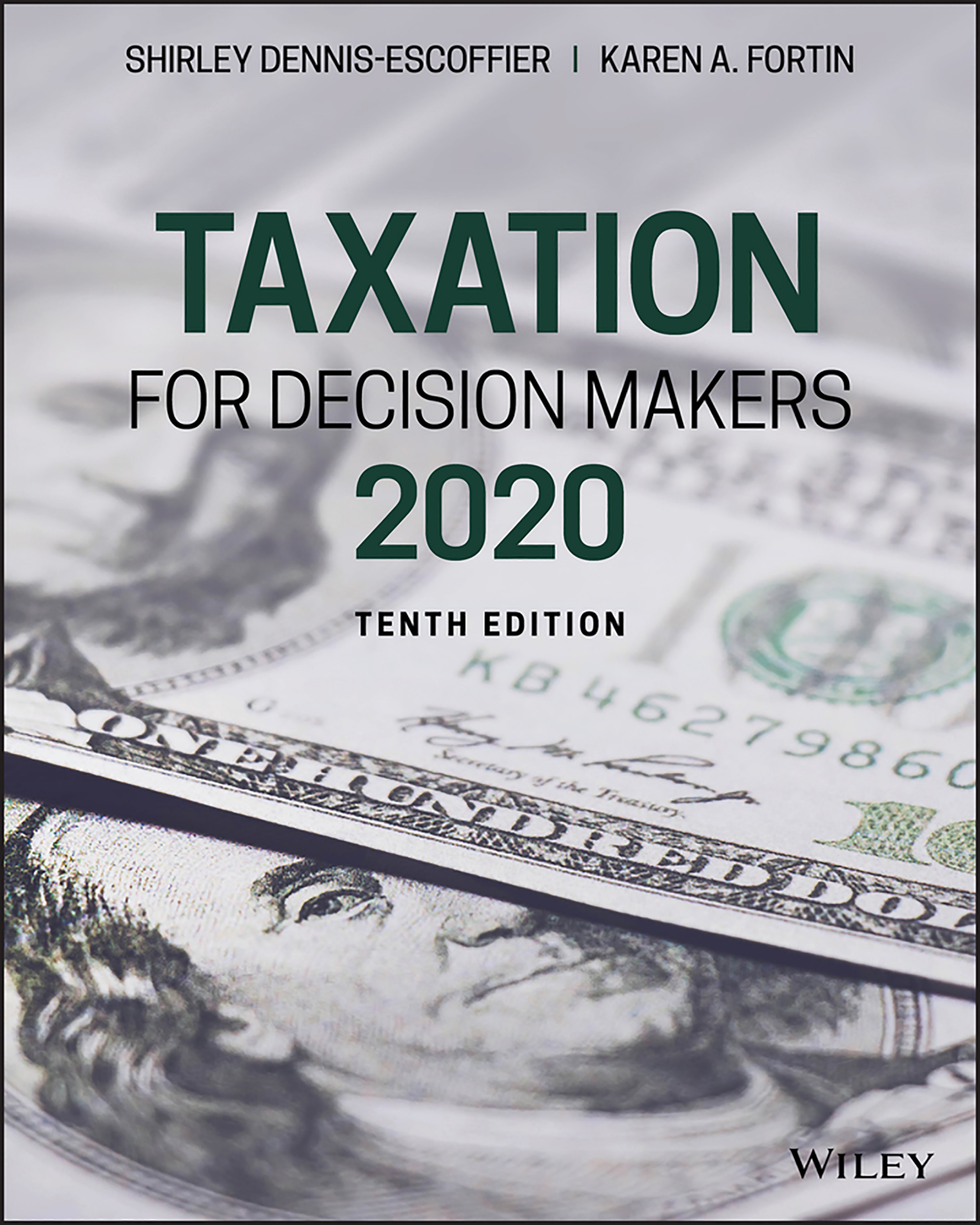
SHIRLEY DENNIS-ESCOFFIER | KAREN A. FORTIN

TAXATION FOR DECISION MAKERS 2020

TENTH EDITION



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Taxation for Decision Makers

2020 EDITION

Shirley Dennis-Escoffier

and

Karen A. Fortin

WILEY

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This book was set in 10/12 TimesLTStd-Roman by SPi Global, Chennai and printed and bound by Quad Graphics.

This book was previously published by Pearson Education, Inc.

ISBN: 978-1-119-56210-8 (PBK)
ISBN: 978-1-119-60171-5 (EVALC)
Serial Record: ISSN 2006209815

The inside back cover will contain printing identification and country of origin if omitted from this page. In addition, if the ISBN on the back cover differs from the ISBN on this page, the one on the back cover is correct.

To the memory of Marty Escoffier who was always ready with a willing hand to help, a word of encouragement as deadlines neared, and a sense of humor that never failed to make us laugh when we needed it most. His presence has been missed as we have worked on this revision.

Shirley Dennis-Escoffier and Karen A. Fortin

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Preface

FOCUS

This text is designed for a one-semester introductory tax course at either the undergraduate or graduate level. It is ideal for an MBA course or any program emphasizing a decision-making approach. This text introduces all tax topics on the CPA exam in only 12 chapters.

COMPREHENSIVE YET CLEAR AND CONCISE

This text covers basic taxation of all taxable entities—individuals, corporations, S corporations, partnerships, and fiduciary entities, emphasizing a balance between concepts and details. Tax concepts and applications are presented in a clear, concise, student-friendly writing style with sufficient technical detail to provide a foundation for future practice in taxation and consulting while not overwhelming the student with seldom-encountered details.

WHAT'S NEW THIS EDITION

This text has been completely updated for all law changes and pronouncements issued through the first four months of 2019. In addition to updating all chapters for these changes, Chapter 1 was modified to better introduce the taxation of corporations and flow-through businesses including an introductory discussion of the qualified business income deduction. Additional details are provided in Chapter 5 regarding reporting on the individual tax return and in Chapter 11 on the returns for the flow-through businesses. Chapter 5 was rewritten and new sample filled-in tax forms have been introduced in this chapter as well as in other several chapters of the text.

TAX PLANNING

TAX PLANNING

The importance of tax planning is emphasized throughout the text. Margin icons are woven into each chapter to highlight planning opportunities. Tax planning strategies are introduced early in Chapter 2 along with the impact of taxes on cash flow.

LEARNING OBJECTIVES

Each chapter begins with learning objectives for that specific chapter as well as a basic introduction to the included topics, emphasizing why decision makers need to understand these topics. Each chapter is organized by learning objective making is easy to identify relevant topics.

SETTING THE STAGE—AN INTRODUCTORY CASE

Each chapter opens with a case that focuses on one or more key issues within the chapter to promote critical analysis and decision-making skills. The case is then revisited at the end of the chapter with a suggested solution to stimulate further class discussion.

EXAMPLES

Rigorous topics are tackled through numerous simple but realistic examples.

Example 1.1

When Alex Rodriguez, the former Texas Rangers shortstop, lived in Texas (a state with no individual income tax), he owed more than $271,000 to California (which assesses a nonresident income tax) for games he played in that state during baseball season. It was estimated that if the Rangers had played all their games at home, A-Rod's state tax bill could have been reduced by more than half a million dollars a year. When A-Rod switched to the New York Yankees, his state and local tax burden increased dramatically. On the $155 million that A-Rod was to be paid over his initial seven-year contract, he was expected to owe $3.57 million to New York City and an additional $6.19 million to the State of New York for income taxes.

KEY CASES

Key Cases bring real world applications into the classroom.

KEY CASES *In 2008, actor Wesley Snipes was sentenced to 3 years in prison for willfully failing to file tax returns for years 1999–2004, a period in which he earned more than $38 million. Following an unsuccessful appeal, he served his sentence in a medium-security prison in Pennsylvania.*

In December 2014, Representative Michael Grimm, who had just been re-elected to his third term in Congress, resigned from Congress after agreeing to plead guilty to felony tax fraud. The indictment alleged that he kept two sets of records for a restaurant he previously owned concealing more than $1 million in gross receipts and underreporting his employees' wages to avoid federal and state taxes. He served 7 months in prison.

EXPANDED TOPICS

The *Expanded Topics* section included at the end of Chapters 3, 4, 6, 11, and 12 contains more advanced topics for instructors who wish to challenge their students. These advanced discussions relate to the other material within the chapters, but which our adopters and reviewers have indicated could be omitted to allow more time for the more critical material.

SUMMARY

Each chapter closes with a *Summary* of the most important topics introduced in the chapter, reinforcing important concepts for students.

KEY TERMS

A list of *Key Terms* is included at the end of each chapter. They appear in bold print and are keyed to the first page on which the term is discussed.

TEST YOURSELF

Each chapter includes a *Test Yourself* section of five multiple-choice questions for students to assess their understanding of topics covered in the chapter. Answers to these questions follow the end-of-chapter materials.

PROBLEM ASSIGNMENTS

More than 60 problems are included at the end of each chapter. *Check Your Understanding* includes a wide variety of noncomputational questions that review the topics included in the chapter. *Crunch the Numbers* presents quantitative problems covering the computational aspects of chapter materials. Comprehensive problems integrate topics covered in several different chapters.

DEVELOP PLANNING SKILLS

Develop Planning Skills problems give students the opportunity to test their knowledge in planning situations. The tax planning suggestions integrated throughout the text continually remind students of the importance of developing appropriate planning strategies.

THINK OUTSIDE THE TEXT

For instructors wishing to challenge their students, *Think Outside the Text* questions develop critical thinking skills by requiring students to expand their thinking beyond the material covered in the chapter.

IDENTIFY THE ISSUES

Identify the Issues includes short scenarios designed to challenge the students to identify issues and formulate research questions. These scenarios, however, do not provide enough information to enable students to develop definitive solutions but are designed to help students practice the issue-identification step in the research process, a step that many new tax students consider the most difficult.

DEVELOP RESEARCH SKILLS

Develop Research Skills requires students to research the relevant authorities and present possible solutions. These can be solved using a subscription-based tax service or free Internet sources. Citations to relevant Internal Revenue Code sections, cases, and rulings are included only in the Instructor's Manual along with solutions to these research problems, allowing each instructor to decide what, if any, hints should be given to students when a problem is assigned.

FILL-IN THE FORMS

Most of the chapters have problems that require completion of one of more tax forms in a *Fill-in the Forms* section. Some of these are very basic and may simply require completion of forms for earlier problems—usually one or two forms—and will assist in familiarizing the student with basic tax forms. There are, however, several chapters that have more comprehensive problems that require completion of a number of forms. These will present a challenge to the student and lend themselves to completion in small groups. These include returns for individuals and the four types of business entities covered. All or parts of these problems may be assigned when the instructor feels the students are ready for additional challenges presented in translating tax knowledge to form completion. The solutions for these problems are only included in the Instructor's Manual.

CHAPTER APPENDICES

End-of-chapter appendices introduce topics not typically covered in a first tax course including corporate reorganizations and taxation of nonprofit entities. These materials are placed in chapter appendices to allow instructors the flexibility to include or omit them as deemed appropriate.

UP-TO-DATE

This text has been completely updated for all recent legislation and for all IRS pronouncements available as of April 2019.

ORGANIZATION

This text is ideal for schools with only one required tax course. Its 12 chapters can be covered in one semester, with time for assessments, eliminating the need to omit chapters. The text emphasizes tax planning to stimulate students' thinking in terms of the effect taxation has on decisions for both individuals and entities.

There are two introductory chapters in Part I. The first chapter includes a brief introduction to the different types of taxes and introduces Adams Smith's Canons of Taxation that can be used throughout the text to evaluate specific tax legislation. To emphasize to students the decision-making focus of this text, the first chapter introduces simple problems on the choice of business entity and provides an easily understood background for the more complex material to follow. The second chapter covers tax compliance issues, an introduction to tax planning, and the basics of tax research. A sample research problem (with sources included in an appendix) is included that can be used to guide students in performing basic tax research at any time during the course.

Part II has three chapters that cover income and expenses, as well as other topics needed for individual return preparation. Chapter 3 answers the question, "What is income?" by exploring the various facets of taxable and nontaxable income for entities as well as individuals. Chapter 4 introduces an example of a dual planning orientation (the two sides to any transaction) with the discussion of employee compensation, a subject often relegated to the end of a text where, unfortunately, many students are never introduced to it. This topic provides an opportunity for students to view transactions from an individual employee's perspective (maximizing employee benefits while minimizing taxable income) and the employer's perspective (designing an optimum compensation plans that combines salary and benefits to attract valuable employees). The chapter provides a broader view of income by including the perspective of the entity making the payments.

Chapter 5 includes deductions for individuals and the additional related information on credits and tax rates necessary to complete an individual tax return. This allows the assignment and completion of basic individual tax returns early in the term.

The focus in Parts III and IV turns primarily to business-related subjects covering general business expenses in Chapter 6 and then capital recovery through depreciation, depletion, and amortization in Chapter 7. Chapters 8 and 9 present discussions of taxable and nontaxable property dispositions, respectively.

With the completion of Chapters 6 through 9, the student is ready to apply the information to the basic business entities starting in Part V with the regular corporation in Chapter 10. The specifics of the sole proprietorship and the basic flow-through entities of partnerships and S corporations and their relationship to their owners are included in Chapter 11.

Part VI includes an introduction to wealth transfer taxes—estate and gift taxes. It also includes a discussion of income taxation of estates and trusts, the tax effects on beneficiaries, and the kiddie tax.

YOUR COURSE YOUR WAY

The organization of the text is designed primarily to respond to our adopters who have indicated that many students' interest in taxation is delayed until they are introduced to the provisions affecting their own current or potential taxation. Chapters 3 through 5 now contain the primary information relevant to individual taxation (excluding property transactions) for instructors who prefer introducing individual taxation prior to taxation of entities. Alternatively, Chapter 3,

selected topics from Chapter 4, and Chapter 6 may be covered in sequence with topics unique to individuals tackled later in the term along with entity taxation. The flexibility of this text makes it easy to change the sequence of chapters as well as the topics within the chapters. Sections of the chapters are easily identifiable allowing instructors to pick and choose those they deem more important for classroom coverage. We have emphasized the readability of the text so that instructors feel comfortable simply assigning sections to be read by students outside of the class while spending their limited classroom time on more complex topics. This text also works particularly well for instructors who use a flipped-classroom approach to their course.

SUPPLEMENTS

Supplements include an author-prepared Solutions Manual, a separate Instructor's Manual with solutions to the Research and Tax Return Problems, an extensive Test Bank, and PowerPoint slides.

COMMENTS AND SUGGESTIONS

We realize that it is almost impossible for a text to be completely free of technical errors or to include every relevant topic. We welcome comments and suggestions on how we can improve the next edition. Please email your comments and suggestions to sdennis@miami.edu.

ACKNOWLEDGMENTS

We wish to acknowledge and thank Saira Fida at the University of Miami for her extensive help in this edition. We are grateful to the entire Wiley team for their assistance.

Shirley Dennis-Escoffier and Karen A. Fortin

About the Authors

Shirley Dennis-Escoffier is an associate professor at the University of Miami, where she teaches both graduate and undergraduate tax classes. She received her Ph.D. from the University of Miami and returned to UM after teaching at the University of Hawaii and California State University in Hayward. She is a Certified Public Accountant licensed to practice in Florida. She is a Past President of the American Taxation Association and remains actively involved in the association receiving the Outstanding Service Award. She is also involved with the American Institute of Certified Public Accountants. She has received several teaching awards including the University of Miami Excellence in Teaching Award and the Masters in Taxation Excellence in Teaching Award. She has published numerous articles in tax and accounting journals and is the recipient of an Ernst and Young Foundation tax research grant.

Karen A. Fortin retired from her position as Professor of Accounting and Taxation at the University of Baltimore, where she had been Department Chair and taught graduate and undergraduate tax classes in both the Business School and the Law School. She received her Ph.D. from the University of South Carolina and held teaching positions at the University of Wisconsin–Milwaukee and the University of Miami. She was a Wisconsin Certified Public Accountant and a recipient of a Sells Award. During her teaching years, she was active in the American Taxation Association and the American Accounting Association as an editor, reviewer, and chairperson for numerous events. As a member of the AICPA she served on several committees and task forces. She has published numerous articles in tax and accounting journals and has co-authored and edited a number of textbooks.

Introduction to Taxation and Its Environment

PART I

CHAPTER 1 An Introduction to Taxation

CHAPTER 2 The Tax Practice Environment

CHAPTER 1 An Introduction to Taxation

CHAPTER OUTLINE

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LEARNING OBJECTIVES

After completing this chapter, you should be able to:

1.1 Explain the basic types of taxes and the bases on which they are levied by various governmental units.

1.2 Compare the effects of progressive, proportional, and regressive tax systems on taxpayers' incomes.

1.3 Explain the characteristics of a good tax system using characteristics of equity, economy, certainty, and convenience.

1.4 Describe the components of the basic income tax model and understand how the tax due is calculated.

1.5 Identify the most common business entities recognized by the U.S. tax system and explain the basic differences in ownership and their effects on entity taxation.

This chapter presents an overview of the types of taxation, key concepts to facilitate understanding taxation, and an introduction to business entities in the United States. The detailed provisions of income tax law follow in subsequent chapters. Similarly, detailed calculations are covered in subsequent chapters as these figures change with each tax year. The focus of this chapter is on developing a broad understanding of how the U.S. income tax system works.

The first section provides background information on the types of taxation (income, consumption, wealth, and wealth transfer taxes). It is followed by a discussion of the effects of various tax rate structures (progressive, proportional, and regressive), examples of each type, and their effects. It ends with a brief description of Adam Smith's Canons of Taxation (equity, economy, certainty, and convenience), which provide the framework for assessing what constitutes a "good" tax.

An introductory discussion of federal income taxation follows and introduces the three types of taxable persons—individuals, C corporations, and fiduciaries—the ultimate payers of all income taxes. The basic tax model is introduced and the concepts of gross income, taxable income, tax rates, gross tax liability, and tax credits are presented in the context of the tax model.

The final section discusses business entities and how they are subject to federal income taxes (sole proprietorships, partnerships, C corporations, and S corporations). The individual owner of a sole proprietorship is taxed on the business's income. Partnerships and S corporations are conduit or flow-through entities that pass their income (and loss) items through to their owners for taxation at the owner level. A C corporation's

income is subject to double taxation, first at the entity level by the corporate income tax and then a second time when distributed to shareholders as dividends. A table comparing the basic attributes of each of these entities completes this chapter.

SETTING THE STAGE—AN INTRODUCTORY CASE

Wing Hue, an engineer from China with U.S. residency status, recently obtained permanent employment with a U.S. consulting firm. Before coming to the United States, Hue developed a totally new system of gears for bicycles. He obtained a patent on his gear design and plans to solicit several venture capitalists for funds to begin manufacturing and marketing the gears as a venture separate from his consulting work. He believes his gear design would be attractive to both bicycle manufacturers and repair shops as replacements for existing gears.

As a student in China, Hue never had sufficient income to pay taxes. He understands that as a U.S. resident, he is subject to a variety of taxes. He is particularly interested in how his gear manufacturing enterprise will be taxed. He asks you for a brief explanation of the potential taxes that he faces as an employee and as an entrepreneur. We will return to this case at the end of this chapter.

1.1 AN INTRODUCTION TO TAXES

1.1.1 WHAT IS A TAX?

A tax is a forced payment (meaning required by the law and is not voluntary) to a governmental unit that is unrelated to the value of goods or services received. Failure to collect and remit taxes to the appropriate governmental unit, subjects the responsible persons to civil, or even criminal, penalties.

One tax that is familiar to most U.S. citizens is the federal income tax (for individuals, this includes filing Form 1040). The individual calculates his or her taxable income and tax liability to report in a specific tax year. The income taxes are then remitted to the federal government, and possibly state and/or local governments, by a date specified by the taxing authority.[1]

Two more familiar taxes are sales taxes and real property taxes. Many states (and other smaller governmental units) require the sellers of certain consumer goods or services to collect sales taxes on these purchases. The owners of real property are responsible for property taxes levied annually by the local government, based on the assessed value on that property. A bill is sent to the owner for these property taxes and, if unpaid, the government may seize the property.

There are hidden taxes as well. Hidden taxes are those taxes paid on a taxable purchase but not specifically itemized as part of the purchase price. For example, in the price of gasoline there are significant taxes imbedded in the pump price. This is also true for cigarettes and alcoholic beverages. Nevertheless, if we want that particular good (legally, that is), we pay the hidden tax.

Remember, taxes are often called forced extractions. You must pay them to the government, but you may have no direct benefit from them. This is in contrast to a garbage collection fee (where the payment is in exchange for the service). Although we may benefit from governmental activities paid for by taxes, they are not levied as a payment for the goods or services. For example, property taxes to support local schools are based on the value of the property owned. They are unrelated to the owner's school-age children (if any) who benefit from free public education.

[1] Individuals are assessed federal income taxes only if their income exceeds their allowable deductions (including their standard or itemized deductions).

Our current income tax system is complex. Its primary goal is no longer to meet the revenue needs of the government's basic functions, but has evolved into an engine that fosters the economic and social goals lawmakers deem appropriate. As our government has grown, so have the laws governing the determination of taxable income and taxes owed. Although there have been many calls for simplifying the tax system, it is necessary to have a basic understanding of the current tax system and its potential alternatives, before developing a new tax system to either replace or supplement the current federal system.

To begin this introductory study of the income tax system, certain basic tax concepts, alternative types of taxes, and the types of tax rates that can be applied to a taxable base are introduced. Adam Smith's canons of taxation, developed many years ago, provide a foundation for assessing whether a tax is indeed a good tax. Once an understanding of these concepts is integrated with an understanding of the current income tax laws, one can intelligently participate in discussions about reforming our current tax system.

While embarking on this journey to understand taxation, remember to ask a few questions: (1) Which taxing authority is requiring the tax collection? (2) Which person or business entity is being subject to the taxation? (3) Which income is included as taxable (and when)? (4) Which expenses are deductible for tax purposes (and when)?

1.1.2 EVOLUTION OF THE FEDERAL INCOME TAX

The federal income tax is the most significant tax assessed by the U.S. government. The initially simple concept of taxing income expanded over the years into an exceedingly complicated system. During the Civil War there was a federal income tax, however, the federal income tax system as we know it today began in 1913 when the 16th Amendment to the U.S. Constitution was ratified. The 16th Amendment gave Congress the power to lay and collect taxes "on income, from whatever source derived," without the previous requirement that all direct taxes be imposed based on population. This first federal income tax law enacted in 1913 consisted of only 16 pages and required only a simple individual income tax return.

Each time the income tax statutes were revised between 1913 and 1939, an entire set of new provisions replaced the existing law. In 1939 this procedure changed, and the income tax laws were codified as the **Internal Revenue Code**. Amendments and revisions were then made to the specific sections of the Code, rather than replacing the old law with an entirely new set of statutes.

