Chapter 2 Income Tax Concepts

This chapter is the foundation for this text.

The concepts established here are fundamental to understanding the topics in subsequent chapters. ***Chapters 3 through 16*** incorporate a "look back" approach that discusses the operation of the U.S. tax system through the conceptual framework developed in this chapter. You may want to spend as many as five 50-minute class periods on this chapter's content. Emphasize to students the importance of reading the ***Concept Review*** at the beginning of each subsequent ***chapter*** (***3 through 16***). Also, point out the "***concept checks"*** located throughout the chapters.

Teaching Tip #1: A drill approach during class time reinforces the concepts presented in the chapter. When students come to class, hand out a list of scenarios that demonstrate the concepts to be discussed that day. Go around the classroom and have students discuss the concept that explains the answer to the inherent question. The problems at the end of the chapter fit this approach very well.

Teaching Tip #2: The next several pages contain examples I use as in-class exercises or additional homework problems. (I have included the answers for you.) Students need as much practice as we can give them on understanding the concepts. The efforts made now will pay off later.

Teaching Tip #3: Suggest to students they rely on ***Table 2-1*** to gain a familiarity with the Concepts and related Constructs and Doctrines. This table gives students a map to follow and a resource to look back on later.

Writing assignments: ***Problems 24, 29, 32, and 56; and Ethics Discussion Case 82*** are suggested. ***Problem 21*** can be presented in modified writing assignment form.

21A. Andrew Evans and his sister, Barbara Evans-DeCarlo, each receive a salary of $80,000. Neither Andrew nor Barbara has any other source of income. During the current year, Barbara paid $800 more in tax than Andrew. Barbara has come to you to receive help in understanding why her tax bill is higher than Andrew's. Write a letter to Barbara explaining the possible source(s) of the difference.

Chapter 2, Class Exercises #1
General & Accounting Concepts (and Constructs)

1. Jeromy receives a $480 tax credit for childcare. The credit was earned because of Jeromy's expenditures for day care for his daughter while Jeromy worked. What concept explains why Jeromy receives this tax credit?
   Ans: Ability To Pay

2. Bowow Company allows its employees to make personal Xerox copies without charge on the company copy machines. What concept helps explain why the benefit received is not taxable to Bowow employees?
   Ans: Administrative Convenience Concept

3. Glenda sells 100 shares of ICBM stock to her brother for $10,000. The shares originally cost Glenda a total of $12,000. Glenda is not allowed to deduct the loss realized on the sale of the stock shares. What concept applies to this event?
   Ans: Arms-Length Transaction Concept

4. Doria sells a van to a corporation in which she is a 40% stockholder. She realizes a loss of $2,500 on the sale. She is not allowed to deduct the loss for tax purposes, because in addition to her ownership percentage, her spouse owns 30%. Which concepts apply?
   Ans: Arms-Length Transaction & Related Party Rules

5. The State of Utah collects sales tax of 6.25% at the point of sale on purchases of most goods. What concept dictates the point of sale collection?
   Ans: Pay As You Go

6. Hugh, a self-employed contractor, is scrambling around to refigure his estimated 2009 income tax liability, because he needs to mail his fourth quarter estimated tax payment January 15, 2010. What concept is causing Hugh to scramble?
   Ans: Pay As You Go

7. Sharon is the sole shareholder of Grimsley Corporation. During the year, Sharon received $44 of cash dividends from Grimsley. The dividends are included in Sharon's gross income. She has a current-year income tax liability of $5,905. Grimsley Corporation has a current-year income tax liability of $156,700. What concept dictates that both Sharon and the corporation pay tax on their separate incomes?
   Ans: Entity Concept

8. Francis "hired" her four-year-old son to be the office manager of her real estate firm. She deducted his $20,000 annual salary as a business expense. The IRS disallowed the deduction upon examination of Francis' tax return. Why?
   Ans: Substance Over Form Doctrine

9. Pat is a partner in Oil Exploration Limited Partnership. For the current year the partnership reported net income of $130,000. Pat's share of the income is $1,300. Pat reports that amount in her gross income. The partnership pays no income tax on its earnings. What concept applies here?
   Ans: Entity Concept (Partnerships are Conduits)

10. Alicia is a self-employed electrician. All cash payments she receives from customers are deposited into a bank account held in the name of her son. Alicia does not have use of the funds. Therefore, she does not think she needs to include the cash receipts in her gross income. What corollary of the Entity Concept dictates that Alicia needs to include the receipts in her income?
    Ans: Assignment of Income Doctrine

