Principles of Taxation

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for Business and Investment Planning 2022 Edition

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To Zane, Tony, Tom, and Jessica

About the Authors

Sally M. Jones

Sally M. Jones is professor emeritus of accounting at the McIntire School of Commerce, University of Virginia, where she taught undergraduate and graduate tax courses. Before joining the Virginia faculty in 1992, Professor Jones spent 14 years on the faculty of the Graduate School of Business, University of Texas at Austin. She received her undergraduate degree from Augusta College, her MPA from the University of Texas, and her PhD from the University of Houston. She is also a CPA. Professor Jones was the first editor of *Advances in Taxation* (JAI Press) and the *PriceWaterhouse Case Studies in Taxation.* She has published numerous articles in the *Journal of Taxation, The Tax Adviser,* and the *Journal of the American Taxation Association.* Professor Jones is a frequent speaker at tax conferences and symposia, a past president of the American Taxation Association, and the 2000 recipient of the Ray M. Sommerfeld Outstanding Tax Educator Award.

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Shelley C. Rhoades-Catanach is an associate professor of accountancy at Villanova University. She teaches a variety of tax courses in Villanova's undergraduate, masters of accounting, and graduate tax programs. Before joining the Villanova faculty in 1998, Professor Rhoades-Catanach spent four years on the faculty of Washington University in St. Louis. She has also served as a visiting faculty member at the Darden Graduate School, University of Virginia, and at INSEAD, an international MBA program in Fontainebleau, France. She received her undergraduate degree in accounting from the University of Nebraska at Lincoln and her PhD from the University of Texas at Austin. Professor Rhoades-Catanach has published articles in numerous journals, including the *Journal of the American Taxation Association, Accounting Review, Issues in Accounting Education, Journal of Accounting Education,* and *Review of Accounting Studies.* She has served as president, vice president, and trustee of the American Taxation Association and on the editorial boards of the *Journal of the American Taxation Association* and the *Journal of International Accounting, Auditing and Taxation.* She is the former co-editor of the *Journal of International Accounting, Auditing and Taxation.* Professor Rhoades-Catanach is the 2010 recipient of the Ray M. Sommerfeld Outstanding Tax Educator Award.

Sandra Renfro Callaghan

Sandra Renfro Callaghan is an associate professor of accounting at the Neeley School of Business at Texas Christian University. She joined the faculty in 1998 after earning her PhD in accounting from Michigan State University. Her current research is primarily focused on topics in taxation, executive compensation, and the Affordable Health Care Act. Professor Callaghan teaches tax and financial accounting courses both at the undergraduate and the graduate level and has earned numerous teaching awards, including the Deans' Teaching Award and Neeley School of Business Alumni Professor of the Year. She has served in various leadership roles, including president of the American Taxation Association and member of the American Accounting Association Council. Professor Callaghan earned a BS from Texas Christian University and an MPA from the University of Texas at Austin. Prior to earning her PhD, she was a tax professional with Ernst & Young.

University of Nebraska-Lincoln

Thomas R. Kubick is an associate professor and Fulk faculty chair at the University of Nebraska–Lincoln, where he teaches undergraduate and graduate tax courses. Prior to joining the University of Nebraska–Lincoln in July 2019, he was an associate professor at the University of Kansas. A native of Lincoln, he received his undergraduate and graduate degrees from the University of Nebraska–Lincoln. He holds numerous professional certifications, including the Chartered Financial Analyst (CFA), Certified Public Accountant (CPA), Chartered Alternative Investment Analyst (CAIA), Certified Management Accountant (CMA), Certified Fraud Examiner (CFE), and Certified Financial Planner (CFP). Professor Kubick's research interests include taxation, corporate finance, and incentives. His research has been published in numerous academic journals such as the *Journal of Accounting and Economics, The Accounting Review, Management Science, Review of Accounting Studies, Journal of Corporate Finance, National Tax Journal,* and the *Journal of the American Taxation Association.* He currently serves on the editorial boards of *Accounting Horizons, Journal of Business Finance and Accounting,* and the *Journal of International Accounting Research.*

A Note from the Authors

We welcome Dr. Thomas R. Kubick as the newest addition to the author team of *Principles of Taxation for Business and Investment Planning.* Professor Kubick is the Ellsworth L. Fulk Chair of Accountancy at the University of Nebraska–Lincoln. He is a longtime adopter and enthusiastic champion of the text and its approach to teaching taxation. We are thrilled that Tom has agreed to join our team and look forward to his future contributions to the text.

Principles of Taxation for Business and Investment Planning is a unique approach to the subject of taxation. This text is designed for use in introductory tax courses included in either undergraduate or graduate business programs. Its objective is to teach students to recognize the major tax issues inherent in business and financial transactions. The text focuses on fundamental concepts, the mastery of which provides a permanent frame of reference for future study of advanced tax topics. Unlike traditional introductory texts, *Principles of Taxation for Business and Investment Planning* downplays the technical detail that makes the study of taxation such a nightmare for business students. Traditional texts are heavily compliance oriented and convince many students that the tax law is too complex and specialized to be relevant to their future careers. This text attempts to do just the opposite by convincing students that an understanding of taxation is not only relevant but critical to their success in the business world.

Principles of Taxation for Business and Investment Planning has its origin in the 1989 White Paper titled *Perspectives on Education: Capabilities for Success in the Accounting Profession,* published jointly by the Big Eight public accounting firms. The White Paper expressed disenchantment with the narrow technical focus of undergraduate accounting curricula and called for scholastic emphasis on a broad set of business skills necessary for professional success. The Accounting Education Change Commission (AECC), operating under the aegis of the American Accounting Association, embraced the philosophy reflected in the White Paper. In September 1990, the AECC published its Position Statement No. One, titled *Objectives of Education for Accountants.* This statement reiterated that an undergraduate business education should provide a base for lifelong learning.

Beginning in 1996, the American Institute of CPAs (AICPA) and the American Taxation Association (ATA) developed the Model Tax Curriculum (MTC) as a resource for accounting educators seeking to develop or modify accounting programs or course offerings to best prepare students to enter the accounting profession. The primary objective of the MTC is for students to understand the role taxation plays in business decision-making and financial reporting by building a foundation for future learning in tax, even if the student does not plan on becoming a tax professional. The MTC has been updated several times since its inception to provide ongoing support and guidance to tax educators.

Despite these calls for reform, many undergraduate tax courses are taught in a traditional manner based on a paradigm developed 60 years ago. In the modern era of business education, the first generation of tax teachers were practitioners: accountants or attorneys hired as adjunct faculty to initiate students into the mysteries of the Internal Revenue Code of 1954. These practitioners taught their students in the same way they trained their employees. In doing so, they created a compliance-oriented paradigm. In today's world, this traditional paradigm is an anachronism. Business students don't need to learn how to generate tax information. Instead, they must learn how to use tax information to make good business and financial decisions.

A Paradigm for the Introductory Tax Course

Principles of Taxation for Business and Investment Planning provides a paradigm for meeting the educational needs of tax students in the 21st century. This paradigm is based on three postulates:

- **Postulate 1: Students should learn the tax law as an integrated component of a complex economic environment.** They should be aware of the role taxes play in financial decision making and should understand how taxes motivate people and institutions to engage in certain transactions.

- **Postulate 2: Students should comprehend the tax law as an organic whole rather than as a fragmented collection of rules and regulations.** They should learn general tax rules rather than the myriad of exceptions that confuse rather than clarify the general rules. They should appreciate how the general rules apply to all taxpaying entities before they learn how specialized rules apply to only certain entities. Finally, they should learn how the law applies to broad categories of transactions rather than to a particular transaction.
- **Postulate 3: Students who learn fundamental concepts have a permanent frame of reference into which they can integrate the constant changes in the technical minutiae of the law.** The rapid evolution of the tax law results in a short shelf life for much of the detailed information contained in undergraduate tax texts. Yet the key elements of the law—the statutory and judicial bedrock—do not change with each new revenue act. Students who master these key elements truly are prepared for a lifetime of learning.

We authors know that traditional paradigms die hard and educational reform is difficult. Nevertheless, we believe that change in the way college and university professors teach tax is both inevitable and worthwhile. Our responsibility to our students is to prepare them to cope in a business world with little tolerance for outdated skills or irrelevant knowledge. Our hope is that *Principles of Taxation for Business and Investment Planning* is a tool that can help us fulfill that responsibility.

Using This Text in a First-Semester Tax Course

Principles of Taxation for Business and Investment Planning is designed for use in a one-semester (15-week) introductory tax course. Instructors can choose which of the 18 chapters deserve a full week's coverage and which can be covered in less than a week. Instructors may even decide to omit chapters that seem less relevant to the educational needs of their students. Business students who complete a one-semester course based on this text will be well prepared to function in the modern tax environment. If they are required (or may elect) to take a second tax course, they will have a solid, theoretical foundation on which to build.

This is the 25th annual edition of *Principles of Taxation for Business and Investment Planning.* Adopters of the text will certainly have many excellent suggestions to improve the next edition. We welcome any and all comments and encourage fellow teachers to e-mail us with their input (smj7q@virginia.edu, shelley.rhoades@villanova.edu, s.callaghan@tcu.edu, and tkubick@unl.edu).

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Changes in *Principles of Taxation*, 2022 edition

Chapter 1

- Updated all Tax Talks, examples, and end-of-chapter problems as needed.
- Updated all references to state income tax, sales tax, and excise tax rates.
- Updated Exhibit 1.1 to include fiscal year 2019 federal tax revenue data.
- Added new Tax Talk on page 1–11.

Chapter 2

- Updated federal deficit and national debt data on page 2–3.
- Updated discussion of payroll and self-employment taxes for changes to inflation-adjusted Social Security tax threshold on page 2–3.
- Updated Tax Talk to reflect new CBO projection of public debt to GDP on page 2–7.
- Updated Tax Talk discussion on the complexity of Internal Revenue Code on page 2–8.
- Updated Share of Income/Share of Taxes discussion on page 2–17 to reflect most current data available.

Chapter 3

- Updated the cost of Private Letter Ruling on page 3–12.

Chapter 4

- Added new Tax Talk on page 4–6.
- Revised Global Tax Costs example on page 4–10.

Chapter 5

- No significant changes in this edition.

Chapter 6

- Added new Tax Talks on pages 6–9 and 6–25.
- Revised the discussion of the treatment of unearned revenue from inventory sales on page 6–19 to reflect application of the one-year deferral method to merchandise inventory.
- Updated discussion of NOL carryforwards for changes made by the CARES Act, including a new example.
- Updated discussion of excess business loss limitation for changes made by the CARES Act.
- Updated 2021 excess business loss thresholds on page 6–27.
- Discussion of business meals updated for CAA of 2021 temporary allowance of 100% deduction for business meals provided by a restaurant.

Chapter 7

- Updated discussion of Section 179 deduction for 2021 thresholds.
- Revised discussion of qualified improvement property to reflect the CARES Act retroactive change to treat such assets as 15-year recovery property if placed in service after December 31, 2017.
- Revised examples on pages 7–13 and 7–20 dealing with real property improvements.
- Updated passenger automobile limits to 2020 amounts.

Chapter 8

- Expanded example of book/tax differences from installment sale on page 8–26.

Chapter 9

- Added new Tax Talk on page 9–8.
- Added discussion of three-year replacement period for property lost through condemnation on page 9–10.
- Expanded wash sale example on page 9–14.

