

*SWFT 2018 Essentials of Taxation*

Chapter 1: Introduction to Taxation

End-of-Chapter Question, Exercise, and Problem Correlations



Essentials of Taxation 20e (2017)	Essentials of Taxation 21e (2018)	Essentials of Taxation 21e (2018) Learning Objectives	Exact Same	Revised	Brand New	Source Volume: Ind. Income Taxes 41e (2018) OR Corporations 41e (2018)	Source Volume Chapter	Source Volume Question, Problem, or Exercise #
<b>Discussion Questions (DQ)</b>								
N/A	N/A							
<b>Computational Exercises (EX)</b>								
N/A	N/A							
<b>Problems (PR)</b>								
PR1	PR1	LO1,2,5	x					
PR2	PR2	LO1	x			V1	1	DQ7
PR3	PR3	LO2	x			V1	1	DQ8
PR4	PR4	LO1,6	x			V1	1	DQ6
PR5	PR5	LO2	x					
PR6	PR6	LO2	x			V1	1	DQ9
PR7	PR7	LO2			x	V1	1	DQ15
PR8	PR8	LO2	x			V1	1	DQ11
PR9	PR9	LO4,5	x					
PR10	PR10	LO4,5	x					
PR11	PR11	LO3,5	x					
PR12	PR12	LO2	x					
PR13	PR13	LO6	x					
PR14	PR14	LO6		x		V1	1	DQ48
PR15	PR15	LO2	x					
PR16	PR16	LO2		x				
PR17	PR17	LO5	x					
PR18	PR18	LO5	x					
<b>Comprehensive Tax Return Problems (CP)</b>								
N/A	N/A							
<b>Research Problems (RP)</b>								
N/A	N/A							
<b>Roger CPA Review Questions (RCPA)</b>								
N/A	N/A							
<b>Bridge Discipline Problems (BD)</b>								
BD1	BD1		x					
BD2	BD2		x					

**EOC 1-1**

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Essentials of Taxation 20e (2017)	Essentials of Taxation 21e (2018)	Essentials of Taxation 21e (2018) Learning Objectives	Exact Same	Revised	Brand New	Source Volume: Ind. Income Taxes 41e (2018) OR Corporations 41e (2018)	Source Volume Chapter	Source Volume Question, Problem, or Exercise #
BD3	BD3		x					
BD4	BD4		x					
BD5	BD5		x					

## EOC 1-2

**CHAPTER 1**  
**INTRODUCTION TO TAXATION**  
**SOLUTIONS TO PROBLEM MATERIALS**

**PROBLEMS**

1. (LO 1, 2, 5) Some tax and nontax considerations James should investigate include the following:
  - State and local income taxes.
  - State and local sales taxes.
  - State and local property taxes.
  - Employee implications of the move (Will James lose current employees? Is the labor market better in the new location? Is cost of living lower or higher in new location?)
  - Logistics/transportation of products to customers (specifically document lower costs)
  - State infrastructure (better in new location?)
2. (LO 1) A tax is *proportional* if the rate of tax remains constant for any given income level. The tax is *progressive* if a higher rate of tax applies as the tax base increases.
3. (LO 2)
  - a. The parsonage probably was not listed on the property tax rolls because it was owned by a tax-exempt church. Apparently, the taxing authorities are not aware that ownership has changed.
  - b. Ethan should notify the authorities of his purchase. This will force him to pay back taxes but will eliminate *future* interest and penalties.
4. (LO 1, 6) (See Digging Deeper 1.) As to Adam Smith's canon on *economy*, the Federal income tax yields a mixed result. From the standpoint of the IRS, economy exists as collection costs are nominal (when compared with revenue generated). The government's cost of collecting Federal taxes amounts to less than one-half of 1 percent of the revenue collected. Economy is not present, however, if one looks to the compliance effort and costs expended by taxpayers. According to recent estimates, about 56% of individual taxpayers who file a return pay a preparer, and one-third purchase tax software.
5. (LO 2) Jang probably will be required to pay the Washington use tax if, and when, he applies for Washington license plates. In this case, the use tax probably is the same amount as the Washington sales tax. See the discussion in connection with Example 4 in textbook.
6. (LO 2) Although the Baker Motors bid is the lowest, from a long-term financial standpoint, it is the best. The proposed use of the property by the state and the church probably will make it exempt from the School District's ad valorem tax. This would hardly be the case with a car dealership. In fact, commercial properties (e.g., car dealerships) often are subject to higher tax rates.

