

Solutions Manual

South-Western Federal Taxation: Taxation of Business Entities

2014 Edition

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CHAPTER 1

INTRODUCTION TO TAXATION

SOLUTIONS TO PROBLEM MATERIALS

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P In Prior Edition</u>
1	LO 1, 2, 5	Effect of state and local taxes on decision making	Unchanged	1
2	LO 1	Proportional and progressive rates contrasted	Unchanged	2
3	LO 2	Ad valorem tax on realty: conversion from tax-exempt to residential status	Unchanged	3
4	LO 1, 6	Adam Smith and canon of convenience	Modified	4
5	LO 2	Use taxes	Unchanged	5
6	LO 2	Excise and general sales taxes compared	Unchanged	6
7	LO 2	Federal gift tax and use of annual exclusions	Unchanged	7
8	LO 2	Conversion of tax-exempt realty to commercial status and effect on ad valorem property tax	Unchanged	8
9	LO 2	Ethics problem	Unchanged	9
10	LO 2	Conversion of tax-exempt realty to commercial status and effect on ad valorem property tax	Unchanged	10
11	LO 2	Avoiding sales tax through use of out-of-state purchase	Unchanged	11
12	LO 2	Severance taxes	Unchanged	12
13	LO 2	Avoiding state or local sales tax through use of out-of-area purchases	New	
14	LO 2	Ad valorem tax on residential property: reasons for variation	New	
15	LO 2	Issue recognition	Unchanged	15
16	LO 3	Income tax formula: individuals and corporations compared	Unchanged	16
17	LO 4, 5	Entity choice	Unchanged	17
18	LO 4, 5	Entity choice	Unchanged	18
19	LO 3, 5	Tax rate determination	Unchanged	19
20	LO 3, 5	Tax rate determination	Unchanged	20
21	LO 2	Ad valorem tax: assessment in terms of revenue Production	Unchanged	21
22	LO 5	Ethics: maintaining inventories	New	
23	LO 6	Ethics: offshore preparation of tax returns	Unchanged	22
24	LO 6	Justification for various tax provisions	Modified	24
25	LO 6	Justification for various tax provisions	Modified	25

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P In Prior Edition</u>
26	LO 2	Internet activity	Unchanged	26
27	LO 2	Internet activity	Unchanged	27
28		Internet activity	Unchanged	28
29		Internet activity	Unchanged	29
30		Internet activity	Unchanged	30
31	LO 5	Wherewithal to pay concept illustrated: Involuntary conversion	New	
Bridge				
Discipline				
<u>Problem</u>				
1		Bridge to Economics	Unchanged	1
2		Bridge to Economics	Unchanged	2
3		Bridge to Ethics and Equity	Unchanged	3
4		Bridge to Ethics and Equity	Unchanged	4
5		Bridge to Economics	Unchanged	5
6		Multiple justification for several tax provisions	Modified	23

PROBLEMS

1. Some tax considerations James should investigate include the following:
 - State and local income taxes.
 - State and local sales taxes.
 - State and local property taxes.Many such taxes could affect any cost-of-living differential. pp. 1-5, 1-11, and 1-14
2. 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. pp. 1-2 and 1-3
3.
 - a. The parsonage probably was not listed on the property tax rolls since 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.p. 1-11
4. As to Adam Smith's canon on *economy*, the Federal income tax yields a mixed result. From the standpoint of the IRS, economy is there as collection costs are nominal (when compared to revenue generated). Economy is not present, however, if one looks to the compliance effort and costs expended by taxpayers. Digging Deeper 1
5. 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. p. 1-6 and Example 4
6. 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 non-food 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.pp. 1-5 and 1-6
7. $16 \text{ (donees)} \times \$14,000 \text{ (annual exclusion)} \times 10 \text{ years} = \$2,240,000$. p. 1-10 and Example 13
8. Because the property is no longer being used for religious purposes, the downtown location should no longer be exempt from ad valorem taxes. Also, the church would have an income tax problem (unrelated business income) with the lease payment it receives. p. 1-11

9. In all probability, the residence was not on the property tax rolls when it was owned by a tax-exempt organization (i.e., St. Matthew's Catholic Church)—see p. 1-11 in the text. Also clear is the fact that the taxing authority is not aware that the residence is no longer owned by a tax-exempt organization.

