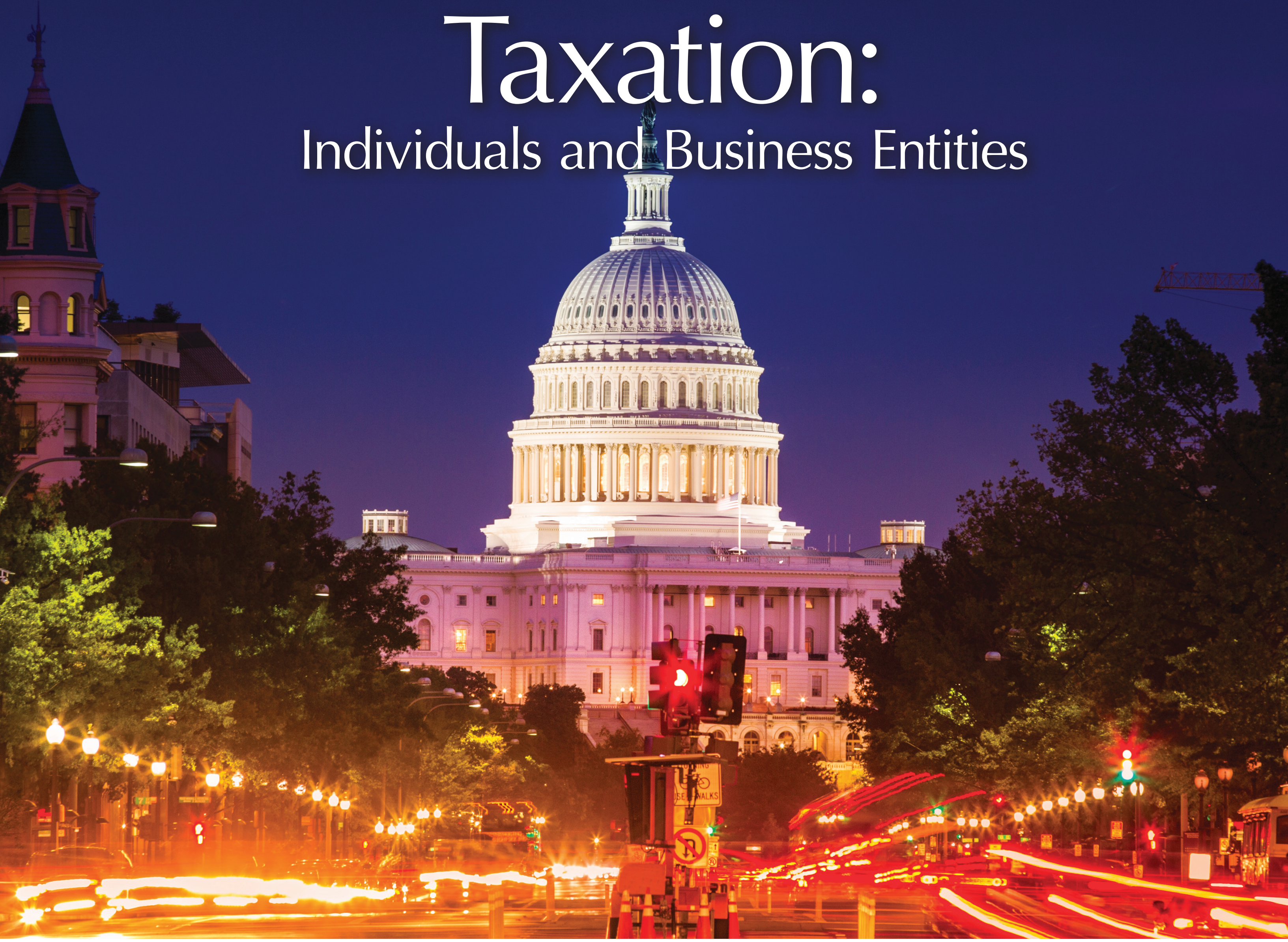
Cengage

South-Western Federal Taxation

Essentials of Taxation:
Individuals and Business Entities



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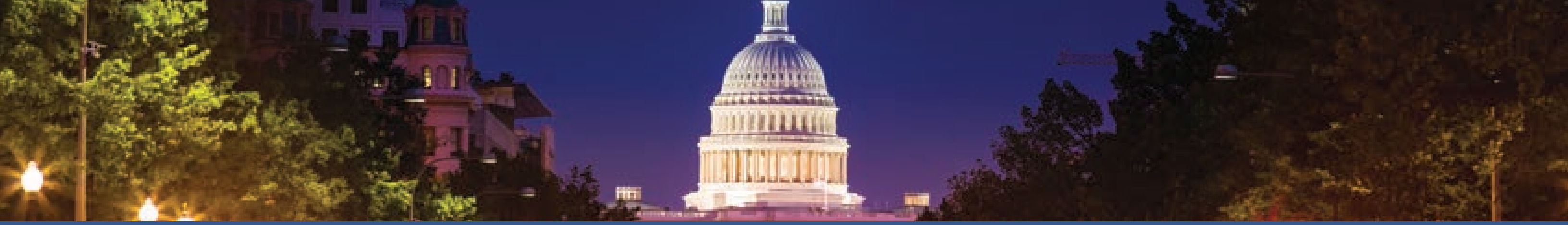

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Each chapter has additional content that is described and highlighted throughout the text. This can be found at **www.cengage.com**.

