

## CHAPTER 2 TAX RESEARCH METHODOLOGY

### DISCUSSION QUESTIONS

- 2-1. The primary purpose of tax research is to aid in finding solutions to tax problems.

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- 2-2. The basic steps in conducting tax research include the following:

Establish the Facts. This step involves the gathering of facts, including tax and nontax considerations.

Identify the Issues. The tax researcher must identify both issues of fact and issues of law. In so doing, the researcher must rely on a combination of education, training, and experience.

Locate the Appropriate Authority. The researcher must locate authority relevant to the client's situation. Authority may include both primary and secondary authority.

Evaluate the Authority. This step in the tax research process requires the researcher to analyze the authority, including the current status of the authority and the precedential value of the authority.

Develop Conclusions and Recommendations. The researcher must arrive at his or her conclusions based on the first four steps of the tax research process.

Communicate the Recommendations. The final step in the research process is to communicate to the client the facts, assumptions, issues, sources of authority, and conclusions and recommendations.

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- 2-3. First, the researcher must understand the mechanical techniques that are used to identify and locate the tax authorities that relate to solving a problem. Second, the researcher must be creative and explore all of the relevant relationships among the facts and the problems at hand.

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- 2-4. Significant tax facts that a tax practitioner might want to obtain could include any of the following:

The client's tax entity(ies).

The client's family status and stability.

The client's past, present, and projected marginal tax rates.

The client's legal domicile and citizenship.

The client's motivation for the transaction.

Relationships among the client and other parties involved in the transaction.

Whether special tax rules apply.

Whether the transaction is proposed or completed.

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2-5. The researcher should be aware of the following pitfalls:

1. The researcher may attempt to research a problem before fully understanding the facts and circumstances relevant to the client's situation.
2. Often the researcher may have a tendency to ignore new questions that arise as the research task progresses.
3. The client may fail to provide all of the information that is vital to an accurate solution.
4. The tax researcher may approach a tax problem without considering other constraints on the solution to the problem, such as economic factors or personal preferences of the client.

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- 2-6.
- a. T (lower tax liability).
  - b. NT (economic constraints).
  - c. NT (personal preference).
  - d. NT (personal preference).
  - e. NT (personal preference).
- 2-7.
- a. NT (personal preference). Might also be classified as T, since the taxpayer's motivation for a potential transaction is known.
  - b. NT (personal preference)
  - c. NT (family preference)
  - d. T (lower tax liability)
  - e. T (lower tax liability)

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- 2-8. Research issues can be divided into two major categories, namely, fact issues and law issues. Fact issues are concerned with problems such as the dates of the transactions, the amounts involved in an exchange, reasonableness, intent, and purpose. Law issues arise when the facts are well established, but it is not clear which portion of the tax law applies.

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- 2-9. The legal concept of *collateral estoppel* bars relitigation on the same facts or the same issues. Therefore, the tax practitioner must be certain that his or her case is researched fully and no issues have been overlooked. If an issue is not addressed in the original case, it may be lost forever.

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- 2-10. Tax research may be spread over a lengthy period of time. The researcher must be aware of changes that occur during this period which might affect the outcome of the research. Applicable law or facts might be subject to changes which will cause the researcher to arrive at different conclusions and recommendations, even concerning completed research activities.

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- 2-11. All tax authority does not carry the same precedential value. The tax researcher must consider the source of the authority, including whether the source of authority is a primary or secondary source, and the force of the authority. Primary authority comes from statutory, administrative, and judicial sources. In fact, statutory authority is the basis for all tax provisions.

Secondary authority consists of unofficial sources of tax information, such as tax journal articles, textbooks, and newsletters. The researcher should be cautious in relying upon secondary authority which does not have precedential value, but which may be of assistance in clarifying or explaining the primary authority. In addition, the researcher must take into account new issues that have developed since the date of the authority.

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- 2-12. Statutory sources include the Constitution, tax treaties, and tax laws that have been passed by Congress. Administrative authority includes the various rulings of the Treasury Department and the IRS. Judicial authority consists of the collected rulings of the various courts on Federal tax matters.

