

**CHAPTER 2**  
**WORKING WITH THE TAX LAW**  
**SOLUTIONS TO PROBLEM MATERIALS**

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
1	LO 1	Minimizing tax liability	New	
2	LO 1	Codification of the Code	New	
3	LO 1	Origination of tax law	New	
4	LO 1	Committee reports	Unchanged	4
5	LO 1	Code section numbers	Unchanged	5
6	LO 2, 5	Treaties	Unchanged	6
7	LO 1, 2	Regulation citation	New	
8	LO 1, 2	Regulations	Modified	8
9	LO 1, 4	Types of Regulations	Unchanged	9
10	LO 1	Revenue Procedure citation	New	
11	LO 1, 4	Authority	Unchanged	11
12	LO 1	Citations	New	
13	LO 1	Using the judicial system	Unchanged	13
14	LO 1	Small Cases Division	Unchanged	14
15	LO 1	U.S. District Court	Unchanged	15
16	LO 1, 5	Judicial alternatives: trial courts	Unchanged	16
17	LO 1	U.S. Court of Federal Claims	Unchanged	17
18	LO 1	Judicial system	Unchanged	18
19	LO 1	<i>Stare decisis</i>	New	
20	LO 1	Appellate court and fact-finding determination	Unchanged	20
21	LO 1	Circuit Court of Appeals	New	
22	LO 1	Circuit Court of Appeals	Unchanged	22
23	LO 1, 4	Court decision validity	Unchanged	23
24	LO 2	Summary Opinion versus Regular versus Memo Tax Court decision	Unchanged	24

**Instructor:** For difficulty, timing, and assessment information about each item, see p. 2-3.

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
25	LO 2	Citations	Unchanged	25
26	LO 1, 2	Abbreviations	Unchanged	26
27	LO 2	Commerce Clearing House citations	Unchanged	27
28	LO 2	Location of decision of U.S. Court of Federal Claims	Unchanged	28
29	LO 1, 2	Cumulative Bulletin	Unchanged	29
30	LO 3	Tax research	Modified	30
31	LO 4	Tax research defined	New	
32	LO 1, 2	Judicial system	Unchanged	32
33	LO 1, 2	Judicial system	Unchanged	33
34	LO 1, 2	Citations	Modified	34
35	LO 1, 2	Publishers' citations	Modified	35
36	LO 6	Tax avoidance versus tax evasion	Unchanged	36

**Instructor:** For difficulty, timing, and assessment information about each item, see p. 2-3.

<u>Research Problem</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
1	Reliability	New	
2	Library research	New	
3	Internet activity	Unchanged	3

Question/ Problem	Difficulty	Est'd completion time	Assessment Information	
			AICPA* Core Comp	AACSB* Core Comp
1	Easy	5	FN-Research	Analytic   Reflective Thinking
2	Easy	5	FN-Research	Analytic   Reflective Thinking
3	Easy	5	FN-Research	Analytic
4	Easy	5	FN-Research	Analytic
5	Easy	5	FN-Research	Analytic
6	Medium	20	FN-Reporting   FN-Research	Communication   Analytic
7	Easy	5	FN-Research	Analytic
8	Medium	10	FN-Research	Analytic
9	Hard	15	FN-Research	Analytic
10	Easy	5	FN-Research	Analytic
11	Hard	15	FN-Research	Analytic
12	Medium	10	FN-Research	Analytic
13	Hard	15	FN-Research   FN-Risk Analysis	Analytic   Reflective Thinking
14	Easy	10	FN-Research	Analytic
15	Medium	10	FN-Research	Analytic
16	Hard	25	FN-Research	Communication   Analytic
17	Medium	10	FN-Research	Analytic
18	Medium	10	FN-Research	Analytic
19	Easy	5	FN-Research	Analytic   Reflective Thinking
20	Easy	5	FN-Research	Analytic
21	Easy	10	FN-Research	Analytic
22	Easy	10	FN-Research	Analytic
23	Hard	20	FN-Research	Analytic
24	Medium	10	FN-Research	Analytic
25	Medium	15	FN-Research	Analytic
26	Medium	20	FN-Research	Analytic
27	Easy	5	FN-Research	Analytic
28	Easy	5	FN-Research	Analytic
29	Medium	15	FN-Research	Analytic
30	Medium	15	FN-Research	Analytic   Reflective Thinking
31	Easy	5	FN-Leverage Technology   FN-Research	Analytic   Technology
32	Medium	15	FN-Research	Analytic
33	Medium	15	FN-Research	Analytic
34	Easy	15	FN-Research	Analytic
35	Easy	15	FN-Research	Analytic
36	Medium	10	FN-Research	Analytic

**\*Instructor:** See the Introduction to this supplement for a discussion of using AICPA and AACSB core competencies in assessment.

## DISCUSSION QUESTIONS

1. This statement is not necessarily correct. In structuring business transactions and engaging in other tax planning activities, a tax advisor must be cognizant that the objective of tax planning is not necessarily to minimize the tax liability. Instead, a taxpayer should maximize his or her after-tax return, which may include maximizing nontax as well as noneconomic benefits. p. 2-2
2. Technically no. Although Congress did not recodify the law in the Tax Reform Act (TRA) of 1986, the magnitude of the changes made by TRA of 1986 did provide some rationale for renaming the Federal tax law the Internal Revenue Code of 1986. p. 2-2
3. Federal tax legislation generally originates in the House of Representatives where it is first considered by the House Ways and Means Committee. Tax bills originate in the Senate when they are attached as riders to other legislative proposals. For example, the Tax Equity and Fiscal Responsibility Act of 1982 originated in the Senate and its constitutionality was unsuccessfully challenged in the courts. p. 2-3
4. Referrals from the House Ways and Means Committee, the Senate Finance Committee, and the Joint Conference Committee are usually accompanied by Committee Reports. These Committee Reports often explain the provisions of the proposed legislation and are therefore a valuable source for ascertaining the *intent of Congress*. What Congress had in mind when it considered and enacted tax legislation is, of course, the key to interpreting such legislation by taxpayers, the IRS, and the courts. Since Regulations normally are not issued immediately after a statute is enacted, taxpayers often look to Committee Reports to determine Congressional intent. p. 2-4
5. When there is not enough space between Code sections, subsequent Code sections are given A, B, C, etc. designations. A good example is the treatment of §§ 280A through 280H. p. 2-6 and Footnote 2
6. Hoffman, Maloney, and Raabe, CPAs  
5191 Natorp Boulevard  
Mason, OH 45040

March 22, 2010

Mr. Paul Bishop  
Teal, Inc.  
100 International Drive  
Tampa, Florida 33620

Dear Mr. Bishop:

This letter is in response to your request about information concerning a conflict between a U.S. treaty with France and a section of the Internal Revenue Code. The major reason for treaties between the U.S. and certain foreign countries is to eliminate double taxation and to render mutual assistance in tax enforcement.

Section 7852(d) provides that if a U.S. treaty is in conflict with a provision in the Code, neither will take general precedence. Rather, the more recent of the two will have precedence. In your case, the French treaty takes precedence over the Code section.

A taxpayer must disclose on the tax return any positions where a treaty overrides a tax law. There is a \$1,000 penalty per failure to disclose for individuals and a \$10,000 penalty per failure for corporations.

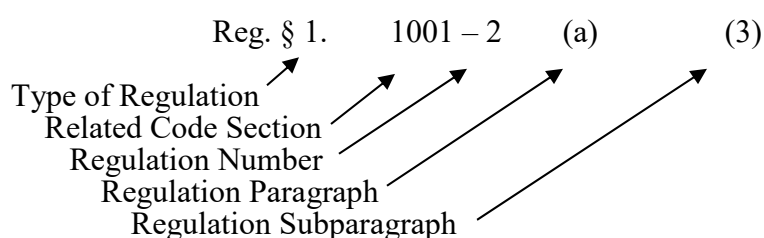
Should you need more information, feel free to contact me.

