon changes in that process for its success. Thus, tax plans generally must be based on the existing law and administrative processes because only the facts are readily modified. The ultimate significance of those facts stems, of course, from existing options already in the code.

Tax-Planning Considerations

The fundamental problems encountered in tax planning might be compared to those inherent in, say, a decision to transport an object from New York City to Atlanta. Momentarily ignoring operational constraints, there appear to be an almost unlimited number of ways to achieve the objective. That is, the object could be shipped by a commercial carrier (with air, rail, ship, or surface carrier possibilities); it might be personally delivered; or a friend might deliver it. However, only a few transportation methods are realistic because of various operational constraints such as time (the object must be delivered before 9 A.M. on Monday morning), cost (the object must be shipped in the most inexpensive manner possible), and/or bulk (the object may be so large as to exclude all but a few possibilities). The transportation decision can be managed successfully only if the decision-maker (1) knows which options actually exist and (2) understands the constraints. A tax problem has very similar boundaries.

Statutory Options

The Internal Revenue Code already contains many options from which a taxpayer must select alternative courses of action. For example, a taxpayer generally can choose to operate his business as a sole proprietorship, a partnership, or a corporation. By exercising any option, a taxpayer automatically causes several different portions of the code to apply to his business operations, any one of which may create a drastically different tax result. In addition to selecting a basic business form, a taxpayer may also have an opportunity to select a tax year, choose certain accounting methods, determine whether the entity selected should be a "foreign" or "domestic" one, choose between a "taxable" and "nontaxable" incorporation transaction, or decide whether or not to capitalize certain expenditures. Selecting the most advantageous combination of statutory tax options is obviously a difficult task, depending importantly upon the decision-maker's knowledge of the very existence of those options.

Client Constraints

In addition to understanding all of the options implicit in the Internal Revenue Code, a tax planner must also understand the objectives and operational constraints inherent in his client's activities. Those objectives and constraints typically are a combination of personal, financial, legal, and social considerations. For example, such personal objectives as a desire to maximize wealth, to control the distribution of property after death, to drive a competitor out of business, or to retire with minimal financial concerns may dictate certain actions. Personal objectives are often constrained by financial and legal obstacles. A tax planner can understand a client's objectives only if that client is willing to confide in the adviser; therefore, it is absolutely essential that mutual trust and openness exist between the client and the tax adviser before a tax-planning engagement is undertaken.

Because tax plans often necessarily involve very significant financial and legal implications, much tax planning is better achieved through a team effort than through individual work. For example, in an estate planning engagement, it is not unusual to include the taxpayer's attorney, his insurance agent, and a trust officer, as well as his CPA on the tax-planning team. By combining the special ex-

pertise of several individuals, the client is better served, and more importantly, the team approach generally protects the client from the danger of "secondary infection" that is, from the danger of putting into operation a plan which may succeed from a tax standpoint but which may have undesirable legal or financial consequences.

Creativity

Even if a tax adviser knows all of the pertinent code provisions and fully understands all of his client's objectives and constraints, the optimal tax plan may not be obvious. An optimal plan depends on the creative resources of the planner. Using all of his knowledge, he must test tentative solutions in a methodical process that rejects some alternatives and suggests others. Without a systematic method of considering and rejecting the many alternatives, the tax planner is likely to overlook the very alternative he seeks. As suggested earlier in this study, one common reason for overlooking a good alternative is simply the tax adviser's failure to think long and/or hard enough about the problem. There appears to be a tendency to rush to the books or to another person for help, hoping that the best solution will automatically surface, when what is really needed is more creative thought on the subject. The thinking process is often stimulated by ideas found in books or suggested by other persons. Our recommendation is not that books and consultants be avoided, but rather that the ideas obtained from these sources be given an opportunity to mature in quiet contemplation.

Tax-Planning Aids

Books

Tax library materials can help generate successful tax-planning ideas. Many practical ideas are contained in AICPA Tax Study No. 4, *Tax Practice Management,* by William L. Raby.[2] In addition to the "tax-planning ideas" portion of a client file (suggested in chap-

[2] William L. Raby, Tax Study No. 4, *Tax Practice Management* (New York: American Institute of Certified Public Accountants, 1974).

ter 2 of this study), Raby recommends more complete "tax-planning surveys" and "year-end tax reviews" to better evaluate and anticipate business and estate-planning decisions. AICPA Tax Study No. 3, *Guide to Federal Tax Elections*, edited by Joel M. Forster, is a useful aid in locating many of the options that exist in the code.[3]

In addition to these two AICPA publications, most of the commercial tax services include, in some form or another, tax-planning ideas intended to assist the CPA in his practice.[4] For example, Prentice-Hall's service, *Federal Taxes*, contains a tax-savings-idea "index" consisting of four major classifications: (1) types of taxpayers, (2) income, (3) deductions and credits, and (4) miscellaneous. Subtopics within each classification refer the reader to editorial explanations scattered throughout that tax service. In addition, Prentice-Hall publishes a separate, two-volume *Tax Ideas* service.[5] Volume one deals with everyday business and personal transactions; volume two concentrates on somewhat more complicated tax problems. This service features a transaction checklist of those tax matters that should be taken into account for any given transaction.

