

**Solution Manual for South Western Federal
Taxation 2014 Individual Income Taxes 37th
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Solutions Manual

South-Western Federal Taxation: Individual Income Taxes 2014 Edition

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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:</u> <u>Present</u> <u>Edition</u>	<u>Q/P</u> <u>in Prior</u> <u>Edition</u>
1	LO 1	Tax effect on a change in circumstances	Unchanged	1
2	LO 1	Interplay of different types of taxes	Unchanged	2
3	LO 2	Constitutionality of Federal income tax	Unchanged	3
4	LO 2	Income tax as a “mass tax”	Unchanged	4
5	LO 2	Pay-as-you-go system	Unchanged	5
6	LO 3	Adam Smith and canon of economy	New	
7	LO 3	Proportional and progressive rates contrasted	Unchanged	7
8	LO 4	Ad valorem tax on realty: conversion from exempt to residential status	Unchanged	8 tax-
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 taxes: tax holiday as an	New inducement for new business	
11	LO 4	Ad valorem tax on residential property:	New reasons for variation	
12	LO 4	Ad valorem tax on personalty: means of	New avoidance	
13	LO 4	Federal excise status: current status as to	New scope	
14	LO 4	Excise taxes: hotel occupancy and car rental	Unchanged	14
15	LO 4	Excise and general sales taxes compared	Unchanged	15 16
	LO 4	Avoiding state or local sales tax through use of out-of-area purchases	New	
17	LO 4	Avoiding sales tax through Internet purchase	Unchanged	18
18	LO 4	Estate and inheritance taxes contrasted	Unchanged	19
19	LO 4	Federal gift tax: availability of the marital deduction for transfers between spouses	Unchanged	20

		application of unified credit		
21	LO 4	Federal gift tax: annual exclusion	New	
22	LO 4	Federal taxes: individual and corporations	New compared	
			Status:	Q/P
Question/	Learning		Present	in Prior
<u>Problem</u>	<u>Objective</u>	<u>Topic</u>	<u>Edition</u>	<u>Edition</u>
23	LO 4	State income tax: various attributes	Unchanged	24
		1-	1	
24	LO 4	State income tax: audit potential due to IRS	Unchanged	25 assessment
25	LO 4	Application of jock tax	Unchanged	26
26	LO 4, 5	State income tax return disclosure of Internet purchases; client refusal to answer tax return question and ethical implications	Unchanged	27
27	LO 4	State income taxes: checkoff boxes and special causes	Unchanged	28
28	LO 4	State taxes: amnesty programs	Unchanged	29
29	LO 4	FICA and FUTA contrasted	Unchanged	30 30 LO 4 FICA: Medicare component New
31	LO 4	FICA: application to family	Unchanged	31
32	LO 4	Severance, franchise, and occupation taxes	Unchanged	32 and fees
33	LO 4	VAT: characteristics and usage	Unchanged	33
34	LO 4	National sales tax and VAT: regressive	Unchanged	34 aspects
35	LO 4, 5	Tax problems of cash basis taxpayers with employment turnover	Unchanged	35 high
36	LO 5	Assessing risk of audit by the IRS	Unchanged	36
37	LO 5	IRS audit: characteristics of	Modified	37
38	LO 5	IRS audit: appeal procedures	Unchanged	38
39	LO 5	Statute of limitations: purpose and application of	Unchanged	39
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 5, 6	Ethics: offshore preparation of tax returns	Unchanged	46
47	LO 7	Revenue neutral tax reform	Modified	47
48	LO 7	Multiple justification for several tax provisions	Unchanged	48
49	LO 7	Justification for various tax provisions	Modified	49
50	LO 7, 8	Justification for various tax provisions	Modified	51 51 LO

- 7 Wherewithal to pay concept illustrated: New
 involuntary conversion

52	LO 8	Arm's length concept: definition of and	Unchanged	52	reason for
53	LO 8	Tax treatment of leasehold improvements: judicial versus legislative rules	Unchanged	53	

DISCUSSION QUESTIONS

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.

p. 1-2
2. 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 will 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 local (and perhaps even the state) taxing authorities. Besides the real estate taxes, personal property taxes could be imposed on the furnishings. p. 1-2
3. 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*. p. 1-3
4. 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
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 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 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. pp. 1-5 and 1-6

8. a. The parsonage probably was not listed on the property tax rolls since 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.