Part 1

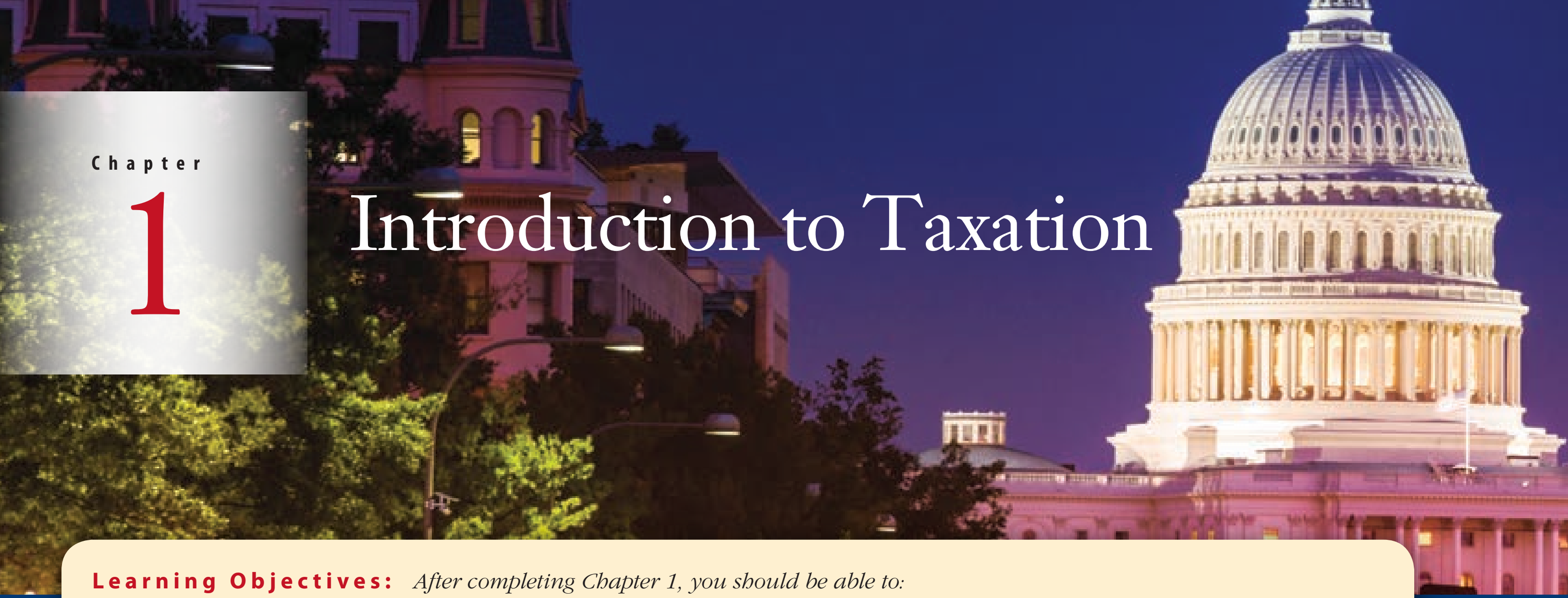
The World of Taxation

Chapter 1
Introduction to Taxation

Chapter 2
Working with the Tax Law

Chapter 3
Taxes in the Financial Statements

Part 1 provides an introduction to taxation in the United States. Taxes imposed by Federal, state, and local governments are discussed. A unique tax planning framework is introduced that is applied throughout the text in developing tax planning strategies for both business entities and individual taxpayers. The tax research process, including the role played by the legislative, administrative, and judicial branches in shaping our tax laws and providing guidance for tax compliance and planning, is introduced. Part 1 concludes with a chapter on accounting for income taxes in financial statements, as a bridge to topics covered in other accounting courses.



Chapter 1

Introduction to Taxation

Learning Objectives: *After completing Chapter 1, you should be able to:*

- **LO.1** **Explain the importance of taxes, how to study taxes, and how tax and finance professionals work with taxes.**
- **LO.2** **Explain the components of a tax.**
- **LO.3** **Identify the various taxes affecting business entities and individuals.**
- **LO.4** **Describe the basic tax formula for individuals and business entities.**
- **LO.5** **Explain the tax systems that apply to business entities and their owners.**
- **LO.6** **Identify tax planning opportunities using a general framework for tax planning.**
- **LO.7** **Explain the economic, social, equity, political, and compliance considerations that underlie the tax law.**
- **LO.8** **Describe the influence of the IRS and the courts on the Federal tax system.**

Chapter Outline

Tax Talk *How many people were taxed, who was taxed, and what was taxed tell more about a society than anything else.* —Charles Adams

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The Big Picture

A Typical Tax Year for A Modern Family

