SWFT 2018 Comprehensive Volume
Chapter 1: An Introduction to Taxation and Understanding the Federal Tax Law
End-of-Chapter Question, Exercise, and Problem Correlations

Comp. Vol. 40e (2017)	Comp. Vol. 41e (2018)	Comp. Vol. 41e (2018) Learning Objectives	Exact Same	Revised	Brand New	Source Volume: Ind. Income Taxes 41e (2018) OR Corporations 41e (2018)	Source Volume Chapter	Source Volume Question, Problem, or Exercise #
Discussion Questions (DQ)								
DQ1	DQ1	LO1		x		V1	1	DQ1
DQ2	DQ2	LO1	x			V1	1	DQ2
DQ3	DQ3	LO2	x			V1	1	DQ3
DQ4	DQ4	LO2	x			V1	1	DQ4
DQ5	DQ5	LO2	x			V1	1	DQ5
DQ6	DQ6	LO3			x	V1	1	DQ6
DQ7	DQ7	LO3	x			V1	1	DQ7
DQ8	DQ8	LO4	x			V1	1	DQ8
DQ9	DQ9	LO4	x			V1	1	DQ9
DQ10	DQ10	LO4	x			V1	1	DQ10
DQ11	DQ11	LO4		x		V1	1	DQ11
DQ12	DQ12	LO4	x			V1	1	DQ12
DQ13	DQ13	LO4		x		V1	1	DQ13
DQ14	DQ14	LO4	x			V1	1	DQ14
DQ15	DQ15	LO4	x			V1	1	DQ15
DQ16	DQ16	LO4		x		V1	1	DQ16
DQ17	DQ17	LO4	x			V1	1	DQ17
DQ18	DQ18	LO4	x			V1	1	DQ18
DQ19	DQ19	LO4	x			V1	1	DQ19
DQ20	DQ20	LO4		x		V1	1	DQ20
DQ21	DQ21	LO4		x		V1	1	DQ21
DQ22	DQ22	LO4	x			V1	1	DQ22
DQ23	DQ23	LO4		x		V1	1	DQ23
DQ24	DQ24	LO4		x		V1	1	DQ24
DQ25	DQ25	LO4,5	x			V1	1	DQ25
DQ26	DQ26	LO4		x		V1	1	DQ26
DQ27	DQ27	LO4	x			V1	1	DQ27
DQ28	DQ28	LO4		x		V1	1	DQ28
DQ29	DQ29	LO4	x			V1	1	DQ29
DQ30	DQ30	LO4	x			V1	1	DQ30
DQ31	DQ31	LO4	x			V1	1	DQ31

Comp. Vol. 40e (2017)	**Comp. Vol. 41e (2018)**	**Comp. Vol. 41e (2018) Learning Objectives**	**Exact Same**	**Revised**	**Brand New**	**Source Volume: Ind. Income Taxes 41e (2018) OR Corporations 41e (2018)**	**Source Volume Chapter**	**Source Volume Question, Problem, or Exercise #**
DQ32	DQ32	LO4	**x**			V1	1	DQ32
DQ33	DQ33	LO4	**x**			V1	1	DQ33
DQ34	DQ34	LO4		**x**		V1	1	DQ34
DQ35	DQ35	LO4,5		**x**		V1	1	DQ35
DQ36	DQ36	LO5	**x**			V1	1	DQ36
DQ37	DQ37	LO5	**x**			V1	1	DQ37
DQ38	DQ38	LO5	**x**			V1	1	DQ38
DQ39	DQ39	LO5		**x**		V1	1	DQ39
DQ40	DQ40	LO5		**x**		V1	1	DQ40
DQ41	DQ41	LO5,6	**x**			V1	1	DQ41
DQ42	DQ42	LO5	**x**			V1	1	DQ42
DQ43	DQ43	LO5		**x**		V1	1	DQ43
DQ44	DQ44	LO5,6		**x**		V1	1	DQ44
DQ45	DQ45	LO5,6	**x**			V1	1	DQ45
DQ46	DQ46	LO7		**x**		V1	1	DQ46
DQ47	DQ47	LO7	**x**			V1	1	DQ47
DQ48	DQ48	LO7,8		**x**		V1	1	DQ48
DQ49	DQ49	LO7	**x**			V1	1	DQ49
DQ50	DQ50	LO8	**x**			V1	1	DQ50
Computational Exercises (EX)								
N/A								
Problems (PR)								
N/A								
Cumulative (Tax Return) Problems (CP)								
N/A								
Research Problems (RP)								
	RP1				**x**	V1	1	RP1
	RP2				**x**	V1	1	RP1
Roger CPA Review Questions (RCPA)								
N/A								

