Name: _____ Class: _____ Date: _____

Chapter 01: An_Introduction_to_Taxation_and_Understanding_the_Federal_Tax_Law

True / False

1. Because the law is complicated, most individual taxpayers are not able to complete their Federal income tax returns without outside assistance.

a. True
b. False

ANSWER: True

2. The ratification of the Sixteenth Amendment to the U.S. Constitution was necessary to validate the Federal income tax on corporations.

a. True
b. False

ANSWER: False

3. Before the Sixteenth Amendment to the Constitution was ratified, there was no valid Federal income tax on individuals.

a. True
b. False

ANSWER: False

4. The first income tax on individuals (after the ratification of the Sixteenth Amendment to the Constitution) levied tax rates from a low of 1% to a high of 6%.

a. True
b. False

ANSWER: True

5. The Federal income tax on individuals generates more revenue than the Federal income tax on corporations.

a. True
b. False

ANSWER: True

6. The pay-as-you-go feature of the Federal income tax on individuals conforms to Adam Smith's canon (principle) of certainty.

a. True
b. False

ANSWER: False

7. The Medicare component of the FICA tax (1.45% on wages) is *progressive* as the tax due increases as wages increase.

a. True
b. False

ANSWER: False

8. The Federal estate and gift taxes are examples of *progressive* rate taxes.

a. True
b. False

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ANSWER: True

9. The Federal excise tax on gasoline has a *proportional* effect on all taxpayers (that is, neither progressive or regressive).

a. True
b. False

ANSWER: False

10. Currently, the Federal corporate income tax is less *progressive* than the individual income tax.

a. True
b. False

ANSWER: True

11. Mona inherits her mother's personal residence, which she converts to a furnished rental house. These changes should affect the amount of *ad valorem* property taxes levied on the properties.

a. True
b. False

ANSWER: True

12. A *fixture* will be subject to the *ad valorem* tax on *personalty* rather than the *ad valorem* tax on *realty*.

a. True
b. False

ANSWER: False

13. Even if property tax rates are not changed, the amount of *ad valorem* taxes imposed on realty may not remain the same.

a. True
b. False

ANSWER: True

14. The *ad valorem* tax on personal use personalty is more often avoided by taxpayers than the *ad valorem* tax on business use personalty.

a. True
b. False

ANSWER: True

15. An excise tax is often used to try to influence behavior.

a. True
b. False

ANSWER: True

16. There is a Federal excise tax on hotel occupancy.

a. True
b. False

ANSWER: False

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17. The Federal gas-guzzler tax applies only to automobiles manufactured overseas and imported into the United States.

a. True
b. False

ANSWER: False

18. The amount of the state excise taxes on gasoline varies from state to state.

a. True
b. False

ANSWER: True

19. Not all of the states that impose a general sales tax also have a use tax.

a. True
b. False

ANSWER: False

20. Sales made over the internet are not exempt from the application of a general sales (or use) tax.

a. True
b. False

ANSWER: True

21. Two persons who live in the same state but in different counties may not be subject to the same general sales tax rate.

a. True
b. False

ANSWER: True

22. States impose either a state income tax *or* a general sales tax, but not both types of taxes.

a. True
b. False

ANSWER: False

23. A safe and easy way for a taxpayer to avoid local and state sales taxes is to make the purchase in a state that levies no such taxes.

a. True
b. False

ANSWER: False

24. On transfers by death, the Federal government relies on an estate tax, while states may impose an estate tax, an inheritance tax, both taxes, or neither tax.

a. True
b. False

ANSWER: True

25. An inheritance tax is a tax on a decedent's right to pass property at death.

a. True

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b. False

ANSWER: False

26. One of the major reasons for the enactment of the Federal estate tax was to prevent large amounts of wealth from being accumulated within a family unit.

a. True
b. False

ANSWER: True

27. Under Clint's will, all of his property passes to either the Lutheran Church or to his spouse. No Federal estate tax will be due on Clint's death.

a. True
b. False

ANSWER: True

28. Under the usual state inheritance tax, two heirs, a cousin and a son of the deceased, would not be taxed at the same rate.

a. True
b. False

ANSWER: True

29. The annual exclusion, currently $18,000, is available for gift and estate tax purposes.

a. True
b. False

ANSWER: False

30. In 2024, José, a widower, sells land (fair market value of $100,000) to his daughter, Linda, for $50,000. José has not made a taxable gift.

a. True
b. False

ANSWER: False

31. Julius, a married taxpayer, makes gifts to each of his six children. A maximum of twelve annual exclusions could be allowed as to these gifts.

a. True
b. False

ANSWER: True

32. One of the motivations for making a gift is to save on income taxes.

a. True
b. False

ANSWER: True

33. The formula for the Federal income tax on corporations is the same as that applicable to individuals.

a. True

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b. False

ANSWER: False

34. A state income tax *can* be imposed on *nonresident* taxpayers who earn income within the state on an itinerant basis.

a. True
b. False

ANSWER: True

35. For state income tax purposes, some states allow a credit for dependents rather than a deduction.

a. True
b. False

ANSWER: True

36. Some states use their state income tax return as a means of collecting unpaid use tax.

a. True
b. False

ANSWER: True

37. No state may offer an income tax amnesty program more than once.

a. True
b. False

ANSWER: False

38. For Federal income tax purposes, there never has been a general amnesty period.

a. True
b. False

ANSWER: True

39. Under state amnesty programs, all delinquent and unpaid income taxes are forgiven.

a. True
b. False

ANSWER: False

40. When a state decouples from a Federal tax provision, it means that this provision will *not* apply for state income tax purposes.

a. True
b. False

ANSWER: True

41. The principal objective of the FUTA tax is to provide some measure of retirement security.

a. True
b. False

ANSWER: False

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42. Currently, the tax base for the Social Security component of the FICA is *not* limited to a dollar amount.

a. True
b. False

ANSWER: False

43. A parent employs her twin daughters, age 17, in her sole proprietorship. The daughters are *not* subject to FICA coverage.

