

# The Professional Practice of Taxation

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## Chapter Introduction

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This book focuses on the income taxation of individuals. Most income tax laws that apply to individuals apply in the same manner to entities such as corporations, partnerships, and trusts. So, this book is a survey of the fundamentals of income taxation that applies to *all* taxpayers, but we present these foundational rules in the context of an individual taxpayer.

You may recall when you received your first paycheck and were disappointed to learn there was a major difference in your gross pay and your take-home pay. You may have realized that most of this difference was for taxes that you owed, but likely did not understand why you had to pay these. You also realized it would be more difficult to meet your financial goals, such as paying your rent or saving for college. We review the taxes that are withheld from your paycheck, as well as other taxes, in LO7, Other Taxes Paid by Individuals.

While a course in the fundamentals of income taxation is required in most accounting degree programs, this book will benefit you whether or not you practice as an accountant. Everyone who has positive taxable income is subject to federal income tax, so the knowledge you gain from this study will prepare you to effectively manage your personal tax liability.

We have divided the material into six parts:

- I. Introduction to Income Taxation
- II. Income
- III. Deductions
- IV. Taxation of Property Transactions
- V. Other Individual Topics
- VI. CPA Evolution: Core – Tax

The foundational rules covered in the first four sections generally apply to individuals and business entities. Section V reviews the rules that apply specifically to individuals and have little application to entities. Section VI provides an overview of the taxation of corporations, S corporations, limited liability companies, partnerships, and tax-exempt organizations. We focus on the topics in these areas that are tested on the Core – Tax section of the CPA Exam.

LEARNING OBJECTIVES	TOPICS	PRACTICE OPPORTUNITIES
<p><b>1</b> Explain the goal of tax planning and its focus on after-tax income.</p>	<p><b>1.1 The Basics of Tax Planning</b></p> <ul style="list-style-type: none"> <li>• The IRS: An Uninvited Third Party</li> <li>• The Goal of Tax Planning</li> <li>• Considering Tax Costs and Non-Tax Costs</li> </ul>	<ul style="list-style-type: none"> <li>• Example 1.1.1 Dangers of Not Knowing Tax Consequences</li> <li>• Example 1.1.2 Maximizing After-Tax Income</li> <li>• Example 1.1.3 Ignoring Tax Effects</li> <li>• Example 1.1.4 Ignoring Non-Tax Costs</li> <li>• Practice Problem 1.1.1 Determining Tax Consequences</li> </ul>
<p><b>2</b> Distinguish the parts of the individual income tax formula used to compute the tax due or tax refund.</p>	<p><b>1.2 Individual Income Tax Formula</b></p>	
<p><b>3</b> Compare tax compliance with tax planning.</p>	<p><b>1.3 Tax Compliance vs. Tax Planning</b></p> <ul style="list-style-type: none"> <li>• Closed vs. Open Transactions</li> <li>• Marginal Tax Rates, Average Tax Rates, and Effective Tax Rates</li> <li>• Tax Planning Opportunities               <ul style="list-style-type: none"> <li>• Rates Vary across Time Periods</li> <li>• Rates Vary across Jurisdictions</li> <li>• Rates Vary across Types of Income</li> <li>• Rates Vary across Different Types of Taxpayers</li> <li>• Rates Vary within a Family</li> <li>• Time Value of Money</li> <li>• Static vs. Dynamic Tax Planning</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Example 1.3.1 Closed vs. Open Transactions</li> <li>• Example 1.3.2 Tax Planning and Marginal Tax Rates</li> <li>• Example 1.3.3 Marginal Tax Rates and Deductions</li> <li>• Example 1.3.4 Tax Rates</li> <li>• Example 1.3.5 Changing Tax Rates</li> <li>• Example 1.3.6 Changing Tax Jurisdictions</li> <li>• Example 1.3.7 Rates across Different Types of Income</li> <li>• Example 1.3.8 Rates Vary across Taxpayers</li> <li>• Example 1.3.9 Family Tax Planning</li> <li>• Example 1.3.10 Time Value of Money</li> <li>• Example 1.3.11 Time Value of Money—Deduction</li> <li>• Example 1.3.12 Time Value of Money—Income Taxes</li> <li>• Example 1.3.13 Dynamic Forecasting—Income Effect</li> <li>• Example 1.3.14 Dynamic Forecasting—Substitution Effect</li> <li>• Practice Problem 1.3.1 Calculating Tax Liability</li> <li>• Practice Problem 1.3.2 Marginal, Average, and Effective Tax Rates</li> <li>• Practice Problem 1.3.3 Determining Present Value</li> </ul>
<p><b>4</b> Differentiate between tax avoidance and tax evasion.</p>	<p><b>1.4 Tax Avoidance vs. Tax Evasion</b></p> <ul style="list-style-type: none"> <li>• Tax Evasion</li> <li>• Tax Ethics</li> </ul>	<ul style="list-style-type: none"> <li>• Example 1.4.1 Tax Avoidance</li> <li>• Practice Problem 1.4.1 Tax Evasion</li> </ul>

<p><b>5</b> Compare the appropriate accounting methods to use when complying with tax rules and with GAAP rules.</p>	<p><b>1.5 Tax Rules vs. GAAP</b></p>	<ul style="list-style-type: none"> <li>• Example 1.5.1 Tax Rules vs. GAAP</li> <li>• Practice Problem 1.5.1 Reporting Payments</li> </ul>
<p><b>6</b> Classify tax laws based on the reasons Congress created them.</p>	<p><b>1.6 Goals of Tax Policymakers</b></p> <ul style="list-style-type: none"> <li>• Raise Revenue</li> <li>• Social Objectives</li> <li>• Economic Objectives</li> <li>• Equity Objectives <ul style="list-style-type: none"> <li>• Horizontal vs. Vertical Equity</li> <li>• Tax Rate Structures</li> </ul> </li> <li>• Political Objectives</li> </ul>	<ul style="list-style-type: none"> <li>• Example 1.6.1 Proportional vs. Progressive Tax Structures</li> <li>• Example 1.6.2 Tax System Objectives</li> <li>• Practice Problem 1.6.1 Determining a Tax Policy Objective</li> </ul>
<p><b>7</b> Describe taxes paid by individuals at the federal, state, and local levels.</p>	<p><b>1.7 Other Taxes Paid by Individuals</b></p> <ul style="list-style-type: none"> <li>• Other Federal Taxes <ul style="list-style-type: none"> <li>• Employment Taxes</li> <li>• Excise Taxes</li> <li>• Transfer Taxes</li> </ul> </li> <li>• State and Local Taxes <ul style="list-style-type: none"> <li>• Income Taxes</li> <li>• Sales and Use Taxes</li> <li>• Property Taxes</li> <li>• Excise Taxes</li> </ul> </li> <li>• Implicit Taxes</li> </ul>	<ul style="list-style-type: none"> <li>• Example 1.7.1 Implicit Taxes</li> <li>• Practice Problem 1.7.1 Use Tax</li> </ul>
<p><b>8</b> Discuss career opportunities for tax professionals.</p>	<p><b>1.8 Professional Taxation as a Career</b></p> <ul style="list-style-type: none"> <li>• The Role of a Tax Professional</li> <li>• Characteristics of Successful Tax Professionals</li> <li>• Artificial Intelligence in Taxation</li> </ul>	<ul style="list-style-type: none"> <li>• Practice Problem 1.8.1 Careers in Accounting</li> </ul>

### Tax Forms referenced in this chapter

Form 1040	U.S. Individual Income Tax Return
Form 1040, Schedule 1	Additional Income and Adjustments to Income
Form 1040, Schedule 2	Additional Taxes
Form 1040, Schedule 3	Additional Credits and Payments

# 1.1 The Basics of Tax Planning

## LEARNING OBJECTIVE 1

Explain the goal of tax planning and its focus on after-tax income.



VIDEO  
CONTENT

The study of federal income taxation is exciting, challenging, and rewarding. Careers in professional taxation are fulfilling because all taxpayers want to structure their transactions in a tax-efficient manner. If you like the idea of adding value to others, then you will enjoy being a tax advisor to individuals and businesses. You need a thorough understanding of federal income taxation rules to be an effective tax planner, but the job requires much more than that. A tax professional must also have excellent analytical skills, be creative, and be an effective problem-solver and communicator. The purpose of this book is to provide you with the knowledge and skills you need to be a tax professional, which will provide great career opportunities for you. Keep in mind that you also have to pay federal income tax on your earnings. So, even if you are not interested in a tax career, this text will prepare you to structure your own transactions in such a manner as to maximize your *after-tax income*.

In this initial section, we describe big picture items to consider when evaluating how best to execute tax-efficient transactions, including:

- The Internal Revenue Service (IRS) is a potential uninvited third party to *all* financial transactions, which means the tax implications for all transactions need to be considered.
- The goal of tax planning is not to minimize taxes but to *maximize after-tax income*, given your spending and investing goals.
- You should consider both tax costs and non-tax costs when evaluating transactions. While taxpayers often ignore the tax effects of a transaction because of a lack of knowledge, tax professionals should focus on both the tax costs and the relevant non-tax costs.

## The IRS: An Uninvited Third Party

The services of tax professionals are in high demand because there is a potential tax effect for every transaction engaged in by an individual. Thus, the Internal Revenue Service (IRS) is a potential uninvited third party to every financial transaction. If taxpayers do not understand the tax consequences of their transactions, poor decisions can result.

### EXAMPLE 1.1.1

#### Dangers of Not Knowing Tax Consequences



Assume you plan to sell a five-year-old automobile to your neighbor for \$10,000. Just before the transaction is finalized, a third party appears who informs you that once you receive the \$10,000, they will legally take some of it from you—you will only keep what is left over. Would you continue with the transaction if this was all the information you had?

#### SOLUTION

We hope your answer would be a resounding “NO!” You should have at least two questions for the third party:

- What right do you have to take some of my \$10,000?
- How much of the \$10,000 do you plan to take?

If the third party plans to take only \$5, then you might decide to proceed and not waste your time finding out why they can legally take some of your money. But if they plan to take \$1,000, you might want to delay the transaction until you receive legal advice from an expert.

Every day, many people engage in financial transactions having no idea what the tax consequences will be. This is no different than the scenario in Example 1.1.1: selling your car for \$10,000 and not knowing how much of your money the third party will take. The third party in Example 1.1.1 (if you haven't already guessed) represents the IRS, and the \$1,000 represents the tax you might pay on the gain from selling your car.

If you know the tax consequences *before* a transaction occurs, you have three options:

- If satisfied with the tax results, you finalize the transaction.
- If not satisfied with the tax results, you seek advice to find a more tax-efficient way to structure the transaction.
- If a better tax result is not possible, you may decide not to pursue the transaction.

Once a taxpayer understands the tax consequences of a particular transaction, they can move on to the tax planning stage, which we discuss in the next section.

## The Goal of Tax Planning

Do you think an outcome of appropriate tax planning is to minimize a taxpayer's tax liability for the year? Were that the goal, then the ultimate success would be to reduce a taxpayer's tax liability to zero—actually an easy goal to meet. If a taxpayer had no income for the year, then there would be no tax liability, and you would have minimized their taxes. But your client will also be a very poor and hungry person, so this cannot be the proper goal.

The appropriate goal for tax planning is to maximize *after-tax income*. **After-tax income** is net income after reducing revenue for all expenses, including federal income taxes. Conceptually, the goal is to make as much net profit as you can and, in the process, structure your transactions in the manner that is the most tax efficient.

**Related exercise: Discussion Question 1**

Carolinda owns a large manufacturing company and plans to build a new manufacturing plant in either Florida or Ohio. Her chief financial officer presents her with the following annual projections for placing the plant in each state.

	<u>Revenue</u>	<u>Non-income tax costs</u>	<u>Income tax</u>
Florida	\$800,000	\$600,000	\$ 80,000
Ohio	\$900,000	\$525,000	\$150,000

Carolinda has told you that she is leaning toward choosing Florida because the income taxes are much lower than in Ohio. She asks for your advice.

### SOLUTION

There are several ways to evaluate the two alternatives.

- Which choice maximizes revenue? Ohio: \$900,000 vs. \$800,000
- Which choice minimizes taxes? Florida: \$80,000 vs. \$150,000
- Which choice maximizes after-tax income?

Florida: \$120,000 (\$800,000 – \$600,000 – \$80,000)

Ohio: \$225,000 (\$900,000 – \$525,000 – \$150,000)

You should advise Carolinda that Ohio maximizes her company's after-tax income. The goal of tax minimization would have led to a suboptimal choice of Florida.

### EXAMPLE 1.1.2 Maximizing After-Tax Income



**Related exercise: Brief Exercise 1**

## Considering Tax Costs and Non-Tax Costs

Both tax and non-tax costs must be considered when making financial and investment decisions. **Tax costs** include any type of tax paid to a local, state, federal, or foreign government. **Non-tax costs** include all expenses other than tax costs, as well as non-financial factors such as risk, location, brand reputation, and sustainability concerns. Let's focus first on the problems that can arise if you do not include the factors that determine tax costs in the decision-making process. This can lead to poor decision-making, as you will see in the following Example.

### EXAMPLE 1.1.3 Ignoring Tax Effects



Dennis rents an apartment for \$1,200 per month. He would like to buy a house, so his monthly payment builds more wealth in the long run. If he purchases a home with a 10% down payment and borrows the remaining funds needed, his monthly payment will be \$1,500 per month, consisting of \$100 applied to his loan principal and \$1,400 interest. Dennis tells you that because his rent payment is \$300 per month less than his mortgage payment, he plans to keep renting. Dennis is in the 24% tax bracket. He asks you if you agree with his decision.

(You will learn later in the course that interest expense related to the acquisition of a principal residence is deductible, but rent expense is not. Also, assume that Dennis qualifies to itemize his deductions. You need these two pieces of information to render the proper advice.)

#### SOLUTION

Dennis is ignoring the tax effects of these alternatives. The mortgage payment is \$300 greater than the rent payment before the consideration of taxes. Taxes do not affect the rent payment, but because the mortgage interest is deductible, the \$1,400 of interest paid each month will reduce his tax liability. His tax savings is a function of his marginal tax rate, which is 24%.

Monthly interest payment	\$1,400
× Marginal tax rate	× 24%
<u>Tax savings due to interest deduction</u>	<u>\$ 336</u>
Mortgage payment	\$1,500
<u>Less: Tax savings</u>	<u>(336)</u>
<u>Cash outflow after-tax effect</u>	<u>\$1,164</u>

Once Dennis considers the tax savings of \$336, the mortgage payment is \$36 per month less than the rent payment (\$1,200 – \$1,164). Renting may not be less expensive than buying a home when considering just the monthly payment.

From the calculations made in Example 1.1.3, it seems Dennis would be better off purchasing a house, but before giving Dennis a final opinion, you need to also consider the non-tax costs of renting versus owning, which we explore in the next Example.

### EXAMPLE 1.1.4 Ignoring Non-Tax Costs



If your analysis stops where Example 1.1.3 ends, and Dennis purchases the house, you may have given him inappropriate advice. While it is true that Dennis ignored the tax effects of the alternatives, the discussion above ignores non-tax costs. Are there more non-tax costs to owning a home than to renting?

#### SOLUTION

Definitely! For example, Dennis will likely pay property taxes on his house. He will also incur repairs for the house, some of which can be very expensive, like a new roof or a new air-conditioning system. If the total of those additional expenses amounts to more than \$36 per month, then he may be better off continuing to rent his apartment. If Dennis purchases the house, he has the opportunity to build equity in it, which he will not have if renting. These are complex decisions that tax professionals can help individuals make.

While taxpayers often ignore the tax effects of a transaction, tax professionals can overweight the tax consequences if they do not consider the relevant non-tax costs. Effective tax planning requires consideration of both tax and non-tax costs.

**Related exercise: Multiple Choice Question 1**

Barry has a lucrative law practice in New York City that produces a generous profit. He frequently takes his clients golfing and to New York Yankees games for entertainment. He believes it is good business to maintain a professional and personal relationship with his clients. Barry is not a tax accountant and doesn't understand the tax effect of these expenses. How would you advise Barry regarding the tax consequences of these expenditures?

## PRACTICE PROBLEM 1.1.1 Determining Tax Consequences

### SOLUTION

As Barry's accountant, it is your responsibility to determine if expenses incurred are deductible or not. You will learn later in this course that entertainment expenses are not deductible as a business expense (see Chapter 10, LO3, Entertainment and Education Expenses). Therefore, you should advise Barry that he needs to determine how much additional revenue he is generating from these activities in comparison to the after-tax cost of the entertainment. Because of the limited deductibility of the expenses, perhaps he should reduce the amounts spent on these activities.



# 1.2 Individual Income Tax Formula

## LEARNING OBJECTIVE 2

Distinguish the parts of the individual income tax formula used to compute the tax due or tax refund.

We use the tax formula for individuals as a guide for the organization of this book. We have included the chapters that relate to each part of the formula in **Illustration 1.1**. (The Form 1040 line numbers are from the 2025 Form 1040 because this was the most recent version available at the time of publication.) This chapter and Chapter 2, Fundamentals of the Federal Income Tax System, provide an introduction and framework for the study of income taxation. The other chapters cover specific parts of the tax formula. You will understand the terms in the tax formula better once you study them in the appropriate chapters. **Illustration 1.2** provides Schedules 1, 2, and 3 that flow into Form 1040. Schedule 1-A is new for 2025 and it is included in Appendix B. It includes four new temporary deductions, as added by the new 2025 tax law (House Resolution 1).



**ILLUSTRATION 1.1** Tax Formula, Chapter Alignment, and Form 1040 Line Numbers

	Chapters	Line #s on Form 1040
Gross income	5, 6, 7, 12, 13, 14, 15	1–9
<u>Less: Deductions for adjusted gross income</u>	8, 9, 10, 11	10
Adjusted gross income		11
<u>Less: Greater of standard deduction or itemized deductions</u>	9	12
<u>Less: Qualified business income deduction</u>	5	13a
<u>Less: Other deductions</u>	7, 8, 9	13b
Taxable income		15

ILLUSTRATION 1.1 (continued)

	Chapters	Line #s on Form 1040
× Tax rate	4	
Tax		16
Less: Tax credits	16	19, 20, 27–31
Plus: Other taxes	17	17, 23
Total tax		24
Less: Prepayments of tax	3	25, 26
Taxes due (refund)	3	34, 37

ILLUSTRATION 1.2 Form 1040 and Schedules 1, 2, and 3



**1040** U.S. Individual Income Tax Return **2025** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2025, or other tax year beginning , 2025, ending , 20 See separate instructions.

