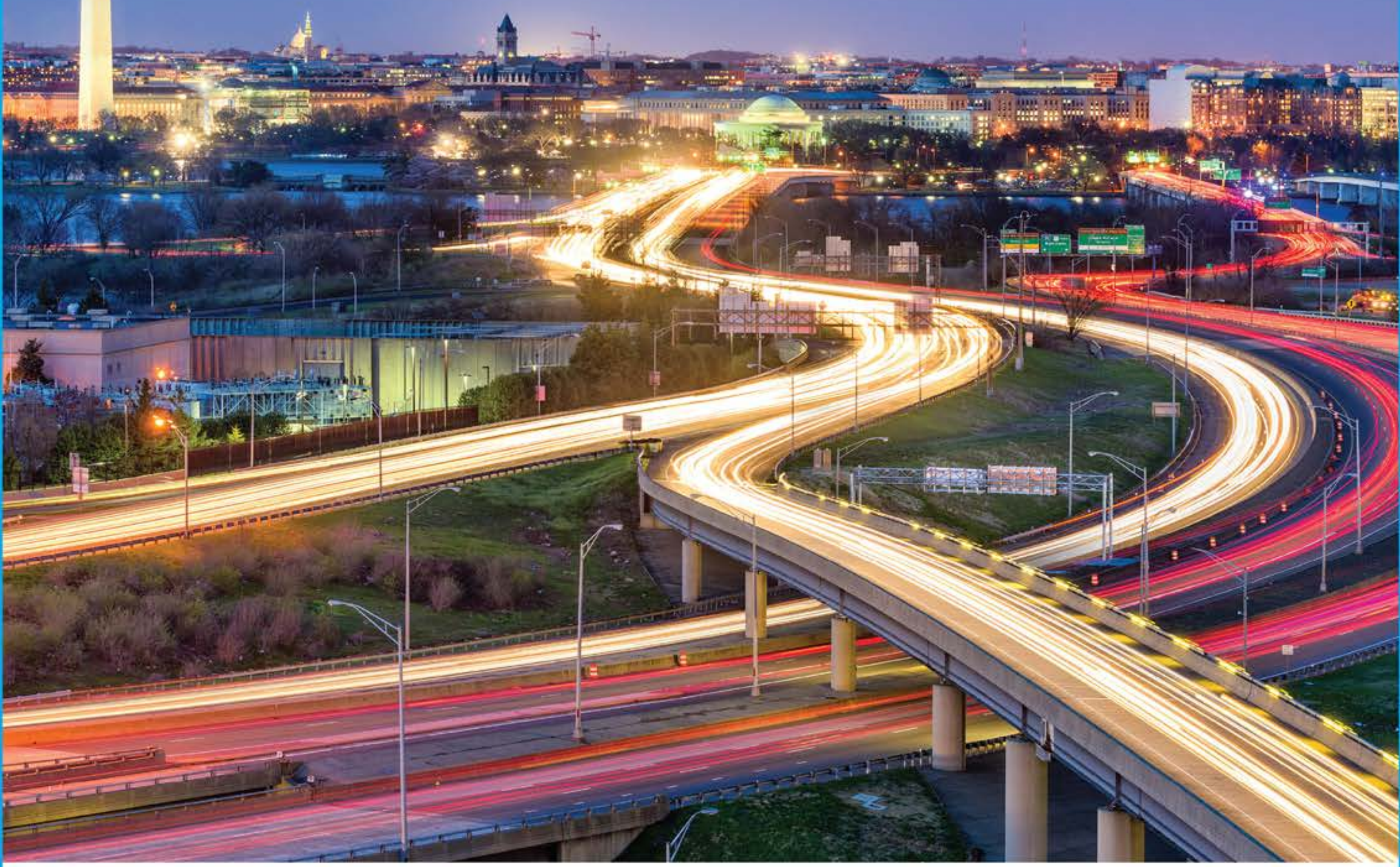
CENGAGE

SOUTH-WESTERN
FEDERAL TAXATION

COMPREHENSIVE VOLUME



INCLUDED: the answer company™ THOMSON REUTERS® intuit proconnect. Becker

Maloney • Young
Nellen • Persellin

2021

2019 Tax Rate Schedules

Single—Schedule X

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 9,700	.........10%	$ 0
9,700	39,475	$ 970.00 + 12%	9,700
39,475	84,200	4,543.00 + 22%	39,475
84,200	160,725	14,382.50 + 24%	84,200
160,725	204,100	32,748.50 + 32%	160,725
204,100	510,300	46,628.50 + 35%	204,100
510,300	....	153,798.50 + 37%	510,300

Head of household—Schedule Z

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 13,850	.........10%	$ 0
13,850	52,850	$ 1,385.00 + 12%	13,850
52,850	84,200	6,065.00 + 22%	52,850
84,200	160,700	12,962.00 + 24%	84,200
160,700	204,100	31,322.00 + 32%	160,700
204,100	510,300	45,210.00 + 35%	204,100
510,300	....	152,380.00 + 37%	510,300

Married filing jointly or Qualifying widow(er)—Schedule Y–1

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 19,400	.........10%	$ 0
19,400	78,950	$ 1,940.00 + 12%	19,400
78,950	168,400	9,086.00 + 22%	78,950
168,400	321,450	28,765.00 + 24%	168,400
321,450	408,200	65,497.00 + 32%	321,450
408,200	612,350	93,257.00 + 35%	408,200
612,350	....	164,709.50 + 37%	612,350

Married filing separately—Schedule Y–2

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 9,700	.........10%	$ 0
9,700	39,475	$ 970.00 + 12%	9,700
39,475	84,200	4,543.00 + 22%	39,475
84,200	160,725	14,382.50 + 24%	84,200
160,725	204,100	32,748.50 + 32%	160,725
204,100	306,175	46,628.50 + 35%	204,100
306,175	....	82,354.75 + 37%	306,175

2020 Tax Rate Schedules

Single—Schedule X

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 9,875	.........10%	$ 0
9,875	40,125	$ 987.50 + 12%	9,875
40,125	85,525	4,617.50 + 22%	40,125
85,525	163,300	14,605.50 + 24%	85,525
163,300	207,350	33,271.50 + 32%	163,300
207,350	518,400	47,367.50 + 35%	207,350
518,400	....	156,235.00 + 37%	518,400

Head of household—Schedule Z

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 14,100	.........10%	$ 0
14,100	53,700	$ 1,410.00 + 12%	14,100
53,700	85,500	6,162.00 + 22%	53,700
85,500	163,300	13,158.00 + 24%	85,500
163,300	207,350	31,830.00 + 32%	163,300
207,350	518,400	45,926.00 + 35%	207,350
518,400	....	154,793.50 + 37%	518,400

Married filing jointly or Qualifying widow(er)—Schedule Y–1

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 19,750	.........10%	$ 0
19,750	80,250	$ 1,975.00 + 12%	19,750
80,250	171,050	9,235.00 + 22%	80,250
171,050	326,600	29,211.00 + 24%	171,050
326,600	414,700	66,543.00 + 32%	326,600
414,700	622,050	94,735.00 + 35%	414,700
622,050	....	167,307.50 + 37%	622,050

Married filing separately—Schedule Y–2

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 9,875	.........10%	$ 0
9,875	40,125	$ 987.50 + 12%	9,875
40,125	85,525	4,617.50 + 22%	40,125
85,525	163,300	14,605.50 + 24%	85,525
163,300	207,350	33,271.50 + 32%	163,300
207,350	311,025	47,367.50 + 35%	207,350
311,025	....	83,653.75 + 37%	311,025

Tax Formula for Individuals

Income (broadly defined)	$xx,xxx
Less: Exclusions	(x,xxx)
Gross income	$xx,xxx
Less: Deductions *for* adjusted gross income	(x,xxx)
Adjusted gross income	$xx,xxx
Less: The greater of— Total itemized deductions *or* standard deduction	(x,xxx)
Less: Personal and dependency exemptions*	(x,xxx)
Deduction for qualified business income**	(x,xxx)
Taxable income	$xx,xxx
Tax on taxable income	$ x,xxx
Less: Tax credits (including Federal income tax withheld and prepaid)	(xxx)
Tax due (or refund)	$ xxx

*Exemption deductions are not allowed from 2018 through 2025.
**Only applies from 2018 through 2025.

Basic Standard Deduction Amounts

Filing Status	2019	2020
Single	$12,200	$12,400
Married, filing jointly	24,400	24,800
Surviving spouse	24,400	24,800
Head of household	18,350	18,650
Married, filing separately	12,200	12,400

Amount of Each Additional Standard Deduction

Filing Status	2019	2020
Single	$1,650	$1,650
Married, filing jointly	1,300	1,300
Surviving spouse	1,300	1,300
Head of household	1,650	1,650
Married, filing separately	1,300	1,300

Personal and Dependency Exemption*

2019	2020
$4,200	$4,300

*Note: Exemption deductions have been suspended from 2018 through 2025. However, the personal and dependency exemption amount is used for other purposes (including determining whether a "qualifying relative" is a taxpayer's dependent).

IT'S NOT JUST AN EXAM, IT'S YOUR FUTURE +

A legacy of learning for a lifetime of success

As the industry's leading partner in CPA Exam preparation, we work harder (and smarter) to help you prepare the way that works best for you. Becker CPA Exam Review is as close as you can get to the real thing. It follows the AICPA blueprint and includes a user-interface that mirrors the exam, so you're already familiar come exam day.

Personalized learning

No two people learn exactly the same way. That's why our proprietary **Adapt2U Technology** makes learning more personal – and more dynamic. Powered by Sana Labs' award-winning artificial intelligence, it constantly assesses your knowledge as you study and uses this information to provide you with Personalized Review Sessions at the end of each unit.

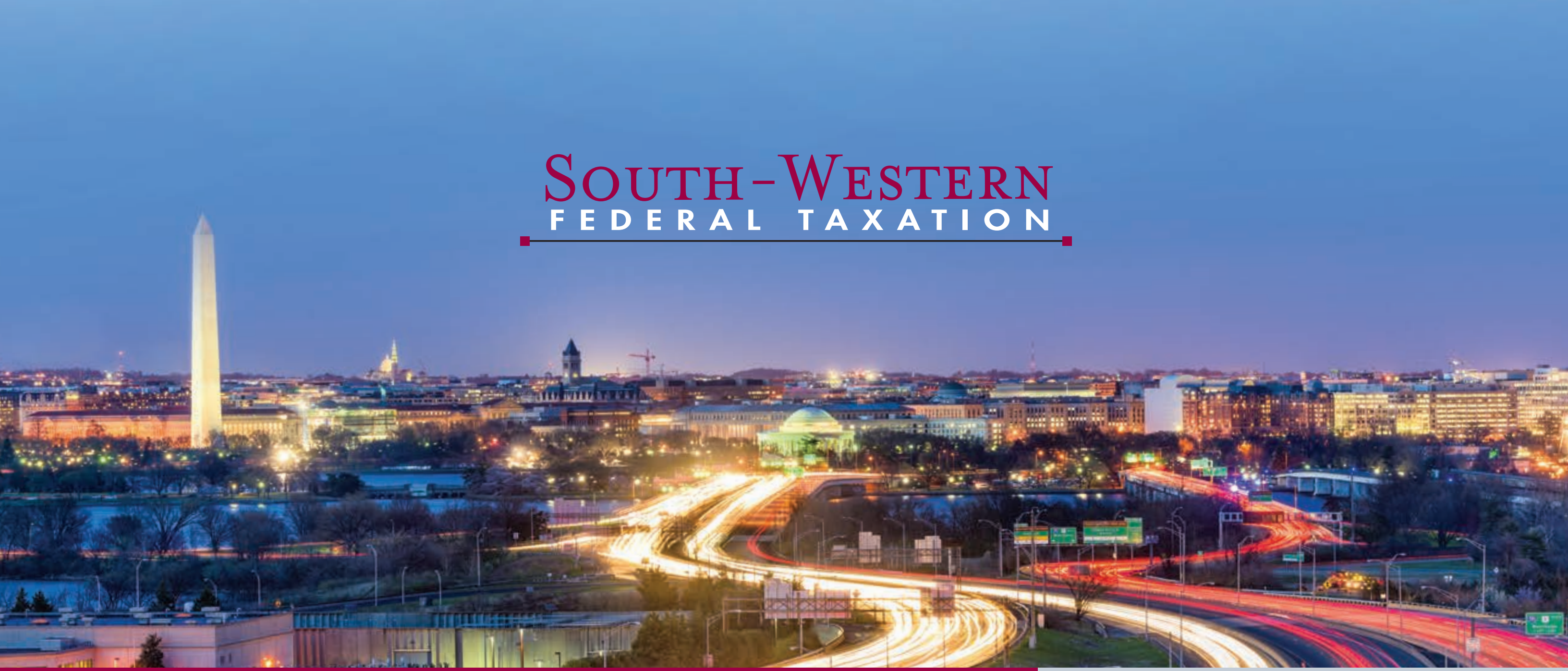
1 million+
candidates have prepared with Becker

90%+
of Watt Sells award winners (2005-2018) have prepared with Becker

The top 100
accounting firms rely on Becker for their staff's exam preparation

2,900+
accounting firms, corporations, alliances, government agencies and universities choose Becker

ISBN-13: 978-0-357-35977-8 • ISBN-10: 0-357-35977-1



SOUTH-WESTERN
FEDERAL TAXATION

COMPREHENSIVE VOLUME 2021

General Editors

David M. Maloney
Ph.D., CPA

James C. Young
Ph.D., CPA

Annette Nellen
J.D., CPA, CGMA

Mark B. Persellin
Ph.D., CPA, CFP®

Contributing Authors

James H. Boyd
Ph.D., CPA
Arizona State University

Bradrick M. Cripe
Ph.D., CPA
Northern Illinois University

D. Larry Crumbley
Ph.D., CPA
Texas A&M University - Corpus Christi

Andrew D. Cuccia
Ph.D., CPA
University of Oklahoma

Steven C. Dilley
J.D., Ph.D., CPA
Michigan State University

William H. Hoffman, Jr.
J.D., Ph.D., CPA
University of Houston

David M. Maloney
Ph.D., CPA
University of Virginia

Annette Nellen
J.D., CPA, CGMA
San Jose State University

Mark B. Persellin
Ph.D., CPA, CFP®
St. Mary's University

William A. Raabe
Ph.D., CPA
Madison, Wisconsin

Toby Stock
Ph.D., CPA
Ohio University

James C. Young
Ph.D., CPA
Northern Illinois University

Kristina Zvinakis
Ph.D.
The University of Texas at Austin

CENGAGE

Australia • Brazil • Mexico • Singapore • United Kingdom • United States

CENGAGE

South-Western Federal Taxation: Comprehensive Volume, 2021 Edition

David M. Maloney, James C. Young, Annette Nellen, Mark B. Persellin

Senior Vice President, Higher Ed Product, Content, and Market Development: Erin Joyner

Product Director: Jason Fremder

Assoc. Product Manager: Jonathan Gross

Sr. Content Manager: Nadia Saloom

Learning Designer: Emily S. Lehmann

Marketing Manager: Chris Walz

Marketing Coordinator: Sean D. Messer

Sr. Digital Delivery Lead: Tim Richison

Production Service: SPi Global

Designer: Chris A. Doughman

Text Designer: Red Hangar Design

Cover Image: iStock.com/Sean Pavone

Cover Designer: Bethany Bourgeois

Intellectual Property:
Analyst: Ashley Maynard
Project Manager: Carly Belcher

Design Images:
Concept Summary: iStock.com/enot-poloskun
Global Tax Issues: enot-poloskun/E+/Getty Images
Ethics & Equity: iStock.com/LdF
Cumulative Problems/Tax Return Problems: iStock.com/peepo
Financial Disclosure Insights: Vyaseleva Elena/Shutterstock.com
Framework 1040: Concept Photo/Shutterstock.com

ISSN: 0741-5184
2021 Annual Edition

Student Edition with Intuit ProConnect + RIA Checkpoint
ISBN: 978-0-357-35931-0
Loose Leaf Edition with Intuit Proconnect + RIA Checkpoint
ISBN: 978-0-357-35939-6

Cengage
200 Pier 4 Boulevard
Boston, MA 02210
USA

Cengage is a leading provider of customized learning solutions with employees residing in nearly 40 different countries and sales in more than 125 countries around the world. Find your local representative at **www.cengage.com**.

