Solutions to Chapter 2 Problem Assignments

Check Your Understanding

1. [LO 2.1] *DIF Formula*

What is the purpose of the DIF formula? What happens if someone has a high DIF score?

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.

2. [LO 2.1] *Types of Audits*

Describe the various 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.

3. [LO 2.1] *Appeal Options*

If the taxpayer does not agree with proposed adjustments, what are the alternatives available to a taxpayer who receives a 30-day letter?

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.

4. [LO 2.1] *Appeal Options*

What alternatives are available when a taxpayer receives a 90-day letter?

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.

5. [LO 2.1] *Hazards of Litigation*

Explain the meaning of 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.

6. [LO 2.1] *Trial Courts and Appeals*

What are the three courts in which a taxpayer initiates tax litigation to settle a dispute with the IRS? To which courts can adverse decisions from these courts be appealed?

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.

7. [LO 2.1] *Appeals Process*

Your client, Teresa, claimed a dependency exemption for her elderly father. Upon audit, the IRS agent disallowed the dependency exemption. Teresa received a 30-day letter notifying her of the proposed additional tax liability of $1,050. Teresa is very upset by this assessment and tells you that she refuses to pay "another dime" and she wants to take this "all the way to the Supreme Court, if necessary." What advice should you give Teresa?

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.

8. [LO 2.1] *Taxpayer Penalties*

Do taxpayers face only monetary fines or can they be sentenced to jail?

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

9. [LO 2.1] *Statute of Limitations*

What is a statute of limitations? What is its significance to taxpayers?

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.

10. [LO 2.2] *Avoidance vs. Evasion*

What is the difference between tax avoidance and tax 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.

11. [LO 2.2] *Preparer Penalties*

Can tax return preparers be assessed 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.) 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.

12. [LO 2.2] *Sources of Guidance*

Name three sources of guidance for tax professionals.

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

13. [LO 2.2] *SSTS*

What are the *Statements on Standards for Tax Services*? Who issues them?

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.

14. [LO 2.2] *SSTS*

What guidelines are provided by the *Statement on Standards for Tax Services No. 3* regarding a CPA's reliance on information supplied by the client for use in preparing the client's tax return?

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.

15. [LO 2.2] *SSTS*

Statement on Standards for Tax Services No. 4 states that a CPA may use estimates in completing a tax return. When would using estimates be appropriate in tax return preparation?

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.

16. [LO 2.3] *Tax Planning vs. Compliance*

Distinguish tax planning from tax 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.

17. [LO 2.3] *Tax vs. Nontax Factors*

For each of the following independent situations, identify whether the item would be primarily a tax or a nontax factor in tax planning.

a. The taxpayer lost a quarter of her net worth when the dot-com bubble burst and does not want to own any investments with risk such as stocks.

b. The taxpayer hates to pay any federal income taxes and would rather pay an equal amount of money to an accountant or attorney than pay taxes to the federal government.

c. The taxpayer has a large capital loss carryforward from last year.

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.

18. [LO 2.3] *Marginal Tax Rates*

Beta Corporation anticipates $800,000 of taxable income for the year before considering additional projects. What marginal tax rate should it use in evaluating a project that may generate $200,000 of additional income?

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.

19. [LO 2.3] *Marginal Tax Rates*

Maria is a single individual with taxable income of $75,000 in 2016. What marginal tax rate should she use to determine the tax savings from a $2,000 deductible expense?

Solution: Maria should use a 25% tax rate because her income is between $37,650 and $91,150. Her tax savings will be $500 ($2,000 deduction x 25%).

20. [LO 2.3] *Tax Planning*
Identify three tax planning strategies.

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

21. [LO 2.3] *Business Purpose Doctrine*
Explain the 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.

22. [LO 2.4] *Primary vs. Secondary Authority*
What is the difference between primary authority and 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.

23. [LO 2.4] *Steps in Tax Research*
Describe the basic steps in performing tax research.

Solution: The basic steps include: (1) gather the facts and identify the issues, (2) locate the sources of authority, (3) evaluate the relevant authorities, and (4) communicate the recommendations.

24. [LO 2.4] *Tax Service*
What is a 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 and are usually available only through paid subscriptions.

25. [LO 2.4] *Committee Reports*
As a bill proceeds through Congress, various committee reports are generated. What three committee reports typically are generated as a result of this process?