Sincerely,

Alice Hanks, CPA  
Tax Partner

p. 2-19

7. Income tax



p. 2-7

8. Since Regulations interpret the Code, they are arranged in the same sequence as the Code. Regulations are prefixed by a number that designates the type of tax or administrative, procedural, or definitional matter to which they relate. These Regulations would be cited as follows with subparts added for further identification. The subparts have no correlation with the subsections in the Code.

- a. Reg. § 1.132.
- b. Prop. Reg. § 1.2036.
- c. Temp. Reg. § 1.482.
- d. Reg. § 1.1504.

p. 2-7

9. In many Code sections, Congress has given to the “Secretary or his delegate” the authority to prescribe Regulations to carry out the details of administration or otherwise to complete the prevailing administrative rules. Under such circumstances, it almost could be said that Congress is delegating its legislative powers to the Treasury Department. Regulations that are issued pursuant to this type of authority truly possess the force and effect of law and often are called “legislative” Regulations. Examples of “legislative” Regulations include those that address consolidated returns issued under §§ 1501 through 1505 and those that addressed the debt/equity question issued under § 385 (withdrawn).

Legislative Regulations are to be distinguished from “interpretive” Regulations, which purport to rephrase and elaborate on the meaning (i.e., intent of Congress) of a particular Code Section. An example of interpretive Regulations are those issued under § 1031 for like-kind exchanges.

Procedural Regulations are “housekeeping-type” instructions indicating information that taxpayers should provide to the IRS as well as information about the management and conduct of the IRS itself.

The need to distinguish between these three types of Regulations relates to their validity as a tax law source.

pp. 2-8 and 2-27

10. Rev. Proc. 99-40 is the 40th revenue procedure issued during 1999, and it appears on page 60 of Volume 2 of the Cumulative Bulletin in 1999. p. 2-8

11. The items would probably be ranked as follows (from highest to lowest):

- (1) Internal Revenue Code.
- (2) Legislative Regulation.
- (3) Interpretive Regulation.
- (4) Revenue Ruling.
- (5) Proposed Regulation (most courts ignore Proposed Regs.).
- (6) Letter ruling (valid only to the taxpayer to whom issued).

pp. 2-7 to 2-11, 2-27, 2-28, and Exhibit 2.1

12. a. A Proposed Regulation, with 1 referring to the type of regulation (i.e., income tax), 381 is the related code section number, (b) is the subsection number, 1 is the paragraph designation, and (a) is the subparagraph designation.
- b. Revenue Ruling number 171, appearing on page 208 of Volume 1 of the Cumulative Bulletin issued in 1972.
- c. Technical Advice Memorandum number seventeen issued during the third week of 2008.

pp. 2-7 to 2-11

13. Caleb must consider several factors in deciding whether to take the dispute to the judicial system:

- How expensive will it be?
- How much time will be consumed?
- Does he have the temperament to engage in the battle?
- What is the probability of winning?

Once a decision is made to litigate the issue, the appropriate judicial forum must be selected.

- Tax Court judges have more expertise in tax matters.

- The tax deficiency need not be paid to litigate in the Tax Court. However, if Caleb loses, interest must be paid on any unpaid deficiency.
- If a trial by jury is preferred, the U.S. Tax Court is the appropriate forum.
- The tax deficiency must be paid before litigating in the District Court or the Court of Federal Claims.
- If an appeal to the Federal Circuit is important, Caleb should select the Court of Federal Claims.

A survey of the decisions involving the issues in dispute is appropriate. If a particular court has taken an unfavorable position, that court should be avoided.

pp. 2-11 to 2-17

14. a. No. There is no appeal from the Small Cases Division.
- b. No. Deficiency cannot exceed \$50,000.
- c. Yes.
- d. No. However, decisions are now published on the Tax Court's website.
- e. Yes.
- f. Yes.

pp. 2-11 to 2-17

15. The major advantage of a U.S. District Court is the availability of a trial by a jury. One disadvantage of a U.S. District Court is that the tentative tax deficiency first must be paid before the Court will hear and decide the controversy. In the U.S. Tax Court, the tax need not be paid prior to litigating the controversy (although interest will be due on an unpaid deficiency). pp. 2-12 to 2-14

16. Hoffman, Raabe, and Maloney, CPAs  
5191 Natorp Boulevard  
Mason, OH 45040

July 8, 2010

Mr. Dwain Toombs  
200 Mesa Drive  
Tucson, AZ 85714

Dear Mr. Toombs:

You have three alternatives should you decide to pursue your \$311,000 deficiency in the court system. One alternative is the U.S. Tax Court, the most popular forum. Some people believe that the Tax Court judges have more expertise in tax matters. The main advantage is that the U.S. Tax Court is the only trial court where the tax need not be paid prior to litigating the controversy. However, interest will be due on an unpaid deficiency. The interest rate varies from one quarter to the next as announced by the IRS.

One disadvantage of the U.S. Tax Court is the possible delay that might result before a case is decided. The length of delay depends on the Court calendar, which includes a schedule of locations where cases will be tried. Another disadvantage is being unable to have the case heard before a jury.

The major advantage of another alternative, the U.S. District Court, is the availability of a trial by jury. One disadvantage of a U.S. District Court is that the tentative tax deficiency first must be paid before the Court will hear and decide the controversy.

The Court of Federal Claims, the third alternative, is a trial court that usually meets in Washington, D.C. It has jurisdiction for any claim against the United States that is based on the Constitution, any Act of Congress, or any regulation of an executive department. The main advantage of the U.S. Court of Federal Claims occurs when a taxpayer's applicable Circuit Court previously has rendered an adverse decision. Such a taxpayer may select the Court of Federal Claims, since any appeal instead will be to the Federal Circuit. One disadvantage of the Court of Federal Claims is that the tentative deficiency first must be paid before the Court will hear and decide the controversy.

I hope this information is helpful, and should you need more help, please contact me.

Sincerely,

Agnes Reynolds, CPA  
Tax Partner

pp. 2-12 to 2-14, Figure 2.3, and Concept Summary 2.1

17. The main advantage of the U.S. Court of Federal Claims occurs when a taxpayer's applicable Circuit Court previously has rendered an adverse decision. Such a taxpayer may select the U.S. Court of Federal Claims since any appeal will be to the Federal Circuit.

One disadvantage of the U.S. Court of Federal Claims is that the tentative tax deficiency first must be paid before the Court will hear and decide the controversy. Another disadvantage is that a jury trial is not available.

