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Concepts in Federal Taxation

2020 EDITION

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2020 EDITION

Concepts in Federal Taxation

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Concepts in Federal Taxation, 2020 Edition

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Library of Congress Control Number: 2019934626

Package
Student Edition + Tax Prep Software + RIA Checkpoint ISBN:
978-0-357-11036-2

Package:
Loose-leaf Edition + Tax Prep Software + RIA Checkpoint ISBN:
978-0-357-11038-6

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Printed in the United States of America
Print Number: 01 Print Year: 2019

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PREFACE

Many students view the introductory tax course as an impossible task of learning the Internal Revenue Code. The Code, which is the statutory basis of the federal income tax system, is complex and can be intimidating to students and tax professionals. However, we feel strongly that tax education can be interesting and, with the straightforward yet complete coverage in *Concepts in Federal Taxation*, offer a refreshing, thought-provoking textbook. Designed specifically for the introductory tax course, this book is rigorous enough for students specializing in taxation, but it will not intimidate those who plan to pursue other areas of accounting and business.

FUNDAMENTAL STRUCTURE

Conceptual Approach

There are two ways to look at the rules that govern federal taxation: the technical approach and the conceptual approach. The traditional "technical approach" looks at the reams of tax authority as thousands of specific and distinct code sections, regulations, exceptions, and qualifications. This approach treats income tax in such great depth that the first-time tax student has difficulty understanding the myriad rules, exceptions to those general rules, and exceptions to the exceptions. As a result, students tend to view the first tax course as a long string of unrelated topics that they must memorize to pass the course.

The "conceptual approach" presents taxation as a small number of unifying concepts—principles that apply in the application of specific tax rules and authorities. These concepts define taxation. An analogy can be made to mathematical operations: by understanding how multiplication works and memorizing the nine times tables, people learn to multiply any number by any other number. One can multiply 23 by 25 correctly without having memorized a times table that includes that pair of numbers. Likewise, knowing the underlying concepts that shape tax law allows students to understand a wide range of tax law without committing every line of the Internal Revenue Code to memory.

Organization

Instead of focusing on the individual aspects of taxation, this textbook emphasizes transactions that are common to all tax entities. This allows the text to focus more on the overall scheme of taxation (What is income? What is a deduction? and so on) with individual tax return preparation a secondary issue. As a result, Chapter 1 introduces the individual tax formula and briefly discusses the "for" versus "from" adjusted gross income distinction that is unique to individuals, but the mechanics of the individual tax calculation are not discussed in detail until Chapter 8. Furthermore, itemized deductions are not accorded the traditional in-depth treatment. Again, the focus is on the more common itemized deductions, and elaborate technical detail is omitted for the more unusual items.

The text is organized into the following six parts:

- **Part I: Conceptual Foundations of the Tax Law**
  - **Chapter 1** provides an overview of the tax system, briefly discusses other types of taxes, outlines the general income tax calculation, discusses the nature of tax planning, and introduces ethical considerations of tax practice.
  - **Chapter 2** develops the conceptual framework and uses it to explain the operation of the tax system in general. Each subsequent chapter begins with a brief review of the concepts discussed in this chapter.

- **Part II: Gross Income**
  - **Chapter 3** classifies various sources of income and explains the common problems encountered within each income classification. Its overview of property transactions differentiates the taxation of capital gains and losses from other sources of income. The chapter concludes with an introduction to the accounting methods that affect the recognition of income.
  - **Chapter 4** classifies allowable exclusions from income according to the purpose of the exclusion and discusses the problems commonly encountered with exclusions in each category.
- **Part III: Deductions**
  - **Chapter 5** provides an overview of the general criteria necessary to obtain a tax deduction and concludes with a discussion of the effect of a taxpayer's accounting method on the timing of deductions.
  - **Chapter 6** addresses specific business expense deductions that are subject to special rules and limitations.
  - **Chapter 7** covers deductions for losses. The chapter distinguishes annual losses from transaction losses, and discusses the limitations on the deductibility of the two types of losses. This discussion includes the treatment of net operating losses, the at-risk rules, passive losses, capital losses, and casualty losses.
  - **Chapter 8** discusses the unique features of the individual income tax calculation, itemized deductions, and tax credits available to individuals.
- **Part IV: Property Transactions**
  - **Chapter 9** introduces the property investment cycle and discusses common acquisition problems.
  - **Chapter 10** provides the allowable deductions for property expenditures. This includes the MACRS depreciation system, depletion deductions, and allowable amortization deductions.
  - **Chapter 11** discusses dispositions of property and explains the classification and calculation of the gain or loss from a disposition of property.
  - **Chapter 12** covers the common nonrecognition situations related to property dispositions, including exchanges, involuntary conversions, and sales of a principal residence.
- **Part V: Income Tax Entities**
  - **Chapter 13** discusses the nontax characteristics that should be considered in choosing a business entity and the incidence of taxation of each entity and presents the comparative differences at formation of a business.
  - **Chapter 14** compares the differences in tax treatments during the operation of an entity and concludes with an overview of the effect of distributions on an entity and its owners.
  - **Chapter 15** finishes the life-cycle discussion with coverage of deferred compensation, tax credits, the alternative minimum tax, and international tax aspects of entities.
- **Part VI: Tax Research**
  - **Chapter 16** provides the mechanics of tax research. Problems that require the student to find particular types of authorities using print, CD-ROM, and Internet tax services, and research cases for all chapters in the text are provided in this chapter. Instructors wishing to introduce students to tax research may want to cover this chapter early in the course.

HALLMARK FEATURES

The most important objective at the introductory level is to gain a conceptual view of income tax law and then relate those concepts to basic aspects of everyday economic life. Through continual reinforcement, the concepts quickly become the backbone of understanding. The 2020 edition of *Concepts in Federal Taxation* has a lineup of outstanding features that will help students improve their skills and understanding while learning the concepts.

Learning Objectives

Each chapter opens with a set of learning objectives to guide students through mastering the chapter's material. Learning objectives are shown in the margins near the relevant chapter content and are also identified in the end of chapter materials to reinforce these key learning objectives and help students learn more efficiently.

Concept Review

To solidify and expound upon the conceptual foundation presented in Chapter 2, the subsequent chapters begin with a review of the general concepts, accounting concepts, income concepts, and deduction concepts that have been covered in previous chapters. Page references for each concept allow students to easily locate material and refresh their memory.

concept review

GENERAL CONCEPTS

Ability to pay A tax should be based on the amount that the taxpayer can afford to pay, relative to other taxpayers. pg. 2-2

Administrative convenience Those items for which the cost of compliance would exceed the revenue generated are not taxed. pg. 2-3

Arm's-length transaction A transaction in which all parties have bargained in good faith and for their individual benefit, not for the benefit of the transaction group. pg. 2-4

Related party Family members, corporations that are owned by family members, and certain other relationships between entities in which the power to control the substance of a transaction is evidenced through majority ownership. pg. 2-4

ACCOUNTING CONCEPTS

Annual accounting period All entities must report the results of their operations on an annual basis (the tax year). Each tax year stands on its own, apart from other tax years. pg. 2-9

Assignment of income The tax entity that owns the income produced is responsible for the tax on the income, regardless of which entity actually receives the income. pg. 2-8

Conduit entity An entity for which the tax attributes flow through to its owners for tax purposes. pg. 2-6

Substance over form Transactions are to be taxed according to their true intention rather than some form that may have been contrived. pg. 2-11

Tax benefit rule Any deduction taken in a prior year that is recovered in a subsequent year is income in the year of recovery, to the extent that a tax benefit was received from the deduction. pg. 2-10

INCOME CONCEPTS

All-inclusive income All income received is taxable unless a specific provision in the tax law either excludes the income from taxation or defers its recognition to a future tax year. pg. 2-12

Capital recovery No income is realized until the taxpayer receives more than the amount invested to produce the income. The amount invested in an asset represents the maximum amount recoverable. pg. 2-13

Claim of right A realization occurs whenever an amount is received without any restriction as to its disposition. pg. 2-14

Constructive receipt Income is deemed to be received when it is made unconditionally available to the taxpayer. pg. 2-15

Legislative grace Any tax relief provided is the result of a specific act of Congress that must be strictly applied and interpreted. All income received is taxable unless a specific provision in the tax law excludes the income from taxation. Deductions must be approached with the philosophy that nothing is deductible unless a provision in the tax law allows the deduction. pg. 2-12

Realization No income or loss is recognized until it has been realized. A realization involves a change in the form and/or substance of a taxpayer's property rights that results from an arm's-length transaction. pg. 2-14

Wherewithal to pay Income is recognized in the period in which the taxpayer has the means to pay the tax on the income. pg. 2-16

Examples

Continually rated as this textbook's biggest strength, each chapter includes numerous student-friendly examples. The examples present familiar situations in a question-and-discussion format that offers detailed explanations.

Example 24 Jorge receives 200 shares of MNO Corporation common stock as a gift from his grandfather. At the date of the gift, the shares have a fair market value of $20,000. During the current year, Jorge receives dividends totaling $2,000 on the stock. Recall that the tax law excludes the value of a gift from the gross income of the recipient. What are the tax effects for Jorge of the gift from his grandfather?

Discussion: The receipt of the stock as a gift from the grandfather is specifically excluded from Jorge's income by the tax law. However, the exclusion applies only to the value of the gift received and does not exclude from tax any subsequent income Jorge receives on the gift property.[12] Therefore, Jorge is taxed on the $2,000 in dividends received on the stock.

Concept Check

Concept Checks appear throughout each chapter to keep students on track by reinforcing the critical tax concepts illustrated.

concept check

The *capital recovery concept* allows the recovery of capital invested in an asset. The amount invested in an asset is the maximum amount recoverable under this concept. *Adjusted basis* represents a taxpayer's unrecovered investment in an asset. Therefore, the maximum loss that can be recognized from a casualty or theft is the asset's adjusted basis. An *arm's-length* transaction is one in which all parties to the transaction have bargained in good faith and for their individual benefit, not for the benefit of the transaction group. *Related party* transactions are usually subject to scrutiny by the IRS because the tax law assumes that related parties do not transact at arm's length. The substance-over-form doctrine taxes transactions according to their true intent rather than some (possibly) contrived form of the transaction. This concept prevents a taxpayer from recognizing a loss on the sale of stock if it is replaced within 30 days of (either before or after) the date of sale.

END-OF-CHAPTER MATERIALS

Ensure that students master chapter concepts with a wide array of end-of-chapter assignments designed to do everything from testing basic chapter comprehension to applying concepts and procedures to complex tax situations.

Chapter Summary

Students can verify their understanding of the key concepts illustrated in the chapter by reviewing the succinct Chapter Summary, which appears at the end of every chapter.

Key Terms

Part of the difficulty of this course can be traced to its specialized vocabulary. As learning the terminology serves as a basis for learning how to apply the concepts, each chapter includes a list of key terms with page references.

Primary Tax Sources

Rather than interrupting the text with extensive footnoting of specific subsections of the Internal Revenue Code, the primary tax law sources appear at the end of each chapter with explanatory notations. This approach uses more references to Treasury regulations, revenue rulings, and court cases than may appear in other introductory tax textbooks.

Discussion Questions and Problems

Many of the approximately 1,300 end-of-chapter problems do not call for mathematical solutions. Rather, they require an explanation of the appropriate treatment, based on the concepts. These problems are valuable learning tools, which encourage students to apply the concepts and formulate a solution.

Traditional problems that can be solved by reference to the examples in the chapter are also provided, and they address every topic in the chapter. In most cases, two or more problems exist for each topic. A number of problems exist for each learning objective. Problems that require client communication are designated with a Communication Skills icon.

Communication Skills

Issue Identification Problems

These problems ask students to identify the tax issues inherent in a factual situation and determine the possible tax treatments.

Technology Applications

A complete end-of-chapter section containing problems on Internet Skills, Research Skills, and Spreadsheet Skills enhance students' familiarity with the technology tools needed for problem solving.

Tax Simulation

- **Tax Simulations** in Chapters 3–12 teach database searching and writing skills that are important requirements for understanding tax concepts. These cases can be

solved using only the Code and Regulations, giving students hands-on practice with the research and writing skills required to complete the tax simulations featured on the CPA Examination.

- **Research Skills Exercises** require students to research relevant tax topics.
- **RIA Research Exercises** require students to use the Checkpoint® tax research database to complete the assignment.
- **Tax Form Problems** containing expanded client information allow students to complete tax forms obtained from the IRS website without additional instruction. These problems may be also worked using tax preparation software such as Intuit ProConnect Tax Software.
- **Spreadsheet Skills Problems** are designed to make students aware that spreadsheets are useful tax planning tools. With the 2020 edition, spreadsheet templates that are designed to provide assistance to the student as they set up and work the problem have been included.
- **Internet Skills Exercises** introduce students to sources of tax information available on the Internet.

Research Skills

THOMSON REUTERS CHECKPOINT®

Tax Form Skills

Spreadsheet Skills

Internet Skills

Comprehensive Problems

These problems cover several issues discussed within a chapter, requiring students to develop an advanced understanding by combining and applying multiple concepts.

Integrative Problems

These problems require students to fuse together material learned in previous chapters, combining it with information found within the current chapter. Integrative problem 84 in Chapter 4 provides the information necessary to calculate the gross income of a taxpayer. Integrative problem 75 in Chapter 8 follows up by providing the information necessary to complete the tax return for the same taxpayer. This approach allows students to complete a complex tax return in two stages, spreading the work out over the semester rather than preparing it for a single due date.

Tax Return Problem (Appendix A)

This problem is presented in three phases, which correspond to the organization of the text. Each phase presents some information in actual tax documents that a taxpayer might receive from common third-party sources. This approach makes it easier to become familiar with tax reporting and tax compliance forms as the material is covered, rather than in one burst at the end of the semester. The problem can be worked manually or with tax preparation software such as Intuit ProConnect Tax Software.

Discussion Cases

These cases stimulate thinking about issues raised in the chapter. All case material can be used to emphasize communication in the tax curriculum.

Tax Planning Cases

These cases require students to use the concepts in the chapter to devise an optimal tax plan for the facts given.

Ethics Discussion Cases

These cases provide ethical dilemmas related to the chapter material that must be resolved according to the Statements on Standards for Tax Services of the American Institute of Certified Public Accountants (AICPA). A link to the complete AICPA statements on standards is provided on the companion website.

RECENT REVISIONS

Fine-Tuned End of Chapter Material

All end of chapter content has been thoroughly updated with respect to tax law changes. This material has also been carefully revised to enhance the readability of the question parts.

Part Openers Set the Stage for Learning

Part openers highlight the structure of the material, which begins with the conceptual foundations of tax law and flows through the calculation of gross income, the deductions that are allowed in computing taxable income, property transaction, the life-cycle approach to business entities, and finally, the mechanics of tax research.

Updates Reflect the Latest Tax Laws

This annual edition reflects the latest tax laws and changes to tax codes and regulations to keep your course current—including the new tax rate schedules and amounts.

Online Homework Options

A Complete Learning System—CengageNOWv2

CengageNOWv2 for Taxation takes students from motivation to mastery. Built on principles of learning, designed and created hand-in-hand with educators, Cengage digital solutions focus on engagement, taking students through levels of application, analysis, and critical thinking with depth and context unmatched in the market.

CengageNOWv2 elevates thinking by providing superior content designed with the entire student workflow in mind. Students learn more efficiently with the variety of engaging assessments and learning tools. For instructors, CengageNOWv2 provides ultimate control and customization and a clear view into student performance that allows for the opportunity to tailor the learning experience to improve outcomes.

CengageNOWv2 for *Concepts in Federal Taxation* offers the following:

- All standard end-of-chapter problems from the text, expanded and enhanced to follow the workflow a professional would follow to solve various client scenarios. These enhancements better engage students and encourage thinking like a tax professional.
- Select algorithmic problems in CengageNOWv2 provide students with additional opportunities to practice key taxation concepts. Algorithmic questions allow students to work the same problem multiple times with changing variables, which encourages deeper understanding of the material.
- Detailed feedback for each homework question! CengageNOWv2 questions include enhanced, immediate feedback so your students can learn as they go. Levels of feedback include an option to "check my work" within an assignment. Instructors can decide how much feedback their students receive and when.
- Built-in Test Bank for online assessment.
- For students who need additional support, CengageNOWv2's Adaptive Study Plan contains quizzes and an eBook.
- The ability to analyze student work from the gradebook and generate reports on learning outcomes. Each problem is tagged in the Solutions Manual and CengageNOWv2 by Accredited Business Programs and learning objective.

INSTRUCTOR RESOURCES

Concepts in Federal Taxation has been adopted by a wide range of schools and by instructors who have unique philosophies and approaches in their courses. Our supplemental materials have been developed to have a positive impact on all aspects of the course.

Instructor Companion Website

www.cengage.com/login
Easily download the instructor resources you need from the password-protected, instructor-only website. If you are a new instructor, you will need to register with Cengage by creating a new instructor account. Instructors will be directed to the Cengage dashboard after logging in. Here, instructors may add any Cengage book to the "bookshelf," including the 2020 edition of *Concepts in Federal Taxation* simply by searching by the author, title, or ISBN (9780357110362). After adding the book to your "bookshelf," you will be able to access the links to the Instructor Companion Website and accompanying resources.

Instructor's Manual

Simplify class preparation with the wealth of teaching tips and advanced assignment ideas provided in the Instructor's Manual. A concise overview and detailed lecture outline (including references to relevant problems in the textbook) are provided for each chapter, along with invaluable teaching ideas—including those for incorporating writing assignments, class/group exercises, and research projects. This rich array of resources is further enhanced with the inclusion of useful planning documents on designing a course, grading and developing team activities, and sample syllabi that outline the incorporation of technology, communication, and group assignments in the tax curriculum. Available on the instructor website.

Solutions Manual

Carefully verified to ensure accuracy, the Solutions Manual reproduces all end-of-chapter materials from the textbook and provides in-depth discussions of the answers to help instructors efficiently grade assignments. Charts that detail all problems by topic have been included to simplify planning and assignment selection. In addition, problems requiring key skills like critical thinking and communication, as well as comprehensive and integrative problems, have been labeled. Available on the instructor website.

Test Bank

The Test Bank helps instructors efficiently assess your students' understanding with problems and questions that reflect the textbook's conceptual approach. The Test Bank offers a variety of question types—including true/false, matching, multiple choice, short answer, and comprehensive problems. Test Bank questions are also identified by level of difficulty for easy selection and have been tagged to Accredited Business Program and AICPA standards. This is particularly valuable during the accreditation process or when your school wants to standardize assessment. Available through Cognero, a full-featured, online assessment system.

Cengage Testing Powered by Cognero

This is a flexible, online system that allows you to: author, edit, and manage test bank content from multiple Cengage solutions create multiple test versions in an instant deliver tests from your LMS, your classroom or wherever you want.

Custom Solutions

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Ensure that your textbook is the perfect match for your course and that your students get the most out of their textbook dollar by giving them exactly what they need. Cengage's Custom Solutions allows you create a personalized textbook—whether that means making a small modification to *Concepts in Federal Taxation* to match your syllabus or combining multiple sources to create something truly unique that fits the way you teach. Contact your Cengage representative to explore Custom Solutions for your course.

STUDENT RESOURCES

Checkpoint Student Edition from Thomson Reuters®

Students are introduced to tax research with access to Checkpoint®, the leading online tax research database. Its intuitive, Web-based design makes it fast and simple to navigate and its comprehensive collection of primary tax law, cases, and rulings is unmatched. Each new copy of this textbook has been automatically bundled with access to Checkpoint® for six months.

Intuit ProConnect Online

Each new copy of this textbook has been automatically bundled with Intuit ProConnect Online access.

ACKNOWLEDGMENTS

The successful completion of this project resulted from the involvement of many special individuals. The authors and publisher would like to thank the following survey participants who helped us think about the many dimensions of the revision:

Susan Anders, *St. Bonaventure University*
Tina Begay, *Salish Kootenai College*
Michael P. Belleman, *St. Clair County Community College*
Cynthia Blanthorne, *University of Rhode Island*
Leon W. Blazey Jr., *Case Western Reserve University*
Patrick Borja, *Citrus College*
Dr. Jack Bower, *Eastern University*
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Darryl L. Brown, *Illinois Wesleyan University*
Carla Cabarle, *Minot State University*
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Roberta Klein, *Rochester Institute of Technology*
Laura Lachmiller, *Bowling Green State University*
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Britton A. McKay, *Georgia Southern University*
Connie Mersch, *Monmouth College*
Cindy Miglietti, *Bowling Green State University Firelands*
Debra J. O'Connor, *College of the Holy Cross*
Chuck Pier, *Angelo State University*
Pamela C. Smith, *The University of Texas at San Antonio*
Marc Spiegel, *University of California, Irvine*
Jason Stanfield, *Purdue University*
Selvi Stanislaus, *Lincoln Law School*
James Sundberg, *Eastern Michigan University*
MaryBeth Tobin, *Bridgewater State University*
Mark Turner, *University of St Thomas–Houston*
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Concepts in Federal Taxation is revised annually. We encourage all adopters to participate in the continuing development of this book by providing comments and suggestions for improving the textbook and supplementary materials. Please address these comments to:

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Thank you again for your support.

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Mark Higgins
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INTRODUCTION

WHY STUDY FEDERAL INCOME TAXATION?

If you are beginning the study of the federal income tax law and plan to become a tax attorney or accountant, why you are taking this course is obvious. But if you want to become a management accountant or auditor, why should you study federal income taxation? Don't accountants rely on tax specialists to do tax research and prepare tax returns? Better yet, why should a business executive, an attorney, a physician, or a farmer take a tax course? Each of them also can, and often does, have professional tax advisers to take care of his or her tax problems. The heart of the answer lies in the fact that most economic transactions have an income tax effect.

The income tax law influences personal decisions of individuals. The decision to buy a house instead of renting one may depend on the after-tax cost of the alternatives. Although the payment of rent reimburses the owner of the dwelling for mortgage interest and property tax, a tenant cannot deduct the cost of renting a home. However, a homeowner can save income tax by deducting home mortgage interest and property tax and perhaps reduce the after-tax cost of buying relative to renting.

Example 1 Zola lives in an apartment she rents for $700 per month. She is considering purchasing a house, which will require an initial cash outlay of $5,000 and monthly payments of $850. Although none of the $5,000 initial down payment is deductible, $800 of the monthly payment is deductible as interest expense. Assuming that Zola earns 6% on her investments and is in the 24% tax rate bracket, what is the after-tax monthly cost of purchasing the house?

Discussion: Assuming that Zola itemizes her deductions, the $800 interest payment will be deductible. Her taxable income will be reduced by $800 per month, resulting in tax savings of $192 ($800 × 24%). This leaves her with a net after-tax house payment of $608. However, she will lose interest income on the $5,000 investment of $25 per month [$5,000 × (6% × 1 = 12)]. She will not have to pay any tax on the lost interest, resulting in an after-tax interest loss of $19 [$25 − ($25 × 24%)]. Her net after-tax monthly cost of purchasing the house is $627 ($608 + $19). Because this is less than her rent of $700, Zola will come out ahead by $73 per month by purchasing the house.

This analysis of Zola's investment in a house considers only the tax aspects of the investment. Clearly, other factors influence the decision to purchase a house—potential appreciation in value, the intangible value of owning your own home, and so on. The point is that the tax consequences are one objective factor to consider when making various decisions, but they are rarely the sole or controlling factor.

Other personal decisions are often influenced by tax savings. For example, a taxpayer may decide to accelerate or defer charitable donations or elective medical treatment to claim the deductions in the year that results in the most significant tax savings. Even child-care decisions may be based on the availability of tax savings in the form of a child-care tax credit.

Example 2 On January 1 of each year, Steve gives $2,000 to his church. For 2019, his income is more than double its usual amount because of a one-time gain from a sale of stock. In a typical year, Steve is in the 24% tax rate bracket. Because of his increased income in 2019, Steve estimates that he will be in the 32% tax rate bracket, but his income will return to normal in 2020. What steps might Steve take to reduce his tax bill?

Discussion: Instead of waiting until January 1, 2020, to make his regular $2,000 donation, which will reduce his tax by $480 ($2,000 × 24%), Steve could pay the contribution in 2019. By taking the deduction in 2019 when he is in the 32% tax

rate bracket, Steve saves $640 ($2,000 × 32%) in tax. By accelerating his $2,000 charitable contribution by a few days, he saves an extra $160 in tax ($640 − $480).

From these examples, you can see that income taxes can and do have an influence on routine decisions. However, the cost of the income tax is more than just the outlay for the tax liability. A knowledge of the income tax laws enables taxpayers to make decisions that can reduce these other costs. By being familiar with the tax laws, an individual can enter into transactions that will provide the best tax result for both the taxpayer and the taxpayer's family. By minimizing the income tax burden, taxpayers conserve wealth that can be put to other uses. Last, taxpayers are responsible for reporting their correct taxable income to the government. Knowing the tax laws protects against audits by the IRS that could result in additional tax owed and penalties for improper reporting of the tax liability.

