South-Western Federal Taxation 2020 Essentials of Taxation Individuals and Business Entities 23rd edition Nellen Solutions Manual

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CHAPTER 1

INTRODUCTION TO TAXATION

SOLUTIONS TO PROBLEM MATERIALS

PROBLEMS

1. (LO 1, 2, 5) Some tax and nontax considerations James should investigate include the following:

   - State and local income taxes.
   - State and local sales taxes.
   - State and local property taxes.
   - Employee implications of the move (Will James lose current employees? Is the labor market better in the new location? Is cost of living lower or higher in new location?).
   - Logistics/transportation of products to customers (specifically document lower costs).
   - State infrastructure (better in new location?).

2. (LO 1) 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.

3. (LO 2)
   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.

4. (LO 1, 6) (See Digging Deeper 1.) As to Adam Smith's canon on *economy*, the Federal income tax yields a mixed result. From the standpoint of the IRS, economy exists as collection costs are nominal (when compared with revenue generated). The government's cost of collecting Federal taxes amounts to less than one-half of 1 percent of the revenue collected. Economy is not present, however, if one looks to the compliance effort and costs expended by taxpayers. According to recent estimates, about 56% of individual taxpayers who file a return pay a preparer, and one-third purchase tax software.

5. (LO 2) Jang probably will be required to pay the Washington use tax if, and when, he applies for Washington license plates. In this case, the use tax probably is the same amount as the Washington sales tax. See the discussion in connection with Example 4 in textbook.

6. (LO 2) 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.

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7. (LO 2) 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.

8. (LO 2) 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).

9. (LO 4, 5)

Nellen, Young, Raabe, & Maloney, CPAs
5191 Natorp Boulevard
Mason, OH 45040

February 25, 2020

Cynthia Clay
1206 Seventh Avenue
Fort Worth, TX 76101

Dear Cynthia:

I am writing this letter to help you decide on what form of entity to choose for your new burrito delivery business. In our phone conversation, you indicated that you expect to have losses for the first two years in this business and then make substantial profits in subsequent years. You and Marco also indicated that you are concerned about potential personal liability.

While I can't make a conclusive recommendation based on the information you have given me, I can provide you with some general guidelines that should simplify your decision. First, given your concern about personal liability, a partnership does not appear to be a desirable option (you would both be personally liable for any injuries to customers). Similarly, given your expectation of losses in the first two years, it does not appear that a C corporation would be a desirable choice, at least initially. This is because any losses in the corporation could only be used to offset future corporate profits—you could not use the losses to immediately offset your personal tax liability.

Thus, two choices exist which provide limited liability and deductibility of losses on your personal income tax return. These are the S corporation and the limited liability company. If you choose an S corporation, we would probably convert the entity to a C corporation when the business becomes profitable. At that point, profits would be taxed at the C corporation rate. A second tax would be levied on your personal income tax return for any dividends paid by the corporation once it achieves C status. In contrast, limited liability companies are taxed like partnerships—all income would be taxed on your personal income tax return in profitable years. The relative desirability of each of these two forms depends on a number of factors. One of the most important factors in your situation is the relationship between your personal tax rate and the tax rate of a C corporation. If you are in a high tax bracket and if the income in the business is sufficiently low, you might be best off choosing the S corporation. Alternatively, if you expect the business to generate a sufficiently large profit each year, it might be best to choose the limited liability company. However, with the recent enactment of the Tax Cuts and Jobs Act of 2017, the decision becomes more complex. The qualified business income deduction for income from flow-though entities along with the new flat tax rate of 21% that applies to corporations also must be taken into consideration.

If you would like me to give you a clearer recommendation, we should meet at your earliest convenience. If you have any additional questions, please call me.

Best regards,

Julian Jackson, CPA

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10. (LO 4, 5)

a.

	Year 1	Year 2	Year 3
Corporate Tax Liability			
Sales revenue	$150,000	$320,000	$600,000
Cash expenses	(30,000)	(58,000)	(95,000)
Depreciation	(25,000)	(20,000)	(40,000)
Taxable income	$ 95,000	$242,000	$465,000
Corporate tax liability	$ 19,950	$ 50,820	$ 97,650
Cash Available for Dividends			
Sales revenue	$150,000	$320,000	$600,000
Tax-free interest income	5,000	8,000	15,000
Cash expenses	(30,000)	(58,000)	(95,000)
Corporate tax liability	(19,950)	(50,820)	(97,650)
Cash available for dividends	$105,050	$219,180	$422,350
Ashley's After-Tax Cash Flow			
Dividend received	$105,050	$219,180	$422,350
Tax on dividend at 15% rounded	(15,758)	(32,877)	(63,353)
After-tax cash flow	$ 89,292	$186,303	$358,997
PV of cash flow*	$ 79,729	$148,520	$255,534
Present value	$483,783		

*Present value factors (.8929, .7972, .7118) from Appendix F.

b.

