

## Chapter 2

# Tax Research, Practice, and Procedure

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### SUMMARY OF CHAPTER

Tax practice involves the preparation of tax returns and representation of clients before the audit or appellate divisions of the Internal Revenue Service. To become a competent professional, skilled in these three functional areas of tax practice, it is necessary to be proficient in the art of tax research.

The tax specialist needs to understand the organizational structure of the IRS and its administrative procedures to provide fully informed tax consulting services to taxpayers involved in disputes with the IRS. Thus, this chapter includes a discussion of the internal organization of the IRS, the functions of the various administrative groups, the rules relating to practice before the IRS, and the procedures for examination of returns, including correspondence examinations, office examinations, and field examinations.

### Tax Reference Materials

#### ¶2001 Classification of Materials

Tax reference materials are usually classified as primary “authoritative” sources or secondary “reference” sources. Primary source materials include the Internal Revenue Code (Statutory Authority), Treasury Regulations and Internal Revenue Service Rulings (Administrative Authority), and the various decisions of the trial courts and the appellate courts (Judicial Authority).

Secondary reference materials consist primarily of the various loose-leaf tax reference services. Additional secondary materials include periodicals, textbooks and treatises, published papers from tax institutes and symposia, newsletters, and, more recently, the various computer-assisted research services.

### Primary Source Materials

#### ¶2021 Statutory Authority

The authority of the U.S. government to raise revenue through a federal income tax is derived from the Sixteenth Amendment to the Constitution, enacted in 1913. In subsequent years, with the growing complexity of the tax law, the multitude of revenue acts were codified into Title 26 of the United States Code, known as the Internal Revenue Code of 1939. The Code was later revised and rewritten as the Internal Revenue Code of 1954. However, as a result of the sweeping changes made by the Tax Reform Act of 1986, the Code has been renamed the Internal Revenue Code of 1986. The major portion of the Code dealing with federal income tax is located in Chapter 1 of Subtitle A. This extremely important chapter, entitled “Normal Taxes and Surtaxes,” is further divided into subchapters (A-W), and each subchapter is then generally divided into parts and subparts which are then divided into numbered sections. These sections are typically referred to as “Code Sections.”

*Authoritative Weight of Congress.* Congressional amendments to tax laws can override prior court decisions, including Supreme Court decisions. However, the Supreme Court and the lower courts cannot override tax laws passed by Congress. Only a tax treaty with a foreign country may override a tax law, and only if it takes effect after the tax law was enacted.

*Interpreting new Code changes.* Upon completion of major tax legislation, the staff of the Joint Committee on Taxation (in consultation with the staffs of the House Ways and Means and Senate Finance Committees) often will prepare a general explanation of the act, commonly known as the Bluebook because of the color of its cover. *The IRS does not recognize this detailed explanation as legally binding. However, the bluebook does provide valuable guidance to tax advisers and taxpayers until interpretations are issued by the Treasury Department, i.e., Treasury Regulations.*

*Interpreting prior Code changes.* The House Ways and Means Committee, Senate Finance Committee and the Joint Conference Committee issues Committee Reports on public hearings on tax proposals. These Committee Reports are useful for determining Congressional intent where the Code is unclear on a certain issue. They can be found in special volumes of the *Cumulative Bulletins*. *Merten's Law of Federal Income Taxation*, a commercial publication, is also useful for interpreting prior Code changes. Written by tax professionals, it is widely respected for its in-depth discussions on legal issues and is often cited by the courts.

## ¶2035 Administrative Authority

Section 7805(a) of the Internal Revenue Code authorizes the Treasury Department (part of the executive branch of government) to issue rules and regulations and to interpret the Code. Treasury Regulations have the authority of law when dealing with the Internal Revenue Service. Even in court they have significant judicial weight. However, the courts are not bound to follow these administrative interpretations if they are in conflict with the law.

*Treasury Decisions.* Final Regulations are issued as Treasury Decisions (TDs) in the Federal Register. The types of treasury regulations issued are:

1. *Final Regulations.* Represent binding authority.
2. *Temporary Regulations.* Represent binding for up to 3 years.
3. *Proposed Regulations.* Represent non-binding, persuasive authority.

*Revenue Rulings.* Revenue Rulings are the official pronouncements of the National Office of the IRS. Like Regulations, they interpret the tax law. However, they address narrower issues and are *persuasive authority*, not binding authority.

*Revenue Procedures.* Revenue Procedures are issued in the same manner as Revenue Rulings, but deal with the internal management practices and procedures of the IRS.

*Letter Rulings.* Individual letter rulings are issued by the National Office of the IRS upon a taxpayer's request, for a fee, and describe how the IRS will treat a *proposed* transaction for tax purposes.

*Technical Advice Memoranda (TAM's).* TAM's are issued by the National Office of the IRS to one of the four regional offices, or 33 district offices, in order to address questions by IRS personnel concerning tax treatment for completed transactions.

*Determination letters.* Determination letters are issued at the request of taxpayers and provide guidance on the application of the tax law. Unlike letter rulings, determination letters are issued by the District Director rather than the National Office of the IRS.

## ¶2055 Judicial Authority

The judiciary plays a major role in the development of our interdependent system of common law. Depending upon the jurisdiction of the court, and its relative ranking as a source of legal authority, judicial interpretation provides varying degrees of legal precedent.

*Choosing a trial court.* Since the taxpayer is the party initiating legal action, he/she can choose the judicial forum. Generally, three options are available, U.S. Tax Court, Federal District Court or U.S. Court of Federal Claims.

1. U.S. Tax Court.
  - a. *Tax jurisdiction.* The Tax Court is a national court that hears tax cases from all parts of the country. Its judges are tax specialists. Accordingly, decisions of the Tax Court are generally considered to be more authoritative than decisions of the other two trial courts.
  - b. *Types of tax decisions.* The Tax Court issues so-called "regular decisions" that involve novel legal issues and are officially published by the government. It also issues "memorandum decisions" that involve purely factual issues or the application of existing law. These latter decisions are not published by the government but are available from CCH and RIA.
  - c. *No advance payment required.* When litigating in the Tax Court, the taxpayer is not required to pay the alleged deficiency until and unless the case is decided against him or her.

- d. *Regular Decisions v. Memorandum Decisions.* Tax Court decisions that rest on factual determinations or on previously decided legal issues are known as Memorandum decisions, as distinguished from the Regular decisions that involve issues not previously decided by the court. Regular decisions are published by the government in bound, serially numbered volumes; however, Memorandum decisions are not published by the government. Tax Court memorandum decisions are published by CCH, a Wolters Kluwer business under the title *Tax Court Memorandum Decisions*, while the Research Institute of America (RIA) series is called *RIA Memorandum Decisions*.

## 2. Federal District Court.

- a. *Tax and non-tax jurisdiction.* District Courts have jurisdiction over questions that involve any point of federal law, including such diverse topics as labor relations, civil rights and criminal offenses. Thus, while they occasionally hear tax cases, they do not specialize in tax matters.
- b. *Jury trial option.* Only in a District Court can the taxpayer request a jury trial, but only for issues of fact, not issues of law.
- c. *Pay in advance.* For a dispute to be heard before the District Court, however, the taxpayer first must pay the tax in dispute and sue the federal government for a refund.

## 3. U.S. Court of Federal Claims.

- a. *Tax and non-tax jurisdiction.* The U.S. Court of Federal Claims has jurisdiction over any monetary claim brought against the U.S. government. Like the District Courts, the U.S. Court of Federal Claims does not specialize in tax matters.
- b. *Pay in advance.* Another aspect similar to the District Court is that the taxpayer must pay the alleged deficiency and sue the government for a refund.

