CHAPTER 1

AN INTRODUCTION TO TAXATION AND UNDERSTANDING THE FEDERAL TAX LAW

SOLUTIONS TO PROBLEM MATERIALS

Question/ Problem	Learning Objective	Topic	Status: Present Edition	Q/P in Prior Edition
1	LO 1	Interplay of different types of taxes	New	
2	LO 2	Constitutionality of Federal income tax for corporations	Unchanged	2
3	LO 2	Income tax as a "mass tax"	Unchanged	3
4	LO 2	Pay-as-you-go system	Unchanged	5
5	LO 3	Criteria for "good" tax system	Unchanged	6
6	LO 3	Adam Smith and canon of certainty	New	
7	LO 3	Proportional and progressive rates contrasted	New	
8	LO 4	Ad valorem tax on realty: conversion from tax-exempt to residential status	New	
9	LO 4	Conversion of tax-exempt realty to commercial status and effect on ad valorem property tax	Unchanged	9
10	LO 4	Ad valorem tax on realty: effect of tax holiday	Unchanged	10
11	LO 4	Ad valorem tax on realty: effect of valuation reassessment	New	
12	LO 4	Ad valorem tax: assessment in terms of revenue production	Unchanged	12
13	LO 4	Excise taxes: both Federal and state	New	
14	LO 4	Excise taxes: hotel occupancy and car rental	Unchanged	13
15	LO 4	Excise and general sales taxes compared	New	
16	LO 4	Avoiding sales tax through use of out-of-state purchase	Unchanged	14
17	LO 4	Avoiding local sales taxes	Unchanged	16
18	LO 4	Avoiding sales tax through Internet purchase	Unchanged	17
19	LO 4	Estate and inheritance taxes contrasted	New	
20	LO 4	Federal gift tax: availability of the marital deduction for transfers between spouses	Modified	20

Instructor: For difficulty, timing, and assessment information about each item, see p. 1-4.

Question/ Problem	Learning Objective	Topic	Status: Present Edition	Q/P in Prior Edition
21	LO 4	Federal transfer taxes: justification for and application of unified credit	Modified	21
22	LO 4	Federal gift tax: annual exclusion	New	
23	LO 4	Income tax formula: individuals and corporations compared	Modified	23
24	LO 4	State income taxes: "piggyback" and "decoupling" concepts	New	
25	LO 4	Application of jock tax	Unchanged	24
26	LO 4, 5	State income tax return disclosure of Internet purchases; client refusal to answer tax return question and ethical implications	Unchanged	26
27	LO 4	State income tax: characteristics	Modified	27
28	LO 4	State income taxes: checkoff boxes and special causes	New	
29	LO 4	State taxes: amnesty programs	New	
30	LO 4	FICA and FUTA contrasted	Unchanged	29
31	LO 4	FICA: application to family	Unchanged	30
32	LO 4	Severance, franchise, and occupation taxes and fees	New	
33	LO 4	VAT: characteristics and usage	Unchanged	33
34	LO 4	National sales tax and VAT: regressive aspects	Unchanged	34
35	LO 4, 5	Tax problems of cash basis taxpayers with high employment turnover	Unchanged	35
36	LO 5	Assessing risk of audit by the IRS	Modified	36
37	LO 5	IRS audit: characteristics of	Modified	37
38	LO 5	IRS audit: appeal procedures	Unchanged	38
39	LO 5	Statute of limitations: purpose and application of	New	
40	LO 5	Statute of limitations: IRS assessments	Unchanged	40
41	LO 5	Interest on tax refunds	Unchanged	41
42	LO 5, 6	Statute of limitations and substantial omissions; ethical considerations of tax return preparer	Unchanged	42
43	LO 5	Penalties for failure to file and failure to pay	Modified	43
44	LO 5	Penalties for negligence and fraud	Modified	44
45	LO 5, 6	Tax practice and ethical guidelines: statute of limitations	Unchanged	45
46	LO 5, 6	Ethics: offshore preparation of tax returns	New	
47	LO 7	Revenue neutral tax reform	Modified	46
48	LO 7	Multiple justification for several tax provisions	Unchanged	47
49	LO 7	Justification for various tax provisions	Unchanged	48
50	LO 7	Involuntary conversion: application and nonapplication of wherewithal to pay concept	New	
51	LO 7, 8	Justification for various tax provisions	Modified	51

Instructor: For difficulty, timing, and assessment information about each item, see p. 1-4.

