Test Bank

South Western Federal Taxation
Comprehensive Volume

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TRUE/FALSE

1. The ratification of the Sixteenth Amendment to the U.S. Constitution was not necessary to validate the Federal income tax on corporations.

   ANS:  T
   The Sixteenth Amendment validated the tax on individuals. The income tax on corporations had been previously sanctioned by the courts.

   PTS:  1       REF:  p. 1-3

2. The Federal income tax on corporations generates more revenue than the Federal income tax on individuals.

   ANS:  F
   Just the opposite is the case.

   PTS:  1       REF:  Figure 1-1

3. The pay-as-you-go feature of the Federal income tax on individuals conforms to Adam Smith’s canon of convenience.

   ANS:  T
   Pay-as-you-go refers to the withholding provisions applicable to wages and other types of income and adds convenience to the tax system.

   PTS:  1       REF:  p. 1-4

4. The FICA tax (Social Security component) on wages is progressive since the tax due increases as wages increase.

   ANS:  F
   The FICA tax (Social Security component) is proportional because the rate is constant regardless of the wages earned.

   PTS:  1       REF:  Example 2

5. The Federal estate and gift taxes are examples of progressive taxes.

   ANS:  T       PTS:  1       REF:  p. 1-5

6. Currently, the Federal income tax is more progressive than it has been in the past.

   ANS:  F
   Currently, the Federal income tax has six rates. At one time, it had fifteen rates.

   PTS:  1       REF:  p. 1-6
7. Marie inherits her mother’s personal residence, which she converts to a furnished rent house. This change should not affect the amount of *ad valorem* property taxes levied on the properties.

ANS: F
Conversion from residential to rental use will increase the taxes. Furthermore, Marie’s mother may have had a senior citizen exemption on the property, which will no longer be appropriate. Lastly, the furnishings in the rent house could now be subject to an *ad valorem* tax on personalty.

PTS: 1 REF: p. 1-7

8. A *fixture* will be subject to the *ad valorem* tax on realty rather than the *ad valorem* tax on personalty.

ANS: T
By definition, a fixture becomes part of the real estate to which it is attached.

PTS: 1 REF: p. 1-6

9. Brayden issues a conservation easement on the family vacation home. Because the easement adds value to the property, Brayden’s property taxes should increase.

ANS: F
Since the easement places a restriction on the use of the property, its value should decrease. Many taxing jurisdictions allow a special valuation discount in these situations.

PTS: 1 REF: p. 1-7

10. The *ad valorem* tax on personal use personalty is more often avoided by taxpayers than the *ad valorem* tax on personalty devoted to business use.

ANS: T PTS: 1 REF: p. 1-8

11. As the tax is difficult to avoid, many states levy an *ad valorem* tax on intangibles (e.g., stocks and bonds).

ANS: F
The statement is incorrect in several respects. First, the tax on intangibles is easily avoided (e.g., make use of an out-of-state broker). Second, very few (not many) states impose such a tax.

PTS: 1 REF: p. 1-8

12. Federal excise tax is no longer imposed on the sale of leather goods.

ANS: T
Such tax existed in the past but was rescinded.

PTS: 1 REF: p. 1-9

13. The retail sales of tobacco products are subject to both Federal and state excise taxes.

14. The Federal gas-guzzler tax applies only to automobiles manufactured overseas and imported into the U.S.

ANS: F
No such restriction is imposed. Although many of the European luxury and sports car manufacturers were initially hit hard by the tax, the law is silent on this matter.

PTS: 1 REF: p. 1-8 | Footnote 9

15. Unlike the Federal counterpart, the state excise taxes on gasoline do vary from state to state.

ANS: T
The state excise tax rates on gasoline are not constant.

PTS: 1 REF: p. 1-9

16. Because they are politically unpopular, many cities are reducing or eliminating their hotel occupancy and car rental surcharges.

ANS: F
As visitors cannot vote, these taxes are popular with residents. Since they are often used to finance large capital improvements (e.g., athletic stadiums), these taxes are not decreasing, and their rates are becoming formidable.

PTS: 1 REF: p. 1-9

17. If a state imposes a general sales tax, it will have a use tax.

ANS: T
Every state that has a general sales tax also has a use tax. There are no states with only a sales or use tax.

PTS: 1 REF: p. 1-9

18. Sales made by mail order are exempt from the application of a general sales (or use) tax.

ANS: F
They are not exempt but compliance is sporadic.

PTS: 1 REF: p. 1-10

19. Two persons who live in the same state but in different counties may not be subject to the same general sales tax rate.

ANS: T
This possibility could exist if local jurisdictions exact additional sales taxes.

PTS: 1 REF: Example 5
20. States impose either a state income tax or a general sales tax, but not both types of taxes.

   ANS: F
   Many states impose both.

   PTS: 1    REF: p. 1-9 | p. 1-14

21. Canceling a scheduled sales tax holiday has proven to be an easy way to generate more state and local revenue.

   ANS: F
   These special holidays are very popular with both merchants and consumers—both of which have a strong voter impact at the polls.

   PTS: 1    REF: p. 1-10

22. A safe and easy way for a taxpayer to avoid local and state sales taxes is to have the purchase sent to an address in another state that levies no such taxes.

   ANS: F
   A review of the Example 4 discussion shows that this may not always be a successful way to go.

   PTS: 1    REF: Example 4

23. The Federal government imposes an estate tax, while many states may impose either inheritance or estate taxes or both.

   ANS: T
   The Federal government imposes an estate tax while many states impose an estate tax, an inheritance tax, or both.

   PTS: 1    REF: Example 6

24. An estate tax is a tax on a decedent’s right to pass property at death.

   ANS: T    PTS: 1    REF: p. 1-11

25. One of the major reasons for the enactment of the Federal estate tax was to raise large amounts of revenue.

   ANS: F
   The estate tax was never intended to be a large source of revenue.

   PTS: 1    REF: p. 1-11

26. Under Clint’s will, all of his property passes to either the Lutheran Church or to his wife. No Federal estate tax will be due on Clint’s death.

   ANS: T
   A combination of the charitable and marital deductions will eliminate Clint’s taxable estate.

   PTS: 1    REF: p. 1-11
27. Under a state inheritance tax, two heirs, a cousin and a son of the deceased, would not be taxed at the same rate.

ANS: T
The more closely related the heir is to the decedent, the larger the exemption allowed and/or the lower the tax rate imposed.

PTS: 1 REF: p. 1-12

28. The annual exclusion, currently $12,000, is available for both gift and estate tax purposes.

ANS: F
The annual exclusion is not available for estate tax purposes.

