CHAPTER 1

An Introduction to Taxation and Understanding the Federal Tax Law

LEARNING OBJECTIVES

After completing Chapter 1, you should be able to:

LO.1 Appreciate why taxation is important. (pp. 1-2 to 1-3)

LO.2 Understand some of the history and trends of the Federal income tax. (pp. 1-3 to 1-4)

LO.3 Know some of the criteria for selecting a tax structure; understand the components of a tax structure. (pp. 1-4 to 1-6)

LO.4 Identify the different taxes imposed in the United States at the Federal, state, and local levels. (pp. 1-6 to 1-19)

LO.5 Understand the administration of the tax law, including the audit process utilized by the IRS. (pp. 1-19 to 1-23)

LO.6 Know some of the ethical guidelines involved in tax practice. (pp. 1-23 to 1-24)

LO.7 Recognize the economic, social, equity, and political considerations that justify various aspects of the tax law. (pp. 1-25 to 1-32)

LO.8 Describe the role played by the IRS and the courts in the evolution of the Federal tax system. (pp. 1-32 to 1-34)
Samantha has a summer internship with an accounting firm in Atlanta. On her first day at the firm, she filled out a variety of employment-related forms. Her only previous employment was helping out in her family’s grocery store on Saturdays while she was in high school. She received an allowance, but the amount was not related to the number of hours she worked. For the prior three summers, Samantha attended summer school.

Samantha’s monthly compensation is $5,000 (payable semimonthly). When she receives her first paycheck, it is for only $1,733.75. She knew that there would be some withholdings, but she is surprised at how much was deducted from the $2,500. (She is scheduled to take her two required Federal tax courses this coming academic year.) How would you determine if Samantha’s paycheck is for the correct amount and explain the difference between her gross pay and net pay? Read the chapter and formulate your response.

The primary objective of this chapter is to provide an overview of the Federal tax system. Among the topics discussed are the following:

- The importance and relevance of taxation.
- The history of the Federal income tax in brief.
- The types of taxes imposed at the Federal, state, and local levels.
- Some highlights of tax law administration.
- Tax concepts that help explain the reasons for various tax provisions.
- The influence that the Internal Revenue Service (IRS) and the courts have had in the evolution of current tax law.

1.1 Learning and Coping with Taxation

The study of taxation is important because taxes permeate our society. Even the simplest of decisions can carry tax implications. Does it matter, for example, which son or daughter pays the medical bills when all of four adult children contribute to the support of their widowed mother? Or if you use your automobile in a business, is it worth your time and effort to use the actual cost method of calculating the expenses rather than the simpler automatic mileage method?

Effectively coping with taxes often involves making decisions based on timing considerations. Does the employee who is trying to decide between a traditional Individual Retirement Account (IRA) and a Roth IRA want the tax benefit up front (i.e., traditional) or at retirement (i.e., Roth)? Timing considerations are paramount when it is deemed desirable to accelerate (or defer) income or accelerate (or defer) deductions for any one year.

The study of taxation teaches us not to overlook the less obvious taxes that can block our intended objective. A grandson inherits his grandmother’s personal residence. He has heard that rental property can generate significant income tax benefits. But does he realize that a change of ownership may unlock an appraised-value freeze on the property? Or that conversion from residential to income-producing use will cause an increase in ad valorem taxes on realty? Thus, an attractive income tax result could be materially diminished by adverse property tax consequences.

It is essential in working with taxation to maintain a balanced perspective. A corporation that is deciding where to locate a new factory does not automatically select the city or state that offers the most generous tax benefits. Nor does the person who is retiring to a warmer climate pick Belize over Arizona because the former has no
income tax while the latter does. Tax considerations should not control, but they
remain one of many factors to be considered.

The study of taxation involves reviewing a multitude of rules and exceptions and,
when possible, trying to understand the justification for them. But the desired goal
of this learning process is the ability to recognize issues that carry tax implications.
Suppose, for example, that you come upon a situation that involves a discharge of
indebtedness. If you know that forgiveness of debt results in income but there are
exceptions to this rule, the battle is won! The issue has been identified, and the out-
come (i.e., when an exception applies) can easily be resolved by additional research.

1.2 HISTORY OF U.S. TAXATION

EARLY PERIODS
The concept of an income tax can hardly be regarded as a newcomer to the Western
Hemisphere. An income tax was first enacted in 1634 by the English colonists in the
Massachusetts Bay Colony, but the Federal government did not adopt this form of
taxation until 1861. In fact, both the Federal Union and the Confederate States of
America used the income tax to raise funds to finance the Civil War. Although mod-
est in its reach and characterized by broad exemptions and low rates, the income tax
generated $376 million of revenue for the Federal government during the Civil War.

When the Civil War ended, the need for additional revenue disappeared, and the
income tax was repealed. Once again the Federal government was able to finance
its operations almost exclusively from customs duties (tariffs). It is interesting to
note that the courts held that the Civil War income tax was not contrary to the
Constitution.

When a new Federal income tax on individuals was enacted in 1894, its opponents
were prepared and were able to successfully challenge its constitutionality. The U.S.
Constitution provided that “No Capitation, or other direct, Tax shall be laid, unless
in Proportion to the Census or Enumeration herein before directed to be taken.” In
Pollock v. Farmers’ Loan and Trust Co., the U.S. Supreme Court found that taxes on the
income of real and personal property were the legal equivalent of a tax on the prop-
erty involved and, therefore, required apportionment.1

A Federal corporate income tax, enacted by Congress in 1909, fared better in the
judicial system. The U.S. Supreme Court found this tax to be constitutional because it
was treated as an excise tax.2 In essence, it was a tax on the right to do business in the
corporate form. As such, it was likened to a form of the franchise tax.3 The corporate
form of doing business had been developed in the late nineteenth century and was an
unfamiliar concept to the framers of the U.S. Constitution. Since a corporation is an
entity created under law, jurisdictions possess the right to tax its creation and opera-
tion. Using this rationale, many states still impose franchise taxes on corporations.

The ratification of the Sixteenth Amendment to the U.S. Constitution in 1913
sanctioned both the Federal individual and corporate income taxes and, as a conse-
quence, neutralized the continuing effect of the Pollock decision.

REVENUE ACTS
Following ratification of the Sixteenth Amendment, Congress enacted the Revenue
Act of 1913. Under this Act, the first Form 1040 was due on March 1, 1914. The law
allowed various deductions and personal exemptions of $3,000 for a single individual
and $4,000 for married taxpayers. Rates ranged from a low of 2 percent to a high of
6 percent. The 6 percent rate applied only to taxable income in excess of $500,000!4

1See the discussion of state franchise taxes later in the chapter.
2AFTR 2834, 31 S.Ct. 342 (USSC, 1911).
315 S.Ct. 912 (USSC, 1895). See Chapter 2 for an explanation of
the citations of judicial decisions.
4This should be contrasted with the highest 2010 tax rate of 35%, which
applies once taxable income exceeds $373,650.
Various revenue acts were passed between 1913 and 1939. In 1939, all of these revenue laws were codified into the Internal Revenue Code of 1939. In 1954, a similar codification of the revenue law took place. The current law is entitled the Internal Revenue Code of 1986, which largely carries over the provisions of the 1954 Code. To date, the Code has been amended numerous times since 1986. This matter is discussed further in Chapter 2 under Origin of the Internal Revenue Code.

**HISTORICAL TRENDS**

The income tax has proved to be a major source of revenue for the Federal government. Figure 1.1, which contains a breakdown of the major revenue sources, demonstrates the importance of the income tax. Estimated income tax collections from individuals and corporations amount to 56 percent of the total receipts.

The need for revenues to finance the war effort during World War II converted the income tax into a mass tax. For example, in 1939, less than 6 percent of the U.S. population was subject to the Federal income tax. In 1945, over 74 percent of the population was subject to the Federal income tax.

Certain changes in the income tax law are of particular significance in understanding the Federal income tax. In 1943, Congress passed the Current Tax Payment Act, which provided for the first pay-as-you-go tax system. A pay-as-you-go income tax system requires employers to withhold for taxes a specified portion of an employee’s wages. Persons with income from other than wages may have to make quarterly payments to the IRS for estimated taxes due for the year.

One trend that has caused considerable concern is the increasing complexity of the Federal income tax laws. In the name of tax reform, Congress has added to this complexity by frequently changing the tax laws. Most recent legislation continues this trend. Increasingly, this complexity forces many taxpayers to seek assistance. According to recent estimates, about 60 percent of all taxpayers who file a return pay a preparer, and 22 percent purchase tax software. At this time, therefore, substantial support exists for tax law simplification.

### 1.3 Criteria Used in the Selection of a Tax Structure

In the eighteenth century, Adam Smith identified the following canons of taxation, which are still considered when evaluating a particular tax structure:

- **Equality.** Each taxpayer enjoys fair or equitable treatment by paying taxes in proportion to his or her income level. Ability to pay a tax is the measure of how equitably a tax is distributed among taxpayers.

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Convenience. Administrative simplicity has long been valued in formulating tax policy. If a tax is easily assessed and collected and its administrative costs are low, it should be favored. An advantage of the withholding (pay-as-you-go) system is its convenience for taxpayers.

Certainty. A tax structure is good if the taxpayer can readily predict when, where, and how a tax will be levied. Individuals and businesses need to know the likely tax consequences of a particular type of transaction.

Economy. A good tax system involves only nominal collection costs by the government and minimal compliance costs on the part of the taxpayer. Although the government's cost of collecting Federal taxes amounts to less than one-half of 1 percent of the revenue collected, the complexity of our current tax structure imposes substantial taxpayer compliance costs.

By these canons, the Federal income tax is a contentious product. Equality is present as long as one accepts ability to pay as an ingredient of this component. Convenience exists due to a heavy reliance on pay-as-you-go procedures. Certainty probably generates the greatest controversy. In one sense, certainty is present since a mass of administrative and judicial guidelines exists to aid in interpreting the tax law. In another sense, however, certainty does not exist since many questions remain unanswered and frequent changes in the tax law by Congress lessen stability. Particularly troublesome in this regard are tax provisions that are given a limited life (e.g., 2009). If not extended by Congress, the provisions expire. All too often, Congress does not give the necessary approval in time, and the extension has to be applied retroactively. Economy is present if only the collection procedure of the IRS is considered. Economy is not present, however, if one focuses instead on taxpayer compliance efforts and costs.

1.4 The Tax Structure

TAX BASE

A tax base is the amount to which the tax rate is applied. In the case of the Federal income tax, the tax base is taxable income. As noted later in the chapter (Figure 1.2), taxable income is gross income reduced by certain deductions (both business and personal).
TAX RATES

Tax rates are applied to the tax base to determine a taxpayer’s liability. The tax rates may be proportional or progressive. A tax is proportional if the rate of tax remains constant for any given income level. Examples of proportional taxes include most excise taxes, general sales taxes, and employment taxes (FICA, FUTA).

EXAMPLE 1

Bill has $10,000 of taxable income and pays a tax of $3,000, or 30%. Bob’s taxable income is $50,000, and the tax on this amount is $15,000, or 30%. If this constant rate is applied throughout the rate structure, the tax is proportional.

A tax is progressive if a higher rate of tax applies as the tax base increases. The Federal income tax, Federal gift and estate taxes, and most state income tax rate structures are progressive.

EXAMPLE 2

If Cora, a married individual filing jointly, has taxable income of $10,000, her tax for 2010 is $1,000 for an average tax rate of 10%. If, however, Cora’s taxable income is $50,000, her tax will be $6,663 for an average tax rate of 13.3%. The tax is progressive since higher rates are applied to greater amounts of taxable income.

INCIDENCE OF TAXATION

The degree to which various segments of society share the total tax burden is difficult to assess. Assumptions must be made concerning who absorbs the burden of paying the tax. For example, since dividend payments to shareholders are not deductible by a corporation and are generally taxable to shareholders, the same income is subject to a form of double taxation. Concern over double taxation is valid to the extent that corporations are not able to shift the corporate tax to the consumer through higher commodity prices. Many research studies have shown a high degree of shifting of the corporate income tax, converting it into a consumption tax that is borne by the ultimate purchasers of goods.

The progressiveness of the Federal income tax rate structure for individuals has varied over the years. As late as 1986, for example, there were 15 rates, ranging from 0 to 50 percent. These later were reduced to two rates of 15 and 28 percent. Currently, there are six rates ranging from 10 to 35 percent.

1.5 MAJOR TYPES OF TAXES

Why does a text devoted primarily to the Federal income tax discuss state and local taxes? A simple illustration shows the importance of non-Federal taxes.

EXAMPLE 3

Rick is employed by Flamingo Corporation in San Antonio, Texas, at a salary of $74,000. Rick’s employer offers him a chance to transfer to its New York City office at a salary of $94,000. A quick computation indicates that the additional taxes (Federal, state, and local) involve approximately $12,000.

Although Rick must consider many nontax factors before he decides on a job change, he should also evaluate the tax climate. How do state and local taxes compare? For example, neither Texas nor San Antonio imposes an income tax, but New York State and New York City both do. Consequently, what appears to be a $20,000 pay increase is only $8,000 when the additional taxes of $12,000 are taken into account.
PROPERTY TAXES

Correctly referred to as ad valorem taxes because they are based on value, property taxes are a tax on wealth, or capital. In this regard, they have much in common with estate taxes and gift taxes discussed later in the chapter. Although property taxes do not tax income, the income actually derived (or the potential for any income) may be relevant insofar as it affects the value of the property being taxed.

Property taxes fall into two categories: those imposed on realty and those imposed on personality, or assets other than land and buildings. Both have added importance since they usually generate a deduction for Federal income tax purposes (see Chapter 10).

Ad Valorem Taxes on Realty

Property taxes on realty are used exclusively by states and their local political subdivisions, such as cities, counties, and school districts. They represent a major source of revenue for local governments, but their importance at the state level has waned over the past few years. Some states, for example, have imposed freezes on upward revaluations of residential housing.

How realty is defined can have an important bearing on which assets are subject to tax. This is especially true in jurisdictions that do not impose ad valorem taxes on personality. Primarily a question of state property law, realty generally includes real estate and any capital improvements that are classified as fixtures. Simply stated, a fixture is something so permanently attached to the real estate that its removal will cause irreparable damage. A built-in bookcase might well be a fixture, whereas a movable bookcase would not be a fixture. Certain items such as electrical wiring and plumbing cease to be personality when installed in a building and become realty.

The following are some of the characteristics of ad valorem taxes on realty:

- Property owned by the Federal government is exempt from tax. Similar immunity usually is extended to property owned by state and local governments and by certain charitable organizations.
- Some states provide for lower valuations on property dedicated to agricultural use or other special uses (e.g., wildlife sanctuaries). Reductions in appraised valuations may also be available when the property is subject to a conservation easement (e.g., a limitation on further development).
- Some states partially exempt the homestead, or personal residence, portion of property from taxation. Additionally, modern homestead laws normally protect some or all of a personal residence (including a farm or ranch) from the actions of creditors pursuing claims against the owner.
- Lower taxes may apply to a residence owned by a taxpayer age 65 or older.
- When non-income-producing property (e.g., a personal residence) is converted to income-producing property (e.g., a rental house), typically the appraised value increases.
- Some jurisdictions extend immunity from tax for a specified period of time (a tax holiday) to new or relocated businesses. A tax holiday can backfire, however, and cause more harm than good. If it is too generous, it can damage the local infrastructure (e.g., less funding for public works and education).

Unlike the ad valorem tax on personality (see below), the tax on realty is difficult to avoid. Since real estate is impossible to hide, a high degree of taxpayer compliance is not surprising. The only avoidance possibility that is generally available is associated with the assessed value of the property. For this reason, the assessed value of the property—particularly, a value that is reassessed upward—may be subject to controversy and litigation.

The history of the ad valorem tax on realty has been marked by inconsistent application due to a lack of competent tax administration and definitive guidelines for
assessment procedures. In recent years, however, some significant improvements have occurred. Some jurisdictions, for example, have computerized their reassessment procedures so that they will immediately affect all property located within the jurisdiction. Even more aggravating for the property owner is an increase in assessed value that is based on past market values and does not reflect the true current value. This kind of increase often occurs during periods of economic downturn, when real estate prices decline. Under these conditions, increases in assessed value are likely to cause considerable taxpayer dissatisfaction and lead to proposals for legislative relief, such as a freeze on upward property assessments.

**Ad Valorem Taxes on Personalty**

*Personalty* can be defined as all assets that are not realty. It may be helpful to distinguish between the classification of an asset (realty or personalty) and the use to which it is put. Both realty and personalty can be either business use or personal use property. Examples include a residence (realty that is personal use), an office building (realty that is business use), surgical instruments (personalty that is business use), and regular wearing apparel (personalty that is personal use).

Personalty can also be classified as tangible property or intangible property. For ad valorem tax purposes, intangible personalty includes stocks, bonds, and various other securities (e.g., bank shares).

The following generalizations may be made concerning the ad valorem taxes on personalty:

- Particularly with personalty devoted to personal use (e.g., jewelry, household furnishings), taxpayer compliance ranges from poor to zero. Some jurisdictions do not even attempt to enforce the tax on these items. For automobiles devoted to personal use, many jurisdictions have converted from value as the tax base to arbitrary license fees based on the weight of the vehicle. Some jurisdictions also consider the vehicle’s age (e.g., automobiles six years or older are not subject to the ad valorem tax because they are presumed to have little, if any, value).
- For personalty devoted to business use (e.g., inventories, trucks, machinery, equipment), taxpayer compliance and enforcement procedures are measurably better.

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*The distinction, important for ad valorem and for Federal income tax purposes, often becomes confused when personalty is referred to as “personal” property to distinguish it from “real” property. This designation does not give a complete picture of what is involved. The description “personal” residence, however, is clearer, since a residence can be identified as being realty. What is meant, in this case, is realty that is personal use property.*
Which jurisdiction possesses the authority to tax movable personalty (e.g., railroad rolling stock) always has been and continues to be a troublesome issue.

A few states levy an ad valorem tax on intangibles such as stocks and bonds. Taxpayer compliance may be negligible if the state lacks a means of verifying security transactions and ownership.

**TRANSACTION TAXES**

Transaction taxes, which characteristically are imposed at the manufacturer’s, wholesaler’s, or retailer’s level, cover a wide range of transfers. Like many other types of taxes (e.g., income taxes, death taxes, and gift taxes), transaction taxes usually are not within the exclusive province of any level of taxing authority (Federal, state, local government). As the description implies, these levies place a tax on transfers of property and normally are determined by multiplying the value involved by a percentage rate.

**Federal Excise Taxes**

Long one of the mainstays of the Federal tax system, Federal excise taxes had declined in relative importance until recently. In recent years, Congress substantially increased the Federal excise taxes on such items as tobacco products, fuel and gasoline sales, and air travel. Other Federal excise taxes include the following:

- Manufacturers’ excise taxes on trucks, trailers, tires, firearms, sporting equipment, and coal and the gas guzzler tax on automobiles.9
- Alcohol taxes.
- Miscellaneous taxes (e.g., the tax on wagering).

The list of transactions covered, although seemingly impressive, has diminished over the years. At one time, for example, there was a Federal excise tax on admission to amusement facilities (e.g., theaters) and on the sale of such items as leather goods, jewelry, furs, and cosmetics.

When reviewing the list of both Federal and state excise taxes, one should recognize the possibility that the tax laws may be trying to influence social behavior. For example, the gas guzzler tax is intended as an incentive for the automobile companies to build fuel-efficient cars.

**State and Local Excise Taxes**

Many state and local excise taxes parallel the Federal version. Thus, all states tax the sale of gasoline, liquor, and tobacco products; however, unlike the Federal version, the rates vary significantly. For gasoline products, for example, compare the 37.5 cents per gallon imposed by the state of Washington with the 8 cents per gallon levied by the state of Alaska. For tobacco sales, contrast the 7 cents per pack of 20 cigarettes in effect in South Carolina with the $3.46 per pack applicable in the state of Rhode Island. Given the latter situation, is it surprising that the smuggling of cigarettes for resale elsewhere is so widespread?

Other excise taxes found at some state and local levels include those on admission to amusement facilities, on the sale of playing cards, and on prepared foods. Most states impose a transaction tax on the transfer of property that requires the recording of documents (e.g., real estate sales).10 Some extend the tax to the transfer of stocks and other securities.

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9The gas guzzler tax is imposed on the manufacturers of automobiles (both domestic and foreign) and increases in amount as the mileage ratings per gallon of gas decrease. For example, a Maserati Gran Turismo manages 13 miles per gallon in suburban driving and starts at $121,100, which includes a $2,100 gas guzzler tax.

10This type of tax has much in common with the stamp tax levied by Great Britain on the American colonies during the pre-Revolutionary War period in U.S. history.
Over the last few years, two types of excise taxes imposed at the local level have become increasingly popular: the hotel occupancy tax and the rental car “surcharge.” Since they tax the visitor who cannot vote, they are a political windfall and are often used to finance special projects that generate civic pride (e.g., convention centers, state-of-the-art sports arenas). These levies can be significant, as demonstrated by Houston’s hotel tax of 17 percent and the car rental tax and fees of 35 percent at the Kansas City, Missouri airport.

**General Sales Taxes**

The distinction between an excise tax and a general sales tax is easy to make. One is restricted to a particular transaction (e.g., the 18.4 cents per gallon Federal excise tax on the sale of gasoline), while the other covers a multitude of transactions (e.g., a 5 percent tax on all retail sales). In actual practice, however, the distinction is not always that clear. Some state statutes exempt certain transactions from the application of the general sales taxes (e.g., sales of food to be consumed off the premises, sales of certain medicines and drugs). Also, it is not uncommon to find that rates vary depending on the commodity involved. Many states, for example, allow preferential rates for the sale of agricultural equipment or apply different rates (either higher or lower than the general rate) to the sale of automobiles. With many of these special exceptions and classifications of rates, a general sales tax can take on the appearance of a collection of individual excise taxes.

A use tax is an ad valorem tax, usually at the same rate as the sales tax, on the use, consumption, or storage of tangible property purchased outside the state but used within the state. The purpose of a use tax is to prevent the avoidance of a sales tax. Every state that imposes a general sales tax levied on the consumer also has a use tax. Alaska, Delaware, Montana, New Hampshire, and Oregon have neither tax. There is no Federal general sales or use tax.

**Example 4**

The state where Susan resides imposes a 5% general sales tax, but the neighboring state has no sales tax. Susan purchases an automobile for $20,000 from a dealer located in the neighboring state. Has she saved $1,000 in sales taxes? No, because the state use tax will pick up the difference between the tax paid in the neighboring state (none here) and what would have been paid in the state in which Susan resides.

The use tax is difficult to enforce for many purchases and is therefore often avoided. In some cases, for example, it may be worthwhile to make purchases through an out-of-state mail-order business or the websites of local vendors. In spite of shipping costs, the avoidance of the local sales tax that otherwise might be incurred can lower the cost of such products as computer components. Some states
are taking steps to curtail this loss of revenue. For items such as automobiles (refer to Example 4), the use tax probably will be collected when the purchaser registers the item in his or her home state.

**EXAMPLE 5**

Pete and Sam both live in a state that has a general sales tax of 3%. Sam, however, resides in a city that imposes an additional general sales tax of 2%. Even though Pete and Sam live in the same state, one is subject to a rate of 3%, while the other pays a tax of 5%.

For various reasons, some jurisdictions will suspend the application of a general sales tax. New York City does so to stimulate shopping. Illinois has permanently suspended the tax on construction materials used to build power-generating plants. Texas and numerous other states do so annually on clothing right before the beginning of the school year. Such suspensions are similar to the tax holidays granted for ad valorem tax purposes. As state revenues have declined in recent years, many states have had misgivings about the advisability of scheduling further sales tax holidays. Turning off the spigot could have political consequences, however. These holidays are extremely popular with both merchants and shoppers, so their termination could cause voter backlash at the polls.

**Severance Taxes**

Severance taxes are transaction taxes that are based on the notion that the state has an interest in its natural resources (e.g., oil, gas, iron ore, coal). Therefore, a tax is imposed when the natural resources are extracted.

For some states, severance taxes can be a significant source of revenue. Due to the severance tax on oil production, Alaska has been able to avoid both a state income tax and a state general sales tax.

**TAXES ON TRANSFERS AT DEATH**

The right to transfer property or to receive property upon the death of the owner may be subject to estate and/or inheritance taxes. Consequently, such taxes fall into the category of excise taxes. If the tax is imposed on the right to pass property at death, it is classified as an estate tax. If it taxes the right to receive property from a decedent, it is termed an inheritance tax. As is typical of other types of excise taxes, the value of the property transferred provides the base for determining the amount of the tax.

The Federal government imposes only an estate tax. State governments, however, may levy inheritance taxes, estate taxes, or both. Some states (e.g., Florida, Texas) levy neither tax.

**EXAMPLE 6**

At the time of her death, Wilma lived in a state that imposes an inheritance tax but not an estate tax. Mary, one of Wilma’s heirs, lives in the same state. Wilma’s estate is subject to the Federal estate tax, and Mary is subject to the state inheritance tax.
The Federal Estate Tax
The Revenue Act of 1916 incorporated the estate tax into the tax law. The tax was originally intended to prevent large concentrations of wealth from being kept within a family for many generations. Whether this objective has been accomplished is debatable. Like the income tax, estate taxes can be reduced through various planning procedures.

The gross estate includes property the decedent owned at the time of death. It also includes property interests, such as life insurance proceeds paid to the estate or to a beneficiary other than the estate if the deceased-insured had any ownership rights in the policy. Quite simply, the gross estate represents property interests subject to Federal estate taxation.11 All property included in the gross estate is valued as of the date of death or, if the alternate valuation date is elected, six months later.12

Deductions from the gross estate in arriving at the taxable estate include funeral and administration expenses, certain taxes, debts of the decedent, casualty losses13 incurred during the administration of the estate, transfers to charitable organizations, and, in some cases, the marital deduction. The marital deduction is available for amounts actually passing to a surviving spouse (a widow or widower).

Once the taxable estate has been determined and certain taxable gifts made by the decedent during life have been added to it, the estate tax can be computed. From the amount derived from the appropriate tax rate schedules, various credits should be subtracted to arrive at the tax, if any, that is due.14 Although many other credits are also available, probably the most significant is the unified transfer tax credit. The main reason for this credit is to eliminate or reduce the estate tax liability for modest estates. For 2009, the amount of the credit is $1,455,800. Based on the estate tax rates, the credit exempts a tax base of up to $3.5 million.

EXAMPLE 7
Ned made no taxable gifts before his death in 2009. If Ned’s taxable estate amounts to $3.5 million or less, no Federal estate tax is due because of the application of the unified transfer tax credit. Under the tax law, the estate tax on a taxable estate of $3.5 million is $1,455,800.

The Federal estate tax has been criticized by some for imposing a hardship on small businesses and, in particular, on family farms. Many believe that the need to pay the estate tax on the death of a major owner often forces the heirs to dissolve and liquidate the family business. In the Tax Relief Reconciliation Act of 2001, Congress responded to this criticism and scheduled a phaseout of the Federal estate tax, to be accomplished over a 10-year period by increasing the amount of the credit at periodic intervals. Consequently, the Federal estate tax was due to be eliminated in 2010. For budgetary reasons, the Act included a “sunset” provision that reinstates the Federal estate tax (as it was prior to the phaseout) as of January 1, 2011. Although some in Congress have tried to enact legislation that would repeal the sunset provision, their efforts have not been successful. As it stands now, therefore, the Federal estate tax is scheduled to end and then begin again. Obviously, this is a situation that cannot last, as it makes meaningful estate planning impossible. (Sunset provisions are discussed further later in the chapter.)

State Taxes on Transfers at Death
As noted earlier, states may levy an inheritance tax, an estate tax, or both. The two forms of taxes on transfers at death differ according to whether the tax is imposed on the heirs or on the estate.

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11For further information on these matters, see Chapter 27.
12See the discussion of the alternate valuation date in Chapter 13.
13For a definition of “casualty losses,” see the Glossary in Appendix C.
14For tax purposes, it is always crucial to appreciate the difference between a deduction and a credit. A credit is a dollar-for-dollar reduction of tax liability.
Characteristically, an inheritance tax divides the heirs into classes based on their relationship to the decedent. The more closely related the heir, the lower the rates imposed and the greater the exemption allowed. Some states completely exempt from taxation amounts passing to a surviving spouse.

**GIFT TAXES**

Like taxes on transfers at death, a **gift tax** is an excise tax levied on the right to transfer property. In this case, however, the tax is imposed on transfers made during the owner’s life and not at death. A gift tax applies only to transfers that are not offset by full and adequate consideration.

**EXAMPLE 8**

Carl sells property worth $50,000 to his daughter for $1,000. Although property worth $50,000 has been transferred, only $49,000 represents a gift, since this is the portion not supported by full and adequate consideration.

**The Federal Gift Tax**

First enacted in 1932, the Federal gift tax was intended to complement the estate tax. If lifetime transfers by gift were not taxed, it would be possible to avoid the estate tax and escape taxation entirely.

Only taxable gifts are subject to the gift tax. For this purpose, a taxable gift is measured by the fair market value of the property on the date of transfer less the annual exclusion per donee and, in some cases, less the marital deduction, which allows tax-free transfers between spouses. Each donor is allowed an annual exclusion of $13,000 in 2010 for each donee.15

**EXAMPLE 9**

On December 31, 2010, Louise (a widow) gives $13,000 to each of her four married children, their spouses, and her eight grandchildren. On January 2, 2011, she repeats the procedure, giving $13,000 to each recipient. Due to the annual exclusion, Louise has not made a taxable gift, although she transferred $208,000 ($13,000 (annual exclusion) × 16 (donees)) in 2010 and $208,000 ($13,000 (annual exclusion) × 16 (donees)) in 2011, for a total of $416,000 ($208,000 + $208,000).

A special election applicable to married persons allows one-half of the gift made by the donor-spouse to be treated as being made by the nondonor-spouse (gift splitting). This election to split the gifts of property made to third persons has the effect of increasing the number of annual exclusions available. Also, it allows the use of the nondonor-spouse’s unified transfer tax credit and may lower the tax rates that will apply.

The gift tax rate schedule is the same as that applicable to the estate tax. The schedule is commonly referred to as the **unified transfer tax schedule**.

The Federal gift tax is cumulative in effect. What this means is that the tax base for current taxable gifts includes past taxable gifts. Although a credit is allowed for prior gift taxes, the result of adding past taxable gifts to current taxable gifts could be to force the donor into a higher tax bracket.16 Like the Federal estate tax rates, the Federal gift tax rates are progressive (see Example 2 earlier in this chapter).

The unified transfer tax credit is available for all taxable gifts; the amount of this credit for 2009 is $345,800. There is, however, only one unified transfer tax credit, and it applies both to taxable gifts and to the Federal estate tax. In a manner of speaking, therefore, once the unified transfer tax credit has been exhausted for Federal gift tax purposes, it is no longer available to insulate a decedent’s transfers from the Federal estate tax, except to the extent of the excess of the credit amount for estate tax purposes over that for gift tax purposes.

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15The purpose of the annual exclusion is to avoid the need to report and pay a tax on modest gifts. Without the exclusion, the IRS could face a real problem of taxpayer noncompliance. The annual exclusion is indexed as the level of inflation warrants. The exclusion was $12,000 from 2006 through 2008.

16For further information on the Federal gift tax, see Chapter 27.
As noted above, the Tax Relief Reconciliation Act of 2001 proposes to phase out the Federal estate tax. The reason for the elimination of the estate tax does not apply to the gift tax. Unlike death, which is involuntary, the making of a gift is a voluntary parting of ownership. Thus, the ownership of a business can be transferred gradually without incurring drastic and immediate tax consequences. As a result, the Federal gift tax is to be retained with the unified transfer tax credit frozen at $345,800 (which covers a taxable gift of $1 million).

Even though a larger unified transfer tax credit of $1,455,800 in 2009 is available for transfers by death, lifetime gifts continue to be attractive. If income-producing property is involved (e.g., marketable securities, rental real estate), a gift may reduce income taxes for the family unit by shifting subsequent income to lower-bracket donees. If the gift involves property that is expected to appreciate in value (e.g., life insurance policies, real estate, artworks), future increases in value will be assigned to the donee and will not be included in the donor’s estate. Also important is that due to the annual exclusion ($13,000 per donee in 2010), some of the gift is not subject to any gift tax. Recall that the gift-splitting election enables married donors to double up on the annual exclusion.

**INCOME TAXES**

Income taxes are levied by the Federal government, most states, and some local governments. The trend in recent years has been to place greater reliance on this method of taxation. This trend is not consistent with what is happening in other countries, and in this sense, our system of taxation is somewhat different.

Income taxes generally are imposed on individuals, corporations, and certain fiduciaries (estates and trusts). Most jurisdictions attempt to assure the collection of income taxes by requiring pay-as-you-go procedures, including withholding requirements for employees and estimated tax prepayments for all taxpayers.

**Federal Income Taxes**

The Federal income tax that is imposed on individuals follows the formula set forth in Figure 1.2. The formula for the individual income tax establishes the framework followed in the text. Beginning with Chapter 3, each component of the formula is

<table>
<thead>
<tr>
<th><strong>Figure 1.2</strong> Formula for Federal Income Tax on Individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income (broadly conceived) $xx,xxx</td>
</tr>
<tr>
<td>Less: Exclusions (income that is not subject to tax) $xxx</td>
</tr>
<tr>
<td>Gross income (income that is subject to tax) $xx,xxx</td>
</tr>
<tr>
<td>Less: Certain deductions (usually referred to as deductions for adjusted gross income) $xxx</td>
</tr>
<tr>
<td>Adjusted gross income $xx,xxx</td>
</tr>
<tr>
<td>Less: The greater of certain personal and employee deductions (usually referred to as itemized deductions) $xxx</td>
</tr>
<tr>
<td>or The standard deduction (including any additional standard deduction) $xxx</td>
</tr>
<tr>
<td>and Less: Personal and dependency exemptions $xxx</td>
</tr>
<tr>
<td>Taxable income $xx,xxx</td>
</tr>
<tr>
<td>Tax on taxable income (see the Tax Tables and Tax Rate Schedules in Appendix A) $xxx</td>
</tr>
<tr>
<td>Less: Tax credits (including Federal income tax withheld and other prepayments of Federal income taxes) $xxx</td>
</tr>
<tr>
<td>Tax due (or refund) $xxx</td>
</tr>
</tbody>
</table>
illustrated and explained. In large part, the text coverage of individual taxpayers follows the same order as the components in the formula.

Like its individual counterpart, the Federal corporate income tax is progressive in nature. But its application does not require the computation of adjusted gross income (AGI) and does not provide for the standard deduction and personal and dependency exemptions. All allowable deductions of a corporation fall into the business-expense category. In effect, therefore, the taxable income of a corporation is the difference between gross income (net of exclusions) and deductions. Chapter 17 summarizes the rules relating to the determination of taxable income of corporations.

State Income Taxes
All but the following states impose an income tax on individuals: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

Some of the characteristics of state income taxes are summarized as follows:

- With few exceptions, all states require some form of withholding procedures.
- Most states use as the tax base the income determination made for Federal income tax purposes.
- A minority of states go even further and impose a flat rate upon AGI as computed for Federal income tax purposes. Several apply a rate to the Federal income tax liability. This is often referred to as the piggyback approach to state income taxation. Although the term piggyback does not lend itself to precise definition, in this context, it means making use, for state income tax purposes, of what was done for Federal income tax purposes.
- Some states are somewhat eroding the piggyback approach by “decoupling” from selected recent tax reductions passed by Congress. The purpose of the decoupling is to retain state revenue that would otherwise be lost. In other words, the state cannot afford to allow its taxpayers the same deductions for state purposes that are allowed for Federal purposes.
- Because of the tie-ins to the Federal return, a state may be notified of any changes made by the IRS upon audit of a Federal return. In recent years, the exchange of information between the IRS and state taxing authorities has increased. Lately, some states (e.g., California) are playing a major role in revealing tax shelter abuses to the IRS.
- Most states allow a deduction for personal and dependency exemptions. Some states substitute a tax credit for a deduction.
- A diminishing minority of states allow a deduction for Federal income taxes.
- Virtually all state income tax returns provide checkoff boxes for donations to various causes. Many are dedicated to medical research and wildlife programs, but special projects are not uncommon. For example,
Oklahoma has one to retire the debt incurred for its new capitol dome, while Wisconsin tries to finance part of the renovation of Lambeau Field (home of the Green Bay Packers). These checkoff boxes have been criticized as adding complexity to the returns (e.g., one state has 24 boxes) and misleading taxpayers.  

- Most states allow their residents some form of tax credit for income taxes paid to other states.
- The objective of most states is to tax the income of residents and those who regularly conduct business within the state (e.g., nonresidents who commute to work). These states also purport to tax the income of nonresidents who earn income within the state on an itinerant basis. Usually, however, the visitors actually taxed are highly paid athletes and entertainers. This so-called jock tax has been much criticized as being discriminatory due to its selective imposition.
- The due date for filing generally is the same as for the Federal income tax (the fifteenth day of the fourth month following the close of the tax year).
- Some states have occasionally instituted amnesty programs that allow taxpayers to pay back taxes (and interest) on unreported income with no (or reduced) penalty. In many cases, the tax amnesty has generated enough revenue to warrant the authorization of follow-up programs covering future years—one state has had four amnesty periods, and seven states have had at least three. Amnesties usually include other taxes as well (e.g., sales, franchise, severance). One major advantage of amnesty programs is that they uncover taxpayers that were previously unknown to the taxing authority.

Nearly all states have an income tax applicable to corporations. It is difficult to determine those that do not because a state franchise tax (discussed later in the chapter) sometimes is based in part on the income earned by the corporation.

**Local Income Taxes**

Cities imposing an income tax include, but are not limited to, Baltimore, Cincinnati, Cleveland, Detroit, Kansas City (Missouri), New York, Philadelphia, and St. Louis. The application of a city income tax is not limited to local residents.

**EMPLOYMENT TAXES**

Classification as an employee usually leads to the imposition of employment taxes and to the requirement that the employer withhold specified amounts for income taxes. The material that follows concentrates on the two major employment taxes: FICA (Federal Insurance Contributions Act—commonly referred to as the Social Security tax) and FUTA (Federal Unemployment Tax Act). Both taxes can be justified by social and public welfare considerations: FICA offers some measure of retirement security, and FUTA provides a modest source of income in the event of loss of employment.

