

CHAPTER OUTLINE

Setting the Stage—An Introductory Case	3
1.1 An Introduction to Taxes	3
1.2 Types of Tax Rate Systems	13
1.3 Characteristics of a Good Tax	16
1.4 The Taxing Units and the Basic Income Tax Model	19
1.5 Choice of Business Entity	30
Revisiting the Introductory Case	39
Summary	39
Key Terms	40
Test Yourself	40
Problem Assignments	41
Answers to Test Yourself	45

LEARNING OBJECTIVES

After completing this chapter, you should be able to:

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| 1.1 Explain the basic types of taxes and the bases on which they are levied by various governmental units. | 1.4 Describe the basic parts of the corporate and individual income tax models and understand how the tax due is calculated for each of them. |
| 1.2 Compare the effects of progressive, proportional, and regressive tax systems on taxpayers' incomes. | 1.5 Identify the most common business entities recognized by the U.S. tax system and explain the basic differences in ownership and their effects on entity taxation. |
| 1.3 Explain the characteristics of a good tax system using characteristics of equity, economy, certainty, and convenience. | |

This chapter presents an overview of the various types of taxation, the basic concepts important to the evaluation and understanding of taxation, and an introduction to alternate business forms and taxable entities. These serve as a backdrop to the more detailed provisions of income tax law that follow in subsequent chapters. This chapter is not concerned with specific numbers or their origin, as the majority of these numbers change with each filing year. Their specific applications will be discussed in subsequent chapters. Instead, the focus is on developing a broad understanding of how the U.S. income tax system works.

This first part begins with some background information on the various forms of taxation (income, consumption, wealth, and wealth transfer taxes). It is followed by a discussion of the effects of various tax rate structures (progressive, proportional, and regressive), examples of each type, and their effects. It ends with a brief description of Adam Smith's Canons of Taxation (equity, economy, certainty, and convenience), which provide the framework for assessing what constitutes a "good" tax.

An introductory discussion of federal income taxation follows and introduces the three types of taxable persons—individuals, C corporations, and fiduciaries—the ultimate payers of all income taxes. The basic tax model is introduced and the concepts of gross income, taxable income, tax rates, gross tax liability, and tax credits are presented in the context of the tax model.

The final section ends with a discussion of the various business entities that are subject to federal income taxes, including sole proprietorships, partnerships, C corporations, and S corporations. The individual owner of a sole proprietorship is taxed on the business's income. Partnerships and S corporations are conduit or flow-through entities that pass their income (and loss) items through to their owners for taxation at the owner

level. A C corporation's income is subject to double taxation, first at the entity level by the corporate income tax and then a second time when distributed to shareholders as dividends. A table comparing the basic attributes of each of these entities completes this chapter.

Wing Hue, an engineer from China with U.S. residency status, recently obtained permanent employment with a U.S. consulting firm. Before coming to the United States, Hue developed a totally new system of gears for bicycles. He obtained a patent on his gear design and plans to solicit several venture capitalists for funds to begin manufacturing and marketing the gears as a venture separate from his consulting work. He believes his gear design would be attractive to both bicycle manufacturers and repair shops as replacements for existing gears.

As a student in China, Hue never had sufficient income to pay taxes. He understands that as a U.S. resident, he is subject to a variety of taxes. He is particularly interested in how his gear manufacturing enterprise will be taxed. He asks you for a brief explanation of the potential taxes that he faces as an employee and as an entrepreneur. We will return to this case at the end of this chapter.

**SETTING THE
STAGE—AN
INTRODUCTORY
CASE**

1.1.1 WHAT IS A TAX?

A tax is a forced payment made to a governmental unit that is unrelated to the value of goods or services received. Taxes are not voluntary. When income exceeds an allowable minimum, income taxes are assessed on that excess income by the federal government, and possibly, by certain state and/or local governments.¹ Many states (and other smaller governmental units) require the sellers of certain consumer goods or services to collect sales taxes on these purchases. Failure to collect and remit these taxes to the appropriate governmental unit, subjects the responsible persons to civil, or even criminal, penalties.

The owners of real property are responsible for property taxes levied annually by the local government, based on the assessed value on that property. A bill is sent to the owner for these property taxes and, if unpaid, the government may seize the property.

There are hidden taxes as well. Hidden taxes are those taxes paid on a taxable purchase but not specifically itemized as part the purchase price. When we buy gasoline for our automobiles, there are significant taxes imbedded in the pump price. The same is true for many other items, such as cigarettes and alcoholic beverages. Nevertheless, if we want that particular good (legally, that is), we pay the hidden tax.

Taxes are not levied as punishment (as are fines for speeding), nor are they levied as payment for government goods or services (such as garbage collection fees). Although we may benefit from governmental activities paid for by these taxes, there is generally no direct connection between the benefit a taxpayer receives and the taxes paid. Property taxes to support local schools are based on the value of the property owned and are unrelated to the owner's school-age children (if any) who benefit from free public education. Thus, taxes are often called forced extractions. You must pay them, but you may have no direct benefit from them.

For a number of years, there has been a realization that the current income tax system is no longer workable due to its complexity. Its primary goal is no longer to meet the revenue needs of the government's basic functions, but has evolved into an engine that fosters the economic and social goals lawmakers deem appropriate. As our government has grown, so have the laws

**1.1 AN
INTRODUCTION
TO TAXES**

¹ Individuals are assessed federal income taxes only if their income exceeds their allowable deductions (including personal and dependency exemptions plus their standard or itemized deductions).

governing the determination of taxable income and taxes owed. Although there have been many calls for simplifying the tax system, it is necessary to have a basic understanding of the current tax system and its potential alternatives, before developing a new tax system to either replace or supplement the current federal system.

To begin this introductory study of the income tax system, certain basic tax concepts, alternative types of taxes, and the types of tax rates that can be applied to a taxable base are introduced. Adam Smith's canons of taxation, developed many years ago, provide a foundation for assessing whether a tax is indeed a good tax. Once an understanding of these concepts is integrated with an understanding of the current income tax laws, one can intelligently participate in discussions about reforming our current tax system.

1.1.2 EVOLUTION OF THE FEDERAL INCOME TAX

The federal income tax is the most significant tax assessed by the U.S. government. What was once an initially simple concept of taxing income, has expanded over the years into an exceedingly complicated system. Although there had been a federal income tax during the Civil War, the federal income tax system as we know it today did not begin until 1913 when the 16th Amendment to the U.S. Constitution was ratified. The 16th Amendment gave Congress the power to lay and collect taxes "on income, from whatever source derived," without the previous requirement that all direct taxes be imposed based on population. This first federal income tax law enacted in 1913 consisted of only 16 pages and required only a simple individual income tax return.

Each time the income tax statutes were revised between 1913 and 1939, an entire set of new provisions replaced the existing law. In 1939 this procedure changed, and the income tax laws were codified as the **Internal Revenue Code**. Amendments and revisions were then made to the specific sections of the Code, rather than replacing the old law with an entirely new set of statutes.

In 1954, there was another major overhaul of the tax laws. In this 1954 recodification, the income, estate, gift, and excise tax laws were incorporated into the *Internal Revenue Code of 1954*. There were many significant tax law changes between then and 1986, each amending the *Internal Revenue Code of 1954*. Because the Tax Reform Act of 1986 was so extensive, the Code was renamed the *Internal Revenue Code of 1986*. Any current changes to the tax laws are now amendments to the *Internal Revenue Code of 1986*.

A number of factors influence the federal tax laws, but probably the makeup of Congress is the most important. The political parties have different views of the level of taxation relative to the services that should be provided by the federal government. In general, the Democratic and Republican Parties disagree on whether the federal government or the state and local governments are best able to serve the public interest. Individual states or regions have particular interests that their elected representatives espouse and bargain to achieve. This often leads to rather strange results; for example, the federal government successfully sued the tobacco industry for the harm done by cigarette smoking while maintaining subsidy programs for tobacco farmers.

Washington is full of lobbyists who try to influence representatives and senators to sponsor or vote for legislation favorable to their particular industries. This influence is manifested in two ways. First, industries contribute substantial monies to election campaigns, pouring the greatest amount of money into the campaigns of persons they believe will support their positions—incumbent or not. Second, many lobbyists and political action committees (PACs) have extremely large staffs available to research various technical issues. They can funnel this research, often slanted in their desired direction, to the various members of Congress. It is not unusual for a lobbyist to have provided the basic text of a tax law introduced in Congress.

The attempt to satisfy the many constituencies of our elected representatives has led to a collection of tax laws that have become more and more complex. This has significantly increased

the compliance burden on taxpayers as well as Internal Revenue Service (IRS) administration. In spite of many calls for simplification, Congress continues to pass additional tax provisions, adding complexity to the system, without revisiting or deleting existing provisions.

Both political parties provide tax breaks to their constituents referred to as **tax expenditures**. Tax expenditures can take the form of special exclusions, deductions, credits or preferential rates for specific activities. These tax expenditures result in a reduction in the revenue that would be collected under a more comprehensive income tax. Although many of these tax expenditures are viewed positively because they can stimulate the economy, the dispute among politicians is usually over how to pay for them. They can usually be paid for in one of three ways: (1) reducing spending, (2) adding to the budget deficit, or (3) raising other tax revenue to offset the cost of the tax expenditures. Although politicians say they want to cut spending, they have been very ineffective in doing so. They usually add to the budget deficit or increase taxes. This dilemma has led to an alternative way to minimize the cost of tax expenditures by making them temporary rather than permanent. A tax expenditure expected to expire in only one or two years, needs to raise far less revenue to pay for it than making the expenditure permanent. Unfortunately, the uncertainty surrounding the extension of some of these provisions has made tax planning increasingly difficult so that much of the expected economic stimulus is negated by this uncertainty.

The impact the political ideological differences have had on our tax system can be illustrated through a brief review of the last six years of Congress. With a divided Congress after the 2010 elections, the subsequent rancor between the parties created gridlock in Washington effectively stymieing most of the 2011–2012 legislative initiatives. This led to what became known as the “fiscal cliff.” The Budget Control Act of 2011 was passed only by including a provision that imposed “sequestration” resulting in 10 percent across-the-board spending cuts on January 1, 2013 if Congress and the President could not come to an agreement prior to that time. Given the state of the weak economy that remained throughout 2012, there were many dire predictions of return to recession if there was no corrective legislation to continue the majority of the temporary tax cuts. The debate continued until January 2, 2013 when the Taxpayer Relief Act was approved by both houses of Congress retroactively extending most provisions through 2014. When the debt ceiling was reached early in 2013, the Republican majority in the House and the Democratic majority in the Senate had failed to reach agreement on almost anything. The result was sequester and the shut-down of the government for 2½ weeks in October. A basic two-year budget bill was finally passed towards the end of 2013.

Congressional inaction continued into 2015, but with House Speaker John Boehner’s surprise resignation in October, a compromise budget bill was passed funding the government through the end of President Obama’s term in office. Prior to recessing for the holidays, Congress passed the Protecting Americans from Tax Hikes Act of 2015, which President Obama signed into law on December 18th. This Act made permanent a few key tax provisions and retroactively, but temporarily, extended many other tax breaks that had expired at the end of 2014. It does, however, add to the budget deficit.

The elections in November 2016 gave the Republican Party control of the House of Representatives, the Senate, *and* the White House. This now gives them their best opportunity in some time to enact change. House Speaker Paul Ryan developed a fairly detailed proposal for tax reform before the election, but President Trump has indicated that he does not agree with all the provisions. Although Congress, not the President, writes the tax laws, the President retains veto power over proposed legislation with which he does not agree. The legislative process and some of the current proposals for tax reform are discussed in the next chapter but only time will reveal what the new administration has planned for tax reform.

Although this text is primarily about the federal income tax, a basic understanding of other taxes will be helpful before we begin exploring the federal income tax in more detail.

1.1.3 STATE AND LOCAL INCOME TAXES

While most students are aware of the federal income tax, not all are familiar with state and local income taxes. The increasing importance of these taxes is reflected in the growth of state and local tax (SALT) practices in public accounting. Most states (and some local governments) impose corporate and/or personal (individual) income taxes on both residents and nonresidents.² States, however, normally tax nonresidents only on income from business activities or property located within that state.

Example 1.1

When Alex Rodriguez, the former Texas Rangers shortstop, lived in Texas (a state with no individual income tax), he owed more than \$271,000 to California (for nonresident income tax) for games he played there during baseball season. It was estimated that if the Rangers had played all their games at home, A-Rod's state tax bill would have been reduced by more than half a million dollars a year.³ When A-Rod became a New York Yankee, his state and local tax burden increased dramatically. On the \$155 million that A-Rod was to be paid over his seven-year contract, he was expected to owe \$3.57 million to New York City and an additional \$6.19 million to the State of New York for income taxes.⁴ His tax burden increased further when he renegotiated his contract for \$275 million over ten years.

The state in which a corporation is organized has the right to impose an income tax on that corporation under the residency principle. Alternatively, the source principle allows taxation of a business that has an economic connection to a state (derives income from assets or activities located within a state). When a resident corporation of one state derives income from business activities in another state, double taxation could result. To minimize this, states that levy an income tax on its resident businesses usually allow them to claim a credit for some or all of the income taxes paid to other states. The type and degree of connection between a business and a state necessary for the state to impose a tax is referred to as **nexus**.

Example 1.2

Corian Corporation manufactures equipment for sale nationwide. Corian's corporate headquarters and production facilities are located in Florida. Corian has regional sales offices in New York, Illinois, and California. Corian has nexus in Florida, New York, Illinois, and California due to the presence of employees and business property in those states.

In place of the income tax, some states impose a franchise tax. A **franchise tax** is an excise tax based on the right to do business or own property in the state. Whether the tax is called an income tax or a franchise tax, the tax is usually determined based on corporate income.⁵

Most states piggyback their computation of state taxable income on the federal income tax system by beginning with individual or corporate federal taxable income. Piggybacking on the federal system is particularly problematical, however, when Congress amends the tax law

² States not imposing a corporate income tax or other form of business tax include Nevada, South Dakota, and Wyoming. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not impose individual income taxes. Additionally, some states only tax certain types of interest and dividend income.

³ Mark Hyman, "Why the 'Jock Tax' Doesn't Play Fair," *Business Week*, July 7, 2003, p. 37.

⁴ Dan Kadison, "\$10M is Ballpark for Taxman," *The New York Post*, February 17, 2004, p. 4.

⁵ A few states impose their franchise tax on a corporation's stock value or net worth, either in addition to or instead of a tax on corporate income if it results in a higher tax.

resulting in reduced taxable income (for example, by increasing or accelerating deductions). To minimize the potential impact on state tax revenues, many states adopt a fixed version of federal tax law by computing state taxable income as determined under the federal tax rules in effect as of a specific date. This allows state legislatures time to study the impact of changes on state revenue before adopting them. Although most states eventually adopt the federal changes, considerable delays are common.

When a corporation has nexus in several states, each state taxes only a percentage of the corporation's income based on the business allocated to that state. Although computations differ from state to state, many states use a three-factor allocation formula based on sales, payroll costs, and tangible property. Some states place more weight on the sales factor, while others weigh these factors equally.⁶

Southeastern Corporation does business and has nexus in States X and Y. Its sales, payroll costs, and tangible property located in each state are:

Example 1.3

	Sales	Payroll	Property
State X	\$800,000	\$315,000	\$540,000
State Y	\$800,000	\$135,000	\$360,000
Total	\$1,600,000	\$450,000	\$900,000

Based on these dollar figures, the percentages for the three factors are as follows:⁷

	Sales	Payroll	Property	Total
State X	50%	70%	60%	180%
State Y	50%	30%	40%	120%
Total	100%	100%	100%	

If each factor is weighted equally, the apportionment formula computes the average of the three factors so that the apportionment percentage for State X is 60 percent ($180\%/3$) and the apportionment percentage for State Y is 40 percent ($120\%/3$). Southeastern Corporation allocates 60 percent of its income to State X and 40 percent to State Y.