Since it is only a question of time before the omission is noticed by the taxing authority, it would be advisable for the Toths to get the matter cleared up. In many cases, further delay can lead to additional interest and penalties. p. 1-11

10. 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. p. 1-11
11. Eileen may have avoided the sales tax but she will be vulnerable to the Wyoming use tax. This tax will be imposed when Wyoming discovers she has not paid its sales tax—probably when she registers the car in Wyoming. See the discussion in connection with Example 4. pp. 1-5 and 1-6
12. Severance taxes are imposed on the extraction of natural resources. Particularly with high prices on such commodities as oil and coal, the revenue from severance taxes will increase. p. 1-14
13. a. Jackson County must be in a state that imposes a lower (or no) sales tax. With certain major purchases (i.e., "big ticket" items), any use tax imposed by the state of their residence could come into play.
- b. In some states, the sales tax rate can vary depending on the county and/or city.
- p. 1-5
14. A possible explanation could be that Sophia made capital improvements (e.g., added a swimming pool) to her residence while her parents became retirees (e.g., reached age 65). p. 1-11
15. Earl probably purchased his computer out of state by use of a catalog or through the Internet. In such cases, state collection of the sales (use) tax is improbable without taxpayer compliance. pp. 1-5 and 1-6
16. Corporations cannot claim the standard deduction (or itemized deductions) and exemptions (personal and dependency). Thus, the intermediate designation of adjusted gross income (AGI) is not necessary. All allowable deductions of a corporation fall into the business-expense category. In effect, therefore, the taxable income of a corporation is the difference between gross income (net of exclusions) and deductions. p. 1-15

17.

Smith, Raabe, and Maloney, CPAs
5191 Natorp Boulevard
Mason, OH 45040

February 25, 2013

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 regular "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 regular "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 regular "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

pp. 1-17 to 1-19

18. a.	2013	2014	2015
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	<u>\$ 95,000</u>	<u>\$242,000</u>	<u>\$465,000</u>
Corporate Tax Liability	<u>\$ 20,550</u>	<u>\$ 77,630</u>	<u>\$158,100</u>
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	<u>\$104,450</u>	<u>\$192,370</u>	<u>\$361,900</u>
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	<u>\$ 88,782</u>	<u>\$163,514</u>	<u>\$307,615</u>
PV of Cash Flow*	<u>\$ 80,712</u>	<u>\$135,128</u>	<u>\$231,111</u>
Present Value	<u>\$446,951</u>		

*Present value factors (.9091, .8264, .7513) from Appendix F.

b.	2013	2014	2015
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	<u>\$ 95,000</u>	<u>\$242,000</u>	<u>\$465,000</u>
Individual Tax Liability**	<u>\$ 33,250</u>	<u>\$ 84,700</u>	<u>\$162,750</u>
**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	<u>\$ 91,750</u>	<u>\$185,300</u>	<u>\$357,250</u>
PV of Cash Flow	<u>\$ 83,410</u>	<u>\$153,132</u>	<u>\$268,402</u>
Present Value	<u>\$504,944</u>		

- 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 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 incorporating, since only the corporate tax will be incurred (\$256,280), which is less than her

individual tax (\$280,700). The value of her stock will increase and she can then sell the stock at a later date at favorable capital gains rates.

