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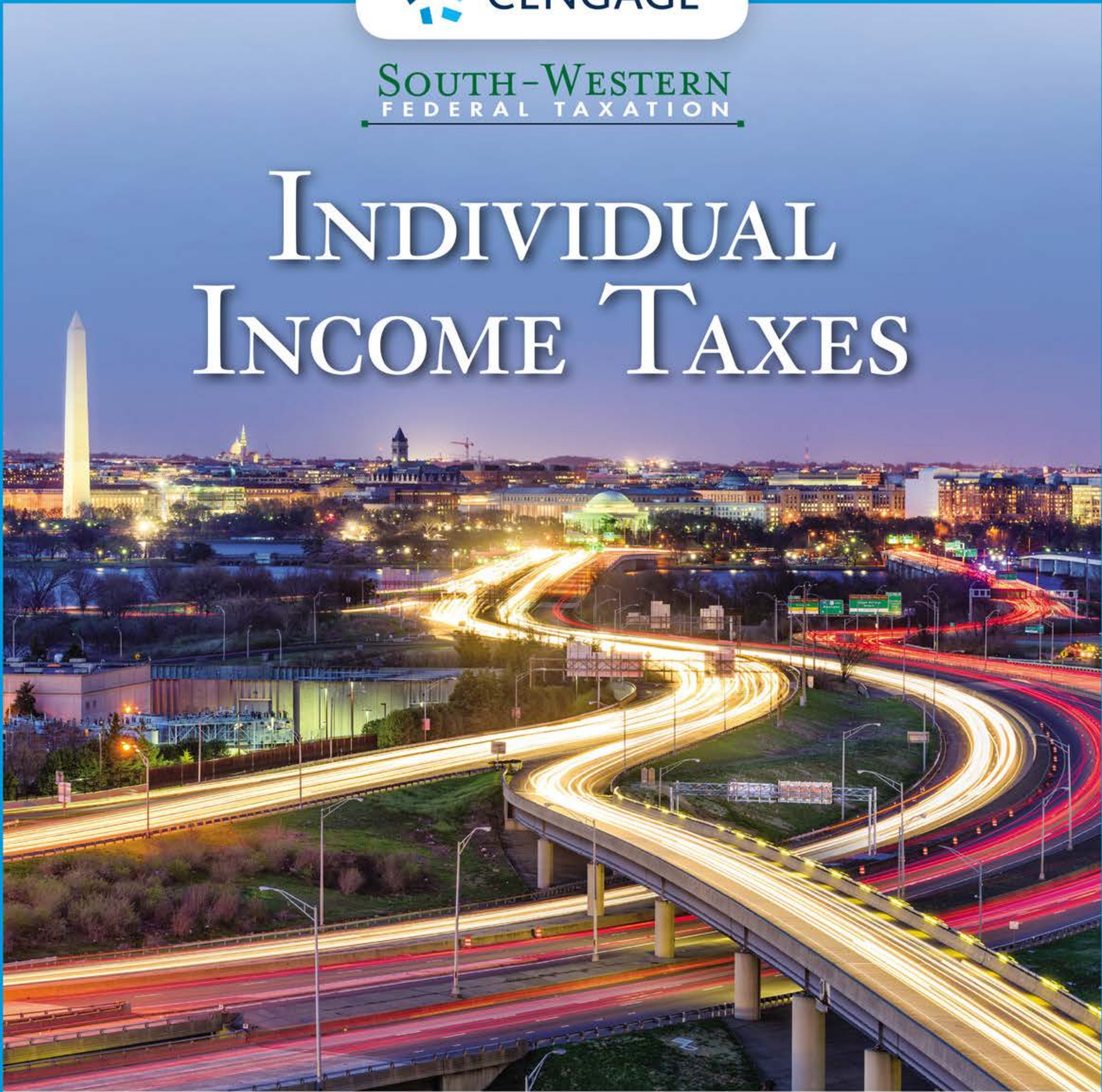
FEDERAL TAXATION

INDIVIDUAL INCOME TAXES



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2022

2020 Tax Rate Schedules

Single—Schedule X

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 9,875	.........10%	$ 0
9,875	40,125	$ 987.50 + 12%	9,875
40,125	85,525	4,617.50 + 22%	40,125
85,525	163,300	14,605.50 + 24%	85,525
163,300	207,350	33,271.50 + 32%	163,300
207,350	518,400	47,367.50 + 35%	207,350
518,400	....	156,235.00 + 37%	518,400

Head of household—Schedule Z

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 14,100	.........10%	$ 0
14,100	53,700	$ 1,410.00 + 12%	14,100
53,700	85,500	6,162.00 + 22%	53,700
85,500	163,300	13,158.00 + 24%	85,500
163,300	207,350	31,830.00 + 32%	163,300
207,350	518,400	45,926.00 + 35%	207,350
518,400	....	154,793.50 + 37%	518,400

Married filing jointly or Qualifying widow(er)—Schedule Y–1

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 19,750	.........10%	$ 0
19,750	80,250	$ 1,975.00 + 12%	19,750
80,250	171,050	9,235.00 + 22%	80,250
171,050	326,600	29,211.00 + 24%	171,050
326,600	414,700	66,543.00 + 32%	326,600
414,700	622,050	94,735 .00 + 35%	414,700
622,050	....	167,307.50 + 37%	622,050

Married filing separately—Schedule Y–2

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 9,875	.........10%	$ 0
9,875	40,125	$ 987.50 + 12%	9,875
40,125	85,525	4,617.50 + 22%	40,125
85,525	163,300	14,605.50 + 24%	85,525
163,300	207,350	33,271.50 + 32%	163,300
207,350	311,025	47,367.50 + 35%	207,350
311,025	....	83,653.75 + 37%	311,025

2021 Tax Rate Schedules

Single—Schedule X

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 9,950	.........10%	$ 0
9,950	40,525	$ 995.00 + 12%	9,950
40,525	86,375	4,664.00 + 22%	40,525
86,375	164,925	14,751.00 + 24%	86,375
164,925	209,425	33,603.00 + 32%	164,925
209,425	523,600	47,843.00 + 35%	209,425
523,600	....	157,804.25 + 37%	523,600

Head of household—Schedule Z

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 14,200	.........10%	$ 0
14,200	54,200	$ 1,420.00 + 12%	14,200
54,200	86,350	6,220.00 + 22%	54,200
86,350	164,900	13,293.00 + 24%	86,350
164,900	209,400	32,145.00 + 32%	164,900
209,400	523,600	46,385.00 + 35%	209,400
523,600	....	156,355.00 + 37%	523,600

Married filing jointly or Qualifying widow(er)—Schedule Y–1

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 19,900	.........10%	$ 0
19,900	81,050	$ 1,990.00 + 12%	19,900
81,050	172,750	9,328.00 + 22%	81,050
172,750	329,850	29,502.00 + 24%	172,750
329,850	418,850	67,206.00 + 32%	329,850
418,850	628,300	95,686.00 + 35%	418,850
628,300	....	168,993.50 + 37%	628,300

Married filing separately—Schedule Y–2

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 9,950	.........10%	$ 0
9,950	40,525	$ 995.00 + 12%	9,950
40,525	86,375	4,664.00 + 22%	40,525
86,375	164,925	14,751.00 + 24%	86,375
164,925	209,425	33,603.00 + 32%	164,925
209,425	314,150	47,843.00 + 35%	209,425
314,150	....	84,496.75 + 37%	314,150

Tax Formula for Individuals

Income (broadly defined)	$xx,xxx
Less: Exclusions	(x,xxx)
Gross income	$xx,xxx
Less: Deductions *for* adjusted gross income	(x,xxx)
Adjusted gross income	$xx,xxx
Less: The greater of— Total itemized deductions *or* standard deduction	(x,xxx)
Less: Personal and dependency exemptions*	(x,xxx)
Deduction for qualified business income**	(x,xxx)
Taxable income	$xx,xxx
Tax on taxable income	$ x,xxx
Less: Tax credits (including Federal income tax withheld and prepaid)	(xxx)
Tax due (or refund)	$ xxx

*Exemption deductions are not allowed from 2018 through 2025.
**Only applies from 2018 through 2025.

Note: For 2021, individuals using the standard deduction may also subtract *from* adjusted gross income, cash charitable contributions of up to $300 ($600 if married, filing jointly).

Basic Standard Deduction Amounts

Filing Status	2020	2021
Single	$12,400	$12,550
Married, filing jointly	24,800	25,100
Surviving spouse	24,800	25,100
Head of household	18,650	18,800
Married, filing separately	12,400	12,550

Amount of Each Additional Standard Deduction

Filing Status	2020	2021
Single	$1,650	$1,700
Married, filing jointly	1,300	1,350
Surviving spouse	1,300	1,350
Head of household	1,650	1,700
Married, filing separately	1,300	1,350

Personal and Dependency Exemption

2020	2021
$4,300	$4,300

Note: Exemption deductions have been suspended from 2018 through 2025. However, the personal and dependency exemption amount is used for other purposes (including determining whether a "qualifying relative" is a taxpayer's dependent).

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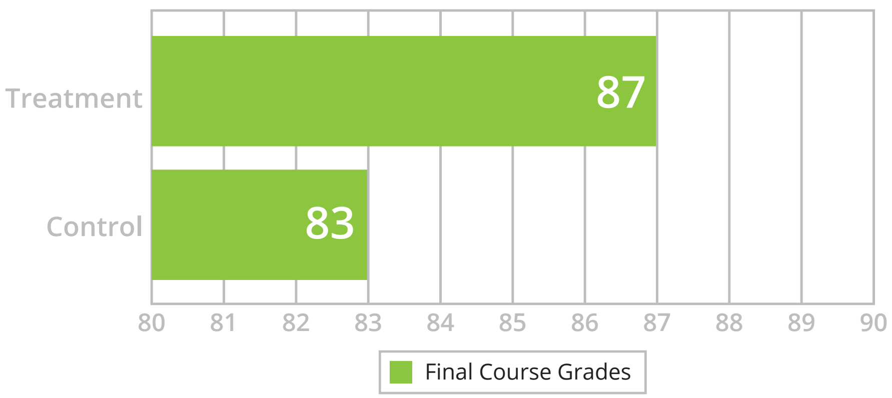

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"I love the check your work option. Really, when you're having a hard time figuring out an answer, sometimes working backwards is the best way to understand conceptually what you're doing wrong."

Brad Duncan
University of Utah

"[I liked]...the read-a-loud option with the ebook... This helped when first starting a chapter and then when studying for tests."

