South-Western Federal Taxation 2017 Essentials of Taxation Individuals and Business Entities 20th edition Raabe Solutions Manual

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South-Western Federal Taxation 2017 Essentials of Taxation Individuals and Business Entities 20th edition Raabe Solutions M

CHAPTER 1

INTRODUCTION TO TAXATION

SOLUTIONS TO PROBLEM MATERIALS

PROBLEMS

1. (LO 1, 2, 5) Some tax and nontax considerations James should investigate include the following:

   - State and local income taxes.
   - State and local sales taxes.
   - State and local property taxes.
   - Employee implications of the move (Will James lose current employees? Is the labor market better in the new location? Is cost of living lower or higher in new location?)
   - Logistics/transportation of products to customers (specifically document lower costs)
   - State infrastructure (better in new location?)

2. (LO 1) A tax is *proportional* if the rate of tax remains constant for any given income level. The tax is *progressive* if a higher rate of tax applies as the tax base increases.

3. (LO 2)
   a. 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.

   b. Ethan should notify the authorities of his purchase. This will force him to pay back taxes but will eliminate *future* interest and penalties.

4. (LO 1, 6) As to Adam Smith's canon on *economy*, the Federal income tax yields a mixed result. From the standpoint of the IRS, economy exists as collection costs are nominal (when compared with revenue generated). The government's cost of collecting Federal taxes amounts to less than one-half of 1 percent of the revenue collected. Economy is not present, however, if one looks to the compliance effort and costs expended by taxpayers. According to recent estimates, about 56% of individual taxpayers who file a return pay a preparer, and one-third purchase tax software.

5. (LO 2) Jim probably will be required to pay the Washington use tax if, and when, he applies for Washington license plates. In this case, the use tax probably is the same amount as the Washington sales tax. See the discussion in connection with Example 4 in textbook.

6. (LO 2) 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.

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7. (LO 2) An *excise tax* is limited to a particular transaction (e.g., sale of gasoline), while a general *sales tax* covers a multitude of transactions (e.g., sale of all nonfood goods).

   a. The following states *do not* impose a general sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon.

   b. There is no Federal general sales tax.

8. (LO 2) A possible explanation could be that Sophia made capital improvements (e.g., added a swimming pool) to her residence and her parents became retirees (e.g., reached age 65).

9. (LO 4, 5)

Raabe, Maloney, Young, & Nellen, CPAs
5191 Natorp Boulevard
Mason, OH 45040

February 25, 2016

Cynthia Clay
1206 Seventh Avenue
Fort Worth, TX 76101

Dear Cynthia:

I am writing this letter to help you decide on what form of entity to choose for your new burrito delivery business. In our phone conversation, you indicated that you expect to have losses for the first two years in this business and then make substantial profits in subsequent years. You and Marco also indicated that you are concerned about potential personal liability.

While I can't make a conclusive recommendation based on the information you have given me, I can provide you with some general guidelines that should simplify your decision. First, given your concern about personal liability, a partnership does not appear to be a desirable option (you would both be personally liable for any injuries to customers). Similarly, given your expectation of losses in the first two years, it does not appear that a C corporation would be a desirable choice, at least initially. This is because any losses in the corporation could only be used to offset future corporate profits—you could not use the losses to immediately offset your personal tax liability.

Thus, two choices exist which provide limited liability and deductibility of losses on your personal income tax return. These are the S corporation and the limited liability company. If you choose an S corporation, we would probably convert the entity to a C corporation when the business becomes profitable. At that point, profits would be taxed at the C corporation rates. A second tax would be levied on your personal income tax return for any dividends paid by the corporation once it achieves C status. In contrast, limited liability companies are taxed like partnerships—all income would be taxed on your personal income tax return in profitable years. The relative desirability of each of these two forms depends on a number of factors. One of the most important factors in your situation is the relationship between your personal tax rate and the tax rate of a C corporation. If you are in a high tax bracket and if the income in the business is sufficiently low, you might be best off choosing the S corporation. Alternatively, if you expect the business to generate a sufficiently large profit each year, it might be best to choose the limited liability company.

If you would like me to give you a clearer recommendation, we should meet at your earliest convenience. If you have any additional questions, please call me.

Best regards,

Julian Jackson, CPA

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10. (LO 4, 5)

a.

	2015	2016	2017
Corporate Tax Liability			
Sales Revenue	$150,000	$320,000	$600,000
Cash Expenses	(30,000)	(58,000)	(95,000)
Depreciation	(25,000)	(20,000)	(40,000)
Taxable Income	$ 95,000	$242,000	$465,000
Corporate Tax Liability	$ 20,550	$ 77,630	$158,100
Cash Available for Dividends			
Sales Revenue	$150,000	$320,000	$600,000
Tax-Free Interest Income	5,000	8,000	15,000
Cash Expenses	(30,000)	(58,000)	(95,000)
Corporate Tax Liability	(20,550)	(77,630)	(158,100)
Cash Available for Dividends	$104,450	$192,370	$361,900
Ashley's After-Tax Cash Flow			
Dividend Received	$104,450	$192,370	$361,900
Tax on Dividend at 15% rounded	(15,668)	(28,856)	(54,285)
After-Tax Cash Flow	$ 88,782	$163,514	$307,615
PV of Cash Flow*	$ 79,273	$130,353	$218,960
Present Value	$428,586		

*Present value factors (.8929, .7972, .7118) from Appendix F.

b.

	2015	2016	2017
Individual Tax Liability			
Sales Revenue	$150,000	$320,000	$600,000
Cash Expenses	(30,000)	(58,000)	(95,000)
Depreciation	(25,000)	(20,000)	(40,000)
Taxable Income	$ 95,000	$242,000	$465,000
Individual Tax Liability**	$ 33,250	$ 84,700	$162,750

**Rate = 35%

Ashley's After-Tax Cash Flow			
Sales Revenue	$150,000	$320,000	$600,000
Tax-Free Interest Income	5,000	8,000	15,000
Cash Expenses	(30,000)	(58,000)	(95,000)
Individual Tax Liability	(33,250)	(84,700)	(162,750)
After-Tax Cash Flow	$ 91,750	$185,300	$357,250
PV of Cash Flow*	$ 81,924	$147,721	$254,291
Present Value	$483,936		

*Present value factors (.8929, .7972, .7118) from Appendix F.

c. If Ashley wants to have access to all available cash from the business, then she will have to pay out dividends annually. As seen in the answers to parts a. and b. above, the present value of future cash flows is substantially greater if she does not incorporate under this assumption. Alternatively, if she does not need to pay out dividends, then she may be better off by

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incorporating, since only the corporate tax will be incurred [$256,280 ($20,550 + $77,630 + $158,100)], which is less than her individual tax [$280,700 ($33,250 + $84,700 + $162,750)]. The value of her stock will increase and she can then sell the stock at a later date at favorable capital gains rates.

11. (LO 3, 5) Using the corporate tax rate schedule inside the cover of the textbook, Mauve's tax liability (on $105,000) is $24,200. Since Mauve would pay $0.39 on the next dollar of taxable income earned, its marginal tax rate is 39%. Its average tax rate is the ratio of tax liability to taxable income or approximately 23% ($24,200/$105,000). Its effective tax rate is the ratio of tax liability to total income or approximately 20% ($24,200/$120,000).

12. (LO 2)
    a. In terms of taxpayer compliance, an ad valorem tax on personalty is less desirable than one on realty. However, a tax on business personalty, such as inventory, is to be preferred over one on personal use (i.e., nonbusiness) personalty.

    b. A tax on stock and bonds would be too easily avoided. The taxing authority would have no means of ascertaining ownership of these assets.

    c. Poor taxpayer compliance is to be expected for any tax on personal use personalty. However, if boats had to be periodically licensed (e.g., safety inspection), this could provide the taxing authority with a means of discovering unreported boat ownership.

13. (LO 6)
    a. Economic justification. The tax law addresses the energy crisis—in terms of both reliance on foreign oil and the need to ease the problem of climate change.

    b. Economic justification. See the comments under part a. above.

    c. Equity considerations. To alleviate the effect of multiple taxation of the same income.

    d. Administrative feasibility (Influence of the Internal Revenue Service). The limitation reduces the number of casualty and theft losses that can be claimed and thereby eases the audit burden on the IRS.

    e. Economic justification. Research and development activities are encouraged by allowing immediate or faster write-off of these expenditures.

    f. Economic justification. The justification for the domestic production activities deduction is to stimulate the U.S. manufacturing industry. By providing a limitation on the source of the wages involved, it also encourages job growth.

    g. Social justification. The charitable deduction helps fund private organizations and causes that are operated in the interest of the general welfare. This relieves government of the need for considerable public funding.

    h. Economic justification. Known as the S election, the provision encourages small businesses to operate in the corporate form without suffering all of the tax disadvantages of the Regular (C) Corporation.

14. (LO 6)
    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.

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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. Social considerations dictate that the tax law should not be used to encourage certain activities that are deemed to be contrary to public policy.

e. The NOL carryback provision is an equity consideration that is 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.

15. (LO 2) A value added tax (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.

A national sales tax taxes numerous transactions and is collected on the final sale of goods and services to the consumer. Consequently, it is collected from the consumer and not the producer of the product as does a VAT.

In terms of taxpayer compliance, a VAT is preferable to a national sales tax. Without significant collection efforts, a national sales tax could easily be circumvented or avoided in many ways (e.g., resorting to a barter system of doing business, etc.).

16. (LO 2) The Internet Activity research problems require that the student access various sites on the Internet. Thus, each student's solution likely will vary from that of the others. You should determine the skill and experience levels of the students before making the assignment, coaching them where necessary so as to broaden the scope of the exercise to the entire available electronic world.

Make certain that you encourage students to explore all parts of the World Wide Web in this process, including the key tax sites, but also information found through the websites of newspapers, magazines, businesses, tax professionals, government agencies, political outlets, and so on. They should work with Internet resources other than the Web as well, including newsgroups and other interest-oriented lists.

Build interaction into the exercise wherever possible, asking the student to send and receive e-mail in a professional and responsible manner.

17. (LO 5) See the Internet Activity comment above.

18. (LO 5) See the Internet Activity comment above.

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BRIDGE DISCIPLINE PROBLEMS

1. Answer will vary with each student.

2. Answer will vary with each student.

3. Answer will vary with each student.

4. When taxes become "too high," taxpayers increase the rates of tax cheating, because the payoff from misconduct increases. Property and transaction taxes are difficult to cheat on, as the tax base is easily detectible, while cheating on taxes on income and asset transfers may be more easily accomplished, and enforcement activities by the taxing agency become more expensive. High rates of tax cheating can lead to several undesirable consequences.

   - A "conspicuous consumption" society, wherein taxpayers use their tax underpayments to increase their lifestyles in a public fashion.

   - A loss of confidence in the self-assessment system, such that certain levels of cheating are assumed to occur, and the number of cheaters increases.

   - The "missing revenue" keeps the government from delivering the goods and services that the taxes are supposed to pay for.

   - Political gridlock can occur when it becomes impossible to raise tax rates high enough, or broaden the tax base enough, to offset the cheaters' "missing revenue."

5. 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. Thus, 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.

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CHAPTER 2

WORKING WITH THE TAX LAW

SOLUTIONS TO PROBLEM MATERIALS

PROBLEMS

1. (LO 1) See Exhibit 2.4.

   a. The Tax Court must follow its own cases, the pertinent U.S. Circuit Court of Appeals, and the Supreme Court.

   b. The Court of Federal Claims must follow its own decisions, the Federal Circuit Court of Appeals, and the Supreme Court.

   c. The District Court must follow its own decisions, the pertinent U.S. Circuit Court of Appeals, and the Supreme Court.

2. (LO 1, 3)

   Raabe, Maloney, Young, & Nellen, CPAs
   5191 Natorp Boulevard
   Mason, OH 45040

   March 25, 2016

   Mr. Butch Bishop
   Tile, Inc.
   100 International Drive
   Tampa, Florida 33620

   Dear Mr. 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. The major reason for treaties between the United States and certain foreign countries is to eliminate double taxation and to render mutual assistance in tax enforcement.

   Section 7852(d) provides that if a U.S. treaty is in conflict with a provision in the Code, neither will take general precedence. Rather, the more recent of the two will have precedence. In your case, the Spanish treaty takes precedence over the Code 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 for corporations.

