CHAPTER 1

UNDERSTANDING AND WORKING WITH THE FEDERAL TAX LAW

SOLUTIONS TO PROBLEM MATERIALS

DISCUSSION QUESTIONS

1. (LO 1) When enacting tax legislation, Congress often is guided by the concept of revenue neutrality so that any changes neither increase nor decrease the net revenues raised under the prior rules. Revenue neutrality does not mean that any one taxpayer's tax liability remains the same. Since this liability depends on the circumstances involved, one taxpayer's increased tax liability could be another's tax saving. Revenue-neutral tax reform does not reduce deficits, but at least it does not aggravate the problem.

2. (LO 2) Economic, social, equity, and political factors play a significant role in the formulation of tax laws. Furthermore, the Treasury Department, the IRS, and the courts have had impacts on the evolution of tax laws. For example, control of the economy has been an important economic consideration in passing a number of laws (e.g., rapid depreciation, changes in tax rates). But ultimately the tax law is written by Congress.

3. (LO 2) The tax law encourages technological progress by allowing immediate (or accelerated) deductions and tax credits for research and development expenditures.

4. (LO 2) Saving leads to capital formation and makes funds available to finance home construction and industrial expansion. For example, the tax laws provide incentives to encourage savings by giving private retirement plans preferential treatment.

5. (LO 2)
   a. Code § 1244 allows ordinary loss treatment on the worthlessness of small business corporation stock (discussed in Chapter 4). Since this stock normally would be a capital asset, the operation of § 1244 converts a less desirable capital loss into a more attractive ordinary loss. This tax treatment was designed to aid small businesses in raising needed capital through the issuance of stock.

   b. The S corporation election (see footnote 5 and a detailed discussion in Chapter 12) allows the profits (or losses) of the corporation to flow through to its individual shareholders (avoiding the corporate income tax). In addition, the qualified business income deduction may apply to any flow-through profits (allowing a maximum 20% deduction to the shareholders). However, with the corporate tax rate being 21% (and individual marginal tax rates potentially being higher), individuals need to compare the benefits of avoiding the corporate tax rate with the taxes on any S corporation flow-through profits.

6. (LO 2) Reasonable persons can, and often do, disagree about what is fair or unfair. In the tax area, moreover, equity is generally tied to a particular taxpayer's personal situation. For example, one equity difference relates to how a business is organized (i.e., partnership versus corporation). Two businesses may be equal in size, similarly situated, and competitors in the production of goods or services, but they may not be comparably treated under the tax law if one is a partnership and the other is a corporation. The corporation is subject to a separate Federal income tax of 21%; the partnership is not. The tax law can and does make a distinction between these business forms. Equity,

then, is not what appears fair or unfair to any one taxpayer or group of taxpayers. Equity is, instead, what the tax law recognizes.

7. (LO 2) This deduction can be explained by social considerations. The deduction shifts some of the financial and administrative burden of socially desirable programs from the public (the government) sector to the private (the citizens) sector.

8. (LO 2) Preferential treatment of private retirement plans encourages saving. Not only are contributions to Keogh (H.R. 10) plans and certain Individual Retirement Accounts (IRA) deductible, but income from these contributions accumulates on a tax-free basis.

9. (LO 2) The availability of percentage depletion on the extraction and sale of oil and gas and specified mineral deposits and a write-off (rather than capitalization) of certain exploration costs encourage the development of natural resources.

10. (LO 2) Favorable treatment of corporate reorganizations provides an economic benefit. By allowing corporations to combine and split without adverse consequences, corporations are in a position to reduce their taxes and possibly more effectively compete with other businesses (both nationally and internationally).

11. (LO 2) Although the major objective of the Federal tax law is the raising of revenue, other considerations explain many provisions. In particular, economic, social, equity, and political factors play a significant role. Added to these factors is the impact the Treasury Department, the Internal Revenue Service, and the courts have had and will continue to have on the evolution of Federal tax law.

12. (LO 2) The deduction allowed for Federal income tax purposes for state and local income taxes is not designed to neutralize the effect of multiple taxation on the same income. At most, this deduction provides only partial relief. The $10,000 overall limitation on state and local taxes also reduces the tax benefit of these taxes. Only allowing a full tax credit would achieve complete neutrality.

    a. With the standard deduction, a taxpayer is *indirectly* obtaining the benefit of a deduction for any state or local income taxes he or she may have paid. The standard deduction is in lieu of itemized deductions, which include any allowed deductions for state and local income taxes.

    b. If the taxpayer is in the 10% tax bracket, $1 of a deduction for state or local taxes would save $0.10 of Federal income tax liability. In the 32% tax bracket, the saving becomes $0.32. The deduction approach (as opposed to the allowance of a credit) favors high-bracket taxpayers.

13. (LO 2) Under the general rule, a transfer of a partnership's assets to a new corporation could result in a taxable gain. However, if certain conditions are met, § 351 postpones the recognition of any gain (or loss) on the transfer of property by Heather to a controlled corporation (see Example 4).

    The wherewithal to pay concept recognizes the inequity of taxing a transaction when Heather lacks the means with which to pay any tax. Besides, Heather's economic position would not change significantly should the transfer occur. Heather owned the assets before the transfer and still would own the assets after a transfer to a controlled corporation. See Chapter 4 for a more detailed discussion of § 351.

14. (LO 2) Yes. Once incorporated, the business may be subject to the Federal corporate income tax. However, the 21% corporate tax rate *might* be lower than Heather's individual tax rates, especially if dividends are not paid to Heather.

    The corporate income tax could be avoided altogether by electing to be an S corporation. An S corporation is generally not taxed at the corporate level; instead, the income flows through the corporate veil and is taxed at the shareholder level. An S election allows a business to operate as a