Filed pursuant to section 301.9100-2  Combat zone  Deceased MM / DD / YYYY Spouse MM / DD / YYYY

Other

Your first name and middle initial Last name Your social security number

If joint return, spouse's first name and middle initial Last name Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions. Apt. no. Check here if your main home, and your spouse's if filing a joint return, was in the U.S. for more than half of 2025.

City, town, or post office. If you have a foreign address, also complete spaces below. State ZIP code **Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.  You  Spouse

Foreign country name Foreign province/state/country Foreign postal code

**Filing Status**  Single  Head of household (HOH)  Married filing jointly (even if only one had income)  Qualifying surviving spouse (QSS)  Married filing separately (MFS). Enter spouse's SSN above and full name here: If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent:  If treating a nonresident alien or dual-status alien spouse as a U.S. resident for the entire tax year, check the box and enter their name (see instructions and attach statement if required):

Check only one box.

**Digital Assets** At any time during 2025, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.)  Yes  No

**Dependents** (see instructions)

	Dependent 1	Dependent 2	Dependent 3	Dependent 4
(1) First name				
(2) Last name				
(3) SSN				
(4) Relationship				
(5) Check if lived with you more than half of 2025	(a) <input type="checkbox"/> Yes (b) <input type="checkbox"/> And in the U.S.	(a) <input type="checkbox"/> Yes (b) <input type="checkbox"/> And in the U.S.	(a) <input type="checkbox"/> Yes (b) <input type="checkbox"/> And in the U.S.	(a) <input type="checkbox"/> Yes (b) <input type="checkbox"/> And in the U.S.
(6) Check if	<input type="checkbox"/> Full-time student <input type="checkbox"/> Permanently and totally disabled	<input type="checkbox"/> Full-time student <input type="checkbox"/> Permanently and totally disabled	<input type="checkbox"/> Full-time student <input type="checkbox"/> Permanently and totally disabled	<input type="checkbox"/> Full-time student <input type="checkbox"/> Permanently and totally disabled
(7) Credits	<input type="checkbox"/> Child tax credit <input type="checkbox"/> Credit for other dependents	<input type="checkbox"/> Child tax credit <input type="checkbox"/> Credit for other dependents	<input type="checkbox"/> Child tax credit <input type="checkbox"/> Credit for other dependents	<input type="checkbox"/> Child tax credit <input type="checkbox"/> Credit for other dependents

Check if your filing status is MFS or HOH and you lived apart from your spouse for the last 6 months of 2025, or you are legally separated according to your state law under a written separation agreement or a decree of separate maintenance and you did not live in the same household as your spouse at the end of 2025.

**Income** Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld. If you did not get a Form W-2, see instructions.

1a	Total amount from Form(s) W-2, box 1 (see instructions)	1a
b	Household employee wages not reported on Form(s) W-2	1b
c	Tip income not reported on line 1a (see instructions)	1c
d	Medicaid waiver payments not reported on Form(s) W-2 (see instructions)	1d
e	Taxable dependent care benefits from Form 2441, line 26	1e
f	Employer-provided adoption benefits from Form 8839, line 31	1f
g	Wages from Form 8919, line 6	1g
h	Other earned income (see instructions). Enter type and amount:	1h
i	Nontaxable combat pay election (see instructions)	1i
z	Add lines 1a through 1h	1z
2a	Tax-exempt interest	2a
3a	Qualified dividends	3a
c	Check if your child's dividends are included in <input type="checkbox"/> 1 <input type="checkbox"/> Line 3a	2 <input type="checkbox"/> Line 3b
4a	IRA distributions	4a
c	Check if (see instructions) <input type="checkbox"/> 1 <input type="checkbox"/> Rollover	2 <input type="checkbox"/> QCD 3 <input type="checkbox"/>
5a	Pensions and annuities	5a
c	Check if (see instructions) <input type="checkbox"/> 1 <input type="checkbox"/> Rollover	2 <input type="checkbox"/> PSO 3 <input type="checkbox"/>
6a	Social security benefits	6a
c	If you elect to use the lump-sum election method, check here (see instructions)	6b
d	If you are married filing separately and lived apart from your spouse the entire year (see inst.), check here	7a
7a	Capital gain or (loss). Attach Schedule D if required	7a
b	Check if: <input type="checkbox"/> Schedule D not required <input type="checkbox"/> Includes child's capital gain or (loss)	8
8	Additional income from Schedule 1, line 10	8
9	Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7a, and 8. This is your total income	9
10	Adjustments to income from Schedule 1, line 26	10
11a	Subtract line 10 from line 9. This is your adjusted gross income	11a

Attach Sch. B if required.

Filing Status and Dependents (Chapter 4)

Income: Lines 1–9 (Chapters 5–7, 12–15)

Deduction: Line 10 (Chapters 5, 8–11)

ILLUSTRATION 1.2 (continued)



Form 1040 (2025) Page 2

<b>Tax and Credits</b>		11b	Amount from line 11a (adjusted gross income)	11b
<b>12a</b> Someone can claim <input type="checkbox"/> You as a dependent <input type="checkbox"/> Your spouse as a dependent				
<b>b</b> <input type="checkbox"/> Spouse itemizes on a separate return <b>c</b> <input type="checkbox"/> You were a dual-status alien				
<b>d</b> You: <input type="checkbox"/> Were born before January 2, 1961 <input type="checkbox"/> Are blind				
Spouse: <input type="checkbox"/> Was born before January 2, 1961 <input type="checkbox"/> Is blind				
<b>e</b> <b>Standard deduction or itemized deductions</b> (from Schedule A)		12e		
<b>Standard deduction for—</b> • Single or Married filing separately, \$15,750 • Married filing jointly or Qualifying surviving spouse, \$31,500 • Head of household, \$23,625 • If you checked a box on line 12a, 12b, 12c, or 12d, see inst.	<b>13a</b> Qualified business income deduction from Form 8995 or Form 8995-A	13a		Deductions: Lines 12–13 (Chapters 5, 8–11)
	<b>b</b> Additional deductions from Schedule 1-A, line 38	13b		
	<b>14</b> Add lines 12e, 13a, and 13b	14		
	<b>15</b> Subtract line 14 from line 11b. If zero or less, enter -0-. This is your <b>taxable income</b>	15		
<b>16</b> Tax (see instructions). Check if any from Form(s): <b>1</b> <input type="checkbox"/> 8814 <b>2</b> <input type="checkbox"/> 4972 <b>3</b> <input type="checkbox"/>		16		Additional tax: Lines 17, 23 (Chapter 17)
<b>17</b> Amount from Schedule 2, line 3		17		
<b>18</b> Add lines 16 and 17		18		Prepayments of tax: Lines 25, 26 (Chapter 3)
<b>19</b> Child tax credit or credit for other dependents from Schedule 8812		19		
<b>20</b> Amount from Schedule 3, line 8		20		Credits: Lines 27–31 (Chapter 16)
<b>21</b> Add lines 19 and 20		21		
<b>22</b> Subtract line 21 from line 18. If zero or less, enter -0-		22		
<b>23</b> Other taxes, including self-employment tax, from Schedule 2, line 21		23		
<b>24</b> Add lines 22 and 23. This is your <b>total tax</b>		24		
<b>Payments and Refundable Credits</b>				
<b>25</b> Federal income tax withheld from:				
<b>a</b> Form(s) W-2		25a		Prepayments of tax: Lines 25, 26 (Chapter 3)
<b>b</b> Form(s) 1099		25b		
<b>c</b> Other forms (see instructions)		25c		
<b>d</b> Add lines 25a through 25c		25d		
<b>26</b> 2025 estimated tax payments and amount applied from 2024 return		26		
If you made estimated tax payments with your former spouse in 2025, enter their SSN (see instructions):				
<b>27a</b> Earned income credit (EIC)		27a		Credits: Lines 27–31 (Chapter 16)
<b>b</b> Clergy filing Schedule SE (see instructions)				
<b>c</b> If you do not want to claim the EIC, check here <input type="checkbox"/>				
<b>28</b> Additional child tax credit (ACTC) from Schedule 8812. If you do not want to claim the ACTC, check here <input type="checkbox"/>		28		
<b>29</b> American opportunity credit from Form 8863, line 8		29		
<b>30</b> Refundable adoption credit from Form 8839, line 13		30		
<b>31</b> Amount from Schedule 3, line 15		31		
<b>32</b> Add lines 27a, 28, 29, 30, and 31. These are your <b>total other payments and refundable credits</b>		32		
<b>33</b> Add lines 25d, 26, and 32. These are your <b>total payments</b>		33		
<b>Refund</b>				
<b>34</b> If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you <b>overpaid</b>		34		
<b>35a</b> Amount of line 34 you want <b>refunded to you</b> . If Form 8888 is attached, check here <input type="checkbox"/>		35a		
<b>b</b> Routing number				
<b>c</b> Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings				
<b>d</b> Account number				
<b>36</b> Amount of line 34 you want <b>applied to your 2026 estimated tax</b>		36		
<b>Amount You Owe</b>				
<b>37</b> Subtract line 33 from line 24. This is the <b>amount you owe</b> . For details on how to pay, go to <a href="http://www.irs.gov/Payments">www.irs.gov/Payments</a> or see instructions		37		
<b>38</b> Estimated tax penalty (see instructions)		38		
<b>Third Party Designee</b>				
Do you want to allow another person to discuss this return with the IRS? See instructions. <input type="checkbox"/> Yes. Complete below. <input type="checkbox"/> No				
Designee's name		Phone no.	Personal identification number (PIN)	
<b>Sign Here</b>		Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.		
Your signature		Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Spouse's signature. If a joint return, <b>both</b> must sign.		Date	Spouse's occupation	If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.)
Phone no.		Email address		
<b>Paid Preparer Use Only</b>				
Preparer's name		Preparer's signature	Date	PTIN
Firm's name		Check if: <input type="checkbox"/> Self-employed		
Firm's address		Phone no.		
		Firm's EIN		

Go to [www.irs.gov/Form1040](http://www.irs.gov/Form1040) for instructions and the latest information. Form 1040 (2025)

Individuals file their individual income taxes on Form 1040.<sup>1</sup> Form 1040 is a more detailed version of the tax formula, as shown in Illustration 1.2. Form 1040 has two pages and also includes Schedules 1, 2, and 3. The top half of page 1 of Form 1040 is for demographic information. The remainder of pages 1 and 2 flow as described below (between the end of Schedule 1 and the start of Schedule 2).

<sup>1</sup>Taxpayers age 65 and over have the option to file Form 1040-SR. Form 1040-SR makes it easier to report retirement income and the standard deduction. It also has a larger font, so it is easier for senior citizens to read.

ILLUSTRATION 1.2 (continued)



**SCHEDULE 1  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Additional Income and Adjustments to Income**

Attach to Form 1040, 1040-SR, or 1040-NR.

Go to [www.irs.gov/Form1040](http://www.irs.gov/Form1040) for instructions and the latest information.

OMB No. 1545-0074

**2025**  
Attachment  
Sequence No. **01**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR

Your social security number

For 2025, enter the amount reported to you on Form(s) 1099-K that was included in error or for personal items sold at a loss . . . . .

**Note:** The remaining amounts reported to you on Form(s) 1099-K should be reported elsewhere on your return depending on the nature of the transaction. See [www.irs.gov/1099k](http://www.irs.gov/1099k).

<b>Part I Additional Income</b>		
<b>1</b>	Taxable refunds, credits, or offsets of state and local income taxes . . . . .	<b>1</b>
<b>2a</b>	Alimony received . . . . .	<b>2a</b>
<b>b</b>	Date of original divorce or separation agreement (see instructions): _____	
<b>3</b>	Business income or (loss). Attach Schedule C . . . . .	<b>3</b>
<b>4</b>	Other gains or (losses). Check if any from Form(s): <input type="checkbox"/> 4797 <input type="checkbox"/> 4684 . . . . .	<b>4</b>
<b>5</b>	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E . . . . .	<b>5</b>
<b>6</b>	Farm income or (loss). Attach Schedule F . . . . .	<b>6</b>
<b>7</b>	Unemployment compensation. If you repaid a 2025 overpayment (see instructions), check here <input type="checkbox"/> and enter amount repaid: _____ . . . . .	<b>7</b>
<b>8</b>	Other income:	
<b>a</b>	Net operating loss . . . . .	<b>8a</b> ( )
<b>b</b>	Gambling . . . . .	<b>8b</b>
<b>c</b>	Cancellation of debt . . . . .	<b>8c</b>
<b>d</b>	Foreign earned income exclusion from Form 2555 . . . . .	<b>8d</b> ( )
<b>e</b>	Income from Form 8853 . . . . .	<b>8e</b>
<b>f</b>	Income from Form 8889 . . . . .	<b>8f</b>
<b>g</b>	Alaska Permanent Fund dividends . . . . .	<b>8g</b>
<b>h</b>	Jury duty pay . . . . .	<b>8h</b>
<b>i</b>	Prizes and awards . . . . .	<b>8i</b>
<b>j</b>	Activity not engaged in for profit income . . . . .	<b>8j</b>
<b>k</b>	Stock options . . . . .	<b>8k</b>
<b>l</b>	Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property . . . . .	<b>8l</b>
<b>m</b>	Olympic and Paralympic medals and USOC prize money (see instructions) . . . . .	<b>8m</b>
<b>n</b>	Section 951(a) inclusion (see instructions) . . . . .	<b>8n</b>
<b>o</b>	Section 951A(a) inclusion (see instructions) . . . . .	<b>8o</b>
<b>p</b>	Section 461(l) excess business loss adjustment . . . . .	<b>8p</b>
<b>q</b>	Taxable distributions from an ABLÉ account (see instructions) . . . . .	<b>8q</b>
<b>r</b>	Scholarship and fellowship grants not reported on Form W-2 . . . . .	<b>8r</b>
<b>s</b>	Nontaxable amount of Medicaid waiver payments included on Form 1040, line 1a or 1d . . . . .	<b>8s</b> ( )
<b>t</b>	Pension or annuity from a nonqualified deferred compensation plan or a nongovernmental section 457 plan . . . . .	<b>8t</b>
<b>u</b>	Wages earned while incarcerated . . . . .	<b>8u</b>
<b>v</b>	Digital assets received as ordinary income not reported elsewhere. See instructions . . . . .	<b>8v</b>
<b>z</b>	Other income. List type and amount: _____ _____	<b>8z</b>
<b>9</b>	Total other income. Add lines 8a through 8z . . . . .	<b>9</b>
<b>10</b>	Combine lines 1 through 7 and 9. This is your <b>additional income</b> . Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8 . . . . .	<b>10</b>

ILLUSTRATION 1.2 (continued)



Schedule 1 (Form 1040) 2025

Page 2

<b>Part II Adjustments to Income</b>		
11	Educator expenses . . . . .	11
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 . . . . .	12
13	Health savings account deduction. Attach Form 8889 . . . . .	13
14	Moving expenses for members of the Armed Forces. Attach Form 3903. If claiming only storage fees (see instructions), check here <input type="checkbox"/> . . . . .	14
15	Deductible part of self-employment tax. Attach Schedule SE . . . . .	15
16	Self-employed SEP, SIMPLE, and qualified plans . . . . .	16
17	Self-employed health insurance deduction . . . . .	17
18	Penalty on early withdrawal of savings . . . . .	18
19a	Alimony paid . . . . .	19a
	b Recipient's SSN . . . . .	
	c Date of original divorce or separation agreement (see instructions): _____	
20	IRA deduction. If you are married filing separately and lived apart from your spouse for the entire year (see instructions), check here <input type="checkbox"/> . . . . .	20
21	Student loan interest deduction . . . . .	21
22	Reserved for future use . . . . .	22
23	Archer MSA deduction . . . . .	23
24	Other adjustments:	
	a Jury duty pay (see instructions) . . . . .	24a
	b Deductible expenses related to income reported on line 8l from the rental of personal property engaged in for profit . . . . .	24b
	c Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8m . . . . .	24c
	d Reforestation amortization and expenses . . . . .	24d
	e Repayment of supplemental unemployment benefits under the Trade Act of 1974 . . . . .	24e
	f Contributions to section 501(c)(18)(D) pension plans . . . . .	24f
	g Contributions by certain chaplains to section 403(b) plans . . . . .	24g
	h Attorney fees and court costs for actions involving certain unlawful discrimination claims (see instructions) . . . . .	24h
	i Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations . . . . .	24i
	j Housing deduction from Form 2555 . . . . .	24j
	k Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041) . . . . .	24k
	z Other adjustments. List type and amount: _____ _____	24z
25	Total other adjustments. Add lines 24a through 24z . . . . .	25
26	Add lines 11 through 23 and 25. These are your <b>adjustments to income</b> . Enter here and on Form 1040, 1040-SR, or 1040-NR, line 10 . . . . .	26

Schedule 1 (Form 1040) 2025

Income	Lines 1–9, including Part I of Schedule 1
Deductions for AGI	Line 10 (Part II of Schedule 1)
Standard deduction or itemized deduction	Line 12e
Qualified business income deduction	Line 13a
Other deductions	Line 13b (Schedule 1-A)
Taxable income	Line 15
Tax from tax tables	Line 16
Additional taxes	Lines 17 (Part I of Schedule 2) and 23 (Part II of Schedule 2)
Tax credits	Lines 19, 20 (Part I of Schedule 3), 27–31 (Part II of Schedule 3)
Total tax	Line 24
Tax withheld and other payments	Lines 25–26
Tax due or refund	Lines 34, 37

**Related exercises: Discussion Questions 2, 3**  
**Brief Exercise 2**  
**Multiple Choice Questions 2, 3**

ILLUSTRATION 1.2 (continued)



**SCHEDULE 2  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Additional Taxes**

Attach to Form 1040, 1040-SR, or 1040-NR.

