

2018 EDITION

McGraw-Hill's

# TAXATION *of* INDIVIDUALS AND BUSINESS ENTITIES

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**McGraw-Hill's**

# Taxation of Individuals and Business Entities

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## Dedications

*We dedicate this book to:*

*My entire family, whose love and support helped make this book possible, and to Professor Dave Stewart for his great example and friendship over the last three decades.*

**Brian Spilker**

*My wife, Marilyn, daughters Margaret Lindley and Georgia, son Benjamin, and parents Bill and Linda.*

**Ben Ayers**

*My wife, Jill, and my children Annika, Corinne, Lina, Mitch, and Connor.*

**John Barrick**

*My family, Jane, Mark, Sarah, Chloe, Lily, Jeff, and Nicole, and to Professor James E. Wheeler, my mentor and friend.*

**Ed Outslay**

*JES, Tommy, and Laura.*

**John Robinson**

*My family: Dan, Travis, Alix, and Alan, and to Professor Dave Stewart.*

**Connie Weaver**

*My wife, Anne, sons Matthew and Daniel, and daughters Whitney and Hayley.*

**Ron Worsham**

## About the Authors

**Brian Spilker** (PhD, University of Texas at Austin, 1993) is the Robert Call/Deloitte Professor in the School of Accountancy at Brigham Young University. He teaches taxation in the graduate and undergraduate programs at Brigham Young University. He received both BS (Summa Cum Laude) and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Arthur Young & Co. (now Ernst & Young). After his professional work experience, Brian earned his PhD at the University of Texas at Austin. In 1996, he was selected as one of two nationwide recipients of the Price Waterhouse Fellowship in Tax Award. In 1998, he was a winner of the American Taxation Association and Arthur Andersen Teaching Innovation Award for his work in the classroom; he has also been awarded for his use of technology in the classroom at Brigham Young University. Brian researches issues relating to tax information search and professional tax judgment. His research has been published in journals such as *The Accounting Review*, *Organizational Behavior and Human Decision Processes*, *Journal of the American Taxation Association*, *Behavioral Research in Accounting*, *Journal of Accounting Education*, *Journal of Corporate Taxation*, and *Journal of Accountancy*.



Courtesy of Brian Spilker

**Ben Ayers** (PhD, University of Texas at Austin, 1996) holds the Earl Davis Chair in Taxation and is the dean of the Terry College of Business at the University of Georgia. He received a PhD from the University of Texas at Austin and an MTA and BS from the University of Alabama. Prior to entering the PhD program at the University of Texas, Ben was a tax manager at KPMG in Tampa, Florida, and a contract manager with Complete Health, Inc., in Birmingham, Alabama.



Courtesy Ben Ayers

Ben teaches tax planning and research courses in the undergraduate and graduate programs at the University of Georgia. He is the recipient of 11 teaching awards at the school, college, and university levels, including the Richard B. Russell Undergraduate Teaching Award, the highest teaching honor for University of Georgia junior faculty members. His research interests include the effects of taxation on firm structure, mergers and acquisitions, and capital markets and the effects of accounting information on security returns. He has published articles in journals such as *The Accounting Review*, *Journal of Finance*, *Journal of Accounting and Economics*, *Contemporary Accounting Research*, *Review of Accounting Studies*, *Journal of Law and Economics*, *Journal of the American Taxation Association*, and *National Tax Journal*. Ben was the 1997 recipient of the American Accounting Association's Competitive Manuscript Award, the 2003 and 2008 recipient of the American Taxation Association's Outstanding Manuscript Award, and the 2016 recipient of the American Taxation Association's Ray M. Sommerfeld Outstanding Tax Educator Award.



Courtesy John Barrick

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Courtesy Ed Outslay

**Ed Outslay** (PhD, University of Michigan, 1981) is a professor of accounting and the Deloitte/Michael Licata Endowed Professor of Taxation in the Department of Accounting and Information Systems at Michigan State University, where he has taught since 1981. He received a BA from Furman University in 1974 and an MBA and PhD from the University of Michigan in 1977 and 1981. Ed currently teaches graduate classes in corporate taxation, multiunit enterprises, accounting for income taxes, and international taxation. In February 2003, Ed testified before the Senate Finance Committee on the Joint Committee on Taxation's Report on Enron Corporation. MSU has honored Ed with the Presidential Award for Outstanding Community Service, Distinguished Faculty Award, John D. Withrow Teacher-Scholar Award, Roland H. Salmonson Outstanding Teaching Award, Senior Class Council Distinguished Faculty Award, MSU Teacher-Scholar Award, and MSU's 1st Annual Curricular Service-Learning and Civic Engagement Award in 2008. Ed received the Ray M. Sommerfeld Outstanding Tax Educator Award in 2004 and the Lifetime Service Award in 2013 from the American Taxation Association. He has also received the ATA Outstanding Manuscript Award twice, the ATA/Deloitte Teaching Innovations Award, and the 2004 Distinguished Achievement in Accounting Education Award from the Michigan Association of CPAs. Ed has been recognized for his community service by the Greater Lansing Chapter of the Association of Government Accountants, the City of East Lansing (Crystal Award), and the East Lansing Education Foundation. He received a National Assistant Coach of the Year Award in 2003 from AFLAC and was named an Assistant High School Baseball Coach of the Year in 2002 by the Michigan High School Baseball Coaches Association.

**John Robinson** (PhD, University of Michigan, 1981) is the Patricia '77 and Grant E. Sims '77 Eminent Scholar Chair in Business. Prior to joining the faculty at Texas A&M, John was the C. Aubrey Smith Professor of Accounting at the University of Texas at Austin, Texas, and he taught at the University of Kansas where he was the Arthur Young Faculty Scholar. In 2009–2010 John served as the Academic Fellow in the Division of Corporation Finance at the Securities and Exchange Commission. He has been the recipient of the Henry A. Bubb Award for outstanding teaching, the Texas Blazer's Faculty Excellence Award, and the MPA Council Outstanding Professor Award. John also received the 2012 Outstanding Service Award from the American Taxation Association (ATA). John served as the 2014–2015 president (elect) of the ATA and is the ATA's president for 2015–2016. John conducts research in a broad variety of topics involving financial accounting, mergers and acquisitions, and the influence of taxes on financial structures and performance. His scholarly articles have appeared in *The Accounting Review*, *The Journal of Accounting and Economics*, *Journal of Finance*, *National Tax Journal*, *Journal of Law and Economics*, *Journal of the American Taxation Association*, *The Journal of the American Bar Association*, and *The Journal of Taxation*. John's research was honored with the 2003 and 2008 ATA Outstanding Manuscript Awards. In addition, John was the editor of *The Journal of the American Taxation Association* from 2002–2005. Professor Robinson received his J.D. (*Cum Laude*) from the University of Michigan in 1979, and he earned a PhD in accounting from the University of Michigan in 1981. John teaches courses on individual and corporate taxation and advanced accounting.