Nonbusiness income, such as interest, dividends, rent and royalties, is taxed in only one state—the state in which the corporation is domiciled or the state in which the underlying property is located or used.⁸

Income tax planning for multistate corporations usually involves shifting income from high-tax states to low-tax states by shifting assets from one state to another or by outsourcing some functions to eliminate or move nexus from a particular state. Businesses that are expanding or relocating facilities should measure the impact this will have on the amount of income apportioned to the state. For example, a corporation with plans to expand its facilities should avoid a high tax-rate state that uses an apportionment formula that weights property and payroll factors

⁶ Because of the variation in allocation formulas between states, some corporations may have more than 100 percent of their total taxable income subject to state income taxes.

⁷ The percentage for each factor is determined by dividing the dollar amount of the item attributable to that state by the total dollar amount for that factor. For example, payroll for State X is \$315,000. Dividing \$315,000 by the total payroll costs of \$450,000 means 70 percent of all payroll costs were incurred in State X.

⁸ The corporation's domicile is the principal place from which the business is managed or directed, not necessarily the state of incorporation.

more heavily. The expansion of plant and the addition of employees can increase the percentage of total income subject to state tax.

1.1.4 EMPLOYMENT TAXES

Employment taxes include those specified under the Federal Insurance Contributions Act (FICA) along with federal and state unemployment taxes. The **FICA tax** has two components: Social Security and Medicare. Social Security pays monthly retirement benefits (also survivor and disability benefits) to qualified individuals. The 6.2 percent Social Security tax applies to salaries and wages up to an annual maximum of \$127,200 for 2017. The Medicare tax pays for medical insurance for individuals who are elderly or disabled. The 1.45 percent Medicare portion of the FICA tax applies to all salary and wages without limit. Thus, an employer pays 7.65 percent FICA tax on each employee's wages up to \$127,200 and 1.45 percent on compensation above \$127,200.

In addition to the employer FICA tax, employees pay a matching FICA tax. Employers withhold the employee portion of the FICA tax from the employee's salary or wages and forward it to the federal government (along with any income tax withheld).

Example 1.4

Maria is an employee of Marlin Corporation. In 2017, Maria received a salary of \$130,000. Marlin Corporation paid a Social Security tax of \$7,886 ($\$127,200 \text{ limit} \times 6.2\%$) plus a Medicare tax of \$1,885 ($\$130,000 \times 1.45\%$) for a total FICA tax of \$9,771. Marlin Corporation withheld \$7,886 from Maria's pay for her share of Social Security tax and \$1,885 for her Medicare tax. Marlin Corporation also withheld income tax based on Maria's W-4 form that indicated her filing status (single) and number of dependents (none). Marlin Corporation forwards both the employer's and employee's share of FICA tax to the federal government, as well as any income tax withheld for Maria.

Self-employed individuals (such as independent contractors, sole proprietors and partners) must pay the self-employment tax that includes both the employer and employee share of FICA tax, as discussed in detail in Chapter 4.

In addition to FICA taxes, employers are also required to pay federal and state unemployment taxes. These taxes fund temporary unemployment benefits for employees terminated from their jobs without cause. The rate under the Federal Unemployment Tax Act (FUTA) is 6 percent on the first \$7,000 of wages. The state rates vary widely but the federal government allows a credit of up to 5.4 percent for state unemployment taxes the employer pays. Unemployment taxes are usually only paid by the employer and not the employee. Self-employed individuals are not eligible to collect unemployment benefits so they do not pay unemployment taxes for themselves; they pay unemployment taxes only for their employees.

1.1.5 WEALTH TAXES

Wealth taxes are based on the taxable entity's total wealth or the value of specific types of property. The most common wealth tax is the **real property tax**. This **ad valorem** tax is levied on individuals and businesses that own real property—land and buildings—and is assessed on the fair market value of the property. Local taxing jurisdictions rely heavily on the real property tax for the support of schools, police and fire protection, and other services furnished by the local municipality. The federal government generally does not levy any form of wealth tax, leaving the various forms of wealth taxes to the state or local governments.

To determine the rate at which the real property taxes will be levied, the municipality “works backward.” The total budget is determined along with the total assessed valuation for all property subject to the tax. A mill levy (a “mill” is one-tenth of one cent) is then determined based on the total assessed value of the property to raise the revenue required by the budget. The mill levy is applied to each individual property within the district to determine its separate property tax.

A municipality’s budget is \$1,000,000 and the total assessed value of all the property subject to the property tax is \$200,000,000. To raise the required \$1,000,000, a five-mill levy is required per \$1 of assessed value ($\$1,000,000/\$200,000,000 = \$.005$). When this mill levy is applied to a piece of property with an assessed value of \$100,000, the owner would pay \$500 ($\$.005 \times \$100,000$) in real property taxes.

Example 1.5

Other forms of wealth taxes include the personal property tax, the tangible property tax, and the intangible property tax. These taxes are collected annually on property owned as of a certain date based on a predetermined fixed rate applied to the fair market value of the property. Personal property or tangible property taxes are more likely to be levied on the value of a business’s inventory and/or operating assets. Individuals may not always escape this tax, however, as a number of states base a part of the cost of obtaining automobile registrations or license plates on the value of the auto as an ad valorem tax.

Some states levy intangible taxes on the value of receivables, stocks, bonds, and other forms of investment instruments owned by businesses and individuals. Intangible taxes are based on a fixed tax rate times the fair market value of the intangible assets owned as of a specific date.

Two major problems related to wealth taxes have lessened government reliance on them as a source of revenue: the difficulty in establishing fair market value annually and the taxpayer’s ability to “hide” personal property. The market value of many types of personal property (tangible or intangible) is not verifiable, leading to significant undervaluation by taxpayers. Moreover, the government may not know who owns a specific asset unless there is a way to trace or detect ownership. Thus, most local governments rely heavily on real property taxes rather than other types of personal property taxes, as real estate is much harder to hide. Through the assessment system, taxes are thought to be levied on a more uniform basis across the value of the properties.⁹

Based on ability to pay, wealth taxes would seem to be a sound source of tax revenue. Many items, however, such as a personal residence, do not produce direct income, and the owner may have little or no disposable income with which to pay the tax—a major problem for the elderly or others on fixed incomes when real property taxes increase.

1.1.6 WEALTH TRANSFER TAXES

Wealth transfer taxes are levied when all or part of an individual’s wealth is transferred to another person. Since 1916, the United States has had an **estate tax**, a wealth transfer tax that applies to transfers of property as a result of the owner’s death. A second wealth transfer tax, the **gift tax**, was enacted in 1932. The gift tax is imposed on a donor who makes a gratuitous lifetime transfer of property.¹⁰ To avoid double taxation on these transfers, the recipient is not subject to income tax on gifted or inherited property.

⁹ Ideally, there would be an annual valuation process, but in reality, property assessments may increase or decrease based on indices only, or are otherwise revised only when a property is sold.

¹⁰ Chapter 12 contains a more detailed discussion of wealth transfer taxes.

Since 1976, the federal estate and gift taxes have been unified. Gift transfer taxes are levied based on a person's transfers during his or her lifetime with the final estate tax based on transfers at death. The tax is assessed on the fair market value of the property transferred by the transferee. To ease the administrative burden, an *annual* gift exclusion (currently \$14,000 per recipient per year) prevents smaller gifts from being subject to the transfer tax.¹¹ Additionally, unlimited transfers to a spouse and qualified charities (during lifetime and at death) escape taxation. A unified gift and estate *lifetime* credit (equivalent to the tax on a transfer of \$5.49 million in 2017) assures that a certain base amount of wealth can be transferred to others (including children, grandchildren, other relatives, and friends) through lifetime gifts or transfers at death free of a transfer tax.

Example 1.6

In 2017, Marleen gave \$50,000 to a qualified charity. She also gave each of her five grandchildren 700 shares of stock valued at \$10,000 on their birthdays. The charitable gift is not subject to the gift tax. The birthday gifts are also free of the gift tax (and Marleen does not have to file a gift tax return) as they do not exceed each grandchild's \$14,000 annual gift tax exclusion. If Marlee gives an additional \$10,000 to each grandchild this year, she now exceeds the annual gift exclusion ($\$10,000 + \$10,000 - \$14,000 = \$6,000$ taxable gift to each) and would have to file a gift tax return for 2017. This notifies the government that she is using some of her lifetime unified credit.

Marleen's gifts remain free of any gift tax until her total taxable gifts exhaust her unified credit that is equal to the tax on total taxable gifts of \$5.49 million (the current lifetime exclusion). The grandchildren have no tax consequences on the receipt of the gifts because gifts are not subject to income taxes. They will, however, be subject to income tax on future dividends received or realized gains on any stock sales.

With the integration of the gift and estate taxes, any unified credit not used for lifetime gifts can be used for transfers made by the decedent's estate. Thus, the decedent's estate escapes taxation unless his or her total lifetime taxable gifts plus taxable transfers at death exceed the lifetime exclusion.¹²

A number of states levy inheritance taxes rather than estate taxes. The inheritance tax is based on a person's right to receive property upon the death of another. The tax rates and amount excluded from taxation vary with the relationship of the heir to the decedent and the value of the property received. The estate normally pays the inheritance tax, but the tax paid reduces the total value of the property transferred to the heir. In addition to an inheritance or estate tax, many states also levy a gift tax.

1.1.7 CONSUMPTION TAXES

Consumption taxes may take many forms, but the **sales tax** is the most common form in the United States. Most states levy sales taxes on some or all of the goods and services purchased, although certain items considered necessities may be exempt from tax. For example, food, clothing, prescriptions, and many services may be excluded from the sales tax while items not considered necessities such as restaurant meals, rental cars, and hotel rooms are taxed. Purchases of inventory for resale are usually exempt from sales tax because the inventory will be taxed when sold; however, purchases for use in a business are taxable as a final sale.

¹¹ If a taxpayer's annual gifts to an individual recipient do not exceed \$14,000, the donor is not required to file a gift tax return. A husband and wife can combine their \$14,000 annual exclusions through gift splitting to jointly give up to \$28,000 to each recipient annually.

¹² The lifetime exclusion for taxable transfers is \$5,490,000 for 2017 (\$5,450,000 for 2016). Chapter 12 has a more complete discussion of the annual and lifetime exclusions for taxable transfers.

The retailer is responsible for collecting and remitting sales taxes to the appropriate state and local tax authority. Because the determination of items subject to sales tax varies greatly from state to state, multistate retailers must determine not only the appropriate sales tax rates (which may vary within a zip code due to local sales taxes) but also determine which items are subject to tax in each location.

The concept of nexus is as important in determining the sales tax as it is for an income tax. A state cannot require an out-of-state business to collect sales tax unless it has nexus with the state. The exact definition for sales tax nexus may differ from that of income tax nexus. A business may have nexus in a state for sales taxes but not for income taxes or vice versa. For example, employees from out-of-state who solicit sales within a state may create sales tax nexus but not income tax nexus.

Each state that imposes a sales tax also imposes a companion use tax. A **use tax** is imposed on property to be used in one state but purchased in another state if no sales tax was paid in the state of purchase. A use tax is self-assessed and usually at the same rate as the sales tax. Without a use tax, there is an incentive to purchase from out-of-state businesses not required to collect a state sales tax to the detriment of in-state businesses.

JX Corporation operates in a state with a 6 percent sales and use tax. JX purchases office supplies over the Internet from an out-of-state supplier for \$2,000. JX pays no sales tax. If JX purchased these supplies from the local office supply store, it would have to pay a sales tax of \$120 ($\$2,000 \times 6\%$). JX should file a use tax return and pay the \$120 use tax to its state because the supplies will be used within the state.

Example 1.7

Most states have difficulty collecting use taxes from individuals (except for automobiles that require registration with the state). Collection from businesses is much easier to enforce because most states regularly audit in-state businesses for compliance with sales and use tax laws.

One benefit of a consumption tax like the sales tax is that it encourages savings—considered a necessity for continued investment and economic growth. A person can avoid the sales tax by not purchasing certain goods for consumption; income that is not consumed is available for savings. The income tax not only taxes income whether consumed or saved, but taxes the income earned on savings, further discouraging savings.

Other types of consumption taxes include excise taxes, value-added taxes, and turnover taxes—although only the excise tax is in common use in this country. An excise tax is another form of sales tax and the only sales tax levied by the federal government. Excises are generally levied on taxable goods for which there is a low elasticity of demand or on goods whose use the government wishes to discourage, such as tobacco products and alcoholic beverages. This latter group of excises is generally referred to as “sin” taxes.¹³ Other excises offset some of the costs incurred by the government for certain services, for example, the tax on airline tickets helps pay for the system of air traffic controllers.

The **value-added tax (VAT)**, in use in most of the developed countries of the world, has not been adopted in the United States. It is a type of sales tax that is added to a product or service based on the value added at specific points in the production or service process. Although there are several methods for calculating the value-added tax, it basically works as described in the following example.

¹³ The indirect costs incurred from the consumption of these products must be borne by the government; that is, treating persons for lung cancer and alcoholism is the justification for taxing these products at rates that are designed to discourage their use.

Example 1.8

A business buys parts to manufacture a widget. The parts cost \$400, to which a 10 percent value-added tax is added by the seller—a total cost of \$440. The business assembles the parts into a widget and sells the assembled widget for \$800 plus a 10 percent value-added tax of \$80—the purchaser’s total purchase price is \$880. The business, however, remits only \$40 of the tax to the government—the total \$80 VAT less a credit for the \$40 VAT paid to the supplier of the purchased parts. The government collects the other \$40 from the parts supplier. The consumer pays the full tax on the product to the last business in the business chain. The tax collected at each step is based on the difference in the price paid for the goods coming in and the price received when leaving.

Some features of a VAT differentiate it from a sales tax. First, it is generally included directly in the selling price at the consumer level. Second, the VAT is not levied on goods exported to other countries. Businesses that export goods to other countries receive refunds of the VAT paid on exported goods. When the United States exports goods to a foreign country in competition with another exporting country that levies a value-added tax (instead of a corporate income tax), the United States may be at a competitive disadvantage. All other costs being equal, the U.S. firm will have to charge more than the other exporter to make the same profit because it receives no rebate of income taxes while the foreign exporter receives a rebate of its value-added taxes.¹⁴

The turnover tax, another consumption tax, is a sales tax levied at each step of a business chain—both wholesale and retail—but with no rebates or credits for prior taxes paid. Thus, if one firm handles all the steps in a manufacturing process from raw materials to finished goods, the tax is levied only once, when the product is sold to the consumer. If, however, that same product’s manufacturing process is handled by two or three firms, the tax is levied and collected each time the items move from one manufacturer to the other—driving up its costs relative to the manufacturer that is able to complete the various manufacturing steps.

1.1.8 TARIFFS AND DUTIES

Tariffs are taxes levied on goods and materials brought into a country, usually for one of two reasons: (1) A foreign business sells goods to the purchasers in the destination country at prices that may be below production costs in an attempt to capture a market and put the local operations out of business. (2) A local business’s operating costs are higher than those costs for the same product produced in the foreign jurisdiction.¹⁵

Import duties are similar to tariffs as they are taxes on goods brought into a country and levied by the destination country. When persons travel abroad, they are permitted to purchase a certain amount of goods and bring them back “duty free.” When the duty-free allowance is exceeded, the government levies a tax on the excess. This encourages the purchase of goods at home by making imported goods more expensive. Export duties are taxes levied on goods that are leaving the country of origin. These taxes discourage producers from selling their goods abroad by making them more expensive. In this way, they are available for purchase in the country of origin at lower prices.

¹⁴ Foreign firms that sell goods within the United States may be subject to U.S. income taxes, but they may be levied at rates significantly different from those faced by comparable U.S. firms. Taxation of foreign corporations is discussed in Chapter 3.

¹⁵ The tariffs on foreign steel introduced by the George W. Bush administration are examples of taxes levied because of the concern that foreign countries were “dumping” steel here at prices below their costs.