CHAPTER 1

AN INTRODUCTION TO TAXATION AND UNDERSTANDING THE FEDERAL TAX LAW

SOLUTIONS TO PROBLEM MATERIALS

DISCUSSION QUESTIONS

1. (LO 1, 4)
   a. John must now separate home expenses between personal and rental use and may be subject to the transient occupancy tax.

   b. Theresa has become self-employed. Now she will be subject to self-employment tax and will have to make quarterly installment payments of estimated income and payroll taxes.

   c. Paul might have some moving expenses that he can deduct. His personal taxes will change because Florida does not impose an income tax, while California does.

2. (LO 1, 4) The income tax consequences that result are Marvin's principal concern. Any rent he receives is taxed as income, but operating expenses and depreciation will generate deductions that offset some or all of the income or even yield a loss. Marvin must also consider the effect of other taxes. Because the property is being converted from residential to commercial use, he can expect an increase in the ad valorem property taxes levied by the local (and perhaps even the state) taxing authorities. Besides the real estate taxes, personal property taxes could be imposed on the furnishings.

3. (LO 2) The statement is only partly correct. The Federal income tax on corporations was not a problem as it had previously been sanctioned by the Supreme Court. What had been declared unconstitutional was the tax on individuals as it applied to the income *from property*.

4. (LO 2) 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.

5. (LO 2) 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 nonwage 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.

6. (LO 3) The tax law of State X appears to violate the *certainty* and *simplicity* principles.

7. (LO 3) A tax is *proportional* if the rate of tax remains constant for any given income level. The tax is *progressive* if a higher rate of tax applies as the tax base increases.

8. (LO 4)
   a. The parsonage probably was not listed on the property tax rolls because it was owned by a tax-exempt church. Apparently, the taxing authorities are not aware that ownership has changed.

   b. Ethan should notify the authorities of his purchase. This will force him to pay back taxes but will eliminate *future* interest and penalties.

9. (LO 4) 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.

10. (LO 4)
    a. In this case, the "tax holiday" probably concerns exemption from ad valorem taxes. "Generous" could involve an extended period of time (e.g., 10 years) and include both realty and personalty.

    b. The school district could be affected in two ways. First, due to the erosion of the tax base, less revenue would be forthcoming. Second, new workers would mean new families and more children to educate.

11. (LO 4) A possible explanation is that Sophia made capital improvements (e.g., added a swimming pool) to her residence and her parents became retirees (e.g., reached age 65).

12. (LO 4) Presuming that the dockage facilities are comparable in Massachusetts, the Morgans may be trying to avoid ad valorem taxes. Taxes on nonbusiness personalty vary from one state to another and are frequently avoided.

13. (LO 4) In general, Federal excise taxes apply to fewer items than in the past. However, lawmakers have focused on and increased certain Federal excise taxes (e.g., those on tobacco products, gasoline, and air travel).

14. (LO 4) 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 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.

15. (LO 4) An *excise tax* is limited to a particular transaction (e.g., sale of gasoline), while a general *sales tax* covers a multitude of transactions (e.g., sale of all nonfood goods).

    a. The following states *do not* impose a general sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon.

    b. There is no Federal general sales tax.