The *Standard Federal Tax Reporter*, published by Commerce Clearing House, contains a tax-planning section, organized on a topical basis, in its index volume. The editorial comments found there contain sufficient detail to handle the easier tax-planning problems and are cross-referenced to other CCH paragraphs that aid in the solution of the more difficult problems. Volume 5A of *Federal Income, Gift and Estate Taxation*, published by Matthew Bender, contains a "Planning Aids" section as well as a "tax calendar" for various types of taxpayers.

Although neither the *Tax Coordinator*, published by the Research Institute of America, nor the *Tax Management Portfolios*, published by the Bureau of National Affairs, contain tax-planning volumes

[3] Joel M. Forster, ed., Tax Study No. 3, *Guide to Federal Tax Elections* (New York: American Institute of Certified Public Accountants, 1971).

[4] For additional details concerning the publishers of the several commercial tax services, see exhibit 4.12, p. 126.

[5] Prentice-Hall also publishes a five-volume *Estate Planning* service; however, its content is not limited solely to tax ideas, but considers all facets of the estate planning function.

per se, both include tax-planning recommendations throughout in the commentary on the tax issues to which they relate. Matthew Bender also publishes the three-volume *Income Tax Techniques* and the three-volume *Estate Tax Techniques,* both edited by the J. K. Lasser Tax Institute. The authors of these services are various practitioners who have tried to anticipate the difficulties in tax planning for clients.

Many other books, with varying degrees of sophistication, have been written on tax planning; it simply is not practical to mention each of them individually. Suffice it to note that readers should not be misled by all of the titles including the phrase *tax planning.* Many of these publications are intended for specific taxpayers and their unique tax problems, for example, tax planning for professionals, for real estate transactions, for closely held corporations, or for international operations. Topics covered in one publication are often duplicated in another. Before a practitioner decides to purchase such a book, he would be well advised to examine it in detail to make certain that it actually adds something to the material already available in his library. Although many of these publications can be of material assistance in tax-planning work, there is no good substitute for the ability which comes only from years of experience.

Continuing Education

The extension of formal classroom instruction beyond the college campus during the past decade may be partially attributable to the institution of mandatory continuing education requirements for several professions, including the profession of accountancy. For tax practitioners, however, tax institutes provided continuing professional instruction long before it became mandatory in any state.

Today, continuing education programs are a second major source of assistance in successful tax planning. Well-developed courses are readily available from national, state, and local professional societies, educational institutions, and private organizations. The American Institute of Certified Public Accountants annually publishes a catalog describing most of the continuing education programs offered by the AICPA and the state CPA societies. The 1975-76 catalog includes a description of eighty-five different courses in taxation. The durations of the courses described there vary from

"one-half day" to "six nights." Costs of participation, when stated, vary from $25 to $170 per course. Most courses are scheduled during the summer and fall, throughout the United States.

Information about other tax courses can frequently be found in tax periodicals. Some courses are directed to the beginner, others to an advanced audience. Some cover specific subjects; others are of general interest. Some are well developed and taught by highly qualified instructors; others have been hastily prepared and are poorly presented. Obviously the caveat "let the buyer beware" is applicable in the selection of any course.

Tree Diagrams

In tax-planning work, the alternatives that an adviser must consider multiply quickly. After clearly identifying a general course of action (based on an understanding of the client's objective and knowledge of the code), and before reaching a conclusion, an adviser might consider structuring his problem in the form of a "tree diagram." This technique is commonly utilized in management services work.[6] Such an exercise ensures a thorough and systematic consideration of each alternative because it focuses on the critical questions in a sequential manner. The branches of the tree derive from options existing in the code, any one of which can achieve the client's objective. After ordering the options in this fashion, the adviser should quantify the tax result implicit in each alternative. This quantification will facilitate discovery of many of the risks and constraints that, in turn, eliminate some alternatives and favor others. For an example of a tree diagram, see figure 8.1 (p. 221).