Cengage products are represented in Canada by Nelson Education, Ltd.

To learn more about Cengage platforms and services, register or access your online learning solution, or purchase materials for your course, visit **www.cengage.com**.

Printed in the United States of America
Print Number: 01 Print Year: 2020

Preface

COMMITTED TO EDUCATIONAL SUCCESS

South-Western Federal Taxation (SWFT) is the most trusted and best-selling series in college taxation. We are focused exclusively on providing the most useful, comprehensive, and up-to-date tax texts, online study aids, tax preparation tools, and research tools to help instructors and students succeed in their tax courses and beyond.

SWFT is a comprehensive package of teaching and learning materials, significantly enhanced with each edition to meet instructor and student needs and to add overall value to learning taxation.

The *SWFT Comprehensive Volume,* 2021 Edition provides a dynamic learning experience inside and outside of the classroom. Built with resources and tools that have been identified as the most important, our complete learning system provides options for students to achieve success.

In addition, the *SWFT Comprehensive Volume,* 2021 Edition provides accessible, comprehensive, and authoritative coverage of the relevant tax code and regulations as they pertain to the individual and business taxpayer, as well as coverage of all major developments in Federal Taxation.

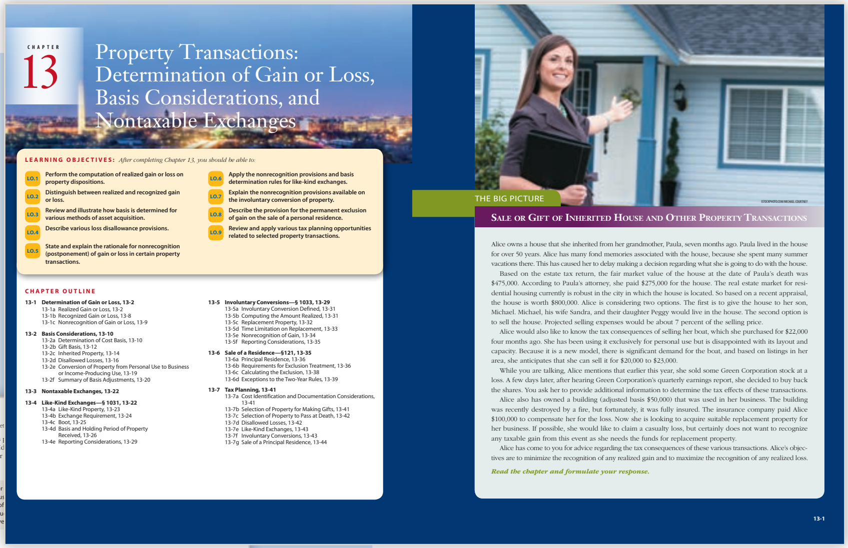
In revising the 2021 Edition, we focused on:

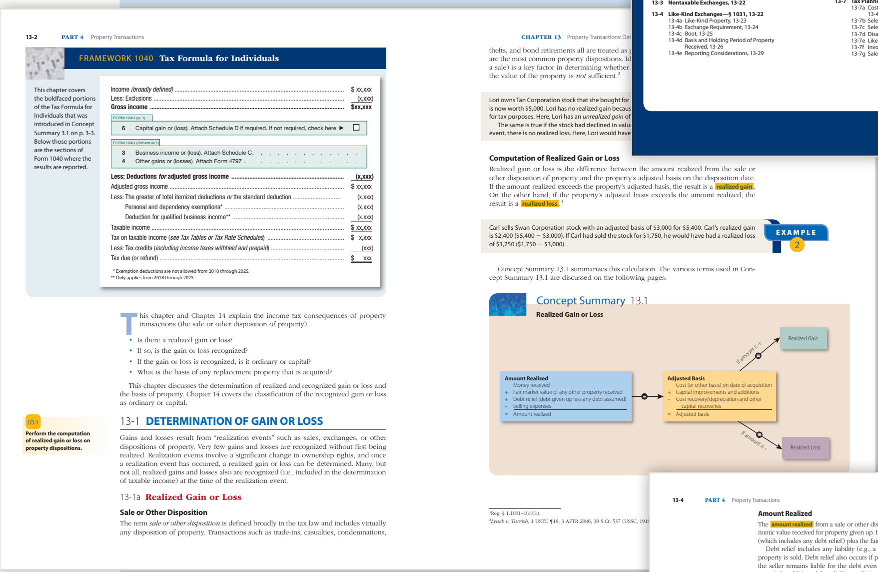
- ***Accessibility. Clarity. Substance.*** The text authors and editors made this their mantra as they revised the 2021 Edition. Coverage has been streamlined to make it more accessible to students, and difficult concepts have been clarified, all without losing the substance that makes up the *South-Western Federal Taxation* series.
- ***Developing professional skills.*** SWFT excels in bringing students to a professional level in their tax knowledge and skills, to prepare them for immediate success in their careers. In this regard, we include development of speaking and writing communications skills, the use of tax preparation and tax research software, orientation toward success on the CPA Exam, consideration of the time value of money in the tax planning process, and facility with advanced spreadsheet applications and data analytics.
- ***CengageNOWv2 as a complete learning system.*** Cengage Learning understands that digital learning solutions are central to the classroom. Through sustained research, we continually refine our learning solutions in CengageNOWv2 to meet evolving student and instructor needs. CengageNOWv2 fulfills learning and course management needs by offering a personalized study plan, video lectures, auto-graded homework, auto-graded tests, and a full eBook with features and advantages that address common challenges.

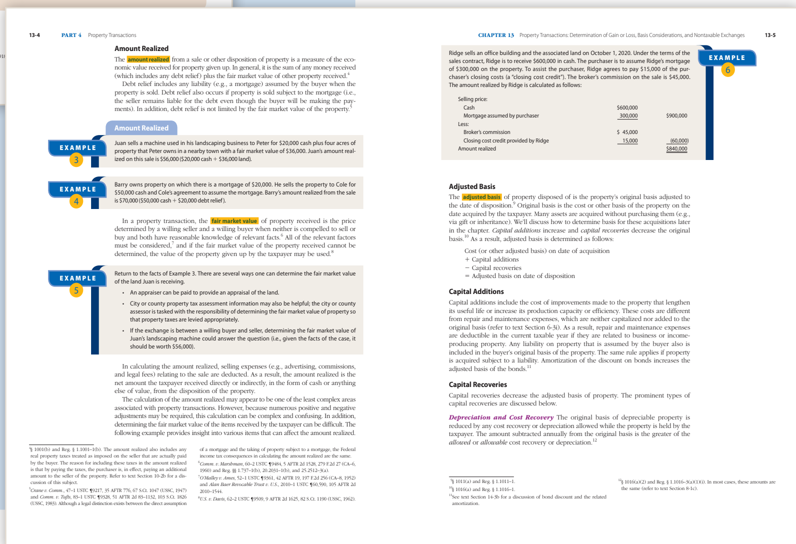
Learning Tools and Features to Help Students Make the Connection

FULL-COLOR DESIGN: We understand that students struggle with learning difficult tax law concepts and applying them to real-world scenarios. The 2021 Edition uses color to bring the text to life, capture student attention, and present the tax law in an understandable and logical format.

- Selected **content is streamlined** to guide students in focusing on the most important concepts for the CPA Exam while still providing in-depth coverage of topics.


CHAPTER 13
Property Transactions: Determination of Gain or Loss, Basis Considerations, and Nontaxable Exchanges
THE BIG PICTURE
Sale or Gift of Inherited House and Other Property Transactions


FRAMEWORK 1040 Tax Formula for Individuals
13-1 DETERMINATION OF GAIN OR LOSS
Concept Summary 13.1
Realized Gain or Loss



- Examples are clearly labeled and directly follow concepts to assist with student application. An **average of over 40 examples in each chapter** use realistic situations to illustrate the complexities of the tax law and allow students to integrate chapter concepts with illustrations and examples.

COMPUTATIONAL EXERCISES: Students need to learn to apply the concepts covered in each chapter. These exercises, many of which mirror text examples, allow students to practice and apply what they are learning.

- Found in the end-of-chapter sections of the textbook
- CengageNOWv2 provides algorithmic versions of these problems

26. **LO.1** Melba purchases land from Adrian. Melba gives Adrian $225,000 in cash and agrees to pay Adrian an additional $400,000 one year later plus interest at 5%.
    a. What is Melba's adjusted basis for the land at the acquisition date?
    b. What is Melba's adjusted basis for the land one year later?
27. **LO.1** On July 1, 2020, Katrina purchased tax-exempt bonds (face value of $75,000) for $82,000. The bonds mature in five years, and the annual interest rate is 3%.
    a. How much interest income and/or interest expense must Katrina report in 2020, assuming that straight-line amortization is appropriate?
    b. What is Katrina's adjusted basis for the bonds on January 1, 2021?

RESEARCH AND DATA ANALYTICS PROBLEMS:

- Research problems provide students with vital practice in an increasingly demanded skill area. Some of these end-of-chapter items ask students to analyze tax data, helping them to understand the application of this information in various scenarios. These essential features prepare students for professional tax environments.

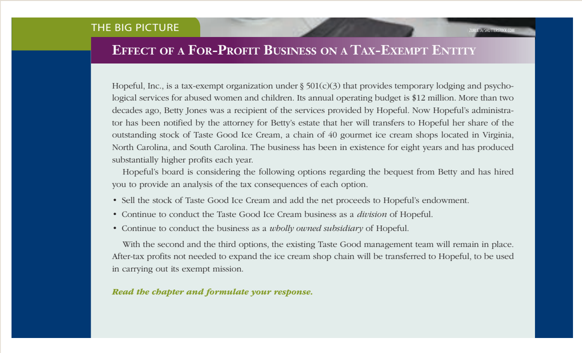
BECKER PROFESSIONAL EDUCATION REVIEW QUESTIONS: End-of-Chapter CPA Review Questions from Becker PREPARE STUDENTS FOR SUCCESS. Students review key concepts using proven questions from Becker Professional Education®—one of the industry's most effective tools to prepare for the CPA Exam.

- Located in select end-of-chapter sections
- Tagged by concept in CengageNOWv2
- Questions similar to what students would actually find on the CPA Exam

Becker CPA Review Questions

1. Jasmin purchased 100 shares of Pinkstey Corporation (publicly traded company) on January 1 of year 1 for $5,000. The FMV of the shares at the end of year 1 was $6,000. On January 1 of year 4, Pinkstey Corporation declared a 2-for-1 stock split when the fair market value of the stock was $65 per share. On January 1 of year 5, Jasmin sold all of her Pinkstey Corporation stock when the fair market value was $40 per share. Which of the following statements is true?
    a. Jasmin reports $6,500 in gross income for the 2-for-1 stock split in year 4.
    b. Jasmin's basis in the Pinkstey Corporation stock at the end of year 4 is $65 per share.
    c. Jasmin has no taxable income for the Pinkstey Corporation stock in year 4.
    d. Jasmin owns 100 shares in Pinkstey Corporation stock at the end of year 4.

See how the SWFT series helps students understand the big picture and the relevancy behind what they are learning.



THE BIG PICTURE

ZURIJETA/SHUTTERSTOCK.COM

Effect of a For-Profit Business on a Tax-Exempt Entity

Hopeful, Inc., is a tax-exempt organization under § 501(c)(3) that provides temporary lodging and psychological services for abused women and children. Its annual operating budget is $12 million. More than two decades ago, Betty Jones was a recipient of the services provided by Hopeful. Now Hopeful's administrator has been notified by the attorney for Betty's estate that her will transfers to Hopeful her share of the outstanding stock of Taste Good Ice Cream, a chain of 40 gourmet ice cream shops located in Virginia, North Carolina, and South Carolina. The business has been in existence for eight years and has produced substantially higher profits each year.

Hopeful's board is considering the following options regarding the bequest from Betty and has hired you to provide an analysis of the tax consequences of each option.

- Sell the stock of Taste Good Ice Cream and add the net proceeds to Hopeful's endowment.
- Continue to conduct the Taste Good Ice Cream business as a *division* of Hopeful.
- Continue to conduct the business as a *wholly owned subsidiary* of Hopeful.

With the second and the third options, the existing Taste Good management team will remain in place. After-tax profits not needed to expand the ice cream shop chain will be transferred to Hopeful, to be used in carrying out its exempt mission.

