★ CHAPTER ONE ★

AN OVERVIEW OF FEDERAL TAXATION

LEARNING OBJECTIVES

Upon completion of this chapter you will be able to:

- Trace the historical development of our Federal income tax system
- Explain the key terms used to describe most taxes
- Identify the different types of Federal taxes found in the United States, including
  - Income taxes
  - Wealth transfer taxes
  - Employment taxes
  - Excise taxes
- Understand the relationship between estate and gift taxes
- Explain the differences in the employment taxes levied on employees versus those levied on self-employed individuals
- Identify some of the more common social and economic goals of our Federal tax system

CHAPTER OUTLINE

INTRODUCTION

The United States has developed what is perhaps the most sophisticated and complex national tax programs in the world today. This system of taxation has an impact on almost every business and investment decision as well as many personal decisions. Decisions a business enterprise must make, such as the form it will take (i.e., sole proprietorship, partnership, limited liability company, or corporation), the length and nature of its operations, and the manner in which it will be terminated cannot be made without consideration of the tax consequences. An individual's decisions regarding employment contracts and alternative forms of compensation, as well as place and duration of employment, will be affected by the Federal tax structure. Even such personal choices as housing, family size, marital relationships, and termination of these relationships by divorce or death involve some of the most complex rules of the Federal tax law. This complexity places a *premium* on knowledge of the various types of Federal taxes imposed on those who by chance or choice must operate within the system's boundaries.

The purpose of this book is to introduce the reader to the Federal income taxation of individuals. A corollary objective of the authors is to aid the reader in the development of his or her *tax awareness* (i.e., ability to recognize tax problems, pitfalls, and planning opportunities). Such an awareness is not only an important attribute of accountants and lawyers—it is *essential* for everyone who chooses a career in business.

THE NATURE OF A TAX

The Supreme Court of the United States has defined a *tax* as ''an exaction for the support of the Government.''[1] Thus, what a tax does is to provide a means through which the government derives a majority of the revenues necessary to keep it in operation. A tax is not merely a source of revenue, however. As discussed in a later section of this chapter, taxes have become a powerful instrument that policymakers use to attain social as well as economic goals.

A tax normally has one or more of the following characteristics:

1. There is no *direct relationship* between the exaction of revenue and any benefit to be received by the taxpayer. Thus, a taxpayer cannot trace his or her tax payment to an Army jeep, an unemployment payment, a weather satellite, or any of the myriad expenditures that the Federal government authorizes.
2. Taxes are levied on the basis of *predetermined criteria*. In other words, taxes can be objectively determined, calculated, and even planned around.
3. Taxes are levied on a *recurring* or *predictable* basis. Most taxes are levied on an annual basis, although some, like the estate tax, are levied only once.
4. Taxes *may be distinguished* from regulations or penalties. A regulation or penalty is a measure specifically designed to control or stop a particular activity. For instance, at one time Congress imposed a charge on the products of child labor. This charge was specifically aimed at stopping the use of children in manufacturing and thus was a regulation rather than a tax, even though it was called a ''tax.'' Also, taxes can be distinguished from licenses and fees, which are payments made for some special privilege granted or services rendered (e.g., marriage license or automobile registration fee).

---

[1] *U.S. v. Butler*, 36-1 USTC ¶9039, 16 AFTR 1289, 297 U.S. 1, 70 (USSC, 1936). An explanation of case citations such as this is presented in Chapter 2.

The major types of taxes imposed by taxing authorities within the United States (e.g., income, employment, and wealth transfer taxes) are discussed later in this chapter. As will be noted, one or more of the above characteristics can be found in each of these various taxes.

DEVELOPMENT OF U.S. TAXATION

The entire history of the United States, from its beginnings as a colony of England to the present day, is entwined with the development of Federal taxation. From its infancy until well into the current century, the United States Federal tax system closely paralleled the tax laws of its mother country, England.[2]

EXCISE AND CUSTOMS DUTIES

Shortly after the colonies won independence and became the United States of America, tariffs became the Federal government's principal revenue-raising source.[3] At the time of its adoption in 1789, the U.S. Constitution gave Congress the power to levy and collect taxes. Promptly exercising this authority, Congress passed as its first act the Tariff Act of 1789, which imposed a system of duties (called excise taxes) on imports.

FEDERAL INCOME TAX

As time passed and the Federal government enlarged the scope of its activities, it became more and more apparent to political leaders that they would have to identify additional sources of revenue to supplement the tariff system. A tax on income was a likely alternative, but Congress was concerned about the constitutionality of an income tax. Under the original Constitution, any *direct* tax imposed by Congress was required to be *apportioned* among the states on the basis of relative populations. Under such a system the Federal tax rates that apply to citizens of one state may be different from those that apply to another state because the sizes of the states' populations differed. If such a system had been tried, it would have been politically and practically unworkable.

Example 1. Assume that Congress imposed a $50,000 tax on income. Assume further that the United States was composed of only three states with populations as follows: Vermont—2,000; Texas—3,000; and New York—5,000. Under the original Constitution, if the income tax were a direct tax, it would be allocated among the states according to population, and each state's tax burden would be as follows: Vermont, $10,000 (20% of total population × $50,000 tax); Texas, $15,000 (30% of $50,000); and New York, $25,000 (50% of $50,000).

Example 2. Assume the sum of the residents' income in each state above was as follows: Vermont—$100,000; Texas—$300,000; and New York—$1,000,000. In such a case, the average rate of tax on income in each state would be as follows: Vermont, 10% ($10,000 tax ÷ $100,000 income); Texas, 5% ($15,000 ÷ $300,000); and New York, 2.5% ($25,000 ÷ $1,000,000). Since incomes are not distributed among the states in the same proportion as residents, the Federal government would be required to

[2] The states in turn have developed their own systems of taxation which often parallel—but sometimes diverge from—the Federal tax system.

[3] A tariff is a duty imposed on an importer. Since it is a cost of the product being imported, it usually is passed on to the consumer as part of the product's price. Thus, the higher the tariff imposed on a product, the higher must be its price if importation is to be profitable.

assess taxes on citizens of different states at *different rates*—a resident of Vermont might pay taxes at a rate of 10% while a resident of New York paid only 2.5%.

Despite the apportionment requirement, Congress enacted the first Federal income tax in 1861 to finance the vastly increased expenditures brought on by the Civil War. The tax was applied uniformly to all residents—the apportionment requirement being ignored, apparently on the belief that the income tax was not a direct tax. In *Springer v. U.S.*,[4] however, a taxpayer challenged the Civil War income tax, asserting that the tax was unconstitutional because it was direct, and that any direct tax required apportionment.

The distinction between *direct* taxes and indirect taxes has never been completely clarified. According to some, a direct tax is one that cannot be avoided or at least shifted to another with ease. Two taxes generally considered direct taxes are head taxes and property taxes; neither of these can be escaped without difficulty. Customs duties and other excise taxes are normally considered indirect taxes, since they can be avoided by not purchasing the particular good. Beyond these examples, however, the issue is unresolved. In *Springer*, the Supreme Court specifically addressed the question of whether an income tax was a direct tax and, therefore, whether apportionment was required. The Court held that only head taxes and real estate taxes were direct taxes and all other taxes, including the income tax, were indirect. Thus Congress had not violated the Constitution in ignoring the apportionment clause when it imposed the income tax. Although this case dealt squarely with the issue, the decision did not end the controversy.

The income tax was allowed to expire shortly after the Civil War, in 1872, but was reenacted in almost identical form in 1894. Upon reinstatement, it again was attacked as a direct tax requiring apportionment. In *Pollock v. Farmers' Loan and Trust Co.*,[5] the Supreme Court focused specifically on the income tax as it applied to income from real estate. The Court believed this case to be different from *Springer* and held that a tax on income from real estate was the equivalent of a tax on the real estate itself. Accordingly, the Court held that the tax was unconstitutional because it was a direct tax imposed without apportionment. After this decision, the constitutionality of an income tax was again suspect.

Undaunted by the *Pollock* decision, proponents of a Federal income tax continued their efforts and in 1909 were successful in bringing about a corporate income tax. This tax was upheld by the Supreme Court in *Flint v. Stone Tracy Co.*[6] when the Court held that it was an excise tax measured by corporate income, rather than a direct tax.

Concurrent with its passage of the 1909 corporate income tax, Congress proposed an amendment to the Constitution that would allow it to levy a tax on *all* incomes *without* apportionment among the states based on population. This effort culminated in the passage of the Sixteenth Amendment on February 25, 1913, which provided that,

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

Without hesitation, Congress enacted the Revenue Act of 1913 on October 3, 1913 and made it retroactive to March 1, 1913.

Because of special exemptions and the progressive tax rates of the 1913 income tax law, it too was challenged as a denial of due process of law as guaranteed by the Fifth Amendment to the Constitution. In 1916 the Supreme Court upheld the validity of

---

[4] 102 U.S. 586 (USSC, 1880).

[5] 3 AFTR 2602, 157 U.S. 429 (USSC, 1895).

[6] 3 AFTR 2834, 220 U.S. 107 (USSC, 1911).

the new income tax law in *Brushaber v. Union Pacific Railroad Co.*[7] Although many changes have taken place, the United States has not been without a Federal income tax since 1913.

As historical conditions changed and the Federal government's need for additional revenues increased, Congress exercised its income taxing authority by the passage of many separate pieces of legislation that resulted in greater complexity in the Federal income tax law. Each new revenue act was a reenactment of a previous revenue act with added amendments. This process created great confusion for those working with the law, since it could be necessary to research more than 100 separate sources to determine exactly what law was currently in effect. In addition, the reenactment of a statute sometimes suggested that any intervening interpretation of that statute (law) by the courts or the Treasury was approved by Congress, although no such Congressional approval was expressly stated. Congress resolved the confusion in 1939 with its systematic arrangement of all tax laws into the Internal Revenue Code of 1939, a permanent codification that required no reenactment.

The 1939 Code was revised in 1954 and again in 1986. Thus, today's governing Federal tax law is the *Internal Revenue Code of 1986*. The 1986 Code has been amended by significant tax changes made since 1986, and it will continue to be amended to incorporate changes in the tax law as those changes are enacted.

FEDERAL WEALTH TRANSFER TAXES

In 1916, the very same year the Supreme Court upheld the constitutionality of the Federal income tax, Congress enacted the first Federal law to impose a tax on the transfer of property triggered by the death of an individual. The value of the transfer was measured by the fair market value of the various assets included in the decedent's estate, and consequently the tax imposed on the transfer is referred to as the estate tax. The Federal estate tax imposed a progressive tax on the value on the decedent's taxable estate.

Because an individual could avoid the imposition of the Federal estate tax simply by giving away his or her property before death, Congress enacted the first Federal gift tax in 1924[8] to prevent full scale avoidance of the estate tax.

Like the Federal income tax, these Federal wealth transfer taxes have undergone significant changes since first enacted, adding to their complexity. These taxes are discussed later in this chapter.

FEDERAL TAXES AS A SOURCE OF REVENUE

Among sources of revenue, only the Federal income tax can claim a dominant role in providing the funds with which the U.S. government operates. The chart in Exhibit 1-1 illustrates the role of the Federal income tax in providing funding for President Bush's proposed 2007 budget. Note the limited role of excise taxes. Federal transfer taxes are even less significant and are included in the "other" category as a revenue source.

KEY TAX TERMS

Before examining the various types of Federal taxes in more detail, the reader must first become familiar with basic tax terminology. Some of the more common terms are briefly presented below.

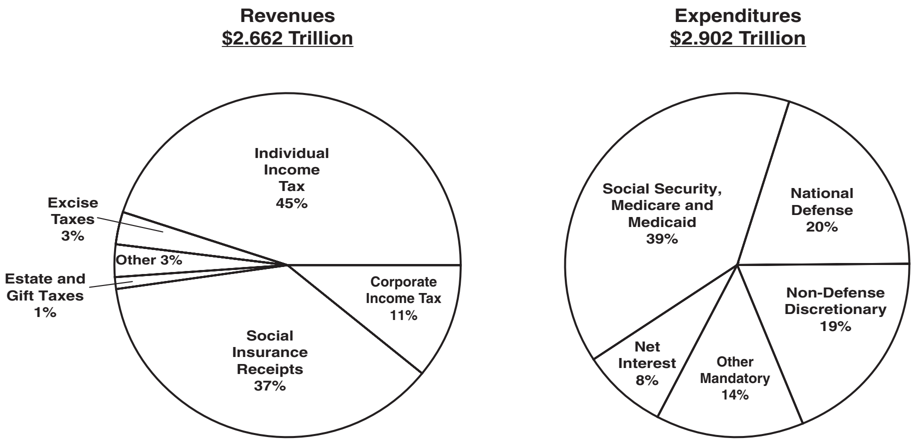
---

[7] 240 U.S. 1 (USSC, 1916).

