PART

I

Conceptual Foundations of the Tax Law

CHAPTER 1

FEDERAL INCOME TAXATION—AN OVERVIEW

CHAPTER 2

INCOME TAX CONCEPTS

Thomson Learning™

CHAPTER

1

Federal Income Taxation—An Overview

CHAPTER LEARNING OBJECTIVES

- Discuss what constitutes a tax and the various types of tax rate structures that may be used to calculate a tax.
- Introduce the major types of taxes in the United States.
- Identify the primary sources of federal income tax law.
- Define *taxable income* and other commonly used tax terms.
- Introduce the calculation of taxable income for individual taxpayers and the unique personal deductions allowed to individuals.
- Develop a framework for tax planning and discuss the effect of marginal tax rates and the time value of money on tax planning.
- Make the distinction between tax avoidance and tax evasion.
- Introduce ethical considerations related to tax practice.

Thomson Learning™

INTRODUCTION

We have all heard the adage, "There's nothing certain but death and taxes." However, equating death and taxes is hardly a fair characterization of taxation. It is often stated that taxes are the price we pay for a civilized society. An early decision of the U.S. Supreme Court described a tax as "an extraction for the support of the government." Regardless of your personal view of taxation, society as we know it could not function without some system of taxation. People constantly demand that the government provide them with various services, such as defense, roads, schools, unemployment benefits, medical care, and environmental protection. The cost of providing the services that the residents of the United States demand is principally taxation. People are introduced to taxation at an early age. Remember the candy bar that had a price sticker of 25 cents yet actually cost 27 cents? The tax collector is all around us. Upon receiving their first paycheck, many are surprised that the $100 they earned resulted in a check of only $80 after taxes were deducted. The point is that taxes are a fact of life. Learning to deal with taxes, and perhaps using them to your advantage, is an essential element of success in today's world.

The federal income tax is a sophisticated and complex array of laws that imposes a tax on the income of individuals, corporations, estates, and trusts. Current tax law has developed over a period of more than 85 years through a dynamic process involving political, economic, and social forces. At this very minute, Congress is considering various changes in the tax law; the Internal Revenue Service (IRS) and the courts are issuing new interpretations of current tax law, and professional tax advisers are working to determine the meaning of all these changes.

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

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

Thomson Learning™

DEFINITION AND EVALUATION OF A TAX

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

Definition of a Tax

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

A tax could be viewed as an involuntary contribution required by law to finance the functions of government. The amount of the contribution extracted from

the taxpayer is unrelated to any privilege, benefit, or service received from the government agency imposing the tax. According to the IRS definition, a tax has the following characteristics:

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

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

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

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

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

Discussion: Each payer of the tax receives a direct benefit—a new sewer line. Therefore, the 1% tax payment is considered a payment to the government unit to reimburse it for improvements to the taxpayer's property. The taxpayers would treat the payment as an investment in their property and not as a tax. The 1% tax in this case is a special assessment for local benefits. An assessment differs from a tax in that an assessment is levied only on a specific group of taxpayers who receive the benefit of the assessment.

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

Standards for Evaluating a Tax

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

Thomson Learning™

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

The concept of equality requires consideration of both horizontal and vertical equity. **Horizontal equity** exists when two similarly situated taxpayers are taxed the same. **Vertical equity** exists when taxpayers with different situations are taxed differently but fairly in relation to each taxpayer's ability to pay the tax. This means that those taxpayers who have the greatest ability to pay the tax should pay the greatest proportion of the tax. These equity concepts are reflected to a great extent in the federal income tax. Certain low-income individuals pay no tax. As a person's taxable income level increases, the tax rate increases from 10 percent to 15 percent to 27 percent to 30 percent to 35 percent to 38.6 percent.

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

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

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

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

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

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

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

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

Thomson Learning™

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

Certainty in the tax law is necessary for tax planning. An individual's federal income tax return is due on the fifteenth day of the fourth month (usually April 15) after the close of the tax year. A corporation's return is due on the fifteenth day of the third month after the close of its tax year.[2] The balance of tax due with the return is usually paid by check to the IRS. However, determining the amount of tax due may not be so simple. When planning an investment that will extend over several tax years, the ability to predict with some degree of certainty how the results of the investment will be taxed is important to the investment decision. Frequent changes in the tax law create uncertainty for the tax planner. For example, the Taxpayer Relief Act of 1997 amended approximately 800 code sections and added nearly 300 sections. In addition to these legislative amendments to the tax law, the IRS and the courts issue a constant stream of decisions and interpretations on tax issues, which results in a tax law that is in a continual state of refinement. However, for the average individual taxpayer, who has wages subject to withholding, receives some interest income, owns a home, pays state and local taxes, and perhaps donates to a church or other charities, there is little complexity and a great deal of certainty in the tax law despite the numerous changes to the tax system.

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

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

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

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

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

Tax Rates and Structures

Tax rates are often referred to as a *marginal rate*, an *average rate*, or an *effective rate.* In addition, a tax rate structure is frequently described as being *proportional*, *regressive*, or *progressive.* Because a tax rate structure indicates how the average tax rate varies

Thomson Learning™

with changes in its tax base, examining a rate's structure helps in understanding and evaluating the effect of a tax.

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

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

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

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

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

The **marginal tax rate** is the rate of tax that will be paid on the next dollar of income or the rate of tax that will be saved by the next dollar of deduction. The marginal tax rate is used in tax planning to determine the effect of reporting additional income or deductions during a tax year. One objective of tax planning is to minimize the marginal rate and to keep the marginal rate relatively constant from one year to the next. The marginal tax rates for an individual taxpayer are 10 percent, 15 percent, 27 percent, 30 percent, 35 percent, and 38.6 percent.[3] If you know a person's taxable income (the tax base), you can find the marginal tax rate in the tax rate schedules in Appendix B.

▲ **EXAMPLE 6** Don has an asset he could sell this year at a $10,000 profit, which would increase his marginal tax rate from 15% to 27%. If he waits until next year to sell the asset, he is sure his other income will be less and the $10,000 gain will be taxed at 15%. Should Don sell the asset this year or wait until next year?

Discussion: By waiting until next year to sell the asset, Don's tax savings on the sale are $1,200 [$10,000 × (27% − 15%)]. In addition, he will postpone the payment of the tax interest-free for a year (a time value of money savings). Assuming that he can sell the asset early in the next year and does not need the proceeds from the sale before next year, he should wait until next year to sell the asset to take advantage of the lower marginal tax rate and the time value of money savings on the tax to be paid on the gain.

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

▲ **EXAMPLE 7** Assume that in example 6, Don sells the asset in 2003 and reports taxable income of $40,000. Also, Don collects $50,000 on a life insurance policy that is not taxable income. Don's tax on $40,000 is $7,092 (using the tax rate schedules in Appendix B). In addition, the only difference between Don's economic income and his taxable income is proceeds from the life insurance policy. What are Don's marginal, average, and effective tax rates?

Discussion: Based on the facts given, Don's marginal tax rate is 27% (from the tax rate schedules). His average tax rate is 17.73% ($7,092 ÷ $40,000). The effective tax rate on his economic income of $90,000 ($40,000 in taxable income + $50,000 in nontaxable income) is 7.88% ($7,092 ÷ $90,000) and is much less than both the marginal and average tax rates.

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

Thomson Learning™

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

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

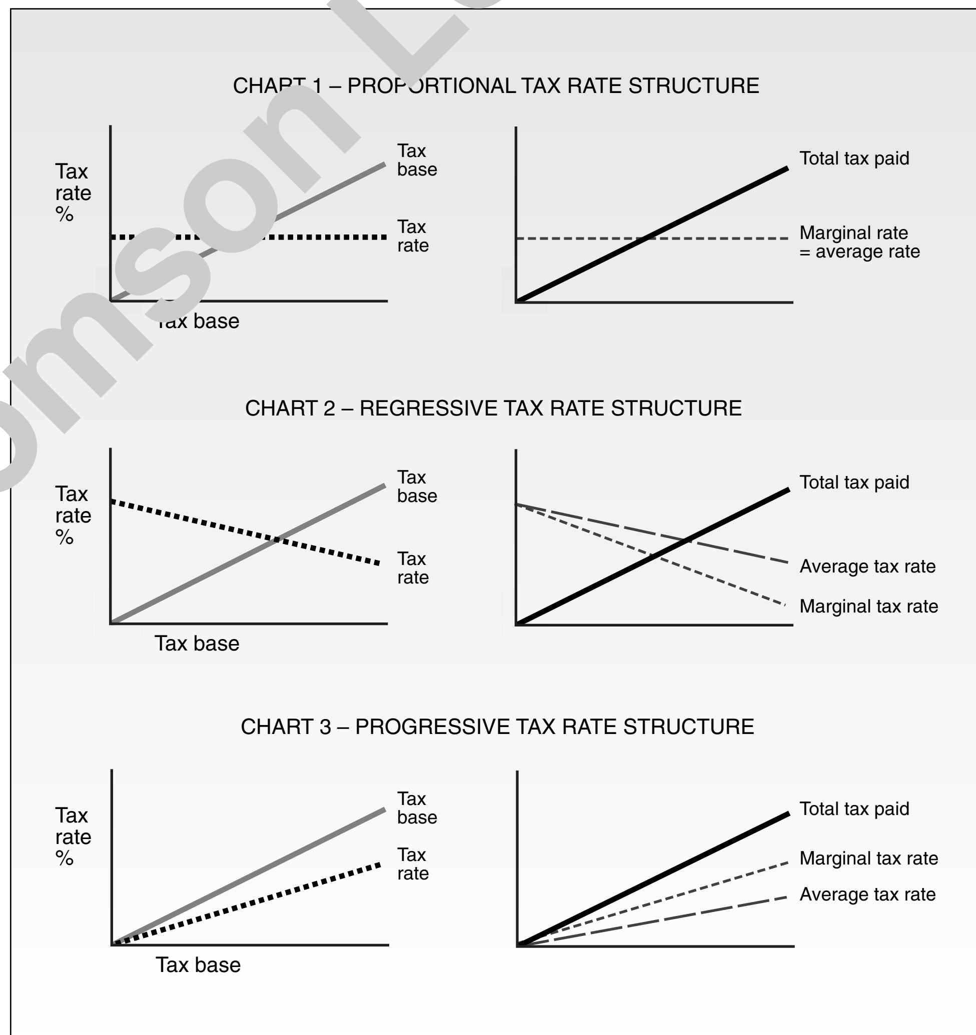
▲ **EXAMPLE 8** Betsy bought a new suit for $350. The sales tax at 7% totaled $24.50. Steve bought a new lawn tractor for $3,500. At 7%, the sales tax he paid came to $245. Is the sales tax proportional?

