South-Western Federal Taxation 2020 Individual Income Taxes 43rd edition Young Solutions Manual

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CHAPTER 1

AN INTRODUCTION TO TAXATION AND UNDERSTANDING THE FEDERAL TAX LAW

SOLUTIONS TO PROBLEM MATERIALS

DISCUSSION QUESTIONS

1. (LO 1, 4)
   a. John must now document rental receipts and separate his home expenses between personal and rental use, and he may be subject to the transient occupancy tax.

   b. Theresa has become self-employed. Now she will be subject to self-employment tax and may have to make quarterly installment payments of estimated income and self-employment tax. Theresa will be required to make payroll tax payments if she hires individuals to work in her business.

   c. Paul's employer might have some moving expenses that it can deduct (in general, Paul cannot deduct moving expenses). Paul's personal taxes will change because Florida does not impose an income tax but California does.

2. (LO 1, 4) 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 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 the local (and perhaps even the state) taxing authorities. Besides the real estate taxes, personal property taxes could be imposed on the furnishings.

3. (LO 2) The statement is only partly correct. The Federal income tax on corporations was not a problem since it had previously been sanctioned by the Supreme Court. What had been declared unconstitutional was the tax on individuals as it applied to the income *from property*.

4. (LO 2) 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.

5. (LO 2) 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 nonwage 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.

6. (LO 3) The tax law of State X appears to violate the *certainty* and *simplicity* principles.

7. (LO 3) A tax is *proportional* if the rate of tax remains constant for any given income level. The tax is *progressive* if a higher rate of tax applies as the tax base increases.

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8. (LO 4)
   a. The parsonage probably was not listed on the property tax rolls because 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 may eliminate *future* interest and penalties.

9. (LO 4) 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.

10. (LO 4)
    a. In this case, the "tax holiday" probably concerns exemption from ad valorem taxes. "Generous" could involve an extended period of time (e.g., 10 years) and include both realty and personalty.

    b. The school district could be affected in two ways. First, due to the erosion of the tax base, less revenue would be forthcoming. Second, new workers would mean new families and more children to educate.

11. (LO 4) A possible explanation is that Sophia made capital improvements (e.g., added a swimming pool) to her residence and her parents became retirees (e.g., reached age 65).

12. (LO 4) Presuming that the dockage facilities are comparable in Massachusetts, the Morgans may be trying to avoid ad valorem taxes. Taxes on nonbusiness property vary from one state to another and are frequently avoided.

13. (LO 4) In general, Federal excise taxes apply to fewer items than in the past. Lawmakers have focused on, and increased, certain Federal excise taxes (e.g., those on tobacco products, gasoline, and air travel).

14. (LO 4) 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 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.

15. (LO 4) An *excise tax* is limited to a particular transaction (e.g., sale of gasoline), whereas a general *sales tax* covers a multitude of transactions (e.g., sale of all nonfood 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.

16. (LO 4)
    a. Jackson County must be in a state that imposes a lower (or *no*) sales tax. With certain major purchases (i.e., big-ticket items), any use tax imposed by the state of the Grays' residence could come into play.

    b. In some states, the sales tax rate varies depending on the county and/or city.

    Note: Generally, buyers are subject to the sales and use tax rate where they live. Thus, for example, if the Grays buy goods in a different state with zero or a lower sales tax rate than in their state, they owe use tax to their home state for the difference.

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17. (LO 4) Earl probably purchased his computer out of state through a catalog or via the internet. In such cases, state collection of the sales (use) tax is not likely. Earl needs to pay use tax on his own (which is equal to the sales tax).

18. (LO 4) 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 and Texas) levy neither tax.

    b. The Federal government imposes an estate tax.

19. (LO 4) 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). As a result, in the case of spousal transfers, there is no tax reason to prefer transfers at death over lifetime gifts.

20. (LO 4)
    a. The purpose of the unified transfer tax credit is to eliminate the tax on all but substantial gifts and estates.

    b. Yes. The credit for 2019 is $4,505,800; for 2018, it is $4,417,800.

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

21. (LO 4) $570,000. 19 donees (5 married children + 5 spouses + 9 grandchildren) × $15,000 (annual exclusion for 2019) × 2 donors (Elijah and Anastasia) = $570,000.

22. (LO 4) The individual income tax is progressive in nature; the corporate income tax is assessed at a flat 21% rate. In addition, the corporate income tax does not make any distinction as to deductions—only business deductions are allowed. Nor does it require the computation of adjusted gross income (AGI) or provide for the standard deduction and the deduction for qualified business income.

23. (LO 4)
    a. For state income tax purposes, "piggyback" means making use of what was done for Federal income tax purposes. By "decoupling," a state decides not to allow a particular Federal provision (e.g., exclusion, deduction, credit) for state income tax purposes.

    b. States often use IRS audit results to identify errors that might also exist on the taxpayer's state tax return.

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

24. (LO 4) What happened here likely is not a coincidence. The IRS probably notified the state of California regarding Hernando's omission of income. Thus, California followed up with its own audit.

25. (LO 4) 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.

26. (LO 4, 5)
    a. This type of question has no relevance to the state income tax, but is a reminder to individual taxpayers about the use tax and a simple way for individual taxpayers to pay any use tax due on internet and mail-order purchases. Without the line on the state income tax return, individual taxpayers would be required to file a separate use tax return.

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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.

27. (LO 4) The checkoff boxes add complexity to the return and mislead taxpayers into presuming that they are not paying for the donation.

28. (LO 4)

a. They uncover taxpayers who were previously unknown to the taxing authority. In addition, amnesty programs can bring taxpayers that are not in compliance with tax laws into compliance.

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

c. No general amnesty program has been offered for any Federal taxes.

29. (LO 4)

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 the Federal and state government.

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

30. (LO 4)

a. Unlike the Social Security portion of FICA, there is no dollar limit on the imposition of the Medicare tax.

b. The 0.9% Medicare addition applies to taxpayers with wages or net self-employment income in excess of $200,000 ($250,000 for married filing jointly).

31. (LO 4) Only children under age 18 are excluded from FICA. Other family members, including spouses, must be covered.

32. (LO 4)

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 minerals.

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.

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.

d. Customs duties are taxes on the importation of certain foreign goods. They are imposed by the Federal government and are not found at the state and local level.

e. Export duties are taxes imposed on the export of certain commodities (e.g., oil, coffee). They are common in less-developed nations and are not levied by the United States.

