

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

DISCUSSION QUESTIONS

1. (LO 1) Various answers are possible, including using the Key Terms at the end of each chapter, referring to the Glossary (Appendix C), looking up the footnote resources to the Internal Revenue Code in Appendix D, using chapter features (e.g., Global Tax Issues, Ethics & Equity, Tax Planning, and Framework 1040), examining the tax forms used in the chapters, and completing additional end-of-chapter assignments. All of these resources will help students engage more deeply with the materials and help their understanding.
2. (LO 1, 4)
 - a. John must now document rental receipts and separate his home expenses between personal and rental use, and he may be subject to the transient occupancy tax.
 - b. Theresa has become self-employed. Now she will be subject to self-employment tax and may have to make quarterly installment payments of estimated income and self-employment tax. Theresa will be required to make payroll tax payments if she hires individuals to work in her business.
 - c. Paul's employer might have some moving expenses that it can deduct (in general, Paul cannot deduct moving expenses). Paul's personal taxes will change because Florida does not impose an income tax but California does.
3. (LO 1, 4) The income tax consequences that result are Marvin's principal concern. Any rent he receives is taxed as income, but operating expenses and depreciation will generate deductions that offset some or all of the income or even yield a loss. Marvin must also consider the effect of other taxes. Because the property is being converted from residential to commercial use, he can expect an increase in the ad valorem property taxes levied by the local (and perhaps even the state) taxing authorities. Besides the real estate taxes, personal property taxes could be imposed on the furnishings.
4. (LO 2) To finance our participation in World War II, the scope of the income tax was expanded considerably—from a limited coverage of 6% to over 74% of the population. Hence, the description of the income tax as being a "mass tax" became appropriate.
5. (LO 2) For wage earners, the tax law requires employers to withhold a specified dollar amount from wages paid to the employee to cover income taxes and payroll taxes. Persons with nonwage income generally are required to make quarterly payments to the IRS for estimated taxes. Both procedures ensure that taxpayers will be financially able to meet their annual tax liabilities. That is, the amounts withheld are meant to prepay the employee's income taxes and payroll taxes related to the wages earned.
6. (LO 3) The tax law of this state appears to violate the *certainty* and *simplicity* principles.

7. (LO 3) A tax is *regressive* if it represents a larger percentage of the income of a low-income taxpayer relative to the income of a high-income taxpayer. Examples of regressive taxes include sales and excise taxes. A tax is *progressive* if it represents a larger percentage of the income of a high-income taxpayer relative to the income of a low-income taxpayer. The Federal income tax is an example of a progressive tax.
8. (LO 4)
- The parsonage probably was not listed on the property tax rolls because it was owned by a tax-exempt church. Apparently, the taxing authorities are not aware that ownership has changed.
 - Ethan should notify the authorities of his purchase. This will force him to pay back taxes but may eliminate *future* interest and penalties.
9. (LO 4) Although the Baker Motors bid is the lowest, from a long-term financial standpoint, it is the best. The proposed use of the property by the state and the church probably will make it exempt from the school district's ad valorem tax. This would hardly be the case with a car dealership. In fact, commercial properties (e.g., car dealerships) often are subject to higher tax rates.
10. (LO 4)
- In this case, the "tax holiday" probably concerns exemption from ad valorem taxes. "Generous" could involve an extended period of time (e.g., 10 years) and include both realty and personalty.
 - The school district could be affected in two ways. First, due to the erosion of the tax base, less revenue would be forthcoming. Second, new workers would mean new families and more children to educate.
11. (LO 4) A possible explanation is that Sophia made capital improvements (e.g., added a swimming pool) to her residence and her parents became retirees (e.g., reached age 65).
12. (LO 4) Presuming that the dockage facilities are comparable in Massachusetts, the Morgans may be trying to avoid ad valorem taxes. Taxes on nonbusiness property vary from one state to another and are frequently avoided.
13. (LO 4) In general, Federal excise taxes apply to fewer items than in the past. Lawmakers have focused on and increased certain Federal excise taxes (e.g., those on tobacco products, gasoline, and air travel).
14. (LO 4) Jayla could have been overcharged, but it is likely that at least part of the excess is attributable to a hotel occupancy tax and a car rental tax. In major cities, these types of excise taxes have become a popular way of financing capital improvements such as sports arenas and stadiums. Consequently, the amount of the taxes could be significant.
15. (LO 4) An *excise tax* is limited to a particular transaction (e.g., sale of gasoline), whereas a general *sales tax* covers a multitude of transactions (e.g., sale of all nonfood goods).
- The following states *do not* impose a general sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon.
 - There is no Federal general sales tax.

16. (LO 4)
- Jackson County must be in a state that imposes a lower (or *no*) sales tax. With certain major purchases (i.e., big-ticket items), any use tax imposed by the state of the Garcías' residence could come into play.
 - In some states, the sales tax rate varies depending on the county and/or city.
- Note:** Generally, buyers are subject to the sales and use tax rate where they live. For example, if the Garcías buy goods in a different state with a zero or lower sales tax rate than in their state, they owe use tax to their home state for the difference.
17. (LO 4) Caleb probably purchased his computer out of state through a catalog or via the internet. In such cases, state collection of the sales (use) tax is not likely. Caleb needs to pay use tax on his own (which is equal to the sales tax).
18. (LO 4) If the tax is imposed on the right to pass property at death, it is classified as an estate tax. If it taxes the right to receive property from a decedent, it is termed an inheritance tax.
- Some states impose both an estate tax and an inheritance tax. Some states (e.g., Florida and Texas) levy neither tax.
 - The Federal government imposes an estate tax.
19. (LO 4) Jake either has a severe misunderstanding as to the rules regarding transfer taxes or is lying to Jessica to delay any parting with his wealth. The marital deduction allows interspousal transfers (whether by gift or at death) free of any tax (either gift or estate). As a result, in the case of spousal transfers, there is no tax reason to prefer transfers at death over lifetime gifts.
20. (LO 4)
- The purpose of the unified transfer tax credit is to eliminate the tax on all but substantial gifts and estates.
 - Yes. The credit for 2022 is \$4,769,800; for 2021, it is \$4,625,800.
 - Yes. The credit is available to cover transfers by gift or by death (or both), but the amount can be used only once.
21. (LO 4) $\$608,000$. $19 \text{ donees (5 married children + 5 spouses + 9 grandchildren)} \times \$16,000 \text{ (annual exclusion for 2022)} \times 2 \text{ donors (Elijah and Anastasia)} = \$608,000$.
22. (LO 4) The individual income tax is progressive in nature; the corporate income tax is assessed at a flat 21% rate. In addition, the corporate income tax does not make any distinction as to deductions—only business deductions are allowed. Nor does it require the computation of adjusted gross income (AGI) or provide for the standard deduction and the deduction for qualified business income.
23. (LO 4)
- For state income tax purposes, “piggyback” means making use of what was done for Federal income tax purposes. By “decoupling,” a state decides not to allow a particular Federal provision (e.g., exclusion, deduction, credit) for state income tax purposes.
 - States often use IRS audit results to identify errors that might also exist on the taxpayer's state tax return.
 - Most states allow their residents some form of tax credit for income taxes paid to other states.
24. (LO 4) What happened here likely is not a coincidence. The IRS probably notified the state of California regarding Hernando's omission of income, and California followed up with its own audit.