In 1954, there was another major overhaul of the tax laws. In this 1954 recodification, the income, estate, gift, and excise tax laws were incorporated into the *Internal Revenue Code of 1954*. There were many significant tax law changes between then and 1986, each amending the *Internal Revenue Code of 1954*. Because the Tax Reform Act of 1986 was so extensive, the Code was renamed the *Internal Revenue Code of 1986*. Any current changes to the tax laws are now amendments to the *Internal Revenue Code of 1986*.

A number of factors influence the federal tax laws, but similar to all law, probably the makeup of Congress is the most important. Democratic and Republican Parties disagree on how to best serve the public interest. Additional initiatives are from lobbyists trying to influence representatives and senators to sponsor or vote for legislation favorable to their particular industries. Accomplishing the particular interests of each elected representative leads to rather strange results. For example, the federal government successfully sued the tobacco industry for the harm done by cigarette smoking while maintaining subsidy programs for tobacco farmers.

This industry influence is generally manifested in two ways. First, industries contribute substantial monies to election campaigns, pouring the greatest amount of money into the campaigns of persons they believe will support their positions—incumbent or not. Second, many

lobbyists and political action committees (PACs) have extremely large staffs available to research various technical issues. They can funnel this research, often slanted in their desired direction, to the various members of Congress. It is not unusual for a lobbyist to have provided the basic text of a tax law introduced in Congress.

The attempt to satisfy the many constituencies of our elected representatives has led to a collection of tax laws that have become more and more complex. This has significantly increased the compliance burden on taxpayers as well as Internal Revenue Service (IRS) administration. In spite of many calls for simplification, Congress continues to pass additional tax provisions, adding complexity to the system, without revisiting or deleting existing provisions.

Both political parties provide tax breaks to their constituents referred to as **tax expenditures**. Tax expenditures can take the form of special exclusions, deductions, credits or preferential rates for specific activities. These tax expenditures result in a reduction in the revenue that would be collected under a more comprehensive income tax. Although many of these tax expenditures are viewed positively because they can stimulate the economy, the dispute among politicians is usually over how to pay for them. They can usually be paid for in one of three ways: (1) reducing spending, (2) adding to the budget deficit, or (3) raising other tax revenue to offset the cost of the tax expenditures. Although politicians say they want to cut spending, they have been very ineffective in doing so. They usually add to the budget deficit or increase taxes. This dilemma has led to an alternative way to minimize the cost of tax expenditures by making them temporary rather than permanent. A tax expenditure expected to expire in only a few years, needs to raise far less revenue to pay for it than making the expenditure permanent. Unfortunately, the uncertainly surrounding the extension of some of these provisions makes tax planning difficult so that much of any expected economic stimulus is negated by this uncertainly.

The elections in November 2016 gave the Republican Party control of the House of Representatives, the Senate, and the White House. This gave them their best opportunity in some time to enact change. In December 2017, Congress passed the Tax Cuts and Jobs Act which permanently reduced corporate tax rates from a high of 35 percent to a flat rate of 21 percent. Individual tax rates were also slightly reduced, but only temporarily. These cuts were paid for by placing new limits on some deductions, completely eliminating other deductions, and adding over $1.4 trillion to the budget deficit. The legislative process through which tax proposals become law is discussed in the next chapter.

Although this text is primarily about the federal income tax, a basic understanding of other taxes will be helpful before we begin exploring the federal income tax in more detail.

1.1.3 STATE AND LOCAL INCOME TAXES

While most students are aware of the federal income tax, not all are familiar with state and local income taxes. The increasing importance of these taxes is reflected in the growth of state and local tax (SALT) practices in public accounting. Most states (and some local governments) impose corporate and/or personal (individual) income taxes on both residents and nonresidents.[2] States, however, normally tax nonresidents only on income from business activities or property located within that state.

[2] States not imposing a corporate income tax or other form of business tax include Nevada, South Dakota, and Wyoming. States that do not impose individual incomes taxes are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Additionally, some states only tax certain types of interest and dividend income.

Example 1.1

When Alex Rodriguez, the former Texas Rangers shortstop, lived in Texas (a state with no individual income tax), he owed more than $271,000 to California (for nonresident income tax) for games he played there during baseball season. It was estimated that if the Rangers had played all their games at home, A-Rod's state tax bill would have been reduced by more than half a million dollars a year.[3] When A-Rod became a New York Yankee, his state and local tax burden increased dramatically. On the $155 million that A-Rod was to be paid over his initial seven-year contract, he was expected to owe $3.57 million to New York City and an additional $6.19 million to the State of New York for income taxes.[4]

The state in which a corporation is organized has the right to impose an income tax on that corporation under the residency principle. Alternatively, the source principle allows taxation of a business that has an economic connection to a state (derives income from assets or activities located within a state).

When a resident corporation of one state derives income from business activities in another state, double taxation could result. To minimize this, states that levy an income tax on its resident businesses usually allow them to claim a credit for some or all of the income taxes paid to other states. Historically, the type and degree of connection between a business and a state necessary for the state to impose a tax is referred to as **nexus**.

Example 1.2

Corian Corporation manufactures equipment for sale nationwide. Corian's corporate headquarters and production facilities are located in Florida. Corian has regional sales offices in New York, Illinois, and California. Corian has nexus in Florida, New York, Illinois, and California due to the presence of employees and business property in those states.

In place of the income tax, some states impose a **franchise tax**. A franchise tax is an excise tax based on the right to do business or own property in the state. Whether the tax is called an income tax or a franchise tax, the tax is usually determined based on corporate income.[5]

Most states piggyback their computation of state taxable income on the federal income tax system by beginning with individual or corporate federal taxable income. Piggybacking on the federal system is particularly problematical, however, when Congress amends the tax law resulting in reduced taxable income (for example, by increasing or accelerating deductions). To minimize the potential impact on state tax revenues, many states adopt a fixed version of federal tax law by computing state taxable income as determined under the federal tax rules in effect as of a specific date. This allows state legislatures time to study the impact of changes on state revenue before adopting them. Although most states eventually adopt the federal changes, considerable delays are common.

When a corporation has nexus in several states, each state taxes only a percentage of the corporation's income based on the business allocated to that state. Although computations differ from state to state, many states use a three-factor allocation formula based on sales, payroll costs, and tangible property. Some states place more weight on the sales factor, while others weigh these factors equally.[6]

[3] Mark Hyman, "Why the 'Jock Tax' Doesn't Play Fair," Business Week, July 7, 2003, p. 37.
[4] Dan Kadison, "$10M is Ballpark for Taxman," The New York Post, February 17, 2004, p. 4.
[5] A few states impose their franchise tax on a corporation's stock value or net worth, either in addition to or instead of a tax on corporate income if it results in a higher tax.
[6] Because of the variation in allocation formulas between states, some corporations may have more than 100 percent of their total taxable income subject to state income taxes.

Example 1.3

Southeastern Corporation does business and has nexus in States X and Y. Its sales, payroll costs, and tangible property located in each state are:

	Sales	Payroll	Property
State X	$800,000	$315,000	$540,000
State Y	800,000	135,000	360,000
Total	$1,600,000	$450,000	$900,000

Based on these dollar figures, the percentages for the three factors are as follows:[7]

	Sales	Payroll	Property	Total
State X	50%	70%	60%	180%
State Y	50%	30%	40%	120%
Total	100%	100%	100%	

If each factor is weighted equally, the apportionment formula computes the average of the three factors so that the apportionment percentage for State X is 60 percent (180%/3) and the apportionment percentage for State Y is 40 percent (120%/3). Southeastern Corporation allocates 60 percent of its income to State X and 40 percent to State Y.

Nonbusiness income, such as interest, dividends, rent and royalties, is taxed in only one state—the state in which the corporation is domiciled or the state in which the underlying property is located or used.[8]

Income tax planning for multistate corporations usually involves shifting income from high-tax states to low-tax states by shifting assets from one state to another or by outsourcing some functions to eliminate or move nexus from a particular state. Businesses that are expanding or relocating facilities should measure the impact this will have on the amount of income apportioned to the state. For example, a corporation with plans to expand its facilities should avoid a high tax-rate state that uses an apportionment formula that weights property and payroll factors more heavily. The expansion of plant and the addition of employees can increase the percentage of total income subject to state tax.

1.1.4 EMPLOYMENT TAXES

Employment taxes include those specified under the Federal Insurance Contributions Act (FICA) along with federal and state unemployment taxes. The **FICA tax** has two components: Social Security and Medicare. Social Security pays monthly retirement benefits (also survivor and disability benefits) to qualified individuals. The 6.2 percent Social Security tax applies to salaries and wages up to an annual maximum of $132,900 for 2019 ($128,400 for 2018). The Medicare tax pays for medical insurance for individuals who are elderly or disabled. The 1.45 percent Medicare portion of the FICA tax applies to all salary and wages without limit. Thus, an employer pays 7.65 percent FICA tax on each employee's wages up to $132,900 and 1.45 percent on compensation above $132,900.

[7] The percentage for each factor is determined by dividing the dollar amount of the item attributable to that state by the total dollar amount for that factor. For example, payroll for State X is $315,000. Dividing $315,000 by the total payroll costs of $450,000 means 70 percent of all payroll costs were incurred in State X.

[8] The corporation's domicile is the principal place from which the business is managed or directed, not necessarily the state of incorporation.

In addition to the employer FICA tax, employees pay a matching FICA tax. Employers withhold the employee portion of the FICA tax from the employee's salary or wages and forward it to the federal government (along with any income tax withheld).

Example 1.4

Maria is an employee of Marlin Corporation. In 2019, Maria received a salary of $135,000. Marlin Corporation paid a Social Security tax of $8,239.80 ($132,900 limit x 6.2%) plus a Medicare tax of $1,957.50 ($135,000 × 1.45%) for a total FICA tax of $10,197.30. Marlin Corporation withheld $8,239.80 from Maria's pay for her share of Social Security tax and $1,957.50 for her Medicare tax. Marlin Corporation also withheld income tax based on Maria's W-4 form that indicated her filing status (single). Marlin Corporation forwards both the employer's and employee's share of FICA tax to the federal government, as well as any income tax withheld for Maria.

Remember, payroll tax and federal income tax are two separate taxes. When Marlin Corporation calculates its federal income tax liability, the corporation will deduct payroll taxes it paid for all employees (for Maria the amount is $10,197.30). This payroll tax expense is an ordinary and necessary business expense that reduces taxable income for the corporation when calculating its federal income tax liability.

Self-employed individuals (such as independent contractors, sole proprietors and partners) must pay the self-employment tax that includes both the employer and employee share of FICA tax, as discussed in detail in Chapter 4. Similarly, a deduction that is an adjustment to income will be discussed in detail which provides self-employed individuals a similar deduction to the corporate payroll tax expense deduction (i.e., Marlin Corporation's deduction for payroll taxes paid for all employees in the example above).

In addition to FICA taxes, employers are also required to pay federal and state unemployment taxes. These taxes fund temporary unemployment benefits for employees terminated from their jobs without cause. The rate under the Federal Unemployment Tax Act (FUTA) is 6 percent on the first $7,000 of wages. The state rates vary widely but the federal government allows a credit of up to 5.4 percent for state unemployment taxes the employer pays. Unemployment taxes are usually only paid by the employer and not the employee. Self-employed individuals are not eligible to collect unemployment benefits so they do not pay unemployment taxes for themselves; they pay unemployment taxes only for their employees.

1.1.5 WEALTH TAXES

Wealth taxes are based on the taxable entity's total wealth or the value of specific types of property. The most common wealth tax is the **real property tax**. This **ad valorem** tax is levied on individuals and businesses that own real property—land and buildings—and is assessed on the fair market value of the property. Local taxing jurisdictions rely heavily on the real property tax for the support of schools, police and fire protection, and other services furnished by the local municipality. The federal government generally does not levy any form of wealth tax, leaving the various forms of wealth taxes to the state or local governments.

To determine the rate at which the real property taxes will be levied, the municipality "works backward." The total budget is determined along with the total assessed valuation for all property subject to the tax. A mill levy (a "mill" is one-tenth of one cent) is then determined based on the total assessed value of the property to raise the revenue required by the budget. The mill levy is applied to each individual property within the district to determine its separate property tax.

Example 1.5

A municipality's budget is $1,000,000 and the total assessed value of all the property subject to the property tax is $200,000,000. To raise the required $1,000,000, a five-mill levy is required per $1 of assessed value ($1,000,000/$200,000,000 = $.005). When this mill levy is applied to a piece of property with an assessed value of $100,000, the owner would pay $500 ($.005 × $100,000) in real property taxes.

Other forms of wealth taxes include the personal property tax, the tangible property tax, and the intangible property tax. These taxes are collected annually on property owned as of a certain date based on a predetermined fixed rate applied to the fair market value of the property. Personal property or tangible property taxes are more likely to be levied on the value of a business's inventory and/or operating assets. Individuals may not always escape this tax, however, as a number of states base a part of the cost of obtaining automobile registrations or license plates on the value of the auto as an ad valorem tax.

Some states levy intangible taxes on the value of receivables, stocks, bonds, and other forms of investment instruments owned by businesses and individuals. Intangible taxes are based on a fixed tax rate times the fair market value of the intangible assets owned as of a specific date.

Two major problems related to wealth taxes have lessened government reliance on them as a source of revenue: the difficulty in establishing fair market value annually and the taxpayer's ability to "hide" personal property. The market value of many types of personal property (tangible or intangible) is not verifiable, leading to significant undervaluation by taxpayers. Moreover, the government may not know who owns a specific asset unless there is a way to trace or detect ownership. Thus, most local governments rely heavily on real property taxes rather than other types of personal property taxes, as real estate is much harder to hide. Through the assessment system, taxes are thought to be levied on a more uniform basis across the value of the properties.[9]

Based on ability to pay, wealth taxes would seem to be a sound source of tax revenue. Many items, however, such as a personal residence, do not produce direct income, and the owner may have little or no disposable income with which to pay the tax—a major problem for the elderly or others on fixed incomes when real property taxes increase.

1.1.6 WEALTH TRANSFER TAXES

Wealth transfer taxes are levied when all or part of an individual's wealth is transferred to another person. Since 1916, the United States has had an **estate tax**, a wealth transfer tax that applies to transfers of property as a result of the owner's death. A second wealth transfer tax, the **gift tax**, was enacted in 1932. The gift tax is imposed on a donor who makes a gratuitous lifetime transfer of property.[10] To avoid double taxation on these transfers, the recipient is not subject to income tax on inherited property or property received as a gift.

Since 1976, the federal estate and gift taxes have been unified. Gift transfer taxes are levied based on a person's transfers during his or her lifetime with the final estate tax based on transfers at death. The tax is assessed on the fair market value of the property transferred.

A tax liability may be avoided if the gift is less than the *annual* exclusion ($15,000 per recipient per year in 2019 and 2018) or if the taxpayer uses their lifetime credit to offset the tax liability (equivalent to the tax on $11.4 million in 2019). Additionally, unlimited transfers to a spouse and qualified charities (during lifetime and at death) escape taxation.

The purpose of the annual gift exclusion is to ease the administrative burden as it prevents smaller gifts from being subject to the transfer tax (and does not result in a gift tax return filing requirement).[11] The unified gift and estate *lifetime* credit assures that a certain base amount

[9] Ideally, there would be an annual valuation process, but in reality, property assessments may increase or decrease based on indices only, or are otherwise revised only when a property is sold.
[10] Chapter 12 contains a more detailed discussion of wealth transfer taxes.
[11] If a taxpayer's annual gifts to an individual recipient do not exceed $15,000, the donor is not required to file a gift tax return.

of wealth can be transferred to others (including children, grandchildren, other relatives, and friends) through lifetime gifts or transfers at death free of a transfer tax.

Example 1.6

In 2019, Marleen gave $50,000 to a qualified charity. She also gave each of her five grandchildren 700 shares of stock valued at $10,000 on their birthdays. The charitable gift is not subject to the gift tax. The birthday gifts are also free of the gift tax (and Marleen does not have to file a gift tax return) as they do not exceed each grandchild's $15,000 annual gift tax exclusion.

If Marleen gives an additional $10,000 to each grandchild this year, she now exceeds the annual gift exclusion ($10,000 + $10,000 − $15,000 = $5,000 taxable gift to each) and would have to file a gift tax return for 2019. This notifies the government that she is using some of her lifetime unified credit. However, assuming she has not exhausted her lifetime unified credit, no tax is due. Marleen's gifts remain free of any gift tax until her total taxable gifts exhaust her unified credit that is equal to the tax on total taxable gifts over her lifetime of $11.4 million (the 2019 lifetime exclusion).

The grandchildren have no tax consequences on the receipt of the gifts because gifts are not subject to income taxes. They will, however, be subject to income tax on future dividends received or realized gains on any stock sales.

With the integration of the gift and estate taxes, any unified credit not used for lifetime gifts can be used for transfers made by the decedent's estate. Thus, the decedent's estate escapes taxation unless his or her total lifetime taxable gifts plus taxable transfers at death exceed the lifetime exclusion.[12]

A number of states levy inheritance taxes rather than estate taxes. The inheritance tax is based on a person's right to receive property upon the death of another. The tax rates and amount excluded from taxation vary with the relationship of the heir to the decedent and the value of the property received. The estate normally pays the inheritance tax, but the tax paid reduces the total value of the property transferred to the heir. In addition to an inheritance or estate tax, many states also levy a gift tax.

1.1.7 CONSUMPTION TAXES

Consumption taxes may take many forms, but the **sales tax** is the most common form in the United States. Most states levy sales taxes on some or all of the goods and services purchased, although certain items considered necessities may be exempt from tax. For example, food, clothing, prescriptions, and many services may be excluded from the sales tax while items not considered necessities such as restaurant meals, rental cars, and hotel rooms are taxed. Purchases of inventory for resale are usually exempt from sales tax because the inventory will be taxed when sold; however, purchases for use in a business are taxable as a final sale.

The retailer is responsible for collecting and remitting sales taxes to the appropriate state and local tax authority. Because the determination of items subject to sales tax varies greatly from state to state, multistate retailers must determine not only the appropriate sales tax rates (which may vary within a zip code due to local sales taxes) but also determine which items are subject to tax in each location.

The concept of nexus is also important in determining the sales tax, as it is for an income tax. The exact definition for sales tax nexus may differ from that of income tax nexus. A business may have nexus in a state for sales taxes but not for income taxes or vice versa. For example,

[12] The lifetime exclusion for taxable transfers is $11,400,000 for 2019 ($11,180,000 for 2018 and $5,490,000 for 2017). Chapter 12 has a more complete discussion of the annual and lifetime exclusions for taxable transfers.

employees from out-of-state who solicit sales within a state may create sales tax nexus but not income tax nexus.

Historically, case law did not permit a state to collect sales tax unless it had a physical presence in the state (which generally meant the business had property or employees in the state). However, as businesses evolve so must the laws that regulate them.

KEY CASE *Wayfair, Inc. recently challenged a new law in South Dakota based on the legal precedent from two prior cases. Under National Bellas Hess, Inc. v. Department of Revenue of Ill. (386 U. S. 753) and Quill Corp. v. North Dakota (504 U. S. 298) South Dakota may not require a business that has no physical presence in the state to collect its sales tax. Consumer compliance rates are notoriously low, however, and it is estimated that Bellas Hess and Quill cause South Dakota to lose between $48 and $58 million annually. Thus, South Dakota Legislature enacted a law requiring out-of-state sellers to collect and remit sales tax "as if the seller had a physical presence in the state." The Act covers only sellers that, on an annual basis, deliver more than $100,000 of goods or services into the state or engage in 200 or more separate transactions for the delivery of goods or services into the state. Wayfair, Inc. challenged the new law and lost. In June 2018, the Supreme Court upheld the law with its decision in South Dakota v. Wayfair, Inc. (138 S. Ct. 2080), changing the e-commerce landscape. The precedent set by this decision is that a state may now require a business to collect sales tax even if that business does not have a physical presence in that state (overruling the physical presence requirement which generally meant the business had property or employees in the state).*

Other states are now in the process of establishing new laws as a result of this decision to generate tax revenues from online retailers that do not have a physical presence in their state, but do meet a requirement set by that state.

Each state that imposes a sales tax also imposes a companion use tax. A **use tax** is imposed on property to be used in one state but purchased in another state if no sales tax was paid in the state of purchase. A use tax is self-assessed and usually at the same rate as the sales tax. Without a use tax, there is an incentive to purchase from out-of-state businesses not required to collect a state sales tax to the detriment of in-state businesses.

Example 1.7

JX Corporation operates in a state with a 6 percent sales and use tax. JX purchases office supplies over the Internet from an out-of-state supplier for $2,000. JX pays no sales tax. If JX purchased these supplies from the local office supply store, it would have to pay a sales tax of $120 ($2,000 × 6%). JX should file a use tax return and pay the $120 use tax to its state because the supplies will be used within the state.

Most states have difficulty collecting use taxes from individuals (except for automobiles that require registration with the state). Collection from businesses is much easier to enforce because most states regularly audit in-state businesses for compliance with sales and use tax laws.

One benefit of a consumption tax like the sales tax is that it encourages savings—considered a necessity for continued investment and economic growth. A person can avoid the sales tax by not purchasing certain goods for consumption; income that is not consumed is available for savings. The income tax not only taxes income whether consumed or saved, but taxes the income earned on savings, further discouraging savings.

Other types of consumption taxes include excise taxes, value-added taxes, and turnover taxes—although only the excise tax is in common use in this country. An excise tax is another form of sales tax and the only sales tax levied by the federal government. Excises are generally

levied on taxable goods for which there is a low elasticity of demand or on goods whose use the government wishes to discourage, such as tobacco products and alcoholic beverages. This latter group of excises is generally referred to as "sin" taxes.[13] Other excises offset some of the costs incurred by the government for certain services, for example, the tax on airline tickets helps pay for the system of air traffic controllers.

The **value-added tax (VAT)**, in use in most of the developed countries of the world, has not been adopted in the United States. It is a type of sales tax that is added to a product or service based on the value added at specific points in the production or service process. Although there are several methods for calculating the value-added tax, it basically works as described in the following example.

Example 1.8

A business buys parts to manufacture a widget. The parts cost $400, to which a 10 percent value-added tax is added by the seller—a total cost of $440. The business assembles the parts into a widget and sells the assembled widget for $800 plus a 10 percent value-added tax of $80—the purchaser's total purchase price is $880. The business, however, remits only $40 of the tax to the government—the total $80 VAT less a credit for the $40 VAT paid to the supplier of the purchased parts. The government collects the other $40 from the parts supplier. The consumer pays the full tax on the product to the last business in the business chain. The tax collected at each step is based on the difference in the price paid for the goods coming in and the price received when leaving.

