CHAPTER 1
AN INTRODUCTION TO TAXATION
AND UNDERSTANDING THE FEDERAL TAX LAW

CHAPTER HIGHLIGHTS

1.1 LEARNING AND COPING WITH TAXATION

A review of the history of the U.S. Federal tax system is helpful for the student to gain an understanding of the principles, which have shaped the development of the system. This chapter introduces the student to the structure of the U.S. Federal tax system, the major types of taxes, and the organizational aspects of administering the tax law.

1.2 HISTORY OF U.S. TAXATION

A. There have been several income taxes in the past. The first North American income tax was enacted in 1634 in the Massachusetts Bay Colony. The first U.S. income tax was passed in 1861 to help finance the Civil War. In 1894, the Supreme Court, in Pollock v. Farmers' Loan and Trust Co., held that an early version of the individual income tax was unconstitutional. In response to this Supreme Court decision, a constitutional amendment was passed to authorize the individual income tax. The Sixteenth Amendment, which was ratified in 1913, gave Congress the power to impose and collect an income tax. Before the Sixteenth Amendment, the corporate income tax was held to be an excise tax, and therefore, deemed constitutional by the Supreme Court.

B. Various Revenue Acts were passed between 1913 and 1939. In 1939, these Acts were codified into the Internal Revenue Code of 1939, which was later recodified in 1954 and renamed in 1986 as the Internal Revenue Code of 1986.
C. Over the years, the individual income tax has become the major source of revenue (45% of Federal receipts in 2010) for the Federal government. During World War II, the tax went from a select tax to a mass tax.

1.3 CRITERIA USED IN THE SELECTION OF A TAX STRUCTURE

Adam Smith listed certain criteria with which to evaluate a particular tax or tax structure. These "canons of taxation" are equality, convenience, certainty, and economy.

I1.4 THE TAX STRUCTURE

A. Tax Base. The tax base is the amount to which the tax rate is applied.

B. Tax Rates. Tax rates are the percentage applied to the tax base.

A progressive tax is one in which the tax rates increase as the tax base increases. The Federal income, gift, and estate taxes and most state income taxes are progressive taxes.

A proportional tax is one in which the rate of tax remains constant despite the size of the tax base.

C. The incidence of taxation is the degree to which each segment of society shares the total tax burden.

1.5 MAJOR TYPES OF TAXES

A. Property taxes or ad valorem taxes are taxes that are based on value. The tax is usually imposed on realty or personalty. Realty taxes are a major source of revenue for local government. Personalty taxes on personal use property generally have low compliance by taxpayers, except personal property taxes on items such as automobiles. Compliance with personalty taxes on business use property, such as inventory and machinery, is markedly better.

B. Transaction taxes impose a tax on transfers of property and are normally computed as a straight percentage of the value of the property involved.

Excise taxes are taxes on products such as gasoline, telephone usage, air travel, alcohol, and tobacco. Both the Federal and state governments usually impose some form of excise tax. At the local level, hotel occupancy taxes and rental car “surcharges” have become more prevalent.

Sales taxes differ from excise taxes in that sales taxes are applied to many different transactions, while excise taxes are applied to one product or transaction. A use tax is designed to prevent circumvention of the sales tax, such as where a resident of a state with a sales tax buys products in another state with no sales tax or a lower sales tax rate in an attempt to avoid the sales tax. Many states allow local sales taxes by cities, counties, etc., besides the general sales tax.

C. Death taxes are taxes imposed on either the right to transfer property at death (estate tax) or the right to receive property from a decedent (inheritance tax).
The Federal estate tax is designed to prevent large concentrations of wealth from being kept within the same family. The unified transfer credit eliminates or reduces the estate tax liability for small estates. The Federal government does not impose an inheritance tax.

Most states levy some form of death tax. If the death tax is an inheritance tax, the rates are generally lower for close family members and get larger the more distant the heir.

D. The Federal gift tax was enacted into law to complement the estate tax since without it, it would be possible to avoid the estate tax by making lifetime gifts and eliminating the gross estate. The Federal gift tax is determined by taking into account prior taxable gifts so that the tax rate is based on cumulative taxable gifts.

