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Concepts in Federal Taxation

2022 EDITION

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2022 EDITION

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***Concepts in Federal Taxation*,**
2022 Edition

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PREFACE

Many students view the introductory tax course as an impossible task of learning the Internal Revenue Code. The Code, which is the statutory basis of the federal income tax system, is complex and can be intimidating to students and tax professionals. However, we feel strongly that tax education can be interesting and, with the straightforward yet complete coverage in *Concepts in Federal Taxation*, offer a refreshing, thought-provoking textbook. Designed specifically for the introductory tax course, this book is rigorous enough for students specializing in taxation, but it will not intimidate those who plan to pursue other areas of accounting and business.

FUNDAMENTAL STRUCTURE

Conceptual Approach

There are two ways to look at the rules that govern federal taxation: the technical approach and the conceptual approach. The traditional "technical approach" looks at the reams of tax authority as thousands of specific and distinct code sections, regulations, exceptions, and qualifications. This approach treats income tax in such great depth that the first-time tax student has difficulty understanding the myriad rules, exceptions to those general rules, and exceptions to the exceptions. As a result, students tend to view the first tax course as a long string of unrelated topics that they must memorize to pass the course.

The "conceptual approach" presents taxation as a small number of unifying concepts—principles that apply in the application of specific tax rules and authorities. These concepts define taxation. An analogy can be made to mathematical operations: by understanding how multiplication works and memorizing the nine times tables, people learn to multiply any number by any other number. One can multiply 23 by 25 correctly without having memorized a times table that includes that pair of numbers. Likewise, knowing the underlying concepts that shape tax law allows students to understand a wide range of tax law without committing every line of the Internal Revenue Code to memory.

Organization

Instead of focusing on the individual aspects of taxation, this textbook emphasizes transactions that are common to all tax entities. This allows the text to focus more on the overall scheme of taxation (What is income? What is a deduction? and so on) with individual tax return preparation a secondary issue. As a result, Chapter 1 introduces the individual tax formula and briefly discusses the "for" versus "from" adjusted gross income distinction that is unique to individuals, but the mechanics of the individual tax calculation are not discussed in detail until Chapter 8. Furthermore, itemized deductions are not accorded the traditional in-depth treatment. Again, the focus is on the more common itemized deductions, and elaborate technical detail is omitted for the more unusual items.

The text is organized into the following six parts:

- **Part I: Conceptual Foundations of the Tax Law**
  - **Chapter 1** provides an overview of the tax system, briefly discusses other types of taxes, outlines the general income tax calculation, discusses the nature of tax planning, and introduces ethical considerations of tax practice.
  - **Chapter 2** develops the conceptual framework and uses it to explain the operation of the tax system in general. Each subsequent chapter begins with a brief review of the concepts discussed in this chapter.

- **Part II: Gross Income**
  - **Chapter 3** classifies various sources of income and explains the common problems encountered within each income classification. Its overview of property transactions differentiates the taxation of capital gains and losses from other sources of income. The chapter concludes with an introduction to the accounting methods that affect the recognition of income.
  - **Chapter 4** classifies allowable exclusions from income according to the purpose of the exclusion and discusses the problems commonly encountered with exclusions in each category.
- **Part III: Deductions**
  - **Chapter 5** provides an overview of the general criteria necessary to obtain a tax deduction and concludes with a discussion of the effect of a taxpayer's accounting method on the timing of deductions.
  - **Chapter 6** addresses specific business expense deductions that are subject to special rules and limitations.
  - **Chapter 7** covers deductions for losses. The chapter distinguishes annual losses from transaction losses, and discusses the limitations on the deductibility of the two types of losses. This discussion includes the treatment of net operating losses, the at-risk rules, passive losses, capital losses, and casualty losses.
  - **Chapter 8** discusses the unique features of the individual income tax calculation, itemized deductions, and tax credits available to individuals.
- **Part IV: Property Transactions**
  - **Chapter 9** introduces the property investment cycle and discusses common acquisition problems.
  - **Chapter 10** provides the allowable deductions for property expenditures. This includes the MACRS depreciation system, depletion deductions, and allowable amortization deductions.
  - **Chapter 11** discusses dispositions of property and explains the classification and calculation of the gain or loss from a disposition of property.
  - **Chapter 12** covers the common nonrecognition situations related to property dispositions, including exchanges, involuntary conversions, and sales of a principal residence.
- **Part V: Income Tax Entities**
  - **Chapter 13** discusses the nontax characteristics that should be considered in choosing a business entity and the incidence of taxation of each entity and presents the comparative differences at formation of a business.
  - **Chapter 14** compares the differences in tax treatments during the operation of an entity and concludes with an overview of the effect of distributions on an entity and its owners.
  - **Chapter 15** finishes the life-cycle discussion with coverage of deferred compensation, tax credits, the alternative minimum tax, and international tax aspects of entities.
- **Part VI: Tax Research**
  - **Chapter 16** provides the mechanics of tax research. Problems that require the student to find particular types of authorities using print, CD-ROM, and Internet tax services, and research cases for all chapters in the text are provided in this chapter. Instructors wishing to introduce students to tax research may want to cover this chapter early in the course.