Jennifer Loughren
Student,
Northeast Iowa Community College

AMT Formula for Individuals

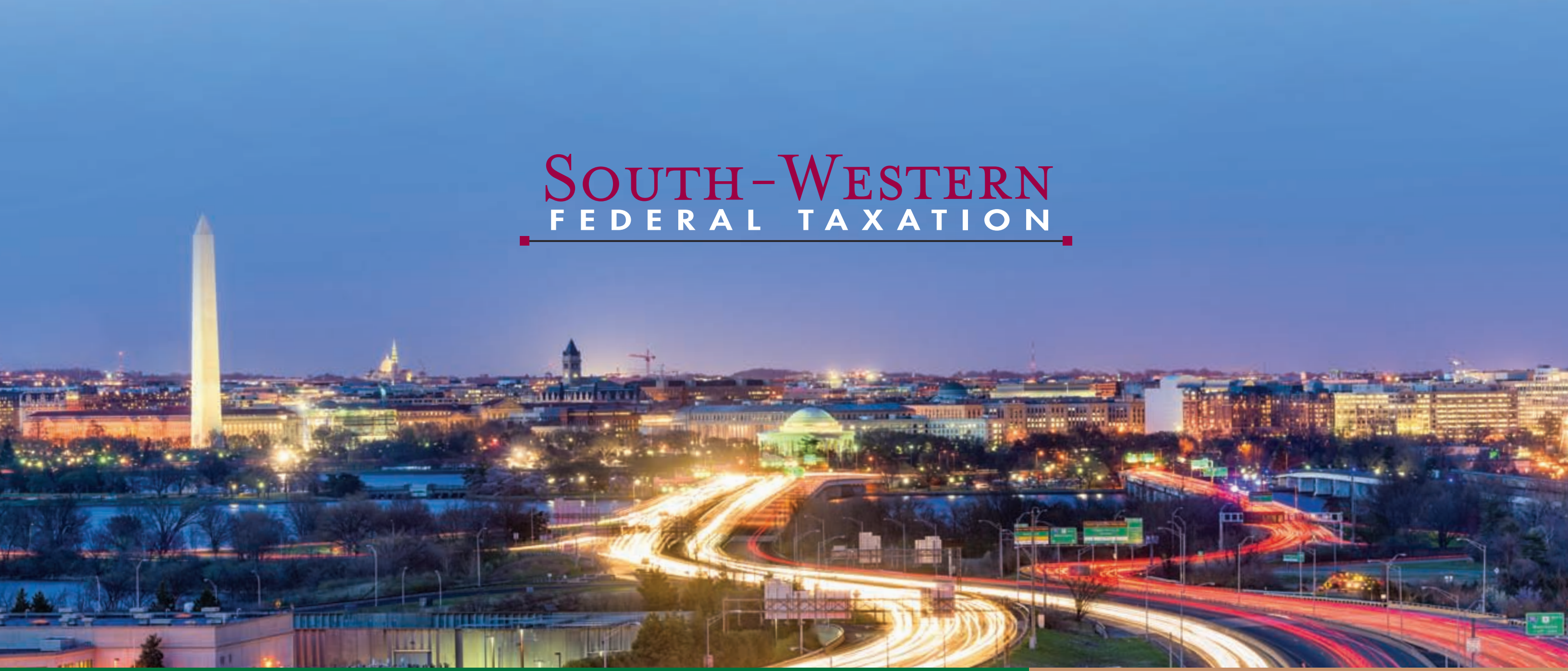
Taxable income (increased by any standard deduction taken)
Plus or minus: Adjustments
Plus: Preferences
Equals: Alternative minimum taxable income (AMTI)
Minus: Exemption
Equals: Alternative minimum tax (AMT) base
Multiplied by: 26% or 28% rate
Equals: Tentative minimum tax before foreign tax credit
Minus: AMT foreign tax credit
Equals: Tentative minimum tax (TMT)
Minus: Regular tax liability (less any foreign tax credit)
Equals: AMT (if TMT > regular tax liability)

2020 AMT Exemption and Phaseout for Individuals

		Phaseout	
Filing Status	**Exemption**	**Begins at**	**Ends at**
Married, filing jointly	$113,400	$1,036,800	$1,490,400
Single or Head of household	72,900	518,400	810,000
Married, filing separately	56,700	518,400	745,200

2021 AMT Exemption and Phaseout for Individuals

		Phaseout	
Filing Status	**Exemption**	**Begins at**	**Ends at**
Married, filing jointly	$114,600	$1,047,200	$1,505,600
Single or Head of household	73,600	523,600	818,000
Married, filing separately	57,300	523,600	752,800



INDIVIDUAL INCOME TAXES 2022

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South-Western Federal Taxation: Individual Income Taxes, 2022 Edition

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Preface

COMMITTED TO EDUCATIONAL SUCCESS

South-Western Federal Taxation (SWFT) is the most trusted and best-selling series in college taxation. We are focused exclusively on providing the most useful, comprehensive, and up-to-date tax texts, online study aids, tax preparation tools, and research tools to help instructors and students succeed in their tax courses and beyond.

SWFT is a comprehensive package of teaching and learning materials, significantly enhanced with each edition to meet instructor and student needs and to add overall value to learning taxation.

Individual Income Taxes, 2022 Edition provides a dynamic learning experience inside and outside of the classroom. Built with resources and tools that have been identified as the most important, our complete learning system provides options for students to achieve success.

Individual Incomes Taxes, 2022 Edition provides accessible, comprehensive, and authoritative coverage of the relevant tax code and regulations as they pertain to the individual taxpayer, as well as coverage of all major developments in Federal taxation.

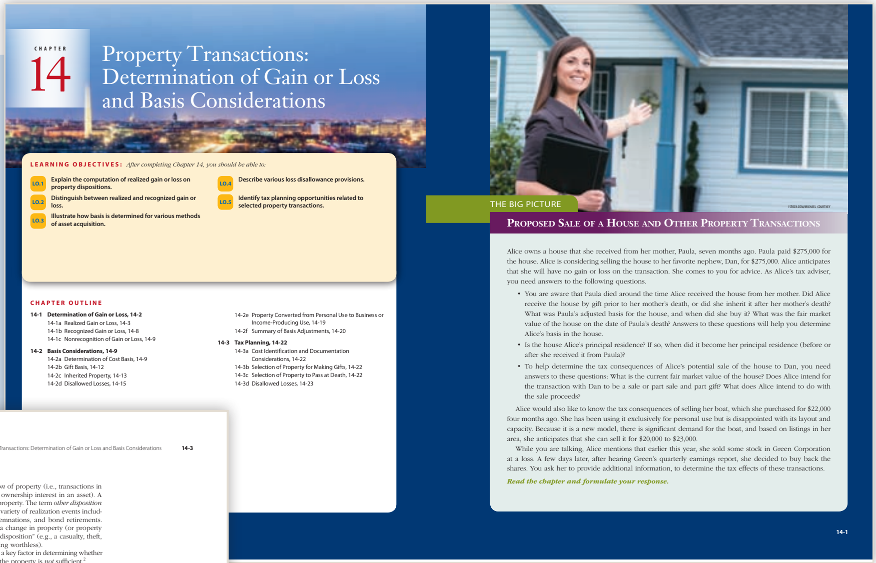
In revising the 2022 Edition, we focused on:

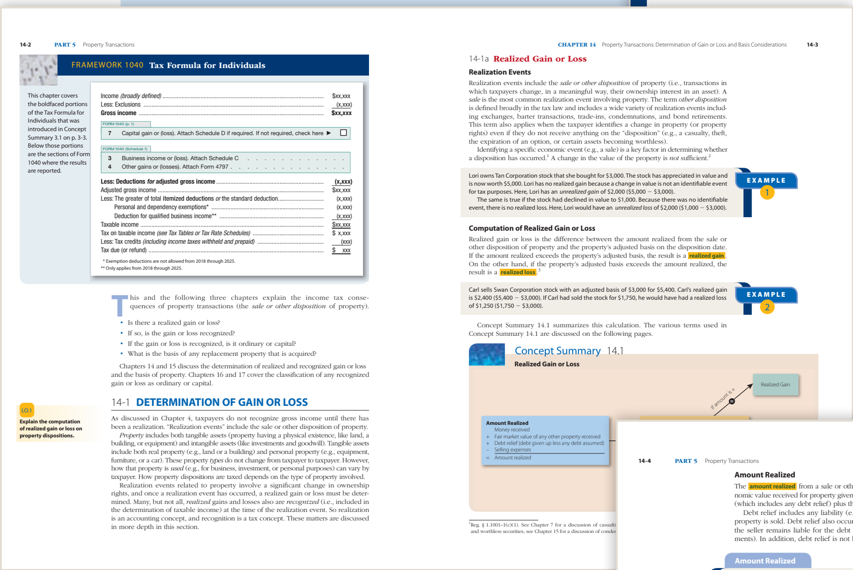
- ***Accessibility. Clarity. Substance.*** The authors and editors made this their focus as they revised the 2022 edition. Coverage has been streamlined to make it more accessible to students, and difficult concepts have been clarified, all without losing the substance that makes up the *South-Western Federal Taxation* series.
- ***Developing professional skills.*** SWFT excels in bringing students to a professional level in their tax knowledge and skills, to prepare them for immediate success in their careers. We include development of written and verbal communication skills, the use of tax preparation and tax research software, orientation toward success on the CPA Exam, exposure to tax policy and tax law development, consideration of the time value of money in the tax planning process, and experience with advanced spreadsheet applications and data analytics.
- ***CengageNOWv2 as a complete learning system.*** Cengage Learning understands that digital learning solutions are central to the classroom. Through sustained research, we continually refine our learning solutions in CengageNOWv2 to meet evolving student and instructor needs. CengageNOWv2 fulfills learning and course management needs by offering a personalized study plan, video lectures, auto-graded homework, auto-graded tests, and a full eBook with features and advantages that address common challenges.

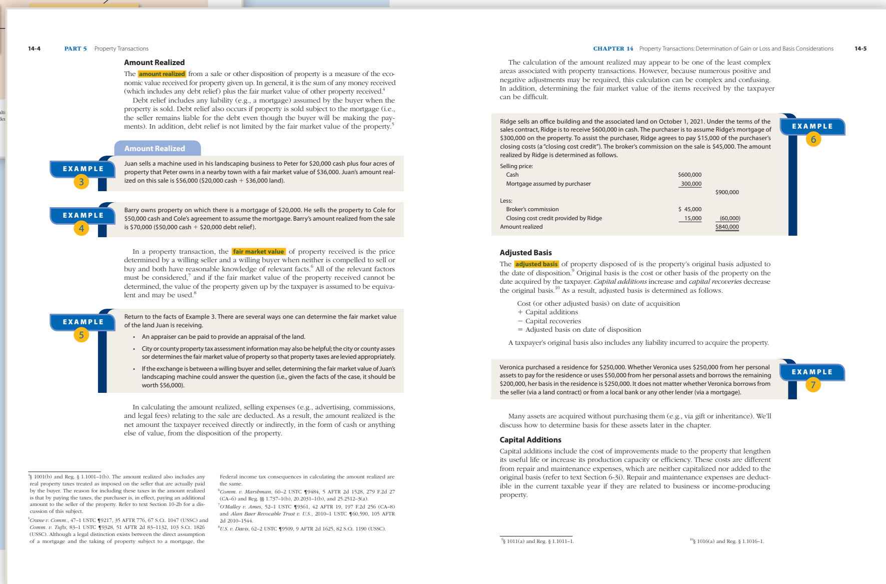
Learning Tools and Features to Help Students Make the Connection

FULL-COLOR DESIGN: We understand that students struggle with learning difficult tax law concepts and applying them to real-world scenarios. The 2022 edition uses color to bring the text to life, capture student attention, and present the tax law in an understandable and logical format.

- Selected **content is streamlined** to guide students in focusing on the most important concepts for the CPA Exam while still providing in-depth coverage of topics.







- Examples are clearly labeled and directly follow concepts to assist with student application. An **average of over 40 examples in each chapter** use realistic situations to illustrate the complexities of the tax law and allow students to integrate chapter concepts with illustrations and examples.

