South Western Federal Taxation 2022 Comprehensive 45th edition Young Solutions Manual

SKU: 9780357511015-SOLUTIONS

CHAPTER 1

AN INTRODUCTION TO TAXATION AND UNDERSTANDING THE FEDERAL TAX LAW

SOLUTIONS TO PROBLEM MATERIALS

DISCUSSION QUESTIONS

1. (LO 1) Various answers are possible, including using the Key Terms at the end of each chapter, referring to the Glossary (Appendix C), looking up the footnote resources to the Internal Revenue Code in Appendix D, using chapter features (e.g., Global Tax Issues, Ethics & Equity, Tax Planning, and Framework 1040), examining the tax forms used in the chapters, and completing additional end-of-chapter assignments. All of these resources will help students engage more deeply with the materials and help their understanding.

2. (LO 1, 4)
   a. John must now document rental receipts and separate his home expenses between personal and rental use, and he may be subject to the transient occupancy tax.

   b. Theresa has become self-employed. Now she will be subject to self-employment tax and may have to make quarterly installment payments of estimated income and self-employment tax. Theresa will be required to make payroll tax payments if she hires individuals to work in her business.

   c. Paul's employer might have some moving expenses that it can deduct (in general, Paul cannot deduct moving expenses). Paul's personal taxes will change because Florida does not impose an income tax but California does.

3. (LO 1, 4) The income tax consequences that result are Marvin's principal concern. Any rent he receives is taxed as income, but operating expenses and depreciation will generate deductions that offset some or all of the income or even yield a loss. Marvin must also consider the effect of other taxes. Because the property is being converted from residential to commercial use, he can expect an increase in the ad valorem property taxes levied by the local (and perhaps even the state) taxing authorities. Besides the real estate taxes, personal property taxes could be imposed on the furnishings.

4. (LO 2) To finance our participation in World War II, the scope of the income tax was expanded considerably—from a limited coverage of 6% to over 74% of the population. Hence, the description of the income tax as being a "mass tax" became appropriate.

5. (LO 2) For wage earners, the tax law requires employers to withhold a specified dollar amount from wages paid to the employee to cover income taxes and payroll taxes. Persons with nonwage income generally are required to make quarterly payments to the IRS for estimated taxes. Both procedures ensure that taxpayers will be financially able to meet their annual tax liabilities. That is, the amounts withheld are meant to prepay the employee's income taxes and payroll taxes related to the wages earned.

6. (LO 3) The tax law of this state appears to violate the *certainty* and *simplicity* principles.

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7. (LO 3) A tax is *regressive* if it represents a larger percentage of the income of a low-income taxpayer relative to the income of a high-income taxpayer. Examples of regressive taxes include sales and excise taxes. A tax is *progressive* if it represents a larger percentage of the income of a high-income taxpayer relative to the income of a low-income taxpayer. The Federal income tax is an example of a progressive tax.

8. (LO 4)
   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 may eliminate *future* interest and penalties.

9. (LO 4) Although the Baker Motors bid is the lowest, from a long-term financial standpoint, it is the best. The proposed use of the property by the state and the church probably will make it exempt from the school district's ad valorem tax. This would hardly be the case with a car dealership. In fact, commercial properties (e.g., car dealerships) often are subject to higher tax rates.

10. (LO 4)
   a. In this case, the "tax holiday" probably concerns exemption from ad valorem taxes. "Generous" could involve an extended period of time (e.g., 10 years) and include both realty and personalty.

   b. The school district could be affected in two ways. First, due to the erosion of the tax base, less revenue would be forthcoming. Second, new workers would mean new families and more children to educate.

11. (LO 4) A possible explanation is that Sophia made capital improvements (e.g., added a swimming pool) to her residence and her parents became retirees (e.g., reached age 65).

12. (LO 4) Presuming that the dockage facilities are comparable in Massachusetts, the Morgans may be trying to avoid ad valorem taxes. Taxes on nonbusiness property vary from one state to another and are frequently avoided.

