Solutions to Homework Assignments: Chapter 3

1. "The goal of tax planning is to minimize taxes." Explain why this statement is not true.

In general terms, the goal of tax planning is to maximize the taxpayer's after- tax wealth while simultaneously achieving the taxpayer's nontax goals. Maximizing after-tax wealth is not necessarily the same as tax minimization. Specifically, maximizing after-tax wealth requires one to consider both the tax and nontax costs and benefits of alternative transactions, whereas tax minimization focuses solely on a single cost (i.e., taxes).

25. Describe the business purpose, step-transaction, and substance-over-form doctrines. What types of tax planning strategies may these doctrines inhibit?

The business purpose doctrine allows the IRS to challenge and disallow business expenses for transactions with no underlying business motivation. The step-transaction doctrine allows the IRS to collapse a series of related transactions into one transaction to determine the tax consequences of the transaction. Finally, the substance-over-form doctrine allows the IRS to consider the transaction's substance regardless of its form, and where appropriate, reclassify the transaction according to its substance. The IRS uses these doctrines where they expect taxpayer abuse. They can be used to void income shifting, conversion, and timing strategies.

26. What is the difference between tax avoidance and tax evasion?

Tax avoidance is the legal act of arranging one's affairs to minimize taxation. It has long been endorsed by the courts and Congress. In contrast to tax avoidance, tax evasion (willful intent to defraud the government) falls outside the confines of legal tax avoidance. In many cases there is a clear distinction between avoidance (e.g., not paying tax on municipal bond interest) and evasion (e.g., not paying tax on $1,000,000 game show prize). In other cases, the line between tax avoidance and evasion is less clear. In these situations, professional judgment, the use of a "smell test," and consideration of the business purpose, step transaction, and substance-over-form doctrines may prove useful.

32. Isabel, a calendar-year taxpayer, uses the cash method of accounting for her sole proprietorship. In late December she received a $20,000 bill from her accountant for consulting services related to her small business. Isabel can pay the $20,000 bill anytime before January 30 of next year without penalty. Assume her marginal tax rate is 40 percent this year and next year, and that she can earn an after-tax rate of return of 12 percent on her investments. When should she pay the $20,000 bill—this year or next?

Option 1: Pay $20,000 bill in December:
$20,000 tax deduction x 40 percent marginal tax rate = $8,000 in present value tax savings.

After-tax cost = Pretax Cost – Present Value Tax Savings

= $20,000 – $8,000 = $12,000

Option 2: Pay $20,000 bill in January:
$20,000 tax deduction x 40 percent marginal tax rate = $8,000 in tax savings in one year.

Present Value of Tax Savings = $8,000 x .893 (Discount Factor, 1 Year, 12 percent)

= $7,144

After-tax cost = Pretax Cost – Present Value Tax Savings

= $20,000 – $7,144 = $12,856

Paying the $20,000 in December is the clear winner.

49. Bendetta, a high-tax-rate taxpayer, owns several rental properties and would like to shift some income to her daughter, Jenine. Bendetta instructs her tenants to send their rent checks to Jenine so Jenine can report the rental income. Will this shift the income from Bendetta to Jenine? Why or why not?

Merely sending the checks to Jenine is not sufficient to shift the rental income from Bendetta to Jenine under the assignment of income doctrine. To shift the rental income to Jenine, she must earn the income. In this case, this means that Jenine must actually own the rental property to report the rental income.

54. Duff is really interested in decreasing his tax liability, and by his very nature he is somewhat aggressive. A friend of a friend told him that cash transactions are more difficult for the IRS to identify and, thus, tax. Duff is contemplating using this “strategy” of not reporting cash collected in his business to minimize his tax liability. Is this tax planning? What are the risks with this strategy?

This is not tax planning. Instead, this strategy is tax evasion. The rewards of tax evasion include stiff monetary penalties and imprisonment.

55. Using the facts from the previous problem, how would your answer change if instead, Duff adopted the cash method of accounting to allow him to better control the timing of his cash receipts and disbursements?

This strategy would fall within the confines of legitimate tax planning, and thus, Duff should not be subject to the potential risks associated with tax evasion.