COMPUTATIONAL EXERCISES: Students need to learn to apply the rules and concepts covered in each chapter to truly understand them. These exercises, many of which mirror text examples, allow students to practice and apply what they are learning.

- ❏ Found in the end-of-chapter sections of the textbook
- ❏ CengageNOWv2 provides algorithmic versions of these problems

Computational Exercises

16. **LO.1, 2** Sally owns real property for which the annual property taxes are $9,000. She sells the property to Kate on March 9, 2021, for $550,000. Kate pays the real property taxes for the entire year on October 1, 2021.
    a. How much of the property taxes can be deducted by Sally and how much by Kate?
    b. What effect does the property tax apportionment have on Kate's adjusted basis in the property?
    c. What effect does the apportionment have on Sally's amount realized from the sale?
    d. How would the answers in parts (b) and (c) differ if Sally paid the taxes?
17. **LO.1** Melba purchases land from Adrian. Melba gives Adrian $225,000 in cash and agrees to pay Adrian an additional $400,000 one year later plus interest at 5%.
    a. What is Melba's adjusted basis for the land at the acquisition date?
    b. What is Melba's adjusted basis for the land one year later?

RESEARCH AND DATA ANALYTICS PROBLEMS:

- ❏ Research Problems provide students with vital practice in an increasingly demanded skill area. Some of these end-of-chapter items ask students to analyze tax data, helping them to understand the application of this information in various scenarios. These essential features prepare students for professional tax environments.

BECKER PROFESSIONAL EDUCATION REVIEW QUESTIONS: End-of-chapter CPA Review Questions from Becker PREPARE STUDENTS FOR SUCCESS. Students review key concepts using proven questions from Becker Professional Education®—one of the industry's most effective tools to prepare for the CPA Exam.

- ❏ Located in select end-of-chapter sections
- ❏ Tagged by concept in CengageNOWv2
- ❏ Questions similar to what students would actually find on the CPA Exam

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Becker CPA Review Questions

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1. Jasmin purchased 100 shares of Pinkstey Corporation (publicly traded company) on January 1 of year 1 for $5,000. The FMV of the shares at the end of year 1 was $6,000. On January 1 of year 4, Pinkstey Corporation declared a 2-for-1 stock split when the fair market value of the stock was $65 per share. On January 1 of year 5, Jasmin sold all of her Pinkstey Corporation stock when the fair market value was $40 per share. Which of the following statements is true?
   a. Jasmin reports $6,500 in gross income for the 2-for-1 stock split in year 4.
   b. Jasmin's basis in the Pinkstey Corporation stock at the end of year 4 is $65 per share.
   c. Jasmin has no taxable income for the Pinkstey Corporation stock in year 4.
   d. Jasmin owns 100 shares in Pinkstey Corporation stock at the end of year 4.
2. Alice gifted stock to her son, Bob, in year 5. Alice bought the stock in year 1 for $8,300. The value of the stock on the date of gift was $6,400. Bob sold the stock in year 7 for $15,800. What is Bob's recognized gain or loss on the sale in year 7?
   a. $0 c. $9,400 gain
   b. $7,500 gain d. $15,800 gain

See how the SWFT series helps students understand the big picture and the relevancy behind what they are learning.

THE BIG PICTURE

The First Job

After an extensive search, Morgan, a recent college graduate with a major in child development, has accepted a job with Enrichment Child Care Center (ECCC) in a neighboring state. ECCC is located in the western suburbs of a large metropolitan city, roughly 30 miles from the center of the city. Morgan will be moving into a two-bedroom apartment about two miles from ECCC. At ECCC, Morgan will work with pre-school children Monday to Friday from 7 A.M. to 3 P.M. One of the reasons she accepted the position at ECCC is the flexibility it provides. Because she is eager to pay off her student loans and save to buy a house, she has decided to freelance in the late afternoons and evenings and on weekends—joining the "gig economy."

She finds two ways to freelance: (1) transporting people, packages, and meals for a few companies where she finds work through an "app" (like driving for Uber) and (2) tutoring elementary school students in English and math. Her tutoring can take place online or in person (either in her apartment or at the child's home). She has dedicated the second bedroom in her apartment for freelancing. She has a large table and several chairs in this bedroom that allow her to meet her tutoring students or connect with them via her laptop. She keeps all of her freelancing records in a file cabinet, which she keeps in a closet in the bedroom. She also purchases and keeps various supplies for her tutoring activities in the closet. Although there are some freelance driving options in the suburbs, most often Morgan heads for the city, where there are more passengers and higher fares.

What are some of the income tax issues presented by this situation?

Read the chapter and formulate your response.

THE BIG PICTURE: Tax Solutions for the Real World. Taxation comes alive at the start of each chapter as The Big Picture examples provide a glimpse into the lives, families, careers, and tax situations of typical filers. Students will follow a family, individual, or other taxpayer throughout the chapter, to discover how the concepts they are learning apply in the real world.

Finally, to solidify student comprehension, each chapter concludes with a **Refocus on the Big Picture** summary and tax planning scenario. These scenarios re-emphasize the concepts and topics from the chapter and allow students to confirm their understanding of the material.

FRAMEWORK 1040:

Fitting It All Together. This chapter-opening feature demonstrates how topics within *Individual Income Taxes* fit together, using the Income Tax Formula for Individuals as the framework. The framework helps students organize their understanding of the chapters and topics to see how they relate to the basic tax formula and then identify where these items are reported on Form 1040. Framework 1040 helps students navigate topics by explaining how tax concepts are organized.

FRAMEWORK 1040 **Tax Formula for Individuals**

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

Income *(broadly defined)*	$ xx,xxx
Less: Exclusions	(x,xxx)
Gross income	**$ xx,xxx**

FORM 1040 (p. 1)

7 Capital gain or (loss). Attach Schedule D if required, If not required, check here ▶ ☐

FORM 1040 (Schedule 1)

3 Business income or (loss). Attach Schedule C

4 Other gains or (losses). Attach Form 4797

5 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E

Less: Deductions *for* adjusted gross income	**(x,xxx)**
Adjusted gross income	$ xx,xxx
Less: The greater of total itemized deductions *or* the standard deduction	**(x,xxx)**

FORM 1040 (p. 1)

12 **Standard deduction or itemized deductions** (from Schedule A)

Personal and dependency exemptions*	(x,xxx)
Deduction for qualified business income**	(x,xxx)
Taxable income	$ xx,xxx
Tax on taxable income *(see Tax Tables or Tax Rate Schedules)*	$ x,xxx
Less: Tax credits *(including income taxes withheld and prepaid)*	(xxx)
Tax due (or refund)	$ xxx

*Exemption deductions are not allowed from 2018 through 2025.
**Only applies from 2018 through 2025.

Use this chapter-opening **Framework 1040**, which shows the topics as they appear in the individual tax formula, to understand where on Form 1040 these chapter topics appear.

FINANCIAL DISCLOSURE INSIGHTS:

Tax professionals need to understand how taxes affect financial statements. **Financial Disclosure Insights**, appearing throughout the text, use current information about existing taxpayers to highlight book-tax reporting differences, effective tax rates, and trends in reporting conventions.

FINANCIAL DISCLOSURE INSIGHTS Tax and Book Depreciation

A common book-tax difference relates to the depreciation amounts that are reported for GAAP and Federal income tax purposes. Typically, tax depreciation deductions are accelerated; that is, they are claimed in earlier reporting periods than is the case for financial accounting purposes.

Almost every tax law change since 1980 has included depreciation provisions that accelerate the related deductions relative to the expenses allowed under GAAP. Accelerated cost recovery deductions represent a means by which the taxing jurisdiction infuses the business with cash flow created by the reduction in the year's tax liabilities.

For instance, recently, about one-quarter of General Electric's deferred tax liabilities related to depreciation differences. Ford's depreciation differences amounted to about one-third of its deferred tax liabilities. And for the trucking firm Ryder Systems, depreciation differences accounted for virtually all of the deferred tax liabilities.

ETHICS & EQUITY Punching the Time Clock at Year-End

As the end of the tax year approaches, Julie, a successful full-time real estate developer and investor, recognizes that her income tax situation for the year could be bleak. Unless she and her spouse, Ralph, are able to generate more hours of participation in one of her real estate rental activities, they will not reach the material participation threshold. Consequently, the tax losses from the venture will not be deductible. To ensure deductibility, Julie suggests the following plan:

- She will document the time she spends "thinking" about her rental activities.
- During the week, Ralph will visit the apartment building to oversee (in a management role) the operations of the rentals.
- On weekends, she and Ralph will visit the same units to further evaluate the operations.
- Also on the weekends, while they are doing their routine household shopping, they will be on the lookout for other rental properties to buy. Julie plans to count both her and Ralph's weekend hours toward the tally of total participation.

Julie contends that the law clearly allows the efforts of one's spouse to count for purposes of the material participation tests. Likewise, nothing in the tax law requires taxpayers to be efficient in their hours of participation. How do you react?

ETHICS & EQUITY:

Some tax issues do not have just one correct answer. **Ethics & Equity** features will spark critical thinking and invite classroom discussion, enticing students to evaluate their own value system. Suggested answers to Ethics & Equity scenarios appear in the Solutions Manual.

TAX PLANNING:

Chapters include a separate section calling attention to how taxpayers can use the law to reach financial and other goals. Tax planning applications and suggestions also appear throughout each chapter.

11-6 TAX PLANNING

11-6a Minimizing the Impact of Passive Activity Losses

Perhaps the biggest challenge individuals face with the passive activity loss rules is to recognize the potential impact of the rules and then to structure their affairs to minimize this impact. If a taxpayer does invest in an activity that produces losses subject to the passive activity loss rules, the following discussion describes strategies that may help minimize the loss of current deductions.

Taxpayers who have passive activity losses should adopt a strategy of buying an interest in an activity that is generating passive activity income that can be offset (or sheltered) by the existing passive activity losses. From a tax perspective, it would be foolish to buy a loss-generating passive activity unless (1) the taxpayer has other passive activity income to shelter, (2) the activity is rental real estate that can qualify for the $25,000 exception, or (3) the activity qualifies for the exception available to real estate professionals.

GLOBAL TAX ISSUES From "All Sources" Is a Broad Definition

When § 61 refers to "income from whatever source derived," the law is reaching far beyond the borders of the United States. Although one interpretation of "source" in this context is type of income (e.g., wages and interest), a broader interpretation revolves around the place where the income is generated. In this context, citizens and residents of the United States are subject to taxation on income earned from sources both inside and outside the country. This "worldwide income" tax base can cause potential double taxation problems, with other countries also taxing income earned within their borders. However, mechanisms such as the foreign tax credit can alleviate these tax burdens.

Over the years, a number of individuals have relocated to other countries and renounced their U.S. citizenship to avoid high U.S. tax rates. Others who have already relocated may renounce their U.S. citizenship to avoid complicated filing and reporting requirements. After hitting a record high of 5,411 in 2017, the number of expatriations declined to 2,071 in 2019. However, 5,816 individuals gave up their U.S. citizenship in the first six months of 2020. Once per quarter, the Department of State publishes the names of U.S. citizens who have renounced their citizenship. Some of these individuals may owe Federal taxes upon renouncing. See § 877A.

See "Americans are renouncing their citizenship in record numbers" at **https:// fortune.com/2020/08/07/americans-renouncing-citizenship-passport-2020.**

GLOBAL TAX ISSUES:

The **Global Tax Issues** feature gives insight into the ways in which taxation is affected by international concerns and illustrates the effects of various events on tax liabilities across the globe.

