# *Principles of Taxation for Business and Investment Planning 2016 19th edition Jones Solutions Manual*

SKU: 9781259549250-SOLUTIONS

# *Chapter 2 Policy Standards for a Good Tax*

## Questions and Problems for Discussion

1. This question is designed to lead to a class discussion of the various tax policy issues introduced in Chapter 2.

2. Historically, the federal income tax system has not generated enough revenue to fund the government's spending programs. Consequently, the federal government has borrowed money to make up its deficits (excess of spending over revenues) and in doing so has amassed an $11 trillion national debt. The federal government operated at a deficit in every year from 1970 through 1998. In 1999 and 2000, it operated at a small surplus (excess of revenues over spending), but reverted to massive deficit spending in 2001 and subsequent years.

3. Governments can impose a new tax (by identifying and taxing a new base), increase the rate of an existing tax, or expand the base of an existing tax.

4. Governments that fail to control the growth of their money supply run the risk of devaluing the currency and triggering a crippling rate of inflation. Therefore, simply printing more money to fund an operating deficit is not a viable, long-term solution to an insufficient tax system.

5. a. Mrs. E could enter the work force. Her after-tax earnings could offset the decrease in the couple's disposable income attributable to the tax rate increase. If Mr. E works for an hourly wage, he could possibly work more hours for his employer. If he doesn't have this option, he could take a second job or even start a new business.

   b. As a self-employed individual, Mrs. F may have the flexibility to increase the number of hours devoted to her business. Her additional after-tax earnings could offset the decrease in the couple's disposable income attributable to the tax rate increase. Mr. F has the same options as Mr. E.

   c. In this case, Mr. and Mrs. G have the same options as Mr. E and Mr. F. Because they are both full-time employees, their ability to increase their before-tax income may be limited.

6. a. Mr. H may not have any realistic way to decrease the time spent at work and increase his leisure time, even if the after-tax value of his labor decreases because of a tax rate increase. Mrs. H's behavior should not change because of a tax rate increase.

   b. Mrs. J could quit her job and leave the work force if the couple decides that her leisure time is worth more than the after-tax value of her labor.

   c. As a self-employed individual, Ms. K has the flexibility to decrease the number of hours devoted to her business, thereby substituting additional leisure time for labor.

7. An increase in the income tax rate decreases the after-tax value of the bond investment but does not affect the value of the luxury auto. (Her personal use and enjoyment of the auto are nontaxable benefits to Ms. V.) Consequently, she may decide to consume the $40,000 (i.e., buy the auto) rather than to save it.

8. People derive many psychological benefits from working: a sense of self-worth and self-reliance, prestige and status, intellectual challenge, a social network, and a belief that their work makes the world a better place. These forms of *psychic income* may be as important (or even more important) than monetary incentives.

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9. A national sales tax might reduce the aggregate level of consumer demand for taxable goods and services. In this case, the tax base would decrease and state and local sales tax revenues would decline.

10. Arguably, the estate tax is more convenient for two reasons. First, individuals with accumulated wealth can't avoid the tax indefinitely. Second, a person's death is a matter of public record so that the IRS can easily determine when a potentially taxable event (the transfer of wealth at death) has occurred.

11. Market economies (and the firms operating in those economies) adapt to the various taxes imposed on business transactions. The longer a tax (or a specific tax rule) has been in effect, the better the business community understands it. When governments change the tax system, the business community must spend time and money studying and reacting to the change. Firm managers must reassess, or even modify, their tax strategies. Thus, any change in the tax environment is both costly and unsettling, even if the purpose of the change is to improve the environment.

12. Clearly, the system in which employers must withhold and remit income tax from their employees' paychecks is more convenient for the government because the collection process is greatly concentrated. The withholding system is more convenient for individual employees who are not required to compute their monthly tax bills or mail tax payments to the government. Instead, their employers perform these tasks on the individuals' behalf. The withholding system shifts much of the cost of compliance to employers and is, therefore, more inconvenient from the employers' perspective.

13. a. This provision clearly is intended to encourage and reward a certain economic behavior (the purchase and use of snow removal equipment by private firms) and, therefore, meets the definition of a tax preference.

    b. Jurisdiction E is assuming that it can reduce its snow removal costs by $550,000 because more firms will own the equipment to perform this function for themselves.

14. For the income tax system to be equitable, the tax base (taxable income) should be defined as precisely as possible to reflect each individual's economic ability to pay. However, the greater the number of personal and financial circumstances taken into account in defining taxable income, the greater the complexity of the law.

15. a. This is a progressive rate structure with a -0- rate on income up to $35,000 and a 15 percent rate on income in excess of $35,000.

    b. This is a proportionate rate structure.

    c. This is a regressive rate structure with a 15 percent rate on income up to $80,000 and a -0- percent rate on income in excess of $80,000.

