

2001
**CCH
Federal
Tax**

STUDY MANUAL

Edward C. Foth



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CCH INCORPORATED
Chicago

EDITORIAL STAFF

Ron Saxinger

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ISBN 0-8080-0514-6

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<http://www.cch.com>

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HOW TO USE THIS STUDY MANUAL

This manual is provided as an aid to your study of *CCH Federal Taxation—Comprehensive Topics, Basic Principles, and Federal Tax Course*, and is designed to reinforce your understanding and to help you master the main concepts presented in the textbook.

The **Study Manual** outlines and highlights the in-depth textbook presentation and contains objective questions (and answers) for self-evaluation that will help you measure your understanding and identify those topics that are in need of further study. Also included are a series of tax return problems designed to complement your conceptual study and to provide exposure to various aspects of tax return preparation.

This manual should be used to help you master the material as you initially study each chapter and, at a later date, will provide a convenient and effective means of quickly reviewing the material before examinations. The proper approach for combining use of this guide with textbook material is as follows:

1. Read the chapter outline in the **Study Manual**. Note that key words are **boldfaced** and important concepts are italicized.
2. Read the corresponding chapter in your textbook.
3. Answer the objective questions in the **Study Manual** and compare your answers with those found at the end of the chapter. The number of items correctly answered will give you an indication of your understanding of the chapter.
4. Work the problems assigned in the textbook.
5. Work the **Study Manual** tax return problems.

Never rely on this manual as a substitute for a thorough reading of the textbook. Mastery of the material can be obtained only through use of your textbook in conjunction with this manual.

This **Study Manual** will be revised annually. Any comments or suggestions will be sincerely appreciated.

Edward C. Foth
DePaul University

Cross-Reference to Textbooks

The following provides a cross-reference between the Topics in this Study Manual and the corresponding chapters in the CCH taxation textbooks:

Study Manual	Comprehensive Topics	Basic Principles	Federal Tax Course
<i>Topic</i>	<i>Chapter</i>	<i>Chapter</i>	<i>Chapter</i>
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2	2	2	1, 14
3	3	3	2
4	4	4	4
5	5	5	5
6	6	6	6, 7, 11
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8	8	8	8
9	9	9	12, 13
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18	18	16	17, 24
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20	20	16	19
21	21	16	18
22	22	17	27, 28
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TOPIC 1

INTRODUCTION TO FEDERAL TAXATION AND UNDERSTANDING THE FEDERAL TAX LAW

Summary

This chapter presents information concerning sources of revenue and tax collection data. Also provided is a historical background of the U.S. revenue system and federal tax legislation. Tax avoidance is distinguished from tax evasion, and the impact of tax penalties is discussed. Basic tax concepts are also explained.

Outline

I. Sources of Revenue.

- A. Individual income taxes provide approximately 50 percent of the government's tax revenue; corporate income taxes provide approximately 13 percent.
- B. Other revenues are provided by estate and gift taxes, excise taxes, and customs taxes.

II. Tax Collection Data.

- A. More than 216 million tax returns and supplementary documents were filed in 1997.
- B. IRS is relying on computer technology to cross-check taxpayer information.

III. Tax Penalties.

- A. Penalties are imposed for failure to pay taxes when due, failure to make federal tax deposits, late filing, negligence, fraud, etc.
- B. Jail sentences may be imposed for those found guilty of tax fraud.

IV. Taxpayer Obligations.

- A. Tax evasion is escaping tax by illegal means.
- B. Tax avoidance is a reduction of tax through legal means.

V. History of Federal Tax Legislation.

- A. The Sixteenth Amendment to the Constitution (ratified on February 25, 1913) gave Congress the power to tax income from whatever source derived without apportionment among the States.
- B. Revenue Act of 1913 imposed a new income tax on the net income of individuals and corporations, and made it retroactive to March 1, 1913.
- C. The Internal Revenue Code of 1939 was the first separate codification of the internal revenue laws.
- D. The Internal Revenue Code of 1954 completely revised the Internal Revenue Code of 1939.
 - 1. Largest piece of federal tax legislation in history.
 - 2. The Internal Revenue Code of 1954 was frequently amended (e.g., Tax Reform Act of 1984).
- E. The Tax Reform Act of 1986, one of the most significant tax law revisions in history, renamed the Internal Revenue Code the Internal Revenue Code of 1986.

VI. Federal Tax Legislative Process.

- A. Tax legislation generally begins in the House of Representatives.
 - 1. Hearings before the House Ways and Means Committee.
 - 2. The Committee drafts tax bill and sends to House for debate.
 - 3. Tax bill passed by House is sent to Senate Finance Committee.
- B. Finance Committee may amend bill, then send to Senate for possible additional amendments and passage.
 - 1. If Senate- and House-passed versions of tax bill differ, the tax bill is sent to Conference Committee for resolution of differences.
 - 2. Uniform tax bill sent back to House and Senate for approval in final form.
 - 3. The tax bill passed by House and Senate goes to President.

