Appendix C

Tax Research

Tax research is the process of determining the most probable tax consequences of a course of action undertaken by an individual or organization. Because of the complexity of state, local, and federal tax laws, most taxpayers are unable to conduct research on their own behalf. Consequently, they engage professionals such as certified public accountants (CPAs) or attorneys to investigate the tax consequences of their business, investment, and financial transactions. Taxpayers expect to receive fair value in return for the substantial fees paid to their tax advisors. Specifically, they expect their advisors to provide accurate, useful, and complete tax information on a timely basis.

A client may engage a tax advisor to research a transaction (or series of transactions) that has already occurred. In such case, the advisor must identify the consequences of the transaction and the proper reporting of the transaction on the client’s tax return. Because the transaction is complete, the facts surrounding the transaction are a matter of record and are no longer subject to the client’s control. The tax consequences of such a closed-fact transaction can’t be changed, even if they are not to the client’s liking. Thus, the advisor is limited to providing a tax compliance service to the client.

Alternatively, a client may engage a tax advisor to research a transaction that the client proposes to undertake at some future date. In this case, the advisor not only can determine the tax consequences of the prospective transaction but also can suggest ways in which the transaction can be modified to result in a more favorable outcome. The facts surrounding a prospective transaction have yet to be established and, therefore, are subject to the client’s control. In such an open-fact transaction, the advisor can help the client create facts that will influence the tax consequences. Clearly, this tax planning service can be extremely valuable to clients who want to maximize the after-tax value of their transactions.

Purpose of This Appendix

For the working tax professional, tax research is often critical to determining the tax consequences of client transactions. The details of the tax law are so numerous and complex that the tax professional cannot possibly memorize the answers to all tax questions. Thus the ability to find answers via tax research is a skill developed through training and experience. Men and women who enter the tax profession have completed many hours of formal study as part of their

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¹ For students familiar with *Principles of Taxation for Business and Investment Planning*, this appendix reviews the basic steps in the tax research process introduced in Appendix C of *Principles* and expands on the discussion of step 3, identifying relevant authorities. For students not familiar with *Principles*, this Appendix provides a thorough introduction to the tax research process.
undergraduate and graduate education. During their careers, they will devote many more hours to maintaining the currency of their technical tax knowledge. Tax professionals also learn by doing. As with any skill, proficiency comes with practice, and tax professionals become more proficient with every research project they undertake.

Tax students gain a broad understanding of fundamental concepts in taxation from textbooks, but cannot possibly address all tax questions using the material covered in these references. An understanding of the tax research process facilitates the student’s quest for additional tax knowledge and provides a deeper familiarity with the sources of tax law. Many tax textbooks include entire chapters on tax research and several textbooks are devoted entirely to the subject. Most graduate accounting and law programs offer a course on tax research. Obviously, this Appendix provides only a brief discussion of the fundamentals of a complex subject. However, after reading this Appendix, students should be ready to try their hand at solving the Research Problems provided at the end of the chapters. Students who do so will enjoy an intellectual challenge that will increase their understanding of the fascinating subject of taxation.

The Tax Research Process

The tax research process can be broken down into six steps. This appendix provides a description of each research step, followed by an example of the application of the step to a research case. Students who are just starting to develop their research skills should focus on and complete each distinct step in sequence. By doing so, students will establish good research “habits.” As they become more proficient, students will gradually integrate the steps into a seamless research process. Those students who become accomplished researchers will automatically perform the six steps for every research project they undertake.

Step 1: Understand the client’s transaction and ascertain the facts

Before a researcher can analyze the tax consequences of a transaction, she must thoroughly understand the transaction itself. Specifically, the researcher should discuss the details of transaction with her client to ascertain the client’s motivation. What are the client’s business or financial objectives in undertaking the transaction? What does the client foresee as the desired outcome? What risks have the client identified? By asking these types of questions, the researcher acquaints herself with the nontax features of the transaction before considering any tax implications.

