

INCORPORATING TAX LAW INTO LEGAL AND REGULATORY ENVIRONMENT OF BUSINESS COURSES

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I. INTRODUCTION

Part of preserving one's personal or corporate wealth requires protection from government regulation. Taxation is one of the most powerful regulatory tools the state wields. Individuals, businesses, and many other entities are taxed. The federal government imposes taxes as does each state and local government in the United States. Types of taxes include income, payroll, property, sales, imports, estates and

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gifts, among others.¹ Learning to legally decrease one's tax burden can provide enormous financial benefits over a period of one's career. When business students are no longer eating Top Ramen, Turbo Tax will no longer meet their individual or corporate financial planning needs. When graduated business students begin to accumulate wealth they need to know how taxation affect them. Some basic knowledge of individual and corporate taxation and other asset protection tools will be essential to the undergraduate business curriculum.

While the notion of paying taxes has not changed since the first recorded taxes were levied in Mesopotamia in 4500 B.C.,² this topic yet remains highly relevant for the business law student. Indeed, the most significant recent amendment to the federal tax law was passed in 2017, with the enactment of the Tax Cuts and Jobs Act of 2017.³ The effects of this statute are still being played out, and so increasing student awareness of current tax law remains a highly relevant pedagogical venture.

The primary contribution of this article is to provide the business law instructor with information which every business student should know about tax law. The objective of this paper is to prepare

¹ For a list of taxes upheld by the Supreme Court, see GRAY, *LIMITATIONS OF TAXING POWER*, 352.

² *Earliest Taxes – Ancient Mesopotamia (6,000 B.C.)* “The earliest tax records are from the ancient Mesopotamian city-state of Lagash where soft clay tablets served as a receipt of taxes levied on cattle and crops. These taxes were used to supply the defense of the city state.” (<https://taxfitness.com.au/Blog/earliest-taxes-ancient-mesopotamia-6000-bc>, last visited January 14, 2021.).

³ Tax Cuts and Jobs Act, Pub. L. No. 115-97.

students to be better equipped to meet corporate needs.⁴ There is very little space available to add subject matter in the curriculum of legal and regulatory environment of business courses. However, if anything should be included, it is the law of taxation. Business graduates are required to assume greater responsibility for managing tax issues facing their companies and their own personal lives. It may seem obvious that increased knowledge of tax law would be beneficial to one's success in business and one's personal life. However, there appears to be a gap between basic knowledge of tax law acquired in United States' undergraduate education and the knowledge employers expect of graduates, and required of managers and entrepreneurs.

This paper proposes that business law undergraduate education should include elements of tax law in a less discursive manner and provide greater understanding of individual and corporate tax law. Tax law courses in the United States are traditionally an essential component of accounting programs.⁵ At least one study shows the general population's tax knowledge increases with age⁶; as a result, we assert that business students' knowledge of tax law should be superior to the general population and non-business students. The traditional focus of tax law within business education, if any, has been training in

⁴ See *Symposium: The Future of Law, Business and Legal Education: How to Prepare Students to Meet Corporate Needs*, 17 *Chap. L. Rev.* 195 (2013).

⁵ Peggy Hite & John Hasseldine, *A Primer on Tax Education in the United States of America*, 10 *J. Acct. Ed.*, 3-13 (2010).

⁶ Adrian Furnham, *Understanding the Meaning of Tax: Young Peoples' Knowledge of the Principles of Taxation*, *J. Soc. Econ.* 34 (2005) 703-13.

individual taxation, but this paper argues for a broader instructional overview to meet long-term educational needs of business students entering a corporate environment. Long-term educational needs for business students includes an introduction of personal and business tax law.⁷ Students, in short, should be able to recognize tax law issues as an integrated component of the legal and regulatory environment of business, which means, in part, there are tax and non-tax factors in management and financial decision-making. Additionally, non-accounting students in a business program should explore ethical issues arising from tax considerations.⁸

In this paper, we first introduce the topic of the law of taxation and why this article is currently needed in the business law classroom.⁹

⁷ Stephen T. Limberg, et al., *Organizing Tax Instruction: Evidence Regarding How Students Organize Tax Knowledge*, 13 J. Acct. Ed., at 45-58 (1995). (this paper highlights the common approach of undergraduate education that offers both individual taxation and taxable entities).

⁸ *Id.* at 5.

⁹ There are many excellent law review articles covering the art of effective law teaching. See Rachel Arnow-Richman, *Employment as Transaction*, 39 SETON HALL L. REV. 447 (2009); Rachel Arnow-Richman et al., *Teaching Transactional Skills in Upper-Level Doctrinal Courses: Three Exemplars*, 10 TENN. J. BUS. L. 367 (2009); Scott J. Burnham, *Drafting in the Contracts Class*, 44 ST. LOUIS U. L.J. 1535 (2000); Christina L. Kunz et al., *Incorporating Transactional Skills Training Into First-Year Doctrinal Courses*, 10 TENN. J. BUS. L. 331 (2009); Robin A. Boyle, *Contract Drafting Courses for Upper-Level Students: Teaching Tips*, 14 PERSP. 87 (2006) (providing “course structure and teaching tips” for contracts drafting electives); David V. Snyder, *Closing the Deal in Contracts: Introducing Transactional Skills in the First Year*, 34 U. TOL. L. REV. 689 (2003); Llewellyn Joseph Gibbons, *Teaching Intellectual Property Licensing Transactionally*, 34 U. TOL. L. REV. 717 (2003); Daniel B. Bogart, *The Right Way to Teach Transactional*

We seek to provide a framework for the business law professor with limited subject-matter space allotted to the professor in a semester-long business law course.¹⁰ This article adds to pedagogical research by extending the discussion on lesser-addressed topics in legal studies scholarship.¹¹ Similarly, this article supplements and updates the sparse articles published on the topic, and extends a call to legal studies textbook writers to include a chapter on tax law. It then offers an overview of tax law in the United States to frame the case-study discussion and highlight the learning outcomes for students. Students are encouraged to read this overview section in preparation for the case study. We conclude with a teacher's note, a grading rubric, corresponding example solutions to the rubric, and skill building assignments. The paper is designed to teach taxation in one or two

Lawyers: Commercial Leasing and the Forgotten "Dirt Lawyer," 62 U. PITT. L. REV. 355 (2001).

¹⁰ See Carol J. Miller & Susan J. Crain, *Legal Environment v. Business Law Courses: A Distinction Without a Difference?*, 28 J. Legal Stud. Educ. 149-206 (2011). (this article explores undergraduate law-based course requirements in schools of business in order to discuss the reliability of interchangeably using the course titles, Legal and Regulatory Environment in Business or simply Business Law.).

¹¹ See Robert J. Landry, III, *Ethical Considerations in Filing Personal Bankruptcy: A Hypothetical Case Study*, 29 J. Legal Stud. Educ. 59-93 (2012) (Landry highlights the lack of scholarship in the Journal of Legal Studies in Education and the American Business Law Journal in certain areas of legal studies scholarship). See also Read & Bailey, *Avoiding the Philip Seymour Hoffman Problem: Teaching the Law of Wills to Business Law Students*, forthcoming (2015).

hours within a business law course for undergraduate and MBA students.

