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Chapter 1
Introduction to Federal Taxation and Understanding the Federal Tax Law

SUMMARY OF CHAPTER

This chapter presents information on the magnitude of federal taxes collected and on taxpayer obligations. Also, the history of U.S. federal taxation is briefly summarized followed by a review of the federal legislative process.

Fundamental Aspects of Federal Taxation

¶1101 Sources of Revenue

Types of federal taxes include (1) income taxes on corporations, individuals, and fiduciaries, (2) employment taxes, (3) estate and gift taxes, and (4) excise and customs taxes. Also, revenues are generated from state and local taxes. Consideration is given to the attractiveness of alternative systems—the value-added tax and flat tax.

¶1121 Tax Collection and Penalties

Taxes are big business and figures are given to demonstrate just how vast and complex the federal revenue collection system has become. In 1989, the civil tax penalty provisions were extensively revamped to create a fairer, less complex and more effective penalty system. Changes were made in the (1) document and information return penalties, (2) accuracy-related penalties, (3) preparer, promoter, and protester penalties, and (4) penalties for failure to file or pay.

¶1131 Taxpayer Obligations

A clear understanding of tax avoidance versus tax evasion is necessary to achieve good tax planning. Tax avoidance is legal and a legitimate pursuit of a business entity. Tax evasion requires the presence of a tax liability. There is a legal obligation to disclose a tax liability based on completed transactions and the refusal to report the tax liability is illegal.

¶1151 Brief History of the Federal Income Tax

The adoption of the Sixteenth Amendment to the Constitution enabled Congress to levy "taxes on income, from whatever source derived." A brief chronological history of changes affecting the tax law from 1913 to the present is presented.

- *16th Amendment (2/15/1913)*. Congress empowered itself to tax income.
- *Revenue Act of 1913*. Imposed income tax on individuals, corporations and other entities, effective 3/1/1913.
- *Internal Revenue Codes of 1939, 1954 and 1986.* Recodified the numerical referencing format of legislative tax law after significant tax law revisions had occurred.

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¶1161 Federal Tax Legislative Process

Steps in the enactment of a revenue bill are (1) origination in the House of Representatives Ways and Means Committee, (2) passage by the House, (3) passage by the Senate, (4) resolution of differences in House and Senate versions by the Joint Conference Committee, composed of members of both legislative bodies, (5) approval of the final version by both the House and the Senate, (6) approval or veto by the President, and (7) incorporation into the Internal Revenue Code. Both the Senate and the House must vote affirmatively by a two-thirds majority to override a veto.

¶1165 Tax Reform

The Tax Cuts and Jobs Act was the most significant tax legislation since the Tax Reform Act of 1986. Major features of the act are discussed below.

Underlying Rationale of the Federal Income Tax

¶1171 Objectives of the Tax Law

The federal income tax system is comprised of a complicated and continually evolving blend of legislative provisions, administrative pronouncements, and judicial decisions. The primary purpose of the tax law is obviously to raise revenue, but social, political, and economic objectives are also important. These various objectives, which frequently work at cross-purposes with the revenue-raising objective of the law, must be examined and understood to appreciate the rationale underlying the immense multipurpose body of law known as the federal income tax.

¶1175 Economic Factors

Numerous provisions of the tax law have been employed to help stimulate the economy, to encourage capital investment, or to direct resources to selected business activities. Examples include the following: MACRS depreciation; the optional expensing election in lieu of depreciation; percentage depletion; special farming elections to expense rather than to capitalize expenses for soil and water conservation, land clearing, and fertilizers; the S corporation provisions; the Section 1244 stock loss provision; and the tax rate structure for regular corporations.

¶1181 Social Factors

Numerous tax provisions can best be explained in light of their underlying social objectives. Examples include the following: the tax-free status accorded to employees on premiums paid by an employer on group-term insurance, accident and health plans, and medical benefit plans; and the tax-deferred status accorded to employees' current income under deferred compensation plans.

¶1185 Political Factors

Since the tax law is created by Congress, and Congress consists of several hundred elected officials, political factors play a major role in the development of tax legislation. Additionally, special interest groups and influential constituents have a definite impact on the legislative process. For example, depletion under the percentage depletion method is limited to 50% of "taxable net

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income before depletion" for all natural resource properties except oil and gas properties. For oil and gas properties, the limit is 100% of taxable net income before depletion.