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

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

▲ **Figure 1–1**

Tax Rate Structures



Thomson Learning™

If a tax rate structure is regressive, the marginal tax rate will be less than the average tax rate as the tax base increases. Note that although the average tax rate and the marginal tax rate both decrease as the tax base increases, the total tax paid will increase. As a result, a person with a low tax base will pay a higher average and a higher marginal rate of tax than will a person with a high tax base. The person with the high tax base will still pay more dollars in total tax. Although a pure regressive tax rate structure (as defined earlier) does not exist in the United States, example 9 illustrates a regressive tax.

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

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

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

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

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

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

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

PROGRESSIVE RATE STRUCTURE. A **progressive rate structure** is defined as a tax in which the average tax rate increases as the tax base increases. On a graph, a progressive tax rate structure would look like Chart 3 in Figure 1–1.

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

The progressive tax rate structure reflects the embedding in the federal income tax rates of Adam Smith's equality criterion. Recall that according to this criterion, taxpayers should pay according to their ability to pay the tax. The use of progressive

Thomson Learning™

rate structures, wherein people with higher taxable income levels pay higher marginal tax rates, promotes equality.

▲ **EXAMPLE 11** Doug reports $16,000 a year in taxable income from wages he earns watering the greens at the Hot Water Golf Course. Shawana earns $35,000 in annual taxable income as a first grade teacher.

Discussion: Doug and Shawana's 2003 income taxes using the single taxpayer rates are as follows:

	Doug's Tax (income: $16,000)	**Shawana's Tax (income: $35,000)**
Tax on income of $6,000 @ 10%	$ 600	$ 600
Tax on income from $6,000 to $28,400 @ 15%	1,500	3,360
Tax on income above $28,400 @ 27%	-0-	1,782
Total tax	$2,100	$5,742
Marginal tax rate	15%	27%
Average tax rate	13.1%	16.4%

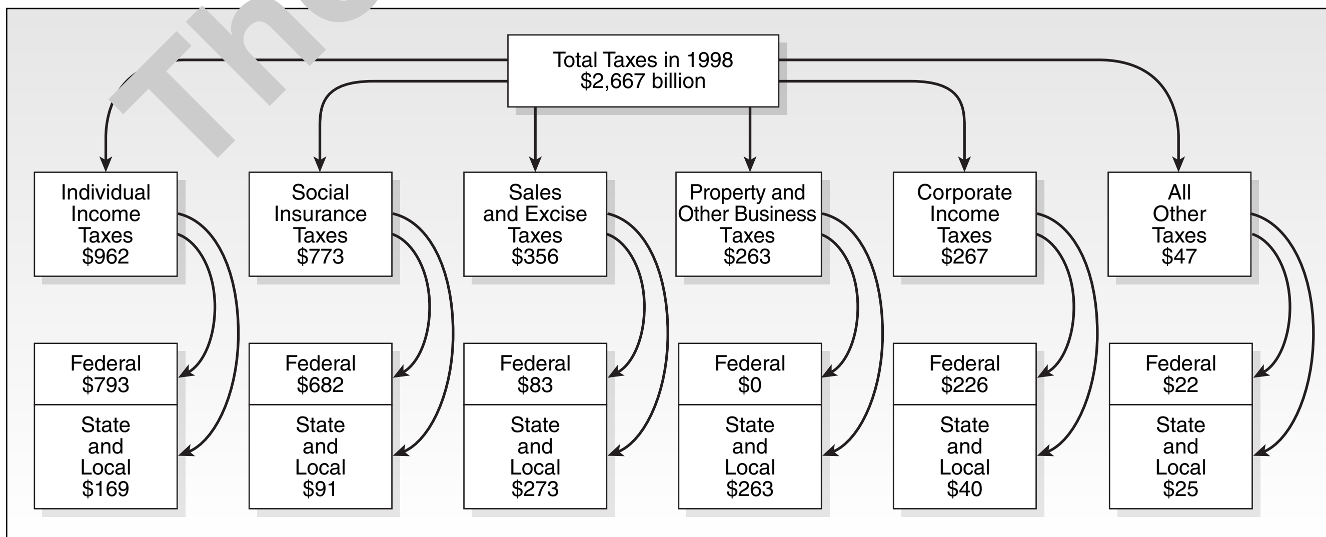
Discussion: As a result of Shawana's larger tax base and the progressive tax rates, her marginal and average tax rates are higher than Doug's. Thus, the tax rate structure of the federal income tax promotes equality among taxpayers.

Major Types of U.S. Taxes

The federal, state, and local governments use a variety of taxes to fund their operations. Figure 1–2 depicts tax revenues generated by federal, state, and local government bodies by source for 1998. An examination of the sources of tax revenue shows that the bulk of the federal government's revenues is derived from the income tax and social insurance tax. State and local governments also receive a substantial portion of their revenues from a tax on income, with the sales tax and the property tax also providing significant revenue. In terms of overall taxes collected in the United States, the federal income tax produces almost as much revenue as all other forms of state and local taxes combined. Although this text covers the basic operation of the federal income tax, it is helpful to have a basic understanding of the other taxes levied by governments. As will be seen throughout the text, many taxes affect and interact with the rules for the federal income tax. Each major type of tax is discussed briefly in turn. Do not be concerned with the mechanics of the taxes at this point. Focus only on their general nature.

▲ **Figure 1–2**

1998 Government Revenues by Source (Estimated in Billions)



SOURCE: Tax Foundation, Inc., estimates based on National Income and Product Account definitions. Figures may not add up because of rounding.

Thomson Learning™

Income Taxes

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

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

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

Employment Taxes

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

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

The Social Security tax is imposed on employees and self-employed individuals. Employers are required to match employees' payments into the system.[9] Because a self-employed person is both an employee and an employer, the self-employment tax rate is twice the employee tax, resulting in an equivalent payment of tax by employee/employer and the self-employed.[10] The tax on employees and employers is a constant percentage of wages up to a maximum wage base. Both the percentage and the maximum wage base have been raised over time. As Table 1–1 shows, the tax has two components. In 2003, a tax of 6.2 percent is levied on the first $87,000 of wages for Old Age, Survivors, and Disability Insurance (OASDI). A tax of 1.45 percent on

Thomson Learning™

▲ **Table 1–1**

Social Security Tax Rates for Employees and Employers

Year	OASDI[1]	MHI[2]	Total	Maximum Wage Base	Maximum Tax Paid
1999	6.20		6.20	$72,600	$4,501
		1.45	1.45	Wages earned	No maximum
			7.65		
2000	6.20		6.20	$76,200	$4,724
		1.45	1.45	Wages earned	No maximum
			7.65		
2001	6.20		6.20	$80,400	$4,985
		1.45	1.45	Wages earned	No maximum
			7.65		
2002	6.20		6.20	$84,900	$5,264
		1.45	1.45	Wages earned	No maximum
			7.65		
2003	6.20		6.20	$87,000	$5,394
		1.45	1.45	Wages earned	No maximum
			7.65		

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

all wages pays for Medical Health Insurance (MHI). Before 1994, the MHI portion was subject to a maximum wage base. This established a maximum amount of Social Security tax that any taxpayer would pay. However, the abolition of the maximum MHI wage base for tax years after 1993 eliminated the ceiling on Social Security taxes.

▲ **EXAMPLE 12** Jenny earned $2,000 during February 2003 in her job as a carpenter for Acme Construction Company. How much Social Security tax must be paid by Jenny and Acme on her February earnings?

Discussion: Jenny must pay 6.2% (OASDI) and 1.45% (MHI) on the first $87,000 of income earned in 2003. Thus, Jenny must pay $153 [($2,000 × 6.2%) + ($2,000 × 1.45%)] in Social Security taxes on her wages. Acme must match the $153 in Social Security taxes Jenny paid on the wages.

▲ **EXAMPLE 13** Chandra earned $95,000 as the administrator of the Local Accounting Program in 2003. How much Social Security tax does Chandra pay in 2003?

Discussion: Chandra pays the maximum OASDI of $5,394 (6.2% × $87,000) and $1,378 (1.45% × $95,000) of MHI for a total Social Security payment of $6,772. Her employer is required to pay the same amount on Chandra's behalf.

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

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

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

Self-employed individuals pay a tax equal to the sum of the employee's and employer's payments. Thus in 2003, net self-employment income is subject to a tax of 12.4 percent (6.2% × 2) on the first $87,000 of income for OASDI and 2.9 percent (1.45% × 2) on all net self-employment income for MHI. Because employees are not taxed on the Social Security contribution made on their behalf by their employers, self-

Thomson Learning™

employed taxpayers are allowed to deduct one-half of their self-employment tax as a business expense to equalize the tax treatments of employees and the self-employed.

▲ **EXAMPLE 15** Assume that in example 13, Chandra's $95,000 in earnings constitutes net self-employment income rather than wages as an employee. How much self-employment tax must Chandra pay on her self-employment income?

Discussion: Chandra pays $10,788 (12.4% × $87,000) of OASDI and $2,755 (2.9% × $95,000) of MHI, for a total self-employment tax of $13,543. Note that this is equal to the total tax paid by Chandra and her employer ($6,772 × 2) in example 13. Because Chandra is self-employed, she must pay the equivalent of the employee's and employer's tax.

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

Sales Tax

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

Property Taxes

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

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

▲ **EXAMPLE 16** Maria Corporation owns a piece of land that it purchased for $6,000 in 1998. During the current year, the county tax assessor determines that the fair market value of the land is $8,000. In the county in which the land is located, assessed values are 50% of the fair market value. What is the assessed value of Maria Corporation's land?

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

Thomson Learning™

percentage to 75%, the corporation would pay property tax based on an assessed value of $6,000 ($8,000 × 75%).