The researcher must discover all the facts concerning the client’s transaction. Like a newspaper reporter, the researcher should question the client about the precise “who, when, where, why, and how” of the transaction. The researcher
should not assume that the client’s initial summary of the transaction is factually accurate and complete. Perhaps the client hasn’t determined all the facts that the researcher needs. Or the client may have discounted the significance of certain facts and omitted them from the initial summary. The researcher should encourage the client to be objective in stating the facts. Oftentimes a client will unwittingly present the researcher with the client’s subjective conclusions about the facts rather than with the facts themselves.

When a researcher is working with a client to uncover the relevant facts, the researcher must take into account the level of the client’s tax knowledge. If the client has some knowledge of the tax law, the researcher can ask questions that presume such knowledge. On the other hand, if the client is unsophisticated in tax matters, the researcher should ask only questions that the client can answer without reference to the tax law.

Applying Step 1. Sara Colter, a professional photographer, is a new client who has engaged your accounting firm to determine the tax consequences of a proposed transaction: Sara’s sale of a 12-acre tract of land to CCM Inc. Sara provides the following facts in her initial summary of the transaction.

Sara purchased the land from Mr. and Mrs. Bianca in 1994 for $400,000 cash.

Sara and CCM Inc. have reached a tentative agreement under which CCM will pay $325,000 cash for the land and will pay all transaction expenses.

As a tax professional, you know that the tax consequences of a transaction may depend on whether the parties involved are “related parties” for federal tax purposes. You also know that the tax consequences of the sale of an asset depend on the classification of the asset as capital or noncapital. Because Sara is unsophisticated in tax matters, you cannot ask her directly if she and CCM Inc. are related parties. Nor can you ask Sara if the land is a capital asset. Because of her lack of tax knowledge, such questions would be meaningless to your client. Accordingly, you decide to ask Sara the following series of questions.

Do you have any personal relationship with Mr. and Mrs. Bianca? Did you know them in any capacity other than as the sellers of the land that you purchased in 1994?

What was your reason for purchasing the land? Have you made any improvements to the land since 1994? Have you purchased or sold any other real estate during the last ten years?

How did you and CCM Inc. reach an agreement that the land is worth only $325,000? Why has the land declined in value since you purchased it?

Do you own any stock in CCM Inc.? Who are CCM Inc.’s stockholders?
In response to your questions, Sara provides the following additional facts.

She has no personal relationship with the Biancas and did not know them prior to her purchase of their land. The purchase was arranged through a professional real estate broker.

She purchased the land because she thought that its value would increase over time and she could eventually sell it at a profit. She has not made any improvements to the land; it is in exactly the same condition today as the day she purchased it. She has never purchased nor sold any other real estate other than her personal residence.

Two months ago, Sara obtained two independent appraisals of the value of the land. The appraisals both concluded that the current market value of the land is $325,000. CCM Inc. performed its own appraisal that confirmed this value. The $75,000 decline in value is attributable to local zoning restrictions on the land that were put in place in 1997.

Sara does not own any CCM Inc. stock. Twenty-four individual stockholders own the 1,000 outstanding CCM shares. Two of these stockholders are Sara’s brother Jack and Jack’s son Robert. Sara is not acquainted with any of the other stockholders.

Step 2: Identify the tax issues, problems, or opportunities suggested by the facts and formulate specific research questions

After a researcher is satisfied that she understands her client’s transaction and knows all the relevant facts, she can proceed to the second step in the research process. In this step, the researcher identifies the tax issue or issues suggested by the transaction. The ability to recognize tax issues is the product of technical education and professional experience. Consequently, this step is usually the most difficult for students learning tax research skills.

The identification of issues leads to the formulation of tax research questions. The tax researcher should be as precise as possible in formulating questions. A precise question is narrowly stated and provides clear parameters for the remaining steps in the research process. An imprecise question which is vague or overly broad in scope may provide insufficient parameters and result in wasted time and effort.

