TT TEXTBOOK TESTBANKS

Solutions Manual for South: Western Federal Taxation 2026: Comprehensive 49th Young

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Solution and Answer Guide

Young, Persellin, Nellen, Cuccia, Lassar, Maloney, Cripe, SWFT Comprehensive Volume 2026, 9798214043753; Chapter 1: An Introduction to Taxation and Understanding the Federal Tax Law

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Discussion Questions

1. (LO 1) Various answers are possible, including using the Key Terms at the end of each chapter, referring to the Glossary (Appendix C), looking up the footnote resources to the Internal Revenue Code in Appendix D, using chapter features (e.g., Global Tax Issues, Ethics & Equity, Tax Planning, and Framework 1040), examining the tax forms used in the chapters, and completing additional end-of-chapter assignments. All of these resources will help students engage more deeply with the materials and help their understanding.

2. (LO 1, 6)

   a. John must now start including any rental income in his taxable income. This will require him to document rental receipts and separate his home expenses between personal and rental use, and he may be subject to the transient occupancy tax.

   b. Theresa has become self-employed. Now she will be subject to self-employment tax and may have to make quarterly installment payments of estimated income and self-employment tax. Theresa will be required to make payroll tax payments if she hires individuals to work in her business.

   c. Paul's employer might have some moving expenses that it can deduct (in general, Paul cannot deduct moving expenses). Paul's personal taxes will change because Florida does not impose an income tax but California does.

3. (LO 1, 6) The income tax consequences that result are Marvin's principal concern. Any rent he receives is taxed as income, but operating expenses and depreciation will generate deductions that offset some or all of the income or even yield a loss. Marvin must also consider the effect of other taxes. Because the property is being converted from residential to commercial use, he can expect an increase in the ad valorem property taxes levied by the local (and perhaps even the state) taxing authorities. Besides the real estate taxes, personal property taxes could be imposed on the furnishings.

4. (LO 2)

   a. This is the ideal approach to handling a tax cut—for every dollar lost, a new dollar is gained.

   b. All the sunset provision does is reinstate the law as it existed prior to the tax cut. Here, the possibility exists that Congress will rescind (or postpone) the sunset provision before it takes effect.

   c. Indexation is a procedure whereby the IRS makes annual adjustments to certain key tax components to take into account inflation, as required by law. Some of the more important components that are adjusted include tax brackets and the standard deduction amounts.

5. (LO 2)

   a. To encourage pension plans is to stimulate saving (economic consideration). Also, it provides security from the private sector for retirement to supplement public programs which tend to provide lesser benefits (social considerations). An opposing consideration is that only higher income individuals are able to fully fund their pension plans and, thus, gain the greater tax benefit from the favorable rules for retirement savings.

   b. To make education more widely available is to promote a socially desirable objective. A better educated workforce also serves to improve the country's economic capabilities. As a result, education tax incentives can be justified on both social and economic grounds. A weakness in the current incentives is that they are only for college education, rather than also in preparation for other careers including health care, personal care, construction, and skilled trades (e.g., mechanics, electricians, and plumbers).

   c. The encouragement of home ownership can be justified on both social and economic grounds. For example, if a person owns a home and has no mortgage by the time they retire, their monthly living expenses will be lower. An opposing consideration to the tax breaks for home ownership is that the mortgage interest deduction applies to debt up to $750,000, thus providing a greater tax break to higher income individuals who can qualify for this large of a mortgage. Also, renters indirectly pay property taxes through their rent, but receive no tax deduction for that indirect payment. Finally, the home ownership tax breaks today apply once the home is acquired; there are no tax incentives to help an individual buy a home (such as a first-time homebuyer tax credit).

6. (LO 2, 3)

   a. Social considerations explain the credit. It is socially desirable to encourage parents to provide care for their children while they work.

   b. These deductions raise the issue of preferential tax treatment for homeowners—taxpayers who rent their personal residences do not receive comparable treatment. Even so, the encouragement of home ownership can be justified on economic and social grounds.

   c. Activities deemed contrary to public policy should not result in tax savings.

d. The NOL carryforward provision is an equity consideration designed to mitigate the effect of the annual accounting period concept.

e. The installment method of reporting gain is consistent with the wherewithal to pay concept—the seller is taxed when the payments are made by the purchaser.

f. The exclusion from Federal income taxation of interest from state and local bonds can be justified largely on political considerations. Political goodwill is generated by allowing state and local jurisdictions to secure financing at a lower cost (i.e., interest rate) due to favorable Federal income tax treatment.

g. The treatment of prepaid income is justified under the wherewithal to pay concept. It also eases the task of the IRS as to administration of the tax law.

7. (LO 2)

   a. Mia's realized gain from the condemnation is $320,000 [$400,000 (amount of award) − $80,000 (cost basis of the warehouse)]. However, her recognized gain is limited to $120,000—the amount received that was not reinvested.

   b. None of the gain is recognized because Mia reinvested the full amount of the condemnation award.

   c. In this case, all of Mia's $320,000 realized gain is recognized. Mia reinvested only $80,000 of the $400,000 award, so the $320,000 difference between these two amounts means any realized gain will be recognized to the extent of this difference.

   d. The involuntary conversion provision can be justified under the wherewithal to pay concept and the notion that the taxpayer's economic position has not changed. In part b., for example, Mia has retained none of the award and has reinvested in property similar to that taken by the city.

8. (LO 3) If the collection is worth more than $1,000, the mother has probably made a gift of the excess value to her son. There is a possibility that the transaction could result in the assessment of a gift tax. Sales or other transactions between related parties are subject to the arm's length test. In this case, for example, would the mother have made this sale for $1,000 if the purchaser had been an unrelated third party?

9. (LO 4) To finance our participation in World War II, the scope of the income tax was expanded considerably—from a limited coverage of 6% to over 74% of the population. Hence, the description of the income tax as being a "mass tax" became appropriate.

10. (LO 4) For wage earners, the tax law requires employers to withhold a specified dollar amount from wages paid to the employee to cover income taxes and payroll taxes. Persons with nonwage income generally are required to make quarterly payments to the IRS for estimated taxes. Both procedures ensure that taxpayers will be financially able to meet their annual tax liabilities. That is, the amounts withheld are meant to prepay the employee's income taxes and payroll taxes related to the wages earned.

11. (LO 5) The tax law of this state appears to violate the *certainty* and *simplicity* principles.

12. (LO 5) A tax is *regressive* if it represents a larger percentage of the income of a low-income taxpayer relative to the income of a high-income taxpayer. Examples of

regressive taxes include sales and excise taxes. A tax is *progressive* if it represents a larger percentage of the income of a high-income taxpayer relative to the income of a low-income taxpayer. The Federal income tax is an example of a progressive tax.

13. (LO 6)

    a. The parsonage probably was not listed on the property tax rolls because it was owned by a tax-exempt church. Apparently the taxing authorities are not aware that ownership has changed.

    b. Ethan should notify the authorities of his purchase. This will force him to pay back taxes but may eliminate *future* interest and penalties.

14. (LO 6) Although the Baker Motors bid is the lowest from a long-term financial standpoint, it is the best. The proposed use of the property by the state and the church probably will make it exempt from the school district's ad valorem tax. This would hardly be the case with a car dealership. In fact, commercial properties (e.g., car dealerships) often are subject to higher tax rates.

15. (LO 6)

    a. In this case, the "tax holiday" probably concerns exemption from ad valorem taxes. "Generous" could involve an extended period of time (e.g., 10 years) and include both realty and personalty.

    b. The school district could be affected in two ways. First, due to the erosion of the tax base, less revenue would be forthcoming. Second, new workers would mean new families and more children to educate.

16. (LO 6) A possible explanation is that Sophia made capital improvements (e.g., added a swimming pool) to her residence and her parents became retirees (e.g., reached age 65).

17. (LO 6) Presuming that the dockage facilities are comparable in Massachusetts, the Agarwals may be trying to avoid ad valorem taxes on their boat. They should review the property tax laws of these two states to determine if the property tax on the boat is owed based on where the boat is moored or where the owner resides (or possibly both). In addition, some other factor, such as where the boat is registered or titled, might be important.

