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Federal Taxation 2020

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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 and the subsequent guidance affecting individual taxpayers
- Complete updating of significant court cases and IRS rulings and procedures during 2018 and early 2019
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2019
- Whenever new updates become available, they will be accessible via MyLab Accounting
- Focus on critical thinking skills with additional Tax Strategy and Critical Thinking Problems
- Updating of the end-of-chapter tax return problems to 2018 (2018 tax forms are included because the 2019 tax forms were not available when this edition went to print)
- Addition of shorter tax form problems, focusing on single forms or schedules

CORPORATIONS

- Complete updating of the chapter material for the provisions in the Tax Cuts and Jobs Act of 2017 and the subsequent guidance affecting corporations and other entities
- The comprehensive corporate tax return, Problem C:3-66, has all new numbers for the 2018 forms
- The comprehensive partnership tax return, Problem C:9-58, has all new numbers for the 2018 forms
- The comprehensive S corporation tax return, Problem C:11-62, has all new numbers for the 2018 forms
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2019
- Whenever new updates become available, they will be accessible via MyLab Accounting
- Focus on critical thinking skills with additional Tax Strategy and Critical Thinking Problems
- Addition of shorter tax form problems, focusing on single forms or schedules

SOLVING TEACHING AND LEARNING CHALLENGES

The Rupert/Anderson/Hulse 2020 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 2020: Individuals
- Federal Taxation 2020: Corporations, Partnerships, Estates & Trusts (the companion book to Individuals)
- Federal Taxation 2020: 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:3-66 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/Hulse 2020 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:

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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.

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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/Hulse 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.

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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.

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

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These comments provide supplemental information pertaining to the adjacent text.

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Instructor's Solutions Manual authored by Kenneth Anderson from University of Tennessee, David Hulse from University of Kentucky, and Timothy Rupert from Northeastern University	• Solutions to discussion questions • Solutions to problems • Solutions to comprehensive and tax strategy problems
Test Bank 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. • Type (Multiple-choice, true/false, short-answer, essay) • Page references to where content is found in the text
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Please send any comments to Kenneth E. Anderson, David S. Hulse, 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 2017, 150 million individual income tax returns were filed, and collections from individuals totaled $1.45 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 2019 and (2) the gradual decrease in corporate income taxes for the same period. Individual income taxes have remained fairly stable during the past 60 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 7% of total federal revenues in 2019.

▼ TABLE I:1-1
Breakdown of Federal Revenues

	1960	1975	2000	2019
Individual income taxes	44%	45%	50%	50%
Social insurance taxes and contribution	16	32	32	36
Corporation income taxes	23	15	10	7
Other	17	8	8	7
Total	100%	100%	100%	100%

Source: Council of Economic Advisers, *Economic Indicators* (Washington, DC: U.S. Government Printing Office, 1967, 1977, 2018).

[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 2019, 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 2019. Her federal income taxes for the year are $3,406, computed as follows: the first $9,700 of taxable income is taxed at 10% and the remaining $20,300 at 12%. (For tax rates, see the Quick Reference section of the text.)

Allen, who also is single, has taxable income of $60,000. A 10% rate applies to the first $9,700 of taxable income, 12% on the next $29,775, and a 22% rate applies to the taxable income over $39,475. Thus, Allen's total tax is $9,059 [(0.10 × $9,700) + (0.12 × $29,775) + (0.22 × $20,525)].

If Allen's taxable income is $120,000, a 24% rate applies to $35,800 of his taxable income ($120,000 − $84,200) because the 24% rate applies to taxable income above $84,200 for a single individual and his total tax for the year is $22,975. 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., $3,406 to $9,059 to $22,975). 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, $35,900 ($240,000 − $204,100) is subject to the 35% rate. Alternatively, if Allen has taxable income of $600,000, $89,700 ($600,000 − $510,300) 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 30 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 lower taxes for higher income taxpayers and slightly higher taxes for other taxpayers.[4] ◀

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[3] See the Quick Reference section of the text for the 2019 tax rates and Chapter I:2 for a discussion of the computation procedures. 2018 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 $132,900 for 2019. 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 $8,240 ($132,900 × 0.062). Taxpayer A's average rate of OASDI tax is 6.2% while Taxpayer B's average rate of tax is 2.06% ($8,240/$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 2019. Tania's taxable income would be reduced from $185,000 to $165,000 if she purchases the residence. Because a 32% tax rate applies to her taxable income from $165,000 to $185,000, 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 2019 would incur a total tax liability of $168,488. The taxpayer's marginal tax rate is 37%, but his average tax rate is 30.6% ($168,488/$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 2019. 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 $20,575. Her average tax rate is 18.70% ($20,575 ÷ $110,000). Amelia's effective tax rate is 11.76% ($20,575 ÷ $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 2019 rates), but an average tax rate of 22.17%, computed as follows:

Taxable income		$190,000
Tax on first $160,725 of taxable income		$32,749
Remaining taxable income	$29,275	
Times: Marginal tax rate	× 0.32	9,368
Total tax liability		$ 42,117

$$\text{Average tax rate} = \frac{\text{Total tax}}{\text{Taxable income}} = \frac{\$\,42{,}117}{\$190{,}000} = 22.17\%$$

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. The CBO uses the tax liability divided by comprehensive household income in computing effective tax rates.

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 for a particular state usually are based on a weighted-average formula consisting of net worth, income, and sales times modified federal taxable income.

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 Quick Reference section 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 2020 Web page at www.pearsonhighered.com/pearsontax.

[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. 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 (2019) 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 $11,400,000 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 2018 was $11,180,000.

EXAMPLE I:1-6 ▶ Antonio makes the following gifts in the year 2019:

- $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 2019, the exclusion has been increased to $11,400,000. For further details, see *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*, 2020 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 2019. 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 $11,400,000 deduction in 2019)	(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, 2020 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 million per person and is indexed annually for inflation. For 2019, the unified credit exclusion amount is $11,400,000 ($11,180,000 for 2018). In essence, estates of individuals dying in 2019 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 $11,400,000. 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 $4,505,800, based on an exclusion amount of $11,400,000 and is computed as follows: [$345,800 + 0.40 (11,400,000 − 1,000,000)]. See the tax rates for estate and gift taxes in the Quick Reference section of the text.

EXAMPLE I:1-8 ▶ **Barry died in 2019, 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 Quick Reference for table)	(4,505,800)
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)	(4,505,800)
Unified transfer tax due		$ 1,348,000 ◀

[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 $132,900 (2019) 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 $132,900 (in 2019). 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 2019.[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 $23,500 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 40 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.

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

Complying with the tax laws is enormously expensive for both businesses and individuals in the United States. Americans will spend more than 8.9 billion hours complying with IRS tax filing requirements in 2016, and tax compliance will cost approximately \$409 billion.[23] Compliance with state and local taxes costs billions more. Clearly, the cost of complying with the nation's tax laws is significant, in terms of both money and time. With some simplification for low and middle income taxpayers in the TCJA of 2017, compliance costs may decrease slightly for tax years after 2017.

A more difficult question is whether the tax structure is economical in terms of taxpayer compliance. The issues of tax avoidance and tax evasion are becoming increasingly more important. The IRS estimates the gross tax gap to be \$458 billion, which is just over 18% of total taxes owed.[24] The tax gap is defined as the difference between the reported tax liability and the true tax liability.

SIMPLICITY

One of the important measures of any tax system is that of simplicity, or at least, not undue complexity. Taxpayers should be able to understand and comply with any tax system within reasonable boundaries. The sales tax is an example of a tax system that is relatively simple, although the sales tax as it applies to businesses can become fairly complex. The federal income tax system in the United States has become inordinately complex over the years and complexity is one of the major criticisms of the income tax. The following is a quote from the report from the President's Advisory Panel on Federal Tax Reform:[25]

> In short, our current tax code is a complicated mess. Instead of clarity, we have opacity. Instead of simplicity, we have complexity. Instead of fair principles, we have seemingly arbitrary rules. Instead of contributing to economic growth, it detracts from growth. Time and time again, witnesses told the Panel about these failings in the tax code.

