Concepts in Federal Taxation 2022 29th edition Murphy Solutions Manual

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CHAPTER 1
Federal Income Taxation—An Overview

You will probably want to devote three 50-minute class periods to cover all the topics within this chapter. Alternatively, you may want to consider eliminating some of the topics from in-class coverage. The chapter introduces many topics that will be discussed in depth later. However, the explanations of most topics are complete and do not need further elaboration. For example, extensive elaboration about the major types of U.S. taxes and about tax planning is probably unnecessary.

Teaching Tip #1: A good in-class exercise is to have students assess whether a certain type of tax is a good tax using Adam Smith's canons of taxation (e.g., sales tax on food or excise tax on tires). After the students have read the relevant text material and prepared ***Discussion Question 1***, divide the class into two groups. Have one group defend the selected tax as "good" and the other group defend it as "bad." This exercise can be an in-class discussion or debate. Alternatively, it can be a writing assignment. Be aware that students often have difficulty in choosing the proper base (i.e., income, consumption, or value) to make their comparisons. A discussion that revolves around using the proper base for comparison will lead to a discussion about tax rate structures (progressive, proportional, and regressive). The tax rate structure of a certain tax can differ depending on the base used for comparison. For example, a sales tax can be regressive or proportional depending upon the base for determination (income or consumption, respectively.) ***Examples 8 through 11*** in the text highlight these issues.

Teaching Tip #2: ***Discussion Case 74*** is designed to introduce students to alternative taxing systems. Specifically, a value-added system is contrasted with the current U.S. system. Have students read the assigned article and answer the questions included in the case. Then, on the due date of the assignment, group the students together in class and allow them time to come to some form of consensus. After 10–15 minutes, briefly summarize consensus answers.

Teaching Tip #3: ***Tax Planning Case 76*** is also a good in-class exercise. It can be used as a cumulative problem to help emphasize some of the computational aspects of income taxation and to reinforce planning characteristics inherent within income taxation. This problem also makes a good exam question.

Writing Assignments: ***Problems 51, 58, and 59; Technology Application Problem 73; and Tax Planning Case 76*** are the suggested writing assignments for this chapter.

You may modify ***Problem 59*** to allow students to practice composing different forms of business communication they may encounter in the "real world." Here is an example using a memo to a senior accountant as the suggested business form.

> Assume you are a recent graduate from your college or university working for Bigg, Beste, and Associates, CPAs. Last Monday, Mabel Hallston, an architect with Bluestone and Associates, met with a senior accountant of your firm. Mabel

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wonders whether she is receiving good tax advice from R&P, the firm she has used for several years. Annually, R&P sends Mabel a summary information sheet prior to completing her income tax return. Mabel fills out the sheet and sends it to R&P along with appropriate documentation. She has always received a refund. The senior has asked you to prepare a memo in which you explain why Mabel may not be getting good tax advice from R&P.

Note: Experiment with your modifications. Do not feel locked into any of my suggestions.

Lecture Outline

I. A tax is an involuntary payment required by law, unrelated to any specific benefit or service received from the governmental agency imposing the tax
   A. A tax is not
      1. A licensing fee
      2. A toll
      3. A parking meter fee
      4. City water and sewer payments
      5. A fine or penalty
   B. ***Examples[1] 1 and 2 and Problems 40 and 41*** fit here

II. Adam Smith's four criteria for a good tax system
   A. Equality: a tax should be based on the taxpayer's ability to pay
      1. Horizontal equity exists when two similarly situated taxpayers are taxed the same (***Example 3***)
      2. Vertical equity exists when differently situated taxpayers are taxed differently, but fairly, in relation to each taxpayer's ability to pay the tax (***Example 4***)
         a. The United States' progressive tax rate structure follows vertical equity
      3. Some tax laws may seem inequitable because economic, social, or administrative reasons often dominate lawmakers' objectives when creating tax law (***Example 5***)
   B. Certainty: a taxpayer should know when and how a tax is to be paid and should be able to determine the amount of tax
      1. Important for tax planning

[1]Throughout this Instructor's Manual, all references to Examples, Tables, Problems, etc. are to the Textbook.

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a. Due date (usually April 15 for calendar-year individual taxpayers and March 15 for calendar-year partnership and S corporation taxpayers)
b. Balance due paid by check to the Department of Treasury and sent to the IRS
c. Amount calculated from tax rate schedules or tax tables
d. Certainty can be violated by
1. Frequent tax law changes
2. Various courts' interpretations
3. IRS rulings and regulation changes

2. Generally, certainty exists for the average taxpayer

C. Convenience: a tax should be levied when the taxpayer has the funds to pay the tax
1. Pay-as-you-go system
a. Withholding
b. Estimated quarterly payments
2. Self-assessment and voluntary compliance system

D. Economy: compliance and administrative costs should be at a minimum
1. IRS budget is about one-half of 1 percent of tax collected
2. Taxpayer costs can be high
a. Record-keeping
b. Fees to accountants and/or attorneys

III. Tax rates and structures

A. Tax = Tax base × Tax rate
B. Tax base is the value subject to taxation (e.g., taxable income or amount of a purchase)
C. Tax rates can be defined in three ways (***Problems 42 to 44***)
1. Marginal tax rate is the rate of tax paid on the next dollar of taxable income or the rate of tax saved by the next dollar of a deduction
a. Used in tax planning (***Example 6***)
2. Average tax rate is the total federal income tax divided by taxable income (tax base)
a. Indicates the average rate of tax on each dollar of income included in taxable income (***Example 7***)
3. Effective tax rate is the total federal income tax divided by the taxpayer's economic income (tax base + nontaxable or excluded income)

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D. Three tax rate structures explain how the rates vary with a change in tax base (***Problems 45 and 46***)
   1. Proportional: the average tax rate remains the same as the tax base increases
      a. ***Chart 1 in Figure 1-1***
      b. Marginal tax rate = Average tax rate at all levels of the tax base (***Example 8***)
   2. Regressive: the average tax rate decreases as the tax base increases
      a. ***Chart 2 in Figure 1-1***
      b. The total tax paid increases, although both the average tax rate and the marginal tax rate decrease (***Examples 9 and 10***)
   3. Progressive: the average tax rate increases as the tax base increases
      a. ***Chart 3 in Figure 1-1***
      b. The marginal tax rate is higher than the average tax rate as the tax base increases (**Example 11**)

IV. Major types of U.S. taxes
   A. ***Figure 1-2*** shows the number of days worked to pay taxes by type of tax
   B. Income tax generates the bulk of federal taxes
      1. Individuals, corporations, estates, and trusts
      2. Most states and localities with taxes on income base their computation formulae on the federal income tax computation model
   C. Employment taxes
      1. Social Security (FICA) includes both Old Age, Survivors, and Disability Insurance (OASDI) and Medical Health Insurance (MHI)
         a. Imposed on employees, employers, and self-employed persons
            1. Employers match employees' payments
            2. Self-employed persons pay both portions
            3. ***Table 1-1*** lists tax rates and maximum wage bases: the OASDI maximum wage base is $142,800 for 2021
            4. ***Examples 12 to 15 and Problems 47 to 51***
      2. Unemployment taxes
         a. State (SUTA) and Federal (FUTA)
         b. A tax of 6.2 percent is levied on the first $7,000 of wages for FUTA
            1. No FUTA is paid for employees earning less than $1,500 per calendar quarter and certain classes of agricultural workers

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2. Employers are allowed a credit of up to 5.4 percent for SUTA paid
3. The minimum FUTA tax rate is 0.8 percent (6.2% – 5.4%)

D. Sales taxes provide large amounts of revenue for state and local governments
   1. Flat tax rate
   2. Many types of goods and services are exempt from sales tax
      a. Food
      b. Farm equipment
      c. Medical services
      d. Sales to tax-exempt organizations

E. Property taxes are based on assessed values (often 50 to 75 percent of the estimated FMV)
   1. Referred to as *ad valorem* taxes
   2. Real property: land and structures (***Example 16***)
   3. Personal property: everything else (***Example 17***)

F. Excise taxes
   1. Imposed on quantity, not value—one tire, one pack of cigarettes, or one gallon of gasoline

G. Wealth transfer taxes
   1. Gift tax
      a. Paid by donors on the value of annual gifts over $15,000 in 2021
      b. The $15,000 excluded amount is a per-donee annual exclusion
      c. Married couples are allowed $30,000 per person per year (***Example 18***)
      d. No gift tax on gifts to spouses or charities (***Example 19***)
      e. Donees are not taxed on any amounts received as gifts
      f. Gifts not otherwise excluded from tax may be excluded using the unified donative-transfers credit of $ 11.7 million in 2021 for gifts and estates
   2. Estate taxes
      a. Levied on fair market value (FMV) of decedent's assets
      b. All property may pass to surviving spouse tax-free
      c. Estate taxes are paid from the assets of the estate
      d. Generally, few estates have levies of estate taxes because of the unified donative-transfers credit of $11.7 million in 2021

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e. Income tax may be assessed on earnings from estate assets prior to their distribution

H. Health care related taxes

The Affordable Care Act implemented or changed five tax provisions to pay for the cost of subsidizing health care for those who cannot afford health insurance

1. Hospital insurance tax (***Example 20)***
    a. For tax years beginning after December 31, 2012, 0.9 percent tax is applied on the wages received in excess of $250,000 for taxpayers who are married and filing jointly ($125,000 for married filing separately and $200,000 for all other taxpayers)
    b. Tax is also applicable on net self-employment income over the threshold amounts
2. Medicare contribution tax (***Example 21***)
    a. For tax years beginning after December 31, 2012, 3.8 percent tax is applied on unearned income of individuals, estates, and trusts
    b. Imposed on the lesser of net investment income or modified adjusted gross income in excess of $250,000 for married taxpayers filing jointly ($125,000 for married filing separately and $200,000 for all other taxpayers)
3. Unreimbursed medical expenses are only deductible in excess of 10 percent of the adjusted gross income (AGI) (***Example 28***)
4. Contributions to health flexible spending arrangements (FSAs)
    a. Limited to $2,750
    b. Indexed for inflation after December 31, 2013
5. Indoor tanning excise tax
    a. A 10 percent excise tax on indoor tanning services performed after June 30, 2010

V. Three primary sources of federal tax law (see ***Chapter 16*** for a detailed discussion on tax research)

A. Legislative sources are led by the Internal Revenue Code

1. **Hint:** Bring a copy of the Code to class and have a student read from a selected section. Point out the general language of the Code and the necessity of other sources of tax law to often answer questions

B. Administrative sources include the Treasury regulations issued by the IRS

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1. **Hint:** Bring a set of Treasury regulations to class. Point out that they are interpretations of the Code, but not all Code sections have related regulation sections
2. Other administrative pronouncements from the IRS
    a. Revenue rulings
    b. Revenue procedures
    c. Other pronouncements

C. Judicial sources are the various courts that hear tax cases
1. U.S. Tax Court, U.S. District Court, and Claims Court
2. U.S. Court of Appeals—12 regions
3. U.S. Supreme Court decides which cases it will hear; usually limited to those of major importance (e.g., a constitutional issue) or those that will resolve conflicting decisions of Courts of Appeals

D. Secondary sources include tax reference services, tax journals, tax newsletters, and textbooks

VI. Tax terminology and the computational framework (***Exhibit 1-1***)

A. Income broadly includes all forms of wealth enhancement
1. Gross income results when exclusions are subtracted from all income (***Chapter 3*** discusses gross income in detail)
2. Exclusions result from legislative grace
    a. Gifts, inheritances, and interest on certain municipal bonds
    b. ***Chapter 4*** discusses exclusions in detail
3. Deferrals differ from exclusions in that someday these items will be taxed

B. Taxable income is gross income less deductions and exemptions
1. Not the same as net income determined using GAAP
2. GAAP are concerned with financial reporting
3. Tax law is concerned with revenue collection

C. Ordinary income is the common type of income earned by individuals and businesses (***Problems 52 and 53***)
1. Business profits, dividend income, wages, rents, and interest
2. Taxed at regular tax rates

D. Gains result when an asset is sold for more than its cost
1. Most gains produce ordinary income
2. Gains from the sale of certain (capital) assets result in capital gains

E. Deductions are allowed only through legislative grace (***Problems 54 and 55***)
1. Expenses (***Chapters 5 and 6*** discuss these in detail)

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a. Trade or business
b. Personal
1. Itemized deductions
2. Nondeductible expenses

2. Losses (***Chapter 7*** discusses these in detail)
a. Transaction losses represent losses of capital invested in an asset
b. Annual losses result from an excess of allowable deductions for a year over income recognized for the year

F. Tax rates are adjusted for inflation annually
1. Taxable income times the applicable rate = Tax liability
2. ***Table 1-2***: 2021 tax rate schedules
3. ***Exhibit 1-2***: The hidden inflation tax

G. Prepayments include withholding and quarterly payments

H. Tax liability (**Problems 56 and 57**)
1. Tax due means that prepayments are less than the tax liability
2. Refund *due* means that prepayments exceed the tax liability

I. Tax credits reduce tax liabilities dollar for dollar
1. Use ***Example 22*** for comparison of deductions and credits
2. ***Chapters 8 and 15*** discuss credits in detail

J. Filing returns
1. Due dates
a. Fifteenth day of the fourth month after the end of the tax year for individuals, estates, trusts, and corporations
b. Fifteenth day of the third month after the end of the tax year for partnerships and S corporations
2. Extensions and amended returns (***Examples 23 to 25***)
3. Statute of limitations (***Discussion Question 29***)
a. Generally three years from filing due date
b. Six years for omitting more than 25 percent of gross income
c. Unlimited for fraud or no return