II. LITERATURE REVIEW: LEGAL STUDIES TEXTBOOKS AND SCHOLARSHIPS

Currently, no textbook in the category of business law or legal and regulatory environment covers the topic of taxation in chapter or book form. A review of forty-two business law or legal and regulatory environment textbooks shows little treatment of taxation.¹² There is

¹² The following textbooks are used primarily in schools of business and are written by professor or practitioners who teach in a school of business. Some of the books listed vary only by edition, but we included the updated edition because the edition had new chapters. NANCY K. KUBASEK, *DYNAMIC BUSINESS LAW* 1149-64 (3RD ED. MCGRAW HILL 2014); GORDON W. BROWN & PAUL A. SUKYS, *BUSINESS LAW WITH UCC APPLICATIONS* 678-698 (13th ed. McGraw Hill 2013); JANE MALLOR ET AL., *BUSINESS LAW* 689-708 (15TH ED. MCGRAW-HILL/IRWIN 2012); NANCY KUBASEK ET AL., *DYNAMIC BUSINESS LAW: SUMMARIZED CASES* 1071-1088 (McGraw-Hill/Irwin 2012); JOHN E. ADAMSON, *LAW FOR BUSINESS AND PERSONAL USE* 356-371 (18th ed. Thomson/South-Western 2009); HENRY CHEESEMAN, *BUSINESS LAW: LEGAL ENVIRONMENT, ONLINE COMMERCE, BUSINESS ETHICS, AND INTERNATIONAL ISSUES* 876-893 (8th ed. Pearson Higher Ed 2013); MARGARET E. VROMAN, *BUSINESS LAW BASICS* 189-193 (Kendall Hunt 2009); A. JAMES BARNES, TERRY M. DWORKIN & ERIC RICHARDS, *LAW FOR BUSINESS* 682-703 (12th ed. McGraw-Hill/Irwin 2015); KENNETH CLARKSON, ROGER MILLER & FRANK CROSS, *BUSINESS LAW: TEXT AND CASES: LEGAL, ETHICAL, GLOBAL, AND CORPORATE ENVIRONMENT* 1018-1038 (12th ed. Cengage Learning 2012); DAVID TWOMEY & MARIANNE JENNINGS, *ANDERSON'S BUSINESS LAW AND THE LEGAL ENVIRONMENT, STANDARD VOLUME* 1169-1185 (22nd ed. Cengage Learning 2013); MICHAEL BIXBY ET AL., *THE LEGAL ENVIRONMENT OF BUSINESS* 492-495 (5th ed. 2011); ANTHONY LIUZZO, *ESSENTIALS OF BUSINESS LAW* 448-63 (8TH ED. MCGRAW-HILL HIGHER EDUC. 2012); DON MAYER ET AL., *ADVANCED BUSINESS LAW AND THE LEGAL ENVIRONMENT* 627-647 (1st ed.

Flatworld 2013); JEFFREY BEATTY & SUSAN SAMUELSON, CENGAGE ADVANTAGE BOOKS: INTRODUCTION TO *BUSINESS LAW* 556-71 (4TH ED. CENGAGE LEARNING 2012); ROGER MILLER, *BUSINESS LAW TODAY, STANDARD: TEXT & SUMMARIZED CASES* 956-973 (10th ed. Cengage Learning 2012); ROGER MILLER & GAYLORD JENTZ, *BUSINESS LAW TODAY, STANDARD EDITION* 1074-1088 (8th ed. W. Legal Studies in Bus. 2007); RICHARD MANN & BARRY ROBERTS, SMITH AND ROBERSON'S *BUSINESS LAW* 1077-97 (15th ed. Cengage Learning 2008); HENRY R. CHEESEMAN, *ESSENTIALS OF BUSINESS AND ONLINE COMMERCE LAW* 594-600 (Prentice Hall 2005); KEITH ABBOTT, NORMAN PENDLEBURY & KEVIN WARDMAN, *BUSINESS LAW* 307-14 (9TH ED. CENGAGE LEARNING 2013); ROGER MILLER, *BUSINESS LAW: TEXT AND CASES - THE FIRST COURSE* (Cengage Learning 2014); HENRY R. CHEESEMAN, *THE LEGAL ENVIRONMENT OF BUSINESS AND ONLINE COMMERCE* (7th ed. Prentice Hall 2012); NANCY K. KUBASEK, BARTLEY A BRENNAN & M. NEIL BROWNE, *THE LEGAL ENVIRONMENT OF BUSINESS* (6th ed. Pearson Higher Ed 2014); O. LEE REED ET AL., *THE LEGAL AND REGULATORY ENVIRONMENT OF BUSINESS* (16th ed. McGraw-Hill Higher Educ. 2012); DAVID KELLY ET AL., *BUSINESS LAW* (Taylor & Francis 2011); DANIEL V. DAVIDSON, BRENDA E. KNOWLES & LYNN M. FORSYTHE, *BUSINESS LAW: PRINCIPLES AND CASES IN THE LEGAL ENVIRONMENT* (South-Western Pub 2011); DAWN BENNETT-ALEXANDER & LINDA HARRISON, *THE LEGAL, ETHICAL, AND REGULATORY ENVIRONMENT OF BUSINESS IN A DIVERSE SOCIETY* (McGraw-Hill/Irwin 2011); TONY MCADAMS, *LAW, BUSINESS AND SOCIETY* (10th ed. McGraw-Hill/Irwin 2011); SEAN MELVIN, *THE LEGAL ENVIRONMENT OF BUSINESS: A MANAGERIAL APPROACH: THEORY TO PRACTICE* (McGraw-Hill/Irwin 2010); DON MAYER ET AL., *THE LEGAL ENVIRONMENT OF BUSINESS* (1st ed. Flatworld 2012); DON MAYER ET AL., *FOUNDATIONS OF BUSINESS LAW AND THE LEGAL ENVIRONMENT* (1st ed. Flatworld 2012); CONSTANCE E. BAGLEY, *MANAGERS AND THE LEGAL ENVIRONMENT: STRATEGIES FOR THE 21ST CENTURY* (7th ed. Cengage Learning 2012); JEFFREY BEATTY, SUSAN SAMUELSON & DEAN A. BREDESON, *LEGAL ENVIRONMENT* (5th ed. Cengage Learning 2012); ROGER E. MEINERS, AL H. RINGLEB & FRANCES EDWARDS, *THE LEGAL ENVIRONMENT OF BUSINESS* (11th ed. Cengage Learning 2011); ROGER MILLER & FRANK CROSS, *THE*

one notable exception; Myron Scholes and Mark Wolfson publish *Taxes and Business Strategy*.¹³ Their book is specifically for MBA students embarking on careers in corporate finance, strategy, money management, investment banking, and venture capital. The first edition (1992) of *Taxes and Business Strategy* states the book's emphasis: "Effective tax planning requires consideration be given to (i) tax implications of a proposed transaction to all parties of the contract, (ii) explicit taxes, implicit taxes, and tax clienteles, and (iii) the costs of implementing various tax planning strategies."¹⁴ Scholes and Wolfson make the connection between the legal environment of business and tax; they also focus on tax skills and not detailed tax rules and facts, a pedagogical approach espoused in this paper. Legal studies textbooks show that textbooks designed for undergraduate legal studies have brief instructional reference to tax law.

Additionally, taxation is barely addressed in legal journals.

LEGAL ENVIRONMENT TODAY: BUSINESS IN ITS ETHICAL, REGULATORY, E-COMMERCE, AND GLOBAL SETTING (7th ed. Cengage Learning 2012); ROGER MILLER, ET AL., ESSENTIALS OF THE LEGAL ENVIRONMENT (4th ed. Cengage Learning 2010); MARIANNE JENNINGS, BUSINESS: ITS LEGAL, ETHICAL, AND GLOBAL ENVIRONMENT (9th ed. Cengage Learning 2010); JOHN ADAMSON, 21ST CENTURY BUSINESS: BUSINESS LAW (2nd ed. Cengage Learning 2010); JON RUSH & MICHAEL OTTLEY, BUSINESS LAW: PRINCIPLES AND CASES IN THE LEGAL ENVIRONMENT (1st ed. Cengage Learning 2006); MARIANNE JENNINGS, CENGAGE ADVANTAGE BOOKS: FOUNDATIONS OF THE LEGAL ENVIRONMENT OF BUSINESS (2nd ed. Cengage Learning 2012); FREDERICK JONES & CRISTEN DUTCHER, BUSINESS ETHICS: DEVELOPING ANALYTICAL AND CRITICAL THINKING SKILLS (4th ed. Kendall Hunt 2012); NANCY KUBASEK ET AL., DYNAMIC BUSINESS LAW: THE ESSENTIALS (2nd ed. McGraw-Hill/Irwin 2012).

¹³ MYRON SCHOLES ET AL. *TAXES AND BUSINESS STRATEGY* (5th ed. Pearson 2014).

