PRINCIPLES OF TAXATION
for Business and Investment Planning

2017

Sally M. Jones
Shelley C. Rhoades-Catanach
Sandra R. Callaghan

McGraw Hill Education

Principles of Taxation

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Sally M. Jones

Professor Emeritus of Accounting
McIntire School of Commerce
University of Virginia

Shelley C. Rhoades-Catanach

Associate Professor of Accountancy
School of Business
Villanova University

Sandra R. Callaghan

Associate Professor of Accounting
Neeley School of Business
Texas Christian University

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To Zane, Tony, and Tom

About the Authors

Sally M. Jones is professor emeritus of accounting at the McIntire School of Commerce, University of Virginia, where she taught undergraduate and graduate tax courses. Before joining the Virginia faculty in 1992, Professor Jones spent 14 years on the faculty of the Graduate School of Business, University of Texas at Austin. She received her undergraduate degree from Augusta College, her MPA from the University of Texas, and her PhD from the University of Houston. She is also a CPA. Professor Jones was the first editor of *Advances in Taxation* (JAI Press) and the *PriceWaterhouse Case Studies in Taxation.* She has published numerous articles in the *Journal of Taxation, The Tax Adviser,* and the *Journal of the American Taxation Association.* Professor Jones is a frequent speaker at tax conferences and symposia, a past president of the American Taxation Association, and the 2000 recipient of the Ray M. Sommerfeld Outstanding Tax Educator Award.

Shelley Rhoades-Catanach is an associate professor of accountancy at Villanova University and a CPA. She teaches a variety of tax courses in Villanova's undergraduate, masters of accounting, and graduate tax programs. Before joining the Villanova faculty in 1998, Professor Rhoades-Catanach spent four years on the faculty of Washington University in St. Louis. She has also served as a visiting faculty member at the Darden Graduate School, University of Virginia, and at INSEAD, an international MBA program in Fontainebleau, France. She received her undergraduate degree in accounting from the University of Nebraska at Lincoln and her PhD from the University of Texas at Austin. Professor Rhoades-Catanach has published articles in numerous journals, including the *Journal of the American Taxation Association, Accounting Review, Issues in Accounting Education, Journal of Accounting Education,* and *Review of Accounting Studies.* She has served as president, vice president, and trustee of the American Taxation Association and on the editorial boards of the *Journal of the American Taxation Association* and the *Journal of International Accounting, Auditing and Taxation.* She currently serves as co-editor of the *Journal of International Accounting, Auditing, and Taxation.* Professor Rhoades-Catanach is the 2010 recipient of the Ray M. Sommerfeld Outstanding Tax Educator Award.

Sandra Renfro Callaghan is an associate professor of accounting at the Neeley School of Business at Texas Christian University. She joined the faculty in 1998 after earning her PhD in accounting from Michigan State University. Her current research is primarily focused on topics in taxation, executive compensation, and the Affordable Health Care Act. Professor Callaghan teaches tax and financial accounting courses both at the undergraduate and graduate level and has earned numerous teaching awards including the Deans' Teaching Award and Neeley School of Business Alumni Professor of the Year. She has served in various leadership roles, including president, with the American Taxation Association and with the American Accounting Association Council. Professor Callaghan also earned a BS from Texas Christian University and an MPA from the University of Texas at Austin. Prior to earning her PhD, she was a tax professional with Ernst & Young.

A Note from the Authors

Principles of Taxation for Business and Investment Planning is a unique approach to the subject of taxation. This text is designed for use in introductory tax courses included in either undergraduate or graduate business programs. Its objective is to teach students to recognize the major tax issues inherent in business and financial transactions. The text focuses on fundamental concepts, the mastery of which provides a permanent frame of reference for future study of advanced tax topics. Unlike traditional introductory texts, *Principles of Taxation for Business and Investment Planning* downplays the technical detail that makes the study of taxation such a nightmare for business students. Traditional texts are heavily compliance oriented and convince many students that the tax law is too complex and specialized to be relevant to their future careers. This text attempts to do just the opposite by convincing students that an understanding of taxation is not only relevant but critical to their success in the business world.

Principles of Taxation for Business and Investment Planning has its origin in the 1989 White Paper titled *Perspectives on Education: Capabilities for Success in the Accounting Profession,* published jointly by the Big Eight public accounting firms. The White Paper expressed disenchantment with the narrow technical focus of undergraduate accounting curricula and called for scholastic emphasis on a broad set of business skills necessary for professional success. The Accounting Education Change Commission (AECC), operating under the aegis of the American Accounting Association, embraced the philosophy reflected in the White Paper. In September 1990, the AECC published its Position Statement No. One, titled *Objectives of Education for Accountants.* This statement reiterated that an undergraduate business education should provide a base for lifelong learning.

Despite these calls for reform, many undergraduate tax courses are taught in a traditional manner based on a paradigm developed a half-century ago. In the modern (postwar) era of business education, the first generation of tax teachers were practitioners: accountants or attorneys hired as adjunct faculty to initiate students into the mysteries of the newly enacted Internal Revenue Code of 1954. These practitioners taught their students in the same way they trained their employees. In doing so, they created a compliance-oriented paradigm. In today's world, this traditional paradigm is an anachronism. Business students don't need to learn how to generate tax information. Instead, they must learn how to use tax information to make good business and financial decisions.

A Paradigm for the Introductory Tax Course

Principles of Taxation for Business and Investment Planning provides a paradigm for meeting the educational needs of tax students in the 21st century. This paradigm is based on three postulates:

- **Postulate 1: Students should learn the tax law as an integrated component of a complex economic environment.** They should be aware of the role taxes play in financial decision making and should understand how taxes motivate people and institutions to engage in certain transactions.
- **Postulate 2: Students should comprehend the tax law as an organic whole rather than as a fragmented collection of rules and regulations.** They should learn general tax rules rather than the myriad of exceptions that confuse rather than clarify the general rules. They should appreciate how the general rules apply to all taxpaying entities before they learn how specialized rules apply to only certain entities. Finally, they should learn how the law applies to broad categories of transactions rather than to a particular transaction.
- **Postulate 3: Students who learn fundamental concepts have a permanent frame of reference into which they can integrate the constant changes in the technical minutiae of the law.** The rapid evolution of the tax law results in a short shelf life for much of the detailed information contained in undergraduate tax texts. Yet the key elements of the law—the statutory and judicial bedrock—do not change with each new revenue act. Students who master these key elements truly are prepared for a lifetime of learning.

The authors know that traditional paradigms die hard and educational reform is difficult. Nevertheless, we also believe that change in the way college and university professors teach tax is both inevitable and worthwhile. Our responsibility to our students is to prepare them to cope in a business world with little tolerance for outdated skills or irrelevant knowledge. Our hope is that *Principles of Taxation for Business and Investment Planning* is a tool that can help us fulfill that responsibility.

Using This Text in a First-Semester Tax Course

Principles of Taxation for Business and Investment Planning is designed for use in a one-semester (15-week) introductory tax course. Instructors can choose which of the 18 chapters deserve a full week's coverage and which can be covered in less than a week. Instructors may even decide to omit chapters that seem less relevant to the educational needs of their students. Business students who complete a one-semester course based on this text will be well prepared to function in the modern tax environment. If they are required (or may elect) to take a second tax course, they will have a solid, theoretical foundation on which to build.

This is the twentieth annual edition of *Principles of Taxation for Business and Investment Planning*. Adopters of the text will certainly have many excellent suggestions to improve the next edition. We welcome any and all comments and encourage fellow teachers to e-mail us with their input (smj7q@virginia.edu, shelley.rhoades@villanova.edu, and s.callaghan@tcu.edu).