As noted above, a tax adviser cannot prepare a tree diagram for a tax problem until he fully understands his client's objective and determines the tax rules applicable to each available method of achieving that objective. Knowledge of the client's objective can come only from a complete and open discussion of the problem with the client. In an operational sense, objectives and constraints can only be determined in the same way in which facts are estab-

[6] For further description of this technique in general see R. J. Ainslie and Alan A. Kenney, "Decision Tables—A Tool for Tax Practitioners," *Tax Adviser*, June 1972, pp. 336-45; see also Harley M. Courtney and Patricia C. Elliott, "Computing for Tax Planning," *Tax Adviser*, May 1974, pp. 288-97.

lished in compliance engagements. Determination of the possible alternatives stems from a unique blend of prior experience, reading, and thinking about the problem. Ascertaining the tax outcome for each alternative is based on the same research techniques described in the earlier chapters of this study. In summary, then, the only major differences between the tax research methodologies applicable to compliance work and to planning work are in the adviser's ability to identify possible alternatives and in his method for selecting the best of the several alternatives considered. In an attempt to focus on these aspects of tax planning, the following pages illustrate the process involved in a relatively simple planning engagement. We will not examine in detail the procedures by which the tax adviser determines the tax result implicit in each option, since they are the same as those followed in a "closed-fact" situation.[7]

A Tax-Planning Example

To illustrate the procedures that might be utilized in a tax-planning engagement, assume that during 1972 a client, a recently retired army general, purchased all 200 shares of outstanding stock in NNH Corporation for $200,000. NNH's only asset at the time of this purchase consisted of seventy acres of unimproved (and unencumbered) land with a tax basis of $90,000 and a fair market value of $200,000. Assume further that NNH has no current or accumulated earnings and profits.

In 1974, the city council approved construction of a new downtown expressway that would pass directly alongside the NNH property. Consequently, the fair market value of that property increased to $300,000.

After discussions with several developers, the client decided to have NNH improve the property with streets, sewers, water mains, and so on, and to subdivide the property for sale to builders and prospective homeowners. The anticipated additional investment required is estimated to be $100,000; the client hopes that the addi-

[7] For additional general background information, see Harry Z. Garian, Tax Study No. 1, *Tax Guide for Incorporating A Closely Held Business* and Stuart R. Josephs, Tax Study No. 2, *Tax Planning Techniques for Individuals* (New York: American Institute of Certified Public Accountants, 1969 and 1971, respectively).

tional improvements will increase the value of the land to $450,000 within the next twelve months.

Early in 1975, the client begins to discuss with his tax adviser the potential tax implications of his proposed business venture. Before leaving the adviser's office, the client makes it clear that he intends to make this his last business venture. He wants to make as large a profit as possible from this land deal and then invest the proceeds in a retirement annuity that, along with his military retirement pay, will guarantee him and his wife a comfortable living for as long as they live. He asks the tax adviser to make recommendations concerning the tax implications of his land development plans.

At this point the tax practitioner, using his experience and creativity, must identify alternative courses of action and recommend the one that achieves the client's predetermined objectives with the least possible tax cost. Several approaches are available to the practitioner. He can, for example, simply apply the client's facts to his announced plans and determine the implicit tax result. This approach, however, would really not be considered tax planning; although a tax adviser must often recommend against the plan originally proposed by a client, he generally attempts to recommend one or more alternatives that can achieve the most important client objectives in a tax-preferred manner.

In order to keep this example simple, we have assumed that

1. the client is married and files a joint return each year.
2. the client receives exactly $20,000 of ordinary *taxable* income each year in addition to that specifically attributable to this land development project.
3. the client does *not* qualify for income averaging.
4. the client sells all of the lots in one year.
5. the client personally invests the additional $100,000 necessary to make the land improvements (with no interest cost assumed).

In an actual engagement, obviously, these constraints could only be determined through consultation with the client. In fact, many of the "constraints" assumed in this example would actually constitute important tax-planning alternatives. For example, the opportunity

to spread the sale of lots over several years—either to qualify for capital gain treatment under the "safe harbor" rules of Section 1237 or to obtain the benefit of lower marginal tax rates that necessarily accompany a lower annual (ordinary) income—is an obvious alternative to the solution suggested in this example. Another equally obvious alternative would be to "bunch" the ordinary income in a single year in order to take advantage of income averaging opportunities available under Sections 1301-1305. As explained above, we have made assumptions that disqualify alternatives in order to keep the example simple. We have also assumed that the normal corporate tax rate is 22 percent on all corporate taxable income, and the surtax rate is 26 percent on all income over $25,000.