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

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

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

Other Taxes

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

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

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

In addition to these excise taxes, in 1990 Congress added a 10-percent luxury tax on certain items. The 10-percent luxury tax applied to the purchase price of automobiles, boats, airplanes, jewelry, and furs that exceeded a set price. Congress repealed the luxury tax on all items except automobiles, effective for 1993. The luxury tax on automobiles expired after 2002.[11]

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

Thomson Learning™

basic understanding of the operation of the two taxes will aid in understanding some of the income tax issues related to gifts and estates that are discussed later in the text.

Federal Gift Tax. A gift tax is imposed on the fair market value of gifts made between individuals.[12] Neither the donor nor the donee is subject to income tax on gifts. The donor of the gift property is responsible for reporting and paying the gift tax. The gift tax has several exclusions, the most basic of which is an annual exclusion of $11,000 per donee.[13] Under this provision, taxpayers can give as many individuals as they wish as much as $11,000 a year each and pay no gift tax. A married couple can use this exclusion to make tax-free gifts of up to $22,000 per person per year. The annual gift exclusion is indexed for inflation for gifts made after December 31, 1998. Taxpayers are also allowed to make unlimited gifts to their spouses and to charities without payment of the gift tax.

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

Discussion: Ansel and Hannah each are entitled to give $11,000 to any person each year. Therefore, they may make gifts of up to $22,000 to an individual without incurring any gift tax. Because the fair market value of the car is less than $22,000, it is not subject to gift tax.

▲ **EXAMPLE 19** On their 25th wedding anniversary, Ansel gave Hannah a diamond ring that cost $30,000. Is the gift subject to the gift tax?

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

As these examples illustrate, the most common forms of gifts, such as those for birthdays, graduations, weddings, and anniversaries, are not subject to the gift tax. However, when a gift is made that is not totally excludable under one of these provisions, the taxpayer may use the unified donative-transfers credit to avoid payment of the gift tax.[14] The **unified donative-transfers credit** allows a lifetime credit against gift and estate taxes. The credit is equivalent to being able to exclude $1 million in property from the gift and/or the estate tax in 2003. In 2004, the estate tax exemption amount increases to $1.5 million, and it will continue to increase until the amount reaches $3.5 million in 2009. The estate tax is repealed in 2010. The gift tax exemption will remain at $1 million throughout the period.

Federal Estate Tax. The estate tax is levied on the fair market value of the assets a taxpayer owned at death.[15] The executor of the estate is responsible for valuing the assets of the estate, administering the assets before their distribution to the heirs, paying the estate taxes, and distributing the assets to the estate's beneficiaries. As with the gift tax, several exclusions and the unified donative-transfers credit limit taxation of estates to those estates that are fairly substantial.[16] The fair market value of the estate's assets is reduced by funeral and administrative costs, debts owned by the taxpayer, amounts bequeathed to charities, and the marital deduction for property passing to the surviving spouse. The marital deduction is unlimited—all amounts that pass to a surviving spouse are exempt from the estate tax. Judicious use of the marital deduction and the donative-transfers credit lets the value of most estates go untaxed at the death of the first spouse. Because the unified donative-transfers credit is a cumulative lifetime amount that applies to both gifts and property passing through the estate, careful planning is required to minimize the lifetime tax on gifts and property held at death. Suffice it to say that the gift and estate tax provisions can be quite complex. Taxpayers with substantial assets should seek competent professional advice in planning their estates to minimize the liability for these taxes.

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

Thomson Learning™

Sources of Federal Income Tax Law

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

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

The federal income tax law dates to 1913 and has been amended, revised, and reworked numerous times since. The current statutory source of federal income tax law is the **Internal Revenue Code of 1986,** as amended (referred to as the *Code*). The tax law is laid out in the Code by section number. Thus, the basic reference to a particular tax law provision is to the section of the Code in which the law is stated. Often, particular tax treatments are referred to by their Code section number. For example, Section 179 lets a taxpayer deduct up to $25,000 of the cost of qualifying depreciable property in the year of acquisition (rather than depreciating it over its tax life). Tax practitioners refer to this election as the *Section 179 election.* Therefore, when appropriate, references to Code sections will include the popular terminology associated with that section.

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

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

In addition to providing interpretive guidance, the IRS has responsibility for ensuring taxpayers' compliance with the tax law. During 2000, the IRS processed 226 million tax returns, provided tax preparation assistance to 124 million taxpayers, and audited 1.3 million tax returns filed by individual taxpayers. When audited by the IRS, taxpayers are allowed to present their reasoning for the items in question on their return. As might be expected, disputes often arise between taxpayers and the IRS concerning its interpretations and enforcement of the tax law. Most disputes are resolved through the IRS appeals process. However, taxpayers who are dissatisfied with the result of the appeals process are entitled to take their disputes to court for settlement.

Court decisions establish precedent in the interpretation of the tax law. Taxpayers and the IRS are generally bound by the interpretation of a court on a particular issue. However, the loser of an initial court case may appeal the decision to a U.S.

Thomson Learning™

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

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

Federal Income Tax Terminology

Individuals, corporations, and certain estates and trusts are subject to tax on their federal taxable income. Federal taxable income is defined by the tax law and differs from both financial accounting and economic measures of income. The general computational framework for determining the taxable income of all taxpayers is shown in Exhibit 1–1. Both the terms used in the computations and the order of the computational framework are prescribed in the tax law.

Income

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

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

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

▲ Exhibit 1–1

INCOME TAX COMPUTATIONAL FRAMEWORK

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

Thomson Learning™

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

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

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

Income also results from gains. A **gain** is the difference between the selling price of an asset and its tax cost and is the result of disposing of the asset.[20] Usually, a gain will be the result of a sale of a single asset. Most gains produce ordinary income. However, gains on the sale of certain types of assets receive special treatment in the determination of taxable income and the tax liability. These gains are called *capital gains* and result from the sale of capital assets.

Deductions

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

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

The term **loss** refers to two distinctly different types of events. A loss occurs when an asset is disposed of for a selling price that is less than its tax cost. This type of loss is referred to as a **transaction loss** and represents a loss of capital invested in the asset. In later chapters, it will be necessary to apply limits to the amount of a loss that can be deducted in a tax year. To apply the limits, losses are characterized as per-

Thomson Learning™

sonal, business, or capital. These limits deny deductions for most personal losses, place a cap on the amount of capital losses that may be deducted in the year of the loss, and allow business losses to be fully deducted as incurred.

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

Individuals, trusts, and estates may subtract predetermined amounts called **exemptions** to determine their taxable incomes. The exemption deduction for individuals is, in effect, Congress's recognition that people need a minimum amount of income to provide for their basic living expenses. Thus, this minimum amount of income is deducted as an exemption and is not subject to tax. The deduction for individual exemptions is reduced for high-income taxpayers. Apparently, the reduction is Congress's way of saying that these taxpayers have enough income to support themselves and that the ability-to-pay concept should prevail. Since the minimum basic costs of living increase each year because of inflation, the exemption amounts are indexed to inflation and increase each year to reflect the increased costs individuals incur.

Thomson Learning™

Income Tax Rates

The 2003 tax rate schedules for two classes of individual taxpayers and corporations are reproduced in Table 1–2.[23] A full set of tax rates for individuals, corporations, estates, and trusts for 2002 and 2003 is reproduced in Appendix B. The income tax is calculated by multiplying taxable income by the applicable tax rates. Each year, the

▲ **Table 1–2**

2003 Tax Rate Schedules

Single Taxpayers

If taxable income is over	But not over	The tax is	Of the amount over
$ -0-	$ 6,000	.... 10%	$ -0-
6,000	28,400	$ 600.00 + 15%	6,000
28,400	68,800	3,960.00 + 27%	28,400
68,800	143,500	14,868.00 + 30%	68,800
143,500	311,950	37,278.00 + 35%	143,500
311,950	....	96,235.50 + 38.6%	311,950

Married Taxpayers Filing Jointly and Surviving Spouse

If taxable income is over	But not over	The tax is	Of the amount over
$ -0-	$ 12,000	.... 10%	$ -0-
12,000	47,450	$ 1,200.00 + 15%	12,000
47,450	114,650	6,517.50 + 27%	47,450
114,650	174,700	24,661.50 + 30%	114,650
174,700	311,950	42,676.50 + 35%	174,700
311,950	....	90,714.00 + 38.6%	311,950

Corporate Tax Rate Schedule

If taxable income is over	But not over	The tax is	Of the amount over
$ -0-	$ 50,000	.... 15%	$ -0-
50,000	75,000	$ 7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	....	6,416,667 + 35%	18,333,333

IRS publishes new tax rate schedules that are adjusted for cost-of-living increases. Adjusting the tax rate schedules for changes in the cost of living helps to minimize a hidden tax that results from inflation.

Assume the following information (shown in Exhibit 1–2): A single taxpayer's taxable income in 2002 was $27,700. The rate of inflation in 2003 was 1.6 percent, and the taxpayer was able to keep up with inflation by increasing her income. Her taxable income goes up by $443 to $28,143 ($27,700 × 1.016%) in 2003. At this point, the taxpayer is no better or worse off in 2003 than in 2002. Her income increase merely kept up with the rate of inflation. The top panel of Exhibit 1–2 shows that failure to adjust the 2003 tax rates for the 1.6 percent inflation rate results in $90 in additional tax. The increased tax is attributable to two sources. First, the increased income results in an additional $66 (15% × $443) in tax, even if the marginal rate stays the same from the first to the second year. Second, the problem worsens when the inflated income pushes the taxpayer into a higher marginal tax bracket (tax bracket creep) causing an additional $23 in tax [(27% − 15%) × ($28,143 − $27,950)]. Thus, the taxpayer is worse off, because she pays $90 more tax on the same deflated income when tax rates are not adjusted for inflation. The net result is an increase of after-tax income of only $353 ($443 − $90), which is less than the rate of inflation.