E. In the United States, income taxes are levied by the Federal government and most state governments and are the most popular forms of tax. Income taxes are imposed on individuals, corporations, and certain estates and trusts. The tax formula for individuals is shown as follows:

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<th>Determine</th>
<th>Income broadly conceived</th>
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<tr>
<td>Less</td>
<td>(Exclusions)</td>
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<tr>
<td>Equals</td>
<td>Gross income</td>
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<td>Less</td>
<td>(Certain business deductions and deductions for AGI)</td>
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<tr>
<td>Equals</td>
<td>Adjusted gross income</td>
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<tr>
<td>Less</td>
<td>(Greater of itemized deductions or the standard deduction)</td>
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<tr>
<td>Less</td>
<td>(Exemptions)</td>
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<tr>
<td>Equals</td>
<td>Taxable income</td>
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<tr>
<td>Calculate</td>
<td>Tax on taxable income</td>
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<tr>
<td>Less</td>
<td>(Credits and withholding)</td>
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<tr>
<td>Equals</td>
<td>Tax due or (refund)</td>
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For individual taxpayers a standard deduction amount is available to taxpayers who do not itemize deductions.

The Federal income tax applies to corporations. The taxable income of a corporation is the difference between gross income and deductions.

Nearly all of the states impose a state income tax on individuals and corporations. All but the following states impose an income tax on individuals: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. New Hampshire and Tennessee impose an individual income tax only on interest and dividends. Most states pattern their income tax after the Federal income tax and use an adjusted Federal taxable income figure as a base on which to apply the tax. However, due to budgetary constraints, some states are “decoupling” from certain recent Federal tax reductions. Most states have some form of withholding procedures. The states taxing authorities work closely with the IRS and share information about audits and other changes in tax returns. Many cities impose an income tax including but not limited to Cleveland, Detroit, New York, and Philadelphia.
F. Employment taxes such as the FICA (Federal Insurance Contributions Act) tax are collected by the Federal government. The FICA tax consists of the old age, survivors, and disability insurance tax and the hospital insurance tax (Medicare).

FICA taxes fund the Social Security system and are levied on both the employee and the employer. Employees and self-employed individuals pay FICA tax and Medicare tax on wages they earn. For 2011, the Social Security Tax is 4.2 percent for employees, 6.2% for employers with a base of $106,800 and the Medicare tax is 1.45 percent with no base limit for both employees and employers. The employer must match an employee's contribution.

The FUTA tax is levied only on the employer with the purpose of providing the states with funds to administer the unemployment program. A credit is allowed for any FUTA paid to a state government.

G. Other U. S. Taxes. Federal Customs Duties are tariffs on certain imported goods. In recent years, Customs Duties are used more to protect U.S. industries from foreign competition than to raise revenue to run the government.

There are several miscellaneous state and local taxes such as franchise taxes, occupational taxes, etc.

H. Proposed U.S. Taxes. There are several proposed changes to the U.S. tax system. These changes include The Flat Tax, The Value Added Tax, and a national sales tax. The Flat Tax would keep the income tax with substantial changes. The other two taxes would replace the U.S. income tax with a different system of taxation altogether.

1.6 TAX ADMINISTRATION

A. The Internal Revenue Service (IRS), which is part of the Treasury Department, has responsibility for administering the Federal tax law. The IRS uses statistical sampling techniques to select tax returns for an audit.

B. IRS audits are classified as "office audits" or "field audits." Office audits are restricted in scope and are conducted in the IRS office. A field audit is comprehensive and is conducted on the premises of the taxpayer or the taxpayer's representative.

C. The general statute of limitations for an IRS assessment is three years from the date the return is filed, unless the return is filed early in which case the limitation period runs from the date the return is due. There is no statute of limitations if no return or a fraudulent return is filed.

D. The interest rate used by the federal government for overpayments and underpayments of tax are adjusted quarterly. For the first quarter of 2011, the rate is 4 percent. See www.irs.gov for the current rates. Besides interest, various penalties are applied for noncompliance. For "failure to file" a tax return a penalty of five percent per month, or fraction thereof, is charged up to a 25 percent maximum. The penalty for "failure to pay" is one-half percent per month, or fraction thereof, up to a maximum of 25 percent. If both penalties apply to the same return, the failure to file penalty is reduced by the failure to pay penalty. Penalties also apply where the underpayment is due to negligence or fraud.
E. Penalties are also assessed on tax return preparers. These include penalties for understatement of a tax liability if it is based on a position that cannot realistically be sustained, any willful attempt to understate taxes, and violation of certain procedural matters.

