

CHAPTER 1

INTRODUCTION TO TAXATION

LECTURE NOTES

OVERVIEW

The primary objective of this chapter is to provide an overview of the Federal tax system. Among the topics discussed are the following.

- The importance and relevance of taxation.
- The types of taxes imposed at the Federal, state, and local levels.
- The types of taxes imposed on various business entities.
- Tax planning and minimization strategies.
- The various considerations that impact tax law as well as the influence the Internal Revenue Service (IRS) and the courts have had in the evolution of current tax law.

SUMMARY OF CHANGES IN THE CHAPTER

The following are notable changes in the chapter from the 2020 Edition.

- Modified discussion on incidence of taxation to better address taxes paid indirectly.
- Expanded discussion of the terms *progressive* and *regressive* to also illustrate the effect of taxes; added two new examples.
- Added new problem asking students to review additional features in the textbook and how they can help in studying taxation.

THE BIG PICTURE

The Big Picture discussion in Chapter 1 addresses several situations commonly encountered by taxpayers that also create taxable income consequences. For example, students may not be familiar with the concept that gift giving (even in families) creates tax consequences for the gift giver or that working in another state subjects a taxpayer to tax in more than just his or her home state.

While students may not yet have significant exposure to all the tax issues raised in the Big Picture scenario, the exercise provides an opportunity to help students think about why tax consequences might arise and how to go about expanding their knowledge of tax law. For example, employing children in a family business raises questions about FICA withholding as well as what constitutes reasonable compensation. The student might make the link to FICA withholding after reading the chapter. However, a quick search on the IRS's web page results in a page that provides information about tax consequences that arise when hiring family members ([irs.gov/Businesses/Small-Businesses-&Self-Employed/Family-Help](https://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Family-Help)). The FICA withholding discussion might lead to a discussion of incentives related to family members' salaries which

could nicely lead into a discussion of why the IRS might be interested in auditing a family business/closely held business.

The scenario could also be integrated into a discussion of what is the “best” tax system, especially because the Carters are currently employed while the Walkers are retirees. The instructor could use this fact to address why differently situated taxpayers may have varying preferences about what type of tax system is the “best” tax system.

TAXES IN OUR LIVES

1. 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.
2. Ultimately, all taxes are paid by individuals. The corporate income tax, for example, is paid directly by the corporation, but it really is paid 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.
3. Federal, state, and local elections often include initiatives that deal with taxation. Candidates running for office often have ideas on tax changes they would like to make if they are elected.

The Relevance of Taxation to Accounting and Finance Professionals

4. A large corporation may devote about 25% of its net income to pay income taxes, plus it is 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.
5. Given its significance, taxation is a crucial topic for accounting and finance professionals. They must understand the various types of business taxes to assist effectively with:
 - a. 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.
 - b. 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.
 - c. 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.

- d. 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.
 - e. 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.
 - f. 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.
- 6. The level and depth of tax knowledge needed for any accounting or tax professional depends on his or her specific job.
 - 7. It is essential to maintain a balanced perspective when working with tax systems. Tax considerations should not control decisions, but they are one of many factors to be considered.

How to Study Taxation

- 8. 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.
- 9. Taxation is an important and exciting topic due to constant changes made by the three branches of the 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.
- 10. One should focus on understanding the rules and the why(s) behind them rather than memorizing the many isolated or disconnected rules and terms. 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.

Individuals and Taxes

11. The diagram on page 1-4 in the text illustrates the many ways individuals interact with taxes.

THE STRUCTURE OF TAX SYSTEMS

12. 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 and by the base subject to tax.

Tax Rates

13. Tax rates can be progressive, proportional, or regressive.
14. A tax rate is *progressive* if the rate increases as the tax base increases. The Federal income tax is structured as a progressive tax.
15. 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.
16. *Regressive* tax rates decrease as the tax base increases.
 - a. Federal employment taxes, such as FICA and FUTA, are regressive.
 - b. When the tax base and the taxpayer's ability to pay generally are positively correlated, 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.
17. 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).