1.2 TYPES OF TAX RATE SYSTEMS

1.2.1 THE PROGRESSIVE TAX RATE SYSTEM

The current federal income tax system is a **progressive tax system**—one in which the tax rates increase as income increases. The progressive tax system is based on the fundamental belief that taxpayers with higher levels of income should pay a greater proportion of the taxes necessary to support the government. This is known as the “ability to pay” or the “wherewithal to pay” concept. Most taxpayers probably believe that a progressive system is a fair tax system in that they agree that people who have more should contribute more to the country’s welfare through taxes. There is, however, nothing that makes a progressive tax system inherently fairer—the fairness of a tax is a value judgment that varies from person to person.

The U.S. income tax rate structure has always been progressive with initial rates in 1913 of 1 percent to 7 percent. In 1945, to fund the war, the top rate increased to 94 percent.¹⁶ In 1985, 15 tax brackets ranged from a low of 11 percent to a high of 50 percent. In an attempt to simplify the tax system, the Tax Reform Act of 1986 drastically reduced the number of brackets as well as the rates. However, the top rate and the number of rates have continued to change either to raise revenue to balance the budget or to provide a tax cut when budget surpluses were predicted.

The current federal tax rates range from 10 percent to 39.6 percent. The range of income subject to a specific tax rate is known as a tax bracket. As the taxpayers’ income exceeds a specific bracket, income within that next bracket is subject to the increased percentage rate. Table 1.1 shows the tax rates for single individuals for 2017. The brackets to which these rates apply are adjusted annually for inflation.

Two types of income are subject to lower tax rates: dividend income and long-term capital gains. Dividend income is taxed at a lower rate because a corporation pays tax on earned income but is not allowed a deduction for dividends paid to its shareholders. Shareholders’ dividend income is effectively subject to a second tax at the shareholder level. To minimize the impact of this double taxation, the dividend income of individual shareholders is taxed at lower tax rates as shown in Table 1.1.

To encourage long-term investment, individuals who own their investments (such as stock) for more than 12 months are taxed at lower rates when sold. Table 1.1 provides the long-term capital gain tax rates for single individuals. Short-term capital gains (those that do not meet the more-than-one-year holding period) are taxed at an individual’s ordinary income tax rate.

Corporations also face progressive tax rates consisting of four nominal tax rates of 15%, 25%, 34% and 35% and two surtaxes applied at different income levels. Unlike individuals, corporations that have taxable incomes above certain levels do not keep the benefit of the lower tax rates on income below these levels. A five percent surtax eliminates the benefit of the 15 percent and 25 percent brackets on income below \$75,000 and a three percent surtax eliminates the

Table 1.1 Ordinary Income, Dividend Income, and Long-Term Capital Gains Tax Rates for Single Individuals in 2017

Total taxable income	Ordinary income tax rate	Dividend income tax rate	Long-term capital gain tax rate
\$9,325 or less	10%	0%	0%
\$9,326–\$37,950	15%	0%	0%
\$37,951–\$91,900	25%	15%	15%
\$91,901–\$191,650	28%	15%	15%
\$191,651–\$416,700	33%	15%	15%
\$416,701–\$418,400	35%	15%	15%
Over \$418,400	39.6%	20%	20%

¹⁶ See www.taxpolicycenter.org/statistics/historical-top-tax-rate.

benefit of the 34 percent rate on income below \$10,000,000. The tax brackets for corporations, including both nominal rates and surtaxes, are shown in Table 1.2. Corporations also have no special long-term capital gains tax rates. Their capital gains are taxed using the same rates as their ordinary income.

Table 1.2 Corporate Tax Rates

Taxable income	Tax rate
0–\$50,000	15%
\$50,001–\$75,000	25%
\$75,001–\$100,000	34%
\$100,001–\$335,000	39% (34% nominal rate + 5% surtax)
\$335,001–\$10,000,000	34%
\$10,000,001–\$15,000,000	35%
\$15,000,001–\$18,333,333	38% (35% nominal rate + 3% surtax)
Over \$18,333,333	35%

There are several other important tax rate concepts in a progressive tax rate system. An **average tax rate** is determined by dividing the taxpayer's tax liability by taxable income. For example, a corporation with \$75,000 of taxable income and a tax liability of \$13,750 [(\$50,000 × 15%) + (\$25,000 × 25%)] has an average tax rate of 18.33 percent (\$13,750/\$75,000). In highlighting the tax effects on different groups of taxpayers, the average tax rate is often used to compare the percentage of taxes paid on taxable earned income.

The **marginal tax rate** is the tax rate that applies to the next dollar of taxable income (or deduction).

Example 1.9

Sarah is single with taxable income of \$120,000 that puts her in the 28 percent marginal tax bracket. If she earns an additional \$10,000 in ordinary income, her taxable income increases to \$130,000 and she will pay an additional \$2,800 (\$10,000 × 28% marginal tax rate) in income tax. If, instead, she has \$10,000 of additional deductions, her taxable income decreases to \$110,000, she will save \$2,800 in income taxes.

As a taxpayer moves from one tax bracket to another, the marginal tax rate moves from one rate to the next. For decision purposes, the marginal tax rate is the most relevant rate for tax planning. Basic tax planning strategies that use the marginal tax rate are discussed in Chapter 2.¹⁷

In a progressive individual income tax system, the marginal tax rate is always higher than the average tax rate. The average rate may approach the highest marginal rate, but there is always some income that was taxed at a lower rate preventing the average rate from equaling the marginal rate for individuals.

In the corporate system of taxation, however, the marginal and average tax rates are identical for two corporate income ranges (with its structure of nominal rates and surtaxes). For corporate incomes between \$335,000 and \$10,000,000, the nominal rate is 34 percent, the marginal rate is 34 percent, and the average rate is 34 percent. The 5 percent surtax on incomes between \$100,000 and \$335,000 wipes out the benefit of the lower nominal tax rates of 15 and 25 percent. When corporate income reaches \$18,333,333 or more, the nominal, marginal, and average rates

¹⁷ A third tax rate, the effective tax rate, divides the taxes paid by an individual's economic income (both taxable and nontaxable).

are all 35 percent. Again, the 38 percent tax rate (including the 3 percent surtax) on income from \$15,000,000 to \$18,333,333 offsets the lower 34 percent rate on income below \$10,000,000.

1.2.2 PROPORTIONAL “FLAT” TAX RATE

One alternative to a progressive system of taxation is a proportional or flat tax system. A true **proportional tax system** would require all income to be taxed at the same rate regardless of the amount or type of the taxpayer’s income. Thus, marginal and average tax rates would be identical over all ranges of income.

The state sales tax is the most common example of a proportional tax; the tax paid is a fixed percentage of the amount spent. There have been a number of flat income tax proposals,¹⁸ but none has been a true proportional tax—one that allows no deductions. Prior flat-tax proposals have all been some form of a modified proportional tax system that allowed limited deductions from income effectively providing a 0 (zero) percent tax rate on income equal to the limited deductions. None of these proposals, however, would have raised enough revenue to replace the current federal income tax system.

1.2.3 REGRESSIVE TAXES

A **regressive tax system** is one in which taxpayers pay a decreasing proportion of their income as their incomes increase. As the taxpayer’s income goes from one bracket to another, his or her average tax on total income decreases, as does the marginal tax rate.

The only regressive taxes that taxpayers are subject to at the federal level are FICA and unemployment taxes. The 6.2 percent Social Security portion of the FICA tax only applies to salaries and wages up to a maximum of \$127,200.¹⁹ The 1.45 percent Medicare portion of the FICA tax applies to all salary and wages without limit and is a proportional tax.²⁰ As a taxpayer’s salary or wage exceeds the Social Security maximum, the rate drops to 0 (zero) percent for additional wages and the 6.2 percent average tax rate begins to decrease for an employee as shown below:

Wages	Social Security tax @ 6.2%	Average %
\$75,000	\$4,650.00	6.2%
\$150,000	\$7,886.40	5.3%

The Medicare portion, however, is proportional.

Wages	Medicare tax @ 1.45%	Average %
\$75,000	\$1,087.50	1.45%
\$150,000	\$2,175.00	1.45%

¹⁸ The most widely publicized flat-tax proposal excluded investment income and capital gains from tax and allowed only standard and dependency deductions. Examples of recently proposed taxes include the 17 percent flat tax proposed as part of the Tax Simplification Act of 2007 and the 20 percent flat tax proposed as part of the Flat Tax Act of 2009. Several of the potential Republican candidates for the 2012 Presidential election had also proposed alternative versions of a flat tax, but no serious flat tax proposals emerged during the most recent elections.

¹⁹ The ceiling was \$118,500 for both 2016 and 2015.

²⁰ Employers also pay FICA taxes in addition to that withheld from employees so that the total Social Security rate is 12.4 percent (6.2% employer rate + 6.2% employee rate) and the Medicare rate is 2.9 percent (1.45% × 2). Self-employed individuals, however, must pay both the employer’s and employee’s share (referred to as the self-employment tax), resulting in a combined rate of 15.3 percent on the first \$127,200 of self-employment income and 2.9 percent on the excess. An additional 0.9 percent Medicare surtax is only assessed on the taxpayer and not assessed on businesses. The detailed computations of the additional Medicare surtax are discussed in Chapter 5.

The FUTA also is a regressive tax because the unemployment rate of 6 percent only applies to the first \$7,000 of an employee's wages. When the employee's wages exceed this amount, no further unemployment taxes are collected and the average rate falls below 6 percent, similar to the average Social Security portion of the FICA tax rate.

1.3 CHARACTERIS- TICS OF A GOOD TAX

Raising revenue is only one of the many goals of taxation. The tax laws foster many economic and social goals such as wealth redistribution, price stability, economic growth, full employment, home ownership, charitable activities, and environmental preservation. For example, the government encourages contributions to charities through the charitable contribution deduction. If the charitable organizations did not exist, the government would have to undertake many of the activities the charities provide. Thus, the tax law is used to achieve this social objective.

In 1776, Adam Smith proposed the concepts known as the four **canons of taxation**, *equity, convenience, certainty, and economy* in *The Wealth of Nations*.²¹ To this day, these concepts are still valid for determining whether a tax should be considered a good tax. No one since Adam Smith has come up with a more widely accepted criteria for judging a tax, although other criteria have been added.

1.3.1 EQUITY

Equity is probably the most difficult of the four canons on which to achieve consensus. When is a tax equitable? How a person answers that question depends on that person's perspective, background, and view of society. A person who works very hard and earns an extremely good living, may not view the progressive tax system as equitable when 40 percent or more of any additional earned income is taken away in taxes. On the other hand, someone supporting a large family on a meager income may not believe that paying any taxes, when basic necessities cannot be purchased, is an equitable tax system.

The basic idea of equity is that persons with similar incomes should face similar taxes on that income. There is a major problem in determining when persons have similar incomes, however.

In the current U.S. system, most capital assets held by individuals for more than 12 months are taxed at rates significantly lower than the maximum tax rate for salary or wages income. Consider Taxpayers A and B who are in the same marginal tax bracket because of equal salaries. They each earn an additional \$20,000—Taxpayer A by working overtime and Taxpayer B by selling stock resulting in a \$20,000 long-term capital gain. Taxpayer A pays tax at the ordinary income tax rate on his additional wages while Taxpayer B benefits from the lower capital gains tax rate on his extra income by selling an investment asset. Is this equitable? Should equivalent incomes be taxed equally?

Capital gains tax rates on the disposition of capital assets held for a minimum period of time have traditionally been taxed at rates lower than regular income tax rates for several reasons. First, there is no inflation adjustment for capital gains; yet often the capital gain is an inflation gain rather than a real gain. If inflation is very high, the taxpayer may indeed have a loss when constant dollars are considered, but he or she will still be subject to the capital gains tax. Lower capital gains rates encourage investors to move money from unprofitable investments into more profitable ones. When capital gains rates are high, taxpayers tend to keep their appreciated but no-longer-profitable assets to avoid the tax. (This is called the *lock-in effect* of capital

²¹ Smith's 1776 work was originally titled *An Inquiry Into the Nature and Causes of the Wealth of Nations* but was shortened into *The Wealth of Nations* (New York: Dutton, 1910).

gains taxes.) In each of the situations described above, there are arguments for both sides of the equity issue.

Equity would also require persons with higher-incomes to pay a greater proportion of that income in taxes than lower-income persons—a concept referred to as *the ability to pay*, that is the basis for a progressive tax rate system. As a person's income increases, he or she is assumed to need a smaller percentage of that income for basic living and other expenses and, thus, is in a better position to pay a greater share of that income in taxes. There are difficulties with this concept of equity, however.

Compare two families: one family consists of a husband and wife and one healthy child with \$50,000 in annual income; the other consists of a husband and wife with six children, two of whom have significant handicaps, but with an annual income of \$60,000. When focusing only on the dollar amount of income, equity would tell us that the second family should pay a greater percentage of their income than the first—but which family really has the better ability to pay the tax? The U.S. tax system relieves some of the extra tax burden on the second family through the number of dependency exemptions, the medical expense deduction, and child care credits—but this also complicates the system.

Tax policy struggles to achieve fairness. Differing notions of fairness, however, guarantee that this goal remains elusive. The fairness debate revolves around two very different concepts of what is equitable or fair. **Horizontal equity**, one of the key principles of tax fairness, asserts that persons in similar circumstances should face similar tax burdens. The difficult part is determining when different taxpayers are in similar circumstances.

Susan rents a condominium for \$2,500 per month. Barry pays \$2,500 per month on the mortgage for his condominium in the same building. Both Susan and Barry are single, have no dependents, and have annual incomes of \$75,000. Susan cannot deduct any portion of her rent, but Barry can deduct the interest and taxes portion of his mortgage payment. In this case, the goal of horizontal equity gives way to the objective of encouraging home ownership.

Example 1.10

The other major fairness concept is **vertical equity**. Vertical equity asserts that persons with higher incomes should pay not only more tax but also higher percentages of their income as tax. Underlying this is the economic theory that income has diminishing marginal utility. In other words, as a person's income rises, each dollar is worth less to that person. As a result, higher rates are necessary to obtain approximately comparable sacrifices from all taxpayers. Although this has long been a feature of the U.S. tax system (as evidenced by the progressive tax rates), it remains controversial, especially among those subject to the higher tax rates.

Bill and Susan, married with two children, have taxable income of \$75,000. Shelly and John, also married with two children, have taxable income of \$150,000. Because their income is twice that of Bill and Susan, vertical equity would require that Shelley and John pay more than twice the income tax that Bill and Susan pay.

Example 1.11

There is no one answer as to what truly constitutes an equitable tax system. As we try to make the tax system appear to be more equitable, more complexity is introduced into that system. The simplest system of all would be a single rate of tax applied to all increases in a person's wealth (including that used for consumption, the economists' definition of income); yet, this probably will never be considered because it would not be perceived as fair.

1.3.2 ECONOMY

A tax meets the criterion of economy when the amount of revenue it raises is at an optimum level after the costs of administration and compliance are considered. The costs of a tax are not just limited to the costs incurred for tax administration and collection. Certain taxes impose an enormous burden on the taxpayer for compliance. More than half the individual taxpayers in the United States use some form of tax preparer to assist in preparing their tax returns. Many businesses have their own tax departments with no other responsibility than to ensure that all federal, state, and local income, employment, and property taxes are paid in a timely manner.

Compare a state income tax to a state sales tax based on the concept of economy. A sales tax is collected at the point of retail purchase and remitted by the retailer to the state. The purchaser simply pays the added tax to the retailer when the good or service is purchased. To comply with state income tax requirements, taxpayers generally cannot use the information from their federal tax returns without a number of adjustments. Thus, the taxpayer must pay a preparer or spend additional time preparing the state income tax return. The state must use procedures similar to the federal government to check for accuracy and compliance to the laws applicable to these returns. The state must conduct many more audits on individual taxpayers to audit the same percentage of returns as the number of audits conducted on retailers remitting sales taxes. Thus, administrative costs are much higher for the income tax. Yet, in many states, the income tax is a revenue source secondary to the sales tax. Based on economy, a national sales tax has great appeal.

