

# Study Guide

---

## South-Western Federal Taxation Taxation of Business Entities

**2009 EDITION**

**James E. Smith, Ph. D., CPA**

College of William and Mary

**William A. Raabe, Ph. D., CPA**

The Ohio State University

**David M. Maloney, Ph. D., CPA**

University of Virginia

Prepared by

**Timothy R. Koski**

Middle Tennessee State University





**Study Guide to accompany South-Western Federal Taxation: Taxation of Business Entities, 2009 Edition**

**James E. Smith, William A. Raabe,  
David M. Maloney**

**Prepared by Timothy R. Koski  
Middle Tennessee State University**

Vice President of Editorial, Business: Jack  
W. Calhoun

Editor-in-Chief: Rob Dewey

Senior Developmental Editor: Craig Avery

Marketing Manager: Kristen Hurd

Marketing Communications Manager: Libby  
Shipp

Content Project Manager: Corey Geissler

Media Editor: Robin Browning

Website Project Manager: Brian Courter

Senior Frontlist Buyer: Doug Wilke

Production Service: Pre-PressPMG

Senior Art Director: Michelle Kunkler

Cover Designer: Craig Ramsdell

Cover Image: © Getty Images, Inc.

© 2009, 2008 South-Western, a part of Cengage Learning

ALL RIGHTS RESERVED. No part of this work covered by the copyright hereon may be reproduced or used in any form or by any means—graphic, electronic, or mechanical, including photocopying, recording, taping, Web distribution, information storage and retrieval systems, or in any other manner—except as may be permitted by the license terms herein.

For product information and technology assistance, contact us at  
**Cengage Learning Academic Resource Center,**  
**1-800-423-0563**

For permission to use material from this text or product,  
submit all requests online at [www.cengage.com/permissions](http://www.cengage.com/permissions)  
Further permissions questions can be emailed to  
[permissionrequest@cengage.com](mailto:permissionrequest@cengage.com)

ISBN-13: 978-0-324-66220-7

ISBN-10: 0-324-66220-3

**South-Western Cengage Learning**

5191 Natorp Boulevard  
Mason, OH 45040  
USA

Cengage Learning products are represented in Canada by  
Nelson Education, Ltd.

For your course and learning solutions, visit [academic.cengage.com](http://academic.cengage.com)  
Purchase any of our products at your local college store or at our  
preferred online store [www.ichapters.com](http://www.ichapters.com)

# CONTENTS

---

Chapter 1	INTRODUCTION TO TAXATION.....	1-1
Chapter 2	WORKING WITH THE TAX LAW.....	2-1
Chapter 3	TAXES ON THE FINANCIAL STATEMENTS.....	3-1
Chapter 4	GROSS INCOME.....	4-1
Chapter 5	BUSINESS DEDUCTIONS.....	5-1
Chapter 6	LOSSES AND LOSS LIMITATIONS.....	6-1
Chapter 7	PROPERTY TRANSACTIONS: BASIS, GAIN AND LOSS, AND NONTAXABLE EXCHANGES.....	7-1
Chapter 8	PROPERTY TRANSACTIONS: CAPITAL GAINS AND LOSSES, SECTION 1231, AND RECAPTURE PROVISIONS.....	8-1
Chapter 9	CORPORATIONS: ORGANIZATION, CAPITAL STRUCTURE, AND OPERATING RULES.....	9-1
Chapter 10	CORPORATIONS: EARNINGS & PROFITS AND DISTRIBUTIONS.....	10-1
Chapter 11	PARTNERSHIPS AND LIMITED LIABILITY ENTITIES.....	11-1
Chapter 12	S CORPORATIONS.....	12-1
Chapter 13	MULTIJURISDICTIONAL TAXATION.....	13-1
Chapter 14	BUSINESS TAX CREDITS AND CORPORATE ALTERNATIVE MINIMUM TAX.....	14-1
Chapter 15	COMPARATIVE FORMS OF DOING BUSINESS.....	15-1
Chapter 16	INTRODUCTION TO THE TAXATION OF INDIVIDUALS.....	16-1
Chapter 17	INDIVIDUAL AS EMPLOYEES AND PROPRIETORS.....	17-1



# CHAPTER 1

---

## Introduction to Taxation

### CHAPTER HIGHLIGHTS

**A**

proper analysis of the United States tax system begins with an examination of the tax structure and types of taxes employed in the United States. Knowledge of historical principles that guided the development of the system, and investigating the various motivations that underlie existing provisions of the tax law, will help in understanding the US tax system. This chapter also introduces the various taxable and nontaxable business entities and provides an overview of tax planning.