The U.S. Court of Federal Claims is a trial court that usually meets in Washington, D.C. It has jurisdiction for any claim against the United States that is based on the Constitution, any Act of Congress, or any Regulation of an executive department.

pp. 2-12 to 2-15

18. See Figure 2.3 and Concept Summary 2.1.
- There is no appeal by either the taxpayer or the IRS from a decision of the Small Cases Division of the U.S. Tax Court. pp. 2-11 to 2-17
  - The first appeal would be to the Sixth Circuit Court of Appeals. Further appeal would be to the U.S. Supreme Court. pp. 2-13, 2-15, and Figures 2.3 and 2.4
  - Same as b. above. pp. 2-13, 2-15, and Figures 2.3 and 2.4
  - The appeal would be to the Federal Circuit Court of Appeals and then to the U.S. Supreme Court. pp. 2-13, 2-15, and Figures 2.3 and 2.4



19. Under the doctrine of *stare decisis*, each case (except in the Small Cases Division) has precedential value for future tax decisions with the same controlling set of facts. p. 2-12
20. Both the Code and the Supreme Court indicate that the Federal appellate courts are bound by findings of facts unless they are clearly erroneous. Thus, the *role* of appellate courts is limited to a review of the record of trial compiled by the trial courts. Thus, the appellate process usually involves a determination of whether the trial court applied the proper law in arriving at its decision. Rarely will an appellate court disturb a lower court's fact-finding determination. p. 2-15
21. A U.S. District Court decision from Kansas (choice e.) may be appealed to the Tenth Circuit Court of Appeals. Other states in the jurisdiction of the Tenth Circuit Court of Appeals are Oklahoma, New Mexico, Colorado, Utah, and Wyoming. p. 2-14 and Figure 2.4
22. The appropriate Circuit Court for an appeal depends on where the litigation originated. For example, an appeal from Texas would go to the Fifth Circuit, or an appeal from Colorado would go to the Tenth Circuit. p. 2-14 and Figure 2.4
23.
  - a. If the taxpayer chooses a U.S. District Court as the trial court for litigation, the U.S. District Court of Wyoming would be the forum to hear the case. Unless the prior decision has been reversed on appeal, one would expect the same court to follow its earlier holding. pp. 2-11 and 2-28
  - b. If the taxpayer chooses the U.S. Court of Federal Claims as the trial court for litigation, the decision that previously was rendered by this Court should have a direct bearing on the outcome. If the taxpayer selects a different trial court (i.e., the appropriate U.S. District Court or the U.S. Tax Court), the decision that was rendered by the U.S. Court of Federal Claims would be persuasive, but not controlling. It is, of course, assumed that the result that was reached by the U.S. Court of Federal Claims was not reversed on appeal. pp. 2-11, 2-15, and 2-28
  - c. The decision of a U.S. Circuit Court of Appeals will carry more weight than will one that was rendered by a trial court. Since the taxpayer lives in California, however, any appeal from a U.S. District Court or the U.S. Tax Court would go to the Ninth Circuit Court of Appeals (see Figure 2.2). Although the Ninth Circuit Court of Appeals might be influenced by what the Second Circuit Court of Appeals has decided, it is not compelled to follow such holding. pp. 2-11, 2-15, 2-28, and Figure 2.4
  - d. Because the U.S. Supreme Court is the highest appellate court, one can place complete reliance upon its decisions. Nevertheless, one should investigate any decision to see whether the Code has been modified with respect to the result that was reached. There also exists the rare possibility that the Court may have changed its position in a later decision. pp. 2-11, 2-15, 2-28, and Figure 2.3
  - e. When the IRS acquiesces to a decision of the U.S. Tax Court, it agrees with the result that was reached. As long as such acquiescence remains in effect, taxpayers can be assured that this represents the position of the IRS on the issue that was involved. Keep in mind, however, that the IRS can change its mind and can, at any time, withdraw the acquiescence and substitute a nonacquiescence. p. 2-16
  - f. The issuance of a nonacquiescence usually reflects that the IRS does not agree with the result that was reached by the U.S. Tax Court. Consequently, taxpayers are placed on notice that the IRS will continue to challenge the issue that was involved. pp. 2-16 and 2-17

24. The differences between a Regular decision, a Memorandum decision, and a Summary Opinion of the U.S. Tax Court are summarized as follows:

- In terms of substance, Memorandum decisions deal with situations that require only the application of previously established principles of law. Regular decisions involve novel issues that have not been resolved by the Court. In actual practice, however, this distinction is not always observed.
- Memorandum decisions officially were published until 1999 in mimeograph form only, but Regular decisions are published by the U.S. Government in a series that is designated as the *Tax Court of the United States Reports*. Memorandum decisions are now published on the Tax Court website. Both Regular and Memorandum decisions are published by various commercial tax services (e.g., CCH and RIA).
- A Summary Opinion is a Small Cases Division case involving amounts of \$50,000 or less. They are not precedents for any other court decisions and are not reviewable by any higher court. Proceedings are timelier and less expensive than a Memorandum or Regular decision. Some of these Summary Opinions can be found on the U.S. Tax Court Internet website.

pp. 2-16 and 2-17

25. a. This is a citation for a Regular decision of the U.S. Tax Court that was issued in 1970. The decision can be found in Volume 54, page 1514, of the Tax Court of the United States Reports, published by the U.S. Government Printing Office. pp. 2-16 to 2-18 and Concept Summary 2.2
- b. This is a citation for a decision of the U.S. Second Circuit Court of Appeals that was rendered in 1969. The decision can be found in Volume 408, page 1117, of the Federal Reporter, Second Series (F.2d), published by West Publishing Company. pp. 2-16 to 2-18 and Concept Summary 2.2
- c. This is a citation for a decision of the U.S. Second Circuit Court of Appeals that was rendered in 1969. The decision can be found in Volume 1 for 1969, paragraph 9319, of the U.S. Tax Cases, published by Commerce Clearing House. pp. 2-16 to 2-18 and Concept Summary 2.2
- d. This is a citation for a decision of the U.S. Second Circuit Court of Appeals that was rendered in 1969. The decision can be found in Volume 23, page 1090, of the Second Series of American Federal Tax Reports, now published by RIA (formerly P-H). pp. 2-16 to 2-18 and Concept Summary 2.2
- [Note that the citations that appear in parts b., c., and d. are for the same case.]
- e. This is a citation for a decision of the U.S. District Court of Mississippi that was rendered in 1967. The decision can be found in Volume 293, page 1129, of the Federal Supplement Series, published by West Publishing Company. pp. 2-16 to 2-18 and Concept Summary 2.2
- f. This is a citation for a decision of the U.S. District Court of Mississippi that was rendered in 1967. The decision can be found in Volume 1 for 1967, paragraph 9253, of the U.S. Tax Cases, published by Commerce Clearing House. pp. 2-16 to 2-18 and Concept Summary 2.2

- g. This is a citation for a decision of the U.S. District Court of Mississippi that was rendered in 1967. The decision can be found in Volume 19, page 647, of the Second Series of American Federal Tax Reports, now published by RIA (formerly P-H). pp. 2-16 to 2-18 and Concept Summary 2.2

[Note that the citations that appear in parts e., f., and g. are for the same case.]

- h. This is a citation for a decision of the U.S. Supreme Court that was rendered in 1935. The decision can be found in Volume 56, page 289, of the Supreme Court Reporter, published by West Publishing Company. pp. 2-16 to 2-18 and Concept Summary 2.2
- i. This is a citation for a decision of the U.S. Supreme Court that was rendered in 1935. The decision can be found in Volume 1 for 1936, paragraph 9020, of the U.S. Tax Cases, published by Commerce Clearing House. pp. 2-16 to 2-18 and Concept Summary 2.2
- j. This is a citation for a decision of the U.S. Supreme Court that was rendered in 1935. The decision can be found in Volume 16, page 1274, of the American Federal Tax Reports, now published by RIA (formerly P-H). pp. 2-16 to 2-18 and Concept Summary 2.2

[Note that the citations that appear in parts h., i., and j. are for the same case.]