a. True
b. False

ANSWER: True

44. Unlike FICA, FUTA requires that employers comply with state as well as Federal rules.

a. True
b. False

ANSWER: True

45. A major advantage of a flat tax type of income tax is its simplicity.

a. True
b. False

ANSWER: True

46. The value added tax (VAT) *has not* had wide acceptance in the international community.

a. True
b. False

ANSWER: False

47. If more IRS audits are producing a higher number of *no change* results, this indicates increased compliance on the part of taxpayers.

a. True
b. False

ANSWER: False

48. The amount of a taxpayer's itemized deductions *will* increase the chance of being audited by the IRS.

a. True
b. False

ANSWER: True

49. An office audit by the IRS takes place at the office of the taxpayer.

a. True
b. False

ANSWER: False

50. The IRS agent auditing the return *will* issue an RAR even if the taxpayer owes no additional taxes.

a. True

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b. False

ANSWER: True

51. If a special agent becomes involved in the audit of a return, this indicates that the IRS suspects that fraud is involved.

a. True
b. False

ANSWER: True

52. If a taxpayer files early (i.e., before the due date of the return), the statute of limitations on assessments begins on the date the return is filed.

a. True
b. False

ANSWER: False

53. For omissions from gross income in excess of 25% of that reported, there is no statute of limitations on additional income tax assessments by the IRS.

a. True
b. False

ANSWER: False

54. If an income tax return is *not* filed by a taxpayer, there is no statute of limitations on assessments of tax by the IRS.

a. True
b. False

ANSWER: True

55. If fraud is involved, there is no time limit on the assessment of a deficiency by the IRS.

a. True
b. False

ANSWER: True

56. The IRS is required to redetermine the interest rate on underpayments and overpayments once a year.

a. True
b. False

ANSWER: False

57. A calendar year taxpayer files his 2023 Federal income tax return on March 4, 2024. The return reflects an overpayment of $6,000, and the taxpayer requests a refund of this amount. The refund is paid on May 16, 2024. The refund need not include interest.

a. True
b. False

ANSWER: True

58. For individual taxpayers, the interest rate for income tax refunds (overpayments) *is* the same as that applicable to assessments (underpayments).

a. True

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b. False

ANSWER: True

59. During any month in which both the failure to file penalty and the failure to pay penalty apply, the failure to file penalty is *increased* by the amount of the failure to pay penalty.

a. True
b. False

ANSWER: False

60. When interest is charged on a deficiency, any part of a month counts as a full month.

a. True
b. False

ANSWER: False

61. For the negligence penalty to apply, the underpayment must be caused by intentional disregard of rules and regulations without intent to defraud.

a. True
b. False

ANSWER: True

62. Upon audit by the IRS, Faith is assessed a deficiency of $40,000 of which $25,000 is attributable to negligence. The 20% negligence penalty will apply to $25,000.

a. True
b. False

ANSWER: True

63. If a tax deficiency is attributable to fraud, the negligence penalty will not be imposed.

a. True
b. False

ANSWER: True

64. The *civil* fraud penalty can entail large fines and possible incarceration.

a. True
b. False

ANSWER: False

65. Even though a client refuses to correct an error on a past return, it may be possible for a practitioner to continue to prepare returns for the client.

a. True
b. False

ANSWER: True

66. In preparing an income tax return, the use of a client's estimates is *not* permitted.

a. True

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b. False

ANSWER: False

67. In preparing a tax return, all questions on the return must be answered.

a. True

b. False

ANSWER: False

68. A CPA firm in California sends many of its less complex tax returns to be prepared by a group of accountants in India. If certain procedures are followed, this outsourcing of tax return preparation is proper.

a. True

b. False

ANSWER: True

69. The objective of *pay-as-you-go* (*paygo*) is to improve administrative feasibility.

a. True

b. False

ANSWER: True

70. When Congress enacts a tax cut that is phased in over a period of years, revenue neutrality is achieved.

a. True

b. False

ANSWER: False

71. A tax cut enacted by Congress that contains a *sunset provision* will make the tax cut temporary.

a. True

b. False

ANSWER: True

72. The tax law provides various tax credits, deductions, and exclusions that are designed to encourage taxpayers to obtain additional education. These provisions can be justified on both economic and equity grounds.

a. True

b. False

ANSWER: False

73. Various tax provisions encourage the creation of certain types of retirement plans. Such provisions can be justified on both economic and social grounds.

a. True

b. False

ANSWER: True

74. To lessen or eliminate the effect of multiple taxation, a taxpayer who is subject to both foreign and U.S. income taxes on the same income is allowed either a deduction or a credit for the foreign tax paid.

a. True

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b. False

ANSWER: True

75. To mitigate the effect of the annual accounting period concept, the tax law permits the carryforward of excess charitable contributions of a particular year to other years.

a. True

b. False

ANSWER: True

76. Jason's business warehouse is destroyed by fire. Because the insurance proceeds exceed the basis of the property, a gain results. If Jason shortly reinvests the proceeds in a new warehouse, no gain is recognized due to the application of the wherewithal to pay concept.

a. True

b. False

ANSWER: True

77. Because it is consistent with the wherewithal to pay concept, the tax law requires a seller to recognize a gain in the year the installment sale occurs.

a. True

b. False

ANSWER: False

78. Stealth taxes have the effect of generating additional taxes from all taxpayers.

a. True

b. False

ANSWER: False

79. A provision in the law that compels accrual basis taxpayers to pay a tax on prepaid income in the year received and *not* when earned is consistent with generally accepted accounting principles.

a. True

b. False

ANSWER: False

80. As a matter of administrative convenience, the IRS would prefer to have Congress decrease (rather than increase) the amount of the standard deduction allowed to individual taxpayers.

a. True

b. False

ANSWER: False

81. In cases of doubt, courts have held that tax relief provisions should be broadly construed in favor of taxpayers.

a. True

b. False

ANSWER: False

82. On occasion, Congress has to enact legislation that clarifies the tax law in order to change a result reached by the U.S.