pp. 1-14 and 1-15

19. Without the new product line, Palmer would offset all of its 2013 and 2014 income with the NOL carryforward and would have no regular tax liability until 2014. With the new product line, Palmer would have taxable income of \$20,000 (\$50,000 income – \$30,000 NOL carryforward) in 2014. That is, all \$70,000 of 2013 income would be offset by the NOL carryforward and \$30,000 of the 2014 income would be offset. Assuming no changes in corporate tax rates, Palmer would face a 0% tax rate in 2013 and a 15% tax rate in 2014 if the new product line were chosen versus a 0% tax rate if the line were not chosen. The tax rate faced in 2014 in the new product line would be the discounted value of the 15% rate over one year. For example, assuming a 10% discount rate, the tax rate would be 13.6% ($15\%/1.1$). pp. 1-27, 1-28, and Example 35
20. 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% ($\$24,200/\$120,000$). pp. 1-27, 1-28, and Example 34
21.
 - 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.

pp. 1-12 and 1-13

22. Particularly in Mason's case where the business carries a large assortment of medical equipment and supplies, the use of inventories is necessary. Otherwise, it is not possible to clearly reflect the income of any one year. Although the misstatement of income of one year may be offset by the results of the following year—Mason's rationalization—taxes are based on a one year period. p. 1-32
23. The practice of outsourcing the preparation of tax returns is ethical if three steps are taken.
 - Maintain client confidentiality.
 - Verify the accuracy of the work done.
 - The client should be notified, preferably in writing, of the outsourcing.

See Global Tax Issues on p. 1-30.

24. 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 global warming. p. 1-29
- b. Economic justification. See the comments under part a. above. p. 1-29
- c. Equity considerations—to alleviate the effect of multiple taxation of the same income. p. 1-31
- d. Administrative feasibility. The limitation reduces the number of casualty and theft losses that can be claimed and thereby eases the audit burden on the IRS. p. 1-34
- e. Economic justification. Research and development activities are encouraged by allowing immediate or faster write-off of these expenditures. p. 1-29
- 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 will also encourage job growth. p. 1-29
- 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. p. 1-31
- 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. p. 1-29
25. a. Social considerations explain the credit. It is socially desirable to encourage parents to provide care for their children while they work. p. 1-31
- 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. pp. 1-29 and 1-31
- 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. pp. 1-31 and 1-32
- 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. p. 1-31
- e. The NOL carryback provision is an equity consideration that is designed to mitigate the effect of the annual accounting period concept. p. 1-31 and Example 35
- 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. p. 1-32

- 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.
p. 1-32
 - 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.
p. 1-32
26. 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 web sites 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.
27. See the Internet Activity comment above.
28. See the Internet Activity comment above.
29. See the Internet Activity comment above.
30. See the Internet Activity comment above.
31.
 - a. Mia's realized gain from the condemnation is \$320,000 [\$400,000 (amount of award) – \$80,000 (cost basis of the warehouse)]. However, her recognized gain is limited to \$120,000—the amount received that was not reinvested.
 - b. None of the gain is recognized because Mia reinvested the full amount of the condemnation award.
 - c. As none of the gain was reinvested, the full \$320,000 is recognized as income.
 - d. The involuntary conversion provision can be justified under the wherewithal to pay concept and the notion that the taxpayer's economic position has not changed. In part b., for example, Mia has retained none of the award and has reinvested in property similar to that taken by the city.
- p. 1-32

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 pay-off 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. The student should choose the Pro or Con position and present arguments accordingly.

PRO

- The U.S. government needs additional revenues.
- The U.S. government needs a new revenue source, as the income tax cannot be expanded meaningfully much beyond its current condition, in a political and economic sense.
- A transaction tax is simple and easy to enforce.
- A transaction tax is difficult to cheat on.
- “The rest of the world” already uses the VAT, so statutory and administrative difficulties have been ironed out by the other countries.

CON

- Transaction taxes can be regressive as to income.
- Transaction taxes do not always track to the taxpayer’s ability to pay.
- Transaction taxes actually are paid by the ultimate consumer of the good or service, so it is misleading to collect the tax prior to the final sale.
- Political and business forces in the U.S. will keep the VAT from being adopted.
- Even though the initial VAT rate will be low, politicians will increase it significantly in the future.