- k. This is a citation for a decision of the former U.S. Court of Claims that was rendered in 1970. The decision can be found in Volume 422, page 1336, of the Federal Reporter, Second Series, published by West Publishing Company. This court is the Claims Court (renamed the Court of Federal Claims effective October 30, 1992) and current cases are in the Federal Claims Reporter. pp. 2-16 to 2-18, Footnote 20, and Concept Summary 2.2
26. a. CA-2. An abbreviation that designates the U.S. Second Circuit Court of Appeals. pp. 2-16 to 2-18
- b. Fed.Cl. An abbreviation for the Federal Claims Reporter published by West Publishing Company. It includes the decisions of the U.S. Court of Federal Claims and begins with Volume 27. pp. 2-16 to 2-18
- c. aff'd. An abbreviation for "affirmed," which indicates that a lower court decision was affirmed (approved of) on appeal. p. 2-15
- d. rev'd. An abbreviation for was "reversed," which indicates that a lower court decision was reversed (disapproved of) on appeal. p. 2-15
- e. rem'd. An abbreviation for "remanded," which indicates that a lower court decision is being sent back by a higher court for further consideration. p. 2-15
- f. Cert. denied. The Writ of Certiorari has been denied by the U.S. Supreme Court. This writ means that the Court will not accept an appeal from a lower court and, therefore, will not consider the case further. p. 2-15
- g. Acq. An abbreviation for "acquiescence" (agreement). The IRS follows a policy of either acquiescing or nonacquiescing to certain decisions. p. 2-16
- h. B.T.A. An abbreviation for the Board of Tax Appeals. From 1924 to 1942, the U.S. Tax Court was designated as the Board of Tax Appeals. p. 2-16

- i. USTC. U.S. District Court, U.S. Circuit Court of Appeals, U.S. Court of Federal Claims, and U.S. Supreme Court decisions that address Federal tax matters are reported in the Commerce Clearing House U.S. Tax Cases (USTC) and the RIA (formerly P-H) American Federal Tax Reports (AFTR) series. pp. 2-17, 2-18, and Concept Summary 2.2
  - j. AFTR. See the solution to i. above. p. 2-18 and Concept Summary 2.2
  - k. F.3d. All of the decisions (both tax and nontax) of the U.S. Claims Court (before October 1982) and the U.S. Circuit Court of Appeals are published by West Publishing Company in a reporter that is designated as the Federal Reporter, Second Series (F.2d). Volume 999, published in 1993, is the last volume of the Federal Second Series. It is followed by the Federal Third Series (F.3d). p. 2-18 and Concept Summary 2.2
  - l. F.Supp. Most Federal District Court decisions, dealing with both tax and nontax issues, are published by West Publishing Company in their Federal Supplement Series (F.Supp.). p. 2-18 and Concept Summary 2.2
  - m. USSC. An abbreviation for the U.S. Supreme Court. p. 2-18
  - n. S.Ct. West Publishing Company publishes all of the U.S. Supreme Court decisions in its Supreme Court Reporter (S.Ct.). p. 2-18 and Concept Summary 2.2
  - o. D.Ct. An abbreviation for a U.S. District Court decision. p. 2-18
27. a. None.
- b. USTC.
- c. USTC.
- d. USTC.
- e. TCM.
- pp. 2-17, 2-18, and Concept Summary 2.2
28. Decisions of the U.S. Court of Federal Claims (formerly named the Claims Court) are published in the USTCs, AFTRs, and the West Publishing Co. reporter called the Federal Reporter, Second Series (F.2d) (before October 1982) and Claims Court Reporter (beginning October 1982 through October 30, 1992). The name of the U.S. Court of Federal Claims was changed from the Claims Court effective October 30, 1992. Currently, this court's decision are published in the Federal Claims Reporter. p. 2-18 and Concept Summary 2.2
29. a. Yes. Exhibit 2.1
- b. No. Not published there. Concept Summary 2.2 and p. 2-11
- c. No. Published by private publishers. Exhibit 2.1 and p. 2-9
- d. Yes. Exhibit 2.1 and p. 2-9
- e. Yes. Exhibit 2.1 and p. 2-7

- f. No. Concept Summary 2.2 and p. 2-18
  - g. Yes, when major tax legislation has been enacted by Congress. p. 2-9 and Footnote 10
  - h. Yes. p. 2-16
  - i. No. Concept Summary 2.2
30. After understanding the relevant facts:
- Ashley may begin with the index volumes of the available tax services: RIA, CCH, BNA Portfolios, etc.
  - A key word search on an online service could be helpful—WESTLAW, LEXIS, CCH, and RIA Checkpoint.
  - Ashley may employ a key word search of a CD-ROM and browse through a tax service, IRS publications, etc. West Publishing, CCH, Kleinrock, and RIA offer CD-ROM products.
  - Ashley could consult CCH's Federal Tax Articles to locate current appropriate articles written about alimony payments. RIA's Tax Service also has a topical "Index to Tax Articles" section that is organized using the RIA paragraph index system.
  - Ashley may consult The Accounting & Tax Index which is available in three quarterly issues and a cumulative year-end volume covering all four quarters.
  - Up-to-date information may be found on the World Wide Web feature of the Internet. Various legal, accounting, and financial gateways can be found by clicking on highlighted words or phrases.
- pp. 2-21 to 2-34
31. Tax research is the method by which a tax practitioner, student, or professor determines the best available solution to a situation that possesses tax consequences. In other words, it is the process of finding a competent and professional conclusion to a tax issue or problem. p. 2-24

## PROBLEMS

32. a. Tom has some false notions. He must sue in the U.S. District Court of his locality and not in any other U.S. District Court. p. 2-12 and Concept Summary 2.1
- b. Tom has four choices of courts with respect to his Federal tax question, and a state court is not one of the choices. He may go to the U.S. Tax Court, Small Cases Division of the U.S. Tax Court, U.S. District Court, or U.S. Court of Federal Claims. pp. 2-11, 2-12, and Figure 2.3
- c. The B.T.A. decision is an old U.S. Tax Court decision that may have little validity today. Even if the decision still is good law, it probably will have little impact upon a U.S. District Court and certainly no impact upon a state court. pp. 2-16, 2-28, and 2-29

- d. The U.S. Court of Federal Claims is a trial court that usually meets in Washington, D.C., and Tom cannot appeal from a U.S. District Court to the U.S. Court of Federal Claims. Any appeal from his U.S. District Court would be to the Sixth Circuit Court of Appeals (and not to the Second). pp. 2-13 to 2-15, Figures 2.3 and 2.4, and Concept Summary 2.1
  - e. Few tax decisions reach the U.S. Supreme Court. The U.S. Supreme Court must agree to hear a court case. p. 2-15
- 33.
- a. T. p. 2-13 and Concept Summary 2.1
  - b. A. p. 2-18 and Concept Summary 2.2
  - c. D, C, A, and U. p. 2-18 and Concept Summary 2.2
  - d. D, C, A, and U. p. 2-18 and Concept Summary 2.2
  - e. U. p. 2-15
  - f. C and U. pp. 2-12 and 2-13
  - g. D. p. 2-13 and Concept Summary 2.1
  - h. D, T, and C. pp. 2-12, 2-13, Figure 2.3, and Concept Summary 2.1
  - i. A and U. pp. 2-14 to 2-15 and Figure 2.3
  - j. C. p. 2-14, Footnote 16, Concept Summary 2.1 and Figure 2.3
  - k. T. pp. 2-11 and 2-28
  - l. T. p. 2-13 and Concept Summary 2.1
- 34.
- a. N, a cite for an IRS Revenue Ruling.
  - b. T, U.S. Tax Court.
  - c. A, U.S. Circuit Court of Appeals.
  - d. U, U.S. Supreme Court.
  - e. T, U.S. Tax Court (previous name of the Tax Court).
  - f. D, U.S. District Court.
  - g. T, U.S. Tax Court.
  - h. N, a cite for a Letter Ruling.
  - i. T, U.S. Tax Court's Small Cases Division decision.
- pp. 2-10, 2-15 to 2-18, and Concept Summary 2.2

35.   a.     U.S.  
      b.     CCH.  
      c.     W.  
      d.     RIA.  
      e.     CCH.  
      f.     RIA.  
      g.     U.S.  
      h.     U.S.  
      i.     W.  
      j.     U.S.

pp. 2-7, 2-16 to 2-18, and Concept Summary 2.2

36.   a.     E.  
      b.     E.  
      c.     A.  
      d.     A.  
      e.     A.

pp. 2-31 to 2-33

The answers to the **Research Problems** are incorporated into the *Instructor's Guide with Lecture Notes* to accompany the 2011 Annual Edition of *SOUTH-WESTERN FEDERAL TAXATION: COMPREHENSIVE VOLUME*.

