1970

Tax Administration & Procedure: Examination (January 1970)

William & Mary Law School

MARSHALL-WYTHE SCHOOL OF LAW

Tax Administration & Procedure

Time: 3 hours
Type - Open Book

Examination - January 1970

Question I - Time 1 hour

Mr. Kramer, your client, a cash basis taxpayer, on January 3, 1970, received by certified mail a "90 day letter" mailed on January 2, 1970. The deficiency shown in the "90 day letter" was in the amount of $3,000 for the taxable year 1962. Mr. Kramer filed a timely return for the year 1962, in which he reported a total gross income of $20,000, his salary, and paid a total tax of $4,000. The "90 day letter" contained the following items which made up the deficiency:

1. Bonus income in the amount of $5,000 which was available for payment to Mr. Kramer in 1962. (He never requested payment of the bonus and did not receive payment of the bonus in 1962).

2. Gain income of $2,000, the fair market value of 20 shares of Public Corp. Stock. (This stock was distributed to Mr. Kramer in 1962 in exchange for Small Corp. stock. Mr. Kramer's basis for The Small Corp. stock was zero. Mr. Kramer did not report the $2,000 gain on the exchange because he <u>erroneously</u> believed that the exchange was part of a reorganization as defined by Section 368 and, therefore, was not recognized at that time.)

3. A bad debt deduction in the amount of $2,000 which Mr. Kramer claimed for 1962 was disallowed. The reason for the disallowance was that the debt did not become worthless until the taxable year 1968. (Mr. Kramer took the same bad debt as a deduction for the taxable year 1968. He did so because of the honest and correct belief that 1968 and not 1962, as he originally believed was the year in which the debt became worthless. His 1968 return was audited in July 1969 and the bad debt deduction was allowed).

The "90 day letter" received on January 3, 1970 was not the first experience Mr. Kramer had with the Commissioner concerning item I., the bonus, and item 2, the stock exchange. In 1966, Mr. Kramer received a check for the bonus of $5,000. However, he never cashed the check and for that reason did not report it in his gross income for 1966. The Commissioner mailed a "90 day letter" to Mr. Kramer on March 1, 1968 showing a deficiency in the amount of $1,500 for the year 1966 as a result of the omission of the bonus from gross income. Mr. Kramer filed a timely petition with the Tax Court and in an opinion dated June 1, 1969 the Tax Court adopted Mr. Kramer's argument that the bonus was constructively received in the year 1962, and determined that there was no deficiency for the year 1966.

Mr. Kramer's former experience with item 2, the stock exchange was somewhat indirect. The Service asserted a deficiency against Mr. Kramer's solely owned corporation, Kramer, Inc. for the year 1966. The deficiency arose in connection with a sale by Kramer, Inc. of the Public Corp. stock, which Mr. Kramer transferred to Kramer, Inc. in a section 351 transaction. Under section 362 Kramer, Inc's basis for the stock received in a section 351 transaction is Mr. Kramer's basis for the stock. Kramer, Inc. took the position that Mr. Kramer's basis for the stock was $2,000, the fair market value of the stock on the date it was received by Mr. Kramer in 1962. The Kramer, Inc. argument was based on the theory that the exchange of Small Corp. stock for Public Corp. stock was not part of a reorganization and, therefore, Mr. Kramer should have recognized his gain at that time and taken a stepped-up basis. Kramer, Inc. paid the deficiency in the amount of $1,000 ($4,000 realized - zero basis = 4,000 gain x 25% tax rate) and filed a refund claim for $500.00 (4,000 realized - $2,000 basis = $2,000 x 25% tax rate). The Commissioner allowed the timely refund claim on December 1, 1969.

The Commissioner is entirely correct on the merits of all items raised in the "90 day letter" received by Mr. Kramer on January 3, 1970.

(a) What procedural defense or defenses are available to Mr. Kramer with respect to the deficiency for 1962? Explain in detail.

(b) What result should a Court reach with respect to the 1962 deficiency? Explain in detail.

(c) Would that result be different if the case went before the District Court on a refund procedure rather than before the Tax Court on a deficience procedure? Explain in detail.

Question No. 2 - Time 20 min.

Mr. Foley filed a timely return for the taxable year 1967. He showed a tax of $4,000, a credit under section 31 of $5,000 for income tax withheld, and requested on the return that the Commissioner credit the $1,000 excess to his estimated tax for the year 1968. The Commissioner informed Mr. Foley by letter on June 15, 1968 that the credit would not be proper because Mr. Foley did not correctly calculate his 1967 tax. The Commissioner's calculations caused the tax to be increased by $1,000 so that the tax totaled $5,000. The Commissioner's reason for the increase was that Mr. Foley was not entitled to 4 dependency deductions which Mr. Foley had claimed on his return for his son, George, George's wife, and their two children.

Although he was entitled to all of the dependency deductions Mr. Foley decided not to dispute the matter because he thought he would have a difficult time adequately proving his expenses for the dependents. He, therefore, took no additional action.

On January 12, 1970, Mr. Foley received a "90 day letter" dated January 10, 1970, containing a notice of a deficiency for the year 1967. The deficiency set forth in the notice was in the amount of $500 and related solely to the sale of certain capital assets. Mr. Foley sent a check in the amount of $500 plus interest to the date of the check to the District Director in payment of the asserted deficiency on January 13, 1970. However he now has had some second thoughts about both the denial of the dependency deductions and the denial of preferential treatment for the capital transactions and seeks your advice.

On the merits Mr. Foley is entitled to the dependency deduction and the preferential treatment for the capital transactions.

Questions:

(a) What procedural steps, if any, are open to Mr. Foley to bring these matters up for consideration on the merits?