7. (LO 2) An *excise tax* is limited to a particular transaction (e.g., sale of gasoline), while a general *sales tax* covers a multitude of transactions (e.g., sale of all nonfood goods).
- a. The following states *do not* impose a general sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon.
  - b. There is no Federal general sales tax.
8. (LO 2) A possible explanation is that Sophia made capital improvements (e.g., added a swimming pool) to her residence and her parents became retirees (e.g., reached age 65).
9. (LO 4, 5) Raabe, Young, Nellen, & Maloney, CPAs  
5191 Natorp Boulevard  
Mason, OH 45040

February 25, 2016

Cynthia Clay  
1206 Seventh Avenue  
Fort Worth, TX 76101

Dear Cynthia:

I am writing this letter to help you decide on what form of entity to choose for your new burrito delivery business. In our phone conversation, you indicated that you expect to have losses for the first two years in this business and then make substantial profits in subsequent years. You and Marco also indicated that you are concerned about potential personal liability.

While I can't make a conclusive recommendation based on the information you have given me, I can provide you with some general guidelines that should simplify your decision. First, given your concern about personal liability, a partnership does not appear to be a desirable option (you would both be personally liable for any injuries to customers). Similarly, given your expectation of losses in the first two years, it does not appear that a C corporation would be a desirable choice, at least initially. This is because any losses in the corporation could only be used to offset future corporate profits—you could not use the losses to immediately offset your personal tax liability.

Thus, two choices exist which provide limited liability and deductibility of losses on your personal income tax return. These are the S corporation and the limited liability company. If you choose an S corporation, we would probably convert the entity to a C corporation when the business becomes profitable. At that point, profits would be taxed at the C corporation rates. A second tax would be levied on your personal income tax return for any dividends paid by the corporation once it achieves C status. In contrast, limited liability companies are taxed like partnerships—all income would be taxed on your personal income tax return in profitable years. The relative desirability of each of these two forms depends on a number of factors. One of the most important factors in your situation is the relationship between your personal tax rate and the tax rate of a C corporation. If you are in a high tax bracket and if the income in the business is sufficiently low, you might be best off choosing the S corporation. Alternatively, if you expect the business to generate a sufficiently large profit each year, it might be best to choose the limited liability company.

If you would like me to give you a clearer recommendation, we should meet at your earliest convenience. If you have any additional questions, please call me.

Best regards,

Julian Jackson, CPA

10. (LO 4, 5)

a.

	<u>2016</u>	<u>2017</u>	<u>2018</u>
<b>Corporate Tax Liability</b>			
Sales Revenue	\$150,000	\$320,000	\$600,000
Cash Expenses	(30,000)	(58,000)	(95,000)
Depreciation	<u>(25,000)</u>	<u>(20,000)</u>	<u>(40,000)</u>
Taxable Income	<u>\$ 95,000</u>	<u>\$242,000</u>	<u>\$465,000</u>
Corporate Tax Liability	<u>\$ 20,550</u>	<u>\$ 77,630</u>	<u>\$158,100</u>
<b>Cash Available for Dividends</b>			
Sales Revenue	\$150,000	\$320,000	\$600,000
Tax-Free Interest Income	5,000	8,000	15,000
Cash Expenses	(30,000)	(58,000)	(95,000)
Corporate Tax Liability	<u>(20,550)</u>	<u>(77,630)</u>	<u>(158,100)</u>
Cash Available for Dividends	<u>\$104,450</u>	<u>\$192,370</u>	<u>\$361,900</u>
<b>Ashley's After-Tax Cash Flow</b>			
Dividend Received	\$104,450	\$192,370	\$361,900
Tax on Dividend at 15% rounded	<u>(15,668)</u>	<u>(28,856)</u>	<u>(54,285)</u>
After-Tax Cash Flow	<u>\$ 88,782</u>	<u>\$163,514</u>	<u>\$307,615</u>
PV of Cash Flow*	<u>\$ 79,273</u>	<u>\$130,353</u>	<u>\$218,960</u>
Present Value	<u>\$428,586</u>		

\*Present value factors (.8929, .7972, .7118) from Appendix F.

b.