PTS: 1 REF: p. 1-13

29. José, a widower, sells land (fair market value of $100,000) to his daughter, Linda, for $50,000. José has made a taxable gift of $38,000.

ANS: T
$100,000 (value of land) – $50,000 (consideration received) – $12,000 (per donee annual exclusion) = $38,000 (taxable gift).

PTS: 1 REF: Example 8 | Example 9

30. Julius, a married taxpayer, makes gifts to each of his six children. A maximum of six annual exclusions could be allowed as to these gifts.

ANS: F
If Julius can obtain the consent of his wife to make the election to split the gifts, twelve per donee annual exclusions are available.

PTS: 1 REF: p. 1-12

31. One of the motivations for making a gift is to save on income taxes.

ANS: T
This presumes that income-producing property is involved and that the donee is in a lower tax bracket than the donor.

PTS: 1 REF: p. 1-13

32. Under the Tax Relief Reconciliation Act of 2001, only the Federal gift tax will ultimately be repealed.

ANS: F
It is the Federal estate tax that is to be repealed.

33. The formula for the Federal income tax on corporations is not the same as that applicable to individuals.

ANS: T
For example, an AGI determination is required only for individual taxpayers.

PTS: 1 REF: p. 1-14

34. A state income tax will not be imposed on nonresident taxpayers who earn income within the state or on an itinerant basis.

ANS: F
Highly-paid taxpayers (e.g., entertainers, athletes) are often subject to a state’s income tax. The so-called “jock tax” has been criticized since it singles out highly-paid and well known personalities and is not imposed on the average business traveler.

PTS: 1 REF: p. 1-15

35. Some states have offered income tax amnesty programs on more than one occasion.

ANS: T
One state has had at least four.

PTS: 1 REF: p. 1-15

36. For Federal income tax purposes, there never has been a general amnesty period.

ANS: T
Limited amnesty has been made available as to various tax penalties in certain tax shelter situations.

PTS: 1 REF: p. 1-15 | Footnote 17

37. Under state amnesty programs, all delinquent and unpaid income taxes are forgiven.

ANS: F
The taxes and interest are not forgiven. Only the penalties are forgiven.

PTS: 1 REF: p. 1-15

38. When a state decouples from a Federal tax provision, it means that this provision will not apply for state income tax purposes.

ANS: T
In view of tight state finances, decoupling from various Federal tax cuts has become quite common.

PTS: 1 REF: p. 1-14
39. The principal objective of the FUTA tax is to provide some measure of retirement security.

ANS: F
This is the objective of the FICA tax.

PTS: 1 REFER: p. 1-16

40. Currently, the tax base for the Medicare component of the FICA is limited to a dollar amount.

ANS: F
There is no dollar amount limitation on the Medicare component of FICA.

PTS: 1 REFER: p. 1-16

41. A parent employs his twin daughters, age 17, in his sole proprietorship. The daughters are subject to FICA coverage.

ANS: F
There is an exemption for taxpayer’s children who are under age 18.

PTS: 1 REFER: p. 1-16

42. Unlike FICA, FUTA requires that employers comply with state as well as Federal rules.

ANS: T
This is a major difference between FICA and FUTA.

PTS: 1 REFER: p. 1-16

43. A major disadvantage of a flat tax type of income tax is its complexity.

ANS: F
Just the opposite is the case.

PTS: 1 REFER: p. 1-18

44. The value added tax (VAT) has had wide acceptance in the international community.

ANS: T
Its use in 136 countries seems to represent “wide acceptance.”

PTS: 1 REFER: p. 1-18

45. The amount a taxpayer contributes to charity may increase the chance of being audited by the IRS.

ANS: T
If the taxpayer itemizes and claims a charitable deduction that is unusually large, the chances of being selected for audit increase.

PTS: 1 REFER: p. 1-19
46. In an office audit, the audit by the IRS takes place at the taxpayer’s office.

ANS: F
What is described is a field audit. An office audit takes place at the office of the IRS.

PTS: 1 REF: p. 1-20

47. The IRS agent auditing the return will not issue an RAR if the taxpayer owes no additional taxes.

ANS: F
An RAR can result in no change, a deficiency, or a refund.

PTS: 1 REF: p. 1-20

48. If a “special agent” becomes involved in the audit of a return, this indicates that the IRS suspects that fraud is involved.

ANS: T PTS: 1 REF: p. 1-20

49. If a taxpayer files late (i.e., after the due date of the return), the statute of limitations on assessments begins on the date the return is filed.

ANS: T PTS: 1 REF: p. 1-21

50. For omissions from gross income in excess of 25% of that reported, there is no statute of limitations on additional income tax assessments by the IRS.

ANS: F
Unless fraud is involved, the statute of limitations in this case is six years.

PTS: 1 REF: Example 14

51. If an income tax return is not filed by a taxpayer, there is no statute of limitations on assessments of tax by the IRS.

ANS: T PTS: 1 REF: p. 1-21

52. If fraud is involved, there is no time limit on the assessment of a deficiency by the IRS.

ANS: T PTS: 1 REF: p. 1-21

53. The IRS is required to redetermine the interest rate on underpayments and overpayments once a year.

ANS: F
Interest rates are determined quarterly by the IRS.

PTS: 1 REF: p. 1-22
54. A calendar year taxpayer files his 2007 Federal income tax return on March 3, 2008. The return reflects an overpayment of $5,200, and the taxpayer requests a refund of this amount. The refund is paid on June 18, 2008. The refund must include interest.

ANS: T
Since over 45 days have gone by since the due date of the return (April 15, 2008), interest must be paid on the refund.

PTS: 1 REF: p. 1-22

55. For individual taxpayers, the interest rate for income tax refunds (overpayments) is the same as that applicable to assessments (underpayments).

ANS: T
There exists no difference in the applicable interest rates for individual taxpayers.

PTS: 1 REF: p. 1-22

56. During any month in which both the failure to file penalty and the failure to pay penalty apply, the failure to file penalty is reduced by the amount of the failure to pay penalty.

ANS: T PTS: 1 REF: Example 15

57. When interest is charged on a deficiency, any part of a month counts as a full month.

ANS: F
Interest accrues daily.

PTS: 1 REF: p. 1-22

58. For the negligence penalty to apply, the underpayment must be caused by intentional disregard of rules and regulations without intent to defraud.

ANS: T
In the negligence penalty situation, there is no intent to defraud requirement.

PTS: 1 REF: p. 1-22

59. Upon audit by the IRS, Faith is assessed a deficiency of $40,000 of which $25,000 is attributable to negligence. The 20% negligence penalty will apply to $40,000.

ANS: F
The negligence penalty applies only to $25,000.