Tax Bases

18. Most taxes are levied on one of four kinds of tax bases.
 - a. Transactions [including sales or purchases of goods and services, and transfers of wealth (e.g., by gift or at death)].
 - b. Property or wealth (including ownership of specific kinds of property).
 - c. 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).
 - d. Income on a gross or net-of-expenses basis.

Incidence of Taxation

19. A taxpayer's tax burden includes not only taxes paid *directly* (like income taxes), but also taxes paid *indirectly*. Often, the *incidence* of various taxes directly paid by businesses is on the final consumer of goods and services.
20. 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.

TYPES OF TAXES

21. In introducing the discussion of the various components of the U.S. tax system, Figure 1–1 at the end of these Lecture Notes may be a useful resource.
22. Transaction taxes include Federal and state excise taxes and state and local general sales taxes, severance taxes, death taxes, and gift taxes.

Taxes on the Production and Sale of Goods

23. Federal Excise Taxes. Examples of Federal excise taxes include those imposed on tobacco, gasoline, telephone usage, air travel, and alcohol.
 - a. Since World War II, the role of excise taxes in financing the Federal government has steadily declined, falling from about 30 to 40% of revenues just prior to the war to about 3% now.
 - b. Currently, trucks, trailers, tires, liquor, tobacco, firearms, certain sporting equipment, medical devices, and air travel all are subject to Federal excise taxes.
 - c. Excise taxes extend beyond sales transactions; they also are levied on privileges and rights.
 - d. The bases used for Federal excise taxes are as diverse as the goods that are taxed (i.e., by the gallon, by the dose, by the price paid per ticket, etc.). Some are levied on the producer, some the reseller, and some on consumers.
 - e. With the exception of Federal excise taxes on alcohol, tobacco, and firearms, Federal excise taxes are due at least quarterly, when the Federal excise tax return (Form 720) is filed.
24. State Excise Taxes. Many states levy excise taxes on the same items taxed by the Federal government.
 - a. The tax on specific goods can vary dramatically among states. These differences at the state level can provide ample incentive for smuggling between states and for state-line enterprises specializing in taxed goods.

- b. Other goods and services subject to state and local excise taxes include admission to amusement facilities; hotel occupancy; rental of other facilities; and sales of playing cards, oleomargarine products, and prepared foods. Some counties impose a tax on transfers of property that require recording of documents (such as real estate sales and sales of stock and securities).
25. Local Excise Taxes. Over the last few years, two types of excise taxes imposed at the local level have become increasingly popular: hotel occupancy tax and the rental car “surcharge.”
- a. They tax the visitor who cannot vote, and so are a political windfall and serve as a means of financing special projects that generate civic pride.
 - b. A few cities have created excise taxes that apply to digital transactions, like fees for streaming music and movies, app downloads, Uber and Lyft fares, and Airbnb rentals.
26. General Sales Tax. The broad-based general sales tax is a major source of revenue for most state and local governments. It is used in all but five states (Alaska, Delaware, Montana, New Hampshire, and Oregon).
- a. The sales tax typically employs a proportional tax rate and includes retail sales of tangible personal property (and occasionally personal services) in the base.
 - b. Some states exempt medicine and groceries from the base, and sometimes tax rates vary with the good being sold.
 - c. Local general sales taxes, over and above those levied by the state, are common.
 - d. For various reasons, some jurisdictions temporarily suspend the application of a general sales tax. Many states schedule the sales tax holiday for August back-to-school buying.
 - (1) Due to revenue shortfalls, many previously exempt categories (e.g., certain food products) are now subject to tax in some states.
 - (2) The expansion of the sales tax to the performance of personal services has increased and will likely continue to do so.
27. Use Taxes. Every state that imposes a general sales tax also applies a use tax. The purpose of the use tax is to prevent the avoidance of the sales tax through the purchase of items in other states that have no sales taxes or that provide for lower rates.

28. Value Added Tax. The value added tax (VAT) is a variation of a sales tax and is levied at each stage of production on the value added by the producer.
- a. A VAT is used by almost all countries around the world; the United States is one of the few countries that does not use a VAT.
 - b. The tax typically serves as a major source of revenue for governments that use it.

