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An Overview of Federal Taxation

Test Bank

True or False

_________ 1. A correlation exists between the amount of Federal tax an individual pays and the value of benefits an individual receives.

_________ 2. The Thirteenth Amendment enacted in 1916 made it clear that Congress had the right to impose an income tax.

_________ 3. The Federal income tax base is called "adjusted gross income."

_________ 4. The gift tax and the estate tax provide a very significant portion of total Federal revenues.

_________ 5. As a source of revenue, the Federal corporate income tax is larger than the Federal individual income tax.

_________ 6. Congress has chosen to exclude many sources of income from taxation even though it has the authority to tax income from whatever source derived.

_________ 7. A source of income is taxable only when listed as a taxable source of revenue in the Internal Revenue Code.

_________ 8. An expenditure is deductible only when listed as a deduction in the Internal Revenue Code.

_________ 9. If T is in the 35 percent tax rate bracket, then all of T's income is being taxed at 35 percent.

_________ 10. Knowing his marginal tax rate allows a taxpayer to determine the tax impact of an additional dollar added to the tax base or an additional dollar of deduction.

_________ 11. A credit is different from a deduction in that the credit reduces the base amount subject to the tax, whereas a deduction directly reduces the tax liability itself.

_________ 12. The unitary tax is a device that the Federal government has developed to tax corporations on income that they have earned outside the boundaries of the United States.

_________ 13. Interest income earned on government obligations issued by a state or local government (e.g., the state of Ohio) is generally subject to Federal income taxation.

________ 14. Congress enacted wealth transfer taxes primarily to diversify the Federal government's sources of income.

________ 15. The estate tax applicable credit amount is $5,120,000 million in 2012.

________ 16. The estate tax applicable credit amount, generally available only to low income families filing joint income tax returns, reduces the federal income tax.

________ 17. The gift tax and the estate tax exempt the same amount from taxation in 2012.

________ 18. By making the gift-splitting election, an unmarried donor can in effect make use of twice the annual exclusion to which she is normally entitled.

________ 19. Unlike the unified transfer tax, the typical state inheritance tax imposes a tax on the right to receive property at death.

________ 20. Both FICA and FUTA impose a double tax on the employer and the employee.

________ 21. Self-employed individuals are required to pay self-employment taxes if self-employment income is $400 or more.

________ 22. FUTA tax revenues are used by the Federal government to augment unemployment-benefit programs of the various states.

________ 23. An excise tax is imposed on the profits of a business or profession, but not on an individual's income.

________ 24. A "tax expenditure" is the amount of tax revenue that Congress budgets for social programs.

________ 25. A taxpayer is allowed to change the structure of a transaction for the sole purpose of avoiding taxes, even though the change in structure has no other economic effect.

Multiple Choice

________ 26. Which of the following characteristics would *not* be used to describe the generic nature of a "tax"?

a. Normally, there is a direct relationship between the exaction of revenue and the benefits received by the taxpayer.

b. A tax is levied on the basis of predetermined criteria.

c. A tax is levied on the basis of recurring periods.

d. A tax may be distinguished from a penalty because it is not specifically designed to control or stop a particular activity.

e. At least in the United States, taxes are often used to meet certain social as well as economic goals.

________ 27. Which one of the following statements is *not* true concerning tax rates?

a. A proportional tax rate is one in which an increasing percentage rate is applied to increasing increments of the tax base.

b. The marginal tax rate of any rate structure is that percentage at which the next dollar added to the tax base will be taxed.

c. The average tax rate is the percentage of taxable income paid in tax.

d. The effective tax rate is the percentage of total income paid in tax.

e. An individual cannot pay more in Federal income taxes than he reports as taxable income unless his marginal tax rate exceeds 100 percent.

