PRINCIPLES OF TAXATION
for Business and Investment Planning

2016

Sally M. Jones
Shelley C. Rhoades-Catanach

McGraw Hill Education

Principles of Taxation

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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

McGraw Hill Education

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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 ONE

Exploring 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 TWO

Fundamentals of Tax Planning

PART THREE

The Measurement of Taxable Income

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

The Taxation of Business Income

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

The Individual Taxpayer

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

The Tax Compliance Process

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 fl

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 a cial shifts of income from one taxpayer to another. Over 80 years ago, the Supreme C decided that income must be taxed to the person who earns it, even if another person l legal right to the wealth represented by the income.[5] Thus, a business owner who rec a $10,000 check in payment for services rendered to a client can't avoid reporting $10 income by simply endorsing the check over to his daughter. In the picturesque languag the Court, the tax law must disregard arrangements "by which the fruits are attributed different tree from that on which they grew."

The Supreme Court elaborated on this theme in the case of a father who detached gotiable interest coupons from corporate bonds and gave the coupons to his son as a

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

		Entity M		*Entity N*
Year 0:				
Before-tax cash flow		$25,000		$25,0
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 inc Firm Z operates in State Z, which imposes a flat 10 percent tax on business income federal purposes, state income tax payments are deductible in the computation of tax income.[8] Both firms face a 39 percent federal tax rate. Under these facts, Firms Y a 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	$2,928	$2,745

A comparison of these after-tax cash flows gives us our third income tax planning im: *Tax costs decrease (and cash flows increase) when income is generated in a jurisdi*

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
all-events test 140
allowance method 144
annualized income 127
calendar year 125
cash method of accounting 131
constructive receipt 132
deferred tax asset 138
deferred tax liability 138
direct write-off method 144
economic performance 141
fiscal year 125
generally accepted accounting principles (GAAP) 135
gross income 124
hybrid method of accounting 134
key-person life insurance policies 130
method of accounting 128
net operating loss (NOL)
NOL carryforw
payment liabili
permanent diffe
personal servic corporation
prepaid income
realization 13
recognition 1
recurring item exception 1
short-period ret
tax benefit rule
tax

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

- 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

Temporary

- Prepaid income
- Bad debts
- Accrued expenses failing th 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 cl An employee discovered a cache of gold coins in a desk drawer. A local c Firm LK the rightful owner of the coins, which have a $72,000 FMV. D recognize income because of this lucky event?

LO 6-2 2. Discuss the choice of a taxable year for the following businesses:

a. Retail plant and garden center.
b. French bakery.
c. Chimney cleaning business.
d. Moving and transport business.
e. Software consulting business.

LO 6-3 3. Corporation DB operates three different lines of business. Can the corpo different overall method of accounting for each line or must the corporati overall method?

LO 6-3 4. Lester Inc. owns 55 percent of the outstanding stock of Marvin Corporat

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.

connect ACCOUNTING **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 corporation with $48,300 taxable income?

b. What are the tax liability, the marginal tax rate, and the average tax rate fo ration with $615,800 taxable income?

c. What are the tax liability, the marginal tax rate, and the average tax

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 e in the form of a question.

LO 4-3 1. Dr. P is a physician with his own medical practice. For the last several y marginal income tax rate has been 39.6 percent. Dr. P's daughter, who is student, has no taxable income. During the last two months of the year, structs his patients to remit their payments for his services directly to his

LO 4-3 2. Mr. and Mrs. K own rental property that generates $4,000 monthly revenue. T is 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 an 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 each returned magazine. During December 2015, Bontaine recorded $919,400 of mag azine sales. During January 2016, Bontaine refunded $82,717 to retailers that returne magazines purchased during December. Can Bontaine reduce its 2015 income by th refund paid?

LO 6-1, 6-6 2. CheapTrade, an accrual basis, calendar year corporation, operates a discount secur ties brokerage business. CheapTrade accepts orders to buy or sell marketable secur ties for its customers and charges them a commission fee for effecting the transactio in a timely, low-cost manner. CheapTrade executes an order on the "trade" date, bu title to the securities is not legally transferred and payment to or from the customer not due until the "settlement date." In the normal five-day interval between the trad and settlement dates, CheapTrade performs administrative and accounting functions

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 al realty that T needs for use in its business. The FMV of the realty is NS's adjusted basis is $5.6 million. Both NS and T are in the 35 perc bracket. Discuss the tax implications of each of the following cours decide which course you would recommend to NS.

a. NS could exchange the realty for newly issued shares of T stock w

b. NS could sell the realty to T for $4 million cash.

c. NS could lease the realty to T for its annual fair rental value of $6

LO 9-5 2. Firm K, a noncorporate taxpayer, has owned investment land with a $ four years. Two unrelated parties want to acquire the land from K. Pa $770,000 cash, and Party B has offered another tract of land with a $ K accepts Party B's offer, it would hold the new land for no more than selling it. The FMV of this land should appreciate 10 percent annuall capital gain is 15 percent, and it uses a 7 percent discount rate to comp

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 engineeri The new entity, MST Consulting Services, LLP, began operations on Januar and uses the calendar year for reporting purposes. The partners expect to work MST, and each contributed cash and other property to the partnership suffici mence operations.

