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PEARSON'S

Federal Taxation 2017

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2016
TAX RATE SCHEDULES
INDIVIDUAL TAXPAYERS

Single [§1(c)]:

If taxable income is:	The tax is:
Not over $9,275	10% of taxable income.
Over $9,275 but not over $37,650	$927.50, plus 15% of the excess over $9,275.
Over $37,650 but not over $91,150	$5,183.75, plus 25% of the excess over $37,650.
Over $91,150 but not over $190,150	$18,558.75, plus 28% of the excess over $91,150.
Over $190,150 but not over $413,350	$46,278.75, plus 33% of the excess over $190,150.
Over $413,350 but not over $415,050	$119,934.75, plus 35% of the excess over $413,350.
Over $415,050	$120,529.75, plus 39.6% of the excess over $415,050.

Head of Household [§1(b)]:

If taxable income is:	The tax is:
Not over $13,250	10% of taxable income.
Over $13,250 but not over $50,400	$1,325.00, plus 15% of the excess over $13,250.
Over $50,400 but not over $130,150	$6,897.50, plus 25% of the excess over $50,400.
Over $130,150 but not over $210,800	$26,835.00, plus 28% of the excess over $130,150.
Over $210,800 but not over $413,350	$49,417.00, plus 33% of the excess over $210,800.
Over $413,350 but not over $441,000	$116,258.50, plus 35% of the excess over $413,350.
Over $441,000	$125,936.00, plus 39.6% of the excess over $441,000.

Married, Filing Joint and Surviving Spouse [§1(a)]:

If taxable income is:	The tax is:
Not over $18,550	10% of taxable income.
Over $18,550 but not over $75,300	$1,855.00, plus 15% of the excess over $18,550.
Over $75,300 but not over $151,900	$10,367.50, plus 25% of the excess over $75,300.
Over $151,900 but not over $231,450	$29,517.50, plus 28% of the excess over $151,900.
Over $231,450 but not over $413,350	$51,791.50, plus 33% of the excess over $231,450.
Over $413,350 but not over $466,950	$111,818.50, plus 35% of the excess over $413,350.
Over $466,950	$130,578.50, plus 39.6% of the excess over $466,950.

Married, Filing Separate [§1(d)]:

If taxable income is:	The tax is:
Not over $9,275	10% of taxable income.
Over $9,275 but not over $37,650	$927.50, plus 15% of the excess over $9,275.
Over $37,650 but not over $75,950	$5,183.75, plus 25% of the excess over $37,650.
Over $75,950 but not over $115,725	$14,758.75, plus 28% of the excess over $75,950.
Over $115,725 but not over $206,675	$25,895.75, plus 33% of the excess over $115,725.
Over $206,675 but not over $233,475	$55,909.25, plus 35% of the excess over $206,675.
Over $233,475	$65,289.25, plus 39.6% of the excess over $233,475.

Capital Gains and Dividends

Capital gains and losses are assigned to baskets. Five possible tax rates will apply to most capital gains and losses:

- Ordinary income tax rates (up to 39.6% in 2016) for gains on assets held one year or less
- 28% rate on collectibles gains and includible Sec. 1202 gains
- 20% rate on gains on assets held for more than one year and qualified dividends (for taxpayers whose regular tax bracket is 39.6%)
- 15% rate on gains on assets held for more than one year and qualified dividends (for taxpayers whose regular tax bracket is higher than 15% and less than 39.6%)
- 0% rate on gains on assets held for more than one year and qualified dividends (for taxpayers whose regular tax bracket is not higher than 15%)

Note: The net investment income of higher income taxpayers (modified AGI greater than $200,000 for single and $250,000 for married filing jointly) also may be subject to an additional tax of 3.8%. Net investment income includes dividends and capital gains, along with other types of investment income.

Social Security Tax—2016

Category	Rate	Dollar Limit
OASDI	6.2%	$118,500
Medicare*	1.45%	First $200,000 of wages ($250,000 for joint returns)
	2.35%	Wages greater than $200,000 ($250,000 for joint returns)

*Only the employee is required to pay the additional Medicare tax on wages above $200,000 ($250,000 for joint returns). The employer pays Medicare tax of 1.45% on all wages.

Self-Employment Tax—2016

Category	Rate	Dollar Limit
OASDI	12.4%	$118,500
Medicare	2.9%	First $200,000 of self-employment income ($250,000 combined self-employment income for joint returns)
	3.8%	Self-employment income greater than $200,000 ($250,000 for joint returns)

Alternative Minimum Tax—2016

If AMTI minus the exemption amount is:		The tax is:	
Over—	But Not Over—		Of the Amount Over—
$0	$186,300*	26%	$0
$186,300*		$48,438* + 28%	$186,300

*$93,150 and $24,219 for married taxpayers filing separately.

AMT exemption amounts (before phase-outs and other adjustments):

Unmarried individuals (other than surviving spouses and heads of households)	$53,900
Married individuals filing joint returns and surviving spouses	83,800
Married individuals filing separate returns	41,900

STANDARD DEDUCTION

Filing Status	
Married individuals filing joint returns and surviving spouses	$12,600
Heads of households	9,300
Unmarried individuals (other than surviving spouses and heads of households)	6,300
Married individuals filing separate returns	6,300
Additional standard deduction for the aged and the blind	
Individual who is married and surviving spouses	1,250*
Individual who is unmarried and not a surviving spouse	1,550*
Taxpayer claimed as dependent on another taxpayer's return: Greater of (1) earned income plus $350, or (2) $1,050.	

*These amounts are $2,500 and $3,100, respectively, for a taxpayer who is both aged and blind.

PERSONAL AND DEPENDENCY EXEMPTION AND PHASE-OUTS

Personal and dependency exemption	$ 4,050
Phase-outs for high income taxpayers:	
Personal and dependency exemptions are reduced by 2% for each $2,500 increment (or part of increment) for AGI above the threshold amount.	
Itemized deductions are reduced by 3% for each dollar of AGI above the threshold amounts (taxpayers cannot lose more than 80% of their allowable itemized deductions).	
For both provisions, the AGI threshold amounts are:	
Married individuals filing joint returns and surviving spouses	$311,300
Heads of households	285,350
Unmarried individuals (other than surviving spouses and heads of households)	259,400
Married individuals filing separate returns	155,650

2016
TAX RATE SCHEDULES

ESTATES AND TRUSTS [§1 (e)]:

If taxable income is:	The tax is:
Not over $2,550	15% of taxable income.
Over $2,550 but not over $5,950	$382.50 plus 25% of the excess over $2,550.
Over $5,950 but not over $9,050	$1,232.50 plus 28% of the excess over $5,950.
Over $9,050 but not over $12,400	$2,100.50 plus 33% of the excess over $9,050.
Over $12,400	$3,206.00 plus 39.6% of the excess over $12,400.

