2019 | **Individuals**

Pearson's

# Federal Taxation 2019


TIMOTHY J. RUPERT    KENNETH E. ANDERSON

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DAVID S. HULSE · LEANN LUNA · CHARLENE HENDERSON · JARED MOORE
WILLIAM D. BRINK · SUSAN L. PORTER · MICHAEL S. SCHADEWALD

# PEARSON'S FEDERAL TAXATION

# 2019

# INDIVIDUALS

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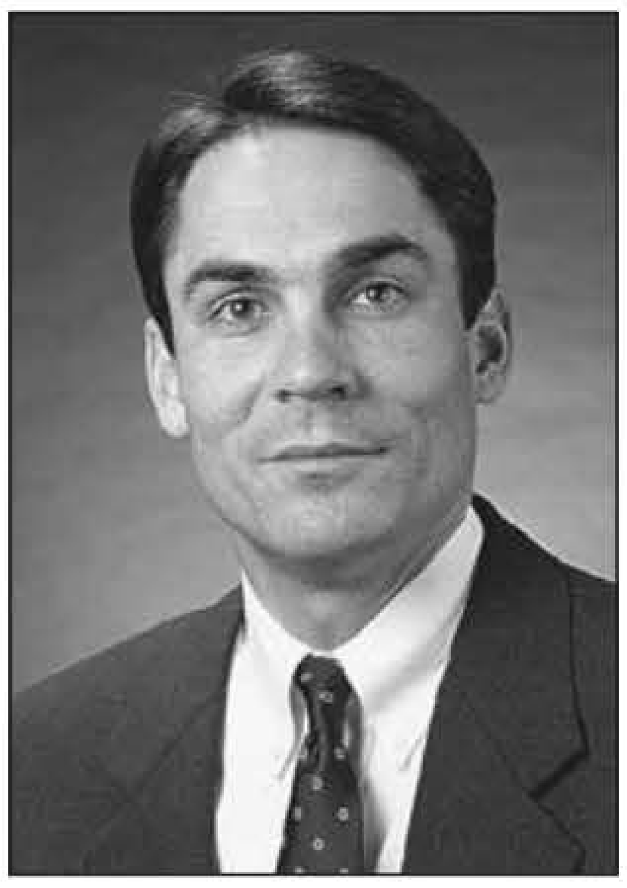

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# PREFACE

## New to this Edition

### INDIVIDUALS

- Complete updating of the chapter material for the provisions in the Tax Cuts and Jobs Act of 2017 affecting individual taxpayers, including an explanation of the new rules and the related implications of the following items:
  - Reduction in marginal tax rates
  - Elimination of personal and dependency exemptions
  - Changes in the deductability of state and local taxes and casualty losses
  - Elimination of miscellaneous itemized deductions
  - Changes to the alternative minimum tax
  - Increase in the child tax credit
- Complete updating of significant court cases and IRS rulings and procedures during 2017 and early 2018
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2018
- Whenever new updates become available, they will be accessible via MyLab Accounting
- Updating of the end-of-chapter tax return problems to 2017 (2017 tax forms are included because the 2018 tax forms were not available when this edition went to print), but also including a supplemental explanation for each tax return problem of how the solution will change for the 2018 tax year given the provisions of the Tax Cuts and Jobs Act.

### CORPORATIONS

- Complete updating of the chapter material for the provisions in the Tax Cuts and Jobs Act of 2017 affecting corporations and other entities, including an explanation of the new rules and the related implications of the following items:
  - Reduced corporate tax rate
  - Qualified business income deduction
  - New limitations on interest, business losses, and NOLs
  - New rules for the taxation of international transactions
  - The comprehensive corporate tax return, Problem C:3-65, has all new numbers for the 2017 forms
- The comprehensive partnership tax return, Problem C:9-58, has all new numbers for the 2017 forms
- The comprehensive S corporation tax return, Problem C:11-62, has all new numbers for the 2017 forms
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2018
- Whenever new updates become available, they will be accessible via MyLab Accounting

### SOLVING TEACHING AND LEARNING CHALLENGES

The Rupert/Anderson 2019 Series in Federal Taxation is appropriate for use in any first course in federal taxation, and comes in a choice of three volumes:

- Federal Taxation 2019: Individuals
- Federal Taxation 2019: Corporations, Partnerships, Estates & Trusts (the companion book to Individuals)
- Federal Taxation 2019: Comprehensive (14 chapters from Individuals and 15 chapters from Corporations)

** For a customized edition of any of the chapters for these texts, contact your Pearson representative and he or she can create a custom text for you.

- The *Individuals* volume covers *all* entities, although the treatment is often briefer than in the *Corporations* and *Comprehensive* volumes. The Individuals volume, therefore, is appropriate for colleges and universities that require only one semester of taxation as well as those that require more than one semester of taxation. Further, this volume adapts the suggestions of the Model Tax Curriculum as promulgated by the American Institute of Certified Public Accountants.
- The *Corporations, Partnerships, Estates & Trusts* and *Comprehensive* volumes contain three comprehensive tax return problems whose data change with each edition, thereby keeping the problems fresh. Problem C:3-65 contains the comprehensive corporate tax return, Problem C:9-58 contains the comprehensive partnership tax return, and Problem C:11-62 contains the comprehensive S corporation tax return, which is based on the same facts as Problem C:9-58 so that students can compare the returns for these two entities.
- The *Corporations, Partnerships, Estates & Trusts* and *Comprehensive* volumes contain sections called Financial Statement Implications, which discuss the implications of Accounting Standards Codification (ASC) 740. The main discussion of accounting for income taxes appears in Chapter C:3. The financial statement implications of other transactions appear in Chapters C:7, C:8, and C:16 (Corporations volume only).

Rupert/Anderson 2019 Series in Federal Taxation has an appropriate blend of technical content of the tax law with a high level of readability for students. It is focused on enabling students to apply tax principles within the chapter to real-life situations using many strong pedagogical aids:

### Real-World Example

These comments relate the text material to events, cases, and statistics occurring in the tax and business environment. The statistical data presented in some of these comments are taken from the IRS's Statistics of Income at www.irs.gov.

### Book-to-Tax Accounting Comparison

These comments compare the tax discussion in the text to the accounting and/or financial statement treatment of this material. Also, the last section of Chapter C:3 discusses the financial statement implications of federal income taxes.

### What Would You Do in This Situation?

Unique to the Rupert/Anderson series, these boxes place students in a decision-making role. The boxes include many *controversies* that are as yet unresolved or are currently being considered by the courts. These boxes make extensive use of **Ethical Material** as they represent choices that may put the practitioner at odds with the client.

### Stop & Think

These "speed bumps" encourage students to pause and apply what they have just learned. Solutions for each issue are provided in the box.

