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2023 EDITION

McGRAW HILL'S ESSENTIALS OF FEDERAL TAXATION

SPILKER
AYERS
BARRICK
LEWIS
ROBINSON
WEAVER
WORSHAM

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chapter

1 An Introduction to Tax

Learning Objectives

Upon completing this chapter, you should be able to:

- **LO 1-1** Demonstrate how taxes influence basic business, investment, personal, and political decisions.
- **LO 1-2** Discuss what constitutes a tax and the general objectives of taxation.
- **LO 1-3** Describe the three basic tax rate structures and calculate a tax.
- **LO 1-4** Identify the various federal, state, and local taxes.
- **LO 1-5** Apply appropriate criteria to evaluate alternative tax systems.

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Storyline Summary

Taxpayer:	Margaret (she/her/hers)
Employment status:	Margaret is a full-time student at the University of Georgia.
Current situation:	She is beginning her first tax class.

Margaret (she/her/hers) is a junior beginning her first tax course. She is excited about her career prospects as an accounting major but hasn't had much exposure to taxes. On her way to campus she runs into an old friend, Eddy (he/his), who is going to Washington, D.C., to protest recent proposed changes to the U.S. tax system. Eddy is convinced the IRS is evil and that the current tax system is blatantly unfair and corrupt. He advocates for a simpler, fairer method of taxation. Margaret is intrigued by Eddy's passion but questions whether he has a complete understanding of the U.S. tax system. She decides to withhold all judgments about it (or about pursuing a career in taxation) until the end of her tax course. ■

LO 1-1 WHO CARES ABOUT TAXES AND WHY?

A clear understanding of the role of taxes in everyday decisions will help you make an informed decision about the value of studying taxation or pursuing a career in taxation. One view of taxation is that it represents an inconvenience every April 15th (the annual due date for filing federal individual tax returns without extensions). However, the role of taxation is much more pervasive than this view suggests. Your study of this subject will provide you a unique opportunity to develop an informed opinion about taxation. As a business student, you can overcome the mystery that encompasses popular impressions of the tax system and perhaps, one day, share your expertise with friends or clients.

What are some common decisions you face that taxes may influence? In this course, we alert you to situations in which you can increase your return on investments by up to one-third! Even the best lessons in finance courses can't approach the increase in risk-adjusted return that smart tax planning provides. Would you like to own your home someday? Tax deductions for home mortgage interest and real estate taxes can reduce the after-tax costs of owning a home relative to renting. Thus, when you face the decision to buy or rent, you can make an informed choice if you understand the relative tax advantages of home ownership. Would you like to retire someday? Understanding the tax-advantaged methods of saving for retirement can increase the after-tax value of your retirement nest egg—and thus increase the likelihood that you can afford to retire, and do so in style. Other common personal financial decisions that taxes influence include choosing investments, evaluating alternative job offers, saving for education expenses, and performing gift or estate planning. Indeed, taxes are a part of everyday life and have a significant effect on many of the personal financial decisions all of us face.

The role of taxes is not limited to personal finance. Taxes play an equally important role in fundamental business decisions such as the following:

- What organizational form should a business use?
- Where should the business be located?
- How should business acquisitions be structured?
- How should the business compensate employees?
- What is the appropriate mix of debt and equity for the business?
- Should the business rent or own its equipment and property?
- How should the business distribute profits to its owners?

Savvy business decisions require owners and managers to consider all costs and benefits in order to evaluate the merits of a transaction. Although taxes don't necessarily dominate these decisions, they do represent large transaction costs that businesses should factor into the financial decision-making process.

Taxes also play a major part in the political process. U.S. presidential candidates often distinguish themselves from their opponents based upon their tax rhetoric. Indeed, the major political parties generally have very diverse views of the appropriate way to tax the public.[1] Determining who is taxed, what is taxed, and how much is taxed are tough questions with nontrivial answers. Voters must have a basic understanding of taxes to evaluate the merits of alternative tax proposals. Later in this chapter, we'll introduce criteria you can use to evaluate alternative tax proposals.

[1]The U.S. Department of the Treasury provides a "history of taxation" on its website (www.treasury.gov/resource-center/faqs/Taxes/Pages/historyrooseveltmessage.aspx). You may find it interesting to read this history in light of the various political parties in office at the time.

TAXES IN THE REAL WORLD Tax Policy: Republicans versus Democrats

Both Democrats and Republicans desire the same things: a civilized society and a healthy economy. However, neither party can agree on what defines a civilized society or which path best leads to a healthy economy. As of August 2021 the national debt was $28.6 trillion, up from $26.8 trillion the year before, and growing, yet the only thing we might agree on is that something has gone wrong. Regardless of which party or candidate you support, each party's agenda will affect your income and taxes in various ways.

To explore the divide, let's examine excerpts from each party's National Platform from our most recent presidential election (2020).

Republicans

"We are the party of a growing economy that gives everyone a chance in life, an opportunity to learn, work, and realize the prosperity freedom makes possible."

"Government cannot create prosperity, though government can limit or destroy it. Prosperity is the product of self-discipline, enterprise, saving and investment by individuals, but it is not an end in itself. Prosperity provides the means by which citizens and their families can maintain their independence from government, raise their children by their own values, practice their faith, and build communities of cooperation and mutual respect."

"Republicans consider the establishment of a pro-growth tax code a moral imperative. More than any other public policy, the way government raises revenue—how much, at what rates, under what circumstances, from whom, and for whom—has the greatest impact on our economy's performance. It powerfully influences the level of economic growth and job creation, which translates into the level of opportunity for those who would otherwise be left behind."

"A strong economy is one key to debt reduction, but spending restraint is a necessary component that must be vigorously pursued."* www.gop.com/platform/restoring-the-american-dream/.

Democrats

"Our tax system has been rigged against the American people by big corporations and their lobbyists, and by Republican politicians who dole out tax cuts to their biggest donors while leaving working families to struggle."

"Democrats will take action to reverse the Trump Administration's tax cuts benefiting the wealthiest Americans and rewarding corporations for shipping American jobs overseas. We will crack down on overseas tax havens and close loopholes that are exploited by the wealthiest Americans and biggest corporations. We will make sure the wealthy pay their fair share in taxes. We will make sure investors pay the same tax rates as workers and bring an end to expensive and unproductive tax loopholes, including the carried interest loophole. Corporate tax rates, which were cut sharply by the 2017 Republican tax cut, must be raised, and 'trickle-down' tax cuts must be rejected. Estate taxes should also be raised back to the historical norm."

"Democrats will reform the tax code to be more progressive and equitable, and reduce barriers for working families to benefit from targeted tax breaks, including the Earned Income Tax Credit and the Child Tax Credit. Our program of reform will provide immediate, marked relief for working families, including more generous, refundable tax credits to benefit low- and middle-income families, and easier and more equitable access to tax provisions that help working families build wealth, including by equalizing tax benefits for retirement contributions and providing more accessible tax breaks for homeownership."† www.democrats.org/where-we-stand/party-platform/.

Conclusion

Each party fundamentally believes the government should create/maintain cities and states that form a civilized society, and that government should foster a healthy economy. However, they choose very different paths to reach this objective. Democrats want to raise taxes on the wealthy and create government programs that cost more money, while Republicans wish to lower taxes and decrease government size and spending. Both motives are authentic; however, current and cumulative deficits indicate that current revenue is insufficient to meet government spending. Solving these problems will require civil discourse, education, and research/information in order to find realistic, effective solutions.

*GOP, "Restoring the American Dream," www.gop.com/platform/restoring-the-american-dream/.

†Democratic Platform Committee, "The 2020 Democratic Party Platform," www.democrats.org/where-we-stand/party-platform/.

In summary, taxes affect many aspects of personal, business, and political decisions. Developing a solid understanding of taxation should allow you to make informed decisions in these areas. Thus, Margaret can take comfort that her semester will likely prove useful to her personally. Who knows? Depending on her interest in business, investment, retirement planning, and the like, she may ultimately decide to pursue a career in taxation.

LO 1-2

WHAT QUALIFIES AS A TAX?

THE KEY FACTS

What Qualifies as a Tax?

- The general purpose of taxes is to fund government agencies.
- Unlike fines or penalties, taxes are not meant to punish or prevent illegal behavior; however, "sin taxes" are meant to discourage certain behaviors.
- To qualify as a tax, three criteria must be met. The payment must be:
  - Required;
  - Imposed by a government agency; and
  - Not tied directly to the benefit received by the taxpayer.

"Taxes are the price we pay for a civilized society." —Oliver Wendell Holmes Jr.

Taxes have been described in many terms: some positive, some negative, some printable, some not. Let's go directly to a formal definition of a tax, which should prove useful in identifying alternative taxes and discussing alternative tax systems.

A **tax** *is a payment required by a government that is unrelated to any specific benefit or service received from the government*. The general purpose of a tax is to fund the operations of the government (to raise revenue). Taxes differ from fines and penalties in that taxes are not intended to punish or prevent illegal behavior. Nevertheless, by allowing deductions from income, our federal tax system encourages certain behaviors like charitable contributions, retirement savings, and research and development. Thus, we can view it as discouraging other legal behavior. For example, **sin taxes** impose relatively high surcharges on alcohol and tobacco products.[2] Cigarette taxes include a $1.01 per pack federal tax, a state tax in all 50 states, and also a few municipal taxes as well.[3]

Key components of the definition of a tax are that the payment is:

- Required (it is not voluntary);
- Imposed by a government agency (federal, state, or local); and
- Not tied directly to the benefit received by the taxpayer.

This last point is not to say that taxpayers receive no benefits from the taxes they pay. They benefit from national defense, a judicial system, law enforcement, government-sponsored social programs, an interstate highway system, public schools, and many other government-provided programs and services. The distinction is that taxes paid are not *directly* related to any specific benefit received by the taxpayer. For example, the price of admission to Yellowstone National Park is a fee rather than a tax because a specific benefit is received.

Can taxes be assessed for special purposes, such as a 1 percent sales tax for education? Yes. Why is an **earmarked tax,** a tax that *is* assessed for a specific purpose, still considered a tax? Because the payment made by the taxpayer does not directly relate to the specific benefit *received by the taxpayer*.

Example 1-1

Margaret travels to Birmingham, Alabama, where she rents a hotel room and dines at several restaurants. The price she pays for her hotel room and meals includes an additional 2 percent city surcharge to fund roadway construction in Birmingham. Is this a tax?

Answer: Yes. The payment is required by a local government and does not directly relate to a specific benefit that Margaret receives.

Example 1-2

Margaret's parents, Bill and Mercedes, recently built a house and were assessed $1,000 by their county government to connect to the county sewer system. Is this a tax?

Answer: No. The assessment was mandatory and it was paid to a local government. However, the third criterion was not met because the payment directly relates to a specific benefit (sewer service) received by the payees. For the same reason, tolls, parking meter fees, and annual licensing fees are also not considered taxes.

[2] Sin taxes represent an interesting confluence of incentives. On the one hand, demand for such products as alcohol, tobacco, and gambling is often relatively inelastic because of their addictive quality. Thus, taxing such a product can raise substantial revenues. On the other hand, one of the arguments for sin taxes is frequently the social goal of *reducing* demand for such products.

[3] Federal excise taxes on cigarettes are found in §5701(b). State taxes are as much as $4.35 per pack in Connecticut and New York. The District of Columbia imposes a tax of $4.50 per pack. Anchorage, New York City, and Chicago impose municipal taxes on cigarettes as well. The taxes on a pack of cigarettes in Chicago are $8.26 ($1.01 federal, $2.98 state, $3.00 county, and $1.98 city).

HOW TO CALCULATE A TAX

LO 1-3

In its simplest form, the amount of tax equals the tax base multiplied by the tax rate:

Eq. 1-1 $$\text{Tax} = \text{Tax Base} \times \text{Tax Rate}$$

The **tax base** defines what is actually taxed and is usually expressed in monetary terms, whereas the **tax rate** determines the level of taxes imposed on the tax base and is usually expressed as a percentage. For example, a taxable purchase of $30 times a sales tax rate of 6 percent yields a tax of $1.80 ($1.80 = $30 × .06).

Federal, state, and local jurisdictions use a large variety of tax bases to collect tax. Some common tax bases (and related taxes) include taxable income (federal and state income taxes), purchases (sales tax), real estate values (real estate tax), and personal property values (personal property tax).

Different portions of a tax base may be taxed at different rates. A single tax applied to an entire base constitutes a **flat tax.** In the case of **graduated taxes,** the base is divided into a series of monetary amounts, or **brackets,** and each successive bracket is taxed at a different (gradually higher or gradually lower) percentage rate.

Calculating some taxes—income taxes for individuals, for example—can be quite complex. Advocates of flat taxes argue that the process should be simpler. But as we'll see throughout the text, most of the difficulty in calculating a tax rests in determining the tax *base,* not the tax rate. Indeed, there are only three basic tax rate structures (proportional, progressive, and regressive), and each can be mastered without much difficulty.

THE KEY FACTS

How to Calculate a Tax

- Tax = Tax base × Tax rate
- The tax base defines what is actually taxed and is usually expressed in monetary terms.
- The tax rate determines the level of taxes imposed on the tax base and is usually expressed as a percentage.
- Different portions of a tax base may be taxed at different rates.

DIFFERENT WAYS TO MEASURE TAX RATES

Before we discuss the alternative tax rate structures, let's first define three different tax rates that will be useful in contrasting the different tax rate structures: the marginal, average, and effective tax rates.

Tax is computed on a tax base, which is generally taxable income. Taxable income is gross income minus deductions (see the Individual Income Tax Overview, Dependents, and Filing Status chapter for a detailed discussion of the individual income tax formula). The **marginal tax rate** is the incremental tax paid on an incremental amount of additional income or deductions.

Eq. 1-2 $$\text{Marginal Tax Rate} = \frac{\Delta\text{Tax}^*}{\Delta\text{Taxable Income}} = \frac{(\text{New Total Tax} - \text{Old Total Tax})}{(\text{New Taxable Income} - \text{Old Taxable Income})}$$

*Δ means *change in.*

Specifically, "old" refers to the current tax and "new" refers to the revised tax after incorporating the additional income (or deductions) in question. In graduated income tax systems, additional income (deductions) can push a taxpayer into a higher (lower) tax bracket, thus changing the marginal tax rate.

Example 1-3

Margaret's parents, Bill and Mercedes, file a joint tax return. They have $160,000 of taxable income this year (gross income minus deductions). Assuming the following federal tax rate schedule applies, how much federal income tax will they owe this year?[4]

(*continued on page 1-6*)

[4]The tax rate schedules for single, married filing jointly, married filing separately, and head of household are included in Appendix C.

Married Filing Jointly (and Surviving Spouses)

Not over $20,550	10% of taxable income
Over $20,550 but not over $83,550	$2,055 + 12% of taxable income in excess of $20,550
Over $83,550 but not over $178,150	$9,615 + 22% of taxable income in excess of $83,550
Over $178,150 but not over $340,100	$30,427 + 24% of taxable income in excess of $178,150
Over $340,100 but not over $431,900	$69,295 + 32% of taxable income in excess of $340,100
Over $431,900 but not over $647,850	$98,671 + 35% of taxable income in excess of $431,900
Over $647,850	$174,253.50 + 37% of taxable income in excess of $647,850

Answer: Bill and Mercedes will owe $26,434, computed as follows:

$26,434 = $9,615 + 22% × $76,450 ($160,000 − $83,550)

Note that in this graduated tax rate structure, the first $20,550 of taxable income is taxed at 10 percent, the next $63,000 of taxable income (between $20,550 and $83,550) is taxed at 12 percent, and Bill and Mercedes's last $76,450 of taxable income (between $83,550 and $160,000) is taxed at 22 percent.

Many taxpayers incorrectly believe that all their income is taxed at their marginal rate. This mistake leads people to say, "I don't want to earn any additional money because it will put me in a higher tax bracket." Bill and Mercedes are currently in the 22 percent marginal tax rate bracket, but notice that not all their income is taxed at this rate. Their *marginal* tax rate is 22 percent. This means that small increases in income will be taxed at 22 percent, and small increases in deductions will generate tax *savings* of 22 percent. If Bill and Mercedes receive a large increase in income (or in deductions) such that they change tax rate brackets, we could not identify their marginal tax rate simply by knowing their current tax bracket.

Example 1-4

What if: Bill, a well-known economics professor, signs a publishing contract with an $80,000 royalty advance. Using the rate schedule from Example 1-3, what would Bill and Mercedes's marginal tax rate be on this $80,000 of additional income?

Answer: 23.55 percent, computed as follows:

Description	Amount	Explanation
(1) Taxable income with $80,000 of additional income	$240,000	$80,000 of additional income plus $160,000 taxable income (Example 1-3)
(2) Tax on $240,000 taxable income	$ 45,271	Using the rate schedule in Example 1-3, $45,271 = $30,427 + 24% × ($240,000 − $178,150)
(3) Taxable income before $80,000 of additional income	$160,000	Example 1-3
(4) Tax on $160,000 taxable income	$ 26,434	Example 1-3
Marginal tax rate on $80,000 of additional income	**23.55%**	$\frac{\Delta \text{Tax}}{\Delta \text{Taxable income}} = [(2) - (4)]/[(1) - (3)]$

Note that Bill and Mercedes's marginal tax rate on the $80,000 of additional income rests *between* the 22 percent and 24 percent bracket rates because a portion of the additional income ($178,150 − $160,000 = $18,150) is taxed at 22 percent, with the remaining income ($240,000 − $178,150 = $61,850) taxed at 24 percent.

Example 1-5

What if: Assume now that, instead of receiving a book advance, Bill and Mercedes start a new business that *loses* $90,000 this year (it results in $90,000 of additional deductions). What would be their marginal tax rate for these additional deductions?

Answer: 20.49 percent, computed as follows:

Description	Amount	Explanation
(1) Taxable income with $90,000 of additional deductions	$ 70,000	$160,000 taxable income (Example 1-3) less $90,000 of additional deductions
(2) Tax on $70,000 taxable income	$ 7,989	Using the rate schedule in Example 1-3, $7,989 = $2,055 + 12% × ($70,000 − $20,550)
(3) Taxable income before $90,000 of additional deductions	$160,000	Example 1-3
(4) Tax on $160,000 taxable income	$ 26,434	Example 1-3
Marginal tax rate on $90,000 of additional deductions	**20.49%**	$\frac{\Delta \text{Tax}}{\Delta \text{Taxable income}}$ = [(2) − (4)]/[(1) − (3)]

Bill and Mercedes's marginal tax rate on $90,000 of additional deductions (20.49 percent) differs from their marginal tax rate on $80,000 of additional income (23.55 percent) in these scenarios because the relatively large increase in deductions in this example causes some of their income to be taxed in a lower tax rate bracket, while the relatively large increase in income in Example 1-4 causes some of their income to be taxed in a higher tax rate bracket. Taxpayers often will face the same marginal tax rates for small changes in income and deductions.

THE KEY FACTS

Different Ways to Measure Tax Rates

- Marginal tax rate
  - The tax that applies to the next increment of income or deduction.
  - $= \frac{\Delta \text{Tax}}{\Delta \text{Taxable income}}$
  - Useful in tax planning.
- Average tax rate
  - A taxpayer's average level of taxation on each dollar of *taxable* income.
  - $= \frac{\text{Total tax}}{\text{Taxable income}}$
  - Useful in budgeting tax expense.
- Effective tax rate
  - A taxpayer's average rate of taxation on each dollar of *total* income (taxable *and* nontaxable income).
  - $= \frac{\text{Total tax}}{\text{Total income}}$
  - Useful in comparing the relative tax burdens of taxpayers.

The marginal tax rate is particularly useful in tax planning because it represents the rate of taxation or savings that would apply to additional income (or deductions). In the Tax Planning Strategies and Related Limitations chapter, we discuss basic tax planning strategies that use the marginal tax rate.

The **average tax rate** represents a taxpayer's average level of taxation on each dollar of taxable income. Specifically,

Eq. 1-3

$$\text{Average Tax Rate} = \frac{\text{Total Tax}}{\text{Taxable Income}}$$

The average tax rate is often used in budgeting tax expense as a portion of income (i.e., determining what percent of taxable income earned is paid in tax).

Example 1-6

Assuming Bill and Mercedes have $160,000 of taxable income and $10,000 of nontaxable income, what is their average tax rate?

Answer: 16.52 percent, computed as follows:

Description	Amount	Explanation
(1) Taxable income	$160,000	
(2) Tax on $160,000 taxable income	$ 26,434	Example 1-3
Average tax rate	**16.52%**	$\frac{\text{Total tax}}{\text{Taxable income}}$ = (2)/(1)

We should not be surprised that Bill and Mercedes's average tax rate is lower than their marginal tax rate because, although they are currently in the 22 percent tax rate bracket, not all of their taxable income is subject to tax at 22 percent. The first $20,550 of their taxable income is taxed at 10 percent, their next $63,000 is taxed at 12 percent, and only their last $76,450 of taxable income is taxed at 22 percent. Thus, their average tax rate is considerably lower than their marginal tax rate.

The **effective tax rate** represents the taxpayer's average rate of taxation on each dollar of total income (sometimes referred to as economic income), including taxable *and* nontaxable income. Specifically,

Eq. 1-4

$$\text{Effective Tax Rate} = \frac{\text{Total Tax}}{\text{Total Income}}$$

Relative to the average tax rate, the effective tax rate provides a better depiction of a taxpayer's tax burden because it gives the taxpayer's total tax paid as a ratio of the sum of both taxable and nontaxable income.

Example 1-7

Again, given the same income figures as in Example 1-6 ($160,000 of taxable income and $10,000 of nontaxable income), what is Bill and Mercedes's effective tax rate?

