



1

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 it is identified as a deduction in the Internal Revenue Code.
- _____ 9. If T is in the 35% 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 majority of states do not impose an income tax.
- _____ 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. In determining an individual’s taxable income, the only deduction from AGI is the standard deduction.
- _____ 15. The estate tax unified credit is \$11,580,000 million in 2020.
- _____ 16. For purposes of the estate and gift tax in 2020, taxpayers are entitled to a credit that eliminates the estate tax on an estate of up to \$11,580,000 and a similar credit for gift tax purposes of \$11,580,000. As a result, a single person could give away \$11,580,000 during life and another \$11,580,000 at death and completely avoid gift and estate taxes on a total of \$23,160,000.

- _____ 17. The gift tax and the estate tax exempt the same amount from taxation in 2020.
- _____ 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. A husband and wife who make a gift and consent to gift splitting can file a joint gift tax return rather than two separator gift tax returns.
- _____ 20. Unlike the unified transfer tax, the typical state inheritance tax normally is based on the relationship between the decedent and the heir.
- _____ 21. The few states that impose an estate or inheritance tax also impose a gift tax to ensure that taxpayers cannot avoid the death tax by simply giving their property away before they die.
- _____ 22. Both FICA and FUTA impose a double tax on the employer and the employee.
- _____ 23. Self-employed individuals are required to pay self-employment taxes if self-employment income is \$400 or more.
- _____ 24. This year Q had wages of \$50,000. His employer properly withheld Social Security taxes of \$3,825. Q will pay income taxes on his wage income of \$46,175 (\$50,000 – \$3,825).
- _____ 25. For the current year, T has wages of \$200,000. He will pay Social Security and Medicare taxes of 7.65% on \$200,000.
- _____ 26. K worked for two employers during the year, earning \$100,000 from each. Both employers withheld Social Security and Medicare taxes. K is entitled to a credit for a portion of his Social Security taxes but not his Medicare taxes.
- _____ 27. S is single. Her additional Medicare tax (also known as the Medicare surtax) of 0.9% applies to all of her wages if her total wages exceed \$200,000.
- _____ 28. C earned wages in 2020 of \$100,000. In addition, he had self-employment income of \$70,000. C will pay self-employment tax of about \$9,891.
- _____ 29. R is self-employed and for the current year had self-employment income of \$80,000. His self-employment tax is \$12,240. Since R is effectively employing himself, he may deduct the \$12,240 as a deduction for adjusted gross income.
- _____ 30. H is single and has self-employment income of \$300,000. His self-employment tax will be computed using \$277,050 but the additional Medicare tax will be based on \$300,000.
- _____ 31. M, single, is an employee and for the current year he had wages of \$180,000. He is also self-employed and has self-employment income of \$100,000. M will pay the additional Medicare tax on \$72,350.
- _____ 32. G, single, is self-employed and has self-employment of \$300,000. G may deduct a portion of his self-employment tax, including a deduction for a portion of any additional Medicare tax he may be required to pay.
- _____ 33. R and S are married. R's wages for the year were \$150,000 while S had wages of \$120,000. The couple is not subject to the additional Medicare tax of .9 percent.
- _____ 34. The additional Medicare tax of .9% would apply to taxpayers filing a joint return if the husband has wage income of \$210,000 and his wife has self-employment income of \$40,000.
- _____ 35. H and W are married and file a joint return. H's wages are \$130,000 and W's wages are \$110,000. In addition, they have interest income of \$40,000 and dividend income of \$30,000. Neither has any self-employment income. After subtracting their deductions, their taxable income was \$260,000. The additional Medicare tax of .9% applies in this situation since the couple's total taxable income exceeds \$250,000.
- _____ 36. To compute the additional Medicare tax, a husband and wife that file a joint return must combine their wages or self-employment income.
- _____ 37. An employer must withhold the additional Medicare tax for a husband with wages of more than \$200,000 even though his wife has wages from another employer of \$25,000.
- _____ 38. JKL Incorporated employs M. M's wages are \$400,000 and, consequently, he will be required to pay the additional Medicare tax. The corporation must match and pay the amount of additional Medicare tax.