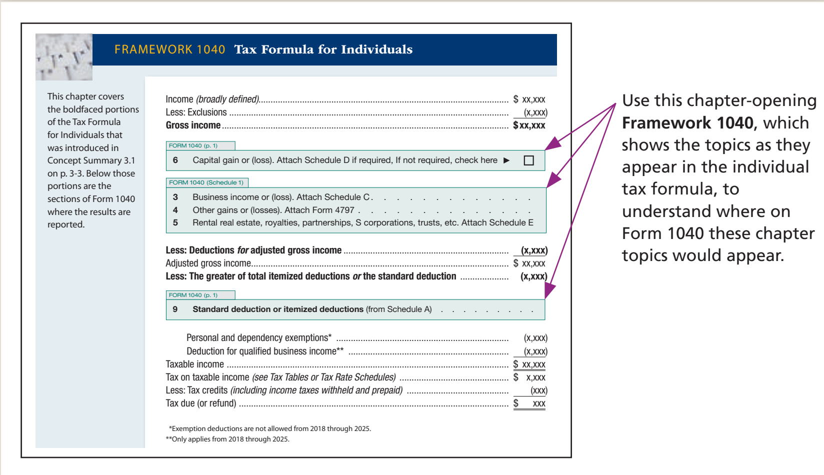
Read the chapter and formulate your response.

THE BIG PICTURE: Tax Solutions for the Real World. Taxation comes alive at the start of each chapter as The Big Picture examples give a glimpse into the lives, families, careers, and tax situations of typical filers. Students will follow a family, individual, or other taxpayer throughout the chapter, to discover how the concepts they are learning apply in the real world.

Finally, to solidify student comprehension, each chapter concludes with a **Refocus on the Big Picture** summary and tax planning scenario. These scenarios re-emphasize the concepts and topics from the chapter and allow students to confirm their understanding of the material.

FRAMEWORK 1040:

Fitting It All Together. This chapter-opening feature demonstrates how individual income tax topics fit together, using the Income Tax Formula for Individuals as the framework. The framework helps students organize their understanding of the chapters and topics to see how they relate to the basic tax formula and then identify where these items are reported on Form 1040. Framework 1040 helps students navigate topics by explaining how tax concepts are organized.



FRAMEWORK 1040 **Tax Formula for Individuals**

This chapter covers the boldfaced portions of the Tax Formula for Individuals that was introduced in Concept Summary 3.1 on p. 3-3. Below those portions are the sections of Form 1040 where the results are reported.

Income *(broadly defined)*	$ xx,xxx
Less: Exclusions	(x,xxx)
Gross income	**$ xx,xxx**

FORM 1040 (p. 1)

6 Capital gain or (loss). Attach Schedule D if required, If not required, check here ▶ ☐

FORM 1040 (Schedule 1)

3 Business income or (loss). Attach Schedule C

4 Other gains or (losses). Attach Form 4797

5 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E

Less: Deductions *for* adjusted gross income	**(x,xxx)**
Adjusted gross income	$ xx,xxx
Less: The greater of total itemized deductions *or* the standard deduction	**(x,xxx)**

FORM 1040 (p. 1)

9 **Standard deduction or itemized deductions** (from Schedule A)

Personal and dependency exemptions*	(x,xxx)
Deduction for qualified business income**	(x,xxx)
Taxable income	$ xx,xxx
Tax on taxable income *(see Tax Tables or Tax Rate Schedules)*	$ x,xxx
Less: Tax credits *(including income taxes withheld and prepaid)*	(xxx)
Tax due (or refund)	$ xxx

*Exemption deductions are not allowed from 2018 through 2025.

**Only applies from 2018 through 2025.

Use this chapter-opening **Framework 1040**, which shows the topics as they appear in the individual tax formula, to understand where on Form 1040 these chapter topics would appear.

FINANCIAL DISCLOSURE INSIGHTS: Tax professionals need to understand how taxes affect financial statements. **Financial Disclosure Insights**, appearing throughout the text, use current information about existing taxpayers to highlight book-tax reporting differences, effective tax rates, and trends in reporting conventions.

FINANCIAL DISCLOSURE INSIGHTS **Tax and Book Depreciation**

A common book-tax difference relates to the depreciation amounts that are reported for GAAP and Federal income tax purposes. Typically, tax depreciation deductions are accelerated; that is, they are claimed in earlier reporting periods than is the case for financial accounting purposes.

Almost every tax law change since 1980 has included depreciation provisions that accelerate the related deductions relative to the expenses allowed under GAAP. Accelerated cost recovery deductions represent a means by which the taxing jurisdiction infuses the business with cash flow created by the reduction in the year's tax liabilities.

For instance, recently, about one-quarter of General Electric's deferred tax liabilities related to depreciation differences. For Toyota's and Ford's depreciation differences, that amount was about one-third. And for the trucking firm Ryder Systems, depreciation differences accounted for all but 1 percent of the deferred tax liabilities.

ETHICS & EQUITY: Some tax issues do not have just one correct answer. **Ethics & Equity** features will spark critical thinking and invite classroom discussion, enticing students to evaluate their own value system. Suggested answers to Ethics & Equity scenarios appear in the Solutions Manual.

ETHICS & EQUITY **Punching the Time Clock at Year-End**

As the end of the tax year approaches, Julie, a successful full-time real estate developer and investor, recognizes that her income tax situation for the year could be bleak. Unless she and her spouse, Ralph, are able to generate more hours of participation in one of her real estate rental activities, they will not reach the material participation threshold. Consequently, the tax losses from the venture will not be deductible. To ensure deductibility, Julie suggests the following plan:

- She will document the time she spends "thinking" about her rental activities.
- During the week, Ralph will visit the apartment building to oversee (in a management role) the operations of the rentals.
- On weekends, she and Ralph will visit the same units to further evaluate the operations.
- Also on the weekends, while they are doing their routine household shopping, they will be on the lookout for other rental properties to buy. Julie plans to count both her and Ralph's weekend hours toward the tally of total participation.

Julie contends that the law clearly allows the efforts of one's spouse to count for purposes of the material participation tests. Likewise, nothing in the tax law requires taxpayers to be efficient in their hours of participation. How do you react?

TAX PLANNING: Chapters include a separate section calling attention to how taxpayers can use the law to reach financial and other goals. Tax planning applications and suggestions also appear throughout each chapter.

27-5 **TAX PLANNING**

27-5a **The Federal Gift Tax**

For gifts that generate a tax, consideration must be given to the present value to the donor of the gift taxes paid. Because the donor loses the use of these funds, the expected interval between a gift (the imposition of the gift tax) and death (the imposition of the estate tax) may make the gift less attractive from an economic standpoint. On the plus side, however, are the estate tax savings that result from any gift tax paid. Because these funds are no longer in the gross estate of the donor (except for certain gifts within three years of death), the estate tax thereon is avoided.

GLOBAL TAX ISSUES **Tracking Down Tax Dollars**

Non-U.S. persons who earn income within the United States may need to file a Federal income tax return, but they may not have a Social Security number for filing purposes. If not, they can use a nine-digit Individual Tax Identification Number (ITIN) instead. The IRS issues ITINs upon the submission of an application and proof of identification (e.g., a driver's license). As the IRS does not require an applicant to show that he or she is in the United States legally, the ITINs are freely available to undocumented persons (i.e., illegal immigrants). The use of an ITIN also can enable the holder to carry out other financial transactions (e.g., establish a bank account, secure a credit card, and obtain a loan).

The position of the IRS is that the current ITIN procedure brings in revenue that otherwise would not be forthcoming. Some undocumented workers want to comply with the law and pay the income taxes they owe. This practice should not be discouraged, as the tax law applies with equal force to legal and illegal residents of the United States.

However, ITINs have been criticized for their use by illegal immigrants and undocumented workers. A recent report found that individuals who are not authorized to work in the United States were paid $4.2 billion in refundable tax credits, such as the child tax credit, because they were able to file tax returns using an ITIN.

GLOBAL TAX ISSUES: The **Global Tax Issues** feature gives insight into the ways in which taxation is affected by international concerns and illustrates the effects of various events on tax liabilities across the globe.

Take your students from Motivation to Mastery with CengageNOWv2

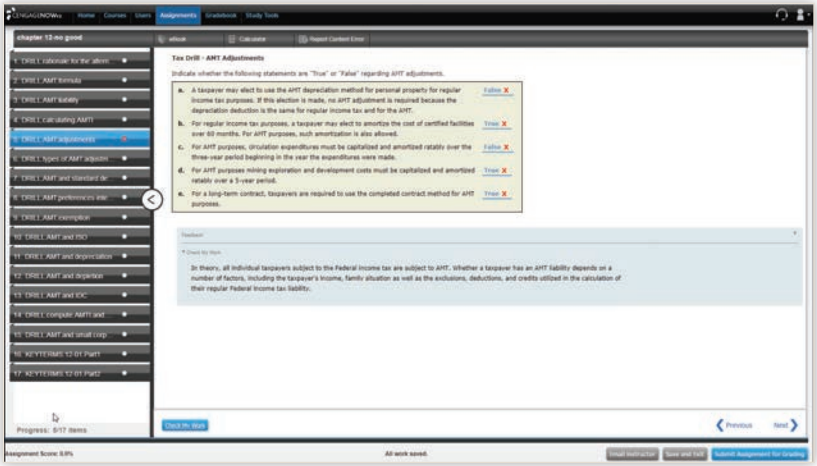
CengageNOWv2 is a powerful course management tool and online homework resource that elevates student thinking by providing superior content designed with the entire student workflow in mind.

- **MOTIVATION:** engage students and better prepare them for class
- **APPLICATION:** help students learn problem-solving behavior and skills to guide them to complete taxation problems on their own
- **MASTERY:** help students make the leap from memorizing concepts to actual critical thinking

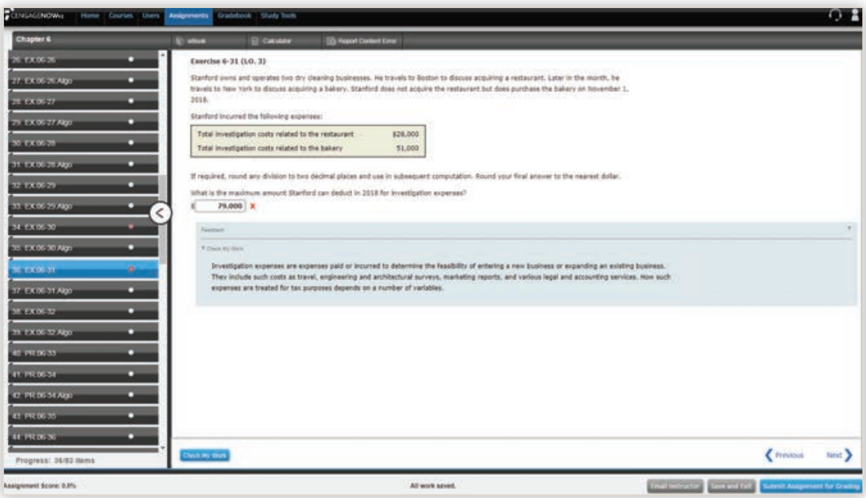
Motivation —

Many instructors find that students come to class unmotivated and unprepared. To help with engagement and preparedness, CengageNOWv2 for SWFT offers:

- **"Tax Drills" test students on key concepts and applications.** With three to five questions per learning objective, these "quick-hit" questions help students prepare for class lectures or review prior to an exam.



Application —



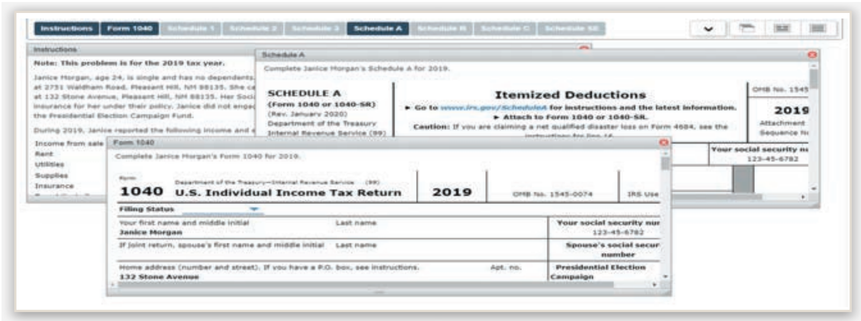
Students need to learn problem-solving behavior and skills, to guide them to complete taxation problems on their own. However, as students try to work through homework problems, sometimes they become stuck and need extra help. To reinforce concepts and keep students on the right track, CengageNOWv2 for SWFT offers the following.

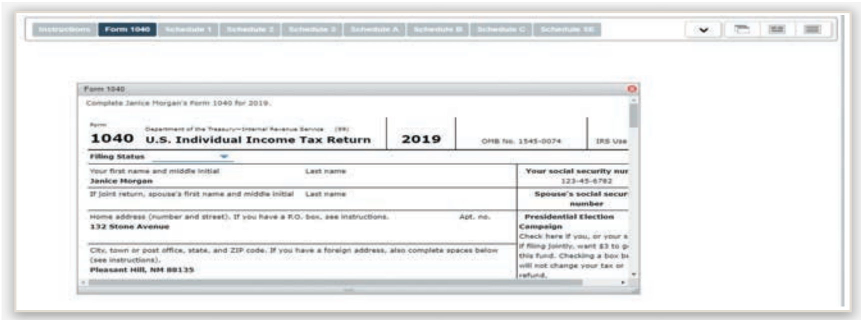
- **End-of-chapter homework from the text** is expanded and enhanced to follow the workflow a professional would use to solve various client scenarios. These enhancements better engage students and encourage them to think like a tax professional.

- **Algorithmic versions** of end-of-chapter homework are available for computational exercises and at least 15 problems per chapter.
- **"Check My Work" Feedback.** Homework questions include immediate feedback so students can learn as they go. Levels of feedback include an option for "check my work" prior to submission of an assignment.
- **Post-Submission Feedback.** After submitting an assignment, students receive even more extensive feedback explaining why their answers were incorrect. Instructors can decide how much feedback their students receive and when, including the full solution.
- **Built-in Test Bank** for online assessment.

Mastery —

- **Tax Form Problems** give students the option to complete the Cumulative Intuit ProConnect Problems and other homework items found in the end-of-chapter manually or in a digital environment.
- **"What-If" Questions** allow students to develop a deeper understanding of the material as they are challenged to use their prior knowledge of the tax situations and critically think through new attributes to determine how the outcome will change.
- **An Adaptive Study Plan** comes complete with an eBook, practice quizzes, crossword puzzle, glossary, and flashcards. It is designed to help give students additional support and prepare them for the exam.





CengageNOWv2 Instant Access Code ISBN: 978-0-357-35947-1 (two-semester access)

Contact your Cengage Learning Consultant about different bundle options.

EXTENSIVELY REVISED. DEFINITIVELY UP TO DATE.