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Motivation —

To help with student engagement and preparedness, CengageNOWv2 for SWFT offers:

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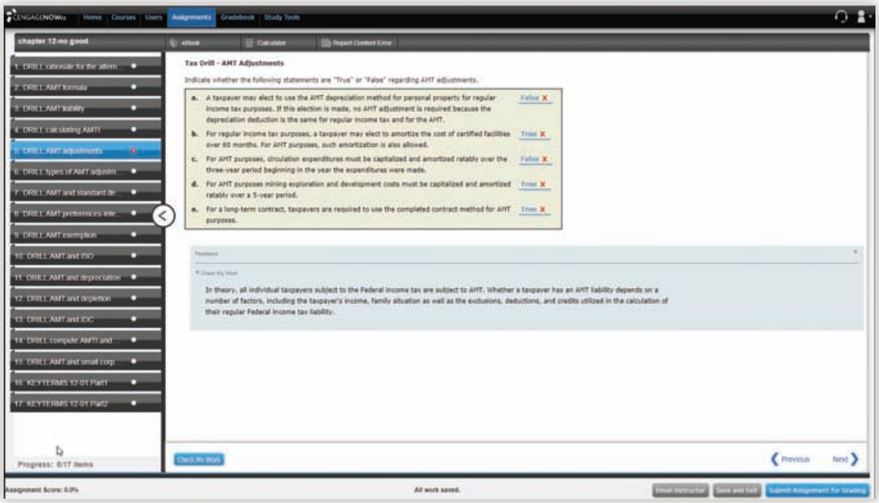

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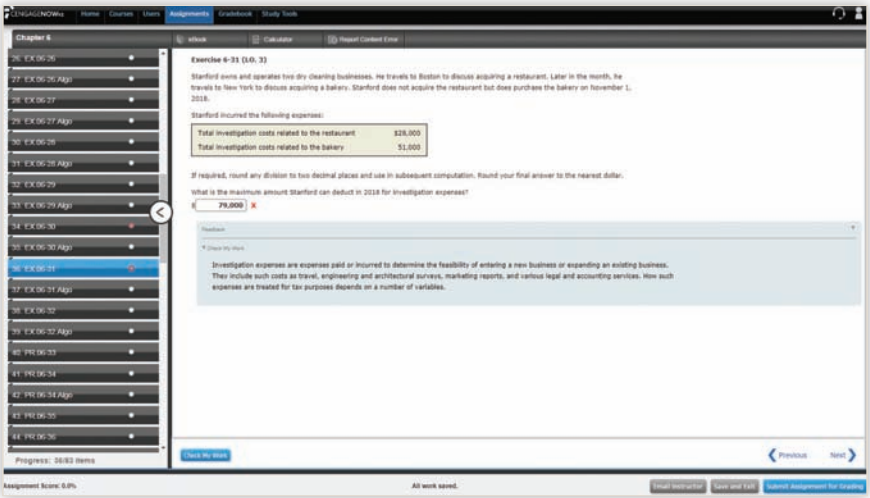

Students need to learn problem-solving behavior and skills, to guide them to complete taxation problems on their own. However, as students try to work through homework problems, sometimes they become stuck and need extra help. To reinforce concepts and keep students on the right track, CengageNOWv2 for SWFT offers the following.

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Mastery —

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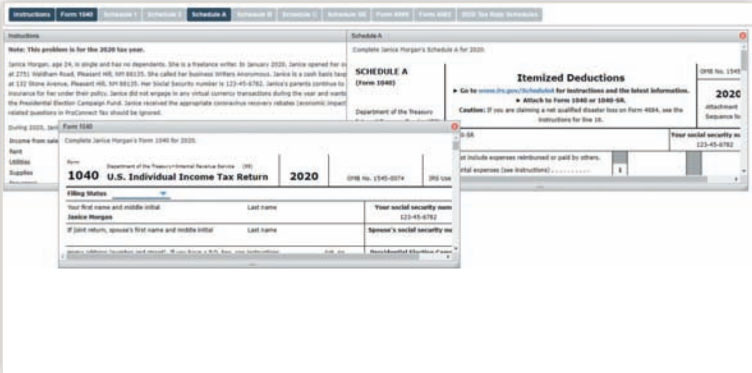

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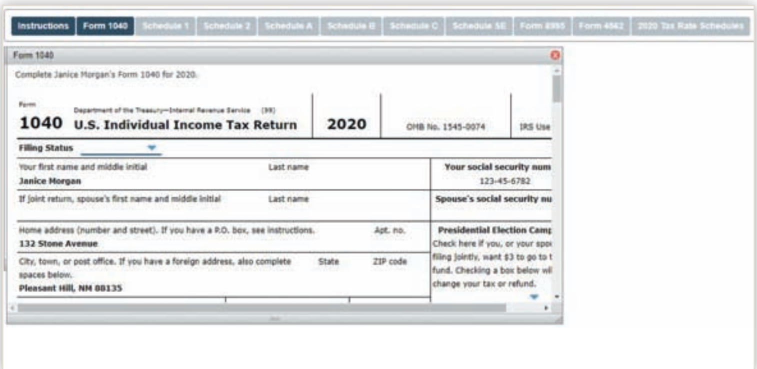

EXTENSIVELY REVISED. DEFINITIVELY UP TO DATE.

Each year the ***South-Western Federal Taxation*** series is updated with thousands of changes to each text. Some of these changes result from the feedback we receive from instructors and students in the form of reviews, focus groups, web surveys, and personal e-mail correspondence to our authors and team members. Other changes come from our careful analysis of the evolving tax environment. **We make sure that every tax law change relevant to the introductory taxation course was considered, summarized, and fully integrated into the revision of text and supplementary materials.**

The ***South-Western Federal Taxation*** authors have made every effort to keep all materials up to date and accurate. All chapters contain the following general changes for the 2022 edition.

- Updated materials to reflect changes made by Congress through legislative action (including the tax provisions contained in the CARES Act, the Consolidated Appropriations Act of 2021, and the American Rescue Plan Act of 2021).
- Streamlined chapter content (where applicable) to clarify material and make it easier for students to understand.
- Revised numerous materials as the result of changes caused by indexing of statutory amounts.
- Revised Problem Materials, Computational Exercises, and CPA Exam problems.
- Updated Chapter Outlines to provide an overview of the material and to make it easier to locate specific topics.
- Revised *Financial Disclosure Insights* and *Global Tax Issues* as to current developments.

In addition, the following materials are available online.

- An appendix that helps instructors broaden and customize coverage of important tax provisions of the Affordable Care Act. (Instructor Companion Website at **www.cengage.com/login**)
- An appendix that has comprehensive tax return problems for the 2020 tax filing year (Appendix F). (Instructor Companion Website at **www.cengage.com/login**)
- An appendix that covers depreciation and the Accelerated Cost Recovery System (ACRS). (Instructor Companion Website at **www.cengage.com/login**)

Chapter 1

- Removed Exhibit 1.4 (on IRS audit types), but retained text discussion.
- Expanded judicial concepts to also include judicial doctrines and added new text and example on the substance over form doctrine.
- Updated end-of-chapter materials as needed.

Chapter 2

- Made minor changes to various exhibits and concept summaries.
- Updated references and citations throughout the chapter.
- Expanded Internal Revenue Bulletin coverage to include IRS Notices.
- Changed references to RIA Checkpoint to Thomson Reuters Checkpoint.
- Updated end-of-chapter materials as needed.

Chapter 3

- Updated chapter materials to reflect changes to Form 1040 and related schedules; updated exhibit summarizing when Form 1040 Schedules 1 through 3 are used.
- Updated explanation and examples of the child tax credit to reflect 2021 changes made by the American Rescue Plan Act of 2021.
- Updated chapter materials to reflect 2021 inflation adjustments.
- Updated material on virtual currency (including revised question on page 1 of Form 1040).
- Updated exhibit summarizing the 0, 15, and 20% breakpoints for the alternative tax on net capital gains.
- Revised and clarified materials (including end-of-chapter materials) as needed.

Chapter 4

- The discussion of Income Received by an Agent was moved to text Section 4-2 with the discussion of the timing of income recognition.
- Updated Global Tax Issues feature entitled "From 'All Sources' Is a Broad Definition" for the number of recent expatriations.

- Added Ethics & Equity feature on the expansion of unemployment benefits during the COVID-19 pandemic.
- Revised and clarified discussion and examples as needed.
- Added two examples related to the relationship of the all-events test to financial reporting.
- Added example of potential income shifting to a taxpayer not subject to the kiddie tax to highlight the general benefits of income shifting and the impact of the kiddie tax on this benefit.
- Deleted former homework Problem 55 that required completion of Worksheet 1, Figuring Your Taxable Benefits, from IRS Publication 915.

Chapter 5

- Modified Learning Objective 1 to address the definition of exclusions and that they are distinguishable from items that are not income.
- Combined the learning objective on cancellation of debt with the learning objective related to other exclusions.
- Renamed text Section 5-1 as "Income Exclusions."
- Moved material on corporate distributions from text Section 5-11 to new text Section 5-1b, to illustrate an example of something received that is not income.
- Moved and renamed former text Section 5-16 as text Section 5-14 to improve flow of chapter materials.
- The discussion of corporate payments called "dividends" (but not considered dividends for tax purposes) was moved to Chapter 4 (as part of gross income discussion).
- Updated text, examples, and end-of-chapter materials as needed, including 2021 inflation adjustments.

Chapter 6

- Revised and updated chapter materials as needed; clarified chapter materials when necessary.
- Updated text for inflation-adjusted items.
- Replaced summary of a *Fortune* article on executive compensation with summary of a *Wall Street Journal* article (text Section 6-4c).
- Revised and updated end-of-chapter materials as needed (including changes needed to reflect revised inflation-adjusted items).
- Modified items in tax form and tax computation problems to be more reflective of current income levels.

Chapter 7

- Cited a recent Tax Court decision that provides a comprehensive overview of the law related to worthless securities [*MCM Investment Management, LLC* (T.C.Memo. 2019–158)].
- Updated text to include discussion of COVID-19 casualties (and the ability to deduct these in the year prior to the loss).
- Added a new example (Example 27) demonstrating how to amortize research and experimentation expenditures incurred in taxable years beginning after December 31, 2021.
- Noted (in footnote 37) the retroactive delay of the excess business loss provision by the CARES Act (revised effective date is taxable years beginning after December 31, 2020).
- Modified the net operating loss materials to reflect changes made by the CARES Act.
- Added new part to Problem 40 to allow students to compute the appropriate deduction for research and experimentation expenditures incurred in taxable years beginning after December 31, 2021; also added a related question to the test bank and modified an essay question.
- Updated remainder of chapter materials as needed (including various inflation-adjusted amounts).

Chapter 8

- Updated chapter materials to reflect inflation adjustments to § 179 (including SUVs) and luxury automobiles.
- Updated Form 4562 and Schedule C (Form 1040) to 2020 forms.
- Updated text and end-of-chapter materials as needed (both dates and to reflect inflation adjustments to § 179); revised other materials as needed.