- I. The Structure of Taxes (Tax Terminology)
  - A. Taxes have two components: tax rate and tax base.
  - B. Tax Rates – Tax rates can be structured to yield:
    1. Proportional tax: The rate of tax remains constant over the tax base (sales tax);
    2. Progressive tax: Tax rates increase as the tax base grows larger (Federal income, gift & estate tax);
    3. Regressive tax: Tax rates decrease as the tax base grows larger (Federal employment taxes such as FUTA and FICA).
  - C. Tax Base – Most taxes are levied on one of the following tax bases:
    1. Transactions (including sales and transfers of wealth);
    2. Property or wealth (including real estate taxes and ownership of property);
    3. Privileges and rights (including ability to use the corporate form or to be in certain professions, excise taxes, and custom duties);
    4. Income (can be on gross or net income).
- II. Types of Taxes
  - A. After income taxes, transaction taxes usually affect more US taxpayers than any other type of tax. In many countries, transaction taxes are even more important than income taxes.
  - B. Taxes on the Production and Sale of Goods: Levied on the sale, consumption, or production of commodities or services. Examples of transaction taxes include:
    1. Excise Taxes
      - a. Levied by Federal and state governments on exchanges of specified commodities (oil, alcohol, phone service, and tobacco) or services.
      - b. Excise taxes may be levied on producers, resellers or consumers.
      - c. May have significant impact on specific industries.
      - d. Although excise tax rates are generally proportional, they may vary greatly from state to state.

2. Sales and Use Taxes
- a. Major sources of income for most state and local governments, and cover a broad base of transactions.
  - b. Items subject to tax vary by state, and rates may vary by locality.
  - c. The rate is proportional and collected by retailers.
  - d. For various reasons, states may suspend the general sales tax, either permanently on some items, or for short intervals.
  - e. A use tax is imposed on items bought in a lower sales tax locality and transported for use in another locality. Every state that imposes a sales tax also imposes a use tax. The rate is usually the same as the sales tax rate. Use taxes are difficult to enforce on many purchases.
3. Value Added Tax (VAT)
- a. In many countries around the world, the VAT has gained acceptance as a major source of revenue.
  - b. A VAT is a sales tax levied on the value added at each stage of production.
- C. Employment Taxes: As imposed by Federal and state governments, these taxes include:
1. FICA taxes (Federal Insurance Retirement Act)
    - a. Tax imposed on the self-employed, employees, and their employers. Accounts for about 1/3 of the Federal revenues; only the income tax provides more Federal revenue.
    - b. Proceeds finance retirement (Social Security) and medical costs (Medicare)
      - (1) Employee rate is 6.2% for Social Security (SS) up to \$102,000 for 2008 and 1.45% for Medicare (no ceiling). Total of 7.65% if income is \$102,000 or less. Employer matches the contributions.
      - (2) Self-employed pay the employee and the employer portions. This is 12.4% (2 X 6.2%) for SS and 2.9% (2 X 1.45%) for Medicare. Income limits are the same as for employees. Thus, a total of 15.3% if income is \$102,000 or less.
  2. FUTA (Federal Unemployment Tax Act)
    - a. Generally has a state counterpart. Amounts finance state unemployment compensation benefits. As with FICA, this is a regressive tax.
    - b. The rate is generally 6.0% of the first \$7,000 of wages and paid only by the employer. States may impose special taxes on employees to provide disability benefits and/or supplemental unemployment benefits.
    - c. Federal credit of up to 5.4% may be allowed for unemployment taxes paid to the state. Thus, the amount required to be paid to the IRS could be as low as 0.6%.
- D. Death Taxes: Levied by Federal and state governments on the right to transfer property at death. This is intended to prevent large concentrations of wealth.
1. Estate Taxes are imposed on the decedent. Inheritance taxes are imposed on the recipient. Estate taxes are imposed at the federal level. States may levy either or both types.
  2. The tax base is the fair market value (FMV) of the property owned by the decedent at death, less allowable deductions (funeral costs, administration expenses, certain taxes,

