

CHAPTER 1

**AN INTRODUCTION TO TAXATION
AND UNDERSTANDING THE FEDERAL TAX LAW**

LECTURE NOTES

LEARNING AND COPING WITH TAXATION

1. A few simple illustrations of the effect of taxation on individual behavior help emphasize the role taxation plays in our everyday world.
 - a. Whether to purchase or rent a personal residence. The purchase route offers deductions for interest on home mortgage and ad valorem property taxes, while rent paid on a residence provides no tax benefit.
 - b. Finance the purchase of an automobile with funds from a home equity loan. Although interest on consumer purchases is not deductible, interest on a home equity loan is deductible.
 - c. For those on the borderline between itemizing and claiming the standard deduction, concentrate certain expenditures (e.g., charitable contributions, consumer purchases subject to sales tax, elective medical procedures, property taxes) within one year. This allows itemizing in the concentration years and the use of the standard deduction in alternate years.
 - d. Divorced parents with dependent children can make wise annual choices as to how the dependency exemptions are to be allocated between them.
2. Although much is said about avoiding transactions that are purely tax motivated, most often tax considerations are overlooked.
 - a. Ivana has a tract of land that she acquired 20 years ago at a cost of \$20,000. The land, currently worth \$200,000, is desired by her church for use as a youth summer camp. Ivana has been told by the church treasurer that if she sells the land to the church for \$20,000, she will recover her capital investment and obtain a charitable deduction of \$180,000. Good advice? Not quite! The sale also causes Ivana to recognize capital gain of \$18,000.

- b. Butch maintains an office in his home which he uses in his trade or business. Since the office is the only room that is air conditioned, he sees no harm in letting his family use it while he is out-of-town. Unfortunately, there is harm. Butch obtains no office in the home deduction because the exclusive business use requirement is not met.
3. Learning and coping with taxation is a multi-step proposition.
- a. Once you learn certain general rules you need to recognize when they apply. Although you may not be certain as to what they are, you also need to know that certain exception can and do intervene.
 - b. A client collects on a life insurance policy. You are aware that the proceeds of life insurance are an exclusion from gross income. Nevertheless, the circumstances seem odd since your client is not related to the insured. Further inquiry reveals the insured owed money to your client and assigned the policy in satisfaction of the debt. Thus, an exception to the general rule comes into play. Under the transfer-for-valuable-consideration exception, your client has income measured by the difference between the insurance proceeds and the basis he had in the debt that was settled (plus any post-transfer premiums paid).
 - c. Jenny is looking for tax-free income. She is considering two investments: general purpose bonds issued by the state of Arkansas and bonds issued by the city of Little Rock to build a municipal sports arena. Jenny is inclined to favor the Little Rock bonds since their yield is higher. What is the difference? The interest on both bonds is not subject to income tax (i.e., the general rule) but the interest from special purpose bonds could be subject to the alternative minimum tax, or AMT (i.e., the exception).
4. Taxation, then, requires a mastery of certain general rules, being able to apply them, and knowing when exceptions might apply.

HISTORY OF U.S. TAXATION

EARLY PERIODS

5. Constitutionality and Type of Taxpayer. Emphasize the difference between the income tax on individuals and that imposed on corporations in terms of whether such taxes were allowed under the U.S. Constitution prior to the passage of the Sixteenth Amendment.
- a. The tax imposed on individuals was broad enough to tax income from real and personal property. As such, it was a direct tax and required apportionment under the constitution.
 - (1) In *Pollock v. Farmers' Loan and Trust Co.*, the Supreme Court found the income tax applicable to individuals unconstitutional.

- (2) The Court did not hold however, that a tax on income from personal services was unconstitutional.
- b. The corporate income tax, enacted in 1909, was held to be constitutional, because it was deemed to be an excise tax. In essence, it was considered to be a tax on the right to do business in the corporate form. It was likened to a form of franchise tax. Because a corporation is an entity created under state law, jurisdictions possess the right to tax its creation and operation. Note that many states still impose franchise taxes on corporations under this rationale.
- 6. Tests of Constitutionality. The income tax imposed during the Civil War period came and went without ever being successfully challenged under the U.S. Constitution. Only when the income tax was reenacted in 1894 was the issue of constitutionality raised again and pursued in the courts.
- 7. Criticism of Income Tax. One of the reasons the income tax evoked such criticism was that many regarded it as an invasion of privacy. At the turn of the century, financial affairs were regarded as highly personal and only concerned the party involved, not the business of the U.S. government.
- 8. Ratification of Sixteenth Amendment. The timing of the ratification of the Sixteenth Amendment to the U.S. Constitution (1913) was instrumental in the financing of U.S. participation in World War I.

REVENUE ACTS

- 9. Tax Law Prior to IRC of 1939. The tax practitioner or the tax professor of past years must have encountered difficulty prior to the enactment of the Internal Revenue Code of 1939.
 - a. For example, the resolution of a particular problem might have required reference to dozens of different statutes.
 - b. Also, what was established as the law in one particular statute could have been rescinded or modified by a later statute.
 - c. The code approach solved such problems by bringing all of these statutory materials together in one place and provided the practitioner with the latest word on any one issue (since changes are incorporated into a code).

HISTORICAL TRENDS

10. The income tax is a major source of revenue for the Federal Government (see **Figure 1.1 in the text**). The need for revenues to finance World War II converted the income tax into a mass tax. Currently, the Federal income tax laws have become increasingly complex.