25. (LO 4) If Mike is drafted by a team in one of the listed states, he will escape state income tax on income earned within that state (e.g., training camp, home games). He will not, however, escape the income tax (state and local) imposed by jurisdictions where he plays away games. Called the “jock tax,” it is applied to out-of-state athletes and entertainers.
26. (LO 4, 5)
- This type of question has no relevance to the state income tax, but is a reminder to individual taxpayers about the use tax and a simple way for individual taxpayers to pay any use tax due on internet and mail-order purchases. Without the line on the state income tax return, individual taxpayers would be required to file a separate use tax return.
 - As the preparer of the state income tax return, you should not leave questions unanswered unless there is a good reason for doing so. It appears that Hannah has no justifiable reason.
27. (LO 4) The checkoff boxes add complexity to the return and mislead taxpayers into presuming that they are not paying for the donation.
28. (LO 4)
- They uncover taxpayers who were previously unknown to the taxing authority. In addition, amnesty programs can bring taxpayers who are not in compliance with tax laws into compliance.
 - Amnesty provisions can apply to other than income taxes (e.g., sales, franchise, severance).
 - No general amnesty program has been offered for any Federal taxes.
29. (LO 4)
- FICA offers some measure of retirement security, and FUTA provides a modest source of income in the event of loss of employment.
 - FICA is imposed on both employer and employee, while FUTA is imposed only on the employer.
 - FICA is administered by the Federal government. FUTA, however, is handled by both the Federal and state government.
 - This applies only to FUTA. The merit system rewards employers who have low employee turnover because this reduces the payout of unemployment benefits.
30. (LO 4)
- Unlike the Social Security portion of FICA, there is no dollar limit on the imposition of the Medicare tax.
 - The 0.9% Medicare addition applies to taxpayers with wages or net self-employment income in excess of \$200,000 (\$250,000 for married filing jointly).
31. (LO 4) Only children under age 18 who are employed in a parent’s unincorporated trade or business are excluded from FICA. Other family members, including spouses, must be covered.
32. (LO 4)
- Severance taxes are transaction taxes that are based on the notion that the state has an interest in its natural resources. The tax is imposed on the extraction of minerals.
 - Franchise taxes are levied on the right to do business in the state. Typically, they are imposed on corporations and are based on their capitalization.

- c. Occupational fees are applicable to trades or businesses and are licenses to practice. Most are not significant revenue producers, and the amounts collected are utilized to defray the cost of regulating the profession.
 - d. Customs duties are taxes on the importation of certain foreign goods. They are imposed by the Federal government and are not found at the state and local level.
 - e. Export duties are taxes imposed on the export of certain commodities (e.g., oil, coffee). They are common in less-developed nations and are not levied by the United States.
33. (LO 4)
- a. The United States is the only country in the OECD (Organization of Economic Cooperation and Development) that does not have a value added tax (VAT). Over 140 countries use a VAT. In spite of its extensive use by other countries, the adoption of a VAT by the United States appears doubtful. Instead, the United States places high reliance on the income tax as its major revenue source.
 - b. A VAT taxes the increment in value as goods move through the production and manufacturing stages to the marketplace. Although the tax is paid by the producer, it is reflected in the selling price of the goods. Therefore, a VAT is a tax on consumption.
 - c. Because it is an effective generator of revenue, the VAT has been criticized as leading to more government spending.
34. (LO 4)
- a. Both the national sales tax and the VAT are taxes on consumption. Both taxes impose more of a burden on low-income taxpayers who must spend a larger proportion of their incomes on essential purchases relative to higher-income taxpayers. As a result, the taxes are regressive in effect.
 - b. The regressive effect might be partly remedied by granting some sort of credit, rebate, or exemption to low-income taxpayers.
35. (LO 4, 5)
- a. Serena may have record-keeping issues related to the cash transactions. The short-term holiday workers should be on the payroll because they are employees, and Serena owes FICA and FUTA on their wages and must file Forms 940 and 941 with the IRS. Serena must also timely issue a W-2 wage form to each of her employees.
 - b. High. First, Serena is self-employed. Second, she operates partially on a cash basis. Third, the opportunity to understate income and/or overstate expenses is high. Fourth, she has some workers who appear to be misclassified and for whom she may not have issued tax reporting forms.
36. (LO 5)
- a. A correspondence audit is probably involved. These audits involve a limited number of issues (i.e., taxpayer failed to report some dividend income) and most often are easily resolved.
 - b. An audit that is conducted in an IRS office is called an office audit.
 - c. The revenue agent's report (RAR) accepts the taxpayer's return as filed.
 - d. When a special agent becomes involved, this usually means that fraud is suspected.

37. (LO 5) In many unresolved audit disagreements at the agent level, the taxpayer should consider an appeal to the Independent Office of Appeals. Although it is part of the IRS, it is authorized to resolve audit disputes. It has greater settlement authority than does the agent. In many cases, a compromise reached at the Independent Office of Appeals can avoid a costly and time-consuming judicial proceeding.
38. (LO 5) The purpose of a statute of limitations is to preclude parties from prosecuting stale claims. The passage of time makes the defense of such claims difficult because witnesses and other evidence may no longer be available. In the Federal tax area, statutes of limitations cover additional assessments by the IRS and the pursuit of refund claims by taxpayers.
39. (LO 5)
- The normal three-year statute of limitations will begin to run on the original due date of the return (usually, the fifteenth day of the fourth month after year-end; April 15). When the return is filed early, the normal filing date controls.
 - Now the statute of limitations starts to run on the filing date. If the due date controlled (see part a. above), the taxpayer could shorten the assessment period by filing late.
 - If a return that is due is not filed, the statute of limitations does not start to run. It does not matter that the failure to file was due to an innocent error on the part of the taxpayer or adviser.
 - Regardless of the fact that an innocent misunderstanding was involved, there is no statute of limitations when a return is not filed.
40. (LO 5) No. Interest is not paid if the refund is made within 45 days of when the return was filed. However, a return is not considered filed until its due date. As a result, the period from April 15 to May 28, 2022, does not satisfy the 45-day requirement.
41. (LO 5, 6)
- Normally, the three-year statute of limitations applies to additional assessments the IRS can make. However, if a substantial omission from gross income is made, the statute of limitations is increased to six years. A substantial omission is defined as omitting in excess of 25% of the gross income reported on the return.
 - No, it would not. The proper procedure would be to advise Andy to disclose the omission to the IRS. Absent the client's consent, do not make the disclosure yourself.
 - If Andy refuses to make the disclosure and the omission has a material carryover effect to the current year, you should withdraw from the engagement.
42. (LO 5) \$4,000, determined as follows:
- | | | |
|---|--------------|----------------|
| Failure to pay penalty [0.5% × \$40,000 × 2 months] | | \$ 400 |
| Plus: | | |
| Failure to file penalty [5% × \$40,000 × 2 months] | \$4,000 | |
| Less failure to pay penalty for the same period | <u>(400)</u> | <u>3,600</u> |
| Total penalties | | <u>\$4,000</u> |
43. (LO 5)
- \$100,000 (20% × \$500,000).
 - \$375,000 (75% × \$500,000). The answer presumes that civil (not criminal) fraud is involved.