Topics covered in the simulation:

- Basis of contributed property
- Depreciation of contributed property

How Can Technology Help Improve Student Success?

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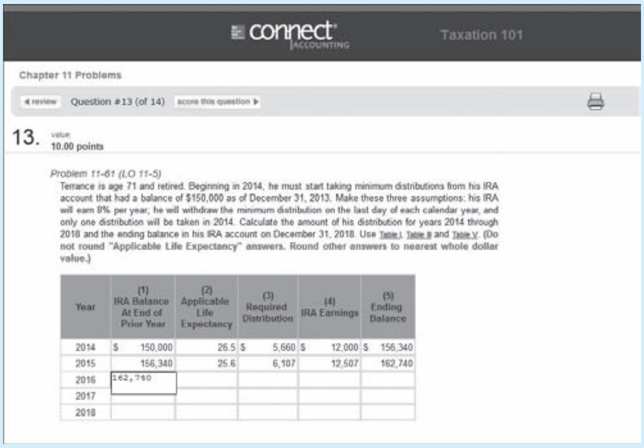
McGraw-Hill *Connect Accounting* is a digital teaching and learning environment that gives students the means to better connect with their coursework, their instructors, and the important concepts that they will need to know for success now and in the future. With *Connect Accounting,* instructors can 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.

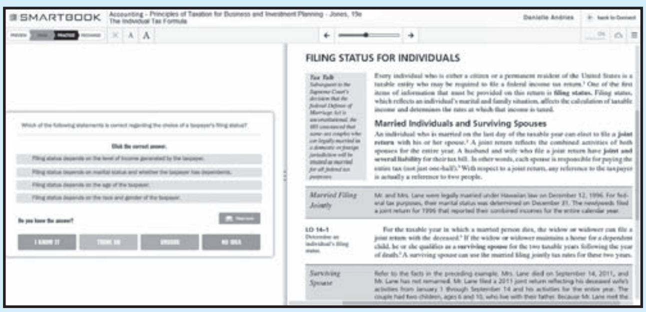
In short, *Connect Accounting* offers students powerful tools and features that optimize their time and energy, enabling them to focus on learning.

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

SmartBook, powered by LearnSmart

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.

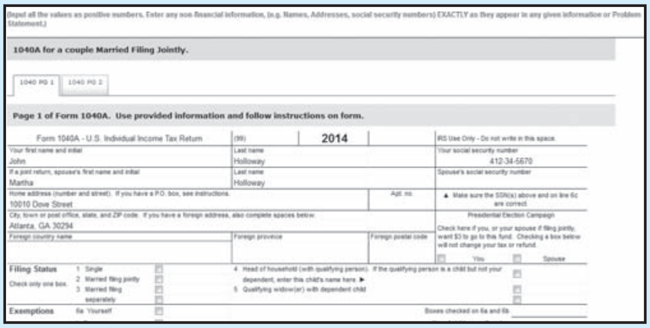
SmartBook™, which is powered by LearnSmart, is the first and only adaptive reading experience designed to change the way students read and learn. It creates a personalized reading experience by highlighting the most impactful concepts a student needs to learn at that moment in time. As a student engages 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.

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.

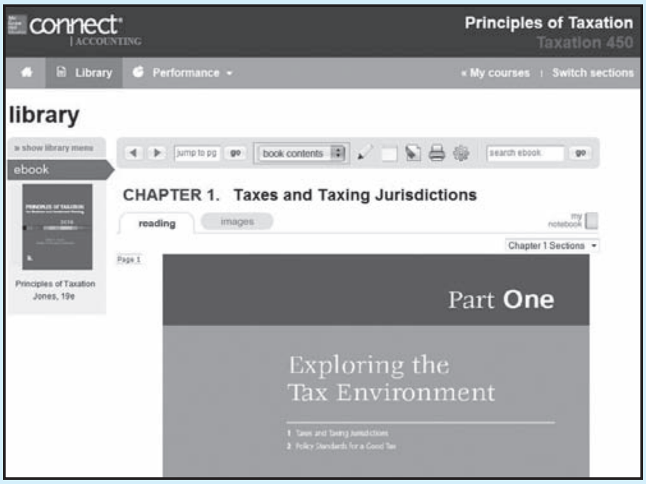


Online assignments

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.



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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.