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. 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 will be forthcoming. Second, new workers mean new families and more children to educate.

p. 1-7

11. A possible explanation could be that Sophia made capital improvements (e.g., added a swimming pool) to her residence while her parents became retirees (e.g., reached age 65). p. 1-7
12. 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. p. 1-8
13. 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, plus the increase in the tax on tobacco products, seems to indicate an expansion of excise taxes at the Federal level. p. 1-9
14. 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
15. 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 non-food 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.

p. 1-10

16. 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 their residence could come into play.

24. 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. p. 1-15
25. 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. pp. 1-16 and 1-17
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. p. 1-17
- 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. 1-26
27. The checkoff boxes add complexity to the return and mislead taxpayers into presuming that they are not paying for the donation. pp. 1-15, 1-16, and Footnote 17
28. a. They uncover taxpayers that 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.
- p. 1-16 and Footnote 18
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. 1-17 and 1-18
30. a. Unlike the Social Security portion of FICA, there is no dollar limit on the imposition of the Medicare tax.
- b. The 0.9% Medicare addition applies to taxpayers with wages or net self-employment income in excess of \$200,000 (\$250,000 for married filing jointly).

pp. 1-17 and 1-18

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

32. 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 the mineral. p. 1-11
- 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. p. 1-19
- 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. p. 1-19
- 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. p. 1-19
- 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. Footnote 24
33. a. Including all of OECD members, approximately 120 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.
- c. Because it is an effective generator of revenue, the VAT has been criticized as leading to more government spending.
- p. 1-20, Global Tax Issues
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.
- pp. 1-20 and 1-21
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. 1-18 and 1-22
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.
- c. Self-employed taxpayers who file Schedule C are more likely to be picked for audit. Jayden's situation is particularly vulnerable since he is showing little (if any) profit due to large deductions. The IRS might well wish to check these deductions to see if they are justified and properly substantiated.
- d. Does Bernard's reported income support his lifestyle? If not, then maybe Bernard has income that is not being reported.
- e. Homer is not a likely candidate for audit.
- f. If Gloria did not report the dividend, the IRS matching procedure will catch the omission. In all probability a correspondence audit will result.
- g. This could well be one of those situations where disclosure through the news media generates an audit. Embezzled funds are taxable.
- h. 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.
- i. Information received from a state taxing authority can lead to an IRS audit. This is apparently what has happened in the case of Marcus.
- j. Guy is vulnerable for audit in two respects. First, he deals entirely in cash which is easy to hide. Second, his personal life could make him subject to retribution (i.e., "informant" possibility as to former companion).

pp. 1-15, 1-21, and 1-22

- 37. 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 appears, this usually means that fraud is suspected.

pp. 1-22 and 1-23

- 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. 1-23
- 39. 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 since witnesses and other evidence may no longer be available. In the Federal tax area, there are statutes of limitations covering additional assessments by the IRS and the pursuit of refund claims by taxpayers. p. 1-23

- 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. 1-23 and 1-24

- 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. 1-24
- 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 20
 - 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. p. 1-26
 - 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. 1-26

43. \$4,000, determined as follows:

Failure to pay penalty [0.5% × \$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 <u>(400)</u>	<u>3,600</u>	Total penalties <u>\$4,000</u>

p. 1-25 and Example 21

- 44. a. \$100,000 (20% × \$500,000).
- b. \$375,000 (75% × \$500,000). The answer presumes that civil (not criminal) fraud is involved.

p. 1-25

- 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 2009 tax return would not expire until April 15, 2013 (three years after the normal due date for filing). p. 1-24
- 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 2010 through 2012 if you cannot correctly reflect the tax liability due to the omission for 2009. p. 1-26

46. 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.