CRITERIA USED IN THE SELECTION OF A TAX STRUCTURE

11. Adam Smith and Canons of Taxation.
- a. Equality – Each taxpayer enjoys fair and equitable treatment by paying taxes in proportion to his income level (ability to pay).
 - b. Convenience – A tax should be easily assessed and collected with its administrative costs being low.
 - c. Certainty – A tax structure is “good” if the taxpayer can readily predict when, where, and how a tax will be levied.
 - d. Economy – A “good” tax system involves only nominal collection costs by the government and minimal compliance costs by the taxpayer.

THE TAX STRUCTURE

TAX BASE

12. The tax base is the amount to which the tax rate is applied.
- a. For Federal income tax, the tax base is taxable income.
 - b. See **Figure 1-2 in the text** for the individual tax formula.

TAX RATES

13. Marginal Tax Rate versus Average Tax Rate. In understanding the nature of any type of progressive tax, it helps to explain the difference between the marginal tax rate and the average tax rate. The marginal rate is the percentage at which the last dollar is taxed while the average rate is the percentage applicable to the whole amount that is subject to tax.
14. Proportional versus Progressive. A tax is proportional if the rate of tax remains constant for any given income level. A tax is progressive if a higher rate of tax applies as the tax base increases.

MAJOR TYPES OF TAXES

15. In introducing the discussion of the various components of U.S. tax system, **Figure 1-1** appearing at the end of these **Lecture Notes** may be helpful.

PROPERTY TAXES

16. Personalty versus Realty. Realty is land and anything permanently attached to land, and personalty are all assets that are not realty. Personalty that become fixtures, however, is treated as realty. Both realty and personalty can be either business use or personal use.
- a. Ad valorem taxes look to the value of the property as the base for the imposition of the tax. How such value is determined varies and often is subject to controversy between the property owner and the taxing authority. Four methods are currently in use for assessing the value of real estate:
- (1) Actual purchase or construction price.
 - (a) In many cases, this includes the cost involved in remodeling an existing structure (e.g., renovating a kitchen in a personal residence—installing indirect lighting, granite countertops, etc.)
 - (b) The improvements made [see (i) above] may require building permits or local inspections and clearance and, thus, come to the attention of the local taxing authorities. This leads to increased assessment of value.
 - (2) Sales prices or construction costs of comparable properties.
 - (a) The sales price used should be current.
 - (b) If the assessments are based on old data, the so-called “backdoor tax increase” described in the *Tax in the News* (page 1-8 of the text) can occur.
 - (3) Cost of reproducing a building, less allowance for depreciation and obsolescence from the time of actual construction.
 - (4) Capitalization of income from rental property.
- b. Whether or not a property tax is based on value (i.e., *ad valorem*) could be important for income tax purposes.
- c. *Ad valorem* taxes are exclusively within the province of the states and their local political subdivisions.
- d. By virtue of ownership or type of use, some property may be exempt from tax.

- (1) Tax holidays are frequently used to attract new industry. Such holidays are particularly popular in selecting the location of foreign automobile assembly and manufacturing facilities. All too often, they lead to intense bidding wars among competing jurisdictions.
 - (2) Also popular is the practice of issuing scenic easements. In return for the promise not to further develop the property, the owner receives a reduced property tax assessment. The favorable tax treatment can be justified on the grounds of environmental (i.e., ecological) betterment.
 - (3) Property owned by the Federal (and usually state and local) government is exempt from tax.
 - (4) Some states provide for lower valuations on property dedicated to agricultural use.
 - (5) Some states partially exempt the personal residence portion of property from taxation.
- e. Compliance and enforcement procedures regarding *ad valorem* taxes on personalty varies considerably. Compliance and enforcement may be unusually poor in the case of personal use items and intangibles.

TRANSACTION TAXES

17. Transaction Taxes. Transaction taxes include Federal and state excise taxes and state and local general sales taxes, severance taxes, death taxes, and gift taxes.
- a. Federal excise tax. Examples of Federal excise taxes include those imposed on tobacco, gasoline, telephone usage, air travel, and alcohol.
 - (1) In the past, Federal excise taxes were imposed on entertainment admissions, jewelry, leather goods, cosmetics, boats, aircraft, and luxury automobiles.
 - (2) The recent increase in the tobacco tax may portend increased Federal use of excise taxes to raise revenue. See *Tax in the News* on page 1-10 of the text.
 - b. State and local excise tax.
 - (1) Currently, many states are experiencing revenue shortfalls. One remedy has been to raise the state excise tax on tobacco products.
 - (2) Note that the sale of many products (e.g., tobacco, gasoline, alcohol) are subject to *both* state and Federal versions.

- c. Excise tax versus general sales tax. The difference between an excise tax and a general sales tax is tied to the scope of the transaction covered by the tax.
 - (1) Excise tax. Excise taxes deal with the transfer of a specified commodity (e.g., tobacco and alcohol).
 - (2) Sales tax. Sales taxes cover a wide range of products or transactions. Some states exempt certain transactions (e.g., sales of food to be consumed off the premises, and sales of certain medicines and drugs).
 - (a) Due to revenue shortfalls, many previously exempt categories (e.g., certain food products) are now subject to tax in some states.
 - (b) The expansion of the sales tax to the performance of personal services has increased and will continue to do so.
- d. Use tax. Every state that has a general sales tax also imposes 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. A use tax is an ad valorem tax, usually at the same rate as the sales tax, on the use, consumption, or storage of tangible property. Alaska, Delaware, Montana, New Hampshire, and Oregon do not have a sales nor use tax.
- e. Sales tax holidays are becoming more popular. Many states (e.g., North Carolina, Missouri, Georgia, Iowa, New York, Connecticut) are joining Texas in scheduling the holiday for August back-to-school buying.
- f. Sales tax avoidance.
 - (1) Particularly easy to accomplish when services are involved.
 - (2) As to catalog sales, difficult to enforce compliance.
 - (3) As to e-tailers, there is compliance only if the seller has a physical presence in the buyer's state.