VII. Audit and appeal process

A. Tax return selection process
1. Discriminant Function System (DIF)
2. Taxpayer Compliance Measurement Program (TCMP) is currently suspended
3. Document perfection and information-matching programs

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a. All returns are checked for mathematical errors
b. W-2s, 2000

B. Types of examinations
1. Correspondence
2. Office: informal audits
3. Field: almost all taxpayers need representation

C. Settlement procedures
1. Revenue agent's report and Form 870
2. A 30-day letter

D. Administrative appeals
1. A 90-day letter is the statutory notice of deficiency
2. Taxpayers who are not interested in going to court can simply wait for 90 days to have the deficiency formally assessed and then pay any additional amounts due. Taxpayers who do not want to pay first must file a petition with the U.S. Tax Court within 90 days of the date of the letter
3. The decision to take an unresolved tax issue to court involves a number of additional factors and typically is made only with the advice of legal counsel specializing in tax litigation

VIII. Individual income tax calculation (***Exhibit 1-3***)

A. Adjusted gross income number is unique to individual taxpayers (***Problem 58*** compares the effect of "from" versus "for")

B. Deductions *for* AGI
1. Trade or business expenses
2. Rental and royalty expenses
3. Capital loss deduction
4. IRA contribution
5. Reimbursed employee business expenses
6. Half of the self-employment taxes paid
7. Self-employed medical insurance premiums
8. Up to $2,500 of interest on qualified student loans

C. Deductions *from* AGI
1. Itemized deductions or
2. Standard deduction
a. Amounts for 2021 (***Examples 26 and 27***)
1. $12,550 for a single individual
2. $ 25,100 for a married couple

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3. Itemized deductions are discussed fully in ***Chapter 8***
   Types of personal expenses allowed as itemized deductions:
   a. Medical, taxes, interest, and charitable contributions

IX. Tax planning is used to maximize after-tax wealth

A. Timing of income and deductions
   Time value of money considerations (***Examples 29 and 30 and Problems 61 and 62***)
   a. Present values (***Table 1-3***)
   b. Defer income recognition
   c. Accelerate deductions
   2. Marginal tax rate considerations ***Table 1-4*** (***Problem 63***)
   a. Receive income in the year with the lowest marginal rate
   b. Take deductions in the year with the highest marginal rate

B. Shifting of income among related taxpayers (***Example 31 and Problem 64***)
   1. ***Chapter 14*** discusses splitting income between the taxpayer and the taxpayer's corporation; also see ***Examples 32 and 33***

C. Evasion versus avoidance; illegal versus legal
   1. Three elements for evasion
   a. Willfulness
   b. Tax underpayment
   c. Affirmative act by a taxpayer to evade tax
   2. ***Examples 34 and 35 and Problems 65 and 66*** offer situations comparing
   a. Evasion and avoidance

X. Ethical considerations in tax practice

A. ***Exhibit 1-4*** contains a list of preparer penalties
B. *IRS Circular 230* covers all tax practitioners
C. AICPA Code of Professional Conduct is enforceable for members of AICPA
D. AICPA's Statements on Standards for Tax Services
   1. Seven advisory guidelines for CPAs (see www.cengagebrain.com)
   2. Suggested assignment: ***Ethics Discussion Case 77***

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Annotated Bibliography

CREATING THE NET INVESTMENT INCOME TAX REGULATIONS: A CONVERSATION WITH DAVID KIRK, by Robert S. Keebler, *Journal of Accountancy* (July 2014).

An interview with one of the authors of the regulations for the net investment income tax which includes a short overview of the tax, a discussion of the types of income subject to the tax and the goals of the tax.

AICPA SUES IRS TO STOP RETURN PREPARER PROGRAM, by Alastair M. Nevius, *Journal of Accountancy*, (October 2014).

A report on the suit filed in the U.S. District Court to stop the IRS's voluntary certification program for tax preparers filed by the AICPA. Among other things, the AICPA's complaint states that the rule introducing the new program is "arbitrary and capricious" because it creates new categories of return preparers which will confuse taxpayers and "…does nothing to address the issues of unethical or fraudulent tax return preparers."

IRS INTRODUCES VOLUNTARY CERTIFICATION PROGRAM FOR TAX PREPARERS, by Alastair M. Nevius, *Journal of Accountancy* (August 2014).

A short review of the IRS's voluntary tax preparer certification program which it introduced after having its mandatory tax preparer regulation program struck down in February 2014 by the Federal Court of Appeals for the District of Columbia.

FEDERAL COURT STRIKES DOWN IRS TAX RETURN PREPARER REGISTRATION PROGRAM by Alastair M. Nevius, in *Journal of Accountancy Online* (January 22, 2013),

Reports on the decision of U.S. District Court for the District of Columbia on the Federal regulation of tax return preparers.

COURT UPHOLDS INJUNCTION; IRS REOPENS PTIN SYSTEM by Paul Bonner and Alistair M. Nevius, in *Journal of Accountancy Online* (February 3, 2013),

Reports on the continuing battle between the U.S. District Court for the District of Columbia and the IRS the IRS's return preparer registration program

2010-2011 REVISIONS TO CIRCULAR 230 by John C. Gardner, Joseph Kastantin and William E. Maas, 42 *Tax Advisor* (January 2012), 42-48.

Circular 230 prescribes who may practice before the IRS. Recent revisions have been extensive. This article discusses those changes and contains commentary on them from the AICPA, ABA, and others in the tax community.

TAXING CONSUMPTION AND OTHER SINS by James R. Hines, Jr., *Journal of Economic Perspectives* (Winter 2007), 49-68.

Compares the US system of taxation with systems that rely more heavily on the taxation of consumption.

THE NATIONAL RETAIL SALES TAX: WHAT WOULD THE RATE HAVE TO BE? by William G. Gale (May 2005)

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PROGRESSIVE CONSUMPTION TAXATION AS A REMEDY FOR THE U.S. SAVING SHORTFALL by Robert H. Frank, *The Economist's Voice*, Volume 2, Issue 3 (2005).

The author argues that a consumption tax may be a remedy for America's propensity to spend instead of to save.

REASONABLE INQUIRY REQUIRED TO AVOID TAX-PREPARER PENALTY *Journal of Accountancy Online* (October 2003),
Provides a summary of the decision in *James J. Schneider, CPA v. United States* (S.D. Ind.), 2003-1 USTC ¶50,352.

IRS INCREASES CRIMINAL INVESTIGATION OF TAX RETURN PREPARERS *Internal Revenue Service, The Digital Daily*

HOW WELL DO YOU KNOW YOUR TAX PREPARER? by Julie Watson, *Forbes.com* (March 3, 2002)

GUIDING PRINCIPLES OF GOOD TAX POLICY by Nicholas Fiore, *Journal of Accountancy Online* (February 2002)

NEW STANDARDS FOR TAX PRACTICE by J. Edward Swails, *Journal of Accountancy* (November 2000)

The AICPA has adopted eight Statements on Standards for Tax Services as enforceable standards for AICPA members, replacing the Statements on Responsibilities in Tax Practice. What issues did the tax executive committee face in turning the advisory SRTPs into mandatory SSTSs? And how will members be affected?

ACCOUNTING METHOD CHANGES by Scott E. Grimes, Victor Sanchez and Marilyn K. Wiggam, *Journal of Accountancy* 65 (April 1998)

New rules apply to the previously cumbersome process of requesting IRS approval for an accounting method change. CPAs should consider the planning opportunities now possible with their employers and clients.

WHAT YOU SHOULD KNOW ABOUT THE IRS APPEALS PROCESS by Donald P. Lan, Jr., 11 *Practical Tax Lawyer* (Spring 1997), 49-62.

Offers advice on issues to be considered in deciding whether to pursue a tax case at IRS Appeals. Discusses how to invoke the jurisdiction of Appeals; filing protests in Appeals; the Appellate conference; settlement with Appeals; and Appeals mediation.

A PRACTITIONERS' ROUNDTABLE ON THE TAXPAYER BILL OF RIGHTS 2 by Don Herskowitz, Jim Dougherty and Bruce K. Gribens, 28 *Tax Adviser* (July 1997), 426-31.

Discusses provision of the Taxpayer Bill of Rights 2 signed into law July 30, 1996; the creation of the Taxpayer Advocate; and taxpayer assistance orders;

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installment agreements; interest abatement; changes to collection practices; joint return liability; trust fund taxes.

CYBERSPACE TRANSACTIONS PRESENT INTERESTING INTERNATIONAL STATE AND LOCAL TAX ISSUES by Marc M. Levey, Thomas A. O'Donnell, and J. Pat Powers, 49 *Tax Executive* (Nov. - Dec. 1997), 476-86.

Explains state and international tax issues related to the sale of goods and services via the Internet. Considers characterization, sourcing, "permanent establishment" in an electronic environment, transfer pricing, and compliance issues. Also discusses state legislation on electronic commerce.

WHAT CAN AMERICA LEARN FROM THE BRITISH TAX SYSTEM? By William G. Gale, 50 *National Tax Journal* (Dec. 1997), 753-77.

Presents an overview of the U.K. tax system and compares and contrasts it with the U.S. system. Identifies areas in which the two corporate and income tax systems converge and diverge, and argues that the U.S. might take cues on simplification from the British system.

WOULD TAX EVASION AND TAX AVOIDANCE UNDERMINE A NATIONAL RETAIL SALES TAX? by Matthew N. Murray, 50 *National Tax Journal* (Mar. 1997), 167-82.

Argues that shifting to an indirect tax system (a national sales tax) will not necessarily reduce tax avoidance and tax evasion behavior by businesses and individuals, particularly if the tax rate is set high to maintain revenue neutrality. Lack of experience precludes a more definitive statement.

A COMPLETE GUIDE TO TAX-RELATED STATUTES OF LIMITATIONS by David Schmudde, 10 *Practical Tax Lawyer* (Spring 1996), 5-14.

Reviews tax statutes of limitations, their application, and exceptions. Discusses the effect of limitation periods; tolling; limitations periods on refunds, collection actions, and criminal offenses; mitigation; and limitations period for partnerships and S corporations.

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CHAPTER 1

FEDERAL INCOME TAXATION - AN OVERVIEW

2022 Edition	Topic	Status
Questions		
1	Adam Smith's system requirements	Unchanged
2	How well income tax and employment taxes meet Adam Smith's requirements	Unchanged
3	Proportional, regressive, or proportional tax	Unchanged
4	Proportional, regressive, or proportional tax	Unchanged
5	Federal income tax as a revenue producer	Unchanged
6	Collection of income taxes	Unchanged
7	Sales tax versus excise tax	Unchanged
8	Collection of sales and excise taxes	Unchanged
9	Real property versus personal property taxes	Unchanged
10	Gift tax	Unchanged
11	Estate tax	Unchanged
12	Valuation of gift and estate assets	Unchanged
13	Payment of gift and estate taxes	Unchanged
14	Primary sources of tax law	Unchanged
15	Supreme Court cases	Unchanged
16	Federal income tax base	Unchanged
17	Exclusion	Unchanged
18	Deferral versus exclusion	Unchanged
19	Gross income versus income	Unchanged
20	Deductibility of expenses	Unchanged
21	Expense versus loss	Unchanged

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2022 Edition	Topic	Status
22	Transaction loss versus annual loss	Unchanged
23	Legislative grace concept	Unchanged
24	Inflation effects on taxes	Unchanged
25	Pay-as-you-go collection of taxes	Unchanged
26	Tax credits	Unchanged
27	Tax credit versus deduction	Unchanged
28	Tax credit versus deduction	Unchanged
29	Statute of limitations	Unchanged
30	Auditing returns	Unchanged
31	IRS examinations	Unchanged
32	30-day letters	Unchanged
33	90-day letters	Unchanged
34	Individual versus corporate taxable income	Unchanged
35	Deductions for and from AGI	Unchanged
36	Standard deduction	Unchanged
37	Why study taxes?	Unchanged
38	Goal of tax planning	Unchanged
39	Tax planning-who benefits	Unchanged
Problems		
40	What is a tax?	Unchanged
41	Definition of a tax - five scenarios	Unchanged
42	Calculation of tax and tax rates (marginal, average, effective)	Unchanged
43	Calculation of tax - comparing entities	Unchanged

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2022 Edition	Topic	Status
44	Social Security calculation/tax rate (marginal, average, effective)	Unchanged
45	Progressive, proportional, regressive taxes	Unchanged
46-CT	Progressive, proportional, regressive taxes	Unchanged
47	Social Security tax calculation	Unchanged
48	Social Security tax calculation	Unchanged
49	Social Security tax calculation/payment by employer	Unchanged
50	Self-employment tax calculation	Unchanged
51	Social security/self-employment tax	Unchanged
52	Classification of income items	Unchanged
53	Classification of income items	Unchanged
54	What is deductible?	Unchanged
55	Classification of deduction items	Unchanged
56	Calculation of taxable income/tax liability	Unchanged
57	Calculation of taxable income/tax liability	Unchanged
58-COMM	Effect of deduction FOR/FROM adjusted gross income	Unchanged
59-COMM	Tax planning	Unchanged
60	Gift versus Income	Unchanged
61-CT	Tax planning	Date updates only
62	Tax planning	Date updates only
63	Tax planning	Date updates only
64-CT	Tax planning - income splitting	Unchanged

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2022 Edition	Topic	Status
65	Evasion versus avoidance	Date updates only
66	Evasion versus avoidance	Date updates only
67-IID	Prepaid taxes	Date updates only
68-IID	Student loan interest	Unchanged
69-IID	Gift versus sale of stock	Unchanged
70-IID	Income splitting	Unchanged
71	INTERNET	Unchanged
72	INTERNET	Unchanged
73	Research Problem	Unchanged
74	Research Problem	Unchanged
75	Spreadsheet Problem	Unchanged
76-DC-CT	Value-added Tax	Unchanged
77-DC-CT	How inflation adjustments preserve after tax income	Date updates only
78-TPC-COMM	Actions an owner can take to reduce taxes	Unchanged
79-EDC-CT	Statements on Standards for Tax Services (SSTS) to situations in problem 67	Unchanged

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CHAPTER 1

FEDERAL INCOME TAXATION - AN OVERVIEW

DISCUSSION QUESTIONS

1. Briefly state Adam Smith's four requirements for a good tax system.

   a. Equality - A tax should be imposed based on the taxpayer's ability to pay.

   b. Certainty - The taxpayer should be able to determine the amount of tax and how to make the required payment.

   c. Convenience - The tax should be levied as close as possible to the time the taxpayer receives the amount subject to tax.

   d. Economy - The cost of taxpayer compliance and administering the tax system should be small in relation to the revenue generated.

