

A History of the Income Tax Law and a Glance at the Sources of Current Law

James F. Ivers III and Stephan R. Leimberg*

Learning Objectives

An understanding of the material in this chapter should enable you to

- 2-1. Describe the pressure for revenues that led to the adoption of the 16th Amendment by Congress, and explain the Amendment's significance for modern tax law.
- 2-2. Describe the functions of the income tax system.
- 2-3. Describe the three basic sources of income tax law today, and explain the role played by each source.

Chapter Outline

EARLY TAX LAW 2.2
 INCREASED PRESSURE FOR REVENUES 2.2
 THE 16TH AMENDMENT 2.3
 THE CODE 2.3
 FUNCTIONS OF THE INCOME TAX SYSTEM 2.4
 Revenue-Producing Function 2.4
 Economic Function 2.4
 Social Function 2.5
 Regulatory Function 2.5
 Counterbalancing Factors 2.5

*Stephan R. Leimberg, JD, CLU, is a former professor of taxation and estate planning at The American College.

SOURCES OF TAX LAW TODAY 2.6

Legislative 2.6

Executive 2.8

Judicial 2.13

SUMMARY 2.16**CHAPTER REVIEW 2.16**

What at first was plunder assumed the softer name of revenue.

Thomas Paine

That most delicious of all privileges—spending other people’s money.

John Randolph

EARLY TAX LAW

Objective 2-1

The tax history of the United States mirrors the general history of this country. Under the Articles of Confederation, the first governing instrument adopted by the Continental Congress in 1777, the federal government had no taxing power or right to collect custom duties. Several attempts to amend the Articles and give Congress a power to tax failed.

Because the Articles of Confederation proved to be too weak, the Constitution, written in 1787 and ratified in 1789, enlarged the powers of the federal government. However, the framers of the Constitution feared that the accumulation of power by the federal government would result in tyranny similar to the absolute monarchy of King George III of England. Therefore the government was divided into three coequal branches of government (legislative, executive, and judicial) with a system of checks and balances. The original taxing power of the federal government under the Constitution was sharply limited by the uniformity and apportionment clauses—Article I, Sections 8 and 9, of the Constitution. A detailed explanation is beyond the scope of this chapter, but it is sufficient to say, in retrospect, that these clauses precluded the federal government from imposing an income tax.

INCREASED PRESSURE FOR REVENUES

The high cost of the Civil War brought about the first governmental attempt to collect a tax on income. The tax soon expired, but by 1894 governmental needs for revenue led to the adoption of another income tax.

Within a year, the constitutional validity of this tax was tested. In the famous case of *Pollock v. Farmers' Loan and Trust Company*, the U.S. Supreme Court held that the tax was neither apportioned among the states nor uniform and was therefore unconstitutional, as Pollock had claimed.

Congressional reaction to the *Pollock* decision was shaped by the increasing pressures as well as the demands for a steady and sufficient source of revenue. The result was a political compromise in 1909 that levied a tax on corporations. However, even while the constitutionality of the Revenue Act of 1909 was being considered, Congress realized the need for a broader tax base.

THE 16TH AMENDMENT

16th Amendment

In 1909, the *16th Amendment* to the Constitution, which nullified the *Pollock* decision, was adopted by Congress. After appropriate action by the states, it was declared ratified on February 25, 1913. The 16th Amendment says the following:

The Congress shall have the power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

It is this amendment that dispensed with the apportionment requirement and therefore became the foundation for the basic framework of our modern tax law. The broad and sweeping language that permitted “income, from whatever source derived” to be taxed pervades the entire income tax law and has far-reaching implications.

Congress quickly utilized the newly sanctioned revenue source. The corporate income tax created by the Revenue Act of 1909 was discontinued. Individuals, as well as corporations, then became subject to the broad new income tax introduced by Congress in 1913.

THE CODE

The Revenue Act of 1913 was quickly followed by a series of additional revenue acts. In 1939 the entire federal tax law was codified and entitled the Internal Revenue Code of 1939. The crucial need to raise revenue to finance World War II turned the income tax from a tax on wealthy taxpayers to a tax on the majority of the population. This period also saw the introduction of the withholding provisions for employees. After the war the Code provisions were rearranged and revised. The result was the Internal Revenue Code of

1954. The Code is now called the Internal Revenue Code of 1986, however, as a result of the voluminous changes wrought by the Tax Reform Act of 1986. Numerous additional changes have been made since 1986.

FUNCTIONS OF THE INCOME TAX SYSTEM

Objective 2-2

Revenue-Producing Function

The income tax law originated as a revenue-producing mechanism to supply money for the administration and operation of the federal government. The bulk of the government's net receipts are still produced by the federal income tax. Congress, however, does not enact tax laws solely to raise revenue. The tax law also serves economic, social, and regulatory functions.

