

SHIRLEY DENNIS-ESCOFFIER • KAREN A. FORTIN

Taxation

for Decision Makers

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Taxation for Decision Makers

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Shirley Dennis-Escoffier

and

Karen A. Fortin

WILEY

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To the memory of Marty Escoffier who was always ready with a willing hand to help, a word of encouragement as deadlines neared, and a sense of humor that never failed to make us laugh when we needed it most. His presence has been missed as we have worked on this revision.

Shirley Dennis-Escoffier and Karen A. Fortin

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Preface

FOCUS

This text is designed for a one-semester introductory tax course at either the undergraduate or graduate level. It is ideal for an MBA course or any program emphasizing a decision-making approach. This text introduces all tax topics on the CPA exam in only 12 chapters.

COMPREHENSIVE YET CLEAR AND CONCISE

This text covers basic taxation of all taxable entities—individuals, corporations, S corporations, partnerships, and fiduciary entities, emphasizing a balance between concepts and details. Tax concepts and applications are presented in a clear, concise, student-friendly writing style with sufficient technical detail to provide a foundation for future practice in taxation and consulting while not overwhelming the student with seldom-encountered details.

WHAT'S NEW THIS EDITION

The Tax Cuts and Jobs Act passed by Congress in December 2017 is the most significant change to tax law in more than thirty years. This text has been completely updated for all changes made by this Act as well as the Bipartisan Budget Act of 2018 and all other new pronouncements issued in the first several months of 2018. Because the CPA exam will not be testing on the new law until 2019, examples and problems on 2017 law are still included in this text in addition to the new law effective in 2018.

In addition to updating all chapters for changes to the tax law, Chapter 1 was modified to introduce the changes made to the taxation of corporations and flow-through businesses. The decision-making focus of this text is introduced in this first chapter through simple problems on the choice of business form.

Chapter 2 now includes a discussion of the legislative process involved in passing the Tax Cuts and Jobs Act. New tax forms are now introduced in several chapters of the text. A complete set of filled-in forms for a C corporation, partnership, S corporation, and sole proprietorship are also included on the companion website for this text.

Finally, the authors went over the text line-by-line, not only to update it, but to improve readability.

TAX PLANNING

The importance of tax planning is emphasized throughout the text. Margin icons are woven into each chapter to highlight planning opportunities. Tax planning strategies are introduced early in Chapter 2 along with the impact of taxes on cash flow.

LEARNING OBJECTIVES

Each chapter begins with learning objectives for that specific chapter as well as a basic introduction to the included topics, emphasizing why decision makers need to understand these topics. Each chapter is organized by learning objective making it easy to identify relevant topics.

**TAX
PLANNING**

SETTING THE STAGE—AN INTRODUCTORY CASE

Each chapter opens with a case that focuses on one or more key issues within the chapter to promote critical analysis and decision-making skills. The case is then revisited at the end of the chapter with a suggested solution to stimulate further class discussion.

EXAMPLES

Rigorous topics are tackled through numerous simple but realistic examples.

When Alex Rodriguez, the former Texas Rangers shortstop, lived in Texas (a state with no individual income tax), he owed more than \$271,000 to California (which assesses a non-resident income tax) for games he played in that state during baseball season. It was estimated that if the Rangers had played all their games at home, A-Rod's state tax bill could have been reduced by more than half a million dollars a year. When A-Rod switched to the New York Yankees, his state and local tax burden increased dramatically. On the \$155 million that A-Rod was to be paid over his seven-year contract, he was expected to owe \$3.57 million to New York City and an additional \$6.19 million to the State of New York for income taxes. His tax burden increased further when he renegotiated his contract in a deal worth \$275 million over ten years.

Example 1.1

KEY CASES

Key Cases bring real world applications into the classroom.

KEY CASES *In 2008, actor Wesley Snipes was sentenced to 3 years in prison for willfully failing to file tax returns for years 1999–2004, a period in which he earned more than \$38 million. Following an unsuccessful appeal, he served his sentence in a medium-security prison in Pennsylvania.*

In December 2014, Representative Michael Grimm, who had just been re-elected to his third term in Congress, resigned from Congress after agreeing to plead guilty to felony tax fraud. The indictment alleged that he kept two sets of records for a restaurant he previously owned concealing more than \$1 million in gross receipts and underreporting his employees' wages to avoid federal and state taxes. He faced up to 30 months in prison.

EXPANDED TOPICS

The *Expanded Topics* section included at the end of Chapters 3, 4, 6, 11, and 12 contains more advanced topics for instructors who wish to challenge their students. These advanced discussions relate to the other material within the chapters, but which our adopters and reviewers have indicated could be omitted to allow more time for the more critical material.

