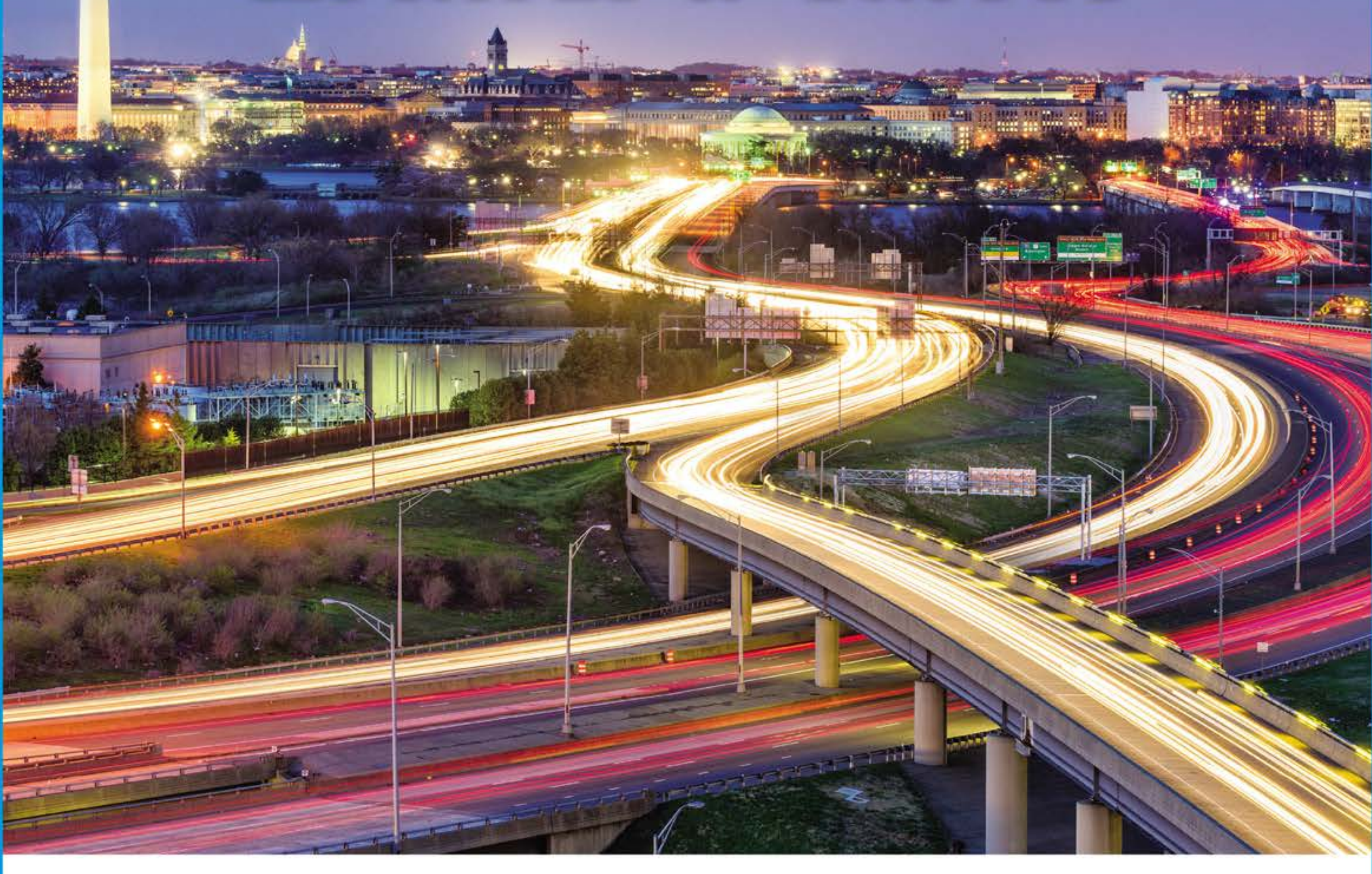
CENGAGE

SOUTH-WESTERN
FEDERAL TAXATION

Corporations, Partnerships, Estates & Trusts



Included: the answer company™ THOMSON REUTERS® ProConnect™ Tax Becker

Raabe • Young
Nellen • Hoffman

2022

Income Tax Rates—Estates and Trusts

Tax Year 2021

Taxable Income		The Tax Is:	
Over—	But not Over—		Of the Amount Over—
$ 0	$ 2,650	10%	$ 0
2,650	9,550	$ 265.00 + 24%	2,650
9,550	13,050	1,921.00 + 35%	9,550
13,050	....	3,146.00 + 37%	13,050

Income Tax Rates—C Corporations, 2018 and after

For all income levels, the tax rate is 21%.

Tax Formula for Corporate Taxpayers

Income *(from whatever source)*	$ xxx,xxx
Less: Exclusions from gross income	− xx,xxx
Gross Income	$ xxx,xxx
Less: Deductions	− xx,xxx
Taxable Income	$ xxx,xxx
Applicable tax rates	× xx%
Gross Tax	$ xx,xxx
Less: Tax credits and prepayments	− x,xxx
Tax Due *(or refund)*	$ xx,xxx

Unified Transfer Tax Rates

For Gifts Made and for Deaths after 2012

If the Amount with Respect to Which the Tentative Tax to Be Computed Is:	The Tentative Tax Is:
Not over $10,000	18 percent of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20 percent of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22 percent of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24 percent of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26 percent of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28 percent of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30 percent of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32 percent of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34 percent of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37 percent of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39 percent of the excess of such amount over $750,000.
Over $1,000,000	$345,800, plus 40 percent of the excess of such amount over $1,000,000.

CENGAGE | CNOW V2

Make a better grade with CNOWv2

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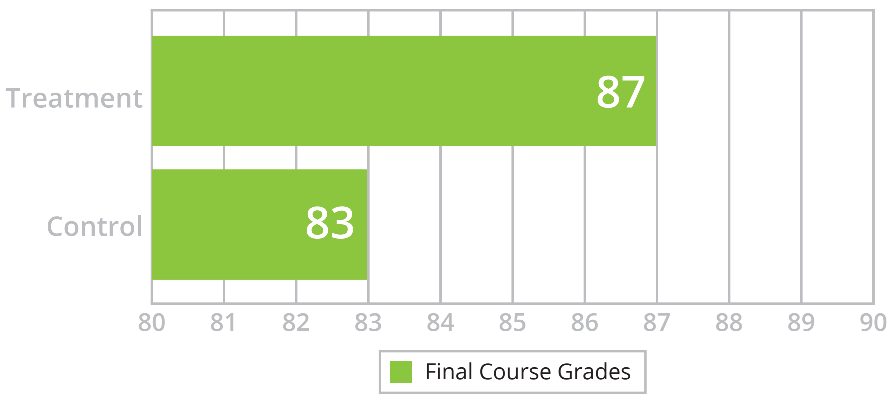

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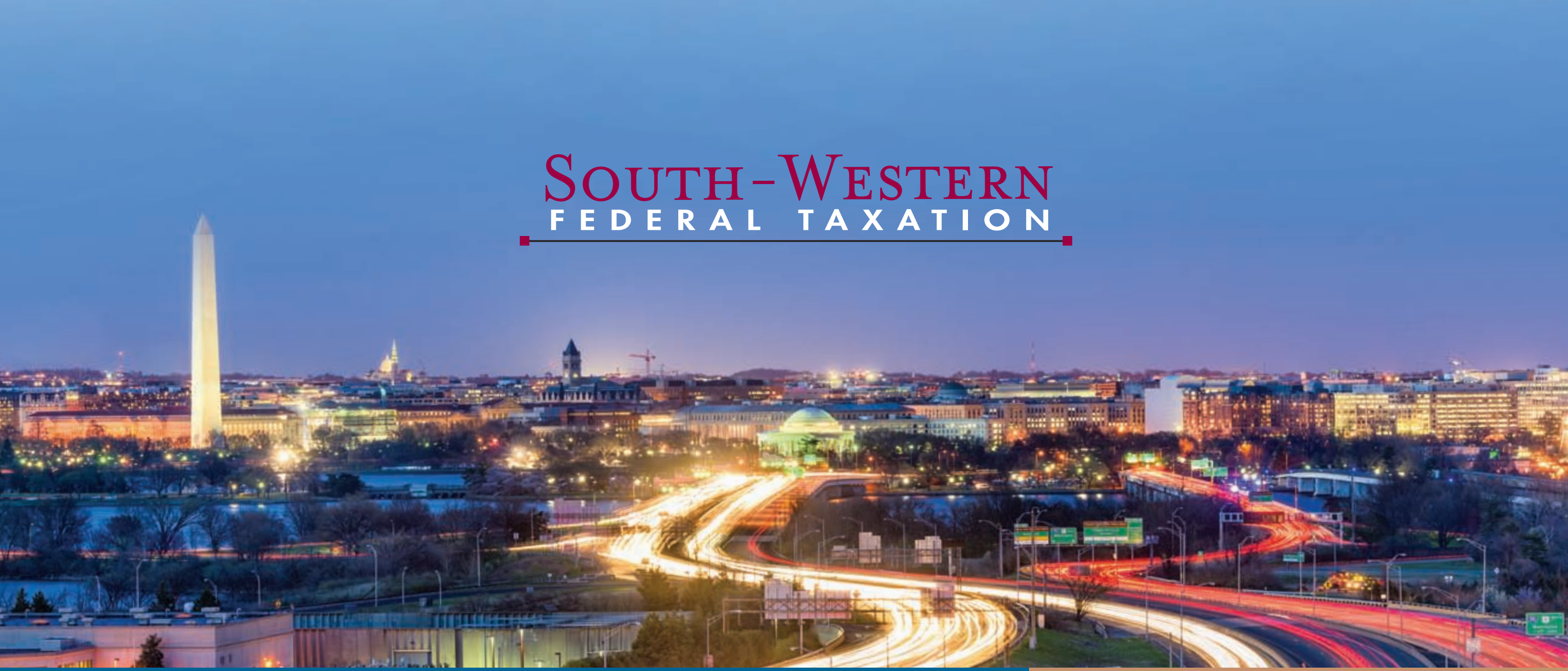
"I love the check your work option. Really, when you're having a hard time figuring out an answer, sometimes working backwards is the best way to understand conceptually what you're doing wrong."

