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Chapter 2
The Tax Practice Environment

Note to Instructor: The reference tables in the appendix of the text may be required for a limited number of answers to the questions and problems in this chapter. This is indicated by "REFERENCE TABLES REQUIRED" after the learning objective

True-False: Insert **T** for **True** or **F** for **False** before each question.

_____ 1. The Internal Revenue Service is part of the Justice Department.

ANSWER: False
LO: 2.1
DIFFICULTY: Easy

_____ 2. The Internal Revenue Service must pay interest on any refund that is not mailed within 30 days of the date the taxpayer's tax return is filed.

ANSWER: False
LO: 2.1
DIFFICULTY: Easy

_____ 3. The statute of limitations for an error overstating expenses by more than 25 percent is 3 years.

ANSWER: True
LO: 2.1
DIFFICULTY: Easy

_____ 4. The Internal Revenue Service has the burden of proof when it is asserting fraud with the intent to evade taxes on the part of the taxpayer.

ANSWER: True
LO: 2.1
DIFFICULTY: Easy

_____ 5. Tax avoidance is the minimization of the tax burden by using acceptable, legal alternatives.

ANSWER: True
LO: 2.2
DIFFICULTY: Easy

_____ 6. A transaction for which there is no legitimate business purpose is automatically assessed a 50% penalty.

ANSWER: False
LO: 2.2 & 2.3
DIFFICULTY: Easy

_____ 7. Circular 230 is issued by the AICPA to provide guidance on tax return preparation by CPAs.

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ANSWER: False
LO: 2.2
DIFFICULTY: Easy

_____ 8. If a CPA finds an error on a previously filed tax return of a client, he or she should advise the client to file an amended return to correct the error.

ANSWER: True
LO: 2.2
DIFFICULTY: Easy

_____ 9. Only CPAs, Enrolled Agents, and Attorneys who prepare tax returns for pay must obtain preparer tax identification numbers.

ANSWER: False
LO: 2.2
DIFFICULTY: Easy

_____ 10. If a firm's discount rate is lower than another firm's, the present value of its future cash flows will be higher.

ANSWER: True
LO: 2.3
DIFFICULTY: Moderate

_____ 11. If a project results in a loss, the tax effect causes a decrease in cash flow.

ANSWER: False
LO: 2.3
DIFFICULTY: Moderate

_____ 12. Legal income shifting includes shifting income among relatives and between a business and its owner/employee.

ANSWER: True
LO: 2.3
DIFFICULTY: Easy

_____ 13. The higher a firm's marginal tax rate used for project evaluation, the greater the net cash flow from the project.

ANSWER: False
LO: 2.3
DIFFICULTY: Easy

_____ 14. The business purpose doctrine requires a transaction to have an economic purpose other than one based solely on tax avoidance.

ANSWER: True

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LO: 2.4
DIFFICULTY: Easy

_____ 15 The Cumulative Bulletin contains reports of all the committees involved in tax writing as well as statements made on the floor of the House or Senate.

ANSWER: False
LO: 2.4
DIFFICULTY: Easy

_____ 16. A letter ruling can only be relied on by the taxpayer for whom it is written.

ANSWER: True
LO: 2.4
DIFFICULTY: Easy

_____ 17. A proposed regulation can be relied on when planning a transaction.

ANSWER: False
LO: 2.4
DIFFICULTY: Easy

_____ 18. Acquiescence by the Internal Revenue Service's Commissioner means that the IRS will follow the decision in the future.

ANSWER: True
LO: 2.4
DIFFICULTY: Easy

_____ 19. The Golsen rule requires the Tax Court to follow all other Federal District Court decisions in the same Circuit.

ANSWER: False
LO: 2.4
DIFFICULTY: Easy

_____ 20. A memo to file for a client should be more detailed than the client letter.

ANSWER: True
LO: 2.4
DIFFICULTY: Easy

Short-answer Questions: Provide a brief written solution to each of the following questions.

1. Explain how tax compliance differs from tax planning.

ANSWER: Tax compliance consists of gathering, evaluating and classifying the relevant information for filing a taxpayer's tax return. Compliance deals primarily with transactions that have already taken place. Tax planning is the process of evaluating the tax consequences associated with a transaction that has yet to take place and making recommendations that will achieve the desired objectives with the least tax cost. Tax planning primarily deals with future transactions.