Each year the ***South-Western Federal Taxation*** series is updated with thousands of changes to each text. Some of these changes result from the feedback we receive from instructors and students in the form of reviews, focus groups, web surveys, and personal e-mail correspondence with our authors and team members. Other changes come from our careful analysis of the evolving tax environment. **We make sure that every tax law change relevant to the introductory taxation course was considered, summarized, and fully integrated into the revision of text and supplementary materials.**

The ***South-Western Federal Taxation*** authors have made every effort to keep all materials up to date and accurate. All chapters contain the following general changes for the 2021 Edition.

- Updated materials to reflect changes made by Congress through legislative action (including the tax provisions contained in the Consolidated Appropriations Act of 2020).
- Streamlined chapter content (where applicable) to clarify material and make it easier for students to understand.
- Revised numerous materials as the result of changes caused by indexing of statutory amounts.
- Revised Problem Materials, Computational Exercises, and CPA Exam problems.
- Updated Chapter Outlines to provide an overview of the material and to make it easier to locate specific topics.
- Revised *Financial Disclosure Insights* and *Global Tax Issues* as to current developments.

In addition, the following materials are available online.

- An appendix that helps instructors broaden and customize coverage of important tax provisions of the Affordable Care Act. (Instructor Companion Website at **www.cengage.com/login**)
- The Depreciation and the Accelerated Cost Recovery System (ACRS) appendix. (Instructor Companion Website at **www.cengage.com/login**)
- An appendix that has comprehensive tax return problems for the 2019 tax filing year (Appendix E). (Instructor Companion Website at **www.cengage.com/login**)
- The *Taxation in the Real World* weekly blog posts for instructors. (**tinyurl.com/swft-blog**)

Chapter 1

- Clarified the wording for several learning objectives.
- Clarified the terms *progressive*, *regressive*, and *proportional* using new examples. These terms are used in the context of how a tax affects low-income taxpayers relative to high-income taxpayers.
- Added a new question to encourage students to review the text to identify features that can help them in learning about taxes (e.g., the glossary and list of key terms in each chapter).

Chapter 2

- Made minor changes to Exhibit 2.4 and Concept Summary 2.1.
- Updated references and citations throughout the chapter.
- Updated discussion on changes to the CPA Exam.

Chapter 3

- Updated chapter materials to reflect revised Form 1040 and related schedules.
- Added exhibit summarizing when Form 1040 Schedules 1 through 3 are used.
- Updated the exhibit summarizing the 0, 15, and 20 percent break points for the alternative tax on net capital gains.
- Added new material on the taxation of virtual currency (text Section 3-7e).
- Updated chapter materials to reflect 2020 inflation adjustments.
- Revised and clarified materials as needed throughout the chapter.

Chapter 4

- Combined former text Sections 4-1d and 4-1e discussing the differences between economic, accounting, and taxable income.
- Moved discussion of group term life insurance to Chapter 5 with other employment-related fringe benefits.

- Added the recognition of unrealized gains on marketable securities for financial reporting purposes as an example of a financial accounting income versus taxable income difference.
- Deleted discussion of Rev.Proc. 2004–34 dealing with the treatment of unearned income prior to the passage of IRC § 451(c).
- Expanded the examples related to imputed interest to include the deemed retransfer from the lender to the borrower required in § 7872(a)(1)(A).

Chapter 5

- Added group term life insurance to discussion of employee fringe benefits (new text Section 5-8e; previously covered in Chapter 4).
- Added a discussion of Rev.Rul. 2019–11 on how the tax benefit rule applies in light of the $10,000 SALT cap added by the TCJA of 2017.
- Updated text materials for 2020 inflation adjustments; revised other materials as needed.
- Added an additional problem on the tax benefit rule with the $10,000 SALT cap.

Chapter 6

- Revised and updated chapter materials as needed; clarified chapter materials when necessary.
- Updated Exhibit 6.2 to reflect revised Form 1040 (and Schedules).
- Updated Exhibit 6.3, summarizing the limitations that may reduce or eliminate the QBI deduction.
- Updated the Ethics & Equity item on marijuana to reflect both medical and nonmedical adult use activities.
- Updated text and end-of-chapter materials as needed to reflect revised inflation-adjusted items and revised Form 1040 (and Schedules).

Chapter 7

- Revised and clarified chapter materials as needed.
- Updated text and end-of-chapter materials to reflect annual inflation adjustments.
- Revised a Research Problem to include implications of states not conforming to TCJA of 2017 changes [e.g., personal casualty losses, excess business loss limitation, net operating loss limitations (carryforward only; 80 percent of taxable income limitation)].

Chapter 8

- Removed discussion of pre-MACRS depreciation systems at beginning of chapter; directed readers to online appendix summarizing these pre-1987 rules.
- Updated chapter materials to reflect various inflation adjustments.
- Updated in-chapter example illustrating Form 4562 and Schedule C (Form 1040) to 2019 forms.
- Selectively removed some overemphasized content.

Chapter 9

- Revised and clarified chapter materials based on adopter feedback.
- Updated text and end-of-chapter materials to reflect revised standard mileage amounts.
- Updated content related to § 401(k) plans, self-employed retirement plans, IRA and Roth IRA, and rollovers.
- Updated balance of end-of-chapter materials as needed.

Chapter 10

- Revised and clarified text as needed.
- Updated text and end-of-chapter materials for annual inflation adjustments.

Chapter 11

- Clarified special rule for real estate professionals, specifically, that if the requirements are met, they can apply a material participation test to their rental real estate (i.e., not *per se* a passive activity).
- Revised and clarified materials as needed throughout the chapter.
- Updated text and end-of-chapter materials to reflect annual inflation adjustments.

Chapter 12

- Updated chapter materials as needed for new law and inflation adjustments.

Chapter 13

- Clarified rules on basis of inherited property.
- Clarified and expanded wash sale rule coverage.

Chapter 14

- Updated text materials for 2020 inflation adjustments to Tax Rate Schedules and alternative tax rate brackets (for net capital gains).
- Added new exhibit on the alternative Tax Rate Schedule for net capital gains.

Chapter 15

- Changed title to better reflect chapter content.
- Revised and clarified materials based on feedback from adopters.
- Updated chapter materials to reflect inflation adjustments to threshold amounts for the QBI deduction.
- Expanded an end-of-chapter problem to include a computation of the taxpayer's marginal tax rate when the taxpayer is in the QBI deduction phaseout range.
- Updated end-of-chapter materials as needed (including revisions for inflation adjustments to threshold amounts).

Chapter 16

- Simplified the explanation of the possible limitation on the salary deduction for a personal service corporation using a special tax year per § 444.
- Removed questions on the salary reduction calculation for a personal service corporation making a § 444 election to use a year other than the required calendar year.

Chapter 17

- Updated chapter materials as needed for new rulings and inflation adjustments.
- Significantly revised chapter materials on accounting for income taxes, emphasizing and illustrating the balance sheet approach adopted by ASC 740.
- Updated end-of-chapter materials as needed.
- Added a new Research Problem focused on the donation of inventory items to local food banks or shelters.

Chapter 18

- Streamlined writing to reduce passive voice and increase clarity.
- Added a new planning section comparing a corporation to proprietorships that do/do not qualify for the § 199A qualified business income deduction.
- Added a new problem that asks students to use Microsoft Excel to compare a corporation to proprietorships that do/do not qualify for the § 199A qualified business income deduction.

Chapter 19

- Revised and updated chapter materials as needed; clarified chapter materials when necessary.
- Created a new Research Problem on Qualified Opportunity Zones (established by the TCJA of 2017).
- Updated end-of-chapter materials as needed.

Chapter 20

- Updated and clarified text and end-of-chapter materials as needed.
- Revised introductory paragraphs in the reorganization discussion.
- Replaced the Financial Disclosure discussion about M&A deals that do not succeed.
- Replaced internet Research Problem 5.

Chapter 21

- Revised LO 7 to focus on the partner's perspective, which now reads as "Describe the information provided on a partner's Schedule K–1 and how the partner reports that information."

- Split old text Section 21-3 into partnership and partner reporting sections.
  - Section 21-3, Partnership Operations and Reporting
  - Section 21-4, Partner Calculations and Reporting
- Revised and renamed text Section 21-5, Other Taxes on Partnership Income.
  - Simplified related-party transactions content and incorporated it into the corresponding section of the Tax Planning materials (text Section 21-9).
  - Covered (only) self-employment tax and the net investment income tax.
- Replaced old Exhibit 21.1 with a chart summarizing partnership taxable year options.
- Added a new Financial Disclosure Insights item to introduce special features of GAAP-basis financial statements issued by partnerships.
- Replaced Research Problem 3.

Chapter 22

- Revised introductory discussion and added Exhibit 22.1 comparing business entities.
- Reduced materials concerning the QBI regime and straight debt.
- Added two new Microsoft Excel problems.
- Added a new Research Problem.

Chapter 23

- Updated statistics relative to the exempt economy, private foundations, and UBIT.
- Added discussion of the effects of tax exemptions on state and local governments.
- Revised and reorganized material on determining exempt status.
- Added material about the investment income tax on universities.
- Added material on filing the Form 990, including potential penalties and loss of exempt status.
- Added one more Microsoft Excel problem.

Chapter 24

- Updated statistics about state/local tax collections.
- Clarified the role of the Multistate Tax Compact, the MTC, and the UDITPA.
- Updated financial statement data for the state/local tax expenses of selected corporations.
- Added definitional material for the use tax and illustrated it in new Exhibit 24.4.
- Added material as to economic sales/use tax nexus and nexus by marketplace facilitators.
- Added material on minimum income taxes by states for flow-through entities.
- Expanded the discussion of how § 118 may generate gross income from government incentives for retention or expansion of a business; added a related planning discussion to the Refocus on the Big Picture feature.
- Added economic nexus items to two Research Problems.

Chapter 25

- Combined income sourcing rules into a single section (text Section 25-3a).
- Updated and added statistics about the global economy, worldwide tax rates, treaty withholding rates, advance pricing agreements, FTC deferrals, and CFCs.
- Added explanation of withholding taxes for payments to non-U.S. persons.
- Added definition of a foreign branch.
- Clarified the makeup of the foreign tax credit general income basket.
- Clarified the application of § 367 to cross-border transfers.
- Reduced discussion of the 2017 one-time transition tax on unrepatriated profits.
- Added comments about tax planning for multinationals.
- Added a Microsoft Excel feature to one problem.

Chapter 26

- Updated statistics about IRS budget and audit rates.
- Updated IRS organizational chart to show the new Independent Office of Appeals.
- Updated statistics about the informant and whistleblower programs.
- Updated various penalty and interest amounts and statistics.
- Updated statistics for offers in compromise.
- Added two more internet Research Problems.

Chapter 27

- Incorporated indexed amounts for deductions, exclusions, and credits.
- Added a cross reference to text Exhibit 28.2 to illustrate the terms and operations of a trust in defining present and future interests.
- Clarified language defining the incidents of ownership for a life insurance policy.
- Clarified the discussion involving the optimal use of the bypass amount.
- Added another Microsoft Excel requirement.

Chapter 28

- Updated statistics as to Form 1041 filings and income sources.
- Updated comparison of Federal income tax liabilities among types of filing entity, showing the high marginal rates on fiduciaries.
- Updated amounts pertaining to AMT and the NIIT for fiduciary entities and clarification of the application of the NIIT to trusts.
- Added and updated examples of entity deductions and their limitations.
- Expanded computations in Example 13.
- Expanded Concept Summary 28.3.

TAX LAW OUTLOOK

From your SWFT Series Editors

Although Congress continues to discuss technical corrections to the Tax Cuts and Jobs Act of 2017 (TCJA), the 2020 election likely will put most legislative tax changes on hold. Nonetheless, we anticipate that Treasury and the IRS will continue to issue guidance on the TCJA throughout 2020 and beyond. With any additional guidance forthcoming, taxpayers and their advisers will continue to evaluate how TCJA changes affect their financial and tax planning strategies and will adjust their plans appropriately. In addition, as candidates prepare for the 2020 presidential election, many tax ideas will be suggested. They present opportunities for students and researchers to analyze how they work and how they measure up against principles of good tax policy.

The SWFT editors will be monitoring these activities and provide updates to adopters as needed, including via the SWFT blog *Taxation in the Real World* (**tinyurl.com/swft-blog**).

SUPPLEMENTS SUPPORT STUDENTS AND INSTRUCTORS

Built around the areas students and instructors have identified as the most important, our integrated supplements package offers more flexibility than ever before to suit the way instructors teach and students learn.

Online and Digital Resources for Students

CENGAGENOWv2

CengageNOWv2 is a powerful course management and online homework tool that provides robust instructor control and customization to optimize the student learning experience and meet desired outcomes.

CengageNOWv2 Instant Access Code ISBN: 978-0-357-35947-1 (two-semester access)

Contact your Cengage Learning Consultant about different bundle options.

the answer company™ THOMSON REUTERS®

Thomson Reuters Checkpoint™ is the leading online tax research database used by professionals. There are three simple ways Checkpoint™ helps introduce students to tax research:

- Intuitive web-based design makes it fast and simple to find what you need.
- Checkpoint™ provides a comprehensive collection of primary tax law, cases, and rulings along with analytical insight you simply can't find anywhere else.
- Checkpoint™ has built-in productivity tools such as calculators to make research more efficient—a resource more tax pros use than any other.

Six months' access to Checkpoint™ (after activation) is packaged automatically with every NEW copy of the textbook.*

intuit proconnect

More than software: Put the experience of ProConnect™ Tax Online on your side.

- Get returns done right the first time with access to all the forms you need, backed by industry-leading calculations and diagnostics.
- Save time with logical data-entry worksheets instead of traditional forms-based methods.
- It's all online, so there's nothing to install or maintain.

Online access to ProConnect™ Tax Online software is offered with each NEW copy of the textbook—at no additional cost to students.*

www.cengage.com Students can use **www.cengage.com** to select this textbook and access Cengage Learning content, empowering them to choose the most suitable format and giving them a better chance of success in the course. Buy printed materials, eBooks, and digital resources directly through Cengage Learning and save at **www.cengage.com**.

Online Student Resources

Students can go to **www.cengage.com** for free resources to help them study as well as the opportunity to purchase additional study aids. These valuable free study resources will help students earn a better grade:

- Flashcards use chapter terms and definitions to aid students in learning tax terminology for each chapter.
- Online glossary for each chapter provides terms and definitions from the text in alphabetical order for easy reference.
- Learning objectives can be downloaded for each chapter to help keep students on track.
- Tax tables used in the textbook are downloadable for reference.