18. (LO 6) In general, Federal excise taxes apply to fewer items than in the past. Lawmakers have focused on and increased certain Federal excise taxes (e.g., those on tobacco products, gasoline, and air travel).

19. (LO 6) Jayla could have been overcharged, but it is likely that at least part of the excess is attributable to a hotel occupancy tax and a car rental tax. In major cities, these types of excise taxes have become a popular way of financing capital improvements such as sports arenas and stadiums. Consequently, the amount of the taxes could be significant.

20. (LO 6)

    (1) **Income Taxes:** Income taxes and employment taxes both fall into this category of tax because they are based on the taxpayer's income.

(2) **Consumption Taxes:** Sales tax and VAT fall into this category because they apply when the taxpayer purchases something. Most excise taxes fall into this category because they relate to the purchase of something such as gasoline, tobacco, alcohol, or airline tickets. State severance taxes also fall into this category given that the extraction is for consumption. But some, such as the 1% excise tax that some corporations will pay on stock buybacks, are not related to consumption.

(3) **Wealth (or Valuation) Taxes:** Property taxes fall into this category because the tax base is the value of the property. Also, estate and gift taxes are computed on the value of the property given.

21. (LO 6)

    a. Jackson County must be in a state that imposes a lower (or *no*) sales tax. With certain major purchases (i.e., big-ticket items), any use tax imposed by the state of the Garcías' residence could come into play.

    b. In some states, the sales tax rate varies depending on the county and/or city.

    Note: Generally, buyers are subject to the sales and use tax rate where they live. For example, if the Garcías buy goods in a different state with a zero or lower sales tax rate than in their state, they owe use tax to their home state for the difference.

22. (LO 6) The base of the sales tax is not the same among all states. Clearly, Muriel lives in a state with an exemption from sales tax for the purchase of baby diapers while Caleb's state does not have such an exemption.

23. (LO 6) If the tax is imposed on the right to pass property at death, it is classified as an estate tax. If it taxes the right to receive property from a decedent, it is termed an inheritance tax.

    a. Some states impose both an estate tax and an inheritance tax. Some states (e.g., Florida and Texas) levy neither tax.

    b. The Federal government imposes an estate tax.

24. (LO 6) The annual transfers will allow Jake to use the annual gift tax exclusion to avoid tax on at least part of the transfers. For 2025 transfers, he will avoid any transfer tax on gifts made to an individual of $19,000 or less. The annual exclusion is indexed for inflation, so transfers in subsequent years may benefit from a larger annual exclusion. Using the annual exclusion will reduce the total amount of taxes on the transfers Jake will make to his friends.

    The tax on any transfers in excess of the annual exclusion will be offset by the unified transfer tax credit. Using part of the unified credit each year will reduce the credit available when he dies, potentially increasing the estate tax.

25. (LO 6)

    a. The purpose of the unified transfer tax credit is to eliminate the tax on all but substantial gifts and estates.

    b. Yes. The credit for 2025 is $5,541,800; for 2024, it is $5,389,800.

    c. Yes. The credit is available to cover transfers by gift or by death (or both), but the amount can be used only once.

26. (LO 6) $722,000. 19 donees (5 married children + 5 spouses + 9 grandchildren) × $19,000 (annual exclusion for 2025) × 2 donors (Elijah and Anastasia) = $722,000.

27. (LO 6) The individual income tax is progressive in nature; the corporate income tax is assessed at a flat 21% rate. In addition, the corporate income tax does not make any distinction as to deductions—only business deductions are allowed. Nor does it require the computation of adjusted gross income (AGI) or provide for the standard deduction and the deduction for qualified business income.

28. (LO 6)

    a. For state income tax purposes, "piggyback" means making use of what was done for Federal income tax purposes. By "decoupling," a state decides not to allow a particular Federal provision (e.g., exclusion, deduction, credit) for state income tax purposes.

    b. States often use IRS audit results to identify errors that might also exist on the taxpayer's state tax return.

    c. Most states allow their residents some form of tax credit for income taxes paid to other states.

29. (LO 6) What happened here likely is not a coincidence. The IRS probably notified the state of California regarding Hernando's omission of income, and California followed up with its own audit.

30. (LO 6) If Mike is drafted by a team in one of the listed states, he will escape state income tax on income earned within that state (e.g., training camp, home games). He will not, however, escape the income tax (state and local) imposed by jurisdictions where he plays away games. Called the "jock tax," it is applied to out-of-state athletes and entertainers.

31. (LO 6, 7)

    a. This type of question has no relevance to the state income tax but is a reminder to individual taxpayers about the use tax and a simple way for individual taxpayers to pay any use tax due on internet and mail-order purchases. Without the line on the state income tax return, individual taxpayers would be required to file a separate use tax return.

    b. As the preparer of the state income tax return, you should not leave questions unanswered unless there is a good reason for doing so. It appears that Hannah has no justifiable reason.

32. (LO 6) The checkoff boxes add complexity to the return and mislead taxpayers into presuming that they are not paying for the donation.

33. (LO 6)

    a. They uncover taxpayers who were previously unknown to the taxing authority. In addition, amnesty programs can bring taxpayers who are not in compliance with tax laws into compliance.

    b. Amnesty provisions can apply to other than income taxes (e.g., sales, franchise, severance).

c. No general amnesty program has been offered for any Federal taxes.

34. (LO 6)

a. FICA offers some measure of retirement security, and FUTA provides a modest source of income in the event of loss of employment.

b. FICA is imposed on both employer and employee, while FUTA is imposed only on the employer.

c. FICA is administered by the Federal government. FUTA, however, is handled by both the Federal and state government.

d. This applies only to FUTA. The merit system rewards employers who have low employee turnover because this reduces the payout of unemployment benefits.

35. (LO 6)

a. Unlike the Social Security portion of FICA, there is no dollar limit on the imposition of the Medicare tax.

b. The 0.9% Medicare addition applies to taxpayers with wages or net self-employment income in excess of $200,000 ($250,000 for married filing jointly).

36. (LO 6) Only children under age 18 who are employed in a parent's unincorporated trade or business are excluded from FICA. Other family members, including spouses, must be covered.

37. (LO 6)

a. Severance taxes are transaction taxes that are based on the notion that the state has an interest in its natural resources. The tax is imposed on the extraction of minerals.

b. Franchise taxes are levied on the right to do business in the state. Typically, they are imposed on corporations and are based on their capitalization.

c. Occupational fees are applicable to trades or businesses and are licenses to practice. Most are not significant revenue producers, and the amounts collected are utilized to defray the cost of regulating the profession.

d. Customs duties are taxes on the importation of certain foreign goods. They are imposed by the Federal government and are not found at the state and local level.

e. Export duties are taxes imposed on the export of certain commodities (e.g., oil, coffee). They are common in less-developed nations and are not levied by the United States.

38. (LO 6)

a. The United States is the only country in the OECD (Organization of Economic Cooperation and Development) that does not have a value added tax (VAT). Over 140 countries use a VAT. In spite of its extensive use by other countries, the adoption of a VAT by the United States appears doubtful. Instead, the United States places high reliance on the income tax as its major revenue source.

b. A VAT taxes the increment in value as goods move through the production and manufacturing stages to the marketplace. Although the tax is paid by the producer, it is reflected in the selling price of the goods. Therefore, a VAT is a tax on consumption.

c. Because it is an effective generator of revenue, the VAT has been criticized as leading to more government spending.

39. (LO 6)

a. Both the national sales tax and the VAT are taxes on consumption. Both taxes impose more of a burden on low-income taxpayers who must spend a larger proportion of their incomes on essential purchases relative to higher-income taxpayers. As a result, the taxes are regressive in effect.

b. The regressive effect might be partly remedied by granting some sort of credit, rebate, or exemption to low-income taxpayers.

40. (LO 6, 7) High. First, Serena is self-employed. Second, she operates partially on a cash basis. Third, the opportunity to understate income and/or overstate expenses is high. Fourth, she has some workers who appear to be misclassified and for whom she may not have issued tax reporting forms.

41. (LO 7)

a. A correspondence audit is probably involved. These audits involve a limited number of issues (i.e., taxpayer failed to report some dividend income) and most often are easily resolved.

b. An audit that is conducted in an IRS office is called an office audit.

c. The revenue agent's report (RAR) accepts the taxpayer's return as filed.

d. When a special agent becomes involved, this usually means that fraud is suspected.