Employment taxes come into play only if two conditions are satisfied. First, is the individual involved an employee (as opposed to self-employed)? The differences between an employee and a self-employed person are discussed in Chapter 9. Second, if the individual involved is an employee, is he or she covered under FICA or FUTA or both? Detailed coverage of both of these taxes is included in Employer’s Tax Guide, an IRS publication.

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17Many taxpayers do not realize that they are paying for the checkoff donation (usually with some of their income tax refund). Unlike the presidential election campaign fund available for Federal income tax purposes ($3 in this case), the contribution is not made by the government.

18Although the suggestion has been made, no comparable amnesty program has been offered for the Federal income tax.
**FICA Taxes**

The FICA tax rates and wage base have increased steadily over the years. It is difficult to imagine that the initial rate in 1937 was only 1 percent of the first $3,000 of covered wages. Thus, the maximum tax due was only $30!

Currently, the FICA tax has two components: Social Security tax (old age, survivors, and disability insurance) and Medicare tax (hospital insurance). The Social Security tax rate is 6.2 percent for 2009 and 2010, and the Medicare tax rate is 1.45 percent for these years. The base amount for Social Security is $106,800 for 2009 and 2010.\(^\text{19}\) There is no limit on the base amount for the Medicare tax. The employer must match the employee’s portion for both the Social Security tax and the Medicare tax.

A spouse employed by another spouse is subject to FICA. However, children under the age of 18 who are employed in a parent’s unincorporated trade or business are exempted.

Taxpayers who are not employees (e.g., sole proprietors, independent contractors) may also be subject to Social Security taxes. Known as the self-employment tax, the rates are 12.4 percent for Social Security and 2.9 percent for Medicare, or twice that applicable to an employee. The tax is imposed on net self-employment income up to a base amount of $106,800 for 2009 and 2010. See Chapter 12 for additional coverage of the self-employment tax.

**FUTA Taxes**

The purpose of the FUTA tax is to provide funds that the states can use to administer unemployment benefits. This leads to the somewhat unusual situation of one tax being handled by both Federal and state governments. The end result of such joint administration is to compel the employer to observe two sets of rules. Thus, state and Federal returns must be filed and payments made to both governmental units.

In 2010, FUTA is 6.2 percent (6.0 percent plus a 0.2 percent surtax) on the first $7,000 of covered wages paid during the year to each employee. The Federal government allows a credit for FUTA paid (or allowed under a merit rating system) to the state. The credit cannot exceed 5.4 percent of the covered wages. Thus, the amount required to be paid to the IRS could be as low as 0.8 percent \((6.2\% - 5.4\%)\).

States follow a policy of reducing the unemployment tax on employers who experience stable employment. Thus, an employer with little or no employee turnover might find that the state rate drops to as low as 0.1 percent or, in some states, even to zero. The reason for the merit rating credit is that the state has to pay fewer unemployment benefits when employment is steady.

FUTA differs from FICA in the sense that the incidence of taxation falls entirely upon the employer. A few states, however, levy a special tax on employees to provide either disability benefits or supplemental unemployment compensation, or both.

**OTHER U.S. TAXES**

To complete the overview of the U.S. tax system, some missing links need to be covered that do not fit into the classifications discussed elsewhere in this chapter.

**Federal Customs Duties**

One tax that has not yet been mentioned is the tariff on certain imported goods.\(^\text{20}\) Generally referred to as customs duties or levies, this tax, together with selective excise taxes, provided most of the revenues needed by the Federal government during the nineteenth century. In view of present times, it is remarkable to note that tariffs and excise taxes alone paid off the national debt in 1835 and enabled the U.S. Treasury to pay a surplus of $28 million to the states.

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\(^{\text{19}}\)The base amount is subject to adjustment annually.  
\(^{\text{20}}\)Less-developed countries that rely principally on one or more major commodities (e.g., oil, coffee) are prone to favor export duties as well.
In recent years, tariffs have served the nation more as an instrument for carrying out protectionist policies than as a means of generating revenue. Thus, a particular U.S. industry might be saved from economic disaster, so the argument goes, by imposing customs duties on the importation of foreign goods that can be sold at lower prices. Protectionists contend that the tariff thereby neutralizes the competitive edge held by the producer of the foreign goods.21

Protectionist policies seem more appropriate for less-developed countries whose industrial capacity has not yet matured. In a world where a developed country should have everything to gain by encouraging international free trade, such policies may be of dubious value. History shows that tariffs often lead to retaliatory action on the part of the nation or nations affected.

**Miscellaneous State and Local Taxes**

Most states impose a franchise tax on corporations. Basically, a **franchise tax** is levied on the right to do business in the state. The base used for the determination of the tax varies from state to state. Although corporate income considerations may come into play, this tax most often is based on the capitalization of the corporation (either with or without certain long-term indebtedness).

Closely akin to the franchise tax are **occupational fees** applicable to various trades or businesses, such as a liquor store license, a taxicab permit, or a fee to practice a profession such as law, medicine, or accounting. Most of these are not significant revenue producers and fall more into the category of licenses than taxes. The revenue derived is used to defray the cost incurred by the jurisdiction in regulating the business or profession in the interest of the public good.

**PROPOSED U.S. TAXES**

Considerable dissatisfaction with the U.S. Federal income tax has led to several recent proposals that, to say the least, are rather drastic in nature. One proposal would retain the income tax but with substantial change. Two other proposals would replace the Federal income tax with an entirely different system of taxation.

**The Flat Tax**

One proposal is for a **flat tax** that would replace the current graduated income tax with a single rate of 17 percent. Large personal exemptions (e.g., approximately $30,000 for a family of four) would allow many low- and middle-income taxpayers to pay no tax. All other deductions would be eliminated, and no tax would be imposed on income from investments.

Various other versions of the flat tax have been suggested that would retain selected deductions (e.g., interest on home mortgages and charitable contributions) and not exclude all investment income from taxation.

The major advantage of the flat tax is its simplicity. Everyone agrees that the current Federal income tax is inappropriately complex. Consequently, compliance costs are disproportionately high. Proponents of the flat tax further believe that simplifying the income tax will significantly reduce the current “tax gap” (i.e., the difference between the amount of taxes that *should be paid* and what is *actually paid*).

Political considerations are a major obstacle to the enactment of a flat tax in its pure form. Special interest groups, such as charitable organizations and mortgage companies, are not apt to be complacent over the elimination of a tax deduction that benefits their industry. In addition, there is uncertainty as to the economic effects of the tax.

It is interesting to note that Russia’s attempt at a progressive income tax was quite disastrous. Not only did high rates drive capital out of the country but also failure to...
report income was rampant. In early 2000, the income tax was repealed and replaced with a 13 percent flat tax. To date, the flat tax has worked quite well. Several Baltic states (Estonia, Latvia, and Lithuania) have followed Russia’s example. Albania, Romania, Slovakia, Georgia, Ukraine, and Serbia have also adopted a flat tax.

**Value Added Tax**

The value added tax (VAT) is one of two proposals that would replace the Federal income tax. Under the VAT, a business would pay the tax (approximately 17 percent) on all of the materials and services required to manufacture its product. In effect, the VAT taxes the increment in value as goods move through production and manufacturing stages to the marketplace. Moreover, the VAT paid by the producer will be reflected in the selling price of the goods. Thus, the VAT is a tax on consumption.

The United States is the only country in the OECD (Organization for Economic Cooperation and Development) that does not have a VAT. Approximately 136 countries around the world use a VAT, ranging from 5 percent in Japan to 25 percent in Denmark. Instead, the United States relies heavily on income taxes.

**Sales Tax**

A national sales tax differs from a VAT in that it would be collected on the final sale of goods and services. Consequently, it is collected from the consumer and not from businesses that add value to the product. Like the VAT, the national sales tax is intended to replace the Federal income tax.

A current proposal for a national sales tax, called the “Fair Tax,” would tax almost all purchases, including food and medicine, at approximately 23 percent. Exempt items include business expenses, used goods, and the costs of education. The “Fair Tax” would replace not only the income tax (both individual and corporate) but also payroll taxes (including the self-employment tax) and the gift and estate taxes. Current sponsors of this proposal, which is reintroduced in each new Congress, include Saxby Chambliss (R–Ga.) in the Senate and John Linder (R–Ga.) in the House.

Critics contend that both forms of consumption taxes, a VAT and a national sales tax, are regressive. They impose more of a burden on low-income taxpayers who must spend larger proportions of their incomes on essential purchases. The proposals attempt to remedy this inequity by granting some sort of credit, rebate, or exemption to low-income taxpayers.

In terms of taxpayer compliance, a value added tax is preferable to a national sales tax. Without significant collection efforts, a national sales tax could easily be circumvented by resorting to a barter system of doing business. Its high rate would also encourage smuggling and black market activities.

### 1.6 Tax Administration

**INTERNAL REVENUE SERVICE**

The responsibility for administering the Federal tax laws rests with the Treasury Department. Administratively, the IRS is part of the Department of the Treasury and is responsible for enforcing the tax laws. The Commissioner of Internal Revenue is appointed by the President and is responsible for establishing policy and supervising the activities of the IRS. See Chapter 26 for more in-depth coverage of the IRS and tax administration issues.

**THE AUDIT PROCESS**

*Selection of Returns for Audit*

Due to budgetary limitations, only a small minority of tax returns are audited. For the fiscal year ended September 30, 2008, the IRS audited only 1 percent of all individual income tax returns filed.
The IRS utilizes mathematical formulas and statistical sampling techniques to select tax returns that are most likely to contain errors and to yield substantial amounts of additional tax revenues upon audit. The mathematical formula yields what is called a Discriminant Information Function (DIF) score. It is the DIF score given to a particular return that may lead to its selection for audit.

To update the DIF components, the IRS selects a cross section of returns, which are subject to various degrees of inspection (i.e., information return verification, correspondence, and face-to-face audits with filers). The results of these audits highlight areas of taxpayer noncompliance and enable the IRS to use its auditors more productively. In recent years, IRS audits have resulted in an increasing number of “no change” results. This indicates that the IRS is not always choosing the right returns to audit (i.e., the ones with errors).

Though the IRS does not openly disclose all of its audit selection techniques, the following observations may be made concerning the probability of selection for audit:

- Certain groups of taxpayers are subject to audit much more frequently than others. These groups include individuals with large amounts of gross income, self-employed individuals with substantial business income and deductions, and taxpayers with prior tax deficiencies. Also vulnerable are businesses that receive a large proportion of their receipts in cash (e.g., cafés and small service businesses) and thus have a high potential for tax avoidance.

**Example 10**

Jack owns and operates a liquor store on a cash-and-carry basis. Since all of Jack’s sales are for cash, he might well be a prime candidate for an audit by the IRS. Cash transactions are easier to conceal than those made on credit.

- If information returns (e.g., Form 1099, Form W–2) are not in substantial agreement with reported income, an audit can be anticipated.
- If an individual’s itemized deductions are in excess of norms established for various income levels, the probability of an audit is increased.
- Filing of a refund claim by the taxpayer may prompt an audit of the return.
- Information obtained from other sources (e.g., informants, news items) may lead to an audit. Recently, for example, the IRS advised its agents to be on the alert for newspaper accounts of large civil court judgments. The advice was based on the assumption that many successful plaintiffs were not reporting as income the taxable punitive damages portion of awards.

The tax law permits the IRS to pay rewards to persons who provide information that leads to the detection and punishment of those who violate the tax laws. The rewards may not exceed 30 percent of the taxes, fines, and penalties recovered as a result of such information.

**Example 11**

After 15 years of service, Rita is discharged by her employer, Dr. Smith. Shortly thereafter, the IRS receives an anonymous letter stating that Dr. Smith keeps two separate sets of books and that the one used for tax reporting substantially understates his cash receipts.

**Example 12**

During a divorce proceeding, it is revealed that Leo, a public official, kept large amounts of cash in a shoe box at home. This information is widely disseminated by the news media and comes to the attention of the IRS. Needless to say, the IRS is interested in knowing whether these funds originated from a taxable source and, if so, whether they were reported on Leo’s income tax returns.

**Types of Audits**

Once a return is selected for audit, the taxpayer is notified. If the issue involved is minor, the matter often can be resolved simply by correspondence (a correspondence audit) between the IRS and the taxpayer.
During 2008, Janet received dividend income from Green Corporation. In early 2009, Green Corporation reported the payment on Form 1099-DIV (an information return for reporting dividend payments), the original being sent to the IRS and a copy to Janet. When preparing her income tax return for 2008, Janet apparently overlooked this particular Form 1099-DIV and failed to include the dividend on Schedule B, Interest and Dividend Income, of Form 1040. In 2010, the IRS sends a notice to Janet calling her attention to the omission and requesting a remittance for additional tax, interest, and penalty. Janet promptly mails a check to the IRS for the requested amount, and the matter is closed.

Other examinations are generally classified as either office audits or field audits. An office audit usually is restricted in scope and is conducted in the facilities of the IRS. In contrast, a field audit involves an examination of numerous items reported on the return and is conducted on the premises of the taxpayer or the taxpayer’s representative.

Upon the conclusion of the audit, the examining agent issues a Revenue Agent’s Report (RAR) that summarizes the findings. The RAR will result in a refund (the tax was overpaid), a deficiency (the tax was underpaid), or a no change (the tax was correct) finding. If, during the course of an audit, a special agent accompanies (or takes over from) the regular auditor, this means the IRS suspects fraud. If the matter has progressed to an investigation for fraud, the taxpayer should retain competent counsel.

Settlement Procedures
If an audit results in an assessment of additional tax and no settlement is reached with the IRS agent, the taxpayer may attempt to negotiate a settlement with a higher level of the IRS. If an appeal is desired, an appropriate request must be made to the Appeals Division of the IRS. The Appeals Division is authorized to settle all disputes based on the hazard of litigation (the probability of favorable resolution of the disputed issue or issues if litigated). In some cases, a taxpayer may be able to obtain a percentage settlement or a favorable settlement of one or more disputed issues.

If a satisfactory settlement is not reached within the administrative appeal process, the taxpayer can litigate the case in the Tax Court, a Federal District Court, or the Court of Federal Claims. However, litigation is recommended only as a last resort because of the legal costs involved and the uncertainty of the final outcome. Tax litigation considerations are discussed more fully in Chapter 2.

STATUTE OF LIMITATIONS
A statute of limitations is a provision in the law that offers a party a defense against a suit brought by another party after the expiration of a specified period of time. The
The purpose of a statute of limitations is to preclude parties from prosecuting stale claims. The passage of time makes the defense of such claims difficult since witnesses may no longer be available or evidence may have been lost or destroyed. Found at the state and Federal levels, such statutes cover a multitude of suits, both civil and criminal.

For our purposes, the relevant statutes deal with the Federal income tax. The two categories involved cover both the period of limitations applicable to the assessment of additional tax deficiencies by the IRS and the period applicable to claims for refunds by taxpayers.

**Assessment by the IRS**

Under the general rule, the IRS may assess an additional tax liability against a taxpayer within three years of the filing of the income tax return. If the return is filed early, the three-year period begins to run from the due date of the return (usually April 15 for a calendar year individual taxpayer). If the taxpayer files the return late (i.e., beyond the due date), the three-year period begins to run on the date filed.

If a taxpayer omits an amount of gross income in excess of 25 percent of the gross income reported on the return, the statute of limitations is increased to six years.

**Example 14**

For 2010, Mark, a calendar year taxpayer, reported gross income of $400,000 on a timely filed income tax return. If Mark omitted more than $100,000 (25% of $400,000), the six-year statute of limitations would apply to the 2010 tax year.

The six-year provision on assessments by the IRS applies only to the omission of income and does not cover other factors that might lead to an understatement of tax liability, such as overstatement of deductions and credits.

There is no statute of limitations on assessments of tax if no return is filed or if a fraudulent return is filed.

**Limitations on Refunds**

If a taxpayer believes that an overpayment of Federal income tax was made, a claim for refund should be filed with the IRS. A claim for refund, therefore, is a request to the IRS that it return to the taxpayer the excessive income taxes paid. A claim for refund generally must be filed within three years from the date the return was filed or within two years from the date the tax was paid, whichever is later. Income tax returns that are filed early are deemed to have been filed on the date the return was due.

**Interest and Penalties**

Interest rates are determined quarterly by the IRS based on the existing Federal short-term rate. Currently, the rates for tax refunds (overpayments) for individual taxpayers are the same as those applicable to assessments (underpayments). For the first quarter (January 1–March 31) of 2010, the rates are 4 percent for refunds and assessments.

For assessments of additional taxes, the interest begins running on the unextended due date of the return. With refunds, however, no interest is allowed if the overpayment is refunded to the taxpayer within 45 days of the date the return is filed. For this purpose, returns filed early are deemed to have been filed on the due date.

In addition to interest, the tax law provides various penalties for lack of compliance by taxpayers. Some of these penalties are summarized as follows:
For a failure to file a tax return by the due date (including extension), a penalty of 5 percent per month up to a maximum of 25 percent is imposed on the amount of tax shown as due on the return. Any fraction of a month counts as a full month.

A penalty for a failure to pay the tax due as shown on the return is imposed in the amount of 0.5 percent per month up to a maximum of 25 percent. Again, any fraction of a month counts as a full month. During any month in which both the failure to file penalty and the failure to pay penalty apply, the failure to file penalty is reduced by the amount of the failure to pay penalty.

Example 15

Adam files his tax return 18 days after the due date of the return. Along with the return, he remits a check for $1,000, which is the balance of the tax he owed. Disregarding the interest element, Adam's total penalties are as follows:

<table>
<thead>
<tr>
<th>penalty</th>
<th>amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Failure to pay penalty (0.5% × $1,000)</td>
<td>$5</td>
</tr>
<tr>
<td>Plus</td>
<td></td>
</tr>
<tr>
<td>Failure to file penalty (5% × $1,000)</td>
<td>$50</td>
</tr>
<tr>
<td>Less failure to pay penalty for the same period</td>
<td>(5)</td>
</tr>
<tr>
<td>Failure to file penalty</td>
<td></td>
</tr>
<tr>
<td>Total penalties</td>
<td>$50</td>
</tr>
</tbody>
</table>

Note that the penalties for one full month are imposed even though Adam was delinquent by only 18 days. Unlike the method used to compute interest, any part of a month is treated as a whole month.

Example 16

Cindy underpaid her taxes for 2009 in the amount of $20,000, of which $15,000 is attributable to negligence. Cindy's negligence penalty is $3,000 (20% × $15,000).

Various penalties may be imposed in the case of fraud. Fraud involves specific intent on the part of the taxpayer to evade a tax. In the case of civil fraud, the penalty is 75 percent of the underpayment attributable to fraud. In the case of criminal fraud, the penalties can include large fines as well as prison sentences. The difference between civil and criminal fraud is one of degree. Criminal fraud involves the presence of willfulness on the part of the taxpayer. Also, the burden of proof, which is on the IRS in both situations, is more stringent for criminal fraud than for civil fraud. The negligence penalty is not imposed when the fraud penalty applies. For possible fraud situations, refer to Examples 11 and 12.

TAX PRACTICE

The area of tax practice is largely unregulated. Virtually anyone can aid another in complying with the various tax laws. If a practitioner is a member of a profession, such as law or public accounting, he or she must abide by certain ethical standards. Furthermore, the Internal Revenue Code imposes penalties upon the preparers of Federal tax returns who violate proscribed acts and procedures.

Ethical Guidelines

The American Institute of CPAs has issued numerous pronouncements dealing with CPAs engaged in tax practice. Originally called “Statements on Responsibilities in Tax Practice,” these pronouncements were intended to be only guides to action. In 2000, however, the AICPA redesignated the pronouncements as “Statements on
Standards for Tax Services” and made them enforceable as part of its Code of Professional Conduct. They include the provisions summarized below.

- Do not take questionable positions on a client’s tax return in the hope that the return will not be selected for audit by the IRS. Any positions taken should be supported by a good-faith belief that they have a realistic possibility of being sustained if challenged. The client should be fully advised of the risks involved and of the penalties that will result if the position taken is not successful.
- A practitioner can use a client’s estimates if they are reasonable under the circumstances. If the tax law requires receipts or other verification, the client should be so advised. In no event should an estimate be given the appearance of greater accuracy than is the case. For example, an estimate of $1,000 should not be deducted on a return as $999.
- Every effort should be made to answer questions appearing on tax returns. A question need not be answered if the information requested is not readily available, the answer is voluminous, or the question’s meaning is uncertain. The failure to answer a question on a return cannot be justified on the grounds that the answer could prove disadvantageous to the taxpayer.
- Upon learning of an error on a past tax return, advise the client to correct it. Do not, however, inform the IRS of the error. If the error is material and the client refuses to correct it, consider withdrawing from the engagement. This will be necessary if the error has a carryover effect and prevents the current year’s tax liability from being determined correctly.

**Statutory Penalties Imposed on Tax Return Preparers**

In addition to ethical constraints, a tax return preparer may be subject to certain statutorily sanctioned penalties, including the following:

- Various penalties involving procedural matters. Examples include failing to furnish the taxpayer with a copy of the return; endorsing a taxpayer’s refund check; failing to sign the return as a preparer; failing to furnish one’s identification number; and failing to keep copies of returns or maintain a client list.
- Penalty for understatement of a tax liability based on a position that lacks any realistic possibility of being sustained. If the position is not frivolous, the penalty can be avoided by disclosing it on the return.
- Penalty for any willful attempt to Understate taxes. This usually results when a preparer disregards or makes no effort to obtain pertinent information from a client.
- Penalty for failure to exercise due diligence in determining eligibility for, or the amount of, an earned income tax credit.

**LET BYGONES BE BYGONES**

Arturo is a new client who wants you to prepare his Federal income tax return for 2010. In the past, he has prepared his own returns but has become overwhelmed by the time and effort involved. In your first meeting with Arturo, you learn that he inherited some foreign rental property several years ago. As of yet, however, he has not reported any transactions regarding the property on his tax returns. He is not averse to including the rent income on his 2010 return but wishes to avoid the hassle of filing amended returns. He prefers to “let bygones be bygones.”

Under these circumstances, do you accept the engagement? Why or why not?
1.7 UNDERSTANDING THE FEDERAL TAX LAW

The Federal tax law is a mosaic of statutory provisions, administrative pronouncements, and court decisions. Anyone who has attempted to work with this body of knowledge would have to admit to its complexity. For the person who has to trudge through a mass of rules to find the solution to a tax problem, it may be of some consolation to know that the law’s complexity can generally be explained. Whether sound or not, there is a reason for the formulation of every rule. Knowing these reasons, therefore, is a considerable step toward understanding the Federal tax law.

The Federal tax law has as its major objective the raising of revenue. But although the fiscal needs of the government are important, other considerations explain certain portions of the law. Economic, social, equity, and political factors also play a significant role. Added to these factors is the marked impact the IRS and the courts have had and will continue to have on the evolution of Federal tax law. These matters are treated in the remainder of the chapter, and, wherever appropriate, the discussion is referenced to subjects covered later in the text.

REVENUE NEEDS

The foundation of any tax system has to be the raising of revenue to cover the cost of government operations. Ideally, annual outlays should not exceed anticipated revenues, thereby leading to a balanced budget with no resulting deficit.

When enacting tax legislation, a deficit-conscious Congress often has been guided by the concept of revenue neutrality. Also referred to as “pay-as-you-go” (“paygo”), the concept means that every new tax law that lowers taxes must include a revenue offset that makes up for the loss. Revenue neutrality does not mean that any one taxpayer’s tax liability will remain the same. Since the circumstances involved will differ, one taxpayer’s increased tax liability could be another’s tax savings. Although revenue-neutral tax reform does not reduce deficits, at least it does not aggravate the problem.

In addition to making changes in the tax law revenue neutral, several other procedures can be taken to mitigate any revenue loss. When tax reductions are involved, the full impact of the legislation can be phased in over a period of years. Or, as an alternative, the tax reduction can be limited to a period of years. When the period expires, the prior law is reinstated through a sunset provision. Most of the major tax bills recently

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LO.7
Recognize the economic, social, equity, and political considerations that justify various aspects of the tax law.
passed by Congress have contained numerous sunset provisions. They provide some semblance of revenue neutrality as some of the bills include tax cuts that were not offset by new sources of revenue. It remains to be seen, however, whether Congress will allow the sunset provisions to take effect and, thereby, kill the tax cuts that were enacted.

Does the recent passage of the American Recovery and Reinvestment Tax Act of 2009 (ARRTA), which contains almost $300 billion in tax relief and negligible revenue offsets, foretell the abandonment of the pay-go approach? Probably not. ARRTA represents a drastic attempt to use the tax system as a means of coping with the current economic downturn. As an emergency measure, it should be regarded as an exception to the norm.

**ECONOMIC CONSIDERATIONS**

Using the tax system in an effort to accomplish economic objectives has become increasingly popular in recent years. Generally, proponents of this goal use tax legislation to amend the Internal Revenue Code in ways designed to help control the economy or encourage certain activities and businesses.

**Control of the Economy**

Congress has used depreciation write-offs as a means of controlling the economy. Theoretically, shorter asset lives and accelerated methods should encourage additional investment in depreciable property acquired for business use. Conversely, longer asset lives and the required use of the straight-line method of depreciation dampen the tax incentive for capital outlays.

Another approach that utilizes depreciation as a means of controlling capital investment is the amount of write-off allowed upon the acquisition of assets. This is the approach followed by the § 179 election to expense assets (see Chapter 8).

A change in the tax rate structure has a more immediate impact on the economy. With lower tax rates, taxpayers are able to retain additional spendable funds. If lower tax rates are accompanied by the elimination of certain deductions, exclusions, and credits, however, the overall result may not be lower tax liabilities.

**Encouragement of Certain Activities**

Without passing judgment on the wisdom of any such choices, it is quite clear that the tax law encourages certain types of economic activity or segments of the economy. For example, the favorable treatment allowed research and development expenditures can be explained by the desire to foster technological progress. Under the tax law, such expenditures can be either deducted in the year incurred or capitalized and amortized over a period of 60 months or more. In terms of the timing of the tax savings, these options usually are preferable to capitalizing the cost with a write-off over the estimated useful life of the asset created. If the asset developed has an indefinite useful life, no write-off would be available without the two options allowed by the tax law.

Part of the tax law addresses the energy crisis—in terms of both our reliance on foreign oil and the need to ease the problem of global warming. For example, a tax credit is allowed for electricity produced from renewable sources, such as biomass, solar, and wind. In addition, tax credits are available to those who purchase motor vehicles that operate on alternative (i.e., nonfossil) fuels. Residential energy credits are allowed for home improvements that conserve energy or make its use more efficient (e.g., solar hot water; geothermal heat pumps). Ecological considerations justify a tax provision that permits a more rapid expensing of the costs of installing pollution control facilities. Measures such as these that aid in maintaining a clean air environment and conserving energy resources can also be justified under social considerations.

Is it wise to stimulate U.S. exports of services? Along this line, Congress has deemed it advisable to establish incentives for U.S. citizens who accept employment overseas. Such persons receive generous tax breaks through special treatment of their foreign-source income.

Is saving desirable for the economy? Saving leads to capital formation and thereby makes funds available to finance home construction and industrial expansion. The tax
law encourages saving by according preferential treatment to private retirement plans. Not only are contributions to Keogh (H.R. 10) plans and certain IRAs deductible, but income from the contributions accumulates free of tax. As noted below, the encouragement of private-sector pension plans can also be justified under social considerations.

Encouragement of Certain Industries

No one can question the proposition that a sound agricultural base is necessary for a well-balanced national economy. Undoubtedly, this can explain why farmers are accorded special treatment under the Federal tax system. Among the benefits are the election to expense rather than capitalize certain soil and water conservation expenditures and fertilizers and the election to defer the recognition of gain on the receipt of crop insurance proceeds.

To stimulate the manufacturing industry, Congress enacted a domestic production activities deduction. The provision provides a tax benefit in the form of a deduction for profits derived from manufacturing activities conducted within the United States. By restricting the deduction to manufacturing income attributable to wages reportable to the IRS, new U.S. jobs will result, and the outsourcing of labor is discouraged. Thus, the tax system is used to encourage both domestic manufacturing and job growth.

Encouragement of Small Business

At least in the United States, a consensus exists that what is good for small business is good for the economy as a whole. Whether valid or not, this assumption has led to a definite bias in the tax law favoring small business.

In the corporate tax area, several provisions can be explained by the desire to benefit small business. One provision permits the shareholders of a small business corporation to make a special election that generally will avoid the imposition of the corporate income tax.25 Furthermore, such an election enables the corporation to pass through its operating losses to its shareholders.

SOCIAL CONSIDERATIONS

Some provisions of the Federal tax law, particularly those dealing with the income tax of individuals, can be explained by social considerations. Some notable examples and their rationales include the following:

- Certain benefits provided to employees through accident and health plans financed by employers are nontaxable to employees. Encouraging such plans is considered socially desirable since they provide medical benefits in the event of an employee’s illness or injury.
- Most premiums paid by an employer for group term insurance covering the life of the employee are nontaxable to the employee. These arrangements can be justified on social grounds in that they provide funds for the family unit to help it adjust to the loss of wages caused by the employee’s death.
- A contribution made by an employer to a qualified pension or profit sharing plan for an employee may receive special treatment. The contribution and any income it generates are not taxed to the employee until the funds are distributed. Such an arrangement also benefits the employer by allowing a tax deduction when the contribution is made to the qualified plan. Private retirement plans are encouraged to supplement the subsistence income level the employee otherwise would have under the Social Security system.26
- A deduction is allowed for contributions to qualified charitable organizations. The deduction attempts to shift some of the financial and administrative burden of socially desirable programs from the public (the government) to the private (the citizens) sector.

25Known as the S election, it is discussed in Chapter 22. 26The same rationale explains the availability of similar arrangements for self-employed persons (the H.R. 10, or Keogh, plan).
A tax credit is allowed for amounts spent to furnish care for certain minor or disabled dependents to enable the taxpayer to seek or maintain gainful employment. Who could deny the social desirability of encouraging taxpayers to provide care for their children while they work?

Various tax credits, deductions, and exclusions are designed to encourage taxpayers to obtain additional education.27

A tax deduction is not allowed for certain expenditures deemed to be contrary to public policy. This disallowance extends to such items as fines, penalties, illegal kickbacks, bribes to government officials, and gambling losses in excess of gains. Social considerations dictate that the tax law should not encourage these activities by permitting a deduction.

Many other examples could be cited, but the conclusion would be unchanged. Social considerations do explain a significant part of the Federal tax law.

EQUITY CONSIDERATIONS

The concept of equity is relative. Reasonable persons can, and often do, disagree about what is fair or unfair. In the tax area, moreover, equity is most often tied to a particular taxpayer’s personal situation. To illustrate, compare the tax positions of those who rent their personal residences with those who own their homes. Renters receive no Federal income tax benefit from the rent they pay. For homeowners, however, a large portion of the house payments they make may qualify for the Federal interest and property tax deductions. Although renters may have difficulty understanding this difference in tax treatment, the encouragement of home ownership can be justified on both economic and social grounds.

In the same vein, compare the tax treatment of a corporation with that of a partnership. Although the two businesses may be of equal size, similarly situated, and competitors in the production of goods or services, they are not treated comparably under the tax law. The corporation is subject to a separate Federal income tax; the partnership is not. Whether the differences in tax treatment can be justified logically in terms of equity is beside the point. The point is that the tax law can and does make a distinction between these business forms.

Equity, then, is not what appears fair or unfair to any one taxpayer or group of taxpayers. Some recognition of equity does exist, however, and explains part of the law. The concept of equity appears in tax provisions that alleviate the effect of multiple taxation and postpone the recognition of gain when the taxpayer lacks the ability or wherewithal to pay the tax. Provisions that mitigate the effect of the application of the annual accounting period concept and help taxpayers cope with the eroding results of inflation also reflect equity considerations.

Alleviating the Effect of Multiple Taxation

The income earned by a taxpayer may be subject to taxes imposed by different taxing authorities. If, for example, the taxpayer is a resident of New York City, income might generate Federal, state of New York, and city of New York income taxes. To compensate for this apparent inequity, the Federal tax law allows a taxpayer to claim a deduction for state and local income taxes. The deduction does not, however, neutralize the effect of multiple taxation, since the benefit derived depends on the taxpayer’s Federal income tax rate. Only a tax credit, rather than a deduction, would eliminate the effects of multiple taxation on the same income.

Equity considerations can explain the Federal tax treatment of certain income from foreign sources. Since double taxation results when the same income is subject to both foreign and U.S. income taxes, the tax law permits the taxpayer to choose between a credit and a deduction for the foreign taxes paid.

27These provisions can also be justified under the category of economic considerations. No one can take issue with the conclusion that a better educated workforce carries a positive economic impact.
The Wherewithal to Pay Concept

The wherewithal to pay concept recognizes the inequity of taxing a transaction when the taxpayer lacks the means with which to pay the tax. It is particularly suited to situations in which the taxpayer’s economic position has not changed significantly as a result of the transaction.

An illustration of the wherewithal to pay concept is the provision of the tax law dealing with the treatment of gain resulting from an involuntary conversion. An involuntary conversion occurs when property is destroyed by a casualty or taken by a public authority through condemnation. If gain results from the conversion, it need not be recognized if the taxpayer replaces the property within a specified period of time. The replacement property must be similar or related in service or use to that involuntarily converted.

**Example 17**

Some of the pasture land belonging to Ron, a rancher, is condemned by the state for use as a game preserve. The condemned pasture land cost Ron $120,000, but the state pays him $150,000 (its fair market value). Shortly thereafter, Ron buys more pasture land for $150,000.

In Example 17, Ron has a realized gain of $30,000 ($150,000 (condemnation award) – $120,000 (cost of land)). It would be inequitable to force Ron to pay a tax on this gain for two reasons. First, without disposing of the property acquired (the new land), Ron would be hard-pressed to pay the tax. Second, his economic position has not changed.

A warning is in order regarding the application of the wherewithal to pay concept. If the taxpayer’s economic position changes in any way, tax consequences may result.

**Example 18**

Assume the same facts as in Example 17, except that Ron reinvests only $140,000 of the award in new pasture land. Now, Ron has a taxable gain of $10,000. Instead of ending up with only replacement property, Ron now has $10,000 in cash.

Mitigating the Effect of the Annual Accounting Period Concept

For purposes of effective administration of the tax law, all taxpayers must report to and settle with the Federal government at periodic intervals. Otherwise, taxpayers would remain uncertain as to their tax liabilities, and the government would have difficulty judging revenues and budgeting expenditures. The period selected for final settlement of most tax liabilities, in any event an arbitrary determination, is one year. At the close of each year, therefore, a taxpayer’s position becomes complete for that particular year. Referred to as the annual accounting period concept, its effect is to divide each taxpayer’s life, for tax purposes, into equal annual intervals.

The finality of the annual accounting period concept could lead to dissimilar tax treatment for taxpayers who are, from a long-range standpoint, in the same economic position.
José and Alicia, both sole proprietors, have experienced the following results during the past three years:

<table>
<thead>
<tr>
<th>Year</th>
<th>José</th>
<th>Alicia</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>$50,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>2009</td>
<td>60,000</td>
<td>60,000</td>
</tr>
<tr>
<td>2010</td>
<td>60,000</td>
<td>(40,000)</td>
</tr>
</tbody>
</table>

Although José and Alicia have the same profit of $170,000 over the period from 2008 to 2010, the finality of the annual accounting period concept places Alicia at a definite disadvantage for tax purposes. The net operating loss procedure offers Alicia some relief by allowing her to apply some or all of her 2010 loss to the earlier profitable years (in this case, 2008). Thus, with a net operating loss carryback, Alicia is in a position to obtain a refund for some of the taxes she paid on the $150,000 profit reported for 2008.

The same reasoning used to support the deduction of net operating losses can explain the special treatment the tax law accords to excess capital losses and excess charitable contributions. Carryback and carryover procedures help mitigate the effect of limiting a loss or a deduction to the accounting period in which it was realized. With such procedures, a taxpayer may be able to salvage a loss or a deduction that might otherwise be wasted.

The installment method of recognizing gain on the sale of property allows a taxpayer to spread tax consequences over the payout period. The harsh effect of taxing all the gain in the year of sale is thereby avoided. The installment method can also be explained by the wherewithal to pay concept since recognition of gain is tied to the collection of the installment notes received from the sale of the property. Tax consequences, then, tend to correspond to the seller’s ability to pay the tax.

**Coping with Inflation**

Because of the progressive nature of the income tax, a wage adjustment to compensate for inflation can increase the income tax bracket of the recipient. Known as bracket creep, its overall impact is an erosion of purchasing power. Congress recognized this problem and began to adjust various income tax components, such as tax brackets, standard deduction amounts, and personal and dependency exemptions, through an indexation procedure. Indexation is based upon the rise in the consumer price index over the prior year.

**Political Considerations**

A large segment of the Federal tax law is made up of statutory provisions. Since these statutes are enacted by Congress, is it any surprise that political considerations influence tax law? For purposes of discussion, the effect of political considerations on the tax law is divided into the following topics: special interest legislation, political expediency situations, and state and local government influences.

**Special Interest Legislation**

There is no doubt that certain provisions of the tax law can largely be explained by the political influence some pressure groups have had on Congress. Is there any other realistic reason that, for example, prepaid subscription and dues income is not the sale (the taxable portion). The tax rules governing the installment method are discussed in Chapter 16.
taxed until earned while prepaid rents are taxed to the landlord in the year received?

The American Jobs Creation Act of 2004 included several good examples of special interest legislation. One provision, sponsored by former Senator Zell Miller (D–Ga.), suspended the import duties on ceiling fans. The nation’s largest seller of ceiling fans is Home Depot, which is based in Atlanta, Georgia. Another provision, sponsored by then House Speaker Dennis Hastert (R–Ill.), reduced the excise taxes on fishing tackle boxes. Representative Hastert’s district includes Plano Molding, a major manufacturer of tackle boxes. The justification for this change was that it placed tackle boxes on a more level playing field with toolboxes (which are not subject to tax). Allegedly, fishermen had been buying and converting toolboxes to avoid the excise tax!

Special interest legislation is not necessarily to be condemned if it can be justified on economic, social, or some other utilitarian grounds. In most cases, however, it is objectionable in that it adds further complexity to an already cluttered tax law. At any rate, it is an inevitable product of our political system.