- _____ 39. FUTA tax revenues are used by the Federal government to augment unemployment-benefit programs of the various states.
- _____ 40. The town of Jamesville, imposes a sales tax of 5% on retail purchases other than food. The tax is a proportional tax and would be considered regressive.
- _____ 41. A “tax expenditure” is the amount of tax revenue that Congress budgets for social programs.
- _____ 42. 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

- _____ 43. 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 receive 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.
- _____ 44. 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.
- _____ 45. What type of tax rate do most excise taxes employ?
 - a. Proportional
 - b. Progressive
 - c. Regressive
 - d. Neutral
 - e. None of the above
- _____ 46. 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
- _____ 47. 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. What is T’s marginal tax rate?
 - a. 10 percent
 - b. 15 percent
 - c. 20 percent
 - d. 10.83 percent
 - e. None of the above

- _____ 48. 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. What is T's average tax rate?
- 10 percent
 - 15 percent
 - 20 percent
 - 10.83 percent
 - None of the above
- _____ 49. Which one of the following statements is true?
- Tax credits reduce tax liability at the marginal tax rate.
 - Both tax credits and tax deductions are offsets to taxable income.
 - Dollar for dollar, tax credits are more valuable than tax deductions.
 - The tax impact of an additional dollar of tax base is determined by multiplying by the average tax rate.
 - "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."
- _____ 50. 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?
- D's marginal tax rate is greater than B's.
 - The value of a \$3,000 IRA deduction to D will be less than the same amount contributed by B to an IRA.
 - 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.
 - B will pay 15% of her taxable income to the government.
 - D will not pay 28% of his taxable income to the government.
- _____ 51. Which one of the following tax entities does *not* pay a Federal income tax?
- Trust
 - Partnership
 - Individual
 - Corporation
 - Estate
- _____ 52. Before adjusted gross income can be computed, what following components must be computed?
- Income
 - Taxable income
 - Gross income
 - Both a and b
 - Both a and c
- _____ 53. Which one of the following cannot be subtracted from the gross estate to compute the total taxable transfers?
- Charitable bequests
 - Taxable gifts made after December 31, 1976
 - Marital deduction
 - Funeral and administrative expenses
 - Both a and c

- _____ 54. Which one of the following statements is *not* true concerning the estate tax unified credit?
- The amount of the unified credit for estate tax purposes can offset a tax up to \$4,577,800 in 2020.
 - The unified credit is a lifetime credit.
 - The unified credit can be used to offset gift taxes and estate taxes.
 - Use of the unified credit is mandatory if one makes a taxable gift.
 - A taxpayer is entitled to two unified credits, one for gift tax and another for the estate tax.
- _____ 55. Which one of the following concerning the estate tax is *not* true?
- The gross estate includes the value of all property owned at date of death, regardless of whether it is located in the U.S.
 - Property included in the gross estate generally is valued as of the date of death.
 - 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.
 - The marital deduction is currently set at a fixed amount, adjusted annually for inflation.
 - Any of the unified credit not used by the first spouse to die can be used by the surviving spouse.
- _____ 56. The unified credit amount effectively shields a maximum of _____ in 2020 from estate tax
- \$155,800
 - \$4,577,800
 - \$1,000,000
 - \$23,160,000
 - \$11,580,000
- _____ 57. Which one of the following statements is *not* true concerning the Federal estate tax?
- In computing the Federal estate tax liability, all gifts made before December 31, 1976 are added to the taxable estate.
 - 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.
 - A decedent is entitled to an unlimited marital deduction for the value of property passing to a surviving spouse.
 - All gift taxes paid on post-1976 gifts are subtracted from the tentative tax on total transfers.
 - For most purposes, a decedent's taxable estate is treated as the decedent's last gift.
- _____ 58. 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?
- Unified credit
 - Marital deduction
 - Annual \$15,000 exclusion per donee in 2020
 - Charitable deduction
 - Both b and d
- _____ 59. A husband gives his wife a total of \$6 million in gifts for the year ended 2020. What is the taxable gift resulting from this transfer for the current year?
- \$0
 - \$5,985,000
 - \$1,000,000
 - \$6,000,000
 - None of the above

- _____ 60. 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 \$15,000 is allowed in 2020 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.
- _____ 61. 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.
- _____ 62. The tax rate to compute the Social Security tax is best considered:
- a. Proportional
 - b. Progressive
 - c. Regressive
 - d. Neutral
 - e. None of the above
- _____ 63. 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.
- _____ 64. Which of the following is *not* a true statement?
- a. The current FUTA tax rate is 6% 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% 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 \$420.
 - e. All of the above are true.