Chapter 10

- Updated Schedule C, Form 1065, Form 1120-S, and Schedule K-1s to 2020 versions.
- Updated discussion of payroll and self-employment taxes for changes to inflation-adjusted Social Security tax threshold on pages 10–11 through 10–15.
- Added a discussion of CARES Act provisions related to payroll and self-employment taxes on pages 10–12 and 10–14.
- Updated filing statistics in Tax Talks throughout.
- Updated QBI thresholds for 2021 inflation adjustments.
- Discussion of employee retention tax credits updated for CAA of 2021 changes

Chapter 11

- Updated filing statistics in Tax Talks throughout.
- Added new Tax Talks on pages 11–4, 11–6, 11–11, and 11–13.
- Updated Form 1120 and Schedule M-3 to 2020 versions.
- Revised discussion of minimum tax credits to incorporate provisions of the CARES Act.
- Discussion of Tax Freedom Day on page 11–16 has not been updated to 2020 statistics. The Tax Foundation has yet to publish a 2020 Tax Freedom Day report.

Chapter 12

- Updated filing statistics in Tax Talk on page 12–8.

Chapter 13

- Added new Tax Talk on page 13–12.

Chapter 14

- Updated for inflation adjustments including tax rate tables, standard deductions, and AMT exemption amounts.
- Updated Tax Talk to reflect most recent IRS SOI data on page14–5.
- Added new Tax Talk (standard deduction) on page 14–11.
- Revised kiddie tax example 14–17.
- Updated earned income credit to reflect 2021 inflation adjustments on page 14–20.
- Added new Tax Talk (COVID filing deadline extension) on page 14–27.
- Updated Volpe family examples throughout chapter to reflect 2021 law.
- Updated Form 1040 to reflect revised version of the 1040 and supporting schedules.

Chapter 15

- Updated all Tax Talks, examples, and end-of-chapter problems.
- Added new Tax Talk discussing hourly workers on page 15–2.
- Updated discussion to include the 1099-NEC on page 15–3.

- Updated examples on pages 15–3 and 15–4 to include 2020 Form W-2 and Form 1099-NEC on page 15–3.
- Added new Tax Talk that discusses the waived required minimum distribution rules under the Cares Act on page 15–20.
- Added new Tax Talk that discusses premature retirement account withdrawals under the the Cares Act on page 15–21.
- Updated coverage of employer-provided plans to reflect 2021 inflation adjustments.
- Updated coverage of individual retirement accounts to reflect 2021 inflation adjustments.

Chapter 16

- Updated all Tax Talks, examples, and end-of-chapter problems.
- Updated Exhibits 16.1, 16.2, and 16.3 to include 2020 Form 1040, Schedule B, Schedule D, and Schedule E.
- Updated coverage of the gift and estate taxes to reflect 2021 inflation adjustments.
- Revised Appendix 16–A to include 2020 Form 8949, Form 1040, Schedule D, and Qualified Dividends and Capital Gain Tax Worksheet.

Chapter 17

- Updated all Tax Talks, examples, and end-of-chapter problems.
- Updated discussion of charitable contributions for changes made by the CARES Act and Consolidated Appropriations Act.

Chapter 18

- Add discussion of special exception to filing and payment deadline due to COVID pandemic on page 18–4.
- Updated all Tax Talks, examples, and end-of-chapter problems.

Content Organization

The content and organization of this text are highly compatible with the Model Tax Curriculum proposed by the American Institute of Certified Public Accountants. According to the AICPA, the introductory tax course should expose students to a broad range of tax concepts and emphasize the role of taxation in the business decision-making process. Under the model curriculum, students first learn to measure the taxable income from business and property transactions. They are then introduced to the different types of business entities and the tax considerations unique to each type. Individual taxation should be one of the last topics covered, rather than the primary focus of the course. Because *Principles of Taxation for Business and Investment Planning* reflects this recommended pedagogical approach, the text is ideal for courses based on the AICPA Model Tax Curriculum.

PART ONE

Exploring the Tax Environment

Part One consists of two chapters that familiarize students with the global tax environment. Chapter 1 describes the environment in terms of the legal relationship between taxes, taxpayers, and governments. Definitions of key terms are developed, and the major taxes are identified. Chapter 2 considers the tax environment from a normative perspective by asking the question: "What are the characteristics of a good tax?" Students are introduced to the notions of tax efficiency and tax equity and learn how contrasting political beliefs about efficiency and equity continue to shape the tax environment.

PART TWO

Fundamentals of Tax Planning

Part Two concentrates on developing a methodology for incorporating tax factors into business decisions. Chapter 3 introduces the pivotal role of net present value of cash flows in evaluating financial alternatives. Students learn how to compute tax costs and tax savings and how to interpret them as cash flows. Chapter 4 covers the maxims of income tax planning. The characteristics of the tax law that create planning opportunities are explained, and the generic techniques for taking advantage of those opportunities are analyzed. Chapter 5 provides a succinct overview of the tax research process and prepares students to solve the research problems included at the end of each chapter. The chapter explains the six steps in the tax research process and contains a cumulative example of the application of each step to a research case.

Part Three focuses on the quantification of business taxable income. Chapter 6 covers the computation of income or loss from ongoing commercial activities, with special emphasis on differences between taxable income and net income for financial statement purposes. Chapters 7 and 8 explore the tax implications of acquisitions and dispositions of business property, while Chapter 9 is devoted to nontaxable exchanges.

Part Four teaches students how to calculate the tax on business income. Chapter 10 describes the function of sole proprietorships, partnerships, LLCs, and S corporations as conduits of income, while Chapter 11 discusses corporations as taxable entities in their own right. Chapter 12 builds on the preceding two chapters by exploring the tax planning implications of the choice of business entity. Chapter 13 broadens the discussion by considering the special problems of businesses operating in more than one tax jurisdiction. This chapter introduces both multistate and international tax planning strategies.

Part Five concentrates on the tax rules and regulations unique to individuals. Chapter 14 presents the individual tax formula and acquaints students with the complexities of computing individual taxable income. Chapter 15 covers compensation and retirement planning. Chapter 16 covers investment and rental activities and introduces wealth transfer planning. Finally, Chapter 17 analyzes the tax consequences of personal activities, with particular emphasis on home ownership.

Part Six consists of Chapter 18, which presents the important procedural and administrative issues confronting taxpayers. It covers the basic rules for paying tax and filing returns, as well as the penalties on taxpayers who violate the rules. Chapter 18 also describes the judicial process through which taxpayers and the IRS resolve their differences.

PART THREE

The Measurement of Taxable Income

PART FOUR

The Taxation of Business Income

PART FIVE

The Individual Taxpayer

PART SIX

The Tax Compliance Process

Key Learning Tools

Learning Objectives

The chapters begin with learning objectives that preview the technical content and alert students to the important concepts to be mastered. These objectives appear again as marginal notations marking the place in the chapter where each learning objective is addressed.

Learning Objectives

After studying this chapter, you should be able to:

LO 4-1. Describe the difference between tax avoidance and tax evasion.

LO 4-2. Explain why an income shift or a deduction shift from one entity to another can affect after-tax cash flows.

LO 4-3. Explain how the assignment of income doctrine constrains income-shifting strategies.

LO 4-4. Determine the effect on after-tax cash flows of deferral of a tax cost.

LO 4-3
Explain how the assignment of income doctrine constrains income-shifting strategies.

Assignment of Income Doctrine

The federal courts have consistently held that our income tax system cial shifts of income from one taxpayer to another. Over 80 years ago decided that income must be taxed to the person who earns it, even if legal right to the wealth represented by the income.[4] Thus, a business a $10,000 check in payment for services rendered to a client can't avo income by simply endorsing the check over to his daughter. In the pi the Court, the tax law must disregard arrangements "by which the fru different tree from that on which they grew."

Examples and Cases

The chapters contain numerous examples and cases illustrating or demonstrating the topic under discussion.

Conflicting Maxims

Firm MN operates as two separate taxable entities, Entities M and N. The firm is ne ing a transaction that will generate $25,000 cash in year 0 and $60,000 cash in yea Entity M undertakes the transaction, taxable income will correspond to cash flow (i.e., M will report $25,000 and $60,000 taxable income in years 0 and 1). If Entity N unde the transaction, it must report the entire $85,000 taxable income in year 0. Entity M 32 percent marginal tax rate, while Entity N has a 21 percent marginal tax rate. Firm MN a 5 percent discount rate to compute NPV.

	Entity M		Entity N	
Year 0:				
Before-tax cash flow		$25,000		$2
Taxable income	$25,000		$85,000	
	.32		.21	

Tax Talk

Each chapter includes items of "Tax Talk." These items highlight new tax planning strategies, tax facts, legislative proposals, or innovative transactions with interesting tax implications reported in the business press.

Tax Talk
Several of Europe's smallest countries, such as Luxembourg, Switzerland, and Ireland, offer very low corporate tax rates to attract multinational corporations. Case in point: Amazon.com channels the profits earned across the 27-nation European Union through its Luxembourg subsidiary.

income.[7] Both firms face a 21 percent federal tax rate. Under these facts, Firms Y have the following after-tax cash flows:

	Firm Y	Firm Z
Before-tax cash/income	$5,000	$5,000
State income tax cost	(200)	(500)
Federal taxable income	$4,800	$4,500
Federal tax cost		
(Taxable income × 21%)	(1,008)	(945)
After-tax cash flow	$3,792	$3,555

A comparison of these after-tax cash flows gives us our third income tax planning *Tax costs decrease (and cash flows increase) when income is generated in a jurisdictio low tax rate.*

Key Terms

Key terms are indicated in boldface in the text. A list of key terms is also supplied at the end of the chapter with page references for easy review. Definitions of key terms from all the chapters are compiled in a Glossary for the text.

Key Terms

accrual method of accounting *6-14*
all-events test *6-19*
allowance method *6-23*
business interest limitation *6-9*
calendar year *6-5*
cash method of accounting *6-10*
constructive receipt *6-11*
deferred tax asset *6-17*
deferred tax liability *6-17*
direct write-off method *6-23*
economic performance *6-20*

excess business loss limitation *6-27*
fiscal year *6-5*
generally accepted accounting principles (GAAP) *6-14*
gross income *6-4*
hybrid method of accounting *6-13*
key-person life insurance policies *6-10*
method of accounting *6-6*
net operating loss (NOL) *6-24*
NOL carryforward *6-25*
payment liability *6-20*

perman differ
person corpo
prepaid
qualifie incom
realizat
recogn
recurri excep
short-p
tax ben
taxable
tempo dif

Sources of Book/ Tax Differences

Chapters 6, 7, 8, 9, 11, 13, and 15 provide a list of the sources of book/tax differences introduced in the chapter.

Sources of Book/Tax Differences

Permanent

- Interest on state and local bonds
- Key-person life insurance proceeds and premiums
- Fines and penalties
- Political contributions and lobbying expense
- Meals and entertainment expenses
- Sexual harassment settlements subject to nondisclosure agreements

Temporary

- Prepaid income
- Bad debts
- Accrued expenses f test
- Compensation accr
- Related party accru
- NOL carryforwards
- Business interest ex

Questions and Problems for Discussion

The questions and problems challenge students to think critically about conceptual and technical issues covered in the chapter. These problems tend to be open-ended and are designed to engage students in debate. Many problems require students to integrate material from previous chapters in formulating their responses.