Go to [www.irs.gov/Form1040](http://www.irs.gov/Form1040) for instructions and the latest information.

OMB No. 1545-0074

**2025**  
Attachment  
Sequence No. **02**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR

Your social security number

<b>Part I Tax</b>		
<b>1</b>	Additions to tax:	
<b>a</b>	Excess advance premium tax credit repayment. Attach Form 8962 . . . . .	<b>1a</b>
<b>b</b>	Repayment of new clean vehicle credit(s) transferred to a registered dealer from Schedule A (Form 8936), Part II. Attach Form 8936 and Schedule A (Form 8936) . . . . .	<b>1b</b>
<b>c</b>	Repayment of previously owned clean vehicle credit(s) transferred to a registered dealer from Schedule A (Form 8936), Part IV. Attach Form 8936 and Schedule A (Form 8936) . . . . .	<b>1c</b>
<b>d</b>	Recapture of net EPE from Form 4255, line 2a, column (l) . . . . .	<b>1d</b>
<b>e</b>	Excessive payments (EPs) on gross EPE from Form 4255. Check applicable box and enter amount. See instructions. (i) <input type="checkbox"/> Line 1a                      (ii) <input type="checkbox"/> Line 1c (iii) <input type="checkbox"/> Line 1d                      (iv) <input type="checkbox"/> Line 2a . . . . .	<b>1e</b>
<b>f</b>	20% EP from Form 4255. Check applicable box and enter amount. See instructions. (i) <input type="checkbox"/> Line 1a                      (ii) <input type="checkbox"/> Line 1c (iii) <input type="checkbox"/> Line 1d                      (iv) <input type="checkbox"/> Line 2a . . . . .	<b>1f</b>
<b>y</b>	Other additions to tax (see instructions): _____	<b>1y</b>
<b>z</b>	Add lines 1a through 1y . . . . .	<b>1z</b>
<b>2</b>	Alternative minimum tax. Attach Form 6251 . . . . .	<b>2</b>
<b>3</b>	Add lines 1z and 2. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 17 . . . . .	<b>3</b>
<b>Part II Other Taxes</b>		
<b>4</b>	Self-employment tax. Attach Schedule SE. Check if any exemption from (see instructions): 1 <input type="checkbox"/> 4361      2 <input type="checkbox"/> 4029      3 <input type="checkbox"/> _____ . . . . .	<b>4</b>
<b>5</b>	Social security and Medicare tax on unreported tip income. Attach Form 4137	<b>5</b>
<b>6</b>	Uncollected social security and Medicare tax on wages. Attach Form 8919 . . . . .	<b>6</b>
<b>7</b>	Total additional social security and Medicare tax. Add lines 5 and 6 . . . . .	<b>7</b>
<b>8</b>	Additional tax on IRAs or other tax-favored accounts. Attach Form 5329 if required. If not required, check here . . . . . <input type="checkbox"/>	<b>8</b>
<b>9</b>	Household employment taxes. Attach Schedule H . . . . .	<b>9</b>
<b>10</b>	Reserved for future use . . . . .	<b>10</b>
<b>11</b>	Additional Medicare Tax. Attach Form 8959 . . . . .	<b>11</b>
<b>12</b>	Net investment income tax. Attach Form 8960 . . . . .	<b>12</b>
<b>13</b>	Uncollected social security and Medicare or RRTA tax on tips or group-term life insurance from Form W-2, box 12 . . . . .	<b>13</b>
<b>14</b>	Interest on tax due on installment income from the sale of certain residential lots and timeshares . . . . .	<b>14</b>
<b>15</b>	Interest on the deferred tax on gain from certain installment sales with a sales price over \$150,000 . . . . .	<b>15</b>
<b>16</b>	Recapture of low-income housing credit. Attach Form 8611 . . . . .	<b>16</b>

(continued on page 2)

ILLUSTRATION 1.2 (continued)



Schedule 2 (Form 1040) 2025

Page 2

<b>Part II Other Taxes (continued)</b>		
<b>17</b>	Other additional taxes:	
<b>a</b>	Recapture of other credits. List type, form number, and amount: _____	<b>17a</b>
<b>b</b>	Recapture of federal mortgage subsidy. If you sold your home, see instructions	<b>17b</b>
<b>c</b>	Additional tax on HSA distributions. Attach Form 8889 . . . . .	<b>17c</b>
<b>d</b>	Additional tax on an HSA because you didn't remain an eligible individual. Attach Form 8889 . . . . .	<b>17d</b>
<b>e</b>	Additional tax on Archer MSA distributions. Attach Form 8853 . . . . .	<b>17e</b>
<b>f</b>	Additional tax on Medicare Advantage MSA distributions. Attach Form 8853	<b>17f</b>
<b>g</b>	Recapture of a charitable contribution deduction related to a fractional interest in tangible personal property . . . . .	<b>17g</b>
<b>h</b>	Income you received from a nonqualified deferred compensation plan that fails to meet the requirements of section 409A . . . . .	<b>17h</b>
<b>i</b>	Compensation you received from a nonqualified deferred compensation plan described in section 457A . . . . .	<b>17i</b>
<b>j</b>	Section 72(m)(5) excess benefits tax . . . . .	<b>17j</b>
<b>k</b>	Golden parachute payments . . . . .	<b>17k</b>
<b>l</b>	Tax on accumulation distribution of trusts . . . . .	<b>17l</b>
<b>m</b>	Excise tax on insider stock compensation from an expatriated corporation . . . . .	<b>17m</b>
<b>n</b>	Look-back interest under section 167(g) or 460(b) from Form 8697 or 8866 . . . . .	<b>17n</b>
<b>o</b>	Tax on non-effectively connected income for any part of the year you were a nonresident alien from Form 1040-NR . . . . .	<b>17o</b>
<b>p</b>	Any interest from Form 8621, line 16f, relating to distributions from, and dispositions of, stock of a section 1291 fund . . . . .	<b>17p</b>
<b>q</b>	Any interest from Form 8621, line 24 . . . . .	<b>17q</b>
<b>z</b>	Any other taxes. List type and amount: _____ _____	<b>17z</b>
<b>18</b>	Total additional taxes. Add lines 17a through 17z . . . . .	<b>18</b>
<b>19</b>	Recapture of net EPE from Form 4255, line 1d, column (l) . . . . .	<b>19</b>
<b>20</b>	Section 965 net tax liability installment from Form 965-A . . . . .	<b>20</b>
<b>21</b>	Add lines 4, 7 through 16, 18, and 19. These are your <b>total other taxes</b> . Enter here and on Form 1040 or 1040-SR, line 23; or Form 1040-NR, line 23b . . . . .	<b>21</b>

ILLUSTRATION 1.2 (continued)



**SCHEDULE 3  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Additional Credits and Payments**

Attach to Form 1040, 1040-SR, or 1040-NR.  
Go to [www.irs.gov/Form1040](http://www.irs.gov/Form1040) for instructions and the latest information.

OMB No. 1545-0074

**2025**  
Attachment  
Sequence No. **03**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR

Your social security number

**Part I Nonrefundable Credits**

<b>1</b>	Foreign tax credit. Attach Form 1116 if required . . . . .		<b>1</b>	
<b>2</b>	Credit for child and dependent care expenses from Form 2441, line 11. Attach Form 2441 . . . . .		<b>2</b>	
<b>3</b>	Education credits from Form 8863, line 19 . . . . .		<b>3</b>	
<b>4</b>	Retirement savings contributions credit. Attach Form 8880 . . . . .		<b>4</b>	
<b>5a</b>	Residential clean energy credit from Form 5695, line 15 . . . . .		<b>5a</b>	
<b>b</b>	Energy efficient home improvement credit from Form 5695, line 32 . . . . .		<b>5b</b>	
<b>6</b>	Other nonrefundable credits:			
<b>a</b>	General business credit. Attach Form 3800 . . . . .	<b>6a</b>		
<b>b</b>	Credit for prior year minimum tax. Attach Form 8801 . . . . .	<b>6b</b>		
<b>c</b>	Adoption credit. Attach Form 8839 . . . . .	<b>6c</b>		
<b>d</b>	Credit for the elderly or disabled. Attach Schedule R . . . . .	<b>6d</b>		
<b>e</b>	Reserved for future use . . . . .	<b>6e</b>		
<b>f</b>	Clean vehicle credit. Attach Form 8936 . . . . .	<b>6f</b>		
<b>g</b>	Mortgage interest credit. Attach Form 8396 . . . . .	<b>6g</b>		
<b>h</b>	District of Columbia first-time homebuyer credit. Attach Form 8859 . . . . .	<b>6h</b>		
<b>i</b>	Qualified electric vehicle credit. Attach Form 8834 . . . . .	<b>6i</b>		
<b>j</b>	Alternative fuel vehicle refueling property credit. Attach Form 8911 . . . . .	<b>6j</b>		
<b>k</b>	Credit to holders of tax credit bonds. Attach Form 8912 . . . . .	<b>6k</b>		
<b>l</b>	Amount on Form 8978, line 14. See instructions . . . . .	<b>6l</b>		
<b>m</b>	Credit for previously owned clean vehicles. Attach Form 8936 . . . . .	<b>6m</b>		
<b>z</b>	Other nonrefundable credits. List type and amount: _____ _____	<b>6z</b>		
<b>7</b>	Total other nonrefundable credits. Add lines 6a through 6z . . . . .		<b>7</b>	
<b>8</b>	Add lines 1 through 4, 5a, 5b, and 7. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 20 . . . . .		<b>8</b>	

**Part II Other Payments and Refundable Credits**

<b>9</b>	Net premium tax credit. Attach Form 8962 . . . . .		<b>9</b>	
<b>10</b>	Amount paid with request for extension to file (see instructions) . . . . .		<b>10</b>	
<b>11</b>	Excess social security and tier 1 RRTA tax withheld . . . . .		<b>11</b>	
<b>12</b>	Credit for federal tax on fuels. Attach Form 4136 . . . . .		<b>12</b>	
<b>13</b>	Other payments or refundable credits:			
<b>a</b>	Form 2439 . . . . .	<b>13a</b>		
<b>b</b>	Section 1341 credit for repayment of amounts included in income from earlier years . . . . .	<b>13b</b>		
<b>c</b>	Net elective payment election amount from Form 3800, Part III, line 6, column (j) . . . . .	<b>13c</b>		
<b>d</b>	Deferred amount of net 965 tax liability (see instructions) . . . . .	<b>13d</b>		
<b>z</b>	Other refundable credits (see instructions): _____ _____	<b>13z</b>		
<b>14</b>	Total other payments or refundable credits. Add lines 13a through 13z . . . . .		<b>14</b>	
<b>15</b>	Add lines 9 through 12 and 14. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 31 . . . . .		<b>15</b>	

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 71480G

Schedule 3 (Form 1040) 2025 Created 11/17/25



# 1.3 Tax Compliance vs. Tax Planning

## LEARNING OBJECTIVE 3

Compare tax compliance with tax planning.

Tax work can broadly be classified as either tax compliance or tax planning. **Tax compliance** is determining the tax effects for transactions that have already occurred, including the preparation of tax returns. **Tax planning** is the process of estimating an individual's tax liability for multiple scenarios and/or multiple years and considering ways to maximize after-tax income.



**Related exercise: Discussion Question 5**

When performing tax work—whether compliance or planning—tax professionals take into account all of the following, each of which we discuss in the next few sections:

- *Open* (future) transactions are preferred over *closed* transactions because one can consider a range of options for structuring the open transactions and choose the one that has the best tax results for their clients.
- *Marginal tax rates* should always be used when evaluating tax planning alternatives.
- Variances in rates across time periods, jurisdictions, types of income, and types of taxpayers create tax planning opportunities.
- Saving a dollar of taxes today is worth more than saving a dollar of taxes next year—assuming tax rates are not changing—because of the *time value of money*. Similarly, paying a dollar of tax next year is better than paying a dollar of tax today.
- Policymakers can use *static* or *dynamic* models to predict the revenue effects of tax law changes.

Both tax planning and tax compliance require tax professionals to research the law to determine the applicable authority. There are many sources of the tax law, and these come from all three branches of the federal government: legislative, administrative, and judicial. We discuss these sources in detail in Chapter 3, LO1, Sources of Tax Authority.

## Closed vs. Open Transactions

Whether a transaction is *open* or *closed* determines if the tax professional is in a compliance mode or planning mode. A **closed transaction** is one where the relevant events have already happened, and the facts are set. The tax professional completes the compliance process by determining how the tax law applies to the facts and the manner reported on the tax return. An **open transaction** is a transaction that is not yet completed. As a tax professional, you will prefer this mode because you can consider a range of options for structuring the transaction and choose the one that has the best tax results for your clients.

**Related exercise: Discussion Question 6**

The following Example explores the benefits of open transactions over closed transactions.

### EXAMPLE 1.3.1 Closed vs. Open Transactions



Xavier purchases 1,000 shares of stock in NEW Corporation for \$90,000 on April 29, Year 1. NEW Corporation reports outstanding earnings throughout the year, and the value of Xavier's stock increases to \$140,000. NEW Corporation announced today, April 27, Year 2, a new patent that has the potential to revolutionize cancer treatment. Assume that Xavier's marginal tax rate is 32%. Let's evaluate how the tax compliance/planning process might play out for a closed transaction and an open transaction.

**Scenario 1:** *Closed Transaction.* By the close of trading on April 27, Year 2, Xavier's stock value increased to \$250,000. Xavier logs into his brokerage account and sells his stock just before the trading day ends for \$250,000. What are the tax effects of this scenario?

**Scenario 2:** *Open Transaction.* On April 27, Year 2, Xavier calls to inform you that he plans to sell the stock today and wants to know whether he should consider any tax effects for his decision. You ask Xavier when he purchased the stock and he tells you April 29, Year 1. How should you respond to Xavier?

#### SOLUTION

**Scenario 1:** *Closed Transaction.* Xavier has a gain of \$160,000 (\$250,000 – \$90,000). Because he did not hold the stock for more than one year, this is a short-term capital gain and Xavier must compute his tax based on his marginal tax rate of 32%. (You will learn the capital gains rules in Chapter 12, LO3, Capital Gains and Losses.) Xavier's tax due is \$51,200 ( $\$160,000 \times 32\%$ ).

**Scenario 2:** *Open Transaction.* You tell Xavier he has two options to consider:

- He could sell the stock today and owe \$51,200 in tax.
- Xavier can hold the stock until April 30, Year 2 (more than one year) and the gain will be a long-term capital gain taxed at a preferential rate of 15%. His tax due on the gain would be \$24,000 ( $\$160,000 \times 15\%$ ).

Clearly, you can add more value for your client when you are in a tax planning mode and discuss options before the transaction happens. By waiting three days to sell his stock, Xavier can save \$27,200 ( $\$51,200 - \$24,000$ ) in taxes, assuming the value of the stock does not change in those three days.

#### Tax Planning Tip



**It is critical that you remind your clients often that they should contact you before completing a transaction, so you can determine the transaction's tax consequences. This way, you can advise the client on the best structure for the transaction to produce the most efficient tax result.**

## Marginal Tax Rates, Average Tax Rates, and Effective Tax Rates


When evaluating tax planning alternatives, you should always use the *marginal tax rate*. The **marginal tax rate** is the tax rate applied to the next additional dollar of income earned. The regular income tax rates of individuals are progressive in nature, meaning that higher tax rates apply to higher levels of income. There are seven different tax brackets for individuals: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. **Illustration 1.3** shows the individual tax brackets for 2026, and this is also included in Appendix A at the end of the book.

**Related exercise: Multiple Choice Question 4**


**ILLUSTRATION 1.3** 2026 Tax Rate Schedules

  <b>For married individuals filing joint returns and qualifying widow(er)s/surviving spouses:</b>	
<b>If taxable income is:</b>	<b>The tax is:</b>
Not Over <b>\$24,800</b>	10% of the taxable income
Over <b>\$24,800</b> but not over <b>\$100,800</b>	<b>\$2,480</b> plus 12% of excess over <b>\$24,800</b>
Over <b>\$100,800</b> but not over <b>\$211,400</b>	<b>\$11,600</b> plus 22% of excess over <b>\$100,800</b>
Over <b>\$211,400</b> but not over <b>\$403,550</b>	<b>\$35,932</b> plus 24% of excess over <b>\$211,400</b>
Over <b>\$403,550</b> but not over <b>\$512,450</b>	<b>\$82,048</b> plus 32% of excess over <b>\$403,550</b>
Over <b>\$512,450</b> but not over <b>\$768,700</b>	<b>\$116,896</b> plus 35% of excess over <b>\$512,450</b>
Over <b>\$768,700</b>	<b>\$206,583.50</b> plus 37% of excess over <b>\$768,700</b>


  

 <b>For heads of households:</b>	
<b>If taxable income is:</b>	<b>The tax is:</b>
Not Over <b>\$17,700</b>	10% of the taxable income
Over <b>\$17,700</b> but not over <b>\$67,450</b>	<b>\$1,770</b> plus 12% of excess over <b>\$17,700</b>
Over <b>\$67,450</b> but not over <b>\$105,700</b>	<b>\$7,740</b> plus 22% of excess over <b>\$67,450</b>
Over <b>\$105,700</b> but not over <b>\$201,750</b>	<b>\$16,155</b> plus 24% of excess over <b>\$105,700</b>
Over <b>\$201,750</b> but not over <b>\$256,200</b>	<b>\$39,207</b> plus 32% of excess over <b>\$201,750</b>
Over <b>\$256,200</b> but not over <b>\$640,600</b>	<b>\$56,631</b> plus 35% of excess over <b>\$256,200</b>
Over <b>\$640,600</b>	<b>\$191,171</b> plus 37% of excess over <b>\$640,600</b>

 <b>For single individuals (other than heads of households and qualifying widow(er)s/surviving spouses):</b>	
<b>If taxable income is:</b>	<b>The tax is:</b>
Not Over <b>\$12,400</b>	10% of the taxable income
Over <b>\$12,400</b> but not over <b>\$50,400</b>	<b>\$1,240</b> plus 12% of excess over <b>\$12,400</b>
Over <b>\$50,400</b> but not over <b>\$105,700</b>	<b>\$5,800</b> plus 22% of excess over <b>\$50,400</b>
Over <b>\$105,700</b> but not over <b>\$201,775</b>	<b>\$17,966</b> plus 24% of excess over <b>\$105,700</b>
Over <b>\$201,775</b> but not over <b>\$256,225</b>	<b>\$41,024</b> plus 32% of excess over <b>\$201,775</b>
Over <b>\$256,225</b> but not over <b>\$640,600</b>	<b>\$58,448</b> plus 35% of excess over <b>\$256,225</b>
Over <b>\$640,600</b>	<b>\$192,979.25</b> plus 37% of excess over <b>\$640,600</b>

 <b>For married individuals filing separate returns:</b>	
<b>If taxable income is:</b>	<b>The tax is:</b>
Not Over <b>\$12,400</b>	10% of the taxable income
Over <b>\$12,400</b> but not over <b>\$50,400</b>	<b>\$1,240</b> plus 12% of excess over <b>\$12,400</b>
Over <b>\$50,400</b> but not over <b>\$105,700</b>	<b>\$5,800</b> plus 22% of excess over <b>\$50,400</b>
Over <b>\$105,700</b> but not over <b>\$201,775</b>	<b>\$17,966</b> plus 24% of excess over <b>\$105,700</b>
Over <b>\$201,775</b> but not over <b>\$256,225</b>	<b>\$41,024</b> plus 32% of excess over <b>\$201,775</b>
Over <b>\$256,225</b> but not over <b>\$384,350</b>	<b>\$58,448</b> plus 35% of excess over <b>\$256,225</b>
Over <b>\$384,350</b>	<b>\$103,291.75</b> plus 37% of excess over <b>\$384,350</b>

The manner in which marginal tax rates affect tax planning decisions is explored in the following two Examples.