HALLMARK FEATURES

The most important objective at the introductory level is to gain a conceptual view of income tax law and then relate those concepts to basic aspects of everyday economic life. Through continual reinforcement, the concepts quickly become the backbone of understanding. The 2022 edition of *Concepts in Federal Taxation* has a lineup of outstanding features that will help students improve their skills and understanding while learning the concepts.

Learning Objectives

Each chapter opens with a set of learning objectives to guide students through mastering the chapter's material. Learning objectives are shown in the margins near the relevant chapter content and are also identified in the end of chapter materials to reinforce these key learning objectives and help students learn more efficiently.

Concept Review

To solidify and expound upon the conceptual foundation presented in Chapter 2, the subsequent chapters begin with a review of the general concepts, accounting concepts, income concepts, and deduction concepts that have been covered in previous chapters. Page references for each concept allow students to easily locate material and refresh their memory.

concept review

GENERAL CONCEPTS

Ability to pay A tax should be based on the amount that the taxpayer can afford to pay, relative to other taxpayers. pg. 2-2

Administrative convenience Those items for which the cost of compliance would exceed the revenue generated are not taxed. pg. 2-3

Arm's-length transaction A transaction in which all parties have bargained in good faith and for their individual benefit, not for the benefit of the transaction group. pg. 2-4

Related party Family members, corporations that are owned by family members, and certain other relationships between entities in which the power to control the substance of a transaction is evidenced through majority ownership. pg. 2-4

ACCOUNTING CONCEPTS

Annual accounting period All entities must report the results of their operations on an annual basis (the tax year). Each tax year stands on its own, apart from other tax years. pg. 2-9

Assignment of income The tax entity that owns the income produced is responsible for the tax on the income, regardless of which entity actually receives the income. pg. 2-8

Conduit entity An entity for which the tax attributes flow through to its owners for tax purposes. pg. 2-6

Substance over form Transactions are to be taxed according to their true intention rather than some form that may have been contrived. pg. 2-11

Tax benefit rule Any deduction taken in a prior year that is recovered in a subsequent year is income in the year of recovery, to the extent that a tax benefit was received from the deduction. pg. 2-10

INCOME CONCEPTS

All-inclusive income All income received is taxable unless a specific provision in the tax law either excludes the income from taxation or defers its recognition to a future tax year. pg. 2-12

Capital recovery No income is realized until the taxpayer receives more than the amount invested to produce the income. The amount invested in an asset represents the maximum amount recoverable. pg. 2-13

Claim of right A realization occurs whenever an amount is received without any restriction as to its disposition. pg. 2-14

Constructive receipt Income is deemed to be received when it is made unconditionally available to the taxpayer. pg. 2-15