Question/ Problem	Learning Objective	Topic	Status: Present Edition	Q/P in Prior Edition
52	LO 8	Arm's length concept: definition of and reason for	New	
53	LO 8	Tax treatment of leasehold improvements: judicial versus legislative rules	Unchanged	53

Instructor: For difficulty, timing, and assessment information about each item, see p. 1-4.

Question/ Problems	Difficulty	Est'd completion time	Assessment Information AICPA* Core Comp	AACSB* Core Comp
1	Easy	5	FN-Research	Reflective Thinking
2	Easy	5	FN-Research	Analytic
3	Easy	5	FN-Measurement	Reflective Thinking
4	Easy	5	FN-Measurement	Analytic
5	Easy	5	FN-Measurement	Analytic
6	Easy	10	FN-Measurement	Analytic
7	Easy	5	FN-Research	Analytic
8	Easy	5	FN-Measurement	Analytic | Reflective Thinking
9	Medium	10	FN-Measurement	Analytic | Reflective Thinking
19	Easy	5	FN-Measurement	Analytic
10	Easy	5	FN-Risk Analysis	Reflective Thinking
11	Easy	5	FN-Measurement	Analytic
12	Easy	10	FN-Risk Analysis	Analytic
13	Easy	5	FN-Measurement	Analytic
14	Medium	10	FN-Reporting | FN-Measurement	Ethics | Analytic
15	Easy	5	FN-Measurement | FN-Risk Analysis	Analytic | Reflective Thinking
16	Easy	5	FN-Measurement	Analytic | Reflective Thinking
17	Easy	5	FN-Reporting | FN-Measurement	Ethics | Analytic
18	Easy	5	FN-Measurement	Analytic
19	Easy	5	FN Measurement	Analytic
20	Easy	10	FN-Measurement	Analytic | Reflective Thinking
21	Easy	10	FN-Measurement	Analytic
22	Easy	10	FN-Measurement	Analytic
23	Easy	5	FN-Measurement	Analytic
24	Medium	15	FN-Measurement	Analytic | Reflective Thinking
25	Easy	5	FN-Measurement	Analytic
26	Easy	5	FN-Measurement	Analytic | Reflective Thinking
27	Easy	5	FN-Measurement	Analytic
28	Medium	15	FN-Measurement	Ethics | Analytic
29	Easy	10	FN-Reporting | FN-Measurement	Analytic
30	Easy	10	FN-Reporting | FN-Measurement	Analytic | Reflective Thinking
31	Easy	10	FN-Measurement	Analytic
32	Easy	5	FN-Measurement	Analytic
33	Easy	5	FN-Measurement	Analytic

***Instructor:** See the Introduction to this supplement for a discussion of using AICPA and AACSB core competencies in assessment.

