

PRINCIPLES OF TAXATION

for Business and Investment Planning

2016

Sally M. Jones
Shelley C. Rhoades-Catanach

Principles of Taxation

Principles of Taxation

for Business and Investment Planning 2016 Edition

Sally M. Jones

*Professor Emeritus of Accounting
McIntire School of Commerce
University of Virginia*

Shelley C. Rhoades-Catanach

*Associate Professor of Accountancy
School of Business
Villanova University*





PRINCIPLES OF TAXATION FOR BUSINESS AND INVESTMENT PLANNING: 2016 EDITION

Published by McGraw-Hill Education, 2 Penn Plaza, New York, NY 10121. Copyright © 2016 by McGraw-Hill Education. All rights reserved. Printed in the United States of America. Previous editions © 2015, 2013, and 2011. No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written consent of McGraw-Hill Education, including, but not limited to, in any network or other electronic storage or transmission, or broadcast for distance learning.

Some ancillaries, including electronic and print components, may not be available to customers outside the United States.

This book is printed on acid-free paper.

1 2 3 4 5 6 7 8 9 0 QVS/QVS 1 0 9 8 7 6 5 4

ISBN 978-1-259-54925-0

MHID 1-259-54925-9

ISSN 1099-5587

Senior Vice President, Products & Markets: *Kurt L. Strand*
Vice President, General Manager, Products & Markets: *Marty Lange*
Vice President, Content Design & Delivery: *Kimberly Meriwether David*
Managing Director: *Tim Vertovec*
Marketing Director: *Brad Parkins*
Senior Brand Manager: *Kathleen Klehr*
Director, Product Development: *Rose Koos*
Director of Digital Content: *Patricia Plumb*
Lead Product Developer: *Ann Torbert*
Product Developer: *Danielle Andries*
Digital Product Developer: *Kevin Moran*
Digital Product Analyst: *Xin Lin*
Director, Content Design & Delivery: *Linda Avenarius*
Program Manager: *Daryl Horrocks*
Content Project Managers: *Dana M. Pauley/Angela Norris*
Technology Specialist: *Sandra Schnee*
Buyer: *Laura M. Fuller*
Design: *Srdjan Savanovic*
Compositor: *MPS Limited*
Printer: *Quad/Graphics*

All credits appearing on page or at the end of the book are considered to be an extension of the copyright page.

The Internet addresses listed in the text were accurate at the time of publication. The inclusion of a website does not indicate an endorsement by the authors or McGraw-Hill Education, and McGraw-Hill Education does not guarantee the accuracy of the information presented at these sites.

To Zane and Tony

About the Authors



Sally M. Jones is professor emeritus of accounting at the McIntire School of Commerce, University of Virginia, where she continues to teach graduate tax courses. Before joining the Virginia faculty in 1992, Professor Jones spent 14 years on the faculty of the Graduate School of Business, University of Texas at Austin. She received her undergraduate degree from Augusta College, her MPA from the University of Texas, and her PhD from the University of Houston. She is also a CPA. Professor Jones was the first editor of *Advances in Taxation* (JAI Press) and the *PriceWaterhouse Case Studies in Taxation*. She has published numerous articles in the *Journal of Taxation*, *The Tax Adviser*, and the *Journal of the American Taxation Association*. Professor Jones is a frequent speaker at tax conferences and symposia, a past president of the American Taxation Association, and the 2000 recipient of the Ray M. Sommerfeld Outstanding Tax Educator Award.



Shelley Rhoades-Catanach is an associate professor of accountancy at Villanova University and a CPA. She teaches a variety of tax courses in Villanova's undergraduate, masters of accounting, and graduate tax programs. Before joining the Villanova faculty in 1998, Professor Rhoades-Catanach spent four years on the faculty of Washington University in St. Louis. She has also served as a visiting faculty member at the Darden Graduate School, University of Virginia, and at INSEAD, an international MBA program in Fontainebleau, France. She received her undergraduate degree in accounting from the University of Nebraska at Lincoln and her PhD from the University of Texas at Austin. Professor Rhoades-Catanach has published articles in numerous journals, including the *Journal of the American Taxation Association*, the *Accounting Review*, *Issues in Accounting Education*, the *Journal of Accounting Education*, and *Review of Accounting Studies*. She has served as president, vice president, and trustee of the American Taxation Association and on the editorial boards of the *Journal of the American Taxation Association* and the *Journal of International Accounting, Auditing and Taxation*. She currently serves as co-editor of the *Journal of International Accounting, Auditing, and Taxation*. Professor Rhoades-Catanach is the 2010 recipient of the Ray M. Sommerfeld Outstanding Tax Educator Award.

A Note from the Authors

Principles of Taxation for Business and Investment Planning is a unique approach to the subject of taxation. This text is designed for use in introductory tax courses included in either undergraduate or graduate business programs. Its objective is to teach students to recognize the major tax issues inherent in business and financial transactions. The text focuses on fundamental concepts, the mastery of which provides a permanent frame of reference for future study of advanced tax topics. Unlike traditional introductory texts, *Principles of Taxation for Business and Investment Planning* downplays the technical detail that makes the study of taxation such a nightmare for business students. Traditional texts are heavily compliance oriented and convince many students that the tax law is too complex and specialized to be relevant to their future careers. This text attempts to do just the opposite by convincing students that an understanding of taxation is not only relevant but critical to their success in the business world.

Principles of Taxation for Business and Investment Planning has its origin in the 1989 White Paper titled *Perspectives on Education: Capabilities for Success in the Accounting Profession*, published jointly by the Big Eight public accounting firms. The White Paper expressed disenchantment with the narrow technical focus of undergraduate accounting curricula and called for scholastic emphasis on a broad set of business skills necessary for professional success. The Accounting Education Change Commission (AECC), operating under the aegis of the American Accounting Association, embraced the philosophy reflected in the White Paper. In September 1990, the AECC published its Position Statement No. One, titled *Objectives of Education for Accountants*. This statement reiterated that an undergraduate business education should provide a base for lifelong learning.

Despite these calls for reform, many undergraduate tax courses are taught in a traditional manner based on a paradigm developed a half-century ago. In the modern (postwar) era of business education, the first generation of tax teachers were practitioners: accountants or attorneys hired as adjunct faculty to initiate students into the mysteries of the newly enacted Internal Revenue Code of 1954. These practitioners taught their

students in the same way they trained their employees. In doing so, they created a compliance-oriented paradigm. In today's world, this traditional paradigm is an anachronism. Business students don't need to learn how to generate tax information. Instead, they must learn how to use tax information to make good business and financial decisions.

A New Paradigm for the Introductory Tax Course

Principles of Taxation for Business and Investment Planning provides a paradigm for meeting the educational needs of tax students in the twenty-first century. This paradigm is based on three postulates:

- **Postulate 1: Students should learn the tax law as an integrated component of a complex economic environment.** They should be aware of the role taxes play in financial decision making and should understand how taxes motivate people and institutions to engage in certain transactions.
- **Postulate 2: Students should comprehend the tax law as an organic whole rather than as a fragmented collection of rules and regulations.** They should learn general tax rules rather than the myriad of exceptions that confuse rather than clarify the general rules. They should appreciate how the general rules apply to all taxpaying entities before they learn how specialized rules apply to only certain entities. Finally, they should learn how the law applies to broad categories of transactions rather than to a particular transaction.
- **Postulate 3: Students who learn fundamental concepts have a permanent frame of reference into which they can integrate the constant changes in the technical minutiae of the law.** The rapid evolution of the tax law results in a short shelf life for much of the detailed information contained in undergraduate tax texts. Yet the key elements of the law—the statutory and judicial bedrock—do not change with each new revenue act. Students who master these key elements truly are prepared for a lifetime of learning.

The authors know that traditional paradigms die hard and educational reform is difficult. Nevertheless, we also believe that change in the way college and university professors teach tax is both inevitable and worthwhile. Our responsibility to our students is to prepare them to cope in a business world with little tolerance for outdated skills or irrelevant knowledge. Our hope is that *Principles of Taxation for Business and Investment Planning* is a tool that can help us fulfill that responsibility.

Using This Text in a First-Semester Tax Course

Principles of Taxation for Business and Investment Planning is designed for use in a one-semester (15-week) introductory tax course. Instructors can choose which of the 18 chapters deserve a full week's coverage and

which can be covered in less than a week. Instructors may even decide to omit chapters that seem less relevant to the educational needs of their students. Business students who complete a one-semester course based on this text will be well prepared to function in the modern tax environment. If they are required (or may elect) to take a second tax course, they will have a solid, theoretical foundation on which to build.

This is the nineteenth annual edition of *Principles of Taxation for Business and Investment Planning*. Adopters of the text will certainly have many excellent suggestions to improve the next edition. We welcome any and all comments and encourage fellow teachers to e-mail us (smj7q@virginia.edu and shelley.rhoades@villanova.edu) with their input.

Sally M. Jones
Shelley C. Rhoades-Catanach

Key Features

The content and organization of this text are highly compatible with the Model Tax Curriculum proposed by the American Institute of Certified Public Accountants. According to the AICPA, the introductory tax course should expose students to a broad range of tax concepts and emphasize the role of taxation in the business decision-making process. Under the model curriculum, students first learn to measure the taxable income from business and property transactions. They are then introduced to the different types of business entities and the tax considerations unique to each type. Individual taxation should be one of the last topics covered, rather than the primary focus of the course. Because *Principles of Taxation for Business and Investment Planning* reflects this recommended pedagogical approach, the text is ideal for courses based on the AICPA Model Tax Curriculum.