¶1187 Tax Policy and Reform Measures

Reform of the tax statutes has been a trend through the years. The tax policy implications of the 1986 revision will be under examination for some time to come. In an effort to further the concept of neutrality in the tax law, the Revenue Reconciliation Act of 1990 made major changes in the way high-income individuals compute their taxable income. Also, for 1991 the tax rate schedules were changed to incorporate a third tax bracket: 31 percent. The Revenue Reconciliation Act of 1993 extended the tax rates to also included a 36 percent bracket and a 39.6 bracket. The Taxpayer Relief Act of 1997 made major modifications to capital gains. The holding period of capital assets to qualify as long term was extended from more than 12 months to more than 18 months. Also, the long-term capital gains tax rate for many items decreased from 28 percent to 20 percent.

The IRS Restructuring and Reform Act of 1998 changed the holding period for long term classification from more than 18 months to more than 12 months. The year 2000 saw the passage of three important tax bills that contain many provisions impacting taxpayers. The Community Renewal Tax Relief Act of 2000 was contained in the Consolidated Appropriations Act, 2001. This Act renewed provisions designed to enhance investment in low- and moderate-income, rural and urban communities. The Act also extended for two years medical savings accounts (MSAs). Also included was a provision expanding innocent spouse relief. The Installment Tax Correction Act of 2000 reinstated the availability of the installment method of accounting for accrual basis taxpayers. The year 2001 brought another tax bill, the Economic Growth and Tax Relief Reconciliation Act of 2001. The major provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 are: reduction in the individual income tax rates; increased 401(k) and IRA contributions; tax relief for financing higher education, including graduate education; estate and gift tax relief; and a reduction in the marriage penalty.

The highlights of the Jobs and Growth Tax Relief Reconciliation Act of 2003 are the rate reductions for individuals, the marriage penalty was reduced, the child tax credit was increased, the maximum tax rate for most long-term capital gains was reduced, the tax rate on dividend income was reduced, additional first-year depreciation was increased, the alternative minimum tax exemption was increased, the accumulated earnings tax rate was reduced, and the tax on undistributed personal holding company income was reduced. The Working Families Tax Relief Act of 2004 extended many of the provisions which were set to expire in 2004. The Pension Protection Act of 2006 contains numerous provisions to strengthen current employer pension plans. Specific reference was given to defined benefit plans. The Emergency Economic Stabilization Act of 2008 provided $700 billion to stabilize the economy. The Act also extended numerous tax provisions that were set to expire at the end of 2008. Included in this list was the AMT (alternative minimum tax). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 extended the Bush-era tax cuts for two more years. This included the capital gains and dividend tax cuts. Further, it cut the payroll tax two percentage points for the year 2011 and put a patch on the alternative minimum tax for two years.

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The American Taxpayer Relief Act of 2012 allowed the US to avert the "fiscal cliff." The Act allowed the Bush-era tax cuts to sunset for single taxpayers with incomes over $418,400 and for couples with income over $470,700 for 2017. Many tax breaks that were to expire were extended. It permanently patched the alternative minimum tax and provides for a maximum estate tax of 40 percent with a $5 million indexed exclusion, $5.49 million for 2017.

Other highlights of the Act include raising the tax on incomes over $418,400 (individuals) and $470,700 (filing jointly) to 39.6 percent in 2017, and the maximum capital gains tax to 20 percent, with a five-year extension on the American Opportunity Tax Credit and a two-year extension on certain business tax items.

The Act also extended all marriage penalty relief provisions. However, the Act reinstated the phaseout of itemized deductions and revived the personal exemption phaseout.

President Obama signed into law in December 2015 The Protecting Americans from Tax Hikes (PATH) Act of 2015. It did much more than just extend the 50-plus provisions that expired at the end of 2014. Some provisions were made permanent, others extended for five years (through 2019) and others extended for two years (through 2016). Among the more notable extensions for individuals are: the American Opportunity Tax Credit, deduction for certain expenses for elementary and secondary school teachers, increases in the earned income credit and transit benefits parity. For businesses the more notable extensions are: enhanced expensing under Section 179, and the research tax credit.

The Tax Cuts and Jobs Act signed into law by President Trump on December 22, 2017 was a massive tax bill. The center piece of the bill is the lowering of the corporate tax rate from a high of 35 percent to a flat 21 percent. The cut in the corporate rate is a permanent change and does not sunset. The changes in tax rates, with respect to individuals, mostly take affect after December 31, 2017 and sunset at the end of 2025. Several of the major changes that affect individuals are: almost doubling of the standard deduction and the limiting of the state and local tax deduction and property tax deduction to $10,000. Also, although the alternative minimum tax remains, the phase-out of the AMT exemption has been dramatically raised and fewer individuals will be subject to the AMT.

Basic Tax Concepts

¶1195 Essential Tax Terms Defined

Terms that have definitions peculiar to income taxation and familiarity with which may be of use before proceeding to the discussion of specific tax topics set out in the chapters are presented for review. Refer to the Glossary of Tax Terms in the back of the book for a comprehensive listing of the tax terms discussed in the explanatory text.