The client should be notified, preferably in writing, of the outsourcing.

See Global Tax Issues on p. 1-26.

47.
 - 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. 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.

pp. 1-27 and 1-32

48.
 - 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). pp. 1-28 and 1-29
 - 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. p. 1-30 and Footnote 31
 - c. The encouragement of home ownership can be justified on both social and economic grounds. p. 1-30
49.
 - a. Economic justification. The tax law addresses the energy crisis—in terms of both reliance on foreign oil and the need to ease the problem of global warming. p. 1-28
 - b. Economic justification. See the comments under part a. above. p. 1-28
 - c. Equity considerations—to alleviate the effect of multiple taxation of the same income. p. 1-30
 - d. Administrative feasibility. The limitation reduces the number of casualty and theft losses that can be claimed and thereby eases the audit burden on the IRS. p. 1-35 and Footnote 37

- e. Economic justification. Research and development activities are encouraged by allowing immediate or faster write-off of these expenditures. p. 1-28

b., for example, Mia has retained none of the award and has reinvested in property similar to that taken by the city.

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p. 1-31 and Examples 23 and 24

52. If the collection is worth more than \$1,000, the mother has probably made a gift to the daughter of the excess value. 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? p. 1-35 and Example 28
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.

pp. 1-35, 1-36, and Example 29

Proposed solutions to the **Research Problems** are found in the Instructor's Guide. Previously, these items were a part of the Instructor's Companion Site for the textbook.

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>	<u>LO 1 Intent</u>	<u>LO 1 of Congress</u>
	New					
2	LO 1	Alternatives for structuring a business	New	transaction		
3	LO 1	Tax Freedom Day	New			
4	LO 1	Tax legislation originates	New			
5	LO 1	Title 26 of the U.S. Code in Subtitle A	New			
6	LO 2, 5	Treaties	Modified	6		
7	LO 1, 2	Regulation citation	New	8	LO 1, 2	Regulations New
9	LO 1, 4	Types of Regulations	Unchanged	9		
10	LO 1	Revenue Ruling citation	New			
11	LO 1, 4	Authority	Unchanged	11		
12	LO 1	Citations	New			
13	LO 1, 5	Letter rulings	Unchanged	13		
14	LO 1	Letter rulings	Modified	14		
15	LO 1	Letter rulings	Unchanged	15		
16	LO 1	TAMs versus TEAMS	Unchanged	16		
17	LO 1	Using the judicial system	Unchanged	17		
18	LO 1	Small Cases Division	Unchanged	18		
19	LO 1	U.S. Court of Federal Claims	New			
20	LO 1, 5	Judicial alternatives: trial courts	Modified	20		
21	LO 1	U.S. Tax Court	Unchanged	21		
22	LO 1	Judicial system	Unchanged	22		
23	LO 1	Petitioner	New			
24	LO 1	Appellate court and fact-finding	Unchanged	24	determination	
25	LO 1	Trial Courts	Unchanged	25		
26	LO 1	Circuit Court of Appeals	New			
27	LO 1	Precedents of courts	Unchanged	27		

28	LO 1	Circuit Court of Appeals	Unchanged	28
29	LO 1, 4	Court decision validity	Unchanged	29
30	LO 2	Citation	New	
31	LO 2	Appeal to U.S. Supreme Court	Unchanged	31
32	LO 2	Citations	New	