While simplicity is an admirable goal of any tax system, achieving this goal in the federal income tax system is difficult and involves the trade-off of other important objectives. For example, simplicity and fairness are almost impossible to achieve together. If the income tax law is extremely simple, like a flat tax rate on all income, the possible result is that many taxpayers will not be treated fairly. Consider this case, two taxpayers, A and B both earn \$100,000 per year and we have a flat rate tax of 20% so that each taxpayer will pay \$20,000 in income taxes for the year. However, assume that taxpayer B has a severe illness that requires him to pay medical expenses of \$60,000 per year. Should both A and B pay the same income tax for the year? There is no absolute correct answer in this case, it depends on your definition of fairness. Thus, making the income tax law simple may not be the top priority in tax reform.

OBJECTIVES OF THE FEDERAL INCOME TAX LAW

The primary objective of the federal income tax law is to raise revenues for government operations. In recent years, the federal government has broadened its use of the tax laws to accomplish various economic and social policy objectives.

ADDITIONAL COMMENT

Among the provisions in the tax law that are designed to enhance the level of health care are the deductibility of medical expenses, deductibility of charitable contributions to hospitals, and exclusion of fringe benefits provided by employers for medical insurance premiums and medical care.

Economic Objectives. The federal income tax law is used as a fiscal policy tool to stimulate private investment, reduce unemployment, and mitigate the effects of inflation on the economy. Consider the following example: Tax credits for businesses operating in distressed urban and rural areas (empowerment zones) are allowed to provide economic revitalization of such areas. This is a clear example of using the federal income tax law to stimulate private investment in specific areas.

[23] Scott A. Hodge, "The Compliance Costs of IRS Regulations," Fiscal Fact No. 512, *Tax Foundation*, June 15, 2016.

[24] Internal Revenue Service Research, Analysis and Statistics, 2016, "Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2008-2010," Publication 1415 (Rev 5-2016), Internal Revenue Service, May.

[25] Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System*, November 2005, p. 2. See the discussion of tax reform in this chapter.

Many items in the tax law are adjusted for inflation by using the consumer price index, including the tax brackets and standard deduction amounts. These inflation adjustments provide relief for individual taxpayers who would otherwise be subject to increased taxes due to the effects of inflation. (See Chapter I:2 for a discussion of the tax computation for individuals.)

Encouragement of Certain Activities and Industries. The federal income tax law also attempts to stimulate and encourage certain activities, specialized industries, and small businesses. One such example is the encouragement of research activities by permitting an immediate write-off of expenses and a special tax credit for increasing research and experimental costs. Special incentives are also provided to the oil and gas industry through percentage depletion allowances and an election to deduct intangible drilling costs.

Certain favorable tax provisions are provided for small businesses, including reduced corporate tax rates of 21%. Favorable ordinary loss (instead of capital loss) deductions are granted to individual investors who sell their small business corporation stock at a loss, provided that certain requirements are met.[26] In addition, noncorporate investors may exclude up to 50% of the gain realized from the disposition of qualified small business stock if the stock is held for more than five years.[27]

ADDITIONAL COMMENT

Deductible contributions made by self-employed individuals to their retirement plans (Keogh plans) totaled $24.7 billion in 2016. Charitable deductions totaled over $234 billion that same year.

Social Objectives. The tax law attempts to encourage or discourage certain socially desirable or undersirable activities. For example:

- Special tax-favored pension and profit-sharing plans have been created for employees and self-employed individuals to supplement the social security retirement system.
- Charitable contributions are deductible to encourage individuals to contribute to charitable organizations.
- The claiming of a deduction for illegal bribes, fines, and penalties has been prohibited to discourage activities that are contrary to public policy.

EXAMPLE I:1-10 ▶ Able Corporation establishes a qualified pension plan for its employees whereby it makes all of the annual contributions to the plan. Able's contributions to the pension trust are currently deductible and not includible in the employees' gross income until the pension payments are distributed during their retirement years. Earnings on the contributed funds also are nontaxable until such amounts are distributed to the employees. ◀

EXAMPLE I:1-11 ▶ Anita contributes $10,000 annually to her church, which is a qualified charitable organization. Anita's marginal tax rate is 24%. Her after-tax cost of contributing to the church is only $7,600 [$10,000 − (0.24 × $10,000)]. ◀

EXAMPLE I:1-12 ▶ Ace Trucking Company incurs $10,000 in fines imposed by local and state governments for overloading its trucks during the current tax year. The fines are not deductible because the activity is contrary to public policy. ◀

The tax law objectives previously discussed are highlighted in Topic Review I:1-2.

Income Tax Reform. On December 22, 2017, President Donald J. Trump signed the TCJA into law. While controversial in nature and supported entirely by the Republicans in Congress, the TCJA is the law of the land. The new law focuses primarily on business taxation, with most of the tax cuts going to corporations.

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[26] Sec. 1244.

[27] Sec. 1202.

TOPIC REVIEW I:1-2

Objectives of the Tax Law

OBJECTIVE	EXAMPLE
Stimulate investment	Provide a tax credit for the purchase of business equipment
Prevent taxpayers from paying a higher percentage of their income in personal income taxes due to inflation (bracket creep)	Index the tax rates and standard deduction for inflation
Encourage research activities that will in turn strengthen the competitiveness of U.S. companies	Allow research expenditures to be written off in the year incurred and offer a tax credit for increasing research and experimental costs
Encourage social objectives	Provide a tax deduction for charitable contributions; provide favorable tax treatment for contributions to qualified pension plans

However, individual taxpayers also have lower tax rates at every level, although relatively small. As mentioned earlier, supporters of the TCJA hope the new law will stimulate the economy and create jobs in a substantive way. Details of the TCJA are provided throughout the book where appropriate.

ENTITIES IN THE FEDERAL INCOME TAX SYSTEM

OBJECTIVE 5

Describe the tax entities in the federal income tax system

The federal income tax law levies taxes on taxpayers. However, not all entities that file income tax returns pay income taxes. For example, a partnership is required to file a tax return but does not pay any income tax because the income (or loss) of the partnership is allocated to the partners who report the income or loss on their individual tax returns. Therefore, the various entities in the federal income tax system may be classified into two general categories, *taxpaying entities* and *flow-through entities*. [28] Taxpaying entities generally are required to pay income taxes on their taxable income. Flow-through entities, on the other hand, generally do not directly pay income taxes but merely pass the income on to a taxpaying entity. The major entities in each category are as follows:

Taxpaying Entities	*Flow-through Entities*
Individuals	Sole proprietorship
C corporations (regular corporations)	Partnerships
	S corporations
	Limited Liability Company (LLC) or Limited Liability Partnership (LLP)
	Trusts

[28] Some entities have characteristics of both categories of entities, including certain types of trusts and S corporations.

Each of these entities is discussed below. The purpose of this section is to provide an overall picture of the various entities in the federal income tax system.

TAXPAYING ENTITIES

Individuals. Individual taxpayers are the principal taxpaying entities in the federal income tax system. In 2019, income taxes paid by individual taxpayers are expected to comprise nearly 50% of total federal revenues. If Social Security taxes are included, individual taxpayers will pay approximately 86% of total federal revenues (see Table I:1-1 for details). Thus, the study of taxation of individuals is a very important topic and is discussed extensively in this *Individuals* textbook.

Individuals pay income taxes on all gross income minus allowable deductions. Gross income minus allowable deductions is referred to as *taxable income*. Gross income subject to taxation may be broadly classified into three categories:

- Earned income from sources such as salaries and wages, business income, and retirement income.
- Investment income, including interest income, dividends, capital gains, and rents and royalties.
- Flow-through income from partnerships, limited liability companies (LLCs), Subchapter S corporations, estates, and trusts.