The bottom panel of Exhibit 1–2 calculates the tax using the actual 2003 rates, which are adjusted for the 1.6 percent inflation rate. The tax on a 2003 taxable income of $28,143 is $3,921. This is a reduction of $24 ($3,945 − $3,921) over the tax calculated using 2002 rates on the same income. The adjustment for inflation in the tax rate brackets leaves the taxpayer with the same inflation-adjusted after-tax income in 2003 [($27,700 − $3,855) × 1.016% = $24,222 ($28,143 − $3,921)] that the taxpayer had in 2002. Thus, the adjustment of the tax brackets for inflation each year ensures that taxpayers whose income merely keeps pace with inflation will not realize a decrease in real after-tax income.

Thomson Learning™

▲ Exhibit 1–2

THE HIDDEN INFLATION TAX

	Tax Year	
	2002	2003
Taxable income	$27,700	$27,700
Increase in taxable income due to 1.6% inflation	-0-	443
Inflation-adjusted taxable income	$27,700	$28,143
Tax using 2002 single taxpayer rates:		
Tax on base amount	$ 600	$ 3,893
Excess taxed at marginal rate		
15%	3,255	
27%		52
Total tax	$ 3,855	$ 3,945
Additional tax resulting from inflation		$ 90

Tax on $28,143 at 2003 tax rates	
Tax on $6,000	$ 600
Tax on income in excess of $6,000	
($28,143 − $6,000) × 15%	3,321
Tax at 2003 rates	$ 3,921
2002 After-tax income $27,700 − $3,855	$23,845
2002 Inflation rate adjustment	× 1.016
2003 Real after-tax income	$24,227
Actual 2003 after-tax income $28,143 − $3,921	$24,222*

*The difference is due to rounding in the calculation of the inflation-adjusted amounts.

Tax Prepayments

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

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

Tax Credits

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

If a taxpayer's marginal tax rate is 30 percent, a $5,000 tax deduction has the same value as a $1,500 tax credit ($5,000 × 30%). Likewise, a $1,000 tax credit has the same value as a $3,333 deduction if the marginal rate is 30 percent ($1,000 ÷ 30%).

▲ **EXAMPLE 20** Ron and Martha, whose marginal tax rate is 30%, paid $1,000 for child care.

Discussion: If the expenditure is treated as a credit, the tax they owe for the year will be reduced by the full $1,000. If the expenditure is treated as a deduction, their tax would be reduced by $300 ($1,000 × 30% marginal rate). Treatment of the expenditure as a credit would save them $700 more than treatment as a deduction.

The most common business tax credits are discussed in Chapter 15. Individuals are also allowed tax credits for certain circumstances and activities. For example, individuals with dependents are allowed a credit of $600 for each qualifying dependent. Restrictions and limitations associated with this tax credit and other common individual tax credits are discussed in Chapter 8.

Filing Returns

In general, all income tax entities must file an annual tax return. (See Chapter 8 for individual filing requirements.) Returns for individuals, estates, trusts, and partnerships must be filed on or before the fifteenth day of the fourth month following the close of the entity's tax year (April 15 for calendar-year taxpayers). Corporate tax returns are due on or before the fifteenth day of the third month following the close of a corporation's tax year (March 15 for calendar-year corporate taxpayers). Taxpayers who cannot complete and file their returns by the regular due date can

Thomson Learning™

apply for extensions for filing the return. Individuals are granted an automatic four-month extension by applying for the extension by the due date of the return. Corporations are allowed an automatic six-month extension; partnerships and trusts can automatically extend their filing date by three months. Filing an extension does not extend the time for paying the tax. Applications for automatic extensions must show and include payment of the estimated amount due with the final return.

▲ **EXAMPLE 21** Thelma procrastinates about preparing her tax return and determines that she cannot complete the return by April 15. She has withholdings and estimated tax payments totaling $8,600 and estimates that her total tax liability for the year will be $8,950. What must Thelma do to extend the date for filing her return?

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

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

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

▲ **EXAMPLE 22** Geraldo Corporation incurred a net operating loss in 2002, its first year of operation. Because the controller knew that Geraldo was going to suffer a loss, he took no deductions for depreciation for 2002. Geraldo's independent auditor came upon the error in 2003, and advised Geraldo that it must take all allowable deductions in the proper year. Should Geraldo file an amended return for 2002?

Discussion: Because the depreciation was not treated properly on the 2002 tax return, Geraldo should file an amended return that takes the proper depreciation deduction for 2002.

▲ **EXAMPLE 23** Walstad Corporation is an accrual basis taxpayer. In 2002, Walstad determined that one of its customers with an accounts receivable balance of $40,000 was in bankruptcy. After conferring with the customer's lawyers, Walstad determined that it would be able to collect only $15,000 of the account and deducted the $25,000 uncollectible amount as a bad debt expense. In 2003, the customer's bankruptcy was settled, and Walstad received $10,000 as a final settlement of the account it had written off. Should Walstad file an amended return for 2002 and correct the bad debt deduction?

Discussion: The actual bad debt is $30,000 ($40,000 − $10,000). The $25,000 bad debt deduction that Walstad took in 2002 was an estimate of the amount of the bad debt. Therefore, the deduction was not incorrect at the time the return was filed. Walstad should deduct the additional $5,000 ($30,000 − $25,000) of actual bad debt in 2003 to adjust the estimate. Amended returns are not filed to adjust estimates on prior year returns. Adjustments to estimates are made on the return for the year in which the actual amount of the deduction becomes known.

Thomson Learning TM

The Audit and Appeal Process within the IRS

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

Tax Return Selection Processes

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

Virtually all returns are checked for mathematical, tax calculation, and clerical errors during the initial processing of the returns. If an error is discovered under this **document perfection program,** the IRS recalculates the amount of tax due and sends an explanation to the taxpayer. Another program of increasing importance is called the **information-matching program.** Information from banks, employers, and others on forms such as the W-2 for wages and withholding and the 1099 for miscellaneous income are matched to the taxpayer's return. For any omitted or incorrect items, the IRS recomputes the tax and sends an explanation to the taxpayer. Finally, a number of **special audit programs** are designed by the IRS and combine computer and manual selection based on various standards that are changed periodically. Some of the standards used include the size of the refund, the amount of adjusted gross income reported, and the amount or type of deduction claimed.

Types of Examinations

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

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

Field examinations are conducted at the taxpayer's place of business and can involve any item on the income tax return as well as any items on the payroll and

Thomson Learning™

excise tax returns. These examinations are handled by more-experienced IRS agents, and almost all taxpayers are represented by their tax advisers. As with office examinations, IRS agents must follow IRS policy on matters of law and are accorded a great deal of latitude in settling matters of fact.

Settlement Procedures

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

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

Administrative Appeals

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

The administrative appeal process allows taxpayers one additional opportunity to reach a settlement before resorting to the courts. The appeals division has the authority to consider the hazards of litigation. For example, when the facts or the law are uncertain, or both, the appeals division may settle issues it does not want to litigate, even if the IRS position has some merit. After what may be lengthy negotiation, taxpayers who finally reach an agreement with the IRS, or who simply don't want to pursue the matter, sign the Form 870 (or Form 870-AD, if the IRS has conceded some issues) and pay the full amount of the deficiency plus any penalties and interest.

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

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

Individual Income Tax Calculation

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

The calculation of an individual's taxable income is outlined in Exhibit 1–3. Note that the general flow remains the same—deductions are subtracted from gross income to arrive at taxable income. Gross income is determined under the general tax

Thomson Learning™

▲ **Exhibit 1–3**

INDIVIDUAL INCOME TAX FORMULA

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

formula. The distinguishing feature of the individual taxable income calculation is that deductions are broken into two classes—deductions for adjusted gross income and deductions from adjusted gross income. This dichotomy of deductions results in an intermediate income number called the **adjusted gross income (AGI).**[24] As will become clear in the discussion that follows, this is a very important income number, because it is used to limit the deductions from adjusted gross income of an individual taxpayer. Deductions are discussed in more detail in later chapters. However, at this point, a general knowledge of the computational form and allowable deductions of individuals is necessary. Each type of deduction is discussed in turn.

Deductions for Adjusted Gross Income

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

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

Although these expenditures are not limited by the income of the taxpayer, other limitations in the tax law may reduce the current period's tax deduction. For example, the allowable deductions for rental properties may be limited by either the

Thomson Learning™

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

Deductions from Adjusted Gross Income

Individuals are allowed to deduct certain personal expenditures and other specified nonpersonal expenditures as **deductions from adjusted gross income.** These deductions are commonly referred to as **itemized deductions.** Note in Exhibit 1–3 that individuals deduct the greater of their allowable itemized deductions or the standard deduction.[26] The **standard deduction** is an amount that Congress allows all taxpayers to deduct regardless of their actual qualifying itemized deduction expenditures. Thus, taxpayers itemize their deductions only if their total allowable itemized deductions exceed the standard deduction. For 2003, the standard deduction is $4,750 for a single individual and $7,950 for a married couple.

▲ **EXAMPLE 24** Festus is a single taxpayer with total allowable itemized deductions of $1,800 in 2003. What is Festus's allowable deduction from adjusted gross income?

Discussion: Festus deducts the larger of his $1,800 in itemized deductions or the $4,750 standard deduction for a single individual. In this case, Festus deducts the $4,750 standard deduction.

▲ **EXAMPLE 25** Assume that in example 24, Festus's total allowable itemized deductions are $6,700 in 2003. What is his allowable deduction from adjusted gross income?

Discussion: Festus would deduct the $6,700 in actual itemized deductions because it exceeds his $4,750 standard deduction.

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

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

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

▲ **EXAMPLE 26** Qualifying medical expenses are deductible to the extent that they exceed 7.5% of a taxpayer's adjusted gross income. During the current year, Li has an adjusted gross income of $40,000 and incurred $4,200 in qualified medical expenses. What is Li's itemized deduction for medical expenses?