CENGAGE UNLIMITED

The first-of-its-kind digital subscription designed specially to lower costs.

Students get total access to everything Cengage has to offer on demand—in one place. That's 20,000 eBooks, 2,300 digital learning products, and dozens of study tools across 70 disciplines and over 675 courses. **www.cengage.com/unlimited**

Printed Resources for Students

Looseleaf Edition (978-0-357-35939-6)

This version provides all the pages of the text in an unbound, three-hole punched format for portability and ease of use. Online access to ProConnect™ Tax Online software is included with every NEW textbook as well as Checkpoint™ from Thomson Reuters.*

*NEW printed copies of the textbook are automatically packaged with access to Checkpoint™ and ProConnect™ Tax Online tax software. If students purchase the eBook, they will not automatically receive access to Checkpoint™ and ProConnect™ Tax Online software.

Comprehensive Supplements Support Instructors' Needs

CENGAGENOWv2

CengageNOWv2 is a powerful course management and online homework tool that provides robust instructor control and customization to optimize the student learning experience and meet desired outcomes. In addition to the features and benefits mentioned earlier for students, CengageNOWv2 includes these features for instructors:

- **Learning Outcomes Reporting** and the ability to analyze student work from the gradebook. Each exercise and problem is tagged by topic, learning objective, level of difficulty, estimated completion time, and business program standards to allow greater guidance in developing assessments and evaluating student progress.
- **Built-in Test Bank for online assessment.** The Test Bank files are included in CengageNOWv2 so that they may be used as additional homework or tests.

Solutions Manual

Written by the ***South-Western Federal Taxation*** editors and authors, the Solutions Manual features solutions arranged in accordance with the sequence of chapter material.

Solutions to all homework items are tagged with their Estimated Time to Complete, Level of Difficulty, and Learning Objective(s), as well as the AACSB's and AICPA's core competencies—giving instructors more control than ever in selecting homework to match the topics covered. The Solutions Manual also contains the solutions to Appendix E: Comprehensive Tax Return Problems and answers with explanations to the end-of-chapter Becker CPA Review Questions. **Available on the Instructor Companion Website at www.cengage.com/login.**

PowerPoint® Lectures with Notes

The Instructor PowerPoint® Lectures contain more than 30 slides per chapter, including outlines and instructor guides, concept definitions, and key points. **Available on the Instructor Companion Website at www.cengage.com/login.**

Test Bank

Written by the ***South-Western Federal Taxation*** editors and authors, the Test Bank contains approximately 2,200 items and solutions arranged in accordance with the sequence of chapter material.

Each test item is tagged with its Estimated Time to Complete, Level of Difficulty, and Learning Objective(s), as well as the AACSB's and AICPA's core competencies—for easier instructor planning and test item selection. The 2021 Test Bank is available in Cengage's test generator software, Cognero.

Cengage Learning Testing Powered by Cognero is a flexible, online system that allows you to:

- author, edit, and manage Test Bank content from multiple Cengage Learning solutions
- create multiple test versions in an instant
- deliver tests from your LMS, your classroom, or wherever you want
- create tests from school, home, the coffee shop—anywhere with internet access (No special installs or downloads needed.)

Test Bank files in Word format as well as versions to import into your LMS are available on the Instructor Companion Website. **Cognero Test Banks available via single sign-on (SSO) account at www.cengage.com/login.**

Other Instructor Resources

All of the following instructor course materials are available online at www.cengage.com/login. Once logged into the site, instructors should select this textbook to access the online Instructor Resources.

- Instructor Guide
- Edition-to-edition correlation grids by chapter
- An appendix that helps instructors broaden and customize coverage of important tax provisions of the Affordable Care Act
- The Depreciation and the Accelerated Cost Recovery System (ACRS) appendix
- Comprehensive Tax Return Problems appendix

Custom Solutions

Cengage Learning Custom Solutions develops personalized solutions to meet your taxation education needs. Consider the following for your adoption of ***South-Western Federal Taxation 2021 Edition***.

- Remove chapters you do not cover or rearrange their order to create a streamlined and efficient text.
- Add your own material to cover additional topics or information.
- Add relevance by including sections from Sawyers/Gill's *Federal Tax Research* or your state's tax laws and regulations.

ACKNOWLEDGMENTS

We want to thank all the adopters and others who participated in numerous online surveys as well as the following individuals who provided content reviews and feedback in the development of the ***South-Western Federal Taxation*** 2021 titles.

David M. Maloney / James C. Young / Annette Nellen / Mark B. Persellin

Lindsay G. Acker, *University of Wisconsin-Madison*
Deborah S. Adkins, *Nperspective, LLC*
Mark P. Altieri, *Kent State University*
Susan E. Anderson, *Elon University*
Henry M. Anding, *Woodbury University*
Jennifer A. Bagwell, *Ohio University*
George Barbi, *Lanier Technical College*
Terry W. Bechtel, *Texas A&M University – Texarkana*
Chris Becker, *LeMoyne College*
Tamara Berges, *UCLA*
Ellen Best, *University of North Georgia*
Tim Biggart, *Berry College*
Rachel Birkey, *Illinois State University*
Patrick M. Borja, *Citrus College / California State University, Los Angeles*
Dianne H. Boseman, *Nash Community College*
Cathalene Bowler, *University of Northern Iowa*
Madeline Brogan, *Lone Star College – Montgomery*
Darryl L. Brown, *Illinois Wesleyan University*
Timothy G. Bryan, *University of Southern Indiana*
Robert S. Burdette, *Salt Lake Community College*
Ryan L. Burger, *Concordia University Nebraska*
Lisa Busto, *William Rainey Harper College*
Julia M. Camp, *Providence College*
Al Case, *Southern Oregon University*
Machiavelli W. Chao, *Merage School of Business, University of California, Irvine*
Eric Chen, *University of Saint Joseph*
Christine Cheng, *Louisiana State University*
James Milton Christianson, *Southwestern University and Austin Community College*
Wayne Clark, *Southwest Baptist University*
Ann Burstein Cohen, *University at Buffalo, The State University of New York*
Ciril Cohen, *Fairleigh Dickinson University*
Seth Colwell, *University of Texas - Rio Grande Valley*
Dixon H. Cooper, *University of Arkansas*
Rick L. Crosser, *Metropolitan State University of Denver*
John P. Crowley, *Castleton University*
Susan E. M. Davis, *South University*
Dwight E. Denman, *Newman University*
James M. DeSimpelare, *Ross School of Business at the University of Michigan*
John Dexter, *Northwood University*
James Doering, *University of Wisconsin – Green Bay*
Michael P. Donohoe, *University of Illinois at Urbana Champaign*
Deborah A. Doonan, *Johnson & Wales University*
Monique O. Durant, *Central Connecticut State University*
Wayne L. Edmunds, *Virginia Commonwealth University*
Rafi Efrat, *California State University, Northridge*
Frank J. Faber, *St. Joseph's College*
A. Anthony Falgiani, *University of South Carolina, Beaufort*
Jason Fiske, *Thomas Jefferson School of Law*
John Forsythe, *Eagle Gate College*
Alexander L. Frazin, *University of Redlands*
Carl J. Gabrini, *College of Coastal Georgia*
Kenneth W. Gaines, *East-West University, Chicago, Illinois*
Carolyn Galantine, *Pepperdine University*
Sheri Geddes, *Hope College*
Alexander Gelardi, *University of St. Thomas*
Daniel J. Gibbons, *Waubonsee Community College*
Martie Gillen, *University of Florida*
Charles Gnizak, *Fort Hays State University*
J. David Golub, *Northeastern University*
George G. Goodrich, *John Carroll University*
Marina Grau, *Houston Community College – Houston, TX*
Vicki Greshik, *University of Jamestown College*
Jeffrey S. Haig, *Santa Monica College*
Marcye S. Hampton, *University of Central Florida*
June Hanson, *Upper Iowa University*
Donald Henschel, *Benedictine University*
Susanne Holloway, *Salisbury University*
Susan A. Honig, *Herbert H. Lehman College*
Jeffrey L. Hoopes, *University of North Carolina*
Christopher R. Hoyt, *University of Missouri (Kansas City) School of Law*
Marsha M. Huber, *Youngstown State University*
Carol Hughes, *Asheville-Buncombe Technical Community College*
Helen Hurwitz, *Saint Louis University*
Richard R. Hutaff, *Wingate University*
Zite Hutton, *Western Washington University*
Steven L. Jager, *Cal State Northridge*
Janeé M. Johnson, *University of Arizona*
Brad Van Kalsbeek, *University of Sioux Falls*
John E. Karayan, *Woodbury University*
Carl Keller, *Missouri State University*
Cynthia Khanlarian, *Concord University*
Bob G. Kilpatrick, *Northern Arizona University*
Gordon Klein, *UCLA Anderson School*
Taylor Klett, *Sam Houston State University*
Aaron P. Knape, *Peru State College*
Cedric Knott, *Colorado State University – Global Campus*
Ausher M. B. Kofsky, *Western New England University*
Emil Koren, *Saint Leo University*
Jack Lachman, *Brooklyn College – CUNY*
Richard S. Leaman, *University of Denver*
Adena LeJeune, *Louisiana College*
Gene Levitt, *Mayville State University*
Teresa Lightner, *University of North Texas*
Sara Linton, *Roosevelt University*
Roger Lirely, *The University of Texas at Tyler*
Jane Livingstone, *Western Carolina University*
Heather Lynch, *Northeast Iowa Community College*
Michael J. MacDonald, *University of Wisconsin-Whitewater*
Mabel Machin, *Florida Institute of Technology*
Maria Alaina Mackin, *ECPI University*
Anne M. Magro, *George Mason University*
Richard B. Malamud, *California State University, Dominguez Hills*
Harold J. Manasa, *Winthrop University*
Barry R. Marks, *University of Houston – Clear Lake*
Dewey Martin, *Husson University*
Anthony Masino, *East Tennessee State University*
Norman Massel, *Louisiana State University*
Bruce W. McClain, *Cleveland State University*
Jeff McGowan, *Trine University*
Allison M. McLeod, *University of North Texas*
Meredith A. Menden, *Southern New Hampshire University*
Robert H. Meyers, *University of Wisconsin-Whitewater*
John G. Miller, *Skyline College*

Tracie L. Miller-Nobles, *Austin Community College*
Jonathan G. Mitchell, *Stark State College*
Richard Mole, *Hiram College*
David Morack, *Lakeland University*
Lisa Nash, *University of North Georgia*
Mary E. Netzler, *Eastern Florida State College*
Joseph Malino Nicassio, *Westmoreland County Community College*
Mark R. Nixon, *Bentley University*
Garth Novack, *Pantheon Heavy Industries & Foundry*
Claude R. Oakley, *DeVry University, Georgia*
Al Oddo, *Niagara University*
Sandra Owen, *Indiana University – Bloomington*
Vivian J. Paige, *Old Dominion University*
Carolyn Payne, *University of La Verne*
Ronald Pearson, *Bay College*
Thomas Pearson, *University of Hawaii at Manoa*
Nichole L. Pendleton, *Friends University*
Chuck Pier, *Angelo State University*
Lincoln M. Pinto, *DeVry University*
Sonja Pippin, *University of Nevada – Reno*
Steve Platau, *The University of Tampa*
Walfyette Powell, *Strayer University*
Darlene Pulliam, *West Texas A&M University*
Thomas J. Purcell, *Creighton University*
John S. Repsis, *University of Texas at Arlington*
John D. Rice, *Trinity University*
Jennifer Hardwick Robinson, *Trident Technical College*
Shani N. Robinson, *Sam Houston State University*
Donald Roth, *Dordt College*
Richard L. Russell, *Jackson State University*
Robert L. Salyer, *Northern Kentucky University*
Rhoda Sautner, *University of Mary*
Bunney L. Schmidt, *Keiser University*
Allen Schuldenfrei, *University of Baltimore*
Eric D. Schwartz, *LaRoche College*
Tony L. Scott, *Norwalk Community College*
Cheryl Sears
Randy Serrett, *University of Houston – Downtown*
Wayne Shaw, *Southern Methodist University*
Paul A. Shoemaker, *University of Nebraska – Lincoln*
Kimberly Sipes, *Kentucky State University*
Georgi Smatrakalev, *Florida Atlantic University*
Randy Smit, *Dordt College*
Leslie S. Sobol, *California State University Northridge*
Marc Spiegel, *University of California, Irvine*
Teresa Stephenson, *University of Wyoming*
Beth Stetson, *Oklahoma City University*
Debra Stone, *Eastern New Mexico University*
Frances A. Stott, *Bowling Green State University*
Todd S. Stowe, *Southwest Florida College*
Julie Straus, *Culver-Stockton College*
Martin Stub, *DeVry University*
James Sundberg, *Eastern Michigan University*
Kent Swift, *University of Montana*
Robert L. Taylor, *Lees-McRae College*
Francis C. Thomas, *Richard Stockton College of New Jersey*
Randall R. Thomas, *Upper Iowa University*
Ronald R. Tidd, *Central Washington University*
MaryBeth Tobin, Bridgewater State University
James P. Trebby, *Marquette University*
Heidi Tribunella, *University of Rochester*
James M. Turner, *Georgia Institute of Technology*
Anthony W. Varnon, *Southeast Missouri State University*
Adria Palacios Vasquez, *Texas A&M University – Kingsville*
Terri Walsh, *Seminole State College of Florida*
Marie Wang
Natasha R. Ware, *Southeastern University*
Mark Washburn, *Sam Houston State University*
Bill Weispfenning, *University of Jamestown (ND)*
Kent Williams, *Indiana Wesleyan University*
Candace Witherspoon, *Valdosta State University*
Sheila Woods, *DeVry University, Houston, TX*
Xinmei Xie, *Woodbury University*
Thomas Young, *Lone Star College – Tomball*

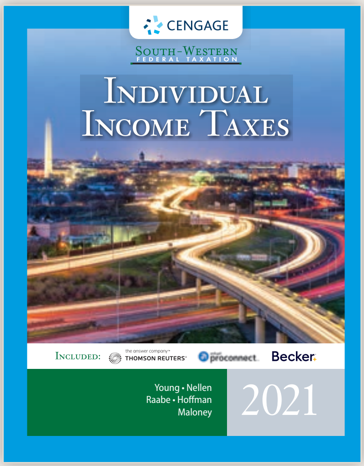
SPECIAL THANKS

We are grateful to the faculty members who have diligently worked through the problems and test questions to ensure the accuracy of the ***South-Western Federal Taxation*** homework, solutions manuals, test banks, and comprehensive tax form problems. Their comments and corrections helped us focus on clarity as well as accuracy and tax law currency. We also thank Thomson Reuters for its permission to use Checkpoint™ with the text.

