



11TH EDITION

FEDERAL Tax Research

Roby B. Sawyers | Steven L. Gill

Federal Tax Research

Federal Tax Research

ELEVENTH EDITION

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Australia • Brazil • Mexico • Singapore • United Kingdom • United States

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Dedications

This book is dedicated to our academic mentors.

Roby B. Sawyers

David E. Hoffman
Charles W. Christian
J. Hal Reneau
Philip M. J. Reckers
Joseph J. Schultz, Jr.

Steven L. Gill

Susan Porter
Lynne Krapf
Gene Whittenburg

In 2015, we unexpectedly lost our friend and co-author Gene Whittenburg. As one of the original authors of *Federal Tax Research*, Gene helped create this market-leading textbook in an environment where computer-based research was just becoming available. It is simply not possible to quantify the degree of our loss. Gene started his life in a small town in Texas; entered the Navy; served his country in Vietnam; earned bachelors, masters, and Ph.D. degrees; and served as a distinguished faculty member at San Diego State University for almost 40 years. The outpouring of sorrow and gratitude from countless former students and colleagues is a wonderful tribute to Gene's love and devotion to teaching.

About the Authors

Photo Courtesy of Roby B. Sawyers



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In addition to being on the author team of *Federal Tax Research*, Dr. Sawyers writes frequently for leading academic, policy, and professional tax journals.

Photo Courtesy of Steven L. Gill



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Professor Gill's research interests include a concentration in taxation including mutual funds and college savings ("529") plans and wider interests in corporate internal control structure and weaknesses, management overconfidence, and earnings quality. Professor Gill has taught at both the undergraduate and graduate levels, and his teaching interests include taxation and financial accounting. In addition to being on the author team of *Federal Tax Research*, Dr. Gill is an author of *Income Tax Fundamentals*.

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The 11th Edition of *Federal Tax Research* includes the deepest analysis of the online research tools available to assist with tax and accounting research. As a result, we believe that the 11th Edition is indispensable to learning and performing real-world research. New features in the 11th edition include:

- A searchable electronic research case classification matrix. Faculty can search for appropriate cases to assign based on the necessary primary tax authority needed in the case (legislative, administrative, judicial), jurisdiction (federal, state, international), entity type or issue, tax type, the similarity of the research case to the facts in the primary sources, and the expected response (short paragraph, research memo, etc.).
- **Chapter 1:** An updated discussion of Circular 230 and the AICPA Code of Professional Conduct, including the impact of the *Ridgely* and *Loving* cases on the regulation of tax return preparers.
- **Chapter 2:** An updated discussion of research on the CPA exam and the importance of citations in tax research.
- **Chapter 3:** An enhanced discussion of tax treaties and committee reports and how they are used in tax research.
- **Chapter 4:** An expanded discussion of regulations, including the process of proposing and issuing final regulations, and an updated discussion of the authority of regulations post-*Mayo*. The chapter also includes additional discussion of private letter rulings and the cost of requesting rulings, an expanded discussion of the Internal Revenue Bulletin as a source of substantial authority, and a more thorough discussion of the litany of documents issued by the Treasury Department's general counsel, including GCMs, CCAs, and FSAs.
- **Chapter 5:** An updated discussion of burden of proof standards to reflect current law.
- **Chapter 6:** A discussion and demonstration of the new Checkpoint Catalyst tool as well as updated screenshots and guidance related to conducting tax research using Thomson Reuters Checkpoint.
- **Chapter 7:** Updated screenshots and guidance related to conducting tax research using CCH IntelliConnect.
- **Chapter 8:** Updated screenshots and guidance related to conducting tax research using BNA Bloomberg, Lexis Tax Center with Lexis Advance Tax, Westlaw, LexisNexis Academic, and Tax Analysts.
- **Chapter 9:** Enhanced discussion of multistate taxation to better explain state income taxes to novice tax researchers as well as updates to screenshots and use of state and local and international research tools in Checkpoint, IntelliConnect, BNA Bloomberg, Lexis Tax Center, LexisNexis Academic, and Westlaw.
- **Chapter 10:** Updated screenshots and guidance related to the use of the FASB Accounting Standards Codification Research System (CRS).