[8] Although repealed in 1926, the Federal gift tax was reinstated in 1932.

Tax Base. A tax base is that amount upon which a tax is levied. For instance, in the case of Federal income taxation, the tax base is *taxable income*. Taxable income is the taxpayer's total income less exclusions, deductions, and exemptions that might be available to a particular taxpayer. In the case of the Federal wealth transfer taxes, the tax base is the fair market value of the property transferred by gift or at death *reduced* by certain exclusions, exemptions, or deductions allowed by Congress.

EXHIBIT 1-1
2008 Proposed Budget



Source: Office of Management & Budget.

Income. Any *permanent* increment to wealth generally is defined as income. Temporary increments such as loans are not considered to be income. Sometimes income is subject to Federal taxation and other times it is not. The taxability of these increments to wealth generally depends upon whether Congress has *exempted* a particular form of income from taxation. Increments to wealth take many forms. Such increments may take the form of cash, property other than cash, or even services that are rendered to the taxpayer. As a general rule, Congress—and the various Federal courts assigned to interpret its laws—consider *any* increment to wealth to be taxable income *unless* it is *excluded* by definition (e.g., loans that must be repaid), by specific statutory authority in the Internal Revenue Code of 1986, or by the Constitution. Each of these possibilities is examined in detail in Chapters 5 and 6, which deal with gross income.

Exclusion. Certain increments to wealth that are *not included* in a particular Federal tax base are referred to as exclusions. Since the Constitution grants Congress the authority to tax income *from whatever source derived*, exclusions are the creations of Congress. For various social, political, or economic reasons, Congress has chosen to exclude many sources of income and wealth transfers from their usual Federal tax base. The more common Congressional objectives of exclusions are discussed in a later section of this chapter.

Example 3. N receives a $12,000 graduation gift from her aunt. N does not have to include this amount in determining taxable income because Congress has specifically excluded gifts from income. If N had received the $12,000 in exchange for rendering services to her aunt, or if N had received the $12,000 for appearing on a television game show, then in both cases she would have to include (report) the amount in income subject to taxation.

Example 4. Refer to *Example 3* above. If N's aunt transfers $12,000 to N in the current year as a graduation gift, and this is the only gift made by the aunt to N in the current year, this transfer will not be subjected to the Federal gift tax. Congress has provided an annual exclusion from gift taxation of $12,000 per donee in 2008.

Deduction. A deduction is a reduction in the gross (total) amount that must be included in the taxable base. For instance, when an individual taxpayer incurs expenses such as medical expenses, interest on a home mortgage, or property taxes, he or she generally will be allowed to deduct these expenses to arrive at taxable income for Federal tax purposes. Similarly, corporations are allowed to deduct most of their costs of doing business to determine corporate taxable income. It is *extremely important* to note, however, that deductions are a matter of legislative grace—unless Congress has specifically authorized a particular deduction, the expense will not be deductible.

Example 5. Individual T purchased his family residence in 2001 for $90,000. T sells his home in 2008 for $80,000. T may not take a deduction for the $10,000 loss (a permanent reduction in wealth) in determining his taxable income *because* Congress has not authorized a deduction for this particular type of loss.

Most deductions available to individual taxpayers and to other taxable entities (i.e., corporations, estates, and trusts) are discussed in detail in Chapters 7 through 12 of this text.

Tax Rates. A tax rate is some percentage applied to the tax base to determine a taxpayer's liability. Tax rate structures usually are either proportional or progressive. A *proportional* tax rate is one that remains at a constant percentage regardless of the size of the tax base. A *progressive* tax rate structure is one in which an increasing percentage rate is applied to increasing increments of the tax base. A *regressive* tax rate structure is one in which a decreasing percentage rate is applied to increasing increments of the tax base.

Example 6. A has a tax base of $5,000 and pays a tax of $500, or 10% of the tax base. B's tax base is $10,000 and the tax on this amount is $1,000, or 10%. If the same constant rate of 10% is applied to any amount of tax base, the tax is proportional.

Example 7. R has a tax base of $10,000 and pays a tax of $500 on the first $5,000, and a tax of $1,000 on the next $5,000. The total tax of $1,500 was calculated by applying a 10% rate to the first $5,000 increment of the tax base and then applying a 20% rate to the excess tax base over $5,000. Since a higher percentage rate is applied as the tax base increases, this is a progressive rate structure.

Most excise taxes (e.g., sales taxes) employ a proportional tax rate. However, both the Federal income and transfer tax rates, as well as most state income tax rates, are progressive. The 2008 Federal income tax rate schedules for individual taxpayers appear on the inside front cover of this text for ready reference. The income tax rates for corporations, estates, and trusts are presented on the inside back cover of the text. The Federal gift and estate tax rates are reproduced in Appendix A-3 at the back of the text. A glance at either of these sources will indicate the progressive nature of the Federal tax system.

Marginal, Average, and Effective Tax Rates. It is not surprising that tax rates receive a great deal of attention. Since taxes have such a significant impact on taxpayer's lives, everyone has an interest in—as well as an opinion about—tax rates. Are tax rates too high or too low? Are they too progressive or too flat? In any dialogue regarding tax rates, it is important to understand the terminology and distinguish between three different tax rate concepts: the marginal rate, the average rate and the effective tax rate.

Marginal Tax Rates. The marginal tax rate of any tax rate structure is that percentage at which the next unit of the tax base will be taxed. For example, in the case of the income tax, if a taxpayer earns an additional dollar of income, the marginal rate would be the rate that applied to that dollar. The marginal tax rates of the Federal income tax rate structure for single and married taxpayers for 2008 and the amounts of income to which they apply are shown below:

Tax Rate	Single Taxpayers Taxable Income	Married Taxpayers Taxable Income
10%	$ 0 – $ 8,025	$ 0 – $ 16,050
15	8,025 – 32,550	16,050 – 65,100
25	32,550 – 78,850	65,100 – 131,450
28	78,850 – 164,550	131,450 – 200,300
33	164,550 – 357,700	200,300 – 357,700
35	Over 357,700	Over 357,700

Note the progressive nature of the rate structure. There are currently six marginal tax rates for individuals, starting at 10% and climbing to a high of 35%. Each of these rates applies to a range of income known as a tax bracket. It is not uncommon to hear people say they are in a particular tax bracket. If a single person says he is in the "25% bracket," it simply means that his taxable income is at a level ($32,550 − $78,850 in 2008) such that the next dollar of income is taxed at 25%. While the tax rates for married taxpayers are the same as those for singles, they generally apply to different brackets of income. For the 10% and 15% rates, the married brackets are exactly twice the size of those for single taxpayers but vary thereafter until the top rate is reached. The potential for implicit tax "penalties" for being married or single, depending on a couple's income, who earns it and other factors, is discussed in Chapter 4.

Over the years, the tax rates and ranges of income to which they apply have varied dramatically. The first income tax that applied in 1913 had seven rates, ranging from 1% to 7%. In contrast, in 1962 there were 23 brackets, beginning at a rate of 22% and ending at 91%! No doubt rates and brackets will continue to change as Congress deems it necessary to balance the budget, raise revenues or to provide a tax cut. A typical tax computation using the current tax rate schedule is illustrated below.

Example 8. H, an unmarried taxpayer, has taxable income of $35,000 for 2008. Referring to tax rate Schedule X on the inside front cover of this text, an unmarried taxpayer with taxable income of $35,000 has a tax of $5,093.75 as computed below. H's marginal tax rate is 25%.

2008 tax on $32,550	$4,481.25
Plus: Tax on income above $32,550 [($35,000 − $32,550 = $2,450) × 25%]	612.50
Tax liability	$5,093.75

A taxpayer's knowledge of his or her marginal tax rate is essential in any tax-planning effort to minimize taxes. Without such knowledge, the tax impact of an additional dollar of the tax base or an additional dollar deduction cannot be determined.

Example 9. Refer to *Example 8*. If unmarried taxpayer H, age 40, is considering depositing \$5,000 in an Individual Retirement Account (the maximum amount allowed in 2008 as a deduction for Federal income tax purposes), he could determine his immediate tax savings to be \$1,250 (the 25% marginal tax rate × the \$5,000 income not taxed). Similarly, if H had a 33% marginal tax rate and wanted to know the after-tax amount of a proposed \$10,000 increase in salary, he would simply multiply \$10,000 by 67% (100% − 33%). In such case, the after-tax value of the \$10,000 salary increase would be \$6,700.

Many individuals, including those who are highly educated, do not understand the marginal tax rate concept. All too often one hears the expression, "I can't afford to earn more because it will throw me into a higher tax bracket and I will keep less than I do now after taxes." This theoretically cannot occur unless the marginal tax rate exceeds 100 percent.

While the rates above normally are used to compute an individual's tax liability, a lower rate can apply. An individual's gains from the sale of so-called capital assets (e.g., corporate stocks) held for more than a year receive preferential treatment. Such gains, referred to as long-term capital gains, usually are taxed at 15 percent but could be taxed as high as 28 percent. However, beginning in 2008, any long-term capital gains of taxpayers in either the 10 or 15 percent income tax bracket will be tax-free. Gains from sales of capital assets that are held for a year or less, short-term capital gains, are tax at an individual's ordinary rates.

Corporate tax rates, like individual rates, are progressive (see inside back cover). The rates run from 15% to 35%. Corporations with taxable incomes less than \$75,000 may take advantage of the lower rates. When taxable income exceeds the \$75,000 threshold, corporations generally face marginal rates of 34% up to \$10,000,000 of taxable income and 35% for taxable incomes exceeding the \$10,000,000 mark. The long-term capital gains of a corporation receive no preferential treatment and are taxed at regular rates.

Average Tax Rates. The average rate is computed by dividing the taxpayer's tax liability by the tax base. For the income tax, the average tax rate is simply the tax divided by taxable income (tax ÷ taxable income).

Example 10. K, an unmarried taxpayer, has 2008 taxable income of \$50,000 and pays a tax of \$8,843.75 [\$4,481.25 + \$4,362.50 (\$50,000 − \$32,550 = \$17,450 × 25%)]. Although her marginal tax rate is 25%, K's average tax rate is only 17.7% (\$8,843.75 ÷ \$50,000).

Average tax rates are a bit misleading in that they seem to suggest that all units of the tax base (e.g., all dollars of income) are treated equally. But as seen above, in a progressive tax rate system where marginal rates increase as income increases, some dollars of income are taxed higher than others. The average tax rate is just that, an average. While providing some insight about the overall rate structure, average rates say little about the true impact of a tax on the taxpayer. For this information, effective tax rates are the preferred statistic.

Effective Tax Rates. The effective tax rate is computed by dividing the tax by some broader measure other than the tax base, often some quantity reflecting taxpayer's ability to pay. For example, for the income tax, the effective tax rate is normally determined by dividing the tax by total economic income (tax ÷ total economic income).

Example 11. Assume the same facts as in *Example 10* except that K's total economic income is \$70,000, the \$20,000 difference between total income and taxable income being attributable to exclusions and deductions (e.g., interest on tax-exempt bonds and the personal exemption). In such case, K would pay taxes at an effective rate of 12.6% [\$8,843.75 ÷ (\$50,000 + \$20,000)].

Marginal rates are often confused with average rates and effective rates. For example, in decrying the harshness of the income tax, people often point to their marginal rate and declare that they are paying that percent (e.g., 25%) of their income to the government. A comparison of Examples 10 and 11 above reveals that this clearly is not the case. Although the taxpayer has a marginal tax rate of 25%, the average rate is 17.7% and the effective rate is only 12.6%.

While effective tax rates provide meaningful information about a taxpayer's tax burden, it is not without problems, the most difficult of which is that there is no uniform definition of total economic income or the amount that will serve as the denominator in the formula. Any use of effective tax rates must recognize this potential weakness. In practice, however, the denominator for any particular purpose such as financial reporting or economic studies is usually well-defined from the outset. As a result, effective tax rates (ETRs) usually provide a relatively straightforward measure of the percentage of income siphoned away by taxes. For this reason, ETRs are of great interest not only to individual taxpayers but also businesses, governments (U.S. and foreign), investors, analysts, academics, public interest groups and others.

