

Tax Practice and Research**Solutions to Problem Materials****DISCUSSION QUESTIONS**

2-1

- a. T could be subject to one of several of the 20% accuracy-related taxpayer penalties, depending on whether the understatement is substantial. If the understatement is not substantial, the negligence penalty could be applied if it were determined that he failed to make a reasonable attempt to comply with the tax laws. To avoid this penalty, he must be able to show that he exercised reasonable care in the preparation of the return or had a reasonable basis for his position. In cases where a taxpayer does not meet these standards, the penalty may be waived if he can show there was reasonable cause for the understatement and that he acted in good faith.

If the understatement exceeds (1) 10% of the correct tax or (2) \$5,000 (\$10,000 for corporations), whichever is larger, the substantial understatement penalty could be applied. The taxpayer can avoid assessment of this penalty only if there is a reasonable basis for the position (if disclosed) or there is substantial authority for the position (if undisclosed). As in the case of the negligence penalty, the taxpayer is not subject to the penalty if reasonable cause and good faith can be demonstrated.

- b. T should file an amended return (Form 1040X) to correct the depreciation error. Under these circumstances, penalties generally are not assessed, although T will be liable for interest on the additional tax due. (See SSTS No. 6 on p. 2-42.)

(See Exhibit 2.7 and pp. 2-33 through 2-35.)

2-2

- a. In the case of an *undisclosed* erroneous position, a taxpayer can avoid assessment of the negligence penalty (insubstantial understatement) only if there is a reasonable basis for his position. The reasonable basis standard is met if the position is "arguable, but fairly unlikely to prevail in court." [Reg. § 1.6662-4(d)] This is generally construed to mean that there is at least a 20% chance of the position being sustained on its merits. (see Exhibit 2.7 and pp. 2-33 and 2-34.)

If the understatement is substantial and the erroneous position is not disclosed, the taxpayer must meet the higher standard of substantial authority

to support his position and avoid a penalty. Reg. § 1.6662-4(d) defines substantial authority as less stringent than the more-likely-than-not standard (generally accepted as greater than 50%) and more stringent than the reasonable basis standard.

- b. Adequate disclosure of the tax treatment of the lawn care expenses, either on the return or with a Form 8275, whichever is appropriate, would protect C from assessment of the negligence or substantial understatement penalty unless the position fails to satisfy the reasonable basis standard.

(See Exhibit 2.7 and pp. 2-33 through 2-36)

- 2-3 From the preparer's standpoint, where the tax treatment of an item is questionable, disclosure is invariably the best protection against all but frivolous positions. Lacking adequate disclosure, the preparer must be able to show that the position has substantial authority for the position.

If H feels that these "very questionable" positions do not meet this standard, it is in her best interest to recommend that these clients follow the IRS guidelines on adequate disclosure. However, such disclosure, while guarding against possible preparer penalties, may expose the client to an increased risk of audit, not only for the current year's returns, but in the case of recurring items, for the previous years' returns as well. In the event the positions are so questionable as to admit the possibility that they would not even meet the reasonable basis standard, even disclosure would not protect the clients from taxpayer penalties. In this case, the clients have nothing to gain and much to lose from disclosure. This being the case, her recommendation to disclose will probably meet with little, if any, success. H may have to make a choice between retaining her clients and facing possible tax preparer penalties. (See pp. 2-40 through 2-42.)

- 2-4 The AICPA's Statements on Standards for Tax Services (SSTS) No. 6 provides the preparer with guidelines which should be followed in the event a preparer discovers an error in a client's previously filed return. Pursuant to this statement, a CPA should inform the client promptly upon becoming aware of the error and recommend the appropriate corrective measures. The preparer has no other responsibilities beyond these steps. He is not obligated to report this error to the IRS, and is, in fact, prohibited from doing so without the client's permission, except where required by law.

In the event the client refuses to correct the error and this stance is unacceptable to the preparers either as a violation of his personal code of ethics, or because the uncorrected error makes it impossible for him to prepare future returns accurately, he should consider withdrawing from the engagement. (See p. 2-42.)

- 2-5 As outlined in solution 2-4 above, SSTS No. 6 provides the preparer with guidelines to follow given the discovery of an error on a previous year's return. P's

first responsibility is to notify his client of the error and to recommend corrective measures. It is then the client's responsibility to correct the error. P has no other responsibility except to ensure that the error is not repeated on subsequent returns. (See p. 2-42.)