Employment Taxes

29. Both Federal and state governments tax the salaries and wages paid to employees.
- a. There are two major employment taxes on the Federal side: FICA and FUTA. These employment taxes represent a major source of funds.
 - (1) The FICA tax accounts for more than one-third of revenues in the Federal budget, second only to the income tax in its contribution.
 - (2) The FUTA tax provides funds to state unemployment benefit programs.
 - b. Most state employment taxes are similar to the FUTA tax, with proceeds used to finance state unemployment benefit payments.
30. FICA Taxes. The FICA tax has two components: old age, survivors, and disability insurance payments (commonly referred to as Social Security) and Medicare health insurance payments.
- a. The Social Security tax rate is 6.2% (for both employee and employer), and the Medicare tax rate is 1.45% (for both employee and employer). The maximum base for the Social Security tax is \$137,700 for 2020 and \$132,900 for 2019. There is no ceiling on the base amount for the Medicare tax.
 - b. Payments usually are made through weekly or monthly electronic payments or deposits to a Federal depository.
 - c. An additional 0.9% Medicare tax is imposed on earned income (including self-employment income) above \$200,000 (single filers) or \$250,000 (married filing jointly).
 - d. Unlike the Social Security tax and the regular Medicare portion, an employer does not match the employees' 0.9% additional Medicare tax.
 - e. An additional 3.8% Medicare tax is assessed on the investment income of individuals whose modified adjusted gross income exceeds \$200,000 or \$250,000.

31. **Self-Employment Tax.** Self-employed individuals also pay into the FICA system in the form of a self-employment (SE) tax. They are required to pay both the employer and the employee portion of the FICA taxes.
- a. The 2020 SE tax rate is 15.3% on self-employment income up to \$137,700 and 2.9% on all additional self-employment income.
 - b. Self-employed individuals deduct half of the SE tax—the amount normally deductible by an employer as a business expense.
32. **Unemployment Taxes.** For 2020, FUTA applies at a rate of 6.0% on the first \$7,000 of covered wages paid during the year to each employee.
- a. FUTA has a regressive rate structure.
 - b. The Federal government allows a credit for unemployment tax paid to the state. The credit cannot exceed 5.4% of the covered wages.
 - c. FUTA and state unemployment taxes differ from FICA in that the tax is imposed only on the employer.

Taxes at Death

33. The transfer of property upon the death of the owner may be a taxable event.
- a. If the tax is imposed on the transferor at death, it is called an estate tax.
 - b. If the law taxes the recipient of the property, it is termed an inheritance tax.
34. As is typical of other types of transaction taxes, the value of the property transferred provides the base for determining the amount of the tax at death.
35. The Federal government imposes an estate tax. Only a few state governments levy their own additional inheritance taxes, estate taxes, or both.
36. **The Federal Estate Tax.** The Federal estate tax was intended to prevent large concentrations of wealth from being kept within a family for many generations. Whether this objective has been accomplished is debatable, because estate taxes can be substantially reduced (or deferred for decades) through careful tax planning activities.
- a. Determination of the estate tax base begins with the gross estate, which includes property the decedent owned at the time of death.
 - b. Deductions from the gross estate in arriving at the taxable estate include funeral and administration expenses, certain taxes, debts of the decedent, and transfers to charitable organizations.

- c. A marital deduction is available for amounts passing to a surviving spouse (a widow or widower).
 - d. Once the taxable estate has been determined and certain taxable gifts have been added to it, one must determine a tentative tax liability. The tentative liability is reduced by a variety of credits to arrive at the amount due.
 - e. In 2020, \$11.58 million of a U.S. decedent's estate effectively is excluded from the estate tax, with a maximum 40% tax rate on any excess. Spouses can share a \$23.16 million estate tax exclusion.
37. State Taxes at Death. State taxes on transfers at death may include an inheritance tax, an estate tax, or both. The taxes will differ according to whether the tax is imposed on the heirs or on the estate. Some states completely exempt from taxation amounts that pass to a surviving spouse.