Brad Duncan
University of Utah

"[I liked]...the read-a-loud option with the ebook... This helped when first starting a chapter and then when studying for tests."

Jennifer Loughren
Student,
Northeast Iowa Community College



CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS

2022

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South-Western Federal Taxation: Corporations, Partnerships, Estates & Trusts, 2022 Edition

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- **Raabe/Young/Nellen/Hoffman,** *South-Western Federal Taxation: Corporations, Partnerships, Estates & Trusts, 2022 Edition*
- **Young/Maloney/Nellen/Persellin/Cuccia,** *South-Western Federal Taxation: Comprehensive Volume, 2022 Edition*
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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.

Corporations, Partnerships, Estates & Trusts, 2022 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.

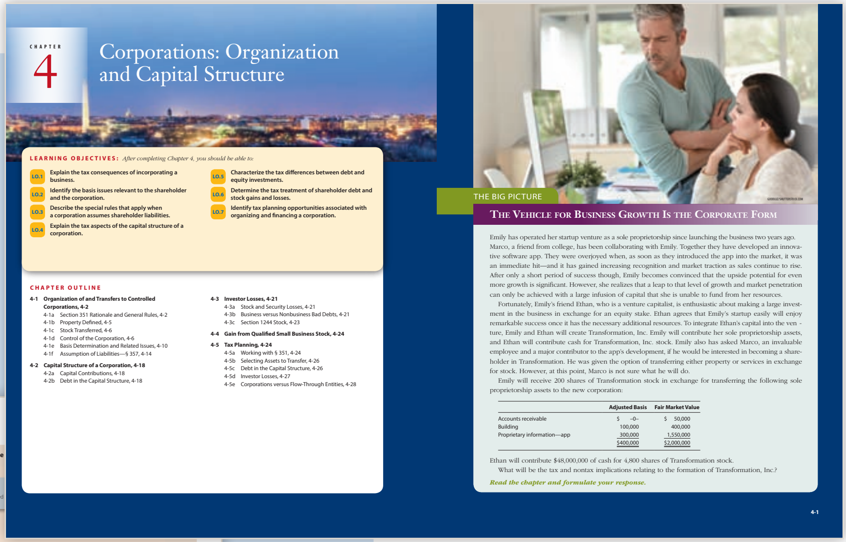
Corporations, Partnerships, Estates & Trusts, 2022 Edition covers tax concepts as they affect corporations, partnerships, estates, and trusts. The authors provide accessible, comprehensive, and authoritative coverage of relevant tax code and regulations, as well as all major developments in Federal income taxation. This market-leading text is intended for students who have had a previous course in taxation.

In revising the 2022 Edition, we focused on:

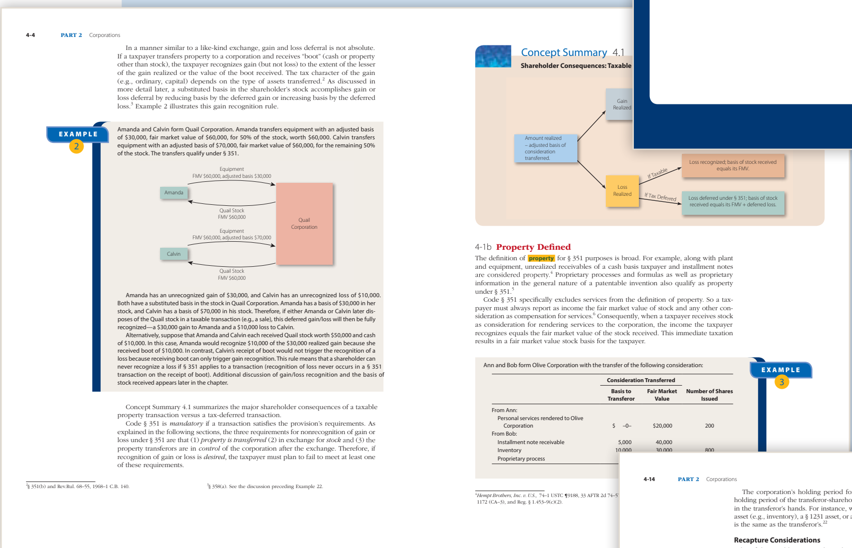
- ***Accessibility. Clarity. Substance.*** The authors and editors made this their focus as they revised the 2022 edition. Coverage has been streamlined to make it more accessible to students, and difficult concepts have been clarified, all without losing the substance that makes up the *South-Western 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. We include development of written and verbal communication skills, the use of tax preparation and tax research software, orientation toward success on the CPA Exam, exposure to tax policy and tax law development, consideration of the time value of money in the tax planning process, and experience 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.

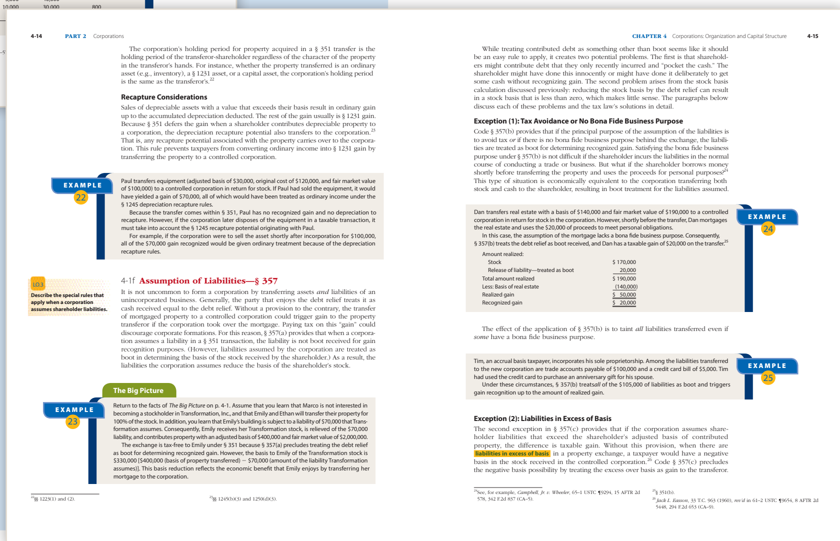
Learning Tools and Features to Help Students Make the Connection

FULL-COLOR DESIGN: We understand that students struggle with learning difficult tax law concepts and applying them to real-world scenarios. The 2022 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.





- **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 rules and concepts covered in each chapter to truly understand them. 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

Computational Exercises

19. LO.1, 2 Marie and Ramesh form Roundtree Corporation with the transfer of the following. Marie performs personal services for the corporation with a fair market value of $80,000 in exchange for 400 shares of stock. Ramesh contributes an installment note receivable (basis $25,000; fair market value $30,000), land (basis $50,000; fair market value $170,000), and inventory (basis $100,000; fair market value $120,000) in exchange for 1,600 shares. Determine Marie and Ramesh's current income, gain, or loss; calculate the basis that each takes in the Roundtree stock.
20. LO.1, 2 Grady exchanges qualified property, basis of $12,000 and fair market value of $18,000, for 60% of the stock of Eadie Corporation. The other 40% of the stock is owned by Pedro, who acquired it five years ago. Calculate Grady's current income, gain, or loss and the basis he takes in his shares of Eadie stock as a result of this transaction.