Travis and Amy Carter are married and live in a state that imposes both a sales tax and an income tax. They have two children, April (age 17) and Martin (age 18). Travis is a mining engineer who specializes in land reclamation. After several years with a mining corporation, Travis established a consulting practice that involves a considerable amount of travel due to work he performs in other states.

Amy is a registered nurse who, until recently, was a homemaker. In November of the current year, she decided to reenter the job market and accepted a position with a medical clinic.

The Carters live only a few blocks from Ernest and Mary Walker, Amy Carter's parents. The Walkers are retired and live on interest, dividends, and Social Security benefits.

The following activities with current year and possible future tax ramifications occurred:

- The ad valorem property taxes on the Carters' residence increased, while those on the Walkers' residence decreased.
- When Travis registered an automobile that was purchased last year in another state, he paid a sales tax to his home state.
- As an anniversary present, the Carters gave the Walkers a recreational vehicle (RV).
- Travis employed his children to draft blueprints and prepare scale models for use in his work. Both April and Martin have had training in drafting and topography.
- Early in the year, the Carters were audited by the state on an income tax return filed a few years ago. Later in the year, they were audited by the IRS on a Form 1040 they filed for the same year. In each case, a tax deficiency and interest were assessed.
- The Walkers were audited by the IRS. Unlike the Carters, they did not have to deal directly with an IRS examiner (an IRS employee) but settled the matter by mail.

Explain these developments and resolve any tax issues raised.

Read the chapter and formulate your response.

LO.1

Explain the importance of taxes, how to study taxes, and how tax and finance professionals work with taxes.

1-1 Taxes in Our Lives

"Taxes are what we pay for civilized society."