Gift Tax

38. The Federal gift tax is an excise tax levied on the right to transfer property. The tax is imposed on transfers made during the owner's life rather than at death.
39. The Federal gift tax is intended to complement the estate tax. The gift tax base is the sum of all taxable gifts made during one's lifetime.
40. The Federal gift tax and the Federal estate tax are unified. The transfer of assets by a decedent at death effectively is treated as a final gift under the tax law.
41. Annual taxable gifts are determined by reducing the fair market value of gifts given by an annual exclusion of \$15,000 per donee; this amount does not use up any of the lifetime exclusion. A married couple can elect gift splitting, which enables them to transfer twice the annual exclusion (\$30,000) per donee per year, before eroding the lifetime exclusion amount.
42. Taxable gifts are reduced by deductions for gifts to charity and to one's spouse (the marital deduction).
43. Gifts for medical and educational purposes may be exempt from the gift tax.

Property Taxes

44. A property tax can be a tax on the ownership of property or a tax on wealth depending on the base used. Most property taxes in the United States are taxes on wealth; they use value as a base.
45. Value-based property taxes are known as ad valorem taxes.

46. **Taxes on Realty.** Property taxes on real property, or realty, are used exclusively by states and their local political subdivisions such as cities, counties, and school districts.
- a. Realty is land and anything permanently attached to land and personalty encompasses all assets that are not realty.
 - b. The following are some of the characteristics of ad valorem taxes on realty.
 - (1) States may have a homestead exemption, which makes some portion of the value of a personal residence exempt from tax.
 - (2) Lower taxes may apply to a residence owned by a taxpayer age 65 or older.
 - (3) Some jurisdictions extend immunity from tax for a specified period of time (a tax holiday) to new or relocated businesses.
 - (4) Some states provide for lower valuations on property dedicated to agricultural use or other special uses (e.g., wildlife sanctuaries).
47. **Taxes on Personalty.** Personal property, or personalty, encompasses all assets that are not realty. Both realty and personalty can be either business use or personal use property.
- a. Personalty also can be classified as tangible property or intangible property.
 - b. The following generalizations may be made concerning the property taxes on personalty.
 - (1) Generally, for individuals, vehicles are the only non-realty personal-use assets subject to property tax. The value of a vehicle typically is established by a schedule based on the vehicle's age and make/model. Usually, any vehicle property tax is assessed and collected along with vehicle license or registration fees.
 - (2) Generally, businesses are assessed property taxes on equipment and other tangible property, although many states do not tax inventory.
 - (3) Some jurisdictions impose an ad valorem property tax on intangibles, like stocks and bonds.

Other U.S. Taxes

48. **Federal Customs Duties.** Customs duties or tariffs can be characterized as a tax on the right to move goods across national borders.

- a. These levies served as the mainstay of the Federal revenue system until slightly after the turn of the nineteenth century. Tariffs and excise taxes alone paid off the national debt in 1835 and enabled the U.S. Treasury to pay a surplus of \$28 million to the states.
 - b. In recent years, tariffs have acted more as an instrument for carrying out protectionist policies and to generate revenue.
 - c. History shows that tariffs often lead to retaliatory action on the part of the nation or nations affected.
49. **Miscellaneous State and Local Taxes.**
- a. A franchise tax is a tax on the privilege of doing business in a state or local jurisdiction. Typically, the tax is imposed by states on corporations, but the tax base varies from state to state.
 - b. Occupational taxes are applicable to various trades or businesses, such as a liquor store license, a taxicab or shared-ride permit, or a fee to practice a profession such as law, medicine, or accounting. Most of these are not significant revenue producers and fall more into the category of licenses than taxes.
50. **Severance Taxes.** Severance taxes are based on the extraction of natural resources (e.g., oil, gas, iron ore, and coal). They are an important source of revenue for many states.