*Appealing a trial court decision.* Once a case has been decided in a trial court, the losing party has a right to appeal. Appeals from the District Court or Tax Court are to one of twelve U.S. Circuit Courts of Appeals. Each circuit is in a separate geographical region. For example, the 11th circuit exercises jurisdiction over disputes of taxpayers residing in Alabama, Florida and Georgia. Appeals from the U.S. Claims Court are to a separate Federal Circuit Court of Appeals, located in Washington D.C. Thus, there are a total of 13 circuit courts of appeals.

*Appealing a Circuit Court of Appeals decision.* Appeals from the 13 circuit courts are to the U.S. Supreme Court, but only after a writ of certiorari is granted. Certiorari is often denied unless the circuit courts are in conflict, or the tax issue is extremely important. The granting of a writ of certiorari indicates that at least four members of the Supreme Court believe that the issue is of sufficient importance to be heard by the full Court.

*Doctrine of Stare Decisis.* Under this doctrine, the courts must stand on their own decisions. In other words, a court's decision is binding to that same court's future decisions regarding the same controlling set of facts.

## Secondary Source Materials

### ¶2075 Analysis of Tax Law Sources

The voluminous bulk and complexity of our tax law makes it extremely difficult to systematically research all of the statutory and administrative provisions associated with a given set of tax issues. Secondary reference materials provide a convenient cross-referenced, continuously updated road map to guide the practitioner in the complicated task of wading through a growing maze of primary tax authority. The various loose-leaf tax services direct the research process to specific primary authorities. However, the editorial opinions included in these services are not intended to be a substitute for authoritative sources of statutory, administrative, and case law.

CCH's *Standard Federal Tax Reporter*, frequently referred to as the *Standard*, consists of 25 coordinated and cross-referenced loose-leaf volumes. This service provides comprehensive coverage of the income tax, primarily through the use of various "Compilations." The Compilations, which are sequentially arranged in Code section order, contain the text of each Code section, followed by the related Treasury Regulations, legislative Committee Reports, and "CCH Explanations." Additionally, this material is supplemented with digests of associated judicial decisions and Revenue Rulings.

Research Institute of America's *United States Tax Reporter* consists of 18 coordinated loose-leaf volumes that are organized by Code sections and updated on a weekly basis. The service is similar to CCH's.

Research Institute of America's *Federal Tax Coordinator* is a 26-volume service organized by topic rather than Code section. It contains editorial explanations that are heavily footnoted, illustrations, planning ideas, and warnings of potential tax traps.

Merten's, *Law of Federal Income Taxation*, is an intensive, annotated work, providing in-depth discussions of general concepts of tax law. Although not generally used as a comprehensive, self-contained reference service, it is regarded as a useful complement to traditional reference services such as CCH or RIA. The Bureau of National Affairs' Tax Management Portfolios service is a topical service with numerous portfolios on various tax topics.

*Computer-Assisted Research.* CCH Tax Research Network is one of several computerized legal data banks available to users to access full texts of statutes, regulations, IRS rulings, and court decisions. Additionally, other computer-assisted systems are available, including Lexis/Nexis, Westlaw from West Publishing Company, and RIA (Research Institute of America).

*Citator.* The Citator outlines the judicial history of a selected case, beginning with the highest court to have ruled on that issue. Then, in descending order, the actions of lower courts are also cited and described. Additionally, a Citator refers to other court cases, which helps to evaluate a given decision as a precedent. The two leading Citator services are published by CCH and RIA.

## Research Methodology

### ¶2125 Types of Tax Research Situations

Essentially, there are two types of tax research situations—"after-the-facts compliance" and "before-the-facts planning." The "closed fact" case, sometimes referred to as *ex post facto* research, involves the legal interpretation of historical events. In contrast, the "open-fact" case typically involves events that have not yet been finalized (i.e., controllable facts). However, whether the primary facts of a research engagement is for tax compliance or tax planning, the underlying methods and techniques should be systematic, thorough, properly documented, and effectively communicated to the client.

### ¶2135 Research Model

The following research model presents a five-step systematic format that can be applied to a "closed-fact" or an "open-fact" case:

1. Gathering the facts and identifying the tax issues to be researched.
2. Locating and studying the secondary and primary authorities relevant to the enumerated tax issues.
3. Updating and evaluating the weight of the various authorities.
4. Reexamining various facets of the research.
5. Arriving at conclusions and communicating the conclusions to the client.

### ¶2147 Research Cases and Examples

The two cases outlined in the text illustrate the *step-by-step* application of selected aspects of research methodology. Additionally, details are highlighted to remind the student of the *trial-and-error* nature of tax research and the need for patience, perseverance, and creativity. (*Note:* It is suggested that for each of the two cases, the student should be directed to the library to carefully follow and duplicate each step of the research process, as outlined in this chapter.) The art of tax research can be mastered only through numerous trips to the tax library and countless hours engaged in the onerous task of reading, analyzing, and evaluating research materials.

### ¶2153 Internet-Based Tax Research Systems

Users can access computerized legal data banks through personal computers and on-line systems provided by CCH IntelliConnect®, Lexis/Nexis, Westlaw®, and RIA Checkpoint®. Basically, the systems can retrieve full-text documents

stored in broad or select data bases and search for related document texts by utilizing key words or phrases without using a preexisting index. These computer-assisted tax research systems also can be used like a citator to locate all judicial decisions that have cited a particular decision or statute.

## Tax Administration

### ¶2211 Organization of the IRS

The Internal Revenue Service (IRS) consists of a National Office, headquartered in Washington, D.C., and an extensive field organization.

In accordance with the Internal Revenue Service Restructuring and Reform Act of 1998, the IRS has modified its entire structure. The new structure divides the IRS into four operating divisions. Each operating division is responsible for serving a group of similar taxpayers. The structure is organized to reflect specific types of taxpayers and common issues associated with these taxpayers.

#### *Operating Divisions*

*Wage and Investment Income Division (W&I).* W&I covers individual taxpayers who only receive wage and/or investment income, which includes approximately 88 million filers. Most of these taxpayers only deal with the IRS when filing their tax returns each year. Compliance matters are limited to such issues as dependency exemption, credits, filing status, and deductions.

*Small Business and Self-Employed Division (SB&SE).* SB&SE is comprised of fully or partially self-employed individuals and small businesses. It includes corporations and partnerships with assets less than or equal to \$5 million. Also, estate and gift taxpayers, fiduciary returns and all individuals who file international returns are examined by this group, which includes approximately 45 million filers.

*Large Business and International Division (LB&I).* LB&I includes businesses with assets over \$10 million or about 210,000 filers. Many complex matters such as tax law interpretation, accounting and regulation issues are common. The largest taxpayers in this group deal with the IRS on an almost continuous basis.

*Tax-Exempt Organizations and Governmental Entities Division (TE&GE).* TE&GE includes pension plans, exempt organizations and the governmental entities, and is comprised of about 24 million filers.

#### *Other Units*

*Criminal Investigation (CI).* CI reports directly to the Service Commissioner and Deputy Commissioner. It operates as a nationwide unit with 35 Special Agent In Charge Offices. CI's mission is to serve the public by investigating potential criminal violations of the Internal Revenue Code and related financial crimes.

*IRS Appeals Office.* The new IRS Appeals Office is headquartered in Washington, D.C., but will maintain the geographic location of current offices. The field staff has been realigned to closely mirror the new operating structure. Thus, within a particular office, Appeals Officers will be designated to work on cases from a particular operating division.

*National Taxpayer Advocate (NTA).* The NTA was designed to help taxpayers who have problems with the IRS, and who were not able to get them resolved through the normal administrative process. The new NTA is organized around two major functions: (1) the casework function—to resolve all individual taxpayer problems; and (2) the systemic analysis and the advocacy function—to work with the operating divisions to identify systemic problems, analyze root causes, implement solutions and proactively identify potential problems with new systems and procedures.