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33. (LO 4)

a. The United States is the only country in the OECD (Organization of Economic Cooperation and Development) that does not have a value added tax (VAT). Over 100 countries use a VAT. In spite of its extensive use by other countries, the adoption of a VAT by the United States appears doubtful. Instead, the United States places high reliance on the income tax as its major revenue source.

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.

c. Because it is an effective generator of revenue, the VAT has been criticized as leading to more government spending.

34. (LO 4)

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 relative to higher-income taxpayers. Thus, the taxes are regressive in effect.

b. The regressive effect might be partly remedied by granting some sort of credit, rebate, or exemption to low-income taxpayers.

35. (LO 4, 5)

a. Serena may have record-keeping issues related to the cash transactions. The short-term holiday workers should be on the payroll because they are employees, and Serena owes FICA and FUTA on their wages and must file Forms 940 and 941 with the IRS. Serena must also timely issue a W–2 wage form to each of her employees.

b. High. First, Serena is self-employed. Second, she operates partially on a cash basis. Third, the opportunity to understate income and/or overstate expenses is high. Fourth, she has some workers who appear to be misclassified and for whom she may not have issued tax reporting forms.

36. (LO 5)

a. 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.

b. An audit that is conducted in an IRS office is called an office audit.

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

d. When a special agent becomes involved, this usually means that fraud is suspected.

37. (LO 5) 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.

38. (LO 5) 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 because witnesses and other evidence may no longer be available. In the Federal tax area, statutes of limitations cover additional assessments by the IRS and the pursuit of refund claims by taxpayers.

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39. (LO 5)

a. The normal three-year statute of limitations will begin to run on the original due date of the return (usually, the fifteenth day of the fourth month after year-end; April 15). When the return is filed early, the normal filing date controls.

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

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

40. (LO 5) 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 28, 2019, does not satisfy the 45-day requirement.

41. (LO 5, 6)

a. Normally, the three-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.

b. No, it would not. 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.

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

42. (LO 5) $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

43. (LO 5)

a. $100,000 (20% × $500,000).

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

44. (LO 5, 6)

a. No. Because no return was filed, the statute of limitations never runs. But even if a return had been filed, the three-year period for the 2015 tax return would not expire until April 15, 2019, three years after the normal due date for filing.

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 2016 through 2018 if you cannot correctly reflect the tax liability due to the omission for 2015.

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45. (LO 5, 6) 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.
- Notify the client, preferably in writing, of the outsourcing.

46. (LO 7)

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

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

c. Indexation is a procedure whereby the IRS makes annual adjustments to certain key tax components to take into account inflation, as required by law. Some of the more important components that are adjusted include tax brackets and the standard deduction amounts.

47. (LO 7)

a. 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).

b. 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.

c. The encouragement of home ownership can be justified on both social and economic grounds.

48. (LO 7, 8)

a. Social considerations explain the credit. It is socially desirable to encourage parents to provide care for their children while they work.

b. These deductions raise the issue of preferential tax treatment for homeowners—taxpayers who rent their personal residences do not receive comparable treatment. Even so, the encouragement of home ownership can be justified on economic and social grounds.

c. The joint return procedure came about to equalize the position of married persons living in common law states with those residing in community property jurisdictions. Political and equity considerations caused this result.

d. Activities deemed contrary to public policy should not result in tax savings.

e. The NOL carryforward provision is an equity consideration designed to mitigate the effect of the annual accounting period concept.

f. 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.

g. 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.

h. 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.

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49. (LO 7)

a. Mia's realized gain from the condemnation is $320,000 [$400,000 (amount of award) − $80,000 (cost basis of the warehouse)]. However, her recognized gain is limited to $120,000—the amount received that was not reinvested.

b. None of the gain is recognized because Mia reinvested the full amount of the condemnation award.

c. As none of the gain was reinvested, the full $320,000 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, Mia has retained none of the award and has reinvested in property similar to that taken by the city.

50. (LO 8) If the collection is worth more than $1,000, the mother has probably made a gift of the excess value to the daughter. There is a possibility that the transaction could result in the assessment 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?

RESEARCH PROBLEMS

These research problems require that students utilize online resources to research and answer the questions. As a result, solutions may vary among students and courses. You should determine the skill and experience levels of the students before assigning these problems, coaching where necessary. Encourage students to use reliable websites and blogs of the IRS and other government agencies, media outlets, businesses, tax professionals, academics, think tanks, and political outlets to research their answers.

1. The sole proprietor is subject to Federal taxes on income, self-employment and payroll taxes (if the sole proprietor has employees), and the gasoline excise tax. State taxes include income and sales and use taxes. Local taxes include property tax, business license tax, and perhaps income tax.

2. An example of a carbon tax proposal of the 115th Congress is S. 1639, American Opportunity Carbon Fee Act of 2017. Examples of financial transaction tax proposals of the 115th Congress include S. 805 and H.R. 1114. Similar proposals may exist for the 116th Congress. Students might also find plans for these types of taxes that do not have legislative language.

3. An example of a sweetened beverage tax proposal is H.R. 1687 (114th Congress), the SWEET Act. It would impose a Federal excise tax of 1% per 4.2 grams of sweetener in specified beverages. Proposals also exist in several states and cities. Some cities, including Berkeley, California, Philadelphia, Pennsylvania, and Boulder, Colorado, have already enacted soda taxes. Considerations in analyzing these proposals include issues of regressivity (an equity and fairness issue), complexity of definitions, burden of enforcement, and neutrality in affecting decision making.

4. Each of the Big Four firms has information on data analytics and how it can be used for tax purposes:

- **pwc.com/us/en/services/tax/tax-innovation.html**
- **home.kpmg.com/xx/en/home/services/tax/global-indirect-tax/data-and-analytics.html**
- **ey.com/us/en/services/tax/tax-performance-advisory/ey-data-analytics-and-tax-administration**
- **deloitte.com/global/en/pages/tax/topics/deloitte-tax-analytics.html#**

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Students might also find how the IRS and state tax agencies are using big data to improve audit selection and enforcement. For example, see IRS, Advance Data & Analytics at **irs.gov/about-irs/strategic-goals/advance-data-analytics.**

SOLUTION TO ETHICS & EQUITY FEATURE

Making Good Use of Out-of-State Relatives (p. 1-12). Who is the true purchaser of the bracelet? If the aunt really made the purchase with her funds and then gave the bracelet to Marcus, no sales or use tax evasion has occurred. More likely, the purchase was made by Marcus indirectly through his aunt—the aunt being reimbursed by Marcus or using funds provided by him. If that is the case, Marcus owes a sales tax on the purchase. Presuming the matter comes to light—the jewelry store might be the weak link—Marcus could be subject to prosecution for tax evasion.

