

Chapter 2

The Tax Practice Environment

True-False: Insert **T** for **True** or **F** for **False** before each question.

- _____ 1. The Internal Revenue Service is part of the Justice Department.
- _____ 2. If a firm's discount rate is higher than another firm's, the present value of its future cash flows will be higher.
- _____ 3. The business purpose doctrine requires a transaction to have an economic purpose other than one based solely on tax avoidance.
- _____ 4. If a project results in a loss, the tax effect causes a decrease in cash flow.
- _____ 5. Legal income shifting includes shifting income among relatives and between a business and its owner/employee.
- _____ 6. Tax avoidance is the minimization of the tax burden by using acceptable, legal alternatives.
- _____ 7. A transaction for which there is no legitimate business purpose is automatically assessed a 50% penalty.
- _____ 8. The Cumulative Bulletin contains reports of all the committees involved in tax writing as well as statements made on the floor of the House or Senate.
- _____ 9. A letter ruling can only be relied on by the taxpayer for whom it is written.
- _____ 10. A proposed regulation can be relied on when planning a transaction.
- _____ 11. The Internal Revenue Service has the burden of proof when it is asserting fraud with the intent to evade taxes on the part of the taxpayer.
- _____ 12. A memo to file for a client should be more detailed than the client letter.
- _____ 13. The Internal Revenue Service must pay interest on any refund that is not mailed within 30 days of the date the taxpayer's tax return is filed.
- _____ 14. The statute of limitations for a fraudulent return is 6 years.
- _____ 15. Circular 230 is issued by the AICPA to provide guidance on tax return preparation by CPAs.
- _____ 16. If a CPA finds an error on a previously filed tax return of a client, he or she must file an amended return to correct the error.
- _____ 17. Only CPAs, Enrolled Agents, and Attorneys who prepare tax returns for pay must obtain preparer tax identification numbers.

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Test Bank Answers: True-False

- | | | | | | | |
|-----------|-----------|-----------|-----------|----------|-----------|----------|
| 1. False | 2. False | 3. True | 4. False | 5. True | 6. True | 7. False |
| 8. False | 9. True | 10. False | 11. True | 12. True | 13. False | |
| 14. False | 15. False | 16. False | 17. False | | | |

Short-answer Questions: Provide a brief written answer to each of the following questions.

1. Explain how tax compliance differs from tax planning.
2. Explain the difference between a closed fact and an open fact transaction.
3. What are three factors that can affect the after-tax cash flow of a project? How does each affect this cash flow?
4. Explain what is meant by changing the character of income? Provide an example.
5. What is the difference between a primary and a secondary source of tax authority?
6. Explain the step transaction doctrine.
7. What is meant by the phrase “substance over form”?
8. What is the purpose of Treasury Regulations?
9. What are the steps that are usually required between introduction and passage of a revenue bill?
10. What is the difference between an interpretive regulation and a legislative regulation?
11. To which trial courts may a taxpayer contest a decision of the IRS?
12. Explain what is meant by the statute of limitations.
13. Explain the difference between tax avoidance and tax evasion.
14. When may a CPA use estimates in the preparation of a client’s tax return?
15. Which tax return preparers are required to obtain preparer tax identification numbers?

Test Bank Answers: Short-answer Questions

1. Tax compliance consists of gathering, evaluating and classifying the relevant information for filing a taxpayer’s tax return. Compliance deals primarily with transactions that have already taken place. Tax planning is the process of evaluating the tax consequences associated with a transaction that has yet to take place and making recommendations that will achieve the desired objectives with the least tax cost. Tax planning primarily deals with future transactions.
2. A closed fact transaction is one in which all of the relevant transactions have been completed.

In an open fact transaction, not all of the steps in the transaction are complete and there are opportunities to control the remaining steps.

3. The marginal tax rate affects the cash flow of a project. The higher the tax rate, the lower the profits on the cash inflow as taxes must be paid on the profit. If there is a loss, however, the higher tax rate lessens the loss due to the offset of the loss against other income.

The discount rate affects the net present value of cash flow. The lower the rate, the greater the net present value will be; the higher the rate, the lower the net present value of the cash flow.