### Ethical Point

These comments provide the ethical implications of material discussed in the adjoining text. Apply what they have just learned.

### Tax Strategy Tip

These comments suggest tax planning ideas related to material in the adjoining text.

### Additional Comment

These comments provide supplemental information pertaining to the adjacent text.

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|---|---|
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| **Instructor's Solutions Manual**<br>authored by Kenneth Anderson from University of Tennessee and Timothy Rupert from Northeastern University | • Solutions to discussion questions<br>• Solutions to problems<br>• Solutions to comprehensive and tax strategy problems |
| **Test Bank**<br>authored by Anthony Masino from East Tennessee State University and Ann Burstein Cohen from SUNY at Buffalo | Over 2,000 multiple-choice, true/false, short-answer, essays, and worked problems.<br>• Type (Multiple-choice, true/false, short-answer, essay)<br>• Page references to where content is found in the text |
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Please send any comments to Kenneth E. Anderson or Timothy J. Rupert.

CHAPTER

# 1

# AN INTRODUCTION TO TAXATION

## LEARNING OBJECTIVES

**After studying this chapter, you should be able to**

1 Discuss the history of taxation in the United States

2 Describe the three types of tax rate structures

3 Describe the various types of taxes

4 Discuss the criteria for a "good" tax structure, the objectives of the federal income tax law, and recent tax reform proposals

5 Describe the tax entities in the federal income tax system

6 Identify the various tax law sources and understand their implications for tax practice

7 Describe the legislative process for the enactment of the tax law

8 Describe the administrative procedures under the tax law

9 Describe the components of a tax practice

10 Understand the importance of computer applications in taxation

## CHAPTER OUTLINE



Federal income taxes have a significant effect on business, investor, and personal decisions in the United States. Because tax rates can be as high as 21% on corporations and over 40% on individuals, virtually every transaction is impacted by income taxes. The following examples illustrate the impact of the tax law on various decisions in our society:

- Because of the deductibility of home mortgage interest and real estate taxes, an individual may decide to purchase a home rather than to continue to rent an apartment.
- An investor may decide to delay selling some stock because of the significant taxes that may result from the sale.
- A corporation may get a larger tax deduction if it leases property rather than purchasing the property.

The purpose of this text is to provide an introduction to the study of federal income taxation. However, before discussing the specifics of the U.S. federal income tax law, it is helpful to have a broad conceptual understanding of the taxation process. This chapter provides an overview of the following topics:

- Historical developments of the federal tax system
- Types of taxes levied and structural considerations
- Objectives of the tax law, including a discussion of recent tax reform proposals
- Taxpaying entities in the federal income tax system
- Tax law sources and the legislative process
- Internal Revenue Service (IRS) collection, examination, and appeals processes
- The nature of tax practice, including computer applications and tax research

**KEY POINT**

In many situations, the use of the tax laws to influence human behavior is deliberate. As will be seen later in this chapter, tax laws are often used to achieve social and economic objectives.

# HISTORY OF TAXATION IN THE UNITED STATES

**OBJECTIVE 1**

*Discuss the history of taxation in the United States*

## EARLY PERIODS

The federal income tax is the dominant form of taxation in the United States. In addition, most states and some cities and counties also impose an income tax. Both corporations and individuals are subject to such taxes.

Prior to 1913 (the date of enactment of the modern-day federal income tax), the federal government relied predominantly on customs duties and excise taxes to finance its operations. The first federal income tax on individuals was enacted in 1861 to finance the Civil War but was repealed after the war. The federal income tax was reinstated in 1894, however, that tax was challenged in the courts because the U.S. Constitution required that an income tax be apportioned among the states in proportion to their populations. This type of tax system, which would be both impractical and difficult to administer, would mean that different tax rates would apply to individual taxpayers depending on their states of residence.

In 1895, the Supreme Court ruled that the tax was in violation of the U.S. Constitution.[1] Therefore, it was necessary to amend the U.S. Constitution to permit the passage of a federal income tax law. This was accomplished by the Sixteenth Amendment, which was ratified in 1913. The Sixteenth Amendment, while being an extraordinarily important amendment, consists of one sentence.

**HISTORICAL NOTE**

The reinstatement of the income tax in 1894 was the subject of heated political controversy. In general, the representatives in Congress from the agricultural South and West favored the income tax in lieu of customs duties. Representatives from the industrial eastern states were against the income tax and favored protective tariff legislation.

**Sixteenth Amendment to the Constitution of the United States**

> The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

[1] *Pollock v. Farmers' Loan & Trust Co.*, 3 AFTR 2602 (USSC, 1895). Note, however, that a federal income tax on corporations that was enacted in 1909 was held to be constitutional because it was treated as an excise tax. See *Flint v. Stone Tracy Co.*, 3 AFTR 2834 (USSC, 1911).

## REVENUE ACTS FROM 1913 TO THE PRESENT

**HISTORICAL NOTE**

The Revenue Act of 1913 contained sixteen pages.

The Revenue Act of 1913 imposed a flat 1% tax (with no exemptions) on a corporation's net income. The rate varied from 1% to 7% for individuals, depending on the individual's income level. However, very few individuals paid federal income taxes because a \$3,000 personal exemption (\$4,000 for married individuals) was permitted as an offset to taxable income. These amounts were greater than the incomes of most individuals in 1913.

**HISTORICAL NOTE**

Before 1939, the tax laws were contained in the most current revenue act, a reenactment of a prior revenue act plus amendments. In 1939, a permanent tax code was established; it was revised in 1954 and 1986.

Various amendments to the original law were passed between 1913 and 1939 as separate revenue acts. For example, a deduction for dependency exemptions was provided in 1917. In 1939, the separate revenue acts were codified into the Internal Revenue Code of 1939. A similar codification was implemented in 1954. The 1954 codification, which was known as the Internal Revenue Code of 1954, included the elimination of many "deadwood" provisions, a rearrangement and clarification of numerous code sections, and the addition of major tax law changes. Whenever changes to the Internal Revenue Code (IRC) are made, the old language is deleted and the new language added. Thus, the statutes are organized as a single document, and a tax advisor does not have to read through the applicable parts of all previous tax bills to find the most current law. In 1986, significant changes were made to the tax law, and the basic tax law was redesignated as the Internal Revenue Code of 1986. In December 2017, the Tax Cuts and Jobs Act (TCJA) was passed by Congress, effective on January 1, 2018. While the major changes relate to businesses, there are significant changes for all taxpayers. The important changes of TCJA are included in this textbook.