- _____ 65. Which one of the following is *not* a type of excise tax?
- A tax on retail sales of products and commodities
 - A tax on facilities and services
 - A tax on income from professional services of physicians, dentists, lawyers, and accountants
 - Occupational taxes
 - Manufacturers' taxes
- _____ 66. Which of the following is *not* an excise tax?
- Use tax
 - Occupational tax
 - Retail sales or products and commodities taxes
 - Manufacturers' taxes
 - Windfall profit tax
- _____ 67. Which one of the following miscellaneous types of taxes is *not* matched with the property or activity that is being taxed?
- Tangible personal property tax covers land, buildings, and residences.
 - Intangible personal property tax covers stocks, bonds, and accounts and notes receivable.
 - Franchise tax covers the right to operate a business in the state of New York.
 - Sales tax covers gross receipts from the retail sale of clothing, automobiles, and equipment.
 - Use tax covers the possession and enjoyment of clothing, automobiles, and equipment.
- _____ 68. Which of the following is *not* a social objective of the tax laws?
- Fight unemployment problems of certain disadvantaged groups of citizens through the targeted jobs credit.
 - Place more after-tax income into the hands of taxpayers for their disposal.
 - Relieve the tax burdens of taxpayers who are 65 or over or are blind.
 - Subsidize the cost of a home, and thus encourage home ownership.
 - Encourage individuals to provide for their future needs by contributing to their retirement savings accounts.
- _____ 69. What principle is *not* a characteristic of a "good" tax?
- The tax is certain and not arbitrary.
 - The tax is "hidden" (i.e., its burden on the public is not apparent).
 - The tax is convenient.
 - The tax is equitable.
 - The tax is economically efficient (i.e., advances an appropriate goal).
- _____ 70. The equity principle does *not* help explain which one of the following?
- Deduction of interest on a home
 - The progressive tax structure
 - Deduction of medical expenses
 - The timing of a tax
 - Deduction of casualty losses
- _____ 71. What tax policy goal(s) best explain(s) the progressive rate structure?
- Tax revenue enhancement
 - Horizontal equity
 - Vertical equity
 - Both b and c

- _____ 72. Which one of the following qualities of a “good tax” is *not* administrative in nature?
- Certainty
 - Economical operation
 - Simplicity
 - Efficiency
 - All are administrative in nature.
- _____ 73. Which of the following transactions is *not* matched with a tax planning technique that will have the effect of minimizing or deferring taxes?
- 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.
 - Corporation X pays no dividends this year. Income is deferred to the stockholders, since they do not pay tax until they receive the dividends.
 - J is in the 32% marginal tax bracket in 2020 and the 12% marginal tax bracket in 2021. 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 2021.
 - J is in the 32% marginal tax bracket in 2020 and the 12% marginal tax bracket in 2021. J chooses to deduct certain discretionary expenses in 2020 rather than in 2021.
 - 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.
- _____ 74. A tax planner (for individual income taxation) does *not* need to understand which one of the following tax factors?
- Amount of income, deduction, and credit
 - Character of income, deduction, and credit
 - Source of income, deduction, and credit
 - Timing of income, deduction, and credit
 - Recognition of income, deduction, and credit
- _____ 75. A single taxpayer has self-employment income of \$300,000. What is his additional Medicare tax?
- based on the excess of \$300,000 over the threshold
 - based on the excess of \$277,500 over the threshold
 - \$0 since the tax only applies to taxpayers who have wage income
 - None of the above

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. **True.** 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. 1-5.)
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. In defining income for tax purposes, § 61 takes an all inclusive approach, explaining that “gross means all income from whatever source derived.” (See p. 1-5.)
8. **True.** (See p. 1-6.)
9. **False.** The 35% 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. 1-9.)
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 12*, pp. 1-6 and 1-12.)
12. **False.** Most states do impose an income tax, 43 in 2020. (See p. 1-15.)
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. 1-15.) (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.** In determining an individual’s taxable income, the taxpayer can deduct the larger of the applicable standard deduction or itemized deductions. In addition, beginning in 2018, eligible taxpayer’s may deduct the qualified business income deduction, generally 20% of the taxpayer’s qualified business income.
15. **False.** The unified credit is \$4,577,800 in 2020, which is equivalent to a tax-free transfer of \$11,580,000 of property in 2020. (See p. 1-17.)
16. **False.** There is a single credit and whatever is used during life against the gift tax is not available for the estate tax. (See p. 1-17.)
17. **True.** In 2020, \$11,580,000 is exempt from gift tax and \$11,580,000 is exempt from estate tax. Note, however, that the total exempt transfers, counting both those during life and those at death, is \$11,580,000 in 2020. Whatever exemption is used during life is not available at death. (See p. 1-20.)