Income Taxes

51. Income taxes are levied by the Federal government, most states, and some local governments. Most jurisdictions attempt to ensure the collection of income taxes by requiring certain pay-as-you-go procedures.
52. **The Structure of the Federal Income Tax.** Although some variations exist, the basic Federal income tax formula is similar for all taxable entities. This formula is shown in Exhibit 1.1 in the text.
- a. The income tax is based on the doctrine known as legislative grace: all income is subject to tax, and no deductions are allowed unless specifically provided for in the law.
 - b. All entities are allowed to deduct business expenses from gross income, but a number of limitations and exceptions are applied.
 - c. Individual rates range from 10% to 37%. Estates and trusts are also subject to income taxation, with rates ranging from 10% to 37%.

- d. Partnerships, qualifying small business corporations, and some limited liability companies are not taxable entities but must file information returns.
 - e. For individuals, deductions are separated into two categories—deductions *for* adjusted gross income (AGI) and deductions *from* AGI. An overview of the individual income tax formula is provided in Exhibit 1.2 in the text.
53. State Income Taxes. Most states impose a traditional income tax on individuals. Tennessee and New Hampshire tax only certain dividend and interest income. Most states also impose either a corporate income tax or a franchise tax based in part on corporate income.
54. Local Income Taxes. The imposition of income taxes by local jurisdictions, though not uncommon, is more the exception than the rule.
55. Concept Summary 1.1 in the text provides an overview of the major taxes existing in the United States and specifies which political jurisdiction imposes them.

INCOME TAXATION OF BUSINESS ENTITIES

Proprietorships

56. The simplest form of business entity is a proprietorship.
57. Because a proprietorship is owned by an individual, the individual has great flexibility in structuring the entity's transactions in a way that will minimize his or her marginal income tax rate.
58. The owner of the proprietorship reports the income and deductions of the business on a Schedule C and the net profit (or loss) of the proprietorship on his or her Form 1040.

C Corporations

59. Corporations that are separate taxable entities are referred to as C corporations because they are governed by Subchapter C of the Internal Revenue Code. (See Chapters 12 and 13 in the text.)
60. A C corporation files its own tax return (Form 1120) and is subject to the Federal income tax.
61. The shareholders then pay income tax on the dividends they receive when the corporation distributes its profits.

Partnerships

62. A partnership is not a separate taxable entity.

63. The partnership files a tax return (Form 1065) on which it summarizes the financial results of the business. Each partner then reports his or her share of the net income or loss and other special items that were reported on the partnership return. (See Chapter 14 in the text.)

S Corporations

64. Corporations that meet certain requirements and pay no Federal income tax at the corporate level are referred to as S corporations, because they are governed by Subchapter S of the Code. (See Chapter 15 in the text.)
65. An S corporation is treated like a C corporation for all nontax purposes. Regarding tax factors, however, an S corporation is more like a partnership.

Limited Liability Companies and Limited Liability Partnerships

66. Limited liability companies (LLCs) and limited liability partnerships (LLPs) offer limited liability and some (but not all) of the other nontax features of corporations.
67. Both forms usually are treated as partnerships for tax purposes.
68. The S corporation, limited liability company, and partnership forms of organization, which are referred to as flow-through entities, avoid the double taxation problem associated with the C corporation.

Dealings between Individuals and Their Business Entities

69. The following are some of the major interactions between owners and business entities.
- a. Owners put assets into a business when they create a business entity (e.g., a proprietorship, partnership, or corporation).
 - b. Owners take assets out of the business during its existence in the form of salary, dividends, withdrawals, redemptions of stock, etc.
 - c. Through their entities, owner-employees set up retirement plans for themselves, including IRAs and qualified retirement and pension plans.
 - d. Owners dispose of all or part of a business entity.
70. The following are a few of the many tax issues that arise.
- a. How the tax law applies at both the owner level and the entity level (i.e., the multiple taxation problem), and what effective tax rate is assessed on such income.

- b. How to move assets into the business with the least adverse tax consequences.
- c. How to pull assets and accumulated profits out of the business with the least adverse tax consequences.
- d. How to dispose of the business entity with the least adverse tax consequences.
- e. Whether certain tax rules will apply less favorably because the business and owner(s) are related parties.

