

## Chapter 2 Tax Compliance, the IRS, and Tax Authorities

### INSTRUCTOR'S MANUAL

#### Learning Objectives

1. Identify the filing requirements for income tax returns and the statute of limitations for assessment.
2. Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.
3. Evaluate the relative weights of the various tax law sources.
4. Describe the legislative process as it pertains to taxation.
5. Perform the basic steps in tax research and evaluate various tax law sources when faced with ambiguous statutes.
6. Describe tax professional responsibilities in providing tax advice.
7. Identify taxpayer and tax professional penalties.

#### Teaching Suggestions

This chapter provides a summary of the filing requirements for income tax returns, the IRS audit process, tax law sources and tax research, tax professional responsibilities, and taxpayer and tax practitioner penalties. The time allotted to this chapter will vary based on your expectations regarding the students' abilities to conduct research in the course. The remaining material in the chapter (filing requirements, IRS audit process, tax professional responsibilities, and taxpayer and tax practitioner penalties) can be covered in a class session (or two).

Compared to chapter 1 and later chapters, the material in chapter 2 could be considered somewhat "dry." Thus, it is important to bring this material to life in the classroom as much as possible. Some suggestions for the class discussion include:

- Filing requirements – provide a basic overview of the filing requirements by entity and statute of limitations and then use discussion questions 1 through 3 and problems 43 – 49 to quiz students on their understanding.
- IRS audit process – most students are interested in how the IRS selects returns for audit. Discussing high-profile IRS cases (Richard Hatch, Survivor; Willie Nelson; Al Capone) or personal experiences with IRS audits is typically well received. After the discussion, quizzing the students on identifying the selection method and audit type for various fact patterns is an effective way to make sure that your students can apply the concepts from this discussion.

- Tax Law Sources – the depth you cover the various sources will vary with your expectations regarding the students’ abilities to conduct research. If students will be expected to research problems, read primary authorities, etc., showing examples of the specific types of authorities that they will research (code sections, regulations, etc.), highlighting their attributes, contrasting different authorities, and discussing how to locate the authorities and make sure that they are “current” should prove beneficial. This discussion could then be followed with a discussion of how to conduct research and an in-class example of a simple research problem. [As an out of class exercise, you might assign students to locate specific primary authorities (e.g., court cases, revenue rulings, etc.) and related discussion in an available tax service (CCH, RIA, BNA, etc.) and have the students summarize the issue addressed in the primary authority and tax service and how they located each authority.]

If instead, students are simply required to have a basic understanding of tax authorities with little or no research expectation, most of the discussion of authorities could focus on comparing different authorities and their relative weights. This discussion can then be reinforced with classroom questions comparing the weight of different authorities or contrasting different authorities using the “one vs. the group” activity suggested below.

- Tax legislation: This discussion may be aided by displaying Exhibit 2-7. You may also remind your class of the ABC Schoolhouse Rock song, “I’m Just A Bill”, that highlights the legislative process. You can download this song on youtube.
- Basic Tax Research Steps: This discussion may be enhanced by walking students through the research example in the text or through one of the end of chapter research problems.
- Tax professional standards/Taxpayer and tax practitioner penalties: This discussion may be enhanced by a discussion of the IRS’ crackdown on tax shelters, the dire consequences associated with not meeting professional standards, and the recent increased thresholds to avoid tax practitioner penalties.