#### Types of Taxes

- Sales and Excise Taxes
- Employment Taxes
- Death Taxes
- Gift Taxes
- Property Taxes
- Privilege and Right Taxes
- Income Taxes

- liabilities of decedent, charitable contributions, and marital deduction), plus prior taxable gifts.
3. Federal Estate Taxes use a progressive rate scheme. Rates range from 18% to 45% in 2008. However, transfers may avoid some or all taxation through the application of the *unified transfer tax credit*. For 2008, this credit exempts a tax base of \$2 million. The amount of the credit for 2008 is \$780,800.
  4. State inheritance taxes are based on the heir's relationship to the decedent.
- E. **Gift Taxes:** Imposed on the right to transfer property during the owner's lifetime. A few states impose gift taxes.
1. Base for the tax is the FMV, at the date of gift, of the property transferred.
  2. Uses the same tax rates as estate taxes; that is, the estate and gift taxes are *unified*. The Unified Transfer Tax Credit for *gifts* is frozen at \$345,800 (offsetting \$1 million of gifts).
  3. Gifts of \$12,000 or less per donee per year are not taxable due to the *annual exclusion* available. Married couples may elect *gift splitting*, which increases the exclusion to \$24,000.
- F. **Property Taxes:** Usually based on ownership or levied on wealth or capital. Those based on value are known as *ad valorem taxes* (at value taxes). These taxes are generally imposed by state and local governments.
1. Taxes on realty are important sources of revenue for localities. The taxes are generally not imposed on Federal and State government property or property owned by charities. Other exemptions or special rates may exist for certain types of property and certain groups of individuals.
  2. Taxes on personalty - taxes may be imposed on property not classified as realty. Taxes on property devoted to personal use have inconsistent taxpayer compliance. Personalty used in business, however, has better compliance. Automobile property tax base may be the weight of the automobile rather than value.
- G. **Taxes on Privileges and Rights:** Usually are excise taxes. Examples of these taxes are:
1. Custom Duties - taxes on the right to move goods across national borders. Tend to be the instrumentality for applying the protectionist policy of the US.
  2. Franchise and Occupational Taxes—taxes on the privilege of doing business or practicing a profession in a state or local jurisdiction.
  3. Severance Taxes - imposed by some states on the extraction of natural resources. They are an important source of income in some states.
- H. **Income Taxes:**
1. Levied by the Federal, most state, and some local governments.
  2. Income taxes are generally imposed on corporations, estates, trusts, and individuals. Most taxing jurisdictions use a pay-as-you-go system for collecting taxes.
  3. Tax Structure – The basic tax formula for all taxable entities is fairly similar.
    - a. Income is broadly included in the tax base, whereas deductions must be specifically provided for in the law.
    - b. Tax rates are progressive; from 10% to 35% for individuals and from 15% to 35% for corporations.
    - c. The taxation of individuals employs an intermediate sum called adjusted gross income (AGI) to distinguish between the two types of individual deductions: *for* AGI, and *from* AGI.

**KEY TERMS**

- Progressive, Regressive, Proportional Tax Rates
- Flow-Through Entities
- Tax Avoidance, Tax Evasion
- Marginal, Average, Effective Tax Rates
- Explicit, Implicit Taxes
- Wherewithal to pay

4. State and Local income Taxes – Most states and a few cities impose income taxes. The calculation these taxes usually relies, to some degree, on Federal income tax law and computations.

### III. Income Taxation of Business Entities

#### A. Proprietorships –

1. This simple form of business is not a separate entity from the individual owner.
2. Profits are reported on the taxpayer's personal return.

#### B. Corporations –

1. Corporations are separate legal entities. Most corporations are separate taxable entities, called C corporations or regular corporations. Corporations that meet certain requirements can elect not to be treated as separate taxable entities. These corporate entities are called Sub S corporations or S corporations.
2. Both of these types of corporations, however, must file tax returns.

#### C. Partnerships –

1. While required to file a return, a partnership is not a separate taxable entity and is not subject to taxation.
2. The financial results of the partnership *flow-through* to the partners and are reported on their tax returns.