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.

26. [LO 2.4] *Committee Reports*
Why are committee reports useful to a tax researcher?

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.

27. [LO 2.4] *Sections of Internal Revenue Code*
What uniquely numbered part of the Internal Revenue Code does a tax researcher usually cite?

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

28. [LO 2.4] *Regulation Citations*
In the citation Reg. §1.247-3, what do the 1 and the 247 indicate?

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.

29. [LO 2.4] *Types of Regulations*
What is the difference between a legislative regulation and an interpretative regulation?

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.

30. [LO 2.4] *Proposed vs. Temporary Regulations*
What is the difference between proposed and temporary regulations? What weight do they carry?

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.

31. [LO 2.4] *Letter Ruling vs. Revenue Ruling*
What is the difference between a letter ruling and a 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.

32. [LO 2.4] *Nonacquiescence*
What signal does the IRS give taxpayers to indicate that a court decision will not be followed?
Solution: To signal disagreement with a court decision, the IRS will publicly "nonacquiesce," indicating it will not follow the decision.

33. [LO 2.4] *Golsen Rule*
Explain the 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.

34. [LO 2.4] *Citator*
What information is found in a 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.

35. [LO 2.4] *Rule 155*
What does it mean when a Tax Court decision says that the decision has been entered under 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.

36. [LO 2.4] *Communicating Tax Research Results*
What are the two forms that practitioners use to communicate the results of their tax research?
Solution: Practitioners communicate the results through a memorandum to the client file and letter to the client.

37. [LO 2.4] *Memo to File*
What are the four sections of a memo to the file? Explain what each section should include.
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.

Crunch the Numbers

38. [LO 2.1] *Penalties*

Adam files his tax return on April 15 and his tax return shows that he owes $3,000. Due to some bad planning, Adam could not pay his taxes when filing his tax return. Adam finally made his payment in full on July 10. What is the late-payment penalty that Adam will be assessed?

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 x 0.5% x 3).

39. [LO 2.1] *Penalties*

Robert decided not to file his return on April 15 because he knew that he could not pay the balance due. He files his return on August 3, paying the full $4,000 balance. What are Robert's expected late-payment/late-filing 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% x 4 x $4,000 = $720, which is greater than the minimum $205 penalty) and a late payment penalty of 2 percent (0.5% x 4 x $4,000 = $80) for a total of 20 percent of the $4,000 balance due. He will be charged a total of $800 (20% x $4,000).

40. [LO 2.1] *Statute of Limitations*

Denise files her 2016 tax return on February 4, 2017. If there is no material understatement of income on her return and the return was properly signed and filed, when does the statute of limitations expire for Denise's 2016 tax return?

Solution: April 15, 2020. The three-year statute of limitations begins to run from the later of the due date or date of filing.

41. [LO 2.1] *Statute of Limitations*

Kevin deliberately omitted $40,000 of gross income from his restaurant on his 2016 tax return. The return indicated gross income of $200,000 when filed on April 14, 2017. When can the IRS no longer pursue Kevin with the threat of collection of the related tax, interest, and penalties?

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, 2020.

Once an assessment of tax is made, the IRS has 10 years within which to collect the taxes.

42. [LO 2.1] *Statute of Limitations*

Alison accidentally omitted $40,000 of gross income from the restaurant she owned on her 2015 tax return. The return showed gross income of $150,000 when filed on October 15, 2016. When can the IRS no longer pursue Alison with the threat of collection of the related tax, interest, and penalties (assuming there was no fraud)?

Solution: October 15, 2022. 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.
Once an assessment of tax is made, the IRS has 10 years within which to collect the taxes.

43. [LO 2.1] *Statute of Limitations*

Thomas received $30,000 in a legal settlement in 2016. The tax treatment of the item is not certain. Thomas's research results were ambiguous and he is not sure if the income is taxable. Because some doubt remained and because he did not think he would be audited, Thomas decided the income was not taxable and did not include it on his tax return filed on April 14, 2017. His gross income, excluding the $30,000 in question, was $50,000.

a. When does the statute of limitations expire for Tom's 2016 tax return?

b. Would your answer change if the IRS can provide fraud?

Solution: a. April 15, 2023. 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. If the IRS can prove fraud, there is no time limit (no statute of limitations) on when it can assess additional taxes, penalties, and interest.

