Chapter 1
An Introduction to Taxation and Understanding the Federal Tax Law

CHAPTER HIGHLIGHTS

A proper analysis of the U.S. tax system begins with an examination of historical principles that guide the development of the system, and with an investigation of the various motivations that underlie existing provisions of the tax law. This chapter also introduces the reader to important tax terminology.

I. History of U.S. Taxation
   A. An income tax on individuals was used to provide financing for the Civil War. When the war ended, the tax was repealed. In 1894, a new individual income tax was enacted, but the Supreme Court held the tax to be unconstitutional. After a constitutional challenge to the taxation of income, the Sixteenth Amendment, which sanctioned both the federal individual and corporate income taxes, was ratified in 1913. The present income tax on individuals was enacted in 1913. The corporate income tax, which was originally adopted in 1909, withstood constitutional challenge because it was viewed as an excise tax, not a direct tax.
   B. Numerous revenue acts, which rewrote completely the federal tax provisions, were enacted between 1913 and 1939. These provisions were reorganized and included, in a more permanent form, in the Internal Revenue Code of 1939. Thereafter, tax laws were changed when Congress adopted amendments to the 1939 Code; a complete rewriting of the laws was unnecessary. A revised Internal Revenue Code was adopted in 1954. The 1954 Code was the controlling body of tax law until 1986. In 1986, Congress enacted the most comprehensive overhaul of the Internal Revenue Code in over thirty years. As a result of the massive changes contained in the new law, the federal tax code was renamed the Internal Revenue Code of 1986. Nevertheless, many of the provisions of the 1954 Code were carried over to the 1986 Code.
   C. In an effort to close various loopholes and to reduce a recurring budget deficit, changes in the tax law have been enacted nearly every year since 1986.
D. One trend that has caused considerable concern is the increased complexity of the federal income tax laws, which imposes substantial taxpayer compliance costs. Congress has added to this complexity through frequent changes in the tax laws.

E. Income tax collections from individuals constitute about half of all federal tax receipts. Social insurance taxes now constitute just under one-third of all federal tax receipts, while corporate income tax receipts have fallen drastically since the 1940s.

II. Tax Terminology

A. Tax rates can be structured to yield a
   1. Proportional tax -- The rate of tax remains constant over the tax base;
   2. Progressive tax -- Tax rates increase as the tax base grows larger; or
   3. Regressive tax -- Tax rates decrease as the tax base grows larger.

B. Taxes should be designed with
   1. Equality of tax treatment among taxpayers in similar circumstances;
   2. Convenience of collection, computation, and administration;
   3. Certainty in application, so that tax planning can occur; and
   4. Economical administration, which requires only nominal collection costs by the government and involves minimal compliance costs on the part of the taxpayer.

C. A number of different tax structures are currently utilized by our federal and state and local governments.
   1. **Ad valorem** taxes are taxes on wealth or capital. Examples include the existing real property taxes and personal property taxes presently favored by state and local governments. The real property tax features a high degree of taxpayer compliance, political manipulation of the assessment process, and assessments based on appraisals, capitalization of attendant income and actual purchase or construction costs. Relative to real property taxes, taxpayer compliance with personal property taxes is inconsistent across taxes and jurisdictions.

   2. **Transaction taxes** are levied on the transfer of property among taxpayers. Examples include: excise taxes, sales and use taxes, taxes on transfers at death and gift taxes, severance taxes, and the value added tax (VAT).
      a. **Excise taxes** are levied by federal and state governments on the exchange of specified commodities, e.g., certain "luxury" items, oil, alcohol, and tobacco. Excise taxes are effective when consumers demonstrate a price-inelastic demand for the commodity.
      b. **Sales and use taxes**, which are often utilized by state and local governments, cover a multitude of transactions. Debate relative to this tax centers around the sale of which items will be subject to the tax.
      c. **Taxes on transfers at death and gift taxes** are levied by federal and state governments on lifetime or testamentary transfers of property to others.
      d. **Severance taxes** are imposed by some states on the extraction of natural resources.
      e. While the U.S. does not employ a **VAT**, the VAT has gained

### KEY TERMS
- Progressive/Regressive/Proportional Tax Rates
- Economic, Social, Equity, Political Motivations
- IRS, Treasury Department
- Income, Wealth, Excise, Employment Taxes
acceptance as a major source of revenue in many developed and less-developed countries.

3. Income taxes are levied chiefly by federal and state governments on the annual incremental change in a taxpayer's wealth. Specific definitions relative to includible income and allowable deductions vary greatly among those governments that impose the tax. Most taxing jurisdictions attempt to ensure the collection of income taxes by requiring certain pay-as-you-go procedures.