The timing of the receipt of the cash flows affects the net present value. The shorter the time period to recovery, the greater the net present value. The longer the time to recovery, the lower the net present value.

Accelerating revenues or postponing expenses will increase the net present value due to the timing of their recognition.

4. Certain types of income may be taxed at different rates. Changing one type of income into another type changes its character and may change how it is taxed. For example, generally capital assets held one year or less are taxed at the tax rates for ordinary income found in the tax rate schedules. Capital assets held more than one year are eligible for special long-term capital gains tax rates that are less than the regular tax rates.

5. Primary sources of tax authority come from statutory, administrative, and judicial sources. Secondary sources consist of tax services (reference services), books, journals and newsletters; these are used to assist researchers in locating and interpreting the primary sources.

6. The step transaction doctrine is normally used to collapse a series of transactions that are dependent on each other into fewer transactions; this collapsing (ignoring intermediate transactions) can radically change the outcome for tax purposes. For example, Joe sells loss property to Bill, recognizing the loss; by prearrangement, Bill then sells the property to Joe's brother. If Joe sold the property directly to his brother he could not have recognized the loss. The Internal Revenue Service can collapse the two sales into the direct sale from Joe to his brother and disallow the loss recognition.

7. The phrase "substance over form" means that the taxation of a transaction will be determined by the reality of the transaction rather than its appearance. For example, a corporation sells property to its sole shareholder at an extremely low price. In reality, this is a part sale and a part dividend distribution (for the bargain element built into the purchase price).

8. Treasury regulations explain, interpret, and provide definitions and examples for the language of the Internal Revenue Code.

9. a. A revenue bill is introduced into the House of Representatives. b. It is generally referred to the House Ways and Means Committee that holds public hearings on the bill. c. The bill is then sent to the floor of the House where it is debated and then voted on. d. If passed, the bill goes to the Senate where it is referred to the Senate Finance Committee. e. The Senate Finance Committee also holds hearings and analyzes the bill, possibly attaching amendments. f. The bill goes to the Senate floor for debate and vote. g. If the bills passed by the House and the Senate differ, they are referred to the Joint Conference Committee to work out differences. h. A compromise bill is then sent back to the House and the Senate. i. After passage by both houses, it is sent on to the President for his signature.

10. Interpretive regulations provide examples and detailed explanations to help interpret the Code. A legislative regulation provides the details of the meaning and rules for a particular Code section as

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directed by the Code. Legislative regulations are considered to have the same level of authority as the Code.

11. The three courts of original jurisdiction to which a taxpayer may contest a decision of the IRS are the Tax Court, the Federal District Courts, and the U.S. Court of Federal Claims. If the taxpayer is dissatisfied with the decision of the particular court that heard the case, the taxpayer may appeal that decision to the appropriate appellate court. Finally, the appellate court decision could be appealed to the U. S. Supreme Court.

12. The statute of limitations is the period of time beyond which legal actions or changes to the tax return cannot be made by either the taxpayer or the government. Under most circumstances, the IRS cannot challenge a tax return later than three years after its due date or the date it was filed, if later.

13. Tax avoidance is the lawful use and interpretation of the tax laws in a manner that minimizes taxes. Tax evasion is the deliberate ignoring of a tax law to reduce taxes and is illegal.

14. A CPA may use estimates to prepare a tax return when actual data is unavailable at the time of filing or missing. A taxpayer may have been the subject of a casualty loss that destroyed records or a computer failure may prevent the recovery of a complete set of financial records. In such a case, the return should not imply greater accuracy than the estimates permit.

15. All persons who prepare tax returns for payment, or who employ one or more persons who are paid for the preparation of all or a substantial portion of a federal tax return or claim for refund, must obtain a PTIN, a Paid Preparer Tax Identification Number.

Problems: Provide numerical solutions for each of the following.

Note to Instructor: The following problems require either present value and/or future value tables (provided in Appendix B of the text on pages 594-595) to solve: Problems 1, 2, and 3.

1. Berman Corporation can accept only one of two projects. The revenue and expenses for each of the projects is shown below. Which project should Berman accept if the corporation has a 10 percent cost of capital and a 34 percent marginal tax rate?