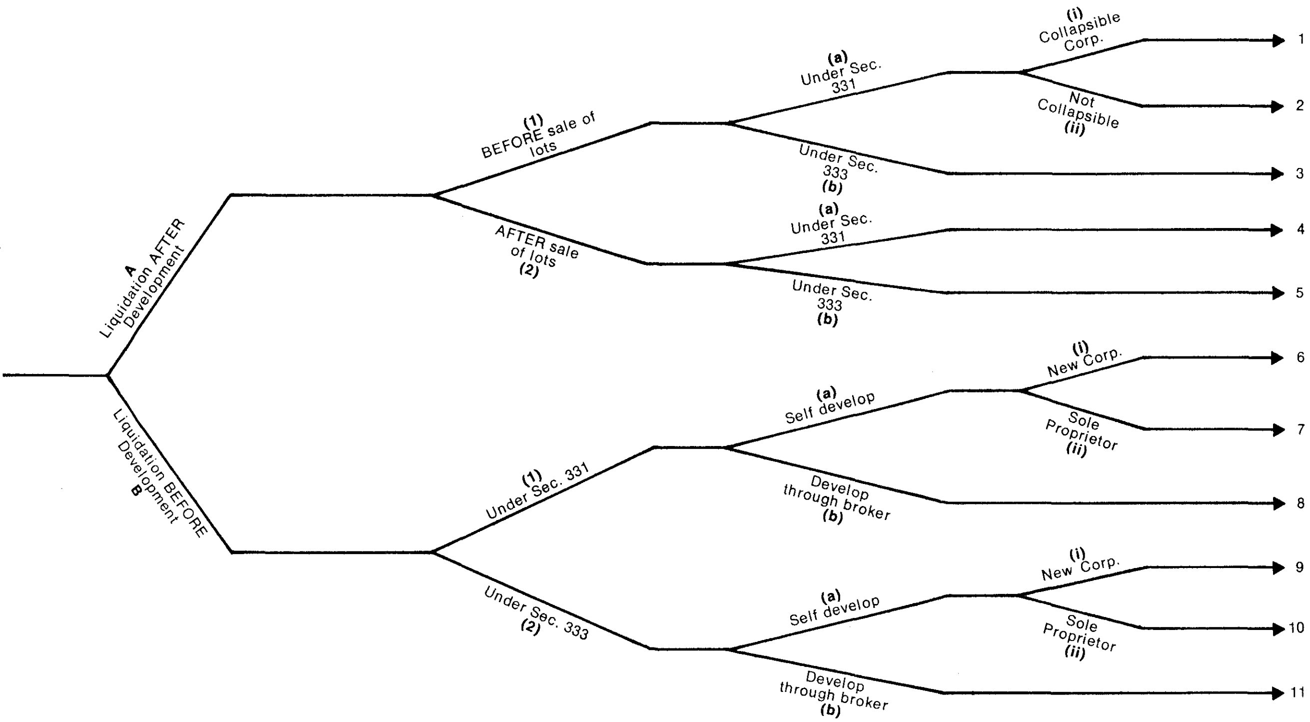
Given these assumptions, it appears that two major issues confront the client. First, there is a prospect of double taxation because the land is currently held by a corporate entity, and the client wants to put all of the proceeds from this venture into a private annuity after completion of the project. Second, there is a chance that some of the gain on the sale of the land could be converted from ordinary income into capital gain. The tree diagram in figure 8.1 outlines eleven possible alternatives. The diagram helps to highlight the constraints under which these alternatives must be pursued. Other alternatives have been rejected on the premise that the client has specifically ruled out those possibilities. For example, one obvious alternative would have been for the client to sell his NNH stock for $300,000. The diagram assumes that the client wants to develop the property and sell the lots; that is, he has rejected the option of selling out and settling for a smaller profit.

Without detailing the procedures used to determine the tax result implicit in each of the eleven branches of this diagram, we will simply note the general tax consequence inherent in that branch. In order to facilitate communication, each branch has been designated by a combination of letters and numbers. Thus, the branch appearing at the top of the diagram can be readily identified as Option A(1)(a)(i); the second option from the top as Option A(1)(a)(ii), and so forth.

Liquidation Under Section 331, After Developing the Property but Before Sale of Lots—Options A(1)(a)(i) and (ii)

Although the land probably would not qualify as either a capital asset (Section 1221) or as a Section 1231 asset, the liquidation of

Figure 8.1
Tree Diagram



the corporation and distribution of the property might be treated as full payment in exchange for the stock (Section 331). If so, because the stock was held for more than six months, the gain would qualify as a long-term capital gain. However, although the client originally did not intend to use the corporation with a view to collapsing it to convert ordinary income into capital gains, the IRS might attempt to invoke Section 341, which would convert the capital gain on liquidation into ordinary income. The two possible tax results can be computed as follows.

Personal Tax

If Sec. 341 is not invoked	*Collapsibility Status*	*If Sec. 341 is invoked*
$ 20,000	Ordinary taxable income	$ 20,000
150,000	Surrender of stock (FMV $450,000 – cost $200,000 – improvements $100,000)	150,000
(75,000)	Long-term capital gain deduction	–
$ 95,000	Total taxable income	$170,000
$ 42,180	Tax liability	$ 90,380

Under this alternative, the subsequent sale of the lots would not create any additional tax liability because the client's new basis in the lots would be $450,000 (assuming the fair market value remained firm at $450,000). Also, under Section 336 the corporation would not recognize gain as a result of the liquidation.