Sally M. Jones
Shelley C. Rhoades-Catanach
Sandra R. Callaghan

Changes in *Principles of Taxation*, 2017 edition

Chapter 1

- Added five new Application Problems.

Chapter 2

- Updated federal deficit and national debt data on page 25.
- Updated data in example on page 39.
- Added five new Application Problems.

Chapter 3

- Added new Learning Objective 3-1.
- Added five new Application Problems.

Chapter 4

- Added five new Application Problems.

Chapter 5

- Added five new Application Problems.
- Added discussion of IRS Publications and their status as secondary authority on pages 101 and 102.

Chapter 6

- Added five new Application Problems.

Chapter 7

- Added five new Application Problems.
- Added new Tax Talk on page 174.
- Updated passenger automobile limitations on page 181.
- Updated for law changes related to the Section 179 deduction on pages 182 and 183.
- Updated for law changes related to bonus depreciation on pages 184 and 185.

Chapter 8

- Added five new Application Problems.

Chapter 9

- Added five new Application Problems.

Chapter 10

- Added five new Application Problems.
- Updated Schedule C, Form 1065, Form 1120-S, and Schedule K-1s to 2015 versions.

- Updated discussion of payroll and self-employment taxes for changes to inflation-adjusted Social Security tax threshold on pages 288 through 292.

Chapter 11

- Added five new Application Problems.
- Updated filing statistics in Tax Talks throughout.
- Updated Form 1120 and Schedule M-3 to 2015 versions.
- Revised discussion of Tax Freedom Day on page 344 to reflect current statistics.

Chapter 12

- Added five new Application Problems.
- Updated filing statistics in Tax Talk on page 368.

Chapter 13

- Added five new Application Problems.

Chapter 14

- Revised and expanded Learning Objectives.
- Updated coverage of standard deduction, exemption amount, individual tax rates, earned income credit, and alternative minimum tax to reflect 2015 inflation adjustments.
- Updated Volpe family examples throughout chapter to include 2014 Form 1040 (pages 1 and 2 and Schedule A).
- Reordered subtopics under Computing Individual Tax beginning on page 435.
- Updated Itemized Deduction Worksheet and Exemption Amount Worksheet to reflect 2015 inflation adjustments.
- Added four new Application Problems and one Tax Planning Case.

Chapter 15

- Added two new Tax Talks on pages 471 and 479.
- Updated examples on pages 461 and 462 to include 2015 Form W-2 and Form 1099-MISC.
- Updated coverage of Employer-Provided Plans beginning on page 478 to reflect 2016 inflation adjustments.
- Updated coverage of Individual Retirement Accounts beginning on page 483 to reflect 2016 inflation adjustments.
- Expanded discussion of rollovers to IRAs beginning on page 488.
- Added five new Application Problems.

Chapter 16

- Added new Tax Talk on page 533.
- Updated Exhibits 16.1, 16.2, and 16.3 to include 2015 Form 1040, Schedule B, Schedule D, and Schedule E.
- Updated coverage of the gift and estate taxes beginning on page 529 to reflect 2016 inflation adjustments to annual gift tax exclusion and lifetime transfer tax exclusion.
- Revised Appendix 16–A to include 2015 Form 8949 and Form 1040, Schedule D.
- Added five new Application Problems.

Chapter 17

- Added new Tax Talk on page 554.
- Added five new Application Problems.

Chapter 18

- Added new Tax Talk on page 599.
- Updated and expanded audit coverage discussion in example on page 589.
- Added five new Application Problems.

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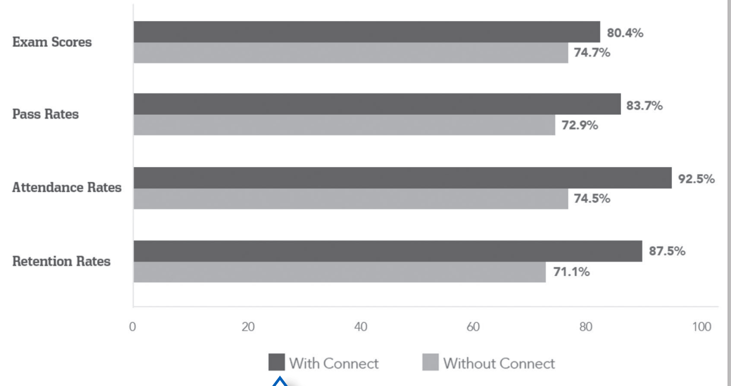

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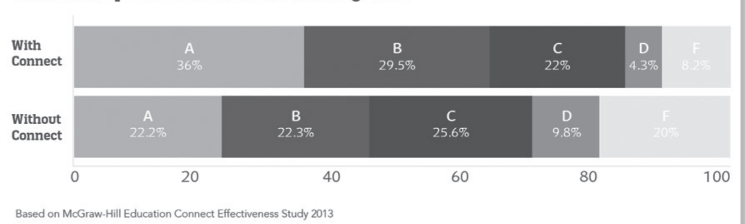

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Key Features

The content and organization of this text are highly compatible with the Model Tax Curriculum proposed by the American Institute of Certified Public Accountants. According to the AICPA, the introductory tax course should expose students to a broad range of tax concepts and emphasize the role of taxation in the business decision-making process. Under the model curriculum, students first learn to measure the taxable income from business and property transactions. They are then introduced to the different types of business entities and the tax considerations unique to each type. Individual taxation should be one of the last topics covered, rather than the primary focus of the course. Because *Principles of Taxation for Business and Investment Planning* reflects this recommended pedagogical approach, the text is ideal for courses based on the AICPA Model Tax Curriculum.

PART ONE

Exploring the Tax Environment

1. Taxes and Taxing Jurisdictions 3

2. Policy Standards for a Good Tax 23

Part One consists of two chapters that familiarize students with the global tax environment. Chapter 1 describes the environment in terms of the legal relationship between taxes, taxpayers, and governments. Definitions of key terms are developed, and the major taxes are identified. Chapter 2 considers the tax environment from a normative perspective by asking the question: "What are the characteristics of a good tax?" Students are introduced to the notions of tax efficiency and tax equity and learn how contrasting political beliefs about efficiency and equity continue to shape the tax environment.

PART TWO

Fundamentals of Tax Planning

3. Taxes as Transaction Costs 49

4. Maxims of Income Tax Planning 73

5. Tax Research 97

Part Two concentrates on developing a methodology for incorporating tax factors into business decisions. Chapter 3 introduces the pivotal role of net present value of cash flows in evaluating financial alternatives. Students learn how to compute tax costs and tax savings and how to interpret them as cash flows. Chapter 4 covers the maxims of income tax planning. The characteristics of the tax law that create planning opportunities are explained, and the generic techniques for taking advantage of those opportunities are analyzed. Chapter 5 provides a succinct overview of the tax research process and prepares students to solve the research problems included at the end of each chapter. The chapter explains the six steps in the tax research process and contains a cumulative example of the application of each step to a research case.

Part Three focuses on the quantification of business taxable income. Chapter 6 covers the computation of income or loss from ongoing commercial activities, with special emphasis on differences between taxable income and net income for financial statement purposes. Chapters 7 and 8 explore the tax implications of acquisitions and dispositions of business property, while Chapter 9 is devoted to nontaxable exchanges.