#### D. S Corporations –

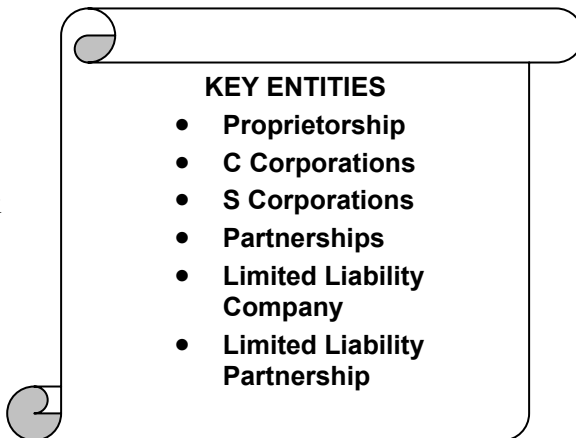
1. S Corporations have the legal characteristics of C corporations but are flow-through entities like partnerships. Financial results of S corporations are reported on the shareholders' tax returns.
2. They avoid the double taxation problems of C corporations.

#### E. Limited Liability Companies & Partnerships –

1. These entities follow the same tax rules as partnerships
2. They have the added benefit of limited liability for their owners.

#### F. Dealings Between Individuals and Entities –

1. There are important tax consequences for transactions involving owners and their business entities.
2. There are numerous tax law provisions governing these transactions.



### IV. Tax Planning Fundamentals

#### A. Overview of Tax Planning

1. A distinction exists between legal tax planning – *tax avoidance*, and illegal tax planning or evading taxes – *tax evasion*.
2. Clients expect practitioners to advise as to how to structure transactions in order to minimize their taxes. This is called *tax planning*.

#### B. General Framework for Income Tax Planning

1. The primary purpose of tax planning is to minimize a taxpayer's total tax liability.
2. The key to good tax planning is assessing the nontax as well as the tax considerations of any business decisions.

#### C. Tax Minimization Strategies Related to Income

1. Avoid income recognition – Use tax exclusions. Numerous possibilities are available to individuals, but not many are provided for corporations.
2. Postpone recognition of income to achieve tax deferral – Although there are tax provisions that limit the shifting of income and expenses across periods, some opportunities still exist.

- D. Tax Minimization Strategies Related to Deductions
1. Maximize deductible amounts – Corporations should maximize the dividends received deduction.
  2. Accelerate recognition of deductions to achieve tax deferral – Accrual basis corporations can deduct charitable contributions in the year preceding the payment, if certain requirements are met.
- E. Tax Minimization Strategies Related to Tax Rates
1. Shift net income from high-bracket years to low-bracket years – This strategy will reduce the total amount of taxes paid by the entity.
  2. Shift net income from high-bracket taxpayers to low-bracket taxpayers – Although there are several tax rules that prevent taxpayers from shifting income from high-bracket taxpayers to low-bracket taxpayers, some opportunities still exist.
  3. Shift net income from high-taxing jurisdictions to low-taxing jurisdictions – The country, state or county in which income is earned can make a difference in the amount of taxes that are paid.
  4. Control the character of the income and deductions – Changing an item’s character from tax-disfavored to tax-favored income (ordinary to capital gain) or deduction (nondeductible to deductible) is beneficial to the taxpayer.
  5. Avoid double taxation – Choose entity forms that reduce or eliminate the possibility of the same income being taxed twice; once at the entity level and again at the owner level.
- F. Tax Minimization Strategies Related to Credits
1. Maximize tax credits – Credits reduce the tax liability dollar for dollar and are not affected by the taxpayer’s tax rate.
  2. A deduction, on the other hand, reduces income dollar for dollar. Its tax benefit is dependent on the tax bracket of the taxpayer.
- G. Thinking Outside the Framework
1. The general framework for income tax planning is presented in Figure 1-3 in the text.
  2. Determining the Tax Burden
    - a. Of the three kinds of tax rates, *marginal*, *average*, and *effective*, the marginal rate is the most useful for tax planning purposes. It is the tax rate on the next dollar of income.
    - b. The current taxes, as well as the present value of future taxes, should be considered.
    - c. In determining the amount of taxes paid, both *explicit* (directly paid) and *implicit* (paid indirectly through higher prices, etc) taxes should be considered.
- V. Understanding the Federal Tax Law
- A. Although the major objective of the Federal tax law is to raise revenue, economic, social, equity, and political considerations also play a significant role in the design of specific tax provisions.
- B. Revenue Needs
1. The foundation of the income tax system is to raise revenues to cover the cost of government operations.
  2. However, the revenues from taxes may not equal the expenditures by the US Congress, resulting in deficit spending.
  3. Congress uses several approaches to reduce deficit spending, such as limiting the number of years a tax benefit is available or using phase-ins or phase-outs.
- C. Economic Considerations
1. The tax law is increasingly being used to accomplish economic goals of the government.