One of the most common uses of the ETR concept can be found in financial reporting. Since taxes have a significant impact on a company's earnings, management, investors, creditors and other users of financial statements are particularly interested in the company's ETR. Due to the importance of taxes on a company's net income, generally accepted accounting principles—specifically FAS 109 and its interpretations—require public companies to provide additional disclosures, a detailed footnote, regarding the impact of income taxes on financial statement income (book income).[9] This information includes the company's ETR. In this context, ETR generally is the percentage of taxes paid on pre-tax book income (tax ÷ pre-tax book income). Although a corporation's statutory U.S. tax rate is normally a flat 35 percent, the ETR usually differs. For example, the footnotes to the financial statements of Microsoft reported an ETR of 31% in 2006 and 26.3% in 2005. Such differences occur because book income may be higher or lower than taxable income. For example, interest income from municipal bonds is included in book income but is excluded from taxable income. Similarly dividend income is fully included in book income but corporations normally pay taxes on only 30 percent of their dividends. On the expense side, book income includes fines and penalties and life insurance premiums on key executives but taxable income does not allow deductions for such costs. In addition, book income includes income from foreign subsidiaries but is not included in a corporation's consolidated taxable income (until is repatriated or paid back to the U.S. usually through dividend payments).

The ETR is a useful tool since it provides a snapshot of whether a business is or is not paying taxes and if so, how much. In addition, the ETR provides a criterion for determining how well a business is managing its tax liability relative to other firms in the same industry or businesses as a whole.

Tax Credits. A tax credit is a dollar-for-dollar offset against a tax liability. A credit is quite different from a deduction, since it directly reduces the tax liability itself, whereas a deduction simply reduces the base amount subject to the tax.

[9] See *Accounting for Income Taxes*, Statement of Financial Accounting Standards No. 109, Financial Accounting Standards Board, 1992. For financial statement purposes, FAS 109 requires income tax expense to be based on financial statement income rather than actual taxable income. Thus actual taxes paid may differ significantly from the reported amount. The ETR provides a picture of the taxes actually paid relative to book income rather than taxable income.

Example 12. T is a single taxpayer with a 28% marginal tax rate. An additional \$100 tax deduction would reduce T's tax by \$28 (28% × \$100). If the \$100 qualified as a tax credit, however, T would have a \$100 tax reduction—the equivalent of a \$357 tax deduction at a marginal tax rate of 28% (\$357 × 28% = \$100).

Tax credits are discussed in detail in Chapter 13 of this text.

MAJOR TYPES OF TAXES

Taxing authorities within the United States have a wide array of taxes with which they raise revenues or attempt to effect social, political, or economic change. The average individual will feel the impact of quite a number of taxes during his or her lifetime. Any attempt to accumulate wealth requires diligent tax planning, and to ignore the impact of Federal, state, and local taxes will serve no useful purpose toward this end. Although the principal thrust of this text is aimed at the Federal income and wealth transfer taxes, some of the other types of taxes merit a brief introduction.

INCOME TAXES

An income tax is an extraction of some of the taxpayer's economic gain, usually on a periodic basis. In addition to the Federal government, many states and some local governments impose a tax on income. For example, New York City residents could pay not only a federal income tax of 35 percent but also a state income tax of 7.7 percent and a city income tax of 4.45 percent. As noted earlier in Exhibit 1-1, the individual income tax was expected to provide 45 percent of the Federal government's fiscal 2008 revenues. Of all the sources providing revenues to the Federal government, the individual income tax is the largest. In contrast, the corporate income tax was expected to provide only 11 percent of the Federal government's projected revenues in fiscal 2008.[10]

The Federal government imposes an income tax on individuals, corporations, estates, and trusts. Usually, a final tax reckoning (reporting and paying taxes due) is made at the end of each year. In order to ensure tax collections, however, Congress has created a pay-as-you-go requirement. Basically, this process requires employers to withhold and remit to the Federal government income taxes on wages paid to employees. Individuals with income from sources other than wages, and most other taxable entities, are required to make estimated tax prepayments during the year.[11]

Application of the Federal income tax to individuals is discussed in Chapters 3 and 4. Computation of a corporation's Federal income tax is explained in Chapter 19. The Federal income taxation of a business operated in either the partnership or corporate form is also examined in Chapter 19. For now, the procedures for determining the Federal income tax liability of corporate and individual taxpayers are reduced to computational formulas presented in Exhibits 1-2 and 1-3 as follows. The components of these formulas are introduced and discussed in greater detail in Chapter 3.

[10] Such heavy reliance on the income tax as a source of government revenues is peculiar to the United States. Most Western European nations have turned to a Value-Added Tax (VAT). A VAT is a system of taxing the increment in value of goods as they move through the production and manufacturing process to the market place. The VAT operates very much like a national sales tax and has occasionally been proposed, though unsuccessfully, for the United States.

[11] This procedure was developed by Congress during World War II to accelerate annual tax payments needed to finance the war effort. The process served so well to increase compliance with, and facilitate administration of, the Federal income tax law that Congress chose not to abandon it at the close of the war.

EXHIBIT 1-2
Tax Formula For Corporate Taxpayers

Income (from whatever source)	$xxx,xxx
Less: Exclusions from gross income	−xx,xxx
Gross income	$xxx,xxx
Less: Deductions	−xx,xxx
Taxable income	$xxx,xxx
Applicable tax rates	xx%
Gross tax	$ xx,xxx
Less: Tax credits and prepayments	−x,xxx
Tax due (or refund)	$ xx,xxx

EXHIBIT 1-3
Tax Formula for Individual Taxpayers

Income (from whatever source)					$xxx,xxx
Less: Exclusions from gross income					−xx,xxx
Gross income					$xxx,xxx
Less: Deductions for adjusted gross income					−xx,xxx
Adjusted gross income					$xxx,xxx
Less:	1.	The larger of:			
		a.	Standard deduction	$x,xxx	
			or	*or*	−x,xxx
		b.	Total itemized deductions	$x,xxx	
	2.	Personal and dependency exemptions × exemption amount			−x,xxx
Taxable income					$xxx,xxx
Applicable tax rates (from Tables or Schedules X, Y, or Z)					xx%
Gross tax					$ xx,xxx
Less: Tax credits and prepayments					−x,xxx
Tax due (or refund)					$ xx,xxx

Most states in the United States impose an income tax of some sort.[12] Generally, state income taxes are designed to operate much like the Federal income tax. Almost all the states have a tax-withholding procedure and most use the income determination for Federal income tax purposes as the tax base. Some states allow a deduction for Federal income taxes, while others exclude income that is subject to Federal income taxation. Interest income from Federal government obligations is not subject to state income taxation, and interest income from state and local government obligations generally is not

[12] States *not* currently imposing an income tax on individuals are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. Tennessee and New Hampshire impose an income tax on an individual's dividend and interest income. Every state imposes either a corporate income tax or a tax on the privilege of conducting business within the state's boundaries. See subsequent discussion of franchise taxes.

subject to either Federal or state income taxation. Most states have developed their own set of rates, exemptions, and credits; however, the filing date for the state income tax return generally coincides with the due date of the taxpayer's Federal income tax return.[13]

One particular problem that has developed in the area of state taxation is the so-called unitary tax. Several states[14] tax businesses on the basis of their global activities, not just their local operations. This asserted right to tax income that has not been earned within the state's boundaries has been subjected to many challenges in the courts; but, as of this date, the unitary tax has not been struck down as unconstitutional.[15] Foreign corporations object to this worldwide combined reporting for many reasons, the most obvious being that it may result in the imposition of state taxation even when no taxable income has been generated by intrastate operations.

WEALTH TRANSFER TAXES

Unlike Federal and state income taxes, wealth transfer taxes are not significant revenue producers. For example, Federal transfer tax revenues for fiscal year 2008 represent less than 1 percent of Federal government revenues.[16] Historically, the primary function of wealth transfer taxes has been to *hinder* the accumulation of wealth by family units. Thus, the goal of wealth redistribution generally underlies the design of estate and gift tax systems.

The estate tax and its partner, the gift tax, are both excise taxes on the transfers of property. The estate tax is imposed on the amount of a decedent's *net* wealth (fair market value of total assets less debts and expenses) that passes to his or her heirs at death. Absent any other rule, the estate tax easily could be avoided by giving away property before death. For this reason, Congress enacted a tax on gifts. The gift tax is imposed on the value of property transferred during an individual's life. As explained below, only a relatively small percentage of taxpayers are affected by the gift or estate tax since they apply only when the transfer of wealth is substantial, (e.g., more than $1,000,000 during life or $2,000,000 at death). But for those to whom the taxes do apply, the cost can be significant.

Prior to 1977, the gift tax and estate tax were two separate taxes. Taxable gifts made during life generally did not impact the estate tax calculation. However, in 1976, the gift tax and estate tax were combined into what is conceptually a unified transfer tax. The taxes are unified in the way that the taxes are calculated. As an individual makes taxable gifts during life, the gift tax is computed on a cumulative basis. To calculate the tax on current year gifts, the donor must add all taxable gifts made in prior years (since 1976) to the current gifts, calculate the gross tax on the sum of the lifetime transfers, and then subtract gift taxes assessed on the prior years' gifts. The remainder is the current year gift tax. When the individual dies, the estate tax is computed in a similar manner by adding all prior taxable gifts to the taxable estate, applying the appropriate rate and subtracting any prior gift taxes assessed. It is sometimes useful to think of the transfer at death as the final gift. Note that in both cases, the addition of prior taxable gifts does not result in the gifts being taxed twice but only raises the marginal rate at which the current transfers are taxed. Like the Federal income tax rate structure, the gift tax and the estate tax rates are progressive.

As a practical matter, the estate and gift tax do not apply to most taxpayers. For starters, to eliminate the vast administrative problems that would result if the gift tax were

[13] For individuals and partnerships, the due date of the Federal income tax return is the fifteenth day of the fourth month following the close of the tax year. For corporate taxpayers, the due date of the Federal return is the fifteenth day of the *third* month following the close of the tax year.

[14] Among those states that tax businesses on the basis of worldwide income are Alaska, California, Colorado, Florida, Idaho, Illinois, Indiana, Massachusetts, Montana, New Hampshire, New York (oil companies only), North Dakota, Oregon, and Utah.

[15] The U.S. Supreme Court upheld California's system of taxing global profits of U.S.-based multinational businesses in *Container Corporation of America v. Franchise Tax Board*, 103 S.Ct. 2933 (USSC, 1983).

[16] Office of Management and Budget, 2008 *Fiscal Year Budget.*

imposed on all gifts (e.g., birthday presents), the tax is imposed only on those transfers that exceed a certain threshold. In 2008, this amount is $12,000. Technically, individuals are entitled to an exclusion of $12,000 per donee per year. The exclusion enables an individual to make an unlimited number of gifts as long as they do not exceed $12,000 per donee in one year. For married couples, these rules permit a husband and wife to give $24,000 a year to a particular donee (e.g., a child) tax free. In addition, to the annual exclusion, gifts to a spouse, charity or transfers for educational or medical purposes normally are not taxable.

Provisions also exist to ensure that only transfers of substantial wealth are subject to tax. For gift tax purposes, gifts in excess of amounts excluded are not subject to tax until the cumulative amount of all gifts exceeds $1,000,000. Similarly, at death, in 2008, there is no estate tax unless total transfers during life and at death exceed $2,000,000. It should be noted that once transfers exceed these levels, the tax is quite high. When total gifts exceed the $1,000,000 mark, the marginal rate begins at 41 percent and rises to 45 percent. When the estate (including lifetime gifts) exceeds the $2,000,000 amount, the marginal rate is 45 percent for 2008-2009. A more detailed discussion of these taxes is provided below.

The Federal Estate Tax. The procedure for computing the Federal estate tax liability is illustrated in Exhibit 1-4.

EXHIBIT 1-4
Computation of Federal Estate Tax Liability

Gross estate		$x,xxx,xxx
Less the sum of:		
Expenses, indebtedness, and taxes	$ xx,xxx	
State death taxes	x,xxx	
Losses	x,xxx	
Charitable bequests	xx,xxx	
Marital deduction	xxx,xxx	−xxx,xxx
Taxable estate		$ xxx,xxx
Plus: Taxable gifts made after December 31, 1976		+xx,xxx
Total taxable transfers		$ xxx,xxx
Tentative tax on total transfer		$ xxx,xxx
Less the sum of:		
Gift taxes paid on post-1976 taxable gifts	$ x,xxx	
Estate tax credit	xx,xxx	
Other tax credits	x,xxx	−xx,xxx
Estate tax liability		$ xx,xxx

A decedent's gross estate includes the value of *all* property owned at date of death, wherever located. This includes the proceeds of an insurance policy on the life of the decedent if the decedent's estate is the beneficiary, or if the decedent had any ownership rights[17] in the policy at time of death. Property is generally included in the gross estate at its *fair market value* as of the date of death.[18]

17 Ownership rights in a life insurance policy include the power to change the policy's beneficiary, the right to cancel or assign the policy, and the right to borrow against the policy.

