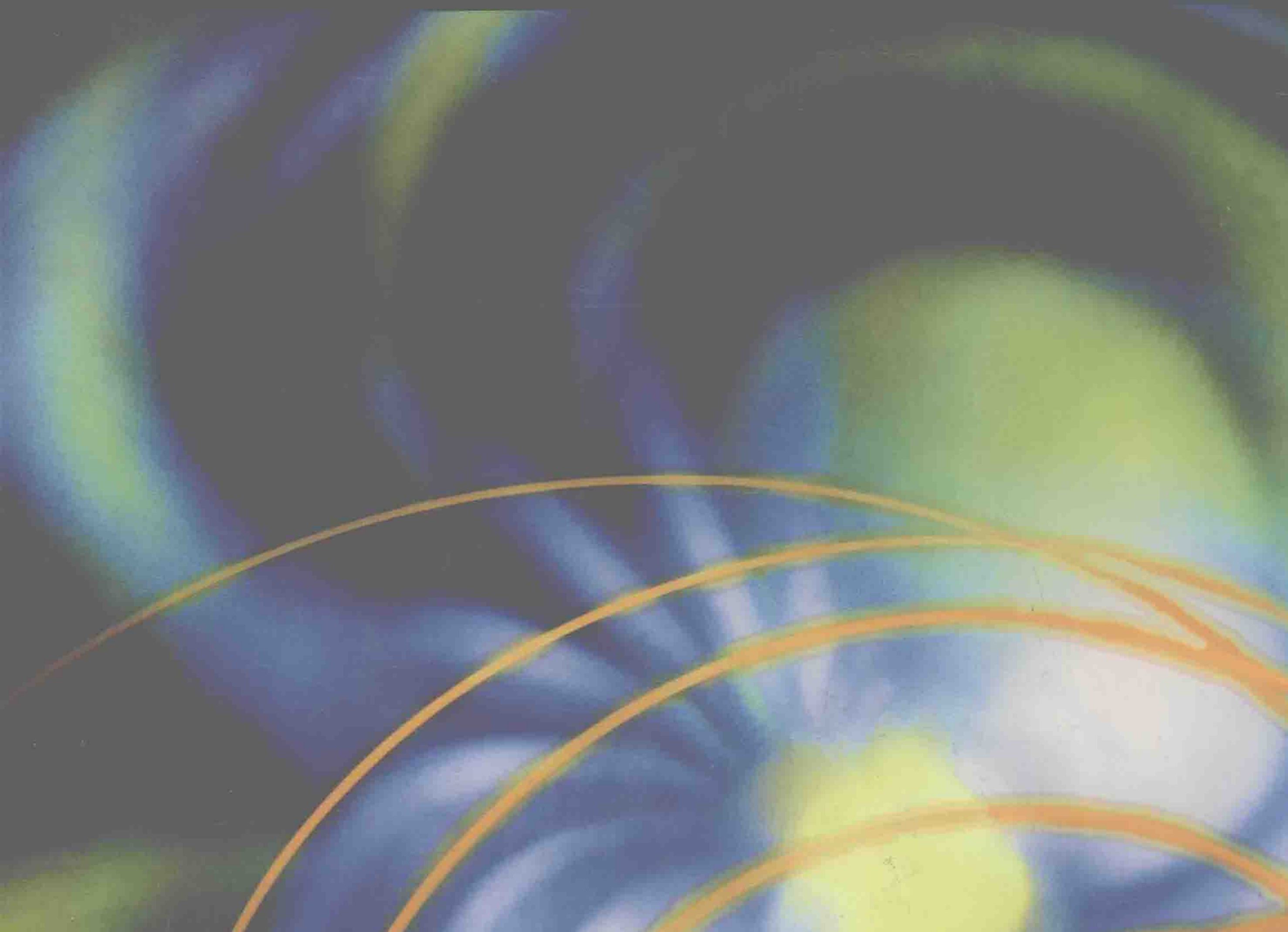
Concepts in Federal Taxation

2001 EDITION



MURPHY & HIGGINS

CONCEPTS IN FEDERAL TAXATION

2001
EDITION

KEVIN E. MURPHY
Oklahoma State University

MARK HIGGINS
University of Rhode Island

CONTRIBUTING AUTHORS:

ARTHUR CASSILL
University of North Carolina—Greensboro

TONYA K. FLESHER
~~University of Mississippi~~

South-Western College Publishing
Thomson Learning™

Australia • Canada • Denmark • Japan • Mexico • New Zealand • Philippines
Puerto Rico • Singapore • South Africa • Spain • United Kingdom • United States

Concepts in Federal Taxation, 2001 Edition, by Murphy and Higgins

Team Director: Dave Shaut
Acquisitions Editor: Scott D. Person
Developmental Editor: Carol Bennett
Marketing Manager: Jennifer Codner
Production Editor: Sandra Gangelhoff
Manufacturing Coordinator: Doug Wilke
Cover Design: R. A. Moore
Cover and Internal Photographs: © PhotoDisc, Inc.
Photography Manager: Cary Benbow
Production House: Lachina Publishing Services
Compositor: Lachina Publishing Services
Printer: R. R. Donnelley & Sons Company, Crawfordsville Manufacturing Division

Printed in the United States of America
1 2 3 4 5 03 02 01 00

For more information contact South-Western College Publishing, 5101 Madison Road, Cincinnati, Ohio, 45227 or find us on the Internet at http://www.swcollege.com

For permission to use material from this text or product, contact us by
- telephone: 1-800-730-2214
- fax: 1-800-730-2215
- web: http://www.thomsonrights.com

ISBN 0-324-02156-9

ISSN 1081-1338

This book is printed on acid-free paper.