Questions and Problems for Discussion

LO 6-1 1. Firm LK bought a warehouse of used furniture to equip several of it An employee discovered a cache of gold coins in a desk drawer. A loc Firm LK the rightful owner of the coins, which have a $72,000 fair mar Does Firm LK recognize income because of this lucky event?

LO 6-2 2. Discuss the choice of a taxable year for the following businesses:
a. Retail plant and garden center.
b. French bakery.
c. Chimney cleaning business.
d. Moving and transport business.
e. Software consulting business.

LO 6-3 3. Corporation DB operates three different lines of business. Can the co different overall method of accounting for each line, or must the corpo overall method?

Application Problems

Application problems give students practice in applying the technical material covered in the chapter. Most of the problems are quantitative and require calculations to derive a numeric solution.

Application Problems

LO 6-1 1. Nello Company owed $23,400 overdue rent to its landlord, Bonview Inc. B
is a desirable tenant, Bonview agreed to settle the overdue account for a
payment from Nello. Both Nello and Bonview are accrual basis taxpayers.
a. What is the tax consequence to Nello of the settlement of its $23,400
able to Bonview? Compute Nello's net cash outflow from the settlem
its tax rate is 35 percent.
b. What is the tax consequence to Bonview of the settlement of its $23
receivable from Nello? Compute Bonview's net cash inflow from th
assuming its tax rate is 21 percent.

Issue Recognition Problems

These issue recognition problems develop students' ability to recognize the tax issues suggested by a set of facts and to state those issues as questions. The technical issues buried in these problems typically are *not* discussed in the chapter. Consequently, students must rely on their understanding of basic principles to analyze the problem, spot the tax concern or opportunity, and formulate the question to be resolved. In short, students must take the first steps in the tax research process.

Issue Recognition Problems

Identify the tax issue or issues suggested by the following situations, and state
the form of a question.

LO 4-1 1. Dr. Phan is a physician with his own medical practice. For the past seve
marginal income tax rate has been 37 percent. Dr. Phan's daughter, who is
dent, has no taxable income. During the last two months of the year, Dr. P
his patients to remit their payments for his services directly to his daughte

LO 4-1 2. Mr. and Mrs. Knight own rental property that generates $4,000 monthly
couple is in the highest marginal tax bracket. For Christmas, Mr. and Mrs
the uncashed rent checks for October, November, and December to the
grandson as a gift.

Research Problems

Research problems provide further opportunity for students to develop their analytic skills. These problems consist of short scenarios that suggest one or more tax issues. The scenarios conclude with explicit research questions for the students to answer. To find the answers, they need access to either a traditional or an electronic tax library.

Research Problems

LO 4-1 1. Using an electronic library such as Checkpoint, CCH IntelliConnect, o
find a federal tax case in which the taxpayer is found guilty of tax evasion.
the case, list the behaviors of the taxpayer that convinced the court that
was evading (rather than legally avoiding) tax.

LO 4-9 2. Using an electronic library such as Checkpoint, CCH IntelliConnect, o
determine how many federal tax cases decided in 2020 contain the
transaction.

LO 4-9 3. Using an electronic library such as Checkpoint, CCH IntelliConnect, o
find a case that discusses the step transaction doctrine in the opinion a
written summary (brief) of the case.

Tax Planning Cases

These cases give students an opportunity to integrate their tax knowledge into a business planning framework. Most cases involve taxpayers who must decide whether to undertake a certain transaction or who must choose between alternative transactions. Students must assume the role of tax adviser by recommending a course of action to maximize the after-tax value of the transaction.

Tax Planning Cases

LO 4-4 1. Mrs. Oliver is negotiating to purchase a tract of land from DC Compan
year taxpayer. DC bought this land six years ago for $480,000. Accordin
appraisal, the land is worth $800,000 in the current real estate market.
DC's director of tax, the company's profit on the sale will be taxed at 35
sale occurs this year. However, this tax rate will definitely decrease to 21
sale occurs next year. Mrs. Oliver is aware that DC would prefer the sale cl
However, Mrs. Oliver needs the land immediately to begin construction o
outlet. She offers to pay $875,000 for the land with the stipulation that the
December 31. Should DC accept Mrs. Oliver's offer?

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- Jordan Cunningham,
Eastern Washington University

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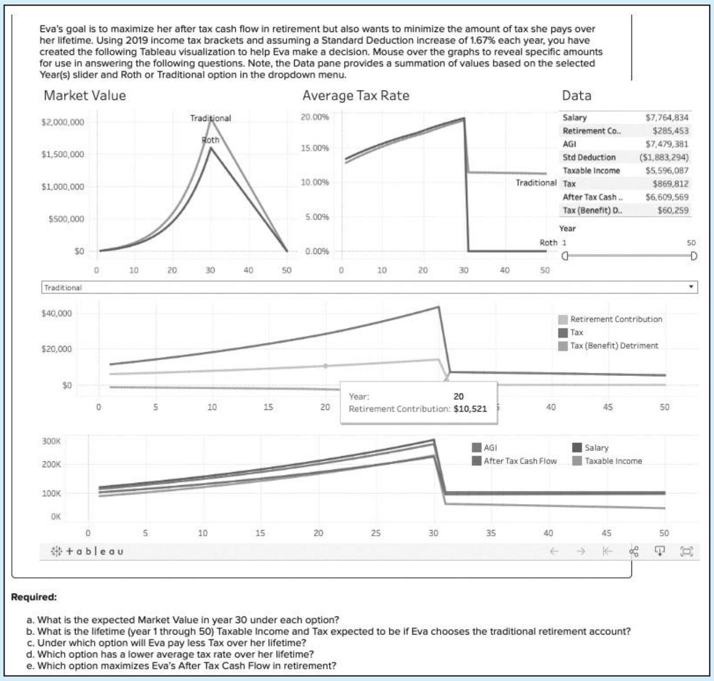
Online Assignments



Source: Internal Revenue Service

Tableau Dashboard Activities

Tableau Dashboard Activities allow students to explore live Tableau dashboards directly integrated into *Connect* through interactive filters and menus as well as auto-graded questions focused on both calculations and analysis. Students can check their understanding and apply what they are learning within the framework of analytics and critical thinking.

Auto-Graded Tax Form Simulations

The auto-graded tax form simulation, assignable within *Connect,* provides a much-improved student experience when solving the tax form–based problems. The tax form simulation allows students to apply tax concepts by completing the actual tax forms online with automatic feedback and grading for both students and professors.

Auto-Graded Tax Planning Cases and Application Problems

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. *Connect* grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes static and algorithmic versions of tax planning cases (some in the form of auto-graded tax form problems) and application problems. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.

Source: Roger CPA Review

Roger CPA Review Powered by UWorld

McGraw-Hill has partnered with Roger CPA Review Powered by UWorld, a global leader in CPA Exam preparation, to provide students a smooth transition from the accounting classroom to successful completion of the CPA Exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA Exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing the CPA Exam. Accordingly, students using these McGraw-Hill materials will have access to Roger CPA Review multiple choice questions supported by explanations written by CPAs focused on exam preparation. McGraw-Hill and Roger CPA Review are dedicated to supporting every accounting student along their journey, ultimately helping them achieve career success in the accounting profession. For more information about the full Roger CPA Review program, exam requirements, and exam content, visit **www.rogercpareview.com.**

TaxAct Professional

Source: TaxAct Professional

TaxAct

Users of *Principles of Taxation for Business and Investment Planning* now have access to TaxAct, one of the leading preparation software companies in the market today.

Please note, TaxAct is compatible only with PCs and not Macs. However, we offer easy-to-complete licensing agreement templates that are accessible within *Connect* and the Instructor Resources Center to enable school computer labs to download the software onto campus hardware for free.

Test Builder in Connect

Available within *Connect,* Test Builder is a cloud-based tool that enables instructors to format tests that can be printed or administered within a LMS. Test Builder offers a modern, streamlined interface for easy content configuration that matches course needs, without requiring a download.

Test Builder allows you to:

- Access all test bank content from a particular title.
- Easily pinpoint the most relevant content through robust filtering options.
- Manipulate the order of questions or scramble questions and/or answers.
- Pin questions to a specific location within a test.
- Determine your preferred treatment of algorithmic questions.
- Choose the layout and spacing.
- Add instructions and configure default settings.

Test Builder provides a secure interface for better protection of content and allows for just-in-time updates to flow directly into assessments.

Mc Graw Hill tegrity

Source: tegrity

Tegrity Campus: Lectures 24/7

Tegrity in *Connect* is a tool that makes class time available 24/7 by automatically capturing every lecture. With a simple one-click start-and-stop process, you capture all computer screens and corresponding audio in a format that is easy to search, frame by frame. Students can replay any part of any class with easy-to-use, browser-based viewing on a PC, Mac, iPod, or other mobile device.

Educators know that the more students can see, hear, and experience class resources, the better they learn. In fact, studies prove it. Tegrity's unique search feature helps students efficiently find what they need, when they need it, across an entire semester of class recordings.

Help turn your students' study time into learning moments immediately supported by your lecture. With Tegrity, you also increase intent listening and class participation by easing students' concerns about note-taking. Using Tegrity in Connect will make it more likely you will see students' faces, not the tops of their heads.

Remote Proctoring & Browser-Locking Capabilities

Mc Graw Hill connect + proctorio

New remote proctoring and browser-locking capabilities, hosted by Proctorio within *Connect,* provide control of the assessment environment by enabling security options and verifying the identity of the student.

Seamlessly integrated within *Connect,* these services allow instructors to control students' assessment experience by restricting browser activity, recording students' activity, and verifying students are doing their own work.

Instant and detailed reporting gives instructors an at-a-glance view of potential academic integrity concerns, thereby avoiding personal bias and supporting evidence-based claims.

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Introduction to Students

Principles of Taxation for Business and Investment Planning explores the role that taxes play in modern life. The book is written for business students who have completed introductory courses in accounting and finance and are familiar with basic business concepts. Those of you who fit this description, regardless of your future career path, will make decisions in which you must evaluate the effect of taxes. At the most fundamental level, all business decisions have the same economic objective: maximization of long-term wealth through cash flow enhancement. The cash flow from any transaction depends on the tax consequences. Therefore, businessmen and -women must appreciate the role of taxes before they can make intelligent decisions, whether on behalf of their firm or on their personal behalf.

Taxes as Business Costs

When businesspeople are asked to identify the common goal of all business decisions, their immediate response tends to be that the goal is to increase profits. When prompted to think past the current year, most eventually conclude that the long-term goal of business decisions is to maximize the value of the firm. In this text, a **firm** is a generic business organization. Firms include sole proprietorships, partnerships, limited liability companies, subchapter S and regular corporations, and any other arrangement through which people carry on a profit-motivated activity. Firm managers know that short-term profits and long-term value are enhanced when operating costs, including taxes, are controlled. Experienced managers never regard taxes as fixed or unavoidable costs. As you will soon discover, opportunities abound for controlling the tax cost of doing business.

The preceding paragraph suggests that tax planning means reducing tax costs to maximize the value of the firm. Firms can reduce taxes by any number of strategies. However, tax cost is only one variable that managers must consider in making business decisions. A strategy that reduces taxes may also have undesirable consequences, such as reducing revenues or increasing nontax costs. Because of nontax variables, the strategy with the least tax cost may not be the best strategy. Therefore, tax minimization in and of itself may be a short-sighted objective. This point is so elementary yet so important: *Effective tax planning must take into account both tax and nontax factors.* When faced with competing strategies, managers should implement the strategy that maximizes firm value, even when that strategy has a higher tax cost than the alternatives. In other words, managers should never let the tax tail wag the business dog.

