

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

DISCUSSION QUESTIONS

1. (LO 1)
 - a. By becoming a dealer, any gains and losses John has are converted from capital to ordinary classification.
 - 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. Due to the home mortgage interest deduction and property tax deduction, most new homeowners will itemize their deductions *from* AGI. Thus, Paul probably will no longer claim the standard deduction on his income tax return.
2. (LO 1) 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) As to Adam Smith's canon on *economy*, the Federal income tax yields a mixed result. From the standpoint of the IRS, economy exists as collection costs are nominal (when compared with revenue generated). The government's cost of collecting Federal taxes amounts to less than one-half of 1 percent of the revenue collected. Economy is not present, however, if one looks to the compliance effort and costs expended by taxpayers. According to recent estimates, about 56% of individual taxpayers who file a return pay a preparer, and one-third purchase tax software.

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 could be 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) Until recently, it appeared that Federal excise taxes had declined significantly as to the number of transactions covered. Taxes on the sale of jewelry, leather goods, cosmetics, and admission to entertainment events are no longer taxed by the Federal government. But the enactment of the gas guzzler tax and the tax on tanning salons, in addition to the increase in the tax on tobacco products, seems to indicate an expansion of excise taxes at the Federal level.
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.

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 2016 is \$2,125,800; for 2015, it is \$2,117,800.
 - 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) $\$532,000$. $19 \text{ donees (5 married children + 5 spouses + 9 grandchildren)} \times \$14,000 \text{ (annual exclusion for 2016)} \times 2 \text{ donors (Elijah and Anastasia)} = \$532,000$.
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. A diminishing number of states allow a deduction for Federal income taxes paid.
 - 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.
 - b. Amnesty provisions can apply to other than income taxes (e.g., sales, franchise, severance).
 - c. As of yet, no general amnesty program has been offered for the Federal income tax.
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. 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.
- 35. (LO 4, 5)
 - 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.
- 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, 2016. 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 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)
- 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.
 - 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.
 - 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 [$.5\% \times \$40,000 \times 2$ months] | | \$ 400 |
| Plus: | | |
| Failure to file penalty [$5\% \times \$40,000 \times 2$ months] | \$4,000 | |
| Less failure to pay penalty for the same period | <u>(400)</u> | <u>3,600</u> |
| Total penalties | | <u>\$4,000</u> |
43. (LO 5)
- \$100,000 ($20\% \times \$500,000$).
 - \$375,000 ($75\% \times \$500,000$). The answer presumes that civil (not criminal) fraud is involved.
44. (LO 5, 6)
- 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 2012 tax return would not expire until April 15, 2016, three years after the normal due date for filing.
 - 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 2013 through 2015 if you cannot correctly reflect the tax liability due to the omission for 2012.
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)
- This is the ideal approach to handling a tax cut—for every dollar lost, a new dollar is gained.
 - Pay-as-you-go is 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 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. Social considerations dictate that the tax law should not be used to encourage certain activities that are deemed to be contrary to public policy.
 - 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?

SOLUTION TO ETHICS & EQUITY FEATURE

Making Good Use of Out-of-State Relatives (p. 1-10). 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.