The Internal Revenue Code, which is the statutory basis of the federal income tax system, makes the introductory tax course seem impossible to many students. The Internal Revenue Code can be intimidating and discouraging to some; there is no question that it is complex.

Nonetheless, we feel strongly that tax education not only can be interesting and enjoyable but that it should be. *Concepts in Federal Taxation, 2001 Edition,* is our solution. We think this text will please instructors with its unique, straightforward, yet complete coverage, and will surprise students by being very readable and interesting. The text is designed for use in the introductory tax course. It is sufficiently rigorous for those students who will go on to specialize in the area of taxes but is unlikely to intimidate those who plan to pursue other areas of accounting and business.

Concepts Behind the Code

There are two ways to look at the rules that govern federal taxation. The traditional or "technical approach" looks at the reams of tax authority as thousands of specific and distinct code sections, regulations, exceptions, and qualifications. The only way to absorb tax accounting in this context is to memorize—and then memorize again when the code changes.

The "conceptual approach" presents taxation as a small number of unifying concepts—principles that apply in the application of specific tax rules and authorities. These concepts define taxation. An analogy can be made to mathematical operations—by understanding how multiplication works and memorizing a 9 by 9 times table, people learn to multiply any number by any other number. One can multiply 23 by 25 correctly without having memorized a times table that includes that pair of numbers. Likewise, knowing the underlying concepts that shape the tax law lets the student understand a wide range of tax law without committing every line of the Internal Revenue Code to memory.

The concepts upon which tax law is built are relatively few and straightforward. In fact, we discuss and analyze all the concepts in a single chapter. These concepts are then reviewed at the beginning of each chapter to which they apply. Through continual reinforcement, the concepts quickly become the backbone of student understanding. ***Concept Checks*** are integrated into the text for added emphasis on the conceptual underpinnings that drive various tax laws. These checks ensure that students understand the concept at hand before moving forward.

While the text is shaped by current tax law, students are not asked to decipher the code itself to understand the law. Instead, students read clear descriptions in everyday English and learn from numerous concise examples. This approach focuses student attention on recognizing the underlying concepts of the code, not on translating and memorizing it. Where necessary, citations to relevant tax authorities are found at the end of the chapter, where they are unlikely to disrupt a student's reading of the material.

Changes for the 2001 Edition

A new section of Technology Applications problems has been added to the 2001 edition. This set of problems includes Internet Assignments, Research Problems, and Spreadsheet Problems. Two Internet Assignments and two Research Problems are available in every chapter. Selected chapters contain Spreadsheet Problems.

Our World Wide Web site (http://murphy.swcollege.com) is now fully operational. *CFT Online* provides supplementary materials in files that can be downloaded by adopters, supplements that address law changes occurring after publication of the text, references to other sites on the Internet providing tax materials, and various other teaching-related materials. Please visit *CFT Online* and tell us the types of information you would like us to add to our site.

Why the Conceptual Approach?

This textbook evolved as a solution to a problem that has frustrated academicians for many years in teaching the first tax course at the undergraduate level. The problem is what we refer to as the "technical approach." The technical approach treats income tax in such great depth that the first-time tax student has difficulty understanding the myriad rules, exceptions to the general rule, and exceptions to the exceptions. As a result, students tend to view the first tax course as a long string of unrelated topics that they must memorize in order to pass the course. The premise of the conceptual approach is that what is important at the introductory level is that students gain a conceptual view of income tax law and be able to relate the concepts to basic aspects of everyday economic life. In the long run, all students taking the course will benefit from gaining more general knowledge than an introductory tax course usually provides.

Chapter 2 develops the conceptual framework and uses it to explain the operation of the tax system in general. Each subsequent chapter begins with a brief review of the concepts used in that chapter's discussion. Students are encouraged to return to Chapter 2 and to review the concepts whenever they are uncertain about the application of a particular concept. Each chapter presents the tax law in terms of the appropriate concepts.

The approach of this textbook is consistent with the way real learning takes place. Real learning is the ability to store information in long-term memory (called *propositions*). As new information arrives in short-term memory, it combines with stored propositions to form new propositions. It is this linkage of prior memory with new information that is the key to learning. Providing the conceptual framework up-front creates in long-term memory basic propositions about income tax law. The brief review of these propositions at the beginning of each chapter further stimulates the memory. As new information is introduced in the chapter, it combines with the stored concepts—which makes it easier to learn the material. *Concept Checks* within the chapter reinforce the linkage between the tax law being discussed and the concepts that drive the tax treatments. In addition, using each chapter's material to link the concepts highlights the integrative nature of tax law and dispels the notion that tax law is a subject that can be mastered only through memorization.