TAX PLANNING FUNDAMENTALS

Overview of Tax Planning and Ethics

- 71. It is a long-standing principle that taxpayers have no obligation to pay more than their fair share of taxes.
- 72. Tax Planning: Avoidance Versus Evasion.
 - a. Minimizing taxes legally is referred to as tax avoidance.
 - b. Tax evasion is attempting to evade income taxes through illegal actions.
 - c. Clients expect tax professionals to provide advice to help them minimize their tax costs through tax planning.
- 73. The Ethics of Tax Planning. Tax planning (avoidance) is a fully ethical activity by the taxpayer and the tax professional, but tax evasion (fraud) is not.
 - a. The tax adviser's actions are limited by the codes of conduct of various professional organizations.
 - b. Other formal restrictions and directives concerning the conduct of the tax professional can be found in two broad forms.
 - (1) Penalties and interest may apply to the taxpayer when a tax liability is understated.
 - (2) Sanctions are used for tax preparers who disregard the tax law. Tax penalties also apply when the tax preparer fails to sign a tax return that he or she has worked on or takes an improper filing position on a tax return.

A General Framework for Income Tax Planning

- 74. The primary goal of tax planning is to design a transaction so as to minimize its tax costs while meeting the other nontax objectives of the client.

75. Careful analysis of the tax formula (refer to Exhibit 1.1 in the text) reveals a series of tax minimization strategies.
76. The General Framework for Income Tax Planning in Exhibit 1.3 in the text lists each element in the income tax formula, develops tax planning strategies designed to minimize taxes, and provides brief summaries of specific examples of tax planning.

Tax Minimization Strategies Related to Income

77. *Avoid income recognition.* (See Example 19 in the text.)
78. *Postpone recognition of income to achieve tax deferral.* (See Example 20 in the text.)

Tax Minimization Strategies Related to Deductions

79. *Maximize deductible amounts.* A corporation that owns stock in another corporation is eligible for a dividends received deduction (DRD).
- a. The DRD is equal to a specified percentage of the dividends received. The percentage is based on the amount of stock that the investor corporation owns in the investee corporation.
 - 50% deduction for ownership of less than 20%.
 - 65% deduction for ownership of 20% or more but less than 80%.
 - 100% deduction for ownership of 80% or more.
 - b. Example 21 in the text demonstrates the tax advantage of dividend income versus interest income.
80. *Accelerate recognition of deductions to achieve tax deferral.* (See Example 22 in the text.)

Tax Minimization Strategies Related to Tax Rates

81. *Shift net income from high-bracket years to low-bracket years.* (See Examples 23 and 24 in the text.)
82. *Shift net income from high-bracket taxpayers to low-bracket taxpayers.* (See Example 25 in the text.)
83. *Shift net income from high-tax jurisdictions to low-tax jurisdictions.* (See Examples 26 and 27 in the text.)
84. *Control the character of income and deductions.* (See Example 28 in the text.)

85. *Avoid double taxation.*

- a. Shareholders can avoid double taxation by electing that a corporate entity become an S corporation. (See Example 29 in the text.)
- b. Other entity choices can be used to avoid double taxation, including partnerships and limited liability companies.
- c. Choosing to operate as a flow-through entity is not the only way to avoid double taxation. Double taxation can be avoided or minimized by having the corporation make tax-deductible payments, such as salaries, rent, and interest to the shareholders. (See Example 30 in the text.)

Tax Minimization Strategies Related to Tax Credits86. *Maximize tax credits.* (See Example 31 in the text.)

- a. A deduction reduces taxable income, which results in a reduction of the tax paid.
- b. A tax credit reduces the tax liability dollar for dollar and is not affected by the taxpayer's tax rate.

UNDERSTANDING THE FEDERAL TAX LAW

87. The Federal tax law reflects the three branches of our Federal government. It is a mixture of laws passed by Congress, explanations provided by the Treasury Department and the Internal Revenue Service (IRS), and court decisions.

Revenue Needs

88. In an ideal world, taxes raised by the government would equal the expenses incurred by government operations.
89. The U.S. Constitution allows deficit spending, and politicians often find it hard to resist the temptation to spend more than the tax system collects currently.