Question/ Problem	Learning Objective	Topic	Status: Present Edition	Q/P in Prior Edition	2-1
				33	LO 2
		Citations	Unchanged	33	
34	LO 1, 2	Abbreviations	Unchanged	34	
35	LO 2	Commerce Clearing House citations	Unchanged	35	
36	LO 2	Location of decision of U.S. Court of Federal Claims	Unchanged	36	
37	LO 1, 2	Internal Revenue Bulletin	Modified	37	
38	LO 3	Tax research	Modified	38	LO 4 Code Unchanged 39
40	LO 2, 4	Tax research	Unchanged	40	
41	LO 6	Primary purpose of tax planning	New		
42	LO 7	CPA exam	Unchanged	42	
43	LO 1	Subchapters	Modified	43	
44	LO 1	Location of Revenue Rulings	Modified	44	
45	LO 1	Federal Register	Modified	45	
46	LO 1, 4	Reliability	Unchanged	46	
47	LO 4	Tax sources	Modified	47	
48	LO 1, 2	Publishers' citations	New		
49	LO 6	Tax avoidance versus tax evasion	Modified	49	

Research Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Deductibility of meals and goodwill	Unchanged	1
2	Subchapters	New	
3	Search for court decision	New	
4	Citations	Unchanged	4
5	Court decision location	Unchanged	5
6	Locating articles in a journal	New	
7	Reliability	Unchanged	7
8	Library research	Unchanged	8
9	Library research	Unchanged	9

10 Internet activity Unchanged 10 11 Internet activity Unchanged

11 DISCUSSION QUESTIONS

1. Determining the intent of Congress is a large part of tax research. p. 2-1
2. The many gray areas, the complexity of the tax laws, and the possibility for different interpretations of the tax law create the necessity of alternatives for structuring a business transaction. p. 2-1
3. The "Tax Freedom Day" for 2012 occurred on April 17, 2012. p. 2-2
4. Federal tax legislation generally originates in the House Ways and Means Committee. p. 2-2
5. The income tax laws are found in Title 26 of the U.S. Code in Subtitle A. p. 2-4
6. Hoffman and Smith, CPAs
5191 Natorp Boulevard Mason, OH
45040

March 22, 2013

Mr. Butch Bishop Tile, 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 Spain 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.

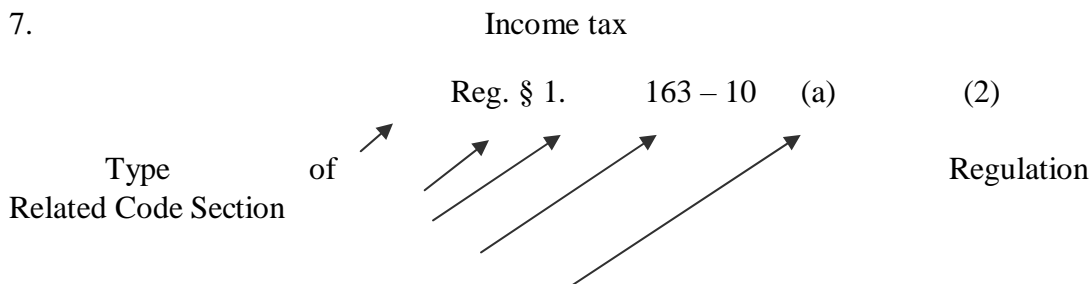
Section 7852(d) provides that if a U.S. treaty is in conflict with a provision in the Code, neither will take general precedence. Rather, the more recent of the two will have precedence. In your case, the Spanish treaty takes precedence over the Code section.

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. 2-18



Regulation
Regulation
Regulation Subparagraph

Number
Paragraph

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. § 1.152.
 - b. Prop. Reg. § 1.274.
 - c. Temp. Reg. § 1.163.
 - d. Reg. § 1.1501.

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 likekind 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. 2-26 to 2-28

10. Notice 90-20 is the 20th Notice issued during 1990, and it appears on page 328 of Volume 1 of the Cumulative Bulletin in 1990. pp. 2-8 and 2-9
11. The items would probably be ranked as follows (from lowest to highest):

- (1) Letter ruling (valid only to the taxpayer to whom issued).
- (2) Proposed Regulation (most courts ignore Proposed Regs.).