*Office of Chief Counsel.* Within the Office of Chief Counsel there is a Division Counsel for each operating division. The Division Counsel provides legal advice and representation, and participates in the plans and activities of the operating division management. The main focus of the Operating Division Counsel is to provide legal services to the operating divisions, take part in planning the strategic use of litigation resources, and assist the operating divisions in developing compliance approaches and new taxpayer service initiatives. Field Counsel will provide litigation services and legal advice on locally managed cases. Field Counsel will consist of attorney groups that will report to an assigned Operating Division counsel.



*Office of Professional Responsibility.* The Office of Professional Responsibility establishes and enforces consistent standards of competence, integrity, and conduct for tax professionals.

*Whistleblower Office.* The IRS Whistleblower Office processes tips received from individuals who spot tax problems in their workplace, while conducting day-to-day personal business or anywhere else they may be encountered. The Whistleblower Office is responsible for assessing and analyzing the tips and after determining their degree of credibility, the case is assigned to the appropriate IRS office for further investigation.

*Communications and Liaison.* The Communications and Liaison Division attempts to ensure that communications with customers, Congress, and stakeholders are consistent and coordinated. The Division also attempts to ensure that there is a quality work environment that is operationally efficient and effective, including an emphasis on automating business processes. It attempts to ensure that there is appropriate collection, use, and protection of information to accomplish IRS business objectives.

*Office of Privacy, Governmental Liaison and Disclosure.* This Division is intended to preserve and enhance public confidence by advocating for the protection and proper use of identity information.

### ¶2215 Representation of Taxpayers

The phrase “practice before the IRS” includes all matters connected with presentations to the IRS relating to a client’s rights, privileges, or liabilities under laws or regulations administered by the IRS. Attorneys or certified public accountants who are not under suspension or disbarment may practice before the IRS. Enrolled agents, may practice before the IRS; however, they must demonstrate special competence in tax matters by written examination administered by the IRS. In certain situations, an individual may represent others without enrollment. The special privilege arises in special situations, e.g., where the client is:

- a. Another individual who is the representative’s *full-time employer*.
- b. A *partnership* of which the representative is a member or a full-time employee;
- c. A member of the representative’s *immediate family*.

### ¶2225 Rulings Programs

The IRS issues communications to taxpayers and IRS personnel in three primary ways: (1) letter rulings, (2) determination letters, and (3) technical advice memoranda. These documents are part of the IRS rulings program, which includes published rulings (Revenue Rulings and Revenue Procedures).

*Letter Rulings.* A letter ruling is a “written statement issued to a taxpayer by the National Office of the IRS that interprets and applies the tax laws to that taxpayer’s specific set of facts.” It is issued in response to a specific request by a taxpayer. The letter ruling is applicable only for the taxpayer who requested the ruling, although it may provide to taxpayers in similar situations some indication of the IRS’s viewpoint.

*Determination Letters.* A determination letter is a “written statement issued by a District Director in response to a written inquiry by a taxpayer which applies the principles and precedents previously announced by the National Office to a specific set of facts.” Determination letters are issued by District Directors whereas rulings are issued by the National Office. Most determination letters are issued as to matters involving pension plans and exempt organizations.

*Technical Advice Memoranda.* Technical advice is “advice or guidance furnished by the National Office upon request of a District or an Appeal Office in response to any technical or procedural question” that develops during the examination or appeals process. Both the taxpayer and the District or Appeals Office may request technical advice. The taxpayer may request advice where there appears to be inconsistency in the application of law or where the issue is unusual or complex. Technical Advice Memoranda are issued by the National Office in response to these requests.

### ¶2245 Taxpayer Compliance Assistance

To assist taxpayers to be in compliance with requirements of the Code and Regulations, the IRS develops and issues IRS Publications which address a variety of general and special topics of concern. Even though IRS Publications are not binding on the IRS, the information contained in IRS Publications provides essential guidance for tax law compliance, particularly in technical or specialized areas.

## Tax Practice and Procedure

### ¶2301 Examination of Returns

The selection of returns for examination begins at the service centers. Returns can be selected by computer programs or by manual selection. The IRS uses the Discriminant Function (DIF) system and returns are also chosen at random for the Taxpayer Compliance Measurement Program (TCMP).

*Correspondence Examinations.* Correspondence examinations involve relatively simple problems that can generally be resolved by mail (e.g., mathematical errors).

*District Office Examinations.* A District Office examination of a return is conducted by a tax auditor of the Audit Division by correspondence or by interview. Returns selected for interview examination generally require some analysis and judgment as well as verification.

*Field Examinations.* Field examinations are conducted by revenue agents and involve more complex issues than do office examinations.

*Audit Reconsideration.* The audit reconsideration is a procedure that is used when a taxpayer has ignored a statutory notice of deficiency or where there has been a breakdown in communication between the taxpayer and the IRS.

### ¶2311 Appeals Process

*Administrative Process.* If the taxpayer and the agent do not agree, the taxpayer will be sent a 30-day letter which explains the appellate procedures and urges the taxpayer to reply within 30 days, either by signing the waiver or by requesting a conference. If the taxpayer does not respond to the 30-day letter, a statutory notice of deficiency (90-day letter) will be sent which gives the taxpayer 90 days to file a petition with the Tax Court.

*IRS Appeals Office.* If an appeal is made within the IRS, an appropriate request must be made. Taxpayers may represent themselves at the Appeals Conference or be represented by an attorney, CPA, or person enrolled to practice before the IRS. The Appeals Officer, who actually handles the appeals, reports to the Regional Director of Appeals, who reports to the Regional Commissioner. Proceedings before the Appeals Office are informal and are held in the District Office.

*Taxpayer's Rights.* The Taxpayer Bill of Rights is a series of provisions which require the Treasury Department to outline in simple and nontechnical terms the rights of a taxpayer and the obligations of the IRS during an audit. The Treasury Department has published the required information statement, Your Rights as a Taxpayer, IRS Publication No. 1. The Taxpayer Bill of Rights is divided into four major categories: (1) taxpayer rights and IRS obligations, (2) levy and lien provisions, (3) proceedings by taxpayers, and (4) authority of the Tax Court.

*Appeal Through the Court System.* Taxpayers filing a petition with the Tax Court may take their cases to the Small Claims Division if the amount of the deficiency or claimed overpayment is not greater than \$50,000, but cases brought to the Small Claims Division may not be appealed.

*Federal Court System.* In addition to the Small Claims Division of the Tax Court, there are three other trial courts or courts of original jurisdiction: (1) the U.S. Tax Court, (2) a federal District Court, and (3) the U.S. Court of Federal Claims. Appeals from the Tax Court and the District Court go to the Circuit Court of Appeals and appeals from the Court of Federal Claims go to the U.S. Court of Appeals for the Federal Circuit. Appeals from all Courts of Appeals go to the U.S. Supreme Court. (See Exhibit 9.)

*Choice of Tax Forum.* There are a number of factors to consider in deciding to litigate a case and where to litigate, including (1) jurisdiction, (2) payment of tax, (3) jury trial, (4) rules of evidence, (5) expertise of judges, (6) publicity, (7) legal precedent, (8) factual precedent, (9) statute of limitations, and (10) discovery.

### ¶2315 Settlement Agreements

Form 870, used when a taxpayer and an IRS appeals officer have reached an agreement as to some or all of the issues in controversy, becomes effective as a waiver of restrictions and assessment when received by the Internal Revenue Service; Form 870-AD, used when neither party is willing to concede in full the unresolved area of disagreement and a mutual concession is reached, is effective upon acceptance by or on behalf of the Commissioner of Internal Revenue.