Economy is also related to the concept of simplicity. The simpler a tax system is, the less costly is administration and compliance. One of the major thrusts of the American Institute of CPAs (AICPA) has been to simplify the tax system. Tax professionals realize that the current system is so complex that even a reasonably well-educated person and his or her tax advisor can readily fall into tax traps because of many obscure and complex provisions. When tax professionals make errors because of the complexity of the law, they may still be held liable for these mistakes—and the cost to the professional may be significant.

1.3.3 CERTAINTY

Certainty is also a canon related to simplicity. Certainty would dictate that a taxpayer know with reasonable accuracy the tax consequences of a transaction at the time the transaction takes place. Unfortunately, U.S. tax laws are continually changing. It is not uncommon today for a change in the tax laws to be effective from the date proposed, rather than from the date passed. This practice imposes an uncertain environment on the taxpayer who is contemplating a transaction that could be affected by a tax law change. He or she does not know if the law will be passed—thus, he or she cannot know if the transaction will be affected. Certainty would dictate that tax laws change as little as necessary so that the outcome of a particular transaction could be predicted with reasonable accuracy.

1.3.4 CONVENIENCE

The last canon of convenience states that a convenient tax is one that would be readily determined and paid with little effort. Consider again the difference between paying a sales tax and an income tax. A sales tax is paid each time a taxed purchase is made. Most people do not consider that they are paying a tax in addition to making a purchase of some good or service. Although the withholding of income taxes from salaries offers a measure of convenience, the myriad of forms and schedules that must be filed to reconcile the actual tax liability with withholding does not always meet the test of convenience. The requirements for estimated tax payments for significant amounts of income from other than salaries and wages simply may be educated guesses, particularly when income is expected to be passed through by partnerships and S corporations. Underestimating these estimated payments based on unknown information places an enormous burden on the taxpayer and may result in underpayment penalties.

1.4 THE TAXING UNITS AND THE BASIC INCOME TAX MODEL

There are only three types of persons²² subject to income taxation in the United States: the individual, the C corporation,²³ and the fiduciary. An individual is a male or female person subject to the tax. A **C corporation** is a business entity formed under state law on which the income tax is levied directly. A fiduciary, either an estate or a trust, may be subject to income taxes. In most cases, however, fiduciary income passes through to income beneficiaries who include it in their income and are responsible for the taxes.²⁴ The **fiduciary** is a modified “flow-through” entity because the entity is taxed only on income retained by the estate or the trust; the income distributed to the recipients is taxed only to the recipients.

Individual taxpayers (including married persons filing jointly) and corporate taxpayers pay the bulk of all income taxes collected. The corporation is the basic business unit, but it is only one of the forms in which a business can operate. In addition to the C or regular corporate form, a business may be organized as a sole proprietorship, a partnership, a limited liability company (LLC), or an S corporation. The income taxes on these businesses are not usually paid by the businesses; instead, at the end of the tax year their income flows through to their owners and they pay the taxes.²⁵ If one flow-through entity owns all or part of another flow-through entity, the income continues to flow through to the second entity until it finally reaches an individual, a C corporation, or a fiduciary tax return for payment of the tax.

The BST partnership is owned one-third by Bob (an individual); one-third by S, an S corporation (owned 100 percent by Jane); and one-third by T (a trust fiduciary). The partnership reports \$300 of income at the end of the current tax year. One hundred dollars of income flows through to each of the owners: Bob, S, and T, but T distributes only \$40 of its \$100 income to Sarah, the beneficiary. Bob includes all \$100 of income along with his other income and pays taxes on the total. S does not pay taxes on the \$100. This \$100 is combined with S’s other income; the total then flows through to Jane, the owner of all of the S corporation stock. Jane includes all of this income on her personal tax return. T pays taxes on the \$60 retained in the trust; the remaining \$40 is taxed to Sarah on her individual tax return, along with her other sources of income.

Example 1.12

The income of C corporations is subject to double taxation—once at the corporate level and again at the owner level when the income is distributed as dividends—because dividends are not deductible by the corporation. Flow-through entities avoid double taxation because their income is passed through at the end of the year to their owners and is taxed once only (at that time) at the owner level. The income of a sole proprietorship is reported along with the individual owner’s other income and is taxed annually.²⁶ The advantages and disadvantages of each of these forms

²² Any entity subject to the income tax is a taxable person; the term “individual” is reserved exclusively for a man, woman, or child subject to an income tax.

²³ The term “C” or “regular corporation” (called “C” corporation because its governing tax rules are contained in Internal Revenue Code subchapter C) is used to distinguish it from a subchapter S (or simply “S”) corporation (whose rules are contained in IRC subchapter S), which is a flow-through entity.

²⁴ An estate is a legal entity which comes into existence only upon the death of the individual whose assets are held by the estate. The estate must file a tax return until all assets can be distributed to the heirs or beneficiaries. Any individual may create a trust by transferring assets to the trust. A trustee administers the trust property for the benefit of the beneficiary.

²⁵ LLCs are usually taxed as partnerships (unless owned by a single individual and then it is taxed as a sole proprietorship); however, an LLC can elect to be taxed as a corporation and would then file a corporate tax return. An S corporation that was previously a C corporation may be subject to tax on specific types of income (as discussed in Chapter 11).

²⁶ Sole proprietorships are technically disregarded entities; however, they are usually grouped with pass-through businesses. There is no separate entity-level tax return for a disregarded entity. All income is reported on a Schedule C as part of the individual’s personal tax return, aggregated with the individual’s other income, and taxed using the individual’s tax rates.

of business are explored later in this chapter. At this point, it is not necessary to have a detailed understanding of taxable and flow-through entities. It is, however, important to understand that individuals and C corporations are the primary taxpaying entities. The primary focus of the text is on tax planning for individuals, C corporations, and flow-through entities because of the latter's effects on the taxation of individuals and C corporations.

The fiduciary (trust or estate) has a vastly different role than a business. A trust is established for a specific purpose, such as managing the assets for beneficiaries who are unable or unwilling to manage the assets themselves. The fiduciary has the responsibility to insure that the wishes of the person establishing the trust are followed. An estate is created at the death of an individual, and its primary purpose is to manage the decedent's assets until they can be distributed to his or her heirs. Income tax planning opportunities are limited for estates and trusts.

The final chapter of this text addresses the basics of estate and trust taxation, along with the estate and gift transfer tax. The first eleven chapters are devoted to the two primary tax-paying entities (individuals and C corporations) and their related flow-through businesses, although the basic principles of income, deduction, gain, and loss discussed throughout this text also apply to fiduciary entities.

1.4.1 THE BASIC TAX MODEL

It is important to have an overall sense of the components of the basic tax model before studying the details of the tax laws. This aids in understanding how the terms and concepts referred to throughout our study of tax fit into the scheme of the basic tax model. This basic model (Figure 1.1) is expanded in later chapters as details are introduced for individuals and corporations.

	Gross income
Less	Deductions
Equals	Taxable income (loss)
Times	Applicable tax rate
Equals	Gross income tax liability
Less	Tax credits
Less	Tax prepayments
Equals	Tax liability owed or refund due

FIGURE 1.1 The basic income tax model

Gross Income

The term **gross income** is an all-inclusive term that includes income from all sources that are not specifically excluded.²⁷ Not all “income” items are positive, however, as losses reduce other positive income items in determining corporate total income or individual gross income. For example, the capital gain on a stock sale increases income while the sale of business assets at a loss reduces income. In general, losses from business or investment transactions are recognized (included in income) only when they are realized through an exchange transaction that determines the amount of the loss. Thus, a decline in stock value cannot be deducted until the stock is actually sold at a loss. Figure 1.2 provides examples of the types of income and loss items included in gross income.

²⁷ An individual reports his or her gross income to the Internal Revenue Service on Form 1040: *U.S. Individual Income Tax Return*. A sample filled-in Form 1040 is included at the end of Chapter 5 and complete sample filled-in tax returns are posted on the companion website for this textbook.

Income item	Discussed in chapter
Gross income from the sale of goods and services	3
Taxable interest income	3
Dividend income	3
Prizes and awards	3
Alimony received	3
Unemployment compensation	3
Taxable portion of Social Security benefits	3
Wages and salary	4
Taxable retirement plan distributions	4
Income (less loss) from rental real estate	6
Gains (less losses) from sale of capital assets	8
Income (less loss) from sole proprietorships, partnerships, and S corporations	11

FIGURE 1.2 Partial listing of items included in gross income

Brogan Corporation has gross income from sales of \$4,500,000, taxable interest income of \$50,000, and a loss of \$400,000 from a partnership that is deducted from its positive income. As a result, Brogan Corporation has total income of \$4,150,000 ($\$4,500,000 + \$50,000 - \$400,000$).

Example 1.13

Losses (negative income) can be grouped into three broad categories: business losses, investment losses, and personal losses.²⁸ Losses are normally deducted from positive income items, except that most personal losses of individuals are not deductible.²⁹

Operating losses incurred as part of an active business are deductible in full against ordinary income. Capital losses from the sale of investment assets are subject to limitations on their deductibility; for example, individuals can deduct only \$3,000 of capital losses in excess of capital gains annually. Capital losses that are not deductible in the current year may be carried forward indefinitely by individuals. Corporations can only offset capital losses against capital gains; they are not deductible against other income. Corporate capital losses in excess of capital gains are carried back three years and then forward five years to offset capital gains realized in carryover years.

John has \$80,000 of salary income, a \$5,000 operating loss from his sole proprietorship, a \$4,000 capital gain on the sale of ABC stock, and a \$13,000 capital loss on the sale of XYZ stock in the current year. The \$4,000 capital gain offsets \$4,000 of the \$13,000 capital loss on the stocks resulting in a net \$9,000 capital loss for the year. The \$5,000 operating loss is deductible in full against John's salary income, but only \$3,000 of the \$9,000 net capital loss is deductible against other income; his net taxable income is \$72,000. The remaining \$6,000 capital loss is carried forward (but not back) and can be deducted in future years subject to the \$3,000 annual limitation.

Example 1.14

Classic Corporation has \$120,000 income from operations and a \$5,000 net capital loss on the sale of stocks held as an investment in 2017. The loss is not deductible currently; instead, the corporation carries it back first to 2014, then to 2015 and 2016. Classic Corporation offsets the capital loss against any capital gains in those prior years, recomputes its tax liability, and files a claim for a refund. If the capital gain is not offset completely by the prior years' capital gains, the remainder is carried forward sequentially to years 2018 through 2022. (If this had been an individual, \$3,000 of the loss could be deducted currently with the remaining \$2,000 carried forward to the next year as illustrated in the previous example.)

Example 1.15

²⁸ Losses are distinguished from deductions for which there must be a specific provision in the Code that allows a reduction in corporate or individual taxable income.

²⁹ Casualty and theft losses of personal property are deductible as itemized deductions to the extent that they exceed 10 percent of the individual's adjusted gross income. These losses are discussed in Chapter 9.

Over the years, certain items have been excluded from gross income. These excluded items may not even be reported on the tax return. Only if an excluded item could affect some other reporting provision is reporting required along with the taxable items. For example, interest on tax-exempt municipal bonds is excluded from income, but an individual taxpayer must report it because it could affect the determination of the taxability of a taxpayer's Social Security benefits. On the other hand, an individual who is the beneficiary of the proceeds of a life insurance policy excludes them from income and does not report them on the tax return. Figure 1.3 provides examples of the types of items excluded from income.

Exclusion item	Discussed in chapter
Tax-exempt interest income from state and local bonds	3
Proceeds of life insurance policies	3
Gifts and inheritances	3
Welfare benefits including food stamps	3
Nontaxable portion of Social Security benefits	3
Scholarships	3
Damages awarded for physical injury	3
Qualified employee fringe benefits	4
Nontaxable portion of retirement plan distributions	4
Up to \$250,000 gain on the sale of a personal residence (\$500,000 if married filing joint return)	8
Gains and losses on property transactions subject to disallowance or nonrecognition provisions	8 and 9
Unrealized gains and losses	9

FIGURE 1.3 Partial listing of exclusions from gross income

Example 1.16

Brogan Corporation (example 1.13) had \$4,150,000 of total income. It also received \$100,000 of tax-exempt interest, collected \$1,000,000 from the life insurance policy on the life of its now-deceased controller, and had unrealized³⁰ appreciation on assets of \$300,000. Its total income remains \$4,150,000 as each of these items is excluded from income.

Deductions

After a corporation determines its total income, or an individual determines gross income, certain deductions are permitted. For an item to be deductible by an individual or a business, there must be either a specific provision or a general category in the Internal Revenue Code that permits the deduction. If there is no provision that allows an item (or class of items) as a deduction, then it cannot be deducted. In addition, deductions for certain items or categories of deductions have been specifically disallowed.

Corporations A corporation's allowable expenses are simply deductions from total income. In general, all businesses, regardless of their form of operation, are allowed deductions for business expenses that are ordinary, reasonable, and necessary. There is a general presumption that all business expenses are deductible unless there is a gross violation of the ordinary, necessary, and reasonable criteria. The tax laws do, however, include several disallowance provisions that disallow deductions for certain items; for example, fines, bribes, and expenses related to tax-exempt income are not deductible.³¹

³⁰ Income is taxed (recognized) only when realized. Thus, if securities have appreciated in value from \$5,000 to \$9,000, the \$4,000 in appreciation will not be taxed until the securities are sold.

³¹ The latter is an example of the matching principle. These expenses are discussed in Chapter 6.

After determining its \$4,150,000 of total income, Brogan Corporation (example 1.13) calculates \$2,300,000 of ordinary and necessary business expenses. Its taxable income is \$1,850,000 (\$4,150,000 – \$2,300,000).

Example 1.17

Individuals Each individual taxpayer is permitted three types of deductions in determining taxable income. The first, called deductions *for* adjusted gross income, consists of specific expenses that Congress has singled out for more favorable treatment than other individual deductions. These deductions reduce an intermediate subtotal between gross income and taxable income called *adjusted gross income (AGI)*, a subtotal unique to individual taxpayers. Figure 1.4 lists some of these special deductions. If an individual does not have any of these special deductions, then his or her gross income and AGI will be the same. The second type of deduction is the greater of the taxpayer's standard deduction (based on the taxpayer's filing status as discussed later) *or* the taxpayer's allowable itemized deductions (based on actual expenditures for such items as medical expenses, taxes, and interest). Figure 1.5 lists a few of an individual's more common itemized deductions. The third type of deduction is for the taxpayer's total allowable personal and dependency exemptions.

Deductions <i>for</i> AGI	Discussed in chapter
Alimony paid	3
Contributions to certain pension or retirement plans (including IRAs)	4
Moving expenses	4
One-half of self-employment taxes	4
Self-employed health insurance premiums	4
Qualified student loan interest expense	5

FIGURE 1.4 Partial listing of deductions for AGI

Itemized Deductions	Discussed in chapter
Taxes (state, local, and foreign income and property taxes)	5
Interest expense (mortgage interest and investment interest)	5
Medical expenses (in excess of 10% of AGI)	5
Charitable contributions (up to 50% of AGI)	5
Unreimbursed employee business expenses, investment expenses, and tax preparation fees (in excess of 2% of AGI)	5
Casualty and theft losses (in excess of 10% of AGI)	9

FIGURE 1.5 Partial listing of itemized deductions

For those deductions subject to limitations, only amounts that are in excess of a minimum or do not exceed a maximum are deductible. If the taxpayer itemizes deductions, they are reported on Schedule A of an individual's Form 1040 as illustrated in Chapter 5.