2. Attempts at stimulation or temperance of the national economy and encouragement or discouragement of specific activities or industries have led to a large number of recent amendments to the Code.
- D. Social Considerations
1. The tax system is also used for social considerations, particularly with regard to individual taxation.
  2. Tax-favored treatment concerning certain employer provided benefits, childcare costs, charitable contributions, and education costs are responses to various social goals.
  3. Tax laws discourage expenditures that are contrary to public policy.
- E. Equity Considerations
1. Attempts are made to maintain sensitivity in the law regarding taxpayers in various circumstances. Of course, definitions of equity often produce heated debate among interested parties.
  2. Nevertheless, the tax law offers:
    - a. Relief from multiple taxation
    - b. Deferral of tax liability until the taxpayer has the *wherewithal to pay* (funds available with which to pay a tax)
    - c. Mitigation of hardships caused by the annual accounting period concept
    - d. Relief from some of the eroding effects of inflation by adjusting income tax components based upon increases in the consumer price index.
- F. Political considerations
1. As might be expected, political considerations are evident in the tax law.
  2. The effect of these considerations largely results in special interest legislation, political expediency situations, and state and local government influences.
- G. The Internal Revenue Service
1. The IRS has contributed to the tax system by encouraging amendments in specific provisions in the tax law.
  2. In its capacity as the protector of the national revenue, the IRS has been instrumental in securing legislation designed to curtail flagrant tax avoidance practices and to ease administration of the tax laws.
- H. Federal Courts
1. In addition to interpreting the tax law, the Federal courts have influenced tax law by formulating certain judicial concepts that provide guidance in the application of various tax provisions.
  2. Also, key court decisions have been instrumental in Congressional changes to the Internal Revenue Code.

## TEST FOR SELF-EVALUATION - CHAPTER 1

**True or False**

Indicate which of the following statements are true or false by circling the correct answer.

- T F 1. A value added tax resembles a national sales tax.
- T F 2. By purchasing goods in a state that has little or no sales tax and then transporting the goods back to one's home state can avoid tax liability.
- T F 3. Under regressive rate structure, the amount of taxes due decreases as the tax base increases.
- T F 4. The federal estate taxes are regressive in nature.
- T F 5. FICA imposes a tax on employers only.
- T F 6. Employment taxes are an example of an *ad valorem* tax.
- T F 7. The *primary* purpose of the income tax system is to encourage desirable economic and social activities.
- T F 8. State governments use the sales tax as one of their primary sources of tax revenues.
- T F 9. An excise tax is a tax on the use, consumption, or storage of property.
- T F 10. Ad Valorem taxes on personalty can be used on both personal-use property and business-use property.
- T F 11. For the objective of minimizing tax liability, a *for* AGI deduction will be more advantageous than a tax credit.
- T F 12. The effective tax rate is the relevant rate to apply in tax planning decisions.
- T F 13. A corporation maximizing its dividend received deduction is an example of deduction tax planning strategy.
- T F 14. Given a choice between a deduction and a credit of equal amount, a taxpayer would ordinarily prefer the *credit*.
- T F 15. A partnership files an income tax return and pays tax based on its taxable income.
- T F 16. While most states levy an excise tax on gasoline, liquor, and tobacco, the rates among states can vary dramatically.
- T F 17. Deferring tax liabilities until the taxpayer has the funds available with which to pay is called the wherewithal to pay concept.

**Fill-in-the-Blanks**

Complete the following statements with the appropriate word(s) or amount(s).