Courtesy John Robinson

**Connie Weaver** (PhD, Arizona State University, 1997) is the KPMG Professor of Accounting at Texas A&M University. She received a PhD from Arizona State University, an MPA from the University of Texas at Arlington, and a BS (chemical engineering) from the University of Texas at Austin. Prior to entering the PhD Program, Connie was a tax manager at Ernst & Young in Dallas, Texas, where she became licensed to practice as a CPA. She teaches taxation in the Professional Program in Accounting and the Executive MBA program at Texas A&M University. She has also taught undergraduate and graduate students at the University of Wisconsin–Madison and the University of Texas at Austin. She is the recipient of several teaching awards, including the 2006 American Taxation Association/Deloitte Teaching Innovations award, the David and Denise Baggett Teaching award, and the college level Association of Former Students Distinguished Achievement award recognizing innovation in teaching taxation. Connie's current research interests include the effects of tax and financial incentives on corporate decisions and reporting. She has published articles in journals such as *The Accounting Review*, *Contemporary Accounting Research*, *Journal of the American Taxation Association*, *National Tax Journal*, *Accounting Horizons*, *Journal of Corporate Finance*, and *Tax Notes*. She serves on the editorial board of *Contemporary Accounting Research and Issues in Accounting Education* and was the 1998 recipient of the American Taxation Association's Outstanding Dissertation award.



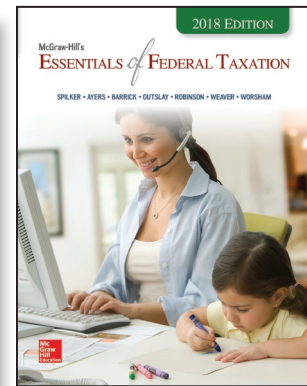
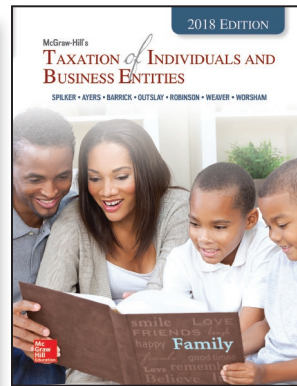
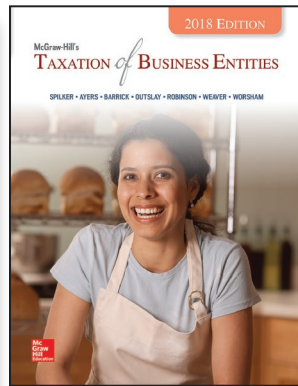
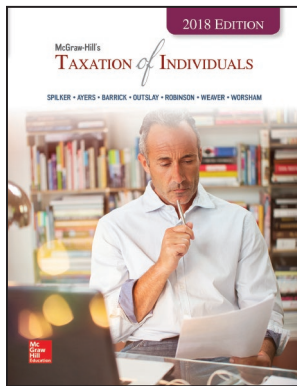
Courtesy Connie Weaver

**Ron Worsham** (PhD, University of Florida, 1994) is an associate professor in the School of Accountancy at Brigham Young University. He teaches taxation in the graduate, undergraduate, MBA, and Executive MBA programs at Brigham Young University. He has also taught as a visiting professor at the University of Chicago. He received both BS and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Arthur Young & Co. (now Ernst & Young) in Dallas, Texas. While in Texas, he became licensed to practice as a CPA. After his professional work experience, Ron earned his PhD at the University of Florida. He has been honored for outstanding innovation in the classroom at Brigham Young University. Ron has published academic research in the areas of taxpayer compliance and professional tax judgment. He has also published legal research in a variety of areas. His work has been published in journals such as *Journal of the American Taxation Association*, *The Journal of International Taxation*, *The Tax Executive*, *Tax Notes*, *The Journal of Accountancy*, and *Practical Tax Strategies*.



Courtesy Ron Worsham

# TEACHING THE CODE IN CONTEXT



*The basic approach to teaching taxation hasn't changed in decades. **Today's student deserves a new approach.** McGraw-Hill's Taxation of Individuals and Business Entities is a bold and innovative series that has been adopted by over 300 schools across the country.*

*McGraw-Hill's Taxation* is designed to provide a unique, innovative, and engaging learning experience for students studying taxation. The breadth of the topical coverage, **the storyline approach to presenting the material**, the emphasis on the tax and nontax consequences of multiple parties involved in transactions, and the integration of financial and tax accounting topics make this book ideal for the modern tax curriculum.

**"This is the best tax book on the market.** It's very readable, student-friendly, and provides great supplements."

– Ann Esarco,  
McHenry County College

"A lot of thought and planning went into the structure and content of the text, and a great product was achieved. **One of the most unique and helpful features is the common storyline** throughout each chapter."

– Raymond J. Shaffer,  
Youngstown State University

Since the first manuscript was written in 2005, 437 professors have contributed 478 book reviews, in addition to 26 focus groups and symposia. Throughout this preface, their comments on the book's organization, pedagogy, and unique features are a testament to the **market-driven nature of *Taxation's* development.**

"The Spilker text, in many ways, is a more logical approach than any other tax textbook. **The text makes great use of the latest learning technologies through Connect and LearnSmart.**"

– Ray Rodriguez, Southern Illinois University–Carbondale

# A MODERN APPROACH FOR TODAY'S STUDENT

**“This text provides a new approach to the teaching of the technical material.** The style of the text material is easier to read and understand. The examples and storyline are interesting and informative. The arrangement makes more sense in the understanding of related topics.”

– Robert Bertucelli, Long Island University–Post

Spilker’s taxation series was built around the following five core precepts:

**1 Storyline Approach:** Each chapter begins with a storyline that introduces a set of characters or a business entity facing specific tax-related situations. Each chapter’s examples are related to the storyline, providing students with opportunities to **learn the code in context**.

**2 Integrated Examples:** In addition to providing examples in-context, we provide **“What if”** scenarios within many examples to **illustrate how variations in the facts might or might not change the answers**.

**“Excellent text; love the story line approach and integrated examples.** It’s easy to read and understand explanations. The language of the text is very clear and straightforward.”

– Sandra Owen, Indiana University–Bloomington

**3 Conversational Writing Style:** The authors took special care to write *McGraw-Hill’s Taxation* in a way that fosters a friendly dialogue between the content and each individual student. The tone of the presentation is intentionally conversational—creating the impression of **speaking with the student**, as opposed to *lecturing to* the student.

**4 Superior Organization of Related Topics:** *McGraw-Hill’s Taxation* provides two alternative topic sequences. In the *McGraw-Hill’s Taxation of Individuals and Business Entities* volume, the individual topics generally follow the tax form sequence, with

**“I believe it breaks down complex topics in a way that’s easy to understand.** Definitely easier than other tax textbooks that I’ve had experience with.”

– Jacob Gatlin, Athens State University

an individual overview chapter and then chapters on income, deductions, investment-related issues, and the tax liability computation. The topics then transition into business-related topics that apply to individuals. This volume then provides a group of specialty chapters dealing with topics of particular interest to individuals (including students), including separate chapters on home ownership, compensation, and retirement savings and deferred compensation. This volume concludes with a chapter covering the taxation of business entities. Alternatively, in the *Essentials of Federal Taxation* volume, the topics follow a more traditional sequence, with topics streamlined (no specialty chapters) and presented in more of a life-cycle approach.