Pedagogy Decodes the Code

The decision to use the conceptual approach in this textbook was based on the desire to make the text more "student-friendly" by providing many examples that use familiar situations. The literature of cognitive psychology tells us that extensive elaborations lead to greater recall. Elaboration is the process of adding something to new information to make it more meaningful. The examples in this book are elaborations designed to add substance to the tax law being discussed, which is why this book has many more examples than other textbooks. The examples are presented in a question-and-discussion format that fully explains the question being asked.

The textbook also takes a different approach to footnotes. Rather than interrupt the text with extensive footnoting of specific subsections or paragraphs of the Internal Revenue Code, the primary tax law sources appear at the end of each chapter with explanatory notations. This approach uses more references to Treasury regulations, revenue rulings, and court cases than usually appear in an introductory tax book. This lets the student who wishes to explore a topic further find the primary tax law sources, which are more explanatory than the Internal Revenue Code.

END-OF-CHAPTER MATERIAL: DEVELOPING SKILLS

Problems. Many of the approximately 1,300 end-of-chapter problems do not call for mathematical solutions. Rather, they require the student to explain the appropriate treatment, based on the concepts. The problems are a valuable learning tool that encourages students to apply the concepts to arrive at a solution. Traditional problems are also provided that can be solved by reference to the examples in the chapter, and they address every aspect of the chapter. In most cases, two or more problems are provided for each aspect. This allows the instructor to choose problems of varying levels of difficulty, based on the instructor's desired level of emphasis for each topic.

Other Assignments. In addition to discussion questions and problems covering the material in each chapter, other material is provided. ***Issue identification problems*** ask the student to identify the tax issues inherent in a factual situation and determine the possible tax treatments for the issues they identify. ***Internet assignments*** introduce students to sources of tax information available on the Internet. **Research problems** require students to research relevant topics. **Spreadsheet problems** are designed to help students develop technology skills and make them aware that spreadsheets are useful tax planning tools.

Tax planning cases require students to use the materials in the chapter to devise an optimal tax plan for the facts given. **Discussion cases** are used to stimulate thinking about issues raised in the chapter. **Ethics discussion cases** provide ethical dilemmas related to the chapter material that the student must resolve according to the Statements on Responsibilities in Tax Practice of the American Institute of Certified Public Accountants (AICPA).

Chapter 1 includes a discussion of the ethical considerations in tax practice, particularly with regard to the AICPA's Statements. The complete set of AICPA statements appears in Appendix D. All case material can be used to emphasize communication in the tax curriculum. As a further aid to those who wish to integrate communication assignments in their courses, problems that are amenable to such use have been designated with a communications icon. (See margin.) The instructor's manual (discussed later) provides specific suggestions on use of the various materials to emphasize communication, technology, and group work in the introductory tax course.

Comprehensive problems cover a number of issues discussed within the chapter. ***Integrative problems*** require the student to bring together material learned in previous chapters and combine it with information in the current chapter. Integrative problem 84 in Chapter 4 provides the information necessary to calculate the gross income of a married couple. Integrative problem 96 in Chapter 8 follows up by providing the information necessary to complete the tax return for the couple. This approach lets the student do a fairly complex tax return in two stages, spreading the work out over the semester rather than preparing it for a single due date. This two-stage tax return problem has been recast in the instructor's manual with the appropriate tax-reporting documents for those who would like to assign a tax return problem but find the problem in Appendix B unsuited to their needs.

The ***tax return problem*** in Appendix B is presented in three phases, which correspond to the organization of the text. Each phase presents some information in actual tax documents that a taxpayer might receive from common third-party sources. Upon working through Appendix B, the student will have completed a fairly complex tax return. The problem can be worked with tax preparation software or manually. This approach familiarizes students with tax reporting and tax compliance forms and relates to the material as it is being covered, rather than in one burst at the end of the semester.

ORGANIZATION: COMPREHENSIVE, YET COMPREHENSIBLE

The entire textbook can be covered in one semester, although some instructors will find it convenient to skip selected chapters. For example, Chapter 16 discusses the basic aspects of tax research. This chapter can be omitted by those who would like to spend more time on other aspects of the course.

By its very nature, the introductory tax course contains much material that relates almost solely to individual taxpayers. We have tried to deemphasize the individual aspects of taxation and focus on transactions common to all tax entities. In this regard, the mechanics of the individual tax calculation are not discussed in depth until Chapter 8. Chapter 1 introduces the individual tax formula and briefly discusses the "for" versus "from" adjusted gross income distinction that is unique to individuals. This lets the text focus more on the overall scheme of taxation—what is income? what is a deduction? and so on—with individual tax return preparation a secondary issue. Further, itemized deductions are not accorded the traditional in-depth treatment. Again, the focus is on the more-common itemized deductions, and elaborate technical detail is omitted for the more-unusual items.

The text is organized into six parts, each of which contains chapters of related materials. The flow of the material is designed to lead the student into the calculation of taxable income and the problems associated with various aspects of the calculation.

Part I introduces the student to the conceptual foundations of tax law. Chapter 1 provides an overview of the tax system, briefly discusses other types of taxes, outlines the general income tax calculation, discusses the nature of tax planning, and introduces ethical considerations of tax practice. Chapter 2 develops the conceptual foundation of the income tax system, using a framework that discusses and illustrates the underlying concepts.

