Chapter 1
An Introduction to Tax

SOLUTIONS MANUAL

Discussion Questions

1. [LO 1] Jessica's friend Zachary once stated that he couldn't understand why someone would take a tax course. Why is this a rather naïve view?

   Taxes are a part of everyday life and have a financial effect on many of the major personal decisions that individuals face (e.g., investment decisions, evaluating alternative job offers, saving for education expenses, gift or estate planning, etc.).

2. [LO 1] What are some aspects of business that require knowledge of taxation? What are some aspects of personal finance that require knowledge of taxation?

   Taxes play an important role in fundamental business decisions such as the following:
   - *What organizational form should a business use?*
   - *Where should the business locate?*
   - *How should business acquisitions be structured?*
   - *How should the business compensate employees?*
   - *What is the appropriate mix of debt and equity for the business?*
   - *Should the business rent or own its equipment and property?*
   - *How should the business distribute profits to its owners?*

   One must consider all transaction costs (including taxes) to evaluate the merits of a transaction.

   Common personal financial decisions that taxes influence include: choosing investments, retirement planning, choosing to rent or buy a home, evaluating alternative job offers, saving for education expenses, and doing gift or estate planning.

3. [LO 1] Describe some ways in which taxes affect the political process in the United States.

   U.S. presidential candidates often distinguish themselves from their opponents based upon their tax rhetoric. Likewise, the major political parties generally have very diverse views of the appropriate way to tax the public. Determining who is taxed, *what is taxed, and how much is taxed are difficult questions. Voters must have a basic understanding of taxes to evaluate the merits of alternative tax proposals offered by opposing political candidates and their political parties.*

4. [LO 2] Courtney recently received a speeding ticket on her way to the university. Her fine was $200. Is this considered a tax? Why or why not?

   The $200 speeding ticket is not considered a tax. Instead, it is considered a fine or penalty. Taxes differ from fines and penalties because taxes are not intended to punish or prevent illegal behavior.

5. [LO 2] Marlon and Latoya recently started building a house. They had to pay $300 to the county government for a building permit. Is the $300 payment a tax? Why or why not?

   The building permit is not considered a tax because $300 payment is directly linked to a benefit that they received (i.e., the ability to build a house).

6. [LO 2] To help pay for the city's new stadium, the city of Birmingham recently enacted a 1 percent surcharge on hotel rooms. Is this a tax? Why or why not?

   The 1 percent surcharge is a tax. The 1 percent surcharge is an earmarked tax – i.e., collected for a specific purpose. The surcharge is considered a tax because the tax payments made by taxpayers do not directly relate to the specific benefit received by the taxpayers.

7. [LO 2] As noted in Example 1-2, tolls, parking meter fees, and annual licensing fees are not considered taxes. Can you identify other fees that are similar?

   There are several possible answers to this question. Some common examples include entrance fees to national parks, tag fees paid to local/state government for automobiles, boats, etc.

8. [LO 2] If the general objective of our tax system is to raise revenue, why does the income tax allow deductions for charitable contributions and retirement plan contributions?

   In addition to the general objective of raising revenue, Congress uses the federal tax system to encourage certain behavior and discourage other behavior. The charitable contribution deduction is intended to encourage taxpayers to support the initiatives of charitable organizations, whereas deductions for retirement contributions are intended to encourage retirement savings.

9. [LO 2] One common argument for imposing so-called sin taxes is the social goal of *reducing* demand for such products. Using cigarettes as an example, is there a segment of the population that might be sensitive to price and for whom high taxes might discourage purchases?

   The most obvious segment sensitive to price may be teenagers and younger adults, although price sensitivity will vary by taxpayer.

10. [LO 3] Dontae stated that he didn't want to earn any more money because it would "put him in a higher tax bracket." What is wrong with Dontae's reasoning?

    Although earning additional taxable income may increase Dontae's marginal tax rate (i.e., put him in a higher tax bracket), the additional income earned does not affect the taxes that Dontae will pay on his existing income. Moving to a higher tax bracket simply means that Dontae will pay a higher tax rate on the additional income earned (not income that he already has).

11. [LO 3] Describe the three different tax rates discussed in the chapter and how taxpayers might use them.

    The marginal tax rate is the tax rate that applies to the taxpayer's additional taxable income or deductions that the taxpayer is evaluating in a decision. Specifically,

$$\textit{Marginal Tax Rate} = \frac{\Delta Tax}{\Delta TaxableIncome} = \frac{(NewTotalTax - OldTotalTax)}{(NewTaxableIncome - OldTaxableIncome)}$$

The marginal tax rate is particularly useful in tax planning because it represents the rate of taxation or savings that would apply to additional taxable income or tax deductions.

The average tax rate represents the taxpayer's average level of taxation on each dollar of taxable income. Specifically,

$$\textit{Average Tax Rate} = \frac{TotalTax}{TaxableIncome}$$

The average tax rate is often used in budgeting tax expense as a portion of income (i.e., what percent of taxable income earned is paid in tax).

The effective tax rate represents the taxpayer's average rate of taxation on each dollar of total income (i.e., taxable and nontaxable income). Specifically,

$$\text{Effective Tax Rate} = \frac{TotalTax}{TotalIncome}$$

Relative to the average tax rate, the effective tax rate provides a better depiction of a taxpayer's tax burden because it depicts the taxpayer's total tax paid as a ratio of the sum of both taxable and nontaxable income earned.

12. [LO 3] Which is a more appropriate tax rate to use to compare taxpayers' tax burdens – the average or the effective tax rate? Why?

    Relative to the average tax rate, the effective tax rate provides a better depiction of a taxpayer's tax burden because it depicts the taxpayer's total tax paid as a ratio of the sum of both taxable and nontaxable income earned.

13. [LO 3] Describe the differences between a proportional, progressive, and regressive tax rate structure.

    A proportional (flat) tax rate structure imposes a constant tax rate throughout the tax base. In other words, as the tax base increases, the taxes paid increases, but the marginal tax rate remains constant. Because the marginal tax rate is constant across all levels of the tax base, the average tax rate remains constant across the tax base and always equals the marginal tax rate. Common examples of proportional taxes include sales taxes and excise taxes (i.e., taxes based on quantity such as gallons of gas purchased).

    A progressive tax rate structure imposes an increasing marginal tax rate as the tax base increases. In other words, as the tax base increases, both the marginal tax rate and the taxes paid increase. Common examples of progressive tax rate structures include federal and most state income taxes and federal estate and gift taxes.

    A regressive tax rate structure imposes a decreasing marginal tax rate as the tax base increases. In other words, as the tax base increases, the taxes paid increases, but the marginal tax rate decreases. Regressive tax rate structures are not common. In the United States, the Social Security tax and the federal employment tax employ a regressive tax rate structure. However, there are other regressive taxes when the tax is viewed in terms of effective tax rates. For example, a sales tax by definition is a proportional tax – i.e., as taxable purchases increase, the sales tax rate (i.e., the marginal tax rate) remains constant. Nonetheless, when you consider that the proportion of one's total income spent on taxable purchases likely decreases as total income increases, the sales tax may be considered a regressive tax.

14. [LO 3] Arnold and Lilly have recently had a heated discussion about whether a sales tax is a proportional tax or a regressive tax. Lilly argues that a sales tax is regressive.

Arnold counters that the sales tax is a flat tax. Who is correct?

Arnold and Lilly are both correct. A sales tax by definition is a proportional tax – i.e., as taxable purchases increase, the sales tax rate (i.e., the marginal tax rate) remains constant. For this reason, Arnold is correct. Nonetheless, when you consider that the proportion of one's total income spent on taxable purchases likely decreases as total income increases, the sales tax may be considered a regressive tax. For this reason, Lilly is correct.

15. [LO 4] Which is the largest tax collected by the U.S. government? What types of taxpayers are subject to this tax?

    The federal income tax is the largest tax collected by the U.S. government. Currently, federal income taxes are levied on individuals, corporations, estates, and trusts.

16. [LO 4] What is the tax base for the Social Security and Medicare taxes for an employee or employer? What is the tax base for Social Security and Medicare taxes for a self-employed individual? Is the self-employment tax in addition to or in lieu of federal income tax?

    Employee wages is the tax base for the Social Security and Medicare taxes. Net earnings from self-employment is the tax base for the self-employment tax. The self-employment tax is in addition to the federal income tax.

17. [LO 4] What are unemployment taxes?

    Employers are required to pay federal and state unemployment taxes, which fund temporary unemployment benefits for individuals terminated from their jobs without cause. The tax base for the unemployment taxes is wages or salary.

18. [LO 4] What is the distinguishing feature of an excise tax?

    Excise taxes differ from other taxes in that the tax base on excise taxes is typically based on the quantity of an item or service purchased. The federal government imposes a number of excise taxes on goods such as alcohol, diesel fuel, gasoline, tobacco products and services such as telephone services. In addition, states also often impose excise taxes on these same items.

19. [LO 4] What are some of the taxes that currently are unique to state and local governments? What are some of the taxes that the federal, state, and local governments each utilize?

    The sales, use, and property (personal, real, intangible) taxes are unique to state and *local governments. Taxes that are common among the federal, state, and local governments include income taxes, excise taxes, and estate and gift taxes.*

20. [LO 4] The state of Georgia recently increased its tax on a pack of cigarettes by $2.00. What type of tax is this? Why might Georgia choose this type of tax?

    The cigarette tax is both considered an excise tax (i.e., a tax based on quantity purchased) and a "sin" tax (i.e., a tax on goods that are deemed to be socially undesirable). Georgia may choose this type of tax to discourage smoking and because sin taxes are often viewed as acceptable ways of increasing tax revenues.

21. [LO 4] What is the difference between a sales tax and a use tax?

    The tax base for sales taxes is retail sales of goods (and some services). The tax base for the use tax is the retail price of goods owned, possessed or consumed within a state that were not purchased within the state (e.g., goods purchased over the internet).

22. [LO 4] What is an *ad valorem* tax? Name an example of this type of tax.

    An ad valorem tax is a tax based on the fair market value of property. Real and personal property taxes are examples of ad valorem taxes.

23. [LO 4] What are the differences between an explicit and an implicit tax?

    An explicit tax is a tax that is directly imposed by a government unit and easily quantified. Implicit taxes are the reduced rates of pretax return that a tax-favored asset produces (e.g., the lower pretax rate of return earned by tax exempt municipal bonds). Although implicit taxes are real and equally important in understanding our tax system, they are difficult to quantify.

24. [LO 4] When we calculate average and effective tax rates, do we consider implicit taxes? What effect does this have on taxpayers' perception of equity?

    Implicit taxes are very difficult to quantify and thus, are generally not considered when calculating average and effective tax rates. Since implicit taxes are ignored in these calculations, taxpayers may conclude that groups of taxpayers investing in tax advantaged assets (subject to implicit tax) do not pay their fair share of tax as represented by a low effective tax rate.

25. [LO 4] Benjamin recently bought a truck in Alabama for his business in Georgia. What different types of federal and state taxes may affect this transaction?

Benjamin will have to pay state sales tax in Alabama for the truck purchased. Assuming the vehicle will be registered in Georgia, Benjamin will have to pay use tax on the purchase at a rate representing any difference in the Alabama sales tax rate and the Georgia use tax rate. Benjamin will also have to pay personal property tax annually on the truck. Finally, since the vehicle is used in Benjamin's business, he will be able to depreciate the truck for federal income tax purposes.

26. [LO 5] Kobe strongly dislikes SUVs and is appalled that so many are on the road. He proposes to eliminate the federal income tax and replace it with a $50,000 annual tax per SUV. Based on the number of SUVs currently owned in the United States, he estimates the tax will generate exactly the amount of tax revenue currently collected from the income tax. What is wrong with Kobe's proposal? What type of forecasting is Kobe likely using?

    Kobe's forecast is based on static forecasting (i.e., he is ignoring how taxpayers may alter their activities in response to the tax law change). Given that taxpayers are likely to substitute purchases of other vehicles for SUVs (i.e., the substitution effect), Kobe's proposal is likely to result in a large discrepancy in projected and actual tax revenues.

27. [LO 5] What is the difference between the income and substitution effects? For which types of taxpayers is the income effect more likely descriptive? For which types of taxpayers is the substitution effect more likely descriptive?

    The income effect predicts that when taxpayers are taxed more (e.g., tax rate increases from 25 to 28 percent), they will work harder to generate the same after-tax dollars. The substitution effect predicts that when taxpayers are taxed more, they will substitute nontaxable activities (e.g., leisure activities) for taxable activities because the marginal value of taxable activities has decreased. The income effect is likely to be more descriptive for taxpayers with insufficient income to meet their necessities, etc. for their desired standard of living. The substitution effect is likely to be more descriptive for taxpayers with sufficient income to meet their necessities and to sustain their desired standard of living.

28. [LO 5] What is the difference between horizontal and vertical equity? How do tax preferences affect people's view of horizontal equity?

    Horizontal equity means that two taxpayers in similar situations pay the same tax. Vertical equity is achieved when taxpayers with greater ability to pay tax, pay more tax relative to taxpayers with a lesser ability to pay tax. One can view vertical equity in terms of tax dollars paid or in terms of tax rates. Proponents of a flat income tax or sales tax (i.e., proportional tax rate structures) are more likely to argue that vertical equity is achieved when taxpayers with a greater ability to pay tax, pay more in tax *dollars. Proponents of a progressive tax system are more likely to argue that taxpayers with a greater ability to pay should be subject to a higher tax rate.*

Governmental units provide tax preferences for a variety of reasons – e.g., encourage investment, social objectives, etc. Whether one views these tax preferences as appropriate or not, greatly influences whether one considers a tax system to be fair in general and specifically, horizontally equitable. Specifically, if one views a tax preference as being inappropriate, this would adversely affect one's view of horizontal equity.

29. [LO 3, LO 5] Montel argues that a flat income tax rate system is vertically equitable. Oprah argues that a progressive tax rate structure is vertically equitable. How do their arguments differ? Who is correct?

    Vertical equity is achieved when taxpayers with greater ability to pay tax, pay more tax relative to taxpayers with a lesser ability to pay tax. One can view vertical equity in terms of tax dollars paid or in terms of tax rates. Proponents of a flat income tax or sales tax (i.e., proportional tax rate structures) are more likely to argue that vertical equity is achieved when taxpayers with a greater ability to pay tax, pay more in tax dollars. Proponents of a progressive tax system are more likely to argue that taxpayers with a greater ability to pay should be subject to a higher tax rate. This view is based upon the argument that the relative burden of a flat tax rate decreases as a taxpayer's income (e.g., disposable income) increases. Which is the correct answer? There is no correct answer. Nonetheless, many feel very strongly regarding one view or the other.

30. [LO 3, LO 5] Discuss why evaluating vertical equity simply based on tax rate structure may be less than optimal.

    Although tax rate structures can be used, in part, to assess vertical equity, focusing on the tax rate structure solely ignores the role that the tax base plays in determining vertical equity. Indeed, focusing on the tax rate structure in evaluating a tax system is appropriate only if the tax base chosen (e.g., taxable income, purchases, property owned, etc.) accurately portrays a taxpayer's ability to pay. This can be a rather strong assumption. Consider the sales tax. Although taxable purchases typically increase as taxpayers' total incomes increase, total incomes typically increase at a much faster rate than taxable purchases. Thus, the gap between taxable purchases and total income widens as total income increases. The end result is that the effective tax rates for those with a greater ability to pay are lower than those taxpayers with a lesser ability to pay. Regressive tax rate structures are generally considered not to satisfy vertical equity (unless one is a strong advocate of the belief that those with a greater ability to pay simply should be paying a higher tax, albeit at a lower rate). In sum, evaluating vertical equity in terms of effective tax rates may be much more *informative than simply an evaluation of tax rate structures.*

31. [LO 4, LO 5] Compare the federal income tax to sales taxes using the "certainty" criterion.

Certainty means that taxpayers should be able to determine when to pay the tax, where to pay the tax, and how to determine the tax. It is relatively easy to determine when and where to pay the federal income tax and sales taxes. For example, individual federal income tax returns and the remaining balance of taxes owed must be filed with the Internal Revenue Service each year on or before April 15th (or the first business day following April 15th). Likewise, sales taxes are paid to retailers when items are purchased, and property taxes are typically paid annually to local governments. The ease of "how to determine the tax," however, varies by tax system. Sales taxes are determined with relative ease – i.e., they are based on the value of taxable purchases. In contrast, income taxes are often criticized as being complex. What are taxable/nontaxable forms of income? What are deductible/nondeductible expenses? When should income or expense be reported? For many taxpayers (e.g., wage earners with few investments), the answers to these questions are straightforward. For other taxpayers (e.g., business owners, individuals with a lot of investments), the answers to these questions are nontrivial. Constant tax law changes enacted by Congress also add to the difficulty in determining the proper amount of income tax to pay. These changes can make it difficult to determine a taxpayer's current tax liability much less plan for the future.

32. [LO 5] Many years ago a famous member of Congress proposed eliminating federal income tax withholding. What criterion for evaluating tax systems did this proposal violate? What would likely have been the result of eliminating withholding?

Eliminating withholding would violate the convenience criterion – i.e., a tax system should be designed to facilitate the collection of tax revenues without undue hardship on the taxpayer or the government (i.e., a tax system should make collection as easy as possible). Eliminating withholding would most likely have slowed collection of taxes and increased taxpayer aggressiveness (or tax evasion). Prior research suggests that taxpayers are more likely to take more aggressive tax positions when they owe additional taxes when filing their return.

33. [LO 5] "The federal income tax scores very high on the economy criterion because the current IRS budget is relatively low compared to the costs of a typical collection agency." Explain why this statement may be considered wrong.

This statement ignores the economy criterion from the taxpayer's perspective. The income tax is often criticized for the compliance costs imposed on the taxpayer. Indeed, for certain taxpayers, record-keeping costs, accountant fees, attorney fees, *etc. can be quite substantial. Advocates of alternative tax systems often challenge the income tax on this criterion.*

Problems

34. [LO 3] Chuck, a single taxpayer, earns $75,000 in taxable income and $10,000 in interest from an investment in City of Heflin bonds. Using the U.S. tax rate schedule, how much federal tax will he owe? What is his average tax rate? What is his effective tax rate? What is his current marginal tax rate?

    Chuck will owe $14,521.25 in federal income tax this year computed as follows: $14,521.25 = $5,183.75 + 25%($75,000 −$37,650).

    Chuck's average tax rate is 19.36.

$$\textit{Average Tax Rate} = \frac{TotalTax}{TaxableIncome} = \frac{\$14{,}521.25}{\$75{,}000} = 19.36\%$$

    Chuck's effective tax rate is 17.08 percent.

$$\textit{Effective tax rate} = \frac{TotalTax}{TotalIncome} = \frac{\$14{,}521.25}{(\$75{,}000 + \$10{,}000)} = 17.08\%$$

    Chuck is currently in the 25 percent tax rate bracket. His marginal tax rate on increases in income up to $16,150 and deductions from income up to $37,350 is 25 percent.

35. [LO 3] Using the facts in the previous problem, if Chuck earns an additional $40,000 of taxable income, what is his marginal tax rate on this income? What is his marginal rate if, instead, he had $40,000 of additional deductions?