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

   Sincerely,

   Alice Hanks, CPA
   Tax Partner

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3. (LO 1)

a. Treasury Regulations are issued by the U.S. Treasury Department, while Revenue Rulings are issued by the National Office of the IRS. Both Regulations and Revenue Rulings are designed to provide an interpretation of the tax law. However, Rulings do not have the same legal force and effect as do Regulations. Usually, Rulings deal with more restricted problems. Rulings "are published to provide precedents to be used in the disposition of other cases and may be cited and relied upon for that purpose." See Rev.Proc. 86–15, 1986–1 CB 544.

b. Revenue Procedures are issued in the same manner as are Revenue Rulings, but Procedures deal with the internal management practices and requirements of the IRS. Familiarity with these Procedures can increase taxpayer compliance and assist the efficient administration of the tax law by the IRS.

c. Letter rulings are issued upon a request. They describe how the IRS will treat a proposed transaction. Unlike Revenue Rulings, letter rulings apply only to the taxpayer who applies for and obtains the ruling, and generally, "may not be used or cited as precedent" [§ 6110(k)(3)]. Letter rulings, used to be "private" (i.e., the content of the ruling was made available only to the taxpayer that requested the ruling). However, Federal legislation and the courts have forced the IRS to modify its position on the confidentiality of letter rulings. Such rulings now are published by a number of commercial tax services.

d. Like letter rulings, determination letters are issued at the request of taxpayers. They provide guidance concerning the application of the tax law. They differ from letter rulings in that the issuing source is the taxpayer's own District Director rather than the National Office of the IRS. In addition, determination letters usually involve completed (as opposed to proposed) transactions. Determination letters are not published, but are made known only to the party making the request.

4. (LO 1, 2) 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.

5. (LO 1)

a. This is 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.

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6. (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.

7. (LO 1, 3)

   Raabe, Maloney, Young, & Nellen, CPAs
   5191 Natorp Boulevard
   Mason, OH 45040

   July 8, 2016

   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. Some people believe that the 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,

   Agnes Reynolds, CPA
   Tax Partner

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8. (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.

9. (LO 1) See Concept Summary 2.1.

		U.S. Tax Court	U.S. District Court	U.S. Court of Federal Claims
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

10. (LO 1) See Exhibit 2.5.

   a. Tenth

   b. Eighth

   c. Ninth

   d. Fifth

   e. Seventh

11. (LO 1) The term *petitioner* is a synonym for plaintiff, which refers to the party requesting action in a court.

12. (LO 1, 2)

   a. 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.

   b. 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.

   c. The decision of a U.S. Circuit Court of Appeals will carry more weight than will one that was rendered by a trial court. Because the taxpayer lives in California, however, any appeal from

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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.

d. 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. There also exists the rare possibility that the Court may have changed its position in a later decision. See Exhibit 2.4.

e. 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 that was 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.

13. (LO 1) The differences between a Regular decision, a Memorandum decision, and a Summary Opinion of the U.S. Tax Court are summarized as follows:

- In terms of substance, Memorandum decisions deal with situations that require only the application of previously established principles of law. Regular decisions involve novel issues that have not been resolved by the Court. In actual practice, however, this distinction is not always observed.
- Memorandum decisions officially were published until 1999 in mimeograph form only, but Regular decisions are published by the U.S. Government in a series that is designated as the *Tax Court of the United States Reports*. Memorandum decisions are now published on the Tax Court website. Both Regular and Memorandum decisions are published by various commercial tax services (e.g., CCH and RIA).
- A Summary Opinion is a Small Cases Division case involving amounts of $50,000 or less. They are not precedents for any other court decisions and are not reviewable by any higher court. Proceedings are timelier and less expensive than a Memorandum or Regular decision. Small cases decisions are published as Summary Opinion, found commercially and on the U.S. Tax Court website.

14. (LO 1)

a. CA–2. An abbreviation that designates the U.S. Second Circuit Court of Appeals.

b. Fed.Cl. An abbreviation for the Federal Claims Reporter published by West Publishing Company. It includes the decisions of the U.S. Court of Federal Claims and begins with Volume 27.

c. *aff'd*. An abbreviation for "affirmed," which indicates that a lower court decision was affirmed (approved of) on appeal.

d. *rev'd*. An abbreviation for "reversed," which indicates that a lower court decision was reversed (disapproved of) on appeal.

e. *rem'd*. An abbreviation for "remanded," which indicates that a lower court decision is being sent back by a higher court for further consideration.

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f. *Cert. denied*. The Writ of Certiorari has been denied by the U.S. Supreme Court. This Writ means that the Court will not accept an appeal from a lower court and, therefore, will not consider the case further.

g. *acq*. An abbreviation for "acquiescence" (agreement). The IRS follows a policy of either acquiescing or nonacquiescing to certain decisions.

h. B.T.A. An abbreviation for the Board of Tax Appeals. From 1924 to 1942, the U.S. Tax Court was designated as the Board of Tax Appeals.

i. USTC. U.S. District Court, U.S. Circuit Court of Appeals, U.S. Court of Federal Claims, and U.S. Supreme Court decisions that address Federal tax matters are reported in the Commerce Clearing House U.S. Tax Cases (USTC) and the RIA (formerly P-H) American Federal Tax Reports (AFTR) series.

j. AFTR. See the solution to part i. above.

k. F.3d. All of the decisions (both tax and nontax) of the U.S. Claims Court (before October 1982) and the U.S. Circuit Court of Appeals are published by West Publishing Company in a reporter that is designated as the Federal Reporter, Second Series (F.2d). Volume 999, published in 1993, is the last volume of the Federal Second Series. It is followed by the Federal Third Series (F.3d).

l. F.Supp. Most Federal District Court decisions, dealing with both tax and nontax issues, are published by West Publishing Company in its Federal Supplement Series (F.Supp.).

m. USSC. An abbreviation for the U.S. Supreme Court.

n. S.Ct. West Publishing Company publishes all of the U.S. Supreme Court decisions in its Supreme Court Reporter (S.Ct.).

o. D.Ct. An abbreviation for a U.S. District Court decision.

15. (LO 2)

a. Ninth Circuit Court of Appeals.

b. U.S. Tax Court.

c. U.S. Supreme Court.

d. Bureau of Tax Appeal (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.

16. (LO 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.

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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.

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.

17. (LO 2)

a. Yes. Exhibit 2.3

b. No. Not published there.

c. No. Published by private publishers. Exhibit 2.3

d. Yes. Exhibit 2.3

e. Yes. Exhibit 2.3

f. No.

g. Yes. Exhibit 2.3

h. No.

18. (LO 2)

a. The U.S. Tax Court.

b. Yes, the appellate court affirmed, or agreed with, the trial court.

c. United Draperies, Inc., the taxpayer.

d. Yes, in effect, by issuing cert. denied to the appellate court decision (refusing to hear the decision).

19. (LO 2, 4) After understanding the relevant facts:

- Yvonne may begin with the index volumes of the available tax services: RIA, CCH, or BNA Portfolios.
- A key word search on an online service could be helpful—Westlaw (or WestlawNext), LexisNexis, CCH *IntelliConnect*, and Thomson Reuters *Checkpoint*.
- Yvonne may browse through IRS publications (available on the IRS website).

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- Yvonne could consult CCH's *Federal Tax Articles* to locate current appropriate articles written about child support payments. Thomson Reuters publishes the *Index to Federal Tax Articles* that is organized using RIA's paragraph index system.

- Yvonne may consult The Accounting & Tax Index, which is available in three quarterly issues and a cumulative year-end volume covering all four quarters.

- Up-to-date information may be found on the Web. Various legal, accounting, and financial gateways can be found by clicking on highlighted words or phrases.

20. (LO 1, 2)

a. Tom has some false notions. He must sue in the U.S. District Court of his locality and not in any other U.S. District Court.

b. Tom has four choices of courts with respect to his Federal tax question, and a state court is not one of the choices. He may go to the U.S. Tax Court, Small Cases Division of the U.S. Tax Court, U.S. District Court, or U.S. Court of Federal Claims.

c. The B.T.A. decision is an old U.S. Tax Court decision that may have little validity today. Even if the decision still is good law, it probably will have little impact upon a U.S. District Court and certainly no impact upon a state court.

d. The U.S. Court of Federal Claims is a trial court that usually meets in Washington, D.C., and Tom cannot appeal from a U.S. District Court to the U.S. Court of Federal Claims. Any appeal from his U.S. District Court would be to the Sixth Circuit Court of Appeals (and not to the Second).

e. Few tax decisions reach the U.S. Supreme Court. The U.S. Supreme Court must agree to hear a court case.

21. (LO 1)

a. T.

b. C (before October 1982) and A.

c. D, C, A, and U.

d. D, C, A, and U.

e. U.

f. C and U.

g. D.

h. D, T, and C.

i. A and U.

j. C.

k. T.

l. T.

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22. (LO 1, 2)
    a. N, a cite for an IRS Revenue Ruling.
    b. T, U.S. Tax Court.
    c. A, U.S. Circuit Court of Appeals.
    d. U, U.S. Supreme Court.
    e. T, U.S. Tax Court (previous name of the Tax Court).
    f. D, U.S. District Court.
    g. T, U.S. Tax Court.
    h. N, a cite for a Letter Ruling.
    i. T, U.S. Tax Court's Small Cases Division decision.

23. (LO 1, 2)
    a. P.
    b. P.
    c. P.
    d. S.
    e. P.
    f. S.
    g. P. Valid for three years.
    h. P.
    i. N.
    j. P.

24. (LO 1)
    b. p. 2-5

25. (LO 1, 2)
    b. Exhibit 2.3

26. (LO 1, 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.

27. (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*).

28. (LO 2) Tax research serves two major functions: (a) alerting the tax advisor to planning opportunities and documentation requirements that can reduce a taxpayer's liability through alternative means of structuring a transaction and (b) determining the correct treatment of completed transactions to ensure accurate compliance with U.S. tax laws. A professional approach to client service, therefore, demands thorough tax research as part of the job. Attention to the requirements of our country's tax laws is also

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mandated by the canons of professional ethics and the regulations applicable to professional tax preparers. Although some clients might prefer a head-in-the-sand approach to tax compliance, the range of potential penalties and interest charges make knowledge of the likely tax treatment of a particular transaction imperative.

The low IRS audit rate, moreover, does not justify playing the "audit lottery." Besides, this low rate masks much higher audit rates for certain categories of taxpayers and certain types of income—including returns prepared by persons known by the IRS to be negligent or unduly aggressive.

29. (LO 1, 4) The Internet Activity research problems require that the student access various sites on the Internet. Thus, each student's solution likely will vary from that of the others.

You should determine the skill and experience levels of the students before making the assignment, coaching them where necessary so as to broaden the scope of the exercise to the entire available electronic world.

Make certain that you encourage students to explore all parts of the World Wide Web in this process, including the key tax sites, but also information found through the websites of newspapers, magazines, businesses, tax professionals, government agencies, political outlets, and so on. They should work with Internet resources other than the Web as well, including newsgroups and other interest-oriented lists.

Build interaction into the exercise wherever possible, asking the student to send and receive e-mail in a professional and responsible manner.

30. (LO 2, 3)

a. Section 61(a)(13): Gross income of a taxpayer includes distributive share of partnership gross income.

b. Section 643(a)(2): Distributable net income of a trust or estate is computed without allowing a deduction for a personal exemption.

c. Section 2503(g)(2)(A): The term "qualified work of art" means any archaeological, historic, or creative tangible personal property.

BRIDGE DISCIPLINE PROBLEMS

1. a. There is a correspondence between the sources of the Federal tax law and the three branches of the law as described in the U.S. Constitution. Congress is the legislative branch, Treasury and the IRS are the executive branch, and the courts are the judicial branch.

But the IRS likely is more aggressive than most other federal agencies, despite its current "customer service" orientation. And there are few federal courts in which the taxpayer's chances of prevailing are so low as they are in tax litigation.

And one seldom sees elsewhere the power of the congressional committees assigned to shepherd tax proposals to a vote.

Remembering the quote of von Bismarck, the making of tax law is a creature unto itself, unparalleled elsewhere in the federal system today.

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b. The high costs of tax litigation, and the low probabilities of success once a taxpayer reaches the court, diminish the checks-and-balances feature of the federal tax system. Very few taxpayer pockets are "deep enough" to pursue a regular strategy of litigation to find the correct computation of one's tax liability. Thus, the government holds an important advantage over the taxpayer in working through the adversarial system that comprises today's federal tax structure.

At least there are plenty of opportunities for the taxpayer to reach an agreeable settlement with the government. The path through IRS appeals has a number of intermediate stops at which the parties can measure the strength of each other's position and negotiate a settlement in computing the tax due. Perhaps this is the trade-off at hand: Negotiated settlements save all parties time and money, even though they are not mentioned in the Constitution or the Revenue Code.

2. Solution will vary by student.

3. Solution will vary by student.

4. There is nothing illegal or immoral about minimizing one's tax liability. A citizen has every legal right to arrange his or her affairs so as to keep the attendant taxes as low as possible. One is required to pay no more taxes than the law demands. There is no ethical difference between a tax advisor's reduction of a tax expense and a cost accountant's reduction of a cost of operating a business.

