**Chapter C:1**

**Tax Research**

**Learning Objectives**

After studying this chapter, the student should be able to:

1. Distinguish between closed fact and open fact tax situations.

2. Describe the steps in the tax research process.

3. Explain how the facts influence tax consequences.

4. Identify the sources of tax law and assess the authoritative value of each.

5. Consult tax services to research an issue.

6. Apply the basics of Internet-based tax research.

7. Use a citator to assess tax authorities.

8. Describe professional guidelines that CPAs in tax practice should follow.

9. Prepare work papers and communicate to clients.

**Areas of Greater Significance**

Since this will usually be a student’s first exposure to tax research, the importance of the facts to the tax results, federal tax services and the citator should be discussed. The widespread use of Internet-based databases for tax research makes this means of tax research much more important. An effort should be made to introduce Internet-based searches to the students if at all possible. The text discusses two types of professional guidelines for CPAs in tax practice.

**Areas of Lesser Significance**

In the interest of time, the following areas may be omitted:

Sample work papers and client letter (Appendix A).

**Problem Areas for Students**

The following areas may prove especially difficult to students:

1. Understanding how to use the tax services and citators.

2. Learning the authoritative value of each source of tax law.

**Highlights of Recent Tax Law Changes**

• For revenue rulings (and other IRS pronouncements) issued after 1999, the full four digits of the year of issuance are provided in the title. For revenue rulings and other pronouncements issued before 2000, only the last two digits of the year of issuance are provided in the title.

• Students should become familiar with the use of Internet-based databases which have replaced the paper services.

• For changes to the IRC enacted after July 29, 1996, the Treasury is generally precluded from issuing regulations with retroactive effect. In the case of final regulations, however, a regulation can be effective on the date proposed or the date on which temporary regulations are filed with the Federal Register. Regulations issued within 18 months of the date of a change to the statute can be issued with retroactive effect.

• Both CCH and RIA provide tax-related information via the Internet. The United States Tax Reporter is also available on LexisNexis and Westlaw.

**Teaching Tips**

• Example C:1-2: Use the example to emphasize to the students the importance of considering nontax objectives as well as tax objectives. p. C:1-2.

• Steps in the Tax Research Process, Paragraph 1: Walk through the steps in the tax research process. As you do this, emphasize to the students that the steps of the tax research process provide an excellent format for a written communication to a client or for a client file. You might consider going over the client communication contained in Appendix A, p. A-2. p. C:1-3.

• If proper citations are being stressed in the course, Table C:1-3, p. C:1-22 is a good reference.

* Illustrate to the students how to use the Internet version of one of the tax services or the LEXIS online service in an in-class demonstration.

**Lecture Outline**

**I. Overview of Tax Research.**

Tax research can be conducted in a number of different settings. Tax research involves solving a specific tax-related question using a number of tax law sources as they apply to a particular situation. Sample work papers demonstrating how to document the results of a research effort are included in Appendix A. In addition, the text discusses two types of professional guidelines for CPAs in tax practice: the AICPA’s guidelines for CPAs in tax practice, the Statements on Standards for Tax Services and Treasury Department Circular 230 (reproduced in Appendix E).

A. Client-oriented research is conducted by accounting and law firms for the benefit of their clients. It involves determining the tax consequences of a certain transaction for a given client. It is performed in:

1. Closed-fact or tax compliance situations. (See Example C:1-1.) p. C:1-2.

2. Open-fact or tax-planning situations. (See Example C:1-2.) p. C:1-2.

B. **Academic settings.** Tax policy research may be conducted by individuals in an academic setting (e.g., accounting programs, law schools, economics departments, etc.).

The tax advisor should always bear in mind the financial accounting implications of proposed transactions. Though interrelated, the two fields of accounting have different orientations and different objectives. Tax accounting is oriented primarily to the Internal Revenue Service. Its objectives include calculating, reporting, and predicting one’s tax liability according to legal principles. Financial accounting is oriented primarily to shareholders, creditors, managers, and employees. Its objectives include determining, reporting, and predicting a business’s financial position and operating results according to Generally Accepted Accounting Principles.