4. Employment taxes include unemployment taxes, which finance state and federal unemployment compensation benefits, and retirement taxes, e.g., the federal FICA tax. These taxes are levied upon or collected by employers, and they provide some income security for employees. The FICA tax is paid equally by employer and employee; the FUTA tax is paid by only the employer. Debate relative to these taxes includes the proper definition of "employer" and "employee", and the desirable employment-tax bases and rates.

5. Other taxes that are part of the U.S. tax system include federal custom duties and miscellaneous state and local taxes, e.g., franchise taxes, occupational taxes, and license fees.

In the 2008 presidential election campaign, two Republican presidential hopefuls suggested alternatives to the current income tax system. Arkansas Governor Mike Huckabee proposed eliminating all income and payroll taxes and replacing them with a flat 23 percent national sales tax. Former Tennessee senator Fred Thomson proposed a voluntary flat tax, with a 10- and 25-percent rate. Both candidates suggested that such tax systems would be fairer and simpler than the current system.

D. The responsibility for administering federal tax laws rests with the Treasury Department.
   1. The Internal Revenue Service (IRS) is part of the Treasury Department and is responsible for enforcing the tax law.
   2. The IRS utilizes mathematical formulas and statistical sampling techniques to select tax returns for audit. However, due to budget constraints, the IRS audits only a small minority of returns.
   3. A statute of limitations provides both parties to a tax a defense against "stale" claims. Generally, the IRS may assess additional tax liabilities against the taxpayer within three years of the filing of an income tax return. This three-year time period is extended to six years for omissions of gross income in excess of 25 percent of that reported. No statute of limitations protection is available with respect to fraudulent tax return positions.

III. Motivations Underlying Specific Tax Provisions
   A. Although the major objective of the federal tax law is to raise revenue, economic, social, equity, and political considerations play a significant role in the design of specific tax provisions.
   B. Economic considerations, including stimulating the national economy, and encouraging or discouraging specific activities or industries, have led to a large
number of recent amendments to the Code. Examples of such economic considerations include:

1. Accelerated depreciation, to encourage expenditures on long-lived productive assets, such as machinery and equipment. However, subsequent law changes have modified the cost recovery system, on the grounds that these provisions favored capital-intensive, rather than labor-intensive, industries, and to reduce the growing federal budget deficit.

2. Lower individual and corporate income nominal tax rates. Such measures can stimulate the general economy by increasing disposable income.

3. Special tax treatment of technological development, including favorable treatment allowed research and development expenditures and patents, and tax credits for certain research and energy expenditures.

4. Support for farmers, thrift institutions, and small business owners. Such taxpayers can claim immediate deductions for expenditures for farm feed and fertilizers, exemption from the uniform capitalization rules for certain farmers, and the "flow-through" of the operating losses of certain small business corporations to their shareholders.

C. Social considerations also affect tax legislation. Tax-favored treatment of certain employer-provided life and health insurance policies, contributions to retirement plans and charitable organizations, and expenditures for child care services are a response to various social goals. On the other hand, tax laws discourage expenditures contrary to public policy, such as bribes and fines.

D. Equity considerations with respect to the tax law attempt to maintain a sensitivity in the law toward taxpayers in various circumstances. Of course, definitions of equity often produce heated debate among interested parties. Nevertheless, the tax law offers

1. Relief from multiple taxation through reductions in the tax on dividend income and deductions for state/local taxes paid from federal gross income.

2. Deferral of tax liability until the taxpayer has funds available to pay a tax.

3. Several provisions, such as the installment sale method and the loss carryover provisions, which offer relief from hardships that may be created by the annual accounting period concept.

4. Relief from the eroding results of inflation through indexation of tax brackets, standard deductions, and exemptions to inflation.

E. Political considerations are evident in the tax law, as might be expected with respect to provisions that are forged in a legislative process.

1. The effects of political considerations on the tax law largely are a result of special interest legislation, political expediency, and state and local government influences.

2. For instance, on the dimension of political expediency, various provisions in the Code attempt to ensure that “wealthy” taxpayers pay some “fair” share of tax. Examples of such provisions include the alternative minimum tax, the imputed interest rules, the passive loss rules, and the limitation on deductible investment interest expense.

F. Tax administrators and the courts also have contributed to the system by imposing or encouraging alterations in specific provisions in the tax law.

1. In its capacity as the protector of the national revenue, the IRS has been instrumental in securing passage of legislation designed to curtail flagrant tax avoidance practices and to ease administration of the tax laws.