RESEARCH PROBLEMS

1. a. In this Tax Court Memorandum decision, the court upheld the IRS's methods of income reconstruction and imposed a civil fraud penalty.

   b. In this letter ruling, a proposed merger between members of an affiliated group qualified for tax-free reorganization treatment under § 355.

   c. The IRS issued a nonaquiescence to *Algerine Smith Estate,* 198 F.2d 515 (CA–5, 1999).

2. a. Code § 708(a) provides that an existing partnership shall be considered as continuing if it is not terminated.

   b. Code § 1371(a) provides that, with exceptions, Subchapter C shall apply to S corporations and its shareholders.

   c. Code § 2503(a) provides that the term "taxable gifts" means the total amount of gifts made during the calendar year, less the deductions provided in Subchapter C.

3. a. Regulation § 1.170A–4(A)(b)(2)(ii)(C) provides that the care of the ill means alleviation or cure of an existing illness and includes care of the physical, mental, or emotional needs of the ill.

   b. Regulation § 1.672(b)–1 defines a nonadverse party as any person who is not an adverse party.

   c. Regulation § 20.2031–7(f) provides several tables for valuation of annuities, life estates, terms for years, and remainders.

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4. a. *Higgens 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.

5. Using the citation, find the case in RIA *Checkpoint* or find the case on the U.S. Tax Court website (www.ustaxcourt.gov), under "Opinions Search" tab.

   The issue in *Green* concerns the deductibility of commuting expenses. The taxpayer, Thomas Green, was a television executive whose office, his primary place of work, was in Manhattan. However, Mr. Green claimed that the den in his Long Island home was also a place of business because he worked there in the evenings. As a result, Mr. Green deducted the commuting costs he incurred driving between his home and his clients' offices, on the way to his Manhattan office. The Tax Court concluded that these costs were nondeductible commuting expenses.

   Mr. Green used an IRS publication (Publication 17, *Your Federal Income Tax*) to support the conclusion that his expenses were deductible commuting expenses. However, IRS publications are not primary sources of tax law on which research conclusions should be based. This was confirmed by the Tax Court. In the opinion, the judge said that even if the sentence taken out of context from the publication could support Mr. Green's conclusion, "…the sources of authoritative law in the tax field are the statute and regulations, and not informal publications such as Your Federal Income Tax."

6. 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-wife'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."

7. In the Tax Court case Kathryn Bernal:

   a. Docket number 930-02.

   b. Filed on February 20, 2003.

   c. Respondent is David Jojola for the IRS.

   d. Kathryn Bernal, the taxpayer, acted as her own attorney (e.g., pro se).

   e. This case was assigned to and written by the Chief Trial Judge Peter J. Panuthos.

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f. The court granted respondent's (IRS) motion to dismiss for lack of jurisdiction. Taxpayer mailed her petition beyond the 3-year available time period.

8. Section 152(f)(3) allows the IRS to disallow a dependency deduction where a relationship is in violation of local law:

"An individual is not a member of the taxpayer's household if at any time during the taxable year of the taxpayer the relationship between such individual and the taxpayer is in violation of local law." S.Rep. No. 1983, 85th Cong., 2d Sess. Indicates that it was the intention of Congress to preclude any dependency deduction for the partner of a taxpayer when the two are living in a quasimarital relationship, which is illicit under the laws of the state in which they reside.

John T. Untermann, 38 T.C. 93 (1962) holds that marital allowances are available only if the man and woman taxpayers are legally married under the laws of the state in which they reside. In a more recent decision [*Cassius L. Peacock,* III, 37 TCM 177, T.C.Memo. 1978–30] involving the interpretation of Arizona law, the exemption was denied on the same grounds.

The couple might consider moving to another state to salvage the deduction in future years. If a state has no criminal sanctions for sexual activity between consenting adults (e.g., California), the dependency exemption would be allowable. See, for example, In *Re Shackelford v. U.S.* [80–1 USTC ¶ 9276, 45 AFTR 2d 80–1074 (D.Ct. Mo., 1980)] where the court interpreted Missouri law so as to permit an unmarried female to claim a dependency exemption for a male who was living with her and had no source of income. See Chapter 9 for a general discussion of personal and dependency exemptions.

Research Problems 9 and 10

The Internet Activity 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 explore all parts of the Web in this research process, including tax research databases, as well as the websites of the IRS, newspapers, magazines, businesses, tax professionals, other government agencies, and political outlets. Students should also work with resources such as blogs, Twitter feeds, and other interest-oriented technologies to research their answers.

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NOTES

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CHAPTER

2

Working With the Tax Law

Essentials of Taxation

SOUTH-WESTERN
FEDERAL TAXATION

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The Big Picture (slide 1 of 2)

- Fred and Megan Samuels review their financial and tax situation with their son, Sam, and daughter-in-law, Dana, who live with them
  - Fred and Megan are in the 28 percent tax bracket
  - Both Sam and Dana are age 21
- Sam, a student at a nearby university, owns some publicly traded stock that he inherited
    - A current sale would result in approximately $8,000 of gross income
      - ($19,000 amount realized - $11,000 adjusted basis)

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The Big Picture (slide 2 of 2)

- Fred and Megan provide about 55 percent of Sam and Dana's support
  - Although neither is now employed, Sam has earned $960 and Dana has earned $900
- The problem:
  - Should the stock be sold?
  - Would the sale prohibit Fred and Megan from claiming Sam and Dana as dependents?
  - Would the stock sale result in a tax liability for Sam and Dana?
- *Read the chapter and formulate your responses*

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Statutory Sources of Tax Law
(slide 1 of 2)

- Internal Revenue Code
  - Codification of the Federal tax law provisions in a logical sequence
  - Have had three codes:
    - 1939, 1954, 1986

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Statutory Sources of Tax Law
(slide 2 of 2)

- Example of Code Citation: § 2(a)(1)(A)
  - § = Abbreviation for "Section"
  - 2 = section number
  - (a) = subsection number
  - (1) = paragraph designation
  - (A) = subparagraph designation

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Legislative Process for Tax Bills

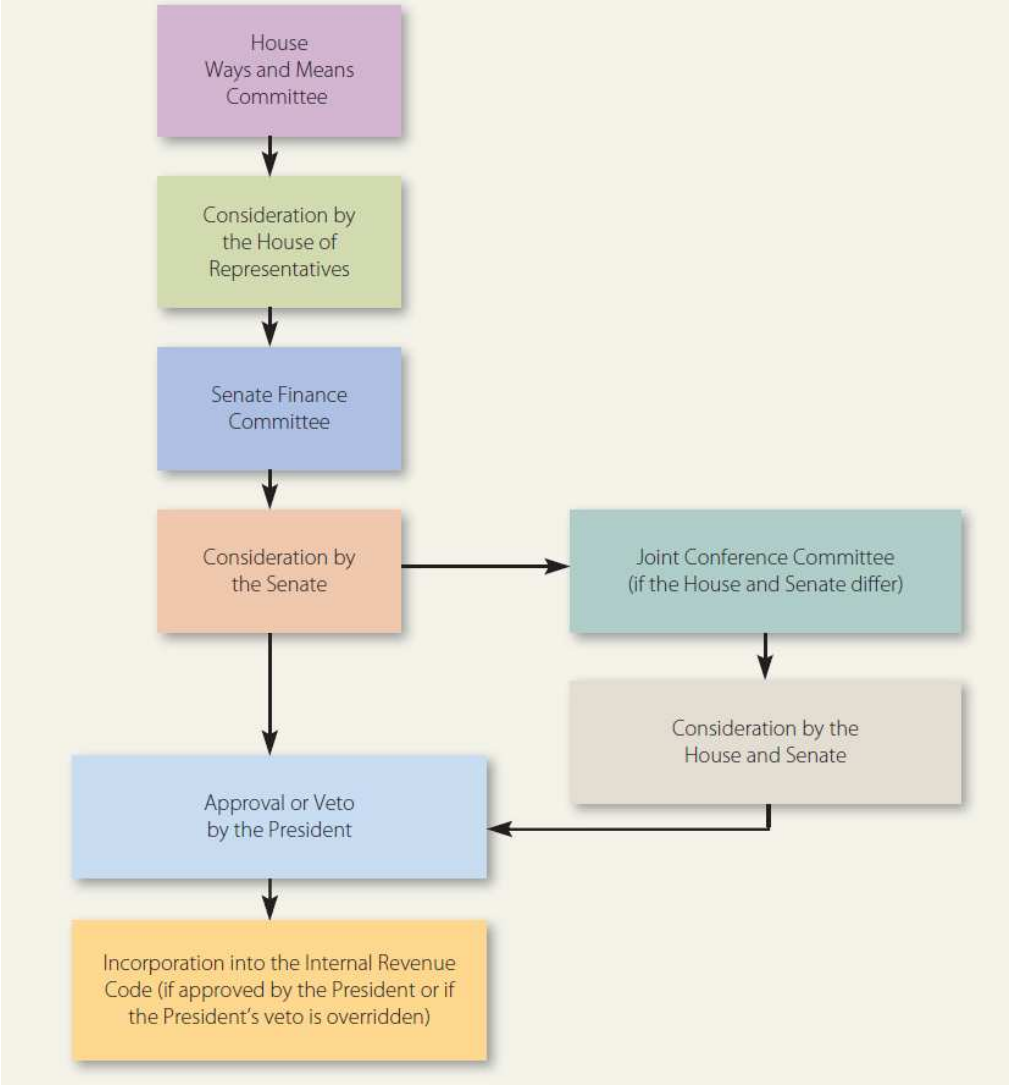

Exhibit 2.1

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Tax Treaties

- The U.S. signs tax treaties with foreign countries to:
  - Avoid double taxation
  - Render mutual assistance in tax enforcement
- Neither a tax law nor a tax treaty takes general precedence
  - When there is a direct conflict, the most recent item will take prevails
  - A taxpayer must disclose on the tax return any position where a treaty overrides a tax law
    - There is a $1,000 penalty per *failure to disclose* for individuals ($10,000 for C corporations)

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Administrative Sources of the Tax Law (slide 1 of 2)

- Treasury Department Regulations
- Revenue Rulings
- Revenue Procedures, and
- Various other administrative pronouncements

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Administrative Sources of Tax Law (slide 2 of 2)

Source	Locations (Selected)	Authority
Regulations	*Federal Register* *Internal Revenue Bulletin*	Force and effect of law. May be cited as precedent.
Temporary Regulations	*Federal Register* *Internal Revenue Bulletin*	May be cited as a precedent.
Proposed Regulations	*Federal Register* *Internal Revenue Bulletin*	Preview of final Regulations. Not yet a precedent.
Revenue Rulings Revenue Procedures Treasury Decisions Actions on Decisions	*Internal Revenue Bulletin*	IRS interpretation only. Weak precedent.
Determination Letters Technical Advice Memoranda	Tax Analysts' *Tax Notes* Thomson Reuters *Checkpoint* Commerce Clearing House *IntelliConnect*	IRS interpretation only. Weak precedent.
Letter Rulings	Thomson Reuters and CCH tax services	Applicable only to taxpayer addressed. May not be cited as precedent.

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Regulations (slide 1 of 4)

- Issued by U.S. Treasury Department
- Provide general interpretations and guidance in applying the Code

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Regulations (slide 2 of 4)

- Issued as:
  - Proposed: preview of final regulations
    - Do not have force and effect of law
  - Temporary: issued when guidance needed quickly
    - Same authoritative value as final regulations
  - Final:
    - Force and effect of law

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Regulations (slide 3 of 4)

- Example of Regulation citation:
  - Reg. § 1.2
    - Refers to Regulations under Code § 2
    - Subparts may be added for further identification
    - The numbering patterns of these subparts often have no correlation with the Code subsections

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Regulations (slide 4 of 4)

- Example of Proposed Regulation citation: Prop. Reg. § 1.2
- Example of Temporary Regulation citation: Temp. Reg. § 1.6081–8T

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Revenue Rulings (slide 1 of 2)

- Officially issued by National Office of IRS
  - Provide specific interpretations and guidance in applying the Code
  - Less legal force than Regulations
  - Issued in IRB and accumulated in the Cumulative Bulletins

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Revenue Rulings (slide 2 of 2)

- Example of Revenue Ruling citation
  - Rev.Rul. 2015–9, 2015–21 I.R.B. 972
    - Explanation: Revenue Ruling Number 9, appearing on page 972 of the 21st weekly issue of the *Internal Revenue Bulletin* for 2015

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Revenue Procedures (slide 1 of 2)

- Concerned with the internal management practices and procedures of the IRS
  - Issued similar to Revenue Rulings
  - Issued in IRB and accumulated in the Cumulative Bulletins

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Revenue Procedures (slide 2 of 2)

- Example of Revenue Procedure citation
  - Rev. Proc. 92-29, 1992-1 CB 748
    - 29th Rev. Procedure in 1992 found in volume 1 of Cumulative Bulletin on page 748

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Letter Rulings (slide 1 of 2)

- Provide guidance to taxpayer on how a transaction will be taxed before proceeding with it
  - Issued for a fee upon a taxpayer's request
  - Describe how the IRS will treat a *proposed* transaction
- Apply only to the taxpayer who asks for and obtains the ruling
  - Post-1984 letter rulings may be substantial authority for purposes of the accuracy-related penalty
- Limited to restricted, pre-announced areas of taxation

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Letter Rulings (slide 2 of 2)

- Example of Letter Ruling citation
  - Ltr.Rul. 201503010
    - 10th ruling issued in the 3rd week of 2015

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Other Administrative Pronouncements (slide 1 of 4)

- Treasury Decisions-issued by Treasury Dept. to:
  - Promulgate new or amend existing Regulations
  - Announce position of the Government on selected court decisions
  - Published in the *Internal Revenue Bulletin*
    - Then transferred to the Cumulative Bulletin

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Other Administrative Pronouncements (slide 2 of 4)

- Determination Letters
  - Issued by Area Director at taxpayer's request
  - Usually involve *completed* transactions
  - Not published
    - Made known only to party making the request

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Other Administrative Pronouncements (slide 3 of 4)

- The IRS also publishes other administrative communications such as
  - Announcements,
  - Notices,
  - IRs (News Releases),
  - Internal Legal Memoranda (ILMs),
  - Chief Counsel Notices (CC), and
  - Prohibited Transaction Exemptions

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Other Administrative Pronouncements (slide 4 of 4)

- A variety of internal memoranda that constitute the working law of the IRS also are released but not officially published, such as
  - General Counsel Memoranda (GCMs),
  - Technical Advice Memoranda (TAMs),
  - Internal Legal Memoranda (ILMs), and
  - Field Service Advice Memoranda (FSAs)
- The IRS indicates that they may not be cited as precedents by taxpayers.
  - However, these working documents do explain the IRS's position on various issues.

