McGRAW-HILL'S

ESSENTIALS OF FEDERAL TAXATION

2020

EDITION

SPILKER ★ AYERS ★ BARRICK
OUTSLAY ★ ROBINSON ★ WEAVER ★ WORSHAM

McGraw-Hill's

Essentials of Federal Taxation

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Dedications

We dedicate this book to:

My family and to Professor Dave Stewart for his great example and friendship.

Brian Spilker

My wife, Marilyn, daughters Margaret Lindley and Georgia, son Benjamin, and parents Bill and Linda.

Ben Ayers

My wife, Jill, and my children Annika, Corinne, Lina, Mitch, and Connor.

John Barrick

My family, Jane, Mark, Sarah, Chloe, Lily, Jeff, and Nicole, and to Professor James E. Wheeler, my mentor and friend.

Ed Outslay

JES, Tommy, and Laura.

John Robinson

My family: Dan, Travis, Alix, Alan, and Anna.

Connie Weaver

My wife, Anne, sons Matthew and Daniel, and daughters Whitney and Hayley.

Ron Worsham

About the Authors

Courtesy Brian Spilker

Brian C. Spilker (PhD, University of Texas at Austin, 1993) is the Robert Call/Deloitte Professor in the School of Accountancy at Brigham Young University. He teaches taxation at Brigham Young University. He received both BS (Summa Cum Laude) and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Arthur Young & Co. (now Ernst & Young). After his professional work experience, Brian earned his PhD at the University of Texas at Austin. He received the Price Waterhouse Fellowship in Tax Award and the American Taxation Association and Arthur Andersen Teaching Innovation Award for his work in the classroom. Brian has also been awarded for his use of technology in the classroom at Brigham Young University. Brian researches issues relating to tax information search and professional tax judgment. His research has been published in journals such as *The Accounting Review, Organizational Behavior and Human Decision Processes, Journal of the American Taxation Association, Behavioral Research in Accounting, Journal of Accounting Education, Journal of Corporate Taxation,* and *Journal of Accountancy.*

Courtesy Ben Ayers

Ben Ayers (PhD, University of Texas at Austin, 1996) holds the Earl Davis Chair in Taxation and is the dean of the Terry College of Business at the University of Georgia. He received a PhD from the University of Texas at Austin and an MTA and BS from the University of Alabama. Prior to entering the PhD program at the University of Texas, Ben was a tax manager at KPMG in Tampa, Florida, and a contract manager with Complete Health, Inc., in Birmingham, Alabama. He is the recipient of 11 teaching awards at the school, college, and university levels, including the Richard B. Russell Undergraduate Teaching Award, the highest teaching honor for University of Georgia junior faculty members. His research interests include the effects of taxation on firm structure, mergers and acquisitions, and capital markets and the effects of accounting information on security returns. He has published articles in journals such as *The Accounting Review, Journal of Finance, Journal of Accounting and Economics, Contemporary Accounting Research, Review of Accounting Studies, Journal of Law and Economics, Journal of the American Taxation Association,* and *National Tax Journal*. Ben was the 1997 recipient of the American Accounting Association's Competitive Manuscript Award, the 2003 and 2008 recipient of the American Taxation Association's Outstanding Manuscript Award, and the 2016 recipient of the American Taxation Association's Ray M. Sommerfeld Outstanding Tax Educator Award.

Courtesy John Barrick

John Barrick (PhD, University of Nebraska at Lincoln, 1998) is currently an associate professor in the Marriott School at Brigham Young University. He served as an accountant at the United States Congress Joint Committee on Taxation during the 110th and 111th Congresses. He teaches taxation in the graduate and undergraduate programs at Brigham Young University. He received both BS and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Price Waterhouse (now PricewaterhouseCoopers). After his professional work experience, John earned his PhD at the University of Nebraska at Lincoln. He was the 1998 recipient of the American Accounting Association, Accounting, Behavior, and Organization Section's Outstanding Dissertation Award. John researches issues relating to tax corporate political activity. His research has been published in journals such as *Organizational Behavior and Human Decision Processes, Contemporary Accounting Research,* and *Journal of the American Taxation Association*.


Courtesy Ed Outslay

Ed Outslay (PhD, University of Michigan, 1981) is a professor of accounting and the Deloitte/Michael Licata Endowed Professor of Taxation in the Department of Accounting and Information Systems at Michigan State University, where he has taught since 1981. He received a BA from Furman University in 1974 and an MBA and PhD from the University of Michigan in 1977 and 1981. Ed currently teaches graduate classes in corporate taxation, multiunit enterprises, accounting for income taxes, and international taxation. In February 2003, Ed testified before the Senate Finance Committee on the Joint Committee on Taxation's Report on Enron Corporation. MSU has honored Ed with the Presidential Award for Outstanding Community Service, the Distinguished Faculty Award, the John D. Withrow Teacher-Scholar Award, the Roland H. Salmonson Outstanding Teaching Award, the Senior Class Council Distinguished Faculty Award, the MSU Teacher-Scholar Award, and MSU's 1st Annual Curricular Service-Learning and Civic Engagement Award in 2008. Ed received the Ray M. Sommerfeld Outstanding Tax Educator Award in 2004 and the Lifetime Service Award in 2013 from the American Taxation Association. He has also received the ATA Outstanding Manuscript Award twice, the ATA/Deloitte Teaching Innovations Award, and the 2004 Distinguished Achievement in Accounting Education Award from the Michigan Association of CPAs. In 2017, Ed received the American Accounting Association / J. Michael and Mary Ann Cook Prize given in "foremost recognition of an individual who consistently demonstrates the attributes of a superior teacher in the discipline of accounting." Ed has been recognized for his community service by the Greater Lansing Chapter of the Association of Government Accountants, the City of East Lansing (Crystal Award), and the East Lansing Education Foundation. He received a National Assistant Coach of the Year Award in 2003 from AFLAC and was named an Assistant High School Baseball Coach of the Year in 2002 by the Michigan High School Baseball Coaches Association.


Courtesy John Robinson

John Robinson (PhD, University of Michigan, 1981) is the Patricia '77 and Grant E. Sims '77 Eminent Scholar Chair in Business. Prior to joining the faculty at Texas A&M, John was the C. Aubrey Smith Professor of Accounting at the University of Texas at Austin, Texas, and he taught at the University of Kansas where he was the Arthur Young Faculty Scholar. In 2009–2010 John served as the Academic Fellow in the Division of Corporation Finance at the Securities and Exchange Commission. He has been the recipient of the Henry A. Bubb Award for outstanding teaching, the Texas Blazer's Faculty Excellence Award, and the MPA Council Outstanding Professor Award. John also received the 2012 Outstanding Service Award from the American Taxation Association (ATA) and in 2017 was named the Ernst & Young and ATA Ray Sommerfeld Outstanding Educator. John served as the 2014–2015 president (elect) of the ATA and was the ATA's president for 2015–2016. John conducts research in a broad variety of topics involving financial accounting, mergers and acquisitions, and the influence of taxes on financial structures and performance. His scholarly articles have appeared in *The Accounting Review*, *The Journal of Accounting and Economics, Journal of Finance*, *National Tax Journal*, *Journal of Law and Economics*, *Journal of the American Taxation Association*, *The Journal of the American Bar Association*, and *The Journal of Taxation*. John's research was honored with the 2003 and 2008 ATA Outstanding Manuscript Awards. In addition, John was the editor of *The Journal of the American Taxation Association* from 2002–2005. Professor Robinson received his J.D. (*Cum Laude*) from the University of Michigan in 1979, and he teaches courses on individual and corporate taxation and advanced accounting.

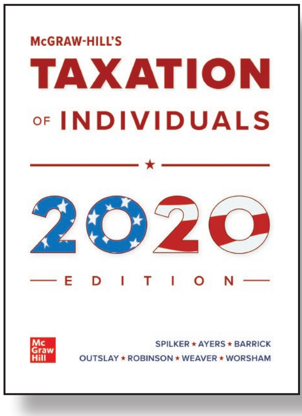
Connie Weaver (PhD, Arizona State University, 1997) is the KPMG Professor of Accounting at Texas A&M University. She received a PhD from Arizona State University, an MPA from the University of Texas at Arlington, and a BS (chemical engineering) from the University of Texas at Austin. Prior to entering the PhD Program, Connie was a tax manager at Ernst & Young in Dallas, Texas, where she became licensed to practice as a CPA. She teaches taxation in the Professional Program in Accounting and the Executive MBA program at Texas A&M University. She has also taught undergraduate and graduate students at the University of Wisconsin–Madison and the University of Texas at Austin. She is the recipient of several teaching awards, including the 2006 American Taxation Association/Deloitte Teaching Innovations award, the David and Denise Baggett Teaching award, and the college and university level Association of Former Students Distinguished Achievement award in teaching. Connie's current research interests include the effects of tax and financial incentives on corporate decisions and reporting. She has published articles in journals such as *The Accounting Review, Contemporary Accounting Research, Journal of the American Taxation Association, National Tax Journal, Accounting Horizons, Journal of Corporate Finance,* and *Tax Notes*. Connie is the senior editor of *The Journal of the American Taxation Association* and she serves on the editorial board of *Contemporary Accounting Research*.

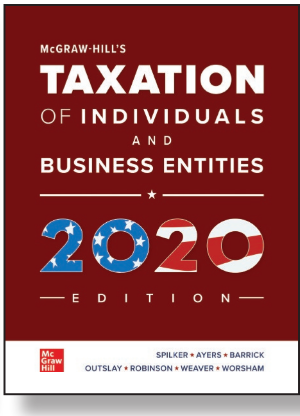
Courtesy Connie Weaver

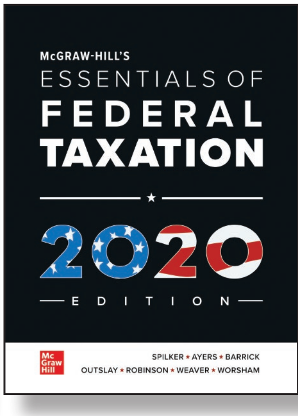
Ron Worsham (PhD, University of Florida, 1994) is an associate professor in the School of Accountancy at Brigham Young University. He teaches taxation in the graduate, undergraduate, MBA, and Executive MBA programs at Brigham Young University. He has also taught as a visiting professor at the University of Chicago. He received both BS and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Arthur Young & Co. (now Ernst & Young) in Dallas, Texas. While in Texas, he became licensed to practice as a CPA. After his professional work experience, Ron earned his PhD at the University of Florida. He has been honored for outstanding innovation in the classroom at Brigham Young University. Ron has published academic research in the areas of taxpayer compliance and professional tax judgment. He has also published legal research in a variety of areas. His work has been published in journals such as *Journal of the American Taxation Association, The Journal of International Taxation, The Tax Executive, Tax Notes, The Journal of Accountancy,* and *Practical Tax Strategies*.

Courtesy Ron Worsham

TEACHING THE CODE IN CONTEXT







The bold innovative approach used by McGraw-Hill's Taxation series is quickly becoming the most popular choice of course materials among instructors and students. It's apparent why the clear, organized, and engaging delivery of content, paired with the most current and robust tax code updates, has been adopted by more than 650 schools across the country.

McGraw-Hill's Taxation is designed to provide a unique, innovative, and engaging learning experience for students studying taxation. The breadth of the topical coverage, **the storyline approach to presenting the material,** the emphasis on the tax and nontax consequences of multiple parties involved in transactions, and the integration of financial and tax accounting topics make this book ideal for the modern tax curriculum.

"Do you want the best tax text? This is the one to use. It has a storyline in each chapter that can relate to real life issues."

Leslie A. Mostow
– University of Maryland, College Park

"This text provides broad coverage of important topics and does so in a manner that is easy for students to understand. The material is very accessible for students."

Kyle Post
– Tarleton State University

Since the first manuscript was written in 2005, 450 professors have contributed 500 book reviews, in addition to 30 focus groups and symposia. Throughout this preface, their comments on the book's organization, pedagogy, and unique features are a testament to the **market-driven nature of *Taxation's* development.**

"I think this is the best book available for introductory and intermediate courses in taxation."

Shane Stinson
– University of Alabama

A MODERN APPROACH FOR TODAY'S STUDENT

McGraw-Hill's Taxation series was built around the following five core precepts:

1. **Storyline Approach:** Each chapter begins with a storyline that introduces a set of characters or a business entity facing specific tax-related situations. Each chapter's examples are related to the storyline, providing students with opportunities to **learn the code in context.**

2. **Integrated Examples:** In addition to providing examples in-context, we provide **"What if"** scenarios within many examples to **illustrate how variations in the facts might or might not change the answers.**

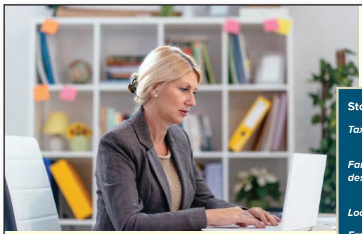
3. **Conversational Writing Style:** The authors took special care to write *McGraw-Hill's Taxation* in a way that fosters a friendly dialogue between the content and each individual student. The tone of the presentation is intentionally conversational—creating the impression of ***speaking with* the student,** as opposed to *lecturing to* the student.

4. **Superior Organization of Related Topics:** *McGraw-Hill's Taxation* provides two alternative topic sequences. In the *McGraw-Hill's Taxation of Individuals and Business Entities* volume, the individual topics generally follow the tax form sequence, with an individual overview chapter and then chapters on income, deductions, investment-related issues, and the tax liability computation. The topics then transition into business-related topics that apply to individuals. This volume then provides a group of specialty chapters dealing with topics of particular interest to individuals (including students), including separate chapters on home ownership, compensation, and retirement savings and deferred compensation. This volume concludes with a chapter covering the taxation of business entities. Alternatively, in the *Essentials of Federal Taxation* volume, the topics follow a more traditional sequence, with topics streamlined (no specialty chapters) and presented in more of a life-cycle approach.

5. **Real-World Focus:** Students learn best when they see how concepts are applied in the real world. For that reason, real-world examples and articles are included in **"Taxes in the Real World"** boxes throughout the book. These vignettes demonstrate current issues in taxation and show the relevance of tax issues in all areas of business.

> "The in-text examples of how to complete tax returns (is a strength of this text). These help students improve their overall understanding of the material as it moves from something abstract to something tangible the student can produce."
>
> Christine Cheng
> – Louisiana State University

A STORYLINE APPROACH THAT RESONATES WITH STUDENTS



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Storyline Summary

Taxpayers:	Courtney Wilson, age 40, and Courtney's mother Dorothy "Gram" Weiss, age 70
Family description:	Courtney is divorced with a son, Deron, age 10, and a daughter, Ellen, age 20. Gram is currently residing with Courtney.
Location:	Kansas City, Missouri
Employment status:	Courtney works as an architect for EWD. Gram is retired.
Filing status:	Courtney is head of household. Gram is single.
Current situation:	Courtney and Gram have computed their taxable income. Now they are trying to determine their tax liability, tax refund, or additional taxes due and whether they owe any payment-related penalties.

Courtney has already determined her taxable income. Now she's working on computing her tax liability. She knows she owes a significant amount of regular income tax on her employment and business activities. However, she's not sure how to compute the tax on the qualified dividends she received from General Electric and is worried that she may be subject to the alternative minimum tax this year. Finally, Courtney knows she owes some self-employment taxes on her business income. Courtney would like to determine whether she is eligible to claim any tax credits, such as the child tax credit for her two children and education credits, because she paid for a portion of her daughter Ellen's tuition at the University of Missouri–Kansas City this year. Courtney is hoping that she has paid enough in taxes during the year to avoid underpayment penalties. She's planning on filing her tax return and paying her taxes on time.

Gram's tax situation is much more straightforward. She needs to determine the regular income tax on her taxable income. Her income is so low she knows she need not worry about the alternative minimum tax, and she believes she doesn't owe any self-employment tax. Gram didn't prepay any taxes this year, so she is concerned that she might be required to pay an underpayment penalty. She plans to file her tax return and pay her taxes by the looming due date.

Each chapter begins with a storyline that introduces a set of characters facing specific tax-related situations. This revolutionary approach to teaching tax emphasizes real people facing real tax dilemmas. Students learn to apply practical tax information to specific business and personal situations. As their situations evolve, the characters are brought further to life.

"Excellent text! Very readable, easy for students to read and understand. Storyline approach and integrated examples make it easy for students to relate to taxpayers and their tax situations."

Sandra Owen
– Indiana State University, Bloomington

Examples

Examples are the cornerstone of any textbook covering taxation. For this reason, *McGraw-Hill's Taxation* authors took special care to create clear and helpful examples that relate to the storyline of the chapter. Students learn to refer to the facts presented in the storyline and apply them to other scenarios—in this way, they build a greater base of knowledge through application. Many examples also include "What if?" scenarios that add more complexity to the example or explore related tax concepts.

Example 2-1

Bill and Mercedes file their 2015 federal tax return on September 6, 2016, after receiving an automatic extension to file their return by October 15, 2016. In 2019, the IRS selects their 2015 tax return for audit. When does the statute of limitations end for Bill and Mercedes's 2015 tax return?

Answer: Assuming the six-year and "unlimited" statute of limitation rules do not apply, the statute of limitations ends on September 6, 2019 (three years after the later of the actual filing date and the *original* due date).

What if: When would the statute of limitations end for Bill and Mercedes for their 2015 tax return if the couple filed the return on March 22, 2016 (before the original due date of April 15, 2016)?

Answer: In this scenario the statute of limitations would end on April 15, 2019, because the later of the actual filing date and the original due date is April 15, 2016.

"I enjoy teaching from the McGraw-Hill Spilker taxation textbook. Students too have commented that they prefer it over other texts they have learned taxation from. The ancillaries, LearnSmart and Connect help in my mission to present the material in a logical, reader-friendly manner."

Cheryl Crespi – Central Connecticut State University

THE PEDAGOGY YOUR STUDENTS NEED TO PUT THE CODE IN CONTEXT

Taxes in the Real World

Taxes in the Real World are short boxes used throughout the book to demonstrate the real-world use of tax concepts. Current articles on tax issues, the real-world application of chapter-specific tax rules, and short vignettes on popular news about tax are some of the issues covered in Taxes in the Real World boxes.

TAXES IN THE REAL WORLD Is It a Deductible State Tax Payment, Charitable Contribution, or Neither?

In recent years, it has become popular for state and local governments to provide state or local tax credits for contributions to certain qualified charities (for example, local hospitals, certain scholarship funds, etc.). While there was no "official" IRS guidance on the federal tax treatment of these contributions, in "unofficial" guidance, the IRS Office of Chief Counsel (see Chief Counsel Advice Memorandum 201105010) advised that a payment to a state agency or charitable organization in return for a tax credit might be characterized as either a deductible charitable contribution or a deductible state tax payment. The 2010 CCA advised that taxpayers could take a charitable deduction for the full amount of the contribution without subtracting the value of the state tax credit received. Hence, for federal tax purposes, the taxpayer could take a charitable contribution deduction for an amount that otherwise was used to reduce the taxpayer's state tax liability. Because individuals deduct both state taxes and charitable contributions as itemized deductions, the IRS was not too concerned with these types of state tax credit programs.

As you might expect, the IRS's laissez-faire stance changed in 2018 with the enactment of the $10,000 limit on the itemized deduction for state, local, and foreign taxes. Specifically, the IRS revisited the federal tax consequences of state and local tax credit programs out of concern that taxpayers may use these programs to bypass the $10,000 limit on state, local, and foreign tax deductions. After further review, the news was not favorable for taxpayers. In Prop. Reg. §1.170A-1(h)(3), the IRS stated that, effective for contributions after August 27, 2018, taxpayers making payments or transferring property to an entity eligible to receive tax-deductible contributions will have to reduce their charitable contribution deductions by the amount of any state or local tax credit received (or expected to be received). Thus, after August 27, 2018, if a taxpayer receives a dollar-for-dollar state tax credit for a contribution to a qualified charity, the charitable contribution deduction is reduced to zero for federal tax purposes (i.e., the contribution is neither a deductible state tax payment or deductible charitable contribution).

Sources: Prop. Reg. §1.170A-1(h)(3); REG-112176-18.

"This is the best text I have found for both my students and myself. Easier to read than other textbooks I have looked at, good examples, and, as mentioned before, I appreciate the instructor resources."

– Esther Ehrlich, CPA, The University of Texas at El Paso

The Key Facts

The Key Facts provide quick synopses of the critical pieces of information presented throughout each chapter.

The **tax base** defines what is actually taxed and is usually expressed in monetary terms, whereas the **tax rate** determines the level of taxes imposed on the tax base and is usually expressed as a percentage. For example, a sales tax rate of 6 percent on a purchase of $30 yields a tax of $1.80 ($1.80 = $30 × .06).

Federal, state, and local jurisdictions use a large variety of tax bases to collect tax. Some common tax bases (and related taxes) include taxable income (federal and state income taxes), purchases (sales tax), real estate values (real estate tax), and personal property values (personal property tax).

Different portions of a tax base may be taxed at different rates. A single tax applied

THE KEY FACTS

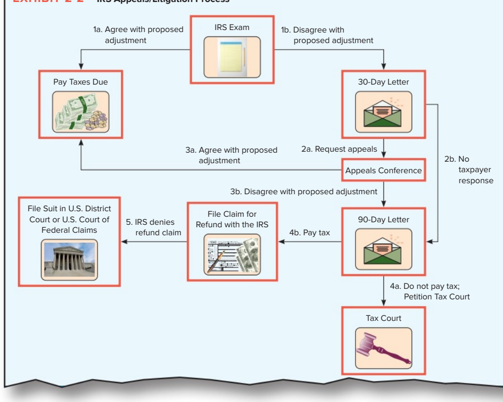
How to Calculate a Tax

- Tax = Tax base × Tax rate
- The tax base defines what is actually taxed and is usually expressed in monetary terms.
- The tax rate determines

Exhibits

Today's students are visual learners, and *McGraw-Hill's Taxation* understands this student need by making use of clear and engaging charts, diagrams, and tabular demonstrations of key material.

EXHIBIT 2-2 IRS Appeals/Litigation Process



"It is easily accessible to students as it is written in easy-to-understand language, and contains sufficient examples to illustrate complicated tax concepts and calculations."

Machiavelli Chao

– University of California, Irvine: The Paul Merage School of Business

PRACTICE MAKES PERFECT WITH A WIDE

Summary

LO 2-1 Identify the filing requirements for income tax returns and the statute of limitations for assessment.

- All corporations must file a tax return annually regardless of their taxable income. Estates and trusts are required to file annual income tax returns if their gross income exceeds $600. The filing requirements for individual taxpayers depend on the taxpayer's filing status, age, and gross income.
- Individual and C corporation tax returns (except for C corporations with a June 30 year-end) are due on the fifteenth day of the fourth month following year-end. For C corporations with a June 30 year-end, partnerships, and S corporations, tax returns must be filed by the fifteenth day of the third month following the entity's fiscal year-end. Any taxpayer unable to file a tax return by the original due date can request an extension to file.
- For both amended tax returns filed by a taxpayer and proposed tax assessments by the IRS, the statute of limitations generally ends three years from the *later* of (1) the date the tax return was actually filed or (2) the tax return's original due date.

LO 2-2 Outline the IRS audit process, how returns are selected, the different types of audits, and what

Summary

A unique feature of *McGraw-Hill's Taxation* is the end-of-chapter summary organized around learning objectives. Each objective has a brief, bullet-point summary that covers the major topics and concepts for that chapter, including references to critical exhibits and examples. All end-of-chapter material is tied to learning objectives.

Learning Objectives

Upon completing this chapter, you should be able to:

LO 2-1 Identify the filing requirements for income tax returns and the statute of limitations for assessment.

LO 2-2 Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.

LO 2-3 Evaluate the relative weights of the various tax law sources.

LO 2-4 Describe the legislative process as it pertains to taxation.

LO 2-5 Perform the basic steps in tax research.

LO 2-6 Describe tax professional responsibilities in providing tax advice.

LO 2-7 Identify taxpayer and tax professional penalties.

DISCUSSION QUESTIONS

Discussion Questions are available in Connect®.

LO 2-1 1. Name three factors that determine whether a taxpayer is required to file a tax return.

LO 2-1 2. Benita is concerned that she will not be able to complete her tax return by April 15. Can she request an extension to file her return? By what date must she do so? Assuming she requests an extension, what is the latest date that she could file her return this year without penalty?

LO 2-1 3. Agua Linda Inc. is a calendar-year corporation. What is the original due date for the corporate tax return? What happens if the original due date falls on a Saturday?

LO 2-2 4. Approximately what percentage of tax returns does the IRS audit? What are the implications of this number for the IRS's strategy in selecting returns for audit?

Discussion Questions

Discussion questions, now available in *Connect*, are provided for each of the major concepts in each chapter, providing students with an opportunity to review key parts of the chapter and answer evocative questions about what they have learned.

VARIETY OF ASSIGNMENT MATERIAL

Problems

Problems are designed to test the comprehension of more complex topics. Each problem at the end of the chapter is tied to one of that chapter's learning objectives, with multiple problems for critical topics.

> **PROBLEMS**
>
> **Select problems are available in Connect®.** connect
>
> LO 2-1 43. Ahmed does not have enough cash on hand to pay his taxes. He was excited to hear that he can request an extension to file his tax return. Does this solve his problem? What are the ramifications if he doesn't pay his tax liability by April 15?
>
> LO 2-1 44. Molto Stancha Corporation had zero earnings this fiscal year; in fact, it lost money. Must the corporation file a tax return?

Tax Forms Problems

Tax forms problems are a set of requirements included in the end-of-chapter material of the 2020 edition. These problems require students to complete a tax form (or part of a tax form), providing students with valuable experience and practice with filling out these forms. These requirements—and their relevant forms—are also included in *Connect*. Each tax form problem includes an icon to differentiate it from regular problems.

> LO 6-1 tax forms 28. Betty operates a beauty salon as a sole proprietorship. Betty also owns and rents an apartment building. This year Betty had the following income and expenses. Determine Betty's AGI and complete page 2 (through line 7) and Schedule 1 of Form 1040 for Betty. You may assume that Betty will owe $2,502 in self-employment tax on her salon income, with $1,251 representing the employer portion of the self-employment tax. You may also assume that her divorce from Rocky was finalized in 2016.
>
> | | |
> |---|---|
> | Interest income | $11,255 |
> | Salon sales and revenue | 86,360 |

Research Problems

Research problems are special problems throughout the end-of-chapter assignment material. These require students to do both basic and more complex research on topics outside of the scope of the book. Each research problem includes an icon to differentiate it from regular problems.

> LO 6-2 research 35. This year Tim is age 45 and is considering enrolling in an insurance program that provides for long-term care insurance. He is curious about whether the insurance premiums are deductible as a medical expense and, if so, what the maximum amount is that can be deducted in any year.
>
> LO 6-2 research 36. Doctor Bones prescribed physical therapy in a pool to treat Jack's broken back. In response to this advice (and for no other reason), Jack built a swimming pool in his backyard and strictly limited use of the pool to physical therapy. Jack paid $25,000 to build the pool, but he wondered if this amount could be deducted as a medical

Planning Problems

Planning problems are another unique set of problems included in the end-of-chapter assignment material. These require students to test their tax planning skills after covering the chapter topics. Each planning problem includes an icon to differentiate it from regular problems.