18 For further discussion of the valuation of a decedent's gross estate, see *Corporate, Partnership, Estate and Gift Taxation*, 2009 Edition, Chapter 14.

The taxable estate is the gross estate reduced by deductions allowed for funeral and administrative expenses, debts of the decedent, certain taxes and losses, state dealth taxes and charitable gifts made from the decedent's estate. It is important to note that there is no limit imposed on the charitable deduction. If an individual is willing to leave his or her entire estate for public, charitable, or religious use, there will be no taxable estate.[19] Finally, an *unlimited* marital deduction is allowed for the value of property passing to a surviving spouse. Thus, if a married taxpayer leaves all of his or her property to the surviving spouse, no Federal estate tax will be imposed on the estate. On the death of the surviving spouse, the couple's wealth may be subject to taxation.

Under current Federal estate tax laws, taxable gifts made after 1976 are added to the taxable estate to arrive at total taxable transfers. A tentative estate tax is then computed on the base amount. All gift taxes paid on post-1976 gifts, as well as certain tax credits, are subtracted from this tentative tax in arriving at the Federal estate tax due, if any. Most estate tax credits have a single underlying purpose—to reduce or eliminate the effect of multiple taxation of a single estate. Estate taxes paid to the various states or foreign countries on property owned by the decedent and located within their boundaries are examples of estate tax credits. However, the major credit available to reduce the Federal estate tax has been the *unified credit*.

The unified credit was a lifetime credit available for all taxable transfers, including taxable gifts made after 1976 through 2003. It had to be used when available; a taxpayer could not decide to postpone use of the credit if he or she made a taxable transfer in any given year. Over the years, the relief provided by the unified credit slowly eroded away with inflation. As a result, more and more taxpayers feared that they would be required to pay estate taxes. With the *Taxpayer Relief Act of 1997*, Congress responded to this fear by increasing the amount of the unified credit to an equivalent exemption of $1,000,000. This amount was further increased by the *Economic Growth and Tax Relief Reconciliation Act of 2001*. Under the 2001 legislation, the unified credit became two separate credits—one for estate tax and another one for gift tax. The estate tax credit was scheduled to grow over the eight years beginning in 2001, eventually reaching an equivalent exclusion amount of $3,500,000. However, the gift tax credit was set at a maximum of $345,800 (an exemption equivalent of $1,000,000). The credit increase for estate taxes occurs ratably as follows:

	Credit		*Exemption Equivalent*	
Year	*Estate Tax*	*Gift Tax*	*Estate Tax*	*Gift Tax*
2002–03	$ 345,800	$345,800	$1,000,000	$1,000,000
2004–05	555,800	345,800	1,500,000	1,000,000
2006–08	780,800	345,800	2,000,000	1,000,000
2009	1,455,800	345,800	3,500,000	1,000,000
2010	Repealed	345,800	Repealed	1,000,000

In 2010, the estate tax, but *not* the gift tax, is scheduled for repeal. The repeal is currently legislated for one year only, however. In 2011, the estate tax returns, with the exemption equivalent amount reverting back to $1 million. The gift tax exemption equivalent amount is increased to $1 million in 2001 and stays there unless and until it is further changed in subsequent legislation.

In 2008, the estate tax credit is $780,800. This amount of credit completely offsets the tax on $2,000,000 of taxable transfers (see Appendix A for the Estate and Gift Transfer Tax Rate Schedules currently in effect). Thus, an individual may make substantial transfers of wealth *before* any tax liability is incurred.

19 For Federal income tax purposes, an individual's charitable contribution deduction may be subject to several limitations. See Chapter 11 for more details.

Example 13. In 2008, D died owning Google stock worth $2,000,000. D had never made a taxable gift. D was not married and had no deductions. In such case, the taxable estate and total taxable transfers would be $2,000,000, and there would be no estate tax computed as follows:

Taxable estate and total taxable transfers	$2,000,000
Gross estate tax (see Appendix A-3)	$ 780,800
Estate tax credit	(780,800)
Tax due	$ 0

Note how the estate tax credit operates to exempt $2,000,000 of total taxable transfers from tax. For this reason, it is commonly said that taxpayers have an estate tax exemption equal to $2,000,000.

Example 14. T had never made any taxable gifts prior to her death in 2008. The tentative tax on T's taxable estate is $800,000, and tax credits *other than* the estate tax credit total $5,000. The federal estate tax due on T's estate will be $14,200 ($800,000 tentative tax − $780,800 estate tax credit − $5,000 other credits).

The Federal Gift Tax. The purpose of the federal gift tax is to prevent a taxpayer's avoidance of the federal estate tax simply by giving away his or her property prior to death. The procedure for computing the federal gift tax liability is presented as a formula in Exhibit 1-5. To arrive at taxable gifts for the year, the taxpayer's total gifts may be reduced by the annual exclusion and by the deductions allowed for property transferred to a spouse or charity. In computing taxable gifts for the current year, note that a donor is allowed an annual exclusion of $12,000 per donee in 2008. The annual exclusion is allowed *each year* even if the donor has made gifts in the prior years to the same donee.

EXHIBIT 1-5
Computation of Federal Gift Tax Liability

Fair market value of all gifts made in the current year		$xxx,xxx
Less the sum of:		
Annual exclusions ($12,000 per donee in 2008)	$ xx,xxx	
Marital deduction	xx,xxx	
Charitable deduction	x,xxx	−xx,xxx
Taxable gifts for current year		$xxx,xxx
Plus: Taxable gifts made in prior years		+xx,xxx
Taxable transfers to date		$xxx,xxx
Tentative tax on total transfers to date		$ xx,xxx
Less the sum of:		
Gift taxes computed at current rates on prior years' taxable gifts	$ x,xxx	
Gift tax credit	x,xxx	−x,xxx
Gift tax due on current gifts		$ xx,xxx

Example 15. T, a widower, wanted his son, daughter-in-law, and their five children to share his wealth. On December 25, 2008 he gave $12,000 to each family member. He repeats these gifts in 2009. Although T has transferred $168,000 [$12,000 × 7 (number of donees) × 2], he has not made taxable gifts in either 2008 or 2009.

The marital and charitable deductions for Federal gift tax purposes are the same as for the Federal estate tax—*unlimited*. Thus, if a taxpayer gives his or her spouse a $2,000,000 anniversary present or transfers $100,000 to his or her church, a taxable gift has not been made.

If taxable gifts have been made for the current year, the cumulative computational procedure of the gift transfer tax must be applied.

Example 16. In 1995, X made his first taxable gift of $100,000 (after the exclusion). The tax (before credits) on this amount was $23,800. X made a second taxable gift of $85,000 in 2008. The tax (before credits) on the second gift is $26,200, computed as follows:

1995 taxable gift	$100,000
2008 taxable gift	+85,000
Cumulative gifts	$185,000
Tax on $185,000	$ 50,000*
Less: Tax on 1995 taxable gift	−23,800*
Tax on 2008 gift	$ 26,200

* See the estate and gift transfer tax rate schedules contained in Appendix A. Also, note that the current year's tax rate is used to compute the tax reduction for the 1995 gift.

Note that the cumulative system of wealth transfer taxation *and* the progressive rate schedule cause a higher tax on the 2008 gift, even though the 2008 gift was $15,000 *less* than the 1995 gift.

The tentative tax liability in the above example is reduced by the unified credit available for the gift tax, $345,800. The gift tax credit is the only credit available to offset the federal gift tax liability.

The unified credit for the gift tax is $345,800 and is equivalent to an exemption of $1,000,000. In applying the credit, it is important to understand that whatever amount is used in one year reduces the amount of the credit available in future years or at death. In other words, if a taxpayer makes no taxable gifts during his or her lifetime, the entire unified credit of $780,800 is available to reduce any estate taxes that otherwise may be due at the taxpayer's death (see Example above). In contrast, if the taxpayer uses all $345,800 of the unified credit to reduce gift taxes, such amount is not available at death.

Example 17. Prior to 2008, T had never made a taxable gift. In 2008, T made her first *taxable* gift of $1,000,000. Using the rate schedule, the gift tax on the $1,000,000 taxable transfer prior to application of the unified credit would be $345,800. However, the credit of $345,800 would completely eliminate the tax. The calculation is shown below:

Current taxable gift	$1,000,000
Prior taxable gifts	—
Total taxable gifts	$1,000,000
Tax	$ 345,800
Unified credit	(345,800)
Gift tax due	$ 0

Example 18. In 1995, Y made her first taxable gift of $350,000. Assume the tax calculated on this gift is $104,800. Y is required to use any available gift tax credit. Consequently, she used $104,800 of her available gift tax credit so that the actual gift tax due is reduced to zero. In 2008, Y makes her second taxable gift of $2,000,000. The tax on this gift is computed as follows:

Taxable gift for 2008		$ 2,000,000
Plus: 1995 taxable gift		+350,000
Taxable transfers to date		$ 2,350,000
Tentative tax on total transfers to date (see Appendix A for tax rates)		$ 938,300
Less: Gift taxes calculated on 1995 gift		−104,800
Tentative tax on 2008 gift		$ 833,500
Less: Remaining gift tax credit:		
Total gift credit available for 2008	$ 345,800	
Less: Gift tax credit used in 1995	− 104,800	− 241,000
Gift tax due on 2008 gift		$ 592,500

Another unique feature of the Federal gift tax involves the *gift-splitting* election available to a married donor. If a donor makes the election on his or her current gift tax return, one half of all gifts made during the year will be considered to have been made by the donor's spouse. The election is valid *only if* both spouses *consent* to gift-splitting.

Example 19. In 2008 husband H makes two gifts of $100,000 each to his son and daughter. His wife W makes a gift of $5,000 to the daughter only. H and W elect gift-splitting on their 2008 gift tax returns. As a result, H will report a gift to the son of $50,000 and a gift to the daughter of $52,500 [½ of ($100,000 + $5,000)], and will claim two $12,000 gift tax exclusions. W will report exactly the same gifts and claim two exclusions.

Without gift-splitting, H would still be entitled to $24,000 of exclusions, but W could only claim an exclusion of $5,000 for her gift to the daughter. Thus, by electing to split gifts, a married donor can, in effect, make use of any annual exclusions not needed by his or her spouse. More importantly, if taxable gifts are made under a gift-splitting arrangement, H can use his unified credit and W can use her lifetime credit to reduce the tax liability.

State and Local Transfer Taxes. Many states and some local jurisdictions impose an inheritance tax on the *right to receive* property at death. Unlike an estate tax, which is imposed on the estate according to value of property transferred by the decedent at death, an inheritance tax is imposed on the recipient of property from an estate.[20] The amount of an inheritance tax payable usually is directly affected by the degree of kinship between the recipient and the decedent. The inheritance tax typically provides an exemption from the tax, which increases as the relationship between the recipient (e.g., surviving spouse, children, grandchildren, parents, etc.) and the decedent becomes closer. In addition, as the relationship becomes closer, the transfer tax rates decrease. Thus, the more closely related one is, the smaller the inheritance tax will be. Generally, little if any inheritance tax exemption is available for transfers to unrelated recipients, and the highest rate is imposed.

20 It is not uncommon for the decedent's will to provide that his or her estate pay any inheritance tax imposed on the recipient of property from the estate.

Example 20. The Indiana inheritance tax is similar to most inheritance taxes. For example, transfers to a surviving spouse and charities are totally exempt. In contrast, the exemption for transfers to children and grandchildren is $100,000, and the rates on the excess run from 1 to 10 percent. As the relationship between the decedent and the beneficiary grows more distant, the exemption shrinks and the rates grow. The exemption for transfers to brothers and sisters and their descendants (e.g., nieces and nephews) is only $500, and the rates range from 7 to 15 percent. Finally, transfers to nonrelatives (e.g., friends) are subject to an even lower exemption, $100, and the rates extend from 10 to 20 percent.