Question/ Problems	Difficulty	Est'd completion time	Assessment Information: AICPA* Core Comp	Assessment Information: AACSB* Core Comp
34	Easy	5	FN-Reporting | FN-Measurement	Analytic | Reflective Thinking
35	Easy	5	FN-Measurement	Analytic | Reflective Thinking
36	Easy	5	FN-Risk Analysis	Analytic | Reflective Thinking
37	Medium	15	FN-Measurement | FN-Risk Analysis	Analytic | Reflective Thinking
38	Medium	10	FN-Reporting | FN-Risk Analysis	Reflective Thinking
39	Medium	15	FN-Reporting | FN-Risk Analysis	Analytic | Reflective Thinking
40	Medium	10	FN-Measurement	Analytic
41	Easy	5	FN-Measurement	Analytic
42	Medium	15	FN-Reporting | FN-Measurement	Ethics | Analytic
43	Medium	10	FN-Measurement	Analytic
44	Easy	10	FN-Measurement	Analytic
45	Medium	15	FN-Measurement | FN-Risk Analysis	Ethics | Analytic
46	Medium	10	FN-Measurement	Ethics | Analytic
47	Medium	15	FN-Measurement	Analytic | Reflective Thinking
48	Medium	15	FN-Measurement	Analytic | Reflective Thinking
49	Medium	15	FN-Measurement	Analytic | Reflective Thinking
50	Medium	10	FN-Reporting | FN-Measurement	Analytic | Reflective Thinking
51	Medium	15	FN-Reporting | FN-Measurement	Analytic | Reflective Thinking
52	Easy	5	FN-Measurement	Analytic
53	Medium	10	FN-Measurement	Analytic | Reflective Thinking

***Instructor:** See the Introduction to this supplement for a discussion of using AICPA and AACSB core competencies in assessment.

DISCUSSION QUESTIONS

1. 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 will 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 local (and perhaps even the state) taxing authorities. Besides the real estate taxes, personal property taxes could be imposed on the furnishings. p. 1-3

2. Agree. The U.S. Supreme Court had already validated the income tax on corporations. It was the income tax on individuals that resulted in judicial problems. p. 1-3

3. In order 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. p. 1-4

4. 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 non-wage 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. p. 1-4

5. 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 its 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. p. 1-5

6. In evaluating the U.S. tax system under Adam Smith's canons of taxation, *certainty* probably generates the greatest controversy. In one sense, certainty is present since a mass of administrative and judicial guidelines exist to aid in interpreting the tax law. In another sense, however, certainty does not exist since many questions remain unanswered, and frequent changes in the tax law by Congress lessens stability. Particularly troublesome in this respect are many provisions that are given limited life. If these provisions are to continue, Congress enacts "extender" legislation. Recently, extender legislation has been passed at the last moment (i.e., just before expiration or even after expiration and given retroactive effect). pp. 1-5 and 1-6

7. A tax is *proportional* if the rate of tax remains constant for any given income level. The tax is *progressive* is a higher rate of tax applies as the tax base increases. p. 1-6

8. 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. 1-7

9. 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. 1-7

10. a. "Generous" probably means a prolonged exemption from ad valorem property taxes.

    b. A new business brings more families into the area. This, in turn, means more children to educate. While costs increase, the tax holiday could mean a loss of tax revenue.

    p. 1-7

11. The improvements to the property probably caused the first tax increase. The second increase was the conversion of the residence to commercial use. p. 1-7

12. 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. 1-8 and 1-9

13. Gasoline, liquor, and tobacco products are examples. p. 1-9

14. Herman could have been overcharged, but at least part of the excess probably is attributable to a hotel occupancy tax and a car rental tax. In the 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. p. 1-10

15. 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. 1-10 and 1-11

16. 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 5. p. 1-10

17. In some states, counties (and cities) are given the option to impose additional sales tax levies. It is possible that this is the situation with Wilson County. If so, this would explain why Velma does her shopping in Grimes County. p. 1-11 and Example 6

18. 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. p. 1-11

19. 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, Texas) levy neither tax.

    b. The Federal government imposes an estate tax.

    p. 1-12

20. 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). There is no tax reason, therefore, to prefer transfers at death over lifetime gifts associated with spousal transfers. pp. 1-12 and 1-13

21. a. The purpose of the unified transfer tax credit is to eliminate the tax on modest gifts and estates.

    b. Yes, for 2011 and 2012. The credit for both is $1,730,800.