		<u>Project A</u>	<u>Project B</u>
Year 1	Revenue	\$800,000	\$700,000
	Expenses	525,000	500,000
Year 2	Revenue	600,000	700,000
	Expenses	425,000	550,000

2. What is the after-tax net present value of a project costing \$600,000 that Plud Corporation can invest in, if the project has the following estimated revenues and expenses?

	Initial cost	\$ 600,000
Year 1	Revenue	2,000,000
	Expenses	1,450,000
Year 2	Revenue	1,800,000
	Expenses	1,250,000

Plud uses an 8 percent discount rate for evaluation and expects a 34 percent marginal tax rate in the relevant years.

3. Carol wants to invest in a project that requires a \$20,000 investment. She expects a before-tax return of \$16,000 in years 1 through 3 from this investment. She uses a 6 percent discount rate for evaluation

but is not sure if her marginal tax rate will be 15 percent or 25 percent. What difference does the marginal tax rate make in the after-tax net present value of this investment?

4. Cynthia and John have dependent twins ages 18. Their joint income places them in the 33 percent marginal tax bracket. What are their total tax savings if they can transfer \$2,000 of taxable income to each of the children? The children have no other taxable income.
5. Shelly runs a small business as a sole proprietorship. The business has average annual income of \$60,000 and Shelly takes \$30,000 out of the business for living expenses each year. If her marginal tax rate is 25 percent due to other income, what is the net income tax effect if she incorporates her business and takes the \$30,000 as salary? (Ignore employment taxes.)
6. William purchased 10,000 shares of stock for \$10 per share late last month. Due to a proposed hostile takeover of the company, the stock has jumped in price to \$16 per share. If he holds the stock for at least a full year, he believes the price will decline to \$14 per share but he will be eligible for the 15 percent long-term capital gains rate for his gain. If he sells now, his gain will be subject to his 33 percent marginal tax rate. Should William sell now or wait one year? Use a one-year present value factor of .909 in your evaluation.
7. Claudia owns business property that has increased in value by \$20,000. If she sells now, three weeks before the end of the tax year, it will be subject to her current 33 percent marginal tax rate. If she waits until the beginning of the next year, she expects her marginal tax rate to decrease to 25 percent. How much more tax will she pay if she sells now rather than waiting the three weeks until next year?
8. Kitty's tax return, which she filed on April 15, showed a balance due of \$8,500. She did not have the money to pay this amount. On September 20, she was finally able to borrow sufficient money to pay the debt. What is Kitty's late payment penalty?
9. Joaquin did not have any money to pay his \$2,000 tax liability on April 15 so he did not file his tax return. He finally filed the return on July 25 and paid \$1,000 of the tax due. He paid the remaining tax due on October 18. What is his total penalty?
10. Walter did not file his 2013 tax return that was due April 15, 2014 until June 2, 2014.
 - a. When does the statute of limitations expire for this return assuming he did not file for an automatic extension?
 - b. When does the statute of limitations expire if Walter forgot to report a land sale that occurred on January 10, 2013? He had a \$20,000 gain on the transaction and he reported gross income for 2013 of \$75,000?
 - c. When does the statute of limitations expire if Walter deliberately omitted the \$20,000 gain on the land sale?
11. Charley Careless had not read much about the preparer penalties that could be assessed for failure to have substantial authority for certain tax positions taken on his client's returns. He prepared a return for one of his clients with an issue that was clearly a problem. If he was paid \$4,000 for the tax return preparation, how much would his potential fine be under the following circumstances:
 - a. Charley should have known that the position did not have a reasonable possibility of success but had failed to do any research.
 - b. Charley knew the position was "iffy" but disclosed the problem.
 - c. Charley knew the position could not be supported but the client expected Charley to get him a large refund.

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12. William just did not like figuring out his taxes each year and he usually had so little income that he didn't owe taxes. He never filed an extension even though he seldom got around to filing before October or November. He finally filed his 2012 return in September of 2013 when he remembered he had sold some stock in early 2012 for a small profit. Unfortunately, he owed \$125 in taxes because of the sale. What is William's failure to file penalty?