Individuals who do not choose to itemize their deductions (and retain the required supporting documentation for their actual expenditures), can instead claim the *standard deduction* set by Congress regardless of actual expenditures. Individuals normally only itemize their deductions if their total deductions exceed their standard deduction allowance. This standard deduction varies by the **filing status** of the taxpayer; for example, a single taxpayer's standard deduction is one-half the standard deduction allowed a married couple filing a joint return as shown in Table 1.3. Thus, an individual may always deduct some amount from income—either the standard deduction *or* his or her itemized deductions—but *not both*.

Table 1.3 Standard Deduction by Filing Status

Filing status	2016	2017
Married filing jointly	\$12,600	\$12,700
Married filing separately	6,300	6,350
Head of household	9,300	9,350
Single	6,300	6,350
Dependent	1,050*	1,050*

*If larger, a dependent's standard deduction is earned income plus \$350 up to their otherwise allowable standard deduction.

The standard deduction varies by filing status because single persons are assumed to have fewer personal expenses than married couples or those who qualify as heads of household.³² Similarly, individuals claimed as dependents on another taxpayer's return (but whose income requires them to file their own return) are not viewed as needing a large standard deduction because they are not self-supporting.³³

Example 1.18

Jessica, a single parent who qualifies as head of household in 2017, has \$49,000 of salary income but only \$3,000 of itemized deductions. Jessica has taxable income before her personal and dependency exemptions of \$39,650 (\$49,000 AGI – \$9,350 standard deduction).

Example 1.19

In 2017, James, who is single, was paid a salary of \$62,000. His itemized deductions (including mortgage interest, property taxes, and charitable deductions) total \$12,000, which is greater than his allowable standard deduction of \$6,350 as a single individual. James has taxable income of \$62,000 – \$12,000 = \$50,000 before the deduction for his personal exemption.

Individuals have another deduction based on the total of the taxpayer's personal exemption and dependency exemptions for each of a taxpayer's dependents (\$4,050 for each). If the individual is self-supporting, he or she claims a personal exemption; married persons filing a joint tax return claim two personal exemptions (one for the husband and one for the wife). Taxpayers also deduct a dependency exemption (also \$4,050) for each person they support who is claimed as a dependent. A person claimed as a dependent on another taxpayer's return, however, *cannot* take a personal exemption deduction for him- or herself even if he or she files a tax return.

Example 1.20

Assume James in the previous example is married with two small children. Their taxable income after their two personal exemptions and two dependency exemptions is \$33,100 [\$62,000 – \$12,700 standard deduction (which is greater than their \$12,000 of itemized deductions) – \$16,200 (\$4,050 × 4 exemptions)].

³² A head of household is a single individual who pays more than half the cost of maintaining a home in which a qualifying child or other dependent relatives lives.

³³ If a dependent is employed and has earned income exceeding \$1,050, the standard deduction is increased to the total of the dependent's earned income *plus* \$350 but cannot exceed the standard deduction based on filing status (\$6,350 if single).

Between the standard deduction allowance (based on the person's filing status) and the exemptions allowed (based on the taxpayer's personal and dependency exemptions), the taxpayer can receive a significant amount of income free of income tax. These basic allowances exempt a substantial number of low-income taxpayers from filing annual tax returns. For example, a married couple's taxable income would need to exceed \$20,800 (\$12,700 + \$4,050 + \$4,050) before they would be required to file an income tax return for 2017. Corporations, on the other hand, must file returns annually regardless of whether they report net income or loss for the tax year.

When the corporation has taken all of its allowable deductions from total income or an individual filer has reduced his or her gross income for the allowable deductions, the taxpayer's taxable income is determined. The taxpayer's next step is to determine the gross tax liability on that income.

Determining the Gross Tax Liability

A corporation uses the corporate tax rate schedule to determine its gross corporate tax liability once taxable income is determined. The corporate tax rates and the income levels at which the rates apply are presented in Table 1.4. Complete tax tables are also included in the Appendix at the end of this text.

Table 1.4 Corporate Tax Rates

Corporate Tax Rates	
<i>If taxable income is:</i>	<i>Tax liability is:</i>
Not over \$50,000	15% of taxable income
Over \$50,000 but not over \$75,000	\$7,500 + 25% of the excess over \$50,000
Over \$75,000 but not over \$100,000	\$13,750 + 34% of the excess over \$75,000
Over \$100,000 but not over \$335,000	\$22,250 + 39% of the excess over \$100,000
Over \$335,000 but not over \$10,000,000	\$113,900 + 34% of the excess over \$335,000
Over \$10,000,000 but not over \$15,000,000	\$3,400,000 + 35% of the excess over \$10,000,000
Over \$15,000,000 but not over \$18,333,333	\$5,150,000 + 38% of the excess over \$15,000,000
Over \$18,333,333	\$6,416,667 + 35% of the excess over \$18,333,333

Waldo Corporation has \$125,000 of taxable income for the current year. Its gross tax is \$32,000 ($\$22,250 + [(\$125,000 - \$100,000) \times 39\%]$). The tax on the first \$100,000 is \$22,250 [$(\$50,000 \times 15\%) + (\$25,000 \times 25\%) + (\$25,000 \times 34\%)$]. Including the tax on the lower bracket(s) in the table simplifies the tax computation; only the tax on income in the last tax bracket is calculated and added to the tax from the preceding bracket.

Molokai Corporation has \$20,000,000 of taxable income for the current year. Its gross tax is \$7,000,000 ($\$6,416,667 + [(\$20,000,000 - \$18,333,333) \times 35\%]$). Corporations in the top tax bracket have the benefit of the lower tax rates fully phased out; they are taxed at a flat 35% rate ($\$20,000,000 \times 35\% = \$7,000,000$). This is the reason many large corporations only consider the 35% rate in their tax planning.

Example 1.21

Individuals determine their tax liability using the appropriate individual tax rate schedule. The tax rate schedule an individual uses corresponds to the taxpayer's filing status; therefore, there are schedules for single individuals, married couples filing jointly, married couples filing separately, and heads of household (e.g., a single parent). Unlike corporations, high income individuals receive full benefit from the progressive tax rates with no surtaxes that reduce the benefit of the lower tax rates. A single individual with \$20,000,000 of taxable income still receives the benefit of the first \$9,325 of income taxed at a 10% rate. Although the actual tax rates are the same for each filing status, they do not apply at the same level of income—that is, the income level at which each higher rate applies varies by the taxpayer's filing status as shown in Table 1.5.

Table 1.5 2017 Tax Rates for Individual Taxpayers by Filing Status

Schedule X Single Individuals	
<i>If taxable income is:</i>	<i>The tax is:</i>
Not over \$9,325	10% of the taxable income
Over \$9,325 but not over \$37,950	\$932.50 + 15% of the excess over \$9,325
Over \$37,950 but not over \$91,900	\$5,226.25 + 25% of the excess over \$37,950
Over \$91,900 but not over \$191,650	\$18,713.75 + 28% of the excess over \$91,900
Over \$191,650 but not over \$416,700	\$46,643.75 + 33% of the excess over \$191,650
Over \$416,700 not over \$418,400	\$120,910.25 + 35% of the excess over \$416,700
Over \$418,400	\$121,505.25 + 39.6% of the excess over \$418,400
Schedule Y-1 Married Individuals Filing Joint Returns	
<i>If taxable income is:</i>	<i>The tax is:</i>
Not over \$18,650	10% of the taxable income
Over \$18,650 but not over \$75,900	\$1,865 + 15% of the excess over \$18,650
Over \$75,900 but not over \$153,100	\$10,452.50 + 25% of the excess over \$75,900
Over \$153,100 but not over \$233,350	\$29,752.50 + 28% of the excess over \$153,100
Over \$233,350 but not over \$416,700	\$52,222.50 + 33% of the excess over \$233,350
Over \$416,700 but not over \$470,700	\$112,728 + 35% of the excess over \$416,700
Over \$470,700	\$131,628 + 39.6% of the excess over \$470,700
Schedule Y-2 Married Individuals Filing Separate Returns	
<i>If taxable income is:</i>	<i>The tax is:</i>
Not over \$9,325	10% of the taxable income
Over \$9,325 but not over \$37,950	\$932.50 + 15% of the excess over \$9,325
Over \$37,950 but not over \$76,550	\$5,226.25 + 25% of the excess over \$37,950
Over \$76,550 but not over \$116,675	\$14,876.25 + 28% of the excess over \$76,550
Over \$116,675 but not over \$208,350	\$26,111.25 + 33% of the excess over \$116,675
Over \$208,350 but not over \$235,350	\$56,364 + 35% of the excess over \$208,350
Over \$235,350	\$65,814 + 39.6% of the excess over \$235,350
Schedule Z Heads of Households	
<i>If taxable income is:</i>	<i>The tax is:</i>
Not over \$13,350	10% of the taxable income
Over \$13,350 but not over \$50,800	\$1,335 + 15% of the excess over \$13,350
Over \$50,800 but not over \$131,200	\$6,952.50 + 25% of the excess over \$50,800
Over \$131,200 but not over \$212,500	\$27,052.50 + 28% of the excess over \$131,200
Over \$212,500 but not over \$416,700	\$49,816.50 + 33% of the excess over \$212,500
Over \$416,700 but not over \$444,550	\$117,202.50 + 35% of the excess over \$416,700
Over \$444,550	\$126,950 + 39.6% of the excess over \$444,550

Example 1.22

Patricia is single with taxable income of \$40,000 in 2017. Her tax liability is \$5,738.75 [$\$5,226.25 + 25\% (\$40,000 - \$37,950)$].

The tax rate schedules illustrate the progressive nature of the federal income tax—as a taxpayer’s taxable income increases, his or her marginal tax rate also increases. For example, a single taxpayer with \$100,000 of taxable income uses Schedule X, and is in the 28 percent marginal tax bracket (the next dollar of income is taxed at 28 percent). If his income had been \$250,000, his marginal tax bracket would have been 33 percent.

Jennie is single and has 2017 taxable income of \$58,000. Using Schedule X, her gross income tax liability is \$10,238.75 [$\$5,226.25 + 25\%(\$58,000 - \$37,950)$].

If Jennie is married and files a joint return with her husband, Peter, they would use Schedule Y-1 for joint return filers. If they had combined taxable income of \$58,000, their tax liability would be only \$7,767.50 [$\$1,865 + 15\%(\$58,000 - \$18,650)$].

Example 1.23

The married filing a joint return schedule normally provides the lowest tax liability for any given amount of taxable income. When higher income spouses each earn approximately the same income, however, their combined incomes are taxed at higher rates on a joint return than if they had remained single and filed separate returns as single individuals. This *marriage penalty* occurs because the bracket widths for the 25 percent, 28 percent, and 33 percent brackets on joint returns are smaller than twice the bracket widths for those tax rates for single returns.

Barbara is single and has taxable income of \$90,000 in 2017. Her income tax is \$18,238.75 [$\$5,226.25 + 25\%(\$90,000 - \$37,950)$] using Schedule X.

Shelly and John are married and have \$180,000 in taxable income, one-half earned equally by each of them. Their income tax is \$37,284.50 [$\$29,752.50 + 28\%(\$180,000 - \$153,100)$] using Schedule Y-1. This is \$807 [$\$37,284.50 - (2 \times \$18,238.75)$] more than they would have to pay if they were not married and were taxed separately as single individuals. The \$807 is their marriage penalty. If they file married filing separately, they would each pay \$18,642.25 [$\$14,876.25 + 28\%(\$90,000 - \$76,550)$] in income tax using Schedule Y-2, a total of \$37,284.50 ($2 \times \$18,642.25$) (Note that because they are married, they cannot choose to file as single individuals.)

Example 1.24

The previous tax calculations implicitly assumed that the taxpayer had no dividends or net long-term capital gains as part of taxable income for the year. As explained in Chapter 8, an individual with a net long-term capital gain from sales of capital assets, files a Schedule D: *Capital Gains and Losses* to report these gains and losses. The instructions for this schedule include a worksheet to determine total tax liability when long-term capital gains are included in the taxpayer's taxable income. Similarly, a worksheet is available to help determine the tax due on dividend income. For most taxpayers, long-term capital gains and dividends are taxed at a 15 percent rate.

George is single and has \$45,000 of taxable income, excluding an \$8,000 long-term capital gain and \$2,000 in dividends eligible for the 15 percent tax rate. George's tax on his \$45,000 of ordinary income is \$6,988.75 [$\$5,226.25 + 25\%(\$45,000 - \$37,950)$]; His tax on the capital gain is \$1,200 ($\$8,000 \times 15\%$); his tax on his dividend income is \$300 ($\$2,000 \times 15\%$) for a total tax liability of \$8,488.75 ($\$6,988.75 + \$1,200 + \300). The favorable dividend and capital gain rates save George \$1,000 [$\$10,000 \times (25\% - 15\%)$] in taxes.

Example 1.25

For individuals whose total taxable income does not exceed the upper limit of the 15 percent tax bracket, long-term capital gains and dividends are taxed at 0 percent. If taxable income exceeds the 15 percent income tax bracket but is less than the 39.6 percent income tax bracket,

the long-term capital gain and dividend portion of that income is taxed at 15 percent.³⁴ The capital gain and dividend portion of taxable income that falls within the 39.6 percent income tax bracket are taxed at the higher capital gain (and dividend income) tax rate of 20 percent as shown in Table 1.1.³⁵

There are no favorable income tax rates for long-term capital gains or dividend income included in the taxable income of corporate taxpayers. They are included in and taxed as ordinary income at the applicable corporate tax rates.

Tax Credits

Both individual and corporate taxpayers are entitled to certain credits that also reduce the tax liability. A business may benefit from the investment tax credit for investing in business equipment and working parents may benefit from the child care credit. A credit reduces the income tax liability in a different way than a deduction because a credit is a direct reduction in the taxpayer's tax liability.

Example 1.26

Carmen is single and has taxable income of \$90,000 in 2017 and her income tax is \$18,238.75 [$\$5,226.25 + 25\%(\$90,000 - \$37,950)$]. If she is entitled to claim a tax credit of \$500, her tax liability is reduced by \$500 to \$17,738.75. If she can claim a deduction for \$500, the deduction reduces her taxable income by \$500 to \$89,500 which only reduces her tax liability by \$125 to \$18,113.75. A \$500 tax credit is much more valuable than a \$500 tax deduction.

A taxpayer must pay the additional tax if the taxpayer's tax liability exceeds allowable credits. If the taxpayer's credits exceed the tax liability, only a limited number of tax credits are refundable after the tax is reduced to zero.³⁶ If nonrefundable tax credits exceed the tax liability, certain credits (for example, the general business credit) may be carried to other years to offset a tax liability in the carryover year. Other credits that exceed that tax liability are lost entirely (for example, the dependent care credit). Figure 1.6 includes a few of the more common credits.

Type of credit	Discussed in chapter
Foreign tax credit	4
Child tax credit	5
Dependent care credit	5
Earned income credit	5
Education credits	5
Credit for excess payroll tax withheld	5
General business credits	10

FIGURE 1.6 Partial listing of tax credits

Tax Prepayments

After an individual or corporation reduces its total tax liability for allowable tax credits, its tax prepayments are deducted. Most taxpayers are required to make some form of prepayment for the anticipated tax liability. Most employers deduct a certain percentage of employees' salary

³⁴ A 25% capital gain tax rate applies to unrecaptured Section 1250 gains and a 28% capital rate applies to collectibles and Section 1202 gains. The 15% rate applies to most middle income taxpayers.

³⁵ Since 2013, the Affordable Care Act requires high-income taxpayers to pay the Medicare surtax on net investment income (NII), including net capital gains (whether long-term or short-term), taxable interest income, dividends, and rental income. This 3.8% NII tax is assessed on the lesser of net investment income or modified adjusted gross income in excess of thresholds based on filing status. The NII tax is discussed in Chapter 5.