## ¶2325 Refunds

Claims for refunds must be filed no later than three years from the date the return was filed or no later than two years from the date the tax was paid, whichever period expires later.

## ¶2333 Interest on Under/Overpayments

Interest is payable on underpayments of tax and on overpayments at an adjustable interest rate based on the federal short-term rate.

## ¶2355 Statute of Limitations

Assessment of any tax must be within three years after the return was filed or after the due date for filing, whichever is later. However, there are some exceptions.

## ¶2365 Penalties

Penalties are treated as additions to federal internal revenue taxes and are therefore not deductible for federal income tax purposes.

**Delinquency Penalties.** There is a penalty for failure to file a return on the due tax and also a penalty for failure to pay the amount of tax due on a tax return. The failure to file penalty is reduced by the 0.5 percent failure to pay penalty for any month in which both apply.

**Accuracy-Related Penalties.** The penalties relating to the accuracy of tax returns have been consolidated into one accuracy-related penalty equal to 20 percent of the portion of the underpayment to which the penalty applies. The penalty applies to the portion of underpayment attributable to one or more of the following areas.

**Negligence Penalty.** A 20 percent penalty is imposed for underpayment of tax due to negligence or intentional disregard of rules or regulations.

**Substantial Understatement of Tax Liability.** If there is a substantial understatement of income tax, an amount equal to 20 percent of the amount of the understatement can be assessed.

**Substantial Valuation Misstatement Penalty.** There are penalties for valuation misstatements of property.

**Substantial Overstatement of Pension Liabilities.** The 20 percent penalty for substantial overstatement of pension liabilities applies only if the actuarial determination of pension liabilities is 200 percent or more of the amount determined to be correct.

**Estate or Gift Tax Valuation Understatements.** A 20 percent penalty is imposed for estate or gift tax valuation understatement if the value of any property claimed on an estate or gift tax return is 65 percent or less of the amount determined to be the correct amount of the valuation.

**Understatements Resulting from Listed and Reportable Transactions.** The penalty is 20 percent of the understatement if the taxpayer disclosed the transaction, and 30 percent if the transaction was not disclosed.

**Fraud-Related Penalties.** There are three fraud-related penalties.

**Penalty for Aiding Understatement of Tax Liability.** Any person who aids in the preparation or presentation of any tax document in connection with matters arising under the internal revenue laws with the knowledge that the document will result in the understatement of tax liability of another person is subject to a penalty of \$1,000 (\$10,000 for a corporation) for a taxable period.

**Civil Fraud Penalty.** If any part of an underpayment is due to fraud, the penalty imposed is 75 percent of the underpayment.

**Criminal Fraud Penalty.** There are a number of fraud provisions.

**Other Penalties.** There are other penalties such as those that follow.

**Estimated Taxes and Underpayment Penalties.** There are penalties for failure to pay or to have withheld sufficient amounts of tax. However, there are ways to avoid these penalties.

**Failure to Make Deposits of Taxes.** Employers are liable for payment of the tax that must be withheld.



*Tax Preparer Penalties.* There are numerous provisions relating to the regulation of the conduct of tax preparers and to the penalties to which tax preparers may be subject.

### ¶2370 Disclosure of a Position on a Return

The taxpayer may avoid the substantial-understatement penalty and the tax return preparer may avoid the penalty for taking a position for which there is not a realistic possibility of being sustained on its merits by disclosing the item on Form 8275, Disclosure Statement. To avoid the accuracy-related penalty, the taxpayer must disclose any nonfrivolous position for which there is not substantial authority but which has a reasonable basis.

### ¶2375 Ethics Rules for Practitioners

The Tax Committee of the American Institute of CPAs issued 10 statements on elected topics between 1964 and 1977. The first two statements were withdrawn in 1982 by the Executive Committee of the Federal Tax Division. The remaining eight statements were revised and renumbered in 1988 and, in 2000, they were renamed "Statements on Standards for Tax Services." Prior to 2000, they were advisory opinions of the Committee as to what are appropriate standards of conduct in certain situations. Effective October 31, 2000, the Statements are enforceable standards for AICPA members. Effective January 1, 2010, the 6th and 7th standards were combined resulting in seven remaining standards.

## ANSWERS TO KEYSTONE PROBLEMS—CHAPTER 2

(¶2161.) The leading case on the issue of the deductibility of home office expenses by teachers is *David J. Weissman*, 85-1 USTC ¶9106, 751 F.2d 512 (CA-3 1984), rev'g 47 TCM 520, Dec. 40,645(M), T.C. Memo. 1983-724. A college professor was required to do scholarly research and writing in addition to teaching. He spent the majority of his employment-related time doing research and writing at home because a quiet and safe place to perform this work was not available at the college. The court held that he was entitled to deduct his home office expenses because his home, not his college office, was his principal place of business. The home office was necessary to carry out an essential aspect of his job (i.e., his research) and was maintained for the convenience of the employer. The 7th Circuit in *Thomas C. Cadwallader v. Commissioner*, 90-2 USTC ¶50,597, aff'g 57 TCM 1030, denied a deduction for a home office maintained for the taxpayer's own convenience where a university provided him with adequate office space. The U.S. Supreme Court, in another office-in-home case, *Nadar E. Soliman*, 93-1 USTC ¶50,014, held that the office-in-home must be the principal place where the activities are performed to be deductible. Since Weissman's principal income-earning activity could be held to be teaching, the deductibility of his office-in-home after the *Soliman* decision would be questionable.

(¶2333.) In an office examination the taxpayer or a representative should take only information or support for items which are requested of the taxpayer by the IRS; otherwise the tax auditor might open up other areas for investigation. Situations may vary, but some practitioners believe that it is better for the taxpayer, assuming he or she has a representative such as a CPA or a lawyer, not to be present because the representative can keep better control over the interview and also approach the matter in a less emotional atmosphere.

IRS personnel should be treated courteously and should be promptly furnished information and substantiation relating to applicable tax return items. Although the cooperation of the taxpayer (or representative) is important, the taxpayer should respond only to questions asked by the agent. Disclosing unnecessary information could cause problems to the taxpayer.

When there is a disagreement after an office examination, if practicable, the taxpayer is given an opportunity for an interview with the tax auditor's immediate supervisor or for a conference with an Appeals officer. If these actions are not feasible, the taxpayer will be sent a 30-day letter from the District Office indicating the proposed adjustments and the courses of action. If the taxpayer agrees with the adjustment, the agreement form can be signed. If the taxpayer disagrees, he or she may request an Appeals Office conference within 30 days, or ignore the 30-day letter and wait for the 90-day letter which allows the taxpayer to file a petition in the Tax Court.

There are a number of factors a taxpayer should consider in trying to decide whether to pursue the matter. Going to the Appeals Office is less expensive than litigation, and yet the taxpayer leaves open the opportunity to file a petition in the Tax Court or to sue for refund in a District Court or the Court of Federal Claims. In addition, a taxpayer is often able to gather more information about the IRS position in the event the taxpayer needs to carry the case further and there

may be a chance that the taxpayer may convince the Appeals Officer that the IRS was incorrect at the agent level. The Appeals Officer may be at some disadvantage in that the officer has not personally prepared the case and is relying on the information presented by the revenue agent, which could be an advantage to the taxpayer. On the other hand, there may be some disadvantages to having an Appeals Conference. New issues might be raised in an Appeals conference, although the IRS's policy is not to raise an issue unless the grounds for such action are "substantial" and the potential effect upon tax liability is "material."

The 10 factors mentioned in the "Choice of Tax Forum" should also be considered. It is important for taxpayers to be aware of the characteristics of the courts so that an appropriate choice can be made if the taxpayer decides to go to court. A taxpayer, having made a decision to go to the District Court, for example, cannot later decide to go to the Tax Court. The taxpayer must think very seriously before taking the case to court. Not only may the economic costs be high, but the psychological and emotional costs may also be high. The taxpayer has to consider whether the tax savings will be worth the legal fees, time, and psychological costs. In deciding to which court to take the case, the taxpayer should not look simply at the statistics on taxpayer winnings in the various courts. Statistics like that only have some value if winnings by taxpayers on similar issues are being examined.