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- 2-13. a. P  
b. P  
c. S  
d. P  
e. P

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- 2-14. a. P  
b. P  
c. P  
d. S  
e. S

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- 2-15. a. S  
b. S  
c. P  
d. P  
e. S

Pages 51-52

- 2-16. A citator is a reference source that enables the researcher to follow the judicial history of court cases.

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- 2-17. A tax service is a coordinated set of reference materials that organizes the tax authority into a useable format, making the Internal Revenue Code more accessible.

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- 2-18. a. *TAXES* - General tax practitioners  
b. *Journal of Taxation* - Sophisticated tax practitioners  
c. *Practical Tax Strategies* – General tax practitioners  
d. *The Tax Adviser* - Members of the AICPA and other tax practitioners  
e. *The ATA Journal of Legal Tax Research* – Tax academics and practitioners.

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- 2-19. All tax authority does not carry the same precedential value. In the process of evaluating the tax authority for the issue under consideration, it is possible that new issues, not previously considered, may become known. In this case, the researcher may be required to gather additional facts, find more pertinent authority, and evaluate the new issues.

Pages 51-52

- 2-20. If a clear solution to a tax research problem has not been obtained, the practitioner must use professional judgment as to the proper conveyance of the research results to the client. In addition, the client might be informed of the alternative possible outcomes of the disputed transaction and give the best acceptable recommendation.

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- 2-21. Include the following items in both the memorandum to the client file and the client letter:
1. A restatement of the pertinent facts from the researcher's perspective.
  2. A summary of any assumptions that the researcher made in the course of his or her research.
  3. A summary of the issues addressed in the research process.
  4. The applicable authority used to arrive at the researcher's conclusions and recommendations.
  5. The researcher's conclusions and recommendations.

Generally, the memorandum to the client file will contain significantly more details than the letter to the client.

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- 2-22. Yes. In many research situations, a fact generates an issue that in turn may lead to an answer or the need for more facts. Similarly, once an answer is found to an issue, it may also cause a new issue to appear or the need to gather more information. The same situation occurs in evaluating authority. Frequently, there will be ambiguity between items of authority that will require the researcher to use his or her critical thinking skills. This may result in new issues becoming known. The researcher would then be required to gather additional facts, find additional pertinent authority, and evaluate the new issues.

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- 2-23. Substantial Authority under Reg. §1.6662-4(d)(3)(iii) includes:

- a. The Internal Revenue Code and other statutory provisions,
- b. Proposed, Temporary, and Final Regulations,
- c. Revenue Rulings and Procedures,
- d. Tax Treaties and regulations there under,
- e. Court Cases,
- f. Congressional Committee Reports,
- g. The Blue Book,
- h. Private Letter Rulings issued after 10/31/76,
- i. Technical Advice Memoranda issued after 10/31/76,
- j. General Counsel Memoranda issued after 3/31/81, and
- k. IRS Information and Press Releases.

It is important to be familiar with the above sources because any position documented based on these authorities will prevent accuracy-related penalties associated with the item or return under review.

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- 2-24. Online tax research systems provide a fast, cheap method for tax practitioners to access tax information that he or she could not afford to buy before the use of computers. Today's online systems allow the distribution of tax research information and entire tax services to multiple tax staff in both small and large CPA firms. They are accessible through the Internet and several public telecommunications networks. The materials that are available with these services are contained in databases that are stored at centralized computer locations. These databases may be accessed from remote locations with the use of a variety of compatible video devices and keyboards. Usually, they can be accessed via compatible handheld devices and computers that the user already owns.

Advantages of such a system over a standard printed service are the ability on the part of the user to index any significant item by using it as a search item in a query, and the ability for the user to tailor his or her query to fit the requirements of a specific tax problem, which can result in the research process being conducted with greater speed and thoroughness; that online services are updated much faster than printed tax services; that they are particularly useful in researching case law, since every word contained in a case is included in the database, which in turn enables the user to save time by directly accessing only those cases that contain the key terms of his or her search, that certain documents may be obtained only from the

central computer library, and that it can be used to obtain regularly published documents to which the researcher does not have access.