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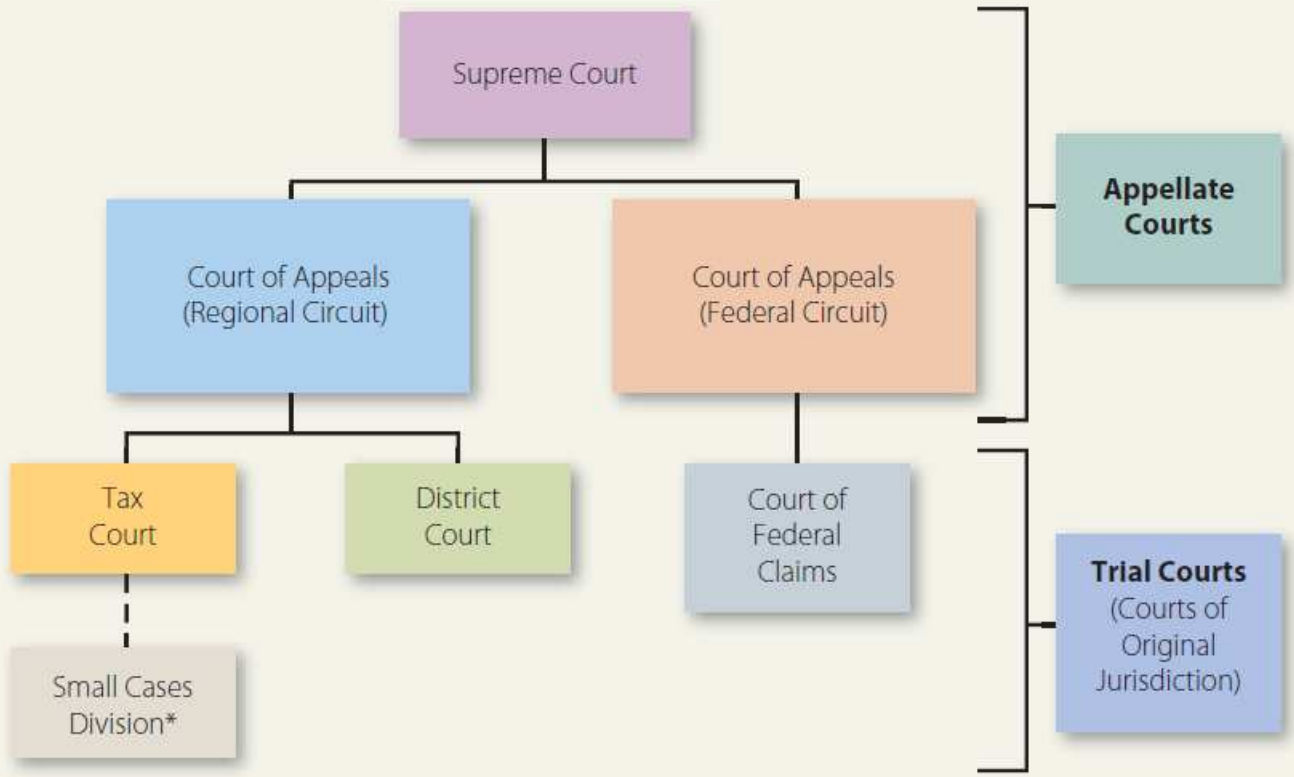
Federal Judicial System

EXHIBIT 2.4 **Federal Judicial System**



* No appeal from this court.

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Judicial Sources (slide 1 of 2)

- There are four courts of original jurisdiction (trial courts)
  - U.S. Tax Court: Regular
  - U.S. Tax Court: Small Cases Division
  - Federal District Court
  - U.S. Court of Federal Claims

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Judicial Sources (slide 2 of 2)

Concept Summary 2.1

Federal Judicial System: Trial Courts

Issue	Tax Court	District Court	Court of Federal Claims
Number of judges per court	19	1 per case	16
Payment of deficiency before trial	No	Yes	Yes
Jury trial available	No	Yes	No
Types of dispute	Tax cases only	Mostly criminal and civil issues	Claims against the United States
Jurisdiction	Nationwide	Location of taxpayer	Nationwide
IRS acquiescence policy	Yes	Yes	Yes
Appeal is to	U.S. Court of Appeals	U.S. Court of Appeals	Court of Appeals for the Federal Circuit

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Appeals Process

- Appeals from District Court or Tax Court go to the U.S. Court of Appeals for circuit where taxpayer resides
- Appeals from Court of Federal Claims is to Court of Appeals for the Federal Circuit
- Appeal to the Supreme Court is by Writ of Certiorari
  - Only granted for those cases it desires to hear

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Courts' Weights as Precedents

- From high to low
  - Supreme Court
  - Circuit Court of Appeals
  - Tax Court (Regular), U.S. Court of Federal Claims, & U.S. District Courts
- Decisions of the Small Cases Division of the Tax Court have no precedential value and cannot be appealed

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Tax Court (slide 1 of 3)

- Issues two types of decisions: Regular and Memorandum
  - Regular decisions involve novel issues not previously resolved by the court
- Regular decisions are published by the U.S. government, for example

Temporary Citation	*MoneyGram International, Inc. and Subsidiaries*, 144 T.C. ___, No. 1 (2015). *Explanation:* Page number left blank because not yet known.
Permanent Citation	*MoneyGram International, Inc. and Subsidiaries*, 144 T.C. 1 (2015). *Explanation:* Page number now available.

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Tax Court (slide 2 of 3)

- Tax Court Memorandum decisions
  - *Memorandum* decisions deal with situations necessitating only the application of already established principles of law
  - Memorandum decisions were not published by the U.S. Government until recently

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Tax Court (slide 3 of 3)

- Memorandum decisions were—and continue to be—published by several tax services
  - Consider, for example, three different ways that *Nick R. Hughes* can be cited:
    - *Nick R. Hughes*, T.C.Memo. 2009–94
      - The 94th Memorandum decision issued by the Tax Court in 2009
    - *Nick R. Hughes*, 97 TCM 1488
      - Page 1488 of Vol. 97 of the CCH Tax Court Memorandum Decisions
    - *Nick R. Hughes*, 2009 RIA T.C.Memo. ¶2009,094
      - Paragraph 2009, 094 of the RIA T.C. Memorandum Decisions

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Examples of District Court Decision Citations

- *Turner v. U.S.*, 2004–1 USTC ¶60,478 (D.Ct. Tex., 2004) (CCH citation)

- *Turner v. U.S.*, 93 AFTR 2d 2004–686 (D.Ct. Tex., 2004) (RIA citation)

- *Turner v. U.S.*, 306 F.Supp.2d 668 (D.Ct. Tex., 2004)(West citation)

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Supreme Court Decisions

- Examples of citations
  - U.S. v. The Donruss Co., (USSC, 1969)
    - 69-1 USTC ¶9167 (CCH citation)
    - 23 AFTR2d 69-418 (RIA citation)
    - 89 S. CT 501 (West citation)
    - 393 U.S. 297 (U.S. Government citation)
    - 21 L.Ed.2d 495 (Lawyer's Co-operative Publishing Co. citation)

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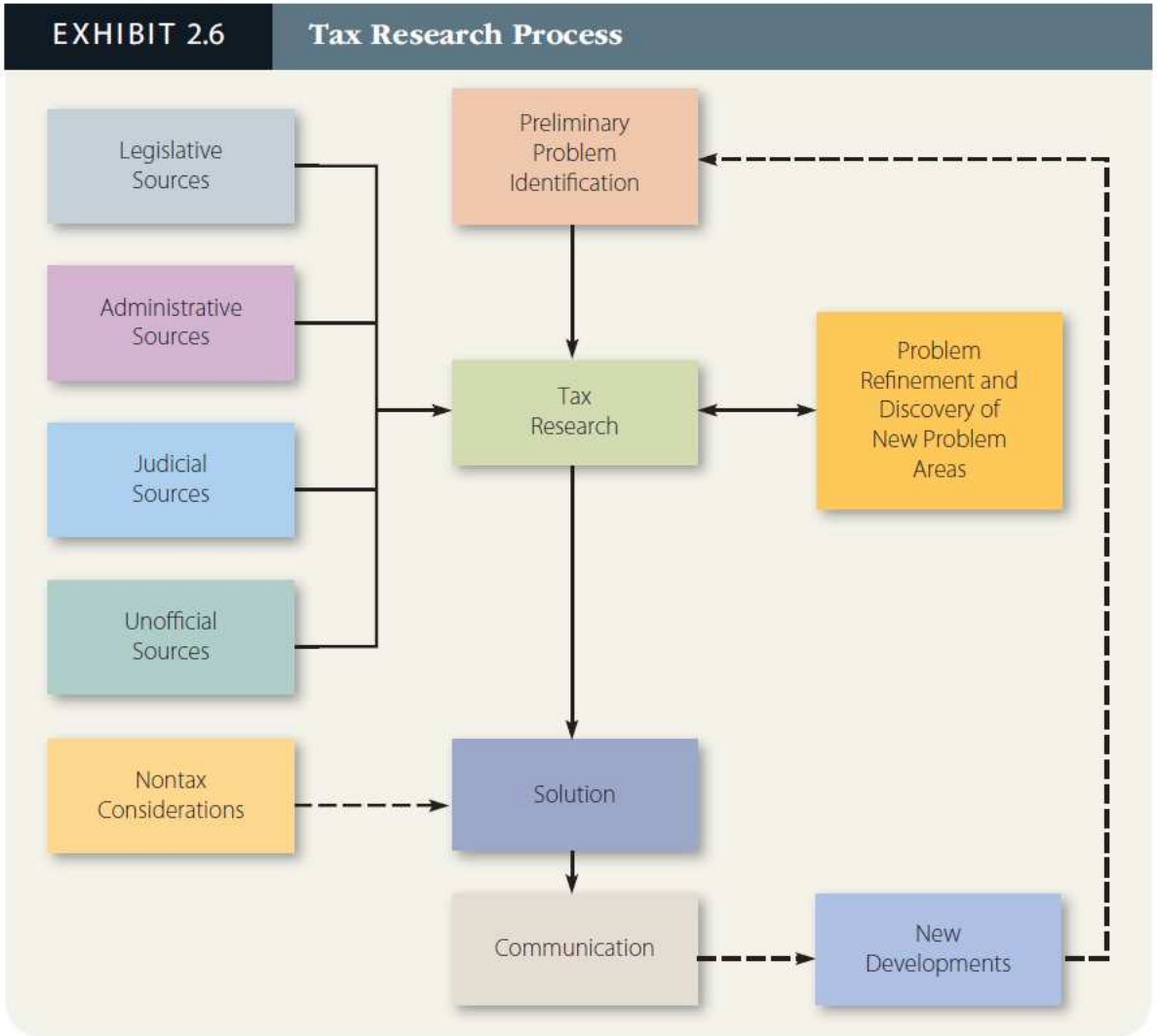
Tax Research Process



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Tax Research

- Tax research is the method by which an interested party determines the best solution to a tax situation
- Tax research involves:
  - Identifying and refining the problem
  - Locating the appropriate tax law sources
  - Assessing the validity of the tax law sources
  - Arriving at the solution or at alternative solutions with due consideration given to nontax factors

