

Chapter 2 Summary of End-of Chapter Problem Revisions

2014 Edition Problem Number	2013 Edition Problem Number	2014 Edition Modification
1	1	
2	2	
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4	4	Problem updated
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33	33	Problem modified
34	34	Problem modified
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36	36	
37	37	Years updated
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39	39	Years updated
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Solutions to Chapter 2 Problem Assignments

Check Your Understanding

1. *Tax Planning vs. Compliance*

Solution: Tax compliance involves the gathering of relevant information, evaluating and classifying that information, filing tax returns, and representing clients at Internal Revenue Service audits. Tax planning is the process of evaluating the tax consequences associated with a transaction and making recommendations to achieve the desired objective at minimal tax cost. It generally involves extensive tax research.

2. *Tax vs. Nontax Factors*

Solution: a. This is primarily a nontax factor situation. The taxpayer has specified that she is risk averse, a personal choice, due to having experienced prior losses.
 b. The taxpayer's dislike of paying taxes is really a nontax factor; this dislike, however, leads him to seek income tax advice to reduce taxes and he is willing to pay significant amounts of money to find ways to avoid taxes. Thus, this really has significant elements of both.
 c. This situation involves tax factors in tax planning. There are numerous ways in which a taxpayer can arrange transactions to take advantage of loss carryovers before they lose significant value due to the time value of these losses.

3. *Marginal Tax Rates*

Solution: Currently, Beta Corporation's marginal tax rate is 34%. Beta's income would need to exceed \$10,000,000 to step-up to the next tax bracket. Therefore, Beta Corporation should use a 34% marginal tax rate in evaluating a project that would generate an additional \$200,000 in income.

4. *Marginal Tax Rates*

Solution: Maria should use a 25% tax rate because her income is between \$36,250 and \$87,850. Her tax savings will be \$500 (\$2,000 deduction x 25%).

5. *Tax Planning*

Solution: Timing, income shifting, and changing the character of income.

6. *Business Purpose Doctrine*

Solution: The business purpose doctrine holds that a transaction will be recognized for tax purposes only if it is made for some business or economic purpose other than a tax avoidance motive.

7. *Primary vs. Secondary Authority*

Solution: Primary authority comes directly from statutory, administrative or judicial sources. Secondary authority consists of tax services, books, journals, and newsletters that assist the taxpayer in locating and interpreting primary authorities.

8. *Committee Reports*

Solution: The House Ways and Means Committee, the Senate Finance Committee, and the Joint Conference Committee may generate committee reports in the process of a bill becoming law.

9. *Committee Reports*

Solution: Committee reports contain a general and technical discussion of a bill's provisions. The reports contain important information about the legislative intent of a bill that may be used to resolve disputes between taxpayers and the Internal Revenue Service. These reports provide the only guidance about a new law until the Treasury provides regulations.

10. *Sections of Internal Revenue Code*

Solution: The Code is cited by a section number. The sections of the Code are consecutively numbered and each section has a unique number.

11. *Regulation Citations*

Solution: The 1 is a prefix that refers to an income tax regulation; the 247 is a root number that designates the Code section to which the regulation is related.

12. *Types of Regulations*

Solution: A legislative regulation is one that has been specifically authorized by the Code to provide the details of the meaning and rules for a Code section. It carries weight similar to that of a Code section.

An interpretive regulation is one that provides a detailed explanation of and examples for a particular Code section. It does not carry the same weight of authority as a legislative regulation.

13. *Proposed vs. Temporary Regulations*

Solution: A proposed regulation provides an advance indication of what position the IRS intends to take on a particular issue. Positions taken in proposed regulations cannot be relied on, as they are simply proposals.

Temporary regulations provide operating rules for a particular Code section until final regulations can be issued. These regulations can be followed until final regulations are issued, so they carry significantly more weight than proposed regulations.

14. *Letter Ruling vs. Revenue Ruling*

Solution: A letter ruling is issued to a specific taxpayer to provide guidance on how a planned transaction will be taxed. It generally applies only to the taxpayer to which it was issued and may not necessarily apply to another taxpayer in a similar situation.

A revenue ruling is issued as general guidance on the tax consequences of a particular transaction. It is usually issued for ambiguous tax situations. Although these rulings are generally fact specific, taxpayers with similar fact situations can rely on them for guidance.