³⁶ There are several refundable credits—that is, credits that will result in a payment to the taxpayer even if there is no tax liability. One such refundable credit is the earned income credit applicable to low-income taxpayers. This credit acts like a negative income tax.

and wage income in the form of tax withholdings. The employer then forwards the income tax withheld to the government for the employee. If, however, the taxpayer has a significant amount of income not covered by withholding, such as self-employment income or transactions on which there is no withholding (such as gains on the sale of investment assets), the individual is required to make quarterly estimated tax payments during the year. Corporations also make estimated tax payments based on anticipated taxable income. Estimated payments are so named because taxpayers must estimate how much income they will earn and the related tax they expect to owe for the year. Failure to make the minimum required tax prepayment may subject the taxpayer to penalties and interest. Individuals who owe less than \$1,000 and corporations less than \$500 when their returns are filed avoid penalties.

Z Corporation's tax liability was \$68,000 and it made \$67,600 in estimated tax payments. It now owes only \$400 for its \$68,000 tax liability because of its \$67,600 in estimated tax payments.

Example 1.27

1.4.2 TRUSTS AND ESTATES

Trusts and estates are the third type of taxable entity called fiduciary entities—nonbusiness legal entities that hold assets and may have income. An estate is created when any person with asset ownership dies. An executor or personal representative manages the estate assets until they are distributed to the heirs or beneficiaries. A trust is created by a person (the grantor) who places control of trust assets in the hands of a trustee for the benefit of a third party (the beneficiary). Because trusts and estates may hold assets that earn income, they are subject to income taxes. Their tax formula has the same characteristics as the basic tax model. The entity is generally taxed on income to the extent the income remains within the entity. Income that is paid out to a beneficiary is taxed only to the beneficiary. Table 1.6 contains the tax rates for estates and trusts for 2017.

Table 1.6 2017 Income Tax Rates for Trusts and Estates

Taxable income	Tax rate
0–\$2,550	15%
\$2,551–\$6,000	25%
\$6,001–\$9,150	28%
\$9,151–\$12,500	33%
Over \$12,500	39.6%

The tax brackets for estates and trusts are much more compact than the individual tax brackets. The highest tax rate begins when taxable income exceeds \$12,500 and there are no 10 or 35 percent tax brackets. Distributing income annually to the beneficiaries usually results in lower overall taxes as beneficiaries are usually in lower marginal tax brackets. The taxation of trusts and estates is discussed in detail in Chapter 12.

A trust has \$2,000 of taxable income in the current year. It can retain the income or distribute it to Craig, the beneficiary. He is a 24-year-old college student in the 10% marginal tax bracket. If the trust retains the income, it will pay a tax of \$300 ($15\% \times \$2,000$). If the trust distributes the \$2,000 to Craig, he will pay \$200 in tax ($10\% \times \$2,000$). Distributing the income to Craig saves \$100 in taxes ($\$300 - \200).

Example 1.28

1.5 CHOICE OF BUSINESS ENTITY

One important consideration when starting your business is determining the best legal and operational structure. This affects its efficiency, transferability, control, reporting of income, taxes paid, and the owners' personal liability. Business entities differ in their legal and tax classification. They are legal structures regulated by state governments and it or its owners are subject to tax at the federal level. It may be difficult to change a legal structure after operations begin, so making the right decision as to its form of operation before the business is opened is important.

A business can be classified as a sole proprietorship, a partnership (general or limited), a corporation, or a limited liability company (LLC). A sole proprietorship is the simplest legal structure for any business. For state law purposes, a sole proprietorship is a single owner business that is not required to formally register with the state, although some states and municipalities may require licenses or permits. Many sole proprietorships do not obtain a separate identification number, but simply use the owner's Social Security number for identification. By default, the legal business name is the same as the owner's name but the business may establish a separate name by creating a "doing business as" (DBA) name. Most states require DBAs to register with the county clerk or Secretary of State.

The ease of forming the sole proprietorship is matched by the ease of closing the business. Any business property reverts to the sole proprietor. The primary disadvantage of the sole proprietorship is that the owner is fully liable for all the debts of the business and could lose all of his or her personal assets to satisfy a judgment against the business. A sole proprietorship is simply not considered an entity separate from its owner.

Example 1.29

Jason operates a small bicycle shop as a sole proprietorship. He recently assembled and sold a bicycle to a new customer. Unfortunately, Jason failed to tighten the nuts securing the front tire. The customer fell off the bike and was severely injured on her first ride. She filed a lawsuit against the bicycle shop for negligence. If Jason loses this lawsuit, he would have to use his personal assets to cover any judgment unless his insurance is sufficient to cover his liability for damages. Jason could lose more than his investment in his business.

Partnerships are formed under state partnership statutes and must have at least two owners (partners). A partnership can be formed as a general partnership, a limited partnership, a limited liability partnership (LLP), or a professional limited liability partnership (PLLP). The difference in these partnership forms involves the liability protection afforded the owners. One advantage of the partnership form is the absence of restrictions on a partner's identity. A partner can be an individual or any type of entity, including another partnership, a corporation, an estate, or a trust. A partnership can have two types of partners—general and limited. All partnerships must have at least one general partner who not only provides capital to the partnership, but is involved in partnership management. Limited partners only provide capital and generally do not participate in management. All partners have equal ownership of all business assets unless the partnership agreement specifies other ownership arrangements. Ownership percentages can vary based on the specifications included in the written partnership agreement. General partners are fully liable for all liabilities of the partnership while the liability of limited partners is limited to their investment. A partnership usually dissolves if a general partner dies or leaves the partnership (unless the partnership agreement provides for continuation of the business by the remaining partners).

Corporations must file articles of incorporation with the state in which their principal office is located. A corporation can issue different classes of stock and bonds, subject to state and federal securities laws. When a business decides to "go public" with an **initial public offering (IPO)** on one of the public securities exchanges, it will usually solicit a large pool of potential investors to become shareholders. Shareholders are only at risk for their capital investment; if the

corporation fails, the shareholders are not liable for the outstanding debts of the corporation. If a shareholder desires to withdraw from the corporation, only a buyer for the stock is necessary. Shareholders do not participate directly in management; instead they only have the right to vote for corporate directors or officers. This facilitates centralized management so that day-to-day operations do not require the input of all the owners. Additionally, the corporation's life is not restricted. The death of an owner or a transfer of stock ownership does not affect the corporation's legal existence.

The limited liability company is a hybrid type of legal business form that provides the limited liability features of a corporation and the operational flexibility of a partnership. The owners are referred to as members. Depending on the state, the members can consist of a single individual (one owner), two or more individuals, corporations, or other LLCs. To form an LLC, you usually must file articles of organization with the state in which the business is organized.

For tax *return* purposes, however, there are only four types of business entities:³⁷

1. Sole proprietorships
2. Partnerships
3. C corporations (regular corporations)
4. S corporations (corporations electing S status)

Regardless of their form, all businesses must report their results of operations following the tax rules for one of these four entities. Limited liability companies with two or more owners default to being taxed as partnerships unless they elect to be taxed as corporations. Of these entities, only C corporations (and limited liability companies electing C corporation status) actually pay income taxes. A sole proprietorship passes its income directly to the sole proprietor using a Schedule C included in the sole proprietor's individual tax return. Partnerships, limited liability companies taxed as partnerships, and S corporations also pass their income through to their owners for taxation at the owner level. These businesses, however, must file *information tax returns* (Form 1065 for partnerships and limited liability companies taxed as partnerships and Form 1120S for S corporations) with the IRS. The entity must provide the owners with the information required for filing their tax returns.³⁸

1.5.1 SOLE PROPRIETORSHIPS

A **sole proprietorship** may be very small with no employees or a large business with thousands of employees. It can operate any type of business—manufacturing, distribution, retail, or service. The owner of the sole proprietorship is not an employee but is considered self-employed. This means that Social Security and Medicare taxes are not withheld from any payments received by the sole proprietor; instead self-employment taxes³⁹ must be paid on the net profit of the business. Because the sole proprietor cannot be an employee, he or she is not eligible for the tax-free employee fringe benefits for which a corporate shareholder-employee would be eligible.⁴⁰

³⁷ There is no separate tax return for an LLC. Most multi-owner LLCs file partnership tax returns but could elect to file as corporations. An LLC choosing to file as an S corporation would have to comply with all of the S corporation rules. A single-owner LLC would usually file as a sole proprietorship.

³⁸ An information return is a tax return that reports each owner's share of profits or losses to the IRS. No tax is paid with this return; instead any tax owed is paid by the owners with their tax returns.

³⁹ Self-employed individuals pay both the employer's and employee's share of Social Security and Medicare taxes resulting in a combined rate of 15.3% on the first \$127,200 of self-employment income and 2.9% on the excess. If a business has a loss, no self-employment tax is owed that year. See Chapter 4 for a detailed discussion of employment taxes. Additionally, because income tax is not withheld for self-employed individuals, they must make their own quarterly estimated payment to the government. See Chapter 5 for a discussion of estimated payments.

⁴⁰ Employee fringe benefits are discussed in Chapter 4. Examples include health insurance, life insurance, moving expenses, and parking benefits.

There is no separate business tax return for a sole proprietorship; income and expenses from operations are reported on Schedule C: *Profit or Loss from Business (Sole Proprietorship)*. Self-employment tax is computed on Schedule SE: *Self-Employment Tax* based on the business profits. These forms are then included with the individual's completed Form 1040: *Individual Tax Return*. The sole proprietor is taxed on all of the net profits from the business as ordinary income regardless of how much he or she withdrew from the business during the year.

Example 1.30

Gary is the sole proprietor of Gary's Garage. Gross income is \$100,000, operating expenses are \$40,000 for the year, and Gary withdrew \$50,000 from the business for his living expenses. Gary reports these operating income and expenses on Schedule C and shows a net profit of \$60,000 (\$100,000 – \$40,000). Gary includes all \$60,000 of net profit from his business and computes taxable income for the year on his Form 1040. The \$50,000 he withdrew has no effect on profit reported or taxes owing. Gary pays self-employment tax on the \$60,000 net business profits and income taxes on his taxable income (after allowable deductions).

A tax advantage for a sole proprietorship is that a business loss can reduce or *shelter* the individual's other income when calculating taxable income.

Example 1.31

Christina's sole proprietorship reports a net loss of \$10,000 for the year. Christina is also an employee of another business with annual salary of \$30,000. Christina uses her \$10,000 loss from the sole proprietorship to shelter part of her salary from taxation, reducing her adjusted gross income to \$20,000.

The tax savings realized from the flow through of a business loss depends on the marginal tax rate of the individual. The individual's marginal tax rate is dependent on his or her other taxable income.

Example 1.32

Joshua, a single individual, owns a sole proprietorship that has a \$20,000 net loss. Joshua's \$480,000 of other taxable income before deducting this loss places him in the 39.6% marginal tax bracket (from the tax rate schedule for a single individual). He has tax savings of \$7,920 ($\$20,000 \times 39.6\%$) from the \$20,000 loss deduction. If, instead, Joshua's taxable income is only \$35,000 before deducting the loss, he would be in the 15% marginal tax bracket and he would have only \$3,000 ($\$20,000 \times 15\%$) in tax savings from the loss.

1.5.2 PARTNERSHIPS

A **partnership** consists of two or more individuals (or other entities) who agree to carry on a business jointly. Similar to sole proprietors, partners cannot be employees of the partnership or participate in most fringe benefits on a tax-free basis. For example, if a partnership provides health insurance for its partners, the partnership can deduct the health insurance premiums as business expenses, but the partners must include them in their taxable income.

A partnership is referred to as a "conduit" or flow-through entity because the income and losses are allocated to and flow through to its owners to be taxed on their individual returns. The partnership itself pays no income tax, but it must file a separate tax return

(Form 1065: *U.S. Partnership Return of Income*). This is only an information return that reports each partner's share of the profits or losses to the IRS to inform the IRS how much each partner should be reporting on his or her individual tax return. Most items of income that flow through to the partners retain their individual character. For example, a partnership's operating income is taxed at the partner's ordinary income tax rate while a long-term capital gain is taxed at the partner's rate for long-term capital gains.

One disadvantage of conduit taxation is that owners are taxed on their share of the profits, even if they receive no cash distributions from the business. They can, however, receive distributions of those previously taxed profits at a later date without incurring a second tax. In addition, similar to a sole proprietor, an individual general partner must pay self-employment taxes on his or her share of partnership profits.

Ginny owns a one-third interest in the PEP Partnership. It reports \$21,000 of operating income for the current tax year but makes no distributions to the partners. Ginny must include \$7,000 ($\$21,000 \times 1/3$) of partnership income in her gross income for the tax year. The \$7,000 is subject to self-employment taxes and if she is in the 25 percent marginal tax bracket she will also pay \$1,750 income tax on her \$7,000 share of the partnership profits this year. In the future, however, Ginny can withdraw \$7,000 from the partnership without being subject to additional tax.

Example 1.33

If a partnership incurs a loss, the loss also flows through to the partners and may be deductible from the partner's other income effectively *sheltering* that other income from tax. The total loss that an owner may deduct from an investment in a partnership is limited to the partner's basis in the partnership interest.⁴¹

Partner's Basis Account

A partner's basis account is a measure of the partner's investment in the partnership at any given time. It ensures that partnership income is taxed only once. It is the upper limit on the amount a partner may receive as a tax-free distribution, as well as the limit on the amount of loss that can be deducted. A partner's beginning basis is determined by the cash and the basis of property contributed to the partnership in exchange for a partnership interest. Basis increases by any income or gains that flow through to the partner and decreases for any losses and distributions. The deduction for losses that flow through is limited to the partner's basis in the partnership interest (after all adjustments for gains, income, and distributions) because a partner's basis can never be negative. Once a partner's basis is reduced to zero, no additional loss can be deducted. This excess loss is carried forward until the partner again has positive basis against which it can then be deducted.

Jennifer is a 40 percent general partner in ABC partnership. Her partnership basis is \$200 at the beginning of year 1. The partnership has \$2,000 of ordinary income and distributes \$450 in cash to Jennifer at the end of year 1. Jennifer has \$800 ($40\% \times \$2,000$) of income, her share that flows through to her. She increases her basis to \$1,000 (\$200 beginning basis + \$800 income passed through), and then reduces it to \$550 by the \$450 distribution ($\$1,000 - \450). Jennifer is in the 28% tax bracket and pays \$224 ($\$800 \times 28\%$) in income taxes on her share of the partnership profits.

Example 1.34

⁴¹ The passive income and at-risk rules may also prevent the deduction unless the partner materially participates in the partnership and his or her investment is at risk. These rules are discussed in Chapter 11.

At the end of year 2, the partnership reports a \$2,500 loss, \$1,000 ($\$2,500 \times 40\%$) of which flows through to Jennifer. Her loss deduction, however, is limited to her \$550 basis; Jennifer carries the remaining \$450 loss ($\$1,000 \text{ loss} - \550 deducted) forward because her partnership interest basis cannot be negative.⁴² Jennifer's tax savings from the \$550 deductible loss are \$154 ($\$550 \times 28\%$).

The partnership's year 3 income is \$5,000 and \$2,000 ($\$5,000 \times 40\%$) flows through to Jennifer. Jennifer reports the \$2,000 as income, increases her basis to \$2,000, and can now deduct the \$450 loss carried over from the prior year. Her basis at the end of the third year is \$1,550 ($\$0 + \$2,000 - \450). Jennifer pays only \$434 ($\$1,550 \times 28\%$) in income taxes on her \$2,000 share of the profit that is reduced for the deductible loss carried forward from the prior year.

A unique feature of the partnership form is the increase in the partners' bases for their share of partnership liabilities. When the partnership repays the debt, the partners' bases are reduced for their share of the repayment. A partnership with liabilities allows its partners to deduct a greater share of losses as a result of this increased basis. If a partner's share of losses exceeds his or her remaining basis, the partner can only reduce basis to zero. The excess losses (after reducing basis to zero) cannot cause a negative basis and cannot be used until there are future increases in bases (from a share of income, contributions to capital or increase in liabilities) against which to deduct these excess losses.