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. 1-19.)
19. **False.** For gift tax purposes, there is no joint gift tax return for gifts made by a husband and wife. Each spouse must file his or her own separate gift tax return. Moreover, in order to utilize gift splitting, each spouse must file a gift tax return to acknowledge his or her consent for its use. (See p. 1-19.)
20. **True.** In 2020, six states and some local jurisdictions impose an inheritance tax, which taxes the right to receive property at death. The amount of the tax is based on the relationship between the decedent and the heir, the closer the relationship is the smaller the tax. (See p. 1-21.)
21. **False.** Of the 18 states and the District of Columbia that impose some type of death tax, only one state, Connecticut, imposes a gift tax. (See p. 1-21.)
22. **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 p. 1-22.)
23. **True.** Self-employed individuals are required to pay self-employment taxes if self-employment income is \$400 or more. (See pp. 1-25 and 1-26.)
24. **False.** For income tax purposes, Q is taxed on his gross wages of \$50,000 notwithstanding he will only receive that amount less Social Security and Medicare taxes ($\$50,000 - \$3,825 = \$46,175$). Social Security and Medicare taxes are separate taxes imposed on wages. For employees, they do not reduce the amount of income subject to income tax. (See *Example 20* and p. 1-23.)
25. **False.** The Social Security tax of 6.2% is capped on a certain wage base determined annually (\$137,700 in 2020). In contrast, the Medicare tax of 1.45% applies to all wages. (See *Example 21* and p. 1-23.)
26. **True.** An employee who has had more than one employer during the year may have paid *excess* Social Security taxes for the year since that tax is capped on a certain wage base amount determined annually. There is no cap on Medicare wages so he will not be entitled to a credit for those taxes. The credit for excess Social Security is claimed on Line 11 of Schedule 3 Other Payments and Refundable Credits of Form 1040 (2019). (See *Example 24* and p. 1-25.)
27. **False.** The additional Medicare tax for single taxpayers applies only to the wages in excess of \$200,000. (See *Example 23* and pp. 1-23 and 1-24.)
28. **False.** C has wages of \$100,000 and self-employment income of \$70,000. His liability for self-employment taxes is generally based on \$64,645 of self-employment income ($\$70,000 \times 92.35\%$) for a tax of \$9,891 ($15.3\% \times \$64,645$). Note that this includes a Social Security tax of 12.4% on the entire \$64,645. However, the amount subject to the Social Security tax of 12.4% is limited to the wage base (\$137,700 in 2020) reduced by the amount of wages received for the year. Thus the amount subject to the Social Security tax would be limited to \$37,700 ($\$137,700 - \$100,000$), producing a smaller self-employment tax. (See *Example 26* and pp. 1-26.)
29. **False.** Although R is effectively employing himself, he is entitled to deduct only one-half of his self-employment tax, \$6,120 ($50\% \times$ self-employment tax of \$12,240). This is essentially the employer's share. (See *Example 25* and pp. 1-26 and 1-27.)
30. **False.** Both the self-employment tax (Social Security and Medicare) and the additional Medicare tax are based on 92.35% ($100\% - 7.65\%$) of self-employment income or \$277,050 ($92.35\% \times \$300,000$). (See *Example 26* and pp. 1-26 and 1-27.)
31. **True.** M has wages of \$180,000 and self-employment income of \$100,000. His wages do not exceed the \$200,000 threshold for a single filer, so he is not liable for the additional Medicare tax on these wages. However, he is liable for the additional Medicare tax on a portion of his self-employment income. For this calculation, only 92.35% of self-employment income is used or \$92,350

(92.35% × \$100,000). In calculating the additional Medicare tax on self-employment income, the \$200,000 threshold for single filers is reduced by M's \$180,000 in wages, resulting in a reduced self-employment income threshold of \$20,000 (\$200,000 – \$180,000). Thus \$72,350 (\$92,350 – \$20,000) is subject to the additional Medicare tax. (See *Example 29* and pp. 1-27 through 1-29.)