**NOTES**



**CHAPTER 1**  
**AN INTRODUCTION TO TAXATION**  
**AND UNDERSTANDING THE FEDERAL TAX LAW**  
**SOLUTIONS TO PROBLEM MATERIALS**

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
1	LO 2	History of Federal income tax	New	
2	LO 2	Constitutionality of Federal income tax for corporations	New	
3	LO 2	Income tax as a “mass tax”	Unchanged	3
4	LO 2	Complexity of Federal income tax	New	
5	LO 2	Pay-as-you-go system	Unchanged	4
6	LO 3	Criteria for “good” tax system	New	
7	LO 3, 4	Proportional versus progressive tax	New	
8	LO 4	Ad valorem tax on realty: conversion of commercial to tax-exempt status	New	
9	LO 4	Conversion of tax-exempt realty to commercial status and effect on ad valorem property tax	Unchanged	9
10	LO 4	Ad valorem tax on realty: effect of tax holiday	Unchanged	10
11	LO 4	Ad valorem tax on realty: effect of valuation reassessment	New	
12	LO 4	Ad valorem tax: assessment in terms of revenue production	Unchanged	12
13	LO 4	Excise taxes: hotel occupancy and car rental	Unchanged	13
14	LO 4	Avoiding sales tax through use of out-of- state purchase	New	
15	LO 4	State and local sales tax holidays	Unchanged	15
16	LO 4	Avoiding local sales taxes	Unchanged	16
17	LO 4	Avoiding sales tax through Internet purchase	Unchanged	17

**Instructor:** For difficulty, timing, and assessment information about each item, see p. 1-4.

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
18	LO 4	Sales tax: selective application as to items covered	Unchanged	18
19	LO 4	Federal transfer taxes: choice of gift or death transfers	Unchanged	20
20	LO 4	Federal gift tax: availability of the marital deduction for transfers between spouses	Unchanged	21
21	LO 4	Federal transfer taxes: justification for and application of unified credit	Unchanged	22
22	LO 4	Federal gift tax: annual exclusion	New	
23	LO 4	Income tax formula: individuals and corporations compared	Unchanged	25
24	LO 4	Application of jock tax	Unchanged	26
25	LO 4	Piggyback approach of state income taxes	Unchanged	27
26	LO 4, 5	State income tax return disclosure of Internet purchases; client refusal to answer tax return question and ethical implications	Unchanged	28
27	LO 4	State income tax: characteristics	Unchanged	29
28	LO 4	State amnesty programs	Unchanged	30
29	LO 4	FICA and FUTA contrasted	Unchanged	31
30	LO 4	FICA: application to family	Unchanged	32
31	LO 4	FICA: limitation on bonus covered	Unchanged	33
32	LO 4	Flat tax: justification for and obstacles to	Unchanged	34
33	LO 4	VAT: characteristics and usage	Unchanged	35
34	LO 4	National sales tax and VAT: regressive aspects	Unchanged	36
35	LO 4, 5	Tax problems of cash basis taxpayers with high employment turnover	Unchanged	37
36	LO 5	Assessing risk of audit by the IRS	Unchanged	38
37	LO 5	IRS audit: characteristics of	Unchanged	39
38	LO 5	IRS audit: appeal procedures	New	
39	LO 5	Tax collection: use of website	New	
40	LO 5	Statute of limitations: IRS assessments	Unchanged	40
41	LO 5	Interest on tax refunds	Unchanged	41
42	LO 5, 6	Statute of limitations and substantial omissions; ethical considerations of tax return preparer	Unchanged	42
43	LO 5	Penalties for failure to file and failure to pay	New	
44	LO 5	Penalties for negligence and fraud	New	
45	LO 5, 6	Tax practice and ethical guidelines: statute of limitations	Unchanged	45
46	LO 7	Revenue neutral tax reform	Modified	46
47	LO 7	Multiple justification for several tax provisions	Unchanged	47
48	LO 7	Justification for various tax provisions	Unchanged	48
49	LO 7	Justification for various tax provisions	Unchanged	49

**Instructor:** For difficulty, timing, and assessment information about each item, see p. 1-4.

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
50	LO 7	Involuntary conversion: application and nonapplication of where-withal to pay concept	Unchanged	50
51	LO 7, 8	Justification for various tax provisions	Unchanged	51
52	LO 8	Arm's length concept: definition of and reason for	Unchanged	52
53	LO 8	Tax treatment of leasehold improvements: judicial versus legislative rules	Unchanged	53

**Instructor:** For difficulty, timing, and assessment information about each item, see p. 1-4.

Question/ Problems	Difficulty	Est'd completion time	Assessment Information	
			AICPA* Core Comp	AACSB* Core Comp
1	Easy	5	FN-Research	Analytic
2	Easy	5	FN-Research	Analytic
3	Easy	5	FN-Measurement	Reflective Thinking
4	Easy	5	FN-Measurement	Analytic
5	Easy	5	FN-Measurement	Analytic
6	Easy	10	FN-Measurement	Analytic
7	Easy	5	FN-Research	Analytic
8	Easy	5	FN-Measurement	Analytic   Reflective Thinking
9	Medium	10	FN-Measurement	Analytic   Reflective Thinking
19	Easy	5	FN-Measurement	Analytic
10	Easy	5	FN-Risk Analysis	Reflective Thinking
11	Easy	5	FN-Measurement	Analytic
12	Easy	10	FN-Risk Analysis	Analytic
13	Easy	5	FN-Measurement	Analytic
14	Medium	10	FN-Reporting   FN-Measurement	Ethics   Analytic
15	Easy	5	FN-Measurement   FN-Risk Analysis	Analytic   Reflective Thinking
16	Easy	5	FN-Measurement	Analytic   Reflective Thinking
17	Easy	5	FN-Reporting   FN-Measurement	Ethics   Analytic
18	Easy	5	FN-Measurement	Analytic
19	Easy	5	FN Measurement	Analytic
20	Easy	10	FN-Measurement	Analytic   Reflective Thinking
21	Easy	10	FN-Measurement	Analytic
22	Easy	10	FN-Measurement	Analytic
23	Easy	5	FN-Measurement	Analytic
24	Medium	15	FN-Measurement	Analytic   Reflective Thinking
25	Easy	5	FN-Measurement	Analytic
26	Easy	5	FN-Measurement	Analytic   Reflective Thinking
27	Easy	5	FN-Measurement	Analytic
28	Medium	15	FN-Measurement	Ethics   Analytic
29	Easy	10	FN-Reporting   FN-Measurement	Analytic
30	Easy	10	FN-Reporting   FN-Measurement	Analytic   Reflective Thinking
31	Easy	10	FN-Measurement	Analytic
32	Easy	5	FN-Measurement	Analytic
33	Easy	5	FN-Measurement	Analytic

**\*Instructor:** See the Introduction to this supplement for a discussion of using AICPA and AACSB core competencies in assessment.