16. Jurisdiction Q could enact:

    *A gross receipts tax*. Because Corporation R and Corporation T both have $5 million gross receipts, they would pay the same tax. Corporation T could argue that this result is horizontally inequitable because its gross and net profit are less than Corporation R's gross and net profit, indicating that Corporation T has less ability to pay a tax.

    *A tax based on gross profit*. Because Corporation R has more gross profit than Corporation T, Corporation R would pay the greater tax. Corporation R could argue that this result is horizontally inequitable because it has a higher ratio of annual operating expenses to gross profit (55.5 percent) than Corporation T (30.1 percent). Consequently, gross profit doesn't accurately reflect the two corporations' ability to pay tax.

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*A tax based on net profit before charitable contributions*. In this case, Corporation R's tax base would be $800,000, and Corporation T's tax base would be $930,000. Corporation T might argue that its generous charitable contributions reduced its economic ability to pay and should be taken into account. Corporation R could refute by arguing that discretionary charitable contributions are irrelevant to the measurement of ability to pay tax on business earnings.

*A tax based on net profit after charitable contributions*. In this case, Corporation R would pay more tax than Corporation T and could argue that allowing Corporation T to deduct charitable contributions violates the concept of horizontal equity.

17. Ms. P should consider her marginal rate: the rate at which the incremental income from the investment will be taxed. For tax planning purposes, the average tax rate that she pays on her entire income is irrelevant.

**Application Problems**

1. a. Next year's revenue will be $880,000 ($8,000,000 base × 11%).
   b. Next year's revenue will be $1,023,000 ($9,300,000 base × 11%).
   c. Next year's revenue will be $770,000 ($7,000,000 base × 11%).

2. a. Next year's revenue will be $441,000 ($29.4 million base × 1.5%).
   b. Next year's revenue will be $540,000 ($36 million base × 1.5%).
   c. Next year's revenue will be $615,000 ($41 million base × 1.5%).

3. Before the tax increase, Mrs. K's disposable income is $35,700 ($42,000 – $6,300 tax). If the tax rate increases from 15 percent to 20 percent, she must earn an additional $2,625 to maintain this income. This number is derived from the following formula.

   ($42,000 + additional income) – 20% ($42,000 + additional income) = $35,700

   If Mrs. K can earn an extra $2,625, her disposable income will not be affected by the rate increase.

| | |
|---|---|
| Taxable income | $44,625 |
| Tax rate | .20 |
| Tax | $8,925 |

   After-tax income ($44,625 – 8,925) = $35,700

4. a. $125,000 tax base (Mr. and Mrs. J's taxable income) × 8% rate increase = $10,000 additional tax collected from Mr. and Mrs. J.

   b.

| | |
|---|---|
| $140,000 increased tax base × 40% | $56,000 |
| Tax collected on original $125,000 base × 32% | (40,000) |
| Additional tax collected from Mr. and Mrs. J | $16,000 |

   c.

| | |
|---|---|
| $110,000 decreased tax base × 40% | $44,000 |
| Tax collected on original $125,000 base × 32% | (40,000) |
| Additional tax collected from Mr. and Mrs. J | $4,000 |

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5. a. Jersey Inc.'s income tax is $273,000 ($3.9 million × 7%), and its average and marginal tax rates are 7%.

   b. Leray Inc.'s income tax is $350,000 ($5 million × 7%). Its average rate is 3.6% ($350,000 ÷ $9.6 million), and its marginal rate is 0%.

   c. Jurisdiction B uses a regressive rate structure because the average rate decreases as the tax base (corporate income) increases.

6. a. Mr. Hill's taxable income is $63,750 ($98,750 – $35,000), and his tax is $8,925 ($63,750 × 14%). His average rate is 9% ($8,925 ÷ $98,750), and his marginal rate is 14%.

   b. Ms. Lui's taxable income is $12,900 ($47,900 – $35,000), and her tax is $1,806 ($12,900 × 14%). Her average rate is 3.8% ($1,806 ÷ $47,900), and her marginal tax rate is 14%.

   c Ms. Archer's average and marginal rates are zero.

   d. Jurisdiction X uses a progressive rate structure because the average rate increases as the tax base (individual income) increases.

7. a. Taxpayer A's tax on $119,400 of income is computed as follows.

| | |
|---|---|
| 6% of first $30,000 of income | $1,800 |
| 10% of next $40,000 of income | 4,000 |
| 20% of next $49,400 of income | 9,880 |
| | $15,680 |

   Taxpayer A's average tax rate is 13.13% ($15,680 ÷ $119,400), and his marginal tax rate is 20 percent.

   b. Taxpayer B's tax on $383,900 of income is computed as follows.

| | |
|---|---|
| 6% of first $30,000 of income | $1,800 |
| 10% of next $40,000 of income | 4,000 |
| 20% of next $130,000 of income | 26,000 |
| 28% of next $183,900 of income | 51,492 |
| | $83,292 |

   Taxpayer B's average tax rate is 21.70% ($83,292 ÷ $383,900), and his marginal tax rate is 28%.