    If Chuck earns an additional $40,000 of taxable income, his marginal tax rate on the income is 26.79 percent.

$$\textit{Marginal Tax Rate} = \frac{\Delta Tax}{\Delta TaxableIncome} = \frac{(\$25{,}236.75 - \$14{,}521.25)}{(\$115{,}000 - \$75{,}000)} = 26.79\ \%$$

    If Chuck instead had $40,000 of additional tax deductions, his marginal tax rate on the deductions would be 24.34 percent.

$$\textit{Marginal Tax Rate} = \frac{\Delta Tax}{\Delta TaxableIncome} = \frac{(\$4{,}786.25 - \$14{,}521.25)}{(\$35{,}000 - \$75{,}000)} = 24.34\%$$

36. [LO 3] In reviewing the tax rate schedule for a single taxpayer, Chuck notes that the tax on $75,000 is $5,183.75 plus 25 percent of the taxable income over $37,650. What does the $5,183.75 represent?

    The $5,183.75 represents the income tax on $37,650 – i.e., $927.50 + 15% ($37,650 – $9,275).

37. [LO 3] Campbell, a single taxpayer, earns $400,000 in taxable income and $2,000 in interest from an investment in State of New York bonds. Using the U.S. tax rate schedule, how much federal tax will she owe? What is her average tax rate? What is her effective tax rate? What is her current marginal tax rate?

    Campbell will owe $115,529.25 in federal income tax this year computed as follows: $115,529.25= $46,278.75 + 33% ×($400,000 − $190,150).

    Campbell's average tax rate is 28.88 percent.

$$\textit{Average Tax Rate} = \frac{TotalTax}{TaxableIncome} = \frac{\$115{,}529.25}{\$400{,}000} = 28.88$$

    Campbell's effective tax rate is 28.74 percent.

$$\textit{Effective tax rate} = \frac{TotalTax}{TotalIncome} = \frac{\$115{,}529.25}{(\$400{,}000 + \$2{,}000)} = 28.74$$

    Campbell is currently in the 33 percent tax rate bracket. Her marginal tax rate on deductions up to $209,850 will be 33 percent. However, her marginal tax rate on the next $13,350 of income will be 33%, and income earned over $413,350 will be 35 percent. Income earned in excess of $415,050 will be taxed at 39.6%.

38. [LO 3] Using the facts in the previous problem, if Campbell earns an additional $15,000 of taxable income, what is her marginal tax rate on this income? What is her marginal rate if, instead, she had $15,000 of additional deductions?

    If Campbell earns an additional $15,000 of taxable income, her marginal tax rate on the income is 33.22 percent.

$$\textit{Marginal Tax Rate} = \frac{\Delta Tax}{\Delta TaxableIncome} = \frac{(\$120{,}512.95 - \$115{,}529.25)}{(\$415{,}000 - \$400{,}000)} = 33.22\ \%$$

If Campbell instead had $15,000 of additional tax deductions, her marginal tax rate on the deductions would be 33.00 percent.

$$\textit{Marginal Tax Rate} = \frac{\Delta Tax}{\Delta TaxableIncome} = \frac{(\$110{,}579.25 - \$115{,}529.25)}{(\$385{,}000 - \$400{,}000)} = 33.00\%$$

39. [LO 3] Jorge and Anita, married taxpayers, earn $150,000 in taxable income and $40,000 in interest from an investment in City of Heflin bonds. Using the U.S. tax rate schedule for married filing jointly, how much federal tax will they owe? What is their average tax rate? What is their effective tax rate? What is their current marginal tax rate?

    Jorge and Anita will owe $29,042.50 in federal income tax this year computed as follows:

    $29,042.50 = $10,367.50 + 25% ($150,000 −$75,300).

    Jorge and Anita's average tax rate is 19.36 percent.

$$\textit{Average Tax Rate} = \frac{TotalTax}{TaxableIncome} = \frac{\$29{,}042.50}{\$150{,}000} = 19.36\%$$

    Jorge and Anita's effective tax rate is 15.29 percent.

$$\textit{Effective tax rate} = \frac{TotalTax}{TotalIncome} = \frac{\$29{,}042.50}{(\$150{,}000 + \$40{,}000)} = 15.29\%$$

    Jorge and Anita are currently in the 25 percent tax rate bracket. Their marginal tax rate on increases of income up to $1,900 and deductions up to $74,700 is 25 percent.

40. [LO 3] Using the facts in the previous problem, if Jorge and Anita earn an additional $100,000 of taxable income, what is their marginal tax rate on this income? What is their marginal rate if, instead, they reported an additional $100,000 in deductions?

    If Jorge and Anita earn an additional $100,000 of taxable income, their marginal tax rate on the income is 28.87 percent.

$$\textit{Marginal Tax Rate} = \frac{\Delta Tax}{\Delta TaxableIncome} = \frac{(\$57{,}913 - \$29{,}042.50)}{(\$250{,}000 - \$150{,}000)} = 28.87\%$$

If Jorge and Anita instead had $100,000 of additional tax deductions, their marginal tax rate on the deductions would be 22.47 percent.

$$\textit{Marginal Tax Rate} = \frac{\Delta Tax}{\Delta TaxableIncome} = \frac{(\$6{,}572.50 - \$29{,}042.50)}{(\$50{,}000 - \$150{,}000)} = 22.47\%$$

41. [LO 3] In reviewing the tax rate schedule for married filing jointly, Jorge and Anita note that the tax on $155,000 is $29,517.50 plus 28 percent of the taxable income over $151,900. What does the $29,517.50 represent?

    The $29,517.50 represents the income tax on $151,900 – i.e., $10,367.50 +25% ($151,900 – 75,300).

42. [LO 3] Scot and Vidia, married taxpayers, earn $240,000 in taxable income and $5,000 in interest from an investment in City of Tampa bonds. Using the U.S. tax rate schedule for married filing jointly, how much federal tax will they owe? What is their average tax rate? What is their effective tax rate? What is their current marginal tax rate?

    Scot and Vidia will owe $54,613 in federal income tax this year computed as follows:

    $54,613 = $51,791.50 + 33% ($240,000 −$231,450).

    Scot and Vidia's average tax rate is 22.76 percent.

$$\textit{Average Tax Rate} = \frac{TotalTax}{TaxableIncome} = \frac{\$54{,}613}{\$240{,}000} = 22.76\%$$

    Scot and Vidia's effective tax rate is 22.29 percent.

$$\textit{Effective tax rate} = \frac{TotalTax}{TotalIncome} = \frac{\$54{,}613}{(\$240{,}000 + \$5{,}000)} = 22.29\%$$

    Scot and Vidia are currently in the 33 percent tax rate bracket. Their marginal tax rate on increases in income up to $173,350 and deductions up to $8,550 is 33 percent.

43. [LO 3] Using the facts in the previous problem, if Scot and Vidia earn an additional $70,000 of taxable income, what is their marginal tax rate on this income? How would your answer differ if they, instead, had $70,000 of additional deductions?

If Scot and Vidia earn an additional $70,000 of taxable income, their marginal tax rate on the income is 33 percent.

$$\textit{Marginal Tax Rate} = \frac{\Delta Tax}{\Delta TaxableIncome} = \frac{(\$77{,}713 - \$54{,}613)}{(\$310{,}000 - \$240{,}000)} = 33\%$$

If Scot and Vidia instead had $70,000 of additional tax deductions, their marginal tax rate on the deductions would be 28.61 percent.

$$\textit{Marginal Tax Rate} = \frac{\Delta Tax}{\Delta TaxableIncome} = \frac{(\$34{,}585.50 - \$54{,}613)}{(\$170{,}000 - \$240{,}000)} = 28.61\%$$

44. [LO 3, LO 4] Melinda invests $200,000 in a City of Heflin bond that pays 6 percent interest. Alternatively, Melinda could have invested the $200,000 in a bond recently issued by Surething, Inc. that pays 8 percent interest with similar risk and other nontax characteristics to the City of Heflin bond. Assume Melinda's marginal tax rate is 25 percent.

   a. What is her after-tax rate of return for the City of Heflin bond?

   Since the City of Heflin bond is a tax exempt bond, Melinda's after tax rate of return on the bond is equal to its pretax rate of return (6 percent).

   b. How much explicit tax does Melinda pay on the City of Heflin bond?

   Since the City of Heflin bond is a tax exempt bond, Melinda pays no explicit tax on the interest earned from the City of Heflin bond.

   c. How much implicit tax does she pay on the City of Heflin bond?

   Melinda earns $12,000 of interest on the City of Heflin bond (i.e., 6% × $200,000). A similar priced taxable bond (i.e., the Surething, Inc. bond) would pay $16,000 of taxable interest (i.e., 8% × $200,000). Melinda pays $4,000 of implicit tax on the City of Heflin bond (i.e., the difference between the pretax interest earned from a similar taxable bond ($16,000) and the pretax interest earned from the City of Heflin bond ($12,000)).

   d. How much explicit tax would she have paid on the Surething, Inc. bond?

   Since Melinda's marginal tax rate is 25 percent, she would have paid $4,000 of *explicit tax (i.e., 25% ×$16,000) on the interest earned from the Surething, Inc. bond.*

e. What is her after-tax rate of return on the Surething, Inc. bond?

Her after-tax income from the Surething, Inc. bond would be $12,000 ($16,000 interest income − $4,000 tax). Thus, her after-tax return from the Surething, Inc. bond would be 6 percent (after-tax income of $12,000 divided by her $200,000 investment).

45. [LO 3, LO 4] {Planning} Hugh has the choice between investing in a City of Heflin bond at 6 percent or a Surething bond at 9 percent. Assuming that both bonds have the same nontax characteristics and that Hugh has a 40 percent marginal tax rate, in which bond should he invest?

Hugh's after tax rate of return on the tax exempt City of Heflin bond is 6 percent. The Surething bond pays taxable interest of 9 percent. Hugh's after tax rate of return on the Surething bond is 5.4 percent (i.e., 9% interest income – (9% ×40%) tax = 5.4%). Hugh should invest in the City of Heflin bond.

46. [LO 3, LO 4] {Planning} Using the facts in the previous problem, what interest rate does Surething, Inc. need to offer to make Hugh indifferent between investing in the two bonds?

To be indifferent between investing in the two bonds, the Surething, Inc. bond should provide Hugh the same after-tax rate of return as the City of Heflin bond (6 percent). To solve for the required pretax rate of return we can use the following formula: After-tax return = Pretax return ×(1 – Marginal Tax Rate).

Surething, Inc. needs to offer a 10 percent interest rate to generate a 6 percent after-tax return and make Hugh indifferent between investing in the two bonds – i.e.,

6% = Pretax return ×(1 – 40%);
Pretax return = 6% / (1 – 40%) = 10%

47. [LO 3, LO 4] {Planning} Fergie has the choice between investing in a State of New York bond at 5 percent and a Surething bond at 8 percent. Assuming that both bonds have the same nontax characteristics and that Fergie has a 30 percent marginal tax rate, in which bond should she invest?

Fergie's after tax rate of return on the tax exempt State of New York bond is 5 percent. The Surething bond pays taxable interest of 8 percent. Fergie's after tax rate of return on the Surething bond is 5.6 percent (i.e., 8% interest income – (8% ×30%)

tax = 5.6%). Fergie should invest in the Surething bond.

48. [LO 3, LO 4] {Planning} Using the facts in the previous problem, what interest rate does the state of New York need to offer to make Fergie indifferent between investing in the two bonds?

To be indifferent between investing in the two bonds, the State of New York bond should provide Fergie the same after-tax rate of return as the Surething bond. Fergie's after tax rate of return on the Surething bond is 5.6 percent (i.e., 8% interest income – (8% ×30%) tax = 5.6%). The state of New York needs to offer a 5.6 percent interest rate to generate a 5.6 percent after-tax return to make Fergie indifferent between investing in the two bonds.

49. [LO 3] Given the following tax structure, what minimum tax would need to be assessed on Shameika to make the tax progressive with respect to average tax rates?

Taxpayer	Salary	Muni-Bond Interest	Total Tax
Mihwah	$10,000	$10,000	$600
Shameika	50,000	30,000	???

Mihwah's average tax rate is 6 percent.

$$\text{Average Tax Rate} = \frac{TotalTax}{TaxableIncome} = \frac{\$600}{\$10{,}000} = 6\%$$

A 6 percent average tax rate on Shameika's $50,000 taxable income would result in $3,000 of tax (i.e., 6% × $50,000 = $3,000). Thus, Shameika must pay more than $3,000 tax (e.g., $3,001) for the tax structure to be progressive with respect to average tax rates.

50. [LO 3] Using the facts in the previous problem, what minimum tax would need to be assessed on Shameika to make the tax progressive with respect to effective tax rates?

Mihwah's effective tax rate is 3 percent.

$$\text{Effective tax rate} = \frac{TotalTax}{TotalIncome} = \frac{\$600}{(\$10{,}000 + \$10{,}000)} = 3\%$$

A 3 percent effective tax rate on Shameika's $80,000 total income would result in $2,400 of tax (i.e., 3% × $80,000 = $2,400). Thus, Shameika must pay more than $2,400 tax (e.g., $2,401) for the tax structure to be progressive with respect to effective tax rates.

51. [LO 3, LO 5] Song earns $100,000 taxable income as an interior designer and is taxed at an average rate of 20 percent (i.e., $20,000 of tax). If Congress increases the income tax rate such that Song's average tax rate increases from 20 percent to 25 percent, how much more income tax will she pay assuming that the income effect is descriptive? What effect will this tax rate change have on the tax base and tax collected?

    Under the current income tax, Song has $80,000 of income after tax. If the income effect is descriptive and Congress increases tax rates so that Song's average tax rate is 25 percent, Song will need to earn to $106,666.67 to continue to have $80,000 of income after tax.

    After-tax income = Pretax income (1 – tax rate)

    $80,000 = Pretax income (1 -.25)

    Pretax income = $106,666.67

    Song will pay $26,666.67 in tax ($106,666.67 × .25). Accordingly, if the income effect is descriptive, the tax base and the tax collected will increase.

52. [LO 3, LO 5] Using the facts from the previous problem, what will happen to the government's tax revenues if Song chooses to spend more time pursuing her other passions besides work in response to the tax rate change and earns only $75,000 in taxable income? What is the term that describes this type of reaction to a tax rate increase? What types of taxpayers are likely to respond in this manner?

    If Song only earns $75,000 of taxable income, she would pay only $18,750 of tax under the new tax structure (i.e., $75,000 × .25). Thus, the government's tax revenues would decrease by $1,250 (i.e., $18,750 −$20,000). This is an example of the substitution effect, which may be descriptive for taxpayers with more disposable income.

53. [LO 5] Given the following tax structure, what tax would need to be assessed on Venita to make the tax horizontally equitable?

Taxpayer	**Salary**	**Total Tax**
Mae	$10,000	$ 600
Pedro	20,000	1,500
Venita	10,000	???

Horizontal equity means that two taxpayers in similar situations pay the same tax. Thus, to make the tax structure horizontally equitable, Venita should pay $600 in tax.

54. [LO 5] Using the facts in the previous problem, what is the minimum tax that Pedro should pay to make the tax structure vertically equitable based on the tax rate paid? This would result in what type of tax rate structure?

Mae's average tax rate is 6 percent.

$$\textit{Average Tax Rate} = \frac{\textit{TotalTax}}{\textit{TaxableIncome}} = \frac{\$600}{\$10{,}000} = 6\%$$

To be vertically equitable with respect to tax rates, Pedro should pay a tax rate higher than 6 percent. A 6 percent tax rate on Pedro's $20,000 taxable income would result in $1,200 of tax (i.e., 6% × $20,000 = $1,200). Thus, Pedro must pay more than $1,200 tax (e.g., $1,201) for the tax structure to be vertically equitable (i.e., to generate a tax rate more than 6 percent).

55. [LO 5] Using the facts in the previous problem, what is the minimum tax that Pedro should pay to make the tax structure vertically equitable with respect to the amount of tax paid? This would result in what type of tax rate structure?

To be vertically equitable with respect to the amount of tax paid, Pedro should pay more in tax dollars than Mae because he earns more taxable income than her. A strict interpretation of this definition would suggest that the tax is vertically equitable if Pedro pays 1 more dollar in tax than Mae (i.e., $601). However, this would result in a regressive tax structure (which most people would argue are not vertically equitable). A less strict interpretation of vertical equity (based on dollar amounts) is that Pedro should pay more tax than Mae but at the same tax rate (i.e., a proportional or flat tax rate structure).

56. [LO 5] Consider the following tax rate structure. Is it horizontally equitable? Why or why not? Is it vertically equitable? Why or why not?

Taxpayer	**Salary**	**Total Tax**
Rajiv	$10,000	$600
LaMarcus	20,000	600
Dory	10,000	600

The tax rate schedule is horizontally equitable because those taxpayers in the same situation (Rajiv and Dory) pay the same tax ($600). The tax is not vertically equitable because the taxpayer with a greater ability to pay (LaMarcus) does not pay more tax, *nor does he pay a higher tax rate.*

57. [LO 5] Consider the following tax rate structure. Is it horizontally equitable? Why or why not? Is it vertically equitable? Why or why not?

Taxpayer	**Salary**	**Total Tax**
Marilyn	$10,000	$ 600
Kobe	20,000	3,000
Alfonso	30,000	6,000

We cannot evaluate whether the tax rate structure is horizontally equitable because we are unable to determine if taxpayers in similar situations pay the same tax (i.e., the problem does not give data for two taxpayers with the same income). The tax rate structure would be considered vertically equitable because taxpayers with higher income pay more tax and at a higher rate. Specifically, Marilyn's, Kobe's, and Alfonso's average tax rates are 6 percent, 15 percent, and 20 percent, respectively.

58. [LO 5] Consider the following tax rate structure. Is it horizontally equitable? Why or why not? Is it vertically equitable? Why or why not?

Taxpayer	**Salary**	**Total Tax**
Rodney	$10,000	$600
Keisha	10,000	600

The tax rate structure is horizontally equitable because taxpayers in similar situations (Rodney and Keisha) pay the same tax. We cannot evaluate whether the tax is vertically equitable because we are unable to determine if taxpayers with a greater ability to pay (higher income) pay more tax.

59. [LO 1, LO 4] {Planning} Lorenzo is considering starting a trucking company either in Texas or Oklahoma. He will relocate his family, which includes his wife, children, and parents, to reside in the same state as his business. What types of taxes may influence his decision of where to locate his business?

Taxes will affect several aspects of Lorenzo's decision. Lorenzo should consider differences in Texas and Oklahoma for (1) business taxes (e.g., corporate taxes), (2) individual income taxes, (3) excise taxes on gasoline, (4) real estate taxes (business and personal), (5) estate taxes (e.g., for wealth transfers from his parents), and (6) sales taxes.

60. [LO 3, LO 5] {Planning} Congress would like to increase tax revenues by 10 percent. Assume that the average taxpayer in the United States earns $65,000 and pays an average tax rate of 15 percent. If the income effect is in effect for all taxpayers, what

average tax rate will result in a 10 percent increase in tax revenues? This is an example of what type of forecasting?

This analysis is an example of dynamic forecasting. Based on the information above, the average taxpayer pays $9,750 of tax (i.e., $65,000 × 15%), leaving $55,250 of income after tax. A 10 percent increase in revenues would mean that the average taxpayer pays $10,725 in tax ($9,750 ×1.10). With this new tax amount, we can solve for the tax rate that would generate this tax amount.

After-tax income = Pretax income × (1 – tax rate)

After-tax income = Pretax income – (Pretax income × tax rate)

After-tax income = Pretax income −Tax

Substituting information from the problem results in:

$55,250 = Pretax income − $10,725

Pretax income = $65,975

We can use the above formula to solve for the new tax rate.

After-tax income = Pretax income × (1 – tax rate)

$55,250 = $65,975 × (1 – tax rate)

Tax rate = $10,725/$65,975 = 16.26%

61. [LO 5] {Research} Locate the IRS Web site at http://www.irs.gov/. For every $100 the IRS collected, how much was spent on the IRS collection efforts? What tax system criterion does this information help you to evaluate with respect to the current U.S. tax system?