Allowable deductions include expenses attributable to the gross income above and certain personal deductions specifically allowed under the tax law. Gross income and allowable deductions are discussed in detail later in this textbook.

The TCJA 2017 made significant changes to the computation of taxable income for individual taxpayers for taxable years beginning after December 31, 2017. Individual taxpayers use the tax formula below to compute their taxable income in 2019:

Total income, from whatever source derived	$xxx
Minus: Exclusions, as provided in the tax law	(xxx)
Gross income	xxx
Minus: Deductions for adjusted gross income	(xxx)
Adjusted gross income (AGI)	xxx
Minus: Deductions from AGI:	
Greater of itemized deductions or standard deduction	(xxx)
Qualified Business Income Deduction	(xxx)
Taxable income	$xxx

Exclusions are items of income that the tax law specifically exempts from taxation. They include such items as gifts, inheritances, interest income from state and local bonds, loans, and life insurance proceeds. Exclusions are discussed in Chapter I:4.

Once an individual determines that an expenditure is allowed as a deduction for tax purposes, he or she must classify the deduction as *for* AGI or *from* AGI. This classification is very important and is discussed in Chapter I:6. Deductions *for* AGI basically are (1) expenses connected with a taxpayer's business or rental property, or (2) other specified deductions, such as contributions to an Individual Retirement Account (IRA) and a number of other specific items. Deductions *from* AGI are either itemized deductions or the standard deduction, whichever is greater. Itemized deductions primarily are personal-type deductions of the taxpayer, such as medical expenses, state and local taxes, mortgage interest, and charitable contributions. Itemized deductions are discussed in Chapter I:8. The standard deduction is a set amount that all taxpayers may deduct. For 2019, the standard deduction is $12,200 ($24,400 for married couples filing a joint return) and is indexed annually for inflation. Thus, if a single taxpayer's itemized deductions for 2019 were $10,000, the taxpayer would deduct the standard deduction of $12,200 instead. On the other hand, if the taxpayer's itemized deductions were $14,000, the taxpayer would deduct $14,000 because that amount exceeds the standard deduction.

Personal and dependency exemptions were allowed prior to 2018. However, the TCJA eliminated these as deductions for individual taxpayers.

Once taxable income is determined, tax rates are applied to this amount to arrive at the income tax liability for the year. Certain credits are allowed that reduce the income tax liability on a dollar-for-dollar basis. Individual income tax rates may be found in the Quick Reference section of the text. Because individuals are subject to withholding and estimated tax payment rules, they may pay a balance due or receive a refund upon filing their tax return.

Individual taxpayers are required to file a tax return annually, Form 1040, which is due on or before April 15 of the year following the taxable year. As can be seen from the tax rate schedules located in the Quick Reference section of the text, rates range from 10% to 37%.

EXAMPLE I:1-13 ▶ Jeff Payne, a single taxpayer, is employed by a large corporation and has the following information for the current year of 2019:

INCOME AND OTHER RECEIPTS	
Salary from corporation	$120,000
Interest income from savings account	13,000
Interest on New York City bond	600
Loan from bank	20,000
Share of income from a partnership in which Jeff is a partner	8,600
Gift from Jeff's grandmother	11,000
Total	$173,200
DEDUCTIONS AND PAYMENTS	
Itemized deductions	17,000
Federal income taxes withheld from salary	25,000

Jeff's taxable income and income tax liability for 2019 would be computed as follows:

Total income		$173,200
Minus: Exclusions:		
Interest on New York City bond	$ 600	
Loan from bank	20,000	
Gift from Jeff's grandmother	$11,000	(31,600)
Gross income		141,600
Minus: Deductions for AGI		0
Adjusted gross income (AGI)		141,600
Minus: Deductions from AGI:		
Itemized deductions		(17,000)
Taxable income		$124,600

The itemized deductions of $17,000 exceed Jeff's allowable standard deduction for 2019 of $12,200 and, therefore, are used to reduce taxable income.

To compute Jeff's income tax liability for the year, the 2019 rate schedules in the Quick Reference section of the text are used. Jeff's income tax liability (using single taxpayer rates) would be $24,079 [$14,383 + 0.24($124,600 − $84,200)]. Since Jeff had $25,000 of federal income taxes withheld from his salary, he would be entitled to a tax refund of $921 ($25,000 − $24,079). ◀

Some types of income are taxed at lower rates. For example, dividends from most U.S. corporations are subject to a maximum rate of 20%. This 20% maximum rate also applies to long-term capital gains, such as gains on the sale of stocks and bonds. With these lower rates, a high-income taxpayer in the 37% marginal tax bracket would only pay a maximum of 20% on any qualified dividends received or long-term capital gains. The remainder of the taxpayer's income would be subject to the higher rates. Taxpayers whose tax rates are below the 37% top rate generally are subject to a maximum tax rate of 15% on qualified dividends and long-term capital gain.

C Corporations. C corporations, many times referred to as regular corporations, also are taxpaying entities. These corporations, both publicly-held corporations traded on stock exchanges and privately-owned corporations, accounted for approximately 7% of total federal revenues in 2019. The percentage of federal revenues provided by C corporations has been steadily declining over the past 40 years, a concern of tax policymakers as more and more taxes are being shifted to individual taxpayers. A major disadvantage of C corporations is they are subject to so-called double taxation. Double taxation results from the corporation paying income tax on its taxable income and shareholders paying income tax on any dividends received from the corporation or on the gain from selling their stock in the corporation. Thus, the same corporate income is subjected to taxation twice—once at the corporate level and again at the shareholder level. For many years, much tax planning has been directed at trying to so arrange the tax affairs of a C corporation to avoid double taxation. This discussion of C corporations is divided into two parts, (1) taxation of C corporations and (2) the operation of double taxation.

Taxation of C Corporations. C corporations are taxed on their taxable income in a manner similar to individuals. The major difference between corporations and individuals is that corporations are not allowed personal deductions. Thus, the concept of AGI does not pertain to corporations. Taxable income for corporations is computed as follows:

Total income, from whatever source derived	$xxx
Minus: Exclusions, as provided in the tax law	(xxx)
Gross income	xxx
Minus: Deductions (ordinary and necessary expenses related to the corporation's trade or business)	(xxx)
Taxable income	$xxx

This taxable income is subject to a flat tax rate of 21%. A more detailed discussion of corporation taxation is contained in Chapter I:16 of this *Individuals* textbook and Chapter C:3 of the *Corporations, Partnerships, Estates, and Trusts* volume.

EXAMPLE I:1-14 ▶ During the current taxable year, Crimson Corporation generated gross income of $1,500,000 and had ordinary and necessary deductions of $900,000, resulting in taxable income of $600,000. Based on the corporation rates, Crimson would be subject to taxes of $126,000 ($600,000 × 21%). ◀

C corporations are required to file tax returns annually using Form 1120, which is generally due on or after the 15th day of the fourth month after the close of the corporation's tax year (e.g., April 15 for calendar year taxpayers).

ADDITIONAL COMMENT

It should be noted that individual taxpayers may also be subject to an additional 3.8% Medicare tax on the dividends as part of a net investment income tax.