**Political Expediency Situations**

Various tax reform proposals rise and fall in favor with the shifting moods of the American public. That Congress is sensitive to popular feeling is an accepted fact. Therefore, certain provisions of the tax law can be explained by the political climate at the time they were enacted.

Measures that deter more affluent taxpayers from obtaining so-called preferential tax treatment have always had popular appeal and, consequently, the support of Congress. A direct approach bars the benefit completely and explains such provisions as the imputed interest rules and the limitations on the deductibility of interest on investment indebtedness. More subtle are provisions that phase out tax breaks as income rises. Because taxpayers may be unaware of what is causing the shift to higher marginal tax rates, these phaseouts are often called “stealth taxes.” The tax law contains several dozen such phaseout provisions. Examples include the earned income credit, child tax credit, lifetime learning credit, and the credit for first-time home purchases. At least for the immediate future, the use of these stealth taxes can be expected to increase.

Other changes explained at least partially by political expediency include the lowering of individual income tax rates, the increase in the personal and dependency exemptions, and the increase in the amount of the earned income credit.

**State and Local Government Influences**

Political considerations have played a major role in the nontaxability of interest received on state and local obligations. In view of the furor that has been raised by state and local political figures every time any modification of this tax provision has been proposed, one might well regard it as next to sacred.

Somewhat less apparent has been the influence state law has had in shaping our present Federal tax law. Such was the case with community property systems. The nine states with community property systems are Louisiana, Texas, New Mexico, Arizona, California, Washington, Idaho, Nevada, and Wisconsin. The rest of the states are classified as common law jurisdictions. The difference between common law and community property systems centers around the property rights possessed by married persons. In a common law system, each spouse owns whatever he or she earns. Under a community property system, one-half of the earnings of each spouse is considered owned by the other spouse.

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*In Alaska, spouses can choose to have the community property rules apply. Otherwise, property rights are determined under common law rules.*
EXAMPLE 20

Al and Fran are husband and wife, and their only income is the $80,000 annual salary Al receives. If they live in New Jersey (a common law state), the $80,000 salary belongs to Al. If, however, they live in Arizona (a community property state), the $80,000 is divided equally, in terms of ownership, between Al and Fran.

At one time, the tax position of the residents of community property states was so advantageous that many common law states adopted community property systems. Needless to say, the political pressure placed on Congress to correct the disparity in tax treatment was considerable. To a large extent this was accomplished in the Revenue Act of 1948, which extended many of the community property tax advantages to residents of common law jurisdictions.

The major advantage extended was the provision allowing married taxpayers to file joint returns and compute their tax liability as if the income had been earned one-half by each spouse. This result is automatic in a community property state, since half of the income earned by one spouse belongs to the other spouse. The income-splitting benefits of a joint return are now incorporated as part of the tax rates applicable to married taxpayers. See Chapter 3.

INFLUENCE OF THE INTERNAL REVENUE SERVICE

The influence of the IRS is apparent in many areas beyond its role in issuing the administrative pronouncements that make up a considerable portion of our tax law. In its capacity as the protector of the national revenue, the IRS has been instrumental in securing the passage of much legislation designed to curtail the most flagrant tax avoidance practices (to close tax loopholes). As the administrator of the tax law, the IRS has sought and obtained legislation to make its job easier (to attain administrative feasibility).

The IRS as Protector of the Revenue

Innumerable examples can be given of provisions in the tax law that stem from the direct influence of the IRS. Usually, such provisions are intended to prevent a loophole from being used to avoid the tax consequences intended by Congress. Working within the letter of existing law, ingenious taxpayers and their advisers devise techniques that accomplish indirectly what cannot be accomplished directly. As a consequence, legislation is enacted to close the loopholes that taxpayers have located and exploited. Some tax law can be explained in this fashion and is discussed in the chapters to follow.

In addition, the IRS has secured from Congress legislation of a more general nature that enables it to make adjustments based on the substance, rather than the formal construction, of what a taxpayer has done. For example, one such provision permits the IRS to make adjustments to a taxpayer’s method of accounting when the method used by the taxpayer does not clearly reflect income.\(^{31}\)

EXAMPLE 21

Tina, a cash basis taxpayer, owns and operates a pharmacy. All drugs and other items acquired for resale, such as cosmetics, are charged to the purchases account and written off (expensed) for tax purposes in the year of acquisition. As this procedure does not clearly reflect income, it would be appropriate for the IRS to require that Tina establish and maintain an ending inventory account.

Administrative Feasibility

Some tax law is justified on the grounds that it simplifies the task of the IRS in collecting the revenue and administering the law. With regard to collecting the revenue, the IRS long ago realized the importance of placing taxpayers on a pay-as-you-go basis. Elaborate withholding procedures apply to wages, while the tax on other types of income may be paid at periodic intervals throughout the year. The IRS has been instrumental in convincing the courts that accrual basis taxpayers should in most cases pay taxes on prepaid income in the year received and not when earned. The

\(^{31}\)See Chapter 16.
approach may be contrary to generally accepted accounting principles, but it is consistent with the wherewithal to pay concept.

Of considerable aid to the IRS in collecting revenue are the numerous provisions that impose interest and penalties on taxpayers for noncompliance with the tax law. Provisions such as the penalties for failure to pay a tax or to file a return that is due, the negligence penalty for intentional disregard of rules and regulations, and various penalties for civil and criminal fraud serve as deterrents to taxpayer noncompliance.

One of the keys to an effective administration of our tax system is the audit process conducted by the IRS. To carry out this function, the IRS is aided by provisions that reduce the chance of taxpayer error or manipulation and therefore simplify the audit effort that is necessary. An increase in the amount of the standard deduction, for example, reduces the number of individual taxpayers who will choose the alternative of itemizing their personal deductions.32 With fewer deductions to check, the audit function is simplified.33

INFLUENCE OF THE COURTS

In addition to interpreting statutory provisions and the administrative pronouncements issued by the IRS, the Federal courts have influenced tax law in two other respects.34 First, the courts have formulated certain judicial concepts that serve as guides in the application of various tax provisions. Second, certain key decisions have led to changes in the Internal Revenue Code.

Judicial Concepts Relating to Tax

A leading tax concept developed by the courts deals with the interpretation of statutory tax provisions that operate to benefit taxpayers. The courts have established the rule that these relief provisions are to be narrowly construed against taxpayers if there is any doubt about their application.

Important in this area is the arm’s length concept. Particularly in dealings between related parties, transactions may be tested by looking to whether the taxpayers acted in an arm’s length manner. The question to be asked is: Would unrelated parties have handled the transaction in the same way?

Rex, the sole shareholder of Silver Corporation, leases property to the corporation for a yearly rent of $60,000. To test whether the corporation should be allowed a rent deduction for this amount, the IRS and the courts will apply the arm’s length concept. Would Silver Corporation have paid $60,000 a year in rent if it had leased the same property from an unrelated party (rather than from Rex)? Suppose it is determined that an unrelated third party would have paid an annual rent for the property of only $50,000. Under these circumstances, Silver Corporation will be allowed a deduction of only $50,000. The other $10,000 it paid for the use of the property represents a nondeductible dividend. Accordingly, Rex will be treated as having received rent income of $50,000 and dividend income of $10,000.

Judicial Influence on Statutory Provisions

Some court decisions have been of such consequence that Congress has incorporated them into statutory tax law. For example, many years ago the courts found that stock dividends distributed to the shareholders of a corporation were not taxable as income. This result was largely accepted by Congress, and a provision in the tax statutes now covers the issue.

On occasion, however, Congress has reacted negatively to judicial interpretations of the tax law.

\[\text{Example 22}\]

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On occasion, however, Congress has reacted negatively to judicial interpretations of the tax law.

\[\text{For a discussion of the standard deduction, see Chapter 3.}\]

\[\text{The same justification was given by the IRS when it proposed to Congress the $100 ($500 in 2009) limitation on personal casualty and theft losses. Imposition of the limitation eliminated many casualty and theft loss deductions and, as a consequence, saved the IRS considerable audit time. Later legislation, in addition to retaining the $100 feature, limits deductible losses to those in excess of 10% of a taxpayer’s adjusted gross income. See Chapter 7.}\]

\[\text{A great deal of case law is devoted to ascertaining congressional intent. The courts, in effect, ask: What did Congress have in mind when it enacted a particular tax provision?}\]
EXAMPLE 23

Nora leases unimproved real estate to Wade for 20 years. At a cost of $400,000, Wade erects a building on the land. The building is worth $150,000 when the lease terminates and Nora takes possession of the property. Does Nora have any income either when the improvements are made or when the lease terminates? In a landmark decision, a court held that Nora must recognize income of $150,000 upon the termination of the lease.

Congress felt that the result reached in Example 23 was inequitable in that it was not consistent with the wherewithal to pay concept. Consequently, the tax law was amended to provide that a landlord does not recognize any income either when the improvements are made (unless made in lieu of rent) or when the lease terminates.

1.8 SUMMARY

In addition to its necessary revenue-raising objective, the Federal tax law has developed in response to several other factors:

- **Economic considerations.** The emphasis here is on tax provisions that help regulate the economy and encourage certain activities and types of businesses.
- **Social considerations.** Some tax provisions are designed to encourage (or discourage) certain socially desirable (or undesirable) practices.
- **Equity considerations.** Of principal concern in this area are tax provisions that alleviate the effect of multiple taxation, recognize the wherewithal to pay concept, mitigate the effect of the annual accounting period concept, and recognize the eroding effect of inflation.
- **Political considerations.** Of significance in this regard are tax provisions that represent special interest legislation, reflect political expediency, and exhibit the effect of state and local law.
- **Influence of the IRS.** Many tax provisions are intended to aid the IRS in the collection of revenue and the administration of the tax law.
- **Influence of the courts.** Court decisions have established a body of judicial concepts relating to tax law and have, on occasion, led Congress to enact statutory provisions to either clarify or negate their effect.

These factors explain various tax provisions and thereby help in understanding why the tax law developed to its present state. The next step involves learning to work with the tax law, which is the subject of Chapter 2.

THE FIRST PAYCHECK

While many of Samantha’s peers have received paychecks at an earlier age, the summer internship was her first “real job.” As a result, each of the withheld amounts on her pay stub needs to be explained to her. Her pay stub reflects the following withheld amounts:

- Fed tax $375.00
- FICA 191.25
- PKfee 50.00
- Gasttax 150.00
- **Total deductions $766.25**

You explain to Samantha that the Fed tax is the Federal income tax withholding at a 15 percent rate. The Gasttax is the state income tax withholding at a 6 percent rate. The FICA amount consists of two components: Social Security tax at a rate of 6.2 percent and Medicare tax at a 1.45 percent rate. Upon further discussion with Samantha, you conclude that the $50 withheld for PKfee covers parking in a nearby garage while she is at work. So Samantha’s take-home pay of $1,733.75 is the correct amount.
DISCUSSION QUESTIONS

1. **LO.2** The first Federal income tax was not enacted until just prior to World War I. Is this a correct statement? Why or why not?

2. **LO.2** The effect of the Sixteenth Amendment to the U.S. Constitution was to validate the Federal income tax imposed on corporations. Do you agree?

3. **LO.2** World War II converted the Federal income tax into a mass tax. Explain.

4. **LO.2** Although the Federal income tax law is complex, most individual taxpayers are able to complete their tax returns without outside assistance. Comment on the accuracy of this statement.

5. **LO.2** How does the pay-as-you-go procedure apply to wage earners? To persons who have income from other than wages?

6. **LO.3** In terms of Adam Smith’s canon of economy, how does the Federal income tax fare?

7. **LO.3, 4** Are the following taxes proportional or progressive?
   a. Social Security tax.
   b. Federal gift tax.
   c. Federal excise tax on cigarettes.
   d. Federal corporate income tax.

8. **LO.4** Cardinal College is considering purchasing two apartment buildings that are near the campus and converting them into student dormitories. The city where the college is located opposes the purchase. Why?

9. **LO.4** The Adams Independent School District wants to sell a parcel of unimproved land that it does not need. Its three best offers are as follows: from State Department of Public Safety (DPS), $2.3 million; from Second Baptist Church, $2.2 million; and from Baker Motors, $2.1 million. DPS would use the property for a new state highway patrol barracks; Second Baptist would start a church school; and Baker would open a car dealership. If you are the financial adviser for the school district, which offer would you prefer? Why?

10. **LO.4** The commissioners for Colby County are actively negotiating with Eagle Industries regarding the location of a new manufacturing facility in the county. As Eagle is considering several other sites, a “generous tax holiday” may be needed to influence its choice. The local school district is opposed to any “generous tax holiday.”
    a. In terms of a “generous tax holiday,” what might the proposal entail?
    b. Why should the school district be opposed?

11. **LO.4** Brent is shocked when he learns that the property taxes on his personal residence have increased for 2010. Not only has the tax rate not changed, but he feels that the value of his residence has decreased. What could be a possible explanation for what has happened?
12. **LO.4** Franklin County is in dire financial straits and is considering a number of sources for additional revenue. Evaluate the following possibilities in terms of anticipated taxpayer compliance:
   a. A property tax on business inventories.
   b. A tax on intangibles (i.e., stocks and bonds) held as investments.
   c. A property tax on boats used for recreational purposes.

13. **LO.4** After his first business trip to a major city, Herman is alarmed when he reviews his credit card receipts. Both the hotel bill and the car rental charge are in excess of the price he was quoted. Was Herman overcharged, or is there an explanation for the excess amounts?

14. **LO.4** Eileen, a resident of Wyoming, goes to Montana to purchase her new automobile. She does this because Wyoming imposes a sales tax while Montana does not. Has Eileen successfully avoided the Wyoming sales tax? Explain.

15. **LO.4** Address the following issues:
   a. What is a sales tax holiday? What purpose might it serve?
   b. If a state anticipates a revenue shortfall, an easy solution is to cancel any scheduled sales tax holidays. Please assess the validity of this statement.

16. **LO.4** Velma lives in Wilson County, which is adjacent to Grimes County. Although the retail stores in both counties are comparable, Velma drives an extra 10 miles to do all of her shopping in Grimes County. Why might she do this?

17. **LO.4** During a social event, Muriel and Earl are discussing the home computer each recently purchased. Although the computers are identical makes and models, Muriel is surprised to learn that she paid a sales tax, while Earl did not. Comment as to why this could happen.

18. **LO.4** On a recent shopping trip to a warehouse discount store, Ruby bought goods worth $400. Although the state and local general sales tax is 7%, she was charged less than $28 (7% × $400) in tax. Why?

19. **LO.4** Alvin, age 75, wants all of his property to eventually pass to his granddaughter, Holly, age 20. From a tax standpoint, would it be cheaper for Alvin to make the transfers to Holly by gift or at death? Explain.

20. **LO.4** Jake (age 72) and Jessica (age 28) were recently married. To avoid any transfer taxes, Jake has promised to leave Jessica all of his wealth when he dies. Is Jake under some misconception about the operation of the Federal gift and estate taxes? Explain.

21. **LO.4** Address the following issues:
   a. What is the purpose of the unified transfer tax credit?
   b. Is the same amount available for both the Federal gift tax and the estate tax? Explain.
   c. Does the use of the credit for a gift affect the amount of credit available for the estate tax? Explain.

22. **LO.4** Fred and Cynthia are husband and wife and have five married children and nine minor grandchildren. For tax year 2010, what is the maximum amount they can give to the family (including the sons- and daughters-in-law) without using any of their unified transfer tax credit?

23. **LO.4** Compare the Federal income tax on corporations with that applicable to individual taxpayers in terms of the following:
   a. Determination of AGI.
   b. Availability of the standard deduction.
   c. Nature of deductions allowed.

24. **LO.4** Mike Barr was an outstanding football player in college and expects to be drafted by the NFL in the first few rounds. Mike has let it be known that he would prefer to sign with a club located in Florida, Texas, or Washington. Mike sees no reason why he should have to pay state income tax on his player’s salary! Is Mike under any delusions? Explain.

25. **LO.4** A state that uses a “piggyback” approach to its income tax has “decoupled” from a recent change in the Internal Revenue Code.
   a. What does this mean?
   b. Why might it have occurred?
26. **LO.4, 5** A question on a state income tax return asks the taxpayer if he or she made any out-of-state Internet or mail-order catalog purchases during the year. The question requires a yes or no answer, and if the taxpayer answers yes, the amount of such purchases is to be listed.
   a. Does such an inquiry have any relevance to the state income tax? If not, why is it being asked?
   b. Your client, Harriet, wants to leave the question unanswered. As the preparer of her return, how do you respond?

27. **LO.4** As to those states that impose an income tax on individuals, comment on the following:
   a. Use of withholding procedures.
   b. Treatment of Federal income taxes paid.
   c. Due date for filing.
   d. A checkoff box for specified charitable contributions.
   e. Credit for income taxes paid to other states.
   f. Exchange of tax information between a state and the IRS.

28. **LO.4** Address the following issues:
   a. What is the justification for a state adopting an amnesty program for its income taxes?
   b. What do such programs cover?
   c. Are they ever repeated?

29. **LO.4** Contrast FICA and FUTA as to the following:
   a. Purpose of the tax.
   b. Upon whom imposed.
   c. Governmental administration of the tax.
   d. Reduction of tax based on a merit rating system.

30. **LO.4** One of the tax advantages of hiring family members to work in your business is that FICA taxes are avoided. Do you agree with this statement? Explain.

31. **LO.4** Ricky, a star athlete in college, receives a $1 million bonus for signing a contract with a professional sports team. How will the bonus be treated for FICA purposes?

32. **LO.4** Regarding the proposal for a “flat tax,” comment on the following:
   a. Justification for.
   b. Major obstacles to enactment.

33. **LO.4** Regarding the value added tax (VAT), comment on the following:
   a. Popularity of this type of tax.
   b. Nature of the tax.

34. **LO.4** Both a value added tax (VAT) and a national sales tax have been criticized as being regressive in their effect.
   a. Explain.
   b. How could this shortcoming be remedied in the case of a national sales tax?

35. **LO.4, 5** Serena operates a lawn maintenance service in Southern California. As most of her employees are itinerant, they are paid on a day-to-day basis. Because of cash-flow problems, Serena requires her customers to pay cash for the services she provides.
   a. What are some of the tax problems Serena might have?
   b. Assess Serena’s chances of audit by the IRS.

36. **LO.5** Assess the probability of an audit in each of the following independent situations:
   a. As a result of a jury trial, Linda was awarded $3.5 million because of job discrimination. The award included $5 million for punitive damages.
   b. Mel operates a combination check-cashing service and pawnshop. He recently broke up with his companion of 18 years and married her teenage daughter.
   c. Cindy has annual AGI in excess of $300,000 and recently donated $40,000 to her church building fund.
   d. Pierre is the maître d’ at a five-star restaurant and also manages the valet parking concession.
   e. Giselle is a cocktail waitress at an upscale night club. She has been audited several times in past years.
   f. Marcus was recently assessed a large state income tax deficiency by the state of California for his utilization of an abusive tax shelter.
37. **LO.5** With regard to the IRS audit process, comment on the following:
   a. Percentage of individual returns audited.
   b. Availability of an “informant’s fee.”
   c. DIF score.
   d. Relevance of information returns (e.g., Form 1099).
   e. Type of audit (i.e., correspondence, office, field).
   f. RAR.
   g. Special agent joins the audit team.

38. **LO.5** Aldo has just been audited by the IRS. He does not agree with the agent’s findings but feels he has only two choices: pay the proposed deficiency or resort to the courts. Do you agree with Aldo’s conclusion? Why or why not?

39. **LO.5** How can a public website collect delinquent taxes?

40. **LO.5** Regarding the statute of limitations on additional assessments of tax by the IRS, determine the applicable period in each of the following situations. Assume a calendar year individual with no fraud or substantial omission involved.
   a. The income tax return for 2009 was filed on February 23, 2010.
   b. The income tax return for 2009 was filed on June 25, 2010.
   c. The income tax return for 2009 was prepared on April 7, 2010, but was never filed. Through some misunderstanding between the preparer and the taxpayer, each expected the other to file the return.
   d. The income tax return for 2009 was never filed because the taxpayer thought no additional tax was due.

41. **LO.5** Brianna, a calendar year taxpayer, files her income tax return for 2009 on February 5, 2010. Although she makes repeated inquiries, she does not receive her refund from the IRS until May 28, 2010. Is Brianna entitled to interest on the refund? Explain.

42. **LO.5, 6** On a Federal income tax return filed five years ago, Andy inadvertently omitted a large amount of gross income.
   a. Andy seeks your advice as to whether the IRS is barred from assessing additional income tax in the event he is audited. What is your advice?
   b. Would your advice differ if you are the person who prepared the return in question? Explain.
   c. Suppose Andy asks you to prepare his current year’s return. Would you do so? Explain.

43. **LO.5** Irene files her income tax return 65 days after the due date of the return without obtaining an extension from the IRS. Along with the return, she remits a check for $30,000, which is the balance of the tax she owes. Disregarding the interest element, what are Irene’s penalties for failure to file and for failure to pay?

44. **LO.5** For tax year 2007, the IRS assesses a deficiency against Ernest for $300,000. Disregarding the interest component, what is Ernest’s penalty if the deficiency is attributable to:
   a. Negligence?
   b. Fraud?

45. **LO.5, 6** In March 2010, Jim asks you to prepare his Federal income tax returns for tax years 2007, 2008, and 2009. In discussing this matter with him, you discover that he also has not filed for tax year 2006. When you mention this fact, Jim tells you that the statute of limitations precludes the IRS from taking any action as to this year.
   a. Is Jim correct about the application of the statute of limitations? Why?
   b. If Jim refuses to file for 2006, should you prepare returns for 2007 through 2009?

46. **LO.7** In terms of tax reform policy, what do the following mean?
   a. Revenue neutrality.
   b. Pay-as-you-go or “paygo.”
   c. Sunset provision.
   d. Stealth taxes.

47. **LO.7** Some tax rules can be justified on multiple grounds (e.g., economic, social, etc.). In this connection, comment on the possible justification for the rules governing the following:
48. **LO.7** Discuss the probable justification for each of the following provisions of the tax law:
   a. The § 179 election to expense certain business assets upon their acquisition.
   b. Favorable treatment accorded to research and development expenditures.
   c. A deduction allowed for income resulting from U.S. production (manufacturing) activities.
   d. Election to expense certain soil and water conservation and fertilizer expenditures.
   e. The deduction allowed for contributions to qualified charitable organizations.

49. **LO.7** Discuss the probable justification for each of the following provisions of the tax law:
   a. An election that allows certain corporations to avoid the corporate income tax and pass losses through to their shareholders.
   b. A tax credit for amounts spent to furnish care for minor children while the parent works.
   c. An election that allows the deferral of gain recognition on the receipt of crop insurance proceeds.
   d. The tax rates applicable to married persons who file a joint return.
   e. Provisions in the tax law that allow taxpayers to carry over to future years unused capital losses and charitable contributions.

50. **LO.7** A provision in the tax law allows gain from an involuntary conversion to be postponed.
    a. Under what circumstances does this provision apply?
    b. What is the justification for the provision?

51. **LO.7, 8** Discuss the probable justification for each of the following aspects of the tax law:
    a. Prepaid income is taxed to the recipient in the year received and not in the year it is earned.
    b. A taxpayer that sells property on an installment basis can recognize gain on the sale over the period the payments are received.
    c. Every year the tax brackets and the amounts of the standard deduction and dependency exemptions are adjusted by the IRS.
    d. Like toolboxes, fishing tackle boxes are not subject to the Federal excise taxes on sporting goods.
    e. The deduction for personal casualty losses is subject to dollar and percentage limitations.

52. **LO.8** What is the “arm’s length” concept, and when is it applicable?

53. **LO.8** Edward leases real estate to Janet for a period of 20 years. Janet makes capital improvements to the property. When the lease expires, Edward reclaims the property, including the improvements made by Janet.
   a. Under current law, at what point does Edward recognize income as a result of Janet’s improvements?
   b. Has the law in part (a) always been the rule?
   c. What is the justification, if any, for the current rule?
LEARNING OBJECTIVES

After completing Chapter 2, you should be able to:

L0.1 Distinguish between the statutory, administrative, and judicial sources of the tax law and understand the purpose of each source. (pp. 2-2 to 2-16)

L0.2 Locate and work with the appropriate tax law sources. (pp. 2-16 to 2-20)

L0.3 Have an awareness of tax research tools. (pp. 2-20 to 2-24)

L0.4 Understand the tax research process. (pp. 2-24 to 2-29)

L0.5 Communicate the results of the tax research process in a client letter and a tax file memorandum. (pp. 2-29 to 2-30)

L0.6 Apply tax research techniques and planning procedures. (pp. 2-30 to 2-34)

L0.7 Be aware of taxation on the CPA examination. (pp. 2-34 to 2-35)
2.1 Tax Sources

Understanding taxation requires a mastery of the sources of the rules of tax law. These sources include not only legislative provisions in the form of the Internal Revenue Code, but also congressional Committee Reports, Treasury Department Regulations, other Treasury Department pronouncements, and court decisions. Thus, the primary sources of tax information include pronouncements from all three branches of government: legislative, executive, and judicial.

In addition to being able to locate and interpret the sources of the tax law, a tax professional must understand the relative weight of authority within these sources. The tax law is of little significance, however, until it is applied to a set of facts and circumstances. This chapter, therefore, both introduces the statutory, administrative, and judicial sources of the tax law and explains how the law is applied to individual and business transactions. It also explains how to apply research techniques and use planning procedures effectively.

A large part of tax research focuses on determining the intent of Congress. While Congress often claims simplicity as one of its goals, a cursory examination of the tax law indicates that it has not been very successful. Faced with a 48-page tax return, James Michener, the author, said, “It is unimaginable in that I graduated from one of America’s better colleges, yet I am totally incapable of understanding tax returns.” David Brinkley, the former television news commentator, observed that “settling a dispute is difficult when our tax regulations are all written in a foreign tongue whose language flows like damp sludge leaking from a sanitary landfill.”

Frequently, uncertainty in the tax law causes disputes between the Internal Revenue Service (IRS) and taxpayers. Due to these gray areas and the complexity of the tax law, a taxpayer may have more than one alternative for structuring a business transaction. In structuring business transactions and engaging in other tax planning activities, the tax adviser must be cognizant that the objective of tax planning is not necessarily to minimize the tax liability. Instead a taxpayer should maximize his or her after-tax return, which may include maximizing nontax as well as noneconomic benefits.

STATUTORY SOURCES OF THE TAX LAW

Origin of the Internal Revenue Code

Before 1939, the statutory provisions relating to taxation were contained in the individual revenue acts enacted by Congress. The inconvenience and confusion that resulted from dealing with many separate acts led Congress to codify all of the Federal tax laws. Known as the Internal Revenue Code of 1939, the codification arranged all Federal tax provisions in a logical sequence and placed them in a separate part of the Federal statutes. A further rearrangement took place in 1954 and resulted in the Internal Revenue Code of 1954, which continued in effect until it was replaced by the Internal Revenue Code of 1986.

The following observations help clarify the codification procedure:

- Neither the 1939, the 1954, nor the 1986 Code changed all of the tax law existing on the date of enactment. Much of the 1939 Code, for example, was incorporated into the 1954 Code. The same can be said for the transition from the 1954 to the 1986 Code. This point is important in assessing judicial and administrative decisions interpreting provisions under prior codes. For example, a decision interpreting § 121 of the Internal Revenue Code of 1954 will have continuing validity since this provision carried over unchanged to the Internal Revenue Code of 1986.

- Statutory amendments to the tax law are integrated into the existing Code. Thus, subsequent tax legislation, such as the Small Business and Work Opportunity Tax Act of 2007, the Economic Stimulus Act of 2008, the Food, Conservation, and Energy Act of 2008, the Housing Assistance Tax Act of 2008, and the American Recovery and Reinvestment Tax Act of 2009, has all become part of the Internal Revenue Code of 1986. In view of the frequency
with which tax legislation has been enacted in recent years, it appears that the tax law will continue to be amended frequently.

**The Legislative Process**

Federal tax legislation generally originates in the House of Representatives, where it is first considered by the House Ways and Means Committee. Tax bills originate in the Senate when they are attached as riders to other legislative proposals. If acceptable to the committee, the proposed bill is referred to the entire House of Representatives for approval or disapproval. Approved bills are sent to the Senate, where they initially are considered by the Senate Finance Committee.

The next step is referral from the Senate Finance Committee to the entire Senate. Assuming no disagreement between the House and Senate, passage by the Senate means referral to the President for approval or veto. If the bill is approved or if the President’s veto is overridden, the bill becomes law and part of the Internal Revenue Code of 1986.

Both the House and the Senate passed the Food, Conservation, and Energy Act of 2008 on May 15, 2008. On May 21, 2008, President George Bush vetoed the bill, but both houses of Congress overwhelmingly voted on May 22, 2008, to override the President’s veto. Thus, the tax provisions contained in this 2008 Act became part of the Internal Revenue Code of 1986.

House and Senate versions of major tax bills frequently differ. One reason bills are often changed in the Senate is that each individual senator has considerable latitude to make amendments when the Senate as a whole is voting on a bill referred to it by the Senate Finance Committee. In contrast, the entire House of Representatives either accepts or rejects what is proposed by the House Ways and Means Committee, and changes from the floor are rare. When the Senate version of the bill differs from that passed by the House, the Joint Conference Committee, which includes members of both the House Ways and Means Committee and the Senate Finance Committee, is called upon to resolve the differences. The deliberations of the Joint Conference Committee usually produce a compromise between the two versions, which is then voted on by both the House and the Senate. If both bodies accept the bill, it is referred to the President for approval or veto. Former Senator Daniel Patrick Moynihan observed that in the last hours of Congress, the White House and lawmakers often agree on a “1,200-page monster, we vote for it; nobody knows what is in it.” Figure 2.1 summarizes the typical legislative process for tax bills.

The role of the Joint Conference Committee indicates the importance of compromise in the legislative process. As an example of the practical effect of the

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**TAX in the NEWS**

**TAX FREEDOM DAY?**

In income tax history, 1913 was an important year. In that year, the Sixteenth Amendment to the Constitution was ratified:

> The Congress shall have power to tax and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The first income tax legislation that definitely was constitutional was passed that same year.

According to the Tax Foundation, in 2009 Tax Freedom Day fell on April 13, eight days earlier than in 2008 and two weeks earlier than in 2007. Tax Freedom Day is the date on which an average taxpayer through working has paid off his or her taxes for the year. Of course, if you lived in Connecticut with the heaviest total tax burden, Tax Freedom Day fell on April 30, 2009. Alaskans paid the least and finished paying off their tax burden on March 23, 2009.


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1The Tax Equity and Fiscal Responsibility Act of 1982 originated in the Senate, and its constitutionality was unsuccessfully challenged in the courts. The Senate version of the Deficit Reduction Act of 1984 was attached as an amendment to the Federal Boat Safety Act.
compromise process, consider Figure 2.2, which shows what happened with amendments to the first-time homebuyer credit in the American Recovery and Reinvestment Tax Act (ARRTA) of 2009.

Referrals from the House Ways and Means Committee, the Senate Finance Committee, and the Joint Conference Committee are usually accompanied by Committee Reports. These Committee Reports often explain the provisions of the proposed legislation and are therefore a valuable source for ascertaining the intent of Congress. What Congress had in mind when it considered and enacted tax legislation is the key to interpreting the legislation. Since Regulations normally are not issued immediately after a statute is enacted, taxpayers and the courts look to Committee Reports to determine congressional intent.

**Arrangement of the Code**

The Internal Revenue Code of 1986 is found in Title 26 of the U.S. Code. In working with the Code, it helps to understand the format. Note the following partial table of contents:

Subtitle A. Income Taxes
   Chapter 1. Normal Taxes and Surtaxes
      Subchapter A. Determination of Tax Liability
         Part I. Tax on Individuals
            Sections 1–5
         Part II. Tax on Corporations
            Sections 11–12

***
In referring to a provision of the Code, the key is usually the Section number. In citing Section 2(a) (dealing with the status of a surviving spouse), for example, it is unnecessary to include Subtitle A, Chapter 1, Subchapter A, Part I. Merely mentioning Section 2(a) will suffice, since the Section numbers run consecutively and do not begin again with each new Subtitle, Chapter, Subchapter, or Part. Not all Code Section numbers are used, however. Note that Part I ends with Section 5 and Part II starts with Section 11 (at present there are no Sections 6, 7, 8, 9, and 10).²

Tax practitioners commonly refer to a specific area of income tax law by Subchapter designation. Some of the more common Subchapter designations include Subchapter C (“Corporate Distributions and Adjustments”), Subchapter K (“Partners and Partnerships”), and Subchapter S (“Tax Treatment of S Corporations and Their Shareholders”). Particularly in the last situation, it is much more convenient to describe the effect of the applicable Code provisions (Sections 1361–1379) as “S corporation status” than as the “Tax Treatment of S Corporations and Their Shareholders.”

Citing the Code

Code Sections are often broken down into subparts.³ Section 2(a)(1)(A) serves as an example.

<table>
<thead>
<tr>
<th>§ 2</th>
<th>(a)</th>
<th>(1)</th>
<th>(A)</th>
</tr>
</thead>
</table>

Abbreviation for “Section”
Section number
Subsection number⁴
Paragraph designation
Subparagraph designation

²When the Code was drafted, Section numbers were intentionally omitted so that later changes could be incorporated into the Code without disrupting its organization. When Congress does not leave enough space, subsequent Code Sections are given A, B, C, etc., designations. A good example is the treatment of Sections 280A through 280H.

³Some Code Sections do not have subparts. See, for example, §§ 211 and 241.

⁴Some Code Sections omit the subsection designation and use, instead, the paragraph designation as the first subpart. See, for example, §§ 212(1) and 1222(1).
Broken down by content, Section 2(a)(1)(A) appears as follows:

- **§ 2 (a)(1)(A)**: Definitions and special rules (relating to the income tax imposed on individuals).
- **Definition of a surviving spouse.**
- **For purposes of § 1 (the determination of the applicable rate schedule), a surviving spouse must meet certain conditions.**
- **One of the conditions necessary to qualify as a surviving spouse is that the taxpayer’s spouse must have died during either of his or her two taxable years immediately preceding the present taxable year.**

Throughout the text, references to Code Sections are in the form given above. The symbols “§” and “§§” are used in place of “Section” and “Sections.” Unless otherwise stated, all Code references are to the Internal Revenue Code of 1986. The following table summarizes the format used in the text:

<table>
<thead>
<tr>
<th>Complete Reference</th>
<th>Text Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 2(a)(1)(A) of the Internal Revenue Code of 1986</td>
<td>§ 2(a)(1)(A)</td>
</tr>
<tr>
<td>Sections 1 and 2 of the Internal Revenue Code of 1986</td>
<td>§§ 1 and 2</td>
</tr>
<tr>
<td>Section 2 of the Internal Revenue Code of 1954</td>
<td>§ 2 of the Internal Revenue Code of 1954</td>
</tr>
<tr>
<td>Section 12(d) of the Internal Revenue Code of 1939</td>
<td>§ 12(d) of the Internal Revenue Code of 1939</td>
</tr>
</tbody>
</table>

**ADMINISTRATIVE SOURCES OF THE TAX LAW**

The administrative sources of the Federal tax law can be grouped as follows: Treasury Department Regulations, Revenue Rulings and Revenue Procedures, and various other administrative pronouncements (see Exhibit 2.1). All are issued by either the U.S. Treasury Department or the IRS.

**ETHICS & EQUITY**

**THE PRESIDENT AND TAX PLANNING**

President Franklin Delano Roosevelt, a frequent critic of people who tried to avoid taxes, told Congress in 1937 that too many individuals want a civilized society at a discount. He said that “successful tax dodging by a minority of very rich individuals breeds efforts for other people to dodge other laws as well as tax laws.” He repeatedly urged Congress to stop the tax-free treatment of interest on state and municipal bonds. Yet Roosevelt filed a tax return indicating that he owned $17,000 of tax-free bonds. Was FDR a hypocrite?

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1Section 12(d) of the Internal Revenue Code of 1939 is the predecessor to § 2 of the Internal Revenue Code of 1954 and the Internal Revenue Code of 1986.
Treasury Department Regulations

Regulations are issued by the U.S. Treasury Department under authority granted by Congress.\(^6\) Interpretive by nature, they provide taxpayers with considerable guidance on the meaning and application of the Code. Regulations carry considerable authority as the official interpretation of tax statutes. They are an important factor to consider in complying with the tax law.

Since Regulations interpret the Code, they are arranged in the same sequence as the Code. A number is added at the beginning, however, to indicate the type of tax or administrative, procedural, or definitional matter to which they relate. For example, the prefix 1 designates the Regulations under the income tax law. Thus, the Regulations under Code § 2 would be cited as Reg. § 1.2, with subparts added for further identification. The numbering patterns of these subparts often have no correlation with the Code subsections. The prefix 20 designates estate tax Regulations, 25 covers gift tax Regulations, 31 relates to employment taxes, and 301 refers to procedure and administration. This list is not all-inclusive.

New Regulations and changes in existing Regulations are usually issued in proposed form before they are finalized. The interval between the proposal of a Regulation and its finalization permits taxpayers and other interested parties to comment on the propriety of the proposal. Proposed Regulations under Code § 2, for example, are cited as Prop.Reg. § 1.2. The Tax Court indicates that Proposed Regulations carry little weight—no more than a position advanced in a written brief prepared by a litigating party before the Tax Court. Finalized Regulations have the force and effect of law.\(^7\)

Sometimes the Treasury Department issues Temporary Regulations relating to matters where immediate guidance is important. These Regulations are issued without

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\(^6\)§ 7805.

\(^7\) F. W. Woolworth Co., 54 T.C. 1233 (1970); Harris M. Miller, 70 T.C. 448 (1978); and James O. Tomerlin Trust, 87 T.C. 876 (1986).

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the comment period required for Proposed Regulations. Temporary Regulations have the same authoritative value as final Regulations and may be cited as precedents. Temporary Regulations must also be issued as Proposed Regulations and automatically expire within three years after the date of issuance.\(^8\)

Proposed, Temporary, and final Regulations are published in the Federal Register, in the Internal Revenue Bulletin (I.R.B.), and by major tax services. Final Regulations are issued as Treasury Decisions (TDs).

Regulations may also be classified as legislative, interpretive, or procedural. This classification scheme is discussed under Assessing the Validity of a Treasury Regulation later in the chapter.