Answer: 15.55 percent, computed as follows:

Description	Amount	Explanation
(1) Total income	$170,000	$160,000 taxable income plus $10,000 in nontaxable income (Example 1-6)
(2) Tax on $160,000 taxable income	$ 26,434	Example 1-3
Effective tax rate	**15.55%**	$\frac{\text{Total tax}}{\text{Total income}} = (2)/(1)$

Should we be surprised that the effective tax rate is lower than the *average* tax rate? No, the effective tax rate will always be equal to or less than the average tax rate. When a taxpayer has no nontaxable income, the effective and average tax rates will be equal, but anytime a taxpayer has nontaxable income, the effective tax rate will be less than the average tax rate.

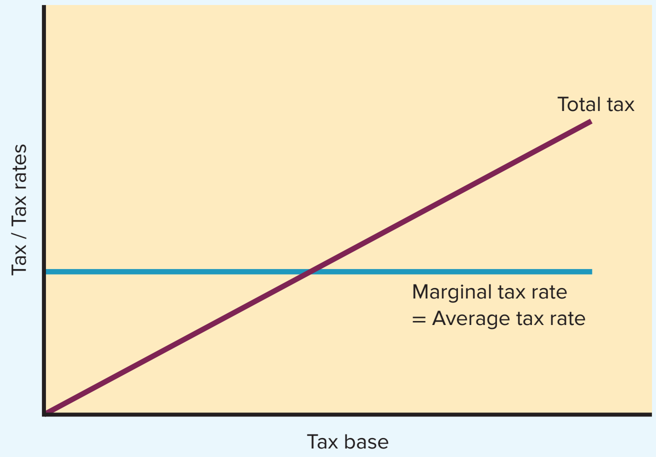
TAX RATE STRUCTURES

There are three basic tax rate structures used to determine a tax: proportional, progressive, and regressive.

Proportional Tax Rate Structure

A **proportional tax rate structure,** also known as a flat tax, imposes a constant tax rate throughout the tax base. As the tax base increases, the taxes paid increase proportionally. Because this rate stays the same throughout all levels of the tax base, the marginal tax rate remains constant and, in fact, equals the average tax rate (see Exhibit 1-1). The 21 percent corporate tax rate is an example of a flat tax. Sales tax is another example of a flat tax.

EXHIBIT 1-1 **Proportional Tax Rate**



To calculate the tax owed for a proportional tax, simply use Equation 1-1 to multiply the tax base by the tax rate. Specifically,

Eq. 1-5 $$\text{Proportional Tax} = \text{Tax Base} \times \text{Tax Rate}$$

Example 1-8

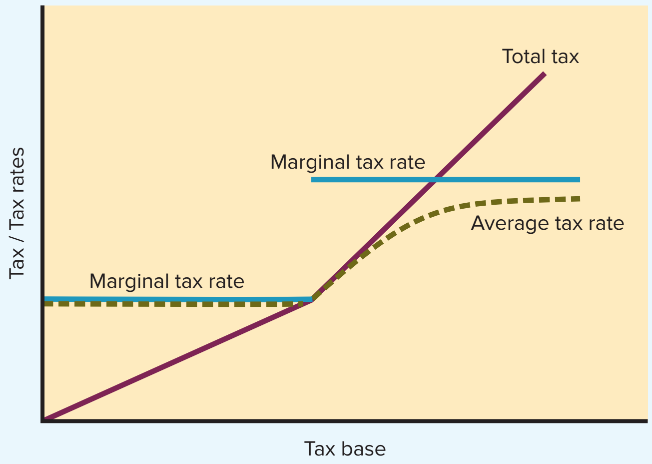
Knowing her dad is a serious Georgia Bulldog fan, Margaret buys a $100 sweatshirt in downtown Athens. The city of Athens imposes a sales tax rate of 7 percent. How much tax does Margaret pay on the purchase?

Answer: $100 purchase (tax base) × 7% (tax rate) = $7

Progressive Tax Rate Structure

A **progressive tax rate structure** imposes an increasing marginal tax rate as the tax base increases. Common examples of progressive tax rate structures include federal and most state income taxes. The tax rate schedule in Example 1-3 is a progressive tax rate structure. As illustrated in Exhibit 1-2, the average tax rate in a progressive tax rate structure will always be less than or equal to the marginal tax rate.

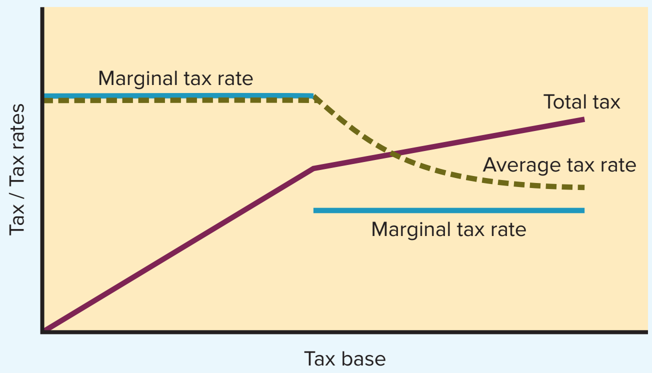
EXHIBIT 1-2 **Progressive Tax Rate**



Regressive Tax Rate Structure

A **regressive tax rate structure** imposes a decreasing marginal tax rate as the tax base increases (see Exhibit 1-3). Regressive tax rate structures are not common. In the United States, the Social Security tax and federal and state unemployment taxes employ a regressive tax rate structure.[5]

EXHIBIT 1-3 **Regressive Tax Rate**



Some taxes are regressive when viewed in terms of effective tax rates. For example, a sales tax is a proportional tax by definition because as taxable purchases increase, the sales tax rate remains constant.[6] Nonetheless, when you consider that the proportion of your total income spent on taxable purchases likely decreases as your total income increases, you can see the sales tax as a regressive tax.

[5]Wages subject to the Social Security tax are capped by an annual limit indexed for inflation. For 2022, the cap is $147,000. Wages in excess of the cap are not subject to the tax. Likewise, the federal and state unemployment tax bases and related unemployment benefits are capped. In contrast, all wages are subject to the Medicare tax, no matter the taxpayer's wages. Thus, the Medicare tax is less regressive.

[6]For example, a destitute taxpayer likely spends all he makes on food and other items subject to the sales tax; thus, all of his income is subject to a sales tax. In contrast, a wealthy taxpayer likely spends only a small fraction of his income on items subject to sales tax (while saving the rest). Thus, less of a wealthy taxpayer's total income is subject to the sales tax, which ultimately results in a lower effective tax rate.

Example 1-9

Bill and Mercedes invite two single friends, Elizabeth and Marc, over for dinner. Elizabeth earns $300,000 annually as CFO of a company and spends $70,000 on purchases subject to the 7 percent sales tax. Marc, who earns $75,000 as a real estate agent, spends $30,000 of his income on taxable purchases. Let's compare their marginal, average, and effective tax rates for the sales tax with those of Bill and Mercedes, who spend $50,000 of their income on taxable purchases:

	Elizabeth	Bill and Mercedes	Marc
(1) Total income	$300,000	$170,000	$75,000
(2) Total purchases subject to 7% sales tax	$ 70,000	$ 50,000	$30,000
(3) Sales tax paid	$ 4,900	$ 3,500	$ 2,100
Marginal tax rate	7.0%	7.0%	7.0%
Average tax rate (3)/(2)	7.0%	7.0%	7.0%
Effective tax rate (3)/(1)	1.6%	2.1%	2.8%

Is the sales tax regressive?

Answer: Yes. In terms of *effective* tax rates, the sales tax is regressive.

When we consider the marginal and average tax rates in Example 1-9, the sales tax has a proportional tax rate structure. But when we look at the *effective* tax rates, the sales tax is a regressive tax. Indeed, Marc, who has the smallest total income, bears the highest effective tax rate, despite all three taxpayers being subject to the same marginal and average tax rates. Why do we see such a different picture when considering the effective tax rate? Because unlike the marginal and average tax rates, the effective tax rate captures the *incidence* of taxation, which relates to the ultimate economic burden of a tax. Thus, a comparison of effective tax rates is more informative about taxpayers' relative tax burdens.

THE KEY FACTS

Tax Rate Structures

- A proportional tax rate structure
  - Imposes a constant tax rate throughout the tax base.
  - As a taxpayer's tax base increases, the taxpayer's taxes increase proportionally.
  - The marginal tax rate remains constant and always equals the average tax rate.
- A progressive tax rate structure
  - Imposes an increasing marginal tax rate as the tax base increases.
- A regressive tax rate structure
  - Imposes a decreasing marginal tax rate as the tax base increases.

TYPES OF TAXES

LO 1-4

"You can't live with 'em. You can't live without 'em." This statement has often been used in reference to bosses, parents, spouses, and significant others. To some degree, it applies equally well to taxes. Although we all benefit in multiple ways from tax revenues, and all civilized nations impose them, it would be hard to find someone who *enjoys* paying them. Most people don't object to the idea of paying taxes. Instead, it's the way taxes are levied that many people, like Margaret's friend Eddy, dislike. Hence, the search for fairness or the "perfect" tax system can be elusive. The following paragraphs describe the major types of taxes currently implemented by federal, state, and local governments. After this discussion, we describe the criteria for evaluating alternative tax systems.

Federal Taxes

The federal government imposes a variety of taxes to fund federal programs such as national defense, Social Security, an interstate highway system, educational programs, and Medicare. Major federal taxes include the individual and corporate income taxes, employment taxes, estate and gift taxes, and excise taxes (each discussed in detail in the following paragraphs). Notably absent from this list are sales tax (a common tax levied by most state and local governments; see the State and Local Taxes chapter) and **value-added tax** (a type of sales tax also referred to as a VAT). Value-added taxes are imposed on the

THE KEY FACTS

Federal Taxes

- Income tax
  - The most significant tax assessed by the U.S. government.
  - Represents approximately 60 percent (combined corporate and individual) of all tax revenues collected in the United States.
  - Levied on individuals, corporations, estates, and trusts.
- Employment and unemployment taxes
  - Second-largest group of taxes imposed by the U.S. government.

(*continued*)

- Employment taxes consist of the Old Age, Survivors, and Disability Insurance (OASDI) tax, commonly called the Social Security tax, and the Medical Health Insurance (MHI) tax, also known as the Medicare tax.
- Unemployment taxes fund temporary unemployment benefits for individuals terminated from their jobs without cause.
- Excise taxes
  - Third-largest group of taxes imposed by the U.S. government.
  - Levied on the *quantity* of products sold.
- Transfer taxes
  - Levied on the fair-market values of wealth transfers upon death or by gift.

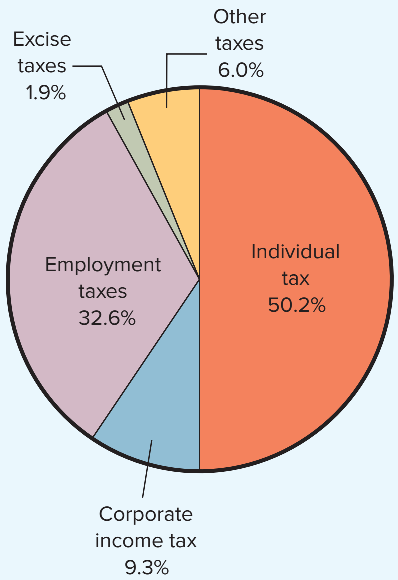
producers of goods and services based on the value added to the goods and services at each stage of production. Most countries in Europe have a VAT.

Income Tax The most significant tax assessed by the U.S. government is the individual **income tax,** representing approximately 50.2 percent of all tax revenues collected in the United States in Fiscal Year 2021. Despite the magnitude and importance of the federal income tax, its history is relatively short. Congress enacted the first U.S. personal income tax in 1861 to help fund the Civil War. This relatively minor tax (with a maximum tax rate of 5 percent) was allowed to expire in 1872. In 1892, Congress resurrected the income tax, but not without dissension among the states. In 1895, the income tax was challenged in *Pollock v. Farmers' Loan and Trust Company,* 157 U.S. 429 (1895). The U.S. Supreme Court ruled that the income tax was unconstitutional because direct taxes were prohibited by the Constitution unless the taxes were apportioned across states based upon their populations. This ruling, however, did not deter Congress. In July 1909, Congress sent a proposed constitutional amendment to the states to remove any doubt as to whether income taxes were allowed by the Constitution—and in February 1913, the 16th Amendment was ratified.

Congress then enacted the Revenue Act of 1913, which included a graduated income tax structure with a maximum rate of 6 percent. The income tax has been an important source of tax revenues for the U.S. government ever since. Today, income taxes are levied on individuals (maximum rate of 37 percent), corporations (flat rate of 21 percent), estates (maximum rate of 37 percent), and trusts (maximum rate of 37 percent). Higher-income taxpayers must also pay a 3.8 percent tax on their net investment income. As Exhibit 1-4 illustrates, the individual income tax and employment taxes represent the largest sources of federal tax revenues. We discuss each of these taxes in greater detail later in the text.

Employment and Unemployment Taxes Employment and unemployment taxes are the second-largest group of taxes imposed by the U.S. government. **Employment taxes** consist of the Old Age, Survivors, and Disability Insurance (OASDI) tax, commonly called the Social Security tax, and the Medical Health Insurance (MHI) tax, known as the Medicare tax. The **Social Security tax** pays the monthly retirement, survivor, and

EXHIBIT 1-4 **U.S. Federal Tax Revenues**



Source: Treasury Department (Fiscal Year 2021).

disability benefits for qualifying individuals, whereas the **Medicare tax** pays for medical insurance for individuals who are elderly or disabled. The tax base for the Social Security and Medicare taxes is wages or salary, and the rates are 12.4 percent and 2.9 percent, respectively. In 2022, the tax base for the Social Security tax is capped at $147,000 (wages over this cap are not subject to the tax). The tax base for the Medicare tax is not capped. Employers and employees split these taxes equally (both pay 6.2 percent Social Security tax and 1.45 percent Medicare tax). Self-employed individuals, however, must pay these taxes in their entirety. In this case, the tax is often referred to as the **self-employment tax.** We discuss these taxes in more depth later in the text. Individual taxpayers with earned income over a threshold amount are also subject to a .9 percent additional Medicare tax (see the Individual Income Tax Computation and Tax Credits chapter for details).

In addition to the Social Security and Medicare taxes, employers are also required to pay federal and state **unemployment taxes,** which fund temporary unemployment benefits for individuals terminated from their jobs without cause. Employers pay federal unemployment tax based on employees' wages or salaries. The Federal Unemployment Tax Act (FUTA) tax is 6.0 percent on only the first $7,000 of income for each employee. Most employers receive a maximum credit of up to 5.4 percent against this FUTA tax for allowable state unemployment tax. Consequently, the effective FUTA rate may be as low as .6 percent (6.0% − 5.4% = .6%).[7]

Excise Taxes **Excise taxes** are taxes levied on the retail sale of particular products. They differ from other taxes in that the tax base for an excise tax typically depends on the *quantity* purchased, rather than a monetary amount. The federal government imposes a number of excise taxes on goods such as alcohol, diesel fuel, gasoline, and tobacco products and on services such as telephone use, air transportation, and the use of tanning beds. In addition, states often impose excise taxes on these same items.

Example 1-10

On the drive home from Florida to Athens, Georgia, Margaret stops at Gasup-n-Go. On each gallon of gasoline she buys, Margaret pays 18.4 cents of federal excise tax and 42.3 cents of state excise tax (plus 4 percent sales tax). Could Margaret have avoided paying excise tax had she stopped in Florida instead?

Answer: No. Had she stopped in Florida instead, Margaret would have paid the same federal excise tax. Additionally, Florida also imposes a state excise tax on gas.

Because the producer of the product pays the excise tax to the government, many people are not even aware that businesses build these taxes into the prices consumers pay. Nevertheless, consumers bear the burden of the taxes because of the higher price.

Transfer Taxes Although they are a relatively minor tax compared to the income tax in terms of revenues collected, federal **transfer taxes**—estate and gift taxes—can be substantial for certain individual taxpayers and have been the subject of much debate in recent years. The **estate tax** (labeled the "death tax" by its opponents) and **gift taxes** are based on the fair market values of wealth transfers made upon death or by gift, respectively. Today, the maximum rate imposed on gifts is 40 percent. Most taxpayers, however, are not subject to estate and gift taxation because of the annual gift exclusion and gift and estate unified tax credits. The annual gift exclusion allows a taxpayer to transfer $16,000 of gifts per donee (gift recipient) each year without being subject to gift taxation. In 2022, the unified tax credit exempts from taxation $12,060,000 in bequests

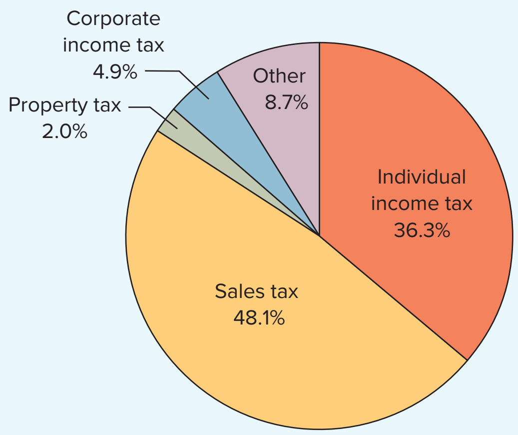
[7]Although employers pay both federal and state unemployment taxes, all unemployment benefits are actually administered and paid by state governments.

(transfers upon death) and lifetime gifts. Thus, only taxpayers with substantial wealth are subject to the gift and estate taxes.

State and Local Taxes

Like the federal government, state and local governments (such as counties, cities, and school districts) use a variety of taxes to generate revenues for their programs (such as education, highways, and police and fire departments). Some of the more common **state** and **local taxes** include income taxes, sales and use taxes, excise taxes, and property taxes. Typically, as shown in Exhibit 1-5, the largest state tax revenues are generated by individual income taxes and state sales taxes—while federal revenues rely primarily on income and employment taxes. Local tax revenues are predominantly from sales and property taxes.

EXHIBIT 1-5 **Average State Tax Revenues**



Source: U.S. Bureau of Census. www.census.gov.

THE KEY FACTS

State and Local Taxes

- Income taxes
  - Most state taxable income calculations largely conform to the federal taxable income calculations, with a limited number of modifications.
- Sales and use taxes
  - The tax base for a sales tax is the retail price of goods and some services.
  - The tax base for the use tax is the retail price of goods owned, possessed, or consumed within a state that were *not* purchased within the state.
- Property taxes
  - Property taxes are ad valorem taxes, meaning that the tax base for each property is the fair market value of that property.
  - Real property taxes consist of taxes on land, structures, and improvements permanently attached to land.
  - Personal property taxes include taxes on all other types of property, both tangible and intangible.
- Excise taxes
  - States typically impose excise taxes on items subject to federal excise tax.

Income Taxes Currently, most states and the District of Columbia impose income taxes on individuals and corporations who either reside in or earn income within the state.[8] This requires individuals working in these states to file a state tax return in addition to the federal return they already file. Calculations of individual and corporate taxable income vary with state law. Nonetheless, state taxable income calculations generally conform to the federal taxable income calculations (California is a notable exception because it has numerous modifications). State income tax rates are signficantly less than the federal rates. Certain local governments such as New York City also impose an income tax and, again, the local calculations generally follow the respective state taxable income calculation.

Sales and Use Taxes Most states, the District of Columbia, and local governments impose sales and use taxes. The tax base for a **sales tax** is the retail price of goods and some services, and retailers are responsible for collecting and remitting the tax; typically, sales tax is collected at the point of sale. The tax base for the **use tax** is the retail price of

[8]Currently, Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming have no personal income tax, and New Hampshire and Tennessee only tax individual dividend and interest income. South Dakota and Wyoming are the only states not imposing either a corporate income or gross receipts tax, although South Dakota does impose a bank franchise tax. Washington imposes a gross receipts tax instead of a corporate income tax. Texas and Ohio have an activity-based tax that is based on net income or gross receipts.

goods owned, possessed, or consumed within a state that were *not* purchased within the state. The purpose of a use tax is to discourage taxpayers from buying goods from retailers without sales tax collection responsibilities in order to avoid or minimize the sales tax in their home state. At the same time, by eliminating the incentive to purchase goods from retailers without sales tax collection responsibilities, a use tax removes any competitive disadvantage a retailer may incur from operating in a state with a high sales tax. To avoid the potential of double-taxing residents on sales taxes, states that impose a sales tax allow residents to take a credit for sales tax paid on goods purchased out of state.

Example 1-11

Margaret buys three new shirts for her dad for $100 from a seller without sales tax collection responsibilities. The seller does not collect Florida sales tax (Margaret's home state). Does Margaret's purchase escape Florida taxation?

Answer: No. Because Florida has a 6 percent use tax, Margaret is liable for $6 in use tax on the purchase ($100 × .06 = $6). Margaret will pay the use tax by filing a Florida use tax return.

Despite the potential importance of the use tax as a source of state tax revenue, states have only recently begun to enforce it. Poor compliance is therefore not surprising; indeed, many individuals have never heard of the use tax. While it is relatively easy to enforce sales tax on goods subject to a registration requirement, such as automobiles, it is quite difficult for states to tax most other untaxed purchases. Recent judicial changes to sales tax collection responsibilities have made the use tax less important. The state of Florida is not likely to search your closet to look for tax-evaded shirts. Note, however, there are several bills before Congress to modernize Internet taxation and to try to subject all Internet sales to sales taxes.

Property Taxes State and local governments commonly use two types of property taxes as sources of revenue: **real property taxes** and **personal property taxes.** Both are **ad valorem taxes,** meaning that the tax base for each is the fair market value of the property, and both are generally collected annually (when imposed).