1. \_\_\_\_\_ taxes are on assets owned by the taxpayer and usually based at fair market value.
2. A \_\_\_\_\_ is not considered a separate entity from its *individual* owner.
3. \_\_\_\_\_ is a sales tax levied at each stage of production on value added by the producer.
4. A tax levied on the extraction of natural resources is a \_\_\_\_\_ tax.
5. Prepaid subscriptions and dues not being taxable until earned but prepaid rents being taxable when received is an example of \_\_\_\_\_ considerations in the tax law.
6. Relief from multiple taxation is an example of the effect of \_\_\_\_\_ considerations in the development of the tax law.
7. With respect to employment taxes, the \_\_\_\_\_ tax is paid equally by the employer and employee, while \_\_\_\_\_ taxes are paid by only the employer.
8. The \_\_\_\_\_ - \_\_\_\_\_ - \_\_\_\_\_ - \_\_\_\_\_ feature of the income tax system compels employers to withhold a specific portion of an employee's wages for taxes.
9. The tax business entities available for an enterprise are \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_.
10. Minimizing taxes legally is referred to as \_\_\_\_\_. However, the attempt to minimize tax liability through subterfuge and fraud is referred to as \_\_\_\_\_.
11. Tax rates can be progressive, proportional, or regressive. \_\_\_\_\_ tax and \_\_\_\_\_ taxes are progressive. \_\_\_\_\_ tax and \_\_\_\_\_ tax on salaries and wages are proportional. \_\_\_\_\_ taxes are regressive.
12. If the death tax is imposed on the transferor at death, it is classified as an \_\_\_\_\_. If it taxes the recipient of the property, it is termed as an \_\_\_\_\_. The Federal government only imposes an \_\_\_\_\_.
13. A(n) \_\_\_\_\_ tax is paid directly to a government whereas a(n) \_\_\_\_\_ tax is paid through higher prices or lower returns on tax-favored investments.
14. A corporation that owns stock in another corporation is eligible for a \_\_\_\_\_.
15. The purpose of the \_\_\_\_\_ system is to provide funds that states can use to provide unemployment benefits.

**Multiple Choice**

Choose the best answer for each of the following questions.

- \_\_\_ 1. Which of the following is progressive in nature related to its tax rate structure?
- a: FICA
  - b: FUTA
  - c: Use Tax
  - d: income tax
- \_\_\_ 2. Which of the following statements is *false*.
- a. Bracket creep is when the tax brackets adjust each year for inflation.
  - b. Installment sale treatment demonstrates the wherewithal to pay concept.
  - c. The allowance of a deduction for state and city income taxes is to help alleviate the effect of multiple taxation.
  - d. The United States believes what is good for small business is good for the economy as a whole.
- \_\_\_ 3. When the tax base is \$10,000, the tax liability is \$3,000. When the tax base is \$100,000, the tax liability is \$40,000. This tax has a rate structure that is:
- a. Regressive.
  - b. Progressive.
  - c. Proportional.
  - d. *Ad Valorem*.
- \_\_\_ 4. Which of the following is a tax minimization strategy.
- a. Shift deductions from high-bracket tax years to low-bracket tax years.
  - b. Accelerate recognition of income to achieve tax deferrals.
  - c. Maximize deductions over credits.
  - d. Convert the character of income from ordinary to capital gains..
- \_\_\_ 5. Shifting income from parents in the highest tax bracket to a child in the lowest tax bracket is an example of which tax minimizing strategy.
- a. Shifting from high-bracket taxpayers to low-bracket taxpayers.
  - b. Avoiding double taxation.
  - c. Shifting from high-bracket tax years to low-bracket tax years.
  - d. Avoiding income recognition through exclusions.
- \_\_\_ 6. Which one of the following can be imposed by both federal government and state government?
- a. General sales tax
  - b. Estate tax
  - c. FUTA tax
  - d. Real property tax