    The IRS' budget for exam and collections as a percentage of revenue collected is about .48 percent. Currently, the IRS collects over $2.5 trillion annually with a budget of $12.0 billion. Thus, for every $100 collected, about .48 cents is spent on collection efforts. This data is useful in evaluating "economy."

62. [LO 4] {Research} Using the Internet, find a comparison of income tax rates across states. What state currently has the highest income tax rate? In considering individual tax burdens across states, what other taxes should you consider?

Hawaii and California currently have the highest individual income tax rate. To compare tax burdens across states, one should also consider real estate and other property taxes, excise taxes (gasoline taxes), and sales taxes.

Chapter 2
Tax Compliance, the IRS, and Tax Authorities

SOLUTIONS MANUAL

Discussion Questions

1. [LO 1] Name three factors that determine whether a taxpayer is required to file a tax return.

   Filing status (e.g., single, married filing joint, etc.), age, and the taxpayer's gross income.

2. [LO 1] Benita is concerned that she will not be able to complete her tax return by April 15. Can she request an extension to file her return? By what date must she do so? Assuming she requests an extension, what is the latest date that she could file her return this year without penalty?

   Benita can file an automatic six-month extension to file her tax return. This extension must be filed by April 15th. October 15th is the latest date she can file her return without penalty. If October 15th falls on a Saturday, Sunday, or holiday, the extended due date will be the 1st day after October 15th that is not a Saturday, Sunday, or holiday.

3. [LO 1] Agua Linda, Inc., is a calendar-year corporation. What is the original due date for the corporate tax return? What happens if the original due date falls on a Saturday?

   The original due date for Agua Linda, Inc.'s corporate tax return is April 15th. If the 15th falls on a Saturday, Sunday, or holiday, the due date will be the 1st day after April 15th that is not a Saturday, Sunday, or holiday. In this example, Agua Linda, Inc.'s due date is April 17th (i.e., the Monday after Saturday the 15th).

4. [LO 2] Approximately what percentage of tax returns does the IRS audit? What are the implications of this number for the IRS's strategy in selecting returns for audit?

   Currently, less than 2 percent of all tax returns are audited. The IRS must be strategic in selecting returns for audit in an effort to promote the highest level of voluntary taxpayer compliance.

5. [LO 2] Explain the difference between the DIF system and the National Research Program. How do they relate to each other?

   The DIF system is basically a scoring system that assigns a score to each tax return that represents the probability that the tax liability on the return has been *underreported (i.e., a higher score, a higher likelihood of underreporting). The IRS derives the weights assigned to specific tax return attributes from historical IRS audit adjustment data from the National Research Program (NRP).*

The NRP analyzes randomly selected returns to ensure that the DIF scorings are representative of the population of tax returns. The DIF system then uses these (undisclosed) weights to score each tax return based on the tax return's characteristics. Returns with higher DIF scores are then reviewed to determine if an audit is the best course of action.

6. [LO 2] Describe the differences between the three types of audits in terms of their scope and taxpayer type.

   The three types of IRS audits consist of correspondence, office, and field examinations. Correspondence examinations are the most common. These audits (as the name suggests) are conducted by mail and generally are limited to one or two items on the taxpayer's return. Among the three types of audits, correspondence audits are generally the most narrow in scope and least complex.

   Office examinations are the second most common audit. As the name suggests, the IRS conducts these audits at the local IRS office. These audits are typically broader in scope and more complex than correspondence examinations. Small businesses, taxpayers operating sole proprietorships, and middle to high-income individual taxpayers are likely candidates for office examinations. In these examinations, the taxpayer receives a notice that identifies the items subject to audit, requests substantiation for these items as necessary, and notifies the taxpayer of the date, time, and location of the exam. Taxpayers may attend the examination alone, or simply let their tax adviser or attorney attend on the taxpayer's behalf.

   Field examinations are the least common audit. The IRS conducts these audits at the taxpayer's office (i.e., place of business), or the location where the taxpayer's books, records and source documents are maintained. Field examinations are generally the broadest in scope and most complex of the three audit types. They can last many months to multiple years and generally are limited to business returns and the most complex individual returns.

7. [LO 2] Simon just received a 30-day letter from the IRS indicating a proposed assessment. Does he have to pay the additional tax? What are his options?

   Simon does not have to pay the additional tax at this time. The 30-day letter instructs the taxpayer that he or she has 30 days (1) to request a conference with an appeals officer, who is independent (resides in a separate IRS division) from the examining agent or (2) to agree to the proposed adjustment. If the taxpayer chooses to go to the appeals conference and reaches an agreement with the IRS at the appeals conference, the taxpayer can then sign the Form 870. If the taxpayer *and IRS do not agree on the proposed adjustment at the appeals conference, or the taxpayer chooses not to request an appeals conference, the IRS will then send the taxpayer a 90-day letter (statutory notice of deficiency).*

8. [LO 2] Compare and contrast the three trial-level courts.

   The U.S. District Court is the only court that provides for a jury trial; the U.S. Tax Court is the only court that allows tax cases to be heard before the taxpayer pays the disputed liability and the only court with a small claims division (hearing claims involving disputed liabilities of $50,000 or less); the U.S. Tax Court judges are tax experts, whereas the U.S. District Court and U.S. Court of Federal Claims judges are generalists. Both the U.S. Tax Court and local U.S. District Court cases appeal to the specific circuit court based on the taxpayer's residence. In contrast, all U.S. Court of Federal Claims cases appeal to the U.S. Circuit Court of Appeals for the Federal Circuit.

9. [LO 3] Compare and contrast the three types of tax law sources and give examples of each.

   The three types of tax law sources include statutory authority issued by Congress (e.g., the Internal Revenue Code, committee reports), judicial authority (i.e., rulings by the U.S. District Court, U.S. Tax Court, U.S. Court of Federal Claims, U.S. Circuit Court of Appeals, or U.S. Supreme Court), and administrative authority (e.g., regulations, revenue rulings, and revenue procedures). In addition to being issued by different groups, the format and purposes of each of these authorities are different. Whereas statutory authorities are tax laws enacted by Congress, judicial and administrative authorities generally interpret enacted tax laws.

10. [LO 3] The U.S. Constitution is the highest tax authority but provides very little in the way of tax laws. What are the next highest tax authorities beneath the U.S. Constitution?

    The Internal Revenue Code of 1986 and Supreme Court decisions represent the highest tax authority beneath the U.S. Constitution. However, the Supreme Court does not establish law, but instead, simply interprets and applies the Code (and other authorities).

11. [LO 3] Jackie has just opened her copy of the Code for the first time. She looks at the table of contents and wonders why it is organized the way it is. She questions whether it makes sense to try and understand the Code's organization. What are some reasons why understanding the organization of the Internal Revenue Code may prove useful?

    One must understand the organization of a code section (i.e., into subsections, paragraphs, subparagraphs, and clauses) to be able to cite the respective law *correctly (e.g., IRC Sec. 162(b)(2)). Many provisions in the Code apply only to specific parts of the Code. If one does not understand what laws are encompassed in the chapter, it would be very difficult to interpret the code section and determine its applicability to a research question. Finally, the Code has been arranged such that, in general, similar code sections are grouped together. Understanding this organization allows the researcher to be much more efficient in locating relevant code sections.*

12. [LO 3] Laura Li, a U.S. resident, works for three months this summer in Hong Kong. What type of tax authority may be especially useful in determining the tax consequences of her foreign income?

    The tax treaty between the U.S. and Hong Kong.

13. [LO 3] What are the basic differences between regulations, revenue rulings, and private letter rulings?

    Regulations are the Treasury Department's official interpretation of the Internal Revenue Code and have the highest authoritative weight among regulations, revenue rulings, and private letter rulings. Regulations are issued in three different forms: proposed, temporary, and final. In addition to being issued in three different forms, regulations also serve three basic purposes: interpretative, procedural, and legislative. Unlike regulations, revenue rulings address the specific application of the Code and regulations to a specific factual situation. Thus, while revenue rulings have less authoritative weight, they provide a much more detailed interpretation of the Code as it applies to a specific transaction and fact pattern. Letter rulings are less authoritative but more specific than revenue rulings and regulations. Letter rulings generally may not be used as precedent by taxpayers. However, they may be cited as authority to avoid the substantial understatement of tax penalty under IRC Sec. 6662 imposed on taxpayers and related tax practitioner penalty under IRC Sec. 6694. Private letter rulings represent the IRS's application of the Code and other tax authorities to a specific transaction and taxpayer. Private letter rulings are issued in response to a taxpayer request and are common for proposed transactions with potentially large tax implications.

14. [LO 3] Under what circumstances would the IRS issue an acquiescence? A nonacquiescence? An action on decision?

    Except for Supreme Court cases, whenever the IRS loses, it may issue an acquiescence or nonacquiescence as guidance for how the IRS intends to respond to the loss. Although an acquiescence indicates that the IRS has decided to "follow" the court's adverse ruling in the future, it does not mean that the IRS agrees with the court's ruling. Instead, it simply means that the IRS will no longer litigate this issue. A nonacquiescence has the exact opposite implications. A nonacquiescence alerts taxpayers that the IRS plans to continue to litigate this *issue. Finally, the IRS also issues actions on decisions, which explain the background reasoning behind an IRS acquiescence or nonacquiescence.*

15. [LO 3] Carlos has located a regulation that appears to answer his tax research question. He is concerned because the regulation is a temporary regulation. Evaluate the authoritative weight of this type of regulation. Should he feel more or less confident in his answer if the regulation was a proposed regulation?

    Temporary regulations, as the name suggests, have a limited life (three years for regulations issued after November 20, 1988). Nonetheless, during their "life," they carry the same authoritative weight as final regulations. Thus, Carlos should be confident in his answer. Proposed regulations are, as the name suggests, "proposed," and thus do not carry the same authoritative weight as temporary or final regulations. Carlos should feel less confident in his answer if it was based on a proposed regulation.

16. [LO 3] Tyrone recently read a regulation that Congress specifically requested the IRS to issue. What type of regulation is this? How does this regulation's authoritative weight compare to other regulations?

    Legislative regulation. Legislative regulations are more rare and are issued when Congress specifically directs the Treasury Department to issue regulations to address an issue in an area of law. In these instances, the Treasury is actually writing the law instead of interpreting the Code. Because legislative regulations actually represent the tax law instead of an interpretation, legislative regulations generally have been viewed to have more authoritative weight than interpretative and procedural regulations. However, in Mayo Foundation for Medical Education & Research v. U.S., 131 S.Ct. 704 (2011), the Supreme Court held (subject to specific conditions) that all Treasury regulations warrant deference.

17. [LO 3] In researching a tax question, you find only one authority (a trial-level court opinion) that is directly on point. Which court would you least prefer to have heard this case and why?

    The U.S. District Court because these decisions are often considered less authoritative and are likely rendered by a district court outside of the taxpayer's jurisdiction (versus the U.S. Tax Court or U.S. Court of Federal Claims which have jurisdiction over all taxpayers regardless of their residence). U.S. District Court decisions are often considered to have the lowest authoritative weight because the U.S. District Court hears a much broader spectrum of issues compared to the U.S. Tax Court or U.S. Court of Federal Claims. Thus, U.S. District Court judges are considered generalists relative to U.S. Tax Court or U.S. Court of Federal Claims judges.

18. [LO 3] What is *stare decisis* and how does it relate to the Golsen rule?

Stare decisis means that a court will rule consistently with (a) its previous rulings (i.e., unless they decide to overrule the decision) and (b) the rulings of higher courts with appellate jurisdiction (i.e., the courts their cases are appealed to). The doctrine of stare decisis presents a special problem for the tax court because it appeals to different circuits based on the taxpayer's residence. To implement the doctrine of stare decisis, the tax court applies the Golsen rule. The Golsen rule simply means that the tax court will abide by the circuit court's rulings that has appellate jurisdiction for a case. The implication of the Golsen rule is that the tax court may issue conflicting opinions in different circuits.

19. [LO 4] Mason was shocked to learn that the current Code is the Internal Revenue Code of 1986. He thought that U.S. tax laws change more frequently. What is wrong with Mason's perception?

    Congress enacts tax legislation virtually every year that changes the Code. 1986 is simply the last major overhaul of the Internal Revenue Code. All enacted changes are incorporated into the Internal Revenue Code of 1986.

20. [LO 4] Describe in general the process by which new tax legislation is enacted.

    As required by the US Constitution (Article 1, Section 7), "All bills for raising revenue shall originate in the House of Representatives." The Senate may propose tax legislation, but the first to formally consider a bill will be the House, typically within its Ways and Means Committee. After the committee debates the proposed legislation and drafts a bill, the bill is sent to the House of Representatives for debate and ultimately a vote (either yea or nay without modification). If the bill is approved, it becomes an act and is sent to the Senate, which refers the act to the Senate Finance Committee. Not to be outdone by the House, the Senate Finance Committee typically amends the act during its deliberations. After the revised act passes the Senate Finance Committee, the act is sent to the Senate for debate and vote. Unlike the process in the House of Representatives, senators may modify the proposed legislation during their debate.

    If the Senate passes the act, both the House and Senate versions of the legislation are sent to the Joint Conference Committee, which consists of members of the House Ways and Means Committee and the Senate Finance Committee. During the Joint Conference Committee deliberations, committee members debate the two versions of the proposed legislation. Possible outcomes for any specific provision in the proposed legislation include adoption of the Senate version, House version, or some compromise version of the two acts. Likewise, it is possible that the Joint Conference Committee will simply choose to eliminate specific provisions from the proposed legislation or fail to reach a compromise on the proposed legislation, thereby terminating the legislation. After the Joint Conference Committee approves the act, the revised legislation is sent to the House and Senate for vote. If approved by both the House and Senate, the act is sent to the *president for his or her signature. If the president signs the act, it becomes law and is incorporated into the Internal Revenue Code of 1986 (i.e., Title 26 of the U.S. Code, which contains all codified laws of the US). If the president vetoes the legislation, Congress may override the veto with a two-thirds positive vote in both the House of Representatives and Senate.*

21. [LO 4] What are the three committees that debate proposed tax legislation? What documents do these committees generate, and how might they be used?

    The House Ways and Means Committee, Senate Finance Committee, and Joint Conference Committee each produce a committee report that explains the current tax law, proposed change in the law, and justification for the change. These committee reports are considered "statutory" sources of the tax law and may be very useful in interpreting tax law changes and understanding Congressional intent. This is especially important after new legislation has been enacted because, with the exception of the Code, there will be very little authority interpreting the new law (i.e., no judicial or administrative authorities because of the time it takes for the new law to be litigated or for the IRS to issue interpretative guidance—e.g., regulations, etc.).

22. [LO 4] The president recently vetoed a tax act passed by the House and Senate. Is the tax act dead? If not, what will it take for the act to be passed?

    Congress may override the presidential veto with a two-thirds positive vote in the House of Representatives and Senate.

23. [LO 5] What are the five basic parts of an internal research memo?

    The memo has five basic parts: (1) facts, (2) issues, (3) authority list, (4) conclusion, and (5) analysis.

24. [LO 5] What is the difference between primary and secondary authorities? Explain the role of each authority type in conducting tax research.

    Primary authorities are official sources of the tax law generated by the legislative branch, judicial branch, or executive/administrative branch. Secondary authorities are unofficial tax authorities that basically interpret and explain the primary authorities. Secondary authorities may be very helpful in understanding a tax issue, but they hold little weight in a tax dispute (hence, the term unofficial tax authorities). Thus, tax advisers should always be careful to verify their understanding of tax law by examining primary authority directly and never cite secondary authority in a tax research memo.

25. [LO 5] Jorge is puzzled that the IRS and his CPA could legitimately reach different conclusions on a tax issue. Why does this happen?

The tax law is not always clear—i.e., the Code does not specifically address the tax consequences of each transaction type or every possible variation of a particular transaction and thus, the application of the tax law is subject to debate and differing interpretations by the IRS, courts, CPAs, taxpayers, etc.

26. [LO 5] What is the difference between open and closed facts? How is this distinction important in conducting tax research?

    Open facts are those that have not yet occurred (e.g., the facts associated with a proposed transaction). Closed facts are those that have already occurred (i.e., facts that have already transpired). The distinction between open and closed facts is important because open facts can be altered, and thus are flexible. Different facts may result in very different tax consequences. Open facts allow the taxpayer to arrange a transaction to achieve the most advantageous outcome.

27. [LO 5] In writing a research memo, what types of facts should be included in the memo?

    Discuss facts that are relevant to the question presented—that is, facts that provide necessary background of the transaction and those facts that may influence the research answer (generally who, what, when, where, and how much). The fact discussion should be relatively brief to focus the reader's attention on the relevant characteristics of the transaction.

28. [LO 5] Amber is a tax expert, whereas Rob is a tax novice. Explain how their process in identifying tax issues may differ.

    A CPA's ability to identify issues is largely a function of his or her tax expertise. A tax expert in a particular area will typically be able to identify quickly the specific tax issues that relate to transactions in that area. A novice, on the other hand, would likely identify broader issues first and then more specific issues as he researched the relevant tax law.

29. [LO 5] Discuss the basic differences between annotated and topical tax services. How are these services used in tax research?

    Annotated tax services are arranged by code section—i.e., for each code section, an annotated service includes the code section, a listing of the code section history, copies of congressional committee reports that explain changes to the code section, a copy of all the regulations issued for the specific code section, the service's unofficial explanation of the code section, and brief summaries (called annotations) of relevant court cases, revenue rulings, revenue procedures, letter rulings, etc. that address issues specific to the code section.

    Topical tax services are arranged by topic (e.g., taxable forms of income, tax-exempt income, trade or business expenses, etc.). For each topic, the services *identify tax issues that relate to each topic, and then explain and cite (i.e., reference) authorities relevant to the issue (code sections, regulations, court cases, revenue rulings, etc.). Beginning tax researchers often prefer topical services, as they generally are easier to read.*

An expert would probably go directly to the relevant portions of an annotated or topical service. A novice may conduct a keyword search in the service, use the tax service's topical index, or browse the tax service to identify the relevant portions of the service.

30. [LO 5] In constructing a keyword search, what should the keyword search include?

    An ideal keyword search typically includes (1) the relevant area of law and (2) a fact or two that describes the transaction.

31. [LO 5] Lindley has become very frustrated in researching a tax issue using keyword searches. What suggestions can you give her?

    If keyword searching is not proving beneficial, check your spelling, make sure you are searching the correct database, rethink your keywords, use another research method, use another tax service, or at as a last resort, take a break.

32. [LO 5] Nola, a tax novice, has a fairly simple tax question. Besides tax services, what are some sources that she can use to answer her question?

    Tax publishers, such as CCH and RIA, produce quick reference tax guides (e.g., the CCH Master Tax Guide or the RIA Tax Handbook) that may be used to answer basic tax questions.

33. [LO 5] Armando identifies a tax research question as being a question of fact. What types of authorities should he attempt to locate in his research?

    If you are researching a question of fact, it is important for the researcher to understand which facts determine the answer. In this type of question, Armando should focus his efforts understanding how various facts impact the research answer and identifying authorities with fact patterns similar to his client's fact pattern.

34. [LO 5] How are citators used in tax research?

    Citators are used to review the history of a case (i.e., was it subsequently appealed and overturned?) and to identify subsequent cases that cite the case (i.e., either favorably, which strengthens the case, or unfavorably, which weakens the case). Citators can also be used to check the status of revenue rulings, *revenue procedures, and other IRS pronouncements.*

35. [LO 5] What is the general rule for how many authorities a research memo should discuss?