CORPORATIONS

If Taxable Income Is:		The Tax Is:	
Over—	But Not Over—		Of the Amount Over—
$ 0	$ 50,000	15%	$ 0
50,000	75,000	$ 7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333		6,416,667 + 35%	18,333,333

UNIFIED CREDIT AMOUNT FOR ESTATE AND GIFT TAX

Year of Gift/Year of Death	Amount of Credit	Basic Exclusion Amount (Exemption Equivalent)
January through June, 1977	$ 30,000 (6,000)[b]	$ 120,666 (30,000)[b]
July through December, 1977	30,000	120,666
1978	34,000	134,000
1979	38,000	147,333
1980	42,500	161,563
1981	47,000	175,625
1982	62,800	225,000
1983	79,300	275,000
1984	96,300	325,000
1985	121,800	400,000
1986	155,800	500,000
1987 through 1997	192,800	600,000
1998	202,050	625,000
1999	211,300	650,000
2000 and 2001	220,550	675,000
2002 and 2003	345,800	1,000,000
2004 and 2005	555,800 (345,800)[a]	1,500,000 (1,000,000)[a]
2006, 2007, and 2008	780,800 (345,800)[a]	2,000,000 (1,000,000)[a]
2009	1,455,800 (345,800)[a]	3,500,000 (1,000,000)[a]
2010	1,730,800[b] (330,800)[a]	5,000,000[b] (1,000,000)[a]
2011	1,730,800	5,000,000
2012	1,772,800	5,120,000
2013	2,045,800	5,250,000
2014	2,081,800	5,340,000
2015	2,117,800	5,430,000
2016	2,125,800	5,450,000

[a] The numbers in parentheses represent the credit and exemption equivalent amounts for the gift tax.
[b] This amount applied if the executor opted to have the estate subject to the estate tax and FMV basis rule in 2010.

UNIFIED TRANSFER TAX RATES

For Transfers Made in 1984 Through 2001:*

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over $10,000	18% of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20% of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22% of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24% of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26% of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28% of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30% of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32% of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34% of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37% of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39% of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41% of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43% of the excess of such amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45% of the excess of such amount over $1,500,000.
Over $2,000,000 but not over $2,500,000	$780,800, plus 49% of the excess of such amount over $2,000,000.
Over $2,500,000 but not over $3,000,000	$1,025,800, plus 53% of the excess of such amount over $2,500,000.
Over $3,000,000	$1,290,800, plus 55% of the excess of such amount over $3,000,000.

* For decedents dying after 2001 and gifts made after 2001, the maximum tax rates are as follows:
Note: The rates in the above schedule still apply to amounts less than the amounts in the second column of the below schedule.

Year	If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
2002	Over $2,500,000	$1,025,800, plus 50% of the excess of such amount over $2,500,000.
2003	Over $2,000,000	$780,800, plus 49% of the excess of such amount over $2,000,000.
2004	Over $2,000,000	$780,800, plus 48% of the excess of such amount over $2,000,000.
2005	Over $2,000,000	$780,800, plus 47% of the excess of such amount over $2,000,000.
2006	Over $2,000,000	$780,800, plus 46% of the excess of such amount over $2,000,000.
2007–2009	Over $1,500,000	$555,800, plus 45% of the excess of such amount over $1,500,000.
2010	Over $500,000**	$155,800, plus 35% of the excess of such amount over $500,000.**
2011–2012	Over $500,000	$155,800, plus 35% of the excess of such amount over $500,000.
2013 and after	Over $1,000,000	$345,800, plus 40% of the excess of such amount over $1,000,000.

** Gift tax only unless the executor opted to have the estate subject to the estate tax and FMV basis rule in 2010.

PEARSON'S FEDERAL TAXATION 2017 INDIVIDUALS

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PEARSON

10 9 8 7 6 5 4 3 2 1
ISBN-10: 0-13-442086-1
ISBN-13: 978-0-13-442086-8

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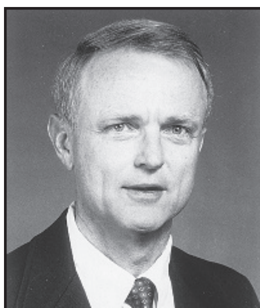

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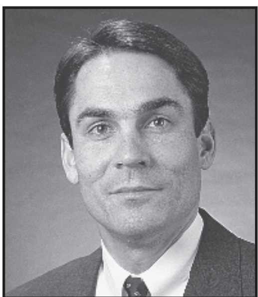

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PREFACE

Why is the Rupert/Pope/Anderson series the best choice for you and your students?

The Rupert/Pope/Anderson 2017 Series in Federal Taxation is appropriate for use in any first course in federal taxation, and comes in a choice of three volumes:

Federal Taxation 2017: Individuals
Federal Taxation 2017: Corporations, Partnerships, Estates & Trusts (the companion book to *Individuals*)
Federal Taxation 2017: Comprehensive (14 chapters from *Individuals* and 15 chapters from *Corporations*)
** For a customized edition of any of the chapters for these texts, contact your Pearson representative and they can create a custom text for you.

- The *Individuals* volume covers *all* entities, although the treatment is often briefer than in the *Corporations* and *Comprehensive* volumes. The *Individuals* volume, therefore, is appropriate for colleges and universities that require only one semester of taxation as well as those that require more than one semester of taxation. Further, this volume adapts the suggestions of the Model Tax Curriculum as promulgated by the American Institute of Certified Public Accountants.
- The *Corporations, Partnerships, Estates & Trusts* and *Comprehensive* volumes contain three comprehensive tax return problems whose data change with each edition, thereby keeping the problems fresh. Problem C:3-66 contains the comprehensive corporate tax return, Problem C:9-58 contains the comprehensive partnership tax return, and Problem C:11-64 contains the comprehensive S corporation tax return, which is based on the same facts as Problem C:9-58 so that students can compare the returns for these two entities.
- The *Corporations, Partnerships, Estates & Trusts* and *Comprehensive* volumes contain sections called Financial Statement Implications, which discuss the implications of Accounting Standards Codification (ASC) 740. The main discussion of accounting for income taxes appears in Chapter C:3. The financial statement implications of other transactions appear in Chapters C:5, C:7, C:8, and C:16 (*Corporations* volume only).

What's New to this Edition?

INDIVIDUALS

- Complete updating of significant court cases and IRS rulings and procedures during 2015 and early 2016.
- Complete updating for the Protecting Americans from Tax Hikes Act of 2015, the Trade Preferences Extension Act of 2015, and the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.
- Discussion of tax extender deductions and credits in 2016.
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2016.
- Whenever new updates become available, they will be accessible via MyAccountingLab.