## ANSWERS TO QUESTIONS—CHAPTER 2

### Topical List of Questions

1. Internal Revenue Code Structure (§2021)
2. Internal Revenue Code Organization (§2021)
3. Treasury Regulations: Judicial Precedent (§2035)
4. Regulations v. Revenue Rulings (§2035)
5. Administrative Sources of Tax Law (§2035)
6. Revenue Ruling and Revenue Procedure Citation (§2035)
7. Judicial Circuits (§2055)
8. Trial Court System (§2055)
9. Tax Court: Regular and Memorandum Decisions (§2055)
10. Tax Court: IRS Acquiescences (§2055)
11. Common Tax Law Abbreviations (§2055 and §2075)
12. Tax Law Publication Services (§2075)
13. Tax Law Publication Services (§2075)
14. Tax Research Methodology: Case #1 (§2147)
15. Tax Research: Computer-Based Research Systems (§2153)
16. Tax Research: Court Case Historical Record (§2153)
17. IRS Organization (§2211)
18. Practice Before the IRS (§2215)
19. Rulings, Determination Letters, and Technical Advice Memoranda (§2225)
20. IRS Examination of Returns: Selection Programs (§2301)
21. IRS Examination of Returns: Selection Criteria (§2301)
22. Correspondence Examinations: Taxpayer Errors Resolved by Mail (§2301)
23. District Office Examinations (§2301)
24. Field Examinations (§2301)
25. Notices of Deficiency (§2311)
26. Appeals Procedure: Administrative Process (§2311)

27. Appeals Procedure: Federal Court System (§2311)
28. Tax Forum Selection (§2311)
29. Delinquency Penalties: Types (§2365)
30. Delinquency Penalties: Reasonable Causes for Avoidance (§2365)
31. Negligence Penalty (§2365)
32. Understatement of Tax Liability Penalty (§2365)
33. Valuation Overstatement Penalty (§2365)
34. Underpayment of Tax Penalty (§2365)
35. Delinquency Penalties: Computation of Penalty (§2365)
36. Negligence Penalty: Computation of Penalty (§2365)
37. Appeals Procedure: Administrative Process (§2311)

## Answers to Questions

### Internal Revenue Code Structure

1. Yes, the Internal Revenue Code of 1986 includes all existing tax laws, regardless of the date when such provisions were enacted.

### Internal Revenue Code Organization

2. The majority of the income tax law is found in the Internal Revenue Code, Subtitle A, Chapter 1.

### Treasury Regulations: Judicial Precedent

3. Yes, Regulations are issued by the U.S. Treasury Department, and are authorized by Congress. In contrast, Revenue Rulings are issued by the Internal Revenue Service, which is a branch of the Treasury Department.

### Regulations v. Revenue Rulings

4. Yes, in dealing with the IRS, Regulations have the authority of law. Revenue Rulings are similar to Regulations in that they represent administrative interpretations of the law; however, they do not have the force and effect of Regulations, but they may be used as precedents.

### Administrative Sources of Tax Law

5. Treasury Regulations, Revenue Rulings, Revenue Procedures, Technical Information Releases and Announcements, Private Letter Rulings, Determination Letters, and Technical Advice Memoranda.

### Revenue Ruling and Revenue Procedure Citation

6. When a Revenue Ruling or a Revenue Procedure is first issued, the available citation is the reference to the Internal Revenue Bulletin. However, once the Cumulative Bulletin for the period has been issued, all rulings and procedures reprinted in that Cumulative Bulletin should be cited according to their permanent CB page references—not according to the temporary IRB reference.

### Judicial Circuits

7. There are presently 11 numbered judicial circuits plus the Federal Circuit. The District of Columbia is a separate Circuit.

### Trial Court System

8. The three trial courts that have jurisdiction over tax cases are the U.S. Tax Court, the U.S. District Court, and the U.S. Court of Federal Claims.

**Tax Court: Regular and Memorandum Decisions**

- 9. Regular decisions require an interpretation of the law; memorandum decisions generally concern only well established principles of law and require only a determination of facts.

**Tax Court: IRS Acquiescences**

- 10. No, an acquiescence to a court decision can be retroactively withdrawn at any time by the IRS.

**Common Tax Law Abbreviations**

- 11.
  - CCH.....CCH, a Wolters Kluwer business
  - RIA . .... Research Institute of America
  - BTA .....Board of Tax Appeals
  - USTC .....United States Tax Cases (published by CCH)
  - AFTR. .... American Federal Tax Reports (RIA original series of tax cases)
  - AFTR2d.....American Federal Tax Reports, 2nd series (current years of tax cases, published by RIA)
  - S.Ct. . .... Supreme Court Reporter (Supreme Court decisions published by West Publishing Co.)
  - CA-3.....Court of Appeals, 3rd Circuit
  - TCM ..... Tax Court Memorandum

**Tax Law Publication Services**

- 12. Research Institute of America (RIA)

**Tax Law Publication Services**

- 13. Merten’s, *Law of Federal Income Taxation*

**Tax Research Methodology: Case #1**

- 14. 2012 = 0; 2013 = \$1,900. See Reg. §1.165-1(d)(2)(ii).

**Tax Research: Computer-Based Research Systems**

- 15. Computer-based research systems in which the text of tax treaties may be found include the publishers CCH, West, Lexis/Nexis, and RIA (Research Institute of America).

**Tax Research: Court Case Historical Record**

- 16. The historical record of a court case can be found in a Citator.

**IRS Organization**

- 17. See Exhibit 8 in the text for the organization of the Internal Revenue Service. The Internal Revenue Service consists of a National Office and an extensive field organization composed of over 100,000 revenue agents, revenue officers, and support personnel. The IRS is divided into four operating divisions, each responsible for serving a group of similar taxpayers.

**Practice Before the IRS**

- 18. Attorneys or certified public accountants who are not under suspension or disbarment may practice before the IRS, as may any person enrolled as an agent. Enrolled agents, however, must demonstrate special competence in tax matters by written examination administered by the IRS. In certain situations, other persons may represent taxpayers:

- (1) An individual may represent another individual who is his or her full-time employer, may represent a partnership of which he or she is a member or a full-time employee, or may represent a member of his or her immediate family.
- (2) Corporations, associations, or organized groups may be represented by bona fide officers or full-time employees.
- (3) Trusts, receiverships, guardianships, or estates may be represented by their trustees, receivers, guardians, administrators, or executors or by full-time employees.
- (4) An individual who prepares the taxpayer's return may represent the taxpayer before officers and employees of the Examination Division of the IRS.

### **Rulings, Determination Letters, and Technical Advice Memoranda**

19. *Private Letter Rulings.* A private ruling is a "written statement issued to a taxpayer by the National Office of the IRS that interprets and applies the tax laws to that taxpayer's specific set of facts." It is issued in response to a specific request by a taxpayer. The private ruling is applicable only for the taxpayer requesting the ruling, although it may provide to taxpayers in similar situations some indication of the IRS's viewpoint.

*Determination Letters.* A determination letter is a "written statement issued by a District Director in response to a written inquiry by a taxpayer which applies the principles and precedents previously announced by the National Office to a specific set of facts." Determination letters are issued by District Directors whereas rulings are issued by the National Office. Most determination letters are issued as to matters involving pension plans and exempt organizations.