Other comments might address the willingness of politicians to adopt a new tax, as they might see such an action as jeopardizing their re-election chances. A chart or map should be included as one of the slides, to show the pervasiveness of the VAT around the world.

6.
 - 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). pp. 1-29 and 1-31
 - 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. pp. 1-29 and 1-31
 - c. The encouragement of home ownership can be justified on both social and economic grounds. pp. 1-29 and 1-31

Notes

CHAPTER 2

WORKING WITH THE TAX LAW

SOLUTIONS TO PROBLEM MATERIALS

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
1	LO 1	Precedents of Courts	Unchanged	1
2	LO 1, 3	Treaties	Modified	2
3	LO 1	Joint Conference Committee	Unchanged	3
4	LO 1	Regulations, revenue rulings, revenue procedures, letter rulings	Unchanged	4
5	LO 1, 2	Authority	Unchanged	5
6	LO 1	Regulations	Modified	6
7	LO 1	Citations	Modified	7
8	LO 1	Small Cases Division	Unchanged	8
9	LO 1	U.S. District Court	Modified	9
10	LO 1, 3	Judicial alternatives: trial courts	Modified	10
11	LO 1	Judicial system	Unchanged	11
12	LO 1	Tax Court and appeal process	Unchanged	12
13	LO 1	Trial Courts	Unchanged	13
14	LO 1	Circuit Court of Appeals	Modified	14
15	LO 1	Petitioner	Modified	15
16	LO 1, 2	Court decision validity	Unchanged	16
17	LO 1	Tax Court Regular and Memorandum Tax decisions	Unchanged	17
18	LO 1	Abbreviations	Unchanged	18
19	LO 2	Citations	Modified	19
20	LO 2	Citations	Unchanged	20
21	LO 2	Court of Federal Claims	Unchanged	21
22	LO 2	Cumulative Bulletin	Modified	22
23	LO 2	Citations	Unchanged	23
24	LO 2, 4	Tax research	Modified	24
25	LO 1, 2	Judicial system	Unchanged	25
26	LO 1	Judicial system	Unchanged	26

<u>Question/ Problem</u>	<u>Learning Objective</u>	<u>Topic</u>	<u>Status: Present Edition</u>	<u>Q/P in Prior Edition</u>
27	LO 1, 2	Citations	Unchanged	27
28	LO 1, 2	Tax sources	Modified	28
29	LO 1	Subchapters	Modified	29
30	LO 1, 2	Location of Revenue Procedures	Modified	30
31	LO 1, 2	Citation	New	
32	LO 1	Appeal to U.S. Supreme Court	Unchanged	32
33	LO 2	Ethics problems	Unchanged	33
34	LO 1, 4	Internet activity	Unchanged	34
35	LO 2, 3	Code citations	Unchanged	35

Bridge
Discipline
Problem

1	Sources of federal tax law	Unchanged	1
2	Tax legislation	Unchanged	2
3	Regulation of tax profession	Unchanged	3
4	Ethics Problem	Unchanged	4

Research
Problem

1	Search for court decision	New	
2	Citations	Unchanged	2
3	Citations	Unchanged	3
4	Subchapters	Unchanged	4
5	Citations	Modified	5
6	Locating article in a journal	New	6
7	Tax Court small cases division	Unchanged	7
8	Locating a decision	Unchanged	8
9	Library research	Unchanged	9
10	Reliability	Modified	10
11	Internet activity	Unchanged	11
12	Internet tax research	Unchanged	12
13	Internet activity	Unchanged	13

PROBLEMS

1.
 - 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.

p. 2-14 and Figures 2.3 and 2.4

2.