13. (LO 4) In general, Federal excise taxes apply to fewer items than in the past. Lawmakers have focused on and increased certain Federal excise taxes (e.g., those on tobacco products, gasoline, and air travel).

14. (LO 4) Jayla could have been overcharged, but it is likely that at least part of the excess is attributable to a hotel occupancy tax and a car rental tax. In major cities, these types of excise taxes have become a popular way of financing capital improvements such as sports arenas and stadiums. Consequently, the amount of the taxes could be significant.

15. (LO 4) An *excise tax* is limited to a particular transaction (e.g., sale of gasoline), whereas a general *sales tax* covers a multitude of transactions (e.g., sale of all nonfood goods).

   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.

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16. (LO 4)
    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 the Garcías' residence could come into play.

    b. In some states, the sales tax rate varies depending on the county and/or city.

    Note: Generally, buyers are subject to the sales and use tax rate where they live. For example, if the Garcías buy goods in a different state with a zero or lower sales tax rate than in their state, they owe use tax to their home state for the difference.

17. (LO 4) Caleb probably purchased his computer out of state through a catalog or via the internet. In such cases, state collection of the sales (use) tax is not likely. Caleb needs to pay use tax on his own (which is equal to the sales tax).

18. (LO 4) If the tax is imposed on the right to pass property at death, it is classified as an estate tax. If it taxes the right to receive property from a decedent, it is termed an inheritance tax.

    a. Some states impose both an estate tax and an inheritance tax. Some states (e.g., Florida and Texas) levy neither tax.

    b. The Federal government imposes an estate tax.

19. (LO 4) Jake either has a severe misunderstanding as to the rules regarding transfer taxes or is lying to Jessica to delay any parting with his wealth. The marital deduction allows interspousal transfers (whether by gift or at death) free of any tax (either gift or estate). As a result, in the case of spousal transfers, there is no tax reason to prefer transfers at death over lifetime gifts.

20. (LO 4)
    a. The purpose of the unified transfer tax credit is to eliminate the tax on all but substantial gifts and estates.

    b. Yes. The credit for 2021 is $4,625,800; for 2020, it is $4,577,800.

    c. Yes. The credit is available to cover transfers by gift or by death (or both), but the amount can be used only once.

21. (LO 4) $570,000. 19 donees (5 married children + 5 spouses + 9 grandchildren) × $15,000 (annual exclusion for 2021) × 2 donors (Elijah and Anastasia) = $570,000.

22. (LO 4) The individual income tax is progressive in nature; the corporate income tax is assessed at a flat 21% rate. In addition, the corporate income tax does not make any distinction as to deductions—only business deductions are allowed. Nor does it require the computation of adjusted gross income (AGI) or provide for the standard deduction and the deduction for qualified business income.

23. (LO 4)
    a. For state income tax purposes, "piggyback" means making use of what was done for Federal income tax purposes. By "decoupling," a state decides not to allow a particular Federal provision (e.g., exclusion, deduction, credit) for state income tax purposes.

    b. States often use IRS audit results to identify errors that might also exist on the taxpayer's state tax return.

    c. Most states allow their residents some form of tax credit for income taxes paid to other states.

24. (LO 4) What happened here likely is not a coincidence. The IRS probably notified the state of California regarding Hernando's omission of income, and California followed up with its own audit.

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25. (LO 4) If Mike is drafted by a team in one of the listed states, he will escape state income tax on income earned within that state (e.g., training camp, home games). He will not, however, escape the income tax (state and local) imposed by jurisdictions where he plays away games. Called the "jock tax," it is applied to out-of-state athletes and entertainers.

26. (LO 4, 5)
    a. This type of question has no relevance to the state income tax, but is a reminder to individual taxpayers about the use tax and a simple way for individual taxpayers to pay any use tax due on internet and mail-order purchases. Without the line on the state income tax return, individual taxpayers would be required to file a separate use tax return.

    b. As the preparer of the state income tax return, you should not leave questions unanswered unless there is a good reason for doing so. It appears that Hannah has no justifiable reason.

27. (LO 4) The checkoff boxes add complexity to the return and mislead taxpayers into presuming that they are not paying for the donation.