Part One consists of two chapters that familiarize students with the global tax environment. Chapter 1 describes the environment in terms of the legal relationship between taxes, taxpayers, and governments. Definitions of key terms are developed, and the major taxes are identified. Chapter 2 considers the tax environment from a normative perspective by asking the question: “What are the characteristics of a good tax?” Students are introduced to the notions of tax efficiency and tax equity and learn how contrasting political beliefs about efficiency and equity continue to shape the tax environment.

Part Two concentrates on developing a methodology for incorporating tax factors into business decisions. Chapter 3 introduces the pivotal role of net present value of cash flows in evaluating financial alternatives. Students learn how to compute tax costs and tax savings and how to interpret them as cash flows. Chapter 4 covers the maxims of income tax planning. The characteristics of the tax law that create planning opportunities are explained, and the generic techniques for taking advantage of those opportunities are analyzed. Chapter 5 provides a succinct overview of the tax research process and prepares students to solve the research problems included at the end of each chapter. The chapter explains the six steps in the tax research process and contains a cumulative example of the application of each step to a research case.

PART ONE

Exploring the Tax Environment

- 1 Taxes and Taxing Jurisdictions 3
- 2 Policy Standards for a Good Tax 23

PART TWO

Fundamentals of Tax Planning

- 3 Taxes as Transaction Costs 49
- 4 Maxims of Income Tax Planning 73
- 5 Tax Research 97

PART THREE

The Measurement of Taxable Income

- 6 Taxable Income from Business Operations 123
- 7 Property Acquisitions and Cost Recovery Deductions 163
- 8 Property Dispositions 207
- 9 Nontaxable Exchanges 249

PART FOUR

The Taxation of Business Income

- 10 Sole Proprietorships, Partnerships, LLCs, and S Corporations 279
- 11 The Corporate Taxpayer 319
- 12 The Choice of Business Entity 355
- 13 Jurisdictional Issues in Business Taxation 381

PART FIVE

The Individual Taxpayer

- 14 The Individual Tax Formula 417
- 15 Compensation and Retirement Planning 453
- 16 Investment and Personal Financial Planning 495
- 17 Tax Consequences of Personal Activities 545

PART SIX

The Tax Compliance Process

- 18 The Tax Compliance Process 579
 - Appendix A Present Value of \$1 603
 - Appendix B Present Value of Annuity of \$1 604
 - Appendix C 2015 Income Tax Rates 605

Part Three focuses on the quantification of business taxable income. Chapter 6 covers the computation of income or loss from ongoing commercial activities, with special emphasis on differences between taxable income and net income for financial statement purposes. Chapters 7 and 8 explore the tax implications of acquisitions and dispositions of business property, while Chapter 9 is devoted to nontaxable exchanges.

Part Four teaches students how to calculate the tax on business income. Chapter 10 describes the function of sole proprietorships, partnerships, LLCs, and S corporations as conduits of income, while Chapter 11 discusses corporations as taxable entities in their own right. Chapter 12 builds on the preceding two chapters by exploring the tax planning implications of the choice of business entity. Chapter 13 broadens the discussion by considering the special problems of businesses operating in more than one tax jurisdiction. This chapter introduces both multistate and international tax planning strategies.

Part Five concentrates on the tax rules and regulations unique to individuals. Chapter 14 presents the individual tax formula and acquaints students with the complexities of computing individual taxable income. Chapter 15 covers compensation and retirement planning. Chapter 16 covers investment and rental activities and introduces wealth transfer planning. Finally, Chapter 17 analyzes the tax consequences of personal activities, with particular emphasis on home ownership.

Part Six consists of Chapter 18, which presents the important procedural and administrative issues confronting taxpayers. It covers the basic rules for paying tax and filing returns, as well as the penalties on taxpayers who violate the rules. Chapter 18 also describes the judicial process through which taxpayers and the IRS resolve their differences.

Key Learning Tools

Learning Objectives

The chapters begin with learning objectives that preview the technical content and alert students to the important concepts to be mastered. These objectives appear again as marginal notations marking the place in the chapter where each learning objective is addressed.

Learning Objectives

After studying this chapter, you should be able to:

- LO 4-1. Describe the difference between tax avoidance and tax evasion.
- LO 4-2. Explain why an income shift or a deduction shift from one entity to another can affect after-tax cash flows.
- LO 4-3. Explain how the assignment of income doctrine constrains income-shifting strategies.
- LO 4-4. Determine the effect on after-tax cash flows of deferral of a tax cost.
- LO 4-5. Discuss why the jurisdiction in which a business operates affects after-tax cash flows.

LO 4-3
Explain how the assignment of income doctrine constrains income-shifting strategies.

Assignment of Income Doctrine

The federal courts have consistently held that our income tax system cannot tolerate artificial shifts of income from one taxpayer to another. Over 80 years ago, the Supreme Court decided that income must be taxed to the person who earns it, even if another person has a legal right to the wealth represented by the income.⁵ Thus, a business owner who receives a \$10,000 check in payment for services rendered to a client can't avoid reporting \$10,000 of income by simply endorsing the check over to his daughter. In the picturesque language of the Court, the tax law must disregard arrangements "by which the fruits are attributed to a different tree from that on which they grew."

The Supreme Court elaborated on this theme in the case of a father who detached negotiable interest coupons from corporate bonds and gave the coupons to his son as a gift. When the father received the interest and dividends on the bonds, the income

Examples and Cases

The chapters contain numerous examples and cases illustrating or demonstrating the topic under discussion.

Conflicting Maxims

Firm MN operates as two separate taxable entities, Entity M and Entity N. The firm is negotiating a transaction that will generate \$25,000 cash in year 0 and \$60,000 cash in year 1. If Entity M undertakes the transaction, taxable income will correspond to cash flow (i.e., Entity M will report \$25,000 and \$60,000 taxable income in years 0 and 1). If Entity N undertakes the transaction, it must report the entire \$85,000 taxable income in year 0. Entity M has a 30 percent marginal tax rate while Entity N has a 25 percent marginal tax rate. Firm MN uses a 5 percent discount rate to compute NPV.

	Entity M	Entity N
Year 0:		
Before-tax cash flow	\$25,000	\$25,000
Taxable income	\$25,000	\$85,000
	.30	.25

Tax Talk

Each chapter includes items of "Tax Talk." These items highlight new tax planning strategies, tax facts, legislative proposals, or innovative transactions with interesting tax implications reported in the business press.

Tax Talk

Several of Europe's smallest countries, such as Luxembourg, Switzerland, and Ireland, offer very low corporate tax rates to attract multinational corporations. Case in point: Amazon.com channels the profits earned across the 28-nation European Union through its Luxembourg subsidiary.

come. Firm Y operates in State Y, which imposes a flat 4 percent tax on business income. Firm Z operates in State Z, which imposes a flat 10 percent tax on business income. For federal purposes, state income tax payments are deductible in the computation of taxable income.⁸ Both firms face a 39 percent federal tax rate. Under these facts, Firms Y and Z have the following after-tax cash flows.

	Firm Y	Firm Z
Before-tax cash/income	\$5,000	\$5,000
State income tax cost	(200)	(500)
Federal taxable income	\$4,800	\$4,500
Federal tax cost (Taxable income × 39%)	(1,872)	(1,755)
After-tax cash flow	<u>\$2,928</u>	<u>\$2,745</u>

A comparison of these after-tax cash flows gives us our third income tax planning tip: Tax costs decrease (and cash flows increase) when income is generated in a jurisdiction with a lower tax rate.

End-of-Chapter Material

Key Terms

Key terms are indicated in boldface in the text. A list of key terms is also supplied at the end of the chapter with page references for easy review. Definitions of key terms from all the chapters are compiled in a Glossary for the text.

Key Terms			
accrual method of accounting	135	economic performance	141
all-events test	140	fiscal year	125
allowance method	144	generally accepted accounting principles (GAAP)	135
annualized income	127	gross income	124
calendar year	125	hybrid method of accounting	134
cash method of accounting	131	key-person life insurance policies	130
constructive receipt	132	method of accounting	128
deferred tax asset	138	net operating loss (NOL)	141
deferred tax liability	138		
direct write-off method	144		
			NOL carryforward payment liability
			permanent difference
			personal service corporation
			prepaid income realization
			recognition
			recurring item exception
			short-period return tax benefit rule
			taxable income

Sources of Book/Tax Differences

Chapters 6, 7, 8, 9, 11, 13, and 15 provide a list of the sources of book/tax differences introduced in the chapter.

Sources of Book/Tax Differences	Permanent	Temporary
	<ul style="list-style-type: none"> Interest on state and local bonds Key-person life insurance proceeds and premiums Fines and penalties Political contributions and lobbying expense Meals and entertainment expense Domestic production activities deduction 	<ul style="list-style-type: none"> Prepaid income Bad debts Accrued expenses failing the all-events test Compensation accruals Related party accruals NOL carryforwards


Questions and Problems for Discussion

Challenge students to think critically about conceptual and technical issues covered in the chapter. These problems tend to be open-ended and are designed to engage students in debate. Many problems require students to integrate material from previous chapters in formulating their responses.

Questions and Problems for Discussion	
LO 6-1	1. Firm LK bought a warehouse of used furniture to equip several of its clerks. An employee discovered a cache of gold coins in a desk drawer. A local collector bought the coins from Firm LK the rightful owner of the coins, which have a \$72,000 FMV. Do you recognize income because of this lucky event?
LO 6-2	2. Discuss the choice of a taxable year for the following businesses: <ol style="list-style-type: none"> Retail plant and garden center. French bakery. Chimney cleaning business. Moving and transport business. Software consulting business.
LO 6-3	3. Corporation DB operates three different lines of business. Can the corporation use different overall methods of accounting for each line or must the corporation use one overall method?
LO 6-3	4. Lester Inc. owns 55 percent of the outstanding stock of Marvin Corporation. The two corporations engage in numerous intercompany transactions that must be eliminated in consolidation.