CORPORATIONS

- The comprehensive corporate tax return, Problem C:3-66, has all new numbers for the 2015 forms.
- The comprehensive partnership tax return, Problem C:9-58, has all new numbers for the 2015 forms.
- The comprehensive S corporation tax return, Problem C:11-64, has all new numbers for the 2015 forms.
- Changes affecting 2016 tax law have been incorporated into the text where appropriate, including the tax legislation listed in the second Individuals bullet item above.
- All tax rate schedules have been updated to reflect the rates and inflation adjustments for 2016.
- Whenever new updates become available, they will be accessible via MyAccountingLab.

MyAccountingLab

MyAccountingLab is an online homework, tutorial, and assessment program designed to work with *Pearson's Federal Taxation 2017* to engage students and improve results. MyAccountingLab's homework and practice questions are correlated

to the textbook, they regenerate algorithmically to give students unlimited opportunity for practice and mastery, and they offer helpful feedback when students enter incorrect answers. Combining resources that illuminate content with accessible self-assessment, MyAccountingLab with eText provides students with a complete digital learning experience—all in one place. To register, go to http://www.pearsonmylabandmastering.com.

For Instructors

MyAccountingLab provides instructors with a rich and flexible set of course materials, along with course-management tools that make it easy to deliver all or a portion of your course online.

- **Powerful Homework and Test Manager** Create, import, and manage online homework and media assignments, quizzes, and tests. Create assignments from online questions directly correlated to this and other textbooks. Homework questions include "Help Me Solve This" guided solutions to help students understand and master concepts. You can choose from a wide range of assignment options, including time limits, proctoring, and maximum number of attempts allowed. In addition, you can create your own questions—or copy and edit ours—to customize your students' learning path.
- **Comprehensive Gradebook Tracking** MyAccountingLab's online gradebook automatically tracks your students' results on tests, homework, and tutorials and gives you control over managing results and calculating grades. All MyAccountingLab grades can be exported to a spreadsheet program, such as Microsoft® Excel. The MyAccountingLab Gradebook provides a number of student data views and gives you the flexibility to weight assignments, select which attempts to include when calculating scores, and omit or delete results for individual assignments.
- **Department-Wide Solutions** Get help managing multiple sections and working with Teaching Assistants using MyAccountingLab Coordinator Courses. After your MyAccountingLab course is set up, it can be copied to create sections or "member courses." Changes to the Coordinator Course flow down to all members, so changes only need to be made once.

We will add the most current tax information to MyAccountingLab as it becomes available.

For Students

MyAccountingLab provides students with a personalized interactive learning environment, where they can learn at their own pace and measure their progress.

- **Interactive Tutorial Exercises** MyAccountingLab's homework and practice questions are correlated to the textbook, and "similar to" versions regenerate algorithmically to give students unlimited opportunity for practice and mastery. Questions offer helpful feedback when students enter incorrect answers, and they include "Help Me Solve This" guided solutions as well as other learning aids for extra help when students need it.
- **Study Plan for Self-Paced Learning** MyAccountingLab's study plan helps students monitor their own progress, letting them see at a glance exactly which topics they need to practice. MyAccountingLab generates a personalized study plan for each student based on his or her test results, and the study plan links directly to interactive, tutorial exercises for topics the student hasn't yet mastered. Students can regenerate these exercises with new values for unlimited practice, and the exercises include guided solutions and multimedia learning aids to give students the extra help they need.
- **Dynamic Study Modules** MyAccountingLab's Dynamic Study Modules work by continuously assessing student performance and activity, then using data and analytics to provide personalized content in real time to reinforce concepts that target each student's particular strengths and weaknesses.

Strong Pedagogical Aids

- Appropriate blend of technical content of the tax law with a high level of readability for students.
- Focused on enabling students to apply tax principles within the chapter to real-life situations.

Real-World Example

These comments relate the text material to events, cases, and statistics occurring in the tax and business environment. The statistical data presented in some of these comments are taken from the IRS's Statistics of Income at www.irs.gov.

Book-to-Tax Accounting Comparison

These comments compare the tax discussion in the text to the accounting and/or financial statement treatment of this material. Also, the last section of Chapter C:3 discusses the financial statement implications of federal income taxes.

What Would You Do in This Situation?

Unique to the Rupert/Pope/Anderson series, these boxes place students in a decision-making role. The boxes include many *controversies* that are as yet unresolved or are currently being considered by the courts. These boxes make extensive use of **Ethical Material** as they represent choices that may put the practitioner at odds with the client.

Stop & Think

These "speed bumps" encourage students to pause and apply what they have just learned. Solutions for each issue are provided in the box.

Ethical Point

These comments provide the ethical implications of material discussed in the adjoining text. Apply what they have just learned.

Tax Strategy Tip

These comments suggest tax planning ideas related to material in the adjoining text.

Additional Comment

These comments provide supplemental information pertaining to the adjacent text.

Program Components

Materials for the instructor may be accessed at the Instructor's Resource Center (IRC) online, located at **www.pearsonhighered.com/phtax** or within the Instructor Resource section of MyAccountingLab. You may contact your Pearson representative for assistance with the registration process.

- ***TaxAct 2015 Software:*** Available via online purchase with Individuals, Corporations, and Comprehensive Texts. This user-friendly tax preparation program includes more than 80 tax forms, schedules, and worksheets. TaxAct calculates returns and alerts the user to possible errors or entries. Consists of Forms 990, 1040, 1041, 1065, 1120, and 1120S.
- ***Instructor's Resource Manual:*** Contains sample syllabi, instructor outlines, and information regarding problem areas for students. It also contains solutions to the tax form/tax return preparation problems.
- ***Solutions Manual:*** Contains solutions to discussion questions, problems, and comprehensive and tax strategy problems. It also contains all solutions to the case study problems, research problems, and "What Would You Do in This Situation?" boxes.
- ***Test Bank:*** Offers a wealth of true/false, multiple-choice, and calculative problems. A computerized program is available to adopters.
- ***PowerPoint Slides:*** Consists of chapter outlines, featuring images, examples, and problems throughout, to aid in class lectures.
- ***Image Library:*** Figures, tables, and tax forms featured in the book are provided as individual files for the convenience of instructors and students.
- ***Multi-State Tax Chapter:*** An entire chapter, complete with problems (and solutions) dedicated to multi-state tax practices.

Acknowledgments

Our policy is to provide annual editions and to prepare timely updated supplements when major tax revisions occur. We are most appreciative of the suggestions made by outside reviewers because these extensive review procedures have been valuable to the authors and editors during the revision process.

