

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

<u>Question/ Problem</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
1	Effect of state and local taxes on decision making	Unchanged	1
2	History of Federal income tax	Unchanged	2
3	Constitutionality of Federal income tax for corporations	Unchanged	3
4	Codification of the tax laws	Unchanged	4
5	Pay-as-you-go system	Unchanged	5
6	Criteria for “good” tax system	Unchanged	6
7	Proportional versus progressive tax	Unchanged	7
8	Issue ID	Unchanged	8
9	Issue ID	Unchanged	9
10	Issue ID	New	
11	Ad valorem tax on realty: effect of tax holiday	New	
12	Ad valorem tax on realty: effect of construction cost	Unchanged	12
13	Ad valorem taxes: taxpayer compliance	Unchanged	13
14	Excise taxes: hotel occupancy and car rental	New	
15	Issue ID	New	
16	State and local sales tax holidays	New	
17	Issue ID	Unchanged	16
18	Issue ID	Unchanged	17
19	General sales tax: avoidance and the use tax	Unchanged	18
20	Inheritance and estate taxes compared	Unchanged	20
21	Federal estate tax: effect of marital and charitable deduction	Unchanged	21
22	Cumulative nature of the Federal gift tax	Unchanged	22
23	Federal gift tax and use of annual exclusions	Modified	23
24	Justification for annual exclusion	Unchanged	24

<u>Question/ Problem</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
25	Justification for the Tax Relief Reconciliation Act of 2001 purported treatment of estate and gift taxes	Unchanged	25
26	Current status of Federal estate and gift taxes	Unchanged	26
27	Income tax formula: individuals and corporations compared	Unchanged	27
28	Issue ID	New	
29	Piggyback approach of state income taxes	New	
30	Correlation of Federal and state income tax rules and audit procedures	Unchanged	30
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32	FICA and FUTA contrasted	Unchanged	32
33	FICA: maximum amount of tax	Unchanged	33
34	FICA and employment of one spouse by another: coverage of children	Unchanged	34
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40	IRS audit: characteristics of	New	
41	Statute of limitations: IRS assessments	Unchanged	41
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44	Penalties for failure to file and failure to pay	Modified	44
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49	Justification for several tax provisions	New	
50	Justification for favorable tax treatment of education expenses	Unchanged	50
51	Economic and social considerations: encouragement of home ownership	Unchanged	51
52	Mitigation of the effect of double taxation of the same income	Unchanged	52
53	Involuntary conversion: application and nonapplication of wherewithal to pay concept	New	
54	Mitigation of annual accounting period concept	Unchanged	54
55	Coping with inflation: indexation procedure	Unchanged	55
56	Issue ID	Unchanged	56

<u>Question/ Problem</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
57	Tax treatment of leasehold improvements: judicial versus legislative rules	Unchanged	57

DISCUSSION QUESTIONS

1. Some tax considerations Irene should investigate include the following:

- State and local income taxes.
- State and local sales taxes.
- State and local property taxes.

Many such taxes could affect any cost-of-living differential. p. 1-2 and Example 1

2. This is not the case. During the Civil War, both the Federal Union and the Confederate States of America had an income tax. Furthermore, an income tax was reenacted in 1894. It was this tax that was held to be unconstitutional by the U. S. Supreme Court and ultimately led to the passage of the Sixteenth Amendment. p. 1-3

3. Not really, since the income tax on corporations was not unconstitutional. It was the income tax levied upon individuals that the Supreme Court had previously invalidated. p. 1-3

4. Initially the tax law would have been part of the Internal Revenue Code of 1939. However, the law later could have been incorporated as part of the recodification in the IRC of 1954. Also possible is that the law could still be in effect. If so, it would be in the IRC of 1986. pp. 1-3 and 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. In addition to Adam Smith's four cannons, the AICPA has suggested six more guides as to tax policy.

- Simplicity.
- Neutrality as to effect on business decisions.
- No deterrent to economic growth and efficiency.
- Taxpayers know about it and when it applies.
- Minimization of noncompliance.
- Predictability as to revenue stream.