	Year 1	Year 2	Year 3
Individual Tax Liability			
Sales revenue	$150,000	$320,000	$600,000
Cash expenses	(30,000)	(58,000)	(95,000)
Depreciation	(25,000)	(20,000)	(40,000)
Taxable income	$ 95,000	$242,000	$465,000
Individual tax liability**	$ 23,750	$ 60,500	$116,250
**Rate = 25%			
Ashley's After-Tax Cash Flow			
Sales revenue	$150,000	$320,000	$600,000
Tax-free interest income	5,000	8,000	15,000
Cash expenses	(30,000)	(58,000)	(95,000)
Individual tax liability	(23,750)	(60,500)	(116,250)
After-tax cash flow	$101,250	$209,500	$403,750
PV of cash flow*	$ 90,406	$167,013	$287,389
Present value	$544,808		

*Present value factors (.8929, .7972, .7118) from Appendix F.

c. If Ashley wants to have access to all available cash from the business, then she will have to pay out dividends annually. As seen in the answers to parts a. and b. above, the present value of future cash flows is substantially greater if she does not incorporate under this assumption. Alternatively, if she does not need to pay out dividends, then she may be better off by incorporating, since only the corporate tax will be incurred, which is less than her individual tax. The value of her stock will increase and she then can sell the stock at a later date at favorable capital gains rates.

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11. (LO 1) **PowerPoint presentations will vary. In favor of high progressivity:**

- Ability to pay.
- Fairness of result.
- Benefits of government skew toward those at upper-income levels.

Contrary to high progressivity:

- Discouragement of work and innovation.
- Unfairness of result.
- Civic engagement by those at lower-income levels requires "skin in the game."

12. (LO 2)

a. In terms of taxpayer compliance, an ad valorem tax on personalty is less desirable than one on realty. However, a tax on business personalty, such as inventory, is to be preferred over one on personal use (i.e., nonbusiness) personalty.

b. A tax on stock and bonds would be too easily avoided. The taxing authority would have no means of ascertaining ownership of these assets.

c. Poor taxpayer compliance is to be expected for any tax on personal use personalty. However, if boats had to be periodically licensed (e.g., safety inspection), this could provide the taxing authority with a means of discovering unreported boat ownership.

13. (LO 6)

a. Economic justification. The tax law addresses the energy crisis—in terms of both reliance on foreign oil and the need to ease the problem of climate change.

b. Economic justification. See the comments under part a. above.

c. Economic justification. Research and development activities are encouraged by allowing immediate or faster write-off of these expenditures.

d. Social justification. The charitable deduction helps fund private organizations and causes that are operated in the interest of the general welfare. This relieves government of the need for considerable public funding.

e. Economic justification. Known as the S election, the provision encourages small businesses to operate in the corporate form without suffering all of the tax disadvantages of the regular (C) corporation.

14. (LO 6)

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.

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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.

15. (LO 2) (See Digging Deeper 5.) A value added tax (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.

A national sales tax taxes numerous transactions and is collected on the final sale of goods and services to the consumer. Consequently, it is collected from the consumer and not the producer of the product as does a VAT.

In terms of taxpayer compliance, a VAT is preferable to a national sales tax. Without significant collection efforts, a national sales tax could easily be circumvented or avoided in many ways (e.g., resorting to a barter system of doing business, etc.).

16. (LO 2) This problem requires students to access various sites on the internet. Thus, each student's solution likely will vary from that of the others. You should determine the skill and experience levels of the students before making the assignment, coaching them where necessary so as to broaden the scope of the exercise to the entire available electronic world. 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.

17. (LO 5) Students' e-mails may vary. Build interaction into the exercise wherever possible, asking the student to send and receive e-mail in a professional and responsible manner.

18. (LO 5) Students' answers may vary.

19. (LO 2, 5) 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.

20. (LO 5) The checkoff boxes add complexity to the return and mislead taxpayers into presuming that they are not paying for the donation.

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BRIDGE DISCIPLINE PROBLEMS

1. Solutions may vary among students.

2. Solutions may vary among students.

3. Solutions may vary among students.

4. When taxes become "too high," taxpayers increase the rates of tax cheating, because the payoff from misconduct increases. Property and transaction taxes are difficult to cheat on, as the tax base is easily detectible, while cheating on taxes on income and asset transfers may be more easily accomplished, and enforcement activities by the taxing agency become more expensive. High rates of tax cheating can lead to several undesirable consequences.

   - A "conspicuous consumption" society, wherein taxpayers use their tax underpayments to increase their lifestyles in a public fashion.
   - A loss of confidence in the self-assessment system, such that certain levels of cheating are assumed to occur, and the number of cheaters increases.
   - The "missing revenue" keeps the government from delivering the goods and services that the taxes are supposed to pay for.
   - Political gridlock can occur when it becomes impossible to raise tax rates high enough, or broaden the tax base enough, to offset the cheaters' "missing revenue."

5. 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.

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. 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.