> 57. The IRS recently completed an audit of Shea's tax return and assessed $15,000 additional tax. Shea requested an appeals conference but was unable to settle the case at the conference. She is contemplating which trial court to choose to hear her case. Provide a recommendation based on the following alternative facts: LO 2-2 planning
>
> a) Shea resides in the 2nd Circuit, and the 2nd Circuit has recently ruled against the position Shea is litigating.
>
> b) The Federal Circuit Court of Appeals has recently ruled in favor of Shea's position.
>
> c) The issue being litigated involves a question of fact. Shea has a very appealing

Comprehensive and Tax Return Problems

Comprehensive and tax return problems address multiple concepts in a single problem. Comprehensive problems are ideal for cumulative topics; for this reason, they are located at the end of all chapters. In the end-of-book Appendix C, we include tax return problems that cover multiple chapters. **Additional tax return problems are also available in *Connect* and *Instructor Resource Center*. These problems range from simple to complex and cover individual taxation, corporate taxation, partnership taxation, and S corporation taxation.**

> **COMPREHENSIVE PROBLEMS**
>
> **Select problems are available in Connect®.** connect
>
> tax forms 54. Marc and Michelle are married and earned salaries this year of $64,000 and $12,000, respectively. In addition to their salaries, they received interest of $350 from municipal bonds and $500 from corporate bonds. Marc contributed $2,500 to an individual retirement account, and Marc paid alimony to a prior spouse in the amount of $1,500. Marc and Michelle have a 10-year-old son, Matthew, who lived with them throughout the entire year. Thus, Marc and Michelle are allowed to claim a $2,000 child tax credit for Matthew. Marc and Michelle paid $6,000 of expenditures that qualify as itemized deductions and they had a total of $3,500 in federal income taxes withheld from their paychecks during the course of the year.

Students—study more efficiently, retain more and achieve better outcomes. Instructors—focus on what you love—teaching.

SUCCESSFUL SEMESTERS INCLUDE CONNECT

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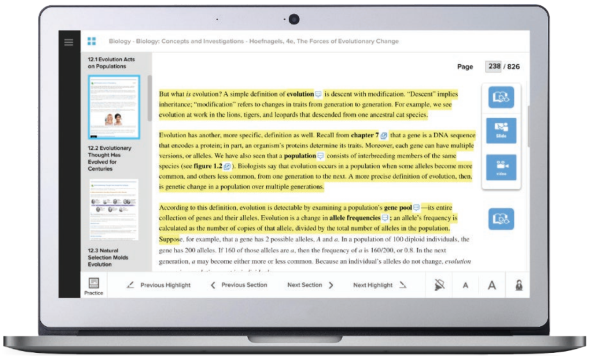

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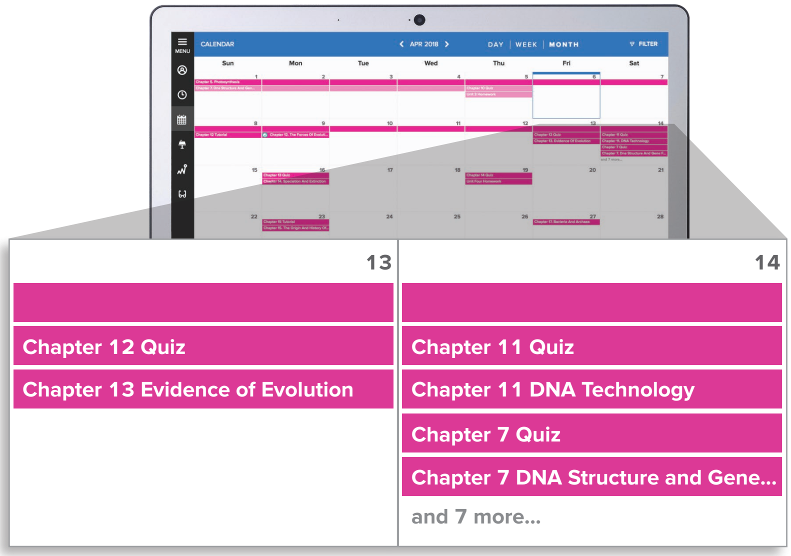

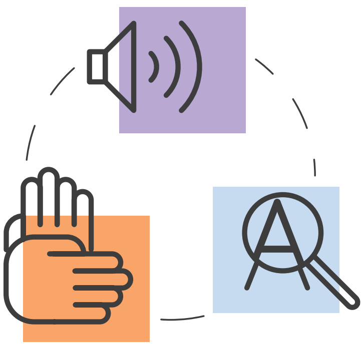

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DIGITAL LEARNING ASSETS TO IMPROVE STUDENT OUTCOMES

> "The quality of the online materials in Connect and Learnsmart are market-leading and unmatched in the tax arena."
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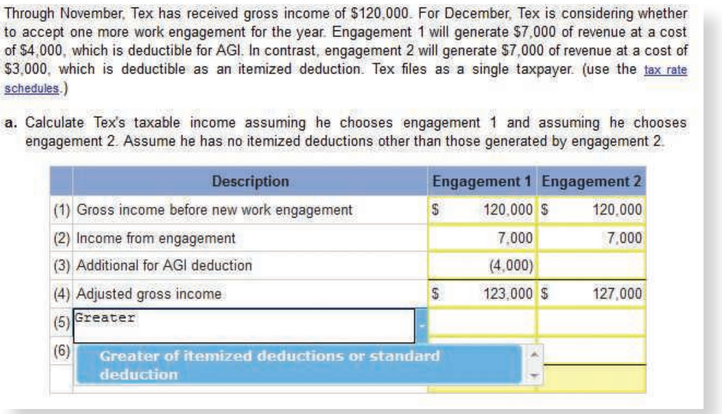
Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes problems, comprehensive problems (available as auto-graded tax forms), and discussion questions. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.



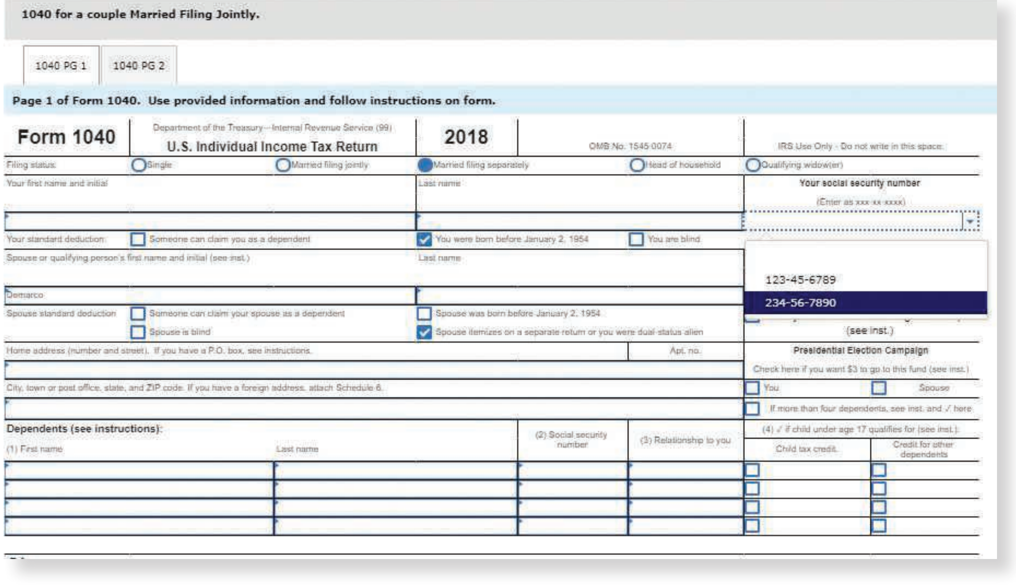
Through November, Tex has received gross income of $120,000. For December, Tex is considering whether to accept one more work engagement for the year. Engagement 1 will generate $7,000 of revenue at a cost of $4,000, which is deductible for AGI. In contrast, engagement 2 will generate $7,000 of revenue at a cost of $3,000, which is deductible as an itemized deduction. Tex files as a single taxpayer. (use the tax rate schedules.)

a. Calculate Tex's taxable income assuming he chooses engagement 1 and assuming he chooses engagement 2. Assume he has no itemized deductions other than those generated by engagement 2.

	Description	Engagement 1	Engagement 2
(1)	Gross income before new work engagement	$ 120,000	$ 120,000
(2)	Income from engagement	7,000	7,000
(3)	Additional for AGI deduction	(4,000)	
(4)	Adjusted gross income	$ 123,000	$ 127,000
(5)	Greater		
(6)	Greater of itemized deductions or standard deduction		

Auto-Graded Tax Forms

The auto-graded **Tax Forms** in Connect provide a much-improved student experience when solving the tax-form based problems. The tax form simulation allows students to apply tax concepts by completing the actual tax forms online with automatic feedback and grading for both students and instructors.



1040 for a couple Married Filing Jointly.

1040 PG 1 | 1040 PG 2

Page 1 of Form 1040. Use provided information and follow instructions on form.

Form 1040 — Department of the Treasury—Internal Revenue Service (99) — U.S. Individual Income Tax Return — 2018 — OMB No. 1545-0074 — IRS Use Only - Do not write in this space.

Filing status: Single | Married filing jointly | Married filing separately | Head of household | Qualifying widow(er)

Your first name and initial | Last name | Your social security number (Enter as xxx-xx-xxxx)

Your standard deduction: Someone can claim you as a dependent | You were born before January 2, 1954 | You are blind

Spouse or qualifying person's first name and initial (see inst.) | Last name

Demarco

123-45-6789

234-56-7890

Spouse standard deduction: Someone can claim your spouse as a dependent | Spouse was born before January 2, 1954 | Spouse is blind | Spouse itemizes on a separate return or you were dual-status alien | (see inst.)

Home address (number and street). If you have a P.O. box, see instructions. | Apt. no. | Presidential Election Campaign

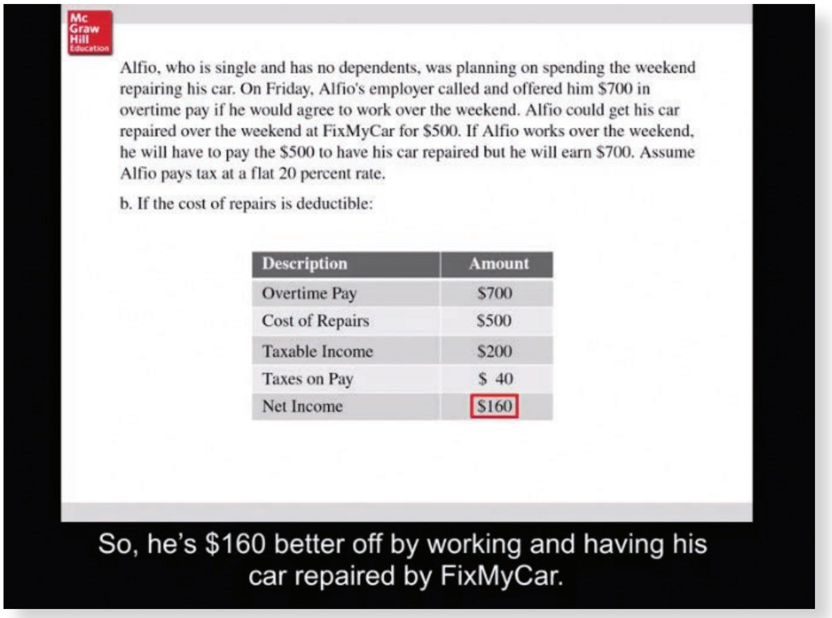
Check here if you want $3 to go to this fund (see inst.) | You | Spouse

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6. | If more than four dependents, see inst. and ✓ here

Dependents (see instructions): (1) First name | Last name | (2) Social security number | (3) Relationship to you | (4) ✓ if child under age 17 qualifies for (see inst.): Child tax credit | Credit for other dependents

Guided Examples

The **Guided Examples,** or “hint” videos, in Connect provide a narrated, animated, step-by-step walk-through of select problems similar to those assigned. These short presentations can be turned on or off by instructors and provide reinforcement when students need it most.



TaxACT®

McGraw-Hill's Taxation can be packaged with tax software from TaxACT, one of the leading preparation software companies in the market today. The 2018 edition includes availability of both *Individuals* and *Business Entities* software, including the 1040 Forms and TaxACT Preparer's Business 3-Pack (with Forms 1065, 1120, and 1120S).

Please note, TaxACT is only compatible with PCs and not Macs. However, we offer easy-to-complete licensing agreement templates that are accessible within Connect and the Instructor Resources Center to enable school computer labs to download the software onto campus hardware for free.

Roger's CPA

McGraw-Hill Education has partnered with Roger CPA Review, a global leader in CPA Exam preparation, to provide students a smooth transition from the accounting classroom to successful completion of the CPA Exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA Exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing the CPA Exam.

Accordingly, students using these McGraw-Hill materials will have access to sample CPA Exam multiple-choice questions and Task-based Simulations from Roger CPA Review, with expert-written explanations and solutions. All questions are either directly from the AICPA or are modeled on AICPA questions that appear in the exam. Task-based Simulations are delivered via the Roger CPA Review platform, which mirrors the look, feel, and functionality of the actual exam.

McGraw-Hill Education and Roger CPA Review are dedicated to supporting every accounting student along their journey, ultimately helping them achieve career success in the accounting profession. For more information about the full Roger CPA Review program, exam requirements, and exam content, visit www.rogercpareview.com.

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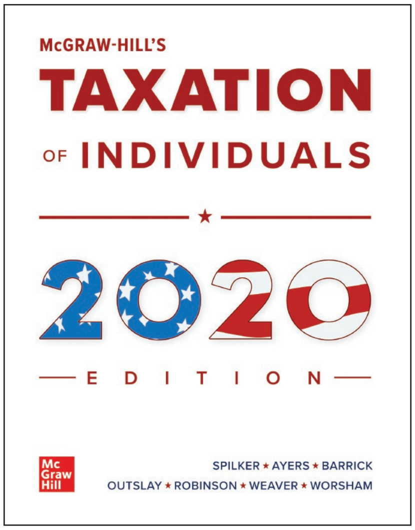
Four Volumes to Fit



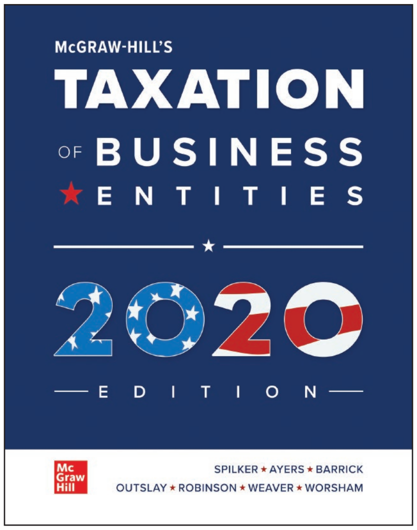
McGraw-Hill's Taxation of Individuals is organized to emphasize topics that are most important to undergraduates taking their first tax course. The first three chapters provide an introduction to taxation and then carefully guide students through tax research and tax planning. Part II discusses the fundamental elements of individual income tax, starting with the tax formula in Chapter 4 and then proceeding to more discussion on income, deductions, investments, and computing tax liabilities in Chapters 5–8. Part III then discusses tax issues associated with business-related activities. Specifically, this part addresses business income and deductions, accounting methods, and tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). Part IV is unique among tax textbooks; this section combines related tax issues for compensation, retirement savings, and home ownership.

Part I: Introduction to Taxation
1. An Introduction to Tax
2. Tax Compliance, the IRS, and Tax Authorities
3. Tax Planning Strategies and Related Limitations

Part II: Basic Individual Taxation
4. Individual Income Tax Overview, Dependents, and Filing Status
5. Gross Income and Exclusions
6. Individual Deductions
7. Investments
8. Individual Income Tax Computation and Tax Credits

Part III: Business-Related Transactions
9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

Part IV: Specialized Topics
12. Compensation
13. Retirement Savings and Deferred Compensation
14. Tax Consequences of Home Ownership



McGraw-Hill's Taxation of Business Entities begins with the process for determining gross income and deductions for businesses, and the tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). Part II provides a comprehensive overview of entities and the formation, reorganization, and liquidation of corporations. Unique to this series is a complete chapter on accounting for income taxes, which provides a primer on the basics of calculating the income tax provision. Included in the narrative is a discussion of temporary and permanent differences and their impact on a company's book "effective tax rate." Part III provides a detailed discussion of partnerships and S corporations. The last part of the book covers state and local taxation, multinational taxation, and transfer taxes and wealth planning.

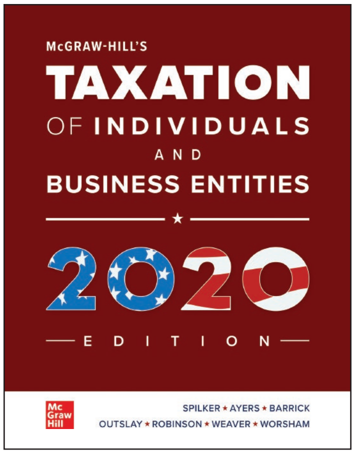
Part I: Business-Related Transactions
1. Business Income, Deductions, and Accounting Methods
2. Property Acquisition and Cost Recovery
3. Property Dispositions

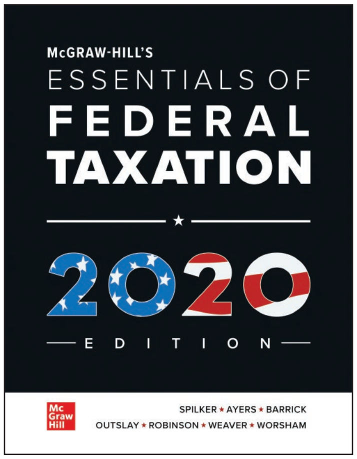
Part II: Entity Overview and Taxation of C Corporations
4. Entities Overview
5. Corporate Operations
6. Accounting for Income Taxes
7. Corporate Taxation: Nonliquidating Distributions
8. Corporate Formation, Reorganization, and Liquidation

Part III: Taxation of Flow-Through Entities
9. Forming and Operating Partnerships
10. Dispositions of Partnership Interests and Partnership Distributions
11. S Corporations

Part IV: Multijurisdictional Taxation and Transfer Taxes
12. State and Local Taxes
13. The U.S. Taxation of Multinational Transactions
14. Transfer Taxes and Wealth Planning

Four Course Approaches





McGraw-Hill's Taxation of Individuals and Business Entities covers all chapters included in the two split volumes in one convenient volume. See Table of Contents.

Part I: Introduction to Taxation

1. An Introduction to Tax
2. Tax Compliance, the IRS, and Tax Authorities
3. Tax Planning Strategies and Related Limitations

Part II: Basic Individual Taxation

4. Individual Income Tax Overview, Dependents, and Filing Status
5. Gross Income and Exclusions
6. Individual Deductions
7. Investments
8. Individual Income Tax Computation and Tax Credits

Part III: Business-Related Transactions

9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

Part IV: Specialized Topics

12. Compensation
13. Retirement Savings and Deferred Compensation
14. Tax Consequences of Home Ownership

Part V: Entity Overview and Taxation of C Corporations

15. Entities Overview
16. Corporate Operations
17. Accounting for Income Taxes
18. Corporate Taxation: Nonliquidating Distributions
19. Corporate Formation, Reorganization, and Liquidation

Part VI: Taxation of Flow-Through Entities

20. Forming and Operating Partnerships
21. Dispositions of Partnership Interests and Partnership Distributions
22. S Corporations

Part VII: Multijurisdictional Taxation and Transfer Taxes

23. State and Local Taxes
24. The U.S. Taxation of Multinational Transactions
25. Transfer Taxes and Wealth Planning

McGraw-Hill's Essentials of Federal Taxation is designed for a one-semester course, covering the basics of taxation of individuals and business entities. To facilitate a one-semester course, *McGraw-Hill's Essentials of Federal Taxation* folds the key topics from the investments, compensation, retirement savings, and home ownership chapters in *Taxation of Individuals* into three individual taxation chapters that discuss gross income and exclusions, *for* AGI deductions, and *from* AGI deductions, respectively. The essentials volume also includes a two-chapter C corporation sequence that uses a life-cycle approach covering corporate formations and then corporate operations in the first chapter and nonliquidating and liquidating corporate distributions in the second chapter. This volume is perfect for those teaching a one-semester course and for those who struggle to get through the 25-chapter comprehensive volume.

Part I: Introduction to Taxation

1. An Introduction to Tax
2. Tax Compliance, the IRS, and Tax Authorities
3. Tax Planning Strategies and Related Limitations

Part II: Individual Taxation

4. Individual Income Tax Overview, Dependents, and Filing Status
5. Gross Income and Exclusions
6. Individual *For* AGI Deductions
7. Individual *From* AGI Deductions
8. Individual Income Tax Computation and Tax Credits

Part III: Business-Related Transactions

9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

Part IV: Entity Overview and Taxation of C Corporations

12. Entities Overview
13. Corporate Formations and Operations
14. Corporate Nonliquidating and Liquidating Distributions

Part V: Taxation of Flow-Through Entities

15. Forming and Operating Partnerships
16. Dispositions of Partnership Interests and Partnership Distributions
17. S Corporations

SUPPLEMENTS FOR INSTRUCTORS

Assurance of Learning Ready

Many educational institutions today are focused on the notion of *assurance of learning*, an important element of many accreditation standards. *McGraw-Hill's Taxation* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful, solution.

Each chapter in the book begins with a list of numbered learning objectives, which appear throughout the chapter as well as in the end-of-chapter assignments. Every test bank question for *McGraw-Hill's Taxation* maps to a specific chapter learning objective in the textbook. Each test bank question also identifies topic area, level of difficulty, Bloom's Taxonomy level, and AICPA and AACSB skill area.

AACSB Statement

McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *McGraw-Hill's Taxation* recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the text and the test bank to the general knowledge and skill guidelines in the revised AACSB standards.

The statements contained in *McGraw-Hill's Taxation* are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *McGraw-Hill's Taxation* and the teaching package make no claim of any specific AACSB qualification or evaluation, we have, within the text and test bank, labeled selected questions according to the eight general knowledge and skill areas.

TestGen

TestGen is a complete, state-of-the-art test generator and editing application software that allows instructors to quickly and easily select test items from McGraw Hill's TestGen testbank content and to organize, edit, and customize the questions and answers to rapidly generate paper tests. Questions can include stylized text, symbols, graphics, and equations that are inserted directly into questions using built-in mathematical templates. With both quick-and-simple test creation and flexible and robust editing tools, TestGen is a test generator system for today's educators.

A HEARTFELT THANKS TO THE MANY COLLEAGUES WHO SHAPED THIS BOOK

The version of the book you are reading would not be the same book without the valuable suggestions, keen insights, and constructive criticisms of the list of reviewers below. Each professor listed here contributed in substantive ways to the organization of chapters, coverage of topics, and use of pedagogy. We are grateful to them for taking the time to read chapters or attend reviewer conferences, focus groups, and symposia in support of the development for the book:

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We also appreciate the expert attention given to this project by the staff at McGraw-Hill Education, especially Tim Vertovec, Managing Director; Kathleen Klehr, Executive Portfolio Manager; Danielle McLimore, Assessment Product Developer; Erin Quinones, Core Product Developer; Lori Koetters, Brian Nacik, and Jill Eccher, Content Project Managers; Jessica Cuevas, Designer; Natalie King, Marketing Director; Zach Rudin, Marketing Manager; and Sue Culbertson, Senior Buyer.

Changes in *Essentials of Federal Taxation,* 2020 Edition

For the 2020 edition of McGraw-Hill's *Essentials of Federal Taxation,* many changes were made in response to feedback from reviewers and focus group participants:

- All **tax forms** have been **updated for the latest available tax form as of March 2019**. In addition, **chapter content** throughout the text has been **updated to reflect tax law changes through March 2019.**

Other notable changes in the 2019 edition include:

Chapter 1

- Updated tax rates for 2019 and Examples 1-3 through 1-7.
- Updated Social Security Wage base for 2019.
- Updated unified Tax Credit for 2019.
- Updated Taxes in the Real World: National Debt for current debt limit.

Chapter 2

- Updated gross income thresholds by filing status for 2019.
- Enhanced discussion of statute of limitations.
- Updated penalty amounts for failure to file a tax return and failure to pay tax owed.

Chapter 3

- Updated tax rates for 2019.
- Updated Exhibit 3-3 for new tax rates post-TCJA.
- Modified Example 3-4 to clarify the solution.

Chapter 4

- Edited discussion of Form 1040 to match up with revised tax forms.
- Updated Exhibit 4-7 to reflect standard deduction amounts for 2019.
- Updated tax rates for 2019 rates.
- Clarified discussion on tiebreaker rules for qualifying child.
- Revised discussion question 11.
- Updated tax forms from 2017 to 2018.

Chapter 5

- Updated for 2019 amounts for qualified transportation benefits.
- Updated for 2019 amounts for Flexible Spending Account contributions.
- Updated for 2019 foreign income exclusion amounts.
- Updated for annual gift tax exclusion and unified tax credit for 2019.
- Updated U.S. Series EE Bond interest income exclusion for 2019.
- Updated inflation adjusted limits for defined benefit plans and defined contribution plans.
- Revised Appendix A and related discussion about how taxpayers determine whether capital gains are taxed at 0, 15, 20, 25, or 28 percent or ordinary tax rates for 2019 tax rate schedules.
- Updated tax forms from 2017 to 2018.

Chapter 6

- Updated excess business loss limitation for 2019.
- Updated discussion of deduction for interest on qualified education loan for 2019.
- Updated modified AGI phase-out thresholds for deductible contributions to traditional IRAs and contributions to Roth IRAs.
- Updated tax forms from 2017 to 2018.

Chapter 7

- Updated AGI floor for medical expense itemized deduction for 2019.
- Updated mileage rate for medical expense itemized deduction for 2019.
- Added a Taxes in the Real World on state and local tax credits and charitable contributions. Revised discussion of casualty and theft losses on personal-use assets.
- Updated standard deduction amounts for 2019 amounts.
- Expanded discussion for deduction for qualified business income and updated for 2019.
- Updated tax forms from 2017 to 2018.

Chapter 8

- Updated tax rate schedules for 2019.
- Moved discussion of net investment income tax to additional tax section.
- Updated discussion of kiddie tax for 2019.
- Updated AMT exemption and tax rate schedule for 2019.
- Updated Social Security tax wage base and self-employment tax base for 2019.
- Updated lifetime learning credit phase-out for 2019.

- Updated earned income credit amounts for 2019.
- Updated tax forms from 2017 to 2018.

Chapter 9

- Updated tax forms from 2017 to 2018.
- Updated definition of interest for the business interest limitation to conform with proposed regulations.
- Added a new Taxes in the Real World on the all-events test for rebate payments.
- Added two new research problems.
- Added a description of the latest IRS position on the deduction of business meals in conjunction with nondeductible entertainment.
- Added example and homework problems on the deduction of business meals.
- Revised examples and text discussion for updated 2018 mileage rates.
- Expanded description of accounting exceptions for small businesses (average annual gross receipts of $26 million or less in prior three years).

Chapter 10

- Updated Exhibit 10-2 for Weyerhaeuser's 2017 assets.
- Updated tax rates for 2019.
- Revised section on §179 amounts to reflect the inflation adjustments for 2019.
- Updated examples for 2019 §179 amounts.
- Clarified treatment of bonus depreciation for AMT purposes.
- Updated discussion and Exhibit 10-10 relating to automobile depreciation limits.
- Updated §179 amount for SUVs for 2019 inflation amount changes.
- Updated tax forms from 2017 to 2018.
- Updated and revised end-of-chapter problems for §179 amounts and bonus depreciation rules.

Chapter 11

- Updated tax rates for 2019.
- Updated Exhibit 11-6 for changes to recapture.
- Clarified discussion of §1250 recapture as it applies to qualified improvement property placed in service prior to 2018.
- Modified discussion of §1239 gains.
- Modified discussion on like-kind exchanges to clarify purpose of a third-party deferred like-kind exchange.
- Updated discussion of boot given in like-kind exchange.
- Added definition of condemnation.
- Added clarification of amortization of foreign R&E expenditures post-December 31, 2021.
- Updated tax forms from 2017 to 2018 forms.