We also are grateful to the various graduate assistants, doctoral students, and colleagues who have reviewed the text and supplementary materials and checked solutions to maintain a high level of technical accuracy. In particular, we would like to acknowledge the following colleagues who assisted in the preparation of supplemental materials for this text:

Ann Burstein Cohen	SUNY at Buffalo
Craig J. Langstraat	University of Memphis
Kate Demarest	Carroll Community College
Allison McLeod	University of North Texas
Mitchell Franklin	LeMoyne College
Anthony Masino	East Tennessee State University

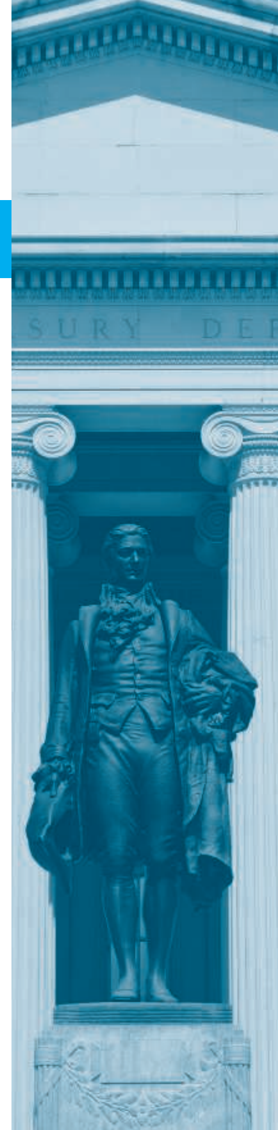
In addition, we want to thank Myron S. Scholes, Mark A. Wolfson, Merle M. Erickson, M. L. Hanlon, Edward L. Maydew, and Terry J. Shevlin for allowing us to use the model discussed in their text, *Taxes and Business Strategy: A Planning Approach*, as the basis for material in Chapter I:18.

Please send any comments to Kenneth E. Anderson or Timothy J. Rupert.

CHAPTER

1

AN INTRODUCTION TO TAXATION



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1. Discuss the history of taxation in the United States
2. Describe the three types of tax rate structures
3. Describe the various types of taxes
4. Discuss the criteria for a "good" tax structure, the objectives of the federal income tax law, and recent tax reform proposals
5. Describe the tax entities in the federal income tax system
6. Identify the various tax law sources and understand their implications for tax practice
7. Describe the legislative process for the enactment of the tax law
8. Describe the administrative procedures under the tax law
9. Describe the components of a tax practice
10. Understand the importance of computer applications in taxation

CHAPTER OUTLINE

History of Taxation in the United States...1-2
Types of Tax Rate Structures...1-4
Other Types of Taxes...1-7
Criteria for a Tax Structure...1-12
Entities in the Federal Income Tax System...1-16
Tax Law Sources...1-24
Enactment of a Tax Law...1-24
Administration of the Tax Law and Tax Practice Issues...1-26
Components of a Tax Practice...1-29
Computer Applications in Tax Practice...1-31

Federal income taxes have a significant effect on business, investor, and personal decisions in the United States. Because tax rates can be as high as 35% on corporations and over 40% on individuals, virtually every transaction is impacted by income taxes. The following examples illustrate the impact of the tax law on various decisions in our society:

- Because of the deductibility of home mortgage interest and real estate taxes, an individual may decide to purchase a home rather than to continue to rent an apartment.
- An investor may decide to delay selling some stock because of the significant taxes that may result from the sale.
- A corporation may get a larger tax deduction if it leases property rather than purchasing the property.

The purpose of this text is to provide an introduction to the study of federal income taxation. However, before discussing the specifics of the U.S. federal income tax law, it is helpful to have a broad conceptual understanding of the taxation process. This chapter provides an overview of the following topics:

- Historical developments of the federal tax system
- Types of taxes levied and structural considerations
- Objectives of the tax law, including a discussion of recent tax reform proposals
- Taxpaying entities in the federal income tax system
- Tax law sources and the legislative process
- Internal Revenue Service (IRS) collection, examination, and appeals processes
- The nature of tax practice, including computer applications and tax research

KEY POINT

In many situations, the use of the tax laws to influence human behavior is deliberate. As will be seen later in this chapter, tax laws are often used to achieve social and economic objectives.

HISTORY OF TAXATION IN THE UNITED STATES

OBJECTIVE 1

Discuss the history of taxation in the United States

EARLY PERIODS

The federal income tax is the dominant form of taxation in the United States. In addition, most states and some cities and counties also impose an income tax. Both corporations and individuals are subject to such taxes.

Prior to 1913 (the date of enactment of the modern-day federal income tax), the federal government relied predominantly on customs duties and excise taxes to finance its operations. The first federal income tax on individuals was enacted in 1861 to finance the Civil War but was repealed after the war. The federal income tax was reinstated in 1894, however, that tax was challenged in the courts because the U.S. Constitution required that an income tax be apportioned among the states in proportion to their populations. This type of tax system, which would be both impractical and difficult to administer, would mean that different tax rates would apply to individual taxpayers depending on their states of residence.

In 1895, the Supreme Court ruled that the tax was in violation of the U.S. Constitution.[1] Therefore, it was necessary to amend the U.S. Constitution to permit the passage of a federal income tax law. This was accomplished by the Sixteenth Amendment, which was ratified in 1913. The Sixteenth Amendment, while being an extraordinarily important amendment, consists of one sentence.

HISTORICAL NOTE

The reinstatement of the income tax in 1894 was the subject of heated political controversy. In general, the representatives in Congress from the agricultural South and West favored the income tax in lieu of customs duties. Representatives from the industrial eastern states were against the income tax and favored protective tariff legislation.

Sixteenth Amendment to the Constitution of the United States

> The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

[1] *Pollock v. Farmers' Loan & Trust Co.*, 3 AFTR 2602 (USSC, 1895). Note, however, that a federal income tax on corporations that was enacted in 1909 was held to be constitutional because it was treated as an excise tax. See *Flint v. Stone Tracy Co.*, 3 AFTR 2834 (USSC, 1911).

REVENUE ACTS FROM 1913 TO THE PRESENT

HISTORICAL NOTE

The Revenue Act of 1913 contained sixteen pages.

HISTORICAL NOTE

Before 1939, the tax laws were contained in the most current revenue act, a reenactment of a prior revenue act plus amendments. In 1939, a permanent tax code was established; it was revised in 1954 and 1986.

The Revenue Act of 1913 imposed a flat 1% tax (with no exemptions) on a corporation's net income. The rate varied from 1% to 6% for individuals, depending on the individual's income level. However, very few individuals paid federal income taxes because a $3,000 personal exemption ($4,000 for married individuals) was permitted as an offset to taxable income. These amounts were greater than the incomes of most individuals in 1913.