The federal income tax became a "mass tax" on individuals during the early 1940s. This change was deemed necessary to finance the revenue needs of the federal government during World War II. In 1939, less than 6% of the U.S. population was subject to the federal income tax; by 1945, 74% of the population was taxed.[2] To accommodate the broadened tax base and to avoid significant tax collection problems, Congress enacted pay-as-you-go withholding in 1943.

A major characteristic of the federal income tax since its inception to today is the manner in which the tax law is changed or modified. The federal income tax is changed on an **incremental** basis rather than a complete revision basis. Under so-called incrementalism, when a change in the tax law is deemed necessary by Congress, the entire law is not changed, but specific provisions of the tax law are added, changed, or deleted on an incremental basis. Thus, the federal income tax has been referred to as a "quiltwork" of tax laws, referring to the patchwork nature of the law. Without question, one of the principal reasons for the complexity of the federal income tax today is the incremental nature of tax legislation.

## REVENUE SOURCES

**ADDITIONAL COMMENT**

In 2016, 150 million individual income tax returns were filed, and collections from individuals totaled \$1.46 trillion.

As mentioned earlier, the largest source of federal revenues is individual income taxes. Other major revenue sources include Social Security (FICA) taxes and corporate income taxes (see Table I:1-1). Two notable trends from Table I:1-1 are (1) the gradual increase in social insurance taxes from 1960 to 2017 and (2) the gradual decrease in corporate income taxes for the same period. Individual income taxes have remained fairly stable during the past 50 years.

**TYPICAL MISCONCEPTION**

It is often assumed that the tax revenue from corporation income taxes is the largest source of tax revenue. However, the revenue generated from this tax only represents approximately 9% of total federal revenues in 2017.

**▼ TABLE I:1-1**
**Breakdown of Federal Revenues**

| | 1960 | 1975 | 2000 | 2017 |
|---|---|---|---|---|
| Individual income taxes | 44% | 45% | 50% | 48% |
| Social insurance taxes and contribution | 16 | 32 | 32 | 35 |
| Corporation income taxes | 23 | 15 | 10 | 9 |
| Other | 17 | 8 | 8 | 8 |
| Total | 100% | 100% | 100% | 100% |

*Source:* Council of Economic Advisers, *Economic Indicators* (Washington, DC: U.S. Government Printing Office, 1967, 1977, 2017).

[2] Richard Goode, *The Individual Income Tax* (Washington, DC: The Brookings Institution, 1964), pp. 2–4.

# TYPES OF TAX RATE STRUCTURES

**OBJECTIVE 2**

*Describe the three types of tax rate structures*

## THE STRUCTURE OF INDIVIDUAL INCOME TAX RATES

Virtually all tax structures are comprised of two basic parts: the **tax base** and the **tax rate.** The tax base is the amount to which the tax rate is applied to determine the tax due. For example, an individual's tax base for the federal income tax is *taxable income,* as defined and determined by the income tax law. Similarly, the tax base for the property tax is generally the fair market value of property subject to the tax. The tax rate is merely the percentage rate applied to the tax base.

**ADDITIONAL COMMENT**

In the 1950s, the top marginal tax rate for individual taxpayers reached 92%. This astonishingly high rate only applied to taxpayers with very high taxable incomes but still is an extremely confiscatory tax rate.

Tax rates may be progressive, proportional, or regressive. A **progressive rate** structure is one where the rate of tax increases as the tax base increases. The most notable tax that incorporates a progressive rate structure is the federal income tax. Thus, as a taxpayer's taxable income increases, a progressively higher rate of tax is applied. For 2018, the federal income tax rates for individuals begin at 10% and increase to 12%, 22%, 24%, 32%, 35%, and 37% as a taxpayer's taxable income increases.[3] Examples I:1-1 and I:1-2 show how the progressive rate structure of the federal income tax operates.

**EXAMPLE I:1-1** ▶ Alice, who is single, has $30,000 taxable income in 2018. Her federal income taxes for the year are $3,410, computed as follows: the first $9,525 of taxable income is taxed at 10% and the remaining $20,475 at 12%. (For tax rates, see the inside front cover.) In 2017, the tax would have been $4,034, which demonstrates the reduction of income taxes under the Tax Cuts and Jobs Act.

Allen, who also is single, has taxable income of $60,000. A 10% rate applies to the first $9,525 of taxable income, 12% on the next $29,175, and a 22% rate applies to the taxable income over $38,700. Thus, Allen's total tax is $9,140 [(0.10 × $9,525) + (0.12 × $29,175) + (0.22 × $21,300)].

If Allen's taxable income is $120,000, a 24% rate applies to $37,500 of his taxable income ($120,000 − $82,500) because the 24% rate applies to taxable income above $82,500 for a single individual and his total tax for the year is $23,090. Thus, the tax rates are progressive because the rate of tax increases as a taxpayer's taxable income increases. ◀

**LEGISLATIVE BACKGROUND**

Beginning with tax year 2018, the top rate for high-income individual taxpayers was decreased to 37% from 39.6%.

Notice in Example I:1-1 that taxable income has doubled in size in the three cases, but the income taxes have more than doubled (i.e., $3,410 to $9,140 to $23,090). This demonstrates how a progressive rate structure operates.

**EXAMPLE I:1-2** ▶ Assume the same facts as in Example I:1-1 except that Alice has taxable income of $240,000. Of Alice's taxable income, $40,000 ($240,000 − $200,000) is subject to the 35% rate. Alternatively, if Allen has taxable income of $600,000, $100,000 ($600,000 − $500,000) is subject to the top marginal rate of 37%. ◀

A **proportional tax** rate, sometimes called a **flat tax,** is one where the rate of tax is the same for all taxpayers, regardless of the level of their tax base. This type of tax rate is generally used for real estate taxes, state and local sales taxes, personal property taxes, customs duties, and excise taxes. A flat tax has been the subject of considerable discussion over the past twenty years and promises to be a controversial topic as the debate on federal income tax reform continues into the future.

**EXAMPLE I:1-3** ▶ Assume the same facts as in Example I:1-1, except that a 17% tax rate applies to all amounts of taxable income. Based on the assumed flat tax rate structure, Alice's federal income tax is $5,100 on $30,000 of taxable income; Allen's tax is $10,200 on $60,000 of taxable income and $20,400 on $120,000 of taxable income. The tax rate is proportional because the 17% rate applies to both taxpayers without regard to their income level. As you can see, a proportional tax rate results in substantially lower taxes for higher income taxpayers.[4] ◀

[3] See the inside front cover for the 2018 tax rates and Chapter I:2 for a discussion of the computation procedures. 2017 rate schedules and tax tables are located immediately before Appendix A.

[4] This example assumes the same tax base (taxable income) for the flat tax as with the current federal tax. Most flat tax proposals allow only a few deductions and, therefore, would generate higher taxes than in the example.