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NOTES

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CHAPTER 1

AN INTRODUCTION TO TAXATION AND UNDERSTANDING THE FEDERAL TAX LAW

LECTURE NOTES

OVERVIEW

The primary objective of this chapter is to provide an overview of the Federal tax system. Among the topics discussed are the following:

- The importance and relevance of taxation.
- A brief history of the Federal income tax.
- The types of taxes imposed at the Federal, state, and local levels.
- Some highlights of tax law administration.
- Tax concepts that help explain the reasons for various tax provisions.
- The influence the Internal Revenue Service (IRS) and the courts have had in the evolution of current tax law.

SUMMARY OF CHANGES IN THE CHAPTER

The following are notable changes in the chapter from the 2019 Edition.

- Updated Exhibit 1.1 (Federal Tax Revenues) and Exhibit 1.4 (IRS Audit Types and Rates) with current data.
- Added "data analysis" discussion to text Section 1-1c (The Relevance of Taxation to Accounting and Finance Professionals).
- Added brief discussion to text Section 1-2c about the need for lawmakers to periodically review tax systems.
- Added a Research Problem asking students to discover how tax practitioners use data analytics and visualization.

THE BIG PICTURE

The Big Picture discussion in Chapter 1 addresses several situations commonly encountered by taxpayers that also create taxable income consequences. For example, students may not be familiar with the concept that gift giving (even in families) creates tax consequences for the gift giver or that working in another state subjects a taxpayer to tax in more than just his or her home state.

While students may not yet have significant exposure to all the tax issues raised in the Big Picture scenario, the exercise provides an opportunity to help students think about why tax consequences might arise and how to go about expanding their knowledge of tax law. For example, employing children in a family business raises questions about FICA withholding as well as what constitutes reasonable compensation. The student might make the link to FICA

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withholding after reading the chapter. However, a quick search on the IRS's web page results in a page that provides information about tax consequences that arise when hiring family members (**irs.gov/businesses/small-businesses-self-employed/family-help**). The FICA withholding discussion might lead to a discussion of incentives related to family members' salaries which could nicely lead into a discussion of why the IRS might be interested in auditing a family business/closely held business.

The scenario could also be integrated into a discussion of what is the "best" tax system, especially because the Carters are currently employed while the Walkers are retirees. The instructor could use this fact to address why differently situated taxpayers may have varying preferences about what type of tax system is the "best" tax system.

APPROACHING THE STUDY OF TAXATION

What Is Taxation?

1. "Taxes are what we pay for civilized society." – Oliver Wendell Holmes, Jr.

2. The primary purpose of taxation—to raise revenue for government operations.

3. Taxation is often used as a tool to influence the behavior of individuals and businesses.

    a. Income tax credits are designed to *encourage* people to purchase a fuel-efficient car.

    b. A tobacco excise tax may *discourage* individuals from smoking.

Taxation in Our Lives

4. Individuals are affected most directly by taxes when they need to pay them.

    a. Direct tax is paid to the government by the person who pays the tax (i.e., personal income tax and property taxes).

    b. Indirect tax includes things such as a state sales tax on the purchase of tangible goods such as clothing. The tax is collected and remitted to the government by the seller. The buyer is charged the tax along with the purchase price of the goods or services or it may be embedded in the price charged.

5. Ultimately, all taxes are paid by individuals.

6. Federal, state, and local elections often include initiatives that deal with taxation, such as whether state income taxes should be raised (or lowered), whether a new tax should be imposed on soda, or whether the sales tax rate should be changed.

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The Relevance of Taxation to Accounting and Finance Professionals

7. Accounting and finance professionals must understand the various types of business taxes to assist effectively with compliance, planning, financial reporting, controversy, cash management, and data analysis.

8. The level and depth of tax knowledge needed for any accounting or tax professional depends on his or her specific job.

9. Much of taxation is transaction-based. How a transaction is structured has varying tax consequences that must be considered.

How to Study Taxation

10. The goal of studying taxation is being able to recognize issues (or transactions) that have tax implications and, when possible, trying to understand the justification for them.

11. Taxation is an important and exciting topic due to constant change by the three branches of our Federal government (as well as changes by state and local governments), the significance of taxes to the bottom line of a company's and an individual's finances, and the impact on our economy and society.

12. In studying taxation, focus on understanding the rules and the why(s) behind them. Also consider how the rules apply to different types of taxpayers and to taxpayers of varying income levels and sophistication of transactions.

A BRIEF HISTORY OF U.S. TAXATION

13. Constitutionality and type of taxpayer. Emphasize the difference between the income tax on individuals and that imposed on corporations in terms of whether such taxes were allowed under the Constitution prior to the passage of the Sixteenth Amendment.

Early Periods

14. The tax imposed on individuals was broad enough to tax income from real and personal property. As such, it was a direct tax and required apportionment under the Constitution.

    a. In *Pollock v. Farmers' Loan and Trust Co.*, the Supreme Court found the income tax applicable to individuals unconstitutional.

    b. However, the Court did not hold that a tax on income from personal services was unconstitutional.

    c. The corporate income tax, enacted in 1909, was held to be constitutional, because it was deemed to be an excise tax. In essence, it was considered to be a tax on the right to do business in corporate form. It was likened to a form of franchise tax.

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Because a corporation is an entity created under state law, jurisdictions possess the right to tax its creation and operation. Note that many states still impose franchise taxes on corporations under this rationale.

15. Tests of constitutionality. The income tax imposed during the Civil War period came and went without ever being successfully challenged under the U.S. Constitution. Only when the income tax was reenacted in 1894 was the issue of constitutionality raised again and successfully pursued in the courts.