**Revenue Rulings and Revenue Procedures**

**Revenue Rulings** are official pronouncements of the National Office of the IRS.\(^9\) They typically provide one or more examples of how the IRS would apply a law to specific fact situations. Like Regulations, Revenue Rulings are designed to provide interpretation of the tax law. However, they do not carry the same legal force and effect as Regulations and usually deal with more restricted problems. Regulations are approved by the Secretary of the Treasury, whereas Revenue Rulings generally are not.

A Revenue Ruling often results from a specific taxpayer’s request for a letter ruling. If the IRS believes that a taxpayer’s request for a letter ruling deserves official publication due to its widespread impact, the letter ruling will be converted into a Revenue Ruling and issued for the information and guidance of taxpayers, tax practitioners, and IRS personnel. Names, identifying descriptions, and money amounts are changed to conceal the identity of the requesting taxpayer. Revenue Rulings also arise from technical advice to District Offices of the IRS, court decisions, suggestions from tax practitioner groups, and various tax publications.

**Revenue Procedures** are issued in the same manner as Revenue Rulings, but deal with the internal management practices and procedures of the IRS. Familiarity with these procedures increases taxpayer compliance and helps make the administration of the tax laws more efficient. The failure of a taxpayer to follow a Revenue Procedure can result in unnecessary delay or, in a discretionary situation, can cause the IRS to decline to act on behalf of the taxpayer.

Both Revenue Rulings and Revenue Procedures serve an important function in that they provide guidance to IRS personnel and taxpayers in handling routine tax matters. Revenue Rulings and Revenue Procedures generally apply retroactively and may be revoked or modified by subsequent rulings or procedures, Regulations, legislation, or court decisions.

Revenue Rulings and Revenue Procedures are published weekly by the U.S. Government in the Internal Revenue Bulletin (I.R.B.). Semiannually, the Internal Revenue Bulletins for a six-month period are gathered together and published in a bound volume called the Cumulative Bulletin (C.B.).\(^10\)

The proper form for citing Rulings and Procedures depends on whether the item has been published in the Cumulative Bulletin or is available only in I.R.B. form. Consider, for example, the following transition:

<table>
<thead>
<tr>
<th>Temporary Citation</th>
<th>Permanent Citation</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>Explanation:</em> Revenue Ruling Number 19, appearing on page 111 of the 28th weekly issue of the Internal Revenue Bulletin for 2009.</td>
<td></td>
</tr>
</tbody>
</table>

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\(^8\)§ 7805(e).

\(^9\)§ 7805(a).

\(^10\)Usually, only two volumes of the Cumulative Bulletin are published each year. However, in the past, when Congress has enacted major tax legislation, other volumes have been published containing the Congressional Committee Reports supporting the Revenue Act. See, for example, the two extra volumes for 1984 dealing with the Deficit Reduction Act of 1984. The 1984–3 Cumulative Bulletin, Volume 1, contains the text of the law itself; 1984–3, Volume 2, contains the Committee Reports. There are a total of four volumes of the Cumulative Bulletin for 1984: 1984–1; 1984–2; 1984–3, Volume 1; and 1984–3, Volume 2.
Note that the page reference of 111 is the same for both the I.R.B. (temporary) and C.B. (permanent) versions of the ruling. The IRS numbers the pages of the I.R.B.’s consecutively for each six-month period so as to facilitate their conversion to C.B. form. Revenue Rulings and other tax resources may be found on Tax Almanac, a free online resource from Intuit at www.taxalmanac.org.

Revenue Procedures are cited in the same manner, except that “Rev.Proc.” is substituted for “Rev.Rul.” Some recent Revenue Procedures dealt with the following matters:

- Guidance updating the consent and revocation procedures for treating intercompany transactions on a separate entity basis.
- The 2010 inflation-adjusted amounts for various indexed amounts in the Code.
- The areas in which the IRS will not issue letter rulings or determination letters.

**Letter Rulings**

*Letter rulings* are issued for a fee upon a taxpayer’s request and describe how the IRS will treat a *proposed* transaction for tax purposes. They apply only to the taxpayer who asks for and obtains the ruling, but post-1984 letter rulings may be substantial authority for purposes of the accuracy-related penalty. Letter rulings can be useful to taxpayers who wish to be certain of how a transaction will be taxed before proceeding with it. Letter rulings also allow taxpayers to avoid unexpected tax costs. Although the procedure for requesting a ruling can be quite cumbersome, sometimes requesting a ruling is the most effective way to carry out tax planning. Nevertheless, the IRS limits the issuance of individual rulings to restricted, preannounced areas of taxation. The main reason the IRS will not rule in certain areas is that they involve fact-oriented situations. Thus, a ruling may not be obtained on many of the problems that are particularly troublesome to taxpayers. The IRS issues more than 2,000 letter rulings each year.

Although letter rulings once were private and not available to the public, the law now requires the IRS to make such rulings available for public inspection after identifying details are deleted. Published digests of private letter rulings can be found in RIA’s *Private Letter Rulings*, BNA’s *Daily Tax Reports*, and Tax Analysts’ *Tax Notes*. In addition, computerized databases of letter rulings are available through several private publishers.

Letter rulings are issued multidigit file numbers, which indicate the year and week of issuance as well as the number of the ruling during that week. Consider, for example, Ltr.Rul. 200916013, which gives a taxpayer an additional 60 days from the date of the ruling to make a late election to file Form 8832.

<table>
<thead>
<tr>
<th>Year</th>
<th>Week</th>
<th>Ruling</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>16</td>
<td>013</td>
</tr>
<tr>
<td></td>
<td>16th week of issuance</td>
<td>13th ruling issued during the 16th week</td>
</tr>
</tbody>
</table>

**Other Administrative Pronouncements**

*Treasury Decisions* (TDs) are issued by the Treasury Department to promulgate new Regulations, amend or otherwise change existing Regulations, or announce the
position of the Government on selected court decisions. Like Revenue Rulings and Revenue Procedures, TDs are published initially in the Internal Revenue Bulletin and subsequently transferred to the Cumulative Bulletin.

The IRS also publishes other administrative communications in the Internal Revenue Bulletin, such as Announcements, Notices, IRs (News Releases), Legal Memoranda (ILMs), Chief Counsel Notices (CC), and Prohibited Transaction Exemptions.

Like letter rulings, determination letters are issued at the request of taxpayers and provide guidance on the application of the tax law. They differ from letter rulings in that the issuing source is an Area Director rather than the National Office of the IRS. Also, determination letters usually involve completed (as opposed to proposed) transactions. Determination letters are not published and are made known only to the party making the request.

**Example 1**

The shareholders of Red Corporation and Green Corporation want assurance that the consolidation of the corporations into Blue Corporation will be a nontaxable reorganization. The proper approach is to ask the National Office of the IRS to issue a letter ruling concerning the income tax effect of the proposed transaction.

**Example 2**

Chris operates a barber shop in which he employs eight barbers. To comply with the rules governing income tax and payroll tax withholdings, Chris wants to know whether the barbers working for him are employees or independent contractors. The proper procedure is to request a determination letter on their status from the appropriate Area Director.

The law now requires that several internal memoranda that constitute the working law of the IRS be released. These General Counsel Memoranda (GCMs), Technical Advice Memoranda (TAMs), and Field Service Advices (FSAs) are not officially published, and the IRS indicates that they may not be cited as precedents by taxpayers. However, these working documents do explain the IRS’s position on various issues.

The National Office of the IRS releases Technical Advice Memoranda (TAMs) weekly. TAMs resemble letter rulings in that they give the IRS’s determination of an issue. Letter rulings, however, are responses to requests by taxpayers, whereas TAMs are issued by the National Office of the IRS in response to questions raised by IRS field personnel during audits. TAMs deal with completed rather than proposed transactions and are often requested for questions relating to exempt organizations and employee plans. TAMs are not officially published and may not be cited or used as precedent.

The Office of Chief Counsel prepares Field Service Advices (FSAs) to help IRS employees. They are issued in response to requests for advice, guidance, and analysis on difficult or significant tax issues. FSAs are not binding on either the taxpayer to whom they pertain or on the IRS.

Field Service Advices are being replaced by a new form of field guidance called Technical Expedited Advice Memoranda (TEAMS). The purpose of TEAMS is to expedite legal guidance to field agents as disputes are developing. FSAs are reverting to their original purpose of case-specific development of facts.

A TEAM guidance differs from a TAM in several ways, including a mandatory pre-submission conference involving the taxpayer. In the event of a tentatively adverse conclusion for the taxpayer or the field agent, a conference of right is offered to the taxpayer and to the field agent; once the conference of right is held, no further conferences are offered.

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14These are unofficially published by the publishers listed in Exhibit 2.1. Such internal memoranda may be substantial authority for purposes of the accuracy-related penalty for post-1984 transactions. Notice 90–20, 1990–1 C.B. 328.

15§ 6110(j)(3).
JUDICIAL SOURCES OF THE TAX LAW

The Judicial Process in General

After a taxpayer has exhausted some or all of the remedies available within the IRS (i.e., no satisfactory settlement has been reached at the agent level or at the Appeals Division level), the dispute can be taken to the Federal courts. The dispute is first considered by a court of original jurisdiction (known as a trial court), with any appeal (either by the taxpayer or the IRS) taken to the appropriate appellate court. In most situations, the taxpayer has a choice of any of four trial courts: a Federal District Court, the U.S. Court of Federal Claims, the U.S. Tax Court, or the Small Cases Division of the U.S. Tax Court. The trial and appellate court system for Federal tax litigation is illustrated in Figure 2.3.

The broken line between the U.S. Tax Court and the Small Cases Division indicates that there is no appeal from the Small Cases Division. The jurisdiction of the Small Cases Division is limited to cases involving amounts of $50,000 or less, and some of its decisions can now be found on the U.S. Tax Court Internet website.

American law, following English law, is frequently “made” by judicial decisions. Under the doctrine of stare decisis, each case (except in the Small Cases Division) has precedential value for future cases with the same controlling set of facts. Most Federal and state appellate court decisions and some decisions of trial courts are published. Published court decisions are organized by jurisdiction (Federal or state) and level of court (trial or appellate).

A decision of a particular court is called its holding. Sometimes a decision includes dicta or incidental opinions beyond the current facts. Such passing remarks, illustrations, or analogies are not essential to the current holding. Although the holding has precedential value under stare decisis, dicta are not binding on a future court.

Knowledge of several terms is important in understanding court decisions. The term plaintiff refers to the party requesting action in a court, and the defendant is the party against whom the suit is brought. Sometimes a court uses the terms petitioner and respondent. In general, “petitioner” is a synonym for “plaintiff,” and “respondent” is a synonym for “defendant.” At the trial court level, a taxpayer is normally the plaintiff (or petitioner), and the Government is the defendant (or respondent).
If the taxpayer wins and the Government appeals as the new petitioner (or appellee), the taxpayer becomes the new respondent.

**Trial Courts**

The differences among the various trial courts (courts of original jurisdiction) can be summarized as follows:

- **Number of courts.** There is only one U.S. Court of Federal Claims and only one Tax Court, but there are many Federal District Courts. The taxpayer does not select the District Court that will hear the dispute but must sue in the one that has jurisdiction where the taxpayer resides.

- **Number of judges.** District Courts have various numbers of judges, but only one judge hears a case. The Court of Federal Claims has 16 judges, and the Tax Court has 19 regular judges. The entire Tax Court, however, reviews a case (the case is sent to court conference) only when important or novel tax issues are involved. Most cases are heard and decided by 1 of the 19 judges.

- **Location.** The Court of Federal Claims meets most often in Washington, D.C., while a District Court meets at a prescribed seat for the particular district. Each state has at least one District Court, and many of the populous states have more than one. Choosing the District Court usually minimizes the inconvenience and expense of traveling for the taxpayer and his or her counsel. The Tax Court is officially based in Washington, D.C., but the various judges travel to different parts of the country and hear cases at predetermined locations and dates. This procedure eases the distance problem for the taxpayer, but it can mean a delay before the case comes to trial and is decided.

- **Jurisdiction of the Court of Federal Claims.** The Court of Federal Claims has jurisdiction over any claim against the United States that is based upon the Constitution, any Act of Congress, or any Regulation of an executive department. Thus, the Court of Federal Claims hears nontax litigation as well as tax cases. This forum appears to be more favorable for issues having an equitable or pro-business orientation (as opposed to purely technical issues) and those requiring extensive discovery.

- **Jurisdiction of the Tax Court and District Courts.** The Tax Court hears only tax cases and is the most popular forum. The District Courts hear a wide variety of nontax cases, including drug crimes and other Federal violations, as well as tax cases. Some Tax Court judges have been appointed from IRS or Treasury Department positions. For this reason, some people suggest that the Tax Court has more expertise in tax matters.

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**STIMULUS PACKAGE REDUCES TAX AUDITS**

Did the efforts to stimulate the economy through tax rebates result in fewer tax audits for millionaires? In 2008, the IRS had to shift its focus to processing tax rebate checks related to the first economic stimulus package. At the same time, the number of wealthy taxpayers swelled. The result was a drop in the number of tax audits for taxpayers making $1 million or more. The Transactional Records Access Clearinghouse affiliated with Syracuse University says only 4 percent of tax returns from this group were audited. The government, however, says 5.6 percent of the millionaires’ returns were audited.

Jury trial. The only court in which a taxpayer can obtain a jury trial is a District Court. Juries can decide only questions of fact and not questions of law. Therefore, taxpayers who choose the District Court route often do not request a jury trial. If a jury trial is not elected, the judge will decide all issues. Note that a District Court decision is controlling only in the district in which the court has jurisdiction.

Payment of deficiency. Before the Court of Federal Claims or a District Court can have jurisdiction, the taxpayer must pay the tax deficiency assessed by the IRS and then sue for a refund. If the taxpayer wins (assuming no successful appeal by the Government), the tax paid plus appropriate interest will be recovered. Jurisdiction in the Tax Court, however, is usually obtained without first paying the assessed tax deficiency. In the event the taxpayer loses in the Tax Court (and no appeal is taken or an appeal is unsuccessful), the deficiency must be paid with accrued interest. With the elimination of the deduction for personal (consumer) interest, the Tax Court route of delaying payment of the deficiency can become expensive. For example, to earn 7 percent after tax, a taxpayer with a 35 percent marginal tax rate will have to earn 10.77 percent. By paying the tax, a taxpayer limits underpayment interest and penalties on the underpayment.

Termination of running of interest. A taxpayer who selects the Tax Court may deposit a cash bond to stop the running of interest. The taxpayer must deposit both the amount of the tax and any accrued interest. If the taxpayer wins and the deposited amount is returned, the Government does not pay interest on the deposit.

Appeals. Appeals from a District Court or a Tax Court decision are to the U.S. Court of Appeals for the circuit in which the taxpayer resides. Appeals from the Court of Federal Claims go to the Court of Appeals for the Federal Circuit. Few Tax Court cases are appealed, and when appeals are made, most are filed by the taxpayer rather than the IRS.

Bankruptcy. When a taxpayer files a bankruptcy petition, the IRS, like other creditors, is prevented from taking action against the taxpayer. Sometimes a bankruptcy court may settle a tax claim.

For a summary of the Federal trial courts, see Concept Summary 2.1.
Appellate Courts

The losing party can appeal a trial court decision to a Circuit Court of Appeals. The 11 geographic circuits, the circuit for the District of Columbia, and the Federal Circuit are shown in Figure 2.4. The appropriate circuit for an appeal depends on where the litigation originated. For example, an appeal from New York goes to the Second Circuit.

If the Government loses at the trial court level (District Court, Tax Court, or Court of Federal Claims), it need not (and frequently does not) appeal. The fact that an appeal is not made, however, does not indicate that the IRS agrees with the result and will not litigate similar issues in the future. The IRS may decide not to appeal for a number of reasons. First, if the current litigation load is heavy, the IRS may decide that available personnel should be assigned to other, more important cases. Second, the IRS may determine that this case is not a good one to appeal. For example, the taxpayer may be in a sympathetic position, or the facts may be particularly strong in his or her favor. In that event, the IRS may wait to test the legal issues involved with a taxpayer who has a much weaker case. Third, if the appeal is from a District Court or the Tax Court, the Court of Appeals of jurisdiction could have some bearing on whether the IRS decides to pursue an appeal. Based on past experience and precedent, the IRS may conclude that the chance for success on a particular issue might be more promising in another Court of Appeals. If so, the IRS will wait for a similar case to arise in a different jurisdiction.

The Federal Circuit at the appellate level provides a taxpayer with an alternative forum to the Court of Appeals of his or her home circuit for the appeal. Appeals from both the Tax Court and the District Court go to a taxpayer’s home circuit. When a particular circuit has issued an adverse decision, the taxpayer may prefer the Court of Federal Claims route since any appeal will be to the Federal Circuit.

16The Court of Appeals for the Federal Circuit was created, effective October 1, 1982, by P.L. 97–164(4/2/82) to hear decisions appealed from the Claims Court (now the Court of Federal Claims).
The Appellate Process  The role of the appellate courts is limited to a review of the record of trial compiled by the trial courts. Thus, the appellate process usually involves a determination of whether the trial court applied the proper law in arriving at its decision. Usually, an appellate court will not dispute a lower court’s fact-finding determination.

An appeal can have any of a number of possible outcomes. The appellate court may approve (affirm) or disapprove (reverse) the lower court’s finding, or it may send the case back for further consideration (remand). When many issues are involved, a mixed result is not unusual. Thus, the lower court may be affirmed (aff’d.) on Issue A and reversed (rev’d.) on Issue B, while Issue C is remanded (rem’d.) for additional fact finding.

When more than one judge is involved in the decision-making process, disagreements are not uncommon. In addition to the majority view, one or more judges may concur (agree with the result reached but not with some or all of the reasoning) or dissent (disagree with the result). In any one case, the majority view controls. But concurring and dissenting views can have influence on other courts or, at some subsequent date when the composition of the court has changed, even on the same court.

Appellate Precedents and the Tax Court  District Courts, the Tax Court, and the Court of Federal Claims must abide by the precedents set by the Court of Appeals of jurisdiction. A particular Court of Appeals need not follow the decisions of another Court of Appeals. All courts, however, must follow the decisions of the U.S. Supreme Court.

This pattern of appellate precedents raises an issue for the Tax Court. Because the Tax Court is a national court, it decides cases from all parts of the country. For many years, the Tax Court followed a policy of deciding cases based on what it thought the result should be, even when its decision might be appealed to a Court of Appeals that had previously decided a similar case differently. A number of years ago this policy was changed in the Golsen\textsuperscript{17} decision. Now the Tax Court will decide a case as it feels the law should be applied only if the Court of Appeals of appropriate jurisdiction has not yet passed on the issue or has previously decided a similar case in accord with the Tax Court’s decision. If the Court of Appeals of appropriate jurisdiction has previously held otherwise, the Tax Court will conform even though it disagrees with the holding. This policy is known as the Golsen rule.

Example 3  Emily lives in Texas and sues in the Tax Court on Issue A. The Fifth Circuit Court of Appeals is the appellate court of appropriate jurisdiction. It has already decided, in a case involving similar facts but a different taxpayer, that Issue A should be resolved against the Government. Although the Tax Court feels that the Fifth Circuit Court of Appeals is wrong, under its Golsen policy it will render judgment for Emily. Shortly thereafter, Rashad, a resident of New York, in a comparable case, sues in the Tax Court on Issue A. Assume that the Second Circuit Court of Appeals, the appellate court of appropriate jurisdiction, has never expressed itself on Issue A. Presuming the Tax Court has not reconsidered its position on Issue A, it will decide against Rashad. Thus, it is entirely possible for two taxpayers suing in the same court to end up with opposite results merely because they live in different parts of the country.

Appeal to the U.S. Supreme Court  Appeal to the U.S. Supreme Court is by Writ of Certiorari. If the Court agrees to hear the case, it will grant the Writ (Cert. granted). Most often, it will deny jurisdiction (Cert. denied). For whatever reason or reasons, the Supreme Court rarely hears tax cases. The Court usually grants certiorari to resolve a conflict among the Courts of Appeals (e.g., two or more appellate courts have assumed opposing positions on a particular issue) or where the tax issue is extremely

\textsuperscript{17}Jack E. Golsen, 54 T.C. 742 (1970).
important. The granting of a *Writ of Certiorari* indicates that at least four members of the Supreme Court believe that the issue is of sufficient importance to be heard by the full Court.

**Judicial Citations**

Having briefly described the judicial process, it is appropriate to consider the more practical problem of the relationship of case law to tax research. As previously noted, court decisions are an important source of tax law. The ability to locate a case and to cite it is therefore a must in working with the tax law. Judicial citations usually follow a standard pattern: case name, volume number, reporter series, page or paragraph number, court (where necessary), and the year of decision. Specific citation formats for each court are presented in the following sections.

**Judicial Citations—The U.S. Tax Court** A good starting point is the U.S. Tax Court (formerly the Board of Tax Appeals). The Tax Court issues two types of decisions: Regular and Memorandum. The Chief Judge decides whether the opinion is issued as a Regular or Memorandum decision. The distinction between the two involves both substance and form. In terms of substance, *Memorandum* decisions deal with situations necessitating only the application of already established principles of law. *Regular* decisions involve novel issues not previously resolved by the court. In actual practice, however, this distinction is not always preserved. Not infrequently, Memorandum decisions will be encountered that appear to warrant Regular status, and vice versa. At any rate, do not conclude that Memorandum decisions possess no value as precedents. Both represent the position of the Tax Court and, as such, can be relied on.

The Regular and Memorandum decisions issued by the Tax Court also differ in form. Memorandum decisions are made available but are not published by the government. Regular decisions are published by the U.S. Government in a series called *Tax Court of the United States Reports (T.C.*)*. Each volume of these *Reports* covers a six-month period (January 1 through June 30 and July 1 through December 31) and is given a succeeding volume number. But there is usually a time lag between the date a decision is rendered and the date it appears in bound form. A temporary citation may be necessary to help the researcher locate a recent Regular decision. Consider, for example, the temporary and permanent citations for *Morton L. Ginsberg*, a decision filed on April 28, 2008:

<table>
<thead>
<tr>
<th>Temporary Citation</th>
<th>Permanent Citation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Explanation: Page number left blank because not yet known.</td>
<td></td>
</tr>
<tr>
<td>Explanation: Page number now available.</td>
<td></td>
</tr>
</tbody>
</table>

Both citations tell us that the case will ultimately appear in Volume 130 of the *Tax Court of the United States Reports*. Until this volume is bound and made available to the general public, however, the page number must be left blank. Instead, the temporary citation identifies the case as being the 7th Regular decision issued by the Tax Court since Volume 129 ended. With this information, the decision can easily be located in either of the special Tax Court services published by Commerce Clearing House and Research Institute of America (formerly by Prentice-Hall). Once Volume 130 is released, the permanent citation can be substituted and the number of the case dropped. Starting in 1999, both Regular decisions and Memorandum decisions are published on the U.S. Tax Court website ([www.ustaxcourt.gov](http://www.ustaxcourt.gov)).

Before 1943, the Tax Court was called the Board of Tax Appeals, and its decisions were published as the *United States Board of Tax Appeals Reports (B.T.A.*)*. These 47 volumes cover the period from 1924 to 1942. For example, the citation *Karl Pauli*, 11 B.T.A. 784 (1928) refers to the 11th volume of the *Board of Tax Appeals Reports*, page 784, issued in 1928.

If the IRS loses in a decision, it may indicate whether it agrees or disagrees with the results reached by the court by publishing an *acquiescence* ("A" or "Acq.") or
nonacquiescence ("NA" or "Nonacq.") respectively. Until 1991, acquiescences and nonacquiescences were published only for certain Regular decisions of the Tax Court, but the IRS has expanded its acquiescence program to include other civil tax cases where guidance is helpful. The acquiescence or nonacquiescence is published in the Internal Revenue Bulletin and the Cumulative Bulletin as an Action on Decision. The IRS can retroactively revoke an acquiescence.

Although Memorandum decisions were not published by the U.S. Government until recently (they are now published on the U.S. Tax Court website), they were—and continue to be—published by Commerce Clearing House (CCH) and Research Institute of America (RIA [formerly by Prentice-Hall]). Consider, for example, the three different ways that Nick R. Hughes can be cited:

Nick R. Hughes, T.C.Memo. 2009–94
The 94th Memorandum decision issued by the Tax Court in 2009.

Nick R. Hughes, 97 TCM 1488
Page 1488 of Vol. 97 of the CCH Tax Court Memorandum Decisions.

Nick R. Hughes, 2009 RIA T.C.Memo. ¶2009,094
Paragraph 2009,094 of the RIA T.C. Memorandum Decisions.

Note that the third citation contains the same information as the first. Thus, ¶2009,094 indicates the following information about the case: year 2009, 94th T.C.Memo. decision. Before the Prentice-Hall Service division was incorporated into Research Institute of America, “P-H” was used instead of “RIA” for the third citation.18

U.S. Tax Court Summary Opinions relate to decisions of the Tax Court’s Small Cases Division. These opinions are published commercially, and on the U.S. Tax Court website, with the warning that they may not be treated as precedent for any other case. For example, Donald Addie, filed on August 25, 2009, is cited as follows:

Donald Addie, T.C. Summary Opinion 2009–129.

In 2005, the U.S. Supreme Court held that decisions of the Small Cases Division must be made public.

**Judicial Citations—The U.S. District Courts, Court of Federal Claims, and Courts of Appeals**

District Court, Court of Federal Claims, Court of Appeals, and Supreme Court decisions dealing with Federal tax matters are reported in both the CCH U.S. Tax Cases (USTC) and the RIA American Federal Tax Reports (AFTR) series.

Federal District Court decisions, dealing with both tax and nontax issues, are also published by West Publishing Company in its Federal Supplement Series (F.Supp.). Volume 999, published in 1998, is the last volume of the Federal Supplement Series. It is followed by the Federal Supplement Second Series (F.Supp.2d). A District Court case can be cited in three different forms as the following examples illustrate:

Explanation: Reported in the first volume of the U.S. Tax Cases published by Commerce Clearing House for calendar year 2004 (2004–1) and located at paragraph 60,478 (¶60,478).


18In this text, this Memorandum decision of the U.S. Tax Court would be cited as Nick R. Hughes, 97 TCM 1488, T.C.Memo. 2009–94.
In all of the preceding citations, note that the name of the case is the same (Turner being the taxpayer), as are the references to the Federal District Court of Texas (D.Ct. Tex.) and the year the decision was rendered (2004).19

Decisions of the Court of Federal Claims20 and the Courts of Appeals are published in the USTCs, AFTRs, and a West Publishing Company reporter called the *Federal Second Series* (F.2d). Volume 999, published in 1995, is the last volume of the *Federal Second Series*. It is followed by the *Federal Third Series* (F.3d). Beginning with October 1982, decisions of the Court of Federal Claims are published in another West Publishing Company reporter entitled the *Claims Court Reporter* (abbreviated as Cls. Ct.). Beginning with Volume 27 on October 30, 1992, the name of the reporter changed to the *Federal Claims Reporter* (abbreviated as Fed.Cl.). The following examples illustrate the different forms:

- **Estate of Gribauskas v. Comm.**
  - 2003–2 USTC ¶60,466 (CCH citation)
  - 92 AFTR 2d 2003–5914 (RIA citation)
  - 342 F.3d 85 (West citation)

- **Apollo Computer, Inc. v. U.S.,**
  - 95–1 USTC ¶50,015 (CCH citation)
  - 74 AFTR 2d 94–7172 (RIA citation)
  - 32 Fed.Cl. 334 (West citation)

Note that *Estate of Gribauskas v. Comm.* is a decision rendered by the Second Circuit Court of Appeals in 2003 (CA–2, 2003), while *Apollo Computer, Inc.* was issued by the Court of Federal Claims in 1994 (Fed.Cl., 1994).

**Judicial Citations—The U.S. Supreme Court** Like all other Federal tax decisions (except those rendered by the U.S. Tax Court), Supreme Court decisions are published by Commerce Clearing House in the USTCs and by RIA in the AFTRs. The U.S. Government Printing Office also publishes these decisions in the *United States Supreme Court Reports* (U.S.), as do West Publishing Company in its *Supreme Court Reporter* (S.Ct.) and the Lawyer’s Co-operative Publishing Company in its *United States Reports, Lawyer’s Edition* (L.Ed.). The following illustrates the different ways the same decision can be cited:

- **U.S. v. The Donruss Co.,**
  - 69–1 USTC ¶9167 (CCH citation)
  - 23 AFTR 2d 69–418 (RIA citation)
  - 89 S.Ct. 501 (West citation)
  - 393 U.S. 297 (U.S. Government Printing Office citation)
  - 21 L.Ed.2d 495 (Lawyer’s Co-operative Publishing Co. citation)

The parenthetical reference (USSC, 1969) identifies the decision as having been rendered by the U.S. Supreme Court in 1969. In this text, the citations of Supreme Court decisions are limited to the CCH (USTC), RIA (AFTR), and West (S.Ct.) versions. See Concept Summary 2.2.

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19In this text, the case would be cited in the following form: *Turner v. U.S.*, 2004–1 USTC ¶60,478, 93 AFTR 2d 2004–686, 306 F.Supp.2d 668 (D.Ct. Tex., 2004). Prentice-Hall Information Services is now owned by Research Institute of America. Although recent volumes contain the RIA imprint, many of the older volumes continue to have the P-H imprint.

20Before October 29, 1992, the Court of Federal Claims was called the Claims Court. Before October 1, 1982, the Court of Federal Claims was called the Court of Claims.
OTHER SOURCES OF THE TAX LAW

Other sources of tax information that a tax practitioner may need to consult include tax treaties and tax periodicals.

Tax Treaties

The United States signs certain tax treaties (sometimes called tax conventions) with foreign countries to render mutual assistance in tax enforcement and to avoid double taxation. Neither a tax law nor a tax treaty automatically takes precedence. When there is a direct conflict, the most recent item will take precedence. A taxpayer must disclose on the tax return any position where a treaty overrides a tax law.21 There is a $1,000 per failure to disclose penalty for individuals and a $10,000 per failure to disclose penalty for corporations.22

Tax Periodicals

The use of tax periodicals can often shorten the research time needed to resolve a tax issue. If the article is relevant to the issue at hand, it may provide the references needed to locate the primary sources of the tax law that apply (e.g., citations to judicial decisions, Regulations, and other IRS pronouncements). Thus, the researcher obtains a “running start” in arriving at a solution to the problem.

21§ 7852(d).
22Reg. §§ 301.6114–1, 301.6712–1, and 301.7701(b)(7).
Among the many indexes available for locating tax articles on a particular tax problem is Commerce Clearing House’s *Federal Tax Articles*. This multivolume service includes a subject index, a Code Section number index, and an author’s index.

Another is the *Index to Federal Tax Articles* (published by Warren, Gorham, and Lamont). Both of these indexes are updated periodically, but are available only in print form.

The following are some of the more useful tax periodicals:

- *Journal of Taxation*
- *Journal of International Taxation*
- *Practical Tax Strategies*
- *Estate Planning*
- *Corporate Taxation*
- *Business Entities*
- [ria.thomsonreuters.com/Journals](ria.thomsonreuters.com/Journals)
- *The Tax Executive*
  - [aaahq.org/ata/_ATAMenu/ATAPubJLTR.html](aaahq.org/ata/_ATAMenu/ATAPubJLTR.html)
- *Oil, Gas & Energy Quarterly*
  - [www.bus.lsu.edu/accounting/faculty/lcrumbley/oilgas.html](www.bus.lsu.edu/accounting/faculty/lcrumbley/oilgas.html)
- *Trusts and Estates*
  - [trustsandestates.com](trustsandestates.com)
- *Journal of Passthrough Entities*
- *TAXES—The Tax Magazine*
  - [tax.cchgroup.com/Books](tax.cchgroup.com/Books)
- *Practical Accountant*
  - [webcpa.com](webcpa.com)
- *Tax Law Review*
  - [www.law.nyu.edu/llmjsd/tax/taxlawreview/ECM_DLV_005627](www.law.nyu.edu/llmjsd/tax/taxlawreview/ECM_DLV_005627)
- *Journal of the American Taxation Association*
  - [aaahq.org/ata/_ATAMenu/ATAPubJATA.html](aaahq.org/ata/_ATAMenu/ATAPubJATA.html)

## 2.2 Working with the Tax Law—Tax Research Tools

Tax law consists of a body of legislative (e.g., Code Sections, tax treaties), administrative (e.g., Regulations, Rulings), and judicial (e.g., court cases) pronouncements. Working with the tax law requires being able to effectively locate and use these sources. A key consideration is the time required to carry out this research and finding activity.

Unless the problem is simple (e.g., the Code Section is known, and there is a Regulation on point), the research process should begin with a tax service.
COMMERCIAL TAX SERVICES

Due to various changes, categorizing tax services has become an almost impossible task. Previously, services could be classified as annotated (i.e., organized by Internal Revenue Code) or topical (i.e., organized by major topics), but this classification system is no longer appropriate for many tax services as their format has been modified. Often the change is due to the acquisition of what was a competing tax service. For example, the United States Tax Reporter (annotated) now has a version that contains the Federal Tax Coordinator 2d (topical).

Tax services also can no longer be distinguished based on whether they are available only in hard copy or online versions. Previously, for example, Tax Management Portfolios was solely a print publication. Now, like most other tax services, it is also accessible online.

In addition, the list of publishers producing the tax services is not the same. Not only have there been ownership changes (e.g., Research Institute of America [RIA] now owns Prentice-Hall [P-H]), but also new players have arrived. LexisNexis for example, through Tax Center, offers primary tax services such as the Code and Regulations as well as material obtained from the Matthew Bender and Kleinrock services. Westlaw, due to its common ownership by Thomson, offers the RIA products and also the Mertens service.

Many new tax services have become like automobiles with a version to fit every practitioner’s needs and financial resources. At one extreme, an abbreviated version of the regular (“Standard”) service (e.g., CCH and its two-volume Federal Tax Guide) is designed for those with minimal tax research needs. For others, the basic product can include “extras” (e.g., CCH and its Federal Excise Tax Reporter).

A partial list of the available commercial tax services includes:

- Tax Research NetWork, Commerce Clearing House Internet service.
- United States Tax Reporter, Research Institute of America.
- RIA Checkpoint, Research Institute of America. The online version of United States Tax Reporter also can include the Federal Tax Coordinator 2d.
- Westlaw services—compilations include access to Tax Management Portfolios, Federal Tax Coordinator 2d, and Mertens.
- TaxCenter, LexisNexis compilation of primary sources and various materials taken from CCH, Matthew Bender, Kleinrock, and Bureau of National Affairs.
- Federal Research Library, Tax Analysts (a nonprofit organization) databases dealing with explanations and commentaries on primary source materials.

USING ONLINE TAX SERVICES

Instructions on how to use a tax service are not particularly worthwhile unless a specific service is involved. Even here, instructions need to be followed by hands-on experience to be effective. For online versions of a tax service, however, following certain procedures can simplify the research process. Since a practitioner’s time is valuable and several research services base usage charges on time spent, time is of the essence.

When the principal emphasis is on time, every shortcut helps. The following suggestions (most of which are familiar to any user of the Internet) may be helpful.23

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23For a more complete discussion of the use of RIA Checkpoint and CCH Tax Research NetWork and Internet research in taxation, see Raabe, Whittenburg, and Sanders, South-Western’s Federal Tax Research, 8th ed. (Cengage Learning South-Western, 2008), Chapters 6 and 7.
Choose keywords for the search carefully. Words with a broad usage, such as *income*, are worthless when standing alone. If the researcher is interested in qualified dividend income, even *dividend income* is too broad because it will call up stock dividends, constructive dividends, liquidating dividends, and more. By using *qualified dividend income* at the outset, the search is considerably narrowed. In RIA *Checkpoint*, for example, these two modifications narrowed the search from over 10,000 items to 3,824 and finally to 884. Obviously, further contraction will be needed, but at least the researcher is starting with a considerably smaller number of potential items.

Take advantage of connectors to place parameters on the search and further restrict the output. Although each service has its own set of connectors, many are used by several services. Thus, quotation marks around a phrase mean *exact phrase* in both RIA *Checkpoint* and CCH *NetWork* (e.g., “personal service corporation”).

Be selective in choosing a database. For example, if the research project does not involve case law, there is no point in including the judicial decision component in the search database. Doing so just adds to the output items and will necessitate further screening through a search modification.

Use a table of contents, index, or citation approach when appropriate. Although the keyword approach is most frequently used, databases can be searched in other ways. Using the table of contents or index is the usual approach with print versions of a tax service. With the citation route, access may be through a statutory (e.g., Code Section), administrative (e.g., Rev.Rul.), or judicial citation (e.g., Tax Court), depending on the tax service. When a judicial citation is involved and only the taxpayer’s last name is known, though, problems can arise. For example, how many responses would a taxpayer named Smith yield? Likewise, before a Code Section is used, consider its scope. How many items would § 162 retrieve? Nevertheless, the use of a table of contents, index, or citation approach can be a valuable time-saver under the right circumstances.

**NONCOMMERCIAL ONLINE SERVICES**

The Internet provides a wealth of tax information in several popular forms, sometimes at no direct cost to the researcher. Using so-called browser software that often is distributed with new computer systems and their communication devices, the tax professional can access information provided around the world that can aid the research process.

- **Home pages (sites) on the Web** are provided by accounting and consulting firms, publishers, tax academics and libraries, and governmental bodies as a means of making information widely available or of soliciting subscriptions or consulting engagements. The best sites offer links to other sites and direct contact to the site providers. One of the best sites available to the tax practitioner is the Internal Revenue Service’s home page, illustrated in Exhibit 2.2. This site offers downloadable forms and instructions, “plain English” versions of Regulations, and news update items. Exhibit 2.3 lists some of the websites that may be most useful to tax researchers and their Internet addresses as of press date. Particularly useful is the directory at [http://taxsites.com](http://taxsites.com), which provides links to accounting and tax sources (including international as well as payroll).

- **Newsgroups** provide a means by which information related to the tax law can be exchanged among taxpayers, tax professionals, and others who subscribe to the group’s services. Newsgroup members can read the exchanges among other members and offer replies and suggestions to inquiries as desired. Discussions address the interpretation and application of existing law, analysis of proposals and new pronouncements, and reviews of tax software.
DATA WAREHOUSING REDUCES GLOBAL TAXES

Many global companies are using data warehouses to collect data, which can be analyzed and used to minimize their global tax liabilities. “You take all of your tax data and dump it into a data warehouse,” says Michael S. Burke of KPMG’s e-tax solutions. “Next, it’s applying a tool to define user requirements—compliance, real time analysis, etc.” The company can then manipulate all of this information to reduce compliance costs, facilitate planning for value added taxes, and minimize time spent dealing with international tax problems.