Various amendments to the original law were passed between 1913 and 1939 as separate revenue acts. For example, a deduction for dependency exemptions was provided in 1917. In 1939, the separate revenue acts were codified into the Internal Revenue Code of 1939. A similar codification was accomplished in 1954. The 1954 codification, which was known as the Internal Revenue Code of 1954, included the elimination of many "deadwood" provisions, a rearrangement and clarification of numerous code sections, and the addition of major tax law changes. Whenever changes to the Internal Revenue Code (IRC) are made, the old language is deleted and the new language added. Thus, the statutes are organized as a single document, and a tax advisor does not have to read through the applicable parts of all previous tax bills to find the most current law. In 1986, major changes were made to the tax law, and the basic tax law was redesignated as the Internal Revenue Code of 1986.

The federal income tax became a "mass tax" on individuals during the early 1940s. This change was deemed necessary to finance the revenue needs of the federal government during World War II. In 1939, less than 6% of the U.S. population was subject to the federal income tax; by 1945, 74% of the population was taxed.[2] To accommodate the broadened tax base and to avoid significant tax collection problems, Congress enacted pay-as-you-go withholding in 1943.

A major characteristic of the federal income tax since its inception to today is the manner in which the tax law is changed or modified. The federal income tax is changed on an **incremental** basis rather than a complete revision basis. Under so-called incrementalism, when a change in the tax law is deemed necessary by Congress, the entire law is not changed, but specific provisions of the tax law are added, changed, or deleted on an incremental basis. Thus, the federal income tax has been referred to as a "quiltwork" of tax laws, referring to the patchwork nature of the law. Without question, one of the principal reasons for the complexity of the federal income tax today is the incremental nature of tax legislation.

REVENUE SOURCES

ADDITIONAL COMMENT

In 2013, 147 million individual income tax returns were filed, and collections from individuals totaled $1.23 trillion.

As mentioned earlier, the largest source of federal revenues is individual income taxes. Other major revenue sources include Social Security (FICA) taxes and corporate income taxes (see Table I:1-1). Two notable trends from Table I:1-1 are (1) the gradual increase in social insurance taxes from 1960 to 2015 and (2) the gradual decrease in corporate income taxes for the same period. Individual income taxes have remained fairly stable during the past 50 years.

TYPICAL MISCONCEPTION

It is often assumed that the tax revenue from corporation income taxes is the largest source of tax revenue. However, the revenue generated from this tax only represents approximately 11% of total federal revenues in 2015.

▼ TABLE I:1-1
Breakdown of Federal Revenues

	1960	1975	2000	2015
Individual income taxes	44%	45%	50%	47%
Social insurance taxes and contribution	16	32	32	33
Corporation income taxes	23	15	10	11
Other	17	8	8	9
Total	100%	100%	100%	100%

Source: Council of Economic Advisers, *Economic Indicators* (Washington, DC: U.S. Government Printing Office, 1967, 1977, 2015).

[2] Richard Goode, *The Individual Income Tax* (Washington, DC: The Brookings Institution, 1964), pp. 2–4.

Types of Tax Rate Structures

OBJECTIVE 2

Describe the three types of tax rate structures

THE STRUCTURE OF INDIVIDUAL INCOME TAX RATES

Virtually all tax structures are comprised of two basic parts: the **tax base** and the **tax rate**. The tax base is the amount to which the tax rate is applied to determine the tax due. For example, an individual's tax base for the federal income tax is *taxable income,* as defined and determined by the income tax law. Similarly, the tax base for the property tax is generally the fair market value of property subject to the tax. The tax rate is merely the percentage rate applied to the tax base.

ADDITIONAL COMMENT

In the 1950s, the top marginal tax rate for individual taxpayers reached 92%. This astonishingly high rate only applied to taxpayers with very high taxable incomes but still is an extremely confiscatory tax rate.

Tax rates may be progressive, proportional, or regressive. A **progressive rate** structure is one where the rate of tax increases as the tax base increases. The most notable tax that incorporates a progressive rate structure is the federal income tax. Thus, as a taxpayer's taxable income increases, a progressively higher rate of tax is applied. For 2016, the federal income tax rates for individuals begin at 10% and increase to 15%, 25%, 28%, 33%, 35%, and 39.6% as a taxpayer's taxable income increases.[3] Examples I:1-1 and I:1-2 show how the progressive rate structure of the federal income tax operates.

EXAMPLE I:1-1 ▶

Alice, who is single, has $30,000 taxable income in 2016. Her federal income taxes for the year are $4,036, computed as follows: the first $9,275 of taxable income is taxed at 10% and the remaining $20,725 at 15%. (For tax rates, see the inside front cover.)

Allen, who also is single, has taxable income of $60,000. A 10% rate applies to the first $9,275 of taxable income, 15% on the next $28,375, and a 25% rate applies to the taxable income over $37,650. Thus, Allen's total tax is $10,771 [(0.10 × $9,275) + (0.15 × $28,375) + (0.25 × $22,350)].

If Allen's taxable income is $120,000, a 28% rate applies to $28,850 of his taxable income ($120,000 − $91,150) because the 28% rate applies to taxable income above $91,150 for a single individual and his total tax for the year is $26,637. Thus, the tax rates are progressive because the rate of tax increases as a taxpayer's taxable income increases. ◀

LEGISLATIVE BACKGROUND

Beginning with tax year 2013, the top rate for high-income individual taxpayers was increased to 39.6% from 35%.

Notice in Example I:1-1 that taxable income has doubled in size in the three cases, but the income taxes have more than doubled (i.e., $4,036 to $10,771 to $26,637). This demonstrates how a progressive rate structure operates.

EXAMPLE I:1-2 ▶

Assume the same facts as in Example I:1-1 except that Alice has taxable income of $200,000. Of Alice's taxable income, $9,850 ($200,000 − $190,150) is subject to the 33% rate. Alternatively, if Allen has taxable income of $450,000, $34,950 ($450,000 − $415,050) is subject to the top marginal rate of 39.6%. ◀

A **proportional tax** rate, sometimes called a **flat tax**, is one where the rate of tax is the same for all taxpayers, regardless of the level of their tax base. This type of tax rate is generally used for real estate taxes, state and local sales taxes, personal property taxes, customs duties, and excise taxes. A flat tax has been the subject of considerable discussion over the past twenty years and promises to be a controversial topic as the debate on federal income tax reform continues into the future.