If the tax issues suggested by a transaction lead to multiple research questions, the researcher must determine the order in which the questions should be answered. In our complex tax system, the answer to one question often depends on the answer to one or more preliminary questions. Tax researchers who understand the hierarchy of their research questions can address each question in the right order and conduct their research with maximum efficiency.
Applying Step 2: After studying the facts, you conclude that Sara’s proposed transaction involves one basic tax issue: will Sara’s sale of the land to CCM Inc. result in a loss that she can deduct on her individual income tax return? This issue suggests four research questions, which you decide to address in the following order.

Will Sara realize a loss on the sale of her land to CCM Inc?

Can Sara recognize her realized loss?

What is the character of any recognized loss?

Given the character of the loss, to what extent can Sara deduct the loss in the computation of taxable income for the year of sale?

Students should note that the research problems provided at the end of the chapters do not require students to perform the first two steps in the tax research process. These problems are deliberately written to contain all the facts necessary to solve the problem. Moreover, the problems provide the specific research question or questions for students to answer. Such is the nature (and weakness) of textbook research problems! But in the real world of tax practice, the first two tasks are not performed by anyone but the researcher herself. If the researcher fails to ascertain the key facts, identify the important issues, and ask the right questions, all her subsequent efforts are futile.

Step 3: Locate relevant tax law authority

As the third step in the research project, the researcher heads for a tax library. Her mission is to locate authority providing answers to her research questions. Traditional libraries consist of shelves filled with books, loose-leaf binders, magazines, and other published materials containing all the technical minutiae of the tax law. Today, traditional libraries are disappearing as professional tax advisors gain access to the electronic libraries available on CD-ROM or the internet. One obvious advantage of electronic libraries is the speed at which researchers can access sources of authority and move among the sources. A second advantage is the ease with which electronic data bases can be updated to include current developments. A third advantage is that an electronic library is portable. A tax researcher with a laptop computer can access her library at any time and from any location.

Regardless of whether a tax researcher is working in a traditional or electronic library, she must be knowledgeable about the content and organization of the reference materials in that library. The researcher must know how to locate references pertaining to the problem at hand. The researcher must also be able
to distinguish between the two main categories of reference materials: primary authorities and secondary authorities.

**Primary Authorities**

All sources of tax information can be categorized as either primary authority or secondary authority. This distinction is important for several reasons. First, only primary authorities may be relied on in the final determination of tax issues. In particular, only primary authorities may be cited in court proceedings when arguing the appropriate application of tax law to a particular transaction. Thus, any research conclusions should be supported by available primary authorities. Primary authorities are items written by the government. Relevant primary authorities arise from three sources: statutory authority, administrative authority, and judicial authority.

The original **statutory authority** for tax law is codified in the **Internal Revenue Code** of 1986. Each numerically ordered section of the Code contains an operational, definitional, or procedural rule relating to one of the federal taxes. Each section of the Code is further divided into subsections, paragraphs, subparagraphs, etc., to provide detailed referencing to the specific legal wording to be cited. Many Code sections contain precise, legalistic language written in a detail-oriented manner whose meaning challenges even seasoned tax professionals. Other Code sections are broad and brief in nature, delegating the authority to write detailed rules and procedures to the administrative function of the Treasury department.

The Treasury department provides a variety of **administrative authority** through its interpretation of the Internal Revenue Code. Sources of administrative authority include treasury regulations, revenue rulings, and revenue procedures. **Treasury regulations** are numbered in sequence to match the code section to which they relate, with the initial number in the sequence indicating the type of tax in question. Income tax regulations begin with a 1, followed by a period and the related Code section. Thus, Reg. Sec. 1.446-1 refers to the first regulation under Section 446. Treasury regulations may be proposed, temporary, or final in nature. Temporary regulations are typically issued in cases where immediate guidance is needed under new statutes, and are often modified before becoming final. Proposed regulations are issued for comment, and are not considered authoritative until reissued in final form. Both temporary and final regulations are effective when issued, and should be considered primary authority whose importance is exceeded only by the Code itself.