## Tax Planning Opportunities

This section introduces a framework that you can use to identify tax planning opportunities. Certain situations are often useful for evaluating different tax planning alternatives and determining which is the most efficient.

### Rates Vary across Time Periods

When marginal tax rates change across time periods, this always presents opportunities for tax planning.

- If rates are *increasing* in the future, it is best to accelerate income and defer deductions in the current year.
- If rates are *decreasing* in the future, it is best to accelerate deductions and defer income in the current year.

**Related exercises: Discussion Questions 8, 9**

The next Example shows how tax rate changes over time present tax planning opportunities.

### EXAMPLE 1.3.5 Changing Tax Rates



Jiera is in the 32% tax bracket for Year 20. Due to changes in her income, next year, her tax bracket will be 37%. Jiera has pledged to make a \$100,000 donation to the College of Business at her alma mater. She has asked your advice about the timing of her donation. Assume that she can deduct the fair market value of the contribution on her return for the year it is made.

#### SOLUTION

Jiera's tax savings for the contribution will be determined by her marginal tax bracket.

	<u>Year 20</u>	<u>Year 21</u>
Contribution	\$100,000	\$100,000
× Marginal tax rate	× 32%	× 37%
<u>Tax savings</u>	<u>\$ 32,000</u>	<u>\$ 37,000</u>
<u>Net cost of contribution</u>	<u>\$ 68,000</u>	<u>\$ 63,000</u>

Jiera should wait until next year to make the contribution, because she will save \$5,000 more in taxes (\$68,000 – \$63,000) than if she makes the contribution in Year 20. This reduces the cost of her contribution by 5% (\$5,000/\$100,000).

Rates can also vary because the taxpayer's tax situation changes from one year to the next. In Example 1.3.5, suppose Congress did *not* change the tax rates. Jiera's marginal tax rate could still increase in Year 21 if her income increased due to a job change or a promotion.

**Related exercise: Application Problem 6**

### Rates Vary across Jurisdictions

Rates can vary across different jurisdictions—whether at the local, state, or international levels. The tax laws and tax rates vary significantly across these jurisdictions. Nine states, for example, do not tax earned income such as wages: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. The three states with the highest individual marginal income tax rates are California (13.3%), Hawaii (11%), and New York (10.9%). The next Example shows the impact different tax rates in different jurisdictions can have on tax planning.

Assume the same facts in Example 1.3.5 except that Jiera lives in California in Year 20 and is moving to Tennessee in March, Year 21. She is in the highest marginal income tax bracket for California. Assume that the charitable contribution is deductible in both states. Does this change your advice to Jiera?

### SOLUTION

Jiera now has two tax rates that are changing from Year 20 to Year 21. The federal marginal tax rate is increasing from 32% to 37%, while her state marginal tax rate is decreasing from 14.4% to 0%. To make a proper decision you need to analyze Jiera's combined federal and state marginal tax rates.

	<u>Federal rate</u>	<u>State rate</u>	<u>Total rate</u>
Year 20	32%	14.4%	46.4%
Year 21	37%	0%	37.0%

Jiera should now make the contribution in Year 20 because her combined marginal tax rate is 9.4 percentage points (46.4 – 37.0) higher in Year 20 than Year 21. Her increased tax savings from making the donation in Year 20 is \$9,400 ( $\$100,000 \times 9.4\%$ ).

## EXAMPLE 1.3.6 Changing Tax Jurisdictions



Related exercises: Discussion Question 11  
Application Problem 7

## Rates Vary across Types of Income

Different tax rates apply to different types of income. As shown in Example 1.3.1, Xavier is taxed at a different rate on his long-term capital gain than short-term capital gain. Often, a taxpayer's ordinary income is taxed at a higher rate than long-term capital gains, so tax professionals look for opportunities to convert ordinary income into long-term capital gains through the structure of a transaction. (Chapter 12, LO3, Capital Gains and Losses, covers the difference in ordinary income rates and capital gain rates.) Qualified dividend income is also taxed at long-term capital gain rates (see Chapter 12, LO2, Dividend Income). Certain types of income are not even taxed at all, such as municipal interest income (interest paid on state and local bonds). The following Example explores a scenario where taxpayers pay different tax rates depending on the type of income received.

Jonathon and Anna are married, and each owns 50% of the stock of a corporation that operates a physical fitness center and spa. Each works at the facility 40 hours per week and receives an annual salary of \$75,000. Once their total income is considered, their marginal tax rate is 37%. This year, the spa had an excellent year financially, earning taxable income of \$500,000, and Jonathon and Anna plan to receive an additional \$20,000 each from the corporation. How would this extra \$20,000 in income for each of them be treated for tax purposes if it is salary compared to a qualified dividend?

### SOLUTION

The additional payment will be taxed at ordinary income rates if it is treated as salary. However, if it is a qualified dividend paid to them as shareholders, then the lower long-term capital gain rates apply. Jonathon and Anna may wish to structure the payment as a dividend for this reason.<sup>3</sup>

## EXAMPLE 1.3.7 Rates across Different Types of Income



Related exercise: Discussion Question 12

## Rates Vary across Different Types of Taxpayers

Tax rates also can vary across different types of taxpayers. This volume focuses only on individual income taxation. Other entities also pay income taxes, such as corporations, which have a flat income tax rate of 21%. Corporations also pay a 21% tax rate on long-term capital gains,

<sup>3</sup>There are additional complexities to this decision that are beyond the scope of discussion at this point (see Chapter 12, LO2, Dividend Income).

whereas individuals pay a rate of 0%, 15%, or 20%. Partnerships, limited liability companies, and S corporations are *flow-through entities* (see Chapter 5, LO4, Business Income for Individuals). Rather than paying income taxes themselves, **flow-through entities** pass income through to their owners, who report the income on their tax returns. Other entities, such as estates and trusts, also pay income taxes; their tax rates are the same rates that apply to individuals, but their income is taxed at the highest marginal rates at much lower income levels than for individuals.

Corporations have a significantly different tax rate structure than individuals. Corporate taxpayers pay a flat rate of 21%, regardless of the level of income. Individuals in the highest marginal tax bracket of 37% may consider whether they would prefer to incorporate and have the income taxed at the corporate rate of 21%. The advantage of the lower corporate rate is partially offset, however, by the second level of tax on corporate income when it is distributed to a shareholder as a dividend. Choosing the best structure for a business is a complex decision that we cover extensively in *Taxation of Business Entities*.

### EXAMPLE 1.3.8

#### Rates Vary across Taxpayers



Return to the facts of Example 1.3.7. Is the corporate structure best for Jonathon and Anna's business from a tax perspective?

#### SOLUTION

If Jonathon and Anna's business structure is a corporation, a corporate tax rate of 21% would apply to the \$500,000 of business income. If, however, their business structure is a flow-through entity, the \$500,000 of taxable income the business earned would flow through to Jonathan and Anna, and they would report it on their individual return and pay taxes on it at their marginal rate of 37%. Therefore, they may be in a better tax situation in the corporate form because the 21% rate is significantly lower than 37%. However, this savings is mitigated by the fact that the \$20,000 paid to both Jonathon and Anna may also be taxed as a dividend to them (which demonstrates how corporate income can be subject to double taxation).

**Related exercises:** Discussion Question 13  
Application Problem 9  
Tax Planning Problem 2

### Rates Vary within a Family

Tax rates vary across different individuals based on their levels of income. This presents opportunities for tax planning within a family. Many wealthy families are more concerned about the total tax paid by the entire family than they are about the tax paid by any one individual. Placing investment assets in the name of the family members who have lower marginal tax rates results in lower taxes for the family.<sup>4</sup>

### EXAMPLE 1.3.9

#### Family Tax Planning



A mother is in the 37% tax bracket and her 25-year-old son is in the 10% tax bracket. The mother gifts \$100,000 of bonds paying 8% interest to her son. What is the overall tax saving for the family in this scenario?

#### SOLUTION

The son will pay tax on the \$8,000 of interest income at a 10% rate, a saving of \$2,160 for the family ( $\$8,000 \times [37\% - 10\%]$ ).<sup>5</sup>

**Related exercise:** Brief Exercise 3

<sup>4</sup>The *kiddie tax* can reduce or eliminate these savings in some situations. This is covered in Chapter 4, Dependency Rules and Filing Status.

<sup>5</sup>The family should also consider whether any gift tax would have to be paid because of the \$100,000 gift. Gift taxes are covered in *Taxation of Business Entities*.

## Time Value of Money

The **time value of money** is the concept that funds available today are worth more than the identical sum in the future due to their earnings potential if they are invested. The time value of money presents tax planning opportunities even when there is no change in tax rates across varying time periods, jurisdictions, types of income, or types of taxpayers. Saving a dollar of taxes today is worth more than saving a dollar of taxes next year because of the time value of money. Similarly, paying a dollar of tax next year is better than paying a dollar of tax today.

**Related exercise: Discussion Question 15**

Return to the facts of Example 1.3.5. Assume that Jiera's tax rate will be 32% in both Year 20 and Year 21, and that Jiera can earn 5% annually on her cash investments. Are the after-tax consequences the same if the \$100,000 donation is made in Year 20 instead of Year 21?

### EXAMPLE 1.3.10 Time Value of Money



#### SOLUTION

The amount of tax savings from the donation, \$32,000 ( $\$100,000 \times 32\%$ ), will be the same whether Jiera makes the contribution in Year 20 or Year 21. But because of the time value of money, reducing Jiera's taxes in Year 20 is better than reducing them in Year 21. If Jiera invests the \$32,000 of tax savings from Year 20 and earns 5% interest, she will earn \$1,600 ( $\$32,000 \times 5\%$ ) of interest income during Year 21.

Will Jiera be able to keep the entire \$1,600 of interest income? No, she must include this in her taxable income for Year 21 and will pay \$512 of tax ( $\$1,600 \times 32\%$ ). So, her net positive cash flow from making the contribution in Year 20 versus Year 21 will be \$1,088 ( $\$1,600 - \$512$ ).

**Illustration 1.4** shows how much \$1 in the future is worth today at the *discount factor* shown. The **discount factor** is based on the rate of return to determine the present value of future income received or taxes owed. The present value of an amount to be received in the future is computed as:

$$\text{Present value} = \text{Discount factor} \times \text{Future amount to be received}$$

**ILLUSTRATION 1.4** Present Value Table—Present Value of a Single Payment

Years	Interest rates									
	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

The discount factor for 1 year at 5% interest is 0.952 in Illustration 1.4. This means that with a 5% discount factor, \$1,000 received one year from today has a present value of only \$952 today ( $0.952 \times \$1,000$ ).

The following two Examples explore the time value of money concept.

### EXAMPLE 1.3.11 Time Value of Money—Deduction



Frank is considering making a \$250,000 cash donation to his favorite charity. Assume he qualifies to deduct the full amount of the donation. Based on other cash flow needs for the next five years, he will make the donation either this year or five years from now. He asks you to compute the economic difference to him between these alternatives. Assume his marginal tax rate is 37% and the discount factor is 5%.

#### SOLUTION

The tax savings to Frank from the donation is \$92,500 ( $\$250,000 \times 37\%$ ). The discount factor for five years at a 5% rate is 0.784. A \$92,500 deduction today will be worth only \$72,520 ( $\$92,500 \times 0.784$ ) if taken five years from now. Frank's deduction is worth \$19,980 more to him this year ( $\$92,500 - \$72,520$ ) than in five years.

### EXAMPLE 1.3.12 Time Value of Money—Income Taxes



Katherine can choose to receive a bonus of \$50,000 either on December 31 of Year 6, or on January 1 of Year 7. Katherine has a marginal tax rate of 24% and the interest rate is 4%. She has asked you what the tax benefit would be if the bonus was deferred to Year 7.

#### SOLUTION

Katherine's tax due on the \$50,000 bonus would be \$12,000 ( $\$50,000 \times 24\%$ ) whether received in Year 6 or Year 7. Delaying the receipt of the bonus by one day to January 1 defers the payment of the tax on the bonus for a full year. A \$12,000 payment in Year 7 only costs her \$11,544 ( $\$12,000 \times 0.962$ ). The discount factor for 1 year with a 4% interest rate is 0.962. Deferring the bonus to Year 7 reduces the economic cost of the tax payment made by her by \$456 ( $\$12,000 - \$11,544$ ).

**Related exercises:** Discussion Question 10  
Multiple Choice Question 5  
Application Problem 8  
Tax Planning Problem 1

## Static vs. Dynamic Tax Planning

When policymakers engage in forecasting the effects of tax policies, they can use *static forecasting* or *dynamic forecasting*. Taxes are based on a relatively simple formula,

$$\text{Tax} = \text{Base} \times \text{Rate}$$

The base can vary and is usually expressed in monetary terms. For example, income earned and the fair market value of property owned are both examples of a tax base. In the equation above, **static forecasting** assumes that the tax collected always increases as the rate increases, and that the variables are independent of one another. If the tax base is \$100,000 and the tax rate is 10%, this produces a tax of \$10,000. If we increase the tax rate to 12%, the base will remain the same and produce \$12,000 of tax.

**Dynamic forecasting**, in contrast, assumes there is a relationship between the two variables in the tax formula. For example, because of an increase in the tax rate, the tax base may actually *decrease* due to a change in taxpayers' behavior across the whole economy. A business or government may expect a certain level of activity and revenue, but if taxpayers change their behavior, these assumptions can be significantly incorrect.

Policymakers should anticipate taxpayers' behavioral responses to rate changes to project future revenue more accurately. These behavioral responses can be described by either the *income effect* or the *substitution effect*. The **income effect** predicts taxpayers respond to increased taxes by working more hours to generate the same after-tax income. The impact of the income effect—the new amount of take-home pay needed to generate the same after-tax income—can be calculated as follows:

$$\frac{\text{Desired take-home pay}}{(100\% - \text{Tax rate})} = \text{Pre-tax pay}$$

The **substitution effect** predicts that taxpayers respond to increased taxes by working fewer hours. Because the marginal value of taxable activities has decreased (they take home less of each additional dollar earned), taxpayers will substitute nontaxable leisure activities for work hours.

The next two Examples examine the tax implications of dynamic forecasting.

Daiko's income is \$36,000 a year and his average tax rate is 12%. He will have after-tax revenue of \$31,680 ( $\$36,000 \times [100\% - 12\%]$ ). If the average tax rate increases to 15%, under a static forecast, Daiko's after-tax revenue will be \$30,600 ( $\$36,000 \times [100\% - 15\%]$ ). Daiko pays \$1,080 more in taxes and has less take-home pay to cover his expenses. How would dynamic forecasting result in a different prediction, assuming the income effect applies?

#### SOLUTION

Dynamic forecasting predicts what Daiko's reaction may be to this change. If the income effect is applied to this scenario, Daiko may choose to work more hours to make sure he maintains the same buying power and has at least \$31,680 of take-home pay. We can compute how much harder he'd have to work as follows:

$$\frac{\text{Desired take-home pay } (\$31,680)}{[100\% - \text{Tax rate } (15\%)]} = \text{Pre-tax pay } (\$37,270)$$

Daiko will need to earn \$37,270 to have take-home pay of \$31,680.

Daiko will need to increase his time worked by 3.53% to maintain his buying power ( $(\$37,270 - \$36,000)/\$36,000$ ). The government is collecting more money than expected in this dynamic forecast, compared to the static forecast.

#### EXAMPLE 1.3.13

##### Dynamic Forecasting—Income Effect



Heather, who makes \$100,000 a year and has an average tax rate of 24%, will have after-tax revenue of \$76,000 ( $\$100,000 \times (100\% - 24\%)$ ). If the tax rate increases to 27%, what would the substitution effect suggest about how Heather would react to this increase?

#### SOLUTION

Under a static forecast, Heather's after-tax revenue would be \$73,000 ( $\$100,000 \times (100\% - 27\%)$ ). Heather now pays \$3,000 more in taxes and has less take-home pay to cover her expenses. The substitution effect predicts that Heather will respond to this increase in her tax rate by working fewer hours. Heather may be satisfied with her take-home pay at \$73,000 and conclude her leisure time is more important relative to her take-home pay, because the increased tax rate raised her marginal cost of working. The substitution effect suggests Heather will not work harder and may even work less, resulting in less revenue for the government.