Sandra A. Augustine, *Hilbert College*
Robyn Dawn Jarnagin, *University of Arkansas*
Kate Mantzke, *Northern Illinois University*
Ray Rodriguez, *Murray State University*
Miles Romney, *Florida State University*
George R. Starbuck, *McMurry University*
Lisa Swallow, *Missoula College University of Montana*
Donald R. Trippeer, *State University of New York College at Oneonta*
Raymond Wacker, *Southern Illinois University, Carbondale*
Michael Weissenfluh, *Tillamook Bay Community College*
Marvin Williams, *University of Houston-Downtown*

The South-Western Federal Taxation Series

To find out more about these books, go to www.cengage.com.



INDIVIDUAL INCOME TAXES, 2021 EDITION

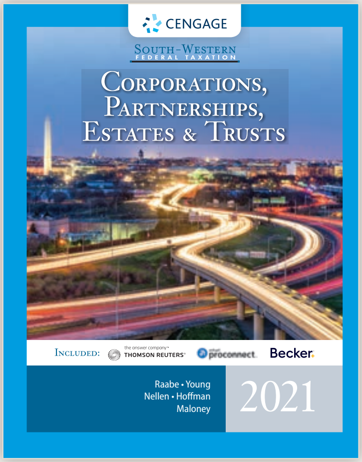
(YOUNG, NELLEN, RAABE, HOFFMAN, MALONEY, Editors) provides accessible, comprehensive, and authoritative coverage of the relevant tax code and regulations as they pertain to the individual taxpayer, as well as coverage of all major developments in Federal taxation.

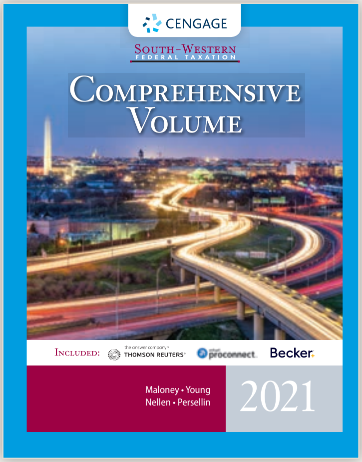
(ISBN 978-0-357-35932-7)

CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS, 2021 EDITION

(RAABE, YOUNG, NELLEN, HOFFMAN, MALONEY, Editors) covers tax concepts as they affect corporations, partnerships, estates, and trusts. The authors provide accessible, comprehensive, and authoritative coverage of relevant tax code and regulations, as well as all major developments in Federal income taxation. This market-leading text is intended for students who have had a previous course in tax.

(ISBN 978-0-357-35933-4)





COMPREHENSIVE VOLUME, 2021 EDITION

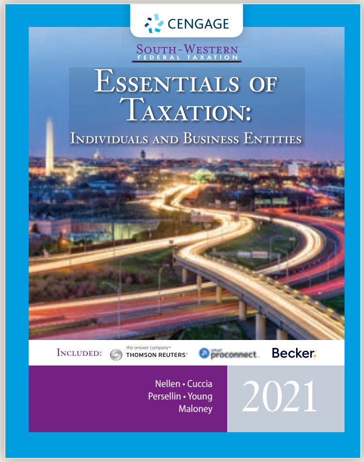
(MALONEY, YOUNG, NELLEN, PERSELLIN Editors)
Combining the number one individual tax text with the number one corporations text, *Comprehensive Volume, 2021 Edition* is a true winner. An edited version of the first two ***South-Western Federal Taxation*** textbooks, this book is ideal for undergraduate or graduate levels. This text works for either a one-semester course in which an instructor wants to integrate coverage of individual and corporate taxation or for a two-semester sequence in which the use of only one book is desired.

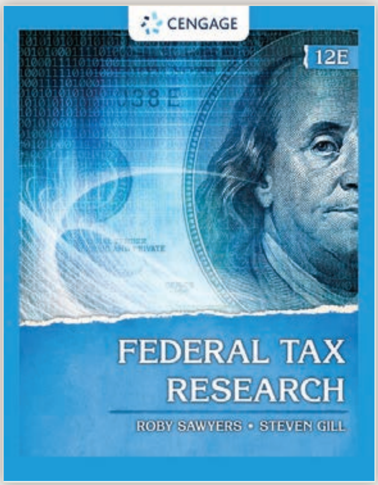
(ISBN 978-0-357-35931-0)

ESSENTIALS OF TAXATION: INDIVIDUALS AND BUSINESS ENTITIES, 2021 EDITION

(NELLEN, CUCCIA, PERSELLIN, YOUNG, MALONEY, Editors) emphasizes tax planning and the multidisciplinary aspects of taxation. This text is designed with the AICPA Model Tax Curriculum in mind, presenting the introductory Federal taxation course from a business entity perspective. Its **Tax Planning Framework** helps users fit tax planning strategies into an innovative pedagogical framework. The text is an ideal fit for programs that offer only one course in taxation where users need to be exposed to individual taxation, as well as corporate and other business entity taxation. This text assumes no prior course in taxation has been taken.

(ISBN 978-0-357-35934-1)





FEDERAL TAX RESEARCH, 12E

(SAWYERS AND GILL). *Federal Tax Research*, Twelfth Edition, offers hands-on tax research analysis and fully covers computer-oriented tax research tools. Also included in this edition is coverage on international tax research, a review of tax ethics, and many new real-life cases to help foster a true understanding of Federal tax law.

(ISBN 978-0-357-36638-7)

ABOUT THE EDITORS

David M. Maloney, Ph.D., CPA, is the Carman G. Blough Professor of Accounting Emeritus at the University of Virginia's McIntire School of Commerce. He completed his undergraduate work at the University of Richmond and his graduate work at the University of Illinois at Urbana-Champaign. Upon joining the Virginia faculty in January 1984, Dr. Maloney taught Federal taxation in the graduate and undergraduate programs and was a recipient of major research grants from the Ernst & Young and KPMG Foundations. Dr. Maloney has published work in numerous professional journals, including *Journal of Taxation, The Tax Adviser, Tax Notes, Corporate Taxation, Accounting Horizons, Journal of Taxation of Investments, and Journal of Accountancy.*

James C. Young is the PwC Professor of Accountancy at Northern Illinois University. A graduate of Ferris State University (B.S.) and Michigan State University (M.B.A. and Ph.D.), Jim's research focuses on taxpayer responses to the income tax using archival data. His dissertation received the PricewaterhouseCoopers/American Taxation Association Dissertation Award, and his subsequent research has received funding from a number of organizations, including the Ernst & Young Foundation Tax Research Grant Program. His work has been published in a variety of academic and professional journals, including the *National Tax Journal, The Journal of the American Taxation Association*, and *Tax Notes*. Jim is a Northern Illinois University Distinguished Professor, received the Illinois CPA Society Outstanding Accounting Educator Award in 2012, and has received university teaching awards from Northern Illinois University, George Mason University, and Michigan State University.

Annette Nellen, J.D., CPA, CGMA, directs San José State University's graduate tax program (MST) and teaches courses in tax research, tax fundamentals, accounting methods, property transactions, employment tax, ethics, leadership, and tax policy. Professor Nellen is a graduate of CSU Northridge, Pepperdine (MBA), and Loyola Law School. Prior to joining SJSU in 1990, she was with a Big 4 firm and the IRS. At SJSU, Professor Nellen is a recipient of the Outstanding Professor and Distinguished Service Awards. Professor Nellen is an active member of the tax sections of the AICPA and American Bar Association. In 2013, she received the AICPA Arthur J. Dixon Memorial Award, the highest award given by the accounting profession in the area of taxation. Professor Nellen is the author of BloombergBNA Tax Portfolio, *Amortization of Intangibles*. She has published numerous articles in the *AICPA Tax Insider, Tax Adviser, State Tax Notes*, and *The Journal of Accountancy*. She has testified before the House Ways & Means and Senate Finance Committees and other committees on Federal and state tax reform. Professor Nellen maintains the 21st Century Taxation website and blog (21stcenturytaxation.com) as well as websites on tax policy and reform, virtual currency, and state tax issues (sjsu.edu/people/annette.nellen/).

Mark B. Persellin, Ph.D., CPA, CFP®, is a Professor of Accounting at St. Mary's University. He is a graduate of the University of Arizona (B.S.), the University of Texas at Austin (M.P.A. in Taxation), and the University of Houston (Ph.D.). He teaches Personal Income Tax, Business Income Tax, and Research in Federal Taxation. Prior to joining St. Mary's University in 1991, Professor Persellin taught at Florida Atlantic University and Southwest Texas University (Texas State University) and worked on the tax staff of a Big 4 firm. His research has been published in numerous academic and professional journals including *The Journal of the American Taxation Association, The Accounting Educators' Journal, The Tax Adviser, The CPA Journal, Journal of Taxation, Corporate Taxation, The Tax Executive, TAXES—The Tax Magazine, Journal of International Taxation,* and *Practical Tax Strategies*. In 2003, Professor Persellin established the St. Mary's University Volunteer Income Tax Assistance (VITA) site, and he continues to serve as a trainer and reviewer at the site.

Brief Contents

Part 1: Introduction and Basic Tax Model

Part 2: Gross Income

Part 3: Deductions and Credits

Part 4: Property Transactions

Part 5: Special Tax Computations and Accounting Periods and Methods

Part 6: Corporations

Part 7: Flow-Through Entities

Part 8: Advanced Tax Practice Considerations

Part 9: Family Tax Planning

Contents

Part 1: Introduction and Basic Tax Model

Part 4: Property Transactions

CHAPTER 13
PROPERTY TRANSACTIONS: DETERMINATION OF GAIN OR LOSS, BASIS CONSIDERATIONS, AND NONTAXABLE EXCHANGES 13-1

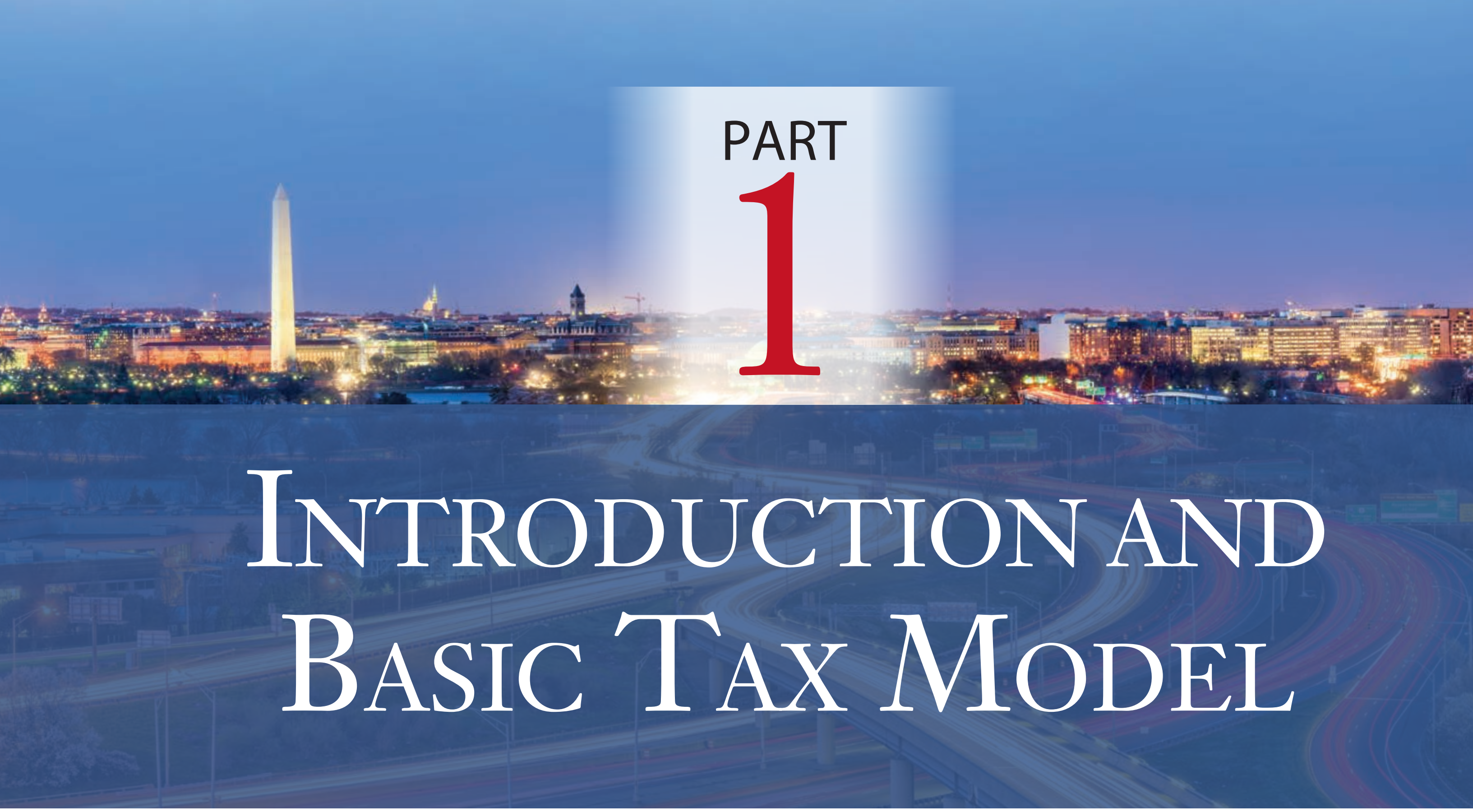
CHAPTER 14
PROPERTY TRANSACTIONS: CAPITAL GAINS AND LOSSES, § 1231, AND RECAPTURE PROVISIONS 14-1