- \_\_\_ 7. The concept of equity appears in tax provisions to provide all of the following except:
- Alleviate the effect of multiple taxation.
  - Cope with inflation.
  - Mitigate the effect of the application of the annual accounting period concept.
  - Encourage certain business activities.
- \_\_\_ 8. Which of the following statement is *false*.
- The basic Federal income tax formula is similar for all taxable entities.
  - Taxpayers can make gifts of \$12,000 or less without paying a transfer tax because of the unified credit.
  - States generally rely on the Federal income tax laws for their income taxation.
  - City income taxes usually apply to income earned in the city regardless of whether the taxpayers live in the city or not.
- \_\_\_ 9. Which of the following is an example of social considerations affecting the tax law.
- The alternative minimum tax.
  - Deductions for contributions to retirement plans.
  - The accelerated depreciation system.
  - The installment sales method.
- \_\_\_ 10. The financial results for all of the following types of entities *flow-through* to their owners *except*:
- S corporations.
  - C corporations.
  - Limited Liability Partnerships.
  - Limited Liability Companies.
- \_\_\_ 11. Tax policy decisions are often motivated by:
- Economic considerations.
  - Social considerations.
  - Equity issues.
  - All of the above.
- \_\_\_ 12. The Federal courts have influenced tax law by all of the following except:
- Formulating certain judicial concepts that serve as guidance in the application of various tax provisions.
  - Interpreting statutory provisions and administrative pronouncements.
  - Making key decisions that have led to changes in the Internal Revenue Code.
  - Changing Congressional intent as to the application of Federal tax law.
- \_\_\_ 13. Which of the following represents the rate structure of the FICA tax?
- 6.2% for Social Security (no ceiling) and 1.45% for Medicare (up to \$97,500).
  - 1.45% for Social Security (no ceiling) and 6.2% for Medicare (up to \$97,500).
  - 1.45% for Social Security (up to \$97,500) and 6.2% for Medicare (no ceiling).
  - 6.2% for Social Security (up to \$97,500) and 1.45% for Medicare (no ceiling).
- \_\_\_ 14. Which of the following statements is true regarding Federal income taxes.
- The first income tax passed in 1916 was at a rate of 1 percent.
  - Income tax rates have never been higher than 75%.
  - The Federal tax law is based on the idea that all income from whatever source derived is subject to Federal income tax.
  - All expenses unless specifically denied are allowed as deductions for Federal income taxes.

- 
- \_\_\_\_\_ 15. The VAT is:
- a. A type of income tax popular in Europe and Canada.
  - b. Levied at each stage of production on the value added by the producer.
  - c. The Federal sales tax collected in the United States.
  - d. A minor revenue generator for most of the countries employing it.
- \_\_\_\_\_ 16. Zolla earned \$120,000 as an executive in 2008. How much FICA did Zolla pay (rounded to the nearest dollar)?
- a. \$7,550.
  - b. \$7,803.
  - c. \$8,064
  - d. \$9,180.
  - e. None of the above.
- \_\_\_\_\_ 17. Zolla earned \$100,000 as an executive in 2008. How much FUTA did Zolla pay in 2008 (rounded to the nearest dollar)?
- a. \$56.
  - b. \$378.
  - c. \$434.
  - d. \$696.
  - e. None of the above.
- \_\_\_\_\_ 18. Most taxes are levied on one of the tax bases listed below except:
- a. Appreciation in value.
  - b. Property or wealth.
  - c. Income.
  - c. Transactions.
- \_\_\_\_\_ 19. Which of these following business entities suffer from “double taxation?”
- a. Partnership
  - b. C Corporation
  - c. S Corporation
  - d. Trust
  - e. Proprietorship
- \_\_\_\_\_ 20. What would Zolla’s FICA tax be if the \$120,000 was self-employment income (rounded to the nearest dollar)?
- a. \$9,180.
  - b. \$14,480.
  - c. \$16,128.
  - d. \$18,360.
  - e. None of the above.

## SOLUTIONS TO CHAPTER 1 QUESTIONS

### True or False

1. T [Value added tax; p.1-7]
2. F Use taxes exist to prevent this. [Use taxes; p.1-7]
3. F Under all three tax rate structures, the amount of taxes due increases as the tax base increases. The structure of tax rates only affects the rate of increase. The regressive taxes increase at a decreasing rate. [Tax rate structure; p.1-2]
4. F [Tax rate structure; p. 1-2]
5. F FICA imposes tax on self-employed, employees and employers. [Employment taxes; p.1-7]  
FUTA only imposes tax on employers.
6. F *Ad valorem* taxes are based on the value of property. [Ad valorem taxes; p.1-11]
7. F The primary purpose of the income tax system is to raise revenue. [The structure of federal income tax; p.1-14]
8. T [Sales tax; p.1-6]
9. F The tax described is the use tax. [Use taxes; p.1-7]
10. T [Ad valorem taxes; p.1-11]
11. T A credit reduces tax liability dollar for dollar, while a *for* AGI deduction reduces liability to the maximum of its marginal rate times the amount of the deduction, which is considerably smaller than a tax credit. [Tax Credit versus deduction; p. 1-25]
12. F The marginal is the most appropriate rate to use in tax planning. [Tax minimization strategy; p.1-19]
13. T [Tax planning strategy; p.1-21]
14. T [Tax planning strategy; p.1-24]
15. F Tax provisions dealing with taxation of individuals encourage social results. Tax provisions dealing with taxation of corporations encourage economic results. [The structure of federal income tax; p.-14]
16. T [types of taxes; p.1-4]
17. T [wherewithal to pay; p.1-29]