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

Thomson Learning TM

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

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

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

TAXES—State, local, and foreign income taxes, real estate taxes, and state and local personal property taxes may be deducted.[29]

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

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

CHARITABLE CONTRIBUTIONS—Gifts to qualified charitable organizations may be deducted. Generally, the deductible contribution may not exceed 50 percent of the taxpayer's adjusted gross income.[31]

PERSONAL CASUALTY AND THEFT LOSSES—Deductions are allowed for losses of property from casualty or theft, subject to two limitations. Because of the limitations, most taxpayers must have a large total loss for the year to get a deduction for a personal casualty or theft loss.[32]

MISCELLANEOUS ITEMIZED DEDUCTIONS—This is a broad category of deductions that includes most expenses related to the production of investment income. The following list of miscellaneous deductions illustrates the types of items deducted in this category:

- Business expenses of an employee not reimbursed by an employer
- Investment-related expenses
- Expenses related to tax return preparation, planning, and examination

Generally, the deduction allowed for miscellaneous itemized deductions must be reduced by 2 percent of the taxpayer's adjusted gross income.[33]

Thomson Learning™

Personal and Dependency Exemptions

Individuals are allowed to deduct a predetermined amount for each qualifying exemption.[34] In 2003, individuals deduct $3,050 for each qualifying personal and dependency exemption. The intention is to exempt from tax a minimum amount of income that is used to support the taxpayer and those who are dependent on that taxpayer. Because support costs increase with inflation, the exemption amounts are increased each year to account for the prior year's inflation. **Personal exemptions** are allowed for the taxpayer and the taxpayer's spouse. **Dependency exemptions** are granted for individuals who are dependent on the taxpayer for support. Although five technical tests (discussed in Chapter 8) must be met to qualify as a dependent, the underlying reasoning is that the dependent must rely on the taxpayer for basic living costs. Thus, children of a taxpayer and other relatives, such as parents and grandchildren who live with the taxpayer, are the most common dependents.

▲ **EXAMPLE 27** John and Nancy are married and have 3 small children who live with them and depend on them for their support. What is John and Nancy's 2003 exemption deduction?

Discussion: John and Nancy are entitled to 2 personal exemptions and 3 dependency exemptions. Their deduction is $15,250 ($3,050 × 5 exemptions).

TAX PLANNING

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

Thomson Learning™

Mechanics of Tax Planning

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

Timing Income and Deductions. A taxpayer's marginal tax rate and the time value of money must be considered in tax planning. The traditional technique of deferring income and accelerating deductions relies solely on the time value of money savings from delaying the tax payment or receiving the tax deduction savings earlier. For example, a taxpayer who expects to be in a 30-percent marginal tax bracket for the next several years might be indifferent about reporting $1,000 in extra income in 2003 or 2004. Regardless of which year the income is reported, the taxpayer pays $300 in tax and keeps $700 ($1,000 − $300) in after-tax income. When the present value of the tax payment is considered (see Table 1–3 for present values factors), it becomes clear that choice of years does make a difference. If the taxpayer's applicable interest rate is 10 percent and the marginal rate is expected to remain the same, deferring payment of the tax until 2004 results in an interest-free loan. The present value of the tax savings is $27:

Tax paid in 2004	$ 300
10% present value factor	× 0.909
Present value of tax paid in 2004	$ 273
Present value of tax paid in 2003	300
Real tax savings by deferring income	$ 27

If the marginal rate is expected to decrease to 15 percent in 2004, the taxpayer has a greater incentive to defer the income. By deferring the income to 2004, the taxpayer receives the benefit of an interest-free loan for one year plus the benefit of the lower marginal tax rate. Deferring the income to 2004 would result in a real tax benefit of $164:

Tax paid in 2004 ($1,000 × 15%)	$ 150
10% present value factor	× 0.909
Present value of tax paid in 2004	$ 136
Present value of tax paid in 2003	300
Real tax savings by deferring income	$ 164

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

If the taxpayer expects the marginal tax rate to increase to 35 percent next year, the income should be reported in 2003. Deferring the income to 2004 would have a real tax cost of $18:

Tax paid in 2004 ($1,000 × 35%)	$ 350
10% present value factor	× 0.909
Present value of tax paid in 2004	$ 318
Present value of tax paid in 2003	300
Real tax cost of deferring income	$ 18

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

▲ **EXAMPLE 28** Ann Corporation owes a $2,000 expense that may be paid and deducted on the cash basis of accounting in either 2003 or 2004. The applicable interest rate is 10%. In which year should Ann Corporation take the deduction if its 2003 marginal tax rate is 25%?

Discussion: The optimal year for taking the deduction depends on Ann Corporation's expected marginal tax rate in 2004. The following schedule calculates the real tax savings (real tax cost) of deducting the expenses in 2003 as compared with deferring the deduction until 2004 at different assumed marginal tax rates:

▲ **Table 1–3**

PRESENT VALUE TABLES

Present Value of a Single Payment

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

Thomson Learning™

	Assumed 2004 Marginal Tax Rates		
	15%	**25%**	**34%**
Tax saved by 2004 deduction	$ 300	$ 500	$ 680
Present value @ 10%	× 0.909	× 0.909	× 0.909
Present value of tax savings	$ 273	$ 455	$ 618
Less: Tax savings of deduction in 2003 @ 25% marginal tax rate	(500)	(500)	(500)
Deduction in 2003 will result in:			
Tax savings	$(227)	$ (45)	
Tax cost			$ 118

Discussion: Ann Corporation should claim the deduction in 2003 if it expects the marginal tax rate to remain at 25% or decrease to 15%. If the corporation expects its marginal rate to increase to 34%, it should defer the deduction to 2004 to save $118.

▲ **EXAMPLE 29** Lanny's marginal tax rate for 2003 is 30%. Lanny has $20,000 in income and $10,000 in deductions that could be reported in 2003 or deferred to 2004. Lanny expects his 2004 marginal tax rate to be 35% and the applicable interest rate to be 10%. When should the items be reported if both the income and deductions must be reported in the same year?

Discussion: The result of reporting both the income and the deductions in 2003 as compared with 2004 is as follows:

	2003	**2004**
Increase in income	$20,000	$20,000
Less: Increase in deductions	(10,000)	(10,000)
Net increase in taxable income	$10,000	$10,000
Marginal tax rate	× 30%	× 35%
Tax on net increase in income	$ 3,000	$ 3,500
Present value factor		× 0.909
Present value of tax in 2003	$ 3,000	$ 3,182

Discussion: Lanny should report the items in 2003 to save $182 in real tax cost.

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

Discussion: The tax cost of reporting each item must be considered separately and the total result compared with reporting both items in 2003 (which was previously determined to be the optimal same-year reporting).

Income

	Report income in	
	2003	**2004**
Increase in taxable income	$20,000	$20,000
Marginal tax rate	× 30%	× 35%
Increase in tax	$ 6,000	$ 7,000
Present value factor		× 0.909
Present value of tax in 2003	$ 6,000	$ 6,363
Net tax savings from reporting in 2003	363	

Thomson Learning™

Deductions

	Report deductions in 2003	2004
Decrease in taxable income	$10,000	$10,000
Marginal tax rate	× 30%	× 35%
Tax savings from deduction	$ 3,000	$ 3,500
Present value factor		× 0.909
Present value of tax savings	$ 3,000	$ 3,182
Net tax savings from reporting in 2004	182	

Discussion: If Lanny reports the $20,000 of income in 2003, he has a real tax savings of $363. Deferring the reporting of the $10,000 in deductions until 2004 results in a real tax savings of $182. Thus, by reporting each item separately in the period that is optimal, he saves $545. This compares with a savings of $182 when both income and deductions are reported in the same tax year.

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

Time Value of Money

1. Defer recognition of income.
2. Accelerate recognition of deductions.

Marginal Tax Rate

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

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

Income Shifting. Income shifting is a method commonly used to reduce taxes. The basic idea behind income shifting is to split a single stream of income among two or more taxpayers to lower the total tax paid. The total tax paid is lower because of the progressive tax rate structure. For example, if a taxpayer in the 30-percent marginal tax rate bracket can shift $1,000 in income to another taxpayer who is in the 10-percent marginal tax rate bracket, $200 [$1,000 × (30% − 10%)] of tax will be saved on the $1,000 in income. Obviously, taxpayers shifting income will want the income to go to taxpayers whom they want to benefit, such as children or grandchildren.

▲ **EXAMPLE 31** A married taxpayer has $100,000 in taxable income in 2003. The taxpayer has 2 children who have no taxable income. What are the tax savings if the taxpayer can legally shift $5,000 in income to each of her children?

Discussion: The taxpayer saves $1,700 in tax by shifting $5,000 in taxable income to each child. Using the rates for married taxpayers, the tax on $100,000 in taxable income is $20,706:

$$\$6{,}517.50 + 27\% (\$100{,}000 - \$47{,}450) = \$20{,}706$$

▲ **Table 1–4**

SUMMARY OF TAX-PLANNING RULES

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

Thomson Learning™

By splitting the income into 3 streams, the taxpayer pays tax on $90,000, and each child pays tax (at single-taxpayer rates) on $5,000. This results in a tax of $19,006:

Tax on $90,000 for a Married Couple

$6,517.50 + 27% ($90,000 − $47,450) = $18,006

Tax on $5,000 for a Single Person

$5,000 × 10% = $500 × 2 = 1,000

Total tax paid $19,006

The result of the income shift to the children is a reduction in the total tax paid on the $100,000 in taxable income of $1,700 ($20,706 − $19,006).

It should be noted that numerous provisions in the tax law make it difficult to get the full advantage of income shifting. For example, merely directing that some of your income be paid to your children will not shift the income for tax purposes. To shift income to family members, you will generally need to transfer ownership of income-producing property to the children in order to shift the income from the property. Unless the parents are willing to give up ownership of income-producing property, income shifting to children is difficult to achieve. Even if a valid transfer of property ownership is made, if the child is younger than 14, provisions exist to take away much of the marginal rate advantage of such a shift.

Another popular income-shifting technique used by owners of a business is to incorporate the business and split income between themselves and the corporation. A review of the corporate tax rates (see Table 1–2) shows that the first $50,000 in taxable income of a corporation is taxed at 15 percent. The owners can split the income by paying themselves salaries, which are deductible by the corporation, and reduce the corporation's taxable income to a lower tax bracket.

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

Discussion: Splitting the income between the taxpayer and a corporation results in a tax savings of $6,000. The taxpayer pays tax on $50,000, and the corporation pays tax on $50,000 ($100,000 income − $50,000 salary). This results in a tax of $14,706:

Tax on $50,000 for a Married Couple

$6,517.50 + 27% ($50,000 − $47,450) = $ 7,206

Tax on $50,000 for a Corporation

$50,000 × 15% = 7,500

Total tax paid $14,706

Before incorporation, the tax paid by the married couple was $20,706. The incorporation and split of the income saves $6,000 ($20,706 − $14,706) in tax.