16. Criticism of income tax. One of the reasons the income tax evoked such criticism was that many regarded it as an invasion of privacy. At the turn of the century, financial affairs were regarded as highly personal and only concerned the party involved, not the business of the U.S. government.

17. Ratification of Sixteenth Amendment. The timing of the ratification of the Sixteenth Amendment to the U.S. Constitution (1913) was instrumental in the financing of U.S. participation in World War I.

Revenue Acts

18. Tax law prior to the 1939 IRC: The tax practitioner or the tax professor of past years must have encountered difficulty prior to the enactment of the Internal Revenue Code of 1939.

    a. For example, the resolution of a particular problem might have required reference to dozens of different statutes.

    b. What was established as the law in one statute could have been rescinded or modified by a later statute.

    c. The code approach solved such problems by bringing all of these statutory materials together in one place (i.e., codification) and provided the practitioner with the latest word on any one issue (since changes are codified).

Trends

19. The income tax is a major source of revenue for the Federal government (see Exhibit 1.1 in the text). The need for revenues to finance World War II converted the income tax from one that applied mostly to high-income individuals to a mass tax.

20. The complexity of current tax laws forces taxpayers to seek assistance in preparing returns: more than one half pay a preparer and one third purchase tax software.

21. New ways of doing business and living often require changes to the tax law. Ideally, lawmakers should review tax systems periodically to ensure that they continue to be efficient in light of changes in how businesses and individuals function.

TAX SYSTEM DESIGN

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Legal Foundation

22. The U.S. Constitution gives Congress the power to "lay and collect taxes" and also provides some limits on this taxing power, which led to enactment of the Sixteenth Amendment to allow for an income tax.

23. The jurisdiction's underlying governing documents must be reviewed to determine whether they impose any restriction relevant to taxation.

The Basic Tax Formula

24. Basic tax formula is: Tax base × Tax rate = Tax liability

25. Tax Base. The tax base is the amount to which the tax rate is applied.

26. For Federal income tax, the tax base is taxable income.

27. Tax Rates. A tax is *proportional* if the rate of tax remains constant for any given income level. A tax is *progressive* if a higher rate of tax applies as the tax base increases.

Tax Principles

28. Adam Smith's (*The Wealth of Nations*) canons of taxation.

    a. Equity. Each taxpayer enjoys fair and equitable treatment by paying taxes in proportion to his income level (ability to pay).

    b. Certainty. A tax structure is "good" if the taxpayer can readily predict when, where, and how a tax will be levied.

    c. Convenience of payment. A tax should be easily assessed and collected with its administrative costs being low.

    d. Economy in collection. A "good" tax system involves only nominal collection costs by the government and minimal compliance costs by the taxpayer.

29. The American Institute of Certified Public Accountants (AICPA) has issued *the Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*. It identifies 12 principles that are commonly used as indicators of desirable tax policy. See Exhibit 1.2 in the text for an application of these principles to a proposed tax law change.

MAJOR TYPES OF TAXES

30. In introducing the discussion of the various components of the U.S. tax system, Figure 1-1 at the end of the Lecture Notes for this chapter may be a useful resource.

Property Taxes

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31. Ad valorem taxes on realty look to the value of the property as the base for the imposition of the tax. How such value is determined varies and often is subject to controversy between the property owner and the taxing authority.

32. Property taxes fall into two categories: those imposed on real property (land and buildings) and those imposed on personal property (assets other than land and buildings).

33. Whether a property tax is based on value (i.e., ad valorem) could be important for income tax purposes.

34. Ad Valorem Taxes on Real Property. Realty is land and anything permanently attached to land.

35. Ad valorem taxes are exclusively within the province of the states and their local political subdivisions.

36. Ad Valorem Taxes on Personal Property. Personalty encompasses all assets that are not realty. Both realty and personalty can be either business use or personal use.

37. Personal property can also be classified as tangible property or intangible property. For ad valorem tax purposes, intangible personalty includes stocks, bonds, and various other securities (e.g., bank shares).

Transaction Taxes

38. Transaction taxes include Federal and state excise taxes and state and local general sales taxes, severance taxes, death taxes, and gift taxes.

39. Federal Excise Taxes. Examples of Federal excise taxes include those imposed on tobacco, gasoline, telephone usage, air travel, and alcohol.

    a. Excise taxes deal with the transfer of a specified commodity (e.g., tobacco or alcohol).

    b. In the past, Federal excise taxes were imposed on entertainment admissions, jewelry, leather goods, cosmetics, boats, aircraft, and luxury automobiles.

40. State and Local Excise Taxes.

    a. All states tax the sale of gasoline, liquor, and tobacco products. However, the rates vary significantly.

    b. Excise taxes found at some state and local levels include those on admission to amusement facilities, on the sale of playing cards, and on prepared foods.

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c. Some counties impose a transaction tax on the transfer of property that requires the recording of documents (e.g., real estate sales).

d. Over the last few years, two types of excise taxes imposed at the local level have become increasingly popular: the hotel occupancy tax and the rental car "surcharge."

41. General Sales Taxes. The difference between an excise tax and a general sales tax is tied to the scope of the transaction covered by the tax.

a. Sales tax. Sales taxes cover a wide range of products or transactions. Some states exempt certain transactions (e.g., sales of food to be consumed off the premises and sales of certain medicines and drugs).

b. Use tax. Every state that has a general sales tax also imposes a use tax. The purpose of the use tax is to prevent the avoidance of the sales tax through the purchase of items in other states that have no sales taxes or that provide for lower rates. A use tax is an ad valorem tax, usually at the same rate as the sales tax, on the use, consumption, or storage of tangible property. Alaska, Delaware, Montana, New Hampshire, and Oregon impose neither a sales nor a use tax.

c. Sales tax holidays are becoming more popular. Many states schedule the holiday for August back-to-school buying or to encourage the purchase of energy-conserving appliances and hurricane preparedness items.

42. Severance Taxes.

a. Transaction taxes that are based on the notion that the state has an interest in its natural resources

b. Imposed when natural resources are extracted.

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Taxes on Transfers at Death

43. These taxes are a type of excise tax and fall under the classification of transaction taxes.

    a. Estate tax versus inheritance tax. If a tax is imposed at death on the right of a decedent 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.

    b. Federal taxation versus state taxation. The Federal government does not impose an inheritance tax and relies exclusively on an estate tax. However, state governments can levy both inheritance taxes and estate taxes.