28. (LO 4)
    a. They uncover taxpayers who were previously unknown to the taxing authority. In addition, amnesty programs can bring taxpayers who are not in compliance with tax laws into compliance.

    b. Amnesty provisions can apply to other than income taxes (e.g., sales, franchise, severance).

    c. No general amnesty program has been offered for any Federal taxes.

29. (LO 4)
    a. FICA offers some measure of retirement security, and FUTA provides a modest source of income in the event of loss of employment.

    b. FICA is imposed on both employer and employee, while FUTA is imposed only on the employer.

    c. FICA is administered by the Federal government. FUTA, however, is handled by both the Federal and state government.

    d. This applies only to FUTA. The merit system rewards employers who have low employee turnover because this reduces the payout of unemployment benefits.

30. (LO 4)
    a. Unlike the Social Security portion of FICA, there is no dollar limit on the imposition of the Medicare tax.

    b. The 0.9% Medicare addition applies to taxpayers with wages or net self-employment income in excess of $200,000 ($250,000 for married filing jointly).

31. (LO 4) Only children under age 18 are excluded from FICA. Other family members, including spouses, must be covered.

32. (LO 4)
    a. Severance taxes are transaction taxes that are based on the notion that the state has an interest in its natural resources. The tax is imposed on the extraction of minerals.

    b. Franchise taxes are levied on the right to do business in the state. Typically, they are imposed on corporations and are based on their capitalization.

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c. Occupational fees are applicable to trades or businesses and are licenses to practice. Most are not significant revenue producers, and the amounts collected are utilized to defray the cost of regulating the profession.

d. Customs duties are taxes on the importation of certain foreign goods. They are imposed by the Federal government and are not found at the state and local level.

e. Export duties are taxes imposed on the export of certain commodities (e.g., oil, coffee). They are common in less-developed nations and are not levied by the United States.

33. (LO 4)

a. The United States is the only country in the OECD (Organization of Economic Cooperation and Development) that does not have a value added tax (VAT). Over 100 countries use a VAT. In spite of its extensive use by other countries, the adoption of a VAT by the United States appears doubtful. Instead, the United States places high reliance on the income tax as its major revenue source.

b. A VAT taxes the increment in value as goods move through the production and manufacturing stages to the marketplace. Although the tax is paid by the producer, it is reflected in the selling price of the goods. Therefore, a VAT is a tax on consumption.

c. Because it is an effective generator of revenue, the VAT has been criticized as leading to more government spending.

34. (LO 4)

a. Both the national sales tax and the VAT are taxes on consumption. Both taxes impose more of a burden on low-income taxpayers who must spend a larger proportion of their incomes on essential purchases relative to higher-income taxpayers. As a result, the taxes are regressive in effect.

b. The regressive effect might be partly remedied by granting some sort of credit, rebate, or exemption to low-income taxpayers.

35. (LO 4, 5)

a. Serena may have record-keeping issues related to the cash transactions. The short-term holiday workers should be on the payroll because they are employees, and Serena owes FICA and FUTA on their wages and must file Forms 940 and 941 with the IRS. Serena must also timely issue a W–2 wage form to each of her employees.

b. High. First, Serena is self-employed. Second, she operates partially on a cash basis. Third, the opportunity to understate income and/or overstate expenses is high. Fourth, she has some workers who appear to be misclassified and for whom she may not have issued tax reporting forms.

36. (LO 5)

a. A correspondence audit is probably involved. These audits involve a limited number of issues (i.e., taxpayer failed to report some dividend income) and most often are easily resolved.

b. An audit that is conducted in an IRS office is called an office audit.

c. The revenue agent's report (RAR) accepts the taxpayer's return as filed.

d. When a special agent becomes involved, this usually means that fraud is suspected.

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37. (LO 5) In many unresolved audit disagreements at the agent level, the taxpayer should consider an appeal to the Independent Office of Appeals. Although it is part of the IRS, it is authorized to resolve audit disputes. It has greater settlement authority than does the agent. In many cases, a compromise reached at the Independent Office of Appeals can avoid a costly and time-consuming judicial proceeding.