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Assessing the Validity of Tax Law Sources (slide 1 of 4)

- Regulations
  - IRS agents must give the Code and the Regulations equal weight when dealing with taxpayers and their representatives
  - Proposed Regulations are not binding on IRS or taxpayer
  - Burden of proof is on taxpayer to show Regulation incorrect

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Assessing the Validity of Tax Law Sources (slide 2 of 4)

- Final Regulations tend to be of three types
  - Procedural: housekeeping-type instructions
  - Interpretive: rephrase what is in Committee Reports and the Code
    - Hard to get overturned
  - Legislative: allow the Treasury Department to determine the details of law
    - Congress has delegated its legislative powers and these cannot generally be overturned

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Assessing the Validity of Tax Law Sources (slide 3 of 4)

- Revenue Rulings
  - Carry less weight than Regulations
  - Not substantial authority in court disputes

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The Big Picture – Example 5
Assessing the Significance of Other Administrative Sources of the Tax Law

- Return to the facts of The Big Picture p. 2-1
- Tax law involving the sale of investment assets is found largely in the Internal Revenue Code
  - The Samuels family will find incontrovertible law for these transactions in the Code
- Rules concerning dependency exemptions chiefly are found in Regulations, Revenue Rulings, and instructions to IRS forms
  - With respect to these tax law sources, the authority of each is less than that of the Code, and the Regulations carry much more weight than the form instructions

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Assessing the Validity of Tax Law Sources (slide 4 of 4)

- Judicial sources
  - Consider the level of the court and the legal residence of the taxpayer
  - Tax Court Regular decisions carry more weight than Memo decisions
    - Tax Court does not consider Memo decisions to be binding precedents
    - Tax Court reviewed decisions carry even more weight
  - Circuit Court decisions where certiorari has been requested and denied by the U.S. Supreme Court carry more weight than a Circuit Court decision that was not appealed
  - Consider whether the decision has been overturned on appeal

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The Big Picture – Example 6
Assessing the Significance of Other Administrative Sources of the Tax Law (slide 1 of 2)

- Return to the facts of The Big Picture on p. 2-1
- Assume that on the Samuels' joint return a dependency exemption is claimed for both Sam and Dana
  - The IRS challenges these exemptions after an audit.
- The likelihood of a successful challenge to the IRS's position in this dispute will turn on several factors
  - Was an appellate court ruling in their favor issued by the Federal circuit in which they live?
    - If so, that decision is controlling law
    - If not and the Samuels' circuit has not ruled to the contrary on the issue, the taxpayers could use the decision as support for their side of the argument

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The Big Picture – Example 6
Assessing the Significance of Other Administrative Sources of the Tax Law (slide 2 of 2)

- Return to the facts of The Big Picture on p. 2-1.
- A Revenue Ruling is found that supports the taxpayers' claim, but how long ago was the Revenue Ruling issued?
  - A legal precedent generally is stronger if it was issued more recently
- Have other courts discussed the appellate court holding?
  - Were those discussions favorable or unfavorable to the Samuels' position?
  - The more courts that follow a holding and cite it favorably, the stronger the legal precedent
- Information of this sort can be found by reviewing the case history of the decision or by consulting a citator

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Tax Law Sources (slide 1 of 2)

- Primary sources of tax law include:
  - The Constitution
  - Legislative history materials
  - Statutes
  - Treaties
  - Treasury Regulations
  - IRS pronouncements, and
  - Judicial decisions
- In general, the IRS considers only primary sources to constitute substantial authority

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Tax Law Sources (slide 2 of 2)

- Secondary Sources include:
  - Legal periodicals
  - Treatises
  - Legal opinions
  - General Counsel Memoranda, and
  - Written determinations
- In general, secondary sources are not authority

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Tax Research Tools (slide 1 of 2)

- A crucial part of the research process is the ability to locate appropriate sources of the tax law
  - Both electronic and paper-based research tools are available to aid in this search
- Unless the problem is simple (e.g., the Code Section is known, and there is a Regulation on point), the research process should begin with a tax service

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Tax Research Tools (slide 2 of 2)

- A partial list of the available commercial tax services includes:
  - Standard Federal Tax Reporter, CCH
  - CCH IntelliConnect, CCH Internet service
  - United States Tax Reporter, RIA
  - RIA Checkpoint, RIA
  - ATX/Kleinrock Tax Expert, CCH/Wolters Kluwer Business services
  - Tax Management Portfolios, BNA
  - Mertens Law of Federal Income Taxation, West Group
  - Westlaw services (including access to Tax Management Portfolios)
  - TaxCenter, LexisNexis
  - Federal Research Library, Tax Analysts

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Taxation on the CPA Examination

- Taxation is included in the 16-hour Regulation section and covers:
  - Federal tax process, procedures, accounting, and planning
  - Federal taxation of property transactions
  - Federal taxation—individuals
  - Federal taxation—entities
- Knowledge is tested using both multiple-choice questions and case studies called simulations

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Refocus on the Big Picture (slide 1 of 3)

- Fred and Megan will need you to conduct some rigorous tax research concerning the proper treatment of the stock sale and to determine the correct number of dependency exemptions for the year
- Your work will entail a review of primary sources of the tax law and some computations for them, using a spreadsheet to illustrate your findings

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Refocus on the Big Picture (slide 2 of 3)

- Communications with your clients will include a variety of phone and e-mail exchanges; a memo for your tax file; and a letter to them, summarizing your findings and recommendations
- Your research likely will be complete using Code sections and several IRS rulings, but you must convey your results to the clients in a manner that is understandable to them, as they likely are untrained in the tax law

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Refocus on the Big Picture (slide 3 of 3)

What If?

- It is not uncommon that you later will receive additional information from Fred and Megan about the affected transactions
  - This may occur if additional facts are discovered by them, if Fred and Megan gave you incomplete information, or if your original interviews and data collection from them were incomplete
- If this new information changes the conclusions and recommendations that you already had developed, you should make certain that the taxpayers understand that your original work no longer is valid and that they should not depend on it

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If you have any comments or suggestions concerning this PowerPoint Presentation for South-Western Federal Taxation, please contact:

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CHAPTER 2

WORKING WITH THE TAX LAW

LECTURE NOTES

OVERVIEW

Federal tax law is a mixture of statutory provisions, administrative pronouncements, and court decisions.

SUMMARY OF CHANGES IN THE CHAPTER

The following are notable changes in the chapter from the 2016 Edition. For major changes, see the Preface to the Instructor's Edition of the text.

- Updated references and citations throughout the chapter.
- Updated materials on administrative tax law sources and commercial tax services.

THE BIG PICTURE

The Big Picture discussion in Chapter 2 introduces the introductory tax student to the idea that answers to tax questions will not always be found in the tax textbook and that research often needs to be undertaken to answer the question.

The discussion in Section 2-3 of the chapter takes the student through the answer to the research questions posed. Depending on the research services available, the instructor might ask the students to formulate keyword searches and then demonstrate what happens when those searches are undertaken in the research service. The instructor could also demonstrate the index feature of the research services to look up topics related to dependents or dependency exemptions. Alternatively, the instructor could ask the students to see if they could verify the correctness of the textbook conclusion or change one of the key facts (e.g., change the relationship between the taxpayers so that the qualifying relative test applies) and ask the student to determine how the conclusion would change, if at all.

TAX SOURCES

Statutory Sources of the Tax Law

1. Statutory sources of law include the Constitution (Article I, Sections 7, 8, and 10), tax treaties, and the Internal Revenue Code.

2. Origin of the Internal Revenue Code.

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a. Constitution. The source of the Federal taxing authority is the U.S. Constitution: "The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States." (Art. I, § 8, Cl. 1)

b. Sixteenth Amendment. The Sixteenth Amendment is the foundation of our Federal income tax: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

3. Internal Revenue Code. The Code generally is supreme in the Federal tax area, unless a U.S. tax treaty is in direct conflict. In this case, TAMRA of 1988 provides that neither a tax law nor a tax treaty takes general precedence. Instead, the most recent item will take precedence.

a. Role of Congress. Unless a *constitutional* issue is involved, Congress can override a U.S. Supreme Court decision by amending the Code.

(1) Code supremacy. This Court supremacy is not the case when the Internal Revenue Code is concerned (i.e., Congress can change the law).

b. Congressional Committee Reports. Congressional Committee Reports may be helpful in interpreting the Code.

(1) Congressional intent. Such reports reflect the intent of Congress in implementing or changing the tax law.

(2) *Cumulative Bulletins*. The Committee Reports usually are conveniently available in special volumes of the *Cumulative Bulletins* as well as online, on the committee's web page (e.g., http://waysandmeans.house.gov/).

c. Public and closed congressional hearings. Congress holds both public and closed hearings on tax proposals.

(1) After public hearings before the House Ways and Means Committee, the public may be excluded in a closed session.

(2) Tax bills may be debated under a closed rule before the full House with approval by the Rules Committee.

(3) Under this closed rule, amendments are not allowed on the House floor unless approved by the House Ways and Means Committee.

(4) The full Senate, however, does not have a closed rule process.

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d. Organization of the Code. The Code is organized into Subtitles, Chapters, and Subchapters. See Figure 2-1 in these Lecture Notes.

e. Interrelation of Code provisions. Tying the various Code provisions together to reach the total result is important.

(1) For example, consider why there are three separate sections dealing with alimony.

(2) Section 71 (in the gross income sequence) makes it taxable to the payee; § 215 (in the deduction sequence) makes it deductible to the payor; and § 62(a)(10) classifies the deduction (as a deduction for AGI) for the payor.

f. Subpart designations. The designation given to the subparts of a Code section will vary.

(1) The usual approach has been to use (a), (b), etc. [e.g., § 162(a)].

(2) On occasion, however, the designation is (1), (2), etc. [e.g., § 212(1)].

g. Code section numbers. Section numbers do not repeat in the same title of the Code. Some Code section numbers contain a capital letter (e.g., a numerical designation such as §§ 453A, 453B).

(1) The reason is that certain numerical sequences in the Code have no space for expansion.

(2) Since there exists a § 453 and a § 454, how else would the two intervening provisions be designated?

h. Recodification. The Internal Revenue Code has been recodified twice.

(1) Internal Revenue Codes of 1939 and 1954. The first was in 1939 and the second was in 1954.

(2) Internal Revenue Code of 1986. Although Congress did not codify and rearrange the law in the Tax Reform Act of 1986, the radical changes did provide some rationale for renaming the entire tax law in the Internal Revenue Code of 1986.

i. General explanation of the act. Upon completion of major tax legislation, the staff of the Joint Committee on Taxation (in consultation with the staffs of the House Ways and Means and Senate Finance Committees) often will prepare a general explanation of the act.

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(1) Bluebook: no legal effect. Commonly known as the "bluebook" because of the color of its cover, the IRS will not accept this detailed explanation as having legal effect (except for purposes of the accuracy-related penalty in § 6662).

(2) Bluebook: temporary guidance. The "bluebook," however, does provide valuable guidance to tax advisers and taxpayers until Regulations are issued, and some letter rulings and general counsel memoranda of the IRS cite such explanations.

4. The legislative process.

a. Evolution of tax law. Some provisions in the tax law take years to become law (e.g., H.R. 10 or Keogh plans).

(1) This process means that with each new Congress the measure had to be reintroduced until it finally gained the required support.

(2) An example of a provision that currently seems to be going through this process is the provision to tax carried interest at ordinary income rather than capital gains tax rates.

b. Deadwood bills. On occasion, Congress will enact deadwood bills. The purpose of such legislation is to "clean up" provisions that are obsolete and possess no continuing validity.

c. Origin of a tax bill. Tax legislation normally originates in the House Ways and Means Committee of the House of Representatives because the U.S. Constitution mandates that revenue raising bills begin in the House. A tax bill might originate in the Senate when it is attached to other legislative proposals.

(1) The Tax Equity and Fiscal Responsibility Act of 1982 originated in the Senate, and its constitutionality was unsuccessfully challenged in the courts.

(2) The Senate version of the Deficit Reduction Act of 1984 was attached as an amendment to the Federal Boat Safety Act.

d. Naming tax legislation. Some tax provisions are commonly referred to by the number the bill received in the House when first proposed or by the name of the member of Congress sponsoring the legislation. For example, the Self-Employed Individuals Tax Retirement Act of 1962 is popularly known as H.R. 10 (House of Representatives Bill No. 10) or as the Keogh Act (Keogh being one of the members of Congress sponsoring the bill). The Roth IRA is named after Senator William Roth, an influential sponsor. Coverdell Education Savings Accounts

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(first called education IRAs) are named after the late Senator Paul Coverdell (R–GA).

e. Beginning in 1997, the president was supposed to be able to cancel provisions from enacted tax legislation under the Line Item Veto Act. President Clinton, on August 11, 1997, did strike two provisions from TRA of 1997 and one nontax provision from the Balanced Budget Act. Congress did not override these cancellations, but the constitutionality of the Line Item Veto Act was challenged in the court system and the Supreme Court held it unconstitutional.

f. Tax legislation is referred from the Senate Finance Committee to the entire Senate. If the House and Senate tax bills disagree, the Joint Conference Committee resolves the differences. (See Exhibits 2.1 and 2.2 in the text.)