Taxes as Household Expenditures

Principles of Taxation for Business and Investment Planning concentrates on the income taxation of business activities and organizations. This doesn't mean that the tax rules applying to individuals are ignored. Quite the contrary. For income tax purposes, individuals and the profit-making activities in which they engage are entwined. As we will observe over and over again, the ultimate taxpayers in every business are the people who own and operate that business.

As you study this text, consider your own role as a lifelong taxpayer. Regardless of who you are, where you live, or how you earn and spend your money, you will pay taxes on a regular basis to any number of governments. In fact, in the United States, taxes are the single largest household expenditure. According to data from the Tax Foundation, Americans devote about 2 hours and 15 minutes of every 8-hour workday to earn enough to pay their local, state, and federal taxes.

People who are clueless about taxes must take a passive role, participating in a tax system they don't understand and over which they exercise no control. In contrast, if you understand how taxes relate to your life, you can take an active role. You can take positive steps to minimize your personal tax to the fullest extent allowed by law. You can make informed financial decisions to take advantage of tax-saving opportunities. You can draw rational conclusions about the efficiency and fairness of existing tax laws and can assess the merit of competing tax reform proposals. Finally, you can change the tax system by participating as a voter in the democratic process.

The Text's Objectives

Principles of Taxation for Business and Investment Planning has three objectives that motivate the overall design of the text, the selection and ordering of topics, and the development of each topic: (1) introducing tax policy issues, (2) bridging the gap between finance and tax, and (3) teaching the framework of the income tax.

Introducing Tax Policy Issues

The first objective is to acquaint you with the economic and social policy implications of the tax systems by which governments raise revenues. Most of the subject matter of the text pertains to today's tax environment and how successful businesses adapt to and take advantage of that environment. But the text also raises normative issues concerning the efficiency and equity of many features of the tax environment. You will learn how certain provisions of the tax law are intended to further the government's fiscal policy goals. You are invited to evaluate these goals and to question whether the tax system is an appropriate mechanism for accomplishing the goals.

The text identifies potentially negative aspects of the tax environment. It explains how taxes may adversely affect individual behavior or cause unintended and undesirable outcomes. You will be asked to consider whether certain provisions of the tax law favor one group of taxpayers over another and whether such favoritism is justifiable on any ethical grounds. After probing both the strengths and the weaknesses of the current tax system, you can draw your own conclusions as to how the system can be improved.

Bridging the Gap between Finance and Tax

The second objective of the text is to bridge the academic gap between the study of financial theory and the study of tax law. Finance courses teach students how to make decisions on the basis of after-tax cash flows. However, these courses give only rudimentary instruction on determining the tax consequences of transactions and overlook the possibilities for controlling tax costs to maximize cash flows. In extreme cases, financial models simply ignore tax consequences by assuming that business decisions are made in a tax-free environment.

Traditional tax law courses err in the opposite direction. These courses teach students to apply statutory rules to well-defined, closed-fact situations to determine the tax consequences. Correct application of the rule is the learning objective. Students are not required to integrate the tax consequences of transactions into a business decision-making framework. In other words, they don't translate tax outcomes into cash flows. Traditional law courses may fail to encourage students to consider how closed-fact situations can be restructured to change the tax outcome and improve financial results. Consequently, students often develop the habit of analyzing transactions from a backward-looking *compliance* perspective rather than a forward-looking *planning* perspective.

The focus of *Principles of Taxation for Business and Investment Planning* is the common ground shared by financial theory and tax law. The connecting links between the two disciplines are stressed throughout the text. You will learn how effective business planning depends on an accurate assessment of relevant tax factors. Tax rules and regulations are presented and illustrated in the context of a decision-making framework. Admittedly, these rules and regulations are tough to master. Two observations should give you reassurance. First, while the tax law is extremely technical and complex, the application of its underlying principles to business decision making is relatively straightforward. Second, you can learn to appreciate tax planning strategies without becoming a tax-compliance expert.

Teaching the Framework of the Income Tax

The third objective of *Principles of Taxation for Business and Investment Planning* is to teach the framework of the federal income tax, the dominant feature of the modern tax environment. This framework has been remarkably stable over time, even though the details of the law change every year. Students who learn the framework needn't worry that their knowledge will be outdated when Congress enacts its next revenue bill.

The federal income tax system has a bad reputation as an impenetrable, intractable body of law. While the income tax law is every bit as complicated as its critics suggest, its framework consists of a manageable number of basic principles. The principles are internally consistent and underlie many technical provisions. By concentrating on these principles, you can attain a sufficient level of tax knowledge in a single introductory course. You will not be a tax expert, but you will be tax literate. You may not be capable of implementing sophisticated tax planning strategies, but you will appreciate how those strategies can improve cash flows and maximize wealth.

Because this text takes a conceptual approach to the tax law, narrowly drawn provisions, exceptions, limitations, and special cases are deemphasized. Details with the potential to confuse rather than clarify tax principles are usually relegated to footnotes. When we do examine a detailed provision of the law, the detail should illuminate an underlying concept. Or we may discuss a thorny technical rule just to emphasize the practical difficulties encountered by tax professionals who don't have the luxury of dealing with concepts.

The conceptual approach should sensitize you to the tax implications of transactions and cultivate your ability to ask good tax questions. This approach downplays the importance of the answers to these questions. Knowing the answers or, more precisely, *finding* the answers to tax questions is the job of accountants and attorneys who devote long hours in their research libraries to that end. A tax-sensitive business manager knows when to consult these experts and can help formulate the tax issues for the expert to resolve. The text's emphasis on issue recognition rather than issue resolution is reflected in the problems at the end of each chapter. Many of these problems ask you to analyze a fact situation and simply identify tax concerns or opportunities. Other problems present you with facts suggesting tax issues with no correct solution.

A Word to Accounting Majors

Principles of Taxation for Business and Investment Planning is an ideal introductory text for those of you who are concentrating in accounting and who may even plan to specialize in taxation. You will benefit enormously from mastering the framework of the income tax as the first step in your professional education. This mastery will be the foundation for the future study of advanced topics. You will gain a command of basic principles on which to rely as you develop an instinct for your subject—a facility for diagnosing the tax issues suggested by unfamiliar and unusual transactions.

The conceptual approach is appropriate for the first tax course because it concentrates on broad issues concerning most taxpayers instead of narrow problems encountered by only a few taxpayers. If you learn these issues, you will be well prepared to expand and deepen your tax knowledge through professional experience. You will understand that taxes are only one aspect of the economic decision-making process. Because of this understanding, those of you who become tax professionals will be equipped to serve your clients not just as tax specialists but as business advisers.

The text also examines the interrelation of taxes and financial reporting. Taxes are a major cost of doing business. That cost and related assets and liabilities are reported in business financial statements in accordance with the requirements of generally accepted accounting principles. While your financial accounting courses will likely cover these requirements in detail, this text approaches these issues from a tax perspective. You will become very familiar with the types of book/tax differences that are common in typical business operations. An understanding of these differences is critical for both tax reporting and financial reporting.

CPA Exam Preparation

This text provides excellent preparation for the CPA exam. The text covers approximately 90 percent of the specified federal tax content of the Regulation portion of the exam. The 10 percent remaining content consists of advanced topics usually covered in a second semester undergraduate tax course.

The CPA exam includes a variety of interactive problems designed to test your knowledge of the tax law and your ability to apply the law in realistic situations. Many of the problems are in the form of *simulations:* short cases in which you must demonstrate your tax research and analytic skills. These are the exact skills that you will learn, practice, and refine as you work your way through *Principles of Taxation for Business and Investment Planning.*

If your instructor is using *Connect's* auto-graded homework for this course, he/she has the ability to assign Roger CPA Review multiple choice questions and task-based simulations, providing you with even more opportunities to prepare for the CPA exam.

Conclusion

The authors hope this introduction has conveyed the message that people who decide on a particular course of action without considering the tax outcomes are making an uninformed, and possibly incorrect, decision. By proceeding with the course of study contained in this text, you will learn to recognize the tax implications of a whole spectrum of transactions. Upon entering the business world, you will be prepared to make decisions incorporating this knowledge. You will spot tax problems as they arise and will call in a tax professional before, rather than after, a transaction with profound tax consequences. Finally, you will understand that effective tax planning can save more money than the most diligent tax compliance.

Brief Contents

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PART FOUR
THE TAXATION OF BUSINESS INCOME

Final PDF to printer

Part One

Exploring the Tax Environment

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Chapter One

Taxes and Taxing Jurisdictions

Learning Objectives

After studying this chapter, you should be able to:

LO 1-1. Define tax, taxpayer, incidence, and jurisdiction.

LO 1-2. Express the relationship between tax base, rate, and revenue as a formula.

LO 1-3. Describe the taxes levied by local governments.

LO 1-4. Describe the taxes levied by state governments.

LO 1-5. Describe the taxes levied by the federal government.

LO 1-6. Explain the structure of the value-added tax levied by foreign governments.

LO 1-7. Summarize why different jurisdictions compete for revenues from the same taxpayer.

LO 1-8. Discuss the reasons why governments modify their tax systems.

LO 1-9. Identify the three primary sources of federal tax law.

An explorer planning a journey through unknown territory prepares by inspecting a map of the territory. The explorer becomes familiar with topographic features such as major highways, mountain ranges, lakes and rivers, and population centers, and he gathers information about the climate of the region and the language and customs of its inhabitants. This preliminary knowledge helps the explorer chart the course and reduces the danger that progress will be impeded by unforeseen circumstances.

For students who are just beginning their study of taxation, the tax environment in which individuals and organizations must function is unknown territory. Chapter 1 serves as a map of this territory. The chapter begins by describing the environment in terms of the relationship between taxes, taxpayers, and governments. It identifies the major types of taxes that businesses routinely encounter and examines how governments with overlapping jurisdictions compete for tax revenues. By reading the chapter, you will gain a familiarity with the tax environment that will help you understand the role of taxes in the business decision-making process.

The chapter should alert you to two important features of the tax environment. First, taxes are *pervasive* because they are so widespread, come in so many varieties, and affect virtually every aspect of modern life. Second, taxes are *dynamic* because the tax laws change so frequently. The rate of change reflects the fact that the economic and political assumptions on which tax structures are based are constantly evolving. While these two features make the tax environment a challenging one for business managers, they also create a vitality that makes the study of tax planning so fascinating.

SOME BASIC TERMINOLOGY

LO 1-1
Define tax, taxpayer, incidence, and jurisdiction.

Before beginning our exploration of the tax environment, we must define some basic terminology. A **tax** can be defined as a payment to support the cost of government. A tax differs from a fine or penalty imposed by a government because a tax is not intended to deter or punish unacceptable behavior. On the other hand, taxes are compulsory rather than voluntary on the part of the payer. A tax differs from a user's fee because the payment of a tax doesn't entitle the payer to a specific good or service in return. In the abstract, citizens receive any number of government benefits for their tax dollars. Nevertheless, the value of government benefits received by any particular person isn't correlated to the tax that person must pay. As the Supreme Court explained:

> A tax is not an assessment of benefits. It is . . . a means of distributing the burden of the cost of government. The only benefit to which the taxpayer is constitutionally entitled is that derived from his enjoyment of the privileges of living in an organized society, established and safeguarded by the devotion of taxes to public purposes.[1]

A **taxpayer** is any person or organization required by law to pay a tax to a governmental authority. In the United States, the term *person* refers to both natural persons (individuals) and corporations. Corporations are entities organized under the laws of one of the 50 states or the District of Columbia. These corporate entities generally enjoy the same legal rights, privileges, and protections as individuals. The taxing jurisdictions in this country uniformly regard corporations as entities separate and distinct from their shareholders. Consequently, corporations are taxpayers in their own right.

