

Chapter 1

Tax Research in Perspective

This book is designed to provide a working knowledge of the methodology of implementation based tax research for an individual who is not already a tax specialist. After a careful reading of this book—and many hours of experience in practicing and using the procedures suggested here—the reader should be capable of finding and using relevant information dealing with tax questions encountered in tax practice today.

This book is not intended to increase an individual's knowledge of any specific technical tax law per se. However, as a secondary benefit, readers may learn more than they previously knew about certain tax provisions as they study the examples offered as problem-solving illustrations. When solving similar tax issues of their own, however, readers should not rely on the conclusions reached in these examples without updating them. Although this book is periodically revised, it is not intended as a substitute for a current tax reference service.

This book does not constitute the provision of legal advice, accounting services, investment advice, written tax advice under Treasury Department Circular No. 230, *Regulations Governing Practice before the Internal Revenue Service*, or professional advice of any kind. It is not intended or written to be used, and cannot be used,

for the purpose of avoiding penalties imposed under the IRC and applicable state or local tax law provisions.¹

Meaning of Research in General

Ideally, a book devoted to tax research would begin with an unambiguous definition of the term *research*. Unfortunately, no such definition exists because 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 this context, looking up an unknown telephone number on the Internet or in a directory could be deemed to constitute research. At the other extreme, a scientist might restrict his or her use of the word *research* to the process of exhaustive experimentation under tightly controlled conditions solely for the purpose of revising previously accepted conclusions in light of recently determined facts. Between these two extremes lie many other alternative definitions.

Perhaps the best way to distinguish between the more common types of tax research that are done today is to create a general classification system based on the purpose of the inquiry. Although other possible classification systems might be used, one based upon the purpose behind the research effort is probably the most useful. These general purposes of tax research include (1) the implementation of rules, (2) the establishment of tax policy, and (3) the advancement of knowledge.

This book does not purport to deal with all of three types of tax research. Except for a few introductory comments in this chapter, this book is restricted to a discussion of the tax research procedures commonly used by a diverse group of professionals—including CPAs—to properly implement the current tax law. In other words, the type of research is focused on determining a defensibly “correct” (and in some instances, an optimal) conclusion to a tax question involving a specific taxpayer or transaction.

Research for Implementation of Rules

Even within the area of tax research for implementation purposes, a difference in the purpose of the research can exist. For example, a taxpayer may ask a tax professional for input regarding the tax treatment of a transaction that has already occurred. This situation is often referred to as tax compliance. On the other hand, the

¹ See Treasury Department Circular No. 230 (Rev. 6-2014) at the IRS website for further information.

taxpayer may ask the tax professional to investigate the most tax effective way of entering into a particular transaction or establishing a new business entity before the actual transaction takes place. This is referred to as tax planning. In either situation, five distinct but closely interrelated steps must be properly addressed in order to achieve a successful research effort. These steps are (1) establish the facts; (2) identify the question or issue; (3) search for an authoritative solution to the question or issue to be resolved; (4) determine a proper application of the frequently incomplete and sometimes conflicting tax authorities; and (5) communicate the conclusion to the interested party. Although a thorough examination of what each of these five steps involves is deferred to later chapters, a summary of each step is included here.

Establishing the Facts

Many tax statutes and their related administrative regulations are necessarily written in general terms. In order to be effective, rules must be stated in terms that adequately describe the vast majority of factual circumstances envisioned by those who establish the rules. Rules stated too broadly invite conflicting interpretation; rules stated too narrowly often fail to achieve their intended objective. However, no matter how carefully the words of a statute or regulation are selected, general rules cannot possibly describe every conceivable factual variation that might be subject to the intended rules. Consequently, the first step in compliance-oriented research necessarily involves the process of obtaining all of the relevant facts so that the researcher can determine which tax rule or rules might apply to those particular events. On the other hand, in a tax planning situation, the taxpayer must carefully ensure that the facts of the proposed transaction are properly aligned with the applicable tax issues and law in order to achieve the desired result.

Determining the Question

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 prior knowledge of tax rules, a researcher usually can state the pertinent questions in terms of very general rules. For example, the tax researcher may ask whether the facts necessitate the recognition of gross income by the taxpayer, or whether the facts permit the taxpayer to claim a deduction in the determination of taxable income. After making an initial search of the authorities to answer the general question, the researcher often discovers that one or more specific technical questions of interpretation must be answered before the general question can be resolved. These secondary questions frequently involve the need

to determine the exact meaning of certain words or phrases as they are used in particular tax rules. For example, the tax researcher may have to determine if a particular payment made by the taxpayer in the fact situation under consideration is *ordinary*, *necessary*, or *reasonable* as those words are used in various sections of the IRC. Alternatively, he or she may have to determine the meaning of the word *primarily* or, perhaps, the meaning of the phrase *trade or business*. Once the general question is restated in this more specific way, the researcher often must return briefly to the process of collecting more facts. From a study of the authorities, the researcher might learn that facts initially not considered important may actually be critical to the resolution of the revised question. After obtaining all necessary facts and resolving the more technical questions, the tax researcher may discover that the general question is also resolved.