ETHICS AND EQUITY

Making Good Use of Out-of-State Relatives (page 1-11). Who is the true purchaser of the bracelet? If the aunt really made the purchase with her funds and then gave it to Marcus, no sales or use tax evasion has occurred. More likely, the purchase was made by Marcus indirectly through his aunt—the aunt being reimbursed by Marcus or using funds provided by him. If such is the case, Marcus owes a sales tax on the purchase. Presuming the matter comes to light—the jewelry store might be the weak link—Marcus could be subject to prosecution for tax evasion.

TAXES ON TRANSFERS BY DEATH AND GIFT

18. These taxes are a type of excise tax and fall under the classification of transaction taxes.
- a. Valuation base. Typical of other types of excise taxes, the value of the property transferred measures the base for determining the amount of the tax.
 - b. Estate tax versus inheritance tax. If a tax is imposed at death on the right of a decedent to pass property at death, it is classified as an estate tax. If it taxes the right to receive property from a decedent, it is termed an inheritance tax.
 - c. Federal taxation versus state taxation. The Federal government does not impose an inheritance tax and relies exclusively on an estate tax. State governments, however, levy inheritance taxes, estate taxes, or both.
19. The Tax Relief Reconciliation Act of 2001 made substantial changes to the Federal estate and gift taxes.
- a. By phase-in increases in the unified transfer tax credit (as applicable to estates), the estate tax is to be eliminated by year 2010. The scheduled increases are as follows:

<u>Year</u>	<u>Credit Allowed</u>	<u>Exclusion * Amount</u>
2002–2003	\$ 345,800	\$1,000,000
2004–2005	555,800	1,500,000
2006–2008	780,800	2,000,000
2009	1,455,800	3,500,000

- * The exclusion amount (also called the exemption equivalent or by-pass amount) is the tax base covered by the credit.

- b. As the 2011 Edition of this text goes to press, the Federal estate tax has expired for 2010.
 - (1) Probabilities are very high that Congress will reinstate the tax for 2010.
 - (2) If reinstated, the tax will be made retroactive to January 1, 2010 (i.e., the expiration date).
 - c. The gift tax is to be retained, and the credit is frozen at \$345,800 (exclusion amount of \$1,000,000). However, each donor is allowed an annual exclusion, \$13,000 in 2010 (\$13,000 in 2009), for each donee.
 - d. The estate tax was deemed objectionable for two reasons.
 - (1) It constitutes a double tax since a decedent's wealth has already been subject to the income tax.
 - (2) To pay the estate tax, many family businesses (particularly farms) are forced to liquidate.
 - e. Both of the reasons given above can be criticized.
 - (1) Not all wealth has been subject to the income tax. For example, consider wealth acquired by gift or inheritance and the unrealized appreciation on existing wealth.
 - (2) Furthermore, the taxes are different. The income tax is a tax on income that is earned. The estate tax is an excise tax on the transfer of wealth by death.
 - (3) With proper planning, the liquidation of a family business to pay estate taxes can easily be averted.
20. Purpose. The purpose of the Federal gift tax is to preclude avoidance of the Federal estate tax.
- a. In this regard, note that the Federal estate tax preceded the Federal gift tax.
 - b. Apparently, most states do not consider the tax avoidance potential as being significant, given that only a few have seen fit to enact a state gift tax.

21. Computation Procedure. The computation procedure for arriving at the Federal gift tax liability is summarized below:
- Amount of taxable gift. The first step is to arrive at the amount of the taxable gift. Simply stated, a taxable gift is the fair market value of the gift less the annual exclusion and, in some cases, the marital deduction.
 - Addition of prior taxable gifts. The second step is to add to the current taxable gifts all prior taxable gifts. Because the gift tax is cumulative in effect, a donor must take into account all taxable gifts made in prior years.
 - Tax rate schedule. Once the total of all current and past taxable gifts has been determined, compute the amount of the gift tax using the unified transfer tax rate schedule.
 - Reductions. The amount so derived from the rate schedule must be reduced by all gift taxes paid on past gifts and by the unified tax credit. The gift tax credit for prior taxable gifts is not what was actually paid, but the amount that would have been paid had the current unified transfer tax rates been in effect.
22. Incentive for Lifetime Transfers. In the light of the unified transfer tax scheme, a pressing question involves the continuing incentive for making lifetime transfers. Since the gift and estate tax rates and credits are the same and because post-1976 taxable gifts are added to the taxable estate in determining death tax liability, what are the advantages of the gift tax approach?
- Annual exclusion. Effective use of the annual exclusion of \$13,000 (indexed for inflation) can avoid or reduce the tax on gifts. The election to "split gifts" is available to married donors doubles the amount of the annual exclusion.
 - Post-gift appreciation. Post-gift appreciation on property avoids the estate tax (with regard to the donor).
 - Shifting property. By shifting income-producing property to lower bracket taxpayers, gifts save income taxes for the family unit in future years.
 - Benefit of tax planning. Except in those few states that impose a gift tax, the gift approach avoids state transfer taxes entirely.