#### EXAMPLE 1.3.14

##### Dynamic Forecasting—Substitution Effect



Which is the proper prediction model, the income effect or substitution effect? There is not one correct answer, and the best answer likely includes some ideas from both. The main point for you to understand is that predicting the revenue effects of tax law changes is very

complex and challenging. Governments looking to increase revenue might assume that taxing higher-income taxpayers will produce a better result. But, if rates are increased too much, the substitution effect may overwhelm the income effect, and the desired results will not be reached.

**Related exercises: Discussion Questions 4, 14  
Application Problem 11**

## PRACTICE PROBLEM 1.3.1

### Calculating Tax Liability

Jonah and Jill are married and file their tax return jointly. Their combined taxable income is \$395,000. Calculate their tax liability.

#### SOLUTION

Their tax liability is \$79,996  $[(\$395,000 - \$211,400) \times 24\% + \$35,932]$

## PRACTICE PROBLEM 1.3.2

### Marginal, Average, and Effective Tax Rates

Jessica is single and has \$175,150 of total income and \$159,050 of taxable income. Calculate her tax liability, marginal tax rate, average tax rate, and effective tax rate.

#### SOLUTION

We first need to determine Jessica's tax liability:

$$\text{Tax liability} = \$30,770 [(\$159,050 - \$105,700) \times 24\% + \$17,966]$$

Now that we have her tax liability, we can determine her marginal tax rate and calculate her average and effective tax rates.

$$\text{Marginal tax rate} = 24\%$$

$$\text{Average tax rate} = 19.35\% (\$30,770/\$159,050)$$

$$\text{Effective tax rate} = 17.57\% (\$30,770/\$175,150)$$

## PRACTICE PROBLEM 1.3.3

### Determining Present Value

Gunther owns a floral shop and projects to have net income of \$65,000, \$75,000, and \$85,000 in Year 0, Year 1, and Year 2, respectively. Assume Gunther has a marginal tax rate of 24% for this net income and a 4% discount factor. Calculate his present value for the net income.

#### SOLUTION

We can determine the present value with the following calculation:

	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>
Net revenues	\$65,000	\$75,000	\$85,000
<u>Less: Tax at 24%</u>	<u>(\$15,600)</u>	<u>(\$18,000)</u>	<u>(\$20,400)</u>
After-tax cash flow	\$49,400	\$57,000	\$64,600
<u>Discount factor (<math>\times 4\%</math>)</u>		<u>0.962</u>	<u>0.925</u>
<u>Present value</u>	<u>\$49,400</u>	<u>\$54,834</u>	<u>\$59,755</u>

$$\text{Total present value} = \$163,989 (\$49,400 + \$54,834 + \$59,755)$$

# 1.4 Tax Avoidance vs. Tax Evasion

## LEARNING OBJECTIVE 4

Differentiate between tax avoidance and tax evasion.

As a tax professional, you must understand the difference between *tax avoidance* and *tax evasion*. **Tax avoidance** is structuring a transaction or arranging your financial affairs in a legal manner to maximize your after-tax income. It is reasonable to expect individuals to avoid taxes, as expressed by a former senior judge of the United States Court of Appeals for the Second Circuit, Learned Hand:



Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.<sup>6</sup>

**Tax evasion** is reducing your tax liability illegally. Most situations are “black and white,” meaning that the taxpayer (or tax professional) can clearly distinguish between tax avoidance and tax evasion. Timing your charitable donation (as discussed in several examples in the previous section) to achieve the most efficient tax outcome is tax avoidance. Alternatively, intentionally omitting \$5,000 of cash income from one's tax return is tax evasion. The more challenging situations for tax professionals are the “gray” issues where there is ambiguity concerning the appropriate tax outcome. Navigating these decisions requires experience, good judgment, and integrity, as we will see in this section.

## Tax Evasion

Tax evasion can be intentional or inadvertent. Inadvertent tax evasion occurs when a taxpayer does not realize that the position taken on a tax return was impermissible. The IRS does distinguish between intentional and inadvertent tax evasion when assessing penalties against taxpayers (see Chapter 3, LO3, Compliance Responsibilities, for more discussion). Tax evasion is a significant issue, particularly for income taxes. The IRS has estimated that \$1 out of every \$6 (about 16%) that should be paid as federal income taxes is not. This percentage would have resulted in underpayment of taxes of approximately \$696 billion in 2022.<sup>7</sup> The federal budget deficit was \$1.4 trillion in 2022, meaning that underpaid taxes accounted for approximately 49% of the federal budget deficit that year.

**Related exercise: Brief Exercise 4**

Compliance with tax laws varies significantly across different types of income. It is highest when someone other than the taxpayer is required to report income to the IRS, such as employers reporting wages paid to each employee to the IRS on a Form W-2. **Illustration 1.5** shows an estimate of the percentage of income underreported by income type. The percentage ranges from near zero for wages to 64% for income from farms.<sup>8</sup>

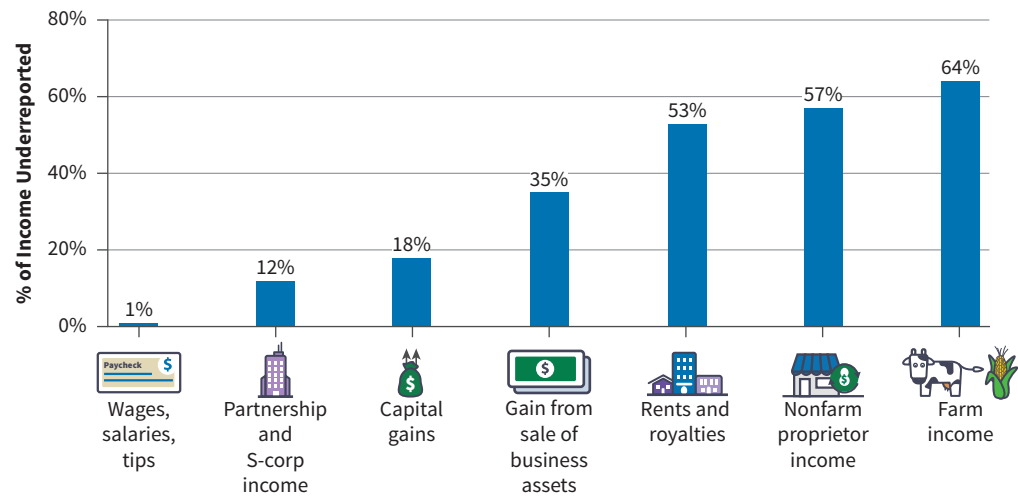
<sup>6</sup>Gregory v. Helvering, 293 U.S. 465 (1935).

<sup>7</sup>U.S. Department of the Treasury, *Federal Tax Compliance Research: Tax Gap Projections for Tax Year 2022*, Publication 5869 (Rev. 10-2024). Page 11, Table 1. Internal Revenue Service, Oct. 2024, [www.irs.gov/pub/irs-pdf/p5869.pdf](http://www.irs.gov/pub/irs-pdf/p5869.pdf).

<sup>8</sup>U.S. Department of the Treasury, *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014-2016*. Publication 1415 (Rev. 10-2022). Catalog Number 10263H. Page 20, Table 5. Internal Revenue Service, Oct. 2022, [www.irs.gov/pub/irs-pdf/p1415.pdf](http://www.irs.gov/pub/irs-pdf/p1415.pdf).

While the noncompliance rate for farmers is high, an analysis of IRS data shows that the average amount of underreported farm income was less than \$4,500, which is significantly less than the amount from bars and restaurants.<sup>9</sup>

**ILLUSTRATION 1.5** Percentage of Income Underreported by Income Type<sup>10</sup>



Income tax fraud is far too prevalent, and several celebrities and athletes have been involved in well-publicized cases after failing to pay taxes they should have.

- Jeffrey Bruce Atkins, more commonly known as the rapper Ja Rule, pled guilty to not filing tax returns from 2004 to 2008. He owed over \$1,000,000 in back taxes and penalties and was sentenced to 28 months in prison.
- The first reality TV show to capture the interest of America was *Survivor*, which first aired in 2000. The first winner, Richard Hatch, was well known to many people as over 125 million viewers watched some part of that initial season. Richard Hatch was the lone survivor, but he could not survive the reach of the IRS when he failed to report his \$1,000,000 prize as income. In May 2006, he was sentenced to 57 months in prison.
- Willie Nelson owed the IRS \$16.7 million for back taxes, which his lawyer managed to negotiate down to \$6 million. Because he lacked the funds to pay off the taxes, Nelson recorded the album, *The IRS Tapes: Who'll Buy My Memories?*, which was sold for the sole purpose of paying his IRS debt.
- *Jersey Shore* star Mike “The Situation” Sorrentino pled guilty to tax evasion in January 2018. He had failed to pay taxes on approximately \$9 million in earnings from 2010 to 2012. He was sentenced to eight months in prison in October 2018.

**Related exercise: Discussion Question 16**

## Spotlight on the Law

### Is the Tax Law Unconstitutional?

The Sixteenth Amendment of the Constitution, ratified in 1913, states that “Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”

<sup>9</sup>Key, Nigel. “Do Most U.S. Farms Really Lose Money? Taxation and Farm Income Underreporting.” *Journal of Agriculture and Applied Economics*. 29 July 2019. 51(4), 646–663. doi.org/10.1017/aae.2019.26.

<sup>10</sup>U.S. Department of the Treasury. *Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2014–2016*. Publication 1415 (Rev. 10-2022). Catalog Number 10263H. Page 20, Table 5. Internal Revenue Service, Oct. 2022, www.irs.gov/pub/irs-pdf/p1415.pdf.

Nevertheless, many taxpayers still argue that the imposition of income taxes is unconstitutional. Can taxpayers refuse to pay taxes based on religious or moral grounds by invoking the First Amendment? Can a taxpayer refuse to pay taxes because they believe that the Internal Revenue Service is not an agency of the United States? Can a taxpayer refuse to pay taxes because they believe that compelled compliance with the federal income tax laws is a form of servitude in violation of the Thirteenth Amendment?

Many claims have been made since 1913, but the courts have held firm that such claims are frivolous, and that the Sixteenth Amendment is constitutional. In *United States v. Lee*, 455 U.S. 252 (1982), the Supreme Court held that religious beliefs in conflict with the payment of taxes provide no basis for refusing to pay the tax, stating, “The tax system could not function if denominations were allowed to challenge the tax system because tax payments were spent in a manner that violates their religious belief.” Also, in *United States v. Fern*, 696 F.2d 1269 (11th Cir. 1983), the Eleventh Circuit declared, “Clearly, the Internal Revenue Service is a ‘department or agency’ of the United States.” And courts have consistently found arguments that taxation constitutes a form of involuntary servitude to be frivolous and not in violation of the Thirteenth Amendment. In Rev. Rul. 2005-19, 2005-1 C.B. 819 and in Notice 2010-33, 2010-17 I.R.B. 609, the IRS discussed this frivolous argument in more detail and warned taxpayers against making such claims.

The tax law is constitutional. Taxpayers may disagree with its formation and results, but nonetheless, must comply and pay their taxes. It is, however, appropriate for taxpayers to hire tax professionals to assist them in structuring their transactions and businesses, so they do not overpay their taxes.

## Tax Ethics

Because taxpayers do not wish to pay fees for answers to black-and-white issues, your clients are more likely to ask for your assistance with gray issues. Tax professionals spend a significant percentage of their time addressing ambiguous areas of the tax law. The proper application of the tax law can be uncertain because either the facts are unclear, or the law is unclear, or both. If the facts are unclear, you must show proper diligence to clarify or find them (though, as you will learn, in some cases the facts are not available). When the law is unclear, you must apply the most relevant tax authority that does exist to the current facts. We will discuss how to handle ambiguous issues in more detail in Chapter 3, LO2, Locating and Evaluating Authority. For now, realize that tax professionals spend significant time working in areas of uncertainty and must exercise proper professional judgment to represent their clients in an appropriate manner. Working with ambiguous tax issues creates an environment where tax professionals must be committed to ethical behavior. As discussed in Chapter 3, LO3, Compliance Responsibilities, tax professionals should serve as advocates for their clients within the parameters allowed by the law and their professional standards.

One of the characteristics of a profession is that it has a code of conduct. The accounting profession has the AICPA’s *Code of Professional Conduct*, which applies to all CPAs, including those who are tax professionals. The AICPA disciplines members of the profession who do not adhere to the code. Because tax professionals so often must make judgments when providing tax advice, the ethical environment in which they operate is very complex. The business and legal communities expect them to make decisions that are reasonable given the circumstances. The Sixth Circuit Court of Appeals provided a helpful description of these expectations in a case from 2006:

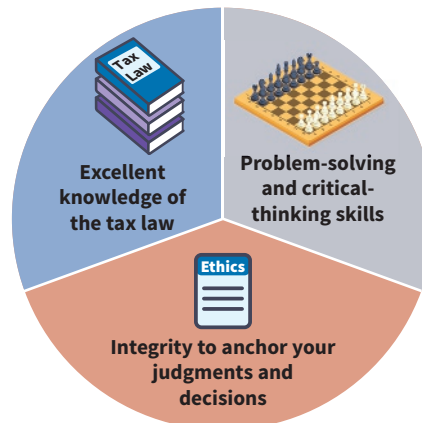
A taxpayer is not required to be perfect for this would be an unrealistic expectation. Even tax specialists cannot be perfect. The Code is complex. Reasonable minds can differ over tax reporting and sometimes the IRS disallows certain transactions. Every time a transaction is challenged or disallowed, the taxpayer is not liable for penalties. Only those taxpayers who fail to meet the applicable standard of care—to do what a reasonable taxpayer would do under the circumstances—can be slapped with negligence penalties and interest. Again, perfection is not required, but when the

predators are circling, no reasonable ostrich sticks its head in the sand.... The ostrich that does pays the penalty.<sup>11</sup>

To be confident of your decisions when dealing with complex tax scenarios, you need three traits (shown in **Illustration 1.6**):

- Excellent knowledge of the tax law,
- Problem-solving and critical-thinking skills, *and*
- Integrity to anchor your decisions and judgments.

**ILLUSTRATION 1.6** Traits for Confident Tax Planning



Source: SofiaV/Shutterstock.com

French philosopher Albert Camus said, “Integrity has no need of rules.” Integrity will help you discern the difference between practicing tax avoidance and slipping into an aggressive mindset that can lead to tax evasion. In Chapter 3, LO4 Tax Professional Responsibilities, we review the standards of professional responsibility that apply to tax professionals. Our goal is to help you develop the three traits listed above so you will have a prosperous and rewarding tax career.

### EXAMPLE 1.4.1 Tax Avoidance



Tax avoidance is exemplified in which of the following situations?

- Abdul prepaid his fourth quarter state income tax payment in December instead of the following January.
- Abdul and his wife are choosing to file as married filing jointly instead of married filing separately to reduce their taxes.
- Abdul structured the disposition of his business store front property in such a manner to defer paying income taxes in the current year.
- Abdul elected to contribute the maximum amount to his retirement plan in the current year.

#### SOLUTION

All these situations are examples of ways for Abdul to reduce his current taxes legally. You will learn more details of these strategies throughout this book. By paying his income taxes in December he accelerates the year for his deduction. Filing jointly almost always results in less taxes than filing separately. Deferring gains from the sale of his business reduces his current tax liability, and maximizing retirement plan contributions creates tax savings in the current year and in the future.

**Related exercises: Discussion Question 17  
Multiple Choice Questions 6, 7**

<sup>11</sup> G.A. Mortensen, CA-6, 2006-1 USTC ¶50,194, 440 F3d 375, at 385. The ostrich was once thought to place its head in the sand to hide from danger, when this would actually create a more dangerous situation for survival.

Which of the following is an example of tax evasion?

- Fred transposed his W-2 salary numbers on his Form 1040.
- Fred omitted \$8 of interest earned from a savings account.
- Fred did not report his cash receipts of \$38,000 from his business.
- Fred reported a deduction that he had researched and had concluded was deductible, but the IRS determined was not deductible.

## PRACTICE PROBLEM 1.4.1 Tax Evasion

### SOLUTION

The correct answer is **c**. Fred must report all income. Omission of *de minimis* income is not considered to be tax evasion, but the amount involved here—\$38,000—is not *de minimis*, and omitting it is tax evasion. (We discuss *de minimis* in greater detail in Chapter 7, LO3, Income from Other Fringe Benefits.)



# 1.5 Tax Rules vs. GAAP

## LEARNING OBJECTIVE 5

Compare the appropriate accounting methods to use when complying with tax rules and with GAAP rules.

As an accounting major, you have spent many hours learning the generally accepted accounting principles (GAAP) that apply to financial reporting. **Do not extend the logic of GAAP to the tax laws. The reporting systems are for two diverse purposes, so many of the rules are different.** In this text you will learn the tax accounting rules, many of which differ from GAAP. This may lead you to ask: Why is there not just one set of reporting standards for both financial accounting *and* tax accounting? That would be much less complex, not only for you as a student, but also for businesses.

**Why** **Why do the financial accounting rules and tax accounting rules differ?** The reason for the different rules is that they exist for very different purposes. The purpose of GAAP is to provide financial statements that are useful for decision-making by investors, creditors, employees, and other users of the information. To be useful, the statements must be relevant. To be relevant, businesses must adhere to certain principles. The **matching principle** requires a business to record expenses incurred during the same period it recognizes the related revenue as earned. This ensures that the business does not overstate income. The **conservatism principle** requires that a business recognize expenses and liabilities as soon as possible, even when there is some uncertainty about the existence of the liability, but recognize revenues and assets only when they are assured of being received. Because outside investors rely on the financial statements to make important decisions, these principles protect the public trust.