2. Based on the discussion in the chapter, evaluate how well each of these taxes meets Adam Smith's four requirements:

   a. Income tax

   Adam Smith's four criteria for evaluating a tax are Equality, Certainty, Convenience, and Economy. The aspects of the income tax that promote each of the individual criteria are:

   Equality - Progressive tax rates; the use of a standard deduction and exemption amounts have the effect of exempting low-income taxpayers from the tax; indexing of tax rates, and standard deduction and exemption amounts that are adjusted for inflation.

   Certainty - The use of an annual accounting period and the consistent use of the same tax return due date.

   Convenience - The use of a pay as you go system of collecting taxes is more convenient than collecting all taxes at one date. Taxpayers determine their own tax due in privacy.

   Economy - The cost of running the IRS is a small percentage of the total tax collected.

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Factors in the tax system that dilute Adam Smith's requirements:

Equality - Income exclusions and special deductions allow taxpayers with high incomes to pay taxes equivalent to those with lower incomes. The use of tax planning by higher income taxpayers also negates some of the equality of the system.

Certainty - The complexity of many of the tax law provisions and numerous changes in the tax law from year to year make an accurate calculation of tax liability less certain.

Convenience - Some would contend that determining the amount of tax to be withheld is difficult for many people, making the pay as you go system less convenient.

Economy - There are significant costs of record-keeping and compliance that are borne by the taxpayers, making the tax less economical.

b. Employment taxes

The aspects of employment taxes that promote compliance with each of the four requirements:

Certainty - The taxes are due as income is earned. Since total income to be earned by the employee is unknown during the year, the total tax will only be known once the year is complete.

Convenience - Taxes are collected by employers and paid by the employer to the government.

Economy - No annual reporting is required by the individual; however, the employer must incur the reporting costs. Costs of compliance are minimal.

Aspects that dilute the requirements:

Equality - The tax is not progressive; the tax consumes more of low-income taxpayer's income than a higher income taxpayer's income.

Economy - The cost of reporting is proportionately higher for smaller businesses.

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3. Based solely on the definitions in the chapter, is the Social Security tax a proportional, regressive, or progressive tax? Explain, and state how the tax might be viewed differently.

Strictly speaking, the Social Security tax is a proportional tax because it is applied at a constant rate (6.20 % up to $142,800 and 1.45% on all wages and salaries) to all levels of the tax base. Using the tax base, salaries and wages, the marginal cost is always equal to the average cost, which is indicative of a proportional tax.

When viewed as a percentage of the taxpayer's total income, the Social Security tax is a regressive tax. That is, if you compare marginal and average tax rates for taxpayers whose income is greater than the OASDI base amount, the marginal tax rate is 1.45% and the average tax rate decreases as income increases. Thus, higher income taxpayers (those whose income exceeds the base amount subject to tax) pay lower marginal and average rates of tax than those whose income does not exceed the base.

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4. Based solely on the definitions in the chapter, is the sales tax a proportional, regressive, or progressive tax? Explain and state how the tax might be viewed differently.

Strictly speaking, the sales tax is a proportional tax because it is applied at a constant rate to all levels of the tax base. Using the tax base, goods and services purchased, the marginal tax rate is always equal to the average tax rate, which is indicative of a proportional tax.

When another base is used to calculate marginal and average tax rates, the tax appears to be regressive. For example, if total economic income is used as the base, lower income taxpayers will spend a higher percentage of their income on items subject to the sales tax when compared to higher income taxpayers. Thus, the marginal tax rate will be less than the average tax rate, which is indicative of a regressive tax.

5. As stated in the text, the federal income tax is the largest revenue-producing tax in use in the United States. Why do you think the income tax produces more revenue than any other tax?

There are two main reasons why the income tax is the largest revenue producer. They evolve around the calculation of a tax as the TAX BASE x TAX RATE. First, the tax rates are generally higher than other most other taxes (10% to 37% versus say, a 7% sales tax). Second, the tax base, taxable income, is larger than most other bases. For example, most individuals' taxable income is greater than the amount they would spend on items subject to a sales or excise tax. Those taxes with higher rate schedules than the income tax (gift tax, estate tax) have relatively small tax bases. That is, not very many gifts and/or estates are subject to the tax in a given year.

6. How are federal, state, and local income taxes collected by the government? Consider the cases of an employee and a self-employed taxpayer.

Employers are required to withhold income taxes on the wages and salaries of their employees. Employers are then responsible for depositing the taxes withheld to the appropriate governmental unit. Self-employed taxpayers are required to estimate their taxes and make quarterly payments to the appropriate governmental unit.

7. How is a sales tax different from an excise tax?

Both are taxes on goods and/or services purchased. A sales tax is a percentage of the value of the sales price of the goods or services. It is paid when the goods and/or services are sold. An excise tax is based on either a quantity or volume of the product being sold, such as a gallon of gasoline or per tire. Although it is technically paid when the goods are sold, the excise tax is generally included in the sales price and is typically not shown separately as a tax.

8. Who is responsible for collecting sales and excise taxes? Who actually pays the tax?

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The seller of the goods and/or services subject to sales and excise taxes are responsible for the collection and payment of the tax. Sales taxes are paid directly by the purchaser as an addition to the sales price of the goods and/or services. The purchaser also pays excise taxes, but they generally are included in the price of the goods and, thus, are not shown as a separate payment by the buyer.

9. Why is a tax on real property used more often than a tax on personal property?

A tax on real property is more commonly used because real property is not mobile and is difficult to conceal. Thus, the tax base is more certain, and the collection of the tax is easier. Personal property is mobile and easily concealed. Thus, it is more difficult to ascertain the value of personal property owned, making the tax base uncertain and the collection of the tax potentially difficult.

10. The gift tax is supposed to tax the transfer of wealth from one taxpayer to another. However, the payment of gift tax on a transfer of property is relatively rare. Why is gift tax not paid on most gifts?

Gift tax payments are rare due to the exclusions from the tax. The basic exclusion is $15,000 per donee per year. This would allow a married couple to make tax-free gifts of up to $30,000 per donee per year. Gifts in excess of the annual exclusion can be tax-free if the donor elects to use part of the unified gift and estate tax credit. Under this credit, the equivalent of $11,700,000 of property transfers may be excluded from gift taxes.

11. The estate tax is a tax on the value of property transferred at death. Why is payment of the estate tax not a common event?

Although many people die every year, most pay little or no estate tax. This is due to two factors: the unlimited marital deduction for property passing to a spouse and the unified gift and estate tax credit. The marital deduction exempts from estate tax any property passing to the decedent's spouse. The unified gift and estate tax credit allows up to $11,700,000 (2021) of tax-free property transfers. Because the majority of people do not have estates exceeding the $11,700,000 tax-free limit, their estates are not taxed. Proper tax planning for larger estates should result in paying no tax on the death of the first spouse through use of the marital deduction.

12. What is the basis for valuing assets transferred by gift and at death?

Gift and estate taxes are based on the fair market value of the property at the date of the gift or at the date of death of the taxpayer.

13. Who is responsible for reporting and paying gift taxes? Estate taxes?

Gift taxes are assessed on the donor of the gift. It is the donor's obligation to properly report and pay taxes on gifts. Estate taxes are reported and paid by the executor of the estate. The person receiving the property has no obligation to pay either gift or estate taxes.

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14. Identify three primary sources of tax law.

    1. Legislative - The Internal Revenue Code of 1986.

    2. Administrative - The income tax regulations and other IRS documents.

    3. Judicial - Trial and appellate court decisions.

15. Explain why the following statement is not necessarily true: "If the IRS disagrees, I'll take my case all the way to the Supreme Court."

    This statement is false because the Supreme Court chooses the cases it will review. Thus, the court may deny the taxpayer a hearing of his case (a writ of certiorari). Generally, the Supreme Court only considers a few tax cases in a given year.

16. What is the federal income tax base?

    A tax base is the value that is subject to tax. The federal income tax base is a prescriptive net income amount called federal taxable income. The base is computed by reducing income from all sources by exclusions, deductions, and losses.

17. What is an exclusion?

    An exclusion is an increase in the taxpayer's wealth that Congress has determined should not be subject to tax or it is a recovery of the taxpayer's capital (i.e., investment in an asset).

18. How is a deferral different from an exclusion?

    An exclusion is income that is never subject to tax. A deferral is income that is not taxed in the current period but will be taxed in a future period. The future period tax may result from inclusion of the income through either lower depreciation/amortization deductions and/or by the inclusion of a larger gain than would have occurred without the deferral.

19. How does gross income differ from income?

    Income (broadly defined) includes both taxable and tax-exempt income. This definition of income is closer to an economist's definition of income than is gross income. Gross income is a more restrictive term. Gross income is income (broadly defined) less income not subject to tax (exclusions). Gross income items are the starting point for reporting on a tax return.

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20. What are the three basic tests that an expense must satisfy to be deductible?

1. The expense must be ordinary,

2. The expense must be necessary, and

3. The expense must be reasonable in amount.

21. What is the difference between an expense and a loss?

Expenses are the ordinary, necessary and reasonable expenditures incurred during a taxable year to earn income. Expenses are normally items that recur each year and whose usefulness does not extend substantially beyond the end of the current year.

A loss normally means that an asset has been disposed of (sold, abandoned, etc.) for a price that is less than its tax cost (basis). A loss generally results from a specific transaction as compared to expenses that are usually incurred throughout the year.

22. How is a transaction loss different from an annual loss?

A transaction loss results when an asset is sold or otherwise disposed of at a price less than its tax cost (basis). An annual loss results from an excess of total deductions over total income for the year. Thus, a transaction loss is the result of a single event, while an annual loss is the cumulative effect of events for an entire year.

23. How does the legislative grace concept help identify amounts that qualify for deduction?

According to the legislative grace concept, an expenditure is not deductible unless a specific provision of the tax law allows the item as a deduction. If an expenditure is identified as an allowable type of deduction by the tax law, it can be subtracted in the taxable income calculation.

24. Based on the example in Exhibit 1--2, explain how inflation can have two effects that result in a hidden tax.

The hidden tax from inflation can result from two effects:

1. As inflation increases the taxpayer's income, additional tax will be paid even though there is no change in the tax rates or increase in the taxpayer's real income, and

2. In some instances, the increase in income due to inflation may push the taxpayer into a higher marginal tax rate bracket. Thus, the taxpayer will be subject to a higher rate of tax without a corresponding change in real income. The problem of creeping into higher marginal tax brackets is partially cured by indexing the tax rates for inflation.

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25. Explain the pay-as-you-go system.

Income taxes are paid on income as close to the time it is received by the taxpayer as possible. This is accomplished through income tax withholding on wages and other types of income (e.g., gambling winnings) and through quarterly estimated tax payments on income that is not subject to withholding (e.g., self-employment income, investment income).

26. What is a tax credit?

A tax credit is an incentive put into the tax law by Congress to encourage taxpayers to enter into specific types of transactions or to provide relief from double taxation. A tax credit is treated like a prepayment of tax because it reduces the amount due by the full amount of the credit (dollar for dollar reduction in tax liability).

27. How is a tax credit different from a tax deduction?

A tax deduction results in a reduction of taxable income (the tax base). Therefore, the tax savings from a deduction are equal to the taxpayer's marginal tax rate multiplied by the amount of the deduction. In contrast, a tax credit is a direct dollar for dollar reduction in the tax liability. Therefore, one dollar of tax credit is worth more than one dollar of tax deduction.

28. If you were in the 24% marginal tax bracket and you could choose either a $1,000 tax credit or a $3,000 tax deduction, which would give you the most tax savings? Why?

The tax credit is a better choice in this case. The tax credit will reduce the tax due by $1,000 (i.e., tax credits directly reduce the amount of tax due). The tax deduction will reduce taxable income by $3,000, resulting in a reduction of the tax due of $720 ($3,000 x 24%). The tax credit gives a $280 ($1,000 - $720) tax advantage to a 24% marginal tax rate payer. The $1,000 tax credit is the equivalent of a $4,167 tax deduction ($1,000 ÷ 24%).