For example, a company wishes to implement an e-procurement technique that would save it $100 million in expenses and increase taxable income. That could mean that about $40 million in additional taxes would go to the U.S. Treasury and state treasuries. By looking at the tax laws worldwide, the company may decide to base the operation in Bermuda, Ireland, or the Philippines where the tax will be only $20 million. That’s a savings of $20 million, which is not taxable.

In many situations, solutions to research problems benefit from, or require, the use of various electronic tax research tools. A competent tax professional must become familiar and proficient with these tools and be able to use them to meet the expectations of clients and the necessities of work in the modern world.24

2.3 Working with the Tax Law—

**Tax Research**

**Tax research** is the method used to determine the best available solution to a situation that possesses tax consequences. In other words, it is the process of finding a competent and professional conclusion to a tax problem. The problem may originate from

<table>
<thead>
<tr>
<th>Website</th>
<th>Web Address at Press Date (Usually preceded by <a href="http://www">http://www</a>.)</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting firms and professional organizations</td>
<td>For instance, the AICPA’s page is at aicpa.org, Ernst and Young is at ey.com, and KPMG is at kpmg.com</td>
<td>Tax planning newsletters, descriptions of services offered and career opportunities, and exchange of data with clients and subscribers</td>
</tr>
<tr>
<td>Cengage Learning South-Western</td>
<td>cengage.com/taxation/swft</td>
<td>Informational updates, newsletters, support materials for students and adopters, and continuing education</td>
</tr>
<tr>
<td>Commercial tax publishers</td>
<td>For instance, tax.com and cch.com</td>
<td>Information about products and services available for subscription and newsletter excerpts</td>
</tr>
<tr>
<td>Court opinions</td>
<td>The site at lexisone.com/lx1/caselaw/freecaslaw covers some state, Federal circuit (last 10 years), Supreme Court (all years) decisions but not Tax Court</td>
<td>Provides a synopsis of result reached by the court</td>
</tr>
<tr>
<td>Internal Revenue Service</td>
<td>irs.gov</td>
<td>News releases, downloadable forms and instructions, tables, Circular 230, and e-mail</td>
</tr>
<tr>
<td>Tax Almanac</td>
<td>taxalmanac.org</td>
<td>Smorgasbord of tax research resources</td>
</tr>
<tr>
<td>Tax Analysts</td>
<td>taxanalysts.com</td>
<td>Policy-oriented readings on the tax law and proposals to change it, moderated bulletins on various tax subjects</td>
</tr>
<tr>
<td>Tax Foundation</td>
<td>taxfoundation.org</td>
<td>Nonprofit educational organization that promotes sound tax policy and measures tax burdens</td>
</tr>
<tr>
<td>Tax laws online</td>
<td>Regulations are at cfr.law.cornell.edu/cfr and the Code is at uscode.house.gov/search/criteria.shtml and www4.law.cornell.edu/uscode</td>
<td>References and links to tax sites on the Internet, including state and Federal tax sites, academic and professional pages, tax forms, and software</td>
</tr>
<tr>
<td>Tax Sites Directory</td>
<td>taxsites.com</td>
<td>References and links to tax sites on the Internet, including state and Federal tax sites, academic and professional pages, tax forms, and software</td>
</tr>
<tr>
<td>U.S. Tax Court decisions</td>
<td>ustaxcourt.gov</td>
<td>Recent U.S. Tax Court decisions</td>
</tr>
</tbody>
</table>

NOTE: Caution: addresses change frequently.

completed or proposed transactions. In the case of a completed transaction, the objective of the research is to determine the tax result of what has already taken place. For example, is the expenditure incurred by the taxpayer deductible or not deductible for tax purposes? When dealing with proposed transactions, the tax research process is concerned with the determination of possible alternative tax consequences. To the extent that tax research leads to a choice of alternatives or otherwise influences the future actions of the taxpayer, it becomes the key to effective tax planning.

Tax research involves the following procedures:

- Identifying and refining the problem.
- Locating the appropriate tax law sources.
- Assessing the validity of the tax law sources.
- Arriving at the solution or at alternative solutions while giving due consideration to nontax factors.
- Effectively communicating the solution to the taxpayer or the taxpayer’s representative.
- Following up on the solution (where appropriate) in light of new developments.

This process is depicted schematically in Figure 2.5. The broken lines indicate steps of particular interest when tax research is directed toward proposed, rather than completed, transactions.

**IDENTIFYING THE PROBLEM**

Problem identification starts with a compilation of the relevant facts involved. In this regard, all of the facts that may have a bearing on the problem must be gathered, as any omission could modify the solution reached. To illustrate, consider what appears to be a very simple problem.

<table>
<thead>
<tr>
<th>LEGISLATIVE SOURCES</th>
<th>JUDICIAL SOURCES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Preliminary Problem Identification</strong></td>
<td><strong>Tax Research</strong></td>
</tr>
<tr>
<td><strong>Problem Refinement and Discovery of New Problem Areas</strong></td>
<td><strong>Solution</strong></td>
</tr>
<tr>
<td><strong>Communication</strong></td>
<td><strong>New Developments</strong></td>
</tr>
</tbody>
</table>

**FIGURE 2.5 Tax Research Process**
Early in December 2010, Fred and Megan review their financial and tax situation with their son, Sam, and daughter-in-law, Dana, who live with them. Fred and Megan are in the 28% tax bracket in 2010. Both Sam and Dana are age 21. Sam, a student at a nearby university, owns some publicly traded stock that he inherited from his grandmother. A current sale of the stock would result in approximately $8,000 of gross income ($19,000 amount realized − $11,000 adjusted basis). At this point, Fred and Megan provide about 55% of Sam and Dana's support. Although neither is now employed, Sam has earned $960 and Dana has earned $900. The problem: Should the stock be sold, and would the sale prohibit Fred and Megan from claiming Sam and Dana as dependents? Would the stock sale in 2010 result in a tax liability for Sam and Dana?

REFINING THE PROBLEM

Initial reaction is that Fred and Megan in Example 4 could not claim Sam and Dana as dependents if the stock is sold, since Sam would then have gross income of more than the exemption amount under § 151(d). However, after 2004, the test for whether a child qualifies for dependency status is first conducted under the qualifying child requirements. Only if these requirements cannot be satisfied is the test for dependency status conducted under the qualifying relative requirements. The gross income test is applicable only under the qualifying relative status. Thus, Sam could sell the stock without penalizing the parents with respect to the gross income test. Under the qualifying child provision, however, Sam must not have provided more than one-half of his own support. Hence, the $19,000 of proceeds from the sale of the stock might lead to the failure of the not self-supporting requirement, depending on how much Sam spends for his support.

Assume, however, that further fact gathering reveals the following additional information:

- Sam does not really need to spend the proceeds from the sale of the stock.
- Sam receives a sizable portion of his own support from a scholarship.

With these new facts, additional research leads to § 152(f)(5) and Regulation § 1.152–1(c), which indicate that a scholarship received by a student is not included for purposes of determining whether Sam is self-supporting under the qualifying child provisions. Further, if Sam does not spend the proceeds from the sale of the stock, the unexpended amount is not counted for purposes of the not self-supporting test. Thus, it appears that the parents would not be denied the dependency exemptions for Sam and Dana, as the qualifying child requirements appear to be satisfied for Sam and the qualifying relative requirements appear to be satisfied for Dana.

LOCATING THE APPROPRIATE TAX LAW SOURCES

Once the problem is clearly defined, what is the next step? Although the next step is a matter of individual judgment, most tax research begins with the index volume of a hard copy tax service or a keyword search on an online tax service as described earlier. If the problem is not complex, the researcher may bypass the tax service or online service and turn directly to the Internal Revenue Code and the Treasury Regulations. For the beginner, the latter procedure saves time and will solve many of the more basic problems. If the researcher does not have a personal copy of the Code or Regulations, resorting to the appropriate volume(s) of a tax service will be necessary.
ASSESSING THE VALIDITY OF THE TAX LAW SOURCES

Once a source has been located, the next step is to assess it in light of the problem at hand. Proper assessment involves careful interpretation of the tax law and consideration of its relevance and validity.

Interpreting the Internal Revenue Code

The language of the Code often is difficult to comprehend fully. Contrary to many people’s suspicions, the Code is not written deliberately to confuse. Unfortunately, though, it often has that effect. The Code is intended to apply to more than 200 million taxpayers, many of whom are willing to exploit any linguistic imprecision to their benefit—to find a “loophole” in popular parlance. Many of the Code’s provisions are limitations or restrictions involving two or more variables. Expressing such concepts algebraically would be more direct; using words to accomplish this task instead is often quite cumbersome. Among the worst such attempts was former § 341(e) relating to so-called collapsible corporations. One sentence had more than 450 words (twice as many as in Abraham Lincoln’s Gettysburg Address). Within this same subsection was another sentence of 300 words.

Assessing the Validity of a Treasury Regulation

Treasury Regulations are the official interpretation of the Code and are entitled to great deference. Occasionally, however, a court will invalidate a Regulation or a portion thereof on the grounds that the Regulation is contrary to the intent of Congress. Usually, the courts do not question the validity of Regulations because of the belief that “the first administrative interpretation of a provision as it appears in a new act often expresses the general understanding of the times or the actual understanding of those who played an important part when the statute was drafted.”

Keep in mind the following observations when assessing the validity of a Regulation:

- IRS agents must give the Code and the Regulations issued thereunder equal weight when dealing with taxpayers and their representatives.
- Proposed Regulations provide a preview of future final Regulations, but they are not binding on the IRS or taxpayers.
- In a challenge, the burden of proof is on the taxpayer to show that a Regulation varies from the language of the statute and has no support in the Committee Reports.
- If the taxpayer loses the challenge, the negligence penalty may be imposed. This accuracy-related penalty applies to any failure to make a reasonable attempt to comply with the tax law and to any disregard of rules and Regulations.
- Final Regulations can be classified as procedural, interpretive, or legislative. Procedural Regulations neither establish tax laws nor attempt to explain tax laws. Procedural Regulations are housekeeping-type instructions, indicating information that taxpayers should provide the IRS, as well as information about the internal management and conduct of the IRS itself.
- Some interpretive Regulations rephrase and elaborate what Congress stated in the Committee Reports that were issued when the tax legislation was enacted. Such Regulations are hard and solid and almost impossible to overturn because they clearly reflect the intent of Congress.
- In some Code Sections, Congress has given the Secretary or his delegate the authority to prescribe Regulations to carry out the details of administration or to otherwise complete the operating rules. Under such circumstances, Congress effectively is delegating its legislative powers to the Treasury Department. Regulations issued pursuant to this type of

29 Augustus v. Comm., 41–1 USTC ¶9255, 26 AFTR 612, 118 F.2d 38 (CA–6, 1941).
30 §§ 6662(a) and (b)(1).
authority possess the force and effect of law and are often called legislative Regulations (e.g., consolidated return Regulations).

Assessing the Validity of Other Administrative Sources of the Tax Law

Revenue Rulings issued by the IRS carry less weight than Treasury Department Regulations. Revenue Rulings are important, however, in that they reflect the position of the IRS on tax matters. In any dispute with the IRS on the interpretation of tax law, taxpayers should expect agents to follow the results reached in any applicable Revenue Rulings.

Actions on Decisions further tell the taxpayer the IRS’s reaction to certain court decisions. Recall that the IRS follows a practice of either acquiescing (agreeing) or nonacquiescing (not agreeing) with selected judicial decisions. A nonacquiescence does not mean that a particular court decision is of no value, but it does indicate that the IRS may continue to litigate the issue involved.

Assessing the Validity of Judicial Sources of the Tax Law

The judicial process as it relates to the formulation of tax law has been described. How much reliance can be placed on a particular decision depends upon the following variables:

- The higher the level of the court that issued a decision, the greater the weight accorded to that decision. A decision rendered by a trial court (e.g., a Federal District Court) carries less weight than one issued by an appellate court (e.g., the Fifth Circuit Court of Appeals). Unless Congress changes the Code, decisions by the U.S. Supreme Court represent the last word on any tax issue.
- More reliance is placed on decisions of courts that have jurisdiction in the area where the taxpayer’s legal residence is located. If, for example, a taxpayer lives in Texas, a decision of the Fifth Circuit Court of Appeals means more than one rendered by the Second Circuit Court of Appeals. This is the case because any appeal from a District Court or the Tax Court would be to the Fifth Circuit Court of Appeals and not to the Second Circuit Court of Appeals.
- A Tax Court Regular decision carries more weight than a Memorandum decision because the Tax Court does not consider Memorandum decisions to be binding precedents. Furthermore, a Tax Court reviewed decision carries even more weight. All of the Tax Court judges participate in a reviewed decision.
- A Circuit Court decision where certiorari has been requested and denied by the Supreme Court carries more weight than a Circuit Court decision that was not appealed. A Circuit Court decision heard en banc (all the judges participate) carries more weight than a normal Circuit Court case.
- A decision that is supported by cases from other courts carries more weight than a decision that is not supported by other cases.
- The weight of a decision also can be affected by its status on appeal. For example, was the decision affirmed or overruled?

In connection with the last two variables, a citator is helpful to tax research. A citator provides the history of a case, including the authority relied on (e.g., other judicial decisions) in reaching the result. Reviewing the references listed in the citator discloses whether the decision was appealed and, if so, with what result (e.g., affirmed, reversed, remanded). It also reveals other cases with the same or similar issues and how they were decided. Thus, a citator reflects on the validity of a case and may lead to other relevant judicial material. If one intends to rely on a judicial decision to any significant degree, “running” the case through a citator is imperative.

32Before October 1, 1982, an appeal from the then-named U.S. Court of Claims (the other trial court) was directly to the U.S. Supreme Court.
34The major citators are published by Commerce Clearing House, RIA, Westlaw, and Shepard’s Citations, Inc.
35The CCH version is available online through the CCH NetWork service; for RIA, use Checkpoint. Shepard’s Internet version is part of LexisNexis.
Assessing the Validity of Other Sources

**Primary sources** of tax law include the Constitution, legislative history materials, statutes, treaties, Treasury Regulations, IRS pronouncements, and judicial decisions. In general, the IRS regards only primary sources as substantial authority. However, reference to **secondary materials** such as legal periodicals, treatises, legal opinions, General Counsel Memoranda, and written determinations may be useful. In general, secondary sources are not authority.

Although the statement that the IRS regards only primary sources as substantial authority is generally true, there is one exception. In Notice 90–20, the IRS expanded the list of substantial authority for purposes of the accuracy-related penalty in § 6662 to include a number of secondary materials (e.g., letter rulings, General Counsel Memoranda, the Bluebook). “Authority” does not include conclusions reached in treatises, legal periodicals, and opinions rendered by tax professionals.

A letter ruling or determination letter is substantial authority only for the taxpayer to whom it is issued, except as noted above with respect to the accuracy-related penalty.

Upon the completion of major tax legislation, the staff of the Joint Committee on Taxation (in consultation with the staffs of the House Ways and Means and Senate Finance Committees) often will prepare a General Explanation of the Act, commonly known as the Bluebook because of the color of its cover. The IRS will not accept this detailed explanation as having legal effect. The Bluebook does, however, provide valuable guidance to tax advisers and taxpayers until Regulations are issued. Some letter rulings and General Counsel Memoranda of the IRS cite Bluebook explanations.

ARRIVING AT THE SOLUTION OR AT ALTERNATIVE SOLUTIONS

Example 4 raised the question of whether a taxpayer would be denied dependency exemptions for a son and a daughter-in-law if the son sold some stock near the end of the year. A refinement of the problem supplies the following additional information:

- Sam and Dana anticipate filing a joint return.

  Section 152(b)(2) indicates that a taxpayer is not permitted a dependency exemption for a married dependent if the married individual files a joint return. Initial reaction is that a joint return by Sam and Dana would be disastrous to the parents. However, more research uncovers two Revenue Rulings that provide an exception if neither the dependent nor the dependent’s spouse is required to file a return but does solely to claim a refund of tax withheld. The IRS asserts that each spouse must have gross income of less than the exemption amount. Therefore, if Sam sells the stock and he and Dana file a joint return, the parents would lose the dependency exemption for both Sam and Dana.

  If the stock is not sold until January 2011, both dependency exemptions are available to the parents in 2010 even if Sam and Dana file a joint return. However, under § 151(d)(2), a personal exemption is not available to a taxpayer who can be claimed as a dependent by another taxpayer (whether actually claimed or not). Thus, if the parents can claim Sam and Dana as dependents, Sam and Dana would lose their personal exemptions on their tax return.

COMMUNICATING TAX RESEARCH

Once the problem has been researched adequately, a memo, letter, or oral presentation setting forth the result may need to be prepared. The form such a communication takes could depend on a number of considerations. For example, does the employer or instructor recommend a particular procedure or format for tax

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**L0.5**

Communicate the results of the tax research process in a client letter and a tax file memorandum.
research memos? Is the memo to be given directly to the client, or will it first go to the preparer’s employer? Who is the audience for the oral presentation? How long should you talk? Whatever form it takes, a good tax research communication should contain the following elements.

- A clear statement of the issue.
- In more complex situations, a short review of the fact pattern that raises the issue.
- A review of the pertinent tax law sources (e.g., Code, Regulations, Revenue Rulings, judicial authority).
- Any assumptions made in arriving at the solution.
- The solution recommended and the logic or reasoning supporting it.
- The references consulted in the research process.

Illustrations of the memos for the tax file and the client letter associated with Example 4 appear in Figures 2.6, 2.7, and 2.8.

2.4 WORKING WITH THE TAX LAW—TAX PLANNING

Tax research and tax planning are inseparable. The primary purpose of effective tax planning is to maximize the taxpayer’s after-tax wealth. This statement does not mean that the course of action selected must produce the lowest possible tax under the circumstances. The minimization of tax liability must be considered in the context of the legitimate business goals of the taxpayer.

A secondary objective of effective tax planning is to reduce or defer the tax in the current tax year. Specifically, this objective aims to accomplish one or more results. Some possibilities are eradicating the tax entirely, eliminating the tax in the current year, deferring the receipt of income, proliferating taxpayers (i.e., forming partnerships and corporations or making lifetime gifts to family members), eluding double taxation, avoiding ordinary income, or creating, increasing, or accelerating deductions. However, this secondary objective should be approached with considerable reservation and moderation. For example, a tax election in one year may accomplish a current reduction in taxes, but it could saddle future years with a disadvantageous tax position.

NONTAX CONSIDERATIONS

There is a danger that tax motivations may take on a significance that does not conform to the true values involved. In other words, tax considerations can operate to impair the exercise of sound business judgment. Thus, the tax planning process can lead to ends that are socially and economically objectionable. Unfortunately, a tendency exists for planning to go toward the opposing extremes of either not enough or too much emphasis on tax considerations. The happy medium is a balance that recognizes the significance of taxes, but not beyond the point at which planning detracts from the exercise of good business judgment.

The remark is often made that a good rule is to refrain from pursuing any course of action that would not be followed were it not for certain tax considerations. This statement is not entirely correct, but it does illustrate the desirability of preventing business logic from being sacrificed at the altar of tax planning.

TAX EVASION AND TAX AVOIDANCE

A fine line exists between legal tax planning and illegal tax planning—tax avoidance versus tax evasion. Tax avoidance is merely tax minimization through legal techniques. In this sense, tax avoidance is the proper objective of all tax planning. Though eliminating or reducing taxes is also a goal of tax evasion, the term implies the use of subterfuge and fraud as a means to this end. Perhaps because common goals are involved, popular usage has blurred the distinction between the two concepts. Consequently, the association of tax avoidance with tax evasion has kept some taxpayers from properly taking advantage of planning possibilities. The now classic words of Judge Learned Hand in Commissioner v. Newman reflect the true values a taxpayer should have:

> Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.39

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As Denis Healy, a former British Chancellor, once said, “The difference between tax avoidance and tax evasion is the thickness of a prison wall.”

**WHO DID NOT PAY HIS INCOME TAXES PROPERLY?**

Representative Charles P. Rangel had to write six checks for a total of approximately $10,800 in back (Federal and state) taxes due on his 2004, 2005, and 2006 tax returns. Among other items, he overlooked paying income taxes on rent income on a beach house he owns in the Dominican Republic. Rangel is chairman of the tax writing committee—the House Ways and Means Committee. Apparently, penalties and interest were not included in the amount paid. What are your thoughts?
The Government Accountability Office estimates that U.S. taxpayers spend at least $107 billion each year on tax compliance costs. The Treasury Department estimates that individuals spend at least 6.4 billion hours preparing Federal income tax returns. Small businesses, self-employed persons, and taxpayers with the highest marginal tax rates have the highest levels of tax evasion.40

FOLLOW-UP PROCEDURES

Because tax planning usually involves a proposed (as opposed to a completed) transaction, it is predicated upon the continuing validity of the advice based upon the tax research. A change in the tax law (either legislative, administrative, or judicial) could alter the original conclusion. Additional research may be necessary to test the solution in light of current developments (refer to the broken lines at the right in Figure 2.5).

TAX PLANNING—A PRACTICAL APPLICATION

Returning to the facts of Example 4, what could be done to protect the dependency exemptions for the parents? If Sam and Dana refrain from filing a joint return, both could be claimed by the parents.

An obvious tax planning tool is the installment method. Could the securities be sold using the installment method under § 453 so that most of the gain is deferred into the next year? Under the installment method, certain gains may be postponed and recognized as the cash proceeds are received. The problem is that the installment method is not available for stock traded on an established securities market.41


*See Chapter 16 for a discussion of installment sales.
A little more research, however, indicates that Sam may be able to sell the stock and postpone the recognition of gain until the following year by selling short an equal number of substantially identical shares and covering the short sale in the subsequent year with the shares originally held. Selling short means that Sam sells borrowed stock (substantially identical) and repays the lender with the stock held on the date of the short sale. This short against the box technique would allow Sam to protect his $8,000 profit and defer the closing of the sale until the following year. However, additional research indicates that 1997 tax legislation provides that the short against the box technique will no longer produce the desired postponement of recognized gain. That is, at the time of the short sale, Sam will have a recognized gain of $8,000 from a constructive sale. Note the critical role of obtaining the correct facts in attempting to resolve the proper strategy for the taxpayers.

Throughout this text, most chapters include observations on Tax Planning. Such observations are not all-inclusive but are intended to illustrate some of the ways in which the material covered can be effectively utilized to minimize taxes.

### 2.5 Taxation on the CPA Examination

The CPA examination has changed from a paper-and-pencil exam to a computer-based exam with increased emphasis on information technology and general business knowledge. The 14-hour exam has four sections, and taxation is included in the 3-hour Regulation section. The taxation part of the Regulation section covers:

- Federal tax process, procedures, accounting, and planning (11–15%).
- Federal taxation of property transactions (12–16%).
- Federal taxation of individuals (13–19%).
- Federal taxation of entities (18–24%).

The CPA examination is not curved to produce a designated pass rate. In theory, if all candidates are well prepared, they will all pass. Of course, if all are unprepared,
all could fail. The likelihood of passing at least one section is greater for candidates who take more than one CPA examination section in a testing window.

Each exam section includes both multiple-choice questions and case studies called simulations. The multiple-choice part consists of three sequential testlets, each containing 24 to 30 questions. These testlets are groups of questions prepared to appear together. In addition, each exam section includes a testlet that consists of two simulations. A candidate may review and change answers within each testlet but cannot go back after exiting a testlet. Candidates take different, but equivalent exams. At some time in the future, five or six shorter simulations may replace the current two large simulations.

Simulations are small case studies designed to test a candidate’s tax knowledge and skills using real-life work-related situations. The simulations range from 30 to 50 minutes in length and complement the multiple-choice questions. Simulations include a four-function pop-up calculator, a blank spreadsheet with some elementary functionality, and authoritative literature appropriate to the subject matter. The taxation database includes authoritative excerpts (e.g., Internal Revenue Code and Federal tax forms) that are necessary to complete the tax case study simulations. Examples of such simulations follow.

The tax citation type simulation requires the candidate to research the Internal Revenue Code and enter a Code Section and subsection. For example, Amber Company is considering using the simplified dollar-value method of pricing its inventory for purposes of the LIFO method that is available to certain small businesses. What Internal Revenue Code Section is the relevant authority to which you should turn to determine whether the taxpayer is eligible to use this method? To be successful, the candidate needs to find § 474.

A tax form completion simulation requires the candidate to fill out a portion of a tax form. For example, Green Company is a limited liability company (LLC) for tax purposes. Complete the income section of the 2009 IRS Form 1065 for Green Company using the values found and calculated on previous tabs along with the following data:

Ordinary income from other partnerships $5,200
Net gain (loss) from Form 4797 2,400
Management fee income 12,000

The candidate is provided with page 1 of Form 1065 on which to record the appropriate amounts.

Candidates can learn more about the CPA examination at www.cpa-exam.org. This online tutorial site reviews the exam’s format, navigation functions, and tools. A 30- to 60-minute sample exam will familiarize a candidate with the types of questions on the examination.

**KEY TERMS**

- Acquiescence, 2–16
- Circuit Court of Appeals, 2–14
- Citator, 2–28
- Court of original jurisdiction, 2–11
- Determination letters, 2–10
- Federal District Court, 2–11
- Finalized Regulations, 2–7
- Interpretive Regulations, 2–27
- Legislative Regulations, 2–28
- Letter rulings, 2–9
- Nonacquiescence, 2–17
- Precedents, 2–15
- Procedural Regulations, 2–27
- Proposed Regulations, 2–7
- Revenue Procedures, 2–8
- Revenue Rulings, 2–8
- Small Cases Division, 2–11
- Tax avoidance, 2–31
- Tax research, 2–24
- Technical Advice Memoranda (TAMs), 2–10
- Temporary Regulations, 2–7
- U.S. Court of Federal Claims, 2–11
- U.S. Supreme Court, 2–15
- U.S. Tax Court, 2–11
- Writ of Certiorari, 2–15
DISCUSSION QUESTIONS

1. **LO.1** The objective of tax planning is to minimize the taxpayer’s tax liability. Discuss this statement.

2. **LO.1** Did Congress recodify the Internal Revenue Code in 1986?

3. **LO.1** Where does Federal tax legislation originate?

4. **LO.1** Why may committee reports be valuable to a tax researcher?

5. **LO.1** When there is not enough space between Code Section numbers, what does Congress do when new tax legislation is enacted?

6. **LO.2, 5** Paul Bishop operates a small international firm named Teal, Inc. A new treaty between the United States and France conflicts with a Section of the Internal Revenue Code. Paul asks you for advice. If he follows the treaty position, does he need to disclose this on his tax return? If he is required to disclose, are there any penalties for failure to disclose? Prepare a letter in which you respond to Paul. Teal’s address is 100 International Drive, Tampa, FL 33620.

7. **LO.1, 2** Interpret this Regulation citation: Reg. § 1.1001–2(a)(3).

8. **LO.1, 2** Explain how Regulations are arranged. How would the following Regulations be cited?
   a. Finalized Regulations under § 132.
   b. Proposed Regulations under § 2036.
   c. Temporary Regulations under § 482.
   d. Legislative Regulations under § 1504.

9. **LO.1, 4** Distinguish between legislative, interpretive, and procedural Regulations.

10. **LO.1** In the citation Rev.Proc. 99–40, 1999–2 C.B. 60, to what do the 40 and the 60 refer?

11. **LO.1, 4** Rank the following items from the highest authority to the lowest in the Federal tax law system:
   a. Interpretive Regulation.
   b. Legislative Regulation.
   c. Letter ruling.
   d. Revenue Ruling.
   e. Internal Revenue Code.
   f. Proposed Regulation.

12. **LO.1** Interpret each of the following citations:
   a. Prop.Reg. § 1.381 (b)–1(a).
   c. TAM 200803017.

13. **LO.1** Caleb receives a 90-day letter after his discussion with an appeals officer. He is not satisfied with the $92,000 settlement offer. Identify the relevant tax research issues facing Caleb.

14. **LO.1** Which of the following would be considered advantages of the Small Cases Division of the Tax Court?
   a. Appeal to the U.S. Tax Court is possible.
   b. A hearing of a deficiency of $65,000 is considered on a timely basis.
   c. Taxpayer can handle the litigation without using a lawyer or certified public accountant.
   d. Taxpayer can use Small Cases Division decisions for precedential value.
   e. The actual hearing is conducted informally.
   f. Travel time will probably be reduced.

15. **LO.1** List an advantage and a disadvantage of using the U.S. District Court as the trial court for Federal tax litigation.

16. **LO.1, 5** Dwain Toombs is considering litigating a tax deficiency of approximately $311,000 in the court system. He asks you to provide him with a short description of his
alternatives indicating the advantages and disadvantages of each. Prepare your response to Dwain in the form of a letter. His address is 200 Mesa Drive, Tucson, AZ 85714.

17. **LO.1** List an advantage and a disadvantage of using the U.S. Court of Federal Claims as the trial court for Federal tax litigation.

18. **LO.1** A taxpayer lives in Michigan. In a controversy with the IRS, the taxpayer loses at the trial court level. Describe the appeal procedure for each of the following trial courts:
   a. Small Cases Division of the U.S. Tax Court.
   b. U.S. Tax Court.
   c. U.S. District Court.
   d. U.S. Court of Federal Claims.

19. **LO.1** What is meant by *stare decisis*?

20. **LO.1** An appellate court will often become involved in fact-finding determination. Discuss the validity of this statement.

21. **LO.1** In which of the following states could a taxpayer appeal the decision of a U.S. District Court to the Tenth Circuit Court of Appeals?
   a. Alaska.
   b. Arkansas.
   c. Florida.
   d. New York.
   e. Kansas.

22. **LO.1** What determines the appropriate Circuit Court of Appeals for a particular taxpayer?

23. **LO.1, 4** In assessing the validity of a prior court decision, discuss the significance of the following on the taxpayer’s issue:
   a. The decision was rendered by the U.S. District Court of Wyoming. Taxpayer lives in Wyoming.
   b. The decision was rendered by the U.S. Court of Federal Claims. Taxpayer lives in Wyoming.
   c. The decision was rendered by the Second Circuit Court of Appeals. Taxpayer lives in California.
   d. The decision was rendered by the U.S. Supreme Court.
   e. The decision was rendered by the U.S. Tax Court. The IRS has acquiesced in the result.
   f. Same as (e), except that the IRS has nonacquiesced in the result.

24. **LO.2** What is the difference between a Regular decision, a Memorandum decision, and a Summary Opinion of the U.S. Tax Court?

25. **LO.2** Interpret each of the following citations:
   a. 54 T.C. 1514 (1970).
   b. 408 F.2d 117 (CA–2, 1969).
   c. 69–1 USTC ¶9319 (CA–2, 1969).
   g. 19 AFTR 2d 647 (D.Ct. Miss., 1967).
   h. 56 S.Ct. 289 (USSC, 1935).
   i. 36–1 USTC ¶9020 (USSC, 1935).
   j. 16 AFTR 1274 (USSC, 1935).
   k. 422 F.2d 1356 (D.Ct. Miss., 1970).

26. **LO.1, 2** Explain the following abbreviations:
   a. CA–2.
   b. Fed.Cl.
   c. aff’d.
   d. rev’d.
   e. rem’d.
   f. *Cert. denied.*
   g. *acq.*
   h. B.T.A.
   i. *USTC.*
   j. AFTR.
   k. F.3d.
   l. F.Supp.
   m. USSC.
   n. S.Ct.
   o. D.Ct.
27. **LO.2** Give the Commerce Clearing House citation for each of the following courts:
   a. Small Cases Division of the Tax Court.
   b. Federal District Court.
   c. U.S. Supreme Court.
   d. U.S. Court of Federal Claims.
   e. Tax Court Memorandum decision.

28. **LO.2** Where can you locate a published decision of the U.S. Court of Federal Claims?

29. **LO.1, 2** Which of the following items can probably be found in the *Cumulative Bulletin*?
   a. Action on Decision.
   b. Small Cases Division of the U.S. Tax Court decision.
   c. Letter ruling.
   d. Revenue Procedure.
   e. Finalized Regulation.
   f. U.S. Court of Federal Claims decision.
   g. Senate Finance Committee Report.
   h. Acquiescences to Tax Court decisions.
   i. U.S. Circuit Court of Appeals decision.

30. **LO.3** Ashley has to prepare a research paper discussing the tax aspects of child support payments for her tax class. Explain to Ashley how she can research this topic using hard copy.

31. **LO.4** Define tax research.

32. **LO.1, 2** Tom has just been audited by the IRS and, as a result, has been assessed a substantial deficiency (which he has not yet paid) in additional income taxes. In preparing his defense, Tom advances the following possibilities:
   a. Although a resident of Kentucky, Tom plans to sue in a U.S. District Court in Oregon that appears to be more favorably inclined toward taxpayers.
   b. If (a) is not possible, Tom plans to take his case to a Kentucky state court where an uncle is the presiding judge.
   c. Since Tom has found a B.T.A. decision that seems to help his case, he plans to rely on it under alternative (a) or (b).
   d. If he loses at the trial court level, Tom plans to appeal to either the U.S. Court of Federal Claims or the U.S. Second Circuit Court of Appeals because he has relatives in both Washington, D.C., and New York. Staying with these relatives could save Tom lodging expense while his appeal is being heard by the court selected.
   e. Even if he does not win at the trial court or appeals court level, Tom feels certain of success on an appeal to the U.S. Supreme Court.

Evaluate Tom’s notions concerning the judicial process as it applies to Federal income tax controversies.

33. **LO.1, 2** Using the legend provided, classify each of the following statements (more than one answer per statement may be appropriate):

<table>
<thead>
<tr>
<th>Legend</th>
<th>Applies to the U.S. District Court</th>
<th>Applies to the U.S. Tax Court</th>
<th>Applies to the U.S. Court of Federal Claims</th>
<th>Applies to the U.S. Circuit Court of Appeals</th>
<th>Applies to the U.S. Supreme Court</th>
<th>Applies to none of the above</th>
</tr>
</thead>
<tbody>
<tr>
<td>D</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>T</td>
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<tr>
<td>C</td>
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<tr>
<td>A</td>
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<td>U</td>
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<td></td>
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<tr>
<td>N</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

   a. Decides only Federal tax matters.
   b. Decisions are reported in the F.3d Series.
   c. Decisions are reported in the USTCs.
d. Decisions are reported in the AFTRs.
e. Appeal is by Writ of Certiorari.
f. Court meets most often in Washington, D.C.
g. Offers the choice of a jury trial.
h. Is a trial court.
i. Is an appellate court.
j. Allows appeal to the Court of Appeals for the Federal Circuit and bypasses the taxpayer’s particular Court of Appeals.
k. Has a Small Cases Division.
l. Is the only trial court where the taxpayer does not have to first pay the tax assessed by the IRS.

34. **LO.1, 2** Using the legend provided, classify each of the following citations as to the type of court:

<table>
<thead>
<tr>
<th>Legend</th>
<th>D</th>
<th>T</th>
<th>C</th>
<th>A</th>
<th>U</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>D =</td>
<td>Applies to the U.S. District Court</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>T =</td>
<td>Applies to the U.S. Tax Court</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C =</td>
<td>Applies to the U.S. Court of Federal Claims</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A =</td>
<td>Applies to the U.S. Circuit Court of Appeals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U =</td>
<td>Applies to the U.S. Supreme Court</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>N =</td>
<td>Applies to none of the above</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

h. Ltr.Rul. 200404009.

35. **LO.1, 2** Using the legend provided, classify each of the following citations as to publisher:

<table>
<thead>
<tr>
<th>Legend</th>
<th>RIA</th>
<th>CCH</th>
<th>W</th>
<th>U.S.</th>
<th>O</th>
</tr>
</thead>
<tbody>
<tr>
<td>RIA =</td>
<td>Research Institute of America</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CCH =</td>
<td>Commerce Clearing House</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>W =</td>
<td>West Publishing Company</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. =</td>
<td>U.S. Government</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>O =</td>
<td>Others</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. 24 T.C. 818.
b. 64 TCM 1594.
c. 563 F.Supp. 379.
d. 45 AFTR 2d 80–1487.
e. 54–2 USTC ¶9714.
f. RIA T.C.Memo. Dec. ¶92726.
i. 104 S.Ct 1495.
j. 348 U.S. 426.

36. **LO.6** Using the legend provided, classify each of the following statements:

<table>
<thead>
<tr>
<th>Legend</th>
<th>A</th>
<th>E</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>A =</td>
<td>Tax avoidance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>E =</td>
<td>Tax evasion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>N =</td>
<td>Neither</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
a. Terry writes a $250 check for a charitable contribution on December 28, 2010, but does not mail the check to the charitable organization until January 10, 2011. She takes a deduction in 2010.
b. Robert decides not to report interest income from a bank because the amount is only $11.75.
c. Jim pays property taxes on his home in December 2010 rather than waiting until February 2011.
d. Jane switches her investments from taxable corporate bonds to tax-exempt municipal bonds.
e. Ted encourages his mother to save most of her Social Security benefits so that he will be able to claim her as a dependent.

RESEARCH PROBLEMS

Research Problem 1. When Oprah gave away Pontiac G6 sedans to her TV audience, was the value of the cars taxable? On Labor Day weekend in 2006, World Furniture Mall in Plano, Illinois, gave away $275,000 of furniture because the Chicago Bears shut out the Green Bay Packers in their football season opener at Lambeau Field in Green Bay (26–0). Was the free furniture in the form of a discount or rebate taxable, or should the furniture company hand the customers a Form 1099–MISC?

Research Problem 2. You are interviewing a client before preparing his tax return. He indicates that he did not list as income $96,000 received as a recovery for false imprisonment. What should you do with respect to this significant recovery?

Partial list of research aids:
CCA 200809001.
Daniel and Brenda Stadnyk, T.C.Memo. 2008–289.
§ 104.