Tax in the News, "Adam Smith Stopped Too Soon," p. 1-5

7. Except for the Federal estate and gift taxes, all excise taxes are proportional. This is also the case with ad valorem property taxes. Besides the Federal estate and gift taxes, income taxes are progressive. p. 1-6 and Examples 2 and 3
8. Gull Company is trying to minimize the value of the real estate. This can be done by keeping personalty from becoming a “fixture.” The jurisdiction where the building is situated probably imposes an ad valorem tax on realty that is higher than that imposed on personalty. Gull also is trying to maximize its cost recovery deduction. p. 1-7
9. Under many ad valorem taxes, property owned by charitable organizations (i.e., churches) is exempt from taxation. This would not be the case with a for-profit commercial enterprise (i.e., automobile dealership). Over a period of time, the \$100,000 differential in the two bids could be more than offset through the collection of additional ad valorem property taxes. In addition, the for-profit commercial entity would generate general sales tax to the local government. p. 1-7
10. The increase in ad valorem property taxes is probably attributable to a number of factors. First, Irene’s grandmother may have been enjoying a lower rate (or lower assessed value) due to her senior citizen status. Second, Irene has converted the property from residential use to rental use. Invariably, income producing property is subject to a higher rate than personal use property. p. 1-7
11.
 - a. “Generous” probably means a prolonged exemption from ad valorem property taxes.
 - b. A new business brings more families into the area. This, in turn, means more children to educate. While costs increase, the tax holiday could mean a loss of tax revenue.p. 1-7
12. It may be that Matt pays more ad valorem taxes than do his neighbors, even though the properties involved are of approximately equal values. Whether this is the case depends on when the value of the other property in the neighborhood last was assessed by the taxing authority. In any event, it is likely that the base for the assessment on Matt’s residence is the acquisition cost of \$150,000. pp. 1-7 and 1-8
13.
 - a. Very difficult to avoid. However, the amount of the tax can be reduced by obtaining a lower appraisal of the real estate.
 - b. Taxpayer compliance is very poor.
 - c. Taxpayer compliance is greater than in the case of personal use personalty.
 - d. Probably the most difficult of all ad valorem taxes to enforce. As a consequence, taxpayer compliance is negligible.pp. 1-7 and 1-8
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. The main issue would appear to be the sales tax on the purchase of the furniture. As the sellers shipped the merchandise out-of-state, it is doubtful that any North Carolina sales tax was collected. What would be due, moreover, would be the Florida use tax. Once the furniture is delivered, is it likely that the Wilsons would volunteer to pay this tax?

If the Wilsons do not pay the tax, what is the likelihood that the Florida sales tax authorities will discover the omission? Barring disclosure by the sellers, an unlikely possibility, such discovery is probably minimal. But keep in mind, however, that Marvin Wilson is a high profile type of person and may be subject to media overage. As was true with Kozlowski (see *Tax in the News* on p. 1-11), this increases the risk of discovery.

16. A sales tax holiday exempts sales of certain (or all) items from state and local sales taxes for a prescribed period of time.
- a. Reasons for such a holiday might be: to stimulate shopping, to encourage the development of industry, to aid school attendance, and to provide a financial break for families with school age children.
 - b. Sales tax holidays are highly popular with both shoppers and merchants. It may be politically unwise to cancel such events.

p. 1-11

17. In some states, counties (and cities) are given the option to impose additional sales tax levies. It is possible that this is the situation with Wilson County. If so, this would explain why Velma does her shopping Grimes County. p. 1-10 and Example 5
18. Earl probably purchased his computer out-of-state by use of a catalog or through the Internet. In such cases, state collection of the sales (use) tax is improbable without taxpayer compliance. p. 1-10
19. Probably not. When, and if, Kara registers her car in Wyoming, she will most likely be forced to pay a use tax. Such use tax is in lieu of the sales tax she would have paid had she purchased the car in Wyoming. Thus, all Kara has accomplished is to postpone the payment of the sales tax for a period of time (i.e., from the date of the purchase of the car to its registration). p. 1-10 and Example 4
20. An inheritance tax is a tax on the right to receive property due to the death of another. As such, it is a tax on the heir. An estate tax is a tax on the right to pass property by death. As such, it is a tax on the decedent. The Federal government levies an estate tax. States levy inheritance or estate taxes or both. p. 1-11 and Example 6
21. Because of the availability of the charitable and marital deductions, no taxable estate results. p. 1-12
22. In computing the gift tax due on current gifts, proceed as follows:

Determine current *taxable* gifts
Add all prior *taxable* gifts
Using current rates, determine the tax on the total
Deduct prior gift taxes deemed paid
Deduct available unified transfer tax credit
Current gift tax due

Consequently, the determination of the *current* gift tax must take into account all *prior* taxable gifts. p. 1-13

23. If the property comes from one of the spouses and the nonowner spouse does not elect to split the gift, the number of annual exclusions allowed is 19, determined as follows: 4 (children) + 4 (spouses of children) + 11 (grandchildren). If the property is jointly owned or, if not, the election to split the gift is made, 38 exclusions [2 (donors) X 19 (donees)] are allowed. p. 1-13 and Example 9
24. The purpose of the annual exclusion is to avoid the need to report and pay taxes on modest gifts. Without the exclusion, the IRS could have a real problem of taxpayer noncompliance. p. 1-13 and Footnote 15
25.
 - a. There exists strong resentment to the Federal estate tax because of its effect on small business. In the case of the family farm, for example, the death of the owner may generate an estate tax that can only be satisfied by selling some or all of the land. Congress is quite concerned about a tax that might cause the break-up of a family business. p. 1-12
 - b. Unlike death, a gift is a voluntary transfer of wealth. As such, gift taxes can be controlled by spacing the transfers over a prolonged period of time. p. 1-14
26. The remark is incorrect in several respects. First, it presumes that death taxes are no more. This is just not so! Even if the changes proposed by the Tax Relief Reconciliation Act of 2001 materialize, the complete phase-out of the Federal estate tax involves a period of ten years. Second, what are the chances that, over a time frame of ten years, Congress will abstain from further modifications of the tax law? It would not be surprising, for example, for Congress to change its mind and decide to retain some or all of the Federal estate tax. Third, Congress has no control over any death taxes imposed by the states. Thus, these taxes on dying may well continue to exist. p. 1-12
27. The Federal income tax applicable to corporations does not require the determination of adjusted gross income (AGI). Nor are corporations allowed personal and dependency exemptions or the standard deduction. All deductions are treated as business expenses, so there are no itemized deductions. p. 1-14
28. Ricky Williams has moved from a state with an income tax (Louisiana) to one without an income tax (Florida). Consequently, all of his *home* games will not generate any state income tax. As to the *away* games, he is vulnerable if the host city and state has an income tax. Thus, his situation is identical to that of Alex Rodriguez (A-Rod) discussed in the *Tax in the News* on p. 1-16.

When Ricky played for the Saints, he could claim some credit against his Louisiana income tax for the out-of-state income taxes paid on the away games. Now this is no longer necessary because of the absence of a Florida income tax. Thus, the possibility of more than one state taxing the same income is avoided.

29. a. The “piggyback” approach means that a state income tax makes use of what has been done for Federal income tax purposes. To “decouple” means that the state will not adopt, for state income tax purposes, the recent Federal income tax change.
- b. Usually, “decoupling” occurs when the state will lose too much revenue by accepting the Federal income tax change.

p. 1-15

30. The state probably has an income tax patterned after the Federal model. As a consequence, an adjustment of a taxpayer’s Federal return may well lead to a similar state adjustment. In many cases, states are notified when the IRS assesses a deficiency against a taxpayer. p. 1-15

31. a. Generally, all the states have withholding procedures.
- b. A diminishing number of states allow a deduction for Federal income taxes paid.
- c. The filing dates are usually consistent with the Federal rule.
- d. Most states allow a deduction (or credit) for personal and dependency exemptions.
- e. Most states allow their residents some form of tax credit for income taxes paid to other states.
- f. Some states have occasionally instituted amnesty programs that allow taxpayers to pay back taxes (and interest) on unreported income with no (or reduced) penalty.