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LO: 2.1 & 2.3
DIFFICULTY: Easy

2. Explain what is meant by the statute of limitations.

ANSWER: The statute of limitations is the period of time beyond which legal actions or changes to the tax return cannot be made by either the taxpayer or the government. Under most circumstances, the IRS cannot challenge a tax return later than three years after its due date or the date it was filed, if later.
LO: 2.1
DIFFICULTY: Easy

3. Explain the difference between tax avoidance and tax evasion.

ANSWER: Tax avoidance is the lawful use and interpretation of the tax laws in a manner that minimizes taxes. Tax evasion is the deliberate ignoring of a tax law to reduce taxes and is illegal.
LO: 2.1 & 2.2
DIFFICULTY: Easy

4. When may a CPA use estimates in the preparation of a client's tax return?

ANSWER: A CPA may use estimates to prepare a tax return when actual data is unavailable at the time of filing or missing. A taxpayer may have been the subject of a casualty loss that destroyed records or a computer failure may prevent the recovery of a complete set of financial records. In such a case, the return should not imply greater accuracy than the estimates permit.
LO: 2.2
DIFFICULTY: Easy

5. Which tax return preparers are required to obtain preparer tax identification numbers?

ANSWER: All persons who prepare tax returns for payment, or who employ one or more persons who are paid for the preparation of all or a substantial portion of a federal tax return or claim for refund, must obtain a PTIN, a Paid Preparer Tax Identification Number.
LO: 2.2
DIFFICULTY: Easy

6. What are three factors that can affect the after-tax cash flow of a project? How does each affect this cash flow?

ANSWER: The marginal tax rate, the discount rate, and the timing of cash flows affect a project's cash flow. The higher the marginal tax rate, the lower the profits on the cash inflow as taxes must be paid on the profit. If there is a loss, however, the higher tax rate lessens the loss due to the offset of the loss against other income. The lower the discount rate, the greater the net present value will be; the higher the rate, the lower the net present value of the cash flow. The shorter the time period to recovery of cash flows, the greater the net present value. The longer the time to recovery, the lower the net present value. Accelerating revenues or postponing expenses will increase the net present value due to the timing of their recognition.
LO: 2.3
DIFFICULTY: Hard

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7. Explain what is meant by changing the character of income? Provide an example.

ANSWER: Certain types of income may be taxed at different rates. Changing one type of income into another type changes its character and may change how it is taxed. For example, generally capital assets held one year or less are taxed at the tax rates for ordinary income found in the tax rate schedules. Capital assets held more than one year are eligible for special long-term capital gains tax rates that are less than the regular tax rates.
LO: 2.3
DIFFICULTY: Moderate

8. Explain the step transaction doctrine.

ANSWER: The step transaction doctrine is normally used to collapse a series of transactions that are dependent on each other into fewer transactions; this collapsing (ignoring intermediate transactions) can radically change the outcome for tax purposes. For example, Joe sells loss property to Bill, recognizing the loss; by prearrangement, Bill then sells the property to Joe's brother. If Joe sold the property directly to his brother he could not have recognized the loss. The Internal Revenue Service can collapse the two sales into the direct sale from Joe to his brother and disallow the loss recognition.
LO: 2.3
DIFFICULTY: Easy

9. What is meant by the phrase "substance-over-form"?

ANSWER: The phrase "substance-over-form" means that the taxation of a transaction will be determined by the reality of the transaction rather than its appearance. For example, a corporation sells property to its sole shareholder at an extremely low price. In reality, this is a part sale and a part dividend distribution (for the bargain element built into the purchase price).
LO: 2.3
DIFFICULTY: Moderate

10. Explain the difference between a closed fact and an open fact transaction.

ANSWER: A closed fact transaction is one in which all of the relevant transactions have been completed. In an open fact transaction, not all of the steps in the transaction are complete and there are opportunities to control the remaining steps.
LO: 2.4
DIFFICULTY: Easy

11. What is the difference between a primary and a secondary source of tax authority?

ANSWER: Primary sources of tax authority come from statutory, administrative, and judicial sources. Secondary sources consist of tax services (reference services), books, journals and newsletters; these are used to assist researchers in locating and interpreting the primary sources.
LO: 2.4
DIFFICULTY: Easy

12. What is the purpose of Treasury Regulations?

ANSWER: Treasury regulations explain, interpret, and provide definitions and examples for the language of the Internal Revenue Code.

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LO: 2.4
DIFFICULTY: Easy

13. What are the steps that are usually required between introduction and passage of a revenue bill?

ANSWER: a. A revenue bill is introduced into the House of Representatives. b. It is generally referred to the House Ways and Means Committee that holds public hearings on the bill. c. The bill is then sent to the floor of the House where it is debated and then voted on. d. If passed, the bill goes to the Senate where it is referred to the Senate Finance Committee. e. The Senate Finance Committee also holds hearings and analyzes the bill, possibly attaching amendments. f. The bill goes to the Senate floor for debate and vote. g. If the bills passed by the House and the Senate differ, they are referred to the Joint Conference Committee to work out differences. h. A compromise bill is then sent back to the House and the Senate. i. After passage by both houses, it is sent on to the President for his signature.
LO: 2.4
DIFFICULTY: Moderate

14. What is the difference between an interpretive regulation and a legislative regulation?

ANSWER: Interpretive regulations provide examples and detailed explanations to help interpret the Code. A legislative regulation provides the details of the meaning and rules for a particular Code section as directed by the Code. Legislative regulations are considered to have the same level of authority as the Code.
LO: 2.4
DIFFICULTY: Moderate

