

Approaching Tax Questions

Keys to Effective Tax Research:

- Knowledge of available research tools - how to use them, which ones to use and when, levels of authority, how to know when your research process is complete.
- Knowledge of the tax law to aid in identifying issues.
- Efficiency and confidence in your research skills.

Sample client question you are faced with:

Jane owns a principal residence with a mortgage of \$200,000 and Bill owns a principal residence with a mortgage of \$220,000. Jane also owns a vacation home with a mortgage of \$50,000. Jane and Bill get married on August 1, 19X2. You are preparing their tax return and are wondering how much mortgage interest expense they may deduct in 19X2. You know that a taxpayer is only entitled to deduct qualified mortgage interest on no more than two homes per year, but that if they had not married, they could have deducted all of their interest on their single returns. You wonder whether they would be allowed to deduct interest on all three homes through July 31, 19X2, and then just on two homes after July 31.

General framework for approaching tax questions and its application to the above question (not all steps will apply in all situations and a different order might work better in some cases):

D) Identify the purpose and stage of your research. For example, has this question come up prior to the transaction occurring (planning stage)? If so, it is likely that the proposed events or transaction can be altered to derive the optimal tax result. In such a situation, the tax consequences of various alternatives should be considered in order to present the tax effects of possible options for how the transaction should occur. In addition, if this is a transaction for which the return has not yet been filed, it is possible that you may be able to obtain a private letter ruling from the IRS if desired and feasible.

Or, you may instead be dealing with a completed transaction, such as when you are preparing the corporate tax return and trying to determine how a particular transaction should be reported. In this situation, planning options usually aren't available. However, it is possible that a tax treatment leads to choices. For example, if an expenditure has to be capitalized, there may still be depreciation options for treating the capitalized item. Research for a completed transaction may also lead to the following questions:

- Does substantial authority exist for the conclusion reached?
- Should the position be disclosed on the tax return to avoid penalties (assuming there is at least a reasonable basis for the position)?

If you are dealing with an issue that arose in the context of an examination by the IRS or other taxing authority, the approach noted above for a completed transaction may be somewhat modified. For example, it is possible that the authority you used in taking a position on the tax return may have been changed subsequent to the examination of the tax return. Also, in presenting your position to the Revenue Agent, you should consider that the issue might not get

resolved at that level, but will instead have to go to the appeals level, or even possibly court where more documentation will likely be required.

Application: Assume that this issue arose in the context of preparing Jane and Bill's tax return. Thus, it is too late to undo the transaction, but it may be possible to restructure the transaction for future years to get a better tax result.

II) Gather all facts and background data.

Relevant data includes dates of transactions, parties involved and whether they are related, location of the transaction to determine whether tax laws of other states or countries might also be relevant, and non-tax concerns of the taxpayer.

Application: Perhaps we should obtain more data on the values of the homes, their basis, and how used as it may be relevant to future planning options.

III) Identify the tax issues, if not yet done.

Application: How should interest expense on the three homes be classified on the tax return? Is there any special rule for taxpayer who married during the tax year.

IV) Ask yourself how much you know about the topic and issue. The answer to this question will help in determining where you should begin your research. If you do not know much about a topic, you will likely want to begin with something that provides a general explanation and overview to the topic, such as a *topical service* or a *treatise*.

Application: Assume that we know how §163 works. We might want to check the legislative histories to recent changes (particularly the Tax Reform Act of 1986) to see if our situation is mentioned. We might also want to look for journal articles and comment letters submitted to the IRS and Treasury Department on this topic to see if the question has previously been brought to the attention of the IRS.

Caution: The explanations found in topical and annotated services, treatises and tax journals represent secondary authority which cannot be relied on to avoid penalties and to support positions before the IRS. We must exercise our judgment as to whether the information in the secondary authority is accurate. While such information can be beneficial in providing a concise introduction to a topic and lead to primary authority, it should never be relied on by itself, but should always be used in conjunction with primary authority.

V) To get an initial understanding of the nature of the issue and research approach, apply the general rule, if applicable, that anything received by a taxpayer is taxable income unless the Internal Revenue Code (Code) specifically excludes it, and nothing is deductible unless there is a specific rule that allows for its deduction.