This is a famous quote from U.S. Supreme Court Justice Oliver Wendell Holmes, Jr. It is engraved at the entrance to the government building at 1111 Constitution Avenue in Washington, D.C.—headquarters of the Internal Revenue Service (IRS). This quote eloquently sums up the primary purpose of taxation—to raise revenue for government operations. Governments at all levels—national, state, and local—require funds for defense, protection (police and fire), education, transportation, the court system, social services, and more. Various types of taxes provide the resources to pay for government services.

In addition, taxation often is used as a tool to influence the behavior of individuals and businesses. For example, an income tax credit (which reduces a taxpayer's tax bill) may be designed to *encourage* people to purchase a fuel-efficient car. A tobacco excise tax may *discourage* individuals from smoking by increasing the cost of tobacco products. The tax system can also be used to provide direct benefits to taxpayers (e.g., to help pay for health insurance) and indirect benefits (in the form of exclusions, deductions, and credits that reduce a taxpayer's tax liability).

Taxes permeate our society. Various types of taxes, such as income, sales, property, and excise taxes, come into play in many of the activities of individuals, businesses, nonprofit entities (like charities), and governments themselves.

Most directly, individuals are affected by taxes by paying them. Taxes may be paid directly or indirectly. A direct tax is paid to the government by the person who owes the tax. Examples include the personal income tax, which is paid by filing a personal income tax return (Form 1040 at the federal level), and property taxes on one's home (paid to the local government). Individuals also pay many taxes indirectly. For example, when you buy gasoline for your car, the price you pay likely includes some of the income taxes and the gasoline excise taxes owed by the oil company. And a renter indirectly pays property taxes assessed on the landlord (who will consider that cost when determining how much rent to charge).

Ultimately, all taxes are paid by individuals. The corporate income tax, for example, is paid directly by the corporation, but it really is paid indirectly by individuals in their capacity as customers, investors (owners), or employees; the taxes are passed along to individuals through higher prices for products and services, lower dividends, and/or lower wages.

Taxes also affect the lives of individuals via the ballot box. Federal, state, and local elections often include initiatives that deal with taxation, such as whether Federal income taxes should be raised (or lowered), whether a new tax should be imposed on soda, or whether the sales tax rate should be increased. Candidates running for office often have ideas on tax changes they would like to make if they are elected.

1-1a The Relevance of Taxation to Accounting and Finance Professionals

The Federal corporate income tax rate is 21 percent. State income taxes constitute, on average, an additional 5 percent. So a large corporation may devote about 25 percent of its net income to pay income taxes. In addition, businesses are subject to employment taxes, property taxes, sales taxes, and various excise taxes. Corporations with international operations are subject to taxation in other countries. Small businesses also pay a variety of taxes that affect profits and cash flows.

Given its significance, taxation is a crucial topic for accounting and finance professionals serving individuals, businesses, and nonprofit entities. They must understand the various types of taxes to assist effectively with:

- *Compliance:* Ensure that the business files all tax returns and makes all tax payments on time. Mistakes and missed due dates will lead to penalties and interest expense.
- *Planning:* Help a business to apply favorable tax rules, like deferring income and obtaining tax credits, to minimize tax liability (and maximize owner wealth). The time value of money concept also is important here, as is coordinating tax planning with other business goals to maximize earnings per share.[1]

[1]A corporate tax director or vice president of tax is typically involved in the strategic planning and growth of the company due to the significance of tax liabilities and planning opportunities to the business. For example, a recent position announcement for a Tax Director at Roblox stated that the director would "lead initiatives to support global growth of the company."