Test Bank Answers: Problems

1. PV of Project A: $[\$275,000 \times (1 - .34) \times .909] + [\$175,000 \times (1 - .34) \times .826] = \$260,386.50$

PV of Project B: $[\$200,000 \times (1 - .34) \times .909] + [\$150,000 \times (1 - .34) \times .826] = \$201,762$

Project A should be undertaken.

2. Year 1: $\$550,000 \times (1 - .34) \times .926 = \$336,138$; Year 2: $\$550,000 \times (1 - .34) \times .857 = \$311,091$;
NPV = $\$336,138 + \$311,091 - \$600,000 = \$47,229$

3. 25% tax rate: $(\$16,000 \times .75 \times .943) + (\$16,000 \times .75 \times .890) + (\$16,000 \times .75 \times .840) = \$32,076$

15% tax rate: $(\$16,000 \times .85 \times .943) + (\$16,000 \times .85 \times .890) + (\$16,000 \times .85 \times .840) = \$36,353$

Difference = $\$36,353 - \$32,076 = \$4,277$ with the lower tax rate.

4. Children's tax: $(\$2,000 - \$1,000 \text{ Std. Deduction}) \times .10 \times 2 = \200 ; Parents' tax savings: $\$4,000 \times .33 = \$1,320$. Net tax savings = $\$1,320 - \$200 = \$1,120$

5. Shelly's tax with business as sole proprietorship: $\$60,000 \times .25 = \$15,000$

Corporation: $(\$60,000 - \$30,000 \text{ salary}) \times .15 = \$4,500$;

Shelly's tax on salary: $\$30,000 \times .25 = \$7,500$; Total tax = $\$4,500 + \$7,500 = \$12,000$.

Tax savings as corporation = $\$15,000 - \$12,000 = \$3,000$

6. Sell now: $\$60,000 \times .33 = \$19,800$ tax; net value = $\$160,000 - \$19,800 = \$140,200$

Hold one year: $\$40,000 \times .15 = \$6,000$; net value = $(\$140,000 - \$6,000) \times .909 = \$121,806$

William should sell now and pay the higher tax.

7. Sell now: $\$20,000 \times .33 = \$6,600$; Sell later: $\$20,000 \times .25 = \$5,000$;

Tax savings by waiting = $\$6,600 - \$5,000 = \$1,600$. She will also defer the payment of the tax for a year resulting in additional savings.

8. 6 months $\times .005 \times \$8,500 = \255

9. (4 months $\times .05 \times \$2,000$) + (3 months $\times .005 \times \$1,000$) = $\$415$

10. a. June 2, 2017

b. June 2, 2020 ($\$20,000/\$75,000$ is more than 25%)

c. If the IRS can prove fraud, there is no statute of limitations.

11. a. $\$2,000$

b. None with disclosure

c. $\$5,000$

12. William's failure to file because of neglect will cost him another \$125 as he is over 60 days late filing and the minimum penalty is the smaller of the amount of tax owed (\$125) or \$135.

Other Objective Questions

1. Place in order the steps in the tax legislative process from the list below:

- ___ a. The bill is referred to the House Ways and Means Committee
- ___ b. The bill is referred to the Joint Conference Committee
- ___ c. A member of the House introduces the tax bill
- ___ d. The bill is forwarded to the President for his signature
- ___ e. The Senate votes on the bill
- ___ f. The House votes on the bill
- ___ g. The bill is referred to the Senate Finance Committee
- ___ h. The Conference Committee sends the bill back to the House and the Senate

2. For each entry in the following list, indicate with a **P** if it is a **primary** source of tax law or an **S** if it is a **secondary** source of tax law.

- | | |
|--------------------------------------|---|
| ___ a. A tax textbook | ___ f. Internal Revenue Code |
| ___ b. Tax Court Decision | ___ g. A Court of Federal Claims decision |
| ___ c. <i>Kiplinger Tax Letter</i> | ___ h. Committee reports |
| ___ d. <i>Journal of Accountancy</i> | ___ i. <i>The Tax Adviser</i> |
| ___ e. Legislative regulations | ___ j. Revenue ruling |

Test Bank Answers: Other Objective Questions

1. Order of steps: c, a, f, g, e, b, h, d.

2. a. S; b. P; c. S; d. S; e. P; f. P; g. P; h. P; i. S; j. P

Multiple Choice: Select the best answer for each of the following questions.