________ 28. What type of tax rate do most excise taxes employ?

a. Proportional

b. Progressive

c. Regressive

d. Neutral

e. None of the above

________ 29. T has a tax base of $30,000 and pays a tax of $2,500 on the first $25,000 and $750 on the next $5,000. This is an example of what type of tax rate?

a. Proportional

b. Progressive

c. Regressive

d. Neutral

e. None of the above

________ 30. T has a tax base of $30,000 and pays a tax of $2,500 on the first $25,000 and $750 on the next $5,000. T has a marginal tax rate of

a. 10 percent

b. 15 percent

c. 20 percent

d. 10.83 percent

e. None of the above

________ 31. T has a tax base of $30,000 and pays a tax of $2,500 on the first $25,000 and $750 on the next $5,000. T has an average tax rate of

a. 10 percent

b. 15 percent

c. 20 percent

d. 10.83 percent

e. None of the above

________ 32. Which one of the following statements is true?

a. Tax credits reduce tax liability at the marginal tax rate.

b. Both tax credits and tax deductions are offsets to taxable income.

c. Dollar for dollar, tax credits are more valuable than tax deductions.

d. The tax impact of an additional dollar of tax base is determined by multiplying by the average tax rate.

e. "I can't afford to earn more because it will throw me into a higher tax bracket and I will keep less than I do now after taxes."

________ 33. B, an unmarried taxpayer, knows that her last dollar of income in the current year will be taxed at 15 percent. D, an unmarried taxpayer, knows that his last dollar of current year income will be taxed at 28 percent. Which of the following statements is *not* true taking into account the above assumptions?

a. D's marginal tax rate is greater than B's.

b. The value of a $3,000 IRA deduction to D will be less than the same amount contributed by B to an IRA.

c. If both parties suffer a $100,000 business loss that is fully deductible, the impact of the deductible loss will be greater on D's return than on B's return.

d. B will pay 15 percent of her taxable income to the government.

e. D will not pay 28 percent of his taxable income to the government.

_________ 34. Which one of the following tax entities does *not* pay a Federal income tax?

a. Trust

b. Partnership

c. Individual

d. Corporation

e. Estate

_________ 35. Before adjusted gross income can be computed, what following components must be computed?

a. Income

b. Taxable income

c. Gross income

d. Both a. and b.

e. Both a. and c.

_________ 36. Which one of the following cannot be subtracted from the gross estate to compute the total taxable transfers?

a. Charitable bequests

b. Taxable gifts made after December 31, 1976

c. Marital deduction

d. Funeral and administrative expenses

e. Both a. and c.

________ 37. Which one of the following statements is *not* true concerning the estate tax applicable credit amount?

a. The applicable estate tax credit amount can offset a tax up to $1,772,800 in 2012.

b. The applicable estate tax credit amount is a lifetime credit.

c. The applicable estate tax credit amount can be used to offset gift taxes and estate taxes.

d. Use of the applicable estate tax credit amount is mandatory if one makes a taxable gift.

e. The entire applicable estate tax credit amount can be used in more than one taxable year to offset additional tax.

________ 38. Which one of the following concerning a decedent's gross estate is *not* true?

a. The gross estate includes the value of all property owned at date of death, wherever located.

b. Property included in the gross estate generally is valued as of the date of death.

c. If the decedent's wife is the beneficiary, proceeds of an insurance policy on the life of the decedent are excludable from the decedent's gross estate.

d. The marital deduction in 2012 is currently set at $5,120,000 million, allowing for a joint marital deduction of $10,240,000.

e. Any of the unified credit not used by the first spouse to die can be used by the surviving spouse.

________ 39. The estate tax applicable credit amount effectively shields a maximum of ______ in 2012 from estate tax

a. $155,800

b. $1,772,800

c. $1,000,000

d. $10,240,000

e. $5,120,000

________ 40. Which one of the following statements is *not* true concerning the Federal estate tax?

a. In computing the Federal estate tax liability, all gifts made after December 31, 1976 are added to the taxable estate.

b. The Federal estate tax is cumulatively computed on taxable gifts made during a donor's lifetime and taxable transfers made at the donor's death.

c. A decedent is entitled to an unlimited marital deduction for the value of property passing to a surviving spouse.

d. All gift taxes paid on post-1976 gifts are subtracted from the tentative tax on total transfers.

e. For most purposes, a decedent's taxable estate is treated as the decedent's last gift.