    Enough to provide a clear understanding of the issue and interpretation of the law. It's important to consider authorities that may support and authorities that may go against your desired conclusion to reach an accurate assessment of the strength of your conclusion.

36. [LO 6] Identify some of the sources for tax professional standards. What are the potential ramifications of failing to comply with these standards?

    Some examples include: the American Institute of CPAs (AICPA) Code of Professional Conduct, the AICPA Statements on Standards for Tax Services (SSTS), the IRS's Circular 230, and statutes enacted by a CPA's specific State Board of Accountancy. Failure to comply with the standards could result in some rather adverse consequences for the tax professional (e.g., being admonished, suspended, barred from practicing before the IRS, admonished, suspended, or expelled from the AICPA, suspension or revocation of the CPA license, etc.).

37. [LO 6] Levi is recommending a tax return position to his client. What standard must he meet to satisfy his professional standards? What is the source of this professional standard?

    AICPA SSTS No. 1 provides that a tax professional must comply with the standards imposed by the applicable tax authority when recommending a tax return position or preparing or signing a tax return. IRC Sec. 6694 provides these standards for federal tax purposes.

    IRC Sec. 6694 imposes a penalty on a tax practitioner for any position that is not supported by substantial authority. A good tax professional evaluates whether supporting authority is substantial based upon the supporting and opposing authorities' weight and relevance. Substantial authority suggests the probability that the taxpayer's position is sustained upon audit or litigation is in the 35 to 40 percent range or above. The tax practitioner can also avoid penalty under IRC Sec. 6694 if the tax return position has at least a reasonable basis (i.e., supported by one or more authorities) and the position is disclosed on the taxpayer's return.

    Circular 230 imposes the same tax practitioner standards as in IRC Sec. 6694 for when a tax practitioner generally may recommend a tax return position (substantial authority and no disclosure or reasonable basis with disclosure).

38. [LO 6] What is Circular 230?

Circular 230 provides regulations governing tax practice and applies to all persons practicing before the IRS. There are five parts of Circular 230: Subpart A describes who may practice before the IRS (e.g., CPAs, attorneys, enrolled agents) and what practicing before the IRS means (tax return preparation, representing clients before the IRS, etc.). Subpart B describes the duties and restrictions that apply to individuals governed by Circular 230. Included in Subpart B are provisions discussing the submission of records to the IRS, guidelines when a practitioner discovers a tax return error, restrictions on charging contingency fees, prohibition of sharing employment with someone suspended from practicing before the IRS, stringent rules relating to providing advice for tax shelters, and standards for when a practitioner can recommend a tax return position. Subparts C and D explain sanctions and disciplinary proceedings for practitioners violating the Circular 230 provisions. Subpart E concludes with a few miscellaneous provisions (such as the Circular 230 effective date).

Circular 230 imposes the same tax practitioner standards as in IRC Sec. 6694 for when a tax practitioner generally may recommend a tax return position (substantial authority and no disclosure or reasonable basis with disclosure).

39. [LO 7] What are the basic differences between civil and criminal tax penalties?

Civil penalties are much more common, generally in the form of monetary penalties, and may be imposed when tax practitioners or taxpayers violate tax statutes without reasonable cause, as the result of negligence or intentional disregard of pertinent rules, or through willful disobedience or outright fraud. Criminal penalties are much less common than civil penalties. They are commonly charged in tax evasion cases (i.e., willful intent to defraud the government) but are imposed only after normal due process (i.e., trial). There is a higher standard for conviction in a criminal trial (beyond a reasonable doubt). However, the penalties are also much higher (i.e., fines up to $100,000 for individuals plus a prison sentence).

40. [LO 7] What are some of the most common civil penalties imposed on taxpayers?

Some common examples of civil penalties that apply to taxpayers include: failure to file a tax return (5 percent of tax due per month with a maximum of 25% of net tax due), failure to pay tax owed (0.5 percent of tax due per month with a maximum of 25% of net tax due), failure to make estimated tax payments (rate varies on federal short-term interest rate and underpayment), substantial understatement of tax (20 percent of understatement), underpayment of tax due to transactions lacking economic substance (20 percent or 40 percent of understatement), providing false withholding information ($500), and fraud (75 percent of liability attributable to fraud).

41. [LO 7] What are the taxpayer's standards to avoid the substantial understatement of tax penalty?

    Taxpayers are not subject to penalty (i.e., a substantial understatement of tax penalty) for a disallowed tax return position if there is substantial authority that supports the tax return position. One evaluates whether supporting authority is "substantial" or not based upon the supporting and opposing authorities' weight and relevance. Substantial authority suggests that the probability that the taxpayer's position is sustained upon audit or litigation is in the 35 to 40 percent range or above. The taxpayer can also avoid penalty if the tax return position has a reasonable basis (i.e., supported by one or more tax authorities) and the position is disclosed on the taxpayer's return.

42. [LO 7] What are the tax practitioner's standards to avoid a penalty for recommending a tax return position?

    IRC Sec. 6694 imposes a penalty on a tax practitioner *for any position that that is not supported by substantial authority. A good tax professional evaluates whether supporting authority is substantial based upon the supporting and opposing authorities' weight and relevance. Substantial authority suggests the probability that the taxpayer's position is sustained upon audit or litigation is in the 35 to 40 percent range or above. The tax practitioner can also avoid penalty under IRC Sec. 6694 if the tax return position has at least a reasonable basis (i.e., supported by one or more tax authorities) and the position is disclosed on the taxpayer's return.*

Problems

43. [LO 1] Ahmed does not have enough cash on hand to pay his taxes. He was excited to hear that he can request an extension to file his tax return. Does this solve his problem? What are the ramifications if he doesn't pay his tax liability by April 15?

    Extensions allow the taxpayer to delay filing a tax return but <u>*do not*</u> *extend the due date for tax payments. If a taxpayer fails to pay the entire balance of tax owed by the original due date of the tax return, the IRS charges the taxpayer interest on the underpayment from the due date of the return until the taxpayer pays the tax. The interest rate charged depends on taxpayer type (e.g., individual vs. corporation) and varies quarterly with the federal short-term interest rate. The interest rate for tax underpayments for individuals equals the federal short-term rate plus three percentage points.*

44. [LO 1] Molto Stancha Corporation had zero earnings this fiscal year; in fact, they lost money. Must they file a tax return?

Yes, all corporations are required to file an income tax return regardless of their taxable income.

45. [LO 1] The estate of Monique Chablis earned $450 of income this year. Is the estate required to file an income tax return?

    No, because the estate's gross income is less than $600, the estate is not required to file an income tax return.

46. [LO 1] Jamarcus, a full-time student, earned $2,500 this year from a summer job. He had no other income this year and will have zero federal income tax liability this year. His employer withheld $300 of federal income tax from his summer pay. Is Jamarcus required to file a tax return? Should Jamarcus file a tax return?

    Jamarcus is not required to file an income tax return because his gross income of $2,500 is well below the gross income threshold for a single taxpayer. However, he should file a tax return to receive a refund of the $300 previously withheld.

47. [LO 1] Shane has never filed a tax return despite earning excessive sums of money as a gambler. When does the statute of limitations expire for the years in which Shane has not filed a tax return?

    The statute of limitations remains open indefinitely for years in which the taxpayer fails to file a return.

48. [LO 1] Latoya filed her tax return on February 10th this year. When will the statute of limitations expire for this tax return?

    The statute of limitations generally ends three years from the later of (i) the date the tax return was actually filed (3 years from February 10th of this year) or (ii) the tax return's original due date (3 years from April 15th of this year). Accordingly, Latoya's statute of limitations for the tax return will end 3 years from April 15th.

49. [LO 1] Using the facts from the previous problem, how would your answer change if Latoya understated her income by 40 percent? How would your answer change if Latoya intentionally failed to report as taxable income any cash payments she received from her clients?

    A six-year statute of limitations applies to IRS assessments if the taxpayer omits items of gross income that exceed 25 percent of the gross income reported on the tax return. Thus, Latoya's statute of limitations would end 6 years from April 15th if she understated her income by 40 percent.

    The statute of limitations remains open indefinitely for fraudulent returns (e.g., if

Latoya intentionally fails to report cash payments received as income).

50. [LO 2] Paula could not reach an agreement with the IRS at her appeals conference and has just received a 90-day letter. If she wants to litigate the issue but does not have sufficient cash to pay the proposed deficiency, what is her best court choice?

    The U.S. Tax Court, the only court that allows tax cases to be heard before the taxpayer pays the disputed liability.

51. [LO 2] In choosing a trial-level court, how should a court's previous rulings influence the choice? How should circuit court rulings influence the taxpayer's choice of a trial-level court?

    It is relatively common for the trial courts (i.e., the U.S. Tax Court, local U.S. District Court, or the U.S. Court of Federal Claims) to interpret and rule differently on the same basic tax issue. Given a choice of courts, the taxpayer should prefer the court that is most likely to rule favorably on his or her particular issues. The taxpayer also has the ability to determine which circuit court (i.e., the circuit court based on her residence or the circuit court for the Federal Circuit) would hear her case through the initial selection of a trial court (i.e., U.S. District Court, U.S. Tax Court, or U.S. Court of Federal Claims). Given that alternative circuit courts may interpret the law differently, a taxpayer should consider the relevant circuit courts judicial history to determine which circuit court (and thus, which trial court) would be more likely to rule favorably for the taxpayer.

52. [LO 2] Sophia recently won a tax case litigated in the 7th Circuit. She recently heard that the Supreme Court denied the *writ of certiorari*. Should she be happy or not, and why?

    The denial of the writ of certiorari means that the Supreme Court has decided not to hear Sophia's case. Thus, Sophia should be happy, as 7th Circuit's ruling will not be reversed by the Supreme Court.

53. [LO 2] Campbell's tax return was audited because she failed to report interest she earned on her tax return. What IRS audit selection method identified her tax return?

    Information matching. This program compares the taxpayer's tax return to information submitted to the IRS from other taxpayers (banks, employers, mutual funds, brokerage companies, mortgage companies, etc.). Information matched includes items such as wages (Form W-2 submitted by employers), interest income (Form 1099-INT submitted by banks), dividend income (Form 1099-DIV submitted by brokerage companies, etc.), etc.

54. [LO 2] Yong's tax return was audited because he calculated his tax liability incorrectly. What IRS audit procedure identified his tax return for audit?

    All returns are checked for mathematical and tax calculation errors. This process is referred to as the document perfection program.

55. [LO 2] Randy deducted a high level of itemized deductions two years ago relative to his income level. He recently received an IRS notice requesting documentation for his itemized deductions. What audit procedure likely identified his tax return for audit?

    The Discriminant Function System (DIF system). The IRS likely selected Randy's return for audit because his high level of itemized deductions relative to his income resulted in a high DIF score.

56. [LO 2] {Planning} Jackie has a corporate client that has recently received a 30-day notice from the IRS with a $100,000 tax assessment. Her client is considering requesting an appeals conference to contest the assessment. What factors should Jackie advise her client to consider before requesting an appeals conference?

    An appeals officer would consider the merits of the unresolved issues as well as the "hazards of litigation"—that is, the probability that the IRS will lose if the case is brought to court and the resulting costs of a taxpayer-favorable ruling. Thus, the appeals officer has a bit more latitude to settle cases than examining agents. Because the appeals division is independent, it may be possible for the taxpayer to receive a more favorable resolution as the appeals officer has less emotionally invested in the audit. On the downside, the appeals officer may raise new issues, and thus, increase the taxpayer's tax exposure. In addition, the longer the dispute continues without resolution, the more interest will accrue on the assessment.

57. [LO 2] {Planning} The IRS recently completed an audit of Shea's tax return and assessed $15,000 additional tax. Shea requested an appeals conference but was unable to settle the case at the conference. She is contemplating which trial court to choose to hear her case. Provide her a recommendation based on the following alternative facts.

    a. Shea resides in the 2nd Circuit, and the 2nd Circuit has recently ruled against the position Shea is litigating.

    Shea should choose the U.S. Court of Federal Claims to move the case to the Federal Circuit jurisdiction instead of the 2nd Circuit.

    b. The Federal Circuit Court of Appeals has recently ruled in favor of Shea's position.

Shea should choose the Federal Circuit jurisdiction, and thus litigate in the U.S. Court of Federal Claims.

c. The issue being litigated involves a question of fact. Shea has a very appealing story to tell but little favorable case law to support her position.

Shea may benefit from a jury trial. Thus, her only option would be the U.S. District Court.

d. The issue being litigated is highly technical, and Shea believes strongly in her interpretation of the law.

Shea would benefit from having her case heard by tax experts. Thus, she should litigate in the U.S. Tax Court.

e. Shea is a local elected official and would prefer to minimize any local publicity regarding the case.

Local publicity is likely to be highest in a U.S. District Court. Thus, Shea should consider the U.S. Tax Court or the U.S. Court of Federal Claims.

58. [LO 3] Juanita, a Texas resident (5th Circuit), is researching a tax question and finds a 5th Circuit case ruling that is favorable and a 9th Circuit case that is unfavorable. Which circuit case has more "authoritative weight" and why? How would your answer change if Juanita were a Kentucky resident (6th Circuit)?

    The 5th Circuit case has more authoritative weight because Juanita lives in the 5th Circuit. If Juanita lived in the 6th Circuit, the 5th and 9th Circuit cases would have equal weight. Juanita should be careful to analyze both cases to understand the underlying reasoning for the different opinions.

59. [LO 3] Faith, a resident of Florida (11th Circuit) recently found a circuit court case that is favorable to her research question. Which two circuits would she prefer to have issued the opinion?

    She would prefer the circuits that would potentially hear her case to have issued the opinion (i.e., the 11th Circuit or the Federal Circuit).

60. [LO 3] Robert has found a "favorable" authority directly on point for his tax question. If the authority is a court case, which court would he prefer to have issued the opinion? Which court would he least prefer to have issued the opinion?

    Given the favorable ruling, Robert should prefer the Supreme Court (i.e., the highest authority) to have issued the opinion. He would least prefer a U.S. District Court in a jurisdiction other than his district as this court would have the *least authoritative weight and would not have jurisdiction for Robert's case if litigated.*

61. [LO 3] Jamareo has found a "favorable" authority directly on point for his tax question. If the authority is an administrative authority, which specific type of authority would he prefer to answer his question? Which administrative authority would he least prefer to answer his question?

    Jamareo should prefer that the authority be an IRS regulation, as this is the highest administrative authority. Private letter rulings are generally considered the least administrative authority; thus, Jamareo would least prefer this type of authority.

62. [LO 3] For each of the following citations identify the type of authority (statutory, administrative, or judicial) and explain the citation.

    a. Reg. Sec. 1.111-1(b)

    Administrative. Type of regulation (1 = income tax), code section 111, regulation number 1, paragraph b.

    b. IRC Sec. 469(c)(7)(B)(i)

    Statutory. Section 469, subsection c, paragraph 7, subparagraph B, clause i.

    c. Rev. Rul. 82-204, 1982-2 C.B. 192

    Administrative. Ruling number 82-204 (204th ruling of 1982), volume of cumulative bulletin 1982-2, page number 192.

    d. *Amdahl Corp*., 108 TC 507 (1997)

    Judicial. Volume 108 of the Tax Court reporter, page 507, year 1997.

    e. PLR 9727004

    Administrative. Year 1997, week number 27 (27th week of 1997), ruling number 004 (4th ruling of the week).

    f. *Hills v. Comm.*, 50 AFTR 2d 82 6070 (11th Cir., 1982)

    Judicial. 50th volume of RIA AFTR2d court reporter, paragraph 82, circuit 11th, year 1982.

63. [LO 3] For each of the following citations, identify the type of authority (statutory, administrative, or judicial) and explain the citation.

a. IRC Sec. 280A(c)(5)

Statutory. Section 280A, subsection c, paragraph 5

b. Rev. Proc. 2004-34, 2004-1 C.B. 911

Administrative. Procedure number 2004-34 (34th procedure of 2004), volume of cumulative bulletin 2004-1, page number 911.

c. *Lakewood Associates*, RIA TC Memo 95-3566.

Judicial. Paragraph number 95-3566 of the RIA Tax Court Memorandum reporter.

d. TAM 200427004

Administrative. Year 2004, week number 27 (27th week of 2004), ruling number 004 (4th ruling of the week).

e. *U.S. v. Muncy*, 2008-2 USTC par. 50,449 (E.D., AR, 2008)

Judicial. 2008-2 volume of the CCH court reporter, paragraph 50,449, Eastern District (E.D.), state Arkansas, year 2008.

64. [LO 4] Justine would like to clarify her understanding of a code section recently enacted by Congress. What tax law sources are available to assist Justine?

The House Ways and Means Committee, Senate Finance Committee, and Joint Conference Committee each produce a committee report that explains the current tax law, proposed change in the law, and justification for the change. These committee reports are considered statutory sources of the tax law and may be very useful in interpreting tax law changes and understanding Congressional intent. This is especially important after new legislation has been enacted because, with the exception of the Code, there will be very little authority interpreting the new law (i.e., no judicial or administrative authorities because of the time it takes for the new law to be litigated or for the IRS to issue interpretative guidance—e.g., regulations, etc.).

65. [LO 5] Aldina has identified conflicting authorities that address her research question. How should she evaluate these authorities to make a conclusion?

The tax researcher should evaluate the hierarchy, jurisdiction, and age of the authority, placing more weight on higher and newer authorities that have jurisdiction over the taxpayer.

66. [LO 5] Georgette has identified a 1983 court case that appears to answer her research question. What must she do to determine if the case still represents "current" law?

    Georgette should check the court case's history in the citator. The citator can be used to review the history of the case to find out, for example, whether it was subsequently appealed and overturned and to identify subsequent cases that cite the case. Favorable citations strengthen a case, while unfavorable citations weaken the case.

67. [LO 5] Sandy has determined that her research question depends upon the interpretation of the phrase "not compensated by insurance." What type of research question is this?

    This is a question of law—i.e., the answer hinges upon the interpretation of a particular phrase in a code section.

68. [LO 5] {Research} J.C. has been a professional gambler for many years. He loves this line of work and believes the income is tax-free.

    a. Use an available tax research service to determine whether J.C.'s thinking is correct. Is the answer to this question found in the Internal Revenue Code? If not, what type of authority answers this question?

    b. Write a short memo communicating the results of your research.

    J.C. is incorrect. It is well established that gambling income is taxable as gross income. This issue is not specifically addressed in the code. Instead, see the following court cases that address this issue. Slavin, Arthur, (1941) 43 BTA 1100, McKenna, James, (1925) 1 BTA 326. Ellery, E., (1944) 4 TC 407 (1944).

69. [LO 5] {Research} Katie recently won a ceramic dalmatian valued at $800 on a television game show. She questions whether this prize is taxable since it was a "gift" she won on the show.

    a. Use an available tax research service to answer Katie's question.

    b. Write a letter to Katie communicating the results of your research.

    IRC Sec. 74(a) provides that gross income includes amounts received as prizes and awards. IRC Sec. 74 provides some exceptions to the general rule, but Katie will not satisfy any of these exceptions.

70. [LO 5] {Research} Pierre recently received a tax penalty for failing to file a tax return. He was upset to receive the penalty, but he was comforted by the thought that he will get a tax deduction for paying the penalty.

a. Use an available tax research service to determine if Pierre is correct.

b. Write a memo communicating the results of your research.

IRC Sec. 162(f) states that no deduction is allowed for any penalty paid to a government for the violation of any law. Reg. Sec. 1.162-21 further clarifies that penalties include civil penalties imposed by Federal, State, or local law, including additions to tax.