Real property consists of land, structures, and improvements permanently attached to land, whereas *personal property* includes all other types of property, both tangible and intangible. Common examples of tangible personal property potentially subject to state and local taxation include automobiles, boats, private planes, business inventory, equipment, and furniture. *Intangible personal property* potentially subject to state and local taxation includes stocks, bonds, and intellectual property—although no state currently imposes property taxes on these intangibles.

Of the two types, real property taxes are easier to administer because real property is not movable and purchases often have to be registered with the state, thereby making it easy to identify the tax base and taxpayer. Furthermore, the taxing body can estimate market values for real property without much difficulty. In contrast, personal property is generally mobile (thus easier to hide) and may be more difficult to value; therefore, personal property taxes are difficult to enforce. Accordingly, whereas all states and the District of Columbia provide for a real property tax, only a majority of states currently impose personal property taxes, most of which are assessed at the time of licensing or registration. However, most states do collect personal property taxes on business property.

Excise Taxes We've said that the tax base for excise taxes is typically the quantity of an item or service purchased. States typically impose excise taxes on items subject to federal excise tax. Transactions subject to state excise tax often include the sale of alcohol, diesel fuel, gasoline, tobacco products, and telephone services.

Implicit Taxes

All the taxes discussed above are **explicit taxes;** that is, they are taxes directly imposed by a government and are easily quantified. **Implicit taxes,** on the other hand, are indirect taxes—not paid directly to the government—that result from a tax advantage the government grants to certain transactions to satisfy social, economic, or other objectives. Implicit taxes are defined as the reduced before-tax return that a tax-favored asset produces because of its tax-advantaged status. Let's examine this concept more closely.

First of all, what does it mean to be *tax-favored*? An asset is said to be tax-favored when the income the asset produces is either excluded from the tax base or subject to a lower (preferential) tax rate, or if the asset generates some other tax benefit such as large tax deductions. These tax benefits, *all other things equal,* result in higher after-tax profits (or lower after-tax costs) from investing in the tax-advantaged assets.

Why do tax-advantaged assets bear an implicit tax, or a reduced before-tax rate of return as a result of the tax advantage? The answer is simple economics. The tax benefits associated with the tax-favored asset increase the demand for the asset. Increased demand drives up the price of the asset, which in turn reduces its before-tax rate of return, which is an implicit tax by definition. Consider Example 1-12.

Example 1-12

Consider two bonds, one issued by the Coca-Cola Co. and the other issued by the State of Georgia. Both bonds have similar nontax characteristics (risk, for example), the same face value of $10,000, and the same market interest rate of 10 percent. The only difference between the two bonds is that the interest income from the Coca-Cola Co. bond is subject to a 22 percent income tax rate, whereas the interest income from the State of Georgia bond is tax-exempt with a 0 percent tax rate. Which of the two bonds is a better investment and should therefore have a higher demand?

	Price	Before-Tax Rate of Return*	Interest Income	Income Tax†	After-Tax Income	After-Tax Rate of Return*
Coca-Cola Co. bond	$10,000	10%	$1,000	$220	$ 780	7.8%
State of GA bond	$10,000	10%	$1,000	$ 0	$1,000	10%

*Before-tax rate of return is calculated as the before-tax income divided by the price of the bond. Likewise, after-tax rate of return is calculated as the after-tax income divided by the price of the bond.
†Income tax equals the taxable interest income ($1,000) multiplied by the assumed income marginal tax rate (22 percent).

Answer: Compare the after-tax rate of return on the bonds. Given the difference between the after-tax rate of return (10 percent vs. 7.8 percent), the better investment—again, all other investment features being equal—is the State of Georgia bond because it provides a higher after-tax rate of return. Because all investors in this example should prefer to buy the State of Georgia bond, the demand for the bond will be high, and its price should increase. This increase in price leads to a lower before-tax rate of return due to the bond's tax-favored status (this is an implicit tax).

Example 1-12 is a basic illustration of the need to consider the role of taxes in investment decisions. Without understanding the relative tax effects associated with each bond, we cannot correctly compare their after-tax returns.

At what point in Example 1-12 would you be indifferent between investing in the Coca-Cola Co. bond and the State of Georgia bond? Assuming both bonds have the same nontax characteristics, you would be indifferent between them when they both provide the same after-tax rate of return. This could occur if the State of Georgia raised the price of its bond from $10,000 to $12,820.51 ($1,000 interest/$12,820.51 price = 7.8% return). Or the State of Georgia could lower its bond interest payment from $1,000 to $780 ($780 interest/$10,000 price = 7.8% return). Either way, the State of Georgia benefits from selling the tax-exempt bonds—either at a higher price or at a lower interest rate relative to other bonds. Let's look more closely at this latter option because it is, in fact, what many tax-exempt bond issuers choose to do.

	Price	Before-Tax Rate of Return	Interest Income	Income Tax	After-Tax Income	After-Tax Rate of Return
Coca-Cola Co. bond	$10,000	10%	$1,000	$220	$780	7.8%
State of GA bond	$10,000	7.8%	$ 780	$ 0	$780	7.8%

Assuming each bond has the same nontax characteristics, an investor should be indifferent between the Coca-Cola Co. bond and the State of Georgia bond. What is the tax burden on investors choosing the Coca-Cola Co. bond? Coca-Cola Co. bond investors are paying $220 of income taxes (explicit taxes). What is the tax burden on investors choosing the State of Georgia bond? While it is true they are subject to zero income taxes (explicit taxes), they are subject to implicit taxes in the form of the $220 less in interest income they accept. This $220 of reduced interest income (2.2 percent reduced before-tax rate of return) is an implicit tax. Although the investors in the State of Georgia bond are not paying this tax directly, they are paying it indirectly.

Does this happen in real life? Yes. Municipal bond interest income (interest income paid on bonds issued by state and local governments) generally is not subject to federal income taxation. Because of their tax-advantaged status, municipalities are able to pay a lower interest rate on their bond issuances and investors are willing to accept the lower rate. This type of indirect federal subsidy allows municipalities to raise money at a reduced cost without the need for direct federal subsidy or approval.

Although we were able to quantify the implicit taxes paid in the above example, in reality it is very difficult to estimate the amount of implicit taxes paid. For example, the federal government subsidizes housing by allowing taxpayers to deduct mortgage interest on their principal residence. Does this subsidy result in an implicit tax in the form of higher housing prices? Probably. Nevertheless, it would be difficult to quantify this implicit tax.

Despite the difficulty of quantifying implicit taxes, you should understand the concept of implicit taxes so you can make informed judgments about the attractiveness of alternative investments and the relative total tax burdens of tax-advantaged investments (considering both explicit and implicit taxes).

THE KEY FACTS

Implicit Taxes

- Implicit taxes are indirect taxes that result from a tax advantage the government grants to certain transactions to satisfy social, economic, or other objectives.
- Implicit taxes are defined as the reduced before-tax return that a tax-favored asset produces because of its tax-advantaged status.
- Implicit taxes are difficult to quantify but important to understand in evaluating the relative tax burdens of tax-advantaged investments.

EVALUATING ALTERNATIVE TAX SYSTEMS

LO 1-5

Although it may appear that tax systems are designed without much forethought, in truth lawmakers engage in continuous debate over the basic questions of whom to tax, what to tax, and how much to tax. Margaret's friend Eddy is obviously upset with what he views as an unfair tax system. But fairness, as we will discuss shortly, is often like beauty—it is in the eye of the beholder. What is fair to one may seem blatantly unfair to others. In the following paragraphs, we offer various criteria (sufficiency, equity, certainty, convenience, and economy) you can use to evaluate alternative tax systems.[9] Satisfying everyone at the same time is difficult—hence, the spirited debate on tax fairness and reform, especially leading up to election years when you get to choose between political parties and their platforms.

[9]Adam Smith identified and described the latter four criteria in *The Wealth of Nations*.

THE KEY FACTS

Evaluating Alternative Tax Systems—Sufficiency

- Judging sufficiency requires assessing the aggregate amount of the tax revenues that must be generated and ensuring that the tax system provides these revenues.
- Static forecasting ignores how taxpayers may alter their activities in response to a proposed tax law change and bases projected tax revenues on the existing state of transactions.
- Dynamic forecasting attempts to account for possible taxpayer responses to a proposed tax law change.

Sufficiency

Judging the **sufficiency** of a tax system means assessing the amount of tax revenues it must generate and ensuring that it provides them. For a country's tax system to be successful, it must provide sufficient revenues to pay for governmental expenditures for a defense system, social services, and so on. This sounds easy enough: Estimate the amount of governmental expenditures that will be required, and then design the system to generate enough revenues to pay for these expenses. In reality, however, accurately estimating governmental expenditures and revenues is a rather daunting and imprecise process. Estimating governmental expenditures is difficult because it is impossible to predict the unknown. For example, in recent years governmental expenditures have increased due to the growth of Homeland Security, the Afghanistan and Iraq wars, natural disasters, economic stimulus packages due to COVID-19, and health care. Likewise, estimating governmental revenues is difficult because tax revenues are the result of transactions influenced by these same national events, the economy, and other factors. Thus, precisely estimating and matching governmental expenditures with tax revenues is nearly impossible.

The task of estimating tax revenues becomes even more daunting when the government attempts to make significant changes to the existing tax system or design a new one. Whenever Congress proposes changing who is taxed, what is taxed, or how much is taxed, its members must consider the taxpayer response to the change. That affects the amount of tax collected, and forecasters' prediction of what taxpayers will do affects the amount of revenue they estimate to collect.

Static versus Dynamic Forecasting One option in forecasting revenue is to ignore how taxpayers may alter their activities in response to a tax law change and instead base projected tax revenues on the existing state of transactions, a process referred to as **static forecasting.** However, this type of forecasting may result in a large discrepancy in projected versus actual tax revenues collected if taxpayers do change their behavior.

The other choice is to attempt to account for possible taxpayer responses to the tax law change, a process referred to as **dynamic forecasting.** Dynamic forecasting is ultimately only as good as the assumptions underlying the forecasts and does not guarantee accurate results. Nonetheless, considering how taxpayers may alter their activities in response to a tax law change is a useful exercise to identify the potential ramifications of the change, even if the revenue projections ultimately miss the mark.[10]

Example 1-13

The city of Heflin would like to increase tax revenues by $2,000,000 to pay for needed roadwork. A concerned taxpayer recently proposed increasing the cigarette excise tax from $1.00 per pack of cigarettes to $6.00 per pack to raise the additional needed revenue. Last year, 400,000 packs of cigarettes were sold in the city. Will the proposal be successful in raising the additional $2,000,000 in proposed tax revenue?

Answer: Not likely. The proposed tax increase of $5, and the assumption that 400,000 packs will still be sold, is an example of static forecasting: It ignores that many taxpayers may respond to the tax change by quitting, cutting down, or buying cheaper cigarettes in the next town.

In some cases, static forecasting can lead to a tax consequence that is the opposite of the desired outcome. In Example 1-13, we might estimate that given Heflin's close proximity to other cities with a $1.00 cigarette tax, the number of packs of cigarettes sold within the city would drop significantly to, say, 50,000. In this case, the tax increase would actually *decrease* tax revenues by $100,000 ($400,000 existing tax − $300,000 new tax)—not a good outcome if the goal was to increase tax revenues.

[10]For more information about the congressional revenue estimating process, including dynamic scoring, see the Joint Committee on Taxation explanation at www.jct.gov/publications.html?func=startdown&id=4687.

Income versus Substitution Effects Example 1-13 described proposed changes in an excise tax, which is a proportional tax. In terms of a progressive tax such as an *income* tax, a tax rate increase or an expansion of the tax base can result in one of two taxpayer responses, both of which are important for dynamic forecasting. The **income effect** predicts that when taxpayers are taxed more, they will work harder to generate the same after-tax dollars. The **substitution effect** predicts that when taxpayers are taxed more, rather than working more, they will substitute nontaxable activities like leisure pursuits for taxable ones because the marginal value of taxable activities has decreased. Which view is accurate? The answer depends on the taxpayer. Consider the following examples.

Example 1-14

Margaret's friend George, who earns $40,000 taxable income as a self-employed mechanic, is taxed at an average rate of 10 percent (resulting in $4,000 of tax). If Congress increases the income tax rate such that George's average tax rate increases from 10 percent to 25 percent, how much more income tax will he pay?

Answer: It depends on whether the income effect or the substitution effect is operating. Assuming George is single and cannot afford a net decrease in his after-tax income, he will likely work more (the income effect rules). Prior to the tax rate increase, George had $36,000 of after-tax income ($40,000 taxable income less $4,000 tax). With the increased tax rate, George will have to earn $48,000 of taxable income to keep $36,000 after taxes [$48,000 − ($48,000 × .25) = $36,000]. Thus, if the income effect rules, the government will collect $12,000 of federal income tax from George, or $8,000 more than under the previous lower tax rate. In this scenario, the tax change increases government revenues because of the increased tax rate *and* the increased tax base.

Whether the substitution effect or the income effect will describe any individual taxpayer's reaction to a tax increase is something we can only guess. But some factors—such as having higher disposable income—are likely to correlate with the substitution effect.

Example 1-15

What if: Now let's assume that George is married and has two young children. Both he and his wife work, and they file a tax return jointly with a 10 percent average tax rate. Either of their incomes is sufficient to meet necessities, even after the tax rate increase. But fixed child care costs make the marginal wage rate (the after-tax hourly wage less hourly child care cost) more sensitive to tax rate increases. In this case, the lower-earning spouse may choose to work less. Suppose George quits his full-time job and takes a part-time position that pays $10,000 to spend more time with his kids and to pursue his passion, reading sports novels. What are the taxes on George's income?

Answer: In this case, George will owe $2,500 tax ($10,000 × .25). Here, the substitution effect operates and the government collects much less than it would have if George had maintained his full-time position because the tax rate increase had a negative effect on the tax base.

As Examples 1-14 and 1-15 illustrate, the response to a tax law change can vary by taxpayer and can greatly affect the magnitude of tax revenues generated by the change. Herein lies one of the challenges in significantly changing an existing tax system or designing a new one: If a tax system fails to generate sufficient revenues, the government must seek other sources to pay for governmental expenditures. The most common source of these additional funds for the federal government is the issuance of debt instruments such as Treasury bonds. This, however, is only a short-term solution to a budget deficit. Debt issuances require both interest and principal payments, which require the federal government to identify even more sources of revenue to service the debt issued or to cut governmental spending (both of which may be unpopular choices with voters). A third option is for the government to default on its debt obligations. However, the costs of this option are potentially devastating. If the historical examples of Mexico, Brazil, Argentina, and Greece are any guide, a U.S. government default on its debt obligations would likely devalue the U.S. dollar severely and have extreme negative consequences for the U.S. capital markets.

The best option is for the government to match its revenues with its expenses—that is, to not spend more than it collects. State governments seem to be more successful in this endeavor than the U.S. federal government. Indeed, all states except Vermont require a balanced budget each year, whereas the federal government has had deficit spending for most of the last 40 years.

TAXES IN THE REAL WORLD National Debt

How much debt does the U.S. have? As of August 2021, it was $28.6 trillion. Almost $23.0 trillion of the national debt is held by public investors, including individual bondholders, institutional investors, and foreign governments such as China, Japan, the United Kingdom, and Brazil. The $5.6 trillion remaining amount represents intragovernmental holdings—primarily Social Security.

Is $28.6 trillion too much to handle? The key issue is fiscal sustainability: the ability to pay off a debt in the future. Rising debt also has other negative consequences, such as higher interest payments, a need for higher taxes, restrictions on policy makers' fiscal policy choices, and the increased probability of a sudden fiscal crisis. If nothing is done to change the national debt trajectory, the debt will grow faster than the economy.

Is the national debt sustainable? The federal government has recently been recording budget deficits that are a larger share of the economy than for any year since the end of World War II. With an aging population, Social Security and other benefits will require larger expenditures. By the end of the current decade, barring any significant policy shifts, the vast majority of federal tax revenue will be consumed by just four expenditures: interest on the debt, Medicare, Medicaid, and Social Security. To finance other governmental expenditures, including defense and all other discretionary programs, policy makers will have to borrow the money to pay for them.

Source: www.treasurydirect.gov/govt/reports/pd/mspd/mspd.htm.

Equity

We've looked at the challenges of designing a tax system that provides sufficient revenues to pay for governmental expenditures. An equally challenging issue is how the tax burden should be distributed across taxpayers. At the heart of this issue is the concept of **equity,** or fairness. Fairness is inherently subject to personal interpretation, and informed minds often disagree about what is fair. There is no "one-size-fits-all" definition of equity or fairness. Nevertheless, it is informative to consider in broad terms what makes a fair or equitable tax system.

In general terms, a tax system is considered fair or equitable if the tax is based on the taxpayer's ability to pay. Taxpayers with a greater ability to pay tax pay more tax. In broad terms, each of the federal, state, and local taxes we've discussed satisfies this criterion. For example, those individuals with greater taxable income, purchases, property, and estates (upon death) generally pay higher dollar amounts in federal income tax, sales tax, property tax, and estate tax. If this is the case, why is there so much debate over the fairness of the U.S. income tax system? The answer is that equity is more complex than our first definition suggests. Let's take a closer look.

Horizontal versus Vertical Equity Two basic types of equity are relevant to tax systems. **Horizontal equity** means that two taxpayers in similar situations pay the same tax. In broad terms, each of the federal, state, and local taxes discussed satisfies this definition. Two individual taxpayers with the same taxable income, same purchases, same value of property, and same estate value pay the same federal income tax, sales tax, property tax, and estate tax. However, on closer inspection we might argue that each of these tax systems is *not* horizontally equitable. Here are some examples:

- Two individual taxpayers with the same income will not pay the same federal income tax if one individual's income was earned as salary and the other individual's income was tax-exempt municipal bond interest income, dividend income, or capital gain(s) income, which can be subject to a lower tax rate.
- Two individuals with the same dollar amount of purchases will not pay the same sales tax if one buys a higher proportion of goods that are subject to a lower sales tax rate, such as groceries.
- Two individuals with real estate of the same value will not pay the same property tax if one individual owns farmland, which is generally subject to a lower property tax rate.
- Finally, two individuals with estates of the same value will not pay the same estate tax if one individual bequeaths more of her property to charity or a spouse because these transfers are not subject to estate tax.

These failures of horizontal equity are due to what we call *tax preferences*. Governments provide tax preferences for a variety of reasons, such as to encourage investment or to further social objectives. Whether we view these tax preferences as appropriate greatly influences whether we consider a tax system to be fair in general and horizontally equitable in particular.

The second type of equity to consider in evaluating a tax system is **vertical equity.** Vertical equity is achieved when taxpayers with greater ability to pay tax pay more tax than taxpayers with less ability to pay. We can think of vertical equity in terms of tax dollars paid or in terms of tax rates. Proponents of a flat income tax or of a sales tax—both of which are proportional tax rate structures—are more likely to argue that vertical equity is achieved when taxpayers with a greater ability to pay tax simply pay more in tax *dollars*. Proponents of a progressive tax system are more likely to argue that taxpayers with a greater ability to pay should be subject to a higher tax *rate*. This view is based upon the argument that the *relative* burden of a flat tax rate decreases as a taxpayer's income increases. Which is the correct answer? There is no correct answer. Nevertheless, many feel very strongly regarding one view or the other.

Our discussion has focused on how we can view alternative tax rate structures in terms of vertical equity, ignoring the role that the tax base plays in determining vertical equity. Indeed, focusing on the tax rate structure in evaluating a tax system is appropriate only if the tax base chosen—whether it's taxable income, purchases, property owned, or something else—accurately portrays a taxpayer's ability to pay. This can be a rather strong assumption. Consider the sales tax in Example 1-9. Although taxable purchases in this example increase as the taxpayers' total incomes increase, total incomes increase at a much faster rate than taxable purchases. Thus, the gap between taxable purchases and total income widens as total income increases. The end result is that the effective tax rates for those with a greater ability to pay are *lower* than for those taxpayers with a lesser ability to pay, making this tax regressive. Regressive tax rate structures are generally considered not to satisfy vertical equity, unless you strongly believe that those with a greater ability to pay do so simply by paying more tax dollars, albeit at a lower tax rate. In sum, evaluating vertical equity in terms of effective tax rates may be much more informative than simply evaluating tax rate structures.

THE KEY FACTS

Evaluating Alternative Tax Systems—Equity

- Questions of equity consider how the tax burden should be distributed across taxpayers.
- Horizontal equity means that two taxpayers in similar situations pay the same tax.
- Vertical equity is achieved when taxpayers with greater ability to pay tax pay more tax than taxpayers with a lesser ability to pay tax.

Certainty

Certainty means that taxpayers should be able to determine when to pay the tax, where to pay the tax, and how to determine the tax. Determining when and where to pay each of the taxes previously discussed is relatively easy. For example, individual federal income tax returns and the remaining balance of taxes owed must be filed with the Internal Revenue Service each year on or before April 15th. Likewise, sales taxes, property taxes, and excise taxes are each determined with relative ease: Sales taxes are based on the value of taxable purchases, property taxes are generally based on assessed property values, and excise taxes are based on the number of taxable units purchased. Indeed, these taxes are calculated for the taxpayer and often charged at regular intervals or at the point of purchase; they do not require a tax return.

In contrast, income taxes are often criticized as being too complex. What are taxable versus nontaxable types of income? What are deductible/nondeductible expenses? When should income or expenses be reported? For wage earners with few investments, the answers to these questions are straightforward. For business owners and individuals with a lot of investments, the answers are nontrivial. Yearly tax law changes enacted by Congress can make it more difficult to determine a taxpayer's current tax liability, much less plan for the future.