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

Tax Evasion and Tax Avoidance

Taxpayers do not have to pay more income tax than is required by the tax law. In fact, taxpayers may plan transactions to make their tax bills as low as possible. In this regard, Judge Learned Hand stated: "[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that

Thomson Learning™

his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."[35]

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

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

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

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

▲ **EXAMPLE 33** Ted, an accountant, uses the cash method of accounting. To avoid reporting additional income in 2003, he does not send his December bills to clients until January 2, 2004.

Discussion: The income was properly reported when collected in 2004. Under the cash method of accounting, Ted properly reported income when his clients paid him. Ted's activity involves permissible tax avoidance.

▲ **EXAMPLE 34** Ken, a painter, spent all the cash he received for his art work. He deposited payments he received by check to his business bank account. When he filed his tax return, he intentionally did not report the cash receipts as income.

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

At this point, you are probably wondering, "How will the IRS ever know?" Most people are aware that it is almost impossible for the government to track every cash receipt of income. In fact, the probability that the IRS will detect underreporting of cash income is quite low. This has led many taxpayers to play the "audit lottery," omitting cash income or overstating deductions, because they know that they probably will not be caught. The IRS estimates that this behavior results in a loss of more than $100 billion per year in tax revenue. This loss must be made up through higher taxes on honest taxpayers. It is clear that if taxpayers were more honest in their reporting of income and deductions, everyone's taxes could be lowered. There is no clear-cut, cost-efficient solution to the evasion problem. However, as future professionals and taxpayers, you should recognize your obligations to your profession and the country when it comes to tax evasion situations. Only through education and ethical taxpayer behavior will the tax evasion problem be resolved. Keep in mind that avoiding detection by the IRS does not somehow magically transform a fraudulent act into allowable behavior. The idea that something is not illegal unless one is caught is an idea that should have died ages ago.

Ethical Considerations in Tax Practice

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

Thomson Learning™

▲ **Exhibit 1–4**

I.R.C. Violations with Penalties for Tax Return Preparers

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

Thomson Learning™

All tax practitioners are subject to the provisions of *IRS Circular 230,* "Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries Before the Internal Revenue Service." Tax attorneys are subject to the ethical code of conduct adopted by the state(s) in which they are licensed to practice. Certified Public Accountants (CPAs) who are members of the American Institute of Certified Public Accountants (AICPA) are governed by the institute's Code of Professional Conduct. The AICPA's Statements on Standards for Tax Services provide eight advisory guidelines for CPAs who prepare tax returns. Although tax practitioners who are not members of the AICPA are not bound by the Code of Professional Conduct and the Statements on Standards for Tax Services, the rules and guidelines contained in them provide useful guidance for all return preparers.

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

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

The eight Statements on Standards for Tax Services (SSTS) provide guidance on what constitutes appropriate standards of tax practice. The statements are intended to supplement, not replace, the Code of Professional Conduct. Because they specifically address the problems inherent in tax practice, each statement is briefly described here. The full text of the SSTS is reproduced in Appendix D.

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

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

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

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

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

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

SSTS No. 6: *Knowledge of Error: Return Preparation.* A CPA who becomes aware of an error in a previous year's return—or of the client's failure to file a required return—should promptly inform the client and recommend measures to correct the error. The CPA may not inform the IRS of the error except when required to do so by law. If the client does not correct the error, the CPA should consider whether to continue the professional relationship and must take reasonable steps to ensure that the error is not repeated if the relationship is continued.

SSTS No. 7: *Knowledge of Error: Administrative Proceedings.* When a CPA becomes aware of an error in a return that is the subject of an administrative proceeding, the CPA should promptly inform the client of the error and recommend measures to be taken. The CPA should request the client's consent to disclose the error to the IRS but should not disclose the error without consent unless required to do so by law. If the client refuses disclosure, the CPA should consider whether to withdraw from representing the client in the administrative proceeding and whether to continue a professional relationship with the client.

SSTS No. 8: *Form and Content of Advice to Clients.* A CPA should use judgment to ensure that advice given to a client reflects professional competence and appropriately serves the client's needs. For all tax advice given to a client, the CPA should adhere to the standards of SSTS No. 1, pertaining to tax return positions. A CPA may choose to notify a client when subsequent developments affect advice previously given on significant tax matters but is under no strict obligation to do so.

CONCEPT CHALLENGE

Reinforce the concepts covered in this chapter by completing the on-line tutorials located at the *Concepts in Federal Taxation* website.

http://murphy.swlearning.com

SUMMARY

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

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

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

Thomson Learning™

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

The study of federal income taxation will help you evaluate how business and personal financial decisions influence the amount of income tax you will have to pay. Awareness of basic income tax concepts will help you recognize opportunities to minimize compliance costs, save taxes, avoid IRS penalties, and make more informed business decisions.

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

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

Thomson Learning™

KEY TERMS

adjusted gross income (AGI) (p. 25)
ad valorem tax (p. 13)
annual loss (p. 19)
average tax rate (p. 7)
certainty (p. 6)
convenience (p. 6)
correspondence examinations (p. 23)
deduction (p. 18)
deductions for adjusted gross income (p. 25)
deductions from adjusted gross income (p. 26)
deferral (p. 17)
dependency exemption (p. 27)
Discriminant Function System (DIF) (p. 23)
document perfection program (p. 23)
economy (p. 6)
effective tax rate (p. 7)
equality (p. 5)
estate tax (p. 14)
exclusion (p. 17)
exemption (p. 19)
expense (p. 18)
field examinations (p. 23)
gain (p. 18)
gift tax (p. 14)
gross income (p. 17)
horizontal equity (p. 5)
information-matching program (p. 23)
Internal Revenue Code of 1986 (p. 16)
IRS Appeals Division (p. 24)
itemized deduction (p. 26)
loss (p. 18)
marginal tax rate (p. 7)
office examinations (p. 23)
ordinary income (p. 18)
pay-as-you-go concept (p. 6)
personal exemption (p. 27)
personal property (p. 13)
progressive rate structure (p. 9)
proportional rate structure (p. 8)
protest letter (p. 24)
real property (p. 13)
regressive rate structure (p. 8)
self-employment tax (p. 11)
Social Security taxes (p. 11)
special audit programs (p. 23)
standard deduction (p. 26)
statute of limitations (p. 22)
taxable income (p. 7)
tax avoidance (p. 33)
tax base (p. 7)
tax credit (p. 21)
tax evasion (p. 33)
Taxpayer Compliance Measurement Program (TCMP) (p. 23)
transaction loss (p. 18)
Treasury regulation (p. 16)
unified donative-transfers credit (p. 15)
vertical equity (p. 5)

PRIMARY TAX LAW SOURCES

[1] Rev. Rul. 77-29.

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

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

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

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

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

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

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

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

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

[11] Sec. 4001—Imposes the tax on luxury automobiles. Phases out the tax by reducing it 1% per year through the year 2002, after which it expires.

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

[13] Sec. 2503—Allows exclusion from gift tax of gifts up to $11,000.

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

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

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

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

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

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

[20] Sec. 1001—Prescribes the calculation of gains and losses for dispositions of property; defines *amount realized* for purposes of determining gain or loss for dispositions.

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

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

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

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

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

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

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

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

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

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

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

[32] Sec. 165—Specifies the allowable deductions for losses.

[33] Sec. 67—Limits the allowable deduction for miscellaneous itemized deductions to the excess of 2% of adjusted gross income.

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

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

Thomson Learning™

Discussion Questions

1. Briefly state Adam Smith's four requirements for a good tax system.
2. Based on the discussion in the chapter, evaluate how well each of these taxes meets Adam Smith's four requirements:
   a. Income tax
   b. Employment taxes
3. Based solely on the definitions in the chapter, is the Social Security tax a proportional, regressive, or progressive tax? Explain, and state how the tax might be viewed differently.
4. Based solely on the definitions in the chapter, is the sales tax a proportional, regressive, or progressive tax? Explain, and state how the tax might be viewed differently.
5. As stated in the text, the federal income tax is the largest revenue-producing tax in use in the United States. Why do you think the income tax produces more revenue than any other tax?

6. How are federal, state, and local income taxes collected by the government? Consider the cases of an employee and a self-employed taxpayer.
7. How is a sales tax different from an excise tax?
8. Who is responsible for collecting sales and excise taxes? Who actually pays the tax?
9. Why is a tax on real property used more often than a tax on personal property?
10. The gift tax is supposed to tax the transfer of wealth from one taxpayer to another. However, the payment of gift tax on a transfer of property is relatively rare. Why is gift tax not paid on most gifts?
11. The estate tax is a tax on the value of property transferred at death. Why is payment of the estate tax not a common event?
12. What is the basis for valuing assets transferred by gift and at death?
13. Who is responsible for reporting and paying gift taxes? estate taxes?
14. Identify three primary sources of tax law.
15. Explain why the following statement is not necessarily true: "If the IRS disagrees, I'll take my case all the way to the Supreme Court."
16. What is the federal income tax base?
17. What is an exclusion?
18. How is a deferral different from an exclusion?
19. How is gross income different from income?
20. What are the three basic tests that an expense must satisfy to be deductible?
21. What is the difference between an expense and a loss?
22. How is a transaction loss different from an annual loss?
23. How does the legislative grace concept help identify amounts that qualify for deduction?
24. What is the purpose of the exemption deduction?
25. Based on the example in Exhibit 1–2, explain how inflation can have two effects that result in a hidden tax.
26. Explain the pay-as-you-go system.
27. What is a tax credit?
28. How is a tax credit different from a tax deduction?
29. If you were in the 30% marginal tax bracket and you could choose either a $1,000 tax credit or a $3,000 tax deduction, which would give you the most tax saving? Why?
30. What is the statute of limitations, and what role does it play in the filing of tax returns?
31. Briefly describe the types of programs used by the IRS to select a return for audit.
32. What are the three types of IRS examinations?
33. What is included in the 30-day letter, and what options does the taxpayer have after receiving one?
34. What does the 90-day letter represent, and what are the choices the taxpayer has after receiving one?
35. How is the calculation of taxable income for an individual different from the calculation of a corporation's taxable income?
36. How do deductions for adjusted gross income and deductions from adjusted gross income of an individual differ?
37. What is the purpose of the standard deduction for individuals?
38. Randy is studying finance at State University. To complete the finance major, he has to take a basic income tax course. Because Randy does not intend to be a tax expert, he considers the course a waste of his time. Explain to Randy how he can benefit from the tax course.
39. Evaluate the following statement: "The goal of good tax planning is to pay the minimum amount of tax."