p. 1-15

32. a. FICA offers some measure of retirement security, and FUTA provides a modest source of income in the event of loss of employment.
- b. FICA is imposed on both employer and employee, while FUTA is imposed only on the employer.
- c. FICA is administered by the Federal government. FUTA, however, is handled by both Federal and state governments.
- d. This applies only to FUTA. The merit system rewards employers who have low employee turnover, since this reduces the payout of unemployment benefits.

pp. 1-16 and 1-17

33. The Social Security portion of FICA stops once a base amount is reached (\$87,000 for 2003, \$84,900 for 2002). There is no limit on the base amount for the Medicare portion of FICA. Current tax rates are 6.2% for Social Security and 1.45% for Medicare. p. 1-17

34. The wife will be subject to FICA, but the son will not. Had the son been 18 years of age or older, he also would be subject to FICA. p. 1-17
35. FUTA can be reduced if the employer has a high merit rating. If the stability of employment is bad (as would be true with Dan), this leads to a lower merit rating and higher FUTA. p. 1-17
36. a. The major justification for a flat tax is simplicity. Because it is perceived as easy to deal with, compliance cost is perceived as being reduced, and this saves time and money.
- b. Because certain groups (e.g., municipalities, charities, home construction) have considerable political influence, eliminating various tax preferences (exclusions, deductions, and credits) in the current income tax law may be difficult to do.
- p. 1-18
37. Although a certain amount of noncompliance can be expected to arise in both forms of taxation, the national sales tax will generate greater opportunity. Since only the ultimate retailer is responsible for collecting the national sales tax, it is more easily circumvented. In the case of a VAT, however, complete avoidance usually requires the collusion of multiple parties. p. 1-19
38. 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. 1-17 and 1-20
39. 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 Julio’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. As the casino probably reported the payout on a Form W-2G, any failure by Mario to report the winnings would be revealed to the IRS when the information return is checked against his return.
- c. Angel’s main source of income is probably the tips she receives from customers. The IRS is well aware that tips are frequently underreported.
- d. If Hope knows anything about Jude’s tax indiscretions, she certainly has strong motivation to play an informer’s role.

- e. Presuming no other source of income, Flo is unlikely to be audited. An employee subject to withholding has little opportunity to manipulate his or her income tax liability.

p. 1-20

- 40.
 - a. The number of returns audited by the IRS is small and has significantly decreased over the years.
 - b. An increase in “no change” audits probably means that the IRS is picking too many of the wrong returns to audit.
 - c. The DIF score helps determine which returns the IRS selects for audit.
 - d. The NRP is designed to provide the IRS with data it can use to update its DIF components.
 - e. A correspondence audit involves matters that can be resolved by mail. An office audit usually is restricted in scope and is conducted in the facilities of the IRS. A field audit involves an examination of numerous items reported on the return and is conducted on the premises of the taxpayer or the taxpayer’s representative.
 - f. Upon the conclusion of the audit, the examining agent issues a Revenue Agent’s Report (RAR) that summarizes its findings. The RAR will result in a refund, a deficiency, or a no change finding.
 - g. When a special agent appears, this usually means that fraud is suspected.

pp. 1-19 to 1-21

- 41.
 - a. The normal three-year statute of limitations will begin to run on April 15, 2003. When the return is filed early, the regular filing date controls.
 - b. Now the statute of limitations starts to run on the filing date. If the date of filing controlled [see part (a) above], the taxpayer could shorten the assessment period by filing late.

pp. 1-21 and 1-22

- 42. 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 20 does not satisfy the 45-day requirement. p. 1-22
- 43.
 - a. Normally, the 3-year statute of limitations applies to additional assessments the IRS can make. However, if a substantial omission from gross income is made, the statute of limitations is increased to six years. A substantial omission is defined as omitting in excess of 25% of the gross income reported on the return. Example 14
 - b. The proper procedure would be to advise Andy to disclose the omission to the IRS. Absent the client’s consent, do not make the disclosure yourself. p. 1-24