Legislative grace Any tax relief provided is the result of a specific act of Congress that must be strictly applied and interpreted. All income received is taxable unless a specific provision in the tax law excludes the income from taxation. Deductions must be approached with the philosophy that nothing is deductible unless a provision in the tax law allows the deduction. pg. 2-12

Realization No income or loss is recognized until it has been realized. A realization involves a change in the form and/or substance of a taxpayer's property rights that results from an arm's-length transaction. pg. 2-14

Wherewithal to pay Income is recognized in the period in which the taxpayer has the means to pay the tax on the income. pg. 2-16

Examples

Continually rated as this textbook's biggest strength, each chapter includes numerous student-friendly examples. The examples present familiar situations in a question-and-discussion format that offers detailed explanations.

Example 24 Jorge receives 200 shares of MNO Corporation common stock as a gift from his grandfather. At the date of the gift, the shares have a fair market value of $20,000. During the current year, Jorge receives dividends totaling $2,000 on the stock. Recall that the tax law excludes the value of a gift from the gross income of the recipient. What are the tax effects for Jorge of the gift from his grandfather?

Discussion: The receipt of the stock as a gift from the grandfather is specifically excluded from Jorge's income by the tax law. However, the exclusion applies only to the value of the gift received and does not exclude from tax any subsequent income Jorge receives on the gift property.[12] Therefore, Jorge is taxed on the $2,000 in dividends received on the stock.

Concept Check

Concept Checks appear throughout each chapter to keep students on track by reinforcing the critical tax concepts illustrated.

concept check

The *capital recovery concept* allows the recovery of capital invested in an asset. The amount invested in an asset is the maximum amount recoverable under this concept. *Adjusted basis* represents a taxpayer's unrecovered investment in an asset. Therefore, the maximum loss that can be recognized from a casualty or theft is the asset's adjusted basis. An *arm's-length* transaction is one in which all parties to the transaction have bargained in good faith and for their individual benefit, not for the benefit of the transaction group. *Related party* transactions are usually subject to scrutiny by the IRS because the tax law assumes that related parties do not transact at arm's length. The substance-over-form doctrine taxes transactions according to their true intent rather than some (possibly) contrived form of the transaction. This concept prevents a taxpayer from recognizing a loss on the sale of stock if it is replaced within 30 days of (either before or after) the date of sale.

END-OF-CHAPTER MATERIALS

Ensure that students master chapter concepts with a wide array of end-of-chapter assignments designed to do everything from testing basic chapter comprehension to applying concepts and procedures to complex tax situations.

Chapter Summary

Students can verify their understanding of the key concepts illustrated in the chapter by reviewing the succinct Chapter Summary, which appears at the end of every chapter.

Key Terms

Part of the difficulty of this course can be traced to its specialized vocabulary. As learning the terminology serves as a basis for learning how to apply the concepts, each chapter includes a list of key terms with page references.

Primary Tax Sources

Rather than interrupting the text with extensive footnoting of specific subsections of the Internal Revenue Code, the primary tax law sources appear at the end of each chapter with explanatory notations. This approach uses more references to Treasury regulations, revenue rulings, and court cases than may appear in other introductory tax textbooks.

Discussion Questions and Problems

Many of the approximately 1,300 end-of-chapter problems do not call for mathematical solutions. Rather, they require an explanation of the appropriate treatment, based on the concepts. These problems are valuable learning tools, which encourage students to apply the concepts and formulate a solution.

Communication Skills

Traditional problems that can be solved by reference to the examples in the chapter are also provided, and they address every topic in the chapter. In most cases, two or more problems exist for each topic. A number of problems exist for each learning objective. Problems that require client communication are designated with a Communication Skills icon.

Issue Identification Problems

These problems ask students to identify the tax issues inherent in a factual situation and determine the possible tax treatments.

Technology Applications

A complete end-of-chapter section containing problems on Research Skills and Spreadsheet Skills enhance students' familiarity with the technology tools needed for problem solving.