**II. Steps in the Tax Research Process.**

When doing tax research in the context of tax planning or just in engaging in tax planning, the emphasis should be placed on the circular nature of the tax research process. It often requires the determination of different facts, restatement of the research question, or reliance on additional authorities. (Refer here to Figure C:1-1) p. C:1-4. There are, however, six basic steps to the tax research process:

A. Determine the facts.

B. Identify the issues (questions).

C. Locate the applicable authorities.

D. Evaluate the authorities and choose those to follow where the authorities conflict.

E. Analyze the facts in terms of the applicable authorities.

F. Communicate conclusions and recommendations to the client.

A professional needs to keep a number of points in mind.

A. The objective is not to minimize taxes per se but rather to maximize the after-tax return.

B. One does not engage in unilateral transactions; thus, the tax ramifications to all parties to the contract are relevant.

C. Taxes are but one cost of doing business.

D. The time for tax planning is not restricted to when one enters into an investment, contract, or other arrangement, but rather the time extends throughout the life of the activity.

Appendix A walks students through the research process.

Tax research often involves a “gray area;” that is, one that does not have a clear-cut, unequivocally correct solution. The issue should be pursued through the use of a specifically tailored set of detailed questions. Tax research may also involve determining which issues need to be researched. It requires a fairly extensive knowledge of tax law to be able to determine which issues need to be researched.

A tax advisor should always bear in mind the financial accounting implications of proposed transactions. An answer that may be desirable from a tax perspective may not always be desirable from a financial accounting perspective. Success in any tax practice, especially at the managerial level, requires consideration of both sets of objectives and orientations.

**III. Importance of the Facts to the Tax Consequences.**

The importance of a particular set of facts to the tax results should be emphasized. Three illustrations are presented for class discussion. These illustrations should naturally lead into a discussion of how a factual situation can be designed to meet the statutory requirements. p. C:1-6.

**IV. The Sources of Tax Law.**

The term “tax law” generally encompasses much more than just the tax statutes as enacted by Congress. The law contains very general language that requires interpretation, both administrative and judicial. Administrative interpretations include Treasury Regulations, revenue rulings, and revenue procedures. Judicial interpretations consist of court decisions. Tax law also consists of committee reports issued by Congress during the legislative process.

A. **Legislative Process.** All tax legislation must originate in the House of Representatives. Tax bills are referred to the House Ways and Means Committee. After a bill is approved by the House Ways and Means Committee, it moves to the floor of the House for consideration. If approved by a majority of the House, it moves to the Senate. After consideration by the Senate Finance Committee, it moves to the Senate floor for approval. Usually the House and Senate bills will not be in complete agreement. The bill will then go to a conference committee consisting of members of both houses. A compromise will then be made between the two versions of the tax bill. The compromise is then voted on by both houses of Congress and goes on to the President for his signature or veto. Both houses of Congress generally hold extensive hearings at which time interested parties are free to testify. The U.S. Government Printing Office publishes the statements made at hearings. Committee reports explaining Congress’s purpose in drafting legislation are published by the U.S. Government Printing Office in the **Cumulative Bulletin**. Committee reports are particularly useful in interpreting the law prior to issuance of Treasury regulations. (See Example C:1-4.) p. C:1-8.

B. **Internal Revenue Code.** The Internal Revenue Code is the foundation of all tax law. It was first codified in 1939. Recodified in 1954, it has now been named the Internal Revenue Code of 1986. Whenever the law is changed, old language is deleted and new language is added. Refer to Figure C:1-2 to illustrate the organizational scheme of the Internal Revenue Code. p. C:1-9.