PART THREE

The Measurement of Taxable Income

6. Taxable Income from Business Operations 125

7. Property Acquisitions and Cost Recovery Deductions 165

8. Property Dispositions 209

9. Nontaxable Exchanges 251

Part Four teaches students how to calculate the tax on business income. Chapter 10 describes the function of sole proprietorships, partnerships, LLCs, and S corporations as conduits of income, while Chapter 11 discusses corporations as taxable entities in their own right. Chapter 12 builds on the preceding two chapters by exploring the tax planning implications of the choice of business entity. Chapter 13 broadens the discussion by considering the special problems of businesses operating in more than one tax jurisdiction. This chapter introduces both multistate and international tax planning strategies.

PART FOUR

The Taxation of Business Income

10. Sole Proprietorships, Partnerships, LLCs, and S Corporations 283

11. The Corporate Taxpayer 323

12. The Choice of Business Entity 361

13. Jurisdictional Issues in Business Taxation 387

Part Five concentrates on the tax rules and regulations unique to individuals. Chapter 14 presents the individual tax formula and acquaints students with the complexities of computing individual taxable income. Chapter 15 covers compensation and retirement planning. Chapter 16 covers investment and rental activities and introduces wealth transfer planning. Finally, Chapter 17 analyzes the tax consequences of personal activities, with particular emphasis on home ownership.

PART FIVE

The Individual Taxpayer

14. The Individual Tax Formula 423

15. Compensation and Retirement Planning 459

16. Investment and Personal Financial Planning 501

17. Tax Consequences of Personal Activities 551

Part Six consists of Chapter 18, which presents the important procedural and administrative issues confronting taxpayers. It covers the basic rules for paying tax and filing returns, as well as the penalties on taxpayers who violate the rules. Chapter 18 also describes the judicial process through which taxpayers and the IRS resolve their differences.

PART SIX

The Tax Compliance Process

18. The Tax Compliance Process 585

Appendix A Present Value of $1 611
Appendix B Present Value of Annuity of $1 612
Appendix C 2016 Income Tax Rates 613

Key Learning Tools

Learning Objectives

The chapters begin with learning objectives that preview the technical content and alert students to the important concepts to be mastered. These objectives appear again as marginal notations marking the place in the chapter where each learning objective is addressed.

Learning Objectives

After studying this chapter, you should be able to:

LO 4-1. Describe the difference between tax avoidance and tax evasion.

LO 4-2. Explain why an income shift or a deduction shift from one entity to another can affect after-tax cash flows.

LO 4-3. Explain how the assignment of income doctrine constrains income-shifting strategies.

LO 4-4. Determine the effect on after-tax cash flows of deferral of a tax cost.

LO 4-5. Discuss why the jurisdiction in which a business operates affects after-tax cash flows.

LO 4-3
Explain how the assignment of income doctrine constrains income-shifting strategies.

Assignment of Income Doctrine

The federal courts have consistently held that our income tax system cannot tolerate a cial shifts of income from one taxpayer to another. Over 80 years ago, the Supreme decided that income must be taxed to the person who earns it, even if another person legal right to the wealth represented by the income.[5] Thus, a business owner who rec a $10,000 check in payment for services rendered to a client can't avoid reporting $1 income by simply endorsing the check over to his daughter. In the picturesque langua the Court, the tax law must disregard arrangements "by which the fruits are attribute different tree from that on which they grew."

The Supreme Court elaborated on this theme in the case of a father who detached tiable interest coupons from corporate bonds and gave the coupons to his son as a

Examples and Cases

The chapters contain numerous examples and cases illustrating or demonstrating the topic under discussion.

Conflicting Maxims

Firm MN operates as two separate taxable entities, Entity M and Entity N. The firm is nego ating a transaction that will generate $25,000 cash in year 0 and $60,000 cash in year 1. Entity M undertakes the transaction, taxable income will correspond to cash flow (i.e., Ent M will report $25,000 and $60,000 taxable income in years 0 and 1). If Entity N undertak the transaction, it must report the entire $85,000 taxable income in year 0. Entity M has 30 percent marginal tax rate while Entity N has a 25 percent marginal tax rate. Firm MN us a 5 percent discount rate to compute NPV.

	Entity M		Entity N	
Year 0:				
Before-tax cash flow		$25,000		$25,000
Taxable income	$25,000		$85,000	
	.30		.25	

Tax Talk

Each chapter includes items of "Tax Talk." These items highlight new tax planning strategies, tax facts, legislative proposals, or innovative transactions with interesting tax implications reported in the business press.

Tax Talk
Several of Europe's smallest countries, such as Luxembourg, Switzerland, and Ireland, offer very low corporate tax rates to attract multinational corporations. Case in point: Amazon.com channels the profits earned across the 28-nation European Union through its Luxembourg subsidiary.

Consider two domestic firms that each receive $5,000 cash, all of which is ta income. Firm Y operates in State Y, which imposes a flat 4 percent tax on business inc Firm Z operates in State Z, which imposes a flat 10 percent tax on business income federal purposes, state income tax payments are deductible in the computation of ta income.[8] Both firms face a 39 percent federal tax rate. Under these facts, Firms Y a have the following after-tax cash flows:

	Firm Y	Firm Z
Before-tax cash/income	$5,000	$5,000
State income tax cost	(200)	(500)
Federal taxable income	$4,800	$4,500
Federal tax cost (Taxable income × 39%)	(1,872)	(1,755)
After-tax cash flow	$2,928	$2,745

A comparison of these after-tax cash flows gives us our third income tax plar

Key Terms

Key terms are indicated in boldface in the text. A list of key terms is also supplied at the end of the chapter with page references for easy review. Definitions of key terms from all the chapters are compiled in a Glossary for the text.

Key Terms

accrual method of accounting 137
all-events test 142
allowance method 146
annualized income 129
calendar year 127
cash method of accounting 133
constructive receipt 134
deferred tax asset 140
deferred tax liability 140
direct write-off method 146

economic performance 143
fiscal year 127
generally accepted accounting principles (GAAP) 137
gross income 126
hybrid method of accounting 136
key-person life insurance policies 132
method of accounting 130
net operating loss

NOL carryforw
payment liabilit
permanent diffe
personal service corporation
prepaid income
realization 13
recognition 1
recurring item exception 14
short-period ret
tax benefit rule

Sources of Book/ Tax Differences

Chapters 6, 7, 8, 9, 11, 13, and 15 provide a list of the sources of book/tax differences introduced in the chapter.

Sources of Book/Tax Differences

Permanent

- Interest on state and local bonds
- Key-person life insurance proceeds and premiums
- Fines and penalties
- Political contributions and lobbying expense
- Meals and entertainment expense
- Domestic production activities deduction

Temporary

- Prepaid income
- Bad debts
- Accrued expenses failing th all-events test
- Compensation accruals
- Related party accruals
- NOL carryforwards

Questions and Problems for Discussion

Challenge students to think critically about conceptual and technical issues covered in the chapter. These problems tend to be open-ended and are designed to engage students in debate. Many problems require students to integrate material from previous chapters in formulating their responses.

Questions and Problems for Discussion

LO 6-1 1. Firm LK bought a warehouse of used furniture to equip several of its cleric An employee discovered a cache of gold coins in a desk drawer. A local cour Firm LK the rightful owner of the coins, which have a $72,000 FMV. Does recognize income because of this lucky event?