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Supreme Court.

a. True
b. False

ANSWER: True

83. Ultimately, most taxes are paid by individuals.

a. True
b. False

ANSWER: True

84. The majority of IRS audits are handled by correspondence.

a. True
b. False

ANSWER: True

85. Sally's neighbor often brags that his employer often pays him in cash "off the books" to save him taxes. Sally is tired of hearing this and contacts the IRS to report the neighbor. If this tip results in taxes collected by the IRS, Sally will likely receive an award of a portion of the tax and penalties collected.

a. True
b. False

ANSWER: True

86. Bracket creep will not exist if there is only a single (flat) tax rate for the income tax.

a. True
b. False

ANSWER: True

Multiple Choice

87. Which, if any, of the following statements best describes the history of the Federal income tax?

a. It did not exist during the Civil War.
b. The Federal income tax on corporations was held by the U.S. Supreme Court to be allowable under the U.S. Constitution.
c. The Federal income tax on individuals was held by the U.S. Supreme Court to be allowable under the U.S. Constitution.
d. Both the Federal income tax on individuals and on corporations was held by the U.S. Supreme Court to be contrary to the U.S. Constitution.

ANSWER: b

88. Which, if any, is *not* one of Adam Smith's canons (principles) of taxation?

a. Economy in collection
b. Certainty
c. Convenience of payment
d. Simplicity

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ANSWER: d

89. Which, if any, of the following taxes are *regressive* (rather than *progressive*)?
    a. State general sales tax
    b. Federal individual income tax
    c. Federal estate tax
    d. Federal gift tax

ANSWER: a

90. Which, if any, of the following transactions will *increase* a taxing jurisdiction's revenue from the *ad valorem* tax imposed on real estate?
    a. A resident dies and leaves his farm to his church.
    b. A large property owner issues a conservation easement as to some of her land.
    c. A tax holiday issued 10 years ago has expired.
    d. A bankrupt motel is acquired by the Red Cross and is to be used to provide housing for homeless persons.
    e. None of these choices are correct.

ANSWER: c

91. Which, if any, of the following transactions will *decrease* a taxing jurisdiction's *ad valorem* tax revenue imposed on real estate?
    a. A tax holiday is granted to an out-of-state business that is searching for a new factory site.
    b. An abandoned church is converted to a restaurant.
    c. A public school is razed and turned into a city park.
    d. A local university sells a dormitory that will be converted for use as an apartment building.

ANSWER: a

92. Which, if any, of the following is a typical characteristic of an *ad valorem* tax on personalty?
    a. Taxpayer compliance is greater for personal use property than for business use property.
    b. The tax on automobiles sometimes considers the age of the vehicle.
    c. Most states impose a tax on intangibles.
    d. The tax on intangibles generates considerable revenue as it is difficult for taxpayers to avoid.

ANSWER: b

93. Federal excise taxes that are *no longer imposed* include:
    a. Tax on air travel.
    b. Tax on wagering.
    c. Tax on alcohol.
    d. None of these choices are correct.

ANSWER: d

94. Taxes *not imposed* by the Federal government include:
    a. Tobacco excise tax.
    b. Customs duties (tariffs on imports).

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c. Tax on rental cars.
d. Gas guzzler tax.

ANSWER: c

95. Taxes levied by *both* states and the Federal government include:
a. General sales tax.
b. Customs duties.
c. Hotel occupancy tax.
d. None of these choices are correct.

ANSWER: d

96. Taxes levied by *all* states include:
a. Tobacco excise tax.
b. Individual income tax.
c. Inheritance tax.
d. General sales tax.

ANSWER: a

97. A use tax is imposed by:
a. The Federal government and all states.
b. The Federal government and a majority of the states.
c. All states but not the Federal government.
d. Most of the states but not the Federal government.

ANSWER: d

98. Gabriele and Lisa are married and live in a common law state. They want to make gifts to their four children in 2024. What is the maximum amount of the annual exclusion they will be allowed for these gifts?
a. $18,000.
b. $36,000.
c. $72,000.
d. $144,000.

ANSWER: d

99. Property can be transferred within the family group by gift or at death. One motivation for preferring the gift approach is:
a. To take advantage of the higher unified transfer tax credit available under the gift tax.
b. To avoid a future decline in value of the property transferred.
c. To take advantage of the per donee annual exclusion.
d. To shift income to higher bracket donees.

ANSWER: c

100. Indicate which, if any, statement is *incorrect*. State income taxes:
a. Can piggyback to the Federal version.

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b. Cannot apply to visiting nonresidents.
c. Can decouple from the Federal version.
d. Can provide occasional amnesty programs.

ANSWER: b

101. State income taxes *generally* can be characterized by:
a. The same date for filing as the Federal income tax.
b. No provision for withholding procedures.
c. Allowance of a deduction for Federal income taxes paid.
d. Applying only to individuals but not to corporations.

ANSWER: a

102. A characteristic of FICA tax is that:
a. It does not apply when one spouse works for the other spouse.
b. It is imposed only on the employer.
c. It provides a modest source of income in the event of loss of employment.
d. None of these choices are correct.

ANSWER: d

103. A characteristic of FUTA is that:
a. It is imposed on both employer and employee.
b. It is imposed solely on the employee.
c. Compliance requires following guidelines issued by both state and Federal regulatory authorities.
d. It is applicable to spouses of employees but *not* to any children under age 18.

ANSWER: c

104. The United States (either Federal, state, or local) *does not* impose:
a. Franchise taxes.
b. Severance taxes.
c. Custom duties.
d. Export duties.

ANSWER: d

105. The proposed *flat tax*:
a. Would increase the number of deductions available to individuals.
b. Would not require individuals to file returns.
c. Would tax the increment in value as goods move through the production and manufacturing stages to the marketplace.
d. Is a type of consumption tax.

ANSWER: d

106. A VAT (value added tax):
a. Is regressive in its effect.

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b. Has not proved popular outside of the United States.
c. Is *not* a tax on consumption.
d. Is used exclusively by third world (less developed) countries.

ANSWER: a

107. Characteristics of the "fair tax" (i.e., national sales tax) include which, if any, of the following:
a. Abolition of the Federal individual (but not the corporate) income tax.
b. Abolition of all Federal income taxes but retention of payroll taxes (including the self-employment tax).
c. Abolition of all Federal income taxes and payroll taxes but retention of the Federal estate and gift taxes.
d. Abolition of all Federal income and payroll taxes as well as the Federal estate and gift taxes.