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- 2-25. Any of the following could be examples of web addresses of three free online Internet sites where someone could find information on various aspects of taxation:
- <http://taxsites.com>
  - [www.irs.gov](http://www.irs.gov)
  - <http://thomas.loc.gov>

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- 2-26. Citations not only document a preparer's research and provide a trail for reviewers to follow but also to support that the preparer has met the substantial authority standard. Citations in a memo immediately signal to a reader the types of documents and level of authority a researcher is relying upon.

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- 2-27. a. Thomson Reuters Checkpoint--A Web-based tax research service that contains research material on federal, state, local, and international taxation. Checkpoint contains analytical material such as the Tax Coordinator 2d and the United States Tax Reporter.
- b. CCH IntelliConnect--A Web-based tax research service that contains CCH's tax services (Tax Research Consultant and Federal Income Tax Reporter) and other federal, state, local, and international legal and tax information.
- c. LexisAdvance Tax--Besides containing all federal and state tax research material, LexisNexis provides access to expert analytical materials from CCH, Tax Analysts, and BNA. In addition, LexisNexis has extensive libraries of newspapers, magazines, journals, and patent records and medical, economic, and accounting databases.
- d. Westlaw and WestlawNext contain all federal, state, local, and international legal sources, including court cases, administrative releases, and statutory information. All government documents (e.g., IRS publications, court cases) are also available on this system.
- 2-28. The disadvantages of using a computerized tax service include the high cost of conducting a search and the broad nature of the database.

The database includes all of the pertinent documents needed to conduct a thorough tax research. However, a computerized tax service does not normally include any type of indices; therefore, the researcher must determine the key words to utilize in his or her search request. If the request is not properly structured, the researcher will not locate the pertinent documents.

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- 2-29. Developing an effective search request requires that the researcher:
1. State the Issue in the Form of a Question
  2. Identify the Keywords

3. Construct a Computer Research Query

4. Select Database and Execute Search

5. Interpret and Refine the Search

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- 2-30. To reduce the number of retrieved documents to a reasonable number, the researcher should modify his or her request, usually by editing the last request transmitted to one that is narrower in scope and utilize more unique key words.

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- 2-31. The Checkpoint search connectors discussed in the text are:
- and – finds documents with both chosen keywords in them
  - or – finds documents with either chosen keywords in them
  - /n - finds documents where the first chosen term is within ‘n’ words of the second chosen term
  - not – finds documents with the term that precedes the connector, but not the term following the connector

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- 2-32 (1) Primary  
(2) Primary  
(3) Primary  
(4) Secondary

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- 2-33. “Engagement Time Cost” could impact an engagement by making the research too costly for the client.

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- 2-34. The “Potential Tax Liability” in a situation by making the research cost exceeds the tax savings.

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- 2-35. The “Accuracy Threshold” could impact how much time is spent on the project. As a general rule, the more accuracy needed by the client, the more research that needs to be done to reach a higher level of client comfort.

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- 2-36. “Professional Ethics” could impact a tax engagement by requiring the researcher to achieve an appropriate comfort level for the research conclusion.

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- 2-37. The four parts of the Uniform CPA Exam are:

1. Auditing and Attestation (AUD)

2. Business Environment and Concepts (BEC)

## 3. Financial Accounting and Reporting (FAR)

## 4. Regulation (REG)

The tax issues covered in the REG section of the Uniform CPA Exam include processes, procedures, accounting, and planning as well as federal taxation of property transactions, individuals, and entities. Ethics and professional and legal responsibilities are key components of the section, requiring that candidates be familiar with Treasury Department Circular 230, the AICPA Statements on Standards for Tax Services, and relevant IRS Code sections and regulations.