**5 Real-World Focus:** Students learn best when they see how concepts are applied in the real world. For that reason, real-world examples and articles are included in **“Taxes in the Real World”** boxes throughout the book. These vignettes demonstrate current issues in taxation and show the relevance of tax issues in all areas of business.





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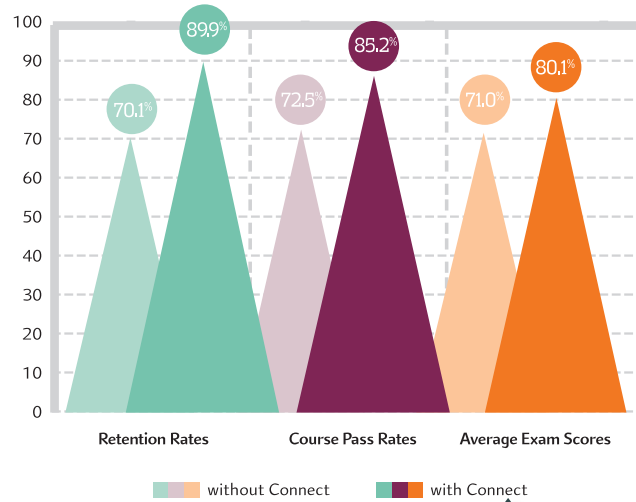
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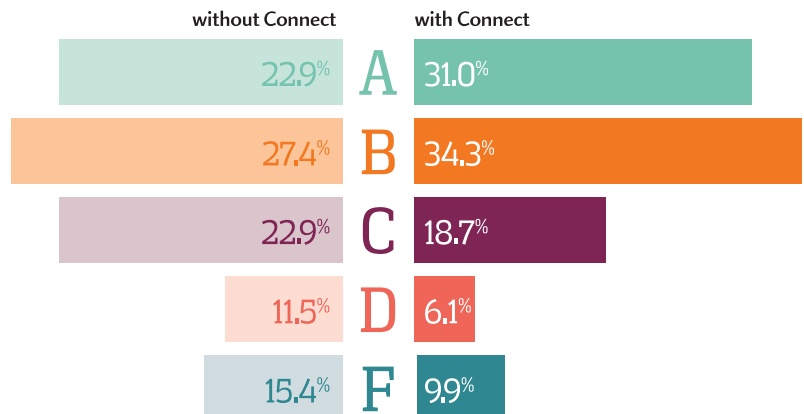
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### Impact on Final Course Grade Distribution



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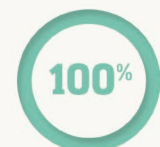
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\*Findings based on a 2015 focus group survey at Pellissippi State Community College administered by McGraw-Hill Education

# ONLINE ASSIGNMENTS

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes a general journal application that looks and feels more like what you would find in a general ledger software package. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.

Through November, Tex has received gross income of \$120,000. For December, Tex is considering whether to accept one more work engagement for the year. Engagement 1 will generate \$7,000 of revenue at a cost of \$4,000, which is deductible for AGI. In contrast, engagement 2 will generate \$7,000 of revenue at a cost of \$3,000, which is deductible as an itemized deduction. Tex files as a single taxpayer. (use the [tax rate schedules](#).)

a. Calculate Tex's taxable income assuming he chooses engagement 1 and assuming he chooses engagement 2. Assume he has no itemized deductions other than those generated by engagement 2.

Description	Engagement 1	Engagement 2
(1) Gross income before new work engagement	\$ 120,000	\$ 120,000
(2) Income from engagement	7,000	7,000
(3) Additional for AGI deduction	(4,000)	
(4) Adjusted gross income	\$ 123,000	\$ 127,000
(5) Greater		
(6) Greater of itemized deductions or standard deduction		

End-of-chapter questions in Connect include:

- Discussion Questions
- Problems
- Comprehensive Problems (**Available in the Auto-graded Tax Forms!**)

## Auto-Graded Tax Forms

The auto-graded **Tax Forms** in Connect provide a much-improved student experience when solving the tax-form based problems. The tax form simulation allows students to apply tax concepts by completing the actual tax forms online with automatic feedback and grading for both students and instructors.

1040 for a couple Married Filing Jointly.

1040 PG1 1040 PG2

**Form 1040** Department of the Treasury—Internal Revenue Service (99) **2016** OMB No. 1545-0074 IRS Use Only - Do not write in this space.

For the year Jan. 1–Dec. 31, 2016, or other tax year beginning , 2016, ending , 2016

See separate instructions

Your first name and initial Last name Your social security number  
 Marc Last name 111-22-3333

If a joint return, spouse's first name and initial Last name Spouse's social security number  
 Michelle Last name 222-33-4444

Home address (number and street). If you have a P.O. box, see instructions. Apt. no. Presidential Election Campaign  
 19 19010 N.W. 135th Street Foreign postal code Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.  
 You Spouse

Head of household (with qualifying person). If the qualifying person is a child but not your dependent, enter this child's name here. \*

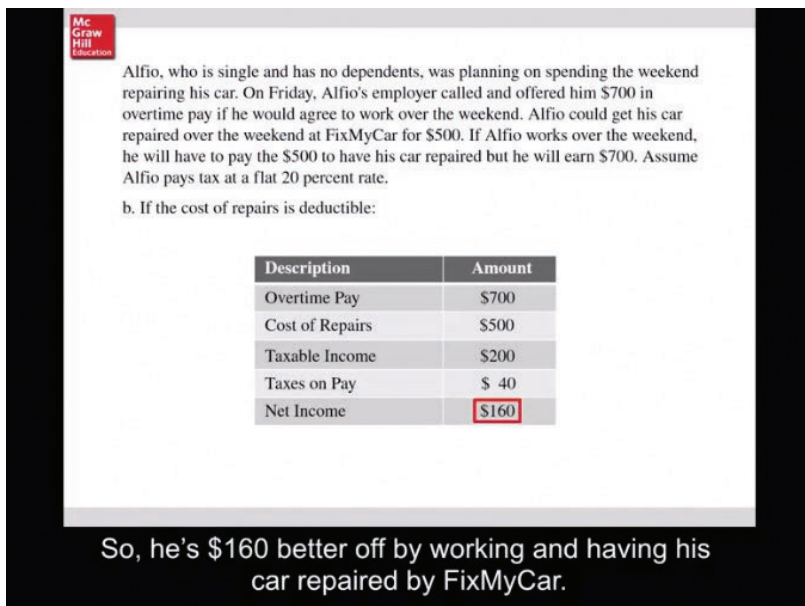
Qualifying widow(er) with dependent child.

3  Married filing separately. Enter spouse's SSN above and full name here. \*

< Prev 1 of 1 Next >

## Guided Examples

The **Guided Examples** in Connect provide a narrated, animated, step-by-step walk-through of select problems similar to those assigned. These short presentations can be turned on or off by instructors and provide reinforcement when students need it most.



Alfio, who is single and has no dependents, was planning on spending the weekend repairing his car. On Friday, Alfio's employer called and offered him \$700 in overtime pay if he would agree to work over the weekend. Alfio could get his car repaired over the weekend at FixMyCar for \$500. If Alfio works over the weekend, he will have to pay the \$500 to have his car repaired but he will earn \$700. Assume Alfio pays tax at a flat 20 percent rate.

b. If the cost of repairs is deductible:

Description	Amount
Overtime Pay	\$700
Cost of Repairs	\$500
Taxable Income	\$200
Taxes on Pay	\$ 40
Net Income	\$160

So, he's \$160 better off by working and having his car repaired by FixMyCar.

