Chapter 1

UNDERSTANDING AND WORKING WITH   
THE FEDERAL TAX LAW

*Lecture Notes*

**OVERVIEW**

Former IRS Commissioner Sheldon Cohen indicates that “taxes are dry, arcane and difficult, but tell me a person’s philosophy of taxes, and I will tell you his or her philosophy of life.”

The tax law is complex and some of its provisions sometimes defy logic. Most often, there are reasons for the tax rules. One may not agree with the reasons, but, nonetheless, they exist. Knowing these reasons can go a long way in helping to understand the tax law. This knowledge is what Chapter 1 conveys. Chapter 1 also provides an instructor with the opportunity to review some of the concepts covered in the first course in taxation.

**SUMMARY OF CHANGES IN THE CHAPTER**

The following are notable changes in the chapter from the 2021 Edition.

* Made minor changes to Exhibit 1.3.
* Updated some examples in the descriptions.
* Updated the partial list of the available commercial tax services.
* Updated discussion on changes to the CPA exam.
* Added a research problem.

### THE BIG PICTURE

Dana loans her nephew $93,000 in 2014 for college. Seven years later, after receiving only $16,000 of repayments, Dana asks about the possibility of deducting the remainder as a bad debt.

* What planning tips might you give Dana?
* What mistakes were made?

**THE WHYS OF THE TAX LAW**

1. While the primary objective of Federal tax law is raising revenue, this is *not* the sole objective of tax laws.

a. Important in explaining various provisions found in the law are economic, social, equity, and political considerations.

b. The Treasury Department, the IRS, and the courts also have significant impacts on the evolution of Federal tax law.

**Revenue Needs**

2. Raising revenue to fund the cost of government operations is the key factor in structuring a tax system.

3. Over the past century, the national debt has been increasing significantly, reaching more than $27.1 trillion, or about $82,000 per citizen, in November 2020.

4. When enacting legislation, Congress is often guided by the concept of revenue neutrality.

a. Changes in the tax law should neither increase nor decrease the net revenues received by the government.

b. There are likely to be both “winners” (taxpayers who see a reduction in taxes paid) and “losers” (taxpayers who see an increase in taxes paid).

**Economic Considerations**

5. Tax law is often used to accomplish economic objectives.

6. Control of the Economy. Congress has used the tax depreciation system as one means of controlling the economy.

a. Shorter asset lives and accelerated methods should encourage additional investments in depreciable business property.

b. Longer asset lives and the use of straight-line depreciation should discourage capital outlays.

c. Congress also uses incentives like immediate expensing (§ 179) and bonus depreciation to stimulate the economy when needed.

d. When tax rates are lowered, taxpayers retain money that can be used for other purposes.

e. If Congress is using the concept of revenue neutrality, rate reductions may be offset by a reduction or elimination of deductions or credits. As a result, lower rates do not always mean lower taxes.

7. Encouragement of Certain Activities.

a. Research and development expenditures can be deducted in the year incurred or, alternatively, capitalized and amortized over a period of 60 months or more.

b. Inventions (including technological innovations) also are encouraged under tax law. Patents can qualify as capital assets, and under certain conditions, their disposition automatically carries long-term capital gain treatment.

c. Ecology is encouraged by allowing pollution control facilities to be amortized over 60 months (rather than over the 39-year period required for most business buildings).

d. Saving, which leads to capital formation, is stimulated by incentives to increase private retirement plans. The encouragement of private-sector pension plans can be justified under social considerations as well.

8. Encouragement of Certain Industries.

a. Tax laws favor farming by allowing expensing of soil and water conservation and fertilizers. Also, farmers can defer the gain recognition on crop insurance proceeds.

b. The tax law favors the development of natural resources (like oil and gas and mineral deposits) by permitting the use of percentage depletion and a write-off (rather than a capitalization) of certain exploration costs.

c. The railroad and banking industries also receive special tax treatment.

9. Encouragement of Small Business. Several provisions illustrate a desire to benefit small business. These include the following.

a. Special treatment of small business corporation stock leading to ordinary (rather than capital) loss treatment (§ 1244 stock).

b. S corporation elections allow the avoidance of corporate income tax and the pass-through of profits (or losses) to the shareholders.

**Social Considerations**

10. Many of the tax provisions passed by Congress can be explained by social desirability.

a. These provisions encourage individuals to work, give to charities, and obtain an education.

b. Employers are encouraged to provide accident, health, and group term life insurance as well as retirement plans for employees.