When liabilities are repaid, partners must also reduce their bases for their share of discharged debt. If the partner's share of the repaid liability exceeds his or her remaining basis, the partner views the excess over basis similar to a "sale" of the partnership interest to avoid a negative basis.

Example 1.35

The partnership in the previous example borrows \$5,000 at the beginning of year 2, increasing Jennifer's partnership basis to \$2,550 [$\$550 \text{ beginning basis} + (40\% \times \$5,000 \text{ liability})$]. Jennifer can now deduct her \$1,000 second-year loss reducing her basis to \$1,550 ($\$2,550 - \$1,000 \text{ loss}$). When the partnership repays \$2,000 of the loan at the beginning of year 3, Jennifer's basis decreases by \$800 ($40\% \times \$2,000$) to \$750 ($\$1,550 - \800). If the partnership has a \$2,400 loss in year 3, Jennifer's deduction is limited to her \$750 remaining partnership basis and her remaining \$210 loss [$(40\% \times \$2,400) - \750] cannot be deducted until she again has basis.

Alternatively, if the partnership had paid off the entire \$5,000 loan at the beginning of year 3, her \$1,550 basis would be reduced to zero and Jennifer would be taxed on the \$450 share of liability that was repaid and exceeds her basis. Her loss cannot be deducted until basis is restored.

Most multi-member limited liability companies are partnerships for tax purposes, filing the Form 1065: *U.S. Return of Partnership Income*. Like partnerships, they are conduits that have their income or loss flow through to their members. This income or loss retains its character when it flows through to the members. Active members in an LLC also pay self-employment tax on their share of profits in the same manner as general partners or sole proprietors.

1.5.3 C CORPORATIONS

Regular corporations are usually referred to as C corporations to distinguish them from S corporations. Corporate shareholders can be employees subject to the same payroll taxes as all other

⁴² Jennifer can increase her basis by contributing cash or other property to the partnership. Her basis will also be increased when the partnership earns a profit and allocates Jennifer's share of that profit to her basis account.

employees. Shareholder-employees can participate in company fringe benefits that are denied tax-free treatment to the working-owners of other business forms (for example, employee health insurance premiums paid by the corporation are fully deductible by the corporation and are a tax-free benefit to shareholder/employees). In addition, the corporate tax rates are lower than individual tax rates, allowing owners to have increased capital for reinvestment and business expansion. A C corporation computes its taxable income and tax on Form 1120: *U.S. Corporate Income Tax Return*.

The main disadvantage of the corporate form is double taxation of corporate income because dividends are not deductible by a corporation. The corporation first pays a tax on its net income when earned; then the after-tax income distributed to most shareholders is taxed as dividend income. (Generally, the other forms of business avoid this double level of tax.) The impact of this double taxation on individual shareholders is somewhat mitigated by the lower tax rates on dividend income.

Tom, a taxpayer in the 25 percent tax bracket, owns the Big Creek Corporation. Big Creek paid \$7,500 in tax on its \$50,000 of taxable income and distributes the \$42,500 in after-tax earnings to Tom as a dividend. He pays \$6,375 ($\$42,500 \times 15\%$) in federal income taxes on the distribution. Total taxes of \$13,875 ($\$7,500 + \$6,375$) are paid on the \$50,000 earned by the corporation, or almost 28 percent of the pretax earnings.

Example 1.36

Another disadvantage of a C corporation is that losses do not flow through to the shareholders. Although the loss provides no tax benefit to shareholders in the year the corporation experiences the loss, corporate losses can offset corporate profits in other years. Corporate net operating losses (NOLs) can be carried back two years and forward for 20 years.

Baba Corporation had the following five-year history of income and loss:

Year	Income (Loss)
2013	\$3,000
2014	\$8,000
2015	(\$12,000)
2016	(\$2,000)
2017	\$12,000

Baba carries its 2015 loss back first to 2013 to offset \$3,000 of income and then carries \$8,000 of its remaining \$9,000 loss to 2014 to offset that year's \$8,000 income, receiving a refund of \$1,650 ($\$11,000 \times 15\%$). It carries the remaining \$1,000 loss from 2015 and the \$2,000 loss in 2016 forward to 2017 reducing taxable income to \$9,000.

Example 1.37

A business that carries an NOL back to a prior profitable year can obtain a quick refund of prior year's taxes from the IRS to use to pay current expenses and make new investments. Due to the time value of money, however, losses carried forward do not provide the same immediate cash inflow as losses carried back.

Although net operating losses can generally be carried back two years and forward twenty years, there are no tax savings from corporate losses until there are corporate profits. If a new C corporation experiences losses in its early years, those losses are trapped at the corporate level until a future profitable year.

Example 1.38

Newborn Corporation, a new C corporation, has a \$40,000 loss in its first tax year, a \$30,000 loss in its second year, a \$20,000 loss in its third year, and finally a \$100,000 profit in its fourth year. Newborn Corporation receives no tax benefit from its losses until its fourth year when it can offset its three years of accumulated losses of \$90,000 against its \$100,000 profit, reducing its taxable income in the fourth year to \$10,000. Its tax savings in the fourth year are \$20,750, the difference between the \$22,250 corporate tax on \$100,000 and the \$1,500 corporate tax on \$10,000. The shareholders cannot deduct any of Newborn Corporation's losses on their individual tax returns.

1.5.4 S CORPORATIONS

S corporations are formed in the same manner as C corporations but they avoid double taxation of corporate income by making a valid S corporation election. To elect S corporation status, the corporation must qualify as a “small business corporation” as defined under Internal Revenue Code Section 1361. The corporation files Form 2553: *Election by a Small Business Corporation*, along with consent statements signed by all shareholders of record at the time the election is made. The election can be made at any time during the preceding year or before the 15th day of the third month of the tax year for which the corporation wishes to have S corporation status.

An S corporation must be a domestic corporation with no more than 100 shareholders who, with limited exception, must be individuals who are not nonresident aliens. It can have only one class of common stock outstanding. If a corporation violates any one of these requirements at any time, the S corporation status is revoked and it will be taxed as a regular C corporation from that time.

Qualifying S corporations use the conduit concept of taxation, passing profits and losses through to their shareholders (similar to partnerships) for taxation at the shareholder level, avoiding the double tax on corporate profits. S corporation shareholders have the same limited liability protection that C corporation shareholders possess but avoid the principal disadvantage of C corporations—double taxation of income.

S corporations file an information tax return, Form 1120S: *U.S. Income Tax Return for an S Corporation*. The shareholders are taxed on their share of profits, whether they are actually distributed to them or retained in the corporation. A conduit entity is usually appropriate if the profits are distributed to the owners rather than reinvested in the business. These profits can then be distributed without the owners incurring any additional tax. Personal-service business activities (such as accounting or engineering) usually fall into this category.

S corporation shareholders can be employees of an S corporation for employment tax purposes, paying the same payroll taxes as other employees on their salary or wages. Similar to partners, however, shareholders who own more than 2 percent of the corporation's stock cannot participate in most employee fringe benefit programs on a tax-free basis. For example, the payment of health insurance premiums by the corporation for shareholders owning more than a 2-percent interest in the corporation, results in additional salary rather than a tax-free benefit.⁴³

A shareholder's basis is a measure of the shareholder's investment in the corporation's stock. A shareholder's beginning basis is the cash and adjusted basis of any property contributed

⁴³ Some of the benefits that greater-than-2-percent S corporation shareholders and partners cannot receive on a tax-free basis include health and accident insurance, group term life insurance, on-premises lodging, employee achievement awards, moving expenses, transit passes, and parking benefits. To mitigate the difference in this treatment of employer-provided health insurance for employees and the self-employed, sole proprietors, S corporation shareholders, and general partners may deduct the cost of health insurance for AGI. See Chapter 4.

to the corporation (or the price paid for the corporate stock). The shareholder's basis increases for the shareholder's share of the corporation's income or gain and decreases for any distributions or losses. The shareholder's deduction for losses is limited to the shareholder's stock basis (similar to a partner's basis limit for a loss deduction). Unlike a partnership, however, S corporation shareholders do not increase basis for debts undertaken by the corporation because S corporation shareholders have no personal liability for corporate debts. Thus, if the entity in examples 1.34 and 1.35 had been an S corporation, Jennifer could not have increased her basis for the corporation's debt.

Assume the facts in examples 1.34 and 1.35 except that the business is an S corporation. Jennifer's basis adjustments are the same for the S corporation as shown in example 1.34. When the S corporation borrows \$5,000 (example 1.35), Jennifer cannot increase her basis and it remains \$550. Jennifer's second-year deduction is limited to her \$550 basis, reducing it to zero. Her remaining \$450 loss is carried forward until she again has basis in her S corporation stock. The loan repayment has no effect on Jennifer's stock basis.

Example 1.39

S corporations and partnerships also differ in that shareholder-employees are not subject to self-employment taxes on the profits of an S corporation as are general partners' shares of the partnership profits. This provides an incentive for S corporation shareholders to take lower salaries (subject to employment taxes) but larger distributions of profits (not subject to self-employment taxes). If the IRS deems the salary paid to a shareholder-employee is unreasonably low on audit, it may reclassify some or all of a cash distribution of profits as salary and assess additional employment taxes on both the shareholder and the corporation (as discussed in Chapter 4).

As conduit entities, partnerships, limited liability companies, and S corporations are especially attractive in the early years of a business activity when operating losses are likely to occur. The early losses of a C corporation are locked inside the corporation and provide no tax benefit until the corporation becomes profitable. Losses from a conduit entity flow through to the owners and benefit the owners in the same year that the loss occurs (assuming the owners are able to deduct the losses). When conduit entity owners have high marginal tax rates, the benefit of loss flow-through is especially attractive.

At first glance, conduit entities may appear to be superior to C corporations from a purely tax perspective. Such a conclusion is shortsighted, however. C corporations have some favorable tax characteristics that are not available to any conduit entity. When these characteristics can be exploited (such as the ability of owners to be treated as employees and to benefit from tax-free employee fringe benefits), they can more than compensate for double taxation.

1.5.5 COMPARING BUSINESS ENTITY ATTRIBUTES

Choosing the best legal entity for the operation of a business activity is an extremely difficult decision. The future needs of both the business and its owners must be estimated and evaluated as part of this decision. Once a decision is implemented it will have long-lasting effects. Changing from one entity type to another can be difficult and expensive. Federal and state income taxes are an important component of the legal entity decision; however, taxes alone are an insufficient criterion for making a decision. Figure 1.7 presents a basic comparison of partnerships, S corporations, and C corporations as operating businesses across some of the tax and nontax attributes that should be considered when evaluating the choice of entity. These various attributes are explored in more detail in later chapters of this text.

Attribute	Partnership	S Corporation	C Corporation
Limited liability protection	Limited partners have limited liability protection. General partners have unlimited liability with respect to partnership debts.	Yes	Yes
Owner identity restrictions	None; any person or entity may be an owner.	Substantial restrictions: corporations, partnerships, certain trusts, and non-resident aliens not permitted.	None; any person or entity may be an owner.
Number of permitted owners	Minimum 2; maximum unlimited	Minimum 1; maximum 100 (family members treated as one)	Minimum 1; maximum unlimited
Differences in ownership rights permitted between owners	Flexible; economic and management rights can vary between general and limited partners.	Generally fixed; only common stock is permitted, but voting rights may vary.	Flexible; no limit on different classes of stock that may be created.
Excludible employee fringe benefits for employee owners	Generally not available.	Generally not available for greater than 2% owners.	Available to all employees.
Tax treatment of capital gains and losses	Gains flow through to partners and are taxed at partner's capital gains tax rate. Losses deductible by partner subject to capital loss limits.	Gains flow through to shareholders and are taxed at owner's capital gains tax rate. Losses deductible by shareholder subject to capital loss limits.	Gains taxed to corporation at same marginal rate as ordinary income. Capital losses are carried back 3 years and forward 5 years.
Marginal tax rate structure applied to ordinary income	Flow through to owner and taxed at owner's marginal tax rate.	Flow through to owner and taxed at owner's marginal tax rate.	Taxed using progressive rate structure for corporations. Substantial power to shelter first \$100,000 of income due to low rates.
Allocation of entity income and loss	Allocations made under partnership agreement.	Fixed; all allocations based on ownership of stock.	N/A; not a conduit entity.
Self-employment taxes	Imposed on ordinary income share of general partners.	Not imposed.	N/A; not a conduit entity.
Overall capacity of owner to derive tax benefit from entity losses	Very good for partners who participate in management and can increase basis for entity debts.	Good for shareholders who are material participants in the business; however, it may be limited because shareholder basis not increased for entity debts.	Not a conduit entity. Corporate net operating losses remain within corporation and are carried back 2 years and forward 20 years for eventual corporate tax benefit.

FIGURE 1.7
Comparison of business
entity attributes

**REVISITING THE
INTRODUCTORY
CASE**

Wing Hue is a resident of the United States and is subject to its income tax laws. As an employee of the consulting firm, Hue is required to pay employment taxes (his share of FICA taxes) through withholding by his employer. His employer also must withhold a certain percentage of his gross income for his income tax liability based on his estimated income. He is subject to income tax rates ranging from 10 to 39.6 percent of his taxable income.

To obtain backing from venture capitalists, Hue may have to agree to the type of entity that will be used for his manufacturing business. The venture capitalists could require Hue to establish a regular corporation to provide flexible ownership and limit their liability. If so, Hue could own a certain percentage of the corporation while also being an employee, fully participating in the corporation's fringe benefits. (If the venture is successful, he will most likely leave his consulting position.) As an owner-employee, Hue can take profits out of the corporation as a salary, subject to FICA taxes and income tax withholding. It will, however, be paid with the before-tax income of the corporation due to the corporation's salary deduction. Corporate profits taken out as dividends will be paid with the after-tax income of the corporation and will be subject to additional taxes when received by Hue and his backers.

The manufacturing business could be established in several other entity forms, if his financial backers allow. It is unlikely the backers would sanction operations as a sole proprietorship (the lenders would have to lend the money directly to Hue). If they did, however, Hue would have to pay self-employment taxes on all profits as well as income taxes. He will, however, be able to deduct losses against his other income.

The backers could permit the business to operate as either a partnership or an S corporation as an alternative to the C corporation. They can limit their liability through either a limited liability company electing partnership taxation or through an S corporation. Both of these entities pass income directly through to the owners for taxation, eliminating the double taxation of earnings. As a general partner, Hue would be responsible for self-employment taxes on his share of partnership income, in addition to income taxes. Hue cannot be an employee of the partnership nor participate in tax-free employee fringe benefits. Although he can be an employee of an S corporation (with FICA taxes and income tax withholding on his salary). Ownership of more than 2 percent of the stock, however, limits his ability to benefit from tax-free employee fringe benefits.

Taxes are required payments to a governmental unit unrelated to the benefits received. In addition to funding government operations, taxes are used to redistribute wealth, foster price stability and economic growth, and meet social goals.

A major source of revenue for many jurisdictions is an income tax, but there are many other bases for levying taxes. Various governmental units levy consumption taxes (sales and use taxes), wealth taxes (property taxes), and wealth transfer taxes (estate and gift taxes). These taxes may be proportional, progressive, or regressive. Adam Smith's four canons of taxation of equity, economy, certainty, and convenience can be used to evaluate a tax.

The income tax is the primary source of revenue for the federal government, but only individuals, corporations, and fiduciaries pay income taxes. Other business entities, such as sole proprietorships, partnerships, and S corporations pass their incomes through to their owners until they reach one of the three types of income tax-paying persons. This income is then included with the other types of income subject to income taxes by an individual, corporation, or fiduciary for taxation by the appropriate jurisdiction(s).

SUMMARY

The impact of income taxes is just one of many things that must be considered when deciding in which form to operate a business. S corporations and limited liability companies can limit the owner's liability for corporate acts. Sole proprietors and partners may have to surrender personal assets to satisfy judgments against the business. Other variations include, but are not limited to, the treatment of employment taxes, participation in fringe benefit programs, and the ability to sell an interest in the business. These and more must be considered when determining in which form to operate a business.