Tax Simulation

- **Tax Simulations** in Chapters 3–12 teach database searching and writing skills that are important requirements for understanding tax concepts. These cases can be solved using only the Code and Regulations, giving students hands-on practice with the research and writing skills required to complete the tax simulations featured on the CPA Examination.

- **Research Skills Exercises** require students to research relevant tax topics.
- **RIA Research Exercises** require students to use the Checkpoint® tax research database to complete the assignment.
- **Tax Form Problems** containing expanded client information allow students to complete tax forms obtained from the IRS website without additional instruction. These problems may be also worked using tax preparation software such as Intuit ProConnect Tax Software.
- **Spreadsheet Skills Problems** are designed to make students aware that spreadsheets are useful tax planning tools.

Research Skills

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Tax Form Skills

Spreadsheet Skills

Comprehensive Problems

These problems cover several issues discussed within a chapter, requiring students to develop an advanced understanding by combining and applying multiple concepts.

Integrative Problems

These problems require students to fuse together material learned in previous chapters, combining it with information found within the current chapter. This approach allows students to complete a complex tax return in two stages, spreading the work out over the semester rather than preparing it for a single due date.

Tax Return Problem (Appendix A)

This problem is presented in three phases, which correspond to the organization of the text. Each phase presents some information in actual tax documents that a taxpayer might receive from common third-party sources. This approach makes it easier to become familiar with tax reporting and tax compliance forms as the material is covered, rather than in one burst at the end of the semester. The problem can be worked manually or with tax preparation software such as ProConnect Tax Software.

Discussion Cases

These cases stimulate thinking about issues raised in the chapter. All case material can be used to emphasize communication in the tax curriculum.

Tax Planning Cases

These cases require students to use the concepts in the chapter to devise an optimal tax plan for the facts given.

Ethics Discussion Cases

These cases provide ethical dilemmas related to the chapter material that must be resolved according to the Statements on Standards for Tax Services of the American Institute of Certified Public Accountants (AICPA). A link to the complete AICPA statements on standards is provided.

RECENT REVISIONS

Fine-Tuned End of Chapter Material

All end of chapter content has been thoroughly updated with respect to tax law changes. This material has also been carefully revised to enhance the readability of the question parts.

Updates Reflect the Latest Tax Laws

This annual edition reflects the latest tax laws and changes to tax codes and regulations to keep your course current—including the new tax rate schedules and amounts.

INSTRUCTOR RESOURCES

Concepts in Federal Taxation has been adopted by a wide range of schools and by instructors who have unique philosophies and approaches in their courses. Our supplemental materials have been developed to have a positive impact on all aspects of the course.

Instructor Companion Website

www.cengage.com/login
Easily download the instructor resources you need from the password-protected, instructor-only website. If you are a new instructor, you will need to register with Cengage by creating a new instructor account. Instructors will be directed to the Cengage dashboard after logging in. Here, instructors may add any Cengage book to the "bookshelf," including the 2022 edition of *Concepts in Federal Taxation* simply by searching by the author, title, or ISBN (9780357515785). After adding the book to your "bookshelf," you will be able to access the links to the Instructor Companion website and accompanying resources.

Instructor's Manual

Simplify class preparation with the wealth of teaching tips and advanced assignment ideas provided in the Instructor's Manual. A concise overview and detailed lecture outline (including references to relevant problems in the textbook) are provided for each chapter, along with invaluable teaching ideas—including those for incorporating writing assignments, class/group exercises, and research projects. This rich array of resources is further enhanced with the inclusion of useful planning documents on designing a course, grading and developing team activities, and sample syllabi that outline the incorporation of technology, communication, and group assignments in the tax curriculum. Available on the instructor website.

Solutions Manual

Carefully verified to ensure accuracy, the Solutions Manual reproduces all end-of-chapter materials from the textbook and provides in-depth discussions of the answers to help instructors efficiently grade assignments. Charts that detail all problems by topic have been included to simplify planning and assignment selection. In addition, problems requiring key skills like critical thinking and communication, as well as comprehensive and integrative problems, have been labeled. Available on the instructor website.