	<u>2016</u>	<u>2017</u>	<u>2018</u>
<b>Individual Tax Liability</b>			
Sales Revenue	\$150,000	\$320,000	\$600,000
Cash Expenses	(30,000)	(58,000)	(95,000)
Depreciation	<u>(25,000)</u>	<u>(20,000)</u>	<u>(40,000)</u>
Taxable Income	<u>\$ 95,000</u>	<u>\$242,000</u>	<u>\$465,000</u>
Individual Tax Liability**	<u>\$ 33,250</u>	<u>\$ 84,700</u>	<u>\$162,750</u>

\*\*Rate = 35%

**Ashley's After-Tax Cash Flow**

Sales Revenue	\$150,000	\$320,000	\$600,000
Tax-Free Interest Income	5,000	8,000	15,000
Cash Expenses	(30,000)	(58,000)	(95,000)
Individual Tax Liability	<u>(33,250)</u>	<u>(84,700)</u>	<u>(162,750)</u>
After-Tax Cash Flow	<u>\$ 91,750</u>	<u>\$185,300</u>	<u>\$357,250</u>
PV of Cash Flow*	<u>\$ 81,924</u>	<u>\$147,721</u>	<u>\$254,291</u>
Present Value	<u>\$483,936</u>		

\*Present value factors (.8929, .7972, .7118) from Appendix F.

c.

If Ashley wants to have access to all available cash from the business, then she will have to pay out dividends annually. As seen in the answers to parts a. and b. above, the present value of future cash flows is substantially greater if she does not incorporate under this assumption. Alternatively, if she does not need to pay out dividends, then she may be better off by incorporating, since only the corporate tax will be incurred [\$256,280 (\$20,550 + \$77,630 + \$158,100)], which is less than her individual tax [\$280,700 (\$33,250 + \$84,700 + \$162,750)]. The value of her stock will increase and she can then sell the stock at a later date at favorable capital gains rates.

11. (LO 3, 5) Using the corporate tax rate schedule inside the cover of the textbook, Mauve's tax liability (on \$105,000) is \$24,200. Since Mauve would pay \$0.39 on the next dollar of taxable income earned, its marginal tax rate is 39%. Its average tax rate is the ratio of tax liability to taxable income or approximately 23% ( $\$24,200/\$105,000$ ). Its effective tax rate is the ratio of tax liability to total income or approximately 20% ( $\$24,200/\$120,000$ ).
12. (LO 2)
- a. In terms of taxpayer compliance, an ad valorem tax on personalty is less desirable than one on realty. However, a tax on business personalty, such as inventory, is to be preferred over one on personal use (i.e., nonbusiness) personalty.
  - b. A tax on stock and bonds would be too easily avoided. The taxing authority would have no means of ascertaining ownership of these assets.
  - c. Poor taxpayer compliance is to be expected for any tax on personal use personalty. However, if boats had to be periodically licensed (e.g., safety inspection), this could provide the taxing authority with a means of discovering unreported boat ownership.
13. (LO 6)
- a. Economic justification. The tax law addresses the energy crisis—in terms of both reliance on foreign oil and the need to ease the problem of climate change.
  - b. Economic justification. See the comments under part a. above.
  - c. Equity considerations. To alleviate the effect of multiple taxation of the same income.
  - d. Administrative feasibility (Influence of the Internal Revenue Service). The limitation reduces the number of casualty and theft losses that can be claimed and thereby eases the audit burden on the IRS.
  - e. Economic justification. Research and development activities are encouraged by allowing immediate or faster write-off of these expenditures.
  - f. Economic justification. The justification for the domestic production activities deduction is to stimulate the U.S. manufacturing industry. By providing a limitation on the source of the wages involved, it also encourages job growth.
  - g. Social justification. The charitable deduction helps fund private organizations and causes that are operated in the interest of the general welfare. This relieves government of the need for considerable public funding.
  - h. Economic justification. Known as the S election, the provision encourages small businesses to operate in the corporate form without suffering all of the tax disadvantages of the Regular (C) Corporation.
14. (LO 6)
- a. Social considerations explain the credit. It is socially desirable to encourage parents to provide care for their children while they work.
  - b. These deductions raise the issue of preferential tax treatment for homeowners—taxpayers who rent their personal residences do not receive comparable treatment. Even so, the encouragement of home ownership can be justified on economic and social grounds.
  - c. The joint return procedure came about to equalize the position of married persons living in common law states with those residing in community property jurisdictions. Political and equity considerations caused this result.
  - d. Activities deemed contrary to public policy should not result in tax savings.