Liquidation Under Section 333, After Developing the Property but Before Sale of Lots—Option A(1)(b)

If the liquidation is executed under Section 333, no gain will be recognized at the time of the liquidation and, according to Section 334(c), the basis in the developed land distributed would be $300,000, the same as the basis of the stock surrendered. (This again assumes that the client contributed the additional $100,000 to NNH to make the land improvements.) The character of the land to the taxpayer would be the same as that to the corporation before liquidation; that is, it would be neither a capital asset nor a Section 1231 asset. No gain would be recognized to the corporation upon liquidation (Section 336). Thus the tax liability would be as follows.

Personal Tax

Ordinary taxable income	$ 20,000
Sale of lots (FMV $450,000 – cost $200,000 – improvements $100,000)	150,000
Taxable income	$170,000
Tax liability	$ 90,380

Liquidation Under Section 331, After Developing the Property and After Sale of Lots—Option A(2)(a)

In the event the corporation sells the developed property before a liquidation is effected under Section 331, it will be required to report the income from the sale of the lots. Undoubtedly the income would be treated as ordinary income since the property was considerably improved and Section 1237, which potentially allows capital gain treatment on the sale of developed land, is not applicable to corporations. Subsequently, the distribution of the cash in liquidation to the sole shareholder would be treated as in full payment in exchange for the stock, and the client would thus realize capital gain treatment (Section 331). The tax consequence would be determined as follows.

Corporate Tax

Sale of improved land	$450,000
Basis of land (cost $90,000 + improvements $100,000)	190,000
Ordinary corporate income	$260,000
Corporate tax liability	$118,300

Personal Tax

Cash distributed in liquidation ($450,000 – corporate tax $118,300)	$331,700
Basis in stock (cost $200,000 + improvements $100,000)	300,000
Capital gain on liquidation	$ 31,700
Ordinary taxable income	20,000
Long-term capital gain deduction	(15,850)
Total taxable income	$ 35,850
Individual tax liability	$ 10,277

Liquidation Under Section 333, After Developing the Property and After Sale of Lots—Option A(2)(b)

Because this alternative assumes a sale of all the property by the corporation prior to liquidation, the corporate tax liability will amount to $118,300 as in the previous option, leaving an after-tax cash distribution of $331,700.

Under the provisions of Section 333(e)(1), the amount of the gain that is not in excess of the taxpayer's ratable share of earnings and profits will be recognized, and treated, as a dividend. Thus, since the client in our example is a 100 percent shareholder, his ratable share of earnings and profits will be $141,700 ($450,000 minus $190,000 (basis) minus $118,300 (corporate tax)) and his recognizable gain on the Section 333 distribution will be $31,700 ($331,700 (cash received) minus $300,000 (basis)), all of which will be treated as a dividend. Thus, in addition to a corporate tax of $118,300, the client will be liable for the following personal income tax.

Personal Tax	
Ordinary taxable income	$ 20,000
Dividend income	31,700
Taxable income	$ 51,700
Tax liability	$ 17,910

Liquidation Under Section 331, Before Developing the Property and Then Accomplishing Development and Sale in a New Corporation—Option B(1)(a)(i)

Liquidating the corporation before land improvements have begun would increase the basis of the property to $300,000. Under a Section 331 liquidation, the client would be treated as having exchanged his stock (a capital asset) for the property distributed to him.

FMV of land received	$300,000
Basis of stock surrendered	200,000
Gain recognized	$100,000

Because the stock surrendered constitutes a Section 1221 capital asset, the client would report a capital gain. Thus, the total personal income tax due on the transaction would be computed as follows.

Personal Tax	
Ordinary taxable income	$ 20,000
Capital gain on surrender of stock	100,000
Long-term capital gain deduction	(50,000)
Taxable income	$ 70,000
Individual tax liability	$ 27,720

A subsequent tax-free transfer, under Section 351, to a new corporation, plus investment of an additional $100,000 for the land development, would increase the basis of the property to $400,000. The new corporation would then incur a corporate tax liability upon sale of the land for $450,000.

Corporate Tax	
Sale of improved land	$450,000
Basis of land ($300,000 + $100,000 investment)	400,000
Ordinary corporate taxable income	$ 50,000
Corporate tax liability	$ 17,500

This alternative offers two major problems, however. First, once the corporation has disposed of the land, a second corporate liquidation must occur, creating an additional tax.

Cash distributed in liquidation ($450,000 – corporate tax $17,500)	$432,500
Basis in stock (basis from Section 351 transfer $300,000 + improvements $100,000)	400,000
Gain on corporate liquidation	$ 32,500

Therefore, according to this alternative, if all transactions occur in the same tax year, the personal tax liability would increase, as follows.

Personal Tax

Ordinary taxable income	$ 20,000
Capital gain on first corporate liquidation	100,000
Capital gain on second corporate liquidation	32,500
Long-term capital gain deduction	(66,250)
Taxable income	$ 86,250
Individual tax liability	$ 36,965

The second and more serious problem associated with this alternative is the risk associated with the liquidation-reincorporation process. It appears highly likely that the IRS could invoke the judicial doctrines of "business purpose" or "step transaction" and thereby ignore the first liquidation entirely. That action would create the same tax result as is described in Option A(2)(a).

