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(1998年版)

CONCEPTS IN FEDERAL TAXATION

(1998 EDITION)

KEVIN E. MURPHY
MARK HIGGINS

世界财经与管理教材大系

东北财经大学出版社

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出版者的话

但凡成事，均缘于势。得势则事成，失势则事不顺。顺势而行，如顺水行舟；借势而动，如假梯登高；造势而为，如太空揽月。治学、从政、经商、置业，均不可一日失势。势者，长处、趋势也。

今日中国，是开放的中国；当今世界，是开放的世界。改革开放，大势所趋，势不可挡。经济开放、文化开放、政治开放，世界需要一个开放的中国，中国更要融入开放的世界。借鉴国际惯例，学习他人之长，已经到了不可不为之时。

借鉴国际惯例，学习他人之长，已属老生常谈，但学什么、如何学、以何为蓝本为众多志士仁人所关注。可喜的是，由赤诚图文信息有限公司精心策划，ITP、McGraw-Hill 及 Simon & Schuster 等国际出版公司特别授权，东北财经大学出版社荣誉出版的“世界财经与管理教材大系”现已隆重面世！她以“紧扣三个面向，精选五大系列，奉献百部名著，造就亿万英才”的博大胸襟和恢弘气势，囊括经济学、管理学、财务与会计学、市场营销学、商务与法律等财经、管理类主干学科，并根据大学教育、研究生教育、工商管理硕士（MBA）和经理人员培训项目（ETP）等不同层次的需要，相应遴选了具有针对性的教材，可谓体系完整，蔚为大观。所选图书多为哈佛、斯坦福、麻省理工、伦敦商学院、埃维商学院等世界一流名校的顶尖教授、权威学者的经典之作，在西方发达国家备受推崇，被广为采用，经久不衰，大有“洛阳纸贵”之势。

借鉴国际惯例，毕竟只是因势而动；推出国粹精品，才是造势而为。在借鉴与学习的同时，更重要的是弘扬民族精神，创建民族文化。“民族的，才是国际的”。我们提倡学他人之长，但更希望立自己之势。

势缘何物，势乃人为。识人、用人、育人、成人，乃人本之真谛。育人才、成能人，则可造大势。育人、成人之根本在教育，教育之要件在教材，教材之基础在出版。换言之，人本之基础在书本。

凡事均需讲效益，所谓成事，亦即有效。高效可造宏基，无效难以为继，此乃事物发展之规律。基于此，我们崇尚出好书、出人才、出效益！

东北财经大学出版社

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Concepts in Federal Taxation is designed for use in an introductory tax course. The textbook provides a conceptual approach that is new to teaching introductory tax materials. The book 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.

In addition to revising the text to reflect the tax law changes that occurred in August 1996, we have made several other changes to the 1998 edition to enhance its usefulness. Materials in the deduction chapters have been rearranged to provide better balance and flow. The specifics of these changes are provided in the *Instructor's Manual*. We have expanded and altered problem sets to provide more choice of problems, continuing our policy of adding 20 percent new problems and modifying 30 percent of the existing problems. Internet assignments have been developed for each chapter; they use chapter topics to illustrate the types of tax material that can be obtained on the Internet. In addition, research problems have been added in Chapter 15 that provide specific research tasks to be performed using print and CD-ROM tax services, as well as the Internet. The most significant change in the 1998 edition is the addition of two new chapters on business entities. These chapters discuss the choice of income tax entity through the use of a business life-cycle approach, which compares the nontax and tax differences of entities from their formation to termination.

Joining the 1998 edition as contributing authors are David B. Davidson, California State University-Long Beach; Tonya Flesher, University of Mississippi; Tom Pearson, University of Hawaii-Manoa; and Will Yancey, Texas Christian University. Susan Bates, Boise State University, has taken up the task of preparing the Test Bank. To assist adopters in bringing multimedia presentations to the classroom, Bobbie C. Martindale, Dallas Baptist University, has developed a package of *PowerPoint* presentations. These new members of the *Concepts in Federal Taxation* author team have provided valuable insights into the continuing development of the text.