________ 41. Which one of the following cannot be subtracted from the fair market value of all gifts made in the current year to compute taxable gifts for the current year?

a. Applicable gift tax credit amount

b. Marital deduction

c. Annual $13,000 exclusion per donee in 2012

d. Charitable deduction

e. Both b. and d.

________ 42. A husband gives his wife a total of $6 million in gifts for the year ended 2012. The taxable gift resulting from this transfer for the current year are

a. $0

b. $5,987,000

c. $1,000,000

d. $6,000,000

e. None of the above

________ 43. Which one of the following statements is *not* true concerning lifetime gifts?

a. A taxpayer may make a $6 million gift to a state university free of the gift tax.

b. The annual gift exclusion of $13,000 is allowed in 2012 even if the donor had made gifts in prior years to the same donee.

c. For purposes of computing a Federal gift tax liability, gifts are valued at the fair market value of the object given at the time of the gift.

d. The election to split gifts that is available to a married donor requires only the consent of the spouse owning the property transferred.

e. The marital and charitable deductions for Federal gift tax purposes are the same as for the Federal estate tax.

________ 44. Which of the following is *not* true concerning local transfer taxes?

a. A decedent's child will likely pay less inheritance tax than a decedent's nephew on the same size gift.

b. An inheritance tax is imposed on the right to receive property at death.

c. State estate taxes are often based on the credit allowed under Federal estate tax laws.

d. Some states will reduce the state estate tax by any inheritance tax imposed on the heir.

e. The federal credit for state estate and inheritance taxes reduces the state tax but not the federal tax.

________ 45. The FICA Tax rate is best considered:

a. Proportional

b. Progressive

c. Regressive

d. Neutral

e. None of the above

________ 46. Which one of the following statements does *not* apply to the Federal Insurance Contribution Act (FICA)?

a. The proceeds raised from the FICA tax are used to finance old-age, survivors, and disability insurance payments (Social Security benefits).

b. Amounts withheld from an individual's paycheck for social security are not subject to income tax.

c. An employer is required to withhold *both* Federal income taxes and FICA taxes from each employee's wages paid during the year.

d. FICA taxes are imposed on each dollar of an employee's wages up to a fixed amount per year.

e. The employer is required to pay over to the Federal government both the employee's portion of FICA tax and his own portion of the FICA tax.

________ 47. Which of the following is *not* a true statement?

a. The current FUTA tax rate is 6.2 percent of the first $7,000 of wages paid during the year to each covered employee.

b. Most states also impose an unemployment tax on employers.

c. A credit is allowed against an employer's FUTA tax liability: a maximum of 5.4 percent of the first $7,000 of wages paid during the year to each covered employee.

d. For an employee paid more than $7,000 during the year, FUTA tax paid by the employer is normally $434.

e. All of the above are true.

________ 48. Which one of the following is *not* a type of excise tax?

a. A tax on retail sales of products and commodities

b. A tax on facilities and services

c. A tax on income from professional services of physicians, dentists, lawyers, and accountants

d. Occupational taxes

e. Manufacturers' taxes

________ 49. Which of the following is *not* an excise tax?

a. Use tax

b. Occupational tax

c. Retail sales or products and commodities taxes

d. Manufacturers' taxes

e. Windfall profit tax

________ 50. Which one of the following miscellaneous types of taxes is *not* matched with the property or activity that is being taxed?

a. Tangible personal property tax covers land, buildings, and residences.

b. Intangible personal property tax covers stocks, bonds, and accounts and notes receivable.

c. Franchise tax covers the right to operate a business in the state of New York.

d. Sales tax covers gross receipts from the retail sale of clothing, automobiles, and equipment.

e. Use tax covers the possession and enjoyment of clothing, automobiles, and equipment.

________ 51. Which of the following is *not* a social objective of the tax laws?

a. Fight unemployment problems of certain disadvantaged groups of citizens through the targeted jobs credit.

b. Place more after-tax income into the hands of taxpayers for their disposal.

c. Relieve the tax burdens of taxpayers who are 65 or over or are blind.

d. Subsidize the cost of a home, and thus encourage home ownership.

e. Encourage individuals to provide for their future needs by contributing to their retirement savings accounts.