Smith, Raabe, and Maloney, CPAs
5191 Natorp Boulevard
Mason, OH 45040

March 22, 2013

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 U.S. 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 French 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

p. 2-6

3. When the Senate version of a tax bill differs from that passed by the House, the Joint Conference Committee, which includes members of both the House Ways and Means Committee and the Senate Finance Committee, is called upon to resolve these differences. The result, usually a compromise of the two versions, is then voted on by both the House and the Senate. pp. 2-3 and 2-4
4.
 - 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. pp. 2-7 to 2-9
 - 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. p. 2-9
 - 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. p. 2-9
 - 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. p. 2-10
5. 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 Proposed Regs.).
 - (3) Revenue Ruling.
 - (4) Interpretive Regulation.
 - (5) Legislative Regulation.
 - (6) Internal Revenue Code.

pp. 2-7 to 2-11, 2-22 to 2-24, and Exhibit 2.1

6. Since Regulations interpret the Code, they are arranged in the same sequence as the Code. Regulations are prefixed by a number that designates the type of tax or administrative, procedural, or definitional matter to which they relate. These Regulations would be cited as follows with subparts added for further identification. The subparts have no correlation with the subsections in the Code.

- a. Reg. § 1.152.
- b. Prop. Reg. § 1.274.
- c. Temp. Reg. § 1.163.

pp. 2-7 and 2-8

7. a. A Temporary Regulation, with 1 referring to the type of Regulation (i.e., income tax), 956 is the related Code section number, 2 is the subsection 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.

pp. 2-7 to 2-10

8. a. No. There is no appeal from the Small Cases Division.
- b. No. Deficiency cannot exceed \$50,000.
- c. Yes.
- d. No. Decisions are not published.
- e. Yes.
- f. Yes.

pp. 2-11 and 2-12

9. The main advantage of the U.S. Court of Federal Claims occurs when a taxpayer's applicable Circuit Court previously has rendered an adverse decision. Such a taxpayer may select the U.S. Court of Federal Claims, since any appeal will be to the Federal Circuit.

One disadvantage of the U.S. Court of Federal Claims is that the tentative deficiency first 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.

pp. 2-12, 2-13, and Concept Summary 2.1

10. Smith, Raabe, and Maloney, CPAs
5191 Natorp Boulevard
Mason, OH 45040

July 8, 2013

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 possible 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 first 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 has rendered an adverse decision. Such a taxpayer may select the Court of Federal Claims, since any appeal instead will be to the Federal Circuit. One disadvantage of the Court of Federal Claims is that the tentative deficiency first 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

p. 2-12 and Concept Summary 2.1

11. See Figure 2.3 and the related discussion.
- 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. pp. 2-11 and 2-12
 - The first appeal would be to the Sixth Court of Appeals. Further appeal would be to the U.S. Supreme Court. pp. 2-13, 2-14, and Figure 2.4
 - Same as b. above. p. 2-13 and Figure 2.4
 - The appeal would be to the Federal Circuit and then to the U.S. Supreme Court. p. 2-13 and Figure 2.4
12. There could be numerous reasons why the IRS may decide not to appeal a case that it loses in the U.S. Tax Court. The failure to appeal, therefore, does not necessarily mean that the IRS agrees with any result that was reached therein. p. 2-13
- 13.
- | | <u>U.S.
Tax
Court</u> | <u>U.S.
District
Court</u> | <u>U.S. Court
of Federal
Claims</u> |
|---|-------------------------------|------------------------------------|---|
| a. Number of regular judges | 19 | 1 | 16 |
| b. Jury trial | No | Yes | No |
| c. Prepayment of deficiency required before trial | No | Yes | Yes |

Concept Summary 2.1

- 14.
- 10th.
 - 8th.
 - 9th.
 - 5th.
 - 7th.
- p. 2-14 and Figure 2.4
15. The term “petitioner” is a synonym for plaintiff, which refers to the party requesting action in a court. p. 2-11
- 16.
- If the taxpayer chooses a U.S. District Court as the trial court for litigation, the U.S. District Court of Wyoming would 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. pp. 2-13 and 2-23
 - If the taxpayer chooses the U.S. Court of Federal Claims as the trial court for litigation, the decision that previously was rendered 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 would 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. pp. 2-13 and 2-23