Significance of Tax Costs

Keeping records and filling out forms to comply with the tax law can consume a substantial amount of time. Table I-1 presents the IRS's estimates of the time involved in record keeping, learning about tax law, preparing a return, and assembling the various commonly filed tax forms. As you can see, the IRS estimates that completing and filing the basic tax return form (Form 1040) requires more than 22 hours on average. When you consider that many taxpayers file a multitude of forms and schedules to detail their tax affairs, the time involved in complying with the tax law is quite substantial.

Tax compliance may also cost a taxpayer money. Taxpayers must weigh the cost of the time and investment needed to prepare their own tax returns, the out-of-pocket cost of hiring a tax preparer to prepare the return, and the risk of additional time and monetary costs for any errors. Thus, taxpayers need to choose whether to save money and spend the time to prepare their own tax returns or to pay to have someone else help determine the proper amount of income tax.

When deciding whether to prepare their own returns, taxpayers should be aware that the amount of income tax shown on the return may contain errors or differences of opinion that may be found in an IRS audit. These differences of opinion can result from a taxpayer's or the tax preparer's lack of familiarity with the tax law and how it applies to the taxpayer. Similarly, the IRS agent performing the audit may not fully understand the

Table I-1

Estimated Average Taxpayer Burden for Individuals by Activity—2018

The average time and costs required to complete and file Form 1040, Form 1040A, Form 1040EZ, their schedules, land accompanying forms will vary depending on individual circumstances. The estimated averages are:

		Average Time Burden (Hours)					
Major Form Filed or Type of Taxpayer	Percentage of Returns	Total Time	Record Keeping	Tax Planning	Form Completion and Submission	All Other	Average Cost (Dollars)
All taxpayers	100	11	5	2	4	1	$200
Type of taxpayer							
Nonbusiness*	70	7	2	1	3	1	110
Business*	30	19	10	3	5	1	400

*You are a "business" filer if you file one or more of the following with Form 1040: Schedule C, C-EZ, E, or F or Form 2106 or 2106-EZ. You are a "nonbusiness" filer if you did not file any of those schedules or forms with Form 1040.

Source: Internal Revenue Service. Form 1040 Instructions, 2018.

law as it applies to a particular situation. In addition to clerical mistakes, tax return errors can result from inadequate communication between a taxpayer and tax preparer. A tax audit may reveal that the taxpayer either is entitled to a refund or owes more tax. If you are entitled to a refund, you have lost the use of the money while it was held by the U.S. Treasury. If you have to pay more tax, you may have to pay extra costs in the form of penalties and interest on the tax you owe. An audit of your return will require an additional investment of your personal time and, quite likely, additional out-of-pocket costs for professional tax advice. In addition, many taxpayers are intimidated when facing an income tax audit.

As your involvement in professional activities increases, taxes and the costs of compliance grow in importance. If you are like most taxpayers, you will want to pay the least tax required by the law. You will also want to spend as little time and money as possible to satisfy the compliance requirements. As Table I-2 shows, in 2001, an average taxpayer worked approximately 119 days to pay federal, state, and local taxes and a taxpayer worked almost one-third (33.26 percent) of the year to pay taxes. Major federal income tax cuts enacted in 2001 and 2003 decreased the number of working days it took from 119 days in 2001 to 105 days in 2004. In 2018, it took an average taxpayer 109 days to pay federal, state, and local taxes. As Table I-2 demonstrates, the amounts paid for taxes represent major expenditures for the typical taxpayer.

Conservation of Wealth

An understanding of basic tax concepts and planning can often help conserve wealth by reducing taxes. To reduce taxes, you need to be able to recognize potential planning situations and problems. Because you know your financial affairs better than anyone else, you are in the best position to spot potential tax-saving opportunities. You should never wait for your tax adviser to find new ways to save you taxes. Although a competent tax adviser will know about tax-planning techniques and current tax developments, you will be more familiar than an adviser is with your financial affairs and objectives. A tax adviser is best used in the same way you use other professionals. When you visit your physician, you usually describe the symptom that brought you to the office to help the doctor identify the proper treatment. When you visit your attorney for a legal problem, you take along the information necessary to help the lawyer identify the legal issues. In both instances, you evaluate information and decide when you need professional assistance. Likewise, you will need to evaluate information, based on your understanding of the tax laws, to determine when you need to consult a professional tax adviser.

Table I-2

Tax Freedom Day

Tax Year	Freedom Day	Number of Days	% of Year
2001	April 29	119	32.6
2002	April 17	107	29.3
2003	April 14	104	28.5
2004	April 15	105	28.8
2005	April 21	117	30.4
2006	April 24	114	31.2
2008	April 16	106	29.0
2009	April 8	98	26.8
2009	April 12	102	27.9
2012	April 17	107	29.2
2013	April 18	108	29.4
2014	April 21	111	30.4
2015	April 24	114	31.2
2016	April 24	114	31.1
2017	April 23	113	30.9
2018	April 19	109	29.9

Source: Tax Foundation, Special Report, Tax Freedom Day 2018, April 2018.

Example 3 Gwen, 19, is a full-time student at State University. Her parents pay all her expenses, which total $12,000 a year. Gwen does not have any other source of support, and she does not pay any income tax. Gwen's father, Marty, owns a substantial portfolio of bonds that earns $12,000 in income each year. Marty is in the 32% tax rate bracket.

Discussion: A tax plan could save Marty money by transferring ownership of the bond portfolio to Gwen, who is in a lower tax bracket. Marty pays $3,840 ($12,000 × 32%) in tax on the investment income. The amount of income left after paying tax is $8,160 ($12,000 − $3,840).

If Marty gave the bond portfolio to Gwen as a gift (which is not subject to income tax), she would be taxed on the income at a lower tax rate than her father. Assuming that Gwen has no other income, her tax on the income would be $1,124. The family could save $2,716 ($3,840 − $1,124) in tax by shifting the income to Gwen. The amount of income left after paying tax is increased to $10,876 ($12,000 − $1,124).

Taxes Influence Routine Decisions

An auditor, management accountant, attorney, physician, or farmer may never prepare a business tax return. Yet, they need a general understanding of the tax effects of their daily business decisions. For example, an auditor might find that an improperly recorded transaction results in an undisclosed tax liability or refund. A managerial accountant may need to consider the tax effects of buying or selling plant assets or acquiring a new business. To provide reliable advice to clients, lawyers often need a general understanding of how the tax laws apply to different types of entities. A doctor may need a general understanding of fringe-benefit plans that can be set up to keep highly qualified nurses and medical technicians as employees. A farmer can benefit from familiarity with the complex rules that govern reporting of income from farm production and the deduction of farm expenses. Individuals can also benefit from a knowledge of the tax laws in their everyday decisions.

Example 4 Isaac wants to remodel his house. During a special promotion, his bank will finance the purchase with a 7% unsecured personal loan. Isaac knows that he can obtain a home equity loan from his bank at 8% interest. If Isaac is in the 24% tax bracket, which loan should he use to finance his remodeling?

Discussion: Interest paid on personal loans is not deductible. However, interest paid on a home equity loan is deductible and treated as acquisition indebtedness if the funds are used to substantially improve the taxpayer's home. If Isaac itemizes his deductions, the interest on the home equity loan is deductible. This makes the real after-tax cost of the home equity loan 6.08% [8% − (8% × 24%)]. Therefore, the home equity loan actually offers a lower after-tax cost than the personal loan.

However, note that if Isaac does not itemize deductions (i.e., he uses the standard deduction), he receives no benefit from the deduction for home equity loan interest. In this case, the personal loan would have a lower after-tax cost, because neither loan would produce deductible interest.

Self-Protection

Another reason for being aware of the federal income tax law is self-protection. Perhaps you have heard others say that all they have to do is give a list of income and deduction items to their tax return preparer. When they get the completed tax return back and pay the tax due, their responsibility for complying with the tax law is finished. If any mistakes are made, it is the preparer's problem. This assumption is erroneous and can lead to disaster.

Taxpayers are fully liable for additional tax, interest, and penalties due because of an error on their tax return. If a person paid to prepare a return misinterprets the information and/or makes a mistake that results in an underpayment of tax, the taxpayer will have to pay any additional amounts owed to the government. Whether the preparer will reimburse the taxpayer for the penalties and interest depends on the agreement with the preparer. Legal recourse against the preparer is available in certain circumstances, but the cost of obtaining reimbursement (e.g., legal fees, court costs) from the preparer may be prohibitive. For your own protection, you should always examine the completed

return. Before you sign and file the return, thoroughly review it with your preparer and be sure you understand any entries that do not seem to be correct. Again, a knowledge of the tax law can help you catch errors or other misrepresentations made by a tax preparer before the return is filed.

Example 5 Raul gives his tax return preparer a list of income and deduction items to be reported on his tax return. The income items total $50,000, and the deduction items total $14,000. When the preparer puts the information on the return, he omits $10,000 of the income and reports only $40,000 ($50,000 − $10,000) in income. In addition, the preparer includes a $2,000 deduction twice so that total deductions are reported as $16,000. As a result, Raul understates his taxable income by $12,000 ($36,000 correct taxable income − $24,000 reported taxable income).

Discussion: If the IRS detects the errors on the return, Raul will have to pay the IRS the additional tax due on the $12,000 understatement plus penalties and interest. Depending on their agreement for preparing the return, Raul may or may not recover part of his costs from the preparer. If the preparer does not agree to reimburse Raul for his mistakes, Raul may take legal action to obtain the amount due from the preparer. However, this can be a costly process and may not be worth the additional tax, penalties, and interest due.

Clearly, all taxpayers can benefit from a basic knowledge of the tax law. Although the federal income tax is only one of many taxes that government bodies use to raise revenue, it is by far the most important in terms of revenue produced and the number of taxpayers affected. Therefore, this book focuses on federal income tax law.

Federal income tax law is a complex array of statutory, administrative, and judicial authorities. Because of its ability to affect taxpayer's decisions, lawmakers frequently make changes in the tax law to achieve economic, social, and/or political objectives. This causes the tax law to be in constant evolution. Professional tax advisers spend a significant portion of their time maintaining their knowledge of this changing body of law. Fortunately, many aspects of the tax law have remained stable over time. The approach used in this book is to provide a conceptual framework for analyzing how particular transactions should be treated for federal income tax purposes. The book then presents the general operation of the tax law and explains it in terms of the basic concepts. Throughout the book, the focus of the discussion is on those aspects of the federal income tax that have remained stable over time. A knowledge of the basic operation of the tax law will enhance your ability to make the best decisions for your individual situation.

Conceptual Foundations of the Tax Law

PART 1

Every society makes choices as to the tax systems that not only raise the necessary revenues to support government expenditures, but within that choice are also inherent reflections of societal values. Not only does a society choose a tax system but the tax system also becomes one of the basic institutions that in itself shapes and molds the society.

—Karen M. Yeager

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Federal Income Taxation—An Overview

1

Learning Objectives:

LO 1 Discuss what constitutes a tax and the various types of tax rate structures that may be used to calculate a tax.

LO 2 Introduce the major types of taxes in the United States.

LO 3 Identify the primary sources of federal income tax law.

LO 4 Define *taxable income* and other commonly used tax terms.

LO 5 Discuss the IRS audit process and taxpayer rights within the process.

LO 6 Introduce the calculation of taxable income for individual taxpayers and the unique personal deductions allowed to individuals.

LO 7 Develop a framework for tax planning and discuss the effect of marginal tax rates and the time value of money on tax planning.

LO 8 Make the distinction between tax avoidance and tax evasion.

LO 9 Introduce ethical considerations related to tax practice.

1-1 INTRODUCTION

We have all heard the adage, "There's nothing certain but death and taxes." However, equating death and taxes is hardly a fair characterization of taxation. It is often stated that taxes are the price we pay for a civilized society. An early decision of the U.S. Supreme Court described a tax as "an extraction for the support of the government." Regardless of your personal view of taxation, society as we know it could not function without some system of taxation. People constantly demand that the government provide them with various services, such as defense, roads, schools, unemployment benefits, medical care, and environmental protection. The cost of providing the services that the residents of the United States demand is principally taxation. People are introduced to taxation at an early age. Remember the candy bar that had a price sticker of 90 cents yet actually cost 96 cents? The tax collector is all around us. Upon receiving their first paycheck, many are surprised that the $100 they earned resulted in a check of only $80 after taxes were deducted. The point is that taxes are a fact of life. Learning to deal with taxes, and perhaps using them to your advantage, is an essential element of success in today's world.

The federal income tax is a sophisticated and complex array of laws that imposes a tax on the income of individuals, corporations, estates, and trusts. Current tax law has developed over a period of more than 100 years through a dynamic process involving political, economic, and social forces. At this very minute, Congress is considering various changes in the tax law; the Internal Revenue Service (IRS) and the courts are issuing new interpretations of current tax law, and professional tax advisers are working to determine the meaning of all these changes.

The purpose of this book is to provide an introduction to the basic operation of the federal income tax system. However, before looking at some of the specifics, it is helpful to have a broad understanding of taxes and how the federal income tax fits into the overall scheme of revenue production. Toward this end, this chapter briefly discusses what constitutes a tax, how taxes are structured, and the major types of taxes in the United States before considering the federal income tax. Next, the primary sources of tax law authority are introduced. These sources provide the basis for calculating the tax and the unique terminology of federal income taxation. This chapter also introduces the tax calculation for individuals, the discussion of which serves as a reference for discussions in

succeeding chapters. The next section of the chapter provides a framework for tax planning and a discussion of tax avoidance and tax evasion.

Because ethics is an important issue in the accounting profession, the chapter concludes with a brief discussion of the ethical considerations related to tax practice. The discussion provides the background that will help you detect ethical issues that you will face if you go on to practice in the tax area.

1-2 DEFINITION AND EVALUATION OF A TAX

LO 1
Discuss what constitutes a tax and the various types of tax rate structures that may be used to calculate a tax.

Because this is a tax text, one starting point is to define what is meant by the term *tax*. Particular types of taxes and tax rules are often criticized as being loopholes, unfair, or creating an excessive burden on a particular group of taxpayers. The discussion that follows presents the four criteria commonly used to evaluate these criticisms. In addition, three types of tax rate structure are presented as an aid in evaluating whether a particular tax is "good" or "bad."

1-2a Definition of a Tax

What is a tax? The IRS defines a tax as "an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes. Taxes are not payments for some special privilege granted or service rendered and are, therefore, distinguishable from various other charges imposed for particular purposes under particular powers or functions of government."[1]

A tax could be viewed as an involuntary contribution required by law to finance the functions of government. The amount of the contribution extracted from the taxpayer is unrelated to any privilege, benefit, or service received from the government agency imposing the tax. According to the IRS definition, a tax has the following characteristics:

1. The payment to the governmental authority is required by law.
2. The payment is required pursuant to the legislative power to tax.
3. The purpose of requiring the payment is to provide revenue to be used for public or governmental purposes.
4. Special benefits, services, or privileges are not received as a result of making the payment. The payment is not a fine or penalty that is imposed under other powers of government.

Although the IRS definition states that the payment of a tax does not provide the taxpayer with directly measurable benefits, the taxpayer does benefit from, among other things, military security, a legal system, and a relatively stable political, economic, and social environment. Payments to a government agency that relate to the receipt of a specific benefit—in privileges or services—are not considered taxes. They are payments for value received or are the result of a regulatory measure imposed by the government agency.

Example 1 Keith lives in Randal County, which enacted a law setting a 1% property tax to provide money for county schools. The 1% tax applies to all property owners in Randal County. All schoolchildren in the county will benefit from the tax, even if their parents do not own property or pay the tax. Is the 1% property tax a tax according to the definition?

Discussion: The property tax is a tax. The tax is a required payment to a government unit. The payment is imposed by a property tax law. The purpose of the payment is to finance public schools. The tax is levied without regard to whether the taxpayer receives a benefit from paying the tax.

Example 2 Assume that in example 1, the tax is imposed on a limited group of property owners to finance the construction of sewer lines to their properties. Is the 1% tax a tax as defined by the IRS?

Discussion: Each payer of the tax receives a direct benefit—a new sewer line. Therefore, the 1% tax payment is considered a payment to the government unit to

reimburse it for improvements to the taxpayer's property. The taxpayers would treat the payment as an investment in their property and not as a tax. The 1% tax in this case is a special assessment for local benefits. An assessment differs from a tax in that an assessment is levied only on a specific group of taxpayers who receive the benefit of the assessment.

Certain payments that look like a tax are not considered a tax under the IRS definition. For example, an annual licensing fee paid to a state to engage in a specific occupation such as medicine, law, or accounting is not a tax because it is a regulatory measure that provides a direct benefit to the payer of the fee. A fee paid for driving on a toll road, the quarter deposited in a parking meter, and payments to a city for water and sewer services are payments for value received and are not taxes according to the IRS's definition. Fines for violating public laws and penalties on tax returns are not taxes. Fines and penalties are generally imposed to discourage behavior that is harmful to the public interest and not to raise revenue to finance government operations.

1-2b Standards for Evaluating a Tax

In *The Wealth of Nations*, Adam Smith identified four basic requirements for a good tax system. Although other criteria can be used to evaluate a tax, Smith's four points are generally accepted as valid and provide a basis for discussion of the primary issues regarding taxes. These requirements are equality, certainty, convenience, and economy. Although Smith clearly stated the maxims, taxpayers have different opinions as to whether the federal income tax strictly satisfies the four requirements.

1. **Equality**—A tax should be based on the taxpayer's *ability to pay*. The payment of a tax in proportion to the taxpayer's level of income results in an equitable distribution of the cost of supporting the government.

The concept of equality requires consideration of both horizontal and vertical equity. **Horizontal equity** exists when two similarly situated taxpayers are taxed the same. **Vertical equity** exists when taxpayers with different situations are taxed differently but fairly in relation to each taxpayer's ability to pay the tax. This means that those taxpayers who have the greatest ability to pay the tax should pay the greatest proportion of the tax. These equity concepts are reflected to a great extent in the federal income tax. Certain low-income individuals pay no tax. As a person's taxable income level increases, the tax rate increases from 10 percent to 12 percent to 22 percent to 24 percent to 32 percent to 35 percent to 37 percent.

Example 3 Tom and Jerry each earn $15,000 a year and pay $1,500 in tax.

Discussion: The two taxpayers pay the same amount of tax on the same amount of income. Because they are treated the same, based on the facts given, horizontal equity exists.

A slight change of facts provides a different result. If Tom is married and supports his wife and 3 children and Jerry is single with no one else to support, the tax appears unfair and not vertically equitable. The lack of vertical equity exists because the taxpayers' situations are no longer the same, yet they pay the same amount of tax on the same income.

Example 4 Assume that because of the size of his family, Tom (example 3) pays $500 in taxes. Jerry still pays $1,500.

Discussion: In this situation, vertical equity is considered to be present. Because he presumably has a greater ability to pay tax, Jerry pays a larger amount of tax than Tom—Jerry's income, although equal to Tom's, supports fewer people.

Some taxpayers consider inequitable the tax law provisions that treat similar income and deductions differently. For example, a person investing in bonds issued by a city does not have to pay tax on the interest income. In contrast, interest income earned on

an investment in corporate bonds is taxed. People who operate proprietorships may deduct the cost of providing their employees with group term life insurance but may not deduct the cost of their own group insurance premium. If the proprietor incorporates, the cost of the insurance for both the shareholder-employee (owner) and employees can be deducted. Thus, the perception of equality often depends on the taxpayer's personal viewpoint. Because the concepts of equity are highly subjective, a tax rule considered equitable by one taxpayer is often considered unfair by a taxpayer who derives no benefit. Often, when evaluating the equality of a tax provision, taxpayers do not consider—or are not aware of—the economic, social, and administrative reasons for what may seem to be an inequity in the tax law.

Example 5 Karen is a single mother who earns $10,000 a year. Jane and her husband, Ben, earn $75,000 a year. Karen and Jane each pay Neighborhood Day Care $2,000 per year for taking care of one child while they work. Because the payment is for qualified child care, Karen is entitled to a $700 reduction in her income tax because of her low income level. Because of their high income level, Jane and Ben receive only a $400 reduction in their income tax. Who is more likely to view this treatment as being inequitable?

Discussion: Jane and Ben may view the tax rule as unfair because Karen receives a larger reduction in tax for the same amount of payment for day care. However, there is increasing emphasis on tax relief for families. Congress has decided that it is important that children be adequately cared for while parents are at work. Thus, Karen's family is given a larger tax break to help provide child care. Without the larger tax reduction, Karen might not be able to afford to pay child-care costs. The difference in treatment could also be based on the ability to pay child-care costs. In addition, the difference in treatment depicts a situation of vertical equity. Because Jane and Ben have higher incomes, vertical equity requires that they pay a higher tax (through receiving a smaller tax credit).

2. Certainty—A taxpayer should know when and how a tax is to be paid. In addition, the taxpayer should be able to determine the amount of tax to be paid.

Certainty in the tax law is necessary for tax planning. An individual's federal income tax return is due on the fifteenth day of the fourth month (usually April 15) after the close of the tax year. A corporation's return is due on the fifteenth day of the fourth month after the close of its tax year.[2] The balance of tax due with the return is usually paid by check to the IRS. However, determining the amount of tax due may not be so simple. When planning an investment that will extend over several tax years, the ability to predict with some degree of certainty how the results of the investment will be taxed is important to the investment decision. Frequent changes in the tax law create uncertainty for the tax planner. In addition to these legislative amendments to the tax law, the IRS and the courts issue a constant stream of decisions and interpretations on tax issues, which results in a tax law that is in a continual state of refinement. However, for the average individual taxpayer, who has wages subject to withholding, receives some interest income, owns a home, pays state and local taxes, and perhaps donates to a church or other charities, there is little complexity and a great deal of certainty in the tax law despite the numerous changes to the tax system.

3. Convenience—A tax should be levied at the time it is most likely to be convenient for the taxpayer to make the payment. The most convenient time for taxpayers to make the payment is as they receive income and have the money available to pay the tax.

Most taxpayers would argue that it is not convenient to keep records, determine the amount of tax due, and fill out complex forms. However, certain aspects of the income tax law make it more convenient than it might be otherwise. Based on the **pay-as-you-go concept**, taxes are paid as close to the time the income is earned as is reasonable. The pay-as-you-go system results in the collection of the tax when the taxpayer has the money to pay the tax. This tax payment system applies to all taxpayers, including the self-employed and those who earn their income from investing activities. This system is discussed in more detail later in this chapter.

The federal income tax is based on self-assessment and voluntary compliance with the tax law. Taxpayers determine in privacy the amount of their income, deductions, and tax due. The tax calculated by the taxpayer is considered correct unless the IRS detects an error and corrects it or selects the return for an audit. The federal income tax system relies on the honesty and integrity of taxpayers in determining their tax payments. This system of self-assessment and voluntary compliance promotes convenience for taxpayers.

> **4. Economy**—A tax should have minimum compliance and administrative costs. The costs of compliance and administration should be kept at a minimum so that the amount that goes to the U.S. Treasury is as large as possible.

The IRS operates on a budget of about one-half of 1 percent of the total taxes collected. However, the IRS's budget does not reflect the full cost of administering the tax law. A taxpayer's personal cost of compliance can be substantial. Taxpayers often need to maintain accounting records for tax reporting in addition to those that are necessary for business decisions. A corporation, for example, might use different depreciation methods and asset lives for financial reporting and for income tax. The taxpayer's personal cost also includes fees paid to attorneys, accountants, and other tax advisers for tax-planning, compliance, and litigation services.

1-2c Tax Rates and Structures

Tax rates are often referred to as a *marginal rate*, an *average rate*, or an *effective rate*. In addition, a tax rate structure is frequently described as being *proportional*, *regressive*, or *progressive*. Because a tax rate structure indicates how the average tax rate varies with changes in its tax base, examining a rate's structure helps in understanding and evaluating the effect of a tax.

To compute a tax, it is necessary to know the tax base and the applicable tax rate. The tax is then computed by multiplying the tax base by the tax rate:

$$\text{Tax} = \text{Tax base} \times \text{Tax rate}$$

A **tax base** is the value that is subject to tax. The tax base for the federal income tax is called **taxable income**. Other common tax bases include the dollar amount of a purchase subject to sales tax, the dollars of an employee's wages subject to payroll tax, and the assessed value of property subject to property tax.

Tax Rate Definitions

When working with the federal income tax, different measures of the rate of tax paid from one year to the next are often compared to evaluate the effectiveness of tax planning and to help make decisions about future transactions. Three different rates are commonly used for these comparisons:

- The marginal tax rate
- The average tax rate
- The effective tax rate

The **marginal tax rate** is the rate of tax that will be paid on the next dollar of income or the rate of tax that will be saved by the next dollar of deduction. The marginal tax rate is used in tax planning to determine the effect of reporting additional income or deductions during a tax year. One objective of tax planning is to minimize the marginal rate and to keep the marginal rate relatively constant from one year to the next. The marginal tax rates for an individual taxpayer are 10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent, and 37 percent.[3] If you know a person's taxable income (the tax base), you can find the marginal tax rate in the tax rate schedules in Appendix B.

Example 6 Don has an asset he could sell this year at a $10,000 profit, which would increase his marginal tax rate from 12% to 22%. If he waits until next year to sell the asset, he is sure his other income will be less and the $10,000 gain will be taxed at 12%. Should Don sell the asset this year or wait until next year?