Part II addresses the calculation of gross income. Chapter 3 classifies various sources of income and explains the common problems encountered within each income classification. Its overview of property transactions differentiates the taxation of capital gains and losses from other sources of income. Accounting methods that affect the recognition of income are introduced at the end of the chapter. Chapter 4 classifies allowable exclusions from income according to the purpose of the exclusion and discusses the problems commonly encountered with exclusions in each category.

Part III discusses the deductions that are allowed in computing taxable income. Chapter 5 provides an overview of the general criteria necessary to obtain a tax deduction. The chapter concludes with a discussion of the effect of a taxpayer's accounting method on the timing of deductions. Chapter 6 addresses specific business expense deductions that are subject to special rules and/or limitations. Deductions for losses are covered in Chapter 7. Annual losses are distinguished from transaction losses, and the limitations on the deductibility of the two types of losses are discussed. This includes the treatment of net operating losses, the at-risk rules, passive losses, capital losses, and casualty and theft losses. The unique features of the individual income tax calculation, itemized deductions, and tax credits available to individuals are discussed in Chapter 8.

Part IV covers property transactions. The property investment cycle is introduced in Chapter 9, and common acquisition problems are discussed. Chapter 10 provides the allowable deductions for property expenditures. This includes the MACRS depreciation system, depletion deductions, and allowable amortization deductions. Dispositions of property are discussed in Chapter 11. The calculation of the gain or loss from a disposition of property is explained, and the classification of gains and losses from property is discussed. Chapter 12 covers the common nonrecognition situations related to property dispositions, including exchanges, involuntary conversions, and sales of a principal residence.

Part V provides the comparative life-cycle approach to business entities. Chapter 13 discusses the nontax characteristics that should be considered in choosing a business entity and the incidence of taxation of each entity; it then presents the comparative differences at formation of a business. Chapter 14 compares the differences in tax treatments during the operation of an entity and concludes with an overview of the effect of distributions on an entity and its owners. Chapter 15 finishes the life-cycle discussion with coverage of deferred compensation, tax credits, the alternative minimum tax, and international tax aspects of entities.

Part VI contains Chapter 16, which provides the mechanics of tax research. Problems that require students to find particular types of authorities using print, CD-ROM, and Internet tax services, and research cases for all chapters in the text, are provided in this chapter. Instructors wishing to introduce their students to tax research will want to cover this chapter early in the course.

Supplementary Materials: Better Tools for Better Understanding

Recognizing the wide range of institutions and classes where *Concepts in Federal Taxation* can make an educational impact, we have developed supplementary materials to aid instructors in all aspects of the course.

Instructor's Manual. The *Instructor's Manual,* prepared by Bobbie Martindale, Dallas Baptist University, includes suggested syllabi for a one-semester course and a two-quarter course. Syllabi of several adopters of the 2000 edition are provided so that users can see how other instructors are using the material in their courses. In addition, the materials include suggestions for incorporating technology, communication, and group assignments in the income tax curriculum. Each chapter begins with an overview of the chapter and specific teaching tips related to the chapter. Each chapter also presents specific ideas for communication and group assignments in that chapter. Lecture notes are provided to assist the instructor in organizing classroom activities, and include suggestions for incorporating material from the problems in the lecture. Each chapter also features an annotated bibliography on selected topics from each chapter for instructors who wish to have their students explore additional aspects of these topics.

Solutions Manual. The *Solutions Manual* provides in-depth discussions of the solutions to the end-of-chapter material. The actual text of each discussion question and problem are reproduced with the solution for easy integration into lecture notes. A chart at the beginning of each chapter cross-references problems in the 2000 edition with their counterparts in the 2001 edition. The chart notes any change made to the problem in the 2001 edition. A second chart lists all problems in the 2001 edition and describes the topic of each problem. To help instructors develop their problem assignments, both charts are coded to flag problems developed for specific purposes. Critical thinking, communications skills, and comprehensive and integrative problems are all designated in the charts. In lieu of providing separate transparency masters, we have printed the 2001 *Solutions Manual* in transparency master format. A three-ring binder to house the solution manual is available upon request.

Test Bank. The *Test Bank,* prepared by Joseph Hagan, East Carolina University, includes a variety of testing methods, all consistent with the conceptual teaching approach. This includes matching questions, multiple-choice questions, short-answer questions, and comprehensive problems. *Thomson Learning Testing Tools* (*TLTT*) is available for producing tests and examinations.

***PowerPoint* Presentations.** To facilitate lecture preparation, a set of *PowerPoint* presentations for each chapter, prepared by Bobbie Martindale, Dallas Baptist University, is available for the 2001 edition.