- 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. Since the taxpayer lives in California, however, any appeal from a U.S. District Court or the U.S. Tax Court would go to the Ninth Circuit Court of Appeals (see Figure 2.3). 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. pp. 2-14, 2-23, and Figure 2.4
 - d. In that 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. pp. 2-14, 2-23, and Figure 2.3
 - 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. p. 2-15
 - 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. p. 2-16
17. 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 web site. 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 Internet web site.
- pp. 2-15 and 2-16

18. a. CA-2. An abbreviation that designates the U.S. Second Circuit Court of Appeals. p. 2-17
- 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. p. 2-17
- c. *aff'd*. An abbreviation for “affirmed,” which indicates that a lower court decision was affirmed (approved of) on appeal. p. 2-13
- d. *rev'd*. An abbreviation for “reversed,” which indicates that a lower court decision was reversed (disapproved of) on appeal. p. 2-13
- e. *rem'd*. An abbreviation “remanded,” which indicates that a lower court decision is being sent back by a higher court for further consideration. p. 2-13
- f. *Cert. denied*. The *Writ of Certiorari* has been denied by the U.S. Supreme Court. This means that the Court will not accept an appeal from a lower court and, therefore, will not consider the case further. p. 2-14
- g. *Acq.* An abbreviation for “acquiescence” (agreement). The IRS follows a policy of either acquiescing or nonacquiescing to certain court decisions. p. 2-15
- 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. p. 2-15
- i. USTC. U.S. District Court, U.S. 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. p. 2-16
- j. AFTR. See the solution to i. above. p. 2-16
- k. F.3d. All of the decisions (both tax and nontax) of the U.S. Claims Court (before October 1982) and the U.S. 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). p. 2-16
- 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.). p. 2-16
- m. USSC. An abbreviation for the U.S. Supreme Court. p. 2-17
- n. S.Ct. West Publishing Company publishes all of the U.S. Supreme Court decisions in its *Supreme Court Reporter* (S.Ct.). p. 2-17
- o. D.Ct. An abbreviation for a U.S. District Court decision. p. 2-16

19. 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.
- pp. 2-15 to 2-18
20. 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. pp. 2-15 to 2-18
- 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. pp. 2-15 to 2-18
- 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. pp. 2-15 to 2-18
- 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. pp. 2-15 to 2-18
- 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. pp. 2-15 to 2-18
21. Decisions of the U.S. Court of Federal Claims (formerly named the Claims Court) are published in the USTCs, AFTRs, and the West Publishing Company reporter called the Federal Reporter, Second Series (F.2d) (before October 1982), and Claims Court Reporter (beginning October 1982 through October 30, 1992). The name of the U.S. Court of Federal Claims was changed from the Claims Court effective October 30, 1992. Currently, this court's decisions are published in the Federal Claims Reporter. p. 2-16

22. a. Yes. Exhibit 2.1
- b. No. Not published. pp. 2-11
- c. No. Published by private publishers. Exhibit 2.1
- d. Yes. Exhibit 2.1
- e. Yes. Exhibit 2.1
- f. No. p. 2-16
- g. Yes, when major tax legislation has been enacted by Congress. p. 2-16
- h. Yes. p. 2-16
23. a. The U.S. Tax Court. p. 2-15
- b. Yes, the appellate court affirmed, or agreed with, the trial court. p. 2-13
- c. United Draperies, Inc., the taxpayer. p. 2-11
- d. Yes, in effect, by issuing cert. denied to the appellate court decision (refusing to hear the decision). p. 2-15
24. After understanding the relevant facts:
- Yvonne may begin with the index volumes of the available tax services: RIA, CCH, BNA Portfolios, etc.
 - A key word search on an online service could be helpful—WESTLAW, LEXIS, CCH, and RIA Checkpoint.
 - Yvonne may employ a key word search of a CD-ROM and browse through a tax service, IRS publications, etc. West Publishing, CCH, Kleinrock, and RIA offer CD-ROM products.
 - Yvonne could consult CCH's Federal Tax Articles to locate current appropriate articles written about child support payments. RIA's Tax Service also has a topical "Index to Tax Articles" section that is organized using the RIA 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 World Wide Web feature of the Internet. Various legal, accounting, and financial gateways can be found by clicking on highlighted words or phrases.