**SELF-STUDY QUESTION**

Assume a tax system with a tax of $1,000 on taxable income of $10,000 and a $1,500 tax on taxable income of $20,000. Is the tax rate system progressive, proportional, or regressive?

**ANSWER**

This tax system is regressive. Even though the amount of tax has increased, the rate of taxation has decreased from 10% on the first $10,000 of taxable income to 5% on the second $10,000 of taxable income.

**ADDITIONAL COMMENT**

In recent years, many countries around the world significantly reduced their tax rates on corporations. As a result, the top 35% tax rate in the United States was one of the highest statutory corporate rates in the world and led many U.S. corporations to move their international operations to other countries. For example, Ireland imposes a 12.5% rate on corporations.

A **regressive tax** rate decreases with an increase in the tax base (e.g., income). Regressive taxes, while not consistent with the fairness of the income tax,[5] are found in the United States. The Social Security (FICA) tax is regressive because a fixed rate of tax of 6.20% for OASDI for both the employer and employee is levied up to a ceiling amount of $128,400 for 2018. So, for example, assume Taxpayer A has income subject to Social Security of $80,000 and Taxpayer B income of $400,000. Taxpayer A's OASDI would be $4,960 ($80,000 × 0.062), Taxpayer B's OASDI would be $7,961 ($128,400 × 0.062). Taxpayer A's average rate of OASDI tax is 6.2% while Taxpayer B's average rate of tax is 1.99% ($7,961/$400,000). Sales taxes, which are levied by many states, are also regressive when measured against the income base.

## THE STRUCTURE OF CORPORATE TAX RATES

Corporations are separate entities and are subject to income tax.[6] Beginning with the 2018 tax year, corporations are subject to a flat rate of 21%,[7] a rate that is a substantial reduction from the top rate for 2017 of 35%. For 2017 and many earlier years, the corporate tax rates were progressive in nature, ranging from 15% to 35%. The reduction in corporate tax rates for 2018 and future years were made for two principal reasons: (1) to make the corporate income tax rate in the United States more competitive with other countries around the world, and (2) to attempt to stimulate the economy and create jobs in the United States. Time will tell if this strategy for corporate income taxes is effective.

## MARGINAL, AVERAGE, AND EFFECTIVE TAX RATES FOR TAXPAYERS

A taxpayer's **marginal tax rate** is the tax rate applied to an incremental amount of taxable income that is added to the tax base. The marginal tax rate concept is useful for planning because it measures the tax effect of a proposed transaction.

**EXAMPLE I:1-4** ▶ Tania, who is single, is considering the purchase of a personal residence that will provide a $20,000 tax deduction for interest expense and real estate taxes in 2018. Tania's taxable income would be reduced from $180,000 to $160,000 if she purchases the residence. Because a 32% tax rate applies to taxable income from $160,000 to $180,000, Tania's marginal tax rate is 32%. Thus, Tania's tax savings from purchasing the personal residence would be $6,400 (0.32 × $20,000). ◀

While the marginal tax rate measures the tax rate applicable to the next $1 of income or deduction for a taxpayer, there are two other tax rates that are used primarily by tax policymakers: average tax rate and effective tax rate. The **average tax rate** is computed by dividing the total tax liability by the amount of taxable income. This represents the average rate of tax for each dollar of taxable income. For example, a single taxpayer with taxable income of $550,000 in 2018 would incur a total tax liability of $169,190. The taxpayer's marginal tax rate is 37%, but his average tax rate is 30.8% ($169,190/$550,000).

[5] See the discussion of equity and fairness later in this chapter.

[6] See Chapter I:16 of this textbook for a more complete discussion of the taxation of C Corporations.

[7] Sec. 11(b).

**ADDITIONAL COMMENT**

One method of calculating economic income is to start with adjusted gross income (AGI), add back items of excludible income, such as tax-exempt bond interest, proceeds of life insurance policies, etc., and then deduct certain nondeductible business expenses, such as life insurance premiums, penalties and fines, etc.

The **effective tax rate** is the total tax liability divided by total economic income. **Total economic income** includes all types of economic income that a taxpayer has for the year. Thus, economic income is much broader than taxable income and includes most types of excludible income, such as tax-exempt bond interest, and generally permits business deductions but not personal-type deductions. It should be pointed out that economic income is *not* statutorily defined and experts may disagree on a precise calculation. The basic purpose of calculating the effective tax rate is to provide a broad measure of taxpayers' ability to pay taxes. Accordingly, the effective tax rate mainly is used by tax policymakers to determine the fairness of the income tax system.

**EXAMPLE I:1-5** ▶ Amelia, who is single, has adjusted gross income of $140,000 and economic income of $175,000 in 2018. The difference is attributable to $35,000 of tax-exempt bond interest. If Amelia has personal deductions of $30,000, then her taxable income is $110,000, and her total tax is $20,690. Her average tax rate is 18.81% ($20,690 ÷ $110,000). Amelia's effective tax rate is 11.82% ($20,690 ÷ $175,000). Amelia's effective tax rate is considerably lower than her average tax rate because of her substantial amount of tax-exempt income. ◀

**STOP & THINK**

***Question:*** Gwen, a single taxpayer, has seen her income climb to $190,000 in the current year. She wants a tax planner to help her reduce her tax liability. In planning for tax clients, tax professionals almost exclusively use the marginal tax rate in their analysis rather than the average tax rate. Why is the marginal tax rate much more important in the tax planning process than the average tax rate?

***Solution:*** Because tax planning is done at the margin, a single taxpayer who has taxable income of $190,000 has a marginal tax rate of 32% (at 2018 rates), but an average tax rate of 22.36%, computed as follows:

| | | |
|---|---|---|
| Taxable income | | $190,000 |
| Tax on first $157,500 of taxable income | | $32,090 |
| Remaining taxable income | $32,500 | |
| Times: Marginal tax rate | × 0.32 | 10,400 |
| Total tax liability | | $ 42,490 |

$$\text{Average tax rate} = \frac{\text{Total tax}}{\text{Taxable income}} = \frac{\$\ 42{,}490}{\$190{,}000} = 22.36\%$$

If a tax planner could reduce Gwen's taxable income by $10,000, Gwen's tax liability would decrease by $3,200 ($10,000 × 0.32). When the taxpayer wants to know how much she can save through tax planning, the appropriate marginal tax rate yields the answer.

Overall, estimated effective federal income tax rates for individuals have increased slightly during the period 2003–2012,[8] amounting to 12.6% in 2012 as compared with 9.1% in 2003. For the highest 20% of households, the effective individual income tax rate increased to 18.0% in 2012 from 14.4% in 2003. The effective tax rate for individuals in the United States is relatively low compared to most other industrialized countries.