Double Taxation of C Corporation Earnings. As mentioned previously, C corporations are subject to double taxation. The corporation pays income tax on its taxable income and then shareholders must pay income tax on any dividends paid by the corporation or on the sale of their stock. Under current tax laws, the impact of double taxation has been substantially decreased by reducing to zero, 15% or 20% the maximum tax rate on most corporate dividends received by individuals. Prior to this reduction in tax rates on qualified dividends, dividends were subject to tax at regular tax rates. Single taxpayers who have taxable income of less than $39,375 have a 0% tax rate on qualified dividends. Single taxpayers who have taxable income of more than $39,375 but less than $434,550 pay a marginal tax rate of 15% on qualified dividends while taxpayers who have taxable income of greater than $434,550 pay a marginal tax rate of 20% on qualified dividends. Thus, under current tax law, a single taxpayer with taxable income of $400,000 has a marginal tax rate of 35% on ordinary income but pays only a 15% tax rate on any dividends received. The same reduced tax rates apply to long-term capital gains on the sale of their corporate stock. The Quick Reference section of the text has the income level cutoffs for the other filing statuses.

EXAMPLE I:1-15 ▶ Using the same facts for Crimson Corporation in Example I:1-14, assume the corporation paid dividends to shareholders during 2019 of $400,000. Further assume that the taxable income of the shareholders is such that they pay a tax rate of 15% on qualified dividends. The shareholders collectively would have to pay individual income taxes of $60,000 ($400,000 × 15%) as the tax rate on qualified dividends is 15%. The total tax on the corporation's taxable income of $600,000, therefore, would be $186,000 ($126,000 paid by Crimson Corporation plus $60,000 paid by the shareholders), or an effective tax rate of 31% ($186,000/$600,000). The 31% is only federal income taxes and does not include any state or local income taxes that the corporation may have to pay. ◀

The double taxation of dividends paid by C corporations has long been criticized as creating income taxes that are too high. Before 2018, corporations were subject to income taxes as high as 35%, and then individuals would typically be taxed on dividends received at rates of 15% to 20%. This so-called "double taxation" could create total taxes of 55% (35% + 20%) on the same income. However, with the corporate rate reduced to 21% in 2018 under the TCJA, the combined taxes are not nearly as onerous as in prior years.

FLOW-THROUGH ENTITIES

The simplest form of a flow-through entity is the sole proprietorship as there are no formal requirements to form such an entity. The net income earned by the proprietor is reported on Schedule C of Form 1040. Thus, the income of the sole proprietorship merely flows to the proprietor's individual tax return. The net income of the sole proprietorship is subject to income tax only once (at the individual level) but is also subject to self-employment tax (Social Security and Medicare taxes).

Flow-through entities, such as partnerships, limited liability companies (LLCs), limited liability partnerships (LLPs), and S corporations have the major advantage of being subject to only one level of taxation. All of these entities file tax returns, but, in general, the entities do not pay any income taxes. The income earned by the entity is allocated to the owners based on their proportionate ownership or some other allocation arrangement. Thus, the entity income tax return is really just an information return. The income allocated to the owners is then reported on their own tax returns. The income of the entity, therefore, is subject to a single level of taxation. This single level of tax is a major advantage of the flow-through form over C corporations.

As a result of the TCJA, to better equalize the tax breaks given to C corporations (i.e., 21% tax rate), most flow-through entities may deduct 20% of qualified business income (QBI). Qualified Business Income is net income from business activities and does not include investment income (interest, dividends, etc.).

EXAMPLE I:1-16 ▶ Assume AB Partnership is in the wholesale hardware business and A and B are 50-50 partners. During 2019, the AB Partnership had gross business receipts of $1,000,000 and business deductions of $400,000, resulting in net income of $600,000. The partnership also had interest and dividend income of $50,000. Based on the above information, AB partnership would have qualified business income (QBI) of $600,000 as the $50,000 of interest and dividends is not part of QBI. Therefore, each partner would be entitled to a 20% deduction of their share of QBI, or $60,000 ($600,000 × 50% × 20%). There are several limitations on the 20% deduction, primarily a limitation based on W-2 wages, and the deduction is not allowed for personal service activities, such as lawyers, accountants, etc. The deduction and limitations are discussed in other areas of this textbook. ◀

To ensure a single level of taxation for flow-through entities, the tax law employs a unique method of basis adjustments. Every owner of the entity has an *adjusted basis* (basis) in his or her ownership interest. An owner's basis in a flow-through entity is determined as follows:

- Each owner obtains an original basis in his or her ownership interest upon the formation of the entity (investment in the entity) or purchase of the interest.
- The owner's basis increases for any additional capital contributions to the entity in subsequent years.
- The owner's basis increases for the owner's share of income for tax purposes or decreases for losses.
- The owner's basis increases for the owner's share of entity liabilities. Differences exist between partnerships and S corporations as to which liabilities are added to an owner's basis. Details on this topic are covered in later chapters of this textbook.
- The owner's basis decreases for money or property distributed to the owner by the entity.

Without these basis adjustments, the owner could be subject to double taxation upon selling his or her interest or upon dissolution of the entity. Practitioners refer to this basis as "outside basis" as opposed to "inside basis," which is the entity's basis in its assets.

EXAMPLE I:1-17 ▶ Wildcat Company is a flow-through entity with two owners, Rich and Teresa. Each owner has a $10,000 original basis in the entity. In its first year of operations, Wildcat Company earns $50,000, which is allocated $25,000 to each owner. Thus, each owner reports $25,000 in his individual income tax return even though the entity does not distribute any of the earnings to the owners. At the beginning of the second year, Rich sells his interest to Steve for $35,000. If Rich did not get an increased basis adjustment for his $25,000 of earnings, he would recognize a $25,000 gain ($35,000 selling price − $10,000 basis in the entity) on the sale of his interest, which taxes him twice on the $25,000. However, both Rich and Teresa do increase their bases to $35,000 ($10,000 original basis + $25,000 share of entity earnings) at the end of the first tax year. Therefore, when Rich sells his interest for $35,000, he incurs no additional taxable gain ($35,000 selling price − $35,000 basis in the entity = $0 gain). ◀

Below is a brief description of the four basic types of flow-through business entities.

Partnerships. A partnership is the classic flow-through entity as it has been around the longest. The Internal Revenue Code (IRC) defines a partnership as "a syndicate, group, pool, joint venture, or other incorporated organization" that carries on any business, financial operation, or venture.[29] Thus, if two or more individuals, corporations, trusts, or estates decide to operate a business or financial venture, the business or venture can be classified as a partnership. Unlike a corporation, which must file incorporation documents with the state, partnerships require no legal documentation. However, tax advisors strongly advise partnerships to have written agreements as to the operation of the partnership and how income, deductions, losses, and credits will be allocated to the partners. Most states have laws that govern the rights and restrictions of partnerships and their partners.

Partnerships file an annual income tax return which is just an information return because the partnership entity is not subject to taxation. The return, Form 1065 (U.S. Partnership Return of Income), reports the results of the partnership's operations. An accompanying form, Schedule K-1, reports the separate income, deductions, losses, and credits that flow through to the partners. The partners, in turn, take the information from their Schedule K-1 and report the various items on their individual returns.

EXAMPLE I:1-18 ▶ Donald and Minnie form a real estate company and decide to operate as a partnership, the DM Partnership. Donald is a 60% partner and Minnie is a 40% partner. Donald invests $60,000 into DM and Minnie contributes real estate with a basis and fair market value of $40,000. In its first year of operation, DM Partnership earns ordinary income of $150,000. The partnership files Form 1065 and reports the $150,000 but is not subject to any income taxation. Included in the

[29] Sec. 761(a).

partnership return are two Schedule K-1s that report $90,000 to Donald ($150,000 × 60%) and $60,000 ($150,000 × 40%) to Minnie. Donald reports $90,000 on his individual income tax return, Form 1040, and Minnie reports $60,000 on her individual return. If the partnership distributed $72,000 to Donald and $48,000 to Minnie during the year, the distributions are considered a return of capital and are not taxable to either partner. Donald's adjusted basis in his partnership interest would be $78,000 ($60,000 + $90,000 − $72,000) and Minnie's adjusted basis would be $52,000 ($40,000 + $60,000 − $48,000). ◀

S Corporations. S corporations are a special form of corporation treated by the tax laws as flow-through entities. They are incorporated under state law just as any other corporation but, if they so elect, are treated as flow-through entities for tax purposes. S corporations are so named because the rules pertaining to this type of entity are located in Subchapter S of the IRC. S corporations have been referred to as "corporations taxed like a partnership." Although this statement is partially true, important differences exist, such as a limitation on the number of shareholders, strict rules on allocation of income or losses, and several other differences. Similar to partnerships, S corporations are not taxed and income, deductions, losses, and credits flow through to its shareholders. Allocations of income, deductions, losses, and credits to shareholders are based on a per share–per day basis. Importantly, S corporation shareholders enjoy limited liability, as do C corporation shareholders.

