Chapter 1

AN OVERVIEW OF FEDERAL TAXATION

INTRODUCTION

This chapter introduces various concepts related to Federal income taxation, the requisite terminology and the various relationships with taxpayers and their financial dealings. The following topics are covered in the chapter:

1. Several basic tax terms—*tax base, tax rate, gross income, inclusion, exclusion, deduction,* and *tax credit*—are defined.

2. Descriptions of the various tax bases—taxable income, retail sales and other transactions (sales taxes), transfers of wealth (estate and gift), property, etc.—and differentiating amongst them. The relative amounts of revenue produced by each tax for various levels of government (i.e., Federal, state, and local) are given.

3. The basic concepts underlying the various taxes—the income tax, the estate and gift taxes, the sales and other transfer taxes, and employment taxes. Average, effective, and marginal tax rates are distinguished from one another.

4. The planning of transactions in order to legally minimize taxes is described.

STUDY SUGGESTIONS

Read and study the chapter thoroughly, paying close attention to the tax terms introduced. Distinguish between the various tax bases in your studies. Compare the various taxes according to their equity, certainty, efficiency, economy, and convenience.

STUDY HIGHLIGHTS

1. There are a number of different types of taxes in use today by various government bodies. The majority of the text covers the Federal income tax.

2. A tax is a means by which a government exacts the funds necessary for it to carry out its operations from its citizens. In addition, a tax normally possesses one or more of the following characteristics:

   a. There is no direct relationship between the exaction of the revenue and any benefit received by the taxpayer.
   b. The tax is levied based on some predetermined criteria.
   c. Taxes are levied on a recurring or predictable basis.
   d. The tax is distinguishable from regulations or penalties.

   Numerous technical terms are used in the area of taxation. Many of them are introduced in this chapter.

DEVELOPMENT OF U.S. TAXATION

3. Early in its existence, the U.S. government was supported by excise and custom duties. These duties became insufficient to support the government by the early twentieth century and steps were begun to impose an income tax.

4. Several attempts to impose such a tax were found to be unconstitutional prior to the passage of the Sixteenth Amendment to the U.S. Constitution because direct taxes were not legal unless apportioned among the states. Federal estate and gift taxes were imposed soon after the imposition of the income tax.

5. See Exhibit 1-1, which illustrates the relative amounts of revenue generated for the U.S. government from various sources and the purposes for U.S. government expenditures. Notice the three major sources of revenue in the proposed 2005 fiscal budget: individual income taxes (47%), social insurance receipts (35%); and corporate income taxes (10%).

6. A *tax base* is the amount upon which a tax is levied.

- **a.** The tax base is multiplied by some tax rate to calculate the tax.
- **b.** For example, the base for a sales tax is taxable sales. Taxable sales commonly include all retail sales other than certain exempt sales (such as sales of unprepared foods, prescription drugs, real estate, etc.).

7. The *tax rate* is multiplied times the tax base to arrive at the amount of the tax. In arriving at the amount of sales taxes due on a transaction, the taxable sales are multiplied by the tax rate.

- **a.** A tax may be proportional or progressive. A proportional tax is assessed at a set rate regardless of the amount of the tax base. A sales tax is an example of a proportional tax. A tax is progressive if the tax rate increases as the tax base increases. The U.S. income tax is an example of a progressive tax. A tax is regressive if the rate decreases as the tax base increases.
- **b.** The *marginal* tax rate is the rate of tax paid on the next dollar or last dollar (i.e., the marginal increase) of income. The marginal increase or decrease in tax is used by taxpayers for decision making.
- **c.** The *average* tax rate is the total tax divided by the total tax base. For the income tax this would be the gross tax divided by taxable income.
- **d.** The *effective* tax rate is the tax divided by some measure chosen. When speaking of the income tax, commentators frequently refer to the effective tax rate as the total tax divided by total income.

8. Income Taxes. For the income tax, the base is taxable income. The U.S. government assesses an income tax on the net taxable income of individuals, corporations, estates, and trusts.