2. In addition to interpreting statutory provisions and administrative pronouncements issued by the IRS, the federal courts have influenced tax law by formulating certain judicial concepts that serve as guides in the application
of various tax provisions and by making decisions that have been of such consequence that changes in the Internal Revenue Code were enacted by Congress specifically to incorporate the decision in the Code, or to provide tax provisions that are contrary to the decision.
TEST FOR SELF-EVALUATION - CHAPTER 1

True or False

Indicate which of the following statements are true or false by circling the correct answer.

T F 1. The federal government raises a large portion of its revenue through the property tax.

T F 2. A value added tax resembles a national sales tax.


T F 4. Property taxes are a form of ad valorem tax.

T F 5. Transaction taxes are most effective when consumers demonstrate a price-elastic demand for the commodity.

T F 6. If tax rates increase as the tax base grows larger, the tax is regressive.

T F 7. A severance tax is a tax on the use, consumption, or storage of tangible property.

T F 8. The primary purpose of some tax laws is to simplify the task of the IRS in collecting the revenue and administering the law.

T F 9. State governments use the sales tax as one of their primary sources of tax revenues.

T F 10. Under the general rule, the IRS may assess an additional tax liability against a taxpayer within six years of the filing of the income tax return.

Fill-in-the-Blanks

Complete the following statements with the appropriate word(s) or amount(s).

1. The ________ Amendment, ratified in ________, authorized the federal income tax on individuals.

2. ________ ________ taxes are taxes on capital or wealth.

3. The research and development tax credit is an example of the effect of ________ considerations in the development of the tax law.

4. The "minimum tax" on wealthy taxpayers is an example of the effect of ________ considerations in the development of the tax law.

5. The deduction for charitable contributions is an example of the effect of ________ considerations in the development of the tax law.
6. Adam Smith believed that a "good" tax would include provisions to assure its ________,
   ________, ________, and ________.

7. With respect to employment taxes, the ________ tax is paid equally by the employer and
   employee, while only the employer pays ________ taxes.

8. The _____-____-____-_____ feature of the income tax system compels employers to
   withhold a specific portion of an employee's wages for taxes.

9. ________ taxes are levied on an activity or event, or the exercise of a specific right in
   property or on a privilege granted.

10. ________, ________, and ________ taxes are levied on the transfer of property and
    normally are determined by a percentage rate multiplied by the value involved.

11. A(n) ________ tax is a tax on the right to receive property from a decedent.

12. The purpose of the ________ system is to provide funds that the states can use to provide
    unemployment benefits.

13. A ________________ ________ establishes the maximum time during which the IRS can
    assess additional tax and the taxpayer can claim a refund.

Multiple Choice

Choose the best answer for each of the following questions.

___ 1. When the tax base is $10,000, the tax liability is $3,000; when the tax base is
   $100,000, the tax liability is $20,000. This tax has a rate structure that is
   a. Progressive.
   b. Regressive.
   c. Proportional.
   d. _Ad Valorem_.

___ 2. When the tax base is $10,000, the tax liability is $3,000; when the tax base is
   $100,000, the tax liability is $35,000. This tax has a rate structure that is
   a. Progressive.
   b. Regressive.
   c. Proportional.
   d. _Ad Valorem_.

___ 3. When the tax base is $10,000, the tax liability is $3,000; when the tax base is
   $100,000, the tax liability is $30,000. This tax has a rate structure that is
   a. Progressive.
   b. Regressive.
   c. Proportional.
   d. _Ad Valorem_.
4. The federal gift and estate taxes are
   a. regressive taxes.
   b. proportional taxes.
   c. progressive taxes.
   d. the gift tax is regressive and the estate tax is progressive.

5. The concept that recognizes the inequity of taxing a transaction when the taxpayer lacks the means with which to pay the tax is
   a. double taxation.
   b. pay-as-you-go.
   c. revenue neutrality.
   d. wherewithal to pay.

6. Which of the following tax code provisions could affect the economic behavior of taxpayers? (More than one answer may be correct.)
   a. Accelerated depreciation provisions.
   b. Favorable treatment for research and development expenditures.
   c. Tax credits for non-fossil fuel motor vehicles.
   d. Both a and c are correct.

7. Examples of social considerations that have affected tax legislation include
   a. the alternative minimum tax.
   b. deductions for contributions to retirement plans.
   c. the investment tax credit.
   d. the installment sale method.

8. The concept of equity appears in tax provisions to
   a. alleviate the effect of multiple taxation.
   b. postpone the recognition of gain when the taxpayer lacks the ability or wherewithal to pay the tax.
   c. mitigate the effect of the application of the annual accounting period concept.
   d. All of the above are indicative of equity principles in tax provisions.

9. The last major reorganization of the Internal Revenue Code was enacted in
   a. 1954.
   b. 1986.
   c. 2003.
   d. 2005.