________ 52. What principle is *not* a characteristic of a "good" tax?

a. The tax is certain and not arbitrary.

b. The tax is "hidden" (i.e., its burden on the public is not apparent).

c. The tax is convenient.

d. The tax is equitable.

e. The tax is economically efficient (i.e., advances an appropriate goal).

_________ 53. The equity principle does *not* help explain which one of the following?

a. Deduction of interest on a home

b. The progressive tax structure

c. Deduction of medical expenses

d. The timing of a tax

e. Deduction of casualty losses

_________ 54. What tax policy goal(s) best explain(s) the progressive rate structure?

a. Tax revenue enhancement

b. Horizontal equity

c. Vertical equity

d. Both b. and c.

_________ 55. Which one of the following qualities of a "good tax" is *not* administrative in nature?

a. Certainty

b. Economical operation

c. Simplicity

d. Efficiency

e. All are administrative in nature.

_________ 56. Which of the following transactions is *not* matched with a tax planning technique that will have the effect of minimizing or deferring taxes?

a. Parents transfer property to a trust. Income from property deposited in trust for their children who are at least 19 years of age is taxed at the children's rate, rather than at the parents' higher tax rate.

b. Corporation X pays no dividends this year. Income is deferred to the stockholders, since they do not pay tax until they receive the dividends.

c. J is in the 28 percent marginal tax bracket in 2012 and the 15 percent marginal tax bracket in 2013. J chooses to pay income tax on his Series EE Federal bonds annually rather than realizing all the interest income when the bonds mature in 2012.

d. J is in the 28 percent marginal tax bracket in 2012 and the 15 percent marginal tax bracket in 2013. J chooses to deduct certain discretionary expenses in 2012 rather than in 2013.

e. S, a heart surgeon, hires his two sons, ages 16 and 18, to clean his office four times a week. The two sons are legitimate employees and do the work they were hired to do.

________ 57. A tax planner (for individual income taxation) does *not* need to understand which one of the following tax factors?

a. Amount of income, deduction, and credit

b. Character of income, deduction, and credit

c. Source of income, deduction, and credit

d. Timing of income, deduction, and credit

e. Recognition of income, deduction, and credit

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An Overview of Federal Taxation

Solutions to Test Bank

True or False

1. False. There is no direct relationship between the exaction of revenue and benefit to be received by the taxpayer. (See p. 1-2.)

2. This situation was not finally resolved until the passage of the Sixteenth Amendment in 1913. Woodrow Wilson, a Democrat, was the president at this time. (See pp. 1-3 through 1-4.)

3. False. A tax base is that amount on which a tax is levied. For Federal income taxation purposes, the tax base is *taxable* income. (See p. 1-4.)

4. False. As a revenue source, these two taxes are insignificant compared to other revenue sources. See Exhibit 1-1, where this tax is included in the "Other" category as a revenue source. (See p. 1-5.)

5. False. As can be seen from Exhibit 1-1, the individual income tax far

overshadows the corporate income tax as a source of revenue for the Federal government. (See p. 1-5.)

6. True. The Constitution grants Congress the authority to tax income from whatever source derived. But for various social, political, or economic reasons, Congress has chosen to exclude many sources of income from the Federal tax base. (See pp. 1-5 and 1-6.)

7. False. As a general rule, Congress considers any increment to wealth to be taxable income unless it is excluded by the Internal Revenue Code. (See p. 1-5.)

8. True. (See p. 1-6.)

9. False. The 35 percent rate is T's marginal rate. The marginal tax rate is that percentage at which the next dollar added to the tax base will be taxed. (See Example 6 and p. 1-7.)

10. True. The marginal tax rate is that percentage at which the last dollar added to the tax rate will be taxed. Knowing the marginal tax rate allows the taxpayer to calculate the tax impact of an additional dollar added to the tax base or an additional dollar deduction. (See p. 1-7.)