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2. 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#**

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

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NOTES

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CHAPTER 1

INTRODUCTION TO TAXATION

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.
- The types of taxes imposed at the Federal, state, and local levels.
- The types of taxes imposed on various business entities.
- Tax planning and minimization strategies.
- The various considerations that impact tax law as well as 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.

- Added "data analysis" discussion to text Section 1-1a (The Relevance of Taxation to Accounting and Finance Professionals).
- 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 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.

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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.

TAXES IN OUR LIVES

1. Various types of taxes, such as income, sales, property, and excise taxes, come into play in many of the activities of individuals, businesses, nonprofit entities (like charities), and governments themselves.

2. Ultimately, all taxes are paid by individuals. The corporate income tax, for example, is paid directly by the corporation, but it really is paid by individuals in their capacity as customers, investors (owners), or employees; the taxes are passed along to individuals through higher prices for products and services, lower dividends, and/or lower wages.

3. Federal, state, and local elections often include initiatives that deal with taxation. Candidates running for office often have ideas on tax changes they would like to make if they are elected.

The Relevance of Taxation to Accounting and Finance Professionals

4. A large corporation may devote about 25% of its net income to pay income taxes, plus it is subject to employment taxes, property taxes, sales taxes, and various excise taxes. Corporations with international operations also are subject to taxation in other countries. Small businesses also pay a variety of taxes that affect profits and cash flows.

5. Given its significance, taxation is a crucial topic for accounting and finance professionals. They must understand the various types of business taxes to assist effectively with:

    a. Compliance: Ensure that the business files all tax returns and makes all tax payments on time. Mistakes can lead to penalties and interest expense.

    b. Planning: Help a business to apply favorable tax rules, like deferring income and obtaining tax credits, to minimize tax liability (and maximize owner wealth). The time value of money concept also is important here, as is coordinating tax planning with other business goals to maximize earnings per share.

    c. Financial reporting: Financial statements include a variety of tax information, including income tax expense on the income statement and deferred tax assets and liabilities on the balance sheet. Footnotes to the financial statements report various tax details including the company's effective tax rate.

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d. Controversy: Assist when the taxpayer interacts with a tax agency (like the IRS). The IRS and state and local tax agencies regularly audit tax returns that have been filed to verify that taxes were properly computed and paid.

e. Cash management: Taxes must be paid on time to avoid penalties and interest. Income taxes must be estimated and paid quarterly and reconciled on the annual return. Other taxes may be due weekly, monthly, or semiannually. Businesses must be sure they have the funds ready when the taxes are due and have procedures to track due dates.

f. Data analysis: With a majority, if not all, of a company's records maintained in digital form, there are opportunities to use this information to enhance profits, better understand the customer base, and improve and understand the information from a tax perspective. Tax practitioners often need skills in data analysis and visualization to identify samples for both internal and external audits, find ways to identify the products and services subject to sales tax in different states, and extract tax data to help inform other business functions, such as where to locate a new sales office.

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

7. It is essential to maintain a balanced perspective when working with tax systems. Tax considerations should not control decisions, but they are one of many factors to be considered (and often, one of the most significant).

How to Study Taxation

8. The goal of studying taxation is being able to recognize issues (or transactions) that have tax implications and trying to understand the justification for the related tax rules.

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

10. One should focus on understanding the rules and the why(s) behind them, rather than memorizing the many isolated or disconnected rules and terms. Aiming for understanding, rather than memorization, will make your journey into the world of taxation interesting and meaningful, and it will prepare you well for dealing with taxation in your accounting or finance career.

Individuals and Taxes

11. The diagram on page 1-4 in the text illustrates the many ways individuals interact with taxes.

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THE STRUCTURE OF TAX SYSTEMS

12. Most taxes have two components: a tax rate and a tax base (such as income, wages, value, or sales price). Tax liability is computed by multiplying these two components. Taxes vary by the structure of their rates and by the base subject to tax.

Tax Rates

13. Tax rates can be progressive, proportional, or regressive.

14. A tax is progressive if a higher rate of tax applies as the tax base increases. The Federal income tax is structured so as to be progressive.

15. A tax is proportional if the rate of tax remains constant, regardless of the size of the tax base. State retail sales taxes are proportional.

16. Regressive tax rates decrease as the tax base increases.

    a. Federal employment taxes, such as FICA and FUTA, are regressive.

    b. While the tax base and the taxpayer's ability to pay generally are positively correlated, many tax pundits view regressive tax rates as unfair. This is because the tax burden decreases as a percentage of the taxpayer's ability to pay.

17. The structure of tax rates only affects the *rate* of increase (i.e., progressive taxes increase at an increasing rate, proportional taxes increase at a constant rate, and regressive taxes increase at a decreasing rate).

Tax Bases

18. Most taxes are levied on one of four kinds of tax bases.

    a. Transactions [including sales or purchases of goods and services, and transfers of wealth (e.g., by gift or at death)].

    b. Property or wealth (including ownership of specific kinds of property).

    c. Privileges and rights (including the ability to do business as a corporation, the right to work in a certain profession, and the ability to move goods between countries).

    d. Income on a gross or net-of-expenses basis.