42. (LO 7) In many unresolved audit disagreements at the agent level, the taxpayer should consider an appeal to the Independent Office of Appeals. Although it is part of the IRS, it is authorized to resolve audit disputes. It has greater settlement authority than does the agent. In many cases, a compromise reached at the Independent Office of Appeals can avoid a costly and time-consuming judicial proceeding.

43. (LO 7) The purpose of a statute of limitations is to preclude parties from prosecuting stale claims. The passage of time makes the defense of such claims difficult because witnesses and other evidence may no longer be available. In the Federal tax area, statutes of limitations cover additional assessments by the IRS and the pursuit of refund claims by taxpayers.

44. (LO 7)

a. The normal three-year statute of limitations will begin to run on the original due date of the return (usually the fifteenth day of the fourth month after year-end; April 15). When the return is filed early, the normal filing date controls.

b. Now the statute of limitations starts to run on the filing date. If the due date controlled (see part a. above), the taxpayer could shorten the assessment period by filing late.

c. If a return that is due is not filed, the statute of limitations does not start to run. It does not matter that the failure to file was due to an innocent error on the part of the taxpayer or adviser.

d. Regardless of the fact that an innocent misunderstanding was involved, there is no statute of limitations when a return is not filed.

45. (LO 7) No. Interest is not paid if the refund is made within 45 days of when the return was filed. However, a return is not considered filed until its due date. As a result, the period from April 15 to May 28, 2025 does not satisfy the 45-day requirement.

46. (LO 7, 8)

a. Normally, the three-year statute of limitations applies to additional assessments the IRS can make. However, if a substantial omission from gross income is made, the statute of limitations is increased to six years. A substantial omission is defined as omitting in excess of 25% of the gross income reported on the return.

b. No, it would not. The proper procedure would be to advise Andy to disclose the omission to the IRS. Absent the client's consent, do not make the disclosure yourself.

c. If Andy refuses to make the disclosure and the omission has a material carryover effect to the current year, you should withdraw from the engagement.

47. (LO 7) $4,000, determined as follows:

Failure to pay penalty [0.5% × $40,000 × 2 months]		$ 400
Plus:		
Failure to file penalty [5% × $40,000 × 2 months]	$4,000	
Less failure to pay penalty for the same period	(400)	3,600
Total penalties		$4,000

48. (LO 7)

a. $100,000 (20% × $500,000).

b. $375,000 (75% × $500,000). The answer presumes that civil (not criminal) fraud is involved.

49. (LO 7, 8)

a. No. Because no return was filed, the statute of limitations never runs. But even if a return had been filed, the three-year period for the 2021 tax return would not expire until April 15, 2025, three years after the normal due date for filing.

b. Although you can only recommend that the return be filed, you cannot force him to do so. However, you should not undertake the engagement for 2022 through 2024 if you cannot correctly reflect the tax liability due to the omission for 2021.

c. As a CPA, you should consider Circular 230, the AICPA Rules of Professional Conduct, the AICPA SSTSs (assuming you are a member of the AICPA), and the rules of conduct for the state where you have your CPA license.

50. (LO 8) The SSTSs are available at: **aicpa-cima.com/resources/download/revised-statements-on-standards-for-tax-services-no-1-4-1-1-2024**.

    a. While it is fine and usually beneficial to use tax preparation software, the preparer should be sure they understand how the software works and verify at least a sampling of items on returns and review all returns for completeness and accuracy. For a new tax calculation such as the renter's credit, the preparer should be sure they understand how the credit is computed and then apply the provision to a variety of fact patterns (e.g., single taxpayers versus married taxpayers) without tax software and compare it to the software's calculation of the credit to ensure that the software is computing the credit correctly.

    b. As noted in SSTS 1.4, members are responsible for their work product and should take "reasonable steps" to be sure any tools they use "are appropriate for the intended purpose." A preparer should not rely on artificial intelligence (AI) to produce a tax answer for a client. If appropriate in terms of security and privacy, AI can be used, similar to conducting research, but as with any other research tool or resource, the preparer must still fully analyze and review the results for accuracy, completeness, and whether current tax law is appropriately applied.

51. (LO 7, 8) The practice of outsourcing the preparation of tax returns is ethical if three steps are taken.

    - Maintain client confidentiality.
    - Verify the accuracy of the work done.
    - Notify the client, preferably in writing, of the outsourcing.

Research Problems

These research problems require that students utilize online resources to research and answer the questions. As a result, solutions may vary among students and courses. You should determine the skill and experience levels of the students before assigning these problems, coaching where necessary. Encourage students to use reliable websites and blogs of the IRS and other government agencies, media outlets, businesses, tax professionals, academics, think tanks, and political outlets to research their answers.

1. The sole proprietor is subject to Federal taxes on income, self-employment and payroll taxes (if the sole proprietor has employees), and the gasoline excise tax. State taxes include income and sales and use taxes. Local taxes include property tax, business license tax, and perhaps income tax.

2. An example of a carbon tax proposal of the 117th Congress is S. 1167, End Polluter Welfare Act. An example of a financial transaction tax proposal of the 118th Congress is H.R. 4119, Tax on Wall Street Speculation Act. Students might also find plans for these types of taxes that do not have legislative language.

3. An example of a sweetened beverage tax proposal is H.R. 2772 (117th Congress), the SWEET Act. Proposals also exist in a number of states and cities. Some cities, including Berkeley, California, Philadelphia, Pennsylvania, and Boulder, Colorado, have

already enacted soda taxes. Considerations in analyzing these proposals include issues of regressivity (an equity and fairness issue), complexity of definitions, burden of enforcement, and neutrality in affecting decision making. Cook County, Illinois (Chicago) passed and then repealed a sweetened beverage tax due to a number of these issues.

4. Each of the Big Four firms has information on data analytics and how it can be used for tax purposes:

    - **pwc.com/us/en/services/consulting/cloud-digital/data-analytics.html**
    - **kpmg.com/xx/en/what-we-do/services/tax/global-indirect-tax-services/data-and-analytics.html**
    - **ey.com/en_us/big-data-analytics**
    - **www2.deloitte.com/us/en/pages/deloitte-analytics/solutions/deloitte-analytics.html**

    Students should also find how the IRS and state tax agencies are using big data to improve audit selection and enforcement. For example, see IRS information in the Internal Revenue Manual (IRM) 1.1.18, Research, Applied Analytics and Statistics Division at:

    - **irs.gov/irm/part1/irm_01-001-018**

5. The Safeguards Rule was created as part of the Gramm-Leach-Bliley Act in 1999 (P.L. 106–102). The FTC summarizes this rule as follows: "The Safeguards Rule requires financial institutions under FTC jurisdiction to have measures in place to keep customer information secure. In addition to developing their own safeguards, companies covered by the Rule are responsible for taking steps to ensure that their affiliates and service providers safeguard customer information in their care." This rule applies to all paid return preparers.

    - **ftc.gov/business-guidance/resources/ftc-safeguards-rule-what-your-business-needs-know**

    IRS Publication 4557 includes several actions preparers should take to protect client data and meet the Safeguards Rule. In reviewing student answers, confirm that they understand the Safeguards Rule and why a preparer obtaining or renewing a PTIN is asked to confirm that they have a data security plan. The publication lists numerous actions, consider whether the three plan elements the student describes are among the most important.

    In August 2022, the IRS Security Summit released a document with explanation and templates to help practitioners update or create a security plan. See IR–2022–147 (August 9. 2022) at **irs.gov/newsroom/security-summit-releases-new-data-security-plan-to-help-tax-professionals-new-wisp-simplifies-complex-area**. The template provided in August 2022 for a Written Information Security Plan (WISP) was updated in August 2024. See IR–2024–208 (August 13, 2024) at **irs.gov/newsroom/irs-security-summit-release-new-written-information-security-plan-to-help-tax-pros-protect-against-identity-thieves-data-risks**.

6. Circular 230 § 10.35 on competence states that a practitioner may become competent for an engagement matter in a variety of ways, including by consulting with experts or studying the law. As a result, if someone at the firm gains a better understanding of virtual currency transactions, the record keeping needed to determine the tax consequences of over 2,500 trades and also consider other rules (e.g., the trader versus investor status of the client), they can accept this client. If the firm is not able to become competent, they may not accept this potential new client.