Our World Wide Web site (http://www.westpub.com/Educate/busecon/073663.htm) is now fully operational. *CFT Online* provides all 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.

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. 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.

Chapter Pedagogy

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 allows the student who wishes to explore a topic further to find the primary tax law sources, which are more explanatory than the Internal Revenue Code.

End-of-Chapter Material

Problems. Many 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 in order to arrive at a solution. More traditional problems are also provided; all can be solved by reference to the examples in the chapter and they address every aspect of the chapter. The problems take advantage of the richness and vastness of income tax to show students how the concepts apply in practice. 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 Features. In addition to discussion questions and problems covering the material in each chapter, various other material is provided. *Internet assignments* introduce students to various sources of tax information available on the Internet. *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 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 72 in Chapter 4 provides the information necessary to calculate the gross income of a married couple. Integrative problem 78 in Chapter 8 follows up by providing the information necessary to complete the tax return for the married couple. This approach allows the student to 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 commonplace 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

The entire textbook can be covered in one semester, although some instructors will find it convenient to skip selected chapters. For example, Chapter 15 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. Instructors who have their students engage in tax research during the first tax course will want to use Chapter 15 early in 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 allows the text to 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 and deductions of individual taxpayers 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 and during the operations of a business. Chapter 14 finishes the operations portion of the life cycle with coverage of deferred compensation, fringe benefits, tax credits, and the alternative minimum tax. An overview of the effect of distributions completes the life-cycle discussion.

Part VI contains Chapter 15, which provides the mechanics of tax research. Problems that require students to research particular types of authorities using print and CD-ROM tax services, and research cases for all chapters in the text are provided in this chapter. As mentioned earlier, instructors wishing to introduce their students to tax research will want to cover this chapter early in the course.

Supplementary Materials

Materials have been specifically developed to aid the instructor in teaching this new approach to the introductory course. This includes an instructor's manual, a solutions manual, transparency masters, a test bank, a reader, *PowerPoint* presentations, and *Tax Tutor.* In addition, other West supplementary materials are available to adopters.

Instructor's Manual. The *Instructor's Manual* includes suggested syllabi for a one-semester course and a two-quarter course. Syllabi of several adopters of the 1997 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. This is followed by a set of lecture notes for the chapter. The lecture notes are designed to assist the instructor in organizing classroom activities and include suggestions for incorporating material from the problems in the instructor's 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. The *Instructor's Manual* is available on floppy disk to allow instructors to easily edit the material for their specific classroom needs.

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. This makes it easier for instructors to integrate the problem material in their lecture notes. A chart at the beginning of each chapter cross references problems in the 1997 edition with their counterparts in the 1998 edition. The chart notes any change made to the problem in the 1998 edition. A second chart lists all problems in the 1998 edition and describes the topic of each problem. To assist instructors in developing 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 1998 *Solutions Manual* in transparency master format. The manual is being distributed unbound with a three-ring binder.

Test Bank. The *Test Bank* that accompanies this book includes a variety of testing approaches. The material is designed to help instructors fashion exams that are consistent with a conceptual teaching approach. This includes matching questions, multiple choice questions, short answer questions, and comprehensive problems. Part of the package accompanying this book is *WESTEST™* 3.1, software for producing tests and examinations.

Reader. *Insights: Readings in Federal Taxation,* 1997 Edition, provides articles from leading tax and popular journals that instructors can use to enhance students' appreciation of the importance of taxation. There are several articles for each chapter. The articles present additional background and interesting applications of the chapter material to real situations. This item is for sale at a nominal charge.