Note to Instructor: The following multiple choice questions require either present value and/or future value tables (provided in Appendix B of the text on pages 594-595) to solve: MC 5, 6, 7, 8, 9, 10, 16, and 17.

1. All of the following are primary sources of tax law except:

- a. Internal Revenue Code
- b. Treasury regulations
- c. Report of the House Ways and Means Committee
- d. Supreme Courts Decisions
- e. All are primary sources of the tax law

2. All of the following are part of the tax research process except:

- a. Establish the facts
- b. Locate relevant authority
- c. Identify the issues
- d. Communicate the findings
- e. All are part of the tax research process

3. The Internal Revenue Service is part of:

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- a. The Office of Budget and Management
 - b. The Justice Department
 - c. The Treasury Department
 - d. Congress
4. Coral Corporation (a C corporation) sold \$100,000 of merchandise for which it paid \$40,000. It also paid \$35,000 of other expenses. All transactions were in cash. What is Coral Corporation's after-tax net cash inflow?
- a. \$100,000
 - b. \$60,000
 - c. \$25,000
 - d. \$21,250
5. James can invest in a project that will cost \$70,000. The project is expected to pay him \$95,000 after-tax in 5 years. What is the maximum discount rate, as a whole number, that he could use to evaluate the project that would yield a positive cash flow?
- a. 5%
 - b. 6%
 - c. 7%
 - d. 8%
6. Copp Co. can invest in a project that costs \$200,000. It is expected to provide a lump sum after-tax return of \$300,000. If Copp uses an 8 percent discount rate for evaluation, in what year must it recover the \$300,000 to produce a positive net cash flow?
- a. 3rd year
 - b. 4th year
 - c. 5th year
 - d. 6th year
7. CK Corporation can invest \$100,000 in a project. After taxes, the project is expected to generate \$40,000 of net income the first year and \$75,000 of net income the second year. If the company uses a 10 percent discount rate to evaluate projects, what is the project's net cash flow?
- a. \$15,000
 - b. \$1,690
 - c. (\$1,690)
 - d. (\$1,315)
8. Merced Company has invested \$200,000 in a project. It had before tax net income of \$100,000 in year 1, \$150,000 in year 2, and \$125,000 in year 3. What is the net present value of this project's after-tax net cash flow if Merced's discount rate is 8 percent and its marginal tax rate is 34 percent in all years?
- a. \$11,464
 - b. \$120,000
 - c. \$211,464
 - d. \$320,400
9. Jacko Corporation has two projects in which it can invest. Project A has a \$500,000 initial cost and will return \$700,000 after tax in 4 years. Project B has a \$300,000 initial cost and its after-tax returns will be \$150,000 in year 1 and \$200,000 in year 2. Using a 7 percent discount rate for evaluation, which project(s) should Jacko invest in?
- a. Project A
 - b. Project B