Application Problems

Give students practice in applying the technical material covered in the chapter. Most of the problems are quantitative and require calculations to derive a numeric solution.

 All applicable Application Problems are available with McGraw-Hill's *Accounting*.

Application Problems

LO 4-2

1. Refer to the corporate rate schedule in Appendix C.
 - a. What are the tax liability, the marginal tax rate, and the average tax rate for a corporation with \$48,300 taxable income?
 - b. What are the tax liability, the marginal tax rate, and the average tax rate for a corporation with \$615,800 taxable income?
 - c. What are the tax liability, the marginal tax rate, and the average tax rate for a corporation with \$16,000 taxable income?

Issue Recognition Problems

Develop students' ability to recognize the tax issues suggested by a set of facts and to state those issues as questions. The technical issues buried in these problems typically are *not* discussed in the chapter. Consequently, students must rely on their understanding of basic principles to analyze the problem, spot the tax concern or opportunity, and formulate the question to be resolved. In short, students must take the first steps in the tax research process.

Issue Recognition Problems

Identify the tax issue or issues suggested by the following situations, and state them in the form of a question.

LO 4-3

1. Dr. P is a physician with his own medical practice. For the last several years, his marginal income tax rate has been 39.6 percent. Dr. P's daughter, who is a graduate student, has no taxable income. During the last two months of the year, Dr. P instructs his patients to remit their payments for his services directly to his daughter.

LO 4-3

2. Mr. and Mrs. K own rental property that generates \$4,000 monthly revenue. They are in the highest marginal tax bracket. For Christmas, Mr. and Mrs. K give the

Research Problems

Provide further opportunity for students to develop their analytic skills. These problems consist of short scenarios that suggest one or more tax issues. The scenarios conclude with explicit research questions for the students to answer. To find the answers, they need access to either a traditional or an electronic tax library.

Research Problems

LO 6-1, 6-6

1. Bontaine Publications, an accrual basis, calendar year corporation, publishes and sells weekly and monthly magazines to retail bookstores and newsstands. The sale agreement provides that the retailers may return any unsold magazines during the one-month period after purchase. Bontaine will refund one-half of the purchase price of each returned magazine. During December 2015, Bontaine recorded \$919,400 of magazine sales. During January 2016, Bontaine refunded \$82,717 to retailers that returned magazines purchased during December. Can Bontaine reduce its 2015 income by the refund paid?

LO 6-1, 6-6

2. CheapTrade, an accrual basis, calendar year corporation, operates a discount securities brokerage business. CheapTrade accepts orders to buy or sell marketable securities for its customers and charges them a commission fee for effecting the transaction in a timely, low-cost manner. CheapTrade executes an order on the "trade" date, but title to the securities is not legally transferred and payment to or from the customer is not due until the "settlement date." In the normal five-day interval between the trade and settlement dates, CheapTrade performs administrative and accounting functions to record the transaction. During the last week of 2015, CheapTrade effected a purchase of

Tax Planning Cases

Give students an opportunity to integrate their tax knowledge into a business planning framework. Most cases involve taxpayers who must decide whether to undertake a certain transaction or who must choose between alternative transactions. Students must assume the role of tax adviser by recommending a course of action to maximize the after-tax value of the transaction.

Tax Planning Cases

- LO 9-8** 1. Firm NS owns 90 percent of Corporation T's outstanding stock. NS also owns realty that T needs for use in its business. The FMV of the realty is \$5.6 million. Both NS and T are in the 35 percent tax bracket. Discuss the tax implications of each of the following courses of action and decide which course you would recommend to NS.
- NS could exchange the realty for newly issued shares of T stock with a value of \$5.6 million.
 - NS could sell the realty to T for \$4 million cash.
 - NS could lease the realty to T for its annual fair rental value of \$600,000.
- LO 9-5** 2. Firm K, a noncorporate taxpayer, has owned investment land with a \$1 million basis for 10 years. Two unrelated parties want to acquire the land from K. Party A offers \$770,000 cash, and Party B has offered another tract of land with a \$1 million basis and a FMV of \$1.1 million. If K accepts Party B's offer, it would hold the new land for no more than 10 years before selling it. The FMV of this land should appreciate 10 percent annually, and it uses a 7 percent discount rate to compute its NPV. Which course of action should K choose to maximize the NPV of the transaction?

CPA Exam Simulations

Prepare students to sit for the computerized CPA exam by working tax problems in a web-based interface identical to that used in the exam. Chapters 8, 10, 11, and 17 include directions to new Kaplan CPA Review simulations. Give your students a competitive edge by familiarizing them with the content and structure of tax questions as well as the software by which the CPA exam is administered.

KAPLAN

CPA REVIEW

CPA Exam Simulation

Please visit the *Connect Library* for the online CPA simulation

Miller, Smith, and Tucker decided to form a partnership to perform engineering consulting services. The new entity, MST Consulting Services, LLP, began operations on January 1, 2017, and uses the calendar year for reporting purposes. The partners expect to work full-time for MST, and each contributed cash and other property to the partnership sufficient to commence operations.

Topics covered in the simulation:

- Basis of contributed property
- Depreciation of contributed property

How Can Technology Help Improve Student Success?

McGraw-Hill Connect Accounting

connect ACCOUNTING McGraw-Hill *Connect Accounting* is a digital teaching and learning environment that gives students the means to better connect with their coursework, their instructors, and the important concepts that they will need to know for success now and in the future. With *Connect Accounting*, instructors can deliver assignments, quizzes, and tests easily online. Students can review course material and practice important skills. *Connect Accounting* provides the following features:

- SmartBook and LearnSmart.
- Auto-graded Online Homework.
- Dynamic links between the problems or questions you assign to your students and the location in the eBook where that concept is covered.
- A powerful search function to pinpoint and connect key concepts to review.

In short, *Connect Accounting* offers students powerful tools and features that optimize their time and energy, enabling them to focus on learning.

For more information about *Connect Accounting*, go to www.connect.mheducation.com, or contact your local McGraw-Hill Higher Education representative.

The screenshot shows a problem titled "13. value 10.00 points". The problem text is: "Terrence is age 71 and retired. Beginning in 2014, he must start taking minimum distributions from his IRA account that had a balance of \$150,000 as of December 31, 2013. Make these three assumptions: his IRA will earn 8% per year; he will withdraw the minimum distribution on the last day of each calendar year, and only one distribution will be taken in 2014. Calculate the amount of his distribution for years 2014 through 2018 and the ending balance in his IRA account on December 31, 2018. Use Table 1 and Table 2. (Do not round 'Applicable Life Expectancy' answers. Round other answers to nearest whole dollar value.)"

Year	(1) IRA Balance At End of Prior Year	(2) Applicable Life Expectancy	(3) Required Distribution	(4) IRA Earnings	(5) Ending Balance
2014	\$ 150,000	26.5	\$ 5,560	\$ 12,000	\$ 156,340
2015	156,340	25.6	6,107	12,507	162,740
2016	162,740				
2017					
2018					

SmartBook, powered by LearnSmart

SMARTBOOK LearnSmart™ is the market-leading adaptive study resource that is proven to strengthen memory recall, increase class retention, and boost grades.

LearnSmart allows students to study more efficiently because they are made aware of what they know and don't know.

SmartBook™, which is powered by LearnSmart, is the first and only adaptive reading experience designed to change the way students read and learn. It creates a personalized reading experience by highlighting the most impactful concepts a student needs to learn at that moment in time. As a student engages with SmartBook, the reading experience continuously adapts by highlighting content based on what the student knows and doesn't know. This ensures that the focus is on the content he or she needs to learn, while simultaneously promoting long-term retention of material.

Use SmartBook's real-time reports to quickly identify the concepts that require more attention from individual students—or the entire class. The end result? Students are more engaged with course content, can better prioritize their time, and come to class ready to participate.

The screenshot shows a problem titled "FILING STATUS FOR INDIVIDUALS". The problem text is: "Every individual who is either a citizen or a permanent resident of the United States is a taxable entity who may be required to file a federal income tax return. One of the first steps in determining that status is to determine the individual's filing status. Filing status, which reflects an individual's marital and family situation, affects the calculation of taxable income and determines the rates at which that income is taxed."

Below the text are several sections with questions and answers:

- Married Individuals and Surviving Spouses:** An individual who is married on the last day of the taxable year can elect to file a joint return with his or her spouse. A joint return reflects the combined incomes of both spouses for the entire year. A husband and wife who file a joint return have joint and several liability for their tax bill. In other words, each spouse is responsible for paying the entire tax due (not just one-half's). With respect to a joint return, any reference to the taxpayer is actually a reference to both people.
- Married Filing Separately:** Mr. and Mrs. Lane were legally married under Texas law on December 12, 1996. For federal tax purposes, their marital status was determined on December 31. The next week, they filed a joint return for 1996 that reported their combined income for the entire calendar year.
- EO 14-1:** For the taxable year in which a married person dies, the widow or widower can file a joint return with the decedent. If the widow or widower maintains a home for a dependent child, he or she qualifies as a surviving spouse for the two taxable years following the year of death. A surviving spouse can use the married filing jointly tax rate for those two years.
- Surviving Spouse:** Mr. and Mrs. Lane filed on September 14, 2011, and Mr. Lane has not remarried. Mr. Lane filed a 2011 joint return reflecting his decedent, which includes from January 1 through September 14 and he includes his one more year. The couple had two children, ages 8 and 10, who live with their father. Because Mr. Lane met the conditions for a surviving spouse, he can file a joint return for 2011 with Mrs. Lane.

Tax Form Simulations

The auto-graded tax form simulation, assignable within *Connect Accounting*, provides 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 professors.