29. What is the statute of limitations, and what role does it play in the filing of tax returns?

The statute of limitations is the period of time that the IRS and/or the taxpayer has to correct an error on a return. The general statute of limitations period is three years from the due date of the return. This gives both the IRS and taxpayers time to correct errors on previously filed returns. If a taxpayer discovers an error in a previously filed return, the error is corrected by filing an amended return before the end of the statute of limitations. Thus, the statute of limitations provides an upper end on the amount of time that the taxpayer and the IRS have to correct a return.

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30. Briefly describe the types of programs used by the IRS to select a return for audit.

The two basic audit programs are the document perfection program and the information matching program. Document perfection involves checking all returns for mathematical, clerical, and tax calculation errors. Information matching uses documents filed by third parties that report various income items to verify that they were properly claimed on the taxpayer's return. These two types of programs do not generate audits per se; rather, taxpayers are notified when errors are found, and the tax is recalculated based on the errors.

Selection of returns for audit is done using either the Discriminant Function System (DIF) or through special audit programs. The DIF is a computerized return selection program that selects those returns with the highest probability of containing errors. This is done by comparing items on returns with pre-determined standards. The standards are developed based on the audit results of the Taxpayer Compliance Measurement Program (TCMP). The TCMP randomly selects returns from various income levels and each item on the return is comprehensively audited. Special audit programs are designed to select returns based on various parameters that the IRS believes may indicate that the returns are likely to contain errors. Factors that have been used in such audit programs are size of refund and the size of certain deductions in relation to income.

31. What are the three types of IRS examinations?

The three types of IRS examinations are correspondence examinations, office examinations, and field examinations. Correspondence examinations are done through the mail and usually involve requests for written documentation of various items on the tax return. Office examinations are conducted at local IRS offices and consist of a meeting between the taxpayer and an IRS representative to resolve factual issues regarding the taxpayers return. Field examinations are done at the taxpayer's place of business and can involve any item on the taxpayer's return. As such, they are the most in-depth type of examination.

32. What is included in the 30-day letter, and what options does the taxpayer have after receiving one?

A 30-day letter includes the revenue agent's report of the results of an IRS examination and a Form 870. If the taxpayer agrees with the results of the examination, the Form 870 is signed. A taxpayer who does not agree with the report may request a meeting with the IRS Appeals Division within 30 days of receiving the revenue agent’s report. The appeals division is the last opportunity for the IRS and the taxpayer to work out an agreement on the issues under examination.

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33. What does the 90-day letter represent, and what are the choices the taxpayer has after receiving one?

The 90-day letter is the formal statutory notice of deficiency that the IRS sends to taxpayers that are unable to reach agreement in the appeals division. After receiving the 90-day letter, taxpayers that do not wish to go to court can wait 90 days and have the IRS formally assess the deficiency and then pay the amount due. Taxpayers who want to litigate must file their litigation action within 90 days of the date of the letter.

34. How is the calculation of taxable income for an individual different from the calculation of a corporation's taxable income?

The main difference is in the classification of deductions. Because a corporation is deemed to be in a trade or business, all of its expense is deductible (i.e., a corporation does not engage in personal transactions and, therefore, does not incur nondeductible personal expenditures). Corporations are not allowed standard deduction amounts in the calculation of taxable income.

Deductions of individuals are limited. An individual's deductions must be classified as being either FOR or FROM adjusted gross income. Deductions FOR adjusted gross income are for business related expenses, rental and royalty expenses, self-employment taxes paid, and other specified expenses. Only certain personal expenditures are allowed as deductions. Many of these deductions are subject to a limit based on the taxpayer's adjusted gross income. Allowable personal expenditures are deductible FROM adjusted gross income. An individual has a choice of deducting actual allowable personal expenditures or taking a pre-determined amount as a deduction, called the standard deduction.

35. How do deductions for adjusted gross income and deductions from adjusted gross income of an individual differ?

Deductions for adjusted gross income are limited to those related to a trade or business, reimbursed employee expenses, rental and royalty expenses, alimony paid, one-half of self-employment tax paid, contributions to individual retirement accounts, and other specified expenses. Deductions for adjusted gross income are always deductible - there is no minimum allowable amount. In addition, they generally are not limited by the taxpayer's income.

Deductions from adjusted gross income are for certain personal expenditures (medical, interest, taxes, charitable contributions, personal casualty losses) and investment related expenses. Many of these deductions are subject to limitations based on the taxpayer's adjusted gross income. In addition, if the taxpayer's adjusted gross income exceeds a pre-specified amount, total itemized deductions are reduced. A minimum deduction from adjusted gross income is allowed to all taxpayers, called the standard deduction.

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36. What is the purpose of the standard deduction for individuals?

The purpose of the standard deduction is to ensure that all individuals get some minimum deduction for personal expenditures. The provision of the standard deduction also promotes administrative convenience because taxpayers who have very small amounts of the allowable personal deductions do not have to keep records necessary to substantiate deductions and fill out tax forms for very small deduction amounts. In addition, the government does not have to incur costs to audit standard deduction amounts.

37. Haru is studying finance at State University. To complete the finance major, he has to take a basic income tax course. Because Haru does not intend to be a tax expert, he considers the course a waste of his time. Explain to Haru how he can benefit from the tax course.

The student's answers may vary, but should contain some of the following points:

1. **When a person enters into an economic transaction there will usually be a related income tax effect.**
2. **Income taxes represent a major expenditure of time and money for most taxpayers. An understanding of basic tax concepts is necessary to avoid overpayment of taxes.**

   - **Tax planning helps conserve wealth.**
   - **The taxpayer has the primary responsibility for recognizing planning opportunities.**

3. **Daily business decisions have a tax effect. The taxpayer needs to be familiar with these tax effects to choose between alternative courses of action.**

4. **The taxpayer is responsible for complying with the tax law even when a tax adviser is hired to prepare returns. Thus, for self-protection, the taxpayer should understand basic tax concepts to be able to identify possible tax related situations.**

38. Evaluate the following statement: "The goal of good tax planning is to pay the minimum amount of tax."

This statement is partially correct. However, a better statement would be that "good tax planning maximizes the real after-tax return on income." To see why this is correct, consider the decision to recognize income in the current year or defer it to next year. If minimization of tax is the sole criteria, then the income is always deferred. However, deferral is not always the optimal choice. Determining the optimal choice requires the calculation of the real after-tax return from recognizing the income currently versus deferring it to the next year. This involves considering the relative marginal tax rates and the time-value of money.

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39. It has often been said that only the rich can benefit from professional tax planning. Based on the information presented in this chapter, why is this statement at least partially true?

To take advantage of the two main tax planning techniques - timing income and deductions and income splitting, taxpayers must have income and deductions that can be manipulated to achieve the best tax effect. Taxpayers whose main source of income is from wages and salaries have a very limited set of options available to them for reduction of their taxes. However, such taxpayers can still obtain a limited amount of benefit from tax planning by actions such as purchasing a home to secure an interest deduction (rather than paying non-deductible rent) and investing savings in tax-exempt securities. In addition, taxpayers with higher incomes have more incentive to spend the time, effort, and money necessary to engage in tax planning because the returns from this type of investment are higher (i.e., they are paying higher marginal tax rates). Therefore, each dollar reduction in taxable income is worth more to high income than to low-income taxpayers.

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PROBLEMS

40. State whether each of the following payments is a tax. Explain your answers.

a. To incorporate his business, Alex pays the state of Texas a $2,000 incorporation fee.

The incorporation fee is not a tax. Alex receives a direct benefit from the payment of the fee - the privilege of operating his business as a corporation

b. The city paves a road and assesses each property owner on the road $4,000 for his or her share of the cost.

The payment of the assessment is not a tax. The assessment is a property improvement. Only the owners of the property benefit from the assessment. The assessment is a charge to reimburse the county government for the cost of paving the road that provides a direct benefit to each owner's property. Such assessments are added to the basis of the property and are not allowed as a property tax deduction.

c. The city of Asheville charges each residence in the city $10 per month to pick up the trash.

The fee to collect the trash is not a tax. The $10 payment provides a specific benefit - the picking up of trash.

d. Rory pays $450 of income tax to the state of California.

State income taxes meet the definition of a tax. They are required to be paid by law and result from the state's legislative power to tax. State income taxes are general purpose revenues, and the payment of the tax does not provide any specific benefits, services, or privileges to the payor.

e. Lanny is fined $45 for exceeding the speed limit.

Fines are not taxes. They are penalties to discourage behavior and are not designed to produce revenues.

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41. Explain why each of the following payments does or does not meet the IRS definition of a tax:

a. Jack is a licensed beautician. He pays the state $45 each year to renew his license to practice as a beautician.

Not a tax. Jack receives a direct benefit from the payment of the licensing fee - he is allowed to practice as a beautician.

b. Polly Corporation pays state income taxes of $40,000 on its $500,000 of taxable income.

State income taxes are a tax under the IRS definition. The taxes are paid to a governmental authority, are paid pursuant to the state's power to tax, are used to provide revenue for the state, and no specific benefit is derived from paying the tax.

c. Winona pays $15 annually for a safety inspection of her automobile that is required by the state.

Safety inspection fees are not taxes. By paying the fee, Winona is allowed to drive her automobile - a specific benefit is received.

d. The Judd Partnership owns land that is valued by the county assessor at $30,000. Based on this valuation, the partnership pays county property taxes of $800.

Ad valorem property taxes meet the IRS definition of a tax. The taxes are paid to a governmental authority, are paid pursuant to the county's power to tax, are used to provide revenue for the county, and no specific benefit is derived from paying the tax.

e. Andrea fails to file her income tax return on time. She files the return late, and the IRS assesses her $25 for the late filing and $5 for interest on the tax due from the due date of the return until the filing date.

The late filing fee and interest charge are not taxes. They are penalties for failing to file a timely tax return. As such, they are used to discourage behavior, not produce revenue.

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42. Aliyah is single with a gross income of $120,000 and a taxable income of $98,000. In calculating taxable income, she properly excluded $10,000 of tax-exempt interest income. Using the tax rate schedules in the chapter, calculate Aliyah's

a. Total tax
b. Marginal tax rate.
c. Average tax rate
d. Effective tax rate

a. The total tax is $17,541
Tax computation: single taxpayer rate schedule for 2021:

Taxable Income	**$ 98,000**	
Tax on	**86,375**	**$14,751.00**
Excess	**$ 11,625**	
Taxed at Marginal Rate	**x 24%**	**2,790.00**
Total Tax		**$17,541.00**

b. The marginal tax rate is 24%.
The marginal tax rate is the rate of tax that would be paid on an additional dollar of income. At a taxable income of $98,000, a single taxpayer would be in the 24% marginal tax rate bracket (from the calculation above).

c. The average tax rate is 17.90%.
The average tax rate is the rate of tax paid on the total tax base; the total tax divided by taxable income. In this case, the total tax is $17,541 on a taxable income of $98,000, which gives an average tax rate of 17.90%:

17.90% = ($17,541 tax ÷ $98,000 taxable income)

d. The effective tax rate is 16.24%.
The effective tax rate is the rate of tax paid on all income (taxable and nontaxable). The total tax paid is divided by the taxpayer's economic income (taxable income + nontaxable income). In this case, Aliyah has $10,000 of tax-exempt income that increases her economic income to $108,000 ($98,000 taxable + $10,000 nontaxable). This results in an effective tax rate of 16.24%:

16.24% = ($17,541 tax ÷ $108,000 economic income)

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43. A taxpayer has $95,000 of taxable income for the current year. Determine the total tax, the marginal tax rate, and the average tax rate if the taxpayer is a

a. Single individual
b. Married couple
c. Corporation

a. The total tax is $16,821.00.
The marginal tax rate is 24%.
The average tax rate is 17.71%.

Total tax on $95,000 for a single individual: 2021 single rate schedule

Taxable Income	**$ 95,000**	
Tax on	**86,375**	**$ 14,751.00**
Excess	**$ 8,625**	
Taxed at Marginal tax rate	**x 24%**	**2,070.00**
Total Tax		**$ 16,821.00**

average tax rate = 17.71% = $16,821 tax ÷ $95,000 taxable income

b. The total tax is $12,397.00.
The marginal tax rate is 22%.
The average tax rate is 12.95%.

Total tax on $95,000 for a married couple: 2021 married, filing jointly rate schedule

Taxable Income	**$ 95,000**	
Tax on	**81,050**	**$ 9.328.00**
Excess	**$ 13,950**	
Taxed at Marginal tax rate	**x 22%**	**3,069.00**
Total Tax		**$ 12,397.00**

average tax rate = 13.05% = $12,397.00 tax ÷ $95,000 taxable income

c. Total tax on $95,000 for a corporation: 2021 corporate rate schedule

Taxable Income	**$ 95,000**	
Taxed at tax rate	**x 21%**	
Total Tax		**$19,950**

average tax rate = 21.00% = $19,950 tax ÷ $95,000 taxable income

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44. Rory earns $70,000 per year as a college professor. Latesia is a marketing executive with a salary of $140,000. With respect to FICA taxes, what are Rory's and Latesia's.

a. Total FICA taxes?

Rory's total FICA taxes: $5,355.00
Latesia's total FICA taxes: $10,710.00

Rory's salary is under the OASDI Social Security base limit. Therefore, he pays the combined 7.65% rate on his full salary, resulting in a tax of $5,355:

$70,000 x 7.65% = $5,355

Latesia's salary is under the OASDI Social Security base limit. Therefore, she pays the combined 7.65% rate on her full salary, resulting in a tax of $10,710:

$140,000 x 7.65% = $10,710

b. Marginal FICA tax rates?