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

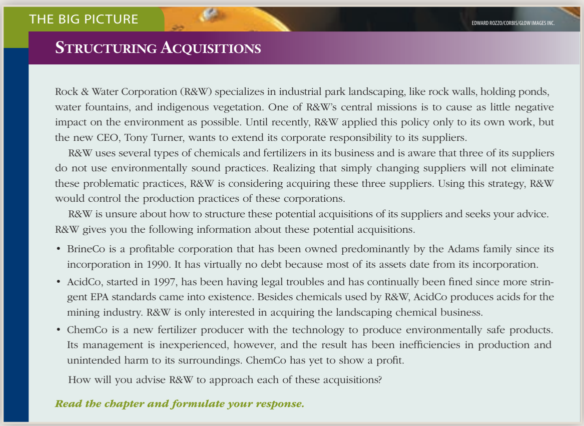
Becker CPA Review Questions

Becker

1. Olinto, Inc., has taxable income (before special deductions and the net operating loss deduction) of $92,000. Included in that amount is $12,000 of interest and dividend income. Forty percent of Olinto's property, payroll, and sales are in its home state. What amount of this taxable income will be taxed by Olinto, Inc.'s home state?
   a. $12,000 c. $44,000
   b. $36,800 d. $90,000

Becker

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



THE BIG PICTURE

EDWARD ROZZO/CORBIS/GLOW IMAGES INC.

Structuring Acquisitions

Rock & Water Corporation (R&W) specializes in industrial park landscaping, like rock walls, holding ponds, water fountains, and indigenous vegetation. One of R&W's central missions is to cause as little negative impact on the environment as possible. Until recently, R&W applied this policy only to its own work, but the new CEO, Tony Turner, wants to extend its corporate responsibility to its suppliers.

R&W uses several types of chemicals and fertilizers in its business and is aware that three of its suppliers do not use environmentally sound practices. Realizing that simply changing suppliers will not eliminate these problematic practices, R&W is considering acquiring these three suppliers. Using this strategy, R&W would control the production practices of these corporations.

R&W is unsure about how to structure these potential acquisitions of its suppliers and seeks your advice. R&W gives you the following information about these potential acquisitions.

- BrineCo is a profitable corporation that has been owned predominantly by the Adams family since its incorporation in 1990. It has virtually no debt because most of its assets date from its incorporation.
- AcidCo, started in 1997, has been having legal troubles and has continually been fined since more stringent EPA standards came into existence. Besides chemicals used by R&W, AcidCo produces acids for the mining industry. R&W is only interested in acquiring the landscaping chemical business.
- ChemCo is a new fertilizer producer with the technology to produce environmentally safe products. Its management is inexperienced, however, and the result has been inefficiencies in production and unintended harm to its surroundings. ChemCo has yet to show a profit.

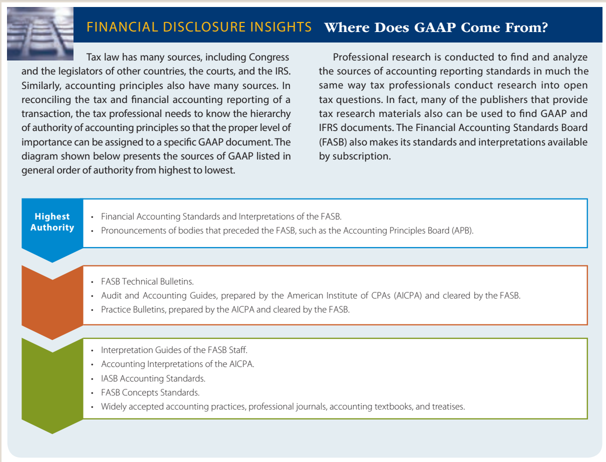
How will you advise R&W to approach each of these acquisitions?

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 provide 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.

FINANCIAL DISCLOSURE INSIGHTS: Tax professionals need to understand how taxes affect the 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 **Where Does GAAP Come From?**

Tax law has many sources, including Congress and the legislators of other countries, the courts, and the IRS. Similarly, accounting principles also have many sources. In reconciling the tax and financial accounting reporting of a transaction, the tax professional needs to know the hierarchy of authority of accounting principles so that the proper level of importance can be assigned to a specific GAAP document. The diagram shown below presents the sources of GAAP listed in general order of authority from highest to lowest.

Professional research is conducted to find and analyze the sources of accounting reporting standards in much the same way tax professionals conduct research into open tax questions. In fact, many of the publishers that provide tax research materials also can be used to find GAAP and IFRS documents. The Financial Accounting Standards Board (FASB) also makes its standards and interpretations available by subscription.

ETHICS & EQUITY **The Costs of Good Tax Planning**

High Tech Tops (HTT), a C corporation based in California, manufactures resilient cases and covers for laptops, smartphones, and tablets. Its sales and profits have more than doubled in each of the last five years (i.e., the company is growth-oriented and recession-proof). Its employees and contractors make above-average wages, so they make important contributions to the local individual income, sales, and property tax collections.

But the Federal and state corporate income tax is another story. Using legal and effective transfer pricing techniques, HTT shifts most of its operating profits to low-tax subsidiaries in Ireland and Singapore. Most of the firm's executives, engineers, and designers are based in the United States, but almost all of the sales operations are run from overseas. HTT's customers live around the world, but its tax liabilities are concentrated in the low-tax jurisdictions.

You are the president of State University, across town from HTT's headquarters. The company sends hundreds of its employees to take graduate and professional courses on your campus, and several of the corporate leaders are frequent guest speakers and adjunct lecturers in classes.

Still, the state income tax the company avoids through its transfer pricing plans would fund millions of dollars of campus growth and improvements for State University.

Should you become involved in the politics of the matter and lobby at your statehouse for tighter rules on transfer pricing? Such an action might result in tax increases that would improve your university's situation, but it also might force HTT to consider moving its headquarters to another location.

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.

9-8 TAX PLANNING

Tax planning techniques for the multinational taxpayer are effective when they combine opportunities presented by Federal income tax law, the tax provisions and economic incentives offered by the overseas jurisdictions in which business is conducted, income-shifting devices, and the use of tax treaties and tax havens.

Return to the timeline of Exhibit 9.6, and consider the decision to operate a multinational business entity as a branch and when to convert the structure of the business to an overseas subsidiary. Exhibit 9.8 identifies the major advantages and disadvantages for each of these decisions from a Federal income tax standpoint.

Additional tax planning opportunities and considerations are discussed below.

9-8a The Foreign Tax Credit Limitation and Sourcing Provisions

The FTC limitation is partially based on the amount of foreign-source taxable income in the numerator of the limitation formula. Consequently, the sourcing of income is extremely important. Generally, in this regard, the U.S. taxpayer benefits when the sourcing rules work to:

- Generate *income* items that are *foreign-source*, to maximize net foreign-source income (the numerator of the FTC fraction). Alternatively, a branch or flow-through entity might want overseas income to be U.S.-source, to increase its 20 percent deduction for qualified business income.[60]
- Realize *deduction* items as *U.S.-source*, to minimize any reduction in net foreign-source income (the numerator of the FTC fraction).

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 appear throughout each chapter.

GLOBAL TAX ISSUES **Tax Reform Adds a New Wrinkle to the Choice of Organizational Form When Operating Overseas**

When the management of a corporation decides to expand its business by establishing a presence in a foreign market, the new business venture may take one of several organizational forms. As each form comes with its respective advantages and disadvantages, making the best choice can be difficult. And the choice is even more challenging now because a new set of rules applies to the taxation of international operations with the enactment of the Tax Cuts and Jobs Act (TCJA) of 2017.

One common approach is to conduct the foreign activity as a *branch* operation of the U.S. corporation. The foreign branch is not a separate legal entity, but a division of the U.S. corporation established overseas. As a result, the U.S. corporation includes in its financial results any gains and losses that the foreign branch produces.

Another common approach to foreign expansion is to organize the foreign operations as a *subsidiary* of the U.S. parent corporation. The subsidiary may be either a *domestic* subsidiary (i.e., organized in the United States) or a *foreign* subsidiary (organized under the laws of a foreign country).

One fundamental tax difference between these two approaches is that parent corporations can elect to consolidate the gains and losses of a domestic subsidiary with the operations of the U.S. parent, but not with the operations of a foreign subsidiary. Thus, the use of a domestic subsidiary to conduct foreign operations generally yields the same final result as the use of a branch. With both approaches, the financial statements of the U.S. parent reflect the results of its worldwide operations.

The TCJA of 2017 changed many of the tax rules associated with international operations and their impact on organizational forms. Now the United States uses a "territorial system" when taxing foreign earnings. These rules generally require U.S. corporations to pay U.S. tax only on their domestic income. Given the complexity of the organizational form decisions and the significance of the changes to international taxation rules in the TCJA of 2017, it will take time for tax professionals to determine the most tax-effective ways of structuring foreign operations of U.S. corporations. See Chapter 9 for additional discussion of the taxation of international operations.