THE KEY FACTS

Evaluating Alternative Tax Systems—Certainty, Convenience, and Economy

- Certainty
  - Certainty means taxpayers should be able to determine when, where, and how much tax to pay.
  - Determining when and where to pay each of the taxes previously discussed is relatively easy.
  - The income tax has been criticized for the complexity of determining how much to pay.
- Convenience
  - Convenience means a tax system should be designed to facilitate the collection of tax revenues without undue hardship on the taxpayer or the government.
  - Various tax systems meet this criterion by tying the collection of the tax as closely as possible to the transaction that generates it.
- Economy
  - Economy means a tax system should minimize compliance and administration costs.
  - Economy can be viewed from both the taxpayer's and the government's perspectives.

Convenience

Convenience suggests that a tax system should be designed to facilitate the collection of tax revenues without undue hardship on the taxpayer or the government. Various tax systems meet this criterion by tying the collection of the tax as closely as possible to the transaction that generates it (when it is most convenient to pay the tax). For example, retailers collect sales taxes when buyers purchase goods. Thus, it is difficult for the buyer to avoid paying sales tax, assuming she is transacting with an ethical retailer. Likewise, employers withhold federal income and Social Security taxes directly from wage earners' paychecks, which speeds the government's collection of the taxes and makes it difficult for taxpayers to evade taxes. If tax withholdings are not sufficient relative to the taxpayer's anticipated income tax liability, or if the taxpayer is self-employed, he or she is required to make quarterly estimated tax installments. Individual quarterly estimated payments are due on April 15, June 15, September 15, and January 15. Corporate estimated tax payments are due on the 15th day of the third, sixth, ninth, and twelfth months of the corporation's fiscal year.

Economy

Economy requires that a good tax system should minimize the compliance and administration costs associated with the tax system. We can view economy from both the taxpayer's and the government's perspectives. Believe it or not, most tax systems fare well in terms of economy, at least from the government's perspective. For example, the current IRS budget represents approximately one-third of a percent of every tax dollar collected. Compared to the typical costs of a collection agency, this is quite low.

How about from the taxpayer's perspective? Here the picture is a bit different. The sales tax imposes no administrative burden on the taxpayer and only small administrative costs on the local retailer. However, out-of-state sellers argue that collecting and remitting use taxes for thousands of state and city jurisdictions would be a substantial burden. Other taxes such as excise taxes and property taxes also impose minimal administrative costs on the taxpayer. In contrast, as we've seen, the income tax is often criticized for the compliance costs imposed on the taxpayer. Indeed, for certain taxpayers, record-keeping costs, accountant fees, attorney fees, and so on can be substantial. Advocates of alternative tax systems often challenge the income tax on this criterion.

Evaluating Tax Systems—The Trade-Offs

At the heart of any debate about tax reform are fundamental decisions and concessions based on the five criteria we've just discussed. Interestingly enough, much of the debate regarding alternative tax systems can be reduced to a choice between simplicity and fairness. Those taxes that generally are simpler and easier to administer, such as the sales tax, are typically viewed as less fair. Those taxes that can be viewed as more fair, such as the federal income tax, often are more complex to administer. Thus, Margaret's friend Eddy faces a difficult choice about which type of tax system to advocate, as do all taxpayers. An understanding of the evaluative criteria should be helpful to anyone trying to reconcile the trade-offs among alternative tax proposals.

CONCLUSION

In almost any society, taxes are a part of life. They influence decisions about personal finance, investment, business, and politics. In this chapter, we introduced the basic concepts of why one should study tax, what a tax is, and how to calculate a tax. We also discussed various tax rates, tax rate structures, and different types of taxes imposed by federal, state, and local governments. Finally, we discussed the criteria that one might use to evaluate alternative tax rate systems. To make informed personal finance, investment, business, and political decisions, one must have a basic understanding of these items. In the following chapters, we expand the discussion of how taxes influence these decisions while providing a basic understanding of our federal income tax system. Read on and learn more!

Summary

Demonstrate how taxes influence basic business, investment, personal, and political decisions. **LO 1-1**

- Taxes are significant costs that influence many basic business, investment, and personal decisions.
  - *Business decisions* include what organizational form to take; where to locate; how to compensate employees; what should be the appropriate debt mix; whether to own versus rent equipment and property; how to distribute profits; and so forth.
  - *Investment decisions* include alternative methods for saving for education or retirement, and so forth.
  - *Personal finance decisions* include evaluating job offers; gift or estate planning; owning a home versus renting; and so forth.
- Taxes also play a major part in the political process. Major parties typically have very diverse views on whom, what, and how much to tax.

Discuss what constitutes a tax and the general objectives of taxation. **LO 1-2**

- The general purpose of taxes is to fund the government. Unlike fines or penalties, taxes are not meant to punish or prevent illegal behavior, but "sin taxes" (on alcohol, tobacco, tanning beds, etc.) are meant to discourage certain behaviors.
- To qualify as a tax, three criteria are necessary: The payment must be (1) required (it is not voluntary), (2) imposed by a government (federal, state, or local), and (3) not tied directly to the benefit received by the taxpayer.

Describe the three basic tax rate structures and calculate a tax. **LO 1-3**

- Tax = Tax rate × Tax base, where the tax base is what is taxed and the tax rate is the level of taxes imposed on the base. For federal income tax, the tax base is taxable income, or gross income minus deductions. Different portions of a tax base may be taxed at different rates.

- There are three different tax rates that are useful in assessing the different tax rate structures, tax planning alternatives, and/or the tax burden of a taxpayer: the marginal, average, and effective tax rates.
  - The *marginal* tax rate is the tax that applies to the next increment of income or deduction.
  - The *average* tax rate represents a taxpayer's average level of taxation on each dollar of taxable income.
  - The *effective* tax rate represents the taxpayer's average rate of taxation on each dollar of total income (taxable *and* nontaxable income).
- The three basic tax rate structures are proportional, progressive, and regressive.
  - A *proportional* tax rate structure imposes a constant tax rate throughout the tax base. As a taxpayer's tax base increases, the taxpayer's taxes increase proportionally. The marginal tax rate remains constant and always equals the average tax rate. A common example is a sales tax.
  - A *progressive* tax rate imposes an increasing marginal tax rate as the tax base increases. As a taxpayer's tax base increases, both the marginal tax rate and the taxes paid increase. A common example is the U.S. federal income tax.
  - A *regressive* tax rate imposes a decreasing marginal tax rate as the tax base increases. As a taxpayer's tax base increases, the marginal tax rate decreases while the total taxes paid increase.

LO 1-4 Identify the various federal, state, and local taxes.

- Federal taxes include the income tax, employment taxes (Social Security and Medicare taxes), unemployment taxes, excise taxes (levied on quantity purchased), and transfer taxes (estate and gift taxes).
- State and local taxes include the income tax (levied by most states), sales tax (levied on retail sales of goods and some services), use tax (levied on the retail price of goods owned or consumed within a state that were purchased from a seller without sales tax collection responsibility), property taxes (levied on the fair market value of real and personal property), and excise taxes.
- Implicit taxes are indirect taxes that result from a tax advantage the government grants to certain transactions to satisfy social, economic, or other objectives. They are defined as the reduced before-tax return that a tax-favored asset produces because of its tax-advantaged status.

LO 1-5 Apply appropriate criteria to evaluate alternative tax systems.

- Sufficiency involves assessing the aggregate size of the tax revenues that must be generated and ensuring that the tax system provides these revenues. Static forecasting ignores how taxpayers may alter their activities in response to a proposed tax law change and bases projected tax revenues on the existing state of transactions. In contrast, dynamic forecasting attempts to account for possible taxpayer responses to a proposed tax law change.
- Equity considers how the tax burden should be distributed across taxpayers. Generally, a tax system is considered fair or equitable if the tax is based on the taxpayer's ability to pay—that is, taxpayers with a greater ability to pay tax pay more tax. Horizontal equity means that two taxpayers in similar situations pay the same tax. Vertical equity is achieved when taxpayers with greater ability to pay tax pay more tax relative to taxpayers with a lesser ability to pay tax.
- Certainty means taxpayers should be able to determine when, where, and how much tax to pay.
- Convenience means a tax system should be designed to facilitate the collection of tax revenues without undue hardship on the taxpayer or the government.
- Economy means a tax system should minimize its compliance and administration costs.

KEY TERMS

ad valorem taxes (1-15)
average tax rate (1-7)
brackets (1-5)
certainty (1-22)
convenience (1-22)
dynamic forecasting (1-18)
earmarked tax (1-4)
economy (1-22)
effective tax rate (1-8)
employment taxes (1-12)
equity (1-20)
estate tax (1-13)

excise taxes (1-13)
explicit taxes (1-16)
flat tax (1-5)
gift tax (1-13)
graduated taxes (1-5)
horizontal equity (1-21)
implicit taxes (1-16)
income effect (1-19)
income tax (1-12)
local tax (1-14)
marginal tax rate (1-5)
Medicare tax (1-13)
personal property tax (1-15)
progressive tax rate structure (1-9)
proportional tax rate structure (1-9)
real property tax (1-15)
regressive tax rate structure (1-10)
sales tax (1-14)
self-employment tax (1-13)
sin taxes (1-4)
Social Security tax (1-12)
state tax (1-14)
static forecasting (1-18)
substitution effect (1-19)
sufficiency (1-18)
tax (1-4)
tax base (1-5)
tax rate (1-5)
transfer taxes (1-13)
unemployment tax (1-13)
use tax (1-14)
value-added tax (1-11)
vertical equity (1-21)

DISCUSSION QUESTIONS

Discussion Questions are available in Connect®.

1. Jessica's friend Zachary once stated that he couldn't understand why someone would take a tax course. Why is this a rather naïve view? LO 1-1
2. What are some aspects of business that require knowledge of taxation? What are some aspects of personal finance that require knowledge of taxation? LO 1-1
3. Describe some ways in which taxes affect the political process in the United States. LO 1-1
4. Courtney recently received a speeding ticket on her way to the university. Her fine was $200. Is this considered a tax? Why or why not? LO 1-2
5. Marlon and Latoya recently started building a house. They had to pay $300 to the county government for a building permit. Is the $300 payment a tax? Why or why not? LO 1-2
6. To help pay for the city's new stadium, the city of Birmingham recently enacted a 1 percent surcharge on hotel rooms. Is this a tax? Why or why not? LO 1-2
7. As noted in Example 1-2, tolls, parking meter fees, and annual licensing fees are not considered taxes. Can you identify other fees that are similar? LO 1-2
8. If the general objective of our tax system is to raise revenue, why does the income tax allow deductions for charitable contributions and retirement plan contributions? LO 1-2
9. One common argument for imposing so-called sin taxes is the social goal of *reducing* demand for such products. Using cigarettes as an example, is there a segment of the population that might be sensitive to price and for whom high taxes might discourage purchases? LO 1-2
10. Dontae stated that he didn't want to earn any more money because it would "put him in a higher tax bracket." What is wrong with Dontae's reasoning? LO 1-3
11. Describe the three different tax rates discussed in the chapter and how taxpayers might use them. LO 1-3
12. Which is a more appropriate tax rate to use to compare taxpayers' tax burdens—the average or the effective tax rate? Why? LO 1-3
13. Describe the differences between proportional, progressive, and regressive tax rate structures. LO 1-3
14. Arnold and Lilly recently had a discussion about whether a sales tax is a proportional tax or a regressive tax. Arnold argued that a sales tax is regressive. Lilly countered that the sales tax is a flat tax. Who was correct? LO 1-3
15. Which is the largest tax collected by the U.S. government? What types of taxpayers are subject to this tax? LO 1-4

LO 1-4 16. What is the tax base for the Social Security and Medicare taxes for an employee or employer? What is the tax base for Social Security and Medicare taxes for a self-employed individual? Is the self-employment tax in addition to or in lieu of federal income tax?

LO 1-4 17. What are unemployment taxes?

LO 1-4 18. What is the distinguishing feature of an excise tax?

LO 1-4 19. What are some of the taxes that currently are unique to state and local governments? What are some of the taxes that the federal, state, and local governments each utilizes?

LO 1-4 20. The state of Georgia recently increased its tax on a pack of cigarettes by $2. What type of tax is this? Why might Georgia choose this type of tax?

LO 1-4 21. What is the difference between a sales tax and a use tax?

LO 1-4 22. What is an ad valorem tax? Name an example of this type of tax.

LO 1-4 23. What are the differences between an explicit and an implicit tax?

LO 1-4 24. When we calculate average and effective tax rates, do we consider implicit taxes? What effect does this have on taxpayers' perception of equity?

LO 1-4 25. Benjamin recently bought a truck in Alabama for his business in Georgia. What different types of federal and state taxes may affect this transaction?

LO 1-5 26. Kobe strongly dislikes SUVs and is appalled that so many are on the road. He proposes to eliminate the federal income tax and replace it with a $50,000 annual tax per SUV. Based on the number of SUVs currently owned in the United States, he estimates the tax will generate exactly the amount of tax revenue currently collected from the income tax. What is wrong with Kobe's proposal? What type of forecasting is Kobe likely using?

LO 1-5 27. What is the difference between the income and substitution effects? For which types of taxpayers is the income effect more likely descriptive? For which types of taxpayers is the substitution effect more likely descriptive?

LO 1-5 28. What is the difference between horizontal and vertical equity? How do tax preferences affect people's view of horizontal equity?

LO 1-3 LO 1-5 29. Montel argues that a flat income tax rate system is vertically equitable. Oprah argues that a progressive tax rate structure is vertically equitable. How do their arguments differ? Who is correct?

LO 1-3 LO 1-5 30. Discuss why evaluating vertical equity simply based on tax rate structure may be less than optimal.

LO 1-4 LO 1-5 31. Compare the federal income tax to sales taxes using the "certainty" criterion.

LO 1-5 32. Many years ago, a famous member of Congress proposed eliminating federal income tax withholding. What criterion for evaluating tax systems did this proposal violate? What would likely have been the result of eliminating withholding?

LO 1-5 33. "The federal income tax scores very high on the economy criterion because the current IRS budget is relatively low compared to the costs of a typical collection agency." Explain why this statement may be considered wrong.

PROBLEMS

Select problems are available in Connect®.

LO 1-3 34. Chuck, a single taxpayer, earns $75,000 in taxable income and $10,000 in interest from an investment in City of Heflin bonds. Using the U.S. tax rate schedule (see Appendix C), how much federal tax will he owe? What is his average tax rate? What is his effective tax rate? What is his current marginal tax rate?

35. Using the facts in problem 34, if Chuck earns an additional $40,000 of taxable income, what is his marginal tax rate on this income? What is his marginal rate if, instead, he had $40,000 of additional deductions? LO 1-3

36. Campbell, a single taxpayer, earns $400,000 in taxable income and $2,000 in interest from an investment in State of New York bonds. Using the U.S. tax rate schedule (see Appendix C), how much federal tax will she owe? What is her average tax rate? What is her effective tax rate? What is her current marginal tax rate? LO 1-3

37. Using the facts in problem 36, if Campbell earns an additional $15,000 of taxable income, what is her marginal tax rate on this income? What is her marginal rate if, instead, she had $15,000 of additional deductions? LO 1-3

38. Jorge and Anita, married taxpayers, earn $150,000 in taxable income and $40,000 in interest from an investment in City of Heflin bonds. Using the U.S. tax rate schedule for married filing jointly (see Example 1-3), how much federal tax will they owe? What is their average tax rate? What is their effective tax rate? What is their current marginal tax rate? LO 1-3

39. Using the facts in problem 38, if Jorge and Anita earn an additional $100,000 of taxable income, what is their marginal tax rate on this income? What is their marginal rate if, instead, they report an additional $100,000 in deductions? LO 1-3

40. Scot and Vidia, married taxpayers, earn $240,000 in taxable income and $5,000 in interest from an investment in City of Tampa bonds. Using the U.S. tax rate schedule for married filing jointly (see Example 1-3), how much federal tax will they owe? What is their average tax rate? What is their effective tax rate? What is their current marginal tax rate? LO 1-3

41. Using the facts in problem 40, if Scot and Vidia earn an additional $80,000 of taxable income, what is their marginal tax rate on this income? How would your answer differ if they, instead, had $80,000 of additional deductions? LO 1-3

42. Melinda invests $200,000 in a City of Heflin bond that pays 6 percent interest. Alternatively, Melinda could have invested the $200,000 in a bond recently issued by Surething Inc. that pays 8 percent interest and has risk and other nontax characteristics similar to the City of Heflin bond. Assume Melinda's marginal tax rate is 25 percent. LO 1-3 LO 1-4

a) What is her after-tax rate of return for the City of Heflin bond?
b) How much explicit tax does Melinda pay on the City of Heflin bond?
c) How much implicit tax does she pay on the City of Heflin bond?
d) How much explicit tax would she have paid on the Surething Inc. bond?
e) What is her after-tax rate of return on the Surething Inc. bond?

43. Hugh has the choice between investing in a City of Heflin bond at 6 percent or investing in a Surething Inc. bond at 9 percent. Assuming that both bonds have the same nontax characteristics and that Hugh has a 40 percent marginal tax rate, in which bond should he invest? LO 1-3 LO 1-4 planning

44. Using the facts in problem 43, what interest rate does Surething Inc. need to offer to make Hugh indifferent between investing in the two bonds? LO 1-3 LO 1-4 planning

45. Fergie has the choice between investing in a State of New York bond at 5 percent and a Surething Inc. bond at 8 percent. Assuming that both bonds have the same nontax characteristics and that Fergie has a 30 percent marginal tax rate, in which bond should she invest? LO 1-3 LO 1-4 planning

46. Using the facts in problem 45, what interest rate does the State of New York bond need to offer to make Fergie indifferent between investing in the two bonds? LO 1-3 LO 1-4 planning

LO 1-3 47. Given the following tax structure, what minimum tax would need to be assessed on Shameika to make the tax progressive with respect to average tax rates?

Taxpayer	Salary	Muni-Bond Interest	Total Tax
Mihwah	$10,000	$10,000	$600
Shameika	$50,000	$30,000	$???

LO 1-3 48. Using the facts in problem 47, what minimum tax would need to be assessed on Shameika to make the tax progressive with respect to effective tax rates?

LO 1-3 LO 1-5 49. Song earns $100,000 taxable income as an interior designer and is taxed at an average rate of 20 percent (i.e., $20,000 of tax). If Congress increases the income tax rate such that Song's average tax rate increases from 20 percent to 25 percent, how much more income tax will she pay assuming that the income effect is descriptive? What effect will this tax rate change have on the tax base and tax collected?

LO 1-3 LO 1-5 50. Using the facts in problem 49, what will happen to the government's tax revenues if Song chooses to spend more time pursuing her other passions besides work in response to the tax rate change and therefore earns only $75,000 in taxable income? What is the term that describes this type of reaction to a tax rate increase? What types of taxpayers are likely to respond in this manner?

LO 1-5 51. Given the following tax structure, what tax would need to be assessed on Venita to make the tax horizontally equitable?

Taxpayer	Salary	Total Tax
Mae	$10,000	$ 600
Pedro	$20,000	$1,500
Venita	$10,000	$???

LO 1-5 52. Using the facts in problem 51, what is the minimum tax that Pedro should pay to make the tax structure vertically equitable based on the tax rate paid? This would result in what type of tax rate structure?

LO 1-5 53. Using the facts in problem 51, what is the minimum tax that Pedro should pay to make the tax structure vertically equitable with respect to the amount of tax paid? This would result in what type of tax rate structure?

LO 1-5 54. Consider the following tax rate structure. Is it horizontally equitable? Why or why not? Is it vertically equitable? Why or why not?

Taxpayer	Salary	Total Tax
Rajiv	$10,000	$600
LaMarcus	$20,000	$600
Dory	$10,000	$600

LO 1-5 55. Consider the following tax rate structure. Is it horizontally equitable? Why or why not? Is it vertically equitable? Why or why not?

Taxpayer	Salary	Total Tax
Marilyn	$10,000	$ 600
Kobe	$20,000	$3,000
Alfonso	$30,000	$6,000

LO 1-5 56. Consider the following tax rate structure. Is it horizontally equitable? Why or why not? Is it vertically equitable? Why or why not?

Taxpayer	Salary	Total Tax
Rodney	$10,000	$600
Keisha	$10,000	$600

57. Lorenzo is considering starting a trucking company in either Texas or Oklahoma. He will relocate his family, which includes his wife, children, and parents, to reside in the same state as his business. What types of taxes may influence his decision of where to locate his business?

LO 1-1 LO 1-4 planning

58. Congress would like to increase tax revenues by 10 percent. Assume that the average taxpayer in the United States earns $65,000 and pays an average tax rate of 15 percent. If the income effect is in effect for all taxpayers, what average tax rate will result in a 10 percent increase in tax revenues? This is an example of what type of forecasting?

LO 1-3 LO 1-5 planning

59. Locate the IRS website at www.irs.gov/. For every $100 the IRS collected, how much was spent on the IRS's collection efforts? What tax system criterion does this information help you to evaluate with respect to the current U.S. tax system?

LO 1-5 research

60. Using the Internet, find a comparison of income tax rates across states. What state currently has the highest income tax rate? In considering individual tax burdens across states, what other taxes should you consider?

LO 1-4 research

UWorld Roger CPA Review

Sample CPA Exam questions from Roger CPA Review are available in Connect as support for the topics in this text. These Multiple Choice Questions and Task-Based Simulations include expert-written explanations and solutions and provide a starting point for students to become familiar with the content and functionality of the actual CPA Exam.

chapter

2

Tax Compliance, the IRS, and Tax Authorities

Learning Objectives

Upon completing this chapter, you should be able to:

LO 2-1 Identify the filing requirements for income tax returns and the statute of limitations for assessment.