Use the tax resources of the Internet to address the following question. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 3. Go to www.taxalmanac.org and www.Legalbitstream.com on the Internet and find the following:

a. Letter rulings.
b. Actions on Decisions.
c. IRS Notices.
d. General Counsel Memoranda.
e. Technical Advice Memoranda.
f. Treasury Decisions.
g. Revenue Rulings.
h. Revenue Procedures.
i. IRS Announcements.
j. U.S. Tax Court Summary decision.
k. U.S. Tax Court Memorandum decision.
CHAPTER 3

Computing the Tax

LEARNING OBJECTIVES

After completing Chapter 3, you should be able to:

LO.1 Recognize and apply the components of the Federal income tax formula. (pp. 3-3 to 3-7)

LO.2 Evaluate the use of the standard deduction in computing taxable income. (pp. 3-7 to 3-11)

LO.3 Apply the rules for arriving at personal exemptions. (p. 3-11)

LO.4 Apply the rules for determining dependency exemptions. (pp. 3-11 to 3-18)

LO.5 Apply the filing requirements and choose the proper filing status. (pp. 3-18 to 3-25)

LO.6 Use the proper method for determining the tax liability. (pp. 3-25 to 3-27)

LO.7 Identify and work with kiddie tax situations. (pp. 3-28 to 3-29)

LO.8 Describe the tax treatment of property transactions. (pp. 3-29 to 3-32)

LO.9 Identify tax planning opportunities associated with the individual tax formula. (pp. 3-32 to 3-35)
FRAMEWORK 1040:
Tax Formula for Individuals

This chapter covers the boldfaced portions of the Tax Formula for Individuals that is introduced in Figure 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

---

A DIVIDED HOUSEHOLD

Polly maintains a household in which she and her unemployed husband (Nick) and stepdaughter (Paige) live. Paige, an accomplished gymnast, graduated from high school last year. Paige has a part-time job but spends most of her time in training and looking for an athletic scholarship to the “right” college. In March, Nick left for parts unknown and has not been seen or heard from since. Polly was more surprised than distressed over Nick’s unexpected departure. One reaction, however, was to sell her wedding rings to a cousin who was getting married. The rings cost $15,000 and were sold for their approximate value of $8,000.

Based on these facts, what are Polly’s income tax concerns for the current year? Read the chapter and formulate your response.

---

THE BIG PICTURE

Tax Solutions for the Real World

The framework for the application of the Federal income tax to individuals is the tax formula. As Chapter 1 mentioned, the tax formula is an integral part of our U.S. tax system (i.e., local, state, and Federal), and Chapter 3 provides a summary of its components. In addition, several of its key components—the standard deduction, personal and dependency exemptions, and tax determination—are discussed at length in Chapter 3.
By introducing the tax formula, therefore, Chapter 3 establishes the framework for almost all of the rest of the individual tax materials in the text.1 The formula and its impact on the chapters to follow are reflected in Figure 3.1.

### 3.1 TAX FORMULA

Before illustrating the application of the Figure 3.1 tax formula, a brief discussion of its components is helpful.

#### COMPONENTS OF THE TAX FORMULA

**Income (Broadly Conceived)**

In the tax formula, “income” is broadly conceived and includes all the taxpayer’s income, both taxable and nontaxable. Although it is essentially equivalent to gross receipts, it does not include a return of capital or receipt of borrowed funds.

Dan decides to quit renting and move into a new house. Consequently, the owner of the apartment building returns to Dan the $600 damage deposit that Dan previously made. To make a down payment on the house, Dan sells stock for $20,000 (original cost of $8,000) and borrows $50,000 from a bank. Only the $12,000 gain from the sale of the stock is income to Dan. The $600 damage deposit and the $8,000 cost of the stock are a return of capital. The $50,000 bank loan is not income as Dan has an obligation to repay that amount.

**Exclusions**

For various reasons, Congress has chosen to exclude certain types of income from the income tax base. The principal income exclusions are discussed in Chapter 5. A partial list of these exclusions is shown in Exhibit 3.1.

**Gross Income**

The Internal Revenue Code defines gross income broadly as “except as otherwise provided . . . , all income from whatever source derived.”2 The “except as otherwise provided” refers to exclusions. Gross income includes, but is not limited to, the items in the partial list in Exhibit 3.2. It does not include unrealized gains. Gross income is discussed in Chapters 4, 13, and 14.

---

1Variations of the framework apply to other taxpayers, e.g., corporations and trusts.

2§ 61(a).
### Exhibit 3.1 Partial List of Exclusions from Gross Income

<table>
<thead>
<tr>
<th>Partial List of Exclusions from Gross Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accident insurance proceeds</td>
</tr>
<tr>
<td>Annuities (cost element)</td>
</tr>
<tr>
<td>Bequests</td>
</tr>
<tr>
<td>Child support payments</td>
</tr>
<tr>
<td>Cost-of-living allowance (for military)</td>
</tr>
<tr>
<td>Damages for personal injury or sickness</td>
</tr>
<tr>
<td>Gifts received</td>
</tr>
<tr>
<td>Group term life insurance, premium paid by employer (for coverage up to $50,000)</td>
</tr>
<tr>
<td>Inheritances</td>
</tr>
<tr>
<td>Interest from state and local (i.e., municipal) bonds</td>
</tr>
<tr>
<td>Life insurance paid on death</td>
</tr>
</tbody>
</table>

### Exhibit 3.2 Partial List of Gross Income Items

<table>
<thead>
<tr>
<th>Partial List of Gross Income Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alimony</td>
</tr>
<tr>
<td>Annuities (income element)</td>
</tr>
<tr>
<td>Awards</td>
</tr>
<tr>
<td>Back pay</td>
</tr>
<tr>
<td>Bargain purchase from employer</td>
</tr>
<tr>
<td>Bonuses</td>
</tr>
<tr>
<td>Breach of contract damages</td>
</tr>
<tr>
<td>Business income</td>
</tr>
<tr>
<td>Clergy fees</td>
</tr>
<tr>
<td>Commissions</td>
</tr>
<tr>
<td>Compensation for services</td>
</tr>
<tr>
<td>Death benefits</td>
</tr>
<tr>
<td>Director’s fees</td>
</tr>
<tr>
<td>Dividends</td>
</tr>
<tr>
<td>Embezzled funds</td>
</tr>
<tr>
<td>Employee awards (in certain cases)</td>
</tr>
<tr>
<td>Employee benefits (except certain fringe benefits)</td>
</tr>
<tr>
<td>Estate and trust income</td>
</tr>
<tr>
<td>Farm income</td>
</tr>
<tr>
<td>Fees</td>
</tr>
<tr>
<td>Gains from illegal activities</td>
</tr>
<tr>
<td>Gains from sale of property</td>
</tr>
<tr>
<td>Gambling winnings</td>
</tr>
<tr>
<td>Group term life insurance, premium paid by employer (for coverage over $50,000)</td>
</tr>
</tbody>
</table>
**Beth received the following amounts during the year.**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$30,000</td>
</tr>
<tr>
<td>Interest on savings account</td>
<td>900</td>
</tr>
<tr>
<td>Gift from her aunt</td>
<td>10,000</td>
</tr>
<tr>
<td>Prize won in state lottery</td>
<td>1,000</td>
</tr>
<tr>
<td>Alimony from ex-husband</td>
<td>12,000</td>
</tr>
<tr>
<td>Child support from ex-husband</td>
<td>6,000</td>
</tr>
<tr>
<td>Damages for injury in auto accident</td>
<td>25,000</td>
</tr>
<tr>
<td>Ten $50 bills in an unmarked envelope found in an airport lounge (airport authorities could not locate anyone who claimed ownership)</td>
<td>500</td>
</tr>
<tr>
<td>Increase in the value of stock held for investment</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Review Exhibits 3.1 and 3.2 to determine the amount Beth must include in the computation of taxable income and the amount she may exclude.  

**Deductions for Adjusted Gross Income**

Individual taxpayers have two categories of deductions: (1) deductions for adjusted gross income (deductions to arrive at adjusted gross income) and (2) deductions from adjusted gross income.

Deductions for adjusted gross income (AGI) are sometimes known as above-the-line deductions because on the tax return they are taken before the “line” designating AGI. They are also referred to as page 1 deductions since they are claimed, either directly or indirectly (i.e., through supporting schedules), on page 1 of Form 1040. Deductions for AGI include, but are not limited to, the following. Many of these items are subject to computational limitations.

- Expenses incurred in a trade or business.
- One-half of self-employment tax paid.
- Unreimbursed moving expenses.
- Contributions to traditional Individual Retirement Accounts (IRAs) and certain other retirement plans.
- Fees for college tuition and related expenses.
- Contributions to Health Savings Accounts (HSAs).

Beth includes $41,000 in computing taxable income ($30,000 salary + $900 interest + $1,000 lottery prize + $12,000 alimony + $500 found property). She excludes $41,000 ($10,000 gift from aunt + $6,000 child support + $25,000 damages). The unrealized gain on the stock held for investment is not included in gross income. Such gain is included in gross income only when it is realized upon disposition of the stock.  

§ 62.
- Penalty for early withdrawal from savings.
- Interest on student loans.
- Excess capital losses.
- Alimony payments.

The principal deductions for AGI are discussed in Chapters 6 through 11, 13, and 14.

**Adjusted Gross Income (AGI)**

AGI is an important subtotal that is the basis for computing percentage limitations on certain itemized deductions, such as medical expenses, charitable contributions, and certain casualty losses. For example, medical expenses are deductible only to the extent they exceed 7.5 percent of AGI, and charitable contribution deductions may not exceed 50 percent of AGI. These limitations might be described as a 7.5 percent *floor* under the medical expense deduction and a 50 percent *ceiling* on the charitable contribution deduction.

**EXAMPLE 3**

Keith earned a salary of $68,000 this year. He contributed $5,000 to his traditional Individual Retirement Account (IRA) and paid $3,000 alimony to his ex-wife. His AGI is computed as follows.

<table>
<thead>
<tr>
<th>Gross income</th>
<th>$68,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$68,000</td>
</tr>
<tr>
<td>Less: Deductions for AGI</td>
<td></td>
</tr>
<tr>
<td>IRA contribution</td>
<td>$5,000</td>
</tr>
<tr>
<td>Alimony payment</td>
<td>3,000</td>
</tr>
<tr>
<td>AGI</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

**EXAMPLE 4**

Assume the same facts as in Example 3, and that Keith also incurred medical expenses of $5,800. Medical expenses are included in itemized deductions to the extent they exceed 7.5% of AGI. In computing his itemized deductions, Keith includes medical expenses of $1,300 ($5,800 medical expenses – $4,500 (7.5% × $60,000 AGI)).

**Personal and Dependency Exemptions**

Exemptions are allowed for the taxpayer, for the taxpayer’s spouse, and for each dependent of the taxpayer. The exemption amount is $3,650 for 2009 and 2010.

**Itemized Deductions**

As a general rule, personal expenditures are disallowed as deductions in arriving at taxable income. However, Congress allows specified personal expenses as *itemized deductions*. Such expenditures include medical expenses, certain taxes and interest, and charitable contributions.

In addition to these personal expenses, taxpayers are allowed itemized deductions for expenses related to (1) the production or collection of income and (2) the management of property held for the production of income. These expenses, sometimes referred to as *nonbusiness expenses*, differ from trade or business expenses. Trade or business expenses, which are deductions for AGI, are incurred in connection with a trade or business. Nonbusiness expenses, on the other hand, are expenses incurred in connection with an income-producing activity that does not qualify as a trade or business.

**EXAMPLE 5**

Leo is the owner and operator of a video game arcade. All allowable expenses he incurs in connection with the arcade business are deductions for AGI. In addition, Leo has an extensive portfolio of stocks and bonds. Leo’s investment activity is not treated as a
trade or business. All allowable expenses that Leo incurs in connection with these investments are itemized deductions.

Itemized deductions include, but are not limited to, the expenses listed in Exhibit 3.3. See Chapter 10 for a detailed discussion of itemized deductions.

**Nondeductible Expenditures**
Many expenditures are not deductible and, therefore, provide no tax benefit. Examples include, but are not limited to, the following.

- Personal living expenses, including any losses on the sale of personal use property.
- Hobby losses.
- Life insurance premiums.
- Expenses incident to jury duty.
- Gambling losses (in excess of gains).
- Child support payments.
- Fines and penalties.
- Political contributions.
- Certain passive losses.
- Funeral expenses.
- Expenses paid on another’s behalf.
- Capital expenditures.

Most of the nondeductible items in this list are discussed further in Chapter 6. Passive loss limitations, however, are treated in Chapter 11.

**STANDARD DEDUCTION**
The **standard deduction** is specified by Congress and depends on the filing status of the taxpayer. The effect of the standard deduction is to exempt a taxpayer’s income, up to the specified amount, from Federal income tax liability. In the past, Congress has attempted to set the tax-free amount represented by the standard deduction approximately equal to an estimated poverty level, but it has not always been consistent in doing so.

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Exhibit 3.3

**Partial List of Itemized Deductions**

- Medical expenses in excess of 7.5% of AGI
- State and local income or sales taxes
- Real estate taxes
- Personal property taxes
- Interest on home mortgage
- Investment interest (to a limited extent)
- Charitable contributions (within specified percentage limitations)
- Casualty and theft losses in excess of 10% of AGI
- Miscellaneous expenses (to the extent the total exceeds 2% of AGI)
  - Union dues
  - Professional dues and subscriptions
  - Certain educational expenses
  - Tax return preparation fee
  - Investment counsel fees
  - Unreimbursed employee business expenses (after a percentage reduction for meals and entertainment)

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S.Rep. No. 92–437, 92nd Cong., 1st Sess., 1971, p. 54. Another purpose of the standard deduction was discussed in Chapter 1 under Influence of the Internal Revenue Service—Administrative Feasibility. The size of the standard deduction has a direct bearing on the number of taxpayers who can itemize deductions. Reducing the number of taxpayers who can itemize also reduces the audit effort required from the IRS.
Basic and Additional Standard Deduction

The standard deduction is the sum of two components: the basic standard deduction and the additional standard deduction. Table 3.1 lists the basic standard deduction allowed for taxpayers in each filing status. All taxpayers allowed a full standard deduction are entitled to the applicable amount listed in Table 3.1. The standard deduction amounts are subject to adjustment for inflation each year.

Federal tax law does not recognize same-sex marriages. By virtue of the Defense of Marriage Act (Pub. L. No. 104-199), a marriage means a legal union only between a man and a woman as husband and wife.

Certain taxpayers are not allowed to claim any standard deduction, and the standard deduction is limited for others. These provisions are discussed later in the chapter.

A taxpayer who is age 65 or over or blind qualifies for an additional standard deduction of $1,100 or $1,400, depending on filing status (see amounts in Table 3.2). Two additional standard deductions are allowed for a taxpayer who is age 65 or over and blind. The additional standard deduction provisions also apply for a qualifying spouse who is age 65 or over or blind, but a taxpayer may not claim an additional standard deduction for a dependent.

To determine whether it is best to itemize, the taxpayer compares the total standard deduction (the sum of the basic standard deduction and any additional standard deductions) with total itemized deductions. Taxpayers can deduct the greater of itemized deductions or the standard deduction. Taxpayers whose itemized deductions are less than the standard deduction compute taxable income using the standard deduction rather than itemizing. Approximately 65 percent of individual tax returns employ the standard deduction.

**Example 6**

Sara, who is single, is 66 years old. She had total itemized deductions of $6,800 during 2010. Her total standard deduction is $7,100 ($5,700 basic standard deduction plus $1,400 additional standard deduction). Sara should compute her taxable income for 2010 using the standard deduction, since it exceeds her itemized deductions.

**Example 7**

Paul and Iris recently were married and purchased a home in October 2009. Their itemized deductions for the year (which include $1,100 in real estate property taxes) do not
exceed the basic standard deduction. When they file their joint return for 2009, they can claim a standard deduction of $12,400 [$11,400 (basic standard deduction) + $1,000 (property taxes standard deduction)].

To promote the sales of automobiles, Congress allowed an additional standard deduction for the sales tax paid on certain auto purchases.

- The deduction cannot exceed the tax attributable to the first $49,500 of the purchase price.
- The purchased vehicle (e.g., auto, SUV, light truck, motorcycle) cannot exceed a gross weight of 8,500 pounds. The original use of the vehicle commenced with the taxpayer.
- The purchase occurred between February 17 and December 31, 2009.
- A phaseout of the deduction occurs when the taxpayer’s AGI exceeds $125,000 ($250,000 on a joint return).

Although the two temporary standard deductions expire at the end of 2009, congressional action to extend the provisions is expected if the current economic difficulties continue. The deductions are claimed on Form 1040, Schedule L.

Property taxes on a personal residence and sales taxes on a personal auto usually are deductions from AGI. Thus, these additional standard deductions represent a tax advantage for taxpayers who do not itemize.

### Individuals Not Eligible for the Standard Deduction
The following individual taxpayers cannot use the standard deduction and therefore must itemize.8

- A married individual filing a separate return where either spouse itemizes deductions.
- A nonresident alien.
- An individual filing a return for a period of less than 12 months because of a change in the annual accounting period.

The death of an individual does not eliminate the standard deduction for the year of death, nor is the deduction allocated to the pre-death portion of the year. If, for example, Sandy (age 80 and single) died on January 14, 2010, his executor could claim a standard deduction of $7,100 [$5,700 (basic standard deduction) + $1,400 (additional standard deduction for age)] on his final income tax return (covering the period from January 1 to January 14, 2010).

### Limitations on the Standard Deduction for Individuals Who Can Be Claimed as Dependents
Special rules apply to the standard deduction and personal exemption of an individual who can be claimed as a dependent on another person’s tax return.

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8§ 63(c)(6).
When filing his or her own tax return, a dependent’s basic standard deduction in 2010 is limited to the greater of $950 or the sum of the individual’s earned income for the year plus $300. However, if the sum of the individual’s earned income plus $300 exceeds the standard deduction, the standard deduction is limited to the appropriate amount shown in Table 3.1. These limitations apply only to the basic standard deduction. A dependent who is 65 or over or blind or both also is allowed the additional standard deduction amount on his or her own return (refer to Table 3.2).

**Example 8**
Susan, who is 17 years old and single, is claimed as a dependent on her parents’ tax return. During 2010, she received $1,200 interest (unearned income) on a savings account. She also earned $400 from a part-time job. When Susan files her own tax return, her standard deduction is $950 (the greater of $950 or the sum of earned income plus $300 ($400 + $300 = $700)).

**Example 9**
Assume the same facts as in Example 8, except that Susan is 67 years old and is claimed as a dependent on her son’s tax return. In this case, when Susan files her own tax return, her standard deduction is $2,350 (the greater of $950 or the $700 sum of earned income plus $300) + $1,400 (the additional standard deduction allowed because Susan is age 65 or over).

**Example 10**
Peggy, who is 16 years old and single, earned $700 from a summer job and had no unearned income during 2010. She is claimed as a dependent on her parents’ tax return. Her standard deduction is $1,000 (the greater of $950 or the sum of $700 earned income plus $300).

**Example 11**
Jack, who is a 20-year-old, single, full-time college student, is claimed as a dependent on his parents’ tax return. He worked as a musician during the summer of 2010, earning $5,900. Jack’s standard deduction is $5,700 (the greater of $950 or the sum of $5,900 earned income plus $300, but limited to the $5,700 standard deduction for a single taxpayer).

**Application of the Tax Formula**
The structure of the individual income tax return (Form 1040, 1040A, or 1040EZ) parallels the tax formula in Figure 3.1. Like the formula, the tax return places major emphasis on the adjusted gross income (AGI) and taxable income (TI) subtotals. In arriving at AGI, however, most exclusions are not reported on the tax return.

**Example 12**
Grace, age 25, is single. She lives with her disabled and dependent mother. Grace is a high school teacher and earned a $60,000 salary in 2010. Her other income consisted of $1,000 interest from a bank account and $500 interest on municipal bonds that she previously had received as a graduation gift. During 2010, she sustained a deductible capital loss of $1,000. Her itemized deductions are $8,800. Grace’s taxable income is computed as follows.

Income (broadly conceived)
- Salary: $60,000
- Interest from bank account: $1,000
- Interest on municipal bonds: $500
  - $61,500

Less: Exclusion—Interest on municipal bonds: (500)
- Gross income: $61,000

Less: Deduction for adjusted gross income—Capital loss: (1,000)
- Adjusted gross income: $60,000

§ 63(c)(5). Both the $950 amount and the $300 amount are subject to adjustment for inflation each year.
3.2 Personal Exemptions

The use of exemptions in the tax system is based in part on the idea that a taxpayer with a small amount of income should be exempt from Federal income taxation. An exemption frees a specified amount of income from tax ($3,650 in 2009 and 2010). The exemption amount is indexed (adjusted) annually for inflation.

Exemptions that are allowed for the taxpayer and spouse are designated as personal exemptions. Those exemptions allowed for the care and maintenance of other persons are called dependency exemptions. An individual cannot claim a personal exemption if he or she is claimed as a dependent by another.10

When a husband and wife file a joint return, they claim two personal exemptions. However, when separate returns are filed, a married taxpayer cannot claim an exemption for his or her spouse unless the spouse has no gross income and is not claimed as the dependent of another taxpayer.11

The determination of marital status generally is made at the end of the taxable year, except when a spouse dies during the year. Spouses who enter into a legal separation under a decree of divorce or separate maintenance before the end of the year are considered to be unmarried at the end of the taxable year. Table 3.3 illustrates the effect of death or divorce upon marital status.

The amount of the exemption is not reduced due to the taxpayer’s death. For example, refer to the case of Helen in Table 3.3. Although she lived for only three days, a full personal exemption is allowed for the tax year. The same rule applies to dependency exemptions. As long as an individual qualified as a dependent at the time of death, the full amount of the exemption is claimed.

3.3 Dependency Exemptions

As is the case with personal exemptions, a taxpayer is permitted to claim an exemption of $3,650 in 2009 and 2010 for each person who qualifies as a dependent. A dependency exemption is available for either a qualifying child or a qualifying relative and must not run afoul of certain other rules (i.e., joint return, nonresident alien prohibitions).

QUALIFYING CHILD

The term qualifying child is used in several Code provisions, including those relating to:

<table>
<thead>
<tr>
<th>TABLE 3.3</th>
<th>Marital Status for Exemption Purposes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxpayers</td>
<td>Marital Status</td>
</tr>
<tr>
<td>• Walt is the widower of Helen, who died on January 3.</td>
<td>Walt and Helen are married.</td>
</tr>
<tr>
<td>• Bill and Jane entered into a divorce decree that is effective on December 31.</td>
<td>Bill and Jane are unmarried.</td>
</tr>
</tbody>
</table>

10§ 151(d)(2).  
11§ 151(b).
- Dependency exemption.
- Head-of-household filing status.
- Earned income tax credit.
- Child tax credit.
- Credit for child and dependent care expenses.

A qualifying child must meet the relationship, abode, age, and support tests.\footnote{\$152(c).} For dependency exemption purposes, a qualifying child also must satisfy the joint return test and the citizenship or residency test.

**Relationship Test**

The relationship test includes a taxpayer’s child (son, daughter), adopted child, stepchild, eligible foster child, brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of these parties (e.g., grandchild, nephew, niece). Note that ancestors of any of these parties (e.g., uncles and aunts) and in-laws (e.g., son-in-law, brother-in-law) are not included.

An adopted child includes a child lawfully placed with the taxpayer for legal adoption even though the adoption is not final. An eligible foster child is one who is placed with the taxpayer by an authorized placement agency or by a judgment decree or other order of any court of competent jurisdiction.

**Abode Test**

A qualifying child must live with the taxpayer for more than half of the year. For this purpose, temporary absences (e.g., school, vacation, medical care, military service, detention in a juvenile facility) are disregarded. Special rules apply in the case of certain kidnapped children.\footnote{\$152(f)(6).}

**Age Test**

A qualifying child must be under age 19 or under age 24 in the case of a student. A student is a child who, during any part of five months of the year, is enrolled full time at a school or government-sponsored on-farm training course.\footnote{\$152(f)(2).} An individual cannot be older than the taxpayer claiming him or her as a qualifying child (e.g., a brother cannot claim his older sister as a qualifying child). The age test does not apply to a child who is disabled during any part of the year.\footnote{\$152(f)(5).}

**Support Test**

A qualifying child cannot be self-supporting (i.e., provide more than one-half of his or her own support). In the case of a student who is a full-time student, scholarships are not considered to be support.\footnote{\$152(f)(3). See the discussion of the credit for the elderly or disabled in Chapter 12.}

**Tiebreaker Rules**

In some situations, a child may be a qualifying child to more than one person. In this event, the tax law specifies which person has priority in claiming the

\footnote{\$152(c).}

\footnote{\$152(f)(6).}

\footnote{\$152(f)(2).}
dependency exemption. Called “tiebreaker rules,” these rules are summarized in Table 3.4 and are illustrated in the examples that follow.

**Example 15**
Tim, age 15, lives in the same household with his mother and grandmother. As the parent (see Table 3.4), the mother has priority as to the dependency exemption.

**Example 16**
Jennifer, age 17, lives in the same household with her parents during the entire year. If her parents file separate returns, the one with the higher AGI has priority as to the dependency exemption.

**Example 17**
Assume the same facts as in Example 16, except that the father moves into an apartment in November (Jennifer remains with her mother). The mother has priority as to the dependency exemption.

**Example 18**
Carlos, age 12, lives in the same household with his two aunts. The aunt with the higher AGI has priority as to the dependency exemption.

### Table 3.4: Tiebreaker Rules for Claiming a Qualifying Child

<table>
<thead>
<tr>
<th>Persons Eligible to Claim Exemption</th>
<th>Person Prevailing</th>
</tr>
</thead>
<tbody>
<tr>
<td>One of the persons is the parent.</td>
<td>Parent</td>
</tr>
<tr>
<td>Both persons are the parents, and the child lives with one parent for a longer period.</td>
<td>Parent with the longer period of residence</td>
</tr>
<tr>
<td>Both persons are the parents, and the child lives with each the same period of time.</td>
<td>Parent with the higher adjusted gross income (AGI)</td>
</tr>
<tr>
<td>None of the persons is the parent.</td>
<td>Person with highest AGI</td>
</tr>
</tbody>
</table>

**Ethics & Equity: Whose Qualifying Child Is He?**

The Rands are successful professionals and have combined AGI of approximately $400,000. Their household includes two children: Henry (age 16) and Belinda (age 22). Belinda is not a student and has a job where she earns $15,000. After a short family meeting in early April, the parties decide that Belinda should claim Henry as her qualifying child. Under this result, Belinda deducts Henry’s dependency exemption, and she claims a child tax credit and an earned income tax credit, for a total tax saving of more than $3,000. Had the Rands claimed Henry on their joint return, no child tax credit or earned income tax credit would have been available. As noted in Chapter 12, these amounts are phased out for higher-income taxpayers. Has the Rand family acted properly?

**Qualifying Relative**
A qualifying relative must meet the relationship, gross income, and support tests. As in the case of the qualifying child category, qualifying relative status also requires that the joint return and nonresident alien restrictions be avoided (see Other Rules

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\[\text{\S} 152(c)(4).\]  
\[\text{\S} 152(d).\]
for Dependency Exemptions below). Children who do not satisfy the qualifying child definition may meet the qualifying relative criteria.

**Example 19**

Inez provides more than half of the support of her son Manuel, age 20, who is neither disabled nor a full-time student. Manuel is not a qualifying child due to the age test, but he is a qualifying relative if the gross income test is met. Consequently, Inez may claim a dependency exemption for Manuel.

**Relationship Test**

The relationship test for a qualifying relative is more expansive than for a qualifying child. Also included are:

- Lineal ascendants (e.g., parents, grandparents).
- Collateral ascendants (e.g., uncles, aunts).
- Certain in-laws (e.g., son-, daughter-, father-, mother-, brother-, and sister-in-law).\(^{19}\)

The relationship test also includes unrelated parties who live with the taxpayer (i.e., they are members of the same household). Member-of-the-household status is not available for anyone whose relationship with the taxpayer violates an enforced local law, or for anyone who was a spouse during any part of the year.\(^{20}\) However, an ex-spouse can qualify as a member of the household in a year following that of the divorce.

As the relationship test indicates, the term “qualifying relative” is somewhat misleading. Persons other than relatives can qualify as dependents. Furthermore, not all relatives qualify—notice the absence of “cousin.”

**Example 20**

Charles provides more than half of the support of both Carol, a family friend who lives with him, and Bert, a cousin who lives in another city. Presuming the gross income test is met, Carol is a qualifying relative, but Bert is not.

**Gross Income Test**

A dependent’s gross income must be **less than** the exemption amount—$3,650 in 2009 and 2010. Gross income is the amount that the tax law counts as taxable. In the case of scholarships, for example, include the taxable portion (e.g., amounts received for room and board) and exclude the nontaxable portion (e.g., amounts received for books and tuition). In contrast, the qualifying child rule does not contain a gross income test.

**Example 21**

Elsie provides more than half of the support of her son, Tom, who does not live with her. Tom, age 26, is a full-time student in medical school, earns $2,000 from a part-time job, and receives a $42,000 scholarship covering his tuition. Elsie may claim Tom as a dependent since he is a qualifying relative, and his gross income is $2,000 (Note: Tom is not a qualifying child due to either the abode or the age test.)

**Example 22**

Aaron provides more than half of the support of his widowed aunt, Myrtle, who does not live with him. Myrtle’s income for the year is as follows: dividend income of $1,100, earnings from pet sitting of $1,200, Social Security benefits of $6,000, and $8,000 interest from City of Milwaukee bonds. Since Myrtle’s gross income is only $2,300 ($1,100 + $1,200), she meets the gross income test and can be claimed as Aaron’s dependent.

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\(^{19}\) Once established by marriage, in-law status continues to exist and survives divorce.  
\(^{20}\) §§ 152(d)(2)(H) and (J)(3).
Support Test

Over one-half of the support of the qualifying relative must be furnished by the one claiming the exemption. Support includes food, shelter, clothing, toys, medical and dental care, education, and the like. However, a scholarship (both taxable and non-taxable portions) received by a student is not counted as support.

**Example 23**

Hal contributed $3,400 (consisting of food, clothing, and medical care) toward the support of his nephew, Sam, who lives with him. Sam earned $1,500 from a part-time job and received a $10,000 scholarship to attend a local university. Assuming that the other dependency tests are met, Hal can claim Sam as a dependent since he has contributed more than half of Sam’s support. The scholarship is not included as support for purposes of this test.

If the individual does not spend funds that have been received from any source, the unexpended amounts are not counted as support.

**Example 24**

Emily contributed $3,000 to her father Ernie’s support during the year. In addition, Ernie received $2,400 in Social Security benefits, $200 of interest, and wages of $600. Ernie deposited the Social Security benefits, interest, and wages in his own savings account and did not use any of the funds for his support. Thus, the Social Security benefits, interest, and wages are not counted as support provided by Ernie. Emily may claim her father as a dependent if the other tests are met.

An individual’s own funds, however, are taken into account if they are applied toward support. In this regard, the source of the funds so used is immaterial.

**Example 25**

Frank contributes $8,000 toward his parents’ total support of $20,000. The parents, who do not live with Frank, obtain the other $12,000 from savings and a home equity loan on their residence. Although the parents have no income, their use of savings and borrowed funds is counted as part of their support. Because Frank does not satisfy the support test, he cannot claim his parents as dependents.

Capital expenditures for items such as furniture, appliances, and automobiles are included in total support if the item does, in fact, constitute support.

**Example 26**

Norm purchased a television set costing $650 and gave it to his mother who lives with him. The television set was placed in the mother’s bedroom and was used exclusively by her. Norm should include the cost of the television set in determining the support of his mother.

Multiple Support Agreements  An exception to the support test involves a multiple support agreement. A multiple support agreement permits one of a group of taxpayers who furnish support for a qualifying relative to claim a dependency exemption for that individual, even if no one person provides more than 50 percent of the support.21 The group together must provide more than 50 percent of the support. Any person who contributed more than 10 percent of the support is entitled to claim the exemption if each person in the group who contributed more than 10 percent agrees in a written consent. This provision frequently enables one of the children of aged dependent parents to claim an exemption when none of the children individually meets the 50 percent support test.

Each person who is a party to the multiple support agreement must meet all other tests (except the support requirement) for claiming the exemption. A person who does not meet the relationship or member-of-the-household requirement, for

21§ 152(d)(3).
instance, cannot claim the dependency exemption, even under a multiple support agreement.

**Example 27**

Wanda, who resides with her son, Adam, received $12,000 from various sources during the year. This constituted her entire support for the year.

<table>
<thead>
<tr>
<th>Support Received</th>
<th>Percentage of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adam, a son</td>
<td>$5,760</td>
</tr>
<tr>
<td>Bob, a son</td>
<td>1,200</td>
</tr>
<tr>
<td>Carol, a daughter</td>
<td>3,600</td>
</tr>
<tr>
<td>Diane, a friend</td>
<td>1,440</td>
</tr>
<tr>
<td><strong>$12,000</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

If Adam and Carol file a multiple support agreement, either may claim the dependency exemption for Wanda. Bob may not claim Wanda because he did not contribute more than 10% of her support. Bob’s consent is not required for Adam and Carol to file a multiple support agreement. Diane does not meet the relationship or member-of-the-household test and cannot be a party to the agreement.

The decision as to who claims Wanda rests with Adam and Carol. If Adam agrees, Carol can claim Wanda, even though Adam furnished more of Wanda’s support.

Each person who qualifies under the more-than-10 percent rule (except for the person claiming the exemption) must complete Form 2120 (Multiple Support Declaration) waiving the exemption. The person claiming the exemption attaches all Forms 2120 to his or her own return.

**Discovering Lost Dependency Exemptions**

For the six years prior to his death, Jesse lived with his daughter, Hannah. Because he had no source of income, Jesse was supported by equal contributions from Hannah and his two sons, Bill and Bob. At Jesse’s funeral, his surviving children are amazed to discover that none of them has been claiming Jesse as a dependent. Upon the advice of the director of the funeral home, they decide to divide, among themselves, the dependency exemptions for the past six years. Multiple Forms 2120 are executed, and each of the three children files amended returns for different past years. As Jesse died late in the current year, none of the children plans to claim him for this tax year.

Comment on the tax expectations of the parties involved.

**Children of Divorced or Separated Parents**

Another exception to the support test applies when parents with children are divorced or separated under a decree of separate maintenance. Generally, the parent having custody of the child (children) for the greater part of the year (i.e., the custodial parent) is entitled to the dependency exemption(s). A special rule applies if the now-unmarried parents live apart for the last six months of the year, and:

- They would have been entitled to the dependency exemption(s) had they been married and filed a joint return.
- They have custody (either jointly or singly) of the child (or children) for more than half of the year.

\[§ 152(e)(1)\]
The special rule grants the dependency exemption(s) to the noncustodial parent if
the divorce (or separate maintenance) decree so specifies or the custodial parent
issues a waiver on Form 8332.23

If the special rule does not apply (i.e., the divorce decree is silent or the custodial
parent does not sign Form 8332), the dependency exemption(s) for the child (chil-
dren) is awarded in accordance with the qualifying child or qualifying relative rules.
When support of the child is determined, alimony received by the custodial parent
does not count as support by the payor parent, but child support received probably
does.24

OTHER RULES FOR DEPENDENCY EXEMPTIONS
In addition to fitting into either the qualifying child or the qualifying relative cate-
gory, a dependent must meet the joint return and the citizenship or residency tests.

Joint Return Test
If a dependent is married, the supporting taxpayer (e.g., the parent of a married
child) generally is not permitted a dependency exemption if the married individual
files a joint return with his or her spouse.25 The joint return rule does not apply,
however, if the following conditions are met.

- The reason for filing is to claim a refund for tax withheld.
- No tax liability would exist for either spouse on separate returns.
- Neither spouse is required to file a return.

See Table 3.5 later in the chapter and the related discussion concerning income
level requirements for filing a return.

Example 28
Paul provides over half of the support of his son Quinn. He also provides over half of
the support of Vera, who is Quinn’s wife. During the year, both Quinn and Vera
had part-time jobs. In order to recover the taxes withheld, they file a joint return. If
Quinn and Vera are not required to file a return, Paul is allowed to claim both as
dependents.

Citizenship or Residency Test
To be a dependent, the individual must be either a U.S. citizen, a U.S. resident, or a
resident of Canada or Mexico for some part of the calendar year in which the tax-
payer’s tax year begins.26

QUALIFYING FOR DEPENDENCY EXEMPTIONS
Concept Summary 3.1 sets forth the tests for the two categories of dependency
exemptions. In contrasting the two categories, the following observations are in
order.

- As to the relationship tests, the qualifying relative category is considerably
  more expansive. Besides including those prescribed under the qualifying
  child grouping, other relatives are added. Nonrelated persons who are
  members of the household are also included.
- The support tests are entirely different. In the case of a qualifying child,
  support is not necessary. What is required in that case is that the child not
  be self-supporting.
- The qualifying child category has no gross income limitation, whereas the
  qualifying relative category has no age restriction.

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23§ 152(e)(2).
24§ 152(d)(5)(A).
25§ 152(b)(2).
26§ 152(b)(3).
CHILD TAX CREDIT

In addition to providing a dependency exemption, a child of the taxpayer also may generate a tax credit. Called the child tax credit, the amount allowed is $1,000 for each dependent child (including stepchildren and eligible foster children) under the age of 17. For a more complete discussion of the child tax credit, see Chapter 12.

3.4 FILING THE RETURN

FILING STATUS

The amount of tax varies considerably depending on which filing status the taxpayer uses.

The following amounts of tax are computed using the 2010 Tax Rate Schedules for a taxpayer (or taxpayers in the case of a joint return) with $60,000 of taxable income (see Appendix A).

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>Amount of Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>$11,181</td>
</tr>
<tr>
<td>Married, filing joint return</td>
<td>8,163</td>
</tr>
<tr>
<td>Married, filing separate return</td>
<td>11,181</td>
</tr>
<tr>
<td>Head of household</td>
<td>9,848</td>
</tr>
</tbody>
</table>

Single Taxpayers

State law governs whether a taxpayer is considered married, divorced, or legally separated. A taxpayer who is unmarried or separated from his or her spouse by a decree of divorce or separate maintenance and does not qualify for another filing status must use the rates for single taxpayers. Marital status is determined as of the last day of the tax year, except when a spouse dies during the year. In that case, marital status is determined as of the date of death.
Under a special relief provision, however, married persons who live apart may be able to qualify as single. Married taxpayers who are considered single under the abandoned spouse rules are allowed to use the head-of-household rates. This filing status is discussed later in the chapter.