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

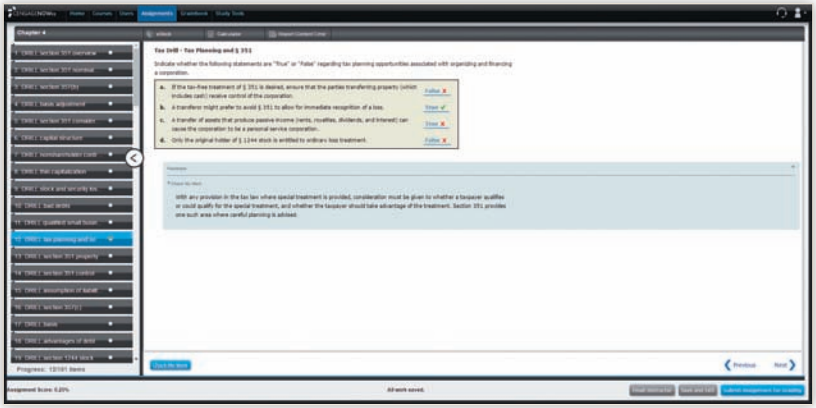
CengageNOWv2 is a powerful course management tool and online homework resource that elevates student thinking by providing superior content designed with the entire student workflow in mind.

- **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

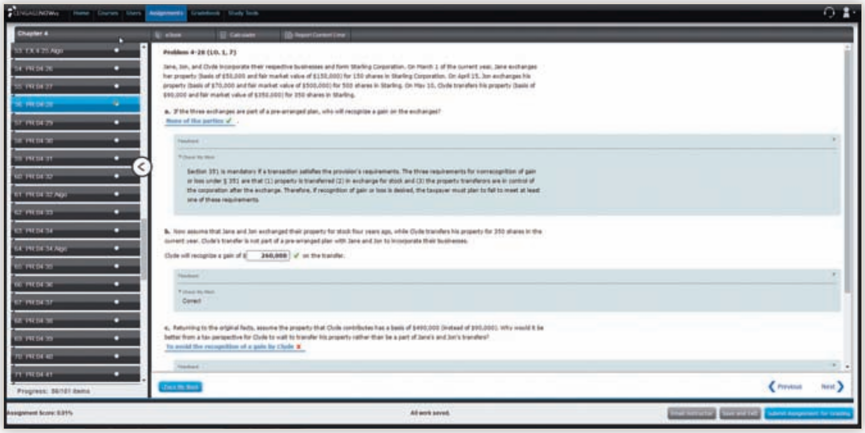
Motivation —

To help with student 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 —



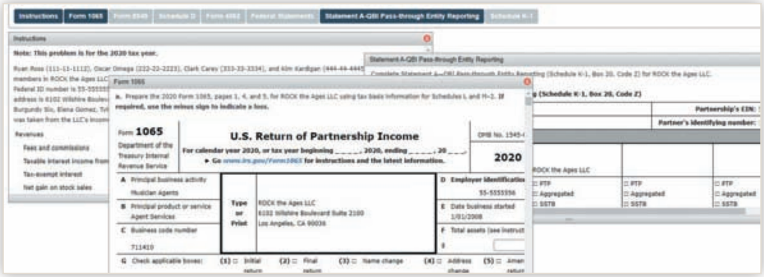
Students need to learn problem-solving behavior and skills, to guide them to complete taxation problems on their own. However, as students try to work through homework problems, sometimes they become stuck and need extra help. To reinforce concepts and keep students on the right track, CengageNOWv2 for 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 Tax problems and other homework items found in the end-of-chapter manually or in a digital environment.
- ❑ **An Adaptive Study Plan** comes complete with an eBook, practice quizzes, glossary, and flashcards. It is designed to help give students additional support and prepare them for the exam.



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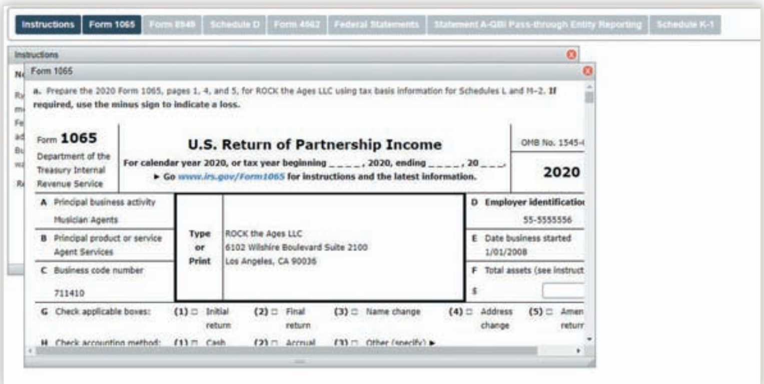

EXTENSIVELY REVISED. DEFINITIVELY UP TO DATE.

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 to 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 second 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 2022 Edition.

- Updated materials to reflect changes made by Congress through legislative action (including the tax provisions contained in the CARES Act and the Consolidated Appropriations Act of 2021).
- 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**)

Chapter 1

- Modified Learning Objectives 1, 3, and 7.
- Made minor changes to various exhibits and concept summaries.
- Updated references and citations throughout the chapter.
- Expanded Internal Revenue Bulletin coverage to include IRS Notices.
- Changed references to RIA Checkpoint to Thomson Reuters Checkpoint.
- Updated end-of-chapter materials as needed.

Chapter 2

- Updated chapter materials to reflect 2021 inflation adjustments to QBI deduction threshold limits.
- Updated example illustrating the completion of 2020 Form 8995-A and Schedule A (Form 8995-A).
- Revised and clarified materials based on feedback from adopters.
- Updated end-of-chapter materials as needed (including revisions for inflation adjustments to QBI deduction threshold limits and completion of 2020 Form 8995).

Chapter 3

- Updated and revised chapter material as needed.
- Updated end-of-chapter materials as needed.
- Noted the changes to the excessive executive compensation rule made by the American Rescue Plan Act of 2021.
- Added a new research problem focused on the CARES Act.

Chapter 4

- Switched Learning Objectives 2 and 3 to allow for better understanding of the relevance of stock basis.
- Switched text Sections 4-1e and 4-1f to enhance student comprehension.
- Reversed the order of discussion of assigning basis in § 351 transactions and the effect of liabilities transferred to a corporation on stock and asset bases.
- Added a test bank problem on § 1202.

Chapter 5

- Revised and updated chapter materials as needed; clarified chapter materials when necessary.
- Updated end-of-chapter materials as needed.

Chapter 6

- Updated text and end-of-chapter materials as needed.

Chapter 7

- Reorganized text Section 7-4.
- Created a new Ethics & Equity item entitled "Poison Pills."

- Revised the chapter introductory material.
- Revised the discussion in text Sections 7-2b and 7-4d.
- Relocated the material on assumption of liabilities.
- Added a "What If?" section to the Refocus on the Big Picture feature.
- Added and replaced several new items.
- Replaced Research Problem 2.

Chapter 8

- Revised Learning Objectives 5, 8, and 10.
- Reordered list of motivations in text Section 8-1a.
- Revised introductory material in text Section 8-3b.
- Reordered material in Exhibit 8.1.
- Revised material in Concept Summary 8.2.
- Revised various materials to account for CARES Act effects.
- Revised material in text Sections 8-5d and 8-6c.
- Revised Excel formula in solution to Problem 41 part (b).
- Added an Excel requirement to a computational exercise.
- Added material to the solution for Research Problem 1.
- Added the 2017 NOL changes to the requirements of Research Problem 6.

Chapter 9

- Revised Learning Objectives 3 and 5.
- Replaced a Global Tax Issues feature ("COVID-19 and Permanent Reisdency").
- Revised the discussion of tax treaties (text Section 9-2).
- Updated and added statistics about the global economy, worldwide tax rates, treaty withholding rates, advance pricing agreements, FTC deferrals, and CFCs.
- Revised Concept Summary 9.4 (which now illustrates the components of Subpart F income).
- Deleted text Section 9-5b ("Creating a Cross-Border Entity").
- Revised and expanded the discussion of Global Intangible Low-Taxed Income (GILTI).
- Added a number of new examples to illustrate text materials.
- Revised remainder of text as appropriate.
- Revised Research Problem 6, which asks students to explore and report on OECD base erosion and profit shifting (BEPS) developments.

Chapter 10

- Revised Learning Objective 1.
- Added Concept Summary entitled "Comparing a Partner's Tax Basis and Capital Account."
- Replaced Research Problem 4.

Chapter 11

- Introduced "hot assets" at the beginning of the chapter to consolidate coverage.
- Added new Concept Summary 11.1 to define hot assets in the context of distributions, § 736 retirement of partnership interest, and sales of a partnership interest.
- Expanded discussion of § 736 tax results applicable to limited partner and/or capital-intensive partnership (in Exhibit 11.1).
- Added consolidated discussion and definitions of hot assets supporting new Learning Objective 2.
- Adjusted partners' bases to more accurately reflect disproportionate beginning bases following property contributions to Problem 28.
- Combined liquidating distribution in Problems 29 and 30 to mirror format of Problem 25 for current (nonliquidating) distributions.
- Added new Research Problem 5 that challenges students to brainstorm ways to simplify partnership taxation and research simplification measures being considered by Congress.