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## TaxACT®

**TaxAct** Professional McGraw-Hill's Taxation can be packaged with tax software from TaxACT, one of the leading preparation software companies in the market today. The 2017 edition includes availability of both *Individuals* and *Business Entities* software, including the 1040 Forms and TaxACT Preparer's Business 3-Pack (with Forms 1065, 1120, and 1120S).

## Roger's CPA

**ROGER** | CPA Review McGraw-Hill Education has partnered with Roger CPA Review, a global leader in CPA Exam preparation, to provide students a smooth transition from the accounting classroom to successful completion of the CPA Exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA Exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing the CPA Exam. Accordingly, students using these McGraw-Hill materials will have access to sample CPA Exam Multiple-Choice questions and Task-based Simulations from Roger CPA Review, with expert-written explanations and solutions. All questions are either directly from the AICPA or are modeled on AICPA questions that appear in the exam. Task-based Simulations are delivered via the Roger CPA Review platform, which mirrors the look, feel and functionality of the actual exam. McGraw-Hill Education and Roger CPA Review are dedicated to supporting every accounting student along their journey, ultimately helping them achieve career success in the accounting profession. For more information about the full Roger CPA Review program, exam requirements and exam content, visit [www.rogercpareview.com](http://www.rogercpareview.com).

# A STORYLINE APPROACH THAT WILL RESONATE WITH STUDENTS



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**Storyline Summary**

**Taxpayers:** Courtney Wilson, age 40, Courtney's mother Dorothy "Gram" Weiss, age 70

**Family description:** Courtney is divorced with a son, Deron, age 10, and a daughter, Ellen, age 20. Gram is currently residing with Courtney.

**Location:** Kansas City, Missouri

**Employment status:** Courtney works as an architect for EWD. Gram is retired.

**Filing status:** Courtney is head of household. Gram is single.

**Current situation:** Courtney and Gram have computed their taxable income. Now they are trying to determine their tax liability, tax refund or additional taxes due, and whether they owe any payment-related penalties.

Courtney has already determined her taxable income. Now she's working on computing her tax liability. She knows she owes a significant amount of regular income tax on her employment and business activities. However, she's not sure how to compute the tax on the qualified dividends she received from General Electric. Courtney is worried that she may be subject to the alternative minimum tax this year because she's heard that an increasing number of taxpayers in her income range must pay the tax. Finally, Courtney knows she owes some self-employment taxes on her business income. Courtney would like to determine whether she is eligible to claim any tax credits such as the child tax credit for her two children and education credits because she paid for a portion of her daughter Ellen's tuition at the University of Missouri-Kansas City this year. Courtney is hoping that she has paid enough in taxes

during the year to avoid underpayment penalties. She's planning on filing her tax return and paying her taxes on time.

Gram's tax situation is much more straightforward. She needs to determine the regular income tax on her taxable income. Her income is so low she knows she need not worry about the alternative minimum tax, and she believes she doesn't owe any self-employment tax. Gram didn't prepay any taxes this year, so she is concerned that she might be required to pay an underpayment penalty. She also expects to file her tax return and pay her taxes by the looming due date.

Each chapter begins with a storyline that introduces a set of characters facing specific tax-related situations. This revolutionary approach to teaching tax emphasizes real people facing real tax dilemmas. Students learn to apply practical tax information to specific business and personal situations. As their situations evolve, the characters are brought further to life.

“The text provides very useful tools that students can read and understand, making it easier to **break the myth that ‘tax is hard.’**”

– Daniel Hoops, Walsh College

“**I absolutely love this textbook.** This textbook makes my job of teaching so much easier.”

– Chuck Pier, Angelo State University

## Examples

Examples are the cornerstone of any textbook covering taxation. For this reason, *McGraw-Hill's Taxation* authors took special care to create clear and helpful examples that relate to the storyline of the chapter. Students learn to refer to the facts presented in the storyline and apply them to other scenarios—in this way, they build a greater base of knowledge through application. Many examples also include “What if?” scenarios that add more complexity to the example or explore related tax concepts.

**Example 2-1**

Bill and Mercedes file their 2013 federal tax return on September 6, 2014, after receiving an automatic extension to file their return by October 15, 2014. In 2017, the IRS selects their 2013 tax return for audit. When does the statute of limitations end for Bill and Mercedes's 2013 tax return?

**Answer:** Assuming the six-year and “unlimited” statute of limitation rules do not apply, the statute of limitations ends on September 6, 2017 (three years after the later of the actual filing date and the original due date).

**What if:** When would the statute of limitations end for Bill and Mercedes for their 2013 tax return if the couple filed the return on March 22, 2014 (before the original due date of April 15, 2014)?

**Answer:** In this scenario the statute of limitations would end on April 15, 2017, because the later of the actual filing date and the original due date is April 15, 2014.

“The **case study approach is excellent** as you follow the taxpayers through the chapters.”

– Irwin Uhr, Hunter College

# THE PEDAGOGY YOUR STUDENTS NEED TO PUT THE CODE IN CONTEXT

## Taxes in the Real World

Taxes in the Real World are short boxes used throughout the book to demonstrate the real-world use of tax concepts. Current articles on tax issues, the real-world application of chapter-specific tax rules, and short vignettes on popular news about tax are some of the issues covered in Taxes in the Real World boxes.

“The Spilker text makes tax easy for students to understand. **It integrates great real-world examples so students can see how topics will be applied in practice.** The integration of the tax form and exhibits of the tax forms in the text are outstanding.”

– Kristen Bigbee, Texas Tech University

**TAXES IN THE REAL WORLD** Republicans vs. Democrats

**Tax Policy: Republicans versus Democrats**

Oliver Wendell Holmes said “taxes are the price we pay to live in a civilized society.” Both Democrats and Republicans desire the same things: a civilized society and a healthy economy. However, neither party can agree on what defines a civilized society or which path best leads to a healthy economy. The U.S. national debt is \$20 trillion dollars and growing, yet the only thing we might agree on is that something has gone wrong. Regardless of which party or candidate you support, each party’s agenda will affect your income and taxes in various ways.

To explore the divide, let’s examine excerpts from each party’s National Platform from our most recent presidential election (2016).

**Republicans**

“We are the party of a growing economy that gives everyone a chance in life, an opportunity to learn, work, and realize the prosperity freedom makes possible.”

“Government cannot create prosperity, though government can limit or destroy it. Prosperity is the product of self-discipline, enterprise, saving and investment by individuals, but it is not an end in itself. Prosperity provides the means by which citizens and their families can maintain their independence from government, raise their children by their own values, practice their faith, and build communities of cooperation and mutual respect.”

“Republicans consider the establishment of a pro-growth tax code a moral imperative. More than any other public policy, the way gov-

**Democrats**

“At a time of massive income and wealth inequality, we believe the wealthiest Americans and largest corporations must pay their fair share of taxes. Democrats will claw back tax breaks for companies that ship jobs overseas, eliminate tax breaks for big oil and gas companies, and crack down on inversions and other methods companies use to dodge their tax responsibilities. We will then use the revenue raised from fixing the corporate tax code to reinvest in rebuilding America and ensuring economic growth that will lead to millions of good-paying jobs.”