**ADDITIONAL COMMENT**

In the determination of tax rates, one should consider the incidence of taxation that involves the issue of who really bears the burden of the tax. If a city raises the real property tax but landlords simply raise rents to pass on the higher taxes, the tax burden is shifted to their tenants. The concept has important implications in determining any kind of average or effective tax rate.

## DETERMINATION OF TAXABLE INCOME AND TAX DUE

As will be discussed in later chapters, the federal income taxes imposed on all taxpayers (individuals, corporations, estates, and trusts) are based on the determination of taxable income. In general, taxable income is computed as follows:

| | |
|---|---|
| Total income (income from whatever source derived) | $xxx |
| Minus: Exclusions (specifically defined items, such as tax-exempt bond interest) | (xx) |

[8] Congressional Budget Office, *Effective Federal Tax Rates Under Current Law, 2001 to 2014* (Washington, DC: U.S. Government Printing Office, August, 2004), p. 10.

| | | |
|---|---|---|
| Gross income | | $xxx |
| Minus: | Deductions (business expenses and itemized deductions) | (xx) |
| Taxable income | | $xxx |
| Times: | Applicable tax rate | × .xx |
| Income tax before credits | | $xxx |
| Minus: | Tax credits | (xx) |
| Total tax liability | | $xxx |
| Minus: | Prepayments | (xx) |
| Balance due or refund | | $xxx |

Each different type of taxpayer (individuals, corporations, etc.) computes taxable income in a slightly different manner, but all use the general framework above. An introductory discussion of the various types of taxpayers is provided later in this chapter. More detailed discussions of individual taxpayers (Chapter I:2) and corporation taxpayers (Chapter I:16) are examined in this *Individuals* book. Corporations, estates, and trusts are further examined in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts.*

# OTHER TYPES OF TAXES

**OBJECTIVE 3**

*Describe the various types of taxes*

## STATE AND LOCAL INCOME AND FRANCHISE TAXES

In addition to federal income taxes, many states and local jurisdictions impose income taxes on individuals and businesses. These state and local taxes have gradually increased over the years and currently represent a significant source of revenue for state and local governments but also represent a significant tax burden on taxpayers.

State and local income taxes vary greatly in both form and rates.[9] Only seven states do not impose an individual income tax.[10] In most instances, state income tax rates are mildly progressive and are based on an individual's federal adjusted gross income (AGI), with minor adjustments.[11] For example, a typical adjustment to a state income tax return is interest income on federal government bonds, which is subject to tax on the federal return but is not subject to state income taxes. Some states also allow a deduction for federal income taxes in the computation of taxable income for state income tax purposes.

**ADDITIONAL COMMENT**

States that do not impose a state income tax depend on other taxes to support the government mission, principally sales taxes.

States imposing a state income tax generally require the withholding of state income taxes and have established mandatory estimated tax payment procedures. The due date for filing state income tax returns generally coincides with the due date for the federal income tax returns (e.g., the fifteenth day of the fourth month following the close of the tax year for individuals).

**ADDITIONAL COMMENT**

State income tax rates for individuals have increased significantly in the past 20 years. More than 23 states now have marginal tax rates of 6% or higher.

Most states impose a corporate income tax, although in some instances the tax is called a **franchise tax**. Franchise taxes usually are based on a weighted-average formula consisting of net worth, income, and sales.

## WEALTH TRANSFER TAXES

U.S. citizens are subject to taxation on certain transfers of property to another person. The tax law provides a unified transfer tax system that imposes a single tax on transfers of property taking place during an individual's lifetime (gifts) and at death (estates). (See the inside back cover of the text for the transfer tax rate schedules.) Formerly, the gift and estate tax laws were separate and distinct. The federal estate tax was initially enacted in 1916. The original gift tax law dates back to 1932. The gift tax was originally imposed to prevent widespread avoidance of the estate tax (e.g., taxpayers could make tax-free gifts of property before their death). Both the gift and estate taxes are wealth transfer taxes levied on the transfer

[9] For a thorough discussion of state and local taxes, see the chapter entitled *Multistate Income Taxation* that accompanies this textbook in electronic form on the Pearson Federal Taxation 2019 Web page at www.prenhall.com/phtax.

[10] These states are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. New Hampshire has an income tax that is levied only on dividend and interest income and Tennessee's income tax applies only to income from stocks and bonds.

[11] See Chapter I:2 for a discussion of the AGI computation.

of property and are based on the fair market value (FMV) of the transferred property on the date of the transfer. TCJA made some significant changes to estate and gift taxes effective January 1, 2018. Those changes will be discussed below. Following are brief descriptions of the gift tax and estate tax.

**KEY POINT**

The $15,000 annual exclusion is an important tax-planning tool for wealthy parents who want to transfer assets to their children and thereby minimize their gift and estate taxes. A husband and wife who have three children could transfer a maximum of $90,000 [($15,000 × 2) × 3] to their children each year without incurring any gift tax.

**The Federal Gift Tax.** The **gift tax** is an excise tax that is imposed on the donor (not the donee) for transfers of property that are considered to be a taxable gift. A gift, generally speaking, is a transfer made gratuitously and with donative intent. However, the gift tax law has expanded the definition to include transfers that are not supported by full and adequate consideration.[12] To arrive at the amount of taxable gifts for the current year, a $15,000 (2018) annual exclusion is allowed per donee.[13] In addition, an unlimited marital deduction is allowed for transfers between spouses.[14] The formula for computing the gift tax is as follows:

| | | | |
|---|---|---|---|
| FMV of all gifts made in the current year | | | $x,xxx |
| Minus: | Annual donee exclusions ($15,000 per donee) | $xx | |
| | Marital deduction for gifts to spouse | xx | |
| | Charitable contribution deduction | xx | (xxx) |
| Plus: | Taxable gifts for all prior years | | xxx |
| Cumulative taxable gifts (tax base) | | | $x,xxx |
| Times: | Unified transfer tax rates | | × .xx |
| Tentative tax on gift tax base | | | $ xxx |
| Minus: | Unified transfer taxes paid in prior years | | (xx) |
| | Unified credit | | (xx) |
| Unified transfer tax (gift tax) due in the current year | | | $ xx |

**ADDITIONAL COMMENT**

The gift tax was enacted to make the estate tax more effective. Without a gift tax, estate taxes could be easily avoided by large gifts made before death.

