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FEDERAL TAX
RESEARCH

ROBY SAWYERS • STEVEN GILL



FEDERAL TAX RESEARCH

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FEDERAL TAX RESEARCH

TWELFTH EDITION

Roby B. Sawyers, Ph.D., CPA
North Carolina State University

Steven L. Gill, Ph.D.
San Diego State University



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Roby B. Sawyers and Steven L. Gill

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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

About the Authors

Photo Courtesy of Roby B. Sawyers



Roby B. Sawyers, Ph.D., CPA, is a professor in the Department of Accounting in the Poole College of Management at North Carolina State University. He earned his undergraduate accounting degree from the University of North Carolina at Chapel Hill, his master's degree from the University of South Florida, and his Ph.D. from Arizona State University. He has taught a variety of undergraduate and graduate tax courses at NC State and has been a visiting professor in the International Management Program at the Catholic University in Lille, France, and the Vienna School of Economics and Business (Wirtschaftsuniversitat Wien). He has also developed and taught continuing education courses for the AICPA, NCACPA, BDO Seidman, RSM, Dixon Hughes Goodman, KPMG, and PricewaterhouseCoopers.

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

Dr. Sawyers is an active member of the AICPA's Tax Division, currently serving on the Tax Practice Responsibilities Committee. He also served on the Tax Executive Committee, the Precertification Education Executive Committee; chaired the Trust, Estate, and Gift Tax Technical Resource Panel; and chaired the AICPA's task force on estate tax reform. He has also been active in tax policy issues in North Carolina, serving as the Chief of Staff for the North Carolina General Assembly's State and Local Fiscal Modernization Study Commission and as an advisor to the General Assembly's Joint Select Committee on Economic Development Incentives and North Carolina's Economic Development Board.

Photo Courtesy of Steven L. Gill



Steven L. Gill, Ph.D., is an associate professor in the Charles W. Lamden School of Accountancy and the Director of Graduate Programs in the Fowler College of Business at San Diego State University. He received a B.S. in accounting from the University of Florida, an M.S. in taxation from Northeastern University (Boston), and a Ph.D. in accounting from the University of Massachusetts. Before entering academia, Professor Gill worked for 12 years in the field of accounting, including roles in public accounting, internal audit, and corporate accounting, and, ultimately, as a vice president of finance. 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 the author of *Income Tax Fundamentals*.

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Preface

The 12th edition of *Federal Tax Research* 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. The book provides the hands-on tax research training and practice you need to succeed in class and on the job. We demonstrate the latest versions of the most widely used online tax research tools such as Thomson Reuters Checkpoint, CCH AnswerConnect, and BNA Bloomberg. CPA candidates benefit from the coverage of professional and legal responsibilities and ethics as well as IRS practice and procedure. This edition focuses on key research skills, critical problem-solving skills, and the communication skills most important for today's workplace.

Updates have been made throughout the book as well as to research cases and end of chapter questions to reflect legislative changes enacted by the Tax Cuts and Jobs Act (TCJA) of 2017. Other updates in the 12th edition include the following:

- **Chapter 1:** New sections discussing the IESBA International Code of Ethics for Professional Accountants and ethical issues surrounding advertising via social media and websites. In addition, we have added discussion of due diligence requirements related to IRC §6695(g) associated with filing returns claiming the earned income tax credit (EITC), child tax credit (CTC), additional child tax credit (ACTC), credit for other dependents (ODC), the American opportunity tax credit (AOTC), and claiming head of household (HOH) filing status.
- **Chapter 2:** Updated examples to better illustrate the tax research process.
- **Chapter 3:** New section and Spotlight on Taxation features discussing the process used by Congress to identify and enact technical corrections to previously enacted legislation.
- **Chapter 4:** New example of the application of the qualified business income deduction enacted by the TCJA. Updated examples of various administrative pronouncements, including revenue procedures, private letter rulings, IRS notices, and AODs.
- **Chapter 5:** New “Spotlight on Taxation” features, including links to a series of videos explaining the Tax Court and its procedures and a discussion of low-income taxpayer clinics.
- **Chapter 6:** 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 AnswerConnect.
- **Chapter 8:** Updated screenshots and guidance related to conducting tax research using Bloomberg Tax, Lexis Advance Tax, Nexis Uni, Westlaw and Tax Notes.
- **Chapter 9:** Enhanced discussion of state income and sales tax nexus as a result of the 2018 Supreme Court *Wayfair* decision. Updated discussion of the U.S. taxation of multinational corporations as a result of the TCJA. Updated discussion of the OECD's Base Erosion and Profit Shifting (BEPS) initiative. Updated screenshots and guidance related

to the use of state and local and international research tools in Checkpoint, Answer-Connect, Bloomberg Tax, Lexis Advance Tax, Nexis Uni, Tax Notes and Westlaw.