Test Bank

The Test Bank helps instructors efficiently assess your students' understanding with problems and questions that reflect the textbook's conceptual approach. The Test Bank offers a variety of question types—including true/false, matching, multiple choice, short answer, and comprehensive problems. Test Bank questions are also identified by level of difficulty for easy selection and have been tagged to Accredited Business Program and AICPA standards. This is particularly valuable during the accreditation process or when your school wants to standardize assessment. Available through Cognero, a full-featured, online assessment system.

Cengage Testing Powered by Cognero

This is a flexible, online system that allows you to: author, edit, and manage test bank content, create multiple test versions in an instant, and deliver tests from your LMS, your classroom or wherever you want.

STUDENT RESOURCES

Checkpoint Student Edition from Thomson Reuters®

Students are introduced to tax research with access to Checkpoint®, the leading online tax research database. Its intuitive, Web-based design makes it fast and simple to navigate and its comprehensive collection of primary tax law, cases, and rulings is unmatched. Each new copy of this textbook has been automatically bundled with access to Checkpoint® for six months.

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ProConnect Tax™

ProConnect™ Tax

Each new copy of this textbook has been automatically bundled with ProConnect Tax™ access.

Contact the Murphy-Higgins Team with Suggestions and Comments

We encourage all adopters to participate in the continuing development of this book by providing comments and suggestions for improving the textbook and supplementary materials. Please address these comments to:

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Thank you again for your support.

Kevin E. Murphy
Mark Higgins
Randall K. Skalberg

INTRODUCTION

WHY STUDY FEDERAL INCOME TAXATION?

If you are beginning the study of the federal income tax law and plan to become a tax attorney or accountant, why you are taking this course is obvious. But if you want to become a management accountant or auditor, why should you study federal income taxation? Don't accountants rely on tax specialists to do tax research and prepare tax returns? Better yet, why should a business executive, an attorney, a physician, or a farmer take a tax course? Each of them also can, and often does, have professional tax advisers to take care of his or her tax problems. The heart of the answer lies in the fact that most economic transactions have an income tax effect.

The income tax law influences personal decisions of individuals. The decision to buy a house instead of renting one may depend on the after-tax cost of the alternatives. Although the payment of rent reimburses the owner of the dwelling for mortgage interest and property tax, a tenant cannot deduct the cost of renting a home. However, a homeowner can save income tax by deducting home mortgage interest and property tax and perhaps reduce the after-tax cost of buying relative to renting.

Example 1 Zola lives in an apartment she rents for $700 per month. She is considering purchasing a house, which will require an initial cash outlay of $5,000 and monthly payments of $850. Although none of the $5,000 initial down payment is deductible, $800 of the monthly payment is deductible as interest expense. Assuming that Zola earns 6% on her investments and is in the 24% tax rate bracket, what is the after-tax monthly cost of purchasing the house?

Discussion: Assuming that Zola itemizes her deductions, the $800 interest payment will be deductible. Her taxable income will be reduced by $800 per month, resulting in tax savings of $192 ($800 × 24%). This leaves her with a net after-tax house payment of $608. However, she will lose interest income on the $5,000 investment of $25 per month [($5,000 × 6%) = $300 ÷ 12 = $25]. She will not have to pay any tax on the lost interest, resulting in an after-tax interest loss of $19 [$25 − ($25 × 24%)]. Her net after-tax monthly cost of purchasing the house is $627 ($608 + $19). Because this is less than her rent of $700, Zola will come out ahead by $73 per month by purchasing the house.

This analysis of Zola's investment in a house considers only the tax aspects of the investment. Clearly, other factors influence the decision to purchase a house—potential appreciation in value, the intangible value of owning your own home, and so on. The point is that the tax consequences are one objective factor to consider when making various decisions, but they are rarely the sole or controlling factor.

Other personal decisions are often influenced by tax savings. For example, a taxpayer may decide to accelerate or defer charitable donations or elective medical treatment to claim the deductions in the year that results in the most significant tax savings. Even child-care decisions may be based on the availability of tax savings in the form of a child-care tax credit.