Discussion: By waiting until next year to sell the asset, Don's tax savings on the sale are $1,000 [$10,000 × (22% − 12%)]. In addition, he will postpone the payment of the tax interest-free for a year (a time value of money savings). Assuming that he can sell the asset early in the next year and does not need the proceeds from the sale before next year, he should wait until next year to sell the asset to take advantage of the lower marginal tax rate and the time value of money savings on the tax to be paid on the gain.

The **average tax rate** is the total federal income tax divided by taxable income (the tax base). This is the average rate of tax on each dollar of income that is taxable. The **effective tax rate** is the total federal income tax divided by the taxpayer's economic income (taxable income plus nontaxable income). Economic income is a broader base; it includes all the taxpayer's income, whether it is subject to tax or not. The effective tax rate is the average rate of tax on income from all taxable and nontaxable sources.

Example 7 Assume that in example 6, Don sells the asset in 2019 and reports taxable income of $40,000. Also, Don collects $50,000 on a life insurance policy that is not taxable income. Don's tax on $40,000 is $4,740 (using the tax rate schedules in Appendix B). In addition, the only difference between Don's economic income and his taxable income is proceeds from the life insurance policy. What are Don's marginal, average, and effective tax rates?

Discussion: Based on the facts given, Don's marginal tax rate is 22% (from the tax rate schedules). His average tax rate is 11.65% ($4,659 ÷ $40,000). The effective tax rate on his economic income of $90,000 ($40,000 in taxable income + $50,000 in nontaxable income) is 5.18% ($4,659 ÷ $90,000) and is much less than both the marginal and average tax rates.

Tax Rate Structures

Tax rate structures are described as being proportional, regressive, or progressive. The structures explain how the tax rates vary with a change in the amount subject to the tax (the tax base).

Proportional Rate Structure A **proportional rate structure** is defined as a tax for which the average tax rate remains the same as the tax base increases. This rate structure is also referred to as a *flat tax*. If you charted a proportional tax rate structure on a graph, it would look like Chart 1 in Figure 1-1.

If a tax rate is proportional, the marginal tax rate and the average tax rate are the same at all levels of the tax base. As the tax base increases, the total tax paid will increase at a constant rate. Examples of proportional taxes are sales taxes, real estate and personal property taxes, and certain excise taxes, such as the tax on gasoline. The sales tax is a fixed percentage of the amount purchased, property tax is a constant rate multiplied by the assessed value of the property, and the gas tax is a constant rate per gallon purchased.

Example 8 Betsy bought a new suit for $350. The sales tax at 7% totaled $24.50. Steve bought a new lawn tractor for $3,500. At 7%, the sales tax he paid came to $245. Is the sales tax proportional?

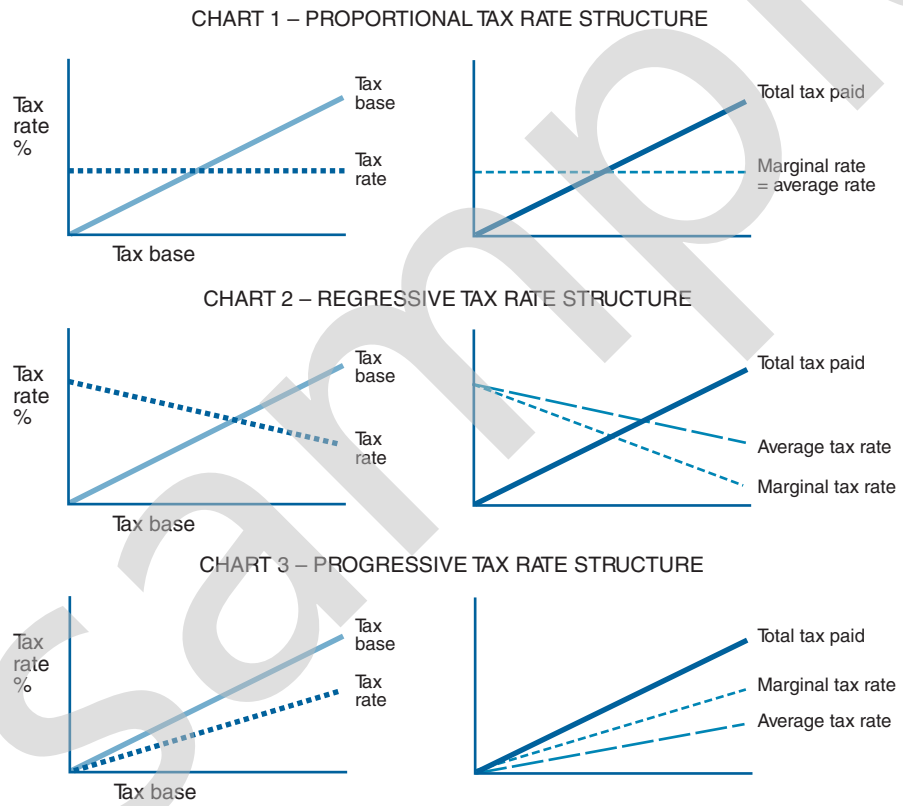
Discussion: Betsy's and Steve's marginal tax rate is 7%. In addition, Betsy's average tax rate is 7% ($24.50 ÷ $350), the same as Steve's (7% = $245 ÷ $3,500). The sales tax is proportional because the marginal and average tax rates are equal at all levels of the tax base (the selling price).

Regressive Rate Structure A **regressive rate structure** is defined as a tax in which the average tax rate decreases as the tax base increases. On a graph, a regressive tax rate structure would look like Chart 2 in Figure 1-1.

If a tax rate structure is regressive, the marginal tax rate will be less than the average tax rate as the tax base increases. Note that although the average tax rate and the marginal tax rate both decrease as the tax base increases, the total tax paid will increase. As a result, a person with a low tax base will pay a higher average and a higher marginal rate of tax than will a person with a high tax base. The person with the high tax base will still

Figure 1-1

Tax Rate Structures



pay more dollars in total tax. Although a pure regressive tax rate structure (as defined earlier) does not exist in the United States, example 9 illustrates a regressive tax.

Example 9 Each year, Alan purchases $4,000 worth of egg rolls and Tranh purchases $17,000 worth of egg rolls. A tax is levied according to the dollar value of egg rolls purchased per the following tax schedule:

Tax Rate Schedule		Alan		Tranh	
Base	**Rate**	**Purchases**	**Tax**	**Purchases**	**Tax**
$-0- < $5,001	10%	$4,000	$ 400	$ 5,000	$ 500
$5,001 < $10,001	7%			5,000	350
More than $10,000	5%			7,000	350
Totals		$4,000	$ 400	$17,000	$1,200
Marginal tax rate			10%		5.0%
Average tax rate			10%		7.1%

Discussion: This tax rate schedule is regressive. The average tax rate applicable to Alan (10%) is greater than the average tax rate for Tranh (7.1%), even though Tranh's tax base is higher. Note that Tranh pays more total tax ($1,200) than Alan ($400).

If a different base is used to evaluate the tax rate structure, the same tax that may be viewed as proportional by one taxpayer may be considered regressive by another taxpayer. For example, using total wages as the tax base for evaluation, a person who spends part of her wages for items subject to sales tax would pay a lower average rate of tax than the person who spends all of his wages on taxable items.

Example 10 Judy earns $25,000 a year and spends it all on items subject to sales tax. Guillermo earns $30,000 a year and is able to save $5,000 of his earnings. He spends the remaining $25,000 on purchases subject to sales tax. If the sales tax rate is 10% of purchase price, is it a regressive tax?

Discussion: Judy and Guillermo pay the same total sales tax ($2,500). Thus, the tax is proportional when evaluated by using purchases as the tax base. However, Guillermo's average tax rate based on wages [8.3% = ($2,500 ÷ $30,000)] is less than Judy's [10% = ($2,500 ÷ $25,000)]. Thus, the sales tax is regressive when using wages to evaluate the tax.

Although property taxes are a proportional tax according to these definitions, an investor in property subject to property taxes might consider the effect of the tax on investments regressive compared with investments in stocks and bonds, which are not subject to property taxes. Similarly, low-income wage earners who pay Social Security tax on all their wages may consider this tax regressive compared with a person whose wages exceed the amount subject to the tax.

Progressive Rate Structure A **progressive rate structure** is defined as a tax in which the average tax rate increases as the tax base increases. On a graph, a progressive tax rate structure would look like Chart 3 in Figure 1-1.

If a tax rate structure is progressive, the marginal tax rate will be higher than the average tax rate as the tax base increases. The average tax rate, the marginal tax rate, and the total tax all increase with increases in the tax base. A person with a low tax base will pay both lower average and marginal rates of tax than will a person with a high tax base.

The progressive tax rate structure reflects the embedding in the federal income tax rates of Adam Smith's equality criterion. Recall that according to this criterion, taxpayers should pay according to their ability to pay the tax. The use of progressive rate structures, wherein people with higher taxable income levels pay higher marginal tax rates, promotes equality.

Example 11 Doug reports $22,000 a year in taxable income from wages he earns watering the greens at the Hot Water Golf Course. Shawana earns $47,000 in annual taxable income as a first grade teacher.

Discussion: Doug and Shawana's 2019 income taxes using the single taxpayer rates are as follows:

	Doug's Tax (income: $22,000)	Shawana's Tax (income: $47,000)
Tax on income of $9,700 @ 10%	$ 970	$ 970
Tax on income from $9,701 to $39,475 @ 12%	1,476	3,573
Tax on income above $39,475 @ 22%	-0-	1,656
Total tax	$2,446	$6,199
Marginal tax rate	12%	22%
Average tax rate	11.1%	13.2%

Discussion: As a result of Shawana's larger tax base and the progressive tax rates, her marginal and average tax rates are higher than Doug's. Thus, the tax rate structure of the federal income tax promotes equality among taxpayers.

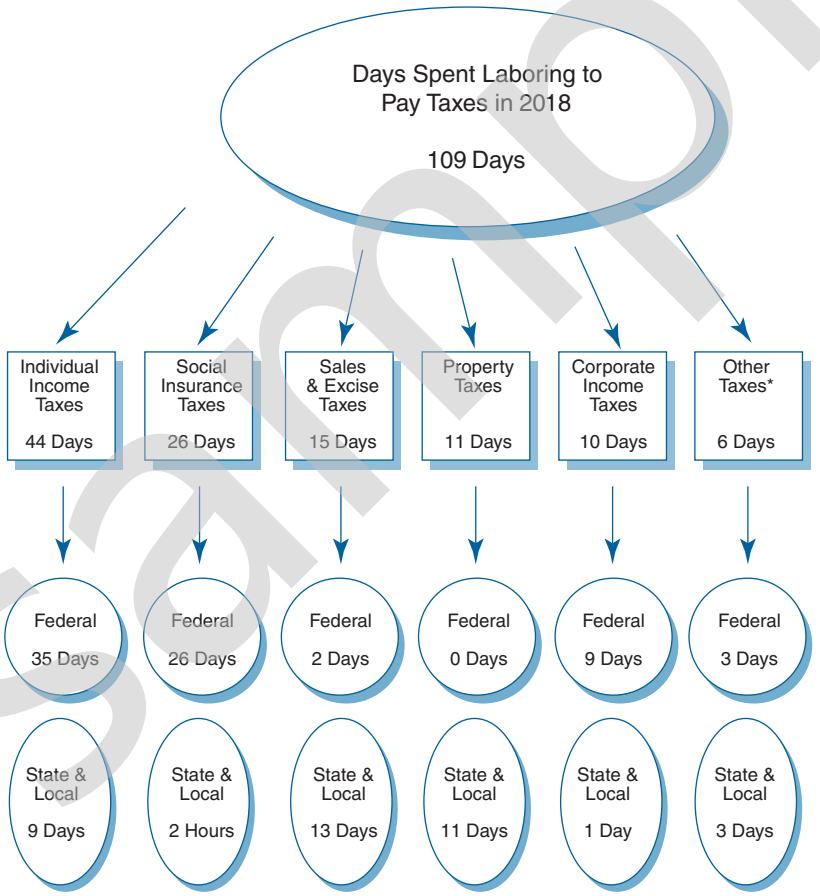
1-3 MAJOR TYPES OF U.S. TAXES

LO 2
Introduce the major types of taxes in the United States.

The federal, state, and local governments use a variety of taxes to fund their operations. Figure 1-2 shows the average number of days worked to pay various taxes in 2018. On average, over 30 percent of the year is devoted to paying various taxes. An analysis of the revenue sources shows that 70 of the 75 days spent working to pay federal taxes were devoted to payment of the income tax (individual and corporate) and social insurance taxes. For states, sales and excise taxes, property taxes, and income taxes require 34 of the 39 days spent working to pay state taxes. By implication, the individual federal

Figure 1-2

Average Number of Days Worked to Pay Taxes by Type of Tax and Level of Government Calendar Year 2018



*Includes other business taxes.
Note: Due to rounding, components do not add up to total.
Sources: Bureau of Economic Analysis and Tax Foundation calculations.

income tax (35 days) produces nearly as much revenue as all forms of state and local taxes (39 days). It should also be noted that social insurance taxes (26 days) provide almost as much revenue to the federal government as individual income taxes (35 days). Although this text covers the basic operation of the federal income tax, it is helpful to have a basic understanding of the other taxes levied by governments. As will be seen throughout the text, many taxes affect and interact with the rules for the federal income tax. Each major type of tax is discussed briefly in turn. Do not be concerned with the mechanics of the taxes at this point. Focus only on their general nature.

1-3a Income Taxes

The federal government levies a tax on the income of individuals, corporations, estates, and trusts. Most states also tax the income on these taxpayers, and a few local governments also impose an income tax on those who work or live within their boundaries. The income tax is levied on a *net* number—taxable income. In its simplest form, taxable income is the difference between the total income of a taxpayer and the deductions allowed that taxpayer. Thus, the study of income taxation is really the study of what

must be reported as income and what is allowed as a deduction from that income to arrive at taxable income.

Each of the three government units that impose an income tax has its own set of rules for determining what is included in income and what is deductible from income to arrive at taxable income. Because most state and local governments begin their taxable income calculations in relation to the federal income tax computation, an understanding of the federal income tax rules is essential for calculating most income taxes. This book makes no attempt to cover the myriad state and local income tax rules.

Income taxes are determined on an annual basis. However, the United States uses a pay-as-you-go collection system under which taxpayers pay an estimate of their tax as they earn their income. Employers must withhold income taxes from wages and salaries of their employees and remit them on a timely basis to the appropriate government body.[4] When taxpayers file their tax returns, these prepaid amounts are credited against their actual bill, resulting in either a refund of taxes, if the prepaid amount is greater than the actual tax, or an additional tax due, if the prepaid amount is deficient.[5] Self-employed taxpayers and those with other sources of income that are not subject to withholding (e.g., dividend and interest income) must make quarterly estimated tax payments that are applied against their tax bills upon filing of the return.[6]

1-3b Employment Taxes

All employees and their employers pay taxes on the wages earned by employees. Employees pay **Social Security taxes** that are matched by their employers.[7] Self-employed individuals pay the equivalent of both halves of the Social Security tax by paying the **self-employment tax**.[8] In addition to the Social Security tax, employers pay unemployment compensation taxes to both the federal and state governments.

Social Security Taxes

Under the Federal Insurance Contribution Act (FICA), a tax is levied on wages and salaries earned. The Social Security system was originally designed to provide retirement benefits to all individuals who contributed to the system. This function has been expanded to include many other social programs, such as medical insurance, disability benefits, and survivor's benefits. The result of this expansion of coverage has been a great increase in the amount of Social Security taxes paid by workers and employers. It should be stressed that the Social Security system is not a "funded" system. Current payments into the system are used to pay current benefits; technically, any excess is placed in a fund. However, the federal government often borrows against this "fund" to pay general government expenses. Thus, there is no absolute guarantee that the amounts paid by current taxpayers will actually be available to them when they are eligible to receive their benefits.

The Social Security tax is imposed on employees and self-employed individuals. Employers are required to match employees' payments into the system.[9] Because a self-employed person is both an employee and an employer, the self-employment tax rate is twice the employee tax, resulting in an equivalent payment of tax by employee/employer and the self-employed.[10] The tax on employees and employers is a constant percentage of wages up to a maximum wage base. Both the percentage and the maximum wage base have been raised over time. As Table 1-1 shows, the tax has two components. A tax of 6.2 percent is levied on the first $132,900 of wages for Old Age, Survivors, and Disability Insurance (OASDI). A tax of 1.45 percent on all wages pays for Medical Health Insurance (MHI).

Example 12 Jenny earned $2,000 during February 2019 in her job as a carpenter for Acme Construction Company. How much Social Security tax must be paid by Jenny and Acme on her February earnings?

Discussion: Jenny must pay 6.2% (OASDI) and 1.45% (MHI) on the first $132,900 of income earned in 2019. Thus, Jenny must pay $153 [($2,000 × 6.2%) + ($2,000 × 1.45%)] in Social Security taxes on her wages. Acme must match the $153 in Social Security taxes Jenny paid on the wages.

Table 1-1

Social Security Tax Rates for Employees and Employers

Year	OASDI[1]	MHI[2]	Total	Maximum Wage Base	Maximum Tax Paid
2015	6.20		6.20	$118,500	$7,254
		1.45	1.45	Wages earned	No maximum
			7.65		
2016	6.20		6.20	$118,500	$7,347
		1.45	1.45	Wages earned	No maximum
			7.65		
2017	6.20		6.20	$127,200	$7,886
		1.45	1.45	Wages earned	No maximum
			7.65		
2018	6.20		6.20	$128,400	$7,961
		1.45	1.45	Wages earned	No maximum
			7.65		
2019	6.20		6.20	$132,900	$8,240
		1.45	1.45	Wages earned	No maximum
			7.65		

[1]Old Age, Survivors, and Disability Insurance
[2]Medical Health Insurance

Example 13 Chandra earned $140,000 as the administrator of the Local Accounting Program in 2019. How much Social Security tax does Chandra pay in 2019?

Discussion: Chandra pays the maximum OASDI of $8,240 (6.2% × $132,900) and $2,030 (1.45% × $140,000) of MHI for a total Social Security payment of $10,270. Her employer is required to pay the same amount on Chandra's behalf.

As with income taxes, Social Security taxes are withheld from the employee's pay by the employer and remitted to the federal government with the employer's Social Security payment and other federal tax withholdings.

Example 14 Assume that in example 12, Acme also withheld $312 in federal income tax and $87 in state income tax from Jenny's February earnings. What is Jenny's actual take-home pay for February?

Discussion: Jenny's February take-home pay is $1,448 after withholding for income tax and Social Security. Out of her earnings of $2,000, $153 is withheld for payment of Social Security tax, $312 for federal income tax, and $87 for state income tax. Acme must pay these taxes to the appropriate government units on a timely basis. Acme will also remit its $153 in Social Security taxes on Jenny's wages when it makes Jenny's payments.

Self-employed individuals pay a tax equal to the sum of the employee's and employer's payments. Thus in 2019, net self-employment income is subject to a tax of 12.4 percent (6.2% × 2) on the first $132,900 of income for OASDI and 2.9 percent (1.45% × 2) on all net self-employment income for MHI. Because employees are not taxed on the Social Security contribution made on their behalf by their employers, self-employed taxpayers are allowed to deduct one-half of their self-employment tax as a business expense to equalize the tax treatments of employees and the self-employed.

Example 15 Assume that in example 13, Chandra's $140,000 in earnings constitutes net self-employment income rather than wages as an employee. How much self-employment tax must Chandra pay on her self-employment income?

Discussion: Chandra pays $16,480 (12.4% × $132,900) of OASDI and $4,060 (2.9% × $140,000) of MHI, for a total self-employment tax of $20,540. Note that this is equal to the total tax paid by Chandra and her employer ($10,270 × 2) in example 13. Because Chandra is self-employed, she must pay the equivalent of the employee's and employer's tax.

Unemployment Taxes

Employers must also pay state and federal unemployment taxes on wages paid to employees to fund unemployment benefits. The Federal Unemployment Tax (FUTA) is 6.2 percent of the first $7,000 in wages paid to each employee. Unemployment taxes do not have to be paid for employees who earn less than $1,500 per calendar quarter and certain classes of agricultural workers. Because each state also levies an unemployment tax, employers are allowed a credit of up to 5.4 percent for the state unemployment taxes they pay. Thus, the minimum FUTA tax rate is 0.8 percent (6.2% − 5.4%).

1-3c Sales Tax

Many state and local governments raise significant amounts of revenue from a sales tax. A sales tax is based on a flat percentage of the selling price of a product or service. In contrast to income and employment taxes, which are based on the income of taxpayers, a sales tax is based on a taxpayer's consumption of goods and services. The business that sells the goods or services subject to the tax collects the tax for the government. However, the tax is still paid by the taxpayer purchasing the goods or services. Each government unit that imposes a sales tax determines which goods and/or services are subject to the tax. Thus, not all goods and services are subject to a sales tax. For example, medical services are typically exempted from the tax. Other items that are often exempted from the sales tax are food, farm equipment, and sales to tax-exempt organizations.

1-3d Property Taxes

A tax on the value of property owned by taxpayers is called a *property tax*. In general, **real property** is land and any structures that are permanently attached to it, such as buildings. All other types of property are referred to as **personal property**. Because real property is immobile and difficult to conceal from tax assessors, local governments such as cities, counties, and school districts prefer it as a revenue source.

Property taxes are referred to as **ad valorem taxes**, because they are based on the value of the property being taxed. However, most property taxes are not based on the true fair market value of the property. Rather, the assessed value of the property is used to determine the tax. The *assessed value* of property varies widely but is typically 50 to 75 percent of the estimated market value of the property. Market values are determined by the designated assessment authority (e.g., the county assessor) based on various factors such as recent comparable sales, replacement cost per square foot, and other local market conditions. The assessed value is then computed as the predetermined percentage of the assessor's valuation.

Example 16 Maria Corporation owns a piece of land that it purchased for $6,000 in 2008. During the current year, the county tax assessor determines that the fair market value of the land is $8,000. In the county in which the land is located, assessed values are 50% of the fair market value. What is the assessed value of Maria Corporation's land?

Discussion: Maria Corporation's assessed value is $4,000 ($8,000 × 50%). Note that the local authority can increase or decrease property taxes on the land by varying the percentage of fair market value that is subject to tax. Thus, if the county raised the percentage to 75%, the corporation would pay property tax based on an assessed value of $6,000 ($8,000 × 75%).

Taxes on personal property are not as common as taxes on real property. The mobility and ease of concealment of personal property make the collection of a personal property tax administratively difficult. However, many local governments continue to selectively impose personal property taxes on types of property that are easier to track. Because of the relatively small number of establishments, property taxes on business property are still widely used. In addition, automobiles and boats are often assessed a personal property tax as part of their annual licensing fee.

Example 17 State A imposes an annual tag fee on automobiles. The licensing fee is $20. A personal property tax is also levied, based on the initial selling price of the automobile and its age. During the current year, Darla paid a $94 tag fee on her automobile. How much of the fee is a personal property tax?

Discussion: Darla's personal property tax on the automobile is $74 ($94 − $20). The $20 licensing fee is not a tax.

1-3e Other Taxes

Income taxes, employment taxes, sales taxes, and property taxes are the primary revenue producers for the various forms of government. However, businesses and individuals pay a number of other taxes. The most important of these are excise taxes and wealth transfer taxes. In addition, state and local governments impose taxes on certain occupations (e.g., liquor dealers) and franchise taxes for the privilege of doing business within their jurisdictions.

Excise Taxes

Excise taxes are imposed on various products and services. The federal government imposes excise taxes on a vast array of products and some services. Many states also levy excise taxes on the same products and services. An excise tax differs from a sales tax in that it is not based on the sales value of the product. Rather, an excise tax is typically imposed on a quantity, such as a gallon of gasoline or a pack of cigarettes. Some products subject to excise taxes include

alcohol	fishing equipment	bullets	tobacco
coal	gasoline	telephone services	
diesel fuels	guns	tires	

Wealth Transfer Taxes

Transfers of wealth between taxpayers are taxed by the federal gift tax and the federal estate tax. Most states also impose taxes on the value of an estate. These taxes are essentially a tax on the right to transfer property to another. **Gift taxes** are paid by the donor of property—the person making the gift. The person who receives the gift, the donee, is not subject to either the gift tax or income tax on the gift. The **estate tax** is paid by the administrator (called the *executor*) of a deceased taxpayer's estate from the assets of the estate. Both the gift tax and the estate tax are based on the fair market value of the property being transferred. In addition, there are numerous exclusions from both taxes, the effect of which is to tax only relatively large gifts and estates. Although gift and estate taxes are vaguely familiar to many people, they are relatively minor revenue producers. However, a basic understanding of the operation of the two taxes will aid in understanding some of the income tax issues related to gifts and estates that are discussed later in the text.