The main purpose of the tax laws, by contrast, is to generate revenue to fund the federal government. (We will discuss additional goals later in this chapter.) This is a very different purpose from providing financial information useful to investors for decision-making. One important area where the tax rules differ from the rules for financial reporting is the timing of recognizing expenses. The tax law does not usually allow taxpayers to estimate expenses; rather, no expense is recorded until the taxpayer knows the amount of the expense with certainty.



**Do not extend the logic of GAAP to the tax laws. The reporting systems are for two diverse purposes, so many of the rules are different.**

### EXAMPLE 1.5.1 Tax Rules vs. GAAP



Akio's Laptops began business this year and manufactures and repairs computers. In the current year, laptop sales totaled \$500,000. The laptops come with a three-year limited warranty. Akio reports on the accrual basis for both tax and financial reporting, and at year-end, he has accounts receivable of \$60,000. Industry data shows that he will not collect approximately 8% of the receivables and that he will incur warranty expense equal to 10% of sales. The amount of bad debts Akio has written off this year is \$2,000, and the amount of warranty expense he incurred is \$8,000. Akio has asked you whether he should treat these items the same for financial reporting and the business's tax return. What should you tell him?

#### SOLUTION

Akio will report revenue of \$500,000 for both financial reporting and taxes. Due to the matching and conservatism principles, he will use the allowance method of reporting bad debts and will record bad debt expense of \$4,800 ( $\$60,000 \times 8\%$ ). Similarly, Akio must create a warranty expense reserve of \$50,000 ( $\$500,000 \times 10\%$ ). His financial reporting entries would be as follows:

##### Financial Reporting Entries:

Bad Debt Expense	\$4,800	
Allowance for Doubtful Accounts		\$4,800
Warranty Expense	\$50,000	
Warranty Reserve		\$50,000

The income tax law does not permit the use of the allowance method to report bad debt expense. The tax law requires use of the direct write-off method; that is, Akio cannot expense an account receivable until he knows the specific customer cannot pay the bill. He also cannot expense warranty repairs until incurred. His tax reporting entries would thus be as follows:

##### Tax Reporting Entries:

Bad Debt Expense	\$2,000	
Accounts Receivable		\$2,000
Warranty Expense	\$8,000	
Cash		\$8,000

Understanding the different purposes of the financial reporting system and the tax laws will help you remember the most important differences in these rules.

**Related exercise: Discussion Question 18**

### PRACTICE PROBLEM 1.5.1 Reporting Payments

Nigel operates his own construction business and frequently makes payments to influence politicians and in that way to receive licenses and permits at a quicker pace than his competitors. Nigel spent \$10,000 for these bribes in the current year. How are these payments handled for financial and tax reporting?

#### SOLUTION

Under GAAP, these payments are reported as a deduction on the income statement. However, the tax law does not allow a deduction for payments against public policy.

# 1.6 Goals of Tax Policymakers

## LEARNING OBJECTIVE 6

Classify tax laws based on the reasons Congress created them.

Prior to 1913, Congress had imposed various income taxes for short time periods to finance specific activities such as wars. In 1913, states ratified the 16<sup>th</sup> Amendment to the Constitution, legalizing the imposition of the income tax. The *Revenue Act of 1913* imposed a 1% tax on incomes above \$3,000, with a top tax rate of 7% on those earning more than \$500,000 per year. Approximately 3% of the population was subject to the 1913 income tax.

The tax laws and rates have changed many times since 1913. From 1936 until 1980, the highest marginal individual tax rate was always 60% or higher, with the highest rate being 94% in 1944 and 1945 during World War II. The lowest top marginal individual tax rate since the Great Depression was 28% in 1988–1990.

This section discusses five main goals that policymakers attempt to achieve with the income tax system:

- Raise revenue
- Social objectives
- Economic objectives
- Equity objectives
- Political objectives

**Related exercise: Brief Exercises 6**

There is often a trade-off between making the law more equitable and making it simple to apply. Equity in tax systems often depends on whether the tax distribution is based on the ability to pay. One measure of the fairness of a tax is whether it is *proportional*, *progressive*, or *regressive*.

## Raise Revenue

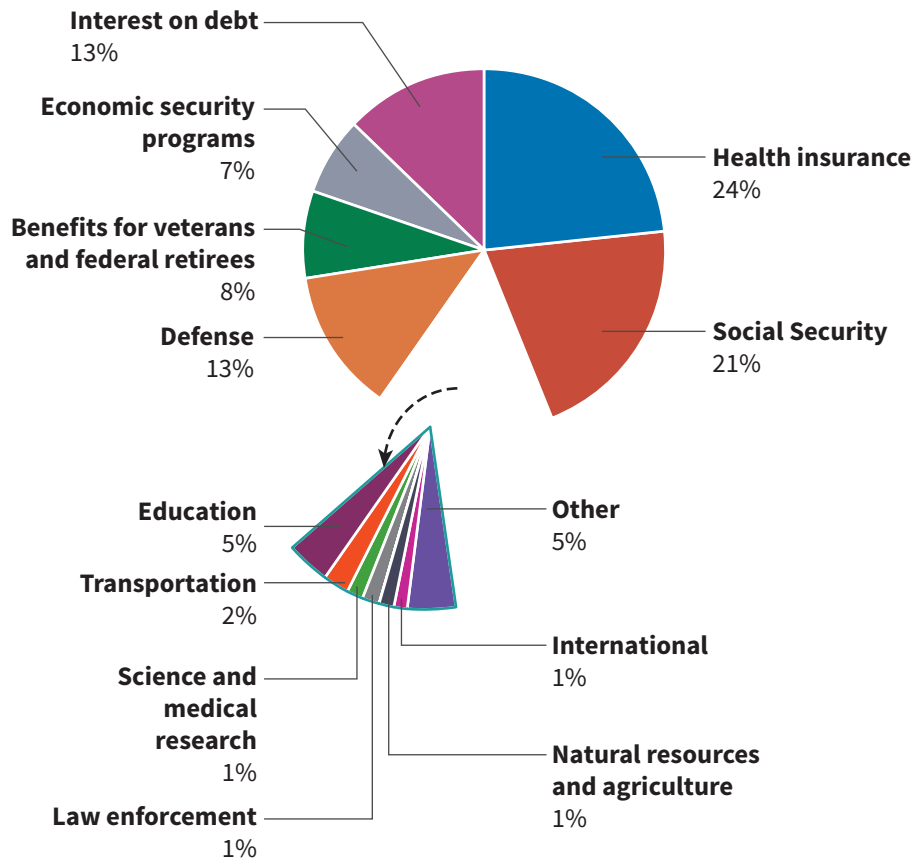
The most important role of the federal income tax is to raise revenue to support the operations of the federal government. **Illustration 1.7** shows the manner in which the government allocates its budget. For fiscal year 2025, the U.S. government spent \$7.0 trillion. Tax revenues accounted for \$5.235 trillion, and the remaining funds were borrowed.<sup>12</sup> The highest priorities for the government were health insurance (24%); Social Security (21%); defense (13%); and benefits for veterans and federal retirees (8%). Interest on the debt accounts for 13% of the budget.

## Social Objectives

Congress also uses the tax law to accomplish certain social objectives. For example, Congress encourages individuals to support certain organizations by allowing taxpayers to deduct contributions to organizations that have a purpose related to one of the following areas: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or



<sup>12</sup>Congressional Budget Office. *Monthly Budget Review: Summary for Fiscal Year 2025*. Table 1, page 1. United States Congress, 10 Nov. 2025. [www.cbo.gov/system/files/2025-11/61307-MBR-FY25-final.pdf](http://www.cbo.gov/system/files/2025-11/61307-MBR-FY25-final.pdf)

**ILLUSTRATION 1.7** 2024 Federal Budget Spending<sup>13</sup>

international amateur sports competition, and preventing cruelty to children or animals.<sup>14</sup> While less tax revenue is collected because of this deduction, taxpayer contributions reduce the funds Congress needs to allocate to support the positive contributions such organizations make to our society.

Charitable contributions are an example of a *tax expenditure*. **Tax expenditures** are special provisions such as exclusions, deductions, deferrals, and credits that benefit specific activities or groups of taxpayers. The federal government does not write a check for these provisions, but the provisions reduce the revenue it receives. For 2026, the largest tax expenditure was \$295 billion for employer-sponsored health insurance.<sup>15</sup> Congress clearly believes there are positive social objectives to employers subsidizing health insurance for their employees.

## Economic Objectives

Another important objective of tax policy is to influence economic growth. When economic growth slows in the United States, Congress often responds with tax incentives that encourage individuals to invest in expanding their businesses. When the Great Recession began in 2008, Congress enacted 50% bonus depreciation in the *2008 Economic Stimulus Act*. This permitted businesses to deduct 50% of the cost of new assets in the year of purchase, which allowed

<sup>13</sup>*Policy Basics: Where Do Our Federal Tax Dollars Go?* Center on Budget and Policy Priorities, Updated 18 July 2024, [www.cbpp.org/research/federal-budget/policy-basics-where-do-our-federal-tax-dollars-go](http://www.cbpp.org/research/federal-budget/policy-basics-where-do-our-federal-tax-dollars-go). Percentages do not add to 100 due to rounding.

<sup>14</sup>IRC §501(c)(3).

<sup>15</sup>U.S. Department of the Treasury. *Tax Expenditures FY2027*. Page 33, Table 3. 16 Dec. 2025, <https://home.treasury.gov/system/files/131/Tax-Expenditures-FY2027.pdf>

business owners to reduce their tax liability more quickly through accelerated deductions.<sup>16</sup> Congress can also use tax laws to decelerate the economy if economic growth happens too quickly, leading to high inflation.

## Equity Objectives

A significant goal of tax policy is to distribute the tax burden as fairly as possible. Many tax laws exist to make the distribution of tax burdens more equitable. One example is the different filing statuses and tax brackets. Taxpayers move from one tax bracket to the next depending on their filing status and level of taxable income. Consider the taxable income level at which someone moves from a 10% marginal tax rate to a 12% marginal tax rate for 2026:

	<b>Married filing jointly</b>	<b>Head of household</b>	<b>Single</b>
Taxable income level at which the marginal tax rate rises from 10% to 12%	\$24,800	\$17,700	\$12,400

The married filing jointly level is double the level for single because taxpayers filing jointly often have two wage earners, and also because there are at least two individuals living in the household. Head of household status is for certain individuals who have a dependent living with them. Single parents often file as head of household.<sup>17</sup> If there were no head of household filing status, these parents would have to file as single, and their income would be taxed at higher tax brackets more quickly than parents who are married. Because there is more than one individual living in a single-parent household, it would be inequitable for them to use the same tax brackets as those filing single. Therefore, the head of household tax table moves from 10% to 12% at approximately the midpoint of the difference in the income level for married filing jointly and for single. This acknowledges that the single parent has more than one individual in the household, but it does not treat the single parent exactly the same as a married filing jointly couple, because there is only one adult wage-earner in a head of household scenario.

This tax rule also demonstrates that there is often a trade-off between equity and complexity. The head of household rules are quite complex, so if the goal was for the law to be as simple as possible Congress would remove this filing status. But then the law would be less equitable with regard to single parents.

## Horizontal vs. Vertical Equity

Two measures often used to evaluate the equitable distribution of the tax burden are *horizontal equity* and *vertical equity*. **Horizontal equity** means that taxpayers in similar situations should pay similar amounts of tax. **Vertical equity** means that those with greater ability to bear the tax burden pay more in taxes than those with less ability to pay. One challenge of applying these measures is defining “ability to pay.” Factors that policymakers could consider regarding ability to pay include:

- Amount of wages
- Net worth
- Number of dependents
- Health issues
- Age

We could add many other items to this list. Which should policymakers consider when determining whether two taxpayers are in a similar situation? The decision is challenging because there are many different opinions regarding the definition of *fairness*. Nevertheless,

<sup>16</sup>The current bonus depreciation rules are covered in Chapter 13, Cost Recovery of Property.

<sup>17</sup>The head of household rules are covered in Chapter 4, LO4, Head of Household and Qualifying Widow(er).

the evaluation of different tax systems on the measures of horizontal and vertical equity does provide useful information for policymakers for comparing different tax regimes.

**Related exercise: Discussion Question 21**

## Tax Rate Structures

The fairness of a tax is also determined by whether the tax is *proportional*, *progressive*, or *regressive*. These terms are defined as follows:

- **Proportional tax:** All taxpayers pay the same tax rate; also known as a *flat tax*.
- **Progressive tax:** The marginal tax rate increases as the tax base increases; the individual income tax is progressive.
- **Regressive tax:** The marginal tax rate decreases as the tax base increases.

Regressive taxes are unusual, and most individuals consider them inequitable. Regressive taxes exist when the government imposes a tax until the tax base reaches a certain level, and then the marginal tax rate decreases or is zero. Social Security taxes are levied on earned income up to \$184,500 (2026) at a rate of 6.2% for employees. It is a regressive tax because earned income above \$184,500 has a marginal tax rate of zero.

**Related exercise: Application Problem 12**

Opinions vary widely on whether proportional taxes or progressive taxes are the fairest. Example 1.6.1 compares the marginal tax rate and average tax rate under both tax structures.

### EXAMPLE 1.6.1 Proportional vs. Progressive Tax Structures



Jared and Kaitlin each file as single taxpayers for 2026. Jared's taxable income is \$75,000 and Kaitlin's is \$150,000. Compute their tax liability using the 2026 tax tables (progressive tax) and then compare those results to their tax liability using a proportional tax of 15%. Which tax structure provides a higher level of vertical equity?

#### SOLUTION

Jared and Kaitlin's 2026 tax liabilities using the regular income tax rates are as follows:

$$\text{Jared: } \$5,800 + 22\% \times (\$75,000 - \$50,400) = \$11,212$$

$$\text{Kaitlin: } \$17,966 + 24\% \times (\$150,000 - \$105,700) = \$28,598$$

Their tax liabilities under a 15% proportional tax are:

$$\text{Jared: } \$75,000 \times 15\% = \$11,250$$

$$\text{Kaitlin: } \$150,000 \times 15\% = \$22,500$$

Now that we have calculated their tax liabilities under each system, we can evaluate the vertical equity of each tax structure:

	<u>Jared</u>	<u>Kaitlin</u>
Taxable income	\$ 75,000	\$150,000
Progressive Tax:		
Tax liability	\$ 11,212	\$ 28,598
Marginal tax rate	22%	24%
Average tax rate	14.95%	19.07%
Proportional tax:		
Tax liability	\$ 11,250	\$ 22,500
Marginal tax rate	15%	15%
Average tax rate	15%	15%

Kaitlin has more income than Jared and pays more in income tax under both the progressive and proportional structures. However, the progressive tax structure has a higher level of vertical equity because Kaitlin's average tax rate is 27.56%  $[(19.07\% - 14.95\%) / 14.95\%]$  higher than Jared's rate.

## Political Objectives

Congress has enacted many tax laws to achieve *social*, *economic*, or *equity* objectives. We will include these reasons for many of the laws discussed in this book, to help you understand why Congress created them. Once you understand the reason for the law, you will remember the law better and be a more effective tax planner. However, Congress sometimes passes laws to meet a political objective. The income tax law itself comes from a political process, so this is inevitable. Businesses spend substantial amounts lobbying Congress to receive preferential tax benefits, and at times they are successful. For example, there are many preferential items in the tax law for the real estate, oil and gas, and insurance industries. While Congress can justify many of these as meeting social, economic, or equity objectives, there is no doubt that some are due to political influence.

**Related exercises:** Discussion Questions 19, 20  
Multiple Choice Questions 8, 9

Indicate the most likely objective—social, economic, or equity—that policymakers would meet with each law:

### Objective

- A tax credit is allowed for adopting children
- Bribes are not deductible
- Mortgage interest on a principal residence is deductible
- Businesses are allowed to depreciate assets over a shorter time period
- A credit is allowed for individuals who buy electric cars
- A taxpayer whose spouse died this year can still use married filing jointly status

### EXAMPLE 1.6.2 Tax System Objectives



### SOLUTION

- A tax credit is allowed for adopting children
- Bribes are not deductible
- Mortgage interest on a principal residence is deductible
- Businesses are allowed to depreciate assets over a shorter time period
- A credit is allowed for individuals who buy electric cars
- A taxpayer whose spouse died this year can still use married filing jointly status this year

### Objective

Social  
Equity  
Social  
Economic  
Social  
Equity

What policy objective describes the deductibility of a business's contribution to a retirement plan for its employees?

### SOLUTION

The deductibility of a business's contribution to a retirement plan for its employees meets the social objective. The objective is to encourage taxpayers to save for retirement, and when businesses help with this objective, the result is socially beneficial for everyone.

### PRACTICE PROBLEM 1.6.1 Determining a Tax Policy Objective

# 1.7 Other Taxes Paid by Individuals

## LEARNING OBJECTIVE 7

Describe taxes paid by individuals at the federal, state, and local levels.



VIDEO  
CONTENT

While our purpose is to provide you with a broad understanding of the federal individual income tax system, individuals pay many other taxes as well. In this section, we first describe the most important *explicit taxes* individuals pay at the federal, state, and local levels. An **explicit tax** is a tax paid to various levels of the government, such as income taxes or sales taxes. At the end of this section, we introduce you to the concept of *implicit taxes*.

## Other Federal Taxes

In addition to income taxes, there are several other federal taxes that raise money for the treasury; this section explores the most common ones.

### Employment Taxes

Employees have Social Security and Medicare taxes withheld from their wages (for more detail see Chapter 17, LO2, Social Security, Medicare, and Self-Employment Taxes). These taxes are known as **employment taxes**. The Social Security rate is 6.2% on the first \$ 184,500 of wages (2026). The Medicare tax is 1.45% on all of an individual's wages. Employers also match both of these taxes, so the total paid to the government for employment taxes is 15.3% of wages  $[(6.2\% + 1.45\%) \times 2]$ . Those who have self-employment income pay the entire 15.3%, known as the **self-employment tax**. Congress levied an additional Medicare tax of 0.9% on wages that exceed \$250,000 if married filing jointly, and \$200,000 for other taxpayers.