Solution To Ethics & Equity Feature

Making Good Use of Out-of-State Relatives (p. 1-23). Who is the true purchaser of the watch? If the aunt really made the purchase with her funds and then gave the watch to Marcus, no sales or use tax evasion has occurred. More likely, the purchase was made by Marcus indirectly through his aunt—the aunt being reimbursed by Marcus or using funds provided by him. If that is the case, Marcus owes a sales tax on the purchase. Presuming the matter comes to light—the jewelry store might be the weak link—Marcus could be subject to prosecution for tax evasion.

Solutions To Becker CPA Review Questions

1. **Choice "a" is correct.** Treasury Department Circular 230 is the IRS publication that addresses the practice before the IRS of practitioners with regard to the rules governing the authority to practice before the IRS, the duties and restrictions relating to practice before the IRS, the sanctions for violations of the regulations, and the rules applicable to disciplinary proceedings.

   Choice "b" is incorrect. Treasury Department Circular 230 does not provide guidance for practicing before the U.S. Tax Court but provides guidance for practicing before the IRS.

   Choice "c" is incorrect. Treasury Department Circular 230 does not address presenting before state boards of accountancy but provides guidance to practitioners on practicing before the IRS.

   Choice "d" is incorrect. The standards for the financial reporting of income taxes are found in Accounting Standards Codification (ASC) Section 740, not Treasury Department Circular 230.

2. **Choice "b" is correct.** All of the other choices are required conduct by a preparer of an income tax return. A preparer must make a reasonable attempt to obtain the necessary information from the taxpayer and make inquiries if the information appears to be incorrect or incomplete. The preparer is not responsible for verifying taxpayer-provided information. The taxpayer is actually responsible for providing the preparer with accurate information.

   Choices "a," "c," and "d" are incorrect, as they are all required conduct by a preparer of an income tax return. A preparer must:

   - Legally minimize the taxpayer's tax liability and abide by the tax code.

- Make a reasonable effort to obtain the necessary information from the taxpayer and make inquiries if the information appears to be incorrect or incomplete.
- Recommend a tax return position only if the preparer has a good faith belief that the position has a realistic possibility of being sustained if challenged.
- Notify the taxpayer if he or she becomes aware of a tax return error.
- Inform the taxpayer on how to correct the situation of the taxpayer having failed to file a tax return.
- Consider withdrawing from the engagement if the taxpayer does not correct the error or file the return the preparer advised him or her about.
- Not inform the IRS without the taxpayer's permission.

Instructor Guide

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Chapter Objectives

The following objectives are addressed in this chapter:

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

1.2 Explain the factors that impact the Federal tax law and identify examples of their effect.

1.3 Explain the role played by the IRS and the courts in the evolution of the Federal tax system.

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

1.5 Apply principles of good tax policy relevant to the design of a tax system.

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

1.7 Explain the administration of the tax law, including the audit process utilized by the IRS.

1.8 Evaluate some of the ethical guidelines involved in tax practice.

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Chapter Outline

In the outline below, each element includes references (in parentheses) to related content. "CO CH.##" refers to the chapter objective; "PPT Slide #" refers to the slide number in the PowerPoint deck for this chapter (provided in the PowerPoints section of the Instructor Resource Center); and, as applicable for each discipline, accreditation or certification standards ("BL 1.3.3"). Introduce the chapter and use the Ice Breaker in the PPT if desired, and if one is provided for this chapter. Review learning objectives for Chapter 1 (PPT Slides 2–4).

I. Approaching the Study of Taxation (1.1, PPT Slides 10–16)

   a. What Is Taxation?
      i. "Taxes are what we pay for civilized society." – Oliver Wendell Holmes, Jr.
      ii. The primary purpose of taxation—to raise revenue for government operations.
      iii. Taxation is often used as a tool to influence the behavior of individuals and businesses.
         1. An income tax credit may be designed to encourage people to purchase a fuel-efficient car.
         2. A tobacco excise tax may discourage individuals from smoking.
   b. Taxation in Our Lives
      i. Individuals are affected most directly by taxes when they need to pay them.
         1. A direct tax is one paid by the taxpayer directly to the government imposing it (i.e., personal income tax and property taxes).
         2. Taxes can be imposed indirectly when embedded in the prices charged by a seller of goods or services. For example, a renter indirectly pays property taxes assessed on the landlord (who will consider that cost when determining how much rent to charge).
      ii. Ultimately, all taxes are paid by individuals.
      iii. Federal, state, and local elections often include initiatives that deal with taxation, such as whether state income taxes should be raised (or lowered), whether a new tax should be imposed on plastic grocery bags, or whether the sales tax rate should be changed.
   c. The Relevance of Taxation to Accounting and Finance Professionals
      i. Accounting and finance professionals must understand the various types of business taxes to assist effectively with compliance; planning; financial reporting; Environmental, Social, and Governance (ESG) reporting; controversy; cash management; data analysis; and tax advocacy.

- ii. The level and depth of tax knowledge needed for any accounting or tax professional depends on the specific job.
- iii. Much of taxation is transaction-based. The transactions in which a taxpayer engages, and how those transactions are structured, can meaningfully impact the taxpayer's tax liability.

d. How to Study Taxation
- i. The goal of studying taxation is to be able to recognize issues (or transactions) that have tax implications and, when possible, what those implications are.
- ii. Taxation is an important and exciting topic due to its relation to the government's ever-changing economic, social, and political goals and its significance to the bottom line of a company and an individual's finances.
- iii. In studying taxation, focus on understanding the rules and the why(s) behind them. Also consider how the rules apply to different types of taxpayers and to taxpayers of varying levels of income and financial sophistication.

II. Understanding the Federal Tax Law (1.2, PPT Slides 17–22)

- i. The Federal tax law is shaped by all three branches of our Federal government.
  1. The primary objective of any tax system is to raise the revenue needed to fund government operations.
  2. Other considerations (economic, social, equity, and political factors) also play a significant role. The Treasury Department, the IRS, and the courts also have significant impacts on the evolution of Federal tax law.

a. Revenue Needs
- i. When enacting tax legislation aimed at non-revenue goals, a deficit-conscious Congress often has been guided by the concept of revenue neutrality so that the legislation neither increases nor decreases the net revenues received by the government.
- ii. When tax reductions are involved, the full impact of the legislation can be phased in over a period of years. Or, as an alternative, the tax reduction can be limited to a period of years. When the period expires, the prior law is reinstated through a sunset provision.

b. Economic Considerations
- i. Regulating the Economy.
  1. Congress has often used the tax depreciation rules as a means of encouraging investment in business assets.
  2. Longer asset lives and use of straight-line depreciation should discourage capital outlays.
  3. Congress also uses incentives such as bonus depreciation to stimulate the economy when needed.
- ii. Encouragement of Certain Activities.

1. Congress also uses the tax law to encourage certain types of economic activity or segments of the economy.
2. Tax law addresses the nation's energy policy—in terms of both our reliance on carbon-based fuels and the need to ease the problem of climate change.
3. The tax law encourages savings, which can be used to help finance business expansion and home construction, by giving private retirement plans preferential treatment.

iii. Encouragement of Certain Industries.
1. Historically, agricultural activities have been favored under Federal tax law.
2. The tax law favors the development of natural resources by permitting the use of percentage depletion and an immediate deduction (rather than a capitalization) of certain exploration costs.
3. The railroad and banking industries also receive special tax treatment under Federal tax law.

iv. Encouragement of Small Business.
1. Small business development is encouraged under the tax law.
2. The shareholders of a small business corporation can make an election that allows the profits (or losses) of the corporation to flow through to its shareholders, avoiding the corporate income tax.
3. Another provision allows non-corporate shareholders of certain small corporations to exclude from income their gain from the sale of the stock if held over five years.