71. [LO 5] {Research} Paris was happy to provide a contribution to her friend Nicole's campaign for mayor, especially after she learned that charitable contributions are tax deductible.

    a. Use an available tax service to determine whether Paris can deduct this contribution.

    b. Write a memo communicating the results of your research.

    It is well established that political contributions are not deductible—either under IRC Sec. 162 as trade or business expenses or under IRC Sec. 170 as charitable contributions.

72. [LO 5] {Research} Matt and Lori recently were divorced. Although grief stricken, Matt was at least partially comforted by his monthly receipt of $10,000 alimony. He was particularly excited to learn from his friend, Denzel, that the alimony was not taxable. Use an available tax service to determine if Denzel is correct. Would your answer change if Matt and Lori continued to live together?

    IRC Sec. 71(a) specifically states that alimony is included in gross income (i.e., it is taxable). If Matt and Lori continue to live together, the $10,000 would not meet the definition of alimony under IRC Sec. 71(b)(1)(C), and thus, would not be taxable.

73. [LO 5] {Research} Shaun is a huge college football fan. In the past, he has always bought football tickets on the street from ticket scalpers. This year, he decided to join the university's ticket program, which requires a $2,000 contribution to the university for the "right" to purchase tickets. Shaun will then pay $400 per season ticket. Shaun understands that the price paid for the season tickets is not tax deductible as a charitable contribution. However, contributions to a university are typically tax deductible.

    a. Use an available tax service to determine how much, if any, of Shaun's $2,000 contribution for the right to purchase tickets is tax deductible.

    b. Write a letter to Shaun communicating the results of your research.

IRC Sec. 170(l) provides that only 80 percent of the amount contributed to the University for the right to purchase tickets is tax deductible.

74. [LO 5] {Research} Latrell recently used his Delta Skymiles to purchase a free round trip ticket to Milan, Italy (value $1,200). The frequent flyer miles used to purchase the ticket were generated from Latrell's business travel as a CPA. Latrell's employer paid for his business trips, and he was not taxed on the travel reimbursement.

    a. Use an available tax research service to determine how much income, if any, does Latrell have to recognize as a result of purchasing an airline ticket with Skymiles earned from business travel.

    b. Write a memo communicating the results of your research.

    IRS Announcement 2002-18 states that frequent flier miles earned for business travel and redeemed for in-kind benefits (e.g., a free airline ticket) do not represent taxable income. This ruling only applies to in-kind benefits and not frequent flier miles converted to cash. Since Latrell used his frequent flier miles to purchase an airline ticket, he will have no taxable income from the transaction.

75. [LO 5] {Research} Benjamin, a new staff accountant for Local Firm CPAs, LLC, takes a CPA review course to help prepare for the CPA exam. Benjamin is not reimbursed for the cost of the course ($1,500), but his firm expects him to take and pass the exam.

    a. Use an available tax research service to determine if Benjamin may deduct the cost of the CPA exam course.

    b. Write a memo communicating the results of your research.

    Benjamin cannot deduct the cost of the CPA review course because passing the exam qualifies Benjamin for a new trade or business. See Rev. Rul. 69-292, 1969-1 CB 84 and William D. Glenn, 62 TC 270 (1974).

76. [LO 6] Randy has found conflicting authorities that address a research question for one of his clients. The majority of the authorities provide an unfavorable answer for his client. Randy estimates that if the client takes the more favorable position on its tax return that there is approximately a 48 percent chance that the position will be sustained upon audit or judicial proceeding. If the client takes this position on its tax return, will Randy be subject to penalty? Will the client potentially be subject to penalty?

    A tax preparer (Randy) may recommend a tax return position and avoid penalty if the position is supported by substantial authority. A good tax professional *evaluates whether supporting authority is substantial based upon the supporting and opposing authorities' weight and relevance. Substantial authority suggests the probability that the taxpayer's position is sustained upon audit or litigation is in the 35 to 40 percent range or above. The tax practitioner can also avoid penalty under IRC Sec. 6694 if the tax return position has at least a reasonable basis (i.e., supported by one or more tax authorities) and the position is disclosed on the taxpayer's return. Because Randy estimates that there is a 48 percent chance that the position will be sustained, the taxpayer does not have to disclose the tax return position on the tax return for Randy to avoid penalty.*

Similar tax return standards apply to taxpayers. Specifically, a taxpayer will also not be subject to an underpayment penalty if there is substantial authority that supports the tax return position or if the tax return position has a reasonable basis and the position is disclosed on the taxpayer's return. Thus, based on the stated facts, Randy's client would also not have to disclose the position on its tax return to avoid penalty.

77. [LO 6] Using the same facts from the previous problem, how would your answer change if Randy estimates that there is only a 20 percent chance that the position will be sustained upon audit or judicial proceeding?

    To avoid both taxpayer and tax preparer penalties, the position must be disclosed on the tax return. Unlike the previous problem, the 20 percent likelihood of success does not meet the substantial authority standard. Thus, disclosure is required to avoid the taxpayer and tax preparer penalties.

78. [LO 7] Sasha owes additional tax imposed in a recent audit. In addition to the tax, will she be assessed other amounts? If so, how will these amounts be determined?

    Sasha will owe interest on the assessed tax. The IRS charges the taxpayer interest on the underpayment from the due date of the return until the taxpayer pays the tax. The interest rate for tax underpayments for individuals equals the federal short-term rate plus three percentage points.

79. [LO 7] Maurice has a client that recently asked him about the odds of the IRS detecting cash transactions not reported on a tax return. What are some of the issues that Maurice should discuss with his client?

    Maurice should discuss the severe negative consequences of committing tax fraud (civil and criminal penalties) as well as his own professional standards. If Maurice suspects that his client is not fully reporting his income, he should carefully consider terminating the client relationship.

Chapter 1
An Introduction to Tax

INSTRUCTOR'S MANUAL

Learning Objectives

1. Demonstrate how taxes influence basic business, investment, personal, and political decisions.
2. Discuss what constitutes a tax and the general objectives of taxes.
3. Describe the different tax rate structures and calculate a tax.
4. Identify the various federal, state and local taxes.
5. Apply appropriate criteria to evaluate alternate tax systems.

Teaching Suggestions

This chapter provides an overview of why taxes are important, what is a tax, how to calculate a tax, various tax rates and tax rate structures, different types of federal, state, and local taxes, and how to evaluate a tax system. One intent of the chapter is to get students thinking about the pervasive influence of taxes and thus why it is important for a business or accounting student to understand taxes. Discussing how taxes impact decisions that they will face (buying a house, investing for retirement, etc.) is an effective way to peak students' interest.

This chapter also provides an opportunity to motivate students by discussing the political importance of taxes and the debate of alternative tax systems. Throughout most of the chapter, you can tie the material discussed back to the debate of alternative tax systems. This is easily done in the section on evaluating alternative tax systems and alternative tax rate structures but may also be done for other parts of the text. For example, when discussing how to calculate a tax, you can point out that once the tax base is computed, it is very easy to calculate virtually any tax. The difficulty is in determining the tax base. The implication of this understanding is that the tax rate structure (e.g., progressive vs. proportional) has little effect on tax complexity.

In teaching this chapter, the time that you spend in class will vary based on how much discussion that you want to incorporate regarding evaluating tax systems and implicit taxes. Most of the concepts in this chapter are relatively straight forward, and thus, the chapter provides students with an introduction to tax without overwhelming them on the first day or so of class. This is particularly important if your students have some trepidation regarding their first tax course.

Implicit tax is typically a difficult concept for students to understand. The text provides a good overview of implicit tax. If you plan to cover implicit tax in some detail, you might alert students that this is a difficult concept and that they should be careful to get familiar with this discussion in the text prior to class.

Assignment Matrix

			Learning Objectives					Text Features		
		Difficulty	LO1	LO2	LO3	LO4	LO5	Research	Planning	Forms
DQ1-1	5 min.	Easy	X							
DQ1-2	5 min.	Easy	X							
DQ1-3	5 min.	Easy	X							
DQ1-4	5 min.	Easy		X						
DQ1-5	5 min.	Medium		X						
DQ1-6	5 min.	Medium		X						
DQ1-7	5 min.	Medium		X						
DQ1-8	10 min.	Medium		X						
DQ1-9	5 min.	Medium		X						
DQ1-10	10 min.	Medium			X					
DQ1-11	15 min.	Medium			X					
DQ1-12	5 min.	Medium			X					
DQ1-13	15 min.	Medium			X					
DQ1-14	10 min.	Medium			X					
DQ1-15	5 min.	Easy				X				
DQ1-16	15 min.	Medium				X				
DQ1-17	5 min.	Easy				X				
DQ1-18	5 min.	Easy				X				
DQ1-19	10 min.	Medium				X				
DQ1-20	10 min.	Medium				X				
DQ1-21	10 min.	Easy				X				
DQ1-22	10 min.	Easy				X				
DQ1-23	15 min.	Medium				X				
DQ1-24	15 min.	Medium				X				
DQ1-25	15 min.	Medium				X				
DQ1-26	15 min.	Medium					X			
DQ1-27	15 min.	Medium					X			
DQ1-28	15 min.	Medium					X			
DQ1-29	15 min.	Medium			X		X			
DQ1-30	20 min.	Medium			X		X			
DQ1-31	15 min.	Medium				X	X			
DQ1-32	15 min.	Medium					X			
DQ1-33	15 min.	Medium					X			
P1-34	20 min.	Medium			X					
P1-35	20 min.	Medium			X					
P1-36	15 min.	Medium			X					
P1-37	20 min.	Medium			X					
P1-38	20 min.	Medium			X					
P1-39	20 min.	Medium			X					
P1-40	20 min.	Medium			X					

P1-41	15 min.	Medium			X					
P1-42	20 min.	Medium			X					
P1-43	20 min.	Medium			X					
P1-44	20 min.	Hard			X	X				
P1-45	15 min.	Medium			X	X			X	
P1-46	15 min.	Medium			X	X			X	
P1-47	15 min.	Medium			X	X			X	
P1-48	15 min.	Medium			X	X			X	
P1-49	20 min.	Hard			X					
P1-50	20 min.	Hard			X					
P1-51	20 min.	Hard			X		X			
P1-52	20 min.	Hard			X		X			
P1-53	20 min.	Hard					X			
P1-54	20 min.	Hard					X			
P1-55	20 min.	Hard					X			
P1-56	20 min.	Hard					X			
P1-57	20 min.	Hard					X			
P1-58	20 min.	Hard					X			
P1-59	25 min.	Hard	X			X			X	
P1-60	25 min.	Hard			X		X		X	
P1-61	25 min.	Medium					X	X		
P1-62	25 min.	Medium				X		X		

Lecture Notes

1) Who cares about taxes and why?
   a) Businesses
   b) Politicians
   c) Individuals
2) What qualifies as a tax?
   a) Definition of a tax
      i) Key components of definition: payment is required, imposed by a government agency, and not directly to the benefit received by the taxpayer.
   b) Earmarked tax – definition & why is this considered a tax
   c) Quiz students on tax definition using examples in the PowerPoint slides.
3) How to calculate a tax
   a) Tax = Tax Base × Tax Rate
      i) Tax Base – what is actually taxed, usually expressed in monetary terms
      ii) Tax Rate – level of taxes imposed on the tax base, usually expressed as a percentage
      iii) Flat taxes
      iv) Graduated taxes
      v) Brackets
4) Different ways to measure tax rates
   a) Marginal tax rate
      i) Definition – tax rate that applies to the next additional increment of a taxpayer’s taxable income (or deductions).

- ii) Formula - $\frac{\Delta Tax}{\Delta TaxableIncome} = \frac{(NewTotalTax - OldTotalTax)}{(NewTaxableIncome - OldTaxableIncome)}$
- iii) Useful in tax planning

b) Average tax rate
- i) Definition – a taxpayer's average level of taxation on each dollar of taxable income
- ii) Formula - $\frac{TotalTax}{TaxableIncome}$
- iii) Useful in budgeting tax expenses or comparing the relative tax burdens of taxpayers.

c) Effective tax rate
- i) Definition – taxpayer's average rate of taxation on each dollar of total income, including taxable *and* nontaxable income.
- ii) Formula - $\frac{TotalTax}{TotalIncome}$
- iii) Provides the best depiction of a taxpayer's tax burden.

d) Work example in the PowerPoint slides calculating tax liability, marginal, average, and effective tax rates.

5) Tax rate structures

a) Proportional tax rate structure
- i) Definition – also known as a flat tax, imposes a constant tax rate throughout the tax base.
- ii) As the tax base increases, the taxes paid increase proportionally.
- iii) The marginal tax rate remains constant and equals the average tax rate across the tax base
- iv) The most common example of a proportional tax is a sales tax.

b) Progressive tax rate structure
- i) Definition – imposes an increasing marginal tax rate as the tax base increases.
- ii) As the tax base increases, both the marginal tax rate and the taxes paid increase.
- iii) Common examples of progressive tax rate structures include federal and state income taxes and federal estate and gift taxes.

c) Regressive tax rate structure
- i) Definition – imposes a decreasing marginal tax rate as the tax base increases.
- ii) As the tax base increases, the taxes paid increases, but the marginal tax rate decreases.
- iii) Regressive tax rate structures are not common. In the United States, only the Social Security tax employs a regressive tax rate structure.

d) Discuss how different taxes can be viewed as having different rate structures when you consider effective tax rates vs. marginal tax rates (e.g., the sales tax).

6) Types of taxes

a) Federal taxes
- i) Income tax: imposed on individuals, corporations, estates and trusts. The largest federal tax.
- ii) Employment taxes: Employment taxes consist of the OASDI tax (Social Security tax) and the MHI tax (Medicare tax). The tax base for these taxes is wages or salary and employers and employees split these taxes equally. Self-employed individuals must pay these taxes in their entirety.
- iii) Unemployment taxes: Employers are also required to pay federal and state unemployment taxes, which fund temporary unemployment benefits for individuals terminated from their jobs without cause.
- iv) Excise taxes: A tax based on quantity of goods or services purchased. Common examples include taxes on alcohol, diesel fuel, gasoline, and tobacco products and on services such as telephone use and air transportation
- v) Transfer taxes: The estate tax and gift taxes are based on the fair market values of wealth transfers upon death or by gift, respectively.

b) State and local taxes
    i) Income tax: most states impose an income tax. The calculation varies by state.
    ii) Sales and use taxes: the tax base for a sales tax is the retail sales of goods and some services. Retailers collect and remit this tax. The tax base for the use tax is the retail price of goods owned, possessed or consumed within a state that were *not* purchased within the state. The purpose of a use tax is to discourage taxpayers from buying goods out of state in order to avoid or minimize the sales tax in their home state.
    iii) Property taxes: assessed on the fair market value of real property and personal property. These are ad valorem taxes.
    iv) Excise taxes
c) Implicit taxes
    i) Indirect taxes that result from a tax advantage the government grants to certain transactions.
    ii) Defined as the reduced before-tax return that a tax-favored asset produces because of its tax advantaged status.
    iii) Difficult to quantify but important to understand in evaluating the relative tax burdens of tax-advantaged investments.
    iv) Walk through examples of implicit taxes in text.

7) Evaluating alternative tax systems
a) Sufficiency
    i) Involves assessing the aggregate size of the tax revenues that must be generated and making sure that the tax system provides these revenuesStatic forecasting: Forecasting revenue ignores how taxpayers might alter their activities in response to a tax law change and to base projected tax revenues on the existing state of transactions.
    iii) Dynamic forecasting: Forecasting which tries to predict possible responses by taxpayers to new tax laws.
    iv) Income Effect: As tax rates go up, people will work harder to maintain same after-tax income.
    v) Substitution Effect: As tax rates go up, people will substitute non-taxable activities because the marginal value of taxable ones has decreased.
b) Equity
    i) A tax system is considered fair or equitable if the tax is based on the taxpayer's ability to pay.
    ii) Horizontal Equity: two taxpayers in similar situations pay the same tax.
    iii) Vertical Equity: taxpayers with greater ability to pay tax, pay more tax relative to taxpayers with a lesser ability to pay tax. Vertical equity can be viewed in terms of tax dollars paid or tax rates. Vertical equity may also be evaluated using effective tax rates instead of simply considering the tax rate structure.
c) Certainty
    i) Taxpayers should be able to determine when to pay the tax, where to pay the tax, and how to determine the tax.
d) Convenience
    i) A tax system should be designed to be collected without undue hardship to the taxpayer.
e) Economy
    i) A tax system should minimize the compliance and administration costs associated with the tax system.

f) Compare the income tax and sales tax using the equity, certainty, convenience, and economy criteria.
g) Evaluating tax systems – the trade-off
   i) Much of the debate regarding alternative tax systems reduces to a choice between simplicity and fairness.
   ii) Those taxes that generally are simpler and easier to administer are typically viewed as less fair. Those taxes that may be viewed as more fair are often are more complex to administer.

Class Activities

- **Designing a tax system**: Tell students that the class has just seceded from the U.S. and needs to develop a tax system sufficient to generate $XX, XXX from the class members. Have the students break into groups of 3-5 to design a tax system. As part of this task, they are to evaluate the advantages and disadvantages of their tax. The group judged by the class to have the most advantageous tax system receives bonus participation points for the day.
- **What is fair?** Put two different tax systems in front of the class – one a proportional tax rate; one a progressive tax system. Poll the class by show of hands to determine which tax system each person views as being fairer. Either in groups or as a class, have the students discuss why they view a specific system as being fairer. After the discussion, poll the class by show of hands to determine if anyone has changed their view of which tax is fairer. Then discuss with the class that there is no right answer as to which system is fairer. Instead, the answer depends on a person's individual views on fairness.
- **One versus the class**: Have one student volunteer as the "one" with the other class members being the "group." Use the key facts boxes in the text to develop multiple-choice questions (A, B, C answers) and then quiz the volunteer and the class on the questions. The volunteer and each class member will need to write the letters A, B, and C on separate sheets of paper and then hold up their appropriate response to the question. Once a student (either the "one" or a member of the "group") misses a question, her or she is eliminated from the competition. After 6 (or some other number) of questions, those students left standing receive bonus participation points for the day.
- **Discuss current tax policy topics**: Find a few recent articles discussing tax reform, the current income distribution, or the millionaire surtax. Post the articles so that students can read before class and ask a few questions to begin the class discussion.

Research Activities

- Show the class the IRS web site and some of the materials included in the web site – e.g., publications, IRS forms, etc.
- Have students research the Presidential candidates tax platforms and compare and contrast the likely changes to the Internal Revenue Code.

Chapter 2
Tax Compliance, the IRS, and Tax Authorities

INSTRUCTOR'S MANUAL

Learning Objectives

1. Identify the filing requirements for income tax returns and the statute of limitations for assessment.
2. Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.
3. Evaluate the relative weights of the various tax law sources.
4. Describe the legislative process as it pertains to taxation.
5. Perform the basic steps in tax research and evaluate various tax law sources when faced with ambiguous statutes.
6. Describe tax professional responsibilities in providing tax advice.
7. Identify taxpayer and tax professional penalties.

Teaching Suggestions

This chapter provides a summary of the filing requirements for income tax returns, the IRS audit process, tax law sources and tax research, tax professional responsibilities, and taxpayer and tax practitioner penalties. The time allotted to this chapter will vary based on your expectations regarding the students' abilities to conduct research in the course. The remaining material in the chapter (filing requirements, IRS audit process, tax professional responsibilities, and taxpayer and tax practitioner penalties) can be covered in a class session (or two).