EXAMPLE I:1-3 ▶

Assume the same facts as in Example I:1-1, except that a 17% tax rate applies to all amounts of taxable income. Based on the assumed flat tax rate structure, Alice's federal income tax is $5,100 on $30,000 of taxable income; Allen's tax is $10,200 on $60,000 of taxable income and $20,400 on $120,000 of taxable income. The tax rate is proportional because the 17% rate applies to both taxpayers without regard to their income level. As you can see, a proportional tax rate results in substantially lower taxes for higher income taxpayers.[4] ◀

[3] See the inside front cover for the 2016 tax rates and Chapter I:2 for a discussion of the computation procedures. 2015 rate schedules and tax tables are located immediately before Appendix A.

[4] This example assumes the same tax base (taxable income) for the flat tax as with the current federal tax. Most flat tax proposals allow only a few deductions and, therefore, would generate higher taxes than in the example.

SELF-STUDY QUESTION

Assume a tax system with a tax of $1,000 on taxable income of $10,000 and a $1,500 tax on taxable income of $20,000. Is the tax rate system progressive, proportional, or regressive?

ANSWER

This tax system is regressive. Even though the amount of tax has increased, the rate of taxation has decreased from 10% on the first $10,000 of taxable income to 5% on the second $10,000 of taxable income.

A **regressive tax** rate decreases with an increase in the tax base (e.g., income). Regressive taxes, while not consistent with the fairness of the income tax,[5] are found in the United States. The Social Security (FICA) tax is regressive because a fixed rate of tax of 6.20% for OASDI for both the employer and employee is levied up to a ceiling amount of $118,500 for 2016. So, for example, assume Taxpayer A has income subject to Social Security of $80,000 and Taxpayer B income of $400,000. Taxpayer A's OASDI would be $4,960 ($80,000 × 0.062), Taxpayer B's OASDI would be $7,347 ($118,500 × 0.062). Taxpayer A's average rate of OASDI tax is 6.2% while Taxpayer B's average rate of tax is 1.84% ($7,347/$400,000). The sales tax, which is levied by many states, is also regressive when measured against the income base.

THE STRUCTURE OF CORPORATE TAX RATES

Corporations are separate entities and are subject to income tax. The federal corporate income tax reflects a stair-step pattern of progression that tends to benefit small corporations. The corporate rates, which have not changed for several years, are as follows:[6]

Taxable Income[7]	*Tax*
First $50,000	15% of taxable income
Over $50,000 but not over $75,000	$7,500 + 25% of taxable income over $50,000
Over $75,000 but not over $100,000	$13,750 + 34% of taxable income over $75,000
Over $100,000 but not over $335,000	$22,250 + 39% of taxable income over $100,000
Over $335,000	34% of taxable income
Over $10,000,000 but not over $15,000,000	$3,400,000 + 35% of taxable income over $10,000,000
Over $15,000,000 but not over $18,333,333	$5,150,000 + 38% over $15,000,000
Over $18,333,333	35% of taxable income

MARGINAL, AVERAGE, AND EFFECTIVE TAX RATES FOR TAXPAYERS

A taxpayer's **marginal tax rate** is the tax rate applied to an incremental amount of taxable income that is added to the tax base. The marginal tax rate concept is useful for planning because it measures the tax effect of a proposed transaction.

EXAMPLE I:1-4 ▶ Tania, who is single, is considering the purchase of a personal residence that will provide a $20,000 tax deduction for interest expense and real estate taxes in 2016. Tania's taxable income would be reduced from $120,000 to $100,000 if she purchases the residence. Because a 28% tax rate applies to taxable income from $100,000 to $120,000, Tania's marginal tax rate is 28%. Thus, Tania's tax savings from purchasing the personal residence would be $5,600 (0.28 × $20,000). ◀

While the marginal tax rate measures the tax rate applicable to the next $1 of income or deduction for a taxpayer, there are two other tax rates that are used primarily by tax policymakers: average tax rate and effective tax rate. The **average tax rate** is computed by dividing the total tax liability by the amount of taxable income. This represents the average rate of tax for each dollar of taxable income. For example, a single taxpayer with taxable income of $450,000 in 2016 would incur a total tax liability of $134,370. The taxpayer's marginal tax rate is 39.6%, but his average tax rate is 29.9% ($134,370/$450,000).

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[5] See the discussion of equity and fairness later in this chapter.

[6] For C corporations with taxable income over $100,000, the lower rates of tax on the first $75,000 of income are gradually phased out by applying a 5-percentage-point surtax on taxable income from $100,000 to $335,000 so that benefits of the favorable rates are eliminated once a corporation's taxable income reaches $335,000. Once taxable income exceeds $335,000 the tax equals 34% of taxable income. A 35% tax rate applies to taxable income in excess of $10 million. For corporations with taxable income in excess of $15 million, a 3 percentage-point-surtax applies to taxable income from $15 million to $18,333,333 to eliminate the lower 34% rate that applies to the first $10 million of taxable income.

[7] Also see the inside back cover for the corporation income tax rates.

ADDITIONAL COMMENT

One method of calculating economic income is to start with adjusted gross income (AGI), add back items of excludible income, such as tax-exempt bond interest, proceeds of life insurance policies, etc., and then deduct certain nondeductible business expenses, such as life insurance premiums, penalties and fines, etc.

The **effective tax rate** is the total tax liability divided by total economic income. **Total economic income** includes all types of economic income that a taxpayer has for the year. Thus, economic income is much broader than taxable income and includes most types of excludible income, such as tax-exempt bond interest, and generally permits business deductions but not personal-type deductions. It should be pointed out that economic income is *not* statutorily defined and experts may disagree on a precise calculation. The basic purpose of calculating the effective tax rate is to provide a broad measure of taxpayers' ability to pay taxes. Accordingly, the effective tax rate mainly is used by tax policymakers to determine the fairness of the income tax system.

EXAMPLE I:1-5 ▶ Amelia, who is single, has adjusted gross income of $140,000 and economic income of $175,000 in 2016. The difference is attributable to $35,000 of tax-exempt bond interest. If Amelia has deductions of $30,000, then her taxable income is $110,000, and her total tax is $23,837. Her average tax rate is 21.67% ($23,837 ÷ $110,000). Amelia's effective tax rate is 13.62% ($23,837 ÷ $175,000). Amelia's effective tax rate is considerably lower than her average tax rate because of her substantial amount of tax-exempt income. ◀

STOP & THINK

Question: Gwen, a single taxpayer, has seen her income climb to $200,000 in the current year. She wants a tax planner to help her reduce her tax liability. In planning for tax clients, tax professionals almost exclusively use the marginal tax rate in their analysis rather than the average tax rate. Why is the marginal tax rate much more important in the tax planning process than the average tax rate?