- e. The NOL carryback provision is an equity consideration that is designed to mitigate the effect of the annual accounting period concept.
  - f. The installment method of reporting gain is consistent with the wherewithal to pay concept—the seller is taxed when the payments are made by the purchaser.
  - g. The exclusion from Federal income taxation of interest from state and local bonds can be justified largely on political considerations. Political goodwill is generated by allowing state and local jurisdictions to secure financing at a lower cost (i.e., interest rate) due to favorable Federal income tax treatment.
  - h. The treatment of prepaid income is justified under the wherewithal to pay concept. It also eases the task of the IRS as to administration of the tax law.
15. (LO 2) (See Digging Deeper 5.) A value added tax (VAT) taxes the increment in value as goods move through the production and manufacturing stages to the marketplace. Although the tax is paid by the producer, it is reflected in the selling price of the goods. Therefore, a VAT is a tax on consumption.
- A national sales tax taxes numerous transactions and is collected on the final sale of goods and services to the consumer. Consequently, it is collected from the consumer and not the producer of the product as does a VAT.
- In terms of taxpayer compliance, a VAT is preferable to a national sales tax. Without significant collection efforts, a national sales tax could easily be circumvented or avoided in many ways (e.g., resorting to a barter system of doing business, etc.).
16. (LO 2) This problem requires students to access various sites on the internet. Thus, each student's solution likely will vary from that of the others. You should determine the skill and experience levels of the students before making the assignment, coaching them where necessary so as to broaden the scope of the exercise to the entire available electronic world. Encourage students to use reliable websites and blogs of the IRS and other government agencies, media outlets, businesses, tax professionals, academics, think tanks, and political outlets to research their answers.
17. (LO 5) Students' e-mails will vary. Build interaction into the exercise wherever possible, asking the student to send and receive e-mail in a professional and responsible manner.
18. (LO 5) Students' answers will vary.
19. (LO 2, 5) If Mike is drafted by a team in one of the listed states, he will escape state income tax on income earned within that state (e.g., training camp, home games). He will not, however, escape the income tax (state and local) imposed by jurisdictions where he plays away games. Called the "jock tax," it is applied to out-of-state athletes and entertainers.
20. (LO 5) The checkoff boxes add complexity to the return and mislead taxpayers into presuming that they are not paying for the donation.

## BRIDGE DISCIPLINE PROBLEMS

1. Answer will vary with each student.
2. Answer will vary with each student.
3. Answer will vary with each student.
4. When taxes become “too high,” taxpayers increase the rates of tax cheating, because the payoff from misconduct increases. Property and transaction taxes are difficult to cheat on, as the tax base is easily detectible, while cheating on taxes on income and asset transfers may be more easily accomplished, and enforcement activities by the taxing agency become more expensive. High rates of tax cheating can lead to several undesirable consequences.
  - A “conspicuous consumption” society, wherein taxpayers use their tax underpayments to increase their lifestyles in a public fashion.
  - A loss of confidence in the self-assessment system, such that certain levels of cheating are assumed to occur, and the number of cheaters increases.
  - The “missing revenue” keeps the government from delivering the goods and services that the taxes are supposed to pay for.
  - Political gridlock can occur when it becomes impossible to raise tax rates high enough, or broaden the tax base enough, to offset the cheaters’ “missing revenue.”
5. (LO 7)
  - a. To encourage pension plans is to stimulate saving (economic consideration). Also, it provides security from the private sector for retirement to supplement rather meager public programs (social considerations).
  - b. To make education more widely available is to promote a socially desirable objective. A better educated workforce also serves to improve the country’s economic capabilities. Thus, education tax incentives can be justified on both social and economic grounds.
  - c. The encouragement of home ownership can be justified on both social and economic grounds.