15. *Tax Service*

Solution: A tax service or reference service is a comprehensive publication providing reference information related to the tax laws that can be used to assist in the tax research process. Most tax services contain the Code, regulations, rulings, and cases as well as an index to aid the researcher in locating the relevant discussions of tax problems. These services come in print (typically a multi-volume, loose-leaf set of books) or electronic versions. The electronic format allows the researcher to use a keyword search to locate relevant information.

16. *DIF Formula*

Solution: The DIF formula is designed to identify those taxpayers for which an audit will be cost effective; that is, that the audit will yield additional taxes sufficient to warrant the expenditure of resources necessary to conduct the audit. When the DIF score is high, indicating a high probability of adjustment to the return, the return will be examined manually to confirm the audit potential. If confirmed, an audit will commence.

17. *Types of Audits*

Solution: *Correspondence audit* is the simplest audit that is conducted when only one or two relatively straightforward items on a return are questioned. The audit and the taxpayer's response can be handled entirely by mail.

An *office audit* involves one or more issues that are too complex for a correspondence audit. The taxpayer is asked to come to a district office for an interview and should bring any records or documents to support the items in question.

Field audits are more comprehensive than office audits and are usually limited to an examination of business returns. Field audits are usually conducted on the taxpayer's premises and generally involve a complete review of the entire financial operations of the business. This type of audit is usually used for corporations.

18. *Appeal Options*

Solution: If the taxpayer does not agree with the proposed deficiency specified in the 30-day letter, he or she may request a conference with an agent of the IRS Appeals Division within 30 days of receiving the letter.

19. *Appeal Options*

Solution: (1) File a petition with the U.S. Tax Court within 90 days of receiving the notice.
 (2) Pay the tax; the taxpayer may then go to a U.S. District Court or the U.S. Court of Federal Claims to sue for refund.
 (3) Take no action and be subject to IRS-enforced collection procedures.

20. *Hazards of Litigation*

Solution: Hazards of litigation refers to factors that may affect the outcome of a case that is litigated such as ambiguous facts, uncertain application of the law to known facts, credibility of witnesses, and the ability to meet the required burden of proof.

21. *Trial Courts and Appeals*

Solution: The taxpayer can initiate litigation in the U. S. Tax Court, the U. S. District Court, or the U. S. Court of Federal Claims. All of the decisions from these courts can be appealed to a higher court except those cases that are tried in the small tax case division of the Tax Court.

22. *Appeals Process*

Solution: The taxpayer should be advised to ask for a meeting with an agent from the IRS Appeals Division as the only cost effective course of action to get the additional tax assessment abated. The costs of litigating would generally far exceed the \$1,050 additional tax that has been assessed and litigation should be discouraged. If she wishes to pursue this in court, she should go to the small case division of the Tax Court.

23. *Taxpayer Penalties*

Solution: If a taxpayer is convicted of criminal fraud (tax evasion), a prison sentence can be imposed.

24. *Statute of Limitations*

Solution: The statute of limitations is the time period beyond which neither the taxpayer nor the IRS can take legal action nor make changes to a tax return.

The statute of limitations brings closure to a tax return for the taxpayer and the IRS. The IRS cannot audit a tax return after the statute of limitations has passed nor can the taxpayer make changes to the return or file a claim for refund beyond that date.

25. *Avoidance vs. Evasion*

Solution: Tax avoidance is the minimization of taxes by using legal alternatives to determine the tax owed. Tax evasion is the avoidance of taxes through illegal means.

26. *Preparer Penalties*

Solution: Yes. Code Section 6694 imposes a penalty of \$1,000 or 50 percent of the fee for the work, if greater, on preparers whose clients' tax deficiencies result from an "unreasonable position" on the return that the preparer knew or should have known was a departure from the rules or regulations and the position was not disclosed. (Disclosure is typically accomplished by using Form 8275; however, filing the form would probably raise a red flag with the IRS.) The Emergency Economic Stabilization Act of 2008 clarified that a reasonable position requires the preparer to have "substantial authority" upholding a "realistic possibility of success" for nonabusive, undisclosed tax return positions. Substantial authority exists if the weight of authorities (including the Internal Revenue Code, regulations, court cases, committee reports, revenue rulings, revenue procedures, and similar documents) supporting the reported tax treatment is substantial in relation to the weight of those authorities taking a contrary position. If the position taken on the tax return involves a tax shelter (or similar abusive transaction called a "listed transaction"), however, a higher "more-likely-than-not" (greater than 50 percent) standard applies.