Rory's marginal FICA tax rate: 7.65%
Latesia's marginal FICA tax rate: 7.65%

The marginal tax rate is the rate of tax that is paid on the next dollar of income subject to the tax. Because Rory is under the base amount, any subsequent income earned up to the $142,800 OASDI base amount is subject to tax at 7.65%. Therefore, his marginal tax rate is 7.65%.

Latesia is also under the base amount, any subsequent income earned up to the $142,800 OASDI base amount is subject to tax at 7.65%. Therefore, her marginal tax rate is 7.65%.

c. Average FICA tax rates?

Rory's average FICA tax rate is 7.65%.
Latesia's average FICA tax rate is 7.65%.

The average tax rate is the total tax divided by the tax base. Rory's average tax rate is 7.65% ($5,355 tax ÷ $70,000 tax base).

Latesia's average tax rate is 7.65% ($10,710 tax ÷ $140,000 tax base)

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d. Effective FICA tax rates?

Rory's effective tax rate: 7.65%
Latesia's effective tax rate: 7.65%

The effective tax rate is the total tax divided by the taxpayer's economic income (tax base + income not subject to the tax base). The effective tax rates based only on their salaries are:

Rory - 7.65% ($5,355 tax ÷ $ 70,000 salary)
Latesia - 7.65% ($10,710 tax ÷ $140,000 salary)

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45. For each of the following, explain whether the rate structure is progressive, proportional, or regressive:

a. Plymouth County imposes a 5% tax on all retail sales in the county. Taxpayers with incomes less than $12,000 receive a refund of the tax they pay.

Sales taxes are proportional as defined in the text. The average tax rate is equal to the marginal tax rate on all items subject to the tax. When evaluated using income as the tax base, sales taxes are generally regressive - low-income taxpayers spend a higher proportion of their income on goods subject to sales tax (their average tax rates are higher). The refund of the sales tax to taxpayers with lower incomes reduces the regressivity of the tax for those taxpayers.

b. The country of Zambonia imposes a 10% tax on the taxable income of all individuals.

The income tax is proportional. The average tax rate is equal to the marginal tax rate at all levels of taxable income. However, the tax becomes regressive if higher income taxpayers have a greater ability to lower their taxable income through exclusions and deductions. This lowers the effective rate of tax for high income taxpayers and induces regressivity into the tax structure.

c. Regan County imposes a property tax using the following schedule:

Assessed Value	Tax
$ -0- to $10,000	$ 40
$10,001 to $40,000	$ 40 + 1% of the value in excess of $10,000
$40,001 to $80,000	$ 340 + 2% of the value in excess of $40,000
$80,001 and above	$1,140 + 3% of the value in excess of $80,000

The property tax is progressive. The marginal tax rates are increasing (1%, 2%, 3%) through the rate structure and are higher than the average tax rate.

d. The city of Thomasville bases its dog licensing fee on the weight of the dog per the following schedule:

Weight (in pounds)	Tax Rate
0 to 40	$ 2 + 50% of weight
41 to 80	$22 + 40% of weight in excess of 40 lbs.
81 and above	$36 + 30% of weight in excess of 80 lbs.

The dog licensing fee is regressive - marginal tax rates are increasing as the tax base increases. The marginal tax rate is less than the average tax rate. For example, the tax on a 20-pound dog is $12 [2 + (50% x 20)]. The average rate is $.60, and the marginal rate is $.50. The tax on a 50-pound dog is $42 [$22 + (40% x 50)], an average rate of $.84 and a marginal rate of $.40. Average tax rates are increasing with levels of the tax base while marginal tax rates are decreasing.

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46. The country of Boodang is the leading producer of sausage. Boodang imposes three taxes on its residents and companies to encourage production of sausage and discourage its consumption. Each applies as follows:

- Income tax: Rates apply to each taxpayer's total income:

$ 0 - $ 50,000	5% of total income
$ 50,001 - $ 200,000	$ 2,500 + 10% of income in excess of $50,000
$200,001 - $ 500,000	$17,500 + 20% of income in excess of $200,000
$500,001 or more	40% of total income

  In calculating total income, sausage workers are allowed to deduct 25% of their salaries. Companies that produce sausage are allowed to deduct 50% of their sales. No other deductions are allowed.

- Sausage tax: All sausage purchases are subject to a 100% of purchase price tax. Residents who consume less than 10 pounds of sausage per year are given a 50% rebate of the sausage tax they paid.

- Property tax: Taxes are based on the distance of a taxpayer's residence from state-owned sausage shops per the following schedule:

0 - 2 miles	$ 15,000 per mile
2 miles - 5 miles	$ 5,000 per mile
5 miles or more	$ 2,000 per mile

  Given the definitions in the chapter, are Boodang's taxes progressive, proportional, or regressive? Evaluate and discuss each tax and the aspect(s) of the tax that you considered in making your evaluation.

  ***Income tax*: The rate schedule is progressive - the marginal tax rate is greater than the average tax rate at all levels. However, the overall tax may be viewed as being regressive due to the deductions allowed to sausage workers and their employers. Because these deductions lower these entities tax base versus non-sausage related entities, their marginal and average tax rates will be lower than comparably paid workers and companies with similar revenues in other businesses.**

  ***Sausage tax:* By definition, the tax rate is proportional - the same tax is paid at all levels of purchases, making the marginal tax rate equal to the average tax rate. The allowance of a credit for small sausage purchasers adds an element of progressivity to the tax. That is, individuals who purchase less than 10 pounds of sausage will have a lower marginal and average tax rate than those who purchase 10 pounds or more. Thus, as the tax base (sausage purchases) increases to 10 pounds, the marginal and average tax rates increase. However, the tax remains proportional for all taxpayers whose purchases are less than 10 pounds, as it does for all taxpayers whose purchases equal or exceed 10 pounds.**

  ***Property tax:* The rate schedule is regressive - as the tax base (miles from a sausage shop) increases, the marginal and average tax rates increase. However, there is an element of proportionality to the tax because it is not cumulative through the base. That is, a different per mile tax is levied at each base level, but the per mile tax does not accumulate as you move through the base. Thus, the marginal and average tax rates are equal through each level - a characteristic of a proportional tax.**

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47. Joe Bob is an employee of Rollo Corporation who receives a salary of $14,000 per month. How much Social Security tax will be withheld from Joe Bob's salary in

a. March?

Joe Bob's salary is under the OASDI Social Security base amount and his entire salary in March will be subject to the 7.65% Social Security tax. Therefore, he will pay $1,071 ($14,000 x 7.65%) of Social Security tax in March.

b. November?

By November, Joe Bob will have earned $140,000 ($14,000 x 10 months) which is $2,800 under the OASDI Social Security base limit of $142,800. Therefore, he will only pay the full 7.65% tax on $2,800 ($142,800 - $140,00) and will pay the 1.45% MHI component on the remaining $11,200 in November, resulting in a tax of $376.60 [($2,800 x 7.65%) + (11,200 x 1.45%)].

48. Return to the facts of problem 47. Assume that each month, Joe Bob has $2,800 in federal income tax and $900 of state income tax withheld from his salary. What is Joe Bob's take-home pay in

a. March?

Joe Bob's gross salary will be reduced by amounts withheld for federal, state, and local taxes. His March take home pay will be $9,229 ($14,000 - $2,800 - $900 - $1,071).

b. November?

Joe Bob's take home pay is $9,923.40 ($14,000 - $2,800 - $900 - $376.60) and reflects the lower amount of Social Security withheld due to exceeding the OASDI base amount.

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49. Gosney Corporation has 2 employees. During the current year, Clinton earns $80,000 and Trahn earns $150,000. How much Social Security tax does Gosney have to pay on the salaries earned by Clinton and Trahn?

Total Social Security tax paid is $17,148.60.

Gosney must match each employee's Social Security tax payment. The OASDI portion of the Social Security tax is 6.2% of wages and salaries up to a maximum of $142,800 in 2021. The MHI portion of the tax is 1.45% of all wages and salaries. Clinton is under the OASDI base and pays 7.65% of his entire salary, $6,120 ($80,000 x 7.65%). Trahn is over the OASDI base and will pay the maximum OASDI and 1.45% on her entire salary, $11,028.60 [($142,800 x 6.2%) + ($150,000 x 1.45%)]. Gosney Corporation must match Clinton and Trahn's payments, a total of $17,148.60.

Clinton-	**$ 80,000 x 7.65% =**		**$ 6,120.00**
Trahn -	**$142,800 x 6.20% =**	**$ 8,853.60**	
	$150,000 x 1.45% =	**2,175.00**	**$11,028.60**
Total Social Security Tax to be Matched			**$17,148.60**

50. Eric is a self-employed financial consultant. During the current year, Eric's net self-employment income is $160,000. What is Eric's self-employment tax?

Eric's self-employment tax is $22,347.20.

As a self-employed taxpayer, Eric is required to pay the equivalent of the employee and the employer's Social Security contribution as a self-employment tax. Eric's self-employment income exceeds the OASDI base amount. Therefore, his self-employment tax is calculated as follows:

OASDI portion of tax:	**$142,800 x (6.20% x 2)=**	**$ 17,707.20**	
MHI portion of tax:	**$160,000 x (1.45% x 2)**	**=**	**4,640.00**
Total self-employment tax			**$ 22,347.20**

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51. Darrell is an employee of Whitney's. During the current year, Darrell's salary is $136,000. Whitney's net self-employment income is also $136,000. Calculate the Social Security and self-employment taxes paid by Darrell and Whitney. Write a letter to Whitney in which you state how much she will pay in Social Security and self-employment taxes and why she owes these amounts.

Darrell's Social Security taxes are $10,404.
Whitney's self-employment taxes are $20,808.

Employees must pay (and the employer must match) the Social Security tax. In 2021, the OASDI portion of the tax is 6.2% on a maximum of $142,800 of wages and salaries. The 1.45% MHI portion of the tax is paid on all wages and salaries. Because Darrell's income is less than the OASDI base, he will pay 6.2% OASDI and 1.45% MHI on all his income, resulting in a tax of $10,404:

OASDI - $136,000 x 6.20%	**$ 8,432**
MHI - $136,000 x 1.45%	**1,972**
Total Social Security tax	**$10,404**

Whitney must match Darrell's payment, resulting in a total Social Security tax paid on Darrell's salary of $20,808 ($10,404 x 2).

Self-employed taxpayers must pay both the employee and employer's share of the tax in computing the self-employment tax. Whitney will pay $20,808 of self-employment tax on her self-employment income:

OASDI - $136,000 x (6.2% x 2)	**$ 16,864**
MHI - $136,000 x (1.45% x 2)	**3,944**
Total self-employment tax	**$ 20,808**

Thus, the total amount of tax paid is the same. The difference between the two taxes is who pays the tax. Employees pay only half of the tax, while self-employed taxpayers must pay the entire tax. Whitney's total liability of $31,212 is comprised of the employer portion of her employee's (Darrell) earnings ($10,404) plus her FICA contribution ($20,808).

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52. Classify the following items as ordinary income, a gain, or an exclusion:

a. The gross revenues of $160,000 and deductible expenses of $65,000 of an individual's consulting business

Income from a business is ordinary income. In this case, the individual has $95,000 ($160,000 - $65,000) of ordinary income.

b. Interest received on a checking account

Interest received on a checking account is ordinary income.

c. Sale for $8,000 of Kummel Corporation stock that cost $3,000

The sale of the stock produces a $5,000 ($8,000 - $3,000) gain.

d. Receipt of $1,000 as a graduation present from grandfather

The $1,000 graduation present is a gift. Because gifts are subject to a separate tax on gifts (i.e., the gift tax), the value of a gift is excluded from the income tax.

e. Royalty income from an interest in a gold mine

Royalty income is ordinary income.

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53. Classify the following items as ordinary income, a gain, or an exclusion:

a. The salary received by an employee

Salaries received by employees are ordinary income.

b. Dividends of $400 received on 100 shares of corporate stock

Dividends on stock are ordinary income.

c. Sale for $10,000 of an antique chair that cost $3,500

The sale of the chair results in a gain of $6,500 ($10,000 - $3,500).

d. Rental income from an apartment building

Rental income is ordinary income.

e. Receipt of an automobile worth $20,000 as an inheritance from Aunt Ruby's estate

The value of property received by inheritance is excluded from gross income.

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54. Explain why each of the following expenditures is or is not deductible:

To be deductible, an expenditure (or loss) must be related to a trade or business or incurred in a production of income (investment) activity. Only specifically authorized personal expenditures (or losses) are deductible.

a. Lumbar, Inc., pays $12,000 as its share of its employees' Social Security tax. The $12,000 is deductible.

The employee's Social Security tax is part of Lumbar's salary expense. The salaries are related to Lumbar's business and are therefore deductible.

b. Luis pays a cleaning service $250 per month to clean his real estate office. The $250 is deductible.

The cleaning costs relate to Luis' business and are deductible.

c. Janice pays a cleaning service $75 per month to clean her personal residence. The $75 is not deductible.

The residence is a personal use asset. The cleaning costs related to a personal use asset are not deductible.

d. Leyh Corporation purchases land to use as a parking lot for $35,000. The $35,000 is not deductible.

The land purchase is a capital expenditure. Capital expenditures cannot be deducted in the year of purchase.

e. Martin spends $50 per month on gasoline for the car he uses to drive to his job as a disc jockey. The $50 is not deductible.