Chapter 12

- Revised Learning Objectives 1, 9, and 10.
- Revised Exhibit 12.1 comparing business entities.
- Revised introductory material in text Section 12-1.
- Updated statistics about S corporations and partnerships/LLCs.
- Deleted Exhibit 12.5.
- Revised material in text Sections 12-3f and 12-3g.
- Placed Discussion Questions, Computational Exercises, and Problems in chronological learning objective order.
- Added two new research problems, one involving data analytics.

Chapter 13

- Revised Learning Objectives 5 and 6.
- Added introductory material on LLPs.
- Updated and revised the chart in Exhibit 13.1.
- Added a communications requirement for Research Problem 1.
- Revised Research Problem 4 and added a communications requirement to it.

Chapter 14

- Made minor modifications to Learning Objectives 5, 6, and 7.
- Updated Global Tax Issues feature related to IAS 12 and the current state of the convergence between U.S. GAAP and IFRS.
- Updated Financial Disclosure Insights feature for corporations paying no income tax in 2018.
- Added a new example emphasizing the intra-period allocation of tax expense (i.e., part of a company's book tax expense may not be included in the tax expense reported in the income statement but instead be included in other sources of comprehensive income reported after continuing operations or other items that directly impact stockholders' equity).
- Added new discussion and three examples of the impact of subsequent events on the accounting for uncertain tax positions.
- Revised former Concept Summary 14.2 (summarizing the provision process); it is now Concept Summary 14.3.
- Added two discussion questions requiring students to:
  - Identify reasons current tax expense as reported in the financial statements may not correspond to the current-year tax returns.
  - Explain the impact of a tax dispute settlement on book income.
- Added a problem requiring students to determine the impact of a tax dispute settlement on book income and provide the related journal entry.
- Modified former Problems 35–40 so they now include an example of a deferred tax benefit as well as an expense.

Chapter 15

- Revised Learning Objective 5.
- Updated statistics about the nonprofit sector of the economy, for private foundations, and for the UBIT.
- Revised language within Exhibit 15.1.
- Updated statistics about the tax on university endowments and the applications for exempt status.
- Added material about the UBIT "silo" rule.
- Deleted some material from the discussion of debt-financed UBTI.
- Added material concerning the loss of exempt status due to a failure to file Form 990.
- Updated end-of-chapter materials as needed, including revising Research Problem 6 and adding new Research Problem 7 (communications and data analytics).
- Revised Research Problem 6.
- Added new Research Problem 7 (communications and data analytics).

Chapter 16

- Added information on the MTC's project to update its *Statement of Information Concerning Practices of Multistate Tax Commission and Signatory States Under Public Law 86–272*, for changes in business practices primarily due to technology.

Chapter 17

- Made minor revisions to Learning Objectives 2 and 6.
- Added text Section 17-3f entitled "Ethics in the Tax Practice."
- Updated and expanded statistics about the IRS workforce and budget.
- Updated statistics about tax filings, offers in compromise, penalties, and audit rates and results.
- Updated and reorganized the material on informants.
- Updated the Ethics & Equity item about self-assessment.
- Expanded materials about the unauthorized practice of law.
- Expanded planning materials about ethics in the tax practice.
- Added a research problem about the timely filing of tax returns.

Chapter 18

- Revised Learning Objective 5.
- Updated statistics about estate and gift tax returns filed.
- Rearranged and revised material in text Sections 18-2a and 18-3b.
- Revised material in Concept Summary 18.3.
- Revised introductory material in text Section 18-3.
- Revised and rearranged material concerning life insurance in the gross estate.
- Updated information about estate and gift tax treaties with other countries.
- Replaced a research problem with a new data analytics problem.

Chapter 19

- Revised Learning Objectives 1, 2, 5, 8, and 9.
- Updated statistics about the net worth of U.S. households.
- Expanded the list of requirements in using a buy-sell agreement.
- Revised the discussion of the § 1014(e) rule.
- Expanded material in text Section 19-3b and added new Example 24.
- Added material on charitable gifts using donor-advised funds.
- Added a new research problem.
- Updated remaining materials as needed (including for inflation adjustments).

Chapter 20

- Revised Learning Objective 1.
- Revised title of text Section 20-1.
- Expanded statistics about Forms 1041 filed.
- Updated tax amounts in Exhibit 20.3.
- Added information about entity tax rates for net long-term capital gains.
- Augmented explanation in Example 4.
- Revised the Ethics & Equity items on pet-assistance trusts and choice of trustee.
- Revised the introductory material in text Section 20-5.
- Replaced a research problem with a new data analytics item.

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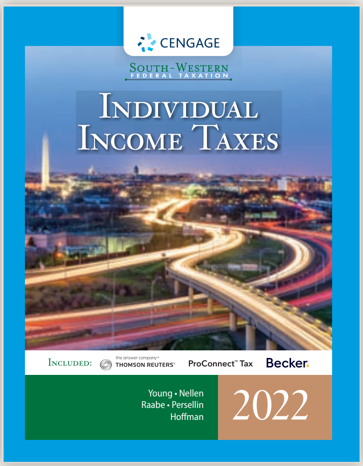

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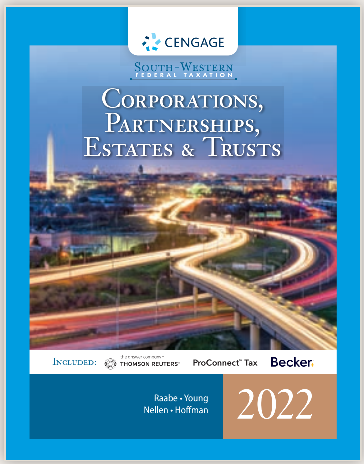

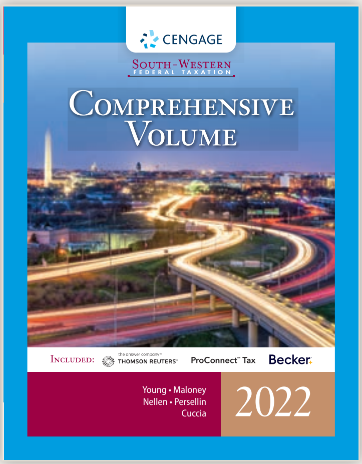

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ESSENTIALS OF TAXATION: INDIVIDUALS & BUSINESS ENTITIES, 2022 EDITION

(NELLEN, CUCCIA, PERSELLIN, YOUNG, 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.

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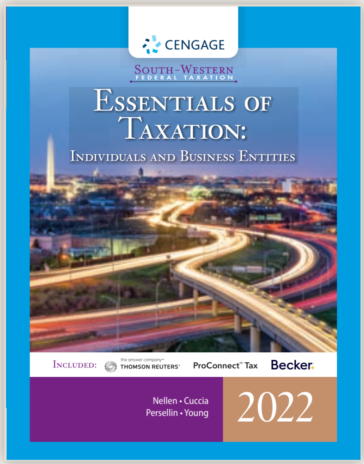

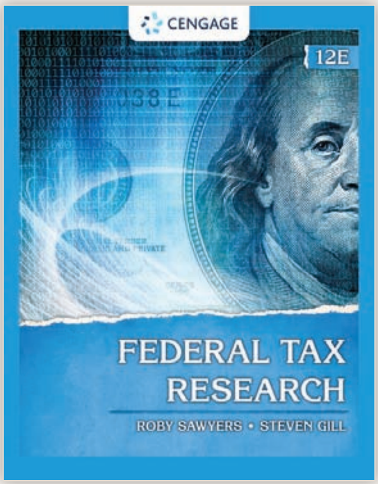

FEDERAL TAX RESEARCH, 12E

(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.