1.7 UNDERSTANDING THE FEDERAL TAX LAW

A. Revenue Needs

Raising revenue is a major function of taxation. However, there are several other functions of the U.S. tax law. The tax law is also used to control the economy. Attempts at stimulation or temperance of the national economy have led to many amendments to the Internal Revenue Code.

B. Economic Considerations

The tax law contains many provisions to encourage investment and capital formation.

Lowering the tax rates gives taxpayers more income to spend, and is another method used to stimulate the economy. An increase in tax rates would have the opposite effect.

Another economic consideration of the tax law is to encourage certain activities. The favorable incentives granted research and development expenditures, the rapid amortization of pollution control facilities, and the special treatment accorded U.S. citizens with foreign-source income are examples of these types of provisions in the tax law. IRAs and other pension plans are examples of using the tax law to help the economic problem of capital formation.

The encouragement of certain industries is another economic consideration of the tax law. Agriculture, for example, is an industry that has special tax benefits.

Small businesses are generally considered good for the economy as a whole. Therefore, certain provisions of the tax law are designed to help small businesses. The S Corporation election is an example of one of the methods Congress uses to help small businesses through tax law provisions.

C. Social Considerations

The U.S. tax law contains many provisions intended to achieve social objectives. Examples of such social provisions are:

1) Nontaxability of employer-sponsored accident and health plans

2) Nontaxability of employer paid premiums for group-term insurance

3) Qualified pension and profit sharing plans

4) Deductions for contributions to charitable organizations
5) Credit for childcare expenditures, higher education, and energy efficient property

6) Disallowance of deductions for expenditures that are against public policy (fines, penalties, etc.)

D. Equity Considerations

The Federal tax law attempts to alleviate the effects of multiple taxation in several areas. Examples include the deduction for state, local, and foreign income tax and the foreign tax credit.

The wherewithal to pay concept recognizes the inequity of taxing a transaction where the taxpayer lacks the means with which to pay the tax. Sometimes the Federal tax rules, such as those where a taxpayer reinvests the proceeds from an involuntary conversion (e.g., a casualty loss) in similar property, allow the taxpayers to defer recognition of gain when his or her economic situation has not changed significantly.

Mitigating the effect of the concept of an annual accounting period is an equity consideration that deals with the inequities, which arise from the arbitrary use of the annual accounting period to divide the taxpayer's life into taxable segments. The annual accounting period concept could lead to different treatment of two individuals who are, from a long-range standpoint, in the same economic position. Measures to alleviate this inequity include the carryover procedure for net operating losses, excess capital losses and excess charitable contributions, and the installment method of recognizing gain.

One major problem in recent years has been bracket creep, which was caused by inflation. Taxpayers were pushed into higher tax brackets without a real increase in income. This problem is addressed by indexing. Each year, beginning in 1989, the tax brackets and the standard deduction are indexed upward by the amount of inflation. The personal and dependency exemptions are also indexed based on inflation.

E. Political Considerations

Special interest legislation includes tax provisions sponsored because of the instigation of influential constituents. Such legislation is inevitable in our political system and can sometimes be justified on economic, social, or utilitarian grounds.

Political expediency is responsible for the passage of tax provisions that have popular appeal such as measures that ensure wealthy taxpayers pay their "fair" share of tax, the lowering of individual income tax rates, and increasing the exemption amount.

State and local influences explain the nontaxability of interest received on state and local obligations, and the extension under Federal tax law of community property tax advantages to residents of common law states.

F. Influence of the IRS

As protector of the revenue, the IRS has a great deal of influence on shaping the tax law. In this role, the IRS tries to close what it sees as loopholes in the tax law.
Many provisions of the tax law are for administrative feasibility, and exist because they simplify the work of the IRS in collecting the revenue or administering the tax law. Withholding procedures place taxpayers on a pay-as-you-go basis and so aid the IRS in the collection of revenue. Interest and penalties imposed for noncompliance with tax laws are also of considerable help to the IRS.

G. Influences of the Courts

The Federal courts have influenced the tax law. Some court decisions have been of such consequence that Congress has incorporated them into the Internal Revenue Code. The rule that allows tax-free stock dividends is an example of a court decision being codified.