2-6 The making of a tax law begins when they are introduced as bills in the House of Representatives, where the Constitution provides that they should begin. The House Ways and Means Committee must pass the bill before it goes to the full House of Representatives. At this time, the Ways and Means Committee holds public hearings where interested parties may send representatives to express their views on the bill. The Ways and Means Committee either kills the bill or reports it out for a full vote by the House of Representatives. After the House of Representatives approves the bill, it is sent to the Senate where the Senate Finance Committee takes charge of it. The Senate Finance Committee also holds hearings on the bill and then reports it out for a full vote by the Senate. Since there are almost always differences between the Senate's bill and the House's bill, both versions are sent to the Joint Conference Committee on Taxation, composed of selected House and Senate members. This committee produces a compromise bill acceptable to both houses of Congress. After the Senate and full House approve the compromise bill, it is then referred to the President for his or her signature or his or her veto. (See pp. 2-6 through 2-7 and the diagram on p. 2-8.)

2-7 Legislative regulations result from specific Congressional authority to the Secretary of the Treasury to issue regulations on a particular Code section. Such regulations have the force and effect of law, with the result that a court reviewing the regulation will not usually substitute its judgment for that of the Treasury Department unless the Treasury has clearly abused its discretion.

Interpretative regulations are not drawn up with specific Congressional authority but, instead, are the Treasury's interpretation of the meaning of a Code section. Interpretative regulations are binding upon the IRS but not the courts. The courts, however, give such regulations great weight and normally will not overturn them unless they are inconsistent with the Code or are unreasonable. (See p. 2-13.)

2-8 Proposed regulations represent a potential interpretation of the law by the Internal Revenue Service. Although they are not final, proposed regulations can serve to guide the taxpayer about the position that the Service will probably take concerning a transaction to which such proposed regulations relate. If the proposed regulations are not finalized, a court is not bound to give them any deference, except to the extent that the regulations represent an appropriate interpretation of the statute made contemporaneously with its enactment.

Final regulations are interpretations of the Internal Revenue Code adopted by the IRS. Under basic principles of administrative law, the final Regulations are accorded great weight by the courts. A final regulation relating to Code § 704 would be cited as Reg. § 1.704. A proposed regulation to Code § 704 would be

cited as Prop. Reg. § 1.704. (See pp. 2-12 through 2-13.)

- 2-9 A revenue ruling is an official interpretation by the Service on the application of the Code to particular facts. Such rulings are published by the National Office of the Internal Revenue Service to promote uniform application of the tax laws and to guide Service personnel and taxpayers alike. (See pp. 2-14 and 2-15.)

Revenue procedures are statements reflecting the internal management practices of the IRS that affect the rights and duties of taxpayers. Occasionally, they are also used to announce procedures to guide the public in dealing with the IRS or to make public something the IRS believes the public should be aware of. (See p. 2-15.)

Revenue rulings and procedures are published in the weekly issues of the *Internal Revenue Bulletin*. They are then accumulated and published semiannually in the *Cumulative Bulletin*. (See p. 2-15.)

- 2-10 A private ruling, or letter ruling, is a written statement, usually in letter form, issued to a taxpayer or his or her authorized representative by the National Office of the Internal Revenue Service in response to a written request from a taxpayer or his or her authorized representative. The private letter ruling interprets and applies the law to a specific set of facts described in the ruling request letter. The ruling is private in that it is issued to an individual taxpayer in response to his request and in the sense that the determination or the advice given in the ruling is applicable only with respect to the particular transaction that is the subject of the ruling. During the process of obtaining a ruling, the IRS may recommend changes in a proposed transaction to assist the taxpayers in achieving result they wish. (See p. 2-15.)

In contrast, a revenue ruling is an official interpretation by the Service. It represents the conclusions of the Service on the application of the Code to the facts recited in them. Revenue ruling are "public," in the sense that they are published to guide the public and Service personnel, and thereby contribute to uniformity in interpretation of the tax law. (See p. 2-14.)

In certain instances, a taxpayer has little choice about whether to submit a ruling request because certain transactions require the filing of a ruling request. The chief advantage of obtaining a ruling is that the taxpayer receives an official interpretation of the tax effects of a transaction. Thus, when a transaction involves substantial sums of money, it is generally advisable to request a ruling on the transaction prior to its consummation. If necessary, the parties may be able to modify the proposed transaction in such a way as to avoid unfavorable tax consequences. Additionally, if the Service rules favorably on the ruling request, the tax consequences resulting from the transaction carried out in conformity with the ruling probably will not be challenged on audit. (See pp. 2-14 and 2-15.)