44. [LO 2.3] *Income Shifting*

Cynthia and Howard, married taxpayers filing a joint return, have $100,000 in taxable income in 2016. They have 4 children (ages 4 through 12) who have no income that is taxable. If they can legally shift $2,000 in taxable income to each child, how much does the family save in taxes?

Solution: $1,620.

Tax on $100,000 for a married couple filing joint return [($100,000 - $75,300) x 25%] + $10,367.50	$16,542.50
Tax on $92,000 for a married couple filing joint return [($92,000 - $75,300) x 25%] + $10,367.50	(14,542.50)
Tax savings to parents ($8,000 x 25% marginal tax bracket)	2,000.00
Tax paid by children [($2,000 - $1,050 standard deduction) x 10% marginal tax rate] x 4 children	(380.00)
Net tax savings to family from income shifting	$1,620.00

(Note: The tax rate schedules and the standard deduction amounts are included in the Appendix at the end of the textbook. The standard deduction for a dependent child is limited to $1,050 as discussed in Chapter 5.)

45. [LO 2.3] *Changing Character of Income*

The 4,000 shares of Medco stock that Diana purchased 11½ months ago for $12 per share are now trading at $19 per share. Diana's regular marginal tax rate is 28 percent and her tax rate for long-term capital gains is 15 percent.

a. What is Diana's after-tax net cash flow from the sale if she sells the stock now?

b. What is Diana's after-tax net cash flow from the sale if she waits one month before selling the stock for $19 per share?
c. What do you recommend?

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 x ($19 - $12) x 28%]. Her after-tax cash inflow will be $68,160 [(4,000 x $19) - $7,840]. Subtracting her $48,000 (4,000 shares x $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 x ($19 - $12) x 15%]. Diana's after-tax cash inflow would be $71,800 [(4,000 x $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.

46. [LO 2.3] *Timing Issues*

Monico Corporation, a cash-basis calendar-year taxpayer, is in the 25 percent marginal tax bracket this year. If it bills its customers at the beginning of December, it will receive $5,000 of income prior to year-end. If it bills its customers at the end of December, it will not receive the $5,000 until January of next year.

a. If it expects its marginal tax rate to remain 25 percent next year, when should it bill its customers? Use a 6 percent discount factor to explain your answer.
b. How would your answer change if Monico's expected marginal tax rate next year is only 15 percent? Explain.
c. How would your answer change if Monico's expected marginal tax rate next year is 34 percent? Explain.

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 x 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 x .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 x 15% x .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 x 34% x .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).

47. [LO 2.3] *Timing Issues*

Kimo Corporation, a cash-basis, calendar-year taxpayer, is in the 25 percent marginal tax bracket this year. Kimo owes a $15,000 expense that it may pay before the end of this year or in January of next year.

a. If it expects its marginal tax rate to be 25 percent next year, should it pay the expense this year or next? Use a 7 percent discount factor to explain your answer.
b. How would your answer change if Kimo's expected marginal tax rate next year is only 15 percent? Explain.
c. How would your answer change if Kimo's expected marginal tax rate next year is 34 percent? Explain.

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 x 25%). If Kimo defers payment of the expense, its net present value of the after-tax savings will be $3,506 ($15,000 x 25% x .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 x 15% x .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 x 34% x .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).

Develop Planning Skills

48. [LO 2.3] *Sole Proprietorship vs. C Corporation*

Jessica plans to invest $150,000 in a second business. She expects to generate a 12 percent before-tax return on her investment the first year. Her marginal tax rate is 25 percent due to the income from her other business. She needs to decide whether to establish this second business as a sole proprietorship or a C corporation.

a. Compute the after-tax cash flow from a sole proprietorship if she withdraws 50 percent of the profits from the business the first year. (Ignore employment taxes.)
b. Compute the after-tax cash flow from a C corporation if she receives a dividend equal to 50 percent of the before-tax profits from the business the first year.

c. What nontax factors should Jessica consider in making this decision?
d. What do you recommend?

Solution: a. The sole proprietorship will generate $18,000 ($150,000 x 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 x 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 x 15%) on its income. Jessica will pay income tax of $1,350 [(50% x $18,000) x 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.