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Incidence of Taxation

19. The degree to which various segments of society share the total tax burden is difficult to assess. Assumptions must be made concerning who absorbs the burden of paying the tax.

20. Many research studies have shown that corporations are able to shift the corporate income tax burden (i.e., so that it is borne by both employees and the ultimate purchasers of goods), thereby avoiding any double taxation on the same income.

21. Tax incidence becomes important in discussions involving the "fair share" of taxation that each party in a society should pay.

TYPES OF TAXES

22. In introducing the discussion of the various components of the U.S. tax system, Figure 1–1 at the end of these Lecture Notes may be a useful resource.

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

Taxes on the Production and Sale of Goods

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

    a. Since World War II, the role of excise taxes in financing the Federal government has steadily declined, falling from about 30 to 40% of revenues just prior to the war to about 3% now.

    b. Currently, trucks, trailers, tires, liquor, tobacco, firearms, certain sporting equipment, medical devices, and air travel all are subject to Federal excise taxes.

    c. Excise taxes extend beyond sales transactions; they are also levied on privileges and rights.

    d. The bases used for Federal excise taxes are as diverse as the goods that are taxed (i.e., by the gallon, by the dose, by the price paid per ticket, etc.). Some are levied on the producer, some the reseller, and some on consumers.

    e. With the exception of Federal excise taxes on alcohol, tobacco, and firearms, Federal excise taxes are due at least quarterly, when the Federal excise tax return (Form 720) is filed.

25. State Excise Taxes. Many states levy excise taxes on the same items taxed by the Federal government.

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a. The tax on specific goods can vary dramatically among states. These differences at the state level provide ample incentive for smuggling between states and for state-line enterprises specializing in taxed goods.

b. Other goods and services subject to state and local excise taxes include admission to amusement facilities; hotel occupancy; rental of other facilities; and sales of playing cards, oleomargarine products, and prepared foods. Some counties impose a tax on transfers of property that require recording of documents (such as real estate sales and sales of stock and securities).

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

a. They tax the visitor who cannot vote, and so are a political windfall and serve as a means of financing special projects that generate civic pride.

b. A few cities have created excise taxes that apply to digital transactions, like song and movie streams, app downloads, Uber and Lyft fares, and Airbnb rentals.

27. General Sales Tax. The general sales tax is a major source of revenue for most state and local governments. It is used in all but five states (Alaska, Delaware, Montana, New Hampshire, and Oregon).

a. The sales tax typically employs a proportional tax rate and includes retail sales of tangible personal property (and occasionally personal services) in the base.

b. Some states exempt medicine and groceries from the base and sometimes tax rates vary with the good being sold.

c. Local general sales taxes, over and above those levied by the state, are common.

d. For various reasons, some jurisdictions temporarily suspend the application of a general sales tax. Many states schedule the sales tax holiday for August back-to-school buying.

(1) Due to revenue shortfalls, many previously exempt categories (e.g., certain food products) are now subject to tax in some states.

(2) The expansion of the sales tax to the performance of personal services has increased and will likely continue to do so.

28. Use Taxes. 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.

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29. Value Added Tax. The value added tax (VAT) is a variation of a sales tax; it is levied at each stage of production on the value added by the producer.

    a. A VAT is used by almost all countries around the world; the United States is one of the few countries that does not use a VAT.

    b. The tax typically serves as a major source of revenue for governments that use it.

Employment Taxes

30. Both Federal and state governments tax the salaries and wages paid to employees.

    a. There are two major employment taxes on the Federal side: FICA and FUTA. These employment taxes represent a major source of funds.

        (1) The FICA tax accounts for more than one-third of revenues in the Federal budget, second only to the income tax in its contribution.

        (2) The FUTA tax provides funds to state unemployment benefit programs.

    b. Most state employment taxes are similar to the FUTA tax, with proceeds used to finance state unemployment benefit payments.

31. FICA Taxes. The FICA tax has two components: old age, survivors, and disability insurance payments (commonly referred to as Social Security) and Medicare health insurance payments.

    a. The Social Security tax rate is 6.2% (for both employee and employer), and the Medicare tax rate is 1.45% (for both employee and employer). The maximum base amount for Social Security is $132,900 for 2019 and $128,400 for 2018. There is no ceiling on the base amount for the Medicare tax.

    b. Payments usually are made through weekly or monthly electronic payments or deposits to a Federal depository.

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

    d. Unlike Social Security and the regular Medicare portion, an employer does not match the employees' 0.9%.

    e. An additional 3.8% Medicare tax is assessed on the investment income of individuals whose modified adjusted gross income exceeds $200,000 or $250,000.

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32. Self-Employment Tax. Self-employed individuals also pay into the FICA system in the form of a self-employment (SE) tax. They are required to pay both the employer and the employee portion of the FICA taxes.

    a. The 2019 SE tax rate is 15.3% on self-employment income up to $132,900 and 2.9% on all additional self-employment income.

    b. Self-employed individuals deduct half of the SE tax—the amount normally deductible by an employer as a business expense.