16. (LO 4)
    a. Jackson County must be in a state that imposes a lower (or *no*) sales tax. With certain major purchases (i.e., big-ticket items), any use tax imposed by the state of the Grays' residence could come into play.

    b. In some states, the sales tax rate varies depending on the county and/or city.

    Note: Generally, buyers are subject to the sales and use tax rate where they live. Thus, for example, if the Grays buy goods in a different state with zero or a lower sales tax rate than in their state, they owe use tax to their home state for the difference.

17. (LO 4) Earl probably purchased his computer out of state through a catalog or via the internet. In such cases, state collection of the sales (use) tax is not likely.

18. (LO 4) If the tax is imposed on the right to pass property at death, it is classified as an estate tax. If it taxes the right to receive property from a decedent, it is termed an inheritance tax.

    a. Some states impose both an estate tax and an inheritance tax. Some states (e.g., Florida and Texas) levy neither tax.

    b. The Federal government imposes an estate tax.

19. (LO 4) 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, in the case of spousal transfers to prefer transfers at death over lifetime gifts.

20. (LO 4)
    a. The purpose of the unified transfer tax credit is to eliminate the tax on all but substantial gifts and estates.

    b. Yes. The credit for 2017 is $2,141,800; for 2016, it is $2,125,800.

    c. Yes. The credit is available to cover transfers by gift or by death (or both), but the amount can be used only once.

21. (LO 4) $532,000. 19 donees (5 married children + 5 spouses + 9 grandchildren) × $14,000 (annual exclusion for 2017) × 2 donors (Elijah and Anastasia) = $532,000.

22. (LO 4) Both taxes are progressive in nature, but the corporate income tax does not make any distinction as to deductions—only business deductions are allowed. Nor does it require the computation of adjusted gross income (AGI) or provide for the standard deduction and personal and dependency exemptions.

23. (LO 4)
    a. For state income tax purposes, "piggyback" means making use of what was done for Federal income tax purposes. By "decoupling," a state decides not to allow a particular Federal provision (e.g., exclusion, deduction, credit) for state income tax purposes.

    b. States often use IRS audit results to identify errors that might also exist on the taxpayer's state tax return.

    c. Most states allow their residents some form of tax credit for income taxes paid to other states.

24. (LO 4) What happened here likely is not a coincidence. The IRS probably notified the state of California regarding Hernando's omission of income. Thus, California followed up with its own audit.

25. (LO 4) 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.

26. (LO 4, 5)
    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.

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.

27. (LO 4) The checkoff boxes add complexity to the return and mislead taxpayers into presuming that they are not paying for the donation.

28. (LO 4)

a. They uncover taxpayers who were previously unknown to the taxing authority. In addition, amnesty programs cause non-compliant taxpayers to become compliant not only for past years, but also for future years.

b. Amnesty provisions can apply to other than income taxes (e.g., sales, franchise, severance).

c. No general amnesty program has been offered for any Federal taxes.

29. (LO 4)

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 the Federal and state government.

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

30. (LO 4)

a. Unlike the Social Security portion of FICA, there is no dollar limit on the imposition of the Medicare tax.

b. The .9% Medicare addition applies to taxpayers with wages or net self-employment income in excess of $200,000 ($250,000 for married filing jointly).

31. (LO 4) Only children under age 18 are excluded from FICA. Other family members, including spouses, must be covered.

32. (LO 4)

a. Severance taxes are transaction taxes that are based on the notion that the state has an interest in its natural resources. The tax is imposed on the extraction of minerals.

b. Franchise taxes are levied on the right to do business in the state. Typically, they are imposed on corporations and are based on their capitalization.

c. Occupational fees are applicable to trades or businesses and are licenses to practice. Most are not significant revenue producers, and the amounts collected are utilized to defray the cost of regulating the profession.

d. Customs duties are taxes on the importation of certain foreign goods. They are imposed by the Federal government and are not found at the state and local level.

e. Export duties are taxes imposed on the export of certain commodities (e.g., oil, coffee). They are common to less-developed nations and are not levied by the United States.