Tax Tutorial. The *Tax Tutor,* developed by John Price of the University of North Texas, is an electronic study guide customized for *Concepts in Federal Taxation.* The *Tax Tutor* reviews each major topic in the chapter and asks students to complete the related interactive self-study questions. Students who answer the questions incorrectly are prompted to review the related material and redo the problem. When the student has completed all the work, the program administers a chapter exam. The software is flexible, allowing instructors to use the *Tax Tutor* however they deem most appropriate. It can function solely as a suggested study tool, or the instructor can compile the exam results and use them in the course grading scheme. This item is for sale at a nominal charge.

***PowerPoint* Presentations.** A set of *PowerPoint* presentations for each chapter is available for the 1988 edition. A disk containing the presentations will be sent to all adopters as part of the supplements package.

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

- *West® CD-ROM Federal Tax Library™* (Compact Disc with Read-Only Memory). The library provides a complete desktop tax research library. Qualified adopters receive one subscription to the complete *Federal Tax Library* through August 31, 1997.
- *WESTLAW®.* WESTLAW is a computer-assisted tax and legal research service that provides access to hundreds of valuable information sources, including the Dow Jones News/Retrieval Database. Qualified adopters receive six free hours of WESTLAW during unrestricted hours (restricted hours are 12:30 P.M. to 5:00 P.M. EST).
- *Tax Legislation Update.* If necessary, a supplement covering new tax legislation affecting the text will be distributed free of charge to adopters.
- *World Wide Web Site Access.* Adopters will have access to the Murphy Concepts section of West Publishing Company's home page on the World Wide Web (http://www.westpub.com/Educate). Supplements for new tax legislation and other information updating the book and supplements will be available for downloading and printing.
- *TurboTax®.* This software by Intuit is a best-selling tax preparation software package. *TurboTax* can be used to solve the comprehensive problems and the problems in Appendix B. The *TurboTax* package, available for student purchase, includes disks bound with a workbook by Sam Hicks. *TurboTax® for Windows®* is also available.

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versity, Monica Newman, Western State College of Colorado, and Rick Walter, University of Louisville, have made significant suggestions for improving the text and related materials. James Young, George Mason University, generously provided advance information on the 1997 inflation adjustments.

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Lastly, the authors would like to thank all the talented individuals at South-Western College Publishing who have helped us with this project (especially Alex von Rosenberg, Esther Craig, 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 Alex von Rosenberg, Editor, South-Western College Publishing, 5101 Madison Road, Cincinnati, Ohio 45227.

Kevin E. Murphy
Mark Higgins

▲ INTRODUCTION ▲

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? They too can, and often do, have professional tax advisers to take care of their 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 and/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 1997, Steve's 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 1997, Steve estimates that he will be in the 36% tax rate bracket, but his income will return to normal in 1998. What steps might Steve take to reduce his tax bill?

Discussion: Instead of waiting until January 1, 1998, to make his regular $2,000 donation, which will reduce his tax by $560 ($2,000 × 28%), Steve could pay the contribution in 1997. By taking the deduction in 1997 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 10 hours on average. When you consider that many taxpayers file a

▲ **Table I–1**

ESTIMATED TAX RETURN PREPARATION TIME, INTERNAL REVENUE SERVICE—1996

SOURCE: Internal Revenue Service. Form 1040 Instructions, 1996.

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., 8 min.	2 hr., 32 min.	4 hr., 43 min.	40 min.
Sch. A (1040)	2 hr., 32 min.	26 min.	1 hr., 10 min.	27 min.
Sch. B (1040)	33 min.	8 min.	17 min.	20 min.
Sch. C (1040)	6 hr., 26 min.	1 hr., 10 min.	2 hr., 5 min.	35 min.
Sch. C-EZ (1040)	46 min.	4 min.	32 min.	20 min.
Sch. D (1040)	51 min.	1 hr., 8 min.	1 hr., 1 min.	41 min.
Sch. E (1040)	2 hr., 52 min.	1 hr., 7 min.	1 hr., 16 min.	35 min.
Sch. EIC (1040)		2 min.	4 min.	20 min.
Sch. F (1040):				
Cash Method	4 hr., 2 min.	35 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.	22 min.	35 min.
Sch. SE (1040):				
Short	20 min.	13 min.	11 min.	14 min.
Long	26 min.	22 min.	34 min.	20 min.