- *Financial reporting:* Financial statements include a variety of tax information, including income tax expense on the income statement and deferred tax assets and liabilities on the balance sheet. Footnotes to the financial statements report various tax details, including the company's effective tax rate. Computation and proper reporting of this information requires knowledge of both tax and the financial reporting rules [including the Financial Accounting Standards Board's Accounting Standards Codification (ASC) 740, *Income Taxes*].
- *Environmental, Social, and Governance (ESG) reporting:* A growing trend in corporate reporting is to address various business sustainability and responsibility matters and report environmental, social, and governance activities and impact. Standard reporting frameworks might include tax metrics, such as the Global Reporting Initiative (GRI) Standards or ones generated by the World Economic Forum.[2] This reporting can include taxes paid in each country (part of "country-by-country reporting"), reconciliation between taxes paid and the statutory tax rate on financial statement profits, financial assistance received from governments via tax deductions and credits, and an explanation of the corporation's tax policy and strategy.[3] Tax professionals assist businesses in identifying relevant and possibly required ESG reporting and help verify that the information is accurate and clearly explained.
- *Controversy:* Assist when the taxpayer interacts with a tax agency (like the IRS). The IRS and state and local tax agencies regularly audit tax returns to verify that taxes were properly computed and paid.
- *Cash management:* Taxes must be paid on time to avoid penalties and interest. Income taxes must be estimated and paid quarterly and reconciled on the annual return. Other taxes may be due weekly, monthly, quarterly, or semiannually. Businesses must be sure they have the funds ready when the taxes are due and have procedures to track due dates.
- *Data analysis:* With a majority, if not all, of a company's records maintained in digital form, there are opportunities to use this information to enhance profits, better understand the customer base, and improve and understand the information from a tax perspective. Tax practitioners often need skills in data analysis and visualization to identify samples for both internal and external audits, find ways to identify the products and services subject to sales tax in different states, and extract tax data to help inform other business functions, such as where to locate a new sales office. The IRS and state tax agencies also use data analysis to help identify potential audit issues.
- *Tax advocacy:* Taxpayers and tax practitioners can add tremendous value to the improvement and evolution of our tax laws by sharing their knowledge, experiences, and ideas with lawmakers and tax agencies. Some of this work is performed by professional organizations [e.g., the American Institute of CPAs (AICPA)], industry associations, and various policy organizations. This input might take the form of comment letters, testimony before legislative committees (delivered in person or submitted for the record), or individual correspondence and meetings.[4]

The level and depth of tax knowledge needed for any accounting or tax professional depends on his or her specific job. The vice president of tax for a company clearly needs thorough knowledge in all areas of taxation; the same is true of a partner in a CPA firm. In contrast, the corporate treasurer likely focuses more on cash management, working closely with the company's tax advisers, so needs only a basic understanding of taxes. Ultimately, a person in any accounting or finance role must have sufficient tax knowledge to converse with tax advisers and understand their client's (or their company's) tax obligations.

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[2] For example, see World Economic Forum, *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*, January 2020; **www3.weforum.org/docs/WEF_IBC_ESG_Metrics_Discussion_Paper.pdf.**

[3] For examples, see Intel Corporation's 2021–22 Corporate Responsibility Report; **csrreportbuilder.intel.com/pdfbuilder/pdfs/CSR-2021-22-Full-Report.pdf;** and The Walt Disney Company's 2021 Corporate Social Responsibility Report; **impact.disney.com/app/uploads/2022/02/2021-CSR-Report.pdf**

[4] For examples of such advocacy, see formal letters submitted by the AICPA (**aicpa.org/advocacy/tax.html**); testimony delivered at tax reform hearings in Congress (**sjsu.edu/people/annette.nellen/website/117th-hearings.htm**); and tax policy activities and reports of various industry and policy organizations such as the U.S. Chamber of Commerce (**uschamber.com/taxes**) and the Center on Budget and Policy Priorities (**cbpp.org/research/topics/federal-tax**).

It is essential to maintain a balanced perspective when working with tax systems. A corporation that is deciding where to locate a new factory does not automatically select the city or state that offers the most generous tax benefits. Nor does the person who is retiring to a warmer climate pick Belize over Arizona because Belize has no income tax while Arizona does. Tax considerations should not control decisions, but they are one of many factors to be considered.

1-1b How to Study Taxation

The goal of studying taxation is to be able to recognize issues (or transactions) that have tax implications and to try to understand the justification for the related tax rules.