*Technical Advice Memoranda.* Technical advice is "advice or guidance furnished by the National Office upon request of a District or an Appeals Office in response to any technical or procedural question" that develops during the examination or appeals process. Both the taxpayer and the District or Appeals Office may request technical advice. The taxpayer may request advice where there appears to be inconsistency in the application of law or where the issue is unusual or complex. Requests for technical advice memoranda sometimes become the basis for a Revenue Ruling.

### **IRS Examination of Returns: Selection Programs**

20. *DIF.* The Discriminant Function system used by the IRS involves computer scoring using mathematical formulae to select tax returns with the highest probability of errors.
- TCMP.* Taxpayer Compliance Measurement Program is a program for measuring taxpayer compliance through specialized audits of individual tax returns.

### **IRS Examination of Returns: Selection Criteria**

21. The following events might cause an IRS examination:
- (1) Total positive income is above specified amounts.
  - (2) Another IRS office or a non-IRS party might provide information (e.g., a tip from a bitter former spouse).
  - (3) A claim for a refund may result in a closer examination of the return.
  - (4) A return of a related party (family member, partner) might be examined to determine the correctness of the taxpayer's return.

### **Correspondence Examinations: Taxpayer Errors Resolved by Mail**

22. Mathematical errors can be broadly defined to mean (1) an error in addition, subtraction, multiplication, or division shown on any return; (2) an incorrect use of any IRS table if such incorrect use is apparent from other information on the return; (3) inconsistent entries on the return; (4) an omission of information required to be supplied on the return to substantiate a return item; or (5) a deduction or credit disallowed by law that is either a specified monetary amount or a percentage, ratio, or fraction—if the items entering into the application of such limit appear on the return.



### District Office Examinations

23. Examples of types of issues which lend themselves to interview examinations are income items that are not subject to withholding, deductions for travel and entertainment, items such as casualty and theft losses that involve the use of fair market value, education expenses, deductions for business related expenses, and determination of basis of property. Also, if the taxpayer's income is low in relation to financial responsibilities as indicated on the return through the number of dependents, or interest expense, or if the taxpayer's occupation is of the type that required only a limited formal education, an office interview might be deemed appropriate. Certain business activities or occupations may also lend themselves to office interview examinations.

### Field Examinations

24. In addition to being less costly than settling at higher levels, negotiations with the revenue agent are generally more informal than higher levels and less demanding as to technical aspects. Also, if questionable issues exist but were not raised at the agent level, it may be wise to settle at that level in order to avoid the possibility of persons at higher levels raising those questionable issues.

### Notices of Deficiency

25. *30-day letter.* If the taxpayer and the agent do not agree, the taxpayer will be sent a 30-day letter which explains the appellate procedures and urges the taxpayer to reply within 30 days either by signing the waiver or by requesting a conference.
- 90-day letter.* If the taxpayer does not respond to the 30-day letter, a statutory notice of deficiency (90-day letter) will be sent which gives the taxpayer 90 days to file a petition with the Tax Court.

### Appeals Procedure: Administrative Process

26. If an appeal is made within the IRS, an appropriate request must be made if required. A taxpayer may go to the Appeals Office at two different times: (1) if the protest is filed within the 30-day period as stated in the 30-day letter, or (2) if the 30-day period passes and the taxpayer files a petition in the Tax Court within 90 days after receipt of a statutory notice of deficiency (the "90-day letter"). The taxpayer may represent himself or herself at an Appeals conference or the taxpayer may be represented by an attorney, CPA, or person enrolled to practice before the IRS.

The Appeals Officer, who actually handles the appeals, reports to the Regional Director of Appeals, who reports to the Regional Commissioner. Proceedings before the Appeals Office are informal and are held in the District Office. The Appeals Officer may request that the taxpayer submit additional information, which could involve additional conferences.

### Appeals Procedure: Federal Court System

27. There is a small tax cases procedure in the Tax Court if the amount of the deficiency or claimed overpayment is not greater than \$50,000. In addition, there are three other trial courts or courts of original jurisdiction: the U.S. Tax Court, a federal District Court, and the U.S. Court of Federal Claims. Appeals from the Tax Court and the District Court go to the Circuit Court of Appeals and appeals from the Court of Federal Claims go to the U.S. Court of Appeals for the Federal Circuit. Appeals from all Courts of Appeals go to the U.S. Supreme Court.

### Tax Forum Selection

28. The factors to be considered include the following:
- (1) Jurisdiction.
  - (2) Payment of tax.
  - (3) Jury trial.
  - (4) Rules of evidence.
  - (5) Expertise of judges.

- (6) Publicity.
- (7) Legal precedent.
- (8) Factual precedent.
- (9) Statute of limitations.
- (10) Discovery.

See also the choice of tax forum section at ¶2311 in the textbook.

### **Delinquency Penalties: Types**

29. The two delinquency penalties are the penalty for failure to file a return and the penalty for failure to pay the tax.

### **Delinquency Penalties: Reasonable Causes for Avoidance**

30. The following are some “reasonable causes” for purposes of avoiding the delinquency penalties:
- (1) A return was mailed in time but returned for insufficient postage.
  - (2) A return was filed within the legal period but in the wrong district.
  - (3) Death or serious illness of the taxpayer or of someone in the immediate family.
  - (4) Unavoidable absence of the taxpayer.
  - (5) Destruction of the taxpayer's business or business records by fire or other casualty.
  - (6) Erroneous information was given the taxpayer by an IRS official.
  - (7) The Taxpayer made an effort to obtain assistance or information necessary to complete the return by a personal appearance at an IRS office but was unsuccessful because the taxpayer, through no fault of his own, was unable to see an IRS representative.
  - (8) The taxpayer is unable to obtain the records necessary to determine the amount of tax due for reasons beyond the taxpayer's control.
  - (9) The taxpayer contacts a competent tax adviser, furnishes the necessary information, and then is incorrectly advised that the filing of a return is not required.

### **Negligence Penalty**

31. A 20 percent penalty, part of the accuracy-related penalty, is imposed for underpayment of tax due to negligence or intentional disregard of rules or regulations.

### **Understatement of Tax Liability Penalty**

32. (1) A taxpayer and (2) any person who aids in the preparation or presentation of any tax document in connection with matters arising under the internal revenue laws who knows that the document will result in the understatement of tax liability of another person.

### **Valuation Overstatement Penalty**

33. Any taxpayer having an underpayment of tax attributable to a valuation overstatement is subject to a penalty. The amount of the penalty is 20 percent and is part of the accuracy-related penalty.

### **Underpayment of Tax Penalty**

34. An individual taxpayer can avoid the penalty for underpayment if the payments of estimated tax are at least as large as any one of the following:
- (1) 90 percent of the tax shown on the return or 100 percent of the tax shown on the return of the individual for the preceding taxable year (assuming it showed a tax liability and covered a taxable year of 12 months); or
  - (2) An amount equal to 90 percent of the tax for the taxable year computed by annualizing the taxable income received for the months in the taxable year ending before the month in which the installment is required to be paid.

**Delinquency Penalties: Computation of Penalty**

35. Jim's total penalties (disregarding interest) are \$400, consisting of a failure to pay penalty of \$40 ( $1/2 \times 1\% \times \$8,000$ ) and a failure to file penalty of \$360 or \$400 ( $5\% \times \$8,000$ ) less the failure to pay penalty of \$40.

**Negligence Penalty: Computation of Penalty**

36. Rose's total penalty is \$4,000 ( $20\% \times \$20,000$ ).

**Appeals Procedure: Administrative Process**

37. There are three options available to Olivia:
- (1) She may request a conference in the IRS Appeals Office.
  - (2) She may ignore the 30-day letter. She would then receive a statutory notice of deficiency at which time she may file a petition in the Tax Court within the 90-day period.
  - (3) She could wait for the 90-day period to expire, pay the assessment, and start a refund suit in the District Court or the Claims Court.