ANSWER: d

108. In terms of probability, which of the following taxpayers would be *least likely* to be audited by the IRS?
a. Taxpayer owns and operates a check-cashing service.
b. Taxpayer is an employed electrician.
c. Taxpayer just received a $3 million personal injury award as a result of a lawsuit.
d. Taxpayer just won a $1 million slot machine jackpot at a Las Vegas casino.

ANSWER: b

109. Which of the following *is* a characteristic of the audit process?
a. Most taxpayer audits involve "special" agents.
b. Self-employed taxpayers are less likely to be selected for audit than employed taxpayers.
c. Less important issues are handled by means of a correspondence audit.
d. If a taxpayer disagrees with the IRS auditor's finding, the only resort is to the courts.

ANSWER: c

110. David files his tax return 45 days after the due date. Along with the return, David remits a check for $40,000. Which is the balance of the tax owed. Disregarding the interest element, David's total failure to file and to pay penalties are:
a. $400.
b. $3,600.
c. $4,000.
d. $4,400.

ANSWER: c

111. A characteristic of the fraud penalties is:
a. When negligence and civil fraud apply to a deficiency, the negligence penalty predominates.
b. When criminal fraud can result in a fine and a prison sentence.
c. When the criminal fraud penalty is 75% of the deficiency attributable to the fraud.
d. When the IRS has the same burden of proof in the case of criminal fraud as with civil fraud.

ANSWER: b

112. Regarding proper ethical accounting guidelines, which, if any, of the following is correct?
a. The use of client estimates in preparing a return may be acceptable.

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b. Under no circumstances should a question on a tax return be left unanswered.
c. If a client has made a mistake in a prior year's return and refuses to correct it, the accountant should withdraw from the engagement.
d. If the exact amount of a deduction is not certain (e.g., around mid-$600s), it *should* be recorded as an odd amount (i.e., $649) so as to increase the appearance of greater certainty.

ANSWER: a

113. Both economic and social considerations can be used to justify:
a. Favorable tax treatment for accident and health plans provided for employees and financed by employers.
b. Disallowance of any deduction for expenditures deemed to be contrary to public policy (e.g., fines, penalties, illegal kickbacks, bribes to government officials).
c. Various tax credits, deductions, and exclusions that are designed to encourage taxpayers to obtain additional education.
d. Allowance of a deduction for state and local income taxes paid.

ANSWER: c

114. Social considerations can be used to justify:
a. Allowance of a credit for child care expenses.
b. Allowing excess capital losses to be carried over to other years.
c. Allowing accelerated amortization for the cost of installing pollution control facilities.
d. Allowing a Federal income tax deduction for state and local sales taxes.

ANSWER: a

115. Allowing a tax credit for certain solar energy property can be justified:
a. As helping small businesses.
b. As promoting administrative feasibility.
c. As promoting a government policy to use alternative energy sources.
d. Based on the wherewithal to pay concept.

ANSWER: c

116. Provisions in the tax law that promote energy conservation and more use of alternative (nonfossil) fuels can be justified by:
a. Political considerations.
b. Economic and social considerations.
c. Promoting administrative feasibility.
d. Encouragement of small business.

ANSWER: b

117. Which, if any, of the following provisions *cannot* be justified as mitigating the effect of the annual accounting period concept?
a. Nonrecognition of gain allowed for involuntary conversions.
b. Net operating loss carryover provisions.
c. Use of the installment method to recognize gain.
d. Carryover of excess capital losses.

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ANSWER: a

118. Which, if any, of the following provisions of the tax law *cannot* be justified as promoting administrative feasibility (simplifying the task of the IRS)?

a. Penalties are imposed for failure to file a return or pay a tax on time.
b. Annual adjustments for indexation increases the amount of the standard deduction allowed.
c. Personal casualty losses in Federally declared disaster areas must exceed 10% of AGI to be deductible.
d. A deduction is allowed for charitable contributions.

ANSWER: d

119. A landlord leases property upon which the tenant makes improvements. The improvements are significant and are not made in lieu of rent. At the end of the lease, the value of the improvements is not income to the landlord. This rule is an example of:

a. A clear reflection of income result.
b. The tax benefit rule.
c. The arm's length concept.
d. The wherewithal to pay concept.

ANSWER: d

120. Before proposing that the state's sales tax be expanded to include food, a legislator should ask whether:

a. The state tax agency will allow this expansion.
b. A majority of his constituents agree.
c. Grocery stores will be able to collect the tax.
d. The state's constitution allows for this tax.

ANSWER: d

121. Jane is the tax director for Tangent Software Corporation. She is unsure whether Tangent is required to charge sales tax when software is provided to customers in State X via the "cloud." This indicates that the sales tax does not meet the principle of:

a. Equity.
b. Certainty.
c. Neutrality.
d. Economic growth and efficiency.

ANSWER: b

122. Two years ago, State Y enacted a new income tax credit for college prep materials. The credit is available to individuals and is equal to 40% of the cost of the items. The credit may not exceed $50 in any year. State Y's director of finance has discovered this year that the amount of credit claimed is far higher than expected. Which principle of good tax policy might not have been considered in designing this tax that caused the original cost estimate to be too low?

a. Equity.
b. Simplicity.
c. Economy in collection.
d. Minimum tax gap.

ANSWER: d

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123. Which of the following statements about a value added tax (VAT) is false?
   a. Many countries use a VAT.
   b. The United States has imposed a VAT since 1913.
   c. A VAT has been proposed in the United States to replace part of the income tax.
   d. A VAT operates similarly to a sales tax.

ANSWER: b

124. The quote engraved on the IRS building in Washington, DC, at the entrance states:
   a. Nothing is certain, except death and taxes.
   b. Taxes are what we pay for civilized society.
   c. Everyone welcome.
   d. Taxes are the most difficult thing in the world to understand.

ANSWER: b

125. Tax functions that accounting and finance professionals may assist clients with include all but the following:
   a. Tax compliance.
   b. ESG reporting of certain tax information.
   c. Cash management to ensure timely payment of taxes.
   d. Tax evasion.