Other Supplementary Materials. In addition to the materials developed specifically for this textbook, the following ITP/West Publishing products are available:

- *Tax Legislation Update.* If necessary, a supplement covering new tax legislation affecting the text will be distributed free to adopters.
- *World Wide Web Site Access: CFT Online.* Adopters will have access to the dedicated *Concepts in Federal Taxation* web site (http://.murphy.swcollege.com). Supplements for new tax legislation and other information updating the book and supplements will be available for downloading and printing.
- *TurboTax®*. This best-selling tax preparation software by Intuit can be used to solve the comprehensive problems and the problems in Appendix B. The *TurboTax* package, available for student purchase, includes CD-ROM bound with a workbook by Jerrold J. Stern, Indiana University, and Intuit.
- *RIA OnPoint System 5 Student Version CD-ROM.* RIA's *Federal Tax Coordinator 2nd* and *United States Tax Reporter* on one easy-to-use CD-ROM is available for student purchase. The inclusion of the Internal Revenue Code, Treasury regulations, and selected rulings and cases allows enhanced tax research pedagogy in the introductory tax course at minimal cost.
- CCH's *U.S. Master Tax Guide Plus*—This comprehensive online federal tax research database is available to be packaged with the 2001 Edition of *Concepts in Federal Taxation*. The *U.S. Master Tax Guide Plus* gives students access to Internal Revenue Code, Rulings and Procedures, IRS Publications, Tax Law Changes and much, much more. Best of all, the CCH *U.S. Master Tax Guide's* online convenience means students can access the material anytime, anywhere. Integrating tax research into your course has never been easier!

Acknowledgments

The successful completion of this project resulted from the involvement of many special individuals. John Wilguess and Bud Lacy have provided valuable insight and overview throughout. Glenda Brock, California State Polytechnic University, Cheryl Metrejean, University of Mississippi, Rick Walter, University of Louisville, Roby Sawyers, North Carolina State University, Kathy Krawczyk, North Carolina State University, Betsy Willis, Baylor University, Marty Wartick, University of Northern Iowa, Larry Tunnel, New Mexico State University, and David Rozelle, Western Michigan University, have made significant suggestions for improving the text and related materials. James Young, George Mason University, generously provided advance information on the 2000 inflation adjustments.

Secretarial assistance was provided by Lois Pazienza, Saundra Manzer, and Linda Wheeler.

Lastly, the authors would like to thank all the talented individuals at South-Western College Publishing who have helped us with this project (especially Jennifer Codner, Carol Bennett, Lora Craver, and Sandy Gangelhoff).

Suggestions

Concepts in Federal Taxation will be revised annually. We encourage all adopters to participate in the continuing development of the book by providing comments and/or suggestions for improving the textbook and supplementary materials. Please address these comments to Kevin Murphy at Oklahoma State University, Mark Higgins at the University of Rhode Island, or Scott Person, Editor, South-Western College Publishing, 5101 Madison Road, Cincinnati, Ohio 45227.

Kevin E. Murphy
Mark Higgins

WHY STUDY FEDERAL INCOME TAXATION

If you are beginning the study of the federal income tax law and plan to become a tax attorney or accountant, why you are taking this course is obvious. But if you want to become a management accountant or auditor, why should you study federal income taxation? Don't accountants rely on tax specialists to do tax research and prepare tax returns? Better yet, why should a business executive, an attorney, a physician, or a farmer take a tax course? Each of them also can, and often does, have professional tax advisers to take care of his or her tax problems. The heart of the answer lies in the fact that most economic transactions have an income tax effect.

The income tax law influences personal decisions of individuals. The decision to buy a house instead of renting one may depend on the after-tax cost of the alternatives. Although the payment of rent reimburses the owner of the dwelling for mortgage interest and property tax, a tenant cannot deduct the cost of renting a home. However, a homeowner can save income tax by deducting home mortgage interest and property tax and perhaps reduce the after-tax cost of buying relative to renting.

▲ **EXAMPLE 1** Zola lives in an apartment she rents for $700 per month. She is considering purchasing a house, which will require an initial cash outlay of $5,000 and monthly payments of $850. Although none of the $5,000 initial down payment is deductible, $800 of the monthly payment is deductible as interest expense. Assuming that Zola earns 6% on her investments and is in the 28% tax rate bracket, what is the after-tax monthly cost of purchasing the house?

Discussion: Assuming that Zola itemizes her deductions, the $800 interest payment will be deductible. Her taxable income will be reduced by $800 per month, resulting in tax savings of $224 ($800 × 28%). This leaves her with a net after-tax house payment of $626. However, she will lose interest income on the $5,000 investment of $25 per month [$5,000 × (6% × 1/12)]. She will not have to pay any tax on the lost interest, resulting in an after-tax interest loss of $18 [$25 − ($25 × 28%)]. Her net after-tax monthly cost of purchasing the house is $644 ($626 + $18). Because this is less than her rent of $700, Zola will come out ahead by $56 per month by purchasing the house.

This analysis of Zola's investment in a house considers only the tax aspects of the investment. Clearly, other factors influence the decision to purchase a house—potential appreciation in value, the intangible value of owning your own home, and so on. The point is that the tax consequences are one objective factor to consider when making various decisions, but they are rarely the sole or controlling factor.

Other personal decisions are often influenced by tax savings. For example, a taxpayer may decide to accelerate or defer charitable donations or elective medical treatment to claim the deductions in the year that results in the most significant tax savings. Even child-care decisions may be based on the availability of tax savings in the form of a child-care tax credit.

▲ **EXAMPLE 2** On January 1 of each year, Steve gives $2,000 to his church. For 2000, his income is more than double its usual amount because of a one-time gain from a sale of stock. In a typical year, Steve is in the 28% tax rate bracket. Because of his increased income in 2000, Steve estimates that he will be in the 36% tax rate bracket, but his income will return to normal in 2001. What steps might Steve take to reduce his tax bill?