You may have heard that tax is a difficult subject because of the many rules, exceptions, and definitions, as well as frequent changes to tax rules. You even may have heard that taxation is boring. Taxation *is* a challenging topic, but it is certainly *not* boring. Taxation is an important and exciting topic due to constant changes made by the three branches of our Federal government (as well as by state and local jurisdictions), the significance of taxes to the bottom line of a company and an individual's finances, and the effects of taxes on our economy and society.

Tax professionals tend to find enjoyment in their chosen field due to the intellectual challenge of dealing with tax rules for compliance and planning purposes, the opportunity to interact with colleagues or clients to help them understand the effects brought about by taxes, and the knowledge that their work affects the financial well-being of individuals and businesses.

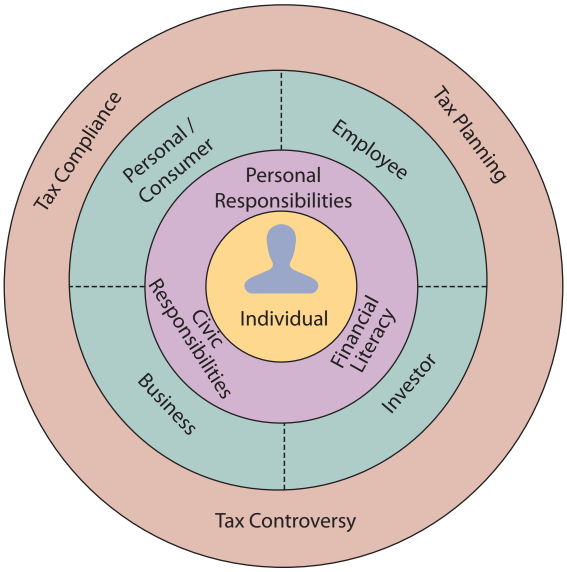
For tax professionals, the study of taxation is an ongoing and intriguing process. When Congress changes the tax law, tax professionals must review the new rules to understand how they affect clients or their employer. In addition, decisions rendered by the courts in tax disputes and guidance issued by the Treasury Department and Internal Revenue Service must be understood to ensure correct compliance with the law and to identify updated tax planning ideas.

In studying taxation, one should focus on understanding the rules and the why(s) behind them rather than memorizing numerous rules and terms. The rules become more meaningful by thinking about why the rule exists for the particular type of tax. For example, why do Federal income tax rules allow for a child care credit? Why is tax depreciation different from that used for financial reporting? Aiming for understanding, rather than memorization, will make your journey into the world of taxation interesting and meaningful, and it will prepare you well for dealing with taxation in your accounting or finance career.

1-1c Individuals and Taxes

The following diagram illustrates the many ways individuals interact with taxes. For example, as shown in the outer circle, individuals pay taxes and file tax returns (tax compliance). They also engage in tax planning as part of their desire to maximize the present value of after-tax wealth. If their tax return is audited or they do not pay their taxes, taxpayers will deal with the IRS or a state/local tax agency (tax controversy). Individuals deal with tax rules and planning in their roles as consumers, employees, investors, and business owners. Tax law is designed around these various taxpayer activities. Finally, as shown by the inner circle, individuals have a personal responsibility to comply with tax laws and pay any taxes due. Individuals also have a civic responsibility to understand taxes in their role as citizens and voters. Moreover, individuals need to understand how taxes affect their personal cash flows, consumption, and savings.

Use this diagram as you study the materials in this text, considering where in the circle various rules fit.



1-2 The Structure of Tax Systems

LO.2
Explain the components of a tax.

Most taxes have two components: a tax rate and a tax base (such as income, wages, value, or sales price). Tax liability is computed by multiplying these two components. Taxes vary by the structure of their rates, the base subject to tax, and whether reductions to the tax liability are allowed (e.g., credits). The tax formula (below) is helpful in both calculating a taxpayer's tax liability for any type of tax and understanding the effect of proposals to change the tax laws.