- c. Both projects
 - d. Neither project
10. Peanut Co. has 2 projects in which it can invest. Project X has a \$300,000 initial cost and will return \$600,000 before tax in year 2. Project Y has \$600,000 initial cost and will return \$1,000,000 before tax in year 4. The company uses an 8 percent discount rate for project evaluation and its marginal tax rate is expected to be 34 percent in all years. Which project(s) should Peanut Co. invest in?
- a. Project X
 - b. Project Y
 - c. Both projects
 - d. Neither project
11. Changing which of the following factors as indicated would increase the after-tax net cash flow of a project:
- a. Delaying revenue recognition
 - b. Increasing the discount rate
 - c. Delaying expense recognition
 - d. Increasing the marginal tax rate
 - e. None increase cash flows
12. Changing which of the following factors as indicated would decrease the after-tax net cash flow of a project:
- a. Delaying the years in which inflows occur
 - b. Delaying revenue recognition
 - c. Increasing the discount rate
 - d. All decrease cash flows
 - e. None decrease cash flows
13. What effect does an increased discount rate have on project evaluations?
- a. Increases net cash flow
 - b. Decreases net cash flow
 - c. Increases the probability that a project will be accepted
 - d. It has no effect on project evaluation
14. How much tax can be saved if John shifts \$2,000 of income to his 18 year old dependent son? John is in the 25 percent tax bracket and his son has no other taxable income in 2013.
- a. \$1,000
 - b. \$500
 - c. \$400
 - d. \$100
15. How much tax can Charles save if he holds stock on which he has a \$30,000 short-term gain until he can use the applicable 15 percent long-term capital gains tax rate? He is in the 25 marginal tax rate for individuals.
- a. \$6,000
 - b. \$4,500
 - c. \$3,000
 - d. \$2,250
16. Carl is unsure of which rate he should use as a discount rate for project evaluations, 7 percent or 10 percent. If he can invest \$30,000 in a project that will return \$40,000 after-tax in four years, what is the result?

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- a. He will always reject the project
 - b. He will reject the project if he uses 10%
 - c. He will reject the project if he uses 7%
 - d. He will reject neither project
17. Crispen Corporation can invest in a project that costs \$400,000. The project is expected to have an after-tax return of \$250,000 in each of years 1 and 2. Crispen normally uses a 10 percent discount rate to evaluate projects but feels it should use 12 percent to compensate for inflation. How much difference does the rate make in the after-tax net present value of the project?
- a. \$50,000
 - b. \$22,500
 - c. \$20,000
 - d. \$11,250
18. The business purpose doctrine:
- a. Requires a transaction to be initiated by a business
 - b. Requires a transaction to benefit the business owner
 - c. Requires the transaction to have an economic purpose other than tax avoidance
 - d. Requires the treatment of a transaction to be based on reality not appearances
19. Which of the following committees is not involved in the tax writing process?
- a. Ways and Means
 - b. Joint Conference
 - c. Judiciary
 - d. Senate Finance
20. The Internal Revenue Code is divided into
- a. Chapters and sections only
 - b. Titles and subtitles only
 - c. Subtitles, chapters, subchapters and sections
 - d. Titles, chapters and sections
21. The primary source of tax authority that provides explanations, definitions, and examples of tax laws is the
- a. Code
 - b. Revenue rulings
 - c. Regulations
 - d. Letter rulings
22. A decision in the small case division of the Tax Court can be appealed only to
- a. Court of Appeals
 - b. Supreme Court
 - c. Regular Tax Court
 - d. Federal District Court
 - e. None of the above
23. Which of the following has the least weight of authority when deciding a tax issue?
- a. Code
 - b. Committee Reports
 - c. Regulations
 - d. Letter ruling

24. What is the unextended due date for a corporation with a March 31 year-end?
 - a. April 15
 - b. May 15
 - c. June 15
 - d. July 15
25. An individual may apply for an automatic extension of time to file a return of
 - a. Extensions are not permitted
 - b. 3 months
 - c. 4 months
 - d. 6 months
26. Which of the following types of returns does not have an unextended due date of the 15th day of the 4th month after the end of the tax year?
 - a. S corporations
 - b. Partnerships
 - c. Individuals
 - d. Trusts
27. What is the penalty for taxpayers who fail to pay their tax liability on a timely basis based on the taxes owing?
 - a. 5% per month
 - b. 2% per month
 - c. 0.5% per month
 - d. \$100 per month
28. What is the minimum penalty for a taxpayer who fails to file his or her return for over 60 days past the due date without reasonable cause?
 - a. The amount owed on the return
 - b. \$135
 - c. The amount owed on the return or \$135, whichever is less
 - d. 4.5% of the amount owed on the return.
29. The statute of limitations for a return that inadvertently overstates expenses by 30 percent of gross revenues is
 - a. 3 years
 - b. 6 years
 - c. 10 years
 - d. Unlimited
30. The Internal Revenue Service program that is designed to uncover easily identified errors or problems is
 - a. The DIF score
 - b. Manual return examination
 - c. Mathematical/clerical error program
 - d. Field audit
31. What is the first notice of a proposed deficiency that a taxpayer receives?
 - a. Examination letter
 - b. 90-day letter