LO 2-2 Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.

LO 2-3 Evaluate the relative weights of the various tax law sources.

LO 2-4 Describe the legislative process as it pertains to taxation.

LO 2-5 Perform the basic steps in tax research.

LO 2-6 Describe tax professional responsibilities in providing tax advice.

LO 2-7 Identify taxpayer and tax return preparer penalties.

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Storyline Summary

Taxpayers:	Bill (he/him/his) and Mercedes (she/her/hers)
Family description:	Bill and Mercedes are married with one daughter, Margaret (she/her/hers), and live in Tampa, Florida.
Employment status:	Bill is an economics professor; Mercedes is a small business owner.
Filing status:	Married, filing jointly
Current situation:	Bill and Mercedes face an IRS audit involving a previous year's interest deductions.

Bill and Mercedes received a notice from the Internal Revenue Service (IRS) that their tax return is under audit for certain interest deductions. As you might expect, they are quite concerned, especially because it has been several years since they claimed the deductions and they worry that all their supporting documentation may not be in place. Several questions run through their minds. How could the IRS audit a tax return that was filed so long ago? Why was their tax return selected, and what should they expect during the audit? The interest deductions they reported were based on advice from their CPA. What would cause the IRS and a CPA to interpret the law differently? What is their financial exposure if the deductions are ultimately disallowed? Will they have to pay interest and penalties in addition to the tax they might owe? ■

Even the most conservative taxpayer is likely to feel anxiety after receiving an IRS notice. This chapter will help answer Bill and Mercedes's questions and provide an overview of the audit process and tax research. While all taxpayers should understand these basics of our tax system, aspiring accountants should be especially familiar with them.

LO 2-1

TAXPAYER FILING REQUIREMENTS

To file or not to file? Unlike Hamlet's "to be or not to be," this question has a pretty straightforward answer. Filing requirements are specified by law for each type of taxpayer. All corporations must file a tax return annually regardless of their taxable income. Estates and trusts are required to file annual income tax returns if their gross income exceeds $600.[1]

The filing requirements for individual taxpayers are a little more complex. Specifically, they depend on the taxpayer's filing status (single, married filing jointly, and so on, discussed in more detail in the Individual Income Tax Overview, Dependents, and Filing Status chapter), age, and gross income (income before deductions). Exhibit 2-1 lists the 2022 gross income thresholds for taxpayers based on their filing status, gross income, and age. As detailed in Exhibit 2-1, the gross income thresholds are calculated as the sum of the standard deduction and additional deductions for taxpayers age 65 or older.[2] These amounts are indexed for inflation and thus change each year. For certain taxpayers, such as the self-employed and those claimed as dependents by another taxpayer, lower gross income thresholds apply.

EXHIBIT 2-1 **2022 Gross Income Thresholds by Filing Status**

Filing Status and Age (in 2022)	2022 Gross Income	Explanation
Single	$12,950	$12,950 standard deduction
Single, 65 or older	$14,700	$12,950 standard deduction + $1,750 additional deduction
Married, filing a joint return	$25,900	$25,900 standard deduction
Married, filing a joint return, one spouse 65 or older	$27,300	$25,900 standard deduction + $1,400 additional deduction
Married, filing a joint return, both spouses 65 or older	$28,700	$25,900 standard deduction + $2,800 additional deductions (2 × $1,400)
Married, filing a separate return	$ 5	IRS Publication 501
Head of household	$19,400	$19,400 standard deduction
Head of household, 65 or older	$21,150	$19,400 standard deduction + $1,750 additional deduction
Surviving spouse with a dependent child	$25,900	$25,900 standard deduction
Surviving spouse, 65 or older, with a dependent child	$27,300	$25,900 standard deduction + $1,400 additional deduction

Source: irs.gov.

Whether a taxpayer is due a refund (which occurs when taxes paid exceed tax liability) does *not* determine whether a taxpayer must file a tax return. Gross income determines whether a tax return is required. Further, note that even a taxpayer whose gross income falls below the respective threshold is not precluded from filing a tax return. Indeed, taxpayers due a refund *should* file a tax return to receive the refund (or claim a refundable tax credit), even if they are not required to file a tax return.

[1]Estates file income tax returns during the administration period (i.e., before all of the estate assets are distributed).

[2]§6012. We describe the standard deduction in detail later in the text. A married taxpayer is required to file a tax return (regardless of gross income) if (i) such individual and their spouse, at the close of the taxable year, did not have the same household as their home; (ii) the individual has gross income of $5 or more and their spouse files a separate return; or (iii) the individual or their spouse is a dependent of another taxpayer who has income (other than earned income) in excess of the standard deduction for a dependent taxpayer (see discussion later in the text regarding standard deduction for dependent taxpayers).

Tax Return Due Date and Extensions

Like the filing requirements, due dates for tax returns vary based on the type of taxpayer. Individual tax returns are due on the fifteenth day of the fourth month following year-end—that is, April 15 for calendar-year individuals. (Due dates that fall on a Saturday, Sunday, or holiday are automatically extended to the next day that is not a Saturday, Sunday, or holiday.) Similarly, tax returns for C corporations (taxable corporations) are generally due on the fifteenth day of the fourth month following the corporation's year-end. The exception is for tax returns for C corporations with a June 30 year-end, which are due on the fifteenth day of the third month (September 15). For both partnerships and S corporations (generally nontaxable corporations), tax returns must be filed by the fifteenth day of the third month following the entity's year-end (March 15 for calendar-year partnerships or S corporations). Any individual, partnership, or S corporation unable to file a tax return by the original due date can, by that same deadline, request a six-month extension to file, which is granted automatically by the IRS. Similarly, C corporations may request an automatic six- or seven-month extension to file depending on the corporation's year-end.[3]

An extension allows the taxpayer to delay filing a tax return but does *not* extend the due date for tax payments. Thus, when a taxpayer files an extension, they must estimate how much tax will be owed. If a taxpayer fails to pay the entire balance of tax owed by the original due date of the tax return, the IRS charges the taxpayer interest on the underpayment from the due date of the return until the taxpayer pays the tax.[4] The interest rate charged depends on taxpayer type (individual or corporation) and varies quarterly with the federal short-term interest rate.[5] For example, the interest rate for tax underpayments for individuals equals the federal short-term rate plus 3 percentage points.[6]

What happens if the taxpayer does not file a tax return by the time required, whether April 15 or an extended deadline? As you might guess, the IRS imposes penalties on taxpayers failing to comply with the tax law. In many cases, the penalties can be quite substantial (see later discussion in this chapter). In the case of failure to file a tax return, the penalty equals 5 percent of the tax due for each month (or partial month) that the return is late. However, the maximum penalty is generally 25 percent of the tax owed, and the failure-to-file penalty does not apply if the taxpayer owes no tax.

THE KEY FACTS

Filing Requirements and Due Dates

- Filing requirements
  - Filing requirements are specified by law for each type of taxpayer.
  - For individuals, filing requirements vary by filing status, gross income, and age.
  - Gross income thresholds are indexed each year for inflation.
- Due dates
  - The due date for tax returns varies based on the type of taxpayer.
  - Individual tax returns are due on April 15 for calendar-year individuals.
  - Due dates that fall on a Saturday, Sunday, or holiday are automatically extended to the next day that is not a Saturday, Sunday, or holiday.
  - Any taxpayer unable to file a tax return by the original due date can request an extension to file.
  - An extension allows the taxpayer to delay filing a tax return but does *not* extend the due date for tax payments.

Statute of Limitations

Despite the diligent efforts of taxpayers and tax professionals, it is quite common for tax returns to contain mistakes. Some may be to the taxpayer's advantage, and others may be to the government's advantage. Regardless of the nature of the mistake, the taxpayer is obligated to file an amended return to correct the error (and request a refund or pay a deficiency) if the statute of limitations has not expired for the tax return. Likewise, the IRS can propose adjustments to the taxpayer's return if the statute of limitations for the return has not expired.

By law, the **statute of limitations** defines the period in which the taxpayer can file an amended tax return or the IRS can assess a tax deficiency for a specific tax year. For both amended tax returns filed by a taxpayer and proposed tax assessments by the IRS, the statute of limitations generally ends three years from the *later* of (1) the date the tax return was actually filed or (2) the tax return's original due date.

[3]June 30 year-end C corporations may request a seven-month extension. All other C corporations may request a six-month extension.

[4]The tax law also imposes a penalty for late payment in addition to the interest charged on the underpayment. We briefly discuss this penalty later in the chapter and in the Individual Income Tax Computation and Tax Credits chapter.

[5]The federal short-term rate is determined from a one-month average of the market yields from marketable obligations of the United States with maturities of three years or less. The IRS issues revenue rulings quarterly to announce the applicable interest rates for tax underpayments and tax overpayments. For example, see Rev. Rul. 2021-17.

[6]This same interest rate applies to individuals who overpay their taxes (i.e., receive a tax refund and interest payment as a result of an IRS audit or from filing an amended tax return).

The statute of limitations for IRS assessment can be extended in certain circumstances. For example, the original three-year statute of limitations for IRS assessments is extended to six years if the taxpayer omits items of gross income that exceed 25 percent of the gross income reported on the tax return. For fraudulent returns, or if the taxpayer fails to file a tax return, the news is understandably worse. The statute of limitations remains open indefinitely in these cases. The statute of limitations can also be voluntarily extended by the taxpayer at the request of the IRS to allow both sides sufficient time to resolve issues.

Example 2-1

Bill and Mercedes file their 2018 federal tax return on September 6, 2019, after receiving an automatic extension to file their return by October 15, 2019. In 2022, the IRS selects their 2018 tax return for audit. When does the statute of limitations end for Bill and Mercedes's 2018 tax return?

Answer: Assuming the six-year and "unlimited" statute of limitation rules do not apply, the statute of limitations ends on September 6, 2022 (three years after the later of the actual filing date and the *original* due date).

What if: When would the statute of limitations end for Bill and Mercedes for their 2018 tax return if the couple filed the return on March 22, 2019 (before the original due date of April 15, 2019)?

Answer: In this scenario, the statute of limitations would end on April 15, 2022, because the later of the actual filing date and the original due date is April 15, 2019.

Taxpayers should prepare for the possibility of an audit by retaining all supporting documents (receipts, cancelled checks, etc.) for a tax return until the statute of limitations expires. After the statute of limitations expires, taxpayers can discard the majority of supporting documents but should still keep a copy of the tax return itself, as well as any documents that may have ongoing significance, such as those establishing the taxpayer's *basis* or original investment in existing assets like personal residences and long-term investments.

LO 2-2

IRS AUDIT SELECTION

Why me? This is a recurring question in life and definitely a common taxpayer question after receiving an IRS audit notice. The answer, in general, is that a taxpayer's return is selected for audit because the IRS has data suggesting the taxpayer's tax return has a high probability of a significant understated tax liability. Budget constraints limit the IRS's ability to audit a majority or even a large minority of tax returns. Currently, fewer than 1 percent of all tax returns are audited. Thus, the IRS must be strategic in selecting returns for audit in an effort to promote the highest level of voluntary taxpayer compliance and increase tax revenues.

Specifically, how does the IRS select tax returns for audit? The IRS uses a number of computer programs and outside data sources (newspapers, financial statement disclosures, informants, and other public and private sources) to identify tax returns that may have an understated tax liability. Common computer initiatives include the **DIF (Discriminant Function) system,** the **document perfection program,** and the **information matching program.** The most important of these initiatives is the DIF system. The DIF system assigns a score to each tax return that represents the probability the tax liability on the return has been underreported (a higher score = a higher likelihood of underreporting). The IRS derives the weights assigned to specific tax return attributes from historical IRS audit adjustment data from the National Research Program.[7] The DIF system then uses these (undisclosed) weights to score each tax return based on

[7]Similar to its predecessor, the Taxpayer Compliance Measurement Program, the National Research Program (NRP) analyzes a large sample of tax returns that are randomly selected for audit. From these randomly selected returns, the IRS identifies tax return characteristics (e.g., deductions for a home office, unusually high tax deductions relative to a taxpayer's income) associated with underreported liabilities, weights these characteristics, and then incorporates them into the DIF system. The NRP analyzes randomly selected returns to ensure that the DIF scorings are representative of the population of tax returns.

the tax return's characteristics. Returns with higher DIF scores are reviewed to determine whether an audit is the best course of action.

All returns are checked for mathematical and tax calculation errors, a process referred to as the document perfection program. Individual returns are also subject to the information matching program. This program compares the taxpayer's tax return to information submitted to the IRS from other taxpayers like banks, employers, mutual funds, brokerage companies, and mortgage companies. Information matched includes items such as wages (Form W-2 submitted by employers), interest income (Form 1099-INT submitted by banks), and dividend income (Form 1099-DIV submitted by brokerage companies). For tax returns identified as incorrect via the document perfection and information matching programs, the IRS recalculates the taxpayer's tax liability and sends a notice explaining the adjustment. If the taxpayer owes tax, the IRS will request payment of the tax due. If the taxpayer overpaid tax, the IRS will send the taxpayer a refund of the overpayment.

In addition to computer-based methods for identifying tax returns for audit, the IRS may use a number of other audit initiatives that target taxpayers working in certain industries, engaging in certain transactions like the acquisition of other companies, or having specific attributes like home office deductions. Taxpayers of a given size and complexity, such as large publicly traded companies, may be audited every year.

THE KEY FACTS

IRS Audit Selection

- The IRS uses a number of computer programs and outside data sources to identify tax returns that may have an understated tax liability.
- Common computer initiatives include the DIF (Discriminant Function) system, the document perfection program, and the information matching program.
- The DIF system assigns a score to each tax return that represents the probability the tax liability on the return has been underreported.
- The document perfection program checks all returns for mathematical and tax calculation errors.
- The information matching program compares the taxpayer's tax return to information submitted to the IRS from other taxpayers.

TAXES IN THE REAL WORLD Where Can You Get a 4 to 1 Return on Investment?

The possible answer for the U.S. federal government is the IRS. In a June 2021 testimony before the Select Revenue Measures Subcommittee and the Oversight Subcommittee of the House Ways and Means Committee, IRS Acting Assistant Secretary of the Office of Tax Policy Mark Mazur laid out the case for more IRS funding. In his testimony, Mazur highlighted the growing measure of tax noncompliance, called the "tax gap," due to taxpayers who do not file returns (about 9 percent of the gross tax gap), who underreport income or overclaim deductions or credits on tax returns (about 80 percent of the gross tax gap), and who underpay taxes despite reporting them in a timely manner (about 11 percent of the gross tax gap). Over the next decade, the gross tax gap is projected to total $7 trillion, approximately 15 percent of all taxes owed.

Mazur presented a proposal for $80 billion of additional IRS funding, which is estimated to raise $320 billion of gross revenue over 10 years, a 4 to 1 return on investment. The additional funding would provide the IRS resources and staffing to address tax noncompliance and better serve taxpayers, invest in better IRS technology systems to help identify noncompliance and improve customer service, improve information reporting to give the IRS better information on less transparent sources of taxpayer income, and, more broadly, improve tax administration. If successful, additional benefits of IRS funding include higher tax revenues to fund the nation's fiscal priorities, lower budget deficits and smaller amounts of federal debt, and potentially more confidence in the fairness of the tax system.

Source: Based on "Testimony of Mark J. Mazur, Acting Assistant Secretary, Office of Tax Policy, U.S. Department of the Treasury, Before the Select Revenue Measures Subcommittee and the Oversight Subcommittee of the House Ways and Means Committee," June 10, 2021. https://home.treasury.gov/news/press-releases/jy0220.

How was Bill and Mercedes's tax return selected for audit? Given the audit focus on certain deductions, the IRS likely selected their return for audit because the amount or type of the deductions resulted in a high DIF score. IRS personnel then determined that the deductions warranted further review and, thus, selected the tax return for audit.

ETHICS

After Bill and Mercedes's tax return was selected for audit, Bill read on the Internet speculation that filing a paper tax return (instead of filing electronically) and extending a tax return deadline decrease the chance of IRS audit. Bill has convinced Mercedes that they need to use these strategies in the future and look for other ways to avoid audit. Has Bill crossed an ethical boundary?

Types of Audits

The three types of IRS audits are correspondence, office, and field examinations. **Correspondence examinations** are the most common. These audits, as the name suggests, are conducted by mail and generally are limited to one or two items on the taxpayer's return. Of the three types of audits, correspondence audits are generally the narrowest in scope and the least complex. The IRS typically requests supporting documentation for one or more items on the taxpayer's return, like charitable contributions deducted, for example. When appropriate documentation is promptly supplied, these audits typically can be concluded relatively quickly. Of course, they can also be expanded to address other issues that arise as a result of the IRS's inspection of taxpayer documents.

Office examinations are the second most common audit. As the name suggests, the IRS conducts them at its local office. These audits are typically broader in scope and more complex than correspondence examinations. Small businesses, taxpayers operating sole proprietorships, and middle- to high-income individual taxpayers are more likely, if audited, to have office examinations. In these examinations, the taxpayer receives a notice that identifies the items subject to audit, requests substantiation for these items as necessary, and notifies the taxpayer of the date, time, and location of the exam. Taxpayers may attend the examination alone or with representation, such as their tax adviser or attorney, or simply let their tax adviser or attorney attend on their behalf.

Field examinations are the least common audit. The IRS conducts these at the taxpayer's place of business or the location where the taxpayer's books, records, and source documents are maintained. Field examinations are generally the broadest in scope and the most complex of the three audit types. They can last months to years and generally are limited to business returns and the most complex individual returns.

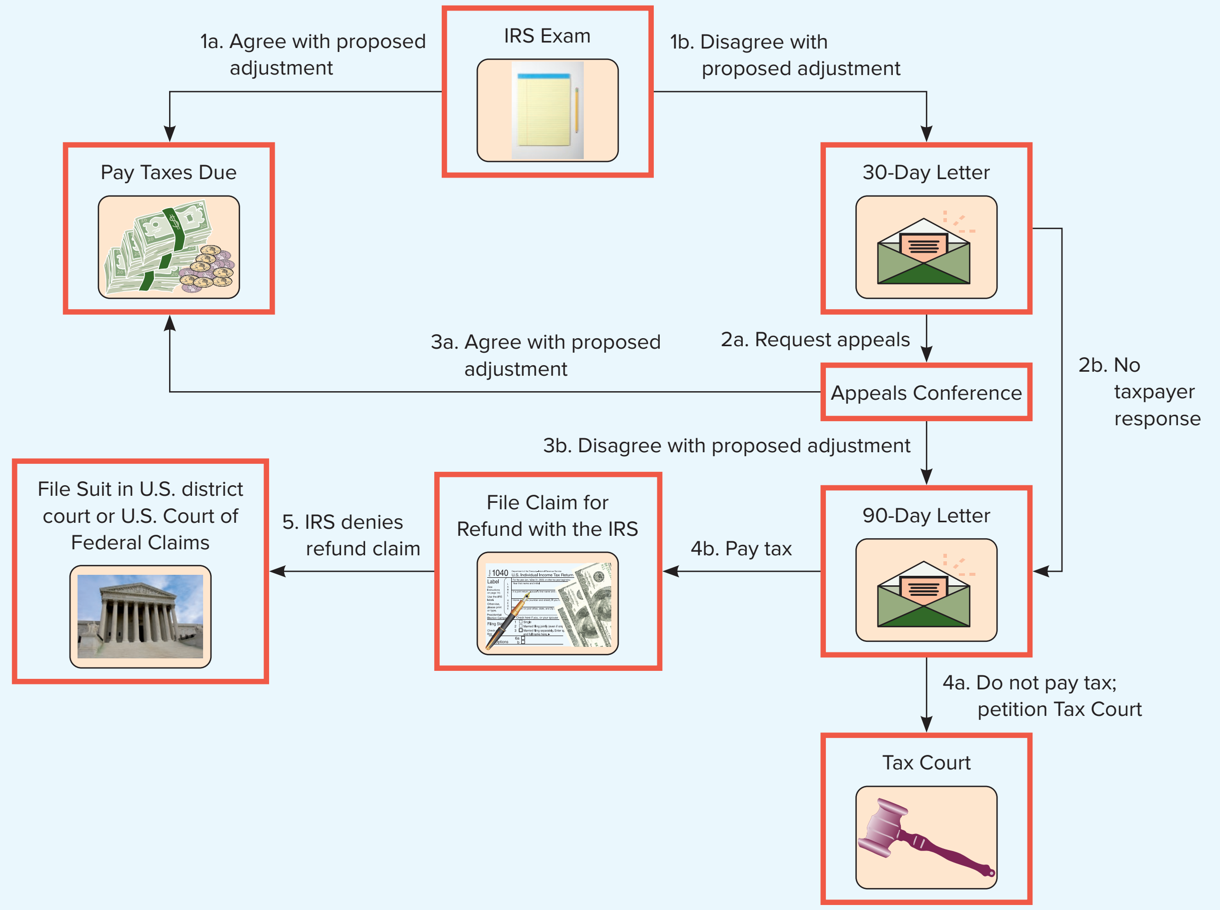
What type of exam do you think Bill and Mercedes will have? Because their return is an individual tax return and the audit is restricted to a relatively narrow set of deductions, their return will likely be subject to a correspondence audit. If the audit were broader in scope, an office examination would be more likely.