Note that the gift tax is cumulative over the taxpayer's lifetime (i.e., the tax calculation for the current year includes the taxable gifts made in prior years). The detailed tax rules relating to the gift tax are covered in Chapter C:12 in both *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* and the *Comprehensive* volume. The following general concepts and rules for the federal gift tax are presented as background material for other chapters of this text dealing with individual taxpayers:

- ▶ Gifts between spouses are exempted from the gift tax due to the operation of an unlimited marital deduction.
- ▶ The primary liability for payment of the gift tax is imposed on the **donor**. The donee is contingently liable for payment of the gift tax in the event of nonpayment by the donor.
- ▶ A donor is permitted a $15,000 annual exclusion for gifts of a present interest to each donee.[15]
- ▶ Charitable contributions are effectively exempted from the gift tax because an unlimited deduction is allowed.
- ▶ The tax basis of the property to the donee is generally the donor's cost. It is the lesser of the donor's cost and the property's FMV on the date of the gift if the property is sold by the donee at a loss. (See Chapter I:5 for a discussion of the gift tax basis rules.)
- ▶ A unified tax credit equivalent to an $11,180,000 deduction, adjusted for inflation, is available to offset any gift tax on taxable gifts that exceed the $15,000 annual exclusion.[16] The exclusion amount in 2017 was $5,490,000.

**EXAMPLE I:1-6** ▶ Antonio makes the following gifts in the year 2018:

- ▶ $50,000 cash gift to his wife
- ▶ $20,000 contribution to the United Way

[12] Sec. 2512(b).

[13] Sec. 2503(b). The annual exclusion for gift tax purposes had been $10,000 for many years. However, for 2002–2005, the inflation adjustment increased the exclusion to $11,000, for 2006–2008, the exclusion was increased to $12,000, for 2009–2012 to $13,000, and for 2013–2017 to $14,000. For 2018 and later years, the current exclusion has been increased to $15,000.

[14] Sec. 2523(a).

[15] A gift of a present interest is an interest that is already in existence and the donee is currently entitled to receive the income from the property. A gift of a future interest comes into being at some future date (e.g., property is transferred by gift to a trust in which the donee is not entitled to the income from the property until the donor dies) and is not eligible for the $15,000 annual exclusion.

[16] The applicable exclusion amount had been $1,000,000 since 2002. Beginning in 2011, the exclusion was increased to $5,000,000, adjusted for inflation. Now, effective in 2018, the exclusion has been increased to $11,180,000. For further details, see *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*, 2019 Edition, Chapters C:12 and C:13.

- Gift of a personal automobile valued at $40,000 to his adult son
- Gift of a personal computer valued at $4,000 to a friend

**The $50,000 gift to his wife is not taxed because of a $15,000 annual exclusion and a $35,000 marital deduction. The $20,000 contribution to the United Way is also not taxed because of the unlimited deduction for charitable contributions. The $40,000 gift Antonio made to his son is reduced by the $15,000 annual exclusion, leaving a $25,000 taxable gift.[17] The $4,000 gift to the friend is not taxed because of the annual exclusion of up to $15,000 in gifts to a donee in a tax year. Thus, total taxable gifts for the current year subject to the unified transfer tax are $25,000.** ◀

**STOP & THINK**

*Question:* An important but frequently overlooked aspect of gift taxes is the interaction of gift taxes and income taxes. In many cases, gifts are made *primarily* for income tax purposes. Why would a gift be made for income tax purposes?

*Solution:* Gifts are frequently made to shift income from one family member to another family member who is in a lower marginal tax bracket. For example, assume Fran and Jan are married, have one 25-year-old son, earn $600,000 per year from their business, and generate $100,000 per year in dividends and interest from a substantial portfolio of stocks and bonds. With such a high level of income, Fran and Jan are in the 37% marginal tax bracket. If they make a gift of some of the stocks and bonds to their son, the dividends and interest attributable to the gift are taxed to the son at his marginal tax rate (maybe 10% or 12%). If the son's marginal tax rate is lower than 37%, the family unit reduces its overall income taxes.

**The Federal Estate Tax.** The **federal estate tax** is part of the unified transfer tax system that is based on the total property transfers an individual makes both during his or her lifetime and at death. The basic structure of the estate tax is shown in Example I:1-7.

**TYPICAL MISCONCEPTION**

**It is sometimes thought that the federal estate tax raises significant amounts of revenue, but it has not been a significant revenue producer since World War II. Only 11,917 estate tax returns were filed in 2015 generating approximately $17 billion in tax revenues. This amount represents about 1% of revenues generated by income taxes on individuals.**

**EXAMPLE I:1-7** ▶ **Amy dies during 2018. The formula for computing the estate tax on Amy's estate is as follows:**

| | |
|---|---|
| Gross estate (FMV of all property owned by the decedent at the date of death) | $xxx,xxx |
| Minus: Deductions for funeral and administration expenses, debts of the decedent, charitable contributions, and the marital deduction for property transferred to a spouse | (x,xxx) |
| Taxable estate | $ x,xxx |
| Plus: Taxable gifts made after 1976 | xx |
| Tax base | $ x,xxx |
| Times: Unified transfer tax rate(s) | × .xx |
| Tentative tax on estate tax base | $ xxx |
| Minus: Tax credits (e.g., the unified tax credit equivalent to a $11,180,000 deduction in 2018) | (xx) |
| Gift taxes paid after 1976 | (xx) |
| Unified transfer tax (estate tax) due | $ xx |

◀

The federal estate tax has been on a roller coaster ride the last several years, with many changes and uncertainties. For a complete discussion of these developments, see *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts, 2019 Edition*, Chapter C:13. Since 2013, however, some certainty has been added to the estate tax law. The computation of the taxable estate and tax base (see Example I:1-7 above) is much the same as in prior years. However, the highest tax rate for tax years after 2012 has been increased to 40% from 35%. More importantly, the unified credit exclusion amount has been made permanent at $11.18 million per person and is indexed annually for inflation. For 2018, the unified credit exclusion amount is $11,180,000 ($5,490,000 for 2017). In essence, estates of individuals dying in 2018 generally will not be subject to estate taxes if their tax base is equal to or less

[17] This example assumes that the automobile is a gift rather than an obligation of support under state law and also assumes that Antonio's wife does not join with Antonio in electing to treat the gift to the son as having been made by both spouses (a gift-splitting election). If gift splitting was elected, donee exclusions of $30,000 (2 × $15,000) would be available, resulting in a taxable gift of only $10,000.

than $11,180,000. With this large exemption amount, most estates will not be subject to estate taxes.

The estate tax rules are discussed in more detail in Chapter C:13 of *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* and in the *Comprehensive* volume. The general rules discussed below are provided as background material for subsequent chapters of this text dealing with individual taxpayers:

- The decedent's property is valued at its FMV on the date of death unless the alternative valuation date (six months after the date of death) is elected. The alternative valuation date may be elected only if the aggregate value of the gross estate decreases during the six-month period following the date of death and the election results in a lower estate tax liability.
- The basis of the property received by the estate and by the decedent's heirs is the property's FMV on the date of death (or the alternate valuation date if it is elected).
- Property transferred to the decedent's spouse is exempt from the estate tax because of the estate tax marital deduction provision.
- The unified credit is $4,417,800, based on an exclusion amount of $11,180,000 and is computed as follows: [$345,800 + 0.40 (11,180,000 − 1,000,000)]. See the tax rates for estate and gift taxes on the inside back cover of this textbook.