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ANSWER TO KEYSTONE PROBLEM—CHAPTER 1

(¶1101.) There is no question that employing only one form of taxing mechanism would be more efficient. However, would it be fairer? It is doubtful. Further, taxes are imposed for several reasons: one, to raise revenue to operate the federal government, and two, for social and economic reasons, such as in the case of the excise or customs taxes.

It would be difficult to think of one tax that could be imposed that would be fair to all citizens and yet raise the necessary revenue. If there was only the federal income tax, many individuals would completely avoid paying taxes.

ANSWERS TO QUESTIONS—CHAPTER 1

Topical List of Questions

1. Tax Collection (¶1101 and ¶1121)
2. Corporation Taxes (¶1101 and ¶1121)
3. Excise Taxes (¶1181)
4. Value-Added Tax: Disadvantages (¶1101)
5. Value-Added Tax: Advantages (¶1101)
6. Tax Avoidance v. Tax Evasion (¶1131)
7. Tax Avoidance: Investment Strategies (¶1131)
8. Tax Evasion Penalties (¶1131)
9. Fraudulent Acts (¶1131)
10. Tax Policy (¶1121)
11. Tax Planning (¶1131)
12. Tax History (¶1151)
13. Taxing System and Social Influences (¶1165)
14. Tax Collection—Constitutional Authority (¶1151)
15. Income Tax Law—Date of Enactment (¶1151)
16. Revenue Legislation—Origination (¶1161)
17. Revenue Legislation—Congressional Committees (¶1161)
18. Joint Conference Committee Functions (¶1165)

Answers to Questions

Tax Collection

1. The government desires corporations to retain large sums of money for capital expansion. Whether or not individuals and corporations should share the tax burden more equally is a political decision.

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Corporation Taxes

2. This relates back to question 1. Some economists believe corporations should be encouraged to expand their activities as much as possible. Only when an individual receives compensation or dividends from a corporation should there be a tax.

Excise Taxes

3. There are excise taxes on numerous items, such as alcohol, tobacco, gasoline, and luxury items such as airplanes, yachts, and expensive automobiles. If the government decides it is in the best interest of the country to control any of these items, it can raise the excise taxes. As the tax rises, consumer consumption will decrease although, as is well known, not proportionately.

Value-Added Tax: Disadvantages

4. A value-added tax is like a sales tax. All individuals have certain needs—food, clothing, and shelter. If these items are taxed, it affects the poor and rich alike. However, the poor spend their income almost totally on these items, while the rich spend only a small percentage of their salaries on food, shelter, and clothing.

Value-Added Tax: Advantages

5. The VAT has the ability to raise huge sums of money. Certainly, if Congress and the President desired to lower the deficit, one way to do so would be to impose a VAT. For each 1 percent of VAT over $12 billion is collected.

Tax Avoidance v. Tax Evasion

6. Tax avoidance implies tax planning. An individual arranges affairs to minimize tax liability. Tax evasion occurs when there is a completed transaction and the taxpayer refuses to pay the tax due.

Tax Avoidance: Investment Strategies

7. With an eye towards tax avoidance, the most logical investment is still tax-exempt municipal bonds. Another opportunity available to some taxpayers is real estate. The real estate rules have been tightened, but many investment opportunities still exist.

Tax Evasion Penalties

8. The U.S. has a self-assessed income tax. To be effective, everyone who has a tax obligation must pay a fair share. An individual enjoying the benefits of the country must help defray the cost. Therefore, individuals convicted of evading taxes are prosecuted as criminals.

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Fraudulent Acts

9. The most common badges of fraud are:

   (1) Understatement of income

   (2) Claiming fictitious or improper deductions

   (3) Accounting irregularities

   (4) Allocation of income to related taxpayers in lower income tax brackets

   (5) Acts and conduct of the taxpayer, e.g., false statements

Tax Policy

10. The tax gap is the dollar amount of taxes due the government but never collected. Much talk has taken place in recent years about the injustice of raising taxes while the tax gap is widening. The year 1996 was the first year in which the tax gap actually shrank in size.

Tax Planning

11. By means of income-shifting, an individual's tax liability can be reduced legally. This is a very important concept in family, financial, and estate and gift tax planning.

Tax History

12. The federal government could not assess a direct tax.

Taxing System and Social Influences

13. Changes in the taxing system to reflect changes in society and lifestyles include the following examples:

   (1) The Taxpayer Relief Act of 1997 incorporated provisions to help families with the cost of higher education.