INCOME TAXES

23. Observations. With reference to income taxes, the following observations would be useful:
- Revenue production (Federal). In terms of revenue production, the income tax represents the major source of funds for the Federal government. See **Figure 1.1** in the text.

- b. Pay-as-you-go concept. For effective administration, pay-as-you-go procedures (e.g., withholding at the source) usually accompany income taxes.
24. Federal income taxes.
- a. Progression concept. Note the progression of the rates in the Federal income tax applicable to individuals and to corporations.
 - b. Summary of Federal income tax formula in **Figure 1.2** in the text.
25. State income taxes—general characteristics.
- a. “Piggyback” concept. The trend as to state income taxes is to use the Federal tax base for income determination. Many states have gone with the “piggyback” concept whereby the tax is a flat rate of the Federal tax liability or a percentage of adjusted gross income as determined for Federal income tax purposes.
 - (1) Most often the “piggyback” approach uses the Federal AGI amount with different deduction (or credits) for spouses and dependents.
 - (2) For state purposes, AGI may be adjusted (e.g., income from Federal bonds is not taxed).
 - (3) Recent Federal tax cuts may not be acceptable to the state due to loss of revenue considerations. In such cases, the state may “decouple” (i.e., not accept) the change.
 - b. Only Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not impose a state income tax on individuals.
 - c. Most state forms provide for the designation of voluntary contributions to state sponsored charitable causes (e.g., Maryland Cancer Fund).
 - d. Although some states have conducted tax amnesty programs, the Federal government has never done so. Perhaps the justification for not doing so is that some (including the IRS) feel that such an amnesty procedure would encourage taxpayers to defer the payment of their taxes. The rationale for those who need the funds currently would be: "Why pay taxes today when I can catch up at amnesty time!"
 - (1) Due to increased revenue shortfalls, state amnesty programs are becoming more widespread.
 - (2) Some states (e.g., Louisiana) have “gone to the well” more than once. Some contend that establishing such a pattern has a demoralizing effect on “honest” taxpayers who routinely comply.

- e. Local income taxes. The imposition of income taxes by local jurisdictions (e.g., cities such as Cleveland, Kansas City, and New York), though not uncommon, is more the exception than the rule.

EMPLOYMENT TAXES

- 26. Limitation of Coverage to FICA and FUTA. The employment taxes material included in Chapter 1 represents a brief overview. Other related matters include:

- a. Employment relationship. For when an employment relationship exists (i.e., employee versus self-employed).
- b. Self-employment tax.
- c. Withholding procedures.
- d. Employer responsibilities. The employer has the responsibility to withhold for income tax and FICA tax.

- 27. FICA Taxes. In connection with FICA, note the following:

- a. Uncertainty of future FICA rate and base amounts. The relevance of the increases in the rates and the base amounts. In this regard, mention the uncertainty that exists as to future increases.
- b. Employee income tax credit for excess FICA withholdings. Relief is provided an employee (i.e., an income tax credit) in the case of excess FICA tax withholdings.
- c. For 2010, the Social Security tax rate is 6.2% and the Medicare tax rate is 1.45%. The base amount for Social Security is \$106,800 for 2010 and 2009. There is no limit on the base amount for the Medicare tax. The employer must match the employee's portion for both Social Security tax and Medicare tax.

- 28. FUTA Taxes.

- a. Purpose. The purpose of the tax is to provide modest financial relief in the event of the unemployment of a covered employee. This should be contrasted with the retirement objective of the FICA tax.
- b. Employer liability. Unlike FICA, the incidence of FUTA falls solely on the employer.
- c. Rate and base. For 2010, FUTA applies at a rate of 6.2 percent of the first \$7,000 of covered wages. Merit rating credits may reduce the tax to a much lower percentage.
- d. Federal and state compliance. Unlike FICA, FUTA requires compliance with both Federal and state provisions.

- e. Publication 15. In connection with the compliance aspects of both FICA and FUTA, stress the utility of Circular E, Employer's Tax Guide, issued by the IRS as Publication 15.

OTHER U.S. TAXES

29. Miscellaneous Taxes.

- a. Federal Customs duties. Customs duties are variously described as import taxes and tariffs.
 - (1) History. Strictly within the province of the Federal government, these levies served as the mainstay of the Federal revenue system until slightly after the turn of the nineteenth century.
 - (2) Regulatory purpose. At this point, however, customs duties are intended for regulatory purposes rather than as a meaningful source of revenue.
 - (3) Use in other countries. Export taxes (as opposed to import taxes) are favored by less developed countries, the economies of which may be based on a few commodities (e.g., bananas, copper, coffee).
- b. Franchise taxes are imposed at the state level.
 - (1) Most often imposed on corporations, they are a tax on the right to do business in that state.
 - (2) Generally, the tax is based on the capitalization of the entity.
 - (3) In some states (i.e., Texas), the earnings of the entity enter into the determination of the amount of the tax. In such cases, the franchise tax resembles a corporate income tax.
- c. Occupation taxes are quite pervasive.
 - (1) These are imposed at the state, local, and even Federal level (e.g., liquor store license and a taxicab permit).
 - (2) Although not negligible in amount, they are not intended to be large revenue producers.
 - (3) The justification for such taxes is to help defray the government's cost of licensing, regulating, and policing a particular occupation or business.