Commuting is a personal expense. Therefore, the cost of commuting does not relate to a business or investment activity and cannot be deducted.

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55. Classify each of the following transactions as a deductible expense, a nondeductible expense, or a loss:

a. Nira sells for $4,300 stock that cost $6,000.

The sale of stock costing $6,000 for $4,300 results in a loss of $1,700 ($4,300 - $6,000).

b. Chiro Medical, Inc., pays $2,200 for subscriptions to popular magazines that it places in its waiting room.

Because the magazines are provided to its customers, the subscriptions have a business purpose and are a deductible expense.

c. Lawrence pays $200 for subscriptions to fly-fishing magazines.

Assuming that Lawrence is not in the fly-fishing business, the use of the magazines is personal and therefore, nondeductible.

d. The Mendota Partnership pays $200,000 to install an elevator in one of its rental properties.

The installation of the elevator has a business purpose. However, because the usefulness of the elevator extends substantially beyond the end of the current year, it cannot be deducted in total as a business expense in the year of the expenditure. The $200,000 cost must be capitalized and deducted through depreciation over its tax life.

e. Sterling Corporation pays $6,000 for lawn maintenance at its headquarters.

The lawn maintenance relates to a business and therefore, it is a deductible business expense.

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56. Based on the following information, what are the taxable income and the tax liability for a single individual?

Total income	$118,000
Excludable income	2,000
Deductions for adjusted gross income	2,500
Deductions from adjusted gross income	8,000

Taxable income is $100,950. Tax Liability is $18,249.

The taxable income for a single individual is $100,950 in 2021:

Total Income		**$118,000**
Excluded Income		**(2,000)**
Gross Income		**$116,000**
Deductions for Adjusted Gross Income		**(2,500)**
Adjusted Gross Income		**$113,500**
Deductions from Adjusted Gross Income		
the Greater of:		
Itemized Deductions	**$ 8,000**	
or		
Standard Deduction	**$12,550**	**(12,550)**
Taxable Income		**$100,950**

The tax on $100,950 in 2021 for a single individual is $18,249:

Taxable Income	**$100,950**	
Tax on	**(86,375)**	**$ 14,751.00**
Tax on excess	**$ 14,575 x 24%**	**3,498.00**
Total tax		**$ 18,249.00**

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57. Based on the facts of problem 56, for a couple filing jointly, determine their adjusted gross income, taxable income and tax liability.

Taxable income is $88,400. Tax Liability is $10,945.

The taxable income for a married couple is $88,400 in 2021:

Total Income		**$118,000**
Excluded Income		**(2,000)**
Gross Income		**$116,000**
Deductions for Adjusted Gross Income		**(2,500)**
Adjusted Gross Income		**$113,500**
the Greater of:		
Itemized Deductions	**$ 8,000**	
or		
Standard Deduction	**$25,100**	**(25,100)**
Taxable Income		**$ 88,400**

The tax on $88,400 in 2021 for a married couple is $10,945.00:

Taxable Income	**$ 88,400**		
Tax on	**(81,050)**		**$9,328.00**
Tax on excess	**$ 7,350**	**x 22%**	**1,617.00**
Total tax			**$10,945.00**

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58. Jasmine's 2021 income tax calculation is as follows:

Gross income	$ 120,000
Deductions for adjusted gross income	(3,000)
Adjusted gross income	$ 117,000
Deductions from adjusted gross income:	
Standard deduction	(12,400)
(Total itemized deductions are $2,300)	
Taxable income	$ 104,600

Before filing her return, Jasmine finds an $8,000 deduction that she omitted from these calculations. Although the item is clearly deductible, she is unsure whether she should deduct it for or from adjusted gross income. Jasmine doesn't think it matters where she deducts the item, because her taxable income will decrease by $8,000 regardless of how the item is deducted. Is Jasmine correct? Calculate her taxable income both ways. Write a letter to Jasmine explaining any difference in her taxable income arising from whether the $8,000 is deducted for or from adjusted gross income.

Instructor's Note: In the given information, the 2021 standard deduction should be $12,550 resulting in taxable income of $104,450. The solution given below uses the correct 2021 standard deduction.

Because Jasmine does not currently itemize her deductions, if the item is deductible from adjusted gross income, the $8,000 deduction will be "lost" because her total itemized deductions would now be $10,300 which is still less than her $12,550 standard deduction amount. Her taxable income would not change if the item is deductible from AGI. Because there is no minimum amount deductible for AGI, the entire $8,000 deduction will reduce taxable income if the deduction is for AGI. Note: If Jasmine had already been itemizing (i.e., her itemized deductions had exceeded $12,550), both deductions would have lowered her taxable income by $8,000.

	Deduction For AGI	Deduction From AGI
Gross income	**$ 120,000**	**$ 120,000**
Deductions for AGI - $3,000 + $8,000	**(11,000)**	**(3,000)**
Adjusted gross income	**$ 109,000**	**$ 117,000**
Deduction from AGI		
Greater of:		
Standard deduction or	**(12,550)**	**(12,550)**
Itemized deductions -		
Taxable income	**$ 96,450**	**$ 104,450**

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59. Since graduating from college, Mabel has used the firm of R&P to prepare her tax returns. Each January, Mabel receives a summary information sheet, which she fills out and sends to R&P along with the appropriate documentation. Because she has always received a refund, Mabel feels that R&P is giving her good tax advice. Write a letter to Mabel explaining why she may not be getting good tax advice from R&P.

Obtaining a refund does not mean that the taxpayer is obtaining good tax planning advice - it simply means that the taxpayer has prepaid, through withholding and estimated tax payments, more than the actual tax liability. Good tax planning focuses on minimizing the tax liability on the income generated. In fact, having a refund due means that the taxpayer has given the government an interest-free loan for the tax year. Better tax planning would result in the taxpayer actually paying a small amount of tax (generally less than $1,000 to avoid any penalty for underpayment of estimated taxes), thus receiving an interest-free loan from the government.

60. Michiko and Saul are planning to attend the same university next year. The university estimates tuition, books, fees, and living costs to be $12,000 per year. Michiko's father has agreed to give her the $12,000 she needs to attend the university. Saul has obtained a job at the university that will pay him $14,000 per year. After discussing their respective arrangements, Michiko figures that Saul will be better off than she will. What, if anything, is wrong with Michiko's thinking?

Because the $12,000 she receives from her father is a gift, Michiko will not have to pay tax on the $12,000. Therefore, the entire $12,000 she receives is available for her to spend. In contrast, the $14,000 Saul receives from his job is subject to both the income and Social Security tax, reducing the amount he has to spend. Assuming that Saul has no other sources of income and that he uses the standard deduction, his income tax will be $160, and he will pay $1,071 ($14,000 x 7.65%) in Social Security tax. This will leave him with only $12,784 ($14,000 - $145 - $1,071). Therefore, Saul is only marginally better off than Michiko under the circumstances.

Income Tax Calculation:	
Adjusted Gross Income (equal to gross income)	**$ 14,000**
Standard Deduction	**(12,550)**
Taxable Income	**$ 1,450**
Tax on $1,450 - ($1,450 x 10%)	**$145**

Note: Saul would most likely have to pay state income taxes on his salary, further reducing the amount he has to spend.

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61. Inga, an attorney, completed a job for a client in November 2021. If she bills the client immediately, she will receive her $10,000 fee before the end of the year. By delaying the billing for a month, she will not receive the $10,000 until 2022. What factors should Inga consider in deciding whether she should delay sending the bill to the client?

Inga should determine the tax cost of reporting the fee income in 2021 compared to the present value of the tax cost of reporting the income in 2022. Thus, she needs to know the:

- **2021 Marginal tax rate,**
- **2022 Marginal tax rate, and**
- **The rate of interest (time value of money factor) on investing the deferred tax from 2021 to 2022.**

For example, assume that Inga's 2021 marginal tax rate is 22%, she expects to be in the 32% tax rate bracket in 2022, and the time value of money is 7%. In general, income should be deferred (time value of money factor) and placed in the year with the lowest marginal tax rate (marginal tax rate factor). In this case, the two general rules conflict and Inga must calculate the present value of the tax for each year:

	2021	2022
Tax paid	$ 2,200	$ 3,200
Present value factor	1.000	x .935
Present value of tax payment	$ 2,200	$ 2,992

In this case, the marginal tax rate effect (put the income in the year with the lowest marginal tax rate) is greater than the present value effect (postpone the recognition of income) resulting in a real tax savings of $792. By billing the fee now and receiving it in 2021, Inga will minimize her tax liability.

62. Art is in the 24% marginal tax bracket for 2021. He owes a $10,000 bill for business expenses. Since he reports taxable income on a cash basis, he can deduct the $10,000 in either 2021 or 2022, depending on when he makes the payment. He can pay the bill at any time before January 31, 2022, without incurring the normal 8% interest charge. If he expects to be in a 32% marginal tax bracket for 2022, should he pay the bill and claim the deduction in 2021 or 2022?

Art should pay the expense and claim the deduction in 2022. In this case, the marginal tax rate effect (put the deduction in the year with the highest marginal tax rate) is greater than the present value effect (take the deduction as soon as possible) resulting in a real tax savings of $563 by deducting the expense in 2021:

	Real Tax Savings	
Claim deduction in 2021	$ 10,000	
Tax savings at marginal rate	x 24%	$ 2,400
Claim deduction in 2022	$ 10,000	
Tax savings at marginal rate	x 32%	
Tax savings	$ 3,200	
Present value factor	x .926	2,963
Net real savings from 2022 deduction		$ 563

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63. Elki would like to invest $50,000 in tax-exempt securities. He now has the money invested in a certificate of deposit that pays 5.75% annually. What rate of interest would the tax-exempt security have to pay to result in a greater return on Elki's investment than the certificate of deposit? Work the problem assuming that Elki's marginal tax rate is 12%, 22%, 24%, and 32%.

The equivalent tax-exempt rate is determined by mathematically equating the after-tax rate of a tax-exempt security (TES) with that of a taxable security (TS). The tax paid on the taxable security is paid at the marginal tax rate (MTR).

TES RATE = TS - Tax Paid = TS - TS x (MTR) = TS x (1 - MTR)

This gives the following tax-exempt equivalent rates for a 5.75% taxable rate:

Equivalent Tax-Exempt Rate		Taxable Rate		(1 - MTR)
5.06%	=	5.75%	x	(1 - 12.0%)
4.485%	=	5.75%	x	(1 - 22.0%)
4.37%	=	5.75%	x	(1 - 24.0%)
3.91%	=	5.75%	x	(1 - 32.0%)

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64. Leroy and Amanda are married and have 3 dependent children. During the current year, they have the following income and expenses:

Salaries	$120,000
Interest income	45,000
Royalty income	27,000
Deductions for AGI	3,000
Deductions from AGI	9,000

a. What is Leroy and Amanda's current year AGA taxable income and income tax liability? Do not consider any tax credits.

Leroy and Amanda's 2021 taxable income is $163,900 and their 2021 tax liability is $27,555*:

Gross income		
Salaries	**$120,000**	
Interest income	**45,000**	
Dividend income	**27,000**	**$ 192,000**
Deductions for AGI		**(3,000)**
Adjusted gross income		**$ 189,000**
Deductions from AGI		
The greater of:		
Standard deduction	**$25,100**	
or		
Itemized deductions	**$ 9,000**	**(25,100)**
Taxable income		**$ 163,900**
Tax on $163,900:		
$9,328 + [22% x ($163,900 - $81,050)]		**$ 27,555**

*** Leroy and Amanda are eligible for the child tax credit if their children are all under age 17. This credit and others are discussed in Chapter 8.**

b. Leroy and Amanda would like to lower their income tax. How much income tax will they save if they legally shift $5,000 of income to each of their children? Assume that the children have no other income and that their income tax rate is 10%.

Leroy and Amanda's taxable income will decrease to $148,900 ($163,900 - $15,000) and their tax liability will be $24,255 {$9,328 + [22% x ($148,900 - $81,050)]}, a $3,300 reduction. Each child's taxable income will be $3,900 ($5,000 - $1,100 standard deduction) and the tax will be $390 ($3,900 x 10%) per child, a total tax of $1,170. Leroy and Amanda will save $2,130 [$27,555 - $25,425 ($24,255 + $1,170)] if they legally shift $5,000 of income to each child.

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65. For each of the following situations, state whether the taxpayer's action is tax evasion or tax avoidance:

a. Tom knows that farm rent received in cash or farm produce is income subject to tax. To avoid showing a cash receipt on his records, he rented 50 acres for his choice of 5 steers to be raised by the tenant. He used 2 of the steers for food for his family and gave 3 to relatives. Because he did not sell the livestock, he did not report taxable income.

Tom's actions would probably be considered tax evasion. Tom knew that farm produce (5 steers) received as rent is income, but he took steps to conceal and not report the income. As a result, he underpaid his income tax.

b. Betty applied for and received a Social Security number for Kate, her pet cat. Surprised by how easy it was to get a Social Security number, she decided to claim a dependent exemption on her tax return for Kate. Other than being a cat, Kate met all the tests for a dependent.

Betty's actions would probably be considered tax evasion. Claiming fictitious dependent deductions is an act often associated with tax protesters. The tax law allows the exemption deduction only for a qualified "individual" which does not include Kate. Betty intentionally claimed a deduction for an amount she knew was not deductible. As a result, Betty underpaid her tax.

c. Glen has put money in savings accounts in 50 banks. He knows a bank is not required to report to the IRS interest it pays him that totals less than $10. Because the banks do not report the payments to the IRS, Glen does not show the interest he receives as taxable income. Although Glen's accountant has told him all interest he receives is taxable, Glen insists that the IRS will never know the difference.