“We will ensure those at the top contribute to our country’s future by establishing a multimillionaire surtax to ensure millionaires and billionaires pay their fair share. In addition, we will shut down the “private tax system” for those at the top, immediately close egregious loopholes like those enjoyed by hedge fund managers, restore fair taxation on multimillion dollar estates, and ensure millionaires can no longer pay a lower rate than their secretaries. At a time of near-record corporate profits, slow wage growth, and rising costs, we need to offer tax relief to middle-class families—not those at the top.”

“We will offer tax relief to hard working, middle-class families for the cost squeeze they have faced for years from rising health care, childcare, education, and other expenses.” <https://www.democrats.org/party-platform#preamble>

**Conclusion**

Each party fundamentally believes the government should create/maintain cities and states that

## The Key Facts

The Key Facts provide quick synopses of the critical pieces of information presented throughout each chapter.

The **tax base** defines what is actually taxed and is usually expressed in monetary terms, whereas the **tax rate** determines the level of taxes imposed on the tax base and is usually expressed as a percentage. For example, a sales tax rate of 6 percent on a purchase of \$30 yields a tax of \$1.80 ( $\$1.80 = \$30 \times .06$ ).

Federal, state, and local jurisdictions use a large variety of tax bases to collect tax. Some common tax bases (and related taxes) include taxable income (federal and state income taxes), purchases (sales tax), real estate values (real estate tax), and personal property values (personal property tax).

Different portions of a tax base may be taxed at different rates. A single tax applied to an entire base constitutes a **flat tax**. In the case of **graduated taxes**, the base is divided

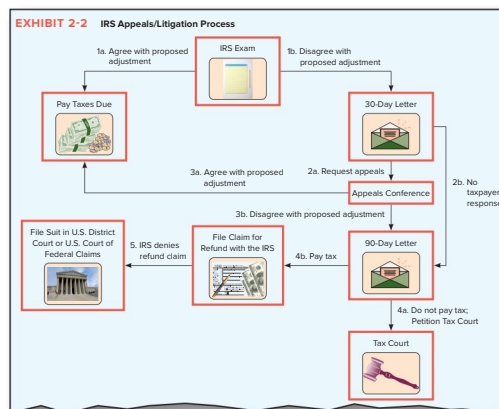
### THE KEY FACTS

#### How to Calculate a Tax

- Tax = Tax base  $\times$  Tax rate
- The tax base defines what is actually taxed and is usually expressed in monetary terms.
- The tax rate determines the level of taxes imposed

## Exhibits

Today’s students are visual learners, and *McGraw-Hill’s Taxation* delivers by making appropriate use of charts, diagrams, and tabular demonstrations of key material.



“A good textbook that uses **great examples throughout the chapters** to give a student an understanding of the tax theory and how it applies to the taxpayers.”

– Jennifer Wright, Drexel University

“Spilker’s use of examples immediately following the concept is a **great way to reinforce the concepts.**”

– Karen Wisniewski, County College of Morris

# PRACTICE MAKES PERFECT WITH A

## Summary

- LO 2-1** Identify the filing requirements for income tax returns and the statute of limitations for assessment.
- All corporations must file a tax return annually regardless of their taxable income. Estates and trusts are required to file annual income tax returns if their gross income exceeds \$600. The filing requirements for individual taxpayers depend on the taxpayer's filing status, age, and gross income.
  - Individual and C corporation tax returns (except for C corporations with a June 30 year-end) are due on the fifteenth day of the fourth month following year-end. For C corporations with a June 30 year-end, partnerships and S corporations, tax returns must be filed by the fifteenth day of the third month following the entity's fiscal year-end. Any taxpayer unable to file a tax return by the original due date can request an extension to file.
  - For both amended tax returns filed by a taxpayer and proposed tax assessments by the IRS, the statute of limitations generally ends three years from the *later* of (1) the date the tax return was actually filed or (2) the tax return's original due date.
- LO 2-2** Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.

## Summary

A unique feature of *McGraw-Hill's Taxation* is the end-of-chapter summary organized around learning objectives. Each objective has a brief, bullet-point summary that covers the major topics and concepts for that chapter, including references to critical exhibits and examples. All end-of-chapter material is tied to learning objectives.

## Learning Objectives

Upon completing this chapter, you should be able to:

- LO 2-1** Identify the filing requirements for income tax returns and the statute of limitations for assessment.
- LO 2-2** Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.
- LO 2-3** Evaluate the relative weights of the various tax law sources.
- LO 2-4** Describe the legislative process as it pertains to taxation.
- LO 2-5** Perform the basic steps in tax research and evaluate various tax law sources when faced with ambiguous statutes.
- LO 2-6** Describe tax professional responsibilities in providing tax advice.
- LO 2-7** Identify taxpayer and tax professional penalties.

**“You can tell the authors of this textbook are still in the classroom and responsible for the day-to-day education of accounting students.**

Examples are representative of the end-of-chapter problems, and the end-of-chapter summary is an excellent study tool.”

– Debra Petrizzo, Franklin University

## DISCUSSION QUESTIONS

Discussion Questions are available in Connect®.



- LO 2-1** 1. Name three factors that determine whether a taxpayer is required to file a tax return.
- LO 2-1** 2. Benita is concerned that she will not be able to complete her tax return by April 15. Can she request an extension to file her return? By what date must she do so? Assuming she requests an extension, what is the latest date that she could file her return this year without penalty?
- LO 2-1** 3. Agua Linda Inc. is a calendar-year corporation. What is the original due date for the corporate tax return? What happens if the original due date falls on a Saturday?

## Discussion Questions

Discussion questions, now available in *Connect*, are provided for each of the major concepts in each chapter, providing students with an opportunity to review key parts of the chapter and answer evocative questions about what they have learned.

“This is a very readable text. **Students will understand it on their own**, generally, freeing more class time for application, practice, and student questions.”

– Valrie Chambers,  
Texas A&M University–Corpus Christi

# WIDE VARIETY OF ASSIGNMENT MATERIAL

**Problems** Problems are designed to test the comprehension of more complex topics. Each problem at the end of the chapter is tied to one of that chapter’s learning objectives, with multiple problems for critical topics.

**PROBLEMS**  
Select problems are available in Connect®.

**LO 2-1** 43. Ahmed does not have enough cash on hand to pay his taxes. He was excited to hear that he can request an extension to file his tax return. Does this solve his problem? What are the ramifications if he doesn't pay his tax liability by April 15?

**LO 2-1** 44. Molto Stancha Corporation had zero earnings this fiscal year; in fact, it lost money. Must the corporation file a tax return?

**Tax Forms Problems** Tax forms problems are a set of requirements included in the end-of-chapter material of the 2018 edition. These problems require students to complete a tax form (or part of a tax form), providing students with valuable experience and practice with filling out these forms. These requirements—and their relevant forms—are also included in *Connect*. Each tax form problem includes an icon to differentiate it from regular problems.