15. To which trial courts may a taxpayer contest a decision of the IRS?

ANSWER: The three courts of original jurisdiction to which a taxpayer may contest a decision of the IRS are the Tax Court, the Federal District Courts, and the U.S. Court of Federal Claims. If the taxpayer is dissatisfied with the decision of the particular court that heard the case, the taxpayer may appeal that decision to the appropriate appellate court. Finally, the appellate court decision could be appealed to the U. S. Supreme Court. The Tax Court also has a Small Case Division but the decision of this court cannot be appealed.
LO: 2.4
DIFFICULTY: Moderate

16. What is the difference between a letter ruling and a revenue ruling?

ANSWER: Revenue rulings, published by the IRS, clarify ambiguous tax situations for which the public needs administrative guidance. Taxpayers who have fact situations that mirror those in the ruling may rely on the ruling for guidance as to the tax outcome of a particular transaction.
A letter ruling provides guidance on how a particular transaction will be taxed, but it is written for a specific taxpayer's prospective transaction and, technically, the tax result applies only to that taxpayer.
LO: 2.4
DIFFICULTY: Moderate

17. What is meant when the Commissioner of the Internal Revenue Service acquiesces to a court decision?

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ANSWER: When the Commissioner of the Internal Revenue Service acquiesces to a court decision, it means that similar disputes will be settled in a manner consistent with the outcome established in the acquiesced case.
LO: 2.4
DIFFICULTY: Easy

18. Explain the Golsen rule.

ANSWER: The Golsen rule requires the Tax Court to follow the Court of Appeals that has direct jurisdiction over the taxpayer in question if the appellate court has ruled on this issue. This also means that the Tax Court may reach opposite decisions for taxpayers in different jurisdictions, even though the cases have identical facts, if there has been no contrary Court of Appeals decision in that jurisdiction. The Tax Court is only bound to follow a decision of the Court of Appeals in the taxpayer's circuit.
LO: 2.4
DIFFICULTY: Easy

Problems: Provide numerical solutions for each of the following.

1. Kitty's tax return, which she filed on April 15, showed a balance due of $8,500. She did not have the money to pay this amount. On September 20, she was finally able to borrow sufficient money to pay the debt. What is Kitty's late payment penalty?

ANSWER: $255; 6 months x .005 x $8,500 = $255.
LO: 2.1
DIFFICULTY: Easy

2. Joaquin did not have any money to pay his $2,000 tax liability on April 15 so he did not file his tax return. He finally filed the return on July 25 and paid $1,000 of the tax due. He paid the remaining tax due on October 18. What is his total penalty?

ANSWER: $415; (4 months x .05 x $2,000) + (3 months x .005 x $1,000) = $415.
LO: 2.1
DIFFICULTY: Easy

3. Walter did not file his 2018 tax return that was due April 15, 2019 until June 2, 2019.
   a. When does the statute of limitations expire for this return assuming he did not file for an automatic extension?
   b. When does the statute of limitations expire if Walter forgot to report a land sale that occurred on January 10, 2018? He had a $20,000 gain on the transaction and he reported gross income for 2018 of $75,000?
   c. When does the statute of limitations expire if Walter deliberately omitted the $20,000 gain on the land sale?

ANSWER: a. June 2, 2022; b. June 2, 2025 ($20,000/$75,000 is more than 25%); c. If the IRS can prove fraud, there is no statute of limitations; because the gain omitted exceeded 25 percent of the gross income on the return, the statute of limitations is 6 years; otherwise the limitation would have been the normal 3 years. The filing deadline for individuals to submit their 2018 tax returns was Monday, April 15, 2019. If April 15 falls on a Sunday, or an observed US holiday, the nation's filing deadline is pushed to the next working business day. Under the tax law, legal holidays in the District of Columbia affect the filing deadline across the nation.

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LO: 2.1
DIFFICULTY: Hard

4. William just did not like figuring out his taxes each year and he usually had so little income that he didn't owe taxes. He never filed an extension even though he seldom got around to filing before October or November. He finally filed his 2018 return in September of 2019 when he remembered he had sold some stock in early 2018 for a small profit. Unfortunately, he owed $125 in taxes because of the sale. What is William's failure to file penalty?

ANSWER: $125; William's failure to file costs him $125 for the tax owed plus another $125 as he is over 60 days late filing and the minimum penalty is the smaller of the amount of tax owed ($125) or $215.
LO: 2.1
DIFFICULTY: Moderate

5. Charley Careless had not read much about the preparer penalties that could be assessed for failure to have substantial authority for certain tax positions taken on his client's returns. He prepared a return for one of his clients with an issue that was clearly a problem. If he was paid $4,000 for the tax return preparation, how much would his potential fine be under the following circumstances:
   a. Charley should have known that the position did not have a reasonable possibility of success but had failed to do any research.
   b. Charley knew the position was "iffy" but disclosed the problem.
   c. Charley knew the position could not be supported but the client expected Charley to get him a large refund.

ANSWER: a. $2,000; b. None with disclosure; c. $5,000.
LO: 2.2
DIFFICULTY: Moderate

6. Berman Corporation can accept only one of two projects. The revenue and expenses for each of the projects is shown below. Which project should Berman accept if the corporation has a 10 percent cost of capital and a 21 percent marginal tax rate?