**Equity Considerations**

11. Equity is a relative concept, and people often disagree as to what is equitable. For tax purposes, equity is equal application of what the tax law recognizes. One measure of equity is whether a tax is progressive (e.g., the Federal income tax on individuals) or regressive (e.g., gasoline excise tax). The determination is made by calculating the percentage of a taxpayer’s income that is used to pay a tax.

12. Alleviating the Effect of Multiple Taxation. Several provisions are intended to alleviate the effect of multiple taxation.

a. Federal tax law allows a taxpayer to claim a deduction for some state and local income taxes. The deduction, however, does not eliminate the effect of multiple taxation.

b. Because double taxation results when the same income is subject to both foreign and U.S. income taxes, the tax law permits the taxpayer to choose either a credit or a deduction for the foreign taxes paid.

c. Triple taxation relief for corporations is provided by a deduction for dividends received from certain domestic corporations. In the case of individual shareholders, they receive a reduced rate of tax (from 0% for lower tax bracket shareholders to 20% for certain high-income shareholders).

d. For the Federal estate tax, several provisions reflect attempts to mitigate the effect of multiple taxation.

(1) A limited credit against the estate tax for foreign death taxes imposed is allowed.

(2) Other estate tax credits are available and can be explained on the same grounds.

13. The Wherewithal to Pay Concept. This concept is based on equity. It recognizes that it is inequitable to tax transactions when the taxpayer has no ability to pay the tax.

a. Applies only where Congress specifically provides; thus, one cannot conclude that a transaction is nontaxable just because no cash results from the exchange.

b. Most wherewithal to pay provisions in the tax law do not permanently avoid gain or loss but operate on a deferral principle. Because of the basis carryover rules, gain or loss merely is postponed to the future disposition.

14. Mitigating the Effect of the Annual Accounting Period Concept. For administrative ease, all taxpayers have to file tax returns yearly. However, all taxpayers do not have a one-year business cycle. To mitigate the effect of annual accounting period concepts, taxpayers are allowed the following.

a. Deductions for net operating losses that occur in other tax years.

b. The installment method.

c. Deduction determination after the year-end when it is difficult to accurately assess the proper amount by year-end. Examples are contributions to IRA and H.R. 10 (Keogh) retirement plans.

15. Coping with Inflation. To overcome the impact of inflation in many areas of the tax law, Congress has included an indexation procedure.

**Political Considerations**

16. Special Interest Legislation. Special interest legislation provides benefits to limited groups of taxpayers. However, this legislation should not be condemned if justified on economic or social grounds.

17. Political Expediency. Congress is sensitive to the general public’s sentiment regarding taxes. Tax provisions like the imputed interest rules and the limitation on the deductibility of interest on investment indebtedness can be explained on this basis.

18. State and Local Government Influences. State and local influences on Federal taxation may be less apparent. The community property system is an example.

**Influence of the Internal Revenue Service**

19. The IRS as Protector of the Revenue. The IRS is influential in many areas beyond its role in issuing administrative pronouncements. It is proactive in closing “loopholes” in tax laws.

20. Administrative Feasibility. Some tax laws are justified on the grounds that they simplify collecting the revenue and administering the law.

a. Such items as the pay-as-you-go basis for collecting taxes and the imposition of interest and penalties on taxpayers for noncompliance with the tax law help ease revenue collection.

b. Laws to aid in the audit process conducted by the IRS.

(1) Standard deduction reduces the number of taxpayers claiming itemized deductions. Fewer deductions to check simplifies the audit function.

(2) The annual gift exclusion is $15,000.

**Influence of the Courts**

21. Judicial Concepts Relating to Tax Law.

a. Substance over form is one of the most important tax concepts developed by the courts.

b. The step transaction approach (also called the telescoping or collapsing process) allows the tax law to disregard any step in a transaction involving many steps, if the results would be the same.

c. The arm’s-length concept suggests that transactions should be constructed such that unrelated parties would have handled the transaction in the same manner.

d. Continuity of interest, which applies primarily to corporation restructuring, has been incorporated into statutory provisions.

e. Business purpose concepts principally apply to corporations. Tax avoidance is not considered to be a sound business purpose.