KEY TERMS

Ad valorem 8	Gift tax 9	Nexus 6	S corporations 36
Average tax rate 14	Gross income 20	Partnership 32	Sales tax 10
Canons of taxation 16	Horizontal equity 17	Progressive tax system 13	Sole proprietorship 31
C corporation 19	Initial public offering (IPO) 30	Proportional tax system 15	Tax expenditures 5
Estate tax 9	Internal Revenue Code 4	Real property tax 8	Use tax 11
FICA tax 8	Losses 21	Regressive tax system 15	Value-added tax (VAT) 11
Fiduciary 19	Marginal tax rate 14		Vertical equity 17
Filing status 23			
Franchise tax 6			

TEST YOURSELF**Answers Appear after the Problem Assignments**

- Which of the following is correctly categorized as a tax?
 - The dog license fee
 - The annual property tax on your home
 - An assessment for putting streetlights in front of your home that increases the home's value
 - The bond a person must post to get out of jail
- What type of tax is a sales tax?
 - Income tax
 - Consumption tax
 - Wealth transfer tax
 - Turnover tax
- What characteristic of a tax states that taxpayers with equal incomes should pay equivalent amounts of taxes?
 - Horizontal equity
 - Vertical equity
 - Certainty
 - Convenience
- Which of the following applies only to individual taxpayers and not to corporations?
 - Taxable income
 - Estimated tax payments
 - Gross income
 - Lower tax rates for long-term capital gains
- Which of the following entities does not pass its income directly through to its owners?
 - Sole proprietorship
 - Partnership
 - C corporation
 - S corporation

Check Your Understanding

1. [LO 1.1] What is a tax? How does a tax differ from a fine?
2. [LO 1.1] What Constitutional Amendment allowed implementation of an income tax? In what year was it ratified?
3. [LO 1.1] Which version of the tax code is applicable today?
4. [LO 1.1] Define tax expenditure?
5. [LO 1.1] What is a SALT practice?
6. [LO 1.1] What is nexus?
7. [LO 1.1] Suntan Corporation sells its products nationwide over the Internet. It has production facilities, warehouses, and offices only in the state of Florida. It has sales in excess of \$600,000 for the year to customers in Arizona. It has no physical presence in Arizona. Can Arizona assess state income tax on Suntan Corporation for the sales made to Arizona customers?
8. [LO 1.1] How does a franchise tax differ from an income tax?
9. [LO 1.1] What three factors are generally used to determine the percentage of corporate income allocated to a particular state?
10. [LO 1.1] What employment taxes are imposed on an employee and an employer?
11. [LO 1.1] What is the most common wealth tax and how is it levied?
12. [LO 1.1] What property is subject to the intangible tax?
13. [LO 1.1] Explain the integration of the gift and estate taxes.
14. [LO 1.1] Differentiate a consumption-based tax from an income tax and illustrate with an example.
15. [LO 1.1] Differentiate a wealth tax from a wealth transfer tax and give examples of each.
16. [LO 1.1] What is a use tax?
17. [LO 1.1] Over what ranges of taxable income in 2017 will the total income tax liability for two persons with equal incomes who file as single individuals equal their income tax liability if they file jointly as a married couple?
18. [LO 1.2] Differentiate a progressive tax system from a proportional and a regressive system and give examples of each.
19. [LO 1.2] What basic tax rates apply to the ordinary income, dividend income, and interest income of an individual? What are they for a corporation?
20. [LO 1.2] What tax rates apply to an individual's capital gains and to which tax brackets do each of these rates apply?
21. [LO 1.3] Briefly explain Adam Smith's four canons of taxation.
22. [LO 1.3] Differentiate horizontal from vertical equity.
23. [LO 1.4] Which three taxable persons pay all of the income taxes?
24. [LO 1.4] Define gross income.
25. [LO 1.4] Briefly describe the basic elements of the tax model.
26. [LO 1.4] Differentiate the tax treatment of an individual's capital losses from the tax treatment of corporate capital losses.

27. [LO 1.4] What are the basic tax rates for an individual and a corporation?
28. [LO 1.4] What are two fiduciary entities and how are they created? Differentiate the grantor, trustee, and beneficiary of a trust.
29. [LO 1.5] What are three characteristics of a sole proprietorship? Do these characteristics differ from those of a partnership? What are three characteristics of a limited liability company that differ from those of a partnership?
30. [LO 1.5] Compare a C corporation to an S corporation.

Crunch the Numbers

31. [LO 1.1] Dane City's total assessed valuation for all of the property in its jurisdiction is \$4,000,000,000. It needs \$20,000,000 in revenue for the services it provides its citizens. Joe owns property that is assessed at \$150,000. How much will he pay in property taxes?
32. [LO 1.1] If a taxpayer has \$40,000 of employee salary in 2017, how much will be withheld for the Social Security and Medicare taxes?
33. [LO 1.1] If a taxpayer has \$140,000 of employee salary, how much will be withheld for the Social Security and Medicare taxes in 2017?
34. [LO 1.4] Determine Amy's taxable income for 2017 if she has \$40,000 of salary income, is single, and claims the standard deduction.
35. [LO 1.4] Marlee, a single parent of one child for whom she claims the exemption, has \$15,000 in itemized deductions and files as head of household for 2017. Determine her taxable income if she has a salary of \$71,000 and interest income of \$1,500.
36. [LO 1.4] Determine a corporation's taxable income if it has \$450,000 of gross receipts, \$145,000 cost of goods sold, \$276,000 of deductible business expenses, \$20,000 of gain on the sale of machinery, and \$500 of interest income from State of New York bonds.
37. [LO 1.4] The Warner Corporation has gross income of \$560,000. It has business expenses of \$325,000, a capital loss of \$20,000, and \$2,500 of interest income on temporary investments. What is the corporation's taxable income?
38. [LO 1.4] Determine George and Mary's taxable income and tax liability for 2017 if George has \$65,000 and Mary has \$45,000 of salary income, they have \$24,000 of allowable itemized deductions, no dependents, and file a joint tax return.
39. [LO 1.4] Refer to the information in problem 34. Determine Amy's income tax liability for 2017.
40. [LO 1.4] Refer to the information in problem 35. Determine Marlee's income tax liability for 2017.
41. [LO 1.4] Refer to the information in problem 36. Determine the corporation's income tax liability.
42. [LO 1.4] Refer to the information in problem 37. Determine Warner Corporation's income tax liability.
43. [LO 1.4] Sally and Jim are married and have taxable income in 2017 of \$160,000. If they could file their income tax as single individuals, each of them would have taxable income of \$80,000. Do they have a marriage penalty when they file their joint return? If so, what is the amount of the penalty?
44. [LO 1.4] Conrad, who has \$180,000 of taxable income, plans to marry Anita, a college student with no taxable income. If they marry on December 21, 2017, they will file jointly and have \$180,000 of taxable income for the year. If they wait until January of 2018 to marry, Conrad will have to file as a single person and report the \$180,000 of taxable income on his separate return.

- a. Will it be to their advantage to marry before the end of 2017 or should they wait until 2018?
 - b. How much in tax will they save or have to pay extra if they marry in 2018?
 - c. How would your answers change if Conrad and Anita marry and each expects \$90,000 of taxable income in 2017?
45. [LO 1.4] Carrie and Stephen have gross salary and wages of \$76,000 in 2017 and file a joint return, claiming two personal exemptions and one dependency exemption for their seven year old child. They have \$15,000 of allowable itemized deductions and a \$240 child care credit. Determine their taxable income and their tax liability.
 46. [LO 1.4] An estate has \$20,000 of taxable income in 2017. What amount of tax will the estate pay if it fails to distribute the income to the beneficiaries?
 47. [LO 1.4] Perform the calculations to prove that the 5 percent surtax on corporate income between \$100,000 and \$335,000 equals the benefit that the corporation enjoys on income of no more than \$100,000.
 48. [LO 1.4] Perform the calculation to prove that the 3 percent surtax on corporate income between \$15,000,000 and \$18,333,333 equals the benefit of the 34 percent tax rate on income of no more than \$10,000,000.
 49. [LO 1.5] John has taxable income of \$30,000. William has taxable income of \$60,000. Determine their 2017 income taxes if they are both single individuals and claim the standard deduction. Compare their incomes and their income taxes. What does this illustrate?
 50. [LO 1.5] Lilikoi Corporation began business in 2015. Lilikoi earned taxable income of \$40,000 in 2015 and \$120,000 in 2016. For 2017, Lilikoi Corporation has a net operating loss of \$50,000 and decides to carry the loss back, filing a refund claim. Compute the amount of corporate income tax that Lilikoi paid for 2015 and 2016 and then determine the amount of tax that will be refunded from carrying back the 2017 NOL.
 51. [LO 1.5] Hunter Corporation has \$250,000 in gross income, \$125,000 in deductible business expenses, and a \$12,000 business tax credit. Determine the corporation's net tax liability.
 52. [LO 1.5] Carolyn has a 50 percent interest in a general partnership that has a \$14,000 loss for the year. She materially participates in the partnership. Her basis in the partnership is \$10,000. She also has salary from other employment of \$46,000. If she is single, has no dependents, and claims the standard deduction, what is her taxable income and her tax liability in 2017?
 53. [LO 1.4 & 1.5] June and John decide to form a business. They each plan to contribute \$20,000 in exchange for a 50 percent interest in the business. They will then take out a bank loan for \$30,000 to cover the balance of their working capital needs. They expect that the business will make a profit of \$64,000 in the first year and that it will not make any cash distributions that year. Excluding the business income, June, who files as head of household, has \$475,000 of other ordinary taxable income. John is married and files a joint return; he and his wife have \$110,000 of other ordinary taxable income. They want to know how much tax the business will pay and how much additional tax they will personally pay in 2017 if they form the business as a partnership, S corporation, or C corporation. Consider only income taxes.
 54. [LO 1.4 & 1.5] Assume the same facts as problem 53, except that the business expects to make a cash distribution of \$28,000 each to June and John the first year. Determine how much tax the business will pay and how much additional tax they will personally pay if they form the business as a partnership, S corporation, or C corporation. Consider only income taxes.
 55. [LO 1.4 & 1.5] Assume the same facts as problem 53, except that John and June expect the business will have a \$44,000 loss in the first year (instead of a \$64,000 profit) and will not make any cash distributions. Determine the income tax savings in the current year for the business and for them personally if they form the business as a partnership, S corporation, or C corporation. (They both

materially participate in the business and their marginal tax bracket will not change because of the business loss.)

56. [LO 1.4 & 1.5] Clara and Charles decide to form a business. They each plan to contribute \$15,000 in exchange for a 50 percent interest. The business will borrow \$20,000 to cover the balance of its working capital needs. In their business plan, Clara and Charles show that the business will have a loss of \$54,000 in its first year. In the second year, however, the business will have a profit of \$60,000 and they will each be able to withdraw \$5,000 from the business. Clara is in the 28 percent marginal tax bracket and Charles is in the 25 percent marginal tax bracket.
- Determine the taxes paid by the business (if any) in the first and second year if they organize the business as (1) a partnership, (2) an S corporation and (3) a C corporation.
 - Determine Clara's and Charles's income tax savings in the first year and their bases in the business at year-end if they organize the business as (1) a partnership, (2) an S corporation, and (3) a C corporation.
 - Determine the income tax Clara and Charles will pay in the second year from business operations and their bases in the business at year-end if they organize the business as (1) a partnership, (2) an S corporation, and (3) a C corporation.
57. [LO 1.5] Carl is a 30 percent partner in the CCF Partnership. At the beginning of the year, his basis in the partnership is \$4,000. The partnership reports \$7,000 of ordinary income and distributes \$3,000 to the partners. What is Carl's basis at the end of the year?

Develop Planning Skills

58. [LO 1.4] John and Martha are planning to be married. Both are professionals each with taxable incomes of \$89,700 annually. They are deciding on a wedding date. They have two dates to choose from: December 14, 2017, or January 11, 2018. If they marry on December 14, 2017, they will have to choose between married filing separately and married filing jointly. Is there an advantage to either method of filing? If they postpone their wedding until the January date and file as single persons, will they reduce their tax bill for 2017?
59. [LO 1.4 & 1.5] Jeremy is setting up a service business. He can either operate the business as a sole proprietorship or he can incorporate as a regular C corporation. He expects that the business will have gross income of \$80,000 in the first year with expenses of \$12,000 excluding the following. He plans to take \$30,000 from the business for living expenses as a salary. Compare his tax costs for 2017 considering only income taxes if he is single, has no dependents or other income, and claims the standard deduction. Which option do you recommend based solely on these tax costs?
60. [LO 1.1, 1.4 & 1.5] Carol has recently incorporated her sole proprietorship and is considering making an S election. The corporation has \$200,000 of gross revenue and expenses of \$75,000 before Carol's salary. She plans to take a gross salary of \$60,000 from the business and this will be her only income for the year. Compare the total tax burden for Carol and the corporation with and without the S election. Consider both income and employment taxes. Carol is single, has no dependents, and uses the standard deduction. She plans to reinvest all of the corporation's net income after taxes into the business. Based on tax burden alone for 2017, should Carol make the S election?

Think Outside the Text

These questions require answers that are beyond the material that is covered in this chapter.

61. [LO 1.2] What is the maximum income tax rate that applies to the employee salary, the employment tax rate(s) on the salary, and the capital gain rate(s) on the long-term capital gains, for these four single individual taxpayers in 2017 (excluding Medicare surtaxes)?
- Employee Salary = \$27,000; Capital Gain = \$9,000
 - Employee Salary = \$132,000; Capital Gain = \$24,000
 - Employee Salary = \$176,000; Capital Gain = \$139,000
 - Employee Salary = \$285,000; Capital Gain = \$248,000

62. [LO 1.2] Do you believe that a progressive, proportional, or regressive tax is the most fair? Explain your answer.
63. [LO 1.2] Is a property tax generally a progressive, proportional, or a regressive tax? Explain.
64. [LO 1.2] If the Congress were to enact a flat tax, do you believe that there should be any exclusions or deductions from income before the single tax rate is applied? Explain
65. [LO 1.3] Evaluate the sales tax and the income tax using Adam Smith's four canons of taxation.
66. [LO 1.4] Evaluate allowing married individuals with dual incomes to choose to file a joint tax return or to file as two single individuals as a remedy for the marriage penalty.
67. [LO 1.4] What is the after-tax interest rate that a corporation in the 38 percent tax bracket pays on a loan of \$100,000 at 7 percent interest?
68. [LO 1.4] Compare the benefits of a \$4,000 deduction and a \$4,000 tax credit for two single taxpayers, one with taxable income of \$50,000 and the other with taxable income of \$200,000.

Search the Internet

For the following four problems, consult the IRS Web site (www.irs.gov).

69. [LO 1.1] Briefly describe the statistical information available when you search the IRS website for statistics.
70. [LO 1.1] How do you make a comment or ask a question about the tax statistics provided by the IRS?
71. [LO 1.1] What subheadings appear under the "Statistics of Income"?
72. [LO 1.1] Where would you find information about the IRS
73. [LO 1.1] Go to www.taxfoundation.org (the Web site for the Tax Foundation).
- What is Tax Freedom Day?
 - When were Tax Freedom Days in 2015 and 2016?

Identify the Issues

Identify the issues or problems suggested by the following situations. State each issue as a question.

74. [LO 1.4] John and Mary filed for divorce in November of the current year. The divorce will not become final until May of the following year.
75. [LO 1.5] DEE is an S corporation with 100 shareholders. John, one of these shareholders, gives half of his shares of stock to his new wife as a wedding gift.
76. [LO 1.5] Clifford owns 75 percent of AFK, a C corporation. He spends little time in the business, but takes a salary of \$750,000.

- b. The annual property tax on your home
- b. Consumption tax
- b. Horizontal equity
- d. Lower tax rates for long-term capital gains
- c. C corporations

**ANSWERS
TO TEST
YOURSELF**