Chapter 9

- Updated text and end-of-chapter materials for revised standard mileage amounts.
- Deleted coverage of § 222 (repealed as part of Consolidated Appropriations Act of 2021).
- Updated example illustrating the completion of Form 8995-A and Schedule A (Form 8995-A).
- Updated text and end-of-chapter materials to reflect inflation adjustments to threshold limits for

the QBI deduction; updated the end-of-chapter QBI deduction form completion problem (Form 8995).

- Revised and clarified materials based on feedback from adopters.

Chapter 10

- Revised and clarified text as needed, including 2021 change to medical expense AGI floor (now permanently set at 7.5% of AGI).
- Added brief comment on CARES Act cash charitable contribution for non-itemizers (a *for* AGI deduction).
- Updated text for annual inflation adjustments.
- Updated end-of-chapter materials as needed.

Chapter 11

- Made minor changes to Learning Objectives 2 and 4.
- Updated chapter materials to reflect inflation adjustments.
- Revised and clarified materials as needed throughout the chapter.
- Added new research problem on virtual currency investing and software tools to help track the necessary information for tax reporting.
- Updated end-of-chapter materials as needed.

Chapter 12

- Updated Ethics & Equity scenarios to reflect current tax law considerations.
- Streamlined text to reflect streamlined AMT.
- Updated problems, improved readability.
- Updated text, examples, and end-of-chapter materials for 2021 inflation adjustments.
- Included revised statistics regarding the number of taxpayers subject to the AMT and the revenue generated by the AMT.

Chapter 13

- Updated chapter materials impacted by the American Rescue Plan Act of 2021, including revisions to the earned income tax credit, the child tax credit, and the credit for child and dependent care expenses.
- Added text materials and end-of-chapter content related to the foreign tax credit (text Section 13-4b and Concept Summary 13.1).
- Added an exhibit summarizing various energy credits (Exhibit 13.4).
- Deleted exhibits showing Form W–4 and Form W–2, while retaining text discussion.
- Updated Affordable Care Act materials.
- Added communications requirements to two research problems.
- Expanded the requirements for Research Problem 5.

Chapter 14

- Modified Learning Objective 1.
- Revised introductory discussion of realized gains and losses (text Section 14-1a).
- Expanded the discussion of basis when a liability is involved, adding Example 7.
- Reduced the discussion of basis computations, deleting former Example 11.
- Updated end-of-chapter tax form problem: completion of a Form 8949 and a Schedule D.

Chapter 15

- Revised a portion of the chapter's introductory materials. Clarified and rearranged other material.
- Revised end-of-chapter tax form problem (completion of a Form 8824).
- Added a communications assignment to Research Problems 1 and 5.

Chapter 16

- Updated Exhibit 16.1 summarizing 2021 and 2020 break points for the 0%/15%/20% alternative tax rates on net capital gains and qualified dividend income.
- Updated the chapter tax return example [including Form 8949, Schedule D (Form 1040), and the capital gains worksheet].
- Updated text and end-of-chapter materials for 2021 inflation adjustments to Tax Rate Schedules and alternative tax rate brackets (for net capital gains).
- Updated other chapter content as needed.
- Updated data analytics tax research problem.

Chapter 17

- Enhanced text materials, Concept Summary 17.1, and Concept Summary 17.3 to show integration with the Chapter 16 capital gain materials more clearly.

- Updated the chapter tax return example [Form 4797 and Schedule D (Form 1040)].
- Updated text and end-of-chapter materials for 2021 inflation adjustments to Tax Rate Schedules and alternative tax rate brackets (for net capital gains).
- Updated other chapter content as needed.
- Updated data analytics tax research problem.

Chapter 18

- Removed discussion of conditions for granting approval to change an accounting period.
- Replaced a research problem with one involving a sole proprietor and the constructive receipt doctrine. Added a communications requirement for the item.

Chapter 19

- Replaced two Ethics & Equity items.
- Revised a Financial Disclosure Insight item.
- Expanded discussion of RMDs and added Exhibit 19.3 with selected RMD factors.
- Added two new examples involving plan distributions.
- Added material on the "stretch IRA."
- Replaced two research problems with four new items.

Chapter 20

- Revised Learning Objective 4.
- Revised title of text Section 20-2a.
- Revised discussion about nontax considerations in choice of entity.
- Updated NOL rules.
- Deleted Exhibit 20.1.
- Revised AMT and tax planning discussions.

TAX LAW OUTLOOK

From your SWFT Series Editors:
Legislation related to the COVID-19 pandemic was a vehicle for tax changes in 2020. And, a wide variety of tax changes were incorporated into the American Rescue Plan Act of 2021 (enacted in March 2021).The Biden administration and Congress have begun to discuss a wide variety of tax law changes, including changes to the Tax Cuts and Jobs Act of 2017 (TCJA). Still others are expected in the Biden administration's Build Back Better plan (with legislation likely to be discussed and possibly enacted before the end of the 117th Congress).

Taxpayers and their advisers will need to evaluate how these changes affect their financial planning strategies and adjust their plans appropriately. The SWFT editors will be monitoring these activities and provide updates to adopters as needed.

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Solutions to all homework items are tagged with their Estimated Time to Complete, Level of Difficulty, and Learning Objective(s), as well as the AACSB's and AICPA's core competencies—giving instructors more control than ever in selecting homework to match the topics covered. The Solutions Manual also contains the solutions to Appendix F: Comprehensive Tax Return Problems and answers with explanations to the end-of-chapter Becker CPA Review Questions. **Available on Instructor Companion Website at www.cengage.com/login.**

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- The Depreciation and the Accelerated Cost Recovery System (ACRS) appendix
- Comprehensive Tax Return Problems appendix

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- Add your own material to cover additional topics or information.
- Add relevance by including sections from Sawyers/Gill's *Federal Tax Research* or your state's tax laws and regulations.

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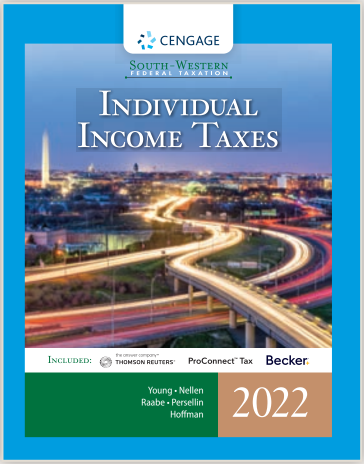

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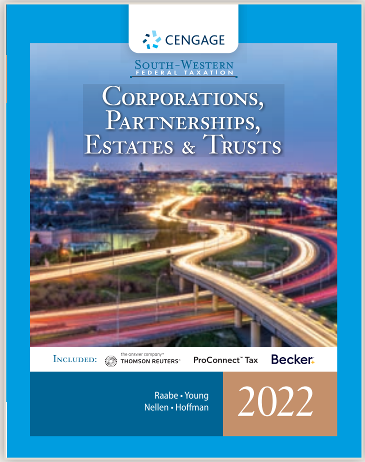

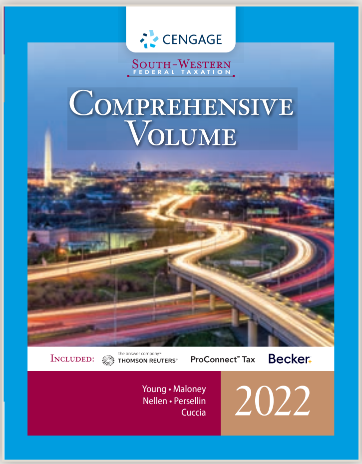

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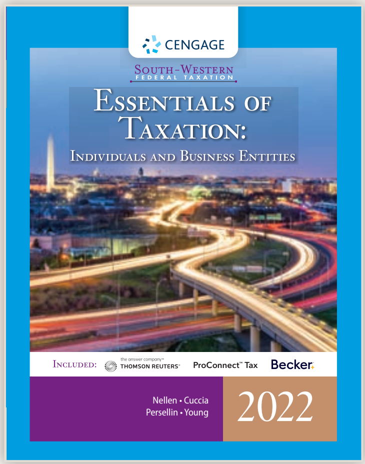