- **Chapter 11:** Enhanced focus on general writing tips for the tax professional as well as using email and text messages to communicate with clients.
- **Chapter 12:** Updated discussion of the fundamental tenants of tax planning.
- **Chapter 13:** Enhanced discussion of the statute of limitations (moved from Chapter 14 to Chapter 13) as well as taxpayer rights and client confidentiality privilege for nonattorneys.
- **Chapter 14:** New discussion of relief from joint and several liability for innocent spouses.

The book has been prepared as a comprehensive, stand-alone reference tool for the user who wishes to become proficient in federal, multistate, and international tax research as well as financial accounting research. It is written for readers who are familiar with the fundamentals of the tax law, at a level that typically is achieved on the completion of two comprehensive introductory courses in taxation in either the accounting program in a business school or second- or third-year courses in a law school. Nearly every accounting, tax, and tax law student can benefit from the tools and strategies found in this book.

Structure and Pedagogy

Too often, textbooks ignore the detailed, pragmatic approach that students require in developing effective and efficient tax research skills. That is why we have included an unprecedented degree of hands-on tax research analysis throughout the text. This book does not simply discuss tax research procedures or the sources of the tax law, nor does it provide a mere sample of the pertinent tax reference material. Rather, the book reflects our conviction that students learn best by active learning and real-world experience using the most comprehensive and important sources of tax law. We have applied this conviction to the many important features of the 11th Edition, including:

- Dozens of exercises, problems, and research cases in each chapter.
- “Spotlight on Taxation” boxes in every chapter to provide tax news and background information to students.
- Chapters on working with the IRS and on tax practice and administration that provide details on important topics such as preparer penalties, statutes of limitations, and the IRS audit and appeals process.
- Assignments requiring students to construct research memos, client letters, and other elements of a comprehensive client file—vital communication skills they will need in practice.
- Hundreds of reproductions, illustrations, and screen captures from the most important tax reference materials to expose students to the real world of tax research.
- Summary charts, diagrams, and other study aids integrated throughout the text.

Students can access chapter-by-chapter study content at the CengageBrain.com home page and can search by author name, title (*Federal Tax Research*), or ISBN (9781337282987) using the search box at the top of the page. This will bring readers to a link for the 11th Edition of *Federal Tax Research*.

The instructor’s portion of the Web site located at www.cengagebrain.com includes the solutions for the end-of-chapter material, a test bank, instructor PowerPoint slides,

lecture notes, and the new searchable research case classification matrix to help guide instructors through the course.

Acknowledgments

We are grateful to our supplement authors and reviewers who provided valuable comments and insights, which guided us in the development of the 11th Edition.

Lucia Smeal, Georgia State University

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We wish to thank all of the book's student and faculty readers who have provided their detailed feedback and suggestions. Without their responses, our efforts would have been greatly diminished in scope. Any errors, of course, are the sole responsibility of the authors.

We welcome your comments and suggestions for further improvements to this text. Please feel free to use the following addresses to convey these remarks:

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PART I

The Tax Research Environment

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Introduction to Tax Practice and Ethics

LEARNING OBJECTIVES

- Describe the elements of modern tax practice in the United States.
- Explain and apply the sources of legal and ethical standards that guide those who engage in tax practice.
- Summarize the limitations on tax research by CPAs and other nonattorneys.