### Fill-in-the-Blanks

1. Property or Ad valorem [Ad valorem taxes; p.1-11]
2. proprietorship [proprietorship; p.1-16]
3. value added tax [VAT; p.1-7]
4. severance [severance tax; p.1-14]
5. political [political consideration; p1.-31]
6. equity [equity consideration; p.1-35]
7. FICA (social security and Medicare), FUTA (unemployment) [FICA and FUTA tax; p.1-3]
8. pay-as-you-go [pay-as-you-go; p.1-14]
9. proprietorship, corporations, partnerships, S corporations, and limited liability companies or limited liability partnerships [Income taxation of business entities; p.1-16]
10. tax avoidance; tax evasion [Tax avoidance and tax evasion; p.1-19]
11. Federal income, Federal estate and gift, State retail sales, Federal Medicare FICA or FUTA [tax rate structure; p.1-2]
12. estate tax; inheritance tax; estate tax [Death taxes; p.1-8]
13. explicit, implicit [explicit and implicit tax; p.1-26]
14. dividends received deduction. [Dividends received deduction; p.1-21]
15. FUTA [Employment taxes; p. 1-7]

**Multiple Choice**

1. d [Tax rates structure; p.1-2]
2. a Bracket creep occurs when taxpayers are pushed into higher tax brackets because of increases in their wages to compensate for inflation. Indexing the tax brackets adjusts for bracket creep. [bracket concept; p.1-22]
3. b On a tax base of \$10,000 the effective tax rate was 30% and, as the tax base increased to \$100,000, the effective tax rate increased to 40%. [Tax rate structure; p.1-2]
4. d [Tax minimization strategy; p.1-19]
5. a [Tax minimization strategy; p.1-19]
6. b [Estate tax; p.1-9]
7. d Encouraging certain business activities is an economic consideration. [Economic Consideration; p.1-27]
8. b Individuals may make gifts of \$12,000 per person per year without using any of their unified credit. [Unified transfer tax credit; p.1-10]
9. b Retirement plan deductions are for social considerations. The AMT is to insure that all taxpayers with substantial economic income pay a minimum amount of taxes, accelerated depreciation is to stimulate the economy, and installment sales treatment is based on the wherewithal to pay, an equity concept. [Social consideration; p.1-28]
10. b C corporations are separate taxable entities. [Flow-through entities; p.1-18]
11. d Economic, social, equity, and political considerations are all factors that influence tax policy decisions. [Tax policy; p.1-23]
12. d The courts cannot change Congressional intent. [Influence of the courts; p.1-33]
13. d [FICA tax; p.1-7]
14. c All income is subject to Federal taxation. The first tax act was in 1913 not 1916, tax rates have been higher than 77% and *no* deductions are allowed unless specifically provided for in the law. [Tax planning strategy; p.1-19]
15. b VAT a *sales tax* that is major source of revenue for those countries which use it. The United State does not currently have a VAT tax. [value added tax; p.1-7]
16. c  $\$8,064 = (102,000 \times 6.2\%) + (120,000 \times 1.45\%)$ . [FICA example; p.1-3]
17. e Only the employer pays FUTA so Zolla paid zero FUTA. [FUTA example; p.1-7]
18. a Taxes are not generally solely on appreciation. Privileges and rights is the fourth base omitted from the list. [Tax base; p.1-4]
19. b [Income taxation of business entities p.1-16]
20. c  $\$16,128 = (\$102,000 \times 12.4\%) + (\$120,000 \times 2.9\%)$ . [FICA example; p.1-3]