**EXAMPLE I:1-8** ▶ **Barry died in 2018, leaving a $12,000,000 gross estate. Of the $12,000,000 gross estate, one-half of the estate was transferred to his wife, administrative and funeral expenses are $30,000, Barry had debts of $200,000, and the remainder of the estate was transferred to his children. The estate tax due is computed as follows:**

| | |
|---|---|
| Gross estate | $12,000,000 |
| Minus: Marital deduction | (6,000,000) |
| Funeral and administrative expenses | (30,000) |
| Decedent's debts | (200,000) |
| Taxable estate | $5,770,000 |
| Plus: Taxable gifts made after 1976 | 0 |
| Tax base | $5,770,000 |
| Tentative tax on estate tax base | $2,253,800[a] |
| Minus: Tax credits (unified tax credit—see above or inside back cover for table) | (4,417,800) |
| Unified transfer tax due | $ —0— ◀ |

[a]$345,800 + [0.40 × ($5,770,000 − $1,000,000)]

Because of the generous credit and deduction provisions (e.g., the unified tax credit and the unlimited marital deduction), few estates are required to pay estate taxes. As can be seen above, the gross estate of the decedent was $12 million but no estate taxes were due primarily because of the large marital deduction and the unified credit. However, estate taxes arise, as is demonstrated below in Example I:1-9.

**EXAMPLE I:1-9** ▶ **Assume the same facts for Barry as in Example I:1-8 except that Barry's gross estate is $30,000,000 rather than $12,000,000. The estate tax due is computed as follows:**

| | |
|---|---|
| Gross estate | $30,000,000 |
| Minus: Marital deduction | (15,000,000) |
| Funeral and administrative expenses | (30,000) |
| Decedent's debts | (200,000) |
| Taxable estate | $ 14,770,000 |
| Plus: Taxable gifts made after 1976 | 0 |
| Tax base | $ 14,770,000 |
| Tentative tax on estate tax base | $ 5,853,800[b] |
| Minus: Tax credits (unified tax credit) | (4,417,800) |
| Unified transfer tax due | $ 1,436,000 ◀ |

[b]$345,800 + [0.40 × ($14,770,000 − $1,000,000)]

**ADDITIONAL COMMENT**

Property taxes are a type of ad valorem tax, from the Latin phrase "according to value."

## OTHER TYPES OF TAXES

Although this text focuses primarily on the federal income tax, some mention should be made of the following other types of taxes levied by federal, state, and local governments.

- **Property taxes** are based on the value of a taxpayer's property, which may include both real estate and personal property. Real estate taxes are a major source of revenue for local governments. In addition, some state and local governments levy a personal property tax on intangibles such as securities and tangible personal property (e.g., the value of a personal automobile).
- **Federal excise taxes** and **customs duties** on imported goods have declined in relative importance over the years but remain significant sources of revenue. Federal excise taxes are imposed on alcohol, tobacco, gasoline, telephone usage, production of oil and gas, and many other types of goods. Many state and local governments impose similar excise taxes on goods and services.

**ADDITIONAL COMMENT**

Proposals to decrease reliance on the federal income tax have focused primarily on consumption taxes, such as a national sales tax or a value-added tax. A value-added tax basically is a sales tax levied at each stage of production on the "value added."

- **Sales taxes** are a major source of revenue for state and local governments. Sales taxes are imposed on retail sales of tangible personal property (e.g., clothing and automobiles). Some states also impose a sales tax on personal services (e.g., accounting and legal fees). Certain items often are exempt from the sales tax levy (e.g., food items or medicines), and the rates vary widely between individual state and local governments. Sales taxes generally are not deductible for federal income tax purposes. However, they are deductible if incurred in a trade or business. In addition, state and local sales taxes are deductible as an itemized deduction if the taxpayer elects to deduct them instead of deducting state and local income taxes.
- Employment taxes include Social Security (**FICA**) and federal and state unemployment compensation taxes. If an individual is classified as an employee, the FICA tax that is imposed on the employee is comprised of two parts: the old-age survivors, and disability insurance (OASDI) and the Medicare or hospital insurance (HI). The OASDI is 6.2% and is imposed on the first $128,400 (2018) of wages. This tax is imposed on both the employer and the employee at the same rate. Similarly, the HI portion is imposed on both the employer and the employee, but it has no ceiling on wages like the OASDI portion. In fact, the HI portion is generally 1.45% of wages, but beginning in 2013, the employee is required to pay an additional 0.9% on wages above $200,000 ($250,000 for married taxpayers filing a joint return). So while the employer will pay 1.45% on all wages, an employee who is single will pay 1.45% on the first $200,000 of wages and 2.35% on any wages over $200,000.

  If an individual is self-employed, a self-employment tax comprised of the OASDI and HI taxes is imposed. The OASDI portion is 12.4% on the individual's self-employment income of up to $128,400 (in 2018). The HI portion is 2.9% on the first $200,000 of self-employment income ($250,000 combined self-employment income for married taxpayers filing a joint return) and 3.8% (2.9% + 0.9%) on any self-employment income over that amount.

**ADDITIONAL COMMENT**

Revenue from employment taxes are indeed significant. In 2016, $1.115 trillion in employment taxes were collected, representing 34% of all Internal Revenue Service collections.

- Employers are required to pay federal and state unemployment taxes to fund the payment of unemployment benefits to former employees. The federal rate is 6.0% on the first $7,000 of wages for each employee in 2018.[19] However, a credit is granted for up to 5.4% of wages for taxes paid to the state government so that the actual amount paid to the federal government may be as low as 0.6%.[20] The amount of tax paid to the state depends on the employer's prior experience with respect to the frequency and amount of unemployment claims. In California, for example, the highest rate of unemployment tax imposed is 6.2% and this rate is subsequently adjusted down if the employer has a small number of unemployment claims to a minimum of 1.5%.

The types of taxes and structural considerations that were previously discussed are summarized in Topic Review I:1-1.

[18] Self-employed individuals receive an income tax deduction equal to 50% of taxes paid on their self-employment income and this deduction is also allowed to compute the amount of self-employment income (see Secs. 164(f) and 1402(a)(12) and Chapter I:14).

[19] Sec. 3301.

[20] Sec. 3302. State unemployment taxes in some states are levied on tax bases above $7,000. For example, the wage base ceiling in North Carolina is $23,100 in 2018.