c. Social Considerations

i. Some provisions of the Federal tax law, particularly those dealing with individuals, can be explained by social considerations.
1. Accident and health plans financed by employers.
2. Group term life insurance coverage for employees.
3. Qualified pension or profit sharing plans for employees.
4. Deduction for contributions to qualified charities.
5. The credit for child and disabled dependent care.
6. The earned income credit provides relief for low-income taxpayers.
7. Credits made available to individuals aged 65 and older. Credits allowed to businesses that incur expenditures to make their facilities more accessible to the disabled.
8. Various tax credits, deductions, and exclusions to encourage additional education.
9. The disallowance for certain expenditures that are contrary to public policy.

d. Equity Considerations

i. Though the desire for a fair and equitable tax law is ubiquitous, agreement on what is “fair” can be anything but.
    1. A tax that imposes the same tax rate on all taxpayers regardless of their ability to pay is a *proportional* tax.
    2. The concept of equity also appears in tax provisions that alleviate the effect of multiple taxation and postpone the recognition of gain when the taxpayer lacks the ability or wherewithal to pay the tax.

ii. Alleviating the Effect of Multiple Taxation. Because double taxation results when the same income is subject to both foreign and U.S. income taxes, the tax law permits the taxpayer to choose between a credit and a deduction for the foreign taxes paid.

iii. The Wherewithal to Pay Concept. Regarding the wherewithal to pay concept (recognizes the inequity of taxing a transaction when the taxpayer lacks the means with which to pay the tax), the text illustrates its application with an involuntary conversion situation. By and large, most wherewithal to pay provisions in the tax law do not permanently avoid gain or loss recognition but operate on a deferral principle (e.g., like-kind exchanges and involuntary conversions). Because of the basis carryover rules, gain or loss recognition merely is postponed to some further disposition that does not meet the requirements of a nontaxable exchange.
    1. Involuntary conversion. If all of the proceeds from an involuntary conversion are invested within the required statutory time period in property that is similar or related in service or use, none of the realized gain is recognized.
    2. Transfer of property to a controlled corporation. A transfer of property to a controlled corporation results in no recognition of gain or loss to the transferor if solely common stock is received in exchange.

iv. Mitigating the Effect of the Annual Accounting Period Concept. The accounting period used to report taxable income and settle any tax liability is one year and is referred to as the annual accounting period concept.
    1. The annual accounting period concept can lead to different tax treatment for taxpayers who are in the same economic position.
    2. Carryback and carryover procedures help mitigate the effect of limiting a loss or a deduction to the accounting period in which it was realized, allowing a taxpayer to salvage a loss or deduction that might otherwise be lost.

v. Coping with Inflation.
    1. Because of the progressive nature of the income tax, a wage adjustment to compensate for inflation could place the employee in a higher income tax bracket. Known as bracket creep, its overall impact is an erosion of purchasing power.

2. Congress recognizes this problem and adjusts various income tax components, such as tax brackets, standard deduction amounts, and a wide variety of other items, through an indexation procedure. Indexation is based on the change in the chained consumer price index over the prior year.

e. Political Influence
    i. Because the tax law is enacted by Congress, it is often influenced by political considerations.
    ii. Special Interest Legislation. The classic example of special interest legislation is the special treatment allowed prepaid subscription and dues income.
        1. Although other types of prepaid income (e.g., rents) are taxed when received, dues and subscriptions are taxed as earned.
        2. Historically, the special relief was the work of the American Automobile Association which desired relief from having to recognize income on the receipt of multi-year dues income.
    iii. Special interest legislation is not necessarily to be condemned if it can be justified on economic, social, or some other utilitarian grounds.
    iv. Political Expediency Situations. Various tax changes can be tied to the shifting moods of the American public.
        1. Measures that deter more affluent taxpayers from obtaining preferential tax treatment have always had popular appeal. Examples include:
            - Imputed interest rules.
            - Limitations on the deductibility of interest on investment indebtedness.
        2. Some provisions phase out tax breaks as income rises. These phaseouts are called “stealth taxes.” Examples include the phaseout of the child tax credit and education tax credits.
    v. State and Local Government Influences. Another change that the community property system has brought to the Federal tax law is the marital deduction allowed for estate and gift tax purposes.
        1. In a community property jurisdiction, the motivation to make gifts between spouses to balance their potential estates is not as severe as in common law jurisdictions, given that each spouse already owns one-half of any community property.

f. Influence of the Internal Revenue Service (1.3, PPT Slides 23–26)
    i. Tax Enforcement. Congress passes laws to close the loopholes that taxpayers have located and exploited. In addition, Congress has passed laws that enable the IRS to make adjustments based on the substance of a transaction. For example, the IRS can make adjustments to a taxpayer’s method of accounting when the method used by the taxpayer does not clearly reflect income.

ii. Tax Administration. Many provisions in the tax law simplify the audit function of the IRS.
    1. Congress long ago realized the importance of placing taxpayers on a pay-as-you-go basis. Withholding procedures apply to wages, but the tax on other types of income may have to be paid via quarterly estimated payments.
    2. Congress has passed many provisions that impose interest and penalties on taxpayers if they don't comply with the tax law.
    3. The audit process conducted by the IRS is key to an effective administration of our tax system. To carry out this function, the IRS is aided by provisions that reduce the chance of taxpayer error or manipulation, thus simplifying the audit effort.

g. Influence of the Courts
  i. Judicial Concepts and Doctrines Relating to Tax. A leading tax concept developed by the courts deals with the interpretation of tax provisions that operate to benefit taxpayers.
    1. If a taxpayer wants a relief provision to apply, the taxpayer must meet the provision's requirements (i.e., no exceptions).
    2. The arm's length concept is applied in dealings between related parties. Transactions may be tested by asking this question: Would unrelated parties have handled the transaction in the same way?
  ii. Judicial Influence on Statutory Provisions.
    1. Some court decisions have been so important that Congress incorporated them into the Internal Revenue Code.
    2. On occasion, Congress reacts negatively to judicial interpretations of the tax law.

III. A Brief History of U.S. Taxation (1.4, PPT Slides 27–32)

a. Early Periods
  i. An income tax was first enacted in America in 1634 by the English colonists in the Massachusetts Bay Colony, but the U.S. Federal government did not adopt an income tax until 1861.
  ii. Both the U.S. Federal Union and the Confederate States of America used the income tax to raise funds to finance the Civil War. When the Civil War ended, the income tax was repealed.
  iii. A new Federal income tax on individuals was enacted in 1894.
    1. In *Pollock v. Farmers' Loan and Trust Co.*, the U.S. Supreme Court found the income tax applicable to individuals unconstitutional.
    2. However, the Court did not hold that a tax on income from personal services was unconstitutional.
  iv. The Federal corporate income tax, enacted in 1909, was held to be constitutional because it was deemed to be an excise tax. In essence, it was considered to be a tax on the right to do business

in corporate form. It was likened to a form of franchise tax. Because a corporation is an entity created under state law, jurisdictions possess the right to tax its creation and operation. Note that many states still impose franchise taxes on corporations under this rationale.

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

b. Revenue Acts
   i. Revenue Act of 1913.
      1. Allowed various deductions and personal exemptions.
      2. Large exemptions excluded all but the more wealthy taxpayers from the new income tax.
      3. Rates ranged from a low of 1% to a high of 6%. The 6% rate applied only to taxable income in excess of $500,000.
   ii. Various revenue acts were passed between 1913 and 1939. In 1939, all of these revenue laws were codified (arranged in a systematic manner) into the Internal Revenue Code of 1939.
      1. A similar codification took place in 1954.
      2. The Internal Revenue Code of 1986, which largely carries over the provisions of the 1954 Code, is our current law.

c. Trends
   i. The income tax is a major source of revenue for the Federal government (see Exhibit 1.1 in the text). The need for revenues to finance World War II converted the income tax from one that applied mostly to high-income individuals to a mass tax.
   ii. The complexity of current tax laws forces taxpayers to seek assistance in preparing returns: more than one-half pay a preparer and most of these returns are prepared using tax software.
   iii. New ways of doing business and living often require changes and/or clarifications to the tax law. Ideally, lawmakers should review tax systems periodically to ensure that they continue to be efficient in light of changes in how businesses and individuals function.