11. False. A credit directly reduces the tax liability itself, whereas a deduction simply reduces the base amount subject to the tax. (See Example 10, pp. 1-9 and 1-10.)

12. False. The unitary tax is a state tax that taxes businesses on the basis of their worldwide activities, not just their local operations. (See p. 1-12.)

13. False. Interest income of Federal government obligations is not subject to state income taxation, and interest income from state and local government obligations is not generally subject to either Federal or state income taxation. (See p. 1-12.) (Note, however, that the interest earned on one state's obligations may be taxable in another state. For example, if a citizen of Connecticut owns New York bonds, the interest on the bonds is not taxable in New York but is taxable in Connecticut on that state's individual income tax return.)

14. False. The primary function of wealth transfer taxes is to limit the accumulation of wealth by family units. (See p. 1-12.)

15. False. The applicable credit amount is $1,772,800 in 2012, which is equivalent to a tax-free transfer of $5,120,000 of property. (See p. 1-14.)

16. False. The Estate tax applicable credit amount is the major credit available to reduce the Federal estate tax. (See p. 1-14.)

17. True. In 2012 $5,120,000 is exempt from gift tax and $5,120,000 is exempt from estate tax. Note, however, that the total exempt transfers, counting both those during life and those at death, is $5,120,000 in 2012. Whatever exemption is used

during life is not available at death. (See p. 1-13.)

18. False. The gift-splitting election is available only to a married donor. If a donor makes the election on his or her current gift tax return, one-half of all gifts made during the year will be considered to have been made by the donor's spouse. The election is valid only if both spouses consent to gift splitting. (See p. 1-16.)

19. True. Many states and some local jurisdictions impose an inheritance tax, which taxes the right to receive property at death. Unlike an estate tax, which is imposed on the value of property transferred by the decedent at death, an inheritance tax is imposed on the recipient of property from an estate. (See pp. 1-17 and 1-18.)

20. False. FICA is imposed on both employers and employees; however, FUTA imposes a tax only on the employer. Self-employed individuals are not eligible for unemployment benefits, and thus are not subject to the FUTA tax. (See pp. 1-18 and 1-23.)

21. True. Self-employed individuals are required to pay self-employment taxes if self-employment income is $400 or more. (See p. 1-20.)

22. True. FUTA augments the unemployment benefit programs of the states. (See p. 1-23.)

23. False. An excise tax is not imposed on the profits of a business or profession. Rather, Federal excise taxes are imposed on the sale of specified articles, various transactions, certain occupations, and the use of certain items. (See p. 1-24.)

24. False. A "tax expenditure" is the estimated amount of revenue lost for failing to tax a particular item. (See p. 1-27.)

25. True. How a particular transaction is structured can determine the tax consequences. For example, the sale of a business could be structured as a sale of assets or a sale of stock. Although in the end, the taxpayer has sold the business, the tax consequences of a sale of assets can differ significantly from a sale of stock. (See pp. 1-29 and 1-30.)

Multiple Choice

26. a. There is no direct relationship between the exaction of revenue and any benefit to be received by the taxpayer. (See p. 1-2.)

27. a. A proportional tax rate is one that remains as a constant percentage regardless of the size of the tax base. A *progressive* tax rate structure is one in which an increasing percentage rate is applied to increasing increments of the tax base. (See p. 1-6.)

28. a. Because most excise taxes remain at a constant percentage regardless of the size of the tax base, they are proportional. (See p. 1-7.)

29. b. A progressive tax rate structure is one in which an increasing percentage rate is applied to increasing increments of the tax base. In the problem, a 10 percent tax rate was applied to the first $25,000, and a 15 percent rate to the next $5,000. (See Examples 4 and 5, p. 1-6.)

30. b. The marginal tax rate of a tax is that percentage at which the next dollar added to the tax base will be taxed. In this problem, $750/$5,000 = 15 percent. (See p. 1-7.)

31. d. Average tax rates equal the tax divided by the tax base. Here, $3,250/$30,000 = 10.83 percent. (See Example 8 on p. 1-8.)