TAX ADMINISTRATION**INTERNAL REVENUE SERVICE**30. Selection of returns for Audit.

- a. Comparison of the current tax return with those filed in past years.
 - (1) Suppose, for example, the current return reflects a significant reduction in dividend income. What has happened to the stock? Perhaps it was sold at a gain and such gain is not reflected on Schedule D? Perhaps it was gifted and such gift was not reported for Federal tax purposes?
 - (2) Other items to consider include the change from employed to self-employed status (e.g., a distribution from a qualified pension or profit-sharing plan not accounted for) or a change in marital status (e.g., alimony payments not being included in gross income or dependency exemptions being claimed incorrectly by an ex-spouse).
- b. The presence of certain items in a return may increase the likelihood of audit.
 - (1) At present, the IRS is showing particular interest whether certain taxpayers should be classified as employees rather than as self-employed.
 - (2) Further, because of the high probability of error in determining the deductible amount, the IRS always has scrutinized large casualty and theft losses.
 - (3) Also sensitive are large charitable contributions of property. The IRS is well aware that the true value of certain types of property (e.g., art objects) is subject to manipulation.
- c. The policy of the IRS regarding rewards to informers.
 - (1) Although the total reward is limited to 30% of the amount collected, the amount paid is strictly discretionary with the IRS.
 - (2) Mere suspicion does not warrant a reward, even though the suspicion proves to be correct.
 - (3) The amount of the reward depends on how helpful the evidence provided is toward collecting the amount due.
- d. Exchange of tax information. Note that many states have arrangements whereby their taxing authorities are authorized to exchange information with the IRS.

- (1) Thus, the assessment of a deficiency by a state taxing authority might lead to an audit of the taxpayer by the IRS as to the Federal tax implications of the change.
 - (2) The reverse of this situation (i.e., a Federal deficiency leading to an audit by the state) is more probable.
- e. Information returns are not in substantial agreement with reported income.
- (1) Lately, the IRS has been reviewing the information reported on Form 1098 (filed by lenders). If the mortgage interest is not reported, this could mean the taxpayer filed no return. If the interest amount is too high for the income shown on the return, underreporting income is probable.
 - (2) Brokers will soon be required to report data regarding sales of securities. Correlation of this information with an investor's tax return, could reveal errors in recognition of gain.

31. Types of Audits:

- a. Types of audits. Note the differences between the various types of audit (i.e., correspondence, office, and field). If the issue is minor, the matter often can be resolved by correspondence between the IRS and the taxpayer. An office audit usually is restricted in scope and is conducted in the facilities of the IRS. A field audit involves an examination of numerous items reported on the return and is conducted on the premises of the taxpayer or the taxpayer's representative.
- b. "No Change Letter." Form 4549, Income Tax Examination Changes, is the Revenue Agent's Report referred to in the text. If nothing is found wrong with the return, the agent will issue what is commonly referred to as a "no change letter."

STATUTE OF LIMITATIONS

32. Necessity. The purpose is to preclude parties from prosecuting stale claims. The passage of time makes the defense of such claims difficult.
- a. Major categories. Note that the Federal tax law really contains two major categories of periods of limitations: one applying to assessments by the IRS and one concerning claims for refunds by taxpayers.
 - b. Exception. An exception to the three-year general rule on assessments (period begins to run from the later of the due date of the return or the filing date) is the substantial omission situation. Observe that this six-year exception only applies to the omission of income and does not cover other factors that might lead to an understatement of tax liability (e.g., overstatement of deductions or credits).

Example: For 2010, Doug, a calendar year individual taxpayer, reported gross income of \$400,000 on a timely filed income tax return. If Doug had omitted more than \$100,000 (25% X \$400,000) in income, the six-year statute of limitations would apply to tax year 2009. This presumes the absence of fraud on the part of Doug. If the omission was deliberate (i.e., due to fraud), the statute never starts to run.

- c. Claims for refund. Claims for refund are limited to within three years from the date the return was filed or within two years from the date the tax was paid, whichever is later.
 - (1) Income tax returns that are filed early are deemed to have been filed on the date the return was due.
 - (2) Taxes withheld are treated as having been paid as of the due date of the return.

INTEREST AND PENALTIES

- 33. Interest. With refunds, no interest is allowed if the overpayment is refunded to the taxpayer within 45 days of the later date the return is filed or is due.
 - a. For income tax purposes, some interest may be deductible while penalties are not.
 - b. For the individual taxpayer, the interest rate for the first quarter of 2010 is 4% for both assessments and refunds. Interest rates are determined quarterly by the IRS on the existing Federal short-term rate.
- 34. Penalties. It is becoming increasingly common for some taxpayers to file Form 4868 (Application for Extension of Time to File U.S. Individual Income Tax Return).
 - a. Note that if an automatic extension is allowed (through August 15 for a calendar year taxpayer), a taxpayer does not avoid the penalty for failure to pay. Thus, a taxpayer who files such an extension may have to include an additional payment when the income tax return is filed. A penalty for failure to pay the tax due as shown on the return is imposed in the amount of 0.5% per month up to a maximum of 25%. Any fraction of a month counts as a full month. During any month in which both the failure to file penalty and failure to pay penalty apply, the failure to file penalty is reduced by the amount of the failure to pay penalty. As long as the balance of the tax due is not more than 10 percent of the total tax liability, the failure to pay penalty does not apply.
 - b. For a failure to file a tax return by the due date, a penalty of 5% per month up to a maximum of 25% is imposed on the amount of the tax shown as due on the return. Any fraction of a month counts as a full month.