Economic Considerations

90. Sometimes tax legislation is designed to help control the economy in some manner or encourage certain activities, industries, or businesses.
91. Encouragement of Certain Activities. Congress often uses the tax law to encourage certain types of economic activity or segments of the economy.
- a. The favorable treatment allowed research and development expenditures (immediate deduction vs. capitalization and amortization) can be explained by the desire to foster technological progress.

- b. Congress has used the tax depreciation rules as a means of encouraging investment in business capital.
 - c. Ecological considerations justify a tax provision that permits a more rapid expensing of the costs of installing pollution control facilities.
 - d. Considering the pressing and continuing problem of a deficit in the U.S. balance of payments, Congress has established incentives for U.S. citizens who accept employment overseas and for business entities that operate in countries outside the United States.
 - e. Saving can lead to capital formation, making funds available to finance home construction and industrial expansion. The tax law encourages saving by according preferential treatment to private retirement plans.
92. Encouragement of Certain Industries.
- a. Historically, agricultural activities have been favored under Federal tax law. Among the tax benefits are the election to expense rather than capitalize certain soil and water conservation expenditures and fertilizers and the election to defer the recognition of gain on the receipt of crop insurance proceeds.
 - b. To stimulate the research and production of alternative fuel sources, tax incentives are allowed with respect to operations and sales of solar and wind energy devices and of autos that do not consume petroleum products.
93. Encouragement of Small Business. The belief that what is good for small business is good for the economy as a whole has led to special provisions in the tax law that favor small business.

Social Considerations

94. Some provisions of the Federal tax law, particularly those dealing with individuals, can be explained by a desire to encourage certain social results.
- a. Certain benefits provided to employees through accident and health insurance plans financed by employers are nontaxable to employees.
 - b. A contribution made by an employer to a qualified pension or profit sharing plan for an employee may receive special treatment.
 - c. A deduction is allowed for contributions to qualified charities.
 - d. Various tax incentives are designed to encourage taxpayers to obtain or extend their level of education.

- e. A tax credit is allowed for amounts spent to furnish care for certain minor or disabled dependents to enable the taxpayer to seek or maintain gainful employment.
- f. A tax deduction is denied for certain expenditures deemed to be contrary to public policy (e.g., fines, penalties, illegal kickbacks, bribes to government officials, and gambling losses in excess of gains).

Equity Considerations

- 95. The concept of equity (or fairness) is relative. Lawmakers and others often consider whether a tax change is progressive or regressive to understand its impact on taxpayers and whether the change should be made.
- 96. If a tax represents the same percentage of the income of all taxpayers, it is a *proportional* tax.
- 97. The Wherewithal to Pay Concept. The wherewithal to pay concept recognizes the inequity of taxing a transaction when the taxpayer lacks the means to pay the tax.
 - a. This underlies a provision in the tax law dealing with the treatment of gain resulting from an involuntary conversion—which occurs when property is destroyed by casualty or taken by a public authority through condemnation.
 - b. If gain results from the conversion, it need not be recognized immediately if the taxpayer replaces the property within a specified time period.
- 98. Mitigating the Effect of the Annual Accounting Period Concept. The application of this annual accounting period concept can lead to dissimilar tax treatment for taxpayers who are, from a long-range standpoint, in the same economic position.

Political Considerations

- 99. A large segment of the Federal tax law is made up of statutory provisions.
- 100. Special Interest Legislation. Certain provisions of the tax law largely can be explained by the political influence some groups have had on Congress.
- 101. State and Local Government Influences. State law has had an influence in shaping our present Federal tax law.
 - a. One example of this effect is the evolution of Federal tax law in response to states with community property systems.
 - b. The difference between common law and community property systems centers around the property rights held by married persons.