Question/ Problems	Difficulty	Est'd completion time	Assessment Information	
			AICPA* Core Comp	AACSB* Core Comp
34	Easy	5	FN-Reporting   FN-Measurement	Analytic   Reflective Thinking
35	Easy	5	FN-Measurement	Analytic   Reflective Thinking
36	Easy	5	FN-Measurement	Analytic   Reflective Thinking
37	Medium	15	FN-Measurement   FN-Risk Analysis	Analytic   Reflective Thinking
38	Medium	10	FN-Reporting   FN-Risk Analysis	Reflective Thinking
39	Medium	15	FN-Reporting   FN-Risk Analysis	Analytic   Reflective Thinking
40	Medium	10	FN-Measurement	Analytic
41	Easy	5	FN-Measurement	Analytic
42	Medium	15	FN-Reporting   FN-Measurement	Ethics   Analytic
43	Medium	10	FN-Measurement	Analytic
44	Easy	10	FN-Measurement	Analytic
45	Medium	15	FN-Measurement   FN-Risk Analysis	Ethics   Analytic
46	Medium	10	FN-Measurement	Analytic
47	Medium	15	FN-Measurement	Analytic   Reflective Thinking
48	Medium	15	FN-Measurement	Analytic   Reflective Thinking
49	Medium	15	FN-Measurement	Analytic   Reflective Thinking
50	Medium	10	FN-Reporting   FN-Measurement	Analytic   Reflective Thinking
51	Medium	15	FN-Reporting   FN-Measurement	Analytic   Reflective Thinking
52	Easy	5	FN-Measurement	Analytic
53	Medium	10	FN-Measurement	Analytic   Reflective Thinking

**\*Instructor:** See the Introduction to this supplement for a discussion of using AICPA and AACSB core competencies in assessment.

**DISCUSSION QUESTIONS**

1. The first American income tax law was enacted during the Civil War. In fact, both sides—the Federal Union and the Confederate States of America—had one. p. 1-3
2. Disagree. The U.S. Supreme Court had already validated the income tax on corporations. It was the income tax on individuals that resulted in judicial problems. p. 1-3
3. In order to finance our participation in World War II, the scope of the income tax was expanded considerably—from a limited coverage of 6% to over 74% of the population. Hence, the description of the income tax as being a “mass tax” became appropriate. p. 1-4
4. It is true that the Federal income tax is complex. What is not true is that *most* taxpayers can complete their returns without outside assistance. Approximately 60% of individual taxpayers pay preparers to complete the return and about 22% purchase preparation software. p. 1-4
5. For wage earners, the tax law requires employers to withhold a specified dollar amount from wages paid to the employee to cover income taxes and payroll taxes. Persons with non-wage income generally are required to make quarterly payments to the IRS for estimated taxes. Both procedures ensure that taxpayers will be financially able to meet their annual tax liabilities. That is, the amounts withheld are meant to prepay the employee’s income taxes and payroll taxes related to the wages earned. p. 1-4
6. As to Adam Smith’s canon on *economy*, the Federal income tax yields a mixed result. From the standpoint of the IRS, economy is there as its collection costs are nominal (when compared to revenue generated). Economy is not present, however, if one looks to the compliance effort and costs expended by taxpayers. p. 1-5
7.
  - a. Proportional.
  - b. Progressive.
  - c. Proportional.
  - d. Progressive.

p. 1-6 and Examples 1 and 2
8. By acquiring the apartment buildings and converting them to dormitories, the properties probably will become tax-exempt since they will be owned by a nonprofit organization. Thus, the city will suffer a decrease in its tax base for ad valorem property tax purposes since it loses what was commercial real estate. p. 1-7
9. Although the Baker Motors bid is the lowest, from a long-term financial standpoint, it is the best. The proposed use of the property by the state and the church probably will make it exempt from the School District’s ad valorem tax. This would hardly be the case with a car dealership. In fact, commercial properties (e.g., car dealerships) often are subject to higher tax rates. p. 1-7

10. a. “Generous” probably means a prolonged exemption from ad valorem property taxes.
- b. A new business brings more families into the area. This, in turn, means more children to educate. While costs increase, the tax holiday could mean a loss of tax revenue.
- p. 1-7
11. Probably what has happened is that the appraised value of the residence has been raised. Unfortunately, there is often a time lag in the appraisal process, and the taxing authority has not yet taken into account any recent changes in value. See *Tax in the News* item on p. 1-8.
12. a. In terms of taxpayer compliance, an ad valorem tax on personalty is less desirable than one on realty. However, a tax on business personalty, such as inventory, is to be preferred over one on personal use (i.e., nonbusiness) personalty.
- b. A tax on stock and bonds would be too easily avoided. The taxing authority would have no means of ascertaining ownership of these assets.
- c. Poor taxpayer compliance is to be expected for any tax on personal use personalty. However, if boats had to be periodically licensed (e.g., safety inspection), this could provide the taxing authority with a means of discovering unreported boat ownership.
- p. 1-8
13. Herman could have been overcharged, but at least part of the excess probably is attributable to a hotel occupancy tax and a car rental tax. In the major cities, these types of excise taxes have become a popular way of financing capital improvements, such as sports arenas and stadiums. Consequently, the amount of the taxes could be significant. p. 1-10
14. Eileen may have avoided the sales tax but she will be vulnerable to the Wyoming use tax. This tax will be imposed when Wyoming discovers she has not paid its sales tax—probably when she registers the car in Wyoming. See the discussion in connection with Example 4. p. 1-10
15. A sales tax holiday exempts sales of certain (or all) items from state and local sales taxes for a prescribed period of time.
- a. Reasons for such a holiday might be: to stimulate shopping, to encourage the development of industry, to aid school attendance, and to provide a financial break for families with school age children.
- b. Sales tax holidays are highly popular with both shoppers and merchants. It may be politically unwise to cancel such events.
- p. 1-11
16. In some states, counties (and cities) are given the option to impose additional sales tax levies. It is possible that this is the situation with Wilson County. If so, this would explain why Velma does her shopping in Grimes County. p. 1-10 and Example 5
17. Earl probably purchased his computer out of state by use of a catalog or through the Internet. In such cases, state collection of the sales (use) tax is improbable without taxpayer compliance. p. 1-10

18. Often a general sales tax is selective in its application. Thus, it may not cover drugs, certain types of clothing, and food items. It appears highly likely that Ruby was not undercharged but, instead, purchased some goods that were not subject to tax. p. 1-10
19. As to gifts, Alvin can give Holly \$1,013,000 [\$13,000 (annual exclusion) + \$1,000,000 (the equivalent of the \$345,800 unified credit)] the first year without incurring any transfer tax. Additional gifts of \$13,000 per year also can be made free of tax. Alternatively, by death Alvin can pass Holly \$3,500,000 (the equivalent of \$1,455,800 unified credit) free of estate tax. A good approach would be to give her the \$1,013,000 now and pass her the \$2,500,000 balance at death. This approach reduces the unified tax credit available at death by \$345,800—the amount used to cover the current gift. pp. 1-12 to 1-14
20. Jake either has a severe misunderstanding as to the rules regarding transfer taxes or is lying to Jessica to delay any parting with his wealth. The marital deduction allows interspousal transfers (whether by gift or at death) free of any tax (either gift or estate). There is no tax reason, therefore, to prefer transfers at death over lifetime gifts associated with spousal transfers. pp. 1-12 and 1-13
21. a. The purpose of the unified transfer tax credit is to eliminate the tax on modest gifts and estates.
- b. No. The gift tax credit is frozen at \$345,800. The estate tax credit was \$780,800 for 2006, 2007, and 2008. It increased to \$1,455,800 in 2009 and is scheduled to stay there until the estate tax is completely eliminated in 2010.
- c. Yes. The credit is available to cover either transfers by gift or by death (or both), but the amount can be used only once.
- pp. 1-11 and 1-13
22. \$494,000. 19 donees (5 married children + 5 spouses + 9 grandchildren) × \$13,000 (annual exclusion for 2010) × 2 donors (Fred and Cynthia) = \$494,000. p. 1-13 and Example 9
23. a. The determination of AGI is not necessary for corporations.
- b. Only individual taxpayers need to make a choice between the standard deduction and itemizing their deductions from AGI.
- c. For corporate taxpayers, only business-related deductions are allowed. Thus, there is no distinction made between deductions for AGI (i.e., business) and deductions from AGI (i.e., personal). For the individual taxpayer, Congress has sanctioned a select few personal deductions.
- p. 1-15
24. If Mike is drafted by a team in one of the listed states, he will escape state income tax on income earned within that state (e.g., training camp, home games). He will not, however, escape the income tax (state and local) imposed by jurisdictions where he plays away games. Called the “jock tax,” it is applied to out-of-state athletes and entertainers. p. 1-16
25. a. The “piggyback” approach means that a state income tax makes use of what has been done for Federal income tax purposes. To “decouple” means that the state will not adopt, for state income tax purposes, the recent Federal income tax change.