If a preparer takes an unreasonable position in a “willful” attempt to understate the taxpayer’s liability or if the preparer is guilty of “reckless or intentional disregard” of rules or regulations, the penalty increases to the greater of \$5,000 or 50 percent of the preparer’s fees. If a preparer is convicted of criminal tax evasion, the penalty can consist of a fine of up to \$100,000 (\$500,000 in the case of a corporation) and imprisonment. Severe monetary penalties also apply to promoters of and advisors to tax shelters for the failure to provide required information returns, maintain required investor lists, and to provide these lists when requested.

27. *Sources of Guidance*

Solution: Treasury Circular 230: *Regulations Governing the Practice before the Internal Revenue Service*, and the AICPA’s *Code of Professional Conduct and Statements on Standards for Tax Services* all contain guidelines for tax professionals.

28. *SSTS*

Solution: The *Statements on Standards for Tax Services* are a series of statements that delineate the extent of a tax practitioner’s responsibility to his or her client, the public, the government, and his or her profession. They are issued by the Federal Taxation Executive Committee of the AICPA.

29. *SSTS*

Solution: In general, a CPA may rely on information furnished by a client and other third parties unless the information appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known by the CPA. If there is such evidence, the CPA must make further inquiry to determine the accuracy of the information provided.

30. *SSTS*

Solution: Estimates are appropriate when records are missing (for example, a flood or fire destroying records) or precise information is not available at the time of filing the tax return.

Crunch the Numbers

31. *Timing Issues*

Solution: a. Monico should wait to bill its customers until the end of December. If Monico’s marginal tax rate is 25%, taxes paid this year would cost \$1,250 ($\$5,000 \times 25\%$) resulting in an after-tax cash inflow of \$3,750 ($\$5,000 - \$1,250$). When considering the time value of money, the cost of the taxes that are deferred until next year will have a present value (cost) of only \$1,179 ($\$1,250 \times .943$ PV factor) or \$71 less ($\$1,250 - \$1,179$).

b. Monico should defer billing its customers. If Monico’s marginal tax rate is 15% next year, then its after-tax cash inflow would be \$4,293 [$\$5,000 - (\$5,000 \times 15\% \times .943$ PV factor)]. Monico should defer billing its customers because this will result in a \$543 higher after-tax cash inflow ($\$4,293 - \$3,750$).

c. Monico should bill its customers in the beginning of December. If Monico’s marginal tax rate is 34% next year, then its after-tax cash inflow would be \$3,397 [$\$5,000 - (\$5,000 \times 34\% \times .943$ PV factor)]. Monico should bill its customers in

the beginning of December because deferral would result in a \$353 after-tax cost (\$3,397 - \$3,750).

32. *Timing Issues*

- Solution:** a. Kimo should pay the expense in this year. Because Kimo's marginal tax rate is expected to be the same, the only consideration is the time value of money. If Kimo chooses to pay the expense this year, it will have an after-tax savings of \$3,750 ($\$15,000 \times 25\%$). If Kimo defers payment of the expense, its net present value of the after-tax savings will be \$3,506 ($\$15,000 \times 25\% \times .935$ PV factor). Therefore, Kimo should pay the expense this year since it will result in a \$244 greater after-tax savings ($\$3,750 - \$3,506$).
- b. Kimo should pay the expense this year. If Kimo's marginal tax rate is expected to decrease to 15%, Kimo will have a lower after-tax savings next year. The net present value of Kimo's after-tax savings would be \$2,104 ($\$15,000 \times 15\% \times .935$ PV factor). Kimo should pay the expense this year since it will result in a \$1,646 greater after-tax savings ($\$3,750 - \$2,104$).
- c. Kimo should wait and pay the expense next year. If Kimo's marginal tax rate is expected to increase to 34%, Kimo will have a greater after-tax savings next year. The net present value of Kimo's after-tax savings would be \$4,769 ($\$15,000 \times 34\% \times .935$ PV factor). Kimo should wait and pay the expense next year since it will result in a \$1,019 greater after-tax savings ($\$4,769 - \$3,750$).

33. *Income Shifting*

Solution: \$1,600.