Print all the values as positive numbers. Enter any non-financial information, (e.g. Names, Addresses, social security numbers) EXACTLY as they appear in any given information or Problem statement.)

1040A for a couple Married Filing Jointly.

1040 PG 1 1040 PG 2

Page 1 of Form 1040A. Use provided information and follow instructions on form.

Form 1040A - U.S. Individual Income Tax Return (99) **2014** (99) Use Only - Do not write in this space

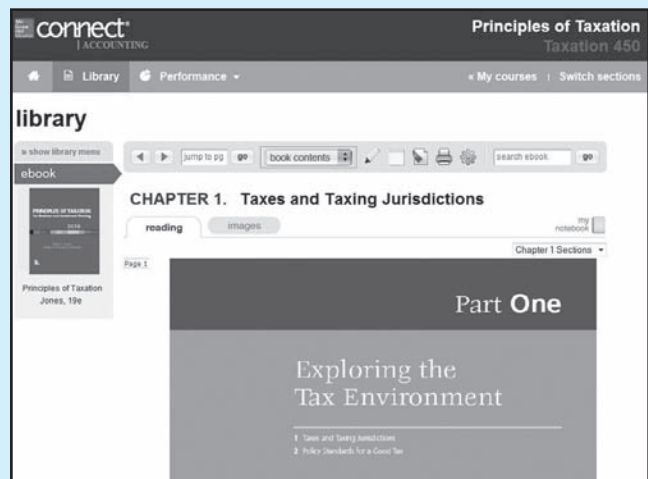
Your first name and initial John	Last name Hollaway	Your social security number 410-34-5670
If a joint return, spouse's first name and initial Martha	Last name Hollaway	Spouse's social security number
Home address (number and street); if you have a P.O. box, see instructions 10010 Dune Street Atlanta, GA 30294		City, town or post office, state, and ZIP code: If you have a foreign address, enter complete address below
Foreign country name	Foreign province	Foreign postal code
Filing Status 1 Single <input type="checkbox"/> 2 Married filing jointly <input checked="" type="checkbox"/> 3 Married filing separately <input type="checkbox"/>	4 Head of household (with qualifying person) <input type="checkbox"/> 5 Qualifying widow(er) with dependent child <input type="checkbox"/>	Check here if you, or your spouse if filing jointly, want \$3 to go to the fund. Checking a box below will not change your tax or refund. Presidential Election Campaign Yes <input type="checkbox"/> No <input type="checkbox"/> Same as <input type="checkbox"/>
Exemptions 06 Yourself <input type="checkbox"/>	Boxes checked on file and file	

Online assignments

Connect Accounting 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. Our assignable, gradable end-of-chapter content includes a general journal application that looks and feels 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.

Student Resource Library

The *Connect Accounting* Student Resources give students access to additional resources such as recorded lectures, online practice materials, an eBook, and more.

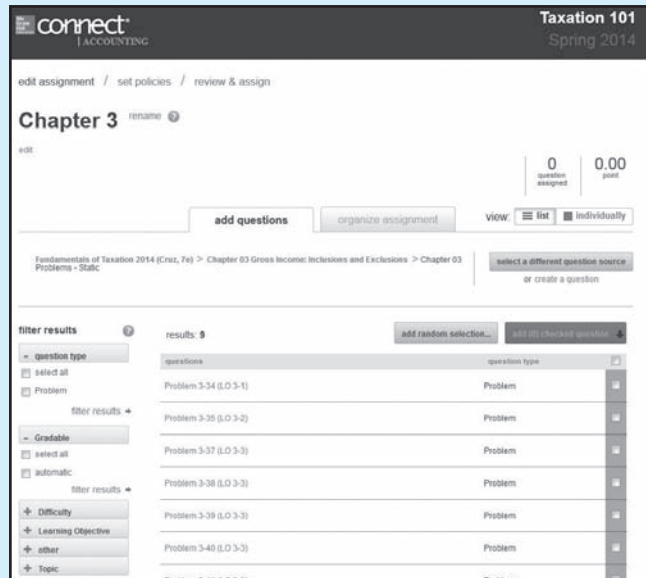


McGraw-Hill Connect Accounting Features

Connect Accounting offers powerful tools, resources, and features to make managing assignments easier, so faculty can spend more time teaching.

Simple Assignment Management and Smart Grading With *Connect Accounting*, students can engage with their coursework anytime, anywhere, making the learning process more accessible and efficient.

- Create and deliver assignments easily with selectable end-of-chapter questions and test bank items.
- Have assignments scored automatically, giving students immediate feedback on their work and comparisons with correct answers.
- Access and review each response; manually change grades or leave comments for students to review.
- Reinforce classroom concepts with practice assignments, instant quizzes, and exams.



Powerful Instructor and Student Reports

Connect Accounting keeps instructors informed about how each student, section, and class is performing, allowing for more productive use of lecture and office hours. The reports tab enables you to:

- View scored work immediately and track individual or group performance with assignment and grade reports.
- Access an instant view of student or class performance relative to learning objectives.
- Collect data and generate reports required by many accreditation organizations, such as AACSB and AICPA.

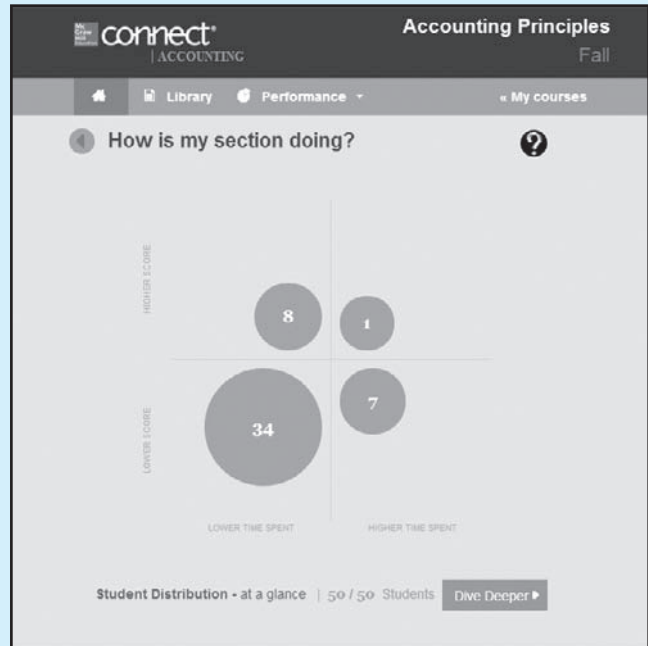


Connect Insight

The first and only analytics tool of its kind, Connect Insight™ is a series of visual data displays—each framed by an intuitive question—to provide at-a-glance information regarding how your class is doing.

Connect Insight™ provides an at-a-glance analysis on five key insights, available at a moment's notice from your tablet device.

- How are my students doing?
- How is my section doing?
- How is this student doing?
- How are my assignments doing?
- How is this assignment going?



Instructor Library

The *Connect Accounting* Instructor Library is your repository for additional resources to improve student engagement in and out of class. You can select and use any asset that enhances your lecture. The *Connect Accounting* Instructor Library includes access to:

- Instructor's Manual
- Test Bank
- Instructor PowerPoint® slides
- Media-rich eBook

Taxation 101
Spring 2015

Library Performance My courses

library

Build a better course with these resources

ebook access and search your textbook | bank create an assignment from our question banks | lectures record and view your lectures

Want to see all the assignments that you've created in this course? View my assignments

pre-made assignment collections
Explore our collections of pre-made assignments. Use them as is or edit them to create your own custom assignments.

pre-built assignments
These assignments have been created from the end of chapter questions in your textbook. Use them as-is or edit them to create your own custom assignments.

Tegrity Campus: Lectures 24/7



Tegrity Campus is a service that makes class time available 24/7 by automatically capturing every lecture. With a simple one-click start-and-stop process, you capture all computer screens and corresponding audio in a format that is easily searchable, frame by frame. Students can replay any part of any class with easy-to-use browser-based viewing on a PC, Mac, or other mobile device.

Help turn your students' study time into learning moments immediately supported by your lecture. With Tegrity Campus, you also increase intent listening and class participation by easing students' concerns about note-taking. Lecture Capture will make it more likely you will see students' faces, not the tops of their heads. To learn more about Tegrity, watch a 2-minute Flash demo at <http://tegritycampus.mhhe.com>.

McGraw-Hill Campus



Campus

McGraw-Hill Campus™ is a new one-stop teaching and learning experience available to users of any learning management system. This institutional service allows faculty and students to enjoy single sign-on (SSO) access to all McGraw-Hill Higher Education materials, including the award-winning McGraw-Hill *Connect* platform, from directly within the institution's website. To learn more about MH Campus, visit <http://mhcampus.mhhe.com>.

Custom Publishing through Create



create™

McGraw-Hill Create™ is a new, self-service website that allows instructors to create custom course materials by drawing upon McGraw-Hill's comprehensive, cross-disciplinary content. Instructors can add their own content quickly and easily and tap into other rights-secured third-party sources as well, then arrange the content in a way that makes the most sense for their course. Instructors can even personalize their book with the course name and information and choose the best format for their students—color print, black-and-white print, or an eBook.

Through Create, instructors can

- Select and arrange the content in a way that makes the most sense for their course.
- Combine material from different sources and even upload their own content.
- Choose the best format for their students—print or eBook.
- Edit and update their course materials as often as they like.

Begin creating now at www.mcgrawhillcreate.com.

McGraw-Hill Customer Experience Group Contact Information

At McGraw-Hill, we understand that getting the most from new technology can be challenging. That's why our services don't stop after you purchase our products. You can contact our Product Specialists 24 hours a day to get product training online. Or you can search the knowledge bank of Frequently Asked Questions on our support website. For Customer Support, call **800-331-5094**, or visit www.mhhe.com/support. One of our Technical Support Analysts will be able to assist you in a timely fashion.