Chapter 12

- Revised section describing the self-employment tax and the additional Medicare tax.
- Updated the discussion on specified service trades or businesses for purposes of the deduction for qualified business income and included reference to new regulation dealing with what constitutes a specified trade or business.
- Updated Social Security wage base limitation for 2019, including related calculations.
- Revised numbers in Example 12-4.
- Eliminated detailed discussion about pre-2018 individual and corporate tax rates.
- Eliminated discussion about pre-2018 dividends received deduction percentages.
- Included more discussion relating to the dividends received deduction.
- Replaced discussion question 5.

Chapter 13

- Edited discussion of transfers of property to a corporation.
- Updated discussion relating to whether a corporation can use the cash method of accounting.
- Clarified discussion on net capital losses. Edited NOL discussion section.
- Edited Example 13-16 and added a new what-if scenario to the example.
- Edited problem 13-59 to reflect inflation adjusted gross receipts test for the cash method.
- Updated tax forms from 2017 to 2018 forms.

Chapter 14

- Edited current E&P discussion.
- Edited stock distribution discussion.
- Edited Example 14-22
- Removed requirement (g) from problem 14-75.

Chapter 15

- Updated discussion on the new rule dealing with the availability of the cash method of accounting for partnerships to reflect inflation adjustment.
- Updated discussion on new excess business loss limitation and how it interacts with other loss limitation rules to reflect inflation adjustments.
- Updated tax forms from 2017 to 2018.
- Revised Taxes in the Real World example.

- Revised end of chapter problems to reflect inflation adjustments.

Chapter 16

- Revised Taxes in the Real World example.
- Added new end of chapter problem on Section 754 basis step-ups.

Chapter 17

- Updated excess business loss limitation for 2019.
- Updated Social Security tax wage base for 2018.
- Updated tax forms from 2017 to 2018.

As We Go to Press

The 2020 Edition is current through March, 2019. You can visit the *Connect Library* for updates that occur after this date.

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McGraw-Hill's

Essentials of Federal Taxation

chapter

1 An Introduction to Tax

Learning Objectives

Upon completing this chapter, you should be able to:

LO 1-1 Demonstrate how taxes influence basic business, investment, personal, and political decisions.

LO 1-2 Discuss what constitutes a tax and the general objectives of taxes.

LO 1-3 Describe the different tax rate structures and calculate a tax.

LO 1-4 Identify the various federal, state, and local taxes.

LO 1-5 Apply appropriate criteria to evaluate alternative tax systems.


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Storyline Summary

Taxpayer:	Margaret
Employment status:	Margaret is a full-time student at the University of Georgia.
Current situation:	She is beginning her first tax class.

Margaret is a junior beginning her first tax course. She is excited about her career prospects as an accounting major but hasn't had much exposure to taxes. On her way to campus she runs into an old friend, Eddy, who is going to Washington, D.C., to protest recent proposed changes to the U.S. tax system. Eddy is convinced the IRS is evil and that the current tax system is blatantly unfair and corrupt. He advocates a simpler, fairer way of taxation. Margaret is intrigued by Eddy's passion but questions whether he has a complete understanding of the U.S. tax system. She decides to withhold all judgments about it (or about pursuing a career in taxation) until the end of her tax course. ■

LO 1-1 WHO CARES ABOUT TAXES AND WHY?

A clear understanding of the role of taxes in everyday decisions will help you make an informed decision about the value of studying taxation or pursuing a career in taxation. One view of taxation is that it represents an inconvenience every April 15th (the annual due date for filing federal individual tax returns without extensions). However, the role of taxation is much more pervasive than this view suggests. Your study of this subject will provide you a unique opportunity to develop an informed opinion about taxation. As a business student, you can overcome the mystery that encompasses popular impressions of the tax system and perhaps, one day, share your expertise with friends or clients.

What are some common decisions you face that taxes may influence? In this course, we alert you to situations in which you can increase your return on investments by up to one-third! Even the best lessons in finance courses can't approach the increase in risk-adjusted return that smart tax planning provides. Would you like to own your home someday? Tax deductions for home mortgage interest and real estate taxes can reduce the after-tax costs of owning a home relative to renting. Thus, when you face the decision to buy or rent, you can make an informed choice if you understand the relative tax advantages of home ownership. Would you like to retire someday? Understanding the tax-advantaged methods of saving for retirement can increase the after-tax value of your retirement nest egg—and thus increase the likelihood that you can afford to retire, and do so in style. Other common personal financial decisions that taxes influence include: choosing investments, evaluating alternative job offers, saving for education expenses, and doing gift or estate planning. Indeed, taxes are a part of everyday life and have a significant effect on many of the personal financial decisions all of us face.

The role of taxes is not limited to personal finance. Taxes play an equally important role in fundamental business decisions such as the following:

- What organizational form should a business use?
- Where should the business locate?
- How should business acquisitions be structured?
- How should the business compensate employees?
- What is the appropriate mix of debt and equity for the business?
- Should the business rent or own its equipment and property?
- How should the business distribute profits to its owners?

Savvy business decisions require owners and managers to consider all costs and benefits in order to evaluate the merits of a transaction. Although taxes don't necessarily dominate these decisions, they do represent large transaction costs that businesses should factor into the financial decision-making process.

Taxes also play a major part in the political process. U.S. presidential candidates often distinguish themselves from their opponents based upon their tax rhetoric. Indeed, the major political parties generally have very diverse views of the appropriate way to tax the public.[1] Determining who is taxed, what is taxed, and how much is taxed are tough questions with nontrivial answers. Voters must have a basic understanding of taxes to evaluate the merits of alternative tax proposals. Later in this chapter, we'll introduce criteria you can use to evaluate alternative tax proposals.

[1] The U.S. Department of the Treasury provides a "history of taxation" on its website (www.treasury.gov/resource-center/faqs/Taxes/Pages/historyrooseveltmessage.aspx). You may find it interesting to read this history in light of the various political parties in office at the time.

TAXES IN THE REAL WORLD Tax Policy: Republicans versus Democrats

Both Democrats and Republicans desire the same things: a civilized society and a healthy economy. However, neither party can agree on what defines a civilized society or which path best leads to a healthy economy. As of January 2019 the national debt is now 22.0 trillion and growing, yet the only thing we might agree on is that something has gone wrong. Regardless of which party or candidate you support, each party's agenda will affect your income and taxes in various ways.

To explore the divide, let's examine excerpts from each party's National Platform from our most recent presidential election (2016).

Republicans

"We are the party of a growing economy that gives everyone a chance in life, an opportunity to learn, work, and realize the prosperity freedom makes possible."

"Government cannot create prosperity, though government can limit or destroy it. Prosperity is the product of self-discipline, enterprise, saving and investment by individuals, but it is not an end in itself. Prosperity provides the means by which citizens and their families can maintain their independence from government, raise their children by their own values, practice their faith, and build communities of cooperation and mutual respect."

"Republicans consider the establishment of a pro-growth tax code a moral imperative. More than any other public policy, the way government raises revenue—how much, at what rates, under what circumstances, from whom, and for whom—has the greatest impact on our economy's performance. It powerfully influences the level of economic growth and job creation, which translates into the level of opportunity for those who would otherwise be left behind."

"A strong economy is one key to debt reduction, but spending restraint is a necessary component that must be vigorously pursued." https://www.gop.com/platform/restoring-the-american-dream/

Democrats

"At a time of massive income and wealth inequality, we believe the wealthiest Americans and largest corporations must pay their fair share of taxes. Democrats will claw back tax breaks for companies that ship jobs overseas, eliminate tax breaks for big oil and gas companies, and crack down on inversions and other methods companies use to dodge their tax responsibilities . . . We will then use the revenue raised from fixing the corporate tax code to reinvest in rebuilding America and ensuring economic growth that will lead to millions of good-paying jobs."

"We will ensure those at the top contribute to our country's future by establishing a multimillionaire surtax to ensure millionaires and billionaires pay their fair share. In addition, we will shut down the "private tax system" for those at the top, immediately close egregious loopholes like those enjoyed by hedge fund managers, restore fair taxation on multimillion dollar estates, and ensure millionaires can no longer pay a lower rate than their secretaries. At a time of near-record corporate profits, slow wage growth, and rising costs, we need to offer tax relief to middle-class families—not those at the top."

"We will offer tax relief to hard working, middle-class families for the cost squeeze they have faced for years from rising health care, child care, education, and other expenses." https://www.democrats.org/party-platform#preamble

Conclusion

Each party fundamentally believes the government should create/maintain cities and states that form a civilized society, and that government should foster a healthy economy. However, they choose very different paths to reach this objective. Democrats want to raise taxes on the wealthy and create government programs that cost more money, while Republicans wish to lower taxes and decrease government size and spending. Both motives are pure; however, current and cumulative deficits indicate that current revenue is insufficient to meet government spending. Solving these problems will require civil discourse, education, and research/information in order to find realistic, effective solutions.

Republicans: https://www.gop.com/platform/restoring-the-american-dream/
Democrats: https://www.democrats.org/party-platform#preamble

In summary, taxes affect many aspects of personal, business, and political decisions. Developing a solid understanding of taxation should allow you to make informed decisions in these areas. Thus, Margaret can take comfort that her semester will likely prove useful to her personally. Who knows? Depending on her interest in business, investment, retirement planning, and the like, she may ultimately decide to pursue a career in taxation.

LO 1-2

WHAT QUALIFIES AS A TAX?

THE KEY FACTS

What Qualifies as a Tax?

- The general purpose of taxes is to fund government agencies.
- Unlike fines or penalties, taxes are not meant to punish or prevent illegal behavior; however, "sin taxes" are meant to discourage some behaviors.
- To qualify as a tax, three criteria must be met. The payment must be:
  - Required;
  - Imposed by a government; and
  - Not tied directly to the benefit received by the taxpayer.

"Taxes are the price we pay for a civilized society." —Oliver Wendell Holmes, Jr.

Taxes have been described in many terms: some positive, some negative, some printable, some not. Let's go directly to a formal definition of a tax, which should prove useful in identifying alternative taxes and discussing alternative tax systems.

A **tax** *is a payment required by a government that is unrelated to any specific benefit or service received from the government*. The general purpose of a tax is to fund the operations of the government (to raise revenue). Taxes differ from fines and penalties in that taxes are not intended to punish or prevent illegal behavior. Nonetheless, by allowing deductions from income, our federal tax system does encourage certain behaviors like charitable contributions, retirement savings, and research and development. Thus, we can view it as discouraging other legal behavior. For example, **sin taxes** impose relatively high surcharges on alcohol and tobacco products.[2] Cigarette taxes include a $1.01 per pack federal tax, a state tax in all 50 states, and also a few municipal taxes as well.[3]

Key components of the definition of a tax are that the payment is:

- Required (it is not voluntary);
- Imposed by a government agency (federal, state, or local); and
- Not tied directly to the benefit received by the taxpayer.

This last point is not to say that taxpayers receive no benefits from the taxes they pay. They benefit from national defense, a judicial system, law enforcement, government-sponsored social programs, an interstate highway system, public schools, and many other government-provided programs and services. The distinction is that taxes paid are not *directly* related to any specific benefit received by the taxpayer. For example, the price of admission to Yellowstone National Park is a fee rather than a tax because a specific benefit is received.

Can taxes be assessed for special purposes, such as a 1 percent sales tax for education? Yes. Why is an **earmarked tax,** a tax that *is* assessed for a specific purpose, still considered a tax? Because the payment made by the taxpayer does not directly relate to the specific benefit *received by the taxpayer*.

Example 1-1

Margaret travels to Birmingham, Alabama, where she rents a hotel room and dines at several restaurants. The price she pays for her hotel room and meals includes an additional 2 percent city surcharge to fund roadway construction in Birmingham. Is this a tax?

Answer: Yes. The payment is required by a local government and does not directly relate to a specific benefit that Margaret receives.

Example 1-2

Margaret's parents, Bill and Mercedes, recently built a house and were assessed $1,000 by their county government to connect to the county sewer system. Is this a tax?

Answer: No. The assessment was mandatory and it was paid to a local government. However, the third criterion was not met since the payment directly relates to a specific benefit (sewer service) received by the payees. For the same reason, tolls, parking meter fees, and annual licensing fees are also not considered taxes.

[2]Sin taxes represent an interesting confluence of incentives. On the one hand, demand for such products as alcohol, tobacco, and gambling is often relatively inelastic because of their addictive quality. Thus, taxing such a product can raise substantial revenues. On the other hand, one of the arguments for sin taxes is frequently the social goal of *reducing* demand for such products.

[3]Federal excise taxes on cigarettes are found in §5701(b). State taxes are as much as $4.35 per pack in New York. Anchorage, New York City, and Chicago impose municipal taxes on cigarettes as well.

HOW TO CALCULATE A TAX

LO 1-3

In its simplest form, the amount of tax equals the tax base multiplied by the tax rate:

Eq. 1-1 $$\textbf{Tax} = \textbf{Tax Base} \times \textbf{Tax Rate}$$

The **tax base** defines what is actually taxed and is usually expressed in monetary terms, whereas the **tax rate** determines the level of taxes imposed on the tax base and is usually expressed as a percentage. For example, a sales tax rate of 6 percent on a purchase of \$30 yields a tax of \$1.80 (\$1.80 = \$30 × .06).

Federal, state, and local jurisdictions use a large variety of tax bases to collect tax. Some common tax bases (and related taxes) include taxable income (federal and state income taxes), purchases (sales tax), real estate values (real estate tax), and personal property values (personal property tax).

Different portions of a tax base may be taxed at different rates. A single tax applied to an entire base constitutes a **flat tax.** In the case of **graduated taxes,** the base is divided into a series of monetary amounts, or **brackets,** and each successive bracket is taxed at a different (gradually higher or gradually lower) percentage rate.

Calculating some taxes—income taxes for individuals or corporations, for example—can be quite complex. Advocates of flat taxes argue that the process should be simpler. But as we'll see throughout the text, most of the difficulty in calculating a tax rests in determining the tax *base*, not the tax rate. Indeed, there are only three basic tax rate structures (proportional, progressive, and regressive), and each can be mastered without much difficulty.

THE KEY FACTS

How to Calculate a Tax

- Tax = Tax base × Tax rate
- The tax base defines what is actually taxed and is usually expressed in monetary terms.
- The tax rate determines the level of taxes imposed on the tax base and is usually expressed as a percentage.
- Different portions of a tax base may be taxed at different rates.

DIFFERENT WAYS TO MEASURE TAX RATES

Before we discuss the alternative tax rate structures, let's first define three different tax rates that will be useful in contrasting the different tax rate structures: the marginal, average, and effective tax rates.

The **marginal tax rate** is the tax rate that applies to the *next additional increment* of a taxpayer's taxable income (or deductions). Specifically,

Eq. 1-2

$$\text{Marginal Tax Rate} = \frac{\Delta\text{Tax*}}{\Delta\text{Taxable Income}} = \frac{(\text{New Total Tax} - \text{Old Total Tax})}{(\text{New Taxable Income} - \text{Old Taxable Income})}$$

*Δ means *change in*.

where "old" refers to the current tax and "new" refers to the revised tax after incorporating the additional income (or deductions) in question. In graduated income tax systems, additional income (deductions) can push a taxpayer into a higher (lower) tax bracket, thus changing the marginal tax rate.

Example 1-3

Margaret's parents, Bill and Mercedes, file a joint tax return. They have \$160,000 of taxable income this year (after all tax deductions). Assuming the following federal tax rate schedule applies, how much federal income tax will they owe this year?[4]

(*continued on page 1-6*)

[4]The tax rate schedules for single, married filing jointly, married filing separately, and head of household are included in Appendix D.

Married Filing Jointly (and Surviving Spouses)

Not over $19,400	10% of taxable income
$19,400 to $78,950	$1,940 + 12% of taxable income in excess of $19,400
$78,950 to $168,400	$9,086 + 22% of taxable income in excess of $78,950
$168,400 to $321,450	$28,765 + 24% of taxable income in excess of $168,400
$321,450 to $408,200	$65,497 + 32% of taxable income in excess of $321,450
$408,200 to $612,350	$93,257 + 35% of taxable income in excess of $408,200
Over $612,350	$164,709.50 + 37% of taxable income in excess of $612,350

Answer: Bill and Mercedes will owe $26,917 computed as follows:

$26,917 = $9,080 + 22% ($160,000 – $78,950)

Note that in this graduated tax rate structure, the first $19,400 of taxable income is taxed at 10 percent, the next $59,550 of taxable income (between $19,400 and $78,950) is taxed at 12 percent, and Bill and Mercedes's last $81,050 of taxable income (between $78,950 and $160,000) is taxed at 22 percent.

Many taxpayers incorrectly believe that all their income is taxed at their marginal rate. This mistake leads people to say, "I don't want to earn any additional money because it will put me in a higher tax bracket." Bill and Mercedes are currently in the 22 percent marginal tax rate bracket, but notice that not all their income is taxed at this rate. Their *marginal* tax rate is 22 percent. This means that small increases in income will be taxed at 22 percent, and small increases in tax deductions will generate tax *savings* of 22 percent. If Bill and Mercedes receive a large increase in income (or in deductions) such that they change tax rate brackets, we could not identify their marginal tax rate simply by knowing their current tax bracket.

Example 1-4

Bill, a well-known economics professor, signs a publishing contract with an $80,000 royalty advance. Using the rate schedule from Example 1-3, what would Bill and Mercedes's marginal tax rate be on this additional $80,000 of taxable income?

Answer: 23.79 percent, computed as follows:

Description	Amount	Explanation
(1) Taxable income with additional $80,000 of taxable income	$240,000	$80,000 plus $160,000 taxable income (Example 1-3)
(2) Tax on $240,000 taxable income	$ 45,949	Using the rate schedule in Example 1-3, $45,949 = $28,765 + 24% ($240,000 – $168,400)
(3) Taxable income before additional $80,000 of taxable income	$160,000	Example 1-3
(4) Tax on $160,000 taxable income	$ 26,917	Example 1-3
Marginal tax rate on additional $80,000 of taxable income	**23.79%**	$\frac{\Delta \text{Tax}}{\Delta \text{Taxable income}}$ = [(2) – (4)]/[(1) – (3)]

Note that Bill and Mercedes's marginal tax rate on the $80,000 increase in taxable income rests *between* the 22 percent and 24 percent bracket rates because a portion of the additional income ($168,400 – $160,000 = $8,400) is taxed at 22 percent, with the remaining income ($240,000 – $168,400 = $71,600) taxed at 24 percent.

Example 1-5

Assume now that, instead of receiving a book advance, Bill and Mercedes start a new business that *loses* $90,000 this year (it results in $90,000 of additional tax deductions). What would be their marginal tax rate for these deductions?

Answer: 21.01 percent, computed as follows:

Description	Amount	Explanation
(1) Taxable income with additional $90,000 of tax deductions	$ 70,000	$160,000 taxable income (Example 1-3) less $90,000
(2) Tax on $70,000 taxable income	$ 8,012	Using the rate schedule in Example 1-3, $8,012 = $1,940 + 12% × ($70,000 − $19,400)
(3) Taxable income before additional $90,000 of tax deductions	$160,000	Example 1-3
(4) Tax on $160,000 taxable income	$ 26,917	Example 1-3
Marginal tax rate on additional $90,000 of tax deductions	**21.01%**	$\frac{\Delta\text{Tax}}{\Delta\text{Taxable income}} = [(2) - (4)]/[(1) - (3)]$

Bill and Mercedes's marginal tax rate on $90,000 of additional deductions (21.01 percent) differs from their marginal tax rate on $80,000 of additional taxable income (23.79 percent) in these scenarios because the relatively large increase in deductions in Example 1-5 causes some of their income to be taxed in a lower tax rate bracket, while the relatively large increase in income in Example 1-4 causes some of their income to be taxed in a higher tax rate bracket. Taxpayers often will face the same marginal tax rates for small changes in income and deductions.

The marginal tax rate is particularly useful in tax planning because it represents the rate of taxation or savings that would apply to additional taxable income (or tax deductions). In the Tax Planning Strategies and Related Limitations chapter, we discuss basic tax planning strategies that use the marginal tax rate.

The **average tax rate** represents a taxpayer's average level of taxation on each dollar of taxable income. Specifically,

Eq. 1-3

$$\text{Average Tax Rate} = \frac{\text{Total Tax}}{\text{Taxable Income}}$$

The average tax rate is often used in budgeting tax expense as a portion of income (i.e., determining what percent of taxable income earned is paid in tax).

THE KEY FACTS

Different Ways to Measure Tax Rates

- Marginal tax rate
  - The tax that applies to the next increment of income or deduction.
  - $= \frac{\Delta\text{Tax}}{\Delta\text{Taxable income}}$
  - Useful in tax planning.
- Average tax rate
  - A taxpayer's average level of taxation on each dollar of *taxable* income.
  - $= \frac{\text{Total tax}}{\text{Taxable income}}$
  - Useful in budgeting tax expense.
- Effective tax rate
  - A taxpayer's average rate of taxation on each dollar of *total* income (taxable *and* nontaxable income).
  - $= \frac{\text{Total tax}}{\text{Total income}}$
  - Useful in comparing the relative tax burdens of taxpayers.

Example 1-6

Assuming Bill and Mercedes have $160,000 of taxable income and $10,000 of nontaxable income, what is their average tax rate?

Answer: 16.82 percent, computed as follows:

Description	Amount	Explanation
(1) Taxable income	$160,000	
(2) Tax on $160,000 taxable income	$ 26,917	Example 1-3
Average tax rate	**16.82%**	$\frac{\text{Total tax}}{\text{Taxable income}} = (2)/(1)$

We should not be surprised that Bill and Mercedes's average tax rate is lower than their marginal tax rate because, although they are currently in the 22 percent tax rate bracket, not all of their taxable income is subject to tax at 22 percent. The first $19,400 of their taxable income is taxed at 10 percent, their next $59,550 is taxed at 12 percent, and only their last $81,050 of taxable income is taxed at 22 percent. Thus, their average tax rate is considerably lower than their marginal tax rate.

The **effective tax rate** represents the taxpayer's average rate of taxation on each dollar of total income (sometimes referred to as economic income), including taxable *and* nontaxable income. Specifically,

Eq. 1-4

$$\text{Effective Tax Rate} = \frac{\text{Total Tax}}{\text{Total Income}}$$

Relative to the average tax rate, the effective tax rate provides a better depiction of a taxpayer's tax burden because it gives the taxpayer's total tax paid as a ratio of the sum of both taxable and nontaxable income earned.

Example 1-7

Again, given the same income figures as in Example 1-6 ($160,000 of taxable income and $10,000 of nontaxable income), what is Bill and Mercedes's effective tax rate?

Answer: 15.83 percent, computed as follows:

Description	Amount	Explanation
(1) Total income	$170,000	$160,000 taxable income plus $10,000 in nontaxable income (Example 1-6)
(2) Tax on $160,000 taxable income	$ 26,917	Example 1-3
Effective tax rate	**15.83%**	$\frac{\text{Total tax}}{\text{Total income}} = (2)/(1)$

Should we be surprised that the effective tax rate is lower than the *average* tax rate? No, the effective tax rate will always be equal to or less than the average tax rate. When a taxpayer has no nontaxable income the effective and average tax rates will be equal, but anytime a taxpayer has nontaxable income the effective tax rate will be less than the average tax rate.

TAX RATE STRUCTURES

There are three basic tax rate structures used to determine a tax: proportional, progressive, and regressive.

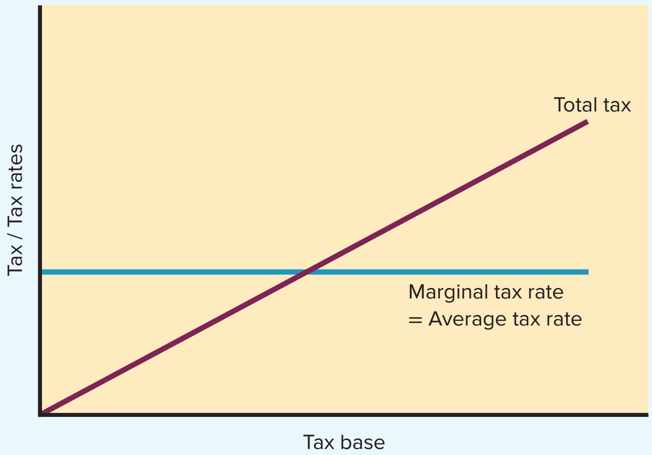
Proportional Tax Rate Structure

A **proportional tax rate structure,** also known as a flat tax, imposes a constant tax rate throughout the tax base. As the tax base increases, the taxes paid increase proportionally. Because this rate stays the same throughout all levels of the tax base, the marginal tax rate remains constant and, in fact, equals the average tax rate (see Exhibit 1-1). The 21 percent corporate tax rate is an example of a flat tax.

To calculate the tax owed for a proportional tax, simply use Equation 1-1 to multiply the tax base by the tax rate.

Eq. 1-5 $$\text{Proportional tax} = \text{Tax base} \times \text{Tax rate}$$

EXHIBIT 1-1 **Proportional Tax Rate**



Example 1-8

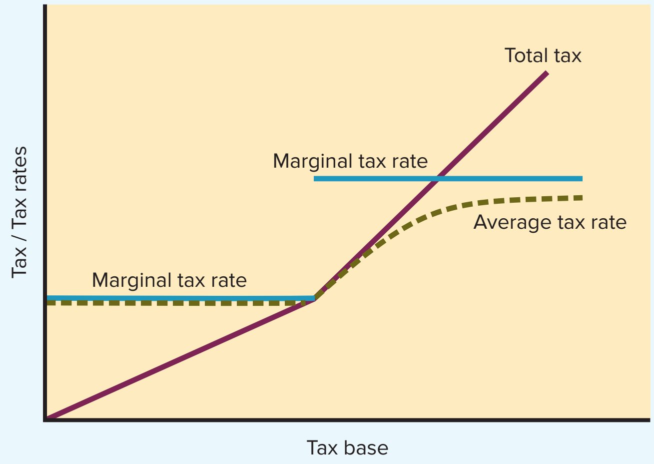
Knowing her dad is a serious Bulldog fan, Margaret buys a $100 sweatshirt in downtown Athens. The city of Athens imposes a sales tax rate of 7 percent. How much tax does Margaret pay on the purchase?

Answer: $100 purchase (tax base) × 7% (tax rate) = $7

Progressive Tax Rate Structure

A **progressive tax rate structure** imposes an increasing marginal tax rate as the tax base increases. Common examples of progressive tax rate structures include federal and most state income taxes. The tax rate schedule in Example 1-3 is a progressive tax rate structure. As illustrated in Exhibit 1-2, the average tax rate in a progressive tax rate structure will always be less than or equal to the marginal tax rate.

EXHIBIT 1-2 Progressive Tax Rate

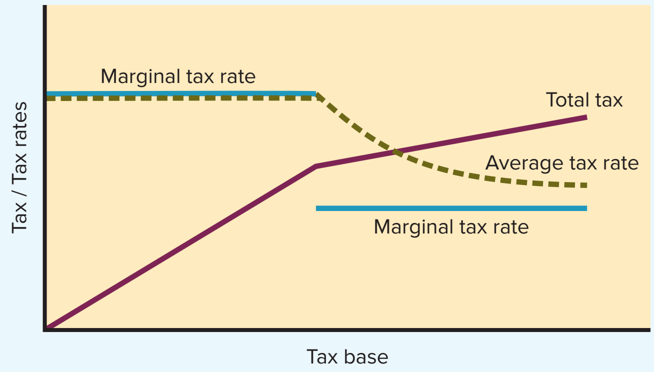


Regressive Tax Rate Structure

A **regressive tax rate structure** imposes a decreasing marginal tax rate as the tax base increases (see Exhibit 1-3). Regressive tax rate structures are not common. In the United States, the Social Security tax and federal and state unemployment taxes employ a regressive tax rate structure.[5]

Some taxes are regressive when viewed in terms of effective tax rates. For example, a sales tax is a proportional tax by definition, because as taxable purchases increase, the sales tax rate remains constant.[6] Nonetheless, when you consider that the proportion of your total income spent on taxable purchases likely decreases as your total income increases, you can see the sales tax as a regressive tax.