After the Audit After the examination, the IRS agent provides a list of proposed adjustments (if any) to the taxpayer for review. If they agree to the proposed changes, the taxpayer signs an agreement form (Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) and pays the additional tax owed or receives the proposed refund. If the taxpayer disputes the proposed changes, the taxpayer will receive a **30-day letter** giving them 30 days to either (1) request a conference with an appeals officer, who is independent and resides in a separate IRS division from the examining agent, or (2) agree to the proposed adjustment. An appeals officer would consider the merits of the unresolved issues as well as the "hazards of litigation"—that is, the probability that the IRS will lose if the case is brought to court and the resulting costs of a taxpayer-favorable ruling. If the taxpayer chooses the appeals conference and reaches an agreement with the IRS there, the taxpayer can then sign Form 870, which signifies that the taxpayer agrees to the immediate assessment and collection of the agreed-upon tax and penalties, if any. If the taxpayer and IRS still do not agree on the proposed adjustment at the appeals conference, or the taxpayer chooses not to request an appeals conference, the IRS will send the taxpayer a **90-day letter.** See Exhibit 2-2.

The 90-day letter (also known as a *statutory notice of deficiency*) explains that the taxpayer has 90 days to either (1) pay the proposed deficiency or (2) file a petition in the U.S. Tax Court to hear the case.[8] The **U.S. Tax Court** is a national court whose judges are tax experts who hear only tax cases. If the taxpayer would like to litigate the case but prefers it to be heard in the local **U.S. district court** or the **U.S. Court of Federal Claims,** the taxpayer must pay the tax deficiency first, then request a refund from the IRS, and then sue the IRS for refund in the court after the IRS denies the refund claim.

[8]If the taxpayer lacks the funds to pay the assessed tax, there is legitimate doubt as to whether the taxpayer owes part or all of the assessed tax, or collection of the tax would cause the taxpayer economic hardship or be unfair or inequitable, the taxpayer can request an offer in compromise with the IRS to settle the tax liability for less than the full amount assessed by completing Form 656, Offer in Compromise.

EXHIBIT 2-2 IRS Appeals/Litigation Process



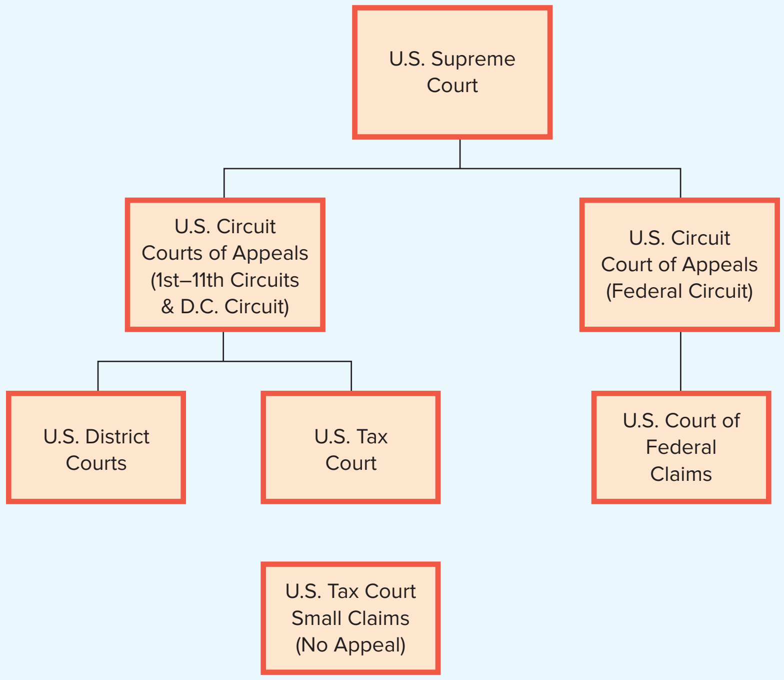
Top: Imageroller/Alamy Stock Photo; Bottom left: Jill Braaten/McGraw Hill

Why would a taxpayer prefer one trial court over others? To understand this, we must appreciate the basic distinguishing factors of each. First and foremost, it is relatively common for the U.S. Tax Court, local U.S. district court, or the U.S. Court of Federal Claims to interpret and rule differently on the same basic tax issue. Given a choice of courts, the taxpayer should prefer the court most likely to rule favorably on their particular issues. The courts also differ in other ways. For example, the U.S. district court is the only court that provides for a jury trial; the U.S. Tax Court is the only court that allows tax cases to be heard *before* the taxpayer pays the disputed liability and the only court with a small claims division (hearing claims involving disputed liabilities of $50,000 or less); and the U.S. Tax Court judges are tax experts, whereas the U.S. district court and U.S. Court of Federal Claims judges are generalists. The taxpayer should consider each of these factors in choosing a trial court. For example, if the taxpayer feels very confident in their tax return position but does not have sufficient funds to pay the disputed liability, they will prefer the U.S. Tax Court. If, instead, the taxpayer is litigating a tax return position that is low on technical merit but high on emotional appeal, a jury trial in the local U.S. district court may be the best option.

What happens after the taxpayer's case has been decided in a trial court? The process may not be quite finished. After the trial court's verdict, the losing party has the right to request one of the 13 **U.S. circuit courts of appeals** to hear the case. Exhibit 2-3 depicts the specific appellant courts for each lower-level court. Both the U.S. Tax Court and local U.S. district court cases are appealed to the specific U.S. circuit court of appeals based on the taxpayer's residence.[9] Cases litigated in Alabama, Florida, and Georgia, for example,

[9]Decisions rendered by the U.S. Tax Court Small Claims Division cannot be appealed by the taxpayer or the IRS.

EXHIBIT 2-3 **Federal Judicial System**



appeal to the U.S. Circuit Court of Appeals for the 11th Circuit, whereas those tried in Louisiana, Mississippi, and Texas appeal to the 5th Circuit. In contrast, all U.S. Court of Federal Claims cases appeal to the U.S. Circuit Court of Appeals for the Federal Circuit (located in Washington, D.C.). Exhibit 2-4 depicts the geographic regions for each of the 11 U.S. circuit courts of appeals defined by numerical region. Not depicted are the U.S. Circuit Court of Appeals for the District of Columbia and the U.S. Circuit Court of Appeals for the Federal Circuit.

Through the initial selection of a trial court—U.S. district court, U.S. Tax Court, or U.S. Court of Federal Claims—the taxpayer has the ability to determine which circuit court would hear an appeal of the case (the U.S. circuit court of appeals based on residence or the U.S. Circuit Court of Appeals for the Federal Circuit). Alternative circuit courts may interpret the law differently, and, therefore, in choosing a trial-level court, the taxpayer should consider the relevant circuit courts' judicial histories to determine which circuit court (and, thus, which trial court) would be more likely to rule in their favor.

After an appeals court hears a case, the losing party has one last option to receive a favorable ruling: a petition to the **U.S. Supreme Court** to hear the case. However, given the quantity of other cases appealed to the U.S. Supreme Court that are of national importance, the Supreme Court agrees to hear only a few tax cases a year—cases with great significance to a broad cross-section of taxpayers or cases litigating issues in which there has been disagreement among the circuit courts. For most tax cases, the Supreme Court refuses to hear the case (denies the ***writ of certiorari***) and litigation ends with the circuit court of appeals decision.

Although litigation of tax disputes is quite common, taxpayers should carefully consider the pros and cons. Litigation can be very costly financially and emotionally, and, thus, it is more appropriately used as an option of last resort, after all other appeal efforts have been exhausted.

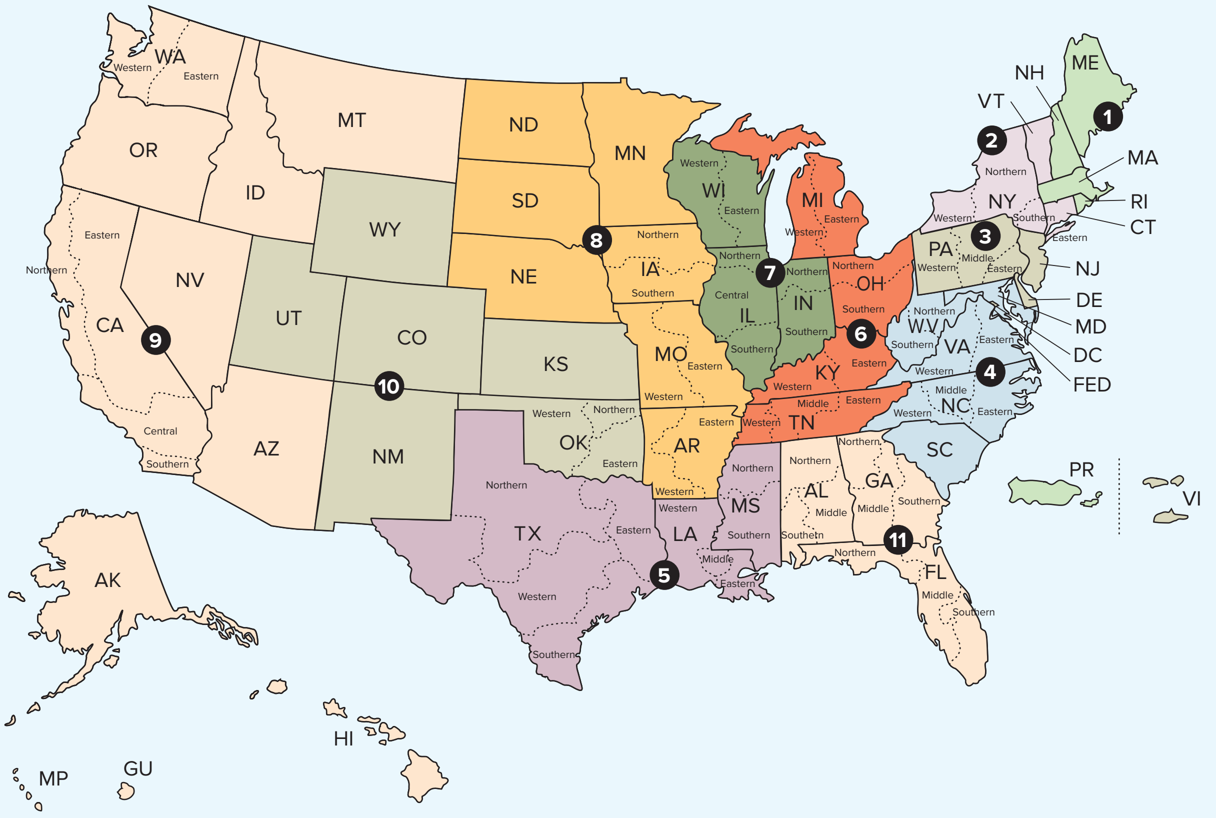
What is the likely course of action for Bill and Mercedes's audit? It is too soon to tell. Before you can assess the likely outcome of their audit, you need a better understanding of both the audit issue and the relevant tax laws that apply to the issue. The next section

THE KEY FACTS

IRS Audits

- The three types of IRS audits are correspondence, office, and field examinations.
- After the audit, the IRS will send the taxpayer a 30-day letter, which provides the taxpayer the opportunity to pay the proposed assessment or request an appeals conference.
- If an agreement is not reached at appeals or the taxpayer does not pay the proposed assessment, the IRS will send the taxpayer a 90-day letter.
- After receiving the 90-day letter, the taxpayer may pay the tax or petition the U.S. Tax Court to hear the case.
- If the taxpayer chooses to pay the tax, the taxpayer may then request a refund of the tax and eventually sue the IRS for refund in the U.S. district court or the U.S. Court of Federal Claims.

EXHIBIT 2-4 **Geographic Boundaries for the U.S. Circuit Courts of Appeals**



Source: United States Courts. www.uscourts.gov.

explains alternative tax law sources. After we discuss the various sources of our tax laws, we'll describe how Bill and Mercedes (or their CPA) can research the sources to identify the best possible course of action.[10]

TAX LAW SOURCES

LO 2-3 LO 2-4

There are two broad categories of tax authorities: primary authorities and secondary authorities. **Primary authorities** are official sources of the tax law generated by the legislative branch (statutory authority issued by Congress), judicial branch (rulings by the U.S. district courts, U.S. Tax Court, U.S. Court of Federal Claims, U.S. circuit courts of appeals, or U.S. Supreme Court), and executive/administrative branch (Treasury and IRS pronouncements). Exhibit 2-5 displays the most common primary sources, their respective citations, and related explanations. We'll discuss each of these authorities below.

Secondary authorities are unofficial tax authorities that interpret and explain the primary authorities, such as tax research services (discussed below), tax articles from professional journals and law reviews, newsletters, and textbooks. For quick questions, practitioners often use the *CCH Master Tax Guide* or *RIA Federal Tax Handbook*.

[10]Accountants should be mindful to not engage in the unauthorized practice of law. In years past, several court cases have addressed this issue without providing a clear understanding between practicing tax accounting and the unauthorized practice of law. At present, tax accountants are not likely to overstep their responsibilities if they limit their advice to tax issues and leave the general legal advice and drafting of legal documents to attorneys.

EXHIBIT 2-5 **Citations to Common Primary Authorities***

Statutory Authorities:	*Citation:*	*Explanation:*
Internal Revenue Code	§162(e)(4)(B)(i)	Section number 162, subsection e, paragraph 4, subparagraph B, clause i
Committee Reports: Senate Finance Committee Report	S. Rep. No. 353, 82d Cong., 1st Sess. 14 (1951)	Senate report number 353, Congress number 82, Congressional session 1, page number 14, year 1951
House Ways and Means Committee Report	H. Rep. No. 242, 82d Cong., 1st Sess. 40 (1951)	House report number 242, Congress number 82, Congressional session 1, page number 40, year 1951
Administrative Authorities:	***Citation:***	***Explanation:***
Final Regulation	Reg. §1.217-2(c)(1)	Type of regulation (1 = income tax), code section 217, regulation number 2, paragraph c, subparagraph number 1
Temporary Regulation	Temp. Reg. §1.217-2(c)(1)	Same as final regulation
Proposed Regulation	Prop. Reg. §1.217-2(c)(1)	Same as final regulation
Revenue Ruling	Rev. Rul. 77-262, 1977-2 C.B. 41	Ruling number 77-262 (262nd ruling of 1977), volume number of cumulative bulletin 1977-2, page number 41
Revenue Procedure	Rev. Proc. 99-10, 1999-1 C.B. 272	Procedure number 99-10 (10th procedure of 1999), volume number of cumulative bulletin 1999-1, page number 272
Private Letter Ruling	PLR 200601001	Year 2006, week number 01 (1st week of 2006), ruling number 001 (1st ruling of the week)
Technical Advice Memorandum	TAM 200402001	Year 2004, week number 02 (2nd week of 2004), ruling number 001 (1st ruling of the week)
Judicial Authorities:	***Citation:***	***Explanation:***
U.S. Supreme Court	*Comm'r v. Kowalski,* 434 U.S. 77 (1977)	Volume 434 of the United States Reporter, page 77, year 1977
	Comm'r v. Kowalski, 98 S. Ct. 315 (1977)	Volume 98 of the West Supreme Court Reporter, page 315, year 1977
	Comm'r v. Kowalski, 77-2 USTC par. 9,748 (S. Ct. 1977)	Volume 77-2 of the CCH USTC court reporter, paragraph 9,748, year 1977
	Comm'r v. Kowalski, 40 AFTR2d 77-6128 (S. Ct. 1977)	Volume 40 of the RIA AFTR2d court reporter, paragraph 77-6128, year 1977
U.S. Circuit Court of Appeals	*Azar Nut Co. v. Comm'r,* 931 F.2d 314 (5th Cir. 1991)	Volume 931 of the West F.2d court reporter, page 314, circuit 5th, year 1991
	Azar Nut Co. v. Comm'r, 91-1 USTC par. 50,257 (5th Cir. 1991)	Volume 91-1 of the CCH USTC court reporter, paragraph 50,257, circuit 5th, year 1991
	Azar Nut Co. v. Comm'r, 67 AFTR2d 91-987 (5th Cir. 1991)	Volume 67 of the RIA AFTR2d court reporter, paragraph 91-987, circuit 5th, year 1991
U.S. Tax Court—Regular decision	*L.A. Beeghly,* 36 TC 154 (1962)	Volume 36 of the Tax Court reporter, page 154, year 1962
U.S. Tax Court—Memorandum decision	*Robert Rodriguez,* RIA TC Memo 2005-012	Paragraph number 2005-012 of the RIA Tax Court Memorandum reporter
	Robert Rodriguez, 85 TCM 1162 (2005)	Volume 85 of the CCH Tax Court Memorandum reporter, page 1162, year 2005
U.S. Court of Federal Claims	*J.R. Cohen v. United States,* 510 F. Supp. 297 (Fed. Cl. 1993)	Volume 510 of the West F. Supp. court reporter, page 297, year 1993
	J.R. Cohen v. United States, 72 AFTR2d 93-5124 (Fed. Cl. 1993)	Volume 72 of the RIA AFTR2d court reporter, paragraph 93-5124, year 1993
	J.R. Cohen v. United States, 93-1 USTC par. 50,354 (Fed. Cl. 1993)	Volume 93-1 of the CCH USTC court reporter, paragraph 50,354, year 1993
U.S. District Court	*Waxler Towing Co., Inc. v. United States,* 510 F. Supp. 297 (W.D. Tenn. 1981)	Volume 510 of the West F. Supp. court reporter, page 297, Western District (W.D.), state Tennessee, year 1981
	Waxler Towing Co., Inc. v. United States, 81-2 USTC par. 9,541 (W.D. Tenn. 1981)	Volume 81-2 of the CCH USTC court reporter, paragraph 9,541, Western District (W.D.), state Tennessee, year 1981
	Waxler Towing Co., Inc. v. United States, 48 AFTR2d 81-5274 (W.D. Tenn. 1981)	Volume 48 of the RIA AFTR2d court reporter, paragraph 81-5274, Western District (W.D.), state Tennessee, year 1981

*It is acceptable to substitute Sec. for § when referring to a code or regulation section.

EXHIBIT 2-6 **Common Secondary Tax Authorities**

Tax Research Services:	***Professional Journals:***
BNA Tax Management Portfolios	*Journal of Accountancy*
CCH Standard Federal Tax Reporter	*Journal of Taxation*
CCH Tax Research Consultant	*Practical Tax Strategies*
RIA Federal Tax Coordinator	*Taxes*
RIA United States Tax Reporter	*Tax Adviser*
Newsletters:	***Quick Reference Sources:***
Daily Tax Report	*IRS Publications*
Federal Tax Weekly Alert	*CCH Master Tax Guide*
Tax Notes	*RIA Federal Tax Handbook*
Law Reviews:	***Textbooks:***
Tax Law Review (New York University School of Law)	*McGraw Hill's Taxation of Individuals and Business Entities*
Virginia Tax Review (University of Virginia School of Law)	*McGraw Hill's Essentials of Federal Taxation*

Secondary authorities may be very helpful in understanding a tax issue, but they hold little weight in a tax dispute (hence their "unofficial" status). Thus, tax advisers should always be careful to verify their understanding of tax law by examining primary authorities directly and to *never* cite secondary authority in a research memo. Exhibit 2-6 lists some of the common sources of secondary authority.

TAXES IN THE REAL WORLD Google: Not Authoritative on Tax Matters

While Internet super giant Google may be the king of all cyberspace knowledge, the Tax Court ruled in *Woodard v. Comm'r,* TC Summary Opinion 2009-150, that a Google search does not constitute reasonable cause to excuse a Harvard MBA/CPA from taking an incorrect tax return position. The Tax Court noted that although the taxpayer had not worked as an accountant for years before filing his tax return, "his accounting degree, MBA, and CPA training, no matter how stale, undoubtedly taught him what sources could be relied upon as definitive; such as, for example, the Internal Revenue Code and the income tax regulations, both of which are readily available on the Internet."

Legislative Sources: Congress and the Constitution

The three legislative or statutory tax authorities are the U.S. Constitution, the Internal Revenue Code, and tax treaties. The **U.S. Constitution** is the highest authority in the United States, but it provides very little in the way of tax law because it contains no discussion of tax rates, taxable income, or other details. Instead, the 16th Amendment provides Congress the ability to tax income directly, from whatever source derived, without apportionment across the states.