33. Unemployment Taxes. For 2019, FUTA applies at a rate of 6.0% on the first $7,000 of covered wages paid during the year to each employee.

    a. FUTA has a regressive rate structure.

    b. The Federal government allows a credit for unemployment tax paid to the state. The credit cannot exceed 5.4% of the covered wages.

    c. FUTA and state unemployment taxes differ from FICA in that the tax is imposed only on the employer.

Taxes at Death

34. The transfer of property upon the death of the owner may be a taxable event.

    a. If the tax is imposed on the transferor at death, it is called an estate tax.

    b. If the law taxes the recipient of the property, it is termed an inheritance tax.

35. As is typical of other types of transaction taxes, the value of the property transferred provides the base for determining the amount of the tax at death.

36. The Federal government imposes an estate tax. Only a few state governments levy their own additional inheritance taxes, estate taxes, or both.

37. The Federal Estate Tax. The Federal estate tax was intended to prevent large concentrations of wealth from being kept within a family for many generations. Whether this objective has been accomplished is debatable, because estate taxes can be substantially reduced (or deferred for decades) through careful tax planning activities.

    a. Determination of the estate tax base begins with the gross estate, which includes property the decedent owned at the time of death.

    b. Deductions from the gross estate in arriving at the taxable estate include funeral and administration expenses, certain taxes, debts of the decedent, and transfers to charitable organizations.

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c. A marital deduction is available for amounts passing to a surviving spouse (a widow or widower).

d. Once the taxable estate has been determined and certain taxable gifts have been added to it, one must determine a tentative tax liability. The tentative liability is reduced by a variety of credits to arrive at the amount due.

e. In 2019, the first $11.4 million of a U.S. decedent's estate effectively is excluded from the estate tax, with a maximum 40% tax rate on any excess. Spouses can share a $22.8 million estate tax exclusion.

38. State Taxes at Death. 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 Tax

39. 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 rather than at death.

40. The Federal gift tax is intended to complement the estate tax. The gift tax base is the sum of all taxable gifts made during one's lifetime.

41. The Federal gift tax and the Federal estate tax are unified. The transfer of assets by a decedent at death effectively is treated as a final gift under the tax law.

42. Annual taxable gifts are determined by reducing the fair market value of gifts given by an annual exclusion of $15,000 per donee; this amount does not use up any of the lifetime exclusion. A married couple can elect gift splitting, which enables them to transfer twice the annual exclusion ($30,000) per donee per year, before eroding the lifetime exclusion amount.

43. Taxable gifts are reduced by deductions for gifts to charity and to one's spouse (the marital deduction).

44. Gifts for medical and educational purposes may be exempt from the gift tax.

Property Taxes

45. A property tax can be a tax on the ownership of property or a tax on wealth, depending on the base used. Most property taxes in the United States are taxes on wealth; they use value as a base.

46. Value-based property taxes are known as ad valorem taxes.

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47. Taxes on Realty. Property taxes on real property, or realty, are used exclusively by states and their local political subdivisions such as cities, counties, and school districts.

    a. Realty is land and anything permanently attached to land and personalty encompasses all assets that are not realty.

    b. The following are some of the characteristics of ad valorem taxes on realty.

        (1) States may have a homestead exemption, which makes some portion of the value of a personal residence exempt from tax.

        (2) Lower taxes may apply to a residence owned by a taxpayer age 65 or older.

        (3) Some jurisdictions extend immunity from tax for a specified period of time (a tax holiday) to new or relocated businesses.

        (4) Some states provide for lower valuations on property dedicated to agricultural use or other special uses (e.g., wildlife sanctuaries).

48. Taxes on Personalty. Personal property, or personalty, encompasses all assets that are not realty. Both realty and personalty can be either business use or personal use.

    a. Personalty also can be classified as tangible property or intangible property.

    b. The following generalizations may be made concerning the property taxes on personalty.

        (1) Generally, for individuals, vehicles are the only non-realty personal-use assets subject to property tax. The value of a vehicle typically is established by a schedule based on the vehicle's age and make/model. Usually, any vehicle property tax is assessed and collected along with vehicle license or registration fees.

        (2) Generally, businesses are assessed property taxes on equipment and other tangible property, although many states do not tax inventory.

        (3) Some jurisdictions impose an ad valorem property tax on intangibles, like stocks and bonds.

Other U.S. Taxes

49. Federal Customs Duties. Customs duties or tariffs can be characterized as a tax on the right to move goods across national borders.

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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.

50. Miscellaneous State and Local Taxes.

a. A franchise tax is a tax on the privilege of doing business in a state or local jurisdiction. Typically, the tax is imposed by states on corporations, but the tax base varies from state to state.

b. Occupational taxes are applicable to various trades or businesses, such as a liquor store license, a taxicab or shared-ride permit, or a fee to practice a profession such as law, medicine, or accounting. Most of these are not significant revenue producers and fall more into the category of licenses than taxes.