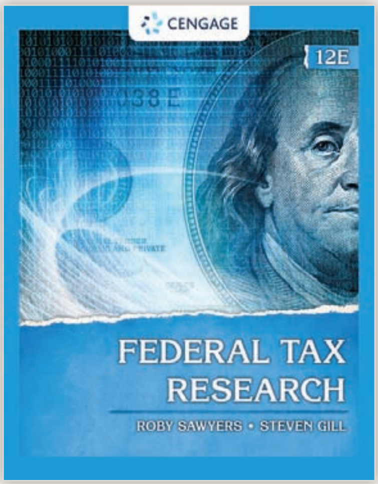

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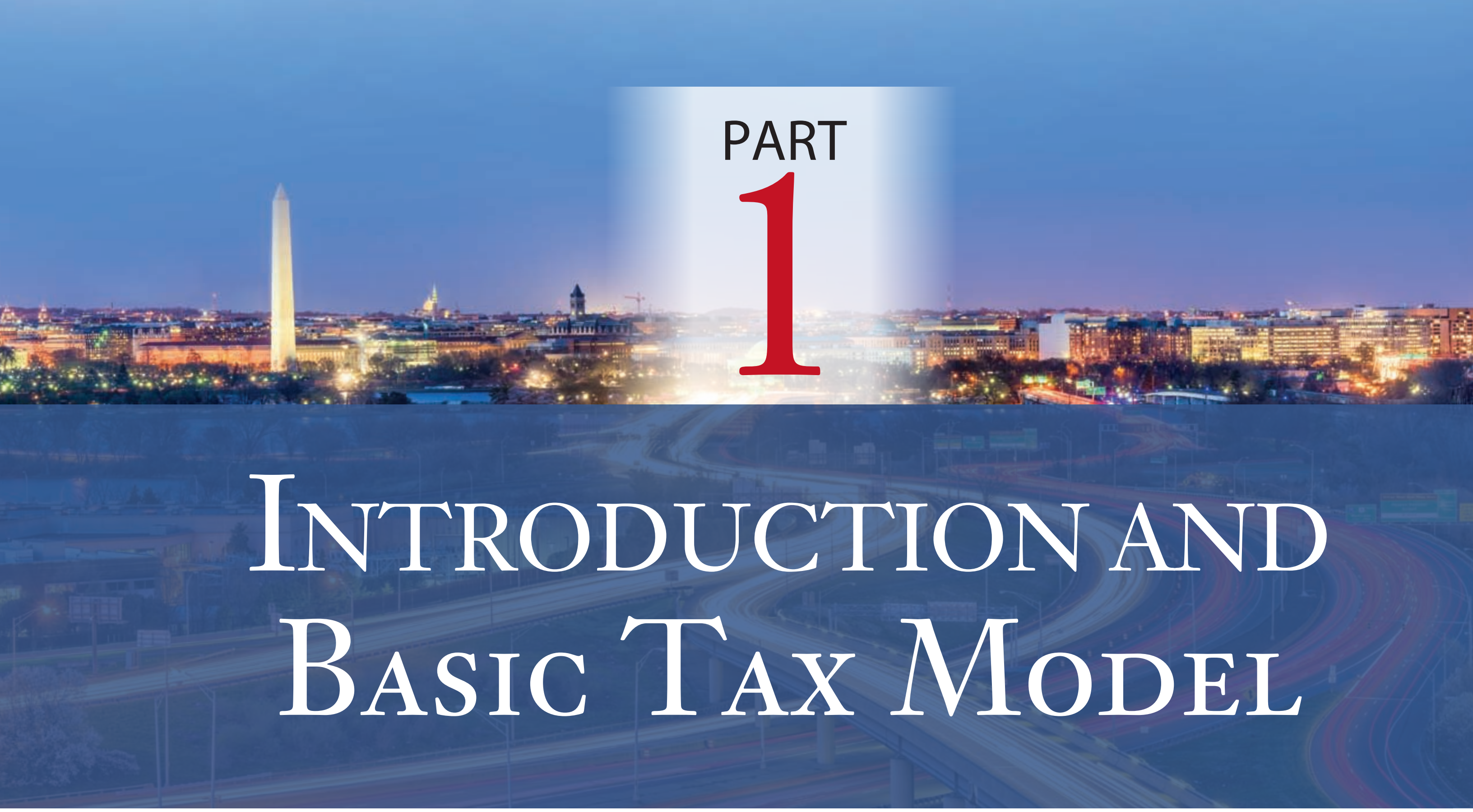
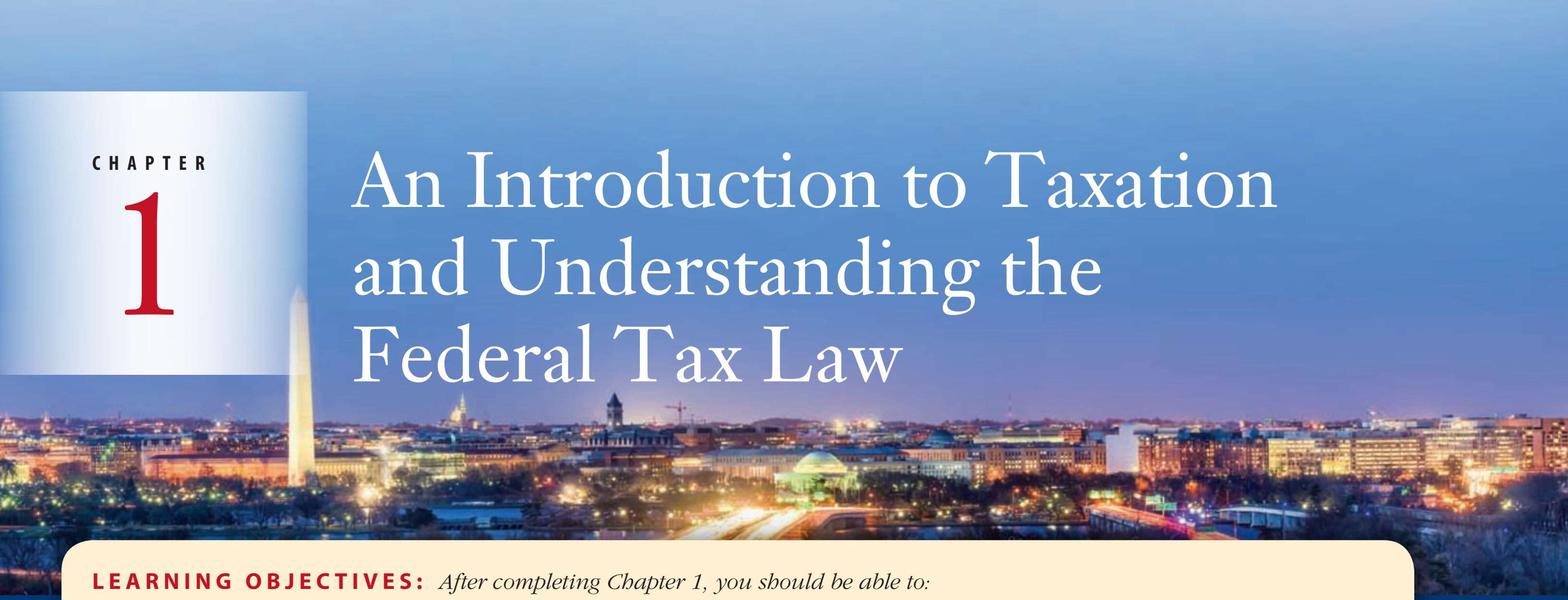


PART 1

Introduction and Basic Tax Model

Part 1 provides an introduction to taxation in the United States. Although this text focuses on income taxation, other types of taxes also are briefly discussed. The purposes of the Federal tax law are examined, and the legislative, administrative, and judicial sources of Federal tax law, including their application to the tax research process, are analyzed. Part 1 concludes by introducing the basic tax model for the individual taxpayer and providing an overview of property transactions.



CHAPTER 1

An Introduction to Taxation and Understanding the Federal Tax Law

LEARNING OBJECTIVES: *After completing Chapter 1, you should be able to:*

LO.1 **Explain the importance of taxation and apply methods for studying this topic.**

LO.2 **Describe some of the history and trends of the Federal income tax.**

LO.3 **Describe and apply principles and terminology relevant to the design of a tax system.**

LO.4 **Identify the different taxes imposed in the United States at the Federal, state, and local levels.**

LO.5 **Explain the administration of the tax law, including the audit process utilized by the IRS.**

LO.6 **Evaluate some of the ethical guidelines involved in tax practice.**

LO.7 **Classify tax rules based on their possible economic, social, equity, and political reasons for inclusion in a particular tax system.**

LO.8 **Explain the role played by the IRS and the courts in the evolution of the Federal tax system.**

CHAPTER OUTLINE

THE BIG PICTURE

Family and Taxes—A Typical Year

Travis and Amy Carter are married and live in a state that imposes both a sales tax and an income tax. They have two children, April (age 17) and Martin (age 18). Travis is a mining engineer who specializes in land reclamation. After several years with a mining corporation, Travis established a consulting practice that involves a considerable amount of travel due to work he performs in other states. Amy is a registered nurse who, until recently, was a homemaker. In November of this year, she decided to reenter the job market and accepted a position with a medical clinic. The Carters live only a few blocks from Ernest and Mary Walker, Amy Carter's parents. The Walkers are retired and live on interest, dividends, and Social Security benefits.

Activities during the year with possible tax ramifications are summarized below.

- The ad valorem property taxes on the Carters' residence are increased, whereas those on the Walkers' residence are lowered.
- When Travis registers an automobile purchased last year in another state, he is required to pay a sales tax to his home state.
- As an anniversary present, the Carters gave the Walkers a recreational vehicle (RV).
- Travis employs his children to draft blueprints and prepare scale models for use in his work. Both April and Martin have had training in drafting and topography.
- Early in the year, the Carters are audited by the state on an income tax return filed a few years ago. Later in the year, they are audited by the IRS on a Form 1040 they filed for the same year. In each case, a tax deficiency and interest were assessed.
- The Walkers are audited by the IRS. Unlike the Carters, they did not have to deal with an agent, but settled the matter by mail.

Explain these developments, and resolve the issues raised.

Read the chapter and formulate your response.

This chapter provides an introduction to our Federal tax system to set a foundation for what you'll learn in subsequent chapters. Among the topics discussed:

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

LO.1

Explain the importance of taxation and apply methods for studying this topic.

1-1 APPROACHING THE STUDY OF TAXATION

1-1a What Is Taxation?

"Taxes are what we pay for civilized society."

This is a famous quote from U.S. Supreme Court Justice Oliver Wendell Holmes, Jr. (1841 to 1935).[1] It is engraved on the government building at 1111 Constitution Avenue in Washington, D.C.—headquarters of the Internal Revenue Service (IRS). This quote eloquently sums up the primary purpose of taxation—to raise revenue for government operations. Governments at all levels—national, state, and local—require funds for defense, protection (police and fire), education, roads, the court system, social services, and more. Various types of taxes provide the resources to pay for government services.

In addition, taxation is often used as a tool to influence the behavior of individuals and businesses. For example, an income tax credit (which reduces a taxpayer's tax bill) may be designed to *encourage* people to purchase a fuel-efficient car. A tobacco excise tax may *discourage* individuals from smoking by increasing the cost of tobacco products. The tax system can also be used to provide direct benefits to taxpayers, such as to help pay for health insurance.

1-1b Taxation in Our Lives

"Nothing is certain, except death and taxes."

Most people attribute this quote to Benjamin Franklin (1706–1790). Taxes permeate our society. Various types of taxes, such as income, sales, property, and excise taxes (discussed in text Section 1-4), come into play in many of the activities of individuals, businesses, nonprofit entities (e.g., charitable organizations), and even governments.

Most directly, individuals are affected by taxes by paying them. Taxes may be paid directly or indirectly. A direct tax is paid to the government by the person who pays the tax. Examples include the personal income tax, which is paid by filing a personal income tax return (Form 1040 at the Federal level), and property taxes on one's home (paid to the local government). Individuals also pay many taxes indirectly. For example, most states impose sales tax on the purchase of tangible goods such as clothes. While this tax is collected and remitted to the government by the seller, the buyer is charged the tax along with the purchase price of the goods or services. Taxes also can be imposed indirectly when embedded in the prices charged by the seller. For example, when you buy gasoline for your car, the price you pay likely includes some of the income taxes and the gasoline excise taxes owed by the oil company. And a renter indirectly pays property taxes assessed on the landlord (who will consider that cost when determining how much rent to charge).

Ultimately, all taxes are paid by individuals. The corporate income tax, for example, is paid directly by the corporation but is really paid indirectly by individuals in their capacity as customers, investors (owners), or employees. Economists and others often study this topic to estimate the percentage of the corporate income tax borne by individuals in these different capacities. It is not easy to measure, but it is known that taxes are passed along to individuals through higher prices, lower dividends, and/or lower wages.

Taxes also affect the lives of individuals via the ballot box. Federal, state, and local elections often include initiatives that deal with taxation, such as whether state income

[1] *Compania General De Tabacos De Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927), dissenting opinion.

taxes should be raised (or lowered), whether a new tax should be imposed on soda, or whether the sales tax rate should be changed. Candidates running for office often have positions on tax changes they would like to make if elected.

Given the pervasiveness of taxation—in our roles as both direct and indirect payers of taxes as well as citizens/voters—it is important that we understand how the tax system operates.

1-1c The Relevance of Taxation to Accounting and Finance Professionals

The U.S. corporate income tax rate is 21 percent. State income taxes can easily constitute, on average, an additional 5 percent. So a large corporation such as a Fortune 500 company may have to devote 26 percent or more of its net income to pay income taxes. In addition, businesses are subject to employment taxes, property taxes, sales taxes, and various excise taxes. Corporations with international operations are subject to taxation in other countries. Small businesses are also subject to a variety of taxes that affect profits and cash flows.