C. **Treasury Regulations.** The Treasury Department issues Treasury Regulations as interpretations of the statute. They provide examples complete with computations to assist in understanding how IRC provisions are applied. Because statutory changes occur frequently, regulations are not always updated in a timely manner. When referring to a regulation, the tax advisor should consult the introductory note in order to determine when the regulation was adopted. Treasury Regulations are first provided in proposed form and the public has an opportunity to comment and suggest changes. Proposed regulations have no more authoritative weight than the position the IRS argues for in a brief, but provide guidance on the Treasury   
Department’s interpretation of a statute. Temporary regulations (which generally are effective upon publication) are often issued soon after a major statutory change to provide guidance on procedural and computational matters. Temporary regulations have the same authoritative value as final regulations; however, they cannot remain temporary for more than a three-year period. Temporary regulations must be issued concurrently with proposed regulations. Final regulations are drafted after the public has had time to comment on the proposed regulations. Final regulations have the same authoritative weight as the statute and generally take effect retroactive to the effective date of the statutory language they interpret.

For changes to the IRC enacted after July 29, 1996, the Treasury is generally precluded from issuing regulations with retroactive effect. In the case of final regulations, however, a regulation can be effective on the date proposed or the date on which temporary regulations are filed with the Federal Register. Regulations issued within 18 months of the date of a change to the statute can be issued with retroactive effect.

Regulations may also be classified as either interpretative or legislative. Interpretative regulations are issued under the general authority of Sec. 7805 and make the statutory language easier to understand and apply. They provide illustrations about how to perform certain computations. Legislative regulations provide rules on highly technical matters where Congress has delegated the rulemaking to the Treasury Department (e.g., consolidated tax return issues). Both types of regulations have the same authoritative weight and will be overturned only in very limited cases such as when, in the Court’s opinion, the regulations exceed the scope of power delegated to the Treasury Department, are contrary to the IRC, or are unreasonable.

Section 7805 provides that the Secretary of the Treasury has the right to prescribe regulations and to provide what extent they are to be applied retroactively. Occasionally, taxpayers can successfully argue that a regulation is invalid and, consequently, should not be followed. This will occur only if the courts find that the regulation is “unreasonable and plainly inconsistent with the revenue statutes.” Some courts apply the **legislative reenactment doctrine**, which holds that regulations finalized many years earlier and not amended by Congress through changes to the statutory language have Congressional approval.

Regulations are cited as follows. Numbers before the decimal point indicate the general subject matter of the regulation. p. C:1-11. Numbers to the right of the decimal place refer to the IRC section being interpreted. Numbers to the right of that number indicate the number of the regulation. Temporary or proposed regulations are cited as Temp. Reg. Sec. or Prop. Reg. Sec. When providing a citation, the researcher should be as precise as possible. An example of this would be Reg. Sec. 1.165-5(I), Ex. 2(I), which refers to the first portion of Example 2 that is contained in the first portion of the fifth regulation interpreting Sec. 165. You may wish at this point to use the **Stop and Think** material, which illustrates the force of law certain regulations have. pp. C:1-10-C:1-11.

D. **Administrative Pronouncements.** There are a number of different means that the IRS uses for interpreting the statute. After referring to the IRC and Treasury Regulations, tax advisors are likely to refer next to IRS interpretations for further authority for answering a tax question.

1. **Revenue Rulings.** Revenue rulings are used to indicate the tax status of a specific transaction, which has wide taxpayer interest. They represent the viewpoint of the IRS and do not have as much authority as federal court cases or regulations. Approximately one hundred rulings are issued each year. A taxpayer does not have to follow a ruling if there is sufficient authority for different treatment. An IRS agent is, however, bound by the rulings. Rulings are published weekly in the **Internal Revenue Bulletin** (I.R.B.) and semiannually in the **Cumulative Bulletin** (C.B.) prior to 2009. Refer now to p. C:1-12 to see how revenue rulings are cited.