44. (LO 5, 6)
- a. No. Because no return was filed, the statute of limitations never runs. But even if a return had been filed, the three-year period for the 2018 tax return would not expire until April 15, 2022, three years after the normal due date for filing.
 - b. Although you can only recommend that the return be filed, you cannot force him to do so. However, you should not undertake the engagement for 2019 through 2021 if you cannot correctly reflect the tax liability due to the omission for 2018.
45. (LO 5, 6) The practice of outsourcing the preparation of tax returns is ethical if three steps are taken.
- Maintain client confidentiality.
 - Verify the accuracy of the work done.
 - Notify the client, preferably in writing, of the outsourcing.
46. (LO 7)
- a. This is the ideal approach to handling a tax cut—for every dollar lost, a new dollar is gained.
 - b. All the sunset provision does is reinstate the law as it existed prior to the tax cut. Here, the possibility exists that Congress will rescind (or postpone) the sunset provision before it takes effect.
 - c. Indexation is a procedure whereby the IRS makes annual adjustments to certain key tax components to take into account inflation, as required by law. Some of the more important components that are adjusted include tax brackets and the standard deduction amounts.
47. (LO 7)
- a. To encourage pension plans is to stimulate saving (economic consideration). Also, it provides security from the private sector for retirement to supplement rather meager public programs (social considerations).
 - b. To make education more widely available is to promote a socially desirable objective. A better educated workforce also serves to improve the country's economic capabilities. As a result, education tax incentives can be justified on both social and economic grounds.
 - c. The encouragement of home ownership can be justified on both social and economic grounds.
48. (LO 7, 8)
- a. Social considerations explain the credit. It is socially desirable to encourage parents to provide care for their children while they work.
 - b. These deductions raise the issue of preferential tax treatment for homeowners—taxpayers who rent their personal residences do not receive comparable treatment. Even so, the encouragement of home ownership can be justified on economic and social grounds.
 - c. The joint return procedure came about to equalize the position of married persons living in common law states with those residing in community property jurisdictions. Political and equity considerations caused this result.
 - d. Activities deemed contrary to public policy should not result in tax savings.
 - e. The NOL carryforward provision is an equity consideration designed to mitigate the effect of the annual accounting period concept.

- f. The installment method of reporting gain is consistent with the wherewithal to pay concept—the seller is taxed when the payments are made by the purchaser.
 - g. The exclusion from Federal income taxation of interest from state and local bonds can be justified largely on political considerations. Political goodwill is generated by allowing state and local jurisdictions to secure financing at a lower cost (i.e., interest rate) due to favorable Federal income tax treatment.
 - h. The treatment of prepaid income is justified under the wherewithal to pay concept. It also eases the task of the IRS as to administration of the tax law.
49. (LO 7)
- a. Mia's realized gain from the condemnation is \$320,000 [\$400,000 (amount of award) – \$80,000 (cost basis of the warehouse)]. However, her recognized gain is limited to \$120,000—the amount received that was not reinvested.
 - b. None of the gain is recognized because Mia reinvested the full amount of the condemnation award.
 - c. In this case, all of Mia's \$320,000 realized gain is recognized. Mia reinvested only \$80,000 of the \$400,000 award, so the \$320,000 difference between these two amounts means any realized gain will be recognized to the extent of this difference.
 - d. The involuntary conversion provision can be justified under the wherewithal to pay concept and the notion that the taxpayer's economic position has not changed. In part b., for example, Mia has retained none of the award and has reinvested in property similar to that taken by the city.
50. (LO 8) If the collection is worth more than \$1,000, the mother has probably made a gift of the excess value to her son. There is a possibility that the transaction could result in the assessment of a gift tax. Sales or other transactions between related parties are subject to the arm's length test. In this case, for example, would the mother have made this sale for \$1,000 if the purchaser had been an unrelated third party?

RESEARCH PROBLEMS

These research problems require that students utilize online resources to research and answer the questions. As a result, solutions may vary among students and courses. You should determine the skill and experience levels of the students before assigning these problems, coaching where necessary. Encourage students to use reliable websites and blogs of the IRS and other government agencies, media outlets, businesses, tax professionals, academics, think tanks, and political outlets to research their answers.

1. The sole proprietor is subject to Federal taxes on income, self-employment and payroll taxes (if the sole proprietor has employees), and the gasoline excise tax. State taxes include income and sales and use taxes. Local taxes include property tax, business license tax, and perhaps income tax.
2. An example of a carbon tax proposal of the 117th Congress is S. 1167, End Polluter Welfare Act. An example of a financial transaction tax proposal of the 117th Congress is H.R. 2735, Tax on Wall Street Speculation Act. Students might also find plans for these types of taxes that do not have legislative language.

3. An example of a sweetened beverage tax proposal is H.R. 2772 (117th Congress), the SWEET Act. Proposals also exist in a number of states and cities. Some cities, including Berkeley, California, Philadelphia, Pennsylvania, and Boulder, Colorado, have already enacted soda taxes. Considerations in analyzing these proposals include issues of regressivity (an equity and fairness issue), complexity of definitions, burden of enforcement, and neutrality in affecting decision making. Cook County, Illinois (Chicago) passed and then repealed a sweetened beverage tax due to a number of these issues.
4. Each of the Big Four firms has information on data analytics and how it can be used for tax purposes:
 - [pwc.com/us/en/services/tax/tax-innovation.html](https://www.pwc.com/us/en/services/tax/tax-innovation.html)
 - home.kpmg.com/xx/en/home/services/tax/global-indirect-tax/data-and-analytics.html
 - [ey.com/en_gl/tax/how-data-analytics-is-transforming-tax-administration](https://www.ey.com/en_gl/tax/how-data-analytics-is-transforming-tax-administration)
 - www2.deloitte.com/global/en/pages/technology/articles/making-data-and-analysis-a-priority.html

Students should also find how the IRS and state tax agencies are using big data to improve audit selection and enforcement. For example, see IRS, Advance Data & Analytics at:

- [irs.gov/about-irs/strategic-goals/advance-data-analytics](https://www.irs.gov/about-irs/strategic-goals/advance-data-analytics)
5. The Safeguards Rule was created as part of the Gramm-Leach-Bliley Act in 1999 (P.L. 106–102). The FTC summarizes this rule as follows: “The Safeguards Rule requires financial institutions under FTC jurisdiction to have measures in place to keep customer information secure. In addition to developing their own safeguards, companies covered by the Rule are responsible for taking steps to ensure that their affiliates and service providers safeguard customer information in their care.” This rule applies to all paid return preparers.
 - [ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/safeguards-rule](https://www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/safeguards-rule)

IRS Publication 4557 includes several actions preparers should take to protect client data and meet the Safeguards Rule. In reviewing student answers, confirm that they understand the Safeguards Rule and why a preparer obtaining or renewing a PTIN is asked to confirm that they have a data security plan. The publication lists numerous actions, consider whether the three actions the student describes are among the most important.

SOLUTION TO ETHICS & EQUITY FEATURE

Making Good Use of Out-of-State Relatives (p. 1-14). Who is the true purchaser of the watch? If the aunt really made the purchase with her funds and then gave the watch to Marcus, no sales or use tax evasion has occurred. More likely, the purchase was made by Marcus indirectly through his aunt—the aunt being reimbursed by Marcus or using funds provided by him. If that is the case, Marcus owes a sales tax on the purchase. Presuming the matter comes to light—the jewelry store might be the weak link—Marcus could be subject to prosecution for tax evasion.