**TOPIC REVIEW I:1-1**

### Types of Taxes and Tax Structure

| Type of Tax | Tax Structure | Tax Base |
|---|---|---|
| **Individuals:** | | |
| Federal income tax | Progressive | Gross income from all sources unless specifically excluded by law reduced by deductions and exemptions |
| State income tax | Progressive | Generally based on AGI for federal income tax purposes with adjustments |
| Federal gift tax | Progressive | FMV of all taxable gifts made during the tax year |
| Federal estate tax | Progressive | FMV of property owned at death plus taxable gifts made after 1976 |
| **Corporations:** | | |
| Federal corporate income tax | Progressive | Gross income from all sources unless specifically excluded by law reduced by deductions |
| State corporate income tax | Proportional or progressive | Federal corporate taxable income with adjustments |
| State franchise tax | Proportional | Usually based on a weighted-average formula consisting of net worth, income, and sales |
| **Other Types of Taxes:** | | |
| Property taxes | Proportional | FMV of personal or real property |
| Excise taxes | Proportional | Customs and duties on imported and domestic goods from alcohol to telephone usage |
| Sales taxes | Proportional | Retail sales of tangible personal property or personal services |
| FICA and self-employment taxes | Regressive | Based on wages or self-employment income |
| Unemployment taxes | Regressive | Usually first $7,000 of an employee's wages |

# Criteria for a tax structure

**OBJECTIVE 4**

*Discuss the criteria for a "good" tax structure, the objectives of the federal income tax law, and recent tax reform proposals*

Establishing criteria for a "good" tax structure was first attempted in 1776 by economist Adam Smith.[21] Smith's four "canons of taxation"—equity, certainty, convenience, and economy—are still used today when tax policy issues are discussed. Many have added a fifth canon of simplicity. Below is a discussion of these criteria and how they relate to income taxes as well as other taxes.

## EQUITY

A rather obvious criteria for a good tax is that the tax be equitable or fair to taxpayers. However, equity or fairness is elusive because of the subjectivity of the concept. What one person may conclude is fair in a particular situation may be considered totally unfair by another person. In other words, fairness is relative in nature and is extremely difficult to measure. For example, the deductibility of mortgage interest on a taxpayer's home certainly seems to be a fair provision for taxpayers. However, for taxpayers who do not own a home but live in a rental apartment, the deductibility of mortgage interest may not be considered as fair because the renter cannot deduct any portion of the rent paid. In other types of situations, the federal tax law includes various measures to ensure that taxpayers are treated fairly. For example, a foreign tax credit is available to minimize the double taxation that would otherwise occur when U.S. taxpayers earn income in a foreign country that is taxed by

[21] Adam Smith, *The Wealth of Nations* (New York: Random House, Modern Library, 1937), pp. 777–779.

**KEY POINT**

Using retroactive dates for changes in the tax law does not help to accomplish the objective of certainty. For example, the effective date of major changes in the estate tax was recently made on a retroactive basis. These retroactive changes created considerable uncertainty for taxpayers and their advisors.

both the United States and the country in which it is earned. (See the glossary at the end of this volume for a definition of tax credits and Chapter I:14 for a discussion of the foreign tax credit.) Two aspects of equity are commonly discussed in the tax policy literature, **horizontal equity** and **vertical equity**. Horizontal equity refers to the notion that similarly situated taxpayers should be treated equally. Thus, two taxpayers who each have income of $50,000 should both pay the same amount of tax. Vertical equity, on the other hand, implies that taxpayers who are not similarly situated should be treated differently. Thus, if Taxpayer A has income of $100,000 and Taxpayer B has income of $20,000, Taxpayers A and B should not pay the same amount of income tax. Vertical equity provides that the incidence of taxation should be borne by those who have the **ability to pay** the tax, based on income or wealth. The progressive rate structure is founded on the vertical equity premise.

## CERTAINTY

A certain tax (1) ensures a stable source of government operating revenues and (2) provides taxpayers with some degree of certainty concerning the amount of their annual tax liability. A tax that is simple to understand and administer provides certainty for taxpayers. For many years, our income tax laws have been criticized as being overly complex and difficult to administer. Consider the remarks of a noted tax authority at a conference on federal income tax simplification:

> Tax advisers—at least some tax advisers—are saying that the income tax system is not working. They are saying that they don't know what the law provides, that the IRS does not know what the law provides, that taxpayers are not abiding by the law they don't know.[22]

While the above statement is over 30 years old, it certainly is still viable today. This uncertainty in the tax law causes frequent disputes between taxpayers and the IRS and has resulted in extensive litigation.

**ADDITIONAL COMMENT**

Humorist Jim Boren has proposed a constitutional amendment that would require any retroactive tax increases to be followed by retroactive elections for president, vice president, and all members of Congress.

The federal tax system has made some attempts to provide certainty for taxpayers. For example, the IRS issues advance rulings to taxpayers, which provides some assurance concerning the tax consequences of a proposed transaction for the taxpayer who requests the ruling. The taxpayer may rely on the ruling if the transaction is completed in accordance with the terms of the ruling request. For example, if a merger of two corporations is being considered, the transaction can be structured so that the shareholders and the corporations do not recognize gain or loss. If a favorable ruling is received and the transaction is completed as planned, the IRS cannot later assert that the merger does not qualify for tax-free treatment.

## CONVENIENCE

A tax law should be easily assessed, collected, and administered. Taxpayers should not be overly burdened with the maintenance of records and compliance considerations (preparation of their tax returns, payment of their taxes, and so on). The income tax in the United States does not fare well in this category, as the annual preparation of income tax returns as well as accumulation of underlying records is a formidable task. One of the reasons that the sales tax is such a popular form of tax for state and local governments is that it is convenient for taxpayers to pay and for the government to collect. The consumer need not complete a tax return or keep detailed records.

**ADDITIONAL COMMENT**

For tax year 2014, approximately 82 million tax returns were prepared by paid tax-return preparers. This represents approximately 55% of all tax returns filed.

## ECONOMY

An economical tax structure should require only minimal compliance and administrative costs. The IRS collection costs, amounting to less than 0.5% of revenues, are minimal relative to the total collections of revenues from the federal income tax. Estimates of taxpayer compliance costs are less certain. One indicator of total compliance costs for taxpayers is the demand for tax professionals. Tax practice has been and continues to be one of the fastest growing areas in public accounting firms. Most large corporations also maintain sizable tax departments that engage in tax research, compliance, and planning activities. In addition, many commercial tax return preparer services are available to assist taxpayers who have relatively uncomplicated tax returns.

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[22] Sidney L. Roberts, "The Viewpoint of the Tax Adviser: An Overview of Simplification," *Tax Adviser,* January 1979, p. 32.