## Assignment Matrix

		Difficulty	Learning Objectives							Text Feature			
			LO1	LO2	LO3	LO4	LO5	LO6	LO7	Research	Planning	Forms	
DQ2-1	5 min.	Easy	X										
DQ2-2	10 min.	Easy	X										
DQ2-3	10 min.	Medium	X										
DQ2-4	5 min.	Easy		X									
DQ2-5	10 min.	Medium		X									
DQ2-6	10 min.	Medium		X									
DQ2-7	10 min.	Medium		X									
DQ2-8	15 min.	Medium		X									
DQ2-9	15 min.	Medium			X								
DQ2-10	10 min.	Easy			X								
DQ2-11	10 min.	Medium			X								
DQ2-12	5 min.	Easy			X								

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DQ2-13	15 min.	Medium			X								
DQ2-14	10 min.	Medium			X								
DQ2-15	10 min.	Medium			X								
DQ2-16	10 min.	Medium			X								
DQ2-17	15 min.	Medium			X								
DQ2-18	15 min.	Medium			X								
DQ2-19	5 min.	Easy				X							
DQ2-20	20 min.	Medium				X							
DQ2-21	15 min.	Medium				X							
DQ2-22	10 min.	Easy				X							
DQ2-23	10 min.	Easy					X						
DQ2-24	15 min.	Medium					X						
DQ2-25	15 min.	Medium					X						
DQ2-26	15 min.	Medium					X						
DQ2-27	15 min.	Medium					X						
DQ2-28	15 min.	Medium					X						
DQ2-29	15 min.	Medium					X						
DQ2-30	10 min.	Easy					X						
DQ2-31	15 min.	Medium					X						
DQ2-32	15 min.	Medium					X						
DQ2-33	15 min.	Medium					X						
DQ2-34	15 min.	Medium					X						
DQ2-35	15 min.	Medium					X						
DQ2-36	20 min.	Medium						X					
DQ2-37	15 min.	Medium						X					
DQ2-38	10 min.	Medium						X					
DQ2-39	15 min.	Medium							X				
DQ2-40	15 min.	Medium							X				
DQ2-41	15 min.	Medium							X				
DQ2-42	15 min.	Medium							X				
P2-43	15 min.	Medium	X										
P2-44	15 min.	Medium	X										
P2-45	15 min.	Medium	X										
P2-46	15 min.	Medium	X										
P2-47	15 min.	Medium	X										
P2-48	15 min.	Medium	X										
P2-49	15 min.	Medium	X										
P2-50	10 min.	Medium		X									
P2-51	15 min.	Medium		X									
P2-52	10 min.	Medium		X									
P2-53	10 min.	Medium		X									
P2-54	10 min.	Medium		X									
P2-55	10 min.	Medium		X									
P2-56	20 min.	Medium		X								X	

P2-57	20 min.	Medium		X							X	
P2-58	15 min.	Medium			X							
P2-59	15 min.	Medium			X							
P2-60	15 min.	Medium			X							
P2-61	15 min.	Medium			X							
P2-62	10 min.	Medium			X							
P2-63	10 min.	Medium			X							
P2-64	15 min.	Medium				X						
P2-65	15 min.	Medium					X					
P2-66	10 min.	Medium					X					
P2-67	10 min.	Medium					X					
P2-68	60 min.	Medium					X			X		
P2-69	60 min.	Medium					X			X		
P2-70	60 min.	Medium					X			X		
P2-71	60 min.	Medium					X			X		
P2-72	60 min.	Medium					X			X		
P2-73	120 min.	Hard					X			X		
P2-74	120 min.	Hard					X			X		
P2-75	60 min.	Medium					X			X		
P2-76	20 min.	Medium						X				
P2-77	20 min.	Hard						X				
P2-78	20 min.	Medium							X			
P2-79	20 min.	Medium							X			X

## Lecture Notes

- 1) Taxpayer filing requirements
  - a) Filing requirements by entity
    - i) Individuals (show Exhibit 2-1)
    - ii) Corporations
  - b) Tax return due date and extensions
    - i) Individuals and partnerships
    - ii) Corporations
  - c) Statute of limitations
    - i) the period in which the taxpayer can file an amended tax return or the IRS can assess a tax deficiency for a specific tax year
    - ii) generally ends three years from the *later* of (1) the date the tax return was actually filed or (2) the tax return's original due date
    - iii) A six-year statute of limitations applies to IRS assessments if the taxpayer omits items of gross income that exceed 25 percent of the gross income reported on the tax return.
    - iv) For fraudulent returns, or if the taxpayer fails to file a tax return, the statute of limitations remains open indefinitely in these cases.