In addition to state and local inheritance taxes on beneficiaries, many states also impose estate taxes on the decedent's estate. The rates imposed on the taxable estate are considerably lower than those of the federal estate tax rates.[21] Beginning in 2005, any inheritance or estate taxes imposed by a state are deductible in computing the Federal taxable estate. While most states impose some type of death tax, only a few states have a gift tax. In those states where there is no gift tax, wholesale avoidance of any state death tax is prohibited by certain special rules. For example, a state law may require that transfers made within one year of death to be included in the death tax base.

EMPLOYMENT TAXES

The Federal government and most states impose some form of employment tax on either self-employed individuals, employees,[22] or employers. The most common form of state employment tax is levied on wages, with the proceeds used to finance the state's unemployment benefits program. State unemployment taxes are imposed on employers who have employees working within the state's boundaries, but only if the employees would be eligible for unemployment benefits from the state. Most states' unemployment taxes are based on the same taxable wage base as that used for the Federal unemployment tax (see discussion below), and employers are allowed to take state unemployment taxes paid as a credit against the Federal unemployment tax liability.

The Federal government imposes two types of taxes on employment—a social security tax and an unemployment tax. The Federal Insurance Contribution Act (FICA) imposes a tax on self-employed individuals, employees, and employers. The FICA tax is paid by both an employee and his or her employer if the employee is eligible for social security and Medicare health insurance benefits. Although subject to a different tax rate, self-employed individuals are required to pay FICA taxes on net earnings from self-employment. The Federal Unemployment Tax Act (FUTA) imposes a tax *only* on the employer. Self-employed individuals are not eligible for unemployment benefits and thus are not subject to the FUTA tax. The tax base and rate structure of both these Federal employment taxes are presented below.

FICA Taxes. FICA taxes, often referred to as Social Security and Medicare taxes, have a long history. Both taxes help pay for a variety of federal programs that together assist individuals in times of need such as old-age, disability, death and illness. Social Security was enacted in 1935 to pay a guaranteed source of income to retired workers normally when they reach age 65. Since 1935 the Act has been modified many, many

---

[21] States that impose both an estate and inheritance tax generally allow a credit against the state estate tax for any inheritance tax imposed on the heirs.

[22] The term "employee" is used to identify persons whose work effort, tools, place of work, and work time periods are subject to the supervision and control of another (the employer). A person who provides his or her own tools and who has the *right* to exercise control over when, where, and for whom services are rendered (i.e., an independent contractor) generally is classified as self-employed rather than as an employee. See Chapter 8 for a discussion of the importance this classification has in the deductions allowed to individuals for Federal income tax purposes.

times, providing more and more benefits. For example, major additions occurred in 1956 and 1960 when the Act was amended to extend benefits for most disabled workers and their families. The programs established by these amendments are now collectively known as the Old Age, Survivors and Disability Insurance (OASDI) programs. In addition to these programs, Congress addressed problems of health care for the aged with the creation of Medicare Health Insurance (MHI) in 1965. Medicare helps pay hospital and medical expenses for persons who have reached age 65. In 2006, Medicare was amended to help pay for prescription drugs.

The Social Security and Medicare programs are paid for primarily through taxes on wages and self-employment income. Taxes to pay for Social Security benefits were first collected in January 1937 at a rate of 1 percent on the first $3,000 of wages or a maximum of only $30! In 1966, tax collections began for Medicare at a rate of .35 percent on the same wage base as for Social Security. At that point, 1966, the total tax for the two components of FICA, Social Security and Medicare, was 4.2 percent (3.85 + .35) on wages of $6,600 or a maximum of $2,772. Since those early days both the tax rates as well as the base have swelled. The rates stopped climbing–at least temporarily–in 1990 when they reached what they are currently: 6.2 percent for Social Security and 1.45 percent for Medicare. The wage base for Social Security changes every year and in 2008 is $102,000. Until 1992, the wage base for Medicare was the same as for Social Security but starting in 1993 the base for Medicare became unlimited and remains unlimited today.

Employees and Employers. FICA taxes are imposed at the combined rate of 7.65 percent (6.2% social security + 1.45% MHI) on each dollar of an employee's wages up to $102,000 plus 1.45 percent on each additional dollar of wages in 2008. As explained above, there is no maximum amount on the MHI component of the FICA tax because the 1.45 percent MHI tax is applicable to *all* compensation. The employer is required to pay a matching amount of FICA taxes for each employee (i.e., the same tax rates on each employee's wage base up to the same limits).[23]

Example 21. During 2008 employee E earns wages of $70,000. As a result, E will pay $5,355 (7.65% × $70,000) FICA taxes, and her employer must pay the same amount as an employment tax.

Example 22. During 2008 employee F earns wages of $240,000. As a result F will pay $9,804 FICA taxes, and her employer must pay the same amount as an employment tax. It is important to note that the 1.45% MHI tax has no ceiling amount. The calculation is as follows:

Social security portion = 6.2% × $102,000 limit	$ 6,324
Plus: MHI portion = 1.45% × $240,000	+3,480
Total FICA taxes	$ 9,804

An employer is required to withhold both Federal income taxes and FICA taxes from each employee's wages paid during the year. The employer is then required to remit these withheld amounts plus the employer's matching FICA taxes for each employee to the IRS on a regular basis, usually weekly or monthly.[24] Employers also are required to file Form 941, Employer's Quarterly Federal Tax Return, by the end of the first month following each quarter of the calendar year (e.g., by April 30, 2008 for the quarter ended

[23] Employers are allowed a tax deduction for all payroll taxes. See Chapter 7 for a discussion of business deductions.

[24] The frequency of these payments depends on the total amount of Federal income taxes withheld and the FICA taxes due on the employer's periodic payroll. The amount of Federal income and FICA taxes to be withheld from each employee's wages, and the reporting and payment requirements are specified in Circular E, *Employer's Tax Guide*, a free publication of the Internal Revenue Service.

March 31, 2008), and pay any remaining amount of employment taxes due for the previous quarter.[25]

In some instances, an employee who has had more than one employer during the year may have paid *excess* FICA taxes for the year and will be entitled to a Federal income tax credit or refund for the excess.

Example 23. During 2008 E earned $100,000 from his regular job and $50,000 from a part-time job. E's full time employer withheld $7,650 ($100,000 × 7.65%) and E's part time employer withheld $3,825 ($50,000 × 7.65%). Each employer made matching contributions and paid the withheld amount and the employer's match to the IRS. Since E has paid a total of $11,475 ($7,650 + $3,825) FICA taxes and the maximum amount due for 2008 is $8,499 [($102,000 × 6.2% = $6,324) + ($150,000 × 1.45% = $2,175)], E will be entitled to a tax credit or refund of the $2,976, the difference between the $11,475 he paid and the $8,499 that is due. Note that this simply represents the FICA taxes withheld on E's wages in excess of the $102,000 maximum amount subject to the 6.2% Social Security rate in 2008 ($150,000 − $102,000 = $48,000 × 6.2% = $2,976).

Self-Employed Taxpayers. Like employees, self-employed individuals are normally required to pay FICA taxes on their self-employment income (commonly known as self-employment tax or the SE tax). The social security portion of self-employment tax rate is 12.4 percent and the MHI portion is 2.9 percent. These rates are *twice* the FICA tax rates imposed on an employee's wages. In 2008, the ceiling amount for the social security portion of the SE tax is $102,000, the same as for employees. As a result, taxpayers with self-employment income not exceeding this amount will pay an SE tax of 15.3 percent on their self-employment income. This tax is computed as part of Form 1040 on Schedule SE. (See Appendix B for this form.) Note that a taxpayer is not required to pay self-employment taxes unless he or she has self-employment income of $400 or more.[26]

Self-Employment Income. Self-employed persons do not receive wages. Employees receive wages. The equivalent of wages for a self-employed person is self-employment income. Self-employment income is generally the trade or business income earned by an individual as an independent contractor, a sole proprietor or a general partner in a partnership. Self-employment income does not include income passive in nature or investment income such as interest, dividends or rents. Nor does it include gains from the sale of property (other than sales of inventory or property customarily held for sale to customers). Note that self-employment income is a "net" concept so expenses related to producing the income may be subtracted in reaching the base.

The most common type of self-employment income is that received by for providing services *other than in an employee capacity*. For example, it includes income earned by accountants, tax preparers, doctors, dentists, veterinarians, engineers, lawyers and consultants as long as they are independent contractors, sole proprietors or general partners. But self-employment income is not limited to income earned by professionals. It also includes income earned by such persons as farmers, fisherman, contractors, subcontractors, massage therapists, graphic designers, hair stylists, salesmen and freelance writers. Income from odd jobs also counts as self-employment income such as income from babysitting and child care, mowing lawns, driving a taxi, painting, tutoring, selling

---

25 Because of significant penalties for underpayment of these Federal employment taxes, most employers exercise great care to make payments on a timely basis. See Circular E for a discussion of these penalties and due dates.

26 Technically, self-employment income is defined as "net earnings from self-employment." Because the amount of net earnings from self-employment is 92.35% of self-employment income, there is no self-employment tax unless the taxpayer's self-employment income is $433 ($400/92.35%) or more. See §§ 1401 and 1402(b).

handicrafts, operating a bed and breakfast or serving on a board of directors. In all cases, the services must have been performed as an independent contractor, sole proprietor or partner to be considered self-employment income.

Whether an individual is an independent contractor or an employee depends on the facts in each case. An individual is normally considered an independent contractor if the payer has the right to control or direct only the result of the work and not how it will be done. Unfortunately, this is a dreadfully controversial area. As might be expected, payers, wanting to avoid payment of a 7.65 percent employment tax, are inclined to call a worker an independent contractor. Conversely, the government, hoping to ensure the collection of employment and income taxes, wants to classify the worker as an employee. To dissuade employers from misclassification, the government imposes severe penalties if the employer intentionally classifies a worker as an independent contractor when it is clear he or she is an employee.

In most cases, an independent contractor's self-employment income is reported to the taxpayer on Form 1099. Just like an employer that must provide an employee with a Form W-2 reporting wages earned, businesses must give a Form 1099 to any "independent contractor" who provides $600 or more of services to the business during the year. Generally a payer is not required to provide a Form 1099 to a corporation but there are a number of exceptions. For example, businesses must always give attorneys a Form 1099 regardless of the form of business in which the attorneys perform their services. Note that while the reporting threshold for a payer is $600, an individual is not required to pay self-employment tax unless his or her total self-employment income is $400 or more.

Calculation of Self-Employment Tax. As a general rule, the self-employment tax is 15.3 percent of self-employment income. However, in computing the amount of a taxpayer's self-employment income subject to tax, a special adjustment is required as explained in the following example.

> **Example 24.** S is a sole proprietor who prepares tax returns. This year his income from operations net of all expenses *except* the self-employment tax related to such income is $10,000. To arrive at the correct measure of *net* income for the sole proprietorship, the taxpayer must reduce the $10,000 by the portion of the self-employment tax that represents a cost of doing business. This is analogous to an employer whose labor expenses include the 7.65 percent FICA tax on an employee's wages (i.e., the employer's matching share of FICA). A self-employed person incurs a similar cost and that cost is one-half of the individual's self-employment tax. Consequently, to determine the self-employment tax base, the tax preparer's income of $10,000 is reduced by one-half of the hypothetical self-employment tax on the $10,000 or $765 [$10,000 × 7.65% (15.3% × ½)]. This results in self-employment income subject to tax of $9,235 ($10,000 − $765). The actual self-employment tax is $1,412.96 (15.3% × $9,235).

Following the approach above, in computing the amount subject to tax for each of the self-employment tax bases (both the 12.4 percent and the 2.9 percent), the taxpayer always reduces net earnings from self-employment by an amount equal to one-half the combined 15.3 percent tax rate times net earnings from self-employment (i.e., 7.65% × net earnings from self-employment).[27] Note that this adjustment applies only in the computation of the amount of the self-employment tax bases. However, consistent with the theory above, a self-employed individual is entitled to an actual deduction for one-half of the self-employment tax as a business expense in computing adjusted gross income. Using the facts of the example, the actual deduction would be $706.48 (1/2 × actual self-employment tax of $1,412.96). Observe that the actual deduction in computing adjusted

[27] § 1402(a)(12).

gross income is $706.48 and not the $765 used to compute the self-employment tax bases. Examples of these calculations are given below.

Each component of the self-employment tax required to be paid is computed as follows:

1. Multiply net earnings from self-employment by one-half of the self-employment tax rate, 7.65% (1/2 × 15.3%) and subtract that amount to reach a tentative tax base of 92.35% of the original amount.[28]
2. Compare the result in step 1 with the maximum base amount for the social security portion of the self-employment tax ($102,000 for 2008) and select the smaller amount.
3. Multiply the amount in step 1 by the Medicare rate of 2.9% and the amount in step 2 by the Social Security rate of 12.4%.
4. Add the amounts of the separate components from step 3. This is the amount of self-employment tax required to be paid.