- (a) President signs; tax bill becomes law.
- (b) President vetoes; a two-thirds vote in House and Senate is needed to override veto.

VII. Basic Tax Concepts.

- A. **Assignment of income.** Income cannot be assigned to another taxpayer. Income is taxed to the person who earned it because of having provided services or because of the ownership of property.
- B. **Basis.** An amount assigned to an asset for purposes of computing depreciation or determining a gain or loss upon the property's sale or exchange. If property is acquired by purchase, its basis is its cost.
- C. **Capital asset.** A taxpayer's capital assets generally consist of property held for investment and property held for personal use. The gains and losses from capital assets are subject to special rules.
- D. **Claim of right doctrine.** Even though an amount of income has not yet been earned, the amount must nevertheless be included in income upon the earlier of actual or constructive receipt if the taxpayer has an unrestricted claim to such amount (e.g., prepaid rent is included in income in the year received).
- E. **Constructive receipt doctrine.** Even though an amount of income has not been physically received, it is nevertheless included in income if it is unqualifiedly available to the taxpayer (e.g., interest accrued on a savings account).
- F. **Substance v. form.** A judicial concept used to determine the true nature of a transaction (e.g., a bargain sale of property to a family member may be treated as a gift).
- G. **Tax benefit rule.** A recovery of an item deducted in an earlier year must be included in income to the extent that the previous deduction provided a benefit by reducing the taxpayer's income tax (e.g., recovery of a bad debt; refund of state income tax).

Objective Questions

True-False

Indicate whether each statement is **true** or **false**.

- _____ 1. The value-added tax is an example of a direct tax.
- _____ 2. The Thirteenth Amendment to the Constitution empowered Congress to collect taxes with apportionment.
- _____ 3. In 1913, the personal exemption for a single person was \$3,000.
- _____ 4. The IRS currently audits approximately five percent of all individual tax returns that are filed.
- _____ 5. Current federal income tax law is found in the Internal Revenue Code of 1986.
- _____ 6. Any Senator may offer amendments to a tax bill from the floor of the Senate.
- _____ 7. The percentage of individual tax returns audited increased in 1997.
- _____ 8. Estate and gift taxes account for approximately 10 percent of the total revenue generated by the federal government.
- _____ 9. The excise tax on alcohol generates the most revenue among excise taxes.
- _____ 10. Property taxes generate the most revenue for local governments.
- _____ 11. The federal income tax is self-assessing.
- _____ 12. There is a clear demarcation line between tax avoidance and tax evasion.
- _____ 13. Germany was the first major country to adopt a value-added tax.
- _____ 14. National revenue collections serve as a window for monitoring social change.
- _____ 15. Over 56 percent of all tax returns are filed by individuals.

- _____ 16. Corporate income taxes accounted for approximately 20 percent of the revenue generated by the government in 1997.
- _____ 17. The federal income tax on corporations is an indirect tax.
- _____ 18. The Deficit Reduction Act of 1984 was the largest revenue-raising bill ever passed.

Answers**True-False**

1. False. It is an indirect tax on value added to a product at all levels of production and distribution.
2. False. The Sixteenth Amendment permitted income taxes without apportionment.
3. True.
4. False. The IRS audits less than two percent of all individual tax returns filed.
5. True.
6. True.
7. False. The percentage of individual returns audited declined to 1.28% from 1.67% in 1996.
8. False. Estate and gift taxes accounted for approximately one percent of the total revenue generated by the federal government.
9. True.
10. True.
11. True.
12. True.
13. False. France was the first major country to adopt a value-added tax.
14. True.
15. True.
16. False. Corporate taxes accounted for 12.6 percent of the revenue generated by the government in 1997.
17. False. The federal income tax on corporations is a direct tax.
18. False. The 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) was the largest revenue-raising bill ever passed.

TOPIC 2

TAX RESEARCH, PRACTICE, AND PROCEDURE

Summary

This chapter provides a basic introduction to the process whereby one systematically searches for the answer to a tax question, using the various primary and secondary sources of tax-related information. This chapter also discusses the internal organization of the IRS, the rules relating to practice before the IRS, and procedures for examination of returns. Also discussed are methods of communication between taxpayers and the IRS and some of the more common penalties to which taxpayers and the tax return preparers may be subject.

Outline

I. Primary Authoritative Sources.

A. Present code is the **Internal Revenue Code of 1986**.

1. Represents Title 26 of the United States Code.
2. Frequently amended.

B. Administrative authority.

1. IRC gives the Treasury Department authority to issue **Regulations** to administer tax laws.

(a) Three types of Regulations:

- (1) **Legislative**—in areas where Congress specifically delegates responsibility to the Treasury Department, these Regulations have the “force and effect of law.”
- (2) **Interpretive**—purpose is to clarify language of the Code as passed by Congress.
- (3) **Procedural**—specify steps to be taken in performing certain acts under the Code.