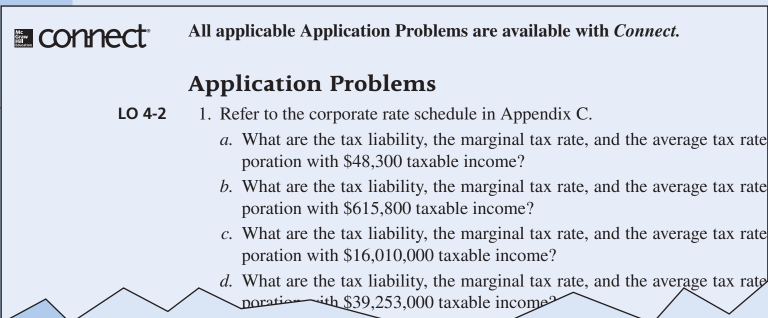
LO 6-2 2. Discuss the choice of a taxable year for the following businesses:
a. Retail plant and garden center.
b. French bakery.
c. Chimney cleaning business.
d. Moving and transport business.
e. Software consulting business.

LO 6-3 3. Corporation DB operates three different lines of business. Can the corporati different overall method of accounting for each line or must the corporation overall method?

LO 6-3 4. Lester Inc. owns 55 percent of the outstanding stock of Marvin Corporation corporations engage in numerous intercompany transactions that must be

Application Problems

Give students practice in applying the technical material covered in the chapter. Most of the problems are quantitative and require calculations to derive a numeric solution.



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All applicable Application Problems are available with *Connect.*

Application Problems

LO 4-2 1. Refer to the corporate rate schedule in Appendix C.
a. What are the tax liability, the marginal tax rate, and the average tax rate poration with $48,300 taxable income?
b. What are the tax liability, the marginal tax rate, and the average tax rate poration with $615,800 taxable income?
c. What are the tax liability, the marginal tax rate, and the average tax rate poration with $16,010,000 taxable income?
d. What are the tax liability, the marginal tax rate, and the average tax rate poration with $39,253,000 taxable income?

Issue Recognition Problems

Develop students' ability to recognize the tax issues suggested by a set of facts and to state those issues as questions. The technical issues buried in these problems typically are *not* discussed in the chapter. Consequently, students must rely on their understanding of basic principles to analyze the problem, spot the tax concern or opportunity, and formulate the question to be resolved. In short, students must take the first steps in the tax research process.

Issue Recognition Problems

Identify the tax issue or issues suggested by the following situations, and state
in the form of a question.

LO 4-1 1. Dr. P is a physician with his own medical practice. For the last several years
ginal income tax rate has been 39.6 percent. Dr. P's daughter, who is a colleg
has no taxable income. During the last two months of the year, Dr. P ins
patients to remit their payments for his services directly to his daughter.

LO 4-1 2. Mr. and Mrs. K own rental property that generates $4,000 monthly revenue. Th
in the highest marginal tax bracket. For Christmas, Mr. and Mrs. K give the
checks for October, November, and Decembe ... 19-year-o...

Research Problems

Provide further opportunity for students to develop their analytic skills. These problems consist of short scenarios that suggest one or more tax issues. The scenarios conclude with explicit research questions for the students to answer. To find the answers, they need access to either a traditional or an electronic tax library.

Research Problems

LO 6-1, 6-6 1. Bontaine Publications, an accrual basis, calendar year corporation, publishes a
sells weekly and monthly magazines to retail bookstores and newsstands. The sa
agreement provides that the retailers may return any unsold magazines during the o
month period after purchase. Bontaine will refund one-half of the purchase price
each returned magazine. During December 2016, Bontaine recorded $919,400 of m
azine sales. During January 2017, Bontaine refunded $82,717 to retailers that retur
magazines purchased during December. Can Bontaine reduce its 2016 income by
refund paid?

LO 6-1, 6-6 2. CheapTrade, an accrual basis, calendar year corporation, operates a discount securit
brokerage business. CheapTrade accepts orders to buy or sell marketable securities
its customers and charges them a commission fee for effecting the transaction i
timely, low-cost manner. CheapTrade executes an order on the "trade" date, but t
to the securities is not legally transferred and payment to or from the customer is
due until the "settlement date." In the normal five-day interval between the trade a
settlement dates, CheapTrade performs administrative and accounting functions
record the transaction. During the last week of 2016, CheapTrade effected over 18,0
transactions with a trading date in 2016 but a settlement date in 2017. CheapTrad
commission from these transactions was $1,712,400. In which year should Ch

Tax Planning Cases

Give students an opportunity to integrate their tax knowledge into a business planning framework. Most cases involve taxpayers who must decide whether to undertake a certain transaction or who must choose between alternative transactions. Students must assume the role of tax adviser by recommending a course of action to maximize the after-tax value of the transaction.

Tax Planning Cases

LO 9-8 1. Firm NS owns 90 percent of Corporation T's outstanding stock. NS
ness realty that T needs for use in its business. The FMV of the realt
and NS's adjusted basis is $5.6 million. Both NS and T are in the 35 p
tax bracket. Discuss the tax implications of each of the following co
and decide which course you would recommend to NS.

a. NS could exchange the realty for newly issued shares of T stock wo

b. NS could sell the realty to T for $4 million cash.

c. NS could lease the realty to T for its annual fair rental value of $600

LO 9-5 2. Firm K, a noncorporate taxpayer, has owned investment land with a
for four years. Two unrelated parties want to acquire the land from
offered $770,000 cash, and Party B has offered another tract of land w
FMV. If K accepts Party B's offer, it would hold the new land for n
years before selling it. The FMV of this land should appreciate

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connect ACCOUNTING Taxation 101

Chapter 11 Problems

◂ review Question #13 (of 14) score this question ▸

13. value: 10.00 points

Problem 11-61 (LO 11-5)
Terrance is age 71 and retired. Beginning in 2014, he must start taking minimum distributions from his IRA account that had a balance of $150,000 as of December 31, 2013. Make these three assumptions: his IRA will earn 8% per year; he will withdraw the minimum distribution on the last day of each calendar year, and only one distribution will be taken in 2014. Calculate the amount of his distribution for years 2014 through 2018 and the ending balance in his IRA account on December 31, 2018. Use Table I, Table II and Table V. (Do not round "Applicable Life Expectancy" answers. Round other answers to nearest whole dollar value.)

Year	(1) IRA Balance At End of Prior Year	(2) Applicable Life Expectancy	(3) Required Distribution	(4) IRA Earnings	(5) Ending Balance
2014	$ 150,000	26.5	$ 5,660	$ 12,000	$ 156,340
2015	156,340	25.6	6,107	12,507	162,740
2016	162,740				
2017					
2018					

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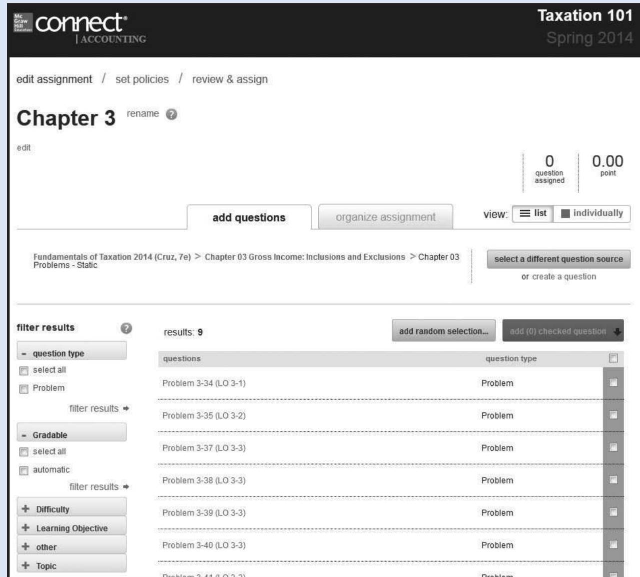