		Project A	Project B
Year 1	Revenue	$800,000	$700,000
	Expenses	525,000	500,000
Year 2	Revenue	600,000	700,000
	Expenses	425,000	550,000

ANSWER: Project A should be undertaken. PV of Project A: [$275,000 x (1 - .21) x .909] + [$175,000 x (1 - .21) x .826] = $311,674.75; PV of Project B: [$200,000 x (1 - .21) x .909] + [$150,000 x (1 - .21) x .826] = $241,503; Project A should be undertaken.
LO 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

7. What is the after-tax net present value of a project costing $600,000 that Plud Corporation can invest in if the project has the following estimated revenues and expenses?

	Initial cost	$ 600,000
Year 1	Revenue	2,000,000
	Expenses	1,450,000
Year 2	Revenue	1,800,000

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Expenses 1,250,000

Plud uses an 8 percent discount rate for evaluation and expects a 21 percent marginal tax rate in the relevant years.

ANSWER: $174,713; Year 1: $550,000 x (1 - .21) x .926 = $402,347; Year 2: $550,000 x (1 - .21) x .857 = $372,366.50; NPV = $402,347 + $372,367 - $600,000 = $174,713.
Present/Future value tables required for solution.
LO 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

8. Carol wants to invest in a project that requires a $20,000 investment. She expects a before-tax return of $16,000 in years 1 through 3 from this investment. She uses a 6 percent discount rate for evaluation but is not sure if her marginal tax rate will be 12 percent or 24 percent. What difference does the marginal tax rate make in the after-tax net present value of this investment?

ANSWER: $5,132 with the lower tax rate; 24% tax rate: ($16,000 x .76 x .943) + ($16,000 x .76 x .890) + ($16,000 x .76 x .840) = $32,504; 12% tax rate: ($16,000 x .88 x .943) + ($16,000 x .88 x .890) + ($16,000 x .88 x .840) = $37,636; Difference = $37,636 - $32,504 = $5,132 with the lower tax rate.
Present/Future value tables required for solution.
LO 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

9. Cynthia and John have dependent twins ages 18. Their joint income places them in the 32 percent marginal tax bracket. What are their total tax savings if they can transfer $2,000 of taxable income to each of the children? The children have no other income that is taxable.

ANSWER: $1,090; Children's tax: ($2,000 - $1,050 Std. Deduction) x .10 x 2 = $190; Parents' tax savings: $4,000 x .32 = $1,280; Net tax savings = $1,280 - $190 = $1,090.
LO: 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

10. William purchased 10,000 shares of stock for $10 per share late last month. Due to a proposed hostile takeover of the company, the stock has jumped in price to $16 per share. If he holds the stock for at least a full year, he believes the price will decline to $14 per share but he will be eligible for the 15 percent long-term capital gains rate for his gain. If he sells now, his gain will be subject to his 32 percent marginal tax rate. Should William sell now or wait one year? Use a one-year present value factor of .909 in your evaluation.

ANSWER: Sell now. Sell now: $60,000 x .32 = $19,800 tax; net value = $160,000 - $19,200 = $140,800; Hold one year: $40,000 x .15 = $6,000; net value = ($140,000 - $6,000) x .909 = $121,806. William should sell now and pay the higher tax.
LO: 2.3
DIFFICULTY: Moderate

Other Objective Questions

1. Place in order the steps in the tax legislative process from the list below:
   ___ a. The bill is referred to the House Ways and Means Committee

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___ b. The bill is referred to the Joint Conference Committee
___ c. A member of the House introduces the tax bill
___ d. The bill is forwarded to the President for his signature
___ e. The Senate votes on the bill
___ f. The House votes on the bill
___ g. The bill is referred to the Senate Finance Committee
___ h. The Conference Committee sends the bill back to the House and the Senate

ANSWER: Order of steps: c, a, f, g, e, b, h, d.
LO: 2.4
DIFFICULTY: Moderate

2. For each entry in the following list, indicate with a **P** if it is a **primary** source of tax law or an **S** if it is a **secondary** source of tax law.

_____ a. A tax textbook
_____ b. Tax Court Decision
_____ c. *Kiplinger Tax Letter*
_____ d. *Journal of Accountancy*
_____ e. Legislative regulations
_____ f. Internal Revenue Code
_____ g. A Court of Federal Claims decision
_____ h. Committee reports
_____ i. *The Tax Adviser*
_____ j. Revenue ruling

ANSWER: a. S; b. P; c. S; d. S; e. P; f. P; g. P; h. P; i. S; j. P
LO: 2.4
DIFFICULTY: Easy

Multiple Choice: Select the best answer for each of the following questions.
Note to Instructor: Present/Future Value Tables required for certain problem solutions as indicated after the learning objective.