**Married Individuals**

The joint return was enacted in 1948 to establish equity between married taxpayers in community property states and those in common law states. Before the joint return was available, taxpayers in community property states were in an advantageous position relative to taxpayers in common law states because they could split their income. For instance, if one spouse earned $100,000 and the other spouse was not employed, each spouse could report $50,000 of income. Splitting the income in this manner caused the total income to be subject to lower marginal tax rates. Each spouse would start at the bottom of the rate structure.

Taxpayers in common law states did not have this income-splitting option, so their taxable income was subject to higher marginal rates. This inconsistency in treatment was remedied by the joint return provisions. The progressive rates in the joint return Tax Rate Schedule are constructed based on the assumption that income is earned equally by the two spouses.

If married individuals elect to file separate returns, each reports only his or her own income, exemptions, deductions, and credits, and each must use the Tax Rate Schedule for married taxpayers filing separately. It generally is advantageous for married individuals to file a joint return, since the combined amount of tax is lower. However, special circumstances (e.g., significant medical expenses incurred by one spouse subject to the 7.5 percent limitation) may warrant the election to file separate returns. It may be necessary to compute the tax under both assumptions to determine the most advantageous filing status.

The Code places some limitations on married persons who file separate returns. Some examples of these limitations are listed below. In such cases, being single would be preferable to being married and filing separately.

- If either spouse itemizes deductions, the other spouse must also itemize.
- The earned income credit and the credit for child and dependent care expenses cannot be claimed (see Chapter 12).
- No deduction is allowed for interest paid on qualified education loans (see Chapter 10).
- Only $1,500 of excess capital losses can be claimed (see Chapter 14).

**Example 30**

Duke and Carla are in the process of divorcing. They qualify this year for a $4,000 earned income credit. If the taxpayers stay married but file separate returns this year, neither party can claim the credit. If instead a joint return is filed, the credit is available, presumably to be divided with the couple’s other assets. If the divorce is finalized this year, both parties will file Forms 1040 using single filing status, and either of them can claim the credit. ■

**Surviving Spouse**

The joint return rates also apply for two years following the death of one spouse, if the surviving spouse maintains a household for a dependent child. The child must be a son, stepson, daughter, or stepdaughter who qualifies as a dependent of the taxpayer. This is referred to as surviving spouse status.\(^{29}\)

\(^{29}\)§ 2(a). The IRS label for surviving spouse status is “Qualifying Widow(er) with Dependent Child.”
EXAMPLE 31
Fred dies in 2009 leaving Ethel with a dependent child. For 2009, Ethel files a joint return with Fred (presuming the consent of Fred’s executor is obtained). For the next two years (2010 and 2011), Ethel, filing as a surviving spouse, may use the joint return rates. In subsequent years, Ethel uses the head-of-household rates if she continues to maintain a household as her home that is the domicile of the child.

Head of Household
Unmarried individuals who maintain a household for one or more dependents may qualify to use the head-of-household rates. The tax liability using the head-of-household rates falls between the liability using the joint return Tax Rate Schedule and the liability using the Tax Rate Schedule for single taxpayers.

To qualify for head-of-household rates, a taxpayer must pay more than half the cost of maintaining a household as his or her home. The household must also be the principal home of a dependent. Except for temporary absences (e.g., school, hospitalization), the dependent must live in the taxpayer’s household for over half the year. The dependent must be either a qualifying child or a qualifying relative who meets the relationship test.

EXAMPLE 32
Dylan is single and maintains a household in which he and his cousin live. Even though the cousin may qualify as a dependent (under the member-of-the-household test), Dylan cannot claim head-of-household filing status. A cousin does not meet the relationship test.

EXAMPLE 33
Emma, a widow, maintains a household in which she and her aunt live. If the aunt qualifies as a dependent, Emma may file as head of household. An aunt meets the relationship test.

EXAMPLE 34
Nancy maintains a household in which she and her daughter, Bernice, live. Bernice, age 27, is single and earns $9,000 from a part-time job. Nancy does not qualify for head-of-household filing status, as she cannot claim Bernice as a dependent (due to the gross income test).

§ 2(b).
§ 2(b)(3)(B). The member-of-the-household test cannot be used for this purpose.

Can Bernice be a dependent under the qualifying child rules? Even though the gross income test is inapplicable for a qualifying child, Bernice does not meet the age test.
Head-of-household status still may be claimed if the taxpayer maintains a separate home for his or her parent or parents, if at least one parent qualifies as a dependent of the taxpayer.\(^3\)  

**Example 35**  
Rick, an unmarried individual, lives in New York City and maintains a household in Scottsdale for his dependent parents. Rick may use the head-of-household rates, even though his parents do not reside in his New York home.

**ETHICS & Equity**  
**Temporary or Permanent Absence?**  
For several years, Minerva, a widow, has maintained a household in which she and her uncle Luther live. Because Luther has no income, he is supported by Minerva and claimed by her as a dependent. In June 2010, Luther is admitted to a medical facility for treatment of a mental disability. In January 2011, Luther unexpectedly dies while still at the facility.

In completing her Federal income tax returns for 2010 and 2011, Minerva intends to file as head of household and claim Luther as her dependent. Comment on the propriety of what Minerva plans to do.

**Abandoned Spouse Rules**  
When married persons file separate returns, several unfavorable tax consequences result. For example, the taxpayer likely must use the very expensive Tax Rate Schedule for married taxpayers filing separately. To mitigate such harsh treatment for some individuals, Congress enacted provisions commonly referred to as the abandoned spouse rules. These rules allow a married taxpayer to file as not married, and thus either as single or head of household, if all of the following conditions are satisfied.\(^4\)

- The taxpayer does not file a joint return.
- The taxpayer paid more than one-half the cost of maintaining his or her home for the tax year.
- The taxpayer’s spouse did not live in the home during the last six months of the tax year.
- The home was the principal residence of the taxpayer’s son, daughter, stepson, stepdaughter, foster child, or adopted child for more than half the year, and the child can be claimed as a dependent.\(^5\)

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\(^3\) § 2(b)(1)(B).

\(^4\) § 7703(b).

\(^5\) § 152(f)(1). The dependency requirement does not apply, however, if the taxpayer could have claimed a dependency exemption except for the fact that the exemption was claimed by the noncustodial parent under a written agreement.
FILING REQUIREMENTS

General Rules

An individual must file a tax return if certain minimum amounts of gross income have been received. The general rule is that a tax return is required for every individual who has gross income that equals or exceeds the sum of the exemption amount plus the applicable standard deduction. For example, a single taxpayer under age 65 must file a tax return in 2010 if gross income equals or exceeds $9,350 ($3,650 exemption plus $5,700 standard deduction). Table 3.5 lists the income levels that require the filing of tax returns.

The additional standard deduction for being age 65 or older is considered in determining the gross income filing requirements. For example, note in Table 3.5 that the 2010 filing requirement for a single taxpayer age 65 or older is $10,750 ($5,700 basic standard deduction + $1,400 additional standard deduction + $3,650 exemption). However, the additional standard deduction for blindness is not taken into account. The 2010 filing requirement for a single taxpayer under age 65 and blind is $9,350 ($5,700 basic standard deduction + $3,650 exemption).

A self-employed individual with net earnings of $400 or more from a business or profession must file a tax return regardless of the amount of gross income.

Even though an individual has gross income below the filing level amounts and therefore does not owe any tax, he or she must file a return to obtain a tax refund of amounts withheld. A return is also necessary to obtain the benefits of the earned income credit allowed to taxpayers with little or no tax liability. Chapter 12 discusses the earned income credit.

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36 The gross income amounts for determining whether a tax return must be filed are adjusted for inflation each year.

37 § 6012(a)(1).
Filing Requirements for Dependents

Computation of the gross income filing requirement for an individual who can be claimed as a dependent on another person’s tax return is subject to more complex rules. Such an individual must file a return if he or she has any of the following.

- Earned income only and gross income that is more than the total standard deduction (including any additional standard deduction) that the individual is allowed for the year.
- Unearned income only and gross income of more than $950 plus any additional standard deduction that the individual is allowed for the year.
- Both earned and unearned income and gross income of more than the larger of $950 or the sum of earned income plus $300 (but limited to the applicable basic standard deduction), plus any additional standard deduction that the individual is allowed for the year.

Thus, the filing requirement for a dependent who has no unearned income is the total of the basic standard deduction plus any additional standard deduction, which includes both the additional deduction for blindness and the deduction for being age 65 or older. For example, the 2010 filing requirement for a single dependent who is under age 65 is $5,700, the amount of the basic standard deduction.

Selecting the Proper Form

The 2010 tax forms had not been released at the date of publication of this text. The following comments apply to the 2009 forms. It is possible that some provisions will change for the 2010 forms.

Although a variety of forms are available to individual taxpayers, the use of some of these forms is restricted. For example, Form 1040EZ cannot be used if the:

- Taxpayer claims any dependents;
- Taxpayer (or spouse) is 65 or older or blind; or
- Taxable income is $100,000 or more.

Taxpayers who desire to itemize deductions from AGI cannot use Form 1040A, but must file Form 1040 (the long form).

E-Filing

The e-file program is an increasingly popular alternative to traditional paper returns. Here, the required tax information is transmitted to the IRS electronically either
directly from the taxpayer (i.e., an “e-file online return”) or indirectly through an
electronic return originator (ERO). EROs are tax professionals who have been
accepted into the electronic filing program by the IRS. Such parties hold themselves
out to the general public as “authorized IRS e-file providers.”

For direct e-filing, a taxpayer must have a personal computer and tax preparation
software with the capability of conveying the information online to an electronic
return transmitter. Otherwise a taxpayer must use an authorized provider to make the
e-file transmission. In most cases, the provider charges a fee for the services rendered.

Through prearrangement with the IRS, many providers offer free e-filing services.
Generally, such services are available only to lower-income taxpayers. A list of these
“Free-File” providers and their eligibility requirements can be obtained at www.irs.gov.

All e-filing taxpayers and tax return preparers must attest to the returns they file.
For most taxpayers, this attesting can be done through an electronic return signa-
ture using a personal identification number.

The e-file approach has two major advantages. First, compliance with the format
required by the IRS eliminates many math and clerical errors that would otherwise
occur. Second, the time required for processing a refund usually is reduced to three
weeks or less.

When and Where to File

Tax returns of individuals are due on or before the fifteenth day of the fourth
month following the close of the tax year. For the calendar year taxpayer, the
usual filing date is on or before April 15 of the following year.38 When the due
date falls on a Saturday, Sunday, or legal holiday, the last day for filing falls on
the next business day. The return should be sent or delivered to an IRS Regional
Service Center.39

If the return is mailed to the proper address with sufficient postage and is postmarked
on or before the due date, it is deemed timely filed. The IRS has issued rules governing
the filing of returns using various private delivery services (e.g., FedEx, UPS).40

If a taxpayer is unable to file the return by the specified due date, a six-month
extension of time is obtained by filing Form 4868 (Application for Automatic Exten-

Although obtaining an extension excuses a taxpayer from a penalty for failure to
file, it does not insulate against the penalty for failure to pay. If more tax is owed, the
filing of Form 4868 should be accompanied by an additional remittance to cover the
balance due. The failure to file and failure to pay penalties are discussed in Chapter 1.

If an individual taxpayer needs to file an amended return (e.g., because of a fail-
ure to report income or to claim an additional deduction or tax credit), Form 1040X
is filed. The form generally is filed within three years of the filing date of the original
return or within two years from the time the tax was paid, whichever is later.

38§ 6072(a).
39The Regional Service Centers and the geographic area each covers also are listed at www.irs.gov/file or in tax forms packages.
40§ 7502(f).
41Reg. § 1.6081–4.
Mode of Payment

Usually, a Federal tax payment is made by check. In that event, the check should be made out to “United States Treasury.” Payments by credit card or electronic fund transfer also are allowed.

3.5 Tax Determination—Computation Procedures

The computation of income tax due (or refund) involves applying the proper set of tax rates to taxable income and then adjusting for available credits. In certain cases, however, the application of the kiddie tax will cause a modification of the means by which the tax is determined.

TAX RATES

The basic Federal income tax rate structure is progressive, with current rates ranging from 10 percent to 35 percent. By way of comparison, the lowest rate structure, which was in effect in 1913–1915, ranged from 1 to 7 percent, and the highest, in effect during 1944–1945, ranged from 23 to 94 percent.

TAX TABLE METHOD

The tax liability is computed using either the Tax Table method or the Tax Rate Schedule method. Most taxpayers compute their tax using the Tax Table. Eligible taxpayers compute taxable income (as shown in Figure 3.1) and must determine their tax by reference to the Tax Table. The following taxpayers, however, may not use the Tax Table method.

- An individual who files a short period return (see Chapter 16).
- Individuals whose taxable income exceeds the maximum (ceiling) amount in the Tax Table. The Tax Table addresses taxable incomes below $100,000 for Form 1040.
- An estate or trust.

The IRS does not release the Tax Tables until late in the year to which they apply. The Tax Rate Schedules, however, are released at the end of the year preceding their applicability. To illustrate, the Tax Table for 2010 is available at the end of 2010. The Tax Rate Schedules for 2010, however, were released at the end of 2009. For purposes of estimating tax liability and making quarterly prepayments, the Tax Rate Schedules usually are consulted. Based on its availability, the 2009 Tax Table will be used to illustrate the tax computation using the Tax Table method.

L0.6 Use the proper method for determining the tax liability.

\*

The 2010 Tax Table was not available from the IRS at the date of publication of this text. The Tax Table for 2009 and the Tax Rate Schedules for 2009 and 2010 are reproduced in Appendix A. For quick reference, the Tax Rate Schedules also are reproduced inside the front cover of this text.
Although the Tax Table is derived by using the Tax Rate Schedules (discussed below), the tax calculated using the two methods may vary slightly. This variation occurs because the tax for a particular income range in the Tax Table is based on the average tax for that range.

**Example 3.6**

Linda is single and has taxable income of $30,000 for calendar year 2009. To determine Linda’s tax using the Tax Table (see Appendix A), find the $30,000 to $30,050 income line. The tax of $4,086 actually is the tax that the Tax Rate Schedule would yield on taxable income of $30,025 (i.e., the average tax between $30,000 and $30,050).

**Tax Rate Schedule Method**

The 2010 rate schedule for single taxpayers is reproduced in Table 3.6.43

**Example 3.7**

Pat is single and had $5,870 of taxable income in 2010. His tax is $587 ($5,870 \times 10\%).

Several terms are used to describe tax rates. The rates in the Tax Rate Schedules often are referred to as statutory (or nominal) rates. The marginal rate is the highest rate that is applied in the tax computation for a particular taxpayer. In Example 37, the statutory rate and the marginal rate both are 10 percent.

**Example 3.8**

Chris is single and had taxable income of $90,000 in 2010. Her tax is $18,909.25 [$16,781.25 + 28\%($90,000 - $82,400)].

The average rate is equal to the tax liability divided by taxable income. In Example 38, Chris has statutory rates of 10 percent, 15 percent, 25 percent, and 28 percent, and a marginal rate of 28 percent. Chris’s average rate is 21 percent ($18,909.25 tax liability \div $90,000 taxable income).

A tax is progressive if a higher rate of tax applies as the tax base increases. The Federal income tax uses progressive rates.

**Example 3.9**

Continue with the facts of Example 38. An alternative computational method provides a clearer illustration of the progressive rate structure.

<table>
<thead>
<tr>
<th>If Taxable Income Is</th>
<th>Of the Amount Over</th>
</tr>
</thead>
<tbody>
<tr>
<td>Over But Not Over</td>
<td>10%</td>
</tr>
<tr>
<td>$0–$8,375</td>
<td>$0–$8,375</td>
</tr>
<tr>
<td>$8,375–$34,000</td>
<td>$837.50 + 15%</td>
</tr>
<tr>
<td>$34,000–$82,400</td>
<td>$4,681.25 + 25%</td>
</tr>
<tr>
<td>$82,400–$171,850</td>
<td>$16,781.25 + 28%</td>
</tr>
<tr>
<td>$171,850–$373,650</td>
<td>$41,827.25 + 33%</td>
</tr>
<tr>
<td>$373,650+</td>
<td>$108,421.25 + 35%</td>
</tr>
</tbody>
</table>

Although the Tax Table is derived by using the Tax Rate Schedules (discussed below), the tax calculated using the two methods may vary slightly. This variation occurs because the tax for a particular income range in the Tax Table is based on the average tax for that range.

Linda is single and has taxable income of $30,000 for calendar year 2009. To determine Linda’s tax using the Tax Table (see Appendix A), find the $30,000 to $30,050 income line. The tax of $4,086 actually is the tax that the Tax Rate Schedule would yield on taxable income of $30,025 (i.e., the average tax between $30,000 and $30,050).

**Tax Rate Schedule Method**

The 2010 rate schedule for single taxpayers is reproduced in Table 3.6.43

Pat is single and had $5,870 of taxable income in 2010. His tax is $587 ($5,870 \times 10\%).

Several terms are used to describe tax rates. The rates in the Tax Rate Schedules often are referred to as statutory (or nominal) rates. The marginal rate is the highest rate that is applied in the tax computation for a particular taxpayer. In Example 37, the statutory rate and the marginal rate both are 10 percent.

Chris is single and had taxable income of $90,000 in 2010. Her tax is $18,909.25 [$16,781.25 + 28\%($90,000 - $82,400)].

The average rate is equal to the tax liability divided by taxable income. In Example 38, Chris has statutory rates of 10 percent, 15 percent, 25 percent, and 28 percent, and a marginal rate of 28 percent. Chris’s average rate is 21 percent ($18,909.25 tax liability \div $90,000 taxable income).

A tax is progressive if a higher rate of tax applies as the tax base increases. The Federal income tax uses progressive rates.

Continue with the facts of Example 38. An alternative computational method provides a clearer illustration of the progressive rate structure.
A special computation limits the effective tax rate on qualified dividends (see Chapter 4) and net long-term capital gain (see Chapter 14).

COMPUTATION OF NET TAXES PAYABLE OR REFUND DUE

The pay-as-you-go feature of the Federal income tax system requires payment of all or part of the taxpayer’s income tax liability during the year. These payments take the form of Federal income tax withheld by employers or estimated tax paid by the taxpayer, or both. The payments are applied against the tax from the Tax Table or Tax Rate Schedules to determine whether the taxpayer will get a refund or pay additional tax.

Employers are required to withhold income tax on compensation paid to their employees and to pay this tax over to the government. The employer notifies the employee of the amount of income tax withheld on Form W–2 (Wage and Tax Statement). The employee should receive this form by January 31 after the year in which the income tax is withheld.

If taxpayers receive income that is not subject to withholding or income from which not enough tax is withheld, they may need to pay estimated tax. These individuals must file Form 1040–ES (Estimated Tax for Individuals) and pay in quarterly installments the income tax and self-employment tax estimated to be due.

The income tax from the Tax Table or the Tax Rate Schedules is reduced first by the individual’s tax credits. There is an important distinction between tax credits and tax deductions. Tax credits reduce the tax liability dollar-for-dollar. Tax deductions reduce taxable income on which the tax liability is based.

EXAMPLE 40

Gail is a taxpayer in the 25% tax bracket. As a result of incurring $1,000 in child care expenses (see Chapter 12 for details), she is entitled to a $200 child care credit ($1,000 child care expenses × 20% credit rate). She also contributed $1,000 to the American Cancer Society and included this amount in her itemized deductions. The child care credit results in a $200 reduction of Gail’s tax liability for the year. The contribution to the American Cancer Society reduces taxable income by $1,000 and results in a $250 reduction in Gail’s tax liability ($1,000 reduction in taxable income × 25% tax rate).

Tax credits are discussed in Chapter 12. The following are several of the more commonly encountered credits.
- Earned income credit.
- Credit for child and dependent care expenses.
- Foreign tax credit.
- Child tax credit.

EXAMPLE 41

Return to the facts of Example 12. Grace’s taxable income is $43,900. Now further assume that Grace reports the following: income tax withheld, $2,300; estimated tax payments, $3,600; and a credit for dependent care expenses, $200. Grace’s net tax payable is computed as follows.

Income tax (from 2010 Tax Rate Schedule for Head of Household, Appendix A, rounded) $ 5,988
Less: Tax credits and prepayments—
  Credit for dependent care expenses $ 200
  Income tax withheld 2,300
  Estimated tax payments 3,600 (6,100)
Net taxes payable (or refund due if negative) $ (112)

§ 3402 for withholding; § 6654 for estimated payments.
UNEARNED INCOME OF CHILDREN TAXED AT PARENTS’ RATE

At one time, a dependent child could claim an exemption on his or her own return even if claimed as a dependent by the parents. This enabled a parent to shift investment income (such as interest and dividends) to a child by transferring ownership of the assets producing the income. The child would pay no tax on the income to the extent that it was sheltered by the child’s exemption and standard deduction amounts.

An additional tax motivation existed for shifting income from parents to children. Although a child’s unearned income in excess of the exemption and standard deduction amounts was subject to tax, it was taxed at the child’s rate, rather than the parents’ rate.

To reduce the tax savings that result from shifting income from parents to children, the net unearned income (commonly called investment income) of certain children is taxed as if it were the parents’ income. Unearned income includes such income as taxable interest, dividends, capital gains, rents, royalties, pension and annuity income, and income (other than earned income) received as the beneficiary of a trust. This provision, commonly referred to as the kiddie tax, applies to any child for any taxable year if the child has not reached age 19 by the close of the taxable year (age 24 if a full-time student) and has unearned income of more than $1,900.45

The kiddie tax does not apply if the child’s earned income exceeds half of his or her support, or if both parents are deceased, or if the child is married and files a joint return.

Net Unearned Income

Net unearned income of a dependent child is computed as follows:

\[
\text{Net unearned income} = \text{Unearned income} - \left(950 + \text{The greater of} \begin{cases} 
$950 & \text{or} \\
\text{The amount of allowable itemized deductions directly connected with the production of the unearned income} & \end{cases} \right)
\]

If net unearned income is zero (or negative), the child’s tax is computed without using the parents’ rate. If the amount of net unearned income is positive, the net unearned income is taxed at the parents’ rate, even if the parents did not transfer the income to the child. The $950 amounts in the preceding formula are subject to adjustment for inflation each year.

Tax Determination

If a child is subject to the kiddie tax, there are two options for computing the tax on the income. A separate return may be filed for the child, or the parents may elect to report the child’s income on their own return. If a separate return is filed for the child, the tax on net unearned income (referred to as the allocable parental tax) is computed on Form 8615 as though the income had been included on the parents’ return.

Example 42

Olaf and Olga have a child, Hans (age 10). In 2010, Hans received $3,000 of interest income and paid investment-related fees of $200. Olaf and Olga had $70,000 of taxable income, not including their child’s investment income. The parents have no qualified dividends or capital gains. Olaf and Olga do not make the parental election.

1. Determine Hans’s net unearned income

\[
\begin{align*}
\text{Gross income (unearned)} & = $3,000 \\
\text{Less: $950} & = (950) \\
\text{Less: The greater of} & = (950) \\
\begin{cases} 
$950 & \text{or} \\
\text{Investment expense ($200)} & \\
\end{cases} \\
\text{Equals: Net unearned income} & = $1,100
\end{align*}
\]

\[\text{§ 1(g)2.}\]
2. **Determine allocable parental tax**

- Parents’ taxable income: $70,000
- Plus: Hans’s net unearned income: 1,100
- **Equals:** Revised taxable income: $71,100
- **Tax on revised taxable income:** $10,138
- Less: Tax on parents’ taxable income: (9,863)
- **Allocable parental tax:** $ 275

3. **Determine Hans’s nonparental tax**

- Hans’s AGI: $ 3,000
- Less: Standard deduction (950)
- Less: Personal exemption (–0–)
- **Equals:** Taxable income: $ 2,050
- Less: Net unearned income: (1,100)
- **Nonparental taxable income:** $ 950
- **Equals: Tax ($950 \times 10\% rate):** $ 95

4. **Determine Hans’s total tax liability**

- Nonparental source tax (step 3) $ 95
- Allocable parental tax (step 2) 275
- **Total tax:** $ 370

---

**Election to Claim Certain Unearned Income on Parent’s Return**

If a child subject to the kiddie tax must file a tax return and meets all of the following requirements, the parent may elect to report the child’s unearned income that exceeds $1,900 on the parent’s own tax return.

- Gross income is from interest and dividends only.
- Gross income is more than $950 but less than $9,500.
- No estimated tax has been paid in the name and Social Security number of the child, and the child is not subject to backup withholding.

If the parental election is made, the child is treated as having no gross income and then is not required to file a tax return. The parental election is made by completing and filing Form 8814.

The parent(s) must also pay an additional tax equal to the smaller of $95 or 10 percent of the child’s gross income over $950. Parents who have substantial itemized deductions based on AGI (see Chapter 10) may find that making the parental election increases total taxes for the family unit. Taxes should be calculated both with the parental election and without it to determine the appropriate choice.

**Other Provisions**

If parents have more than one child subject to the tax on net unearned income, the tax for the children is computed as shown in Example 42 and then allocated to the children based on their relative amounts of income. For children of divorced parents, the taxable income of the custodial parent is used to determine the allocable parental tax. This parent is the one who may elect to report the child’s unearned income. For married individuals filing separate returns, the individual with the greater taxable income is the applicable parent.

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**3.6 GAINS AND LOSSES FROM PROPERTY TRANSACTIONS—IN GENERAL**

Gains and losses from property transactions are discussed in detail in Chapters 13 and 14. Because of their importance in the tax system, however, they are introduced briefly at this point.

When property is sold or otherwise disposed of, gain or loss may result. Such gain or loss has an effect on the income tax position of the party making the sale or other
disposition when the *realized* gain or loss is *recognized* for tax purposes. Without realized gain or loss, there generally can be no recognized gain or loss.

\[
\text{Amount realized from the sale} - \text{Adjusted basis of the property} = \text{Realized gain (or loss)}
\]

The amount realized is the selling price of the property less any costs of disposition (e.g., brokerage commissions) incurred by the seller. The adjusted basis of the property is determined as follows.

- **Cost (or other original basis) at date of acquisition**
- *Add:* Capital additions
- *Subtract:* Depreciation (if appropriate) and other capital recoveries (see Chapter 8)
- *Equals:* Adjusted basis at date of sale or other disposition

All realized gains are recognized (taxable) unless some specific part of the tax law provides otherwise (see Chapter 13 dealing with certain nontaxable exchanges). Realized losses may or may not be recognized (deductible) for tax purposes, depending on the circumstances involved. Generally, losses realized from the disposition of personal use property (property neither held for investment nor used in a trade or business) are not recognized.

**EXAMPLE 4.3**

Ted sells his sailboat (adjusted basis of $4,000) for $5,500. Ted also sells one of his personal automobiles (adjusted basis of $8,000) for $5,000. Ted’s realized gain of $1,500 from the sale of the sailboat is recognized. On the other hand, the $3,000 realized loss on the sale of the automobile is not recognized and will not provide Ted with any deductible tax benefit.

Once it has been determined that the disposition of property results in a recognized gain or loss, the next step is to classify the gain or loss as capital or ordinary. Although ordinary gain is fully taxable and ordinary loss is fully deductible, the same may not hold true for capital gains and capital losses.

### 3.7 GAINS AND LOSSES FROM PROPERTY TRANSACTIONS—CAPITAL GAINS AND LOSSES

Capital gains and losses can generate unique tax consequences. For in-depth treatment of property transactions (including capital gains and losses), refer to Chapters 13 and 14. For now, the overview appearing below should suffice.

**DEFINITION OF A CAPITAL ASSET**

Capital assets include any property held by the taxpayer *other than* property listed in § 1221. The list in § 1221 includes inventory, accounts receivable, and depreciable property or real estate used in a business. Thus, the sale or exchange of assets in these categories usually results in ordinary income or loss treatment (see Chapter 14).

**EXAMPLE 4.4**

Kelly owns a pizza parlor. During the current year, she sells two automobiles. The first automobile, which had been used as a pizza delivery car for three years, was sold at a loss of $1,000. Because this automobile is an asset used in her business, Kelly claims an ordinary loss deduction of $1,000, rather than a capital loss deduction. The second
automobile, which Kelly had owned for two years, was her personal use car. It was sold for a gain of $800. The personal use car is a capital asset. Therefore, Kelly recognizes a capital gain of $800.

The principal capital assets held by an individual taxpayer include assets held for personal (rather than business) use, such as a personal residence or an automobile, and assets held for investment purposes (e.g., corporate securities and land). Capital assets generally include collectibles, which can be subject to unique tax treatment. Collectibles include art, antiques, gems, metals, stamps, some coins and bullion, and alcoholic beverages that are held as investments.

TAXATION OF NET CAPITAL GAIN

Net capital gains are classified and taxed in 2010 as follows.

<table>
<thead>
<tr>
<th>Classification</th>
<th>Maximum Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term gains (held for one year or less)</td>
<td>35%</td>
</tr>
<tr>
<td>Long-term gains (held for more than one year)</td>
<td></td>
</tr>
<tr>
<td>Collectibles</td>
<td>28%</td>
</tr>
<tr>
<td>Certain depreciable property used in a trade or business</td>
<td>25%</td>
</tr>
<tr>
<td>(known as unrecaptured § 1250 gain and discussed in Chapter 14)</td>
<td></td>
</tr>
<tr>
<td>All other long-term capital gains</td>
<td>15% or 0%</td>
</tr>
</tbody>
</table>

The special tax rate applicable to long-term capital gains is called the alternative tax computation. It is used only if the taxpayer’s regular tax rate exceeds the applicable alternative tax rate. The 0 percent rate, noted above, applies only if the taxpayer’s regular tax bracket is 15 percent or less.47

**Example 45**

During 2010, Polly is in the 15% tax bracket and reports the following capital gains.

- Robin Corporation stock (held for 6 months) $1,000
- Crow Corporation stock (held for 13 months) 1,000

Polly’s tax on these transactions is $150 ($1,000 × 15%) as to Robin and $0 ($1,000 × 0%) as to Crow.

**Example 46**

Assume the same facts as in Example 45, except that Polly’s regular tax bracket for the year is 28% (not 15%). Polly’s tax on these transactions becomes $280 ($1,000 × 28%) as to Robin and $150 ($1,000 × 15%) as to Crow.

**DETERMINATION OF NET CAPITAL GAIN**

To arrive at a net capital gain, capital losses are taken into account. The capital losses are aggregated by holding period (short term and long term) and applied against the gains in that category. If excess losses result, they are then shifted to the category carrying the highest tax rate. A net capital gain occurs if the net long-term capital gain (NLTCG) exceeds the net short-term capital loss (NSTCL).

**Example 47**

Colin is in the 35% tax bracket and reports the following capital transactions.

- Penguin Corporation stock (held for 8 months) $1,000
- Owl Corporation stock (held for 10 months) (3,000)
- Stamp collection (held for 5 years) 2,000
- Land (held as an investment for 3 years) 4,000

47§ 1(h)(1).
The Penguin short-term capital gain (STCG) of $1,000 is offset by the Owl short-term capital loss (STCL) of $3,000. The remaining STCL of $2,000 then is applied against the collectible gain of $2,000. The end result is a net long-term capital gain of $4,000 from the land sale, taxed at a 15% rate.

**TREATMENT OF NET CAPITAL LOSS**

For individual taxpayers, net capital loss can be used to offset ordinary income of up to $3,000 ($1,500 for married persons filing separate returns). If a taxpayer reports both short- and long-term capital losses, the short-term category is used first to arrive at the $3,000. Any remaining net capital loss is carried over indefinitely until exhausted. When carried over, the excess capital loss retains its classification as short or long term.

**EXAMPLE 48**

In 2010, Tina has a short-term capital loss of $2,000, a long-term capital loss of $2,500, and no capital gains. She can deduct $3,000 ($2,000 short-term + $1,000 long-term) of this amount as an ordinary loss. The remaining $1,500 is carried over to 2011 as a long-term capital loss.

**TAX PLANNING:**

**3.8 MAXIMIZING THE USE OF THE STANDARD DEDUCTION**

In most cases, the choice between using the standard deduction and itemizing deductions from AGI is a simple matter—pick whichever yields the larger tax benefit. Families in the initial stages of home ownership, for example, will invariably make the itemization choice due to the substantial mortgage interest and property tax payments involved. Older taxpayers, however, may have paid for their homes or are enjoying senior citizen property tax exemptions. For them, the more attractive benefit is the additional standard deduction that can accompany the standard deduction choice.

In some cases, the difference between the standard deduction and itemizing may not be a significant amount. Here, taxes might be saved by alternating between the two options. The taxpayer does this by using the cash method to concentrate multiple years’ deductions in a single year (e.g., paying off a five-year church pledge in one year). Then, the standard deduction is used in alternate years.

**3.9 DEPENDENCY EXEMPTIONS**

**THE JOINT RETURN TEST**

A married person can be claimed as a dependent only if that individual does not file a joint return with his or her spouse. If a joint return has been filed, the damage may be undone if separate returns are substituted on a timely basis (on or before the due date of the return). The latest-filed timely return prevails.48

**EXAMPLE 49**

While preparing a client’s 2009 income tax return on April 2, 2010, the tax practitioner discovered that the client’s daughter filed a joint return with her husband in late January 2010. Presuming that the daughter otherwise qualifies as the client’s dependent, the exemption is not lost if she and her husband file separate returns on or before April 15, 2010.

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48Reg. § 1.6013–1(a)(1).
Keep in mind that the filing of a joint return is not fatal to the dependency exemption if the parties are filing solely to recover all income tax withholdings, they are not required to file a return, and no tax liability would exist on separate returns.

**SUPPORT CONSIDERATIONS**

The support of a qualifying child becomes relevant only if the child is self-supporting. In cases where the child has an independent source of funds, planning could help prevent an undesirable result. When a qualifying relative is involved, meeting the support test is essential, as the dependency exemption is not otherwise available.

**EXAMPLE 50**

Imogene maintains a household that she shares with her son and mother. The son, Barry, is 23 years of age and a full-time student in law school. The mother, Gladys, is 68 years old, and she is active in charitable causes. Barry works part-time for a local law firm, while Gladys has income from investments. In resolving the support issue (or self-support in the case of Barry), compare Imogene’s contribution with that made by Barry and Gladys. In this connection, what Barry and Gladys do with their funds becomes crucial. The funds that are used for nonsupport purposes (e.g., purchase of investments) or not used at all (e.g., deposited in a bank) should not be considered. To the extent possible, the parties should control how much Barry and Gladys contribute to their own support. Records should be maintained showing the amount of support and its source.

Example 50 does not mention the possible application of the gross income test. Presuming Barry is a qualifying child, the amount he earns does not matter, as the gross income test does not apply. Gladys, however, comes under the qualifying relative category, where the gross income test applies. Therefore, for her to be claimed as a dependent, her income that is taxable will have to be less than $3,500.

**COMMUNITY PROPERTY RAMIFICATIONS**

In certain cases, state law can have an effect on the availability of a dependency exemption.

**EXAMPLE 51**

Mitch provides more than half of the support of his son, Ross, and daughter-in-law, Connie, who live with him. Ross, age 22, is a full-time student, while Connie earns $4,000 from a part-time job. Ross and Connie do not file a joint return. All parties live in New York, a common law state. Mitch can claim Ross as a dependent, as he is a qualifying child. Connie is not a dependent because she does not meet the gross income test under the qualifying relative category.

**EXAMPLE 52**

Assume the same facts as in Example 51, except that all parties live in Arizona, a community property state. Now, Connie also qualifies as a dependent. Since Connie’s gross income is only $2,000 (one-half of the community income), she satisfies the gross income test.

**RELATIONSHIP TO THE DEDUCTION FOR MEDICAL EXPENSES**

Generally, medical expenses are deductible only if they are paid on behalf of the taxpayer, his or her spouse, and their dependents. Since deductibility may rest on dependency status, planning is important in arranging multiple support agreements.

Zelda will be supported next year by her two sons (Vern and Vito) and her daughter (Maria). Each will furnish approximately one-third of the required support. If the parties decide that the dependency exemption should be claimed by the daughter under a multiple support agreement, any medical expenses incurred by Zelda should be paid by Maria.
In planning a multiple support agreement, take into account which of the parties is most likely to exceed the 7.5 percent limitation on medical expense deductions (see Chapter 10). In Example 53, for instance, Maria might be a poor choice if she and her family do not expect to incur many medical and drug expenses of their own.

One exception permits the deduction of medical expenses paid on behalf of someone who is not a spouse or a dependent. If the person could be claimed as a dependent except for the gross income or joint return test, the medical expenses are, nevertheless, deductible. For additional discussion, see Chapter 10.

**3.10 Taking Advantage of Tax Rate Differentials**

It is natural for taxpayers to be concerned about the tax rates they are paying. How does a tax practitioner communicate information about rates to clients? There are several possibilities.

The marginal tax rate (refer to Examples 37 through 39) provides information that can help a taxpayer evaluate a particular course of action or structure a transaction in the most advantageous manner. For example, a taxpayer who is in the 15 percent bracket this year and expects to be in the 28 percent bracket next year should, if possible, defer payment of deductible expenses until next year, to maximize the tax benefit of the deduction.

A note of caution is in order with respect to shifting income and expenses between years. Congress has recognized the tax planning possibilities of such shifting and has enacted many provisions to limit a taxpayer’s ability to do so. The kiddie tax is one example. More of these limitations on the shifting of income are discussed in Chapters 4, 5, and 16. Limitations that affect a taxpayer’s ability to shift deductions are discussed in Chapters 6 through 11 and in Chapter 16.

A taxpayer’s effective rate can be an informative measure of the effectiveness of tax planning. The effective rate is computed by dividing the taxpayer’s tax liability by the total amount of income. A low effective rate can be considered an indication of effective tax planning.

One way of lowering the effective rate is to exclude income from the tax base. For example, a taxpayer might consider investing in tax-free municipal bonds rather than taxable corporate bonds. Although pre-tax income from corporate bonds is usually higher, after-tax income may be higher if the taxpayer invests in tax-free municipal bonds.

Another way of lowering the effective rate is to make sure that the taxpayer’s expenses and losses are deductible. For example, losses on investments in passive activities may not be deductible (see Chapter 11). Therefore, a taxpayer who plans to invest in an activity that will produce a loss in the early years should take steps to ensure that the business is treated as active rather than passive. Often, active losses are deductible while passive losses are not.
3.11 **UNEARNED INCOME OF CERTAIN CHILDREN**

Taxpayers can use several strategies to avoid or minimize the effect of the kiddie tax rules. Parents should consider giving a younger child assets that defer taxable income until the child is free of the kiddie tax. For example, U.S. government Series EE savings bonds can be used to defer income until the bonds are cashed in (see Chapter 4).