SUMMARY

Each chapter closes with a *Summary* of the most important topics introduced in the chapter, reinforcing important concepts for students.

KEY TERMS

A list of *Key Terms* is included at the end of each chapter. They appear in bold print and are keyed to the first page on which the term is discussed.

TEST YOURSELF

Each chapter includes a *Test Yourself* section of five multiple-choice questions for students to assess their understanding of topics covered in the chapter. Answers to these questions follow the end-of-chapter materials.

PROBLEM ASSIGNMENTS

More than 60 problems are included at the end of each chapter. *Check Your Understanding* includes a wide variety of noncomputational questions that review the topics included in the chapter. *Crunch the Numbers* presents quantitative problems covering the computational aspects of chapter materials. Comprehensive problems integrate topics covered in several different chapters.

DEVELOP PLANNING SKILLS

Develop Planning Skills problems give students the opportunity to test their knowledge in planning situations. The tax planning suggestions integrated throughout the text continually remind students of the importance of developing appropriate planning strategies.

THINK OUTSIDE THE TEXT

For instructors wishing to challenge their students, *Think Outside the Text* questions develop critical thinking skills by requiring students to expand their thinking beyond the material covered in the chapter.

IDENTIFY THE ISSUES

Identify the Issues includes short scenarios designed to challenge the students to identify issues and formulate research questions. These scenarios, however, do not provide enough information to enable students to develop definitive solutions but are designed to help students practice the issue-identification step in the research process, a step that many new tax students consider the most difficult.

DEVELOP RESEARCH SKILLS

Develop Research Skills requires students to research the relevant authorities and present possible solutions. These can be solved using a subscription-based tax service or free Internet sources. Citations to relevant Internal Revenue Code sections, cases, and rulings are included only in the Instructor's Manual along with solutions to these research problems, allowing each instructor to decide what, if any, hints should be given to students when a problem is assigned.

FILL-IN THE FORMS

Most of the chapters have problems that require completion of one or more tax forms in a *Fill-in the Forms* section. Some of these are very basic and may simply require completion of forms for earlier problems—usually one or two forms—and will assist in familiarizing the student with

basic tax forms. There are, however, several chapters that have more comprehensive problems that require completion of a number of forms. These will present a challenge to the student and lend themselves to completion in small groups. These include returns for individuals and the four types of business entities covered. All or parts of these problems may be assigned when the instructor feels the students are ready for additional challenges presented in translating tax knowledge to form completion. The solutions for these problems are only included in the Instructor's Manual.

CHAPTER APPENDICES

End-of-chapter appendices introduce topics not typically covered in a first tax course including corporate reorganizations and taxation of nonprofit entities. These materials are placed in chapter appendices to allow instructors the flexibility to include or omit them as deemed appropriate.

SAMPLE TAX RETURNS

Sample Filled-In Tax Returns are on the companion website for this text for easy access and updating. There are completed returns for a C corporation, S corporation, partnership, and a self-employed individual.

UP-TO-DATE

This text has been completely updated for all recent legislation and for all IRS pronouncements available as of April 2018.

ORGANIZATION

This text is ideal for schools with only one required tax course. Its 12 chapters can be covered in one semester, with time for assessments, eliminating the need to omit chapters. The text emphasizes tax planning to stimulate students' thinking in terms of the effect taxation has on decisions for both individuals and entities.

There are two introductory chapters in Part I. The first chapter includes a brief introduction to the different types of taxes and introduces Adams Smith's Canons of Taxation that can be used throughout the text to evaluate specific tax legislation. To emphasize to students the decision-making focus of this text, the first chapter introduces simple problems on the choice of business entity and provides an easily understood background for the more complex material to follow. The second chapter covers tax compliance issues, an introduction to tax planning, and the basics of tax research. A sample research problem (with sources included in an appendix) is included that can be used to guide students in performing basic tax research at any time during the course.

Part II has three chapters that cover income and expenses, as well as other topics needed for individual return preparation. Chapter 3 answers the question, "What is income?" by exploring the various facets of taxable and nontaxable income for entities as well as individuals. Chapter 4 introduces an example of a dual planning orientation (the two sides to any transaction) with the discussion of employee compensation, a subject often relegated to the end of a text where, unfortunately, many students are never introduced to it. This topic provides an opportunity for students to view transactions from an individual employee's perspective (maximizing employee benefits while minimizing taxable income) and the employer's perspective (designing an optimum compensation plans that combines salary and benefits to attract valuable employees). The chapter provides a broader view of income by including the perspective of the entity making the payments.