¹⁴ MYRON SCHOLES ET AL. *TAXES AND BUSINESS STRATEGY* (1st ed. Pearson 1992).

This is understandable because taxation is an academic discipline that stands on its own.¹⁵ However, the Academy of Legal Studies in Business (ALSB) includes taxation scholars and teachers who engage in scholarly and pedagogical activities at its conferences and in its publications. The ALSB publishes two major journals: the American Business Law Journal (ABLJ) and the Journal of Legal Studies in Education (JLSE). Regional sections of the ALSB also publish quality, peer-reviewed law reviews.¹⁶ To highlight the scarcity of taxation research in legal studies we conducted a journal review of legal studies in business. The ABLJ has published a limited number of articles that address, in part, some area of taxation.¹⁷ The JLSE has one article that specifically addresses taxation, but most articles address as a sub-part of the article only a concept of taxation.¹⁸

Taxation scholars and teachers publish their research in traditional law review publications or peer-reviewed legal journals. Taxation scholars have addressed the topic of taxation in the context of business law curriculum on a limited basis. A 2007 study reports the findings of a survey of accounting chairpersons regarding the content of law courses in undergraduate business curriculum and whether the business law content prepares students sufficiently for the CPA

¹⁵ See ACADEMY OF LEGAL STUDIES IN BUSINESS, www.alsb.org (last visited Sept. 2, 2020).

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

examination.¹⁹ Notably, this 2007 study shows that accounting chairpersons do not rank taxation as an important topic within the business law curriculum, but do rank business associations as a critical substantive law topic covered on the CPA examination.²⁰ The 2007 study highlights that “in a legal environment textbook, there is usually only one chapter to cover all of the business associations. This coverage, while adequate for non-accountants, is insufficient for accounting students preparing for the CPA examination.”²¹ We propose that business associations’ coverage is likely insufficient for non-accounting students due to lack of taxation focus. An additional insight from the respondent accounting chairpersons in this study was that 70% stated their students were either well-prepared or very well-prepared to take the business law portions of the CPA examination.²² A small body of research examines business law curriculum briefly in the context of taxation content in accounting courses in Australia²³ and the United Kingdom²⁴. This pedagogical study provides a primer on

¹⁹ See Mehmet C. Kocakülâh, *The Business Law Education of Accounting Students in the USA: The Accounting Chairperson’s Perspective*, J. Acct. Ed. Sept. 2008 at 17-36. See also Mehmet C Kocakülâh, *Inconsistencies in the Business Law Education of Accounting Students: A Survey of Accounting Educators*, J. Acct. Ed. Winter 1995 at 75-85.

²⁰ Kocakülâh, *supra* note 20, at 25.

²¹ *Id.* at 27.

²² *Id.* at 30.

²³ See Roger Juchau & Ray Neale, *Taxation in Australian Undergraduate Accounting Courses: A Review and Case Note*, 10 J. Acct. Ed. 27-31 (2001).

²⁴ See Angharad M. Miller & Christine M. Woods, *Undergraduate Tax Education: A Comparison of Educators’ and Employers’ Perceptions in the UK*, 9 J. Acct. Ed., 223-241 (2000); Compare John Craner & Andrew Lymer, *Tax Education in the UK: A Survey of Tax Courses in Undergraduate Accounting Degrees*, 8 J. Acct. Ed. 127-156 (1999).

taxation for students and professors along with instructional and assessment material.

III. BRIEF OVERVIEW OF TAXATION IN THE UNITED STATES

The United States tax system is arguably needlessly complex, a complexity that largely began when the Federal income tax was introduced in 1913.²⁵ Tax professionals are required, at a minimum, to have a working knowledge of the Internal Revenue Code, Treasury Regulations, Revenue Rulings, Revenue Procedures and IRS Letter Rulings.²⁶ Along with the complexity and volume of Federal tax laws, state and local tax laws can also be difficult to understand and apply to particular fact situations. Undergraduate business students will be well-served if they know the following fundamental knowledge of tax law as they enter the workforce.

²⁵ See Hite, *supra* note 7, at 3-13; Susan B. Long & Judyth A. Swingen, *Taxpayer Compliance: Setting New Agendas for Research*, 25 *Law & Soc'y Rev.* 637 (1991) (recounting the burdens and complexity of tax preparation); See also Frank H. Pederson, *Advancing the Study of Tax Complexity with the Usability Model*, 12 *Hous. Bus. & Tax L.J.* 282 (2012). 282, 301-05 (2012) (for a discussion on notions of complexity in the tax literature).

²⁶ Hite, *supra* note 7, at 4; Pederson, *supra* note 26, at 310; See also Samuel Donaldson, *The Easy Case Against Tax Simplification*, 22 *Va. Tax Rev.* 645 (2003) (for an interesting discussion advocating retention of tax complexity).

a. WHO IMPOSES TAXES?**i. Federal**

Congress has the authority to impose a tax on income from any source from which the income is derived.²⁷ The Constitution allows Congress to impose other taxes as well.²⁸ Statutory tax law is contained in the Internal Revenue Code.²⁹ The tax laws are administered and enforced by the Internal Revenue Service, an agency within the Treasury Department. Individuals and business entities must, in most cases, file a tax return with the IRS, reporting the amount of tax paid and determining whether more tax is owed or a refund is due.³⁰

ii. State and Local

State legislatures impose taxes at the state level and county/city councils may impose additional taxes at the local level.

²⁷ U.S. CONST. amend. XVI.; See Edward McCaffery, *The Death of the Income Tax (Or, the Rise of America's Universal Wage Tax*, 95 Ind. L.J. 1233, 1258 (2020) (“The modern income tax was born in 1913 following the ratification of the Sixteenth Amendment to the U.S. Constitution.”).

²⁸ U.S. CONST. art. I, § 8.

²⁹ 26 U.S.C.; Alexander J. Morgenstern, *Corporate Tax Avoidance; Addressing the Merits of Preventing Multinational Corporations from Engaging in the Practice and Repatriating Overseas Profits*, 16 J. Int'l Bus. & L. 333, 336 (the I.R.S. administers the federal statutory tax law); I.R.S., *Forming a Corporation* (Jul. 31, 2020) <https://www.irs.gov/businesses/small-businesses-self-employed/corporations> (discussing the taxes of corporations subject to collection by the IRS).

³⁰ I.R.C. § 7203 (willful failure to file a tax return is a felony); See I.R.S. *Forms, Instructions & Publications* (Dec. 19, 2019), <https://www.irs.gov/forms-instructions>; Who Must File a Return, Payroll Mgmt. Guide, Reg. Sec. 201 (2012), WL 11080 (for a list of all parties who must file a return).

Individuals and businesses must pay these taxes in addition to any Federal taxes that apply. Similar to the Federal government, states have agencies such as departments of revenue to administer and enforce state taxes. In most cases, individuals and businesses must also file a tax return with the state. While some local governments have separate tax collection agencies than the state, many localities depend on the state to provide collection services on behalf of the locality.

b. WHAT IS TAXED?

i. Income

The Internal Revenue Code (Code) imposes a tax on the “taxable income” of individuals, corporations, and estates and trusts.³¹ To arrive at taxable income, the Code has a starting point of “gross income,” which is income from any source derived minus “exclusions” provided by the Code. From there, it is a matter of subtraction to arrive at taxable income. The Code allows for certain deductions from gross income in calculating a taxpayer’s taxable income. Once taxable income is determined, the applicable tax rate is applied to arrive at a gross tax amount. Once the gross tax is determined, tax credits and tax pre-payments reduce the gross tax to a net tax due or, in many cases, a refund.³² Most states typically “piggyback” extensively on the law

³¹ I.R.C. §§ 1, 11.