Liquidation Under Section 331, Before Developing the Property and Then Accomplishing Development and Sale as a Sole Proprietor—Option B(1)(a)(ii)

The tax consequences as a result of the liquidation will, of course, produce the same result as in the previous alternative: the property basis will increase to $300,000 and the client will recognize a $100,000 long-term capital gain. The subsequent development costs will add an additional $100,000 to the $300,000 basis. The sale of the land for $450,000 will thus create a $50,000 recognizable gain that would probably constitute ordinary income. The client's tax liability would be as follows.

Personal Tax

Ordinary taxable income	$ 20,000
Ordinary gain on sale of land ($450,000 – basis $400,000)	50,000
Gain on corporate liquidation	100,000
Long-term capital gain deduction	(50,000)
Taxable income	$120,000
Individual tax liability	$ 55,620*

*Utilizing "alternative" long-term capital gain tax

Although this alternative appears to have a desirable tax result, it exposes the client to a substantial financial risk in that the land development would take place outside of a corporate entity. If a major, unforeseen liability should arise during the development process, all of the client's assets would be available to settle creditors' claims. This financial risk, and the cost of possible insurance to cover the risk, would have to be assessed carefully in making a selection. Because the illustration is already sufficiently complicated, and because the added complication would add little if anything to the point of the illustration, we have simply ignored this factor in the remainder of the illustration. Unfortunately, the practitioner cannot dispose of problems so easily.

Liquidation Under Section 331, Before Developing the Property and Then Accomplishing Development and Sale Through a Broker—Option B(1)(b)

The tax consequences here are similar to those in the previous alternative. However, the critical question to be decided is whether development and sale by an *independent* real estate broker would cause the final gain on the sale of the property to be treated as a capital gain, rather than as ordinary income. In addition, the broker's fees would be likely to reduce the anticipated return from the development. In order to simplify the solution, we have ignored this probable additional cost for the purposes of the illustration. Accordingly, the tax computation could be made as follows.

Personal Tax	
Ordinary taxable income	$ 20,000
Gain on liquidation of corporation	100,000
Gain on sale of improved land	50,000
Long-term capital gain deduction	(75,000)
Taxable income	$ 95,000
Individual tax liability	$ 42,180

Whether the client would be able to sustain his claim for capital gain treatment on the sale of the property through an independent broker is questionable. There is some judicial authority to support such a position; however, the consensus of available judicial authority does not. Adoption of this course of action would appear to invite litigation. In addition, this alternative might once again in-

clude a substantial financial risk because it requires development of the land outside the corporate entity.

Liquidation Under Section 333, Before Developing the Property and Then Accomplishing Development and Sale Through a New Corporation—Option B(2)(a)(i)

Under a Section 333 liquidation, no gain would be recognized either to the corporation or to the client. The land distributed in the liquidation would assume the basis of the stock surrendered, in this instance $200,000. Subsequent transfer of the land to a new corporation for purposes of development would be tax free under Section 351. The basis of $200,000 plus $100,000 of additional investment to accomplish the development would increase the corporate basis in the property to $300,000. The sale of the land by the corporation would result in ordinary income as follows.

Corporate Tax	
Sales price of land	$450,000
Corporation's basis in land	300,000
Ordinary corporate taxable income	$150,000
Corporate tax liability	$ 65,500

The subsequent liquidation of the new corporation would create the following gain.

Cash distributed (sales price $450,000 – corporate tax $65,500)	$384,500
Basis of stock surrendered	300,000
Gain on corporate liquidation	$ 84,500

Thus, the client's total personal tax liability would be computed as follows.

Personal Tax	
Ordinary taxable income	$ 20,000
Gain on corporate liquidation	84,500
Long-term capital gain deduction	(42,250)
Taxable income	$ 62,250
Individual tax liability	$ 23,493

As was true in Option B(1)(a)(i), an adviser would again have to question how the IRS would view a liquidation followed by an immediate reincorporation and a subsequent liquidation and having no obvious business purpose other than converting ordinary income into capital gain. This alternative, therefore, appears to be highly questionable and full of litigation potential.

Liquidation Under Section 333, Before Developing the Property and Then Accomplishing Development as a Sole Proprietor—Option B(2)(a)(ii)

As mentioned in the explanation of the previous option, no taxable gain would occur with a Section 333 liquidation. The client would surrender his stock and transfer his basis of $200,000 from the stock to the land received in distribution. The subsequent land improvements would increase the basis of the land to $300,000. The sale of the land would undoubtedly result in ordinary income in the amount of $150,000 ($450,000 – $300,000). Thus the client's tax liability would be determined as follows.