PTS: 1 REF: Example 16

60. If the tax deficiency is attributable to fraud, the negligence penalty will not be imposed.

ANS: T PTS: 1 REF: p. 1-23
61. The civil fraud penalty can entail large fines and possible incarceration.

ANS: F
What is described is criminal fraud. Civil fraud involves a monetary penalty of 75% of the deficiency attributable to fraud.

PTS: 1 REF: p. 1-23

62. Even though a client refuses to correct an error on a past return, it may be possible for a practitioner to continue to prepare returns for the client.

ANS: T
However, if the error is material and carries over to the current year, the preparer should consider withdrawing from the engagement.

PTS: 1 REF: p. 1-23

63. When Congress enacts a tax cut that is phased in over a period of years, revenue neutrality is achieved.

ANS: F
No tax cut is revenue neutral unless accompanied by a revenue offset. A phase-in merely postpones some of the revenue loss caused by the tax cut.

PTS: 1 REF: p. 1-24

64. A tax cut enacted by Congress that contains a sunset provision will keep the tax cut from becoming permanent.

ANS: T
The sunset provision will reinstate former law.

PTS: 1 REF: p. 1-24

65. A new provision in the tax law allowing a domestic production activities deduction for certain manufacturing income also will discourage the outsourcing of jobs overseas.

ANS: T PTS: 1 REF: p. 1-26

66. The tax law provides various tax credits, deductions, and exclusions that are designed to encourage taxpayers to obtain additional education. These provisions can be justified on both economic and equity grounds.

ANS: F
The justification is social and economic.

PTS: 1 REF: p. 1-27 | Footnote 27
67. Various tax provisions encourage the creation of certain types of retirement plans. Such provisions can be justified on both economic and social grounds.

ANS: T
The economic justification is attributable to the savings that result. In terms of social justification, private retirement plans supplement the meager benefits provided by Social Security and, thereby, circumvent the need for public assistance.


68. To lessen, or eliminate, the effect of multiple taxation, a taxpayer who is subject to both foreign and U.S. income taxes on the same income is allowed either a deduction or a credit for the foreign tax paid.

ANS: T PTS: 1 REF: p. 1-28

69. Jason’s business warehouse is destroyed by fire. As the insurance proceeds exceed the basis of the property, a gain results. If Jason shortly reinvests the proceeds in a new warehouse, no gain is recognized due to the application of the wherewithal to pay concept.

ANS: T PTS: 1 REF: p. 1-28 | Example 17

70. In 2004, Congress enacted a provision to allow a deduction for state and local sales taxes. Such a provision can be justified on social grounds.

ANS: F
The provision was intended to place states that rely on sales taxes on parity with those that emphasize state income taxes as a source of revenue. Thus, the justification is one of equity.


71. As it is consistent with the wherewithal to pay concept, the tax law requires a seller to recognize gain in the year the installment sale took place.

ANS: F
The seller is taxed in the year the installment payments are received.

PTS: 1 REF: p. 1-29

72. A provision in the law that compels accrual basis taxpayers to pay a tax on prepaid income in the year received and not when earned is consistent with generally accepted accounting principles.

ANS: F
It is inconsistent with accounting rules, although it can be justified under the wherewithal to pay concept.

PTS: 1 REF: p. 1-32

73. On occasion, Congress has to enact legislation that clarifies the tax law in order to change a result reached by the U.S. Supreme Court.

ANS: T PTS: 1 REF: p. 1-33 | Example 23
MULTIPLE CHOICE

1. Which, if any, of the following statements best describes the history of the Federal income tax?
   a. It existed during the Civil War.
   b. The Federal income tax on corporations was held by the U.S. Supreme Court to be contrary to the U.S. Constitution.
   c. The Federal income tax on individuals was held by the U.S. Supreme Court to be allowable under the U.S. Constitution.
   d. Both the Federal income tax on individuals and on corporations was held by the U.S. Supreme Court to be contrary to the U.S. Constitution.
   e. None of the above.

2. Which, if any, is one of Adam Smith’s canons of taxation?
   a. Economy.
   b. Certainty.
   c. Equality.
   d. Convenience.
   e. All of the above.
   ANS: E  PTS: 1  REF: p. 1-4

3. Which, if any, of the following taxes are proportional (rather than progressive)?
   a. Federal corporate income tax.
   b. Federal gift tax.
   c. Federal estate tax.
   d. Federal employment taxes (i.e., FICA, FUTA).
   e. All of the above.
   ANS: D  Federal employment taxes are applied at a constant rate that does not progress.
   PTS: 1  REF: Examples 2 | Example 3

4. Which, if any, of the following transactions will increase a taxing jurisdiction’s revenue from the ad valorem tax imposed on real estate?
   a. A resident dies and leaves his farm to the state’s agricultural college.
   b. A large property owner issues a conservation easement as to some of her land.
   c. A tax holiday issued 10 years ago expires.
   d. A bankrupt motel is acquired by the Salvation Army and is to be used to provide housing for homeless persons.
   e. None of the above.
   ANS: C  Although a farm was probably subject to reduced valuation (due to its agricultural use), it will now be fully exempt since it is owned by a state college (choice a.). Property that is subject to a conservation easement is usually appraised at a lower value (choice b.). The expiration of a tax holiday means that the property involved now can be fully taxed (choice c.). The motel has been converted from business property to exempt charitable use (choice d.).
   PTS: 1  REF: p. 1-6 | p. 1-7
5. Which, if any, of the following is a typical characteristic of an *ad valorem* tax on personality?

   a. Taxpayer compliance is greater for personal use property than for business use property.
   b. The tax on automobiles sometimes considers the age of the vehicle.
   c. Most states impose a tax on intangibles.
   d. The tax on intangibles generates considerable revenue since it is difficult for taxpayers to avoid.
   e. None of the above.

   ANS: B

   Taxpayer compliance is greater with business use property (choice a.). Very few states impose a tax on intangibles (choice c.) because it is easily avoided and does not generate much revenue (choice d.).

   PTS: 1 REF: p. 1-8

6. Federal excise taxes that are *no longer imposed* include:

   a. Tax on the sale of furs.
   b. Tax on wagering.
   c. Tax on the manufacture of tires.
   d. Tax on air travel.
   e. None of the above.


7. Taxes *not imposed* by the Federal government include:

   a. Liquor excise tax.
   b. Customs duties (tariffs on imports).
   c. General sales tax.
   d. Gas guzzler tax.
   e. None of the above.

   ANS: C

   The Federal government imposes an excise tax on liquor (choice a.), customs duties (choice b.), and a gas guzzler tax (choice d.). It does not impose a general sales tax (choice c.).