- 2) IRS Audit Selection
  - a) Methods of selection
    - i) DIF system
    - ii) Document perfection
    - iii) Information matching
    - iv) Other methods
  - b) Types of audits
    - i) Correspondence
    - ii) Office
    - iii) Field
  - c) After the audit (show Exhibit 2-2)
    - i) Proposed adjustment
    - ii) 30-day letter
    - iii) Appeals conference
    - iv) 90-day letter
    - v) Petition courts
    - vi) Trial level courts and their differences: Tax Court, U.S. District Court, U.S. Court of Federal Claims
    - vii) Choosing a trial level court (show Exhibit 2-3)
    - viii) Circuit Court of Appeals (show Exhibit 2-4)
    - ix) Supreme Court
- 3) Tax Law Sources
  - a) Primary and secondary sources
    - i) Primary tax authorities: (show Exhibit 2-5)
    - ii) Secondary authorities (show Exhibit 2-6)
  - b) Legislative sources: Congress and the Constitution
    - i) U.S. Constitution
    - ii) Internal Revenue Code
    - iii) Legislative process for tax laws (show Exhibit 2-7)
    - iv) Basic organization of the code (show Exhibit 2-8)
    - v) Tax treaties
  - c) Judicial sources: The courts
    - i) The hierarchy of the courts (trial level, appeals, Supreme Court)
    - ii) *Stare decisis*
    - iii) Golsen rule
  - d) Administrative Sources: The U.S. Treasury
    - i) Regulations: 3 different forms (Final, Temporary, Proposed); 3 different purposes (Interpretative, Procedural, Legislative); Highest administrative authority.
    - ii) Revenue Rulings and Revenue Procedures – more detailed than regulations; 2<sup>nd</sup> in administrative weight. Definition of each.
    - iii) Letter rulings: lower authoritative weight; contrast private letter rulings with determination letters and technical advice memorandums
    - iv) Acquiescence, nonacquiescence, and actions on decision: define and explain why important.
- 4) Tax Research
  - a) Understand facts
    - i) Open and closed facts
    - ii) How do you determine facts for a research question?
  - b) Identify issues
    - i) Ability to identify issues varies with experience

- ii) Understand facts, combine facts with understanding of law, identify general issues (Is this income taxable? Is this expense deductible?)
- iii) Research will allow you to identify more specific issues
- iv) Discuss Example 2-4 in class
- c) Locate relevant authorities
  - i) Annotated tax services – definition and what they contain
  - ii) Topical tax services – definition and what they contain
  - iii) How to use these services?
  - iv) Keyword search – area of law and key facts; suggestions if key word searching is not proving beneficial
  - v) Topical index
  - vi) Browsing the service
  - vii) Discuss Example 2-5
- d) Analyze tax authorities
  - i) Questions of fact: hinges upon the facts and circumstances of the taxpayer’s transaction. In this type of question, the researcher will focus on understanding how various facts affect the research answer and identifying authorities with fact patterns similar to her client’s.
  - ii) Questions of law: hinges upon the interpretation of the law, such as interpreting a particular phrase in a code section. If a researcher is faced with this type of question, she will spend much of her time researching the various interpretations of the code section and take note of which authorities interpret the code differently and why.
  - iii) Conflicting authorities: the tax researcher should evaluate the hierarchical level, jurisdiction, and age of the authorities, placing more weight on higher and newer authorities that have jurisdiction over the taxpayer.
  - iv) Checking the status of authorities: citators and methods to check the status of authorities.
- e) Communicate the results
  - i) The basic parts of a memo: facts, issues, authorities, conclusion, and analysis.
  - ii) Facts: Discuss facts that provide necessary background of the transaction and those facts that may influence the research answer.
  - iii) Issues: State the specific issues that the memo addresses. Issues should be written as specifically as possible and be limited to one or two sentences per issue.
  - iv) Authorities: the researcher cites the relevant tax authorities that apply to the issue, such as the IRC, court cases, and revenue rulings. Cite enough to provide a clear understanding of the issue and interpretation of the law.
  - v) Conclusion: One conclusion per issue. Each conclusion should answer the question as briefly as possibly, and preferably indicate why the answer is what it is.
  - vi) Analysis. The goal of the analysis is for the researcher to provide the reader a clear understanding of the area of law and specific authorities that apply. Typically an analysis will be organized to discuss the general area(s) of law first (the Code section) and then the specific authorities (court cases, revenue rulings) that apply to the research question. After you discuss the relevant authorities, apply the authorities to your client’s transaction and explain how the authorities result in your conclusion.
  - vii) The basic parts of a client letter: salutation & social graces, research question and limitations, facts, analysis, and conclusion.
- 5) Tax professional responsibilities
  - a) Tax professionals are subject to various statutes, rules and codes of conduct
    - i) AICPA Code of Professional Conduct
    - ii) AICPA Statement on Standards for Tax Services
    - iii) IRS’ Circular 230
    - iv) State Board of Accountancy Statutes