ANSWER: d

126. Who among the following individuals does not need to have a PTIN?
   a. Sally, a paid intern at a CPA firm, who helps prepare simple returns but does not sign them.
   b. Tam who reviews and signs returns for paying clients.
   c. Jeff who mostly does data entry at the CPA firm where he works but also occasionally handles interview with clients to obtain their tax information.
   d. Pooja who volunteers at an IRS tax preparation site to prepare simple returns for individuals eligible for the free assistance.

ANSWER: d

127. A rationale for the installment sale method tax rule is:
   a. Ability to pay.
   b. Equity and fairness.
   c. Simplicity.
   d. Revenue neutrality.

ANSWER: a

128. The AICPA Statements on Standards for Tax Services are:
   a. Enforceable.
   b. Educational.
   c. Out of date.
   d. Do not exist.

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ANSWER: a

129. "Bracket creep" is avoided by:
   a. Using sunset provisions.
   b. Providing special tax rules for small businesses.
   c. The statute of limitations.
   d. Adjusting the rate brackets for inflation annually.

ANSWER: d

130. A CPA assisting a client with an IRS examination is subject to the following requirement.
   a. The Taxpayer Bill of Rights.
   b. Circular 230.
   c. The Safeguards Rule.
   d. Completion of the IRS Enrolled Agent exam.

ANSWER: b

Matching

Match the statements that relate to each other. Note: Some choices may be used more than once or not at all.

a. Deferral of gains from involuntary conversions
b. Carryforward of net operating losses
c. "No change" is a possible result
d. State income tax applied to a visiting nonresident
e. IRS special agent
f. Undoing the "piggyback" result
g. Ideal budget goal as to new tax legislation
h. Every state that has a general sales tax has one
i. Imposed by all states and the Federal government
j. Imposed by some states but not the Federal government
k. Imposed only by the Federal government
l. No correct match provided

131. Employee temporarily working in another state for two months
ANSWER: d

132. Decoupling
ANSWER: f

133. Discriminant Function (DIF)
ANSWER: l

134. Tax fraud suspected
ANSWER: e

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135. Revenue neutrality
ANSWER: g

136. Revenue Agent's Report (RAR)
ANSWER: c

137. Wherewithal to pay concept
ANSWER: a

138. Mitigation of the annual accounting period concept
ANSWER: b

139. Tax on transfers at death (inheritance type)
ANSWER: j

140. Excise tax on tobacco
ANSWER: i

141. Use tax
ANSWER: h

142. Income tax amnesty
ANSWER: j

143. Import taxes (customs duties)
ANSWER: k

144. “Pay as you go” (paygo)
ANSWER: g

145. Export taxes
ANSWER: l

Using the following choices, show the justification for each provision of the tax law listed.

a. Economic considerations
b. Social considerations
c. Equity considerations
d. Both a. and b.

146. A tax credit for amounts spent to furnish care for children while the parent is at work.
ANSWER: b

147. Additional depreciation deduction allowed for the year the asset is acquired.
ANSWER: a

148. Tax brackets are increased for inflation.

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ANSWER: c

149. A small business corporation can elect to avoid the corporate income tax.
ANSWER: a

150. A deduction for contributions by an employee to certain retirement plans.
ANSWER: d

151. A deduction for qualified tuition paid to obtain higher education.
ANSWER: d

152. A deduction for certain expenses (interest and taxes) incident to home ownership.
ANSWER: d

153. A Federal deduction for state and local income taxes paid.
ANSWER: c

154. A deduction for interest on student loans.
ANSWER: d

155. A bribe to the local sheriff, although business related, is not deductible.
ANSWER: b

156. Contributions to charitable organizations are deductible.
ANSWER: b

157. A Federal deduction for state and local sales taxes paid.
ANSWER: c

158. Tax credits available for the purchase of a vehicle that uses alternative (nonfossil) fuels.
ANSWER: a

159. Tax credits for home improvements that conserve energy.
ANSWER: a

160. More rapid expensing for tax purposes of the costs of installing pollution control devices.
ANSWER: a

Match the statements that relate to each other. Note: Some choices may be used more than once.

a. Three years from date return is filed
b. Three years from due date of return
c. 20% of underpayment
d. 5% per month (25% limit)
e. 0.5% per month (25% limit)
f. Conducted at IRS office

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g. Conducted at taxpayer's office
h. Six years
i. 45-day grace period allowed to IRS
j. No statute of limitations (period remains open)
k. 75% of underpayment
l. No correct match provided

161. Office audit
ANSWER: f

162. Field audit
ANSWER: g

163. Failure to file penalty
ANSWER: d

164. Failure to pay penalty
ANSWER: e

165. Negligence penalty
ANSWER: c

166. Criminal fraud penalty
ANSWER: l

167. Fraud and statute of limitations
ANSWER: j

168. Early filing and statute of limitations (deficiency situations)
ANSWER: b

169. Late filing and statute limitations (deficiency situations)
ANSWER: a

170. No return and statute limitations
ANSWER: j

171. More than 25% gross income omission and statute of limitations
ANSWER: h

172. Interest due on refund
ANSWER: i

Subjective Short Answer

173. Taylor, a widow, makes cash gifts to her five married children (including their spouses) and to her seven

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grandchildren. What is the maximum amount Taylor can give for calendar year 2024 without using her unified transfer tax credit?

ANSWER: $306,000 [$18,000 (annual exclusion) × 17 donees].

174. For the tax year 2023, Noah reported gross income of $300,000 on his timely filed Federal income tax return.

a. Presuming that the general rule applies, when does the statute of limitations on assessments normally expire?

b. Suppose that Noah inadvertently omitted gross income of $76,000. When does the statute of limitations on assessments expire?

c. Suppose the omission was deliberate, not inadvertent. When does the statute of limitations on assessments expire?

ANSWER:
a. Three years from April 15, 2024.
b. If more than 25% of gross income is omitted, a six-year statute applies (i.e., six years from April 15, 2024). In this case, it does because $76,000 is more than $75,000 (25% × $300,000).
c. If fraud is involved, the statute never expires.