Discussion: Instead of waiting until January 1, 2001, to make his regular $2,000 donation, which will reduce his tax by $560 ($2,000 × 28%), Steve could pay the contribution in 2000. By taking the deduction in 2000 when he is in the 36% tax rate bracket, Steve saves $720 ($2,000 × 36%) in tax. By accelerating his $2,000 charitable contribution by a few days, he saves an extra $160 in tax ($720 − $560).

From these examples, you can see that income taxes can and do have an influence on routine decisions. However, the cost of the income tax is more than just the outlay for the tax liability. A knowledge of the income tax laws enables taxpayers to make decisions that can reduce these other costs. By being familiar with the tax laws, an individual can enter into transactions that will provide the best tax result for both the taxpayer and the taxpayer's family. By minimizing the income tax burden, taxpayers conserve wealth that can be put to other uses. Last, taxpayers are responsible for reporting their correct taxable income to the government. Knowing the tax laws protects against audits by the IRS that could result in additional tax owed and penalties for improper reporting of the tax liability.

Significance of Tax Costs

Keeping records and filling out forms to comply with the tax law can consume a substantial amount of time. Table I–1 presents the IRS's estimates of the time involved in record keeping, learning about the tax law, preparing a return, and assembling the various commonly filed tax forms. As you can see, the IRS estimates that completing and filing the basic tax return form (Form 1040) requires more than 11 hours on average. When you consider that many taxpayers file a multitude of forms and schedules to detail their tax affairs, the time involved in complying with the tax law is quite substantial.

Tax compliance also may cost a taxpayer money. Taxpayers must weigh the cost of the time and investment needed to prepare their own tax returns, the out-of-pocket cost of hiring a tax preparer to prepare the return, and the risk of additional time and monetary costs for any errors. Thus, taxpayers need to choose whether to save money and spend the time to prepare their own tax returns or to pay to have someone else help to determine the proper amount of income tax.

When deciding whether to prepare their own returns, taxpayers should be aware that the amount of income tax shown on the return may contain errors or differences of opinion that may be found in an IRS audit. These differences of opinion can result from a taxpayer's or the tax preparer's lack of familiarity with the tax law and how it applies to the taxpayer. Similarly, the IRS agent performing the audit may not fully understand the law as it applies to a particular situation. In addition to clerical mistakes, tax return errors can result from inadequate communication between a taxpayer and tax preparer. A tax audit may reveal that the taxpayer either is

▲ **Table I–1**

Estimated Tax Return Preparation Time, Internal Revenue Service—1999

The time needed to complete and file the following forms will vary depending on individual circumstances. The estimated average times are

Form	Record Keeping	Learning About the Law or the Form	Preparing the Form	Copying, Assembling, and Sending the Form to the IRS
Form 1040	3 hr., 15 min.	2 hr., 39 min.	6 hr., 22 min.	35 min.
Sch. A (1040)	3 hr., 5 min.	40 min.	1 hr., 34 min.	20 min.
Sch. B (1040)	33 min.	8 min.	24 min.	20 min.
Sch. C (1040)	6 hr., 26 min.	1 hr., 11 min.	2 hr., 7 min.	35 min.
Sch. C-EZ (1040)	46 min.	4 min.	34 min.	20 min.
Sch. D (1040)	1 hr., 4 min.	2 hr., 16 min.	1 hr., 39 min.	35 min.
Sch. E (1040)	2 hr., 52 min.	1 hr., 7 min.	1 hr., 16 min.	35 min.
Sch. EIC (1040)		2 min.	14 min.	20 min.
Sch. F (1040):				
Cash Method	4 hr., 2 min.	36 min.	1 hr., 14 min.	20 min.
Accrual Method	4 hr., 22 min.	25 min.	1 hr., 19 min.	20 min.
Sch. R (1040)	20 min.	15 min.	29 min.	35 min.
Sch. SE (1040):				
Short	20 min.	14 min.	13 min.	14 min.
Long	13 min.	20 min.	34 min.	20 min.

SOURCE: Internal Revenue Service. Form 1040 Instructions, 1999.

entitled to a refund or owes more tax. If you are entitled to a refund, you have lost the use of the money while it was held by the U.S. Treasury. If you have to pay more tax, you may have to pay extra costs in the form of penalties and interest on the tax you owe. An audit of your return will require an additional investment of your personal time and, quite likely, additional out-of-pocket costs for professional tax advice. In addition, many taxpayers are intimidated when facing an income tax audit.

As your involvement in professional activities increases, taxes and the costs of compliance grow in importance. If you are like most taxpayers, you will want to pay the least tax required by the law. You will also want to spend as little time and money as possible to satisfy the compliance requirements. As Table I–2 shows, in 1970, an average taxpayer worked approximately 116 days to pay federal, state, and local taxes. By 1999, the time a person had to work to pay taxes had increased by 12.9 percent, to 131 days. In 1999, a taxpayer worked more than one-third (35.9 percent) of the year to pay taxes. Figure I–1 divides an eight-hour work day into the minutes necessary to pay typical expenses. An average person worked 1 hour and 57 minutes each day to pay federal taxes and 54 minutes a day to pay state and local taxes during 1999. Thus, 2 hours and 51 minutes of each working day are devoted to the payment of taxes. The time worked to pay taxes is almost the same as the time worked to pay for household, food, and health care costs, 2 hours and 47 minutes. As Table I–2 and Figure I–1 demonstrate, the amounts paid for taxes represent major expenditures for the typical taxpayer.