Related exercise: Brief Exercise 7

### Excise Taxes

The federal government also levies excise taxes. **Excise taxes** are similar to sales taxes but are based on the quantity purchased rather than the price of the purchase. These are levied on items such as alcohol, tobacco, gasoline, telephone usage, and the use of tanning beds.

### Transfer Taxes

The federal tax laws impose a **gift tax** on the fair market value of property owned by an individual when it is gifted to another individual. Federal law also imposes an **estate tax** that is levied on the fair market value of an individual's gross estate at the time of their death. There are very liberal exemptions for these taxes, so very few individuals pay them. In 2023, approximately 3.1 million individuals died in the United States and 3,690 estates owed estate taxes.<sup>18</sup> The gift tax exists only to support the estate tax. Without the gift tax, wealthy individuals would give away most of their property before dying to avoid the estate tax.

<sup>18</sup>U.S. Department of the Treasury. *Estate Tax Returns Study*. Table 1. Internal Revenue Service, Statistics of Income Division, Sept. 2024. <https://www.irs.gov/pub/irs-soi/23es01fy.xlsx>; and Ahmad, Farida B., Cisewski, Jodi A., and Anderson, Robert N. *Provisional Mortality Data—United States, 2023*. U.S. Department of Health and Human Services, Centers for Disease Control and Prevention, Vol. 73, No. 31, pages 677–681. [www.cdc.gov/mmwr/volumes/73/wr/mm7331a1.htm](http://www.cdc.gov/mmwr/volumes/73/wr/mm7331a1.htm).

## State and Local Taxes

Jurisdictions other than the U.S. federal government also tax their citizens. In this section, we describe some of the taxes that may be levied by state and local governments on individual taxpayers.

### Income Taxes

Most states levy an income tax on individuals who reside in the state or earn income in the state. The computation of state taxable income is based on federal adjusted gross income with adjustments. These adjustments vary across states. Some large cities also impose income taxes.

### Sales and Use Taxes

Most states and some local governments impose sales and use taxes. **Sales tax** is collected based on the sales price of goods and sometimes services. While this tax is paid by the customer, the retailer collects the tax and remits it to the state and/or local government. The **use tax** is levied on the sales price of goods that are owned or consumed within a state but were not purchased within that state. An individual does not pay the use tax to the extent they paid sales tax in the state in which the purchase occurred. Historically, the use tax has not generated significant revenue, but as online sales across state borders have increased, states are enforcing it more aggressively. Additionally, a recent Supreme Court decision in the *Wayfair* case affirms that a state can collect sales tax when a resident of that state purchases a product from a business on the internet, even if the business does not have a physical presence in the state.<sup>19</sup>

**Related exercise: Application Problem 13**

### Property Taxes

State and local governments collect significant revenue from property taxes. **Real property taxes** are levied on land and buildings, and **personal property taxes** are levied on items such as automobiles, boats, and certain assets owned by businesses. The taxes are based on the fair market value of the property.

### Excise Taxes

State and local governments also impose excise taxes on some of the goods taxed at the federal level.

**Related exercise: Discussion Question 22**

## Implicit Taxes

Unlike explicit taxes, which are taxes paid directly to federal, state, or local governments, **implicit taxes** are not actually taxes, nor are they paid to a government. Instead, they are costs imposed on an individual due to a tax advantage that the government has given a particular transaction. We use a hypothetical tax provision to illustrate implicit taxes in the following Example.

<sup>19</sup>*South Dakota v. Wayfair, Inc.* [138 S. Ct. 2080 (2018)].

### EXAMPLE 1.7.1

#### Implicit Taxes



To encourage consumers to purchase and drive electric vehicles, assume that Congress announces in November of Year 9 that it will provide a 10% credit in Year 10 based on the sales price of electric vehicles. Sales information for the vehicles in Year 9 and Year 10 is as follows:

	Year 9	Year 10
Manufacturer's Suggested Retail Price (MSRP)	\$40,000	\$41,500
<u>Less: Discount from the MSRP</u>	(\$ 4,000)	(\$ 2,250)
Average sales price	\$36,000	\$39,250
<u>Less: Tax credit for consumer (10% of average sales price)</u>	N/A	(\$ 3,925)
<u>Net cost to consumer after tax credit</u>	<u>\$36,000</u>	<u>\$35,325</u>

Who has benefited more from this new credit—the consumer or the manufacturer of electric vehicles?

#### SOLUTION

When Congress passed the tax credit, electric cars became a tax-advantaged asset. This tax advantage creates more demand for the asset because consumers believe that the 10% tax credit will lower their cost by 10%. However, increased demand allows the manufacture to raise its suggested retail price to \$41,500 in Year 10 and to reduce the discount given to the consumer from \$4,000 in Year 9 to \$2,250 in Year 10. Even though the taxpayer receives a tax credit of \$3,925, the true economic benefit of the credit has been reduced, because the increased average sales prices of the electric car represent an implicit tax. We calculate the reduction in cost for the consumer as follows:

Tax credit for consumer	\$3,925
<u>Less: Increase in average sales price (Year 10 – Year 9)</u>	(3,250)
<u>Actual reduction in cost for consumer</u>	<u>\$ 675</u>

Who benefited from the 10% credit of \$3,925? The car manufacturer benefited by \$3,250 because it was able to increase the average sales price by \$3,250. The taxpayer can use the \$3,925 credit on his tax return for Year 10, but economically, he benefited from only \$675 of the credit because he paid an implicit tax of \$3,250 to the car manufacturer.

How should implicit taxes affect tax planning? Implicit taxes are very hard to quantify because many factors affect the prices of goods such as electric cars in Example 1.7.1. Implicit taxes never show up on a tax return because an individual does not pay the tax to the government. In Example 1.7.1, the consumer paid the implicit tax for the electric car to the car manufacturer in the form of a higher price for the car. Taxpayers should consider the general idea of implicit taxes when determining the attractiveness of tax-advantaged assets.

**Related exercises:** Discussion Question 23  
Multiple Choice Question 10  
Application Problem 14

### PRACTICE PROBLEM 1.7.1

#### Use Tax

George lives on the Fox River in Illinois and would like to buy a boat. Illinois has a sales tax of 6.25% and Wisconsin has a sales tax of 5%. Would George benefit from purchasing the boat in Wisconsin?

#### SOLUTION

George would pay sales tax of 5% in Wisconsin, but he must also pay a use tax of 1.25% to the state of Illinois. The use tax is levied on the sales price of goods that are owned or consumed within a state but were not purchased within that state.

# 1.8 Professional Taxation as a Career

## LEARNING OBJECTIVE 8

Discuss career opportunities for tax professionals.

Students who choose a career in accounting have many different paths from which to select. The American Institute of Certified Public Accountants (AICPA) has often referred to these varied and rewarding careers as *360 Degrees of Opportunity*. One of these opportunities is a career in taxation. While the general public first thinks of “tax returns” and “compliance” when hearing the word “tax,” this is a misperception of the role that many tax professionals play in businesses and accounting firms. Tax careers are more interesting, challenging, and rewarding than most would imagine.



## The Role of a Tax Professional

Successful organizations understand that to build long-term business value they must include tax professionals in the strategic planning process. Directors of corporations have a responsibility to their shareholders to manage tax risk and tax strategies. Former IRS Commissioner Doug Shulman made the following comments to the National Association of Corporate Directors (NACD) Corporate Governance Conference.

I realize that the IRS Commissioner has not customarily addressed the NACD’s corporate governance conference, but what I want to discuss with you this afternoon is the important role that boards of directors can play in overseeing tax risk and tax strategies of corporations. After all, taxes are one of the biggest expenses of a corporation, so how they are managed is very important to most corporations.... I also understand that even with all of your sophistication, expertise and experience in business and financial affairs, it’s difficult to understand the tax consequences of a complicated business transaction, such as a tax-free reorganization or a hedging transaction, let alone the corporation’s overall tax profile as it relates to federal, state, and international taxes. That’s why you need to have strong tax departments and outside tax advisors. After all, you have finance experts to help you understand the economic value of hedging transactions, and you need tax experts to help you understand the myriad and complex tax issues facing your company.<sup>20</sup>

Business owners who understand the value of structuring transactions in a tax-efficient way build more value for their investors. Tax professionals add value in a wide range of areas, such as:

- Business tax services
- Financial services
- Private wealth consulting
- Estate planning
- International tax
- State and local taxation
- Tax compliance
- Representing clients that have tax controversies
- Mergers and acquisitions

There are also many jobs in the government sector for tax professionals, including positions with the Internal Revenue Service and state revenue departments.

<sup>20</sup>Shulman, Douglas H. *Prepared Remarks before the 2009 National Association of Corporate Directors Corporate Governance Conference*. 19 Oct. 2009, Washington DC, [www.irs.gov/pub/irs-news/ir-09-095.pdf](http://www.irs.gov/pub/irs-news/ir-09-095.pdf).

## Characteristics of Successful Tax Professionals

Tax laws become more complex every year at the federal, state, local, and international levels. Building and maintaining a successful business has also become more challenging because the business environment changes so rapidly. At the same time, technological innovation also presents new opportunities for analyzing tax data. Successful tax professionals are key strategic partners with business owners. To meet these opportunities and challenges, tax professionals need the following skills:

- Integrity
- Problem-solving skills
- Analytical skills
- Oral and written communication skills
- Listening skills
- Research skills
- Technology agility
- Conflict resolution skills

**Related exercise: Brief Exercise 8**

The most common undergraduate degree for an entry-level position in taxation is an accounting degree. Common graduate degrees for those working in taxation are:

- Master of Science in Taxation
- Master of Accounting with Specialization in Tax
- Doctor of Jurisprudence (J.D.)
- L.L.M. in Taxation (focused taxation degree that builds on J.D.)

Many accounting graduates sit for the CPA exam to become certified in their state. A licensed certified public accountant must maintain minimum continuing professional education credits to keep their license active. Each state has its own rules on how and when this is accomplished. Other certifications that an accounting graduate may obtain include:

- Certified Financial Planner
- Certified Estate Planner
- Enrolled Agent
- Certified Information Systems Analyst

All these certifications are valuable to tax professionals who want to build their reputation as full-service tax accountants who add value to individuals, firms, or businesses.

**Related exercises: Discussion Question 24  
Multiple Choice Questions 11, 12**

## Artificial Intelligence in Taxation

Artificial intelligence is transforming, if not revolutionizing, the way that the world works, and the world of professional taxation is not shielded from this. AI tools that are components of tax research software allow tax professionals to be more efficient and precise with the tax plans they structure for their clients. AI is also transforming the tax return preparation process with the ability for tax preparers to scan source documents such as W-2s and 1099s into the system, and the system producing a return for the professional to review. The Internal Revenue Service is also using AI to better predict the returns that should be audited by scanning for abnormalities and anomalies.

Tax professionals need to be adept at using AI to provide the best service to their clients. Successful tax professionals will be strategic advisors who need the skills discussed in this section, such as critical thinking and problem-solving, combined with professional judgement to interpret and validate AI outputs. The tax professional's role takes on increased importance to ensure that ethical issues are considered and that information remains private.

Why is a career in accounting referred to as offering 360 degrees of opportunity?

### SOLUTION

Accounting offers 360 degrees of opportunity because of the diversity of choices a student has when selecting a career path. The roles of an accountant vary across business types and industries and have great potential for growth.

## PRACTICE PROBLEM 1.8.1 Careers in Accounting



INTERACTIVE  
SELF-SCORING QUIZZES

### Featured Professional: Roger Williams, CPA, CVA



Roger has worked in public accounting for 14 years, and he is currently a partner with Patterson, Prince and Associates PC. His areas of specialty include audit, tax, business valuation, business advisory, bookkeeping, and payroll.

#### From Classroom to Career

“Nothing is certain except death and taxes.” Fortunately for us, tax professionals are needed in

both scenarios. Once your family, friends, and even strangers discover you are a tax professional, they become reliant on you for advice and those questions may come at any time. I remember taking a trip to Las Vegas and was greeted by a stranger who chose the seat next to me on the plane. We exchanged names and prior to takeoff were told our flight was being delayed thirty minutes. During this time, he and I spoke about our lives and purpose for the trip, but once he discovered that I was a CPA the tax questions began to flow. For the next hour, we spoke about tax savings opportunities for his electrical contractor and real estate businesses. I gave him advice on how to restructure the companies, and he even pulled out his laptop for me to review his prior year tax returns and current year financial statements.

We exchanged contact information. Shortly afterward, he contacted my office and became a client. Due to our discussion, he found out his journey to Las Vegas was a business trip and could be written off as a business deduction to

reduce his taxes. Not only that, but the fact his electrical contracting business was taxed as a limited liability company and not an S-corp was costing him an additional \$20,000 in annual taxes. Several other opportunities for deductions, such as for equipment and vehicle depreciation, were also discussed, and in the first year of performing his tax return his typical annual tax liability was reduced to nearly zero. After this, he not only became a client, but also a friend. This is why people need tax professionals (even when they don’t think they do), and why I love my profession.

**Professional Skills** Communication is critical for success. Accountants are service-based professionals. Being able to properly articulate findings with our clients, whether written or oral, is key to our work. All clients are not the same. Personalities, situations, preferences, and predictions all are unique for each person we serve. Being able to focus on everyone separately, properly tailoring plans that best suit them, and being able to communicate those results in a manner that they can comprehend is vital to not only the client’s success but our success as well.

**Future Tax Landscape** With artificial intelligence (AI) making its imprint on society, I believe nearly all professions will be affected in some way. Accounting professionals may need to revamp how we provide services to our clients as things become more automated. Soon, we may spend less time performing technical tasks such as simple data entry, and more time on consulting and advisory services that act as the connection between AI and the client. We should spend time understanding artificial intelligence and how best to use it for our clients to provide greater value.

## Review and Practice

### Chapter Summary

This book focuses on the income taxation of individuals. Most income tax laws that apply to individuals apply in the same manner to entities such as corporations, partnerships, and trusts. So, this book is a survey of the fundamentals of income taxation that applies to *all* taxpayers, but we present these foundational rules in the context of an individual taxpayer. While a course in the fundamentals of income taxation

is required in most accounting degree programs, this book will benefit you whether or not you practice as an accountant. Everyone who has positive taxable income is subject to paying federal income tax, so the knowledge you gain from this study will prepare you to effectively manage your personal tax liability.

### 1 Explain the goal of tax planning and its focus on after-tax income.

- The Internal Revenue Service is a potential uninvited third party to *all* financial transactions.
- The goal of **tax planning** is not to minimize taxes but to maximize **after-tax income**.
- While taxpayers often ignore the tax effects of a transaction, tax professionals can overweigh the tax consequences if they do not consider the relevant non-tax costs.

### 2 Distinguish the parts of the individual income tax formula and compute the tax due or tax refund.

- We use the tax formula for individuals as a guide for the organization of this book. This chapter and Chapter 2, Fundamentals of the Federal Income Tax System, provide an introduction and framework for the study of income taxation. The other chapters cover specific parts of the tax formula.

### 3 Compare tax compliance with tax planning.

- Tax professionals prefer **open transactions** to **closed transactions** because they can consider a range of options for structuring the open transactions and choose the one that has the best tax results for their clients.
- **Marginal tax rates** should always be used when evaluating tax planning alternatives.
- Variances in rates across time periods, jurisdictions, types of income, and types of taxpayers create tax planning opportunities.
- Saving a dollar of taxes today is worth more than saving a dollar of taxes next year—assuming tax rates are not changing—because of the **time value of money**. Similarly, paying a dollar of tax next year is better than paying a dollar of tax today.
- Policymakers can use **static** or **dynamic forecasting** to predict the revenue effects of tax law changes.

### 4 Differentiate between tax avoidance and tax evasion.

- Tax professionals must understand the difference between **tax avoidance** and **tax evasion**.
- Integrity helps tax professionals discern the difference between practicing tax avoidance and slipping into an aggressive mindset that can lead to tax evasion.

### 5 Compare the appropriate accounting methods to use when complying with tax rules and with GAAP rules.

- Do not extend the logic of GAAP to the tax laws. The reporting systems are for two diverse purposes so many of the rules are different.

### 6 Classify tax laws based on the reasons Congress created them.

- There are five main goals that policymakers attempt to achieve with the income tax system:
  - Raise revenue
  - Social objectives
  - Economic objectives
  - Equity objectives
  - Political objectives
- There is often a trade-off between making the law more equitable and making it simple to understand.
- Equity in tax systems often depends on whether the tax distribution is based on the ability to pay.
- One measure of the fairness of a tax is whether it is **proportional**, **progressive**, or **regressive**.

### 7 Describe taxes paid by individuals at the federal, state, and local levels.

- Individuals pay many taxes other than income taxes at the federal, state, and local levels.
- An **explicit tax** is a tax paid to various levels of the government, such as income taxes or sales taxes.
- An **implicit tax** is not actually a tax, nor is it paid to a government. Instead, it is a cost imposed on an individual due to a tax advantage that the government has given a particular transaction.

### 8 Discuss career opportunities for tax professionals.

- Students who choose a career in accounting have many different paths to take for their careers. The American Institute of Certified Public Accountants (AICPA) has often referred to these varied and rewarding careers as *360 Degrees of Opportunity*. One of these opportunities is a career in taxation. Tax careers are more interesting, challenging, and rewarding than most would imagine.

## Communication Application

Communication

### Goals of Tax Policymakers

**(LO6)** Your friend Rashad is a marketing major who does not like accounting—and particularly taxation—because he owed money last year on his income tax return. He says there are too many rules to

know, and the average taxpayer doesn't understand how to prepare their own taxes. He thinks the current tax system is awful and has no positive influence on business, society, or its constituents. Write a memo to your friend explaining the various goals of tax policymakers and how tax policy does affect business, society, and its constituents.

### Solution

Dear Rashad,

I know there are a lot of rules in accounting with GAAP and in taxation with many sources of the tax law, but there is a purpose behind both. The rules give structure to an area that needs to be accurate, reliable, and consistent in its reporting and presentation.

The tax law's primary objective is raising revenue, but it also has many other considerations as well. The government can use the tax system to try to accomplish economic objectives, as well as social, equity, and political considerations. To help control the economy and incentivize certain activities, tax law can stimulate businesses by allowing large current deductions to encourage those with capital to invest in small businesses, and areas that need investment such as pollution control and research and development.