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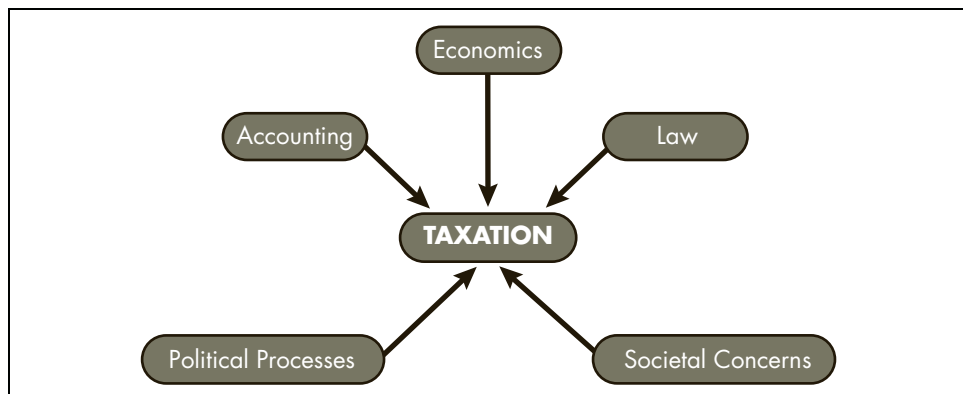
TAX PRACTICE AND TAX RESEARCH have evolved over the last twenty or thirty years into an electronic and often paperless system. For example, in 2016 more than 90 percent of individual taxpayers e-filed their tax returns. In keeping with this continuing transition to an all-electronic tax system, today tax research is almost 100 percent online based. The Uniform CPA Exam recognizes this transition and includes a set of simulation questions that require the candidate to demonstrate accounting and tax research skills by completing short research cases using online searches of authoritative literature, including the Accounting Standards Codification (ASC) and the Internal Revenue Code (IRC). However, before the tax practitioner can complete a tax research project, he or she must understand the tax research process, all its elements, and how each element relates to solving a specific tax problem. The primary purpose of this book is to inform the user on how to effectively obtain tax research results in a timely and efficient manner.

The practice of taxation is the process of applying the tax laws, rules, regulations, and judicial rulings to specific transactions in order to determine the tax consequences to the taxpayer involved. There are many ways to practice tax. Certified public accountants (CPAs), tax attorneys, and enrolled agents often provide compliance and planning services for clients. In addition, tax can be practiced by controllers, chief financial officers (CFOs), tax directors, and other individuals who do tax work as part of their duties within a corporation or other business entity. An understanding of taxation and the tax practice environment is essential to the individual who wants to have a career in the tax area.

Taxation is the process of collecting revenue from citizens to finance government activities. In a modern technological society such as that of the United States, however, taxation comprises an interaction among several disciplines that is far from simple. The tax system is derived from law, accounting, economics, political science, and sociology (Exhibit 1-1). Principles of economics, sociology, and political science provide the environment, while law and accounting precepts are applied in a typical tax practice.

Tax policy questions concerning the effects that a specified tax law change will have on economic growth, the effects of projected inflation on the implementation of the tax law and vice versa, and the effects of the tax law on the United States' balance of payments are addressed by economists. Political scientists, economists, and sociologists examine issues such as who bears the ultimate burden of a tax, how a tax bill becomes

EXHIBIT 1-1: Elements of Taxation



law (including practical effects of the legislative process), the social equity of a tax, and whether a tax is discriminatory. Attorneys interpret taxation statutes and litigate disputes with governmental authorities, and accountants apply the tax laws to current or prospective economic transactions.

1 Elements of Tax Practice

The tax laws of a democratic country such as the United States are created by a political process. In recent years, the result of this political process has been a set of laws that levies taxes on income, sales, estates, gifts, and other items that usually are reflected by the accounting process. Modern tax practice can be separated into three elements: compliance, planning, and litigation, which are all supported by tax research. How these elements of tax practice fit together is illustrated in Exhibit 1-2.

1-1 Tax Compliance

In general, **tax compliance** consists of two separate but related components—tax return preparation and, for certain corporate entities, the preparation of the tax provision on a company's financial statements.

Tax return preparation consists of the gathering of pertinent information, the evaluation and classification of such information, and the filing of necessary tax returns with the appropriate governmental agency. In the United States, this will typically be the Internal Revenue Service (IRS) or the appropriate state agency. Tax compliance also includes other functions necessary to satisfy governmental requirements, such as representation at a client's IRS audit. Non-credentialed tax preparers, enrolled agents (EAs), attorneys, and CPAs all perform tax compliance to some extent. Relatively simple individual, partnership, and corporate tax returns often are completed by non-credentialed tax return preparers. EAs, attorneys, and CPAs usually are involved in the preparation of more complex tax returns; in addition, they provide tax planning services and represent their clients before the IRS at the appeals level.