Tax on \$100,000 for a married couple filing joint return	
$[(\$17,850 \times 10\%) + (\$54,650 \times 15\%) + (\$27,500 \times 25\%)]$	\$16,858
Tax on \$92,000 for a married couple filing joint return	
$[(\$17,850 \times 10\%) + (\$54,650 \times 15\%) + (\$19,500 \times 25\%)]$	(14,858)
Tax savings to parents ($\$8,000 \times 25\%$ marginal tax bracket)	2,000
Tax paid by children $[(\$2,000 - \$1,000 \text{ standard deduction}) \times 10\% \text{ marginal tax rate}] \times 4 \text{ children}$	(400)
Net tax savings to family from income shifting	\$1,600

34. *Changing Character of Income*

- Solution:** a. \$20,160. If Diana sells the stock now, she will recognize a short-term capital gain. She will be taxed at her 28% ordinary rate. Her tax liability will be \$7,840 $[4,000 \times (\$19 - \$12) \times 28\%]$. Her after-tax cash inflow will be \$68,160 $[(4,000 \times \$19) - \$7,840]$. Subtracting her \$48,000 (4,000 shares \times \$12) cost results in a net cash inflow of \$20,160.
- b. \$23,800. If Diana holds on to the stock for more than 12 months, she will be entitled to use the special long-term capital gains rate. Therefore, her tax liability would be reduced to \$4,200 $[4,000 \times (\$19 - \$12) \times 15\%]$. Diana's after-tax cash inflow would be \$71,800 $[(4,000 \times \$19) - \$4,200]$. Subtracting her \$48,000 cost results in a net cash inflow of \$23,800.
- c. Diana should wait and sell the stock in one month. This will afford Diana the ability to use the special long-term capital gains rate, which is less than half of

Diana's ordinary tax rate. Diana's tax liability will be \$3,640 (\$7,840 - \$4,200) lower using the special rate resulting in higher net after-tax cash flow.

35. *Penalties*

Solution: \$45. Adam's tax payment is 1 partial and 2 full months late. He will be assessed a late payment penalty equal to one-half of one percent for each partial and full month or \$45 ($\$3,000 \times 0.5\% \times 3$).

36. *Penalties*

Solution: \$800. Robert's return and tax payment is 1 partial and 3 full months late. He will be assessed a late filing penalty of 18 percent ($4.5\% \times 4 \times \$4,000 = \720 , which is greater than the minimum \$135 penalty) and a late payment penalty of 2 percent ($0.5\% \times 4 \times \$4,000 = \80) for a total of 20 percent of the \$4,000 balance due. He will be charged a total of \$800 ($20\% \times \$4,000$).

37. *Statute of Limitations*

Solution: April 15, 2017. The three year statute of limitations begins to run from the later of the due date or date of filing.

38. *Statute of Limitations*

Solution: The deliberate omission of \$40,000 of gross income will generally constitute fraud (tax evasion) and in those circumstances there is no statute of limitations. The IRS can assess additional taxes, interest, and penalties at any time although it must prove fraud.

If the IRS cannot prove fraud on Kevin's part, then the statute of limitations would expire April 15, 2017.

39. *Statute of Limitations*

Solution: October 15, 2019. The \$40,000 of gross income inadvertently omitted is in excess of 25 percent of the gross income reported ($\$40,000/\$150,000 = 27\%$), so the statute of limitations is extended to 6 years.

40. *Statute of Limitations*

Solution: a. April 15, 2020. If the income proves taxable, Thomas would have omitted gross income in excess of 25 percent of the gross income reported ($\$30,000/\$50,000 = 60\%$) so the statute of limitations is extended to 6 years.

b. Knowingly omitting income constitutes tax evasion (fraud). As long as the IRS can prove fraud, there is no time limit (no statute of limitations) on when it can assess additional taxes, penalties, and interest.

Think Outside the Text

These questions require answers that are beyond the material that is covered in this chapter.

41. *Effect of Law Changes on Tax Planning*

Solution: Because of changes in tax laws, successful plans devised in previous years may no longer be available for replication in the current year. When researching a tax plan,

the tax professional must be certain that a plan follows the laws in effect at the time the plan is to be put into effect. For example, the regulations often are not changed immediately when a section of the Code is amended. If a section of the regulations is affected by a law change, then the regulations cannot be relied on as guidance under the new law for a current plan. Similarly, rulings and case law can be superceded by law changes.

42. *Advantages of Debt vs. Equity*

Solution: The corporation can pay interest on the debt and deduct the interest expense from its gross income. If the corporation pays dividends on the stock, the dividends are not deductible by the corporation. Whether the payment is for interest or dividends, the shareholder recognizes income for the amount received; however, dividend income is taxed at a lower rate. Another consideration is that the corporation can repay debt with no tax consequences to the shareholders. If the corporation retires a shareholder's stock, it is possible that the amount received could also be treated as a dividend unless specific redemption requirements are met.