- **a.** *Taxable income* is gross income less certain deductions.
- **b.** Income is sometimes described as any permanent increment in wealth, whether received in cash, other property, or services rendered to the taxpayer. Any income will be taxable by the Federal government unless the income is specifically exempted from the tax (i.e., excluded from income) under some Federal law. These nontaxable amounts are called *exclusions* from gross income. The remaining income is called *gross income*.
- **c.** *Deductions* are items that are subtracted from gross income in arriving at taxable income. Deductions are allowed for such outlays as business expenses, interest on a home mortgage, and property taxes. Gains from transactions in property are generally included in income, and losses incurred are generally deductible from income in arriving at taxable income.
- **d.** The tax is calculated using legislated tax rate schedules applied to taxable income. The taxable income of individuals is taxed by the Federal government at progressive marginal rates of 10 percent, 15 percent, then 25, then 28, then 33, and eventually 35 percent.

e. The gross income tax is directly reduced by any allowable *credits*. For example, a taxpayer is allowed to reduce his or her tax by as much as 30 percent of expenses incurred for child care costs incurred so that he or she may work.

The tax formulas in Exhibits 1-2 and 1-3 illustrate the relationships pointed out in the preceding definitions. One should begin to learn these formulas to make future study easier.

9. Wealth Transfer Taxes. The wealth transfer taxes are the Federal estate tax and the Federal gift tax. These taxes are based on the fair market value of any property at the time of its transfer.

a. *Estate tax*. The gross estate consists of all property owned by a decedent. In the calculation of the taxable estate, funeral and administrative expenses, debts of the decedent, certain taxes and losses, the marital deduction, and the charitable contribution deduction are allowed.
b. *Gift tax*. The gift tax is a tax on any transfer that is made without adequate consideration. However, transfers made to qualified charities and to one's spouse are not subject to gift tax. In addition, up to $11,000 of gifts per donee may be made each year and excluded from taxable gifts.
c. Note that both the estate tax and the gift tax contain unlimited marital deductions for gifts or bequests to one's spouse. Essentially, the transfer from one spouse to another escapes transfer tax. However, when the second spouse transfers the property, it will be subject to tax at that time (assuming the transferee is not a spouse).
d. The gift and estate tax rates are progressive and unified.

- Gift tax returns are filed annually, and each year the taxable gifts are added to all prior taxable gifts to determine the tax. Therefore, prior taxable gifts cause current gifts to be taxed at the higher tax rates.
- The taxable estate is treated as a final gift, in that it is added to lifetime transfers (made after 1976) in determining the tax.

e. A unified transfer tax credit of $780,800 for 2006-2008 is allowed against the estate tax ($345,800 for the gift tax). This credit is sufficient to offset the estate tax on total transfers of $2,000,000 ($1,000,000 for the gift tax).
f. The estate tax is scheduled for repeal in 2010, and reinstatement in 2011. Related to this repeal, the estate or heir's basis will be a carryover basis, rather than the "fresh start" basis, equal to fair market value. However, the heirs or estates will be able to step-up the basis of appreciated property in an amount up to $1.3 million (plus an additional $4.3 million for a surviving spouse).

10. Employment Taxes. Employment taxes consist of payroll taxes and the self-employment tax.

a. The FICA (Federal Insurance Contributions Act) tax, that is, the Social Security tax, is in fact two taxes—the old age and survivors disability (OASDI) levy and the Medicare Health Insurance (MHI) levy. They are assessed on taxable wages and shared by an employee and his or her employer.
b. The FICA tax is assessed on salaries and wages up to specified maximums (or wage bases). The FICA structure for 2006 is summarized as follows:

	OASDI	*MHI*	*Combined*
Tax rate-Employee	6.2%	1.45%	7.65%
Tax rate-Employer	6.2%	1.45%	7.65%
Tax rate-Total	12.4%	2.9%	15.3%
Wage base (2006)	94,200	Unlimited	

As a result, the combined tax is 7.65% of wages up to $94,200 and 1.45% of wages above $94,200. These amounts are paid by the employer and the employee.

c. For an employee earning $94,200, the employer and employee each pay $7,206 ($94,200 × .0765) for a total of $14,413.

d. In order to include self-employed individuals in the Social Security system, a self-employment tax is assessed against net self-employment income. For 2006, the OASDI tax is assessed at 12.4 percent of self-employment income up to $94,200 (the same as for FICA) and the MHI tax is assessed at 2.9 percent of self-employment income.

e. The self-employed individual will be allowed to deduct half of each tax (i.e., OASDI and MHI) as —

- A deduction in determining the self employment tax. This deduction is always equal to 7.65% of net self-employment income. So, rather than showing it as a deduction, multiply net self employment income by 92.35% (100% − 7.65%).
- An income tax deduction in arriving at adjusted gross income for the self-employment tax paid (line 29, Form 1040).