CHAPTER 2
WORKING WITH THE TAX LAW
SOLUTIONS TO PROBLEM MATERIALS

DISCUSSION QUESTIONS

1. (LO 1) Determining the intent of Congress is a large part of tax research. Reviewing the Committee Reports generated by the House Ways and Means Committee, the Senate Finance Committee, and the Joint Conference Committee (if convened) will assist in determining intent.
2. (LO 1) The many gray areas, the complexity of the tax laws, and the possibility of different interpretations of the tax law create the necessity of alternatives for structuring a business transaction.
3. (LO 1) Federal tax legislation generally originates in the House Ways and Means Committee.
4. (LO 2, 5)

SWFT, LLP
5191 Natorp Boulevard
Mason, OH 45040

October 20, 2022

Ms. Sonja Bishop
Tile, Inc.
100 International Drive
Tampa, FL 33620

Dear Ms. Bishop:

This letter is in response to your request about information concerning a conflict between a U.S. treaty with Spain and a section of the Internal Revenue Code (IRC). The major reasons for treaties between the United States and certain foreign countries is to eliminate double taxation and to render mutual assistance in tax enforcement.

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

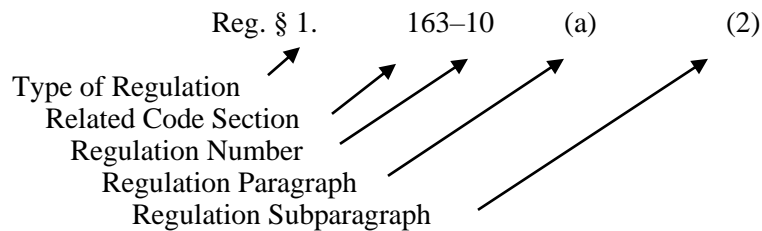
A taxpayer must disclose on the tax return any positions where a treaty overrides a tax law. There is a \$1,000 penalty per failure to disclose for individuals and a \$10,000 penalty per failure to disclose for corporations.

Should you need more information, feel free to contact me.

Sincerely,

Jeffrey Hanks, CPA
Tax Partner

5. (LO 1, 2) Income tax



6. (LO 1) There are a number of limitations on the percentage of depletion deduction, but there is a limited exception for independent producers and royalty owners. This deduction, however, is not available for a taxpayer that is a retailer or refiner. But § 613A(d)(4) indicates that a percentage depletion deduction “shall not apply to the taxpayer for a taxable year if the average daily refinery runs of the taxpayer and such persons for the taxable year exceed 75,000 barrels.” So as long as the independent producer is refining 75,000 barrels or less in a taxable year, the percentage depletion deduction will be available.

7. (LO 1, 4) The items would probably be ranked as follows (from lowest to highest):

- (1) Letter ruling (valid only to the taxpayer to whom issued)
- (2) Proposed Regulation (most courts ignore these)
- (3) Revenue Ruling
- (4) Interpretive Regulation
- (5) Legislative Regulation
- (6) Internal Revenue Code

8. (LO 1)

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

9. (LO 1, 5) TAX FILE MEMORANDUM

DATE: September 21, 2022

FROM: George Ames

SUBJECT: Telephone conversation with Sally Andrews on applicability of 2015 letter ruling

I informed Sally Andrews that only the taxpayer to whom the 2015 letter ruling was issued may rely on the pronouncement. I also stressed that a letter ruling has no precedential value under § 6110(k)(3).

- I pointed out that a letter ruling indicates the position of the IRS on the specific fact pattern presented as of the date of the letter ruling. As such, a letter ruling is not primary authority. However, under Reg. § 1.6662-4(d)(3), a letter ruling is substantial authority for purposes of the accuracy-related penalty in § 6662.
10. (LO 1) Sri should consider the following factors in determining whether he should request a letter ruling from the IRS with respect to the proposed stock redemption:
- For a fee, the IRS will issue a letter ruling at a taxpayer's request and describe how the IRS will treat a proposed transaction. The letter ruling applies only to the requesting taxpayer. A Revenue Ruling is applicable to all taxpayers.
 - Sri must determine whether the possible tax amount is large enough to warrant the costs and time to apply for a letter ruling.
 - If Sri is likely to obtain an adverse letter ruling from the IRS National Office, he should forgo the ruling request.
 - The letter ruling would have substantial authority for purposes of the accuracy-related penalty.
 - Sri needs to consult Rev.Proc. 2022-3 to be certain the IRS will issue a ruling about this tax issue. The IRS will not rule in certain areas that involve fact-oriented situations but will probably issue one here.
11. (LO 1) Letter rulings may be found in:
- *IRS Letter Ruling Reports* (CCH).
 - *Bloomberg BNA Daily Tax Reports*.
 - *Tax Notes* (Tax Analysts).
 - Letter rulings are also available in electronic (online) tax research services (e.g., Thomson Reuters *Checkpoint*).
12. (LO 1) TEAMs are issued by the Office of Chief Counsel to expedite legal guidance to field agents as disputes are developing. TEAMs differ from TAMs as follows:
- A mandatory presubmission conference involves the taxpayer.
 - In the event of a tentatively adverse conclusion to the taxpayer or to the field agent, a conference of right will be offered to the taxpayer and to the field agent.
 - No further conferences are offered once the conference of right is held.
13. (LO 1) Sanjay must consider several factors in deciding whether to take the dispute to the judicial system:
- How expensive will it be?
 - How much time will be consumed?
 - Does he have the temperament to engage in the battle?
 - What is the probability of winning?

- Once a decision is made to litigate the issue, the appropriate judicial forum must be selected.
- Tax Court judges have more expertise in tax matters.
- The tax deficiency need not be paid to litigate in the Tax Court. However, if Sanjay loses, interest must be paid on any unpaid deficiency.
- If a trial by jury is preferred, the U.S. District Court is the appropriate forum.
- The tax deficiency must be paid before litigating in the District Court or the Court of Federal Claims.
- If an appeal to the Federal Circuit is important, Sanjay should select the Court of Federal Claims.
- A survey of the decisions involving the issues in dispute is appropriate. If a particular court has taken an unfavorable position, that court should be avoided.

14. (LO 1) The main advantage of the U.S. Court of Federal Claims occurs when a taxpayer's applicable Circuit Court previously rendered an adverse decision. Such a taxpayer may select the U.S. Court of Federal Claims because any appeal will be to the Federal Circuit.

One disadvantage of the U.S. Court of Federal Claims is that the tentative deficiency must be paid before the Court will hear and decide the controversy.

The U.S. Court of Federal Claims is a trial court that usually meets in Washington, D.C. It has jurisdiction for any claim against the United States that is based on the Constitution, any Act of Congress, or any Regulation of an executive department.

15. (LO 1, 5)
- SWFT, LLP
5191 Natorp Boulevard
Mason, OH 45040

July 7, 2022

Mr. Eddy Falls
200 Mesa Drive
Tucson, AZ 85714

Dear Mr. Falls:

You have three alternatives should you decide to pursue your \$229,030 deficiency in the court system. One alternative is the U.S. Tax Court, the most popular forum. Overall, Tax Court judges have more expertise in tax matters. The main advantage is that the U.S. Tax Court is the only trial court where the tax need not be paid prior to litigating the controversy. However, interest will be due on an unpaid deficiency. The interest rate varies from one quarter to the next as announced by the IRS.