11. Terri files her tax return on April 15, 2012, reporting only her 2011 income, gains, deductions, and losses. She did not include the $2,000 bonus received from her employer on January 10, 2012, relating to her work performance during 2011. What concept will indicate that Terri's actions are correct?
    Ans: Annual Accounting Period Concept

12. Angelo had $4,000 of State Income Taxes withheld from his salary during 2011. On his 2011 federal income tax return, Angelo properly deducted the $4,000 as State Taxes Paid. Upon filing his 2011 State Tax Return on April 15, 2012, he determined that his actual State Income Tax for 2011 was only $3,300. He received a refund of $700 on May 25, 2012, from the amounts withheld by the State. What rule dictates that the $700 is included in Angelo's 2012 income?
    Ans: Tax Benefit Rule following the Annual Accounting Period Concept

Chapter 2, Class Exercises #2
General Concepts

1. One proposal before Congress is to establish a flat tax. Is a flat rate structure based on the ability-to-pay concept?
   Ans: No. The tax levied on a taxpayer is based on the amount that the taxpayer can afford to pay. A taxpayer who has more income than a second taxpayer will pay more tax than the second taxpayer.

2. Opponents to the current progressive tax rate structure of the U.S. system claim it is unfair because the highest individual tax rate is 39.6%. Discuss the "unfairness" of this system using the ability-to-pay concept.

   Ans: Since taxpayers with the highest incomes pay income tax at a rate higher than taxpayers with lower incomes, the ability-to-pay concept is appropriately applied with the current tax system.

3. Discuss how certain exclusions from income undermine the ability-to-pay concept. For purposes of this analysis, use the exclusion for the receipt of gifts.

   Ans: To the extent that a taxpayer has income that is not subject to tax because of an allowable exclusion like gifts, the taxpayer is being taxed at less than her or his ability to pay.

4. Discuss why employees of Lone Pig Brewing Company are not taxed on the free beer they drink during breaks and lunch hours.

   Ans: Although employees are in receipt of income from the free beer provided by the employers, this form of compensation is not taxable because the cost of each employee's tracking his or her consumption, as well as the cost of the government's ensuring that all employees include the cost of the free beer in the income, exceeds the additional tax that would be collected. Thus, under the administrative convenience concept, employees are not taxed on the free beer.

5. All of Justina's tax-related records were destroyed when the moving van transporting her belongings to Colorado Springs rolled off Wolf Creek Pass. Because she did not want to reconstruct the records, Justina used the standard deduction amount when she filed her income tax return. Why is Justina allowed to use the standard deduction amount instead of actual expense amounts?

   Ans: This approach saves the taxpayer time in reconstructing the information and also saves the government time in ensuring the accuracy of the information reported (i.e., the standard deduction is not audited).

6. Henry wants his daughter, Amy, to have his acreage near Moose Crossing. Amy is able to pay up to $75,000 for the property. Henry paid $95,000 for it several years ago. Recently, an appraiser told Henry he could sell it for $200,000. Henry plans to accept the $75,000 from Amy. He thinks that the $75,000 is fair, in part, because he hopes to be able to deduct the loss realized on the sale. Why will Henry be disappointed about his plans to recognize the loss?

   Ans: The sale will not be at arm's-length. This transaction is a form of self-dealing. Amy and Henry are related parties. The realized loss cannot be recognized because of this relationship.

7. Antonio, Renee, and Manuel are the only shareholders of Undula Corporation owning 52%, 44%, and 4%, respectively.

   a. Undula Corporation plans to sell Renee a car purchased for $20,000 two years ago and a current adjusted basis of $15,000 because of depreciation. The agreed purchase price is $8,000. Will Undula be allowed to recognize a loss on the sale? Explain.

Ans: This transaction is at arm's-length. Because Renee does not own more than 50% of the corporation, she is not deemed to be a related party. Therefore, there is no constructive ownership and no self-dealing.

b. Antonio is going to sell manufactured goods from his sole proprietorship to Undula for $40,000. The cost of the goods is $50,000. Will Antonio be allowed to deduct the realized loss on the sale? Explain.

Ans: Antonio is involved with self-dealing in this scenario. Since he owns more than 50% of Undula Corporation, he is deemed to be in control of the entity. He is a related party, and the transaction is not at arm's length. No loss recognition is allowed for Antonio (or his sole proprietorship).