For example, assume Nellie has net self employment income $10,000. She has no FICA salaries or wages for the year. Her self-employment tax is $1,413 ($10,000 × 92.35% × 15.3%). She may also deduct $707 ($1,413 × 50%) for income tax purposes in arriving at adjusted gross income.

f. A taxpayer will pay combined FICA and self-employment OASDI taxes only up to the tax base. In 2006, an individual with salaries of $73,200 and self-employment income of $28,000 would only pay 15.3 percent on $21,000 ($94,200 maximum tax base − $73,200 already subject to FICA withholding) and 2.9 percent on the remainder.

g. A taxpayer who holds more than one job during the year and earns combined wages exceeding the OASDI wage base is entitled to a credit against his or her income tax. In 2006 an individual who earns $59,200 and $38,000 at two jobs would be subject to FICA withholding of $4,529 ($3,670 OASDI and $859 MHI) and $2,907 ($2,356 OASDI and $551 MHI), respectively. Since the total OASDI withheld exceeds the maximum of $5,840 ($94,200 × .062), a credit of $186 ($3,670 + $2,356 − $5,840) may be claimed against the income tax.

h. The U.S. government also assesses a Federal unemployment tax (FUTA). Currently, this tax is 6.2 percent of wages up to $7,000 per year for an annual maximum of $434. This tax is paid by the employer, and a credit is allowed against it for unemployment taxes paid to a state.

11. **Other Federal Taxes.** The Federal government also imposes excise taxes, tariffs, and other taxes.

12. **Common State and Local Taxes and Bases.** State and local governments rely primarily on real property taxes and sales taxes as significant revenue generators, but some also assess income taxes. Certain other taxes are used for social and economic purposes.

a. *Franchise* taxes are assessed on the right to do something within a jurisdiction. For example, corporations pay franchise taxes to the states in order to operate within the state.

b. *Sales* taxes are based on taxable sales, typically at the retail level. Use taxes are assessed on the use of property that is purchased outside the state and immediately brought into the state. A use tax is meant to prevent taxpayers from buying property in another state with no sales tax or a low sales tax rate and bringing it into the state. For example, if a new car is purchased in Oregon (which currently has no sales tax) by a California resident, a use tax will be assessed when he or she registers the car in California.

c. *Property* (or *ad valorem*) taxes are based on the value of certain property held by taxpayers. Most state and local governments assess a real property tax based on the value of real property holdings. Some jurisdictions also assess a tax on certain tangible personal property and/or certain intangible property. Some states, for example, tax the value of registered automobiles annually along with the license fee.

GOALS OF TAXATION

13. Any government body that levies a tax does so with certain goals in mind. These goals are frequently counteracting and it is not always clear what the goals of a particular rule are or whether these goals are being accomplished. Some of the objectives of taxation are as follows:

a. **Economic Objectives.** The economic objectives extend beyond the basic objective of raising revenues. Tax laws can be used to provide for price stability, employment stability, and economic growth. These goals are sometimes accomplished through granting favorable tax treatment to certain activities.

b. **Social Objectives.** The reasoning behind numerous provisions of the tax laws involve social or welfare considerations. Congress has been known to favor charitable contributions, home ownership, retirement savings, and education, as well as numerous other social goals. Social objectives are typically accomplished through tax expenditures. A tax expenditure can be described as the estimated loss of tax revenue to the government because of failure to tax a certain item. For example, the government collects less tax revenue when a taxpayer deducts charitable contributions. The government's loss of revenue related to the taxpayer's contribution is a tax expenditure.

c. **Other Objectives.** A tax should be equitable or fair. It should provide for horizontal equity and vertical equity. Horizontal equity refers to the concept that persons in the same economic situation will be treated equally under a tax system. Vertical equity refers to the concept that persons in different economic situations will be treated in a fair and just way relative to one another. Whether taxpayers are in similar economic situations is generally determined according to their ability to pay the tax, that is, persons with equal abilities to pay the tax should pay the same amount of tax. A tax should also be economically efficient, in that it accomplishes a goal without creating economic distortions. The amount of revenue a tax will generate should be somewhat certain and the tax should not be arbitrary. Finally, a tax should be both economical and convenient to both the government and the taxpayer. It is economical if the cost to the taxpayer and the government is low. It is convenient if it is simple.