Often an answer to a related question must also be resolved before the researcher can proceed to a final conclusion. For example, even if a tax researcher determines that a particular expenditure is not tax deductible, he or she 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 often requires the researcher to move back and forth between fact discovery and issue identification. This procedure continues until all pertinent questions have been satisfactorily answered.

Searching for Authority

Authority in tax matters is voluminous. When dealing with federal tax issues, tax authority nearly always begins with the IRC, as amended, but it quickly expands to include Treasury regulations, judicial decisions, other administrative pronouncements, and sometimes congressional committee reports. Judicial decisions in federal tax disputes are issued by U.S. district courts, the U.S. Tax Court, the U.S. Court of Federal Claims, the various federal circuit courts of appeals, and the U.S. Supreme Court. Administrative pronouncements are issued by the IRS in a variety of formats, including revenue rulings, revenue procedures, IRS notices and announcements, and technical information releases. 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

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

time-consuming task. Furthermore, the search for authority often raises additional questions that can be answered only after the determination of additional facts. Thus, the research process often moves back from 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 questions that have been raised. The taxpayer, of course, must make the final decision about what course of action to take. However, in many circumstances, the taxpayer's decision is guided by the conclusions reached by the adviser. Thus, a tax adviser must resolve the question to his or her own satisfaction before recommending any action to anyone else. In this process, the tax adviser must ensure that proper ethical standards are met and that the recommended tax position meets the required standards in order to avoid the imposition of penalties on either or both the taxpayer and the tax adviser.

Communicating the Conclusion

After thoroughly researching the tax issue and reaching a conclusion, a tax adviser must communicate the information to the interested parties. Drafting tax communications can be very difficult. 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, tax advisers must protect their own rights and professional integrity. Therefore, great care must be exercised in this final step of the implementation-oriented research process. This is especially critical in today's world because of the penalties that may be imposed on the tax adviser if certain standards are not met.

The arrangement of the material in this book follows the sequence of these suggested steps. That is, chapter 2, "The Critical Role of Facts," deals with the search for facts; chapter 3, "The Elusive Nature of Tax Questions," is a discussion of the process by which a tax researcher prepares a statement of the pertinent question. Chapter 4, "Identifying Appropriate Authority," discusses the type of authority that tax practitioners may rely on in resolving tax issues; chapter 5, "Locating Appropriate Authority," explains how relevant authority may be found. Chapter 6, "Assessing and Applying Authority," suggests what to do if the authority is incomplete or conflicting. Chapter 7, "Communicating Tax Research," 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. Chapter 8, "Tax Research in the

Closed-Fact Case: An Example,” and chapter 9, “Research Methodology for Tax Planning,” give detailed examples of this tax research process under two different circumstances; chapter 8 illustrates the research process in a compliance setting, and chapter 9, in a planning situation.

Research for Policy Determination

Our federal tax laws are enacted by Congress in an effort to achieve a variety of goals. In addition to the collection of revenue for the federal government, tax laws are often passed to achieve designated economic and social objectives. For example, the stated objective of the Child and Dependent Care Credit and the Earned Income Credit is to help ease the tax burden of persons who work and also have the responsibility for the care of dependent children. The purpose of the Section 41 research credit and the Section 199 domestic manufacturing deduction is to help stimulate the U.S. economy through research and job creation. With the current huge federal debt as well as the heated discussion dealing with cross-border international business transactions, the use of the tax law to achieve any desired economic goals is one of the most urgent and critical issues facing Congress today. Any tax provision should be investigated thoroughly to determine whether it is efficiently and effectively achieving the intended objectives. The research methodology common to such investigations draws heavily from the discipline of economics. Often econometric models are constructed and much aggregate data obtained to formulate tax policy.

As they attempt to achieve these economic goals, our government representatives should also have factual information about voter preferences. They should know, for example, whether a majority of the voters prefers to deal with problems of pollution through fines and penalty taxes, through incentive provisions in the tax laws, or through nontax legislation. 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. Policy makers should also understand the economic impact of shifting the relative amount of the tax burden between various economic groups in the general population. The research methodology common to determining voter preferences draws heavily on survey techniques developed by sociologists, demographers, and other social scientists.

Every change in tax law potentially has a direct impact on the federal budget and monetary policies as well as on individuals and businesses. Thus, the magnitude and direction of the tax law change should be determined as accurately as possible

before the law is finalized. Operations research techniques and computer technology are 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 a law can achieve its intended objectives. In other ways, the techniques used are quite different. The point is simply that, even within the confines of the work that must be undertaken to provide tax policy prescriptions, the procedures that must be used 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. 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, preferences, or both, surveys based on carefully selected statistical samples are equally mandatory. And if it involves compliance considerations, 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 8 contains an example of implementation-oriented, or compliance, tax research. The objective of chapter 8 is simply to illustrate how a tax researcher might determine the “correct” tax treatment of incorporating a sole proprietorship

under certain stated facts. Chapter 9 demonstrates how tax planning can be used to minimize the tax dangers and maximize the tax opportunities implicit in a different fact setting.