44. The Federal Estate Tax. The Federal estate tax does not apply to all estates; only estates over a certain value are taxed. To accomplish this, the unified transfer tax credit is applied against the value of the estate. To the extent that the credit does not reduce the value of the estate to zero, the estate tax applies.

45. State Taxes on Transfers at Death. May include an inheritance tax, an estate tax, or both. The taxes will differ according to whether the tax is imposed on the heirs or on the estate. Some states completely exempt from taxation amounts that pass to a surviving spouse.

Gift Taxes

46. A gift tax is an excise tax levied on the right to transfer property. The tax is imposed on transfers made during the owner's life and not at death.

47. The Federal Gift Tax. The purpose of the Federal gift tax is to preclude avoidance of the Federal estate tax.

    a. In this regard, note that the Federal estate tax preceded the Federal gift tax.

    b. In 2019, the Federal gift tax allows each donor an annual exclusion of $15,000 for gifts to each donee (the same as in 2018).

    c. Apparently, most states do not consider the tax avoidance potential as being significant, given that only a few have seen fit to enact a state gift tax.

48. Gift splitting effectively allows the annual exclusion to double.

49. The gift tax and estate tax rate schedules are the same. The schedule is commonly referred to as the unified transfer tax rate schedule.

50. The Federal gift tax is cumulative in effect. What this means is that the tax base for current taxable gifts includes past taxable gifts.

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51. Making lifetime gifts of property carries several tax advantages over passing the property at death.

    a. If income-producing property is involved, a gift may shift subsequent income to donees in a lower income tax bracket.

    b. If the gift involves property that is expected to appreciate in value, future increases in value will be assigned to the donee and will not be included in the donor's estate.

    c. Due to the annual exclusion ($15,000 per donee in 2019 and 2018), some of the gift can escape tax.

Income Taxes

52. Income taxes are levied by the Federal government, most states, and some local governments. Most jurisdictions attempt to ensure the collection of income taxes by requiring pay-as-you-go procedures.

53. Federal Income Taxes. With reference to income taxes, the following observations would be useful:

    a. Exhibit 1.3 in the text illustrates the formula for the Federal income tax imposed on individuals.

    b. The Federal corporate income tax is not progressive but instead uses a flat tax rate of 21%. Also, it does not include the computation of adjusted gross income (AGI) and does not provide for the standard deduction and personal and dependency exemptions.

54. State Income Taxes. Some characteristics of state income taxes include:

    a. "Piggyback" concept. The trend as to state income taxes is to use the Federal tax base for income determination. Most states have gone with the "piggyback" concept whereby the state income tax liability is calculated as a flat rate applied to an adjusted Federal taxable income amount.

    b. Some states "decouple" from selected Federal tax changes passed by Congress. The purpose of the decoupling is to retain state revenue that would otherwise be lost.

    c. Many state income tax returns provide checkoff boxes for donations to various causes. Many are dedicated to medical research and wildlife programs, but special projects are not uncommon.

    d. Some states have occasionally instituted amnesty programs that allow taxpayers to pay back taxes (and interest) on unreported income with no (or reduced)

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penalty. In many cases, the tax amnesty has generated enough revenue to warrant the authorization of follow-up programs covering future years. Amnesties usually include other taxes as well (e.g., sales, franchise, and severance).

55. Local Income Taxes. The imposition of income taxes by local jurisdictions (e.g., cities such as Cleveland, Kansas City (Missouri), and New York), though not uncommon, is more the exception than the rule.

Employment Taxes

56. There are two major employment taxes: FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act). Both taxes can be justified by social and public welfare considerations. A limitation exists depending on the employment relationship (i.e., employee versus self-employed).

57. FICA Taxes.

    a. Uncertainty of future FICA rate and base amounts. In this regard, mention the uncertainty that exists as to future increases.

    b. Employee income tax credit for excess FICA withholdings. Relief is provided an employee (i.e., an income tax credit) in the case of excess FICA tax withholdings.

    c. The Social Security tax rate is 6.2% (and generally does not change), and the Medicare tax rate is 1.45%. The base amount for Social Security is $132,900 for 2019 ($128,400 for 2018). There is no limit on the base amount for the Medicare tax. The employer must match the employee's portion for both Social Security tax and Medicare tax.

        (1) An additional 0.9% is imposed on earned income (including self-employment income) above $200,000 (single filers) or $250,000 (married filing jointly).

        (2) Unlike Social Security and the regular Medicare portion, an employer does not have to match the 0.9%.

    d. Taxpayers who are not employees (e.g., sole proprietors, independent contractors) are subject to a form of Social Security tax known as self-employment tax. The applicable rate is 12.4% for Social Security and 2.9% for Medicare tax, or twice that applicable to an employee.

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58. FUTA Taxes.

a. The purpose of the tax is to provide modest financial relief in the event of the unemployment of a covered employee. This should be contrasted with the retirement objective of the FICA tax.

b. Unlike FICA, the incidence of FUTA falls solely on the employer.

c. For 2019, FUTA applies at a rate of 6.0% of the first $7,000 of covered wages. Merit rating credits may reduce the tax to a much lower percentage.

d. Unlike FICA, FUTA requires compliance with both Federal and state provisions. Also, FUTA is paid entirely by the employer.

Other U.S. Taxes

59. View the summary of taxes in the United States in Concept Summary 1.2 in the text.

60. Federal Customs Duties. Customs duties are variously described as import taxes and tariffs.

a. These levies served as the mainstay of the Federal revenue system until slightly after the turn of the nineteenth century. Tariffs and excise taxes alone paid off the national debt in 1835 and enabled the U.S. Treasury to pay a surplus of $28 million to the states.

b. In recent years, tariffs have been an instrument for carrying out protectionist policies instead of a means of generating revenue.

c. History shows that tariffs often lead to retaliatory action on the part of the nation or nations affected.

61. Miscellaneous State and Local Taxes.

a. Most states impose a franchise tax on corporations for the right to do business in that state.

b. Generally, the tax is based on the capitalization of the entity.

c. Similar to the franchise tax are occupational fees that apply to various trades or businesses (e.g., a liquor store license; a taxicab permit; or a fee to practice a profession such as law, medicine, or accounting). Most of these are not significant revenue producers, and the fees are used to fund the costs of regulating the business or profession in the interest of the public good.