The Internal Revenue Service (IRS), as an agency within the Treasury Department, also issues a number of authoritative and non-authoritative types of guidance. For researchers, the most useful of these issuances are revenue rulings and revenue procedures. **Revenue rulings** are issued to address a specific fact pattern and tax issue arising for that set of facts. These rulings are
helpful to taxpayers whose facts match those of the ruling in applying tax provisions. Revenue rulings are published in the *Cumulative Bulletin* for the year of issuance and are numbered in the order issued. For example, the citation Rev. Rul. 91-30, 1991-1 CB 61 refers to the 30th revenue ruling issued in 1991, found on page 61 of the first volume of the 1991 *Cumulative Bulletin*.

**Revenue procedures** address taxpayer administrative and procedural issues, such as information requirements for reporting special transactions, or how and when to file certain forms. Revenue procedures are also published in the *Cumulative Bulletin*, and cited in the same manner as revenue rulings, with Rev. Proc. as the appropriate initial abbreviation.

The IRS also issues two types of administrative guidance that are authoritative only for the specific taxpayer to whom they are issued, and cannot be relied on as authority by any other taxpayer. A taxpayer may request a **private letter ruling** (PLR) from the IRS regarding the appropriate tax treatment of a proposed transaction or a completed transaction for which a tax return has not yet been filed. The request must detail all relevant facts surrounding the transactions, and requires payment of a user’s fee that may be as high as several thousand dollars. The PLR will control the tax treatment of the transaction for that taxpayer, if completed in the manner described in the factual statement of the ruling request. A **technical advice memorandum** (TAM) may be requested by a revenue agent or appeals officer during the examination or appeal of a taxpayer’s return. The TAM represents the position of the IRS on a disputed item in the return, and applies only to the taxpayer for whom it was issued.

When conflicts between taxpayers and the IRS cannot be resolved administratively, federal courts are often called upon to hear tax cases. Their decisions represent **judicial authority** interpreting the tax law and often expanding it beyond the narrow language of the code. Chapter 17 of *Principles* describes the various levels of trial and appellate courts that hear tax cases. For researchers, the decisions rendered by these courts are important sources of primary authority in addition to the code and administrative pronouncements of the Treasury Department.

**Secondary Authorities**

While primary authorities are required to adequately support tax conclusions and recommendations, they are written in detailed legal and technical language and are often difficult to understand and interpret. Secondary authorities, such as textbooks, treatises, professional journals, and commercial tax services, attempt to explain and interpret the tax law. Commercial tax services also organize information about primary authorities in a manner that facilitates tax research. While these resources are an excellent starting point in the tax research process, the researcher should always ensure that any conclusions drawn from secondary resources are adequately supported by the underlying primary authority. Our
discussion of secondary authorities will focus on describing the content of the more popular commercial tax services. In the next section, we'll explore how these services can be used to guide the tax research process.

Traditionally, tax services are multi-volume publications in looseleaf form, containing a wealth of tax information. Most services are now also available electronically, either on CDrom or over the Internet. While each service has its own organizational format and special features, there are commonalities in the type and scope of information presented. In paper format, tax services are organized either topically or by Code section. The popular Code-arranged tax services are United States Tax Reporter (published by RIA) and Standard Federal Tax Reporter (published by CCH). The popular topically-arranged tax services are Federal Tax Coordinator 2d (published by RIA), CCH Federal Tax Service (published by CCH), Law of Federal Income Taxation (also called Mertens, published by West), and Tax Management Portfolios (published by BNA). In electronic format, each type of information is contained in a separate database, with the ability to search multiple databases and with frequent hyperlinks from items in one database to related items in other databases. The RIA Checkpoint online tax research service includes both the United States Tax Reporter and Federal Tax Coordinator 2d. The CCH Internet Tax Research Network includes both Standard Federal Tax Reporter and CCH Federal Tax Service.