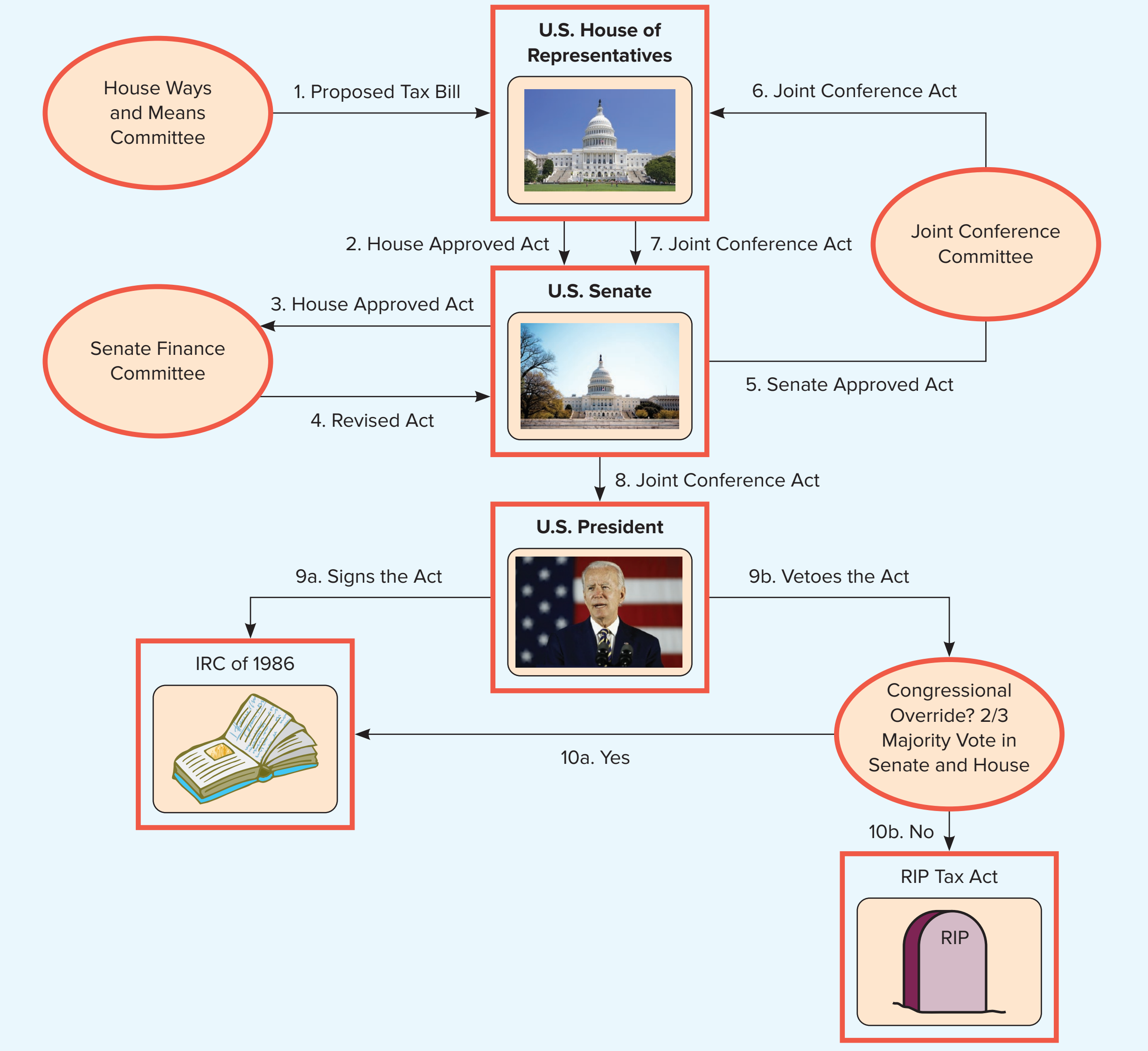
Various attempts to amend the U.S. Constitution with regard to taxation—for example, one effort to repeal the 16th Amendment entirely and one to require a two-thirds majority in both houses to raise taxes—have so far met with failure.

Internal Revenue Code The second (and main) statutory authority is the **Internal Revenue Code of 1986,** as amended, known as the Code. The Internal Revenue Code has the same authoritative weight as tax treaties and Supreme Court rulings. Thus, a taxpayer should feel very confident in a tax return position, such as taking a deduction, that is specifically allowed by the Code. The Internal Revenue Code is unique in that all federal tax authorities—all administrative and judicial authorities except tax treaties and the Constitution—can be seen as an interpretation of it. Hence, understanding the relevant code section(s) is critical to being an efficient and effective tax professional.

Congress enacts tax legislation virtually every year that changes the Code; 1986 was simply the last major overhaul. Prior to 1986, tax law changes were incorporated into the Internal Revenue Code of 1954, the year a new numbering system and other significant changes were introduced. Before that, tax law changes were incorporated into the Internal Revenue Code of 1939, which was the year the tax law was first codified.

The Legislative Process for Tax Laws Exhibit 2-7 illustrates the legislative process for enacting tax laws. As required by the U.S. Constitution (Article 1, Section 7), "All Bills for raising Revenue shall originate in the House of Representatives." The Senate may propose tax legislation, but the first to formally consider a bill will be the House, typically within its Ways and Means Committee. After the committee debates the proposed legislation and drafts a bill, the bill goes to the House of Representatives floor for debate and ultimately a vote (either yea or nay without modification). If the bill is approved, it becomes an *act* and is sent to the Senate, which typically refers the act to the

EXHIBIT 2-7 **Tax Legislation Process**



Top: fstockfoto/iStock/Getty Images; middle: Glow Images; bottom: Christos S/Shutterstock

Senate Finance Committee. Not to be outdone by the House, the Senate Finance Committee usually amends the act during its deliberations. After the revised act passes the Senate Finance Committee, it goes to the Senate for debate and vote. Unlike representatives, senators may modify the proposed legislation during their debate.

If the Senate passes the act, both the House and Senate versions of the legislation are sent to the Joint Conference Committee, which consists of members of the House Ways and Means Committee and the Senate Finance Committee. During the Joint Conference Committee deliberations, committee members debate the two versions of the proposed legislation. Possible outcomes for any specific provision in the proposed legislation include adoption of the Senate version, the House version, or some compromise version of the two acts. Likewise, the Joint Conference Committee may simply choose to eliminate specific provisions from the proposed legislation or fail to reach a compromise, thereby terminating the legislation.

After the Joint Conference Committee approves the act, the revised legislation is sent to the House and Senate for vote. If both the House and Senate approve it, the act is sent to the president for their signature. If the president signs the act, it becomes law and is incorporated into the Internal Revenue Code of 1986 (Title 26 of the U.S. Code, which contains *all* codified laws of the United States). If the president vetoes the legislation, Congress may override the veto with a two-thirds positive vote in both the House and the Senate.

The House Ways and Means Committee, Senate Finance Committee, and Joint Conference Committee each produces a committee report that explains the current tax law, proposed change in the law, and reasons for the change. These committee reports are considered statutory sources of the tax law and may be very useful in interpreting tax law changes and understanding congressional intent. These committee reports are especially important after new legislation has been enacted because, with the exception of the Code, there will be very little authority interpreting the new law (i.e., no judicial or administrative authorities because of the time it takes for the new law to be litigated or for the IRS to issue interpretative guidance).

THE KEY FACTS

Statutory Authorities

- U.S. Constitution
  - The 16th Amendment provides Congress the ability to tax income directly, from whatever source derived, without apportionment across the states.
- Internal Revenue Code
  - The main statutory authority is the Internal Revenue Code of 1986.
  - The Internal Revenue Code has the same authoritative weight as tax treaties and Supreme Court rulings.
  - Changes to the Code are passed by the House of Representatives and Senate and signed into law by the president.
  - The House Ways and Means Committee and Senate Finance Committee oversee tax legislation in the House of Representatives and Senate, respectively.
  - When referencing a tax law, the researcher generally refers to the law by its code section.
- Treaties
  - Tax treaties are agreements negotiated between countries that describe the tax treatment of entities subject to tax in both countries.

Basic Organization of the Code The Internal Revenue Code is divided into subtitles, chapters, subchapters, parts, subparts, and sections. All existing and any new tax laws are placed in the Code within a specific subtitle, chapter, subchapter, part, subpart, and section. When referencing a tax law, the researcher generally refers to the law simply by its code section. Code sections are numbered from 1 to 9834, with gaps in the section numbers to allow new code sections to be added to the appropriate parts of the Code as needed. If necessary to create space for new code sections, capital letters may be added to section numbers to create new code sections (e.g., 280A). Each code section is further divided into subsections, paragraphs, subparagraphs, and clauses to allow more specific reference or citation. See Exhibit 2-5 for an example code citation and explanation.

Memorizing the various subtitles and chapters of the Code has limited value (except to impress your friends at parties). However, understanding the *organization* of the Code is important, especially for the aspiring tax accountant. (See Exhibit 2-8.) First, you must understand the organization of a code section, its subsections, paragraphs, subparagraphs, and clauses to be able to cite the respective law correctly as, for example, §162(b)(4). Second, note that many provisions in the Code apply only to specific segments of the Code. For example, it is quite common for a code section to include the phrase "for purposes of this chapter, . . ." If you do not understand what laws are encompassed in the chapter, it will be very difficult for you to interpret the code section and determine its applicability to a research question.

Finally, remember that code sections addressing similar transactions, such as deductions, or topics, such as C corporations, are grouped together. Consider a researcher faced with the question of whether an item of income is taxable. If the researcher understands the organization of the Code, they can quickly focus their research on code sections 61–140, which provide a broad definition of gross income, list items specifically included in gross income, and identify items specifically excluded from gross income.

EXHIBIT 2-8 **Example of Code Organization**

Subtitle A—Income Taxes
Chapter 1—Income Taxes
Subchapter A—Determination of Tax Liability
Part I—Definition of Gross Income, Adjusted Gross Income, Taxable Income, etc. (Secs. 61–68)
Sec. 61—Gross Income Defined
Sec. 62—Adjusted Gross Income Defined
Sec. 63—Taxable Income Defined
Subsection 63(c)—Standard Deduction
Paragraph 63(c)(2)—Basic Standard Deduction
Subparagraph 63(c)(2)(A)
Clause 63(c)(2)(A)(i)
Part II—Items Specifically Included in Gross Income (Secs. 71–90)
Sec. 71—Alimony
Sec. 72—Annuities
Sec. 73—Services of Child
Sec. 74—Prizes & Awards
Part III—Items Specifically Excluded from Gross Income (Secs. 101–140)
Sec. 101—Certain Death Benefits
Sec. 102—Gifts and Inheritances
Sec. 103—Interest on State & Local Bonds

Tax Treaties **Tax treaties** are negotiated agreements between countries that describe the tax treatment of entities subject to tax in both countries, such as U.S. citizens earning investment income in Spain. The U.S. president has the authority to enter into a tax treaty with another country after receiving the Senate's advice. If you are a U.S. citizen earning income abroad or an accountant with international clients, you need knowledge of U.S. tax laws, the foreign country's tax laws, and the respective tax treaty between the United States and the foreign country for efficient tax planning. Because the focus in this text is on U.S. tax laws, we only briefly mention the importance of tax treaties as a statutory authority.

Example 2-2

Bill recently spent a summer in Milan, Italy, teaching a graduate-level economics course. While in Italy he earned a $20,000 stipend from Bocconi University and some interest in a temporary banking account that he established for the trip. What tax laws must Bill consider to understand any tax liability from his $20,000 stipend?

Answer: U.S. tax laws, Italian tax laws, and the U.S.–Italy tax treaty will determine the tax consequences of the amounts Bill earned in Italy.

THE KEY FACTS

Judicial Authorities

- Our judicial system has the ultimate authority to interpret the Internal Revenue Code and settle disputes between taxpayers and the IRS.
- The Supreme Court is the highest judicial authority.
- Beneath the Supreme Court, the 13 circuit courts of appeals represent the next highest judicial authority.

(continued)

Judicial Sources: The Courts

Our judicial system has the ultimate authority to interpret the Internal Revenue Code and settle disputes between the IRS and taxpayers. As Exhibit 2-3 illustrates, there are five basic sources of judicial authority (three trial-level courts, 13 U.S. circuit courts of appeals, and the Supreme Court). We've noted that the Supreme Court, along with the Code, represents the highest tax-specific authority. An important distinction between the two, however, is that the Supreme Court does not establish law but instead simply interprets and applies the Code (along with other authorities). Thus, the Code and the Supreme Court should never be in conflict.[11]

[11]The Supreme Court has the authority to declare a Code provision unconstitutional.

Below the Supreme Court, the 13 U.S. circuit courts of appeals represent the next highest judicial authority. The lowest level of judicial authority consists of three different types of trial-level courts (94 U.S. district courts that hear cases involving taxpayers that reside within their respective districts, the U.S. Court of Federal Claims, and the U.S. Tax Court). Given that the U.S. Tax Court hears only tax cases and that its judges are "tax experts," its decisions typically have more weight than those rendered by a district court or the U.S. Court of Federal Claims.[12] Likewise, because the U.S. Court of Federal Claims hears a much narrower set of issues than U.S. district courts (only monetary claims against the U.S. government), its decisions have more weight than district court decisions.

In rendering court decisions, all courts apply the judicial doctrine of ***stare decisis.*** This doctrine means that a court will rule consistently with (a) its previous rulings (unless, due to evolving interpretations of the tax law over time, the court decides to overturn an earlier decision) and (b) the rulings of higher courts with appellate jurisdiction (the courts its cases are appealed to). The implication of *stare decisis* is that a circuit court will abide by Supreme Court rulings and its own rulings, whereas a trial-level court will abide by Supreme Court rulings, its respective circuit court's rulings, and its own rulings. For example, a district court in California would follow U.S. 9th Circuit and Supreme Court rulings as well as the court's own rulings.

The doctrine of *stare decisis* presents a special problem for the U.S. Tax Court because it appeals to different circuit courts based on the taxpayer's residence. To implement the doctrine of *stare decisis,* the tax court applies the ***Golsen* rule.**[13] The *Golsen* rule simply states that the Tax Court will abide by rulings of the circuit court that has appellate jurisdiction for a case.

- The lowest level of judicial authority consists of three different types of trial-level courts (U.S. district courts, the U.S. Court of Federal Claims, and the U.S. Tax Court).
- U.S. Tax Court decisions typically are considered to have more authoritative weight than decisions rendered by a district court or the U.S. Court of Federal Claims.
- All courts apply the judicial doctrine of *stare decisis,* which means that a court will rule consistently with its previous rulings and the rulings of higher courts with appellate jurisdiction.

Example 2-3

What if: If Bill and Mercedes opt to litigate their case in the U.S. Tax Court, by which circuit court's rulings will the court abide?

Answer: Because Bill and Mercedes live in Florida, the U.S. Tax Court will abide by the circuit court with appellate jurisdiction in Florida, which happens to be the U.S. 11th Circuit Court.

Administrative Sources: The U.S. Treasury

Regulations, Revenue Rulings, and Revenue Procedures The Treasury Department, of which the IRS is a bureau, is charged with administering and interpreting the tax laws of the United States, among other duties such as printing money and advising the president on economic issues. **Regulations** are the Treasury Department's official interpretation of the Internal Revenue Code, have the highest authoritative weight, and often contain examples of the application of the Code that may be particularly helpful to the tax researcher. Regulations are issued in three different forms: final, temporary, and proposed. The names are very descriptive. **Final regulations** are regulations that have been issued in final form, and, thus, unless or until revoked, they represent the Treasury's interpretation of the Code. **Temporary regulations** have a limited life (three years for regulations issued after November 20, 1988). Nonetheless, during their life, they carry the same authoritative weight as final regulations. Finally, all regulations are issued in the form of **proposed regulations** first, to allow public comment on them. Proposed regulations do not carry the same authoritative weight as temporary or final regulations.

In addition to being issued in three different forms (proposed, temporary, and final), regulations also serve three basic purposes: interpretative, procedural, and legislative.

THE KEY FACTS

Administrative Authorities

- The Treasury Department is charged with administering and interpreting the tax laws.
- Regulations
  - Regulations are the Treasury Department's official interpretation of the Internal Revenue Code and have the highest authoritative weight.
  - Regulations are issued in three different forms (proposed, temporary, and final) and serve three basic purposes (interpretative, procedural, and legislative).

(*continued*)

[12]The Tax Court renders both "regular" and "memorandum" decisions. Regular decisions involve new or unusual points of law, whereas memorandum decisions involve questions of fact or the application of existing law. Both decisions have similar authoritative weight. Decisions issued by the Tax Court's Small Claims division may not be cited as precedent.

[13]*Golsen v. Comm'r,* 54 TC 742 (1970).

- Revenue rulings and revenue procedures
  - Revenue rulings and revenue procedures are second in administrative authoritative weight after regulations.
  - Revenue rulings address the application of the Code and regulations to a specific factual situation.
  - Revenue procedures explain in greater detail IRS practice and procedures in administering the tax law.
- Letter rulings
  - Letter rulings are less authoritative but more specific than revenue rulings and regulations.
  - Private letter rulings represent the IRS's application of the Code and other tax authorities to a specific transaction and taxpayer.

Most regulations, regardless of whether they are issued in proposed, temporary, or final form, are interpretative or procedural regulations. As the names suggest, **interpretative regulations** represent the Treasury's interpretation of the Code. In Bill and Mercedes's case, these might be the regulations issued under §163, which discuss interest deductions. **Procedural regulations** explain Treasury Department procedures as they relate to administering the Code. Again, for Bill and Mercedes's case, these might be the regulations issued under §6501 regarding the statute of limitations for IRS assessment and collection. **Legislative regulations,** the rarest type, are issued when Congress specifically directs the Treasury Department to create regulations to address an issue in an area of law. In these instances, the Treasury is actually writing the law instead of interpreting the Code. Because legislative regulations represent tax law instead of an interpretation of tax law, legislative regulations generally have been viewed to have more authoritative weight than interpretative and procedural regulations. However, in *Mayo Foundation for Medical Education & Research v. United States,* 562 U.S. 44 (2011), the Supreme Court held (subject to specific conditions) that all Treasury regulations warrant deference. It is thus a very difficult process to challenge any regulation, and taxpayers are cautioned not to take tax return positions inconsistent with regulations.

Revenue rulings and revenue procedures are second in administrative authoritative weight after regulations. But unlike regulations, revenue rulings address the application of the Code and regulations to a specific factual situation. Thus, while **revenue rulings** have less authoritative weight, they provide a much more detailed interpretation of the Code as it applies to a specific transaction and fact pattern. For example, Rev. Rul. 87-22 discusses the deductions of prepaid interest (points) a taxpayer may claim when refinancing the mortgage for a principal residence, whereas the Code and regulations do not specifically address this issue. Although revenue rulings are binding on the IRS (until revoked, superseded, or modified), courts may agree or disagree with a revenue ruling. Thus, while revenue rulings should be carefully evaluated because they represent the IRS's interpretation, courts may provide a different interpretation of the tax law that a taxpayer might choose to follow. **Revenue procedures** are also much more detailed than regulations. They explain in greater detail IRS practice and procedures in administering the tax law. For example, Rev. Proc. 87-56 provides the specific depreciation lives for depreciable assets (discussed in the Property Acquisition and Cost Recovery chapter). As with revenue rulings, revenue procedures are binding on the IRS until revoked, modified, or superseded.

Letter Rulings Below revenue rulings and revenue procedures in authoritative weight rest letter rulings. As you might guess, letter rulings are less authoritative but more specific than revenue rulings and regulations. Letter rulings generally may not be used as precedent by taxpayers. However, they may be cited as authority to avoid the substantial understatement of tax penalty under §6662 imposed on taxpayers and the related tax practitioner penalty under §6694 (discussed later in this chapter). **Private letter rulings** represent the IRS's application of the Code and other tax authorities to a specific transaction and taxpayer. Private letter rulings are issued in response to a taxpayer request and are common for proposed transactions with potentially large tax implications. For example, companies commonly request a private letter ruling to ensure that a proposed corporate acquisition meets the definition of a tax-free exchange. However, the IRS also maintains a list of certain issues on which it refuses to rule, such as the tax consequences of proposed federal tax legislation. Each year, the IRS publishes an updated list of these transactions in a revenue procedure.

Other types of letter rulings include determination letters and technical advice memorandums. **Determination letters,** issued by local IRS directors, are generally not controversial. An example of a determination letter is the request by an employer for the IRS to rule that the taxpayer's retirement plan is a "qualified plan." **Technical advice memorandums** differ from private letter rulings in that they are generated for completed transactions and usually are requested by an IRS agent during an IRS audit.

Is this a comprehensive list of IRS pronouncements? No. In addition to the pronouncements listed above, the IRS issues several less common types, which are beyond the scope of this text. A couple of other pronouncements, however, warrant some discussion.

As we mentioned above, the IRS and taxpayers litigate tax cases in a number of courts and jurisdictions. Obviously, the IRS wins some of these cases and loses others. Except for Supreme Court cases, whenever the IRS loses, it may issue an **acquiescence** or **nonacquiescence** as guidance for how the IRS intends to respond to the loss. Although an acquiescence indicates that the IRS has decided to *follow* the court's adverse ruling in the future, it does not mean that the IRS *agrees* with it. Instead, it simply means that the IRS will no longer litigate this issue.

A nonacquiescence has the exact opposite implications and alerts taxpayers that the IRS does plan to continue to litigate this issue. Finally, the IRS also issues **actions on decisions,** which explain the background reasoning behind an IRS acquiescence or nonacquiescence.[14] What are noticeably absent from the list of administrative authorities? IRS publications and tax return form instructions. *Neither are considered primary authorities and should not be cited as precedent. Likewise, it is not advisable to rely on either to avoid taxpayer or tax practitioner penalties.*

TAX RESEARCH

LO 2-5

Now that you have a basic understanding of the different types of tax authority, why do you think that the IRS and taxpayers disagree with respect to the tax treatment of a transaction? In other words, why would the IRS and Bill and Mercedes's CPA reach different conclusions regarding the deductibility of certain expenses? The answer is that, because the Code does not specifically address the tax consequences of each transaction type or every possible variation of a particular transaction, the application of the tax law is subject to debate and differing interpretations by the IRS, courts, tax professionals, taxpayers, and so on. Tax research, therefore, plays a vital role in allowing us to identify and understand the varying authorities that provide guidance on an issue; assess the relative weights of differing authorities; understand the risks associated with different tax return positions; and, ultimately, draw an appropriate conclusion regarding the application of the tax law to the issue. The following paragraphs describe the basic process of tax research that tax professionals use to identify and analyze tax authorities to answer tax questions. We will then revisit Bill and Mercedes's issue and view the research memo prepared by their CPA.

Step 1: Understand Facts

To answer a tax question, you must understand it. To understand the question, you must know the facts. There are two basic types of facts: open facts and closed facts. *Open facts* have not yet occurred, such as the facts associated with a proposed transaction. *Closed facts* have already occurred. The distinction between open and closed facts is important because, unlike closed facts, open facts can be altered, and different facts may result in very different tax consequences. Open facts allow the taxpayer to arrange a transaction to achieve the most advantageous outcome. Thus, they are especially important in tax planning.