Some features of a VAT differentiate it from a sales tax. First, it is generally included directly in the selling price at the consumer level. Second, the VAT is not levied on goods exported to other countries. Businesses that export goods to other countries receive refunds of the VAT paid on exported goods. When the United States exports goods to a foreign country in competition with another exporting country that levies a value-added tax (instead of a corporate income tax), the United States may be at a competitive disadvantage. All other costs being equal, the U.S. firm will have to charge more than the other exporter to make the same profit because it receives no rebate of income taxes while the foreign exporter receives a rebate of its value-added taxes.[14]

The turnover tax, another consumption tax, is a sales tax levied at each step of a business chain—both wholesale and retail—but with no rebates or credits for prior taxes paid. Thus, if one firm handles all the steps in a manufacturing process from raw materials to finished goods, the tax is levied only once, when the product is sold to the consumer. If, however, that same product's manufacturing process is handled by two or three firms, the tax is levied and collected each time the items move from one manufacturer to the other—driving up its costs relative to the manufacturer that is able to complete the various manufacturing steps.

1.1.8 TARIFFS AND DUTIES

Tariffs are taxes levied on goods and materials brought into a country, usually for one of two reasons: (1) A foreign business sells goods to the purchasers in the destination country at prices that may be below production costs in an attempt to capture a market and put the local operations out

[13] The indirect costs incurred from the consumption of these products must be borne by the government; that is, treating persons for lung cancer and alcoholism is the justification for taxing these products at rates that are designed to discourage their use.

[14] Foreign firms that sell goods within the United States may be subject to U.S. income taxes, but they may be levied at rates significantly different from those faced by comparable U.S. firms. Taxation of foreign corporations is discussed in Chapter 3.

of business. (2) A local business's operating costs are higher than those costs for the same product produced in the foreign jurisdiction.[15]

Import duties are similar to tariffs as they are taxes on goods brought into a country and levied by the destination country. When persons travel abroad, they are permitted to purchase a certain amount of goods and bring them back "duty free." When the duty-free allowance is exceeded, the government levies a tax on the excess. This encourages the purchase of goods at home by making imported goods more expensive. Export duties are taxes levied on goods that are leaving the country of origin. These taxes discourage producers from selling their goods abroad by making them more expensive. In this way, they are available for purchase in the country of origin at lower prices.

1.2 TYPES OF TAX RATE SYSTEMS

1.2.1 THE PROGRESSIVE TAX RATE SYSTEM

The current federal income tax system is a **progressive tax system**—one in which the tax rates increase as income increases. The system is based on the belief that taxpayers with higher levels of income should pay a greater proportion of the taxes necessary to support the government. This is known as the "ability to pay" or the "wherewithal to pay" concept.

The U.S. income tax rate structure has always been progressive with initial rates in 1913 of 1 percent to 7 percent. In 1945, to fund the war, the top rate increased to 94 percent.[16] In 1985, there were 15 tax brackets from a low of 11 percent to a high of 50 percent. In an attempt to simplify the tax system, the Tax Reform Act of 1986 drastically reduced the number of brackets as well as the rates. However, the top rate and the number of rates have continued to change either to raise revenue to balance the budget or to provide a tax cut when budget surpluses were predicted.

The current federal tax rates for individuals range from 10 percent to 37 percent. The range of income subject to a specific tax rate is known as a tax bracket. As the taxpayers' income exceeds a specific bracket, income within that next bracket is subject to the increased percentage rate. This percentage is referred to as the marginal tax rate and is discussed in more detail later in this chapter.

Table 1.1 shows the tax rates on ordinary income for single individuals and married couples filing a joint return for 2019. The brackets to which these rates apply are adjusted annually for inflation.

Table 1.1 Ordinary Income Tax Rates for 2019

Tax rates	Taxable income for single individuals	Taxable income for married filing a joint return
10%	$0–$9,700	$0–$19,400
12%	$9,701–$39,475	$19,401–$78,950
22%	$39,476–$84,200	$78,951–$168,400
24%	$84,201–$160,725	$168,401–$321,450
32%	$160,726–$204,100	$321,451–$408,200
35%	$204,101–$510,300	$408,201–$612,350
37%	Over $510,300	Over $612,350

As an individual's income increases through this progressive tax rate schedule, the lower tax rates continue to apply to the amount of income in each of the lower tax brackets. As a result,

[15] The tariffs on foreign steel are examples of taxes levied because of the concern that foreign countries were "dumping" steel here at prices below their costs.

[16] See www.taxpolicycenter.org/statistics/historical-top-tax-rate.

the first $9,700 of income of all single individuals is taxed at only the 10 percent rate—even individuals whose total taxable income exceeds $1 million.

Two types of income are subject to lower tax rates: dividend income and long-term capital gains. Dividend income is taxed at a lower rate because a corporation pays tax on earned income but is not allowed a deduction for dividends paid to its shareholders. Shareholders' dividend income is effectively subject to a second tax at the shareholder level. To minimize the impact of this double taxation, the dividend income of individual shareholders is taxed at lower tax rates as shown in Table 1.2.

Table 1.2 2019 Tax Rates for Dividend Income and Long-term Capital Gains

Tax rates for dividend income and long-term capital gains	Taxable income for single individuals	Taxable income for married filing a joint return
0%	$0–$39,375	$0–$78,750
15%	$39,376–$434,550	$78,751–$488,850
20%	Over $434,550	Over $488,850

To encourage long-term investment, individuals owning investments (such as stock) for more than 12 months are taxed at lower rates when sold. Table 1.2 provides the long-term capital gain tax rates which are the same rates that apply to dividend income. Short-term capital gains (those that do not meet the more-than-one-year holding period) are taxed at an individual's ordinary income tax rate.

Prior to 2018, corporations also faced progressive tax rates consisting of four nominal tax rates of 15%, 25%, 34% and 35% and two surtaxes applied at different income levels. Corporations also had no special long-term capital gains tax rates; their capital gains were taxed using the same rates as their ordinary income. Since 2018, corporations pay a flat tax rate of 21 percent on all taxable income.

There are several other important tax rate concepts in a progressive tax rate system. An **average tax rate** is determined by dividing the taxpayer's tax liability by taxable income. For example, a single individual with $250,000 of taxable income and a tax liability of $62,694 pays a 35 percent tax rate on the last $45,900 of income above the $204,100 starting point for the 35 percent tax bracket but has an average tax rate of only 25.08 percent ($62,694/$250,000). In highlighting the tax effects on different groups of taxpayers, the average tax rate is often used to compare the percentage of taxes paid on taxable earned income.

The **marginal tax rate** is the tax rate that applies to the next dollar of taxable income (or deduction).

Example 1.9

Sarah is single with taxable income of $120,000 that puts her in the 24 percent marginal tax bracket. If she earns an additional $10,000 in ordinary income, her taxable income increases to $130,000 and she will pay an additional $2,400 ($10,000 × 24% marginal tax rate) in income tax. If, instead, she has $10,000 of additional deductions, her taxable income decreases to $110,000, she will save $2,400 in income taxes.

As a taxpayer moves from one tax bracket to another, the marginal tax rate moves from one rate to the next. For decision purposes, the marginal tax rate is the most relevant rate for tax planning. Basic tax planning strategies that use the marginal tax rate are discussed in Chapter 2.[17]

[17] A third tax rate, the effective tax rate, divides the taxes paid by an individual's economic income (both taxable and nontaxable).

In a progressive individual income tax system, the marginal tax rate is always higher than the average tax rate. The average rate may approach the highest marginal rate, but there is always some income that was taxed at a lower rate preventing the average rate from equaling the marginal rate for individuals.

1.2.2 PROPORTIONAL "FLAT" TAX RATE

One alternative to a progressive system of taxation is a proportional or flat tax system. A **proportional tax system** requires all income to be taxed at the same rate regardless of the amount or type of the taxpayer's income. Thus, marginal and average tax rates would be identical over all ranges of income.

Since 2018, corporations are taxed at a flat rate of 21 percent on their taxable income. The state sales tax is another common example of a proportional tax; the tax paid is a fixed percentage of the amount spent.

1.2.3 REGRESSIVE TAXES

A **regressive tax system** is one in which taxpayers pay a decreasing proportion of their income as their incomes increase. As the taxpayer's income goes from one bracket to another, his or her average tax on total income decreases, as does the marginal tax rate.

The only regressive taxes that taxpayers are subject to at the federal level are FICA and unemployment taxes. The 6.2 percent Social Security portion of the FICA tax only applies to salaries and wages up to a maximum of $132,900.[18] The 1.45 percent Medicare portion of the FICA tax applies to all salary and wages without limit and is a proportional tax.[19] As a taxpayer's salary or wage exceeds the Social Security maximum, the rate drops to 0 (zero) percent for additional wages and the 6.2 percent average tax rate begins to decrease for an employee as shown below:

Wages	Social security tax @ 6.2%	Average %
$75,000	$4,650.00	6.2%
$200,000	$8,239.80	4.1%

The Medicare portion, however, is proportional.

Wages	Medicare tax @ 1.45%	Average %
$75,000	$1,087.50	1.45%
$200,000	$2,900.00	1.45%

The FUTA tax also is regressive because the unemployment rate of 6 percent only applies to the first $7,000 of an employee's wages. When the employee's wages exceed this amount, no further unemployment taxes are collected and the average rate falls below 6 percent, similar to the average Social Security portion of the FICA tax rate.

[18] The ceiling was $128,400 for 2018, $127,200 for 2017 and $118,500 for 2016.

[19] Employers also pay FICA taxes in addition to that withheld from employees so that the total Social Security rate is 12.4 percent (6.2% employer rate + 6.2% employee rate) and the Medicare rate is 2.9 percent (1.45% × 2). Self-employed individuals, however, must pay both the employer's and employee's share (referred to as the self-employment tax), resulting in a combined rate of 15.3 percent on the first $132,900 of self-employment income and 2.9 percent on the excess. An additional 0.9 percent Medicare surtax is only assessed on the taxpayer and not assessed on businesses. The detailed computations of the additional Medicare surtax are discussed in Chapter 5.

1.3 CHARACTERISTICS OF A GOOD TAX

Raising revenue is only one of the many goals of taxation. The tax laws foster many economic and social goals such as wealth redistribution, price stability, economic growth, full employment, home ownership, charitable activities, and environmental preservation. For example, the government encourages contributions to charities through the charitable contribution deduction. If the charitable organizations did not exist, the government would have to undertake many of the activities the charities provide. Thus, the tax law is used to achieve this social objective.

In 1776, Adam Smith proposed the concepts known as the four **canons of taxation**, *equity, convenience, certainty,* and *economy* in *The Wealth of Nations*.[20] To this day, these concepts are still valid for determining whether a tax should be considered a good tax. No one since Adam Smith has come up with a more widely accepted criteria for judging a tax, although other criteria have been added.

1.3.1 EQUITY

Equity is probably the most difficult of the four canons on which to achieve consensus. When is a tax equitable? How a person answers that question depends on that person's perspective, background, and view of society. The basic idea of equity is that persons with similar incomes should face similar taxes on that income. There is a major problem in determining *when* persons have similar incomes and their *ability to pay* the tax.

Consider the following example. Taxpayers A and B earn equal salaries and are in the same marginal tax bracket. They each need to earn an additional $20,000 to cover a large expense that year. Taxpayer A works overtime and Taxpayer B sells stock purchased 5 years ago. In the U.S., gains on most investment assets held by individuals for more than 12 months are taxed at significantly lower rates (due to their classification as long-term capital gains) than salary or wages income. Taxpayer A's $20,000 is taxed at the ordinary income tax rate (as additional wages). Taxpayer B's $20,000 is taxed at the lower tax rates and benefits from their classification as long-term capital gains. Is this equitable?

Capital gains tax rates on the disposition of capital assets held for a minimum period of time have traditionally been taxed at rates lower than regular income tax rates for several reasons. First, there is no inflation adjustment for capital gains; yet often the capital gain is an inflation gain rather than a real gain. If inflation is very high, the taxpayer may indeed have a loss when constant dollars are considered, but he or she will still be subject to the capital gains tax. Lower capital gains rates encourage investors to move money from unprofitable investments into more profitable ones. When capital gains rates are high, taxpayers tend to keep their appreciated but no-longer-profitable assets to avoid the tax. (This is called the *lock-in effect* of capital gains taxes.) In each of the situations described above, there are arguments for both sides of the equity issue.

Equity would also require persons with higher-incomes to pay a greater proportion of that income in taxes than lower-income persons—a concept referred to as *the ability to pay,* that is the basis for a progressive tax rate system. As a person's income increases, he or she is assumed to need a smaller percentage of that income for basic living and other expenses and, thus, is in a better position to pay a greater share of that income in taxes. There are difficulties with this concept of equity, however.

Compare two families: one family consists of a husband and wife and one healthy child with $50,000 in annual income; the other consists of a husband and wife with six children, two of whom have significant handicaps, but with an annual income of $60,000. When focusing only on the dollar amount of income, equity would tell us that the second family should pay a greater

[20] Smith's 1776 work was originally titled *An Inquiry Into the Nature and Causes of the Wealth of Nations* but was shortened into *The Wealth of Nations* (New York: Dutton, 1910).

percentage of their income than the first—but which family really has the better ability to pay the tax? The U.S. tax system relieves some of the extra tax burden on the second family through the medical expense deduction and child care credits—but this also complicates the system.

Tax policy struggles to achieve fairness. Differing notions of fairness, however, guarantee that this goal remains elusive. The fairness debate revolves around two very different concepts of what is equitable or fair. **Horizontal equity**, one of the key principles of tax fairness, asserts that persons in similar circumstances should face similar tax burdens. The difficult part is determining when different taxpayers are in similar circumstances.

Example 1.10

Susan rents a condominium for $2,500 per month. Barry pays $2,500 per month on the mortgage for his condominium in the same building. Both Susan and Barry are single, have no dependents, and have annual incomes of $75,000. Susan cannot deduct any portion of her rent, but Barry can deduct the interest and taxes portion of his mortgage payment. In this case, the goal of horizontal equity gives way to the objective of encouraging home ownership.

The other major fairness concept is vertical equity. **Vertical equity** asserts that persons with higher incomes should pay not only more tax but also higher percentages of their income as tax. Underlying this is the economic theory that income has diminishing marginal utility. In other words, as a person's income rises, each dollar is worth less to that person. As a result, higher rates are necessary to obtain approximately comparable sacrifices from all taxpayers. Although this has long been a feature of the U.S. tax system (as evidenced by the progressive tax rates), it remains controversial, especially among those subject to the higher tax rates.

Example 1.11

Bill and Susan, married with two children, have taxable income of $75,000. Shelly and John, also married with two children, have taxable income of $150,000. Because their income is twice that of Bill and Susan, vertical equity would require that Shelley and John pay more than twice the income tax that Bill and Susan pay.

There is no one answer as to what truly constitutes an equitable tax system. As we try to make the tax system appear to be more equitable, more complexity is introduced into that system. The simplest system of all would be a single rate of tax applied to all increases in a person's wealth (including that used for consumption, the economists' definition of income); yet, this probably will never be considered because it would not be perceived as fair.

1.3.2 ECONOMY

A tax meets the criterion of economy when the amount of revenue it raises is at an optimum level after the costs of administration and compliance are considered. The costs of a tax are not just limited to the costs incurred for tax administration and collection. Certain taxes impose an enormous burden on the taxpayer for compliance. More than half the individual taxpayers in the United States use some form of tax preparer to assist in preparing their tax returns. Many businesses have their own tax departments with no other responsibility than to ensure that all federal, state, and local income, employment, and property taxes are paid in a timely manner.

Compare a state income tax to a state sales tax based on the concept of economy. A sales tax is collected at the point of retail purchase and remitted by the retailer to the state. The purchaser simply pays the added tax to the retailer when the good or service is purchased. To comply with state income tax requirements, taxpayers generally cannot use the information from their federal

tax returns without a number of adjustments. Thus, the taxpayer must pay a preparer or spend additional time preparing the state income tax return. The state must use procedures similar to the federal government to check for accuracy and compliance to the laws applicable to these returns. The state must conduct many more audits on individual taxpayers to audit the same percentage of returns as the number of audits conducted on retailers remitting sales taxes. Thus, administrative costs are much higher for the income tax. Yet, in many states, the income tax is a revenue source secondary to the sales tax. Based on economy, a national sales tax has great appeal.

Economy is also related to the concept of simplicity. The simpler a tax system is, the less costly is administration and compliance. One of the major thrusts of the American Institute of CPAs (AICPA) has been to simplify the tax system. Tax professionals realize that the current system is so complex that even a reasonably well-educated person and his or her tax advisor can readily fall into tax traps because of many obscure and complex provisions. When tax professionals make errors because of the complexity of the law, they may still be held liable for these mistakes—and the cost to the professional may be significant.

1.3.3 CERTAINTY

Certainty is also a canon related to simplicity. Certainty would dictate that a taxpayer know with reasonable accuracy the tax consequences of a transaction at the time the transaction takes place. Unfortunately, U.S. tax laws are continually changing. It is not uncommon today for a change in the tax laws to be effective from the date proposed, rather than from the date passed. This practice imposes an uncertain environment on the taxpayer who is contemplating a transaction that could be affected by a tax law change. He or she does not know if the law will be passed—thus, he or she cannot know if the transaction will be affected. Certainty would dictate that tax laws change as little as necessary so that the outcome of a particular transaction could be predicted with reasonable accuracy.

Example 1.12

The Tax Cuts and Jobs Act (TCJA) that was passed in December 2017 made most changes effective as of January 1, 2018. Changes to the bonus depreciation provision, however, were retroactive to September 27, 2017, the date when the changes were first proposed. The effective date for this provision was made retroactive because equipment manufacturers were concerned that if the special tax provision was available only for equipment purchased in 2018, customers would not purchase any equipment in the last quarter of 2017.

Although the reduction in the corporate tax rate was a permanent change, many of the provisions in the TCJA are temporary and will expire in a few years. These temporary provisions include not only the bonus depreciation provision but also the reduction in individual tax rates. It is unknown whether Congress will extend the lower individual tax rates when they expire.

1.3.4 CONVENIENCE

The last canon of convenience states that a convenient tax is one that would be readily determined and paid with little effort. Consider again the difference between paying a sales tax and an income tax. A sales tax is paid each time a taxed purchase is made. Most people do not consider that they are paying a tax in addition to making a purchase of some good or service. Although the withholding of income taxes from salaries offers a measure of convenience, the myriad of forms and schedules that must be filed to reconcile the actual tax liability with withholding does not always meet the test of convenience. The requirements for estimated tax payments for significant amounts of income from other than salaries and wages simply may be educated guesses, particularly when income is expected to be passed through by partnerships and S corporations.

Underestimating these estimated payments based on unknown information places an enormous burden on the taxpayer and may result in underpayment penalties.

1.4 THE TAXING UNITS AND THE BASIC INCOME TAX MODEL

There are only three types of persons[21] subject to income taxation in the United States: the individual, the C corporation,[22] and the fiduciary. An individual is a male or female person subject to the tax. A **C corporation** is a business entity formed under state law on which the income tax is levied directly. A fiduciary, either an estate or a trust, may be subject to income taxes.[23] In most cases, however, fiduciary income passes through to income beneficiaries who include it in their income and are responsible for the taxes. The **fiduciary** is a modified "flow-through" entity because the entity is taxed only on income retained by the estate or the trust; the income distributed to the recipients is taxed only to the recipients.

Individual taxpayers (including married persons filing jointly) and corporate taxpayers pay the bulk of all income taxes collected. The corporation is the basic business unit, but it is only one of the forms in which a business can operate. In addition to the C or regular corporate form, a business may be organized as a sole proprietorship, a partnership, a limited liability company (LLC), or an S corporation.[24] The income taxes on these businesses are not usually paid by the businesses; instead, at the end of the tax year their income flows through to their owners and they pay the taxes. If one flow-through entity owns all or part of another flow-through entity, the income continues to flow through to the second entity until it finally reaches an individual, a C corporation, or a fiduciary tax return for payment of the tax.

Partnerships and S corporations are not taxpaying entities; however, they are required to file informational returns. Business entities are discussed further in section 1.5.

Example 1.13

The BST partnership is owned one-third by Bob (an individual); one-third by S, an S corporation (owned 100 percent by Jane); and one-third by T (a trust fiduciary). The partnership reports $300 of income at the end of the current tax year on Form 1065, an informational filing. One hundred dollars of income flows through to each of the owners, reported to them on a Schedule K-1: Bob, S, and T, but T distributes only $40 of its $100 income to Sarah, the beneficiary. On his Form 1040, Bob includes all $100 of income along with his other income and pays taxes on the total. S does not pay taxes on the $100, but does file a Form 1120S, also an informational filing. This $100 is combined with S's other income on Form 1120S; the total then flows through to Jane, reported on Schedule K-1, the owner of all of the S corporation stock. Jane includes all of this income on her Form 1040, her personal tax return. T pays taxes on the $60 retained in the trust (Form 1041); the remaining $40 is taxed to Sarah on her individual tax return (Form 1040), along with her other sources of income.

The income of C corporations is subject to double taxation—once at the corporate level and again at the owner level when the income is distributed as dividends—because dividends are not deductible by the corporation. Flow-through entities avoid double taxation because their income

[21] Any entity subject to the income tax is a taxable person; the term "individual" is reserved exclusively for a man, woman, or child subject to an income tax.

[22] The term "C" or "regular corporation" (called "C" corporation because its governing tax rules are contained in Internal Revenue Code subchapter C) is used to distinguish it from a subchapter S (or simply "S") corporation (whose rules are contained in IRC subchapter S), which is a flow-through entity.

[23] An estate is a legal entity which comes into existence only upon the death of the individual whose assets are held by the estate. The estate must file a tax return until all assets can be distributed to the heirs or beneficiaries. Any individual may create a trust by transferring assets to the trust. A trustee administers the trust property for the benefit of the beneficiary.

[24] LLCs are usually taxed as partnerships (unless owned by a single individual and then it is taxed as a sole proprietorship); however, an LLC can elect to be taxed as a corporation and would then file a corporate tax return.

is passed through at the end of the year to their owners and is taxed once only (at that time) at the owner level. The income of a sole proprietorship is reported along with the individual owner's other income and is taxed annually.[25] The advantages and disadvantages of each of these forms of business are explored later in this chapter. At this point, it is not necessary to have a detailed understanding of taxable and flow-through entities. It is, however, important to understand that individuals and C corporations are the primary taxpaying entities. The primary focus of the text is on tax planning for individuals, C corporations, and flow-through entities because of the latter's effects on the taxation of individuals and C corporations.

The fiduciary (trust or estate) has a vastly different role than a business. A trust is established for a specific purpose, such as managing the assets for beneficiaries who are unable or unwilling to manage the assets themselves. The fiduciary has the responsibility to insure that the wishes of the person establishing the trust are followed. An estate is created at the death of an individual, and its primary purpose is to manage the decedent's assets until they can be distributed to his or her heirs. Income tax planning opportunities are limited for estates and trusts.

The final chapter of this text addresses the basics of estate and trust taxation, along with the estate and gift transfer tax. The first eleven chapters are devoted to the two primary tax-paying entities (individuals and C corporations) and their related flow-through businesses, although the basic principles of income, deduction, gain, and loss discussed throughout this text also apply to fiduciary entities.