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**EXERCISES**

- 2-38. All can be found online (however, a researcher may have to pay a subscription fee for access to them). For the second part of the question, the answer will vary by individual school campus library.
- 2-39. All responses and answers will vary with the availability of tax research services available for student use on your campus. Information regarding how students can gain access to the system for research projects in your classes should be obtained by the instructor. If the tax research service is not available on your campus, the student will state so.
- 2-40. Form 3903 and its instructions deal with moving expenses. IRS forms and publications can be accessed at: <https://www.irs.gov/forms-pubs>.
- 2-41. IRS Publication 3 is the Armed Forces' Tax Guide. IRS forms and publications can be accessed at: <https://www.irs.gov/forms-pubs>.
- 2-42. IRS Publication 575 deals with Pension and Annuity Income. IRS forms and publications can be accessed at: <https://www.irs.gov/forms-pubs>.
- 2-43. Form 1040-PR can be found at: <https://www.irs.gov/forms-pubs>.
- 2-44. Publication 1542 is no longer updated by the IRS. Instead, the IRS updates per diem rates in annual (or more frequent) IRS Notices. At the time of the book's printing, the most recent IRS Notice was Notice 2016-58.
- 2-45. Answers will vary over time.
- 2-46. Issues that may be relevant in determining the tax consequences of these transactions include the following:
1. Does the condemnation of the land constitute an involuntary conversion of §1231 property?
  2. If gain is realized, how is it computed?
  3. If gain is recognized, is it ordinary income or capital gain?
  4. Can any of the gain be deferred?
  5. How is the award for damages treated?



2-47. Issues that may be relevant in determining the tax consequences of these transactions include the following:

1. Did the accident result from a “willful act” by Joey (i.e., his not setting the brake)?
2. Does the accident qualify for the casualty loss deduction for Joey?
3. How are the damages to the car and other property measured?
4. Are any payments for Nick’s injuries deductible by Joey?
5. Is the damage to Nick’s house deductible by Joey?

2-48. Issues that may be relevant in determining the tax consequences of these transactions include the following:

1. Who has the liability for the tax on the \$75,000, John, Marsha, or both?
2. Could John and Marsha’s other income have any impact on the taxability of the \$75,000?
3. Did John receive any benefit from the income and how might that affect any income tax liability?
4. Do John and Marsha live in a community property or common law state and what impact would that have on any tax liability?
5. If John reimburses the bank for the \$75,000, is it deductible to him?

2-49. Issues that may be relevant in determining the tax consequences of these transactions include the following:

1. Is the receipt of the restricted stock compensation to Dave?
2. Is there any gain realized on the receipt of the stock? If so, how is the gain computed?
3. If gain is recognized on the receipt of the stock, is it ordinary income or capital gain?
4. Can any of the gain be deferred? If so, how?
5. What is Dave’s basis in the restricted stock?
6. If Dave sells the stock after seven years, how will any gain or loss be taxed?

2-50. Issues that may be relevant in determining the tax consequences of these transactions include the following.

1. What are the tax consequences of rents received in advance?
2. Is Ericka a cash or accrual basis taxpayer?
3. If she is a cash basis taxpayer, how is the rent treated?
4. If she is an accrual basis taxpayer, how is the rent treated?
5. How are any expenses (e.g., depreciation and real estate taxes) associated with the rental income treated?

2-51. The query should include several of the following key words:

redemption  
call  
proceeds  
tax-exempt  
bonds  
municipal

2-52. The query should include several of the following key words:

treaty  
Germany  
fellowship income  
fellowship grant  
internship

Examples of queries include the following:

“treaty Germany” /10 & fellowship or internship (CheckPoint)

treaty w/10 Germany and fellowship or internship (Lexis)

2-53. The query should include several of the following key words:

capitalize  
fringe benefits  
overhead  
build  
building  
slack time  
idle time  
employee  
employee costs  
addition  
factory

Examples of queries include the following:

capitalize & overhead & fringe /3 benefits (CheckPoint)

capitalize and overhead and fringe w/3 benefits (Lexis)

2-54. The query should include several of the following key words:

retroactive  
election  
accounting  
accounting methods

Examples of queries include the following:

“accounting /20 method” and retroactive\* (CheckPoint)

accounting w/20 method and retroactive (Lexis)

2-55. Suitable search queries might be:

constructive /10 dividend (CheckPoint)

constructive w/10 dividend (Lexis)