Proposed U.S. Taxes

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62. Considerable dissatisfaction with the U.S. Federal income tax has led to several recent proposals that are drastic in measure.

63. Flat Tax. Proposed to replace the current graduated income tax with a single rate of 19%.

    a. This proposal achieves some of the administrative advantages of a value added tax (VAT) relative to a sales tax, while also partially addressing concerns that consumption taxes impose a relatively heavier tax burden on lower-income taxpayers.

    b. Wages, pension contributions, materials costs, and capital investments are deducted from the tax base.

    c. Individuals (or households) are assessed a 19% flat-rate tax on wages and pension benefits above an exemption of $25,500 for a family of four. No other income is taxable, and no other deductions are allowed.

64. National Sales Tax.

    a. Would operate similarly to most state sales taxes although the tax base would be larger. The rate would also be higher to generate the revenues needed to replace the Federal income tax.

    b. The proposed "Fair Tax" is a type of national sales tax.

        (1) 23% tax on all purchases, including food and medicine, real property, and many types of services.

        (2) Exempt items are business expenses, used goods, and education costs.

        (3) The "Fair Tax" would replace income tax (both individual and corporate), payroll taxes, gift, and estate taxes.

65. Value Added Tax. Imposed on the value added by each party in a production cycle.

    a. A system of credits results in the VAT ultimately only being paid by the final consumer. This form of VAT—a credit invoice VAT—is similar to a sales tax, but more efficient because assessment throughout the production process better ensures collection of the tax.

    b. A VAT has been considered in the United States various times since the 1960s.

    c. One challenge of implementing a VAT in the United States is that it is a regressive tax. As a result, adjustments need to be implemented to protect lower-

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income taxpayers. Another challenge is that the Treasury Department (and IRS) will have to learn how to implement and enforce the VAT.

GLOBAL TAX ISSUES

VAT in USA? Is the United States out of sync with other countries by not having a VAT? What are the advantages and disadvantages of VAT?

66. Carbon Tax. Aims to help reduce carbon emissions. The tax could be applied to fossil fuels based on their level of greenhouse gas emissions. Some people suggest a higher gasoline excise tax as a simple form of a carbon tax.

67. Financial Transaction Tax. A financial transaction tax can take many forms.

    a. For example, it could be imposed on the value of financial instruments purchased.

    b. It could be restricted in some way (e.g., only applying to high-frequency trading).

    c. It could be imposed on the value of bank assets.

    d. Because the tax base is quite large, the tax rate would likely be low, perhaps even less than 1%.

    e. The primary concern with this type of tax is the possible adverse effects on financial markets.

TAX ADMINISTRATION

Internal Revenue Service

68. Treasury Department is responsible for administering Federal tax laws.

69. The IRS is responsible for enforcing the tax laws.

70. The Commissioner of the IRS is appointed by the president and is responsible for establishing policy and supervising IRS activities.

The Audit Process

71. Selection of Returns for Audit. Only a small number of tax returns are audited each year. The probability for audit increases for higher-income taxpayers. Tax returns are selected for audit in different ways:

    a. A common technique for individuals is called information matching. For example, the IRS compares information returns it receives to an individual's tax return.

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b. Certain groups of taxpayers are subject to audit much more frequently than others. These groups include individuals with large amounts of gross income, self-employed individuals with substantial deductions, and taxpayers with prior tax deficiencies.

c. If information returns are not in substantial agreement with reported income.

d. If an individual's itemized deductions are in excess of averages established for various income levels, the probability of an audit is increased.

e. Filing of a refund claim by the taxpayer may prompt an audit of the return.

f. Information obtained from other sources (e.g., informants and news items) may lead to an audit.

72. Types of Audits. Note the differences between the various types of audit (i.e., correspondence, office, and field).

a. If the issue is minor, the matter often can be resolved by correspondence between the IRS and the taxpayer.

b. An office audit usually is restricted in scope and is conducted in the facilities of the IRS.

c. A field audit involves an examination of numerous items reported on the return and is conducted on the premises of the taxpayer or the taxpayer's representative.

d. At the end of an audit, the examining agent issues a Revenue Agent's Report (RAR) that summarizes the findings. The RAR will result in a refund (the tax was overpaid), a deficiency (the tax was underpaid), or a no change (the tax was correct) finding.

73. Settlement Procedures.

a. If an audit results in an assessment of additional tax and no settlement is reached with the IRS agent, the taxpayer may attempt to negotiate a settlement with a higher level of the IRS.

b. If a satisfactory settlement is not reached in the administrative appeal process, the taxpayer can litigate the case in the Tax Court, a Federal District Court, or the Court of Federal Claims.

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Statute of Limitations

74. A statute of limitations is a provision that requires any lawsuit to be brought within a reasonable period of time.

    a. Found at the state and Federal levels, such statutes cover a multitude of suits, both civil and criminal.

    b. For the Federal tax law, there are two major categories: one applying to assessments by the IRS and one concerning claims for refunds by taxpayers.

75. Assessment by the IRS.

    a. The IRS may assess an additional tax liability against a taxpayer within three years of the filing of the income tax return.

    b. If a taxpayer omits an amount of gross income in excess of 25% of the gross income reported on the return, the statute of limitations is increased to six years. This applies only to the omission of income.

    c. There is no statute of limitations on assessments of tax if no return is filed or if a fraudulent return is filed.

    Example: For 2019, Mark, a calendar year taxpayer, reported gross income of $400,000 on a timely filed income tax return. If Mark had omitted more than $100,000 (25% × $400,000) in income, the six-year statute of limitations would apply to 2019 tax year. This presumes the absence of fraud on the part of Mark. If the omission was deliberate (i.e., due to fraud), the statute never starts to run.

76. Limitations on Refunds. Claims for refund are limited to within three years from the date the return was filed or within two years from the date the tax was paid, whichever is later. (Income tax returns that are filed early are deemed to have been filed on the date the return was due.)

Interest and Penalties

77. With refunds, no interest is allowed if the overpayment is refunded to the taxpayer within 45 days of the later date the return is filed or is due.

78. The tax law provides various penalties for lack of compliance by taxpayers. Some of these penalties are summarized as follows:

    a. For a failure to file a tax return by the due date, a penalty of 5% per month up to a maximum of 25% is imposed on the amount of the tax shown as due on the return. Any fraction of a month counts as a full month.