Federal Gift Tax A gift tax is imposed on the fair market value of gifts made between individuals.[11] Neither the donor nor the donee is subject to income tax on gifts. The donor of the gift property is responsible for reporting and paying the gift tax. The gift tax has several exclusions, the most basic of which is an annual exclusion of $15,000 per donee.[12] Under this provision, taxpayers can give as many individuals as they wish as much as $15,000 a year each and pay no gift tax. A married couple can use this exclusion to make tax-free gifts of up to $30,000 per person per year. The annual gift exclusion is indexed for inflation for gifts made after December 31, 2003. Taxpayers are also allowed to make unlimited gifts to their spouses and to charities without payment of the gift tax.

Example 18 Ansel and Hanna gave their daughter a new car for graduation. The car cost $18,000. Is the gift subject to the gift tax?

Discussion: Ansel and Hannah each are entitled to give $15,000 to any person each year. Therefore, they may make gifts of up to $30,000 to an individual without incurring any gift tax. Because the fair market value of the car is less than $30,000, it is not subject to gift tax.

Example 19 On their 25th wedding anniversary, Ansel gave Hannah a diamond ring that cost $50,000. Is the gift subject to the gift tax?

Discussion: Gifts to a spouse are not subject to gift tax, regardless of the value transferred. Therefore, the ring is not subject to the gift tax.

As these examples illustrate, the most common forms of gifts, such as those for birthdays, graduations, weddings, and anniversaries, are not subject to the gift tax. However, when a gift is made that is not totally excludable under one of these provisions, the taxpayer may use the unified donative-transfers credit to avoid payment of the gift tax.[13] The **unified donative-transfers credit** allows a lifetime credit against gift and estate taxes. The credit is equivalent to be able to exclude $11.4 million in property from the gift and/or the estate tax in 2019.

Federal Estate Tax The estate tax is levied on the fair market value of the assets a taxpayer owned at death.[14] The executor of the estate is responsible for valuing the assets of the estate, administering the assets before their distribution to the heirs, paying the estate taxes, and distributing the assets to the estate's beneficiaries. As with the gift tax, several exclusions and the unified donative-transfers credit limit taxation of estates to those estates that are fairly substantial.[15] The fair market value of the estate's assets is reduced by funeral and administrative costs, debts owned by the taxpayer, amounts bequeathed to charities, and the marital deduction for property passing to the surviving spouse. The marital deduction is unlimited—all amounts that pass to a surviving spouse are exempt from the estate tax. Judicious use of the marital deduction and the donative-transfers credit lets the value of most estates go untaxed at the death of the first spouse. Because the unified donative-transfers credit is a cumulative lifetime amount that applies to both gifts and property passing through the estate, careful planning is required to minimize the lifetime tax on gifts and property held at death. Suffice it to say that the gift and estate tax provisions can be quite complex. Taxpayers with substantial assets should seek competent professional advice in planning their estates to minimize the liability for these taxes.

Although the transfer of property from an estate to the heirs of the decedent has no income tax effect, the estate itself is subject to income tax while it holds the assets of the decedent. The executor of the estate must file an income tax return that reports the income and the deductions related to the assets of the decedent for the period between the date of death and the final distribution of the estate's assets.

Health Care Related Taxes

The Affordable Care Act[16] implements a number of taxes to pay for the cost of subsidizing health care for those who cannot afford to purchase health insurance. Beginning in 2013, the following tax increases are imposed on individuals.

Increased HI for higher-income workers and self-employed taxpayers For tax years beginning after December 31, 2012, an additional 0.9 percent hospital insurance (HI) tax applies wages received in excess of the threshold amount ($250,000 for a married couple filing jointly, $125,000 for a married individual filing a separate return, and $200,000 for all other taxpayers). For married individuals filing a joint return, the tax is imposed on the combined wages of the spouses. The additional 0.9 percent HI tax also applies to net self-employment in excess of the threshold amounts. The HI tax is in addition to the Social Security taxes imposed on wages and self-employment income.

Example 20 Cinda earns $220,000 as an analyst at Lovekamp Securities in 2019. What is her total Social Security tax in 2019?

Discussion: Cinda pays the $8,240 ($132,900 × 6.2%) maximum OASDI, $3,190 ($220,000 × 1.45%) of MHI, and $180 [($220,000 − $200,000) × 0.9%] of HI, for a total Social Security tax of $11,610. If the $220,000 was Cinda's net self-employment income, the OASDI and MHI taxes would double to $16,480 and $6,380, but the HI tax would remain $180.

Surtax on unearned income of higher-income individuals For tax years beginning after December 31, 2012, a 3.8 percent Medicare contribution tax on unearned income is imposed on individuals, estates, and trusts. For individuals, the tax is imposed on the lesser of net investment income or modified adjusted gross income in excess of the threshold amount ($250,000 for a married couple filing jointly, $125,000 for a married individual filing a separate return, and $200,000 for all other taxpayers).

Example 21 In example 20, assume that Cinda also has $10,000 in net investment income. If her modified adjusted gross income is $204,000, what is Cinda's Medicare contribution tax?

Discussion: Cinda must pay a 3.8% tax on the lesser of ($10,000 net investment income) or $4,000 ($204,000 modified adjusted gross income − $200,000). Her Medicare contribution tax is $152 ($4,000 × 3.8%). NOTE: If Cinda's modified adjusted gross income was $216,000, her tax would be $380 [$10,000 < ($216,000 − $200,000) × 3.8%].

Lower threshold for deducting medical expenses For tax years beginning after December 31, 2017, unreimbursed medical expenses are only deductible to the extent they exceed 7.5 percent of adjusted gross income for the year.

Limitation on contributions to health FSAs For 2019, contributions to health flexible spending arrangements (health FSAs) are limited to $2,700, down from an overall $5,000 FSA limit prior to the Affordable Care Act (ACA). The original $2,500 limitation is adjusted annually for inflation for tax years beginning after December 31, 2013.

Indoor tanning excise tax Amounts paid for indoor tanning services performed after June 30, 2010, are subject to a 10 percent excise tax. Tanning salons are responsible for collecting the excise tax and paying over the tax on a quarterly basis. Tanning salons that fail to collect the tax from patrons are liable for the excise tax.

1-4 SOURCES OF FEDERAL INCOME TAX LAW

LO 3
Identify the primary sources of federal income tax law.

This text contains a general discussion of the federal income tax and by itself should not be considered a substitute for the original sources of the tax law. Before making a final decision about a tax issue, you should review the appropriate original source of the tax rule on which you are going to rely. Thus, it is important to be aware of the legislative, administrative, and judicial sources of tax law. These sources are frequently referred to as *primary sources* of tax law. The discussion that follows briefly outlines the primary sources. A more detailed discussion of the primary authorities is contained in Chapter 16, Tax Research. The remainder of this text generally will not make specific references to sources of tax law. Instead, this book makes generic reference to "tax law" to simplify the discussion.

The end of each chapter includes a list of applicable sources keyed to footnote numbers in the chapter and a brief summary of each source. For those who wish to read the primary sources, they are available in most university and public libraries. Briefly, our citations follow common tax practice, with deference to *The Bluebook: A Uniform System of Citation* (Harvard Law Review Association) and the *Chicago Manual of Style* (University of Chicago Press). For example, *Sec. 61* refers to Section 61 of the Internal Revenue Code of 1986 as amended. *Reg. Sec. 1.61-2* refers to the second Treasury regulation issued that interprets Section 61. *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), is a citation to a 1934 court case that was decided by the U.S. Court of Appeals for the Second Circuit. The case is located in volume 69 of the *Federal Reporter* case series, beginning at page 809. A complete explanation of all citations and how to locate the primary sources can be found in Chapter 16.

The federal income tax law dates to 1913 and has been amended, revised, and reworked numerous times since. The current statutory source of federal income tax law is the **Internal Revenue Code of 1986**, as amended (referred to as the *Code*). The tax law is laid out in the Code by section number. Thus, the basic reference to a particular tax law provision is to the section of the Code in which the law is stated. Often, particular tax treatments are referred to by their Code section number. For example, Section 179 lets a taxpayer deduct a portion of the cost of qualifying depreciable property in the year of acquisition (rather than depreciating it over its tax life). Tax practitioners refer to this election as the *Section 179 election*. Therefore, when appropriate, references to Code sections will include the popular terminology associated with that section.

The Internal Revenue Service is the branch of the Treasury Department that is responsible for interpreting and administering the tax law. The Treasury provides overall interpretive guidance on the Code by issuing **Treasury regulations**.[17] Regulations undergo an intensive review and public comment process before they are issued. Because of this intensive review, interpretations of regulations generally carry considerable authority, sometimes approaching that of the Code.

In fulfilling its administrative function, the IRS issues revenue rulings, revenue procedures, and a variety of other pronouncements that provide guidelines on the interpretation of the Code. Because the IRS issues several hundred rulings each year, they do not undergo the extensive review process accorded regulations. As such, they are given less weight as an authority than a Treasury regulation.

In addition to providing interpretive guidance, the IRS has responsibility for ensuring taxpayers' compliance with the tax law. During 2014, the IRS processed 154 million income tax returns, provided tax preparation assistance to 98 million taxpayers, and audited 1.4 million tax returns filed by individual taxpayers. When audited by the IRS, taxpayers are allowed to present their reasoning for the items in question on their return. As might be expected, disputes often arise between taxpayers and the IRS concerning its interpretations and enforcement of the tax law. Most disputes are resolved through the IRS appeals process. However, taxpayers who are dissatisfied with the result of the appeals process are entitled to take their disputes to court for settlement.

Court decisions establish precedent in the interpretation of the tax law. Taxpayers and the IRS are generally bound by the interpretation of a court on a particular issue. However, the loser of an initial court case may appeal the decision to a U.S. Circuit Court of Appeals. A loss at the appellate level may be further appealed to the U.S. Supreme Court. However, the Supreme Court limits its review of tax cases to those of major importance (e.g., a constitutional issue) or to resolving conflicting decisions in the appellate courts. A Supreme Court decision is not subject to review—it is the final interpretation of the law. Only Congress can override an interpretation of the Supreme Court by amending the Code section in question.

Tax information is also published in a variety of secondary sources. These resources include tax reference services, professional tax journals, tax newsletters, and textbooks. Secondary sources are useful when researching an issue, and they are often helpful for understanding the primary sources. However, you should exercise care when using secondary sources because their interpretations are not authoritative.

1-5 FEDERAL INCOME TAX TERMINOLOGY

LO 4
Define *taxable income* and other commonly used tax terms.

Individuals, corporations, and certain estates and trusts are subject to tax on their federal taxable income. Federal taxable income is defined by the tax law and differs from both financial accounting and economic measures of income. The general computational

Exhibit 1-1

Income Tax Computational Framework

	Income "Broadly Defined" (includes income from all sources)
Minus:	Excluded income
Equals:	Gross income
Minus:	Deductions
Equals:	Taxable income
×	Tax rate (schedule of rates)
Equals:	Income tax
Minus:	Tax credits
	Tax prepayments
Equals:	Tax (refund) due with return

framework for determining the taxable income of all taxpayers is shown in Exhibit 1-1. Both the terms used in the computations and the order of the computational framework are prescribed in the tax law.

1-5a Income

The term *income* is used in several ways. Therefore, always be sure you understand the context in which the term is used. As broadly defined, income includes both taxable and nontaxable types of income. This definition includes all income that belongs to the taxpayer. *Gross income* is a more restrictive term. As Exhibit 1-1 shows, **gross income** is income broadly defined minus income items that are excluded from taxation.[18] Items of gross income are included in the computation of taxable income. Generally, gross income is the starting point for reporting income items on a tax return. Chapter 3 discusses the most commonly encountered gross income items.

A fundamental rule in regard to income is that an item is included in gross income unless it is specifically excluded by the tax law. **Exclusions** represent increases in a taxpayer's wealth and recoveries of the taxpayer's capital investment that Congress has decided should not be subject to income tax. Thus, income exclusions are not counted as gross income. Common income exclusions include inheritances, gifts, and interest on certain municipal bonds. Exclusions are discussed in Chapter 4.

Although not an explicit part of the income tax computation, deferrals of income and deductions are also found in the tax law. A **deferral** is an item that does not affect the current period's taxable income but will affect taxable income in a future tax year. Thus, a deferral is like an exclusion in that it does not have a current tax effect. However, it differs in that an exclusion is *never* subject to tax, whereas a deferral *will be* subject to tax at some point in the future.

Taxable income is a net number and is the tax base. Taxable income is determined by subtracting deductions and exemptions from gross income. Taxable income is the tax base that is multiplied by the applicable tax rate to compute the federal income tax. Taxable income is usually different from financial accounting income computed by using generally accepted accounting principles.

The differences between financial accounting income and taxable income generally arise because taxable income is computed according to the rules prescribed by the tax law. Tax accounting rules are not based on generally accepted accounting principles (GAAP). GAAP are concerned with determining the "true income" for an annual period. The income tax is geared to producing and collecting tax revenues and providing incentives for particular economic and social transactions. An important difference between the two objectives is that the income tax system attempts to collect the tax on income in the period during which the taxpayer has the resources to pay the tax. Under GAAP, having the resources to pay taxes is of no concern. As a result, specific income and deduction items may be accelerated, deferred, or permanently excluded from the current year's taxable income computation, as opposed to the GAAP treatment. For example, prepaid rental income may be amortized over the lease period for financial reporting but must be reported in full in the year it is collected for tax reporting. Another example is the treatment of depreciable property. For tax purposes, assets must be depreciated by using a statutorily determined recovery period, without regard for their actual useful life. For financial reporting, the same asset is depreciated over its useful life. These are but two examples of income and deduction items that are different for financial and taxable income and that will be discussed throughout the text.

Income is also referred to as *ordinary income*. **Ordinary income** is the recurring income earned by a taxpayer for a tax year.[19] It is the common type of income that people and businesses expect to earn. Ordinary income typically includes business profits, rent from property, interest on investments, dividend income, and wages. Ordinary income is subject to tax using regular tax rates and computations explained in later chapters. That is, ordinary income receives no special treatment under the laws.

Income also results from gains. A **gain** is the difference between the selling price of an asset and its tax cost and is the result of disposing of the asset.[20] Usually, a gain will

be the result of a sale of a single asset. Most gains produce ordinary income. However, gains on the sale of certain types of assets receive special treatment in the determination of taxable income and the tax liability. These gains are called *capital gains* and result from the sale of capital assets.

1-5b Deductions

Deductions are amounts that the tax law specifically allows as subtractions from gross income. Deductions are a matter of legislative grace. The concept of legislative grace gives us a basic rule to follow to determine items that qualify for deduction. The rule is that an item may not be deducted unless the tax law specifically permits it. Deductions are characterized as *expenses* and *losses.*

An **expense** is a current period expenditure that is incurred to earn income. Deductions for expenses are limited to those incurred in a trade or business,[21] in an income-producing activity (investment activity),[22] and certain specifically allowed personal expenses of individuals. Trade or business expenses and income-producing expenses must be ordinary, necessary, and reasonable in amount to be deductible. Allowable personal expenses are deductible as itemized deductions and are subject to strict limitations.

The term **loss** refers to two distinctly different types of events. A loss occurs when an asset is disposed of for a selling price that is less than its tax cost. This type of loss is referred to as a **transaction loss** and represents a loss of capital invested in the asset. In later chapters, it will be necessary to apply limits to the amount of a loss that can be deducted in a tax year. To apply the limits, losses are characterized as personal, business, or capital. These limits deny deductions for most personal losses, place a cap on the amount of capital losses that may be deducted in the year of the loss, and allow business losses to be fully deducted as incurred.

The second type of loss is an annual loss. An **annual loss** results from an excess of allowable deductions for a tax year over the reported income for the year. The treatment of the annual loss depends on the activity in which the loss is incurred. Chapter 7 discusses the limitations on and treatment of all losses, transaction and annual.

1-5c Income Tax Rates

The 2019 tax rate schedules for two classes of individual taxpayers and corporations are reproduced in Table 1-2 (p. 1-22).[23] A full set of tax rates for individuals and corporations for 2018 and 2019 is reproduced in Appendix B. The income tax is calculated by multiplying taxable income by the applicable tax rates. Each year, the IRS publishes new tax rate schedules that are adjusted for cost-of-living increases. The Tax Cuts and Jobs Act provides a new metric for calculating these cost of living increases. Before January 1, 2018, the IRS used CPI to adjust the tax rate schedules for changes in cost of living. Beginning on January 1, 2018, the IRS will begin to use the Chained Consumer Price Index for All Urban Consumers C-CPI-U. It is expected that C-CPI-U will show inflation growing at a slower rate than did CPI. Adjusting the tax rate schedules for changes in the cost of living helps minimize a hidden tax that results from inflation.

Assume the following information (as shown in Exhibit 1-2): A single taxpayer's taxable income in 2018 was $38,500. The rate of inflation in 2018 was 2.0 percent, and the taxpayer was able to keep up with inflation by increasing her income. Her taxable income goes up by $770 to $39,270 ($38,500 × 1.02%) in 2019. At this point, the taxpayer is no better or worse off in 2019 than in 2018. Her income increases merely kept up with the rate of inflation. The top panel of Exhibit 1-2 shows that failure to adjust the 2019 tax rates for the 2.0 percent inflation rate results in $149 in additional tax. The increased tax is attributable to two sources. First, the increased income results in an additional $92 (12% × $770) in tax, even if the marginal rate stays the same from the first to the second year. Second, the problem worsens when the inflated income pushes the taxpayer into a higher marginal tax bracket (tax bracket creep) causing an additional $57 in tax [(22% − 12%) × ($39,270 − $38,700)]. Thus, the taxpayer is worse off, because she

Exhibit 1-2

The Hidden Inflation Tax

	Tax Year	
	2018	2019
Taxable income	$38,500	$ 38,500
Increase in taxable income due to inflation		770
Inflation-adjusted taxable income	$38,500	$ 39,270
Tax using 2018 single taxpayer rates:		
Tax on base amount	$ 953	$ 4,454
Excess taxed at marginal rate		
12%	3,477	
22%		125
Total tax	$ 4,430	$ 4,579
Additional tax resulting from inflation		$ 149
Tax on $39,270 at 2019 tax rates		
Tax on $9,700		$ 970
Tax on income in excess of $9,700		
($39,270 − $9,700) × 12%		3,548
Tax at 2019 rates		$ 4,518
2018 After-tax income $38,500 − $4,430		$ 34,070
2018 Inflation rate adjustment		× 1.02
2019 Real after-tax income		$ 34,751
Actual 2019 after-tax income $39,270 − $4,518		$ 34,751

pays $149 more tax on the same deflated income when tax rates are not adjusted for inflation. The net result is an increase of after-tax income of only $621 ($770 − $149), which is less than the rate of inflation.

The bottom panel of Exhibit 1-2 calculates the tax using the actual 2019 rates, which are adjusted for the 2.0 percent inflation rate. The tax on a 2019 taxable income of $39,270 is $4,518. This is a reduction of $61 ($4,579 − $4,518) over the tax calculated using 2018 rates on the same income. The adjustment for inflation in the tax rate brackets leaves the taxpayer with the same inflation-adjusted after-tax income in 2019 [($38,500 − $4,430) × 1.02% = $34,751 ($39,270 − $4,518)] that the taxpayer had in 2018. Thus, the adjustment of the tax brackets for inflation each year ensures that taxpayers whose income merely keeps pace with inflation will not realize a decrease in real after-tax income.

1-5d Tax Prepayments

The pay-as-you-go system requires the payment of tax as the income is earned and when the taxpayer has the resources available to pay the tax. Tax prepayments are subtracted from the income tax liability to determine whether the taxpayer has underpaid and owes additional tax with the return (tax due) or is entitled to a refund of overpaid taxes (refund due). Employees prepay taxes on wages through payroll-tax withholding. Other types of income, such as pensions and some gambling winnings, are also subject to the withholding of tax by the payer. The employer or other person withholding the tax pays the tax withheld to the IRS, to be credited to the taxpayer's account with the government.

Table 1-2

2019 Tax Rate Schedules

Single Taxpayers

If Taxable Income Is Over	But Not Over	The Tax Is	Of the Amount Over
$ -0-	9,700	..... 10%	$ -0-
9,700	39,475	$ 970 + 12%	9,700
39,475	84,200	4,543 + 22%	39,475
84,200	160,725	14,382.50 + 24%	84,200
160,725	204,100	32,748.50 + 32%	160,725
204,100	510,300	46,628.50 + 35%	204,100
510,300	.....	153,798.50 + 37%	510,300

Married Taxpayers Filing Jointly and Surviving Spouse

If Taxable Income Is Over	But Not Over	The Tax Is	Of the Amount Over
$ -0-	19,400	..... 10%	$ -0-
19,400	78,950	$ 1,940 + 12%	19,400
78,950	168,400	9,086 + 22%	78,950
168,400	321,450	28,765 + 24%	168,400
321,450	408,200	64,497 + 32%	321,450
408,200	612,350	93,257 + 35%	408,200
612,350	.....	164,709.50 + 37%	612,350

Corporate Tax Rate Schedule

If Taxable Income Is Over	But Not Over	The Tax Is	Of the Amount Over
$ -0-	$ unlimited	..... 21%	$ -0-

Self-employed people and taxpayers with income not subject to withholding (trade or business income, interest income, dividend income, gains from sales of assets, etc.) are required to make quarterly payments of their current-year estimated tax payments. An individual usually makes quarterly payments on April 15, June 15, and September 15 of the tax year and on January 15 of the next year. This corresponds to the fifteenth day of the fourth, sixth, and ninth months of the tax year and the fifteenth day of the first month of the following year. A corporation makes its estimated tax payments on the fifteenth day of the fourth, sixth, ninth, and twelfth months of its tax year. Estates and trusts follow the estimated tax schedule used by individuals. Estimated tax payments, like withheld amounts, are subtracted as credits for the prepayment of tax.

1-5e Tax Credits

A **tax credit** is a direct reduction in the income tax liability. In effect, tax credits are treated like tax prepayments. As Exhibit 1-1 shows, a credit is not deducted to arrive at taxable income but is instead subtracted directly from the income tax liability. Thus, a tax credit is more valuable than a deduction of an equal amount, because the credit yields a larger reduction in the total tax due. Tax credits are often used as incentives to encourage taxpayers to enter into specific types of transactions that Congress feels will further some public purpose.

If a taxpayer's marginal tax rate is 24 percent, a $5,000 tax deduction has the same value as a $1,200 tax credit ($5,000 × 24%). Likewise, a $1,000 tax credit has the same value as a $4,167 deduction if the marginal rate is 24 percent ($1,000 ÷ 24%).

Example 22 Ron and Martha, whose marginal tax rate is 24%, paid $1,000 for child care.

Discussion: If the expenditure is treated as a credit, the tax they owe for the year will be reduced by the full $1,000. If the expenditure is treated as a deduction, their tax would be reduced by $240 ($1,000 × 24% marginal rate). Treatment of the expenditure as a credit would save them $760 more than treatment as a deduction.

The most common business tax credits are discussed in Chapter 15. Individuals are also allowed tax credits for certain circumstances and activities. For example, individuals with dependents are allowed a credit of $2,000 for each qualifying dependent. Restrictions and limitations associated with this tax credit and other common individual tax credits are discussed in Chapter 8.

1-5f Filing Returns

In general, all income tax entities must file an annual tax return. (See Chapter 8 for individual filing requirements.) Returns for individuals, corporations, estates, and trusts must be filed on or before the fifteenth day of the fourth month following the close of the entity's tax year (April 15 for calendar-year taxpayers). Partnership and S Corporation tax returns are due on or before the fifteenth day of the third month following the close of the tax year (March 15 for calendar-year corporate taxpayers). Taxpayers who cannot complete and file their returns by the regular due date can apply for extensions for filing the return. Individuals are granted an automatic six-month extension by applying for the extension by the due date of the return. Corporations are allowed an automatic six-month extension; partnerships and trusts can automatically extend their filing date by three months. Filing an extension does not extend the time for paying the tax. Applications for automatic extensions must show and include payment of the estimated amount due with the final return.

Example 23 Thelma procrastinates about preparing her tax return and determines that she cannot complete the return by April 15. She has withholdings and estimated tax payments totaling $8,600 and estimates that her total tax liability for the year will be $8,950. What must Thelma do to extend the date for filing her return?

Discussion: Thelma can extend the period for filing her return to October 15 (six months from April 15) by filing the application for automatic extension by April 15. This only grants Thelma permission to delay the filing of the return. She must pay the $350 ($8,950 − $8,600) estimated tax she owes when she applies for the extension.

Taxpayers and the government can correct errors on returns within a limited time period called the **statute of limitations**. Generally, once the statute of limitations has expired, corrections cannot be made. The general statute of limitations is three years from the due date of the return, not including extensions. The three-year statute of limitations has several exceptions, the most important of which deal with fraudulently prepared returns. The statute of limitations runs for six years when a taxpayer omits gross income in excess of 25 percent of the gross income reported on the return. The government can bring charges of criminal fraud against a taxpayer at any time. That is, neither the three-year nor the six-year statute of limitations protects a taxpayer who willfully defrauds the government.