Glen's actions would probably be considered tax evasion. All income that is not specifically excluded must be reported as income regardless of the amount. Glen had reason to know the interest income was taxable, he took steps to conceal the income and to omit it from his tax return. As a result, Glen underpaid his tax.

d. Bob entered a contract to sell a parcel of land at a $25,000 gain in 2020. To avoid reporting the gain in 2020, he closed the sale and delivered title to the land to the buyers on January 2, 2022.

Bob's actions are considered tax avoidance and are an acceptable method of planning the timing of income reporting. A sale of land occurs when title passes to the buyer. Bob properly reported the gain in 2022.

e. Asha's taxable income for 2021 puts her in the 32% marginal tax bracket. She has decided to purchase new equipment for her business during 2022. A special election allows Asha to treat the $25,000 of the cost of the equipment as a current period expense. Because she expects to be in a lower tax bracket next year, Asha buys and begins using $25,000 worth of the equipment during December 2021. She claims a $25,000 expense deduction under the special election for 2021.

Asha's actions would be considered tax avoidance. The $25,000 expense election is available for property placed in service in a trade or business during

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the year. Asha's decision to purchase the equipment in 2021 to accelerate the tax deduction is an acceptable tax planning technique.

66. In each of the following situations, explain why the taxpayer's action is or is not tax evasion:

a. Jamal owns an electrical appliance repair service. When a client pays him in cash, he gives the cash to his daughter, Tasha. Jamal does not report the cash he gives to Tasha in his business income. Tasha has no other income, and the amount of cash that she receives from Jamal is small enough that she is not required to file a tax return.

Jamal is engaged in tax evasion. Through his direction of the cash to his daughter, he has willfully caused an underpayment of his tax.

b. Roberta and Dudley are married. Roberta usually prepares their tax return. However, she was in the hospital and unable to prepare the return for 2020, so Dudley did it. In preparing their 2021 return, Roberta notices that Dudley included $1,000 of tax-exempt municipal bond interest in their 2020 gross income. To correct this mistake, Roberta takes a $1,000 deduction on the 2021 return.

This would not constitute tax evasion. Roberta is not making an affirmative action to evade taxation. She has incorrectly taken the deduction in the wrong year. She should file an amended return for 2020 and correct the mistake. Honest mistakes do not constitute tax evasion.

c. In 2021, Hearthome Corporation receives notice that the IRS is auditing its 2019 return. In preparing for the audit, Hearthome's controller, Monique, finds a mistake in the total for the 2019 depreciation schedule that resulted in a $5,000 overstatement of depreciation expense.

This would not constitute tax evasion. Mistakes can be made in totaling schedules and making other calculations. Hearthome has not made an affirmative action to evade taxation. It should file an amended return for 2019 and correct the depreciation error.

d. While preparing his tax return, Will becomes unsure of the treatment of a deduction item. He researches the issue and can find no concrete tax law authority pertaining to the particular item. Will calls up his buddy Dan, an accounting professor, for advice. Dan tells Will that if the law is unclear, he should treat the deduction in the most advantageous manner. Accordingly, Will deducts the full amount of the item, rather than capitalizing and amortizing it over 5 years.

When the tax law is unclear on the treatment of an item, treating the item to the taxpayer's advantage is not tax evasion. Will's act is intentional, but it is done to avoid tax rather than evade tax.

e. Sonja is a free-lance book editor. Most companies for which she works pay her by check. In working out the terms of a job, a new client agrees to pay her by giving her a new computer valued at $3,600. In preparing her tax return, Sonja notes that the client failed to report to the IRS the value of the computer as income for Sonja. Knowing that her chances of getting caught were small, Sonja does not include the $3,600 value of the computer in her gross income.

Sonja has engaged in tax evasion. She has willfully acted to cause an underpayment of tax. Playing the "audit lottery" is not tax avoidance, it is tax evasion.

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ISSUE IDENTIFICATION PROBLEMS

In each of the following problems, identify the tax issue(s) posed by the facts presented. Determine the possible tax consequences of each issue that you identify.

67. Marla had $2,100 in state income taxes withheld from her 2021 salary. When she files her 2021 state income tax return, her actual state tax liability is $2,300.

The issue is how much tax Marla owes for 2021. Because she has prepaid $2,100 through withholding, she only pays $200 ($2,100 - $2,300) with her 2021 tax return.

68. While reading a State College alumni newsletter, Linh is surprised to learn that interest paid on student loans is deductible. Linh graduated from college 2 years ago and paid $1,200 in interest during the current year on loans that he took out to pay his college tuition.

The issue is whether Linh qualifies for the interest deduction. Although student loan interest is deductible, there are limitations on the amount of interest that can be deducted. The requirements for deducting qualified student loan interest are discussed in Chapter 6.

69. Victoria's son needs $5,000 for tuition at the Motown School of Dance. Victoria, who is in the 32% marginal tax rate bracket, intends to pay the tuition by selling stock worth $5,000 that she paid $2,000 for several years ago.

The issue is whether Victoria should sell the stock or gift it to her son. Gifts are not taxable to either the donor or the donee. The sale of the stock will produce a $3,000 capital gain. If the stock has been held for more than one year, Victoria will pay a $450 ($3,000 x 15%) tax on the gain. Because her son is a student, his marginal income tax rate is likely lower than Victoria's. If his marginal tax rate is either 10% or 12%, then he will pay no tax on the gain (the capital gain rate for taxpayers in the 10% and 12% brackets is zero).

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70. Joey and Camilla are married and have three children, ages 8, 16, and 18. They own a commercial cleaning business that is organized as a sole proprietorship and makes $140,000 annually. They have $30,000 of other taxable income (net of allowable deductions).

The issue is what Joey and Camilla can do to decrease their tax liability. One option is to incorporate their cleaning business. This analysis will be done in a later chapter.

Another tax savings opportunity would be to employ their 16- and 18-year children in the business. Each child could earn up to $12,550 (standard deduction amount) tax-free. This would reduce the taxable income of either the sole proprietorship or the corporation, resulting in tax savings at either the parent's 24% marginal tax rate (if they continue to use the sole proprietorship) or the corporation's 21% marginal tax rate. Any income the children receive above $12,550 would be taxed at 10%, resulting in additional tax savings.

71. **COMMUNICATION SKILLS**. Audrey opened Hardy Consulting Services during the current year. She has one employee, Deng, who is paid a salary of $30,000. Audrey is confused about the amount of federal unemployment tax she is required to pay on Deng's salary. The state unemployment tax rate is 4%. Audrey has asked you to determine how much federal unemployment tax she is required to pay on Deng's salary. Write Audrey a letter explaining the amount of federal unemployment tax she must pay.

Sec. 3301 states that the FUTA rate is 6.2%. Sec. 3306(b)(1) limits the maximum amount of wages subject to the FUTA tax to $7,000. This sets the tax on Deng's salary at a maximum of $434 ($7,000 x 6.2%).

Sec. 3302(a)(1) provides credits against the tax for contributions paid into state unemployment compensation funds. Section 3302(c)(2) limits the maximum credit rate to 90% of 6% (as specified in Sec. 3302(d), or 5.4%). However, if the amounts are not paid into the state unemployment fund by the due date of the federal return, Sec. 3302(a)(3) limits the credit to 90% of the amount that would have been allowable had the amounts been paid on or before the due date of the return.

Assuming that Audrey pays the state unemployment tax before the due date of her federal return, she will receive a credit of 4% on $7,000 in salary paid to Deng. Therefore, her federal unemployment tax will be $154 [$7,000 x (6.2% - 4%)].

72. **COMMUNICATION SKILLS** Shawna earns $95,000 as a biologist for Berto Corporation. She also consults with other businesses on compliance with environmental regulations. During the current year, she earns $50,000 in consulting fees. Determine the amount of self-employment tax Shawna owes on her consulting income.

Her self-employment tax = $7,064.78.

The question to be resolved is whether Shawna must pay the 12.4% OASDI rate on all of her consulting income. Sec. 164(f) allows the deduction of one-half of self-employment taxes paid. Sec. 1402(a)(2) provides that self-employment

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income is reduced by one-half the self-employment tax rate (1/2 x 15.3% = 7.65%) multiplied by net earnings from self-employment. Therefore, only 92.35% (1 - 7.65%) of net earnings from self-employment is subject to self-employment tax.

Shawna's net self-employment income is $46,175 ($50,000 x 92.35%). Reg. Sec. 1.1402(b) - 1(b)(2)(ii) indicates that the maximum self-employment income subject to the OASDI tax is the excess contribution base ($142,800 in 2021). When Shawna's net self- employment income is added to her wages as a biologist, the total amount of $141,175 ($46,175 + $95,000) is less than the maximum contribution base of $142,800. So, she pays the 12.4% OASDI tax on the entire $46,175. In addition, Reg. Sec. 1.1402(b) - 1(b)(2)(iii) requires payment of the 2.9% MHI portion of the tax on all net self-employment income as well. ($46,175 for Shawna). This results in a self-employment tax of $7,064.78

OASDI on $46,175	**- $46,175 x 12.4%**	**$5,725.70**
MHI on $46,175	**- $46,175 x 2.9%**	**$1,339.08**
Total self-employment tax		**$7,064.78**

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73. **SPREADSHEET PROBLEM** Using the information below, prepare a spreadsheet that will calculate an individual's taxable income. The spreadsheet should be flexible enough to accommodate single and married taxpayers as well as changes in the information provided below. A template to assist the student in solving this problem can be found at www.cengagebrain.com.

Number of dependents	2
Salary	$75,000
Interest	8,000
Deductions for adjusted gross income	2,800
Deductions from adjusted gross income	14,000

There are many different ways the students can solve this problem. The goal of the assignment is to expose the student to Excel "If Statements". Set forth below is one possible solution.

Input Area:		
Filing Status	M	
Dependents	2	
Salary		$75,000
Interest		$8,000
Other Income		$-0-
Gross Income		**$83,000**
Deductions for AGI		$2,800
Adjusted Gross Income		**$80,200**
Itemized Deductions	$14,000	
or		
Standard Deduction	$25,100	$25,100
Taxable Income		**$55,100**

Input Area:		
Filing Status	S	
Dependents	2	
Salary		75000
Interest		8000
Other Income		0
Gross Income		**=SUM(C5:C7)**
Deductions for AGI		2800
Adjusted Gross Income		**=C8-C9**
Itemized Deductions	14000	
or		
Standard Deduction	=IF(B2="S",12550, IF(B2="M",25100,18800))	=IF(B11>B12,B11,B12)
Taxable Income		**=C10-C13**

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DISCUSSION CASES

74.

a. What is a value-added tax and how does it work?

A value-added tax (VAT) is a flat tax rate applied to the value added at each stage of production. Under the credit method discussed in the article, as goods are sold the VAT is added to the sales price. Any VAT paid on purchases is credited against the amount charged on sales, and the net amount is payable to the government. For example, assuming a 10% VAT rate, a firm that purchased raw materials costing $2,000, processed them and sold the resulting product for $5,000, would have a VAT payable of $300:

VAT charged on sales	**$ 5,000 x 10% =**	**$ 500**
Less: VAT paid on purchases	**$ 2,000 x 10% =**	**200**
Net VAT due		**$ 300**

The purchaser of the goods would have a $500 credit for VAT paid to be applied against the VAT it charged on the sale of the product. If the purchaser then sold the goods to a retailer for $9,000, the gross tax would be $900 which would be reduced to $400 by the $500 credit for purchases:

VAT charged on sales	**$ 9,000 x 10% =**	**$ 900**
Less: VAT paid on purchases	**$ 5,000 x 10% =**	**500**
Net VAT due		**$ 400**

Assuming that the retailer then sold the goods for $16,000 plus the 10% VAT ($17,600 total selling price including the VAT), it would have a net VAT due of $700:

VAT charged on sales	**$ 16,000 x 10% =**	**$1,600**
Less: VAT paid on purchases	**$ 9,000 x 10% =**	**900**
Net VAT due		**$ 700**

The 10% VAT has produced a total tax of $1,600 ($200 + $300 + $400 + $700) throughout the life cycle of the goods. Note that consumers will ultimately bear the burden of the VAT because they will not receive any credit for VAT paid.

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b. Evaluate the rate structures of the two proposed taxes. Are they proportional, progressive, or regressive?

Because the VAT is a flat rate applied to the tax base (value added at each stage of production), it meets the definition of a proportional tax. However, because the ultimate tax is borne by the consumer, and consumption, as a percent of income, decreases as income rises (higher income taxpayers spend a lower percentage of their total income on items subject to the VAT), the VAT is regressive when the tax is considered as a percentage of total income. This effect can be somewhat mitigated by such actions as exempting "necessities" from the tax (e.g., food, medical care, and so on) or by providing low-income taxpayers an income tax credit that approximates the amount of VAT they would pay on such necessities. In either case, providing exceptions to the system increases the complexity, and consequently, the cost of administering the tax.

c. What, if anything, is wrong with Tom's and/or Joe's point of view? Be sure to explain this part in depth.