³² Employees typically have income tax withheld by their employer throughout the

contained in the Code in determining taxable income for state income tax purposes.

ii. Payroll

The Code also imposes a tax on wages separate from income tax. These taxes are commonly referred to as “payroll” taxes. This term technically means the two taxes that consist of the Federal Insurance Contributions Act (FICA).³³ These two taxes are the Old, Age, Survivors, and Disability Insurance (OASDI) tax, which is used to fund the Social Security program; and the Hospital Insurance tax, which is used to fund the Medicare program. In fact, many people refer to the taxes as “social security” tax and “Medicare” tax. The social security tax is 6.2% of an employee’s wages up to a ceiling amount.³⁴ The Medicare tax is 1.45% of an employee’s wages, but there is no ceiling amount. An additional 0.9% tax may apply if a taxpayer’s wages exceed \$200,000. Employers must also match the amount paid by employees.³⁵

year. The employer remits the income tax withheld to the IRS. The employee receives an IRS Form W-2 from their employer indicating the amount of wages earned during the year in addition to the amount of income tax withheld. The employee then takes this information and reports it on the employee’s Form 1040 and corresponding state income tax return. Self-employed individuals must pay estimated quarterly taxes since they have no employer to withhold income taxes; I.R.S. Tax Withholding Estimator The IRS, <https://www.irs.gov/individuals/tax-withholding-estimator> (last visited, Aug. 15, 2020).

³³ I.R.C. § 3101.

³⁴ The ceiling amount for 2021 is \$142,800; see Kaily Hagen, *Are Millennials Right to Be Skeptical of Social Security's Future?* NASDAQ (Aug. 15, 2020, 12:46 PM), <https://www.nasdaq.com/articles/are-millennials-right-to-be-skeptical-of-social-securitys-future-2020-08-15> (last visited August 15, 2020).

³⁵ I. R.C. §§ 3101, 3111. (IRC imposes a 7.65% tax on every individual’s income

iii. Property

A major source of revenue for local governments is taxation on the value of property within the jurisdiction.³⁶ The most common property tax is imposed on the value of real property, including homes, farmland, and commercial property. Personal property can also be subject to property tax, most commonly personal property used in a trade or business. Some states also subject vehicles to property tax even if used for personal purposes.³⁷ The Federal government generally does not generally impose property taxes.

iv. Sales

States typically impose taxes on a buyer when the buyer purchases goods and, in some cases, services. While the legal imposition of the tax is on the buyer, the seller has a legal obligation to collect the tax from the buyer and remit the tax to the state.³⁸ Cities

from employment and a 7.65% tax on employers on wages paid.).

³⁶See *State & Local Revenue, News & Analysis*, NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS, <https://www.nasra.org/revenue#:~:text=Income%20and%20sales%20taxes%20make,economic%20conditions%20and%20tax%20policies>. (last visited August 15, 2020).

³⁷ See CHARLES W. SWENSON, SANJAY GUPTA, JOHN E. KARAYAN & JOSEPH W. NEFF, *STATE AND LOCAL TAXATION: PRINCIPLES AND PLANNING* 98-100 (2d ed. 2004).

³⁸ See, e.g., ARIZONA TRANSACTION PRIVILEGE TAX, Ariz. Rev. Stat. Ann. § 42-5008

and counties are often allowed to increase the state sales tax rate to generate additional revenue. Rates may vary depending on the product that is purchased. For example, some states impose a lower rate or no sales tax on the purchase of food items, medications, clothing, etc. Typically, sales tax only applies on the end consumer, thus exempting “sales for resale.” Charities are sometimes exempt from sales tax on the purchase of goods.

v. Gifts, Trusts and Estates

With some exceptions, the Code imposes a tax on the value of an individual’s estate after the death of that individual. As a companion tax, gift tax is imposed on gifts made from one individual to another. For 2021, no estate tax is imposed on an estate valued at less than \$11,700,000.³⁹ Gifts are not subject to the gift tax unless the taxable gift is for more than an annual exclusion of \$15,000.⁴⁰ If the gift tax applies, the tax is on the giver. Thus, an individual can make a nontaxable gift to as many individuals throughout the year as long as the gift is not more than \$15,000 to each individual. If an individual is married, then the individual’s spouse can consent to allow the individual to make a gift of \$30,000 per year per individual without being subject to the gift tax.⁴¹ Gifts to charities and to spouses are not

et seq. (In some unique situations, the imposition of the tax is on the seller rather than the buyer and the seller must also remit the tax.); see also *Carter Oil Company, Inc. v. Arizona Department of Revenue*, 460 P.3d 808 (2020) (addresses Arizona’s transaction privilege tax).

³⁹I.R.C. § 2010 as amended by the Tax Cuts and Jobs Act of 2017. This amount is adjusted each year.

⁴⁰I.R.C. § 2503; see William Finestone, *LOW INTEREST RATE GIFT TAXING*, 47 *EST. PLAN* 13 (2020) (annual exclusion gifts currently \$15,000 per donee).

⁴¹I.R.C. § 2513; see Jay A. Soleda, *GIFT AND ESTATE TAXES: THE CASE FOR*

subject to the gift tax.⁴² If the gift tax applies, the tax is on the giver and the recipient is not subject to tax on the receipt of the gift. Trusts and estates are also generally subject to income tax on income that is accumulated within the trust and not distributed to beneficiaries.⁴³

vi. Excise

Excise tax is a tax imposed on specified transactions. This includes a broad array of taxes imposed on fuel, telecommunications, tobacco, alcohol, airline, coal, and even tanning salon services, among others.⁴⁴ Other taxes (often called “duties”) may be imposed on goods imported from other countries.

DEUNIFICATION, 57 HARV. J. LEGIS. 439 (Summer 2020) (arguing that gift tax has been practically regulated out of existence).

⁴² I.R.C. §§ 2522-23; *Petter v. C.I.R.*, T.C.M. 2009-2802009 WL 459813798; T.C.M. (CCH) 534, see All Citations (Approx. 18 pages) (public policy favors gifts to charity).

⁴³ I.R.C. § 641; RESTATEMENT (THIRD) OF TRUSTS § 60 (AM. LAW INST. 2003); U.T.C. § 504 (2005). (A discretionary trust is distinguished by the nature of the beneficiary's interest. In a pure discretionary trust, the trustee has uncontrolled discretion in making distributions to the beneficiary.); See 76 AM. JUR. 2D Trusts § 108 (2008); see also *Martin v. Martin*, 374 N.E.2d 1384 (1978) (some trusts grant the trustee discretion but subject that discretion to a standard such as education or support).

⁴⁴ See, e.g., I.R.C. MISCELLANEOUS EXCISE TAXES, Sub. D, E; See Jedediah Bodgeral, MAINTAINING PROFITABILITY OF GOVERNMENT CONTRACTS IN THE AGE OF INCREASING TARIFFS, , 49 Pub. Cont. L.J. 275, 295-296 (Winter 2020) (discussion on excise taxes)

c. WHO IS TAXED?

i. Individuals

Individual taxpayers are subject to many of the taxes discussed in this article. Undergraduate business students, however, specifically need to have a fundamental understanding of the individual income tax. Individuals determine their income tax liability by employing a formula set forth in the Code. The formula can be summarized as follows:

	Income from any source derived
-	exclusions
=	gross income
-	deductions allowed to arrive at adjusted gross income
=	adjusted gross income (AGI)
-	deductions from AGI allowed to arrive at taxable
income	
=	taxable income
x	tax rate
=	gross tax
-	tax credits and prepayments
=	tax due or refund

Clearly, the starting point for the individual income tax formula is very broad. This includes salaries and wages, rents, business income, dividends, interest, gains on the sale of property, royalties,

income from pass-through entities such as partnerships and S corporations, annuities, among others.⁴⁵ Common *exclusions* from gross income provided by the Code include gifts, inheritances, scholarships, tax-exempt interest, life insurance proceeds, certain employer-paid employee benefits, sale of a personal residence, among others.