- c A negligence penalty of 20% is imposed if any of the underpayment was for intentional disregard of the rules and regulations with intent to defraud.
- d Various fraud penalties may be imposed. Fraud is a deliberate action on the part of the taxpayer evidenced by deceit, misrepresentation, concealment, etc.

TAX PRACTICE

35. Relationship to the Code of Ethics. The AICPA's "Standards for Tax Services" (SSTs) are a part of the Code of Ethics and are enforceable by the AICPA and most state's licensing statutes.
- a. Do not feel compelled to follow an administration determination for a prior year if the determination was based on facts and circumstances that could have changed.
 - b. Unless an agreement to do so exists, a tax practitioner does not have an obligation to follow up tax advice given to the client. Before continuing to rely on the original advice, the client has the responsibility to determine its continuing validity.
 - c. Do not take questionable positions on a client's tax return in the hope that the return will not be selected for audit by the IRS.
 - d. A practitioner can use a client's estimates if they are reasonable under the circumstances.

ETHICS AND EQUITY

Let Bygones Be Bygones (page 1-24). In spite of Arturo's expressed preference, you should recommend that amended returns be filed (For all open years) reporting the offshore rent activities. Unreported foreign income is a sensitive issue with the IRS, and a taxpayer who makes voluntary disclosure is generally better off than one who is caught in an audit.

If Arturo still refuses to file amended returns, you must determine what affect such omission has on 2010. Is there a carryover effect that is material enough to preclude you from arriving at a proper reflection of taxable income for 2010? If so, you must decline the engagement. If not, you may prepare the current return. Such a return must, moreover, include the rental activities relating to 2010.

UNDERSTANDING THE FEDERAL TAX LAW

36. Multiple Objectives. The tax law does not have as its sole objective the raising of revenue.
- a. Other objectives. Also important in explaining various provisions found in the law are economic, social, equity, and political considerations.
 - b. Effect of IRS and the courts. In this regard, the IRS and the courts have also had an impact on the law's present form.
37. Simplicity versus Other Objectives. Though the tax law is complex and some of its provisions sometimes defy logic, there is a reason for every rule.
- a. One may not agree with the reason but, nonetheless, it exists.
 - b. Knowing about these reasons can go a long way in helping to understand the tax law.

REVENUE NEEDS

38. Revenue Neutrality. Public pressure to control Federal budget deficits probably will dictate that most tax legislation will be revenue neutral. Changes made to the tax code will neither increase nor decrease the net cash flow result reached under the prior rules.
- a. The Tax Relief Reconciliation Act of 2001 was the first of several exceptions to the “revenue neutrality” rule.
 - b. Recent budget deficits have caused Congress to reaffirm a pay-as-you-go (“paygo”) policy with future tax legislation.

ECONOMIC CONSIDERATIONS

39. Control of the Economy. Examples of provisions used by Congress intended to impact on the economy are:
- a. Depreciation systems (e.g., MACRS).
 - b. Investment tax credit provisions including the rehabilitation credit.
 - c. Expansion and contraction of the tax base.
 - d. Lowering of tax rates.

40. Encouragement of Certain Activities. In connection with encouragement of certain activities, mention could be made of the following:
- a. Research and development. Technological progress is encouraged by allowing taxpayers to expense immediately research and development costs (§ 174). Incremental R & D expenditures also give rise to a special credit (§ 41).
 - b. International trade. International trade is encouraged by the foreign earned income exclusion (§ 911).
41. Special Treatment for Certain Industries. In addition to farming, the tax law provides special favors for certain industries. Examples include:
- a. Oil and gas. The option to expense intangible drilling and development costs provides a tax advantage to those engaged in oil and gas exploration [§ 263(c)].
 - b. Minerals. Percentage depletion often allows a larger write-off for mineral interests than would otherwise be available (§ 613).
 - c. Publishing. The publishing industry is aided by the immediate expensing allowed for certain circulation expenditures (§ 173).
42. Special Treatment for Small Business. Congressional favoritism for small business can be illustrated by the following provisions:
- a. S corporation election. The S corporation election generally provides for the elimination of the corporate income tax and allows a pass-through of losses to the shareholders (§§ 1361 to 1379).
 - b. Small business corporation stock. Special treatment is allowed for small business corporation stock that may lead to ordinary (rather than capital) loss treatment (§ 1244).
 - c. Exception to accrual method for small corporations. Most corporations will have to use the accrual method of accounting. One exception for corporations with annual average gross receipts that do not exceed \$5,000,000 permits the use of the cash method of accounting [§ 448(b)].
 - d. Corporate tax rates. The corporate tax rate structure, including the phaseout provisions, definitely favors corporations with lower taxable incomes. See the corporate tax rates on the inside of the back cover of the text.

SOCIAL CONSIDERATIONS

43. Examples.
- a. Accident and health plans financed by employers.
 - b. Group term life insurance coverage for employees.
 - c. Private-sector pension plans.
 - d. Deduction for charitable contributions.
 - e. The credit for child and disabled dependent care.
 - f. Various tax credits, deductions, and exclusions to encourage additional education.
 - g. The disallowance for certain expenditures that are contrary to public policy.
 - h. The earned income credit provides relief for low income taxpayers.