Application: The mortgage interest on the third house is not deductible.

VI) Think of what Code section applies. For most research questions, the Code is the starting point because it is the key primary authority for federal tax questions. For relatively new tax rules, you should also find it useful to read the legislative history (committee reports). These are most easily found in an annotated tax service following the text of the IRC section for the section you are dealing with. If you don't know what Code section applies, use the index at the back of your paperback Code book. Or, use the index to one of the tax services in your tax library. For example, if you looked up purchase price/purchase price allocation in the CCH or RIA tax service, it would lead you to a paragraph in one of the compilations where you should easily be able to tell what Code section(s) is involved.

Application: We are aware that §163 applies here. But, we should keep an open mind to other sections or court doctrines that may be relevant.

VII) Consider exceptions and special rules. It is important to read the entire Code provision that deals with your question. For example, subsection (a) of most Code sections is the general rule, and subsequent subsections are exceptions, special rules and definitions. If you don't read the entire section, you will not have all the pertinent information. In addition, you need to check the regulations, including proposed regulations, as well as look for pertinent Notices, Revenue Rulings, and Revenue Procedures. In checking for regulations, DO NOT just rely on the paperback regulations books you may have at your desk. Such books are out of date as soon as you receive them. Be sure to check one of the tax services that is updated on a weekly or monthly basis to see if new regulations have been issued (check the "T.D." date of the regulations). Often the CCH or RIA annotated services are useful for this search.

Application: We should read §163 as well as the headings of each of the subsections within that Code section. We should also look for regulations under this section and check the date that the regulations were issued.

Can we find a rule in the law allowing all of the interest to be deductible through July 31? The §1.163-10T regulations and Notice 88-74 which are the only official guidance from the IRS on mortgage interest do not address this question. We should check the legislative history to §163(h) to see if we can tell from Congressional intent what the answer should be.

Practice Tip: After reading the Code and regulations, ask yourself if this is enough to answer your question. Or, is there terminology that is not defined, such as "substantially all" or "primary purpose", etc.? Or, is your question not specifically enough addressed? If you do not have enough from the Code and regulations, then knowing what questions remain will better focus your search for court cases and IRS rulings.

VIII) Identify key words in this problem and go to an index of an annotated or topical service. You may need to use more than one service. If you have not yet done so, you should read the legislative history which you will find in the annotated service following the IRC section. For example, following the text of §163 in the compilation covering that section, you will find

excerpts from the committee reports that added and/or amended §163 within the past few years. You will also find annotations (short summaries) of IRS rulings and case law under §163.

Application: mortgage interest, marriage.

IX) Consult the primary authority you are directed to by the annotated and/or topical service. Be sure to retrieve and read the text of relevant cases and rulings; do NOT rely on the annotation in the tax service or the headnote to the court case. The items are only intended to let you know if the case might be on point; you need to read the entire case or ruling to determine if they are at all applicable. Be sure to ask yourself whether your facts are distinguishable from those in court cases and rulings you find. That is, play "devil's advocate" to see if you can strike down your own initial conclusions.

Also be sure to check that the research tool you are using is updated or look for recent developments elsewhere. If you are not sure how the particular service you are using reports current developments or how often it is updated, be sure to read the "how to use" section of the service (usually in volume 1 or a help screen).

In addition to checking the new developments section of the tax service you used, also be sure to verify the status of revenue rulings and revenue procedures by using a Citator (for example, the "finding lists" in the CCH Citator), or the AutoCite (AC) function if using Lexis. Also, be sure to ask yourself whether the law discussed in a revenue ruling or revenue procedure or notice is still current. When the law changes, the IRS does not revoke old rulings issued under the prior version of the law. Also, when reading regulations, be sure to check when they were issued (the date usually follows the "T.D." number) to determine if changes have been made to the statute (IRC) subsequent to the issuance of the regulations. If statutory changes have been made subsequent to the issuance of the regulations you found, you will need to determine what was changed and whether or not the regulations are still reliable.