Thomson Learning™

40. It has often been said that only the rich can benefit from professional tax planning. Based on the information presented in this chapter, why is this statement at least partially true?

PROBLEMS

41. State whether each of the following payments is a tax. Explain your answers.
- **a.** To incorporate his business, Alex pays the state of Texas a $2,000 incorporation fee.
- **b.** The city paves a road and assesses each property owner on the road $4,000 for his or her share of the cost.
- **c.** The city of Asheville charges each residence in the city $10 per month to pick up the trash.
- **d.** Rory pays $450 of income tax to the state of California.
- **e.** Lanny is fined $45 for exceeding the speed limit.

42. Explain why each of the following payments does or does not meet the IRS's definition of a tax:
- **a.** Jack is a licensed beautician. He pays the state $45 each year to renew his license to practice as a beautician.
- **b.** Polly Corporation pays state income taxes of $40,000 on its $500,000 of taxable income.
- **c.** Winona pays $15 annually for a safety inspection of her automobile that is required by the state.
- **d.** The Judd Partnership owns land that is valued by the county assessor at $30,000. Based on this valuation, the partnership pays county property taxes of $800.
- **e.** Andrea fails to file her income tax return on time. She files the return late, and the IRS assesses her $25 for the late filing and $5 for interest on the tax due from the due date of the return until the filing date.

43. Susan is single with a gross income of $90,000 and a taxable income of $78,000. In calculating gross income, she properly excluded $10,000 of tax-exempt interest income. Using the tax rate schedules in the chapter, calculate Susan's
- **a.** Total tax
- **b.** Marginal tax rate
- **c.** Average tax rate
- **d.** Effective tax rate

44. A taxpayer has $95,000 of taxable income for the current year. Determine the total tax, the marginal tax rate, and the average tax rate if the taxpayer is a
- **a.** Single individual
- **b.** Married couple
- **c.** Corporation

45. Rory earns $60,000 per year as a college professor. Latesia is a marketing executive with a salary of $120,000. With respect to the Social Security tax, what are Rory's and Latesia's
- **a.** Total taxes?
- **b.** Marginal tax rates?
- **c.** Average tax rates?
- **d.** Effective tax rates?

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

Assessed Value	Tax
$ 0 to $10,000	$ 40
$10,001 to $40,000	$ 40 + 1% of the value in excess of $10,000
$40,001 to $80,000	$ 340 + 2% of the value in excess of $40,000
$80,001 and above	$1,140 + 3% of the value in excess of $80,000

- **d.** The city of Thomasville bases its dog licensing fee on the weight of the dog per the following schedule:

Weight (in pounds)	Tax Rate
0 to 40	$ 2 + 50% of weight
41 to 80	$22 + 40% of weight in excess of 40 lbs.
81 and above	$36 + 30% of weight in excess of 80 lbs.

Thomson Learning™

47. The country of Boodang is the leading producer of sausage. Boodang imposes three taxes on its residents and companies to encourage production of sausage and discourage its consumption. Each tax applies as follows:

- Income tax—Rates apply to each taxpayer's total income:

$ -0- –$ 50,000	5% of total income
$ 50,001–$200,000	$ 2,500 + 10% of income in excess of $ 50,000
$200,001–$500,000	$17,500 + 20% of income in excess of $200,000
$500,001 or more	40% of total income

In calculating total income, sausage workers are allowed to deduct 25% of their salaries. Companies that produce sausage are allowed to deduct 50% of their sales. No other deductions are allowed.

- Sausage tax—All sausage purchases are subject to a 100% of purchase price tax. Residents who consume less than 10 pounds of sausage per year are given a 50% rebate of the sausage tax they paid.
- Property tax—Taxes are based on the distance of a taxpayer's residence from state-owned sausage shops per the following schedule:

0–2 miles	$15,000 per mile
2 miles–5 miles	$ 5,000 per mile
5 miles or more	$ 2,000 per mile

Given the definitions in the chapter, are Boodang's taxes progressive, proportional, or regressive? Evaluate and discuss each tax and the aspect(s) of the tax that you considered in making your evaluation.

48. Joe Bob is an employee of Rollo Corporation who receives a salary of $9,000 per month. How much Social Security tax will be withheld from Joe Bob's salary in
a. March?
b. November?

49. Return to the facts of problem 48. Assume that each month, Joe Bob has $2,400 in federal income tax and $800 in state income tax withheld from his salary. What is Joe Bob's take-home pay in
a. March?
b. November?

50. Gosney Corporation has 2 employees. During the current year, Clinton earns $64,000 and Trahn earns $88,000. How much Social Security tax does Gosney have to pay on the salaries earned by Clinton and Trahn?

51. Eric is a self-employed financial consultant. During the current year, Eric's net self-employment income is $90,000. What is Eric's self-employment tax?

52. Darrell is an employee of Whitney's. During the current year, Darrell's salary is $100,000. Whitney's net self-employment income is also $100,000. Calculate the Social Security and self-employment taxes paid by Darrell and Whitney. Write a letter to Whitney in which you state how much she will have to pay in Social Security and self-employment taxes and why she owes those amounts.

53. Classify the following items as ordinary income, a gain, or an exclusion:
a. The gross revenues of $160,000 and deductible expenses of $65,000 of an individual's consulting business
b. Interest received on a checking account
c. Sale for $8,000 of Kummel Corporation stock that cost $3,000
d. Receipt of $1,000 as a graduation present from grandfather
e. Royalty income from an interest in a gold mine

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

Thomson Learning TM

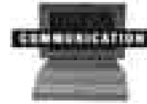
55. Explain why each of the following expenditures is or is not deductible:
- **a.** Lumbar, Inc., pays $12,000 as its share of its employees' Social Security tax. The $12,000 is deductible.
- **b.** Leroy pays a cleaning service $250 per month to clean his real estate office. The $250 is deductible.
- **c.** Janice pays a cleaning service $75 per month to clean her personal residence. The $75 is not deductible.
- **d.** Leyh Corporation purchases land to use as a parking lot for $35,000. The $35,000 is not deductible.
- **e.** Martin spends $50 per month on gasoline for the car he uses to drive to his job as a disc jockey. The $50 is not deductible.

56. Classify each of the following transactions as a deductible expense, a nondeductible expense, or a loss:
- **a.** Nira sells for $4,300 stock that cost $6,000.
- **b.** Chiro Medical, Inc., pays $2,200 for subscriptions to popular magazines that it places in its waiting room.
- **c.** Lawrence pays $200 for subscriptions to fly-fishing magazines.
- **d.** The Mendota Partnership pays $200,000 to install an elevator in one of its rental properties.
- **e.** Sterling Corporation pays $6,000 for lawn maintenance at its headquarters.

57. Based on the following information, what are the taxable income and tax liability for a single individual?

Total income	$91,000
Excludable income	2,000
Deductions for adjusted gross income	2,500
Deductions from adjusted gross income	6,850

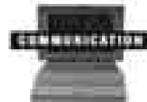
58. Based on the facts in problem 57, calculate the taxable income and the tax liability for a married couple.



59. Reba's 2003 income tax calculation is as follows:

Gross income	$120,000
Deductions for adjusted gross income	(3,000)
Adjusted gross income	$117,000
Deductions from adjusted gross income:	
Standard deduction	(4,750)
(Total itemized deductions are $2,100)	
Personal exemption	(3,050)
Taxable income	$109,200

Before filing her return, Reba finds an $8,000 deduction that she omitted from these calculations. Although the item is clearly deductible, she is unsure whether she should deduct it for or from adjusted gross income. Reba doesn't think it matters where she deducts the item, because her taxable income will decrease by $8,000 regardless of how the item is deducted. Is Reba correct? Calculate her taxable income both ways. Write a letter to Reba explaining any difference in her taxable income arising from whether the $8,000 is deducted for or from adjusted gross income.



60. Since graduating from college, Mabel has used the firm of R&P to prepare her tax returns. Each January, Mabel receives a summary information sheet, which she fills out and sends to R&P along with the appropriate documentation. Because she has always received a refund, Mabel feels that R&P is giving her good tax advice. Write a letter to Mabel explaining why she may not be getting good tax advice from R&P.

61. Michiko and Saul are planning to attend the same university next year. The university estimates tuition, books, fees, and living costs to be $9,000 per year. Michiko's father has agreed to give her the $9,000 she needs to attend the university. Saul has obtained a job at the university that will pay him $11,000 per year. After discussing their respective arrangements, Michiko figures that Saul will be better off than she will. What, if anything, is wrong with Michiko's thinking?

Thomson Learning TM

62. Inga, an attorney, completed a job for a client in November 2003. If she bills the client immediately, she will receive her $10,000 fee before the end of the year. By delaying the billing for a month, she will not receive the $10,000 until 2004. What factors should Inga consider in deciding whether she should delay sending the bill to the client?

63. Art is in the 30% marginal tax bracket for 2003. He owes a $10,000 bill for business expenses. Because he reports taxable income on a cash basis, he can deduct the $10,000 in either 2003 or 2004, depending on when he makes the payment. He can pay the bill at any time before January 31, 2004, without incurring the normal 8% interest charge. If he expects to be in a 34% marginal tax bracket for 2004, should he pay the bill and claim the deduction in 2003 or 2004?

64. Elki would like to invest $50,000 in tax-exempt securities. He now has the money invested in a certificate of deposit that pays 5.75% annually. What rate of interest would the tax-exempt security have to pay to result in a greater return on Elki's investment than the certificate of deposit? Work the problem assuming that Elki's marginal tax rate is 15%, 27%, 30%, and 38.6%.