IV. Tax System Design (1.5, PPT Slides 33–39)

a. Legal Foundation
   i. The U.S. Constitution gives Congress the power to “lay and collect taxes” and also provides some limits on this taxing power, which led to enactment of the Sixteenth Amendment to allow for an income tax.
   ii. The jurisdiction’s underlying governing documents must be reviewed to determine whether they impose any restrictions relevant to taxation.

b. The Basic Tax Formula
    i. Basic tax formula is: Tax base × Tax rate = Tax liability
    ii. Tax Base. The tax base is the amount of the item subject to tax.
    iii. For Federal income tax, the tax base is taxable income.
    iv. Tax Rates. Some taxes, like the sales tax and gasoline excise tax, apply a fixed tax rate to all levels of the tax base. Income taxes tend to use a progressive tax rate structure where a higher rate of tax applies as the tax base increases.

c. Tax Principles
    i. Adam Smith's (*The Wealth of Nations*) canons of taxation.
        1. Equity. Each taxpayer enjoys fair or equitable treatment by paying taxes that reflect his or her relative ability to pay.
        2. Certainty. Taxpayers need to be able to understand how tax rules work so that they understand the effect of the rules on various transactions and when and how the tax should be paid.
        3. Convenience of payment. Taxes should be imposed at a time, and in a manner, that makes payment most convenient.
        4. Economy in collection. A "good" tax system involves only nominal collection costs by the government and minimal compliance costs on the part of the taxpayer.
    ii. The American Institute of Certified Public Accountants (AICPA) has issued the *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*. It identifies 12 principles that are commonly used as indicators of desirable tax policy. See Exhibit 1.2 in the text for an application of these principles to a proposed tax law change.

V. Types of Taxes (1.6, PPT Slides 40–79)

a. Property Taxes
    i. Ad valorem taxes on realty look to the value of the property as the base for the imposition of the tax. How such value is determined varies and often is subject to controversy between the property owner and the taxing authority.
    ii. Property taxes fall into two categories: those imposed on real property (land and buildings) and those imposed on personal property (assets other than land and buildings).
    iii. Whether a property tax is based on value (i.e., ad valorem) could be important for income tax purposes.
    iv. Ad Valorem Taxes on Real Property. Realty is land and anything permanently attached to land.
    v. Ad valorem taxes are exclusively within the province of the states and their local political subdivisions.
    vi. Ad Valorem Taxes on Personal Property. Personalty encompasses all assets that are not realty. Both realty and personalty can be either business use or personal use.

vii. Personal property can also be classified as tangible property or intangible property. For ad valorem tax purposes, intangible personalty includes stocks, bonds, and various other securities (e.g., bank shares).

b. Transaction Taxes
   i. Transaction taxes include Federal and state excise taxes and state and local general sales taxes, severance taxes, death taxes, and gift taxes.
   ii. Federal Excise Taxes. Examples of Federal excise taxes include those imposed on tobacco products, fuel and gasoline sales, and air travel.
      1. Excise taxes are imposed on the purchase of specific goods and services.
   iii. State and Local Excise Taxes.
      1. All states tax the sale of gasoline, liquor, and tobacco products. However, the rates vary significantly.
      2. Excise taxes found at some state and local levels include those on admission to amusement facilities, on the sale of playing cards, and on prepared foods.
      3. Some counties impose a transaction tax on the transfer of property that requires the recording of documents (e.g., real estate sales).
      4. In recent years, two types of excise taxes imposed at the local level have become increasingly popular: the hotel occupancy tax and the rental car "surcharge."
   iv. General Sales Taxes. The difference between an excise tax and a general sales tax is tied to the scope of the transaction covered by the tax.
      1. Sales tax. A general sales tax is imposed on purchases more generally (e.g., a 5% tax on *all* retail sales).Some states exempt certain items from the general sales taxes (e.g., groceries, medicines, and drugs).
      2. Use tax. Every state that has a general sales tax also imposes a use tax. The purpose of the use tax is to prevent the avoidance of the sales tax through the purchase of items in other states that have no sales taxes or that provide for lower rates. A use tax is an ad valorem tax, usually at the same rate as the sales tax, on the use, consumption, or storage of tangible property. Alaska, Delaware, Montana, New Hampshire, and Oregon do not impose sales or use taxes.
      3. Sales tax holidays are becoming more popular. Many states schedule the holiday in summer for back-to-school buying or to encourage the purchase of energy-conserving appliances and hurricane preparedness items.
   v. Severance Taxes.

1. Severance taxes are transaction taxes that are based on the notion that the state has an interest in its natural resources.
2. These taxes are imposed when natural resources are extracted.

c. Wealth Transfer Taxes

i. At the Federal level, these taxes are intended to serve as a backstop to the income tax by imposing tax on income that escapes the income tax and to reduce large concentrations of wealth within families across generations.
   1. An estate tax applies to transfers made upon the death of an individual. The tax is imposed on the estate of the decedent rather than the person receiving the property.
   2. The gift tax, intended to prevent individuals from avoiding the estate tax, is applied to transfers made by an individual while they are still alive.
   3. An inheritance tax is levied on heirs receiving property from a decedent.

ii. The Federal Estate Tax. The Federal estate tax does not apply to all estates; only estates over a certain value are taxed. To accomplish this, the unified transfer tax credit is applied against the value of the estate. To the extent that the credit does not reduce the value of the estate to zero, the estate tax applies. For 2025, the credit exempts taxable transfers of up to $13,990,000, meaning that the vast majority of estates pass tax-free to the heirs.

iii. The Federal Gift Tax. The purpose of the Federal gift tax is to preclude avoidance of the Federal estate tax.
   1. In this regard, note that the Federal estate tax preceded the Federal gift tax.
   2. In 2025, the Federal gift tax allows each donor an annual exclusion of $19,000 for gifts to each donee ($18,000 in 2024).
   3. Apparently, most states do not consider the tax avoidance potential as being significant, given that only a few have seen fit to enact a state gift tax.

iv. Gift splitting effectively allows the annual exclusion to double.

v. The gift tax and estate tax rate schedules are the same. The schedule is commonly referred to as the unified transfer tax rate schedule.

vi. The unified transfer tax is cumulative in effect. What this means is that the tax base for current taxable gifts includes past taxable gifts. The unified transfer tax credit is available for all taxable gifts. As was the case with the Federal estate tax, the credit for 2025 is $5,541,800 (which covers taxable gifts up to $13,990,000) and for 2024 is $5,389,800 (which covers taxable gifts up to $13,610,000). There is, however, only one unified transfer tax credit, and it applies to both taxable gifts and the Federal estate tax. Once the unified transfer tax credit has been used up for Federal gift tax purposes, any transfers at death will be subject to the Federal estate tax.

vii. Making lifetime gifts of property carries several tax advantages over passing the property at death.
    1. If income-producing property is involved, a gift may shift subsequent income to donees in a lower income tax bracket.
    2. If the gift involves property that is expected to appreciate in value, future increases in value will be assigned to the donee and will not be included in the donor's estate.
    3. Due to the annual exclusion ($19,000 per done in 2025; $18,000 per donee in 2024), some of the gift can escape tax.

d. Income Taxes
    i. Income taxes are levied by the Federal government, most states, and some local governments. Most jurisdictions attempt to ensure the collection of income taxes by requiring pay-as-you-go procedures.
    ii. Federal Income Taxes. With reference to income taxes, the following observations would be useful.
        1. Exhibit 1.3 in the text illustrates the formula for the Federal income tax imposed on individuals.
        2. The Federal corporate income tax is not progressive, but instead uses a flat tax rate of 21%. Also, it does not include the computation of adjusted gross income (AGI) and does not provide for the standard deduction or the deduction for qualified business income.
    iii. State Income Taxes. Common characteristics of state income taxes include:
        1. "Piggyback" concept. The trend as to state income taxes is to use the Federal tax base for income determination. Most states have gone with the "piggyback" concept whereby the state income tax liability is calculated as a flat rate applied to an adjusted Federal taxable income amount.
        2. Some states "decouple" from selected Federal tax changes passed by Congress. The purpose of the decoupling is to retain state revenue that would otherwise be lost.
        3. Many state income tax returns provide checkoff boxes for donations to various causes. Many are dedicated to medical research and wildlife programs, but special projects are not uncommon.
        4. Some states have occasionally instituted amnesty programs that allow taxpayers to pay back taxes (and interest) on unreported income with no (or reduced) penalty. In many cases, the tax amnesty has generated enough revenue to warrant the authorization of follow-up programs covering future years.