- c. At one time, the tax position of the residents of community property states was so advantageous that many common law states adopted community property systems. Political pressure placed on Congress to correct the disparity in tax treatment was considerable.
- d. Congress changed the law to extend many of the community property tax advantages to residents of common law jurisdictions.
 - (1) The law change allowed married taxpayers to file joint returns and compute the tax liability as if one-half of the income had been earned by each spouse.
 - (2) The income-splitting benefits of a joint return are incorporated as part of the tax rates applicable to married taxpayers.
- e. A similar motivation can be seen for the gift-splitting provisions of the Federal gift tax and the marital deduction of the Federal estate and gift taxes.

Influence of the Internal Revenue Service

- 102. One of the keys to an effective administration of our tax system is the audit process conducted by the IRS.
- 103. The IRS influences laws by suggesting changes to Congress based on compliance problems it discovers.
- 104. The U.S. Treasury Department and the IRS also affect tax laws via the Regulations and rulings they issue that explain and interpret Code provisions.

Influence of the Courts

- 105. In addition to interpreting statutory provisions and the administrative pronouncements issued by the Treasury Department and the IRS, the Federal courts have influenced tax law in two other ways.
 - a. The courts have developed a number of judicial concepts that help guide the application of various tax provisions, going beyond the strict language of the Code and Treasury Regulations.
 - b. Certain key court decisions have led to changes in the Code and other sources of tax law.
- 106. Judicial Concepts Relating to Tax. In dealings between related parties, the courts test transactions by looking to whether the taxpayers acted in an arm's length manner.
- 107. Judicial Influence on Statutory Provisions. Some court decisions have been of such consequence that Congress has incorporated them into statutory tax law.

SUMMARY

108. Tax professionals must be adept in various skills to deliver expected levels of service to clients and the government.
- Knowledge of technical tax law.
 - Productive with technology and data analytics.
 - Strengths in business acumen and so-called soft skills, like listening and motivation.
 - Functional in problem solving and process improvement.
 - Valued contributor in project management and cost-benefit analysis.
 - Excellent verbal and written communication skills.
109. Tax planning is a means by which to manage the amount and timing of tax liabilities to accomplish one's long-term objectives.
110. The conduct of tax practitioners is regulated by professional associations, lawmakers, and the taxing agencies.
111. In addition to its necessary revenue-raising objective, the Federal tax law has developed in response to several other factors.
- a. Economic considerations. Tax provisions can help to regulate the economy and encourage certain activities and types of businesses.
 - b. Social considerations. Some tax provisions are designed to encourage (or discourage) socially desirable (or undesirable) practices.
 - c. Equity considerations. Tax provisions can alleviate the effect of multiple taxation, recognize the wherewithal to pay concept, and mitigate the effect of the annual accounting period concept.
 - d. Political considerations. Tax provisions can carry out the desires of special interest groups or reflect the effect of state and local law.
 - e. Influence of the IRS. Many tax provisions are intended to aid the IRS in the collection of revenue and the administration of the tax law.
 - f. Influence of the courts. Court decisions have established a body of judicial concepts relating to tax law and have, on occasion, led Congress to enact statutory provisions to either clarify or negate their effect.

RESEARCH PROBLEMS

Solutions to end-of-chapter Research Problems are located in the Solutions Manual.

Figure 1-1
Summary of Taxes in the United States

<u>Type of Tax</u>	<u>Imposed by Jurisdiction</u>		
	<u>Federal</u>	<u>State</u>	<u>Local</u>
Property taxes:			
Ad valorem on realty	No	Yes	Yes
Ad valorem on personalty	No	Yes	Yes
Transaction taxes:			
Excise	Yes	Yes	Few*
General sales	No	Most	Some
Severance	Yes **	Most	No
Estate	Yes	Some	No
Inheritance	No	Some	No
Gift	Yes	Few	No
Income taxes:			
Corporations	Yes	Most	Few
Individuals	Yes	Most	Few
Employment taxes:			
FICA	Yes	No	No
FUTA	Yes	Yes	No
Customs duties	Yes	No	No
Franchise taxes	No	Yes	No
Occupational taxes	Yes ***	Yes	Yes

* An example of a local excise tax might be a tax on hotel occupancy, typically referred to as a transient occupancy tax (TOT).

** For Federal public lands and continental-shelf areas.

*** An example is a fee to operate a beauty salon or barbershop.