One disadvantage of the U.S. Tax Court is the delay that might result before a case is decided. The length of delay depends on the Court calendar, which includes a schedule of locations where cases will be tried. Another disadvantage is being unable to have the case heard before a jury.

The major advantage of another alternative, the U.S. District Court, is the availability of a trial by jury. One disadvantage of a U.S. District Court is that the tentative tax deficiency must be paid before the Court will hear and decide the controversy.

The Court of Federal Claims, the third alternative, is a trial court that usually meets in Washington, D.C. It has jurisdiction for any claim against the United States that is based on the Constitution, any Act of Congress, or any regulation of an executive department. The main advantage of the U.S. Court of Federal Claims occurs when a taxpayer’s applicable Circuit Court previously rendered an adverse decision. Such a taxpayer may select the Court of Federal Claims because any appeal will be to the Federal Circuit instead. One disadvantage of the Court of Federal Claims is that the tentative deficiency must be paid before the Court will hear and decide the controversy.

I hope this information is helpful, and should you need more help, please contact me.

Sincerely,

Abby Reynolds, CPA
Tax Partner

- 16. (LO 1) The U.S. Tax Court hears only tax cases and is the most popular forum for tax cases (generally viewed as an advantage). Overall, Tax Court judges have more tax expertise; many had careers in the Treasury Department or the IRS before being appointed to the Tax Court. A taxpayer does not have to pay the tax deficiency assessed by the IRS before trial, but a taxpayer may deposit a cash bond to stop the running of interest (also viewed as an advantage). Appeals from a Tax Court are to the appropriate U.S. Court of Appeals. A disadvantage is that the taxpayer may not obtain a jury trial in the U.S. Tax Court.
- 17. (LO 1) See Exhibit 2.4, Exhibit 2.5, and Concept Summary 2.1.
 - a. There is no appeal by either the taxpayer or the IRS from a decision of the Small Cases Division of the U.S. Tax Court.
 - b. The first appeal would be to the Sixth Circuit Court of Appeals. Further appeal would be to the U.S. Supreme Court.
 - c. Same as part b. above.
 - d. The appeal would be to the Federal Circuit Court of Appeals and then to the U.S. Supreme Court.
- 18. (LO 1) The term *petitioner* is a synonym for plaintiff, which refers to the party requesting action in a court.
- 19. (LO 1) Both the Code and the Supreme Court indicate that the Federal appellate courts are bound by findings of facts unless they are clearly erroneous. As a result, the *role* of appellate courts is limited to a review of the record of trial compiled by the trial courts. Therefore, the appellate process usually involves a determination of whether the trial court applied the proper law in arriving at its decision. Rarely will an appellate court disturb a lower court’s fact-finding determination.

| | | | | |
|-----|--|-------------------------------|--------------------------------------|---|
| 20. | (LO 1) See Concept Summary 2.1. | <u>U.S. Tax Court</u> | <u>U.S. District Court</u> | <u>U.S. Court of Federal Claims</u> |
| a. | Number of regular judges | 19 | Varies; one judge hears a case | 16 |
| b. | Jury trial | No | Yes | No |
| c. | Prepayment of deficiency required before trial | No | Yes | Yes |

21. (LO 1) See Exhibit 2.5.
- Tenth.
 - Eighth.
 - Ninth.
 - Fifth.
 - Seventh.
22. (LO 1) See Exhibit 2.4.
- The Tax Court must follow its own cases, the pertinent U.S. Circuit Court of Appeals, and the Supreme Court.
 - The Court of Federal Claims must follow its own decisions, the Federal Circuit Court of Appeals, and the Supreme Court.
 - The District Court must follow its own decisions, the pertinent U.S. Circuit Court of Appeals, and the Supreme Court.
23. (LO 1) The appropriate Circuit Court of Appeals for an appeal depends on where the litigation originated. For example, an appeal from Texas would go to the Fifth Circuit Court of Appeals and an appeal from Colorado would go to the Tenth Circuit Court of Appeals. See Exhibit 2.5.
24. (LO 1, 2, 4)
- If the taxpayer chooses a U.S. District Court as the trial court for litigation, the U.S. District Court of Wyoming will be the forum to hear the case. Unless the prior decision has been reversed on appeal, one would expect the same court to follow its earlier holding.
 - If the taxpayer chooses the U.S. Court of Federal Claims as the trial court for litigation, the decision that was rendered previously by this Court should have a direct bearing on the outcome. If the taxpayer selects a different trial court (i.e., the appropriate U.S. District Court or the U.S. Tax Court), the decision that was rendered by the U.S. Court of Federal Claims will be persuasive but not controlling. It is, of course, assumed that the result that was reached by the U.S. Court of Federal Claims was not reversed on appeal.
 - The decision of a U.S. Circuit Court of Appeals will carry more weight than one that was rendered by a trial court. Because the taxpayer lives in California, however, any appeal from a U.S. District Court or the U.S. Tax Court will go to the Ninth Circuit Court of Appeals (see Exhibit 2.4). Although the Ninth Circuit Court of Appeals might be influenced by what the Second Circuit Court of Appeals has decided, it is not compelled to follow such holding. See Exhibit 2.5.
 - Because the U.S. Supreme Court is the highest appellate court, one can place complete reliance upon its decisions. Nevertheless, one should investigate any decision to see whether the Code has been modified with respect to the result that was reached. The rare possibility also exists that the Court may have changed its position in a later decision. See Exhibit 2.4.
 - When the IRS acquiesces to a decision of the U.S. Tax Court, it agrees with the result that was reached. As long as such acquiescence remains in effect, taxpayers can be assured that this represents the position of the IRS on the issue that was involved. Keep in mind, however, that the IRS can change its mind and can, at any time, withdraw the acquiescence and substitute a nonacquiescence.

- f. The issuance of a nonacquiescence usually reflects that the IRS does not agree with the result reached by the U.S. Tax Court. Consequently, taxpayers are placed on notice that the IRS will continue to challenge the issue that was involved.
25. (LO 2) The number 66 is the volume number for the U.S. Tax Court, 39 refers to the page number of the 562nd volume of the *Federal Second Series*, and *nonacq.* means that the IRS disagreed with the decision. The Tax Court (T.C.) cite is to the trial court.
26. (LO 1) There is no automatic right of appeal to the U.S. Supreme Court. Appeal is by Writ of Certiorari. If the Court agrees to hear the dispute, it will grant the Writ (*Cert. granted*). Most often, the highest court will deny jurisdiction (*Cert. denied*).
27. (LO 2) See Concept Summary 2.2.
- a. Ninth Circuit Court of Appeals.
 - b. U.S. Tax Court.
 - c. U.S. Supreme Court.
 - d. Board of Tax Appeals (old name of U.S. Tax Court).
 - e. Tax Court (memorandum decision).
 - f. Court of Claims.
 - g. Not a court decision.
 - h. District Court in New York.
 - i. Not a court decision.
28. (LO 2) See Concept Summary 2.2.
- a. This citation is to a regular decision of the U.S. Tax Court that was issued in 1950. The decision can be found in Volume 14, page 74, of the *Tax Court of the United States Report*, published by the U.S. Government Printing Office.
 - b. This citation is for a decision of the U.S. Fifth Circuit Court of Appeals that was rendered in 1979. The decision can be found in Volume 592, page 1251, of the *Federal Reporter*, Second Series (F.2d), published by West Publishing Company.
 - c. This citation is for a decision of the U.S. Sixth Circuit Court of Appeals that was rendered in 1995. The decision can be found in Volume 1 for 1995, paragraph 50,104 of *U.S. Tax Cases*, published by Commerce Clearing House.
 - d. This citation is for a decision of the U.S. Sixth Circuit Court of Appeals that was rendered in 1995. The decision can be found in Volume 75, page 110, of the *Second Series of American Federal Tax Reports*, published by RIA (Thomson Reuters).
 - e. This citation is for a decision of the U.S. District Court of Texas that was rendered in 1963. The decision can be found in Volume 223, page 663, of the *Federal Supplement Series*, published by West Publishing Company.
 - f. This citation is to a decision of the U.S. First Circuit Court of Appeals that was rendered in 2007. The decision can be found in Volume 491, page 53, of the *Federal Reporter*, Third Series (F.3d), published by West Publishing Company.