5. Arrangement of the Code. The Internal Revenue Code of 1986 is found in Title 26 of the U.S. Code. In working with the Code, it helps to understand the format. The key is usually the section number. For example, in citing Section 2(a), it is unnecessary to include Subtitle A, Chapter 1, Subchapter A, Part I. Mentioning Section 2(a) is sufficient. (See "Citing the Code" in the text.)

Administrative Sources of the Tax Law (See Exhibit 2.3 in the text.)

6. Treasury Department Regulations. The Treasury Department under § 7805(a) has a duty to issue rules and regulations to explain and interpret the Code.

a. Treasury decisions. Final Regulations are issued as Treasury Decisions (TDs) in the *Federal Register*. Regulations carry considerable authority as the official interpretation of tax statutes. They are arranged in the same sequence as the Internal Revenue Code and have the force and effect of law.

b. Types of Regulations issued:

(1) Legislative Regulations.

(2) Interpretative Regulations.

(3) Procedural Regulations.

(4) Temporary Regulations may be cited as precedent and are found in the *Federal Register*, *Internal Revenue Bulletin*, and *Cumulative Bulletin*. They are also concurrently issued as Proposed Regulations (in order to become Final Regulations) and automatically expire within three years after the date of issuance.

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c. Validity of a Regulation. One way courts assess the validity of a Regulation is by the legislative reenactment doctrine. A Regulation is considered to have received congressional approval if the Regulation was finalized many years earlier and during the interim period Congress has not amended the relevant statutory language.

d. Information in *Cumulative Bulletins* and *Internal Revenue Bulletins*. The I.R.B.s for a six-month period are gathered together and published in a bound volume designated as a C.B.

7. Revenue Rulings and Revenue Procedures. The C.B.s and I.R.B.s include a variety of administrative sources, including Revenue Rulings and Revenue Procedures.

a. Revenue Rulings are official pronouncements of the National Office of the IRS and provide guidance to both IRS personnel and taxpayers in handling routine tax matters. They usually deal with more restricted problems than Regulations and do not carry the same legal force and effect as Regulations.

b. Revenue Procedures are issued in the same manner as Revenue Rulings, but they deal with the internal management practices and procedures of the IRS. Revenue Procedures do not carry the same legal force and effect as Regulations.

c. Other materials included in the I.R.B and C.B.:

(1) Announcements of Proposed Regulations as well as the related public hearings.

(2) Treasury decisions.

(3) Executive orders.

(4) Tax conventions (i.e., international treaties).

(5) Legislation (including Committee Reports).

(6) Certain court decisions.

(7) Announcements of court decisions to which the IRS acquiesces or does not acquiesce.

(8) Punitive action (e.g., disbarment, suspension) taken against persons (e.g., attorneys, CPAs) practicing before the IRS.

8. Letter rulings. Letter rulings and determination letters have in common the fact that they apply only to the person who requested the ruling or letter. Note that neither is published by the IRS, but made available to private publishers.

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a. Letter ruling. A letter ruling is a statement issued by the National Office of the IRS in response to a taxpayer's request, which applies the tax law to a proposed transaction. Revenue rulings can result from a taxpayer request for a letter ruling.

b. Determination letter. A determination letter is a statement issued by the Area Director in response to a taxpayer, which applies the tax law to a completed transaction.

9. Other administrative pronouncements. These sources are not the same.

a. Technical Memoranda (TMs) are memoranda from the IRS Commissioner to the Assistant Secretary of the Treasury for Tax Policy. They are drafted by the Legislation and Regulation Division of the Office of Chief Counsel and relate to proposed Treasury Decisions or Regulations.

b. Technical Advice Memoranda (TAMs) are furnished by the National Office of the IRS upon request of an Area Director or an Appeals Officer of the IRS in response to any technical or procedural question (e.g., a completed transaction).

ADDITIONAL LECTURE RESOURCE

Provider of the Tax Law Source

Internal Revenue Code	Congress/President
Regulations	U.S. Treasury Department
Revenue Ruling	National Office of IRS
Letter Ruling	National Office of IRS
Notices and Announcements	National Office of IRS
Determination Letter	Area Director of IRS
Technical Advice Memorandum	National Office of IRS
Treasury Decision	U.S. Treasury Department
Revenue Procedure	National Office of IRS
General Counsel Memorandum	General Counsel's Office of IRS
Action on Decision	Office of Chief Counsel of IRS
Field Service Advice	Office of Chief Counsel of IRS

Judicial Sources of the Tax Law

10. Precedential value. American law, following English common law, is frequently "made" by judicial decisions. Under the doctrine of *stare decisis*, each decision has precedential value for future decisions with the same controlling set of facts.

11. The judicial process in general. After a taxpayer has exhausted some or all of the remedies available within the IRS, the dispute can be taken to the Federal courts. A

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taxpayer chooses the route to pursue a tax conflict from among four alternatives (as illustrated in Exhibit 2.4 and Concept Summary 2.1 in the text).

a. U.S. Court of Federal Claims (hears tax and other monetary claims against the Federal government). This court formerly was called the U.S. Claims Court. There is only one U.S. Court of Federal Claims. The court meets most often in Washington, D.C. Decisions are appealed to the U.S. Court of Appeals (Federal Circuit).

b. U.S. Tax Court (hears only tax cases). Taxpayer does not pay the deficiency before trial. Decisions are appealed to the U.S. Court of Appeals (Regional Circuit).

c. Small Cases Division of the U.S. Tax Court (hears only tax cases). No appeal available. The broken line between the U.S. Tax Court and the Small Cases Division in Exhibit 2.4 in the text indicates that there is no appeal from the Small Cases Division.

(1) $50,000 or less. This court hears cases involving disputed amounts of $50,000 or less.

(2) No written record. The proceedings are informal, and there was no written record of such cases before 2002. Some of the more recent cases can now be found on the U.S. Tax Court website or in online research services.

(3) Informal proceedings.

(a) No necessity for the taxpayer to be represented by a lawyer or other tax adviser.

(b) Special trial judges, rather than Tax Court judges, preside over the proceedings.

(c) Decisions are not precedent for any other court and are not reviewable by any higher court.

d. U.S. District Court (hears tax as well as nontax cases). A jury trial is available. Decisions are appealed to the U.S. Court of Appeals (Regional Circuit). See Exhibit 2.4 in the text.

12. Trial courts. The differences among the various trial courts can be summarized as follows:

- Number of courts.
- Number of judges.
- Location.

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- Jurisdiction of the Court of Federal Claims.
- Jurisdiction of the Tax Court and District Courts.
- Jury trial.
- Payment of deficiency.
- Termination of running of interest.
- Appeals.
- Bankruptcy.

13. Appellate courts. The two appellate courts are the Circuit Courts of Appeal (11 geographical circuits, the circuit for the District of Columbia, and the Federal Circuit) and the Supreme Court (see Exhibit 2.4 in the text).

    a. All courts must follow the decisions of the U.S. Supreme Court.

    b. A particular Court of Appeals need not follow the decisions of another Court of Appeals.

    c. District Courts, the Tax Court, and the Court of Federal Claims must abide by the precedents set by the Court of Appeals of the relevant jurisdiction.

ADDITIONAL LECTURE RESOURCE

Jurisdiction of the Courts of Appeal

First
Maine
Maryland
Massachusetts
New Hampshire
Rhode Island
Puerto Rico

Second
Connecticut
New York
Vermont

Third
Delaware
New Jersey
Pennsylvania
Virgin Islands

District of Columbia
Washington, D.C.

Fourth
Arkansas
North Carolina
South Carolina
Virginia
West Virginia

Fifth
Canal Zone
Louisiana
Mississippi
Texas

Sixth
Kentucky
Michigan
Ohio
Tennessee

Seventh
Illinois
Indiana
Wisconsin

Eighth
Colorado
Iowa
Minnesota
Missouri
Nebraska
North Dakota
South Dakota

Ninth
Alaska
Arizona
California
Hawaii
Idaho
Montana
Nevada
Oregon
Washington
Guam

Tenth
Kansas
New Mexico
Oklahoma
Utah
Wyoming

Eleventh
Alabama
Florida
Georgia

Federal
U.S. Court of Federal Claims

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d. Bankruptcy court. In certain situations, a bankruptcy court may have jurisdiction over tax matters. Since the filing of a bankruptcy petition prevents creditors from filing a claim against a person, a tax dispute may be settled by the bankruptcy court.

e. Locating court cases. Tax cases can be found in a variety of different official and unofficial sources. The instructor can utilize Figure 2-2 in these Lecture Notes to explain the different sources in which tax cases are published.

14. The appellate process. The role of the appellate court is limited to a review of the trial record compiled by the trial court. The appellate process usually involves a determination of whether the trial court applied the proper law in arriving at its decision.

a. Bound by findings of facts unless they are clearly erroneous.

b. The appellate court may approve (affirm) or disapprove (reverse) the lower court's findings, or it may send the case back for further consideration (remand).

c. District Courts, the Tax Court, and the Court of Federal Claims must abide by the precedents set by the Court of Appeals of jurisdiction.

d. All courts must follow the decision of the U.S. Supreme Court.

e. Since the *Golsen* decision [*Jack E. Golsen*, 54 T.C. 742 (1970)], the Tax Court decides a case as it believes the law should be applied only if the Court of Appeals has not passed on the issue.

f. The U.S. Supreme Court grants certiorari to resolve a conflict among the Courts of Appeals or where the tax issue is extremely important.

(1) The granting of a Writ of Certiorari indicates that at least four of the nine members of the Supreme Court believe that the issue is of sufficient importance to be heard by the full Court.

15. Judicial citations. Judicial citations usually follow a standard pattern: case name, volume number, reporter series, page or paragraph number, court, and year of the decision.

a. U.S. Court of Federal Claims. Prior to October 1, 1982, the Claims Court was called the Court of Claims. Beginning on October 29, 1992, the Claims Court underwent a further name change. The new designation, U.S. Court of Federal Claims, begins with Volume 27 of the former *Cl.Ct.* (West citation) now abbreviated as *Fed.Cl*. Claims Court and Court of Federal Claims decisions are now appealable to the Federal Circuit, whereas they were previously appealable only to the Supreme Court.

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(1) *Court of Claims Reporter*. The *Court of Claims Reporter* series, published by the U.S. Government Printing Office, is the primary source of these former Court of Claims cases.

(2) *Federal Reporter* and *Claims Court Reporter*. Court of Claims cases from 1929 to 1932 and from 1960 to September 1982 can be found in the *Federal Reporter*, published by West. Beginning in October 1982, these Claims Court decisions are published in West's *Claims Court Reporter*.

(3) *Federal Claims Reporter*. Beginning with Volume 27 on October 30, 1992, the name of the reporter is changed to the *Federal Claims Reporter*.

b. U.S. Tax Court. Often called the "poor person's court" because a taxpayer does not have to pay the proposed deficiency in order to bring a case before the court.

(1) Organization and authority. In 1969, the Tax Court transitioned from an administrative court to a judicial court. Nineteen regular judges produce both "regular decisions" and so-called "memorandum decisions."

(2) Tax Court decisions. Regular Tax Court decisions are published by the U.S. Government Printing Office as the *Tax Court of the United States Reports*.

c. Memorandum decisions. Memorandum decisions are reproduced by the government in mimeograph form only. However, RIA publishes RIA (formerly Prentice-Hall) T.C. Memorandum Decisions and Commerce Clearing House makes them available as Tax Court Memorandum Decisions.

Other Sources of the Tax Law

16. Tax treaties. Tax legislation enacted in 1988 provided that neither a tax law nor a tax treaty takes general precedence. If there is a conflict between the Code and a treaty, the most recent item takes precedence.

17. Tax periodicals.

a. Can shorten the research time needed to resolve a tax issue.

WORKING WITH THE TAX LAW—TAX RESEARCH

Commercial Tax Services

18. Loose leaf tax services. A number of publishers provide loose leaf (or other currently supplemented) tax services for practitioners. Some of the major services include:

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a. Research Institute of America's (RIA) *United States Tax Reporter* (formerly P-H's *Federal Taxes*).

b. Commerce Clearing House's (CCH) *Standard Federal Tax Reporter*.

c. RIA's *Federal Tax Coordinator 2d.*

d. *Mertens Law of Federal Income Taxation* (Clark, Boardman, Callaghan).

e. *Federal Income, Gift, and Estate Taxation* (Warren, Gorham and Lamont).

f. Bureau of National Affair's (BNA) *Tax Management Portfolios*. Many of these services are also available electronically.