2. **Revenue Procedures.** Revenue procedures usually deal with procedural aspects of tax practice. They are first published in the **Internal Revenue** **Bulletin** and later in the **Cumulative Bulletin** until 2009. Refer now to p. C:1-12 to illustrate how revenue procedures are cited. In addition to revenue rulings and revenue procedures, the *Cumulative Bulletin* contains IRS notices, as well as the texts of proposed regulations, tax treaties, committee reports, and U.S. Supreme Court decisions. For revenue rulings issued after 2008, the Internal Revenue Bulletin is the final reference.

3. **Letter Rulings.** Letter rulings are initiated by taxpayers who ask the IRS to explain the tax consequences of a particular transaction. The IRS responds in a letter ruling that can be relied on only by the person requesting it. They provide insight into the current thinking of the IRS. CCH publishes rulings with any confidential information deleted in a separate letter ruling service. Refer to pp. C: 1-12-C:1-13 to illustrate how letter rulings are cited.

4. **Technical Advice Memoranda.** When a taxpayer’s return is being audited with respect to a complicated, technical matter, the taxpayer may request that the matter be referred to the IRS National Office in Washington, D.C. concerning the appropriate tax treatment. The answer is issued in the form of a Technical Advice Memoranda, which is made available in the form of a letter ruling. Refer to p. C: 1-13 to illustrate how technical advice memoranda are cited.

5. **Tax Information Releases.** Tax Information releases contain information about interpretations of general interest and are released to the news media throughout the United States. Refer now to p. C:1-13 to illustrate how information releases are cited.

6. **Announcements and Notices.** Information releases that are more technical and aimed at tax practitioners are issued in the form of Announcements. Announcements are often issued before temporary or proposed regulations can be issued. The IRS is bound by announcements and notices in the same way as if contained in a revenue ruling. Notices and announcements issued prior to 2009 appear in both the Internal Revenue Bulletin and the Cumulative Bulletin. As of 2009, they appear only in the Internal Revenue Bulletin. Refer now to p. C:1-13 to illustrate how announcements are cited.

E. **Judicial Decisions.** Judicial decisions comprise an important source of tax law. Judicial decisions in different jurisdictions are sometimes in conflict. See Figure C:1-1, p. C:1-15 for a summary of the court system.

**Overview of the Court System.** There are three trial courts - the U.S. Tax Court, the U.S. Court of Federal Claims, and the U.S. District Courts. Litigation may begin in any court, but precedent is an important factor in determining where it should begin. Cash flow also may be an important factor. Taxes must be paid before litigation begins in the U.S. Court of Federal Claims or the U.S. District Courts. After the taxes are paid, a claim for refund is filed, which will be denied by the IRS. A suit for refund is then brought and, if won, a refund with interest is obtained. A suit may be brought in the Tax Court. If lost, the deficiency plus any interest and penalties must be paid. The District Courts are the only place that a jury trial is possible. Decisions can be appealed from the Tax Court and the U.S. District Courts to the Court of Appeals in the taxpayer’s circuit. Appeals from the U.S. Court of Federal Claims are taken to the Court of Appeals for the Federal Circuit. A party who loses at the appellate level can ask the Supreme Court for a **writ of certiorari**. The Supreme Court hears only about six to ten tax cases a year. (See Table C:1-1 Federal Judicial Circuits for a listing of states in the various Courts of Appeals on p. C 1-15.) (See Table C:1-2 for an overview of the court system on p. C: 1-16.)

**U.S. Tax Court.** The U.S. Tax Court originated in 1942 as the successor to the Board of Tax Appeals. It is a court of national jurisdiction that hears only tax-related cases. All taxpayers, regardless of their state of residence, may litigate in the Tax Court. It has 19 judges, including one chief judge. The President, with the consent of the Senate, appoints the judges for a 15-year term and may reappoint them for an additional term. The judges, specialists in tax-related matters, periodically travel to roughly one hundred cities throughout the country to hear cases. In most instances, only one judge hears a case.