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 be the result of inadequate communication between a taxpayer and tax preparer. A tax audit may reveal that the taxpayer either is 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 will probably 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.

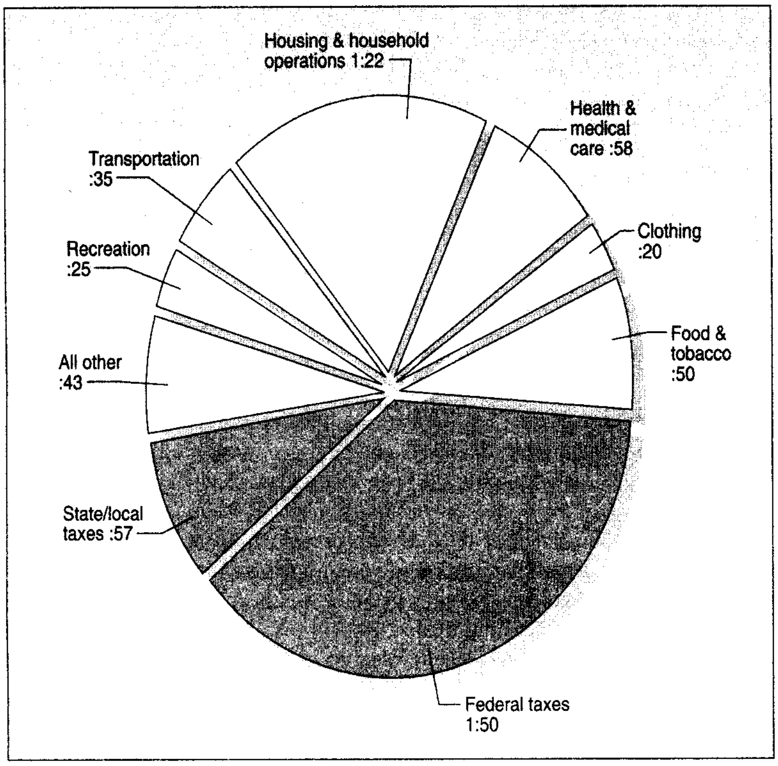
As your involvement in professional activities increases, taxes and the costs of compliance grow in importance. If you are like most taxpayers, you will want to pay the least tax required by the law. You will also want to spend as little time and money as possible to satisfy the compliance requirements. As Table I–2 shows, in 1970 an average taxpayer worked approximately 116 days to pay federal, state, and local taxes. By 1996, the time a person had to work to pay taxes had increased by 9.5 percent, to 127 days. In 1996, a taxpayer worked about one-third (34.5 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 50 minutes each day to pay federal taxes and 57 minutes a day to pay state and local taxes during 1996. Thus, 2 hours and 47 minutes of each working day are devoted to the payment of taxes. The time worked to pay taxes is almost the same

▲ **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
1991	May 3	123	-0-	33.7
1992	May 2*	123	-0-	33.6
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

*Leap year caused Tax Freedom Day to appear one day early.
SOURCE: Tax Foundation, *Tax Features*, May 1996, p. 1.



▲ **Figure I–1**

TAX BITE IN THE EIGHT-HOUR DAY

SOURCE: Tax Foundation, *Tax Features*, May 1996, p. 3.

as the time worked to pay for household, food and tobacco, and health care costs, 3 hours and 10 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.

▲ **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), Gwen would be taxed on the income at a lower tax rate than her father. Assuming 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 gave his tax return preparer a list of income and deduction items to be reported on his tax return. The income items totaled $50,000, and the deduction items totaled $14,000. When the preparer put the information on the return, he omitted $10,000 of the income and reported only $40,000 ($50,000 − $10,000) in income. In addition, the preparer included a $2,000 deduction twice so that total deductions were reported as $16,000. As a result, Raul understated 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 taxpayers' 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.