A corporation's income tax expense as reported on its financial statements is often different from the income tax on its tax return. Financial statements are prepared using generally accepted accounting principles (GAAP) rather than tax law as set out in the IRC, related Treasury regulations, and other administrative pronouncements and court cases. Both tax return preparation and the preparation of the tax provision on financial statements are examined in more detail in later chapters.

EXHIBIT 1-2: Elements of Tax Practice



1-2 Tax Planning

Tax planning is the process of arranging one's financial affairs to minimize tax liabilities. While this usually means minimizing current tax payments, that is not always the case. Whereas **tax avoidance** is a legitimate objective of modern tax practice, **tax evasion** constitutes the illegal nonpayment of a tax and cannot be condoned. Fraudulent acts of any kind are unrelated to the professional practice of tax planning.

Tax planning can be divided into two major categories: **open transactions** and **closed transactions**. In an open transaction, the tax practitioner maintains some degree of control over the potential tax liability because the transaction is not yet completed; for example, the title to an asset has not yet passed. If desired, some modifications to an incomplete transaction can be made to receive more favorable tax treatment. In a closed transaction, however, all of the pertinent actions have been completed; therefore, tax planning may be limited to the presentation of the facts to the government in the most favorable, legally acceptable manner possible.



SPOTLIGHT ON TAXATION

Is Tax Avoidance Legal?

There is nothing inherently illegal or immoral in the avoidance of taxation (i.e., tax planning) according to the tax system's rules. The eminent judge Learned Hand best expressed this doctrine in the dissenting opinion of *Commissioner v. Newman*, 159 F.2d 848 (CA-2, 1947):

Over and over again, courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor, and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions.

1-3 Tax Litigation

A specialized area within the practice of taxation is the concentration on **tax litigation**. Litigation is the process of settling a dispute with another party (in the United States, usually the IRS or a state revenue department) in a court of law. Typically, a tax attorney handles tax litigation that progresses beyond the initial appeal of an IRS or state revenue department audit result. Accountants and other financial advisers can also serve in a support capacity. Later chapters of this book contain additional discussions of the various opportunities and strategies available in tax litigation.

1-4 Tax Research

Tax research is undertaken to answer taxation questions. The tax research process includes the (1) identification of pertinent issues, (2) determination of proper authorities, (3) evaluation of the appropriateness of these authorities, and (4) application of these authorities. Tax research methodology, sources of federal tax law, and tax research tools are examined in Chapters 2 through 8 of this book.

2 Rules and Ethics in Tax Practice

A person who prepares tax returns for monetary or other compensation, or who is licensed to practice in the tax-related professions, is subject to various statutes, rules, and

codes of professional conduct. Tax practitioners (as defined by the IRS) are regulated by **Circular 230**, Regulations Governing Practice before the Internal Revenue Service.

The ethical conduct of an attorney is also governed by the laws of the state(s) in which he or she is licensed to practice. Most states have adopted, often with some modification, guidelines that are based on the **American Bar Association (ABA)** Model Rules of Professional Conduct.

Certified public accountants (CPAs) who are members of the **American Institute of Certified Public Accountants (AICPA)** must follow its Code of Professional Conduct and any other rules generated by the state board(s) of accountancy. The AICPA has also produced a series of Statements on Standards for Tax Services (SSTS), which contain advisory guidelines for AICPA members who prepare tax returns. Although CPAs who are not members of the AICPA are not bound by the Code of Professional Conduct and the SSTS, those rules and standards are a useful source of guidance for all members of the profession. In addition, CPAs are regulated by the state(s) in which they are licensed. As a result, there can be additional statutes, regulations, and requirements that must be met by individuals who practice in certain states.

Statutory tax law also specifies certain penalties and other rules of conduct that apply to all tax return preparers. Chapter 14 addresses these rules.

The basic overlapping sources of rules and ethics for tax practitioners are illustrated in Exhibit 1-3.