Economic Function

The Internal Revenue Code plays an important role in the management of the nation's economy. According to current economic thinking, greater taxes result in lower spending by consumers. The reasoning concludes that by reducing consumer spending (without increasing governmental expenditures) the income tax system can be used to reduce inflationary trends. Conversely, the use of tax incentives or lower tax rates leaves consumers with more cash that, in turn, translates into increased spending, saving, and investment. The hoped-for result is an increase in the national product that will increase the demand for new workers and thus reduce unemployment. Thus the tax system can prevent or reduce the impact of recessions.

Some economic experts feel that the very nature of a progressive income tax will automatically perform both anti-inflationary and antirecessionary functions without Congress actually changing the rates. The theory is that when more dollars (through increased salaries) are available to consumers, their income taxes will increase more than proportionately, resulting in a dampening of their ability to make inflationary expenditures with their increased incomes. During a recession the amount of money collected through the federal income tax decreases more than proportionately as the amount of a taxpayer's income decreases. Thus the relative reduction in income available to taxpayers is less than the reduction in their wages and salaries. Consequently, recessionary forces should be smaller than they otherwise would be. However, it is not always true that recessionary signs are coupled with a reduction in salaries. The value of the dollar is continually being eroded. Salary increases push the taxpayer into increasingly higher tax brackets, leaving less spendable income than before. As a result, our

progressive tax structure does not automatically provide an anti-inflationary function during the type of combined recession-inflation that the United States has sometimes experienced.

Further, the Code has used incentives to encourage economic activity at the taxpayer level. For example, liberal depreciation rules encourage taxpayers to invest capital in their businesses that, in turn, may create more jobs for the nation. Such incentives have been enacted from time to time.

Social Function

As the tax base grew wider and rates became higher, Congress found that in addition to producing revenue, the tax structure could be used as a method of effectuating governmental policy. For example, the income tax, as a progressive tax, could be used to redistribute the national wealth. A progressive tax is one in which the amount of tax increases more than proportionately as the amount of the taxpayer's taxable income increases. Therefore in theory, if not in practice, by taking a higher proportion of tax dollars from higher incomes rather than from lower incomes (and using those dollars for governmental expenditures that benefit lower income taxpayers), the distribution of national wealth can be changed significantly. The social function of the income tax, as well as the progressivity of the rate structure, is a subject of continuing debate.

Regulatory Function

The income tax system performs a limited regulatory function as well as the revenue and social functions mentioned above. Two examples of this use of the tax system to discourage socially undesirable activities are the punitive taxes on certain controlled substances and the tax on automatic weapons.

Counterbalancing Factors

There are, of course, factors that shape the methods used to achieve these ends. Balancing the need of the federal government for revenues is the desire of Congress to be fair to the parties affected. Generally, *fairness* is recognized as being "equal treatment of equals" and reasonable differences in the treatment of unequals. The test of this fairness is how well the tax imposed matches a taxpayer's ability to pay. Counterbalancing a desire to be fair, Congress is keenly aware of the political consequences of its actions. For example, it is generally politically more expedient to tax a small and unorganized group of voters than to tax a large, organized group with an effective and well-financed lobby.

Thus a tax law is a compromise between purposes and people—with great pressures exerted by the economic, political, and social groups who are affected by particular laws, and who constantly lobby in Congress in an attempt to have tax laws changed to their advantage.