Solution: Because tax planning is done at the margin. A single taxpayer who has taxable income of $200,000 has a marginal tax rate of 33% (at 2016 rates), but an average tax rate of 24.76%, computed as follows:

Taxable income		$200,000
Tax on first $190,150 of taxable income		$46,278.75
Remaining taxable income	$9,850	
Times: Marginal tax rate	× 0.33	3,250.50
Total tax liability		$ 49,529.25

$$\text{Average tax rate} = \frac{\text{Total tax}}{\text{Taxable income}} = \frac{\$\ 49{,}529.25}{\$200{,}000} = 24.76\%$$

If a tax planner could reduce Gwen's taxable income by $10,000, Gwen's tax liability would decrease by $3,333 ($10,000 × 0.33). When the taxpayer wants to know how much she can save through tax planning, the appropriate marginal tax rate yields the answer.

Overall, estimated effective federal income tax rates for individuals have increased slightly during the period 2003–2012,[8] amounting to 12.6% in 2012 as compared with 9.1% in 2003. For the highest 20% of households, the effective individual income tax rate increased to 18.0% in 2012 from 14.4% in 2003. The effective tax rate for individuals in the United States is relatively low compared to most other industrialized countries.

ADDITIONAL COMMENT

In the determination of tax rates, one should consider the incidence of taxation that involves the issue of who really bears the burden of the tax. If a city raises the real property tax but landlords simply raise rents to pass on the higher taxes, the tax burden is shifted to their tenants. The concept has important implications in determining any kind of average or effective tax rate.

DETERMINATION OF TAXABLE INCOME AND TAX DUE

As will be discussed in later chapters, the federal income taxes imposed on all taxpayers (individuals, corporations, estates, and trusts) are based on the determination of taxable income. In general, taxable income is computed as follows:

Total income (income from whatever source derived)	$xxx
Minus: Exclusions (specifically defined items, such as tax-exempt bond interest)	(xx)

[8] Congressional Budget Office, *Effective Federal Tax Rates Under Current Law, 2001 to 2014* (Washington, DC: U.S. Government Printing Office, August, 2004), p. 10.

Gross income		$xxx
Minus:	Deductions (business expenses and itemized deductions)	(xx)
	Exemptions (not applicable for corporations)	(xx)
Taxable income		$xxx
Times:	Applicable tax rate	× .xx
Income tax before credits		$xxx
Minus:	Tax credits	(xx)
Total tax liability		$xxx
Minus:	Prepayments	(xx)
Balance due or refund		$xxx

Each different type of taxpayer (individuals, corporations, etc.) computes taxable income in a slightly different manner, but all use the general framework above. An introductory discussion of the various types of taxpayers is provided later in this chapter. More detailed discussions of individual taxpayers (Chapter I:2) and corporation taxpayers (Chapter I:16) are examined in this *Individuals* book. Corporations, estates, and trusts are further examined in *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts.*

OTHER TYPES OF TAXES

OBJECTIVE 3

Describe the various types of taxes

STATE AND LOCAL INCOME AND FRANCHISE TAXES

In addition to federal income taxes, many states and local jurisdictions impose income taxes on individuals and businesses. These state and local taxes have gradually increased over the years and currently represent a significant source of revenue for state and local governments but also represent a significant tax burden on taxpayers.

State and local income taxes vary greatly in both form and rates.[9] Only seven states do not impose an individual income tax.[10] In most instances, state income tax rates are mildly progressive and are based on an individual's federal adjusted gross income (AGI), with minor adjustments.[11] For example, a typical adjustment to a state income tax return is interest income on federal government bonds, which is subject to tax on the federal return but generally is not subject to state income taxes. Some states also allow a deduction for federal income taxes in the computation of taxable income for state income tax purposes.

ADDITIONAL COMMENT

States that do not impose a state income tax depend on other taxes to support the government mission, principally sales taxes.

States imposing a state income tax generally require the withholding of state income taxes and have established mandatory estimated tax payment procedures. The due date for filing state income tax returns generally coincides with the due date for the federal income tax returns (e.g., the fifteenth day of the fourth month following the close of the tax year for individuals).

ADDITIONAL COMMENT

State income tax rates for individuals have increased significantly in the past twenty years. Twenty-three states now have marginal tax rates of 6% or higher.

Most states impose a corporate income tax, although in some instances the tax is called a **franchise tax**. Franchise taxes usually are based on a weighted-average formula consisting of net worth, income, and sales.

WEALTH TRANSFER TAXES

U.S. citizens are subject to taxation on certain transfers of property to another person. The tax law provides a unified transfer tax system that imposes a single tax on transfers of property taking place during an individual's lifetime (gifts) and at death (estates). (See the inside back cover of the text for the transfer tax rate schedules.) Formerly, the gift and estate tax laws were separate and distinct. The federal estate tax was initially enacted in 1916. The original gift tax law dates back to 1932. The gift tax was originally imposed to prevent widespread avoidance of the estate tax (e.g., taxpayers could make tax-free gifts of property

[9] For a thorough discussion of state and local taxes, see the chapter entitled *Multistate Income Taxation* that accompanies this textbook in electronic form on the Pearson Federal Taxation 2017 Web page at www.prenhall.com/phtax.

[10] These states are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. New Hampshire has an income tax that is levied only on dividend and interest income and Tennessee's income tax applies only to income from stocks and bonds.

[11] See Chapter I:2 for a discussion of the AGI computation.

before their death). Both the gift and estate taxes are wealth transfer taxes levied on the transfer of property and are based on the fair market value (FMV) of the transferred property on the date of the transfer. Following are brief descriptions of the gift tax and estate tax.

KEY POINT

The $14,000 annual exclusion is an important tax-planning tool for wealthy parents who want to transfer assets to their children and thereby minimize their gift and estate taxes. A husband and wife who have three children could transfer a maximum of $84,000 [($14,000 × 2) × 3] to their children each year without incurring any gift tax.

The Federal Gift Tax. The **gift tax** is an excise tax that is imposed on the donor (not the donee) for transfers of property that are considered to be a taxable gift. A gift, generally speaking, is a transfer made gratuitously and with donative intent. However, the gift tax law has expanded the definition to include transfers that are not supported by full and adequate consideration.[12] To arrive at the amount of taxable gifts for the current year, a $14,000 (2016) annual exclusion is allowed per donee.[13] In addition, an unlimited marital deduction is allowed for transfers between spouses.[14] The formula for computing the gift tax is as follows:

FMV of all gifts made in the current year			$x,xxx
Minus:	Annual donee exclusions ($14,000 per donee)	$xx	
	Marital deduction for gifts to spouse	xx	
	Charitable contribution deduction	xx	(xxx)
Plus:	Taxable gifts for all prior years		xxx
Cumulative taxable gifts (tax base)			$x,xxx
Times:	Unified transfer tax rates		× .xx
Tentative tax on gift tax base			$ xxx
Minus:	Unified transfer taxes paid in prior years		(xx)
	Unified credit		(xx)
Unified transfer tax (gift tax) due in the current year			$ xx

ADDITIONAL COMMENT

The gift tax was enacted to make the estate tax more effective. Without a gift tax, estate taxes could be easily avoided by large gifts made before death.