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b. A penalty for failure to pay the tax due as shown on the return is imposed in the amount of 0.5% per month up to a maximum of 25%. Any fraction of a month counts as a full month. During any month in which both the failure to file penalty and failure to pay penalty apply, the failure to file penalty is reduced by the amount of the failure to pay penalty.

c. A negligence penalty of 20% is imposed if any of the underpayment was for intentional disregard of the rules and regulations with intent to defraud.

d. Various fraud penalties may be imposed. Fraud is a deliberate action on the part of the taxpayer evidenced by deceit, misrepresentation, concealment, etc. In the case of civil fraud, the penalty is 75% of the underpayment attributable to fraud. In the case of criminal fraud, the penalties can include large fines as well as prison sentences.

GLOBAL TAX ISSUES

Outsourcing of Tax Return Preparation. Outsourcing is being applied to the preparation of tax returns and will likely increase in volume in the coming years. Practitioners justify outsourcing as a means of conserving time and effort that can be applied toward more meaningful tax planning on behalf of their clients. What are other advantages? What are some potential disadvantages of this outsourcing?

Tax Practice

79. Ethical Guidelines. The AICPA's "Statements on Standards for Tax Services" (SSTSs) are a part of the Code of Professional Ethics and are enforceable by the AICPA and most state's licensing statutes.

    a. Tax professionals should not advocate questionable positions. Simply because a return might not be audited is not a good reason to advocate a particular tax return position.

    b. A practitioner can use a client's estimates if they are reasonable under the circumstances.

    c. A practitioner does not have to audit all the information provided by a client. The practitioner should verify that the client-provided information makes sense and should verify that information where it is questionable. A practitioner can use a client's estimates if they are reasonable under the circumstances.

    d. Upon learning of an error on a past tax return, advise the client to correct it. Do not inform the IRS of the error.

80. Statutory Penalties Imposed on Tax Return Preparers.

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a. Various penalties involving procedural matters.

b. Penalty for understatement of a tax liability based on a position that lacks any realistic possibility of being sustained.

c. Penalty for any willful attempt to understate taxes.

d. Penalty for failure to exercise due diligence in determining eligibility for, or the amount of, an earned income tax credit.

UNDERSTANDING THE FEDERAL TAX LAW

81. The Federal tax law reflects the three branches of our Federal government.

a. The primary objective of Federal tax law is the raising of revenue. The tax law does not have as its sole objective the raising of revenue.

b. Other considerations (economic, social, equity, and political factors) also play a significant role. The Treasury Department, the IRS, and the courts also have significant impacts on the evolution of Federal tax law.

Revenue Needs

82. When enacting tax legislation, a deficit-conscious Congress often has been guided by the concept of revenue neutrality so that changes neither increase nor decrease the net revenues received by the government.

83. When tax reductions are involved, the full impact of the legislation can be phased in over a period of years. Or as an alternative, the tax reduction can be limited to a period of years. When the period expires, the prior law is reinstated through a sunset provision.

Economic Considerations

84. Control of the Economy.

a. Congress has used the tax depreciation rules as a means of controlling the economy.

b. Longer asset lives and the use of straight-line depreciation should discourage capital outlays.

c. Congress also uses incentives like immediate expensing (§ 179) and bonus depreciation to stimulate the economy when needed.

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d. Lowering of tax rates. If, however, Congress is using the concept of revenue neutrality, these rate reductions may be offset by a reduction or elimination of deductions or credits. As a result, lower tax rates do not always mean lower taxes.

85. Encouragement of Certain Activities. In connection with encouragement of certain activities, mention could be made of the following:

a. Research and development expenditures can be either deducted in the year incurred or capitalized and amortized over a period of 60 months or more. Inventions are also encouraged by tax law. Patents can qualify as capital assets, and under certain conditions, their sale results in long-term capital gain treatment.

b. Tax law addresses the nation's energy policy—in terms of both our reliance on carbon-based fuels and the need to ease the problem of climate change.

86. Encouragement of Certain Industries.

a. Historically, agricultural activities have been favored under Federal tax law.

b. The tax law favors the development of natural resources by permitting the use of percentage depletion and a write-off (rather than a capitalization) of certain exploration costs.

c. The railroad and banking industries also receive special tax treatment under Federal tax law.

87. Encouragement of Small Business. Small business development is encouraged under the tax law.

a. The shareholders of a small business corporation can make a special election that allows the profits (or losses) of the corporation to flow through to its shareholders, avoiding the corporate income tax.

b. Another provision allows a shareholder in a small business corporation to take an ordinary deduction (rather than a capital loss) for any loss recognized on the stock investment.

Social Considerations

88. Some provisions of the Federal tax law, particularly those dealing with individuals, can be explained by social considerations. Examples:

a. Accident and health plans financed by employers.

b. Group term life insurance coverage for employees.

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c. Qualified pension or profit sharing plans for employees.

d. Deduction for charitable contributions.

e. The credit for child and disabled dependent care.

f. The earned income credit provides relief for low-income taxpayers.

g. Credits made available to elderly and disabled persons. Credits allowed to businesses that incur expenditures to make their facilities more accessible to the disabled.

h. Various tax credits, deductions, and exclusions to encourage additional education.

i. The disallowance for certain expenditures that are contrary to public policy.

Equity Considerations

89. The concept of equity is relative. Equity is not what appears fair or unfair to any one taxpayer or group of taxpayers. The concept of equity appears in tax provisions that alleviate the effect of multiple taxation and postpone the recognition of gain when the taxpayer lacks the ability or wherewithal to pay the tax.

90. Alleviating the Effect of Multiple Taxation. In connection with alleviating the effect of multiple taxation, the text discusses the deduction/credit alternative permitted in the case of foreign income taxes. Other possibilities are summarized below.

a. Relief from possible triple taxation is provided to a corporate shareholder via the dividends received deduction (§§ 243 to 247).

b. The low tax rate on qualified dividend income should be noted. Although double taxation is not eliminated, its effect is lessened by allowing taxation at preferential capital gain rates.

c. Some state income tax laws allow a deduction for Federal income taxes.

d. The Federal estate tax allows a deduction (§ 2058) for the state death taxes paid.