49. [LO 2.3] *Partnership vs. C Corporation*

Richard plans to invest $100,000 for a 50 percent interest in a small business. His friend, Jack, will also invest $100,000 for the remaining 50 percent interest. They expect to generate a 10 percent before-tax return on their investment the first year. Richard's marginal tax rate is 25 percent and Jack's marginal tax rate is 28 percent. They need to decide whether to establish the business as a partnership or a C corporation.

a. If they establish a partnership, compute the after-tax cash flow for each partner if each of them withdraws $4,000 of the profits from the business the first year. What is the amount of cash that remains in the partnership?
b. If they establish a C corporation, compute the after-tax cash flow for each shareholder if each of them receives a dividend of $4,000 from the profits of the business the first year. What is the amount of cash that remains in the C corporation?
c. What nontax factors should Richard and Jack consider in making this decision?
d. What do you recommend?

Solution: a. The partnership has income of $20,000 ($200,000 x 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 x 25%); Jack will pay income tax of $2,800 ($10,000 x 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 x 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 x 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.

Note that when employment taxes are considered (discussed in Chapter 4), the corporate form is even more attractive.

50. [LO 2.3] *Capital Gain vs. Ordinary Income*
Norman considers the purchase of some investment land from his neighbor, Robin, a high school math teacher. Robin purchased the land 10 years ago for $6,000. They have agreed on payments of $800 every month for the next three years for a total of $28,800. They have not agreed on how much of each payment is interest and how much is principal. Norman thought that a fair interest rate would be 8 percent with the rest of each payment allocated to principal. Robin, however, said that he wanted to "give his neighbor a break" and have only 4 percent designated as interest with the rest of each payment allocated to principal. What difference does it make to Norman and to Robin how much is allocated to interest versus principal if the total of the cash payments will not change? Which interest rate would be better for Norman?

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 the lower long-term capital gain rate.

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 Chapter 8).

51. [LO 2.3] *Loan vs. Sale of Property*

Debbie owns investment land that she purchased 10 years ago for $12,000. The land consists of two adjoining lots recently appraised at $80,000. She needs $40,000 cash for another investment opportunity and considers two alternatives: (1) sell half of the land for $40,000 or (2) borrow the $40,000 by taking out a mortgage on the land. Discuss the advantages and disadvantages of each alternative. What do you think Debbie should do?

Solution: (1) If Debbie sells the land, she will have a gain of $34,000 [$40,000 – (50% x $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% x $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% resulting in a tax of $6,800 (20% x 34,000). If she needs a total of $40,000, she will need to make up the $5,100 (or $6,800) 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% x $120,000) - $40,000]. After taxes, she will have an additional $17,000 [$20,000 x (1-.15)] or $16,000 [$20,000 x (1-.20)] 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 better 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.

52. [LO 2.3] *After-Tax Cash Flow*

The manager at Striker Corporation can hire either Ken, a marketing student, who will do research on a marketing plan, or Lisa, a tax student, who will research tax strategies to reduce corporate taxes. If she hires Ken, his wages and benefits will total $5,600 (all tax deductible expenses). Ken's marketing plan is expected to generate $6,000 in new revenues with a probability of success estimated at 80 percent. If she hires Lisa, her wages and benefits will be $6,000 (also fully tax-deductible). Lisa's tax plan is expected to save Striker $5,600 in federal income taxes. The probability of success for this plan is estimated to be 75 percent. Striker's marginal tax rate is 39 percent. Who should the manager hire?

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

		Ken		Lisa
Estimated pretax cash inflow		$6,000		$5,600
Probability of success		x 80%		x 75%
Expected pretax cash inflow		$4,800		$4,200
Tax on expected return (39%)		(1,872)		0
Expected after-tax cash inflow		$2,928		$4,200
Before-tax cost (outflow)	$(5,600)		$(6,000)	
Tax savings (39%)	2,184		2,340	
After-tax cost (outflow)		(3,416)		(3,660)
Net after-tax cash flow		$(488)		$540

53. [LO 2.3] *After-Tax Cash Flow*

Marlin Corporation must decide between two mutually exclusive projects because it lacks sufficient personnel to complete both projects. Each project takes two years to complete and the project selected will be Marlin's only source of taxable income for the two years. The first job would generate $360,000 of revenues in the first year and $80,000 in the second year. Marlin estimates that this job will incur $200,000 of expenses in the first year and $40,000 of expenses in the second year. The second job will generate $220,000 of revenues and $120,000 of expenses in each of the two years. Assuming a 7 percent discount rate, which project should Marlin accept?