38. (LO 5) The purpose of a statute of limitations is to preclude parties from prosecuting stale claims. The passage of time makes the defense of such claims difficult because witnesses and other evidence may no longer be available. In the Federal tax area, statutes of limitations cover additional assessments by the IRS and the pursuit of refund claims by taxpayers.

39. (LO 5)

a. The normal three-year statute of limitations will begin to run on the original due date of the return (usually, the fifteenth day of the fourth month after year-end; April 15). When the return is filed early, the normal filing date controls.

b. Now the statute of limitations starts to run on the filing date. If the due date controlled (see part a. above), the taxpayer could shorten the assessment period by filing late.

c. If a return that is due is not filed, the statute of limitations does not start to run. It does not matter that the failure to file was due to an innocent error on the part of the taxpayer or adviser.

d. Regardless of the fact that an innocent misunderstanding was involved, there is no statute of limitations when a return is not filed.

40. (LO 5) No. Interest is not paid if the refund is made within 45 days of when the return was filed. However, a return is not considered filed until its due date. As a result, the period from April 15 to May 28, 2021, does not satisfy the 45-day requirement.

41. (LO 5, 6)

a. Normally, the three-year statute of limitations applies to additional assessments the IRS can make. However, if a substantial omission from gross income is made, the statute of limitations is increased to six years. A substantial omission is defined as omitting in excess of 25% of the gross income reported on the return.

b. No, it would not. The proper procedure would be to advise Andy to disclose the omission to the IRS. Absent the client's consent, do not make the disclosure yourself.

c. If Andy refuses to make the disclosure and the omission has a material carryover effect to the current year, you should withdraw from the engagement.

42. (LO 5) $4,000, determined as follows:

Failure to pay penalty [0.5% × $40,000 × 2 months]		$ 400
Plus:		
Failure to file penalty [5% × $40,000 × 2 months]	$4,000	
Less failure to pay penalty for the same period	(400)	3,600
Total penalties		$4,000

43. (LO 5)

a. $100,000 (20% × $500,000).

b. $375,000 (75% × $500,000). The answer presumes that civil (not criminal) fraud is involved.

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44. (LO 5, 6)

a. No. Because no return was filed, the statute of limitations never runs. But even if a return had been filed, the three-year period for the 2017 tax return would not expire until April 15, 2021, three years after the normal due date for filing.

b. Although you can only recommend that the return be filed, you cannot force him to do so. However, you should not undertake the engagement for 2018 through 2020 if you cannot correctly reflect the tax liability due to the omission for 2017.

45. (LO 5, 6) The practice of outsourcing the preparation of tax returns is ethical if three steps are taken.

- Maintain client confidentiality.
- Verify the accuracy of the work done.
- Notify the client, preferably in writing, of the outsourcing.

46. (LO 7)

a. This is the ideal approach to handling a tax cut—for every dollar lost, a new dollar is gained.

b. All the sunset provision does is reinstate the law as it existed prior to the tax cut. Here, the possibility exists that Congress will rescind (or postpone) the sunset provision before it takes effect.

c. Indexation is a procedure whereby the IRS makes annual adjustments to certain key tax components to take into account inflation, as required by law. Some of the more important components that are adjusted include tax brackets and the standard deduction amounts.

47. (LO 7)

a. To encourage pension plans is to stimulate saving (economic consideration). Also, it provides security from the private sector for retirement to supplement rather meager public programs (social considerations).

b. To make education more widely available is to promote a socially desirable objective. A better educated workforce also serves to improve the country's economic capabilities. As a result, education tax incentives can be justified on both social and economic grounds.

c. The encouragement of home ownership can be justified on both social and economic grounds.

48. (LO 7, 8)

a. Social considerations explain the credit. It is socially desirable to encourage parents to provide care for their children while they work.

b. These deductions raise the issue of preferential tax treatment for homeowners—taxpayers who rent their personal residences do not receive comparable treatment. Even so, the encouragement of home ownership can be justified on economic and social grounds.

c. The joint return procedure came about to equalize the position of married persons living in common law states with those residing in community property jurisdictions. Political and equity considerations caused this result.

d. Activities deemed contrary to public policy should not result in tax savings.

e. The NOL carryforward provision is an equity consideration designed to mitigate the effect of the annual accounting period concept.