- b. Usually, “decoupling” occurs when the state will lose too much revenue by accepting the Federal income tax change.
- p. 1-15
- 26.
    - a. This type of question has no relevance to the state income tax, but is a less than subtle way of encouraging taxpayers to pay any use tax due on Internet and mail order purchases. See Tax in the News on p. 1-15.
    - b. As the preparer of the state income tax return, you should not leave questions unanswered unless there is a good reason for doing so. It appears that Harriet has no justifiable reason. p. 1-24
  - 27.
    - a. Generally, all the states have withholding procedures.
    - b. A diminishing number of states allow a deduction for Federal income taxes paid.
    - c. The filing dates are usually consistent with the Federal rule.
    - d. The taxpayer is given a choice of having some of the state income tax (usually from any refund) go to a specified charity or some other designated cause.
    - e. Most states allow their residents some form of tax credit for income taxes paid to other states.
    - f. Until recently, the exchange has been one sided—the IRS notifying the state of an assessment against a resident taxpayer. Currently, some states (e.g., California) are advising the IRS as to the existence of abusive tax shelters.
- pp. 1-15 and 1-16
- 28. A state tax amnesty generates revenue. It also serves to uncover taxpayers that the state did not know existed. Thus, this information increases the probability that such taxpayers will continue to file.
    - a. The programs usually require that back taxes, plus interest, be paid and waive other penalties. The amnesty can be limited to income taxes, but often covers other taxes as well (e.g., sales, franchise).
    - b. Subsequent amnesty periods are not uncommon.
- p. 1-16
- 29.
    - a. FICA offers some measure of retirement security, and FUTA provides a modest source of income in the event of loss of employment.
    - b. FICA is imposed on both employer and employee, while FUTA is imposed only on the employer.
    - c. FICA is administered by the Federal government. FUTA, however, is handled by both Federal and state governments.

- d. This applies only to FUTA. The merit system rewards employers who have low employee turnover, since this reduces the payout of unemployment benefits.

pp. 1-16 and 1-17

- 30. Only children under age 18 are excluded from FICA. Other family members, including spouses, must be covered. p. 1-17

- 31. The \$1 million bonus is subject to FICA. If the bonus is received in 2010, the first \$106,800 is subject to a Social Security rate of 6.2% for a total of \$6,621.60. However, the Medicare portion of FICA (or 1.45%) has no limit. Thus, \$14,500 ( $\$1 \text{ million} \times 1.45\%$ ) must be added to the \$6,621.60 for a total FICA of \$21,121.60. p. 1-17

- 32.
  - a. The major justification for a flat tax is simplicity. Because it is perceived as easy to deal with, compliance cost is perceived as being reduced, and this saves time and money.
  - b. Because certain groups (e.g., municipalities, charities, home construction) have considerable political influence, eliminating various tax preferences (exclusions, deductions, and credits) in the current income tax law may be difficult to do.

p. 1-18

- 33.
  - a. Including all of OECD members, a total of 136 countries impose a VAT. Unlike most other countries, the U.S. has no VAT and, instead, places high reliance on the income tax as a major source of revenue.
  - b. A VAT taxes the increment in value as goods move through the production and manufacturing stages to the marketplace. Although the tax is paid by the producer, it is reflected in the selling price of the goods. Therefore, a VAT is a tax on consumption.

p. 1-19

- 34.
  - a. Both the national sales tax and the VAT are taxes on consumption. Both taxes impose more of a burden on low income taxpayers who must spend a larger proportion of their incomes on essential purchases. Thus, the taxes are regressive in effect.
  - b. At least in the case of a national sales tax, the regressive effect might be partly remedied by granting some sort of credit, rebate, or exemption to low income taxpayers.

p. 1-19

- 35.
  - a. Due to the location of the business and the fact that the employees are “itinerant,” Serena may be hiring undocumented aliens. Needless to say, this could cause serious nontax problems involving employment and immigration laws. As to tax problems, is Serena complying with the FICA and income tax withholding rules? Because of the high labor turnover Serena probably has, FUTA costs could be severe.

- b. Very high. First, Serena is self-employed. Second, she operates on a cash basis. Third, the opportunity to understate income and/or overstate expenses is extremely high.

pp. 1-16 and 1-20

- 36.
  - a. The large amount involved means it received media coverage. IRS agents are instructed to take note of such items. Consequently, it would not be surprising if Linda's return for the year involved is audited. Keep in mind that this is a "big ticket item" in terms of possible income tax deficiencies.
  - b. Mel operates a cash business where the potential for omission of income is high. Also, his erratic personal life could make him subject to retribution (i.e., "informed on" to the IRS).
  - c. Cindy could be a candidate for an audit for two reasons. First, her high gross income and AGI. Second, the large donation will exceed the norm for itemized charitable contributions for someone in her income category.
  - d. As a headwaiter, Pierre will receive large tips. He will also share in the business of the valet service which invariably involves gratuities. With so much cash involved, the full reporting of income may not occur. The IRS is aware of this potential for omission.
  - e. Most of Giselle's income probably comes from cash tips. Regarding the past audits, were tax deficiencies assessed? If so, a return visit by the IRS is to be expected.
  - f. Information received from a state taxing authority can lead to an IRS audit. This is apparently what has happened in the case of Marcus.

pp. 1-19 and 1-20

- 37.
  - a. The number of individual returns audited by the IRS is small but has significantly increased over the past few years.
  - b. The tax law permits the IRS to pay rewards to persons who provide information that leads to the detection and punishment of those who violate the tax laws.
  - c. The DIF score helps determine which returns the IRS selects for audit.
  - d. The IRS requires certain information returns to be filed by payors (e.g., employers, banks). If the income recognized by the payees does not conform to that reported by the payors, further inquiry by the IRS probably will take place.
  - e. A correspondence audit involves matters that can be resolved by mail. An office audit usually is restricted in scope and is conducted in the facilities of the IRS. A field audit involves an examination of numerous items reported on the return and is conducted on the premises of the taxpayer or the taxpayer's representative.
  - f. An RAR (Revenue Agent's Report) summarizes the findings of an audit. The RAR can result in no change being made, a deficiency, or a refund being due.
  - g. When a special agent appears, this usually means that fraud is suspected.