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

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

Think Outside the Text

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

54. [LO 2.1] *Statute of Limitations*
From the perspective of both the taxpayer and the IRS, what are the advantages and disadvantages of the 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.

55. [LO 2.1] *Improving Compliance*
What type of penalty or incentive provision do you think would significantly improve compliance with the Internal Revenue Code? Do you think such a provision could be passed?

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.

56. [LO 2.3] *Advantages of Debt vs. Equity*
When Keith created a new corporation as the sole shareholder, he was advised by his accountant to treat 50 percent of the amount invested as a loan and 50 percent as a purchase of stock. Explain the advantages and disadvantages of this structure rather than a 100 percent stock purchase?

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.

57. [LO 2.1, 2.3 & 2.4] *Effect of Law Changes on Tax Planning*
Tax law provisions change over time. Explain how this affects tax planning and tax research.

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 superseded by law changes.

58. [LO 2.4] *Origination of Tax Bills*
Revenue-raising bills (such as tax bills) are supposed to originate in the House of Representatives. How could a senator initiate a tax bill?

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.

59. [LO 2.4] *Benefit of Rulings*
How do rulings issued by the IRS benefit both the IRS and taxpayers?

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.

Search the Internet

60. [LO 2.1] *Locate employment information for Internal Revenue Agent positions*
Go to *www.irs.gov* (the IRS Web site) and click on Careers under Work at IRS. Look under Students & Recent Grads, then under Opportunities, and finally look under Accounting, Budget & Finance to learn more about Internal Revenue Agent positions.

a. What are the basic requirements to work for the IRS as an Internal Revenue Agent at level GS-5?
b. What are the additional requirements to qualify for GS-7 and GS-9?

Solution: a. Entry at the GS-5 level requires 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. Qualifying at the GS-5 level is also possible by meeting one of the following requirements: (1) 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; (2) have a Certificate as a Certified Public Accountant (CPA) obtained through written examination in a state, territory or the District of Columbia; or (3) have a combination of education and experience that included at least 30 semester hours in accounting as outlined above.

b. Qualifying for GS-7 requires all of the GS-5 qualifications plus one of the following requirements: (1) earned a bachelor's degree with either a 3.0 ("B") GPA overall or 3.5 ("B+") on a 4.0 scale in all accounting courses; (2) ranked in the upper one-third of your graduating class; (3) possess membership in a national scholastic college honorary society above the freshman level that meets the requirements of the Association of College Honor Societies; or (4) have at least one year of graduate education in accounting, business, finance, law, economics, management, statistical/quantitative methods or computer science; (5) have at least one year of experience equivalent to the GS-5 level that required knowledge of, and skill in, applying principles, concepts and methodology of professional accounting and related fields; and skill in communicating and dealing with others; or (6) have at least one year of combined graduate education and experience as defined in paragraphs (4) and (5) above.

Qualifying for GS-9 requires all of the above requirements plus one of the following: (1) have a master's or equivalent degree, or two academic years of graduate education in accounting or the fields of business, finance, law, economics, management, statistical/quantitative methods or computer science; (2) have at least one year of experience equivalent to the GS-7 level that required knowledge of and skill in applying the principles, concepts and methodology of professional accounting and related fields, and skill in communicating and dealing effectively with others; or (3) have at least one year of combined graduate education and experience as defined in paragraphs (1) and (2) above. Only graduate education in excess of the amount required for the GS-7 level may be combined with experience to qualify for GS-9.

61. [LO 2.1] *Locate IRS Publication*
Go to *www.irs.gov* (the IRS Web site) and locate Publication 971: Innocent Spouse Relief. What form must be filed to request innocent spouse relief?

Solution: Form 8857

62. [LO 2.1] *Locate IRS Notice*
Go to *www.irs.gov/irb/* (the IRS site containing Internal Revenue Bulletins). Locate and read IRS Notice 2008-14, 2008-4 IRB 310 and answer the following questions.

a. What is the penalty for filing a frivolous tax return?

b. What are the first three broad categories cited in this notice as examples of frivolous positions?

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.