How do you establish the facts for a research question? Interview clients, speak with third parties such as attorneys and brokers, and review client documents such as contracts, prior tax returns, wills, trust documents, deeds, and corporate minutes. When interviewing clients, remember that not many are tax experts. Thus, it is up to the tax professional to ask the correct initial and follow-up questions to obtain all the relevant facts. Also consider nontax factors, such as a client's personal values or objectives, because these often put constraints on tax-planning strategies.

Step 2: Identify Issues

A tax professional's ability to identify issues is largely a function of their type of tax expertise. A tax expert in a particular area will typically be able to identify quickly the

THE KEY FACTS

Tax Research

- The five steps in tax research are (1) understand the facts, (2) identify issues, (3) locate relevant authorities, (4) analyze the tax authorities, and (5) document and communicate research results.
- The two types of tax services that tax professionals use in tax research are annotated tax services, arranged by code section, and topical services, arranged by topic.
- Research questions often consist of questions of fact or questions of law.
  - The answer to a question of fact hinges upon the facts and circumstances of the taxpayer's transaction.
  - The answer to a question of law hinges upon the interpretation of the law, such as interpreting a particular phrase in a code section.
- When the researcher identifies that different authorities have conflicting views, they should evaluate the "hierarchy," jurisdiction, and age of the authorities.
- Once the tax researcher has identified relevant authorities, they must make sure that the authorities are still valid and up to date.

(continued)

[14]Actions on decisions have no precedential value but may be cited as authority to avoid the substantial understatement of tax penalty under §6662 imposed on taxpayers and the related tax practitioner penalty under §6694 (discussed later in this chapter).

- The most common end product of a research question is a research memo, which has five basic parts: (1) facts, (2) issues, (3) authority list, (4) conclusion, and (5) analysis.

specific tax issues that relate to transactions in that area. For example, an expert in corporate acquisitions would quickly identify the tax consequences and specific issues of alternative acquisition types. A novice, on the other hand, would likely identify broader issues first and then more specific issues as they researched the relevant tax law.

What's the best method to identify tax issues? First of all, get a good understanding of the client's facts. Then, combine your understanding of the facts with your knowledge of the tax law. Let's consider the example of Bill and Mercedes's interest deduction. For an expert in this particular area, the issues will be immediately evident. For a novice, the initial response may take the form of a series of general questions: (1) Is this item of expense deductible? (2) Is that item of income taxable? (3) In what year should the expense be deducted? (4) In what year should the item of income be taxed? After you identify these types of general issues, your research will enable you to identify the more specific issues that ultimately determine the tax ramifications of the transaction.

Example 2-4

Elizabeth, Bill and Mercedes's friend who is a shareholder and the CFO of a company, loaned money to her company to help it avoid declaring bankruptcy. Despite Elizabeth's loan, the company did file for bankruptcy, and Elizabeth was not repaid the loan. What issues would a researcher consider?

Answer: The first questions to ask are whether Elizabeth can deduct the bad debt expense and, if so, as what type of deduction? As the researcher delves more into the general issue, he would learn that the type of deduction depends on whether Elizabeth's debt is considered a business or nonbusiness bad debt. This more specific issue depends on whether Elizabeth loaned the money to the company to protect her job (business bad debt) or to protect her stock investment in the company (nonbusiness bad debt). Bad-debt expenses incurred for nonbusiness debts (investment-related debts) are deducted as short-term capital losses but subject to limitations. In contrast, bad-debt expenses for business debts (business-related debts) are generally ordinary deductions and not limited. The exception (potentially applicable to Elizabeth) is that a business bad debt incurred related to an employee loan to an employer is considered a nondeductible unreimbursed employee business expense. Thus, the potential outcomes for Elizabeth are either a deductible short-term capital loss, subject to limitations, or a nondeductible unreimbursed employee business expense.

Why might this case be a good one to litigate in U.S. district court?

Answer: Because a jury might be more likely to be convinced to assess Elizabeth's motives favorably.

Step 3: Locate Relevant Authorities

Step three in the research process is to locate the relevant authorities (code sections, regulations, court cases, revenue rulings) that address the tax issue. Luckily, tax services can aid the researcher in identifying relevant authorities. Most, if not all, of these services are available on the Internet (with a subscription) and thus offer the flexibility to conduct research almost anywhere.[15]

There are two basic types of tax services: annotated and topical. **Annotated tax services** are arranged by Internal Revenue Code section. That is, for each code section, an annotated service includes the code section; a listing of the code section history; copies of congressional committee reports that explain changes to the code section; a copy of all the regulations issued for the specific code section; the service's unofficial explanation of the code section; and brief summaries (called annotations) of relevant court cases, revenue rulings, revenue procedures, and letter rulings that address issues specific to the code section. Two examples of annotated tax services are Commerce Clearing House's (CCH) Standard Federal Tax Reporter and Research Institute of America's (RIA) United States Tax Reporter.

[15]www.irs.gov contains a lot of information (tax forms, IRS publications, etc.) that may be especially useful for answering basic tax questions. In addition, tax publishers, such as CCH and RIA, produce quick reference tax guides (e.g., the *CCH Master Tax Guide* or the *RIA Federal Tax Handbook*) that may be used to answer basic tax questions.

Topical tax services are arranged by topic, such as taxable forms of income, tax-exempt income, and trade or business expenses. For each topic, the services identify tax issues that relate to each topic and then explain and cite authorities relevant to the issue (code sections, regulations, court cases, revenue rulings, etc.). Beginning tax researchers often prefer topical services because they generally are easier to read. Some examples of topical federal tax services include BNA's Tax Management Portfolios, CCH's Tax Research Consultant, and RIA's Federal Tax Coordinator.

How does a researcher use these services? An expert would probably go directly to the relevant portions of an annotated or topical service. A novice may conduct a keyword search in the service, use the tax service's topical index, or browse the tax service to identify the relevant portions. To identify keywords, the researcher should try to describe the transaction in three to five words. An ideal keyword search typically includes (1) the relevant area of law and (2) a fact or two that describes the transaction. Try to avoid keywords that are too broad (income, deduction, taxable) or too narrow ("United Way charitable contribution deduction limit").

Example 2-5

Bill and Mercedes refinanced the mortgage on their principal residence a couple of years ago when their original mortgage's four-year balloon payment came due. Their mortgage institution charged Bill and Mercedes $3,000 of points (prepaid interest) upon the refinancing in order to give them a reduced interest rate. On their CPA's advice, Bill and Mercedes deducted the $3,000 in the year they paid it, but upon audit, the IRS disallowed the deduction. What is the research issue?

Answer: The issue is, should Bill and Mercedes have deducted the $3,000 of points in the year they paid it?

What are some keywords that could identify the relevant tax authority?

Answer: Points (area of law), interest (area of law), refinancing (fact that describes the transaction).

Keyword searching is more an art than an exact science. As you gain a better understanding of different areas of the tax law, you'll become much more efficient at using keywords. If keyword searching is not proving beneficial, check your spelling, make sure you're searching within the correct database, rethink your keywords, use another research method, use another tax service, or, as a last resort, take a break.

While utilizing keyword searches or other research methods to identify potentially relevant areas of law and tax authorities, constantly ask yourself whether you are indeed in the correct area of law. Once the answer to this question is an authoritative yes, you can delve deeper into the area of law and related authorities to answer the question.

Step 4: Analyze Tax Authorities

Once a researcher identifies relevant authorities, they must read carefully to ensure they fully understand them, as well as their application to the research problem. Two basic types of issues researchers will encounter are questions of fact and questions of law.

The answer to a **question of fact** hinges upon the facts and circumstances of the taxpayer's transaction. For example, whether a trade or business expense is "ordinary," "necessary," "reasonable," and, thus, deductible is a question of fact. Specifically, the deductibility of the expense depends upon the underlying facts related to the expense. If you're researching a question of fact, understand *which* facts impact the answer—in this case, which facts make an expense "ordinary," "necessary," and "reasonable" and which do not. In this type of question, the researcher will focus on understanding how various facts affect the research answer and identifying authorities with fact patterns similar to those of their client.

The answer to a **question of law** hinges upon the interpretation of the law, such as a particular phrase in a code section (see the sample research memo in Exhibit 2-9 for an example of a question of law). A researcher faced with this type of question will spend much of their time researching the various interpretations of the code section, taking note of which authorities interpret the code differently and why.

EXHIBIT 2-9 Sample Internal Research Memo

Below is the memo Bill and Mercedes's CPA drafted after researching their issue.

Date:	July 8, 2022
Preparer:	Joe Staff
Reviewer:	Cassandra Miller
Subject:	Deductibility of Points Paid in Refinancing
Facts:	Four years ago Bill and Mercedes's credit union provided them a $250,000 mortgage loan for their new home. The mortgage loan was a four-year interest-only note with a balloon payment at the end of four years. Bill and Mercedes (Floridians residing in the 11th Circuit) chose this type of loan to allow them to minimize their mortgage payment until their other house was sold. After 18 months, Bill and Mercedes sold their other house and refinanced their original short-term loan with a 15-year conventional mortgage. The credit union charged Bill and Mercedes $3,000 in points (prepaid interest) upon the refinancing.
Issue:	Can Bill and Mercedes deduct the points in the year they paid them?
Authorities:	§461(g). Rev. Rul. 87-22, 1987-1 C.B. 146. *J.R. Huntsman v. Comm'r,* 90-2 USTC par. 50,340 (8th Cir. 1990), *rev'g* 91 TC 917 (1988). AOD 1991-002. *P.G. Cao v. Comm'r,* 96-1 USTC par. 50,167 (9th Cir. 1996), *aff'g* 67 TCM 2171 (1994).
Conclusion:	Because Bill and Mercedes's refinancing represents an integrated step in securing permanent financing for their home, substantial authority supports their deduction of the $3,000 in points this year.
Analysis:	§461(g)(1) provides that cash-method taxpayers (Bill and Mercedes) must amortize prepaid interest (points) over the life of the loan instead of receiving a current deduction. §461(g)(2) provides an exception to the general rule of §461(g)(1). Specifically, §461(g)(2) allows cash-method taxpayers to deduct points in the year paid if the related debt was incurred "in connection with the purchase or improvement of," and secured by, the taxpayer's principal residence. The question whether Bill and Mercedes should amortize or currently deduct the points paid to refinance the mortgage on their principal residence depends upon the interpretation of "in connection with the purchase or improvement of" found in §461(g)(2). There are two basic interpretations of "in connection with the purchase or improvement of." In Revenue Ruling 87-22, the IRS rules that points incurred in refinancing a mortgage on a taxpayer's residence are deductible in the year paid to the extent that the taxpayer uses the loan proceeds to improve the taxpayer's residence. Thus, points paid to simply refinance an existing mortgage without improving the residence must be amortized over the life of the loan. In contrast, in *J.R. Huntsman v. Comm'r,* the 8th Circuit Court interpreted the phrase "in connection with the purchase or improvement of" much more broadly and held that points incurred to refinance a mortgage on the taxpayer's principal residence are currently deductible if the refinancing represents an *integrated step to secure permanent financing* for the taxpayer's residence. The facts in *J.R. Huntsman v. Comm'r* are very similar to Bill and Mercedes's facts. Like Bill and Mercedes, the taxpayers in *J.R. Huntsman v. Comm'r* also purchased their principal residence using a short-term loan with a "balloon" payment. When the balloon payment came due, the taxpayers obtained a permanent mortgage on their home (a 30-year conventional mortgage). The 8th Circuit Court held that in this case the permanent mortgage was acquired to extinguish the short-term financing and finalize the purchase of the home. "Thus, where taxpayers purchase a principal residence with a short-term three-year loan secured by a mortgage on the residence, and replace the loan with permanent financing . . . , the permanent mortgage obtained is sufficiently in connection with the purchase of the home to fall within the exception provided for by section 461(g)(2)." In Action on Decision 1991-002, the IRS has indicated that it will not follow the *J.R. Huntsman v. Comm'r* decision outside the 8th Circuit (in the 11th Circuit where Bill and Mercedes live). Nonetheless, other courts (the 9th Circuit in *P.G. Cao v. Comm'r*) have indicated a willingness to apply the 8th Circuit's interpretation of §461(g)(2). That is, they have allowed deductibility of points incurred in refinancing if the refinancing occurred to secure permanent financing, instead of for some other reason such as to secure a lower interest rate. Given the similarity in facts between Bill and Mercedes's refinancing and those in *J.R. Huntsman v. Comm'r* (refinancing of a short-term note to secure permanent financing), substantial authority supports a current deduction of the points paid.

Identifying whether a research question is a question of fact or question of law is primarily helpful when there is some uncertainty in the application of tax law. Distinguishing between these two types of research questions helps the tax researcher focus their efforts appropriately. For many tax questions, the answer is quite clear (e.g., the question is answered definitively in the Internal Revenue Code, regulations, etc.). In these situations, there is no need to attempt to distinguish the research question as a question of fact or question of law.

For many tax questions, the answer is clear with no opposing interpretations or contrary authorities. For other questions, the researcher may identify that different authorities have conflicting views. In this situation, the tax researcher should evaluate the hierarchical level, jurisdiction, and age of the authorities, placing more weight on higher and newer authorities that have jurisdiction over the taxpayer. A tax researcher will become more adept at this process as they gain experience.

Once the tax researcher has identified relevant authorities, they must make sure the authorities are still valid and up to date. For court cases, a **citator**—a research tool that allows you to check the status of several types of tax authorities—can be used to review the history of a case to find out, for example, whether it was subsequently appealed and overturned and to identify subsequent cases that cite it. Favorable citations (e.g., a citation of the case by another authority in support of its ruling) strengthen a case. In contrast, unfavorable citations weaken it (e.g., a citation of the case by another authority that questions or limits the case's decision). Citators can also check the status of revenue rulings, revenue procedures, and other IRS pronouncements. Checking the status of the Code is fairly simple: Just locate the current version. Checking the status of regulations is a little more complicated. Most tax services alert researchers if a regulation has not been updated for certain changes in the Code. If this is the case, the researcher should evaluate whether the changes in the Code make the regulation obsolete.

As detailed in the analysis section of the sample research memo drafted by Bill and Mercedes's CPA (see Exhibit 2-9), whether they should amortize (deduct over the life of the loan) or currently deduct the points paid to refinance the mortgage on their principal residence is a question of law that ultimately depends upon the interpretation of a particular phrase: "in connection with the purchase or improvement of" found in §461(g)(2). Is there a correct answer to this question? No. There is no clear-cut answer. Rather, this is a situation where the tax professional must use professional judgment. Because there is substantial authority supporting the current deduction of the points (discussed in detail in the sample memo), Bill and Mercedes should be able to deduct the points currently without risk of penalty. However, they should be aware that the IRS has clearly stated in an action on decision that it will fight this issue outside the 8th Circuit—for example, in the 11th Circuit, where Bill and Mercedes live.

Step 5: Document and Communicate the Results

After a researcher finishes their research, the final step of the process is to document and communicate the results. The most common end product of a research question is the internal research memo the researcher drafts for their supervisor's attention. The memo has five basic parts: (1) facts, (2) issues, (3) authority list, (4) conclusion, and (5) analysis. The purpose of the memo is to inform the reader of the answer to a research question, and, thus, it should be written in an objective manner by discussing all relevant authorities to the research question, including those authorities that support, as well as those that conflict with, the answer. Below are some suggestions for each part of the memo. Compare these to the execution within the sample internal research memo presented in Exhibit 2-9.

Facts Discuss facts relevant to the question presented—that is, facts that provide necessary background information related to the transaction (generally, who, what, when, where, and how much) and those facts that may influence the research answer. Keeping the fact discussion relatively brief will focus the reader's attention on the relevant characteristics of the transaction.

Issues State the specific issues that the memo addresses. This section confirms that you understand the research question, reminds the reader of the question being analyzed, and allows future researchers to determine whether the analysis in the memo is relevant. Issues should be written as specifically as possible and limited to one or two sentences per issue.

Authorities In this section, cite the relevant tax authorities that apply to the issue, such as the IRC, court cases, and revenue rulings. How many authorities should you cite? Enough to provide a clear understanding of the issue and interpretation of the law. Remember, in order to reach an accurate assessment of the strength of your conclusion, you should consider authorities that may support your desired conclusion, as well as those that may go against it.

Conclusion There should be one conclusion per issue. Each conclusion should answer the question as briefly as possible and, preferably, indicate why the answer is what it is.

Analysis The goal of the analysis is to provide the reader a clear understanding of the area of law and specific authorities that apply. Typically, you will organize an analysis to discuss first the general area(s) of law (the code section), and then the specific authorities (court cases, revenue rulings) that apply to the research question. How many authorities should you discuss? As many as necessary to provide the reader an understanding of the issue and relevant authorities. After you discuss the relevant authorities, apply the authorities to your client's transaction and explain how the authorities result in your conclusion.

Client Letters In addition to internal research memos, tax professionals often send their clients letters that summarize their research and recommendations. Basic components of the client letter include (1) research question and limitations, (2) facts, (3) analysis, and (4) closing. Below are some suggestions for each part of the client letter. Compare these to the execution within the sample client letter presented in Exhibit 2-10.

Research question and limitations. After the salutation (Dear Bill and Mercedes) and social graces (I enjoyed seeing you last week . . .), clearly state the research question addressed and any disclaimers related to the work performed. This portion of the letter ensures that the tax professional and client have a mutual understanding of the question researched and any limitations on the research performed. As in a memo, issues should be written as specifically as possible and be limited to one or two sentences. Most accounting firms have standard boilerplate language regarding the limitations on work performed that is included in every client letter.

Facts. Briefly summarize the facts relevant to the question presented—that is, facts that provide necessary background of the transaction and those facts that may influence the research answer. Keeping the fact discussion relatively brief will focus the client's attention on the relevant characteristics of the transaction.

Analysis. Summarize the relevant authorities (including citations in most situations) and their implications for the client's research question using precise language appropriate for the client's level of tax expertise. The length of this portion of the letter will vary with the complexity of the research question and the client's interest in understanding the specific research details.

Closing. In this section, summarize the key outcome(s) of the research conducted and any recommended client action, thank the client for requesting your service, and remind the client to contact you with additional questions or for further assistance.

In the case of Bill and Mercedes's interest deduction, their CPA recommended a tax return position that the IRS disallowed upon audit. Did their CPA violate their professional responsibilities by recommending a position the IRS disallowed? Good question. Let's take a look at the rules governing tax professional responsibilities.

EXHIBIT 2-10 **Sample Client Letter**

Below is the client letter that Bill and Mercedes's CPA sent to them.

July 8, 2022

Dear Bill and Mercedes,

I enjoyed seeing you last week at the Tampa Bay Boys and Girls Clubs charity auction. What a great event for such a worthy cause!

Thank you for requesting my advice concerning the tax treatment of the points paid when refinancing your mortgage.

My research is based upon the federal income tax laws that apply as of the date of this letter and the facts that you have provided as follows: Four years ago your credit union provided you a $250,000 interest-only note on your home that required a balloon payment at the end of four years. You chose this type of loan to minimize your mortgage payment until your previous house sold. After 18 months, you sold your previous house and refinanced the original short-term loan with a 15-year conventional mortgage. The credit union charged you $3,000 in points upon the refinancing.

After a thorough review of the applicable tax authority, I found there is substantial authority supporting a current deduction of the $3,000 in points paid. §461(g)(2) allows cash-method taxpayers to deduct points in the year paid if the related debt was incurred "in connection with the purchase or improvement of," and secured by, the taxpayer's principal residence. There are two basic interpretations of "in connection with the purchase or improvement of." The IRS has ruled (Revenue Ruling 87-22) that points paid to simply refinance an existing mortgage without improving the residence must be amortized over the life of the loan. In contrast, in *J.R. Huntsman v. Comm'r*, the 8th Circuit Court held that points incurred to refinance a mortgage on the taxpayer's principal residence are currently deductible if the refinancing represents an *integrated step to secure permanent financing* for the taxpayer's residence.

The facts in *J.R. Huntsman v. Comm'r* are very similar to your facts. Like you, the taxpayers in *J.R. Huntsman v. Comm'r* purchased their principal residence using a short-term loan with a balloon payment. When the balloon payment came due, the taxpayers obtained a permanent mortgage on their home. The 8th Circuit Court held that in this case the permanent mortgage was acquired to finalize the purchase of the home and allowed the current deduction of the points.

J.R. Huntsman v. Comm'r provides substantial authority to support a current deduction of the $3,000 in points paid to refinance your initial short-term mortgage. In addition, other courts have applied the 8th Circuit's interpretation of §461(g)(2), which adds "strength" to the 8th Circuit decision. However, the IRS has indicated that it will not follow the *J.R. Huntsman v. Comm'r* decision outside the 8th Circuit (in the 11th Circuit where you live). Accordingly, the IRS would likely disallow the $3,000 deduction upon audit, and, thus, while you have substantial authority to deduct the points currently, there is risk in doing so.

I would be happy to discuss this issue with you in more depth because these types of issues are always difficult. Likewise, if you have any other questions or issues with which I may assist you, please do not hesitate to contact me. Thank you again for requesting my advice.

Sincerely,

Cassandra Miller, CPA

TAX PROFESSIONAL RESPONSIBILITIES

LO 2-6

Tax practitioners are subject to a variety of statutes, rules, and codes of professional conduct. Some examples include the American Institute of CPA's (AICPA) Code of Professional Conduct, the AICPA's **Statements on Standards for Tax Services (SSTS),** the IRS's Circular 230, and statutes enacted by a CPA's specific state board of accountancy. Tax practitioners should absolutely have a working knowledge of these statutes, rules, and guidelines because (1) they establish the professional standards for the practitioner and (2) failure to comply with the standards could result in adverse consequences for the tax professional, such as being admonished, suspended, or barred from practicing before the IRS; being admonished, suspended, or expelled from the AICPA; or