Part 5: Special Tax Computations and Accounting Periods and Methods

Part 7: Flow-Through Entities

APPENDICES

Online Appendices



PART 1

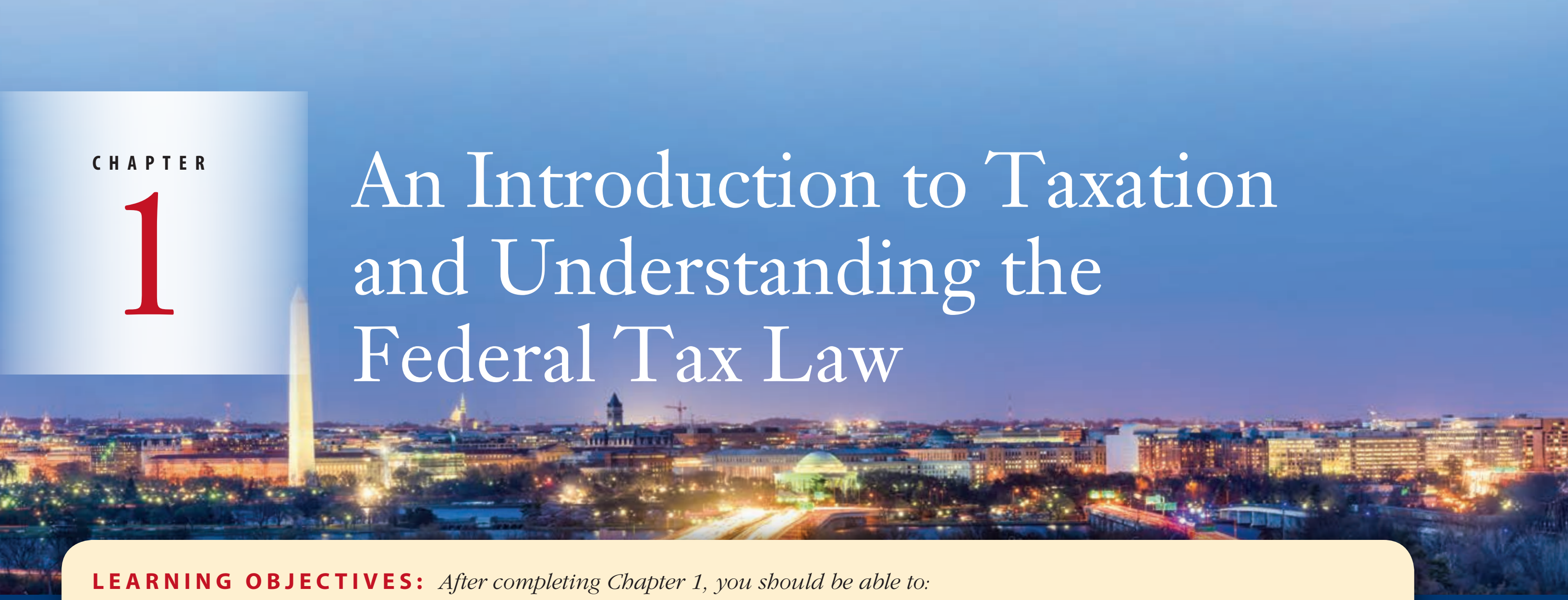
Introduction and Basic Tax Model

CHAPTER 1
An Introduction to Taxation and Understanding the Federal Tax Law

CHAPTER 2
Working with the Tax Law

CHAPTER 3
Computing the Tax

Part 1 provides an introduction to taxation in the United States. Although this text focuses on income taxation, other types of taxes also are briefly discussed. The purposes of the Federal tax law are examined, and the legislative, administrative, and judicial sources of Federal tax law, including their application to the tax research process, are analyzed. Part 1 concludes by introducing the basic tax model for the individual taxpayer and providing an overview of property transactions.



CHAPTER 1

An Introduction to Taxation and Understanding the Federal Tax Law

LEARNING OBJECTIVES: *After completing Chapter 1, you should be able to:*

LO.1 Explain the importance of taxation and apply methods for studying this topic.

LO.2 Describe some of the history and trends of the Federal income tax.

LO.3 Describe and apply principles and terminology relevant to the design of a tax system.

LO.4 Identify the different taxes imposed in the United States at the Federal, state, and local levels.

LO.5 Explain the administration of the tax law, including the audit process utilized by the IRS.

LO.6 Evaluate some of the ethical guidelines involved in tax practice.

LO.7 Classify tax rules based on their possible economic, social, equity, and political reasons for inclusion in a particular tax system.

LO.8 Explain the role played by the IRS and the courts in the evolution of the Federal tax system.

CHAPTER OUTLINE

THE BIG PICTURE

Family and Taxes—A Typical Year

Travis and Amy Carter are married and live in a state that imposes both a sales tax and an income tax. They have two children, April (age 17) and Martin (age 18). Travis is a mining engineer who specializes in land reclamation. After several years with a mining corporation, Travis established a consulting practice that involves a considerable amount of travel due to work he performs in other states. Amy is a registered nurse who, until recently, was a homemaker. In November of this year, she decided to reenter the job market and accepted a position with a medical clinic. The Carters live only a few blocks from Ernest and Mary Walker, Amy Carter's parents. The Walkers are retired and live on interest, dividends, and Social Security benefits.

Activities during the year with possible tax ramifications are summarized below.

- The ad valorem property taxes on the Carters' residence are increased, whereas those on the Walkers' residence are lowered.
- When Travis registers an automobile purchased last year in another state, he is required to pay a sales tax to his home state.
- As an anniversary present, the Carters gave the Walkers a recreational vehicle (RV).
- Travis employs his children to draft blueprints and prepare scale models for use in his work. Both April and Martin have had training in drafting and topography.
- Early in the year, the Carters are audited by the state on an income tax return filed a few years ago. Later in the year, they are audited by the IRS on a Form 1040 they filed for the same year. In each case, a tax deficiency and interest were assessed.
- The Walkers are audited by the IRS. Unlike the Carters, they did not have to deal with an agent, but settled the matter by mail.

Explain these developments, and resolve the issues raised.

Read the chapter and formulate your response.

This chapter provides an overview of the Federal tax system. Among the topics discussed:

- The importance and relevance of taxation and how to study taxation.
- A brief history of the Federal income tax.
- The types of taxes imposed at the Federal, state, and local levels.
- Some highlights of tax law administration.
- Tax concepts that help explain the reasons for various tax provisions.
- The influence the Internal Revenue Service (IRS) and the courts have had in the evolution of current tax law.

LO.1

Explain the importance of taxation and apply methods for studying this topic.

1-1 APPROACHING THE STUDY OF TAXATION

1-1a What Is Taxation?

"Taxes are what we pay for civilized society."

This is a famous quote from U.S. Supreme Court Justice Oliver Wendell Holmes, Jr. (1841 to 1935).[1] It is engraved on the government building at 1111 Constitution Avenue in Washington, D.C.—headquarters of the Internal Revenue Service (IRS). This quote eloquently sums up the primary purpose of taxation—to raise revenue for government operations. Governments at all levels—national, state, and local—require funds for defense, protection (police and fire), education, roads, the court system, social services, and more. Various types of taxes provide the resources to pay for government services.

In addition, taxation is often used as a tool to influence the behavior of individuals and businesses. For example, an income tax credit (which reduces a taxpayer's tax bill) may be designed to *encourage* people to purchase a fuel-efficient car. A tobacco excise tax may *discourage* individuals from smoking by increasing the cost of tobacco products. The tax system can also be used to provide direct benefits to taxpayers, such as to help pay for health insurance.

1-1b Taxation in Our Lives

"Nothing is certain, except death and taxes."

Most people attribute this quote to Benjamin Franklin (1706 to 1790). Taxes permeate our society. Various types of taxes, such as income, sales, property, and excise taxes (discussed in text Section 1-4), come into play in many of the activities of individuals, businesses, nonprofit entities (e.g., charitable organizations), and even governments.

Most directly, individuals are affected by taxes by paying them. Taxes may be paid directly or indirectly. A direct tax is paid to the government by the person who pays the tax. Examples include the personal income tax, which is paid by filing a personal income tax return (Form 1040 at the Federal level), and property taxes on one's home (paid to the local government). Individuals also pay many taxes indirectly. For example, most states impose sales tax on the purchase of tangible goods such as clothes. While this tax is collected and remitted to the government by the seller, the buyer is charged the tax along with the purchase price of the goods or services. Taxes also can be imposed indirectly when embedded in the prices charged by the seller. For example, when you buy gasoline for your car, the price you pay likely includes some of the income taxes and the gasoline excise taxes owed by the oil company.

Ultimately, all taxes are paid by individuals. The corporate income tax, for example, is paid directly by the corporation but is really paid indirectly by individuals in their capacity as customers, investors (owners), or employees. Economists and others often study this topic to estimate the percentage of the corporate income tax borne by individuals in these different capacities. It is not easy to measure, but it is known that taxes are passed along to individuals through higher prices, lower dividends, and/or lower wages.

Taxes also affect the lives of individuals via the ballot box. Federal, state, and local elections often include initiatives that deal with taxation, such as whether state income taxes should be raised (or lowered), whether a new tax should be imposed on soda,

[1] *Compania General De Tabacos De Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927), dissenting opinion.

or whether the sales tax rate should be changed. Candidates running for office often have positions on tax changes they would like to make if elected.

Given the pervasiveness of taxation—in our roles as both direct and indirect payers of taxes as well as citizens/voters—it is important that we understand how the tax system operates.

1-1c The Relevance of Taxation to Accounting and Finance Professionals

The U.S. corporate income tax rate is 21 percent. State income taxes can easily constitute, on average, an additional 5 percent. So a large corporation such as a Fortune 500 company may have to devote 26 percent or more of its net income to pay income taxes. In addition, businesses are subject to employment taxes, property taxes, sales taxes, and various excise taxes. Corporations with international operations are subject to taxation in other countries. Small businesses are also subject to a variety of taxes that affect profits and cash flows.

Given its significance, taxation is a crucial topic for accounting and finance professionals. They must understand the various types of business taxes to assist effectively with the following:

- *Compliance:* Ensure that the business files all tax returns and makes all tax payments on time. Mistakes and missed due dates will lead to penalties and interest expense.
- *Planning:* Help a business apply favorable tax rules, such as income deferral and tax credits, to minimize tax liability (and maximize owner wealth). The time value of money concept is also important here, as is coordinating tax planning with other business goals to maximize earnings per share.
- *Financial reporting:* Financial statements include a variety of tax information, including income tax expense on the income statement and deferred tax assets and liabilities on the balance sheet. Footnotes to the financial statements report various tax details including the company's effective tax rate. Computation and proper reporting of this information require knowledge of both tax and financial reporting rules [including the Financial Accounting Standards Board's Accounting Standards Codification (ASC) 740, *Income Taxes*].
- *Controversy:* This term refers to interaction a taxpayer may have with a tax agency such as the IRS. The IRS and state and local tax agencies regularly audit tax returns that have been filed to verify that taxes were properly computed and paid.
- *Cash management:* Taxes must be paid on time to avoid penalties and interest. Income and self-employment taxes must be estimated and paid quarterly and reconciled on the annual return. Other taxes may be due weekly, monthly, or semiannually. Businesses must be sure they have the funds ready when the taxes are due and have procedures to track due dates.
- *Data analysis:* With a majority, if not all, of a company's records maintained in digital form, there are opportunities to use this information to enhance profits, better understand the customer base, and improve and understand the information from a tax perspective. Tax practitioners often need skills in data analysis and visualization to identify samples for both internal and external audits, find ways to identify the products and services subject to sales tax in different states, and extract tax data to help inform other business functions such as where to locate a new sales office.

These tasks are also relevant to professionals such as CPAs who advise business and individual clients.

The level and depth of tax knowledge needed for any accounting or tax professional depends on his or her specific job. The vice president of tax for a company clearly needs thorough knowledge in all areas of taxation; the same is true of a partner in a CPA firm. In contrast, the corporate treasurer likely focuses more on cash management, while working closely with the company's tax advisers.

Ultimately, much of taxation is transaction-based. How a transaction is structured (e.g., as a sale or a lease) has varying tax consequences that must be considered. Even the purchase of a home can result in significant change—the new mortgage interest and property tax deductions may mean that an individual itemizes her deductions (using Schedule A of Form 1040) rather than using the standard deduction. And life events such as marriage (and divorce) will change an individual's tax situation. Similar "life events" can also affect a corporation (e.g., acquiring a different corporation or spinning off a subsidiary).

It is essential in working with taxation to maintain a balanced perspective. A corporation that is deciding where to locate a new factory does not automatically select the city or state that offers the most generous tax benefits. Nor does the person who is retiring to a warmer climate pick Belize over Arizona because the former has no income tax but the latter does. Tax considerations should not control decisions, but they remain one of many factors to be considered (and often one of the most significant).

1-1d How to Study Taxation

The goal of studying taxation is to be able to recognize issues (or transactions) that have tax implications and, when possible, try to understand the justification for them. Suppose, for example, that you come upon a situation that involves a discharge of indebtedness. If you know that forgiveness of debt results in income but there are exceptions to this rule, the battle is won! The issue has been identified, and the outcome (i.e., when an exception applies) can be resolved through research. A variety of commercial and free tools and resources are available to help you research and reach a conclusion.

You may have heard that tax is a difficult subject because of the many rules, exceptions, and definitions. You even may have heard that taxation is boring. Taxation is a challenging topic, but it is certainly not boring. Taxation is an important and exciting topic due to constant change by the three branches of our Federal government (as well as changes by state and local governments), the significance of taxes to the bottom line of a company and an individual's finances, and the impact on our economy and society.

Tax professionals tend to find enjoyment in their chosen field due to the intellectual challenge of dealing with tax rules for compliance and planning purposes, the opportunity to interact with colleagues or clients to help them understand the effect of taxes, and the knowledge that their work affects the financial well-being of individuals and businesses.

In studying taxation, focus on understanding the rules and the why(s) behind them (rather than memorizing the many isolated or disconnected rules and terms). The rules become more meaningful by thinking about why they exist for the particular type of tax. For example, why does the Federal income tax allow for a casualty loss deduction in certain situations? Why is tax depreciation different from that used for financial reporting? Also consider how the rules apply to different types of taxpayers (like employees, sole proprietors, corporations, investors, children, and retirees). Also think about how the rules apply to taxpayers of varying income levels and sophistication of transactions (a homeowner versus someone who owns assets in several countries). Aiming for understanding rather than memorization will make your journey into the world of taxation interesting and meaningful and will prepare you well for dealing with taxation in your accounting or finance career.

For tax professionals, the study of taxation is an ongoing and intriguing process. When Congress changes the tax law, tax professionals must review the new rules in order to understand how they affect clients or their employer. In addition, decisions rendered by the courts in tax disputes and guidance issued by the Treasury Department and Internal Revenue Service must be understood to ensure correct compliance with the law as well as identification of updated and proper tax planning ideas.

Concept Summary 1.1 illustrates the various ways that individuals deal with, and are affected by, taxes.

LO.2

Describe some of the history and trends of the Federal income tax.