8. Taxes levied by *all* states include:

   a. General sales tax.
   b. Individual income tax.
   c. Gift tax.
   d. Tobacco excise tax.
   e. None of the above.

   ANS: D

   All states impose a tobacco excise tax (choice d.). Most states impose individual income taxes (choice b.) and general sales taxes (choice a.), and only a few states impose gift taxes (choice c.).

9. A use tax is imposed by:
   a. The Federal government and all states.
   b. The Federal government and a majority of the states.
   c. Most of the states and not the Federal government.
   d. All states and not the Federal government.
   e. None of the above.

   ANS: C
   A use tax is a complement to a general sales tax. Consequently, it is imposed by most states
   because only a few states do not have a general sales tax. At this point, the Federal government
   has no general sales tax.

   PTS: 1
   REF: p. 1-9

10. Spencer and Ashley are married and live in a common law state. Spencer wants to make gifts to
     their four children in 2008. What is the maximum amount of the annual exclusion they will be
     allowed for these gifts?
     a. $48,000.
     b. $96,000.
     c. $1,096,000.
     d. $2,096,000.
     e. None of the above.

     ANS: B
     \[4 \times \$12,000 \times 2 = \$96,000\]. It is
     assumed that Ashley will make the election to split the gifts.

     PTS: 1
     REF: p. 1-12 | Example 9

11. Property can be transferred within the family group by gift or at death. One motivation for
     preferring the gift approach is:
     a. To take advantage of the per donee annual exclusion.
     b. To avoid a future decline in value of the property transferred.
     c. To take advantage of the higher unified transfer tax credit available under the gift tax.
     d. To shift income to higher bracket donees.
     e. None of the above.

     ANS: A
     The per donee annual exclusion is only available for gift tax purposes (choice a.). Ideally, gifts
     should involve property that is expected to appreciate in value (choice b.). A higher unified tax
     credit is available for estate tax purposes (choice c.). Usually the donor is trying to shift future
     income to lower bracket donees (choice d.).
12. Indicate which, if any, statement is incorrect. State income taxes:
   b. Can decouple from the Federal version.
   c. Cannot apply to visiting nonresidents.
   d. Can provide occasional amnesty programs.
   e. None of the above.

   ANS: C
   Many states piggyback to the Federal system (choice a.). Some states, due to revenue shortfalls, have decoupled from various provisions of the Federal version (choice b.). The “jock tax,” although much criticized, is very much in being (choice c.). Some states have had more than one amnesty period (choice d.).


13. State income taxes generally can be characterized by:
   a. Provision for withholding procedures.
   b. A different date for filing than the Federal income tax.
   c. Allowance of a deduction for Federal income taxes paid.
   d. Applying only to individuals and not applying to corporations.
   e. None of the above.


14. A characteristic of FICA is that:
   a. It is imposed only on the employer.
   b. It applies when a one spouse works for the other spouse.
   c. It provides a modest source of income in the event of loss of employment.
   d. It is administered by both state and Federal governments.
   e. None of the above.

   ANS: B
   FICA is imposed on both the employer and the employee (choice a.). Spouses who work for each other are not exempt from the tax (choice b.). Its objective is retirement income, not loss of employment (choice c.). It is administered only by the Federal government (choice d.).

   PTS: 1            REF: p. 1-16

15. A characteristic of FUTA is that:
   a. It is imposed on both employer and employee.
   b. It is imposed solely on the employee.
   c. Compliance requires following guidelines issued by both state and Federal regulatory authorities.
   d. It is applicable to spouses of employees but not to any children under age 18.
   e. None of the above.

   ANS: C
   FUTA is imposed only on the employer (choices a. and b.). Choice d. refers to FICA. Since the administration of FUTA is shared by Federal and state governments, employers must comply with the rules issued by each (choice c.).

   PTS: 1            REF: p. 1-16
16. The proposed flat tax:
   a. Would simplify the income tax.
   b. Would eliminate the income tax.
   c. Would tax the increment in value as goods move through the production and
      manufacturing stages to the marketplace.
   d. Is a tax on consumption.
   e. None of the above.

   ANS: A
   There is only a single rate. The tax base is simplified by taxing only limited types of income.
   Many deductions and credits would be eliminated.

   PTS: 1   REF: p. 1-17 | p. 1-18

17. A VAT (value added tax):
   a. Is not regressive in its effect.
   b. Has proved quite popular outside of the U.S.
   c. Is not a tax on consumption.
   d. Is used exclusively by third world (less developed) countries.
   e. None of the above.

   ANS: B
   Both the VAT and a general sales tax are taxes on consumption (choice c.) and are regressive in
   effect (choice a.). The VAT has been adopted by 136 countries (choice b.), many of which (e.g.,
   Japan, Denmark) are not third world countries (choice d.).

   PTS: 1   REF: p. 1-18

18. Characteristics of the “Fair Tax” (i.e., national sales tax) include which, if any, of the following:
   a. Abolition of the Federal individual (but not the corporate) income tax.
   b. Abolition of all Federal income taxes but retention of payroll taxes (including the self-
      employment tax).
   c. Abolition of all Federal income taxes and payroll taxes but retention of the Federal estate
      and gift taxes.
   d. Abolition of all Federal income and payroll taxes as well as the Federal estate and gift
      taxes.
   e. None of the above.

   ANS: D   PTS: 1   REF: p. 1-18

19. In terms of probability, which of the following taxpayers would be least likely to be audited by
   the IRS?
   a. Taxpayer owns and operates a check-cashing service.
   b. Taxpayer is a self-employed electrician.
   c. Taxpayer just received a $3 million personal injury award as a result of a lawsuit.
   d. Taxpayer just won a $1 million slot machine jackpot at a Las Vegas casino.
   e. Taxpayer is employed as a special agent by the IRS.

   ANS: E
   Employees are subject to income tax withholding and have little opportunity to avoid reporting
   income (choice e.). Casino gambling income is subject to Form 1099 reporting (choice d.).

20. Which of the following is not a characteristic of the audit process?
   a. The IRS can reward informants when the information provided leads to the collection of additional taxes.
   b. Most taxpayer audits do not involve “special” agents.
   c. Self-employed taxpayers are more likely to be selected for audit than employed taxpayers.
   d. Less important issues are handled by means of a correspondence audit.
   e. If a taxpayer disagrees with the IRS auditor’s finding, the only resort is to the courts.

ANS: E

Special agents are assigned to an audit only when fraud might be involved (choice b.). Self-employed persons have more flexibility in manipulating income and deductions than do employed taxpayers (choice c.). The next step after an initial audit would be the Appeals Division within the IRS (choice e.). Settlement at this level could avoid costly litigation.