- g. This citation is to a decision of the U.S. District Court of the Virgin Islands that was rendered in 2011. The decision can be found in Volume 775, page 765, of the *Federal Supplement, Second Series* (F.Supp.2d), published by West Publishing Company.
29. (LO 2) See Concept Summary 2.2.
- None.
 - USTC.
 - USTC.
 - USTC.
 - TCM.
30. (LO 2) Decisions of the U.S. Court of Federal Claims (formerly named the Claims Court) are published in the USTCs (CCH); the AFTRs (RIA); and the West Publishing Co. reporter called the *Federal Claims Reporter, Second Series* (F.2d) (before October 1982) and the *Claims Court Reporter* (beginning October 1982 through October 30, 1992). The name of the U.S. Court of Federal Claims was changed from the Claims Court effective October 30, 1992. Currently, this court's decisions are published in the *Federal Claims Reporter*. See Concept Summary 2.2.
31. (LO 1, 2)
- Yes. Exhibit 2.3.
 - No. Not published there. Concept Summary 2.2.
 - No. Published by private publishers and the IRS. Exhibit 2.3.
 - Yes. Exhibit 2.3.
 - Yes. Exhibit 2.3.
 - No. Concept Summary 2.2.
 - Yes. Exhibit 2.3.
 - No. Concept Summary 2.2.
32. (LO 3) After understanding the relevant facts and the accounting rules related to qualified stock options:
- Yvonne can begin with the index volumes of the available tax services: RIA, CCH, or BNA Portfolios.
 - A key word search on an online service should be helpful—Thomson Reuters *Checkpoint*, CCH *IntelliConnect*, LexisNexis, or Westlaw (or WestlawNext).
 - Yvonne may browse through IRS publications (available on the IRS website).
 - Yvonne could consult CCH's *Federal Tax Articles* to locate current appropriate articles written about qualified stock options. Thomson Reuters publishes the *Index to Federal Tax Articles* that is organized using RIA's paragraph index system.
 - Additional information can be found on the internet.

33. (LO 4) The current Code can be found in various places. Several of the major tax services publish paperback editions of the Code (and Regulations). These editions are usually revised twice each year. Further, the text of the Code may be found in the major tax services and as Title 26 of the U.S. Code. The Code also may be found on the Web.
34. (LO 2, 3, 4) The best means of locating tax articles pertinent to your problem is through Commerce Clearing House's *Federal Tax Articles*. This multivolume service includes a subject index, a Code section number index, and an author's index. Another is the *Index to Federal Tax Articles* (published by Thomson Reuters). Both of these indexes are updated periodically but are available only in print form.

Court decisions, revenue rulings and procedures, and other relevant authority may be reviewed for reliability using a *citator* within the commercial tax service. A citator provides the history of a case, including the authority relied on (e.g., other judicial decisions) in reaching the result. Reviewing the references listed in the citator discloses whether the decision was appealed and, if so, with what result (e.g., affirmed, reversed, or remanded). It also reveals other cases with the same or similar issues and how they were decided. As a result, a citator reflects on the validity of a case and may lead to other relevant authority. If one intends to rely on a judicial decision to any significant degree, "running" the case through a citator is imperative.

35. (LO 6) The primary purpose of effective tax planning is to maximize the taxpayer's after-tax wealth. This process can entail an avoidance, a reduction, or a postponement of the tax until the future.

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

There is nothing illegal or immoral about tax avoidance. But it is important to understand the difference between tax avoidance and tax evasion. A citizen has every legal right to arrange his or her affairs to keep the attendant taxes as low as possible. One is required to pay no more taxes than the law demands.

36. (LO 7) Task-based simulations on the CPA exam are case studies that allow candidates to demonstrate their knowledge and skills by generating responses to questions rather than simply selecting an answer. They typically require candidates to use spreadsheets and/or to research authoritative literature provided in the CPA exam (e.g., Internal Revenue Code, Treasury Department Regulations, IRS publications, and Federal tax forms). In addition, the task-based simulations provide increased background material and data that require candidates to determine what information is or is not relevant to the questions.

PROBLEMS

37. (LO 1)
b. Subchapter C; see discussion on p. 2-5.
38. (LO 1, 2)
a. Individual tax rates.
b. Corporate tax rates.
c. Definition of gross income.
d. Definition of adjusted gross income.
e. Trade or business deductions.
f. Production of income expenses.
g. Nondeductibility of personal expenses.

39. (LO 1, 2)
- a. In 2021, the Chair was Richard Neal. He represents the 1st district from the state of Massachusetts.
 - b. In 2021, there were 43 members (25 Democratic; 18 Republican).
 - c. The Committee on Ways and Means is the oldest committee of the United States Congress, and is the chief tax-writing committee in the House of Representatives. The Committee derives a large share of its jurisdiction from Article I, Section VII of the U.S. Constitution which declares, "All Bills for raising Revenue shall originate in the House of Representatives." First established as a select committee on July 24, 1789, it was discharged less than two months later. The committee was reappointed from the first session of the Fourth Congress in 1795 and was formally listed as a standing committee in the House Rules on January 7, 1802. Until 1865, the jurisdiction of the committee (referred to as the Committee of Ways and Means before 1880) included the critically important areas of revenue, appropriations, and banking. Since 1865, the committee has continued to exercise jurisdiction over revenue and related issues such as tariffs, reciprocal trade agreements, and the bonded debt of the United States. Revenue-related aspects of the Social Security system, Medicare, and social services programs also come within the scope of the Committee on Ways and Means.
 - d. In 2021, there were six subcommittees: Health, Oversight, Social Security, Select Revenue Measures, Trade, and Worker and Family Support.
40. (LO 1)
- b. *Internal Revenue Bulletin*; see Exhibit 2.3.
41. (LO 1)
- d. Temporary Regulations; see Exhibit 2.3.
42. (LO 1, 4)
- (1) Code Section.
 - (2) Legislative Regulation.
 - (3) Recent Temporary Regulation.
 - (4) Interpretive Regulation.
 - (5) Revenue Ruling.
 - (6) Proposed Regulation.
 - (7) Letter Ruling.
43. (LO 1, 2)
- a. Provides various prescribed interest rates for Federal income tax purposes for the month of January 2021. The ruling includes short-term, mid-term, and long-term applicable Federal rates (AFR) for January 2021.
 - b. Identifies the proper MACRS class (tax depreciation) for the depreciation of tangible assets that are used in converting corn to fuel grade ethanol.