1. The Internal Revenue Service is part of:
   a. The Office of Budget and Management
   b. The Justice Department
   c. The Treasury Department
   d. Congress

ANSWER: c
LO: 2.1
DIFFICULTY: Easy

2. What is the unextended due date for a corporation with a March 31 year-end?
   a. April 15
   b. May 15
   c. June 15
   d. July 15

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ANSWER: d
LO: 2.1
DIFFICULTY: Easy

3. An individual may apply for an automatic extension of time to file a return of
   a. Extensions are not permitted
   b. 3 months
   c. 4 months
   d. 6 months

ANSWER: d
LO: 2.1
DIFFICULTY: Easy

4. Which of the following types of returns does not have an unextended due date of the 15th day of the 4th month after the end of the tax year?
   a. S corporations
   b. C Corporations
   c. Individuals
   d. Trusts

ANSWER: a
LO: 2.1
DIFFICULTY: Moderate

5. If the due date for a tax return is extended for a taxpayer who has a $2,000 balance due, the taxpayer
   a. must pay the tax due by the original due date to avoid interest
   b. has 30 days following the original due date to pay the $2,000 due without interest
   c. has 60 days following the original due date to pay the $2,000 due without interest
   d. has 6 months following the original due date to pay the $2,000 due without interest

ANSWER: a
LO: 2.1
DIFFICULTY: Moderate

6. The IRS must pay interest on
   a. tax refunds paid later than 30 days after the due date.
   b. tax refunds paid later than 45 days after the due date.
   c. all tax refunds.
   d. The IRS never pays interest on tax refunds.

ANSWER: b
LO: 2.1
DIFFICULTY: Easy

7. Ryan filed his tax return 40 days after the due date and included a check for the $1,800 balance due with the return. Ryan's failure-to-file penalty is
   a. 25%
   b. 20% per month (or partial month)

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c. 5% per month (or partial month) up to a maximum of 25%
d. 0.5% per month (or partial month) up to a maximum of 25%

ANSWER: c
LO: 2.1
DIFFICULTY: Moderate

8. What is the penalty for taxpayers who fail to pay their tax liability with a timely filed tax return for the taxes owing?
a. 5% per month
b. 2% per month
c. 0.5% per month
d. $100 per month

ANSWER: c
LO: 2.1
DIFFICULTY: Easy

9. What is the minimum penalty for a taxpayer who fails to file his or her return for over 60 days past the due date without reasonable cause?
a. The amount owed on the return
b. $135
c. The amount owed on the return or $210, whichever is less
d. 4.5% of the amount owed on the return.

ANSWER: c
LO: 2.1
DIFFICULTY: Easy

10. The statute of limitations for a return that inadvertently overstates expenses by 30 percent of gross revenues is
a. 3 years
b. 6 years
c. 10 years
d. Unlimited

ANSWER: a; the 6-year limit only applies when income is omitted
LO: 2.1
DIFFICULTY: Easy

11. Which type of audit is most frequently used for examination of business returns?
a. Correspondence audit
b. Office audit
c. Noncompliance audit
d. Field audit

ANSWER: d
LO: 2.1
DIFFICULTY: Easy

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12. A taxpayer will receive a 30-day letter
    a. only if the taxpayer is more than 30 days late in filing the tax return.
    b. to provide notification that the taxpayer's return has been selected for audit.
    c. after a 90-day notice of deficiency notifying the taxpayer there is only a 30-day period to file a protest in court
    d. as the first notice of a proposed deficiency

ANSWER: d
LO: 2.1
DIFFICULTY: Easy

13. What is the first notice of a proposed deficiency that a taxpayer receives?
    a. Examination letter
    b. 90-day letter
    c. 60-day letter
    d. 30-day letter

ANSWER: d
LO: 2.1
DIFFICULTY: Easy

14. How long after receiving a Statutory Notice of Deficiency does the taxpayer have to file a petition with the Tax Court?

    a. 30 days
    b. 60 days
    c. 90 days
    d. 6 months

ANSWER: c
LO: 2.1
DIFFICULTY: Easy

15. To which court can a taxpayer appeal an IRS deficiency notice without paying the tax?
    a. District Court
    b. Tax Court
    c. Court of Federal Claims
    d. Court of Appeals for the Federal Circuit

ANSWER: b
LO: 2.1
DIFFICULTY: Easy

16. Which penalty can equal 75 percent of the tax underpayment?
    a. Failure to file
    b. Failure to pay
    c. Negligence
    d. Fraud

ANSWER: d

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LO: 2.1
DIFFICULTY: Easy

17. An offer in compromise is initiated by
    a. The Tax Court
    b. A Revenue agent
    c. The taxpayer
    d. IRS General Council

ANSWER: c
LO: 2.1
DIFFICULTY: Easy

18. A high DIF score indicates which of the following?
    a. The taxpayer is likely to get a refund
    b. The taxpayer's chances of audit are substantially less than 2%
    c. IRS will automatically grant an extension of time to appeal
    d. The taxpayer's chances of audit are fairly high

ANSWER: d
LO: 2.1
DIFFICULTY: Easy

19. Eduardo filed his 2018 tax return on March 15, 2019. Eduardo accidentally omitted $10,000 of income from his individual tax return. The total gross income shown on the tax return was $35,000. When will the statute of limitations expire for Eduardo's 2018 tax return?
    a. March 15, 2022
    b. March 15, 2025
    c. April 15, 2022
    d. April 15, 2025