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f. The installment method of reporting gain is consistent with the wherewithal to pay concept—the seller is taxed when the payments are made by the purchaser.

g. The exclusion from Federal income taxation of interest from state and local bonds can be justified largely on political considerations. Political goodwill is generated by allowing state and local jurisdictions to secure financing at a lower cost (i.e., interest rate) due to favorable Federal income tax treatment.

h. The treatment of prepaid income is justified under the wherewithal to pay concept. It also eases the task of the IRS as to administration of the tax law.

49. (LO 7)

a. Mia's realized gain from the condemnation is $320,000 [$400,000 (amount of award) − $80,000 (cost basis of the warehouse)]. However, her recognized gain is limited to $120,000—the amount received that was not reinvested.

b. None of the gain is recognized because Mia reinvested the full amount of the condemnation award.

c. In this case, all of Mia's $320,000 realized gain is recognized. Mia reinvested only $80,000 of the $400,000 award, so the $320,000 difference between these two amounts means any realized gain will be recognized to the extent of this difference.

d. The involuntary conversion provision can be justified under the wherewithal to pay concept and the notion that the taxpayer's economic position has not changed. In part b., for example, Mia has retained none of the award and has reinvested in property similar to that taken by the city.

50. (LO 8) If the collection is worth more than $1,000, the mother has probably made a gift of the excess value to her son. There is a possibility that the transaction could result in the assessment of a gift tax. Sales or other transactions between related parties are subject to the arm's length test. In this case, for example, would the mother have made this sale for $1,000 if the purchaser had been an unrelated third party?

RESEARCH PROBLEMS

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

1. The sole proprietor is subject to Federal taxes on income, self-employment and payroll taxes (if the sole proprietor has employees), and the gasoline excise tax. State taxes include income and sales and use taxes. Local taxes include property tax, business license tax, and perhaps income tax.

2. An example of a carbon tax proposal of the 116th Congress is H.R. 5457, Carbon Reduction and Tax Credit Act. An example of a financial transaction tax proposal of the 116th Congress is S. 1587, Inclusive Prosperity Act of 2019. Similar proposals may exist for the 117th Congress. Students might also find plans for these types of taxes that do not have legislative language.

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3. An example of a sweetened beverage tax proposal is H.R. 7341 (115th Congress), the SWEET Act. It would impose a Federal excise tax of 1% per 4.2 grams of sweetener in specified beverages. Proposals also exist in several states and cities. Some cities, including Berkeley, California, Philadelphia, Pennsylvania, and Boulder, Colorado, have already enacted soda taxes. Considerations in analyzing these proposals include issues of regressivity (an equity and fairness issue), complexity of definitions, burden of enforcement, and neutrality in affecting decision making.

4. Each of the Big Four firms has information on data analytics and how it can be used for tax purposes:

   - **pwc.com/us/en/services/tax/tax-innovation.html**
   - **home.kpmg.com/xx/en/home/services/tax/global-indirect-tax/data-and-analytics.html**
   - **ey.com/en_gl/tax/how-data-analytics-is-transforming-tax-administration**
   - **www2.deloitte.com/global/en/pages/technology/articles/making-data-and-analysis-a-priority.html**

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

   - **irs.gov/about-irs/strategic-goals/advance-data-analytics**

SOLUTION TO ETHICS & EQUITY FEATURE

Making Good Use of Out-of-State Relatives (p. 1-12). Who is the true purchaser of the bracelet? If the aunt really made the purchase with her funds and then gave the bracelet to Marcus, no sales or use tax evasion has occurred. More likely, the purchase was made by Marcus indirectly through his aunt—the aunt being reimbursed by Marcus or using funds provided by him. If that is the case, Marcus owes a sales tax on the purchase. Presuming the matter comes to light—the jewelry store might be the weak link—Marcus could be subject to prosecution for tax evasion.

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