To achieve S corporation status, the corporation must file an S election and all of its shareholders must consent to that election. S corporations annually file an information return, Form 1120S (U.S. Income Tax Return for an S Corporation), which reports the results of the corporation's operations and, like partnerships, also submits Schedule K-1 to each shareholder which reports the allocable share of income, deduction, loss, and credit that flow through to each shareholder.

Similar to partnerships, S corporations impose only a single level of taxation to its shareholders and the tax law uses basis adjustments to achieve this single level of taxation. The basis adjustments for S corporation shareholders are nearly identical to those for partnerships. The major difference is how liabilities affect the basis of S corporation shareholders. S corporation shareholders obtain basis only for *direct* loans to the corporation and they treat their debt basis separately from stock basis. Partners of a partnership generally increase their basis for all partnership liabilities.

EXAMPLE I:1-19 ▶ Paul and Peter form a corporation in Ohio as equal shareholders. Upon advice from their tax advisor, they decide to elect S corporation status for federal and state tax purposes and file the necessary forms. Both Paul and Peter invest $25,000 in the corporation and each receives 100 shares of common stock of the corporation. During the first year, the corporation reports net ordinary income of $62,000 and a long-term capital gain of $10,000 of Form 1120S. Each shareholder receives a $20,000 distribution from the corporation during the year. In Year 1, the corporation pays no federal or state income taxes, but both Paul and Peter report $31,000 of ordinary income and $5,000 of long-term capital gain on their individual returns. Since the shareholders have sufficient basis, the $20,000 distribution to each shareholder is not subject to taxation. Paul and Peter would each have a basis in their S corporation stock of $41,000 ($25,000 + $31,000 + $5,000 − $20,000) at the end of Year 1. ◀

EXAMPLE I:1-20 ▶ In Year 2, the corporation earns $74,000 of ordinary income and no capital gains. Also, on July 1 of Year 2, Peter sells one-half (50 shares) of his stock to Mary. So, from July 1 to December 31, Paul owns 50% of the corporate stock and Peter and Mary each own 25%. S corporation earnings must be allocated on a per share−per day basis, so the income of $74,000 is allocated to each shareholder as follows:

Paul	$74,000 × 365/365 × 50% = $37,000
Peter	($74,000 × 181/365 × 50%) + ($74,000 × 184/365 × 25%) = $27,674
Mary	$74,000 × 184/365 × 25% = $9,326

◀

Limited Liability Companies. A limited liability company (LLC) is a legal entity under the laws of all 50 states and the District of Columbia and is a very popular organizational form. LLCs combine the best features of a partnership and a corporation by being treated as a partnership while providing the limited liability protection of a corporation. Thus, LLC owners, called members, are subject to a single level of taxation and are not liable for the liabilities of the LLC.

An LLC is formed under state law similar to a corporation. After formed, the LLC elects whether to be taxed either as a partnership or a corporation.[30] Under Treasury Regulations, an LLC with more than one member is treated as a partnership unless the LLC affirmatively elects to be classified as a corporation. In most cases, LLCs will prefer to be classified as a partnership because of the tax advantages of a single level of taxation. If an LLC elects to be treated as a partnership, it files its tax return on Form 1065 (U.S. Partnership Return of Income). The LLC, however, is not legally a partnership; it is just treated as one for federal income tax purposes. A single member LLC is disregarded for tax purposes and the LLC income, deductions, etc. are reported directly on the member's Schedule C of Form 1040 as a sole proprietor. If an LLC elects to be taxed as a corporation under the Treasury Regulations, it would file Form 1120 (U.S. Corporation Income Tax Return). Further, S corporation status can be achieved by electing to be taxed as a corporation and then make an S election. Thus, the LLC would be considered an LLC for state law purposes but an S corporation for income tax purposes.

EXAMPLE I:1-21 ▶ Karen and David start a wholesale business and decide to operate the business as an LLC. They first must legally form the organization under state law. After the LLC is legally formed, they must decide how the LLC will be treated for income tax purposes. Because they want a single level of taxation, Karen and David elect to be treated as a partnership. Since being treated as a partnership is the default classification under Treasury Regulations, no forms need to be filed with the IRS. At the end of the first year, the LLC will file a Form 1065 and check the box indicating that the entity is an LLC filing as a partnership. All partner allocations, basis adjustments, and all other tax rules for the LLC are identical with partnership rules. ◀

Limited Liability Partnerships. All 50 states and the District of Columbia have statutes that allow a business to operate as a limited liability partnership (LLP). Basically, an LLP is similar to an LLC except that a partner of an LLP *is not* liable for any liability arising from acts of negligence or misconduct or similar acts of another partner of the LLP. Thus, an LLP is much more desirable than a general partnership where partners are liable for all partnership liabilities. Professional service organizations, such as many CPA firms, have adopted the LLP form, primarily to limit legal liability.

EXAMPLE I:1-22 ▶ The accounting firm of Gartman & Kuhn, CPAs, is operating as a general partnership and has 20 partners in the firm. The firm is concerned about the unlimited liability that exists for the partnership, especially in today's litigious environment. The firm decides to convert from a partnership to an LLP. The conversion is simple and tax-free,[31] and protects the partners of the new LLP entity against liabilities of the LLP arising from acts of negligence or misconduct of other partners or employees. ◀

OTHER ENTITIES

Trusts. Trusts are somewhat of a hybrid entity in that they may either be a taxpaying entity or flow-through entity. Also, there are a number of different types of trusts, so the discussion here is very general in nature. Trusts typically are subject to income taxation on all of its net income that is *not* distributed to the beneficiaries. The portion of net income that is distributed to beneficiaries is taxed to the beneficiaries. One drawback to the use of trusts is that the income tax rates are extremely progressive, reaching the 37% bracket when the taxable income of the trust reaches $12,750 in 2019. Trusts use Form 1041 to file its tax information.

EXAMPLE I:1-23 ▶ Ben establishes a trust for the benefit of his daughter. The principal amount of the trust is $500,000 and is projected to earn approximately 10% per year. In the current year, the trust earned $50,000 of investment income and had $5,000 of expenses. If the trust did not make any

[30] The LLC makes the election pursuant to the "check-the-box" Regulations, Reg. Secs. 301.7701-1 through -4.

[31] Rev. Rul. 95-37, 1995-1 C.B. 130.

distributions during the year to the daughter, the entire $45,000 (less a small exemption) would be subject to income taxation to the trust. Much of the taxable income would be subject to taxation at the 37% rate. Alternatively, if the trust distributed the entire $45,000 to the daughter, she would report the $45,000 on her individual tax return. Assuming she does not have significant other income, she would most likely be in the 22% marginal tax bracket. The trust's taxable income would be zero and would have no income tax liability. ◀

TAX LAW SOURCES

OBJECTIVE 6

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

The solution to any tax question may only be resolved by reference to tax law sources (also referred to as tax law authority). Tax law sources are generated from all three branches of the federal government, i.e., legislative, executive, and judicial. The principal sources of tax law are as follows:

Branch	*Tax Law Source*
Legislative	Internal Revenue Code
	Congressional Committee Reports
Executive (Administrative)	Income Tax Regulations
	Revenue Rulings
	Revenue Procedures
	Letter Rulings
Judicial	Court Decisions

ADDITIONAL COMMENT

Knowledge of tax law sources could be considered the most important topic in this book. It is similar to the old Chinese proverb that states that if you give a person a fish you have fed him for one day, but if you teach a person how to fish you have fed him for the rest of his life. By analogy, if a person has a knowledge of the tax law sources, he or she should be able to locate the answers to tax questions throughout his or her career.