ANSWER: d; $10,000/$35,000 = 28.6% omitted so the statute of limitations is increased to 6 years
LO: 2.1
DIFFICULTY: Moderate

20. A six-year statute of limitations applies if the taxpayer
    a. understates adjusted gross income by 25%
    b. understates taxable income by 25%
    c. understates gross income by 25%
    d. overstates deduction by 25%

ANSWER: c
LO: 2.1
DIFFICULTY: Moderate

21. Which of the following is <u>not</u> a requirement to qualify for innocent spouse relief?
    a. The individual electing innocent spouse relief must have been abandoned by her spouse for more than 6 months.
    b. The individual establishes that she did not know and had no reason to know that there was an understatement

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c. It would be inequitable to hold the individual liable for the deficiency attributable to the understatement when all facts and circumstances are considered
d. The individual elects innocent spouse relief within the time period that the statute of limitation is open for collection activities.

ANSWER: a
LO: 2.1
DIFFICULTY: Moderate

22. If a tax return preparer prepares a return that involves a "listed transaction," the preparer can avoid all penalties if
a. the position is not unreasonable.
b. the position has a possibility of success.
c. the preparer has substantial authority for the position
d. the position has no support but there is no evidence of fraud.

ANSWER: c
LO: 2.2
DIFFICULTY: Moderate

23. Which of the following paid tax return preparers must have a preparer tax identification number?
a. CPAs
b. Attorneys
c. Enrolled Agents
d. All of the above

ANSWER: d
LO: 2.2
DIFFICULTY: Easy

24. If a tax preparer is convicted of criminal tax evasion, the preparer may be subject to a penalty of
a. a $100,000 fine
b. prison
c. Both a and b
d. Neither a nor b

ANSWER: c
LO: 2.2
DIFFICULTY: Easy

25. Which of the following does not deal with a CPA's standard of conduct
a. Treasury Circular 230
b. AICPA Code of Conduct
c. Internal Revenue Service Manual
d. Statement of Standards for Tax Services

ANSWER: c
LO: 2.2
DIFFICULTY: Easy

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26. Which of the following is not one of the *Statements on Standards for Tax Services*?
    a. Tax Return Positions
    b. Discovery of Fraud
    c. Use of Estimates
    d. Departure from a Previous Position

ANSWER: b
LO: 2.2
DIFFICULTY: Easy

27. According to the *Statements on Standards for Tax Services*, if a CPA discovers an error in a prior return prepared by another tax return preparer, the CPA
    a. is required to notify IRS immediately
    b. should notify the client of the error and request permission to disclose the error to the IRS
    c. must immediately withdraw from the engagement
    d. is required to correct the error on the prior year's return even if it does not affect the current year's tax return

ANSWER: b
LO: 2.2
DIFFICULTY: Easy

28. In 2019, Coral Corporation (a C corporation) sold $100,000 of merchandise for which it paid $40,000. It also paid $35,000 of other expenses. All transactions were in cash. What is Coral Corporation's after-tax net cash inflow?
    a. $100,000
    b. $60,000
    c. $25,000
    d. $19,750

ANSWER: d; $25,000 x .21 = $5,250; $25,000 - $5,250 = $19,750
LO: 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

29. James can invest in a project that will cost $70,000. The project is expected to pay him $95,000 after-tax in 5 years. What is the maximum discount rate, as a whole number, that he could use to evaluate the project that would yield a positive cash flow?
    a. 5%
    b. 6%
    c. 7%
    d. 8%

ANSWER: b; $70,000/$95,000 = .7368; at 5 years: 7% factor = .713; 6% factor = .747
LO 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

30. Copp Co. can invest in a project that costs $200,000. It is expected to provide a lump sum after-tax return of $300,000. If Copp uses an 8 percent discount rate for evaluation, in what year must it recover the $300,000 to produce a positive net cash flow?

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a. 3rd year
b. 4th year
c. 5th year
d. 6th year

ANSWER: c; $200,000/$300,000 = .667; at 8% discount, 5-year factor = .681; 6-year factor = .630
LO 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Hard

31. CK Corporation can invest $100,000 in a project. After taxes, the project is expected to generate $40,000 of net income the first year and $75,000 of net income the second year. If the company uses a 10 percent discount rate to evaluate projects, what is the project's net cash flow?
a. $15,000
b. $1,690
c. ($1,690)
d. ($1,315)

ANSWER: c; $40,000 x .909 = $36,360; $75,000 x .826 = $61,950; $36,360 + $61,950 - $100,000 = ($1,690)
LO 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

32. Merced Company has invested $200,000 in a project. It had before tax net income of $100,000 in year 1, $150,000 in year 2, and $125,000 in year 3. What is the net present value of this project's after-tax net cash flow if Merced's discount rate is 8 percent and its marginal tax rate is 21 percent in all years?
a. $53,116
b. $120,000
c. $253,116
d. $320,400