19. Assessing tax services. In terms of assessing the major tax services, the following points are relevant:

a. Except for arrangement of the subject matter, there is not much difference between CCH's *Standard Federal Tax Reporter* and RIA's *United States Tax Reporter*.

b. RIA's editorial content is generally more detailed than CCH's editorial content. The RIA editorial materials also contain more detailed tax-planning discussions. However, many practitioners feel that rule coverage and case law background are more extensive in CCH.

c. Mertens is an excellent source if the emphasis is on background material for in-depth research. Mertens is, however, difficult reading due to its legalistic style. Also, updating is less frequent than most other services and not as accessible.

d. BNA's *Tax Management Portfolios* (TMPs) comprise a series of monographs on various subjects. As the treatment of a subject usually is exhaustive, a portfolio can serve as a convenient means of familiarizing the reader with the material. Note that portfolios are generally updated on a three-year cycle.

e. In summary, the day-to-day, all-purpose services are CCH and RIA. Mertens and the TMPs are useful for more extensive research and background.

Using Online Tax Services

20. RIA's *Checkpoint* and CCH's *Intelliconnect* are commonly used online tax research services. (Westlaw and Lexis are more commonly used by law firms.) Both services provide access to primary and secondary sources of tax law.

21. Internet. See Exhibit 2.9 in the text.

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22. Key ways to use an online tax service.

    a. Choose keywords for the search carefully.

    b. Take advantage of connectors.

    c. Be selective in choosing a database.

    d. Use a table of contents, index, or citation approach.

Noncommercial Online Tax Services

23. Search Home pages.

24. Search news groups.

25. Definition of research. Tax research is the method whereby one determines the best available solution to a situation that possesses tax consequences. In other words, it is the process of finding a professional conclusion to a tax problem. The problem might originate either from completed or proposed transactions. Tax research involves the following procedures (see Exhibit 2.6 in the text):

    a. Identifying and refining the problem.

    b. Locating the appropriate tax law sources.

    c. Assessing the validity of the tax law sources.

    d. Arriving at the solution or at alternative solutions with due consideration given to nontax factors.

    e. Effectively communicating the solution to the taxpayer or the taxpayer's representative. See Exhibits 2.7 and 2.8 in the text.

        (1) A short review of the fact pattern that raises the issue.

        (2) A clear statement of the research question/issue.

        (3) A review of the pertinent tax law sources (e.g., Code, administrative sources, judicial authority).

        (4) Any assumptions made in arriving at the conclusion.

        (5) The conclusion recommended and the logic or reasoning supporting it.

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(6) The references consulted in the research process.

f. Following up on the solution in the light of new developments.

Identifying the Problem

26. Problem identification must start with a compilation of the relevant facts involved. In other words, all of the facts that may have a bearing on the problem must be gathered.

Refining the Problem

27. Use new facts to refine the tax problem.

Locating the Appropriate Tax Law Sources

28. Once the problem is clearly defined, we index the volume of a hard copy tax service or a keyword search on an online tax service.

Assessing Tax Law Sources

29. Once a source has been located, the next step is to assess it in light of the problem at hand. Proper assessment involves careful interpretation of the tax law with consideration given to its relevance and validity.

30. Interpreting the Internal Revenue Code. This is the greatest challenge for the IRS. The language of the Code is difficult to comprehend fully.

31. Assessing the validity of a Treasury Regulation.

    a. Give the Code equal weight when dealing with taxpayers and their representatives.

    b. Proposed Regulations are not binding.

    c. The burden of proof is on the taxpayer.

    d. If the taxpayer loses the challenge, then a 20% negligence penalty may be imposed.

    e. Final Regulations provide instructions about internal management.

    f. Interpretive Regulations are hard and solid and almost impossible to overturn.

    g. In some Code sections, Congress has given the Treasury Secretary the authority to prescribe Regulations to carry out the details of administration.

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h. Apply the legislative reenactment doctrine.

32. Assessing the validity of other administration sources of the tax law. In any dispute with the IRS on the interpretation of tax law.

33. Assessing the validity of judicial sources of the tax law.

a. The higher the level of the court that issued a decision, the greater the weight accorded to that decision.

b. More reliance is placed on decisions of courts that have jurisdiction in the area where the taxpayer's legal residence is located.

c. A Tax Court Regulator decision carries more weight than a memorandum decision, because the Tax Court does not consider memorandum decisions to be binding.

d. A Circuit Court decision where certiorari has been requested and denied by the U.S. Supreme Court carries more weight than a Circuit Court decision that was not appealed.

e. A decision that is supported by cases from other courts carries more weight than a decision that is not supported by other cases.

f. The weight of a decision also can be affected by its status on appeal.

34. Assessing the validity of other sources.

a. In Notice 90-20, the IRS expanded the list of substantial authority for purposes of the accuracy-related penalty in § 6662 to include a number of secondary materials.

Arriving at the Solution or at Alternative Solutions

Communicating Tax Research

35. A good tax research communication should contain:
- A clear statement of the issue.
- A short review of the facts that raise the issue.
- A review of the pertinent tax law source.
- Any assumptions made in arriving at the solution.
- The solution recommended and the logic or reasoning supporting it.
- The references consulted in the research process.
- It should tell the audience what was researched, the results of the research, and the justification for the recommendation made. (See Exhibits 2.7 and 2.8 in the text.)

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Table 1
Primary and Secondary Tax Law Sources

	Primary	Secondary
Sixteenth Amendment to U.S. Constitution	X	
Tax Treaty	X	
Internal Revenue Code Section	X	
U.S. Supreme Court Decision	X	
U.S. Circuit Court of Appeals Decision	X	
Tax Court Memorandum Decision	X	
Tax Court Regular Decision	X	
U.S. District Court Decision	X	
U.S. Court of Federal Claims Decision	X	
Small Cases Division of U.S. Tax Court	X**	
Final Regulation	X	
Temporary Regulation	X*	
Proposed Regulation	X***	
Revenue Ruling	X	
Revenue Procedure	X	
Senate Finance Committee Report	X	
Bluebook		X
Letter Ruling		X
Technical Advice Memorandum		X
Actions on Decisions		X
Determination Letter		X
Harvard Law Review article		X
Field Service Advice		X
General Counsel Memorandum		X

* Can be outstanding for three years at most.

The categorization of a tax law source as a primary or a secondary source is not black and white. All of the sources categorized as primary in the above table are so categorized because all can be relied on to defend against the application of penalties by the IRS. However, note the following:

** The Tax Court indicates that Small Cases Division opinions should not be used or cited as precedent. As such, these decisions could be categorized as secondary sources.

*** Proposed Regulations are not binding. That is, a taxpayer is not required to follow the guidance in the proposed Regulation unless (or until) the Regulation becomes final. This could lead to the categorization of a proposed Regulation as a secondary source.

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Figure 2-1

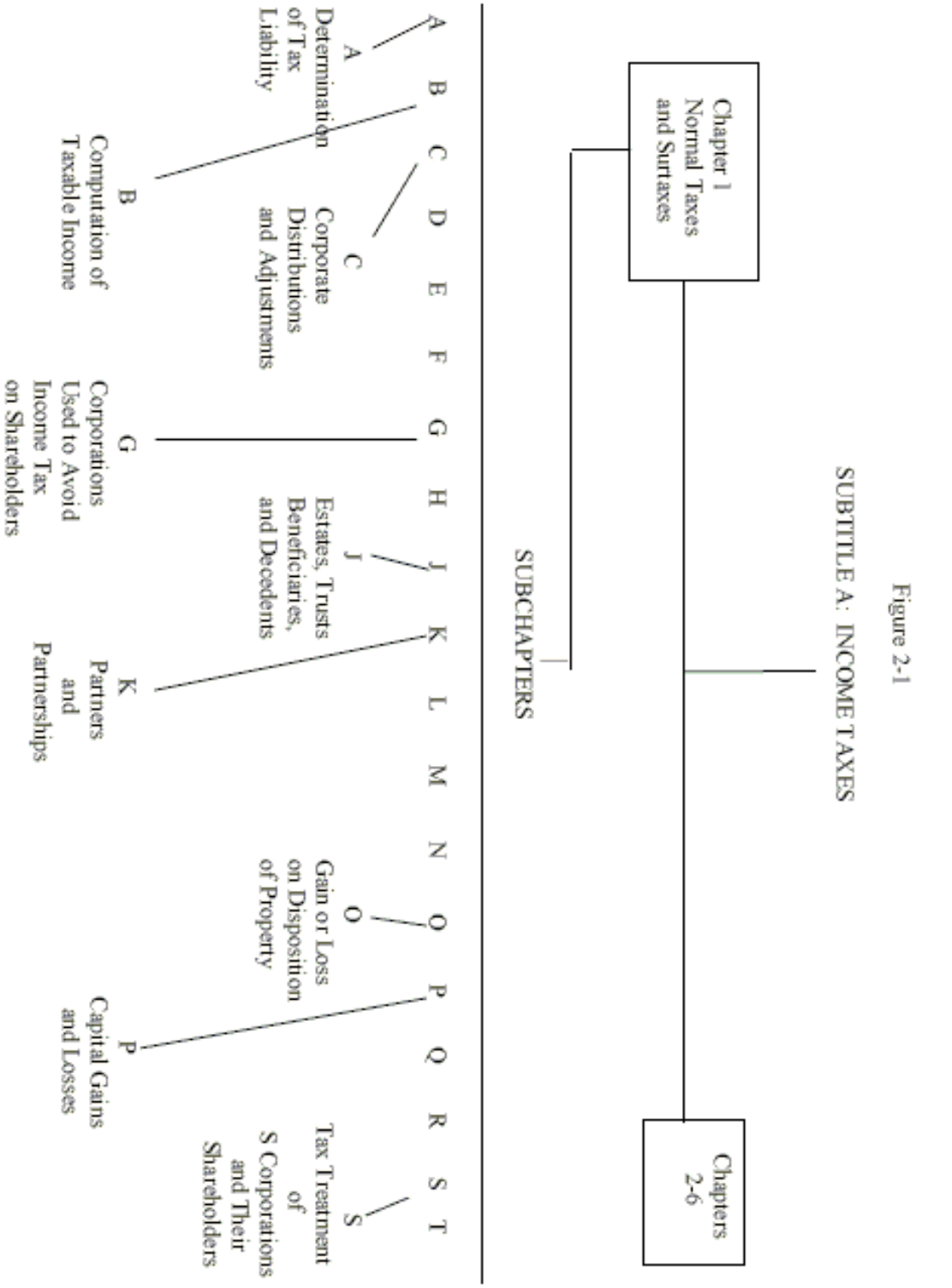

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Figure 2-2
Location of Judicial Sources

	USTC Series	AFTR Series	F.Supp. Series	F.3d Series	Cls.Ct. Series	S.Ct. Series[a]
U.S. District Courts (tax cases)	Yes	Yes	Yes	No	No	No
U.S. Tax Court [b]	No[c]	No[c]	No	No	No	No
U.S. Court of Federal Claims [d] (tax cases)	Yes	Yes	No[e]	Yes[e]	Yes[e]	No
U.S. Courts of Appeal (tax cases)	Yes	Yes	No	Yes	No	No
U.S. Supreme Ct. (tax cases)	Yes	Yes	No	No	No	Yes
U.S. District Courts [f] (all cases)	No	No	Yes	No	No	No
U.S. Courts of Appeal (all cases)	No	No	No	Yes	No	No
U.S. Supreme Court (all cases)	No	No	No	No	No	Yes

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Notes for Figure 2-2:

a Answers also apply to the *United States Supreme Court Reports* (abbreviated U.S.) and to the *United States Reports*, *Lawyers Edition* (abbreviated L.Ed.).

b Regular (not memorandum) decisions are published by the U.S. Government Printing Office (GPO) in *Tax Court of the United States Reports*.

c Both CCH and RIA (formerly P-H) have separate reporters for Regular, Memorandum, and Small Cases Division decisions of the U.S. Tax Court.

d All decisions (both tax and nontax) of the U.S. Court of Federal Claims are published by the U.S. GPO in the *Claims Court Reporter Series*. From 1960 to October 1, 1982, Court of Claims decisions were published in the *Court of Claims Reporter Series*.

e From 1932 to 1960, the Court of Claims decisions were published in the *F.Supp. Series*. Beginning October 1982, the Claims Court decisions are published in the *Claims Court Reporter*. Beginning on October 30, 1992, the Claims Court underwent a further name change. The new designation, U.S. Court of Federal Claims, begins with Volume 27 of the former *Cl.Ct.* (West citation) now abbreviated as *Fed.Cl.*

f "All cases" has reference to nontax as well as tax decisions. Thus, it would include such varied issues as interstate transportation of stolen goods, civil rights violations, and anti-trust suits.