Some expenditures are tax deductible by individual taxpayers. Certain of these deductions are allowed to arrive at the individual's "adjusted gross income" (AGI). Examples of these deductions are business expenses, contributions to individual retirement accounts (IRAs), health savings accounts, educator expenses, and one-half of an individual's self-employment taxes. Deductions allowed *from* AGI to arrive at taxable income are sometimes less advantageous since an individual only benefits from such deductions if the individual "itemizes" the deductions rather than taking the "standard" deduction. Moreover, some of these deductions are limited to a percentage of the individual's AGI.⁴⁶ Examples of these deductions are medical

⁴⁵ I.R.C. § 61(a). *Comm'r v. Schleier*, 515 U.S. 323, 328, 115 S.Ct. 2159, 132 L.Ed.2d 294 (1995) (citation omitted) (exclusions from income must be narrowly construed)

⁴⁶ See, e.g., I.R.C. § 213(a), (f)(2) (for 2018, qualified medical expenses that are incurred by an individual are deductible only to the extent they total more than 7.5% of the individual's adjusted gross income). For a recent case addressing medical expenses see *Sham v. Commissioner of Internal Revenue*, T.C.M. 2020-1192020 WL 4671146T.C.M. (RIA) 2020-1192020 RIA TC Memo 2020-119 (addressing medical expenses).

expenses, charitable contributions, state and local taxes, and mortgage interest on personal residences. The qualified business income (QBI) deduction is also allowed as a deduction from AGI.

Once all allowed deductions are taken from AGI, the individual arrives at taxable income, then multiplies taxable income by the appropriate rate. From this amount, any tax prepayments⁴⁷ and applicable tax credits reduce the individual's tax due on a dollar-for-dollar basis.⁴⁸ If the prepayments exceed the net tax liability of the individual, the individual is entitled to a refund.⁴⁹

Admittedly, an undergraduate non-accounting major does not need to memorize the individual income tax formula. However, a general understanding of how taxable income is determined and some examples of exclusions and deductions provides valuable context for understanding tax laws impacting businesses and business owners, and

⁴⁷ For employees, prepayments are typically withheld by the employer and remitted to the IRS throughout the year. The employee then receives a Form W-2 at shortly after the end of the year informing the employee how much tax was withheld. For self-employed individuals, estimated tax payments are made quarterly by the individual to the IRS quarterly on Form 1040-ES.

⁴⁸ Tax credits for individuals include the earned income credit, adoption credit, and lifetime learning credit, among others. William H. Byrnes & Jason A. Fiske, 3 MERTENS L. FED. INCOME TAX'N § 19:40 Earned Income Credit (August 2020) (recent information on earned income credit).

⁴⁹ See I.R.C. § 55 (Individuals may also be subject to an alternative minimum tax regime or "AMT," which may result in a higher tax than calculated under the regular tax calculation). See also Nicholas Cohen & Manoj Viswanathanal, *Corporate Behavior and the Tax Cuts and Jobs Act*, U. CHI. L. REV. Online 1, (Apr. 2, 2020) (The Tax Cuts and Jobs Act reduced the alternative minimum tax for individuals and eliminated it for corporations).

the relevance of taxation when determining the most appropriate entity for conducting business.

ii. Businesses

One of the first decisions an entrepreneur makes is what type of business entity to form under state law. The most common entities are corporations, partnerships and limited liability companies.⁵⁰ Non-tax characteristics of each of these entities is typically taught in undergraduate business law courses. As indicated earlier, however, the applicable tax law is only briefly discussed.⁵¹ Our position is that since tax law is a significant factor in choice-of-entity decisions and has dramatic impact on business strategy and profitability, tax law should not be as overlooked as it currently is in business law textbooks.

1. Corporations

For tax purposes, corporations are classified as either “C” corporations or “S” corporations.⁵² Subchapter C of the Code and Subchapter S of the Code provide the tax law applicable to the respective types of corporations. We will separately address the tax

⁵⁰ Zachary R. Willenbrink, LLCs: EXEMPT FROM COMMON-LAW FIDUCIARY DUTIES? 85-NOV Wis. Law. 26 (2012).

⁵¹ See *supra* note 13.

⁵² I.R.C. § 1361(a) (definition of S corporations).

law applicable to each.

A. “C” Corporations

A C corporation is itself subject to income taxation.⁵³ Profits distributed by the corporation to its shareholders are generally taxed again at the shareholder level as a dividend.⁵⁴ Thus, corporations are often referred to as “double-taxed.” In most instances, property can be transferred to a corporation by a shareholder without recognizing an immediate tax.⁵⁵ If the corporation’s stock is issued to a person in return for that person’s services, however, the service-provider must generally recognize taxable income to the extent of the fair market value of the stock received.⁵⁶

The corporate income tax formula is similar to the individual income tax formula:

Income from all source derived

⁵³ I.R.C. § 11(a).

⁵⁴ I.R.C. § 61. (If the recipient of the dividend is another C corporation, the dividends received deduction (DRD) usually applies to mitigate multiple levels of taxation). See I.R.C. § 243.

⁵⁵ I.R.C. § 351(a). (This is true only if the transferors of property are in control (80%) of the corporation immediately after the transfer, however.) See I.R.C. § 368(c).

⁵⁶ I.R.C. § 83. If the stock received is “restricted,” then the shareholder may not be required to recognize the fair market value into income until the restriction is removed. Alternatively, the shareholder may elect to include the value of restricted stock into the shareholder’s gross income in the current year rather than in the year the restrictions lapse. See I.R.C. § 83(b).

- exclusions
- = gross income
- deductions
- = taxable income
- x tax rate
- = gross tax
- tax credits and prepayments
- = tax due or refund

Notice, however, for corporations all allowable deductions reduce gross income to arrive at taxable income. There is no intermediate computation of “adjusted gross income.”⁵⁷

As mentioned, distributions from a corporation typically constitute dividends. However, this is only true if the distribution consists of the earnings and profits of the corporation.⁵⁸ If a corporation has no earnings and profits, then the distribution is considered a nontaxable return of the shareholder’s investment (represented by the shareholder’s “tax basis” in the stock), and any distribution amount exceeding both the corporation’s earnings and

⁵⁷ Additionally, unlike individuals, corporations are not subject to the alternative minimum tax starting in 2018. See Section III.e. *infra* (discussion on the impact of the Tax Cuts and Jobs Act of 2017). See David Kamin, et al., *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 *Minn. L. Rev.* 1439 (2019).

⁵⁸ I.R.C. §§ 301(c), 316.

profits and a shareholder's tax basis is usually taxed as a capital gain.⁵⁹

Upon liquidation, a corporation is treated as selling its assets for fair market value.⁶⁰ This causes the corporation to recognize a gain or loss on each asset, as the case may be. Shareholders are also treated as selling their stock in return for the fair market value of the assets received in the liquidation.⁶¹ Thus, the corporation is potentially subject to tax in the year of liquidation as are the shareholders. Exceptions exist if the liquidating corporation liquidates into a parent corporation.⁶²

B. "S" Corporations

If a corporation meets certain requirements, it can qualify as a "small business corporation" (i.e., S corporation). The benefit of qualifying as an S corporation and making the election is that the entity receives "pass-through" status much like a partnership and is not subject to income tax at the entity level.⁶³ To be a qualified small business corporation, the corporation must meet the following requirements:

- * must be a domestic corporation
- * must not be an ineligible corporation

⁵⁹ I.R.C. § 301(c)(3). See Ronald H. Jensen, *Can You Have Your Cake and Eat It Too?: Achieving Capital Gain Treatment While Keeping the Property*, 5 PITT. TAX REV. 75, 108 (Spring, 2008) (for a treatment of capital gains tax considering § 301(c)(3)).

⁶⁰ I.R.C. § 336(a).

⁶¹ I.R.C. § 331(a).

⁶² See I.R.C. §§ 332, 337.

⁶³ I.R.C. §§ 1363, 1366.

- * cannot have more than 100 shareholders
- * cannot have a nonresident alien as a shareholder
- * cannot have an ineligible shareholder
- * can have only one class of stock⁶⁴

An S election is made by timely filing a form with the IRS.⁶⁵ Such election must be made unanimously by the shareholders.⁶⁶ A corporation's S status automatically continues from year-to-year until the shareholder's revoke it, or it fails to qualify as a small business corporation.