SOURCES OF TAX LAW TODAY

Objective 2-3

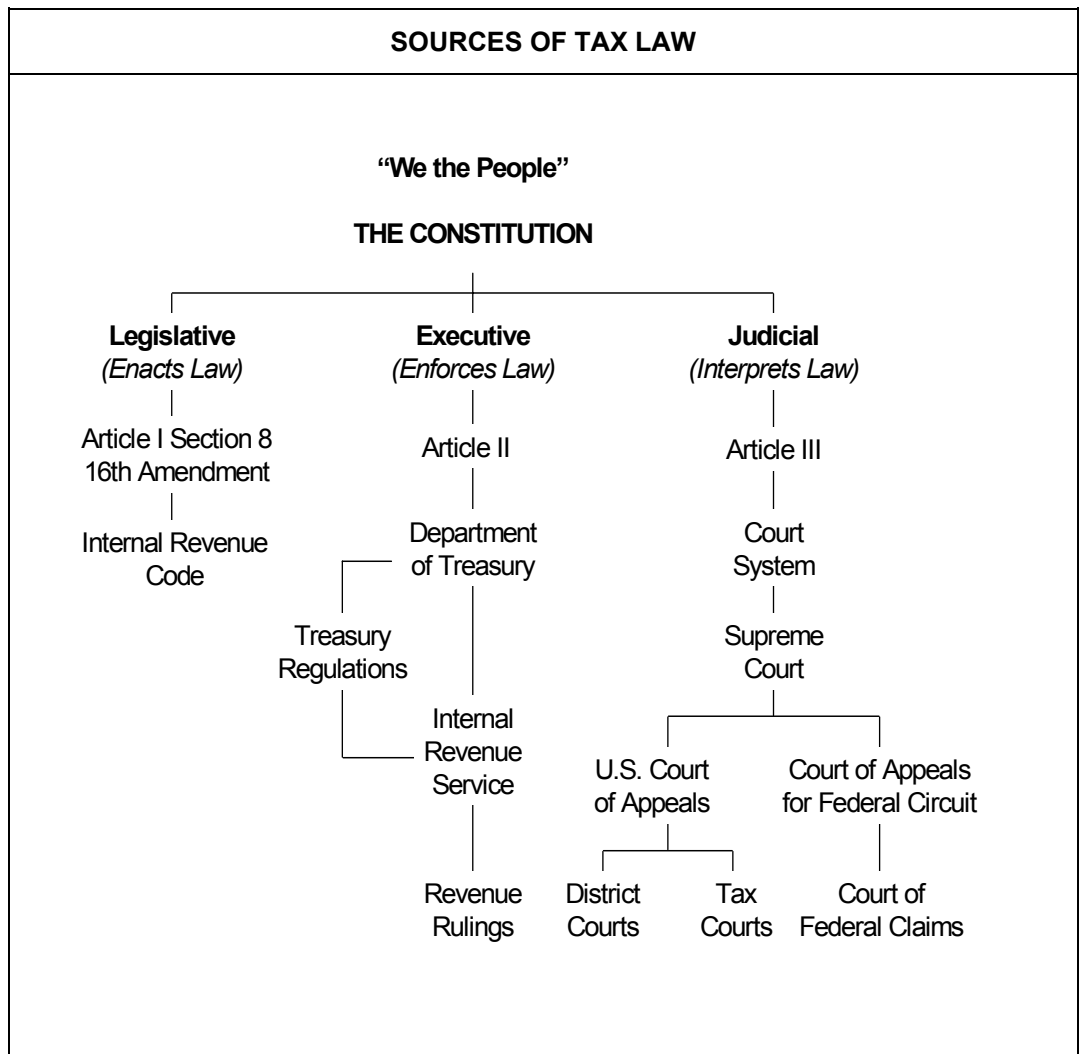
Each of the three coequal branches of the federal government has a major role in the federal income tax system. These roles can be shown graphically by the illustration on the following page.

Legislative

The 16th Amendment to the U.S. Constitution empowered Congress to enact an income tax law now compiled in the Internal Revenue Code. The importance of the Code is that federal taxation must proceed from a statutory origin. The present Code came into effect in 1986. It is revised and updated almost annually by Congress. Specific Code sections or parts of sections can be amended or repealed through the passage of revenue bills, which then supersede the older law as to those provisions. The House of Representatives has the constitutional responsibility for initiating revenue bills. A revenue bill becomes law, in most cases, through the following process:

- Revenue bills are written by the Ways and Means Committee of the House of Representatives, or bills are received by the Ways and Means Committee through referral by the House of Representatives (1) from a member of the House or (2) by suggestion of the Joint Committee on Internal Revenue and Taxation (this is a committee of 10 members—five from the House Ways and Means Committee and five from the Senate Finance Committee).
- The Ways and Means Committee conducts hearings on the revenue bill. Expert opinion will be heard that may influence the form and meaning of the statute.
- The Ways and Means Committee sends an amended bill with the committee's report to the House for adoption.
- The adopted bill is sent to the Senate.
- The Senate sends the bill to the Senate Finance Committee where it is studied, hearings on it are held, and amendments to the bill are made. The amended bill and the committee report are then forwarded to the Senate for passage.

- Sometimes—where there are material differences between the House’s version of the bill and the Senate’s—a joint conference committee consisting of members from both sides develops a compromise version.
- The compromise version must be passed by both houses of Congress.
- The legislation is sent to the president for his signature or veto.
- If the president vetoes it, a two-thirds majority of both houses can revise the legislation and make it law over the president’s veto.



Once a law becomes effective, all taxpayers must follow it unless the law is declared unconstitutional. For example, a law taxing the income of men and women at different rates would be unconstitutional.