Although the format differs, the RIA and CCH Code-arranged services contain similar information. These services reproduce the text of each Code section and related Treasury regulations. Each service also provides some legislative history for each Code section. Following each Code section and its regulations is an editorial explanation written by the publisher. The explanation attempts to clarify application of the Code section. While these editorial explanations are often helpful to researchers in locating primary authority, they do not themselves constitute primary authority and should not be cited. Following the editorial explanation, each service provides a citation listing and brief summary of court cases, revenue rulings, and other primary authorities relevant to the Code section under discussion. These summaries are helpful to the researcher in locating primary authority. Each service also contains a detailed topical index that can be searched for relevant keywords as a means to locate useful material. Finally each service attempts to highlight current developments, and incorporates new information into the text of the service on at least a monthly basis (more frequently in the online versions).

The topically-oriented services are organized according to major topic areas, with more extensive editorial explanation of the application of tax law to specific topics. These services also provide citations to court cases, revenue rulings, and other primary authority related to the topics under discussion. The organization and content of the major topically-oriented services differs
considerably; experience working with a particular service will increase the researcher’s efficiency in finding useful material.

**Strategies for Locating Relevant Authority**

The materials used for tax research will depend on both the nature of the research question and the experience level of the researcher. Skilled researchers tend to rely on those materials they can use most efficiently, to find answers to their questions in minimal time. They may bypass many of the steps suggested below as they find a research approach that works best for them. The novice researcher will tend to examine more materials in a methodical manner, so as to maximize their opportunities to find all relevant information. The strategies suggested below are just that – suggestions!

Let’s suppose you have completed steps 1 and 2 of the research process, as described above, and are now ready to identify relevant authority. One option would be to go directly to the Internal Revenue Code, and use the topical index for the Code to find the relevant Code section. For some research questions, this approach may be sufficient to answer the question. However, what if this approach does not uncover a clear solution? In many cases, more than one Code section may seem to apply. Or the Code may be very general, and the researcher may wish to find other authority that seems to match the specific facts at hand and more clearly support the research conclusions. In that case, the researcher may turn to one of the commercial tax services, and adopt one or more of the following approaches: 1) use the topical index, 2) use the table of contents, or 3) in an electronic service, use a keyword search.

**Using the topical index.** Each service provides a detailed topical index, listing hundreds of tax-related terms alphabetically. As with any index, a single term will appear in multiple places within the service, thus it may be necessary to check several referenced locations before the relevant use of the term is located. The researcher should also try several different wordings or related terms to ensure complete coverage of topics related to the issue being researched.

To illustrate this approach, suppose you are researching an issue related to the deductibility of losses incurred by an individual taxpayer related to a horse-breeding activity. You know from your study of taxation that such losses should be deductible if the activity is considered a trade or business rather than a hobby. A review of the topical index for the United States Tax Reporter, under the letter “H” reveals the topic “Hobby losses and expenses.” This topic heading lists 4 references for the general topic and also provides 8 subtopics, including “horse ranching.” Four additional references are listed for this subtopic. The researcher would turn to each of these 8 references in the search for additional information.

**Using the table of contents.** A researcher may also wish to begin the search for authorities by scanning the table of contents of a tax service to locate an area
of discussion that appears relevant. This approach is particularly useful with topically-oriented services. For the novice researcher, this alternative has the additional benefit of helping the researcher become familiar with the organization of the service.

To illustrate this approach, let's reconsider our example involving horse breeding. The table of contents to the *Federal Tax Coordinator 2d* lists “Chapter M, Deductions: Losses, Bad Debts.” Further examination of the table of contents reveals the following subchapter within Chapter M: “M-5800 Activities Not Engaged in for Profit – Hobby Losses.” This portion of the service would seem a useful starting point in the search for information relevant to the research question.

**Keyword searching.** In an electronic service, the researcher has the option of searching the entire database or a specified portion of the database for user-defined keywords. This type of search is similar to using a topical index, but allows the researcher to combine words and phrases to target the search. While keyword searching can be very efficient, the researcher must take care to ensure that important information is not missed because the keywords were defined too narrowly.

Returning to our example, a keyword search could combine the phrase “hobby loss” and the word “horse” to narrow the identification of potential authorities relative to the material found via use of the topical index or table of contents entries regarding the hobby loss rules. Using the keyword search function in *RIA Checkpoint*, the search “hobby loss” and horse identifies 11 documents within the Federal income tax database in which the phrase “hobby loss” and the word “horse” appear. Each of these documents can then be examined by the researcher to determine their usefulness in answering the research question.