If Subchapter S does not address a particular issue, then the law of Subchapter C applies.⁶⁷ Consequently, since Subchapter S is silent on the rules governing the transfer of property and/or services to an S corporation in exchange for stock, Subchapter C applies.

Since an S corporation is a pass-through entity, an S corporation's income is taxed to the shareholders in the tax year the income is earned. Subsequent distributions of those profits are not taxed to the shareholders since that income was already taxed in the

⁶⁴ I.R.C. § 1361(b) <https://www.irs.gov/businesses/small-businesses-self-employed/s-corporations> (last visited Aug. 17, 2020).

⁶⁵ IRS Form 2553. (<https://www.irs.gov/forms-pubs/about-form-2553>, (last visited August 17, 2020)).

⁶⁶ I.R.C. § 1362.

⁶⁷ I.R.C. § 1371. See Ryan H. Pace, *Debunking the Notion That S Corporations Are Taxed 'Just Like' Partnerships*, 9 No. 4 BUSENT 10 at 2 (2007).

year earned.⁶⁸ Any distributions in excess of the shareholder's investment and share of profits is typically taxed to the shareholder as a capital gain.⁶⁹ As with partnerships, income earned by an S corporation retains its character as it passes through to the shareholders.⁷⁰ Thus, tax-exempt income earned at the entity level is tax-exempt to the shareholder. Capital gains at the entity level are treated as capital gains to the shareholders.

S corporations must file a tax return each year—IRS Form 1120S. The S corporation must provide each shareholder with a Schedule K-1, which informs the shareholder of the shareholder's share of the corporation's income, gain, expense, loss, etc.

Regarding liquidations of an S corporation, Subchapter S is silent. Thus, Subchapter C applies. Nevertheless, the S corporation still retains its pass-through status, which allows any gains recognized at the entity level to only be taxed once—at the shareholder level.

2. Partnerships and Limited Liability Companies

Like S corporations, partnerships are pass-through entities.⁷¹ Consequently, the income of a partnership is only taxed at the partner

⁶⁸ Contrast with discussion on C corporations in III.c.ii.1.A., *supra* (C corporations where the income is taxed at the corporate level and the profits distributed are taxed again as a dividend to the shareholders).

⁶⁹ I.R.C. § 1368.

⁷⁰ I.R.C. § 1366. *Tabé v. Commissioner of Internal Revenue*, T.C.M. Nov. 5, 2019, 2019-1492019 WL 5704635118 T.C.M. (CCH) 400.

⁷¹ I.R.C. §§ 701, 702.

level, not at the entity level.⁷² The Treasury Regulations treat limited liability companies with more than one member as partnerships for income tax purposes.⁷³ Other variations of partnerships, including general partnerships, limited partnerships, limited liability partnerships, and limited liability limited partnerships are all treated as partnerships subject to the provisions of Subchapter K of the Code.

The Code allows property to be transferred to partnerships without the recognition of an immediate tax.⁷⁴ A partner who transfers services to the partnership generally does not recognize into income the fair market value of the partnership interest received if the interest received is an interest in the partnership's capital as opposed to an interest only in the partnership's future profits.⁷⁵

As with an S corporation, the character of the income, deductions, etc., passes through to the partner and the character of the

⁷² I.R.C. § 701.

⁷³ See Treas. Reg. Sec. 301.7701-1. Importantly, an LLC with only one owner is not a partnership. Rather, the Treasury regulations treat it as a "disregarded entity." The entity is thus treated as a sole proprietorship (if the sole owner is an individual) and the income, deductions, etc., are reported directly on the individual's Form 1040. If the sole owner is an entity, then the income, deductions, etc., are reported directly on the owner's tax return (e.g., Form 1120 for a C corporation).

⁷⁴ See I.R.C. § 721(a). (provides that "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.") (Emphasis added.) *Crescent Holdings, LLC v. C.I.R.* 141 T.C. 477 (2013).

⁷⁵ I.R.C. § 83(a); Rev. Proc. 93-27.

item is treated as if the partner was engaged in the transaction directly.⁷⁶ Subsequent distributions of profits to partners are generally not subject to tax since that income has already been taxed to the partners in the year earned by the partnership. Gain is recognized by a partner, however, if the partnership distributes money that exceeds the partner's tax basis in the partnership.⁷⁷ Distributions of non-cash property typically do not cause a partner to recognize taxable income.⁷⁸ Distributions upon liquidation of a partner's interest in the partnership follow the same general rules as non-liquidating distributions with a few modifications.⁷⁹

Although a partnership is a pass-through entity, it must file an annual information return—IRS Form 1065.⁸⁰ The partnership also provides each partner with a Schedule K-1 informing each partner of the partner's share of the partnership's income, gain, loss, expense, etc., so that the partner can properly report and pay the necessary taxes.

⁷⁶ I.R.C. § 702(b). Section 702(b) provides that “[t]he character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share ... shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.” *Rutkoske v. Commissioner of Internal Revenue* 133 Tax Ct. 60 (2017).

⁷⁷ I.R.C. § 731(a)(1).

⁷⁸ *Id.*

⁷⁹ I.R.C. § 731(a)(2). See 11 Mertens L. of Fed. Income Tax'n § 41B:155 (rev. ed. 2020) (The salient difference between liquidating and non-liquidating distributions is that loss generated in a liquidating distribution may be recognized (subject to limitations), while it is not recognized in a non-liquidating distribution.)

⁸⁰ I.R.C. § 6031.

d. Consequences of Failure to Comply with Tax Law

To give taxpayers an incentive to comply with tax laws, the Code provides both civil and criminal penalties.⁸¹

i. Civil Penalties

Failure to comply with certain provisions of the Code may require taxpayers to pay interest⁸² to the government and, in many cases, penalties. Civil penalties are most commonly imposed for the following: failure to file a tax return,⁸³ failure to pay the tax,⁸⁴ accuracy related penalties,⁸⁵ and the fraud penalty.⁸⁶

⁸¹ See, e.g., *Kansas v. Garcia*, 140 S.Ct. 791206 L.Ed.2d 146 (2020). (The U.S. Supreme Court has consistently held that the Federal income tax laws are constitutional and that persons who fail to comply with those laws may be subject to civil and criminal penalties.)

⁸² I.R.C. § 6601. (interest accrues on any underpayment of tax and begins to accrue on the date that payment was due). See I.R.C. § 6601(g) (interest “may be assessed and collected at any time during the period within which the tax to which such interest relates may be collected.”). See I.R.C. § 6502(a)(1), (the period of limitations on the collection of tax begins on the date the IRS assesses the tax); See I.R.C. §§ 6502(a)(1), 6601(g) (in combination form the following rule: the assessment of interest may occur only after the assessment of “the tax to which such interest relates.” (*Field v. United States*, 381 F.3d 109, 113 (2d Cir. 2004). See also *Goldberg v. Commissioner of Internal Revenue*, T.C. Memo. 2020-38.

⁸³ I.R.C. § 6665.

⁸⁴ I.R.C. § 6651.

⁸⁵ I.R.C. § 6662. (If a penalty is determined to apply, § 6662 provides that “there

ii. Criminal Penalties

Common criminal penalties include: tax evasion,⁸⁷ willful failure to collect or pay-over a tax,⁸⁸ failure to file a return or supply information,⁸⁹ fraud, and false statements.⁹⁰ Since many of these crimes are felonies, if found guilty, a person could be sentenced to several years in prison.⁹¹

shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.”).

⁸⁶ I.R.C. § 6663. “If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.”

⁸⁷ I.R.C. § 7201. The willful making of false statements to Treasury representatives in attempt to evade income taxes would be punishable under § 145 [I.R.C.1939], making it a felony to willfully attempt in any manner to evade or defeat income tax, and not punishable solely under § 1001 of Title 18, expressly outlawing false statements in any matter within jurisdiction of any department or agency of the United States. See *U.S. v. Beacon Brass Co.*, U.S.Mass. 1952, 73 S.Ct. 77, 344 U.S. 43, 97 L.Ed. 61. Section 7201 requires affirmative act of evasion while this section is an omission of a duty to make return. See *U.S. v. Ming*, C.A.7 (Ill.) 1972, 466 F.2d 1000, cert. denied 93 S.Ct. 235, 409 U.S. 915, 34 L.Ed.2d 176, rehearing denied 93 S.Ct. 514, 409 U.S. 1051, 34 L.Ed.2d 504.