The **incidence** of a tax refers to the ultimate economic burden represented by the tax. Most people jump to the conclusion that the person or organization that makes a direct tax payment to the government bears the incidence of such tax. But in some cases, the payer can shift the incidence to a third party. Consider the following examples:

Income Tax Incidence

Government G enacts a new tax on corporate business profits. A manufacturing corporation with a monopoly on a product in great demand by the public responds to the new tax by increasing the retail price at which it sells the product. In this case, the corporation is nominally the taxpayer and must remit the new tax to the government. The economic burden of the tax falls on the corporation's customers who indirectly pay the tax in the form of a higher price for the same product.

Property Tax Incidence

Mr. Blaire owns an eight-unit apartment building. Currently, the tenants living in each unit pay $9,600 annual rent. The local government notifies Mr. Blaire that his property tax on the apartment building will increase by $5,400 for the next year. Mr. Blaire reacts by informing his tenants that their rent for the next year will increase by $675. Consequently, Mr. Blaire's total revenue will increase by $5,400. Although Mr. Blaire is the taxpayer who must remit the property tax to the government, the incidence of the tax increase is on the tenants who indirectly pay the tax through higher rent.

[1] Source: *Carmichael* v. *Southern Coal & Coke Co.,* 301 U.S. 495, 522 (1937).

The right of a government to levy tax on a specific person or organization is referred to as **jurisdiction.** Jurisdiction exists because of some rational linkage between the government and the taxpayer. For instance, our federal government has jurisdiction to tax any individual who is a U.S. citizen or who permanently resides in this country.

U.S. Jurisdiction over Citizens

Mrs. Fowler was born in Kentucky and is a U.S. citizen. However, she has lived her entire adult life in Cape Town, South Africa. Even though Mrs. Fowler is a permanent resident of a foreign country, the United States claims jurisdiction to tax her entire income.

U.S. Jurisdiction over Permanent Residents

In 2010, Francoise Benet, a citizen of Algeria, was issued a Green Card authorizing her to reside and work in the United States. Because Ms. Benet is a permanent resident, the United States claims jurisdiction to tax her entire income.

The government also claims jurisdiction to tax individuals who are neither U.S. citizens nor residents (nonresident aliens) but who earn income from a source within the United States.

U.S. Jurisdiction over Nonresident Aliens

Mr. Kohala is a citizen of Spain and resides in Madrid. He owns an interest in a partnership formed under Florida law that conducts a business within the state. Even though Mr. Kohala is a nonresident alien, the United States claims jurisdiction to tax him on his share of the partnership income because the income was earned in this country.

The Relationship between Base, Rate, and Revenue

LO 1-2
Express the relationship between tax base, rate, and revenue as a formula.

Taxes are usually characterized by reference to their base. A **tax base** is an item, occurrence, transaction, or activity with respect to which a tax is levied. Tax bases are usually expressed in monetary terms.[2] For instance, real property taxes are levied on the ownership of land and buildings, and the dollar value of the property is the tax base. When designing a tax, governments try to identify tax bases that taxpayers can't easily avoid or conceal. In this respect, real property is an excellent tax base because it can't be moved or hidden, and its ownership is a matter of public record.

The dollar amount of a tax is calculated by multiplying the base by a tax rate, which is usually expressed as a percentage. This relationship is reflected in the following formula:

$$\text{Tax (T)} = \text{Rate (r)} \times \text{Base (B)}$$

A single percentage that applies to the entire tax base is described as a **flat rate.** Many types of taxes use a **graduated rate** structure consisting of multiple percentages that apply to specified portions or **brackets** of the tax base.

Graduated Rate Structure

Jurisdiction J imposes a tax on real property located within the jurisdiction. The tax is based on the market value of the real property and consists of three rate brackets.

Percentage Rate	*Bracket*
1%	Value from –0– to $100,000
2%	Value from $100,001 to $225,000
3%	Value in excess of $225,000

(*continued*)

[2] A per capita, or head, tax requires each person subject to the tax to pay the same amount to the government. This antiquated type of tax does not have a monetary base.

Company C owns a tract of real property worth $500,000. The tax on this property is $11,750.

1% of $100,000 (first bracket of base)	$ 1,000
2% of $125,000 (second bracket of base)	2,500
3% of $275,000 (third bracket of base)	8,250
Total tax on $500,000 base	$11,750

The term **revenue** refers to the total tax collected by the government and available for public use. Note that in the equation $T = r \times B$, the tax is a function of both the rate and the base. This mathematical relationship suggests that governments can increase revenues by increasing either of these two variables in the design of their tax systems.

Transaction- or Activity-Based Taxes

Taxes can be characterized by the frequency with which they are levied. A tax can be **event or transaction based** so that the tax is triggered only when an event occurs or a transaction takes place. A familiar example is a sales tax levied on the purchase of retail goods and services. A second example is an estate tax levied on the transfer of property from a decedent to the decedent's heirs. Taxpayers may have some degree of control over the payment of these types of taxes. By avoiding the event or transaction on which the tax is based, a person avoids the tax. With certain taxes, such as excise taxes levied on the purchase of liquor and cigarettes, people have total discretion as to whether they ever pay the tax. By choosing not to drink alcoholic beverages or not to smoke, they are also choosing not to pay the excise tax. In contrast, no individual can avoid an estate or inheritance tax levied on the transfer of property at death by indefinitely postponing the event that triggers the tax!

A tax can be described as **activity based** when it is imposed on the cumulative result of an ongoing activity. Taxpayers must maintain records of the activity, summarize the result at periodic intervals, and pay tax accordingly. An annual income tax is a prime example of an activity-based tax.

An **income tax** is imposed on the periodic inflow of wealth resulting from a person's economic activities. For persons who engage in a limited number or variety of economic transactions, the measurement of taxable income is relatively simple. For persons who engage in complex activities involving many economic transactions, the measurement of taxable income can be a challenging process.

Earmarked Taxes

Tax Talk
Washington, D.C., levies a five-cent-per-bag tax on disposable plastic and paper bags. All revenue from the tax is earmarked for the Anacostia River Clean Up and Protection Fund.

Another way to characterize taxes is to link them to government expenditures. The revenues from some taxes are **earmarked** to finance designated projects. For instance, revenues from local real property taxes are typically earmarked to support public school systems. Revenues generated by the federal payroll and self-employment taxes fund the Social Security system (Old-Age, Survivors, and Disability Insurance Trust Fund) and Medicare (Hospital and Supplementary Medical Insurance Trust Funds). Revenues from so-called environmental excise taxes on businesses are appropriated to the Environmental Protection Agency's Hazardous Substance Superfund, which subsidizes the cleanup and disposal of toxic wastes. In contrast to these earmarked taxes, revenues from taxes that pour into a general fund may be spent for any public purpose authorized by the government.

THE PERVASIVE NATURE OF TAXATION

Supreme Court Justice Potter Stewart perfectly described the U.S. tax environment by observing

> Virtually all persons or objects in this country . . . may have tax problems. Every day the economy generates thousands of sales, loans, gifts, purchases, leases, wills, and the like, which suggest the possibility of tax problems for somebody. Our economy is "tax relevant" in almost every detail.[3]

Why are taxes so pervasive in our modern world? One reason is the multiplicity of jurisdictions in which people conduct business. Every firm operates in some geographic location within the taxing jurisdiction of one or more local governments. Local governments include townships, cities, municipalities, counties, and school districts, all of which have operating budgets financed by tax revenues. Local governments are subject to the authority of state governments, and state constitutions or statutes typically regulate the nature and extent of local taxation.

The governments of each of the 50 states and the District of Columbia levy taxes on firms conducting business within their geographic territory. In turn, the states' taxing jurisdiction is subject to federal constitutional and statutory constraints. The federal government represents still another jurisdiction that taxes business activities conducted within the United States. Consequently, even the smallest domestic enterprise is usually required to pay taxes to support at least three different levels of government. If a domestic enterprise conducts any business in a foreign country, the number of potential taxing jurisdictions is even higher.

Business managers who want to control tax costs must be aware of any local, state, federal, or foreign tax for which the firm is, or might become, liable. In the next section of Chapter 1, we will survey the types of taxes levied by different jurisdictions to finance their governments.

Local Taxes

LO 1-3
Describe the taxes levied by local governments.

Local governments depend heavily on real property taxes and personal property taxes, which are frequently referred to as **ad valorem taxes.** According to the most recent census data, these two taxes account for more than 70 percent of local government tax revenues.[4]

Real Property Taxes

All 50 states allow local jurisdictions to tax the ownership of real property sited within the jurisdiction. Real property, or **realty,** is defined as land and whatever is erected or growing on the land or permanently affixed to it. This definition encompasses any subsurface features such as mineral deposits.

Real property taxes are levied annually and are based on the market value of the property as determined by the local government. Elected or appointed officials called **tax assessors** are responsible for deriving the value of realty and informing the owners of the assessed value. Property owners who disagree with the assessed value may challenge the assessment in an administrative or judicial proceeding. A unique feature of real property taxes is that the tax rate is determined annually, according to the jurisdiction's need for revenue for that particular budget year.

Property Tax Rates

Springfield's city council decides that the city must raise $12 million of real property tax revenues during its next fiscal year. Because Springfield's tax assessor determines that the total value of real property located within the city limits is currently $230 million, the council sets the tax rate for the upcoming year at 5.22 percent ($12 million ÷ $230 million). This rate can be adjusted each year, depending on Springfield's future revenue needs and the fluctuating value of its real property tax base.

[3] Source: *United States* v. *Bisceglia,* 420 U.S. 141, 154 (1975).

[4] These and subsequent data are obtained from *Quarterly Summaries of Federal, State, and Local Tax Revenues,* Bureau of the Census, U.S. Department of Commerce.

Tax Talk
After a frenzied year-long bidding war among localities across the country, Amazon finally announced that it will locate its new headquarters (HQ2) in Arlington, Virginia. The package of incentives that Virginia offered to Amazon to seal the deal includes up to $750 million of state and local tax incentives over the next 15 years.

Local governments may establish different tax rates for different classifications of property. For instance, a township may choose to tax commercial realty at a higher rate than residential realty, or a county might tax land used for agricultural purposes at a higher rate than land maintained for scenic purposes. Governments may grant permanent tax-exempt status to realty owned by charitable, religious, or educational organizations and publicly owned realty. They may also grant temporary tax exemptions called **abatements** for limited periods of time. Governments usually grant abatements to lure commercial enterprises into their jurisdiction, thereby creating jobs and benefiting the local economy. From a business manager's point of view, the tax savings from abatements can be significant. Consequently, firms contemplating expansion into new jurisdictions frequently negotiate for property tax abatements before acquiring or beginning construction of realty within the jurisdiction.