The Tax Court has a special policy in dealing with cases where the amount in question does not exceed $50,000 a year (i.e., small cases). Taxpayers can represent themselves without an attorney. The cases are heard by special commissioners instead of one of the Tax Court judges. Decisions under this procedure cannot be appealed.

The IRS has an **acquiescence policy** with regard to federal court decisions that have been decided in the taxpayer’s favor. If it wishes to go on record that it agrees with a federal court decision, it acquiesces. If it wishes to disagree with a decision, it issues a nonacquiescence. This policy is not followed in all federal court decisions. An acquiescence or nonacquiescence is binding on an IRS agent. If a taxpayer is audited and has taken a position, in which the IRS has issued a nonacquiescence, litigation will likely be the only recourse for the taxpayer. IRS acquiescences and nonacquiescences are published in the Internal Revenue Bulletins and Cumulative Bulletins.

Regular decisions of the Tax Court are published by the U.S. Government Printing Office in a bound volume known as the **Tax Court of the United States Reports**. Soon after a decision is made public, it is also published by RIA and CCH in their loose-leaf reporters of Tax Court decisions. Refer now to Table C:1-3, p. C:1-22 to illustrate regular and memo Tax Court citations.

**U.S. District Courts.** Each state has a U.S. district court and more populous states have several district courts. Many different types of cases are heard by this court and a taxpayer may request a jury trial. District court decisions are officially reported in the **Federal Supplement** (F. Supp.) published by West. Tax decisions are also published by RIA in the **American Federal Tax** **Reports** (AFTR) and by CCH in the **U.S.** **Tax Cases** (USTC). Refer now to Table C:1-3, p. C:1-22 to illustrate a district court citation.

**U.S. Court of Federal Claims.** The U.S. Court of Federal Claims, as reorganized in 1982 and renamed in 1992, is a national court with decisions appealable to the Circuit Court of Appeals for the Federal Circuit. U.S. Court of Federal Claims decisions were published in the **Claims Court Reporter** by West Publishing Co. from 1982 to 1992. These cases are now reported in the **Federal Claims Reporter** (Fed. Cl.). In addition, the AFTR and USTC services report these tax decisions. Refer now to Table C:1-3, p. C:1-22 to illustrate this citation.

**Circuit Courts of Appeal.** Trial court decisions are appealable to a particular circuit court of appeals depending upon where the litigation originated. In the case of an individual, it depends upon the taxpayer’s residence on the date of appeal. In the case of a corporation, it is the principal place of business that controls. There are 11 geographical circuits, the circuit for the District of Columbia and the Federal Circuit. (See Figure C:1-3, p. C:1-22). New circuit court of appeals decisions are reported officially in the **Federal Reporter, Third Series** (F.3d) published by West. In addition, AFTR and USTC services report these decisions. Refer now to Table C:1-3, p. C:1-22 to illustrate this citation.

**Supreme Court.** A decision of an appellate court can be appealed to the U.S. Supreme Court. Unless the circuits are divided on the proper treatment of an issue or the issue is deemed of great significance, the Supreme Court will not grant **certiorari**. Decisions of the Supreme Court are the law of the land. If Congress does not agree with a Supreme Court decision, statutory language can be amended to reach the desired result. Supreme Court decisions are published in the **United** **States Supreme Court Reports** (U.S.) by the U.S. Government Printing Office, the **Supreme Court Reporter** (S.Ct.) by West, and the **United States Reports,** **Lawyers’ Edition** (L.Ed.) by Lawyer’s Co-Operative Publishing Co. In addition, the AFTR and USTC services report these tax decisions. Refer now to Table C:1-3, p. C:1-22 to illustrate this citation.

**Precedential Value of Various Decisions.**

1. The Tax Court will generally rule uniformly for taxpayers. It is bound by Supreme Court decisions. In 1970, the **Golsen** rule was adopted which mandates that the Tax Court will follow decisions of the court for the circuit to which a case in question is appealable.