Example 25. Individuals C and D have net earnings from self-employment for 2008 of $50,000 and $150,000, respectively. Self-employment taxes for C and D are determined as follows:

Self-employment tax computation	C		D	
Social Security (12.4% portion)				
Net earnings from self-employment	$50,000		$150,000	
− (1/2 × 15.3% = 7.65%) of net earnings	(3,825)		(11,475)	
SE tax base (92.35% net earnings)*	$46,175		$138,525	
Smaller of SE tax base above or maximum wage base ($102,000 for 2008)	$46,175		$102,000	
× 12.4%	× 12.4%		× 12.4%	
Social Security tax		$5,726		$12,648
MHI (2.9% portion)				
Net earnings from self-employment	$50,000		$150,000	
− (1/2 × 15.3% = 7.65%) of net earnings	(3,825)		(11,475)	
SE tax base (92.35% net earnings)**	$46,175		$138,525	
× 2.9%	× 2.9%		× 2.9%	
MHI tax		1,339		4,017
Total self-employment tax		$7,065		$16,665
Deduct 1/2 SE tax for A.G.I.		$3,533		$ 8,333

* Not to exceed wage base – wages received
**No reduction for wages

C will be allowed to deduct $3,533 (one-half of $7,065 self-employment tax paid) for income tax purposes, and D will be allowed to deduct $8,333 (one-half of $16,665).

[28] Note that the steps can be combined simply by multiplying the individual's net earnings from self-employment by 100% − one-half the current combined self-employment tax rate (i.e., 100% − 7.65% = 92.35%).

Although both will receive a benefit from the income tax deduction, note that only C has received any benefit from the so-called second deduction in arriving at his self-employment tax base for the social security component. Because D's reduced net earnings for self-employment are still greater than the maximum tax base for the social security component, she is required to pay the maximum amount of this component of the self-employment tax for 2008 (i.e., $102,000 × 12.4% = $12,648).

In some instances, a self-employed individual may also earn wages subject to FICA withholding while working as a full or part-time employee. In such a case, the maximum earnings base subject to the social security component of the self-employment tax is reduced by the wages earned as an employee.

Example 26. During 2008 T received wages of $68,000 and had self-employment income of $40,000. In computing T's self-employment tax, the maximum taxable base for the social security tax is reduced by the wages paid because T's employer has already withheld the appropriate FICA amount on these wages.

	Social Security
Maximum tax base	$102,000
Less: Wages subject to FICA tax	(68,000)
Reduced maximum tax base	$ 34,000
Net earnings from self-employment	$ 40,000
Subtract: 7.65% of net earnings from self-employment	(3,060)
	$ 36,940
Smaller of reduced maximum tax base or amount determined above	$ 34,000
Times: Social security tax rate	× 12.4%
Tax on social security component	$ 4,216
Social security tax	$ 4,216
Plus: MHI tax ($36,940 × 2.9%)	1,071
Equals: T's self-employment tax	$ 5,287

T will also have an income tax deduction of $2,644 (one-half of the $5,287 self-employment taxes paid).

FUTA Taxes. A Federal unemployment tax is imposed on employers who pay wages of $1,500 or more during any calendar quarter in the calendar year, or who employ at least one individual on each of some 20 days during the calendar year or previous year.[29] Certain exceptions are made for persons employing agricultural or domestic workers.

FUTA tax revenues are used by the Federal government to augment unemployment benefit programs of the various states. The current FUTA tax rate is 6.2 percent of the first $7,000 of wages paid during the year to each covered employee. This translates into a *maximum* FUTA tax of $434 (6.2% × $7,000) *per employee* per year. Since most states also impose an unemployment tax on employers, a credit is allowed against an employer's FUTA tax liability for any similar tax paid to a state. Currently, the maximum FUTA tax credit allowed for this purpose is 5.4 percent of the covered wages

29 § 3306(a)(1).

(i.e., maximum of \$378 per employee). Thus, the maximum FUTA tax paid is normally \$56 (\$434 – \$378, or 0.8% × \$7,000) per employee.

All employers subject to FUTA taxes must file Form 940, Employer's Annual Federal Unemployment Tax Return, on or before January 31 of the following year. If the employer's tax liability exceeds certain limits, estimated tax payments must be made during the year.[30] Most states require an employer to file unemployment tax returns and make tax payments quarterly.

EXCISE TAXES

The purpose of an excise tax is to tax certain privileges as well as the manufacture, sale, or consumption of specified commodities. Federal excise taxes are imposed on the sale of specified articles, various transactions, occupations, and the use of certain items. This type of tax is not imposed on the profits of a business or profession, however. The major types of excise taxes are as follows:

1. Occupational taxes;
2. Facilities and services taxes;
3. Manufacturers' taxes; and
4. Retail sales of products and commodities taxes.

Occupational Taxes. Some businesses must pay a fee before engaging in their business. These types of businesses include, but are not limited to, liquor dealers, dealers in medicines and dealers in firearms.

Facilities and Services Taxes. The person who pays for services and facilities must pay the tax on these items. The institution or person who furnishes the facilities or services must collect the tax, file returns, and turn over the taxes to the taxing authorities. A few of the common services subject to the facilities and services excise tax include air travel, hotel or motel lodging, and telephone service.

Manufacturers' Taxes. As a rule, certain manufactured goods are taxed at the manufacturing level to make collection easier. Most of these items are of a semi-luxurious or specialized nature, such as sporting goods or firearms. This excise tax applies to the sale or use by the manufacturer, producer, or importer of specified articles. The taxes may be determined by quantity of production (e.g., pounds or gallons) or by a percentage of the sales price. When sales price is used as an index, the tax is based on the sales price of the manufacturer, producer, or importer.

Retail Sales of Products and Commodities Taxes. This excise tax applies to the retail sale or use of diesel fuel, special motor fuels, and fuel used in noncommercial aviation. The tax is collected from the person buying the product by the seller, and the seller must file and pay the tax unless the buyer purchased it tax-free.

State Excise Taxes. Many states and local governments also have excise taxes. They vary in range of coverage and impact, but most parallel the Federal excise taxes. For instance, most states have an excise tax on gasoline, liquor, and cigarettes, as does the Federal government.

[30] See instructions in Circular E, *Supra*, Footnote 25.

ADDITIONAL TYPES OF TAXES

Many other types of taxes are used to augment state, local, and Federal income, employment, excise, and wealth transfer taxes. The three levels of government have never been reluctant to exercise their imagination in creating and developing new ways of supplementing governmental revenues. A few of the other more common types of taxes are briefly explained below.

Franchise Tax. A franchise tax is a tax on the privilege of doing business in a state or local jurisdiction. The measure of the tax generally is the net income of the business or the value of the capital used within the taxing authority's jurisdiction.

Sales Tax. A sales tax is imposed on the gross receipts from the retail sale of tangible personal property (e.g., clothing, automobiles, and equipment) and certain services. Each state or local government determines the tax rate and the services and articles to be taxed. The seller will collect the tax from the consumer at the time of the sale, and then periodically remit the taxes to the appropriate taxing authority. Often a state or local government allows the seller to retain a nominal percentage of the collected taxes to compensate for the additional costs incurred by the seller in complying with the tax requirements.

Use Tax. A use tax is a tax imposed on the use within a state or local jurisdiction of tangible property on which a sales tax was not paid. The tax rate normally equals that of the taxing authority's sales tax.

Doing-Business Penalty. This penalty tax is imposed on a business that has not obtained authorization from the state or local government to operate within its border. Usually, a business must pay a fee for a state charter or some other kind of license as permission to enter business within the state.

Real Property Tax. A real property tax is a tax on the value of realty (land, buildings, homes, etc.) owned by nonexempt individuals or organizations within a jurisdiction. Rates vary with location. This type of tax normally supports local services, such as the public school system or the fire department, and is levied on a recurring annual basis.

Tangible Personal Property Tax. This tax is levied on the value of tangible personalty located within a jurisdiction. Tangible personalty is property not classified as realty and includes such items as office furniture, machinery and equipment, inventories, and supplies. The tax normally must be paid annually, with each local jurisdiction determining its own tax rate and the items to tax.

Intangible Personal Property Tax. This tax is imposed on the value of intangible personalty (i.e., stocks, bonds, and accounts and notes receivable) located within a jurisdiction. The tax generally is paid annually, with each local jurisdiction setting its own tax rate and items to be taxed.

GOALS OF TAXATION

In subsequent chapters, the specific provisions that must be followed to compute the Federal income tax will be discussed in detail. Some may view this discussion as a hopeless attempt to explain what seems like an endless barrage of boring rules—rules that, despite their apparent lack of "rhyme or reason," must be considered if the final tax liability is to be determined. The frustration that students of taxation often feel when studying the rules of Federal tax law is not completely unfounded. Indeed, a famous tax scholar, Boris Bittker, once commented on the increasing intricacy of the tax law, saying, "Can one hope to find a way through a statutory thicket so bristling with detail?"[31] As this statement suggests, many provisions of the law are, in fact, obscure and often appear to be without purpose. However, each provision of the tax law originated with some goal, even if no more than to grant a benefit to some Congressperson's constituency. A knowledge of the goals underlying a particular provision is an important first step toward a comprehension of the provision. An understanding of the purpose of the law is an invaluable tool in attacking the "statutory thicket." In studying taxation, it becomes apparent that many provisions have been enacted with similar objectives. The following discussion reviews some of the goals of taxation that often serve as the reasons behind the rule.

ECONOMIC OBJECTIVES

At first glance, it seems clear that the primary goal of taxation is to provide the resources necessary to fund governmental expenditures. At the Federal level, however, this is not entirely true. As many economists have pointed out, any taxing authority that has the power to control the money supply—as does our Federal government—can satisfy its revenue needs by merely creating money. Nevertheless, complete reliance on the Treasury's printing press to provide the needed resources is not a viable alternative. If the government's expenditures were financed predominantly with funds that it created rather than those obtained through taxation, excess demand would result, which in turn would cause prices to rise, or inflation. Thus, taxation in serving a revenue function also operates along with other instruments of policy to attain a stable price level.

Although Congress can create its own resources, revenue objectives often can explain a particular feature of the law. Consider the personal and dependency exemption deductions, the purpose of which is to free from tax the income needed to maintain a minimum standard of living. Although the cost of living has risen substantially over the years, Congress has been reluctant to increase the amount of these exemptions. The exemption deduction was set at $600 from 1948 to 1969. It slowly crept to $1,000 in 1979 where it essentially stayed until Congress started requiring inflation adjustments in 1985. In effect, the deduction has changed very little over the years, despite significant increases in the price level during this time. The reluctance to alter the exemption amount derives primarily from the potential impact on revenues. A slight increase in the exemption without a corresponding increase in revenues from other sources would result in a tremendous revenue loss because of the number of exemptions taxpayers claim—approximately 259 million in 2002. For similar reasons, Congress has refrained, until recently, from adjusting the tax rate schedules to compensate for inflation, since to do so would significantly reduce its inflow of resources. In 1985, however, both the personal and dependency exemption amount, the standard deduction *and* the individual tax rate schedules were adjusted (indexed) for the increase in the Consumer Price Index that occurred during the previous year.

Revenue considerations also can explain why tax accounting methods sometimes differ from those used for financial accounting. Prior to 1954, an accrual basis taxpayer could neither defer taxation of prepaid income nor deduct estimates of certain expenses, such as the expected costs of servicing warranty contracts. In 1954, the treatment of such items was changed to conform with financial accounting principles that permit deferral of income and accrual of expenses in most situations. The expected revenue loss attributed to this change was $50 million. Within a year after the change, however, the Treasury requested that Congress repeal the new provisions retroactively because estimates of the

31 Boris I. Bittker and Lawrence M. Stone, *Federal Income Taxation*, 5th Ed. (Boston: Little, Brown & Co., 1980) 1iii.

revenue loss were in excess of several billion dollars. In short, Congress responded and, as a result, the treatment of prepaid income and certain accruals for tax and financial accounting purposes differs—a difference attributable to revenue considerations.

The role of Federal taxation in carrying out economic policy extends beyond the realm of revenue raising and price stability. Taxation is a major tool used by the government to attain satisfactory economic growth with full employment. The title of the 1981 tax bill is illustrative: *The Economic Recovery Tax Act of 1981* (ERTA). As the title suggests, a major purpose of this legislation was directed toward revitalizing the health of the economy. ERTA significantly lowered tax rates to spur the economy out of a recession. Its objective was to place more *after-tax* income in the hands of taxpayers for their disposal. By so doing, it was hoped that taxpayers would consume more and thus increase aggregate demand, resulting in economic growth.