EXHIBIT 1-3 Regressive Tax Rate



[5]Wages subject to the Social Security tax are capped each year. Wages in excess of the cap are not subject to the tax. Likewise, the federal and state unemployment tax bases and related unemployment benefits are capped. Alternatively, wages subject to the Medicare tax are proportional because the Medicare tax is not capped.

[6]For example, a destitute taxpayer likely spends all he makes on food and other items subject to the sales tax; thus, all of his income is subject to a sales tax. In contrast, a wealthy taxpayer likely spends only a small fraction of his income on items subject to sales tax (while saving the rest). Thus, less of wealthy taxpayers' total income is subject to the sales tax, which ultimately results in a lower effective tax rate.

Example 1-9

Bill and Mercedes invite two single friends, Elizabeth and Marc, over for dinner. Elizabeth earns $300,000 as CFO of a company and spends $70,000 on purchases subject to the 7 percent sales tax. Marc, who earns $75,000 as a real estate agent, spends $30,000 of his income on taxable purchases. Let's compare their marginal, average, and effective tax rates for the sales tax with those of Bill and Mercedes, who spend $50,000 of their income on taxable purchases:

	Elizabeth	Bill and Mercedes	Marc
(1) Total income	$300,000	$170,000	$75,000
(2) Total purchases subject to 7% sales tax	$ 70,000	$ 50,000	$30,000
(3) Sales tax paid	$ 4,900	$ 3,500	$ 2,100
Marginal tax rate	7.0%	7.0%	7.0%
Average tax rate (3)/(2)	7%	7%	7%
Effective tax rate (3)/(1)	1.6%	2.1%	2.8%

Is the sales tax regressive?

Answer: Yes. In terms of *effective* tax rates, the sales tax is regressive.

THE KEY FACTS

Tax Rate Structures

- A proportional tax rate structure
  - Imposes a constant tax rate throughout the tax base.
  - As a taxpayer's tax base increases, the taxpayer's taxes increase proportionally.
  - The marginal tax rate remains constant and always equals the average tax rate.
- A progressive tax rate structure
  - Imposes an increasing marginal tax rate as the tax base increases.
- A regressive tax rate structure
  - Imposes a decreasing marginal tax rate as the tax base increases.

When we consider the marginal and average tax rates in Example 1-9, the sales tax has a proportional tax rate structure. But when we look at the *effective* tax rates, the sales tax is a regressive tax. Indeed, Marc, who has the smallest total income, bears the highest effective tax rate, despite all three taxpayers being subject to the same marginal and average tax rates. Why do we see such a different picture when considering the effective tax rate? Because unlike the marginal and average tax rates, the effective tax rate captures the *incidence* of taxation, which relates to the ultimate economic burden of a tax. Thus, a comparison of effective tax rates is more informative about taxpayers' relative tax burdens.

TYPES OF TAXES

LO 1-4

"You can't live with 'em. You can't live without 'em." This statement has often been used in reference to bosses, parents, spouses, and significant others. To some degree, it applies equally well to taxes. Although we all benefit in multiple ways from tax revenues, and all civilized nations impose them, it would be hard to find someone who *enjoys* paying them. Most people don't object to the idea of paying taxes. Instead, it's the way taxes are levied that many people, like Margaret's friend Eddy, dislike. Hence, the search for the "perfect" tax can be elusive. The following paragraphs describe the major types of taxes currently used by federal, state, and local governments. After this discussion, we describe the criteria for evaluating alternative tax systems.

Federal Taxes

The federal government imposes a variety of taxes to fund federal programs such as national defense, Social Security, an interstate highway system, educational programs, and Medicare. Major federal taxes include the individual and corporate income taxes, employment taxes, estate and gift taxes, and excise taxes (each discussed in detail in the following paragraphs). Notably absent from this list are sales tax (a common tax levied by most state and local governments) and **value-added tax** (a type of sales tax also referred to as a VAT). Value-added taxes are imposed on the producers of goods and services

THE KEY FACTS

Federal Taxes

- Income tax
  - The most significant tax assessed by the U.S. government.
  - Represents approximately 60 percent (combined corporate and individual) of all tax revenues collected in the United States.
  - Levied on individuals, corporations, estates, and trusts.
- Employment and unemployment taxes
  - Second-largest group of taxes imposed by the U.S. government.

(continued)

- Employment taxes consist of the Old Age, Survivors, and Disability Insurance (OASDI) tax, commonly called the Social Security tax, and the Medical Health Insurance (MHI) tax, also known as the Medicare tax.
- Unemployment taxes fund temporary unemployment benefits for individuals terminated from their jobs without cause.
- Excise taxes
  - Third-largest group of taxes imposed by the U.S. government.
  - Levied on the *quantity* of products sold.
- Transfer taxes
  - Levied on the fair-market values of wealth transfers upon death or by gift.

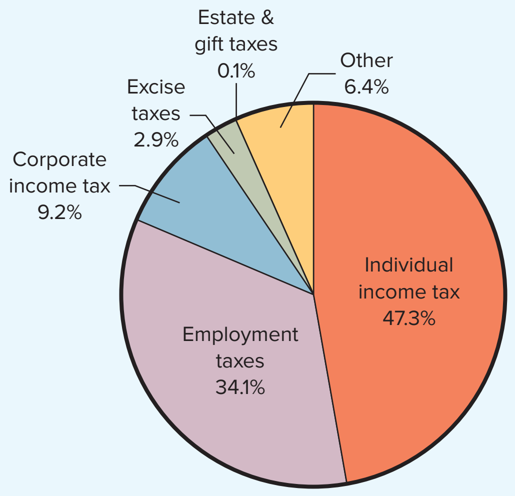
based on the value added to the goods and services at each stage of production. They are quite common in Europe.

Income Tax The most significant tax assessed by the U.S. government is the individual **income tax,** representing approximately 47.3 percent of all tax revenues collected in the United States in 2017. Despite the magnitude and importance of the federal income tax, its history is relatively short. Congress enacted the first U.S. personal income tax in 1861 to help fund the Civil War. This relatively minor tax (with a maximum tax rate of 5 percent) was allowed to expire in 1872. In 1892, Congress resurrected the income tax, but not without dissension among the states. In 1895, the income tax was challenged in *Pollock v. Farmers' Loan and Trust Company,* 157 U.S. 429 (1895). The U.S. Supreme Court ruled that the income tax was unconstitutional because direct taxes were prohibited by the Constitution unless the taxes were apportioned across states based upon their populations. This ruling, however, did not deter Congress. In July 1909, Congress sent a proposed constitutional amendment to the states to remove any doubt as to whether income taxes were allowed by the Constitution—and in February 1913, the 16th Amendment was ratified.

Congress then enacted the Revenue Act of 1913, which included a graduated income tax structure with a maximum rate of 6 percent. The income tax has been an important source of tax revenues for the U.S. government ever since. Today, income taxes are levied on individuals (maximum rate of 37 percent), corporations (flat rate of 21 percent), estates (maximum rate of 37 percent), and trusts (maximum rate of 37 percent). Higher income taxpayers must also pay a 3.8 percent tax on their net investment income. As Exhibit 1-4 illustrates, the individual income tax and employment taxes represent the largest sources of federal tax revenues. We discuss each of these taxes in greater detail later in the text.

Employment and Unemployment Taxes Employment and unemployment taxes are the second-largest group of taxes imposed by the U.S. government. **Employment taxes** consist of the Old Age, Survivors, and Disability Insurance (OASDI) tax, commonly called the Social Security tax, and the Medical Health Insurance (MHI) tax, known as the Medicare tax. The **Social Security tax** pays the monthly retirement, survivor, and disability benefits for qualifying individuals, whereas the **Medicare tax** pays for medical

EXHIBIT 1-4 U.S. Federal Tax Revenues



Source: Treasury Department (Fiscal Year 2017).

insurance for individuals who are elderly or disabled. The tax base for the Social Security and Medicare taxes is wages or salary, and the rates are 12.4 percent and 2.9 percent, respectively. In 2019, the tax base for the Social Security tax is capped at $132,900 (wages over this cap are not subject to the tax). The tax base for the Medicare tax is not capped. Employers and employees split these taxes equally (both pay 6.2 percent Social Security tax and 1.45 percent Medicare tax). Self-employed individuals, however, must pay these taxes in their entirety. In this case, the tax is often referred to as the **self-employment tax.** We discuss these taxes in more depth later in the text. There is a .9 percent additional Medicare tax levied on income earned by employees (employers are exempt) and self-employed taxpayers on income exceeding a threshold amount (see the Individual Income Tax Computation and Tax Credits chapter for details).

In addition to the Social Security and Medicare taxes, employers are also required to pay federal and state **unemployment taxes,** which fund temporary unemployment benefits for individuals terminated from their jobs without cause. As you might expect, the tax base for the unemployment taxes is also wages or salary. Currently, the federal unemployment tax rate is 6 percent. The wage base is the first $7,000 of wages received during the year. The U.S. government allows a credit for state unemployment taxes paid up to 5.4 percent. Thus, the effective federal unemployment tax rate may be as low as .6 percent (6.0% − 5.4% = .6%).[7]

Excise Taxes **Excise taxes** are taxes levied on the retail sale of particular products. They differ from other taxes in that the tax base for an excise tax typically depends on the *quantity* purchased, rather than a monetary amount. The federal government imposes a number of excise taxes on goods such as alcohol, diesel fuel, gasoline, and tobacco products and on services such as telephone use, air transportation, and the use of tanning beds. In addition, states often impose excise taxes on these same items.

Example 1-10

On the drive home from Florida to Athens, Georgia, Margaret stops at Gasup-n-Go. On each gallon of gasoline she buys, Margaret pays 18.4 cents of federal excise tax and 7.5 cents of state excise tax (plus 4 percent sales tax). Could Margaret have avoided paying excise tax had she stopped in Florida instead?

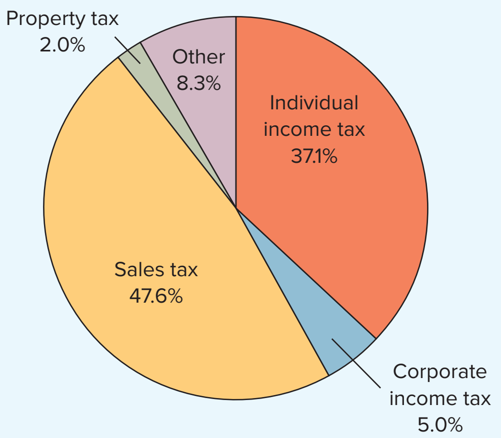
Answer: No. Had she stopped in Florida instead, Margaret would have paid the same federal excise tax. Additionally, Florida imposes higher state taxes on gas.

Because the producer of the product pays the excise tax to the government, many people are not even aware that businesses build these taxes into the prices consumers pay. Nonetheless, consumers bear the burden of the taxes because of the higher price.

Transfer Taxes Although they are a relatively minor tax compared to the income tax in terms of revenues collected, federal **transfer taxes**—estate and gift taxes—can be substantial for certain individual taxpayers and have been the subject of much debate in recent years. The **estate tax** (labeled the "death tax" by its opponents) and **gift taxes** are based on the fair market values of wealth transfers made upon death or by gift, respectively. In 2019, the maximum rate imposed on gifts is 40 percent. Most taxpayers, however, are not subject to estate and gift taxation because of the annual gift exclusion and gift and estate unified tax credits. The annual gift exclusion allows a taxpayer to transfer $15,000 of gifts per donee (gift recipient) each year without gift taxation. In 2019, the unified tax credit exempts from taxation $11,400,000 in bequests (transfers upon death) and lifetime gifts. Thus, only taxpayers with substantial wealth are subject to the gift and estate taxes.

[7]Although employers pay both federal and state unemployment taxes, all unemployment benefits actually are administered and paid by state governments.

EXHIBIT 1-5 Average State Tax Revenues



Source: U.S. Bureau of Census, 2017.

THE KEY FACTS

State and Local Taxes

- Income taxes
  - Most state taxable income calculations largely conform to the federal taxable income calculations, with a limited number of modifications.
- Sales and use taxes
  - The tax base for a sales tax is the retail price of goods and some services.
  - The tax base for the use tax is the retail price of goods owned, possessed, or consumed within a state that were *not* purchased within the state.
- Property taxes
  - Property taxes are ad valorem taxes, meaning that the tax base for each property is the fair market value of that property.
  - Real property taxes consist of taxes on land, structures, and improvements permanently attached to land.
  - Personal property taxes include taxes on all other types of property, both tangible and intangible.
- Excise taxes
  - States typically impose excise taxes on items subject to federal excise tax.

State and Local Taxes

Like the federal government, state and local governments (such as counties, cities, and school districts) use a variety of taxes to generate revenues for their programs (such as education, highways, and police and fire departments). Some of the more common **state** and **local taxes** include income taxes, sales and use taxes, excise taxes, and property taxes. Typically, as shown in Exhibit 1-5, the largest state tax revenues are generated by individual income taxes and state sales taxes—while federal revenues rely primarily on income and employment taxes. Local tax revenues are predominantly from sales and property taxes.

Income Taxes Currently, most states and the District of Columbia impose income taxes on individuals and corporations who either reside in or earn income within the state.[8] This requires individuals working in these states to file a state tax return in addition to the federal return they already file. Calculations of individual and corporate taxable income vary with state law. Nonetheless, state taxable income calculations generally conform to the federal taxable income calculations (California is a notable exception because it has numerous modifications). State income tax rates are significantly less than the federal rates. Certain local governments such as New York City also impose an income tax and, again, the local calculations generally follow the respective state taxable income calculation.

Sales and Use Taxes Most states, the District of Columbia, and local governments impose sales and use taxes. The tax base for a **sales tax** is the retail price of goods and some services, and retailers are responsible for collecting and remitting the tax; typically, sales tax is collected at the point of sale. The tax base for the **use tax** is

[8]Currently, Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming have no personal income tax, and New Hampshire and Tennessee only tax individual dividend and interest income. Nevada and Wyoming do not impose taxes on corporate income, and South Dakota only taxes banks. Washington imposes a gross receipts tax instead of a corporate income tax. Texas and Ohio have an activity-based tax that is based on net income or gross receipts.

the retail price of goods owned, possessed, or consumed within a state that were *not* purchased within the state. The purpose of a use tax is to discourage taxpayers from buying goods out of state in order to avoid or minimize the sales tax in their home state. At the same time, by eliminating the incentive to purchase goods out of state, a use tax removes any competitive disadvantage a retailer may incur from operating in a state with a high sales tax. To avoid the potential of double taxing residents on sales taxes, states that impose a sales tax allow residents to take a credit for sales tax paid on goods purchased out of state.

Example 1-11

Margaret buys three new Lands' End shirts for her dad for $100. Because Lands' End does not have a business presence in Florida (Margaret's home state), it does not collect Florida sales tax on the $100 purchase. Does Margaret's purchase escape Florida taxation?

Answer: No. Because Florida has a 6 percent use tax, Margaret is liable for $6 in use tax on the purchase ($100 × .06 = $6).

Despite the potential importance of the use tax as a source of state tax revenue, states have only recently begun to enforce it. Poor compliance is therefore not surprising; indeed, many individuals have never heard of the use tax. While it is relatively easy to enforce it on goods obtained out of state if they are subject to a registration requirement, such as automobiles, it is quite difficult for states to tax most other out-of-state purchases. The state of Florida is not likely to search your closet to look for tax-evaded Lands' End shirts. Note, however, there are several bills before Congress to modernize Internet taxation and to try to subject all Internet sales to sales taxes.

Property Taxes State and local governments commonly use two types of property taxes as sources of revenue: **real property taxes** and **personal property taxes.** Both are **ad valorem taxes,** meaning that the tax base for each is the fair market value of the property, and both are generally collected annually (when imposed).

Real property consists of land, structures, and improvements permanently attached to land, whereas *personal property* includes all other types of property, both tangible and intangible. Common examples of tangible personal property potentially subject to state and local taxation include automobiles, boats, private planes, business inventory, equipment, and furniture. *Intangible personal property* potentially subject to state and local taxation includes stocks, bonds, and intellectual property—although no state currently imposes property taxes on these intangibles.

Of the two types, real property taxes are easier to administer because real property is not movable and purchases often have to be registered with the state, thereby making it easy to identify the tax base and taxpayer. Furthermore, the taxing body can estimate market values for real property without much difficulty. In contrast, personal property is generally mobile (thus easier to hide) and may be more difficult to value; therefore, personal property taxes are difficult to enforce. Accordingly, whereas all states and the District of Columbia provide for a real property tax, only a majority of states currently impose personal property taxes, most of which are assessed at the time of licensing or registration. However, most states do collect personal property taxes on business property.

Excise Taxes We've said that the tax base for excise taxes is typically the quantity of an item or service purchased. States typically impose excise taxes on items subject to federal excise tax. Transactions subject to state excise tax often include the sale of alcohol, diesel fuel, gasoline, tobacco products, and telephone services.

Implicit Taxes

All the taxes discussed above are **explicit taxes;** that is, they are taxes directly imposed by a government and are easily quantified. **Implicit taxes,** on the other hand, are indirect taxes—not paid directly to the government—that result from a tax advantage the government grants to certain transactions to satisfy social, economic, or other objectives. Implicit taxes are defined as the reduced before-tax return that a tax-favored asset produces because of its tax-advantaged status. Let's examine this concept more closely.

First of all, what does it mean to be *tax-favored*? An asset is said to be tax-favored when the income the asset produces is either excluded from the tax base or subject to a lower (preferential) tax rate, or if the asset generates some other tax benefit such as large tax deductions. These tax benefits, *all other things equal*, result in higher after-tax profits (or lower after-tax costs) from investing in the tax-advantaged assets.

Why do tax-advantaged assets bear an implicit tax, or a reduced before-tax return as a result of the tax advantage? The answer is simple economics. The tax benefits associated with the tax-favored asset increase the demand for the asset. Increased demand drives up the price of the asset, which in turn reduces its before-tax return, which is an implicit tax by definition. Consider Example 1-12.

Example 1-12

Consider two bonds, one issued by the Coca-Cola Co. and the other issued by the State of Georgia. Both bonds have similar nontax characteristics (risk, for example), the same face value of $10,000, and the same market interest rate of 10 percent. The only difference between the two bonds is that the interest income from the Coca-Cola Co. bond is subject to a 22 percent income tax rate, whereas the interest income from the State of Georgia bond is tax-exempt with a 0 percent tax rate. Which of the two bonds is a better investment and should therefore have a higher demand?

	Price	Before-Tax Return*	Interest Income	Income Tax†	After-Tax Income	After-Tax Return*
Coca-Cola Co. Bond	$10,000	10%	$1,000	$220	$ 780	7.8%
State of GA Bond	$10,000	10%	$1,000	$ 0	$1,000	10%

*Before-tax return is calculated as the before-tax income divided by the price of the bond. Likewise, after-tax return is calculated as the after-tax income divided by the price of the bond.
†Income tax equals the taxable interest income ($1,000) multiplied by the assumed income marginal tax rate (22 percent).

Answer: Compare the after-tax returns of the bonds. Given the difference between the return after taxes (10 percent vs. 7.8 percent), the better investment—again, all other investment features being equal—is the State of Georgia bond because it provides a higher *after*-tax return. Because all investors in this example should prefer to buy the State of Georgia bond, the demand for the bond will be high, and its price should increase. This increase in price leads to a lower before-tax return due to the bond's tax-favored status (this is an implicit tax).

Example 1-12 is a basic illustration of the need to consider the role of taxes in investment decisions. Without understanding the relative tax effects associated with each bond, we cannot correctly compare their after-tax returns.

At what point in Example 1-12 would you be indifferent between investing in the Coca-Cola Co. bond and the State of Georgia bond? Assuming both bonds have the same nontax characteristics, you would be indifferent between them when they both provide the same after-tax rate of return. This could occur if the State of Georgia raised the price of its bond from $10,000 to $12,500 ($1,000 interest/$12,500 price = 8% return). Or the State of Georgia could lower its bond interest payment from $1,000 to $800 ($800 interest/$10,000 price = 8% return). Either way, the State of Georgia benefits from selling the tax-exempt bonds—either at a higher price or at a lower interest rate relative to other bonds. Let's look more closely at this latter option, because it is, in fact, what many tax-exempt bond issuers choose to do.

	Price	Before-Tax Return	Interest Income	Income Tax	After-Tax Income	After-Tax Return
Coca-Cola Co. Bond	$10,000	10%	$1,000	$200	$800	8%
State of GA Bond	$10,000	8%	$ 800	$ 0	$800	8%

At this point, assuming each bond has the same nontax characteristics, an investor should be indifferent between the Coca-Cola Co. bond and the State of Georgia bond. What is the tax burden on investors choosing the Coca-Cola Co. bond? Coca-Cola Co. bond investors are paying $200 of income taxes (explicit taxes). What is the tax burden on investors choosing the State of Georgia bond? While it is true they are subject to zero income taxes (explicit taxes), they are subject to implicit taxes in the form of the $200 less in interest income they accept. This $200 of reduced interest income (2 percent reduced before-tax rate of return) is an implicit tax. Although the investors in the State of Georgia bond are not paying this tax directly, they are paying it indirectly.

Does this happen in real life? Yes. Municipal bond interest income (interest income paid on bonds issued by state and local governments) generally is not subject to federal income taxation. Because of their tax-advantaged status, municipalities are able to pay a lower interest rate on their bond issuances and investors are willing to accept the lower rate. This type of indirect federal subsidy allows municipalities to raise money at a reduced cost without the need for direct federal subsidy or approval.

Although we were able to quantify the implicit taxes paid in the above example, in reality it is very difficult to estimate the amount of implicit taxes paid. For example, the federal government subsidizes housing by allowing taxpayers to deduct mortgage interest on their principal residence. Does this subsidy result in an implicit tax in the form of higher housing prices? Probably. Nonetheless, it would be difficult to quantify this implicit tax.

Despite the difficulty of quantifying implicit taxes, you should understand the concept of implicit taxes so you can make informed judgments about the attractiveness of alternative investments and the relative total tax burdens of tax-advantaged investments (considering both explicit and implicit taxes).

THE KEY FACTS

Implicit Taxes

- Implicit taxes are indirect taxes that result from a tax advantage the government grants to certain transactions to satisfy social, economic, or other objectives.
- Implicit taxes are defined as the reduced before-tax return that a tax-favored asset produces because of its tax-advantaged status.
- Implicit taxes are difficult to quantify but important to understand in evaluating the relative tax burdens of tax-advantaged investments.

EVALUATING ALTERNATIVE TAX SYSTEMS

LO 1-5

Although it may appear that tax systems are designed without much forethought, in truth lawmakers engage in continuous debate over the basic questions of whom to tax, what to tax, and how much to tax. Margaret's friend Eddy is obviously upset with what he views as an unfair tax system. But fairness, as we will discuss shortly, is often like beauty—it is in the eye of the beholder. What is fair to one may seem blatantly unfair to others. In the following paragraphs, we offer various criteria (sufficiency, equity, certainty, convenience, and economy) you can use to evaluate alternative tax systems.[9] Satisfying everyone at the same time is difficult. Hence, the spirited debate on tax reform.

[9]Adam Smith identified and described the latter four criteria in *The Wealth of Nations*.

Sufficiency

Judging the **sufficiency** of a tax system means assessing the amount of tax revenues it must generate and ensuring that it provides them. For a country's tax system to be successful, it must provide sufficient revenues to pay for governmental expenditures for a defense system, social services, and so on. This sounds easy enough: Estimate the amount of government expenditures that will be required, and then design the system to generate enough revenues to pay for these expenses. In reality, however, accurately estimating governmental expenditures and revenues is a rather daunting and imprecise process. Estimating governmental expenditures is difficult because it is impossible to predict the unknown. For example, in recent years governmental expenditures have increased due to the growth of Homeland Security, the Afghanistan and Iraq Wars, natural disasters, economic stimulus, and health care. Likewise, estimating governmental revenues is difficult because tax revenues are the result of transactions influenced by these same national events, the economy, and other factors. Thus, precisely estimating and matching governmental expenditures with tax revenues is nearly impossible.

The task of estimating tax revenues becomes even more daunting when the government attempts to make significant changes to the existing tax system or design a new one. Whenever Congress proposes changing who is taxed, what is taxed, or how much is taxed, its members must consider the taxpayer response to the change. That affects the amount of tax collected, and forecasters' prediction of what taxpayers will do affects the amount of revenue they estimate.

THE KEY FACTS

Evaluating Alternative Tax Systems—Sufficiency

- Judging sufficiency requires assessing the aggregate amount of the tax revenues that must be generated and ensuring that the tax system provides these revenues.
- Static forecasting ignores how taxpayers may alter their activities in response to a proposed tax law change and bases projected tax revenues on the existing state of transactions.
- Dynamic forecasting attempts to account for possible taxpayer responses to a proposed tax law change.

Static versus Dynamic Forecasting One option in forecasting revenue is to ignore how taxpayers may alter their activities in response to a tax law change and instead base projected tax revenues on the existing state of transactions, a process referred to as **static forecasting.** However, this type of forecasting may result in a large discrepancy in projected versus actual tax revenues if taxpayers do change their behavior.

The other choice is to attempt to account for possible taxpayer responses to the tax law change, a process referred to as **dynamic forecasting.** Dynamic forecasting is ultimately only as good as the assumptions underlying the forecasts and does not guarantee accurate results. Nonetheless, considering how taxpayers may alter their activities in response to a tax law change is a useful exercise to identify the potential ramifications of the change, even if the revenue projections ultimately miss the mark. For more information about the congressional revenue estimating process, including dynamic scoring, see the Joint Committee on Taxation explanation at https://www.jct.gov/publications.html?func=startdown&id=3720.

Example 1-13

The city of Heflin would like to increase tax revenues by $2,000,000 to pay for needed roadwork. A concerned taxpayer recently proposed increasing the cigarette excise tax from $1.00 per pack of cigarettes to $6.00 per pack to raise the additional needed revenue. Last year, 400,000 packs of cigarettes were sold in the city. Will the proposal be successful in raising the additional $2,000,000 in proposed tax revenue?

Answer: Not likely. The proposed tax increase of $5, and the assumption that 400,000 packs will still be sold, is an example of static forecasting: It ignores that many taxpayers may respond to the tax change by quitting, cutting down, or buying cheaper cigarettes in the next town.

In some cases, static forecasting can lead to a tax consequence that is the opposite of the desired outcome. In Example 1-13, we might estimate that given Heflin's close proximity to other cities with a $1.00 cigarette tax, the number of packs of cigarettes sold within the city would drop significantly to, say, 50,000. In this case, the tax increase would actually *decrease* tax revenues by $100,000 ($400,000 existing tax − $300,000 new tax)—not a good outcome if the goal was to increase tax revenues.