⁸⁸ I.R.C. § 7202. “Any person required under this title to collect, account for, and pay over any tax imposed by this title who willfully fails to collect or truthfully account for and pay over such tax shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than \$10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.”

⁸⁹ I.R.C. § 7203

⁹⁰ I.R.C. § 7206. (Fraud includes declarations made under penalties of perjury, willful assistance to others to commit fraud, falsely executed documents, or removing or concealing documents with the intend to deceive).

⁹¹ See, e.g., I.R.C. §§ 7201, 7206 (up to five years for tax evasion).

e. Impact of the Tax Cuts and Jobs Act of 2017

President Trump signed the Tax Cuts and Jobs Act on December 22, 2017.⁹² Most provisions of the Act took effect as of January 1, 2018. The Act impacted both individuals and businesses in a variety of ways.

i. Individuals

Among the provisions of the Act, those impacting individuals are a decrease of the tax rates, doubling the standard deductions, increasing the child tax credit, eliminating or reducing deductions for items such as moving expenses, casualty losses, state and local taxes, mortgage interest, personal exemptions, and miscellaneous itemized deductions, among others. While the Act changed many provisions of the Code, the underlying formula in calculating taxable income remains largely intact.

ii. Businesses

Perhaps one of the most significant changes the Act made to the Code impacting businesses was the lowering of applicable tax rates. For C corporations, the graduated tax rate brackets that included rates as high as 35% were replaced with a flat-rate tax of 21% on a C

⁹² P.L. 115-97.

corporation's taxable income.⁹³ The Act also eliminated the alternative minimum tax for corporations.⁹⁴ For pass-through entities such as S corporations and partnerships the Act also provides a new qualified business income deduction in certain situations that effectively reduces the tax rate on a partner's or shareholder's respective share of the business income eligible for the deduction.⁹⁵

IV. TEACHER'S NOTE: LEARNING OUTCOMES, SKILL BUILDING ASSIGNMENTS; CASE STUDY AND GRADING RUBRIC

Tax educators must make a judgment about the best approach to organize the tax curriculum. This is no small task for legal studies instructors who have limited space to introduce new subject matter. Tax researchers have examined how young children,⁹⁶ undergraduate and graduate students⁹⁷ organize or catalog tax knowledge.

⁹³ Act Sec. 13001(a); I.R.C. § 11(b). See 26 U.S.C. § 11(b) (2020) ("The amount of the tax imposed by subsection (a) shall be 21 percent of taxable income."); Summary: H.R.1--115th Congress (2017-2018), CONGRESS.GOV (2017), <https://www.congress.gov/bill/115th-congress/house-bill/1>. ("This section reduces the corporate tax rate from a maximum of 35% under the existing graduated rate structure to a flat 21% rate for tax years beginning after 2017."); see also Alistair M. Nevius, How Tax Overhaul Would Change Business Taxes, *J. OF ACCT.*, (Oct. 23, 2018, 11:38 PM), <https://www.journalofaccountancy.com/news/2017/dec/tax-reform-bill-changes-for-businesses-201718071.html>.

⁹⁴ Act Sec. 12001(a); I.R.C. § 55.

⁹⁵ Act Sec. 11011(a); I.R.C. § 199A.

⁹⁶ See Adrian Furnham, *Understanding the Meaning of Tax: Young Peoples' Knowledge of the Principles of Taxation*, *J. Soc. Econ.* 34 (2005) 703-713.

⁹⁷ Stephen Limberg, et al., *Organizing Tax Instruction: Evidence Regarding How Students Organize Tax Knowledge*, *J. ACCT. ED.*, Vol 13, No. 1, 45-58 (1995).

Application of knowledge, through real-world case studies or skill-building exercises, appears to be the most successful approach to catalog tax knowledge.⁹⁸ Business law professors are well-positioned to provide skill-building exercises in taxation by virtue of their law school training in the Socratic Method or mooting (discussion of hypothetical case for practice). Business law professors may also employ the Harvard Business School case study, a favored pedagogical tool of many law professors.⁹⁹ Mooting reinforces fundamental analytic and business skills and values relevant to business or taxation professionals, namely: problem solving, legal analysis and reasoning, communication, organization and management. We propose a single-case, mooted technique to teach principles of taxation to undergraduate business law or MBA students.¹⁰⁰ We follow a number of tax scholars' and teachers'

⁹⁸ *Id.*

⁹⁹ See, e.g., Celeste M. Hammond, *Borrowing from the B Schools: The Legal Case Study as Course Materials for Transaction Oriented Elective Courses: A Response to the Challenges of the MacCrate Report and the Carnegie Foundation for Advancement of Teaching Report on Legal Education*, 11 *TRANS: TENN. J. BUS. L.* 9, 10–11 (2009). See Symposium, *The Future of Law, Business, and Legal Education: How to Prepare Students to Meet Corporate Needs*, 17 *CHAP. L. R.* at 195, 196–201 (2013) (presenting his use of the client file method, which combines the law and business school case methods to give law students an opportunity to apply the law to real-world facts). See also Alicia J. Davis, *Think Like a Businessperson: Using Business School Cases to Create Strategic Corporate Lawyers*, *ST. LOUIS U.L.J.* 59, no. 3 (2015), 823–40.

¹⁰⁰ See Duncan Bentley, *Mooting in an Undergraduate Tax Program*, 7 *L. ED. R.* 97 (1996). See also C Engel, *Not Just a Method But a Way of Learning*, (D Boud & G

recommendations on teaching tax law to undergraduates, which has an emphasis on the process of learning.¹⁰¹ The process of learning we employ focuses on tax skills to be taught and not a process of memorizing the detailed tax rules and facts. Consistent with Mooting, or the Socratic Method, the proposed process of learning follows six steps,¹⁰² which are similar to the four steps proposed by Hite et. al.¹⁰³

1. Study the facts of the case;
2. Identify the tax issue(s);
3. Locate related tax authority;
4. Evaluate the relevance and validity of the authority;
5. Develop conclusions and recommendations;
and
6. Communicate the recommendations.

Before tackling an in-depth case analysis, students will benefit from going through a couple of skill-building exercises with actual

Feletti eds.), *The Challenge of Problem Based Learning* (London: Kogan Page, 1991) 26. See also on alternative models, HS Barrows & RM Tamblyn, *Problem-Based Learning: An Approach to Medical Education* (New York: Springer, 1980); DA Schon, *The Reflective Practitioner* (San Francisco: Basic Books, 1983); and DA Schon, *Educating the Reflective Practitioner* (San Francisco: Jossey-Bass, 1991).

¹⁰¹ Hite, *supra* note 7, at 3-13. See also, R. Gore & B. Wong-on-Wing, *The Acquisition and Transfer of Tax Skills*. J. AM. TAX'N ASS'N 20(2), 117-126 (1998).

¹⁰² Tamara K. Kowalczyk, *Single-case technique for teaching the tax research process*, J. ACCT. ED., 10:1, 15-25 (2001).

¹⁰³ Hite, *supra* note 7, at 8. (Hite et. al suggest the following process: "Instruction is organized around specific tax skills, a task analysis is completed for each skill, instruction is example-based, students are given opportunity to practice real-world tax skills.")

numbers that illustrate how C corporations, partnerships and LLCs (which are treated as partnerships) are treated for income tax purposes.