A thorough knowledge of the various sources above as well as the relative weights attached to each source is vital to tax professionals. Because of the vast volume of tax law sources, the ability to "find an answer" to a tax question is of fundamental importance. In addition, the evaluation of the weight (or importance) of different sources of authority is also crucial in arriving at a proper conclusion. For example, a decision of the U.S. Supreme Court on a tax matter would certainly carry more weight than a Revenue Ruling issued by the Internal Revenue Service.

Clearly, the most authoritative source of tax law is the Internal Revenue Code, which is the tax law passed by Congress. However, Congress is not capable of anticipating every type of transaction that taxpayers might engage in, so most of the statutes in the Code contain very general language. Because of the general language contained in the Code, both administrative and judicial interpretations are necessary to apply the tax law to specific situations and transactions. Thus, the regulations and rulings of the IRS and the decisions of the courts are an integral part of the federal income tax law. For a detailed discussion of tax law sources, see Chapter I:15 (Chapter C:1 of the *Comprehensive* edition). Topic Review I:1-3 provides an overview of the tax law sources.

ENACTMENT OF A TAX LAW

OBJECTIVE 7

Describe the legislative process for the enactment of the tax law

Under the U.S. Constitution, the House of Representatives is responsible for initiating new tax legislation. However, tax bills may also originate in the Senate as riders to nontax legislative proposals. Often, major tax proposals are initiated by the President and accompanied by a Treasury Department study or proposal, and then introduced into Congress by one or more representatives from the President's political party.

STEPS IN THE LEGISLATIVE PROCESS

The specific steps in the legislative process are discussed below and are summarized in Table I:1-2. These steps typically include:

1. A tax bill is introduced in the House of Representatives and is referred to the House Ways and Means Committee.
2. The proposal is considered by the House Ways and Means Committee, and public hearings are held. Testimony may be given by members of professional groups such

TOPIC REVIEW I:1-3

Tax Law Sources

Source	Key Points	Weight of Authority
LEGISLATIVE		
Internal Revenue Code	Contains provisions governing income, estate and gift, employment, alcohol, tobacco, and excise taxes.	Serves as the highest legislative authority for tax research, planning, and compliance activities.
ADMINISTRATIVE		
Treasury Regulations	Represents interpretations of the tax code by the Secretary of the Treasury. Regulations may be initially issued in proposed, temporary, and final form and may either be interpretative or legislative in nature.	Legislative regulations have a higher degree of authority than interpretative regulations. Proposed regulations do not have authoritative weight.
IRS Rulings	The IRS issues Revenue Rulings (letter rulings or published rulings), Revenue Procedures, Information Releases, and Technical Advice Memoranda.	These pronouncements reflect the IRS's interpretation of the law and do not have the same level of scope and authority as Treasury Regulations.
JUDICIAL		
Judicial doctrines	Judicial doctrines are concepts that have evolved from Supreme Court cases that are used by the courts to decide tax issues. Examples include substance over form, tax benefit rule, and constructive receipt.	Judicial doctrines that evolve from Supreme Court cases have substantial weight of authority because they have the force and effect of law.
Judicial interpretations	Tax cases are initially considered by a trial court (i.e., the Tax Court, a Federal district court, or the U.S. Court of Federal Claims). Either the taxpayer or the IRS may appeal to an appeals court. A final appeal is to the U.S. Supreme Court.	A trial court must abide by the precedents set by the court of appeals of the same jurisdiction. An appeals court is not required to follow the decisions of another court of appeals. A Supreme Court decision is the "law of the land."

ADDITIONAL COMMENT

Rep. Richard Neal of Massachusetts is the chairman of the House Ways and Means Committee, and the chairman of the Senate Finance Committee is Sen. Chuck Grassley of Iowa.

HISTORICAL NOTE

For many years, only a few members of Congress were CPAs. This trend is changing. As of December 2015, ten members of the House of Representatives and two members of the Senate are CPAs.

as the American Institute of CPAs and the American Bar Association and from various special-interest groups.

3. The tax bill is voted on by the House Ways and Means Committee and, if approved, is forwarded to the House of Representatives for a vote. Amendments to the bill from individual members of the House of Representatives are generally not allowed.
4. If passed by the House, the bill is forwarded to the Senate for consideration by the Senate Finance Committee, and public hearings are held.
5. The tax bill approved by the Senate Finance Committee may be substantially different from the House of Representatives' version.
6. The Senate Finance Committee reports the Senate bill to the Senate for consideration. The Senate generally permits amendments (e.g., new provisions) to be offered on the Senate floor.
7. If approved by the Senate, both the Senate and House bills are sent to a Joint Conference Committee consisting of an equal number of members from the Senate and the House of Representatives.
8. The Senate and House bills are reconciled in the Joint Conference Committee. This process of reconciliation generally involves substantial compromise if the provisions of both bills are different. A final bill is then resubmitted to the House and Senate for approval.
9. If the Joint Conference Committee bill is approved by the House and Senate, it is sent to the President for approval or veto.
10. A presidential veto may be overturned if a two-thirds majority vote is obtained in both the House and Senate.

▼ **TABLE I:1-2**
Steps in the Legislative Process

1. Treasury studies prepared on needed tax reform
2. President makes proposals to Congress
3. House Ways and Means Committee prepares House bill
4. Approval of House bill by the House of Representatives
5. Senate Finance Committee prepares Senate bill
6. Approval of Senate bill by the Senate
7. Compromise bill approved by a Joint Conference Committee
8. Approval of Joint Conference Committee bill by both the House and Senate
9. Approval or veto of legislation by the President
10. New tax law and amendments incorporated into the Code

11. Committee reports are prepared by the staffs of the House Ways and Means Committee, the Senate Finance Committee, and the Joint Conference Committee as the bill progresses through Congress. These reports help to explain the new law before the Treasury Department drafts regulations on the tax law changes as well as to explain the intent of Congress for passing the new law.

ADMINISTRATION OF THE TAX LAW AND TAX PRACTICE ISSUES

OBJECTIVE 8

Describe the administrative procedures under the tax law

ORGANIZATION OF THE INTERNAL REVENUE SERVICE

The **IRS** is the branch of the Treasury Department that is responsible for administering the federal tax law. It is organized on a type-of-taxpayer basis which allows the IRS to become more specialized. The responsibilities and functions of the various administrative branches include the following:

- The Commissioner of Internal Revenue, appointed by the President, is the chief officer of the IRS. This individual is supported by the Chief Counsel's office, which is responsible for preparing the government's case for litigation of tax disputes.
- The National Office includes a deputy commissioner, a series of assistants to the commissioner, and a chief counsel. A significant responsibility of the National Office is to process ruling requests and to prepare revenue procedures that assist taxpayers with compliance matters.
- Four operating divisions, organized functionally, including (1) Wage and Investment Income, (2) Small Business and Self-Employed, (3) Large Business and International, and (4) Tax Exempt and Government Entities.
- Tax service centers, located around the country, perform tax return processing work, based on the four divisions above. They also select tax returns for audit.
- For the 2017 fiscal year, the IRS had approximately 77,000 full-time equivalent employees and a budget of \$11.5 billion. The number of employees in 2017 is a decrease of 14.4% from 2012. In 2017, the IRS collected \$3.4 trillion, 91 percent of federal government receipts.