- (b) The type of Regulation is indicated by the number preceding the decimal point:

- (1) 1—Income tax
20—Estate tax
25—Gift tax
31—Withholding
301—Procedural
- (2) Example: § 1.301-1(a) is an Income Tax Regulation pertaining to Code Sec. 301.

2. Rulings.

- (a) **Revenue Rulings**—generally have less force than Regulations because they give the Commissioner's interpretation of how the Internal Revenue Code applies to a specific fact situation only; but can be used as precedent.
- (b) **Revenue Procedures**—announce administrative practices followed by IRS.
- (c) **Letter Rulings**—are written statements issued to taxpayers who requested advice concerning a specific transaction. A letter ruling can only be relied upon by the taxpayer to whom issued; it cannot be used as precedent.

C. Judicial authority.

- 1. **U.S. Tax Court**—hears only tax cases:
 - (a) Distinguishing feature is that taxpayer does not have to pay tax before he goes to court.
 - (b) Issues “regular” and “memorandum” decisions; both can be used as precedent.
 - (c) IRS issues “acquiescence” or “nonacquiescence” to regular decisions that it loses.
 - (d) Decisions are appealed to U.S. Court of Appeals.
- 2. **U.S. District Courts**—taxpayer must pay tax and then file suit for refund; decisions are appealed to U.S. Court of Appeals.
- 3. **U.S. Court of Federal Claims**—taxpayer must pay tax and then file suit for refund; decisions are appealed to U.S. Court of Appeals for the Federal Circuit.
- 4. **U.S. Court of Appeals**—decisions have more authority than lower court decisions; decisions are appealed to U.S. Supreme Court.
- 5. **U.S. Supreme Court**—normally hears tax cases only if they involve a conflict between circuits of Appeals Courts.

II. Secondary Source Materials.

- A. Secondary reference materials aid the practitioner by providing a convenient cross-referenced guide through a growing maze of primary tax authority.
- B. The CCH *Standard Federal Tax Reporter* and *Federal Tax Articles* are two of the many secondary reference sources available.

III. Research Methodology.

- A. **After the facts** compliance research (“closed fact” case) generally involves the legal interpretation of historical events. Examples include the proper reporting of an item to be included in a tax return for the prior year, and representation of a client at an IRS audit of a previous year’s return.
- B. **Before the facts** planning (“open fact” case) generally involves events that have not yet been finalized and primarily relates to future tax planning decisions.

C. Five-step research model:

- 1. Gathering the facts and identifying the tax issues to be researched.
 - (a) Attempt to obtain objective information from taxpayer.
 - (b) Look for multiple issues.
- 2. Locating and studying the primary and secondary authorities relevant to the enumerated tax issues.
 - (a) Begin with the compilation materials found in a looseleaf tax service.
 - (b) Be sure to review the “Current Developments” section to determine recent pronouncements.
- 3. Updating and evaluating the weight of the various authorities.
 - (a) Relevant cases must be assessed in terms of value as judicial precedent.
 - (b) Use citator to review current status of case.
- 4. Reexamining various facets of the research.
- 5. Arriving at conclusions and communicating the conclusions to the client.
 - (a) The research report should include:
 - (1) A statement of the facts.
 - (2) An enumeration of the tax issues researched.

- (3) The conclusions reached.
- (4) A discussion of the reasoning and authorities supporting the conclusion.
- (b) The taxpayer should be advised of the potential benefits and risks associated with the recommended action.

IV. CCH CD-ROM and Online Software.

- A. CCH CD-ROM and Online computer software is a research tool that provides full-text retrieval of statutes, regulations, IRS rulings, and judicial decisions as well as the full text of CCH's Federal Income Tax Reporter.
- B. CCH CD-ROM is updated monthly, and the Online resource is updated daily.

V. Tax Administration and Practice.

- A. The National Office of the Internal Revenue Service is located in Washington, D.C.
 - 1. The National Office develops nationwide policies and programs for the administration of the tax law, and oversees four regional offices, five service centers, thirty-three district offices, and numerous branch offices.
 - 2. The National Office consists of the Commissioner of Internal Revenue, the Deputy Commissioner, the Chief Inspector, the Taxpayer Advocate, the Modernization Executive, the Chief Council, Assistants to the Commissioner and Deputy Commissioner, and seven chief subordinate officers.
- B. Each of the four regional offices is supervised by a Regional Commissioner who is responsible for the district offices and service centers that are located in that region.
- C. The District Offices (33) are each headed by a District Director. The District Offices are structured along functional lines into divisions for collection, criminal investigation, examination, resources management, taxpayer services, and (in some districts) employer plans and exempt organizations.

VI. Practice Before the IRS.

- A. A CPA, attorney, or an individual who has passed the IRS enrollment examination may practice before the IRS.