**KEY TERMS:**

*Ad valorem taxes*

*Correspondence audit*

*Death tax*

*Employment taxes*

*Estate tax*

*Excise taxes*

*FICA tax*

*Field audit*

*Flat Tax*

*Franchise Tax*

*FUTA tax*

*Gift tax*

*Inheritance Tax*

*National Sales Tax*

*Occupational Fees*

*Office audit*

*Personalty Tax*

*Realty Tax*

*Revenue neutrality*
Sales tax

Severance Taxes

Statute of limitations

Sunset provision

Use Tax

Value added tax (VAT)

Wherewithal to pay
### TEST FOR SELF-EVALUATION

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

<p>| T | F | 1. | The first U.S. Federal income tax was enacted to provide revenues for the Civil War. |
| T | F | 2. | The Supreme Court held that the 1894 income tax law was constitutional since it was a direct tax. |
| T | F | 3. | The Sixteenth Amendment was necessary to enact the corporate income tax of 1909. |
| T | F | 4. | The first Internal Revenue Code was the Internal Revenue Code of 1939. |
| T | F | 5. | The current tax law is the Internal Revenue Code of 1986, as amended. |
| T | F | 6. | The corporate income tax provides the largest percentage of Federal tax revenues. |
| T | F | 7. | During World War II, the income tax was converted from being a select tax to being a mass tax. |
| T | F | 8. | The responsibility for administering the Federal tax law rests with the Internal Revenue Service, which is part of the Treasury Department. |
| T | F | 9. | The Internal Revenue Service openly reveals its audit selection techniques. |
| T | F | 10. | Historically, the purpose of the gift tax is to prevent widespread avoidance of the estate tax. |
| T | F | 11. | The amount of salary to which the old age, survivors, and disability insurance (OASDI) portion of the FICA tax is subject to an annual maximum amount of $106,800 in 2011. |
| T | F | 12. | Tax rates are applied to a tax base to determine a taxpayer’s liability. |
| T | F | 13. | Tax collections from individual income taxes are the largest portion of the Federal government's budget receipts. |
| T | F | 14. | Ad valorem taxes are taxes that are based on income derived from property. |
| T | F | 15. | Property taxes on personality have a high rate of compliance, while taxes on realty have a low rate of compliance. |
| T | F | 16. | Excise taxes are levied on specific transactions or products, while sales taxes are collected on transactions involving a wide range of products. |
| T | F | 17. | Excise taxes are sometimes used to influence social behavior. |</p>
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<td>T</td>
<td>F</td>
<td>18. The Federal government is the only government allowed to impose excise taxes on products.</td>
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<td>T</td>
<td>F</td>
<td>19. Over the years, the primary purpose of the estate tax in the United States has been to generate revenue with which to operate the Federal government.</td>
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<tr>
<td>T</td>
<td>F</td>
<td>20. The Federal gift tax is imposed on transfers made during the owner’s life and not at death.</td>
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<tr>
<td>T</td>
<td>F</td>
<td>21. State inheritance taxes usually tax all heirs at the same rate.</td>
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<td>T</td>
<td>F</td>
<td>22. In 2011, the annual exclusion for Federal gift tax purposes is $17,500 per year per donee.</td>
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<td>T</td>
<td>F</td>
<td>23. A taxpayer can minimize his Federal gift tax liability by making several small taxable gifts rather than a single large taxable gift.</td>
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<td>T</td>
<td>F</td>
<td>24. All states impose some form of income tax on individuals who reside in that state.</td>
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<td>T</td>
<td>F</td>
<td>25. Some cities impose an income tax along with the Federal and state income taxes.</td>
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<td>T</td>
<td>F</td>
<td>26. In recent years, tariffs have served the nation more as an instrument for carrying out protectionist policies than for generating revenue.</td>
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<td>T</td>
<td>F</td>
<td>27. The interest rates applicable to underpayments and overpayments of Federal income taxes used by the Internal Revenue Service are determined every quarter.</td>
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<td>T</td>
<td>F</td>
<td>28. The progressiveness of the U.S. Federal income tax rate structure for individuals has varied over time.</td>
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<td>T</td>
<td>F</td>
<td>29. Certain provisions of the U.S. income tax law are designed to help small businesses.</td>
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<td>T</td>
<td>F</td>
<td>30. An example of a social consideration in the tax law is the nontaxability of health plan benefits.</td>
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<td>T</td>
<td>F</td>
<td>31. The wherewithal to pay concept states that a taxpayer should pay the tax on all gains, even when his economic position has not changed.</td>
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<tr>
<td>T</td>
<td>F</td>
<td>32. Many provisions of the tax law can be explained by looking at the influence of public opinion on Congress.</td>
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<td>T</td>
<td>F</td>
<td>33. One role assumed by the Internal Revenue Service is that of &quot;protector of the revenue.&quot;</td>
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<td>T</td>
<td>F</td>
<td>34. Some of the tax law is justified because it complicates the Internal Revenue Service's task of collecting revenue.</td>
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Chapter 1: An Introduction to Taxation