Tax Incentives for Boeing

In 2014, Boeing selected a site in Washington State for a new facility to manufacture its 777X airliners. In return, Boeing received a tax incentive package from the state expected to be worth over $8 billion to the aerospace giant. Good Jobs First, a group that tracks government subsidies to business, says the state's new Boeing package is the biggest tax subsidy in U.S. history.

Personal Property Taxes

Most states permit localities to tax the ownership of **personalty,** defined as any asset that is not realty. Like real property taxes, personal property taxes are based on the value of the asset subject to tax. However, such value isn't usually assessed by a government official. Instead, individuals and organizations must determine the value of their taxable personalty and render (i.e., report) the value to the tax assessor.

There are three general classes of taxable personalty: household tangibles, business tangibles, and intangibles.[5] Household tangibles commonly subject to tax include automobiles and recreational vehicles, pleasure boats, and private airplanes. Taxable business tangibles include inventory, furniture and fixtures, machinery, and equipment. The most common intangible assets subject to personal property tax are marketable securities (stocks and bonds).

During the last century, personal property taxation has declined steadily as a revenue source. One reason for the decline is that this tax is much more difficult to enforce than other taxes. Personalty is characterized by its mobility; owners can easily hide their assets or move them to another jurisdiction. Any governmental attempt to actively search for personalty, particularly household tangibles, could violate individual privacy rights. Governments have responded to these practical problems by linking the payment of personal property tax to asset registration or licensing requirements.

Boat Tax Linked to State Registration

All motorboats used on the public waters of Virginia must be registered and titled with the state's Department of Game and Inland Fisheries. Each year, this department provides a list of registered watercraft to the city of Virginia Beach, which then imposes a $1.50 tax on each $100 of value of watercraft permanently garaged, docked, or parked in the city.

[5] Tangible property has physical substance that can be perceived by sight or touch. Intangible property has no physical substance.

State Taxes

LO 1-4
Describe the taxes levied by state governments.

In the aggregate, state governments rely in almost equal measure on sales taxes and income taxes as major sources of funds. These two kinds of taxes account for approximately 90 percent of total state tax revenues.

Retail Sales, Use, and Excise Taxes

Tax Talk
On average, one-third of state and local government spending is devoted to public education.

Forty-five states and the District of Columbia impose a tax on in-state sales of tangible personal property and selected services. (The exceptions are Alaska, Delaware, Montana, New Hampshire, and Oregon.) Moreover, 38 states (including Alaska and Montana) allow local governments to levy sales taxes. Sales taxes have been the great growth taxes of state governments during the past century.[6] In 1930, only two states had a general sales tax. During the depression era, revenue-starved states began enacting temporary sales taxes as an emergency measure. These taxes proved to be both simple and effective and soon became a permanent feature of state tax systems. Sales taxes produce about $290 billion of annual revenue, roughly one-third of all state tax collections. Sales taxes also have become an important revenue source for local governments, although property taxes remain their primary revenue source.

Tax Talk
New York residents bear the heaviest state and local tax burden (12.7 cents of every dollar of income) while Alaska residents bear the lightest (6.5 cents of every dollar of income). The national average state and local tax burden is 9.9 cents of every dollar of income.

A **sales tax** is typically based on the retail price of tangible personalty. State tax rates range from 2.9 percent of the dollar amount in Colorado to 7.25 percent in California. Sales taxes are broad based and apply to most types of consumer goods and even to selected consumer services, such as telephone and cable television service.[7] The tax may take the form of a business tax levied on the seller or, more commonly, a consumption tax levied on the purchaser who is the final user of the goods or services. Regardless of the form, the seller is responsible for collecting the tax at point of sale and remitting it to the state government.

Every state with a sales tax imposes a complementary **use tax** on the ownership, possession, or consumption of tangible goods within the state. The use tax applies only if the owner of the goods didn't pay the state's sales tax when the goods were purchased. A use tax acts as a backstop to a sales tax by discouraging residents from purchasing products in neighboring jurisdictions with lower sales tax rates. The one-two punch of a sales and use tax theoretically ensures that state residents are taxed on all purchases of consumer goods, regardless of where the purchase occurred. As a result, merchants operating in high-tax states are not at a competitive disadvantage with respect to merchants operating in low-tax states.

As a general rule, consumers may take a credit for out-of-state sales taxes against their in-state use tax liability.

Use Tax Calculation

Ms. Goode is a resident of Rhode Island, which has a 7 percent sales and use tax. While on vacation in Hawaii, Ms. Goode purchased a diamond bracelet for $7,600 and paid $304 (4 percent) Hawaiian sales tax. Because Ms. Goode didn't pay her own state's sales tax on the purchase, she owes $228 use tax to Rhode Island. The use tax equals $532 (7 percent of $7,600) minus a $304 credit for the Hawaiian sales tax. If Ms. Goode had vacationed in California and paid that state's 7.25 percent sales tax on her jewelry purchase, she would not owe any Rhode Island use tax.

[6] Jerome Hellerstein and Walter Hellerstein, *State Taxation,* vol. II (Boston: Warren, Gorham & Lamont, 1993), p. 12–1.

[7] Many states provide sales tax exemptions for items considered necessities of life, such as food and prescription drugs.

Tax Talk
The 11 states in which recreational marijuana is legal are experimenting with ways to tax this new base. For example, Colorado imposes a 15 percent tax on the sale of marijuana from a cultivator to a retailer plus an additional 10 percent tax on retail sales to customers, 2.9 percent general sales tax, local sales taxes, and local marijuana taxes (such as a 3.5 percent tax in Denver).

Millions of people are unaware of their responsibility for paying use tax on goods purchased out of state or through mail-order catalogs, or they ignore their self-assessment responsibility. States have recently become much more aggressive in collecting use taxes directly from their residents and have entered into cooperative agreements to share sales and use tax audit information. Twenty-seven states and the District of Columbia have added lines to their personal income tax returns on which individuals are instructed to report the use tax due on their out-of-state and catalog purchases for the year.

An **excise tax** is imposed on the retail sale of specific goods, such as gasoline, cigarettes, and alcoholic beverages, or on specific services, such as hotel and motel accommodations. States may impose an excise tax in addition to or instead of the general sales tax on a particular good or service. In either case, the seller is responsible for collecting and remitting the excise tax. Excise taxes can be extremely heavy. Washington levies a 37.5 cents excise tax on each gallon of gasoline, New York levies a $4.35 excise tax on one pack of cigarettes, and Virginia levies a $19.93 excise tax per gallon of distilled liquor.

A Not-So-Sweet Tax

In 2017, Philadelphia became the first major city to levy an excise tax on nonalcoholic sugar-sweetened beverages. This controversial 1.5-cent-per-ounce “soda tax” was enacted primarily as a revenue-raiser with a side benefit of reducing childhood obesity. A number of other local jurisdictions, including Boulder, Colorado, have followed Philadelphia’s lead by enacting taxes on sugary soft drinks. Needless to say, the beverage industry opposes these new taxes, arguing that such taxes won’t make people healthier, just poorer.

Personal Income Taxes

Forty-three states and the District of Columbia levy some form of personal income tax on individuals who reside in the state and nonresidents who earn income within the state. (The exceptions are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.) The technical details of the computation of taxable income vary considerably from state to state, but the tax rates are uniformly modest. Currently, the maximum rates range from 2.9 percent in North Dakota to 13.3 percent in California.

Corporate Income Taxes

Tax Talk
The IRS is spearheading an effort to allow corporations to file combined electronic federal and state tax returns. Officials anticipate a flood of returns from corporations taking advantage of the simplicity of joint e-filing.

Forty-four states and the District of Columbia tax corporations on their net income attributable to the state. Nevada, Ohio, Texas, and Washington have no corporate income tax; instead, these four states impose a corporate gross receipts tax. Only South Dakota and Wyoming have no corporate income or gross receipts tax. Many states authorize their cities and counties to tax either the income or gross receipts of both incorporated and unincorporated businesses operating within the locality.

The computation of corporate taxable income is prescribed by state law. Conceptually, each state could have its own unique set of computational rules so that one corporation operating in all 44 income-taxing jurisdictions would be required to make 44 different calculations of taxable income. Fortunately for corporate America, differences in the computations are the exception rather than the rule. All states with a net income tax refer to the *federal* definition of taxable income as the starting point for calculating state taxable income. “The outstanding characteristic of state corporate net income measures is their broad conformity to the measure of the federal corporation income tax.”[8]

[8] Source: Walter R. Hellerstein, Jerome Hellerstein, and John Swain, *State Taxation,* 3rd ed. (Carrollton, TX: Thomson Reuters, 2014), p. 7.3.

The major advantage of state conformity to federal income tax law is simplicity. State legislatures don't have to reinvent the wheel by enacting a comprehensive income tax statute. State agencies responsible for administering their state's income tax can refer to regulatory and judicial interpretations of the federal law. A second advantage is that state conformity to federal tax law eases the compliance burdens of corporate taxpayers. The major disadvantage is the states' lack of control over their corporate income tax revenues. Each time the U.S. Congress changes the federal definition of taxable income, the income tax base of conforming states is increased or decreased.

Corporate income tax rates vary from state to state. The majority of states use a flat rate, while the remainder use a mildly progressive graduated rate structure. Currently, the maximum rates range from 2.5 percent in North Carolina to 12 percent in Iowa.

Federal Taxes

LO 1-5
Describe the taxes levied by the federal government.

The U.S. government depends almost exclusively on the income tax as a source of general revenues. The federal income tax applies to both individuals and corporations, as well as trusts and estates. The structure and operation of the federal income tax are discussed in considerable detail in Parts Three, Four, and Five of this text. At this point, suffice it to say that the federal income tax predominates in the business environment.

History of the Income Tax

The modern income tax doesn't have a particularly long history in this country. The federal government enacted the first personal income tax in 1861 to raise money to support the Union armies during the Civil War. Even though Congress allowed the tax to expire in 1872, its revenue-generating capability made a lasting impression on the legislative memory. In 1894, Congress needed a permanent source of funds and decided to resurrect the personal income tax. However, in the landmark case of *Pollock* v. *Farmers' Loan and Trust Company,*[9] the Supreme Court held that the U.S. Constitution did not authorize the federal government to levy a national income tax. Determined to have its way, Congress launched a campaign to change the Constitution, a campaign that ended victoriously on February 25, 1913, when Wyoming became the 36th state to ratify the Sixteenth Amendment:

> 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.
>
> Source: U.S. Constitution

Tax Talk
In response to the economic crisis brought on by the coronavirus, the CARES Act of 2020 temporarily suspended a number of the tax provisions enacted in 2017 as part of the Tax Cuts and Jobs Act.

Congress immediately exercised its new power by passing the Revenue Act of 1913, and the income tax became a permanent feature of American life. In 1939, Congress organized all of the federal tax laws then in effect (income and otherwise) into the first Internal Revenue Code. This compilation was substantially revised as the Internal Revenue Code of 1954 and again as the Internal Revenue Code of 1986. Although Congress has not changed the title of the Internal Revenue Code since 1986, it enacts new legislation each year to amend the Code.

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act into law. This major legislation made sweeping changes to the tax rules that apply to both individual and corporate taxpayers. Many changes affecting individual taxpayers are temporary; the changes apply only for tax years beginning after December 31, 2017, and before January 1, 2026. The changes affecting corporations are permanent.

[9] 157 U.S. 429 (1895).