Once effective, the law is subject to a great deal of interpretation. The House Ways and Means Committee and the Senate Finance Committee reports become extremely important. Both the courts and the Department of Treasury Regulations (discussed below) rely heavily on these reports to determine the intent of the creators before an interpretation is made.

The Code itself contains seven subtitles. Subtitle A is concerned with income taxes; Subtitle B is concerned with estate and gift taxes; and the rest are concerned with other areas of taxation. The Code is then further subdivided. Each subtitle consists of chapters, subchapters, parts, subparts, sections, subsections, paragraphs, subparagraphs, and subparagraph subdivisions known as clauses.

Executive

The president, as the chief enforcer of the law under Article II of the Constitution, has the duty to enforce the collection of tax. He has delegated his responsibility to the Department of the Treasury that, in turn, has delegated the responsibility to its subdivision, the Internal Revenue Service.

The Department of the Treasury has also been granted the power by Congress to enact regulations under the Code. Congress, recognizing that the Code must be written in legal language but that it would not be the proper place to explain how the law will be applied to specific taxpayers, empowered the secretary of the Treasury or his or her delegate to promulgate the rules and regulations that are necessary to enforce the law. Thus the Code itself provides for the Treasury Department to prescribe the rules and regulations needed for the enforcement of the Code. Actually, the Internal Revenue Service writes these regulations, and the secretary of the Treasury approves them. Regulations are issued first in proposed form so that interested taxpayers may file objections or participate in public hearings before the proposed regulations are finalized.

regulations

The *regulations*, or “regs” as they are often called, constitute the official Treasury interpretation of the Code. Regulations may particularize, define, clarify, illustrate, or even amplify the Code. To the extent that these regs are not inconsistent with the Code, they are said to have the force and effect of law. Generally they are presumed to be correct, are followed by Treasury personnel, and are seldom invalidated by the courts. Because they are carefully prepared and unlikely to be quickly changed, taxpayers can ordinarily rely on them in everyday transactions.

Regulations can be held invalid by the courts for a number of reasons. The two principal ones are (1) the regulation is ambiguous and without

persuasive force in determining the true construction of a statute, and (2) the regulation goes beyond the statute (the Code) and thus has no effect. Even if a regulation is held invalid by a lower court, the Treasury can still continue to enforce it unless the Supreme Court itself holds the regulation invalid.

Thus the IRS does not consider itself bound (beyond that particular case) where a regulation is held invalid by any court lower than the Supreme Court, although it now conforms to circuit court decisions for the taxpayer's circuit. At times, therefore, the Service will continue to enforce a regulation (held invalid in a given case) against other taxpayers (even in almost identical circumstances) until the issue is decided by the Supreme Court itself.

The regulations can be accessed in a manner similar to the Code. For example, the regulations pertaining to Section 303 of the Code would use the number 303. Income tax regulations are preceded by the number 1 (one). Therefore the regulations pertaining to Code Section 303, "Distributions in Redemption of Stock to Pay Death Taxes," could be found under the number 1.303 of the regulations.

Treasury Regulations

- Written by IRS personnel and approved by Treasury
 - Can be challenged by taxpayers
 - Seldom overturned by courts
 - May be overturned if ambiguous or beyond the scope of statute
-

Revenue Rulings and Private Rulings

It would be impossible for the Code and regulations to cover the tax consequences of every possible factual situation that can arise. Frequently taxpayers request the Internal Revenue Service's view on the interpretation of a doubtful point of law. In response to these requests, the Service issues various types of administrative rulings.

revenue ruling

Revenue rulings are based on a stated set of facts that usually involve a problem common to a number of taxpayers. These pronouncements are binding on officials of the IRS, and they follow them in their handling of issues arising in particular cases. For example, suppose the law is unclear as to whether a taxpayer can deduct the cost of moving a pet under the moving-expense deduction. If the Internal Revenue Service issues a revenue ruling to the effect that the cost of moving a pet is not deductible, all revenue agents will adhere to the ruling. The taxpayer has the choice of (1) relying upon rulings if the facts and circumstances are substantially the same or

(2) challenging rulings in the courts. Unlike Treasury regulations, the courts need not give rulings any weight.