- b) Failure to comply with statutes can result in being admonished, suspended, or barred from practicing
- 6) Taxpayer and tax practitioner penalties professional responsibilities
  - a) Civil penalties
    - i) Generally in monetary penalties
    - ii) Imposed when tax practitioners or taxpayers violate tax statutes without reasonable cause
  - b) Criminal penalties
    - i) Much less common than civil penalties
    - ii) Penalties are much higher and can include prison sentences
  - c) **Taxpayer** underpayment penalty - no underpayment penalty if there is *substantial authority* that supports the tax return position or if there is a reasonable basis for the position and it is disclosed on the taxpayer's tax return
  - d) A **tax practitioner** will not be subject to penalty if there is *substantial authority* that supports the tax return position or if there is a reasonable basis for the position and it is disclosed on the taxpayer's tax return

## Class Activities

### 1. Suggested class activities

- **Let's choose a court:** Split the class into groups. Explain to the class that you will be asking a series of questions to the class regarding the choice of trial level courts after an audit. After you ask the question, a group may buzz into answer the question when a group member raises his or her hand. If the person gets the question correct, the group will receive one point. If the person misses the question, the group loses one point. The group with the most points after the series of questions will receive bonus participation points for the day. Use the individual court differences and differences in their respective appellate court to generate questions. See problem 57 for examples of questions to pose.
- **One versus the class:** Have one student volunteer as the "one" with the other class members being the "group." Use the key facts boxes in the text to develop basic multiple-choice questions (A, B, C answers) and then quiz the volunteer and the class on the questions. The volunteer and each class member will need to write the letters A, B, and C on separate sheets of paper and then hold up their appropriate response to the question. Once a student (either the "one" or a member of the "group") misses a question, her or she is eliminated from the competition. After 6 (or some other number) of questions, those students left standing receive bonus participation points for the day.

### 2. Research activities

- Take one or more of the research problems at the end of the chapter and pose the following questions after reading the problem: (1) What are the key facts in the problem? (2) What is the general issue to be addressed? (3) What key words would you use to research this question? Then walk the students through how you would conduct the research using an available on-line service.

### 3. Ethics Discussion

From page 2-5:

Ethics	
After Bill and Mercedes' tax return was selected for audit, Bill read on the Internet speculation that filing a paper copy tax return (instead of filing electronically) and extending a tax return decrease the	chance of IRS audit. Bill has convinced Mercedes that they need to use these strategies going forward and look for other ways to avoid audit. Has Bill crossed an ethical boundary?

Discussion points:

- What are the timing requirements for filing a tax return and paying taxes owed?
- Does Bill's action likely violate any IRS regulation?
- If Bill's action does not violate IRS rules, is it ethical?
- Are ethics and IRS rules the same?