EQUITY CONSIDERATIONS

44. Multiple Taxation. In connection with alleviating the effect of multiple taxation, the text discusses the deduction allowed for state and local income taxes and the deduction/credit alternative permitted in the case of foreign income taxes. Other possibilities are summarized below:
- a. Relief from possible triple taxation is provided in the case of a corporate shareholder by the dividends received deduction (§§ 243 to 247).
 - b. The change in 2003 regarding the taxation of qualified dividend income should be noted. Although double taxation is not eliminated, its effect is lessened by allowing taxation at preferential capital gain rates.
 - c. Some state income tax laws allow a deduction for Federal income taxes.
 - d. The Federal estate tax allows a deduction (§ 2058) for the state death taxes paid.

ETHICS AND EQUITY

Treating Everyone the Same (page 1-29). The allowance of a deduction for state and local sales taxes was primarily designed to appease the states of Florida, Nevada, Texas, and Washington which have no income tax. Alternatively, revenue is derived from sales tax sources. Many states, however, impose both significant sales and income taxes (e.g., California, New York). In such cases, taxpayers generally choose to deduct the income tax since it is a larger

amount than the sales tax. But even here, one or more major purchases during the year may reverse this choice. Allowing a deduction for both, sales and income taxes, would not be fair to residents of states where both taxes are not imposed. Besides the states that do not impose an income tax, some states do not impose a sales tax—see pages 1-10 (no sales tax) and 1-15 (no income tax) of the text.

45. Wherewithal to Pay Concept: Application. With regard to the wherewithal to pay concept (recognizes the inequity of taxing a transaction when the taxpayer lacks the means with which to pay the tax), the text illustrates its application with an involuntary conversion situation. By and large, most wherewithal to pay provisions in the tax law do not permanently avoid gain or loss recognition but operate on a deferral principle (e.g., like-kind exchanges and involuntary conversions). Because of the basis carryover rules, gain or loss recognition merely is postponed to some further disposition that does not meet the requirements of a nontaxable exchange (Chapter 12).
- a. Involuntary conversion. If all of the proceeds from an involuntary conversion are invested within the required statutory time period in property that is similar or related in service or use, none of the realized gain is recognized.
 - (1) The wherewithal to pay concept recognizes that the taxpayer's position has not changed and that he or she lacks the means to pay any tax on the sale.
 - (2) Consistent with this approach is the fact that the taxpayer is taxed (to the extent of realized gain) on any of the sale proceeds not reinvested in suitable replacement property.
 - b. Transfer of property to a controlled corporation. A transfer of property to a controlled corporation results in no recognition of gain or loss to the transferor if solely common stock is received in exchange.
 - (1) The wherewithal to pay concept, as set forth in the rules contained in § 351(a), recognizes that the transferor's relative position has not changed sufficiently so as to warrant recognition of gain or loss.
 - (2) However, § 351(b) provides that the receipt by the transferor of other property (i.e., boot) besides stock will cause gain to be recognized to the extent of the lesser of realized gain or the fair market value of such other property. In this type of situation, the wherewithal to pay the tax does exist.
 - d. Lessee improvements. No income is recognized by a lessor when a lessee makes improvements on the leased property or when the lessor takes possession of the improvements on the termination of the lease (§ 109).

ADDITIONAL LECTURE RESOURCE

Mitigating the Effect of the Annual Accounting Period Concept. In addition to the items mentioned in the text (e.g., net operating losses and installment sales), other examples where the tax law mitigates the effect of the annual accounting period concept include the following:

- Crop insurance proceeds. Section 451(d) permits a cash basis taxpayer to defer the recognition of income from the receipt of crop insurance proceeds to the year in which he or she normally would have sold the crop that was destroyed.
 - This deferral is elective.
 - By making the election, therefore, the taxpayer avoids the concentration in the same tax year of the income from two harvests (i.e., sale proceeds from the crop grown the previous year and sold in the current year plus the insurance proceeds from the destruction of the crop in the current year that would have been sold next year).
 - Claim of right and § 1341. On occasion income may be received in one tax year and have to be repaid in a subsequent year. Because it appears that the taxpayer has an unrestricted right to such item when received, it is, therefore, taxable. When such item received under a claim of right is later restored, § 1341 offers the taxpayer a choice of tax treatment.
 - The taxpayer either may claim as a credit the amount of tax restored or may claim as a credit the amount of tax that the prior inclusion in gross income generated.
 - In no event is the finality of the annual accounting period concept disturbed by allowing the taxpayer to file an amended return for the year of inclusion.
 - The approach permitted by § 1341 merely mitigates the effect of the variations in tax brackets that might exist between the year of inclusion and the year of repayment.
 - Disaster area losses. Normally casualty losses are deductible in the year incurred. Section 165(i), however, permits certain disaster area losses to be claimed as deductions in the prior taxable year.
 - This accelerates the benefit of the deduction, all of which might come at a time when the taxpayer has suffered severe economic loss.
 - The disaster area loss provision represents an exception to the annual accounting period concept and can be justified as a relief measure.
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46. Coping with Inflation.
- a. Trend. Although varying in degree, the inflation trend has existed for many years. Expectations are that this pattern will continue into the future.
 - b. Bracket creep. Explain what is meant by the term “bracket creep.”
 - c. Effect on fixed income taxpayer. Explain how indexation would benefit a person with a fixed income (e.g., retiree).