2-1 Circular 230

Circular 230, which constitutes Part 31 of the Treasury Department Regulations, is designed to provide protection to taxpayers and the IRS by requiring tax practitioners to be technically competent and to adhere to **ethical standards**.¹

At present, Circular 230 contains the following definition of **practice before the IRS** in Section 10.2 of Subpart A:

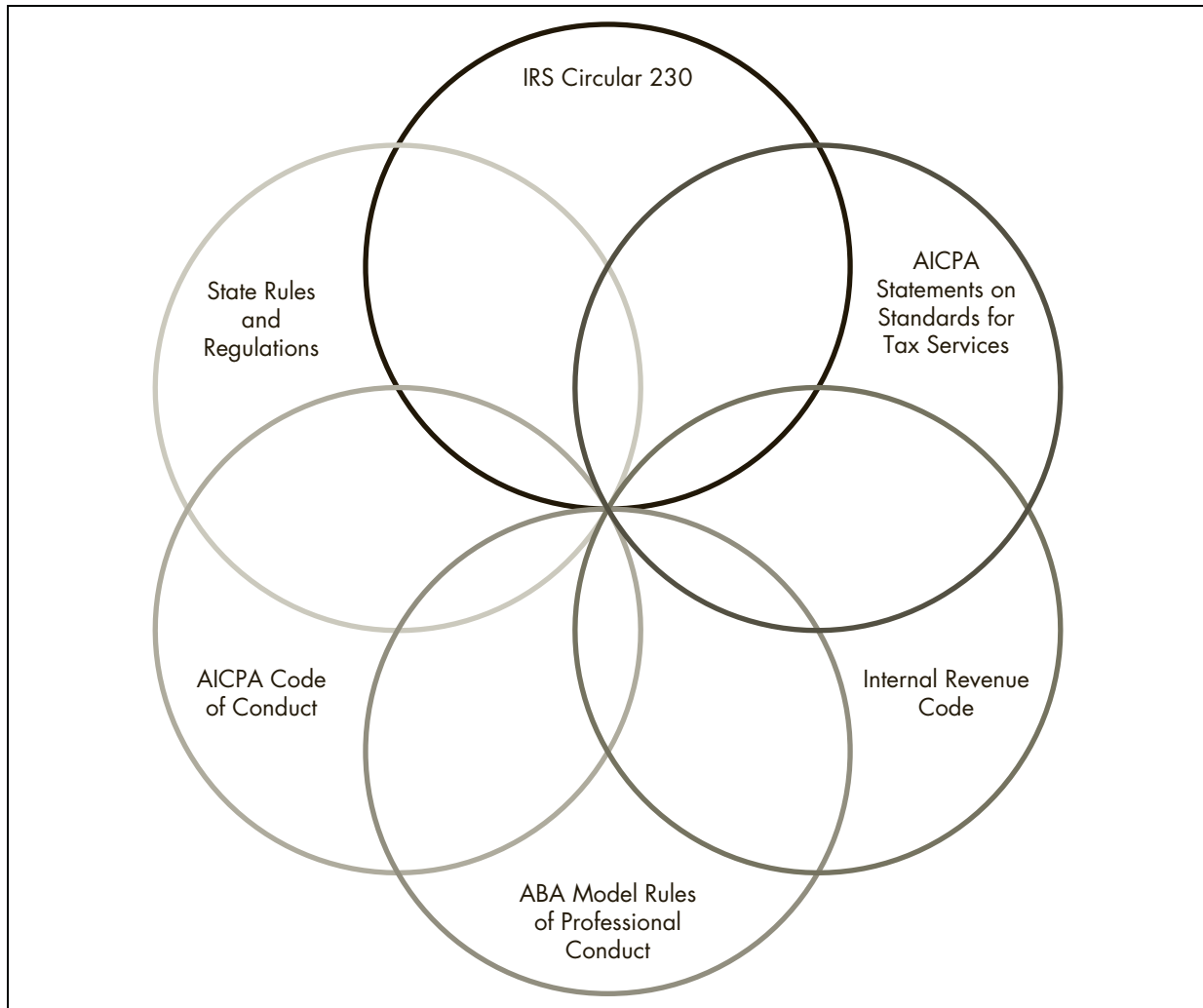
Practice before the Internal Revenue Service comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing documents; filing documents; corresponding and communicating with the Internal Revenue Service; rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion; and representing a client at conferences, hearings, and meetings.