Income versus Substitution Effects Example 1-13 described proposed changes in an excise tax, which is a proportional tax. In terms of a progressive tax such as an *income* tax, a tax rate increase or an expansion of the tax base can result in one of two taxpayer responses, both of which are important for dynamic forecasting. The **income effect** predicts that when taxpayers are taxed more, they will work harder to generate the same after-tax dollars. The **substitution effect** predicts that when taxpayers are taxed more, rather than working more they will substitute nontaxable activities like leisure pursuits for taxable ones because the marginal value of taxable activities has decreased. Which view is accurate? The answer depends on the taxpayer. Consider the following examples.

Example 1-14

Margaret's friend George, who earns $40,000 taxable income as a self-employed mechanic, is taxed at an average rate of 10 percent (resulting in $4,000 of tax). If Congress increases the income tax rate such that George's average tax rate increases from 10 percent to 25 percent, how much more income tax will he pay?

Answer: It depends on whether the income effect or the substitution effect is operating. Assuming George is single and cannot afford a net decrease in his after-tax income, he will likely work more (the income effect rules). Prior to the tax rate increase, George had $36,000 of after-tax income ($40,000 taxable income less $4,000 tax). With the increased tax rate, George will have to earn $48,000 of taxable income to keep $36,000 after taxes [$48,000 − ($48,000 × .25) = $36,000]. Thus, if the income effect rules, the government will collect $12,000 of federal income tax from George, or $8,000 more than under the previous lower tax rate. In this scenario, the tax change increases government revenues because of the increased tax rate *and* the increased tax base.

Whether the substitution effect or the income effect will describe any individual taxpayer's reaction to a tax increase is something we can only guess. But some factors—such as having higher disposable income—are likely to correlate with the substitution effect.

Example 1-15

What if: Now let's assume that George is married and has two young children. Both he and his wife work, and they file a tax return jointly with a 10 percent average tax rate. Either of their incomes is sufficient to meet necessities, even after the tax rate increase. But fixed child care costs make the marginal wage rate (the after-tax hourly wage less hourly child care cost) more sensitive to tax rate increases. In this case, the lower-earning spouse may choose to work less. Suppose George quits his full-time job and takes a part-time position that pays $10,000 to spend more time with his kids and to pursue his passion, reading sports novels. What are the taxes on George's income?

Answer: In this case, George will owe $2,500 tax ($10,000 × .25 = $2,500). Here, the substitution effect operates and the government collects much less than it would have if George had maintained his full-time position, because the tax rate increase had a negative effect on the tax base.

As Examples 1-14 and 1-15 illustrate, the response to a tax law change can vary by taxpayer and can greatly affect the magnitude of tax revenues generated by the change. Herein lies one of the challenges in significantly changing an existing tax system or designing a new one: If a tax system fails to generate sufficient revenues, the government must seek other sources to pay for governmental expenditures. The most common source of these additional funds for the federal government is the issuance of debt instruments such as Treasury bonds. This, however, is only a short-term solution to a budget deficit. Debt issuances require both interest and principal payments, which require the federal government to identify even more sources of revenue to service the debt issued or to cut governmental spending (both of which may be unpopular choices with voters). A third option is for the government to default on its debt obligations. However, the costs of this option are potentially devastating. If the historical examples of Mexico, Brazil, Argentina, and Greece are any guide, a U.S. government default on its debt obligations would likely devalue the U.S. dollar severely and have extreme negative consequences for the U.S. capital markets.

The best option is for the government to match its revenues with its expenses—that is, to not spend more than it collects. State governments seem to be more successful in this endeavor than the U.S. federal government. Indeed, all states except Vermont require a balanced budget each year, whereas the federal government has had deficit spending for most of the last 40 years.

TAXES IN THE REAL WORLD National Debt

How much debt does the U.S. have today? About $22.0 trillion. Almost $16.1 trillion of the national debt is held by public investors, including individual bondholders, institutional investors, and foreign governments such as China, Japan, the United Kingdom, and Brazil. The $5.8 trillion remaining amount represents intragovernmental holdings—primarily Social Security.

Is $22 trillion too much to handle? The key issue is fiscal sustainability: the ability to pay off a debt in the future. Rising debt also has other negative consequences, such as higher interest payments, a need for higher taxes, restrictions on policy makers' fiscal policy choices, and the increased probability of a sudden fiscal crisis. If nothing is done to change the national debt trajectory, the debt will grow faster than the economy.

Is the national debt sustainable? The federal government has recently been recording budget deficits that are a larger share of the economy than any year since the end of World War II. With an aging population, Social Security and other benefits will require larger expenditures. By the end of the current decade, barring any significant policy shifts, the vast majority of federal tax revenue will be consumed by just four expenditures: interest on the debt, Medicare, Medicaid, and Social Security. To finance other government expenditures, including defense and all other discretionary programs, policy makers will have to borrow the money to pay for them.

https://www.treasurydirect.gov/govt/reports/pd/mspd/2018/opds122018.pdf

Equity

We've looked at the challenges of designing a tax system that provides sufficient revenues to pay for governmental expenditures. An equally challenging issue is how the tax burden should be distributed across taxpayers. At the heart of this issue is the concept of **equity,** or fairness. Fairness is inherently subject to personal interpretation, and informed minds often disagree about what is fair. There is no "one-size-fits-all" definition of equity or fairness. Nonetheless, it is informative to consider in broad terms what makes a fair or equitable tax system.

In general terms, a tax system is considered fair or equitable if the tax is based on the taxpayer's ability to pay. Taxpayers with a greater ability to pay tax, pay more tax. In broad terms, each of the federal, state, and local taxes we've discussed satisfies this criterion. For example, those individuals with greater taxable income, purchases, property, and estates (upon death) generally pay higher dollar amounts in federal income tax, sales tax, property tax, and estate tax. If this is the case, why is there so much debate over the fairness of the U.S. income tax system? The answer is that equity is more complex than our first definition suggests. Let's take a closer look.

Horizontal versus Vertical Equity Two basic types of equity are relevant to tax systems. **Horizontal equity** means that two taxpayers in similar situations pay the same tax. In broad terms, each of the federal, state, and local taxes discussed satisfy this definition. Two individual taxpayers with the same taxable income, same purchases, same value of property, and same estate value pay the same federal income tax, sales tax, property tax, and estate tax. However, on closer inspection we might argue that each of these tax systems is *not* horizontally equitable. Here are some examples:

- Two individual taxpayers with the same income will not pay the same federal income tax if one individual's income was earned as salary and the other individual's income was tax-exempt municipal bond interest income, dividend income, or capital gain(s) income, which can be subject to a lower tax rate.
- Two individuals with the same dollar amount of purchases will not pay the same sales tax if one buys a higher proportion of goods that are subject to a lower sales tax rate, such as groceries.
- Two individuals with real estate of the same value will not pay the same property tax if one individual owns farmland, which is generally subject to a lower property tax rate.
- Finally, two individuals with estates of the same value will not pay the same estate tax if one individual bequeaths more of her property to charity or a spouse, because these transfers are not subject to estate tax.

These failures of horizontal equity are due to what we call *tax preferences*. Governments provide tax preferences for a variety of reasons, such as to encourage investment or to further social objectives. Whether we view these tax preferences as appropriate greatly influences whether we consider a tax system to be fair in general and horizontally equitable in particular.

The second type of equity to consider in evaluating a tax system is **vertical equity.** Vertical equity is achieved when taxpayers with greater ability to pay tax, pay more tax than taxpayers with less ability to pay. We can think of vertical equity in terms of tax dollars paid or in terms of tax rates. Proponents of a flat income tax or of a sales tax—both of which are proportional tax rate structures—are more likely to argue that vertical equity is achieved when taxpayers with a greater ability to pay tax, simply pay more in tax *dollars*. Proponents of a progressive tax system are more likely to argue that taxpayers with a greater ability to pay should be subject to a higher tax *rate*. This view is based upon the argument that the *relative* burden of a flat tax rate decreases as a taxpayer's income increases. Which is the correct answer? There is no correct answer. Nonetheless, many feel very strongly regarding one view or the other.

Our discussion has focused on how we can view alternative tax rate structures in terms of vertical equity, ignoring the role that the tax base plays in determining vertical equity. Indeed, focusing on the tax rate structure in evaluating a tax system is appropriate only if the tax base chosen—whether it's taxable income, purchases, property owned, or something else—accurately portrays a taxpayer's ability to pay. This can be a rather strong assumption. Consider the sales tax in Example 1-9. Although taxable purchases in this example increase as the taxpayers' total incomes increase, total incomes increase at a much faster rate than taxable purchases. Thus, the gap between taxable purchases and total income widens as total income increases. The end result is that the effective tax rates for those with a greater ability to pay are *lower* than for those taxpayers with a lesser ability to pay, making this tax regressive. Regressive tax rate structures are generally considered not to satisfy vertical equity, unless you strongly believe that those with a greater ability to pay do so simply by paying more tax dollars, albeit at a lower tax rate. In sum, evaluating vertical equity in terms of effective tax rates may be much more informative than simply evaluating tax rate structures.

THE KEY FACTS

Evaluating Alternative Tax Systems—Equity

- Questions of equity consider how the tax burden should be distributed across taxpayers.
- Horizontal equity means that two taxpayers in similar situations pay the same tax.
- Vertical equity is achieved when taxpayers with greater ability to pay tax, pay more tax than taxpayers with a lesser ability to pay tax.

Certainty

Certainty means that taxpayers should be able to determine when to pay the tax, where to pay the tax, and how to determine the tax. Determining when and where to pay each of the taxes previously discussed is relatively easy. For example, individual federal income tax returns and the remaining balance of taxes owed must be filed with the Internal Revenue Service each year on or before April 15th. Likewise, sales taxes, property taxes, and excise taxes are each determined with relative ease: Sales taxes are based on the value of taxable purchases, property taxes are generally based on assessed property values, and excise taxes are based on the number of taxable units purchased. Indeed, these taxes are calculated for the taxpayer and often charged at regular intervals or at the point of purchase; they do not require a tax return.

In contrast, income taxes are often criticized as being too complex. What are taxable versus nontaxable forms of income? What are deductible/nondeductible expenses? When should income or expenses be reported? For wage earners with few investments, the answers to these questions are straightforward. For business owners and individuals with a lot of investments, the answers are nontrivial. Yearly tax law changes enacted by Congress can make it more difficult to determine a taxpayer's current tax liability, much less plan for the future.

THE KEY FACTS

Evaluating Alternative Tax Systems—Certainty, Convenience, and Economy

- Certainty
  - Certainty means taxpayers should be able to determine when, where, and how much tax to pay.
  - Determining when and where to pay each of the taxes previously discussed is relatively easy.
  - The income tax has been criticized for the complexity of determining how much to pay.
- Convenience
  - Convenience means a tax system should be designed to facilitate the collection of tax revenues without undue hardship on the taxpayer or the government.
  - Various tax systems meet this criterion by tying the collection of the tax as closely as possible to the transaction that generates it.
- Economy
  - Economy means a tax system should minimize compliance and administration costs.
  - Economy can be viewed from both the taxpayer's and the government's perspectives.

Convenience

Convenience suggests that a tax system should be designed to facilitate the collection of tax revenues without undue hardship on the taxpayer or the government. Various tax systems meet this criterion by tying the collection of the tax as closely as possible to the transaction that generates it (when it is most convenient to pay the tax). For example, retailers collect sales taxes when buyers purchase goods. Thus, it is difficult for the buyer to avoid paying sales tax, assuming she is transacting with an ethical retailer. Likewise, employers withhold federal income and Social Security taxes directly from wage earners' paychecks, which speeds the government's collection of the taxes and makes it difficult for taxpayers to evade taxes. If tax withholdings are not sufficient relative to the taxpayer's anticipated income tax liability, or if the taxpayer is self-employed, he or she is required to make quarterly estimated tax installments. Individual quarterly estimated payments are due on April 15, June 15, September 15, and January 15, whereas corporate estimated tax payments are due on the 15th day of the third, sixth, ninth, and twelfth months of the corporation's fiscal year.

Economy

Economy requires that a good tax system should minimize the compliance and administration costs associated with the tax system. We can view economy from both the taxpayer's and the government's perspectives. Believe it or not, most tax systems fare well in terms of economy, at least from the government's perspective. For example, the current IRS budget represents approximately $\frac{1}{3}$ of a percent of every tax dollar collected. Compared to the typical costs of a collection agency, this is quite low.

How about from the taxpayer's perspective? Here the picture is a bit different. The sales tax imposes no administrative burden on the taxpayer and only small administrative costs on the local retailer. However, out-of-state sellers argue that collecting and remitting use taxes for thousands of state and city jurisdictions would be a substantial burden. Other taxes such as excise taxes and property taxes also impose minimal administrative costs on the taxpayer. In contrast, as we've seen, the income tax is often criticized for the compliance costs imposed on the taxpayer. Indeed, for certain taxpayers, record-keeping costs, accountant fees, attorney fees, and so on can be substantial. Advocates of alternative tax systems often challenge the income tax on this criterion.

Evaluating Tax Systems—The Trade-Offs

At the heart of any debate about tax reform are fundamental decisions and concessions based on the five criteria we've just discussed. Interestingly enough, much of the debate regarding alternative tax systems can be reduced to a choice between simplicity and fairness. Those taxes that generally are simpler and easier to administer, such as the sales tax, are typically viewed as less fair. Those taxes that can be viewed as more fair, such as the federal income tax, often are more complex to administer. Thus, Margaret's friend Eddy faces a difficult choice about which type of tax system to advocate, as do all taxpayers. An understanding of the evaluative criteria should be helpful to anyone trying to reconcile the trade-offs among alternative tax proposals.

CONCLUSION

In almost any society, taxes are a part of life. They influence decisions about personal finance, investment, business, and politics. In this chapter, we introduced the basic concepts of why one should study tax, what a tax is, and how to calculate a tax. We also discussed various tax rates, tax rate structures, and different types of taxes imposed by federal, state, and local governments. Finally, we discussed the criteria that one might use to evaluate alternative tax rate systems. To make informed personal finance, investment, business, and political decisions, one must have a basic understanding of these items. In the following chapters we expand the discussion of how taxes influence these decisions while providing a basic understanding of our federal income tax system. Read on and learn more!

Summary

Demonstrate how taxes influence basic business, investment, personal, and political decisions. **LO 1-1**

- Taxes are significant costs that influence many basic business, investment, and personal decisions.
  - *Business decisions* include what organizational form to take; where to locate; how to compensate employees; determining the appropriate debt mix; owning versus renting equipment and property; how to distribute profits; and so forth.
  - *Investment decisions* include alternative methods for saving for education or retirement, and so forth.
  - *Personal finance decisions* include evaluating job offers; gift or estate planning; owning a home versus renting; and so forth.
- Taxes also play a major part in the political process. Major parties typically have very diverse views on whom, what, and how much to tax.

Discuss what constitutes a tax and the general objectives of taxes. **LO 1-2**

- The general purpose of taxes is to fund the government. Unlike fines or penalties, taxes are not meant to punish or prevent illegal behavior; but "sin taxes" (on alcohol, tobacco, tanning beds, etc.) are meant to discourage some behaviors.
- To qualify as a tax, three criteria are necessary: the payment must be (1) required (it is not voluntary), (2) imposed by a government (federal, state, or local), and (3) not tied directly to the benefit received by the taxpayer.

Describe the different tax rate structures and calculate a tax. **LO 1-3**

- Tax = Tax rate × Tax base, where the tax base is what is taxed and the tax rate is the level of taxes imposed on the base. Different portions of a tax base may be taxed at different rates.

- There are three different tax rates that are useful in assessing the different tax rate structures, tax planning alternatives, and/or the tax burden of a taxpayer: the marginal, average, and effective tax rates.
- The *marginal* tax rate is the tax that applies to the next increment of income or deduction. The *average* tax rate represents a taxpayer's average level of taxation on each dollar of taxable income. The *effective* tax rate represents the taxpayer's average rate of taxation on each dollar of total income (taxable *and* nontaxable income).
- The three basic tax rate structures are proportional, progressive, and regressive.
    - A *proportional* tax rate structure imposes a constant tax rate throughout the tax base. As a taxpayer's tax base increases, the taxpayer's taxes increase proportionally. The marginal tax rate remains constant and always equals the average tax rate. A common example is a sales tax.
    - A *progressive* tax rate imposes an increasing marginal tax rate as the tax base increases. As a taxpayer's tax base increases, both the marginal tax rate and the taxes paid increase. A common example is the U.S. federal income tax.
    - A *regressive* tax rate imposes a decreasing marginal tax rate as the tax base increases. As a taxpayer's tax base increases, the marginal tax rate decreases while the total taxes paid increases.

LO 1-4 Identify the various federal, state, and local taxes.

- Federal taxes include the income tax, employment taxes (Social Security and Medicare taxes), unemployment taxes, excise taxes (levied on quantity purchased), and transfer taxes (estate and gift taxes).
- State and local taxes include the income tax (levied by most states), sales tax (levied on retail sales of goods and some services), use tax (levied on the retail price of goods owned or consumed within a state that were purchased out of state), property taxes (levied on the fair market value of real and personal property), and excise taxes.
- Implicit taxes are indirect taxes that result from a tax advantage the government grants to certain transactions to satisfy social, economic, or other objectives. They are defined as the reduced before-tax return that a tax-favored asset produces because of its tax-advantaged status.

LO 1-5 Apply appropriate criteria to evaluate alternative tax systems.

- Sufficiency involves assessing the aggregate size of the tax revenues that must be generated and ensuring that the tax system provides these revenues. Static forecasting ignores how taxpayers may alter their activities in response to a proposed tax law change and bases projected tax revenues on the existing state of transactions. In contrast, dynamic forecasting attempts to account for possible taxpayer responses to a proposed tax law change.
- Equity considers how the tax burden should be distributed across taxpayers. Generally, a tax system is considered fair or equitable if the tax is based on the taxpayer's ability to pay—that is, taxpayers with a greater ability to pay tax, pay more tax. Horizontal equity means that two taxpayers in similar situations pay the same tax. Vertical equity is achieved when taxpayers with greater ability to pay tax, pay more tax relative to taxpayers with a lesser ability to pay tax.
- Certainty means taxpayers should be able to determine when, where, and how much tax to pay.
- Convenience means a tax system should be designed to facilitate the collection of tax revenues without undue hardship on the taxpayer or the government.
- Economy means a tax system should minimize its compliance and administration costs.

KEY TERMS

ad valorem taxes (1-15)
average tax rate (1-7)
bracket (1-3)
certainty (1-22)
convenience (1-22)
dynamic forecasting (1-18)
earmarked tax (1-4)
economy (1-22)
effective tax rate (1-8)
employment taxes (1-12)
equity (1-20)
estate tax (1-13)

excise taxes (1-13)
explicit taxes (1-16)
flat tax (1-5)
gift tax (1-13)
graduated taxes (1-5)
horizontal equity (1-21)
implicit taxes (1-16)
income effect (1-19)
income tax (1-12)
local tax (1-14)
marginal tax rate (1-5)
Medicare tax (1-12)
personal property tax (1-15)
progressive tax rate structure (1-9)
proportional tax rate structure (1-9)
real property tax (1-15)
regressive tax rate structure (1-10)
sales tax (1-14)
self-employment tax (1-13)
sin taxes (1-4)
Social Security tax (1-12)
state tax (1-14)
static forecasting (1-18)
substitution effect (1-19)
sufficiency (1-18)
tax (1-4)
tax base (1-5)
tax rate (1-5)
transfer taxes (1-13)
unemployment tax (1-13)
use tax (1-14)
value-added tax (1-11)
vertical equity (1-21)

DISCUSSION QUESTIONS

Discussion Questions are available in Connect®.

1. Jessica's friend Zachary once stated that he couldn't understand why someone would take a tax course. Why is this a rather naïve view? LO 1-1
2. What are some aspects of business that require knowledge of taxation? What are some aspects of personal finance that require knowledge of taxation? LO 1-1
3. Describe some ways in which taxes affect the political process in the United States. LO 1-1
4. Courtney recently received a speeding ticket on her way to the university. Her fine was $200. Is this considered a tax? Why or why not? LO 1-2
5. Marlon and Latoya recently started building a house. They had to pay $300 to the county government for a building permit. Is the $300 payment a tax? Why or why not? LO 1-2
6. To help pay for the city's new stadium, the city of Birmingham recently enacted a 1 percent surcharge on hotel rooms. Is this a tax? Why or why not? LO 1-2
7. As noted in Example 1-2, tolls, parking meter fees, and annual licensing fees are not considered taxes. Can you identify other fees that are similar? LO 1-2
8. If the general objective of our tax system is to raise revenue, why does the income tax allow deductions for charitable contributions and retirement plan contributions? LO 1-2
9. One common argument for imposing so-called sin taxes is the social goal of *reducing* demand for such products. Using cigarettes as an example, is there a segment of the population that might be sensitive to price and for whom high taxes might discourage purchases? LO 1-2
10. Dontae stated that he didn't want to earn any more money because it would "put him in a higher tax bracket." What is wrong with Dontae's reasoning? LO 1-3
11. Describe the three different tax rates discussed in the chapter and how taxpayers might use them. LO 1-3
12. Which is a more appropriate tax rate to use to compare taxpayers' tax burdens—the average or the effective tax rate? Why? LO 1-3
13. Describe the differences between proportional, progressive, and regressive tax rate structures. LO 1-3
14. Arnold and Lilly recently had a heated discussion about whether a sales tax is a proportional tax or a regressive tax. Arnold argued that a sales tax is regressive. Lilly countered that the sales tax is a flat tax. Who was correct? LO 1-3
15. Which is the largest tax collected by the U.S. government? What types of taxpayers are subject to this tax? LO 1-4

LO 1-4 16. What is the tax base for the Social Security and Medicare taxes for an employee or employer? What is the tax base for Social Security and Medicare taxes for a self-employed individual? Is the self-employment tax in addition to or in lieu of federal income tax?

LO 1-4 17. What are unemployment taxes?

LO 1-4 18. What is the distinguishing feature of an excise tax?

LO 1-4 19. What are some of the taxes that currently are unique to state and local governments? What are some of the taxes that the federal, state, and local governments each utilize?

LO 1-4 20. The state of Georgia recently increased its tax on a pack of cigarettes by $2. What type of tax is this? Why might Georgia choose this type of tax?

LO 1-4 21. What is the difference between a sales tax and a use tax?

22. What is an ad valorem tax? Name an example of this type of tax.

LO 1-4 23. What are the differences between an explicit and an implicit tax?

LO 1-4 24. When we calculate average and effective tax rates, do we consider implicit taxes? What effect does this have on taxpayers' perception of equity?

LO 1-4 25. Benjamin recently bought a truck in Alabama for his business in Georgia. What different types of federal and state taxes may affect this transaction?

LO 1-5 26. Kobe strongly dislikes SUVs and is appalled that so many are on the road. He proposes to eliminate the federal income tax and replace it with a $50,000 annual tax per SUV. Based on the number of SUVs currently owned in the United States, he estimates the tax will generate exactly the amount of tax revenue currently collected from the income tax. What is wrong with Kobe's proposal? What type of forecasting is Kobe likely using?

LO 1-5 27. What is the difference between the income and substitution effects? For which types of taxpayers is the income effect more likely descriptive? For which types of taxpayers is the substitution effect more likely descriptive?

LO 1-5 28. What is the difference between horizontal and vertical equity? How do tax preferences affect people's view of horizontal equity?

LO 1-3 LO 1-5 29. Montel argues that a flat income tax rate system is vertically equitable. Oprah argues that a progressive tax rate structure is vertically equitable. How do their arguments differ? Who is correct?

LO 1-3 LO 1-5 30. Discuss why evaluating vertical equity simply based on tax rate structure may be less than optimal.

LO 1-4 LO 1-5 31. Compare the federal income tax to sales taxes using the "certainty" criterion.

LO 1-5 32. Many years ago a famous member of Congress proposed eliminating federal income tax withholding. What criterion for evaluating tax systems did this proposal violate? What would likely have been the result of eliminating withholding?

LO 1-5 33. "The federal income tax scores very high on the economy criterion because the current IRS budget is relatively low compared to the costs of a typical collection agency." Explain why this statement may be considered wrong.

PROBLEMS

Select problems are available in Connect®.

LO 1-3 34. Chuck, a single taxpayer, earns $75,000 in taxable income and $10,000 in interest from an investment in City of Heflin bonds. Using the U.S. tax rate schedule, how much federal tax will he owe? What is his average tax rate? What is his effective tax rate? What is his current marginal tax rate?

35. Using the facts in problem 34, if Chuck earns an additional $40,000 of taxable income, what is his marginal tax rate on this income? What is his marginal rate if, instead, he had $40,000 of additional deductions? LO 1-3

36. Campbell, a single taxpayer, earns $400,000 in taxable income and $2,000 in interest from an investment in State of New York bonds. Using the U.S. tax rate schedule, how much federal tax will she owe? What is her average tax rate? What is her effective tax rate? What is her current marginal tax rate? LO 1-3

37. Using the facts in problem 36, if Campbell earns an additional $15,000 of taxable income, what is her marginal tax rate on this income? What is her marginal rate if, instead, she had $15,000 of additional deductions? LO 1-3

38. Jorge and Anita, married taxpayers, earn $150,000 in taxable income and $40,000 in interest from an investment in City of Heflin bonds. Using the U.S. tax rate schedule for married filing jointly (see Example 1-3), how much federal tax will they owe? What is their average tax rate? What is their effective tax rate? What is their current marginal tax rate? LO 1-3

39. Using the facts in problem 38, if Jorge and Anita earn an additional $100,000 of taxable income, what is their marginal tax rate on this income? What is their marginal rate if, instead, they report an additional $100,000 in deductions? LO 1-3

40. Scot and Vidia, married taxpayers, earn $240,000 in taxable income and $5,000 in interest from an investment in City of Tampa bonds. Using the U.S. tax rate schedule for married filing jointly (see Example 1-3), how much federal tax will they owe? What is their average tax rate? What is their effective tax rate? What is their current marginal tax rate? LO 1-3

41. Using the facts in problem 40, if Scot and Vidia earn an additional $80,000 of taxable income, what is their marginal tax rate on this income? How would your answer differ if they, instead, had $80,000 of additional deductions? LO 1-3

42. Melinda invests $200,000 in a City of Heflin bond that pays 6 percent interest. Alternatively, Melinda could have invested the $200,000 in a bond recently issued by Surething Inc. that pays 8 percent interest and has risk and other nontax characteristics similar to the City of Heflin bond. Assume Melinda's marginal tax rate is 25 percent. LO 1-3 LO 1-4
    a) What is her after-tax rate of return for the City of Heflin bond?
    b) How much explicit tax does Melinda pay on the City of Heflin bond?
    c) How much implicit tax does she pay on the City of Heflin bond?
    d) How much explicit tax would she have paid on the Surething Inc. bond?
    e) What is her after-tax rate of return on the Surething Inc. bond?

43. Hugh has the choice between investing in a City of Heflin bond at 6 percent or investing in a Surething Inc. bond at 9 percent. Assuming that both bonds have the same nontax characteristics and that Hugh has a 40 percent marginal tax rate, in which bond should he invest? LO 1-3 LO 1-4 planning

44. Using the facts in problem 43, what interest rate does Surething Inc. need to offer to make Hugh indifferent between investing in the two bonds? LO 1-3 LO 1-4 planning

45. Fergie has the choice between investing in a State of New York bond at 5 percent and a Surething Inc. bond at 8 percent. Assuming that both bonds have the same nontax characteristics and that Fergie has a 30 percent marginal tax rate, in which bond should she invest? LO 1-3 LO 1-4 planning

46. Using the facts in problem 45, what interest rate does the State of New York bond need to offer to make Fergie indifferent between investing in the two bonds? LO 1-3 LO 1-4 planning

LO 1-3 47. Given the following tax structure, what minimum tax would need to be assessed on Shameika to make the tax progressive with respect to average tax rates?