43. *Origination of Tax Bills*

Solution: The Senate can initiate a tax bill by attaching the bill to another House-passed revenue bill already under consideration in the Senate. This happened in 1982 when Senator Robert Dole, Chairman of the Senate Finance Committee, put together a package of miscellaneous revenue-raisers and "loophole closings" in his Finance Committee. He then tacked it onto a minor House-passed tax bill that had been stripped of all its original provisions, passed it through the Senate, and sent it to the House. It eventually became the 1982 tax reform act.

44. *Benefit of Rulings*

Solution: The rulings issued by the IRS provide a blueprint for the taxpayer on how to structure a transaction so that the tax consequences are known when the transaction is consummated. Having certainty about the outcome of a transaction is highly beneficial to the taxpayer. This also reduces the number of disagreements between the taxpayer and IRS when the taxpayer follows a sanctioned form of a transaction. This allows the IRS to better allocate its scarce resources.

45. *Statute of Limitations*

Solution: After the statute of limitations has passed, the taxpayer knows that he or she can no longer be audited and additional taxes, interest, and penalties assessed. This allows the taxpayer to move on with certainty for a closed year. In many instances, this allows the taxpayer to dispose of certain records that have no bearing on future years. The closure of years through the statute of limitations also allows the IRS to move on to current years for their audit potential. Unless the IRS suspects fraud, this also limits the IRS's ability to go back through prior years when discrepancies are determined in a year currently under audit. This provides a practical limit to the workload of the Service.

46. *Improving Compliance*

Solution: This question requires the student to develop a position and state whether that position is viable. For example, a penalty such as lifetime in prison may improve compliance but it is unlikely that such a provision would be passed.

Identify the Issues

Identify the issues or problems suggested by the following situations. State each issue as a question.

47. *Medical Expense Deduction*

Solution: Can Barry deduct the cost of the hot tub and its operating expenses as a medical expense deduction?

48. *Penalties*

Solution: Will Simon be assessed late filing penalties? What are his remedies if any penalties are assessed?

49. *Statute of Limitations*

Solution: Will Jennifer be required to pay the \$500 deficiency? Does the statute of limitations apply when no tax return is filed?

50. *Statute of Limitations*

Solution: Can the IRS collect the deficiency of \$1,000? Does the statute of limitations prohibit the assessment of the additional tax?

51. *Evaluating Authority*

Solution: Can Georgia recommend the tax plan to her client without possible adverse consequences? Does the plan meet the requirement of having a realistic possibility of being sustained on its merits?

52. *Realistic Possibility of Success*

Solution: Does a 25 percent chance constitute a realistic possibility that the tax transaction will be sustained on its merits?

53. *Use of Estimates*

Solution: Does the use of cents as well as dollars imply greater accuracy than implied by the estimates?

54. *Error on Prior Year Return*

Solution: What course of action should Jim take as a result of discovering the error?

55. *Deduction Disallowed in Prior Year*

Solution: Can the tax preparer take the deduction on the current year's return even though it was disallowed on a prior year's return?

Develop Research Skills

Solutions to research problems are in a separate file.

Search the Internet

62. *Locate employment information for Internal Revenue Agent positions*

- Solution:** a. For entry at the GS-5 level, you need a bachelor's degree or higher in accounting from an accredited college or university that included at least 30 semester hours in accounting. These 30 hours may include up to 6 semester hours in any combination of courses in business law, economics, statistical/quantitative methods, computerized accounting or financial systems, financial management, or finance. You may also qualify at the GS-5 level if you meet one of the following requirements: (A) Have at least 4 full years of progressive academic study (120 semester hours) at an accredited college or university that included at least 30 semester hours in accounting as outlined above; (B) Have a Certificate as a Certified Public Accountant (CPA) obtained through written examination in a state, territory or the District of Columbia; (C) Have a combination of education and experience that included at least 30 semester hours in accounting as outlined above.
- b. To qualify for a senior-level position in LB&I, you must meet the GS-5 qualifications and have at least one year of specialized experience in progressively responsible and diversified accounting or auditing work.

63. *Locate Tax Court Filing Fees*

- Solution:** The petition filing fee is \$60.00.

64. *Locate Definitions of Terms in Internal Revenue Bulletins*

- Solution:** *Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. *Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. *Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed. *Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

65. *Locate IRS Publication*

- Solution:** Form 8857

66. *Locate IRS Form*

- Solution:** (1) A \$150 application fee or a Form 656-A requesting an exception to the fee because of financial hardship, (2) a Form 656 and either Form 433-A or Form 433-B is required, and (3) payment equal to 20% of the total amount proposed or the first installment (when there are more than 5 installments) must be included.