Compared to chapter 1 and later chapters, the material in chapter 2 could be considered somewhat "dry." Thus, it is important to bring this material to life in the classroom as much as possible. Some suggestions for the class discussion include:

- Filing requirements – provide a basic overview of the filing requirements by entity and statute of limitations and then use discussion questions 1 through 3 and problems 43 – 49 to quiz students on their understanding.
- IRS audit process – most students are interested in how the IRS selects returns for audit. Discussing high-profile IRS cases (Richard Hatch, Survivor; Willie Nelson; Al Capone) or personal experiences with IRS audits is typically well received. After the discussion, quizzing the students on identifying the selection method and audit type for various fact patterns is an effective way to make sure that your students can apply the concepts from this discussion.
- Tax Law Sources – the depth you cover the various sources will vary with your expectations regarding the students' abilities to conduct research. If students will be expected to research problems, read primary authorities, etc., showing examples of the specific types of authorities that they will research (code sections, regulations, etc.), highlighting their attributes, contrasting different authorities, and discussing how to locate the authorities and make sure that they are "current" should prove beneficial. This discussion could then be followed with a discussion of how to conduct research and an in-class example of a simple research problem. [As an out of class exercise, you might assign students to locate specific primary authorities

(e.g., court cases, revenue rulings, etc.) and related discussion in an available tax service (CCH, RIA, BNA, etc.) and have the students summarize the issue addressed in the primary authority and tax service and how they located each authority.]

If instead, students are simply required to have a basic understanding of tax authorities with little or no research expectation, most of the discussion of authorities could focus on comparing different authorities and their relative weights. This discussion can then be reinforced with classroom questions comparing the weight of different authorities or contrasting different authorities using the "one vs. the group" activity suggested below.

- Tax legislation: This discussion may be aided by displaying Exhibit 2-7. You may also remind your class of the ABC Schoolhouse Rock song, "I'm Just a Bill", that highlights the legislative process. You can download this song on YouTube.
- Basic Tax Research Steps: This discussion may be enhanced by walking students through the research example in the text or through one of the end of chapter research problems.
- Tax professional standards/Taxpayer and tax practitioner penalties: This discussion may be enhanced by a discussion of the IRS' crackdown on tax shelters, the dire consequences associated with not meeting professional standards, and the recent increased thresholds to avoid tax practitioner penalties.

Assignment Matrix

			Learning Objectives							Text Feature		
		Difficulty	LO1	LO2	LO3	LO4	LO5	LO6	LO7	Research	Planning	Tax Forms
DQ2-1	5 min.	Easy	X									
DQ2-2	10 min.	Easy	X									
DQ2-3	10 min.	Medium	X									
DQ2-4	5 min.	Easy		X								
DQ2-5	10 min.	Medium		X								
DQ2-6	10 min.	Medium		X								
DQ2-7	10 min.	Medium		X								
DQ2-8	15 min.	Medium		X								
DQ2-9	15 min.	Medium			X							
DQ2-10	10 min.	Easy			X							
DQ2-11	10 min.	Medium			X							
DQ2-12	5 min.	Easy			X							
DQ2-13	15 min.	Medium			X							
DQ2-14	10 min.	Medium			X							
DQ2-15	10 min.	Medium			X							
DQ2-16	10 min.	Medium			X							
DQ2-17	15 min.	Medium			X							
DQ2-18	15 min.	Medium			X							
DQ2-19	5 min.	Easy				X						
DQ2-20	20 min.	Medium				X						

DQ2-21	15 min.	Medium				X						
DQ2-22	10 min.	Easy				X						
DQ2-23	10 min.	Easy					X					
DQ2-24	15 min.	Medium					X					
DQ2-25	15 min.	Medium					X					
DQ2-26	15 min.	Medium					X					
DQ2-27	15 min.	Medium					X					
DQ2-28	15 min.	Medium					X					
DQ2-29	15 min.	Medium					X					
DQ2-30	10 min.	Easy					X					
DQ2-31	15 min.	Medium					X					
DQ2-32	15 min.	Medium					X					
DQ2-33	15 min.	Medium					X					
DQ2-34	15 min.	Medium					X					
DQ2-35	15 min.	Medium					X					
DQ2-36	20 min.	Medium						X				
DQ2-37	15 min.	Medium						X				
DQ2-38	10 min.	Medium						X				
DQ2-39	15 min.	Medium							X			
DQ2-40	15 min.	Medium							X			
DQ2-41	15 min.	Medium							X			
DQ2-42	15 min.	Medium							X			
P2-43	15 min.	Medium	X									
P2-44	15 min.	Medium	X									
P2-45	15 min.	Medium	X									
P2-46	15 min.	Medium	X									
P2-47	15 min.	Medium	X									
P2-48	15 min.	Medium	X									
P2-49	15 min.	Medium	X									
P2-50	10 min.	Medium		X								
P2-51	15 min.	Medium		X								
P2-52	10 min.	Medium		X								
P2-53	10 min.	Medium		X								
P2-54	10 min.	Medium		X								
P2-55	10 min.	Medium		X								
P2-56	20 min.	Medium		X							X	
P2-57	20 min.	Medium		X							X	
P2-58	15 min.	Medium			X							
P2-59	15 min.	Medium			X							
P2-60	15 min.	Medium			X							
P2-61	15 min.	Medium			X							
P2-62	10 min.	Medium			X							
P2-63	10 min.	Medium			X							
P2-64	15 min.	Medium				X						
P2-65	15 min.	Medium					X					
P2-66	10 min.	Medium					X					
P2-67	10 min.	Medium					X					
P2-68	60 min.	Medium					X			X		
P2-69	60 min.	Medium					X			X		

P2-70	60 min.	Medium					X			X		
P2-71	60 min.	Medium					X			X		
P2-72	60 min.	Medium					X			X		
P2-73	120 min.	Hard					X			X		
P2-74	120 min.	Hard					X			X		
P2-75	60 min.	Medium					X			X		
P2-76	20 min.	Medium						X				
P2-77	20 min.	Hard						X				
P2-78	20 min.	Medium							X			
P2-79	20 min.	Medium							X			

Lecture Notes

1) Taxpayer Filing Requirements
   a) Filing requirements by entity
      i) Individuals
         (1) Refer to Exhibit 2-1 Gross Income Thresholds by Filing Status.
      ii) Corporations
   b) Tax Return Due Date and Extensions
      i) Individuals and C corporations
      ii) Partnerships and S corporations
   c) Statute of Limitations
      i) The period in which the taxpayer can file an amended tax return or the IRS can assess a tax deficiency for a specific tax year.
      ii) Generally ends three years from the *later* of (1) the date the tax return was actually filed or (2) the tax return's original due date.
      iii) A six-year statute of limitations applies to IRS assessments if the taxpayer omits items of gross income that exceed 25 percent of the gross income reported on the tax return.
      iv) For fraudulent returns, or if the taxpayer fails to file a tax return, the statute of limitations remains open indefinitely in these cases.
2) IRS Audit Selection
   a) Methods of Selection
      i) DIF system
      ii) Document perfection
      iii) Information matching
      iv) Other methods
   b) Types of Audits
      i) Correspondence
      ii) Office
      iii) Field
   c) After the Audit
      i) Proposed adjustment
      ii) 30-day letter
      iii) Appeals conference
      iv) 90-day letter
      v) Petition courts
         (1) Refer to Exhibit 2-2 IRS Appeals/Litigation Process.

- vi) Trial level courts and their differences: Tax Court, U.S. District Court, U.S. Court of Federal Claims
- vii) Choosing a trial level court
  - (1) Refer to Exhibit 2-3 Federal Judicial System.
- viii) Circuit Court of Appeals
  - (1) Refer to Exhibit 2-4 Geographic Boundaries for the U.S. Circuit Courts of Appeal.
- ix) Supreme Court

3) Tax Law Sources
   - a) Primary and secondary sources
     - i) Primary tax authorities
       - (1) Refer to Exhibit 2-5 Citation to Common Primary Authorities.
     - ii) Secondary authorities
       - (1) Refer to Exhibit 2-6 Common Secondary Tax Authorities.
   - b) Legislative Sources: Congress and the Constitution
     - i) U.S. Constitution
     - ii) Internal Revenue Code
     - iii) Legislative Process for Tax Laws
       - (1) Refer to Exhibit 2-7 Tax Legislation Process.
     - iv) Basic Organization of the Code
       - (1) Refer to Exhibit 2-8 Example of Code Organization.
     - v) Tax treaties
   - c) Judicial Sources: The Courts
     - i) The hierarchy of the courts (trial level, appeals, Supreme Court)
     - ii) *Stare decisis*
     - iii) Golsen rule
   - d) Administrative Sources: The U.S. Treasury
     - i) Regulations: 3 different forms (Final, Temporary, Proposed); 3 different purposes (Interpretative, Procedural, Legislative); Highest administrative authority.
     - ii) Revenue rulings and revenue procedures – more detailed than regulations; 2nd in administrative weight. Definition of each.
     - iii) Letter rulings: lower authoritative weight; contrast private letter rulings with determination letters and technical advice memorandums
     - iv) Acquiescence, nonacquiescence, and actions on decision: define and explain why important.

4) Tax Research
   - a) Understand Facts
     - i) Open and closed facts
     - ii) How do you determine facts for a research question?
   - b) Identify Issues
     - i) Ability to identify issues varies with experience
     - ii) Understand facts, combine facts with understanding of law, identify general issues (Is this income taxable? Is this expense deductible?)
     - iii) Research will allow you to identify more specific issues.
     - iv) Discuss Example 2-4 in class.
   - c) Locate Relevant Authorities
     - i) Annotated tax services – definition and what they contain
     - ii) Topical tax services – definition and what they contain
     - iii) How to use these services?
     - iv) Keyword search – area of law and key facts; suggestions if key word searching is not proving beneficial
     - v) Topical index
     - vi) Browsing the service

vii) Discuss Example 2-5.

d) Analyze Tax Authorities
  i) Questions of fact: hinges upon the facts and circumstances of the taxpayer's transaction. In this type of question, the researcher will focus on understanding how various facts affect the research answer and identifying authorities with fact patterns similar to her client's.
  ii) Questions of law: hinges upon the interpretation of the law, such as interpreting a particular phrase in a code section. If a researcher is faced with this type of question, she will spend much of her time researching the various interpretations of the code section and take note of which authorities interpret the code differently and why.
  iii) Conflicting authorities: the tax researcher should evaluate the hierarchical level, jurisdiction, and age of the authorities, placing more weight on higher and newer authorities that have jurisdiction over the taxpayer.
  iv) Checking the status of authorities: citators and methods to check the status of authorities.

e) Document and Communicate the Results
  i) The basic parts of a memo: facts, issues, authorities, conclusion, and analysis.
    (1) Facts: Discuss facts that provide necessary background of the transaction and those facts that may influence the research answer.
    (2) Issues: State the specific issues that the memo addresses. Issues should be written as specifically as possible and be limited to one or two sentences per issue.
    (3) Authorities: the researcher cites the relevant tax authorities that apply to the issue, such as the IRC, court cases, and revenue rulings. Cite enough to provide a clear understanding of the issue and interpretation of the law.
    (4) Conclusion: One conclusion per issue. Each conclusion should answer the question as briefly as possibly, and preferably indicate why the answer is what it is.
    (5) Analysis. The goal of the analysis is for the researcher to provide the reader a clear understanding of the area of law and specific authorities that apply. Typically an analysis will be organized to discuss the general area(s) of law first (the Code section) and then the specific authorities (court cases, revenue rulings) that apply to the research question. After you discuss the relevant authorities, apply the authorities to your client's transaction and explain how the authorities result in your conclusion.
  ii) The basic parts of a client letter: salutation & social graces, research question and limitations, facts, analysis, and conclusion.

5) Tax Professional Responsibilities
  a) Tax professionals are subject to various statutes, rules and codes of conduct.
    i) AICPA Code of Professional Conduct
    ii) AICPA Statement on Standards for Tax Services
    iii) IRS' Circular 230
    iv) State Board of Accountancy Statutes
  b) Failure to comply with statutes can result in being admonished, suspended, or barred from practicing.

6) Taxpayer and Tax Practitioner Penalties
  a) Civil penalties
    i) Generally in monetary penalties
    ii) Imposed when tax practitioners or taxpayers violate tax statutes without reasonable cause.
  b) Criminal penalties
    i) Much less common than civil penalties
    ii) Penalties are much higher and can include prison sentences
  c) Taxpayer underpayment penalty - no underpayment penalty if there is *substantial authority* that supports the tax return position or if there is a reasonable basis for the position and it is disclosed on the taxpayer's tax return.

d) A tax practitioner will not be subject to penalty if there is *substantial authority* that supports the tax return position or if there is a reasonable basis for the position and it is disclosed on the taxpayer's tax return.

Ethics

From page 2-5:

ETHICS

After Bill and Mercedes's tax return was selected for audit, Bill read on the Internet speculation that filing a paper copy tax return (instead of filing electronically) and extending a tax return decrease the chance of IRS audit. Bill has convinced Mercedes that they need to use these strategies going forward and look for other ways to avoid audit. Has Bill crossed an ethical boundary?

Discussion points:

- What are the timing requirements for filing a tax return and paying taxed owed?
- Does Bill's action likely violate any IRS regulation?
- If Bill's action does not violate IRS rules, is it ethical?
- Are ethics and IRS rules the same?

Class Activities

- **Let's choose a court**: Split the class into groups. Explain to the class that you will be asking a series of questions to the class regarding the choice of trial level courts after an audit. After you ask the question, a group may buzz into answer the question when a group member raises his or her hand. If the person gets the question correct, the group will receive one point. If the person misses the question, the group loses one point. The group with the most points after the series of questions will receive bonus participation points for the day. Use the individual court differences and differences in their respective appellate court to generate questions. See problem 57 for examples of questions to pose.
- **One versus the class**: Have one student volunteer as the "one" with the other class members being the "group." Use the key facts boxes in the text to develop basic multiple-choice questions (A, B, C answers) and then quiz the volunteer and the class on the questions. The volunteer and each class member will need to write the letters A, B, and C on separate sheets of paper and then hold up their appropriate response to the question. Once a student (either the "one" or a member of the "group") misses a question, her or she is eliminated from the competition. After 6 (or some other number) of questions, those students left standing receive bonus participation points for the day.
- **Research activity:** Take one or more of the research problems at the end of the chapter and pose the following questions after reading the problem: (1) What are the key facts in the problem? (2) What is the general issue to be addressed? (3) What key words would you use to research this question? Then walk the students through how you would conduct the research using an available on-line service.

Chapter 1

An Introduction to Tax

Learning Objectives

1. Demonstrate how taxes influence basic business, investment, personal, and political decisions.
2. Discuss what constitutes a tax and the general objectives of taxes.
3. Describe the different tax rate structures and calculate a tax.
4. Identify the various federal, state and local taxes.
5. Apply appropriate criteria to evaluate alternate tax systems.

Who cares about taxes?

- **Businesses**:
  - What organizational form should a business use?
  - Where should the business locate?
  - How should business acquisitions be structured?
  - How should the business compensate employees?
  - What is the appropriate mix of debt and equity for the business?
  - Should the business rent or own its equipment and property?
  - How should the business distribute profits to its owners?

Who cares about taxes?

- **Politicians**:
  - Politicians often distinguish themselves from their opponents based on their tax rhetoric.
  - Voters must have basic knowledge of taxes to evaluate the merits of alternative tax proposals.

Who cares about taxes?

- **Individuals**:
  - Would you like to own a home?
    - Tax deductions for home mortgage interest and real estate taxes can reduce the after-tax costs of owning a home.
  - Would you like to retire?
    - Understanding the tax-advantaged methods of saving for retirement can increase the after-tax value of your retirement nest egg.

What qualifies as a Tax?

- A ***Tax*** is a payment required by a government agency that is unrelated to any specific benefit or service received from the government agency.

- Key components of a tax:
  - Payment required
  - Payment imposed by government agency (federal, state, local)
  - Payment not tied directly to benefit received by the taxpayer.

Tax Question?

- Which of the following constitute a tax?
  - Payment for drivers license?
    - **(Not a tax)**
  - Payment for required (by government) house appraisal?
    - **(Not a tax)**
  - Payment for hotel use of 1% of bill to pay for city projects.
    - **(A tax)**
  - Payment for rental car use of 3% of bill to pay for the roads.
    - **(A tax)**

How to calculate a Tax?

- To calculate a tax, a taxpayer must know:
  - **Tax Rate**: level of taxes imposed on the tax base and is usually expressed as a percentage
  - **Tax Base**: defines what is actually taxed and is usually expressed in monetary terms

Tax = Tax Base × Tax Rate

Different ways to measure tax rates

- **Marginal Tax Rate**: the tax rate that applies to the *next additional increment* of a taxpayer's taxable income.

- **Average Tax Rate**: the taxpayer's average level of taxation on each dollar of taxable income.

- **Effective Tax Rate**: the taxpayer's average rate of taxation on each dollar of total income (both taxable and non-taxable)

Tax Rates Example

- Bill and Mercedes have $160,000 of taxable income and additional $10,000 of nontaxable income. Using the 2015 married-joint tax rates, what is their tax due, ***average*** tax rate, and ***effective*** tax rate? If they receive an additional $80,000 of taxable income, what is their ***marginal*** tax rate on this income?