Conservation of Wealth

An understanding of basic tax concepts and planning can often help conserve wealth by reducing taxes. To reduce taxes, you need to be able to recognize potential planning situations and problems. Because you know your financial affairs better than anyone else, you are in the best position to spot potential tax-saving opportunities. You should never wait for your tax adviser to find new ways to save you taxes. Although a competent tax adviser will know about tax-planning techniques and current tax developments, you will be more familiar than an adviser is with your financial affairs and objectives. A tax adviser is best used in the same way you use other professionals. When you visit your physician, you usually describe the symptom that brought you to the office to help the doctor identify the proper treatment. When you visit your attorney for a legal problem, you take along the information necessary to help the lawyer identify the legal issues. In both instances, you evaluate information and decide when you need professional assistance. Likewise, you will need to evaluate information, based on your understanding of the tax laws, to determine when you need to consult a professional tax adviser.

▲ **Table I–2**

TAX FREEDOM DAY

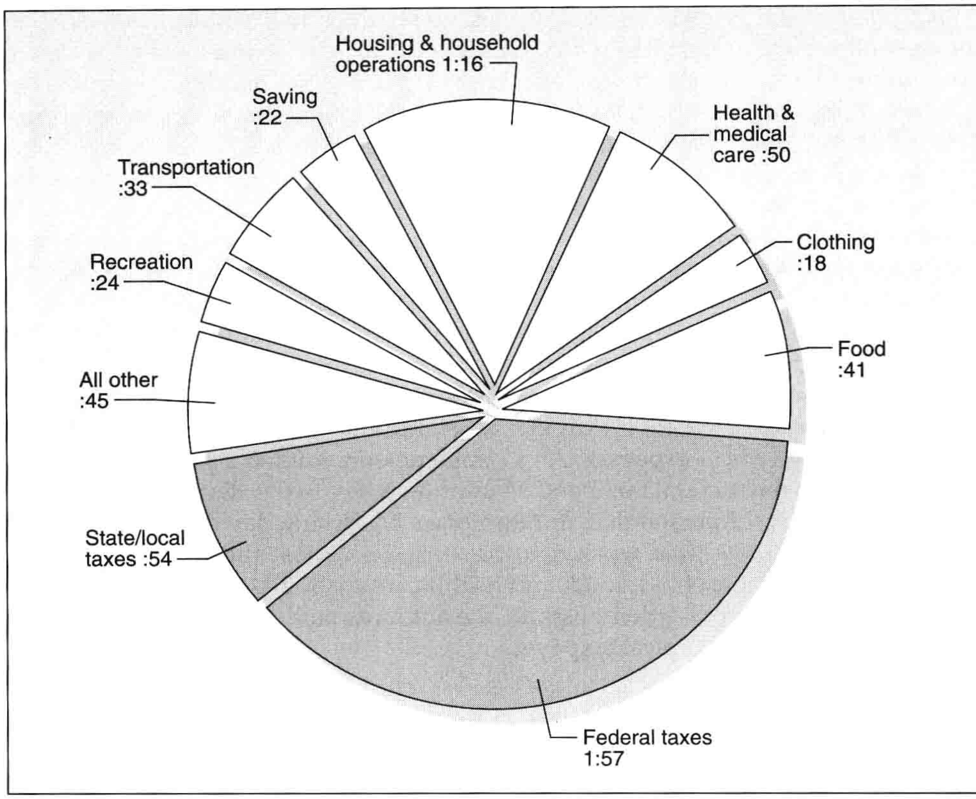
Tax Year	Freedom Day	Number of Days	Increase in Days	% of Year
1950	April 3	93		25.5
1960	April 16*	107	13	29.3
1970	April 26	116	10	31.8
1980	May 1*	122	6	33.3
1993	May 3	123	-0-	33.7
1994	May 5	125	2	34.2
1995	May 7	127	1	34.5
1996	May 7*	127	1	34.5
1997	May 9	129	2	35.3
1998	May 10	130	1	35.4
1999	May 11	131	1	35.9

*Leap year caused Tax Freedom Day to appear one day early.

SOURCE: Tax Foundation, *Tax Features*, April 1999, p. 1.

▲ **Figure I–1**

TAX BITE IN THE EIGHT-HOUR DAY



SOURCE: Tax Foundation, *Tax Features*, April 1999, p. 8

▲ **EXAMPLE 3** Gwen, 19, is a full-time student at State University. Her parents pay all her expenses, which total $12,000 a year. Gwen does not have any other source of support, and she does not pay any income tax. Gwen's father, Marty, owns a substantial portfolio of stock that earns $12,000 in income each year. Marty is in the 31% tax rate bracket.

Discussion A tax plan could save Marty money by transferring ownership of the stock portfolio to Gwen, who is in a lower tax bracket. Marty pays $3,720 ($12,000 × 31%) in tax on the investment income. The amount of income left after paying tax is $8,280 ($12,000 − $3,720).