An example of a social consideration the tax law supports is a business providing group-term life insurance for its employees. Their employees may not be able to afford life insurance. Businesses can deduct the premiums that are paid for this, and the employees are not taxed on the value of this benefit.

People will always disagree with what is fair or not based on their own perspective of the tax law. However, tax law equity looks at what is fair from the government's perspective. For example, if you earn income in a foreign country, you must pay tax to both the United States and the foreign country. But the tax law allows you to take a credit or a deduction for foreign tax paid, making it more equitable. The taxpayer does not have to pay tax on the same income twice.

Political considerations also affect tax law. Special-interest groups and state and local governments attempt to influence the tax law in a way that benefits them. For example, if you work in oil and gas, or live in a state that has significant oil and gas production, you want your state representative to support laws that are advantageous to the oil and gas industry.

All these factors help shape our current tax law system. It is not as random as it may appear sometimes. I hope this has given you a better understanding of the complexities of our federal tax law system.

Sincerely,

## Ethics and Professional Responsibility Application

Ethics

### Fairness of the Tax Law

**(LO6)** Many U.S. taxpayers are upset with the current tax law system. They insist that the law is too complicated, too time-consuming, unfair, and unjust. They believe tax loopholes only favor the rich and the tax burden unfairly falls on the middle-class and lower-income earners. Some will go as far as saying the current tax law system is

unethical and unconstitutional. How would you respond to these criticisms? In addition to the chapter content, see *Statements on Standards for Tax Services* at [www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services](http://www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services), *Circular 230* at [www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230](http://www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230), and Chapter 3, LO4, Tax Professional Responsibilities.

### Solution

It is true that the tax law is complex and always changing. According to the 2024 instructions for Form 1040, it takes a non-business taxpayer eight hours on average to prepare their individual income tax return. A tax practitioner can provide useful guidance to make the job easier.

Many taxpayers see the tax system as unjust and random, but Congress has many goals when making tax policy. Their primary objective is to raise revenue, but they also take into consideration social, economic, equity, and political objectives. Congress designs certain laws with one or more of these objectives in mind.

The tax law is not unconstitutional. The 16<sup>th</sup> amendment of the Constitution, ratified in 1913, states that “Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.” Major revisions were made to the Code in 1939, 1954, and 1986, and, most recently, in 2017 with the *Tax Cuts and Jobs Act* (TCJA).

The National Taxpayers Union Foundation released IRS data showing “the bottom 50% of earners, defined as those with incomes below \$50,339, paid just 3.0% of all federal income taxes. Many in this

group owed no income tax due to having earnings below the taxable threshold or being eligible for tax credits that offset their liability.”<sup>21</sup> For 2021, the IRS provided data showing that taxpayers with adjusted gross incomes between \$50,339–\$178,611 paid an average income tax ranging between 15.87% to 21.11%. The top one percent (incomes above \$663,164) paid an average income tax rate of 26.09%.<sup>22</sup>

Some may find the current tax law system to be cumbersome, but it does follow a progressive tax rate structure that taxes higher earners at a higher rate. The argument should not focus on whether higher income earners pay more, but rather on how much more should they pay?

## Key Terms

After-Tax Income 1-5	Horizontal Equity 1-35	Self-Employment Tax 1-38
Average Tax Rate 1-19	Implicit Taxes 1-39	Static Forecasting 1-24
Closed Transaction 1-15	Income Effect 1-25	Substitution Effect 1-25
Conservatism Principle 1-31	Marginal Tax Rate 1-16	Tax Avoidance 1-28
Discount Factor 1-23	Matching Principle 1-31	Tax Compliance 1-15
Dynamic Forecasting 1-24	Non-Tax Costs 1-6	Tax Costs 1-6
Effective Tax Rate 1-19	Open Transaction 1-15	Tax Evasion 1-27
Employment Taxes 1-38	Personal Property Taxes 1-39	Tax Expenditures 1-34
Estate Tax 1-38	Progressive Tax 1-36	Tax Planning 1-15
Excise Taxes 1-38	Proportional Tax 1-36	Time Value of Money 1-23
Explicit Tax 1-38	Real Property Taxes 1-39	Use Tax 1-39
Flow-Through Entities 1-22	Regressive Tax 1-36	Vertical Equity 1-35
Gift Tax 1-38	Sales Tax 1-39	

## End-of-Chapter Assessment

### Discussion Questions

- (LO1)** Describe the goal of tax planning.
- (LO2)** What is the formula to calculate an individual's taxable income?
- (LO2)** What form(s) is (are) used to file an individual's income tax return?
- (LO3)** Explain why a taxpayer with higher income does not have as large of a behavioral response to an increase in the tax rate as a lower-income taxpayer.
- (LO3)** Differentiate between tax compliance and tax planning.
- (LO3)** Differentiate between an open transaction and a closed transaction.
- (LO3)** What is the marginal tax rate? The average tax rate? The effective tax rate?
- (LO3)** Explain why a taxpayer would want to delay receipt of income or accelerate expenses into the current year.
- (LO3)** In what circumstances would it be better to accelerate income into the current year?
- (LO3)** Name three tax planning opportunities that taxpayers need to be familiar with.
- (LO3)** Discuss why the jurisdiction of a business might affect its after-tax cash flow.
- (LO3)** Why is it important to identify the type of income earned or losses incurred?
- (LO3)** Which entity, an individual or a corporation, would pay more income tax on a net long-term capital gain of \$10,000?
- (LO3)** Explain static versus dynamic forecasting.
- (LO3)** Discuss the phrase “A dollar earned today is worth more than a dollar earned in the future.”
- (LO4)** Which term describes a legal method of reducing taxes?
- (LO4)** Why must a CPA be ethical when providing professional tax advice to others?
- (LO5)** Why are there two different sets of rules to govern the preparation of financial statements and the preparation of tax returns?
- (LO6)** Provide an example of a social objective of the tax law.
- (LO6)** Provide an example of an economic objective of the tax law.
- (LO6)** Describe horizontal equity and vertical equity.
- (LO7)** Name three other types of taxes besides the income tax that an individual may have to pay.
- (LO7)** Hoffman Inc.'s tax liability increased by \$55,000 this year, so it decided to reduce the dividend paid to its shareholders by \$55,000. Who bears the incidence of the increase in tax liability?
- (LO8)** Discuss the different specialty areas in which a person may work in as a tax professional.

<sup>21</sup>Brady, Demian. *Who Pays Income Taxes: Tax Year 2022*. National Taxpayers Union Foundation, 4 Dec. 2024. <https://www.ntu.org/foundation/detail/who-pays-income-taxes-tax-year-2022>.

<sup>22</sup>U.S. Department of the Treasury. *SOI Tax Stats - Individual Income Tax Rates and Tax Shares*. Publication 1304 (Rev. 4-2024). Catalogue Number 63338H. Table 4.3. Internal Revenue Service. [www.irs.gov/pub/irs-pdf/p1304.pdf](http://www.irs.gov/pub/irs-pdf/p1304.pdf).

## Multiple Choice Questions

1. **(LO1)** Which of the following is not an appropriate aspect of effective tax planning?
  - a. Maximizing after-tax income.
  - b. Considering tax costs and non-tax costs.
  - c. Minimizing taxes paid.
  - d. Considering the tax effects of all financial transactions.
2. **(LO2)** Which of the following forms is used to complete and file an individual tax return?
  - a. Form 1120
  - b. Form 1040
  - c. Form 1065
  - d. Form 709
3. **(LO2)** Which of the following statements is true?
  - a. A taxpayer is always guaranteed a refund.
  - b. Form 1065 is used to complete and file an individual tax return.
  - c. A taxpayer can deduct the greater of itemized deductions or the standard deduction.
  - d. The standard deduction is a deduction for adjusted gross income.
4. **(LO3)** Which tax rate is best to use in tax planning?
  - a. Marginal tax rate
  - b. Average tax rate
  - c. Effective tax rate
  - d. None of these
5. **(LO3)** Which of the following does *not* present a tax planning opportunity?
  - a. Difference in tax rates across jurisdictions
  - b. Difference in tax rates across time periods
  - c. Difference in tax rates across entity types
  - d. All are examples of tax planning opportunities.
6. **(LO4)** Which of the following statements is true concerning tax compliance?
  - a. Taxpayers do not have to report income unless it is more than \$100.
  - b. Tax compliance is generally the same across all types of income.
  - c. Tax compliance for farm income is higher than tax compliance for wages.
  - d. Tax compliance for wages is higher than tax compliance for farm income.
7. **(LO4)** Which of the following is an example of tax evasion?
  - a. Taxpayer A accelerates her deductible expenses into December of the current year because she anticipates that her tax rate will be lower next year.
  - b. Taxpayer B has her child on December 30 to claim the child tax credit in the current year.
  - c. Taxpayer C owns a candy store (customers may only pay in cash) and does not report any of the \$33,000 income received.
  - d. Taxpayer D omits dividend income of \$28 from his return because he did not realize he lost his Form 1099-DIV that reported it to him.
8. **(LO6)** Which of the following is not an objective of the federal income tax system?
  - a. Raise revenue
  - b. Ensure the tax law is equitable
  - c. Tax only the rich and never the poor
  - d. Meet specified social objectives
9. **(LO6)** Which of the following policy objectives describes the disallowance of entertainment expenses?
  - a. Political
  - b. Equity
  - c. Economic
  - d. Social
10. **(LO7)** All of the following are examples of taxes that might be paid by individuals to the government except:
  - a. Implicit tax
  - b. Income tax
  - c. Sales tax
  - d. Gift tax
11. **(LO8)** Which certification is most popular among tax accountants?
  - a. Certified Financial Planner
  - b. Certified Public Accountant
  - c. Attorney
  - d. Certified Estate Planner
12. **(LO8)** Which of the following is a possible career in taxation?
  - a. Corporate accounting
  - b. Public accounting
  - c. Government accounting
  - d. All of these

## Brief Exercises

- (LO1)** Narayani is single and has taxable income in 2026 of \$90,000. She is considering working as a freelance designer and will earn an additional \$20,000. Disregarding self-employment tax, what would Narayani's after-tax income be on the \$20,000 if she is in the 24% tax bracket?
- (LO2)** Briefly describe supporting Schedules 1, 2, and 3 for Form 1040.
- (LO3)** Jasmine is single and in the 35% marginal tax bracket. She gifts stock to her father with a fair market value of \$50,000 that earns non-qualified dividend income of \$4,300 in 2026 (meaning that the dividend income is taxed at ordinary income rates). Her dad is in the 12% marginal tax bracket. What is the overall tax saving for the family in this scenario?
- (LO4)** Discuss why tax evasion is a significant issue for the federal government.
- (LO5)** What is the main purpose of GAAP and the main purpose of the tax laws?
- (LO6)** List the five main goals that policymakers attempt to achieve with the income tax system.
- (LO7)** Dexter earns wages of \$88,000 in 2026. What are the total employment taxes paid on the wages?
- (LO8)** List five characteristics of a successful tax professional.

## Application Problems

- (LO3)** Calculate the tax liability for the following taxpayers in 2026:
  - Darius is single and has taxable income of \$100,000.
  - Henry and Harriet are married and file a joint tax return. They have taxable income of \$200,000.
  - Jenny is head of household and has taxable income of \$100,000.
- (LO3)** What is the after-tax income in the following situations for a single taxpayer in 2026?
  - Taxable income received of \$100,000
  - Taxable income received of \$75,000, tax-exempt revenue received of \$25,000
- (LO3)** What is the after-tax cost in the following situations if the taxpayer has additional deductions as stated? Assume the taxpayer is in the 24% marginal tax bracket.
  - Deductible expense paid of \$35,000
  - Deductible expense paid of \$25,000; non-deductible expense paid of \$10,000
- (LO3)** Dre owns Kratum Company and has the following revenue and expenses. Calculate the after-tax net profit (ignoring self-employment tax) for Dre who is single in 2026.

Taxable revenue received	\$125,000
Tax-exempt revenue received	\$ 15,000
Deductible business expenses paid	\$ 4,000
Deductible itemized deductions	\$ 18,000
Non-deductible expenses paid	\$ 5,000

- (LO3)** Sanjay has the following information for 2026:

Filing status	Married filing jointly
Taxable income	\$258,500
Total income	\$290,700

Compute his marginal tax rate, average tax rate, and effective tax rate.

- (LO3)** Sarah has asked for help in determining whether she should receive her \$25,000 bonus check in the current year or next year. In the

current year, her marginal tax rate is 24% and she anticipates she will be in the 32% marginal tax bracket next year. What advice can you give Sarah?

- (LO3)** Aroon is a valuable employee for his company, and he will receive a significant bonus. His employer has asked him to consider moving next year to a new company location in a different state. His bonus is guaranteed and projected to be \$75,000. Aroon can choose to receive the bonus on December 31 of the current year or January 1 of the next year. You are able to determine the following information:

	<u>Marginal tax rate</u>	<u>State tax rate</u>
Current year	24%	10%
Next year	32%	5%

Should Aroon choose to receive his bonus in the current year or next year?

- (LO3)** Kurt, married filing jointly, owns a manufacturing business and has the opportunity to invest in a transaction that will generate \$200,000 before-tax cash flow and taxable income in Year 0.

- Calculate the after-tax cash flow using the tax table for 2026 for married filing jointly.
- How does your answer change if Kurt could restructure the transaction in a way that results in before-tax cash flow and taxable income of \$50,000 in Year 0, \$100,000 in Year 1, and \$50,000 in Year 2? Assume a discount factor of 4% and the same tax rate table as given for 2026.

- (LO3)** Butch, single, operates a sole proprietorship with net income of \$145,000. Butch's taxable income is also \$145,000 including the income from the sole proprietorship. Butch is considering incorporating his business. Calculate the income tax liability for Butch as a sole proprietor (ignoring self-employment tax) and as a corporation in 2026. List two other factors that Butch should consider before deciding to incorporate.

- (LO3)** Barb and Rick are married filing jointly and have taxable income of \$100,000.

- Calculate their tax liability using the 2026 tax rate schedules.
- Calculate their tax liability using a flat rate of 20%.

**11. (LO3)** Quincy is single, has \$65,000 of wages, and pays 20% in federal and state income tax. If the combined federal and state tax rate increases to 25%, how much additional income must Quincy earn to maintain the same desired take-home pay in 2026?

**12. (LO6)** The state Nor lives in has the following income tax rate structure:

Percentage rate	Bracket
8%	Income from \$0–\$100,000
5%	Income from \$100,001–\$200,000
3%	Income in excess of \$200,000

Nor has \$325,000 of income. Calculate Nor's tax liability and indicate what type of tax rate structure his state has.

**13. (LO7)** Dorice lives and works in Indiana but purchased a car from a dealership in Illinois. The sales tax in Indiana is 7% and in Illinois, it is 6.25%. Did Dorice avoid having to pay the additional 0.75% sales tax by purchasing her car in Illinois?

**14. (LO7)** Benny has \$100,000 to invest and is considering two options:

Option A: Earn 6%, investment income is taxable

Option B: Earn 4.8%, investment income is tax-exempt

Benny has a 24% marginal tax rate.

- What is Benny's explicit and implicit tax on both options?
- Which option provides the greater annual after-tax cash flow?

## Tax Planning Problems

Planning

**1. (LO3)** McKeller Company would like to start a new venture. The company is currently in the 24% marginal tax bracket and uses a 5% discount factor. The company projects that the venture will produce before-tax cash flows of \$10,000 in Year 0, \$20,000 in Year 1, and \$30,000 in Year 2.

- Assume that taxable income and the before-tax cash flows are equal in the year received, and compute the present value of the cash flows.
- What if the company can defer receipt of cash flow from Year 0 and Year 1 until Year 2? Recompute the present value of cash flows.
- Assume the same facts in part a, except the company can delay paying any tax on cash flows from Years 0 and 1 until Year 2. Recompute the new present value of cash flows.
- Which option provides the best outcome?

**2. (LO3)** Rafael is thinking of starting an office supplies business specializing in home and office delivery. He is not sure what entity type is best from a tax perspective and needs your help. He projects that he will generate net cash flow and taxable income of \$50,000 in his first year.

- Compare and compute the difference in after-tax cash flow if Rafael structures his business as a C corporation which has a 21% flat rate or an S corporation which has income flowing to him on his personal return at a 24% rate.
- What are some other concerns that Rafael should consider?

## Professional Development Skills

### Communication Problem

Communication

**1. (LO8) Careers in Taxation** Being a full-time accountancy student is exciting and challenging. You are aware that there are many careers within accountancy to choose from, but your interest has been in taxation. Explain to your family why you would like to be a tax accountant and discuss the different career paths within taxation that you can explore.

### Ethics and Professional Responsibilities Problem

Ethics

**1. (LO4) Preparing a Tax Return** A friend of yours has approached you about preparing his tax return. You are in your senior year of college taking a taxation course, and everyone keeps asking you questions and seeking your advice on how to prepare their tax returns and get the largest tax refund possible. You have told them that you have only taken one course so far and are not a CPA. Can you prepare your friend's tax return? Can you accept payment?

In addition to the chapter content, see *Statements on Standards for Tax Services* at [www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services](http://www.aicpa-cima.com/resources/landing/statements-on-standards-for-tax-services), *Circular 230* at [www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230](http://www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230), and Chapter 3, LO4, Tax Professional Responsibilities.

## Research Problem

**Research**

**1. (LO4) Is the Tax Law Constitutional?** Peter “The Prophet” Verdad is a self-proclaimed prophet who claims that the end of times is near. He earns income as a guest lecturer, from the sale of prophecy books and videos, and as a host at a popular radio station. Peter did not file an income tax return for tax years 2011–2018, claiming that the federal income tax system is unconstitutional. He also claims that he shouldn’t have to pay tax because he is essentially the same as a church. What would be your response to Peter if he were your client? Hint: See *Lloyd v. Commissioner*, T.C. Memo. 2020-92 (2020).