51. Severance Taxes. Severance taxes are based on the extraction of natural resources (e.g., oil, gas, iron ore, and coal). They are an important source of revenue for many states.

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. The Structure of the Federal Income Tax. Although some variations exist, the basic Federal income tax formula is similar for all taxable entities. This formula is shown in Exhibit 1.1 in the text.

a. The income tax is based on the doctrine known as legislative grace: all income is subject to tax, and no deductions are allowed unless specifically provided for in the law.

b. All entities are allowed to deduct business expenses from gross income, but a number of limitations and exceptions are applied.

c. Individual rates range from 10% to 37%. Estates and trusts are also subject to income taxation, with rates ranging from 10% to 37%.

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d. Partnerships, qualifying small business corporations, and some limited liability companies are not taxable entities, but must file information returns.

e. For individuals, deductions are separated into two categories—deductions *for* adjusted gross income (AGI) and deductions *from* AGI. An overview of the individual income tax formula is provided in Exhibit 1.2 in the text.

54. State Income Taxes. Most states impose a traditional income tax on individuals. Tennessee and New Hampshire tax only certain dividend and interest income. Most states also impose either a corporate income tax or a franchise tax based in part on corporate income.

55. Local Income Taxes. The imposition of income taxes by local jurisdictions, though not uncommon, is more the exception than the rule.

56. Concept Summary 1.1 in the text provides an overview of the major taxes existing in the United States and specifies which political jurisdiction imposes them.

INCOME TAXATION OF BUSINESS ENTITIES

Proprietorships

57. The simplest form of business entity.

58. Because a proprietorship is owned by an individual, the individual has great flexibility in structuring the entity's transactions in a way that will minimize his or her marginal income tax rate.

59. The owner of the proprietorship reports the income and deductions of the business on a Schedule C and the net profit (or loss) of the proprietorship on his or her Form 1040.

C Corporations

60. Corporations that are separate taxable entities are referred to as C corporations, because they are governed by Subchapter C of the Internal Revenue Code. (See Chapters 12 and 13 in the text.)

61. A C corporation files its own tax return (Form 1120) and is subject to the Federal income tax.

62. The shareholders then pay income tax on the dividends they receive when the corporation distributes its profits.

Partnerships

63. A partnership is not a separate taxable entity.

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64. The partnership files a tax return (Form 1065) on which it summarizes the financial results of the business. Each partner then reports his or her share of the net income or loss and other special items that were reported on the partnership return. (See Chapter 14 in the text.)

S Corporations

65. Corporations that meet certain requirements and pay no tax at the corporate level are referred to as S corporations, because they are governed by Subchapter S of the Code. (See Chapter 15 in the text.)

66. An S corporation is treated like a C corporation for all nontax purposes. Regarding tax factors, however, an S corporation is more like a partnership.

Limited Liability Companies and Limited Liability Partnerships

67. Limited liability companies (LLCs) and limited liability partnerships (LLPs) offer limited liability and some (but not all) of the other nontax features of corporations.

68. Both forms usually are treated as partnerships for tax purposes.

69. The S corporation, limited liability company, and partnership forms of organization, which are referred to as flow-through entities, avoid the double taxation problem associated with the C corporation.

Dealings between Individuals and Their Business Entities

70. The following are some of the major interactions between owners and business entities:

    a. Owners put assets into a business when they create a business entity (e.g., a proprietorship, partnership, or corporation).

    b. Owners take assets out of the business during its existence in the form of salary, dividends, withdrawals, redemptions of stock, etc.

    c. Through their entities, owner-employees set up retirement plans for themselves, including IRAs and qualified retirement and pension plans.

    d. Owners dispose of all or part of a business entity.

71. The following are a few of the many tax issues that arise:

    a. How the tax law applies at both the owner level and the entity level (i.e., the multiple taxation problem), and what effective tax rate is assessed on such income.

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b. How to move assets into the business with the least adverse tax consequences.

c. How to pull assets and accumulated profits out of the business with the least adverse tax consequences.

d. How to dispose of the business entity with the least adverse tax consequences.

e. Whether certain tax rules will apply less favorably because the business and owner(s) are related parties.

TAX PLANNING FUNDAMENTALS

Overview of Tax Planning and Ethics

72. It is a long-standing principle that taxpayers have no obligation to pay more than their fair share of taxes.

73. Tax Planning: Avoidance Versus Evasion.

a. Minimizing taxes legally is referred to as tax avoidance.

b. Tax evasion is attempting to evade income taxes through illegal actions.

c. Clients expect tax professionals to provide advice to help them minimize their tax costs through tax planning.

74. The Ethics of Tax Planning. Tax planning (avoidance) is a fully ethical activity by the taxpayer and the tax professional, but tax evasion (fraud) is not.

a. The tax adviser's actions are limited by the codes of conduct of various professional organizations.

b. Other formal restrictions and directives concerning the conduct of the tax professional can be found in two broad forms:

(1) Penalties and interest may apply to the taxpayer when a tax liability is understated.