[Tax rate(s) X Tax base] – Tax credits = Tax liability

1-2a Tax Rates

Tax rates can be progressive, proportional, or regressive. A tax rate is *progressive* if the rate increases as the tax base increases. The Federal income tax imposed on individuals is a progressive tax as indicated by the Tax Rate Schedules you can find inside the front cover of this text. Currently, the tax rates increase from 10 percent to 37 percent as taxable income (the tax base) increases.

A tax is *proportional* if the rate of tax is constant, regardless of the size of the tax base. State retail **sales taxes** are proportional.

Example 1

Bob purchases an automobile for $6,000. If the sales tax on automobiles is 7% in Bob's state, he will pay a $420 tax. Alternatively, if Bob pays $20,000 for a car, his sales tax will be $1,400 (still 7% of the sales price). Because the average tax rate does not change with the tax base (sales price), the sales tax rate is *proportional*.

Finally, *regressive* tax rates decrease as the tax base increases. Federal **employment taxes**, such as FICA and FUTA, can be termed regressive. When the tax base and the taxpayer's ability to pay generally are positively correlated (i.e., when they move in the same direction), many tax pundits view regressive tax rates as unfair. This is because the tax burden decreases as a *percentage* of the taxpayer's ability to pay.

Example 2

In 2023, the combined Social Security and Medicare tax rate levied on the wages of employees is 7.65% up to a maximum of $160,200 and 1.45% on all wages over $160,200. Pooja earns a salary of $30,000. She pays FICA taxes of $2,295, an average tax rate of 7.65%. Alternatively, if Pooja earns $170,000, she pays $12,397 {(7.65% × $160,200) + [1.45% × ($170,000 − $160,200)]}, an average tax rate of 7.29%.

Once the FICA base exceeds the maximum amount subject to the Social Security part of FICA, the FICA tax rate becomes *regressive* because the tax rate decreases as the tax base increases.

Under all three tax rate structures, the *amount* of taxes due increases as the tax base increases. The structure of tax rates only affects the *rate* of increase (i.e., progressive taxes increase at an increasing rate, proportional taxes increase at a constant rate, and regressive taxes increase at a decreasing rate).

The terms *progressive*, *proportional*, and *regressive* are also used to describe the *effect* of a tax on taxpayers relative to their income. The Federal income tax is *progressive* because the tax represents a greater percentage of a higher-income taxpayer's income relative to a lower-income taxpayer. A flat rate income tax is *proportional* (or flat) since each taxpayer devotes the same percentage of income to pay the tax. Finally, a tax is *regressive* if lower-income taxpayers devote a greater percentage of income to pay the tax relative to higher-income individuals. For example, if two individuals, one with $10,000 of income and the other with $200,000 of income, both buy the same number of gallons of gasoline during the year, the excise tax paid represents a larger percentage of the lower-income individual's income compared to the higher-income individual. See further discussion in text Section 1-6d on equity considerations of tax systems.

The terms *progressive, proportional,* and *regressive* are most often used to describe tax rates in the design of tax systems or to describe the economic effect of taxes on individuals. *Effective tax rates* (described below) are also used for this purpose. For tax compliance and planning purposes, a taxpayer's *statutory, marginal,* and *average* tax rates are determined and used.

The **statutory tax rate** is the tax rate (or rates) specified in the law. For example, Code § 11 provides that the income tax rate for corporations is 21 percent. Code § 1 provides that the top income tax rate applicable to individuals is 37 percent.

The **marginal tax rate** is the tax rate applicable to the next dollar of income (if describing an income tax effect). For example, using the 2023 Tax Rate Schedule included in this text (see Appendix A), notice that a single person with taxable income of $25,000 has a marginal tax rate of 12 percent. This rate is relevant to let a taxpayer know the tax effect of, for example, earning a $1,000 bonus from one's employer (in this case, the taxpayer's income tax would increase by $120; note that employment taxes would also be owed on such income).

The **average tax rate** is equal to the tax liability divided by taxable income. This rate can be useful in comparing taxpayers or a taxpayer's changed tax picture from one year to another.