- c. Discusses the tax treatment of allowances and reimbursements paid to a member of the U.S. House of Representatives. These include allowances for hiring clerks; obtaining office supplies and equipment, telephones, and computers and related services; renting a home district office, communicating with constituents, and traveling (among others).
 - d. Discusses the tax treatment of ATM fees incurred by taxpayers when they obtain a cash advance from an ATM.
44. (LO 1, 2)
- a. Retroactive application of 50% “bonus” depreciation in 2014.
 - b. Limitation of depreciation for autos placed in service in 2019.
 - c. Casualty loss caused by deterioration of concrete foundations.
 - d. Revisions to certain real property depreciation tables.
45. (LO 1, 2) In Announcement 2020-1 (2020–5 I.R.B. 401), the IRS indicated that it had revoked the tax-exempt status of 44 different organizations. As of January 27, 2020, these organizations no longer qualify as tax-exempt organizations [under § 501(c)(3) and § 170(c)(2)].
46. (LO 1, 2) In PLR 201450001, the IRS ruled on the appropriate cost recovery period for outdoor digital LED advertising displays following an election under the involuntary conversion rules to treat the displays as real property.
47. (LO 1, 2)
- a. Rev.Rul. 2019–22 (2019–14 I.R.B. 931).
 - b. The phaseout of the electric vehicle credit for General Motors.
 - c. If a new qualified plug-in electric drive motor vehicle sold by General Motors, LLC, is purchased for use or lease on or after April 1, 2019, the allowable credit is as follows:
 - (1) For vehicles purchased for use or lease on or after April 1, 2019, and on or before September 30, 2019, the credit is 50 percent of the otherwise allowable amount determined under § 30D(b);
 - (2) For vehicles purchased for use or lease on or after October 1, 2019, and on or before March 31, 2020, the credit is 25 percent of the otherwise allowable amount determined under § 30D(b);
 - (3) For vehicles purchased for use or lease on or after April 1, 2020, no credit is allowable.
48. (LO 1, 2) Taxpayers who claim an itemized deduction for the interest they pay on adjustable-rate mortgages and receive a refund from their mortgage company in a following year must include the refund as income. Taxpayers who claimed the standard deduction rather than an actual interest deduction are *not* required to include the refund in income (Announcement 92–172).
49. (LO 1, 2) Loan origination fees (“points”) paid by the buyer with regard to VA and FHA loans may be treated as deductible points in the year of the sale (Rev.Proc. 92–12 and Rev.Proc. 94–27).

50. (LO 2) The IRS maintains a website on virtual currency:

irs.gov/businesses/small-businesses-self-employed/virtual-currencies

In addition, Notice 2014–21 (2014–21 I.R.B. 938) explains how existing tax principles apply to transactions involving virtual currency. In Notice 2014–21, the IRS concludes that virtual currency is property and that sales or exchanges of virtual currency result in capital gains or losses. Code § 1031 provides information on the tax consequences of like-kind exchanges. Currently, § 1031 only applies to real property (e.g., land and buildings). As a result, an exchange of cryptocurrencies will result in a capital gain or loss; § 1031 is not available.

Notice 2014–21 also discusses the tax implications of mining a cryptocurrency (see Q-8, Q-9, and Q-10). When a taxpayer successfully “mines” virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income. The question then becomes whether the mining is a “hobby” or a “trade or business.” The IRS references a news release from April 2007 (FS-2007-18) to help make this determination.

If a taxpayer’s “mining” of virtual currency constitutes a trade or business and the “mining” activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment (generally, gross income derived from carrying on a trade or business less allowable deductions) resulting from those activities constitute self-employment income and are subject to the self-employment tax. Consequently, the fair market value of virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax.

51. (LO 2) A letter ruling is a written determination issued by the IRS Office of Chief Counsel in response to a taxpayer’s written request, prior to the filing of a tax return (or other report required by law).

Rev.Proc. 2022–1 (2022–1 I.R.B. 1) provides significant detail regarding this process (the revenue procedure is more than 115 pages long). The IRS will not provide rulings on certain issues [see, for example, Rev.Proc. 2022–3 (2022–1 I.R.B. 144)], and any ruling applies only to that taxpayer. In addition, any ruling can be revoked by the IRS. Rev.Proc. 2022–1 (which is updated annually) provides a schedule of user fees, a sample format for a letter ruling request, and a checklist for the request. Generally, the user fee is not refundable and the user fee can range from \$30,000 to \$38,000. Of course, the practitioner’s fee also must be factored into this decision. These costs mean that only those tax issues with significant tax costs are considered for a private letter ruling request.

52. (LO 2) The cost of the football tickets for Alejandra and Zach is considered to be an entertainment expense and is not deductible (see § 274). But the cost of the lunch is not considered entertainment because it was purchased separately. As a result, it is deductible as a meal expense (see Reg. § 1.274–12 and Notice 2018–76). The meal expense is subject to the 50% limitation (see § 274 and Reg. § 1.274–11); the alumni tent is not a “restaurant,” so the 50% limitation applies in 2021 and 2022.

53. (LO 4)
- a. P.
 - b. P.
 - c. P.

- d. S.
 - e. P.
 - f. S.
 - g. P. Valid for three years.
 - h. P.
 - i. N.
 - j. P.
 - k. P.
54. (LO 1, 2) See Concept Summary 2.2.
- a. CCH.
 - b. RIA.
 - c. U.S.
 - d. CCH.
 - e. U.S.
 - f. RIA.
 - g. W.
 - h. W.
 - i. W.
 - j. W.
 - k. U.S.
 - l. U.S.
55. (LO 1, 2)
- a. U.S. Supreme Court.
 - b. 1955.
 - c. This is a “landmark case” where the Supreme Court defined the term *income*. Two cases with different facts but the same issue were consolidated by the Supreme Court in this opinion. The common question is whether money received as exemplary damages for fraud or as the punitive two-thirds portion of a treble-damage antitrust recovery must be reported by a taxpayer as gross income. The Supreme Court held that income is realized whenever there are “instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have compete dominion.” So here, both taxpayers had income. And because Congress had not provided an exclusion for these income items, both also were included in gross income.

56. (LO 1, 2)
- a. The court addressed whether an interest the taxpayer held in various jet aircraft constituted a trade or business under § 162 (with a net loss allowed in determining the taxpayer's taxable income) or a hobby under § 183 (with deductions limited to any income generated by the activity). The taxpayer asked the Tax Court to shift the burden of proof to the IRS (from the taxpayer) and asked the Court to excuse the substantial underpayment penalty due to reliance on professional advisers.
 - b. The Tax Court held that the activity did not rise to the level of profit motive to permit deductions (i.e., it was a hobby under § 183). The burden of proof was not shifted to the IRS (so it was the taxpayer's duty to provide evidence of profit motive), and the substantial underpayment penalty that was assessed as reliance on professionals was not supported by evidence.
57. (LO 1, 2)
- a. *Speer v. Commissioner*.
 - b. U.S. Tax Court.
 - c. 2015.
 - d. The court addressed whether unused vacation and sick pay paid to the taxpayer upon retirement was includible as gross income. The taxpayer argued that some of the vacation and sick pay was accrued while the taxpayer was on temporary disability, and so some of the pay should be excluded from income. The Tax Court held that since the leave payments were not paid as workers' compensation (i.e., for personal injuries or sickness), the payments were not excludible from income.
58. (LO 6)
- a. E.
 - b. E.
 - c. A.
 - d. A.
 - e. A.