32. c. A tax credit is a dollar-for-dollar offset against a tax liability. By contrast, a deduction's dollar value is arrived at by determining the tax on taxable income with and without the deduction, the difference being its value. Since the tax rate is not 100 percent, the value of a deduction is less than that of a credit. (See Example 10, p. 1-9.)

33. b. The value of a deduction is greater to that person with the higher marginal tax bracket. D's marginal tax rate is 28 percent and, accordingly, the value of his IRA deduction will be $840 ($3,000 × 28% = $840). B's marginal tax rate is 15 percent and, accordingly, the value of her IRA deduction will be $450 ($3,000 × 15% = $450). (See Example 7, p. 1-8.)

34. b. The Federal government imposes an income tax on individuals, corporations, estates, and trusts. A partnership does not pay tax. Income is passed through from the partnership to the partners, who then report and pay taxes on their share of the partnership income on their own individual returns. (See p. 1-10.)

35. e. (See Exhibit 1-3 on p. 1-11.)

36. b. Taxable gifts made after December 31, 1976 should be added to the taxable estate to calculate total taxable transfers. (See Exhibit 1-4 on p. 1-13.)

37. e. The applicable credit amount is a lifetime cumulative credit. It may be used until the credit is exhausted, but never offsets more tax than the amount of the credit. (See p. 1-14.)

38. d. An *unlimited* marital deduction is allowed for the value of property passing to a surviving spouse. Both the husband and wife have an exemption of $5 million. Under the portability rule, whatever credit is not used by the first spouse to die can be used by the second. (See p. 1-14.)

39. e. The applicable credit amount has the effect of exempting 5,120,000 of property transferred in 2012 by death. (Seep. 1-14.)

40. a. Only *taxable* gifts made after 1976 are added to the taxable estate to arrive at a total taxable transfer. Thus, for example, gifts made under the annual exclusion

are not added back to the taxable estate because they are not taxable. (See p. 1-14.)

41. a. The applicable gift tax credit is subtracted from the tentative tax on total transfers to date to compute the gift tax due. (See Exhibit 1-5 on p. 1-15.)

42. a. The marital and charitable deductions for Federal gift tax purposes are the same as for the Federal estate tax: unlimited. (See p. 1-16.)

43. d. If a donor makes the election for gift splitting on his or her current gift tax return, one-half of all gifts made during the year will be considered to have been made by the donor's spouse. The election is valid only if both spouses consent to gift splitting. (See p. 1-16.)

44. e. An inheritance tax is imposed on the right to receive property at death. The amount payable usually is directly affected by the degree of kinship between the recipient and the decedent. The opposite is true. (Seep. 1-17.)

45. c. For 2012, the FICA tax decreases as a portion of taxable income for every dollar the taxpayer earns over $110,000. Thus, taxpayers earning over $110,100 in 2012 a lower percentage of their total income than those taxpayers earning less than $110,100 in 2012. (See p. 1-18.)

46. b. Even though the taxpayer does not receive these amounts until the future, they are subject to income taxes currently.

47. d. The FUTA tax of $434 ($7,000 × 6.2%) less the credit for state unemployment tax paid of $378 ($7,000 × 5.4%) equals $56 of FUTA tax to be paid by the employer. (See p. 1-23.)

48. c. The purpose of an excise tax is to tax both certain privileges and the manufacture, sale, or consumption of specified commodities. Federal excise taxes are imposed on the sale of specified articles, various transactions, occupations, and the use of certain items. An excise tax is not imposed on the profits of a business or profession. (See p. 1-24.)

49. a. A use tax is a tax imposed on the use within a state or local jurisdiction of tangible property on which a sales tax was not paid. The tax rate normally equals that of the taxing authority's sales tax. The other taxes are all excise taxes. The purpose of an excise tax is to tax both certain privileges and the manufacture, sale, or consumption of specified commodities. (See p. 1-25.)

50. a. The tangible personal property tax is levied on the value of tangible personalty located within a jurisdiction. Tangible personalty is property not classified as realty, and includes such items as office furniture, machinery, equipment, inventories, and supplies. A real property tax is a tax on the value of realty—land, buildings, residences, etc.—owned by nonexempt individuals or organizations within a jurisdiction. (See p. 1-25.)