32. **False.** Although a self-employed person is allowed to deduct 50% of his self-employment tax, none of the additional Medicare tax is deductible. (See *Example 27* and pp. 1-27 and 1-28.)
33. **False.** Married taxpayers who file a joint return are subject to the additional Medicare tax if their joint wages exceed \$250,000. Since the couple's combined wages are \$270,000 (\$150,000 + \$120,000), they will pay the additional Medicare tax on the excess over \$250,000 or \$20,000. (Compare *Examples 22* and *23* and see pp. 1-23 and 1-24.)
34. **False.** The additional .9% Medicare tax applies when the sum of the taxpayer's wages and/or self-employment exceed certain thresholds. These thresholds vary depending on filing status (e.g., wages and self-employment income of \$200,000 for single taxpayers and \$250,000 for taxpayers filing joint returns). For joint filers, the wages and self-employment income of both the husband and wife are combined to determine whether the total exceeds \$250,000. Here the sum of the husband's salary of \$210,000 and his wife's self-employment income of \$40,000 is \$250,000, which does not exceed the threshold of \$250,000. Consequently, the additional Medicare tax of .9% does not apply. (See pp. 1-24 and 1-28.)
35. **False.** The thresholds at which the additional Medicare tax of .9% are imposed are based on the wages and self-employment income of the taxpayer(s) and not taxable income. These thresholds vary depending on filing status (e.g., \$200,000 for single taxpayers and \$250,000 for married filing jointly). For joint filers, wages and self-employment income of both the husband and wife are combined to determine whether the total exceeds \$250,000. Note that the couple would be subject to the special net investment income tax of 3.8% discussed in Chapter 3. (See p. 1-23.)
36. **True.** The additional .9% Medicare tax applies when the sum of the taxpayer's wages and/or self-employment exceed certain thresholds. These thresholds vary depending on filing status (e.g., wages and self-employment income of \$200,000 for single taxpayers and \$250,000 for taxpayers filing joint returns). For joint filers, the wages and self-employment income of both the husband and wife are combined to determine whether the total exceeds \$250,000.
37. **True.** While the additional Medicare tax does not apply to joint filers unless their combined wage and self-employment income exceeds \$250,000, the employer still must withhold where a married taxpayer has wages of more than \$200,000. (See *Example 22*, pp. 1-23 and 1-27.)
38. **False.** Employers are not required to pay the additional Medicare tax. Only employees and self-employed persons with income exceeding the thresholds must pay the additional Medicare tax. (See p. 1-23.)
39. **True.** FUTA augments the unemployment benefit programs of the states. (See p. 1-30.)
40. **True.** In the technical sense, the Jamesville sales tax is an example of a proportional tax in that the same rate applies regardless of increases or decreases in the tax base. However, most proportional taxes are considered regressive in the popular sense because they do not vary or change relative to the individual's ability to pay. (See *Example 11* and pp. 1-11 and 1-12.)
41. **False.** A "tax expenditure" is the estimated amount of revenue lost for failing to tax a particular item. (See p. 1-33.)
42. **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. 1-34 and 1-35.)