**tax forms** 70. Shauna Coleman is single. She is employed as an architectural designer for Streamline Design (SD). Shauna wanted to determine her taxable income for this year. She correctly calculated her AGI. However, she wasn't sure how to compute the rest of her taxable income. She provided the following information with hopes that you could use it to determine her taxable income.

a) Shauna paid \$4,680 for medical expenses for care from a broken ankle. Also, Shauna's boyfriend, Blake, drove Shauna (in her car) a total of 115 miles to the doctor's office so she could receive care for her broken ankle.

b) Shauna paid a total of \$3,400 in health insurance premiums during the year (not through an exchange). SD did not reimburse any of this expense. Besides the

**Research Problems** Research problems are special problems throughout the end-of-chapter assignment material. These require students to do both basic and more complex research on topics outside of the scope of the book. Each research problem includes an icon to differentiate it from regular problems.

**research** 72. Matt and Lori recently were divorced. Although grief stricken, Matt was at least partially comforted by his monthly receipt of \$10,000 alimony. He was particularly excited to learn from his friend, Denzel, that the alimony was not taxable. Use an available tax service to determine if Denzel is correct. Would your answer change if Matt and Lori continued to live together?

**research** 73. Shaun is a huge college football fan. In the past, he has always bought football tickets on the street from ticket scalpers. This year, he decided to join the university's ticket program, which requires a \$2,000 contribution to the university

“The textbook is comprehensive, uses an integrated approach to taxation, contains clear illustrations and examples in each chapter, and has a **wealth of end-of-chapter assignment material.**”

– James P. Trebby, Marquette University

**Planning Problems** Planning problems are another unique set of problems included in the end-of-chapter assignment material. These require students to test their tax planning skills after covering the chapter topics. Each planning problem includes an icon to differentiate it from regular problems.

**LO 2-2** 56. Jackie has a corporate client that has recently received a 30-day notice from the IRS with a \$100,000 tax assessment. Her client is considering requesting an appeals conference to contest the assessment. What factors should Jackie advise her client to consider before requesting an appeals conference?

**LO 2-2** 57. The IRS recently completed an audit of Shea's tax return and assessed \$15,000 additional tax. Shea requested an appeals conference but was unable to settle the case at the conference. She is contemplating which trial court to choose to hear her case. Provide a recommendation based on the following alternative facts:  
a) Shea resides in the 2nd Circuit, and the 2nd Circuit has recently ruled against the

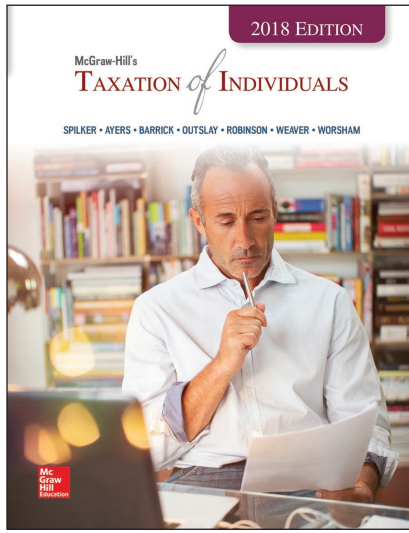
**Comprehensive and Tax Return Problems** Comprehensive and tax return problems address multiple concepts in a single problem. Comprehensive problems are ideal for cumulative topics; for this reason, they are located at the end of all chapters. In the end-of-book Appendix C, we include tax return problems that cover multiple chapters. **Additional tax return problems are also available in the *Connect Library*.** These problems range from simple to complex and cover individual taxation, corporate taxation, partnership taxation, and S corporation taxation.

**COMPREHENSIVE PROBLEMS**  
Select problems are available in Connect®.

**tax forms** 53. Marc and Michelle are married and earned salaries this year of \$64,000 and \$12,000, respectively. In addition to their salaries, they received interest of \$350 from municipal bonds and \$500 from corporate bonds. Marc and Michelle also paid \$2,500 of qualifying moving expenses, and Marc paid alimony to a prior spouse in the amount of \$1,500. Marc and Michelle have a 10-year-old son, Matthew, who lived with them throughout the entire year. Thus, Marc and Michelle are allowed to claim a \$1,000 child tax credit for Matthew. Marc and Michelle paid \$6,000 of expenditures that qualify as itemized deductions and they had a total of \$5,500 in fed-



# Four Volumes to Fit



*McGraw-Hill's Taxation of Individuals* is organized to emphasize topics that are most important to undergraduates taking their first tax course. The first three chapters provide an introduction to taxation and then carefully guide students through tax research and tax planning. Part II discusses the fundamental elements of individual income tax, starting with the tax formula in Chapter 4 and then proceeding to more discussion on income, deductions, investments, and computing tax liabilities in Chapters 5–8. Part III then discusses tax issues associated with business-related activities. Specifically, this part addresses business income and deductions, accounting methods, and tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). Part IV is unique among tax textbooks; this section combines related tax issues for compensation, retirement savings, and home ownership.

#### Part I: Introduction to Taxation

1. An Introduction to Tax
2. Tax Compliance, the IRS, and Tax Authorities
3. Tax Planning Strategies and Related Limitations

#### Part II: Basic Individual Taxation

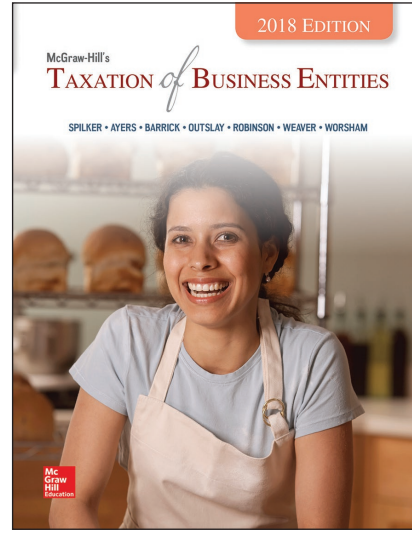
4. Individual Income Tax Overview, Exemptions and Filing Status
5. Gross Income and Exclusions
6. Individual Deductions
7. Investments
8. Individual Income Tax Computation and Tax Credits

#### Part III: Business-Related Transactions

9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

#### Part IV: Specialized Topics

12. Compensation
13. Retirement Savings and Deferred Compensation
14. Tax Consequences of Home Ownership



*McGraw-Hill's Taxation of Business Entities* begins with the process for determining gross income and deductions for businesses, and the tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). Part II provides a comprehensive overview of entities and the formation, reorganization, and liquidation of corporations. Unique to this series is a complete chapter on accounting for income taxes, which provides a primer on the basics of calculating the income tax provision. Included in the narrative is a discussion of temporary and permanent differences and their impact on a company's book "effective tax rate." Part III provides a detailed discussion of partnerships and S corporations. The last part of the book covers state and local taxation, multinational taxation, and transfer taxes and wealth planning.