21. Trent files his tax return 35 days after the due date. Along with the return, Trent remits a check for $8,000 which is the balance of the tax owed. Disregarding the interest element, Trent’s total failure to file and to pay penalties are:
   a. $80.
   b. $720.
   c. $800.
   d. $880.
   e. None of the above.

ANS: C

Following the procedure set forth in Example 15, the penalty is determined as follows:

\[
\begin{align*}
\text{Failure to pay penalty} & \quad \left[1/2\% \times \$8,000 \times 2 \text{ (two months violation)}\right] \quad \$80 \\
\text{Plus:} & \quad \text{Failure to file penalty} \left[5\% \times \$8,000 \times 2 \text{ (two months violation)}\right] \quad \$800 \\
& \quad \text{Less:} \quad \text{Failure to pay penalty} \quad (80) \quad 720 \\
\text{Total penalties} & \quad \$800
\end{align*}
\]

PTS: 1 REF: Example 15

22. A characteristic of the fraud penalties is:
   a. Civil fraud can result in a fine and a prison sentence.
   b. When negligence and civil fraud apply to a deficiency, both penalties are imposed.
   c. The criminal fraud penalty is 75% of the deficiency attributable to the fraud.
   d. The IRS has a greater burden of proof in the case of criminal fraud than with civil fraud.
   e. None of the above.

ANS: D

Choice a. describes criminal fraud, while choice c. describes civil fraud. When both negligence and civil fraud exist as to the same deficiency, both penalties cannot apply and the civil fraud penalty predominates (choice b.). In the case of criminal fraud, the IRS must also show willfulness on the part of the taxpayer (choice d.).

23. Both economic and social considerations can be used to justify:
   a. Various tax credits, deductions, and exclusions that are designed to encourage taxpayers to
      obtain additional education.
   b. Disallowance of any deduction for expenditures deemed to be contrary to public policy
      (e.g., fines, penalties, illegal kickbacks, bribes to government officials).
   c. Favorable tax treatment for accident and health plans provided for employees and financed
      by employers.
   d. Allowance of a deduction for state and local income taxes paid.
   e. None of the above.

   ANS: A  PTS: 1  REF: p. 1-27 | Footnote 27

24. Social considerations can be used to justify:
   a. Allowing a Federal income tax deduction for state and local sales taxes.
   b. Allowing excess capital losses to be carried over to other years.
   c. Allowing accelerated amortization for the cost of installing pollution control facilities.
   d. Allowance of a credit for child care expenses.
   e. None of the above.

   ANS: D
   Equity considerations justify choices a. and b., and economic considerations justify choice c.

   PTS: 1  REF: p. 1-27

25. Allowing a domestic production activities deduction for certain manufacturing income can be
    justified:
    a. As mitigating the effect of the annual accounting period concept.
    b. By economic considerations.
    c. As promoting administrative feasibility.
    d. Based on the wherewithal to pay concept.
    e. None of the above.

   ANS: B
   The deduction will encourage U.S. manufacturing. It also will lead to job growth and discourage
   the outsourcing of labor to overseas.

   PTS: 1  REF: p. 1-26

26. Provisions in the tax law that promote energy conservation and more use of alternative (non-
    fossil) fuels can be justified by:
    a. Political considerations.
    b. Promoting administrative feasibility.
    c. Economic and social considerations.
    d. Encouragement of small business.
    e. None of the above.

   ANS: C
   Although it may be “good politics” to promote measures that ease the problem of global warming
   (choice a.), the real justification is economic (curtail dependence on foreign oil) and social
   (reduce pollution)—choice c. The encouragement of small business (choice d.) is a byproduct of
   these conservation provisions, but is not their justification.

   PTS: 1  REF: p. 1-26
27. Which, if any, of the following provisions of the tax law cannot be justified as promoting administrative feasibility (simplifying the task of the IRS)?
   a. Penalties are imposed for failure to file a return or pay a tax on time.
   b. Prepaid income is taxed in the year received and not in the year earned.
   c. Annual adjustments for indexation increases the amount of the standard deduction allowed.
   d. Casualty losses must exceed $100 per event and 10% of AGI to be deductible.
   e. A deduction is allowed for charitable contributions.

ANS: E
   Choices a. through d. aid the IRS in administering the tax laws. Choice e., particularly when trying to value property contributions, will add to the audit effort required by the IRS.

PTS: 1   REF: p. 1-32 | Footnote 33

28. A landlord leases property upon which the tenant makes improvements. The improvements are significant and are not made in lieu of rent. At the end of the lease, the value of the improvements are not income to the landlord. This rule is an example of:
   a. The wherewithal to pay concept.
   b. The tax benefit rule.
   c. The arm’s length concept.
   d. A clear reflection of income result.
   e. None of the above.

ANS: A   PTS: 1   REF: Example 23

MATCHING

Using the choices provided below, show the justification for each provision of the tax law listed.
   Note: In some cases, more than one answer is appropriate.
   a. Economic considerations
   b. Social considerations
   c. Equity considerations

1. A tax credit for amounts spent to furnish care for children while the parent is at work.
2. Additional depreciation deduction allowed for the year the asset is acquired.
3. Tax brackets are increased for inflation.
4. A small business corporation can elect to avoid the corporate income tax.
5. A deduction for contributions by an employee to certain retirement plans.
6. A deduction for qualified tuition paid to obtain higher education.
7. A deduction for certain expenses (interest and taxes) incident to home ownership.
8. A Federal deduction for state and local income taxes paid.
9. A deduction for certain income from manufacturing activities.
10. A bribe to the local sheriff, although business related, is not deductible.
11. Contributions to charitable organizations are deductible.
13. Tax credits available for the purchase of a vehicle that uses alternative (non-fossil) fuels.
14. Tax credits for home improvements that conserve energy.
15. More rapid expensing for tax purposes of the costs of installing pollution control devices
Match the statements that relate to each other. Note: Choice k may be used more than once.

a. Carryback and carryforward of net operating losses.
b. Deferral of gains from involuntary conversions
c. “No change” is one possible result
d. State income tax applied to visiting nonresident
e. IRS special agent
f. Undoing the “piggyback” result
g. Criteria in the selection of tax returns for audit
h. Ideal budget goal as to new tax legislation
i. Imposed by all states and the Federal government
j. Every state that has a general sales tax has one
k. No correct match provided

16. Jock tax
17. Decoupling
18. DIF
19. Tax fraud suspected
20. Revenue neutrality
21. RAR
22. Wherewithal to pay concept
23. Mitigation of the annual accounting period concept
24. Death tax (either inheritance or estate)
25. Excise tax on liquor
26. Use tax
27. Income tax amnesty
22. ANS: B  PTS: 1  REF: p. 1-28
23. ANS: A  PTS: 1  REF: p. 1-29
24. ANS: K  PTS: 1  REF: p. 1-10
25. ANS: I  PTS: 1  REF: p. 1-9
27. ANS: K  PTS: 1  REF: p. 1-15