91. The Wherewithal to Pay Concept. Regarding the wherewithal to pay concept (recognizes the inequity of taxing a transaction when the taxpayer lacks the means with which to pay the tax), the text illustrates its application with an involuntary conversion situation. By and large, most wherewithal to pay provisions in the tax law do not permanently avoid gain or loss recognition but operate on a deferral principle (e.g., like-kind exchanges and involuntary conversions). Because of the basis carryover rules, gain or loss recognition

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merely is postponed to some further disposition that does not meet the requirements of a nontaxable exchange.

a. Involuntary conversion. If all of the proceeds from an involuntary conversion are invested within the required statutory time period in property that is similar or related in service or use, none of the realized gain is recognized.

b. Transfer of property to a controlled corporation. A transfer of property to a controlled corporation results in no recognition of gain or loss to the transferor if solely common stock is received in exchange.

92. Mitigating the Effect of the Annual Accounting Period Concept. The accounting period used to report taxable income and settle any tax liability is one year and is referred to as the annual accounting period concept.

a. The annual accounting period concept can lead to different tax treatment for taxpayers who are in the same economic position.

b. Carryback and carryover procedures help mitigate the effect of limiting a loss or deduction to the accounting period in which it was realized, allowing a taxpayer to salvage a loss or deduction that might otherwise be lost.

93. Coping with Inflation.

a. Because of the progressive nature of the income tax, a wage adjustment to compensate for inflation could place the employee in a higher income tax bracket. Known as bracket creep, its overall impact is an erosion of purchasing power.

b. Congress recognized this problem and began to adjust various income tax components, such as tax brackets, standard deduction amounts, and personal and dependency exemptions, through an indexation procedure. Indexation is based on the rise in the consumer price index over the prior year.

c. Explain how indexation would benefit a person with a fixed income (e.g., retiree).

Political Considerations

94. A large segment of the Federal tax law is made up of statutory provisions. Because these statutes are enacted by Congress, political considerations often influence tax law.

95. Special Interest Legislation. The classic example of special interest legislation is the special treatment allowed prepaid subscription and dues income.

a. Although other types of prepaid income (e.g., rents) are taxed when received, dues and subscriptions are taxed as earned.

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b. Historically, the special relief was the work of the American Automobile Association which desired relief from having to recognize income on the receipt of multiyear dues income.

96. Special interest legislation is not necessarily to be condemned if it can be justified on economic, social, or some other utilitarian grounds.

97. Political Expediency Situations. Various tax reforms rise and fall in favor with the shifting moods of the American public.

a. Measures that deter more affluent taxpayers from obtaining so-called preferential tax treatment have always had popular appeal. Examples include:

(1) Imputed interest rules.

(2) Limitation on the deductibility of interest on investment indebtedness.

b. Some provisions phase out tax breaks as income rises. These phaseouts are called "stealth taxes." Examples include the phaseout of the child tax credit and education tax credits.

98. State and Local Government Influences. Another change that the community property system has brought to the Federal tax law is the marital deduction allowed for estate and gift tax purposes.

a. In a case where one of the spouses predeceases the other, the surviving spouse's share of the community property is not included in the gross estate and, therefore, is not subject to the Federal estate tax. The marital deduction tries to extend this advantage to noncommunity property (i.e., common law jurisdictions) situations by allowing (within limits) property to pass to the survivor free of tax.

b. In a community property jurisdiction, the motivation to make gifts between spouses to balance their potential estates is not as severe as in common law jurisdictions, given that each spouse already owns one-half of any community property.

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Influence of the Internal Revenue Service

99. The IRS as Protector of the Revenue. Congress passes laws to close the loopholes that taxpayers have located and exploited. In addition, Congress has passed laws that enable the IRS to make adjustments based on the substance of a transaction. For example, the IRS can make adjustments to a taxpayer's method of accounting when the method used by the taxpayer does not clearly reflect income.

100. Administrative Feasibility. Many provisions in the tax law simplify the audit function of the IRS.

    a. The IRS long ago realized the importance of placing taxpayers on a pay-as-you-go basis. Withholding procedures apply to wages, while the tax on other types of income may have to be paid via quarterly estimated payments.

    b. Congress has passed many provisions that impose interest and penalties on taxpayers if they don't comply with the tax law.

    c. The audit process conducted by the IRS is key to an effective administration of our tax system. To carry out this function, the IRS is aided by provisions that reduce the chance of taxpayer error or manipulation, thus simplifying the audit effort.

Influence of the Courts

101. Judicial Concepts Relating to Tax. A leading tax concept developed by the courts deals with the interpretation of statutory tax provisions that operate to benefit taxpayers.

    a. If a taxpayer wants a relief provision to apply, the taxpayer has the responsibility to meet the provision's requirements (i.e., no exceptions).

    b. The arm's length concept is important here. Particularly in dealings between related parties, transactions may be tested by asking this question: Would unrelated parties have handled the transaction in the same way?

102. Judicial Influence on Statutory Provisions.

    a. Some court decisions have been so important that Congress incorporated them into the Internal Revenue Code.

    b. On occasion, Congress reacts negatively to judicial interpretations of the tax law.

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ETHICS AND EQUITY FEATURES

Solutions to Ethics & Equity features are located in the Solutions Manual.

RESEARCH PROBLEMS

Solutions to end-of-chapter Research Problems are located in the Solutions Manual.

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Figure 1-1
Summary of Taxes in the United States

Type of Tax	Imposed by Jurisdiction: Federal	State	Local
Property taxes:			
Ad valorem on realty	No	Yes	Yes
Ad valorem on personalty	No	Yes	Yes
Transaction taxes:			
Excise	Yes	Yes	Few*
General sales	No	Most	Some
Severance	Yes **	Most	No
Estate	Yes	Some	No
Inheritance	No	Some	No
Gift	Yes	Few	No
Income taxes:			
Corporations	Yes	Most	Few
Individuals	Yes	Most	Few
Employment taxes:			
FICA	Yes	No	No
FUTA	Yes	Yes	No
Customs duties	Yes	No	No
Franchise taxes	No	Yes	No
Occupational taxes	Yes ***	Yes	Yes

* An example of a local excise tax might be a tax on hotel occupancy, typically referred to as a transient occupancy tax (TOT).

** For Federal public lands and continental-shelf areas.

*** An example is a fee to operate a beauty salon or barbershop.

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