Amnesties usually include other taxes as well (e.g., sales, franchise, and severance).

iv. Local Income Taxes. Cities imposing an income tax include Baltimore, Cincinnati, Cleveland, Detroit, Kansas City (Missouri), New York, Philadelphia, and St. Louis. The application of a city income tax is not limited to city residents.

e. Employment Taxes

i. There are two major employment taxes: FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act). Both taxes can be justified by social and public welfare considerations. A limitation exists depending on the employment relationship (i.e., employee versus self-employed).

ii. FICA Taxes.

1. Uncertainty of future FICA rate and base amounts. In this regard, mention the uncertainty that exists as to future increases.
2. Employee income tax credit for excess FICA withholdings. Relief is provided an employee (i.e., an income tax credit) in the case of excess FICA tax withholdings.
3. The Social Security tax rate is 6.2% (and generally does not change), and the Medicare tax rate is 1.45%. The base amount for Social Security is $176,100 for 2025 ($168,600 for 2024). There is no limit on the base amount for the Medicare tax. The employer must match the employee’s portion for both Social Security tax and Medicare tax.
   - An additional 0.9% tax is imposed on earned income (including self-employment income) above $200,000 (single filers) or $250,000 (married filing jointly).
   - Unlike Social Security and the regular Medicare portion, an employer does not have to match the employees’ 0.9% tax.

iii. Taxes Related to FICA Taxes.

1. Self-Employment Tax. Taxpayers who are not employees (e.g., sole proprietors, independent contractors) are subject to a form of Social Security tax known as self-employment tax. The applicable rate is 12.4% for Social Security and 2.9% for Medicare tax, or twice that applicable to an employee.
2. Net Investment Income Tax (NIIT). A tax of 3.8% is imposed on net investment income when a taxpayer’s modified adjusted gross income (MAGI) exceeds $250,000 for married taxpayers and $200,000 for single taxpayers.

iv. FUTA Taxes.

1. The purpose of the FUTA tax is to provide funds the states can use to administer unemployment benefits. This should be contrasted with the retirement objective of the FICA tax.
2. Unlike FICA, the incidence of FUTA falls solely on the employer.

3. For 2025, FUTA is 6% on the first $7,000 of covered wages. Merit rating credits may reduce the tax to a much lower percentage.
4. Unlike FICA, FUTA requires compliance with both Federal and state provisions.

f. Other Current Taxes
   i. View the summary of taxes in the United States in Concept Summary 1.2 in the text.
   ii. Federal Customs Duties. Customs duties are variously described as import taxes and tariffs.
      1. These levies served as the mainstay of the Federal revenue system until slightly after the turn of the nineteenth century. Tariffs and excise taxes alone paid off the national debt in 1835 and enabled the U.S. Treasury to pay a surplus of $28 million to the states.
      2. In recent years, tariffs have been an instrument for carrying out protectionist policies and generating revenue.
      3. History shows that tariffs often lead to retaliatory action on the part of the nation or nations affected.
   iii. Miscellaneous State and Local Taxes.
      1. Most states impose a franchise tax on corporations for the right to do business in the state.
      2. Generally, the tax is based on the capitalization of the entity.
      3. Similar to the franchise tax are occupational fees that apply to various trades or businesses (e.g., a liquor store license; a taxicab permit; or a fee to practice a profession such as law, medicine, or accounting). Most of these are not significant revenue producers, and the fees are used to fund the costs of regulating the business or profession in the interest of the public good.

g. Proposed U.S. Taxes
   i. Tax reform discussions over the past few decades have included the possibility of using a consumption tax to replace or supplement the income tax.
   ii. National Sales Tax.
      1. Would operate similarly to most state sales taxes although the tax base would be different from what states use today. The rate would need to be much higher to generate the revenues needed to replace the Federal income tax.
      2. The proposed “Fair Tax” is a type of national sales tax.
         - 23% tax on all purchases, including food and medicine, real property, and many types of services.
         - Exempt items are business expenses, used goods, and education costs.

- The Fair Tax would replace income tax (both individual and corporate), payroll taxes, and gift and estate taxes.

iii. Value Added Tax. Similar to a sales tax but is imposed at each level of the production process.
   1. While ultimate consumers bear the entire burden of the tax, the tax is collected piecemeal throughout the production process. This form of VAT—a credit invoice VAT—is similar to a sales tax. It is viewed as more efficient than a sales tax because assessment throughout the production process better ensures collection of the tax.
   2. A VAT has been considered in the United States various times since the 1960s.
   3. One challenge of implementing a VAT in the United States is that it is a regressive tax. As a result, adjustments need to be implemented to protect lower-income taxpayers. Another challenge is that a VAT is similar to a sales tax which would cause a Federal VAT to increase the cost of items already subject to state sales tax.

iv. Flat Tax. The term “flat tax” is often used to refer to a tax rate structure in which the tax rate is the same at all levels of the tax base.
   1. This proposal achieves some of the administrative advantages of a value added tax (VAT) relative to a sales tax while also partially addressing concerns that consumption taxes impose a relatively heavier tax burden on lower-income taxpayers.
   2. Wages, pension contributions, materials costs, and capital investments are deducted directly from the tax base.
   3. Individuals (or households) are assessed a 19% flat-rate tax on wages and pension benefits above an exemption of $25,500 for a family of four. No other income is taxable, and no other deductions are allowed.

v. Carbon Tax. Aims to help reduce carbon emissions. The tax could be applied to fossil fuels based on their level of greenhouse gas emissions. Some people suggest a higher gasoline excise tax as a simple form of a carbon tax.

vi. Financial Transaction Tax. A financial transaction tax can take many forms.
   1. For example, it could be imposed on the value of financial instruments purchased.
   2. It could be restricted in some way (e.g., only applying to high-frequency trading).
   3. It could be imposed on the value of bank assets.
   4. Because the tax base is quite large, the tax rate would likely be low, perhaps even less than 1%.

5. The primary concern with this type of tax is the possible adverse effects on financial markets.

vii. Space Flight Excise Tax. With the growth of commercial space flight activity, Congress is evaluating whether to assess specific taxes on these commercial ventures, similar to the excise tax on airline tickets. The Securing Protections Against Carbon Emissions (SPACE) Tax Act proposal is also intended to help address the externalities of the emissions resulting from rocket launches.

VI. Tax Administration (1.7, PPT Slides 80–95)

a. The Internal Revenue Service
   i. The responsibility for administering and enforcing the Federal tax laws rests with the Internal Revenue Service (IRS), a division of the U.S. Treasury Department.
   ii. The Commissioner of the IRS is appointed by the President and is responsible for establishing policy and supervising IRS activities.

b. The Audit Process
   i. Selection of Returns for Audit. Only a small number of tax returns are audited each year. The probability for audit increases for higher-income taxpayers. Tax returns are selected for audit in different ways:
      1. A common technique for individuals is called information matching. For example, the IRS compares information returns it receives to an individual's tax return.
      2. Certain groups of taxpayers are subject to audit much more frequently than others. These groups include individuals with large amounts of gross income, self-employed individuals with substantial deductions, and taxpayers with prior tax deficiencies.
      3. If information returns are not in substantial agreement with reported income, an audit can be anticipated.
      4. If an individual's itemized deductions are in excess of averages established for various income levels, the probability of an audit is increased.
      5. Filing of a refund claim by the taxpayer may prompt an audit of the return.
      6. Information obtained from other sources (e.g., informants and news items) may lead to an audit.
   ii. Types of Audits. Note the differences between the various types of audit (i.e., correspondence, office, and field).
      1. If the issue is minor, the matter often can be resolved simply by correspondence between the IRS and the taxpayer.
      2. An office audit usually is restricted in scope and is conducted in IRS offices.