Revenue rulings are published in the IRS Cumulative Bulletin. They can be found in the following manner. The first number following the abbreviation “Rev. Rul.” gives the year the ruling was issued. This is followed by a dash. The second number is in numerical sequence, denoting the order in which the ruling was issued. Rev. Rul. 61-201 would be a ruling issued in 1961 and the 201st revenue ruling issued in that year. The citation in the Cumulative Bulletin would also include (1) the year, (2) the volume of the Cumulative Bulletin for that year, and (3) the page under which the ruling could be found. For example, Rev. Rul. 61-201, 1961-2 C.B. 46 means that the particular ruling in 1961 was the 201st of that year. It would be found in the second volume of the Cumulative Bulletin for 1961 on page 46. Generally, online research services will retrieve a ruling if the user provides the year and the ruling number.

private ruling

Private rulings arise when a taxpayer requests an administrative interpretation on a prospective transaction or on completed transactions that are not involved in returns already filed. Although private rulings are personal to the taxpayer, they have been made available to the public in recent years and are now published after the deletion of certain information. Deleted materials include names and addresses of taxpayers, trade secrets, classified matter, and so forth. Even though published, they still have the same effect—they may not be claimed by another taxpayer as a precedent.

Revenue Procedures

revenue procedures

Revenue procedures describe internal practices and procedures within the IRS. Like revenue rulings, they are published in the Internal Revenue Bulletin. Generally revenue procedures state changes in techniques and administrative procedures used by the Internal Revenue Service. Revenue procedures are generally designated by the abbreviation “Rev. Proc.”

Determination Letters

The National Office of the Internal Revenue Service issues revenue rulings. IRS officials within specific operating divisions have the power to write determination letters regarding various transactions to be reflected on returns that will be filed by various types of taxpayers and organizations. Determination letters are issued only if the answer to the question presented is covered specifically by statute, Treasury decision, or regulation, or specifically by a court decision or ruling opinion published in the Internal Revenue Bulletin. Determination letters contrast with revenue rulings in that such letters are never issued about unclear points of law.

Conflict between Taxpayers and the Internal Revenue Service

Individual taxpayers must generally file returns by April 15 for the previous calendar year or, if they are fiscal taxpayers, by the 15th day of the fourth month after their fiscal year ends. Corporations must file tax returns by March 15, or the 15th day of the third month after their fiscal year ends.

Once a return is filed, the Internal Revenue Service processes the form for mathematical accuracy and audit selection at its service center. The IRS has 3 years from the time the return is filed within which to assess additional taxes. Early returns are deemed to be filed on their due date. One important exception to the 3-year statute of limitations applies when fraud is involved. In such situations, there is unlimited time to audit.

Taxpayers who file incorrect returns may be subject to an accuracy-related penalty that is equal to 20 percent of the amount of the underpayment of tax actually due. The penalty applies to situations involving negligence or disregard of tax laws, substantial understatement of income tax, and substantial valuation misstatements. If fraud is involved, additional civil and criminal penalties can be imposed.

Tax return preparers may also be subject to one or more of several different penalties. These include a penalty of \$1,000 per return for a willful or reckless understatement of a taxpayer's tax liability.

An initial income tax audit by an IRS examiner may take place at an IRS office or at the taxpayer's home or business. A preliminary letter advising the taxpayer of the agent's recommendation and a 30-day right to appeal from that determination will then be sent. If the taxpayer disagrees with the conclusion, he or she may write to the IRS to request a hearing before its Appeals organization.

When a dispute with the IRS is being considered in Appeals, the appeals officers are not permitted to engage in substantive discussions regarding a specific case with other IRS officials in the absence of the taxpayer or his or her representative.

While a case is pending with the Appeals officers, the taxpayer also has the right to request that the issue be referred to the National Office staff for technical advice. Grounds for referral include a lack of uniformity in the disposition of the issue or significant complexity or uniqueness of the issue. Dispute resolution methods in Appeals now also include mediation and arbitration.

If no agreement is reached with Appeals, *statutory notice of deficiency* is issued by the commissioner of Internal Revenue. Following this notice, taxpayers have 90 days to file a petition with the U.S. Tax Court to have their cases heard. If taxpayers allow the 90 days to pass without either paying the tax and/or instituting suit, the IRS can assess a tax deficiency, enter judgment, and seize the taxpayers' property to collect the deficiency.

**statutory notice
of deficiency**

No tax need be paid in advance for cases to be litigated in the U.S. Tax Court. Once a case has been docketed there, an appeals officer is assigned to the case and given exclusive authority to settle within a 4-month period. If no settlement is reached in that time, the case is scheduled for trial.

Alternatively, the taxpayer may choose to pay the tax deficiency and then file a claim for a refund with the IRS. Taxpayers can file suit for a refund in either the U.S. District Court or the U.S. Court of Federal Claims if the claim for a refund is disallowed. Various factors discussed below will affect the taxpayer's choice of the best tribunal before which to try the case. By statute, the taxpayer has 2 years from the date the IRS notice of disallowance of the taxpayer's claim was mailed in which to sue the government for a refund. This 2-year period may be extended only by a written agreement between the taxpayer and the secretary of the Treasury.