- 2-11 A technical advice memorandum is a written advisory statement furnished by the

National Office to a District Director. The memorandum advises the District Director about the appropriate interpretation and application of the tax laws and regulations to a specific factual pattern. A technical advice memorandum may be requested on any technical question that develops on audit or other examination of a taxpayer's return, or at any stage of district office proceedings. Thus, such requests are appropriate when the District Director is auditing the taxpayer's return, when a taxpayer files claims for credit or refund, and when the District Director recommends that a private ruling issued to the taxpayer should be reconsidered by the National Office. (See p. 2-16.)

- 2-12 There are three courts of original jurisdiction, or trial courts: the U.S. Court of Federal Claims, District Court, and Tax Court. Various advantages and disadvantages of these courts are considered below.

U. S. Court of Federal Claims

1. One U.S. Court of Federal Claims, sitting in Washington, D.C., with national jurisdiction.
2. Sixteen judges.
3. Hears a variety of cases including tax cases.
4. No jury trial available.
5. Taxpayer must pay the tax deficiency and sue for a refund.
6. The Court of Federal Claims does not have the power to fine or imprison for contempt of its order. Taxpayer must seek enforcement of the Court of Federal Claims' orders against nonparties in the U.S. District Courts.
7. Appeal to the U.S. Court of Appeals for the Federal Circuit.

(See p. 2-18.)

U. S. District Court

1. Many District Courts with jurisdiction only in the district in which the Court sits.
2. One judge per District Court, with one to several courts per district.
3. Hears a variety of cases, including tax cases.
4. Jury trial available.
5. Taxpayer must pay the tax deficiency and sue for a refund.
6. Full enforcement powers of its orders.

7. Appeal to the U.S. Court of Appeals for the Circuit in which the District is located.

(See p. 2-17.)

Tax Court

1. One U.S. Tax Court, sitting in Washington, D.C., with national jurisdiction—the judges "ride" circuit throughout the United States. Such a practice could mean a delay before the case comes to trial and is decided.
2. Nineteen judges.
3. Hears only tax cases; some believe that this specialized case load allows the judges to develop special expertise in the tax area.
4. No jury trial is available.
5. The taxpayer need not pay the tax deficiency before his or her case can be heard.
6. Full enforcement powers of its orders.
7. Appeal to the U.S. Court of Appeals for the Circuit that has jurisdiction over the taxpayer.

(See p. 2-17.)

2-13

- a. Appeals from the U.S. Court of Federal Claims are taken to the U.S. Court of Appeals for the Federal Circuit located in Washington, D.C. Appeals from this latter Court are to the United States Supreme Court. (See p. 2-19.)
- b. Appeals from the U.S. District Court are taken to the U.S. Court of Appeals for the circuit in which the District Court is located. Appeals from the U.S. Court of Appeals are taken to the U.S. Supreme Court. (See p. 2-19.)
- c. Appeals from the U.S. Tax Court are taken to the U.S. Court of Appeals that has jurisdiction over the taxpayer. Appeals from this Court are taken to the United States Supreme Court. (See pp. 2-19 and 2-21.)
- d. There are no appeals allowable from a decision of the Small Claims Division of the Tax Court. (See p. 2-18.)

2-14 *Memorandum* decisions deal with situations necessitating only the application of already established principles of law. *Regular* decisions involve novel issues not previously resolved by the Court. In practice, however, this distinction breaks down. Both types of cases represent the position of the Tax Court, and can be

relied on by the tax researcher. The Memorandum decisions are officially published in mimeograph form only; Regular decisions are published by the U.S. Government in a series designated *Tax Court of the United States Reports*

Additionally, if the IRS loses in a Regular decision, it usually indicates whether it agrees or disagrees with the result reached by the Court by announcing its acquiescence or nonacquiescence in the *Internal Revenue Bulletin* and the *Cumulative Bulletin*. This procedure is not followed for Memorandum decisions or for the decisions of other courts. (See p. 2-22.)

- 2-15 In most cases, the issue will be settled administratively and not through the courts. Accordingly, the starting point is the Code and pronouncements of the IRS itself. However, court decisions are important and carry great weight with the Service.