Note that the gift tax is cumulative over the taxpayer's lifetime (i.e., the tax calculation for the current year includes the taxable gifts made in prior years). The detailed tax rules relating to the gift tax are covered in Chapter C:12 in both *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts* and the *Comprehensive* volume. The following general concepts and rules for the federal gift tax are presented as background material for other chapters of this text dealing with individual taxpayers:

- Gifts between spouses are exempted from the gift tax due to the operation of an unlimited marital deduction.
- The primary liability for payment of the gift tax is imposed on the **donor**. The donee is contingently liable for payment of the gift tax in the event of nonpayment by the donor.
- A donor is permitted a $14,000 annual exclusion for gifts of a present interest to each donee.[15]
- Charitable contributions are effectively exempted from the gift tax because an unlimited deduction is allowed.
- The tax basis of the property to the donee is generally the donor's cost. It is the lesser of the donor's cost and the property's FMV on the date of the gift if the property is sold by the donee at a loss. (See Chapter I:5 for a discussion of the gift tax basis rules.)
- A unified tax credit equivalent to a $5,000,000 deduction (adjusted for inflation, the amount is $5,450,000 for 2016) is available to offset any gift tax on taxable gifts that exceed the $14,000 annual exclusion.[16]

EXAMPLE I:1-6 ▶ Antonio makes the following gifts in the year 2016:

- $25,000 cash gift to his wife
- $15,000 contribution to the United Way

[12] Sec. 2512(b).

[13] Sec. 2503(b). The annual exclusion for gift tax purposes had been $10,000 for many years. However, for 2002–2005, the inflation adjustment increased the exclusion to $11,000, for 2006–2008, the exclusion was increased to $12,000, and for 2009–2012 to $13,000. For 2013 and later years, the current exclusion has been increased to $14,000.

[14] Sec. 2523(a).

[15] A gift of a present interest is an interest that is already in existence and the donee is currently entitled to receive the income from the property. A gift of a future interest comes into being at some future date (e.g., property is transferred by gift to a trust in which the donee is not entitled to the income from the property until the donor dies) and is not eligible for the $14,000 annual exclusion.

[16] The applicable exclusion amount has been $1,000,000 since 2002. However, beginning in 2011, the exclusion was increased to $5,000,000, adjusted for inflation. For further details, see *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts*, 2017 Edition, Chapters C:12 and C:13.

- Gift of a personal automobile valued at $40,000 to his adult son
- Gift of a personal computer valued at $4,000 to a friend

The $25,000 gift to his wife is not taxed because of a $14,000 annual exclusion and a $11,000 marital deduction. The $15,000 contribution to the United Way is also not taxed because of the unlimited deduction for charitable contributions. The $40,000 gift Antonio made to his son is reduced by the $14,000 annual exclusion to each donee, leaving a $26,000 taxable gift.[17] The $4,000 gift to the friend is not taxed because of the annual exclusion of up to $14,000 in gifts to a donee in a tax year. Thus, total taxable gifts for the current year subject to the unified transfer tax are $26,000.

STOP & THINK

Question: An important but frequently overlooked aspect of gift taxes is the interaction of gift taxes and income taxes. In many cases, gifts are made *primarily* for income tax purposes. Why would a gift be made for income tax purposes?

Solution: Gifts are frequently made to shift income from one family member to another family member who is in a lower marginal tax bracket. For example, assume Fran and Jan are married, have one 25-year-old son, earn $500,000 per year from their business, and generate $100,000 per year in dividends and interest from a substantial portfolio of stocks and bonds. With such a high level of income, Fran and Jan are in the 39.6% marginal tax bracket. If they make a gift of some of the stocks and bonds to their son, the dividends and interest attributable to the gift are taxed to the son at his marginal tax rate (maybe 10% or 15%). If the son's marginal tax rate is lower than 39.6%, the family unit reduces its overall income taxes.

The Federal Estate Tax. The **federal estate tax** is part of the unified transfer tax system that is based on the total property transfers an individual makes both during his or her lifetime and at death. The basic structure of the estate tax is shown in Example I:1-7.

TYPICAL MISCONCEPTION

It is sometimes thought that the federal estate tax raises significant amounts of revenue, but it has not been a significant revenue producer since World War II. Only 9,400 estate tax returns were filed in 2012 generating approximately $8.5 billion in tax revenues. This amount represents less than 1% of revenues generated by income taxes on individuals.

EXAMPLE I:1-7 ► Amy dies during the current year. The formula for computing the estate tax on Amy's estate is as follows:

Gross estate (FMV of all property owned by the decedent at the date of death)	$xxx,xxx
Minus: Deductions for funeral and administration expenses, debts of the decedent, charitable contributions, and the marital deduction for property transferred to a spouse	(x,xxx)
Taxable estate	$ x,xxx
Plus: Taxable gifts made after 1976	xx
Tax base	$ x,xxx
Times: Unified transfer tax rate(s)	× .xx
Tentative tax on estate tax base	$ xxx
Minus: Tax credits (e.g., the unified tax credit equivalent to a $5,450,000 deduction in 2016)	(xx)
Gift taxes paid after 1976	(xx)
Unified transfer tax (estate tax) due	$ xx

The federal estate tax has been on a roller coaster ride the last several years, with many changes and uncertainties. For a complete discussion of these developments, see *Pearson's Federal Taxation: Corporations, Partnerships, Estates & Trusts, 2016 Edition*, Chapter C:13. Beginning January 1, 2013, however, more certainty exists to the estate tax law due to recent changes. The computation of the taxable estate and tax base (see Example I:1-7 above) is much the same as in prior years. However, the highest tax rate for tax years after 2012 has been increased to 40% from 35%. More importantly, the unified credit exclusion amount has been made permanent at $5 million per person and is indexed annually for inflation. For 2016, the unified credit exclusion amount is $5,450,000 ($5,430,000 for 2015). In essence, estates of individuals dying in 2016 generally will not be subject to estate taxes if their tax base is equal to or less

[17] This example assumes that the automobile is a gift rather than an obligation of support under state law and also assumes that Antonio's wife does not join with Antonio in electing to treat the gift to the son as having been made by both spouses (a gift-splitting election). In such event, donee exclusions of $28,000 (2 × $14,000) would be available, resulting in a taxable gift of only $12,000.