McGraw-Hill's Connect Accounting



connect |ACCOUNTING

Connect Accounting offers a number of powerful tools and features to make managing your classroom easier. *Connect Accounting* with Jones 19e offers enhanced features and technology to help both you and your students make the most of your time inside and outside the classroom.

EZ Test Online

This test bank in Word™ format contains multiple-choice questions, essay questions, and short problems. Each test item is coded for level of difficulty and learning objective.

McGraw-Hill's EZ Test Online is a flexible and easy-to-use electronic testing program that allows instructors to create tests from book-specific items. EZ Test Online accommodates a wide range of question types and allows instructors to add their own questions. Multiple versions of the test can be created and any test can be exported for use with course management systems such as BlackBoard/ WebCT. EZ Test Online gives instructors a place to easily administer exams and quizzes online. The program is available for Windows and Macintosh environments.

Changes in *Principles of Taxation*, 2016 edition

Chapter 1

- Revised and expanded Learning Objectives.
- Added two new examples on pages 5 and 8.

Chapter 2

- Updated federal deficit and national debt data on page 25.
- Updated data in example on page 39.

Chapter 3

- Added new Learning Objective 3-1.

Chapter 4

- Revised and expanded Learning Objectives.
- Added new Tax Talk on page 81.
- Expanded discussion of the character variable on page 82.

Chapter 5

- Added nine new Application Problems.
- Former Application Problems now included as Research Problems.

Chapter 6

- Revised and expanded Learning Objectives.

Chapter 7

- Revised and expanded Learning Objectives.
- Added new Tax Talk on page 172.
- Updated passenger automobile limitations on page 180.
- Updated for law changes related to the Section 179 deduction on pages 181 and 182.
- Reorganized discussion of book/tax differences related to cost recovery.

Chapter 8

- Revised and expanded Learning Objectives.
- Reorganized discussion of book/tax differences on asset dispositions to facilitate coverage of this topic.

Chapter 9

- Added new Learning Objectives 9-1 and 9-4.

Chapter 10

- Added new Learning Objectives 10-4 and 10-9.
- Updated Schedule C, Form 1065, Form 1120-S and Schedule K-1s to 2014 versions.

- Updated discussion of payroll and self-employment taxes for changes to inflation-adjusted Social Security tax threshold on pages 284 through 288.
- Updated discussion of limited partner involvement in partnership management to reflect provisions of the Revised Uniform Limited Partnership Act (RULPA).
- Integrated discussion of limited liability companies with discussion of partnership formation.

Chapter 11

- Revised and expanded Learning Objectives.
- Updated filing statistics in Tax Talks throughout.
- Updated Form 1120 and Schedule M-3 to 2014 versions.
- Revised discussion of Tax Freedom Day on page 339 to reflect current statistics.

Chapter 12

- Added new Learning Objective 12-4.
- Updated filing statistics in Tax Talk on page 362.

Chapter 13

- Added new Learning Objective 13-1.
- Integrated discussion of gross receipts taxes into introductory explanation of state and local taxation.
- Updated state tax planning examples for additional reduction in North Dakota corporate income tax rate on pages 387 and 388.

Chapter 14

- Revised and expanded Learning Objectives.
- Updated coverage of standard deduction, exemption amount, individual tax rates, earned income credit, and alternative minimum tax to reflect 2015 inflation adjustments.
- Updated Volpe family examples throughout chapter to include 2014 Form 1040 (pages 1 and 2 and Schedule A).
- Reordered subtopics under Computing Individual Tax beginning on page 429.
- Updated Itemized Deduction Worksheet and Exemption Amount Worksheet to reflect 2015 inflation adjustments

Chapter 15

- Revised and expanded Learning Objectives.
- Added three new Tax Talks on pages 454, 465, and 479.
- Updated examples on pages 455 and 456 to include 2014 Form W-2 and Form 1099-MISC.
- Updated coverage of Employer-Provided Plans beginning on page 472 to reflect 2015 inflation adjustments.
- Updated coverage of Individual Retirement Accounts beginning on page 477 to reflect 2015 inflation adjustments.
- Updated discussion of rollovers to IRAs beginning on page 482.
- Revised example of Rollover to Roth IRA and deleted example of Current and Future Tax Rates on page 483.

Chapter 16

- Revised and expanded Learning Objectives.
- Updated Mr. and Mrs. David examples to include 2014 Form 1040, Schedule B and Schedule E.
- Updated coverage of the gift and estate taxes beginning on page 523 to reflect 2015 inflation adjustments to annual gift tax exclusion and lifetime transfer tax exclusion.
- Revised Appendix 16-A to include 2014 Form 8949 and Form 1040, Schedule D.

Chapter 17

- Revised and expanded Learning Objectives.
- Retitled first subtopic under Gross Income from Whatever Source Derived as Prizes, Awards, Gifts, and Inheritances beginning on page 546.
- Added new Tax Talk on page 557.

Chapter 18

- Revised and expanded Learning Objectives.
- Updated audit coverage data in example on page 583.
- Revised subtopic Your Rights as a Taxpayer on page 584 to include the 2014 expanded Taxpayer Bill of Rights adopted by the IRS.
- Added new Tax Talk on page 588.

Acknowledgments

We want to thank the many friends and colleagues who continue to share their ideas for this textbook. We particularly want to acknowledge the contribution of Professor Sandra Callaghan (Texas Christian University) for her work on *Connect Accounting* and SmartBook™, and Professor Pat Wilkie (University of Virginia) and Professor Jim Young (Northern Illinois University). Their article titled “Teaching the Introductory Tax Course: A Template of the Federal Income Tax Formula, Taxpayer Activities, and Taxpayer Entities” in the *Journal of the American Taxation Association* (Fall 1997) profoundly influenced the organization of this book. Thanks also to the individuals who reviewed the 2014 and 2015 editions of the text. Their expert comments were invaluable, and this edition is significantly improved because of their involvement:

Eric Chen, *Saint Joseph College*

Rick Crosser, *Metropolitan State University of Denver*

Teresa Lightner, *University of North Texas*

Gwendolyn McFadden, *North Carolina A&T State University*

Ian Redpath, *Canisius College*

John Robertson, *Arkansas State University*

Ray Rodriguez, *Southern Illinois University Carbondale*

Jason Stanfield, *Purdue University*

George Violette, *University of Southern Maine*

We are grateful to the entire McGraw-Hill team for their professional support. In particular, we want to acknowledge Tim Vertovec, Kathleen Klehr, Danielle Andries, Dana Pauley, Angela Norris, Brad Parkins, Srdjan Savanovic, and Laura Fuller.

Sally M. Jones
University of Virginia

Shelley C. Rhoades-Catanach
Villanova University

Introduction to Students

Principles of Taxation for Business and Investment Planning explores the role that taxes play in modern life. The book is written for business students who have completed introductory courses in accounting and finance and are familiar with basic business concepts. Those of you who fit this description, regardless of your future career path, will make decisions in which you must evaluate the effect of taxes. At the most fundamental level, all business decisions have the same economic objective: maximization of long-term wealth through cash flow enhancement. The cash flow from any transaction depends on the tax consequences. Therefore, business men and women must appreciate the role of taxes before they can make intelligent decisions, whether on behalf of their firm or on their personal behalf.

Taxes as Business Costs

When businesspeople are asked to identify the common goal of all business decisions, their immediate response tends to be that the goal is to increase profits. When prompted to think past the current year, most eventually conclude that the long-term goal of business decisions is to maximize the value of the firm. In this text, a **firm** is a generic business organization. Firms include sole proprietorships, partnerships, limited liability companies, subchapter S and regular corporations, and any other arrangement through which people carry on a profit-motivated activity. Firm managers know that short-term profits and long-term value are enhanced when operating costs, including taxes, are controlled. Experienced managers never regard taxes as fixed or unavoidable costs. As you will soon discover, opportunities abound for controlling the tax cost of doing business.

The preceding paragraph suggests that tax planning means reducing tax costs to maximize the value of the firm. Firms can reduce taxes by any number of strategies. However, tax cost is only one variable that managers must consider in making business decisions. A strategy that reduces taxes may also have undesirable consequences, such as reducing revenues or increasing nontax costs. Because of nontax variables, the strategy with the least tax cost may not be the best strategy. Therefore, tax minimization in and of itself may be a short-sighted objective. This point is so elementary yet so important: *Effective tax planning must take into account both tax and nontax factors.* When faced with competing strategies, managers should implement the strategy that maximizes firm value, even when that strategy has a higher tax cost than the alternatives. In other words, managers should never let the tax tail wag the business dog.

Taxes as Household Expenditures

Principles of Taxation for Business and Investment Planning concentrates on the income taxation of business activities and organizations. This does not mean that the tax rules applying to individuals are ignored. Quite to the contrary. For income tax purposes, individuals and the profit-making activities in which they engage are entwined. As we will observe over and over again, the ultimate taxpayers in every business are the people who own and operate that business.

As you study this text, consider your own role as a lifelong taxpayer. Regardless of who you are, where you live, or how you earn and spend your money, you will pay taxes on a regular basis to any number of governments. In fact, in the United States, taxes are

the single largest household expenditure. According to data from the Tax Foundation, Americans devote about two hours and 15 minutes of every eight-hour workday to earn enough to pay their local, state, and federal taxes.

People who are clueless about taxes must take a passive role, participating in a tax system they don't understand and over which they exercise no control. In contrast, if you understand how taxes relate to your life, you can take an active role. You can take positive steps to minimize your personal tax to the fullest extent allowed by law. You can make informed financial decisions to take advantage of tax-saving opportunities. You can draw rational conclusions about the efficiency and fairness of existing tax laws and can assess the merit of competing tax reform proposals. Finally, you can change the tax system by participating as a voter in the democratic process.