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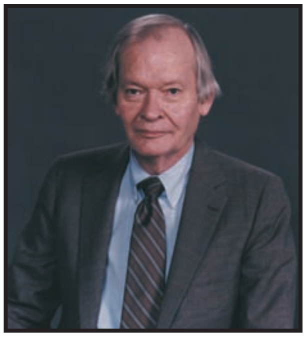

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Brief Contents

Part 1: Introduction to Taxation and Business Entities

Part 2: Corporations

Part 3: Flow-Through Entities

Part 4: Advanced Tax Practice Considerations

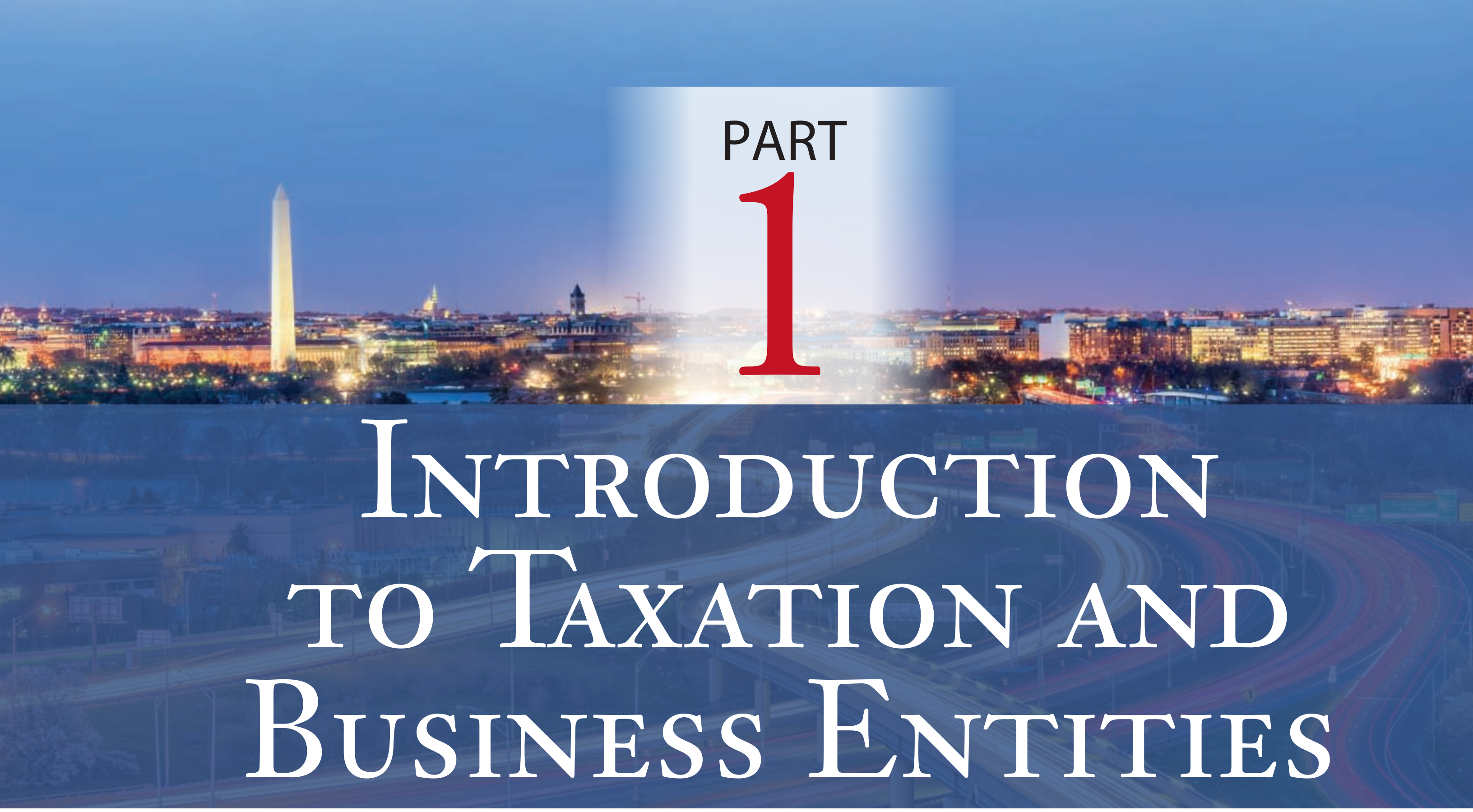
Part 5: Family Tax Planning

Contents

Part 5: Family Tax Planning

APPENDICES

Online Appendices



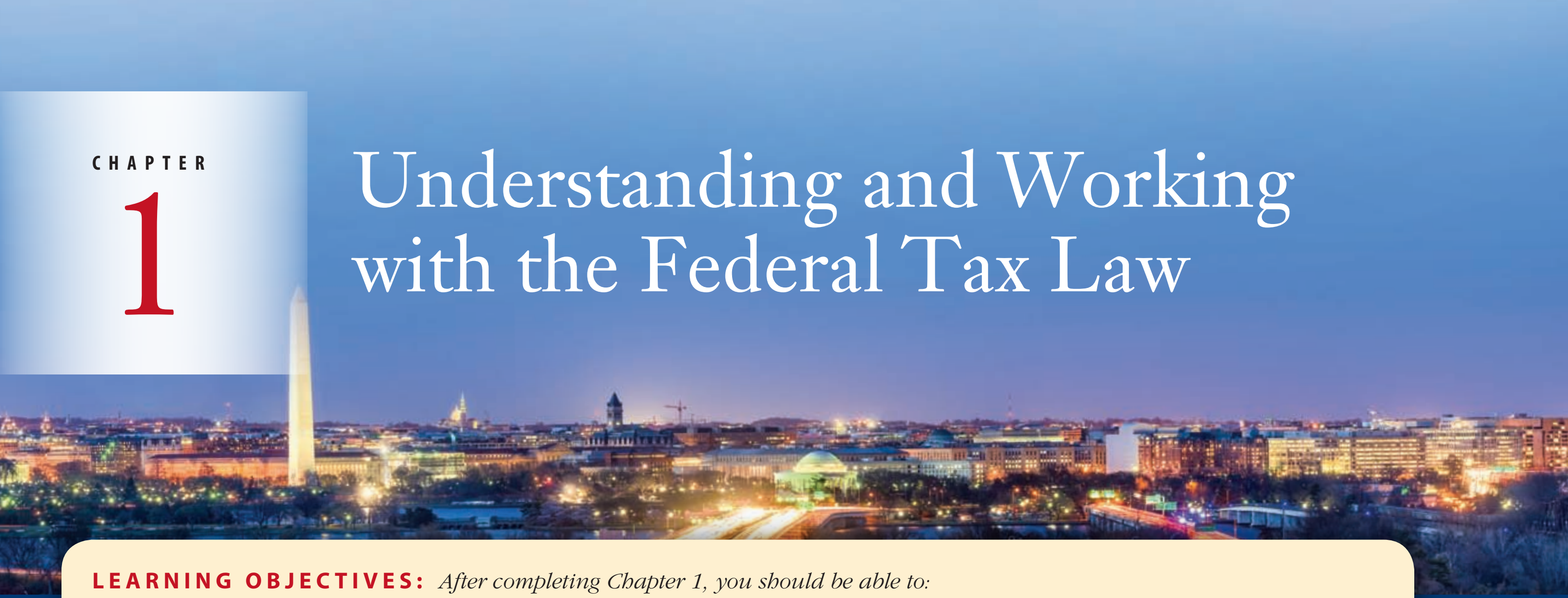
PART 1

Introduction to Taxation and Business Entities

CHAPTER 1
Understanding and Working with the Federal Tax Law

CHAPTER 2
The Deduction for Qualified Business Income for Noncorporate Taxpayers

The opening chapter of the text is devoted to the "whys and hows" of the tax law, and to the tax research process as it is used by the tax professional. Chapter 2 begins by discussing the distinctions between various taxpayer entities, including sole proprietorships, partnerships, and corporations. Then the chapter explores the deduction for qualified business income available to *noncorporate* taxpayers.



CHAPTER

1 Understanding and Working with the Federal Tax Law

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

- **LO.1** Discuss the importance of revenue needs as an objective of Federal tax law.
- **LO.2** Demonstrate the influence of economic, social, equity, and political considerations on the development of the tax law.
- **LO.3** Explain how the IRS, as the protector of the revenue, has affected tax law.
- **LO.4** Recognize the role of the courts in interpreting and shaping tax law.
- **LO.5** Identify tax law sources—statutory, administrative, and judicial.
- **LO.6** List and assess tax law sources.
- **LO.7** Demonstrate the ability to conduct tax research.
- **LO.8** Assess the validity and weight of tax law sources.
- **LO.9** Describe various tax planning procedures.
- **LO.10** Explain the role of taxation on the CPA examination.

CHAPTER OUTLINE

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THE BIG PICTURE

Importance of Tax Research

Dana Andrews advanced $93,000 to her nephew in 2014 to enable him to attend a private university. Over the next few years, the nephew repays Dana $16,000 on the loan. However, seven years later Dana comes to you to determine whether she can claim a bad debt deduction for the $77,000 the nephew has not repaid. What planning tips might you give to Dana? Were any mistakes made?

Read the chapter and formulate your response.

The Federal tax law reflects the three branches of our Federal government. It is a mixture of laws passed by Congress, explanations provided by the Treasury Department and the Internal Revenue Service (IRS), and court decisions. Anyone who has attempted to work with this vast amount of information is familiar with its complexity. Commenting on his 48-page tax return, author James Michener said, "It is unimaginable in that I graduated from one of America's better colleges, yet I am totally incapable of understanding tax returns." A person who must sift through this information to find the solution to a tax problem should recognize that there are reasons behind the law. Knowing these reasons is helpful in understanding the Federal tax law.

1-1 THE WHYS OF THE TAX LAW

The primary objective of Federal tax law is the raising of revenue. Despite the importance of the fiscal needs of the government, however, other considerations (e.g., economic, social, equity, and political factors) play a significant role. The Treasury Department, the IRS, and the courts also have significant impacts on the evolution of Federal tax law. The first part of this chapter focuses on these topics.

LO.1

Discuss the importance of revenue needs as an objective of Federal tax law.