175. Without obtaining an extension, Pam files her income tax return 55 days after the due date. With her return, she pays an additional tax of $60,000. Disregarding any interest element, what is Pam's penalty for failure to pay and to file?

ANSWER: $6,000. Disregarding the interest element, Pam's total penalties are as follows:

Failure to pay penalty (0.5% × $60,000 × 2 months)		$ 600
Plus: Failure to file penalty (5% × $60,000 × 2 months)	$6,000	
Less failure to pay penalty for same period	(600)	5,400
Total penalties		$6,000

176. On his 2024 income tax return, Andrew omitted income and overstated deductions to the extent that his income tax was understated by $500,000. Disregarding any interest element, what is Andrew's penalty if the understatement was due to:

a. Negligence.
b. Civil fraud.
c. Criminal fraud.

ANSWER:
a. $100,000 (20% × $500,000).
b. $375,000 (75% × $500,000).
c. Various fines and/or prison sentence.

177. Several years ago, Logan purchased extra grazing land for his ranch at a cost of $240,000. In 2024, the land is

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condemned by the state for development as a highway maintenance depot. Under the condemnation award, Logan receives $600,000 for the land. Within the same year, he replaces the property with other grazing land. What is Logan's tax situation if the replacement land cost:

a. $210,000?
b. $360,000?
c. $630,000?
d. Why?

ANSWER:
a. The full realized gain of $360,000 [$600,000 (condemnation proceeds) – $240,000 (cost of land)] must be recognized, because only $210,000 was reinvested. The condemnation proceeds of $600,000 exceed the amount reinvested by more than $360,000.
b. Because only $360,000 was reinvested in replacement property, $240,000 ($600,000 – $360,000) of the gain must be recognized.
c. Because the full $600,000 was reinvested, no realized gain need be recognized.
d. If some of the gain is not reinvested, consistent with the wherewithal to pay concept, there exists the ability to pay the tax. Thus, gain is recognized to the extent the proceeds are not reinvested.

178. Paige is the sole shareholder of Citron Corporation. During the year, she leases a building to Citron for a monthly rental of $80,000. If the fair rental value of the building is $60,000, what are the income tax consequences to the parties involved?

ANSWER: The rent charged by Paige is not "arms length"; as such, Citron Corporation's rent deduction is $60,000 (not $80,000). The $20,000 difference is a nondeductible dividend distribution. For Paige, the change merely requires reclassification. Instead of $80,000 of rent income, she has $60,000 of rent income and $20,000 of dividend income.

179. In 1993, Martina leased real estate to Drab Corporation for 20 years. Drab Corporation made significant capital improvements to the property. In 2012, Drab decided not to renew the lease and vacated the property. At that time, the value of the improvements was $800,000. Martina sells the real estate in 2024 for $1,200,000 of which $900,000 is attributable to the improvements. When is Martina taxed on the improvements made by Drab Corporation?

ANSWER: Martina is not subject to taxation on the improvements until she disposes of the property (i.e., 2024). After a controversial Supreme Court decision years ago, Congress clarified the tax law to make it more consistent with the wherewithal to pay concept.

Essay

180. The Federal income tax is based on a pay-as-you-go system and has become a "mass tax." Explain this statement.

ANSWER: The pay-as-you-go system is present in the wage and other withholding procedures. In the case of self-employed persons, it is manifested in the required quarterly payments for estimated taxes. The income tax became a mass tax during World War II when its coverage was extended to 74% of the population (from less than 6% in 1939).

181. In terms of Adam Smith's canons of taxation, how do state sales taxes fare as far as *convenience of payment* is concerned?

ANSWER: Because the sales tax is owed at the time of purchase, the taxpayer is able to determine if they can afford to pay the tax and it is collected at that time rather than say, for example, at the end of the buyer's tax year..

182. Due to population change, Goose Creek School District has decided to close one of its high schools. Since it has no

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further need of the property, the school is listed for sale. The two bids it receives are as follows:

United Methodist Church	$1,700,000
Planet Motors	1,600,000

The United Methodist Church would use the property to establish a sectarian middle school. Planet, a well-known car dealership, would revamp the property and operate it as a branch location.

If you were a member of the School District board, what factors would you consider in evaluating the two bids?

ANSWER: Although the bid from the United Methodist Church is higher, several other factors need to be considered. Does, for example, Goose Creek School District exempt property owned by churches from its *ad valorem* taxes? If so, losing this property from the tax base could prove very costly over the long run. Also, it is probable that income-producing property (such as a car dealership) would be taxed at a higher rate than that owned by a nonprofit organization (a school operated by a church). This assumes, of course, that the school would be taxed at all. The auto dealership also would generate sales tax.

183. Morgan inherits her father's personal residence including all of the furnishings. She plans to add a swimming pool and sauna to the property and rent it as a furnished house. What are some of the *ad valorem* property tax issues Morgan can anticipate?

ANSWER: The real estate taxes probably will increase for several reasons. The capital improvements and the conversion from residential to rental will trigger the increase. Furthermore, the furnishings may generate an *ad valorem* tax on personalty. (Depending on applicable law, furniture might not be subject to tax unless used for business purposes—such as in this case.)

184. In 2022, Deborah became 65 years old. In 2023 she added a swimming pool and in 2024 she converted the residence to rental property and moved into an assisted living facility. Since 2021, Deborah's *ad valorem* property taxes have decreased once and increased twice. Explain.

ANSWER: The decrease probably came in 2022 when Deborah reached age 65. The increases probably occurred in 2023 when she added the pool and in 2024 when the residence was converted to rental property with the property reassessed due to the change in use and/or removal of the homestead exemption.

185. A lack of compliance in the payment of use taxes can be resolved by several means. In this regard, comment on the following:

a. Registration of automobiles.
b. Reporting of Internet purchases on state income tax returns.

ANSWER: a. As reflected in Example 5, re-registration of a car purchased out of state is the occasion for the owner's home state to collect the use tax.
b. Completing the state income tax return reminds (or forces) the taxpayer to pay use tax on out of state purchases.