33. (LO 4)

a. The United States is the only country in the OECD (Organization of Economic Cooperation and Development) that does not have a value added tax (VAT). Approximately 80 countries use a VAT. In spite of its extensive use by other countries, the adoption of a VAT by the United States appears doubtful. Instead, the U.S. places high reliance on the income tax as its major revenue source.

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.

c. Because it is an effective generator of revenue, the VAT has been criticized as leading to more government spending.

34. (LO 4)

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 relative to higher-income taxpayers. Thus, the taxes are regressive in effect.

b. The regressive effect might be partly remedied by granting some sort of credit, rebate, or exemption to low-income taxpayers.

35. (LO 4, 5)

a. Serena may have record-keeping issues related to the cash transactions. The short-term holiday workers should be on the payroll because they are employees and Serena owes FICA and FUTA on their wages and must issue W–2 wage forms to them.

b. High. First, Serena is self-employed. Second, she operates partially on a cash basis. Third, the opportunity to understate income and/or overstate expenses is high. Fourth, she has some workers who appear to be misclassified and for whom she may not have issued tax reporting forms.

36. (LO 5)

a. A correspondence audit is probably involved. These audits involve a limited number of issues (i.e., taxpayer failed to report some dividend income) and most often are easily resolved.

b. What is described is an office audit.

c. The revenue agent's report (RAR) accepts the taxpayer's return as filed.

d. When a special agent becomes involved, this usually means that fraud is suspected.

37. (LO 5) 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.

38. (LO 5) The purpose of a statute of limitations is to preclude parties from prosecuting stale claims. The passage of time makes the defense of such claims difficult because witnesses and other evidence may no longer be available. In the Federal tax area, statutes of limitations cover additional assessments by the IRS and the pursuit of refund claims by taxpayers.

39. (LO 5)

a. The normal three-year statute of limitations will begin to run on April 15, 2017 (actually April 18, 2017 because April 15, 2017 is a Saturday and Emancipation Day in the District of Columbia is observed on Monday, April 17, 2017, making the due date for 2016 individual returns April 18, 2017). When the return is filed early, the normal 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 adviser.

d. Regardless of the fact that an innocent misunderstanding was involved, there is no statute of limitations when a return is not filed.

40. (LO 5) 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.

41. (LO 5, 6)

a. Normally, the three-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.

b. No, it would not. 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.

c. If Andy refuses to make the disclosure and the omission has a material carryover effect to the current year, you should withdraw from the engagement.

42. (LO 5) $4,000, determined as follows:

Failure to pay penalty [.5% × $40,000 × 2 months]		$ 400
Plus:		
Failure to file penalty [5% × $40,000 × 2 months]	$4,000	
Less failure to pay penalty for the same period	(400)	3,600
Total penalties		$4,000

43. (LO 5)

a. $100,000 (20% × $500,000).

b. $375,000 (75% × $500,000). The answer presumes that civil (not criminal) fraud is involved.

44. (LO 5, 6)

a. No. Because no return was filed, the statute of limitations never runs. But even if a return had been filed, the three-year period for the 2013 tax return would not expire until April 15, 2017, three years after the normal due date for filing.

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 2014 through 2016 if you cannot correctly reflect the tax liability due to the omission for 2013.

45. (LO 5, 6) The practice of outsourcing the preparation of tax returns is ethical if three steps are taken.

- Maintain client confidentiality.
- Verify the accuracy of the work done.
- Notify the client, preferably in writing, of the outsourcing.

46. (LO 7)

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 another way of describing revenue neutrality. Thus, tax cuts should not result in an overall loss of government revenue.

c. All the sunset provision does is reinstate the law as it existed prior to the tax cut. Here, the possibility exists that Congress will rescind (or postpone) the sunset provision before it takes effect.

d. Indexation is a procedure whereby the IRS makes annual adjustments to certain key tax components to take into account inflation. Some of the more important components that are adjusted include tax brackets, standard deduction, and personal and dependency exemptions.