Taxpayer	Salary	Muni-Bond Interest	Total Tax
Mihwah	$10,000	$10,000	$600
Shameika	$50,000	$30,000	$???

LO 1-3 48. Using the facts in problem 47, what minimum tax would need to be assessed on Shameika to make the tax progressive with respect to effective tax rates?

LO 1-3 LO 1-5 49. Song earns $100,000 taxable income as an interior designer and is taxed at an average rate of 20 percent (i.e., $20,000 of tax). If Congress increases the income tax rate such that Song's average tax rate increases from 20 percent to 25 percent, how much more income tax will she pay assuming that the income effect is descriptive? What effect will this tax rate change have on the tax base and tax collected?

LO 1-3 LO 1-5 50. Using the facts in problem 49, what will happen to the government's tax revenues if Song chooses to spend more time pursuing her other passions besides work in response to the tax rate change and therefore earns only $75,000 in taxable income? What is the term that describes this type of reaction to a tax rate increase? What types of taxpayers are likely to respond in this manner?

LO 1-5 51. Given the following tax structure, what tax would need to be assessed on Venita to make the tax horizontally equitable?

Taxpayer	Salary	Total Tax
Mae	$10,000	$ 600
Pedro	$20,000	$ 1,500
Venita	$10,000	$???

LO 1-5 52. Using the facts in problem 51, what is the minimum tax that Pedro should pay to make the tax structure vertically equitable based on the tax rate paid? This would result in what type of tax rate structure?

LO 1-5 53. Using the facts in problem 51, what is the minimum tax that Pedro should pay to make the tax structure vertically equitable with respect to the amount of tax paid? This would result in what type of tax rate structure?

LO 1-5 54. Consider the following tax rate structure. Is it horizontally equitable? Why or why not? Is it vertically equitable? Why or why not?

Taxpayer	Salary	Total Tax
Rajiv	$10,000	$600
LaMarcus	$20,000	$600
Dory	$10,000	$600

LO 1-5 55. Consider the following tax rate structure. Is it horizontally equitable? Why or why not? Is it vertically equitable? Why or why not?

Taxpayer	Salary	Total Tax
Marilyn	$10,000	$ 600
Kobe	$20,000	$3,000
Alfonso	$30,000	$6,000

LO 1-5 56. Consider the following tax rate structure. Is it horizontally equitable? Why or why not? Is it vertically equitable? Why or why not?

Taxpayer	Salary	Total Tax
Rodney	$10,000	$600
Keisha	$10,000	$600

57. Lorenzo is considering starting a trucking company either in Texas or Oklahoma. He will relocate his family, which includes his wife, children, and parents, to reside in the same state as his business. What types of taxes may influence his decision of where to locate his business?

LO 1-1 LO 1-4 planning

58. Congress would like to increase tax revenues by 10 percent. Assume that the average taxpayer in the United States earns $65,000 and pays an average tax rate of 15 percent. If the income effect is in effect for all taxpayers, what average tax rate will result in a 10 percent increase in tax revenues? This is an example of what type of forecasting?

LO 1-3 LO 1-5 planning

59. Locate the IRS website at www.irs.gov/. For every $100 the IRS collected, how much was spent on the IRS's collection efforts? What tax system criterion does this information help you to evaluate with respect to the current U.S. tax system?

LO 1-5 research

60. Using the Internet, find a comparison of income tax rates across states. What state currently has the highest income tax rate? In considering individual tax burdens across states, what other taxes should you consider?

LO 1-4 research

ROGER | CPA Review

Source: Roger CPA Review

Sample CPA Exam questions from Roger CPA Review are available in Connect as support for the topics in this text. These Multiple Choice Questions and Task-Based Simulations include expert-written explanations and solutions and provide a starting point for students to become familiar with the content and functionality of the actual CPA Exam.

chapter 2

Tax Compliance, the IRS, and Tax Authorities

Learning Objectives

Upon completing this chapter, you should be able to:

- **LO 2-1** Identify the filing requirements for income tax returns and the statute of limitations for assessment.
- **LO 2-2** Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.
- **LO 2-3** Evaluate the relative weights of the various tax law sources.
- **LO 2-4** Describe the legislative process as it pertains to taxation.
- **LO 2-5** Perform the basic steps in tax research.
- **LO 2-6** Describe tax professional responsibilities in providing tax advice.
- **LO 2-7** Identify taxpayer and tax professional penalties.

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Storyline Summary

Taxpayers:	Bill and Mercedes
Family description:	Bill and Mercedes are married with one daughter, Margaret, and live in Tampa, Florida.
Employment status:	Bill is an economics professor; Mercedes is a small business owner.
Filing status:	Married, filing jointly
Current situation:	Bill and Mercedes face an IRS audit involving a previous year's interest deductions.

Bill and Mercedes received a notice from the Internal Revenue Service (IRS) that their return is under audit for certain interest deductions. As you might expect, they are quite concerned, especially because it has been several years since they claimed the deductions and they worry that all their supporting documentation may not be in place. Several questions run through their minds. How could the IRS audit a return that was filed so long ago? Why was their tax return selected, and what should they expect during the audit? The interest deductions they reported were based on advice from their CPA. What would cause the IRS and a CPA to interpret the law differently? What is their financial exposure if the deductions are ultimately disallowed? Will they have to pay interest and penalties in addition to the tax they might owe? ■

Even the most conservative taxpayer is likely to feel anxiety after receiving an IRS notice. This chapter will help answer Bill and Mercedes's questions and provide an overview of the audit process and tax research. While all taxpayers should understand these basics of our tax system, aspiring accountants should be especially familiar with them.

LO 2-1

TAXPAYER FILING REQUIREMENTS

To file or not to file? Unlike Hamlet's "to be or not to be," this question has a pretty straightforward answer. Filing requirements are specified by law for each type of taxpayer. All corporations must file a tax return annually regardless of their taxable income. Estates and trusts are required to file annual income tax returns if their gross income exceeds $600.[1]

The filing requirements for individual taxpayers are a little more complex. Specifically, they depend on the taxpayer's filing status (single, married filing jointly, and so on, discussed in more detail in the Individual Income Tax Overview, Dependents, and Filing Status chapter), age, and gross income (income before deductions). Exhibit 2-1 lists the 2019 gross income thresholds for taxpayers based on their filing status, gross income, and age. As detailed in Exhibit 2-1, the gross income thresholds are calculated as the sum of the standard deduction and additional deductions for taxpayers age 65 or older.[2] These amounts are indexed for inflation and thus change each year. For certain taxpayers, such as the self-employed and those claimed as dependents by another taxpayer, lower gross income thresholds apply.

EXHIBIT 2-1 2019 Gross Income Thresholds by Filing Status

Filing Status and Age (in 2019)	2019 Gross Income	Explanation
Single	$12,200	$12,200 standard deduction
Single, 65 or older	$13,850	$12,200 standard deduction + $1,650 additional deduction
Married, filing a joint return	$24,400	$24,400 standard deduction
Married, filing a joint return, one spouse 65 or older	$25,700	$24,400 standard deduction + $1,300 additional deduction
Married, filing a joint return, both spouses 65 or older	$27,000	$24,400 standard deduction + $2,600 additional deductions (2)
Married, filing a separate return	$ 5	
Head of household	$18,350	$18,350 standard deduction
Head of household, 65 or older	$20,000	$18,350 standard deduction + $1,650 additional deduction
Surviving spouse with a dependent child	$24,400	$24,400 standard deduction
Surviving spouse, 65 or older, with a dependent child	$25,700	$24,400 standard deduction + $1,300 additional deduction

Source: www.irs.gov.

Whether a taxpayer is due a refund (which occurs when taxes paid exceed tax liability) does *not* determine whether a taxpayer must file a tax return. Gross income determines whether a tax return is required. Further, note that even a taxpayer whose gross income falls below the respective threshold is not precluded from filing a tax return.

[1]Estates file income tax returns during the administration period (i.e., before all of the estate assets are distributed).

[2]IRC §6012. We describe the standard deduction in detail later in the text. A married taxpayer is required to file a tax return (regardless of gross income) if: (i) such individual and his spouse, at the close of the taxable year, did not have the same household as their home; (ii) the individual has gross income of $5 or more and the individual's spouse files a separate return; or (iii) the individual or his spouse is a dependent of another taxpayer who has income (other than earned income) in excess of the standard deduction for a dependent taxpayer (see discussion later in the text regarding standard deduction for dependent taxpayers).

Indeed, taxpayers due a refund *should* file a tax return to receive the refund (or claim a refundable tax credit), even if they are not required to file a tax return.

Tax Return Due Date and Extensions

Like the filing requirements, due dates for tax returns vary based on the type of taxpayer. Individual tax returns are due on the fifteenth day of the fourth month following year-end—that is, April 15 for calendar-year individuals. (Due dates that fall on a Saturday, Sunday, or holidays are automatically extended to the next day that is not a Saturday, Sunday, or holiday.) Similarly, tax returns for taxable corporations ("C" corporations) are generally due on the fifteenth day of the fourth month following the corporation's year-end. The exception is for tax returns for C corporations with a June 30 year-end, which are due on the fifteenth day of the third month (September 15th). For both partnerships and S corporations (generally nontaxable corporations), tax returns must be filed by the fifteenth day of the third month following the entity's year-end (March 15 for calendar-year partnerships or S corporations). Any individual, partnership, or S corporation unable to file a tax return by the original due date can, by that same deadline, request a six-month extension to file, which is granted automatically by the IRS. Similarly, C corporations may request an automatic six- or seven-month extension to file depending on the corporation's year-end.[3]

An extension allows the taxpayer to delay filing a tax return but does *not* extend the due date for tax payments. Thus, when a taxpayer files an extension, she must estimate how much tax will be owed. If a taxpayer fails to pay the entire balance of tax owed by the original due date of the tax return, the IRS charges the taxpayer interest on the underpayment from the due date of the return until the taxpayer pays the tax.[4] The interest rate charged depends on taxpayer type (individual or corporation) and varies quarterly with the federal short-term interest rate.[5] For example, the interest rate for tax underpayments for individuals equals the federal short-term rate plus 3 percentage points.[6]

What happens if the taxpayer does not file a tax return by the time required, whether April 15 or an extended deadline? As you might guess, the IRS imposes penalties on taxpayers failing to comply with the tax law. In many cases, the penalties can be quite substantial (see later discussion in this chapter). In the case of failure to file a tax return, the penalty equals 5 percent of the tax due for each month (or partial month) that the return is late. However, the maximum penalty is generally 25 percent of the tax owed, and the failure-to-file penalty does not apply if the taxpayer owes no tax.

THE KEY FACTS

Filing Requirements and Due Dates

- Filing requirements
  - Filing requirements are specified by law for each type of taxpayer.
  - For individuals, filing requirements vary by filing status, gross income, and age.
  - Gross income thresholds are indexed each year for inflation.
- Due dates
  - The due date for tax returns varies based on the type of taxpayer.
  - Individual tax returns are due on April 15 for calendar-year individuals.
  - Due dates that fall on a Saturday, Sunday, or holiday are automatically extended to the next day that is not a Saturday, Sunday, or holiday.
  - Any taxpayer unable to file a tax return by the original due date can request an extension to file.
  - An extension allows the taxpayer to delay filing a tax return but does *not* extend the due date for tax payments.

Statute of Limitations

Despite the diligent efforts of taxpayers and tax professionals, it is quite common for tax returns to contain mistakes. Some may be to the taxpayer's advantage and others may be to the government's advantage. Regardless of the nature of the mistake, the taxpayer is obligated to file an amended return to correct the error (and request a refund or pay a deficiency) if the statute of limitations has not expired for the tax return. Likewise, the IRS can propose adjustments to the taxpayer's return if the statute of limitations for the return has not expired.

By law, the **statute of limitations** defines the period in which the taxpayer can file an amended tax return or the IRS can assess a tax deficiency for a specific tax year. For both amended tax returns filed by a taxpayer and proposed tax assessments by the IRS, the statute of limitations generally ends three years from the *later* of (1) the date the tax return was actually filed or (2) the tax return's original due date.

[3]June 30 year-end C corporations may request a seven-month extension. All other C corporations may request a six-month extension.

[4]The tax law also imposes a penalty for late payment in addition to the interest charged on the underpayment. We briefly discuss this penalty later in the chapter and in the Individual Income Tax Computation and Tax Credits chapter.

[5]The federal short-term rate is determined from a one-month average of the market yields from marketable obligations of the United States with maturities of three years or less.

[6]This same interest rate applies to individuals who overpay their taxes (i.e., receive a tax refund and interest payment as a result of an IRS audit or from filing an amended tax return).

The statute of limitations for IRS assessment can be extended in certain circumstances. For example, the original three-year statute of limitations for IRS assessments is extended to six years if the taxpayer omits items of gross income that exceed 25 percent of the gross income reported on the tax return. For fraudulent returns, or if the taxpayer fails to file a tax return, the news is understandably worse. The statute of limitations remains open indefinitely in these cases. The statute of limitations can also be voluntarily extended by the taxpayer at the request of the IRS to allow both sides sufficient time to resolve issues.

Example 2-1

Bill and Mercedes file their 2015 federal tax return on September 6, 2016, after receiving an automatic extension to file their return by October 15, 2016. In 2019, the IRS selects their 2015 tax return for audit. When does the statute of limitations end for Bill and Mercedes's 2015 tax return?

Answer: Assuming the six-year and "unlimited" statute of limitation rules do not apply, the statute of limitations ends on September 6, 2019 (three years after the later of the actual filing date and the *original* due date).

What if: When would the statute of limitations end for Bill and Mercedes for their 2015 tax return if the couple filed the return on March 22, 2016 (before the original due date of April 15, 2016)?

Answer: In this scenario the statute of limitations would end on April 15, 2019, because the later of the actual filing date and the original due date is April 15, 2016.

Taxpayers should prepare for the possibility of an audit by retaining all supporting documents (receipts, canceled checks, etc.) for a tax return until the statute of limitations expires. After the statute of limitations expires, taxpayers can discard the majority of supporting documents but should still keep a copy of the tax return itself, as well as any documents that may have ongoing significance, such as those establishing the taxpayer's *basis* or original investment in existing assets like personal residences and long-term investments.

LO 2-2

IRS AUDIT SELECTION

Why me? This is a recurring question in life and definitely a common taxpayer question after receiving an IRS audit notice. The answer, in general, is that a taxpayer's return is selected for audit because the IRS has data suggesting the taxpayer's tax return has a high probability of a significant understated tax liability. Budget constraints limit the IRS's ability to audit a majority or even a large minority of tax returns. Currently, fewer than 1 percent of all tax returns are audited. Thus, the IRS must be strategic in selecting returns for audit in an effort to promote the highest level of voluntary taxpayer compliance and increase tax revenues.

Specifically, how does the IRS select tax returns for audit? The IRS uses a number of computer programs and outside data sources (newspapers, financial statement disclosures, informants, and other public and private sources) to identify tax returns that may have an understated tax liability. Common computer initiatives include the **DIF (Discriminant Function) system,** the **document perfection program,** and the **information matching program.** The most important of these initiatives is the DIF system. The DIF system assigns a score to each tax return that represents the probability the tax liability on the return has been underreported (a higher score = a higher likelihood of underreporting). The IRS derives the weights assigned to specific tax return attributes from historical IRS audit adjustment data from the National Research Program.[7] The DIF system then uses these (undisclosed) weights to score each tax return based on the tax return's characteristics. Returns with higher DIF scores are reviewed to determine whether an audit is the best course of action.

[7]Similar to its predecessor, the Taxpayer Compliance Measurement Program, the National Research Program (NRP) analyzes a large sample of tax returns that are randomly selected for audit. From these randomly selected returns, the IRS identifies tax return characteristics (e.g., deductions for a home office, unusually high tax deductions relative to a taxpayer's income) associated with underreported liabilities, weights these characteristics, and then incorporates them into the DIF system. The NRP analyzes randomly selected returns to ensure that the DIF scorings are representative of the population of tax returns.

All returns are checked for mathematical and tax calculation errors, a process referred to as the document perfection program. Individual returns are also subject to the information matching program. This program compares the taxpayer's tax return to information submitted to the IRS from other taxpayers like banks, employers, mutual funds, brokerage companies, and mortgage companies. Information matched includes items such as wages (Form W-2 submitted by employers), interest income (Form 1099-INT submitted by banks), and dividend income (Form 1099-DIV submitted by brokerage companies). For tax returns identified as incorrect via the document perfection and information matching programs, the IRS recalculates the taxpayer's tax liability and sends a notice explaining the adjustment. If the taxpayer owes tax, the IRS will request payment of the tax due. If the taxpayer overpaid tax, the IRS will send the taxpayer a refund of the overpayment.

In addition to computer-based methods for identifying tax returns for audit, the IRS may use a number of other audit initiatives that target taxpayers working in certain industries, engaging in certain transactions like the acquisition of other companies, or having specific attributes like home office deductions. Taxpayers of a given size and complexity, such as large publicly traded companies, may be audited every year.

THE KEY FACTS

IRS Audit Selection

- The IRS uses a number of computer programs and outside data sources to identify tax returns that may have an understated tax liability.
- Common computer initiatives include the DIF (Discriminant Function) system, the document perfection program, and the information matching program.
- The DIF system assigns a score to each tax return that represents the probability the tax liability on the return has been underreported.
- The document perfection program checks all returns for mathematical and tax calculation errors.
- The information matching program compares the taxpayer's tax return to information submitted to the IRS from other taxpayers.

TAXES IN THE REAL WORLD Turning in Your Neighbor Can Pay Big Bucks

The Wall Street Journal reported that in April 2011 the IRS made its first payment under a new taxpayer whistleblower program that promises large rewards for turning in tax cheats. Under the large-award whistleblower program (where unpaid taxes, interest, and penalties exceed $2 million and the tax cheat, if an individual, has gross income exceeding $200,000 in at least one year), whistleblowers can be paid between 15 and 30 percent of the taxes, interest, and penalties collected by the IRS. Under the small-award whistleblower program (tax, interest, and penalty underpayments of $2 million or less), the IRS may pay whistleblowers up to 15 percent of the unpaid taxes and interest collected. Whistleblowers use IRS Form 211 (www.IRS.gov) to apply for the program, and as you might expect, all whistleblower payments received are fully taxable. In its first payment, the IRS awarded $4.5 million to a former in-house accountant for a large financial services firm. Given the potential windfall to whistleblowers, you might expect a long line of "concerned" citizens applying for the program. You would be correct. As of January 2018, the IRS commissioner announced that the IRS has paid out more than $499 million in awards since 2007, on collection of $3.6 billion based on whistleblower information.

Source: Based on: "Taxes: How to Turn in Your Neighbor to the IRS," *The Wall Street Journal*, WSJ.com, September 3, 2011.

How was Bill and Mercedes's tax return selected for audit? Given the audit focus on certain deductions, the IRS likely selected their return for audit because the amount or type of the deductions resulted in a high DIF score. IRS personnel then determined that the deductions warranted further review and, thus, selected the tax return for audit.

ETHICS

After Bill and Mercedes's tax return was selected for audit, Bill read on the Internet speculation that filing a paper tax return (instead of filing electronically) and extending a tax return deadline decrease the chance of IRS audit. Bill has convinced Mercedes that they need to use these strategies in the future and look for other ways to avoid audit. Has Bill crossed an ethical boundary?

Types of Audits

The three types of IRS audits are correspondence, office, and field examinations. **Correspondence examinations** are the most common. These audits, as the name suggests, are conducted by mail and generally are limited to one or two items on the taxpayer's return. Of the three types of audits, correspondence audits are generally the narrowest in scope and the least complex. The IRS typically requests supporting documentation for one or more items on the taxpayer's return, like charitable contributions deducted, for example. When appropriate documentation is promptly supplied, these audits typically can be concluded relatively quickly. Of course, they can also be expanded to address other issues that arise as a result of the IRS's inspection of taxpayer documents.

Office examinations are the second most common audit. As the name suggests, the IRS conducts them at its local office. These audits are typically broader in scope and more complex than correspondence examinations. Small businesses, taxpayers operating sole proprietorships, and middle- to high-income individual taxpayers are more likely, if audited, to have office examinations. In these examinations, the taxpayer receives a notice that identifies the items subject to audit, requests substantiation for these items as necessary, and notifies the taxpayer of the date, time, and location of the exam. Taxpayers may attend the examination alone or with representation, such as their tax adviser or attorney, or simply let their tax adviser or attorney attend on their behalf.

Field examinations are the least common audit. The IRS conducts these at the taxpayer's place of business or the location where the taxpayer's books, records, and source documents are maintained. Field examinations are generally the broadest in scope and the most complex of the three audit types. They can last months to years and generally are limited to business returns and the most complex individual returns.

What type of exam do you think Bill and Mercedes will have? Because their return is an individual tax return and the audit is restricted to a relatively narrow set of deductions, their return will likely be subject to a correspondence audit. If the audit were broader in scope, an office examination would be more likely.

THE KEY FACTS

IRS Audits

- The three types of IRS audits are correspondence, office, and field examinations.
- After the audit, the IRS will send the taxpayer a 30-day letter, which provides the taxpayer the opportunity to pay the proposed assessment or request an appeals conference.
- If an agreement is not reached at appeals or the taxpayer does not pay the proposed assessment, the IRS will send the taxpayer a 90-day letter.
- After receiving the 90-day letter, the taxpayer may pay the tax or petition the U.S. Tax Court to hear the case.
- If the taxpayer chooses to pay the tax, the taxpayer may then request a refund of the tax and eventually sue the IRS for refund in the U.S. District Court or the U.S. Court of Federal Claims.

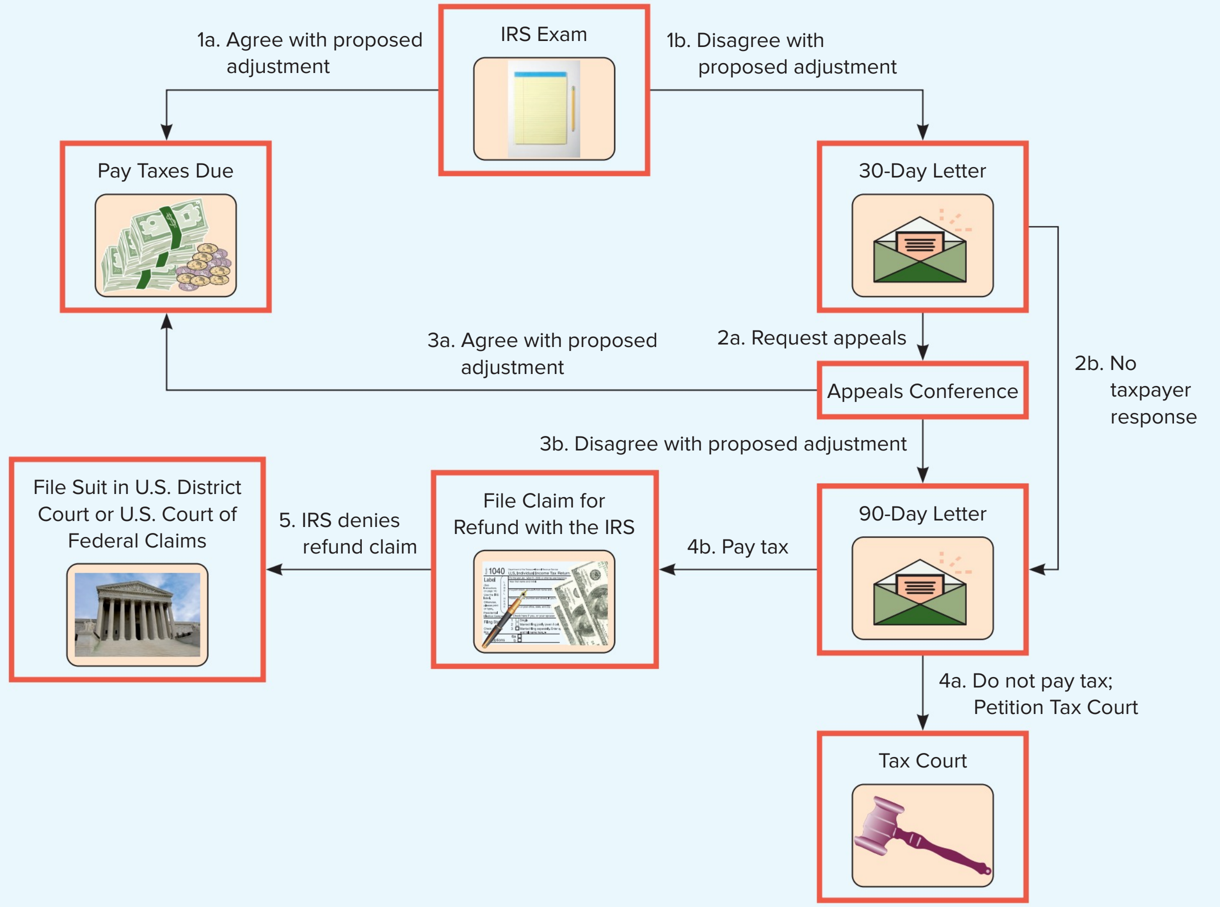
After the Audit After the examination, the IRS agent provides a list of proposed adjustments (if any) to the taxpayer for review. If he or she agrees to the proposed changes, the taxpayer signs an agreement form (Form 870) and pays the additional tax owed or receives the proposed refund. If the taxpayer disputes the proposed changes, the taxpayer will receive a **30-day letter** giving him or her 30 days to either (1) request a conference with an appeals officer, who is independent and resides in a separate IRS division from the examining agent, or (2) agree to the proposed adjustment. An appeals officer would consider the merits of the unresolved issues as well as the "hazards of litigation"—that is, the probability that the IRS will lose if the case is brought to court and the resulting costs of a taxpayer-favorable ruling. If the taxpayer chooses the appeals conference and reaches an agreement with the IRS there, the taxpayer can then sign Form 870, which signifies that the taxpayer agrees to the immediate assessment and collection of the agreed-upon tax and penalties, if any. If the taxpayer and IRS still do not agree on the proposed adjustment at the appeals conference, or the taxpayer chooses not to request an appeals conference, the IRS will send the taxpayer a **90-day letter**. See Exhibit 2-2.

The 90-day letter (also known as a *statutory notice of deficiency*) explains that the taxpayer has 90 days to either (1) pay the proposed deficiency or (2) file a petition in the U.S. Tax Court to hear the case.[8] The **U.S. Tax Court** is a national court whose judges are tax experts who hear only tax cases. If the taxpayer would like to litigate the case but prefers it to be heard in the local **U.S. District Court** or the **U.S. Court of Federal Claims,** the taxpayer must pay the tax deficiency first, then request a refund from the IRS, and then sue the IRS for refund in the court after the IRS denies the refund claim.

Why would a taxpayer prefer one trial court over others? To understand this, we must appreciate the basic distinguishing factors of each. First and foremost, it is relatively common for the U.S. Tax Court, local U.S. District Court, or the U.S. Court of Federal Claims

[8]If the taxpayer lacks the funds to pay the assessed tax, there is legitimate doubt as to whether the taxpayer owes part or all of the assessed tax, or collection of the tax would cause the taxpayer economic hardship or be unfair or inequitable, the taxpayer can request an offer in compromise with the IRS to settle the tax liability for less than the full amount assessed by completing Form 656.