Administrative Authority

(in descending order of authority)

- c. The Internal Revenue Code
- b. Treasury Regulation
- h. A Revenue Ruling
- g. A private letter ruling issued to another taxpayer
- i. A tax article in a leading periodical (not an authority)

Judicial Authority

(in descending order of authority)

- d. A decision of the Supreme Court
- a., f. Decisions of the U.S. District Court having jurisdiction over the case and a decision of the U.S. Tax Court
- e. A decision of the Small Claims Division of the Tax Court (has no precedential value)

(See pp. 2-17 through 2-21.)

- 2-16 Leading tax services generally contain all sources of authority, or at least references to all sources of authority, pertaining to the tax researcher's question. These sources of authority include all relevant statutory authority, IRS pronouncements, and judicial authority, as well as the tax service's own commentaries. The major tax services are identified on page 2-25 and 2-26.
- 2-17 T is quite right to be concerned about this situation and its potential consequences.

Reg. § 1.6694-1(e) provides that a preparer may, without verification, generally rely in good faith on information furnished by the taxpayer. Since T did not know, and apparently had no reason to know prior to 2011, that his client was buying personal equipment and taking the depreciation as a business expense, he probably has little reason to be concerned about the 2010 return. However, Reg. § 1.6694-1(e) goes on to state that the preparer "may not ignore implications of information furnished to him or actually known by him. The preparer must make reasonable inquiries if information appears incorrect or incomplete and must make appropriate inquiries to determine the existence of facts and circumstances required by a Code Section or regulation as a condition to a deduction claim."

As a result of this inadvertent divulgence regarding the personal entertainment equipment, the client has made T aware of the fact that the corporation is taking inappropriate business deductions. Should T continue to depreciate the equipment on subsequent returns, he could be subject to the provisions of § 6694(b), which calls for a \$1,000 penalty for willful understatement of a taxpayer's liability or reckless/ intentional disregard of rules or regulations. In *Pickering*, 82-1 USTC ¶9375 (CA-8, 1982), a preparer was assessed civil penalties for willfully understating a tax liability of a client by deducting as business expenses items which he knew were personal shareholder expenses. The court held that "willfulness does not require fraudulent intent or evil motive; it merely requires a conscious act or omission made in the knowledge that his duty is therefore not being met."

The consequences of a § 6694(b) penalty on a preparer's professional reputation are serious indeed. A practitioner assessed this penalty has violated both the tax law and the AICPA's ethical standards as stated in SSTS No. 3. A willful understatement of a liability can result in disbarment from practice before the IRS as well as the loss of a CPA's license to practice. (See pp. 2-39 through 2-42.)

PROBLEMS

2-18

- a. Reg. § Treasury regulation section.
 1. Part number (1 denotes an income tax regulation).
721 Code section to which regulation relates.
1(a) Subdivision of regulation.

(See Example on p. 2-14.)

- b. Rev. Rul. Revenue ruling.
60-314 Year of issuance and ruling number.

1960-2 C.B. Volume 2 of *Cumulative Bulletins* for 1960.

48 Page 48 of Volume 2.

(See Examples on pp. 2-14 and 2-15.)

- c. Rev. Proc. Revenue procedure.

86-46, Year of issuance, 1986, and procedure number.

1986-2 C.B. Volume 2 of the *Cumulative Bulletins* for 1986.

739 Page 739 of Volume 2 of the *Cumulative Bulletins* for 1986.

(See pp. 2-15.)

- d. Rev. Rul. Revenue ruling.

98-36 Year of issuance, 1998, and ruling number.

I.R.B. #31, 6 31st weekly issue of the *Internal Revenue Bulletin* of 1998.

6 Page 6 of the *Internal Revenue Bulletin*.

(See pp. 2-14.)

- e. §351 Code § 351 of the *Internal Revenue Code of 1986*, as amended. (See pp. 2-9 through 2-11.)

2-19

- a. B.T.A. Board of Tax Appeals—predecessor body to the current Tax Court. (See p. 2-21.)

- b. Acq. Acquiescence—the Internal Revenue Service has the policy of announcing its acquiescence or nonacquiescence to a regular decision of the Tax Court. (See pp. 2-22 and 2-23.)

- c. D. Ct. United States District Court. (See p. 2-23.)

- d. CA-9 The United States Court of Appeals for the Ninth Circuit. (See pp. 2-23 and 2-24.)

- e. F. Supp. Federal District Court decisions, dealing with both tax and nontax issues, are published by West Publishing Company in their *Federal Supplement Series*. (See p. 2-23.)