   (2) During the 1960s and 1970s, there was much interest in helping the poor and the elderly. This was reflected in the taxes and credits allowed for both groups. Alcohol, cigarettes, and gasoline are taxed heavily at the federal level. The imposition of these excise taxes is a social control imposed on consumers by the government in an effort to curb excesses. To further this social policy, a 10 percent luxury tax was imposed in 1990. The luxury tax expired on December 31, 2002.

   (3) In an effort to help low-wage earners, a much larger standard deduction was instituted for 1988 and thereafter.

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Tax Collection—Constitutional Authority

14. The Sixteenth Amendment, which took effect in 1913, gave Congress the clear authority to tax income from whatever source derived.

Income Tax Law—Date of Enactment

15. The Revenue Act of 1913, which imposed an income tax, was made retroactive to March 1, 1913. The date is important for tax purposes because this is the date that is sometimes used as a basis for computing gain and loss.

Revenue Legislation—Origination

16. The Constitution requires that revenue legislation originate in the House of Representatives.

Revenue Legislation—Congressional Committees

17. The first step in revenue legislation is a hearing before the House Ways and Means Committee. If the bill is defeated by the House of Representatives, it may be referred back to committee; if it passes, it is sent to the Senate Finance Committee.

Joint Conference Committee Functions

18. The Joint Conference Committee, composed of ranking members of the House Ways and Means Committee (seven members) and the Senate Finance Committee (five members), is responsible for the resolution of any differences between the House and Senate versions of a tax bill after passage.

ANSWERS TO PROBLEMS—CHAPTER 1

Topical List of Problems

19. Multiple Choice—Legislative Process (¶1161)
20. Multiple Choice—Congressional Powers (¶1151)
21. Multiple Choice—Revenue Sources: Value-Added Tax (¶1101)
22. Multiple Choice—Revenue Sources: Personal Income Tax (¶1171)
23. Multiple Choice—Tax Reform (¶1165)
24. Multiple Choice—Tax Reform (¶1165)
25. Multiple Choice—Legislative Process (¶1161)
26. Multiple Choice—Jobs and Growth Tax Relief Reconciliation Act of 2003 (¶1165)
27. Multiple Choice—Tax Reform (¶1165)
28. Multiple Choice—Tax Concepts (¶1195)
29. Multiple Choice—Tax Concepts (¶1195)
30. Tax Cuts and Jobs Act
31. Research Problem—Tax Avoidance: Business Alternatives

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Answers to Problems

Multiple Choice—Legislative Process

19. a. The legislative process of a tax bill begins with the House Ways and Means Committee.

Multiple Choice—Congressional Powers

20. c. The Sixteenth Amendment granted Congress the right to tax income from whatever source derived.

Multiple Choice—Revenue Sources: Value-Added Tax

21. a. The value-added tax has great appeal to politicians because it has the potential to raise large sums of money.

Multiple Choice—Revenue Sources: Personal Income Tax

22. d. An attractive characteristic of the personal income tax is that it has the ability to raise a considerable amount of money.

Multiple Choice—Tax Reform

23. b. The changes brought about by the Tax Reform Act of 1986 were so extensive that the Internal Revenue Code of 1954 was redesignated as the Internal Revenue Code of 1986.

Multiple Choice—Tax Reform

24. b. The Tax Cuts and Jobs Act did not create a homebuyer's credit.

Multiple Choice—Legislative Process

25. d. The Conference Committee is the vehicle employed for setting differences between the House and Senate versions of a tax bill.

Multiple Choice—Jobs and Growth Tax Relief Reconciliation Act of 2003

26. c. Net capital gains are taxed at a maximum of 20 percent for taxpayers above certain income levels. Collectibles and Section 1202 gains are taxed at 28 percent.

Multiple Choice—Tax Reform

27. b. The Act allows the Bush-era tax cuts to sunset after 2012 on all individuals with income over $400,000 and $450,000 for families.

Multiple Choice—Tax Concepts

28. d. Depreciable property is not a capital asset.

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29. d. Conduits must "file" a tax return even though they need not pay taxes, and the income is "passed through" to the owners.

Tax Cuts and Jobs Act

30. The Tax Cuts and Jobs Act lowered the corporate tax to a flat 21 percent. Further, it suspended the personal exemption until 2026 and altered the itemized deductions.

Research Problem—Tax Avoidance: Business Alternatives

31. The case of the appeal of *Peterson & Pegau Baking Co.* highlights the necessity of careful review of transactions. The sole issue in this case was whether royalties paid to Peterson and Pegau were indeed royalties or disguised dividends. The students should read the testimony of the accountant who prepared the corporate tax return. Of note is the accountant's testimony on the selection of corporate form versus partnership status. The Board of Tax Appeals in this case ruled that the royalties were really disguised dividends.

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