FOCUS ON ETHICS

Tax "Avoidance" vs. Tax "Evasion"

Taxpayers and their advisors should draw a clear distinction between the terms "tax avoidance" and "tax evasion" when striving to maximize benefits provided by law. Distinguishing these terms can help to provide an understanding of what is and is not ethical when dealing with the income tax law.

Tax "avoidance" is generally thought of as the utilization of legitimate strategies and techniques in order to minimize the amount of money a taxpayer will owe to the government. Avoidance techniques do not violate tax laws, but rather use them to the taxpayer's advantage. Timing strategies, permissible income-shifting techniques, and maximizing allowable deductions and credits are general examples of such techniques.

Tax "evasion," on the other hand, refers to the violation of tax laws as a strategy to reduce income tax liability. Examples of tax evasion techniques include underreporting of income, overstatement of deductions (claiming amounts in excess of those actually paid or incurred), claiming tax deductions or other benefits for which the taxpayer does not qualify under applicable law, and other, more sophisticated illegal manipulations of the tax system. Taxpayers should also remember that our income tax system is not illegal or unconstitutional, and that its rules are ignored at the taxpayer's peril. Both civil and criminal penalties can be imposed by the Internal Revenue Service and the U.S. Department of Justice for tax-related violations of the law.

There are, of course, gray areas that fall somewhere between the clear lines of demarcation between tax avoidance and tax evasion. Such gray areas include tax issues that are uncertain due to ambiguous or insufficiently specific tax laws, or issues involving fact patterns not clearly contemplated by applicable law. If a taxpayer is confronted with such an issue, there are a number of different avenues to choose from. Such decisions should be thoughtfully and responsibly made by taxpayers and their advisors. However, taking an overly aggressive position with respect to an unresolved issue of tax law can result in penalties or, in extreme and unreasonable cases, even criminal prosecution.

A privilege of confidentiality generally applies to communications between a taxpayer and a tax adviser authorized to practice before the IRS, including an attorney, CPA, or enrolled agent. The privilege may be asserted in noncriminal tax disputes. It does not apply to disputes involving tax shelter promotions.

Judicial

Article III of the U.S. Constitution states that judicial power shall be vested in one Supreme Court and in such lower courts as Congress shall establish. The jurisdiction of the federal courts includes all cases arising under the laws of the United States, including revenue laws.

The court system that Congress has established comprises trial courts that decide issues of fact and law, appellate courts for a review of issues of law, and the Supreme Court, which is the ultimate reviewer of questions of law.

U.S. Tax Court

U.S. Tax Court

The *U.S. Tax Court* was established for taxpayers who seek a redetermination of a deficiency asserted against them but do not wish first to pay the deficiency. A large majority of tax cases are heard by the Tax Court for this reason. Trial by jury is not available in the Tax Court. Questions of law and fact are decided by Tax Court judges.

The Tax Court has its main offices and trial rooms in Washington, D.C., but trials are conducted also in principal cities throughout the United States. The Tax Court is a special court designed principally for taxpayers who appeal tax deficiencies imposed by the Treasury Department.

To expedite hearings on deficiencies of \$50,000 and under, the Tax Court has a small tax case division. These cases are handled much less formally and much more quickly than other Tax Court cases. Decisions of this division may not be appealed or treated as authority in other cases. The small case procedure is optional at the taxpayer's request.

The IRS does not consider itself bound by a Tax Court decision any more than it does by a Court of Federal Claims or district court decision (except for the particular case in which an adverse decision has been rendered). Thus the IRS often will continue to litigate the same issue in other cases before the same court or in other courts. However, rather than have the Tax Court rule against it in a number of cases (which establishes precedent), the IRS will often negotiate a settlement. When the Service loses a Tax Court case, it will indicate its willingness or unwillingness to follow the case in the future by reporting in the Internal Revenue Bulletin its acquiescence ("acq.") or nonacquiescence ("non-acq.") to the principle of tax law established in that case.

Appeals from the Tax Court by either an unsuccessful taxpayer or the IRS are heard by the U.S. Court of Appeals in the region of the country in which the taxpayer resides. If there is a difference of opinion in the various courts of appeal as to the interpretation of the tax law, the Tax Court follows the decisions of that court of appeals to which the taxpayer may appeal.