8. Reynaldo is self-employed. Because he does not receive a salary, he has no payroll withholding for income taxes. Reynaldo thinks he is exempt from the pay-as-you-go concept. Explain why he is incorrect in this assumption.

   Ans: Voluntary compliance is essential to the operation of the U.S. tax system. Part of the voluntary compliance component is the pay-as-you-go system. It requires all taxpayers to pay tax as income is generated. For taxpayers without withholding from employers, estimated tax payments must be made. Quarterly estimated tax payments are required when estimated tax for a year is at least $500.

Chapter 2, Class Exercises #3
Income Concepts

1. After buying books at the beginning of the semester, Lucy finds a $100 bill outside the door of the bookstore. The $100 is considered gross income. Why?

   Ans: All-inclusive Income Concept and no legislative grace to exclude

2. Ed's spouse, Trixie, died in 2013. Ed received $1,000,000 from a life insurance policy in which he was the beneficiary. Ed invested the funds in Micro-Bionics, Inc., common stock and received $30,000 in cash dividends in 2013. The $1,000,000 is excluded from gross income and the $30,000 is included. Why?

   Ans: Legislative grace provides for the exclusion from gross income of life insurance proceeds; and dividend income has received no legislative grace

3. Ned sold 200 shares of common stock, received $2,000, and had a gain of $1,000 on the sale. Red sold 200 items of inventory from his shop and earned $1,000 from the sales. For tax purposes Ned and Red may have different results, even though their income amounts are the same. Why?

   Ans: Capital Recovery Concept. Stock is a capital asset and capital gains are taxed at a maximum rate of 15%; the inventory is an ordinary income item and the income could be taxed at a marginal rate as high as 35%

4. Alice sold 100 shares of common stock and incurred a loss of $3,500 on the sale. Candice sold 100 items of inventory from her shop and a loss of $3,500 resulted. For tax purposes Alice and Candice have different results. Why?
   Ans: Net capital losses are limited to $3,000 annually; losses on inventory sales are ordinary and have no deduction limits

5. Sally bought a plot of raw land for $2,000 two years ago. She subdivided the land into four equal sized parcels. This year Sally sold one parcel for $800 and another for $400. What are the tax ramifications?
   Ans: Capital Recovery Concept; Allocate the basis of $2,000 into four equal parts of $500. Gain of $300 on the first parcel and a loss of $100 on the second. These two sales are considered separately.

6. Billy Bob bought a small ranch for $200,000 three years ago. This year, oil was discovered on neighboring property; therefore, the county assessor re-valued Billy's property at $350,000. Is there any income tax effect?
   Ans: No realization has occurred.

7. Radio station WLLK received $100,000 from Comfort Elixirs, Inc., to air Comfort's commercials during a local talk show in December 2011. December's ratings dropped sharply when the show's star quit. Shortly thereafter, Comfort contacted WLLK, indicating that it wanted to discontinue its sponsorship and requesting return of $75,000 of the payment. The station continued to air the commercials and kept the $100,000. Comfort brought suit to recover the $75,000. Is the $100,000 included in WLLK's gross income?
   Ans: Yes. Claim of Right Doctrine - No clear obligation to repay and unrestricted use of the money.

8. Sammie is an employee of Mavis Company. The company regularly mails salary checks to employees to arrive on or before the last day of each month. Sammie's regular paycheck arrived at his house on Dec. 31, 2012, but Sammie was on vacation and didn't return until January 2, 2013. Sammie deposited the check in his bank account the following day. The gross amount of the check is included in Sammie's 2012 income. Why?
   Ans: Constructive Receipt Doctrine

9. Rasheed sold a parcel of investment real estate to Opal for $500,000 in 2012. Rasheed will receive $100,000 annually, plus interest at 9%, from 2013 through 2017. Rasheed will recognize no gross income on this sale in 2012. Why?
   Ans: Wherewithal-To-Pay Concept from which the installment sale rules emanate.

Chapter 2, Class Exercises #4
Deduction Concepts

1. Helen is allowed to deduct the $5,000 cash and the Roberta-Glidden painting valued at $1,000 she donated to Catholic Charities Foundation. Why?
   Ans: Legislative Grace permits the deduction of charitable contributions

2. Forby Corporation had its expenditure of $340,000 for salary to its president and sole shareholder disallowed as a deduction by the IRS. Comparable salaries for presidents of similarly sized firms in the same industry average $95,900. The $340,000 was reclassified as a nondeductible cash dividend. What was the reason the IRS used for the disallowance?
   Ans: Lack of Business Purpose for the unreasonable compensation

3. Randi is a self-employed plumber. She spent $12,000 of her personal savings to buy 120 shares of Kryptogenics, Inc., common stock. She also sold several shares of Xenon Corp. stock and incurred $260 of deductible expenditures. Why is the first expenditure not deductible when the second one is deductible?
   Ans: The first is a capital expenditure where the usefulness extends substantially beyond the end of the tax year. The second is directly related to the sale of an investment asset.