A PRELUDE TO TAX PLANNING

14. A taxpayer has no obligation to pay more than his or her minimum tax due.

a. Frequently, one can plan activities so as to minimize the amount of tax due. If there are no costs associated with the changes in activities, or if the costs are small, it may be wise to make any needed changes.

b. Tax planning is particularly fruitful when the changes only involve a change in the form of a transaction. One should realize, however, that the courts will sometimes let the "substance" of a transaction control, rather than its "form."

15. Tax plans take numerous forms. Common goals of tax planning are to defer income and thereby defer income taxes, to convert income to a character that receives favorable treatment or is tax-free, and to maximize or accelerate deductions and thereby reduce or defer taxes.

a. The process of structuring one's affairs to minimize taxes legally is frequently referred to as *tax avoidance*.

b. Using illegal means to escape taxation is referred to as *tax evasion*.

16. **Tax Rates.** In tax planning, it is the marginal tax rate of a taxpayer that should be considered, as opposed to the average tax rate or some other rate. The marginal tax rate is the percentage tax rate to which any change in income (or other base), either addition or reduction, would be subject. It is calculated by dividing the applicable change in the tax by the corresponding change in taxable income. For example, a taxpayer in a 25 percent tax bracket will save $25 if he or she reduces his or her taxable income by $100. This is true, even if the average tax rate for that individual is 16 percent.

STUDY QUESTIONS

True or False

______ **1.** Taxes are frequently used to charge taxpayers for a particular benefit.

______ **2.** The Federal income tax was the first tax imposed by the U.S. Government.

______ **3.** The U.S. income tax was once found unconstitutional because it was a direct tax and was not proportioned amongst the states.

______ **4.** An automobile registration fee is properly classified as a tax.

______ **5.** A credit is an amount subtracted from total income in arriving at taxable income.

______ **6.** The U.S. individual income tax is an example of a proportional tax.

______ **7.** The appropriate tax rate to use in virtually all tax planning decisions is the average tax rate.

______ **8.** A decedent's estate will pay no estate taxes on amounts left to the decedent's surviving spouse because of the marital deduction.

______ **9.** Any lifetime taxable gifts (made after 1976) are added to the taxable estate in calculating the estate tax. In a sense, the taxable estate is treated as the decedent's final gift.

______ **10.** The annual gift tax exclusion of $11,000 is allowed for each donee each year. Accordingly, a grandparent could grant two grandchildren $110,000 pro rata over five years without risking a gift tax liability.

______ **11.** A gift tax marital deduction is a deduction (in calculating taxable gifts) for any amounts given to one's spouse.

______ **12.** A taxpayer who pays more than the maximum amount of FICA (OASDI) is entitled to a credit for the excess against the regular income tax.

______ **13.** A self-employed individual pays a self-employment tax on net self-employment earnings in lieu of the FICA tax, which is paid by employees and employers on salaries and wages.

______ **14.** For 2006, a taxpayer who has wages of $80,200 and self-employment income of $16,000 will pay OASDI (part of self-employment taxes) on $14,000 and MHI on $14,776 ($16,000 × 0.9235) of the self-employment income.

______ **15.** A taxpayer with net earnings from self-employment of $10,000 (and no FICA wages) will pay self-employment tax of $1,530.

______ **16.** Use taxes are used to capture certain retail acquisitions that might avoid the sales tax.

______ **17.** An autonomous (or Federal) government must assess a tax to finance its operations.

______ **18.** Revenue generation is the only purpose for a tax.

______ **19.** A tax is *efficient* if it is economically neutral, except for those intended economic goals.

______ **20.** A tax has horizontal equity if it treats individuals with different income levels similarly and fairly, relative to one another. This frequently is interpreted to mean one pays according to his or her ability to pay.

______ **21.** Planning one's affairs to *legally* minimize the taxpayer's taxes is called tax evasion.

Multiple Choice

22. In order, which are the two sources of the greatest funding for the Federal government?

______ **a.** Corporate income tax; individual income tax
b. Individual income tax; corporate income tax
c. Social insurance taxes; individual income tax
d. Individual income tax; social insurance taxes

23. Which of the following is *not* normally considered a characteristic of a tax?

______ **a.** It is assessed on a predictable (usually recurring) frequency.
b. The assessment is based on some predetermined criteria.
c. It may carry a specific right, such as operating a business.
d. It may be levied on only a portion of the population.