Match the statements that relate to each other. Note: Some choices may be used more than once.

a. 3 years from due date of return
b. 3 years from date return is filed
c. 20% of underpayment
d. 5% per month (25% limit)
e. 0.5% per month (25% limit)
f. Conducted at IRS office
g. Conducted at taxpayer’s office
h. 6 years
i. 45-day grace period allowed to IRS
j. No statute of limitations (period remains open).
k. No correct match provided

28. Office audit
29. Field audit
30. Failure to file penalty
31. Failure to pay penalty
32. Negligence penalty
33. Civil fraud penalty
34. Fraud and statute of limitations
35. Early filing and statute of limitations (deficiency situations)
36. Late filing and statute limitations (deficiency situations)
37. No return and statute limitations
38. More than 25% gross income omission and statute of limitations
39. Interest due on refund

29. ANS: G  PTS: 1  REF: p. 1-20
30. ANS: D  PTS: 1  REF: Example 15
31. ANS: E  PTS: 1  REF: Example 15
32. ANS: C  PTS: 1  REF: Example 16
33. ANS: K  PTS: 1  REF: p. 1-22

NOTE: The penalty is 75% of the deficiency attributable to fraud.

34. ANS: J  PTS: 1  REF: p. 1-21
35. ANS: A  PTS: 1  REF: p. 1-21
36. ANS: B  PTS: 1  REF: p. 1-21
37. ANS: J  PTS: 1  REF: p. 1-21
38. ANS: H  PTS: 1  REF: Example 14
39. ANS: I  PTS: 1  REF: p. 1-21
PROBLEM

1. Peggy, a widow, makes cash gifts to her four married children (including their spouses) and to her eight grandchildren.

   a. What is the maximum amount Peggy can give for calendar year 2008 without using her unified transfer tax credit?

   b. What is the maximum amount Peggy can give for calendar year 2008 also using her unified transfer tax credit? [Note: Peggy has never made any prior taxable gifts.]

   ANS:
   a. $192,000. $12,000 (annual exclusion) × 16 donees = $192,000.

   b. $1,192,000. $12,000 (annual exclusion) × 16 donees = $192,000 + $1,000,000 (the exemption equivalent of a $345,800 credit) = $1,192,000.

   PTS: 1 REF: p. 1-12 | Example 9

2. For the tax year 2008, Kristen reported gross income of $1 million on her timely filed Federal income tax return.

   a. Presuming the general rule applies, when does the statute of limitations on assessments normally expire?

   b. Suppose Kristen inadvertently omitted gross income of $240,000. When does the statute of limitations on assessments expire?

   c. Suppose the omission was deliberate and not inadvertent. When does the statute of limitations on assessments expire?

   ANS:
   a. Three years from April 15, 2009.

   b. If more than 25% of gross income is omitted, a six-year statute applies (i.e., 6 years from April 15, 2009). Here, it does not as $240,000 is not more than $250,000 (25% × $1 million).

   c. If fraud is involved, the statute never expires.

   PTS: 1 REF: p. 1-21 | Example 14
3. Without obtaining an extension, Kelly files her income tax return 80 days after the due date. With her return, she pays an additional tax of $40,000. Disregarding any interest element, what is Kelly’s penalty for failure to pay and to file?

ANS: $6,000. Disregarding the interest element, Kelly’s total penalties are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Failure to pay penalty (0.5% × $40,000 × 3 months)</td>
<td>$600</td>
</tr>
<tr>
<td>Plus: Failure to file penalty (5% × $40,000 × 3 months)</td>
<td>$6,000</td>
</tr>
<tr>
<td>Less failure to pay penalty for same period</td>
<td>(600)</td>
</tr>
<tr>
<td>Total penalties</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

PTS: 1 REF: Example 15

4. On her 2007 income tax return, Valerie omitted income and overstated deductions to the extent that her income tax was understated by $300,000. Disregarding any interest element, what is Valerie’s penalty if the understatement was due to:

a. Negligence.

b. Civil fraud.

c. Criminal fraud.

ANS:

a. $60,000 (20% × $300,000).

b. $225,000 (75% × $300,000).

c. Various fines and/or prison sentence.

PTS: 1 REF: p. 1-22

5. Several years ago, Gordon purchased extra grazing land for his ranch at a cost of $80,000. In 2008, the land is condemned by the state for development as a highway maintenance depot. Under the condemnation award, Gordon receives $200,000 for the land. Within the same year, he replaces the property with other grazing land. What is Gordon’s tax situation if the replacement land cost:

a. $70,000?

b. $120,000?

c. $210,000?

d. Why?
ANS:
a. The full realized gain of $120,000 \([200,000 \text{ (condemnation proceeds)} – 80,000 \text{ (cost of land)}]\) must be recognized, as only $70,000 was reinvested. The condemnation proceeds of $200,000 exceed the amount reinvested by more than $120,000.

b. As only $120,000 was reinvested in replacement property, $80,000 \((200,000 – 120,000)\) of the gain must be recognized.

c. As the full $200,000 was reinvested, no realized gain need be recognized.

d. If some of the gain is not reinvested, consistent with the wherewithal to pay concept there exists the ability to pay the tax.

PTS: 1 
REF: p. 1-28 | Example 17 | Example 18

6. Amy is the sole shareholder of Garnet Corporation. During the year, Amy leases a building to Garnet for a monthly rental of $40,000. If the fair rental value of the building is $30,000, what are the income tax consequences to the parties involved?

ANS:
The rent charged by Amy is not “arms length”; as such, Garnet Corporation’s rent deduction is $30,000 (not $40,000). The $10,000 difference is a nondeductible dividend distribution. For Amy, the change merely requires reclassification. Instead of $40,000 of rent income, she has $30,000 of rent income and $10,000 of dividend income.

PTS: 1 
REF: p. 1-33 | Example 22

7. In 1980, Jonathan leased real estate to Jay Corporation for 20 years. Jay Corporation made significant capital improvements to the property. In 2000, Jay decides not to renew the lease and vacates the property. At that time, the value of the improvements is $900,000. Jonathan sells the real estate in 2008 for $1,300,000 of which $1,000,000 is attributable to the improvements. How and when is Jonathan taxed on the improvements made by Jay Corporation?

ANS:
Jonathan is not subject to taxation on the improvements until he disposes of the property (i.e., 2008). After a controversial Supreme Court decision years ago, Congress clarified the tax law to make it more consistent with the wherewithal to pay concept.