Growth stocks typically pay little in the way of dividends. However, the capital gain on an astute investment may more than offset the lack of dividends. The stock can be held and then sold only when the child’s own tax rates apply.

Taxpayers in a position to do so can employ their children in their business and pay them a reasonable wage for the work they actually perform (e.g., light office help, such as filing). The child’s earned income is sheltered by the standard deduction, and the parents’ business is allowed a deduction for the wages. The kiddie tax rules have no effect on earned income, and the income could be sheltered further if it is contributed to a retirement plan.

**REFOCUS ON THE BIG PICTURE**

Of major concern to Polly is her filing status. If she qualifies as an abandoned spouse, she is entitled to file as head of household. If not, she is considered to be a married person filing separately. Moreover, to be an abandoned spouse, Polly must be able to claim Paige as a dependent. To be a dependent, Paige must meet the requirements of a qualifying child or a qualifying relative.

For qualifying child purposes, Paige must meet either the age (i.e., under age 19) or the full-time student (under age 24) test. Because Paige currently is not a full-time student, is she under age 19? If so, she is a qualifying child. If Paige is not a qualifying child, is she a qualifying relative? Here, the answer depends on meeting the gross income test. How much did Paige earn from her part-time job? If her earnings are under $3,650, she satisfies the gross income test. Thus, if Paige can be claimed as a dependent as either a qualifying child or a qualifying relative, Polly is an abandoned spouse entitled to head-of-household filing status. If not, she is a married person filing separately.

The sale of the wedding rings results in a capital loss of $7,000 ($8,000 — $15,000). Because the loss is for personal use property, it cannot be deducted for tax purposes.

**What If?**

Assume that Nick left for parts unknown in August (not March). Now Polly cannot qualify as an abandoned spouse. Her husband lived in the home during part of the last six months of the year. Consequently, Polly is treated as married and cannot qualify for head-of-household filing status. She must file as a married person filing separately. When Nick left does not affect the dependency issue regarding Paige, however.
DISCUSSION QUESTIONS

1. **LO.1** Rearrange the following items to show the correct formula for arriving at **taxable income** of individuals under the Federal income tax.
   a. Taxable income.
   b. Exclusions.
   c. Income (broadly conceived).
   d. Gross income.
   e. The greater of the standard deduction or itemized deductions.
   f. Adjusted gross income.
   g. Deductions for AGI.
   h. Personal and dependency exemptions.

2. **LO.1, 5, 8, 9** During the year, Becky is involved in the following transactions.
   - Lost money gambling on a trip to a casino.
   - Paid a traffic ticket received while double parking to attend a business meeting.
   - Contributed to the mayor’s reelection campaign. The mayor had promised Becky to get some of her land rezoned.
   - Borrowed money from a bank to make a down payment on a residence.
   - Sold a houseboat and a camper on eBay. Both were personal use items, and the gain from one offset the loss from the other.
   - Her dependent aunt died on January 3 of the year.
   - Paid for the dependent aunt’s funeral expenses.
   - Paid premiums on her own life insurance policy.

   What are the possible income tax ramifications of these transactions?

3. **LO.1** Which of the following items are **inclusions** in gross income?
   a. During the year, a city lot that the taxpayer had purchased as an investment doubled in value.
   b. Amount an off-duty motorcycle police officer received for escorting a funeral procession.
   c. While his mother Shirley was in the hospital, the taxpayer sold Shirley’s jewelry and gave the money to his girlfriend Serena.
   d. Alimony payments received.
   e. A damage deposit the taxpayer recovered when he vacated the apartment he had rented.
   f. Interest received by the taxpayer on an investment in bonds issued by the State of Iowa.
   g. Amounts received by the taxpayer, a baseball “Hall of Famer,” for autographing sports equipment (e.g., balls, gloves).
   h. Jury duty fees received.

4. **LO.1** Which of the following items are **exclusions** from gross income?
   a. Child support payments received.
   b. Damages award received by the taxpayer—one-fourth of the amount was for personal injury reimbursements and three-fourths represented punitive damages.
   c. A new golf cart won in a church raffle.
   d. Amount collected on a loan previously made to a college friend.
   e. Insurance proceeds paid to the taxpayer on the death of her uncle—she was the designated beneficiary under the policy.
f. Interest income on General Electric Company bonds.
g. Scholarship award that covers the taxpayer’s college tuition as well as room and board.
h. Reward paid by the IRS for information provided that led to the conviction of the taxpayer’s former employer for tax evasion.
i. A “store refund” of $200 that the taxpayer received when she discovered an overcharge on the purchase of home appliances.
j. Rare coins worth $8,000 found in an old trunk purchased by the taxpayer at a garage sale.

5. **Lo.1** Does a U.S. citizen who works abroad run the risk of “double taxation”? Why or why not?

6. **Lo.1, 8, 9** In late 2010, the Polks come to you for tax advice. They are considering selling some stock investments for a loss and making a contribution to a traditional IRA. In reviewing their situation, you note that they have large medical expenses and a casualty loss, with neither being covered by insurance. What advice would you give to the Polks?

7. **Lo.2** In choosing between the standard deduction and itemizing deductions from AGI, what effect, if any, do the following variables have?
   a. The age of the taxpayer(s).
   b. Taxpayer’s filing status (e.g., single; married, filing jointly).
   c. The taxpayers have paid off the mortgage on their personal residence.
   d. Whether married taxpayers decide to file separate returns.
   e. The taxpayer’s uninsured personal residence was recently destroyed by fire.
   f. The number of personal and dependency exemptions the taxpayer can claim.

8. **Lo.2** In connection with the standard deduction alternative, comment on the following.
   a. Percentage of taxpayers who chose the standard deduction rather than itemize.
   b. Status of a taxpayer who dies before year-end.
   c. Types of standard deductions available.
   d. When not available.

9. **Lo.2, 3, 5** Mel, age 76 and a widower, is being claimed as a dependent by his daughter. How does this situation affect the following?
   a. Mel’s own individual filing requirement.
   b. Mel’s personal exemption.
   c. The standard deduction allowed to Mel.
   d. The availability of any additional standard deduction.

10. **Lo.4** Patsy maintains a household that includes her eldest son (age 30) and one of Patsy’s cousins (age 28). She can claim the cousin as a dependent but not her son. Explain.

11. **Lo.4** Heather, age 12, lives in the same household with her mother, grandmother, and uncle.
   a. Who can qualify for the dependency exemption?
   b. Who takes preference?
   c. Suppose that Heather’s father, who lives elsewhere and files a separate return, also wants to claim her. Can he do so?

12. **Lo.4** Under what circumstances, if any, can a taxpayer claim an ex-spouse as a dependent? What about claiming the ex-spouse’s relatives as dependents?

13. **Lo.4** Joshua and his two sisters provide more than half of their mother’s support. After comparing notes, Joshua tells his sisters to split the dependency exemption between them, as the deduction will result in a greater tax benefit. Do you see any flaw in Joshua’s advice?

14. **Lo.4** Jerry and Arlene were divorced in 2008. In 2009, Arlene has custody of their children, but Jerry provides nearly all of their support. Who is entitled to claim the children as dependents?

15. **Lo.4** Marcus maintains a household in which his 18-year-old daughter Joely and her husband Thom live. Although Marcus provides most of their support, he does not claim them as dependents because Joely and Thom file a joint return. Is Marcus correct?

16. **Lo.4** Roberto, who is single, is a U.S. citizen and resident. He provides almost all of the support of his parents and two aunts, who are citizens and residents of Guatemala. Roberto’s parents and aunts are seriously considering moving to and becoming residents of Mexico. Would such a move have any impact on Roberto? Why or why not?
17. **LO.5, 9** Jack and Joyce, who are married, had itemized deductions of $7,500 and $500, respectively. Jack suggests that they file separately—he will itemize his deductions from AGI, and she will claim the standard deduction.
   a. Evaluate Jack’s suggestion.
   b. What should they do?

18. **LO.4, 5** Comment on the availability of head-of-household filing status in each of the following situations.
   a. Taxpayer lives alone but maintains the household of his parents, who do not qualify as his dependents.
   b. Taxpayer, a single parent, maintains a home in which she and her unmarried son live. The son, age 18, earns $4,000 from a part-time job.
   c. Assume the same facts as in (b) except that the son is age 20, not 18.
   d. Taxpayer lives alone but maintains the household where her dependent daughter lives.
   e. Taxpayer maintains a household that includes an unrelated friend who qualifies as his dependent.

19. **LO.5** Florence’s husband died in 2007. During 2010, Florence maintains a household in which she and her son, Derrick, live. Determine Florence’s filing status for 2010 based on the following independent variables:
   a. Derrick is single and does not qualify as Florence’s dependent.
   b. Derrick is married and does not qualify as Florence’s dependent.
   c. Derrick is married and does qualify as Florence’s dependent.
   d. Would any of the previous answers change if Florence’s husband died in 2008 (not 2007)? Explain.

20. **LO.5** Several years ago, after a particularly fierce argument, Fran’s husband moved out and has not been heard from or seen since. Because Fran cannot locate her husband, she uses a “married, filing separate” income tax return. Comment on Fran’s status.

21. **LO.4, 5** In many cases, a surviving spouse ultimately becomes a head of household for filing status purposes. Explain this statement.

22. **LO.7** In connection with the kiddie tax, comment on the following.
   a. Justification for the tax.
   b. Earned income versus unearned income.
   c. Age exception.
   d. Effect of parental election.
   e. Parents file separate returns.
   f. Parents are divorced.

23. **LO.8** During the year, Hernando recorded the following transactions. How should Hernando treat these transactions for income tax purposes?
   - Gain on the sale of stock held as an investment for 10 months.
   - Gain on the sale of land held as an investment for 4 years.
   - Gain on the sale of a houseboat owned for 2 years and used for family vacations.
   - Loss on the sale of a reconditioned motorcycle owned for 3 years and used for recreational purposes.

24. **LO.8** Several years ago, Milton and Arlene inherited equal shares of their father’s coin collection. When they sold the collection this year, Milton paid a tax based on 28% of his profit while Arlene’s tax rate was only 25%. Presuming each had the same amount of gain, explain the difference in result.

25. **LO.8** During the year, Brandi had the following transactions: a long-term capital gain from the sale of land; a short-term capital loss from the sale of stock; and a long-term capital gain from the sale of a gun collection.
   a. How are these transactions treated for income tax purposes?
   b. Does this treatment favor the taxpayer or the IRS? Explain.

26. **LO.4, 5, 9** Marcie is divorced, and her married son, Jamie (age 25), and his wife, Audry (age 18), live with her. During the year, Jamie earned $4,800 from a part-time job and filed a joint return with Audry to recover his withholdings. Audry has no income. Marcie can prove that she provided more than 50% of Jamie and Audry’s support. Marcie does
not plan to claim Jamie as a dependent because he has too much gross income. She does not plan to claim Audry as a dependent because Audry signed the joint return with Jamie. In fact, Marcie plans to use single filing status as none of the persons living in her household qualifies as her dependent. Comment on Marcie's intentions based on the following assumptions:

a. All parties live in Indiana (a common law state).
b. All parties live in California (a community property state).

27. **LO.4, 9** Erica Hill and her two brothers, Ted and Rick Lamb, equally furnish all of the support of their mother. Erica is married and has four children. Her brothers are single and claim the standard deduction. Erica’s mother, Donna Lamb, is not in good health. What suggestions can you make regarding the tax position of the parties?

### PROBLEMS

28. **LO.1** Compute taxable income in each of the following independent situations.

a. Drew and Meg, ages 40 and 41, are married and file a joint return. In addition to three dependent children, they have AGI of $65,000 and itemized deductions of $12,000.

b. Sybil, age 40, is single and supports her dependent parents who live with her and also supports her grandparents (mother’s parents) who are in a nursing home. She has AGI of $80,000 and itemized deductions of $8,000.

c. Scott, age 49, is an abandoned spouse. His household includes three unmarried step-sons who qualify as his dependents. He has AGI of $75,000 and itemized deductions of $9,500.

d. Amelia, age 33, is a surviving spouse and maintains a household for her four dependent children. She has AGI of $58,000 and itemized deductions of $10,200.

e. Dale, age 42, is divorced but maintains the home in which he and his daughter, Jill, live. Jill is single and qualifies as Dale’s dependent. Dale has AGI of $64,000 and itemized deductions of $9,900.

**Note:** Problems 29 and 30 can be solved by referring to Figure 3.1, Exhibits 3.1 through 3.3, Tables 3.1 and 3.2, and the discussion under Deductions for Adjusted Gross Income in this chapter.

29. **LO.1, 8** Compute the taxable income for 2010 for Curtis on the basis of the following information. His filing status is single.

<table>
<thead>
<tr>
<th>Income/Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$90,000</td>
</tr>
<tr>
<td>Interest income from bonds issued by City of San Diego</td>
<td>3,000</td>
</tr>
<tr>
<td>Alimony payments made</td>
<td>3,600</td>
</tr>
<tr>
<td>Contribution to traditional IRA</td>
<td>5,000</td>
</tr>
<tr>
<td>Gift from grandparents</td>
<td>26,000</td>
</tr>
<tr>
<td>Capital loss from stock investment</td>
<td>2,000</td>
</tr>
<tr>
<td>Amount lost in football office pool (sports gambling is illegal where Curtis lives)</td>
<td>1,500</td>
</tr>
<tr>
<td>Number of potential dependents (two cousins, who live in another state)</td>
<td>?</td>
</tr>
<tr>
<td>Age</td>
<td>39</td>
</tr>
</tbody>
</table>

30. **LO.1** Compute the taxable income for 2010 for Mattie on the basis of the following information. Mattie is married but has not seen or heard from her husband since 2008.

<table>
<thead>
<tr>
<th>Income/Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$60,000</td>
</tr>
<tr>
<td>Interest on bonds issued by AT&amp;T Corporation</td>
<td>3,000</td>
</tr>
<tr>
<td>Interest on CD issued by Wells Fargo Bank</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash dividend received on Chevron common stock</td>
<td>2,200</td>
</tr>
<tr>
<td>Life insurance proceeds paid on death of aunt (Mattie was the designated beneficiary of the policy)</td>
<td>100,000</td>
</tr>
<tr>
<td>Inheritance received on death of aunt</td>
<td>200,000</td>
</tr>
<tr>
<td>Casey (a cousin) repaid a loan Mattie made to him in 2007 (no interest was provided for)</td>
<td>5,000</td>
</tr>
<tr>
<td>Itemized deductions (state income tax, property taxes on residence, interest on home mortgage, charitable contributions)</td>
<td>10,200</td>
</tr>
<tr>
<td>Number of dependents (children, ages 17 and 18)</td>
<td>2</td>
</tr>
<tr>
<td>Age</td>
<td>40</td>
</tr>
</tbody>
</table>
31. **LO.2** Determine the amount of the standard deduction allowed for 2010 in the following independent situations. In each case, assume the taxpayer is claimed as another person’s dependent.
   a. Edward, age 18, has income as follows: $600 interest from a certificate of deposit and $6,000 from repairing cars.
   b. Sarah, age 18, has income as follows: $400 cash dividends from a stock investment and $3,600 from handling a paper route.
   c. Colin, age 16, has income as follows: $900 interest on a bank savings account and $700 for painting a neighbor’s fence.
   d. Kara, age 15, has income as follows: $300 cash dividends from a stock investment and $600 from grooming pets.
   e. Kay, age 67 and a widow, has income as follows: $1,200 from a bank savings account and $3,000 from baby-sitting.

32. **LO.4** Using the legend provided below, classify each statement as to the taxpayer for dependency exemption purposes.

<table>
<thead>
<tr>
<th>Legend</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>QC</td>
<td>Could be a qualifying child</td>
</tr>
<tr>
<td>QR</td>
<td>Could be a qualifying relative</td>
</tr>
<tr>
<td>B</td>
<td>Could satisfy the definition of both a qualifying child and a qualifying relative</td>
</tr>
<tr>
<td>N</td>
<td>Could not satisfy the definition of either a qualifying child or a qualifying relative</td>
</tr>
</tbody>
</table>

   a. Taxpayer’s son has gross income of $6,000.
   b. Taxpayer’s niece has gross income of $3,000.
   c. Taxpayer’s mother lives with him.
   d. Taxpayer’s daughter is age 25 and disabled.
   e. Taxpayer’s daughter is age 18 but does not live with him.
   f. Taxpayer’s cousin lives with her.
   g. Taxpayer’s brother does not live with her.
   h. Taxpayer’s sister lives with him.
   i. Taxpayer’s nephew is age 20 and a full-time student.
   j. Taxpayer’s grandson does not live with her and has gross income of $3,000.

33. **LO.3, 4** Determine the number of personal and dependency exemptions in each of the following independent situations.
   a. Leo and Amanda (ages 48 and 46) are husband and wife and furnish more than 50% of the support of their two children, Elton (age 18) and Trista (age 24). During the year, Elton earns $4,500 providing transportation for elderly persons with disabilities, and Trista receives a $5,000 scholarship for tuition at the law school she attends.
   b. Audry (age 65) is divorced and lives alone. She maintains a household in which her ex-husband, Clint, and his mother, Olive, live and furnishes more than 50% of their support. Olive is age 82 and blind.
   c. Crystal, age 45, furnishes more than 50% of the support of her married son, Andy (age 18), and his wife, Paige (age 19), who live with her. During the year, Andy earned $8,000 from a part-time job. All parties live in Maryland (a common law state).
   d. Assume the same facts as in (c), except that all parties live in New Mexico (a community property state).

34. **LO.3, 4** Determine the number of personal and dependency exemptions in each of the following independent situations.
   a. Alberto, a U.S. citizen and resident, contributes 100% of the support of his parents who are citizens of Mexico and live there.
   b. Pablo, a U.S. citizen and resident, contributes 100% of the support of his parents who are citizens of Guatemala. Pablo’s father is a resident of Guatemala, and his mother is a legal resident of the United States.
   c. Marlena, a U.S. citizen and resident, contributes 100% of the support of her parents who are also U.S. citizens but are residents of Germany.
   d. Elena is a U.S. citizen and a resident of Italy. Her household includes Mario, a four-year-old adopted son who is a citizen of Spain.
35. **LO.3, 4** Determine how many dependency exemptions are available in each of the following independent situations. Specify whether any such exemptions would come under the qualifying child or the qualifying relative category.

   a. Andy maintains a household that includes a cousin (age 12), a niece (age 18), and a son (age 26). All are full-time students. Andy furnishes all of their support.
   
   b. Minerva provides all of the support of a family friend’s son (age 18) who lives with her. She also furnishes most of the support of her stepmother who does not live with her.
   
   
   d. Karen maintains a household that includes her ex-husband, her mother-in-law, and her brother-in-law (age 23 and not a full-time student). Karen provides more than half of all of their support. Karen is single and was divorced in the current year.

36. **LO.4** Jenny, age 14, lives in a household with her father, uncle, and grandmother. The household is maintained by the uncle. The parties, all of whom file separate returns, have AGI as follows: father ($30,000), uncle ($40,000), and grandmother ($50,000).

   a. Who is eligible to claim Jenny as a dependent?
   
   b. Who has preference as to the exemption?

37. **LO.3, 4** Determine the number of personal and dependency exemptions for 2010 in each of the following independent situations.

   a. Marcus (age 68) and Alice (age 65 and blind) file a joint return. They furnish more than 50% of the support of a niece, Ida, who lives with them. Ida (age 20) is a full-time student and earns $5,000 during the year tutoring special needs children.
   
   b. Penny (age 45) is single and maintains a household in which she and her cousin, Clint, live. Clint (age 18) earns $4,900 from doing yard work, but receives more than 50% of his support from Penny.
   
   c. Trent (age 38) is single and lives alone. He provides more than 50% of the support of his parents (ages 69 and 70) who are in a nursing home.
   
   d. Jack and Carol were divorced in 2007, and Carol has custody of their three children (ages 5, 7, and 9). Jack does not furnish more than half of their support, and the divorce decree is silent as to the dependency exemptions. Carol signs a Form 8332.

38. **LO.4, 9** Isaiah and Inez (ages 88 and 89) live in an assisted care facility and for years 2009 and 2010 received their support from the following sources.

<table>
<thead>
<tr>
<th>Percentage of Support</th>
</tr>
</thead>
<tbody>
<tr>
<td>Social Security benefits</td>
</tr>
<tr>
<td>Daughter</td>
</tr>
<tr>
<td>Nephew</td>
</tr>
<tr>
<td>Cousin</td>
</tr>
<tr>
<td>Sister</td>
</tr>
<tr>
<td>Family friend (not related)</td>
</tr>
</tbody>
</table>

   a. Which persons are eligible to claim the dependency exemptions under a multiple support agreement?
   
   b. Must Isaiah and Inez be claimed by the same person(s) for both 2009 and 2010?
   
   c. Who, if anyone, can claim their medical expenses?

39. **LO.5** In each of the following independent situations, determine Winston’s filing status. Winston is not married.

   a. Winston maintains a household in which he and a family friend, Ward, live. Ward qualifies as Winston’s dependent.
   
   b. Winston lives alone, but he maintains a household in which his parents live. The mother qualifies as Winston’s dependent, but the father does not.
   
   c. Winston lives alone but maintains a household in which his married daughter, Karin, lives. Both Karin and her husband (Winston’s son-in-law) qualify as Winston’s dependents.
40. **LO. 4, 5** Nadia died in 2008 and is survived by her husband, Jerold, and her 18-year-old daughter, Macy. Jerold is the executor of Nadia’s estate. Jerold maintains the household in which he and Macy live and furnishes more than 50% of her support. Macy had earnings from part-time employment as follows: $4,000 in 2008; $5,000 in 2009; and $6,000 in 2010. She is a full-time student for 2010 (but not for 2008 and 2009). What is Jerold’s filing status for:
   a. 2008?
   b. 2009?
   c. 2010?

41. **LO. 3, 4, 5** Perry died in 2009 and is survived by his wife, Rosalyn (age 39), his married daughter, Sue (age 18), and his son-in-law, Peyton (age 22). Rosalyn is the executor of her husband’s estate. She also maintains the household where she, Sue, and Peyton live and furnishes more than 50% of their support. During 2009 and 2010, Peyton is a full-time student, while Sue earns $16,000 ($8,000 each year) conducting aerobics classes. Sue and Peyton do not file joint returns. For years 2009 and 2010, what is Rosalyn’s filing status, and how many exemptions can she claim based on each of the following assumptions?
   a. All parties live in Pennsylvania (a common law state).
   b. All parties live in Texas (a community property state).

42. **LO. 4, 9** Walter and Nancy provide 60% of the support of their daughter (age 18) and son-in-law (age 22). The son-in-law (John) is a full-time student at a local university, while the daughter (Irene) holds various part-time jobs from which she earns $11,000. Walter and Nancy engage you to prepare their tax return for 2010. During a meeting with them in late March 2011, you learn that John and Irene have filed a joint return. What tax advice would you give based on the following assumptions?
   a. All parties live in Louisiana (a community property state).
   b. All parties live in New Jersey (a common law state).

43. **LO. 1, 2, 3, 4, 5, 6** Using the Tax Rate Schedules, compute the 2010 tax liability for Miles. Miles (age 42) is a surviving spouse and provides all of the support of his four minor children who live with him. He also maintains the household in which his parents live and furnished 60% of their support. Besides interest on City of Dallas bonds in the amount of $1,500, Miles’s father received $2,400 from a part-time job. Miles has a salary of $80,000, a short-term capital loss of $4,000, a cash prize of $1,000 from a church raffle, and itemized deductions of $9,500.

44. **LO. 1, 2, 3, 4, 5, 6, 8** Morgan (age 45) is single and provides more than 50% of the support of Rosalyn (a family friend), Flo (a niece, age 18), and Jerold (a nephew, age 18). Both Rosalyn and Flo live with Morgan, but Jerold (a French citizen) lives in Canada. Morgan earns a salary of $85,000, contributes $5,000 to a traditional IRA, and receives sales proceeds of $15,000 for an RV that cost $60,000 and was used for vacations. She has $8,200 in itemized deductions. Use the Tax Rate Schedules to compute Morgan’s 2010 tax liability.

45. **LO. 5** Which of the following individuals are required to file a tax return for 2010? Should any of these individuals file a return even if filing is not required? Why?
   a. Sam is married and files a joint return with his spouse, Lana. Both Sam and Lana are 67 years old. Their combined gross income was $21,000.
   b. Ronald is a dependent child under age 19 who received $5,100 in wages from a part-time job.
   c. Mike is single and is 67 years old. His gross income from wages was $10,100.
   d. Patricia, age 19, is a self-employed single individual with gross income of $4,500 from an unincorporated business. Business expenses amounted to $4,000.

46. **LO. 5** Which of the following taxpayers must file a Federal income tax return for 2010?
   a. Ben, age 19, is a full-time college student. He is claimed as a dependent by his parents. He earned $5,000 wages during the year.
   b. Anita, age 12, is claimed as a dependent by her parents. She earned interest income of $1,200 during the year.
   c. Earl, age 16, is claimed as a dependent by his parents. He earned wages of $2,700 and interest of $1,100 during the year.
d. Ellen, age 17, is claimed as a dependent by her parents. She earned interest of $300 during the year. In addition, she earned $550 during the summer operating her own business at the beach, where she painted caricatures of her customers.

47. **LO.5, 6, 9** Corey and Addison are engaged and plan to get married. During 2010, Corey is a full-time student and earns $8,000 from a part-time job. With this income, student loans, savings, and nontaxable scholarships, he is self-supporting. For the year, Addison is employed and reports $60,000 wages. How much 2010 income tax, if any, can Addison save if she and Corey marry in 2010 and file a joint return?

48. **LO.1, 3, 6, 7** Taylor, age 18, is claimed as a dependent by her parents. For 2010, she records the following income: $4,000 wages from a summer job; $1,900 interest from a money market account; and $1,000 interest from City of Boston bonds.
   a. What is Taylor’s taxable income?
   b. What is Taylor’s Federal income tax? [Her parents file a joint return and report taxable income of $120,000 (no dividends or capital gains).]

49. **LO.1, 3, 6, 7** Terri, age 17, is claimed as a dependent on her parents’ 2010 return, on which they report taxable income of $100,000 (no qualified dividends or capital gains). Terri earned $1,900 pet sitting and $2,400 in interest on a savings account. What are Terri’s taxable income and tax liability?

50. **LO.1, 3, 6, 7** Charlene, age 17, is claimed as a dependent on her parents’ 2010 return. During the year, Charlene earned $4,000 in interest income and $2,000 from part-time jobs.
   a. What is Charlene’s taxable income?
   b. How much of Charlene’s income is taxed at her own tax rate? At her parents’ rate?
   c. Can the parental election be made? Why or why not?

51. **LO.6, 8** During the year, Ophelia recorded the following transactions involving capital assets.
   - Gain on the sale of unimproved land (held as an investment for 3 years) $ 3,000
   - Loss on the sale of a camper (purchased 2 years ago and used for family vacations) (5,000)
   - Loss on the sale of ADM stock (purchased 9 months ago as an investment) (1,000)
   - Gain on the sale of a fishing boat and trailer (acquired 11 months ago at an auction and used for recreational purposes) 2,000
   a. If Ophelia is in the 35% bracket, how much income tax results?
   b. If Ophelia is in the 15% bracket?

52. **LO.6, 8** During the year, Chester incurred the following transactions involving capital assets.
   - Gain on the sale of an arrowhead collection (acquired as an investment at different times but all pieces have been held for more than one year) $ 6,000
   - Loss on the sale of IBM Corporation stock (purchased 11 months ago as an investment) (4,000)
   - Gain on the sale of a city lot (acquired 5 years ago as an investment) 2,000
   a. If Chester is in the 33% bracket, how much income tax results?
   b. If Chester is in the 15% bracket?

53. **LO.9** Each year, the Hundleys normally have itemized deductions of $9,500, including a $3,600 pledge payment to their church. Upon the advice of a friend, they do the following: in early January 2010, they pay their pledge for 2009; during 2010, they pay the pledge for 2010; and in late December 2010, they prepay their pledge for 2011.
   a. Explain what the Hundleys are trying to accomplish.
   b. What will be the tax saving if their marginal tax bracket is 25% for all three years? (Assume the standard deduction amounts for 2010 and 2011 are the same.)
54. Cory L. and Amber N. Fuller (ages 39 and 37) are married and live at 4380 Cottonwood Drive, Casper, WY 82609. Cory (Social Security No. 123–45–6782) is employed by the Natroma County public works department, while Amber (Social Security No. 123–45–6783) holds a part-time job with a nursing group that provides home care services to disabled persons.

During 2009, the Fullers had the following receipts.

Salaries $51,000 (Cory) + $39,000 (Amber) $90,000
Interest income—
- City of Cheyenne general purpose bonds $2,100
- Chevron Corporation bonds 900
- CD issued by Wells Fargo Bank 1,300 4,300
Annual gift from Amber’s parents 26,000
Bingo games sponsored by church $1,000 (winnings) — $900 (losses) 100
Loan repayment by Eric Fuller 10,000
Jury duty fees 800

The loan repayment was for an interest-free loan Cory made to his brother five years ago to help pay for his wedding. In November 2009, Amber served on a jury and was paid $800 as a fee. Unfortunately, some of her expenses (see below) were not reimbursed.

The Fullers had the following expenditures for 2009.

Medical expenses (not covered by insurance) $1,800
Taxes—
- State and local sales taxes (receipts retained) $1,900
- Property taxes on residence 5,000 6,900
- Interest on home mortgage 3,100
- Charitable contributions 3,600
- Contribution to traditional IRA (on Amber’s behalf) 5,000
- Expenses not reimbursed in connection with jury service (parking) 60
- Contribution to U.S. congressional representative’s reelection campaign 100

The Fullers maintain a household that includes Matilda (Cory’s widowed mother, age 66—Social Security No. 123–45–6781); Zelda (daughter, age 22—Social Security No. 123–45–6784); Eva, (daughter, age 19—Social Security No. 123–45–6785); and Perry (son, age 17—Social Security No. 123–45–6786). Except for the summer months, Zelda spent all of 2009 at a sorority house at State University where she is a full-time student. Her tuition is partly covered by a scholarship of $9,000. Eva graduated from high school in May 2009 and is uncertain about whether to attend college. She earned $8,000 during the year modeling and deposited the money in a savings account.

Federal income tax withheld was $4,100 (Cory) and $3,000 (Amber). The appropriate amount of Social Security and Medicare tax was withheld. Determine the Federal income tax for 2009 for the Fullers on a joint return by completing the appropriate forms. They do not wish to contribute to the Presidential Election Campaign Fund. If an overpayment results, it is to be refunded to them. Suggested software: H&R BLOCK At Home.

55. Kirk R. Percy (age 48) is a widower who lives at 1408 Poplar Avenue, Bowling Green, KY 42101. Kirk (Social Security No. 111–11–1111) is employed by a local law firm as its office manager and personnel director. Kirk’s late wife, Grace (Social Security No. 123–45–6780), a teacher for the Warren County School District, was killed in an automobile accident in late November 2008. She was serving as coach for the high school debating team that was traveling to the state finals in Louisville.
Kirk maintains a household that includes Ruby Hawkins (age 65, Social Security No. 123–45–6789); Stacey Percy (age 23, Social Security No. 123–45–6788); Darlene Percy (age 22, Social Security No. 123–45–6787); and Eric Percy (age 19, Social Security No. 123–45–6786). Ruby is Grace’s mother, and her only income is from Social Security benefits. Stacey, a daughter, is a senior in law school and plans to graduate in May 2010. She has a job offer from Kirk’s employer. Darlene, a daughter, is not working or going to school. However, she is engaged to be married and plans to live in West Virginia with her physician husband. Eric, a son, graduated from high school in December and has enlisted in the U.S. Marine Corps. He will leave for boot camp in January 2010.

Amounts received by Kirk in 2009 are summarized as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$69,000</td>
</tr>
<tr>
<td>Interest income—</td>
<td></td>
</tr>
<tr>
<td>State of Kentucky general purpose bonds</td>
<td>$1,700</td>
</tr>
<tr>
<td>Savings account at Lexington Bank &amp; Trust</td>
<td>1,200</td>
</tr>
<tr>
<td>Inherited real estate (appraised value)</td>
<td>90,000</td>
</tr>
<tr>
<td>Life insurance proceeds—</td>
<td></td>
</tr>
<tr>
<td>Eagle Insurance Company</td>
<td>$100,000</td>
</tr>
<tr>
<td>State Board of Education</td>
<td>20,000</td>
</tr>
<tr>
<td>Lawsuit settlement</td>
<td>300,000</td>
</tr>
<tr>
<td>Estate sale</td>
<td>12,000</td>
</tr>
</tbody>
</table>

The inherited real estate consists of lots that Grace had purchased in Richmond, Kentucky, for $60,000 and was holding as an investment. Kirk also considers the lots to be a good investment and intends to keep them.

Several years ago, Kirk and Grace thought it would be a good idea to hold life insurance on each other. Consequently, they contacted an agent for Eagle Insurance Company, and each took out a policy (maturity value of $50,000) on the other. The policies pay double in case of accidental death, so Kirk collected $100,000 (in January 2009) on the policy he held on Grace. (Kirk inherited Grace’s policy on his own life and redesignated his children as the beneficiaries.) The insurance proceeds of $20,000 that Kirk received via the State Board of Education are part of Kentucky’s policy of providing modest insurance coverage for public school teachers.

After his wife’s death, Kirk filed a lawsuit against the trucking company that caused the fatal accident. Fearful of the results of a jury trial, the company paid Kirk $300,000 in full settlement of his claim. The amount was paid to Kirk in August 2009 and was classified as being solely for personal injuries. With some help from his employer law firm, Kirk handled the case on his own and did not hire an attorney.

In April 2009, Kirk conducted an estate sale to dispose of Grace’s belongings that no one in the family wanted (e.g., furs, jewelry, china, furniture). The $12,000 Kirk received from the sale is approximately $10,000 less than the items cost.

Kirk’s expenditures for 2009 are summarized as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funeral expenses</td>
<td>$11,000</td>
</tr>
<tr>
<td>Medical expenses (including $6,000 for Ruby’s dental implants)</td>
<td>7,000</td>
</tr>
<tr>
<td>Gambling loss</td>
<td>3,000</td>
</tr>
<tr>
<td>Premiums on life insurance policy</td>
<td>900</td>
</tr>
<tr>
<td>Taxes—</td>
<td></td>
</tr>
<tr>
<td>State income taxes (including withholdings for 2009)</td>
<td>$3,200</td>
</tr>
<tr>
<td>Property taxes on personal residence</td>
<td>3,100</td>
</tr>
<tr>
<td>Interest on home mortgage</td>
<td>4,200</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>3,600</td>
</tr>
</tbody>
</table>

Although Grace’s funeral was in 2008, Kirk deferred paying the bill until after he had received some life insurance proceeds in 2009. The gambling loss of $3,000 was the net result of a vacation trip to a Mississippi resort casino. The life insurance premiums were paid to the Eagle Insurance Company and involve the policy Kirk inherited from Grace covering his life (see prior comment). The Percys pledge $1,800
a year to their church. However, in December 2009, Kirk paid the pledges for both 2009 and 2010.

**Part 1—Tax Computation**

Using the appropriate forms and schedules, determine Kirk’s Federal income tax for 2009. In addition to Federal income tax of $4,500 withheld from his wages, Kirk applied his 2008 overpayment of $210 toward his 2009 tax liability. Kirk wants any 2009 overpayment handled in the same way. Assume that the proper amounts of Social Security and Medicare taxes were withheld. Kirk does not contribute to the Presidential Election Campaign Fund. Suggested software: H&R BLOCK At Home.

**Part 2—Follow-up Advice**

In early 2010, the following events take place. Kirk believes that these events will affect his tax status significantly. Consequently, he requests your advice.

- Ruby decides she wants to live with one of her sons and moves to Indiana.
- Stacey continues to live at home but begins working for a law firm.
- Darlene gets married and moves to West Virginia.
- Eric, who joined the Marine Corps, leaves for boot camp.
- In January, Kirk pays off the mortgage on his personal residence.
- Kirk invests any excess insurance and lawsuit settlement funds in general purpose municipal bonds.

Write a letter to Kirk explaining in general terms the tax-related changes that will take place in 2010, and the additional tax liability that will result. Assume that Kirk’s salary remains the same and that other variables not mentioned (e.g., property and state income taxes) do not change. Use the Tax Rate Schedules to compute the Federal income tax projected for 2010. Since Kirk works for a law firm, you can assume that he is aware of the meaning of certain tax concepts (e.g., dependency exemption, standard deduction).

**RESEARCH PROBLEMS**

Note: Solutions to Research Problems can be prepared by using the Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

**Research Problem 1.** Don and Mary Dewey are successful professionals with a combined AGI of approximately $400,000. Their household includes two children: Debra (age 16) and Van (age 23). Van is not a student but works at a part-time job, where he earns $16,000. Don has heard that it might be beneficial if Van, rather than Don and Mary, claims Debra as a qualified child for income tax purposes. At a Chamber of Commerce meeting, Don asks you to advise him on this matter.

Prepare a letter to Don at 4321 Mount Vernon Road, Dover, DE 19901, advising him about the advantages of such a choice and whether it is feasible. In your letter, discuss the relevance of Code §§ 24, 32, 151, and 152.

**Research Problem 2.** Bernice and Nate were divorced on July 7, 2009. Under the divorce decree, Bernice received full custody of their three children, and Nate was awarded the dependency exemptions for them. After the trial was over, Nate had Bernice sign a release of her rights to the dependency exemptions for the next five years. In early April 2010, Bernice realizes the tax costs to her of losing the deduction for the dependency exemptions. Besides contacting Nate, who is already delinquent in his child support payments, does Bernice have any way out?
Use the tax resources of the Internet to address the following questions. Do not restrict your search to the Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

**Research Problem 3.** When taxpayers pay federal income taxes by means of a credit or debit card, they are charged “convenience fees” by the issuer of the card. Are these fees themselves deductible? (Note: The IRS issued a notice during 2009 clarifying its position on this matter.) Summarize your findings in a memo to the tax research file.

**Research Problem 4.** Send to your instructor a table of the last ten years’ amounts of the standard deduction and personal exemption for a single individual.

**Research Problem 5.** Prepare a graph for your school’s Accounting Club of the Federal income tax rates that apply at taxable income levels up to $200,000 for each filing status.