2-56. a. Issues that may be relevant in determining whether Sam Manuel may deduct the losses from his "activity" include the following:

1. Is the activity considered a hobby or a business activity?
2. Is the fact that Mr. Manuel previously operated the activity on a full-time basis relevant to the question of whether the loss is deductible?
3. Does the taxpayer have the burden of proof in determining whether the activity is operated for income or profit?
4. Does Mr. Manuel have to establish a profit motive for each year that losses are incurred, or once a profit motive is established is this adequate proof for subsequent years?
5. Is the fact that the activity was conducted on a part-time basis by Mr. Manuel, who was a full-time employee of another entity, indicative that the activity must be a hobby and not a business carried on with intent to earn a profit?
6. How much of his time does Mr. Manuel spend on this activity?
7. Does Mr. Manuel invest a significant amount of his money and other resources for the activity?
8. Does Mr. Manuel advertise and otherwise solicit buyers for his products?
9. Can Mr. Manuel substantiate the expenditures that he has incurred?
10. Does Mr. Manuel keep detailed accounting records for the activity separate and apart from his other activities?
11. Is a reasonable expectation of making a profit required in order to determine whether an activity is a trade or business?

b. Examples of key words: hobby, business, activity, losses, employee, profit.

- 2-57. a. Issues relevant to the tax treatment of the payment received by the partner include the following:
1. Was the \$125,000 payment received by Matthew Broadway a distribution in liquidation of his partnership interest?
  2. If the payment is a payment in liquidation of Matthew's partnership interest, should the amount be treated as ordinary income or should the amount be treated as received in exchange for his interest in the partnership?
  3. Will the entire payment be subject to the same tax treatment, or should \$45,000 of the payment, representing the settlement of the fee dispute, be treated differently from the remainder of the payment?
  4. Does the partnership use the cash or the accrual basis of accounting for tax purposes?
  5. Under the partnership's method of accounting, when would the fee income be included in the partnership's ordinary income?
  6. Was the fee accounted for in the partnership's prior year return or was the fee included in partnership income only upon settlement of the dispute in the year following the year of receipt?
  7. Does the fact that the fee was placed in an escrow account until the dispute was settled influence the proper time for including the fee in income?
  8. Does the constructive receipt doctrine apply to the partnership?
  9. Does the assignment of income doctrine apply in this case to make the fee income taxable to Matthew Broadway, the partner who is withdrawing?
- b. Examples of key words: accrual, cash, accounting, partnership, distribution, constructive receipt.
- 2-58 a. Issues which may be important in determining the allocation of the costs among the lots include:
1. Is the increase in fair market value of improved property indicative of the benefits derived by the property?
  2. What was the taxpayer's purpose behind making the improvements?
  3. Does the taxpayer intend to sell all six of the lots?
  4. Do the street, water, and sewer improvements benefit the three undeveloped lots?
  5. What was the fair market value of each lot immediately after the subdivision, but prior to the improvements?
  6. Are certain of the lots more desirable because of easier access, etc?
  7. Is the relative sales price of each of the three single-family homes relevant for allocating the construction costs?
- b. Examples of key words: improvements, subdividing, real estate, realty, costs.

- 2-59. a. Issues which may be relevant to the tax treatment of the proceeds from the sale of the home include:
1. Can Tom take advantage of the §121 exclusion from the sale of a primary residence?
  2. If Tom's gain is taxable, can he take advantage of the installment sale provisions?
  3. If the property has previously been used for business (i.e. rental or home office) will there be any depreciation recapture?
  4. What is the basis of the old home?
  5. How was title of the old home held by Tom and his wife?
  6. Does the divorce decree specify anything other than a 50/50 split of the residence between Tom and his wife?
- b. Examples of key words: divorce, decree, house, residence, gain, exclusion, occupies, Section 121.
- 2-60. a. Additional information that would be helpful in this situation, based on relevant factors for determining a profit motive as listed in Regulation §1.183-2, includes the following:
1. Does Vinny plan to continue his medical practice while he works on his winery?
  2. If he does plan to continue working at his medical practice, does he plan to continue full-time?
  3. How much time and effort are he and/or his family members planning to devote to the winery?
  4. If other family members will be helping with the winery, will they be leaving their occupations to have more time to help out?
  5. Does he plan to carry on the winery endeavor in a business-like manner, keeping books and records, etc.?
  6. Did the taxpayer attempt to acquire knowledge about the winery business or talk to experts in the field?
  7. Is the couple's wealth sufficient to maintain them if future profits don't materialize?
  8. Does Vinny derive little personal or recreational pleasure from this activity?
- b. Additional questions posed to the taxpayer.
- c. No. What Vinny's two children now do for a living is irrelevant.
- d. Will the winery be considered by the IRS to be a bona-fide business with a profit motive or merely a hobby?
- e. Additional research questions might include:
1. Is the taxpayer close to retirement age, and if so, how much will his retirement income be?