**ANSWERS TO PROBLEMS—CHAPTER 2****Topical List of Problems**

38. Multiple Choice—Internal Revenue Code Organization (§2021)
39. Multiple Choice—Treasury Regulations Publication (§2035)
40. Multiple Choice—Revenue Rulings Publication (§2035)
41. Multiple Choice—Tax Court Memorandum Decisions Publication (§2055)
42. Multiple Choice—Tax Court Regular Decisions Publication (§2055)
43. Practice Before the IRS (§2215)
44. Appeals Procedure: Refund Claims (§2325)
45. IRS Letter Rulings: Areas Not Subject to Rulings (§2225)
46. Delinquency Penalties: Reasonable Causes for Avoidance (§2365)
47. Tax Preparer Penalties (§2365)
48. Statute of Limitations: Omissions of Income (§2355)
49. Tax Practice Ethics (§2375)
50. Tax Practice Ethics (§2375)
51. Delinquency Penalties: Computation of Penalty (§2365)
52. Valuation Misstatement Penalty: Computation of Penalty (§2365)
53. Statute of Limitations: Omissions of Income (§2355)
54. Refunds: Timeliness of Claims (§2325)
55. Multiple Choice—Notices of Deficiencies (§2355)
56. Multiple Choice—Statute of Limitations: Omissions of Income (§2355)
57. Multiple Choice—Statute of Limitations: Refund Claims (§2325)
58. Multiple Choice—Tax Practice Ethics (§2375)
59. Multiple Choice—Tax Forum Selection (§2325 and §2311)
60. Multiple Choice—Appeals Procedure (§2311)
61. Multiple Choice—Tax Preparer Penalties (§2365)
62. Research Problem—Revenue Rulings

63. Research Problem—Code References
64. Research Problem—Revenue Rulings
65. Research Problem—IRS Letter Rulings
66. Research Problem—Regulations
67. Research Problem—Code Organization
68. Research Problem—Citator Case Citations
69. Research Problem—Code Organization
70. Research Problem—Code References
71. Research Problem—Citator Case Citations
72. Research Problem—Regulations
73. Research Problem—Legal Terms: Definitions
74. Research Problem—Code References
75. Research Problem—Code References
76. Research Problem—Publishers' Loose-Leaf Services
77. Research Problem—Electronic Data Base
78. Research Problem—District Office Examinations: Nonappearance
79. Research Problem—Business Expense
80. Research Problem—Exclusion from Gross Income

### Answers to Problems

#### Multiple Choice—Internal Revenue Code Organization

38. b. Partners and partnerships is the topic covered in Code Sec. 731 of the Internal Revenue Code.

#### Multiple Choice—Treasury Regulations

39. d. Treasury Regulations are published in the *Federal Register*.

#### Multiple Choice—Revenue Rulings Publication

40. (c) and (d). Revenue Rulings are published when they are issued in the *Federal Register*. They are also published in the *Internal Revenue Bulletin* (issued weekly).

#### Multiple Choice—Tax Court Memorandum Decisions Publication

41. d. *Tax Court Memorandum Decisions* (cited TCM), published by CCH, would be a publication in which to find memorandum decisions of the U.S. Tax Court.

#### Multiple Choice Tax Court Regular Decisions Publication

42. c. *United States Tax Court Reporter* (cited TC), published by the Government Printing Office would be the publication in which to find regular decisions of the U.S. Tax Court.

#### Practice Before the IRS

43. Attorneys or certified public accountants who are not under suspension or disbarment may practice before the IRS as may any person enrolled as an agent. Thus, if Matthew is an attorney or CPA, he may represent Timothy as well as if he has become an enrolled agent by taking a written examination administered by the IRS. If Matthew was related to Timothy, he could represent him without enrollment.

**Appeals Procedure: Refund Claims**

44. Yes, Marvin should file a claim for refund by filing Form 1040X (Amended U.S. Individual Income Tax Return) and mail it to the IRS Center where he filed the original return. A claim for refund must be filed within three years from the date the return was filed or within two years from the date the tax was paid, whichever is later. Therefore, since he filed the return on August 15, 2011, and paid the tax on February 15, 2012, he must file the claim by August 15, 2014.

**IRS Letter Rulings: Areas Not Subject to Rulings**

45. No, because the IRS will not issue rulings in a number of general areas, one of which applies to this situation. The IRS will not issue a ruling on the results of a transaction that lacks bona fide business purposes or has as its principal purpose the reduction of federal taxes. As Steve's principal purpose for wanting to incorporate is the reduction of taxes and the transaction also lacks business purpose, he would not receive a ruling from the IRS.

**Delinquency Penalties: Reasonable Causes for Avoidance**

46. No, because the penalty can be avoided if the taxpayer can show that failure to file and/or pay was due to reasonable cause and not to willful neglect. The *Internal Revenue Manual* states that if a return is mailed on time but returned for insufficient postage, the "reasonable cause" requirement for avoiding the penalty is met.

**Tax Preparer Penalties**

47. Joe is subject to a preparer penalty. Any preparer who endorses or otherwise negotiates a refund check issued to a taxpayer for a return or claim for refund prepared by the preparer is liable for a penalty of \$500 with respect to such check. Thus, Joe is potentially liable for a penalty of \$500 as a result of his depositing Karen's refund check into his account in payment for his services.

**Statute of Limitations: Omissions of Income**

48. Jim must omit more than \$50,000 ( $\$200,000 \times 25\%$ ) for the six-year statute of limitations to apply. If the taxpayer omits income in excess of 25 percent of the gross income reported on his return, the IRS has six years in which to make any additional assessment of tax. In computing gross income, revenues from the sales of goods or services are not to be reduced by costs of goods sold.

**Tax Practice Ethics**

49. Per "Statements on Standards for Tax Services," Andrea should ask Rodney to disclose the error to the IRS. If Rodney does not comply with her request, Andrea may have a duty to withdraw from the engagement. Since the Statements indicate standards followed by members of the accounting profession, a violation of them might mean that "due care" has not been exercised. Thus, if Rodney does not comply with Andrea's request and she does not withdraw from the engagement, she may be subject to charges of negligence.

**Tax Practice Ethics**

50. No, per the AICPA "Statements on Standards for Tax Services." In preparing a tax return, a CPA may take a position contrary to Treasury Department or IRS interpretations of the Code without disclosure if there is reasonable support for the position.



**Delinquency Penalties: Computation of Penalty**

51. (1) Failure to pay penalty:

3% (.5% per month for the 6 months from April 16 through September 20,  
with the fractional month counted as a full month) of the \$1,200 balance due      \$ 36

(2) Failure to file penalty:

Penalty at 5% for maximum of five months, 25% of \$1,200      300

Less: failure to pay penalty for 5 months ( $\$6 \times 5$ )      – 30

Failure to file penalty      270

Total delinquency penalties (1) and (2)      \$306

**Valuation Misstatement Penalty: Computation of Penalty**

52. The valuation claimed (\$50,000) is 250% of the correct valuation (\$20,000). The penalty, however, is 40% of the underpayment of tax since a charitable contribution is involved. Tommy's underpayment of tax is \$12,000, which means the penalty is \$4,800.

**Statute of Limitations: Omissions of Income**

53. 25% of gross income of \$420,000 ( $\$400,000 + \$20,000$ ) is \$105,000. If Sandy omitted \$100,000 income, which is less than \$105,000, the statute of limitation would be three years.

If she omitted \$120,000 income, which is greater than \$105,000, the statute of limitation would be increased to six years.

**Refunds: Timeliness of Claims**

54. If Brent files the claim on March 14, 2013, he can recover \$6,000 because the claim is filed within a three-year period from the due date of the return. (He filed the original return before the due date.) If he files the claim on May 15, 2013, his recovery is limited to the amount he actually paid during the last two years, that is, the \$3,000 paid on June 10, 2011.