- h. The Appeals Division is a part of the IRS that is authorized to resolve audit disputes. It has greater settlement authority than the audit agent. The Appeals Division is the taxpayer's last chance to settle a tax dispute before resorting to the courts.

pp. 1-20 and 1-21

- 38. In many unresolved audit disagreements at the agent level, the taxpayer should consider an appeal to the Appeals division. Although it is part of the IRS, it is authorized to resolve audit disputes. It has greater settlement authority than does the agent. In many cases, a compromise reached at the Appeals Division can avoid a costly and time-consuming judicial proceeding. p. 1-21
- 39. By posting (or threatening to post) the delinquency on the Internet, the humiliation involved results in taxpayer compliance. See *Tax in the News* on p. 1-21.
- 40.
  - a. The normal three-year statute of limitations will begin to run on April 15, 2010. When the return is filed early, the regular filing date controls.
  - b. Now the statute of limitations starts to run on the filing date. If the date of filing controlled [see part (a) above], the taxpayer could shorten the assessment period by filing late.
  - c. If a return that is due is not filed, the statute of limitations does not start to run. It does not matter that the failure to file was due to an innocent error on the part of the taxpayer or advisor.
  - d. Regardless of the fact that an innocent misunderstanding was involved, there is no statute of limitations when a return is not filed.

pp. 1-21 and 1-22

- 41. No. Interest is not paid if the refund is made within 45 days of when the return was filed. However, a return is not considered filed until its due date. Thus, the period from April 15 to May 28 does not satisfy the 45-day requirement. p. 1-22
- 42.
  - a. Normally, the 3-year statute of limitations applies to additional assessments the IRS can make. However, if a substantial omission from gross income is made, the statute of limitations is increased to six years. A substantial omission is defined as omitting in excess of 25% of the gross income reported on the return. Example 14
  - b. The proper procedure would be to advise Andy to disclose the omission to the IRS. Absent the client's consent, do not make the disclosure yourself. p.1-24
  - c. If Andy refuses to make the disclosure and the omission has a carryover effect to the current year, you should withdraw from the engagement. p. 1-24

43. \$4,500, determined as follows:

Failure to pay penalty [ $0.5\% \times \$30,000 \times 3$ months]		\$ 450
Plus:		
Failure to file penalty [ $5\% \times \$30,000 \times 3$ months]	\$4,500	
Less failure to pay penalty for the same period	<u>(450)</u>	<u>4,050</u>
Total penalties		<u>\$4,500</u>

p. 1-23 and Example 15

44. a. \$60,000 ( $20\% \times \$300,000$ ).
- b. \$225,000 ( $75\% \times \$300,000$ ). The answer presumes that civil (not criminal) fraud is involved.

p. 1-23

45. a. No. Since no return was filed, the statute of limitations never runs. But even if a return had been filed, the three-year period for the 2006 tax return would not expire until April 15, 2010 (three years after the normal due date for filing). p. 1-22
- b. Although you can only recommend that the return be filed, you cannot force him to do so. However, you should not undertake the engagement for 2007 through 2009 if you cannot correctly reflect the tax liability due to the omission for 2006. p. 1-24
46. a. This is the ideal approach to handling a tax cut—for every dollar lost, a new dollar is gained.
- b. Pay-as-you-go is really another way of describing revenue neutrality. Thus, tax cuts should not result in an overall loss of revenue.
- c. All the sunset provision does is to reinstate the law as it existed prior to the tax cut. Here, there exists the possibility that Congress will rescind (or postpone) the sunset provision before it takes effect.
- d. Stealth taxes are not taxes but increase taxes for higher income taxpayers in an indirect manner. The result occurs since various deductions/credits are phased out as income rises.

pp. 1-25 and 1-31

47. a. Energy credits are allowed for various residential improvements that conserve energy. Credits are available for taxpayers who purchase motor vehicles that operate on alternative (i.e., non-fossil) fuels. The cost of installing pollution control devices can be expensed for tax purposes over a shorter period of time. p. 1-26
- b. To encourage pension plans is to stimulate saving (economic consideration). Also, it provides security from the private sector for retirement to supplement rather meager public programs (social considerations). pp. 1-26 and 1-27
- c. To make education more widely available is to promote a socially desirable objective. A better educated workforce also serves to improve the country's economic capabilities. Thus, education tax incentives can be justified on both social and economic grounds. p. 1-28 and Footnote 27

- d. The encouragement of home ownership can be justified on both social and economic grounds. p. 1-28
- 48.
- a. Economic justification. By providing an election to expense, § 179 encourages additional capital investment. p. 1-26
  - b. Economic justification. Research and development activities are encouraged by allowing immediate or faster write-off of these expenditures. p. 1-26
  - c. Economic justification. The justification for the domestic production activities deduction is to stimulate the U.S. manufacturing industry. By providing a limitation on the source of the wages involved, it will also encourage job growth. p. 1-27
  - d. Economic justification. Allowing these costs to be expensed rather than capitalized provides an immediate tax benefit to farmers and the agriculture industry. p. 1-26
  - e. Social justification. The charitable deduction helps fund private organizations and causes that are operated in the interest of the general welfare. This relieves government of the need for considerable public funding. p. 1-27
- 49.
- a. Economic justification. Known as the S election, the provision encourages small businesses to operate in the corporate form without suffering all of the tax disadvantages. p. 1-27
  - b. Social justification. A tax incentive that encourages a parent to obtain child care in order to maintain gainful employment is socially desirable. p. 1-28
  - c. Economic justification. A tax provision that benefits the agriculture industry. p. 1-26
  - d. Political justification. Married persons in community property jurisdictions always enjoyed the income-splitting benefits when they filed income tax returns. To provide this benefit to married persons elsewhere (i.e., common law jurisdictions), the law was changed. Thus, the influence of state law resulted in the present rule regarding joint Federal income tax returns. p. 1-31
  - e. Equity justification. Excess capital losses and charitable contributions that cannot be deducted in the current year for various reasons can be carried over to other years. These provisions help mitigate the occasional harsh consequences of the annual accounting period concept. p. 1-30
- 50.
- a. The requirements for the postponement of gain under the involuntary conversion provisions are as follows. First, an involuntary conversion must occur. Second, the proceeds from the conversion must be reinvested within a specified period of time in property that is similar or related in service or use. p. 1-29
  - b. The taxpayer's economic position has not changed and under the wherewithal to pay concept, there is no additional means with which to pay any tax. Thus, any realized gain is deferred. Examples 17 and 18
- 51.
- a. The treatment of prepaid income can be justified on the notion of promoting administrative feasibility. As a practical matter, the best time to impose a tax is when the taxpayer has the funds. p. 1-32

- b. The installment method of reporting gain is consistent with the wherewithal to pay concept—the seller is taxed when the payments are made by the purchaser. p. 1-30
  - c. What is described is the indexation procedure. The procedure avoids the so-called bracket creep caused by inflation and can be justified on equity grounds. p. 1-30
  - d. As noted in the text, the tackle box exemption from the Federal excise tax on sporting goods can be explained under political considerations. Quite clearly, the provision is an example of special interest legislation. p. 1-30
  - e. The limitations placed on casualty and theft losses reduce the number of such deductions and thereby simplifies the audit process. Thus, they can be justified in the interest of administrative feasibility. p. 1-33 and Footnote 33
52. The arm's length concept was created by the courts in order to evaluate transactions between related parties. In its application, the arm's length standard becomes how the transactions would have been carried out if the parties involved had not been related. Example 22
53. a. Edward recognizes income associated with the improvements when he disposes of the property (including the improvements).
- b. No. In an early decision, the U.S. Supreme Court held that income should be recognized when the lease terminates.
- c. The justification for the current rule is the wherewithal to pay concept.
- p. 1-34 and Example 23

The answers to the **Research Problems** are incorporated into the *Instructor's Guide with Lecture Notes* to accompany the 2011 Annual Edition of *SOUTH-WESTERN FEDERAL TAXATION: COMPREHENSIVE VOLUME*.

**NOTES**