Congress also has used the tax structure to directly attack the problem of unemployment. In 1977, employers were encouraged to increase employment by the introduction of a general jobs tax credit, which effectively reduced the cost of labor. In 1978, Congress eliminated the general jobs credit and substituted a targeted jobs credit. This credit could be obtained only if employers hired certain targeted groups of individuals who were considered disadvantaged or handicapped. This credit was expanded in 1983 to stimulate the hiring of economically disadvantaged youth during the summer. The credit was further refined and is now referred to as the work opportunity credit. As the credit for jobs suggests, Congress believes that major economic problems can be solved using the tax system.

A subject closely related to economic growth and full employment is investment. To stimulate investment spending, Congress has enacted numerous provisions. For example, accelerated depreciation methods—the modified accelerated cost recovery system (MACRS)—may be used to compute the deduction for depreciation, thus enabling rapid recovery of the taxpayer's investment.

Congress encourages certain industries by granting them favorable tax treatment. For example, the credit for research and experimental expenditures cited above clearly benefits those engaged in technology businesses. Other tax provisions are particularly advantageous for other groups such as builders, farmers, and producers of natural resources. Special incentives also are available for manufacturers. As will become clear in later chapters, the income tax law is replete with rules designed to encourage, stimulate, and assist various enterprises as Congress has deemed necessary over the years.

SOCIAL OBJECTIVES

The tax system is used to achieve not only economic goals but social objectives as well. Some examples are listed below:

1. The deduction for charitable contributions helps to finance the cost of important activities that otherwise would be funded by the government.
2. The deduction for interest on home mortgages subsidizes the cost of a home and thus encourages home ownership.
3. The work opportunity credit noted above exists to fight unemployment problems of certain disadvantaged groups of citizens.
4. Larger standard deductions are granted to taxpayers who are 65 or over, or who are blind, to relieve their tax burden.

5. Deductions for contributions to retirement savings accounts encourage individuals to provide for their future needs.

These examples are representative of the many provisions where social considerations provide the underlying rationale.

The above discussion is but a brief glimpse of how social and economic considerations have shaped our tax law. Interestingly, most of the provisions mentioned have been enacted in the past 25 years. During this time, Congress has relied increasingly on the tax system as a means to strike at the nation's ills. Whether the tax law can be used successfully in this manner is unclear. Many believe that attacking such problems should be done directly through government expenditure programs—not through so-called *tax expenditures*. A *tax expenditure* is the estimated amount of revenue lost for failing to tax a particular item (e.g., scholarships), for granting a certain deduction (e.g., charitable contributions), or for allowing a credit (e.g., work opportunity credit). The concept of tax expenditures was developed by noted tax authority Stanley S. Surrey. While Assistant Secretary of the Treasury for Tax Policy during 1961–1969, Surrey and his supporters urged that certain activities should not be encouraged by subsidizing them through reduced tax liabilities. They argued that paying for government-financed activities in such a roundabout fashion makes their costs difficult if not impossible to determine. In addition, they asserted that such expenditures are concealed from the public eye as well as from the standard budgetary review process.[32] Others, however, argued that the tax system could be used effectively for this purpose. Whether either view is correct, Congress currently shows no apparent signs of discontinuing use of the tax system to influence taxpayers' behavior.

OTHER OBJECTIVES

Although social and economic goals provide the rationale for much of our tax law, many provisions can be explained in terms of certain well-established principles of taxation. These principles are simply the characteristics that "good" taxes exhibit. Most tax experts agree that a tax is good if it satisfies the following conditions:[33]

1. The tax is *equitable* or fair;
2. The tax is *economically efficient* (i.e., it advances a goal where appropriate and otherwise is as neutral as possible);
3. The tax is *certain* and not arbitrary;
4. The tax can be administered by the government and complied with by the taxpayer at a *low cost* (i.e., it is *economical* to operate); and
5. The tax is *convenient* (i.e., administration and compliance can be carried out with the utmost simplicity).

These five qualities represent important principles of taxation that must be conformed with in pursuing social and economic goals. As discussed below, these criteria have greatly influenced our tax law.

Equity. A tax system is considered equitable if it treats all persons who are in the same economic situation in the same fashion. This aspect of equity is referred to as *horizontal equity*. In contrast, *vertical equity* implies that taxpayers who are not in the same situation will be treated differently—the difference in treatment being fair and just.

---

32 The annual U.S. budget now contains a projection of annual tax expenditures.

33 These qualities were first identified by Adam Smith. See The *Wealth of Nations*, Book V, Chapter II, Part II (New York: Dutton, 1910).

There are two major obstacles in implementing the equity concept as explained. First, there must be some method to determine when taxpayers are in the same economic situation. Second, there must be agreement on reasonable distinctions between those who are in different situations. The manner in which these obstacles are addressed explains two significant features of our tax system.

As indicated above, the first major difficulty in implementing the equity concept is identification of some technique to determine when taxpayers are similarly situated. For tax purposes, it is well settled that similarity is measured in terms of a taxpayer's *ability to pay*. Hence, taxpayers with equal abilities to pay should pay equal taxes. To the dismay of some tax policymakers, however, there is no simple, unambiguous index of an individual's ability. A taxpayer's ability to pay is the composite of numerous factors including his or her wealth, income, family situation, health, and attitude. Clearly, no one measure captures all of these factors. This being so, tax specialists generally have agreed that the best objective measure of ability to pay is income. This agreement, that income is a reasonable surrogate for ability to pay and thus serves the equity principle, explains in part why the primary tax used by the Federal government is an *income* tax.

The second obstacle in implementing the equity concept concerns the treatment of taxpayers who are differently situated. In terms of income, the problem may best be explained by reference to two taxpayers, A and B. If A's income (e.g., $100,000) exceeds B's (e.g., $20,000), it is assumed that A has more ability to pay and thus should pay more tax. The dilemma posed is not whether A and B should pay differing amounts of tax, but rather, what additional amount may be fairly charged to A. If a proportional tax of five percent is levied against A and B, A pays $5,000 (5% of $100,000) and B pays $1,000 (5% of $20,000). While application of this tax rate structure results in A paying $4,000 more than B absolutely, A pays the same amount in relative terms; that is, they both pay the *same* 5 percent. Those charged with the responsibility of developing Federal tax policy have concluded that paying more tax in absolute terms does not adequately serve the equity goal. For this reason, a progressive tax rate structure is used, requiring relatively more tax to be paid by those having more income. With respect to A and B above, this structure would require that A pay a greater percentage of his income than B.

The equity principle explains (at least partially) not only the basic structure of our predominant tax device—an income tax and its progressive tax rate structure—but also explains many other provisions in our law. In fact, some of the factors mentioned earlier that affect a taxpayer's ability to pay are recognized explicitly by separate provisions in the Code. For example, a taxpayer may deduct medical expenses and casualty losses—items over which the taxpayer has little or no power—if such items exceed a certain level. Similarly, a taxpayer's family situation is considered by allowing exemption deductions for dependents whose support is the taxpayer's responsibility.

There are many other specific situations where the equity principle controls the tax consequences. For example, fairness dictates that taxes should not be paid when the taxpayer does not have the *wherewithal to pay* (i.e., the money to pay the tax). This is true even though the transaction results in income to the taxpayer.

> **Example 27.** Upon the theft of valuable machinery, LJM Corporation received a $20,000 insurance reimbursement. Assuming the machinery had a cost (adjusted for depreciation) of $5,000, LJM has realized a $15,000 gain ($20,000 − $5,000). Although the corporation has realized a gain, it also has lost the productive capacity of the machinery. If LJM reinvests the entire $20,000 proceeds in similar assets within two years of the theft, the gain is not taxed but rather deferred. This rule derives from Congressional belief that equity would not be served if taxes were levied when the taxpayer did not have the wherewithal to pay. In addition, the taxpayer's total economic situation has not been so materially altered as to require recognition of the gain.

Administrative Concerns. The final three qualities of a good tax—certainty, economy, and simplicity—might be aptly characterized as administrative in nature. Numerous provisions exist to meet administrative goals. Some of these are so obvious as to be easily overlooked. For example, the certainty requirement underlies the provision that a tax return generally is due each April 15, while economy of collection is the purpose, at least in part, for withholding. Similarly, provisions requiring the taxpayer to compute the tax using tables provided by the IRS are motivated by concerns for simplicity.

Perhaps the most important aspect of the administrative principles is that they often conflict with other principles of taxation. Consequently, one principle must often be adhered to at the expense of another. For example, our tax system could no doubt be more equitable if each individual's ability to pay was personally assessed, much like welfare agents assess the needs of their clients. However, this improvement could be obtained only at a substantial administrative cost. The administrative principle is first in importance in this case, as well as in many others.

A PRELUDE TO TAX PLANNING

Although taxes affect numerous aspects of our lives, their impact is not uncontrollable. Given an understanding of the rules, taxes can be managed with considerable success. Successful management, however, is predicated on good tax planning.

Tax planning is simply the process of arranging one's actions in light of their potential tax consequences. It should be emphasized that the tax consequences sometimes turn on how a particular transaction is structured—that is, *form* often controls taxation.

Example 28. Z is obligated to make monthly payments of interest and principal on a note secured by his home. During the year, he was short of cash so his mother, B, who lives with Z, made the payments for him. Even though B made the payments directly, she may not deduct the interest expense because interest is deductible only if it relates to a debt for which the taxpayer is personally liable. Moreover, her son cannot deduct the expense since he did not make payment. Note that the deduction could have been obtained had the payment been structured properly. If Z had received a gift of cash from his mother and then made payment, he could have claimed the interest deduction. Alternatively, if B had been jointly liable on the note, she could have deducted the interest payments she made.

In the example above, note that regardless of how the transaction is structured, the result is the same *except for* the tax ramifications. By merely planning and changing the form of the transaction, tax benefits are obtained. Before jumping to the conclusion that form always governs taxation, a caveat is warranted. Courts often are obliged to disregard form and let substance prevail. Notwithstanding the form versus substance difficulty, the point to be gained is that the pattern of a transaction often determines the tax outcome.

The obvious goal of most tax planning is the minimization of the amount that a person or other entity must transfer to the government. The legal minimization of taxes is usually referred to as *tax avoidance*. Although the phrase "tax avoidance" may have a criminal connotation, there is no injustice in legally reducing one's taxes. The most profound statement regarding the propriety of tax avoidance is found in a dissenting opinion authored by Judge Learned Hand in the case of *Commissioner v. Newman*. Judge Hand wrote:[34]

[34] 159 F.2d 848 (CA-2. 1947).

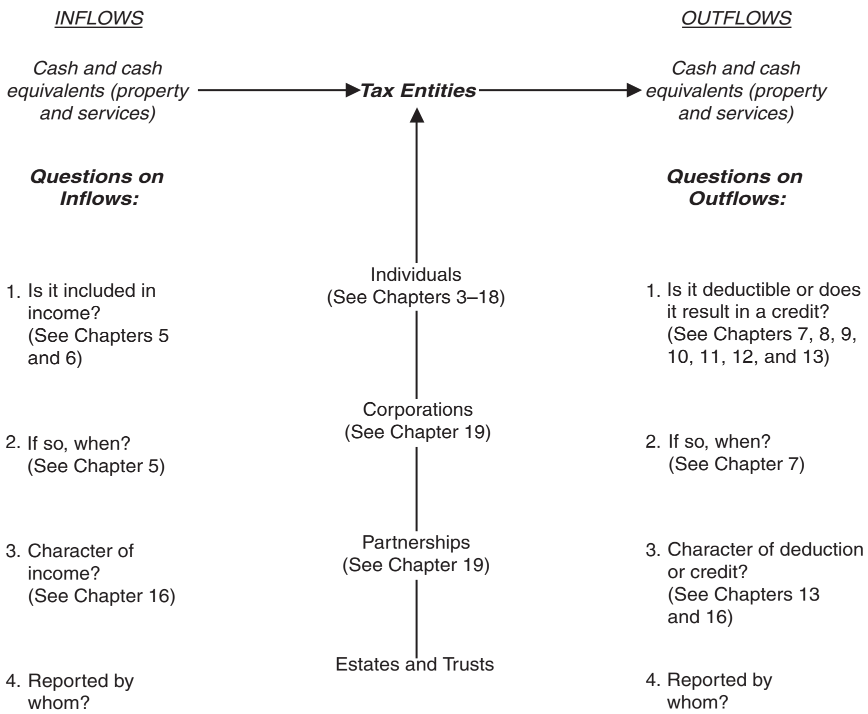
> Over and over again courts have said that there is nothing sinister in so arranging one's affairs so as to keep taxes as low as possible. Everybody does so, rich or poor, and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary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

This statement is routinely cited as authority for taking those steps necessary to reduce one's taxes. It should be emphasized that tax planning and tax avoidance involve only those actions that are legal. *Tax evasion* is the label given to illegal activities that are designed to reduce the tax liability.