- (3) Revenue Ruling.
- (4) Interpretive Regulation.
- (5) Legislative Regulation.
- (6) Internal Revenue Code.

pp. 2-5 to 2-9, 2-26 to 2-28, and Exhibit 2.1

12. a. A Temporary Regulation, with 1 referring to the type of Regulation (i.e., income tax), 956 is the related Code section number, 2 is the subsection number, and T refers to temporary.
- b. Revenue Ruling number 15, appearing on page 975 of the 23rd weekly issue of the *Internal Revenue Bulletin* for 2012.
- c. Letter Ruling 51, issued in the 4th week of 2002.

pp. 2-6 to 2-9

13. TAX FILE MEMORANDUM

September 23, 2013

FROM: George Ames

SUBJECT: Telephone conversation with Sally Andrews on applicability of 2003 letter ruling

I told Sally Andrews that only the taxpayer to whom the 2003 letter ruling was issued may rely on the pronouncement. I stressed that a letter ruling has no precedential value under § 6110(j)(3).

I pointed out that a letter ruling indicates the position of the IRS on the specific fact pattern present as of the date of the letter ruling. As such, a letter ruling is not primary authority. However, under Notice 90-20, 1990-1 C.B. 328, a letter ruling is substantial authority for purposes of the accuracy-related penalty in § 6662.

pp. 2-8, 2-9, 2-29, and Exhibit 2.1

14. Sri should consider the following factors in determining if he should request a letter ruling from the IRS with respect to the proposed stock redemption:
- For a fee, the IRS will issue a letter ruling at a taxpayer's request and describe how the IRS will treat a proposed transaction. The letter ruling applies only to the requesting taxpayer. A Revenue Ruling is applicable to all taxpayers.

- Sri must determine if the possible tax amount is large enough to warrant the costs and time to apply for a letter ruling. Here the tax issue is probably important enough to do so.

- If Sri is likely to obtain an adverse letter ruling from the National Office, he should forgo the ruling request.
- The letter ruling would have substantial authority for purposes of the accuracy-related penalty.
- Sri would need to consult Rev. Proc. 2013-1 to be certain the IRS will issue a ruling about this tax issue. The IRS will not rule in certain areas that involve fact-oriented situations, but will probably issue one here.

pp. 2-8 and 2-9

15. Letter rulings may be found in:

- Private Letter Rulings (RIA).
- BNA Daily Tax Reports.
- Tax Notes (Tax Analysts).
- IRS Letter Rulings Report (CCH).

p. 2-8 and Exhibit 2.1

16. TEAMS are issued by the Office of Chief Counsel to expedite legal guidance to field agents as disputes are developing. TEAMS differ from TAMs as follows:

- A mandatory pre-submission conference involving the taxpayer.
- In the event of a tentatively adverse conclusion to the taxpayer or to the field, a conference of right will be offered to the taxpayer and to the field.
- No further conferences are offered once the conference of right is held.

p. 2-10

17. Dwain 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 Dwain loses, interest must be paid on any unpaid deficiency.

Dear Mr. Falls:

You have three alternatives should you decide to pursue your \$229,030 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. 2-11, 2-12, Figure 2.3, and Concept Summary 2.1

21. The U.S. Tax Court hears only tax cases and is the most popular forum for tax cases. Some people suggest that the Tax Court has more expertise in tax matters. A taxpayer does not have to pay the tax deficiency assessed by the IRS before trial, but a taxpayer may deposit a cash bond to stop the running of interest. Appeals from a Tax Court are to the appropriate U.S. Court of Appeals. A taxpayer may not obtain a jury trial in the U.S. Tax Court.
p. 2-12
22. See Figure 2.3 and Concept Summary 2.1.
 - a. 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. p. 2-10

- 27. a. The Tax Court must follow its own cases, the pertinent U.S. Circuit Court of Appeals, and the Supreme Court.