The government corrects errors on taxpayers' returns through its audit process. Taxpayers correct errors on prior year returns by filing amended returns. Amended returns are not used to adjust returns for previous years. (See discussion of the tax benefit rule in Chapter 2.) An amended return should be filed only if a taxpayer finds that an item of income that should have been included in gross income was omitted in the original filing or if the taxpayer improperly included an item of income in a prior year. Taxpayers also should file amended returns if they find that they failed to take an allowable deduction or if they find that they took an improper deduction on an earlier return.

Example 24 Geraldo Corporation incurred a net operating loss in 2018, its first year of operation. Because the controller knew that Geraldo was going to suffer a loss, he took no deductions for depreciation for 2018. Geraldo's independent auditor found the error in 2019 and advised Geraldo that it must take all allowable deductions in the proper year. Should Geraldo file an amended return for 2018?

Discussion: Because the depreciation was not treated properly on the 2018 tax return, Geraldo should file an amended return that takes the proper depreciation deduction for 2018.

Example 25 Walstad Corporation is an accrual basis taxpayer. In 2018, Walstad determined that one of its customers with an accounts receivable balance of $40,000 was in bankruptcy. After conferring with the customer's lawyers, Walstad determined that it would be able to collect only $15,000 of the account and deducted the $25,000 uncollectible amount as a bad debt expense. In 2019, the customer's bankruptcy was settled, and Walstad received $10,000 as a final settlement of the account it had written off. Should Walstad file an amended return for 2018 and correct the bad debt deduction?

Discussion: The actual bad debt is $30,000 ($40,000 − $10,000). The $25,000 bad debt deduction that Walstad took in 2018 was an estimate of the amount of the bad debt. Therefore, the deduction was not incorrect at the time the return was filed. Walstad should deduct the additional $5,000 ($30,000 − $25,000) of actual bad debt in 2019 to adjust the estimate. Amended returns are not filed to adjust estimates on prior year returns. Adjustments to estimates are made on the return for the year in which the actual amount of the deduction becomes known.

1-6 THE AUDIT AND APPEAL PROCESS WITHIN THE IRS

LO 5
Discuss the IRS audit process and taxpayer rights within the process.

The federal income tax system is based on self-assessment, which requires taxpayers to report and pay their taxes correctly. IRS examinations, or audits, can vary from a letter that requests supporting information by mail to a full-scale, continuous examination of large corporations in which teams of IRS agents work at each taxpayer's office. Taxpayers who do not agree to changes suggested by the IRS during an audit can appeal the matter to a higher administrative level within the IRS. Generally, taxpayers cannot be charged with any additional taxes, interest, or penalties without first being formally notified. Whenever settlement cannot be reached with the IRS, the taxpayer can initiate litigation in one of the trial courts.

1-6a Tax Return Selection Processes

The IRS cannot possibly examine every return that is filed. It does examine as many returns as possible, given its staffing and facility levels. Currently, this amounts to only about 2 percent of all returns filed. The IRS uses five general methods to verify that taxpayers are properly self-assessing their taxes. One of the most important is a computerized return selection program called the **Discriminant Function System (DIF)**. Through mathematical analysis of historical data, this program selects those returns with the highest probability of containing errors. Selected returns are typically examined only for specific items such as charitable contributions or employee business expenses. A related program is the **Taxpayer Compliance Measurement Program (TCMP)**. Returns are randomly selected from different income levels, and every item on the return is comprehensively audited. The results are used to set the parameters for the DIF computer selection program. The IRS suspended the TCMP audits in 1996 because of reductions in its budget.

Virtually all returns are checked for mathematical, tax calculation, and clerical errors during the initial processing of the returns. If an error is discovered under this **document perfection program**, the IRS recalculates the amount of tax due and sends an explanation to the taxpayer. Another program of increasing importance is called the

information-matching program. Information from banks, employers, and others on forms such as the W-2 for wages and withholding and the 1099 for miscellaneous income are matched to the taxpayer's return. For any omitted or incorrect items, the IRS recomputes the tax and sends an explanation to the taxpayer. Finally, a number of **special audit programs** are designed by the IRS and combine computer and manual selection based on various standards that are changed periodically. Some of the standards used include the size of the refund, the amount of adjusted gross income reported, and the amount or type of deduction claimed.

1-6b Types of Examinations

There are three basic types of IRS examinations. **Correspondence examinations** are those that can be routinely handled by mail. Most originate at the IRS service centers and involve routine requests for supporting documents such as canceled checks or some other written instruments. A written reply to the questions raised, along with copies of supporting documents, usually completes the examination.

Office examinations are conducted at the local district office of the IRS and usually involve middle-income, nonbusiness returns, and small sole proprietorships. The taxpayer is notified by letter of the date and time of the exam, as well as the items for which proof is requested. Most taxpayers appear for themselves, although some are represented by their return preparers or other tax advisers. The audit is relatively informal, and the IRS agent has considerable discretion in resolving factual questions such as substantiation of travel expenses. For questions of law, however, the agent must follow IRS policy as expressed in Treasury regulations, revenue rulings and procedures, and the like, even if court decisions indicate otherwise.

Field examinations are conducted at the taxpayer's place of business and can involve any item on the income tax return as well as any items on the payroll and excise tax returns. These examinations are handled by more-experienced IRS agents, and almost all taxpayers are represented by their tax advisers. As with office examinations, IRS agents must follow IRS policy on matters of law and are accorded a great deal of latitude in settling matters of fact.

1-6c Settlement Procedures

After the examination, the agent prepares a report, known as the revenue agent's report (RAR), describing how each issue was settled and the amount of any additional tax or refund due the taxpayer. The agent also prepares a waiver of restrictions on assessment (Form 870), which states that the taxpayer waives any restrictions against assessment and collection of the tax by the IRS. Both items are mailed to the taxpayer in a letter commonly called a 30-day letter, along with an IRS publication describing the taxpayer's appeal rights.

A signed Form 870 means that the taxpayer agrees to the proposed changes, but it is not binding on either the taxpayer or the IRS. The taxpayer merely agrees to pay the additional tax due while reserving the right to file for a refund in a subsequent court action. Generally, the IRS rejects a settlement reached by its agents only if there is fraud or a misrepresentation of a material fact.

1-6d Administrative Appeals

A taxpayer who does not agree with the agent's report may request a meeting with agents from the **IRS Appeals Division** within 30 days of the date of the letter. If the additional tax due exceeds $2,500, the taxpayer must include a written response to the agent's findings; the taxpayer's response is called a **protest letter**. When the amount is less than $2,500 or is the result of a correspondence or office examination, no written protest is required.

The administrative appeal process allows taxpayers one additional opportunity to reach a settlement before resorting to the courts. The appeals division has the authority to consider the hazards of litigation. For example, when the facts or the law are uncertain, or both, the appeals division may settle issues it does not want to litigate, even if

the IRS position has some merit. After what may be lengthy negotiation, taxpayers who finally reach an agreement with the IRS, or who simply don't want to pursue the matter, sign the Form 870 (or Form 870-AD, if the IRS has conceded some issues) and pay the full amount of the deficiency plus any penalties and interest.

Taxpayers unable to reach an agreement in the appeals division, or who have bypassed the appeals division by failing to respond to the 30-day letter, are sent a statutory notice of deficiency. This letter is the official notification by the IRS that it intends to assess or charge the taxpayer for some additional taxes, and is commonly referred to as a 90-day letter.

Taxpayers who are not interested in going to court can simply wait 90 days to have the deficiency formally assessed and then pay any additional amounts due. Taxpayers who want to litigate in district court or the claims court first must pay the amounts due and file for a refund in the court of their choice. 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. The decision to take an unresolved issue to court involves a number of additional factors and typically is made only with the advice of legal counsel specializing in tax litigation.

1-7 INDIVIDUAL INCOME TAX CALCULATION

The general tax calculation presented in Exhibit 1-1 applies to all taxpayers. However, the tax law modifies this calculation for individuals to take into account the unique characteristics of individual taxpayers.

The calculation of an individual's taxable income is outlined in Exhibit 1-3. Note that the general flow remains the same—deductions are subtracted from gross income to arrive at taxable income. Gross income is determined under the general tax formula. The distinguishing feature of the individual taxable income calculation is that deductions are broken into two classes—deductions for adjusted gross income and deductions from adjusted gross income. This dichotomy of deductions results in an intermediate income number called the **adjusted gross income (AGI)**.[24] In fact, it will become clear in the discussion that follows, this is a very important income number, because it is used to limit the deductions from adjusted gross income of an individual taxpayer. Deductions are discussed in more detail in later chapters. However, at this point, a general knowledge of the computational form and allowable deductions of individuals is necessary. Each type of deduction is discussed in turn.

Exhibit 1-3

Individual Income Tax Formula

	All sources of income (broadly defined)	$ XXX
Minus:	Exclusions from income	(XXX)
Equals:	Gross income	$ XXX
Minus:	Deductions *for* adjusted gross income	
	Trade or business expenses	
	Rental and royalty expenses	
	Other specifically allowable deductions	(XXX)
Equals:	**ADJUSTED GROSS INCOME**	$ XXX
Minus:	Deductions *from* adjusted gross income	
	Personal deductions: the greater of	
	1. itemized deductions (allowable personal expenses and certain other allowable deductions)	
	OR	
	2. individual standard deduction	(XXX)
Equals:	Taxable income	$ XXX

1-7a Deductions for Adjusted Gross Income

LO 6

Introduce the calculation of taxable income for individual taxpayers and the unique personal deductions allowed to individuals.

Individuals are always allowed to deduct the qualified expenses they incur as **deductions for adjusted gross income**. In contrast to deductions from adjusted gross income, deductions in this class are not subject to reduction based on the income of the taxpayer. That is, once the allowable amount of an expenditure in this category has been determined, it is not subject to further reduction based on the income of the taxpayer. The allowable deductions for adjusted gross income are generally those that are incurred in a trade or business of the taxpayer or that are related to the earning of other forms of income. In addition, several other specifically allowed items are deductible for adjusted gross income. Deductions for adjusted gross income include

Trade or business expenses
Rental and royalty expenses
Capital loss deductions
Contributions to individual retirement accounts (IRAs)
Reimbursed employee business expenses
1/2 of self-employment taxes paid
Self-employed medical insurance premiums
Up to $2,500 of interest on qualified student loans

Although these expenditures are not limited by the income of the taxpayer, other limitations in the tax law may reduce the current period's tax deduction. For example, the allowable deductions for rental properties may be limited by either the vacation home rules or the passive activity loss rules. Losses on the sale of capital assets are deductible but are first netted against capital gains. If the result is a net capital loss, the current year's deduction is limited to a maximum of $3,000.[25] These losses and other limits are covered in the chapters on deductions and losses. The important point to remember for now is that once the allowable amount of a deduction for adjusted gross income has been determined, it is not subject to further reduction. In addition, there is no preset minimum allowable amount of deductions for adjusted gross income.

1-7b Deductions from Adjusted Gross Income

Individuals are allowed to deduct certain personal expenditures and other specified nonpersonal expenditures as **deductions from adjusted gross income**. These deductions are commonly referred to as **itemized deductions**. Note in Exhibit 1-3 that individuals deduct the greater of their allowable itemized deductions or the standard deduction.[26] The **standard deduction** is an amount that Congress allows all taxpayers to deduct regardless of their actual qualifying itemized deduction expenditures. Thus, taxpayers itemize their deductions only if their total allowable itemized deductions exceed the standard deduction. For 2019, the standard deduction is $12,200 for a single individual and $24,400 for a married couple.

Example 26 Festus is a single taxpayer with total allowable itemized deductions of $1,800 in 2018. What is Festus's allowable deduction from adjusted gross income?

Discussion: Festus deducts the larger of his $1,800 in itemized deductions or the $12,200 standard deduction for a single individual. In this case, Festus deducts the $12,200 standard deduction.

Example 27 Assume that in example 26, Festus's total allowable itemized deductions are $12,700 in 2019. What is his allowable deduction from adjusted gross income?

Discussion: Festus would deduct the $12,700 in actual itemized deductions because it exceeds his $12,200 standard deduction.

As these examples illustrate, just because a particular expenditure is allowed as an itemized deduction does not necessarily mean that a taxpayer incurring the expense will actually deduct it. Itemized deductions reduce taxable income only when a taxpayer's total itemized deductions exceed the allowable standard deduction.

In addition to giving all taxpayers some minimum amount of deduction, the standard deduction eliminates the need for every taxpayer to list every qualifying personal expenditure. This makes it easier for taxpayers with small amounts of qualifying expenditures to comply with the tax law and relieves the government from having to verify millions of deductions that would have been claimed as a result of itemizing. Thus, the standard deduction is an important tool that the government uses to promote income tax law compliance by removing the burden of record-keeping and reporting for relatively small amounts of deductible items.

In the deduction classification scheme, specifically allowed personal expenditures are classified as itemized deductions.[27] Many allowable itemized deductions are subject to an income limitation. That is, the amount of the qualifying expenditure must be reduced by a percentage of the taxpayer's adjusted gross income to determine the actual deduction. The effect of using this type of income limitation is to disallow deductions for amounts that are small in relation to the taxpayer's income.

Example 28 Qualifying medical expenses are deductible to the extent that they exceed 7.5% of a taxpayer's adjusted gross income. During the current year, Li has an adjusted gross income of $40,000 and incurred $4,200 in qualified medical expenses. What is Li's itemized deduction for medical expenses?

Discussion: Li must reduce the $4,200 of qualified medical expenses by $3,000 ($40,000 × 7.5%), resulting in deductible medical expenses of $1,200.

Note that the effect of the limitation is to allow larger deductions for taxpayers with smaller incomes. Another taxpayer incurring the same $4,200 in expenses who had an adjusted gross income of only $25,000 would be allowed to deduct $2,325 [$4,200 − ($25,000 × 7.5% = $1,875)] of the medical expenses.

The following list is intended to acquaint you with the categories of itemized deductions available to individuals. At this point, you should note the types of personal expenses that are allowed as a deduction. Do not be concerned about the detailed deduction requirements and limitations. These issues are explained in more detail in Chapter 8.

Medical Expenses—Unreimbursed medical expenses are deductible to the extent that they exceed 7.5 percent of adjusted gross income. Medical expenses include the cost of medical insurance, physicians, hospitals, glasses and contact lenses, and a multitude of other items. Because of the AGI limit, many taxpayers benefit from these deductions only when there is a major illness in the family.[28]

Taxes—State, local, and foreign income taxes, real estate taxes, and state and local personal property taxes not in excess of $10,000 may be deducted.[29]

Interest—An individual's itemized deduction for personal interest expense is limited to the following[30]:

- Home mortgage interest related to the acquisition of a home
- Investment interest expense

Charitable Contributions—Gifts to qualified charitable organizations may be deducted. Generally, the deductible contribution may not exceed 60 percent of the taxpayer's adjusted gross income.[31]

1-7c Personal and Dependency Exemptions

Prior to January 1, 2018, individuals were allowed to deduct a predetermined amount for each qualifying exemption.[32] In 2017, individuals were allowed to deduct $4,050 for each qualifying personal and dependency exemption. Personal exemptions were allowed for the taxpayer and the taxpayer's spouse. Dependency exemptions were granted for individuals who are dependent on the taxpayer for support.

1-8 TAX PLANNING

LO 7 Develop a framework for tax planning and discuss the effect of marginal tax rates and the time value of money on tax planning.

The objective of tax planning is to maximize after-tax wealth. An effective tax plan results in a reduction of taxes for the planning period. Because a planning period may be two or more years, focusing on reducing tax for one year without considering any offsetting effects for other years can lead to excessive tax payments. The traditional planning technique of deferring income and accelerating deductions may not always be the best tax plan. The traditional technique considers only the time value of money savings that can be obtained from delaying tax payments on income or receiving tax savings from deductions sooner. Although the time value of money must always be considered, changes in marginal tax rates from one year to the next can have effects that offset the time value of money. Thus in many cases, changes in both the marginal tax rate and the time value of money must be considered when developing a tax plan. The mechanics of tax planning demonstrate basic techniques that can be used to help make tax-planning decisions. The planning discussion concludes by pointing out that tax avoidance is acceptable but tax evasion is not.

1-8a Mechanics of Tax Planning

The mechanics of tax planning focus on the issues of timing and income shifting. The timing question to be answered is when income and deductions should be claimed to save the most *real tax.* To make decisions involving timing, it is necessary to compare the tax effects of changes in marginal tax rates and the time value of money. To make the optimal choice among different alternatives, the calculations must be done to determine the *real* after-tax cost of each alternative. Income shifting involves moving income among related taxpayers to achieve the lowest marginal taxes (and lowest total tax) on the entire income of the related taxpayers. Shifting is commonly done by transferring income-producing property among family members and by using corporations that taxpayers control to shift income into the lowest marginal tax rates.

Timing Income and Deductions

A taxpayer's marginal tax rate and the time value of money must be considered in tax planning. The traditional technique of deferring income and accelerating deductions relies solely on the time value of money savings from delaying the tax payment or receiving the tax deduction savings earlier. For example, a taxpayer who expects to be in a 24-percent marginal tax bracket for the next several years might be indifferent about reporting $1,000 in extra income in 2019 or 2020. Regardless of which year the income is reported, the taxpayer pays $240 in tax and keeps $760 ($1,000 − $240) in after-tax income. When the present value of the tax payment is considered (see Table 1-3 for present values factors), it becomes clear that choice of years does make a difference. If the taxpayer's applicable interest rate is 10 percent and the marginal rate is expected to remain the same, deferring payment of the tax until 2020 results in an interest-free loan. The present value of the tax savings is $22:

Tax paid in 2020	$ 240
10% present value factor	×0.909
Present value of tax paid in 2020	$ 218
Present value of tax paid in 2019	240
Real tax savings by deferring income	$ 22

If the marginal rate is expected to decrease to 12 percent in 2020, the taxpayer has a greater incentive to defer the income. By deferring the income to 2020, the taxpayer receives the benefit of an interest-free loan for one year plus the benefit of the lower marginal tax rate. Deferring the income to 2020 would result in a real tax benefit of $144:

Tax paid in 2020 ($1,000 × 12%)	$ 120
10% present value factor	×0.909
Present value of tax paid in 2020	$ 109
Present value of tax paid in 2019	240
Real tax savings by deferring income	$ 131

Table 1-3

Present Value Tables

	Present Value of a Single Payment						
Year	5%	6%	7%	8%	9%	10%	12%
1	0.952	0.943	0.935	0.926	0.917	0.909	0.893
2	0.907	0.890	0.873	0.857	0.842	0.826	0.797
3	0.864	0.840	0.816	0.794	0.722	0.751	0.712
4	0.823	0.792	0.793	0.735	0.708	0.683	0.636
5	0.784	0.747	0.713	0.681	0.650	0.621	0.567
6	0.746	0.705	0.666	0.630	0.596	0.564	0.507
7	0.711	0.665	0.623	0.583	0.547	0.513	0.452
8	0.677	0.627	0.582	0.540	0.502	0.467	0.404
9	0.645	0.592	0.544	0.500	0.460	0.424	0.361
10	0.614	0.558	0.508	0.463	0.422	0.386	0.322

Table 1-3 shows how much $1 to be paid at a future date is worth today at the discount rate indicated.

If the taxpayer expects the marginal tax rate to increase to 35 percent next year, the income should be reported in 2019. Deferring the income to 2020 would have a real tax cost of $78:

Tax paid in 2020 ($1,000 × 35%)	$ 350
10% present value factor	×0.909
Present value of tax paid in 2020	$ 318
Present value of tax paid in 2019	240
Real tax savings by not deferring income	$ 78

The same approach can be used to determine the best timing for a deduction. However, keep in mind that deductions are the opposite of income—they reduce taxes paid. Therefore, the optimal choice for deductions is to maximize the real after-tax reduction in taxes paid. In many situations, it may be necessary to compare the offsetting effects of income and deduction items.

Example 29 Lanny's marginal tax rate for 2019 is 24%. Lanny has $20,000 in income and $10,000 in deductions that could be reported in 2019 or deferred to 2020. Lanny expects his 2020 marginal tax rate to be 35% and the applicable interest rate to be 10%. When should the items be reported if both the income and deductions must be reported in the same year?

Discussion: The result of reporting both the income and the deductions in 2019 as compared with 2020 is as follows:

	2019	2020
Increase in income	$ 20,000	$ 20,000
Less: Increase in deductions	(10,000)	(10,000)
Net increase in taxable income	$ 10,000	$ 10,000
Marginal tax rate	× 24%	× 35%
Tax on net increase in income	$ 2,400	$ 3,500
Present value factor		× 0.909
Present value of tax in 2019	$ 2,400	$ 3,182

Discussion: Lanny should report the items in 2019 to save $782 in real tax cost.

Example 30 If Lanny could report the income or deductions separately, when should the income and the deductions be reported to maximize the tax savings?

Discussion: The tax cost of reporting each item must be considered separately and the total result compared with reporting both items in 2019 (which was previously determined to be the optimal same-year reporting).

Income

	Report Income In 2019	Report Income In 2020
Increase in taxable income	$ 20,000	$ 20,000
Marginal tax rate	× 24%	× 35%
Increase in tax	$ 4,800	$ 7,000
Present value factor		× 0.909
Present value of tax in 2019	$ 4,800	$ 6,363
Net tax savings from reporting in 2019	$ 1,563	

Deductions

	Report Deduction In 2019	Report Deduction In 2020
Decrease in taxable income	$ 10,000	$ 10,000
Marginal tax rate	× 24%	× 35%
Tax savings from deduction	$ 2,400	$ 3,500
Present value factor		× 0.909
Present value of tax savings	$ 2,400	$ 3,182
Net tax savings from reporting in 2020	$ 782	

Discussion: If Lanny reports the $20,000 of income in 2019, he has a real tax savings of $1,563. Deferring the reporting of the $10,000 in deductions until 2020 results in a real tax savings of $782. Thus, by reporting each item separately in the period that is optimal, he saves $2,345. This compares with a savings of $782 when both income and deductions are reported in the same tax year.

In summary, there are four general rules of thumb when planning the timing of income and deductions. Two are based on time value of money propositions, and two are based on marginal tax rate considerations:

Time Value of Money
1. Defer recognition of income.
2. Accelerate recognition of deductions.

Marginal Tax Rate
3. Put income into the year with the lowest expected marginal tax rate.
4. Put deductions into the year with the highest expected marginal tax rate.

These general rules of thumb can be used in most situations. However, if there is a conflict between the time value rule and the marginal tax rate rule, the only way to determine the optimal strategy is to calculate the real tax cost of each. Table 1-4 summarizes the rules of thumb and indicates when calculation of the real tax cost is necessary.

Income Shifting

Income shifting is a method commonly used to reduce taxes. The basic idea behind income shifting is to split a single stream of income among two or more taxpayers to lower the total tax paid. The total tax paid is lower because of the progressive tax rate

Table 1-4

Summary of Tax-Planning Rules

	Marginal Tax Rate		
Type of Item	**Increasing**	**Decreasing**	**Unchanged**
Income	Calculate	Defer	Defer
Deduction	Calculate	Accelerate	Accelerate

structure. For example, if a taxpayer in the 22-percent marginal tax rate bracket can shift $1,000 in income to another taxpayer who is in the 10-percent marginal tax rate bracket, $120 [$1,000 × (22% − 10%)] of tax will be saved on the $1,000 in income. Obviously, taxpayers shifting income will want the income to go to taxpayers whom they want to benefit, such as children or grandchildren.

Example 31 A married taxpayer has $100,000 in taxable income in 2019. The taxpayer has two children who have no taxable income. What are the tax savings if the taxpayer can legally shift $5,000 in income to each of her children?

Discussion: The taxpayer saves $1,500 in tax by shifting $5,000 in taxable income to each child. Using the rates for married taxpayers, the tax on $100,000 in taxable income is $13,707:

$$\$9{,}086 + 22\% \ (\$100{,}000 - \$78{,}950) = \$13{,}717$$

By splitting the income into three streams, the taxpayer pays tax on $90,000, and each child pays tax (at single-taxpayer rates) on $5,000. This results in a tax of $12,517.

Tax on $90,000 for a Married Couple	
$9,086 + 22% ($90,000 − $78,950) =	$11,517
Tax on $5,000 for a Single Person	
$5,000 × 10% = $500 × 2 =	1,000
Total tax paid	$12,517

The result of the income shift to the children is a reduction in the total tax paid on the $100,000 in taxable income of $1,200 ($13,717 − $12,517).

It should be noted that numerous provisions in the tax law make it difficult to get the full advantage of income shifting. For example, merely directing that some of your income be paid to your children will not shift the income for tax purposes. To shift income to family members, you will generally need to transfer ownership of income-producing property to the children in order to shift the income from the property. Unless the parents are willing to give up ownership of income-producing property, income shifting to children is difficult to achieve. Even if a valid transfer of property ownership is made, if the child is younger than 18, provisions exist to take away much of the marginal rate advantage of such a shift.

Historically a popular income shifting technique used by owners of a business has been to incorporate the business and split the income between themselves and the corporation. The current law contains a 21 percent flat corporate tax rate. This means that income splitting with a corporation will only work when an individual has an effective tax rate greater than 21 percent. The following two examples illustrate this effect.