4. Michael sold a personal-use car that had cost $5,000 for $2,000. Why is the loss realized on this transaction disallowed as a deduction?
   Ans: Personal losses are disallowed

5. Craig bought a business-use vehicle for $20,000. He used the vehicle for three years and properly deducted $4,000 annually as depreciation expense. At the beginning of year 4, Craig sold the vehicle for $7,500. Why is Craig's deductible loss only $500?
   Ans: Craig deducted capital recovery amounts of $4,000 annually for three years. Therefore, the adjusted basis was $8,000 at the date of sale. Only $7,500 of the adjusted basis was recovered. The realized loss is recognized because it was incurred with business-use property.

Lecture Outline

I. Federal income taxation is based on a system of rules
   A. Understanding the basic system gives the student the
      1. Ability to determine treatment of transactions
      2. Foundation for understanding the exceptions
   B. Exceptions stem from alternative goals
      1. Social
      2. Economic

        3. Political
    C. A *Concept* is a broad principle
        1. *Constructs* and *Doctrines* are interpretive devices to apply concepts
            a. Construct is a mechanism developed to implement a concept
            b. Doctrine is a construct developed via the courts
    D. ***Discussion Question #1*** is good for creating understanding of artificial systems
        1. **Hint:** Divide your class into small groups and have each solve ***Discussion Question #1***

II. General Concepts apply to almost all aspects of the income tax system
    A. Ability to Pay Concept (***Problems 18 to 21***)
        1. Tax levied based on an amount that taxpayer can afford to pay
        2. Taxable income reflects deductions and exclusions due to Ability to Pay (***Examples 1 and 2***)
        3. Tax credits also follow Ability to Pay
        4. Progressive tax rate structure
    B. Administrative Convenience Concept
        1. Cost vs. benefit
            a. Taxpayer considerations
            b. Government considerations
        2. Examples of Administrative Convenience
            a. Fringe benefit exclusions (***Example 3***)
            b. Standard deduction amounts (***Example 4***)
    C. Arm's-Length Transaction Concept requires economic reality (***Problems 22 and 23***)
        1. Self-dealing via related party transactions (***Figure 2-1***)
            a. Family members
            b. More than 50%-owned corporations (***Example 5***)
            c. Corporations and partnerships if same person owns over 50% of both
    D. Pay As You Go Concept
        1. Encourages voluntary compliance through withholding (***Example 6***) and estimated tax payments

III. Accounting Concepts give directions for properly reporting transactions
    A. Entity Concept provides for determination of the proper taxpaying unit
        1. Taxable Entities (***Problems 25 and 26***)
            a. Individuals

b. Corporations
c. Estates
d. Certain Trusts
2. Conduit Entities are nontaxable (***Problem 27***)
a. Income, losses, etc. pass through to Taxable Entities
b. S Corporations (***Example 8; Problem 28***)
1. ***Examples 7 and 8*** discuss the differences between C and S Corporations
c. Partnerships (***Problem 30***)
d. Trusts have both Conduit and Taxable characteristics
3. Sole Proprietorships (***Examples 9 to 11***)
a. Business items are segregated from personal items
b. Report business net income on Individual tax return
c. **Hint:** Bring a Form 1040 and Schedule C to class (or use the copies provided in ***Appendix C*** of the textbook). You can easily demonstrate the concept of pass-through to the tax return of the taxable entity (the individual).