EXHIBIT 2-2 **IRS Appeals/Litigation Process**



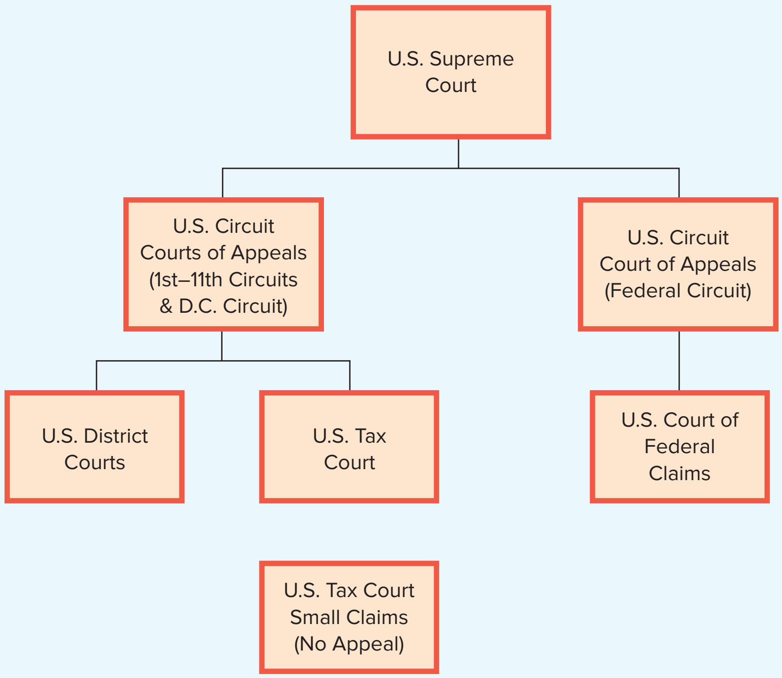
(IRS Exam): ©Imageroller/Alamy Stock Photo; (Supreme Court): ©McGraw-Hill Education/Jill Braaten, photographer

to interpret and rule differently on the same basic tax issue. Given a choice of courts, the taxpayer should prefer the court most likely to rule favorably on his or her particular issues. The courts also differ in other ways. For example, the U.S. District Court is the only court that provides for a jury trial; the U.S. Tax Court is the only court that allows tax cases to be heard *before* the taxpayer pays the disputed liability and the only court with a small claims division (hearing claims involving disputed liabilities of $50,000 or less); and the U.S. Tax Court judges are tax experts, whereas the U.S. District Court and U.S. Court of Federal Claims judges are generalists. The taxpayer should consider each of these factors in choosing a trial court. For example, if the taxpayer feels very confident in her tax return position but does not have sufficient funds to pay the disputed liability, she will prefer the U.S. Tax Court. If, instead, the taxpayer is litigating a tax return position that is low on technical merit but high on emotional appeal, a jury trial in the local U.S. District Court may be the best option.

What happens after the taxpayer's case has been decided in a trial court? The process may not be quite finished. After the trial court's verdict, the losing party has the right to request one of the 13 **U.S. Circuit Courts of Appeals** to hear the case. Exhibit 2-3 depicts the specific appellant courts for each lower-level court. Both the U.S. Tax Court and local U.S. District Court cases are appealed to the specific U.S. Circuit Court of Appeals based on the taxpayer's residence.[9] Cases litigated in Alabama, Florida, and Georgia, for

[9]Decisions rendered by the U.S. Tax Court Small Claims Division cannot be appealed by the taxpayer or the IRS.

EXHIBIT 2-3 **Federal Judicial System**



example, appeal to the U.S. Circuit Court of Appeals for the 11th Circuit, whereas those tried in Louisiana, Mississippi, and Texas appeal to the 5th Circuit. In contrast, all U.S. Court of Federal Claims cases appeal to the U.S. Circuit Court of Appeals for the Federal Circuit (located in Washington, D.C.). Exhibit 2-4 depicts the geographic regions for each of the 11 U.S. Circuit Courts of Appeals defined by numerical region. Not depicted are the U.S. Circuit Court of Appeals for the District of Columbia and the U.S. Circuit Court of Appeals for the Federal Circuit.

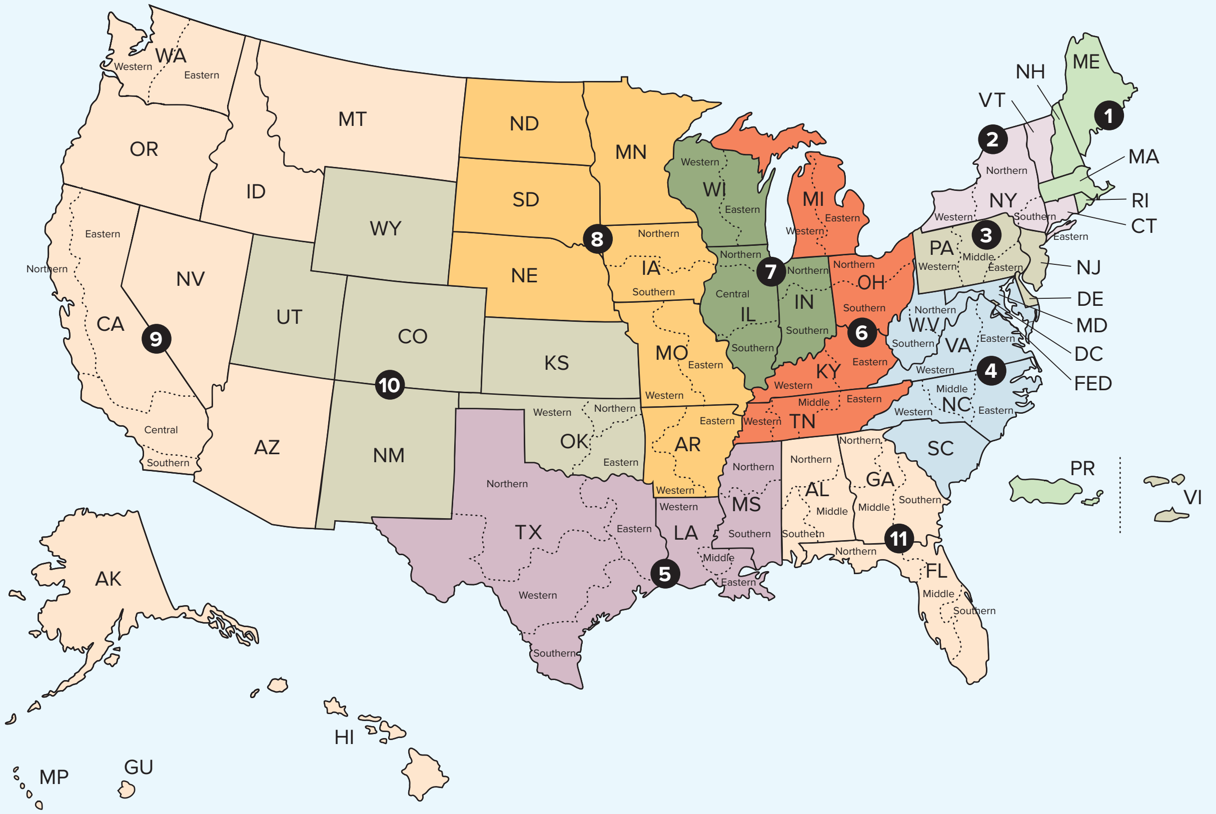
Through the initial selection of a trial court—U.S. District Court, U.S. Tax Court, or U.S. Court of Federal Claims—the taxpayer has the ability to determine which circuit court would hear an appeal of the case (the U.S. Circuit Court of Appeals based on residence or the U.S. Circuit Court of Appeals for the Federal Circuit). Alternative circuit courts may interpret the law differently, and therefore, in choosing a trial-level court, the taxpayer should consider the relevant circuit courts' judicial histories to determine which circuit court (and thus, which trial court) would be more likely to rule in his or her favor.

After an appeals court hears a case, the losing party has one last option to receive a favorable ruling: a petition to the **U.S. Supreme Court** to hear the case. However, given the quantity of other cases appealed to the U.S. Supreme Court that are of national importance, the Supreme Court agrees to hear only a few tax cases a year—cases with great significance to a broad cross-section of taxpayers or cases litigating issues in which there has been disagreement among the circuit courts. For most tax cases, the Supreme Court refuses to hear the case (denies the ***writ of certiorari***) and litigation ends with the circuit court decision.

Although litigation of tax disputes is quite common, taxpayers should carefully consider the pros and cons. Litigation can be very costly financially and emotionally, and thus it is more appropriately used as an option of last resort, after all other appeal efforts have been exhausted.

What is the likely course of action for Bill and Mercedes's audit? It is too soon to tell. Before you can assess the likely outcome of their audit, you need a better understanding of both the audit issue and the relevant tax laws that apply to the issue. The next section explains alternative tax law sources. After we discuss the various sources of our tax laws,

EXHIBIT 2-4 **Geographic Boundaries for the U.S. Circuit Courts of Appeals**



Source: www.uscourts.gov/courtlinks.

we'll describe how Bill and Mercedes (or their CPA) can research the sources to identify the best possible course of action.[10]

TAX LAW SOURCES

LO 2-3 LO 2-4

There are two broad categories of tax authorities: primary authorities and secondary authorities. **Primary authorities** are official sources of the tax law generated by the legislative branch (statutory authority issued by Congress), judicial branch (rulings by the U.S. District Courts, U.S. Tax Court, U.S. Court of Federal Claims, U.S. Circuit Courts of Appeals, or U.S. Supreme Court), and executive/administrative branch (Treasury and IRS pronouncements). Exhibit 2-5 displays the most common primary sources, their respective citations, and related explanations. We'll discuss each of these authorities below.

Secondary authorities are unofficial tax authorities that interpret and explain the primary authorities, such as tax research services (discussed below), tax articles from professional journals and law reviews, newsletters, and textbooks. For quick questions, practitioners often use the *CCH Master Tax Guide* or *RIA Federal Tax Handbook*.

[10]Accountants should be mindful to not engage in the unauthorized practice of law. In years past, several court cases have addressed this issue without providing a clear understanding between practicing tax accounting and the unauthorized practice of law. At present, tax accountants are not likely to overstep their responsibilities if they limit their advice to tax issues and leave the general legal advice and drafting of legal documents to attorneys.

EXHIBIT 2-5 Citations to Common Primary Authorities

Statutory Authorities:	***Citation:***	***Explanation:***
Internal Revenue Code	IRC Sec. 162(e)(4)(B)(i)	Section number 162, subsection e, paragraph 4, subparagraph B, clause i
Committee Reports: Senate Finance Committee Report	S. Rep. No. 353, 82d Cong., 1st Sess. 14 (1951)	Senate report number 353, Congress number 82, Congressional session 1, page number 14, year 1951
House Ways and Means Committee Report	H. Rep. No. 242, 82d Cong., 1st Sess. 40 (1951)	House report number 242, Congress number 82, Congressional session 1, page number 40, year 1951
Administrative Authorities:	***Citation:***	***Explanation:***
Final Regulation	Reg. Sec. 1.217-2(c)(1)	Type of regulation (1 = income tax), code section 217, regulation number 2, paragraph c, subparagraph number 1
Temporary Regulation	Temp. Reg. Sec. 1.217-2(c)(1)	Same as final regulation
Proposed Regulation	Prop. Reg. Sec. 1.217-2(c)(1)	Same as final regulation
Revenue Ruling	Rev. Rul. 77-262, 1977-2 C.B. 41	Ruling number 77-262 (262nd ruling of 1977), volume number of cumulative bulletin 1977-2, page number 41
Revenue Procedure	Rev. Proc. 99-10, 1999-1 C.B. 272	Procedure number 99-10 (10th procedure of 1999), volume number of cumulative bulletin 1999-1, page number 272
Private Letter Ruling	PLR 200601001	Year 2006, week number 01 (1st week of 2006), ruling number 001 (1st ruling of the week)
Technical Advice Memorandum	TAM 200402001	Year 2004, week number 02 (2nd week of 2004), ruling number 001 (1st ruling of the week)
Judicial Authorities:	***Citation:***	***Explanation:***
U.S. Supreme Court	*Comm. v. Kowalski,* 434 U.S. 77 (S. Ct., 1977)	Volume 434 of the United States Reporter, page 77, year 1977
	Comm. v. Kowalski, 98 S. Ct. 315 (S. Ct., 1977)	Volume 98 of the West court reporter, page 315, year 1977
	Comm. v. Kowalski, 77-2 USTC par. 9,748 (S. Ct., 1977)	Volume 77-2 of the CCH court reporter, paragraph 9,748, year 1977
	Comm. v. Kowalski, 40 AFTR2d 77-6128 (S. Ct., 1977)	Volume 40 of the RIA AFTR2d court reporter, paragraph 77-6128, year 1977
U.S. Circuit Court of Appeals	*Azar Nut Co. v. Comm.,* 931 F.2d 314 (5th Cir., 1991)	Volume 931 of the West F.2d court reporter, page 314, circuit 5th, year 1991
	Azar Nut Co. v. Comm., 91-1 USTC par. 50,257 (5th Cir., 1991)	Volume 91-1 of the CCH USTC court reporter, paragraph 50,257, circuit 5th, year 1991
	Azar Nut Co. v. Comm., 67 AFTR2d 91-987 (5th Cir., 1991)	Volume 67 of the RIA AFTR2d court reporter, paragraph 91-987, year 1991
U.S. Tax Court—Regular decision	*L.A. Beeghly,* 36 TC 154 (1962)	Volume 36 of the Tax Court reporter, page 154, year 1962
U.S. Tax Court—Memorandum decision	*Robert Rodriguez,* RIA TC Memo 2005-012	Paragraph number 2005-012 of the RIA Tax Court Memorandum reporter
	Robert Rodriguez, 85 TCM 1162 (2005)	Volume 85 of the CCH Tax Court Memorandum reporter, page 1162, year 2005
U.S. Court of Federal Claims	*J.R. Cohen v. U.S.,* 510 F. Supp. 297 (Fed. Cl., 1993)	Volume 510 of the West F. Supp. court reporter, page 297, year 1993
	J.R. Cohen v. U.S., 72 AFTR2d 93-5124 (Fed. Cl., 1993)	Volume 72 of the RIA AFTR2d court reporter, paragraph 93-5124, year 1993
	J.R. Cohen v. U.S., 93-1 USTC par. 50,354 (Fed. Cl., 1993)	Volume 93-1 of the CCH USTC court reporter, paragraph 50,354, year 1993
U.S. District Court	*Waxler Towing Co., Inc. v. U.S.,* 510 F. Supp. 297 (W.D, TN, 1981)	Volume 510 of the West F. Supp. court reporter, page 297, Western District (W.D.), state Tennessee, year 1981
	Waxler Towing Co., Inc. v. U.S., 81-2 USTC par. 9,541 (W.D., TN, 1981)	Volume 81-2 of the CCH USTC court reporter, paragraph 9,541, Western District (W.D.), state Tennessee, year 1981
	Waxler Towing Co., Inc. v. U.S., 48 AFTR2d 81-5274 (W.D., TN, 1981)	Volume 48 of the RIA AFTR2d court reporter, paragraph 81-5274, Western District (W.D.), state Tennessee, year 1981

EXHIBIT 2-6 **Common Secondary Tax Authorities**

Tax Research Services:	***Professional Journals:***
BNA Tax Management Portfolios	*Journal of Accountancy*
CCH Standard Federal Tax Reporter	*Journal of Taxation*
CCH Tax Research Consultant	*Practical Tax Strategies*
RIA Federal Tax Coordinator	*Taxes*
RIA United States Tax Reporter	*Tax Adviser*
Newsletters:	***Quick Reference Sources:***
Daily Tax Report	*IRS Publications*
Federal Tax Weekly Alert	*CCH Master Tax Guide*
Tax Notes	*RIA Federal Tax Handbook*
Law Reviews:	***Textbooks:***
Tax Law Review (New York University School of Law)	*McGraw-Hill's Taxation of Individuals and Business Entities*
Virginia Tax Review (University of Virginia School of Law)	*McGraw-Hill's Essentials of Federal Taxation*

Secondary authorities may be very helpful in understanding a tax issue, but they hold little weight in a tax dispute (hence their "unofficial" status). Thus, tax advisers should always be careful to verify their understanding of tax law by examining primary authorities directly and to *never* cite secondary authority in a research memo. Exhibit 2-6 lists some of the common sources of secondary authority.

TAXES IN THE REAL WORLD Google: Not Authoritative on Tax Matters

While Internet super giant Google may be the king of all cyberspace knowledge, the Tax Court ruled in *Woodard v. Comm.*, TC Summary Opinion 2009-150, that a Google search does not constitute reasonable cause to excuse a Harvard MBA/CPA from taking an incorrect tax return position. The Tax Court noted that although the taxpayer had not worked as an accountant for years before filing his tax return, "his accounting degree, MBA, and CPA training, no matter how stale, undoubtedly taught him what sources could be relied upon as definitive; such as, for example, the Internal Revenue Code and the income tax regulations, both of which are readily available on the Internet."

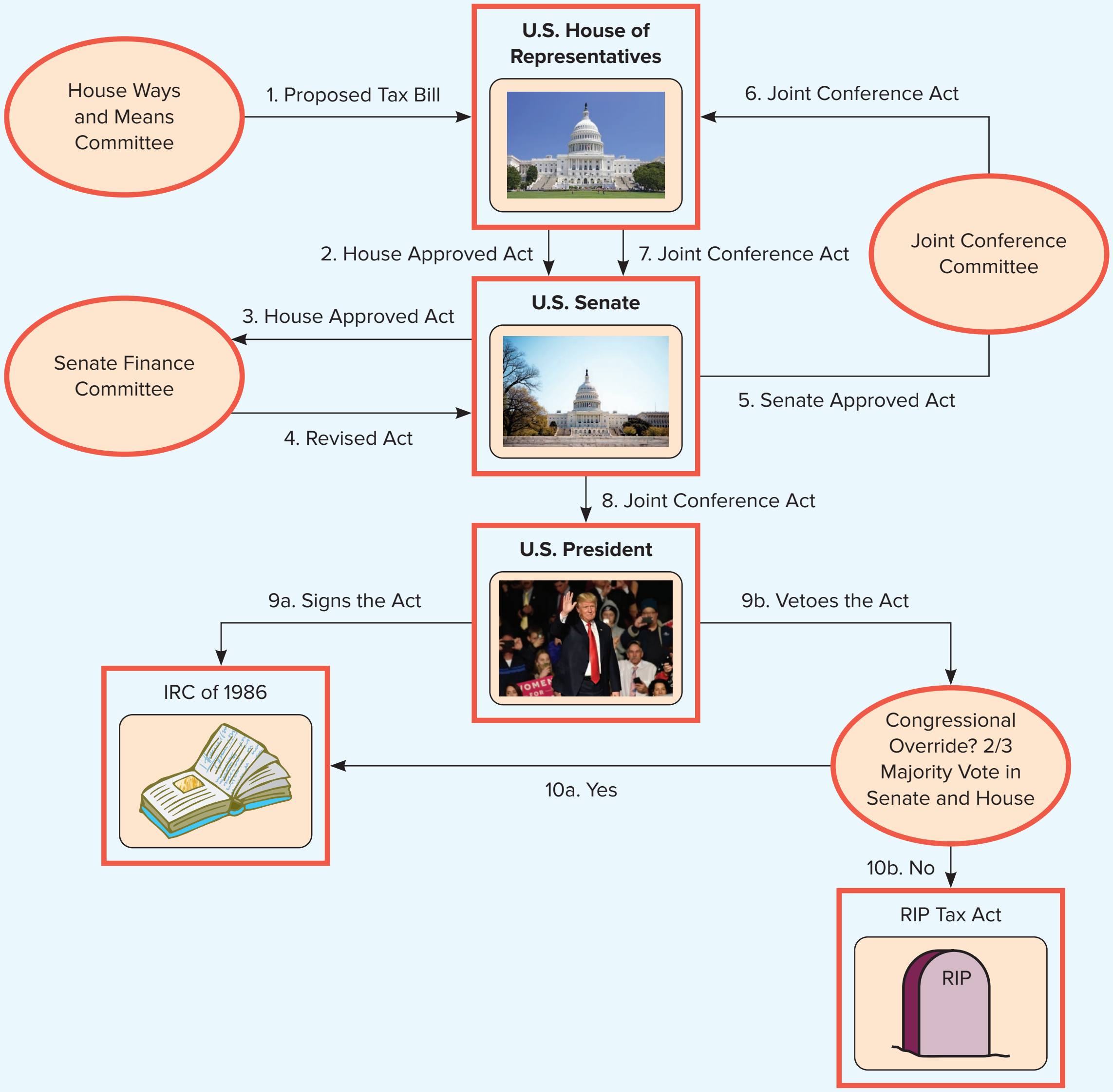
Legislative Sources: Congress and the Constitution

The three legislative or statutory tax authorities are the U.S. Constitution, the Internal Revenue Code, and tax treaties. The **U.S. Constitution** is the highest authority in the United States, but it provides very little in the way of tax law since it contains no discussion of tax rates, taxable income, or other details. Instead, the 16th Amendment provides Congress the ability to tax income directly, from whatever source derived, without apportionment across the states.

Various attempts to amend the U.S. Constitution with regard to taxation—for example, one effort to repeal the 16th Amendment entirely and one to require a two-thirds majority in both houses to raise taxes—have so far met with failure.

Internal Revenue Code The second (and main) statutory authority is the **Internal Revenue Code of 1986,** as amended, known as the Code. The Internal Revenue Code has the same authoritative weight as tax treaties and Supreme Court rulings. Thus, a taxpayer should feel very confident in a tax return position, such as taking a deduction, that is specifically allowed by the Code. The Internal Revenue Code is unique in that all federal tax authorities—all administrative and judicial authorities except tax treaties and the

EXHIBIT 2-7 **Tax Legislation Process**



(U.S. House): ©iStockphoto/Getty Images; (Senate): ©Glow Images; (President): ©Evan El-Amin/Shutterstock

Constitution—can be seen as an interpretation of it. Hence, understanding the relevant code section(s) is critical to being an efficient and effective tax professional.

Congress enacts tax legislation virtually every year that changes the Code; 1986 was simply the last major overhaul. Prior to 1986, tax law changes were incorporated into the Internal Revenue Code of 1954, the year a new numbering system and other significant changes were introduced. Before that, tax law changes were incorporated into the Internal Revenue Code of 1939, which was the year the tax law was first codified.

The Legislative Process for Tax Laws Exhibit 2-7 illustrates the legislative process for enacting tax laws. As required by the U.S. Constitution (Article 1, Section 7), "All bills for raising revenue shall originate in the House of Representatives." The Senate may propose tax legislation, but the first to formally consider a bill will be the House, typically within its Ways and Means Committee. After the committee debates the proposed legislation and drafts a bill, the bill goes to the House of Representatives floor for debate and ultimately a vote (either yea or nay without modification). If the bill is approved, it becomes an *act* and is sent to the Senate, which typically refers the act to the Senate Finance Committee. Not to be outdone by the House, the Senate Finance Committee usually amends the act during its deliberations. After the revised act passes the Senate Finance Committee, it goes to the Senate for debate and vote. Unlike representatives, senators may modify the proposed legislation during their debate.

If the Senate passes the act, both the House and Senate versions of the legislation are sent to the Joint Conference Committee, which consists of members of the House Ways and Means Committee and the Senate Finance Committee. During the Joint Conference Committee deliberations, committee members debate the two versions of the proposed legislation. Possible outcomes for any specific provision in the proposed legislation include adoption of the Senate version, the House version, or some compromise version of the two acts. Likewise, the Joint Conference Committee may simply choose to eliminate specific provisions from the proposed legislation or fail to reach a compromise, thereby terminating the legislation.

After the Joint Conference Committee approves the act, the revised legislation is sent to the House and Senate for vote. If both the House and Senate approve it, the act is sent to the president for his or her signature. If the president signs the act, it becomes law and is incorporated into the Internal Revenue Code of 1986 (Title 26 of the U.S. Code, which contains *all* codified laws of the United States). If the president vetoes the legislation, Congress may override the veto with a two-thirds positive vote in both the House and the Senate.

The House Ways and Means Committee, Senate Finance Committee, and Joint Conference Committee each produce a committee report that explains the current tax law, proposed change in the law, and reasons for the change. These committee reports are considered statutory sources of the tax law and may be very useful in interpreting tax law changes and understanding congressional intent. These committee reports are especially important after new legislation has been enacted because, with the exception of the Code, there will be very little authority interpreting the new law (i.e., no judicial or administrative authorities because of the time it takes for the new law to be litigated or for the IRS to issue interpretative guidance).

Basic Organization of the Code The Internal Revenue Code is divided into subtitles, chapters, subchapters, parts, subparts, and sections. All existing and any new tax laws are placed in the Code within a specific subtitle, chapter, subchapter, part, subpart, and section. When referencing a tax law, the researcher generally refers to the law simply by its code section. Code sections are numbered from 1 to 9834, with gaps in the section numbers to allow new code sections to be added to the appropriate parts of the Code as needed. Each code section is further divided into subsections, paragraphs, subparagraphs, and clauses to allow more specific reference or citation. See Exhibit 2-5 for an example code citation and explanation.

Memorizing the various subtitles and chapters of the Code has limited value (except to impress your friends at parties). However, understanding the *organization* of the Code is important, especially for the aspiring tax accountant. (See Exhibit 2-8.) First, you must understand the organization of a code section, its subsections, paragraphs, subparagraphs, and clauses to be able to cite the respective law correctly as, for example, IRC Sec. 162(b)(4). Second, note that many provisions in the Code apply only to specific parts of the Code. For example, it is quite common for a code section to include the phrase "for purposes of this chapter, . . ." If you do not understand what laws are encompassed in the chapter, it will be very difficult for you to interpret the code section and determine its applicability to a research question.

Finally, remember that code sections addressing similar transactions, such as deductions, or topics, such as C corporations, are grouped together. Consider a researcher faced with the question of whether an item of income is taxable. If the researcher understands the organization of the Code, she can quickly focus her research on code sections 61–140, which provide a broad definition of gross income, list items specifically included in gross income, and identify items specifically excluded from gross income.

THE KEY FACTS

Statutory Authorities

- U.S. Constitution
  - The 16th Amendment provides Congress the ability to tax income directly, from whatever source derived, without apportionment across the states.
- Internal Revenue Code
  - The main statutory authority is the Internal Revenue Code of 1986.
  - The Internal Revenue Code has the same authoritative weight as tax treaties and Supreme Court rulings.
  - Changes to the Code are passed by the House of Representatives and Senate and signed into law by the president.
  - The House Ways and Means Committee and Senate Finance Committee oversee tax legislation in the House of Representatives and Senate, respectively.
  - When referencing a tax law, the researcher generally refers to the law by its code section.
- Treaties
  - Tax treaties are agreements negotiated between countries that describe the tax treatment of entities subject to tax in both countries.

EXHIBIT 2-8 **Example of Code Organization**

Subtitle A—Income Taxes
- Chapter 1—Income Taxes
  - **Subchapter A—Determination of Tax Liability**
    - Part I—Definition of Gross Income, Adjusted Gross Income, Taxable Income, etc. (Sec. 61–68)
      - **Sec. 61—Gross Income Defined**
      - **Sec. 62—Adjusted Gross Income Defined**
      - **Sec. 63—Taxable Income Defined**
        - Subsection 63(c)—Standard Deduction
          - **Paragraph 63(c)(2)—Basic Standard Deduction**
            - Subparagraph 63(c)(2)(A)
              - **Clause 63(c)(2)(A)(i)**
    - Part II—Items Specifically Included in Gross Income (Sec. 71–90)
      - **Sec. 71—Alimony**
      - **Sec. 72—Annuities**
      - **Sec. 73—Services of Child**
      - **Sec. 74—Prizes & Awards**
    - Part III—Items Specifically Excluded from Gross Income (Sec. 101–140)
      - **Sec. 101—Certain Death Benefits**
      - **Sec. 102—Gifts and Inheritances**
      - **Sec. 103—Interest on State & Local Bonds**

Tax Treaties

Tax treaties are negotiated agreements between countries that describe the tax treatment of entities subject to tax in both countries, such as U.S. citizens earning investment income in Spain. The U.S. president has the authority to enter into a tax treaty with another country after receiving the Senate's advice. If you are a U.S. citizen earning income abroad or an accountant with international clients, you need knowledge of U.S. tax laws, the foreign country's tax laws, and the respective tax treaty between the United States and the foreign country for efficient tax planning. Because the focus in this text is on U.S. tax laws, we only briefly mention the importance of tax treaties as a statutory authority.