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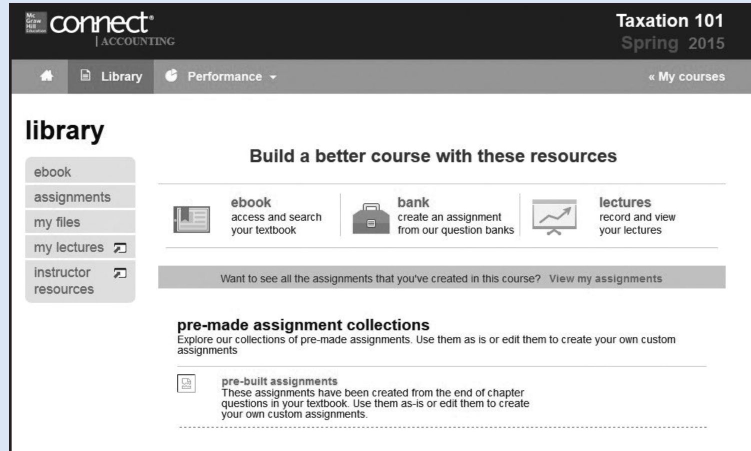

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Introduction to Students

Principles of Taxation for Business and Investment Planning explores the role that taxes play in modern life. The book is written for business students who have completed introductory courses in accounting and finance and are familiar with basic business concepts. Those of you who fit this description, regardless of your future career path, will make decisions in which you must evaluate the effect of taxes. At the most fundamental level, all business decisions have the same economic objective: maximization of long-term wealth through cash flow enhancement. The cash flow from any transaction depends on the tax consequences. Therefore, business men and women must appreciate the role of taxes before they can make intelligent decisions, whether on behalf of their firm or on their personal behalf.

Taxes as Business Costs

When businesspeople are asked to identify the common goal of all business decisions, their immediate response tends to be that the goal is to increase profits. When prompted to think past the current year, most eventually conclude that the long-term goal of business decisions is to maximize the value of the firm. In this text, a **firm** is a generic business organization. Firms include sole proprietorships, partnerships, limited liability companies, subchapter S and regular corporations, and any other arrangement through which people carry on a profit-motivated activity. Firm managers know that short-term profits and long-term value are enhanced when operating costs, including taxes, are controlled. Experienced managers never regard taxes as fixed or unavoidable costs. As you will soon discover, opportunities abound for controlling the tax cost of doing business.

The preceding paragraph suggests that tax planning means reducing tax costs to maximize the value of the firm. Firms can reduce taxes by any number of strategies. However, tax cost is only one variable that managers must consider in making business decisions. A strategy that reduces taxes may also have undesirable consequences, such as reducing revenues or increasing nontax costs. Because of nontax variables, the strategy with the least tax cost may not be the best strategy. Therefore, tax minimization in and of itself may be a short-sighted objective. This point is so elementary yet so important: *Effective tax planning must take into account both tax and nontax factors.* When faced with competing strategies, managers should implement the strategy that maximizes firm value, even when that strategy has a higher tax cost than the alternatives. In other words, managers should never let the tax tail wag the business dog.

Taxes as Household Expenditures

Principles of Taxation for Business and Investment Planning concentrates on the income taxation of business activities and organizations. This does not mean that the tax rules applying to individuals are ignored. Quite the contrary. For income tax purposes, individuals and the profit-making activities in which they engage are entwined. As we will observe over and over again, the ultimate taxpayers in every business are the people who own and operate that business.

As you study this text, consider your own role as a lifelong taxpayer. Regardless of who you are, where you live, or how you earn and spend your money, you will pay taxes on

a regular basis to any number of governments. In fact, in the United States, taxes are the single largest household expenditure. According to data from the Tax Foundation, Americans devote about two hours and 15 minutes of every eight-hour workday to earn enough to pay their local, state, and federal taxes.

People who are clueless about taxes must take a passive role, participating in a tax system they don't understand and over which they exercise no control. In contrast, if you understand how taxes relate to your life, you can take an active role. You can take positive steps to minimize your personal tax to the fullest extent allowed by law. You can make informed financial decisions to take advantage of tax-saving opportunities. You can draw rational conclusions about the efficiency and fairness of existing tax laws and can assess the merit of competing tax reform proposals. Finally, you can change the tax system by participating as a voter in the democratic process.

The Text's Objectives

Principles of Taxation for Business and Investment Planning has three objectives that motivate the overall design of the text, the selection and ordering of topics, and the development of each topic.

Introducing Tax Policy Issues

The first objective is to acquaint you with the economic and social policy implications of the tax systems by which governments raise revenues. Most of the subject matter of the text pertains to today's tax environment and how successful businesses adapt to and take advantage of that environment. But the text also raises normative issues concerning the efficiency and equity of many features of the tax environment. You will learn how certain provisions of the tax law are intended to further the government's fiscal policy goals. You are invited to evaluate these goals and to question whether the tax system is an appropriate mechanism for accomplishing the goals.

The text identifies potentially negative aspects of the tax environment. It explains how taxes may adversely affect individual behavior or cause unintended and undesirable outcomes. You will be asked to consider whether certain provisions of the tax law favor one group of taxpayers over another and whether such favoritism is justifiable on any ethical grounds. After probing both the strengths and weaknesses of the current tax system, you can draw your own conclusions as to how the system can be improved.

Bridging the Gap between Finance and Tax

The second objective of the text is to bridge the academic gap between the study of financial theory and the study of tax law. Finance courses teach students how to make decisions on the basis of after-tax cash flows. However, these courses give only rudimentary instruction on determining the tax consequences of transactions and overlook the possibilities for controlling tax costs to maximize cash flows. In extreme cases, financial models simply ignore tax consequences by assuming that business decisions are made in a tax-free environment.

Traditional tax law courses err in the opposite direction. These courses teach students to apply statutory rules to well-defined, closed-fact situations to determine the tax consequences. Correct application of the rule is the learning objective. Students are not required to integrate the tax consequences of transactions into a business decision-making framework. In other words, they don't translate tax outcomes into cash flows. Traditional

law courses may fail to encourage students to consider how closed-fact situations can be restructured to change the tax outcome and improve financial results. Consequently, students often develop the habit of analyzing transactions from a backward-looking *compliance* perspective rather than a forward-looking *planning* perspective.

The focus of *Principles of Taxation for Business and Investment Planning* is the common ground shared by financial theory and tax law. The connecting links between the two disciplines are stressed throughout the text. You will learn how effective business planning depends on an accurate assessment of relevant tax factors. Tax rules and regulations are presented and illustrated in the context of a decision-making framework. Admittedly, these rules and regulations are tough to master. Two observations should give you reassurance. First, while the tax law is extremely technical and complex, the application of its underlying principles to business decision making is relatively straightforward. Second, you can learn to appreciate tax planning strategies without becoming a tax-compliance expert.

Teaching the Framework of the Income Tax

The third objective of *Principles of Taxation for Business and Investment Planning* is to teach the framework of the federal income tax, the dominant feature of the modern tax environment. This framework has been remarkably stable over time, even though the details of the law change every year. Students who learn the framework needn't worry that their knowledge will be outdated when Congress enacts its next revenue bill.

The federal income tax system has a bad reputation as an impenetrable, intractable body of law. While the income tax law is every bit as complicated as its critics suggest, its framework consists of a manageable number of basic principles. The principles are internally consistent and underlie many technical provisions. By concentrating on these principles, you can attain a sufficient level of tax knowledge in a single introductory course. You will not be a tax expert, but you will be tax literate. You may not be capable of implementing sophisticated tax planning strategies, but you will appreciate how those strategies can improve cash flows and maximize wealth.