ADDITIONAL COMMENT

A survey of members of the American Institute of CPAs found that more than half of the 1,036 members who responded had an unfavorable opinion of the IRS. However, the accountants gave the IRS good marks for courtesy and a willingness to solve problems.

ENFORCEMENT PROCEDURES

ADDITIONAL COMMENT

Individuals may call 800-366-4484 to report misconduct of IRS employees.

All tax returns are initially checked for mathematical accuracy and items that are clearly erroneous. The Form W-2 amounts (e.g., wages, and so on), Form 1099 information return amounts (e.g., relating to dividend and interest payments, and so on) and other forms filed with the IRS by the payer are checked against the amounts reported on the tax return. If differences are noted, the IRS Center merely sends the taxpayer a bill for the corrected amount of tax and a statement of the differences. This type of examination is referred to as a correspondence audit. In some instances, the difference is due to a classification error by the IRS, and the additional assessment can be resolved by written correspondence. A refund check may be sent to the taxpayer if an overpayment of tax has been made.

EXAMPLE I:1-24 ► Bart is an author of books and properly reports royalties on Schedule C (Profit or Loss from Business). The IRS computer matching of the Form 1099 information returns from the publishing companies incorrectly assumes that the royalties should be reported on Schedule E (Supplemental Income and Loss). If the IRS sends the taxpayer a statement of the difference and an adjusted tax bill, this matter (including the abatement of added tax, interest, and penalties) should be resolved by correspondence with the IRS. ◄

ADDITIONAL COMMENT

The IRS audit rate has continued to decline over the past 10 years. In 2016, the percentage of returns audited by the IRS dropped to 0.60%. Of course, the audit rate varies by levels and types of income. Higher income taxpayers and self-employed taxpayers face higher audit rates.

SELECTION OF RETURNS FOR AUDIT

The U.S. tax system is based on self-assessment and voluntary compliance. However, enforcement by the IRS is essential to maintain the integrity of the tax system. The IRS uses both computers and experienced personnel to select returns for examination. With respect to the use of the computer, a **Discriminant Function System (DIF)** is used to classify returns to be selected for audit. The DIF system generates a "score" for a return based on the potential for the return to generate additional tax revenue. After returns are scored under the DIF system, the returns are manually screened by experienced IRS personnel who decide which returns warrant further examination. In the aggregate, less than 1% of all individual returns are selected for examination each year. Some examples of situations where individuals are more likely to be audited include the following:

ADDITIONAL COMMENT

A special task force has recommended that the percentage of returns audited be increased to 2.5%. Many individuals feel that the probability of being audited is so low as to be disregarded.

- Individuals who are sole proprietors and claim expenses in connection with their trade or businesses, especially if significant tax losses are incurred.
- Itemized deductions exceeding an average amount for the person's income level
- Filing of a refund claim by a taxpayer who has been previously audited, where substantial tax deficiencies have been assessed
- Individuals who are self-employed with substantial business income or income from a profession (e.g., a medical doctor)

ETHICAL POINT

A CPA is not permitted to recommend a position to a client that exploits the IRS audit selection process.

Audit Procedures. Audits of most individuals are handled through an **office audit procedure** in an office of the IRS. In most cases, an individual is asked to substantiate a particular deduction, credit, or income item (e.g., charitable contributions that appear to be excessive). The office audit procedure does not involve a complete audit of all items on the return.

EXAMPLE I:1-25 ► Brad obtains a divorce during the current year and reports a $30,000 deduction for alimony. The IRS may conduct an office audit to ascertain whether the amount is properly deductible as alimony and does not represent a disguised property settlement to Brad's ex-wife. Brad may be asked to submit verification (e.g., a property settlement agreement between the spouses that designates the payments as alimony). ◄

KEY POINT

A taxpayer may appear on his or her own behalf before the IRS during an audit. An attorney or CPA in good standing is authorized to practice before the IRS upon the filing of a written statement that he or she is currently so qualified and is authorized to represent the taxpayer.

A **field audit procedure** often is used for corporations and individuals engaged in a trade or business. A field audit generally is broader in scope than the office audit (e.g., several items on the tax return may be reviewed). A field audit usually is conducted at the taxpayer's place of business or the office of his or her tax advisor.

Most large corporations are subject to annual audits. The year under audit may be several years prior to the current year because the corporation often will waive the statute of limitations pending the resolution of disputed issues.

STATUTE OF LIMITATIONS

Most taxpayers feel a sense of relief after they have prepared their income tax return and have mailed it to the IRS. However, the filing of the tax return is not necessarily the end of the story for that particular taxable year. It is possible, of course, that the IRS may select their tax return for audit after the return has been initially processed or a taxpayer may have filed an amended return to correct an error or omission.

REAL-WORLD EXAMPLE

Based on an IRS audit, the Mustang Ranch, Nevada's most famous legal bordello, was assessed some $13 million in taxes. When the amount owed could not be paid, the IRS sold the property to recoup the taxes.

Both the IRS and taxpayers can make corrections to a return after it has been originally filed. Fortunately, both only have a limited time period in which to make such corrections. This time period is called the **statute of limitations** and prevents either the taxpayer or the IRS from changing a filed tax return after the time period has expired. The general rule for the statute of limitations is three years from the later of the date the tax return was actually filed or its due date.[32] However, a six-year statute of limitations applies if the taxpayer omits items of gross income that in total exceed 25% of the gross income reported on the return.[33] The statute of limitations remains open indefinitely if a fraudulent return is filed or if no return is filed.[34]

EXAMPLE I:1-26 ▶ Betty, a calendar-year taxpayer, is audited by the IRS in February 2019 for the tax year 2017. During the course of the audit, the IRS proposes additional tax for 2017, because Betty failed to substantiate certain travel and entertainment expense deductions. During the course of the audit, the IRS discovers that Betty failed to file a tax return for 2012, and in 2014 an item of gross income amounting to $26,000 was not reported. Gross income reported on the 2014 return was $72,000. Assuming Betty's 2017 return was filed on or before its due date (April 15, 2018), the IRS may assess a deficiency for 2017 because the three-year statute of limitations will not expire until April 15, 2021. A deficiency also may be assessed for the 2014 return because a six-year statute of limitations applies since the omission is more than 25% of the gross income reported on the return. A deficiency also may be assessed for 2012 as there is no statute of limitations for fraud. ◀

ADDITIONAL COMMENT

More than 150 penalties can be imposed on taxpayers. In fact, applying the penalties has become so complicated that the IRS is currently considering ways to consolidate and simplify them.

INTEREST

Interest accrues on both assessments of additional tax due and on refunds that the taxpayer receives from the government.[35] No interest is paid on a tax refund if the amount is refunded by the IRS within 45 days of the day prescribed for filing the return (e.g., April 15) determined without regard to extensions.[36] If a return is filed after the filing date, no interest is paid if the refund is made within 45 days of the date the return was filed.

EXAMPLE I:1-27 ▶ Beverly, a calendar-year taxpayer, files her 2018 tax return on March 1, 2019, and requests a $500 refund. No interest accrues on the refund amount if the IRS sends the refund check to Beverly within 45 days of the April 15, 2019, due date. ◀

ADDITIONAL COMMENT

In addition to the penalties listed on this page, the government also assesses penalties for civil fraud and criminal fraud. Criminal fraud carries a maximum penalty of $100,000, a prison sentence of up to five years, or both.

PENALTIES

Various nondeductible penalties are imposed on the net tax due for failure to comply, including

- ▶ A penalty of 5% per month (or fraction thereof) subject to a maximum of 25% for failure to file a tax return[37]

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[32] Secs. 6501(a) and (b)(1). Similar rules apply to claims for a refund filed by the taxpayer. Section 6511(a) requires that a refund claim be filed within three years of the date the return was filed or within two years of the date the tax was paid, whichever is later. For more information on the rules for statute of limitations, see Chapter C:15 in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*.