Personal Tax	
Ordinary taxable income	$ 20,000
Ordinary income from sale of lots	150,000
Taxable income	$170,000
Individual tax liability	$ 90,380

This alternative also involves the extra financial risk of developing the land outside the safety of a corporate entity.

Liquidation Under Section 333, Before Developing the Property and Then Accomplishing Development Through an Independent Broker—Option B(2)(b)

As in the two previous alternatives, this option transfers the land from the corporation to the client through liquidation and transfers the $200,000 basis in the stock to the land. The additional development costs of $100,000 can again be added to the basis of the land. The same critical questions encountered under Option B(1)(b) are crucial to the tax result in this alternative. If, as a result of sale through a broker, capital gain treatment can be justified, the following tax cost would be incurred.

Personal Tax

Ordinary taxable income	$ 20,000
Capital gain on sale of land ($450,000 – basis $300,000)	150,000
Long-term capital gain deduction	(75,000)
Taxable income	$ 95,000
Individual tax liability	$ 42,180

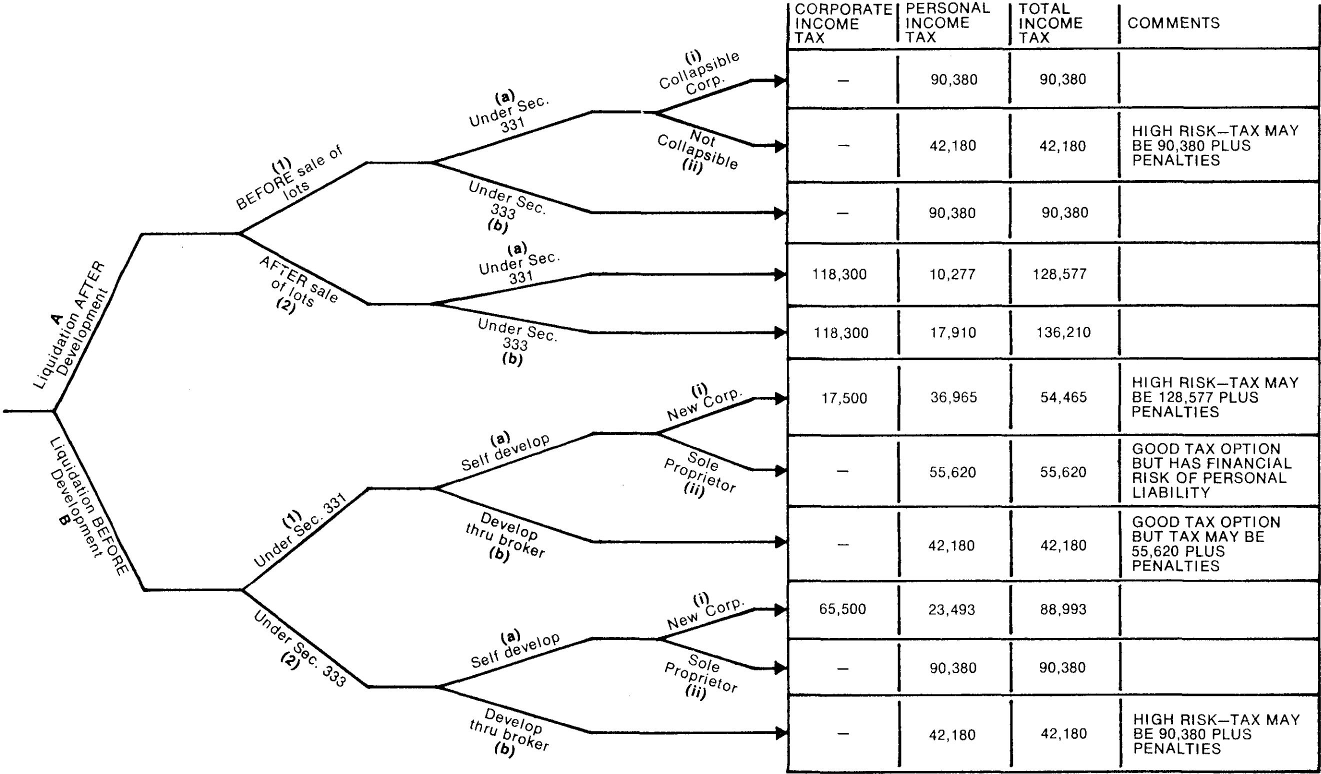
Summary

By adding the results of the foregoing computations to figure 8.2, opposite, we can readily observe some very interesting results. Three alternatives—A(1)(a)(ii), B(1)(b), and B(2)(b)—each produce an equally low tax liability ($42,180). However, each of these alternatives involves a rather high risk. If the alternatives are carried out as proposed, they are likely to be challenged by the IRS and, in at least two instances, may result in rather sizable deficiency assessments. That is, both Option A(1)(a)(ii) and B(2)(b), if challenged during an audit, could result in a deficiency assessment of $48,200. For instance, if Option A(1)(a)(ii) were found to involve a collapsible corporation, the tax liability would amount to $90,380, not including possible penalties. Similarly, if capital gain treatment were to be denied on Option B(2)(b), the revised tax liability would be $90,380, not including any penalties. Although Option B(1)(b) appears to be much more appealing taxwise, it involves the added financial risk common to all noncorporate operations. In the latter alternative, even if challenged successfully, the deficiency assessment would amount to only $13,440 (excluding penalties).