(2) Sanctions are used for tax preparers who disregard the tax law. Tax penalties also apply when the tax preparer fails to sign a tax return that he or she has worked on or takes an improper filing position on a tax return.

A General Framework for Income Tax Planning

75. The primary goal of tax planning is to design a transaction so as to minimize its tax costs, while meeting the other nontax objectives of the client.

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76. Careful analysis of the tax formula (refer to Exhibit 1.1 in the text) reveals a series of tax minimization strategies.

77. The General Framework for Income Tax Planning in Exhibit 1.3 in the text lists each element in the income tax formula, develops tax planning strategies designed to minimize taxes, and provides brief summaries of specific examples of tax planning.

Tax Minimization Strategies Related to Income

78. *Avoid income recognition*. (See Example 19 in the text.)

79. *Postpone recognition of income to achieve tax deferral*. (See Example 20 in the text.)

Tax Minimization Strategies Related to Deductions

80. *Maximize deductible amounts*. A corporation that owns stock in another corporation is eligible for a dividends received deduction (DRD).

    a. The DRD is equal to a specified percentage of the dividends received. The percentage is based on the amount of stock that the investor corporation owns in the investee corporation.
    - 50% deduction for ownership of less than 20%.
    - 65% deduction for ownership of 20% or more but less than 80%.
    - 100% deduction for ownership of 80% or more.

    b. Example 21 in the text demonstrates the tax advantage of dividend income versus interest income.

81. *Accelerate recognition of deductions to achieve tax deferral*. (See Example 22 in the text.)

Tax Minimization Strategies Related to Tax Rates

82. *Shift net income from high-bracket years to low-bracket years*. (See Examples 23 and 24 in the text.)

83. *Shift net income from high-bracket taxpayers to low-bracket taxpayers*. (See Example 25 in the text.)

84. *Shift net income from high-tax jurisdictions to low-tax jurisdictions*. (See Examples 26 and 27 in the text.)

85. *Control the character of income and deductions*. (See Example 28 in the text.)

86. *Avoid double taxation*.

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a. Shareholders can avoid double taxation by electing that a corporate entity become an S corporation. (See Example 29 in the text.)

b. Other entity choices can be used to avoid double taxation, including partnerships and limited liability companies.

c. Choosing to operate as a flow-through entity is not the only way to avoid double taxation. Double taxation can be avoided or minimized by having the corporation make tax-deductible payments, such as salaries, rent, and interest to the shareholders. (See Example 30 in the text.)

Tax Minimization Strategies Related to Credits

87. *Maximize tax credits*. (See Example 31 in the text.)

a. A deduction reduces taxable income, which results in a reduction of the tax paid.

b. A tax credit reduces the tax liability dollar for dollar and is not affected by the taxpayer's tax rate.

UNDERSTANDING THE FEDERAL TAX LAW

88. The Federal tax law reflects the three branches of our Federal government. It is a mixture of laws passed by Congress, explanations provided by the Treasury Department and the Internal Revenue Service (IRS), and court decisions.

Revenue Needs

89. In a perfect world, taxes raised by the government would equal the expenses incurred by government operations.

90. The U.S. Constitution allows deficit spending, and politicians often find it hard to resist the temptation to spend more than the tax system collects currently.

Economic Considerations

91. Sometimes tax legislation is designed to help control the economy or encourage certain activities, industries, or businesses.

92. Encouragement of Certain Activities. Congress often uses the tax law to encourage certain types of economic activity or segments of the economy.

a. The favorable treatment allowed research and development expenditures (immediate deduction vs. capitalization and amortization) can be explained by the desire to foster technological progress.

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b. Congress has used the tax depreciation rules as a means of encouraging investment in business capital.

c. Ecological considerations justify a tax provision that permits a more rapid expensing of the costs of installing pollution control facilities.

d. Considering the pressing and continuing problem of a deficit in the U.S. balance of payments, Congress has established incentives for U.S. citizens who accept employment overseas, and for business entities that operate in countries outside the United States.

e. Saving can lead to capital formation, making funds available to finance home construction and industrial expansion. The tax law encourages saving by according preferential treatment to private retirement plans.

93. Encouragement of Certain Industries.

a. Historically, agricultural activities have been favored under Federal tax law. Among the tax benefits are the election to expense rather than capitalize certain soil and water conservation expenditures and fertilizers and the election to defer the recognition of gain on the receipt of crop insurance proceeds.

b. To stimulate the research and production of alternative fuel sources, tax incentives are allowed with respect to operations and sales of solar and wind energy devices, and of autos that do not consume petroleum products.

94. Encouragement of Small Business. The belief that what is good for small business is good for the economy as a whole has led to special provisions in the tax law that favor small business.