24. The Federal income tax was finally legalized by which of the following?

______ **a.** The Supreme Court decision on *Flint v. Stone Tracy*
b. The Sixteenth Constitutional Amendment in 1913
c. The *Internal Revenue Code of 1939*
d. The *Tax Act of 1921*

25. D is subject to a tax that requires that she pay 10 percent of her first $10,000 and 15 percent of all additional taxable income. D has total income of $22,000 and taxable income of $15,000. If D's total tax is $1,750, which of the following is *not* true?

______ **a.** D's average tax rate is 11.67 percent.
b. D's marginal tax rate is 12.5 percent.
c. D's effective tax rate is 7.95 percent of her total income.
d. This tax is considered a progressive tax.

26. Which of the following is *not* a proper tax definition?

______ **a.** The tax base is the amount upon which the tax is levied (e.g., taxable sales).
b. A credit is a direct reduction in the tax base.
c. The tax rate is applied to the tax base in calculating the gross tax.
d. The tax base for the income tax is taxable income.

27. Mary is single and has taxable income of $32,000. Her income tax rate is 10 percent of income up to $7,550, 15% of income from $7,550 to $30,650 and 25 percent of income over that amount (up to $74,200). What are Mary's gross tax and her marginal tax rate, on any additional earnings, respectively?

______ **a.** $4,558 and 14.24 percent ($4,558/$32,000).
b. $8,000 and 25 percent.
c. $4,558 and 25 percent.
d. Not determinable from these facts.

28. Which of the following represents the formula for the marginal tax rate?

______ **a.** Total tax / total taxable income.
b. Increase in tax / corresponding increase in taxable income.
c. Total tax / total economic income.
d. Total tax − total credits.

29. Which of the following is *not* deductible in arriving at the taxable estate of an individual?

______ **a.** Funeral and administration expenses.
b. Charitable bequests to qualified charities.
c. Bequests to one's surviving spouse.
d. The federal estate tax.

30. N made the following gifts of cash during the current calendar year:

To H, her husband	$50,000
To D, her daughter	50,000
To her church	50,000

What is the total amount of N's taxable gifts for the year?

______ **a.** $117,000
b. $150,000
c. $50,000
d. $39,000

31. O made the following gifts of cash to her only child, P:

2004	$ 8,000
2005	50,000
2006	20,000

No previous gifts have been made to P or any other recipient. Which of the following is *not* true?

______ **a.** O's taxable gifts for 2006 are $9,000
b. O's prior taxable transfers in the 2006 gift tax calculation are $58,000
c. O's gift tax for 2006 is $0.
d. O may make additional transfers exceeding $950,000 before actually having to pay gift taxes since the unified transfer tax credit is sufficient to offset the tax on transfers of $1,000,000.

32. A taxpayer who works for more than one employer during a year and earns wages in excess of the OASDI maximum ($94,200 for 2006) is entitled to which of the following with respect to the taxes withheld in excess of the annual maximum?

______ **a.** A refund from the last employer for the excess.
b. A credit against his or her Federal income tax for the excess.
c. No compensation whatsoever, since the limit is applied on wages from each employer.
d. No compensation whatsoever, since the additional tax merely buys additional benefits.

33. K was paid a salary of $95,000 by his employer during 2006. Which of the following *does not* apply to K?

______ **a.** K's OASDI wages are $94,200.
b. K's MHI wages are $95,000.
c. K's total FICA tax is $7,170.
d. K is entitled to a credit of $50 for excess OASDI taxes paid.

34. Congress frequently grants taxpayers a tax incentive for making certain expenditures individually rather than the government making direct subsidies. These tax concessions are referred to as which of the following?

______ **a.** Tax loopholes
b. Incentive deductions
c. Tax expenditures
d. Indirect expenditures

35. Which of the following is a tax expenditure?

______ **a.** A cost to the government of collecting the tax.
b. A cash expenditure made possible through tax collections.
c. A tax saving to a taxpayer because he or she qualified for some tax incentive.
d. A special fund set up to finance foreign investigative trips by members of Congress.

36. Which of the following is *not* a common successful tax planning device?

______ **a.** Deferral of taxable income, thereby deferring taxes
b. Conversion of taxable income to a character that receives preferential treatment, thereby reducing taxes
c. Investing in assets that generate tax-free income, thereby reducing taxes
d. Shifting income to family members in higher tax brackets to minimize family tax burdens

Completion

37. The specific amount upon which a tax is levied is the tax ________ . This amount for the income tax is ________ .

38. The Federal government assesses two wealth transfer taxes: the ________ and the ________ .

39. The rate of tax paid on the ________ of income earned by a taxpayer is the relevant amount used in tax planning. It is referred to as the ________ rate.