ANSWER: a; $100,000 (1 - .21) x .926 = $73,154; $150,000 (1 - .21) x .857 = $101,554.50; $125,000 (1 - .21) x .794 = $78,407.50; $73.154 + $101,554.50 + $78,407.50 - $200,000 = $53,116
LO 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

33. Jacko Corporation has two projects in which it can invest. Project A has a $500,000 initial cost and will return $700,000 after tax in 4 years. Project B has a $300,000 initial cost and its after-tax returns will be $150,000 in year 1 and $200,000 in year 2. Using a 7 percent discount rate for evaluation, which project(s) should Jacko invest in?
a. Project A only
b. Project B only
c. Both projects
d. Neither project

ANSWER: c; ($700,000 x .763) – $500,000 = $34,100; ($150,000 x .935) + ($200,000 x .873) - $300,000 = $14,850
LO 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

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34. Peanut Co. has 2 projects in which it can invest. Project X has a $300,000 initial cost and will return $600,000 before tax in year 2. Project Y has $600,000 initial cost and will return $1,000,000 before tax in year 4. The company uses an 8 percent discount rate for project evaluation and its marginal tax rate is expected to be 21 percent in all years. Which project(s) should Peanut Co. invest in?
    a. Project X only
    b. Project Y only
    c. Both projects
    d. Neither project

ANSWER: a ; Project X: $600,000 (1 - .21) (.857) – $300,000 = $106,218. Project Y: $1,000,000 (1 - .21)(.735) - $600,000 = ($19,350)
LO 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

35. Changing which of the following factors as indicated would increase the after-tax net cash flow of a project:
    a. Delaying revenue recognition
    b. Increasing the discount rate
    c. Delaying expense recognition
    d. Increasing the marginal tax rate
    e. None increase cash flows

ANSWER: c
LO: 2.3
DIFFICULTY: Moderate

36. Changing which of the following factors as indicated would decrease the after-tax net cash flow of a project:
    a. Delaying the years in which inflows occur
    b. Delaying revenue recognition
    c. Increasing the discount rate
    d. All decrease cash flows
    e. None decrease cash flows

ANSWER: d
LO: 2.3
DIFFICULTY: Moderate

37. What effect does an increased discount rate have on project evaluations?
    a. Increases net cash flow
    b. Decreases net cash flow
    c. Increases the probability that a project will be accepted
    d. It has no effect on project evaluation

ANSWER: b
LO: 2.3
DIFFICULTY: Moderate

38. How much tax can be saved if John shifts $2,000 of income to his 18 year old dependent son? John is in the 22 percent tax bracket and his son has no other income that is taxable in 2019.
    a. $1,000

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b. $500
c. $345
d. $100

ANSWER: c ; $2,000 x .22 = $440; ($2,000 - $1,050) x .10 = $95; $440 - $95 = $345
LO: 2.3
DIFFICULTY: Easy

39. How much tax can Charles save if he holds stock on which he has a $30,000 short-term gain until he can use the applicable 15 percent long-term capital gains tax rate? He is in the 32 percent marginal tax bracket for individuals.
a. $5,100
b. $4,500
c. $3,000
d. $2,250

ANSWER: a ; (32% -15%) x $30,000 = $5,100
LO: 2.3
DIFFICULTY: Easy

40. Carl is unsure of which rate he should use as a discount rate for project evaluations, 7 percent or 10 percent. If he can invest $30,000 in a project that will return $40,000 after-tax in four years, what is the result?
a. He will always reject the project
b. He will reject the project if he uses 10%
c. He will reject the project if he uses 7%
d. He will reject neither project

ANSWER: b; $40,000 x .763 = $30,520; $30,520 - $30,000 = $520; $40,000 x .683 = $27,320; $27,320 - $30,000 = ($2,680)
LO 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

41. Crispen Corporation can invest in a project that costs $400,000. The project is expected to have an after-tax return of $250,000 in each of years 1 and 2. Crispen normally uses a 10 percent discount rate to evaluate projects but feels it should use 12 percent to compensate for inflation. How much difference does the rate make in the after-tax net present value of the project?
a. $50,000
b. $22,500
c. $20,000
d. $11,250

ANSWER: d; 10%: $250,000 x (.909 + .826) = $433,750; 12%: $250,000 x (.893 + .797) = $422,500; $433,750 - $422,500 = $11,250
LO 2.3 REFERENCE TABLES REQUIRED
DIFFICULTY: Moderate

42. The business purpose doctrine:
a. Requires a transaction to be initiated by a business
b. Requires a transaction to benefit the business owner
c. Requires the transaction to have an economic purpose other than tax avoidance

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d. Requires the treatment of a transaction to be based on reality not appearances

ANSWER: c
LO: 2.3
DIFFICULTY: Easy

43. A closed-fact situation means that
a. all of the client's transactions have occurred and the research focuses on finding support for the action already taken.
b. all of the client's transactions have not yet occurred so the events may be carefully planned.
c. the client's tax return has not yet been filed.
d. the client is requesting tax planning advice for a future transaction.