pp. 2-18 to 2-25

25. 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. p. 2-12 and Figure 2.4
- 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. pp. 2-11, 2-12, and Figure 2.3
- 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. p. 2-15
- 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). pp. 2-13 to 2-16, Figures 2.3 and 2.4, and Concept Summary 2.1
- e. Few tax decisions reach the U.S. Supreme Court. The U.S. Supreme Court must agree to hear a court case. p. 2-14
26. a. T. Concept Summary 2.1
- b. C (before October 1982) and A. p. 2-16
- c. D, C, A, and U. pp. 2-16
- d. D, C, A, and U. pp. 2-16
- e. U. p. 2-14
- f. C and U. pp. 2-14 and 2-16
- g. D. Concept Summary 2.1
- h. D, T, and C. Figure 2.3
- i. A and U. Figure 2.3
- j. C. Concept Summary 2.1 and Figure 2.3
- k. T. p. 2-12 and Figure 2.3
- l. T. Concept Summary 2.1

27. 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.

pp. 2-15 to 2-18

28. a. P.
b. P.
c. P.
d. S.
e. P.
f. S.
g. P. Valid for 3 years.
h. P.
i. N.
j. P.

pp. 2-22 to 2-24

29. b. p. 2-5
30. b. Exhibit 2.1
31. 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. p. 2-15
32. 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). p. 2-14

33. 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 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. pp. 2-18 and 2-19

34. 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 web sites 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.

p. 2-16 and www.ustaxcourt.gov

35. 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 PROBLEM

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.

- 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. Chapter 1

RESEARCH PROBLEMS

1.
 - a. In a Tax Court Memorandum decision, the court upheld the IRS's methods of income reconstruction and imposed a civil fraud penalty.
 - b. A proposal merger between members of an affiliated group qualified for tax-free reorganization treatment under § 355.
 - c. The IRS issued a nonacquiescence 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.
4.
 - a. Subchapter B covers "Computation of Taxable Income."
 - b. Subchapter D covers "Deferred Compensation."
 - c. Subchapter F covers "Tax-Exempt Organizations."
 - d. Subchapter K covers "Partnership and Partners."
 - e. Subchapter P covers "Capital Gain and Losses."
5.
 - a. Higgens v. Comm., 312 U.S. 212 (1941).
 - b. Talen v. U.S. 355 F.Supp. 2d 22 (D. D. C., 2004).
 - c. Rev. Rul. 2008-18, 2008-13 IRB 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., TC Memo. 2001-284.

6. The title of the article is “Reporting Dilemma: Personal Use of Rental Properties” on pages 326 to 328. According to Prop. Reg. Sec. 1. 280A-1(d), the personal use rules supersede the fair rental rules.

7. 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 a 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 previously litigated 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 estop a party from litigating the same issue in a regular Tax Court case. So 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.”

8. 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.
- 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.

9. 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 quasimartial 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 AFTR2d 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 16 for a general discussion of personal and dependency exemptions.

10. As for the World Furniture Mall promotion, the discount or rebate could be tax free since a rebate of all or a portion of the purchase price of property generally does not result in gross income. The customer would have a zero basis in the furniture. Rev. Rul. 76-96, 1976-1 C.B. 23 and Rev. Rul. 88-95, 1988-2 C.B. 28. See "Furniture for Nothing and It's all Tax-Free," Journal of Taxation, December 2006, pp. 382 and 383.

11. 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 web sites 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.

12. See the Internet Activity comment above.

13. See the Internet Activity comment above.