RESEARCH PROBLEMS

1.
 - a. *Higgins v. Comm.*, 312 U.S. 212 (1941).
 - b. *Talen v. U.S.*, 355 F.Supp.2d 22 (D.Ct. D.C., D.D.C., 2004).
 - c. Rev.Rul. 2008-18, 2008-13 I.R.B. 674.
 - d. *Pahl v. Comm.*, 150 F.3d 1124 (CA-9, 1998).
 - e. *Veterinary Surgical Consultants PC*, 117 T.C. 141 (2001).
 - f. *Yeagle Drywall Co.*, T.C. Memo. 2001-284.

2. IRC § 7463(b) states that a decision entered into by any small case decision “shall not be reviewed in any other court and shall not be treated as precedent for any other case.”

In the reviewed opinion *Larry Mitchell* 131 T.C. 215 (2008), the court held that an ex-spouse’s share of military retirement payments is subject to tax. This same issue had been litigated previously by the taxpayer in *Mitchell*, T.C. Summ. 2004–160.

In the past, the Tax Court has used collateral estoppel in small tax case decisions to stop (estop) a party from litigating the same issue in a regular Tax Court case. As a result, this reviewed decision seems to contradict their stance. Judge Holmes stated that this Tax Court decision means “that they are without effect on future litigation at all.”

3. For the Oprah car giveaway, the 234 audience recipients who received keys to a car were taxed on the value of the car, which was in the \$30,000 range. Because they were merely present in the audience, the fair market value was included in gross income under § 61.

As for the World Furniture Mall promotion, the discount or rebate could be tax-free because a rebate of all or a portion of the purchase price of property generally does not result in gross income. The customer would have a zero basis in the furniture. Rev.Rul. 76–96 and Rev.Rul. 88–95. See “Furniture for Nothing and It’s all Tax-Free,” *Journal of Taxation*, December 2006, pp. 382 and 383.

4. There does not appear to be a clear-cut answer to this question. Code § 104 allows exclusion from gross income for damages paid on account of physical injuries and physical sickness. However, the IRS requires observable bodily harm for an exclusion to be available (Ltr.Rul. 200041022).

So is false imprisonment physical? In CCA 200809001, the IRS allowed an exclusion for a settlement with an institution for sexual abuse. However, the Tax Court in *Daniel and Brenda Stadnyk*, T.C. Memo. 2008–289 would not allow an exclusion for \$49,000 received for about one day in a jail.

Brenda Stadnyk was dissatisfied with an automobile purchase, so she placed a stop payment order on the check she tendered to the dealership. Bank One listed the reason for not paying the dealership as a “NSF check.” The dealership then filed a criminal complaint against her for passing a worthless check. She spent about one day in a holding area in a county jail.

In “Why False Imprisonment Recoveries Should Not Be Taxable,” *Tax Notes*, June 8, 2009, pp. 1217–1220, Robert Wood provides a lengthy discussion of this problem.

Research Problems 5 and 6

These research problems require that students utilize online resources to research and answer the questions. As a result, solutions may vary among students and courses. You should determine the skill and experience levels of the students before assigning these problems, coaching where necessary. Encourage students to use reliable websites and blogs of the IRS and other government agencies, media outlets, businesses, tax professionals, academics, think tanks, and political outlets to research their answers.

5. (1) A Google search will likely produce a variety of links, including one to Cornell University Law School’s Legal Information Institute (law.cornell.edu/uscode/text/26/61). This section defines gross income broadly. In addition to the 14 items specifically listed as income, § 61 directs the reader to other IRC sections and indicates that the list of income items is not all-inclusive. In general, the IRC takes a broad view of income; everything is income unless an IRC section specifies that the amount is not income.

- (2) To find the case, go to the U.S. Tax Court website and on the “Orders & Opinions” drop down menu, click on Opinions Search. Enter the name Mark Spitz in the “Case Name Keyword” field and click on the Search button.
- a. The tax years are 2001 and 2002, as indicated in the first sentence of the case, not 2006, the year in the citation, which is the year the case was decided.
 - b. As noted above, 2006.
 - c. The court decided in favor of the IRS.
 - d. At the end of the decision, the penalty in § 6662 is discussed. This section imposes a 20% accuracy-related penalty on any portion of a tax liability underpayment (the situation in which Mr. Spitz found himself) attributable to a substantial understatement of income tax. Mr. Spitz was found not liable for the penalty because the court indicated that he was unsophisticated in tax law and had relied on a competent adviser to prepare his return.
- 6.
- a. From the “Orders & Opinions” drop down menu, click on Opinions Search. On the “Opinions Search” tab, review the “Opinion Type” choices.
 - b./c. From the “Orders & Opinions” drop down menu, click on Opinions Search. On the “Opinions Search” tab, select the appropriate opinion type, and enter a common last name in the “Case Name Keyword” bar.
 - d. From the “Rules & Guidance” drop down menu, click on Tax Court Rules.
 - e. The student e-mail should summarize the items above. Look for proper grammar and e-mail etiquette in addition to the correct answer.

SOLUTION TO ETHICS & EQUITY FEATURE

Reporting Tax Fraud (p. 2-7). A survey given in 2014 by the IRS Oversight Board indicated that 86 percent of Americans believe that it is unacceptable to cheat on their taxes. On the other hand, that same survey indicated that 11 percent of taxpayers said that some cheating on their taxes was acceptable.

In October 2019, the IRS released its latest assessment of the tax gap (IR-2019-159). The IRS estimates that the gross average tax gap for the years 2011, 2012, and 2013 is about \$441 billion per year. Voluntary payments or IRS administrative/enforcement efforts were \$60 billion, resulting in a net tax gap of approximately \$381 billion. These figures translate to around 83.6% of taxes being paid voluntarily and on time. See also [irs.gov/pub/irs-pdf/p1415.pdf](https://www.irs.gov/pub/irs-pdf/p1415.pdf) and [irs.gov/pub/irs-pdf/p5365.pdf](https://www.irs.gov/pub/irs-pdf/p5365.pdf).

In May 2021, the Department of the Treasury estimated the 2019 gross tax gap to be around \$630 billion, with more than \$3.6 trillion of taxes owed but only about \$3 trillion paid voluntarily. Enforcement activities and late penalties brought in \$76 billion of additional revenues. The Treasury Department estimated the voluntary compliance rate (after enforcement activities) to be about 84.8% (roughly the same as in the 2019 IRS study). The Treasury report is at [home.treasury.gov/system/files/136/The-American-Families-Plan-Tax-Compliance-Agenda.pdf](https://www.home.treasury.gov/system/files/136/The-American-Families-Plan-Tax-Compliance-Agenda.pdf). The Treasury Department attributes the tax gap to areas where there is limited information reporting (rental income and proprietorship income), sophisticated (and complex) pass-through entity structures, and offshore income. See also the Committee for a Responsible Federal Government blog on the tax gap ([crfb.org/blogs/primer-understanding-tax-gap](https://www.crfb.org/blogs/primer-understanding-tax-gap)).