Once a promising starting point is located, via the topical index, table of contents, or a keyword search, the researcher can examine related material in the service. For example, if the search term is found within an editorial explanation, the researcher should read the related Code section, scan the regulations, and examine any references to court cases or other primary authorities to determine whether that material addresses the tax issue at hand. Cross-references within the material initially examined can also lead the researcher in promising directions for further exploration. When primary authorities have been identified that appear relevant, the researcher should read those sources carefully.

If the first application of the process described above fails to provide an answer to the tax research question, additional iterations will be necessary. The researcher might proceed by trying other search terms, defining the search either more broadly or more narrowly, and combining use of the topical index, table of contents, and various keywords to discover useful information. The researcher may also wish to consult more than one service.
Applying Step 3. To begin your search for authority, you turn to the table of contents of the Federal Tax Coordinator 2d. You locate “Chapter I, Sales and Exchanges, Capital Gains and Losses, Cost Recovery Recapture, Depreciation Recapture.” Within this chapter, Subchapter I-2500, “Amount of Gain or Loss on Sale or Exchange,” refers you to Section 1001 of the Internal Revenue Code. When you examine this section, you determine that subsections (a) and (c) seem relevant.

Section 1001. Determination of amount of and recognition of gain or loss

(a) Computation of gain or loss

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(c) Recognition of gain or loss

Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

Section 1001(c) reminds you that gain or loss realized on a sale or exchange is not always recognized. Further examination of the subchapters of Chapter I in the Federal Tax Coordinator 2d reveals I-3500, “Losses Resulting from Sales and Exchanges Between Related Taxpayers.” This subchapter points you to Section 267, which provides that a taxpayer cannot recognize a loss realized on a sale to a related party.

Step 4: Analyze relevant authority and answer the research questions

Regardless of whether a researcher is reading from a printed page or a computer screen, she must have the skill to interpret and evaluate the authority at hand. In some cases, the authority may provide an unambiguous answer to the researcher’s question. In other cases, the answer may be equivocal because the authority is inconclusive or subject to interpretation. Or perhaps different sources of authority provide conflicting answers. In these cases, the researcher must bring her judgment to bear in analyzing the authority and answering the question.

As part of the analytic process, the researcher should decide if the authority requires her to make a factual judgment or an evaluative judgment. In making a factual judgment, the researcher compares the authority to a set of facts. Assuming that the facts are complete and accurate, the researcher can provide a definitive answer to the research question. For example, consider the following research problem.
Mr. Johnson provides 100 percent of the financial support for Ms. Lewis, who is Mr. Johnson’s sister-in-law. Does Ms. Lewis qualify as Mr. Johnson’s dependent?

Section 152 provides the relevant statutory authority for this research question.

Sec. 152. Dependent defined

(a) General definition

For purposes of this subtitle, the term "dependent" means any of the following individuals over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer:

1. A son or daughter of the taxpayer, or a descendant of either,
2. A stepson or stepdaughter of the taxpayer,
3. A brother, sister, stepbrother, or stepsister of the taxpayer,
4. The father or mother of the taxpayer, or an ancestor of either,
5. A stepfather or stepmother of the taxpayer,
6. A son or daughter of a brother or sister of the taxpayer,
7. A brother or sister of the father or mother of the taxpayer,
8. A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer, or
9. An individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 7703, of the taxpayer) who, for the taxable year of the taxpayer, has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household.

By comparing the facts of this research problem to the relevant authority, a researcher can conclude that Ms. Lewis qualifies as Mr. Johnson’s dependent. Therefore, the answer to the research questions is an unqualified “yes.”

Researchers are required to make evaluative judgments when the relevant authority relates to a conclusion inferred from a set of facts, rather than to the facts themselves. By definition, conclusions are subjective; different observers may infer different conclusions from the same facts. A researcher who must draw a conclusion to complete a research project can never be sure that such conclusion will go unchallenged by the IRS. Therefore, the researcher should never give an unqualified answer to a research question requiring an evaluative judgment. This point is illustrated by the following research problem.