1-2 A BRIEF HISTORY OF U.S. TAXATION

1-2a Early Periods

An income tax was first enacted in 1634 by the English colonists in the Massachusetts Bay Colony, but the Federal government did not adopt an income tax until 1861. In fact, both the Federal Union and the Confederate States of America used the income tax to raise funds to finance the Civil War.

When the Civil War ended, the need for additional revenue disappeared and the income tax was repealed. Once again the Federal government was able to finance its operations almost exclusively from customs duties (tariffs).

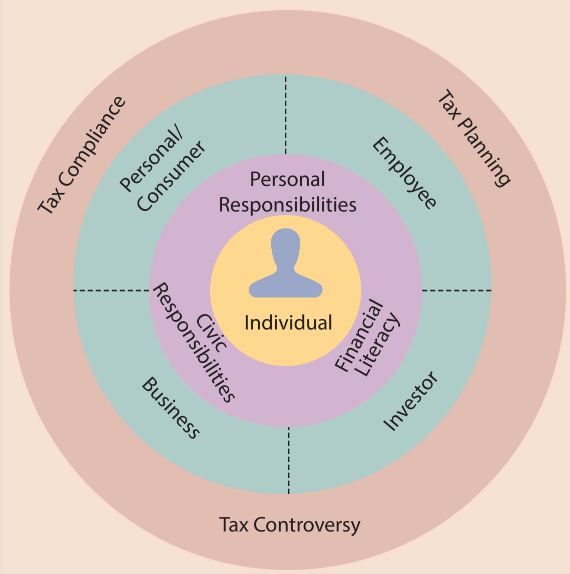
When a new Federal income tax on individuals was enacted in 1894, its opponents were prepared to successfully challenge its constitutionality. In *Pollock v. Farmers' Loan*

Concept Summary 1.1

Individuals and Taxes

The diagram to the right illustrates the many ways individuals interact with taxes. For example, as shown in the outer circle, individuals pay taxes and file tax returns (tax compliance). They also engage in tax planning as part of their desire to maximize after-tax wealth. If their tax return is audited or they do not pay their taxes, taxpayers will deal with the IRS or their state tax agency (tax controversy). Individuals deal with tax rules and planning in their roles as consumers, employees, investors, and business owners. Tax law is designed around these various taxpayer activities. Finally, as shown by the inner circle, individuals have a personal responsibility to comply with tax laws and pay any taxes due. Individuals also have a civic responsibility to understand taxes in their role as citizens and voters. And individuals need to understand how taxes affect their personal cash flows, consumption, and savings.

Use this diagram as you study the materials in this text, considering where in the circle various rules fit.



and Trust Co., the U.S. Supreme Court found that taxes on the income of real and personal property were the legal equivalent of a tax on the property involved and, therefore, required apportionment based on the population of the United States, as required by Article I, Section 8 of the Constitution.[2]

A Federal corporate income tax, enacted by Congress in 1909, fared better in the judicial system. The U.S. Supreme Court found this tax to be constitutional because it was treated as an excise tax.[3] In essence, it was a tax on the right to do business in the corporate form. So it was viewed as a form of the franchise tax.[4] Since the corporate form of doing business had been developed in the late nineteenth century, it was unknown to the framers of the U.S. Constitution. Because a corporation is an entity created under law, jurisdictions possess the right to tax its creation and operation. Using this rationale, many states still impose franchise taxes on corporations.

The ratification of the Sixteenth Amendment to the U.S. Constitution in 1913 sanctioned both the Federal individual and corporate income taxes and, as a consequence, neutralized the continuing effect of the *Pollock* decision.

1-2b **Revenue Acts**

After the Sixteenth Amendment was ratified by the states, Congress enacted the Revenue Act of 1913. Under this Act, the first Form 1040 was due on March 1, 1914. The law allowed various deductions and personal exemptions of $3,000 for a single individual and $4,000 for married taxpayers. These large exemptions excluded all but the more wealthy taxpayers from the new income tax.[5] Rates ranged from a low of 1 percent to a high of 6 percent. The 6 percent rate applied only to taxable income in excess of $500,000![6]

Various revenue acts were passed between 1913 and 1939. In 1939, all of these revenue laws were codified (arranged in a systematic manner) into the Internal Revenue Code of 1939. In 1954, a similar codification took place. The Internal Revenue Code of 1986, which largely carries over the provisions of the 1954 Code, is our current law. Tax law changes occur almost every year (how this happens is discussed in Chapter 2).

[2] 3 AFTR 2602, 15 S.Ct. 912 (USSC, 1895). See Chapter 2 for an explanation of the citations of judicial decisions.

[3] *Flint v. Stone Tracy Co.*, 3 AFTR 2834, 31 S.Ct. 342 (USSC, 1911).

[4] See the discussion of state franchise taxes later in text Section 1-4g.

[5] A $3,000 exemption in 1913 would be about $79,000 today, while a $4,000 exemption would be about $105,000.

[6] This should be contrasted with the highest 2020 tax rate of 37%, which applies once taxable income exceeds $518,400 for single taxpayers and $622,050 for married taxpayers filing a joint return.

1-2c Trends

The income tax is a major source of revenue for the Federal government. Exhibit 1.1 shows the tax revenue sources[7] and the importance of the income tax. Income tax collections from individuals and corporations amount to 59 percent of the total receipts. One revenue source missing from the Exhibit 1.1 pie chart is borrowing to cover the deficit, which in recent years has represented between 10 to 40 percent of total government revenues.

The need for revenues to finance the war effort during World War II converted the income tax from one that applied mostly to high-income individuals to a *mass tax*. In 1939, less than 6 percent of the U.S. population was subject to the Federal income tax. By 1945, more than 74 percent of the population was subject to the Federal income tax.[8]

Certain tax law changes are important to understand. In 1943, Congress passed the Current Tax Payment Act, which provided for a pay-as-you-go tax system. A pay-as-you-go income tax system requires employers to withhold a specified portion of an employee's wages and remit them to the government to cover the worker's income taxes. Persons with income from other than wages may have to make quarterly payments to the IRS for estimated taxes due for the year.

The increasing complexity of the Federal income tax laws causes concern among many, including lawmakers, taxpayers, and tax practitioners. Congress has added to this complexity by frequently changing the tax laws (e.g., by adding or deleting deductions or tax credits). This complexity forces many taxpayers to seek assistance in preparing their income tax returns. According to estimates, more than one-half of individual taxpayers who file a return pay a preparer and one-third purchase tax software.[9]

New ways of doing business and living often require changes to the tax law. For example, increased longevity requires a need for more revenues from Social Security taxes (and/or an increase in retirement age). Increased global business activity means modifying a country's tax system to be more in line with other countries to make sure businesses are not impeded when entering the global marketplace. Ideally, lawmakers should review tax systems periodically to ensure that they continue to be efficient in light of changes in how businesses and individuals function.

LO.3

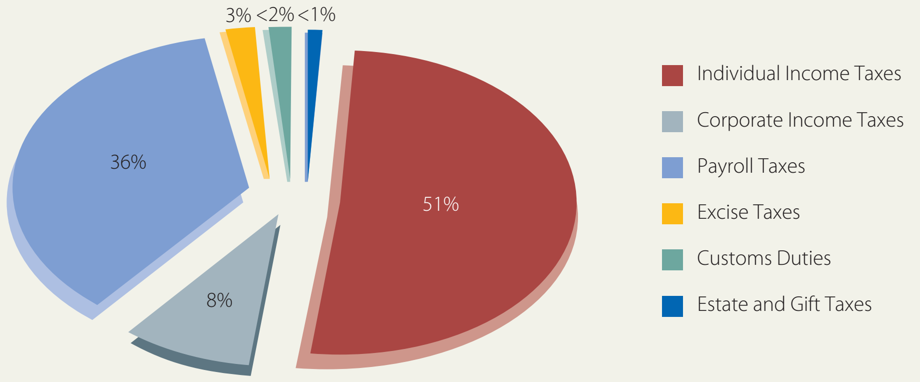
Describe and apply principles and terminology relevant to the design of a tax system.

1-3 TAX SYSTEM DESIGN

1-3a Legal Foundation

Article I, Section 8 of the U.S. Constitution states in part: "The Congress shall have power to lay and collect taxes." The Constitution also provided some limits on this taxing power, which led to the enactment of the Sixteenth Amendment to allow for an income

EXHIBIT 1.1 **Federal Tax Revenues (Estimated) in 2020**



[7] Revenue data can be found at **cbo.gov** and **whitehouse.gov/omb**. The instruction booklet for Form 1040 includes a revenue pie chart that includes borrowing to cover the deficit, as well as a pie chart that shows government spending in broad categories.

[8] Richard Goode, *The Individual Income Tax* (Washington, D.C.: The Brookings Institution, 1964), pp. 2–4.

[9] The Tax Foundation estimates that individual taxpayers spend over $20 billion and devote about 1.35 billion hours in preparing their tax returns.

tax (discussed in text Section 1-2a). This history lesson is important for a legislature or an electorate that wants to change a tax system. The jurisdiction's underlying governing documents (whether a country, state, or city) must be reviewed to determine whether they impose any restrictions relevant to taxation.

For example, the California Constitution (Article 13A) states that the maximum tax rate for real property taxation is 1 percent. The Florida Constitution (Section 5) specifies limits on the imposition of income taxes on natural persons. Also, state law may impose limitations on the types or amounts of taxes that cities and counties can impose.

Thus, the governing documents of a jurisdiction must be considered as part of any effort to modify that jurisdiction's tax system to make sure the change is permissible. If a change is not permissible but desired, then the governing document must be amended, as was done with the addition of the Sixteenth Amendment to the U.S. Constitution.

1-3b The Basic Tax Formula

The basic formula for any tax is:

Tax base X **Tax rate** = **Tax liability**

Tax Base

A tax base is the amount to which the tax rate is applied. In the case of the Federal income tax, the tax base is *taxable income*. As noted later in the chapter (Exhibit 1.3), taxable income is gross income reduced by certain deductions (both business and personal).

Tax Rates

Tax rates are applied to the tax base to determine a taxpayer's liability. Some taxes, like the sales tax and the gasoline excise tax, apply a fixed tax rate to all transactions.

EXAMPLE 1

Kansas applies a sales tax rate of 6.5% to all taxable items. In contrast, Illinois applies a sales tax rate of 6.25% for most taxable items but applies a rate of 1% when the tax base consists of food or prescription drugs.

Alternatively, for some taxes, tax rates may vary depending on the details of the tax base. Income taxes tend to use a *progressive* tax rate structure where a higher rate of tax applies as the tax base increases.

EXAMPLE 2

Bill and Cora, a married couple filing jointly, have taxable income of $15,000. Their Federal income tax rate for 2020 is 10%, which is the rate that applies to the first $19,750 of taxable income for a married couple filing jointly.

If, however, their taxable income is $85,000, their Federal income tax rates progress from 10% to 12% to 22% as their taxable income increases. In this case, their 2020 Federal income tax liability is $10,280. The Federal income tax uses a *progressive* rate structure that applies higher rates to taxable income (the tax base) as that income increases (see Appendix A to confirm these calculations, and note how progressivity is built into the rate structure of the Federal income tax).

The basic tax formula (shown above) is relevant for both computing taxes and planning, as well as for reforming a tax system. For example, if a legislator wants to lower tax rates but generate the same amount of tax revenues, the tax base must be increased. However, if she wants to increase tax revenues, the tax base can be increased *or* tax rates can be increased (or both can be increased). Changes to the tax base will depend on how it is constructed. For example, the income tax base is taxable income (income minus income exclusions minus deductions). To increase this tax base, income exclusions could be eliminated or deductions could be limited. The details of the income tax base are discussed in later chapters. Tax system changes also involve canons (or principles) of taxation, discussed next.

1-3c Tax Principles

In the late 1700s, Adam Smith identified the following *canons (or principles) of taxation*, which are still considered today when evaluating a particular tax structure:[10]

- *Equity*. Each taxpayer enjoys fair or equitable treatment by paying taxes in proportion to his or her income level. Ability to pay a tax is one of the measures of how equitably a tax is distributed among taxpayers.
- *Certainty*. A tax should be certain rather than arbitrary. Taxpayers need to be able to understand how tax rules work so that they understand the effect of the rules on various transactions and can comply.
- *Convenience of payment*. Taxes should be imposed in a manner that involves a convenient time for payment. An advantage of the existing withholding system (pay-as-you-go) is its convenience for taxpayers.
- *Economy in collection*. A *good* tax system involves only nominal collection costs by the government and minimal compliance costs on the part of the taxpayer.

The American Institute of Certified Public Accountants (AICPA) has issued suggestions to guide tax reform and policy activities. Titled *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, the monograph identifies 12 principles that are commonly used as indicators of desirable tax policy. The first four principles are adapted from Adam Smith's *The Wealth of Nations*. The complete list follows:[11]

1. *Equity and Fairness*. Similarly situated taxpayers should be taxed in a similar manner.
2. *Certainty*. Taxpayers should have certainty rather than ambiguity as to when and how a tax is paid as well as how to calculate it.
3. *Convenience of Payment*. A tax should be due at a time and manner that is most convenient for the taxpayer.
4. *Effective Tax Administration*. Tax compliance and administrative costs should be kept to a minimum.
5. *Information Security*. Taxpayer information must be protected from improper disclosure.
6. *Simplicity*. Tax rules should be simple so that taxpayers understand them and can follow them in a cost-efficient manner.
7. *Neutrality*. The effect of tax rules on taxpayer decision making should be kept to a minimum.
8. *Economic Growth and Efficiency*. The tax system should not harm economic growth or distort economic effects among different activities and investments.
9. *Transparency and Visibility*. Taxpayers should know that a tax exists and how and when it applies to them.
10. *Minimum Tax Gap*. A tax should be structured to minimize noncompliance.
11. *Accountability to Taxpayers*. Taxpayers should have access to information on taxes as well as proposed law changes and their rationale.
12. *Appropriate Government Revenues*. Tax rules should enable the government to predict the amount and timing of revenue production.

Exhibit 1.2 provides an application of these principles to a proposed tax law change.

LO.4

Identify the different taxes imposed in the United States at the Federal, state, and local levels.

1-4 MAJOR TYPES OF TAXES

Why does a text devoted primarily to the Federal income tax discuss state and local taxes? A simple illustration demonstrates the importance of non-Federal taxes.

[10] *The Wealth of Nations* (New York: Dutton, 1910), Book V, Chapter II, Part II.

[11] AICPA, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, 2017. Similarly, see GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, 2005. As "long-standing criteria," the GAO lists "equity; economic efficiency; and a combination of simplicity, transparency, and administrability."