2. How much in losses is the business expected to incur in the start-up years?
  3. What were the start-up costs?
  4. Where did the investment money come from?
  5. What is the tax-entity form of the business?
  6. What is the taxpayer's past, present, and projected marginal tax rates?
  7. Are there special tax rules that apply to the winery business?
- 2-61. a. Additional information that would be helpful in this situation includes the following:
1. Was there any oversight of the accountant by the home office or by a CPA?
  2. What types of internal controls, if any, were in place to prevent the embezzlement?
  3. Was there an audit performed by competent outside auditors?
  4. What system, if any, did the taxpayer have in place to receive and review payroll tax deposits and remittances?
- b. Additional questioning of the taxpayer.
- c. Yes.
- d. Did the taxpayer exercise "ordinary business care and prudence in providing for the payment of its tax liabilities" by establishing oversight of the manager's actions to the extent that, as a result, relief is mandated by the statute, warranting abatement of the penalties due to "reasonable cause"?
- e. Additional research questions might include:
1. Has the taxpayer already submitted an offer in compromise to the IRS?
  2. Have there been any arrangements made for the accountant to repay the embezzled funds?
  3. If so, has the taxpayer remitted any funds to the IRS and, if so, how much?
  4. Does the taxpayer have an unblemished history of making past payroll tax deposits on time?
- 2-62. a. Additional information that would be helpful in this situation includes the following:
1. Is there a divorce decree that calls for the monthly fixed payments of \$12,000?
  2. If so, does the divorce decree stipulate what the payments are for?
  3. Are there any children involved from the marriage, and if so, is any of the \$12,000 considered provision for child support?

4. Is the taxpayer legally required to continue the monthly payments after death of the ex-spouse?
  5. Are the monthly payments being made in cash or property?
  - b. Additional questioning of the taxpayer.
  - c. The taxpayer's age is not necessarily significant to this issue.
  - d. Are tax payments on payments to an ex-spouse deductible?
  - d. Additional research questions might include:
    1. What is the ex-spouse's financial situation, and has it changed significantly since the divorce?
    2. Has the ex-spouse since remarried?
    3. Was there a pre-nuptial agreement?
    4. Have the taxpayer's been living in the same household since the divorce?
- 2-63. a. The primary tax issues involved with this case are as follows.
1. Are lottery winnings considered ordinary income or capital gains?
  2. What is the basis of a winning lottery ticket?
  3. Is the assignment of rights to the winnings to a third party considered constructive receipt of the winnings to the taxpayer?
  4. Is the assignment of rights to a third party considered a capital investment?
- b. Examples of key words:
- lottery
  - installments
  - future
  - investment
  - gross income
  - capital gain
  - lump-sum
  - ordinary income
- 2-64. a. The primary tax issues involved with this case are as follows:
1. Are there any restrictions on starting a business on an Indian Reservation?
  2. Can an Indian tribe be a shareholder in an S corporation?
  3. Is the Indian tribe a Federally recognized tax-exempt organization?
  4. What restrictions are there on tax-exempt organizations in S Corporations?

5. Is an Indian tribe considered an “individual” for Federal income tax purposes?

b. Examples of key words:

Indian tribe  
individual  
shareholder  
S corporation  
tax-exempt  
tribal government  
eligible