Tom's view of the VAT is off the mark. Although it is appealing to think that the VAT is a good way to get the rich to pay their "fair share" of taxes, the tax is generally more of a burden on lower income taxpayers. At Tom's level of income, it is likely that he is spending all that he makes on consumable items that are subject to the VAT. On the other hand, Joe will spend more on consumable items than Tom, resulting in a higher gross VAT paid. However, it is unlikely that Joe will spend all of his income on items subject to the VAT. Therefore, Tom will be paying a higher percentage of his total income in VAT when compared to Joe. In addition, the VAT will not affect Joe as much as Tom, because most VAT systems exempt medical services from the VAT. Therefore, most of the income Joe receives will not have any VAT charged to it, allowing Joe to escape even more of the tax.

The income tax increase proposed by Joe would be more effective in increasing Joe's taxes as compared to the one by Tom. At his current level of income Tom pays no income tax; his taxable income is $14,900 [$40,000 - $25,100 standard deduction = $14,900. His income tax before tax credits is $1,490 ($14,900 X 10%); however, he is allowed a $10,000 tax credit for his 5 children (assuming all are under age 17) which reduces his tax liability to $0. If his tax rate was increased from 10% to 20%, he would still have no tax liability due to the tax credits. Therefore, implementing the increased tax rates will not increase Tom's taxes. Even those taxpayers who have modest incomes would experience an increase in tax if the rates are increased as proposed. However, those in the lowest marginal tax rate bracket would only be subject to one 10 percent increment increase, while the highest bracket taxpayers would experience five 10 percent increases. The result (assuming that no corresponding "loophole" deductions are given that high income taxpayers could use to reduce their taxable income) is to add relatively more tax burden to higher income taxpayers than to lower income taxpayers.

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75. Nora and Vanessa are married and have 2 dependent children. This is a summary of their 2021 tax return:

Adjusted gross income	$107,837
Deductions from adjusted gross income:	
Standard deduction	(25,100)
Taxable income	$ 82,737
Tax liability	$9,699

a. Assuming that Nora and Vanessa's 2021 adjusted gross income will increase at the 2.5% rate of inflation and that the standard deduction amount does not change, calculate their 2022 taxable income. Calculate the tax liability on this income using the 2021 tax rate schedules (See Appendix B).

Their tax liability would be $10,292

Nora and Vanessa's 2021 adjusted gross income will increase to $110,533 in 2022. With no increase in the standard deduction, their taxable income will increase to $85,433. Their tax liability using 2021 rates would be $10,292:

Adjusted gross income - $107,837 x 1.025	**$110,533**
Deductions from adjusted gross income:	
Standard deduction	**(25,100)**
Taxable income	**$ 85,433**
Tax liability - $9,328 + [22% x ($85,433 - $81,050)]=	**$ 10,292**

In 2021, their after tax adjusted gross income was $98,138 ($107,837 - $9,699). With no adjustment for inflation, their after tax adjusted gross income increases by $2,103 ($110,533 - $10,292 = $100,241 - $98,138). This is an increase of 2.14% ($2,103 ÷ $98,138), which is less than the rate of inflation.

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b. Calculate Nora and Vanessa's projected 2022 taxable income and tax liability, assuming that their adjusted gross income will increase by 2.5% and that all other inflation adjustments are made. Compare these calculations with those in part a and explain how the inflation adjustments preserve Nora and Vanessa's after-tax income.

2022 taxable income = $84,805 2022 tax liability = $9,941

The 2022 inflation adjustments will result in a 2022 standard deduction of $25,728 (2021 standard deduction of $25,100 X 1.025).

The applicable 2022 tax rate for a married couple filing a joint return after the inflation adjustments will be= $9,561 + 22% of excess over $83,076.

2021 tax bracket is: $9,328 + 22% of taxable income in excess of $81,050

$9,328 X 1.025 = $9,561

$81,050 X 1.025 = $83,076

In 2022, the standard deduction for a married couple increases to $25,728. These inflation adjustments reduce Nora and Vanessa's taxable income to $84,805. The inflation adjusted 2022 rate schedule results in a tax of $9,941. These inflation adjustments provide Nora and Vanessa with an after tax adjusted gross income of $100,592 ($110,533 - $9,941). This is a 2.5% [($100,592 - $98,138) ÷ $98,138] increase, which reflects the rate of inflation. Thus, by adjusting the standard deduction and tax rate schedules for inflation, Nora and Vanessa's after-tax income has been preserved.

Adjusted gross income - $107,837x 1.025%	**$110,533**
Deductions from adjusted gross income:	
Standard deduction	**(25,728)**
Taxable income	**$ 84,805**
Tax liability - $9,561 + [22% x ($84,805 - $83,076)]	**$ 9,941**

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TAX PLANNING CASE

76. Bonnie is married and has 1 child. She owns Bonnie's Rib Joint, which produces a taxable income of approximately $120,000 per year.

a. Assume that Bonnie's taxable income is $40,000 without considering the income from the rib joint. How much tax will she pay on the $120,000 of taxable income from the rib joint?

Additional tax = $22,295

Bonnie's 2021 total taxable income is determined by adding the $120,000 of taxable income from the rib joint to her $40,000 of other taxable income, resulting in a taxable income of $160,000. The tax on $160,000 of taxable income for a married couple in 2021 is $ 26,697:

From Table 1-2 - Married Taxpayers, Filing Jointly Rate Schedule

Tax on $160,000 = $9,328 + [22% x ($160,000 - $81,050)]
= $ 26,697

The tax on the $120,000 rib joint income is the difference in the tax they would have paid on the $40,000 of other income and the tax paid on the full $160,000. The tax on $40,000 of taxable income for a married couple in 2021 is $4,402 [$1,990 + 12% x ($40,000 - $19,900)]. Therefore, the tax on the additional $120,000 of income generated by the rib joint is $22,295 ($26,697 - $4,402).

b. You work for the firm that prepares Bonnie's tax return. Bonnie has asked the partner for whom you work to adviser her on how she might lower her taxes. The partner has assigned you this task. Draft a memorandum to the partner that contains at least two options Bonnie could use to lower her taxes. For each option, explain the calculations that support the tax savings from your recommendation.

One strategy would be for Bonnie and her spouse to each contribute to an Individual Retirement Account (IRA). Such contributions are deductions for adjusted gross income so the couple would reduce their taxable income whether they used the standard deduction or itemized deductions. Each spouse can contribute and deduct $6,000 (See chapter 6) which would reduce their taxable income by $12,000. This would result in taxable income of $148,000 ($160,000 - $12,000), income tax of $24,057 and tax savings of $2,640 ($26,697 - $24,057):

Tax on $148,000 for a married couple:

$9,328 + [22% x ($148,000 - $81,050)] = $ 24,057

Another strategy that Bonnie should consider is to hire her child and pay the child a reasonable salary. Of course, the child must be employable - old enough and competent to perform the job. For example, if Bonnie's child could be employed in a job that pays $12,000 per year, this would reduce the rib joint income by $12,000. This will shift $12,000 of income taxed at Bonnie's 22% marginal tax rate to her child. The child would be allowed a standard deduction of $12,550 and would pay no tax on the $12,000. The result will be a total tax of $24,057 and a tax savings of $2,640 ($26,697 - $24,057):

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Tax on $148,000 for a married couple:

$9,328 + [22% x ($148,000 - $81,050)] = $ 24,057

Instructor's Note: Assuming the child had no other income, the child would be entitled to a standard deduction of $12,550 and there would be no tax on the child's income. The standard deduction for a dependent is discussed Chapter 8.

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ETHICS DISCUSSION CASE

77. Return to the facts of problem 65. Assume that you are the CPA in charge of preparing the tax return for each of the taxpayers in the problem. Based on the Standards for Tax Services (which can be found at www.cengagebrain.com), explain what you should do in each case. Your discussion should indicate which, if any, of the eight statements is applicable and your obligations with regard to each applicable statement. If the facts are not sufficient to determine whether a statement applies to a situation, discuss the circumstances in which the statement would apply.

Parts a, b, and c of problem 65 involve tax evasion and therefore, present ethical issues for the CPA preparing the returns of the taxpayers. The taxpayers in parts d and e are not evading taxes and the CPA can prepare and sign the returns of the taxpayers in those circumstances.

In all 3 evasion cases, if the CPA is aware of the evasion behavior, SSTS #1 would apply. This statement would not allow the CPA to prepare or sign a return if the CPA believes that a position taken on the return does not have a "reasonable possibility" of being sustained if challenged. SSTS Interpretation 1-1 states that in order to meet the "reasonable possibility" standard, the CPA must believe, in good faith, that the position is warranted by existing law or can be supported by a good-faith argument that the existing law is incorrect. Because the taxpayers in parts a, b, and c are taking positions on their returns that would not be sustained if audited by the IRS, a CPA with knowledge of those positions should not prepare or sign the returns. The question in each case is whether the CPA would be expected to have knowledge of the evasion. Each of the 3 situations is discussed in turn.

a. Tom knows that farm rent received in cash or farm produce is income subject to tax. To avoid showing a cash receipt on his records, he rented 50 acres for his choice of 5 steers to be raised by the tenant. He used 2 of the steers for food for his family and gave 3 to relatives. Because he did not sell the livestock, he did not report taxable income.

It is quite likely that the CPA preparing the return in this case would not have knowledge of the evasion behavior. SSTS #3 allows the CPA to rely on information furnished by the client. However, if the CPA has reason to believe that the information provided by the client is incomplete or incorrect, reasonable inquiries should be made by the CPA. In this regard, SSTS #3 indicates that prior year's tax returns be referred to whenever feasible. For example, if the CPA had prepared Tom's return in a previous year and Tom had rented the land for cash that had been properly reported on the prior year's return, the CPA should inquire as to why no income from the farm land is being reported this year. However, if the CPA had not prepared the prior year's returns or if Tom has never reported income from the rental of the land, the CPA would not generally be expected to have knowledge of the rental arrangement. SSTS #3 also requires the CPA to make use of other information known to the CPA. In this regard, the statement indicates that the CPA should consider information known to the CPA from the tax return of another client if it is relevant to the return being prepared. This could occur if the CPA also prepares the return of the person who rented the land from Tom. If that return shows a rental deduction and the CPA is aware that the land was rented from Tom, the CPA should consider this information in determining whether Tom has provided complete and correct information.

b. Betty applied for and received a Social Security number for Kate, her pet cat. Surprised by how easy it was to get a Social Security number, she decided to claim a dependent

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exemption on her tax return for Kate. Other than being a cat, Kate met all the tests for a dependent.

As in part a, the CPA preparing Betty's return is allowed to rely on the information provided by Betty, unless there is reason to believe that the information on Kate is incorrect. If the CPA had prepared the previous year's return, the additional exemption should cause the CPA to inquire about the circumstances of the new dependent. If the CPA had not prepared the prior year return, it is quite likely that the CPA would not have knowledge of Kate's status as a cat and could, in good faith, prepare and sign the return.

c. Glen has put money in savings accounts in 50 different banks. Glen knows a bank is not required to report to the IRS interest it pays him that totals less than $10. Because the banks do not report the payments to the IRS, Glen does not show the interest he received as taxable income. Although Glen's accountant has told him all interest he receives is taxable, Glen insists that the IRS will never know the difference.

In this case, it appears from the facts (assuming that the CPA preparing the return is the accountant in the facts) that the CPA does have knowledge that the information that Glen is providing is incorrect and should not prepare or sign the return per SSTS #1 and SSTS #3. That is, if Glen had previously inquired about the taxability of interest and then reports no interest in the information given to the CPA, SSTS #3 would require the CPA to review prior year's returns and make other reasonable inquiries about the omission of the interest income. SSTS #1 also requires that a CPA not recommend a position that exploits the IRS audit selection process. The likelihood of the IRS detecting the omission of income is irrelevant to the CPA's obligations under SSTS #1.

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Chapter 1
Check Figures

40. a. not a tax.
b. not a tax.
c. not a tax.
d. a tax.
e. not a tax

41. a. not a tax.
b. a tax.
c. not a tax.
d. a tax.
e. not a tax.

42. a. tax = $17,541
b. 24%
c. 17.90%
d. 16.24%

43. a. tax = $16,821
b. tax = $12,397
c. tax = $19,950

44. Rory = $5,355; Latisha = $10,710

45. a. proportional
b. proportional
c. progressive
d. regressive

46 income tax - progressive
sausage tax - proportional
property tax - regressive.

47. a. $1,071
b. $376.60

48. a. $9,229
b. $9,923.40

49. Clinton-$6,120; Tranh-$11,028.60

50. $21,714.80

51. Darrell-$10,404; Whitney-$20,808

52. a. ordinary income
b. ordinary income
c. gain
d. exclusion
e. ordinary income

53. a. ordinary income
b. ordinary income
c. gain
d. ordinary income
e. exclusion

54. a. related to a business
b. related to a business
c. personal use asset
d. capital expenditure
e. personal expense

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55. a. loss of $1,700
b. deductible expense
c. nondeductible expense
d. nondeductible capital expenditure
e. deductible expense.

56. taxable income = $100,950; tax $18,249

57. taxable income = $88,400; tax $10,945

58. taxable income (from AGI) is greater by $8,000

59. N/A

60. Saul's tax = $145

61 2021 and 2022 marginal tax rates; time value of money

62. net savings from 2021 deduction = $563

63. 12.0% = 5.06%
22.0% = 4.485%
24.0% = 4.37%
32.0% = 3.91%

64. a. taxable income = $163,900
b. tax savings = $2,130

65. a. evasion
b. evasion
c. evasion
d. avoidance
e. avoidance

66. a. evasion
b. not evasion
c. not evasion
d. not evasion
e. evasion

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