63. [LO 2.2] *Locate Circular 230*

Go to the IRS site (*www.irs.gov*) and search for "Circular No. 230." Download a copy of *Treasury Circular 230: Regulations Governing the Practice before the Internal Revenue Service.*

a. Read §10.33 and then list four best practices for tax advisors.

b. Read §10.37 regarding requirements for written advice. What six guidelines must a practitioner follow when giving written advice? Under what circumstances can a practitioner rely on the advice of others?

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. Under §10.37, practitioners must: (1) base the written advice on reasonable factual and legal assumptions (including assumptions as to future events); (2) reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know; (3) use reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter; (4) not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable; (5) relate applicable law and authorities to facts; and (6i) not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit

64. [LO 2.2] *Locate SSTS*

Go to *www.aicpa.org* (the AICPA's Web site) and search for *Statements on Standards for Tax Services*. Read the history section of the most recent version of the *Statements on Standards for Tax Services*. What reasons were provided for revising the SSTS?

Solution: Since the issuance of the original SSTSs, 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.

65. [LO 2.4] *Locate Definitions of Terms in Internal Revenue Bulletins*
Go to *www.irs.gov/irb/* (the IRS site containing Internal Revenue Bulletins). Locate the Definition of Terms section in a recent IRB. Differentiate between the following terms as used by the IRS in its rulings: amplified, modified, clarified, and distinguished.
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.

66. [LO 2.4] *Locate Tax Court Filing Fees*
Go to *www.ustaxcourt.gov* (the Tax Court site). What is the filing fee to file a small tax case?
Solution: The petition filing fee is $60.00.

Identify the Issues

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

67. [LO 2.4] *Medical Expense Deduction*
Your client, Barry Backache, suffers from a pain in the neck caused by arthritis. He installed a hot tub in his backyard. His doctor advised him that daily periods in the hot tub would relieve his pain in the neck.
Solution: Can Barry deduct any portion of the cost of the hot tub or its operating expenses as a medical expense deduction?

68. [LO 2.4] *Penalties*
Two months before the due date for his tax return, Simon provides his accountant with all of the information necessary for filing his return. The accountant was overworked during tax season and files the return after its due date.
Solution: Will Simon be assessed late filing penalties? What are his remedies if any penalties are assessed?

69. [LO 2.4] *Statute of Limitations*
Jennifer did not file a tax return for 2006 because she honestly believed that no tax was due.

In 2016, the IRS audits Jennifer and the agent proposes a deficiency of $500.

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

70. [LO 2.4] *Statute of Limitations*
On his 2011 tax return, Stewart inadvertently overstates deductions in excess of 25 percent of the adjusted gross income on his return. In 2016, the IRS audits Stewart and the agent proposes a deficiency of $1,000.

Solution: Does the statute of limitations prohibit the assessment of the additional tax?

71. [LO 2.4] *Evaluating Authority*
Georgia researched a major tax plan for a client. She discovered a case in a circuit that is not the client's circuit that is unfavorable to the client. She has also found a revenue ruling that appears to have facts similar to her client's that sanctions the preferred alternative.

Solution: Does the case or revenue rulings have more authority for the client? Can Georgia recommend the tax plan to her client without possible adverse consequences? Does the plan meet the requirement of having substantial authority upholding a realistic possibility of success?

72. [LO 2.4] *Realistic Possibility of Success*
Bert has developed a position for a client on a potential tax transaction that he believes has approximately a 25 percent chance of surviving in a judicial proceeding.

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

73. [LO 2.4] *Use of Estimates*
In preparing the client's tax return, Verne must use a number of estimates supplied by his client because the client's computer records were corrupted and the client has not been able to retrieve the correct numbers in time to file the return by its due date. The client's tax returns have always included cents as well as dollars.

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

74. [LO 2.4] *Error on Prior Year Return*
Jim was reviewing several of a client's prior tax returns in preparation for completing the current year's return. Jim discovered a serious error on the return filed almost three years earlier that would subject the client to $40,000 in additional taxes.

Solution: What course of action should Jim take as a result of discovering the error? Is Jim required to notify the IRS of the error? Can Jim continue to prepare the current year's return if the client does not want to correct the error?

75. [LO 2.4] *Deduction Disallowed in Prior Year*
Last year, the IRS disallowed a deduction on a client's tax return when it was audited. The client wants you to deduct a similar item on this year's tax return.

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 76 – 81 are in Instructor's Manual.