Tax Court

- Does not require prepayment of assessed deficiency
 - No trial by jury available
 - Appeals taken to U.S. Court of Appeals for taxpayer's circuit
 - IRS need not "acquiesce"
-

U.S. Court of Federal Claims**U.S. Court of
Federal Claims**

The *U.S. Court of Federal Claims* (called the U.S. Claims Court until its name was changed in December 1992) is a trial court that became operative on October 1, 1982, when the U.S. Court of Claims ceased to exist as such. It continues to hear cases that would have been heard by the old Court of Claims, whose jurisdiction was limited to refund cases (the tax must be paid before jurisdiction can be invoked). Appeals from the Court of Federal Claims are heard by another court simultaneously created under the Federal Courts Improvement Act of 1982. This appellate court is called the Court of Appeals for the Federal Circuit and is, in fact, a merger of the old U.S. Court of Claims and the Court of Customs and Patents Appeals. Both of these courts generally follow the tax precedents of the Court of Claims as opposed to following the tax precedents established by the taxpayer's home district court. Since the abolishment of the U.S. Court of Claims, there is no longer any tax forum where appeal is taken directly to the U.S. Supreme Court.

U.S. District Court**U.S. District
Court**

The *U.S. District Court* (of which there is at least one for each state), like the U.S. Court of Federal Claims, can only hear tax cases in which the taxpayer has first paid the deficiency and has been denied a refund by the Internal Revenue Service.

The U.S. District Court is unique in that it is the only court in which a taxpayer may request a jury trial. In a case where there is a jury, the jury decides questions of fact; the judge decides questions of law. For example, sometimes taxpayers will choose to institute suit in a district court because

their battles with the IRS are essentially factual, and they believe they will obtain a sympathetic jury. As to questions of law, a district court in a certain location must follow decisions of that particular court's corresponding court of appeals as precedent. Appeals from a district court can be made to the U.S. Court of Appeals and then further to the Supreme Court.

U.S. Court of Appeals

U.S. Court of Appeals

The *U.S. Court of Appeals* consists of 12 circuit courts located throughout the country. These courts hear appeals that are taken by either taxpayers or the Treasury from decisions rendered by the Tax Court or a district court. The U.S. Court of Appeals is the second highest level in the court system. Its importance is underscored by the fact that the only appeal from one of its decisions is to the Supreme Court itself. Both district courts and the Tax Court must follow decisions of the Court of Appeals to which the taxpayer may appeal. The Court of Appeals of one region is not bound to follow decisions by the Court of Appeals in another region. Although a favorable decision in a sister court may be persuasive, it is not controlling. Taxpayers who must use the Court of Appeals in a region other than where the favorable decision was rendered cannot be sure of the outcome of their cases, even if the facts of their cases are almost identical to the facts of a case previously decided elsewhere. Of course, a favorable decision in one circuit may be relied upon by other taxpayers in that same circuit.

U.S. Supreme Court

U.S. Supreme Court

The *U.S. Supreme Court* is the highest court in the land. Supreme Court decisions are required to be followed by taxpayers as well as by the Internal Revenue Service. However, there are few tax cases that the high court decides. This is because Supreme Court review of tax cases is generally available only if the Court itself grants petitions for appeal. Supreme Court review, therefore, is a matter of discretion with the Supreme Court and not a matter of right. The Supreme Court will most probably review a tax case if (1) there is a conflict between the courts of appeal for different circuits, or (2) an important and recurring problem in tax law administration is involved, or (3) many taxpayers are involved, or (4) the decision of a lower court conflicts with long-standing practice or existing legal authority.

A Supreme Court interpretation of tax law is the law of the land until (1) Congress enacts a new statute, tantamount to overturning a decision interpreting the Internal Revenue Code, or (2) the Court overrides its own prior decision in rare situations.

SUMMARY

The history of the income tax parallels the history of the financial needs of the United States. The strain of a modern government attempting to meet the costs of both wartime expenditures and peacetime services created a demand for additional revenues. Once established, the overriding importance of the individual and corporate income taxes in the federal revenue structure has never diminished.

Aside from revenue purposes, the income tax has been used with varying degrees of success to perform social, economic, and regulatory functions.

The source of the federal income tax law is ultimately the people. The intent of the people was expressed through the Constitution, which in turn gives legislative power to Congress. Congress exercises this power in the form of the Internal Revenue Code, which is further modified and expanded by the Internal Revenue Service's regulations and rulings. Court decisions on particular issues further interpret and expound on statutory law as well as IRS regulations and rulings. The importance and effect of these court cases is in turn determined by the status of the court. The hierarchy of the court system (and hence the weight given to a decision of that particular court) at the highest level starts with the Supreme Court and works its way down to courts of original jurisdiction known as the United States Court of Federal Claims, the United States District Court, and the United States Tax Court.