POLITICAL CONSIDERATIONS

47. The classic example of special interest legislation is the special treatment allowed prepaid subscription and dues income.
- a. Although other types of prepaid income (e.g., rents) are taxed when received, dues and subscriptions are taxed as earned.
 - b. Historically the special relief was the work of the American Automobile Association which desired relief from having to recognize income on the receipt of multiyear dues income.
48. Political Expediency Situations. Various tax reforms rise and fall in favor with the shifting moods of the American public.
- a. Measures that deter more affluent taxpayers from obtaining so-called preferential tax treatment have always had popular appeal. Examples include:
 - (1) Alternative minimum tax.
 - (2) Imputed interest rules.
 - (3) Limitation on the deductibility of interest on investment indebtedness.
 - b. Other changes in the tax law that can at least partially be explained by political expediency include:
 - (1) Lowering of individual tax rates.
 - (2) Increase in the amount for personal and dependency exemptions.
 - (3) Increase in the amount of the earned income credit.
49. State and Local Government Influences. Another change that the community property system has brought to the Federal tax law is the marital deduction allowed for estate and gift tax purposes.

- a. In a case where one of the spouses predeceases the other, the surviving spouse's share of the community property is not included in the gross estate and, therefore, is not subject to the Federal estate tax. The marital deduction tries to extend this advantage to noncommunity property (i.e., common law jurisdictions) situations by allowing (within limits) property to pass to the survivor free of tax.
- b. In a community property jurisdiction, the motivation to make gifts between spouses to balance their potential estates is not as severe as in common law jurisdictions, given that each spouse already owns one-half of any community property.

INFLUENCE OF THE INTERNAL REVENUE SERVICE

50. IRS as Protector of the Revenue. Examples of the “loophole” closing procedure initiated by the IRS include the following:
- a. Disallowance as a deduction certain excess investment interest expense [§ 163(d)].
 - b. The imputed interest rules (§§ 483 and 7872).
 - c. The alternative minimum tax (§§ 55-59).
 - d. The hobby loss disallowance rules (§ 183).
 - e. The possible disallowance of certain entertainment expenses (§ 274).
 - f. The possible disallowance of certain expenses relating to an office in the home and the rental of vacation homes (§ 280A).
 - g. The virtual elimination of the deduction for prepaid interest by cash basis taxpayers (§ 461).
 - h. At risk limitations (§ 465).
 - i. Limitations on passive activity losses (§ 469).
 - j. Taxation of unearned income of a minor child at the parents' rate – the kiddie tax [§ 1(g)].
 - k. For partnerships, S corporations, and personal service corporations, a requirement that they utilize a calendar year for tax purposes [§§ 441(i), 706, and 1378] under certain circumstances.

- l. Except for certain financial institutions, unavailability of the reserve method for deducting bad debts (§ 166).
 - m. The right to make adjustments to a taxpayer's method of accounting in order to clearly reflect income [§ 446(b)].
51. Administrative Feasibility. Many provisions in the tax law simplify the audit function of the IRS.
- a. Some of these include the following:
 - (1) Increases in the amount of the standard deduction.
 - (2) Additional limitations imposed on itemized deductions include a 7.5 percent floor on medical expenses [§ 213(a)], a 10% floor on casualty losses [§ 165(h)], and a 2 percent floor on miscellaneous deductions (including most employee expenses) (§ 67).
 - b. The effect of (1) and (2) above is to keep many taxpayers from itemizing deductions *from* AGI. With fewer taxpayers itemizing and more claiming the standard deduction, the IRS has a smaller number of Schedules A to audit.
52. Penalties. In the past, a multitude of penalties either have been increased or instituted to improve taxpayer compliance. Some of these include the following:
- a. Raising of the negligence penalty from 5% to 20%.
 - b. The civil fraud penalty was increased from 50% to 75% [§ 6653(b)].

INFLUENCE OF THE COURTS

53. Legislative versus Judicial Influence. Barring one exception (i.e., constitutional issues), Congress has the last word on what the Federal tax law should be.
- a. If Congress does not choose to accept a judicial decision, therefore, it can change the tax law to neutralize the result.
 - b. In some cases, Congress may see fit to incorporate the result of a decision and make it part of the tax law.
 - c. On occasion, the decision leads to uncertainty in that it fails to provide guidelines for similar but not identical factual situations. To clarify the matter, Congress may amend the tax law to establish such guidelines.
 - d. By and large, Congress will accept the decisions of the courts and they become part of the tax law.

54. Illustrations. Examples of the reaction by Congress to various court decisions are summarized below:
- a. Stock dividends. A series of judicial decisions finally arrived at the conclusion that most stock dividends do not generate taxable income.
 - (1) This result was accepted by Congress and later amplified in current § 305.
 - (2) Subsequent taxpayer abuse led to the exceptions contained in § 305(b) making certain stock dividends taxable.
 - b. Interest-free loans. Because of the controversy over the gift tax treatment of interest-free loans, which was eventually resolved by the Supreme Court, Congress enacted § 7872.
 - (1) Although this provision basically affirmed the Court's holding as to gift tax consequences, the Code goes much further.
 - (2) Besides furnishing specific guidelines, § 7872 also covers the income tax ramifications.
 - (3) Thus, this is an example of Congress approving, clarifying, and amplifying a decision of the Supreme Court.

Figure 1-1

SUMMARY OF TAXES IN THE U.S.

<u>Type of Tax</u>	<u>Imposed by Jurisdiction</u>		
	<u>Federal</u>	<u>State</u>	<u>Local</u>
Property taxes --			
<i>Ad valorem</i> on realty	No	Yes	Yes
<i>Ad valorem</i> 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.

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

*** An example would be the tax on the occupation of accepting wagers.

NOTES