Given its significance, taxation is a crucial topic for accounting and finance professionals. They must understand the various types of business taxes to assist effectively with the following:

- *Compliance:* Ensure that the business files all tax returns and makes all tax payments on time. Mistakes and missed due dates will lead to penalties and interest expense.
- *Planning:* Help a business apply favorable tax rules, such as income deferral and tax credits, to minimize tax liability (and maximize owner wealth). The time value of money concept is also important here, as is coordinating tax planning with other business goals to maximize earnings per share.
- *Financial reporting:* Financial statements include a variety of tax information, including income tax expense on the income statement and deferred tax assets and liabilities on the balance sheet. Footnotes to the financial statements report various tax details, including the company's effective tax rate. Computation and proper reporting of this information require knowledge of both tax and financial reporting rules [including the Financial Accounting Standards Board's Accounting Standards Codification (ASC) 740, *Income Taxes*].
- *Controversy:* This term refers to interaction a taxpayer may have with a tax agency such as the IRS. The IRS and state and local tax agencies regularly audit tax returns that have been filed to verify that taxes were properly computed and paid.
- *Cash management:* Taxes must be paid on time to avoid penalties and interest. Income and self-employment taxes must be estimated and paid quarterly and reconciled on the annual return. Other taxes may be due weekly, monthly, or semiannually. Businesses must be sure they have the funds ready when the taxes are due and have procedures to track due dates.
- *Data analysis:* With a majority, if not all, of a company's records maintained in digital form, there are opportunities to use this information to enhance profits, better understand the customer base, and improve and understand the information from a tax perspective. Tax practitioners often need skills in data analysis and visualization to identify samples for both internal and external audits, find ways to identify the products and services subject to sales tax in different states, and extract tax data to help inform other business functions such as where to locate a new sales office.

These tasks are also relevant to professionals such as CPAs who advise business and individual clients.

The level and depth of tax knowledge needed for any accounting or tax professional depends on the specific job. The vice president of tax for a company clearly needs thorough knowledge in all areas of taxation; the same is true of a partner in a CPA firm. In contrast, the corporate treasurer likely focuses more on cash management, while working closely with the company's tax advisers.

Ultimately, much of taxation is transaction-based. How a transaction is structured (e.g., as a sale or a lease) has varying tax consequences that must be considered. Even the purchase of a home can result in significant change—the new mortgage interest and property tax deductions may mean that an individual itemizes her deductions (using Schedule A of Form 1040) rather than using the standard deduction. And life events such as marriage (and divorce) will change an individual's tax situation. Similar "life events" can also affect a corporation (e.g., acquiring a different corporation or spinning off a subsidiary).

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

1-1d **How to Study Taxation**

The goal of studying taxation is to be able to recognize issues (or transactions) that have tax implications and, when possible, try to understand the justification for them. Suppose, for example, that you come upon a situation that involves a discharge of indebtedness. If you know that forgiveness of debt results in income but that there are exceptions to this rule, you're doing well. The issue has been identified, and the outcome (i.e., when an exception applies) can be resolved through research. A variety of commercial and free tools and resources are available to help you research and reach a conclusion.

You may have heard that tax is a difficult subject because of the many rules, exceptions, and definitions. You even may have heard that taxation is boring. Taxation is a challenging topic, but it is certainly not boring. Taxation is an important and exciting topic due to constant change by the three branches of our Federal government (as well as changes by state and local governments), the significance of taxes to the bottom line of a company and an individual's finances, and the impact on our economy and society.

Tax professionals tend to find enjoyment in their chosen field due to the intellectual challenge of dealing with tax rules for compliance and planning purposes, the opportunity to interact with colleagues or clients to help them understand the effect of taxes, and the knowledge that their work affects the financial well-being of individuals and businesses.

In studying taxation, focus on understanding the rules and the why(s) behind them (rather than memorizing the many isolated or disconnected rules and terms). The rules become more meaningful by thinking about why they exist for the particular type of tax. For example, why does the Federal income tax allow for a casualty loss deduction in certain situations? Why is tax depreciation different from that used for financial reporting? Also consider how the rules apply to different types of taxpayers (like employees, sole proprietors, corporations, investors, children, and retirees). Also think about how the rules apply to taxpayers of varying income levels and sophistication of transactions (a homeowner versus someone who owns assets in several countries). Aiming for understanding rather than memorization will make your journey into the world of taxation interesting and meaningful and will prepare you well for dealing with taxation in your accounting or finance career.

For tax professionals, the study of taxation is an ongoing and intriguing process. When Congress changes the tax law, tax professionals must review the new rules in order to understand how they affect clients or their employer. In addition, decisions rendered by the courts in tax disputes and guidance issued by the Treasury Department and Internal Revenue Service must be understood to ensure correct compliance with the law as well as identification of updated and proper tax planning ideas.

Concept Summary 1.1 illustrates the various ways that individuals deal with, and are affected by, taxes.

1-2 **A BRIEF HISTORY OF U.S. TAXATION**

LO.2

Describe some of the history and trends of the Federal income tax.

1-2a **Early Periods**

An income tax was first enacted in 1634 by the English colonists in the Massachusetts Bay Colony, but the Federal government did not adopt an income tax until 1861. In fact, both the Federal Union and the Confederate States of America used the income tax to raise funds to finance the Civil War.

When the Civil War ended, the need for additional revenue disappeared and the income tax was repealed. Once again the Federal government was able to finance its operations almost exclusively from customs duties (tariffs).

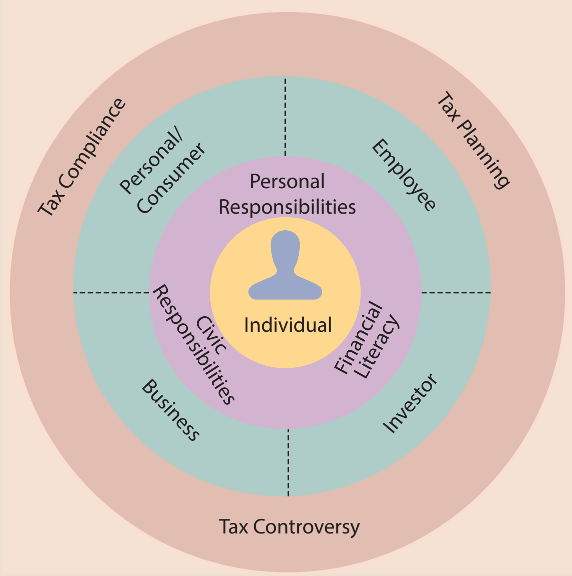
When a new Federal income tax on individuals was enacted in 1894, its opponents were prepared to successfully challenge its constitutionality. In *Pollock v. Farmers' Loan*

Concept Summary 1.1

Individuals and Taxes

The diagram to the right illustrates the many ways individuals interact with taxes. For example, as shown in the outer circle, individuals pay taxes and file tax returns (tax compliance). They also engage in tax planning as part of their desire to maximize after-tax wealth. If their tax return is audited or they do not pay their taxes, taxpayers will deal with the IRS or their state tax agency (tax controversy). Individuals deal with tax rules and planning in their roles as consumers, employees, investors, and business owners. Tax law is designed around these various taxpayer activities. Finally, as shown by the inner circle, individuals have a personal responsibility to comply with tax laws and pay any taxes due. Individuals also have a civic responsibility to understand taxes in their role as citizens and voters. And individuals need to understand how taxes affect their personal cash flows, consumption, and savings.

Use this diagram as you study the materials in this text, considering where in the circle various rules fit.



and Trust Co., the U.S. Supreme Court found that taxes on the income of real and personal property were the legal equivalent of a tax on the property involved and, therefore, required apportionment based on the population of the United States, as required by Article I, Section 8 of the Constitution.[2]

A Federal corporate income tax, enacted by Congress in 1909, fared better in the judicial system. The U.S. Supreme Court found this tax to be constitutional because it was treated as an excise tax.[3] In essence, it was a tax on the right to do business in the corporate form. So it was viewed as a form of the franchise tax.[4] Since the corporate form of doing business had been developed in the late nineteenth century, it was unknown to the framers of the U.S. Constitution. Because a corporation is an entity created under law, jurisdictions possess the right to tax its creation and operation. Using this rationale, many states still impose franchise taxes on corporations.

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

1-2b Revenue Acts

After the Sixteenth Amendment was ratified by the states, Congress enacted the Revenue Act of 1913. Under this Act, the first Form 1040 was due on March 1, 1914. The law allowed various deductions and personal exemptions of $3,000 for a single individual and $4,000 for married taxpayers. These large exemptions excluded all but the more wealthy taxpayers from the new income tax.[5] Rates ranged from a low of 1 percent to a high of 6 percent. The 6 percent rate applied only to taxable income in excess of $500,000.[6]

Various revenue acts were passed between 1913 and 1939. In 1939, all of these revenue laws were codified (arranged in a systematic manner) into the Internal Revenue Code of 1939. In 1954, a similar codification took place. The Internal Revenue Code of 1986, which largely carries over the provisions of the 1954 Code, is our current law. Tax law changes occur almost every year (how this happens is discussed in Chapter 2).

[2] 3 AFTR 2602, 15 S.Ct. 912 (USSC, 1895). See Chapter 2 for an explanation of the citations of judicial decisions.

[3] *Flint v. Stone Tracy Co.*, 3 AFTR 2834, 31 S.Ct. 342 (USSC, 1911).

[4] See the discussion of state franchise taxes later in text Section 1-4g.

[5] A $3,000 exemption in 1913 would be about $79,000 today, while a $4,000 exemption would be about $106,000.

[6] This should be contrasted with the highest 2021 tax rate of 37%, which applies once taxable income exceeds $523,600 for single taxpayers and $628,300 for married taxpayers filing a joint return.

1-2c Trends

The income tax is a major source of revenue for the Federal government. Exhibit 1.1 shows the tax revenue sources[7] and the importance of the income tax. Income tax collections from individuals and corporations amount to 58 percent of the total receipts. One revenue source missing from the Exhibit 1.1 pie chart is borrowing to cover the deficit, which in recent years has represented between 10 to 40 percent of total government revenues.

The need for revenues to finance the war effort during World War II converted the income tax from one that applied mostly to high-income individuals to a *mass tax*. In 1939, less than 6 percent of the U.S. population was subject to the Federal income tax. By 1945, more than 74 percent of the population was subject to the Federal income tax.[8]

Certain tax law changes are important to understand. In 1943, Congress passed the Current Tax Payment Act, which provided for a pay-as-you-go tax system. A pay-as-you-go income tax system requires employers to withhold a specified portion of an employee's wages and remit them to the government to cover the worker's income taxes. Persons with income from other than wages may have to make quarterly payments to the IRS for estimated taxes due for the year.

The increasing complexity of the Federal income tax laws causes concern among many, including lawmakers, taxpayers, and tax practitioners. Congress has added to this complexity by frequently changing the tax laws (e.g., by adding or deleting deductions or tax credits). This complexity forces many taxpayers to seek assistance in preparing their income tax returns. According to estimates, more than one-half of individual taxpayers who file a return pay a preparer and one-third purchase tax software.[9]

New ways of doing business and living often require changes to the tax law. For example, increased longevity requires a need for more revenues from Social Security taxes (and/or an increase in retirement age). Increased global business activity means modifying a country's tax system to be more in line with other countries to make sure businesses are not impeded when entering the global marketplace. Ideally, lawmakers should review tax systems periodically to ensure that they continue to be efficient in light of changes in how businesses and individuals function.