If the IRS lost any case you are relying on, check on whether the IRS issued an acquiescence or non-acquiescence on the case. (See the later discussion in this outline on "Checking for relevant activity issued subsequent to issuance of a court case").

X) Conduct a search on the IRS website (www.irs.gov). The IRS might have an industry directive, audit guideline or other information pertinent to your question that was not in your commercial tax research tool.

XI) If you don't find anything on point in the service, consider checking IRS letter rulings (private letter rulings, technical advice memorandum, chief counsel advice rulings). This step may lead to a ruling that provides the IRS interpretation of the code sections and legislative history relevant to our question. The IRS is allowed to issue private rulings even where regulations are not yet complete. Although PLRs and TAMs issued to other taxpayers may not be used or cited as precedent per IRC §6110(j), they do provide an indication of how the IRS interprets certain rules and they do constitute substantial authority under §6662.

Application: We should be sure our search included IRS rulings.

XII) If you still can't find an answer in the regulations, IRS rulings or court cases, then,

A) Re-read the legislative history to determine if we missed anything or whether the reasons provided for the rule provide us with an answer.

Application: Does Congress' reason for adding the mortgage interest limitations seem to support deducting interest on three homes, or just two?

B) Re-check the cases you found to see if there were any concurring opinions which may help formulate a supportable position to your issue.

C) Think of another area of the law related to your issue where there is guidance that may help you to structure an argument one way or the other, that is, analogize.

Application: A possible analogy is Revenue Ruling 75-238, 1975-1 C.B. 257, which would allow Jane and Bill to sell both of their principal residences after marriage and defer the gains into one new residence. Perhaps this ruling could help us. Or, it might just mean that they must deduct the interest on the two principal residences and not on the vacation home for all of 19X2.

Would denial of a deduction for interest on three homes in 19X2 constitute a "marriage penalty?" If so, does that help us in finding an answer? [If you are curious as to the answer posed by the question in this example, research it!]

D) Ask a colleague. Perhaps someone has been involved with a similar issue. Perhaps they will see something you have overlooked.

E) For issues dealing with relatively new areas of the law, look for comments letters that have been submitted by tax practitioner groups or taxpayers. These may point out that others also have the same questions and that no answer exists. Such letters may also refer to relevant primary authority or analogies that you did not consider. A good source for finding comment letters, such as those submitted by TEI, the ABA or the AICPA, is by conducting a search in the Tax Notes Today database (available by subscription or via Lexis). You may also want to look for articles in tax periodicals for the same purpose. A new area you may also want to consider is on-line discussion groups that some publishers and professional organizations, such as Tax Analysts¹ have formed. However, be careful about the potential disclosure of your issues.

F) Consider calling the technical specialist in the relevant area at the IRS National Office. You can find their name and phone number using Tax Analyst's Tax Directory, or by looking in the preamble to the regulations (if any exist) or in any Notice or Revenue Ruling that exists. If that person no longer works there, speak to their replacement. While this verbal advice is not binding, it might help direct you in resolving your research question. This would also be a good opportunity to discuss the prospects of submitting a ruling request with the IRS National Office.

¹See <http://www.tax.org/>.

G) Consider requesting a private ruling from the IRS National Office. For the procedures on this, see the first Revenue Procedure of the year. For a list of areas where the IRS will not rule, see the third Rev. Proc. of the year (*e.g.* Rev Proc 2009-3). Also be sure to check in the RIA *Citator* or the "Finding List" in the CCH *Citator* to determine if these Revenue Procedures have been modified since they were issued.

H) Once you have reached a conclusion, consider whether or not the position needs to be disclosed on the tax return to avoid substantial understatement of tax penalties (Code §6662 and related regulations; Form 8275 or 8275-R).

KEY - approach the above tasks with an open and creative mind. You will find that with experience and keeping up to date with the tax law, you will better identify issues, traps and solutions.

XIII) Additional considerations:

A) Whether the answer for state income tax or international tax purposes will be different - is more research needed?

B) Are there non-tax factors that need to be considered such as the effect on financial statement income, cash needs, etc.?

C) Are there any special reporting requirements - 1099s, other special forms?