67. *Locate IRS Notice***Solution:** a. \$5,000

b. Positions that are the same as or similar to the following are frivolous:

(1) Compliance with the internal revenue laws is voluntary or optional and not required by law. (This statement is followed by 9 examples.)

(2) The Internal Revenue Code is not law (or “positive law”) or its provision are ineffective or inoperative, including the sections imposing an income tax or requiring the filing of tax returns, because the provision have not been implemented by regulations even though the provisions in question either (a) do not expressly require the Secretary to issue implementing regulations to become effective or (b) expressly require implementing regulations which have been issued.

(3) A taxpayer’s income is excluded from taxation when the taxpayer rejects or renounces United States citizenship because the taxpayer is a citizen exclusively of a State (sometimes characterized as a “natural-born citizen” of a sovereign state”), that is claimed to be a separate country or otherwise not subject to the laws of the United States. This position includes the argument that the United States does not include all or a part of the physical territory of the 50 States and instead consists of only places such as the District of Columbia, Commonwealths and Territories (e.g. Puerto Rico), and Federal enclaves (e.g., Native American reservations and military installations), or similar arguments described as frivolous in Rev. Rul. 2004-28, 2004-1 CB 624 or Rev. Rul. 2007-22, 2007-14 IRB 866.

68. *Locate Circular 230***Solution:** a. (1) Communicating clearly with the client regarding the terms of the engagement. (2) Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts. (3) Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice. (4) Acting fairly and with integrity in practice before the Internal Revenue Service.

b. The opinion must prominently disclose that (1) the opinion does not reach a conclusion at the confidence level of at least more likely than not with respect to one or more significant federal tax issues addressed by the opinion; and (2) with respect to those significant tax issues, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

69. *Locate SSTs***Solution:** Since the issuance of the original SSTs, members asked for clarification on certain matters, such as the duplication of the language in SSTs No. 6 and No. 7. Also, changes in federal and state tax laws raised concerns regarding the need to

revise SSTS No. 1. As a result, the original SSTS Nos. 1-8 were updated, No. 6 and No. 7 were combined, and the original No. 8 was renumbered as SSTS No. 7.

Develop Planning Skills

70. *Sole Proprietorship vs. C Corporation*

Solution: a. The sole proprietorship will generate \$18,000 ($\$150,000 \times 12\%$) in before-tax cash flow. It will pay no taxes directly; Jessica will pay all taxes. Jessica will pay income taxes of \$4,500 ($\$18,000 \times 25\%$) reducing the net cash flow to \$13,500 ($\$18,000 - \$4,500$).

(Note that although this problem said to ignore employment taxes, you should be aware that self-employment taxes will reduce the net cash flow.)

b. The corporation will pay income tax of \$2,700 ($\$18,000 \times 15\%$) on its income. Jessica will pay income tax of \$1,350 [$(50\% \times \$18,000) \times 15\%$ dividend rate]. The net cash flow as a corporation is $\$18,000 - \$2,700 - \$1,350 = \$13,950$.

c. There are a number of nontax factors to consider such as her personal liability, the ease of raising additional capital, the ease of sale of ownership interests, and participation in fringe benefits.

d. With significant income from other sources, the corporate form would protect the assets generating this income. In addition, by paying taxes at the corporate rate and leaving a significant portion of the income in the corporation, the business has more capital with which to grow. At a later date, if Jessica needs to take money from the corporation, she could do so as salary and avoid the double tax on this income (although as salary, the corporation and Jessica would have to pay employment taxes) or withdraw more dividends. Based on the tax rates of both the corporation and Jessica, paying dividends would result in a lower tax liability. Either way, the corporate form appears to be a better fit for Jessica's situation.

71. *Partnership vs. C Corporation*

Solution: a. The partnership has income of \$20,000 ($\$200,000 \times 10\%$) but will pay no taxes; thus, it will have cash remaining in the partnership of \$12,000 ($\$20,000 - \$8,000$ distributed to Richard and Jack). Richard and Jack will each pay taxes on their one-half share of the partnership's \$20,000 income. Richard will pay income tax of \$2,500 ($\$10,000 \times 25\%$); Jack will pay income tax of \$2,800 ($\$10,000 \times 28\%$). Richard will have an after-tax cash inflow of \$1,500 ($\$4,000 - \$2,500$) and Jack will have an after-tax cash inflow of \$1,200 ($\$4,000 - \$2,800$). Total taxes paid are \$5,300 ($\$2,500 + \$2,800$).