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

    pp. 1-12 and 1-14

22. $572,000. 22 donees (6 married children + 6 spouses + 10 grandchildren) × $13,000 (annual exclusion for 2011) × 2 donors (Miles and Trudy) = $572,000. p. 1-13 and Example 10

23. 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

24. "Piggyback" means making use, for state income tax purposes, of what was done for Federal income tax purposes. By "decoupling," a state decides not to allow a particular Federal change (e.g., exclusion, deduction, credit) for state income tax purposes. p. 1-15

25. 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. pp. 1-16 and 1-17

26. a. This type of question has no relevance to the state income tax, but is a less than subtle way of encouraging taxpayers to pay any use tax due on Internet and mail order purchases. p. 1-17

    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 Harriet has no justifiable reason. p. 1-26

27. a. Generally, all the states have withholding procedures.

    b. A diminishing number of states allow a deduction for Federal income taxes paid.

    c. The filing dates are usually consistent with the Federal rule.

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

    pp. 1-16 and 1-17

28. The checkoff boxes add complexity to the return and mislead taxpayers into presuming that they are not paying for the donation. p. 1-16

29. a. They expose taxpayers that were previously unknown to the taxing authority.

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

    c. As of yet, no general amnesty program has been offered for the Federal income tax.

    p. 1-17

30. 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 Federal and state governments.

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

    pp. 1-17 and 1-19

31. Only children under age 18 are excluded from FICA. Other family members, including spouses, must be covered. p. 1-18

32. 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 the mineral. p. 1-11

    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. p. 1-19

    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. p. 1-19

33. a. Including all of OECD members, a total of 136 countries impose a VAT. Unlike most other countries, the U.S. has no VAT and, instead, places high reliance on the income tax as a major source of revenue.

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.

p. 1-20

34. 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. Thus, the taxes are regressive in effect.

b. At least in the case of a national sales tax, the regressive effect might be partly remedied by granting some sort of credit, rebate, or exemption to low income taxpayers.

pp. 1-20 and 1-21

35. a. Due to the location of the business and the fact that the employees are "itinerant," Serena may be hiring undocumented aliens. Needless to say, this could cause serious nontax problems involving employment and immigration laws. As to tax problems, is Serena complying with the FICA and income tax withholding rules? Because of the high labor turnover Serena probably has, FUTA costs could be severe.

b. Very high. First, Serena is self-employed. Second, she operates on a cash basis. Third, the opportunity to understate income and/or overstate expenses is extremely high.

pp. 1-18 and 1-21

36. a. The large amount involved means it received media coverage. IRS agents are instructed to take note of such items. Consequently, it would not be surprising if Linda's return for the year involved is audited. Keep in mind that this is a "big ticket item" in terms of possible income tax deficiencies.

b. Mel operates a cash business where the potential for omission of income is high.

c. Cindy could be a candidate for an audit due to her high gross income and AGI.

d. As a headwaiter, Pierre will receive large tips. He will also share in the business of the valet service which invariably involves gratuities. With so much cash involved, the full reporting of income may not occur. The IRS is aware of this potential for omission.

e. Most of Giselle's income probably comes from cash tips. Regarding the past audits, were tax deficiencies assessed? If so, a return visit by the IRS is to be expected.

f. Information received from a state taxing authority can lead to an IRS audit. This is apparently what has happened in the case of Marcus.

g. Guy is vulnerable for audit in two respects. First, he deals entirely in cash which is easy to make secret. Second, his personal life could make him subject to retribution (i.e., "informant" possibility as to former companion).

h. Rick's only source of income are wages which will be reported to the IRS through his Form W-2. Thus, he has little opportunity to avoid reporting income.

pp. 1-16, 1-21, and 1-22

37. a. The tax law permits the IRS to pay rewards to persons who provide information that leads to the detection and punishment of those who violate the tax laws.

b. The DIF score helps determine which returns the IRS selects for audit.

c. 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.

d. What is described is an office audit.

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

f. When a special agent appears, this usually means that fraud is suspected.

pp. 1-21 to 1-23

38. In many unresolved audit disagreements at the agent level, the taxpayer should consider an appeal to the Appeals division. 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 Appeals Division can avoid a costly and time-consuming judicial proceeding. p. 1-23

39. 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 since witnesses and other evidence may no longer be available. In the Federal tax area, there are statutes of limitations covering additional assessments by the IRS and the pursuit of refund claims by taxpayers. p. 1-23

40. a. The normal three-year statute of limitations will begin to run on April 15, 2011. When the return is filed early, the regular filing date controls.

b. Now the statute of limitations starts to run on the filing date. If the date of filing 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 advisor.