Example 2 On January 1 of each year, Steve gives $2,000 to his church. For 2020, his income is more than double its usual amount because of a one-time bonus he receives from his employer. In a typical year, Steve is in the 24% tax rate bracket. Because of his increased income in 2020, Steve estimates that he will be in the 32% tax rate bracket, but his income will return to normal in 2021. What steps might Steve take to reduce his tax bill?

Discussion: Instead of waiting until January 1, 2021, to make his regular $2,000 donation, which will reduce his tax by $480 ($2,000 × 24%), Steve could pay the contribution in 2020. By taking the deduction in 2020 when he is in the 32% tax

rate bracket, Steve saves $640 ($2,000 × 32%) in tax. By accelerating his $2,000 charitable contribution by a few days, he saves an extra $160 in tax ($640 − $480).

From these examples, you can see that income taxes can and do have an influence on routine decisions. However, the cost of the income tax is more than just the outlay for the tax liability. A knowledge of the income tax laws enables taxpayers to make decisions that can reduce these other costs. By being familiar with the tax laws, an individual can enter into transactions that will provide the best tax result for both the taxpayer and the taxpayer's family. By minimizing the income tax burden, taxpayers conserve wealth that can be put to other uses. Last, taxpayers are responsible for reporting their correct taxable income to the government. Knowing the tax laws protects against audits by the IRS that could result in additional tax owed and penalties for improper reporting of the tax liability.

Significance of Tax Costs

Keeping records and filling out forms to comply with the tax law can consume a substantial amount of time. Table I-1 presents the IRS's estimates of the time involved in record keeping, learning about tax law, preparing a return, and assembling the various commonly filed tax forms. As you can see, the IRS estimates that completing and filing the basic tax return form (Form 1040) requires more than 22 hours on average. When you consider that many taxpayers file a multitude of forms and schedules to detail their tax affairs, the time involved in complying with the tax law is quite substantial.

Tax compliance may also cost a taxpayer money. Taxpayers must weigh the cost of the time and investment needed to prepare their own tax returns, the out-of-pocket cost of hiring a tax preparer to prepare the return, and the risk of additional time and monetary costs for any errors. Thus, taxpayers need to choose whether to save money and spend the time to prepare their own tax returns or to pay to have someone else help determine the proper amount of income tax.

When deciding whether to prepare their own returns, taxpayers should be aware that the amount of income tax shown on the return may contain errors or differences of opinion that may be found in an IRS audit. These differences of opinion can result from a taxpayer's or the tax preparer's lack of familiarity with the tax law and how it applies to the taxpayer. Similarly, the IRS agent performing the audit may not fully understand the law as it applies to a particular situation. In addition to clerical mistakes, tax return errors can result from inadequate communication between a taxpayer and tax preparer. A tax audit may reveal that the taxpayer either is entitled to a refund or owes more tax. If you are entitled to a refund, you have lost the use of the money while it was held by the U.S. Treasury. If you have to pay more tax, you may have to pay extra costs in the form of penalties and interest on the tax

Table I-1

Estimated Average Taxpayer Burden for Individuals by Activity

		Average Burden					
		Average Time (Hours)					Average Cost (Dollars)**
Type of Taxpayer	Percentage of Returns	Total Time*	Record Keeping	Tax Planning	Form Completion and Submission	All Other	
All taxpayers	100	11	5	2	4	1	$210
Type of taxpayer							
Nonbusiness***	70	7	2	1	3	1	130
Business***	30	19	10	3	5	1	410

*Detail may not add to total time due to rounding.
**Dollars rounded to the nearest $10.
***You are considered a "business" filer if you file one or more of the following with Form 1040 or 1040-SR: Schedule C, E, or F or Form 2106. You are considered a "nonbusiness" filer if you don't file any of those schedules or forms with Form 1040 or 1040-SR.

you owe. An audit of your return will require an additional investment of your personal time and, quite likely, additional out-of-pocket costs for professional tax advice. In addition, many taxpayers are intimidated when facing an income tax audit.