The Sixteenth Amendment: Pro and Con

Supporters of the Sixteenth Amendment praised the new income tax because it applied only to the very wealthy and forced "the Carnegies, the Vanderbilts, the Morgans, and the Rockefellers" to pay while sparing the middle class from pain. But opponents of the tax warned, "When men get into the habit of helping themselves to the property of others, they cannot easily be cured of it."[10]

Employment and Unemployment Taxes

The two largest programs sponsored by the federal government are the Social Security system, which provides monthly old-age, survivors, and disability benefits to qualifying citizens and residents, and Medicare, which provides hospital insurance for people who are elderly or disabled. These programs aren't funded from the general revenues generated by the income tax. Instead, the revenues from the federal **employment taxes** are earmarked to pay for Social Security and Medicare. These taxes are based on annual wages and salaries paid by employers to their employees and on the net income earned by self-employed individuals. The details of these important taxes are discussed in Chapter 10.

Tax Talk
According to a 2019 report by the Joint Committee on Taxation, 67.8 percent of individual taxpayers pay more in Social Security and Medicare taxes than federal income tax.

The federal and state governments act in coordination to provide monetary benefits to individuals who are temporarily unemployed through no fault of their own. This national unemployment insurance system is administered by the states and financed by federal and state taxes imposed directly on employers. These **unemployment taxes** are based on the annual compensation paid to employees. Virtually every business in this country pays unemployment taxes with respect to its workforce, and significant planning opportunities do exist for controlling this particular cost. Nevertheless, because of the narrow scope of the unemployment taxes, we will not discuss them further in this text.

Other Federal Taxes

Tax Talk
In 1934, excise taxes raised 46 percent of federal revenues.

The federal government raises general revenues from excise taxes imposed on the retail purchase of specific goods and services such as tobacco products, luxury automobiles, and firearms. The federal **transfer taxes,** which are based on the value of an individual's wealth transferred by gift or at death, are also a source of general revenues. Transfer taxes play a key role in family tax planning and are described in detail in Chapter 16. As Exhibit 1.1 shows, these two types of taxes are an insignificant source of federal funds. In fiscal year 2018, excise taxes accounted for only 2.4 percent of federal tax revenues, while transfer taxes accounted for just .8 percent.

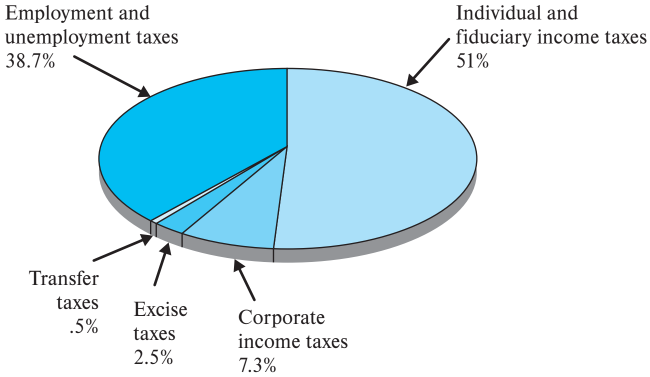
Taxes Levied by Foreign Jurisdictions

LO 1-6
Explain the structure of the value-added tax levied by foreign governments.

The types of foreign taxes that firms encounter when expanding from domestic to international operations are as varied as the languages, politics, and cultures characterizing the global environment. Many foreign taxes have a familiar structure. National governments and their political subdivisions the world over levy income taxes, property taxes, and retail sales taxes. Other taxes have no counterpart in the United States and are therefore less familiar to domestic companies operating abroad. For instance, many industrialized nations depend heavily on some type of **value-added tax (VAT)** as a revenue source. Value-added taxes are levied on firms engaged in any phase of the production of goods and are based on the incremental value that the firm adds to the goods.

[10] Source: National Commission on Economic Growth and Tax Reform, quote from "Unleashing America's Potential: A Pro-Growth, Pro-Family Tax System for the 21st Century," 70 *Tax Notes* 413, 418. Originally appeared in a 1909 editorial in *The New York Times.*

EXHIBIT 1.1
Fiscal Year 2019 Federal Tax Revenues



Value-Added Tax

Firm M and Firm W operate in a jurisdiction that imposes a 5 percent VAT. Firm M manufactures small electronic appliances. M's material cost per unit is $40, and M sells each unit to Firm W, a regional distributor for $46. The $6 difference represents the incremental value that M added to the production process. Therefore, M must pay a 30-cent VAT (5 percent of $6) for each unit sold.

Firm W sells the appliances purchased from Firm M to various unrelated retailers for $50 per unit. Firm W's $4 gross profit on the sale of each unit represents the incremental value that W added to the production process by providing distribution services. Consequently, Firm W must pay a 20-cent VAT (5 percent of $4) for each unit sold.

This example is extremely simplistic because it ignores the possibility that both Firm M and Firm W can shift the economic incidence of the VAT by increasing the price at which they sell their product to the next business in the production sequence. To the extent that a VAT is shifted along the entire production sequence to the final purchaser (the customer who buys the product for personal consumption), the VAT resembles a retail sales tax.

Jurisdictional Competition

LO 1-7
Summarize why different jurisdictions compete for revenues from the same taxpayer.

Domestic businesses pay tax to state and local governments, as well as to the federal government. International businesses pay tax to any number of foreign jurisdictions. Governments understand that their taxing jurisdictions overlap and that, as a result, they are competing for revenues from the same businesses. They also understand that taxpayers are mobile and that business managers make location decisions with an eye on comparative tax costs. Thus, jurisdictional competition creates an interesting tension. On the one hand, a government that fails to protect its jurisdictional turf may lose revenues to more assertive taxing authorities. On the other hand, a government that is overly aggressive may drive businesses away from its jurisdiction.

In the United States, the competing levels of government have traditionally accommodated each other by relying on different taxes as their primary source of funding. As we learned earlier in the chapter, property taxes are the mainstay of local governments, while retail sales taxes are used almost exclusively by state governments. Our federal government doesn't levy either property taxes or a national sales tax but instead relies on income and employment taxes for its revenues.

Ready for a National Sales Tax?

A group of business executives organized as Americans for Fair Taxation are publicly campaigning to replace the federal income tax, Social Security and Medicare employment taxes, and transfer taxes with a 23 percent national sales tax. The tax would apply to retail purchases of all goods and services, including food, medicine, and housing. According to AFT, this new tax would raise the same federal revenue as existing taxes, while stimulating economic growth.

Corporations conducting business in more than one state face particularly difficult problems of duplicative taxation. The jurisdictional concerns of corporations engaged in interstate commerce are discussed more fully in Chapter 13. Of course, the potential for jurisdictional conflict is greatest when corporations operate on a global scale. Industrialized nations assume that it is in their self-interest to promote the growth of international business operations. These nations understand that if they fail to adapt their tax systems to the needs of the worldwide marketplace, their economies will be at a competitive disadvantage. Consequently, the industrialized nations have created a network of bilateral and multilateral tax treaties to minimize friction among their respective tax systems and to reduce duplicative taxation of international businesses. The role of these treaties and other unique features of international tax planning are covered in Chapter 13.

DYNAMIC NATURE OF TAXATION

LO 1-8
Discuss the reasons why governments modify their tax systems.

Business managers must understand not only that taxes are pervasive in the modern world but that tax systems are in a constant state of flux. Tax systems are dynamic because they must be attuned to the fiscal condition of their respective jurisdictions. In every jurisdiction, individual citizens and organizations continually reevaluate the nature and level of services they want from their governments. Governments, in turn, must reassess the tax systems that pay for those services.

Tax Base Changes

Tax Talk
States often devote gambling revenues to popular public services. A member of Congress boasted that Oregon residents "are gambling for education, salmon restoration, parks, and economic activity. It's an amazing phenomenon."

Any government dependent on a tax system that fails to raise sufficient revenues will sooner or later be forced to change the system. The loss of revenue-generating power is often attributable to an eroding tax base. For instance, cities that depend on real property taxes experience a decline in revenues when their populations decrease. As families and businesses move away from urban areas, residential and commercial properties located within the city lose value. Owners can no longer afford to maintain the properties and, in extreme cases, they may simply abandon them. Cities only worsen this cycle of deterioration if they raise their property tax rates. The only solution may be to identify an alternative tax base or a source of nontax revenue.

Legalized Gambling

One important source of nontax revenue is legalized gambling. About 40 years ago, a few states experimented with lotteries as a means of raising money. Lotteries proved so lucrative that 44 states and the District of Columbia are now sponsoring these betting games. In the late 1980s, states in the Midwest and the South decided to shore up their tax bases by going into the casino business and gave private gambling corporations legal monopolies to operate within the state. Today, casinos are legal in more than half the states, and all but two states (Hawaii and Utah) depend on some form of gambling as a source of revenue.

A Gambler's Worst Bet

According to recent census data, state lotteries on average pay back only 62 percent of the money received from ticket sales—the smallest share of the take of any legal gambling game. In contrast, slot machines, which offer the worst odds of any private casino game, generally pay back a minimum of 80 percent of the money fed into them.

Sales Tax Expansion

Tax Talk
A poll by the National Taxpayers Union found that 65 percent of the people surveyed oppose new Internet sales taxes.

State and local governments are aggressive in exploiting new tax bases that develop in the economy. Historically, state sales taxes apply to retail purchases of tangible property but not to purchases of retail services. Because of the dramatic growth in the service sector over the past several decades, an increasing number of states are adding selected services, such as utilities, cable television, parking, and theater tickets, to their sales tax base. Currently, Hawaii, New Mexico, North Dakota, and South Dakota are the most aggressive in taxing services.

Sales Tax on Rentals

Beginning on September 1, 2017, Airbnb began collecting and remitting South Dakota's state and local sales tax from vacationers who rent lodging in the Mount Rushmore state. The tax is based on the rental fee and is billed when the lodging is booked. Because South Dakota has no personal or corporate income tax, the state depends heavily on its sales tax to generate revenue.

For the past 26 years, states have lobbied the federal government to enact legislation permitting them to collect sales tax on mail-order and Internet sales to in-state customers. In 1992, the Supreme Court ruled that states lacked jurisdiction to tax these so-called remote sales unless the seller had a physical presence, such as an office or storefront, in the state.[11] In 2018, the Court issued a landmark decision overturning this physical presence requirement.[12] This decision frees state governments to enact legislation compelling catalog and online retailers to collect sales tax based on the residence of the purchaser. According to the states, such legislation will level the fiscal playing field between remote retailers and brick-and-mortar retailers, while raising enormous amounts of additional sales tax revenue.

Taxes and the Political Process

Tax Talk
According to Otto von Bismarck, the "Iron Chancellor" of 19th-century Germany, "The less people know about how sausages and laws are made, the better they'll sleep at night."

The political process by which tax law is made contributes to the dynamic nature of taxes. In this country, local, state, and federal tax laws are the result of democratic systems in which elected or appointed representatives decide on the appropriate tax structure. These representatives are sensitive to the political climates of their respective constituencies. As these climates change over time, representatives may decide that the tax structure should change as well. Many of these changes have little to do with revenues. Instead, the changes are philosophic in nature, reflecting a shift in the public attitude concerning the proper role of taxes in society.

Special interest groups have a significant effect on the tax legislative process. Thousands of organizations have pet provisions in the existing law or wish lists for new provisions. These organizations use their own emissaries or hire professional lobbyists to communicate their point of view to government officials. The constant pressure from powerful organizations with competing and even conflicting political objectives adds to the vibrant nature of the tax law.