Social Considerations

95. Some provisions of the Federal tax law, particularly those dealing individuals, can be explained by a desire to encourage certain social results

a. Certain benefits provided to employees through accident and health insurance plans financed by employers are nontaxable to employees.

b. A contribution made by an employer to a qualified pension or profit sharing plan for an employee may receive special treatment.

c. A deduction is allowed for contributions to qualified charities.

d. Various tax incentives are designed to encourage taxpayers to obtain or extend their level of education.

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e. A tax credit is allowed for amounts spent to furnish care for certain minor or disabled dependents to enable the taxpayer to seek or maintain gainful employment.

f. A tax deduction is denied for certain expenditures deemed to be contrary to public policy (e.g., fines, penalties, illegal kickbacks, bribes to government officials, and gambling losses in excess of gains).

Equity Considerations

96. In the tax area, equity is most often tied to a particular taxpayer's personal situation.

97. The Wherewithal to Pay Concept. The wherewithal to pay concept recognizes the inequity of taxing a transaction when the taxpayer lacks the means with which to pay the tax.

a. This underlies a provision in the tax law dealing with the treatment of gain resulting from an involuntary conversion—which occurs when property is destroyed by casualty or taken by a public authority through condemnation.

b. If gain results from the conversion, it need not be recognized immediately if the taxpayer replaces the property within a specified time period.

98. Mitigating the Effect of the Annual Accounting Period Concept. The application of this annual accounting period concept can lead to dissimilar tax treatment for taxpayers who are, from a long-range standpoint, in the same economic position.

Political Considerations

99. A large segment of the Federal tax law is made up of statutory provisions.

100. Special Interest Legislation. Certain provisions of the tax law largely can be explained by the political influence some groups have had on Congress.

101. State and Local Government Influences. State law has had an influence in shaping our present Federal tax law.

a. One example of this effect is the evolution of Federal tax law in response to states with community property systems.

b. The difference between common law and community property systems centers around the property rights held by married persons.

c. At one time, the tax position of the residents of community property states was so advantageous that many common law states adopted community property

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systems. Political pressure placed on Congress to correct the disparity in tax treatment was considerable.

d. Congress changed the law to extend many of the community property tax advantages to residents of common law jurisdictions.

(1) Allowed married taxpayers to file joint returns and compute the tax liability as if one-half of the income had been earned by each spouse.

(2) The income-splitting benefits of a joint return are incorporated as part of the tax rates applicable to married taxpayers.

e. A similar motivation can be seen for the gift-splitting provisions of the Federal gift tax and the marital deduction of the Federal estate and gift taxes.

Influence of the Internal Revenue Service

102. One of the keys to an effective administration of our tax system is the audit process conducted by the IRS.

103. The IRS influences laws by suggesting changes to Congress based on compliance problems it discovers.

104. The U.S. Treasury Department and the IRS also affect tax laws via the Regulations and rulings they issue that explain and interpret Code provisions.

Influence of the Courts

105. In addition to interpreting statutory provisions and the administrative pronouncements issued by the Treasury Department and the IRS, the Federal courts have influenced tax law in two other ways.

a. The courts have developed a number of judicial concepts that help guide the application of various tax provisions, going beyond the strict language of the Code and Treasury Regulations.

b. Certain key court decisions have led to changes in the Code and other sources of tax law.

106. Judicial Concepts Relating to Tax. In dealings between related parties, the courts test transactions by looking to whether the taxpayers acted in an arm's length manner.

107. Judicial Influence on Statutory Provisions. Some court decisions have been of such consequence that Congress has incorporated them into statutory tax law.

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SUMMARY

108. Tax professionals must be adept in various skills to deliver expected levels of service to clients and the government.
- Knowledge of technical tax law.
- Productive with technology and data analytics.
- Strengths in business acumen and so-called soft skills, like listening and motivation.
- Functional in problem solving and process improvement.
- Valued contributor in project management and cost-benefit analysis.
- Excellent verbal and written communication skills.

109. Tax planning is a means by which to manage the amount and timing of tax liabilities to accomplish one's long-term objectives.

110. The conduct of tax practitioners is regulated by professional associations, lawmakers, and the taxing agencies.

111. In addition to its necessary revenue-raising objective, the Federal tax law has developed in response to several other factors.

a. Economic considerations. Tax provisions can help to regulate the economy and encourage certain activities and types of businesses.

b. Social considerations. Some tax provisions are designed to encourage (or discourage) socially desirable (or undesirable) practices.

c. Equity considerations. Tax provisions can alleviate the effect of multiple taxation, recognize the wherewithal to pay concept, and mitigate the effect of the annual accounting period concept.

d. Political considerations. Tax provisions can carry out the desires of special interest groups or reflect the effect of state and local law.

e. Influence of the IRS. Many tax provisions are intended to aid the IRS in the collection of revenue and the administration of the tax law.

f. Influence of the courts. Court decisions have established a body of judicial concepts relating to tax law and have, on occasion, led Congress to enact statutory provisions to either clarify or negate their effect.

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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