As your involvement in professional activities increases, taxes and the costs of compliance grow in importance. If you are like most taxpayers, you will want to pay the least tax required by the law. You will also want to spend as little time and money as possible to satisfy the compliance requirements. As Table I-2 shows, in 2000, an average taxpayer worked May 1 to pay federal, state, and local taxes and a taxpayer worked almost one-third (33.00 percent) of the year to pay taxes. Major federal income tax cuts enacted from 2001 through 2009 decreased tax freedom day to April 9 in 2010. However by 2019, tax freedom day has increased to April 16 which represents 29% of the tax year pay federal, state, and local taxes. As Table I-2 demonstrates, the amounts paid for taxes represent major expenditures for the typical taxpayer.

Conservation of Wealth

An understanding of basic tax concepts and planning can often help conserve wealth by reducing taxes. To reduce taxes, you need to be able to recognize potential planning situations and problems. Because you know your financial affairs better than anyone else, you are in the best position to spot potential tax-saving opportunities. You should never wait for your tax adviser to find new ways to save you taxes. Although a competent tax adviser will know about tax-planning techniques and current tax developments, you will be more familiar than an adviser is with your financial affairs and objectives. A tax adviser is best used in the same way you use other professionals. When you visit your physician, you usually describe the symptom that brought you to the office to help the doctor identify the proper treatment. When you visit your attorney for a legal problem, you

Table I-2

Tax Freedom Days in the U.S.

Year	Tax Freedom Day	% of Year
1960	April 11	27.70%
1970	April 19	29.60%
1980	April 21	30.40%
1990	April 21	30.40%
2000	May 1	33.00%
2010	April 9	26.90%
2011	April12	27.70%
2012	April 13	29.20%
2013	April 18	29.40%
2014	April 21	30.20%
2015	April 24	31.20%
2016	April 22	30.90%
2017	April 23	30.90%
2018	April 19	29.70%
2019	April 16	29.00%

take along the information necessary to help the lawyer identify the legal issues. In both instances, you evaluate information and decide when you need professional assistance. Likewise, you will need to evaluate information, based on your understanding of the tax laws, to determine when you need to consult a professional tax adviser.

Example 3 Gwen, 19, is a full-time student at State University. Her parents pay all her expenses, which total $12,000 a year. Gwen does not have any other source of support, and she does not pay any income tax. Gwen's father, Marty, owns a substantial portfolio of bonds that earns $12,000 in income each year. Marty is in the 32% tax rate bracket.

Discussion: A tax plan could save Marty money by transferring ownership of the bond portfolio to Gwen, who is in a lower tax bracket. Marty pays $3,840 ($12,000 × 32%) in tax on the investment income. The amount of income left after paying tax is $8,160 ($12,000 − $3,840).

If Marty gave the bond portfolio to Gwen as a gift (which is not subject to income tax), she would be taxed on the income at a lower tax rate than her father. Assuming that Gwen has no other income, her tax on the income would be $1,124. The family could save $2,716 ($3,840 − $1,124) in tax by shifting the income to Gwen. The amount of income left after paying tax is increased to $10,876 ($12,000 − $1,124).

Taxes Influence Routine Decisions

An auditor, management accountant, attorney, physician, or farmer may never prepare a business tax return. Yet, they need a general understanding of the tax effects of their daily business decisions. For example, an auditor might find that an improperly recorded transaction results in an undisclosed tax liability or refund. A managerial accountant may need to consider the tax effects of buying or selling plant assets or acquiring a new business. To provide reliable advice to clients, lawyers often need a general understanding of how the tax laws apply to different types of entities. A doctor may need a general understanding of fringe-benefit plans that can be set up to keep highly qualified nurses and medical technicians as employees. A farmer can benefit from familiarity with the complex rules that govern reporting of income from farm production and the deduction of farm expenses. Individuals can also benefit from a knowledge of the tax laws in their everyday decisions.