35. The courts have established the rule that the relief provisions of the Code are to be broadly interpreted.

36. Some court decisions have been of such consequence that Congress has written them into the tax laws.

37. The tax law attempts to encourage technological progress.

38. Economic considerations in the tax law help regulate the economy.

39. One equity consideration of the tax law is the alleviation of multiple taxation.

40. Carryback and carryover procedures help mitigate the effect of limiting a loss or deduction to the accounting period in which it was realized.

41. The amounts of the standard deduction, exemptions, and tax brackets will be indexed for inflation in the future.

42. In future years, budget deficit problems will probably influence many new tax provisions passed by Congress.

43. For purposes of the gift tax, a special election applicable to married persons allows 75 percent of a gift made by a donor spouse to be treated as made by the nondonor spouse.

44. In order to mitigate the effects of double taxation, most states allow nonresidents a tax credit for income taxes paid to their resident state.

45. Taxpayers can be fined and sent to prison for committing civil tax fraud when filing their Federal tax return.

Multiple Choice

Choose the best answer for each of the following questions.

1. Which of the following is an employment tax?
   a. The Gift Tax
   b. FICA Tax
   c. Customs duties
   d. Excise taxes

2. Which of the following items will not be subject to indexing under the tax law?
   a. The standard deduction
   b. Personal and dependency exemptions
   c. The child care credit
   d. The tax brackets

3. The total FICA tax rate imposed on individual taxpayers is?
   a. OASDI rate plus the FUTA rate
   b. OASDI rate less FUTA rate
c. OASDI rate plus Medicare rate  
d. OASDI rate less Medicare rate  

4. The installment method of reporting gains can be justified based on:  
a. Mitigation of the annual accounting period  
b. Wherewithal to pay  
c. Social consideration  
d. Both mitigation of the annual accounting period and wherewithal to pay  

5. Raul's gross income is $80,000 and he has business deductions of $6,000. His itemized deductions are $10,000 and he has one personal exemption. Raul's taxable income is calculated as:  
a. $80,000 - 6,000 - 10,000  
b. $80,000 - 6,000 - 10,000 - exemption  
c. $80,000 - 6,000 - 10,000 + exemption  
d. $80,000 - 6,000 - exemption  

6. Jeanne earned wages of $120,000. The total amount of FICA tax due from Jeanne and her employer is calculated as follows:  
a. \[\text{(OASDI rate} \times \text{annual maximum)} + \text{(Medicare rate} \times $120,000)\]  
b. \[\text{(OASDI rate} \times \text{annual maximum)} + \text{(Medicare rate} \times $120,000)\] x 2  
c. \[(\text{OASDI rate} + \text{Medicare rate}) \times \text{annual maximum} \times 2\]  
d. \[(\text{OASDI rate} + \text{Medicare rate}) \times $120,000 \times 2\]  

7. The total FUTA tax payable by their employer before any state credits is calculated as:  
a. FUTA wages x FUTA rate  
b. (FUTA wages x FUTA rate) x 2  
c. (FUTA wages x FUTA rate) x 50%  
d. FUTA wages x (FUTA rate - FICA rate)  

8. Byron files his tax return 45 days late. Along with the return, he remits a check for $6,000, which is the balance of the tax owed. Disregarding interest, what is Byron's penalty for failure to file?  
a. $-0-  
b. $60  
c. $540  
d. $600  

9. The value added tax is:  
a. used by several European Union countries  
b. a form of income tax on corporations  
c. a tax on consumption  
d. both used by several European Union countries and a tax on consumption  

10. John received $140,000 when the state condemned his house for a new freeway. The house cost John $84,000. John immediately purchased a new home for $140,000. From this sale, John should report a taxable gain of:  
a. $-0-  
b. $56,000  
c. $140,000  
d. $84,000  