Chapter 5 includes deductions for individuals and the additional related information on credits and tax rates necessary to complete an individual tax return. This allows the assignment and completion of basic individual tax returns early in the term.

The focus in Parts III and IV turns primarily to business-related subjects covering general business expenses in Chapter 6 and then capital recovery through depreciation, depletion, and amortization in Chapter 7. Chapters 8 and 9 present discussions of taxable and nontaxable property dispositions, respectively.

With the completion of Chapters 6 through 9, the student is ready to apply the information to the basic business entities starting in Part V with the regular corporation in Chapter 10. The specifics of the sole proprietorship and the basic flow-through entities of partnerships and S corporations and their relationship to their owners are included in Chapter 11.

Part VI includes an introduction to wealth transfer taxes—estate and gift taxes. It also includes a discussion of income taxation of estates and trusts, the tax effects on beneficiaries, and the kiddie tax.

YOUR COURSE YOUR WAY

The organization of the text is designed primarily to respond to our adopters who have indicated that many students' interest in taxation is delayed until they are introduced to the provisions affecting their own current or potential taxation. Chapters 3 through 5 now contain the primary information relevant to individual taxation (excluding property transactions) for instructors who prefer introducing individual taxation prior to taxation of entities. Alternatively, Chapter 3, selected topics from Chapter 4, and Chapter 6 may be covered in sequence with topics unique to individuals tackled later in the term along with entity taxation. The flexibility of this text makes it easy to change the sequence of chapters as well as the topics within the chapters. Sections of the chapters are easily identifiable allowing instructors to pick and choose those they deem more important for classroom coverage. We have emphasized the readability of the text so that instructors feel comfortable simply assigning sections to be read by students outside of the class while spending their limited classroom time on more complex topics. This text also works particularly well for instructors who use a flipped-classroom approach to their course.

SUPPLEMENTS

Supplements include an author-prepared Solutions Manual, a separate Instructor's Manual with solutions to the Research and Tax Return Problems, an extensive Test Bank, and PowerPoint slides.

COMMENTS AND SUGGESTIONS

We realize that it is almost impossible for a text to be completely free of technical errors or to include every relevant topic. We welcome comments and suggestions on how we can improve the next edition. Please email your comments and suggestions to sdennis@miami.edu.

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Introduction to Taxation and Its Environment

PART I

- CHAPTER 1** An Introduction to Taxation
- CHAPTER 2** The Tax Practice Environment

CHAPTER OUTLINE

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Yourself 44

LEARNING OBJECTIVES

After completing this chapter, you should be able to:

- 1.1 Explain the basic types of taxes and the bases on which they are levied by various governmental units.
- 1.2 Compare the effects of progressive, proportional, and regressive tax systems on taxpayers' incomes.
- 1.3 Explain the characteristics of a good tax system using characteristics of equity, economy, certainty, and convenience.
- 1.4 Describe the components of the basic income tax model and understand how the tax due is calculated.
- 1.5 Identify the most common business entities recognized by the U.S. tax system and explain the basic differences in ownership and their effects on entity taxation.

This chapter presents an overview of the various types of taxation, the basic concepts important to the evaluation and understanding of taxation, and an introduction to alternate business forms and taxable entities. These serve as a backdrop to the more detailed provisions of income tax law that follow in subsequent chapters. This chapter is not concerned with specific numbers or their origin, as the majority of these numbers change with each filing year. Their specific applications will be discussed in subsequent chapters. Instead, the focus is on developing a broad understanding of how the U.S. income tax system works.

This first part begins with some background information on the various forms of taxation (income, consumption, wealth, and wealth transfer taxes). It is followed by a discussion of the effects of various tax rate structures (progressive, proportional, and regressive), examples of each type, and their effects. It ends with a brief description of Adam Smith's Canons of Taxation (equity, economy, certainty, and convenience), which provide the framework for assessing what constitutes a "good" tax.

An introductory discussion of federal income taxation follows and introduces the three types of taxable persons—individuals, C corporations, and fiduciaries—the ultimate payers of all income taxes. The basic tax model is introduced and the concepts of gross income, taxable income, tax rates, gross tax liability, and tax credits are presented in the context of the tax model.

The final section ends with a discussion of the various business entities that are subject to federal income taxes, including sole proprietorships, partnerships, C corporations, and S corporations. The individual owner of a sole proprietorship is taxed on the business's income. Partnerships and S corporations are conduit or flow-through entities