Tax Rates Solution

- **Tax Due** = \$31,785.50, computed as:

  \$31,785.50 = \$29,517.50 + 28% × (\$160,000 − \$151,900)

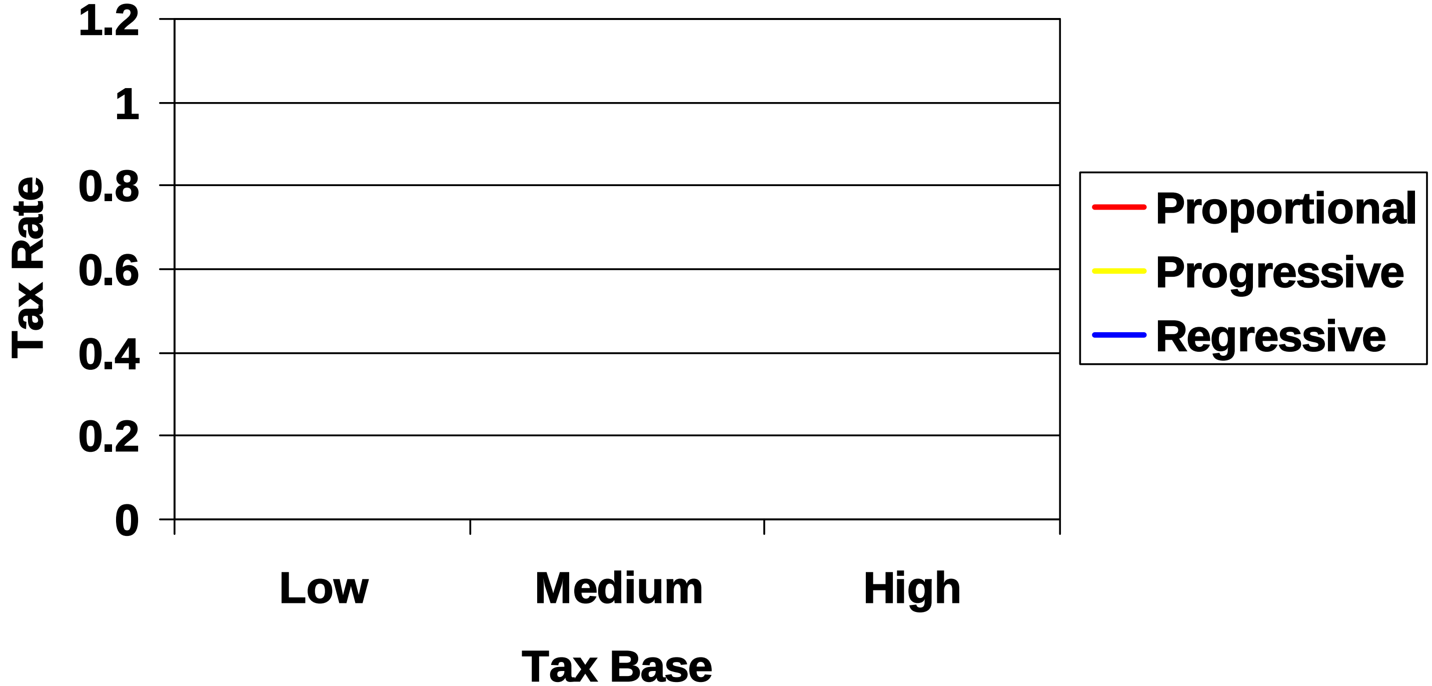
- **Average tax rate**: 19.87% (\$31,851.50 /160,000)
- **Effective tax rate**: 18.70% (\$31,851.50 /170,000)
- **Marginal tax rate**: 28.53% (\$54,279 − \$31,785.50)/ (\$240,000 − \$160,000)

Tax Rate Structures

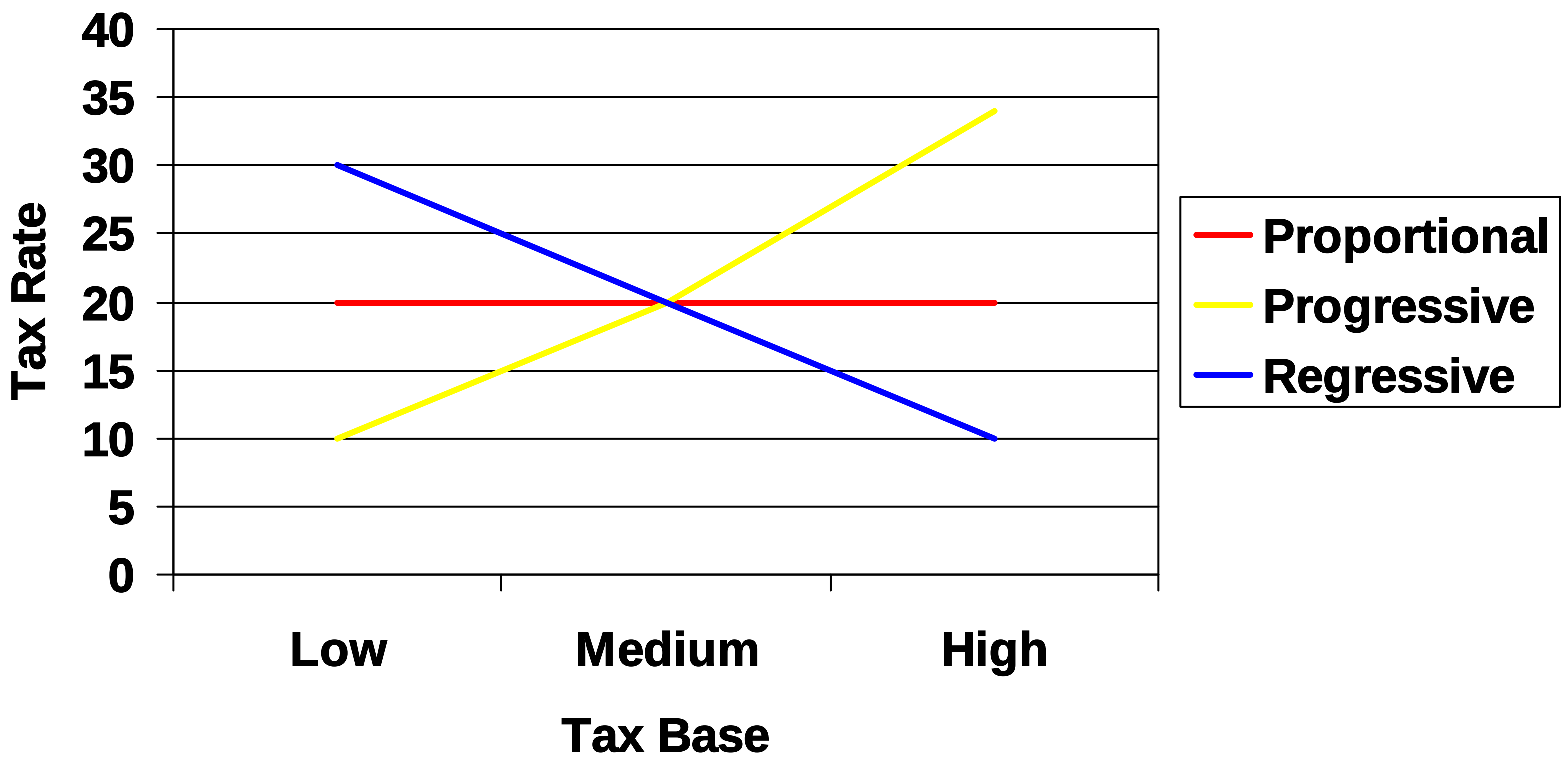
- **Proportional Tax Rate (Flat Tax)**: imposes a constant tax rate throughout the tax base.
- **Progressive Tax Rate**: imposes an increasing marginal tax rate as the tax base increases.
- **Regressive Tax Rate**: imposes a decreasing marginal tax rate as the tax base increases.

Tax Rate Structure Question

- How would a chart look which is mapping out the three different tax structures?



Tax Rate Structures Example



Types of Taxes

- **Federal Taxes**:
  - Income taxes
  - Employment and unemployment taxes
  - Excise taxes
  - Transfer taxes
- **State and local taxes**:
  - Sales and use taxes
  - Property taxes
  - Income taxes
  - Excise taxes
- **Implicit taxes**

Federal Taxes

- **Income taxes**
  - Represents approximately 56.8% of all tax revenues collected in the United States (Individuals 46.2% and Corporations 10.6%)
  - Levied on individuals, corporations, estates, and trusts
- **Employment and Unemployment taxes**
  - Second largest group of taxes imposed by the U.S. government
  - Employment taxes include the OASDI (Social Security tax), and the MHI tax (Medicare tax)
  - Unemployment taxes fund temporary unemployment benefits for individuals terminated from their jobs without cause

Federal Taxes

- **Excise taxes**
  - Third largest group of taxes imposed by the U.S. government
  - levied on the *quantity* of products sold
- **Estate and Gift taxes**
  - levied on the fair market values of wealth transfers upon death or by gift

State and Local Taxes

- **Sales and Use taxes**
  - Tax base for a sales tax is the retail sales of goods and some services
  - Tax base for the use tax is the retail price of goods owned, possessed or consumed within a state that were *not* purchased within the state
- **Property taxes**
  - Property taxes are ad valorem taxes, meaning that the tax base for each is the fair market value of the property
  - Real property taxes consists of taxes on land and structures permanently attached to land
  - Personal property taxes includes taxes on all other types of property, both tangible and intangible

State and Local Taxes

- **Income taxes**
  - Most state taxable income calculations largely conform to the federal taxable income calculations, with a limited number of modifications
- **Excise taxes**
  - States typically impose excise taxes on items subject to federal excise tax

Implicit Taxes

- Indirect taxes that result from a tax advantage the government grants to certain transactions.
- Defined as the reduced before-tax return that a tax-favored asset produces because of its tax advantaged status.
- Difficult to quantify but important to understand in evaluating the relative tax burdens of tax-advantaged investments.

How to evaluate different tax systems?

- **Sufficiency**: involves assessing the aggregate size of the tax revenues that must be generated and making sure that the tax system provides these revenues.
- **Equity**: how the tax burden should be distributed across taxpayers.
- **Certainty**: means that taxpayers should be able to determine when to pay the tax, where to pay the tax, and how to determine the tax.
- **Convenience**: tax system should be designed to be collected without undue hardship to the taxpayer.
- **Economy**: should minimize the compliance and administration costs associated with the tax system.

Sufficiency

- Types of revenue forecasting:
  - **Static**: Forecasting revenue ignores how taxpayers might alter their activities in response to a tax law change and to base projected tax revenues on the existing state of transactions.
  - **Dynamic**: Forecasting which tries to predict possible responses by taxpayers to new tax laws.
    - **Income Effect**: as tax rates go up, people will work harder to maintain same after-tax income.
    - **Substitution Effect**: as tax rates go up, people will substitute non-taxable activities because the marginal value of taxable ones has decreased.

Equity

- In general terms, a tax system is considered fair or equitable if the tax is based on the taxpayer's ability to pay.

- **Horizontal Equity**: two taxpayers in similar situations pay the same tax.
- **Vertical Equity**: taxpayers with greater ability to pay tax, pay more tax relative to taxpayers with a lesser ability to pay tax.

Chapter 2

Tax Compliance, the IRS and Tax Authorities

Learning Objectives

1. Identify the filing requirements for income tax returns and the statute of limitations for assessment.
2. Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.
3. Evaluate the relative weights of the various tax law sources.
4. Describe the legislative process as it pertains to taxation.

Learning Objectives (cont.)

5. Perform the basic steps in tax research and evaluate various tax law sources when faced with ambiguous statutes.
6. Describe tax professional responsibilities in providing tax advice.
7. Identify taxpayer and tax professional penalties.

Taxpayer Filing Requirements

- Corporations: All must file regardless of taxable income
- Estates and Trusts: Required to file if gross income exceeds $600
- Individuals: Filing is determined by taxpayer's filing status, age, and gross income

2016 Gross Income Thresholds by Filing Status

EXHIBIT 2-1 2016 Gross Income Thresholds by Filing Status

Filing Status and Age (in 2016)	2016 Gross Income	Explanation
Single	$10,350	$6,300 standard deduction + $4,050 personal exemption
Single, 65 or older	$11,900	$6,300 standard deduction + $1,550 additional deduction + $4,050 personal exemption
Married, filing a joint return	$20,700	$12,600 standard deduction + $8,100 personal exemptions (2)
Married, filing a joint return, one spouse 65 or older	$21,950	$12,600 standard deduction + $1,250 additional deduction (2) + $8,100 personal exemptions (2)
Married, filing a joint return, both spouses 65 or older	$23,200	$12,600 standard deduction + $2,500 additional deductions (2) + $8,100 personal exemptions (2)
Married, filing a separate return	$ 4,050	$4,050 personal exemption
Head of household	$13,350	$9,300 standard deduction + $4,050 personal exemption
Head of household, 65 or older	$14,900	$9,300 standard deduction + $1,550 additional deduction + $4,050 personal exemption
Surviving spouse with a dependent child	$16,650	$12,600 standard deduction + $4,050 personal exemption
Surviving spouse, 65 or older, with a dependent child	$17,900	$12,600 standard deduction + $1,250 additional deduction + $4,050 personal exemption

Tax Return Due Date

- **Individuals**: 15^{th} day of 4^{th} month following end of tax year
- **C Corporations**: Generally 15^{th} day of the 4^{th} month following end of tax year
- **Partnerships & S corporations**: 15^{th} day of 3^{rd} month following end of tax year
- Due dates on a Saturday, Sunday, or holiday are extended to next business day
- Individuals, corporations, and partnerships are allowed to apply for an automatic extensions

Return Due Date Examples

- Corporation XYZ, Inc. has a tax year which ends on August 31st. When will their tax return be due?

  December 15th

- Assume they filed an extension, when would the tax return be due?

  June 15th

Statute of Limitations

- Often tax returns are filed with incorrect amounts reported either in the taxpayer's favor or the government's favor.
- **Statute of limitations**: the time in which the taxpayer can file an amended return or the IRS can assess a tax deficiency.
  - Generally ends **3 years** from the *later* of (1) the date the tax return was actually filed, or (2) the tax return's original due date.

Statute of Limitations Example

- Bill and Mercedes file their 2012 federal tax return on September 6, 2013 after receiving an automatic extension to file their return by October 16, 2013 (October 15 was a Sunday). When does their statute of limitations end for their 2012 tax return?
  - **September 6, 2016** (3 years after the later of the actual filing date and the original due date)

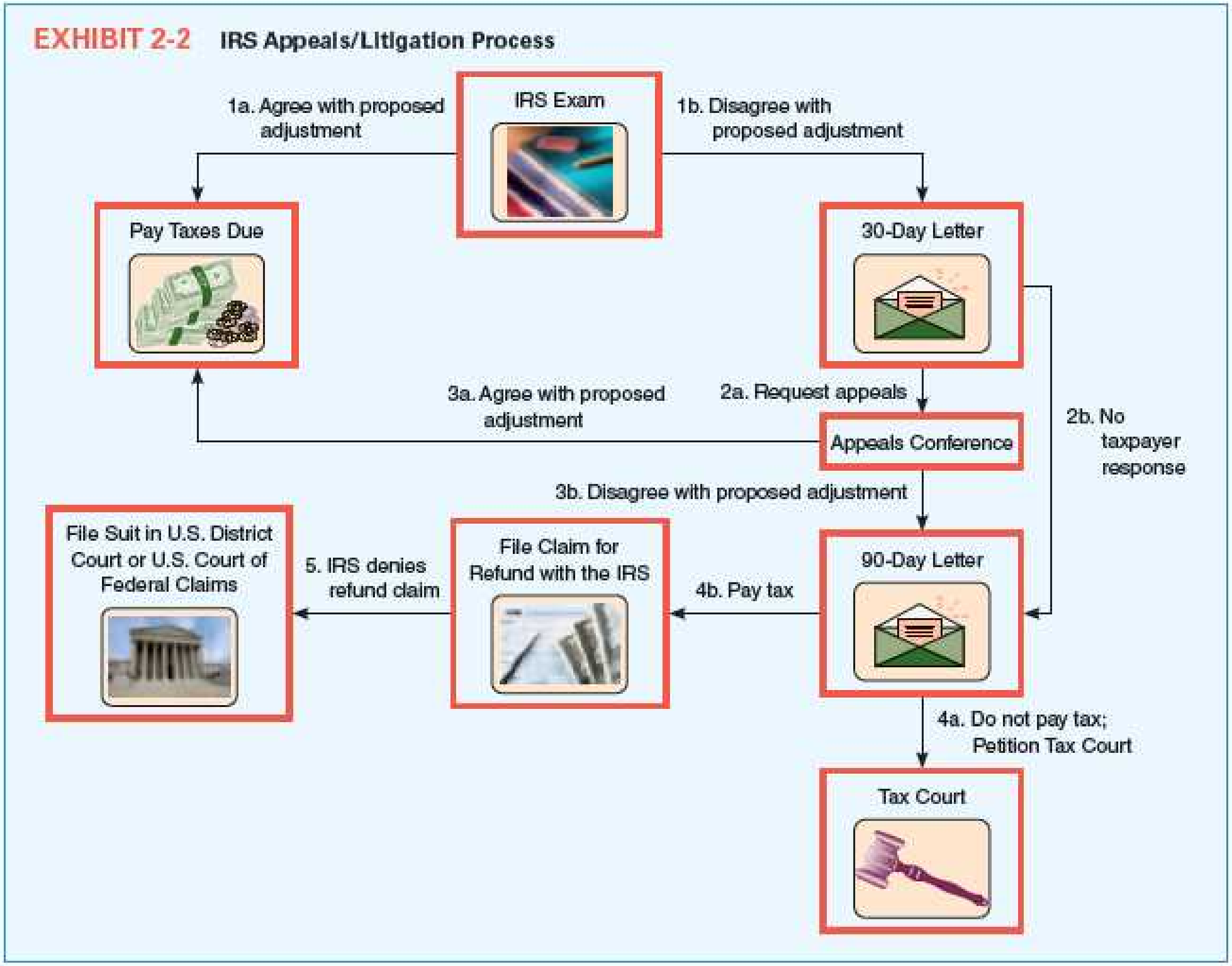
IRS Audit Selection

- In general a taxpayer's return is selected for audit because the IRS believes the tax return has a high probability of being incorrect.
  - IRS uses computer programs to identify tax returns which might have an understated liability.
    - Discriminant Function (DIF) system (scoring system)
    - Document perfection (checks for math errors, etc.)
    - Information matching programs (compares tax return data with other IRS information)

Types of Audits

- **Correspondence examinations**:
  - Most common audit
  - Conducted by mail and are generally limited to 1 or 2 items on the return
- **Office examinations**:
  - Second most common audit
  - Conducted in the local IRS office and tends to be broader in scope
- **Field examinations**:
  - Least common audit
  - Held at the taxpayer’s place of business and can last months to years.