1-1a Revenue Needs

Raising revenues to fund the cost of government operations is the primary function of a tax system. In a perfect world, taxes raised by the government would equal the expenses incurred by government operations. However, this goal has not been the case in the United States. Over the past century, the national debt has been increasing significantly, reaching more than $27.1 trillion, or about $82,000 per citizen and $218,000 per taxpayer, in November 2020. According to the U.S. National Debt Clock, the U.S. total unfunded liabilities (including Social Security, Medicare, and Federal employee and veterans benefits) could be as much as $155 trillion, or about $470,000 per citizen.

When enacting tax legislation, Congress is often guided by the concept of **revenue neutrality** so that any changes neither increase nor decrease the net revenues received by the government. With revenue neutral legislation, there are likely to be both "winners" (taxpayers who see a reduction in taxes paid) and "losers" (taxpayers who see an increase in taxes paid).

LO.2

Demonstrate the influence of economic, social, equity, and political considerations on the development of the tax law.

1-1b Economic Considerations

Using the tax system to attempt to accomplish economic objectives generally involves changing the Internal Revenue Code[1] to help control the economy in some manner or encourage certain activities and businesses.

Control of the Economy

Congress has used tax depreciation rules as one means of controlling the economy. Theoretically, shorter asset lives and accelerated methods should encourage additional investments in depreciable business property. On the other hand, longer asset lives and the use of straight-line depreciation should discourage capital outlays. Congress also uses incentives like immediate expensing (§ 179) and bonus depreciation to stimulate the economy when needed.

A change in tax rates has a more immediate impact on the economy. When tax rates are lowered, taxpayers retain money that can be used for other purposes (e.g., purchases or savings). If, however, Congress is using the concept of revenue neutrality, these rate reductions may be offset by a reduction or elimination of deductions or credits. As a result, lower rates do not always mean lower taxes.

[1]The Internal Revenue Code is a compilation of Federal tax legislation that appears in Title 26 of the U.S. Code.

Encouragement of Certain Activities

Congress uses the tax law to encourage certain types of economic activity or segments of the economy. For example, research and development expenditures can be deducted in the year incurred or, alternatively, capitalized and amortized over a period of 60 months or more.[2]

Inventions (including technological innovations) also are encouraged under tax law. Patents can qualify as capital assets, and under certain conditions, their disposition automatically carries long-term capital gain treatment.[3]

Are ecological considerations a desirable objective? This objective explains why pollution control facilities can be amortized over a 60-month period (rather than over the 39-year period required for most business buildings).

Is saving desirable for the economy? Saving leads to capital formation and thus makes funds available to finance home construction and industrial expansion. The tax law provides incentives to encourage saving by giving private retirement plans preferential treatment. Contributions to certain Individual Retirement Accounts (IRAs) and Keogh (H.R. 10 plans) are deductible, and income from these contributions accumulates on a tax-free basis.

Encouragement of Certain Industries

Historically, agricultural activities have been favored under Federal tax law. Among the benefits are the election to expense rather than capitalize certain expenditures for soil and water conservation and fertilizers and the election to defer the recognition of gain on the receipt of crop insurance proceeds.

The tax law favors the development of natural resources (like oil and gas and mineral deposits) by permitting the use of percentage depletion and a write-off (rather than a capitalization) of certain exploration costs. The railroad and banking industries also receive special tax treatment.

Encouragement of Small Business

Small business development also is encouraged under the tax law. For example, a shareholder in a small business corporation can take an ordinary deduction (rather than a capital loss) for a loss recognized on a stock investment.[4] Another provision permits the shareholders of a small business corporation to make a special election that allows the profits (or losses) of the corporation to flow through to its shareholders (avoiding the corporate income tax).[5]

1-1c Social Considerations

Some of the tax laws, especially those related to the Federal income tax of individuals, can be explained by social considerations. Here are some notable examples:

- Certain benefits provided to employees through accident and health plans financed by employers are nontaxable. It is socially desirable to encourage these plans because they provide medical benefits in the event of an employee's illness or injury. Further, insurance companies are paying for these benefits (rather than the government).
- Most premiums paid by an employer for group term insurance covering the life of the employee are nontaxable. These funds help the family unit adjust to the loss of wages caused by the employee's death.
- A deduction is allowed for contributions to qualified charities. The deduction shifts some of the financial and administrative burden of socially desirable programs from the public (the government) to the private sector.

[2] If the asset developed has no estimated useful life, no write-off would be available without the two options allowed by the tax law.

[3] A long-term capital gain has a favorable tax advantage for individuals.

[4] Known as § 1244 stock (and subject to specific annual limitations), this subject is covered in Chapter 4.

[5] Known as the S corporation election, this subject is discussed extensively in Chapter 12.

- Various tax credits, deductions, and exclusions are designed to encourage taxpayers to obtain additional education.[6] To encourage adoptions (and defray the costs of adopting a child), Congress established the adoption expenses tax credit.
- Certain expenses are deemed to be contrary to public policy and are not deductible. These expenses include fines, penalties, illegal kickbacks, and bribes to government officials.

1-1d Equity Considerations

The concept of equity (or fairness) is relative. Reasonable persons can, and often do, disagree about what is fair or unfair. Compare the tax treatment of a corporation with that of a partnership. The corporation is subject to a separate Federal income tax; the partnership is not. The tax law can and does make a distinction between these business forms.

One measure of equity is whether a tax is *progressive* (e.g., the Federal income tax on individuals) or *regressive* (e.g., gasoline excise tax). The determination is made by calculating the percentage of a taxpayer's income that is used to pay a tax.

Equity, then, is not what appears fair or unfair to any one taxpayer or group of taxpayers. It is, instead, what the tax law recognizes. The concept of equity appears in tax provisions that alleviate the effect of multiple taxation and postpone the recognition of gain when the taxpayer lacks the ability or wherewithal to pay the tax. Equity also helps mitigate the effect of the application of the annual accounting period concept and helps taxpayers cope with the eroding result of inflation.

Alleviating the Effect of Multiple Taxation

The same income earned by a taxpayer may be subject to taxes imposed by different taxing authorities. If, for example, the taxpayer is situated in New York City, income might generate Federal, New York state, and New York City income taxes. To compensate for this inequity, the Federal tax law allows a taxpayer to claim a deduction for some state and local income taxes (with an overall limit of $10,000). The deduction, however, does not eliminate the effect of multiple taxation; the benefit derived from the deduction depends on the taxpayer's Federal income tax rate.[7]

Equity considerations can explain the Federal tax treatment of income from foreign sources. Because double taxation results when the same income is subject to both foreign and U.S. income taxes, the tax law permits the taxpayer to choose either a credit or a deduction for the foreign taxes paid.

Another example is the corporate income tax, which can lead to multiple taxation of the same income.

EXAMPLE 1

During the current year, Gray Corporation has net income of $100,000, including $5,000 of dividends received from stock it owns in IBM Corporation. Assume that Gray Corporation distributes its after-tax income to its shareholders (all individuals).

The shareholder distribution will be subject to two income taxes: the corporate income tax when the income is earned by Gray Corporation and the individual income tax when it is distributed to the shareholders as a dividend.[8]

The $5,000 that Gray receives from IBM Corporation fares even worse. Because it is paid from income earned by IBM, it has been subjected to a third income tax (the corporate income tax imposed on IBM).[9]

[6] These provisions also can be justified under the category of economic considerations since a better educated workforce carries a positive economic impact.

[7] A tax credit rather than a deduction would eliminate the effects of multiple taxation on the same income.

[8] This result materializes because, under the tax law, a corporation is not allowed a deduction for the dividend distributions it makes. In addition to any income tax assessed on the dividend, a 3.8% Medicare tax also applies to certain high-income shareholders.

[9] This "triple taxation" is mitigated by a dividends received deduction, which Gray Corporation is allowed.

Congress has moved to mitigate the multiple taxation of corporate profits in several ways. For corporate shareholders, for whom triple taxation is possible, the law provides a deduction for dividends received from certain domestic corporations. The deduction, usually 50 percent of the dividends, would be allowed to Gray Corporation for the $5,000 it received from IBM Corporation (see the discussion in Chapter 3). For the individual shareholder, the law taxes qualified dividends at lower rates (from 0 percent for lower tax bracket shareholders to 20 percent for certain high-income shareholders). By allowing a lower tax rate, this approach *mitigates* (not *eliminates*) the effect of multiple taxation (see the discussion in Chapter 5).

In the area of the Federal estate tax, several provisions reflect attempts to mitigate the effect of multiple taxation. For example, a limited credit against the estate tax for foreign death taxes imposed is allowed. Other estate tax credits are available and can be explained on the same grounds.[10]

The Wherewithal to Pay Concept

The **wherewithal to pay** concept recognizes the inequity of taxing a transaction when the taxpayer lacks the means (i.e., funds) to pay the tax. This concept is typically applied to transactions where the taxpayer's economic position has not changed significantly. The following examples illustrate this concept.