8. a. Both taxpayers earn $500,000 total income over the 10-year period.

   b. Taxpayer O paid an annual tax of $3,800 on $50,000 taxable income. Thus, taxpayer O paid $38,000 tax for the 10-year period and had an average tax rate of 7.6% ($38,000 ÷ $500,000). Taxpayer P paid an annual tax of $1,200 on $20,000 taxable income for years 1 through 5 and an annual tax of $7,800 on $80,000 taxable income for years 6 through 10. Thus, taxpayer P paid $45,000 tax for the 10-year period and had an average tax rate of 9% ($45,000 ÷ $500,000).

9. a. Individual C's excise tax is $15 and C's average tax rate is 3% ($15 ÷ $500).

   b. Individual D's excise tax is $70 and D's average tax rate is 1.4% ($70 ÷ $5,000).

   c. Jurisdiction Z's excise tax meets a strict definition of vertical equity because individual D, who has a larger tax base than individual C, pays more tax than individual C. However, the tax is regressive because individual D's average tax rate is less than individual C's average tax rate.

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**Issue Recognition Problems**

1. Does Country O have a sufficient tax system? Does Country O have a surplus (an excess of $903 million total revenues over $877 total expenditures) or a deficit (an excess of $800 general expenditures over $718 general revenues.)? Note that this question mirrors the current debate concerning whether federal payroll tax receipts and Social Security/Medicare disbursements should be on-budget or off-budget.

2. Will the increase in the gross receipts tax rate cause firms to conduct less business in County M so that the aggregate gross receipts after the tax increase are less than $400 million? Is a static forecast of the incremental revenue from the rate increase appropriate because the county's improved road system will encourage increased business activity within its jurisdiction?

3. Is the horizontal equity of the federal income tax impaired because the law gives preferential treatment for one type of physical disability (blindness) but not for other types of disabilities (paralysis)? Does Mrs. K have less ability to pay income tax than Mr. L?

4. Is the economic benefit of the certainty and stability resulting from the moratorium negated by the fact that Country C cannot use its tax system as an instrument of fiscal policy (lower rates, new tax breaks to combat unemployment, etc.) in its attempt to combat the recession?

5. Does the complexity of the new provision undermine the provision's tax policy goal (a subsidy for families with high utility bills)? Is the new provision, in fact, inequitable because it benefits only a subgroup of individual taxpayers?

6. Could Jurisdiction J provide the same level of clean-up services directly (through a government program) for less than $1.9 million?

**Research Problems**

1. The CBO's estimate of the U.S. government's total budget surplus (deficit) for the current fiscal year is updated monthly. Monthly Treasury Statements provide annual surplus (deficit) estimates that include both Social Security and Postal Service receipts. However, the CBO also restates the annual surplus (deficit) estimates by excluding these "off-budget" items.

2. "The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our principled research, insightful analysis, and engaged experts have informed smarter tax policy at the federal, state, and local levels."

   a. Tax Freedom Day is the day when individual taxpayers stop working to pay their annual local, state, and federal taxes and begin working to provide after-tax disposable income for themselves. Tax Freedom Day in 2014 was April 21.

   b. Americans would have to work an additional 15 days (until May 6) to pay off the 2014 federal budget deficit.

3. The answer to this problem depends on which day the students access the website.

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**Tax Planning Cases**

1. Based on a static forecast, a 1 percent increase in the sales tax rate would increase Jurisdiction B's annual revenue by $5 million. A new 2 percent corporate income tax would also increase revenue by $5 million (2 percent of a $275 million tax base less $500,000 cost of the new agency).

2. In developing a dynamic forecast of the incremental revenue from the sales tax rate increase, sales tax rates in the neighboring jurisdictions would be an important fact. If these rates are less than 7.5 percent, residents of Jurisdiction B might react to the rate increase by traveling to a neighboring jurisdiction to make their purchases. The extent of this behavioral reaction might depend on whether Jurisdiction B has a use tax (which would also be increased to 7.5 percent) and an effective mechanism for collecting such tax. A second important fact is based on geography. Are the neighboring jurisdictions within a reasonable travel distance for Jurisdiction B shoppers?

   The corporate income tax rates in the two neighboring jurisdictions would be important factors in a dynamic forecast of the incremental revenue from Jurisdiction B's new net income tax. The nontax costs and benefits of operating a business in Jurisdiction B compared to the nontax costs and benefits of operating in the neighboring jurisdictions would be important information. For example, does Jurisdiction B offer a more skilled labor force or cheaper electrical power than neighboring jurisdictions? These facts are relevant in estimating the extent to which corporations would maintain their current level of business activity within Jurisdiction B, in spite of the new tax cost.

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