Another highly uncertain result is implicit in Option B(1)(a)(i). If a revenue agent proposes to collapse the two liquidations into one and if we consider only the second liquidation as a valid one, the tax result would involve a liquidation after corporate development of the land with a potential tax liability of $128,577, or a deficiency assessment of $74,112, without penalties.

Taking into consideration *only* the tax factors, alternatives B(1)(b) and B(1)(a)(ii) appear to be the most attractive options. Option B(1)(b), as already noted, projects a possible tax liability of $42,180, with a potential deficiency assessment of $13,400, for a likely tax cost of $55,620. Option B(1)(a)(ii), which requires

Figure 8.2
Tree Diagram



CORPORATE INCOME TAX	PERSONAL INCOME TAX	TOTAL INCOME TAX	COMMENTS
–	90,380	90,380	
–	42,180	42,180	HIGH RISK—TAX MAY BE 90,380 PLUS PENALTIES
–	90,380	90,380	
118,300	10,277	128,577	
118,300	17,910	136,210	
17,500	36,965	54,465	HIGH RISK—TAX MAY BE 128,577 PLUS PENALTIES
–	55,620	55,620	GOOD TAX OPTION BUT HAS FINANCIAL RISK OF PERSONAL LIABILITY
–	42,180	42,180	GOOD TAX OPTION BUT TAX MAY BE 55,620 PLUS PENALTIES
65,500	23,493	88,993	
–	90,380	90,380	
–	42,180	42,180	HIGH RISK—TAX MAY BE 90,380 PLUS PENALTIES

immediate liquidation of the corporation and assumes the development and sale of the land by your client as a sole proprietor, offers the least litigation risk. The total tax would amount to $55,620, the same as the maximum projected under B(1)(b). Nevertheless, both of these alternatives include the financial risk of operating without the liability protection of a corporation, and the latter option probably involves additional costs for the broker's services. As noted earlier, in an actual planning engagement, both of these costs would have to be estimated and added to our illustration before a recommendation could be made to the client.[8]

Once all of the reasonable alternatives have been researched and their tax results determined, a tax adviser should recommend a course of action to his client. In some circumstances, the client may elect to ignore tax results and base his decision on other considerations. In the final analysis, only the client can determine which alternative is best for him. The qualified tax adviser will, however, give his client all of the information needed to make an intelligent decision; in most instances, the adviser's recommendation will be accepted by the client.

This example demonstrates a systematic approach to the research of alternative courses of action available to a taxpayer. This tax-planning process represents a serial rearrangement of facts over which a client can still exercise control. Such a systematic creation and evaluation of alternative strategies is the key to profitable tax planning.

Tax-Planning Communications

Practitioners should recognize distinct differences between communicating research conclusions in a tax compliance problem and making recommendations in a tax-planning engagement. In tax compliance work, the facts and the law pertinent to the solution are generally fixed. Therefore, once the appropriate statute and all related authorities have been identified and evaluated, the researcher

[8] In such an engagement, much of the computational work could be adapted to a computer program, which would include calculations for income averaging, the maximum tax on earned income, and so forth. Obviously computers can eliminate many hours of labor in planning engagements, often at minimal cost through time-sharing arrangements.

generally can offer his conclusion to the client with reasonable certainty that it is "correct."

Reaching an optimal conclusion in a tax-planning engagement is much less certain. The "facts" are merely preliminary proposals based on many estimates and assumptions. Furthermore, the enactment of a proposed plan is not fixed in time. It may occur next week, next month, or two years hence. Consequently, at the time the plan is finally executed, even the tax statutes upon which it is based may have changed and the tax alternative originally recommended may no longer be the preferred one. Because of these uncertainties, the tax adviser should prepare for his client a written memorandum containing a statement of the assumptions and the recommended plan of action, qualified as follows:

1. A statement should be included emphasizing the fact that unless the plan is actually implemented as originally assumed, the tax results may be substantially altered.
2. It should be stressed that the recommendations are based on current tax authority and that possible delays in implementation may change the result because of changes in the law during the interim period.

The foregoing recommendations generally concur with the opinion expressed in the AICPA's Statement of Responsibilities in Tax Practice No. 8, as quoted on page 168. Although the AICPA committee did not recommend *routine* use of such precautionary language, tax advisers should seriously consider the adoption of such standard "disclaimer" statements in most tax-planning engagements.

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