186. What are the pros and cons of the following state and local tax provisions?

a. An *ad valorem* property tax holiday made available to a manufacturing plant that is relocating.
b. Hotel occupancy tax and a rental car surcharge.
c. A back-to-school sales tax holiday.

ANSWER: a. Such a holiday is designed to attract new industry to the area. This will bring more jobs and growth in consumption. On the other hand, if the tax holiday is

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too generous, this places a strain on available public revenue. The result could be that schools and capital maintenance (roads, public services) will suffer.

b. The hotel occupancy tax and car rental surcharges are popular because they mainly impact visitors. Also, they can generate considerable revenue to finance major capital improvements. If these taxes become excessive, however, they could discourage major events (such as conventions).

c. Such holidays are popular with both merchants and consumers and serve the social need of defraying some of the costs of sending children to school. Once established, however, they are difficult to get rid of. Thus, they become an annual drain on sales tax revenue.

In addition, since they are available to buyers at all income levels, they provide tax savings to taxpayers who do not need them and who might obtain greater tax breaks than others, as they have more funds to spend on the tax free items.

187. What is a severance tax? How productive can it be in terms of generating revenue?

ANSWER: A severance tax is one imposed when natural resources (e.g., oil, gas, iron ore, coal) are extracted. It is based on the notion that the state has an interest in such resources. For some states, the revenue from severance taxes can be significant. Alaska, for example, relies heavily on its severance taxes and has been able to avoid both a state income tax and a general sales tax.

188. What is the difference between an inheritance tax and an estate tax? Who imposes these taxes?

ANSWER: An inheritance tax is a tax on the right to receive property from a decedent. An estate tax is imposed on the right to pass property at death. The Federal government imposes estate taxes and states impose inheritance taxes. Some states impose both, whereas others impose neither.

189. Antonio dies with an estate worth $20 million. Under his will, $10 million passes to his spouse and $10 million goes to his church. What is Antonio's Federal estate tax result?

ANSWER: None. After a marital deduction of $10 million and a charitable deduction of $10 million, Antonio's taxable estate is $0.

190. What might cause an individual to owe income taxes in more than one state?

ANSWER: Working in more than one state or owning income-generating property in more than one state can cause this.

191. Virtually all state income tax returns contain checkoff boxes for donations to various causes. On what grounds has this procedure been criticized?

ANSWER: In many cases, the procedure is overused (i.e., a multiplicity of boxes). This overuse adds complexity to the return. Also, in most cases, the donation is being drawn from any income tax refund that might be due. Thus, taxpayers may not fully appreciate that they are paying for such checkoffs.

192. State and local governments are sometimes forced to find ways to generate additional revenue. Comment on the pros and cons of the following procedures:

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a. Decouple what would be part of the piggyback format of the state income tax.
b. Tax amnesty provisions.
c. Internet shaming.

ANSWER: a. The decoupling process is easily accomplished regarding new Federal tax changes that have never taken effect at the state level. Taxpayers are not apt to miss what they never have enjoyed.
b. Tax amnesty provisions generate considerable revenue. It also unmasks many taxpayers who have not previously paid taxes. Now that the taxing jurisdiction is aware of their existence, they will tend to pay taxes in the future.
c. By use of a public internet site, the taxing authority posts the names of those taxpayers that are delinquent as to various taxes (e.g., sales, income). This public humiliation (or threat of) very often results in compliance.

193. Briana lives in one state and works in the adjoining state. Both states tax the income she earns from her job. Does Briana have any relief from this apparent double taxation of the same income?

ANSWER: Most states allow their residents some form of tax credit for the income taxes paid to other states. In Briana's case, the credit would be allowed by the state where she lives for the taxes paid to the state where she works.

194. In late June 2024, Art is audited by the state and a large deficiency is assessed. In November of the same year, his Federal income tax return is audited by the IRS. What has probably happened?

ANSWER: The IRS has been notified by the state concerning the results of the June audit.

195. Two months after the burglary of his personal residence, Eric is audited by the IRS. Among the items taken in the burglary was a shoe box containing approximately $50,000 in cash. Eric is the owner and operator of a cash-and-carry liquor store. Eric wonders why he was audited. Can you help explain?

ANSWER: Although Eric's audit by the IRS could be the result of sheer chance, this appears unlikely. Press coverage of the burglary, particularly if the items stolen were enumerated, could have put the IRS on notice. Why would anyone keep such a large amount of cash at his personal residence? Also, Eric is in a business where tax evasion is easily accomplished.

196. Rick, the sole proprietor of an adult entertainment club, is audited by the IRS. On the third day of the field audit, the regular IRS agent is accompanied by a special agent. Should Rick be concerned by this new development? Explain.

ANSWER: Yes, he should. Special agents rarely appear during an audit unless the regular agent suspects that fraud may be involved. Considering the type of business Rick conducts, the heavy use of cash probably exists. With cash involved, tax evasion is easier to carry out.

197. Tracy has just been audited and the IRS agent has issued an RAR that assesses a large deficiency. Since Tracy disagrees with the result, her next step is to go to court. Do you agree?

ANSWER: Tracy might save herself time and expense by going to the Independent Office of Appeals of the IRS. Here, the IRS has the authority to negotiate a settlement based on the "hazards of litigation" (i.e., the probabilities of winning or losing). If a settlement is reached, resorting to the courts is avoided.

198. Brayden files his Federal income tax return by April 15 but does not pay the tax. Although he expects to pay interest on the large amount of tax he still owes, he feels that the timely filing has avoided any penalties. Is Brayden's assumption correct?

ANSWER: Although Brayden has avoided the failure to file penalty, the failure to pay penalty will apply. It is 0.5% per

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month up to a maximum of 25% of the tax due as shown on the return.

199. Melinda has been referred to you by one of your clients. In the past, she has prepared her own income tax returns, but she has become overwhelmed by the increased complexity of the tax law. Consequently, Melinda wants you to prepare her return for calendar year 2024. In reviewing her 2023 return, you note that she has claimed as a deduction the entire cost of a business building that should have been capitalized and depreciated. What course of action should you follow?