(b) What specific steps would you take at this time? Explain in detail.

Question No. 3 - 45 minutes

Mr. Peace, a citizen strongly opposed to this governments foreign policy, which he considered militaristic, decided that he was morally obligated to refrain from taking any positive steps to aid the government in implementing this policy. As a result of this attitude he filed no income tax return for the year 1960 even though he had received gross income in the amount of $20,000. In addition Mr. Peace destroyed all records of his 1960 business transactions.

On June 1, 1969 Mr. Peace received a "30 day letter" advising him that the Commissioner was planning on asserting a deficiency against him for the taxable year 1960. The notice dated May 28, 1969 set forth an alleged tax due for 1960 in the amount of $5,000, and showed a credit under Section 31 against that tax of $1,000 for income tax withheld. In addition the notice showed penalties under Section 6651 in the amount of $1,000 and Section 6653 in the amount of $2,500. The entire deficiency was totaled at $8,500.

$5,000	Tax
1,000	6651 Penalty
2,500	6653 Penalty
$8,500	Deficiency
(1,000)	Credit Section 31

When Mr. Peace received the "30 day letter" he determined that the tax in the amount of $5,000 as fixed by the Commissioner was correct. He immediately filed a return for the year 1960 showing a tax of $5,000, a credit under Section 31 of $1,000, and included with the return a check in the amount of $4,000.

The Commissioner in response notifed Mr. Peace on August 1, 1969 that the entire deficiency in the amount of $8,500 had been assessed on July 1, 1969. The Commissioner included in the letter a demand for payment of the balance in the amount of $3,500 within 10 days. Mr. Peace, who still thinks that the penalties should not be imposed has never paid the balance. Yesterday, he received word that if payment was not made soon his property would be seized and sold in order to collect $3,500 outstanding. Mr. Peace called you and informed you that he only could raise $2,000 in cash to satisfy the obligation.

Questions:

(a) Is the Commissioner correct with respect to the penalties he has imposed.

(b) Did he calculate the amount of the penalties correctly.

(c) If you disagree with the Commission on the penalties imposed or the amount of the penalties, what penalties would you impose? Calculate the amount of those penalties?

(d) What criminal charges, if any, could be imposed against Mr. Peace?

(e) Advise Mr. Peace of any steps he can take to litigate the question of penalties and to prevent sale and seizure of his property.

(f) Will any interest charges be imposed on Mr. Peace for the tax year 1960? You don't need to make exact calculations.

Question 4 - 30 minutes

In March of 1966, the Service conducted an audit of Mr. Kent's income tax return for the calendar year 1964. A deficiency of $2,000 was being considered as a result of certain alleged improper personal deductions taken by Mr. Kent in the year 1964. A "30 day letter", which showed a deficiency of $2,000 resulting from the disallowance of the said deduction was sent to Mr. Kent on July 1, 1966. On July 2, 1966 Mr. Kent sent a check in payment of the deficiency, which was assessed on July 15, 1966.

On June 15, 1968 Mr. Kent received a 90 day letter, mailed June 12, 1968, showing a deficiency in the amount of $7,000 for the calendar year 1964. The deficiency resulted from an erroneous omission from gross income of an amount in excess of 25% of the gross income stated in Mr. Kent's return for the year 1964. Mr. Kent filed a petition with the Tax Court on July 2, 1968. In his petition Mr. Kent asserted that the Commissioner was in error with respect to the deficiency set forth in the 90 day letter and in addition Mr. Kent had failed to take some business deductions which if allowed would result in an overpayment of his 1964 tax in the amount of $10,000. If the Tax Court determines on the merits that there was a $7,000 deficiency and a $10,000 overpayment, can Mr. Kent receive refund in the amount of $3,000 ($10,000 - $7,000 deficiency)?

Question 5 - 25 minutes

(A) Time 10 minutes

In March 1968, Mrs. Zelt's 1965 income tax return was audited. Following the receipt of a 30 day letter Mrs. Zelt filed a protest and requested an appellate conference. Mrs. Zelt agreed to the assessment of a $1, 000 deficiency resulting from the disallowance of certain medical deductions. Other deficiencies set forth in the "30 day letter" ~~the~~ for same year were considered. However, the Audit Division agreed that the deficiency should be limited to $1, 000. On April 1, 1968 Mrs. Zelt signed an 870 A-D and paid the deficiency.

On Junuary 1, 1969 Mrs. Zelt filed a claim for refund of the $1, 000 deficiency which she had paid on April 1, 1968. The claim was denied on April 16, 1969. On August 16, 1969 Mrs. Zelt sued for refund in the Federal District Court.

Questions:

(a) If you represented the Commissioner, what arguments would you make in the defense of the disallowance of the refund claim?

(b) If you represented Mrs. Zelt how would you refute that argument?

(c) If you were on the District Court how would you rule ?

(B) Time 15 minutes

On January 4, 1964 Mr. Grantor created a revocable trust. The income earned on the trust funds was properly taxable to Mr. Grantor. However, the trust erroneously paid the tax of $1, 000 on the income earned from the trust assets for the year 1964 in the amount of $5, 000. Mr. Grantor for the year 1964 filed a timely return showing gross income of $30, 000 and a tax of $8, 000.

On April 14, 1968 the trustee discovered that Mr. Grantor should have reported the income and on that same day filed a refund claim for the $1, 000 tax paid by the trust in 1964. The claim was denied by the Service on May 15, 1968. The notice of disallowance which was sent by certified mail cited the case of Stone v White, 301, U.S. 532, 57 S. Ct. 851 (1937).

Question:

What advice would you give the trustee?