22. Judicial Influence on Statutory Provisions. Courts interpret the tax law and may have substantial impact on statutory provisions.

a. Congress generally accepts the decisions of the courts, and those decisions become part of the tax law. In some cases, Congress may see fit to incorporate the result of a decision and make it part of the tax law.

b. On occasion, a decision leads to uncertainty by failing to provide guidelines for similar but not identical factual situations. To clarify the matter, Congress may amend the tax law to establish such guidelines.

c. If Congress does not choose to accept a judicial decision, it can change the tax law to neutralize the result. Congress has the last word on what the Federal tax law should be barring certain exceptions (e.g., constitutional issues).

**SUMMARY**

23. In addition to revenue raising, the Federal tax law is influenced by economic, social, equity, and political considerations.

24. Influence of the IRS and the courts are also instrumental in the development of tax laws.

**RECONCILING ACCOUNTING CONCEPTS**

25. The vast majority of an entity’s business transactions receive the same treatment for financial accounting purposes as they do under Federal and state tax law. But “book-tax differences” exist. These are differences between Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) and tax rules.

**WORKING WITH THE TAX LAW—TAX SOURCES**

26. The primary sources of tax law include information from all three branches of government: legislative (or statutory), executive, and judicial.

27. Learning to work with the tax law involves three basic steps:

1. Familiarity with the sources of the law.

2. Application of research techniques.

3. Effective use of planning procedures.

**Statutory Sources of the Tax Law**

28. Origin of the Internal Revenue Code.

a. Before 1939, the tax law provisions were not codified.

b. The first codification was in 1939 and the recodification was in 1954.

c. The Internal Revenue Code of 1986 *was not* a recodification of the tax law. To emphasize the magnitude of the changes made by the Tax Reform Act of 1986, the Code title was changed.

29. The Legislative Process. For an illustration of the legislative process, see Exhibit 1.1 in the text.

a. Committee reports are an important source for ascertaining the intent of Congress when passing new tax laws. These are key for interpreting legislation, especially before Regulations have been issued.

b. The role of the Joint Conference Committee indicates the importance of compromise in the legislative process.

c. Exhibit 1.2 in the text illustrates what happened in the Tax Cuts and Jobs Act (TCJA) of 2017 regarding corporate tax rates and a new qualified business income deduction for noncorporate taxpayers.

30. Arrangement of the Internal Revenue Code.

a. In referring to a provision of the Code, the key is usually the Section number.

b. Tax researchers often refer to a specific area of income taxation by Subchapter designation.

31. Citing the Code.

a. Proper citation formats are presented on text page 1-16.

b. Some Code Section citations contain a capital letter (e.g., § 280A to § 280H). This is because certain Code numerical sequences have no space for expansion.

**Administrative Sources of the Tax Law**

32. Administrative sources are issued by either the U.S. Treasury Department or the IRS.

33. Treasury Department Regulations. Under § 7805, the Treasury Department has a duty to issue rules and Regulations to explain and interpret the Code.

a. Regulations, which carry considerable authority as the official interpretation of tax law, may be issued in proposed, temporary, or final form.

b. Because they interpret the Code, Regulations are arranged in the same manner as the Code but have a prefix indicating the type of tax to which they apply.

34. Revenue Rulings and Revenue Procedures. Official pronouncements of the National Office of the IRS.

a. Revenue Rulings (Rev.Rul.) are official pronouncements of the National Office of the IRS and are designed to provide interpretation of the tax law, although they do not carry the same legal force and effect as Regulations.

b. Revenue Procedures (Rev.Proc.) deal with the internal management practices and procedures of the IRS.

c. Both serve to provide guidance to IRS personnel and taxpayers in handling routine tax matters.

d. Both are published weekly by the U.S. Government in the *Internal Revenue Bulletin* (I.R.B.).

e. Proper citation formats are presented on text page 1-19.

f. Revenue Rulings and other tax resources may be found at the IRS website: **irs.gov**.

35. Other Administrative Pronouncements.

a. Letter Rulings (Ltr.Rul. or PLR) are issued by the National Office of the IRS upon a taxpayer’s request and describe how the IRS will treat a proposed transaction for tax purposes.

(1) They apply only to the taxpayer who asks for and obtains the ruling.