MULTIPLE CHOICE

43. a. There is no direct relationship between the exaction of revenue and any benefit to be received by the taxpayer. (See p. 1-2.)
44. 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. 1-11.)
45. a. Because most excise taxes remain at a constant percentage regardless of the size of the tax base, they are proportional. (See p. 1-11.)
46. 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% tax rate was applied to the first \$25,000, and a 15% rate to the next \$5,000. (See *Examples 4 and 5*, p. 1-8.)
47. 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.)
48. d. Average tax rates equal the tax divided by the tax base. Here, $(\$2,500 + \$750) / \$30,000 = 10.83$ percent. (See *Example 7* on p. 1-9.)
49. 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 12*, p. 1-12.)
50. b. The value of a deduction is greater to that person with the higher marginal tax bracket. D's marginal tax rate is 28% and, accordingly, the value of his IRA deduction will be \$840 ($\$3,000 \times 28\% = \840). B's marginal tax rate is 15%, and accordingly, the value of her IRA deduction will be \$450 ($\$3,000 \times 15\% = \450). (See *Example 6*, p. 1-9.)
51. 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. 1-14.)
52. e. (See Exhibit 1-4 on p. 1-15.)
53. b. Taxable gifts made after December 31, 1976, should be added to the taxable estate to calculate total taxable transfers. (See Exhibit 1-5 on p. 1-17.)
54. e. If the unified credit is used during the taxpayer's lifetime to reduce or eliminate the gift tax, the amount that is available for estate tax purposes is reduced. It may be used until the credit is exhausted, but never offsets more tax than the amount of the credit. (See p. 1-17.)
55. 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 \$11,580,000 (2020). Under the portability rule, whatever credit is not used by the first spouse to die can be used by the second. (See p. 1-17.)
56. e. The applicable credit amount has the effect of exempting \$11,580,000 of property transferred in 2020 by death. (See p. 1-17.)
57. 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 that do not exceed the amount of the annual exclusion are not added back to the taxable estate because they were not taxable. (See p. 1-17.)
58. a. The unified tax credit is subtracted from the tentative tax on total transfers to date to compute the gift tax due. Thus the amount of taxable gifts to the wife is zero. (See Exhibit 1-5 on p. 1-17.)
59. a. A gift to a spouse normally is deductible and, therefore, does not result in a taxable transfer. The marital and charitable deductions for Federal gift tax purposes are the same as for the Federal estate tax: unlimited. (See p. 1-20.)

60. 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. 1-19.)
61. 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 federal credit for state estate taxes reduces the federal estate tax and not the state death tax. (See p. 1-21.)
62. c. Social Security taxes are considered regressive. For 2020, the FICA tax decreases as a portion of taxable income for every dollar the taxpayer earns over \$137,700 (2020). Thus, taxpayers earning over \$137,700 in 2020 pay a lower percentage of their total income than those taxpayers earning less than \$137,700 in 2020. (See p. 1-22.)
63. b. Even though the taxpayer does not receive these amounts until the future, they are subject to income taxes currently.
64. d. The FUTA tax of \$420 ($\$7,000 \times 6\%$) less the credit for state unemployment tax paid of \$378 ($\$7,000 \times 5.4\%$) equals \$42 of FUTA tax to be paid by the employer. (See p. 1-30.)
65. 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. 1-30.)
66. 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. 1-30.)
67. 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. 1-31.)
68. 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. 1-32 and 1-33.)
69. b. A "good" tax should be equitable, economically efficient, certain, low cost, and convenient. (See pp. 1-33 and 1-34.)
70. a. Social and economic principles best explain the deduction of interest on a home, rather than equity. (See pp. 1-32 through 1-34.)
71. 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 p. 1-34.)
72. d. Three of the qualities of a good tax—certainty, economy, and simplicity—might be aptly characterized as administrative in nature. (See p. 1-35.)
73. 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 2020, he would have been taxed at 12% rate rather than at a 32% rate. (See pp. 1-35 through 1-37.)
74. c. The four basic questions for tax planning concern the amount, character, timing, and recognition of income, deductions, and credits. (See p. 1-36.)
75. b. For self-employed taxpayers, the additional Medicare tax is based on the excess of 92.35% of net earnings from self-employment or \$277,500 ($\$300,000 \times 92.35\%$) over the threshold. (See *Example 25* and p. 1-27.)

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.

<i>Subject</i>	<i>Current Law</i>	<i>Proposed Change</i>
National sales tax of 5% 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% 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 employers	Generally 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.
Business meals	50% currently deductible if related to a trade or business.	Reduce the 50 percent to 10 percent.

Note: 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% 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% 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% of AGI to 7.5% of AGI in 1986, conditions favor a continuation of current policy.

- d. Historically, the justification given for the deduction of both meal and entertainment expenses was that such expenditures are ordinary and necessary expenses of a trade or business. The 50% 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. Congress specifically addressed entertainment expenses in the Tax Cuts and Jobs Act of 2017 and eliminated the deduction for all entertainment. But it appears that it retained the deduction for some meals. At this writing, July 12, 2018, the treatment of the quiet business meal where business is discussed is not clear.

Presumably, the 50% the taxpayer cannot deduct encourages employers to promote moderation among their credit card-carrying executives. In reality, 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% 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 the deduction for meals altogether. Everyone must eat so it can be argued that the Federal government should not subsidize meals with any type of deduction. 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% limitation, as suggested, seems like a move in the right direction.