#### Part I: Business-Related Transactions

1. Business Income, Deductions, and Accounting Methods
2. Property Acquisition and Cost Recovery
3. Property Dispositions

#### Part II: Entity Overview and Taxation of C Corporations

4. Entities Overview
5. Corporate Operations
6. Accounting for Income Taxes
7. Corporate Taxation: Nonliquidating Distributions
8. Corporate Formation, Reorganization, and Liquidation

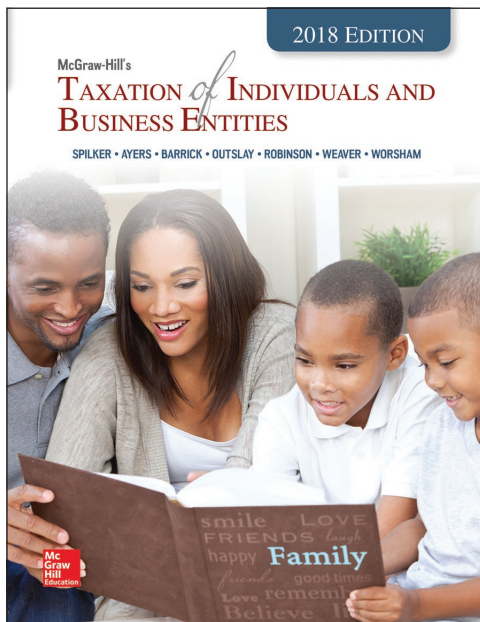
#### Part III: Taxation of Flow-Through Entities

9. Forming and Operating Partnerships
10. Dispositions of Partnership Interests and Partnership Distributions
11. S Corporations

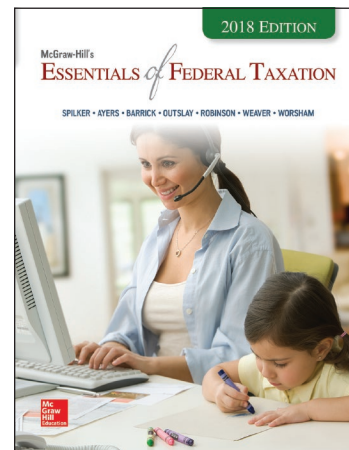
#### Part IV: Multijurisdictional Taxation and Transfer Taxes

12. State and Local Taxes
13. The U.S. Taxation of Multinational Transactions
14. Transfer Taxes and Wealth Planning

# Four Course Approaches



*McGraw-Hill's Taxation of Individuals and Business Entities* covers all chapters included in the two split volumes in one convenient volume. See Table of Contents.



*McGraw-Hill's Essentials of Federal Taxation* is designed for a one-semester course, covering the basics of taxation of individuals and business entities. To facilitate a one-semester course, *McGraw-Hill's Essentials of Federal Taxation* folds the key topics from the investments, compensation, retirement savings, and home ownership chapters in *Taxation of Individuals* into three individual taxation chapters that discuss gross income and exclusions, *for* AGI deductions, and *from* AGI deductions, respectively. The essentials volume also includes a two-chapter C corporation sequence that uses a life-cycle approach covering corporate formations and then corporate operations in the first chapter and nonliquidating and liquidating corporate distributions in the second chapter. This volume is perfect for those teaching a one-semester course and for those who struggle to get through the 25-chapter comprehensive volume.

#### Part I: Introduction to Taxation

1. An Introduction to Tax
2. Tax Compliance, the IRS, and Tax Authorities
3. Tax Planning Strategies and Related Limitations

#### Part II: Individual Taxation

4. Individual Income Tax Overview, Exemptions, and Filing Status
5. Gross Income and Exclusions
6. Individual *For* AGI Deductions
7. Individual *From* AGI Deductions
8. Individual Income Tax Computation and Tax Credits

#### Part III: Business-Related Transactions

9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

#### Part IV: Entity Overview and Taxation of C Corporations

12. Entities Overview
13. Corporate Formations and Operations
14. Corporate Nonliquidating and Liquidating Distributions

#### Part V: Taxation of Flow-Through Entities

15. Forming and Operating Partnerships
16. Dispositions of Partnership Interests and Partnership Distributions
17. S Corporations

# SUPPLEMENTS FOR INSTRUCTORS

## Assurance of Learning Ready

Many educational institutions today are focused on the notion of *assurance of learning*, an important element of many accreditation standards. *McGraw-Hill's Taxation* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful, solution.

Each chapter in the book begins with a list of numbered learning objectives, which appear throughout the chapter as well as in the end-of-chapter assignments. Every test bank question for *McGraw-Hill's Taxation* maps to a specific chapter learning objective in the textbook. Each test bank question also identifies topic area, level of difficulty, Bloom's Taxonomy level, and AICPA and AACSB skill area.

## AACSB Statement

McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *McGraw-Hill's Taxation* recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the text and the test bank to the general knowledge and skill guidelines in the revised AACSB standards.

The statements contained in *McGraw-Hill's Taxation* are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *McGraw-Hill's Taxation* and the teaching package make no claim of any specific AACSB qualification or evaluation, we have, within the text and test bank, labeled selected questions according to the eight general knowledge and skill areas.

## TestGen

TestGen is a complete, state-of-the-art test generator and editing application software that allows instructors to quickly and easily select test items from McGraw Hill's TestGen testbank content and to organize, edit, and customize the questions and answers to rapidly generate paper tests. Questions can include stylized text, symbols, graphics, and equations that are inserted directly into questions using built-in mathematical templates. With both quick-and-simple test creation and flexible and robust editing tools, TestGen is a test generator system for today's educators.

## A HEARTFELT THANKS TO THE MANY COLLEAGUES WHO SHAPED THIS BOOK

The version of the book you are reading would not be the same book without the valuable suggestions, keen insights, and constructive criticisms of the list of reviewers below. Each professor listed here contributed in substantive ways to the organization of chapters, coverage of topics, and the use of pedagogy. We are grateful to them for taking the time to read chapters or attend reviewer conferences, focus groups, and symposia in support of the development for the book:

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# Changes in *Taxation of Individuals and Business Entities*, 2018 Edition

For the 2018 edition of McGraw-Hill's *Taxation of Individuals and Business Entities*, many changes were made in response to feedback from reviewers and focus group participants:

- All **tax forms** have been **updated for the latest available tax form as of January 2017**. In addition, **chapter content** throughout the text has been **updated to reflect tax law changes through January 2017**.

Other notable changes in the 2018 edition include:

## Chapter 1

- Updated tax rates for 2017.
- Updated Social Security Wage base for 2017.
- Updated Unified Tax Credit for 2017.
- Updated Taxes in the Real World: Republicans vs. Democrats.
- Updated Taxes in the Real World: Affordable Care Act amount for 2017.
- Updated Taxes in the Real World: National Debt for current debt limit.
- Updated Exhibit 1-4 for 2015 Federal revenues by source from Treasury.
- Updated Exhibit 1-5 for 2015 State revenues by source from U.S. Census.

## Chapter 2

- Updated gross income thresholds by filing status for 2017.
- Revised discussion of primary authorities and IRS Publications and tax forms.
- Updated penalty amounts for failure to file a tax return and willful understatement of tax.

## Chapter 3

- Updated tax rates for 2017.
- Updated Exhibit 3-3 for new tax rates.

## Chapter 4

- Updated personal exemption amounts for 2017.
- Updated standard deduction amounts for 2017.
- Updated tax rates for 2017.
- Updated tax forms from 2015 to 2016 forms.
- Clarified discussion of who is a qualifying person for head of household filing status for divorced parents by editing footnote to Exhibit 4-9 and Appendix B.