PTS: 1 
REF: p. 1-33 | Example 23
ESSAY

1. Timothy recently converted a warehouse into apartment lofts, which he is renting to single professionals. In making the conversion, he emphasized improvements that were portable in nature. Thus, the sprinkler system, heating and cooling units, and room dividers are all removable from the building. In terms of *ad valorem* property taxes, what was Timothy trying to accomplish?

ANS:
When personalty is permanently attached to real estate so that its removal will cause irreparable damage, it becomes a fixture. Consequently, it ceases to be personalty and is now regarded as realty. The classification of an asset is important because different *ad valorem* taxes apply to realty than to personalty. For one thing, the *ad valorem* tax on realty is less easily avoided. Also to be considered is the possibility that the *ad valorem* tax on personalty (even if it cannot be avoided) could be lower than that applicable to realty.

PTS: 1  REF: p. 1-6

2. Due to the population change, the Goose Creek School District has decided to close one of its high schools. Since it has no further need of the property, the school is listed for sale. The two bids it receives are as follows:

   United Methodist Church $1,700,000
   Planet GMC Motors 1,600,000

The United Methodist Church would use the property to establish a sectarian middle school. Planet, a well-known car dealership, would revamp the property and operate it as a branch location.

If you were a member of the School District board, what factors would you consider in evaluating the two bids?

ANS:
Although the bid from the United Methodist Church is higher, several other factors need to be considered. Does, for example, Goose Creek School district exempt property owned by churches from its *ad valorem* taxes? If so, losing this property from the tax base could prove very costly over the long run. Also, it is probable that income-producing property (such as a car dealership) would be taxed at a higher rate than that owned by a nonprofit organization (a school operated by a church). This assumes, of course, that the school would not be taxed at all. The auto dealership also would generate sales tax.

PTS: 1  REF: p. 1-6 | p. 1-7
3. Morgan inherits her father’s personal residence including all of the furnishings. She plans to add a swimming pool and sauna to the property and rent it as a furnished house. What are some of the *ad valorem* property tax problems Morgan can anticipate?

ANS:
The real estate taxes probably will increase for several reasons. The capital improvements and the conversion from residential to rental will trigger the increase. Furthermore, the furnishings may generate an *ad valorem* tax on personalty. (Depending on applicable law, furniture might not be subject to tax unless used for business purposes—such as in this case.)

PTS: 1  REF: p. 1-7 | p. 1-8

4. A large municipality is considering the enactment of an *ad valorem* tax on personal jewelry. What, if any, problem would you anticipate with such a tax?

ANS:
The compliance problem can be expected to be monumental. This is invariably the case with *ad valorem* taxes imposed on personal use personalty. Unfortunately, the taxing authority will have an almost impossible task ascertaining who owns jewelry and what it is worth.

PTS: 1  REF: p. 1-8

5. A lack of compliance in the payment of use taxes can be eased by several means. In this regard, comment on the following:

a. Registration of automobiles.

b. Reporting of Internet purchases on state income tax returns.

ANS:
a. As reflected in Example 4 in the text, re-registration of a car purchased out-of-state is the occasion for the owner’s home state to collect the use tax.

b. Completing the state income tax return reminds (or forces) the taxpayer to pay use tax on out-of-state-purchases.

PTS: 1  REF: Tax in the News on p. 1-15

6. What are the pros and cons of the following state and local tax provisions?

a. An *ad valorem* property tax holiday made available to a manufacturing plant that is relocating.

b. Hotel occupancy tax and a rental car surcharge.

c. A back-to-school sales tax holiday.
ANS:
a. Such a holiday is designed to attract new industry to the area. This means more jobs and
growth in consumption. On the other hand, if the tax holiday is too generous, this places a
strain on available public revenue. The result could be that schools and capital maintenance
(roads, public services) will suffer.

b. The hotel occupancy tax and car rental surcharges are popular because they mainly impact
visitors. Also, they can generate considerable revenue to finance major capital
improvements. If these taxes become excessive, however, they could discourage major
events (such as conventions).

c. Such holidays are very popular with both merchants and consumers and serve the social
need of defraying some of the costs of sending children to school. Once established,
however, they are virtually impossible to get rid of. Thus, they become an annual drain on
sales tax revenue.


7. The Tax Relief Reconciliation Act of 2001 made certain changes in the estate and gift taxes.

a. What were these changes?

b. Why were they made?

ANS:
a. The Federal estate tax is to be phased out by 2010. The gift tax is retained.

b. The Federal estate tax was causing the break-up of many family businesses and farms. This
does not happen with the gift tax as gifts are voluntary and within the control of the donor.


8. In spite of legislative changes which phase out the estate tax, considerable motivation continues
to exist for making lifetime gifts. Explain this motivation in the light of the following:

a. Availability of the per donee annual exclusion.

b. Income tax considerations.

c. Future estate tax considerations.

ANS:
a. For gift tax purposes, the per donee annual exclusion is a “free ride.” By using multiple
donees (see Example 9 in the text) and making the election to split the gifts (p. 1-12), a
considerable amount of property can be given that is not subject to any gift tax. Also, the per
donee annual exclusion is not available for estate tax purposes.

b. Presuming the donees are in lower tax brackets than the donor, gifts of income-producing
assets can save income taxes for the family unit.

c. The gift of property that is expected to increase in value will keep such future appreciation
from being subject to the estate tax upon the later death of the donor.

PTS: 1  REF:  p. 1-13
9. State and local governments are sometimes forced to find ways to cover revenue shortfalls. Comment on the pros and cons of the following procedures:

a. Decouple what would be part of the piggyback format of the state income tax.

b. Taxing nonresidents on income earned within the state.

c. Tax amnesty provisions.

ANS:

a. The decoupling process is easily accomplished as to new Federal tax changes that have never taken effect at the state level. Taxpayers are not apt to miss what they never have enjoyed.

b. Referred to as the “jock tax,” the state and local income tax is imposed on visiting athletes and entertainers. This approach is somewhat unfair since it targets only those with high incomes. Other itinerants with modest earnings are generally not affected.

c. Tax amnesty provisions generate considerable revenue. It also unmasks many taxpayers who have not previously paid taxes. Now that the taxing jurisdiction is aware of their existence, they will tend to pay taxes in the future.


10. How does Alaska avoid the need of having either a state general sales tax or a state income tax?

ANS:

Alaska derives enough revenue from its severance taxes on oil and gas production to avoid the need for either of these taxes.

PTS: 1 REF: p. 1-10

11. Two months after the burglary of his personal residence, Eric is audited by the IRS. Among the items taken in the burglary was a shoe box containing approximately $50,000 in cash. Eric is the owner and operator of a cash-and-carry liquor store. Eric wonders why he was audited. Can you help explain?