[11] *Quill Corporation* v. *North Dakota,* 504 U.S. 298 (1992).

[12] *South Dakota* v. *Wayfair,* 138 S.Ct. 1543 (2018).

People don't enjoy paying tax and are willing to devote considerable money and effort to avoid doing so. Each time taxpayers or their advisers devise a new tactic to reduce their tax burdens, governments respond by enacting a new rule to render the tactic ineffective. This constant gamesmanship is another reason why the tax environment is dynamic. As humorist Dave Barry explains, "[Tax laws] are constantly changing as our elected representatives seek new ways to ensure that whatever tax advice we receive is incorrect."*

SOURCES OF FEDERAL TAX LAW

LO 1-9
Identify the three primary sources of federal tax law.

Throughout this text, we will constantly refer to the **tax law.** For modern tax systems, this term encompasses three sources of authority: statutory law, administrative pronouncements, and judicial decisions. In combination, these sources provide the rules of the game by which both taxpayers and governments must abide. This final section of Chapter 1 describes the primary sources of authority that comprise our federal tax law. In subsequent chapters of the text, you will encounter much technical information originating from this body of law. You should have a much easier time understanding this information if you are familiar with the underlying sources from which the information is derived.

Statutory Authority

In its narrowest sense, federal tax law means the **Internal Revenue Code of 1986,** the voluminous compilation of statutory rules enacted by Congress. The Internal Revenue Code is a dynamic document; at least once a year, Congress passes legislation that adds to, deletes from, or modifies its provisions.

Legislative Process

According to the United States Constitution, the tax legislative process must begin in the House of Representatives. The original version of a new tax bill is drafted by the **House Ways and Means Committee** and is then considered by the full House. If the House votes to approve the bill, it moves to the **Senate Finance Committee.** That committee can make revisions, additions, or deletions to the House bill before presenting its amended bill to the full Senate for approval.

Oftentimes, the amended bill approved by the Senate is quite different from the original bill approved by the House. In such case, both versions of the tax bill are considered by a **Conference Committee** composed of members from both the House and Senate committees. This committee reconciles the differences between the two versions and drafts a compromise bill. If both the House and Senate vote to approve the Conference Committee's final version, the bill is submitted to the president for signature or veto. If the president signs the bill, it is redesignated as a tax act and becomes law.

Referencing Code Sections

The Internal Revenue Code consists of numerically ordered **sections,** beginning with Section 1 and ending (at last count) with Section 9834. Each section contains an operational, definitional, or procedural rule relating to one of the federal taxes. Code section numbers have become the language in which tax experts communicate, and accountants and lawyers have incorporated many of them into their professional jargon. (Bob, I think our client has a real Section 469 problem.) Sections are divided into subsections, paragraphs, subparagraphs, and so on. In the footnotes to the text, a reference such as §469(f)(3)(B) is citing the precise statutory rule under discussion.

* Source: Dave Barry

Administrative Authority

The Department of the Treasury is responsible for writing regulations to interpret and illustrate the rules contained in the Internal Revenue Code. These **Treasury regulations** provide tremendous guidance to taxpayers and their advisers. The Treasury regularly publishes new regulations or amends existing regulations to keep abreast of legislative developments. While Treasury regulations carry great authority as the government's official explanation of the law, they are not laws in and of themselves. On rare occasions, taxpayers have convinced the federal courts that a regulation was an incorrect interpretation of statute and was therefore invalid.[13]

The citation to a Treasury regulation consists of a sequence of numbers, the first of which identifies the type of federal tax under consideration. For instance, a regulation beginning with 1 is an income tax regulation. The next number identifies the Code section to which the regulation relates. The last number in the sequence is the number of the regulation itself. The citation Reg. §1.469-4 refers to the fourth Treasury regulation relating to Section 469 of the Internal Revenue Code. Some sections have only one regulation while others have dozens, and some Code sections have no interpretive regulations at all!

The **Internal Revenue Service (IRS),** the subdivision of the Treasury responsible for the enforcement of the law and collection of tax, provides still more guidance in the form of revenue rulings and revenue procedures. A **revenue ruling** explains how the IRS applies the tax law to a particular set of facts. A **revenue procedure** advises taxpayers how to comply with IRS procedural or administrative matters. While these pronouncements carry much less authority than the Code and regulations, they do represent the IRS's official position and provide valuable insight on specific issues. Rulings and procedures are published in weekly **Internal Revenue Bulletins (I.R.B.).** Until 2009, the IRS compiled I.R.B.s into semiannual **Cumulative Bulletins (C.B.).** Footnote references such as Rev. Rul. 2019-11, 2019-17 I.R.B. 1041, and Rev. Proc. 89-17, 1989-1 C.B. 118 are citing these sources of authority.

Goodbye to the Penny

In one of the first revenue rulings published after Congress enacted the Internal Revenue Code of 1954, the IRS authorized taxpayers to eliminate the penny from their bookkeeping by rounding numbers up or down to the nearest dollar.

Judicial Authority

The third primary source of tax law is the federal judicial system. Taxpayers who disagree with the IRS's interpretation of the law as it applies to their own situations may take their cases to federal court. The hundreds of legal decisions handed down every year clarify the correct implementation of the tax law. The weight of authority of a particular case depends on the court that rendered the verdict. Trial court verdicts have less authority than verdicts by an appellate court. A Supreme Court verdict is the equivalent of law and becomes the final word in any tax dispute. Chapter 18 discusses the process by which a federal judge or jury resolves a controversy between a taxpayer and the IRS. When this text refers to a judicial decision, an accompanying footnote provides the complete legal cite. You can use the citation to locate the decision in any law library or commercial tax service.

[13] The Internal Revenue Code occasionally empowers the Treasury to write regulations that have the force and effect of law. These so-called legislative regulations have the same authority as statutory law.

Conclusion

Business managers engaged in effective tax planning take into account the variety of taxes existing in the modern economic environment. When making strategic decisions, managers must consider their firm's total tax burden rather than any tax in isolation. A strategy that decreases the cost of one tax could easily increase the cost of another. The primary focus of this text is the federal income tax; as a result, other taxes that affect business and investment decisions will be mentioned only occasionally. Even so, many income tax planning strategies are valid in other tax contexts. Decision makers should remember that every tax represents a controllable cost of conducting business.

As greater numbers of U.S. firms expand their operations across national boundaries, jurisdictional tax planning becomes crucial. Managers must decide which tax systems are attractive and which systems are inhospitable to foreign investors. They must be aware of differences between competing tax regimes and how those differences can be exploited to the firm's advantage. In today's tax environment, successful tax planning must be conducted on a global scale.

Key Terms

abatement *1-8*
activity-based tax *1-6*
ad valorem tax *1-7*
bracket *1-5*
Conference Committee *1-16*
Cumulative Bulletin (C.B.) *1-17*
earmarked tax *1-6*
employment tax *1-12*
event- or transaction-based tax *1-6*
excise tax *1-10*
flat rate *1-5*
graduated rate *1-5*
House Ways and Means Committee *1-16*
incidence *1-4*
income tax *1-6*
Internal Revenue Bulletin (I.R.B.) *1-17*
Internal Revenue Code of 1986 *1-16*
Internal Revenue Service (IRS) *1-17*
jurisdiction *1-5*
personalty *1-8*
real property tax *1-7*
realty *1-7*
revenue *1-6*
revenue procedure *1-17*
revenue ruling *1-17*
sales tax *1-9*
section *1-16*
Senate Finance Committee *1-16*
tax *1-4*
tax assessor *1-7*
tax base *1-5*
tax law *1-16*
taxpayer *1-4*
transfer tax *1-12*
Treasury regulation *1-17*
unemployment tax *1-12*
use tax *1-9*
value-added tax (VAT) *1-12*

Questions and Problems for Discussion

LO 1-1 1. How do tax payments differ from other payments that people or organizations make to governmental agencies?

LO 1-1 2. The Green River, which is heavily polluted by industrial waste, flows through State S. Eighty-five companies operate manufacturing facilities that border the river. State S recently enacted legislation requiring each company to pay $50,000 annually into a special fund to clean up the Green River. Does this payment meet the definition of a tax?

LO 1-1, 1-2 3. Custer County is considering raising revenues by imposing a $25 fee on couples who obtain a marriage license within the county. Does this fee meet the definition of a transaction-based tax?

LO 1-1 4. Mr. Powell owns a residential apartment complex in a suburban area. This year, the local jurisdiction increased the property tax rate on the apartment complex. To offset this additional cost, Mr. Powell decreased the amount he usually spends on maintaining the exterior of the building and the landscaping. Who bears the incidence of the increased property tax?

LO 1-1 5. Mr. and Mrs. Ahern pay $18,000 annual tuition to a private school for their three children. They also pay $2,300 property tax on their personal residence to support the local public school system. Should Mr. and Mrs. Ahern be exempt from this property tax?

LO 1-1 6. A local government imposed a new 2 percent tax on the gross receipts of businesses operating within its jurisdiction. XYZ Company, which manufactures soap and other toiletries, responded to the tax by reducing the size of its bars of soap and purchasing a cheaper grade of ingredients. By making these changes, XYZ maintained its before-tax level of profits. Who bears the incidence of the new gross receipts tax?

LO 1-2, 1-3 7. Why is real property a better tax base than personal property?

LO 1-2, 1-3 8. Many local jurisdictions apply a low property tax rate to land owned by privately operated golf courses. What is the economic justification for such a preferential rate?

LO 1-3 9. Churchill University is located in a small town that depends on real property taxes for revenue. Over the past decade, the university has expanded by purchasing a number of commercial buildings and personal residences and converting them to classrooms and dormitories. In what way could this expansion result in a decline in the town's revenues?

LO 1-4 10. Why can people avoid paying an excise tax more readily than they can avoid paying a sales tax?

LO 1-3, 1-4, 1-8 11. A city government increased its local sales tax from 1 percent to 2 percent of the dollar value of consumer goods purchased in the city. However, the city's sales tax revenues increased by only 30 percent after the doubling of the tax rate. What factors might account for this result?

LO 1-4, 1-5 12. Both the federal government and many states impose so-called sin taxes: excise taxes levied on the retail sale of liquor and cigarettes. Discuss the reasons why sales of these particular items make a good tax base.

LO 1-5 13. Does the federal income tax or the federal payroll tax have the broader tax base?

LO 1-3, 1-7 14. Differentiate between a property tax and a transfer tax.

LO 1-5, 1-7 15. One way for the federal government to increase tax revenues would be to enact either a VAT or a national retail sales tax. The U.S. sales tax could be collected in the same manner and at the same time as state and local sales taxes. Which tax would be less costly for the federal government to implement and administer? Which tax would be less likely to cause jurisdictional conflict?

LO 1-9 16. The Internal Revenue Code and Treasury regulations are two major sources of federal tax law. Differentiate between the Code and the regulations in terms of their relative weight of authority.

All applicable Application Problems are available with *Connect.*

Application Problems

LO 1-1 1. Mr. Josh Kenney, a U.S. citizen and resident of Vermont, owns 100 percent of the stock of JK Services, which is incorporated under Vermont law and conducts business in four counties in the state. JK Services owns 100 percent of the stock of JK Realty, which is incorporated under Massachusetts law and conducts business in Boston.

a. How many taxpayers are identified in the given statement of facts?

b. Identify the governments with jurisdiction to tax each of these taxpayers.