ANSWER: a
LO: 2.4
DIFFICULTY: Moderate

44. An open-fact situation means that
a. all of the client's transactions have occurred and the research focuses on finding support for the action already taken.
b. all of the client's transactions have not yet occurred so the events may be carefully planned.
c. the client's tax return has not yet been filed.
d. the client is requesting assistance regarding a previously filed tax return.

ANSWER: b
LO: 2.4
DIFFICULTY: Moderate

45. All of the following are part of the tax research process except:
a. Establish the facts
b. Locate relevant authority
c. Identify the issues
d. Communicate the findings
e. All are part of the tax research process

ANSWER: e
LO: 2.4
DIFFICULTY: Moderate

46. All of the following are primary sources of tax law except:
a. Internal Revenue Code
b. Treasury regulations
c. Report of the House Ways and Means Committee
d. Supreme Court decisions
e. All are primary sources of the tax law

ANSWER: e
LO: 2.4
DIFFICULTY: Easy

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47. Which of the following is the highest authority for tax research?
    a. Internal Revenue Code
    b. Treasury Regulations
    c. Revenue Procedures
    d. Revenue Rulings

ANSWER: a
LO: 2.1
DIFFICULTY: Easy

48. Which of the following committees is not involved in the tax writing process?
    a. Ways and Means
    b. Joint Conference
    c. Judiciary
    d. Senate Finance

ANSWER: c
LO: 2.4
DIFFICULTY: Moderate

49. The Internal Revenue Code is divided into
    a. Chapters and sections only
    b. Titles and subtitles only
    c. Subtitles, chapters, subchapters and sections
    d. Titles, chapters and sections

ANSWER: c
LO: 2.4
DIFFICULTY: Moderate

50. The primary source of tax authority that provides explanations, definitions, and examples of tax laws is the
    a. Internal Revenue Code
    b. Revenue rulings
    c. Regulations
    d. Letter rulings

ANSWER: c
LO: 2.4
DIFFICULTY: Easy

51. The number appearing immediately to the right of the decimal in a regulation citation indicates
    a. subsection of the Code section being interpreted
    b. the sequential number of the regulation
    c. the Code section being interpreted
    d. the part of Title 26 of the Code of Federal Regulations in which the section will be found.

ANSWER: c
LO: 2.4
DIFFICULTY: Easy

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52. A decision in the small case division of the Tax Court can be appealed only to
    a. Supreme Court
    b. Regular Tax Court
    c. Federal District Court
    d. There is no appeal.

ANSWER: d
LO: 2.4
DIFFICULTY: Easy

53. Which of the following has the least weight of authority when deciding a tax issue?
    a. Code
    b. Committee Reports
    c. Regulations
    d. Letter ruling

ANSWER: d
LO: 2.4
DIFFICULTY: Moderate

54. The document that provides the application of the law to a particular set of facts is a
    a. Regulation
    b. Revenue Ruling
    c. Revenue Procedure
    d. Information Release

ANSWER: b
LO: 2.4
DIFFICULTY: Easy

55. The principal reason a researcher uses a tax service is to
    a. provide explanations of relevant case law
    b. provide discussions of key issued related to specific Code sections
    c. provide citations to primary sources of authority
    d. provide answers to specific issues

ANSWER: c
LO: 2.4
DIFFICULTY: Moderate

56. Jury trials are only available in
    a. Court of Appeals
    b. Supreme Court
    c. Regular Tax Court
    d. Federal District Court
    e. None of the above

ANSWER: d
LO: 2.4

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DIFFICULTY: Easy

57. The Golsen Rule
    a. requires the Tax Court to follow the decisions of the District Courts
    b. can result in opposite holdings on identical facts in the Tax Court
    c. requires the Supreme Court to hear cases in which the holdings of the Appellate Courts differ
    d. applies to the US Federal District Court only

ANSWER: b
LO: 2.4
DIFFICULTY: Moderate

58. If the Supreme Court decides to hear an appeal of a tax case, it will grant a
    a. writ of habeas corpus
    b. writ of stare decisis
    c. writ of appeal remanding
    d. writ of certiorari

ANSWER: d
LO: 2.4
DIFFICULTY: Easy

59. A citator
    a. provides a history of a court case
    b. provides lists of other decisions that cite a particular case
    c. provides an alphabetical listing of court cases
    d. provides a numerical listing of Revenue Rulings
    e. All of the above

ANSWER: e
LO: 2.4
DIFFICULTY: Easy

60. The term "on all fours" is generally interpreted to mean
    a. the client's situation has been heard in four circuits
    b. the client's situation is factually similar in its relevant issues
    c. there are four issues that must be addressed
    d. four similar cases have been identified and consulted

ANSWER: b
LO 2.4
DIFFICULTY: Easy

61. The Tax Cuts and Jobs Act is numbered H.R. 1 and after passage by Congress became P.L. 115-97. The prefix and the suffix of the public law number refer to the following, respectively:
    a. the session of Congress that passed the law; bills adopted during that Congressional session
    b. bills adopted during that Congressional session; the session of Congress that passed the law
    c. Neither a or b

ANSWER: a

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LO 2.4
DIFFICULTY: Easy

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