Because this text takes a conceptual approach to the tax law, narrowly drawn provisions, exceptions, limitations, and special cases are deemphasized. Details with the potential to confuse rather than clarify tax principles are usually relegated to footnotes. When we do examine a detailed provision of the law, the detail should illuminate an underlying concept. Or we may discuss a thorny technical rule just to emphasize the practical difficulties encountered by tax professionals who don't have the luxury of dealing with concepts.

The conceptual approach should sensitize you to the tax implications of transactions and cultivate your ability to ask good tax questions. This approach downplays the importance of the answers to these questions. Knowing the answers or, more precisely, *finding* the answers to tax questions is the job of accountants and attorneys who devote long hours in their research libraries to that end. A tax-sensitive business manager knows when to consult these experts and can help formulate the tax issues for the expert to resolve. The text's emphasis on issue recognition rather than issue resolution is reflected in the problems at the end of each chapter. Many of these problems ask you to analyze a fact situation and simply identify any tax concerns or opportunities. Other problems present you with facts suggesting tax issues with no correct solution.

A Word to Accounting Majors

Principles of Taxation for Business and Investment Planning is an ideal introductory text for those of you who are concentrating in accounting and who may even plan to specialize

in taxation. You will benefit enormously from mastering the framework of the income tax as the first step in your professional education. This mastery will be the foundation for the future study of advanced topics. You will gain a command of basic principles on which to rely as you develop an instinct for your subject—a facility for diagnosing the tax issues suggested by unfamiliar and unusual transactions.

The conceptual approach is appropriate for the first tax course because it concentrates on broad issues concerning most taxpayers instead of narrow problems encountered by only a few taxpayers. If you learn these issues, you will be well prepared to expand and deepen your tax knowledge through professional experience. You will understand that taxes are only one aspect of the economic decision-making process. Because of this understanding, those of you who become tax professionals will be equipped to serve your clients not just as tax specialists but as business advisers.

CPA Exam Preparation

This text provides excellent preparation for the computer-based CPA exam. The text covers approximately 90 percent of the specified federal tax content of the Regulation portion of the exam. The 10 percent remaining content consists of advanced topics usually covered in a second-semester undergraduate tax course.

The CPA exam includes a variety of interactive problems designed to test your knowledge of the tax law and your ability to apply the law in realistic situations. Many of the problems are in the form of *simulations:* short cases in which you must demonstrate your tax research and analytic skills. These are the exact skills that you will learn, practice, and refine as you work your way through *Principles of Taxation for Business and Investment Planning*.

Conclusion

The authors hope this introduction has conveyed the message that people who decide on a particular course of action without considering the tax outcomes are making an uninformed, and possibly incorrect, decision. By proceeding with the course of study contained in this text, you will learn to recognize the tax implications of a whole spectrum of transactions. Upon entering the business world, you will be prepared to make decisions incorporating this knowledge. You will spot tax problems as they arise and will call in a tax professional before, rather than after, a transaction with profound tax consequences. Finally, you will understand that effective tax planning can save more money than the most diligent tax compliance.

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Part One

Exploring the Tax Environment

1 Taxes and Taxing Jurisdictions

2 Policy Standards for a Good Tax

Chapter One

Taxes and Taxing Jurisdictions

Learning Objectives

After studying this chapter, you should be able to:

LO 1-1. Define tax, taxpayer, incidence, and jurisdiction.

LO 1-2. Express the relationship between tax base, rate, and revenue as a formula.

LO 1-3. Describe the taxes levied by local governments.

LO 1-4. Describe the taxes levied by state governments.

LO 1-5. Describe the taxes levied by the federal government.

LO 1-6. Explain the structure of the value-added tax levied by foreign governments.

LO 1-7. Summarize why different jurisdictions compete for revenues from the same taxpayer.

LO 1-8. Discuss the reasons why governments modify their tax systems.

LO 1-9. Identify the three primary sources of federal tax law.

An explorer planning a journey through unknown territory prepares by inspecting a map of the territory. The explorer becomes familiar with topographic features such as major highways, mountain ranges, lakes and rivers, and population centers, and gathers information about the climate of the region and the language and customs of its inhabitants. This preliminary knowledge helps the explorer chart the course and reduces the danger that progress will be impeded by unforeseen circumstances.

For students who are just beginning their study of taxation, the tax environment in which individuals and organizations must function is unknown territory. Chapter 1 serves as a map of this territory. The chapter begins by describing the environment in terms of the basic relationship between taxes, taxpayers, and governments. It identifies the major types of taxes that businesses routinely encounter and examines how governments with overlapping jurisdictions compete for tax revenues. By reading the chapter, you will gain a familiarity with the tax environment that will help you understand the role of taxes in the business decision-making process.

The chapter should alert you to two important features of the tax environment. First, taxes are *pervasive* because they are so widespread, come in so many varieties, and affect virtually every aspect of modern life. Second, taxes are *dynamic* because the tax laws

change so frequently. The rate of change reflects the fact that the economic and political assumptions on which tax structures are based are constantly evolving. While these two features make the tax environment a challenging one for business managers, they also create a vitality that makes the study of tax planning so fascinating.

SOME BASIC TERMINOLOGY

LO 1-1
Define tax, taxpayer, incidence, and jurisdiction.

Before beginning our exploration of the tax environment, we must define some basic terminology. A **tax** can be defined as a payment to support the cost of government. A tax differs from a fine or penalty imposed by a government because a tax is not intended to deter or punish unacceptable behavior. On the other hand, taxes are compulsory rather than voluntary on the part of the payer. A tax differs from a user's fee because the payment of a tax doesn't entitle the payer to a specific good or service in return. In the abstract, citizens receive any number of government benefits for their tax dollars. Nevertheless, the value of government benefits received by any particular person isn't correlated to the tax that person must pay. As the Supreme Court explained:

> A tax is not an assessment of benefits. It is . . . a means of distributing the burden of the cost of government. The only benefit to which the taxpayer is constitutionally entitled is that derived from his enjoyment of the privileges of living in an organized society, established and safeguarded by the devotion of taxes to public purposes.[1]

A **taxpayer** is any person or organization required by law to pay a tax to a governmental authority. In the United States, the term *person* refers to both natural persons (individuals) and corporations. Corporations are entities organized under the laws of one of the 50 states or the District of Columbia. These corporate entities generally enjoy the same legal rights, privileges, and protections as individuals. The taxing jurisdictions in this country uniformly regard corporations as entities separate and distinct from their shareholders. Consequently, corporations are taxpayers in their own right.

The **incidence** of a tax refers to the ultimate economic burden represented by the tax. Most people jump to the conclusion that the person or organization that makes a direct tax payment to the government bears the incidence of such tax. But in some cases, the payer can shift the incidence to a third party. Consider the following examples.

Income Tax Incidence

Government G enacts a new tax on corporate business profits. A manufacturing corporation with a monopoly on a product in great demand by the public responds to the new tax by increasing the retail price at which it sells the product. In this case, the corporation is nominally the taxpayer and must remit the new tax to the government. The economic burden of the tax falls on the corporation's customers who are indirectly paying the tax in the form of a higher price for the same product.