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11. Interest rates charged by the IRS for taxpayer assessments (underpayments) and for tax refunds (overpayments) are determined:
   a. Monthly
   b. Quarterly
   c. Semi-Annually
   d. Annually

12. Vicky filed her 2010 individual tax return on January 15, 2011. The return was properly signed and filed. The statute of limitations for Vicky's 2010 return expires on:
   a. January 15, 2014
   b. April 15, 2014
   c. January 15, 2013
   d. April 15, 2013

13. Mark and Silva are married with four grown children, three of whom are married, and six grandchildren. What is the maximum amount Mark and Jane can give to their family in 2011 without incurring the Federal gift tax if they elect "gift splitting?"
   a. $246,000
   b. $220,000
   c. $312,000
   d. $338,000

14. Which of the following is not an economic consideration of the tax law?
   a. Encouragement of small business
   b. Encouragement of certain industries
   c. The wherewithal to pay concept
   d. Encouragement of certain activities

15. The net operating loss provision of the tax law is an example of:
   a. An economic consideration
   b. A social consideration
   c. A political consideration
   d. An equity consideration

16. Which of the following is not a social consideration in the tax law?
   a. Qualified pension and profit-sharing plan
   b. Expensing soil and water conservation costs
   c. Child care credit
   d. A speeding ticket paid by a truck driver is nondeductible

17. Which of the following is the best example of a tax law provision designed to aid in controlling the economy?
   a. Depreciation deduction
   b. Child care credit
   c. Personal exemption
   d. Net operating loss carryover

18. Smith Corporation pays $4,000 per month rent on a building to Mary Smith, its sole shareholder. The fair market value of the rent determined at "arm's length" would be $1,800 per month. Smith Corporation will be allowed a monthly rental deduction of:
   a. $0-
   b. $1,800

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c. $2,200  
d. $4,000

19. A father rents property to his daughter for $10,000 a year. If the IRS wants to examine this transaction, it will be interested in:  
a. The tax benefit rule  
b. Installment sales rules  
c. The arm's length concept  
d. Public policy limitations

20. Several years ago, Fran entered into an agreement to rent a building to Meg for 20 years. During the first year of the lease, Meg made $60,000 in capital improvements to the building. This year the lease is terminated and Fran takes possession of the building. The fair market value of the capital improvements in the year of termination is $75,000. In the year of the termination of the lease, Fran must recognize taxable gain of:  
a. $-0-  
b. $15,000  
c. $60,000  
d. $75,000

21. On a tax return that is filed 45 days late, Christy pays $33,000 in additional taxes. Of this amount, $10,000 is attributable to Christy's negligence. What is Christy's negligence penalty?  
a. $-0-  
b. $500  
c. $2,000  
d. $6,600

22. When a tax base is $20,000, the tax liability is $6,000 and when the tax base is $200,000, the tax liability is $60,000. This tax rate structure is:  
a. Progressive  
b. Regressive  
c. Proportional  
d. Parallel

23. When a tax base is $20,000, the tax liability is $6,000 and when the tax base is $200,000, the tax liability is $80,000. This tax rate structure is:  
a. Progressive  
b. Regressive  
c. Proportional  
d. Parallel

24. For 1913 individual tax returns filed on March 1, 1914, the maximum marginal tax rate was.  
a. 6%  
b. 10%  
c. 12%  
d. 15%

25. The pay-as-you-go system of withholding used by the United States Government was passed into law in:  
a. 1913  
b. 1925
26. A(n) ________ tax is an ad valorem tax (usually at the same rate as the sales tax) on the utilization, consumption, or storage of tangible property.
   a. Excise
   b. Severance
   c. Luxury
   d. Use

27. Which of the following states does not impose an income tax on individuals?
   a. Virginia
   b. Nevada
   c. Vermont
   d. Alabama

28. Which of the following was not part of the Guiding Principles of Good Tax Policy issued by the AICPA?
   a. The tax system should not reduce economic growth and efficiency.
   b. The tax system should be simple.
   c. The tax system should influence business decisions.
   d. The tax system should be structured to minimize noncompliance.