Example 32 Assume that the $100,000 in taxable income in example 31 comes from a business owned by the taxpayer. If the taxpayer incorporates the business and pays herself a salary of $50,000, what is the tax savings?

Discussion: Splitting the income between the taxpayer and a corporation results in a tax increase of $2,395. The taxpayer pays tax on $50,000, and the corporation pays tax on $50,000 ($100,000 income − $50,000 salary). This results in a tax of $16,112:

Tax on $50,000 for a Married Couple	
$1,940.00 + 12% ($50,000 − $19,400) =	$ 5,612
Tax on $50,000 for a Corporation	
$50,000 × 21% =	10,500
Total tax paid	$16,112

Before incorporation, the tax paid by the married couple was $13,717. The incorporation and split of the income actually costs the couple an additional $2,395 ($16,112 − $13,717) in tax.

Example 33 Assume the business in Example 32 earns $400,000 in income. If $100,000 of the income is reported on the taxpayer's individual return, and $300,000 is reported by the corporation, how much is the tax savings?

Tax on $400,000 for a Married Couple	
$65,497 + 32% (400,000 − 321,400) =	$ 90,649
Tax on $100,000 for a Married Couple	
$9,086 + 22% (100,000 − 78,950) =	13,717
Tax on $300,000 for a Corporation	
$300,000 × 21% =	$ 63,000
Total	$ 76,717
Tax Savings	$ 13,932

Discussion: Taxpayers only benefit from income splitting with a corporation if their marginal tax rate exceeds 21%, the flat rate of tax imposed on corporations under the 2017 Tax Cuts and Jobs Act.

Numerous other income-shifting techniques can be used by owners of a business. These include shifting income by employing children and using fringe-benefit packages to get tax-subsidized health care. It should be noted that careful planning is required to gain the optimal tax advantage from such shifting plans. The tax law contains many provisions designed to block blatant shifting schemes that lack economic substance. These provisions are discussed throughout the remainder of the text as they apply to the study of income and deductions.

1-8b Tax Evasion and Tax Avoidance

LO 8
Make the distinction between tax avoidance and tax evasion.

Taxpayers do not have to pay more income tax than is required by the tax law. In fact, taxpayers may plan transactions to make their tax bills as low as possible. In this regard, Judge Learned Hand stated: "[A] transaction, otherwise within an exception of the tax law, does not lose its immunity because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[33]

Tax evasion occurs when a taxpayer uses fraudulent methods or deceptive behavior to hide the actual tax liability. Tax evasion usually involves three elements:

- Willfulness on the part of the taxpayer
- An underpayment of tax
- An affirmative act by the taxpayer to evade the tax

Tax evasion often involves rearranging the facts about a transaction to receive a tax benefit. An intentional misrepresentation of facts on a tax return to avoid paying tax is not acceptable taxpayer behavior. Tax evasion is illegal and is subject to substantial penalties. Note that unintentional mathematical or clerical errors on the return are not generally considered tax evasion.

Tax planning uses tax avoidance methods. **Tax avoidance** is the use of legal methods allowed by the tax law to minimize a tax liability. Tax avoidance generally involves planning an intended transaction to obtain a specific tax treatment. Further, tax avoidance is based on disclosure of relevant facts concerning the tax treatment of a transaction.

Example 34 Ted, an accountant, uses the cash method of accounting. To avoid reporting additional income in 2019, he does not send his December bills to clients until January 2, 2020.

Discussion: The income was properly reported when collected in 2020. Under the cash method of accounting, Ted properly reported income when his clients paid him. Ted's activity involves permissible tax avoidance.

Example 35 Ken, a painter, spent all the cash he received for his art work. He deposited payments he received by check to his business bank account. When he filed his tax return, he intentionally did not report the cash receipts as income.

Discussion: Ken is engaged in tax evasion. Ken's method of reducing his tax is illegal, and he is subject to substantial penalties.

At this point, you are probably wondering, "How will the IRS ever know?" Most people are aware that it is almost impossible for the government to track every cash receipt of income. In fact, the probability that the IRS will detect underreporting of cash income is quite low. This has led many taxpayers to play the "audit lottery," omitting cash income or overstating deductions because they know that they probably will not be caught. The IRS estimates that this behavior results in a loss of more than $300 billion per year in tax revenue. This loss must be made up through higher taxes on honest taxpayers. It is clear that if taxpayers were more honest in their reporting of income and deductions, everyone's taxes could be lowered. There is no clear-cut, cost-efficient solution to the evasion problem. However, as future professionals and taxpayers, you should recognize your obligations to your profession and the country when it comes to tax evasion situations. Only through education and ethical taxpayer behavior will the tax evasion problem be resolved. Keep in mind that avoiding detection by the IRS does not somehow magically transform a fraudulent act into allowable behavior. The idea that something is not illegal unless one is caught is an idea that should have died ages ago.

1-9 ETHICAL CONSIDERATIONS IN TAX PRACTICE

LO 9
Introduce ethical considerations related to tax practice.

The field of tax practice is virtually unregulated—anyone who wishes to can prepare tax returns for a fee. However, anyone who prepares tax returns for monetary considerations, or who is licensed to practice in the tax-related professions, is subject to various rules and codes of professional conduct. For example, the Internal Revenue Code contains provisions (see Exhibit 1-4 for a list of preparer penalties) that impose civil and criminal penalties on tax return preparers for various improprieties.

All tax practitioners are subject to the provisions of *IRS Circular 230*, "Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service." Tax attorneys are subject

Exhibit 1-4

IRC Violations with Penalties for Tax Return Preparers

Understatement of taxpayer's liability because of unrealistic positions
Understatement of taxpayer's liability because of willful or reckless conduct
Failure to furnish a copy of a return to the taxpayer
Failure to sign a return
Failure to furnish identifying information
Failure to retain a copy or a list of returns prepared
Failure to file correct information returns
Negotiation of tax refund check
Improper disclosure or use of information on taxpayer's return
Organizing (or assisting in doing so) or promoting and making or furnishing statements with respect to abusive tax shelters
Aiding and abetting an understatement of tax liability
Aiding or assisting in the preparation of a false return

to the ethical code of conduct adopted by the state(s) in which they are licensed to practice. Certified Public Accountants (CPAs) who are members of the American Institute of Certified Public Accountants (AICPA) are governed by the institute's Code of Professional Conduct. The AICPA's Statements on Standards for Tax Services (SSTS) provide seven advisory guidelines for CPAs who prepare tax returns. Although tax practitioners who are not members of the AICPA are not bound by the Code of Professional Conduct and the Statements on Standards for Tax Services, the rules and guidelines contained in them provide useful guidance for all return preparers.

The AICPA Code of Professional Conduct is a set of rules that set enforceable ethical standards for members of the institute. The standards are broad and apply to all professional services that a CPA may render, including tax advice and tax return preparation. For example,

1. Rule 102 requires CPAs to perform professional services with objectivity and integrity, and to avoid any conflict of interest. CPAs should neither knowingly misrepresent facts nor subordinate their judgment to that of others in rendering professional advice.
2. Rule 202 requires compliance with all standards that have been promulgated by certain bodies designated by the AICPA's governing council.
3. Rule 301 states that CPAs will not disclose confidential client data without the specific consent of the client, except under certain specified conditions.

The seven SSTS provide guidance on what constitutes appropriate standards of tax practice. The statements are intended to supplement, not replace, the Code of Professional Conduct. Because they specifically address the problems inherent in tax practice, each statement is briefly described here. The full text of the SSTS can be found by going to www.cengage.com.

SSTS No. 1: *Tax Return Positions.* CPAs should not recommend that a position be taken on a return unless they believe that, if the position is challenged, it is likely to be sustained, which is known as the *realistic possibility standard.* CPAs should not prepare a return or sign as preparer of a return if they know the return takes a position that could not be recommended because it does not meet the realistic possibility standard. However, a CPA may recommend any return position that is not frivolous, so long as the position is adequately disclosed on the return. SSTS Interpretation No. 1-1 (reproduced in Appendix D) contains the AICPA interpretation of the realistic possibility standard.

SSTS No. 2: *Answers to Questions on Returns.* A CPA should make a reasonable effort to obtain from the client and provide appropriate answers to all questions on a

tax return before signing as preparer. Where reasonable grounds exist for omission of an answer, no explanation for the omission is required, and the CPA may sign the return unless the omission would cause the return to be considered incomplete.

SSTS No. 3: *Procedural Aspects of Preparing Returns.* A CPA may in good faith rely upon, without verification, information furnished by the client or third parties. Reasonable inquiries should be made if the information furnished appears to be incorrect, incomplete, or inconsistent. The CPA should use previous years' returns whenever possible to avoid omissions. In addition, the CPA may appropriately use information from the tax return of another client if the information would not violate the confidentiality of the CPA-client relationship and is relevant to and necessary for proper preparation of the return.

SSTS No. 4: *Use of Estimates.* A CPA may prepare returns using estimates provided by the taxpayer if it is impracticable to obtain exact data and the estimates are reasonable, given the facts and circumstances.

SSTS No. 5: *Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision.* If a CPA follows the standards in SSTS No. 1, the result of an administrative proceeding or court decision with respect to a prior return of the taxpayer does not bind the CPA as to how the item should be treated in a subsequent year's return.

SSTS No. 6: *Knowledge of Error: Return Preparation and Administrative Proceedings.* A CPA who becomes aware of an error in a previous year's return—or of the client's failure to file a required return—should promptly inform the client and recommend measures to correct the error. The CPA may not inform the IRS of the error except when required to do so by law. If the client does not correct the error, the CPA should consider whether to continue the professional relationship and must take reasonable steps to ensure that the error is not repeated if the relationship is continued. When a CPA becomes aware of an error in a return that is the subject of an administrative proceeding, the CPA should promptly inform the client of the error and recommend measures to be taken. The CPA should request the client's consent to disclose the error to the IRS but should not disclose the error without consent unless required to do so by law. If the client refuses disclosure, the CPA should consider whether to withdraw from representing the client in the administrative proceeding and whether to continue a professional relationship with the client.

SSTS No. 7: *Form and Content of Advice to Clients.* A CPA should use judgment to ensure that advice given to a client reflects professional competence and appropriately serves the client's needs. For all tax advice given to a client, the CPA should adhere to the standards of SSTS No. 1, pertaining to tax return positions. A CPA may choose to notify a client when subsequent developments affect advice previously given on significant tax matters but is under no strict obligation to do so.

CHAPTER SUMMARY

Taxes are a fact of everyday life. Taxes are levied on income, products, property holdings, and transfers of wealth. The federal income tax is the largest revenue producer of all the taxes in use in the United States. Therefore, a solid understanding of the basic rules of the income tax system is essential to maximize your after-tax income.

The term *tax* has been defined, and concepts have been examined that will help you reach your own conclusions about whether a tax is "good" or "bad." Keep these evaluations in mind as you continue through the text and as you read articles on proposed tax legislation.

The income tax law is a complex body of constantly changing information that is issued by legislative, administrative, and judicial sources. When evaluating a particular tax rule, it may be necessary to consult resources in all three areas.

Tax terms used in income tax computation have been defined in this chapter. Subsequent chapters explain the terms and build on the basic information. When you encounter a new term in later chapters, do not hesitate to refer to this chapter to see how the new term fits into the computational framework.

The study of federal income taxation will help you evaluate how business and personal financial decisions influence the amount of income tax you will have to pay. Awareness of basic income tax concepts will help you

recognize opportunities to minimize compliance costs, save taxes, avoid IRS penalties, and make more informed business decisions.

The practical approach to tax planning discussed in this chapter does not require you to be a tax specialist to become an effective tax planner. In later chapters, you will be asked to solve tax-planning problems that require you to make decisions about when an item of income or deduction should be reported. When solving these problems, you will need to consider the effects of changes in the marginal tax rate and the time value of money.

Finally, always be aware of the difference between tax evasion and tax avoidance. Avoid tax evasion—it is illegal. Tax avoidance is legal and is expected of taxpayers.

KEY TERMS

adjusted gross income (AGI) (p. 1-26)
ad valorem taxes (p. 1-14)
annual loss (p. 1-20)
average tax rate (p. 1-8)
certainty (p. 1-6)
convenience (p. 1-6)
correspondence examinations (p. 1-25)
deductions (p. 1-20)
deductions for adjusted gross income (p. 1-27)
deductions from adjusted gross income (p. 1-27)
deferral (p. 1-19)
Discriminant Function System (DIF) (p. 1-24)
document perfection program (p. 1-24)
economy (p. 1-7)
effective tax rate (p. 1-8)
equality (p. 1-5)
estate tax (p. 1-15)
exclusions (p. 1-19)
expense (p. 1-20)
field examinations (p. 1-25)
gain (p. 1-19)
gift taxes (p. 1-15)
gross income (p. 1-19)
horizontal equity (p. 1-5)
information-matching program (p. 1-25)
Internal Revenue Code of 1986 (p. 1-17)
IRS Appeals Division (p. 1-25)
itemized deductions (p. 1-27)
loss (p. 1-20)
marginal tax rate (p. 1-7)
office examinations (p. 1-25)
ordinary income (p. 1-19)
pay-as-you-go concept (p. 1-6)
personal property (p. 1-14)
progressive rate structure (p. 1-10)
proportional rate structure (p. 1-8)
protest letter (p. 1-25)
real property (p. 1-14)
regressive rate structure (p. 1-8)
self-employment tax (p. 1-12)
Social Security taxes (p. 1-12)
special audit programs (p. 1-25)
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tax evasion (p. 1-33)
Taxpayer Compliance Measurement Program (TCMP) (p. 1-24)
transaction loss (p. 1-20)
Treasury regulations (p. 1-18)
unified donative-transfers credit (p. 1-16)
vertical equity (p. 1-5)

PRIMARY TAX LAW SOURCES

[1]Rev. Rul. 77–29.

[2]Sec. 6072—Specifies the general rules for due dates of tax returns.

[3]Sec. 1—Imposes a tax on the taxable income of different classes of individual taxpayers; provides tax rates by class of taxpayer and requires adjustment of rate schedules each year for inflation; limits the tax rate on net long-term capital gains to 0 percent, 15 percent, and 20 percent.

[4]Sec. 3402—Requires employers to withhold estimates of taxes on wages and salaries paid to employees.

[5]Sec. 31—Provides that amounts withheld as tax from salaries and wages are allowed as credits against that year's tax liability.

[6]Sec. 6654—Provides that all individuals must pay estimated taxes when their tax liability is expected to be greater than $1,000; imposes a penalty for not paying the proper amount of estimated tax.

[7]Sec. 3101—Imposes the Social Security tax on employees; provides rates of tax to be paid.

[8]Sec. 1402—Defines *self-employment income* and provides for the tax to be paid on base amounts as specified in the Social Security Act for each tax year.

[9]Sec. 3111—Imposes the Social Security tax on employers for wages paid to employees.

[10]Sec. 1401—Provides the tax rates for self-employment taxes.

[11]Sec. 2501—Imposes a tax on transfers of property by gift.

[12]Sec. 2503—Allows exclusion from gift tax of gifts up to $15,000.

[13]Sec. 2505—Allows unified credit against taxable gifts.

[14]Sec. 2001—Imposes a tax on the assets of an estate. Provides tax rates on estate assets and for unlimited marital exclusion.

[15]Sec. 2010—Provides for unified tax credit against tax liability of an estate.

[16]Patient Protection and Affordable Care Act, P.L. 11–148 and Health Care and Education Reconciliation Act of 2010, P.L. 111–152—Imposes new taxes on individuals and businesses to pay for health care costs of those who cannot afford health insurance.

[17]Sec. 7801—Directs the secretary of the Treasury to issue the regulations necessary to implement and interpret the tax law.

[18]Sec. 61—Provides the general definition of *gross income* as all income from whatever source derived.

[19]Sec. 64—Defines *ordinary income* as income that does not result from the sale or exchange of property that is not a capital asset or an asset described in Sec. 1231.

[20]Sec. 1001—Prescribes the calculation of gains and losses for dispositions of property;

defines *amount realized* for purposes of determining gain or loss for dispositions.

[21]Sec. 162—Allows the deduction of all ordinary and necessary expenses incurred in a trade or business of the taxpayer.

[22]Sec. 212—Allows the deduction of all ordinary and necessary expenses incurred in a production-of-income activity of the taxpayer.

[23]Sec. 11—Imposes an income tax on corporations and provides the applicable tax rate schedules.

[24]Sec. 62—Defines *adjusted gross income* for individual taxpayers and specifies the deductions allowed as deductions for adjusted gross income.

[25]Sec. 1211—Sets forth the limit on deductions of capital losses of corporations and individuals.

[26]Sec. 63—Defines *taxable income*. Allows individual taxpayers to deduct the greater of their allowable itemized deductions or the standard deduction. Standard deduction amounts are specified and are required to be adjusted annually for inflation.

[27]Sec. 211—Generally allows specific personal expenditures as itemized deductions of individuals.

[28]Sec. 213—Allows the deduction of medical expenses as an itemized deduction for individual taxpayers; defines *medical expenses* and prescribes limitations on the amount of the deduction.

[29]Sec. 164—Specifies the allowable deductions for taxes.

[30]Sec. 163—Specifies the allowable deductions for interest.

[31]Sec. 170—Allows the deduction of contributions to qualified charitable organizations.

[32]Sec. 151—Allows an exemption deduction for the taxpayer, the taxpayer's spouse, and for each qualifying dependent.

[33]Helvering v. Gregory, 69 F.2d 809 at 810 (2d Cir. 1934).

DISCUSSION QUESTIONS

1. **LO1** Briefly state Adam Smith's four requirements for a good tax system.
2. **LO1** Based on the discussion in the chapter, evaluate how well each of these taxes meets Adam Smith's four requirements:
   a. Income tax
   b. Employment taxes
3. **LO1,2** 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.
4. **LO1,2** 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.
5. **LO2** 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?
6. **LO2** How are federal, state, and local income taxes collected by the government? Consider the cases of an employee and a self-employed taxpayer.
7. **LO2** How is a sales tax different from an excise tax?
8. **LO2** Who is responsible for collecting sales and excise taxes? Who actually pays the tax?
9. **LO2** Why is a tax on real property used more often than a tax on personal property?
10. **LO2** 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?
11. **LO2** 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?
12. **LO2** What is the basis for valuing assets transferred by gift and at death?
13. **LO2** Who is responsible for reporting and paying gift taxes? estate taxes?
14. **LO3** Identify three primary sources of tax law.
15. **LO3** 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."
16. **LO4** What is the federal income tax base?
17. **LO4** What is an exclusion?
18. **LO4** How is a deferral different from an exclusion?
19. **LO4** How is gross income different from income?
20. **LO4** What are the three basic tests that an expense must satisfy to be deductible?
21. **LO4** What is the difference between an expense and a loss?
22. **LO4** How is a transaction loss different from an annual loss?
23. **LO4** How does the legislative grace concept help identify amounts that qualify for deduction?
24. **LO4** Based on the example in Exhibit 1-2, explain how inflation can have two effects that result in a hidden tax.
25. **LO4** Explain the pay-as-you-go system.
26. **LO4** What is a tax credit?
27. **LO4** How is a tax credit different from a tax deduction?
28. **LO4** If you were in the 24 percent 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?

29. **LO5** What is the statute of limitations, and what role does it play in the filing of tax returns?

30. **LO5** Briefly describe the types of programs used by the IRS to select a return for audit.

31. **LO5** What are the three types of IRS examinations?

32. **LO5** What is included in the 30-day letter, and what options does the taxpayer have after receiving one?

33. **LO5** What does the 90-day letter represent, and what are the choices the taxpayer has after receiving one?

34. **LO6** How is the calculation of taxable income for an individual different from the calculation of a corporation's taxable income?

35. **LO6** How do deductions for adjusted gross income and deductions from adjusted gross income of an individual differ?

36. **LO6** What is the purpose of the standard deduction for individuals?

37. **LO7** Randy is studying finance at State University. To complete the finance major, he has to take a basic income tax course. Because Randy does not intend to be a tax expert, he considers the course a waste of his time. Explain to Randy how he can benefit from the tax course.

38. **LO7** Evaluate the following statement: "The goal of good tax planning is to pay the minimum amount of tax."

39. **LO7** 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?

PROBLEMS

40. **LO1** 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.
    b. The city paves a road and assesses each property owner on the road $4,000 for his or her share of the cost.
    c. The city of Asheville charges each residence in the city $10 per month to pick up the trash.
    d. Rory pays $450 of income tax to the state of California.
    e. Lanny is fined $45 for exceeding the speed limit.

41. **LO1** Explain why each of the following payments does or does not meet the IRS's 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.
    b. Polly Corporation pays state income taxes of $40,000 on its $500,000 of taxable income.
    c. Winona pays $15 annually for a safety inspection of her automobile that is required by the state.
    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.
    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.

42. **LO1** Susan is single with a gross income of $120,000 and a taxable income of $98,000. In calculating gross income, she properly excluded $10,000 of tax-exempt interest income. Using the tax rate schedules in the chapter, calculate Susan's
    a. Total tax
    b. Marginal tax rate
    c. Average tax rate
    d. Effective tax rate

43. **LO1** 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

44. **LO1** Rory earns $70,000 per year as a college professor. Latesia is a marketing executive with a salary of $140,000. With respect to the Social Security tax, what are Rory's and Latesia's
    a. Total taxes?
    b. Marginal tax rates?
    c. Average tax rates?
    d. Effective tax rates?

45. **LO1** For each of the following, explain whether the rate structure is progressive, proportional, or regressive:
    a. Plymouth County imposes a 5 percent tax on all retail sales in the county. Taxpayers with incomes less than $12,000 receive a refund of the tax they pay.
    b. The country of Zambonia imposes a 10 percent tax on the taxable income of all individuals.
    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

    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.

46. **LO1** 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 tax 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 percent of their salaries. Companies that produce sausage are allowed to deduct 50 percent of their sales. No other deductions are allowed.
    - Sausage tax—All sausage purchases are subject to a 100 percent of purchase price tax. Residents who consume less than 10 pounds of sausage per year are given a 50 percent 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.

47. **LO2** 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?
    b. November?

48. **LO2** Return to the facts of problem 47. Assume that each month, Joe Bob has $2,800 in federal income tax and $900 in state income tax withheld from his salary. What is Joe Bob's take-home pay in
    a. March?
    b. November?

49. **LO2** Gosney Corporation has two 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?

50. **LO2** 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?

51. **LO2** 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 have to pay in Social Security and self-employment taxes and why she owes those amounts. **Communication Skills**

52. **LO4** 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
    b. Interest received on a checking account
    c. Sale for $8,000 of Kummel Corporation stock that cost $3,000
    d. Receipt of $1,000 as a graduation present from grandfather
    e. Royalty income from an interest in a gold mine

53. **LO4** Classify the following items as ordinary income, a gain, or an exclusion:
    a. The salary received by an employee
    b. Dividends of $400 received on 100 shares of corporate stock
    c. Sale for $10,000 of an antique chair that cost $3,500
    d. Rental income from an apartment building
    e. Receipt of an automobile worth $20,000 as an inheritance from Aunt Ruby's estate

54. **LO4** Explain why each of the following expenditures is or is not deductible:
    a. Lumbar, Inc., pays $12,000 as its share of its employees' Social Security tax. The $12,000 is deductible.
    b. Leroy pays a cleaning service $250 per month to clean his real estate office. The $250 is deductible.
    c. Janice pays a cleaning service $75 per month to clean her personal residence. The $75 is not deductible.
    d. Leyh Corporation purchases land to use as a parking lot for $35,000. The $35,000 is not deductible.
    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.

55. **LO4** 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.
    b. Chiro Medical, Inc., pays $2,200 for subscriptions to popular magazines that it places in its waiting room.
    c. Lawrence pays $200 for subscriptions to fly-fishing magazines.
    d. The Mendota Partnership pays $200,000 to install an elevator in one of its rental properties.
    e. Sterling Corporation pays $6,000 for lawn maintenance at its headquarters.

56. **LO6** Based on the following information, what are the taxable income and 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

57. **LO6** Based on the facts in problem 56, calculate the taxable income and the tax liability for a married couple.

Communication Skills

58. **LO6** Reba's 2019 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	(12,200)
(Total itemized deductions are $2,300)	
Taxable income	$104,800

Before filing her return, Reba 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. Reba 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 Reba correct? Calculate her taxable income both ways. Write a letter to Reba explaining any difference in her taxable income arising from whether the $8,000 is deducted for or from adjusted gross income.

Communication Skills

59. **LO7** 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.

60. **LO7** 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?

61. **LO7** Inga, an attorney, completed a job for a client in November 2019. 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 2020. What factors should Inga consider in deciding whether she should delay sending the bill to the client?

62. **LO7** Art is in the 24 percent marginal tax bracket for 2019. He owes a $10,000 bill for business expenses. Because he reports taxable income on a cash basis, he can deduct the $10,000 in either 2019 or 2020, depending on when he makes the payment. He can pay the bill at any time before January 31, 2020, without incurring the normal 8 percent interest charge. If he expects to be in a 32 percent marginal tax bracket for 2020, should he pay the bill and claim the deduction in 2019 or 2020?

63. **LO7** 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 percent 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 percent, 22 percent, 24 percent, and 32 percent.