Property Tax Incidence

Mr. Blaire owns an eight-unit apartment building. Currently, the tenants living in each unit pay $9,600 annual rent. The local government notifies Mr. Blaire that his property tax on the apartment building will increase by $5,400 for the next year. Mr. Blaire reacts by informing his tenants that their rent for the next year will increase by $675. Consequently, Mr. Blaire's total revenue will increase by $5,400. Although Mr. Blaire is the taxpayer who must remit the property tax to the government, the incidence of the tax increase is on the tenants who will indirectly pay the tax through higher rent.

[1] *Carmichael* v. *Southern Coal & Coke Co.*, 301 U.S. 495, 522 (1937).

The right of a government to levy tax on a specific person or organization is referred to as **jurisdiction.** Jurisdiction exists because of some rational linkage between the government and the taxpayer. For instance, our federal government has jurisdiction to tax any individual who is a U.S. citizen or who permanently resides in this country.

U.S Jurisdiction over Citizens

Mrs. Fowler was born in Kentucky and is a U.S. citizen. However, she has lived her entire adult life in Cape Town, South Africa. Even though Mrs. Fowler is a permanent resident of a foreign country, the United States claims jurisdiction to tax her entire income.

The government also claims jurisdiction to tax individuals who are neither U.S. citizens nor residents (nonresident aliens) but who earn income from a source within the United States.

U.S. Jurisdiction over Nonresident Aliens

Mr. Kohala is a citizen of Spain and resides in Madrid. He owns an interest in a partnership formed under Florida law that conducts a business within the state. Even though Mr. Kohala is a nonresident alien, the United States claims jurisdiction to tax him on his share of the partnership income because the income was earned in this country.

The Relationship between Base, Rate, and Revenue

LO 1-2
Express the relationship between tax base, rate, and revenue as a formula.

Taxes are usually characterized by reference to their base. A **tax base** is an item, occurrence, transaction, or activity with respect to which a tax is levied. Tax bases are usually expressed in monetary terms.[2] For instance, real property taxes are levied on the ownership of land and buildings, and the dollar value of the property is the tax base. When designing a tax, governments try to identify tax bases that taxpayers can't easily avoid or conceal. In this respect, real property is an excellent tax base because it can't be moved or hidden, and its ownership is a matter of public record.

The dollar amount of a tax is calculated by multiplying the base by a tax rate, which is usually expressed as a percentage. This relationship is reflected in the following formula:

$$\text{Tax (T)} = \text{Rate (r)} \times \text{Base (B)}$$

A single percentage that applies to the entire tax base is described as a **flat rate.** Many types of taxes use a **graduated rate** structure consisting of multiple percentages that apply to specified portions or **bracket** of the tax base.

Graduated Rate Structure

Jurisdiction J imposes a tax on real property located within the jurisdiction. The tax is based on the market value of the real property and consists of three rate brackets.

Percentage Rate	*Bracket*
1%	Value from –0– to $100,000
2%	Value from $100,001 to $225,000
3%	Value in excess of $225,000

Company C owns a tract of real property worth $500,000. The tax on this property is $11,750.

1% of $100,000 (first bracket of base)	$ 1,000
2% of $125,000 (second bracket of base)	2,500
3% of $275,000 (third bracket of base)	8,250
Total tax on $500,000 base	$11,750

[2] A per capita, or head, tax requires each person subject to the tax to pay the same amount to the government. This antiquated type of tax does not have a monetary base.

The term **revenue** refers to the total tax collected by the government and available for public use. Note that in the equation $T = r \times B$, the tax is a function of both the rate and the base. This mathematical relationship suggests that governments can increase revenues by increasing either of these two variables in the design of their tax systems.

Transaction- or Activity-Based Taxes

Taxes can be characterized by the frequency with which they are levied. A tax can be **event or transaction based** so that the tax is triggered only when an event occurs or a transaction takes place. A familiar example is a sales tax levied on the purchase of retail goods and services. A second example is an estate tax levied on the transfer of property from a decedent to the decedent's heirs. Taxpayers may have some degree of control over the payment of these types of taxes. By avoiding the event or transaction on which the tax is based, a person avoids the tax. With certain taxes, such as excise taxes levied on the purchase of liquor and cigarettes, people have total discretion as to whether they ever pay the tax. By choosing not to drink alcoholic beverages or not to smoke, they are also choosing not to pay the excise tax. In contrast, no individual can avoid an estate or inheritance tax levied on the transfer of property at death by indefinitely postponing the event that triggers the tax!

A tax can be described as **activity based** when it is imposed on the cumulative result of an ongoing activity. Taxpayers must maintain records of the activity, summarize the result at periodic intervals, and pay tax accordingly. An annual income tax is a prime example of an activity-based tax.

An **income tax** is imposed on the periodic inflow of wealth resulting from a person's economic activities. For persons who engage in a limited number or variety of economic transactions, the measurement of taxable income is relatively simple. For persons who engage in complex activities involving many economic transactions, the measurement of taxable income can be a challenging process.

Earmarked Taxes

Tax Talk
Washington, D.C., levies a five-cent-per-bag tax on disposable plastic and paper bags. All revenue from the tax is earmarked for the Anacostia River Clean Up and Protection Fund.

Still another way to characterize taxes is to link them to government expenditures. The revenues from some taxes are **earmarked** to finance designated projects. For instance, revenues from local real property taxes are typically earmarked to support public school systems. Revenues generated by the federal payroll and self-employment taxes fund the Social Security system (Old-Age, Survivors, and Disability Insurance Trust Fund) and Medicare (Hospital and Supplementary Medical Insurance Trust Funds). Revenues from so-called environmental excise taxes on businesses are appropriated to the Environmental Protection Agency's Hazardous Substance Superfund, which subsidizes the cleanup and disposal of toxic wastes. In contrast to these earmarked taxes, revenues from taxes that pour into a general fund may be spent for any public purpose authorized by the government.

THE PERVASIVE NATURE OF TAXATION

Supreme Court Justice Potter Stewart perfectly described the U.S. tax environment by observing:

> Virtually all persons or objects in this country . . . may have tax problems. Every day the economy generates thousands of sales, loans, gifts, purchases, leases, wills, and the like, which suggest the possibility of tax problems for somebody. Our economy is "tax relevant" in almost every detail.[3]

[3] *United States* v. *Bisceglia*, 420 U.S. 141, 154 (1975).

Why are taxes so pervasive in our modern world? One reason is the multiplicity of jurisdictions in which people conduct business. Every firm operates in some geographic location within the taxing jurisdiction of one or more local governments. Local governments include townships, cities, municipalities, counties, and school districts, all of which have operating budgets financed by tax revenues. Local governments are subject to the authority of state governments, and state constitutions or statutes typically regulate the nature and extent of local taxation.

The governments of each of the 50 states and the District of Columbia levy taxes on firms conducting business within their geographic territory. In turn, the states' taxing jurisdiction is subject to federal constitutional and statutory constraints. The federal government represents still another jurisdiction that taxes business activities conducted within the United States. Consequently, even the smallest domestic enterprise is usually required to pay taxes to support at least three different levels of government. If a domestic enterprise conducts any business in a foreign country, the number of potential taxing jurisdictions is even higher.

Business managers who want to control tax costs must be aware of any local, state, federal, or foreign tax for which the firm is, or might become, liable. In the next section of Chapter 1, we will survey the types of taxes levied by different jurisdictions to finance their governments.

Local Taxes

LO 1-3
Describe the taxes levied by local governments.

Local governments depend heavily on real property taxes and personal property taxes, which are frequently referred to as **ad valorem taxes.** According to the most recent census data, these two taxes account for more than 70 percent of local government tax revenues.[4]

Real Property Taxes

All 50 states allow local jurisdictions to tax the ownership of real property sited within the jurisdiction. Real property or **realty** is defined as land and whatever is erected or growing on the land or permanently affixed to it. This definition encompasses any subsurface features such as mineral deposits.