36. Tax research and tax planning are inseparable.
    - The primary purpose of effective tax planning is to reduce the taxpayer's total tax bill.
    - The secondary objective of effective tax planning is to reduce or defer the tax in the current tax year.

Nontax Considerations

37. Tax considerations may impair the exercise of sound business judgment by the taxpayer. The goal should be a balance that recognizes the significance of taxes, but not beyond the point where planning detracts from the exercise of good business judgment.

Components of Tax Planning

38. Avoid the recognition of income.

39. Defer the recognition of income.

40. Convert the classification of income.

41. Choose the business entity with the desired tax attributes.

42. Preserve formalities by generating and maintaining supporting documentation.

43. Act in a manner consistent with the intended objective.

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Tax Avoidance and Tax Evasion

44. Avoidance versus evasion. There is a fine line between legal tax planning and illegal tax planning—tax avoidance versus tax evasion. However, the consequences of the two are as vast as the difference between a lightning bug and lightning.

    a. Tax avoidance. Tax avoidance is merely tax minimization through legal techniques. In this sense, tax avoidance becomes the proper objective of all tax planning.

    b. Evasion. Evasion, while also aimed at the elimination or reduction of taxes, connotes the use of subterfuge and fraud as a means to an end.

Follow-Up Procedures

Tax Planning—A Practical Application

TAX RESEARCH ON THE CPA EXAMINATION

45. The CPA examination has changed from a paper-and-pencil exam to a computer-based exam with increased emphasis on information technology and general business knowledge. The 14-hour exam has four sections, and taxation is included in the three-hour Regulations section.

46. Each exam section includes multiple-choice questions and two other sections that have short task-based simulation questions. The Regulations section is 60% Taxation and 40% Law & Professional Responsibilities.

47. Candidates can learn more about the CPA examination at www.cpa-exam.org. This online tutorial site's topics include:
    - Common tools.
    - Navigation.
    - Form completion.
    - Numeric entry.
    - Research questions.
    - Authoritative literature search.
    - Written communication.

RESEARCH PROBLEMS

Solutions to end-of-chapter Research Problems are located in the Solutions Manual.

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IN-CLASS EXERCISES

Q1. The shareholders of Red Corporation and Green Corporation want assurance that the consolidation of the corporation into Blue Corporation will be a nontaxable reorganization.

Solution:
The proper approach is to request that the National Office of the IRS issue a letter ruling concerning the income tax effect of the proposed transaction.

Q2. Chris operates a barbershop in which he employs eight barbers. To comply with the rules governing income tax and payroll tax withholding, Chris wants to know whether the barbers working for him are employees or independent contractors.

Solution:
The proper procedure is to request a determination letter on their status from the appropriate Area Director.

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1. Identify the correct answer about the purposes of Schedules M–1 and M–3.

	Reconciles Book Income (Loss) with Income per Return	Distinguishes Between Permanent and Temporary Differences
a)	Both Schedule M-1 and Schedule M-3	Neither Schedule M-1 nor M-3
b)	Both Schedule M-1 and Schedule M-3	Schedule M-1 Only
c)	Schedule M-1 Only	Both Schedule M-1 and Schedule M-3
d)	Both Schedule M-1 and Schedule M-3	Schedule M-3 Only

a) Incorrect. Both schedules M-1 and M-3 reconcile a corporation's book income to its taxable income. Schedule M-3, which is for corporations with total assets of $10 million or more, also differentiates between temporary differences and permanent differences, a distinction not made on schedule M-1.
b) Incorrect. Both schedules M-1 and M-3 reconcile a corporation's book income to its taxable income. Schedule M-3, which is for corporations with total assets of $10 million or more, also differentiates between temporary differences and permanent differences, a distinction not made on schedule M-1.
c) Incorrect. Both schedules M-1 and M-3 reconcile a corporation's book income to its taxable income. Schedule M-3, which is for corporations with total assets of $10 million or more, also differentiates between temporary differences and permanent differences, a distinction not made on schedule M-1.
d) Correct! Both schedules M-1 and M-3 reconcile a corporation's book income to its taxable income. Schedule M-3, which is for corporations with total assets of $10 million or more, also differentiates between temporary differences and permanent differences, a distinction not made on schedule M-1.

2. Kelsey Corporation is an accrual-basis, calendar-year domestic corporation which is not part of a consolidated group. In the current tax year, Kelsey recorded over $10 million in gross receipts and ended the year with $9 million in total assets. Which reconciliation schedule—Schedule M–1 or Schedule M–3—should Kelsey file along with its corporate tax return for the current year?

a) Only Schedule M–1 can be filed.
b) Schedule M–3 is required.
c) Depends on how many years the corporation has been in existence.
d) Only Schedule M–1 is required, but Schedule M–3 may be substituted instead.

a) Incorrect. A corporation with total assets of $10 million or more is required to file a schedule M-3 to reconcile its financial statement income to its taxable income. A corporation with total assets of less than $10 million is only required to use schedule M-1 but may substitute schedule M-3 since it provides all of the information in a schedule M-1, just with an additional level of detail, such as differentiating between permanent and temporary differences.
b) Incorrect. A corporation with total assets of $10 million or more is required to file a schedule M-3 to reconcile its financial statement income to its taxable income. A corporation with

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total assets of less than $10 million is only required to use schedule M-1 but may substitute schedule M-3 since it provides all of the information in a schedule M-1, just with an additional level of detail, such as differentiating between permanent and temporary differences.

c) Incorrect. A corporation with total assets of $10 million or more is required to file a schedule M-3 to reconcile its financial statement income to its taxable income. A corporation with total assets of less than $10 million is only required to use schedule M-1 but may substitute schedule M-3 since it provides all of the information in a schedule M-1, just with an additional level of detail, such as differentiating between permanent and temporary differences.

d) **Correct!** A corporation with total assets of $10 million or more is required to file a schedule M-3 to reconcile its financial statement income to its taxable income. A corporation with total assets of less than $10 million is only required to use schedule M-1 but may substitute schedule M-3 since it provides all of the information in a schedule M-1, just with an additional level of detail, such as differentiating between permanent and temporary differences.

3. Indicate for each of the following financial statement items whether it would cause no adjustment or whether its absolute value would be either added to or subtracted from net income per books when computing taxable income on the Schedule M–1.

	Municipal Bond Interest Earned	**Excess of Capital Losses Over Capital Gains**	**Interest Expense Associated with Purchase of Municipal Bonds**
a)	Subtracted from	No adjustment	No adjustment
b)	Added to	No adjustment	Subtracted from
c)	Subtracted from	Added to	Added to
d)	Subtracted from	No adjustment	Added to

a) Incorrect. Municipal bond interest earned is included in financial statement income but must be subtracted since it is not taxable. A corporation may not deduct capital losses in excess of capital gains so, although included in financial statement income, the losses must be added to reconcile to taxable income. Since interest income on municipal bonds is not taxable, interest expense associated with the purchase of the bonds is not deductible. Since it is a deduction from financial statement income, it must be added back to reconcile to taxable income.

b) Incorrect. Municipal bond interest earned is included in financial statement income but must be subtracted since it is not taxable. A corporation may not deduct capital losses in excess of capital gains so, although included in financial statement income, the losses must be added to reconcile to taxable income. Since interest income on municipal bonds is not taxable, interest expense associated with the purchase of the bonds is not deductible. Since it is a deduction from financial statement income, it must be added back to reconcile to taxable income.

c) **Correct!** Municipal bond interest earned is included in financial statement income but must be subtracted since it is not taxable. A corporation may not deduct capital losses in excess of capital gains so, although included in financial statement income, the losses must be added to reconcile to taxable income. Since interest income on municipal bonds is not taxable, interest expense associated with the purchase of the bonds is not deductible. Since

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it is a deduction from financial statement income, it must be added back to reconcile to taxable income.

d) Incorrect. Municipal bond interest earned is included in financial statement income but must be subtracted since it is not taxable. A corporation may not deduct capital losses in excess of capital gains so, although included in financial statement income, the losses must be added to reconcile to taxable income. Since interest income on municipal bonds is not taxable, interest expense associated with the purchase of the bonds is not deductible. Since it is a deduction from financial statement income, it must be added back to reconcile to taxable income.

4. Indicate for each of the following financial statement items whether it would cause no adjustment or whether its absolute value would be either added to or subtracted from net income per books when computing taxable income on the Schedule M–1.

	Premiums Paid on Key Employee Life Insurance	**Excess of Book vs. Tax Depreciation**	**Accrued Warranty Expense**
a)	No adjustment	No adjustment	No adjustment
b)	No adjustment	No adjustment	Subtracted from
c)	Subtracted from	Added to	Subtracted from
d)	Added to	Added to	Added to

a) Incorrect. Premiums paid on key employee life insurance, the excess of book depreciation over tax depreciation, and accrued warranty expense, all reduce financial statement income but are not deductible for tax purposes. As a result, each will be added to financial statement income on schedule M-1 to reconcile to taxable income.

b) Incorrect. Premiums paid on key employee life insurance, the excess of book depreciation over tax depreciation, and accrued warranty expense, all reduce financial statement income but are not deductible for tax purposes. As a result, each will be added to financial statement income on schedule M-1 to reconcile to taxable income.

c) Incorrect. Premiums paid on key employee life insurance, the excess of book depreciation over tax depreciation, and accrued warranty expense, all reduce financial statement income but are not deductible for tax purposes. As a result, each will be added to financial statement income on schedule M-1 to reconcile to taxable income.

d) Correct! Premiums paid on key employee life insurance, the excess of book depreciation over tax depreciation, and accrued warranty expense, all reduce financial statement income but are not deductible for tax purposes. As a result, each will be added to financial statement income on schedule M-1 to reconcile to taxable income.

5. Kookaburra Corporation reports net income per books of $575,000 for the current tax year. Included in this amount are the following items.

Item	Amount
Accrued vacation expense	$50,000
Meals and entertainment expense	40,000
Depreciation expense	35,000
Inventory shrinkage (accrual based on a percentage	5,000

Depreciation reported on the current year tax return is $40,000.

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Considering only the above information, what is Kookaburra Corporation's tax- able income for the current tax year?

a) $655,000
b) $650,000
c) $640,000
d) $645,000

a) Incorrect. Accrued vacation expense of $50,000 and inventory shrinkage based on a percentage of sales of $5,000 are both accrued and deducted for financial statement purposes, but cannot be deducted for tax until they are actually incurred; therefore, they must be added back to financial statement income to calculate taxable income. Only ½ of meals and entertainment expense is deductible for tax purposes, requiring that 50%, or $20,000, also be added back to income, resulting in total increases of $50,000 + $5,000 + $20,000 or S75, 000. Tax depreciation of $40,000 exceeds financial statement depreciation of $35,000 by $5,000, which will result in a ($5,000) adjustment in taxable vs. book income. As a result, taxable income will be financial statement income of $575,000 + $75,000 - $5,000, or $645,000.
b) Incorrect. Accrued vacation expense of $50,000 and inventory shrinkage based on a percentage of sales of $5,000 are both accrued and deducted for financial statement purposes, but cannot be deducted for tax until they are actually incurred; therefore, they must be added back to financial statement income to calculate taxable income. Only ½ of meals and entertainment expense is deductible for tax purposes, requiring that 50%, or $20,000, also be added back to income, resulting in total increases of $50,000 + $5,000 + $20,000 or S75, 000. Tax depreciation of $40,000 exceeds financial statement depreciation of $35,000 by $5,000, which will result in a ($5,000) adjustment in taxable vs. book income. As a result, taxable income will be financial statement income of $575,000 + $75,000 - $5,000, or $645,000.
c) Incorrect. Accrued vacation expense of $50,000 and inventory shrinkage based on a percentage of sales of $5,000 are both accrued and deducted for financial statement purposes, but cannot be deducted for tax until they are actually incurred; therefore, they must be added back to financial statement income to calculate taxable income. Only ½ of meals and entertainment expense is deductible for tax purposes, requiring that 50%, or $20,000, also be added back to income, resulting in total increases of $50,000 + $5,000 + $20,000 or S75, 000. Tax depreciation of $40,000 exceeds financial statement depreciation of $35,000 by $5,000, which will result in a ($5,000) adjustment in taxable vs. book income. As a result, taxable income will be financial statement income of $575,000 + $75,000 - $5,000, or $645,000.
d) **Correct!** Accrued vacation expense of $50,000 and inventory shrinkage based on a percentage of sales of $5,000 are both accrued and deducted for financial statement purposes, but cannot be deducted for tax until they are actually incurred; therefore, they must be added back to financial statement income to calculate taxable income. Only ½ of meals and entertainment expense is deductible for tax purposes, requiring that 50%, or $20,000, also be added back to income, resulting in total increases of $50,000 + $5,000 + $20,000 or S75, 000. Tax depreciation of $40,000 exceeds financial statement depreciation of $35,000 by $5,000, which will result in a ($5,000) adjustment in taxable vs. book income.

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