64. **LO7** Leroy and Amanda are married and have three 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 taxable income and income tax liability?
b. Leroy and Amanda would like to lower their income tax. How much income tax will they save if they validly transfer $5,000 of the interest income to each of their children? Assume that the children have no other income and that they are entitled to a $1,050 standard deduction.

65. **LO8** 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 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.
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.
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.
d. Bob entered a contract to sell a parcel of land at a $25,000 gain in 2018. To avoid reporting the gain in 2018, he closed the sale and delivered title to the land to the buyers on January 2, 2019.
e. Asha's taxable income for 2019 puts her in the 32 percent marginal tax bracket. She has decided to purchase new equipment for her business during 2020. 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 2019. She claims a $25,000 expense deduction under the special election for 2019.

66. **LO8** 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.
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 2018, so Dudley did it. In preparing their 2019 return, Roberta notices that Dudley included $1,000 of tax-exempt municipal bond interest in their 2018 gross income. To correct this mistake, Roberta takes a $1,000 deduction on the 2019 return.
c. In 2019, Hearthome Corporation receives notice that the IRS is auditing its 2017 return. In preparing for the audit, Hearthome's controller, Monique, finds a mistake in the total for the 2017 depreciation schedule that resulted in a $5,000 overstatement of depreciation expense.
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 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.

e. Sonja is a freelance 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. Aware that her chances of getting caught are small, Sonja does not include the $3,600 value of the computer in her gross income.

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 2019 salary. When she files her 2019 state income tax return, her actual state tax liability is $2,300.

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.

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

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).

TECHNOLOGY APPLICATIONS

Internet Skills

71. The purpose of this assignment is to introduce you to the tax information provided by the Internal Revenue Service on its website (www.irs.gov). Go to this site and look at the various types of information provided and write a short summary of what the IRS offers at its site. Chapter 1 discusses the audit and appeals process. Locate Publication 17, Tax Information for Individuals, and find the discussion of the examination and appeals process. Print out the text of this discussion.

Internet Skills

72. Many legislative, administrative, and judicial resources are available on the Internet. These can be located using a search engine or a tax directory site on the Internet. This assignment is designed to acquaint you with some of the tax directory sites. Go to one of the tax directory sites provided in Exhibit 16-6 (Chapter 16) and describe the types of information you can access from the site. Use at least three links to other sites and describe the information at each of the sites.

Communication Skills

73. 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 percent. 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.

Communication Skills

74. 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.

75. 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.cengage.com. Spreadsheet

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

DISCUSSION CASES

76. A value-added tax has been the subject of much debate in recent years as a tax to use to help reduce the deficit. Various forms of value-added taxes are used throughout Europe, Canada, and in many other countries. To acquaint yourself with the basic operation of a value-added tax, read the following article:
Peter Chin and Joel G. Siegel, "What the Value-Added Tax Is All About," *TAXES—The Tax Magazine*, January 1989, pp. 3–13.

After reading the article, consider the following circumstances:
Joe is married and has 2 children. A brain surgeon, he earns about $300,000 annually from his medical practice and averages about $250,000 in investment income. Jane, Joe's wife, spends most of her time doing volunteer work for charitable organizations. Tom is also married and has 5 children. He earns $40,000 per year working as a maintenance man for Joe.

While Joe was working late one night, he and Tom had a serious disagreement about two new tax bills recently introduced to help reduce the deficit. The first bill would levy a 10 percent value-added tax on all goods and services. A second bill introduced at the same time would add an additional 10 percent tax to each of the seven current tax rate brackets (i.e., 10 percent would become 20 percent, 12 percent would become 22 percent, 22 percent would become 32 percent, 24 percent would become 34 percent, 32 percent would become 42 percent, 35 percent would become 45 percent, and 37 percent would become 47 percent).

Joe is concerned that the imposition of a value-added tax would mean that fewer people could afford medical treatment. Both his patients and his practice would suffer from the tax. Tom strongly disagrees with Joe. He thinks that Joe does not want to pay his fair share of taxes. Tom charges that Joe can afford to hire tax accountants to help him avoid paying higher income taxes, even with the higher tax rates. By enacting a value-added tax, Tom believes, high-income taxpayers like Joe will have to pay up. He thinks it is the only fair way to raise taxes to bring down the deficit.

After several hours of arguing, neither could convince the other that he was wrong. Joe finally ended the discussion by saying that he would get an independent person knowledgeable in tax law to decide who is right.

You work for the firm that prepares Joe's tax return and advises him on managing his finances. The tax partner of your firm asks you to prepare a memorandum discussing the merits and deficiencies of the two proposals as they apply to Joe and Tom. In your memorandum, you are directed to specifically consider the following and provide a response:

a. What is a value-added tax, and how does it work?
b. Evaluate the rate structures of the two proposed taxes. Are they proportional, progressive, or regressive?
c. What, if anything, is wrong with Tom's and/or Joe's point of view? Be sure to explain this part in depth.

77. Norman and Vanessa are married and have 2 dependent children. This is a summary of their 2019 tax return:

Adjusted gross income	$107,837
Deductions from adjusted gross income:	
Standard deduction	(24,400)
Taxable income	$ 83,437
Tax liability	$ 10,073

a. Assuming that Norman and Vanessa's 2019 adjusted gross income will increase at an estimated 2.5 percent rate of inflation and that the standard deduction amounts does not change, calculate their 2020 taxable income. Calculate the tax liability on this income using the 2019 tax rate schedules (see Appendix B).

b. Calculate Norman and Vanessa's projected 2020 taxable income and tax liability, assuming that their adjusted gross income will increase by 2.5 percent and that all other inflation adjustments are made. Compare these calculations with those in part a, and explain how the inflation adjustments preserve Norman and Vanessa's after-tax income.

TAX PLANNING CASES

Communication Skills

78. Bonnie is married and has one 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 income from the rib joint?

b. You work for the firm that prepares Bonnie's tax return. Bonnie has asked the partner for whom you work to advise 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.

ETHICS DISCUSSION CASE

79. 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 Statements on Standards for Tax Services (which can be found at www.cengage.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.

Income Tax Concepts

2

Learning Objectives:

LO 1 Discuss the operation of the U.S. income tax as a system and how concepts, constructs, and doctrines provide overall guidance in the tax treatment of items that affect taxable income.

LO 2 Identify the general concepts that underlie the tax system and explain how the concepts affect taxation.

LO 3 Explain the effect of accounting concepts, how such concepts provide guidance in determining when an item of income should be included in gross income, and when an expense item is deductible.

LO 4 Describe income concepts and explain how they aid in determining which items constitute gross income for tax purposes.

LO 5 Discuss deduction concepts and how such concepts affect what may be deducted for income tax purposes.

2-1 INTRODUCTION

LO 1
Discuss the operation of the U.S. income tax as a system and how concepts, constructs, and doctrines provide overall guidance in the tax treatment of items that affect taxable income.

The federal income tax is based on a system of rules and regulations that determine the treatment of various items of income and expense. The key point to be made is that federal income taxation is based on a *system*. In fact, it shares the characteristics of any type of system. We are all familiar with systems; our society is organized by systems of rules. Some systems are natural and afford us little leeway in abiding by them. For example, gravity is part of the environmental system in which we live and a force that cannot be overcome without great difficulty. Because of our knowledge of and experience with the concept of gravity, we have learned that we must be aware of its effects on our behavior. For example, because of the effect of gravity, you cannot walk off a cliff without suffering grave consequences.

Most of the legal and social systems we deal with every day are artificial. That is, people make rules and prescribe actions to enforce them. In these systems, detailed rules are developed for general concepts. For example, all states have testing requirements that must be met to get a driver's license. A person who moves from one state to another generally has no problem passing the test in the new state because the general concepts involved in driving an automobile do not change from location to location.

Artificial systems are distinguished from natural systems by exceptions to the general rules of the system. These exceptions are necessary to meet specific needs. Returning to our driving example, we know that most states permit you to make a right turn at a red light after making a complete stop (i.e., the general rule). However, traffic experts have determined that some intersections are so hazardous that the general rule cannot be followed. The result is an exception to the law—we cannot make a right turn on red after a complete stop at some intersections. How do we identify those instances in which we may not make a right turn on red? Simple—the rules provide that an appropriately labeled sign be posted to alert us to the exception.

As with all artificial systems, the federal income tax system has been developed around general concepts that guide us in its application to various types of transactions. There are, of course, exceptions that do not follow from the application of the general concepts. These exceptions generally stem from the desire to use the tax system to promote some social, economic, or political goal. For example, the income tax law provides an exclusion from income for employer-provided health insurance policies. This payment of the employee's expenses by the employer could be taxed. However, to encourage

employers to provide health-care coverage for their employees (a social goal), Congress has excluded such payments from the employee's income. Another example of an exception involves losses on the sale of stocks. Net loss deductions on the sale of stocks by individuals are limited to $3,000 per year. However, to encourage investment in small companies (an economic goal), a special provision in the tax law allows the deduction of up to $50,000 in losses from an investment in the stock of a new company. The only effective way to learn the exceptions in the tax law is through experience and study. That is, there are no explicit "no right turn on red" signs in the tax law. The major exceptions to the general concepts of taxation are presented in this book, but the focus is on developing the ability to determine the treatment of transactions by applying the general concepts of taxation.

This chapter groups income tax concepts by their major function(s) within the income tax system. The four major groupings for discussion purposes are *general concepts, accounting concepts, income concepts,* and *deduction concepts.* Throughout the remaining chapters, the text constantly refers to these concepts to help explain the tax treatments being presented. You must understand these concepts, so we suggest that you return to this chapter and review the applicable concepts before you begin reading a new chapter. To help you, each chapter begins with a summary of the concepts applicable to the chapter's material.

Before beginning the discussion of the concepts, it is necessary to introduce a bit of terminology used throughout the remainder of the book. A **concept** is a broad principle that provides guidance on the income tax treatment of transactions. Because a specific concept covers many transactions, concepts are broad. A **construct** is a mechanism that has been developed to implement a concept. A **doctrine** is a construct that has been developed by the courts. Thus, constructs and doctrines are the interpretive devices necessary to apply a concept. When this book refers to a concept, the text includes all its related constructs and doctrines. An example of a concept is the annual accounting period concept; it requires all income tax entities to report their results on an annual basis. To properly identify the income of each annual period, each entity must select an accounting method. In this example, *annual accounting period* is the concept, and *accounting method* is the construct necessary to implement the concept. Thus, when we talk about the annual accounting period concept, the accounting method construct is implicitly a part of the concept.

This chapter introduces and discusses the fundamental concepts of income taxation. The discussion of each concept includes the fundamental constructs and doctrines necessary to begin the study of income taxation.

2-2 GENERAL CONCEPTS

LO 2
Identify the general concepts that underlie the tax system and explain how the concepts affect taxation.

General concepts provide guidance on the overall operation and implementation of the income tax system. As such, these concepts apply to almost every aspect of the system, be it an accounting issue, an income issue, or a deduction issue.

2-2a Ability-to-Pay Concept

A fundamental concept underlying the income tax structure is the **ability-to-pay concept**. This concept states that the tax levied on a taxpayer should be based on the amount that the taxpayer can afford to pay. The first result of this concept is that the income tax base is a *net* income number (i.e., income minus deductions and losses) rather than a *gross* figure such as total income received. Therefore, the tax base recognizes different deduction levels incurred by taxpayers as well as different levels of income.

Example 1 Jerry and Jody each have a total income of $65,000. Jerry's allowable deductions are $20,000, and Jody's allowable deductions are $35,000.

Discussion: Although Jerry and Jody have identical total incomes, Jerry's allowable deductions are $15,000 less than Jody's. Thus, Jerry has a greater ability to pay taxes than does Jody. Allowing deductions in the income tax base recognizes taxpayers' varying abilities to pay.

The example of Jerry and Jody illustrates that the notions of *income* and *deduction* are fundamental constructs that are used to implement one aspect of the ability-to-pay concept. Losses and tax credits also reduce the amount of tax due and are related to a taxpayer's ability to pay tax. These constructs were defined and discussed in Chapter 1, and we will not elaborate further at this juncture. However, we would note that the study of income taxation is essentially the study of what makes up these constructs. It is important to remember that these constructs are really the basic elements of the system.

A second aspect of the ability-to-pay concept is the use of a progressive tax rate structure. Recall that a progressive tax is one in which higher levels of the tax base are subjected to increasingly higher tax rates. Individuals with large taxable incomes pay a higher marginal tax rate than do individuals with small taxable incomes. Thus, both the tax base—taxable income—and the tax rate applied to the base are determined by the taxpayer's ability to pay tax. It should be noted that the ability-to-pay concept is undermined by provisions that exclude certain types of income from the tax base. That is, to the extent that a taxpayer has income that is not subject to tax because of an allowable exclusion, the taxpayer is being taxed at less than her or his ability to pay.

Example 2 Dewitt and Gloria are a retired couple with a taxable income of $32,000. The primary source of their taxable income is Gloria's pension and taxable dividends and interest. In addition, Dewitt and Gloria own municipal bonds that pay annual interest of $14,000 that is not included in their taxable income. What is the effect of the exclusion of the bond interest on the ability-to-pay concept?

Discussion: Because the $14,000 in interest from the bonds is available to pay Dewitt and Gloria's taxes, the exclusion of the interest from the tax base allows them to pay less tax than they could afford to pay. This effect is somewhat mitigated by the lower interest rates found on tax-exempt bonds when compared with taxable bonds. That is, by investing in municipal bonds, Dewitt and Gloria have accepted a lower interest rate than they could have obtained by investing in taxable bonds. Thus, they have paid some implicit tax on the bonds (although none of it goes to the federal government) by accepting the lower tax-exempt bond rate.

2-2b Administrative Convenience Concept

Throughout the discussion of the income tax, a particular item often is not treated consistently with the basic concept applicable to the situation. Many of these treatments result from the **administrative convenience concept**. This concept states that items may be omitted from the tax base whenever the cost of implementing a concept exceeds the benefit of using it. The cost is generally the time and effort for taxpayers to accumulate the information necessary to implement the concept as well as the cost to the government of ensuring compliance with the concept. The benefit received from implementation is generally the amount of tax that would be collected. Thus, many items that meet the definition of *income* are not taxed because the cost of collecting the information necessary to ensure compliance would be greater than the tax produced by the income.

Example 3 Bravo Company provides a break room for its employees. Free coffee is provided to the employees there at a cost to Bravo of ten cents per cup. Leroy is an employee of Bravo Company who drinks three cups of coffee in the break room on an average day. Is Leroy taxed on the free coffee he receives from Bravo Company?

Discussion: Under general concepts of income recognition (discussed later in this chapter and in depth in Chapter 3), Leroy receives income when he drinks the free coffee provided by his employer. This is, in effect, a form of compensation Bravo provides to its employees. However, the cost of each employee's tracking his or her consumption of coffee, as well as the cost of the government's ensuring that all employees include the cost of their free coffee in their income, exceeds the additional tax that would be collected. Thus, under the administrative convenience concept, Leroy is not taxed on the free coffee.

Another aspect of this concept relates to deductions for individuals. The tax law lets individuals take deductions for certain personal expenditures (e.g., medical expenses,

charitable contributions). However, many individuals incur only small amounts of these allowable personal deductions. In these situations, the tax law lets a taxpayer take a standard deduction in lieu of accumulating the information necessary to deduct the actual allowable deductions. This treatment saves taxpayers' time in accumulating and reporting deduction information and the government's time in ensuring the accuracy of the information reported (i.e., the standard deduction does not need to be audited).

Example 4 Tara believes that she probably does not have a significant amount of allowable personal deductions in 2019. Even if she searches her records, she figures it's unlikely she can document more than $12,200, the 2019 standard deduction for a single taxpayer.

Discussion: Tara may elect to deduct the $12,200 standard deduction. This relieves her of having to document her small amount of allowable personal deductions, and the government incurs no cost to ensure that her deductions are correct. When taxpayers' allowable personal deductions are close to the amount of their allowable standard deduction, it is more convenient for them to deduct the allowable standard deduction than spend a lot of time trying to document deductions that may provide very little tax savings.

2-2c Arm's-Length Transaction Concept

In seeking to pay the minimum amount of tax, taxpayers often structure transactions that may not reflect economic reality. In many such cases, the transaction is not given any tax effect because the transaction is deemed not to conform with the **arm's-length transaction concept**. An arm's-length transaction is one in which all parties have bargained in good faith and for their individual benefits, not for the benefit of the transaction group. Transactions that are not made at arm's length are generally not given any tax effect or are not given the intended tax effect.

Example 5 Bo, the sole shareholder of Shoe Company, owns a shoe-stretching machine for which he paid $15,000 and that is worth $18,000. He sells the machine to Shoe Company for $5,000. Can Bo deduct the loss on the sale of the machine to Shoe Company?

Discussion: Because Bo was, in effect, negotiating with himself when he sold the machine to Shoe Company, the transaction was not made at arm's length, and Bo will not be allowed to deduct the loss on the sale. NOTE: Bo can deal at arm's length with Shoe Company. However, the tax law assumes that related parties (defined subsequently) do not transact at arm's length. One effect of this assumption is that losses on sales to related parties are always disallowed, even if the transaction is made at arm's length and the price reflects fair market value.

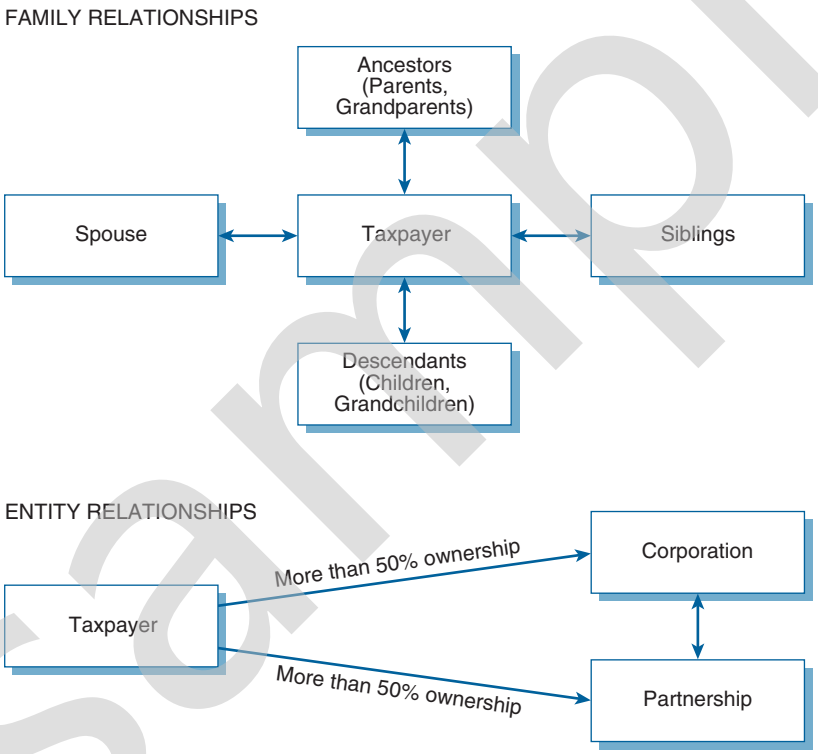
As example 5 shows, transactions that are not made at arm's length generally involve an element of self-dealing. The tax law has formally incorporated the notion of self-dealing through a set of **related party provisions**.[1] Some of the more-common related party relationships (as depicted in Figure 2-1) are

1. Individuals and their families. Family members include a spouse, brothers, sisters, lineal descendants (children, grandchildren), and ancestors (parents, grandparents).
2. Individuals and a corporation (or a partnership) if the individual owns more than 50 percent of the corporation (or the partnership).
3. A corporation and a partnership if the same person owns more than 50 percent of both the corporation and the partnership.

Note that all these relationships have the potential for self-dealing, either because of family relationships or a substantial ownership interest in an entity. The more-than-50-percent test for corporations and partnerships is based on the level of ownership necessary to control the actions of these entities. In example 5, Bo and Shoe Company are related parties because Bo owns more than 50 percent of Shoe Company and effectively controls Shoe Company's actions. Thus, when Bo deals with Shoe Company, he really deals with himself. In trying to circumvent the related party rules, individuals might

Figure 2-1

Related Party Relationships



reduce their direct ownership in a corporation or a partnership by distributing ownership among family members, other corporations, or partnerships that they control. This effort is stymied by the **constructive ownership rules**, which state the relationships within which an individual is deemed to indirectly own an interest actually owned by another person or entity. These rules can be complex and are beyond the scope of this text.

2-2d Pay-as-You-Go Concept

The U.S. income tax system is one in which voluntary compliance is essential to the operation of the system. Most taxpayers comply with the requirement that they file a return each year and pay the tax due on their taxable income. However, the payment of the entire tax bill at the end of the year could be unduly burdensome for those taxpayers who do not have the foresight to save money for the payment of the tax or who do not have the ability to adequately estimate the amount of the tax they owe. To alleviate situations in which taxpayers are faced with a huge tax bill at the end of the year, the **pay-as-you-go concept** requires taxpayers to pay tax as they generate income. This concept is implemented through withholding and estimated tax payment requirements. The withholding provisions require employers to withhold amounts from each employee's paycheck to pay the tax on the income in that check. The withheld amounts are remitted to the government, and taxpayers receive credit on their tax returns for the tax paid through withholding. This minimizes the probability of a taxpayer facing a huge tax bill at the end of the year. Note that the taxpayer might pay too much tax through this process. In such cases, the government simply refunds the excess tax that has been paid.

Example 6 Giovanna is a machinist who works for Adilia Company. During the current year, she earned $32,500 and had $2,850 of federal income tax withheld from her paycheck. In filing her return, Giovanna's actual tax was determined to be $3,000. How much tax must Giovanna pay when she files her return for the current year?

Discussion: Although Giovanna's actual tax is $3,000, she has already paid in $2,850 through withholding. Therefore, she has to pay only $150 ($3,000 – $2,850) when she files her current year's return. NOTE: The withholding provisions ease for Giovanna the burden of having to come up with the full $3,000 when she files her tax return. By having Giovanna pay as she goes (her employer withholds tax payments), the tax system encourages voluntary compliance; it spreads the burden of taxes over the period of time during which the income is being earned.

Although salaries paid by employers constitute a large percentage of the income taxed in the United States, it is by no means the only source of income for individual taxpayers. That is, taxpayers often earn income independent of any employee–employer relationship. Many people are their own bosses (i.e., self-employed), others earn income from investments such as savings accounts, dividends from stock, and sales of assets, and retired individuals collect pensions, Social Security benefits, and income from investments. To ensure that such taxpayers have the means to pay the tax due on these various sources of income, all individual taxpayers are required to make quarterly estimated tax payments—to meet the estimated tax payment requirements—when their estimated tax due for the year is at least $1,000.[2] Corporations also must file quarterly estimated tax payments. Thus, taxpayers who have significant amounts of income that are not subject to withholding by employers are also required to adhere to the pay-as-you-go concept. Failure to make the required estimated tax payments will result in a penalty for underpayment of estimated taxes.

2-3 ACCOUNTING CONCEPTS

LO 3
Explain the effect of accounting concepts, how such concepts provide guidance in determining when an item of income should be included in gross income, and when an expense item is deductible.

Accounting concepts guide the proper accounting for and recording of transactions that affect the tax liability of taxpayers. To determine the treatment of a transaction, we must first identify the appropriate taxpaying unit. Next, we must ascertain the rationale that controls its tax treatment in order to record it. Finally, the transaction must be reported in the correct tax period. These ideas appear to be rather simplistic and part of basic bookkeeping. That is partly true. However, without these basic accounting concepts, the tax system could not function in an orderly and efficient manner. Perhaps even more important, without these concepts, taxpayers could manipulate their affairs so as to avoid paying taxes for many years.

2-3a Entity Concept

The most basic accounting concept is the **entity concept**. According to the entity concept, each tax unit must keep separate records and report the results of its operations separate and apart from other tax units. The tax law requires that all tax units be classified as one of two basic entity types: taxable or conduit. The characteristics and unique features of each of the taxable and conduit entities are discussed in detail in Chapters 13 and 14.

Taxable entities are those that are liable for the payment of tax. That is, taxable entities must pay a tax based on their taxable income. The four entities responsible for the payment of income tax are individuals; regular, or C corporations; estates; and some trusts.

Conduit entities are nontaxable reporting entities. A conduit entity is one in which the tax attributes (income, deductions, losses, credits) of the entity flow through the entity to the owner(s) of the entity for tax purposes. The entities record transactions undertaken by the entity and report the results to the government. However, these entities pay no tax on the results of their operations. Rather, the tax characteristics (i.e., the income, deductions, losses, tax credits) of the operating results are passed through the conduit entity and are taxed to its owners. NOTE: All conduit entities are owned by one or more taxable entities. Two types of conduit entities authorized by the tax law are partnerships and subchapter S corporations.[3,4] Hereafter, any reference to a corporation means a taxable C corporation. Conduit corporations are referred to as *S corporations*.