51. b. Placing more after-tax income into the hands of taxpayers for their disposal is generally considered an economic objective of the tax laws rather than a social objective. (See pp. 1-26 and 1-27.)

52. b. A "good" tax should be equitable, economically efficient, certain, low cost, and convenient. (See pp. 1-28 and 1-29.)

53. a. Social and economic principles best explain the deduction of interest on a home, rather than equity. (See pp. 1-26 through 1-27.)

54. c. Vertical equity implies that taxpayers who are not in the same situation will be treated differently. A progressive rate structure taxes those taxpayers with higher income at a higher rate than lower income taxpayers. (See pp. 1-28 and 1-29.)

55. d. Three of the qualities of a good tax—certainty, economy, and simplicity—might be aptly characterized as administrative in nature. (See p. 1-28.)

56. c. All of the techniques listed except for c have the effect of deferring income, maximizing the value of deductions, or minimizing the effect of taxes on income received. The answer c would mean a greater tax bite to the taxpayer because, had he waited until 2010, he would have been taxed at 15 percent rather than at 28 percent. (See pp. 1-31 and 1-32.)

57. c. The four basic questions for tax planning concern the amount, character, timing, and recognition of income, deductions, and credits. (See p. 1-32.)

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An Overview of Federal Taxation

Comprehensive Problems

1. Currently, the United States has a very complex tax system. One of the ways to cure this problem is to enact changes in the U.S. tax laws that eliminate some of the complexity. Listed below are some of the more popular suggestions for raising additional revenue, together with a statement of the law as it currently exists. Comment on the suggested changes as they relate to the discussions involving public policy, equity, and simplicity in Chapter 1 of your text.

Subject *Current Law* *Proposed Change*

National sales tax of 5 percent on most sales (Value Added Tax; VAT) Does not exist at the Federal level but is very popular with state and local American governments and Western European governments. Apply a 5 percent VAT to most sales as an additional Federal revenue source.

Home mortgage interest deduction Deduction may be taken for interest paid on the first $ 1 million of principal. Limit the deduction to $20,000 of mortgage interest for a couple filing a joint return.

Health insurance premiums currently paid by employersGenerally not included in employees' income for tax purposes. Include the value of employer provided health insurance in the gross income for tax purposes of employees.

Meal and entertainment expenses 50 percent currently deductible if related to a trade or business. Reduce the 50 percent to 10 percent.

Note to instructor: The response to this question is a subjective one with no "correct" answer. The student should incorporate in his answer, however, the basic discussion in the text regarding the role of a tax in the political system and the various standards used to evaluate that role in modern society.

Solutions to Comprehensive Problems

1. a. VAT is a system adopted throughout Western Europe as a popular form of governmental revenue raising. Additionally, many American states and local governments use a sales tax as a principal form of revenue raising. If a VAT were introduced nationally into the United States, it could be attacked upon grounds of fairness in that it is a regressive tax. The greater one's overall wealth, the smaller the percentage of that wealth one would pay in VAT. Additionally, unless sizable exceptions were created for food, medicine, and other basic necessities, the impact of the VAT could be very harsh on those with fixed incomes, such as the poor and the aged. Although superficially such a tax seems fairly simple, the introduction of exceptions and qualifications, which seems endemic to a fair national sales tax, would quickly introduce great complexity into what seems to be a simple system. Presumably, the impact of the VAT would be on the *incremental value* added to the property by each successive vendor. If this were the case, determining what value was added for purposes of levying the tax could become quite complicated because that determination would produce the impact of the tax on each successive vendor.