(2) The IRS must make letter rulings available for public inspection after identifying details are deleted.

b. Technical Advice Memorandums (TAMs) are issued by the National Office of the IRS and resemble letter rulings. However, they are issued in response to questions raised during audits. TAMs deal with completed rather than proposed transactions.

c. Proper citation format for Ltr.Rul. and TAM with explanations are presented on text page 1-19.

d. Letter rulings and TAMs issued are issued with multi-digit file numbers (e.g., Ltr.Rul. 202012012).

e. Like letter rulings, determination letters are issued at the request of taxpayers and provide guidance concerning the application of the tax law. They differ from individual rulings in that:

(1) The issuing source is an IRS Area Director (rather than the National Office of the IRS).

(2) Determination letters usually involve completed (as opposed to proposed) transactions.

(3) Determination letters are not published by the government and are made known only to the party making the request.

**Judicial Sources of the Tax Law**

36. The Judicial Process in General.

a. Once a taxpayer has exhausted remedies available within the IRS, the dispute can be taken to the Federal courts.

(1) The dispute is first considered by a court of original jurisdiction (trial court).

(2) Appeals may be taken to the appropriate appellate court.

(3) The Federal trial and appellate court system is illustrated in Exhibit 1.4 in the text.

b. The Small Cases Division of U.S. Tax Court hears informal cases of $50,000 or less. The ruling of the judge is final (no appeal is available), and these rulings are not precedent for any other cases.

c. The *plaintiff* is the party requesting action in a court, and the *defendant* is the party against whom the suit is brought. Sometimes a court uses the terms *petitioner* and *respondent*. In general, petitioner is a synonym for *plaintiff*, and *respondent* is a synonym for *defendant*.

d. American law, following English law, is frequently “created” by judicial decisions. Under the doctrine of *stare decisis*, each case has precedential value for future decisions with the same controlling set of facts.

37. Trial Courts. Courts in which a taxpayer may pursue a tax conflict are as follows.

a. The U.S. Court of Federal Claims hears tax and other Federal government cases. It has 16 judges.

b. The U.S. Tax Court hears only tax cases. It has 19 regular judges.

c. There are numerous U.S. District Courts based on geographical location. Each court has one judge and taxpayers can have a jury trial.

1. The Tax Court hears only Federal tax cases and is the most frequently used forum for tax cases. The Tax Court hears only Federal tax cases and is the most frequently used forum for tax cases since its judges have more tax expertise

e. Concept Summary 1.1 in the text provides a summary of the organization of the tax trial courts.

38. Appellate Courts. Appeals from trial courts are to the U.S. Court of Appeals for the appropriate jurisdiction. (Exhibit 1.5 in the text illustrates the jurisdictions of the Federal Courts of Appeals.)

a. Generally, a three-judge panel hears a case, but occasionally the full court will decide more controversial conflicts.

b. If the IRS or taxpayer loses at the trial court level, either or both may appeal. When it loses, the IRS may choose not to appeal for a number of reasons.

c. *Appealing from the Tax Court.* The Tax Court is a national court, meaning that it hears and decides cases from all parts of the country.

(1) Under the *Golsen* rule, the Tax Court decides a case as it believes the law should be applied only if the Court of Appeals of appropriate jurisdiction has not yet ruled on the issue or has previously affirmed the Tax Court’s rationale.

(2) If the Court of Appeals has ruled on a case similar to the one being heard by the Tax Court, the Tax Court will conform to the Appeals Court decision under the *Golsen* rule, even though it disagrees with the decision.

d. *Appeal to the U.S. Supreme Court.*

(1) Appeal to the U.S. Supreme Court requires a Writ of Certiorari.

(2) If the Court agrees to hear the case, it grants the Writ but most often, it will deny.

(3) Court grants certiorari to resolve a conflict among the courts or when the tax issue is extremely important.

(4) All individuals and the IRS must follow the decisions of the U.S. Supreme Court.

39. Judicial Citations. Proper judicial citation formats for all court cases are presented on text pages 1-24 through 1-27 and summarized in Concept Summary 1.2 in the text.

40. For additional reinforcement of locating judicial sources, consider using Figure 1-1 at the end of these Lecture Notes.

**Other Sources of the Tax Law**

41. Tax Treaties. Tax conventions (treaties) are signed by the United States and foreign countries to render mutual assistance in tax enforcement and to avoid double taxation. Neither a tax law nor a tax treaty takes general precedence. When there is a conflict, the most recent item will take precedence.

42. Tax Periodicals. Online sources of various periodicals are listed on text page 1-28.

**WORKING WITH THE TAX LAW—LOCATING and using TAX SOURCES**

**Commercial Tax Services**

43. In the past, commercial tax services could be classified as annotated (i.e., organized by Internal Revenue Code) or topical (i.e., organized by major topics). However, as tax research has become electronic, this classification system is no longer appropriate.