2-1a Who May Practice [Circular 230 § 10.3] Under Section 10.3, Subpart A, of Circular 230, the following individuals may practice before the IRS:

1. Attorneys
2. CPAs
3. EAs
4. Enrolled actuaries
5. Enrolled retirement plan agents
6. Registered tax return preparers²

¹ Circular 230 as revised in June 2014 can be found on the IRS's Website at www.irs.gov/pub/irs-pdf/pcir230.pdf.

² While the term "registered tax return preparer" is still in Circular 230, as a practical matter it is not being used by the IRS. Preparers who are not CPAs, EAs, or attorneys (called non-credentialed tax return preparers by the IRS) may participate in the voluntary Annual Filing Season Program and receive a certificate from the IRS upon completion of 18 hours of continuing education.

EXHIBIT 1-3: Sources of Rules and Ethics for Tax Practitioners

These individuals are collectively referred to as Circular 230 practitioners.

In order to practice before the IRS, an attorney must be a member in good standing of the bar of the highest court in any state, possession, territory, or commonwealth or the District of Columbia. Likewise, CPAs and enrolled actuaries must be qualified to practice in any state, possession, territory, or commonwealth or the District of Columbia. No further substantive examination is required. Applicants for EAs and enrolled retirement plan agents may be granted temporary recognition to practice until the application is approved.



SPOTLIGHT ON TAXATION

CPA Mobility

While CPAs are licensed by their home state, a uniform system allowing CPAs to practice across state lines has been endorsed by the AICPA and the National Association of State Boards of Accountancy (NASBA). A total of 52 states, territories, and



SPOTLIGHT ON TAXATION (CONTINUED)

the District of Columbia have passed mobility laws that essentially allow a CPA with a license from one state to practice outside his or her home state without getting an additional license in the state in which he or she will be serving a client. NASBA and the AICPA sponsor a CPA mobility Website at www.cpamobility.org. After entering your principal place of business where you will be performing services and the type of services you will perform, the site provides a summary of the individual and firm requirements for the target state as well as relevant links.

Individuals who are not attorneys or CPAs can qualify to practice before the IRS by becoming an **enrolled agent (EA)**. An EA is someone who has either passed a special IRS examination or worked for the IRS for five years. The procedures for becoming an EA are detailed in Circular 230, Subpart A, §§ 10.4, 10.5, and 10.6. EAs have the same rights as attorneys and CPAs to represent clients before the IRS. Under Circular 230, an EA must renew his or her enrollment card on a three-year cycle.

The Enrolled Agent Special Enrollment Examination (SEE) is an online exam given throughout the year that consists of three parts covering individual taxation, business taxation and representation, and practices and procedures. For additional information on the SEE, see the Prometric Testing Website: www.prometric.com/en-us/clients/SEE/Pages/landing.aspx.

For each enrollment cycle, EAs, like attorneys and CPAs, must meet certain continuing education requirements as defined in Subpart A, § 10.6. For an EA's enrollment card to be renewed, he or she must complete 72 hours (i.e., an average of 24 hours per year) of qualifying continuing education for each three-year enrollment period. In addition, a minimum of 16 hours of continuing education credit must be completed during each year of an enrollment cycle. Subpart A, § 10.6(f) defines what qualifies as continuing education for EAs.

For more information on EAs, see www.irs.gov/taxpros/agents and www.naea.org.



SPOTLIGHT ON TAXATION

Does the IRS Have Authority to Regulate Tax Preparers?

Two recent court cases have called into question the ability of the IRS to regulate anyone, including CPAs and attorneys who are only providing tax return preparation services. In the *Loving* case, the court said that for purposes of Circular 230, practice must be undertaken by a representative of the taxpayer. A representative must have the authority to bind others, and a tax return preparer filing an amended return does not have that authority. In *Ridgely v. Lew*, the court held that a contingent fee arrangement was allowed in the case of a CPA who filed an amended return for refund for a client before the IRS commenced an audit of the return. The court ruled that under Circular 230, the IRS was limited to regulating practice and that the preparation of an ordinary refund claim did not constitute practice before the IRS. The IRS has not amended Circular 230 language since both of these cases were decided [*Ridgely v. Lew* (114 AFTR 2d 2014-5249, DC Dist Col), and *Loving v. IRS* (111 AFTR 2d 2013-589, DC Dist Col)].