- c. If Andy refuses to make the disclosure and the omission has a carryover effect to the current year, you should withdraw from the engagement. p. 1-24
44. \$1,500, determined as follows:
- | | | |
|---|--------------|----------------|
| Failure to pay penalty [0.5% X \$10,000 X 3 months] | | \$ 150 |
| Plus: | | |
| Failure to file penalty [5% X \$10,000 X 3 months] | \$1,500 | |
| Less failure to pay penalty for the same period | <u>(150)</u> | <u>1,350</u> |
| Total penalties | | <u>\$1,500</u> |
- p. 1-22 and Example 15
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 1999 tax return would not expire until April 15, 2003 (three years after the normal due date for filing). p. 1-22
- b. Although you can only recommend that the return be filed, you cannot force him to do so. However, you should not undertake the engagement for 2000 through 2002 if you cannot correctly reflect the tax liability due to the omission for 1999. p. 1-24
46. Although it is permissible to use estimates, such estimates should not be presented so as to give the impression of greater accuracy than is the case. pp. 1-23 and 1-24
47. Revenue neutral tax reform means that any statutory changes made will neither increase nor decrease the net revenues raised under the prior rules. It does not mean that any one taxpayer's tax liability will remain the same as this will depend on the circumstances involved. p. 1-25
48. Favorable tax treatment is allowed for research and development expenditures. Such expenditures can be either deducted in the year incurred or capitalized and amortized over a period of 60 months or more. p. 1-26
49. a. Economic considerations—encouragement of certain activities. In this case, the stimulation of U.S. export of services. p. 1-26
- b. Economic considerations—control of the economy. In this case, the goal was to stimulate capital investment. p. 1-26
- c. Economic considerations—encouragement of certain industries. The deferral allows the farmer to postpone recognizing income (due to the insurance proceeds) on a destroyed crop. Otherwise there would be a bunching of income in the same year (i.e., sale of last year's crop plus insurance from the destruction of this year's crop). p. 1-27
- d. Economic considerations—encouragement of small business. What is described is the election under Subchapter S of the Code. p. 1-27
- e. Social considerations. By making the premium deductible by the employer and largely nontaxable to the employee, these plans are encouraged. p. 1-27

- f. Equity considerations—mitigation of the annual accounting period concept. pp. 1-29 and 1-30
50. The favorable tax treatment of additional education expenditures can be justified on *both* economic and social considerations. A better educated workforce stimulates economic growth. Additionally, education fosters social well-being by providing a better-informed and economically-secure populace. p. 1-27 and Footnote 27
51. Ashley definitely is in a more favorable Federal income tax position. The interest expense and property tax components of her mortgage payments qualify as itemized deductions. Unfortunately, none of Jacob's rent payment provides him with any tax benefit. The only justification for the disparity in tax treatment is that Congress, based on economic and social grounds, has seen fit to encourage home ownership. p. 1-28
52. It does not eliminate double taxation since a deduction only saves taxes to the extent of the appropriate tax rate. A credit, not a deduction, is a dollar-for-dollar reduction of tax liability. p. 1-28
53. a. Justin's realized gain on the transaction is \$120,000 [\$140,000 (condemnation award – \$20,000 (cost of the land)]. His recognized gain is the lower of the realized gain of \$120,000 or the amount of the condemnation proceeds not reinvested (\$140,000 – \$15,000 = \$125,000).
- b. As all of the award is reinvested, no gain is recognized.
- c. \$10,000 of the gain must be recognized, the excess of the condemnation award over the amount reinvested.
- Examples 17 and 18
54. It allows a taxpayer to obtain some benefit from a loss that occurs in one year by carrying it back and/or forward to profitable years. p. 1-29, 1-30, and Example 19
55. Indexation is provided for various components for the Federal income tax structure (e.g., tax rates, personal exemptions). p. 1-30
56. The IRS is very wary of dealings between related parties. Here, the temptation to manipulate transactions to achieve tax benefits is very much present. Consequently, the arm's length standard is applied to test the validity of the arrangement. In the case at hand, the question to be asked is "Would a nonrelated party have paid an annual rent of \$24,000 for the property Renee has leased?" p. 1-33 and Example 22
57. 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. 1-33, 1-34, and Example 23

NOTES