44. A partial list of the available commercial tax services includes:

* *CCH IntelliConnect and CCH AnswerConnect, CCH/Wolters Kluwer. Includes the Standard Federal Tax Reporter (along with other CCH materials).*
* *Thomson Reuters Checkpoint, Research Institute of America. Includes RIA’s Federal Tax Coordinator 2d and United States Tax Reporter.*
* *Practical Tax Expert*, CCH/Wolters Kluwer.
* *Tax Management Portfolios*, Bloomberg BNA.
* *Mertens Law of Federal Income Taxation*, Thomson Reuters.
* Thomson Reuters *Westlaw* and *WestlawNext*—compilations include access to *Tax Management Portfolios*, *Federal Tax Coordinator 2d*, and *Mertens*.
* LexisNexis *Tax Center*—a compilation of primary sources and various materials taken from CCH, Matthew Bender, Kleinrock, and Bloomberg BNA.

**Using Electronic (Online) Tax Services**

45. A competent tax professional must become familiar and proficient with electronic research services and be able to use them to complete research projects efficiently.

46. To simplify the research process, the following suggestions may be helpful.

a. Carefully choose keywords for the search.

b. Take advantage of connectors to place parameters on the search and further restrict the output.

c. Be selective in choosing the data to search.

d. Use a table of contents, an index, or a citation when appropriate.

e. Always check for current developments.

**Noncommercial Electronic (Online) Tax Sources**

47. The internet provides a wealth of tax information in several popular forms, that allow a tax professional to access a significant amount of information that can aid the research process.

a. Websites are provided by accounting and consulting firms, publishers, tax academics, libraries, and governmental bodies as a means of making information widely available.

(1) One of the best sites available to the tax professional is the Internal Revenue Service’s home page, illustrated in Exhibit 1.6 of the text.

(2) Exhibit 1.7 in the text lists some of the websites that may be most useful to tax researchers.

b. Blogs and RSS sites provide a means by which information related to the tax law can be exchanged among taxpayers, tax professionals, and others who subscribe to the group’s services.

**WORKING WITH THE TAX LAW—TAX RESEARCH**

48. Tax research is the process of finding a competent and professional conclusion to a tax problem. The tax research process is illustrated in Exhibit 1.8 in the text.

**Identifying the Problem**

49. Problem identification starts by documenting the relevant facts involved with the issue. All of the facts that might have a bearing on the problem must be gathered; if any facts are omitted, the solution provided will likely change.

50. Refining the Problem. The problem will be refined during the research process as research is an iterative rather than a lineal process.

51. Further Refinement of the Problem. The problem will be further refined during the research process as research is an iterative rather than a lineal process.

**Locating the Appropriate Tax Law Sources**

52. Once a problem is clearly defined, the next step is a matter of individual judgment, but most tax research begins with a keyword search using an electronic tax service.

53. If the problem is not complex, the researcher may turn directly to the Internal Revenue Code and the Treasury Regulations. The Code and Regulations are available in print form (and accessible electronically).

**Assessing the Validity of Tax Law Sources**

54. The tax sources identified as relevant to the tax problem need to be interpreted and assessed as to their legal weight and validity.

55. Interpreting the Internal Revenue Code. Language of the Code is often complex: therefore, it must be read carefully, watching particularly for restrictive language and definitions that vary from one Code Section to another.

56. Assessing the Validity of a Treasury Regulation.

a. Treasury Regulations may have the force and effect of law; however, courts have held a Regulation or a portion invalid if contrary to the intent of Congress. Burden of proof is on the taxpayer to show that the Regulation should be invalidated.

b. Regulations that merely reprint or rephrase what Congress has stated in its Committee Reports are almost impossible to overturn.

c. Through the Code, Congress may give the “Secretary or his delegate” the authority to prescribe Regulations to administer or otherwise provide operating tax rules. Since Congress has delegated its legislative powers to the Treasury Department, these legislative Regulations have the power of law.

57. Assessing the Validity of Other Administrative Sources of the Tax Law. While Revenue Rulings issued by the IRS carry less weight than Regulations, they do reflect the position of the IRS on tax matters.

58. Assessing the Validity of Judicial Sources of the Tax Law. How much reliance can be placed on a particular decision depends upon the level of the court, the residence of the taxpayer, whether the decision represents the weight of authority on the issue, and the outcome or status of the decision on appeal.