Real property taxes are levied annually and are based on the market value of the property as determined by the local government. Elected or appointed officials called **tax assessors** are responsible for deriving the value of realty and informing the owners of the assessed value. Property owners who disagree with the assessed value may challenge the assessment in an administrative or judicial proceeding. A unique feature of real property taxes is that the tax rate is determined annually, based on the jurisdiction's need for revenue for that particular budget year.

Property Tax Rates

Springfield's city council decides that the city must raise $12 million of real property tax revenues during its next fiscal year. Because Springfield's tax assessor determines that the total value of real property located within the city limits is currently $230 million, the council sets the tax rate for the upcoming year at 5.22 percent ($12 million ÷ $230 million). This rate can be adjusted each year, depending on Springfield's future revenue needs and the fluctuating value of its real property tax base.

[4] These and subsequent data are obtained from *Quarterly Summaries of Federal, State, and Local Tax Revenues*, Bureau of the Census, U.S. Department of Commerce.

Local governments may establish different tax rates for different classifications of property. For instance, a township may choose to tax commercial realty at a higher rate than residential realty, or a county might tax land used for agricultural purposes at a higher rate than land maintained for scenic purposes. Governments may grant permanent tax-exempt status to realty owned by charitable, religious, or educational organizations and publicly owned realty. They may also grant temporary tax exemptions called **abatements** for limited periods of time. Governments usually grant abatements to lure commercial enterprises into their jurisdiction, thereby creating jobs and benefiting the local economy. From a business manager's point of view, the tax savings from abatements can be significant. Consequently, firms contemplating expansion into new jurisdictions frequently negotiate for property tax abatements before acquiring or beginning construction of realty within the jurisdiction.

Tax Incentives for Boeing

In 2014, Boeing selected a site in Washington state for a new facility to manufacture its 777X airliners. In return, Boeing received a tax incentive package from the state expected to be worth over $8 billion to the aerospace giant. Good Jobs First, a group that tracks government subsidies to business, says the state's new Boeing package is the biggest tax subsidy in U.S. history.

Personal Property Taxes

Most states permit localities to tax the ownership of **personalty,** defined as any asset that is not realty. Like real property taxes, personal property taxes are based on the value of the asset subject to tax. However, such value isn't usually assessed by a government official. Instead, individuals and organizations must determine the value of their taxable personalty and render (i.e., report) the value to the tax assessor.

There are three general classes of taxable personalty: household tangibles, business tangibles, and intangibles.[5] Household tangibles commonly subject to tax include automobiles and recreational vehicles, pleasure boats, and private airplanes. Taxable business tangibles include inventory, furniture and fixtures, machinery, and equipment. The most common intangible assets subject to personal property tax are marketable securities (stocks and bonds).

During the last century, personal property taxation has declined steadily as a revenue source. One reason for the decline is that this tax is much more difficult to enforce than other taxes. Personalty is characterized by its mobility; owners can easily hide their assets or move them to another jurisdiction. Any governmental attempt to actively search for personalty, particularly household tangibles, could violate individual privacy rights. Governments have responded to these practical problems by linking the payment of personal property tax to asset registration or licensing requirements.

State Taxes

LO 1-4
Describe the taxes levied by state governments.

In the aggregate, state governments rely in almost equal measure on sales taxes and income taxes as major sources of funds. These two kinds of taxes account for approximately 90 percent of total state tax revenues.

Retail Sales, Use, and Excise Taxes

Forty-five states and the District of Columbia impose a tax on in-state sales of tangible personal property and selected services. (The exceptions are Alaska, Delaware, Montana, New Hampshire, and Oregon.) Moreover, 38 states allow local governments to levy additional

[5] Tangible property has physical substance that can be perceived by sight or touch. Intangible property has no physical substance.

Tax Talk
On average, 36 percent of state and local government spending is devoted to public education.

sales taxes. Sales taxes have been the great growth taxes of state governments during the past century.[6] In 1930, only two states had a general sales tax. During the depression era, revenue-starved states began enacting temporary sales taxes as an emergency measure. These taxes proved to be both simple and effective and soon became a permanent feature of state tax systems. Sales taxes produce about $243 billion of annual revenue, roughly one-third of all state tax collections. Sales taxes also have become an important revenue source for local governments, although property taxes remain their primary revenue source.

Tax Talk
New York residents bear the heaviest state and local tax burden (12.6 cents of every dollar of income) while Wyoming residents bear the lightest (6.9 cents of every dollar of income). The national average state and local tax burden is 9.8 cents of every dollar of income.

A **sales tax** is typically based on the retail price of tangible personalty. Combined state and local tax rates range from 1.78 percent of the dollar amount in Alaska to 9.46 percent in Tennessee. Sales taxes are broad based and apply to most types of consumer goods and even to selected consumer services, such as telephone or cable television service.[7] The tax may take the form of a business tax levied on the seller or, more commonly, a consumption tax levied on the purchaser who is the final user of the goods or services. Regardless of the form, the seller is responsible for collecting the tax at point of sale and remitting it to the state government.

Every state with a sales tax imposes a complementary **use tax** on the ownership, possession, or consumption of tangible goods within the state. The use tax applies only if the owner of the goods did not pay the state's sales tax when the goods were purchased. A use tax acts as a backstop to a sales tax by discouraging residents from purchasing products in neighboring jurisdictions with lower sales tax rates. The one-two punch of a sales and use tax theoretically ensures that state residents are taxed on all purchases of consumer goods, regardless of where the purchase occurred. As a result, merchants operating in high-tax states are not at a competitive disadvantage with respect to merchants operating in low-tax states.

As a general rule, consumers may take a credit for out-of-state sales taxes against their in-state use tax liability.

Use Tax Calculation

Ms. Goode is a resident of New Jersey, which has a 7 percent sales and use tax. While on vacation in Hawaii, Ms. Goode purchased a diamond bracelet for $7,600 and paid $304 (4 percent) Hawaiian sales tax. Because Ms. Goode did not pay her own state's sales tax on the purchase, she owes $228 use tax to New Jersey. The use tax equals $532 (7 percent of $7,600) minus a $304 credit for the Hawaiian sales tax. If Ms. Goode had vacationed in California and paid that state's 7.25 percent sales tax on her jewelry purchase, she would not owe any New Jersey use tax.

Tax Talk
According to the Campaign for Tobacco-Free Kids, states are losing $1 billion annual revenue from excise taxes on tobacco because of untaxed Internet sales and cigarette smuggling.

Millions of people are unaware of their responsibility for paying use tax on goods purchased out of state or through mail-order catalogs, or they ignore their self-assessment responsibility. States have recently become much more aggressive in collecting use taxes directly from their residents and have entered into cooperative agreements to share sales and use tax audit information. Twenty-five states have added lines to their personal income tax returns on which individuals are instructed to report the use tax due on their out-of-state and catalog purchases for the year.

An **excise tax** is imposed on the retail sale of specific goods, such as gasoline, cigarettes, or alcoholic beverages, or on specific services, such as hotel or motel accommodations. States may impose an excise tax in addition to or instead of the general sales tax on a particular good or service. In either case, the seller is responsible for collecting and

[6] Jerome Hellerstein and Walter Hellerstein, *State Taxation*, vol. II (Boston: Warren, Gorham & Lamont, 1993), p. 12–1.

[7] Many states provide sales tax exemptions for items considered necessities of life, such as food and prescription drugs.