## Chapter 5

- Updated for 2017 amounts for Flexible Spending Account contributions.
- Added discussion of new exclusion for awards and prize money for Team USA Olympic and Paralympic athletes.
- Revised discussion of foreign-earned income exclusion and updated for 2017 exclusion amounts.
- Updated for annual gift tax exclusion and unified tax credit for 2017.
- Updated U.S. Series EE Bond interest income exclusion for 2017.
- Updated tax forms from 2015 to 2016 forms.

## Chapter 6

- Updated mileage rate for 2017 moving expense deduction.
- Updated phase-out for interest on qualified education loan for 2017.
- Updated pending expiration date for qualified education expense deduction.
- Updated mileage rate for medical expense itemized deduction for 2017.
- Updated standard business mileage rate for 2017.
- Updated thresholds for the itemized deduction and personal exemption phase-outs for 2017.
- Updated standard deduction and personal exemption amounts for 2017.
- Updated tax forms from 2015 to 2016 forms.

## Chapter 7

- Updated tax rates for 2017.
- Updated tax forms from 2015 to 2016 forms.

## Chapter 8

- Updated tax rate schedules for 2017.
- Updated AMT discussion for medical expense adjustment.
- Updated AMT exemption and AMT tax rate schedule for 2017.
- Revised Self-Employment Tax discussion.
- Updated Social Security Tax wage base and Self-Employment Tax base for 2017.
- Updated Lifetime Learning Credit phase-out for 2017.
- Updated Earned Income Credit amounts for 2017.
- Updated tax forms from 2015 to 2016 forms.

## Chapter 9

- Updated standard business mileage rate for 2017.
- Updated tax forms from 2015 to 2016.

## Chapter 10

- Updated tax rates for 2017.
- Updated tax forms from 2015 to 2016 forms.
- Updated §179 amounts for inflation adjustments.
- Updated examples and end of chapter problems for 2017 §179 amounts.
- Clarified luxury car (§280F) depreciation limit calculation.

## Chapter 11

- Updated tax rates for 2017.
- Updated tax forms from 2015 to 2016 forms.
- Clarified related-party holding period rules.
- Clarified like-kind exchange debt offset rules.

## Chapter 12

- Updated qualified transportation fringe amounts for 2017.
- Updated tax forms from 2015 to 2016.
- Updated Exhibits 12-2 through 12-4 and 12-8 for 2016 proxy statements.
- Updated Taxes in the Real World for 2016 proxy statement information.

## Chapter 13

- Increased salary for Dave Allan in storyline.
- Updated inflation adjusted limits for defined benefit plans, defined contribution plans, and individually managed plans.
- Updated Exhibit 13-6 to reflect most recent proxy statement for Coca-Cola Company.
- Updated AGI phase-out thresholds for deductible contributions to traditional IRAs and contributions to Roth IRAs.
- Updated Saver's credit information.
- Clarified language in Discussion Question 33.
- Clarified language in Problem 50 part e.

## Chapter 14

- Clarified that the terms “dwelling unit” and “home” are used interchangeably.
- Updated discussion of government's list of expenditures from 2015–2024 to 2016–2025.
- Updated URL in footnote 4.
- Inserted new footnote 7 indicating that the IRS recently ruled that a couple's need to move because of a birth of a second child was an unforeseen circumstance (LTR 201628002).

- In the discussion about combined limit for qualifying debt, the use of average method and chronological method of determining deductible interest expense has been changed to the “simple” and “exact” methods of determining deductible interest expense, respectively. This is consistent with the terminology provided in the regulations.
- Updated Taxes in the Real World (“Double Take on Home-Related Interest Deductions”) to reflect the fact that the IRS has now acquiesced to the *Voss* 12<sup>th</sup> Circuit case. Consequently, the finding in *Voss* should apply to taxpayers anywhere in the country.
- Updated Example 14-14 dealing with the IRS method versus Tax Court method of allocating rent expense to reflect non-leap year in 2017.
- Clarified discussion of losses from nonresidential rental property.
- Updated tax forms from 2015 to 2016.
- Clarified that taxpayer's personal use of an office disqualifies the taxpayer from claiming a home office deduction in Example 14-17.
- Updated settlement statement in Appendix A.
- Clarified language in Discussion Question 2.

## Chapter 15

- In Exhibit 15-3, changed “Nontaxable” to “Tax deferred” when discussing the tax consequences of contributing appreciated property to the various entities.
- Updated URL in Taxes in the Real World titled Comparing Entities Selected.
- Shortened the fact pattern in problem 73. The relevant facts have not changed.

## Chapter 16

- Updated the discussion on stock option compensation.
- Revised Taxes in the Real World for Facebook stock options.
- Updated the compliance section for new year-end filing.

## Chapter 17

- Updated the Taxes in the Real World saga of Weatherford.
- Updated the material to incorporate the new FASB rules on disclosures of deferred tax assets and liabilities.
- Updated the Microsoft uncertain tax benefit footnote disclosure.
- Updated the FASB's projects involving accounting for income taxes.

## Chapter 18

- Edited key facts summary of earnings and profits (E&P) calculation.
- Edited discussion of effect of distributions on E&P.

- Streamlined and edited discussion of effect of noncash property distributions and the effect of these distributions on taxable income and E&P.
- Clarified examples of effect of distributions on E&P.

#### **Chapter 19**

- Clarified facts in Example 19-25.
- Clarified facts in Comprehensive Problems 19-58 and 19-59.

#### **Chapter 20**

- Added new Taxes in the Real World box in passive losses discussion.
- Clarified the definition of material participant for passive loss purposes.
- Clarified new partnership tax return due date.
- Clarified the connection between 704(b) capital accounts and partnership agreements.

#### **Chapter 21**

- Clarified the explanation of disproportionate distributions to be more consistent with the §751(b) proposed regulations.
- Clarified the problem illustrating disproportionate distributions to be more consistent with the §751(b) proposed regulations.
- Clarified the explanation of special basis adjustments applicable to distributions.

#### **Chapter 22**

- Revised discussion of the family member rules for purposes of the S corporation qualification requirements.
- Revised discussion of the excess passive investment income rules.
- Updated Social Security Tax wage base for 2017.
- Updated tax forms from 2015 to 2016 forms.

#### **Chapter 23**

- Updated Exhibit 23-4.
- Updated Taxes in the Real World for sourcing receipts.
- Updated Taxes in the Real World for apportionment.

#### **Chapter 24**

- Updated the discussion on the OECD base erosion and profit-shifting project.
- Updated the proposals for international tax reform.
- Updated the discussion on inversions.

#### **Chapter 25**

- Clarified computation for unified credit.
- Updated exemption equivalent for inflation adjustment made for 2016.
- Revised terminology used for unified credit, which is now referred to as the “applicable credit.”
- Updated tax forms for 2016.
- Revised discount factors for changes in the regulations.
- Revised ethics problem to focus on what constitutes an intent to make a gift.

## As We Go to Press

The 2018 Edition is current through February 21, 2017. You can visit the *Connect Library* for updates that occur after this date.



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