59. Assessing the Validity of Other Sources.

a. The IRS regards only primary sources as substantial authority. Primary sources include the Constitution, legislative history materials, statutes, treaties, judicial decisions, Treasury Regulations, and IRS pronouncements.

b. While secondary sources are not substantial authority, they still may be very useful. Some, such as letter rulings, Chief Council Advice, can bring protection from accuracy-related penalties. The general explanation of tax legislation prepared by the Joint Committee on Taxation (“Bluebook”) can also provide protection from accuracy penalties.

**Arriving at the Solution or at Alternative Solutions**

60. After evaluating the tax law and applying it to the facts of the tax problem, a solution to the tax issues must be developed by applying professional judgment.

a. The research may not result in a clear solution either because the law is not clear on the issue or due to incomplete knowledge of the tax facts. Thus, alternative treatments may be presented.

b. The personal risk preference and clients’ desired outcome must be considered.

**Communicating Tax Research**

61. Once the conclusions have been reached, they must be communicated to the supervisor and the client.

a. Format may be in memo, letter, or spoken presentation.

b. Good tax research communication should contain the following elements.

* Clear statement of the issue.
* Short review of the facts that raised the issue.
* Review of relevant tax law sources.
* Any assumptions made in arriving at the solution.
* Solution recommended and the logic or reasoning supporting it.
* References consulted in the research process.

62. Exhibits 1.9, 1.10, and 1.11 in the text present a sample client letter and memoranda for the tax files based on the facts of *The Big Picture*.

**WORKING WITH THE TAX LAW—TAX PLANNING**

**Nontax Considerations**

63. Tax considerations can operate to impair sound business judgment. Tax and nontax considerations should be balanced.

**Components of Tax Planning**

64. The key components of tax planning include the following.

a. Avoid the recognition of income (usually by resorting to a nontaxable source or nontaxable event). For example, passing property by death avoids income tax on any built-in appreciation.

b. Defer the recognition of income (or accelerate deductions). For example, like-kind exchanges (§ 1031) and involuntary conversions (§ 1033) defer gain; installment sales both postpone and spread the recognition of gain.

c. Convert the classification of income (or deductions) to a more advantageous form. For example, converting inventory to investment property may change ordinary income to capital gain; § 1244 converts a stock loss from capital to ordinary.

d. Choose the business entity with the desired tax attributes. For example, partnerships and S corporations avoid double taxation of business income and allow the pass through of losses. Partnerships allow more flexibility in the allocation of income among owners than do S corporations but may subject them to more self-employment tax.

e. Preserve formalities by generating and maintaining supporting documentation. For example, transfers from shareholders to a corporation treated as a loan rather than as a contribution to capital will allow subsequent distributions to be treated as deductible interest rather than nondeductible dividends.

f. Act in a manner consistent with the intended objective. For example, a taxpayer claiming to be a dealer when selling land for a loss cannot later claim to be an investor if a subsequent sale would yield a gain; a taxpayer making lifetime gifts cannot continue to control the property gifted.

65. There is a fine line between legal tax planning and illegal tax planning—tax avoidance versus tax evasion. However, the consequences are as vast as the differences between a lightning bug and lightning.

a. Tax avoidance is merely tax minimization through legal techniques. In this sense, tax avoidance becomes the proper objective of all tax planning.

b. Evasion, while also aimed at the elimination or reduction of taxes, connotes the use of subterfuge and fraud as a means to an end.

**Follow-Up Procedures**

66. Tax planning usually involves proposed, as opposed to completed, transactions. The tax law can change by the time the transaction is completed; therefore, additional research should be performed to check the current status of the tax law.

**Tax Planning—A Practical Application**

67. In reference to *The Big Picture* scenario, discuss what should be done to help protect Dana’s bad debt deduction.

**TAXATION ON THE CPA EXAMINATION**

68. The CPA exam continues to test in the familiar four sections—Auditing and Attestation (AUD), Business Environment and Concepts (BEC), Financial Accounting and Reporting (FAR), and Regulation (REG).

69. The exam continues to evolve, placing less emphasis on remembering-and-understanding skills, and greater focus on higher-level analysis and evaluation skills.