Example 2-2

Bill recently spent a summer in Milan, Italy, teaching a graduate level economics course. While in Italy he earned a $20,000 stipend from Bocconi University and some interest in a temporary banking account that he established for the trip. What tax laws must Bill consider to understand any tax liability from his $20,000 stipend?

Answer: U.S. tax laws, Italian tax laws, and the U.S.–Italy tax treaty will determine the tax consequences of the amounts Bill earned in Italy.

THE KEY FACTS

Judicial Authorities

- Our judicial system has the ultimate authority to interpret the Internal Revenue Code and settle disputes between taxpayers and the IRS.
- The Supreme Court is the highest judicial authority.
- Beneath the Supreme Court, the 13 Circuit Courts of Appeals represent the next highest judicial authority.

(*continued*)

Judicial Sources: The Courts

Our judicial system has the ultimate authority to interpret the Internal Revenue Code and settle disputes between the IRS and taxpayers. As Exhibit 2-3 illustrates, there are five basic sources of judicial authority (three trial-level courts, 13 U.S. Circuit Courts of Appeals, and the Supreme Court). We've noted that the Supreme Court, along with the Code, represents the highest tax-specific authority. An important distinction between the two, however, is that the Supreme Court does not establish law but instead simply interprets and applies the Code (along with other authorities). Thus, the Code and the Supreme Court should never be in conflict.[11]

[11]The Supreme Court has the authority to declare a Code provision unconstitutional.

Below the Supreme Court, the 13 U.S. Circuit Courts of Appeals represent the next highest judicial authority. The lowest level of judicial authority consists of three different types of trial-level courts (94 U.S. District Courts that hear cases involving taxpayers that reside within their respective districts, the U.S. Court of Federal Claims, and the U.S. Tax Court). Given that the U.S. Tax Court hears only tax cases and that its judges are "tax experts," its decisions typically have more weight than those rendered by a district court or the U.S. Court of Federal Claims.[12] Likewise, because the U.S. Court of Federal Claims hears a much narrower set of issues than U.S. District Courts (only monetary claims against the U.S. government), its decisions have more weight than district court decisions.

In rendering court decisions, all courts apply the judicial doctrine of ***stare decisis.*** This doctrine means that a court will rule consistently with (a) its previous rulings (unless, due to evolving interpretations of the tax law over time, the court decides to overturn an earlier decision) and (b) the rulings of higher courts with appellate jurisdiction (the courts its cases are appealed to). The implication of *stare decisis* is that a circuit court will abide by Supreme Court rulings and its own rulings, whereas a trial-level court will abide by Supreme Court rulings, its respective circuit court's rulings, and its own rulings. For example, a district court in California would follow U.S. 9th Circuit and Supreme Court rulings as well as the court's own rulings.

The doctrine of *stare decisis* presents a special problem for the U.S. Tax Court because it appeals to different circuit courts based on the taxpayer's residence. To implement the doctrine of *stare decisis*, the tax court applies the **Golsen rule.**[13] The Golsen rule simply states that the tax court will abide by rulings of the circuit court that has appellate jurisdiction for a case.

- The lowest level of judicial authority consists of three different types of trial-level courts (U.S. District Courts, U.S. Court of Federal Claims, and the U.S. Tax Court).
- U.S. Tax Court decisions typically are considered to have more authoritative weight than decisions rendered by a district court or the U.S. Court of Federal Claims.
- All courts apply the judicial doctrine of *stare decisis*, which means that a court will rule consistently with its previous rulings and the rulings of higher courts with appellate jurisdiction.

Example 2-3

What if: If Bill and Mercedes opt to litigate their case in the U.S. Tax Court, by which circuit court's rulings will the court abide?

Answer: Because Bill and Mercedes live in Florida, the U.S. Tax Court will abide the circuit court with appellate jurisdiction in Florida, which happens to be the U.S. 11th Circuit Court.

Administrative Sources: The U.S. Treasury

Regulations, Revenue Rulings, and Revenue Procedures The Treasury Department, of which the IRS is a bureau, is charged with administering and interpreting the tax laws of the United States, among other duties such as printing money and advising the president on economic issues. **Regulations** are the Treasury Department's official interpretation of the Internal Revenue Code, have the highest authoritative weight, and often contain examples of the application of the Code that may be particularly helpful to the tax researcher. Regulations are issued in three different forms: final, temporary, and proposed. The names are very descriptive. **Final regulations** are regulations that have been issued in final form, and thus, unless or until revoked, they represent the Treasury's interpretation of the Code. **Temporary regulations** have a limited life (three years for regulations issued after November 20, 1988). Nonetheless, during their life, they carry the same authoritative weight as final regulations. Finally, all regulations are issued in the form of **proposed regulations** first, to allow public comment on them. Proposed regulations do not carry the same authoritative weight as temporary or final regulations.

In addition to being issued in three different forms, regulations also serve three basic purposes: interpretative, procedural, and legislative. Most regulations are issued as

THE KEY FACTS

Administrative Authorities

- The Treasury Department is charged with administering and interpreting the tax laws.
- Regulations
  - Regulations are the Treasury Department's official interpretation of the Internal Revenue Code and have the highest authoritative weight.
  - Regulations are issued in three different forms (proposed, temporary, and final) and serve three basic purposes (interpretative, procedural, and legislative).

(continued)

[12]The Tax Court renders both "regular" and "memorandum" decisions. Regular decisions involve new or unusual points of law, whereas memorandum decisions involve questions of fact or the application of existing law. Both decisions have similar authoritative weight. Decisions issued by the Tax Court's Small Claims division may not be cited as precedent.

[13]54 TC 742 (1970).

- Revenue rulings and revenue procedures
  - Revenue rulings and revenue procedures are second in administrative authoritative weight after regulations.
  - Revenue rulings address the application of the Code and regulations to a specific factual situation.
  - Revenue procedures explain in greater detail IRS practice and procedures in administering the tax law.
- Letter rulings
  - Letter rulings are less authoritative but more specific than revenue rulings and regulations.
  - Private letter rulings represent the IRS's application of the Code and other tax authorities to a specific transaction and taxpayer.

interpretative or procedural regulations. As the names suggest, **interpretative regulations** represent the Treasury's interpretation of the Code. In Bill and Mercedes's case, these might be the regulations issued under IRC Sec. 163, which discuss interest deductions. **Procedural regulations** explain Treasury Department procedures as they relate to administering the Code. Again, for Bill and Mercedes's case, these might be the regulations issued under IRC Sec. 6501 regarding the statute of limitations for IRS assessment and collection. **Legislative regulations,** the rarest type, are issued when Congress specifically directs the Treasury Department to create regulations to address an issue in an area of law. In these instances, the Treasury is actually writing the law instead of interpreting the Code. Because legislative regulations represent tax law instead of an interpretation of tax law, legislative regulations generally have been viewed to have more authoritative weight than interpretative and procedural regulations. However, in *Mayo Foundation for Medical Education & Research v. U.S.,* 131 S.Ct. 704 (2011), the Supreme Court held (subject to specific conditions) that all Treasury regulations warrant deference. It is thus a very difficult process to challenge any regulation, and taxpayers are cautioned not to take tax return positions inconsistent with regulations.

Revenue rulings and revenue procedures are second in administrative authoritative weight after regulations. But unlike regulations, revenue rulings address the application of the Code and regulations to a specific factual situation. Thus, while **revenue rulings** have less authoritative weight, they provide a much more detailed interpretation of the Code as it applies to a specific transaction and fact pattern. For example, Rev. Rul. 87-22 discusses the deductions of prepaid interest (points) a taxpayer may claim when refinancing the mortgage for a principal residence, whereas the Code and regulations do not specifically address this issue. Although revenue rulings are binding on the IRS (until revoked, superseded, or modified), courts may agree or disagree with a revenue ruling. Thus, while revenue rulings should be carefully evaluated because they represent the IRS's interpretation, courts may provide a different interpretation of the tax law that a taxpayer might choose to follow. **Revenue procedures** are also much more detailed than regulations. They explain in greater detail IRS practice and procedures in administering the tax law. For example, Rev. Proc. 87-56 provides the specific depreciation lives for depreciable assets (discussed in the Property Acquisition and Cost Recovery chapter). As with revenue rulings, revenue procedures are binding on the IRS until revoked, modified, or superseded.

Letter Rulings Below revenue rulings and revenue procedures in authoritative weight rest letter rulings. As you might guess, letter rulings are less authoritative but more specific than revenue rulings and regulations. Letter rulings generally may not be used as precedent by taxpayers. However, they may be cited as authority to avoid the substantial understatement of tax penalty under IRC Sec. 6662 imposed on taxpayers and the related tax practitioner penalty under IRC Sec. 6694 (discussed later in this chapter). **Private letter rulings** represent the IRS's application of the Code and other tax authorities to a specific transaction and taxpayer. Private letter rulings are issued in response to a taxpayer request and are common for proposed transactions with potentially large tax implications. For example, companies commonly request a private letter ruling to ensure that a proposed corporate acquisition meets the definition of a tax-free exchange. However, the IRS also maintains a list of certain issues on which it refuses to rule, such as the tax consequences of proposed federal tax legislation. Each year, the IRS publishes an updated list of these transactions in a revenue procedure.

Other types of letter rulings include determination letters and technical advice memorandums. **Determination letters,** issued by local IRS directors, are generally not controversial. An example of a determination letter is the request by an employer for the IRS to rule that the taxpayer's retirement plan is a "qualified plan." **Technical advice memorandums** differ from private letter rulings in that they are generated for completed transactions and usually are requested by an IRS agent during an IRS audit.

Is this a comprehensive list of IRS pronouncements? No. In addition to the pronouncements listed above, the IRS issues several less common types, which are beyond the scope of this text. A couple of other pronouncements, however, warrant some discussion. As we mentioned above, the IRS and taxpayers litigate tax cases in a number of courts and jurisdictions. Obviously, the IRS wins some of these cases and loses others. Except for Supreme Court cases, whenever the IRS loses, it may issue an **acquiescence** or **nonacquiescence** as guidance for how the IRS intends to respond to the loss. Although an acquiescence indicates that the IRS has decided to *follow* the court's adverse ruling in the future, it does not mean that the IRS *agrees* with it. Instead, it simply means that the IRS will no longer litigate this issue.

A nonacquiescence has the exact opposite implications and alerts taxpayers that the IRS does plan to continue to litigate this issue. Finally, the IRS also issues **actions on decisions,** which explain the background reasoning behind an IRS acquiescence or non-acquiescence.[14] What are noticeably absent from the list of administrative authorities? IRS publications and tax return form instructions. *Neither are considered primary authorities and should not be cited as precedent. Likewise, it is not advisable to rely on either to avoid taxpayer or tax practitioner penalties.*

TAX RESEARCH

LO 2-5

Now that you have a basic understanding of the different types of tax authority, why do you think that the IRS and taxpayers disagree with respect to the tax treatment of a transaction? In other words, why would the IRS and Bill and Mercedes's CPA reach different conclusions regarding the deductibility of certain expenses? The answer is that, because the Code does not specifically address the tax consequences of each transaction type or every possible variation of a particular transaction, the application of the tax law is subject to debate and differing interpretations by the IRS, courts, tax professionals, taxpayers, and so on. Tax research, therefore, plays a vital role in allowing us to identify and understand the varying authorities that provide guidance on an issue; assess the relative weights of differing authorities; understand the risks associated with different tax return positions; and ultimately, draw an appropriate conclusion regarding the application of the tax law to the issue. The following paragraphs describe the basic process of tax research that tax professionals use to identify and analyze tax authorities to answer tax questions. We will then revisit Bill and Mercedes's issue and view the research memo prepared by their CPA.

THE KEY FACTS

Tax Research

- The five steps in tax research are (1) understand the facts, (2) identify issues, (3) locate relevant authorities, (4) analyze the tax authorities, and (5) document and communicate research results.
- The two types of tax services that tax professionals use in tax research are annotated tax services, arranged by code section, and topical services, arranged by topic.
- Research questions often consist of questions of fact or questions of law.
  - The answer to a question of fact hinges upon the facts and circumstances of the taxpayer's transaction.
  - The answer to a question of law hinges upon the interpretation of the law, such as interpreting a particular phrase in a code section.
- When the researcher identifies that different authorities have conflicting views, she should evaluate the "hierarchy," jurisdiction, and age of the authorities.
- Once the tax researcher has identified relevant authorities, she must make sure that the authorities are still valid and up to date.

(continued)

Step 1: Understand Facts

To answer a tax question, you must understand it. To understand the question, you must know the facts. There are two basic types of facts: open facts and closed facts. *Open facts* have not yet occurred, such as the facts associated with a proposed transaction. *Closed facts* have already occurred. The distinction between open and closed facts is important because, unlike closed facts, open facts can be altered, and different facts may result in very different tax consequences. Open facts allow the taxpayer to arrange a transaction to achieve the most advantageous outcome. Thus, they are especially important in tax planning.

How do you establish the facts for a research question? Interview clients, speak with third parties such as attorneys and brokers, and review client documents such as contracts, prior tax returns, wills, trust documents, deeds, and corporate minutes. When interviewing clients, remember that not many are tax experts. Thus, it is up to the tax professional to ask the correct initial and follow-up questions to obtain all the relevant facts. Also consider nontax factors, such as a client's personal values or objectives, because these often put constraints on tax-planning strategies.

Step 2: Identify Issues

A tax professional's ability to identify issues is largely a function of his or her type of tax expertise. A tax expert in a particular area will typically be able to identify quickly the

[14]Actions on decisions have no precedential value but may be cited as authority to avoid the substantial understatement of tax penalty under IRC Sec. 6662 imposed on taxpayers and the related tax practitioner penalty under IRC Sec. 6694 (discussed later in this chapter).

- The most common end product of a research question is a research memo, which has five basic parts: (1) facts, (2) issues, (3) authority list, (4) conclusion, and (5) analysis.

specific tax issues that relate to transactions in that area. For example, an expert in corporate acquisitions would quickly identify the tax consequences and specific issues of alternative acquisition types. A novice, on the other hand, would likely identify broader issues first and then more specific issues as he or she researched the relevant tax law.

What's the best method to identify tax issues? First of all, get a good understanding of the client's facts. Then, combine your understanding of the facts with your knowledge of the tax law. Let's consider the example of Bill and Mercedes's interest deduction. For an expert in this particular area, the issues will be immediately evident. For a novice, the initial response may take the form of a series of general questions: (1) Is this item of expense deductible? (2) Is that item of income taxable? (3) In what year should the expense be deducted? (4) In what year should the item of income be taxed? After you identify these types of general issues, your research will enable you to identify the more specific issues that ultimately determine the tax ramifications of the transaction.

Example 2-4

Elizabeth, Bill and Mercedes's friend who is a shareholder and the CFO of a company, loaned money to her company to help it avoid declaring bankruptcy. Despite Elizabeth's loan, the company did file for bankruptcy, and Elizabeth was not repaid the loan. What issues would a researcher consider?

Answer: The first questions to ask are whether Elizabeth can deduct the bad debt expense and, if so, as what type of deduction? As the researcher delves more into the general issue, he would learn that the type of deduction depends on whether Elizabeth's debt is considered a business or nonbusiness bad debt. This more specific issue depends on whether Elizabeth loaned the money to the company to protect her job (business bad debt) or to protect her stock investment in the company (nonbusiness bad debt). Bad-debt expenses incurred for nonbusiness debts (investment-related debts) are deducted as capital losses and thus subject to limitations, whereas bad-debt expenses for business debts (business-related debts) are ordinary deductions and not limited.

Why might this case be a good one to litigate in U.S. District Court?

Answer: Because a jury might be more likely to be convinced to assess Elizabeth's motives favorably.

Step 3: Locate Relevant Authorities

Step three in the research process is to locate the relevant authorities (code sections, regulations, court cases, revenue rulings) that address the tax issue. Luckily, tax services can aid the researcher in identifying relevant authorities. Most, if not all, of these services are available on the Internet (with a subscription) and thus offer the flexibility to conduct research almost anywhere.[15]

There are two basic types of tax services: annotated and topical. **Annotated tax services** are arranged by Internal Revenue Code section. That is, for each code section, an annotated service includes the code section; a listing of the code section history; copies of congressional committee reports that explain changes to the code section; a copy of all the regulations issued for the specific code section; the service's unofficial explanation of the code section; and brief summaries (called annotations) of relevant court cases, revenue rulings, revenue procedures, and letter rulings that address issues specific to the code section. Two examples of annotated tax services are Commerce Clearing House's (CCH) Standard Federal Tax Reporter and Research Institute of America's (RIA) United States Tax Reporter.

[15]www.IRS.gov contains a lot of information (tax forms, IRS publications, etc.) that may be especially useful for answering basic tax questions. In addition, tax publishers, such as CCH and RIA, produce quick reference tax guides (e.g., the *CCH Master Tax Guide* or the *RIA Federal Tax Handbook*) that may be used to answer basic tax questions.

Topical tax services are arranged by topic, such as taxable forms of income, tax-exempt income, and trade or business expenses. For each topic, the services identify tax issues that relate to each topic and then explain and cite authorities relevant to the issue (code sections, regulations, court cases, revenue rulings, etc.). Beginning tax researchers often prefer topical services, because they generally are easier to read. Some examples of topical federal tax services include BNA's Tax Management Portfolios, CCH's Tax Research Consultant, and RIA's Federal Tax Coordinator.

How does a researcher use these services? An expert would probably go directly to the relevant portions of an annotated or topical service. A novice may conduct a keyword search in the service, use the tax service's topical index, or browse the tax service to identify the relevant portions. To identify keywords, the researcher should try to describe the transaction in three to five words. An ideal keyword search typically includes (1) the relevant area of law and (2) a fact or two that describes the transaction. Try to avoid keywords that are too broad (income, deduction, taxable) or too narrow.

Example 2-5

Bill and Mercedes refinanced the mortgage on their principal residence a couple of years ago when their original mortgage's four-year balloon payment came due. Their mortgage institution charged Bill and Mercedes $3,000 of points (prepaid interest) upon the refinancing in order to give them a reduced interest rate. On their CPA's advice, Bill and Mercedes deducted the $3,000 in the year they paid it, but upon audit, the IRS disallowed the deduction. What is the research issue?

Answer: The issue is, should Bill and Mercedes have deducted the $3,000 of points in the year they paid it?

What are some keywords that could identify the relevant tax authority?

Answer: Points (area of law), interest (area of law), refinancing (fact that describes the transaction).

Keyword searching is more an art than an exact science. As you gain a better understanding of different areas of the tax law, you'll become much more efficient at using keywords. If keyword searching is not proving beneficial, check your spelling, make sure you're searching within the correct database, rethink your keywords, use another research method, use another tax service, or as a last resort, take a break.

While utilizing keyword searches or other research methods to identify potentially relevant areas of law and tax authorities, constantly ask yourself whether you are indeed in the correct area of law. Once the answer to this question is an authoritative yes, you can delve deeper into the area of law and related authorities to answer the question.

Step 4: Analyze Tax Authorities

Once a researcher identifies relevant authorities, she must read carefully to ensure she fully understands them, as well as their application to the research problem. Two basic types of issues researchers will encounter are questions of fact and questions of law.

The answer to a **question of fact** hinges upon the facts and circumstances of the taxpayer's transaction. For example, whether a trade or business expense is "ordinary," "necessary," "reasonable," and thus deductible, is a question of fact. If you're researching a question of fact, understand *which* facts determine the answer—in this case, which facts make an expense "ordinary," "necessary," and "reasonable" and which do not. In this type of question, the researcher will focus on understanding how various facts affect the research answer and identifying authorities with fact patterns similar to those of her client.

The answer to a **question of law** hinges upon the interpretation of the law, such as a particular phrase in a code section (see the sample research memo in Exhibit 2-9 for an example of a question of law). A researcher faced with this type of question will spend much of her time researching the various interpretations of the code section, taking note of which authorities interpret the code differently and why.

EXHIBIT 2-9 Sample Internal Research Memo

Below is the memo Bill and Mercedes's CPA drafted after researching their issue.

Date: July 8, 2019

Preparer: Joe Staff

Reviewer: Sandra Miller

Subject: Deductibility of Points Paid in Refinancing

Facts: Four years ago Bill and Mercedes's credit union provided them a $250,000 mortgage loan for their new home. The mortgage loan was a four-year interest-only note with a balloon payment at the end of four years. Bill and Mercedes (Floridians residing in the 11th Circuit) chose this type of loan to allow them to minimize their mortgage payment until their other house was sold. After 18 months, Bill and Mercedes sold their other house and refinanced their original short-term loan with a 15-year conventional mortgage. The credit union charged Bill and Mercedes $3,000 in points (prepaid interest) upon the refinancing.

Issue: Can Bill and Mercedes deduct the points in the year they paid them?

Authorities: IRC Sec. 461(g).

Rev. Rul. 87-22, 1987-1 CB 146.

J.R. Huntsman v. Comm. (8 Cir., 1990), 90-2 USTC par. 50,340, rev'g 91 TC 917 (1988).

AOD 1991-002.

P.G. Cao v. Comm. (9 Cir., 1996), 96-1 USTC par. 50,167, aff'g 67 TCM 2171 (1994).

Conclusion: Because Bill and Mercedes's refinancing represents an integrated step in securing permanent financing for their home, substantial authority supports their deduction of the $3,000 in points this year.

Analysis: IRC Sec. 461(g)(1) provides that cash-method taxpayers (Bill and Mercedes) must amortize prepaid interest (points) over the life of the loan instead of receiving a current deduction. IRC Sec. 461(g)(2) provides an exception to the general rule of Sec. 461(g)(1). Specifically, IRC Sec. 461(g)(2) allows cash-method taxpayers to deduct points in the year paid if the related debt was incurred "in connection with the purchase or improvement of," and secured by, the taxpayer's principal residence. The question whether Bill and Mercedes should amortize or currently deduct the points paid to refinance the mortgage on their principal residence depends upon the interpretation of "in connection with the purchase or improvement of" found in IRC Sec. 461(g)(2).

There are two basic interpretations of "in connection with the purchase or improvement of." In Revenue Ruling 87-22, the IRS rules that points incurred in refinancing a mortgage on a taxpayer's residence are deductible in the year paid to the extent that the taxpayer uses the loan proceeds to improve the taxpayer's residence. Thus, points paid to simply refinance an existing mortgage without improving the residence must be amortized over the life of the loan.

In contrast, in *J.R. Huntsman v. Comm.*, the 8th Circuit Court interpreted the phrase "in connection with the purchase or improvement of" much more broadly and held that points incurred to refinance a mortgage on the taxpayer's principal residence are currently deductible if the refinancing represents an *integrated step to secure permanent financing* for the taxpayer's residence. The facts in *J.R. Huntsman v. Comm.* are very similar to Bill and Mercedes's facts. Like Bill and Mercedes, the taxpayers in *J.R. Huntsman v. Comm.* also purchased their principal residence using a short-term loan with a "balloon" payment. When the balloon payment came due, the taxpayers obtained a permanent mortgage on their home (a 30-year conventional mortgage). The 8th Circuit Court held that in this case the permanent mortgage was acquired to extinguish the short-term financing and finalize the purchase of the home. "Thus, where taxpayers purchase a principal residence with a short-term three-year loan secured by a mortgage on the residence, and replace the loan with permanent financing . . . , the permanent mortgage obtained is sufficiently in connection with the purchase of the home to fall within the exception provided for by section 461(g)(2)."

In Action on Decision 1991-002, the IRS has indicated that it will not follow the *J.R. Huntsman v. Comm.* decision outside the 8th Circuit (in the 11th Circuit where Bill and Mercedes live). Nonetheless, other courts (the 9th Circuit in *P.G. Cao v. Comm.*) have indicated a willingness to apply the 8th Circuit's interpretation of IRC Sec. 461(g)(2). That is, they have allowed deductibility of points incurred in refinancing if the refinancing occurred to secure permanent financing, instead of for some other reason such as to secure a lower interest rate.

Given the similarity in facts between Bill and Mercedes's refinancing and those in *J.R. Huntsman v. Comm.* (refinancing of a short-term note to secure permanent financing), substantial authority supports a current deduction of the points paid.

For many tax questions, the answer is clear with no opposing interpretations or contrary authorities. For other questions, the researcher may identify that different authorities have conflicting views. In this situation, the tax researcher should evaluate the hierarchical level, jurisdiction, and age of the authorities, placing more weight on higher and newer authorities that have jurisdiction over the taxpayer. A tax researcher will become more adept at this process as she gains experience.

Once the tax researcher has identified relevant authorities, she must make sure the authorities are still valid and up to date. For court cases, a **citator**—a research tool that allows you to check the status of several types of tax authorities—can be used to review the history of a case to find out, for example, whether it was subsequently appealed and overturned and to identify subsequent cases that cite it. Favorable citations (for example, a citation of the case by another authority in support of its ruling) strengthen a case. In contrast, unfavorable ones weaken it (for example, a citation of the case by another authority that questions or limits the case's decision). Citators can also check the status of revenue rulings, revenue procedures, and other IRS pronouncements. Checking the status of the Code is fairly simple: just locate the current version. Checking the status of regulations is a little more complicated. Most tax services alert researchers if a regulation has not been updated for certain changes in the Code. If this is the case, the researcher should evaluate whether the changes in the Code make the regulation obsolete.

As detailed in the analysis section of the sample research memo drafted by Bill and Mercedes's CPA (see Exhibit 2-9), whether they should amortize (deduct over the life of the loan) or currently deduct the points paid to refinance the mortgage on their principal residence is a question of law that ultimately depends upon the interpretation of a particular phrase: "in connection with the purchase or improvement of" found in IRC Sec. 461(g)(2). Is there a correct answer to this question? No. There is no clear-cut answer. Rather, this is a situation where the tax professional must use professional judgment. Because there is substantial authority supporting the current deduction of the points (discussed in detail in the sample memo), Bill and Mercedes should be able to deduct the points currently without risk of penalty. However, they should be aware that the IRS has clearly stated in an action on decision that it will fight this issue outside the 8th Circuit—for example, in the 11th Circuit, where Bill and Mercedes live.

Step 5: Document and Communicate the Results

After a researcher finishes her research, the final step of the process is to document and communicate the results. The most common end product of a research question is the internal research memo the researcher drafts for her supervisor's attention. The memo has five basic parts: (1) facts, (2) issues, (3) authority list, (4) conclusion, and (5) analysis. The purpose of the memo is to inform the reader of the answer to a research question, and thus, it should be written in an objective manner by discussing all relevant authorities to the research question, including those authorities that support, as well as those that conflict with, the answer. Below are some suggestions for each part of the memo. Compare these to the execution within the sample internal research memo presented in Exhibit 2-9.

Facts Discuss facts relevant to the question presented—that is, facts that provide necessary background information related to the transaction (generally, who, what, when, where, and how much) and those facts that may influence the research answer. Keeping the fact discussion relatively brief will focus the reader's attention on the relevant characteristics of the transaction.

Issues State the specific issues that the memo addresses. This section confirms that you understand the research question, reminds the reader of the question being analyzed, and allows future researchers to determine whether the analysis in the memo is relevant. Issues should be written as specifically as possible and limited to one or two sentences per issue.