Example 4 Isaac wants to remodel his house. During a special promotion, his bank will finance the purchase with a 7% unsecured personal loan. Isaac knows that he can obtain a home equity loan from his bank at 8% interest. If Isaac is in the 24% tax bracket, which loan should he use to finance his remodeling?

Discussion: Interest paid on personal loans is not deductible. However, interest paid on a home equity loan is deductible and treated as acquisition indebtedness if the funds are used to substantially improve the taxpayer's home. If Isaac itemizes his deductions, the interest on the home equity loan is deductible. This makes the real after-tax cost of the home equity loan 6.08% [8% − (8% × 24%)]. Therefore, the home equity loan actually offers a lower after-tax cost than the personal loan.

However, note that if Isaac does not itemize deductions (i.e., he uses the standard deduction), he receives no benefit from the deduction for home equity loan interest. In this case, the personal loan would have a lower after-tax cost, because neither loan would produce deductible interest.

Self-Protection

Another reason for being aware of the federal income tax law is self-protection. Perhaps you have heard others say that all they have to do is give a list of income and deduction items to their tax return preparer. When they get the completed tax return back and pay the tax due, their responsibility for complying with the tax law is finished. If any mistakes are made, it is the preparer's problem. This assumption is erroneous and can lead to disaster.

Taxpayers are fully liable for additional tax, interest, and penalties due because of an error on their tax return. If a person paid to prepare a return misinterprets the information and/or makes a mistake that results in an underpayment of tax, the taxpayer will have to pay any additional amounts owed to the government. Whether the preparer will reimburse the taxpayer for the penalties and interest depends on the agreement with the preparer. Legal recourse against the preparer is available in certain circumstances, but the cost of obtaining reimbursement (e.g., legal fees, court costs) from the preparer may be prohibitive. For your own protection, you should always examine the completed return. Before you sign and file the return, thoroughly review it with your preparer and be sure you understand any entries that do not seem to be correct. Again, a knowledge of the tax law can help you catch errors or other misrepresentations made by a tax preparer before the return is filed.

Example 5 Raul gives his tax return preparer a list of income and deduction items to be reported on his tax return. The income items total \$50,000, and the deduction items total \$14,000. When the preparer puts the information on the return, he omits \$10,000 of the income and reports only \$40,000 (\$50,000 − \$10,000) in income. In addition, the preparer includes a \$2,000 deduction twice so that total deductions are reported as \$16,000. As a result, Raul understates his taxable income by \$12,000 (\$36,000 correct taxable income − \$24,000 reported taxable income).

Discussion: If the IRS detects the errors on the return, Raul will have to pay the IRS the additional tax due on the \$12,000 understatement plus penalties and interest. Depending on their agreement for preparing the return, Raul may or may not recover part of his costs from the preparer. If the preparer does not agree to reimburse Raul for his mistakes, Raul may take legal action to obtain the amount due from the preparer. However, this can be a costly process and may not be worth the additional tax, penalties, and interest due.

Clearly, all taxpayers can benefit from a basic knowledge of the tax law. Although the federal income tax is only one of many taxes that government bodies use to raise revenue, it is by far the most important in terms of revenue produced and the number of taxpayers affected. Therefore, this book focuses on federal income tax law.

Federal income tax law is a complex array of statutory, administrative, and judicial authorities. Because of its ability to affect taxpayer's decisions, lawmakers frequently make changes in the tax law to achieve economic, social, and/or political objectives. This causes the tax law to be in constant evolution. Professional tax advisers spend a significant portion of their time maintaining their knowledge of this changing body of law. Fortunately, many aspects of the tax law have remained stable over time. The approach used in this book is to provide a conceptual framework for analyzing how particular transactions should be treated for federal income tax purposes. The book then presents the general operation of the tax law and explains it in terms of the basic concepts. Throughout the book, the focus of the discussion is on those aspects of the federal income tax that have remained stable over time. A knowledge of the basic operation of the tax law will enhance your ability to make the best decisions for your individual situation.