3. A field audit involves an examination of numerous items reported on the return and is conducted at the taxpayer's location or that of the taxpayer's representative.
4. At the end of an audit, the examining agent issues a Revenue Agent's Report (RAR) that summarizes the findings. The RAR will result in a refund (the tax was overpaid), a deficiency (the tax was underpaid), or a no change (the tax was correct) finding.

iii. Settlement Procedures.
1. If an audit results in an assessment of additional tax and no settlement is reached with the IRS agent, the taxpayer may attempt to negotiate a settlement with a higher level of the IRS.
2. If a satisfactory settlement is not reached in the administrative appeal process, the taxpayer can litigate the case in the Tax Court, a Federal District Court, or the Court of Federal Claims.

c. Statute of Limitations

i. A statute of limitations is a provision that requires any lawsuit to be brought within a reasonable period of time.
1. Found at the state and Federal levels, such statutes cover a multitude of suits, both civil and criminal.
2. For the Federal income tax, there are two major categories: one applying to assessments by the IRS and one concerning claims for refunds by taxpayers.

ii. Assessment by the IRS.
1. The IRS may assess an additional tax liability against a taxpayer within three years of the filing of the income tax return.
2. If a taxpayer omits an amount of gross income in excess of 25% of the gross income reported on the return, the statute of limitations is increased to six years. This applies only to the omission of income.
3. There is no statute of limitations on assessments of tax if no return is filed or if a fraudulent return is filed.

Example: For 2025, Mark, a calendar year taxpayer, reported gross income of $400,000 on a timely filed income tax return. If Mark omitted more than $100,000 (25% × $400,000) in income, the six-year statute of limitations would apply to the 2025 tax year. This presumes the absence of fraud on the part of Mark. If the omission was deliberate (i.e., due to fraud), the statute never starts to run.

iii. Limitations on Refunds. Claims for refund are limited to within three years from the date the return was filed or within two years from the date the tax was paid, whichever is later. (Income tax returns that are filed early are deemed to have been filed on the date the return was due.)

d. Interest and Penalties

i. With refunds, no interest is allowed if the overpayment is refunded to the taxpayer within 45 days of the date the return is filed.
ii. The tax law provides various penalties for lack of compliance by taxpayers. Some of these penalties are summarized as follows:
   1. For failure to file a tax return by the due date, a penalty of 5% per month up to a maximum of 25% is imposed on the amount of tax shown as due on the return. Any fraction of a month counts as a full month.
   2. A penalty for failure to pay the tax due as shown on the return is imposed in the amount of 0.5% per month up to a maximum of 25%. Any fraction of a month counts as a full month. During any month in which both the failure to file penalty and the failure to pay penalty apply, the failure to file penalty is reduced by the amount of the failure to pay penalty.
   3. A negligence penalty of 20% is imposed if any of the underpayment was for intentional disregard of rules and Regulations without intent to defraud.
   4. Various penalties may be imposed in the case of fraud. Fraud is a deliberate action on the part of the taxpayer evidenced by deceit, misrepresentation, concealment, etc. In the case of civil fraud, the penalty is 75% of the underpayment attributable to fraud. In the case of criminal fraud, the penalties can include large fines as well as prison sentences.

e. Tax Practice
   i. Ethical Guidelines (1.8, PPT Slides 96–102).
      1. Circular 230. “Regulations Governing Practice before the Internal Revenue Service” issued by the Treasury Department.
         (a) Contain rules of conduct to be allowed to practice before the IRS.
         (b) Administered by the IRS Office of Professional Responsibility (OPR).
         (c) A Circular 230 violation could lead to the loss or suspension of a CPA’s license at the state level as well.
      2. Statements on Standards for Tax Services (SSTS). Statements issued by the AICPA and enforceable as part of its Code of Professional Conduct.
         (a) Any tax position taken should be supported by a good-faith belief that they have a realistic possibility of being sustained if challenged.
         (b) Upon learning of an error on a past tax return, advise the client to correct it. Do not inform the IRS of the error.
         (c) Every effort should be made to answer questions appearing on tax returns. The failure to answer a question on a return cannot be justified on the grounds that the answer could prove disadvantageous to the taxpayer.

(d) A practitioner can use a client's estimates if they are reasonable under the circumstances.
(e) Practitioners have a responsibility to protect the security of taxpayer information, including when it is transmitted and how it is stored electronically.
(f) Practitioners must exercise appropriate professional judgment and care when relying on any type of tool to provide services. These tools may help in performing tax and accounting work, but the ultimate responsibility for preparing a correct tax return or reaching the correct answer using tax research tools rests with the tax practitioner.

ii. Statutory Penalties Imposed on Tax Return Preparers.
1. Penalty for understatement of a tax liability based on a position that lacks substantial authority.
2. Penalty for any willful attempt to understate taxes.
3. Penalty for failure to exercise due diligence in determining eligibility for, or the amount of, an earned income tax credit, the child tax credit, the American opportunity tax credit, or head-of-household filing status.
4. Various penalties involving procedural matters.

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Discussion Questions

You can assign these questions several ways: in a discussion forum in your LMS; as whole-class discussions in person; or as a partner or group activity in class.

1. Discussion 1 (1.1 and 1.6, PPT Slides 10–16 and 40–79) Duration 15 minutes.
   a. Marvin is the executor and sole heir of his aunt's estate. The estate includes her furnished home, which Marvin is considering converting to rental property to generate additional cash flow. What are some of the tax considerations Marvin may confront?
      i. Answer: The income tax consequences that result are Marvin's principal concern. Any rent he receives is taxed as income, but operating expenses and depreciation will generate deductions that offset some or all of the income or even yield a loss. Marvin must also consider the effect of other taxes. Because the property is being converted from residential to commercial use, he can expect an increase in the ad valorem property taxes levied by the local (and perhaps even the state) taxing authorities. Besides the real estate taxes, personal property taxes could be imposed on the furnishings.
2. Discussion 2 (1.6 and 1.7, PPT Slides 40–95) Duration 15 minutes.
   a. A question on a state income tax return asks the taxpayer if any out-of-state internet or mail-order catalog purchases were made during the

year. The question requires a yes or no answer, and if the taxpayer answers yes, the total dollar amount of these purchases is to be provided.

1. Does this inquiry have any relevance to the state income tax? If not, why is it being asked?
2. Your client, Hannah, wants to leave the question unanswered. As the preparer of her return, how do you respond?
    i. Answer:
        1. This type of question has no relevance to the state income tax but is a reminder to individual taxpayers about the use tax and a simple way for individual taxpayers to pay any use tax due on internet and mail-order purchases. Without the line on the state income tax return, individual taxpayers would be required to file a separate use tax return.
        2. As the preparer of the state income tax return, you should not leave questions unanswered unless there is a good reason for doing so. It appears that Hannah has no justifiable reason.

3. Discussion 3 (1.2 and 1.3, PPT Slides 17–26) Duration 15 minutes.
    a. Discuss the probable justification for each of the following aspects of the tax law. Be sure to use concepts and terminology covered in this chapter.
        1. A tax credit is allowed for amounts spent to furnish care for minor children while the parent works.
        2. Deductions for interest on home mortgage and property taxes on a personal residence.
        3. Fines and penalties are not deductible.
        4. Net operating losses of a current year can be carried forward to profitable years.
        5. A taxpayer who sells property on an installment basis can recognize gain on the sale over the period the payments are received.
        6. The exclusion from Federal tax of certain interest income from state and local bonds.
        7. Prepaid income is taxed to the recipient in the year received and not in the year earned.
            i. Answer:
                1. Social considerations explain the credit. It is socially desirable to encourage parents to provide care for their children while they work.
                2. These deductions raise the issue of preferential tax treatment for homeowners—taxpayers who rent their personal residences do not receive comparable treatment. Even so, the encouragement of home ownership can be justified on economic and social grounds.
                3. Activities deemed contrary to public policy should not result in tax savings.

4. The NOL carryforward provision is an equity consideration designed to mitigate the effect of the annual accounting period concept.
5. The installment method of reporting gain is consistent with the wherewithal to pay concept—the seller is taxed when the payments are made by the purchaser.
6. The exclusion from Federal income taxation of interest from state and local bonds can be justified largely on political considerations. Political goodwill is generated by allowing state and local jurisdictions to secure financing at a lower cost (i.e., interest rate) due to favorable Federal income tax treatment.
7. The treatment of prepaid income is justified under the wherewithal to pay concept. It also eases the task of the IRS as to administration of the tax law.

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- 1 Show Me How video: DQ.01-07, LO 02: Tax Law Justification
- 1 Concept Clips/Quick Lessons video: Individuals and Taxes

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