Trusts are a mixture of taxable and conduit entities. A trust is an arrangement in which a trustee manages assets for the benefit of another, referred to as the *beneficiary*. The trust reports the results of its operations to the government (a conduit

characteristic). Any income distributed by the trust to the beneficiary is taxable to the beneficiary. However, the trust must pay income tax on any income that is earned but not distributed to the beneficiary (a taxable entity characteristic). Thus, trusts are both taxable and conduit entities in that they are taxed on income that is retained and are not taxed on income that is distributed.

To illustrate the relationship between the two basic types of entities, consider a 100-percent owner of a corporation. The corporation is recognized as an entity separate from its owner for purposes of recording transactions. That is, the owner cannot commingle personal transactions with those of the corporation for tax purposes. All income, deductions, losses, and credits attributable to the operation of the business are identified and recorded on the books of the corporation. The summarized results of these transactions are then reported on the corporation's tax return, and a tax is paid on the corporate taxable income. The owner of the corporation includes as income on an individual tax return only any salary or dividends she or he receives from the corporation. However, a different result is obtained if the corporation is organized as an S corporation. As a conduit entity, the S corporation still identifies and records on its books only those items that are attributable to the operation of the corporation. The summarized results of the transactions are reported to the government, but the S corporation pays no tax on its income. Rather, the income of the S corporation is reported on the tax return of the owner, along with the owner's other items of income and deductions, and a tax is paid based on the owner's taxable income. The 2017 Tax Cuts and Jobs Act added a new deduction for non-corporate taxpayers on qualified business income (QBI). The QBI deduction, also referred to as the "pass-through deduction," generally allows a taxpayer to deduct from taxable income 20 percent of the business income minus business expenses.[5] This deduction is discussed in greater detail in Chapters 6 and 13.

Example 7 Martina and Fran each own 50% of the stock of Card Corporation. During the current year, Card Corporation had a taxable income of $80,000 and paid a total of $20,000 in dividends. What are the tax effects of Card Corporation's income and dividend distributions?

Discussion: As a separate and distinct taxable entity, Card Corporation must pay the tax on its $80,000 in taxable income. Martina and Fran each must include the $10,000 in dividends she received from Card Corporation in her calculation of taxable income. Note that the dividends are being taxed twice—once when included as income by the corporation and again when distributed to the shareholders.

Example 8 Assume the same facts as in example 7, except that Card Corporation is an S corporation. What are the tax effects of Card Corporation's income and dividend distributions?

Discussion: An S corporation is a conduit entity. The $80,000 is Qualified Business Income. The S corporation is entitled to deduct 20% of its Qualified Business Income, so $64,000 of income flows through to the owners and is included on their tax returns. Card Corporation pays no income tax. Martina and Fran each must include $32,000 in income on her individual tax return. Because the $64,000 is being taxed to the owners, the dividends paid are not taxed again to the owners. Rather, the dividends are considered a repayment of their investment that reduces the amount invested in the stock of the corporation.

The distinction between entities becomes blurred when a business is owned as a sole proprietorship. Although not technically a conduit entity, the sole proprietorship does not pay tax on its income. The books of the sole proprietorship are kept separate and distinct from the personal transactions of the owner. However, the income tax attributes of the business are reported on the owner's return, in much the same manner as a conduit entity.

Example 9 Karina is a machinist for Silver Marine Company. At nights and on weekends, she repairs washing machines and dryers. During the current year, Karina's income from her repair business was $10,000, and she incurred $3,500 in expenses to produce this income. She also earned a salary of $30,000 from Silver Marine and had $400 in interest income from a savings account. How should Karina treat these items on her tax return?

Discussion: Karina's repair business is a sole proprietorship, which is similar to a conduit entity. In accounting for the repair business, she must keep the results of the repair business separate from her other taxable transactions. The business income of $10,000 and business expenses of $3,500 result in an income of $6,500 from the repair business. She would be allowed a QBI deduction of $1,300 ($6,500 × 20%). The $5,200 ($6,500 − $1,300) in business income is then added to her salary and interest income on her individual return, and Karina pays tax on the sum of all her income.

The result for our sole proprietor appears to be much ado about nothing. However, two important aspects of this entity treatment prevent income manipulation. First, because the commingling of business and personal transactions is not allowed, owners cannot turn nondeductible personal items into deductible business expenses. The classic example of this separation is interest expense. As we shall see in Chapter 5, all interest paid on debt incurred in a trade or business (i.e., the sole proprietorship) is fully deductible, whereas interest paid on debt used for personal purposes (other than qualified home mortgage interest and education loan interest) is not deductible. The entity concept requires the owner to identify these two types of interest for each entity and deduct them according to the rules for that entity. Without such a split, business owners would effectively be allowed to deduct all their interest, and basic wage earners would get no deduction for interest on their personal debts. This treatment would result in an inequity most taxpayers would not tolerate.

Example 10 In example 9, assume that Karina owns a van that she uses on repair calls. She also drives the van to work at Silver Marine and for various other personal purposes such as trips to the store, taking the kids to school, and so on. How should Karina account for the van and its operating costs?

Discussion: For tax purposes, the van is viewed as two distinct assets. One asset is used in her repair business, whereas the other asset is used as a personal vehicle. Karina must keep records that adequately document the use of the van in her repair business. She can deduct the costs incurred in using the van in her repair business. The costs incurred for her personal use of the van are not deductible. This separation of business and personal use is required by the entity concept.

The second major aspect of the reporting of a conduit entity's income on the return of the owner of the entity is that, with the exception of the 20 percent deduction for QBI from pass-through entities, conduit entities are not useful in income-shifting strategies. This results from the progressive nature of the federal income tax. Recall that in a progressive tax rate structure, the higher your taxable income is, the greater your marginal tax rate becomes. If each conduit entity paid tax on its separate income, taxpayers would be able to arrange their affairs into a multitude of conduit entities, all of which are taxed at the lowest marginal income tax rate. Under such circumstances, the income tax would effectively become a flat tax at the lowest tax rate instead of the progressive rate desired. By passing the income through to the owners of the conduit entity, income shifting by using such entities is not an effective tax-planning strategy. As an aside, it should be noted that the tax laws' requirement that taxable entities aggregate results from all their income-producing activities also contains a positive element. That is, if the conduit entity posts a loss from its operations, the taxable entity or entities that own the conduit are generally allowed to use this loss to offset income from other sources.

Example 11 Assume the same facts as in example 9, except that Karina's repair income was $8,000 and her expenses for producing this income were $11,000. How should Karina treat this on her tax return?

Discussion: The loss from the repair business flows through to Karina's individual return. The $3,000 loss is deductible on Karina's individual tax return, reducing the tax she would have paid on her other income.

Assignment-of-Income Doctrine

One corollary of the entity concept is the judicially developed **assignment-of-income doctrine**.[6] According to this doctrine, all income earned from services provided by an entity is to be taxed to that entity, and income from property is to be taxed to the entity that

owns the property. Merely directing payment of income (i.e., assigning income) that has been earned by one entity to another, although legal, does not relieve the owner of the income from paying tax. Thus, it is not possible to avoid the payment of tax on wages earned by simply having them paid to someone else. Although you may legally assign the right to receive income to another, the income tax is imposed on the person who earns the income.

Example 12 Sharon owns a landscaping business. She has a 2-year-old son, Jeffrey. To provide funds for Jeffrey's college education, Sharon has every tenth customer make her or his check payable to Jeffrey. Sharon deposits the checks in a savings account in Jeffrey's name. Is Sharon taxed on the amounts paid to Jeffrey?

Discussion: Under the assignment-of-income doctrine, Sharon cannot escape taxation on the income from her labor by directing the payments to Jeffrey. Sharon is taxed on all income earned by the landscaping business, regardless of who receives payment for the services.

Similarly, the owner of a building cannot escape taxation on the income from the building by having the rents paid to another entity. The only legal way for the building owner to pass the taxability of the income to the other entity is to legally transfer ownership of the building to that entity.

Example 13 Andrea owns a house that she rents out to college students attending State University. Her grandson Andy is a student at State University. To help Andy with his college expenses, Andrea has her tenants pay the rent to Andy. Is Andrea taxed on the rental income?

Discussion: Because Andrea owns the rental property, she is taxed on all rents, whether she or Andy receives the payments. Under the assignment-of-income doctrine, the owner of property is taxed on the income of the property, regardless of who actually receives the income.

Discussion: For Andrea to avoid payment of tax on the rental income, she would have to make a valid gift of the house to Andy. This would make Andy the owner of the property and thus taxable on the rental income. Andy would pay no income tax on the receipt of the gift property. Andrea may or may not have to pay a gift tax on such a transfer.

2-3b Annual Accounting Period Concept

The second accounting concept is that of an annual accounting period. The **annual accounting period concept** states that all entities must report the results of their operations on an annual basis and that each taxable year is to stand on its own, apart from other tax years.[7] The most basic result of this concept is that all entities must choose an annual accounting period for reporting their results to the government. The two basic types of accounting periods are calendar years, which end December 31, and fiscal years, which end on the last day of any other month the taxpayer chooses. Although all entities are allowed to choose their accounting period, most individuals elect to be calendar-year taxpayers. This book assumes the taxpayer is using the calendar year unless otherwise noted. The election of a fiscal year carries some important restrictions, the most important of which are discussed in Chapter 13.

Accounting Method

An important outgrowth of the annual accounting period requirement is that each taxpayer must select an **accounting method** to determine the year(s) in which taxable transactions are to be reported.[8] The two basic allowable methods are the **cash basis of accounting** and the **accrual basis of accounting**. Taxpayers using the cash basis are taxed on income as it is received and take deductions as they are paid. In contrast, accrual basis taxpayers report their income as it is earned and take deductions as they are incurred, without regard to the actual receipt or payment of cash. At this point, a simple example will illustrate the basic differences between the two methods of accounting.

Example 14 Steen, Inc., is in the carpet-cleaning business. In December 2019, Steen cleans Gary's business office and bills him $200. Gary pays Steen in January 2020.

Discussion: Assume that both Steen, Inc., and Gary are cash basis taxpayers. Although Steen earns the $200 during 2019, it is not taxed on the $200 until payment is received in 2020. Similarly, Gary takes the deduction for the carpet-cleaning expense in 2020 when he makes the payment.

Example 15 Assume that in example 14, both Steen, Inc., and Gary are accrual basis taxpayers.

Discussion: Steen must include the $200 in the year in which it was earned, 2019, and Gary takes his deduction in the year the carpet-cleaning expense is incurred, 2019.

Discussion: Assume that Steen, Inc., is on the cash basis and Gary is on the accrual basis of accounting. Steen does not include the $200 in income until it is received in 2020. Gary deducts the carpet-cleaning expense in the year incurred, 2019.

Note that the use of the cash method violates generally accepted accounting principals (GAAP), which require books to be kept using the accrual method. The accrual method used for tax purposes is generally the same as that used in financial accounting under GAAP. However, various limitations and exceptions apply to the application of each method. The most important of these are discussed as they apply to income recognition in Chapter 3 and to deductions in Chapter 5.

Tax Benefit Rule

The requirement that each tax year stand on its own, apart from other tax years, leads to some problems when circumstances arise in which one transaction could affect more than one year. This has led to development of the **tax benefit rule**. Under this rule, any deduction taken in a prior year that is recovered in a subsequent year is reported as income in the year it is recovered, to the extent that a tax benefit is received from the deduction.[9] The tax benefit received means the amount by which taxable income was actually reduced by the deduction recovered. Consider the following examples:

Example 16 Rayson Corporation is an accrual basis taxpayer selling widgets for cash and on account. Late in 2017, Rayson sells $500 worth of widgets on account to Tom. In 2018, before any payment is made to Rayson, Tom is sentenced to 20 years in prison for embezzlement. How should the corporation account for this series of events?

Discussion: Because Rayson Corporation is on the accrual basis, it includes the $500 sale to Tom as income in the year of the sale, 2017. The tax law does not generally allow taxpayers to use the allowance method of accounting for bad debts, so Rayson must wait until it determines that Tom's debt is worthless to take a bad debt deduction. Going to jail for 20 years is enough evidence that Tom won't pay the debt, so Rayson should take a bad debt deduction of $500 in 2018. The recognition of the bad debt in 2018 stems from the annual accounting period concept requirement that the events of each tax year stand alone. Rayson Corporation does not go back to amend the income reported in 2017.

Example 17 While Tom is in prison, his aunt dies and leaves him a considerable inheritance. He had always felt badly about not paying Rayson Corporation for the widgets, so in 2018, he sends Rayson a check for the $500. How should Rayson account for the $500?

Discussion: Because Rayson Corporation took a deduction for Tom's bad debt in 2018, the tax benefit rule requires it to include the $500 in its 2019 income. Note again that there is no attempt to adjust the prior year's income. The events of each tax year stand apart from each other under the annual accounting period concept.

As these examples demonstrate, the tax benefit rule has its most common applications in situations in which an annual accounting period and an accounting method interact. It is necessary to put accrual basis and cash basis taxpayers in the same position after accounting for all years involved. In example 16, if Rayson Corporation had been a cash basis taxpayer, it would have recognized no income from the initial sale to Tom, because it never received payment. However, when Rayson received the $500 payment

in 2019, it would have been included in income under the cash basis. Thus, over the three-year period, both a cash basis and an accrual basis taxpayer would have recognized income of $500 from the transactions in examples 16 and 17.

Substance-over-Form Doctrine

The accounting concepts, constructs, and doctrines presented to this point require that all transactions be traced to and recorded by the entity responsible for that transaction in accordance with the method of accounting selected by that entity. Occasionally, the basis for recording the transaction is not clear. That is, taxpayers attempting to avoid taxation sometimes carefully sculpt transactions that are unrealistic in the ordinary sense.

Example 18 Bill is the sole proprietor of Bill's Sub Shop. To lower his tax on the income from the sub shop, Bill "employs" his three-year-old daughter as a janitor at a salary of $200 per week. Is Bill's employment of his daughter unrealistic?

Discussion: Because it is unlikely that a three-year-old could perform such services, Bill's characterization of his daughter as an employee is unrealistic.

Although the courts have consistently held that taxpayers are under no legal obligation to pay more tax than the law prescribes (i.e., tax avoidance is a legal activity), the courts have also said that transactions must bear some semblance of reality. This judicially created concept is referred to as the **substance-over-form doctrine**. The doctrine states that the taxability of a transaction is determined by the reality of the transaction, rather than some (perhaps contrived) appearance.[10] This is generally interpreted to mean that a transaction is to be taken at its face value only when it has some business or economic purpose other than the avoidance of tax.

Example 19 In example 18, should Bill be allowed to deduct the salary paid to his daughter?

Discussion: Because the payment of the salary to his daughter is unrealistic under the circumstances, Bill would not be allowed a deduction for salary. This arrangement lacks economic substance and is solely for the purpose of tax avoidance. Thus, the form of the arrangement (daughter as an employee) is ignored, and the tax treatment is based on the substance of the transaction (a gift to his daughter, which is not deductible).

When might substance over form apply? This is a difficult and subjective question that has no hard-and-fast answers that apply in every situation. However, a few factors should alert us to the possibility of this doctrine being invoked by the IRS. The major element to look for is whether the transaction has economic substance. Most legitimate business transactions are made at arm's length between two parties, neither of which stands to benefit by mutual manipulation of the transaction. Consider the following examples:

Example 20 Selma is the president and chief executive officer of Megainternational Corporation. Megainternational is a large, publicly held corporation that operates in more than 50 countries around the world. During the current year, Selma receives a salary of $1,000,000. Can Megainternational deduct the $1,000,000 salary paid to Selma?

Discussion: Megainternational can deduct the entire $1,000,000 in salary paid to Selma. The salary contract was negotiated at arm's length between Selma and Megainternational. Because Megainternational is a publicly held corporation, Selma is not able to exert undue influence over her contract, and the salary paid to her would be typical of such a position.

Example 21 Eugene is the president and chief executive officer of Florence Dunes Company. Florence is a corporation that is wholly owned by Eugene and his wife, Dahlia. Florence pays Eugene a salary of $300,000 during the current year and a bonus of $200,000. The bonus is paid even though Florence has only $250,000 in income. Although Florence has been in business for more than 10 years, it has never paid a dividend. Can Florence deduct the $500,000 in salary and bonus it pays to Eugene?

Discussion: Because Florence is wholly owned by Eugene and Dahlia, salary payments to the owners are subject to extra scrutiny. All deductions are subject to the requirement that they be reasonable under the facts and circumstances. In Eugene's case, the first question is whether the $300,000 salary is reasonable when compared with the salaries paid by comparable companies to executives who do not control the corporation. Any portion of the salary that is unreasonable is considered a dividend paid to the owner. Dividends are not deductible expenses of a corporation.

Eugene's bonus payment is suspicious under the circumstances. Because Florence has never paid a dividend, the payment of such a large bonus relative to the income of the corporation to a 100-percent owner appears to be more in the nature of a dividend distribution. Thus, although the form of the payment is a salary bonus, the substance of the payment is that of a dividend distribution under the facts presented. It is unlikely that the bonus can be deducted as a salary payment by Florence.

2-4 INCOME CONCEPTS

LO 4
Describe income concepts and explain how they aid in determining which items constitute gross income for tax purposes.

Income concepts determine what constitutes taxable income, explain why one type of income is taxed differently than other income, and establish the period in which income is to be reported.

2-4a All-Inclusive Income Concept

The broadest income concept is the **all-inclusive income concept**. Under this concept, all income received is considered taxable unless some specific provision can be found in the tax law that excludes the item in question from taxation. Income can be received in any form: cash, property, services, and so on. Thus, the tax law always starts with the proposition that anything of value received is taxable.[11] Many situations dealing with income recognition are covered in Chapter 3, so we are using only one example here to illustrate the pervasive nature of this concept.

Example 22 Felicia is a tax accountant with Oil Rich Company. Alice is a plumber. Both are cash basis taxpayers. Felicia had a problem with her plumbing that Alice fixed. The normal charge for this service would have been $300. However, Alice agreed to waive her fee in exchange for some tax advice from Felicia relating to her business. Does either Felicia or Alice have taxable income from this agreement?

Discussion: Both Felicia and Alice have income from rendering services, Alice from the plumbing repair and Felicia from the provision of tax advice. Although income was never reduced to cash by either party, both received something of value in exchange for their services. Alice should report the $300 as income when she receives the promised tax advice. Felicia should report $300 of income when Alice fixes her plumbing.

We noted earlier that certain items of income are not subject to tax. How do we know which items are taxable and which are not? As with all exceptions to the general concepts, only study and experience in working with the tax laws provide answers. Chapter 4 discusses some major income items that are excluded from taxation.

2-4b Legislative Grace Concept

Exclusions are based on the **legislative grace concept**. This concept states that any tax relief provided to taxpayers is the result of specific acts of Congress that must be applied and interpreted strictly. Note that relief from taxes on income received can take several forms. Income can be either permanently excluded from tax, or it may be deferred for taxation in a future period (resulting in a time value of money savings). *Legislative grace* means that only Congress can grant an exclusion from income, and the exclusion must be taken in its narrowest sense. An example illustrates these two related notions.

Example 23 Jorge receives 200 shares of MNO Corporation common stock as a gift from his grandfather. At the date of the gift, the shares have a fair market value of $20,000. During the current year, Jorge receives dividends totaling $2,000 on the stock. Recall that the tax law excludes the value of a gift from the gross income of the recipient. What are the tax effects for Jorge of the gift from his grandfather?

Discussion: The receipt of the stock as a gift from the grandfather is specifically excluded from Jorge's income by the tax law. However, the exclusion applies only to the value of the gift received and does not exclude from tax any subsequent income Jorge receives on the gift property.[12] Therefore, Jorge is taxed on the $2,000 in dividends received on the stock.

One other form of tax relief that Congress has provided is special treatment for certain types of income. Most income received and allowable losses incurred by taxpayers are simply added to (or deducted from, in the case of losses) the income tax return of the taxpayer and taxed according to the taxpayer's marginal tax rate. In tax jargon, this is referred to as *ordinary income (loss)*. Congress has created a special class of income treatment for gains and losses arising from the sale of capital assets. A **capital asset** is generally defined as any asset that is *not* a receivable, inventory, real or depreciable property used in a trade or business, or certain intangible assets, such as copyrights.[13] Thus, capital assets primarily consist of stocks, bonds, and other investment-related assets. In addition, all personal use assets (home, furniture, clothing, automobile, etc.) of individual taxpayers are capital assets.

The gains and losses from the sale of capital assets, known as **capital gains** and **capital losses**, must be separated from other gains and losses and aggregated through a prescribed netting procedure before they enter into the taxpayer's income calculation. Net long-term capital gains are currently given preferential treatment through a reduction in the tax rate that must be paid on this type of income. Currently, the tax rate paid on net long-term capital gains is 15 percent (zero percent if the taxpayer's AGI is below $78,750 married filing jointly, 20 percent if the taxpayer's AGI exceeds $488,850 married filing jointly), versus the top marginal tax rate of 37 percent for individual taxpayers. If the netting procedure results in a net capital loss for the year, only $3,000 of the net capital loss can be deducted from an individual's tax return per year.[14] Chapter 3 provides an overview of capital gains, whereas Chapter 11 covers capital gains and losses in more detail. For now, just remember that capital gains and losses are treated differently than all other types of income and losses.

2-4c Capital Recovery Concept

Once it has been determined that an item of taxable income has been received, the next logical step is to determine the amount of the income that belongs in the calculation of taxable income. In most cases, this is straightforward. However, sales of investment and/or business assets require more guidance. The **capital recovery concept** states that no income is taxed until all capital previously invested in the asset is recovered.[15] That is, on any asset purchased, all investment in the asset must be recorded to determine the amount of profit (or loss) made upon disposition of the asset. The amount invested in an asset is referred to as its **basis**.[16]

Example 24 Earl purchases 100 shares of ABC Company's common stock at a total cost of $1,000. When he sells the stock, one lot of 50 shares is sold for $600 and the other 50 shares are sold for $300. What are the tax effects of these sales?

Discussion: Because there are two separate sales of the stock at different prices, each sale must be considered separately. Each 50-share lot has a basis of $500 (half the $1,000 purchase price). The lot sold for $600 results in a $100 ($600 – $500) taxable gain. That is, Earl has recovered $100 more than he invested in the 50 shares.

The 50 shares sold for $300 result in a loss of $200 ($300 – $500). Note that a loss is nothing more than invested capital that has not been recovered. Because of the capital recovery concept, we recognize gains only when the recovery from the disposition of an asset is greater than the amount invested in the asset. A loss results when all the capital invested in an asset is not recovered upon its disposition.

2-4d Realization Concept

A crucial question regarding income items is when to recognize the income (i.e., in which accounting period it should be taxed). In this regard, the taxpayer's accounting method resolves many of the problems. However, some general concepts provide additional guidance. The most basic recognition concept is the **realization concept**. This concept states that no income is recognized for tax purposes (i.e., is included in taxable income) until it has been realized by the taxpayer. In most cases, realization occurs when an arm's-length transaction takes place: Goods are sold, services are rendered, and so on. Mere changes in value without the advent of a realization event—in which the taxpayer receives the change in value—do not result in a taxable recognition.[17]

Example 25 Assume that in example 24, Earl purchases the 100 shares of ABC common stock on July 2, 2018. On December 31, 2018, the 100 shares have a fair market value of $1,200. The first lot of 50 shares is sold for $600 on February 5, 2019. As of December 31, 2019, the remaining 50 shares have a fair market value of $400. What is Earl's recognized income from the stock in 2018? in 2019?

Discussion: Although the shares gain $200 in value as of December 31, 2018, Earl still holds the shares and has not realized the increase in value. Therefore, the change in value does not result in a recognition of income in 2018. He realizes the $100 gain from the sale of the first 50 shares in 2019 and reports it in that year. The loss in value of $100 as of December 31, 2019, has not been realized, so Earl cannot deduct this loss in value until he realizes it through sale.

Claim-of-Right Doctrine

To aid in determining when a realization has occurred, the **claim-of-right doctrine** states that a realization occurs whenever an amount is received without restriction as to its disposition.[18] An item is received without restriction when the receiver has no definitive obligation to repay the amount received. Income received under a claim of right is reported in the year of receipt. If income is realized under a claim of right and a repayment of part or all of the receipt occurs in a later year, it is accounted for as a deduction in the year of repayment because of the annual accounting period concept. When a taxpayer receives amounts with their use restricted in some substantial manner, those amounts are not realized until the restriction is removed.

Example 26 Sadie, a landlord and a cash basis taxpayer, enters into a 1-year lease agreement with Bob, a tenant, on December 1, 2019. The agreement calls for a monthly rent of $500, with payment of first and last months' rents upon signing. In addition, Bob is required to pay a $100 cleaning deposit that is to be returned at the end of the lease if the property is returned in good condition. What are the tax effects for Sadie of receiving the $1,100?

Discussion: The first and last months' rents are taxable when received. Sadie is on a cash basis and has an unrestricted right to the use of the rent payments. However, she must return the cleaning deposit at the end of the lease if Bob abides by its terms. Because of this restriction, Sadie does not have a claim of right to the cleaning deposit when she receives it, and it is not taxed at that time. If Sadie keeps all or part of the deposit at the end of the lease, it is included in her income at that time.