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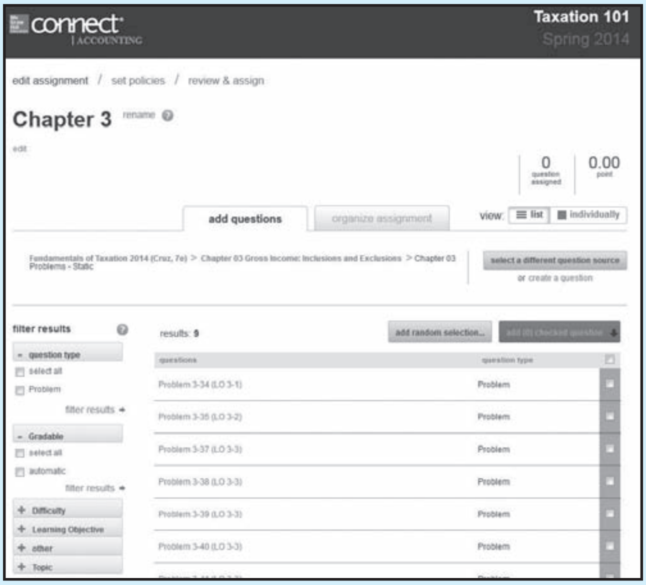

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Connect Accounting keeps instructors informed about how each student, section, and class is performing, allowing for more productive use of lecture and office hours. The reports tab enables you to:

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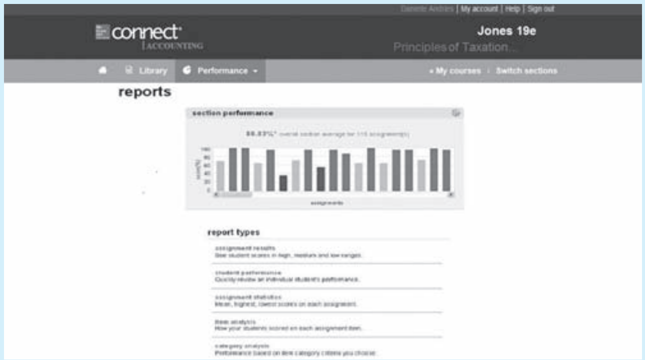

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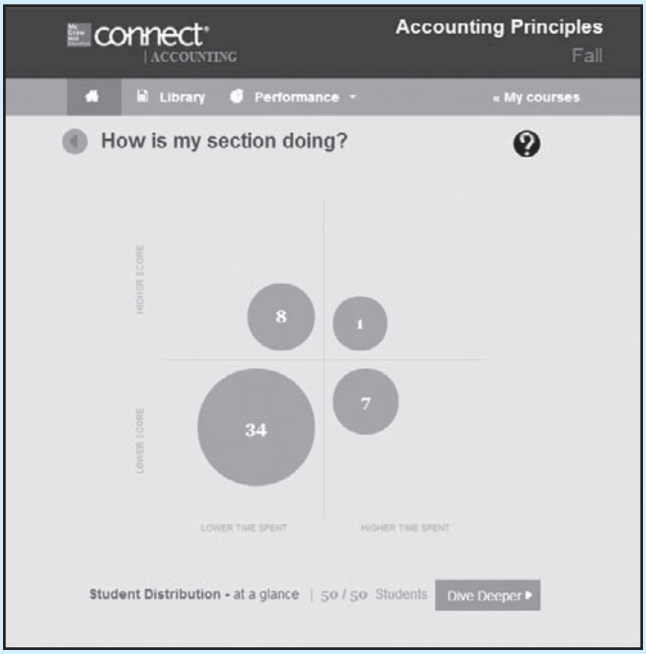
The first and only analytics tool of its kind, Connect Insight™ is a series of visual data displays—each framed by an intuitive question—to provide at-a-glance information regarding how your class is doing.

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?



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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:

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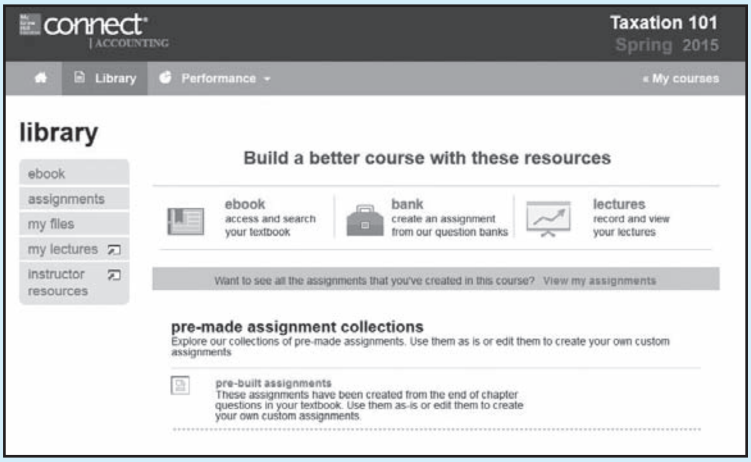

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Changes in *Principles of Taxation*, 2016 edition

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.

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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.

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Part **One**

Exploring the Tax Environment