ANSWER: You should recommend to Melinda that an amended return be filed for 2023 correcting the error. If she refuses, you should assess the gravity of the error and how it impacts on your ability to file an accurate return for 2024. If you cannot do so, then you must decline the engagement.

200. Your client, Connie, won $12,000 in a football office pool. She sees no reason to include it in her income for several reasons. First, the amount won will not be reported to the IRS. Second, as an average income employee, she is unlikely to be audited by the IRS. Third, she feels that she has probably lost this much in other past office pools. How do you respond?

ANSWER: As a practitioner, you cannot play the audit lottery. You must prepare a proper return for her. Although the use of estimates is allowed, Connie's assumptions as to her losses are not realistic. Even if they were reliable, gambling losses cannot be offset against gambling winnings but must be separately deducted. Thus, the $12,000 must be reported as income or you cannot prepare Connie's return.

201. Under what conditions is it permissible, from an ethical standpoint, for a CPA firm to outsource tax return preparation to a third party?

ANSWER: First, the clients' confidentiality must be preserved. Second, the CPA firm must verify the accuracy of the work. Third, the clients must be advised as to the practice.

202. In terms of revenue neutrality, comment on a tax cut enacted by Congress that:

a. Contains revenue offsets.
b. Includes a sunset provision.

ANSWER:
a. Ideally, to achieve revenue neutrality, all tax cuts should be accompanied by revenue offsets.
b. A sunset provision does not account for the immediate revenue losses generated by a tax cut. It merely provides that such losses will not continue beyond a specified date when the tax cut expires and the former tax law is reinstated.

203. The tax law contains various tax credits, deductions, and exclusions that are designed to encourage taxpayers to obtain additional education. On what grounds can these provisions be justified?

ANSWER: Social and economic considerations are the justification. As to the latter, a better educated workforce carries a positive economic impact.

204. The tax law contains various provisions that encourage home ownership.

a. On what basis can this objective be justified?
b. Are there any negative considerations? Explain.

ANSWER:
a. Home ownership can be justified on economic and social grounds.
b. Granting tax advantages to persons who are purchasing their homes places the taxpayers who rent at a disadvantage. The result is inequality in treatment.

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205. The tax law allows an income tax deduction (or a credit) for foreign income taxes. Explain why.

ANSWER: The deduction (or a credit) for foreign income taxes can be justified on the grounds that it mitigates the double tax imposed on the same income.

206. The tax law allows, under certain conditions, deferral of gain recognition for involuntary conversions.

a. What is the justification for this relief measure?
b. What happens if the proceeds are not entirely reinvested?

ANSWER:
a. By recognizing that the taxpayer's relative economic situation has not changed and that they lack the wherewithal to pay a tax, any recognition of realized gain is deferred.
b. If the proceeds from an involuntary conversion are not fully reinvested in property that is similar or related in service or use, recognized gain results. Such recognized gain cannot exceed realized gain and will be limited to the amount of the proceeds not reinvested. Recognition is based on the notion that the taxpayer now has the wherewithal to pay the tax that results.

207. How do the net operating loss provisions in the tax law mitigate the effect of the annual accounting concept?

ANSWER: Without the allowance of a loss carryforward, the losses would disappear. As shown by Example 27, this result places a business with profit and loss fluctuations on a more level playing field with one that maintains a stable income pattern.

208. In connection with facilitating the function of the IRS in the administration of the tax laws, comment on the utility of the following:

a. An increase in the amount of the standard deduction.
b. Dollar and percentage limitations on the deduction of personal casualty losses in Federally declared disaster areas.
c. Availability of interest and penalties for taxpayer noncompliance.

ANSWER:
a. An increase in the amount of the standard deduction reduces the number of taxpayers who choose to itemize their personal deductions. This, in turn, reduces the deductions the IRS has to check.
b. Limitations placed on casualty and theft losses curtail the number of taxpayers who can claim the deduction.
c. The imposition of extra penalties, in addition to the tax owed, definitely deters taxpayer noncompliance.

209. Congress reacts to judicial decisions that interpret the tax law in different ways. When it approves of a decision, Congress may act to amend the Code to incorporate the holding. When it disapproves, Congress may amend the Code to nullify its effect. Give an example of each one of these congressional reactions.

ANSWER: Congress approved of the judicial conclusion that most stock dividends should be nontaxable and amended the Code to this effect. However, it disagreed as to when leasehold improvements should be taxed to a lessor. Consistent with the wherewithal to pay concept, the improvements are to be taxed on the termination of the lease. Thus, Congress overturned a judicial holding that would have taxed such improvements in the year they are made by the lessee.

210. Can a taxpayer start the three-year statute of limitations on additional assessments by the IRS by filing his income tax return early (i.e., before the due date)? Can the period be shortened by filing late (i.e., after the due date)?

ANSWER: The answer is *no* in both cases. When filing early, the statute starts to run on the due date of the return. When

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filing late however, the filing date controls.

211. Congressman Smith wants to impose a new tax on sugar drinks. Analyze this proposal against the principles of equity, simplicity, and neutrality.

ANSWER:

- Equity – The tax is regressive in that it will represent a larger portion of a low-income individual's income relative to a higher-income individual.
- Simplicity – While it sounds simple because the ingredients on a container should indicate if there is sugar, issues might arise as to how other forms of sugar, such as corn syrup, affect application of the tax. Also, the amount of sugar in beverages can vary, so some might argue that the tax should not apply if the sugar level is minimal. Will the tax apply to drinks already subject to the alcohol taxes? (Include some discussion of problems of defining sugar drink in the answer.)
- Neutrality – The tax will likely reduce sales of sugar drinks.

212. Ultimately, most taxes are paid by individuals. Explain what this means in terms of income and payroll taxes paid by a corporation.

ANSWER: A corporation pays many types of taxes, but like any other expenditure, some of these taxes are ultimately paid by an individual. Income taxes are included in the price the corporation charges for goods and services. Or all or part might result in reduced earnings affecting investors or through reduced wages affecting employees. The payroll taxes paid by the corporate employer are likely borne by workers in the form of lower wages. That is, if the employer did not have to pay the taxes, it could pay higher wages to employees. These taxes might also be borne by customers and investors.

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