40. The concept that taxpayers who are situated similarly should be taxed similarly is referred to as ________ The companion concept that taxpayers who are situated differently should be treated differently in a fair and just fashion is referred to as ________ . The criteria for determining how one is "situated" with respect to a particular tax base is referred to as ________ .

Problems

A. Willard-Skip is self-employed and earned a net income for tax purposes of $35,000 from his business. Willard's only other income was dividends and interest of $5,000.

1. Calculate Willard's self-employment tax and his adjusted gross income.
2. How would your answer to "1" differ if Willard also had earned FICA wages of $65,200?
3. How would your answer to "1" differ if Willard's net earnings from the business were $98,000, and there were no wages?

SOLUTIONS TO STUDY QUESTIONS

True or False

1. False. A user fee is not a tax. (See p. 1-2.)

2. False. The first taxes imposed by the Federal government were excise and customs duties. (See p. 1-2.)

3. True. It was found unconstitutional on these grounds in 1895. (See p. 1-3.)

4. False. This is an example of a user fee. (See p. 1-2.)

5. False. Deductions are subtracted from income in arriving at taxable income. *Credits* directly reduce the gross tax in arriving at the tax due. (See pp. 1-6 and 1-8.)

6. False. Since the tax rate ranges from 15 percent to 39.6 percent as the taxable income increases, it is considered progressive. (See p. 1-7.)

7. False. The marginal tax rate is used in most tax planning situations. (See p. 1-7.)

8. True. This is the purpose for the marital deduction. Of course, if the property is still owned by the survivor when he or she dies, the property may be taxed at that time. (See p. 1-11.)

9. True. The taxable estate is added to the lifetime gifts to arrive at total transfers. The total transfers are used to determine the total transfer tax at the progressive rates. (See p. 1-11.)

10. True. The $11,000 applies to each donee each year. Two donees at $11,000 per year does add up to $110,000 in five years. (See p. 1-12.)

11. True. The amount that is given to one's spouse is deducted as a marital deduction in the calculation of taxable gifts. (See p. 1-13.)

12. True. This can occur if an employee works for more than one employer and earns more than the OASDI wage base. (See p. 1-18.)

13. True. The two taxes apply to the two classes of personal earnings. The maximum amount of income subject to self-employment tax, however, is reduced by any salaries and wages to prevent a taxpayer from having more than the maximum amount taxed for the year under the two taxes combined. (See p. 1-18.)

14. True. The maximum wage base for OASDI is $94,200, and for MHI is unlimited. This individual will pay OASDI only on the base remaining after taxable FICA wages ($94,200 − $80,200 = $14,000). (See p. 1-17.)

15. False. The taxpayer calculates the $1,530 tax, but then he or she can deduct one-half of that amount before calculating the self-employment tax. Therefore, the tax is $1,413 [($10,000 − 0.5 × $1,530) × 0.153] or ($10,000 × 0.9235 × .153). (See p. 1-18.)

16. True. The tax is assessed on properties purchased in another jurisdiction and immediately brought into the state to be used. (See p. 1-22.)

17. False. The government could print money or borrow; however, economic instability certainly would result from excess demand for goods. (See p. 1-23.)

18. False. Numerous economic, social, and other objectives exist, including the objective to provide economic stability. Many people believe that the majority of the social and economic incentives should be removed from the system. (See pp. 1-23 through 1-28.)

19. True. Efficiency refers to the ability of a tax to raise the desired amount of taxes without causing unintended economic distortions. (See p. 1-26.)

20. False. The type of equity described, that is, a person pays according to his or her ability to pay, is vertical equity. (See p. 1-26.)

21. False. Tax evasion is illegal. Legal tax reduction is referred to as *tax avoidance*. (See p. 1-28.)

Multiple Choice

22. **d.** The largest source is the individual income tax, and the next is the social insurance taxes. (See Exhibit 1-1 and p. 1-5.)

23. **c.** There should be no direct relationship, like operating a business, related to paying the tax. (See p. 1-1.)

24. **b.** The Constitution was changed in 1913 to allow the United States to assess a tax that was not apportioned among the states. (See p. 1-3.)