29. The American Institute of CPAs has a set of enforceable pronouncements for tax practice by CPAs. The name of these pronouncements is:
   a. The Tax Code of Ethics
   b. Circular 230
   c. Statements on Standards for Tax Services
   d. Statements on Responsibilities in Tax Practice

30. For 2010, Maureen, a calendar year taxpayer, reported gross income of $200,000 on a timely filed income tax return. Maureen omitted $52,000 from that return. Because of her omission, the statute of limitation for her 2010 return is?
   a. 3-years
   b. 4-years
   c. 5-years
   d. 6-years

31. In the case of civil fraud by a taxpayer, the penalty is _____ percent of the underpayment attributable to the fraud.
   a. 5
   b. 8
   c. 20
   d. 75

32. In the case of negligence by a taxpayer, the penalty is _____ percent of the underpayment attributable to the fraud.
   a. 5
   b. 8
   c. 20
   d. 75
33. Interest paid by a taxpayer on an understatement of income tax is _____ percent in the first quarter of 2011.
   a. 4
   b. 5
   c. 6
   d. 8
SOLUTIONS TO CHAPTER 1

True or False

1. True The U.S. income tax was for the Civil War. [Early Periods p.1-3]
2. False The income tax was unconstitutional because it was not apportioned. [Early Periods p.1-3]
3. False The 1909 corporate income tax was held to be constitutional. [Early Periods p.1-3]
4. True The first Code was the 1939 Code. [Revenue Acts p.1-3]
5. True The current tax law is the Internal Revenue Code of 1986. [Revenue Acts p.1-3]
6. False The individual income tax provides the largest percent. [Historical Trends p.1-4]
7. True The income tax went from a select tax to a mass tax in WWII. [Historical Trends p.1-4]
8. True The Treasury Department administers the income tax through the Internal Revenue Service. [Internal Revenue Service p.1-21]
10. True Preventing the avoidance of the estate tax is the purpose of the gift tax. [2010] [The Federal Gift Tax p.1-13]
11. True Salary for OASDI tax is subject to an annual maximum of $106,800 in 2010. [Employment Taxes p.1-16]
12. True Tax rates are applied to the tax base. [Tax Rates p.1-6]
13. True Individual income taxes are the largest portion the budget receipts. [Historical Trends p.1-4]
14. False Ad valorem taxes are based on the value of the property. [Property Taxes p.1-7]
15. False The tax on realty has a high compliance rate. [Property Taxes p.1-8]
16. True Excise taxes are on specific transaction and sales taxes are general. [Transaction Taxes p.1-10]
17. True Excise taxes are used to influence behavior. [Transaction Taxes p.1-9]
18. False State and local governments can also impose excise taxes. [Transaction Taxes p.1-10]
19. False The estate tax is intended to prevent concentrations of wealth.[2010] [Death Taxes p.1-12]
20. True Gift taxes are imposed on transfers during the donor’s life. [Gift Taxes p.1-13]
21. False Inheritance taxes generally are imposed on distant heirs at a higher rate. [Death Taxes p.1-12]
22. False The exclusion is $13,000 per year in 2011. The exclusion will be indexed in the future as the level of inflation warrants. [Gift Taxes p.1-13]
23. False The gift tax is based on the taxpayer's cumulative taxable gifts. [Gift Taxes p.1-14]
24. False Several states do not have a state income tax. [Income Taxes p.1-16]
25. True Some cities impose an income tax. [Income Taxes p.1-17]
26. True Recently, tariffs have served to carry out protectionist policies. [Other U.S. Taxes p.1-19]
27. True Interest rates are determined quarterly. [Interest and Penalties p.1-24]
28. True The progressiveness of tax rates has varied over time. [Incidence of Taxation p.1-6]
29. True Certain tax law provisions are to help small business. [Economic Considerations p.1-29]
30. True Nontaxability of health plans is a social consideration. [Social Considerations p.1-30]
31. False The wherewithal to pay concept recognizes that under some circumstances, even though a gain has been realized by the taxpayer, the taxpayer's economic position may not have changed. [Equity Considerations p.1-31]
32. True The mood of the American public influences the tax law. [Political Considerations p.1-33]
33. True Protector of the Revenue is one role of the IRS. [Influence of the IRS p.1-34]
34. False  Some of the law is justified because it simplifies the work of the IRS. [Influence of the IRS p. 1-34]
35. False  The relief provisions are to be narrowly interpreted. [Influence of the Courts p. 1-35]
36. True  Some court decisions are codified. [Influence of the Courts p. 1-35]
37. True  Technological progress is encouraged by the tax law. [Economic Considerations p. 1-28]
38. True  The tax law helps regulate the economy. [Economic Considerations p. 1-28]
39. True  The tax law helps alleviate multiple taxation. [Equity Considerations p. 1-31]
40. True  Accounting periods are mitigated by carrybacks and carryovers. [Equity Considerations p. 1-32]
41. True  The standard deduction, exemptions, and tax brackets are indexed for inflation. [Equity Considerations p. 1-33]
42. True  Budget deficits influence many tax provisions since a deficit-conscious Congress is often guided by the concept of revenue neutrality. [Revenue Needs p. 1-27]
43. False  The gift is split 50-50. [Gift Taxes p. 1-13]
44. False  Most states allow their residents some form of tax credit for income taxes paid to other states. [Income Taxes p. 1-16]
45. False  Taxpayers can be fined and sent to prison for committing criminal (not civil) tax fraud. [Interest and Penalties p. 1-25]