2. U.S. district court decisions have precedential value only for subsequent cases heard in the same district. District courts must follow decisions of the Supreme Court and the court of appeals to which the case is appealable.

3. The U.S. Court of Federal Claims must rule consistently with the Supreme Court, Circuit Court of Appeals for the Federal Circuit, and its own earlier decisions.

4. A circuit court of appeals is bound by the Supreme Court and earlier decisions made by that circuit. *Green v.* US 185 F. 3d 67, 84 AFTR 2d 99-5415, 99-2 USTC **¶**50,701 (3rd Cir, 1999).

The Green Case appears on page 67, volume 185 of the *Federal Reporter, Third Series.* It is also published in volume 84, page 99-5415 on AFTR, Second Series, and in Volume 2, Paragraph 50,701 of the 199 USTC. The parenthetical information indicates that the Third Circuit decided the case in 1999 (*The Federal Reporter, Second Series* reference is found in footnote 33 of this chapter).

Because the courts are not always in agreement, a taxpayer can sometimes **forum shop** to select a court that is likely to be most favorable to the taxpayer’s position. You may wish to use the **Stop and Think** materials at this point, which illustrate the importance of forum shopping. p. C:1-24.

F. **Tax Treaties.** The United States has treaties with a number of foreign countries. The treaties may pertain to tax and other matters. The provisions contained in a treaty in most cases override the rules contained in the IRC. p. C: 1-24.

G. **Tax Periodicals.** Writings of tax experts in tax periodicals can provide useful insight into provisions contained in the IRC, Regulations, cases, or rulings. A list of periodicals is found on p. C:1-24. Published articles and tax service commentaries are secondary sources of authority. Primary sources of authority are the IRC and administrative and judicial interpretations. Only primary authorities should be cited.

**V. Tax Services.**

Organizationally, there are two types of tax services: first, “annotated,” and second, “topical.” An annotated tax service is organized by IRC section. The IRC-arranged subdivisions of this service are likely to encompass several topics. A topical tax service is organized by broad topic. The topically arranged subdivisions of this service are likely to encompass several IRC sections. The principal annotated tax services are United States Tax Reporter and Standard Federal Tax Reporter. The main topical services are Federal Tax Coordinator 2d and Tax Management Portfolios.

**VI. The Internet as a Research Tool.**

Internet databases are rapidly replacing books as the principal source of tax-related information. These databases encompass not only the IRC, Treasury Regulations, court cases, state laws, and other primary authorities, but also citators and secondary sources such as tax service reporters, treatises, journals, and newsletters. The principal advantages of using Internet-based tax services are ease and speed of access. The databases can be accessed using annotations or a “key word” approach. The annotated versions are arranged by IRC section. The annotations accompany editorial commentaries and include digests and summaries of IRS pronouncements and court opinions that interpret a particular IRC section. A topical tax service is organized by broad topic, including income taxes, estate and gift taxes, and excise taxes. The topically arranged sub-divisions of this service are likely to encompass several IRC sections. Each database is updated on a timely basis. See Table C:1-4 on p. C:1-25 for a summary of the key features of tax services.

The most widely used Internet-based research services are RIA’s Checkpoint™ (hereafter CHECKPOINT), accessible at <http://checkpoint.riag.com>, and the CCH Tax Research NetWork™ (hereafter CCH NETWORK), accessible at <http://tax.cchgroup.com/network>. Both services are updated continuously and store information in databases (called libraries). A list of these libraries can be found on p. C:1-26. Table C:1-5 on p. C:1-28 provides a table of Connectors used in RIA CHECKPOINT and CCH NETWORK. This chapter and the textbook discuss Internet-based tax services in general and focuses on CHECKPOINT for illustrative purposes, but they all work in a similar manner.