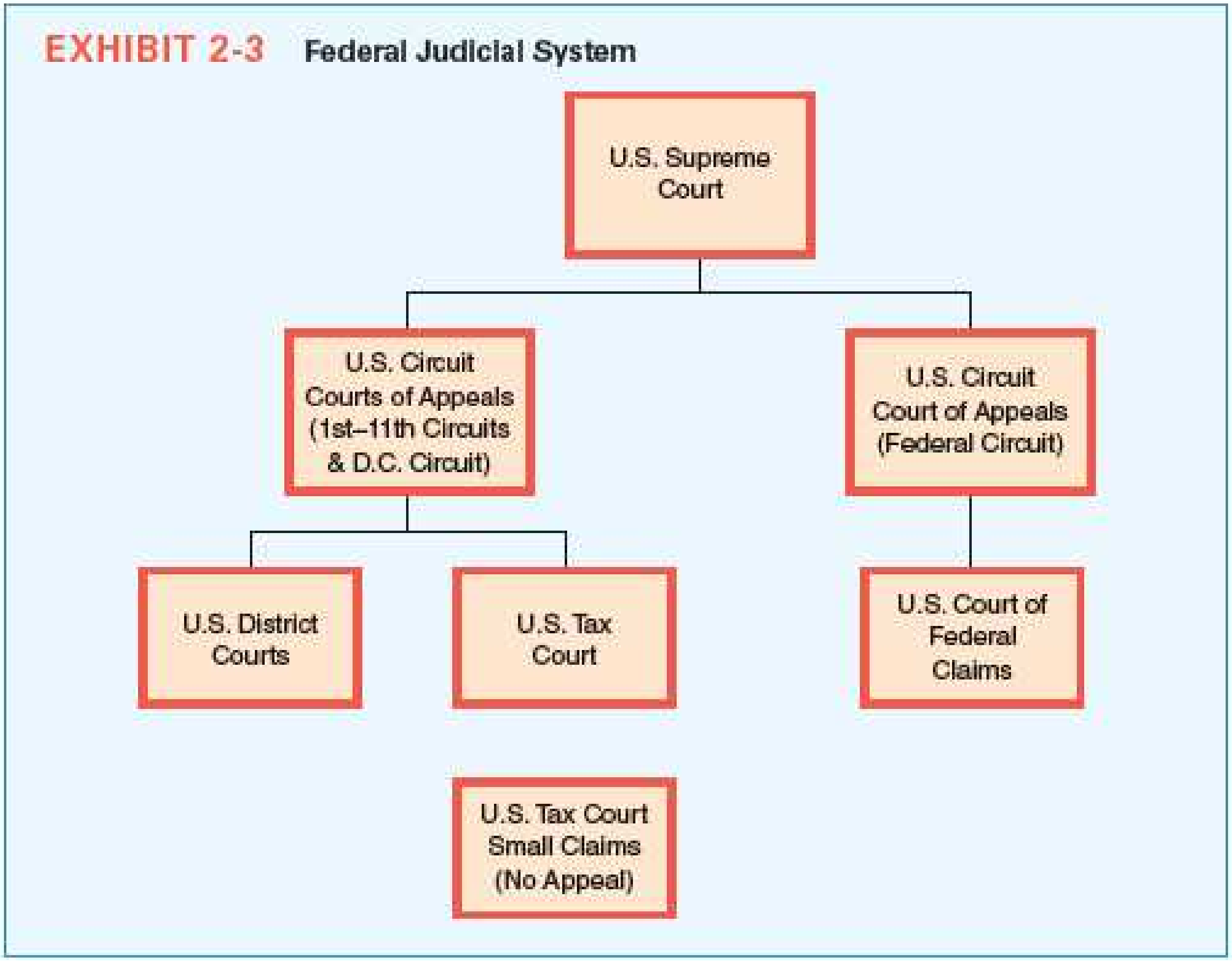
IRS Appeals/Litigation Process



Trial Level Courts

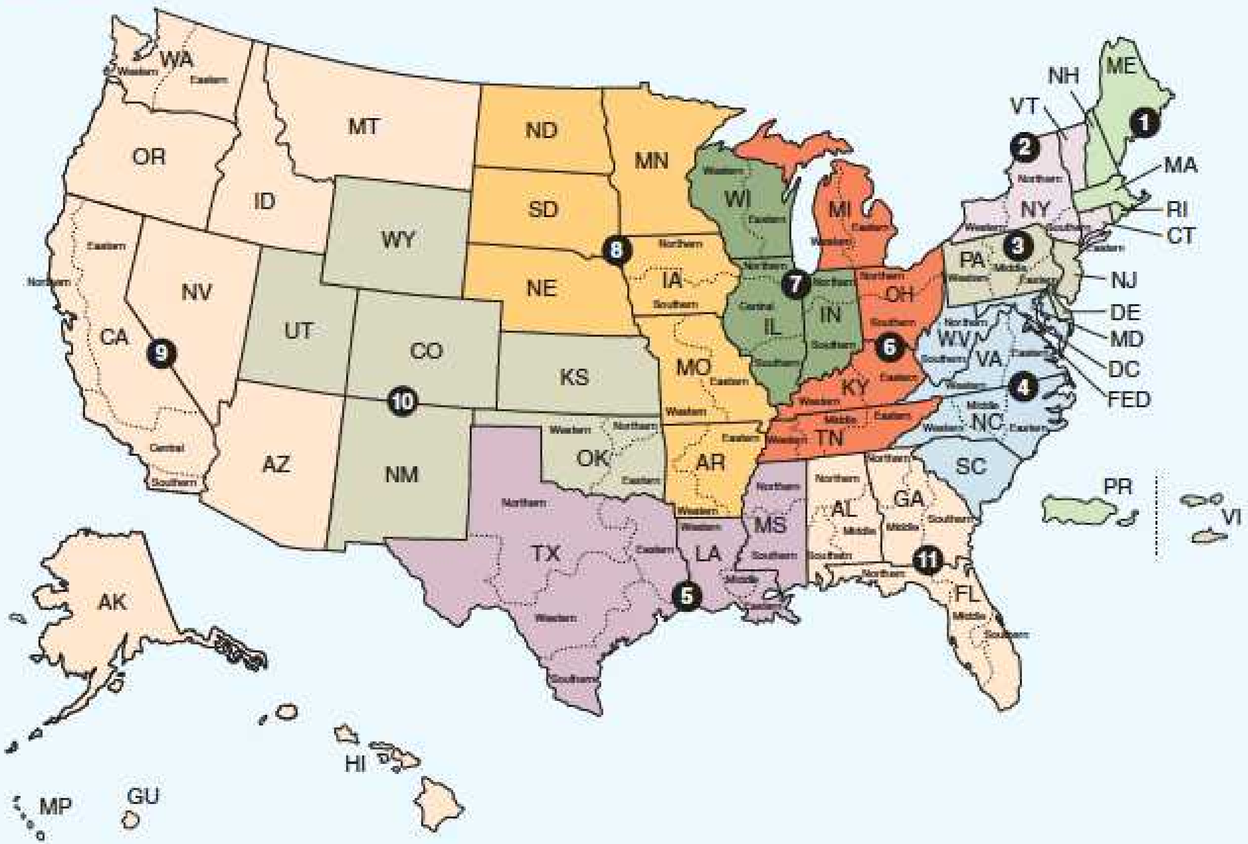
- Tax Court
  - National court; Tax experts; Do not pay tax 1st
- U.S. District Court
  - Local court; Possible jury trial; Generalists; Pay tax 1st
- U.S. Court of Federal Claims
  - National court; Generalists; Pay tax 1st; Appeals to U.S. Circuit Court of Appeals for the Federal Circuit

Federal Judicial System



U.S. Circuit Courts of Appeal

EXHIBIT 2-4 Geographic Boundaries for the U.S. Circuit Courts of Appeal



Source: www.uscourts.gov/courtlinks

*U.S. District Court jurisdictions for those states with more than one U.S. District Court are also depicted (for example, the state of Washington is divided into Eastern and Western Districts).

†Not depicted are the U.S. Circuit Court of Appeals for the District of Columbia and the U.S. Circuit Court of Appeals for the Federal Circuit.

Tax Law Sources

- **Primary Authorities**: Official sources of tax law
  - Statutory sources (e.g., Internal Revenue Code)
  - Judicial sources (the courts)
  - Administrative sources (IRS pronouncements)
- **Secondary Authorities**: Unofficial tax authorities
  - Tax services
  - Tax articles

Primary Tax Authorities

EXHIBIT 2-5 **Citations to Common Primary Authorities**

Statutory Authorities:	***Citation:***	***Explanation:***
Internal Revenue Code	IRC Sec. 162(e)(2)(B)(i)	Section number 162, subsection e, paragraph 2, subparagraph B, clause i
Committee Reports: Senate Finance Committee Report	S. Rep. No. 353, 82d Cong., 1st Sess. 14 (1951).	Senate report number 353, Congress number 82, Congressional session 1, page number 14, year 1951
House Ways and Means Committee Report	H. Rep. No. 242, 82d Cong., 1st Sess. 40 (1951)	House report number 242, Congress number 82, Congressional session 1, page number 40, year 1951
Administrative Authorities:	***Citation:***	***Explanation:***
Final Regulation	Reg. Sec. 1.217-2(c)(1)	Type of regulation (1 = income tax), code section 217, regulation number 2, paragraph number c, subparagraph number 1
Temporary Regulation	Temp. Reg. Sec. 1.217-2(c)(1)	Same as final regulation
Proposed Regulation	Prop. Reg. Sec. 1.217-2(c)(1)	Same as final regulation
Revenue Ruling	Rev. Rul. 77-262, 1977-2 C.B. 41	Ruling number 77-262 (262nd ruling of 1977), volume number of cumulative bulletin 1977-2, page number 41
Revenue Procedure	Rev. Proc. 99-10, 1999-1 C.B. 272	Procedure number 99-10 (10th procedure of 1999), volume number of cumulative bulletin 1999-1, page number 272
Private Letter Ruling	PLR 200601001	Year 2006, week number 01 (1st week of 2006), ruling number 001 (1st ruling of the week)
Technical Advice Memorandum	TAM 200402001	Year 2004, week number 02 (2nd week of 2004), ruling number 001 (1st ruling of the week)

Primary Tax Authorities

Judicial Authorities:	Citation:	
U.S. Supreme Court	*Comm. v. Kowalski*, 434 U.S. 77 (S. Ct., 1977)	Volume 434 of the GPO court reporter, page 77, year 1977
	Comm. v. Kowalski, 98 S. Ct. 315 (S. Ct., 1977)	Volume 98 of the West court reporter, page 315, year 1977
	Comm. v. Kowalski, 77-2 USTC par. 9,748 (S. Ct., 1977)	Volume 77-2 of the CCH court reporter, paragraph 9,748, year 1977
	Comm. v. Kowalski, 40 AFTR2d 77-6128 (S. Ct., 1977)	Volume 40 of the RIA AFTR2d court reporter, paragraph 77-6128, year 1977
U.S. Circuit Court of Appeals	*Azar Nut Co. v. Comm.*, 931 F.2d 314 (5th Cir., 1991)	Volume 931 of the West F.2d court reporter, page 314, circuit 5th, year 1991
	Azar Nut Co. v. Comm., 91-1 USTC par. 50,257 (5th Cir., 1991)	Volume 91-1 of the CCH USTC court reporter, paragraph 50,257, circuit 5th, year 1991
	Azar Nut Co. v. Comm., 67 AFTR2d 91-987 (5th Cir., 1991)	Volume 67 of the RIA AFTR2d court reporter, paragraph 77-6128, year 1977
U.S. Tax Court—Regular decision	*L.A. Beeghly*, 36 TC 154 (1962)	Volume 36 of the Tax Court reporter, page 154, year 1962
U.S. Tax Court—Memorandum decision	*Robert Rodriguez*, RIA TC Memo 2005-012	Paragraph number 2005-012 of the RIA Tax Court Memorandum reporter
	Robert Rodriguez, 85 TCM 1162 (2005)	Volume 85 of the CCH Tax Court Memorandum reporter, page 1162, year 2005
U.S. Court of Federal Claims	*J.R. Cohen v. U.S.*, 510 F. Supp. 297 (Fed. Cl., 1993)	Volume 510 of the West F. Supp. court reporter, page 297, year 1993
	J.R. Cohen v. U.S., 72 AFTR2d 93-5124 (Fed. Cl., 1993)	Volume 72 of the RIA AFTR2d court reporter, paragraph 93-5124, year 1993
	J.R. Cohen v. U.S., 93-1 USTC par. 50,354 (Fed. Cl., 1993)	Volume 93-1 of the CCH USTC court reporter, paragraph 50,354, year 1993
U.S. District Court	*Waxler Towing Co., Inc. v. U.S.*, 510 F. Supp. 297 (W.D, TN, 1981)	Volume 510 of the West F. Supp. court reporter, page 297, Western District (W.D.), state Tennessee, year 1981
	Waxler Towing Co., Inc. v. U.S., 81-2 USTC par. 9,541 (W.D., TN, 1981)	Volume 81-2 of the CCH USTC court reporter, paragraph 9,541, Western District (W.D.), state Tennessee, year 1981
	Waxler Towing Co., Inc. v. U.S., 48 AFTR2d 81-5274 (W.D., TN, 1981)	Volume 48 of the RIA AFTR2d court reporter, paragraph 81-5274, Western District (W.D.), state Tennessee, year 1981

Secondary Tax Authorities

EXHIBIT 2-6 **Common Secondary Tax Authorities**

Tax Research Services:

BNA Tax Management Portfolios

CCH Standard Federal Tax Reporter

CCH Tax Research Consultant

RIA Federal Tax Coordinator

RIA United States Tax Reporter

Newsletters:

Daily Tax Report

Federal Tax Weekly Alert

Tax Notes

Law Reviews:

Tax Law Review (New York University School of Law)

Virginia Tax Review (University of Virginia School of Law)

Professional Journals:

Journal of Accountancy

Journal of Taxation

Practical Tax Strategies

Taxes

Tax Adviser

Quick Reference Sources:

IRS Publications

CCH Master Tax Guide

RIA Federal Tax Handbook

Textbooks:

McGraw-Hill's Taxation of Individuals and Business Entities

McGraw-Hill's Essentials of Federal Taxation

Tax Sources

- Are the following **primary** or **secondary** sources?
  - Internal Revenue Code
    - (Primary)
  - Tax Article in USA Today
    - (Secondary)
  - Article on Supreme Court Opinion
    - (Secondary)
  - Supreme Court Opinion
    - (Primary)
  - RIA Federal Tax Coordinator
    - (Secondary)
  - Treasury Regulations
    - (Primary)

Statutory Authorities

- **U.S. Constitution**
  - The 16th Amendment provides Congress the ability to tax income directly, from whatever source derived, without apportionment across the states
- **Tax Treaties**
  - Agreements negotiated between countries that describe the tax treatment of entities subject to tax in both countries

Statutory Authority: Internal Revenue Code

- The main statutory authority
- Changes enacted by Congress
- Organization of Internal Revenue Code:

Subtitle A – Income Taxes

Chapter 1 – Income Taxes

Subchapter A – Determination of Tax Liability

Part I – Definition of Gross Income, Adjusted Gross Income, Taxable Income, etc. (Sec. 61 – 68)

Sec. 61 – Gross Income Defined

Sec. 62 – Adjusted Gross Income Defined

Sec. 63 – Taxable Income Defined

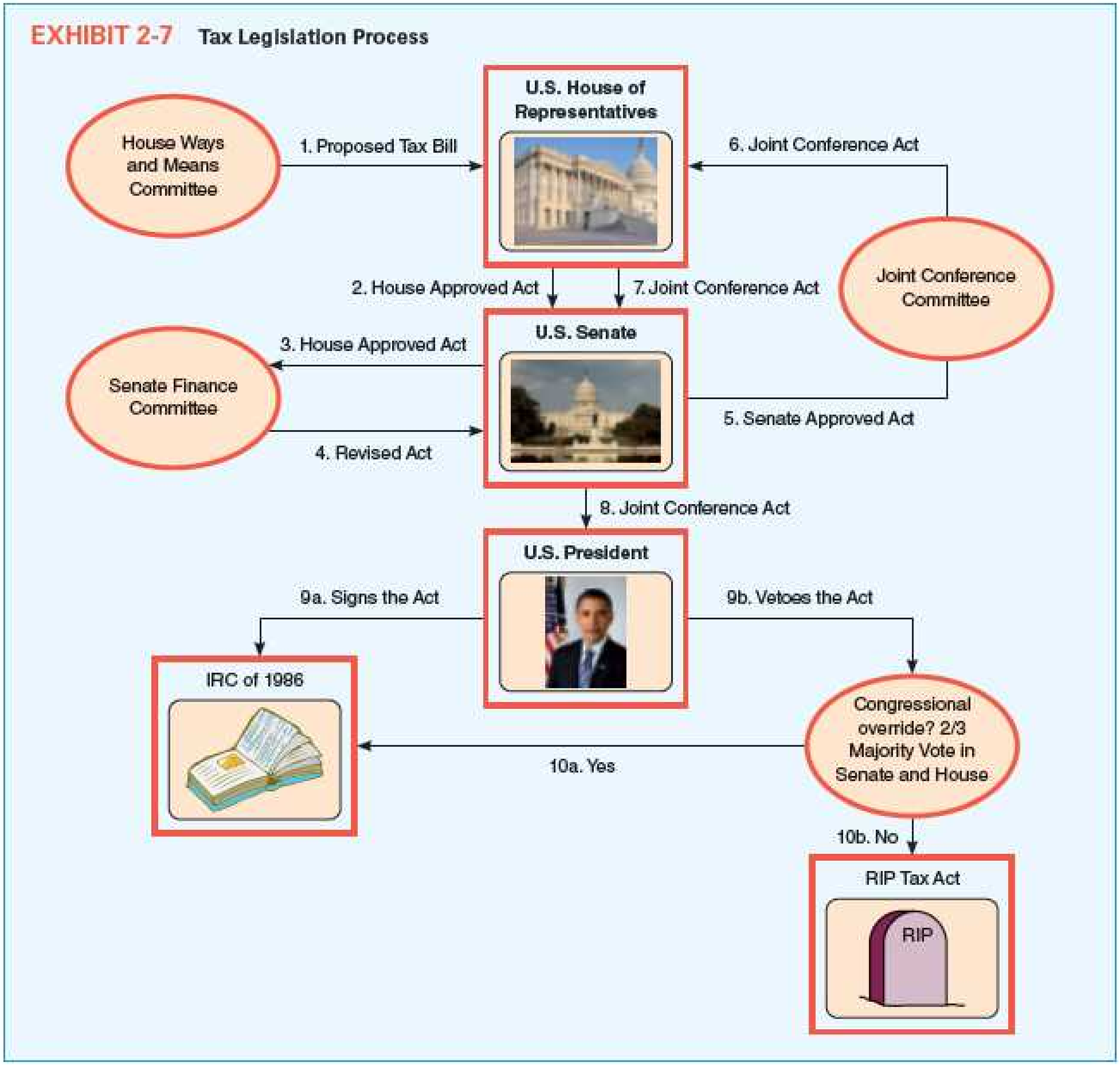
Subsection 63(c) – Standard Deduction

Paragraph 63(c)(2) – Basic Standard Deduction

Subparagraph 63(c)(2)(A) - …

Clause 63(c)(2)(A)(i) - …

Tax Legislation Process



Judicial Sources: The Courts

- Tasked with the ultimate authority to interpret the Internal Revenue Code and settle disputes between taxpayers and the IRS
- **Supreme Court:** The highest judicial authority and on the same level with the Internal Revenue Code with regard to authority
- **Court of Appeals:** 13 Circuit Courts which is the next level of judicial authority

Judicial Sources: The Courts

- **Trial Level Courts:** 3 trial level courts
  - **US District Court**
  - **US Court of Federal Claims**
  - **US Tax Court**
- All courts apply the judicial doctrine of ***stare decisis***, which means that a court will rule consistently with its previous rulings and the rulings of higher courts with appellate jurisdiction. The Tax Court applies the **Golsen** rule.

Administrative Sources: The US Treasury

- **Regulations**: Treasury departments official interpretation of the Internal Revenue Code
- **3 Different Forms:**
  - Final
  - Temporary
  - Proposed
- **3 Different Purposes:**
  - Interpretative
  - Procedural
  - Legislative

Administrative Sources: The US Treasury

- **Revenue Rulings**: Less authoritative weight, but they provide a much more detailed interpretation of the Code (e.g., application to a specific factual situation)
- **Revenue Procedures**: Explain in great detail IRS practice and procedures in administering tax law
- **Letter Rulings**: Less authoritative but more specific than revenue rulings and regulations (e.g., applied to a specific taxpayer)

Tax Research

- Step 1: Understand the facts
- Step 2: Identify issues
- Step 3: Locate relevant authorities
- Step 4: Analyze tax authorities
- Step 5: Document and Communicate the results

Tax Research

- Two types of tax services used in tax research
  - **Annotated**
  - **Topical**
- Research questions often consist of **questions of fact** or **questions of law**
  - The answer to a question of fact hinges upon the facts and circumstances of the taxpayer's transaction
  - The answer to a question of law hinges upon the interpretation of the law, such as, interpreting a particular phrase in a code section

Tax Research

- When the researcher identifies that different authorities have ***conflicting*** views, she should evaluate the "**hierarchy**," **jurisdiction**, and **age** of the authorities
- Once the tax researcher has identified relevant authorities, she must make sure that the authorities are still valid and up to date

Tax Memo Layout

- Facts
- Issues
- Authorities
- Conclusion
- Analysis

Client Letter Layout

- Salutation and Social Graces
- Research Question and Limitations
- Facts
- Analysis
- Closing

Tax Professional Responsibilities

- Tax professionals are subject to various statutes, rules and codes of conduct:
  - AICPA Code of Professional Conduct
  - AICPA Statement on Standards for Tax Services
  - IRS' Circular 230
  - State Board of Accountancy Statutes

- Failure to comply with statutes can result in being admonished, suspended, or barred from practicing

Taxpayer and Tax Practitioner Penalties

- **Civil Penalties**: most common type of penalties
  - Generally in monetary penalties
  - Imposed when tax practitioners or taxpayers violate tax statutes without reasonable cause
- **Criminal Penalties**: much less common than civil penalties
  - Penalties are much higher and can include prison sentences

Taxpayer and Tax Practitioner Penalties

- A **taxpayer** and **tax practitioner** will not be subject to an underpayment penalty if:
  - there is ***substantial authority*** that supports the tax return position **<u>or</u>**
  - if there is a **reasonable basis** for the position and it is **disclosed** on the taxpayer's **tax return**