Mrs. Clancy operates a business as sole proprietorship. Last week, she traveled to New York for an important meeting with a major client. Mrs. Clancy paid $2,615 for a first-class airline ticket and paid $340 per night for her hotel room. She spent $290 on dinner for herself and her client. Can Mrs. Clancy deduct these business expenses on her Schedule C, Form 1040?
Section 162 provides the relevant statutory authority for this research question.

Sec. 162. Trade or business expenses

(a) In general

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, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business.

This authority requires the researcher to evaluate the circumstances surrounding Mrs. Clancy’s travel expenses. If the expenses were not lavish and extravagant, the entire amount is deductible. However, if some amount was lavish or extravagant, such amount is nondeductible. Note that the term “lavish or extravagant” is a matter of opinion, and reasonable persons might disagree as to whether the term describes Mrs. Clancy’s expenses. If the researcher believes that the facts and circumstances support a conclusion that the travel expenses were not lavish or extravagant, she could advise Mrs. Clancy to deduct the expenses. But the researcher should qualify her advise by explaining the risk that an IRS agent might draw the opposite conclusion and disallow the deduction.

Applying Step 4. Based on your reading of Section 1001(a), you determine that Sara will realize a $75,000 loss if she sells her land to CCM Inc. for $325,000 cash. According to the general rule of Section 1001(c), realized losses are recognized “except as otherwise provided in this subtitle.” Therefore, Sara can recognize the loss and report it on her tax return for the year of sale unless Section 267 disallows the loss. The portions of Section 267 that seem applicable to Sara’s case read as follows:

Sec. 267. Losses, expenses, and interest with respect to transactions between related taxpayers

(a) In general

(1) Deduction for losses disallowed

No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b).
(b) Relationships

The persons referred to in subsection (a) are:

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(c) Constructive ownership of stock

For purposes of determining, in applying subsection (b), the ownership of stock—

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) ...stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

According to Section 267(a)(1), Sara cannot recognize her realized loss if she and CCM Inc. are related parties. According to Section 267(b)(2), Sara and CCM Inc. are related parties if Sara directly or indirectly owns more than 50 percent in value of CCM’s outstanding stock. You know that Sara does not own any CCM stock directly, but you are uncertain as to whether she owns any stock indirectly. Section 267(c)(2) provides that Sara is considered to own any CCM stock owned by her “family.” When you refer to the facts you established during your first meeting with Sara, you discover that you do not know how many shares of CCM stock are owned by Sara’s brother Jack and nephew Robert.

Step 5: Repeat steps 1 through 4 as many times as necessary!

At some point in the research process, even an expert researcher may discover that she does not have all the facts necessary to complete her analysis of the client’s transaction. In such case, the researcher must repeat step one by obtaining additional information from the client. Oftentimes the additional information suggests additional tax issues and research questions that the researcher must address. A researcher may have to repeat Steps 1 through 4 several times before she is satisfied with her analysis.

Applying Step 5. You contact Sara to ask one more question: how many shares of CCM stock do Jack and Robert each own? She replies that Jack owns 350 shares and Robert owns 200 shares of the 1,000 outstanding shares of CCM
stock. With this additional fact, you can complete your analysis of Section 267 as it applies to Sara’s proposed sale.

According to Section 267(c)(2), Sara’s family includes her brother Jack but does not include her nephew Robert. Therefore, Sara indirectly owns the 350 CCM shares directly owned by Jack. However, Jack also indirectly owns the 200 CCM shares owned by his son Robert. Section 267(c)(5) states that Jack’s indirect ownership of these shares is disregarded for the purpose of determining Sara’s ownership. Based on these statutory rules, you conclude that Sara directly and indirectly owns only 350 (35 percent) of Cam’s 1,000 outstanding shares of stock. Thus, she and CCM Inc. are not related parties, Section 267(a) will not apply to her sale of the land to the corporation, and Sara can recognize her $75,000 realized loss.