47. (LO 7)

a. 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).

b. 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.

c. The encouragement of home ownership can be justified on both social and economic grounds.

48. (LO 7, 8)

a. Social considerations explain the credit. It is socially desirable to encourage parents to provide care for their children while they work.

b. These deductions raise the issue of preferential tax treatment for homeowners—taxpayers who rent their personal residences do not receive comparable treatment. Even so, the encouragement of home ownership can be justified on economic and social grounds.

c. The joint return procedure came about to equalize the position of married persons living in common law states with those residing in community property jurisdictions. Political and equity considerations caused this result.

d. Activities deemed contrary to public policy should not result in tax savings.

e. The NOL carryback provision is an equity consideration that is designed to mitigate the effect of the annual accounting period concept.

f. 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.

g. The exclusion from Federal income taxation of interest from state and local bonds can be justified largely on political considerations. Political goodwill is generated by allowing state and local jurisdictions to secure financing at a lower cost (i.e., interest rate) due to favorable Federal income tax treatment.

h. The treatment of prepaid income is justified under the wherewithal to pay concept. It also eases the task of the IRS as to administration of the tax law.

49. (LO 7)

a. Mia's realized gain from the condemnation is $320,000 [$400,000 (amount of award) − $80,000 (cost basis of the warehouse)]. However, her recognized gain is limited to $120,000—the amount received that was not reinvested.

b. None of the gain is recognized because Mia reinvested the full amount of the condemnation award.

c. As none of the gain was reinvested, the full $320,000 is recognized as income.

d. The involuntary conversion provision can be justified under the wherewithal to pay concept and the notion that the taxpayer's economic position has not changed. In part b., for example, Mia has retained none of the award and has reinvested in property similar to that taken by the city.

50. (LO 8) If the collection is worth more than $1,000, the mother has probably made a gift of the excess value to the daughter. Quite possibly the transaction could result in the imposition of a gift tax. Sales or other transactions between related parties are subject to the arm's length test. In this case, for example, would the mother have made this sale for $1,000 if the purchaser had been an unrelated third party?

RESEARCH PROBLEMS

These research problems require that students utilize online resources to research and answer the questions. As a result, solutions may vary among students and courses. You should determine the skill and experience levels of the students before assigning these problems, coaching where necessary. Encourage students to use reliable websites and blogs of the IRS and other government agencies, media outlets, businesses, tax professionals, academics, think tanks, and political outlets to research their answers.

1. The sole proprietor is subject to Federal taxes on income, self-employment and payroll taxes (if the sole proprietor has employees), and the gasoline excise tax. State taxes include income and sales and use taxes. Local taxes include property tax, business license tax, and perhaps income tax.

2. Examples of carbon tax proposals of the 114th Congress include S. 1548, American Opportunity Carbon Fee Act of 2015, and H.R. 309, Gas Tax Replacement Act of 2015. Examples of financial transaction tax proposals of the 114th Congress include S. 1371, S. 1373, and H.R. 1464. Similar proposals may exist for the 115th Congress. Students might also find plans for these types of taxes that do not have legislative language.

SOLUTION TO ETHICS & EQUITY FEATURE

<u>Making Good Use of Out-of-State Relatives (p. 1-12)</u>. Who is the true purchaser of the bracelet? If the aunt really made the purchase with her funds and then gave the bracelet to Marcus, no sales or use tax evasion has occurred. More likely, the purchase was made by Marcus indirectly through his aunt—the aunt being reimbursed by Marcus or using funds provided by him. If such is the case, Marcus owes a sales tax on the purchase. Presuming the matter comes to light—the jewelry store might be the weak link—Marcus could be subject to prosecution for tax evasion.