A. Skill-Building Exercises.

Skill-building exercise #1. Elisha and Dylan are experts at computers. After graduating from college, they decide to open a computer consulting business to help individuals and businesses with any questions they have about their computers. Let's assume their lawyer and accountant recommend they form a C corporation with Elisha and Dylan as the only shareholders and employees. They each own 50% of the business. Moreover, assume they enjoy success in the first year and the C corporation's taxable income is \$100,000. The applicable tax rate for the C corporation is 21%. Assume further that after the tax is paid, the corporation distributes the remaining income equally to Elisha and Dylan as a dividend. Assume the dividend tax rate that applies to Elisha and Dylan is 15% for each of them. How much in total tax was paid by the corporation? Elisha and Dylan?

Answer: The Corporation's tax is \$21,000 ($\$100,00 \times 21\%$)

Elisha's tax is \$5,925 ($\$39,500 \times 15\%$)

Dylan's tax is \$5,925 ($\$39,500 \times 15\%$)

Skill-building exercise #2. Jordan and Andrew are computer experts. Everyone asks them for help when they are frustrated with either their computer software, hardware, or network issues. Consequently, after graduating from college they decide to open a computer consulting business to help individuals and businesses with

any questions they have about their computers. Let's assume their lawyer and accountant recommend they form a limited liability company (LLC) with Jordan and Andrew as the only members. They each own 50% of the business. They have no employees, and it is just the two of them working for the business. Moreover, assume they enjoy success in the first year and the LLC's business income is \$100,000. Since the LLC is a pass-through entity, the \$100,000 is not taxed to the entity; rather, \$50,000 is taxed to Jordan and \$50,000 is taxed to Andrew. Assume that the applicable effective tax rate for each Jordan and Andrew is 20%. How much in total tax is paid by Jordan and Andrew?

Answer:

Jordan's tax is \$10,000 ($\$50,000 \times 20\%$)

Andrew's tax is \$10,000 ($\$50,000 \times 20\%$)

After becoming familiar with the fundamental tax characteristics of C corporations, S corporations and partnerships (including LLCs), students are now ready for a case assignment. We recommend this case assignment be given after the students have also studied the non-tax characteristics of the various business entities so that the students can complete a thorough analysis of which business entity they recommend given a particular hypothetical factual situation, and arrive at a reasoned conclusion.

B. Case assignment

Brianne and Alexis just graduated from college with degrees in business. Along the way they gained valuable knowledge in the areas of accounting, economics, finance, law, marketing, and business communications, among others. Consequently, they decide to open a business called ABC Business Consulting, which will focus on helping

entrepreneurs get started and be successful in many of the important components of a growing business.

Initially, Brianne and Alexis will be the only owners. After they get their business up and running, they may entertain the idea of adding other owners/investors if the proposed owners/investors can bring valuable services or needed capital to the business. Of course, they are interested in protecting their personal assets from the debts of the business in case the business ultimately cannot pay its bills.

You can assume that the following information is also applicable:

1. The tax rate applicable to C corporations is 21%.
2. Brianne and Alexis are each taxed at 15% on any dividends received from a C corporation.
3. Brianne and Alexis are each in the 20% individual income tax bracket on income other than dividends from a C corporation.
4. The business's net income is \$60,000 for the year.
5. If the business is a C corporation, it distributes a dividend to both Brianne and Alexis in an equal amount with the money remaining after the corporation itself pays its income taxes.
6. If the business is an S corporation, partnership, or LLC, the business distributes \$30,000 to Brianne and \$30,000 to Alexis.

Given the particular factual situation of this case assignment, assume that Brianne and Alexis have a

choice to form a C corporation, S corporation, general partnership, or LLC as the entity in which to run their business. They have asked you to make a recommendation to them. Write a letter to Brianne and Alexis making a recommendation to them regarding which entity they should form. Be sure to use the facts given to provide a thorough analysis of the various non-tax and tax advantages/disadvantages of each possible entity, and your reasons for making the specific recommendation.

C. Multiple Choice Exam

Choose the best answer.

1. Gross income is all income derived from:

- a. any source.
- b. any source less charitable contributions.
- c. less taxes owed.
- d. any sources less exclusions.

2. The Social Security tax rates is ____ of any employee's wages up to a ceiling amount.

- a. 6.0 percent.
- b. 6.1 percent.
- c. 6.2 percent.
- d. 7.25 percent.

3. The ceiling amount of wages for Social Security tax purposes in 2021 is:

- a. \$142,800.

- b. \$129,000.
- c. \$122,400.
- d. \$1,000,000.

4. A Subchapter C corporation is

- a. not subject to income tax.
- b. subject to taxation.
- c. not subject to taxation if the shareholders pay income tax.
- d. not subject to tax due to its charitable organization status.

5. The Old, Age, Survivors and Disability Insurance tax is used by the federal government to fund:

- a. hospitals.
- b. Individual Retirement Accounts.
- c. Medicare.
- d. Social Security.

6. The largest source of tax revenue for local governments is

- a. sales tax.
- b. transfer payment from the federal government.
- c. payroll tax.
- d. property taxes.

7. A tax of the purchase of goods and services is most commonly called a(n) __ tax.

- a. sales
- b. inventory
- c. value added

d. nominal

8. Gifts are subject to the gift tax to the giver only if they

a. are given by the giver to avoid tax.

b. are over \$15,000 per recipient in a given year.

c. are made in cash.

d. are transferred on December 31st of the year.

9. Specific transaction taxes are known as _____ taxes.

a. excise

b. accumulated

c. progressive

d. alternative minimum

10. Common exclusions from gross income for individuals do not include which of the following:

a. received gifts.

b. inheritances.

c. life insurance proceeds.

d. capital gains.

11. Adjusted gross income is

a. Gross income minus adjustments.

b. Gross income plus adjustments.

c. All sources of income with no adjustments

d. Gross income minus tax liability.

12. To qualify as a Subchapter S corporation an entity must have all but which of the following characteristics?

a. must be a domestic corporation.

b. must have only a single shareholder.

- c. cannot have nonresident alien shareholders.
- d. may have only one class of stock.

13. Which of the following statements is true?

- a. The IRS Code forbids property to be transferred by a partner to the partnership.
- b. Distributions of non-cash property typically do not cause a partner to recognize taxable income.
- c. Partnership do not have to file an informational return with the IRS.
- d. Failure to file a tax return does not result in civil penalties.

14. The Tax Cuts and Jobs Act was enacted in:

- a. 2017
- b. 2010
- c. 2000
- d. 1886.

15. Under the Tax Cuts and Job Act,

- a. the graduated tax rate for C corporations was replaced by a flat tax of 35%.
- b. the underlying formula for calculating taxable income was radically changed.
- c. the underlying formula for calculating taxable income was remained largely intact
- d. the graduate tax rate for C corporations remained the same.

D. Assessment

The following sample rubric can be used by instructors to assess a student's understanding of the skill building and case study's learning objectives. The rubric contains tax and non-tax learning objectives. Consequently, the skill-building and case study is best given to students after the instructor covers the tax material and non-tax material relating to business associations.

STUDENT ASSESSMENT OF THE LEARNING OBJECTIVES FOR THE SKILL-BUILDING AND CASE STUDY						
Rate the student's effectiveness relating to the following learning objectives on a scale of 1 – 5: (1) poor, (2) fair, (3) good, (4) very good and (5) excellent.						
LEARNING OBJECTIVE	1	2	3	4	5	COMMENTS
1. Discusses the differences in liability protection to owners of various entities.						
2. Accurately discusses the different tax treatment of C corporations and flow-through entities (partnerships/LLCs and S corporations).						
3. Addresses the difference in management structure of the different business entities.						
4. Discusses limitation on attracting future investors that may be ineligible shareholders of an S corporation.						
5. Conclusion and recommendations are consistent with analysis.						
6. Communication, grammar, organization, etc.						
7. Other comments:						

V. CONCLUSION

Understanding tax law is an important part of effectively managing and operating a business. Students studying the legal environment of business must be taught the fundamentals of tax law. Most business law textbooks touch on tax law only very briefly and do not have a chapter on the subject. The discussion of fundamental tax law in this article provides a good way for instructors of legal environment of business courses to integrate tax law into their discussion of business associations. Students will benefit from this not only in their professional careers as business leaders, but also in their personal lives.