The **effective tax rate** is equal to taxes paid (often the tax liability) divided by the taxpayer's ability to pay (some income measure, like adjusted gross income or disposable income). This rate is often used by policy makers to measure the progressivity of a tax system. For financial reporting purposes, effective tax rate generally refers to total tax expense as a percentage of pretax book income (see text Section 3-3c).

Example 3

In 2023, Jasmine, who is single, has adjusted gross income of $78,850, uses the standard deduction of $13,850, and has $65,000 of taxable income. Her Federal income tax computed using the Tax Rate Schedule is $9,608, determined as follows (using the Tax Rate Schedule for single taxpayers in Appendix A):

10% × $11,000	$1,100
12% × ($44,725 – $11,000)	4,047
22% × ($65,000 – $44,725)	4,461
Total Federal income tax	$9,608

- Jasmine's *statutory tax rates* are 10%, 12%, and 22%.
- Jasmine's *marginal tax rate* is 22%. Her next dollar of income is taxed at this rate (and this tax rate will be applied until she reaches $95,375 of taxable income, at which point her marginal tax rate becomes 24%).
- Jasmine's *average tax rate* is 14.78% ($9,608 ÷ $65,000).
- Jasmine's *effective tax rate* (using her AGI) is 12.19% ($9,608 ÷ $78,850).

In the example above, the statutory, marginal, average, and effective tax rates differ because they were determined using the *progressive* Federal income tax for individuals. If instead, the taxpayer was a corporation, all the tax rates would be 21 percent because the Federal corporate income tax is *proportional*.

1-2b Tax Bases

Most taxes are levied on one of four kinds of tax bases.

- Transactions [including sales or purchases of goods and services and transfers of wealth (e.g., by gift or at death)].
- Property or wealth (including ownership of specific kinds of property).

Information on criteria used in designing a tax structure can be found on this book's companion website: www.cengage.com

1 Digging Deeper

- Privileges and rights (including the ability to do business as a corporation, the right to work in a certain profession, and the ability to move goods between countries).
- Income on a gross or net-of-expenses basis.

Because the Federal income tax usually has the most significant influence when decisions are made, it is the principal focus of this text.

1-2c Incidence of Taxation

We most often think of our tax burden as including only the taxes we pay *directly* (like income taxes). But we also pay many taxes *indirectly*. Often, the *incidence* of various taxes directly paid by businesses is on the final consumer of goods and services. Similarly, the incidence of property taxes on an apartment building is primarily on the tenant rather than the owner, since the owner factors this tax into the rental rate. Individuals also bear the incidence of the corporate income tax in their capacities as employees and investor/owners.

In evaluating tax systems, it is important to consider taxes paid both directly and indirectly in order to understand the effect of taxes on individuals. Determining the incidence of all taxes, though, is not easy due to the influence of economic factors, like the effect of supply and demand on the pricing of goods and services at any point in time.

1-3 Types of Taxes

LO.3

Identify the various taxes affecting business entities and individual.

Taxes can be categorized into three broad types:[5]

1. Transaction taxes.
2. Valuation or wealth taxes.
3. Income taxes.

Each category is explained next with examples of taxes that fit within each category.

1-3a Transaction Taxes

Sales taxes and some **excise taxes** are imposed on certain transactions, such as the production, sale, or consumption of commodities or the use of services. Excise taxes and general sales taxes differ by the breadth of their bases. An excise tax base is limited to a specific kind of good or service, but a general sales tax is broad-based (e.g., it might be levied on all retail sales). All levels of government impose excise taxes, while state and local governments (but not the U.S. Federal government) make heavy use of the general sales tax.

Federal Excise Taxes

Together with customs duties, excise taxes served as the principal source of revenue for the United States during its first 150 years of existence. Since World War II, the role of excise taxes in financing the Federal government has decined steadily, falling from about 30 to 40 percent of revenues just prior to the war to about 2 percent now. During this time, the Federal government came to rely upon income and employment taxes as its principal sources of funds.

[5]A fourth type of tax is a head tax that is a fixed amount per person, such as $10 per person. There are few examples of these taxes in the U.S. so are not covered in this chapter.