b. The corporation will have to pay \$3,000 ($\$20,000 \times 15\%$) tax on its income. After the \$8,000 dividend distribution to Richard and Jack, its remaining cash is \$9,000 ($\$20,000 - \$3,000 - \$8,000$). Richard and Jack will each have to pay \$600 ($\$4,000$ dividend $\times 15\%$ dividend rate) in income taxes. Richard and Jack each have an after-tax cash inflow of \$3,400 ($\$4,000 - \600). Total tax is \$4,200 ($\$3,000 + \$600 + \600).

c. Some of the nontax factors that Richard and Jack should consider include their exposure to liability as partners in the partnership, their ability to raise additional

capital, the ease of selling their ownership interests, and their participation in fringe benefits.

d. As presented, it appears that the corporation offers the best alternative form of business. They are able to benefit from the corporation's lower tax rates and this form provides the best overall cash flow considering both the business and the owners at this time. Richard and Jack are paying very high taxes on income that flows through to them from the partnership. With the limited distributions made, they have little positive cash flow. If they intend to leave most of the income in the business, they can avoid the taxes at their level through the corporate form. If at a later date, they need income, they can make additional dividend distributions.

e. Considering employment taxes: (a) The partnership will still generate \$20,000 of income but pay no taxes. When it distributes the \$8,000 to the partners, it will still have \$12,000 remaining. Richard and Jack will each have to pay self-employment taxes on the \$10,000 ($50\% \times \$20,000$) of income passed through to them. $\$10,000 \times 92.35\% \times 15.3\% = \$1,413$ each or \$2,826 for both. They will each be able to deduct the employer's half of their self-employment taxes from the \$10,000 income passed through from the partnership. Thus, they will pay income taxes on \$9,294 of income ($\$10,000 - \706). Richard will have to pay income taxes of \$2,324 ($\$9,294 \times 25\%$) on this income. Jack will have to pay income taxes of \$2,602 ($\$9,294 \times 28\%$) on this income.

As each of them receives only a \$4,000 distribution from the partnership, Richard will have a small positive cash flow and Jack will have a negative cash flow.

Richard's cash flow is \$263 ($\$4,000 - \$1,413 \text{ SE tax} - \$2,324 \text{ income tax}$). Jack's negative cash flow is -\$15 ($\$4,000 - \$1,413 \text{ SE tax} - \$2,602 \text{ income tax}$).

Total taxes are \$7,752 ($\$1,413 + \$1,413 + \$2,324 + \$2,602$).

The answers to (b) will not change. Dividends are not self-employment income and are only subject to income taxes.

In addition to the nontax factors discussed in (c) above, Jack must also have sufficient outside income to absorb his negative cash flow from the partnership.

The answer to (d) does not change. When employment taxes are considered, the corporate form is even more attractive.

72. *Capital Gain vs. Ordinary Income*

Solution: Robin would have a gain or income totaling \$22,800 ($\$28,800 - \$6,000$ basis) on the sale of land. If interest of only 4 percent is designated, Robin will have less interest income to recognize and more gain on the sale of the property than if an interest rate of 8 percent were designated. A lower interest rate benefits Robin because the interest income is taxed at his ordinary income rates, while the gain on the property sale generally will be taxed at a maximum 15 percent tax rate as a long-term capital gain.

If Norman is purchasing this property as an investment or to build a personal residence, the 8 percent interest rate would be better for him because it would result in a higher interest expense deduction for the debt. Although this results in a lower property basis, the higher current interest rate is preferable because it gives him a higher current deduction against ordinary income. Although gain realized on a

subsequent sale will be higher, the tax on that gain will be postponed until it is sold and the gain will be capital gain normally taxed at favorable rates. If Norman builds a principal residence on the property, any future realized gain may escape taxation completely (due to the Section 121 exclusion discussed in a later chapter).

73. *Loan vs. Sale of Property*

Solution: (1) If Debbie sells the land, she will have a gain of \$34,000 [$\$40,000 - (50\% \times \$12,000)$] on the sale. If she is not in the top tax bracket, she will most likely have to pay a capital gains tax of \$5,100 ($15\% \times \$34,000$) on the sale leaving her with a net cash inflow of \$34,900 ($\$40,000 - \$5,100$). If she is in the top tax bracket, her capital gains tax rate would be 20% and she would also be subject to an additional 3.8% surtax resulting in a tax as high as \$8,092 ($23.8\% \times \$34,000$). If she needs a total of \$40,000, she will need to make up the \$5,100 (or \$8,092) shortfall from her other funds or borrow that amount. She would have a much smaller debt than if she borrowed the entire \$40,000. If she does not expect the property to continue to increase in value or to possibly decrease in value in the future, then selling when its value is at a high point would be best.