1.4.1 THE BASIC TAX MODEL

It is important to have an overall sense of the components of the basic tax model before studying the details of the tax laws. This aids in understanding how the terms and concepts referred to throughout our study of tax fit into the scheme of the basic tax model. This basic model (Figure 1.1) is expanded in later chapters as details are introduced for individuals and corporations.

	Gross income
Less	Deductions
Equals	Taxable income (loss)
Times	Applicable tax rate
Equals	Gross income tax liability
Less	Tax credits
Less	Tax prepayments
Equals	Tax liability owed or refund due

FIGURE 1.1 The basic income tax model

Gross Income

The term **gross income** is an all-inclusive term that includes income from all sources that are not specifically excluded.[26] Not all "income" items are positive, however, as losses reduce other positive income items in determining gross income. For example, the capital gain on a stock sale increases income while the sale of business assets at a loss reduces income. In general, losses from business or investment transactions are recognized (included in income) only when they are realized through an exchange transaction that determines the amount of the loss. Thus, a decline in stock value cannot be deducted until the stock is actually sold at a loss. Figure 1.2 provides examples of the types of income and loss items included in gross income.

[25] Sole proprietorships are technically disregarded entities; however, they are usually grouped with flow-through businesses. There is no separate entity-level tax return for a disregarded entity. All income is reported on a Schedule C as part of the individual's personal tax return, aggregated with the individual's other income, and taxed using the individual's tax rates.

[26] An individual reports his or her gross income to the Internal Revenue Service on Form 1040: *U.S. Individual Income Tax Return*. A sample filled-in Form 1040 is included at the end of Chapter 5.

Income item	Discussed in chapter
Gross income from the sale of goods and services	3
Taxable interest income	3
Dividend income	3
Prizes and awards	3
Unemployment compensation	3
Taxable portion of Social Security benefits	3
Wages and salary	4
Taxable retirement plan distributions	4
Income (less loss) from rental real estate	6
Gains (less losses) from sale of capital assets	8
Income (less loss) from sole proprietorships, partnerships, and S corporations	11

FIGURE 1.2 Partial listing of items included in gross income

Example 1.14

Brogan Corporation has gross income from sales of $4,500,000, taxable interest income of $50,000, and a Schedule K-1 reporting $400,000 as its share of loss from a partnership that is deducted from its positive income. As a result, Brogan Corporation has total income of $4,150,000 ($4,500,000 + $50,000 – $400,000).

Losses (negative income) can be grouped into three broad categories: business losses, investment losses, and personal losses.[27] Losses are normally deducted from positive income items, except that most personal losses of individuals are not deductible.[28]

Operating losses incurred as part of an active business are deductible in full against ordinary income (and any excess net operating losses are carried forward to offset operating profits in future years). Capital losses from the sale of investment assets are subject to limitations on their deductibility; for example, individuals can deduct only $3,000 of capital losses in excess of capital gains annually. Capital losses that are not deductible in the current year may be carried forward by individuals and deducted from future income for an unlimited number of years until completely used. Corporations can only offset capital losses against capital gains; they are not deductible against other income. Corporate capital losses in excess of capital gains are carried back three years and then forward five years to offset capital gains realized in carryover years. Corporate capital losses that cannot be used in these carryover years are lost.

Example 1.15

John has $80,000 of salary income, a $5,000 operating loss from his sole proprietorship, a $4,000 capital gain on the sale of ABC stock, and a $13,000 capital loss on the sale of XYZ stock in the current year. The $4,000 capital gain offsets $4,000 of the $13,000 capital loss on the stocks resulting in a net $9,000 capital loss for the year. The next step is to determine what is included in John's gross income. John's salary of $80,000 is included and the $5,000 operating loss from his sole proprietorship is also included in determining gross income. However, only $3,000 of the $9,000 net capital loss is included in the current year gross income calculation. John's net gross income is $72,000 ($80,000 – $5,000 – $3,000).

The remaining $6,000 capital loss ($9,000 net capital loss – $3,000 used in the current year) is carried forward (but not back) and can be deducted in future years subject to the $3,000 annual limitation.

[27] Losses are distinguished from deductions for which there must be a specific provision in the Code that allows a reduction in corporate or individual taxable income.

[28] Losses of personal property from a casualty (such a hurricane) are deductible as itemized deductions to the extent that they exceed 10 percent of the individual's adjusted gross income. These losses are discussed in Chapter 9.

Example 1.16

Classic Corporation has $120,000 income from operations and a $5,000 net capital loss on the sale of stocks held as an investment in 2019. When calculating Classic Corporation's taxable income, the loss is not deductible in the current year (2019). The corporation reviews the tax returns for the prior three years (2016, then to 2017 and 2018) for any capital gains in those years. Classic Corporation offsets the $5,000 capital loss against any capital gains in those three prior years, recomputes its tax liability, and files a claim for a refund of taxes paid. If the three prior years do not have sufficient capital gains to use the entire $5,000 loss generated in 2019, the remainder is carried forward sequentially to years 2020 through 2024. (If this had been an individual, $3,000 of the loss could be deducted in 2019 with the remaining $2,000 carried forward to 2020 as illustrated in the previous example.)

Over the years, certain items have been excluded from gross income. These excluded items may not even be reported on the tax return. Only if an excluded item could affect some other reporting provision is reporting required along with the taxable items. For example, interest on tax-exempt municipal bonds is excluded from income, but an individual taxpayer must report it because it could affect the determination of the taxability of a taxpayer's Social Security benefits. On the other hand, an individual who is the beneficiary of the proceeds of a life insurance policy excludes them from income and does not report them on the tax return. Figure 1.3 provides examples of the types of items excluded from income.

Exclusion item	Discussed in chapter
Tax-exempt interest income from state and local bonds	3
Proceeds of life insurance policies	3
Gifts and inheritances	3
Welfare benefits including food stamps	3
Nontaxable portion of Social Security benefits	3
Scholarships	3
Damages awarded for physical injury	3
Qualified employee fringe benefits	4
Nontaxable portion of retirement plan distributions	4
Up to $250,000 gain on the sale of a personal residence ($500,000 if married filing joint return)	8
Gains and losses on property transactions subject to disallowance or nonrecognition provisions	8 and 9
Unrealized gains and losses	9

FIGURE 1.3 Partial listing of exclusions from gross income

Example 1.17

Brogan Corporation (example 1.14) had $4,150,000 of total income. It also received $100,000 of tax-exempt interest, collected $1,000,000 from the life insurance policy on the life of its now-deceased controller, and had unrealized[29] appreciation on assets of $300,000. Its total income remains $4,150,000 as each of these items is excluded from income.

Deductions

After gross income is determined, certain deductions are permitted. For an item to be deductible by an individual or a business, there must be either a specific provision or a general category in the Internal Revenue Code that permits the deduction. If there is no provision that allows an item

[29] Income is taxed (recognized) only when realized. Thus, if securities have appreciated in value from $5,000 to $9,000, the $4,000 in appreciation will not be taxed until the securities are sold.

(or class of items) as a deduction, then it cannot be deducted. In addition, deductions for certain items or categories of deductions have been specifically disallowed.

Corporations A corporation's allowable expenses are simply deductions from total income. In general, all businesses, regardless of their form of operation, are allowed deductions for business expenses that are ordinary, reasonable, and necessary. There is a general presumption that all business expenses are deductible unless there is a gross violation of the ordinary, necessary, and reasonable criteria. The tax laws do, however, include several disallowance provisions that disallow deductions for certain items; for example, fines, bribes, and expenses related to tax-exempt income are not deductible.[30]

Example 1.18

After determining its $4,150,000 of total income, Brogan Corporation calculates $2,300,000 of ordinary and necessary business expenses. Its taxable income is $1,850,000 ($4,150,000 – $2,300,000).

Individuals Each individual taxpayer is permitted two types of deductions in determining taxable income.[31] The first, called adjustments to income, consists of specific expenses that Congress has singled out for more favorable treatment than other individual deductions. These deductions reduce an intermediate subtotal between gross income and taxable income called *adjusted gross income (AGI)*, a subtotal unique to individual taxpayers. Figure 1.4 lists some of these special deductions. If an individual does not have any of these special deductions, then his or her gross income and AGI will be the same.

Adjustments to income	Discussed in chapter
Contributions to certain pension or retirement plans (including IRAs)	4
One-half of self-employment taxes	4
Self-employed health insurance premiums	4
Qualified student loan interest expense	5

FIGURE 1.4 Partial listing of adjustments to income

The second type of deduction is the greater of the taxpayer's standard deduction (based on the taxpayer's filing status as discussed later) *or* the taxpayer's allowable itemized deductions (based on actual expenditures for such items as medical expenses, taxes, and interest). Figure 1.5 lists a few of an individual's more common itemized deductions.

Itemized deductions	Discussed in chapter
Taxes (state and local income and property taxes)	5
Interest expense (mortgage interest and investment interest)	5
Medical expenses	5
Charitable contributions	5
Casualty losses	9

FIGURE 1.5 Partial listing of itemized deductions

For those deductions subject to limitations, only amounts that are in excess of a minimum or do not exceed a maximum are deductible. If the taxpayer itemizes deductions, they are reported on Schedule A of an individual's Form 1040 as illustrated in Chapter 5.

[30] The latter is an example of the matching principle. These expenses are discussed in Chapter 6.

[31] The qualified business income deduction, a third type of deduction, was added by the Tax Cuts and Jobs Act for 2018–2025 to address the difference between the tax rates for C corporations and pass-through businesses (sole proprietorships, partnerships, S corporations, and LLCs). This deduction is 20 percent of qualified business income and is discussed later in this chapter.

Individuals who do not choose to itemize their deductions (and retain the required supporting documentation for their actual expenditures), can instead claim the **standard deduction** set by Congress regardless of actual expenditures. Individuals normally only itemize their deductions if their total deductions exceed their standard deduction allowance. This standard deduction varies by the **filing status** of the taxpayer; for example, a single taxpayer's standard deduction is one-half the standard deduction allowed a married couple filing a joint return as shown in Table 1.3. Thus, an individual may always deduct some amount from income—either the standard deduction *or* his or her itemized deductions—*but not both*.

Table 1.3 Standard Deduction by Filing Status

Filing status	2019	2018
Married filing jointly	$24,400	$24,000
Married filing separately	$12,200	12,000
Head of household	$18,350	18,000
Single	$12,200	12,000
Dependent	$1,100*	1,050*

*If larger, a dependent's standard deduction is earned income plus $350 up to their otherwise allowable standard deduction.

The standard deduction varies by filing status because single persons are assumed to have fewer personal expenses than married couples or those who qualify as heads of household.[32] Similarly, individuals who are dependents of another taxpayer (but whose income requires them to file their own return) are not viewed as needing a large standard deduction because they are not self-supporting.[33]

Example 1.19

Jessica, a single parent who qualifies as head of household in 2019, has $49,000 of salary income but only $3,000 of itemized deductions. Jessica calculates taxable income using the $18,350 head of household standard deduction as it is greater than the $3,000 of itemized deductions. Jessica has taxable income of $30,650 ($49,000 AGI – $18,350 standard deduction).

Example 1.20

In 2019, James, who is single, earned a salary of $62,000. His itemized deductions (including mortgage interest, property taxes, and charitable deductions) total $15,000, which is greater than his allowable standard deduction of $12,200 as a single individual. James has taxable income of $62,000 – $15,000 = $47,000.

The standard deduction allows a taxpayer to receive a significant amount of income tax free, exempting a substantial number of low-income taxpayers from filing annual tax returns. For example, a married couple's taxable income would have to exceed the $24,400 standard deduction before they would be required to file an income tax return for 2019. Corporations, on the other hand, must file returns annually regardless of whether they report net income or loss for the tax year.

[32] A head of household is a single individual who pays more than half the cost of maintaining a home in which a qualifying child or other dependent relatives lives.

[33] If a dependent is employed and has earned income exceeding $1,100, the standard deduction is increased to the total of the dependent's earned income *plus* $350 but cannot exceed the standard deduction based on filing status ($12,200 if single).

A new deduction was added for 2018–2025 to address the difference between the tax rates for a C corporation and flow-through businesses (including sole proprietorships, partnerships, S corporations, and LLCs) that are taxed at their owners' individual rates. Unlike most tax deductions which provide for the recovery of costs incurred, this deduction is generated by a business earning income. In effect, the deduction provides an indirect means of reducing the marginal tax rate that applies to qualified income from flow-through businesses. The deduction is 20 percent of **qualified business income (QBI)**. QBI is defined as the income from an eligible business conducted in the U.S. It excludes investment-related items (capital gains, dividends, and interest income), and reasonable compensation paid to the individual. There are various limits for this calculation which will be covered in Chapters 5 and 11.

Example 1.21

Jorge is a 50% partner of JC Partnership which is in the hardware business. JC Partnership had gross receipts of $350,000 and deductible business expenses of $200,000, resulting in $150,000 of income from operations. JC Partnership also had a $20,000 long-term capital gain from an investment. JC Partnership has $150,000 of QBI because investment-related income (the capital gain) is not qualified business income. Jorge would be entitled to a $15,000 deduction for his share of QBI ($150,000 QBI x 50% share x 20%). If Jorge is in the 22% marginal tax bracket, the QBI deduction saves him $3,300 ($15,000 deduction x 22% marginal tax rate) in income taxes reducing his tax liability on his share of partnership operating income from $16,500 ($75,000 x 22%) to only $13,200 ($16,500 – $3,300) effectively reducing his tax rate on that income to only 17.6% ($13,200/$75,000).

When the corporation has taken all of its allowable deductions from total income or an individual filer has reduced his or her gross income for the allowable deductions, the taxpayer's taxable income is determined. The taxpayer's next step is to determine the gross tax liability on that income.

Determining the Gross Tax Liability

Since 2018, corporations are subject to a 21 percent flat corporate tax rate on their taxable income.

Example 1.22

Waldo Corporation has $125,000 of taxable income for 2019. Its gross tax is $26,250 ($125,000 × 21%). Molokai Corporation has $20,000,000 of taxable income for 2019. Its gross tax is $4,200,000 ($20,000,000 × 21%).

Individuals determine their tax liability using the appropriate individual tax rate schedule. The tax rate schedule an individual uses corresponds to the taxpayer's filing status; therefore, there are schedules for single individuals, married couples filing jointly, married couples filing separately, and heads of household (e.g., a single parent). Upper income individuals continue to receive the full benefit from the progressive tax rates (that is, there is no phase-out of the lower tax rates). As a result, a single individual with $20,000,000 of taxable income still receives the benefit of the first $9,700 of income taxed at a 10 percent rate. Although the actual tax rates are the same for each filing status, they do not apply at the same level of income—that is, the income level at which each higher rate applies varies by the taxpayer's filing status as shown in Table 1.4.

Table 1.4 2019 Tax Rates for Individual Taxpayers by Filing Status

Schedule X Single Individuals (Unmarried other than surviving spouse or head of household)	
If taxable income is:	***The tax is:***
Not over $9,700.00	10% of taxable income
Over $9,700.00 but not over $39,475.00	$970.00 plus 12% of the excess over $9,700.00
Over $39,475.00 but not over $84,200.00	$4,543.00 plus 22% of the excess over $39,475.00
Over $84,200.00 but not over $160,725.00	$14,382.50 plus 24% of the excess over $84,200.00
Over $160,725.00 but not over $204,100.00	$32,748.50 plus 32% of the excess over $160,725.00
Over $204,100.00 but not over $510,300.00	$46,628.50 plus 35% of the excess over $204,100.00
Over $510,300.00	$153,798.50 plus 37% of the excess over $510,300.00

Schedule Y-1 Married Individuals Filing Joint Return (and Surviving Spouses)	
If taxable income is:	***The tax is:***
Not over $19,400.00	10% of taxable income
Over $19,400.00 but not over $78,950.00	$1,940.00 plus 12% of the excess over $19,400.00
Over $78,950.00 but not over $168,400.00	$9,086.00 plus 22% of the excess over $78,950.00
Over $168,400.00 but not over $321,450.00	$28,765.00 plus 24% of the excess over $168,400.00
Over $321,450.00 but not over $408,200.00	$65,497.00 plus 32% of the excess over $321,450.00
Over $408,200.00 but not over $612,350.00	$93,257.00 plus 35% of the excess over $408,200.00
Over $612,350.00	$164,709.50 plus 37% of the excess over $612,350.00

Schedule Y-2 Married Individuals Filing Separate Returns	
If taxable income is:	***The tax is:***
Not over $9,700.00	10% of taxable income
Over $9,700.00 but not over $39,475.00	$970.00 plus 12% of the excess over $9,700.00
Over $39,475.00 but not over $84,200.00	$4,543.00 plus 22% of the excess over $39,475.00
Over $84,200.00 but not over $160,725.00	$14,382.50 plus 24% of the excess over $84,200.00
Over $160,725.00 but not over $204,100.00	$32,748.50 plus 32% of the excess over $160,725.00
Over $204,100.00 but not over $306,175.00	$46,628.50 plus 35% of the excess over $204,100.00
Over $306,175.00	$82,354.75 plus 37% of the excess over $306,175.00

Schedule Z Heads of Households	
If taxable income is:	***The tax is:***
Not over $13,850.00	10% of taxable income
Over $13,850.00 but not over $52,850.00	$1,385.00 plus 12% of the excess over $13,850.00
Over $52,850.00 but not over $84,200.00	$6,065.00 plus 22% of the excess over $52,850.00
Over $84,200.00 but not over $160,700.00	$12,962.00 plus 24% of the excess over $84,200.00
Over $160,700.00 but not over $204,100.00	$31,322.00 plus 32% of the excess over $160,700.00
Over $204,100.00 but not over $510,300.00	$45,210.00 plus 35% of the excess over $204,100.00
Over $510,300.00	$152,380.00 plus 37% of the excess over $510,300.00

Example 1.23

Patricia is single with taxable income of $40,000 in 2019. Her tax liability is $4,658.50 [$4,543.00 + 22% ($40,000 – $39,475)].

The tax rate schedules illustrate the progressive nature of the federal income tax; that is, as a taxpayer's taxable income increases, his or her marginal tax rate also increases. For example, a single taxpayer with $100,000 of taxable income uses Schedule X, and is in the 24 percent

marginal tax bracket (the next dollar of income is taxed at 24 percent). If income had been $250,000, the marginal tax bracket would have been 35 percent.

Example 1.24

Jennie is single and has 2019 taxable income of $58,000. Using Schedule X, her gross income tax liability is $8,618.50 [$4,543.00 + 22%($58,000 – $39,475)].

If Jennie is married and files a joint return with her husband, Peter, they would use Schedule Y-1 for joint return filers. If they had combined taxable income of $58,000, their tax liability would be only $6,572 [$1,940 + 12%($58,000 – $19,400)].

The married filing a joint return schedule normally provides the lowest tax liability for any given amount of taxable income. When higher income spouses each earn approximately the same income, however, their combined incomes are taxed at higher rates on a joint return than if they had remained single and filed separate returns as single individuals. This *marriage penalty* occurs because the bracket width for the 35 percent bracket on joint returns is $204,150 ($612,350 – $408,200) which is smaller than the bracket width for the 35 percent tax rate for single returns, $306,200 ($510,300 – $204,100).

Example 1.25

Barbara is single and has taxable income of $400,000 in 2019. Her income tax is $115,193.50 [$46,628.50 + 35% ($400,000 – $204,100)] using Schedule X.

Shelly and John are married and have $800,000 in taxable income, one-half earned equally by each of them. Their income tax is $234,140 [$164,709.50 + 37%($800,000 – $612,350)] using Schedule Y-1. If Shelly and John were not married and filed separately as single individuals, their income tax would be the same as Barbara. Their total income tax as a married couple is $3,753 [$234,140 – (2 × $115,193.50)] more than if taxed separately as single individuals. The $3,753 is their marriage penalty.

If they file as married filing separately, they would each pay $117,070.00 [$82,354.75 + 37%($400,000 – $306,175)] in income tax using Schedule Y-2, a total of $234,140 (2 × $117,070.00) which is the same total income tax they would pay by filing as married filing jointly. (Note that because they are married, they cannot choose to file as single individuals.)

The previous tax calculations implicitly assumed that the taxpayer had no dividends or net long-term capital gains as part of taxable income for the year. As explained in Chapter 8, an individual with a net long-term capital gain from sales of capital assets, files a Schedule D: *Capital Gains and Losses* to report these gains and losses. The instructions for this schedule include a worksheet to determine total tax liability when long-term capital gains are included in the taxpayer's taxable income. Similarly, a worksheet is available to help determine the tax due on dividend income. The tax rates for long-term capital gains and dividends for 2019 are shown in Table 1.5.[34]

[34] Since 2013, the Affordable Care Act requires high-income taxpayers to pay the Medicare surtax on net investment income (NII), including net capital gains (whether long-term or short-term), taxable interest income, dividends, and rental income. This 3.8% NII tax is assessed on the lesser of net investment income or modified adjusted gross income in excess of thresholds based on filing status. Combining this 3.8% NII tax with the 20% capital gains rate results in an effective tax rate of 23.8% for capital gains and dividend income of high-income taxpayers. The NII tax is discussed in Chapter 5.

Table 1.5 Tax Rates for Dividend Income and Long-term Capital Gains

Long-term capital gains and dividend tax rate*	Taxable income for single individuals	Taxable income for married filing a joint return**	Taxable income for head of household
0%	$0–$39,375	$0–$78,750	$0–$52,750
15%	$39,376–$434,550	$78,751–$488,850	$52,751–$461,700
20%	Over $434,550	Over $488,850	Over $461,700

*Rate can be as high as 28% for collectibles and 25% for unrecaptured §1250 gain (see Chapter 8).
**Amounts if married filing separately are half the amount for filing a joint return.

Example 1.26

George is single and has a total taxable income of $55,000. His taxable income includes $45,000 of income taxed at ordinary rates. The remaining $10,000 is $8,000 long-term capital gain and $2,000 in dividends which are eligible for the 15 percent tax rate. George's tax on his $45,000 of ordinary income is $5,758.50 [$4,543.00 + 22%($45,000 – $39,475)]; his tax on the capital gain is $1,200 ($8,000 × 15%); his tax on his dividend income is $300 ($2,000 × 15%) for a total tax liability of $7,258.50 ($5,758.50 + $1,200 + $300). The favorable dividend and capital gain rates save George $700 [$10,000 × (22% – 15%)] in taxes.

There are no favorable income tax rates for long-term capital gains or dividend income included in the taxable income of corporate taxpayers. They are included in and taxed as ordinary income at the 21 percent corporate tax rate.

Tax Credits

Both individual and corporate taxpayers are entitled to certain credits that also reduce the tax liability. A business may benefit from the investment tax credit for investing in business equipment and working parents may benefit from the child care credit. A credit reduces the income tax liability in a different way than a deduction because a credit is a direct reduction in the taxpayer's tax liability.