The Text's Objectives

Principles of Taxation for Business and Investment Planning has three objectives that motivate the overall design of the text, the selection and ordering of topics, and the development of each topic.

Introducing Tax Policy Issues

The first objective is to acquaint you with the economic and social policy implications of the tax systems by which governments raise revenues. Most of the subject matter of the text pertains to today's tax environment and how successful businesses adapt to and take advantage of that environment. But the text also raises normative issues concerning the efficiency and equity of many features of the tax environment. You will learn how certain provisions of the tax law are intended to further the government's fiscal policy goals. You are invited to evaluate these goals and to question whether the tax system is an appropriate mechanism for accomplishing the goals.

The text identifies potentially negative aspects of the tax environment. It explains how taxes may adversely affect individual behavior or cause unintended and undesirable outcomes. You will be asked to consider whether certain provisions of the tax law favor one group of taxpayers over another and whether such favoritism is justifiable on any ethical grounds. After probing both the strengths and weaknesses of the current tax system, you can draw your own conclusions as to how the system can be improved.

Bridging the Gap between Finance and Tax

The second objective of the text is to bridge the academic gap between the study of financial theory and the study of tax law. Finance courses teach students how to make decisions on the basis of after-tax cash flows. However, these courses give only rudimentary instruction on determining the tax consequences of transactions and overlook the possibilities for controlling tax costs to maximize cash flows. In extreme cases, financial models simply ignore tax consequences by assuming that business decisions are made in a tax-free environment.

Traditional tax law courses err in the opposite direction. These courses teach students to apply statutory rules to well-defined, closed-fact situations to determine the tax consequences. Correct application of the rule is the learning objective. Students are not required to integrate the tax consequences of transactions into a business decision-making framework. In other words, they don't translate tax outcomes into cash flows. Traditional law courses may fail to encourage students to consider how closed-fact situations can be restructured to change the tax outcome and improve financial results. Consequently, students

often develop the habit of analyzing transactions from a backward-looking *compliance* perspective rather than a forward-looking *planning* perspective.

The focus of *Principles of Taxation for Business and Investment Planning* is the common ground shared by financial theory and tax law. The connecting links between the two disciplines are stressed throughout the text. You will learn how effective business planning depends on an accurate assessment of relevant tax factors. Tax rules and regulations are presented and illustrated in the context of a decision-making framework. Admittedly, these rules and regulations are tough to master. Two observations should give you reassurance. First, while the tax law is extremely technical and complex, the application of its underlying principles to business decision making is relatively straightforward. Second, you can learn to appreciate tax planning strategies without becoming a tax-compliance expert.

Teaching the Framework of the Income Tax

The third objective of *Principles of Taxation for Business and Investment Planning* is to teach the framework of the federal income tax, the dominant feature of the modern tax environment. This framework has been remarkably stable over time, even though the details of the law change every year. Students who learn the framework needn't worry that their knowledge will be outdated when Congress enacts its next revenue bill.

The federal income tax system has a bad reputation as an impenetrable, intractable body of law. While the income tax law is every bit as complicated as its critics suggest, its framework consists of a manageable number of basic principles. The principles are internally consistent and underlie many technical provisions. By concentrating on these principles, you can attain a sufficient level of tax knowledge in a single introductory course. You will not be a tax expert, but you will be tax literate. You may not be capable of implementing sophisticated tax planning strategies, but you will appreciate how those strategies can improve cash flows and maximize wealth.

Because this text takes a conceptual approach to the tax law, narrowly drawn provisions, exceptions, limitations, and special cases are deemphasized. Details with the potential to confuse rather than clarify tax principles are usually relegated to footnotes. When we do examine a detailed provision of the law, the detail should illuminate an underlying concept. Or we may discuss a thorny technical rule just to emphasize the practical difficulties encountered by tax professionals who don't have the luxury of dealing with concepts.

The conceptual approach should sensitize you to the tax implications of transactions and cultivate your ability to ask good tax questions. This approach downplays the importance of the answers to these questions. Knowing the answers or, more precisely, *finding* the answers to tax questions is the job of accountants and attorneys who devote long hours in their research libraries to that end. A tax-sensitive business manager knows when to consult these experts and can help formulate the tax issues for the expert to resolve. The text's emphasis on issue recognition rather than issue resolution is reflected in the problems at the end of each chapter. Many of these problems ask you to analyze a fact situation and simply identify any tax concerns or opportunities. Other problems present you with facts suggesting tax issues with no correct solution.

A Word to Accounting Majors

Principles of Taxation for Business and Investment Planning is an ideal introductory text for those of you who are concentrating in accounting and who may even plan to specialize in taxation. You will benefit enormously from mastering the framework of the income tax as the first step in your professional education. This mastery will be the foundation for the

future study of advanced topics. You will gain a command of basic principles on which to rely as you develop an instinct for your subject—a facility for diagnosing the tax issues suggested by unfamiliar and unusual transactions.

The conceptual approach is appropriate for the first tax course because it concentrates on broad issues concerning most taxpayers instead of narrow problems encountered by only a few taxpayers. If you learn these issues, you will be well prepared to expand and deepen your tax knowledge through professional experience. You will understand that taxes are only one aspect of the economic decision-making process. Because of this understanding, those of you who become tax professionals will be equipped to serve your clients not just as tax specialists but as business advisers.

CPA Exam Preparation

This text provides excellent preparation for the computer-based CPA exam. The text covers approximately 90 percent of the specified federal tax content of the Regulation portion of the exam. The 10 percent remaining content consists of advanced topics usually covered in a second-semester undergraduate tax course.

The CPA exam includes a variety of interactive problems designed to test your knowledge of the tax law and your ability to apply the law in realistic situations. Many of the problems are in the form of *simulations*: short cases in which you must demonstrate your tax research and analytic skills. These are the exact skills that you will learn, practice, and refine as you work your way through *Principles of Taxation for Business and Investment Planning*.

Conclusion

The authors hope this introduction has conveyed the message that people who decide on a particular course of action without considering the tax outcomes are making an uninformed, and possibly incorrect, decision. By proceeding with the course of study contained in this text, you will learn to recognize the tax implications of a whole spectrum of transactions. On entering the business world, you will be prepared to make decisions incorporating this knowledge. You will spot tax problems as they arise and will call in a tax professional before, rather than after, a transaction with profound tax consequences. Finally, you will understand that effective tax planning can save more money than the most diligent tax compliance.

Brief Contents

A Note from the Authors viii

Introduction to Students xxv

PART ONE

Exploring the Tax Environment

- 1** Taxes and Taxing Jurisdictions 3
- 2** Policy Standards for a Good Tax 23

PART TWO

Fundamentals of Tax Planning

- 3** Taxes as Transaction Costs 49
- 4** Maxims of Income Tax Planning 73
- 5** Tax Research 97

PART THREE

The Measurement of Taxable Income

- 6** Taxable Income from Business Operations 123
- 7** Property Acquisitions and Cost Recovery Deductions 163
 - Appendix 7–A** Midquarter Convention Tables 204
- 8** Property Dispositions 207
- 9** Nontaxable Exchanges 249

PART FOUR

The Taxation of Business Income

- 10** Sole Proprietorships, Partnerships, LLCs, and S Corporations 279
- 11** The Corporate Taxpayer 319
 - Appendix 11–A** Schedule M-3 for Reconciling Book and Taxable Income 351
- 12** The Choice of Business Entity 355

- 13** Jurisdictional Issues in Business Taxation 381

PART FIVE

The Individual Taxpayer

- 14** The Individual Tax Formula 417
 - Appendix 14–A** Itemized Deduction Worksheet 450
 - Appendix 14–B** Exemption Amount Worksheet 451
- 15** Compensation and Retirement Planning 453
- 16** Investment and Personal Financial Planning 495
 - Appendix 16–A** Comprehensive Schedule D Problem 539
- 17** Tax Consequences of Personal Activities 545
 - Appendix 17–A** Social Security Worksheet (Adapted from IRS Publication 915) 576

PART SIX

The Tax Compliance Process

- 18** The Tax Compliance Process 579

APPENDIXES

- A** Present Value of \$1 603
- B** Present Value of Annuity of \$1 604
- C** 2015 Income Tax Rates 605