70. Elements of the revised exam include:

a. Task-based simulations, a highly effective way to assess higher-order skills are part of each section of the CPA exam.

b. Total testing time is 16 hours (4 hours per section).

c. Multiple-choice questions and task-based simulations each contribute about 50% toward the candidate’s score in the AUD, FAR, and REG sections. In the BEC section, multiple-choice questions contribute about 50% of the scoring, with 35% coming from task-based simulations and 15% from written communication.

d. Using Bloom’s taxonomy, the CPA exam tests remembering and understanding, application, analysis, and evaluation. In prior years, the CPA exam only tested for the first two of these items.

**Preparation Blueprints**

71. To prepare for the CPA exam, candidates are able to use AICPA-developed blueprints that replaced the Content Specification Outline (CSO) and Skill Specification Outline (SSO).

72. The blueprints contain about 600 representative tasks, which are aligned with the skills required of newly licensed CPAs, across the four exam sections.

**Regulation Section**

73. The REG section of the CPA exam is administered in five blocks called testlets, which feature multiple-choice questions (MCQs) and task-based simulations (TBSs). Candidates receive at least one research question (research-oriented TBS) that requires the candidate to search the applicable authoritative literature and find an appropriate reference.

74. There are five content areas in the REG section of the CPA exam.

a. Area 1: Ethics, professional responsibilities, and Federal tax procedures (weight 10–20%).

b. Area 2: Business law (weight 10–20%).

c. Area 3: Federal taxation of property transactions (weight 12–22%).

d. Area 4: Federal taxation of individuals (weight 15–25%).

e. Area 5: Federal taxation of entities (weight 28–38%).

75. In 2020, the AICPA and the National Association of State Boards of Accountancy (NASBA) announced the start of a modification to the CPA exam expected for 2024. The change aims to ensure the CPA designation reflects the knowledge and skills expected of a CPA today. The new approach to the CPA exam (and licensure) is a core plus disciplines. The core includes accounting, auditing, tax, and technology; all candidates take this part of the CPA exam. The three disciplines are business analysis and reporting, information systems and controls, and tax compliance and planning, with candidates taking an exam in one of these areas.

### THE BIG PICTURE

If Dana truly intended the advance made to her nephew to be a loan, she should have documented that intent, along with formalizing all the characteristics normally associated with a loan including the interest rate, repayment dates, and penalties for failure to make scheduled repayments. Failure to preserve the formalities of the debt raises the possibility the advance will be viewed as a gift with no income tax consequences.

**ETHICS AND EQUITY FEATURES**

Solutions to the Ethics & Equity features are located in the Solutions Manual.

**RESEARCH PROBLEMS**

Solutions to end-of-chapter Research Problems are located in the Solutions Manual.

**Figure 1-1**

**LOCATION OF JUDICIAL SOURCES**

USTC AFTR F.Supp. F.3d Cls.Ct. S.Ct.

Series Series Series Series Series Series(a)

U.S. District Courts  
(tax cases) Yes Yes Yes No No No

U.S. Tax Court(b) No(c) No(c) No No No No

U.S. Claims Court(d)

(tax cases) Yes Yes No(e) Yes(e) Yes(e) No

U.S. Courts of Appeals  
(tax cases) Yes Yes No Yes No No

U.S. Supreme Court  
(tax cases) Yes Yes No No No Yes

U.S. District Courts  
(all cases)(f) No No Yes No No No

U.S. Courts of Appeals  
(all cases) No No No Yes No No

U.S. Supreme Court  
(all cases) No No No No No Yes

(a) Answers also apply to the United States Supreme Court Reports (abbreviated U.S.) and to the United States Reports, Lawyer’s Edition (abbreviated L.Ed.).

(b) Regular (not Memorandum) decisions are published by the U.S. Government Printing Office in Tax Court of the United States Reports.

(c) Both CCH and RIA have separate services for reporting the decisions of the U.S. Tax Court (both regular and memorandum).

(d) All decisions (both tax and nontax) of the U.S. Court of Claims were published by the U.S. Government Printing Office in Court of Claims Reporter Series. Ceased publication September 30, 1982.

1. From 1945 to 1960, the Court of Claims decisions were published by West Publishing Company in the F.Supp. Series; from 1960, to September 30, 1982, in the F.2d Series; from October 1, 1982, to September 30, 1992, in the Claims Court Reporter; and beginning October 1, 1992, in the Federal Claims Reporter.
2. The reference to “all cases” pertains to nontax as well as tax cases. Thus, it would include such varied issues as interstate transportation of stolen goods, civil rights violations, and antitrust suits.