25. **b.** D's marginal tax rate is the rate paid on the last dollar of income, or 15 percent. The other statements are true. (See pages 1-7 through 1-8.)

26. **b.** A tax credit is a direct reduction in the tax itself, not the tax base. (See p. 1-6 through 1-8.)

27. **c.** Her tax is calculated as follows: [(0.10 × $7,550) + 0.15 × ($30,650 − $7,550) + 0.25 × ($32,000 − $30,650)]. Her marginal tax rate is the amount she would pay on an additional $1 in income, which is 25 percent. (See p. 1-7.)

28. **b.** The marginal tax rate is the marginal tax divided by the marginal income, or as stated alternatively in choice **b**. (See p. 1-7.)

29. **d.** The Federal estate tax is not allowed in computing the tax itself. (See p. 1-11.)

30. **d.** The gifts to the husband and the church are deductible under the marital deduction and the charitable deduction, respectively. The gift to N's daughter is subject to the $11,000 annual exclusion, so only $40,000 is considered a taxable gift. (See p. 1-13.)

31. **b.** O's taxable transfers to date are $39,000, all in 2006, due to the annual exclusion of $11,000. As a result, O may subsequently transfer $961,000 ($1,000,000 − $39,000) without actually having to pay gift taxes. (See p. 1-12.)

32. **b.** The amount of the overpayment is recoverable as a refundable credit against the Federal income tax. (See p. 1-18.)

33. **d.** K's FICA tax is $6,885 ($94,200 × .0765 + $800 × .0145). There is no credit for excess FICA unless a taxpayer works for more than one employer during the year. In this case, there is also no excess FICA paid. (See p. 1-18.)

34. **c.** The term *tax expenditures* refers to the concept that by granting taxpayers a tax reduction to undertake some encouraged behavior, Congress in effect makes an expenditure, since the Federal treasury is reduced in the amount of the "expenditure." (See p. 1-25.)

35. **c.** A tax expenditure is an incentive provided to taxpayers to induce them to do something they otherwise would not do. Essentially, since the government receives less revenue because of the tax incentive, it has made an "expenditure." (See p. 1-25.)

36. **d.** Shifting income to family members in lower tax brackets is a common family tax planning tool. (See pp. 1-27 through 1-28.)

Completion

37. base; taxable income

38. gift tax; estate tax

39. last/next amount; marginal

40. horizontal equity; vertical equity; ability to pay

Problems

A. The required calculations are as follows:

1.

	UP TO $94,200	*OVER $94,200*	*TOTAL*
Net income from business	$ 35,000		$ 35,000
Tax rate	15.3%		×15.3%
Tentative tax	$ 5,335		$ 5,355
Net income from business	$ 35,000		$ 35,000
Less: One-half total tax	−2,678		−2,678
Equals: Difference*	$ 32,322		$ 32,322
Enter: Lesser of above or the maximum wage base	$ 32,322		
Tax rate	× 15.3%		
Self-employment tax due	$ 4,945		$ 4,945
Net income from business			$ 35,000
Dividends and interest			+5,000
One-half of self-employment tax			−2,473
Equals: A.G.I.			$ 37,527

*Equals 92.35% of total self-employment income.

2.

Wage base for 2006	$ 94,200		
Less; FICA wages	−65,200		
Equals: Remaining wage base	$ 29,000		
Net self-employment earnings from "1"	$ 32,322		
Excess net self-employment earnings over remaining wage base		$3,322	
Lesser of above	$ 29,000	$3,322	
Tax rate	15.3%	2.9%	
Self-employment tax due	$ 4,437	$ 96	$ 4,533
Net income from business			$ 35,000
Wages			+65,200
One-half of self-employment tax			−2,267
Equals: A.G.I.			$ 97,933

3.

Net income from business			$ 98,000
Tax rate			×15.3%
Tentative tax			$ 14,994

Net income from business			$ 98,000
Less: One-half total tax			−7,497
Equals: Difference			$ 90,503

Enter: Lesser of above or the maximum wage base	$90,503	$ 0	
Tax rate	×15.3%	×2.9%	
Self-employment tax due	$13,847	$ 0	$ 13,847

Net income from business			$ 98,000
Dividends and interest			+5,000
One-half of self-employment tax			−6,923
Equals: A.G.I.			$ 96,077

There are various ways to organize these calculations. You may find it useful to consult Schedule SE from Form 1040.