The planning effort for Federal income taxation (the principal area covered in this text) requires an understanding of the answer to *four* basic questions regarding the flow of cash and cash equivalents into and out of various tax entities. These questions regard the amount, character, and timing of income, deductions and credits, and recognition (reporting) of these items. The answers depend upon the tax entity that receives or transfers the cash or cash equivalents, its tax accounting period and methods, and whether the entity is considered a taxpayer separate from its owners or simply a conduit through which items of income, gain, loss, deduction, or credit flow to its owners. The tax entities recognized for Federal tax purposes, and the tax planning questions, are presented in Exhibit 1-6.

Tax planning efforts often involve deferring the recognition of income or shifting the incidence of its tax to a lower tax bracket entity (e.g., from parents to children), or accelerating, deferring, or shifting deductions and credits to tax periods or among tax entities with higher or lower tax rates. Keeping this overall scheme of tax minimization in mind, many of the subsequent chapters of this text conclude with a discussion of tax planning considerations.

EXHIBIT 1-6
Tax Planning Perspective



PROBLEM MATERIALS

DISCUSSION QUESTIONS

1-1 *Tax Bases.* Describe the tax bases for the Federal income tax and for each of the Federal wealth transfer taxes.

1-2 *Tax Rates.* Distinguish between a proportional tax rate structure and a progressive tax rate structure. What is the significance of the marginal tax rate under either a proportional or a progressive rate structure?

1-3 *Progressive, Proportional, and Regressive Taxes.* The media often refer to sales taxes as regressive. Similar comments are made when discussing social security taxes (FICA). Are the media correct? Include in your comments an explanation of the different types of tax rate structures.

1-4 *Deduction vs. Credit.* Distinguish between a deduction and a credit. If a credit is allowed for 20 percent of an expenditure in lieu of a deduction for the total expenditure, under what circumstances should you prefer the credit? The deduction?

1-5 *Individual vs. Corporate Taxable Income.* Based on the tax formulas contained in Exhibits 1-2 and 1-3, what are the significant differences in computing a corporation's taxable income as opposed to computing an individual's taxable income?

1-6 *Withholding Taxes at Source.* What do you believe is the principal reason that Congress continues the pay-as-you-go requirements of employers withholding Federal income taxes from the wages paid their employees?

1-7 *Marital Deduction.* Describe the marital deduction allowed for Federal estate and gift taxes. How might an individual use this deduction to avoid all Federal wealth transfer taxes?

1-8 *Estate Tax Credit.* How is the estate transfer tax credit applied in determining taxable wealth transfers?

1-9 *Annual Gift Tax Exclusion.* What is the amount of the annual Federal gift tax exclusion? If a widow were interested in making gifts to her daughter and seven grandchildren, how much could she transfer to them in any given year before incurring a taxable gift?

1-10 *Gift-Splitting Election.* What is the gift-splitting election allowed for Federal gift tax purposes? How might the marital deduction be used to explain why Congress allows this election?

1-11 *Estate vs. Inheritance Taxes.* Distinguish between an estate and an inheritance transfer tax.

1-12 *Federal Employment Taxes.* Distinguish between FICA and FUTA taxes. Between an employee and his or her employer, who bears the greater burden of these taxes?

1-13 *Unemployment Taxes.* For 2008 what is the maximum FUTA tax an employer can expect to pay if he or she has three employees during the year and the minimum salary paid is $10,000? If the employer also is subject to state unemployment taxes, what is the maximum amount of credit he or she will be allowed against the FUTA tax liability?

1-14 *Sales vs. Use Tax.* Distinguish between a sales and a use tax. Assume you live in state A but near the border of state B and that state A imposes a much higher sales tax than does state B. If you were planning to purchase a new automobile, what might you be tempted to do? How might state A discourage your plan?

1-15 *Tax Expenditures.* It is often suggested that many of our social problems can be cured through use of tax incentives.
- **a.** Discuss the concept of tax expenditures.
- **b.** Expand on the text's discussion of the pros and cons of tax expenditures vis-a-vis direct governmental expenditures.

1-16 *Goals of Taxation.* In a recent discussion concerning what a fair tax is, the following comments were made: (1) the fairest tax is one that someone else has to pay; (2) people should be taxed in accordance with the benefits they obtain (i.e., taxes are the price paid for the benefit); (3) a head tax would be the fairest; and (4) why tax at all?—just use the printing press. Discuss the first three of these comments in terms of equity and explain whether the fourth represents a viable alternative.

PROBLEMS

1-17 *Marginal Tax Rates.* T, a single taxpayer, has taxable income of $40,000 for 2008. If T anticipates a marginal tax rate of 15 percent for 2009, what income tax savings could she expect by accelerating $1,000 of deductible expenditures planned for 2009 into the 2008 tax year?

1-18 *Tax Rate Schedules and Rate Concepts.* An examination of the tax rate schedules for single taxpayers (see the inside cover of the text) indicates that the tax is a "given dollar amount" plus a percentage of taxable income exceeding a particular level.
- **a.** Explain how the "given dollar amounts" are determined.
- **b.** Assuming the taxpayer has a taxable income of $50,000 and is single, what is his tax liability for 2008?
- **c.** Same facts as (b). What is the taxpayer's marginal tax rate?
- **d.** Same facts as (b). What is the taxpayer's average tax rate?
- **e.** Assuming the taxpayer has tax-exempt interest income from municipal bonds of $30,000, what is the taxpayer's effective tax rate?

1-19 *Tax Equity.* Taxpayer R has a taxable income of $20,000. Similarly, S has a taxable income of $20,000. Each taxpayer pays a tax of $1,000 on his income.
- **a.** Discuss whether the tax imposed is equitable. Include in your discussion comments concerning horizontal and vertical equity.
- **b.** Assume S has a taxable income of $40,000 and pays a tax of $2,000 on his income. Discuss whether the tax imposed is equitable in light of this new information.

1-20 *Tax Fairness.* R and S both own homes in Houston. Both have an appraised value of $200,000 and, consequently, both R and S pay $5,000 in real property taxes. Explain why such a tax may be considered fair by some and unfair by others.

1-21 *Understanding Tax Rate Concepts.* Indicate whether the following statements are true or false and, if false, explain why.
- **a.** Tax-exempt income would cause the taxpayer's average tax rate to increase.
- **b.** Tax-exempt income would cause the taxpayer's marginal tax rate to decrease.
- **c.** Tax-exempt income would cause the taxpayer's effective tax rate to decrease.

1-22 *Understanding Tax Rate Concepts.* Indicate whether the following statements are true or false and, if false, explain why.

a. From a technical point of view, sales taxes are progressive.
b. From a popular point of view, sales taxes are regressive.
c. From a popular point of view, sales taxes are proportional.
d. From a technical point of view, there are no regressive taxes in the United States.

1-23 *Think Tax.* From a tax perspective, a transaction that may make sense for one taxpayer may be complete nonsense for another. Consider two married taxpayers, H and W who earn $500,000 per year and L and M who earn $20,000 per year. Both plan on buying interest-paying bonds with a face value of $1,000, either State of Indiana bonds paying 6% tax-exempt interest or AT&T bonds paying eight percent taxable interest. Assume the bonds are in all other respects equivalent (e.g., price, risk, etc.). Show (with calculations) why it would make perfect sense for H and W to buy the Indiana bonds but it would be foolish for L and M to buy the Indiana bonds.

1-24 *Identifying Tax Expenditures.* Indicate whether the following would be considered a tax expenditure.

a. Tax deduction allowed for payment of gasoline purchased by a taxicab driver who owns and operates his own taxicab business.
b. Deduction for charitable contributions made by individual taxpayers.
c. Postponement of taxation of income earned on an individual's savings in an Individual Retirement Account until such income is distributed.
d. Straight-line depreciation of an office building used in a trade or business.
e. Tax credit for purchase of electric automobile.
f. Deduction for interest paid on a home mortgage.

1-25 *Advantages and Disadvantages of Tax Expenditures.* Indicate whether the following would be considered an advantage or disadvantage of a tax expenditure.

a. Administrative costs less than other forms of government financial assistance
b. Beneficiaries easily identified
c. Only those entitled to financial assistance receive it
d. Costs and budgetary effects readily assessed
e. Benefits (e.g., from deductions) rise and fall without direct approval from the government
f. Less palatable to beneficiaries
g. Effect on tax system

1-26 *Taxable Gifts.* M made the following cash gifts during 2008:

To her son	$50,000
To her daughter	50,000
To her niece	10,000

a. If M is unmarried, what is the amount of taxable gifts she has made in 2008?
b. If M is married and her husband agrees to split gifts with her, what is the total amount of taxable gifts made by M and her husband for 2008?

1-27 *Taxable Estate.* R dies in 2008. R made taxable gifts during his lifetime in 1987, 1988, 1990, 1994, and 1996 but paid no Federal transfer taxes due to the unified transfer tax credit in effect in those years. What effect will these taxable gifts have on determining the following:

a. R's Federal taxable estate?
b. The rates imposed on the Federal taxable estate?

1-28 *Estate Tax Computation.* T died on January 4, 2008. He owned the following property on his date of death:

Cash	$2,500,000
Stocks and bonds	700,000
Residence	800,000
Interest in partnership	350,000
Miscellaneous personal property	25,000

Upon T's death, he owed $80,000 on the mortgage on his residence. T also owned a life insurance policy. The policy was term life insurance which paid $200,000 to his mother upon his death. Its value immediately before his death was $0. T had all of the incidents of ownership with regard to the policy.

During his life, T had made only one gift. He gave a diamond ring worth $30,000 (it was an old family heirloom) to his daughter in 1995. No gift taxes were paid on the gift due to the annual exclusion (gift-splitting was elected) and the unified transfer tax credit in effect for that year. The ring was worth $50 000 on his date of death.

T's will contained the following provisions:

a. To my wife I leave all of the stocks and bonds.

b. To my alma mater, State University, I leave $50,000 to establish a chair for a tax professor in the Department of Accounting in the School of Business.

c. The residue of my estate is to go to my daughter.

Compute T's estate tax before any credits other than the Federal estate tax credit.

1-29 *Inheritance Taxes.* This year Bob died, leaving $500,000 to his heirs. His state of residence imposes an inheritance tax. Indicate whether the following statements are true or false and, if false, explain why. Consider using the Internet to find information on how the inheritance tax laws of your state operate.

a. The amount of the inheritance tax is $0 since Bob's estate does not exceed the 2008 taxable threshold of $2 million.

b. Assume Bob is single. The amount of inheritance tax due from Bob's estate, like the Federal estate tax, is the same regardless of whom he names as the beneficiaries.

c. Assume Bob is married. The amount of inheritance tax due from Bob's estate—like the Federal estate tax—is zero if he leaves the entire amount to his surviving spouse or children.

d. Any inheritance tax paid by Bob's estate may be used to reduce any Federal estate tax his estate owes.

1-30 *Excess FICA Taxes.*During 2008 E earned $70,000 of wages from employer X and $30,000 of wages from employer Y. Both employers withheld and paid the appropriate amount of FICA taxes on E's wages.

a. What is the amount of excess taxes paid by E for 2008?

b. Would it make any difference in the amount of E's refund or credit of the excess of FICA taxes if he was a full-time employee of each employer for different periods of the year, as opposed to a full-time employee of X and a part-time employee of Y for the entire year?

1-31 *Self-Employment Tax.* During 2008 H had earnings from self-employment of $50,000 and wages of $78,000 from employer X. Employer X withheld and paid the appropriate amount of FICA taxes on H's wages. Compute H's self-employment tax liability for 2008. What is the amount of H's income tax deduction for the self-employment taxes paid?

1-32 *Tax Awareness.* Assume that you are currently employed by Corporation X in state A. Without your solicitation, Corporation Y offers you a 20 percent higher salary if you will relocate to state B and become its employee. What tax factors should you consider in making a decision as to the offer?