GLOSSARY 607

INDEX 619

Contents

A Note from the Authors viii

Introduction to Students xxv

PART ONE

EXPLORING THE TAX ENVIRONMENT

Chapter 1

Taxes and Taxing Jurisdictions 3

Some Basic Terminology 4

The Relationship between Base, Rate, and Revenue 5

Transaction- or Activity-Based Taxes 6

Earmarked Taxes 6

The Pervasive Nature of Taxation 6

Local Taxes 7

State Taxes 8

Federal Taxes 10

Taxes Levied by Foreign Jurisdictions 12

Jurisdictional Competition 13

Dynamic Nature of Taxation 13

Tax Base Changes 13

Taxes and the Political Process 14

Sources of Federal Tax Law 15

Statutory Authority 15

Administrative Authority 16

Judicial Authority 16

Conclusion 17

Key Terms 17

Questions and Problems for Discussion 17

Application Problems 18

Issue Recognition Problems 20

Research Problems 21

Tax Planning Cases 21

Chapter 2

Policy Standards for a Good Tax 23

Standards for a Good Tax 24

Taxes Should Be Sufficient 24

The National Debt 25

How to Increase Tax Revenues 25

Static versus Dynamic Forecasting 25

Behavioral Responses to Rate Changes 27

Taxes Should Be Convenient 30

Taxes Should Be Efficient 30

The Classical Standard of Efficiency 31

Taxes as an Instrument of Fiscal Policy 31

Taxes and Behavior Modification 32

Taxes Should Be Fair 34

Ability to Pay 34

Horizontal Equity 34

Vertical Equity 35

Distributive Justice 38

The Perception of Inequity 40

Conclusion 40

Key Terms 41

Questions and Problems for Discussion 41

Application Problems 43

Issue Recognition Problems 44

Research Problems 45

Tax Planning Case 45

PART TWO

FUNDAMENTALS OF TAX PLANNING

Chapter 3

Taxes as Transaction Costs 49

The Role of Net Present Value in

Decision Making 50

Quantifying Cash Flows 50

The Concept of Present Value 50

The Issue of Risk 52

Net Present Value Example 53

Taxes and Cash Flows 53

The Significance of Marginal Tax Rate 54

Net Present Value Example Revisited 55

The Uncertainty of Tax Consequences 57

Structuring Transactions to Reduce Taxes 59

An Important Caveat 60

Transactional Markets 60

Conclusion 64

Key Terms 65

Questions and Problems for Discussion 65

Application Problems 66

Issue Recognition Problems 69

Tax Planning Cases 70

Chapter 4**Maxims of Income Tax Planning 73**

- Tax Avoidance—Not Evasion 74
- What Makes Income Tax Planning Possible? 74
- The Entity Variable 75
 - Income Shifting* 76
 - Deduction Shifting* 76
 - Constraints on Income Shifting* 77
- The Time Period Variable 77
 - Income Deferral and Opportunity Costs* 79
 - Income Deferral and Rate Changes* 80
- The Jurisdiction Variable 81
- The Character Variable 81
 - Determining the Value of Preferential Rates* 82
 - Constraints on Conversion* 83
 - Implicit Taxes* 83
- Developing Tax Planning Strategies 84
 - Additional Strategic Considerations* 85
 - Tax Legal Doctrines* 87
- Conclusion 88
- Key Terms 89
- Questions and Problems for Discussion 89
- Application Problems 90
- Issue Recognition Problems 93
- Research Problems 94
- Tax Planning Cases 95

Chapter 5**Tax Research 97**

- Developing Tax Research Skills 97
 - The Tax Research Process* 98
- Step 1: Get the Facts 99
- Step 2: Identify the Issues 100
- Step 3: Locate Authority 101
 - Primary Authorities* 101
 - Secondary Authorities* 103
 - Strategies for Locating Relevant Authority* 104
- Step 4: Analyze Authority 107
- Step 5: Repeat Steps 1 through 4 109
- Step 6: Communicate Your Conclusions 110
- Conclusion 112
- Key Terms 113
- Questions and Problems for Discussion 113
- Application Problems 114
- Issue Recognition Problems 116
- Research Problems 116
- Tax Planning Cases 119

PART THREE**THE MEASUREMENT OF TAXABLE INCOME****Chapter 6****Taxable Income from Business Operations 123**

- Business Profit as Taxable Income 124
- The Taxable Year 125
 - Changing a Taxable Year* 126
 - Annualizing Income on a Short-Period Return* 126
- Methods of Accounting 128
 - Tax Policy Objectives* 129
- The Cash Method 131
 - Constructive Receipt* 132
 - Prepaid Expenses and Interest* 133
 - Merchandise Inventories* 134
 - Limitations on Use of the Cash Method by Corporations* 135
- The Accrual Method 135
 - Contrasting Perspectives on Income Measurement* 136
 - Permanent versus Temporary Differences* 136
 - Tax Expense versus Tax Payable* 138
 - Temporary Book/Tax Accounting Differences* 139
- Net Operating Losses 145
 - The Problem of Excess Deductions* 145
 - Solution: The NOL Deduction* 146
 - Valuing an NOL Deduction* 147
 - Giving Up an NOL Carryback* 148
 - Accounting for NOLs* 149
- Conclusion 149
- Sources of Book/Tax Differences 150
- Key Terms 150
- Questions and Problems for Discussion 150
- Application Problems 151
- Issue Recognition Problems 158
- Research Problems 160
- Tax Planning Cases 160

Chapter 7**Property Acquisitions and Cost Recovery Deductions 163**

- Deductible Expense or Capitalized Cost? 164
 - Repairs and Cleanup Costs* 165
 - Deductions of Capital Expenditures as Subsidies* 167
- The Critical Role of Tax Basis 168
 - Basis, Cost Recovery, and Cash Flow* 168
 - Cost Basis* 169

Introduction to Cost Recovery Methods	171
Inventories and Cost of Goods Sold	171
<i>The Unicap Rules</i>	172
<i>Computing Cost of Goods Sold</i>	172
Depreciation of Tangible Business Assets	173
<i>Book and Tax Concepts of Depreciation</i>	173
<i>The MACRS Framework</i>	173
<i>Limited Depreciation for Passenger Automobiles</i>	179
<i>Section 179 Expensing Election</i>	180
<i>Bonus Depreciation</i>	182
<i>Purchase versus Leasing Decision</i>	183
Amortization of Intangible Assets	184
<i>Organizational and Start-Up Costs</i>	185
<i>Leasehold Costs and Improvements</i>	186
<i>Business Acquisition Intangibles</i>	187
<i>Comprehensive Example of a Lump-Sum Purchase</i>	188
Depletion of Natural Resources	189
<i>Percentage Depletion</i>	189
Cost Recovery-Related Book/Tax Differences	191
<i>Depreciation Book-Tax Differences</i>	191
<i>Inventory Book/Tax Differences</i>	191
<i>Book/Tax Difference for Organizational and Start-up Costs</i>	192
<i>Book/Tax Difference for Goodwill</i>	192
Conclusion	193
Sources of Book/Tax Differences	193
Key Terms	194
Questions and Problems for Discussion	194
Application Problems	195
Issue Recognition Problems	200
Research Problems	201
Tax Planning Cases	202
Appendix 7–A Midquarter Convention Tables	204

Chapter 8

Property Dispositions 207

Computation of Gain or Loss Recognized	208
<i>Sales and Exchanges</i>	209
<i>Seller-Financed Sales</i>	211
<i>Disallowed Losses on Related Party Sales</i>	214
Tax Character of Gains and Losses	215
<i>Capital Asset Definition</i>	216
<i>Capital Loss Limitation</i>	216
<i>Taxation of Capital Gains</i>	218
<i>Capital Asset Definition Revisited</i>	218

Dispositions of Noncapital Assets	219
<i>Inventory</i>	219
<i>Business Accounts Receivable and Supplies</i>	220
<i>Section 1231 Assets</i>	221
<i>Depreciation Recapture</i>	223
<i>Comprehensive Example</i>	227
Other Property Dispositions	229
<i>Abandonment and Worthlessness</i>	229
<i>Foreclosures</i>	231
<i>Casualties and Thefts</i>	231
Book/Tax Differences on Asset Dispositions	232
<i>Gain or Loss Book/Tax Differences</i>	232
<i>Book/Tax Difference for Nondeductible Capital Loss</i>	233
Conclusion	233
Sources of Book/Tax Differences	234
Key Terms	234
Questions and Problems for Discussion	234
Application Problems	235
Issue Recognition Problems	244
Research Problems	245
Tax Planning Cases	246
CPA Exam Simulation	247

Chapter 9

Nontaxable Exchanges 249

Tax Neutrality for Asset Exchanges	249
A Generic Nontaxable Exchange	250
<i>Exchanges of Qualifying Property</i>	250
<i>The Substituted Basis Rule</i>	251
<i>The Effect of Boot</i>	252
<i>Book/Tax Difference from Nontaxable Exchange</i>	253
<i>Summary</i>	254
Like-Kind Exchanges	254
<i>Exchanges of Mortgaged Properties</i>	257
Involuntary Conversions	259
Formations of Business Entities	260
<i>Corporate Formations</i>	260
<i>Partnership Formations</i>	262
Wash Sales	263
Conclusion	263
Sources of Book/Tax Differences	264
Key Terms	264
Questions and Problems for Discussion	264
Application Problems	265
Issue Recognition Problems	271
Research Problems	272
Tax Planning Cases	273
Comprehensive Problems for Part Three	274

PART FOUR

THE TAXATION OF BUSINESS INCOME

Chapter 10

Sole Proprietorships, Partnerships, LLCs, and S Corporations 279

Sole Proprietorships	280
<i>Overview of Schedule C</i>	280
<i>Employment Taxes</i>	284
<i>Self-Employment Tax</i>	287
Partnerships	288
<i>Forming a Partnership</i>	288
<i>Limited Liability Companies</i>	289
<i>Partnership Reporting Requirements</i>	291
<i>Tax Consequences to Partners</i>	292
<i>Adjusting the Basis of a Partnership Interest</i>	296
Subchapter S Corporations	300
<i>Eligible Corporations</i>	300
<i>Tax Consequences to Shareholders</i>	303
<i>Adjusting the Basis of S Corporation Stock</i>	306
Conclusion	307
Key Terms	308
Questions and Problems for Discussion	308
Application Problems	309
Issue Recognition Problems	314
Research Problems	315
Tax Planning Cases	316
CPA Exam Simulation	317

Chapter 11

The Corporate Taxpayer 319

Legal Characteristics of Corporations	320
<i>Affiliated Groups</i>	320
<i>Nonprofit Corporations</i>	322
Computing Corporate Taxable Income	322
<i>The Dividends-Received Deduction</i>	324
<i>Reconciling Book Income and Taxable Income</i>	325
Computing the Regular Corporate Tax	326
<i>Personal Service Corporations</i>	328
<i>Reduced Tax Burden on Domestic Manufacturers</i>	328
Tax Credits	329
<i>Rehabilitation Credit</i>	330
Alternative Minimum Tax	331
<i>Alternative Minimum Taxable Income</i>	332
<i>Calculating AMT</i>	334
<i>Minimum Tax Credit</i>	335
Payment and Filing Requirements	336