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- c. 60-day letter
 - d. 30-day letter
32. To which court can a taxpayer appeal an IRS deficiency notice without paying the tax?
- a. District Court
 - b. Tax Court
 - c. Court of Federal Claims
 - d. Court of Appeals for the Federal Circuit
33. Which penalty is equal to 75 percent of the tax underpayment?
- a. Failure to file
 - b. Failure to pay
 - c. Negligence
 - d. Fraud
34. An offer in compromise is initiated by
- a. The Tax Court
 - b. A Revenue agent
 - c. The taxpayer
 - d. IRS General Council
35. If a tax preparer is convicted of criminal tax evasion, the preparer may be subject to a penalty of
- a. a \$100,000 fine only
 - b. prison only
 - c. Both a and b
 - d. Neither a nor b
36. Failure to follow the AICPA Code of Conduct can result in
- a. A fine
 - b. Suspension
 - c. Expulsion
 - d. Both a and b
 - e. Either b or c
37. Which of the following does not deal with a CPA's standard of conduct
- a. Treasury Circular 230
 - b. AICPA Code of Conduct
 - c. Internal Revenue Service Manual
 - d. Statement of Standards for Tax Services
38. Which of the following is not one of the Statements on Standards for Tax Services?
- a. Tax Return Positions
 - b. Discovery of Fraud
 - c. Use of Estimates
 - d. Departure from a Previous Position
39. A high DIF score indicates which of the following?
- a. The taxpayer is likely to get a refund
 - b. The taxpayer's chances of audit are substantially less than 2%
 - c. IRS will automatically grant an extension of time to appeal
 - d. The taxpayer's chances of audit are fairly high

40. Eduardo filed his 2013 tax return on March 15, 2014. Eduardo accidentally omitted \$10,000 of income from his individual tax return. The total gross income shown on the tax return was \$35,000. When will the statute of limitations expire for Eduardo's 2013 tax return?
- March 15, 2017
 - March 15, 2020
 - April 15, 2017
 - April 15, 2020
41. Which of the following is not a requirement to qualify for innocent spouse relief?
- The individual electing innocent spouse relief must have been abandoned by her spouse for more than 6 months.
 - The individual establishes that she did not know and had no reason to know that there was an understatement
 - It would be inequitable to hold the individual liable for the deficiency attributable to the understatement when all facts and circumstances are considered
 - The individual elects innocent spouse relief within the time period that the statute of limitation is open for collection activities.
42. If a tax return preparer prepares a return that involves a "listed transaction," the preparer can avoid all penalties if
- the position is not unreasonable.
 - the position has a possibility of success.
 - the preparer has substantial authority for the position
 - the position has no support but there is no evidence of fraud.
43. Which of the following paid tax return preparers must have a preparer tax identification number?
- CPAs
 - Attorneys
 - Enrolled Agents
 - All of the above

Test Bank Answers: Multiple Choice

- e
- e
- c
- d; $\$25,000 \times .15 = \$3,750$; $\$25,000 - \$3,750 = \$21,250$
- b; $\$70,000/\$95,000 = .7368$; At 5 years: 7% factor = .713; 6% factor = .747
- c; $\$200,000/\$300,000 = .667$; At 8% discount, 5-year factor = .681; 6-year factor = .630
- c; $\$40,000 \times .909 = \$36,360$; $\$75,000 \times .826 = \$61,950$; $\$36,360 + \$61,950 - \$100,000 = (\$1,690)$
- a; $\$100,000 (1 - .34) \times .926 = \$61,116$; $\$150,000 (1 - .34) \times .857 = \$84,843$; $\$125,000 (1 - .34) \times .794 = \$65,505$; $\$61,116 + \$84,843 + \$65,505 - \$200,000 = \$11,464$
- c; $(\$700,000 \times .763) - \$500,000 = \$34,100$; $(\$150,000 \times .935) + (\$200,000 \times .873) - \$300,000 = \$14,850$
- a; Project X: $\$600,000 (1 - .34) (.857) - \$300,000 = \$39,372$. Project Y: $\$1,000,000 (1 - .34)(.735) - \$600,000 = (\$114,900)$
- c
- d
- b
- c. $\$2,000 \times .25 = \500 ; $(\$2,000 - \$1,000) \times .10 = \$100$; $\$500 - \$100 = \$400$