Before focusing on the details of implementation-oriented research in subsequent chapters, however, it may be helpful to note some examples of policy-oriented tax research and documents. Among some of the most significant are the AICPA's Statements on Standards for Tax Services. These statements contain the AICPA's standards of tax practice which delineate AICPA members' responsibilities to taxpayers, the public, the government, and the profession. These standards provide the means whereby the professional performance of CPAs and other tax practitioners can be measured. Currently, there are seven AICPA Statements on Standards for Tax Services, including statements on (1) *Tax Return Positions*, (2) *Answers to Questions on Returns*, (3) *Certain Procedural Aspects of Preparing Returns*, (4) *Use of Estimates*, (5) *Departure From a Position Previously Concluded in an Administrative Proceeding or Court Decision*, (6) *Knowledge of Error: Return Preparation and Administrative Proceedings*, and (7) *Form and Content of Advice to Taxpayers*. The AICPA has also issued certain interpretations of these statements. These statements replace the Statements on Responsibilities in Tax Practice, which the AICPA had issued to provide a body of advisory opinions on good tax practice, and which had come to be relied on as the appropriate articulation of professional conduct in a CPA's tax practice.

In addition to these standards, the AICPA has published various studies that address policy issues dealing with revenue collection and the tax law itself. The AICPA issued its first Statement of Tax Policy in 1974.³ Eight additional statements were issued in the next seven years. In 1993, the AICPA issued an exposure draft of Statement of Tax Policy 10, *Integration of the Corporate and Shareholder Tax Systems*. More recent examples include the AICPA's *Understanding Tax Reform: A Guide to 21st Century Alternatives*, issued in 2005, and *Understanding Social Security Reform: The Issues and Alternatives*, 2nd edition, published in March 2005.⁴

Tax-policy-oriented research has also been done at institutions such as the National Bureau of Economic Research and the Brookings Institute. An example is Brookings' Studies on Governmental Finance, which is devoted to examining issues in taxation and public expenditure policy. One book in this series is *Federal*

³ *Taxation of Capital Gains* (New York: American Institute of Certified Public Accountants, 1974), 28 pages.

⁴ For more information on AICPA tax advocacy, legislation, and policy, including Tax Policy Concept Statements, see www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/TAXLEGISLATIONPOLICY/ADVOCACY/Pages/default.aspx.

Tax Policy by Joseph A. Pechman.⁵ This book discusses individual and corporate income taxes, consumption taxes, payroll taxes, estate and gift taxes, and state and local taxes. The emphasis of the book, however, is on other issues such as the effects of taxation on economic incentives and changes in fiscal relations between the federal and the state and local governments.

In recent years, the AICPA and individual CPA firms have become more active in their efforts to influence tax policy and procedure by committing significant resources to support policy-oriented research. These efforts include funding tax research symposia for academicians and practitioners, research grants for established academicians, and dissertation awards for aspiring researchers. In addition, the AICPA regularly responds to tax policy issues considered by Congress. For example, Congress passed the Sarbanes-Oxley Act of 2002 in response to perceived audit failures. Although this act does not address specific tax provisions found in the IRC, the act does specify certain rules and procedures that must be followed by CPA firms that provide auditing and other services, including tax. As Congress deliberated the passage of this act, the AICPA provided input to the debate. Additionally, after the act was passed, the AICPA again provided input as regulations associated with the act were created. Other more recent examples include the AICPA's input to Congress opposing any codification of an "economic substance standard" in the IRC and its comments on Section 6624, which originally imposed a "more likely than not" standard that had to be met by tax advisers in order to avoid preparer penalties. Originally, this standard was much higher than the standard imposed on taxpayers themselves. As a result of the input by the AICPA and other experts, this standard imposed on tax advisers has been changed to a "reasonable" rather than the original "more likely than not" standard.

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 is mentioned in this perspectives chapter for two reasons: first, to give the tax practitioner a broad overview of the purpose and focus of various types of tax research and second, to suggest to accountants and others, who, by their own inclination are implementation-oriented, the importance of their efforts and input that should be included in policy-oriented projects.

Many have called for a broader participation and cooperation in the determination of tax policy. In the past, the tax research efforts of theoreticians have all too

⁵ This book, published in 1987 (5th ed.), by the Brookings Institution, 1775 Massachusetts Avenue, Washington, D.C. 20036, is still available through vendors, such as www.Amazon.com.

often ignored any 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. An important first step in this hoped-for cooperation 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 used by the more implementation-oriented group.

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