Distributions of Profits to Investors	337
<i>Alternatives to Double Taxation</i>	338
Incidence of the Corporate Tax	339
Conclusion	340
Sources of Book/Tax Differences	340
Key Terms	340
Questions and Problems for Discussion	340
Application Problems	341
Issue Recognition Problems	347
Research Problems	348
Tax Planning Cases	349
CPA Exam Simulation	350
Appendix 11–A Schedule M-3 for Reconciling Book and Taxable Income	351

Chapter 12

The Choice of Business Entity 355

Tax Planning with Passthrough Entities	356
<i>Tax Benefit of Start-Up Losses</i>	356
<i>Avoiding a Double Tax on Business Income</i>	357
<i>Income Shifting among Family Members</i>	358
Partnership or S Corporation?	361
<i>Contrasting Characteristics</i>	361
<i>Two Planning Cases</i>	363
Tax Planning with Closely Held Corporations	364
<i>Getting Cash out of the Corporation</i>	364
<i>Decline of the Corporate Tax Shelter</i>	367
<i>Penalty Taxes on Corporate Accumulations</i>	368
<i>Controlled Corporate Groups</i>	370
Conclusion	371
Key Terms	371
Questions and Problems for Discussion	371
Application Problems	373
Issue Recognition Problems	377
Research Problems	378
Tax Planning Cases	379

Chapter 13

Jurisdictional Issues in Business Taxation 381

State and Local Taxation	382
<i>Gross Receipts Taxes</i>	382
<i>Constitutional Restrictions on State Jurisdiction</i>	383
<i>Apportionment of Business Income</i>	385
<i>Tax Planning Implications</i>	387

Tax Consequences of International Business Operations	388
<i>Income Tax Treaties</i>	388
<i>U.S. Jurisdiction to Tax Global Income</i>	389
Foreign Tax Credit	390
<i>Limitation on the Annual Credit</i>	390
Organizational Forms for Overseas Operations	393
<i>Branch Offices and Foreign Partnerships</i>	393
<i>Domestic Subsidiaries</i>	393
<i>Foreign Subsidiaries</i>	394
Deferral of U.S. Tax on Foreign Source Income	396
<i>Controlled Foreign Corporations</i>	398
<i>Transfer Pricing and Section 482</i>	401
<i>Book/Tax Differences Related to Foreign Operations</i>	402
Conclusion	402
Sources of Book/Tax Differences	403
Key Terms	403
Questions and Problems for Discussion	403
Application Problems	405
Issue Recognition Problems	409
Research Problems	410
Tax Planning Cases	411
Comprehensive Problems for Part Four	412

PART FIVE

THE INDIVIDUAL TAXPAYER

Chapter 14

The Individual Tax Formula 417

Filing Status for Individuals	418
<i>Married Individuals and Surviving Spouses</i>	418
<i>Unmarried Individuals</i>	419
Overview of the Taxable Income Computation	419
<i>The Four-Step Procedure</i>	419
<i>Step 1: Calculate Total Income</i>	420
<i>Step 2: Calculate Adjusted Gross Income</i>	420
<i>Step 3: Subtract Standard Deduction or Itemized Deductions</i>	420
<i>Step 4: Subtract Exemption Amount</i>	425
<i>The Taxable Income Formula</i>	428
Computing Individual Tax	429
<i>The Elusive Marginal Tax Rate</i>	431
<i>The Marriage Penalty Dilemma</i>	432
Individual Tax Credits	434
<i>Child Credit</i>	434
<i>Dependent Care Credit</i>	435
<i>Earned Income Credit</i>	435
<i>Excess Social Security Tax Withholding Credit</i>	436

Alternative Minimum Tax	437
Payment and Filing Requirements	439
Conclusion	440
Key Terms	441
Questions and Problems for Discussion	441
Application Problems	442
Issue Recognition Problems	447
Research Problems	448
Tax Planning Cases	449
Appendix 14–A Itemized Deduction Worksheet	450
Appendix 14–B Exemption Amount Worksheet	451

Chapter 15

Compensation and Retirement Planning 453

The Compensation Transaction	454
Employee or Independent Contractor?	454
<i>Tax Consequences of Worker Classification</i>	454
<i>Worker Classification Controversy</i>	455
Wage and Salary Payments	457
<i>Reasonable Compensation</i>	457
<i>Foreign Earned Income Exclusion</i>	460
Employee Fringe Benefits	461
<i>Fringe Benefits and Self-Employed Individuals</i>	462
<i>Compensation Planning with Fringe Benefits</i>	463
Employee Stock Options	464
<i>Book/Tax Difference</i>	466
<i>Incentive Stock Options</i>	466
Employment-Related Expenses	468
<i>Moving Expenses</i>	468
Retirement Planning	469
<i>Tax Advantages of Qualified Retirement Plans</i>	469
<i>Premature Withdrawals</i>	471
Types of Qualified Plans	472
<i>Employer-Provided Plans</i>	472
<i>Keogh Plans for Self-Employed Individuals</i>	476
Individual Retirement Accounts	477
<i>Limits on IRA Contributions</i>	477
<i>Deduction of IRA Contributions</i>	478
<i>Withdrawals from IRAs</i>	480
<i>Rollovers to IRAs</i>	482
Conclusion	483
Sources of Book/Tax Differences	483
Key Terms	483
Questions and Problems for Discussion	484
Application Problems	485
Issue Recognition Problems	490
Research Problems	492
Tax Planning Cases	493

Chapter 16**Investment and Personal Financial Planning 495**

Business versus Investment Activities	496
Investments in Financial Assets	496
<i>Dividend and Interest Income</i>	496
<i>Tax-Exempt Interest</i>	499
<i>Deferred Interest Income</i>	500
<i>Life Insurance Policies and Annuity Contracts</i>	502
Gains and Losses from Security Transactions	504
<i>Computing Gains and Losses</i>	504
Tax Consequences of Capital Gains and Losses	507
<i>Netting Capital Gains and Losses</i>	507
<i>Preferential Rates on Long-Term Capital Gains</i>	509
<i>Policy Reasons for a Preferential Rate</i>	511
<i>Capital Loss Limitation</i>	512
Investments in Small Corporate Businesses	513
<i>Qualified Small Business Stock</i>	513
<i>Section 1244 Stock</i>	514
Investment Expenses	514
<i>Investment Interest Expense</i>	515
Investments in Real Property	516
<i>Undeveloped Land</i>	516
<i>Rental Real Estate</i>	517
Investments in Passive Activities	518
<i>Passive Activity Loss Limitation</i>	519
<i>Planning with Passive Activity Losses</i>	521
Unearned Income Medicare Contribution Tax	522
Wealth Transfer Planning	522
<i>The Transfer Tax System</i>	523
<i>The Gift Tax</i>	523
<i>The Estate Tax</i>	525
Conclusion	528
Key Terms	528
Questions and Problems for Discussion	528
Application Problems	529
Issue Recognition Problems	536
Research Problems	537
Tax Planning Cases	537
Appendix 16–A Comprehensive Schedule D Problem	539

Chapter 17**Tax Consequences of Personal Activities 545**

Gross Income from Whatever Source Derived	545
<i>Prizes, Awards, Gifts, and Inheritances</i>	546
<i>Legal Settlements</i>	547

<i>Government Transfer Payments</i>	548
<i>Gains on Sales of Personal Assets</i>	550
Personal Expenses	551
<i>Medical Expenses</i>	551
<i>Local, State, and Foreign Tax Payments</i>	552
<i>Charitable Contributions</i>	553
<i>Tax Subsidies for Education</i>	554
Personal Losses	555
<i>Losses on Sales of Personal Assets</i>	555
<i>Casualty and Theft Losses</i>	556
<i>Hobby and Gambling Losses</i>	557
Tax Consequences of Home Ownership	558
<i>Home Mortgage Interest Deduction</i>	559
<i>Vacation Homes</i>	560
<i>Exclusion of Gain on Sale of Principal Residence</i>	560
Itemized Deductions as AMT Adjustments	561
Conclusion	562
Key Terms	563
Questions and Problems for Discussion	563
Application Problems	564
Issue Recognition Problems	570
Research Problems	571
Tax Planning Cases	572
Comprehensive Problems for Part Five	573
CPA Exam Simulations	574
Appendix 17–A Social Security Worksheet (Adapted from IRS Publication 915)	576

PART SIX**THE TAX COMPLIANCE PROCESS****Chapter 18****The Tax Compliance Process 579**

Filing and Payment Requirements	580
<i>Late-Filing and Late-Payment Penalty</i>	581
<i>Return Processing</i>	582
The Audit Process	583
<i>Your Rights as a Taxpayer</i>	584
<i>Noncompliance Penalties</i>	585
<i>Tax Return Preparer Penalties</i>	588
Contesting the Result of an Audit	589
<i>Litigation</i>	589
<i>A Case History: Lori Williams v. United States</i>	591
<i>Making the Legal System More Taxpayer Friendly</i>	592

<i>IRS Collection Procedures</i>	593
<i>The Innocent Spouse Rule</i>	594
Conclusion	595
Key Terms	595
Questions and Problems for Discussion	595
Application Problems	597
Issue Recognition Problems	599
Research Problems	600
Tax Planning Cases	600

Appendix A	Present Value of \$1	603
Appendix B	Present Value of Annuity of \$1	604
Appendix C	2015 Income Tax Rates	605
Glossary		607
Index		619

Part One

Exploring the Tax Environment

- 1 Taxes and Taxing Jurisdictions
- 2 Policy Standards for a Good Tax