B. Assignment of Income Doctrine (***Problems 31 and 32***)
1. A prohibitive provision
2. "Whoever provides services reports the income derived from the efforts" (***Example 12***)
3. **Hint:** Bring a copy of *Lucas v. Earl*, 281 US 111 (1930) to class. Read the prose containing the "fruit and tree" analogy.
4. Transfer of title of property is valid way to assign income (***Example 13***)

C. Annual Accounting Period Concept
1. Each tax year stands apart from all others
2. Calendar years are most common
3. Fiscal years may fit a natural business year better
a. Retailers with FYE January 31, after the holiday busy season
b. CPA firms with FYE of September or October
4. Cash or Accrual Accounting Method (***Problems 33 and 34***)
a. **Hint:** Emphasize that "cash" really means cash-equivalent
b. ***Examples 14 and 15***

D. Tax Benefit Rule (***Examples 16 and 17; Problems 35 and 36***)
1. Recovery of prior year deduction reported as income when recovered
2. Only applies if tax benefit received previously

E. Substance-Over-Form Doctrine (***Problem 37; Examples 18 to 22***)

1. Reality of a transaction determines taxability
2. **Hint:** This is the "Duck Rule: ‘If it walks like.., and quacks like.., it is...’ "

IV. Income Concepts determine what constitutes taxable income

A. All-Inclusive Income Concept
   1. **Hint:** Read (or have a student read) *IRC* §61 to reinforce - taxable income determination begins with "everything"
   2. All economic benefits received are income (***Example 23***)

B. Legislative Grace Concept (***Example 24***)
   1. Exclusions, deductions, and credits
      a. Reductions in income
      b. Only due to Congressional action
   2. These provisions are narrowly and strictly applied and interpreted
   3. Special tax treatment for certain types of income
      a. Capital Assets are *not*, receivables, inventory, real or depreciable property used in a trade or business, and certain intangibles (most business assets are not capital)
         1. **Hint:** Go over examples of Capital Assets. Students tend to focus on the GAAP concept of capital assets and are confused about the tax definition.
         2. A net (aggregate) capital gain is taxed at a maximum rate of 15% for individuals (***Problem 42***) (0% for taxpayers in the 10 or 15% marginal rate brackets)
         3. A net (aggregate) capital loss is limited to $3,000 per year for individuals (***Problem 41***)

C. Capital Recovery Concept (***Problems 40 to 42; Example 25***)
   1. No gain is taxed until all capital invested in an asset is recovered
   2. If full amount of investment is not recovered on disposition, a loss is realized

D. Realization Concept (***Problems 43 and 44***)
   1. No recognition until realization (***Example 26***)
   2. Arms-length transaction & wealth increases
   3. Claim of Right Doctrine
      a. Amounts <u>received</u> without restriction are included in year of receipt
      b. ***Examples 27 to 29; Problems 45 to 47***
   4. Constructive Receipt Doctrine
      a. Concerns cash basis taxpayers only

b. Income is deemed realized
    1. When unconditionally available without physical possession
    2. Taxpayer must be aware of availability (***Example 33***)
    3. No restrictions or limitations over taxpayer's control
    4. ***Examples 30 to 33; Problems 48 and 49***
    5. **Hint:** Use ***Figure 2-2*** to help students understand the differences in constructive receipt and claim of right. Notice the timing: claim of right applies when payment is received -- constructive receipt applies prior to actual receipt

E. Wherewithal-To-Pay Concept provides reasoning for certain deferral provisions
  1. Taxation should occur when taxpayer has resources to pay
    a. Like-kind exchanges (***Example 34***)
    b. Installment sales provisions
  2. Affects certain accrual basis taxpayers too (***Example 35***)
    a. Advance payments for goods and services are income
  3. **Hint:** Students tend to confuse wherewithal-to-pay and ability-to-pay. Stress that wherewithal-to-pay is a transaction concept. Ability-to-pay is a system-wide concept.

F. ***Problem 52*** is an overall Income Concepts problem

V. Deduction Concepts provide the basis for determining the what, how much and when of deductions.
  A. Legislative Grace: nothing is deductible without a provision of tax law
  B. Business Purpose Concept: *Business purpose* must be > *Tax avoidance* motives
    1. Expenses incurred in trade or business (***Examples 36 and 37***)
    2. Expenses related to production of income (Investment Expenses) (***Examples 38 and 39***)
    3. Personal expenses are disallowed (***Problem 57; Examples 40 and 41***)
      a. Itemized deduction exception (***Example 42***)
      b. Exemption amount exception
  C. Capital Recovery Concept
    1. Basis is the amount invested (the cost) in an asset (***Example 43; Problem 61***)
    2. Capital expenditures establish long-term assets (***Examples 44 to 48***)

a. Capital is recovered via depreciation
b. Adjusted basis is the amount of unrecovered investment

D. ***Problems 54 and 55*** are good overall Deduction Concept problems

Concept Challenge. ***Have students complete the on-line quizzes available at the textbook's website (www.cengagebrain.com)***

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