- **Chapter 10:** Enhanced discussion of various forms of written and oral communication with clients.
- **Chapter 11:** Updated tax planning examples for changes made by the TCJA.
- **Chapter 12:** Updated IRS audit statistics, discussion of the Taxpayer First Act of 2019, and an enhanced discussion of the process for requesting an appeal using the IRS’s Small Case Request Procedures.
- **Chapter 13:** Enhanced discussion of the common law “mailbox” rule and the 2019 *Baldwin v. U.S.*, Ninth Circuit Court of Appeals decision.

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 12th edition, including the following:

- 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 Cengage.com home page and can search by author name, title (*Federal Tax Research*), or ISBN (9780357366387) using the search box at the top of the page. This will bring readers to a link for the 12th edition of *Federal Tax Research*.

The instructor’s portion of the Website located at Cengage.com/Dashboard includes the solutions for the end-of-chapter material, a test bank, instructor PowerPoint slides, lecture notes, and a 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 12th edition.

Richard Barnes, NC State University

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:

Roby B. Sawyers
Department of Accounting, Poole College of Management
NC State University
Raleigh, NC 27695-8113
robby_sawyers@ncsu.edu

Steven L. Gill
Charles W. Lamden School of Accountancy
San Diego State University
San Diego, CA 92182-8221
sgill@mail.sdsu.edu

Roby B. Sawyers
Steven L. Gill

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The Tax Research Environment

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CHAPTER 2 Tax Research Methodology 45

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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.

CHAPTER OUTLINE

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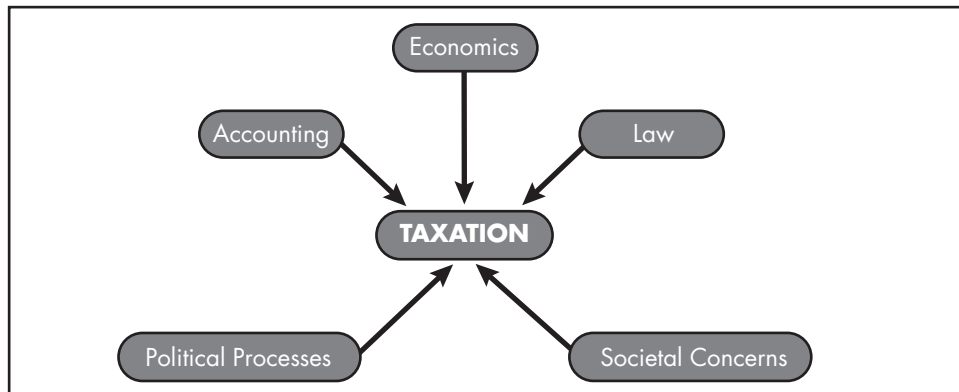
TAX PRACTICE AND TAX RESEARCH have evolved over the last 20 or 30 years into an electronic and often paperless system. For example, in 2018 more than 90 percent of individual taxpayers e-filed their tax returns. In keeping with this continuing transition to an all-electronic tax system, today tax research 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 (EAs)** 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 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.

EXHIBIT 1-1 Elements of Taxation



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.

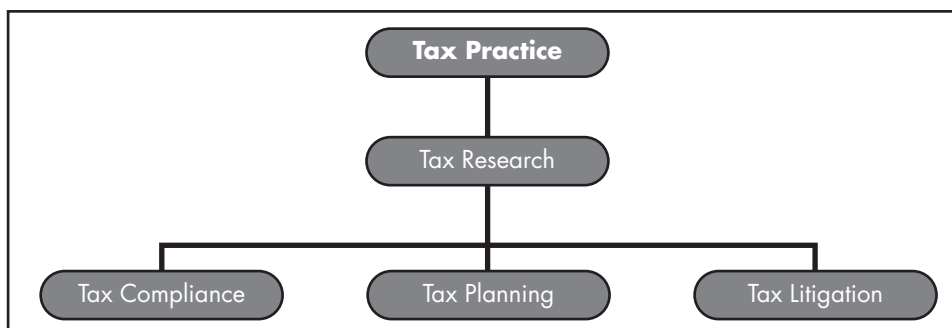
Tax return preparation consists of the gathering of pertinent information, the evaluation and classification of such information, and the filing of necessary tax returns with the appropriate governmental agency. In the United States, this will typically be the Internal Revenue Service (IRS) or the appropriate state agency. Tax compliance also includes other functions necessary to satisfy governmental requirements, such as representation at a client's IRS audit. Noncredentialed tax preparers, EAs, attorneys, and CPAs all perform tax compliance to some extent. Relatively simple individual, partnership, and corporate tax returns often are completed by noncredentialed 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.

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**

EXHIBIT 1-2 Elements of Tax Practice



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 IRS.

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.

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 13 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 § 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.