- b. The Court of Federal Claims must follow its own decisions, the Federal Circuit Court of Appeals, and the Supreme Court.
- c. The District Court must follow its own decisions, the pertinent U.S. Circuit Court of Appeals, and the Supreme Court.

p. 2-15 and Figure 2.3

28. The appropriate Circuit Court of Appeals for an appeal depends on where the litigation originated. For example, an appeal from Texas would go to the Fifth Circuit Court of Appeals, or an appeal from Colorado would go to the Tenth Circuit Court of Appeals. p. 2-13 and Figure 2.4
29. 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. 2-12 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. 2-10, 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. 2-10, 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. 2-10, 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

- 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. p. 2-16
30. The number 66 is the volume number for the U.S. Tax Court, 39 refers to the page number of the 562nd volume of the Federal Second Series, and nonacq. means that the IRS disagreed with the decision. The Tax Court (T.C.) cite is to the trial court. pp. 2-17 and 2-18
31. There is no automatic right of appeal to the U.S. Supreme Court. Appeal is by *writ of certiorari*. If the Court agrees to hear the dispute, it will grant the *writ (Cert. granted)*. Most often, the highest court will deny jurisdiction (*Cert. denied*). p. 2-15
32. a. Ninth Circuit Court of Appeals.
- b. U.S. Tax Court.
- c. U.S. Supreme Court.
- d. Bureau of Tax Appeal (old name of U.S. Tax Court).
- e. Tax Court (memorandum decision).
- f. Court of Claims.
- g. Not a court decision.
- h. District Court in New York.
- i. Not a court decision.
- pp. 2-16 to 2-19
33. a. This citation is to a regular decision of the U.S. Tax Court that was issued in 1950. The decision can be found in Volume 14, page 74, of the Tax Court of the United States Report, published by the U. S. Government Printing Office. pp. 2-16 to 2-19 and Concept Summary 2.2
- b. This citation is for a decision of the U. S. Fifth Circuit Court of Appeals that was rendered in 1979. The decision can be found in Volume 592, page 1251, of the Federal Reporter, Second Series (F. 2d), published by West Publishing Company. pp. 2-16 to 2-19 and Concept Summary 2.2
- c. This citation is for a decision of the U.S. Sixth Circuit Court of Appeals that was rendered in 1995.

The decision can be found in Volume 1 for 1995, paragraph 50,104 of U.S. Tax Cases, published by Commerce Clearing House. pp. 2-16 to 2-19 and Concept Summary 2.2

- d. This citation is for a decision of the U.S. Sixth Circuit Court of Appeals that was rendered in 1995. The decision can be found in Volume 75, page 110, of the Second Series of American Federal Tax Reports, published by RIA. pp. 2-16 to 2-19 and Concept Summary 2.2
- e. This citation is for a decision of the U.S. District Court of Texas that was rendered in 1963. The decision can be found in Volume 223, page 663, of the Federal Supplement Series, published by West Publishing Company. pp. 2-16 to 2-19 and Concept Summary 2.2
34. a. CA-2. An abbreviation that designates the U.S. Second Circuit Court of Appeals. pp. 2-16 to 2-19
- 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 2-19
- c. aff'd. An abbreviation for "affirmed," which indicates that a lower court decision was affirmed (approved of) on appeal. p. 2-14
- d. rev'd. An abbreviation for was "reversed," which indicates that a lower court decision was reversed (disapproved of) on appeal. p. 2-14
- 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. 2-14
- 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. pp. 2-17, 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). pp. 2-17, 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. 2-17 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. 2-17

35. a. None.