If Marty gave the stock portfolio to Gwen as a gift (which is not subject to income tax), she would be taxed on the income at a lower tax rate than her father. Assuming that the $12,000 in investment income is taxed at 15%, Gwen's tax on the income would be $1,800. The family could save $1,920 ($3,720 − $1,800) in tax by shifting the income to Gwen. The amount of income left after paying tax is increased to $10,200 ($12,000 − $1,800).

Taxes Influence Routine Decisions

An auditor, management accountant, attorney, physician, or a farmer may never prepare a business tax return. Yet, they need a general understanding of the tax effects of their daily business decisions. For example, an auditor might find that an improperly recorded transaction results in an undisclosed tax liability or refund. A managerial accountant may need to consider the tax effects of buying or selling plant assets or acquiring a new business. To provide reliable advice to clients, lawyers often need a general understanding of how the tax laws apply to different types of entities. A doctor may need a general understanding of fringe-benefit plans that can be set up to keep highly qualified nurses and medical technicians as employees. A farmer can benefit from familiarity with the complex rules that govern reporting of income from farm production and the deduction of farm expenses. Individuals can also benefit from a knowledge of the tax laws in their everyday decisions.

▲ **EXAMPLE 4** Isaac wants to buy a new car. During a special promotion, the dealer will finance the purchase with a 6% loan. Isaac knows that he can obtain a home equity loan from his bank at 8% interest. If Isaac is in the 28% tax bracket, which loan should he use to finance his new car?

Discussion: Interest paid on personal loans is not deductible. However, interest paid on a home equity loan is deductible. If Isaac itemizes his deductions, the interest on the home equity loan is deductible. This makes the real after-tax cost of the home equity loan 5.76% [8% − (8% × 28%)]. Therefore, the home equity loan actually offers a lower after-tax cost than the dealer loan.

However, note that if Isaac does not itemize deductions (i.e., he uses the standard deduction), he receives no benefit from the deduction for home equity loan interest. In this case, the dealer loan would have a lower after-tax cost, because neither loan would produce deductible interest.

Self-Protection

Another reason for being aware of the federal income tax law is self-protection. Perhaps you have heard others say that all they have to do is give a list of income and deduction items to their tax return preparer. When they get the completed tax return back and pay the tax due, their responsibility for complying with the tax law is finished. If any mistakes are made, it is the preparer's problem. This assumption is erroneous and can lead to disaster.

Taxpayers are fully liable for additional tax, interest, and penalties due because of an error on their tax return. If a person paid to prepare a return misinterprets the information and/or makes a mistake that results in an underpayment of tax, the taxpayer will have to pay any additional amounts owed to the government. Whether the preparer will reimburse the taxpayer for the penalties and interest depends on the agreement with the preparer. Legal recourse against the preparer is available in certain circumstances, but the cost of obtaining reimbursement (e.g., legal fees, court costs) from the preparer may be prohibitive. For your own protection, you should always examine the completed return. Before you sign and file the return, thoroughly review it with your preparer and be sure you understand any entries that do not seem to be correct. Again, a knowledge of the tax law can help you catch errors or other misrepresentations made by a tax preparer before the return is filed.

▲ **EXAMPLE 5** Raul gives his tax return preparer a list of income and deduction items to be reported on his tax return. The income items total $50,000, and the deduction items total $14,000. When the preparer puts the information on the return, he omits $10,000 of the income and reports only $40,000 ($50,000 − $10,000) in income. In addition, the preparer includes a $2,000 deduction twice so that total deductions are reported as $16,000. As a result, Raul understates his taxable income by $12,000 ($36,000 correct taxable income − $24,000 reported taxable income).

Discussion: If the IRS detects the errors on the return, Raul will have to pay the IRS the additional tax due on the $12,000 understatement plus penalties and interest. Depending on their agreement for preparing the return, Raul may or may not recover part of his costs from the preparer. If the preparer does not agree to reimburse Raul for his mistakes, Raul may take legal action to obtain the amount due from the preparer. However, this can be a costly process and may not be worth the additional tax and penalties and interest due.

Clearly, all taxpayers can benefit from a basic knowledge of the tax law. Although the federal income tax is only one of many taxes that government bodies use to raise revenue, it is by far the most important in terms of revenue produced and the number of taxpayers affected. Therefore, this book focuses on federal income tax law.

Federal income tax law is a complex array of statutory, administrative, and judicial authorities. Because of its ability to affect taxpayer's decisions, lawmakers frequently make changes in the tax law to achieve economic, social, and/or political objectives. This causes the tax law to be in constant evolution. Professional tax advisers spend a significant portion of their time maintaining their knowledge of this changing body of law. Fortunately, many aspects of the tax law have remained stable over time. The approach used in this book is to provide a conceptual framework for analyzing how particular transactions should be treated for federal income tax purposes. The book then presents the general operation of the tax law and explains it in terms of the basic concepts. Throughout the book, the focus of the discussion is on those aspects of the federal income tax that have remained stable over time. A knowledge of the basic operation of the tax law will enhance your ability to make the best decisions for your individual situation.

▲ BRIEF TABLE OF CONTENTS ▲

▲ PART V
INCOME TAX ENTITIES 549

▲ PART VI
TAX RESEARCH 701