You continue to analyze sources of information and sources of authority that pertain to your last two research questions. You ultimately conclude that Sara’s $75,000 recognized loss will be characterized as a long-term capital loss. She can deduct this loss in the year of sale to the extent of any capital gain recognized during the year. If the capital loss exceeds her capital gain, Sara is allowed to deduct $3,000 of the excess in the computation of adjusted gross income. Any nondeductible loss becomes a long-term capital loss carryforward into subsequent taxable years.

**Step 6: Document your research and communicate your conclusions**

The tax researcher’s task is to find an accurate, useful, and complete answer to the research question(s) concerning her client’s situation. This task is not finished until the researcher documents her work by preparing a written summary of the research process. Such summary usually takes the form of a research memo that includes (1) a statement of the pertinent facts, (2) an analysis of the relevant sources of authority, (3) an explanation of the researcher’s conclusions, and (4) the details of any advice given to the client as part of the research engagement. This memo becomes a permanent record of the research process - a record to which the researcher (or any other professional) can refer at a future date.

The researcher also must communicate her conclusions to the client. Typically, the researcher writes a client letter containing information similar to that in her research memo. In writing the letter, the researcher should tailor both the contents and writing style to accommodate the client. For example, a letter to a client who has extensive tax knowledge may contain technical references that would be inappropriate in a letter to a client with minimal tax knowledge. Similarly, a letter to an individual who has been both a client and friend for many years may be written in an informal style that would be inappropriate for a letter to the chief financial officer of a new corporate client.
Applying Step 6. After writing a research memo for your permanent record, you write the following letter to Sara Colter.

March 5, 1999

Ms. Sara Colter
1812 Riverbend Place
Kirkwood, Missouri 62119

Dear Ms. Colter:

This letter is in response to your inquiry concerning the tax consequences of a proposed sale of 12 acres of undeveloped land to CCM Inc. Before stating my conclusions, I'd like to summarize the facts of your case. You purchased the land in 1994 as a long-term investment. The purchase price was $400,000 and the sellers of the property, Mr. and Mrs. Bianca, are unrelated to you. You have not improved the land in any way since date of purchase, and have neither purchased nor sold any other real estate with the exception of your personal residence. CCM Inc. is a closely held corporation with 1,000 shares of outstanding stock. Although you do not own any shares, your brother Jack Colter and his son Robert Colter own 350 and 200 shares respectively. You are not acquainted with any other CCM stockholders. The accuracy of my conclusions depends entirely on my understanding of these facts. Consequently, if the statement of facts is in any way incorrect or incomplete, please notify me immediately.

If you sell your land to CCM Inc. for the proposed contract price of $325,000, you will realize a $75,000 loss. This loss equals the excess of your $400,000 investment in the land over the $325,000 cash you will receive at closing. You are allowed to report this loss on your individual tax return in the year of sale unless you and CCM Inc. are “related parties” within the meaning of the tax law. According to my research, you and CCM Inc. do not meet the statutory definition of “related parties,” even though your brother and nephew own an aggregate 55 percent interest in CCM Inc. Therefore, you can report your $75,000 loss for tax purposes. Because you held the land for investment and owned it for more than one year, the loss is classified as a long-term capital loss. You can deduct a long-term capital loss to the extent of your capital gains for the year. If your capital loss exceeds your capital gains, you can deduct only $3,000 of the excess against other sources of income.

Thank you for giving my firm the opportunity to advise you in this matter. If you have any questions about my conclusions, please don’t hesitate to call me. If you proceed with your plans to sell the land, I would be glad to meet with you to
develop a strategy to maximize your deduction for the projected $75,000 capital loss.

Sincerely,

Bridget McGuffin

**Key Terms**

- Administrative authority
- Internal Revenue Code
- Judicial authority
- Primary authorities
- Private letter ruling
- Secondary authorities
- Statutory authority
- Technical advice memorandum
- Treasury regulations
- Revenue procedures
- Revenue rulings