- f. NA. See Acq. Nonacquiescence by the IRS to a regular decision of the Tax Court. (See footnote 14, p. 2-22.)

- g. Ct. Cls. Court of Federal Claims. (See p. 2-24.)
- h. USTC District Court, Court of Federal Claims, Courts of Appeal, and Supreme Court decisions dealing with Federal tax matters are reported by Commerce Clearing House in *U.S. Tax Cases*. (See p. 2-23.)
- i. AFTR District Court, Court of Federal Claims, Courts of Appeal, and Supreme Court decisions dealing with Federal tax matters are reported by Prentice Hall in their series *American Federal Tax Reports*. (See p. 2-23.)
- j. Cert. Den. Appeal to the United States Supreme Court is by Writ of Certiorari. If the Court accepts the case, it will grant the Writ; i.e., Certiorari granted. If the Court refuses to hear the case, it will deny the writ; i.e., Cert. denied. (See p. 2-21.)
- k. aff'g—affirming aff'd—affirmed The lower court's decision (e.g., Tax Court) is affirmed by the appellate court (e.g., Fifth Circuit). (See p. 2-41.)
- l. rev'g—reversing rev'd—reversed The lower court's decision is reversed. (See p. 2-41.)
- m. rem'g—remanding rem'd—remanded The case is being returned to the lower court for reconsideration in light of the higher court's directive. (See p. 2-41.)

2-20

- a. 41 Volume.

TCM *Tax Court Memorandum Reports*, Commerce Clearing House.

289 Page.

(See Example on p. 2-23.)

- b. 93 Volume.

S. Ct. *Supreme Court Reporter*, West Publishing Co.

2820 Page.

(USSC, 1973) United States Supreme Court, and year of decision. Exhibit 2.5 on p. 2-25.

- c. 71-1 Volume 1, USTC for the year 1971.

USTC *U. S. Tax Cases*, Commerce Clearing House.

¶9241 Paragraph number.

(CA-2, 1971) Decision rendered by the U.S. Court of Appeals for the Second Circuit in 1971. (See the first Example on p. 2-23.)

d. 236 Volume.

F. Supp. *Federal Supplement*, West Publishing Co.

761 Page.

(D. Ct. Va., 1974) Decision rendered by the District Court of Virginia in 1974. (See the third Example on p. 2-23.)

e. T.C. Memo *Tax Court Memorandum*, RIA.

1977-20 The 20th decision issued in 1977. (See Example on p. 2-23.)

f. 48 Volume.

T.C. *United States Tax Court Reports*, U.S. Government.

430 Page.

(1967) Year of decision. (See Example on p. 2-22.)

g. 6 Volume.

AFTR2d Second series of the *American Federal Tax Reports*, RIA (or Prentice Hall.)

5095 Page.

(CA-2, 1960) United States Court of Appeals for the Second Circuit, and year of decision. (See the second Example on p. 2-24.)

h. 589 Volume.

F.2d Second series of the *Federal Reporter*, West Publishing Co.

446 Page.

(CA-9, 1979) United States Court of Appeals for the Ninth Circuit, and year of decision. (See the first Example on p. 2-24.)

i. 277 Volume.

U.S. *United States Supreme Court Reports*, U.S. Government Printing Office.

508 Page.

(USSC, 1928) United States Supreme Court, and year of decision. (See the Example on p. 2-24.)

2-21

- a. Reg. § 1.165-7(a)(2). (See p. 2-14.)
- b. Rev. Rul. 87-34, 1987-1 C.B. 101. (See p. 2-15.)
- c. Ltr. Rul. 8652113. (See p. 2-16.)

2-22

- a. *Roger A. Schubel*, 77 T.C. 701 (1982). (See p. 2-22.)
- b. (1) *H. N. Schilling, Jr.*, 33 TCM 1097. (See p. 2-23.)
(2) *H. N. Schilling, Jr.*, T.C. Memo 1974-246. (See p. 2-23.)
- c. (1) *Nodiak v. Comm.*, 66-1 USTC ¶9262 (CA-2, 1966). (See p. 2-24.)
(2) *Nodiak v. Comm.*, 17 AFTR2d 396 (CA-2, 1966). (See p. 2-24.)
(3) *Nodiak v. Comm.*, 356 F.2d 911 (CA-2, 1966). (See p. 2-24.)

TAX RESEARCH PROBLEMS

Solutions to the Tax Research Problems (2-23-2-33) are contained in the *Instructor's Resource Guide and Test Bank* for 2013.