**VII. Citators.**

Citators serve two functions: (1) they provide a history of the case; and (2) they list other authorities that have cited the case. The citator allows the user to input the names of specific case citations, and see all related pronouncements and status changes.

**VIII. Professional Guidelines for Tax Services.**

Professional guidelines for tax services are contained in both government-imposed and professional-imposed tax standards. Circular 230 sets forth rules to practice before the Internal Revenue Service and pertains to certified public accountants, attorneys, enrolled agents, and other persons representing taxpayers before the IRS. It presents duties and restrictions relating to such practice and prescribes sanctions and disciplinary proceedings for violating these regulations. Circular 230 also provides guidelines for written advice to taxpayers. In June 2014, these guidelines were significantly revised and eliminated the distinction between covered opinions and written advice. All rules are now governed under what is referred to as a “reasonable practitioner standard.” In the case of written advice, the practitioner is now supposed to base advice under reasonable assumptions and consider the facts that are important and not base an opinion on the probability of audit. p. C: 1-32.

Statements on Standards for Tax Services (SSTS), issued by the American Institute of Certified Public Accountants and reproduced in Appendix E, set forth guidelines governing ethical issues in tax practice. Although the SSTSs are not legally enforceable, they carry significant moral weight, and may be cited in a negligence lawsuit as the proper “standard of care” for tax practitioners. They also provide grounds for the termination or suspension of one’s professional license. The Standards provide an ethical framework to govern the normative relationship between a tax advisor and his or her client, where, unlike an auditor, a tax advisor acts as the client’s advocate. The seven standards are provided beginning on p. C:1-33.

**IX. Sample Work Papers.**

Appendix A presents a set of sample work papers, including a draft of a client letter and a memo to the file. The work papers indicate the issues to be researched, the authorities addressing the issues, and the researcher’s conclusions concerning the appropriate tax treatment, with rationale for its use. Formats differ from firm to firm. The sample offers general guidance concerning the content of work papers.

**Court Case Briefs**

The following court cases illustrate how the courts, through judicially enunciated doctrines, impact the interpretation of tax law.

***Hirotoshi Yamamoto v. CIR****,* 73 T.C. 946 (1980), aff’d. in unpublished opinion 672 F.2d 924 (9th Cir., 1982).

Yamamoto (Y) owned 100% of the stock of P Corporation. P Corporation owned 100% of the stock of subsidiary S. S was heavily indebted to P. During 1970 and 1971, S made loans to Y. Y transferred real property to S, those transactions being recorded as sales, in exchange for cash, release of Y’s indebtedness to S and assumption of Y’s liabilities by S. Subsequently, S transferred this property to P at a price equal to S’s book value in the property. Additionally, Y purchased stock of P in exchange for cash.

Y argued that the step-transaction theory should apply to these transactions so they should be collapsed into one transaction and qualify for tax-free treatment under IRC Sec. 351. The court rejected this argument, stating that the rules for transfers to a controlled corporation did not apply because the property transfers and stock transfer had separate legal significance. The facts were consistent with this decision. This case involves a detailed analysis of the substance over form issue.

***Evelyn F. Gregory v. Helvering***, 293 U.S. 465 (1935).

Mrs. Gregory owned all of the stock of a corporation, which owned 1,000 shares of stock of another corporation. To get these shares and to obtain more favorable tax treatment, a new corporation was organized and the 1,000 shares of stock were transferred to it by the old corporation in what was claimed to be a nontaxable reorganization. The new corporation then dissolved and distributed its only asset, the shares of stock, to its sole shareholder, Mrs. Gregory. Mrs. Gregory then sold the stock and reported capital gains tax treatment on the sale. The Supreme Court held that a nontaxable reorganization had not occurred since the new corporation had no relation to the business of the old corporation and was formed solely as part of a preconceived plan with no business purpose. Tax avoidance was held not to be a sufficient business purpose to permit a tax-free reorganization to occur.