Example 1.27

Carmen is single and has taxable income of $90,000 in 2019. Using Schedule X, her income tax is $15,774.50 [$14,382.50 + 24%($90,000 – $84,200)]. As illustrated in the basic tax model in Figure 1.1, a credit reduces Carmen's tax liability dollar for dollar. If she is entitled to claim a tax credit of $500, her tax liability is reduced by $500 to $15,274.50. Compare Carmen's tax liability if instead of a $500 credit, she was entitled to a $500 deduction. If she can claim a deduction for $500, the deduction reduces her taxable income by $500 to $89,500 which only reduces her tax liability to $15,654.50, a $120 reduction ($15,774.50 – $15,654.50). The $120 tax savings may also be calculated by taking the reduction in taxable income times Carmen's marginal tax rate ($500 x 24% = $120). A $500 tax credit is much more valuable than a $500 tax deduction.

A taxpayer must pay the additional tax if the taxpayer's tax liability exceeds allowable credits. If the taxpayer's credits exceed the tax liability, only a limited number of tax credits are refundable after the tax is reduced to zero.[35] If nonrefundable tax credits exceed the tax liability,

[35] There are several refundable credits—that is, credits that will result in a payment to the taxpayer even if there is no tax liability. One such refundable credit is the earned income credit applicable to low-income taxpayers. This credit acts like a negative income tax and is discussed in Chapter 5.

Type of credit	Discussed in chapter
Foreign tax credit	4
Child tax credit	5
Dependent care credit	5
Earned income credit	5
Education credits	5
Credit for excess payroll tax withheld	5
General business credits	10

FIGURE 1.6 Partial listing of tax credits

certain credits (for example, the general business credit) may be carried to other years to offset a tax liability in the carryover year. Other credits that exceed that tax liability are lost entirely (for example, the dependent care credit). Figure 1.6 includes a few of the more common credits.

Tax Prepayments

After an individual or corporation reduces its total tax liability for allowable tax credits, its tax prepayments are deducted. Most taxpayers are required to make some form of prepayment for the anticipated tax liability. Most taxpayers are familiar with withholding on wages earned as an employee. This is a form of prepayment where an employer deducts a certain percentage of an employees' salary and wage income in the form of tax withholdings. The employer then forwards the income tax withheld to the government for the employee. If, however, the taxpayer has a significant amount of income not covered by withholding, such as self-employment income or transactions on which there is no withholding (such as gains on the sale of investment assets), the individual is required to make quarterly estimated tax payments during the year. Corporations also make estimated tax payments based on anticipated taxable income. Estimated payments are so named because taxpayers must estimate how much income they will earn and the related tax they expect to owe for the year. Failure to make the minimum required tax prepayment may subject the taxpayer to penalties and interest. Individuals who owe less than $1,000 and corporations less than $500 when their returns are filed avoid penalties.

Example 1.28

Z Corporation's tax liability was $68,000 and it made $67,600 in estimated tax payments. It now owes only $400 for its $68,000 tax liability because of its $67,600 in estimated tax payments.

1.4.2 TRUSTS AND ESTATES

Trusts and estates are the third type of taxable entity called fiduciary entities—nonbusiness legal entities that hold assets and may have income. An estate is created when any person (the decedent) with asset ownership dies. An executor or personal representative manages the estate assets until they are distributed to the heirs or beneficiaries. A trust is created by a person (the grantor) who places control of trust assets in the hands of a trustee for the benefit of a third party (the beneficiary). Because trusts and estates may hold assets that earn income, they are subject to income taxes. Their tax formula has the same characteristics as the basic tax model. The entity is generally taxed on income to the extent the income remains within the entity. Income that is paid out to a beneficiary is taxed only to the beneficiary. Table 1.6 contains the tax rates for estates and trusts for 2019.

Table 1.6 2019 Income Tax Rates for Trusts and Estates

Income Tax Rates for Trusts and Estates	
If taxable income is:	***The tax is:***
Not over $2,600	10% of taxable income
Over $2,600 but not over $9,300	$260.00 plus 24% of the excess over $2,600
Over $9,300 but not over $12,750	$1,868.00 plus 35% of the excess over $9,300
Over $12,750	$3,075.50 plus 37% of the excess over $12,750
Tax Rates for Long-term Capital Gains and Dividend Income	
If taxable income is:	***The tax rate is:***
Not over $2,650	0%
Over $2,650 but not over $12,950	15%
Over $12,950	20%

The tax brackets for estates and trusts are much more compact than the individual tax brackets. The highest tax rate begins when taxable income exceeds $12,750 and there are no 12, 22, or 32 percent tax brackets. Distributing income annually to the beneficiaries usually results in lower overall taxes as beneficiaries are usually in lower marginal tax brackets. The taxation of trusts and estates is discussed in detail in Chapter 12.

Example 1.29

A trust has $5,000 of taxable income in the current year. It can retain the income or distribute it to Craig, the beneficiary. He is a 24-year-old college student in the 10% marginal tax bracket. If the trust retains the income, it will pay a tax of $836 [$260 + (24% × $5,000 – 2,600)]. If the trust distributes the $5,000 to Craig, he will pay $500 in tax (10% × $5,000). Distributing the income to Craig saves $336 in taxes ($836 – $500).

1.5 CHOICE OF BUSINESS ENTITY

One important consideration when starting your business is determining the best legal and operational structure. This affects its efficiency, transferability, control, reporting of income, taxes paid, and the owners' personal liability. Business entities differ in their legal and tax classification. They are legal structures regulated by state governments and it or its owners are subject to tax at the federal level. It may be difficult to change a legal structure after operations begin, so making the right decision as to its form of operation before the business is opened is important.

A business can be classified as a sole proprietorship, a partnership (general or limited), a corporation, or a limited liability company (LLC). A sole proprietorship is the simplest legal structure for any business. For state law purposes, a sole proprietorship is a single owner business that is not required to formally register with the state, although some states and municipalities may require licenses or permits. Many sole proprietorships do not obtain a separate identification number, but simply use the owner's Social Security number for identification. By default, the legal business name is the same as the owner's name but the business may establish a separate name by creating a "doing business as" (DBA) name. Most states require DBAs to register with the county clerk or Secretary of State.

The ease of forming the sole proprietorship is matched by the ease of closing the business. Any business property reverts to the sole proprietor. The primary disadvantage of the sole

proprietorship is that the owner is fully liable for all the debts of the business and could lose all of his or her personal assets to satisfy a judgment against the business. A sole proprietorship is simply not considered an entity separate from its owner.

Example 1.30

Jason operates a small bicycle shop as a sole proprietorship. He recently assembled and sold a bicycle to a new customer. Unfortunately, Jason failed to tighten the nuts securing the front tire. The customer fell off the bike and was severely injured on her first ride. She filed a lawsuit against the bicycle shop for negligence. If Jason loses this lawsuit, he would have to use his personal assets to cover any judgment unless his insurance is sufficient to cover his liability for damages. Jason could lose more than his investment in his business.

As discussed in section 1.5.1, to report Jason's income and deductions from the sole proprietorship, Jason includes a Schedule C with his Form 1040. The net income or loss from the sole proprietorship is included in Jason's taxable income.

Partnerships are formed under state partnership statutes and must have at least two owners (partners). A partnership can be formed as a general partnership, a limited partnership, a limited liability partnership (LLP), or a professional limited liability partnership (PLLP). The difference in these special forms involves the liability protection afforded the owners. One advantage of the partnership form is the absence of restrictions on a partner's identity. A partner can be an individual or any type of entity, including another partnership, a corporation, an estate, or a trust. A partnership can have two types of partners—general and limited. All partnerships must have at least one general partner who not only provides capital to the partnership, but is involved in partnership management. Limited partners only provide capital and generally do not participate in management. All partners have equal ownership of all business assets unless the partnership agreement specifies other ownership arrangements. Ownership percentages can vary based on the specifications included in the written partnership agreement. General partners are fully liable for all liabilities of the partnership while the liability of limited partners is limited to their investment. A partnership usually dissolves if a general partner dies or leaves the partnership (unless the partnership agreement provides for continuation of the business by the remaining partners).

Corporations must file articles of incorporation with the state in which their principal office is located. A corporation can issue different classes of stock and bonds, subject to state and federal securities laws. When a business decides to "go public" with an **initial public offering (IPO)** on one of the public securities exchanges, it will usually solicit a large pool of potential investors to become shareholders. Shareholders are only at risk for their capital investment; if the corporation fails, the shareholders are not liable for the outstanding debts of the corporation. If a shareholder desires to withdraw from the corporation, only a buyer for the stock is necessary. Shareholders do not participate directly in management; instead they only have the right to vote for corporate directors or officers. This facilitates centralized management so that day-to-day operations do not require the input of all the owners. Additionally, the corporation's life is not restricted. The death of an owner or a transfer of stock ownership does not affect the corporation's legal existence.

The limited liability company is a hybrid type of legal business form that provides the limited liability features of a corporation and the operational flexibility of a partnership. The owners are referred to as members. Depending on the state, the members can consist of a single individual (one owner), two or more individuals, corporations, or other LLCs. To form

an LLC, you usually must file articles of organization with the state in which the business is organized.

For tax *return* purposes, however, there are only four types of business entities:[36]

1. Sole proprietorships
2. Partnerships
3. C corporations (regular corporations)
4. S corporations (corporations electing S status)

Regardless of their form, all businesses must report their results of operations following the tax rules for one of these four entities. Limited liability companies with two or more owners default to being taxed as partnerships unless they elect to be taxed as corporations. Of these entities, only C corporations (and limited liability companies electing C corporation status) actually pay income taxes. A sole proprietorship passes its income directly to the sole proprietor using a Schedule C included in the sole proprietor's individual tax return. Partnerships, limited liability companies taxed as partnerships, and S corporations also pass their income through to their owners for taxation at the owner level. These businesses, however, must file *information tax returns* (Form 1065 for partnerships and limited liability companies taxed as partnerships and Form 1120S for S corporations) with the IRS. The entity must provide the owners with the information required for filing their tax returns.[37]

1.5.1 SOLE PROPRIETORSHIPS

A **sole proprietorship** may be very small with no employees or a large business with thousands of employees. It can operate any type of business—manufacturing, distribution, retail, or service. The owner of the sole proprietorship is not an employee but is considered self-employed. This means that Social Security and Medicare taxes are not withheld from any payments received by the sole proprietor; instead self-employment taxes[38] must be paid on the net profit of the business. Because the sole proprietor cannot be an employee, he or she is not eligible for the tax-free employee fringe benefits for which a corporate shareholder-employee would be eligible.[39]

There is no separate business tax return for a sole proprietorship; income and expenses from operations are reported on Schedule C: *Profit or Loss from Business (Sole Proprietorship)*. Self-employment tax is computed on Schedule SE: *Self-Employment Tax* based on the business profits (including the deduction as an adjustment to income for 50 percent of self-employment taxes). These forms are then included with the individual's completed Form 1040: *Individual Tax Return*. The sole proprietor is taxed on all of the net profits from the business as ordinary income regardless of how much he or she withdrew from the business during the year.

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[36] There is no separate tax return for an LLC. Most multi-owner LLCs file partnership tax returns but could elect to file as corporations. An LLC choosing to file as an S corporation would have to comply with all of the S corporation rules. A single-owner LLC would usually file as a sole proprietorship.

[37] An information return is a tax return that reports each owner's share of profits or losses to the IRS. No tax is paid with this return; instead any tax owed is paid by the owners with their tax returns.

[38] Self-employed individuals pay both the employer's and employee's share of Social Security and Medicare taxes resulting in a combined rate of 15.3% on the first $132,900 of self-employment income and 2.9% on the excess. If a business has a loss, no self-employment tax is owed that year. See Chapter 4 for a detailed discussion of employment taxes. Additionally, because income tax is not withheld for self-employed individuals, they must make their own quarterly estimated payment to the government. See Chapter 5 for a discussion of estimated payments.

[39] Employee fringe benefits are discussed in Chapter 4. Examples include health insurance, life insurance, and parking benefits.

Example 1.31

Gary is the sole proprietor of Gary's Garage. Gross income is $100,000, operating expenses are $40,000 for the year, and Gary withdrew $50,000 from the business for his living expenses. Gary reports the operating income and expenses on Schedule C and shows a net profit of $60,000 ($100,000 – $40,000). Gary includes all $60,000 of net profit from his business in his gross income and computes his taxable income for the year on his Form 1040. The $50,000 he withdrew has no effect on profit reported or taxes owed. Gary pays self-employment tax on the $60,000 net business profits and income taxes on his taxable income (after allowable deductions, including the deduction for 50% of self-employment taxes and the deduction for 20% QBI).

A tax advantage for a sole proprietorship is that a business loss can reduce or *shelter* the individual's other income when calculating taxable income.[40]

Example 1.32

Christina's sole proprietorship reports a net loss of $10,000 for the year. Christina is also an employee of another business with annual salary of $30,000. Christina uses her $10,000 loss from the sole proprietorship to shelter part of her salary from taxation, reducing her adjusted gross income to $20,000.

The tax savings realized from the flow through of a business loss depends on the marginal tax rate of the individual. The individual's marginal tax rate is dependent on his or her other taxable income.

Example 1.33

Joshua, a single individual, owns a sole proprietorship that has a $20,000 net loss. Joshua's $550,000 of other taxable income before deducting this loss places him in the 37 percent marginal tax bracket (from the tax rate schedule for a single individual). He has tax savings of $7,400 ($20,000 × 37%) from the $20,000 loss deduction.

If, instead, Joshua's taxable income is only $35,000 before deducting the loss, he would be in the 12 percent marginal tax bracket and he would have only $2,400 ($20,000 × 12%) in tax savings from the loss.

1.5.2 PARTNERSHIPS

A **partnership** consists of two or more individuals (or other entities) who agree to carry on a business jointly. Similar to sole proprietors, partners cannot be employees of the partnership or participate in most fringe benefits on a tax-free basis. For example, if a partnership provides health insurance for its partners, the partnership can deduct the health insurance premiums as business expenses, but the partners must include them in their taxable income.

A partnership is referred to as a "conduit" or flow-through entity because the income and losses are allocated to and flow through to its owners to be taxed on their individual returns.

[40] The Tax Cuts and Jobs Act introduced a new limitation on losses beginning in 2018. The maximum amount of net business losses from a sole proprietorship, partnership or S corporation that can be deducted on an owner's return is generally limited to $250,000 ($500,000 if married filing jointly); the disallowed excess loss is treated as a NOL and carried forward. Note that when the business has a loss, no self-employment tax is owed and there is no QBI deduction.

The partnership itself pays no income tax, but it must file a separate tax return (Form 1065: *U.S. Partnership Return of Income*). This is only an information return that includes a Schedule K-1 to report each partner's share of the profits or losses. This informs the IRS, and the partners, how much each partner should be reporting on his or her individual tax return. Most items of income that flow through to the partners retain their individual character. For example, a partnership's operating income is taxed at the partner's ordinary income tax rate while a long-term capital gain is taxed at the partner's rate for long-term capital gains.

One disadvantage of conduit taxation is that owners are taxed on their share of the profits, even if they receive no cash distributions from the business. They can, however, receive distributions of those previously taxed profits at a later date without incurring a second tax (the distribution impacts the partner's basis, discussed below). In addition, similar to a sole proprietor, an individual general partner must pay self-employment taxes on his or her share of partnership profits and is entitled to a QBI deduction.

Example 1.34

Ginny owns a one-third interest in the PEP Partnership. It reports $21,000 of operating income on Form 1065 for the current tax year but makes no distributions to the partners. Ginny receives a Schedule K-1 reporting $7,000 ($21,000 × 1/3) as her share of partnership income to include in her gross income for the tax year. The $7,000 is subject to self-employment taxes and she is entitled to a QBI deduction of $1,400 ($7,000 × 20%). If she is in the 22 percent marginal tax bracket she will also pay $1,232 income tax [($7,000 – $1,400) × 22%] on her $7,000 share of the partnership profits this year less her QBI deduction. The QBI deduction effectively reduces the tax rate on the partnership income from her 22% marginal tax rate to only 17.6% ($1,232/$7,000). In the future, however, Ginny can withdraw $7,000 from the partnership without being subject to additional tax (the withdrawal reduces Ginny's basis in PEP).

If a partnership incurs a loss, the loss also flows through to the partners and may be deductible from the partner's other income effectively *sheltering* that other income from tax. The total loss that an owner may deduct from an investment in a partnership is limited to the partner's basis in the partnership interest.[41]

Partner's Basis Account

A partner's basis account is a measure of the partner's investment in the partnership at any given time. It ensures that partnership income is taxed only once. It is the upper limit on the amount a partner may receive as a tax-free distribution, as well as the limit on the amount of loss that can be deducted.

A partner's beginning basis is determined by the cash and the basis of property contributed to the partnership in exchange for a partnership interest. A partner's basis is updated each tax year based on the activities of the partnership. Basis increases by any income or gains that flow through to the partner, decreases for any distributions to the partner, then decreases for losses that flow through to the partner. The deduction for losses that flow through is limited to the partner's basis in the partnership interest (after all adjustments for gains, income, and distributions)

[41] The passive income and at-risk rules may also prevent the deduction unless the partner materially participates in the partnership and his or her investment is at risk. These rules are discussed in Chapter 11.

because a partner's basis can never be negative. Once a partner's basis is reduced to zero, no additional loss can be deducted. This excess loss is carried forward until the partner again has positive basis against which it can then be deducted.

Example 1.35

Jennifer is a 40 percent general partner in ABC partnership. Her partnership basis is $200 at the beginning of year 1. Jennifer is in the 22% marginal tax bracket. From an income tax perspective, Jennifer reviews (1) the additional taxes paid (or saved) due to her share of partnership income or (loss) and (2) her basis in her partnership interest.

The partnership reports $2,000 of ordinary income on Form 1065 and distributes $450 in cash to Jennifer at the end of year 1. Jennifer's Schedule K-1 reports $800 (40% × $2,000) of income, her share that flows through to her. She increases her basis to $1,000 ($200 beginning basis + $800 income passed through), and then reduces it by the $450 distribution to her. Thus, Jennifer's basis at the end of year 1 is $550 ($200 + $800 – $450). In year 1, Jennifer also includes $800 in gross income and is allowed a QBI deduction of $160 ($800 × 20%) resulting in additional income taxes paid of $140.80 [($800 – $160) × 22%) on her share of the partnership profits. In year 1 Jennifer does not pay any income taxes as a result of the distribution, the distribution only impacts Jennifer's basis.

At the end of year 2, the partnership reports a $2,500 loss, $1,000 ($2,500 × 40%) of which flows through to Jennifer. Jennifer's basis at the beginning of year 2 is her basis from the end of year 1, $550. Although the loss that flows through to Jennifer is $1,000, she may only include $550 in her gross income in year 2. Her loss deduction is limited to her $550 basis. Jennifer carries the remaining $450 loss ($1,000 loss – $550 deducted) forward because her partnership interest basis cannot be negative.[42] Jennifer's tax savings from the $550 deductible loss are $121 ($550 × 22%). Jennifer's basis at the end of year 2 is $0 ($550 – $550).

The partnership's year 3 income is $5,000 and $2,000 ($5,000 × 40%) flows through to Jennifer. Jennifer updates her basis calculation to include the $2,000 as income, increasing her basis from $0 to $2,000. Now, she has sufficient basis to deduct the $450 loss carried over from the prior year. Her basis at the end of the year 3 is $1,550 ($0 + $2,000 – $450). Next, Jennifer calculates her income inclusion for year 3. Jennifer's share of the year 3 profit ($2,000), but it is reduced for the deductible loss carried forward from the prior year ($450). Thus, Jennifer pays income taxes in year 3 on a $1,550 inclusion ($2,000 – $450) less a QBI deduction of $200 [($2,000 profit – $1,000 prior loss) × 20%], resulting in $297 [($1,550 – $200) × 22%] of additional income taxes in year 3.

A unique feature of the partnership form is the increase in the partners' bases for their share of partnership liabilities. When the partnership repays the debt, the partners' bases are reduced for their share of the repayment. A partnership with liabilities allows its partners to deduct a greater share of losses as a result of this increased basis. If a partner's share of losses exceeds his or her remaining basis, the partner can only reduce basis to zero. The excess losses (after reducing basis to zero) cannot cause a negative basis and cannot be used until there are future increases in bases (from a share of income, contributions to capital or increase in liabilities) against which to deduct these excess losses.

When liabilities are repaid, partners must also reduce their bases for their share of discharged debt. If the partner's share of the repaid liability exceeds his or her remaining basis, the partner views the excess over basis similar to a "sale" of the partnership interest to avoid a negative basis.

[42] Jennifer can increase her basis by contributing cash or other property to the partnership. Her basis will also be increased when the partnership earns a profit and allocates Jennifer's share of that profit to her basis account.

Example 1.36

The partnership in the previous example borrows $5,000 at the beginning of year 2, increasing Jennifer's partnership basis to $2,550 [$550 beginning basis + (40% × $5,000 liability)]. Jennifer can now deduct her $1,000 second-year loss reducing her basis to $1,550 ($2,550 – $1,000 loss). When the partnership repays $2,000 of the loan at the beginning of year 3, Jennifer's basis decreases by $800 (40% × $2,000) to $750 ($1,550 – $800). If the partnership has a $2,400 loss in year 3, Jennifer's deduction is limited to her $750 remaining partnership basis and her remaining $210 loss [(40% × $2,400) – $750] cannot be deducted until she again has basis.

Alternatively, if the partnership had paid off the entire $5,000 loan at the beginning of year 3, her $1,550 basis would be reduced to zero and Jennifer would be taxed on the $450 share of liability that was repaid and exceeds her basis. Her loss cannot be deducted until basis is restored.

Most multi-member limited liability companies are partnerships for tax purposes, filing the Form 1065: *U.S. Return of Partnership Income*. Like partnerships, they are conduits that have their income or loss flow through to their members. This income or loss retains its character when it flows through to the members. Active members in an LLC also pay self-employment tax on their share of profits in the same manner as general partners or sole proprietors.

1.5.3 C CORPORATIONS

Regular corporations, including both publicly-held corporations traded on a stock exchange and privately-owned corporations, are usually referred to as C corporations to distinguish them from S corporations. Corporate shareholders can be employees subject to the same payroll taxes as all other employees. Shareholder-employees can participate in company fringe benefits that are denied tax-free treatment to the working-owners of other business forms (for example, employee health insurance premiums paid by the corporation are fully deductible by the corporation and are a tax-free benefit to shareholder/employees). In addition, the corporate tax rate is lower than individual tax rates, allowing owners to have increased capital for reinvestment and business expansion. A C corporation computes its taxable income and tax on Form 1120: *U.S. Corporate Income Tax Return*.

The main disadvantage of the corporate form is double taxation of corporate income because dividends are not deductible by a corporation. The corporation first pays a 21 percent tax on its net income when earned; then the after-tax income distributed to most shareholders is taxed as dividend income. (Generally, the other forms of business avoid this double level of tax.) The impact of this double taxation on individual shareholders is somewhat mitigated by the lower tax rates on dividend income.