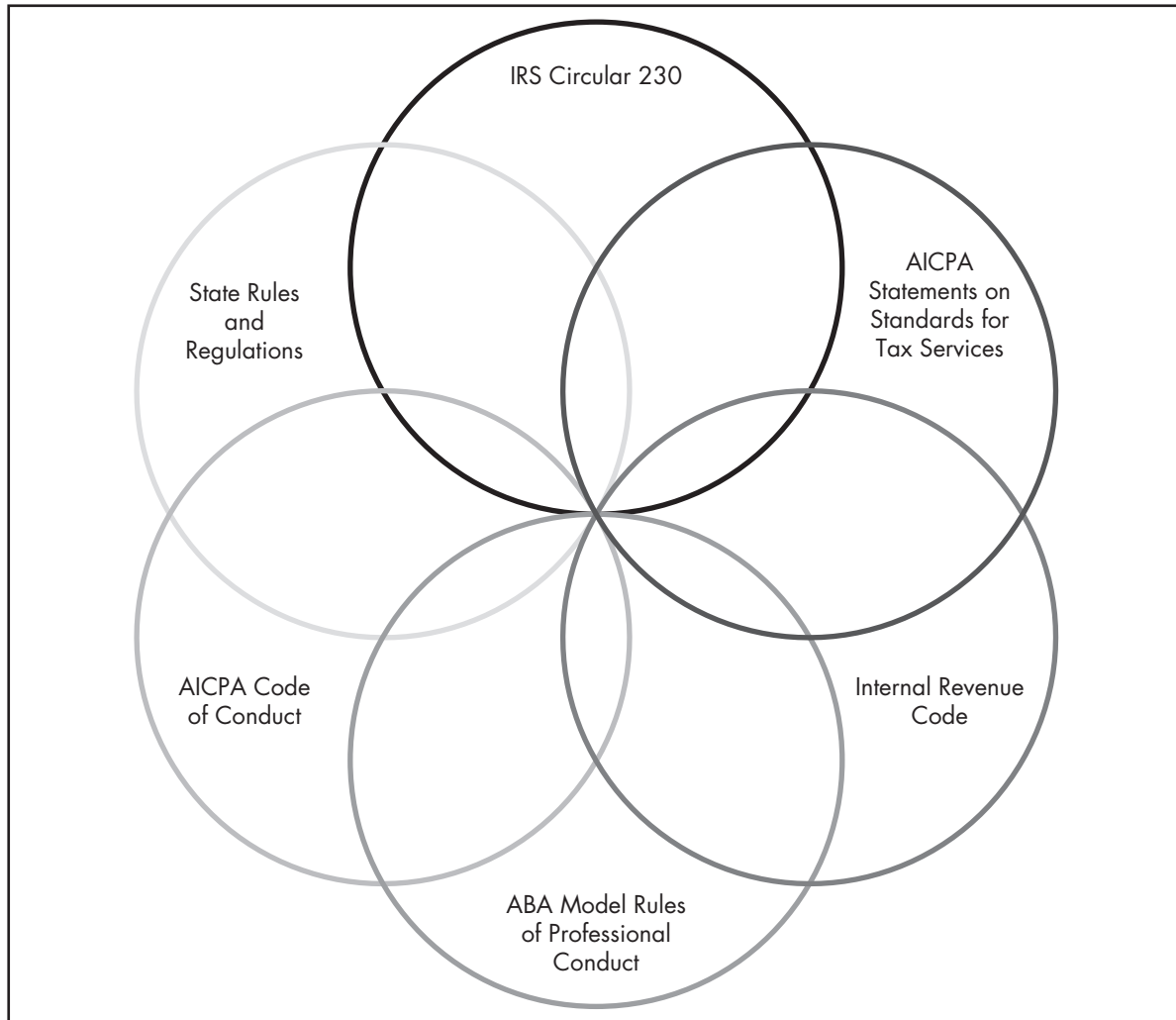
2-1a Who May Practice [Circular 230 § 10.3] Under § 10.3, Subpart A, of Circular 230, the following individuals may practice before the IRS:

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

These individuals are collectively referred to as Circular 230 practitioners.

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 noncredentialed 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

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 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 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 EA 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/tax-professionals/enrolled-agents and www.naea.org.

2-1b Limited Practice and Representing Oneself EAs, CPAs, and attorneys have unlimited representation rights before the IRS. This allows these individuals to represent their clients in matters including audits and payment and collection issues as well as appeals. Practice as enrolled actuaries and enrolled retirement plan agents is limited to specific issues related to the specialty. While Circular 230 provides limited practice rights to registered tax return preparers, effective January 1, 2016, noncredentialed tax return preparers have limited practice rights only if they participate in the IRS **Annual Filing Season Program**.

Limited practice rights allow individuals to represent clients whose returns they prepared and signed, but only before revenue agents, customer service representatives, and similar IRS employees. Noncredentialed tax return preparers who do not participate in the Annual Filing Season Program are allowed to prepare tax returns but have no authority to represent clients before the IRS. Additional information on the status of the new tax return preparer requirements can be found at the IRS Website. The frequently asked questions section on unenrolled preparers and the Annual Filing Season Program are located at www.irs.gov/tax-professionals/frequently-asked-questions-annual-filing-season-program.