D) Do any elections need to be made? If yes, by when? For example, in order to amortize capitalized start-up expenditures, a timely election must be made per §195.

E) Does the answer involve a change in method of accounting? If yes, additional tasks are required (see §446, §481 and Rev. Proc. 97-27 and 2008-52).

F) Does the question involve an area currently under consideration by Congress for change? If so, you must review the proposal and consider the effective date of the proposal, the likelihood of passage and the potential impact on your research results.

G) Are there any planning opportunities presented by either this question or related areas?

XIV) Communicate the results of your research. This may take the form of a research memo for the tax return file for that year, a ruling request to be submitted to the IRS, a letter to be given to the IRS, a memo to co-workers, etc.

Query - what do you think the answer to the mortgage interest question is?

Practice with the above framework

Some of the research problems you are assigned in class will be "easy" in that you will find authority on point to answer your questions. This is fine because one of the objectives of this class is to teach you how to use the tools in the library, reach conclusions and communicate findings. In practice, whether you work in a corporate tax department, public accounting firm or for the IRS or FTB, you will find that not all questions have "easy" answers. Many questions seem to have no answer or leave you with a "gray" answer. The framework outlined above will help you get through all types of problems, regardless of the level of difficulty.

During the semester, you will work on both "easy" and challenging problems. You will be assigned a few "gray area" problems as homework. You will bring your findings to class, meet in small groups and discuss solutions. This is illustrative of another research technique - get advice and suggestions from colleagues. During the semester, we will work on a few of the following "gray area" questions. See the syllabus for the due dates.

- 1) In 19X8, Mr. W, an attorney, reimbursed client Sue for a payment that Sue had to make to the IRS and Franchise Tax Board because of erroneous advice that W had provided to Sue. The total payment to Sue was \$50,000 for tax, \$24,000 of interest and \$10,000 for a penalty. The tax relates to an erroneous calculation and legal interpretation made on Sue's return. W has malpractice insurance with a \$20,000 deductible, but did not file a claim because he did not want his rates to go up or his policy to be canceled (W had three claims in prior years). W seeks your advice on whether he may deduct all or part of the \$84,000 paid to Sue. Be sure to consider the following: Does the existence of the insurance policy affect your answer? What about the deductible portion of the insurance policy? If all or part is deductible, under what Code section - §162, §165, other? Does it matter that \$10,000 was Sue's penalty (see §162(f)), or does it lose its taint as a penalty because Joe is just reimbursing Sue for it? Does Sue have income from this transaction? Explain.
- 2) Your individual client won a contest in 19X9 in which the prize was a 4 week, all expenses paid trip to Europe. The issuer of the prize gave your client a Form 1099 showing prize winnings of \$50,000 which appears to be the value of such a trip when no special discounts of any kind are used. Your client found out that the issuer of the prize only had to pay \$38,000 for the prize and your client's own travel agent told him that such a trip could be put together using various discounts and promotional offers for about \$40,000. Your client asks you if they must use the amount on the Form 1099 or if they may use a lower amount. How should this prize be

valued? If you determine that the amount should be lower, how should you report the 1099 on the tax return?

- 4) X Corporation develops software. X has no physical inventory because all software and documentation is transferred only via telecommunications. X's costs of developing the software are not inventoriable under Section 263A (because they are excluded R&E costs) and X incurs no costs for paper or diskettes other than as used in development. Should X be excepted from having to maintain inventories because it has no inventory (and little or no inventory costs)? Assuming X's average annual gross receipts in the prior three-year tax period does not exceed \$5 million, may X use the cash method of accounting, rather than the accrual method? Consider how §471 and 1.471-1 and 1.446-1(c)(2)(i) apply here.

- 5) Karen acquired four domain names a few years ago in the hopes of either selling them, or perhaps using one of them herself. This year, she was contacted by a potential buyer and offered \$400,000 for one of the names. Karen's basis in the name is zero. Karen has run a few ads on E-Bay to try sell the domain names, but the current offer came via direct contact from the potential buyer. Karen would like to know if her \$400,000 gain will be taxed as ordinary income (39.6%) or as a capital gain (20%).