Example 1.37

Tom, a taxpayer with dividend income in the 15 percent tax bracket, owns the Big Creek Corporation. Big Creek paid $10,500 in tax on its $50,000 of taxable income and distributes the $39,500 in after-tax earnings to Tom as a dividend. He pays $5,925 ($39,500 × 15%) in federal income taxes on the distribution. Total taxes of $16,425 ($10,500 + $5,925) are paid on the $50,000 earned by the corporation, or almost 33 percent of the pretax earnings.

Another disadvantage of a C corporation is that losses do not flow through to the shareholders and there is no tax benefit to shareholders in the year the corporation experiences the loss. Corporate losses can offset corporate profits in future years, as net operating losses can be carried forward an unlimited number of years. However, when a net operating loss (NOL) generated after 2017 is carried forward, it can offset no more than 80 percent of the taxable income before the

NOL deduction.[43] So until there are future corporate profits, there are no tax savings from corporate losses. If a new C corporation experiences losses in its early years, those losses are trapped at the corporate level until a future profitable year.

Example 1.38

Newborn Corporation incorporated as a new C corporation in 2018 and has a $40,000 loss in its first tax year, a $30,000 loss in its second year, a $20,000 loss in its third year, and finally a $140,000 profit in its fourth year. Newborn Corporation receives no tax benefit from its losses until its fourth year when it can offset its three years of accumulated losses of $90,000 against its $140,000 profit, reducing its taxable income in the fourth year to $50,000. Its tax savings in the fourth year are $18,900 ($90,000 × 21%), the difference between the corporate tax on $140,000 and the corporate tax on $50,000. The shareholders could not deduct any of Newborn Corporation's losses on their individual tax returns.

If in the fourth year Newborn's profits were only $100,000, the NOL carry forward could offset only $80,000 (80% of $100,000) in that year, reducing taxable income to $20,000. The excess $10,000 NOL would be carried forward to future years and would also be subject to the 80% limit in those years.

1.5.4 S CORPORATIONS

S corporations are formed in the same manner as C corporations but they avoid double taxation of corporate income by making a valid S corporation election so they are treated by the tax laws as flow-through businesses. To elect S corporation status, the corporation must qualify as a "small business corporation" as defined under Internal Revenue Code Section 1361. The corporation files Form 2553: *Election by a Small Business Corporation*, along with consent statements signed by all shareholders of record at the time the election is made. The election can be made at any time during the preceding year or before the 15th day of the third month of the tax year for which the corporation wishes to have S corporation status.

An S corporation must be a domestic corporation with no more than 100 shareholders who, with limited exception, must be individuals who are not nonresident aliens. It can have only one class of common stock outstanding. If a corporation violates any one of these requirements at any time, the S corporation status is revoked and it will be taxed as a regular C corporation from that time.

Qualifying S corporations use the conduit concept of taxation, passing profits and losses through to their shareholders (similar to partnerships) for taxation at the shareholder level, avoiding the double tax on corporate profits. S corporation shareholders have the same limited liability protection that C corporation shareholders possess but avoid the principal disadvantage of C corporations—double taxation of income.

S corporations file an information tax return, Form 1120S: *U.S. Income Tax Return for an S Corporation,* which also includes a Schedule K-1 to report the shareholder's share of income (or loss) for the tax year. The shareholders are taxed on their share of profits, whether they are actually distributed to them or retained in the corporation. A conduit entity is usually appropriate if the profits are distributed to the owners rather than reinvested in the business. These profits can then be distributed without the owners incurring any additional tax. Personal-service business activities (such as engineering) usually fall into this category.

S corporation shareholders can be employees of an S corporation for employment tax purposes, paying the same payroll taxes as other employees on their salary or wages. Similar to partners, however, shareholders who own more than 2 percent of the corporation's stock cannot participate in most employee fringe benefit programs on a tax-free basis. For example, the

[43] Net operating losses (NOLs) incurred prior to 2018 can be carried back two years but forward only 20 years. The 80% taxable income limit does not apply to these losses.

payment of health insurance premiums by the corporation for shareholders owning more than a 2-percent interest in the corporation, results in additional salary rather than a tax-free benefit.[44]

A shareholder's basis is a measure of the shareholder's investment in the corporation's stock. A shareholder's beginning basis is the cash and adjusted basis of any property contributed to the corporation (or the price paid for the corporate stock). The shareholder's basis increases for the shareholder's share of the corporation's income or gain and decreases for any distributions or losses. The shareholder's deduction for losses is limited to the shareholder's stock basis (similar to a partner's basis limit for a loss deduction). Unlike a partnership, however, S corporation shareholders do not increase basis for debts undertaken by the corporation because S corporation shareholders have no personal liability for corporate debts. Thus, if the entity in examples 1.35 and 1.36 had been an S corporation, Jennifer could not have increased her basis for the corporation's debt.

Example 1.39

Assume the facts in examples 1.35 and 1.36 except that the business is an S corporation. Jennifer's basis adjustments are the same for the S corporation as shown in example 1.35. When the S corporation borrows $5,000 (example 1.36), Jennifer cannot increase her basis and it remains $550. Jennifer's second-year deduction is limited to her $550 basis, reducing it to zero. Her remaining $450 loss is carried forward until she again has basis in her S corporation stock. The loan repayment has no effect on Jennifer's stock basis.

S corporations and partnerships also differ in that shareholder-employees are not subject to self-employment taxes on the profits of an S corporation as are general partners' shares of the partnership profits. This provides an incentive for S corporation shareholders to take lower salaries (subject to employment taxes) but larger distributions of profits (not subject to self-employment taxes). If the IRS deems the salary paid to a shareholder-employee is unreasonably low on audit, it may reclassify some or all of a cash distribution of profits as salary and assess additional employment taxes on both the shareholder and the corporation (as discussed in Chapter 4).

As conduit entities, partnerships, limited liability companies, and S corporations are especially attractive in the early years of a business activity when operating losses are likely to occur. The early losses of a C corporation are locked inside the corporation and provide no tax benefit until the corporation becomes profitable. Losses from a conduit entity flow through to the owners and benefit the owners in the same year that the loss occurs (assuming the owners are able to deduct the losses). When conduit entity owners have high marginal tax rates, the benefit of loss flow-through is especially attractive.

At first glance, conduit entities may appear to be superior to C corporations from a purely tax perspective. Such a conclusion is shortsighted, however. C corporations have some favorable tax characteristics that are not available to any conduit entity. Exploiting these characteristics (such as the ability of owners to be treated as employees and to benefit from tax-free employee fringe benefits), can more than compensate for double taxation.

1.5.5 COMPARING BUSINESS ENTITY ATTRIBUTES

Choosing the best legal entity for the operation of a business activity is an extremely difficult decision. The future needs of both the business and its owners must be estimated and evaluated as part of this decision. Once a decision is implemented it will have long-lasting effects. Changing from one entity type to another can be difficult and expensive. Federal and state income taxes are an important component of the legal entity decision; however, taxes alone are an insufficient

[44] Some of the benefits that greater-than-2-percent S corporation shareholders and partners cannot receive on a tax-free basis include health and accident insurance, group term life insurance, on-premises lodging, employee achievement awards, transit passes, and parking benefits. To mitigate the difference in this treatment of employer-provided health insurance for employees and the self-employed, sole proprietors, S corporation shareholders, and general partners may deduct the cost of health insurance as an adjustment to income. See Chapter 4.

criterion for making a decision. Figure 1.7 presents a basic comparison of partnerships, S corporations, and C corporations as operating businesses across some of the tax and nontax attributes that should be considered when evaluating the choice of entity. These various attributes are explored in more detail in later chapters of this text.

Attribute	Partnership	S corporation	C corporation
Limited liability protection	Limited partners have limited liability protection. General partners have unlimited liability with respect to partnership debts.	Yes	Yes
Owner identity restrictions	None; any person or entity may be an owner.	Substantial restrictions: corporations, partnerships, certain trusts, and non-resident aliens not permitted.	None; any person or entity may be an owner.
Number of permitted owners	Minimum 2; maximum unlimited	Minimum 1; maximum 100 (family members treated as one)	Minimum 1; maximum unlimited
Differences in ownership rights permitted between owners	Flexible; economic and management rights can vary between general and limited partners.	Generally fixed; only common stock is permitted, but voting rights may vary.	Flexible; no limit on different classes of stock that may be created.
Excludible employee fringe benefits for employee owners	Generally not available.	Generally not available for greater than 2% owners.	Available to all employees.
Tax treatment of capital gains and losses	Gains flow through to partners and are taxed at partner's capital gains tax rate. Losses deductible by partner subject to capital loss limits.	Gains flow through to shareholders and are taxed at owner's capital gains tax rate. Losses deductible by shareholder subject to capital loss limits.	Gains taxed to corporation at the flat 21% rate applicable to ordinary income. Net capital losses are carried back 3 years and forward 5 years.
Marginal tax rate structure applied to ordinary income	Flow through to owner and taxed at owner's marginal tax rate.	Flow through to owner and taxed at owner's marginal tax rate.	Taxed at a flat 21% rate.
QBI deduction	20% of qualified business income	20% of qualified business income	Not eligible
Allocation of entity income and loss	Allocations made under partnership agreement.	Fixed; all allocations based on ownership of stock.	N/A; not a conduit entity.
Self-employment taxes	Imposed on ordinary income share of general partners.	Not imposed.	N/A; not a conduit entity.
Tax forms filed	Form 1065	Form 1120S	Form 1120
Overall capacity of owner to derive tax benefit from entity losses	Very good for partners who participate in management and can increase basis for entity debts.	Good for shareholders who are material participants in the business; however, it may be limited because shareholder basis not increased for entity debts.	Not a conduit entity. Corporate net operating losses remain within corporation and are carried forward for eventual corporate tax benefit.

FIGURE 1.7
Comparison of business entity attributes

REVISITING THE INTRODUCTORY CASE

Once Wing Hue establishes residency in the United States, he is subject to the tax laws. Depending on the type of entity Wing Hue selects for his manufacturing enterprise will determine how his gear business will be taxed.

As an employee of the consulting firm, Hue will report his salary as part of his gross income and his share of FICA taxes will be withheld by his employer. His employer also must withhold a certain percentage of his gross income for his income tax liability based on his estimated income. He is subject to income tax rates ranging from 10 to 37 percent of his taxable income.

To obtain backing from venture capitalists, the investors may require Hue to use a certain type of entity. If the venture capitalists require Hue to establish a C corporation (to provide flexible ownership and limit their liability), Hue could own a certain percentage of the corporation while also being an employee. This allows Hue to fully participate in the corporation's fringe benefits. (If the venture is successful, he will most likely leave his consulting position.) As an owner-employee, Hue can take profits out of the corporation as a salary, subject to FICA taxes and income tax withholding. It will, however, be paid with the before-tax income of the corporation due to the corporation's salary deduction. Corporate profits taken out as dividends will be paid with the after-tax income of the corporation and will be subject to additional taxes when received by Hue and his backers.

The manufacturing business could be established in several other entity forms, if his financial backers allow. It is unlikely the backers would sanction operations as a sole proprietorship (the lenders would have to lend the money directly to Hue). If they did, however, Hue would have to pay self-employment taxes on all profits as well as income taxes. He will, however, be able to deduct losses against his other income.

The backers could permit the business to operate as either a partnership or an S corporation as an alternative to the C corporation. They can limit their liability through the S corporation or a limited liability company electing partnership taxation. These entities pass income directly through to the owners for taxation, eliminating the double taxation of earnings. As a general partner, Hue would be responsible for self-employment taxes on his share of partnership income, in addition to income taxes. Hue cannot be an employee of the partnership nor participate in tax-free employee fringe benefits. Although he can be an employee of an S corporation (with FICA taxes and income tax withholding on his salary), ownership of more than 2 percent of the stock limits his ability to benefit from tax-free employee fringe benefits.

SUMMARY

Taxes are required payments to a governmental unit and are unrelated to the benefits received by the taxpayer as a result of the payment. In addition to funding government operations, taxes are used to redistribute wealth, foster price stability and economic growth, and meet social goals.

A major source of revenue for many jurisdictions is an income tax, but there are many other bases for levying taxes. Various governmental units levy consumption taxes (sales and use taxes), wealth taxes (property taxes), and wealth transfer taxes (estate and gift taxes). These taxes may be proportional, progressive, or regressive. Adam Smith's four canons of taxation of equity, economy, certainty, and convenience can be used to evaluate a tax.

The income tax is the primary source of revenue for the federal government, but only individuals, corporations, and fiduciaries pay income taxes. Other business entities, such as sole proprietorships, partnerships, and S corporations pass their incomes through to their owners until they reach one of the three types of income tax-paying persons. This income is then included with the other types of income subject to income taxes by an individual, corporation, or fiduciary for taxation by the appropriate jurisdiction(s).

The impact of income taxes is just one of many things that must be considered when deciding in which form to operate a business. S corporations and limited liability companies can limit the owner's liability for corporate acts. Sole proprietors and partners may have to surrender personal assets to satisfy judgments against the business. Other variations include, but are not limited to, the treatment of employment taxes, participation in fringe benefit programs, and the ability to sell an interest in the business. These and more must be considered when determining in which form to operate a business.

KEY TERMS

Ad valorem 8
Average tax rate 14
Canons of taxation 16
C corporation 19
Estate tax 9
FICA tax 7
Fiduciary 19
Filing status 24
Franchise tax 6
Gift tax 9
Gross income 20
Horizontal equity 17
Initial public offering (IPO) 31
Internal Revenue Code 4
Losses 21
Marginal tax rate 14
Nexus 6
Partnership 33
Progressive tax system 13
Proportional tax system 15
Qualified business income (QBI) 25
Real property tax 8
Regressive tax system 15
S corporations 37
Sales tax 10
Sole proprietorship 32
Standard deduction 24
Tax expenditures 5
Use tax 11
Value-added tax (VAT) 12
Vertical equity 17

TEST YOURSELF

Answers Appear after the Problem Assignments

1. Which of the following is correctly categorized as a tax?
a. The dog license fee
b. The annual property tax on your home
c. An assessment for putting streetlights in front of your home that increases the home's value
d. The bond a person must post to get out of jail

2. What type of tax is a sales tax?
a. Income tax
b. Consumption tax
c. Wealth transfer tax
d. Turnover tax

3. What characteristic of a tax states that taxpayers with equal incomes should pay equivalent amounts of taxes?
a. Horizontal equity
b. Vertical equity
c. Certainty
d. Convenience

4. Which of the following applies only to individual taxpayers and not to corporations?
a. Taxable income
b. Estimated tax payments
c. Gross income
d. Lower tax rates for long-term capital gains

5. Which of the following entities does not pass its income directly through to its owners?
a. Sole proprietorship
b. Partnership
c. C corporation
d. S corporation

PROBLEM ASSIGNMENTS

Check Your Understanding

1. [LO 1.1] What is a tax? How does a tax differ from a fine?
2. [LO 1.1] What Constitutional Amendment allowed implementation of an income tax? In what year was it ratified?
3. [LO 1.1] Which version of the tax code is applicable today?
4. [LO 1.1] Define tax expenditure.
5. [LO 1.1] What is a SALT practice?
6. [LO 1.1] What is nexus?
7. [LO 1.1] Suntan Corporation sells its products nationwide over the Internet. It has production facilities, warehouses, and offices only in the state of Florida. It has sales in excess of $600,000 for the year to customers in Arizona. It has no physical presence in Arizona. Can Arizona assess state income tax on Suntan Corporation for the sales made to Arizona customers?
8. [LO 1.1] How does a franchise tax differ from an income tax?
9. [LO 1.1] What three factors are generally used to determine the percentage of corporate income allocated to a particular state?
10. [LO 1.1] What employment taxes are imposed on an employee and an employer?
11. [LO 1.1] What is the most common wealth tax and how is it levied?
12. [LO 1.1] What property is subject to the intangible tax?
13. [LO 1.1] Explain the integration of the gift and estate taxes.
14. [LO 1.1] Differentiate a consumption-based tax from an income tax and illustrate with an example.
15. [LO 1.1] Differentiate a wealth tax from a wealth transfer tax and give examples of each.
16. [LO 1.1] What is a use tax?
17. [LO 1.2] Over what ranges of taxable income in 2019 will the total income tax liability for two persons with equal incomes who file as single individuals equal their income tax liability if they file jointly as a married couple?
18. [LO 1.2] Differentiate a progressive tax system from a proportional and a regressive system and give examples of each.
19. [LO 1.2] What basic tax rates apply to the ordinary income, dividend income, and interest income of an individual? What are they for a corporation?
20. [LO 1.2] What tax rates apply to an individual's capital gains?
21. [LO 1.3] Briefly explain Adam Smith's four canons of taxation.
22. [LO 1.3] Differentiate horizontal from vertical equity.
23. [LO 1.4] Which three taxable persons pay all of the income taxes?
24. [LO 1.4] Define gross income.
25. [LO 1.4] Briefly describe the basic elements of the tax model.
26. [LO 1.4] Differentiate the tax treatment of an individual's capital losses from the tax treatment of corporate capital losses.
27. [LO 1.4] What are the basic tax rates for an individual and a corporation?

28. [LO 1.4] What are two fiduciary entities and how are they created? Differentiate the grantor, trustee, and beneficiary of a trust.

29. [LO 1.5] What are three characteristics of a sole proprietorship? Do these characteristics differ from those of a partnership? What are three characteristics of a limited liability company that differ from those of a partnership?

30. [LO 1.5] Compare a C corporation to an S corporation.

Crunch the Numbers

31. [LO 1.1] Dane City's total assessed valuation for all of the property in its jurisdiction is $4,000,000,000. It needs $20,000,000 in revenue for the services it provides its citizens. Joe owns property that is assessed at $150,000. How much will he pay in property taxes?

32. [LO 1.1] If a taxpayer has $40,000 of employee salary in 2019, how much will be withheld for the Social Security and Medicare taxes?

33. [LO 1.1] If a taxpayer has $140,000 of employee salary, how much will be withheld for the Social Security and Medicare taxes in 2019?

34. [LO 1.4] Determine Amy's taxable income for 2019 if she has $40,000 of salary income, is single, and claims the standard deduction.

35. [LO 1.4] Marlee, a single parent of one dependent child, has $19,000 in itemized deductions and files as head of household for 2019. Determine her taxable income and income tax liability if she has a salary of $71,000 and interest income of $1,500.

36. [LO 1.4] Determine a corporation's taxable income if it has $450,000 of gross receipts, $145,000 cost of goods sold, $276,000 of deductible business expenses, $20,000 of gain on the sale of machinery, and $500 of tax-exempt interest income from State of New York bonds.

37. [LO 1.4] The Warner Corporation has gross income of $560,000. It has business expenses of $325,000, a capital loss of $20,000, and $2,500 of interest income on temporary investments. What is the corporation's taxable income?

38. [LO 1.4] Determine George and Mary's taxable income and tax liability for 2019 if George has $65,000 and Mary has $45,000 of salary income, they have $20,000 of allowable itemized deductions, no dependents, and file a joint tax return.

39. [LO 1.4] Refer to the information in problem 34. Determine Amy's income tax liability for 2019.

40. [LO 1.4] Refer to the information in problem 36. Determine the corporation's income tax liability.

41. [LO 1.4] Refer to the information in problem 37. Determine Warner Corporation's income tax liability.

42. [LO 1.4] Sally and Jim are married and have taxable income in 2019 of $700,000. If they could file their income tax as single individuals, each of them would have taxable income of $350,000. Do they have a marriage penalty when they file their joint return? If so, what is the amount of the penalty?

43. [LO 1.4] Conrad, who has $220,000 of taxable income, plans to marry Anita, a college student with no taxable income. If they marry on December 21, 2019, they will file jointly and have $220,000 of taxable income for the year. If they wait until January of 2020 to marry, Conrad will have to file as a single person and report the $220,000 of taxable income on his individual return.

a. Will it be to their advantage to marry before the end of 2019 or should they wait until 2020?

b. How much in tax will they save or have to pay extra if they marry in 2019?

c. How would your answers change if Conrad and Anita marry and each expects $110,000 of taxable income in 2019?

44. [LO 1.4] Carrie and Stephen have gross salary and wages of $76,000 in 2019, file a joint return, and have a seven year old dependent child. They have $15,000 of allowable itemized deductions and a $240 child care credit. Determine their taxable income.

45. [LO 1.4] An estate has $20,000 of taxable income in 2019. What amount of tax will the estate pay if it fails to distribute the income to the beneficiaries?

46. [LO 1.5] John has taxable income of $30,000. William has taxable income of $60,000. Determine their 2019 income taxes if they are both single individuals and claim the standard deduction. Compare their incomes and their income taxes. What does this illustrate?

47. [LO 1.5] Hunter Corporation has $250,000 in gross income, $125,000 in deductible business expenses, and a $12,000 business tax credit. Determine the corporation's net tax liability.

48. [LO 1.5] Carolyn has a 50 percent interest in a general partnership that has a $14,000 loss for the year. She materially participates in the partnership. Her basis in the partnership is $10,000. She also has salary from other employment of $46,000. If she is single, has no dependents, and claims the standard deduction, what are her taxable income and tax liability in 2019?

49. [LO 1.4 & 1.5] June and John decide to form a business. They each plan to contribute $20,000 in exchange for a 50 percent interest in the business. They will then take out a bank loan for $30,000 to cover the balance of their working capital needs. They expect that the business will make a profit of $64,000 in the first year and that it will not make any cash distributions that year. Excluding the business income, June, who files as head of household, has $110,000 of other ordinary taxable income. John is married and files a joint return; he and his wife have $110,000 of other ordinary taxable income. They want to know how much tax the business will pay and how much additional tax they will personally pay in 2019 if they form the business as a partnership, S corporation, or C corporation. Consider only income taxes. Assume June and John qualify for the 20 percent qualified business income (QBI) deduction.

50. [LO 1.4 & 1.5] Assume the same facts as problem 49, except that the business expects to make a cash distribution of $17,000 each to June and John the first year. Determine how much tax the business will pay and how much additional tax they will personally pay if they form the business as a partnership, S corporation, or C corporation. Consider only income taxes.

51. [LO 1.4 & 1.5] Assume the same facts as problem 49, except that John and June expect the business will have a $44,000 loss in the first year (instead of a $64,000 profit) and will not make any cash distributions. Determine the income tax savings in the current year for the business and for them personally if they form the business as a partnership, S corporation, or C corporation. (They both materially participate in the business and their marginal tax bracket will not change because of the business loss.)