LO.3

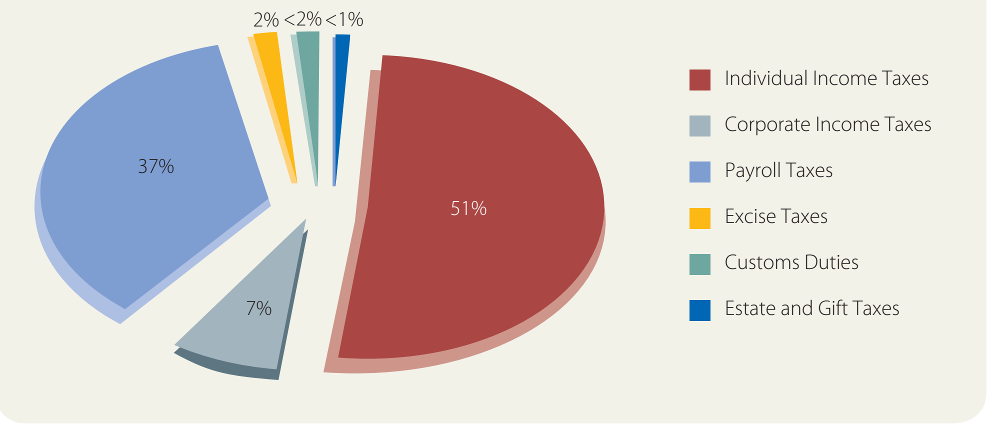
Describe and apply principles and terminology relevant to the design of a tax system.

1-3 TAX SYSTEM DESIGN

1-3a Legal Foundation

Article I, Section 8 of the U.S. Constitution states in part: "The Congress shall have power to lay and collect taxes." The Constitution also provided some limits on this taxing power, which led to the enactment of the Sixteenth Amendment to allow for an income

EXHIBIT 1.1 **Federal Tax Revenues (Estimated) in 2021**



[7] Revenue data can be found at **cbo.gov** and **whitehouse.gov/omb**. The instruction booklet for Form 1040 includes a revenue pie chart that includes borrowing to cover the deficit, as well as a pie chart that shows government spending in broad categories.

[8] Richard Goode, *The Individual Income Tax* (Washington, D.C.: The Brookings Institution, 1964), pp. 2–4.

[9] The Tax Foundation estimates that individual taxpayers spend over $20 billion and devote about 1.35 billion hours in preparing their tax returns.

tax (discussed in text Section 1-2a). This history lesson is important for a legislature or an electorate that wants to change a tax system. The jurisdiction's underlying governing documents (whether a country, state, or city) must be reviewed to determine whether they impose any restrictions relevant to taxation.

For example, the California Constitution (Article 13A) states that the maximum tax rate for real property taxation is 1 percent. The Florida Constitution (Section 5) specifies limits on the imposition of income taxes on natural persons. Also, state law may impose limitations on the types or amounts of taxes that cities and counties can impose.

Thus, the governing documents of a jurisdiction must be considered as part of any effort to modify that jurisdiction's tax system to make sure the change is permissible. If a change is not permissible but desired, then the governing document must be amended, as was done with the addition of the Sixteenth Amendment to the U.S. Constitution.

1-3b The Basic Tax Formula

The basic formula for any tax is:

Tax base Ⓧ **Tax rate** ⊜ **Tax liability**

Tax Base

A tax base is the amount to which the tax rate is applied. In the case of the Federal income tax, the tax base is *taxable income*. As noted later in the chapter (Exhibit 1.3), taxable income is gross income reduced by certain deductions (both business and personal).

Tax Rates

Tax rates are applied to the tax base to determine a taxpayer's liability. Some taxes, like the sales tax and the gasoline excise tax, apply a fixed tax rate to all transactions.

EXAMPLE 1

Kansas applies a sales tax rate of 6.5% to all taxable items. In contrast, Illinois applies a sales tax rate of 6.25% for most taxable items but applies a rate of 1% when the tax base consists of food or prescription drugs.

Alternatively, for some taxes, tax rates may vary depending on the details of the tax base. Income taxes tend to use a *progressive* tax rate structure where a higher rate of tax applies as the tax base increases.

EXAMPLE 2

Bill and Chris, a married couple filing jointly, have taxable income of $15,000. Their Federal income tax rate for 2021 is 10%, which is the rate that applies to the first $19,900 of taxable income for a married couple filing jointly.

If, however, their taxable income is $85,000, their Federal income tax rates progress from 10% to 12% to 22% as their taxable income increases. In this case, their 2021 Federal income tax liability is $10,197. The Federal income tax uses a *progressive* rate structure that applies higher rates to taxable income (the tax base) as that income increases (see Appendix A to confirm these calculations, and note how progressivity is built into the rate structure of the Federal income tax).

The basic tax formula (shown above) is relevant for both computing taxes and planning, as well as for reforming a tax system. For example, if a legislator wants to lower tax rates but generate the same amount of tax revenues, the tax base must be increased. However, if she wants to increase tax revenues, the tax base can be increased *or* tax rates can be increased (or both can be increased). Changes to the tax base will depend on how it is constructed. For example, the income tax base is taxable income (income minus income exclusions minus deductions). To increase this tax base, income exclusions could be eliminated or deductions could be limited. The details of the income tax base are discussed in later chapters. Tax system changes also involve canons (or principles) of taxation, discussed next.

1-3c Tax Principles

In the late 1700s, Adam Smith identified the following *canons (or principles) of taxation*, which are still considered today when evaluating a particular tax structure:[10]

- *Equity*. Each taxpayer enjoys fair or equitable treatment by paying taxes in proportion to his or her income level. Ability to pay a tax is one of the measures of how equitably a tax is distributed among taxpayers.
- *Certainty*. A tax should be certain rather than arbitrary. Taxpayers need to be able to understand how tax rules work so that they understand the effect of the rules on various transactions and can comply.
- *Convenience of payment*. Taxes should be imposed in a manner that involves a convenient time for payment. An advantage of the existing withholding system (pay-as-you-go) is its convenience for taxpayers.
- *Economy in collection*. A *good* tax system involves only nominal collection costs by the government and minimal compliance costs on the part of the taxpayer.

The American Institute of Certified Public Accountants (AICPA) has issued suggestions to guide tax reform and policy activities. Titled *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, the monograph identifies 12 principles that are commonly used as indicators of desirable tax policy. The first four principles are adapted from Adam Smith's *The Wealth of Nations*. The complete list follows:[11]

1. *Equity and Fairness*. Similarly situated taxpayers should be taxed in a similar manner.
2. *Certainty*. Taxpayers should have certainty rather than ambiguity as to when and how a tax is paid as well as how to calculate it.
3. *Convenience of Payment*. A tax should be due at a time and manner that is most convenient for the taxpayer.
4. *Effective Tax Administration*. Tax compliance and administrative costs should be kept to a minimum.
5. *Information Security*. Taxpayer information must be protected from improper disclosure.
6. *Simplicity*. Tax rules should be simple so that taxpayers understand them and can follow them in a cost-efficient manner.
7. *Neutrality*. The effect of tax rules on taxpayer decision making should be kept to a minimum.
8. *Economic Growth and Efficiency*. The tax system should not harm economic growth or distort economic effects among different activities and investments.
9. *Transparency and Visibility*. Taxpayers should know that a tax exists and how and when it applies to them.
10. *Minimum Tax Gap*. A tax should be structured to minimize noncompliance.
11. *Accountability to Taxpayers*. Taxpayers should have access to information on taxes as well as proposed law changes and their rationale.
12. *Appropriate Government Revenues*. Tax rules should enable the government to predict the amount and timing of revenue production.

Exhibit 1.2 provides an application of these principles to a proposed tax law change.

LO.4

Identify the different taxes imposed in the United States at the Federal, state, and local levels.

1-4 MAJOR TYPES OF TAXES

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

[10] *The Wealth of Nations* (New York: Dutton, 1910), Book V, Chapter II, Part II.

[11] AICPA, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, 2017. Similarly, see GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, 2005. As "long-standing criteria," the GAO lists "equity; economic efficiency; and a combination of simplicity, transparency, and administrability."

EXAMPLE 3

Rick is employed by Flamingo Corporation in San Antonio, Texas, at a salary of $74,000. Rick's employer offers him a chance to transfer to its New York City office at a salary of $94,000.

Although Rick must consider many nontax factors before he decides on a job change, he should also evaluate the tax climate. How do state and local taxes compare? For example, neither Texas nor San Antonio imposes an income tax, but New York State and New York City do. A quick computation indicates that the additional income taxes (Federal, state, and local) involve approximately $12,000.

Consequently, what appears to be a $20,000 pay increase is actually only about $8,000 when the additional $12,000 of income taxes are taken into account. Other taxes and costs (e.g., sales taxes, property taxes, food, utilities, transportation) will also have to be factored into a decision.

EXHIBIT 1.2 Application of the *Guiding Principles of Good Tax Policy*

The *Guiding Principles of Good Tax Policy* can be applied to evaluate an existing tax rule or a proposed change. Here is an example of how the principles apply to a state's proposal to exempt college textbooks from sales tax.

Principle	Application	Result
Equity and fairness	Although all college students would pay no sales tax on their textbooks, the effect varies among students based on their ability to pay. This proposal provides tax savings not only to lower-income students but also to higher-income students who may not need the tax break to cover school costs. Also, higher-income students might buy full-price new books rather than lower-cost used books, resulting in larger tax savings.	Not fully met
Certainty	College textbooks can be identified, such as by looking at what is listed on a course syllabus.	Met
Convenience of payment	A sales tax exemption generally means that the tax is not owed at the time of purchase. If, instead, the exemption is structured for the student to pay the sales tax and apply for a refund later, convenience of payment would not be met.	Met
Effective tax administration	Sellers will have additional record keeping and reporting requirements to separate tax-exempt textbook sales from taxable sales. Some type of system is needed to prove that the buyer is a student purchasing a book for a college class. The state tax agency will incur additional time and costs in writing rules, modifying tax forms, and auditing compliance with the new rule.	Not met
Information security	If obtaining the exemption requires that students show proof to retailers that they are a student, there should be no need to provide a Social Security number. If students are required to claim the exemption with the state tax agency after purchasing the textbooks, the agency might request a student's Social Security number, which could increase the risk of identity theft.	Likely met
Simplicity	"Textbook" needs to be defined. The intent of the exemption is to benefit students. The seller needs to verify that the book is for use by a student for a class. For example, both students and nonstudents might buy a copy of *Romeo and Juliet*. Only the student purchasing it for a college class is entitled to the sales tax exemption. Complexity exists in the procedures needed to ensure that the exemption is used properly.	Not met
Neutrality	Students purchase textbooks because they are needed for class. The exemption is unlikely to change a student's behavior.	Met
Economic growth and efficiency	The exemption will reduce costs of attending college by a small amount. As a result, the change is unlikely to result in a greater number of college graduates (which might benefit the economy). Savings from not paying sales tax might be spent on other consumables. The impact on the economy is likely minor.	Met
Transparency and visibility	Students and textbook sellers are likely to be aware of the exemption because colleges will promote it as a reduction in the cost of attending college.	Met
Minimum tax gap	Students may abuse the rule by using the exemption for books that are not for class use. Nonstudents may abuse this rule by claiming they are college students.	Not met
Accountability to taxpayers	Were students and universities, particularly those funded by the state, aware of the textbook sales tax exemption proposal? Students and universities could provide information to legislators on whether there is a need for a sales tax exemption or if other financial support would be more helpful. Bookstores would want an opportunity to provide information on the compliance costs and challenges of the exemption.	More information needed
Appropriate government revenue	Existing data on how many textbooks are purchased enable the government to estimate how much tax revenues will decrease due to the new exemption.	Met

Conclusion: Although the majority of the principles are met, the ones that are not met (effective tax administration, simplicity, and minimum tax gap) are significant. If lawmakers believe this tax exemption is necessary to help lower costs for college students, they should consider alternative means of achieving the goal that are less complex. For example, grants could be offered or increased for college students in need of financial assistance.