65. Leroy and Amanda are married and have three dependent children. During the current year, they have the following income and expenses:

Salaries	$96,000
Interest income	45,000
Dividend income	27,000
Deductions for AGI	3,000
Deductions from AGI	9,000

a. What is Leroy and Amanda's current year taxable income and income tax liability?
b. Leroy and Amanda would like to lower their income tax. How much income tax will they save if they validly transfer $5,000 of the interest income to each of their children? Assume that the children have no other income and that they are entitled to a $750 standard deduction but are not allowed a personal exemption deduction.

66. Tina owns and operates Timely Turn Tables (TTT) as a sole proprietorship. TTT's taxable income during the current year is $80,000. In addition to the TTT income, Tina has the following income and expenses during the current year:

Interest income	$ 3,000
Dividend income	8,000
Royalty income	28,000
Deductions for AGI	2,500
Deductions from AGI	12,000

a. What is Tina's current year taxable income and income tax liability?
b. Tina would like to lower her tax by incorporating Timely Turn Tables. How much income tax will she save if she incorporates TTT and pays herself a salary of $40,000?

67. For each of the following situations, state whether the taxpayer's action is tax evasion or tax avoidance.
a. Tom knows that farm rent received in cash or farm produce is income subject to tax. To avoid showing a cash receipt on his records, he rented 50 acres for 5 steers to be raised by the tenant. He used 2 of the steers for food for his family and gave 3 to relatives. Because he did not sell the livestock, he did not report taxable income.
b. Betty applied for and received a Social Security number for Kate, her pet cat. Surprised by how easy it was to get a Social Security number, she decided to claim a dependent exemption on her tax return for Kate. Other than being a cat, Kate met all the tests for a dependent.
c. Glen has put money in savings accounts in 50 banks. He knows a bank is not required to report to the IRS interest it pays him that totals less than $10. Because the banks do not report the payments to the IRS, Glen does not show the interest he receives as taxable income. Although Glen's accountant has told him all interest he receives is taxable, Glen insists that the IRS will never know the difference.
d. Bob entered a contract to sell a parcel of land at a $25,000 gain in 2002. To avoid reporting the gain in 2002, he closed the sale and delivered title to the land to the buyers on January 2, 2003.
e. Asha's taxable income for 2003 puts her in the 30% marginal tax bracket. She has decided to purchase new equipment for her business during 2004. A special election al-

Thomson Learning™

lows Asha to treat $25,000 of the cost of the equipment as a current period expense. Because she expects to be in a lower tax bracket next year, Asha buys and begins using $25,000 worth of the equipment during December 2003. She claims a $25,000 expense deduction under the special election for 2003.

68. In each of the following situations, explain why the taxpayer's action is or is not tax evasion:

a. Jamal owns an electrical appliance repair service. When a client pays him in cash, he gives the cash to his daughter Tasha. Jamal does not report the cash he gives to Tasha in his business income. Tasha has no other income, and the amount of cash that she receives from Jamal is small enough that she is not required to file a tax return.

b. Roberta and Dudley are married. Roberta usually prepares their tax return. However, she was in the hospital and unable to prepare the return for 2002, so Dudley did it. In preparing their 2003 return, Roberta notices that Dudley included $1,000 of tax-exempt municipal bond interest in their 2002 gross income. To correct this mistake, Roberta takes a $1,000 deduction on the 2003 return.

c. In 2003, Hearthome Corporation receives notice that the IRS is auditing its 2001 return. In preparing for the audit, Hearthome's controller, Monique, finds a mistake in the total for the 2001 depreciation schedule that resulted in a $5,000 overstatement of depreciation expense.

d. While preparing his tax return, Will becomes unsure of the treatment of a deduction item. He researches the issue and can find no concrete tax law authority pertaining to the particular item. Will calls his buddy Dan, an accounting professor, for advice. Dan tells Will that if the law is unclear, he should treat the deduction in the most advantageous manner. Accordingly, Will deducts the full amount of the item, rather than capitalizing and amortizing it over 5 years.

e. Sonja is a freelance book editor. Most companies for which she works pay her by check. In working out the terms of a job, a new client agrees to pay her by giving her a new computer valued at $3,600. In preparing her tax return, Sonja notes that the client failed to report to the IRS the value of the computer as income for Sonja. Aware that her chances of getting caught are small, Sonja does not include the $3,600 value of the computer in her gross income.

Issue Identification Problems

In each of the following problems, identify the tax issue(s) posed by the facts presented. Determine the possible tax consequences of each issue that you identify.

69. Marla had $2,100 in state income taxes withheld from her 2003 salary. When she files her 2003 state income tax return, her actual state tax liability is $2,300.

70. While reading a State College alumni newsletter, Linh is surprised to learn that interest paid on student loans is deductible. Linh graduated from college 2 years ago and paid $1,200 in interest during the current year on loans that he took out to pay his college tuition.

71. Victoria's son needs $5,000 for tuition at the Motown School of Dance. Victoria, who is in the 35% marginal tax rate bracket, intends to pay the tuition by selling stock worth $5,000 that she paid $2,000 for several years ago.

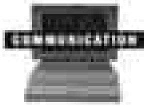
72. Joey and Camilla are married and have three children, ages 8, 16, and 18. They own a commercial cleaning business that is organized as a sole proprietorship and makes $120,000 annually. They have $30,000 of other taxable income (net of allowable deductions).

Technology Applications

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

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

Thomson Learning™



75. **RESEARCH PROBLEM** Audrey opened Hardy Consulting Services during the current year. She has one employee, Deng, who is paid a salary of $30,000. Audrey is confused about the amount of federal unemployment tax she is required to pay on Deng's salary. The state unemployment tax rate is 4%. Audrey has asked you to determine how much federal unemployment tax she is required to pay on Deng's salary. Write Audrey a letter explaining the amount of federal unemployment tax she must pay.

76. **RESEARCH PROBLEM** Shawna earns $70,000 as a biologist for Berto Corporation. She also consults with other businesses on compliance with environmental regulations. During the current year, she earns $25,000 in consulting fees. Determine the amount of self-employment tax Shawna owes on her consulting income.

77. **SPREADSHEET PROBLEM** Using the information below, prepare a spreadsheet that will calculate an individual's taxable income. The spreadsheet should be flexible enough to accommodate single and married taxpayers as well as changes in the information provided below.

Number of dependents	2
Salary	$75,000
Interest	8,000
Deductions for adjusted gross income	2,800
Deductions from adjusted gross income	12,100

Discussion Cases

78. A value-added tax has been the subject of much debate in recent years as a tax to use to help reduce the deficit. Various forms of value-added taxes are used throughout Europe, Canada, and in many other countries. To acquaint yourself with the basic operation of a value-added tax, read the following article:

Peter Chin and Joel G. Siegel, "What the Value-Added Tax Is All About," *TAXES—The Tax Magazine,* January 1989, pp. 3–13.

After reading the article, consider the following circumstances:

Joe is married and has 2 children. A brain surgeon, he earns about $300,000 annually from his medical practice and averages about $250,000 in investment income. Jane, Joe's wife, spends most of her time doing volunteer work for charitable organizations. Tom is also married and has 5 children. He earns $20,000 per year working as a maintenance man for Joe.

While Joe was working late one night, he and Tom had a serious disagreement about two new tax bills recently introduced to help reduce the deficit. The first bill would levy a 10% value-added tax on all goods and services. A second bill introduced at the same time would add an additional 10% tax to each of the six current tax rate brackets (i.e., 10% would become 20%, 15% would become 25%, 27% would become 37%, 30% would become 40%, 35% would become 45%, and 38.6% would become 48.6%).

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

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

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

a. What is a value-added tax, and how does it work?

b. Evaluate the rate structures of the two proposed taxes. Are they proportional, progressive, or regressive?

c. What, if anything, is wrong with Tom's and/or Joe's point of view? Be sure to explain this part in depth.

Thomson Learning™

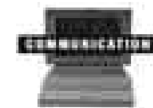
79. Norman and Vanessa are married and have 2 dependent children. This is a summary of their 2002 tax return:

Adjusted gross income	$65,850
Deductions from adjusted gross income:	
Standard deduction	(7,850)
Exemptions ($3,000 × 4)	(12,000)
Taxable income	$46,000
Tax liability	$ 6,300

a. Assuming that Norman and Vanessa's 2003 adjusted gross income will increase at the 1.6% rate of inflation and that the standard deduction and exemption amounts do not change, calculate their 2003 taxable income. Calculate the tax liability on this income using the 2002 tax rate schedules (Appendix A).

b. Calculate Norman and Vanessa's projected 2003 taxable income and tax liability, assuming that their adjusted gross income will increase by 1.6% and that all other inflation adjustments are made. Compare these calculations with those in part a, and explain how the inflation adjustments preserve Norman and Vanessa's after-tax income.

TAX PLANNING CASES



80. Bonnie is married and has 1 child. She owns Bonnie's Rib Joint, which produces a taxable income of approximately $100,000 per year.

a. Assume that Bonnie's taxable income is $40,000 without considering the income from the rib joint. How much tax will she pay on the $100,000 of income from the rib joint?

b. You work for the firm that prepares Bonnie's tax return. Bonnie has asked the partner for whom you work to advise her on how she might lower her taxes. The partner has assigned you this task. Draft a memorandum to the partner that contains at least two options Bonnie could use to lower her taxes. For each option, explain the calculations that support the tax savings from your recommendation.

81. Barbara is going to purchase a car for $20,000. She has two financing options: She can finance the purchase through the dealer at 1 percent for 48 months, with monthly loan payments of $425, or she can take a $2,000 rebate on the purchase price and finance the remaining $18,000 with a 7.5 percent home equity loan whose monthly payment will be $435. The interest on the home equity loan is deductible; the interest on the dealer loan is not. Barbara is in the 30% marginal tax rate bracket. Determine her best course of action in financing the purchase of the car.

ETHICS DISCUSSION CASE

82. Return to the facts of problem 67. Assume that you are the CPA in charge of preparing the tax return for each of the taxpayers in the problem. Based on the Statements on Standards for Tax Services (Appendix D), explain what you should do in each case. Your discussion should indicate which, if any, of the eight statements is applicable and your obligations with regard to each applicable statement. If the facts are not sufficient to determine whether a statement applies to a situation, discuss the circumstances in which the statement would apply.

Thomson Learning™