[33] Sec. 6501(e). See also *Stephen G. Colestock*, 102 T.C. 380 (1994), where the Tax Court ruled that the extended six-year limitation period applied to a married couple's entire tax liability for the tax year at issue, not just to items that constituted substantial omissions of gross income. Thus, the IRS was able to assert an increased deficiency and additional penalties attributable to a disallowed depreciation deduction.

[34] Sec. 6501(c).

[35] Sec. 6621(a). The rate is adjusted four times a year by the Treasury Department based on the current interest rate for short-term federal obligations. The interest rate individual taxpayers must pay to the IRS on underpayments of tax is the federal short-term rate plus three percentage points. The interest rate paid to taxpayers on overpayments of tax is the federal short-term rate plus two percentage points. The annual interest rate on noncorporate underpayments and overpayments for the period October 1, 2018, through December 31, 2018, was 5%.

[36] Sec. 6611(e).

[37] Sec. 6651(a)(1). The penalty assessed may be very small in some instances even though the taxpayer owes a large tax bill for the year because penalties are imposed on the net tax due. The percentages are increased to 15% per month (or fraction thereof) up to a maximum of 75% if the penalty is for fraudulent failure to file under Sec. 6651(f).

ADDITIONAL COMMENT

In many cases, these penalties can be avoided if the taxpayer can show there is "reasonable cause." See Chapter C:15 in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* for further discussion.

- A penalty of 0.5% per month (or fraction thereof) up to a maximum of 25% for failure to pay the tax that is due[38]
- An accuracy-related penalty of 20% of the underpayment for items such as negligence or disregard of rules or regulations, any substantial understatement of income tax, or any substantial misstatement of valuation[39]
- A 75% penalty for fraud[40]
- A penalty based on the current interest rate for underpayment of estimated taxes[41]
- Significant penalties on tax return preparers have been enacted by Congress. In general, these new penalties are applicable for any position on a tax return where there is a "realistic possibility" (one-in-three chance) that the position would not be upheld in a court of law. The penalty is not assessed if the position is disclosed in the return.

ADDITIONAL COMMENT

Pete Rose, major league baseball's all-time hit leader, was sent to prison in 1990 for income tax evasion.

ADMINISTRATIVE APPEAL PROCEDURES

If an IRS agent issues a deficiency assessment, the taxpayer may make an appeal to the IRS Appeals Division. Some disputes involve a gray area (e.g., a situation where some courts have held for the IRS whereas other courts have held for the taxpayer on facts that are similar to the disputed issue). In such a case, the taxpayer may be able to negotiate a compromise settlement (e.g., a percentage of the disputed tax amount plus interest and penalties) with the Appeals Division based on the "hazards of litigation" (i.e., the probability of winning or losing the case if it is litigated).

COMPONENTS OF A TAX PRACTICE

OBJECTIVE 9

Describe the components of a tax practice

Tax practice is a rapidly growing field that provides substantial opportunities for tax specialists in public accounting, law, and industry. The tasks performed by a tax professional may range from the preparation of a simple Form 1040 for an individual to the conduct of tax research and planning for highly complex business situations. Tax practice consists of the following activities:

- Tax compliance and procedure (i.e., tax return preparation and representation of a client in administrative proceedings before the IRS)
- Tax research
- Tax planning and consulting
- Financial planning

TYPICAL MISCONCEPTION

Many people believe that a tax practitioner should serve in the capacity of a neutral, unbiased expert. They tend to forget that tax practitioners are being paid to represent their clients' interests. A tax practitioner may sometimes recommend a position that is defensible, but where the weight of authority is on the side of the IRS.

TAX COMPLIANCE AND PROCEDURE

Preparation of tax returns is a significant component of tax practice. Tax practitioners often prepare federal, state, and local tax returns for individuals, corporations, estates, trusts, and so on. In larger corporations, the tax return preparation (i.e., compliance) function usually is performed by a company's internal tax department staff. In such a case, a CPA or other tax practitioner may assist the client with the tax research and planning aspects of their tax practice, and may even review their return before it is filed.

An important part of tax practice consists of assisting the client in negotiations with the IRS. If a client is audited, the practitioner acts as the client's representative in discussions with the IRS agent. If a tax deficiency is proposed, the practitioner assists the client if

[38] Sec. 6651(a)(2). If the failure to file penalty (5%) and the failure to pay the tax penalty (0.5%) are both applicable, the failure to file penalty is reduced by the failure to pay penalty per Sec. 6651(c)(1). Further, the penalty is increased to 1% per month after the IRS notifies the taxpayer that it will levy on the taxpayer's assets.

[39] Sec. 6662.

[40] Sec. 6663.

[41] Sec. 6654.

an administrative appeal is contemplated with the IRS's Appellate Division. In most instances, an attorney is retained if litigation is being considered.

TAX RESEARCH

Tax research is the search for the best possible defensibly correct solution to a problem involving either a completed transaction (e.g., a sale of property) or a proposed transaction (e.g., a proposed merger of two corporations). Research involves each of the following steps:

- Determine the facts.
- Identify the issue(s).
- Identify and analyze the tax law sources (i.e., code provisions, Treasury Regulations, administrative rulings, and court cases).
- Evaluate nontax (e.g., business) implications.
- Solve the problem.
- Communicate the findings to the client.

Tax research may be conducted in connection with tax return preparation, tax planning, or procedural activities. A more thorough discussion of tax research is presented in Chapter I:15.

SELF-STUDY QUESTION

Do large national CPA firms generally stress the importance of tax research in connection with tax-return preparation or tax planning?

ANSWER

The large CPA firms emphasize their skills in tax planning. Sometimes a slight alteration of a proposed transaction can save the client substantial tax dollars. This is high-value-added work and can be billed at premium rates.

TAX PLANNING AND CONSULTING

Tax planning involves the process of structuring one's affairs so as to minimize the amount of taxes *and* maximize the after-tax return. Thus, optimal tax planning is *not* to just pay the least amount of tax but to maximize after-tax cash flows. A text from several years ago on tax research and planning has delineated the following tax planning principles:[42]

- Keep sufficient records.
- Forecast the effect of future events.
- Support the plan with a sound business purpose.
- Base the plan on sound legal authorities.
- Do not carry a good plan too far.
- Make the plan flexible.
- Integrate the tax plan with other factors in decision making.
- Conduct research to learn whether a similar plan has previously proved unsuccessful (e.g., a court case involving similar facts may have upheld the IRS's position).
- Consider the "maximum" risk exposure of the client (e.g., if the plan is subsequently challenged by the IRS and the tax treatment is disallowed, what is the economic impact upon the taxpayer?).
- Consider the effect of timing (e.g., whether it is more beneficial to take a deduction in one year versus another).
- Shape the plan to the client's needs and desires.

ADDITIONAL COMMENT

Several national accounting firms have divided their tax departments into two basic groups, consulting and compliance. The tax consultants work with clients in tax planning and consulting matters and do not prepare tax returns. Tax returns are prepared by the compliance staff.

CPAs and attorneys frequently are engaged by their clients to perform consulting services to optimize the client's tax situation. For example, a major corporation client is considering the acquisition of a major international corporation and wants to make sure that the tax implications of such an acquisition are properly managed. The CPA will be engaged to perform a thorough review of the transaction to ensure that the client is fully aware of the tax results of the acquisition, and possibly may request an advance ruling from the IRS.

Because of the importance of planning in tax practice, subsequent chapters in this text include a separate section on tax planning to discuss issues that are related to the topical coverage. These tax planning principles should be kept in mind when attempting to use the

[42] Norton, Fred W., *Federal Taxation: Research, Planning, and Procedures 2Ed*, © 1979. Printed and Electronically reproduced by permission of Pearson Education, Inc., Upper Saddle River, New Jersey. The tax planning principles are still viable today.