Multiple Choice

1. B  FICA is an employment tax. [Employment Taxes p. 1-18]
2. C  The child care credit is not indexed. [Equity Considerations p. 1-33]
3. C  The OASDI rate plus Medicare rate is the total rate. [Employment Taxes p. 1-18]
4. D  The installment method mitigates the annual accounting period and the wherewithal to pay concept since recognition of gain is tied to the collection of the installment note. [Equity Considerations p. 1-32]
5. B  $80,000 - 6,000 - 10,000 - exemption. [Income Taxes p. 1-14]
6. B  [[(OASDI rate x annual maximum) + (Medicare rate x $120,000)] x 2. [Employment Taxes p. 1-18]
8. C  5% per month or fraction thereof, or 10% x $6,000 = $600, less failure to pay penalty of .5% per month or fraction thereof, (1% x $6,000 = $60), which equals $540. [Interest and Penalties p. 1-24]
9. D  The VAT is a consumption tax used by several European countries. [Proposed U.S. Taxes p. 1-20]
10. A  The gain is not taxable. [Equity Considerations p. 1-31]
11. B  The interest rates are determined quarterly. [Interest and Penalties p. 1-24]
12. B  The statute of limitations is 3 years from due date of the return. [Statute of Limitations p. 1-23]
13. D  By electing "gift splitting" to 13 family members (4 children, 3 spouses of children, and 6 grandchildren), $338,000 can be given in 2011 (13 x $13,000 x 2). [Gift Taxes p. 1-31]
14. C  Wherewithal to pay is an equity consideration. [Equity Considerations p. 1-31]
15. D  NOLs are an equity consideration. [Equity Considerations p. 1-32]
16. B  Soil and water conservation expensing is an economic consideration. [Economic Considerations p. 1-28]
17. A  The depreciation deduction aids in controlling the economy. [Economic Considerations p. 1-28]
18. B  The amount is what would be paid to an unrelated third party. [Influence of the Courts p. 1-35]
19. C Rentals between related parties are judged by the arms length concept. [Influence of the Courts p. 1-35]

20. A The improvements are not income. [Influence of the Courts p. 1-36]

21. C $2,000 = 20\% \times 10,000$ [Interest and Penalties p. 1-25]

22. C When the tax rate stays the same the tax is proportional. [Tax Rates p. 1-6]

23. A When the tax rate increases the tax is progressive. [Tax Rates p. 1-6]


25. C The pay-as-you-go system was passed in 1943. [Historical Trends p. 1-4]

26. D A use tax is an ad valorem tax. [Transaction Taxes p. 1-10]

27. B Nevada does not have a state income tax. [Income Taxes p. 1-16]

28. C The tax should be neutral in terms of its effect on business decisions. [Criteria Used in the Selection of a Tax Structure p. 1-5]


30. D The omission is 30\% (60,000 / 200,000), which exceeds 25\%. Thus, the statute of limitation is 6-years. [Statute of Limitations p. 1-21]

31. D The civil fraud penalty is 75\% of the underpayment. [Interest and Penalties p. 1-25]

32. C The civil fraud penalty is 20\% of the underpayment. [Interest and Penalties p. 1-25]

33. A The interest rate is 4\% in the 1st quarter of 2011. [Interest and Penalties p. 1-24]