ANS:

Although Eric’s audit by the IRS could be the result of sheer chance, this appears unlikely. Press coverage of the burglary, particularly if the items stolen were enumerated, could have put the IRS on notice. Why would anyone keep such a large amount of cash at his personal residence? Also, Eric is in a business where tax evasion is easily accomplished.

PTS: 1 REF: p. 1-19 | Example 10 | Example 12
12. Tom, a calendar year taxpayer, filed his 2003 Federal income tax return on April 1, 2004. In 2008, the IRS audits this return and assesses an income tax deficiency against Tom. On the grounds that the statute of limitations has run, Tom disputes the assessment. Is Tom correct? Why?

ANS:
Tom is correct as to the usual three-year statute of limitations. This would have expired on April 17, 2007, which is three years from the due date of the return. Tom is not correct if the six-year statute applies. The six-year statute applies if there has been a more-than-25% omission from gross income. Lastly, there is no statute of limitations if Tom has acted fraudulently.

PTS: 1 REF: p. 1-21 | Example 14

13. Compare civil fraud with criminal fraud with regard to the following:

a. Penalties imposed.

b. Degree of proof.

ANS:

a. Civil fraud results in a penalty of 75% of the deficiency attributable to fraud. Criminal fraud involves various fines and a possible prison sentence.

b. In both cases, the burden of proof is on the IRS. In the case of criminal fraud, the IRS must show a degree of willfulness on the part of the taxpayer.


14. Melinda has been referred to you by one of your clients. In the past, she has prepared her own income tax returns, but she has become overwhelmed by the increased complexity of the tax law. Consequently, Melinda wants you to prepare her return for calendar year 2008. In reviewing her 2007 return, you note that she has claimed as a deduction the entire cost of a business building that should have been capitalized and depreciated. What course of action should you follow?

ANS:
You should recommend to Melinda that an amended return be filed for 2007 correcting the error. If she refuses, you should assess the gravity of the error and how it impacts on your ability to file an accurate return for 2008. If you cannot do so, then you must decline the engagement.

PTS: 1 REF: p. 1-23

15. In terms of revenue neutrality, comment on the following:

a. A tax cut enacted by Congress that also contains revenue offsets.

b. A tax cut enacted by Congress that is phased in over a period of years.

c. A tax cut enacted by Congress that contains a sunset provision.
ANS:
a. Ideally, to achieve revenue neutrality all tax cuts should be accompanied by revenue offsets.

b. The phase-in approach to a tax cut was taken by Congress in the Tax Relief Reconciliation Act of 2001 (e.g., the phase-in of the repeal of the Federal estate tax) and reduces the short-run revenue loss.

c. A sunset provision does not account for the immediate revenue losses generated by a tax cut. It merely provides that such losses will not continue beyond a specified date when the tax cut expires and the former tax law is reinstated.


16. In 2005, Congress enacted a provision that allows a domestic production activities deduction. What is the justification for this provision?

ANS:
The justification for the domestic production activities deduction is economic. It is intended to encourage the domestic manufacturing industry. Hopefully, it will also have the effect of generating new jobs and discourage the outsourcing of labor to outside the U.S.

PTS: 1 REF: p. 1-26

17. The tax law contains various provisions that encourage home ownership.

a. On what basis can this objective be justified?

b. Are there any negative considerations? Explain.

ANS:
a. Home ownership can be justified on economic and social grounds.

b. Granting tax advantages to persons who are purchasing their homes places the taxpayers who rent at a disadvantage. The result is inequality in treatment.

PTS: 1 REF: p. 1-27

18. The tax law allows an income tax deduction for state and local income taxes or state and local sales taxes paid. Explain the justification for each.

ANS:
The deduction for state and local income taxes can be justified on the grounds that it mitigates the double tax imposed on the same income. The deduction for sales taxes paid cannot be similarly justified. Here, the rationale was to place those states that rely on a general sales tax on a parity with those that emphasize an income tax. Thus, if a resident of Montana (which imposes an income tax but no sales tax) can deduct the state income tax, should not a resident of Wyoming (which imposes a general sales tax but no income tax) be able to deduct the sales tax?

19. The tax law allows, under certain conditions, deferral of gain recognition for involuntary conversions.

   a. What is the justification for this relief measure?

   b. What happens if the proceeds are not entirely reinvested?

ANS:
   a. By recognizing that the taxpayer’s relative economic situation has not changed and that he or she lacks the wherewithal to pay a tax, any recognition of realized gain is deferred.

   b. If the proceeds from an involuntary conversion are not fully reinvested in property that is similar or related in service or use, recognized gain results. Such recognized gain cannot exceed realized gain and will be limited to the amount of the proceeds not reinvested. Recognition is based on the notion that the taxpayer now has the wherewithal to pay the tax that results.

PTS: 1   REF: p. 1-28 | Example 17 | Example 18

20. In connection with facilitating the function of the IRS in the administration of the tax laws, comment on the utility of the following:

   a. An increase in the amount of the standard deduction.

   b. Dollar and percentage limitations on the deduction of personal casualty losses.

   c. Power to make adjustments to properly reflect a taxpayer’s income.

   d. Availability of interest and penalties for taxpayer noncompliance.

   e. Arm’s length standard.

ANS:
   a. An increase in the amount of the standard deduction reduces the number of taxpayers who choose to itemize their personal deductions. This, in turn, cuts down on the deductions the IRS has to check.

   b. Limitations placed on casualty and theft losses curtail the number of taxpayers who can claim the deduction.

   c. This power is particularly useful to prevent taxpayers from manipulating accounting procedures. Such was the case in Example 21 (page 1-31 of the text).

   d. The imposition of extra penalties, in addition to the tax owed, definitely deters taxpayer noncompliance.

   e. If the parties are related, taxpayer manipulation is facilitated. The arm’s length standard furnishes the IRS with a means of combating such manipulation.

21. Congress reacts to judicial decisions that interpret the tax law in different ways. When it approves of a decision, Congress may act to amend the Code to incorporate the holding. When it disapproves, Congress may amend the Code to nullify its effect. Give an example of each one of these congressional reactions.

ANS:
Congress approved of the judicial conclusion that most stock dividends should be nontaxable and amended the Code to this effect. However, it disagreed as to when leasehold improvements should be taxed to a lessor. Consistent with the wherewithal to pay concept, the improvements are to be taxed on the termination of the lease. Thus, Congress overturned a judicial holding that would have taxed such improvements in the year they are made by the lessee.

PTS: 1       REF: p. 1-33 | Example 23