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

pp. 1-23 and 1-24

41. 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. Thus, the period from April 15 to May 27 does not satisfy the 45-day requirement. p. 1-24

42. a. Normally, the 3-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. Example 20

b. 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. p. 1-26

c. If Andy refuses to make the disclosure and the omission has a carryover effect to the current year, you should withdraw from the engagement. p. 1-26

43. $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

p. 1-24 and Example 21

44. a. $100,000 (20% × $500,000).

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

p. 1-25

45. a. No. Since no return was filed, the statute of limitations never runs. But even if a return had been filed, the three-year period for the 2007 tax return would not expire until April 15, 2011 (three years after the normal due date for filing). p. 1-24

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 2008 through 2010 if you cannot correctly reflect the tax liability due to the omission for 2007. p. 1-26

46. 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. 1-27.

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

b. Pay-as-you-go is really another way of describing revenue neutrality. Thus, tax cuts should not result in an overall loss of revenue.

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

p. 1-27

48. a. Energy credits are allowed for various residential improvements that conserve energy. Credits are available for taxpayers who purchase motor vehicles that operate on alternative (i.e., non-fossil) fuels. The cost of installing pollution control devices can be expensed for tax purposes over a shorter period of time. p. 1-28

b. 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. 1-28 and 1-29

c. 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. p. 1-29 and Footnote 27

d. The encouragement of home ownership can be justified on both social and economic grounds. p. 1-30

49. a. Economic justification. By providing an election to expense, § 179 encourages additional capital investment. p. 1-28

b. Economic justification. Research and development activities are encouraged by allowing immediate or faster write-off of these expenditures. p. 1-28

c. 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

d. 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. 1-29

e. 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

f. Social justification. A tax incentive that encourages a parent to obtain child care in order to maintain gainful employment is socially desirable. p. 1-29

50. a. Chad's realized gain from the condemnation is $80,000 [$100,000 (amount of the award) – $20,000 (cost of the land)]. However, his recognized gain is limited to $30,000—the amount received that was not reinvested.

b. None of the gain is recognized since Chad reinvested the full amount of the condemnation award.

c. Since none of the gain was reinvested, the full $80,000 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, Chad has retained none of the award and has reinvested in property similar to that taken by the state highway department.

p. 1-31 and Examples 23 and 24

51. a. 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 25

b. 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

c. What is described is the indexation procedure. The procedure avoids the so-called bracket creep caused by inflation and can be justified on equity grounds. p. 1-32

d. A subtle way to tax the more affluent taxpayers without imposing new and direct taxes is to deny them the benefits of certain relief provisions. Known as "stealth taxes," the approach phases out tax breaks as income rises. These taxes are politically motivated as "taxing the rich" and have popular appeal. p. 1-33

e. 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. 1-33

f. 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. 1-34

g. The limitations placed on casualty and theft losses reduce the number of such deductions and thereby simplifies the audit process. Thus, they can be justified in the interest of administrative feasibility. p. 1-34 and Footnote 33

52. If the collection is worth more than $1,000, the mother has probably made a gift to the daughter of the excess value. Quite possibly the transaction could result in the imposition 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? p. 1-35 and Example 28

53. a. Edward recognizes income associated with the improvements when he disposes of the property (including the improvements).

b. No. In an early decision, the U.S. Supreme Court held that income should be recognized when the lease terminates.

c. The justification for the current rule is the wherewithal to pay concept.

p. 1-35 and Example 29

The answers to the **Research Problems** are incorporated into the *Instructor's Guide with Lecture Notes* to accompany the 2012 Annual Edition of *SOUTH-WESTERN FEDERAL TAXATION: INDIVIDUAL INCOME TAXES.*