The tax is commonly employed in Europe, where, at least in some European countries, the rate of voluntary compliance with tax rules is low. . Although there is little evidence to suggest that the rate of voluntary compliance has decreased significantly in the United States over the last several years, the very serious lack of sufficient Federal revenues may cause the United States to adopt a national sales tax, despite the obvious disadvantage that it detrimentally impacts low-income groups. To some extent, Congressional reluctance to introduce a tax that does not extract a larger percentage contribution from wealthier citizens has been ameliorated by the 10, 15, 25, 28, 33 and 35 percent tax rates.

b. The home mortgage interest deduction has long been a sacred deduction in the Internal Revenue Code. Presumably, the advantage of the deduction was the stimulus it provided home owners, the home building industry, and other allied industries. Commentators for many years have questioned the fairness of allowing those who own homes to deduct their mortgage interest if renters were not allowed to deduct some or all of their rental payments. It appears that the deduction favors the middle and upper class since only those sufficiently wealthy to acquire a house are able to take the mortgage interest deduction. If the deduction is to remain, a good argument could be made on the grounds of equity that it be limited. The current principal amount, $1 million, seems far too high. Why should someone who can afford to buy a $1 million residence be allowed to deduct the mortgage interest on such a purchase when lower-income individuals who cannot afford to purchase a house are allowed no deduction for their rents?

The mortgage interest deduction is very popular with the American middle class because it is a "tax break" they can all identify as being very advantageous to them. Hence, the deduction is politically popular. Additionally, the deduction has very strong support from the home building industry, which will lobby Congress to ensure the continuance of the deduction. In summary, on grounds of equity, the deduction should be modified or eliminated, but the strong public policy arguments made by its very powerful proponents will be difficult for anyone to overcome.

c. For many years, employers who paid the medical insurance premiums of their employees provided these employees with a non-taxed benefit because Congress provided that the benefits were not taxable. As can be imagined, the American labor movement fought long and hard for this exemption and its continuation is a product of their strong lobbying on its behalf. But the exemption is inequitable to those who must pay for their own health insurance and/or some or all of their own medical bills. Since, as the chapter points out, a deduction is only worth the amount expended times the marginal tax rate, a person who deducts his own medical insurance receives only a partial benefit (i.e., 35% of the amount of the insurance premiums). The rest of the expenditure is borne solely by the taxpayer. It is much better for the employee if the employer pays the premium and the government does not tax the benefit of the payment. Such a system is very inequitable for anyone who pays his or her own premiums or medical bills. The result is a system where the best-treated workers (e.g., those highly paid with strong unions) are better treated than minimum wage workers who receive no employer-provided health benefits. The situation is made worse, of course, by the 7.5 percent limitation now imposed on the deductibility of medical expenses, which has totally eliminated the benefit of the deduction for all but those with very large medical expenses. The net result is that a fair tax system would either include employer-provided health benefits as income or increase the medical-expense deduction to benefit lower-paid workers. Given the great political controversy that the elimination of this benefit would generate, however, and the ease with which Congress has almost totally eliminated medical expense deductions by increasing the base from 5 percent of A.G.I. to 7.5 percent of A.G.I. in 1986, conditions favor a continuation of current policy.

d. The justification of a deduction for meal and entertainment expenses is that such expenditures are ordinary and necessary expenses of a trade or business. The 50 percent limitation was imposed to obtain some control over taxpayers who exercised no control over their expenditures under the theory that the government would subsidize their extravagance. The 50 percent the taxpayer cannot deduct presumably encourages employers to encourage moderation among their credit card-carrying executives. In point of fact, this deduction is probably a testament to the ignorance of the vast majority of taxpayers about even the basics of their own system. Many taxpayers believe that if they are allowed to deduct $1,000 annually in meals and entertainment the government is subsidizing them by $1,000. In fact, of course, the subsidy is only the taxpayer's marginal tax rate times 50 percent of the costs; the remainder of the expenditure is borne by the taxpayer.

If Congress were really concerned about abuses in this area, it might consider eliminating this deduction altogether. The vast majority of American workers do not have any tax deductible meals or entertainment. This is a deduction usually reserved to the professional classes with higher marginal tax rates. And, as most commentators have observed, the distinction between business and personal enjoyment is hard to draw in many of these cases. In summary, although an equitable system might eliminate this deduction, a 10 percent limitation, as suggested, is a move in the right direction.