52. [LO 1.4 & 1.5] Clara and Charles decide to form a business. Clara plans to contribute $9,000 for a 30 percent interest and Charles plans to contribute $21,000 for a 70 percent interest. The business will borrow $20,000 to cover the balance of its working capital needs. In their business plan, Clara and Charles show that the business will have a loss of $54,000 in its first year. In the second year, however, the business will have a profit of $90,000 and the business will distribute $3,000 to Clara and $7,000 to Charles. Clara is in the 24 percent marginal tax bracket and Charles is in the 22 percent marginal tax bracket; both are in the 15 percent tax bracket for dividend income. In year 2, assume Clara and Charles qualify for the 20 percent qualified business income (QBI) deduction.

a. Determine the taxes paid by the business (if any) in the first and second year if they organize the business as (1) a partnership, (2) an S corporation and (3) a C corporation.

b. Determine Clara's and Charles's income tax savings in the first year and their bases in the business at year-end if they organize the business as (1) a partnership, (2) an S corporation, and (3) a C corporation.

c. Determine the income tax Clara and Charles will pay in the second year from business operations and their bases in the business at year-end if they organize the business as (1) a partnership, (2) an S corporation, and (3) a C corporation.

53. [LO 1.5] Carl is a 30 percent partner in the CCF Partnership. At the beginning of the year, his basis in the partnership is $4,000. The partnership reports $7,000 of ordinary income and distributes $3,000 to the partners. What is Carl's basis at the end of the year?

Develop Planning Skills

54. [LO 1.4] John and Martha are planning to be married. Both are professionals each with taxable incomes of $360,000 annually. They are deciding on a wedding date. They have two dates to choose from: December 14, 2019, or January 11, 2020. If they marry on December 14, 2019, they will have to choose between married filing separately and married filing jointly. Is there an advantage to either method of filing? If they postpone their wedding until the January date and file as single persons, will they reduce their tax bill for 2019?

55. [LO 1.4 & 1.5] Jeremy is setting up a service business. He can either operate the business as a sole proprietorship or he can incorporate as a regular C corporation. He expects that the business will have gross income of $80,000 in the first year with expenses of $12,000 excluding the following. He plans to take $30,000 from the business for living expenses as a salary. Compare his tax costs for 2019 considering only income taxes if he is single, has no dependents or other income, and claims the standard deduction. Which option do you recommend based solely on these tax costs?

56. [LO 1.4 & 1.5] Carol has recently incorporated her sole proprietorship and is considering making an S election. The corporation has $200,000 of gross revenue and expenses of $75,000 before Carol's salary. She plans to take a gross salary of $40,000 from the business and this will be her only income for the year. Compare the total tax burden for Carol and the corporation with and without the S election. Consider only income taxes. Carol is single, has no dependents, and uses the standard deduction. She plans to reinvest all of the corporation's net income after taxes into the business. Based on the tax burden alone for 2019, should Carol make the S election?

Think Outside the Text

These questions require answers that are beyond the material that is covered in this chapter.

57. [LO 1.2] What is the maximum income tax rate that applies to the employee salary, the employment tax rate(s) on the salary, and the capital gain rate(s) on the long-term capital gains, for these four single individual taxpayers in 2019 (excluding Medicare surtaxes)?
a. Employee Salary = $27,000; Capital Gain = $9,000
b. Employee Salary = $132,000; Capital Gain = $24,000
c. Employee Salary = $176,000; Capital Gain = $139,000
d. Employee Salary = $285,000; Capital Gain = $248,000

58. [LO 1.2] Do you believe that a progressive, proportional, or regressive tax is the most fair? Explain your answer.

59. [LO 1.2] Is a property tax generally a progressive, proportional, or a regressive tax? Explain.

60. [LO 1.2] If the Congress were to enact a flat tax for individual taxpayers, do you believe that there should be any exclusions or deductions from income before the single tax rate is applied? Explain.

61. [LO 1.3] Evaluate the sales tax and the income tax using Adam Smith's four canons of taxation.

62. [LO 1.4] Evaluate allowing married individuals with dual incomes to choose to file a joint tax return or to file as two single individuals as a remedy for the marriage penalty.

63. [LO 1.4] What is the after-tax interest rate that a corporation pays on a loan of $100,000 at 7 percent interest?

64. [LO 1.4] Compare the benefits of a $4,000 deduction and a $4,000 tax credit for two single taxpayers, one with taxable income of $50,000 and the other with taxable income of $200,000.

Search the Internet

For the following four problems, consult the IRS website (www.irs.gov).

65. [LO 1.1] Briefly describe the statistical information available when you go to the IRS website and click on About IRS, and then click on Tax Statistics.

66. [LO 1.1] Go to the IRS website and click on About IRS, and then click on Tax Statistics. What subheadings appear under the "Statistics of Income"?

67. [LO 1.1] Search the IRS website for VITA. Briefly describe this program.

68. [LO 1.1] Search the IRS website for TCE. Briefly describe this program.

69. [LO 1.1] Go to www.taxfoundation.org (the website for the Tax Foundation).
a. What is Tax Freedom Day?
b. When were Tax Freedom Days in 2017 and 2018?

Identify the Issues

Identify the issues or problems suggested by the following situations. State each issue as a question.

70. [LO 1.4] John and Mary filed for divorce in November of the current year. The divorce will not become final until May of the following year.

71. [LO 1.5] DEE is an S corporation with 100 shareholders. John, one of these shareholders, gives half of his shares of stock to his new wife as a wedding gift.

72. [LO 1.5] Clifford owns 75 percent of AFK, a C corporation. He spends little time in the business, but takes a salary of $750,000.

ANSWERS TO TEST YOURSELF

1. **b.** The annual property tax on your home

2. **b.** Consumption tax

3. **a.** Horizontal equity

4. **d.** Lower tax rates for long-term capital gains

5. **c.** C corporations

The Tax Practice Environment

CHAPTER 2

LEARNING OBJECTIVES

After completing this chapter, you should be able to:

2.1 Discuss the basic elements of tax compliance including filing requirements, the audit and appeal process, and noncompliance penalties.

2.2 Understand the multiple sources impacting a tax preparer's professional responsibilities and ethical standards and the effects of failure to adhere to them.

2.3 Explain the importance of cash flow, present value, and marginal tax rate when making tax decisions and how they affect tax planning strategies.

2.4 Explain the steps in the tax research process and demonstrate the ability to evaluate primary sources of authority, reach reasonable conclusions, and communicate the results.

CHAPTER OUTLINE

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Tax practice involves tax compliance, tax planning, and tax research. A practitioner involved in compliance must understand the laws regulating how and when to file a client's tax return, as well as those governing how and what items are reported on the return. Practitioners who fail to meet acceptable levels of competence or fulfill their responsibilities to their clients and the tax system may be subject to severe penalties. Tax professionals need a well-developed sense of personal and professional ethics to carry out their responsibilities in spite of client pressures.

Although much of the work done by tax practitioners is compliance oriented, the most challenging assignments often involve tax planning. Tax professionals must determine all the relevant facts, completely analyze all possible issues and outcomes (including the present values of net cash flows), and using their knowledge and experience, present their clients with the best alternative.

Taxpayers and the Internal Revenue Service may disagree on the tax treatment of a specific transaction because the Internal Revenue Code does not address every possible variation or tax consequence of every type of transaction. The application of the tax law to a specific set of facts is subject to differing interpretations. Tax research plays a vital role in identifying and interpreting the various sources of tax authority in two commonly encountered situations. First, tax practitioners defend clients' completed transactions so that the client receives the best possible tax outcome. Second, they assist clients contemplating a potential tax transaction to understand the possible outcomes.

Tax professionals must use all of the tools available to solve tax problems. They should consult both the actual tax laws and the interpretations of the Treasury Department and judiciary before communicating their recommendations to their clients, detailing their reasoning and conclusions in acceptable form.

SETTING THE STAGE—AN INTRODUCTORY CASE

Your friend, Kevin, has asked for your advice. He was recently audited by the IRS and received a notice stating that they were reclassifying his part-time dog training business as a hobby. They disallowed many of his deductions related to the business resulting in a tax deficiency of $3,000. Kevin does not believe he owes the additional tax (and really cannot afford to pay it). He would like your advice regarding his appeal options. We will return to this case at the end of this chapter.

2.1 TAX COMPLIANCE

Accountants have many opportunities to specialize in tax compliance, tax planning, or a combination of both. More than 50 percent of all taxpayers pay someone else to prepare their tax returns. Tax preparation is generally referred to as tax compliance. **Tax compliance** consists of gathering relevant information, evaluating and classifying the information, and filing the tax returns. Tax compliance also includes representing clients at an Internal Revenue Service (IRS) audit.

Commercial tax return preparers, attorneys, and certified public accountants (CPAs) all perform tax compliance to some extent. Commercial tax return preparers (such as H&R Block) often complete only the more basic individual and business tax returns. CPAs and attorneys usually prepare more complex tax returns, represent their clients before the IRS, and provide extensive tax planning services. Many businesses employ their own internal tax advisers. The largest U.S. corporate tax departments employ up to 400 tax professionals on a full-time basis who spend much of their time complying with local, state and federal tax provisions. The top tax executive in these corporations typically has a title such as Vice President of Taxation and usually reports to the Chief Financial Officer (CFO). Individuals working for large corporations frequently develop industry specializations, and many accountants hired by private industry have prior tax experience in either public practice or government.

The largest single employer of tax professionals is the Treasury Department, of which the IRS is a part. The Justice Department, the Tax Court, the Office of Management and Budget, and various congressional committees, as well as state and local governments, employ numerous tax professionals.

2.1.1 FILING A TAX RETURN

Returns for individuals, C corporations, estates, and trusts must be filed on or before the fifteenth day of the fourth month following the close of the taxpayer's tax year (April 15 for calendar-year taxpayers).[1] Partnership and S corporate tax returns are due on or before the fifteenth day of the third month following the close of the tax year (March 15 for calendar-year taxpayers). When the legal due date for a return falls on a weekend or legal holiday, the due date is the next weekday.[2] For example, if April 15 is a Saturday, the due date for individual tax returns is Monday, April 17. If the taxpayer cannot file the return by its due date, the taxpayer can file a request by the due date for a six-month extension to file the return. This is normally granted automatically by the IRS.[3] Filing an extension does not extend the time for paying the tax, however. Applications for automatic extensions must include payment of any tax owed based on the taxpayer's reasonable estimate of his or her final tax liability.

[1] Prior to 2016, all C corporation returns were due the fifteenth day of the third month following the close of the tax year and partnership returns were due the fifteenth day of the fourth month. C corporations with a June 30 year end will continue to be due September 15th until 2025.

[2] §7503.

[3] Reg. §1.6081-4T. Individuals must file Form 4868 no later than the original due date of the return to obtain an automatic six-month extension. Corporations and partnerships receive an automatic six-month extension by filing Form 7004. Trusts can receive a maximum 5½-month extension.

Taxpayers who overpay their income tax through excess withholding or large quarterly estimated payments effectively loan money to the federal government. The government is not required to pay interest on any tax overpayment that is refunded within 45 days after the due date for the return.[4] This is why the IRS tries to process refund requests quickly. Interest is owed the taxpayer only if the refund is mailed after the 45-day grace period.[5]

Late Filing and Late Payment Penalties

The IRS may impose a *failure-to-file penalty* on taxpayers who fail to file an income tax return on a timely basis, and a *failure-to-pay penalty*, in addition to charging interest, on taxpayers who fail to pay the tax on time.[6] The failure-to-pay penalty is 0.5 percent of the tax liability for each month (or part of a month) that the payment is late. The maximum penalty is 25 percent of the tax liability.

Example 2.1

Kyle's tax return filed on April 15 showed he owed $5,000 in taxes. Due to some bad planning, Kyle could not pay his taxes with his return. Kyle finally made his payment in full on June 5. Kyle's penalty is 1 percent, 0.5 percent for two months—one full month and one partial month. Kyle's late payment penalty is $50 (1% × $5,000).

The failure-to-pay penalty will not be applied during the six-month automatic extension of the filing period if at least 90 percent (80 percent for 2018) of the actual tax liability is paid by the original due date and any balance due is paid when the return is filed by the end of the extension period.

The failure-to-file penalty is 5 percent per month (or partial month) that the return is late, with a maximum of 25 percent, also based on the taxpayer's tax liability. If the 0.5 percent failure-to-pay penalty and the failure-to-file penalty both apply, the failure-to-file penalty drops to 4.5 percent per month (or part month), and the total combined penalty remains 5 percent of the tax liability. The maximum combined penalty for the first five months is 25 percent. Thereafter, the 0.5 percent per month failure to pay penalty continues for 45 more months (an additional 22.5 percent). The combined penalties can reach a total of 47.5 percent of the tax liability over time. In abusive situations involving a fraudulent failure-to-file, the late-filing penalty can increase to 15 percent a month, up to a maximum 75 percent of the tax liability.

Example 2.2

Kyle did not to file his return on April 15 because he could not pay the balance due. He files his return on June 5 and pays the full $5,000 balance at that time. He can expect a notice from the IRS charging an additional $500 in late-payment/late-filing penalties ($5,000 × 10%), 5 percent for each of two months. Kyle could have saved $450 in penalties by filing the forms on April 15 even if he could not pay the tax.

If a taxpayer files a return more than 60 days late, the minimum failure-to-file penalty equals the smaller of $215 or 100 percent of the tax due on the return. If no tax is owed on an individual's return, however, there is no penalty. Because flow-through entities, such as partnerships and S corporations normally pay no tax on which to base a penalty, their late filing penalty is based on the number of owners. The penalty is $205 for each month or partial month (up to

[4] §6611(e)(1).

[5] The interest rate for individuals is the federal short-term interest rate plus three percentage points. The interest rate for corporations is generally the short-term rate plus two percentage points. §6611(a) and §6621(a)(1).

[6] The interest rate for tax underpayments is determined by adding three percentage points to the short-term federal rate that is calculated each quarter. §7206.

12 months) the return is late multiplied by the total number of partners or shareholders during the year.

A taxpayer who cannot pay the full tax with the return can request an installment agreement with the IRS.[7] Generally, the IRS will accept an installment agreement if the tax owed is less than $10,000 and the balance due will be paid within three years. The taxpayer must pay a user fee to obtain the installment agreement and is charged interest and late payment penalties.

Statute of Limitations

Some taxpayers feel a sense of relief when they receive their refund check for an overpayment of tax, erroneously assuming that once their refund is processed they will not be audited. Although the IRS usually does not audit an individual's return more than two years after the date a return is filed, the general statute of limitations allows up to three years. The **statute of limitations** is the period of time beyond which legal actions or changes to the tax return cannot be made by either the taxpayer or the government. The general statute of limitations is three years from the date a return is filed or its due date, whichever is later.[8] Filing a return early does not start the clock on the statute of limitations.

Example 2.3

Maureen, a calendar-year individual, files her income tax return for 2019 on March 31, 2020. The return is treated as filed on April 15, 2020, its due date. The statute of limitations expires on April 15, 2023.

If instead of filing her return in March, Maureen requests an automatic six-month extension of time and files her return on October 15, 2020, the statute of limitations for Maureen's 2019 return now expires on October 15, 2023.

The general three-year statute of limitations is extended to six-years if a taxpayer omits gross income in excess of 25 percent of the gross income reported on the tax return. The six-year statute of limitations only applies to omitted income, not excess deductions; therefore, claiming excess deductions does not extend the statute of limitations to six years.

Example 2.4

John filed his 2018 tax return on April 2, 2019. His return showed $30,000 of salary income only. John failed to include an $8,000 capital gain on an early January stock transaction. The omitted gain exceeds 25 percent of the gross income shown on his return (25% × $30,000 = $7,500) and extends the statute of limitations to April 15, 2025.

As part of the government's war on tax shelters, the Treasury instituted disclosure rules that require participants in tax shelters to disclose these transactions (referred to as listed transactions) on their tax returns or face significant penalties. Congress extended the statute of limitations for tax returns not complying with these disclosure requirements until one year after the date the required information is provided to the IRS.

A fraudulent return triggers an unlimited assessment period, as there is no statute of limitations for fraud. Although the government can bring fraud charges at any time, the burden of proof is on the IRS to show that the return was fraudulent.[9] If a fraudulent return is filed, a later

[7] Form 9465: Installment Agreement Request can be filed separately or can be attached to the tax return.
[8] §6501(a) and (b)(1).
[9] Burden of proof is a legal concept requiring the party who is subject to carrying the burden of proof to demonstrate, by appropriate evidence, that the particular requirement has been met.

non-fraudulent amended return does not start the three-year or six-year limitation period. When a taxpayer files an incomplete return or no return at all, the statute of limitations does not begin to run until a complete return is filed.

Refund claims can be initiated by a taxpayer within three years of the filing date for the return or two years from the date the tax is paid, whichever is later. If a taxpayer did not file a return because no tax was due, the claim for refund must be filed within two years of the date the tax was paid. A taxpayer files a claim for refund by amending the return using Form 1040X for an individual or Form 1120X for a corporation.

Example 2.5

Joyce filed her 2016 return on April 15, 2017 paying the $3,000 tax owed. An audit in May 2019 asserted a deficiency of $400 that Joyce paid May 17. Upon reviewing the return, Joyce discovers an unclaimed $700 tax credit. If Joyce files a claim for a refund by April 15, 2020, she can recover $700. If she fails to file a refund claim until after April 15, 2020 (but before May 18, 2021), she can only recover the $400 deficiency payment. If Joyce fails to file her claim before May 18, 2021, she will not be entitled to any refund.

2.1.2 SELECTING RETURNS FOR AUDIT

Over one million individual returns are audited annually, an audit rate of less than one percent of the returns filed. Because only a small number of tax returns can be audited each year, the IRS relies upon a sophisticated computer model to identify returns that possess the greatest potential revenue for the IRS's investment of audit resources. In addition to this computer selection process, a number of returns are manually selected for examination at an examiner's discretion.

All individual and business tax returns are routinely reviewed by the IRS for obvious errors, such as the omission of Social Security or taxpayer identification numbers. After this initial review, tax returns are processed through the IRS computer program. One of the most important functions performed by this program is the matching of information recorded on a return with corresponding data received from third parties (for example, a Form W-2 from an employer). This document matching program uncovers millions of cases of discrepancies between the income that recipients report on their tax returns and the corresponding payments reported by the payers.

This computer program also checks for math errors to uncover relatively simple and readily identifiable problems that can be resolved easily through the mail. When a mathematical or clerical error is identified, the IRS mails a corrected tax computation to the taxpayer and requests that he or she pay the additional tax within ten days of the date of the notice. If the deficiency is paid within this period, no interest is charged on the underpayment. When an error results in a taxpayer overpayment, the IRS usually sends a corrected computation of the tax, together with a brief explanation of the error, and refunds the excess payment.

The IRS also conducts an unallowable item program. If a return includes an unallowable item, the IRS computes the adjustment in taxes and notifies the taxpayer by mail. If the taxpayer is able to adequately explain the questioned item, the assessment is abated. However, the case continues as a correspondence or office audit if the taxpayer's response is deemed unsatisfactory.

After a return is processed through the various programs, it is rated for its audit potential by computer scoring using the discriminant inventory function (DIF) formula. When the computer calculates a high DIF score, the potential that an examination of that return will result in a change to the income tax liability is also high. Attempts have been made by several taxpayers to obtain the actual DIF formula under the Freedom of Information Act, but the courts have refused to require the IRS to disclose detailed information, stating that it would undermine the program.

In addition to the computerized identification methods used to select returns for IRS examination, returns may be selected manually for a variety of reasons. Information provided by an

informant may initiate an examination. The IRS Whistleblower Office processes tips it receives from individuals. A reward of between 15 and 30 percent of the total proceeds that the IRS collects can be paid if the IRS moves ahead based on the information provided.[10] All rewards, of course, are fully taxable.[11]

Example 2.6

The highest whistleblower award ever paid was $104 million to a former employee of Swiss bank UBS for revealing schemes used by the bank to help American citizens dodge taxes. UBS paid more than $780 million to avoid criminal prosecution and turned over account information for more than 4,500 American clients.[12]

The government also conducts undercover operations. Each district performs criminal investigations by special agents who look for fraud. Revenue agents suspend work whenever fraud is detected and refer the case to special agents in IRS Criminal Investigation.

KEY CASE *The courts have upheld the legality of evidence that the IRS obtained through a special agent who posed as an investor interested in businesses with substantial cash flow subject to skimming. The owner and his wife disclosed their skimmed invoices to the undercover agent who noted the location of the records in their home. A few days later the IRS agents executed a search warrant and seized the records.*[13]

2.1.3 TYPES OF AUDITS

Frequently, IRS personnel question only one or two items on a selected return, such as charitable contributions. In these cases, an examination is typically conducted as a **correspondence examination**. The IRS auditor requests that the taxpayer verify the questioned item by mailing copies of receipts, canceled checks, or other documentation to the IRS.[14] If the taxpayer requests an interview or the issues become too complex, the case is referred to an office or field examination for resolution.

Office examinations usually involve one or more issues that require some analysis and the exercise of the IRS auditor's judgment, rather than a mere verification of an item. The taxpayer is asked to come to the district office for an interview and bring any records and documents that support the questioned items. Taxpayers may attend this examination alone, with a tax advisor or attorney, or let their tax advisor attend on their behalf.

Field examinations are more comprehensive than office audits and are the least common type of audit. Field examinations are usually conducted on the taxpayer's premises and generally involve a complete review of the entire financial operations of the business. This type of audit can last from months to years and is usually limited to business returns and the most complex individual returns.

When the IRS has audited a taxpayer's return for the same item in either of the two previous years with no change to the tax liability, the taxpayer can request a suspension of the current year's audit and a review of whether the audit should proceed.

[10] §7623. The reward may be limited to 10% if the whistleblower's contribution is not considered substantial. The IRS Whistleblower's Office will determine the extent to which the whistleblower's information contributed to the administrative or judicial action and the amount of the reward.
[11] To claim a reward, Form 211: *Application for Reward for Original Information* is used.
[12] David Kocieniewski, "Whistle-Blower Awarded $104 Million by I.R.S." *New York Times*, 9/11/12.
[13] *Jones v.* Berry, 722 F.2d 443; 83-2 USTC ¶9653; 52 AFTR 2d 6188 (9th Cir., 1983), cert. denied, 466 US 971 (1984).
[14] The *Internal Revenue Manual* suggests that this type of audit is limited to certain types of issues, such as minor business expenses, interest deductions, and charitable contributions.

Example 2.7

In August 2019, the IRS notified Diana that it plans to audit her 2017 interest expense deduction. Two years earlier, the IRS audited Diana's 2015 interest expense deduction but assessed no additional tax. Diana may request that the IRS suspend the audit of her 2017 interest expense deduction.

If, instead of interest expense, the IRS had audited Diana's 2015 charitable contributions, Diana could not request a suspension of her 2017 audit because the previous audit was for a different deduction.

2.1.4 THE APPEALS PROCEDURE

When an audit is complete, there are three possible outcomes. First, the agent may find that the return is correct as filed. If, however, the agent proposes adjustments to either increase or decrease the tax, the taxpayer may agree or disagree. If the taxpayer agrees, the taxpayer signs an agreement and pays the additional taxes owed or receives the proposed refund. Any interest owed is generally determined from the due date of the return to the date of payment. If the taxpayer is owed a refund, interest is paid on the refund.