- b. USTC.
- c. USTC.
- d. USTC.
- e. TCM.

pp. 2-17, 2-18, and Concept Summary 2.2

36. 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. pp. 2-17, 2-18, and Concept Summary 2.2

37. a. Yes. Exhibit 2.1

- b. No. Not published there. Concept Summary 2.2
- c. No. Published by private publishers. pp. 2-8, 2-9, and Exhibit 2.1
- d. Yes. p. 2-8 and Exhibit 2.1
- e. Yes. p. 2-7 and Exhibit 2.1
- f. No. pp. 2-17, 2-18, and Concept Summary 2.2
- g. Yes. p. 2-16
- h. No. Concept Summary 2.2

38. After understanding the relevant facts:

- Yvonne 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.
- Yvonne 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.
- Yvonne could consult CCH’s Federal Tax Articles to locate current appropriate articles written about child support payments. RIA’s Tax Service also has a topical “Index to Tax Articles” section that is organized using the RIA paragraph index system.
- Yvonne 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. 2-20 to 2-31

39. The current Code can be found in various places. Several of the major tax services publish paperback editions of the Code (and Regulations). These editions are usually revised twice each year. An annotated and abridged version of the Code and Regulations is published annually by Cengage/South-Western (by James E. Smith). Further, the text of the Code may be found in the major tax services and as Title 26 of the U.S. Code. The Code also may be found on the Web. p. 2-26 and Footnote 35
40. The best means of locating tax articles pertinent to your problem is through Commerce Clearing House’s Federal Tax Articles. This multi-volume service includes a subject index, a Code § number index, and an author’s index. In addition, you might wish to try the RIA (formerly P-H) tax service’s topical “Index to Tax Articles” section [organized using the RIA (formerly P-H) paragraph index system].

Court decisions and Revenue Rulings may be reviewed for reliability by using the Federal Tax Citator that is published by Research Institute of America (formerly Prentice-Hall). The Citator consists of six bound volumes and monthly cumulative paperback supplements. The researcher must be sure to examine the cumulative paperback supplements to determine the current status of a case. Commerce Clearing House also publishes a Citator.

The Commerce Clearing House tax service contains a special volume that is devoted to current matters. RIA integrates the new developments into the body of the service throughout the year. Computer-assisted tax research might also be helpful. pp. 2-20 to 2-31

- 41. The primary purpose of tax planning is to reduce a taxpayer’s overall tax liability. This process can entail an avoidance, reduction, or postponement of the tax until the future.

This process does not mean that the course of action selected must produce the lowest possible tax under the circumstances. Legitimate business goals also must be considered.

There is nothing illegal or immoral about tax avoidance. A citizen has every legal right to arrange his or her affairs so as to keep the attendant taxes as low as possible. One is required to pay no more taxes than the law demands. There is no difference between a tax advisor’s reduction of a tax expense and a cost accountant’s reduction of a cost of operating a business.

pp. 2-32 to 2-35

- 42. Simulations on the CPA exam are small case studies designed to test a candidate’s tax knowledge and skills using real-life, work-related situations. Simulations include a fourfunction pop-up calculator, a blank spreadsheet with some elementary functionality, and authoritative excerpts that are necessary to complete the tax case study simulations (e.g., Internal Revenue Code and Federal tax forms). pp. 2-36 and 2-38

PROBLEMS

- 43. b. p. 2-4
- 44. b. Exhibit 2.1
- 45. d. Exhibit 2.1 46. a. Code section.
- b. Legislative Regulation.

- c. Recent Temporary Regulation.
- d. Interpretive Regulation.
- e. Revenue Ruling.
- f. Letter Ruling.
- g. Proposed Regulation.

pp. 2-26 to 2-30 and Exhibit 2.1

- 47. a. P.
- b. P.
- c. P.
- d. S.
- e. P.
- f. S.
- g. P. Valid for 3 years.
- h. P.
- i. N. j P.

pp. 2-2 and 2-27

- 48. a. CCH
- b. RIA.
- c. U.S.
- d. CCH.
- e. U.S.
- f. RIA.
- g. W.
- h. W.
- i. W.
- j. W.
- k. U.S.
- l. O.

pp. 2-15 to 2-18

- 49. a. E. and Concept Summary 2.2
- b. E.
- c. A.
- d. A.
- e. A.

pp. 2-32 to 2-35

Proposed solutions to the **Research Problems** are found in the Instructor's Guide. Previously, these items were a part of the Instructor's Companion Site for the textbook.

NOTES