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15. c. $(25\% - 15\%) \times \$30,000 = \$3,000$
16. b; $\$40,000 \times .763 = \$30,520$; $\$30,520 - \$30,000 = \$520$; $\$40,000 \times .683 = \$27,320$; $\$27,320 - \$30,000 = (\$2,680)$
17. d; 10%: $\$250,000 \times (.909 + .826) = \$433,750$; $\$250,000 \times (.893 + .797) = \$422,500$; $\$433,750 - \$422,500 = \$11,250$
18. c
19. c
20. c
21. c
22. e
23. d
24. c
25. d
26. a
27. c
28. c
29. a; the 6-year limit only applies when income is omitted.
30. c
31. d
32. b
33. d
34. c
35. c
36. e
37. c
38. b
39. d
40. d
41. a
42. c
43. d

Appendix 2

True-False: Insert **T** for **True** and **F** for **False** before each question.

- _____ 1. The Golsen rule requires the Tax Court to follow all other Federal District Court decisions in the same Circuit.
- _____ 2. Acquiescence by the Internal Revenue Service's Commissioner means that the IRS will follow the decision in the future.

Test Bank Answers: True-False

1. False 2. True

Short-answer Questions: Provide a brief written answer to each of the following questions.

1. What is the difference between a letter ruling and a revenue ruling?
2. What is meant when the Commissioner of the Internal Revenue Service acquiesces to a court decision?

3. Explain the Golsen rule.

Test Bank Answers: Short-answer Questions

1. Revenue rulings, published by the IRS, clarify ambiguous tax situations for which the public needs administrative guidance. Taxpayers who have fact situations that mirror those in the ruling may rely on the ruling for guidance as to the tax outcome of a particular transaction.

A letter ruling provides guidance on how a particular transaction will be taxed, but it is written for a specific taxpayer's prospective transaction and, technically, the tax result applies only to that taxpayer.

2. When the Commissioner of the Internal Revenue Service acquiesces to a court decision, it means that similar disputes will be settled in a manner consistent with the outcome established in the acquiesced case.

3. The Golsen rule requires the Tax Court to follow the Court of Appeals that has direct jurisdiction over the taxpayer in question. Alternatively, however, it also allows the Tax Court to reach opposite decisions for taxpayers in different jurisdictions, even though the cases have identical facts, as long as there has been no contrary Court of Appeals decision. The Tax Court is only bound to follow a decision of the Court of Appeals in the taxpayer's district.

Multiple Choice: Select the best answer for each of the following questions

1. The document that provides the application of the law to a particular set of facts is a
 - a. Regulation
 - b. Revenue Ruling
 - c. Revenue Procedure
 - d. Information Release
2. The principal reason a researcher uses a tax service is to
 - a. provide explanations of relevant case law
 - b. provide discussions of key issues related to specific Code sections
 - c. provide citations to primary sources of authority
 - d. provide answers to specific issues
3. Jury trials are only available in
 - a. Court of Appeals
 - b. Supreme Court
 - c. Regular Tax Court
 - d. Federal District Court
 - e. None of the above
4. The Golsen Rule
 - a. requires the Tax Court to follow the decisions of the District Courts
 - b. can result in opposite holdings on identical facts in the Tax Court
 - c. requires the Supreme Court to hear cases in which the holdings of the Appellate Courts differ
 - d. applies to the US Federal District Court only
5. A citator
 - a. provides a history of a court case
 - b. provides lists of other decisions that cite a particular case

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- c. provides an alphabetical listing of court cases
- d. provides a numerical listing of Revenue Rulings
- e. All of the above

Test Bank Answers: Multiple Choice

- 1. b
- 2. c
- 3. d
- 4. b
- 5. e