10. In addition to interpreting statutory provisions and administrative pronouncements issued by the IRS, the Federal courts have influenced tax law by
    a. formulating certain judicial concepts that serve as guides in the application of various tax provisions.
    b. changing Congressional intent as to the application of Federal tax law.
    c. making key decisions that have led to changes in the Internal Revenue Code.
    d. Both a and c are correct.
11. The federal income tax rate structure for individuals is becoming
   a. less regressive.
   b. more regressive.
   c. less progressive.
   d. more progressive.

12. Which of the following states do not impose an income tax on individuals? (More than one answer may be correct.)
   a. Alabama.
   b. Georgia.
   c. South Carolina.
   d. Texas.
   e. All of the above states impose an income tax.

13. Special tax-reduction provisions supporting the owners of small businesses can be justified on which of the following grounds? (More than one answer may be correct.)
   a. Economic expansion
   b. Political expediency
   c. Social justice
   d. Equity among taxpayers
   e. All of the above are used to justify tax breaks for small business.

14. Over time, the Internal Revenue Service has worked to
   a. make the federal tax system more complex.
   b. make the federal tax system less complex.
   c. keep the federal tax system at a constant level of complexity.
   d. Both a and b.
   e. None of these choices is correct.
SOLUTIONS TO CHAPTER 1 QUESTIONS

True or False

1. F Property taxes are imposed by state and local governments. [Property Taxes, p.1-7]
2. T Both are transaction taxes. [General Sales Taxes, p. 1-10]
3. F The basis of current tax law is the Internal Revenue Code of 1986. [Revenue Acts, p. 1-3]
4. T Such taxes are based on the value of the taxed property. [Property Taxes, p. 1-7]
5. F Transaction taxes are effective when consumers demonstrate a price-inelastic demand for the commodity. [General Sales Taxes, p. 1-10]
7. F The tax described is the use tax. [General Sales Tax, p. 1-10]
8. T This practice reduces compliance costs. [Criteria Used in the Selection of a Tax Structure, p. 1-4]
9. T Sales and use taxes are key revenue sources for the states. [General Sales Taxes, p. 1-10]
10. F The statute of limitations generally expires three years after a return is filed. [Statute of Limitations, p. 1-21]

Fill-in-the-Blanks

1. 16th, 1913 [Early Periods, p. 1-3]
2. ad valorem [Property Taxes, p. 1-7]
3. economic [Encouragement of Certain Activities, p. 1-26]
4. political [Political Expediency Situations, p. 1-31]
5. social [Social Considerations, p. 1-27]
7. FICA, FUTA [Employment Taxes, p. 1-16]
8. pay-as-you-go [Income Taxes, p. 1-14]
12. FUTA [FUTA Taxes, p. 1-17]

Multiple Choice

1. b On a tax base of $10,000 the effective tax rate was 30% and, as the tax base increased to $100,000, the effective tax rate decreased to 20%. [Tax Rates, p. 1-6]
2. a On a tax base of $10,000 the effective tax rate was 30% and, as the tax base increased to $100,000, the effective rate increased to 35%. [Tax Rates, p. 1-6]
3. c On a tax base of $10,000 the effective tax rate was 30% and, as the tax base increased to $100,000, the effective tax rate remained 30%. [Tax Rates, p. 1-6]
4. c Both taxes’ rates increase as the value of the transferred property increases. [Taxes on Transfers at Death, p. 1-11]
5. d This concept is embodied in the installment method of income recognition. [The Wherewithal to Pay Concept, p. 1-29]
6. a,b,c  All of these provisions potentially encourage taxpayers to engage in economic activities that they might not otherwise undertake because of the favorable tax treatment provided. [Economic Considerations, p. 1-26]

7. b  These provisions stabilize the need for government support of retirees. [Social Considerations, p. 1-27]

8. d  Equity reflects fairness among taxpayers and across income levels. [Equity Considerations, p. 1-28]

9. b  While the last major revision was in 1986, many amendments to the 1986 Code have been adopted since then. [Revenue Acts, p. 1-3]

10. d  Courts cannot change congressional intent as to the tax law. [Influence of the Courts, p. 1-33]

11. c  In 1986 there were 15 rates ranging from 0 to 50%; the current tax structure includes rates of 0, 10, 15, 25, 28, 33, and 35%. [Incidence of Taxation, p. 1-6]


13. a,b,c  Small business generally draws the favor of congress. [Understanding the Federal Tax Law, p. 1-25]

14. d  Though, despite their efforts, the federal income tax law seldom gets less complex. [Understanding the Federal Tax Law, p. 1-25]