If the taxpayer disagrees with the agent's proposed adjustments, the agent submits a report of the findings to the review staff. After review, the revenue agent's report is mailed to the taxpayer. The cover letter, called the **30-day letter**, notifies the taxpayer of the proposed deficiency and normally gives the taxpayer 30 days to request a conference with an agent from the **IRS Appeals Division**, which is separate from the IRS division of the examining agent.[15]

The Appeals Division's purpose is to resolve tax controversies without litigation, on a basis that is fair to both the government and the taxpayer. The appeals officer has full authority to consider the hazards of litigation. The term "hazards of litigation" refers to factors that may affect the outcome of the case if it is litigated. This includes ambiguous facts, uncertain application of the law to known facts, credibility of witnesses, and ability to meet the required burden of proof. The great majority of cases are settled at the appellate conference.

If the taxpayer still disagrees with the IRS after an appeals conference or fails to request a conference, a **90-day letter** (statutory notice of deficiency) is mailed to the taxpayer by certified or registered mail. Once this formal assessment has been made, the IRS is entitled to collect the tax. This notice gives the taxpayer three options:

1. File a petition with the U.S. Tax Court within 90 days of receiving the notice.
2. Pay the tax and any penalties; the taxpayer may then go to a U.S. District Court or the U.S. Court of Federal Claims to sue for refund (payment of the tax and penalties stops interest from continuing to accrue if the taxpayer ultimately loses the appeal).
3. Take no action and be subject to IRS-enforced collection procedures.

All litigation begins in one of three trial courts: the U.S. Tax Court, the U.S. District Courts, or the U.S. Court of Federal Claims. The Tax Court is the only court that does not require the taxpayer to pay the tax and then sue for refund. The District Court and Court of Federal Claims cannot hear the taxpayer's case unless he or she is suing for a refund.[16] Consequently, the taxpayer first must pay the disputed tax and then file an unsuccessful claim for refund to obtain a judicial review in either of these latter two courts.

[15] If the additional tax due is more than $10,000, the taxpayer must include a written response to the agent's finding, called a protest letter. For an office audit, an oral request is acceptable if the total proposed additional tax and penalties is $2,500 or less. If the amount is between $2,500 and $10,000, then a brief written statement of disputed issues is required. Reg. §601.106(a)(1)(iii).

[16] The District Court is the only court in which a jury trial can be obtained.

If the amount in dispute (including interest and penalties) does not exceed $50,000 for a tax year, the taxpayer may use the Small Case Division of the Tax Court.[17] Its procedures are less formal than regular Tax Court procedures and the taxpayer may appear without an attorney. This alternative is not available in other courts, and the decision cannot be appealed.

An important consideration is the trial courts' interpretations of the law may differ on the same basic tax issues. Thus, taxpayers usually prefer the court most likely to rule favorably on their issues. Regardless of the judicial route chosen, the unsuccessful party has the right to appeal the decision (except for decisions of the Small Case Division of the Tax Court). Cases decided in the Tax Court and District Court are appealed to the appropriate Circuit Court of Appeals. Appeals from the Court of Federal Claims are decided by the Court of Appeals for the Federal Circuit. Decisions from either appellate court can be appealed to the U.S. Supreme Court. The Supreme Court chooses the cases it will hear on the basis of their significance or because of a conflict in the lower courts. Therefore, the Supreme Court accepts very few tax cases for review.

A taxpayer should not consider tax litigation lightly. The costs for attorney and accountant fees, the filing and processing fees, and the time involved in gathering supporting documentation for the taxpayer's position, make litigation a costly prospect.

2.1.5 TAXPAYER NONCOMPLIANCE PENALTIES

Our self-assessment system requires all individuals filing a tax return to accurately report their income and deductions. Taxpayers who fail to meet their self-assessment obligations are subject to a variety of penalties. Many new penalties have been imposed in response to taxpayers who play the audit lottery; that is, taxpayers take very aggressive positions on their tax returns, gambling that their returns will not be audited. Some view the potential penalties for an unfavorable audit as small enough to be worth the risk. In reaction to this, many penalties were enacted to address this problem.

The most important taxpayer penalties are for negligence and fraud. The negligence penalty is 20 percent of any tax underpayment caused by the taxpayer's intentional disregard of rules and regulations or failure to make a reasonable attempt to comply with the law.[18] The most severe administrative penalty is for civil fraud. This penalty is 75 percent of the tax underpayment attributable to the fraud.[19] Fraud involves deliberately understating the tax owed the government. Due to the severity of the penalty, the burden of proof rests with the IRS to establish by *clear and convincing evidence* that the taxpayer committed fraud.[20] An even more severe penalty applies to criminal fraud, otherwise known as tax evasion. Tax evasion is punishable by imprisonment in addition to significant fines.[21] The IRS has the burden of proof to establish, *beyond a reasonable doubt*, that the taxpayer committed criminal fraud.

KEY CASES *In 2006, Richard Hatch was sentenced to 51 months in federal prison for failing to report $1 million in income won from the first "Survivor" television series along with income from some other sources. He was also ordered to pay almost $475,000 in taxes, interest and penalties.*[22]

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[17] §7463.
[18] §6662(a) and (b)(1). §6662A increases the penalty to 30% for listed and other nondisclosed avoidance transactions and §6707A imposes a penalty of up to $200,000 for failure to report information on "listed" tax shelter transactions.
[19] §6663.
[20] §7454(a).
[21] §7201. Penalties of up to $100,000 ($500,000 for corporations) and/or up to five years in prison may be assessed.
[22] "Tax Report," *Wall Street Journal*, May 17, 2006, Section D, Column 5, page 2 and "FY2006 Examples of General Tax Fraud Investigations," IRS website, *www.irs.gov*.

In 2008, actor Wesley Snipes was sentenced to 3 years in prison for willfully failing to file tax returns from 1999–2004, a period in which he earned more than $38 million. Following an unsuccessful appeal, he served his sentence in a medium-security prison in Pennsylvania.[23]

In December 2014, Representative Michael Grimm, who had just been re-elected to his third term in Congress, resigned after agreeing to plead guilty to felony tax fraud. The indictment alleged that he kept two sets of records for a restaurant he previously owned, concealing more than $1 million in gross receipts and underreporting his employees' wages to avoid federal and state taxes. He served 7 months in prison.[24]

2.1.6 COLLECTION PROCEDURES

The IRS begins the collection of an unpaid tax liability when it mails a bill to the taxpayer requesting payment. If the taxpayer does not respond, the IRS sends a letter demanding payment within 10 days. If the taxpayer still does not respond, the IRS can impose a lien on the taxpayer's property or seize other assets.[25]

All taxes must be collected within 10 years of an assessment. If a taxpayer has not filed a return (or filed a fraudulent return), the tax must be collected within 10 years of the assessment date, regardless of when that assessment is made.[26]

Offer in Compromise

If the IRS believes that collection of the full tax liability is doubtful, it may accept a payment less than the assessment. Such compromises are made if there is either doubt about the liability or its collectability. The IRS is more inclined to settle a delinquent account if no criminal proceedings are pending or contemplated. A taxpayer files Form 656 to make an offer in compromise. It must include a detailed financial statement specifying the hardship the taxpayer would suffer if the entire tax must be paid. Any offer in compromise with five or fewer installment payments must be accompanied by an initial payment of 20 percent of the total amount offered the IRS. All other offers must include the first proposed installment. If the offer is not rejected within 24 months of submission, it is deemed accepted.[27]

Innocent Spouse Relief

When a married couple files a joint tax return, they become joint and severally liable for any tax deficiency related to that return; that is, the IRS can assess either spouse for the entire deficiency if the return is audited.[28] In some situations (such as a now-divorced couple), the IRS assesses whichever spouse it can locate, even though that person may know nothing about the disputed income. Section 6015(b)(1) provides that the innocent spouse can be relieved of any tax liability if all of the following requirements are met:

1. The return contains an understatement of tax attributable to erroneous items of only one of the individuals filing the return.
2. Considering all facts and circumstances, it is unfair to hold the other individual liable for the deficiency attributable to this understatement. It is critical that the other individual did not know, and had no reason to know, that there was the understatement.
3. The individual elects innocent spouse relief within the time period that the statute of limitations is open for collection activities.

[23] Dave Itzkoff, "Wesley Snipes Surrenders to Begin Sentence on Tax Convictions," *New York Times*, 12/9/10.
[24] William K. Rashbaum, "Rep. Michael Grimm Is Said to Agree to Tax Fraud Guilty Plea," *New York Times*, 12/22/14, Jason Horowitz, "Michael Grimm, in a Reversal, Will Resign from Congress," *New York Times*, 12/30/14 and Shane Goldmacher, "Michael Grimm, a Former Congressman and Felon, Wants His Job Back," *New York Times*, 10/1/17.
[25] §§6621 and 6331.
[26] §6502(a)(1).
[27] §7122.
[28] §6013(d)(3).

Example 2.8

Gillian and Steven filed a joint tax return three years ago but have since divorced. Gillian has no contact with Steven and does not know where he lives. At the time the return was filed, Gillian knew that Steven failed to report $5,000 of gambling winnings as they used the $5,000 won for their vacation trip. On audit, Steven's actual unreported gambling winnings were found to be $25,000. Steven cannot be located and Gillian is assessed the full tax due. If Gillian establishes that she did not know, nor had any reason to know, about the additional $20,000 of gambling winnings, the understatement of tax for the additional $20,000 of winnings qualifies for innocent spouse relief. The $5,000 of winnings that Gillian knew about fails to qualify for relief.

2.2 PROFESSIONAL RESPONSIBILITIES AND ETHICS

2.2.1 AVOIDANCE VERSUS EVASION

Any discussion of a tax professional's responsibilities must include the difference between tax avoidance and tax evasion. There is nothing illegal or immoral in the avoidance of tax according to the tax system's rules. Judge Learned Hand best expressed this doctrine in *Commissioner v. Newman*:

> *Over and over again, courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.*[29]

Tax avoidance is the minimization of the tax burden by acceptable, legal alternatives. *Tax evasion*, however, describes illegal means of reducing taxes and is not acceptable. Any practitioner contemplating participation in some form of tax evasion should first study the penalties assessed for civil and criminal tax fraud.

2.2.2 TAX PREPARER REGISTRATION

Since 2011, the IRS has required all tax return preparers to obtain a **preparer tax identification number (PTIN)**. Section 7701(a)(36)(A) defines a tax return preparer as any person who is paid for, or who employs one or more persons who are paid for, the preparation of all or a substantial portion of a federal tax return or claim for refund. Preparers obtain a PTIN by submitting Form W-12 *IRS Paid Preparer Tax Identification Number (PTIN) Application* to the IRS.

2.2.3 TAX PREPARER PENALTIES

Code Section 6694 imposes penalties on preparers when clients' tax deficiencies appear to be the result of an "unreasonable position" on a return that the preparer knew or should have known was a departure from the rules or regulations. The penalty, the greater of $1,000 or 50 percent of the fees for the work, is imposed if the position was not properly disclosed. A reasonable position requires the preparer to have substantial authority upholding a "realistic possibility of success" for nonabusive, undisclosed tax return positions. **Substantial authority** exists if the weight of authorities (discussed later) supporting the reported tax treatment is substantial in relation to the weight of those authorities taking a contrary position. A return preparer without substantial

[29] *Commissioner v.* Newman, 159 F.2d 848, 850–851; 47-1 USTC ¶9175; 35 AFTR 857 (CA-2, 1947).

authority for a tax return position is subject to a penalty unless there is adequate disclosure. Form 8275 is typically used for disclosure—but that would generally raise a red flag with the IRS.

If the tax return position involves a tax shelter (or similar abusive transaction termed a "listed transaction"), a higher "more-likely-than-not" (greater than 50 percent) standard applies. Under current law, a tax return preparer avoids this penalty if the position:

1. Is supported by substantial authority and does not involve a tax shelter
2. Has a reasonable basis and is adequately disclosed or
3. Involves a tax shelter, as defined in Code Section 6662(d)(2)(C)(ii), but the preparer reasonably believes the position is more likely than not correct.

If a preparer takes an unreasonable position in a "willful" attempt to understate the taxpayer's liability or if the preparer is guilty of "reckless or intentional disregard" of rules or regulations, the penalty increases to the greater of $5,000 or 75 percent of the preparer's fees. This type of penalty frequently results in an investigation that may end with the withdrawal of the right to practice.

Preparer penalties are of special importance because of the following:

1. Penalties on the preparer may not be covered by malpractice insurance.
2. Penalties are not deductible.
3. Preparer penalties may result in an IRS review of the preparer's entire practice.

A preparer convicted of criminal tax evasion is subject to a fine of up to $100,000 ($500,000 in the case of a corporation) and imprisonment.

KEY CASES *Raymond Scott Stevenson, the former Vice President of Taxation for Tyco, was sentenced to 3 years in federal prison for failing to report $170 million in company income. Prosecutors claimed that he backdated documents to reduce the company's tax liability. If the correct amount had been reported, Tyco would have faced an additional tax liability of up to $60 million.*[30]

Adrian Dicker, a former BDO Seidman LLP manager, pleaded guilty to tax evasion. He admitted assisting clients engage in tax-shelter transactions that created more than $1 billion in fraudulent tax losses. He faced up to five years in prison for each count of tax evasion.[31]

2.2.4 TAX PROFESSIONALS' DUAL RESPONSIBILITIES

Tax professionals have duties to two parties: the tax system and their clients. In many situations, the duties to these two parties are in conflict. The conflict is most apparent in areas in which the law is not clear or in situations in which the facts are subject to more than one legitimate interpretation. In those cases, the tax professional must decide which party will benefit at the expense of the other. The question then arises to whom the tax professional owes his or her primary responsibility.

Tax practitioners and the IRS view the role of tax practitioners differently. Tax practitioners, especially CPAs and attorneys, see themselves as client advocates. The IRS, however, wants tax practitioners to take an active enforcement role by checking client documentation and probing for other sources of income.

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[30] "Former Tyco VP gets three years in prison," The *Miami Herald*, November 30, 2006, page 3C.

[31] Chad Bray, "Guilty Plea in Bogus Tax Shelters," *The Wall Street Journal*, March 18, 2009, Section D, Column 1, page 3.

The IRS's position is that the tax practitioner's primary responsibility is to the tax system. The IRS Director of Practice stated the following:

> *While it is generally agreed that a tax practitioner owes a client competence, loyalty and confidentiality, it also is recognized that the practitioner has responsibilities to the tax system as well. The latter responsibility is of pervasive importance . . . . In the normal practitioner–client relationship, both duties are recognized and carried out. However, there are situations in which this is difficult. In those situations, the practitioner is required to decide which obligation prevails and, in so doing, may correctly conclude that the obligation to the tax system is paramount . . . . The IRS relies on tax practitioners to assist it in administering the tax laws by being fair and honest in their dealings with the Service and by fostering confidence by their clients in the integrity of the tax system and in complying with it.*[32]

The position of the American Institute of Certified Public Accountants (AICPA) is that a taxpayer has no obligation to pay more taxes than are legally due, and the CPA has a duty to the client to assist in achieving that result. Thus, the tax system is best served by professionals who act with honesty and who are not swayed by client pressure to do otherwise. At the same time, they best serve the public good by helping their clients determine their minimum tax liability under the law. To resolve honest differences in interpretation in favor of one's client does not, by itself, impair the CPA's integrity.

2.2.5 SOURCES OF PROFESSIONAL GUIDANCE

Literature dealing with the ethical responsibilities of a tax practitioner can be found in various publications. All tax practitioners are regulated by *Treasury Circular 230: Regulations Governing Practice before the Internal Revenue Service*. The ethical conduct of a CPA who is a member of the AICPA must follow its *Code of Professional Conduct* and any other rules generated by state boards of accountancy. The AICPA has also developed the *Statements on Standards for Tax Services (SSTS)* that contain guidelines for CPAs who prepare tax returns.

Circular 230

To effectively serve a client's tax needs, the tax practitioner must maintain the privilege to appear before the IRS on behalf of clients. The regulations governing such representation are found in *Circular 230* that protects the IRS and taxpayers by requiring tax preparers to be technically competent and to adhere to ethical standards. *Circular 230* identifies who may practice before the IRS, including representing clients during audit procedures. Tax return preparation or furnishing information in response to an IRS request is not considered practice before the IRS.

A tax practitioner who violates the rules contained within *Circular 230* may be suspended or disbarred from practice before the IRS for incompetence, disreputable conduct, refusal to comply with the rules and regulations of *Circular 230*, or willfully and knowingly deceiving, misleading, or threatening the IRS.

In 2014, the Treasury issued regulations amending *Circular 230* by adding new rules applicable to all written tax advice in client communications. These rules also state that members who oversee a firm's practice must ensure that all employees of the firm comply with *Circular 230*.

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[32] Leslie Shapiro, "Professional Responsibilities in the Eyes of the IRS," *The Tax Adviser* (March 1986) p. 139.

AICPA Code of Professional Conduct

In addition to the regulations imposed by the Treasury Department, CPAs in tax practice must adhere to pronouncements of the accounting profession. AICPA members are subject to the *AICPA Code of Professional Conduct* that discusses the CPA's responsibilities to the public, clients, and colleagues. It states that a CPA should strive for behavior above the minimal level of acceptable conduct required by the law and regulations. Members are expected to perform professional services with integrity, objectivity, and independence. Integrity is measured in terms of what is right and just. Integrity requires a professional to observe both the form and spirit of technical and ethical standards. Objectivity and independence require the professional to be impartial, intellectually honest, and have no conflict of interest.

In December 2014, the AICPA updated its *Code of Professional Conduct* to simplify its application. The updated version retains the substance of the existing ethical standards while incorporating two conceptual frameworks, one for members in public practice and one for members in business. These conceptual frameworks would be used for areas in which the code lacks guidance as a means of identifying, evaluating, and addressing threats that may exist and safeguards that may be applied to eliminate or reduce those threats to an acceptable level.

Statements on Standards for Tax Services (SSTS)

To help delineate the extent of the tax practitioner's responsibility to his or her client, the public, the government, and his or her profession, the AICPA Federal Taxation Executive Committee issued a series of statements defining the appropriate standards applying to tax practice.[33] These statements are intended to address specific problems inherent in the tax practitioner's dual role of serving both the client and the public.

> *SSTS No. 1—Tax Return Positions* The CPA should recommend a tax return position to his or her client only if there is a "realistic possibility" of success if challenged either on appeal with the IRS or in court. A CPA should not prepare or sign as preparer a return that he or she knows takes a position that does not meet the realistic possibility standard. A CPA may recommend a specific return position if there is a reasonable basis for that position, and the position is adequately disclosed on the tax return.
>
> *SSTS No. 2—Answers to Questions on Returns* This statement requires a CPA, before signing as a preparer, to make a reasonable effort to obtain and provide appropriate answers from the client to all questions on a tax return. The fact that an answer might prove disadvantageous is not a valid reason for omitting a response.
>
> *SSTS No. 3—Procedural Aspects of Preparing Returns* This statement examines the CPA's responsibility regarding examination of supporting data, use of prior years' returns, and consideration of relevant information known to the CPA from tax returns of other clients. It sets forth guidelines as to the extent CPAs may rely on information furnished by clients and other third parties; for example, it specifies that although a CPA may in good faith rely upon information furnished by the client or other third parties without verification, blind reliance is unacceptable. If the information furnished appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the CPA, the CPA should make additional inquiries.
>
> *SSTS No. 4—Use of Estimates* This statement defines those situations in which the use of estimates is acceptable on a taxpayer's return (for example, a fire or computer failure destroyed relevant records) and discusses whether disclosure is appropriate. Estimates

[33] The *Statements on Responsibilities in Tax Practice (SRTP)* were issued between 1964 and 1977. The *SSTS* replaced the *SRTP* as of October 31, 2000. The revised *SSTS* that became effective on January 1, 2010 combined *SSTS 6* and *SSTS 7*, reducing the total number of statements from eight to seven.

also may be necessary when records are missing or precise information is not available at the time of filing. If a CPA uses a taxpayer's estimates, however, the estimates should not imply greater accuracy than exists or present misleading facts.

SSTS No. 5—Departure from a Previous Position An administrative proceeding or court decision does not bind the CPA to use the same treatment of an item in a later year's return unless there is a binding contract. The CPA may recommend a more advantageous tax treatment for a later year's tax return, however, as subsequent court decisions and revenue rulings may place the taxpayer in a more favorable position. The recommendation for the tax treatment of an item in a tax return should be based on the facts and the law as they are evaluated at the time the return is prepared.

SSTS No. 6—Knowledge of Error: Return Preparation and Administrative Proceedings If a CPA discovers an error in a client's previously filed tax return, an error in a return that is the subject of an administrative proceeding (such as an examination), or a taxpayer's failure to file a return, the CPA is obligated to inform the client of the problem and to recommend appropriate action. Once the taxpayer has been adequately informed, the course of action is the client's decision. The CPA cannot inform the IRS without the client's permission, except if required by law. If the CPA is preparing the current year's return and the client refuses to correct an error in a prior year's return, *SSTS No. 6* indicates that the CPA should consider withdrawing from the preparation of the taxpayer's current year return or from representing the client in the administrative proceeding and should consider severing any professional relationship with the client. If the CPA does prepare the current year's return, the CPA should take reasonable steps to ensure that the error is not repeated.

SSTS No. 7—Form and Content of Advice to Clients This statement recognizes that changes in the tax laws and the development of new interpretations may affect past tax advice. It addresses the circumstances under which a CPA has a responsibility to update a client when subsequent developments affect previously provided advice. *SSTS No. 7* indicates that the CPA has no duty to update the advice unless the CPA is implementing it or the obligation is specifically provided for in the client's contract. CPAs should state that their advice is based on authorities that are subject to change and that subsequent developments could affect previous professional advice. Thus, the communication of significant developments affecting previous advice is an additional service, rather than an implied obligation in the normal client relationship.

Other Moral Standards

There is more to ethical behavior than simply following the AICPA rules of conduct. The tax professional must deal with different standards of personal morality. All individuals do not use the same level of moral standards in determining whether something is morally right or wrong. Some people feel that cheating on their tax return is morally acceptable because "Everyone does it." Professional fees generated from a client who gets too aggressive seldom justify the cost (in dollars or mental anguish) of defending violations of professional standards or Treasury Department rules.

If a tax professional does not agree with the client's views on what is morally acceptable, the practitioner risks losing the client. Alternatively, they both could face fines and penalties (or even risk going to jail) for failure to follow acceptable moral standards. A tax professional must be ready to deal with clients with varying views on acceptable moral behavior and be willing to accept the consequences for the decisions made.

To be prepared to make these ethical decisions, a tax professional must develop two skills:

1. The ability to recognize ethical dilemmas when confronted by them.
2. The ability to evaluate the alternatives.