(2) If Debbie borrows the entire \$40,000, she can avoid any current taxes. She will, however, be required to make interest and principal payments over a number of years to retire the debt. Her ability to do this is dependent on her other income.

Whether undertaking debt and holding the property will prove the better financial alternative depends on the after-tax interest rate that she will have to pay on the loan (as this is to purchase additional investment property she may be able to deduct the interest) and the present value of the after-tax net profit that she could receive on a future sale. For example, if in three years she anticipates selling the entire property to a developer for \$120,000, her profit on the half of the land will have increased by \$20,000 [$(50\% \times \$120,000) - \$40,000$]. After taxes, she will have an additional \$17,000 [$\$20,000 \times (1 - .15)$] or \$15,240 [$\$20,000 \times (1 - .238)$] if in the top tax bracket and even when present value is considered, this may more than compensate for the interest payments over the three years.

In recommending a final decision, selling would be the best alternative if appreciation potential is only moderate and she has little income to service the debt for the borrowing alternative. If she has other income and expects the property to continue appreciating substantially, she should hold on to the property and borrow against it to obtain the needed funds.

74. *After-Tax Cash Flow*

Solution: The manager should hire Lisa because the expected after-tax cash inflow is greater.

	<u>Ken</u>	<u>Lisa</u>
Estimated pretax cash inflow	\$6,000	\$5,600
Probability of success	<u>x 80%</u>	<u>x 75%</u>
Expected pretax cash inflow	\$4,800	\$4,200
Tax on expected return (39%)	<u>(1,872)</u>	<u>0</u>
Expected after-tax cash inflow	\$2,928	\$4,200

Before-tax cost (outflow)	\$(5,600)		\$(6,000)
Tax savings (39%)	<u>2,184</u>		<u>2,340</u>
After-tax cost (outflow)		<u>(3,416)</u>	<u>(3,660)</u>
Net after-tax cash flow		<u><u>\$(488)</u></u>	<u><u>\$540</u></u>

75. After-Tax Cash Flow

Solution: Marlin should accept Job 2 because it will result in a higher net present value.

	<u>Job 1</u>	<u>Job 2</u>
First year:		
Revenues	\$360,000	\$220,000
Expenses	<u>(200,000)</u>	<u>(120,000)</u>
Before-tax cash flow	\$160,000	\$100,000
Income tax	<u>(45,650)</u>	<u>(22,250)</u>
After-tax cash flow	\$114,350	\$77,750
Second year:		
Revenues	\$80,000	\$220,000
Expenses	<u>(40,000)</u>	<u>(120,000)</u>
Before-tax cash flow	40,000	100,000
Income tax	<u>(6,000)</u>	<u>(22,250)</u>
After-tax cash flow	34,000	77,750
Present value (after-tax cash flow x 0.935)	<u>31,790</u>	<u>72,696</u>
Net present value	<u><u>\$146,140</u></u>	<u><u>\$150,446</u></u>

Appendix 2A—Check Your Understanding

1. Nonacquiescence

Solution: To signal disagreement with a court decision, the IRS will publicly “nonacquiesce,” indicating it will not follow the decision.

2. Golsen Rule

Solution: The Golsen rule requires the Tax Court to follow a decision of the Court of Appeals that has direct jurisdiction over the taxpayer in question. If there has been no appellate decision on an issue in a specific circuit, the Tax Court is free to decide the issue on its own merits.

3. Citator

Solution: A citator contains an alphabetical listing of virtually all tax cases. The citator permits a researcher to determine the case’s history and what other courts may have said about this decision. Each case is followed by a record of other decisions that have cited or referred to this case. The validity of a decision may be assessed by examining how the subsequent cases viewed the cited decision and whether the IRS or other courts agree or disagree with the decision in this case.

4. Rule 155

Solution: A decision entered under Rule 155 means that the court has reached a decision regarding the facts and issues of the case but leaves the computational aspects for the opposing parties to determine.

5. *Memo to File*

Solution: The four sections of a memo to file are: (1) Facts—a statement of all facts necessary to answer the issues raised, in chronological order. (2) Issues—the tax questions involved, numbered separately and presented in logical order. (3) Conclusions—short answers to each numbered issue. (4) Discussion—presentation of the reasoning and authorities on which the conclusions are based.