**Multiple Choice—Notices of Deficiencies**

55. b. If the taxpayer omits from gross income an amount which is in excess of 25 percent of the amount of gross income stated on the return, the tax may be assessed at any time within six years after the return is filed, or the due date for filing, if later. However, there is no such rule for overstated deductions, and therefore the date is three years after the due date of the 2011 return (i.e., April 15, 2015).

**Multiple Choice—Statute of Limitations: Omissions of Income**

56. d. For the six-year statute of limitations to apply, Maude would have had to omit in excess of 25 percent of gross income. In computing gross income, revenues from the sale of goods or services are not to be reduced by cost of goods sold. Also, gross income includes capital gains. Thus, 25 percent of \$440,000 is \$110,000.

**Multiple Choice—Statute of Limitations: Refund Claims**

57. d. There is a special seven-year period of limitation on a claim for refund based on a debt that became wholly worthless or on a worthless security. Code Sec. 6511(d)(1).

**Multiple Choice—Tax Practice Ethics**

58. a. Advise client.

**Multiple Choice—Tax Forum Selection**

59. c. Pay the additional tax, then file a claim for refund.

**Multiple Choice—Appeals Procedure**

60. c. Submit a written protest within a specified time limit.

**Multiple Choice—Tax Preparer Penalties**

61. c. The tax return preparer has the burden of proof.

**Research Problem—Revenue Rulings**

62. Rev. Rul. 57-82 has been superseded by Rev. Rul. 76-74.

**Research Problem—Code References**

63. Code Secs. 2053 and 2054. This is an exercise in locating a detailed Code section reference. However, please note that the reference in the regulation is unintelligible, unless you find out what Code Secs. 2053 and 2054 stand for.

**Research Problem—Revenue Rulings**

64. Rev. Rul. 76-74 supersedes Rev. Ruls. 57-82; 56-445; 55-477.

**Research Problem—IRS Letter Rulings**

65. The date of IRS Letter Ruling 8302032 is October 7, 1982.

**Research Problem—Regulations**

66. Reg. §1.274-8 was adopted on June 24, 1963.

**Research Problem—Code Organization**

67. Section 280A.

**Research Problem—Citator Case Citations**

68. a. CA-2 reversed the district court.  
b. S.Ct. reversed CA-2.

**Research Problem—Code Organization**

69. Standard Deduction: Code Sec. 63; Trade or Business Expenses: Code Sec. 162; Losses: Code Sec. 165; Medical Deductions: Code Sec. 213; Moving Expenses: Code Sec. 217.

**Research Problem—Code References**

70. Code Secs. 902 and 936 are referred to in Code Sec. 56(f)(2)(F)(ii)(II), which has been repealed.

**Research Problem—Citator Case Citations**

71. *Cert. denied*, 296 U.S. 588; 56 S.Ct. 99.

**Research Problem—Regulations**

72. Code Secs. 212 and 266 are referred to in Reg. § 212-1(n).

**Research Problem—Legal Terms: Definitions**

73. ANNOTATED—To make or furnish critical or explanatory notes or comments.  
CERTIORARI—An appellate proceeding for reexamination of action of inferior tribunal or auxiliary process to enable appellate court to obtain further information in pending cause.  
REMANDED—To send back to the same (lower) court out of which a case came for purpose of having some action on it there.

**DICTUM**—Statements and comments in an opinion concerning some rule of law or legal proposition not necessarily involved in or essential to determination of the case at hand are “obiter dicta” and lack the force of an adjudication.

**ACQUIESCED**—When the IRS gives its express consent to a decision of the U.S. Tax Court.

#### Research Problem—Code References

74. No, see Code Sec. 280F(d)(4). MACRS is not allowed for cellular telephones unless business use exceeds 50 percent. If such use is 50 percent or less, depreciation must be computed under the alternative depreciation system.

#### Research Problem—Code References

75. July 10, 1989, is the effective date of Code Sec. 1031(f).

#### Research Problem—Publishers' Loose-Leaf Services

- 76.
- a. In most foreclosures of real estate, the borrower will have a basis below the amount of the outstanding debt because of tax deductions for depreciation on the property. When the property is repossessed, gain is recognized to the extent that the amount realized exceeds the borrower's basis. Code Sec. 1001(a); Reg. § 1.1001-2(a); and *J.W. Yarbrow*, 84-2 USTC ¶ 9691 (CA-5 1984), 737 F.2d 479, cert. denied 105 S.Ct. 959. Any excess of the outstanding debt over the fair market value of the property is ordinary income under the forgiveness of indebtedness rules of Code Sec. 61(a)(12). When a borrower is insolvent, however, this income can be excluded from income to the extent of the amount by which the taxpayer is insolvent. Code Sec. 108(a)(3); Rev. Rul. 90-16, 1990-1 CB 12.

*Result.* Borrower realizes and recognizes a capital gain of \$200,000, which is the excess of the FMV over basis (\$1.2 million – \$1 million). Borrower also has forgiveness of income of \$300,000, which is the excess of the indebtedness over the FMV (\$1.5 million – \$1.2 million), but this gain is not taxed because Borrower is insolvent.

If Borrower is not personally liable on the debt, then the forgiveness of indebtedness exception of Code Sec. 108(a) is not applicable and Borrower must treat the entire amount as being realized on a sale or exchange under Code Sec. 1001. Therefore, Borrower has a capital gain of \$.5 million.

#### Research Problem—Electronic Data Base

77. No, Anthony may not deduct the cost of the bar review course. The courts have held that preparing for the bar exam of a second state is meeting the minimum requirements for practicing in that state and as such is not deductible as education expense. See: *L.R. Adamson*, 32 TCM 486, Dec. 31,963(M), T.C. Memo. 1973-107; *M.D. Siewert*, 80-2 USTC ¶ 9613 (DC Tex 1980); *S.F. Avery*, 76-2 USTC ¶ 9694 (DC Iowa 1976); *M.E. Walker*, 54 TCM 169, Dec. 44,128(M), T.C. Memo. 1987-409; *P.M. Kohen*, 44 TCM 1518, Dec. 39,451(M), T.C. Memo. 1982-625; *J.A. Sharon*, 78-2 USTC ¶ 9834, 591 F.2d 1273 (CA-9 1978), aff'g per curiam 66 TC 515, Dec. 33,890.

#### Research Problem—District Office Examinations: Nonappearance

78. Under Code Sec. 7210, any person who, being duly summoned to appear to testify or to appear and produce books, accounts, records, memoranda, or other papers, as required under Code Secs. 6420(e)(2), 6421(g)(2), 6427(j)(2), 7602, 7603, and 7604(b), neglects to appear or to produce such books, accounts, records, memoranda, or other papers, will, upon conviction thereof, be fined not more than \$1,000, or imprisoned not more than one year, or both, together with costs of prosecution.

#### Research Problem—Business Expense

79. (a) and (b). According to Private Letter Ruling 9144042 (July 1, 1991), the issue is not whether a takeover is hostile or friendly. Rather, the proper inquiry to be made is whether the target corporation obtained a long-term benefit as a result of the expenditure. In order to obtain a deduction, the taxpayer must show it did not obtain a long-term benefit. Each case will turn on its own specific facts and circumstances.

**Research Problem—Exclusion from Gross Income**

80. Damages for impairment of business income are taxable as gross income under Code Sec. 61 (*Hort v. Comm.*, 313 U.S. 28 (1941); *Freeman v. Comm.*, 33 TC 323 (1959), Letter Ruling 9348002). Punitive damages are also taxable under Code Sec. 61 (*Comm. v. Glenshaw Glass*, 348 U.S. 426 (1955)).