CHAPTER REVIEW

Key Terms

16th Amendment
regulations
revenue ruling
private ruling
revenue procedures
statutory notice of deficiency

U.S. Tax Court
U.S. Court of Federal Claims
U.S. District Court
U.S. Court of Appeals
U.S. Supreme Court

Review Questions

Review questions are based on the learning objectives in this chapter. Thus, a [2-3] at the end of a question means that the question is based on learning objective 2-3. If there are multiple objectives, they are all listed.

1. What powers does the 16th Amendment give Congress with regard to the collection of taxes? [2-1]

2. a. Describe the historical evolution of the codified tax system that culminated in the current Internal Revenue Code. [2-1]
b. What is the legal effect of the Code? [2-1]
3. Identify the functions of the income tax system, and describe generally the purposes that each function is designed to accomplish. [2-2]
4. Explain how the income tax system can be used to help curb inflation or lessen the adverse effects of a recession. [2-2]
5. Describe the procedure for the passage and adoption of tax bills. [2-3]
6. Describe the executive powers regarding tax law as well as the delegation of authority for enforcing the law and collecting taxes. [2-3]
7. Explain the function of a Treasury regulation. [2-3]
8. Describe the effect of a particular regulation when it has been held invalid by
 - a. a trial or appeals court [2-3]
 - b. the Supreme Court [2-3]
9. a. What is a revenue ruling and why is it important? [2-3]
b. By whom are revenue rulings issued and where can the rulings be found? [2-3]
10. How does a private ruling differ from a revenue ruling? [2-3]
11. Describe the purpose of revenue procedures. [2-3]
12. Explain what is meant by a determination letter. [2-3]
13. a. When there is a conflict between a taxpayer and the IRS with regard to the amount of tax owed, explain the statutory procedure for resolution of the conflict. [2-3]
b. If the conflict is not resolved, how may an appeal be taken to the courts? [2-3]
14. Distinguish between the three courts that have original jurisdiction to hear tax matters. [2-3]
15. Assume a tax question is at issue in completing the following sentences:
 - a. The only trial court that allows jury trials is the _____. [2-3]
 - b. Cases heard by the U.S. Court of Federal Claims may be appealed to the _____. [2-3]
 - c. The trial court in which a taxpayer can litigate without first paying an assessed deficiency is the _____. [2-3]
16. When is the IRS bound to follow a court decision? [2-3]
17. What avenues of appeal exist if a taxpayer loses a tax case in a trial court? [2-3]

18. Under what circumstances would the Supreme Court review an appeal in a tax case? [2-3]
19. Joe Smith runs an independent trucking company out of Wilmington, Delaware. He travels the Wilmington–New Jersey–New York route. The New Jersey state legislature enacted tough new safety measures for trucks including lower weight limits than those of the surrounding states. Joe decided that it was cheaper for him to continue to use the same heavier trucks and pay a fine in New Jersey for the weight violation, rather than to use numerous smaller trucks to carry his loads. Joe deducted the fines paid on his federal income tax return as an ordinary and necessary business expense.
- Joe was audited by the IRS and the agent denied the deduction for the fines. The agent denied the deduction on the grounds that the Internal Revenue Code prohibits such a deduction. (Focus on the tax procedure and not on the issue of whether the fines are actually deductible.)
- a. What alternatives are now open to Joe
 - i. administratively, within the Internal Revenue Service? [2-3]
 - ii. through the courts? [2-3]
 - b. Suppose Joe selects the Tax Court, and the Tax Court allows his deduction. What effect does this have on
 - i. the Internal Revenue Service? [2-3]
 - ii. Bill Zilch, whose company is based in San Francisco and who has a problem similar to Joe's on the San Francisco–Oregon route? [2-3]
 - c. Assume Joe lost his case in the Tax Court and he appeals to the Third Circuit Court of Appeals, which allows the deduction. What is the effect on
 - i. the Internal Revenue Service? [2-3]
 - ii. Roy Jones, a competitor of Joe's in Wilmington, who runs the same route as Joe and also deducted the fines? [2-3]
 - iii. Bill Zilch? [2-3]
 - d. Assume Joe's original case reaches the Supreme Court of the United States, which allows the deduction. What is the effect on
 - i. the Internal Revenue Service? [2-3]
 - ii. Roy Jones? [2-3]
 - iii. Bill Zilch? [2-3]

This publication is designed to provide accurate and authoritative information about the subject covered. While every precaution has been taken in the preparation of this material, the editor and The American College assume no liability for damages resulting from the use of the information contained in this publication. The American College is not engaged in rendering legal, accounting, or other professional advice. If legal or other expert advice is required, the services of an appropriate professional should be sought.

© 2007 The American College Press
270 South Bryn Mawr Avenue
Bryn Mawr, PA 19010
(888) AMERCOL (263-7265)
www.theamericancollege.edu
All rights reserved