Wherewithal to Pay Concept Illustrations

EXAMPLE 2

White Corporation holds unimproved land to build a new warehouse. The land has a basis to White of $60,000 and a fair market value of $100,000. The land is exchanged for a building (worth $100,000) that White will use in its business.[11]

EXAMPLE 3

White Corporation owns a warehouse that it uses in its business. At a time when the warehouse has an adjusted basis of $60,000, it is destroyed by fire. White collects the insurance proceeds of $100,000, and within two years of the end of the year in which the fire occurred, White uses all of the proceeds to purchase a new warehouse.[12]

EXAMPLE 4

Tom, a sole proprietor, decides to incorporate his business. In exchange for the business's assets (adjusted basis of $60,000 and a fair market value of $100,000), Tom receives all of the stock of Azure Corporation, a newly created corporation.[13] The Azure stock is worth $100,000.

EXAMPLE 5

Rose, Sam, and Tom want to develop unimproved land owned by Tom. The land has a basis to Tom of $60,000 and a fair market value of $100,000. The RST Partnership is formed with the following investments: land worth $100,000 transferred by Tom, $100,000 cash by Rose, and $100,000 cash by Sam. Each party receives a one-third interest in the RST Partnership.[14]

EXAMPLE 6

Amber Corporation and Crimson Corporation decide to consolidate to form Aqua Corporation.[15] Pursuant to the plan of reorganization, Tera exchanges her stock in Amber Corporation (basis of $60,000 and fair market value of $100,000) for stock in Aqua Corporation worth $100,000.

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[10]See Chapter 18.

[11]Here, White has a gain realized of $40,000 [$100,000 amount realized (new building) less $60,000 adjusted basis in old building]. But the gain is deferred (not recognized) since White does not have the *wherewithal to pay* tax (White receives no cash as part of the transaction). The nontaxability of like-kind exchanges applies to the exchange of real property held for investment or used in a trade or business for property to be similarly held or used (i.e., not held for sale).

[12]The nontaxability of gains realized from involuntary conversions applies when the proceeds received by the taxpayer are reinvested within a prescribed period of time in property similar or related in service or use to that converted. Involuntary conversions take place as a result of casualty losses, theft losses, or condemnations by a public authority.

[13]Transfers of property to controlled corporations (§ 351) are discussed in Chapter 4.

[14]The formation of a partnership is discussed in Chapter 10.

[15]Corporate reorganizations are discussed in Chapter 7.

In all of the preceding examples, White Corporation, Tom, or Tera had a realized gain of $40,000 [$100,000 (fair market value of the property received) − $60,000 (basis of the property given up)].[16] To force a taxpayer to recognize any of this gain is inequitable for two reasons. First, the taxpayer did not end the transaction with any cash in hand (i.e., the taxpayer does not have the means to pay the tax).[17] Second, in each case, the taxpayer's economic situation has not changed significantly. In Example 2, White Corporation owned land before the exchange and owns land after the exchange. In Example 4, Tom owns a business both before and after the transaction (just in a different business form).

In these examples, recognized gain is merely postponed and not necessarily avoided. Because basis carries over to the new property or interest acquired in these nontaxable transactions, the gain element is still present and might be recognized on a subsequent taxable disposition. In Example 4, suppose Tom later sells his Azure Corporation stock for $100,000. Tom's basis in the stock is $60,000 (the same basis as in the assets transferred), and the sale results in a recognized gain of $40,000. Tom now has the funds to pay the related tax.

Many of these provisions also prevent the recognition of realized losses.

The wherewithal to pay concept, however, is not followed in every situation. The concept is only applied when the tax law specifically allows it.

EXAMPLE 7

Alicia exchanges stock in Green Corporation (basis of $60,000 and fair market value of $100,000) for stock in Purple Corporation (fair market value of $100,000). If the exchange is not pursuant to a reorganization, Alicia's realized gain of $40,000 is recognized for Federal income tax purposes.[18]

The result reached in Example 7 seems harsh in that the exchange does not place Alicia in a position to pay the tax on the $40,000 gain. Why does the tax law apply the wherewithal to pay concept to the exchange of stock pursuant to a corporate reorganization (Example 6) but not to certain other stock exchanges (Example 7)?

The wherewithal to pay concept is typically applied to situations in which the taxpayer's economic position has not changed significantly. In Example 6, Tera's stock investment in Amber Corporation really continues in the form of the Aqua Corporation stock because Aqua was formed through a consolidation of Amber and Crimson Corporations.[19] In Example 7, however, the investment has not continued. Here, Alicia's ownership in Green Corporation has ceased, and an investment in an entirely different corporation has been substituted.

Mitigating the Effect of the Annual Accounting Period Concept

All taxpayers must report their taxable income to the Federal government at regular intervals. The annual accounting period for the reporting of taxable income (and the settlement of any tax liability) is one year. Referred to as the annual accounting period concept, the effect is to divide each taxpayer's life into equal annual intervals for tax purposes.

[16] Realized gain can be likened to economic gain. However, the Federal income tax is imposed only on that portion of realized gain considered to be recognized under the law. Generally, recognized (or taxable) gain can never exceed realized gain.

[17] If the taxpayer ends up with other property (boot) as part of the transfer, gain may be recognized to this extent. The presence of boot, however, helps solve the wherewithal to pay problem because it provides property (other than the property or interest central to the transaction) with which to pay the tax.

[18] The exchange of stock does not qualify for nontaxable treatment as a like-kind exchange (refer to Example 2).

[19] This is known as the "continuity of interest" concept, which forms the foundation for all nontaxable corporate reorganizations. The concept is discussed at length in Chapter 7.

This annual accounting period concept sometimes leads to different tax treatment for taxpayers who are in the same economic position. Consider the following example.

EXAMPLE 8

Rena and Samuel are both sole proprietors and report the following results during the past three years:

	Profit (or Loss)	
Year	**Rena**	**Samuel**
2019	$50,000	$150,000
2020	60,000	60,000
2021	60,000	(40,000)

Although Rena and Samuel have the same total profit of $170,000 over the three-year period, the annual accounting period concept places Samuel at a definite disadvantage for tax purposes. The net operating loss deduction offers Samuel some relief by allowing him to carry forward (but not back) some or all of his 2021 loss to any profitable years in the future. With a net operating loss carryforward, Samuel may obtain a reduction in future taxes.

The reasoning used to support the net operating loss deduction helps explain the special treatment that excess capital losses and excess charitable contributions receive. Carryback and carryover procedures help mitigate the effect of limiting a loss or a deduction to the accounting period in which it is realized. Using these procedures, a taxpayer can salvage a loss or a deduction that might otherwise be wasted.

Example 9 illustrates how the installment method of recognizing gain on the sale of property allows a taxpayer to spread tax consequences over the payout period.[20] The installment method is supported by the wherewithal to pay concept; recognition of gain corresponds to the collection of cash received from the sale of the property. Tax consequences match the seller's ability to pay the tax.

EXAMPLE 9

In 2019, Tim sold unimproved real estate (cost of $40,000) for $100,000. Under the terms of the sale, Tim receives two notes from the purchaser, each for $50,000 (plus interest). One note is payable in 2020; the other, in 2021.

Without the installment method Tim would have to recognize and pay a tax on the gain of $60,000 for the year of the sale (2019). This result is harsh because none of the sale proceeds will be received until 2020 and 2021.

Using the installment method and presuming the notes are paid when each comes due, Tim recognizes half of the gain ($30,000) in 2020 and the remaining half in 2021.

The annual accounting period concept has been modified to apply to situations where taxpayers may have difficulty accurately assessing their tax positions by year-end. Here, the law permits taxpayers to treat transactions taking place in the next year as having occurred in the prior year.

EXAMPLE 10

Monica, a calendar year taxpayer, is a participant in an H.R. 10 (Keogh) retirement plan (see Appendix C for a definition of a Keogh plan). Under the plan, Monica contributes 20% of her net self-employment income, and this amount is deductible for Federal income tax purposes. On April 9, 2021, Monica

continued

[20]Under the installment method, each payment received by the seller represents a return of basis (the nontaxable portion) and profit from the sale (the taxable portion).

determines that her net self-employment income for calendar year 2020 was $80,000. Consequently, she contributes $16,000 (20% × $80,000) to the plan.

Even though the $16,000 contribution is made in 2021, the law permits Monica to claim this contribution as a deduction in the 2020 tax year. Requiring Monica to make the contribution by December 31, 2020, to obtain the deduction for that year would force her to arrive at an accurate determination of net self-employment income before her income tax return must be prepared and filed.

Similar exceptions to the annual accounting period concept cover certain charitable contributions by accrual basis corporations (Chapter 3) and the dividend distributions by S corporations (Chapter 12).

Coping with Inflation

During periods of inflation, *bracket creep* can plague a working person. Because of the progressive nature of the Federal individual income tax, a wage adjustment that merely compensates for inflation could place the employee in a higher income tax bracket, and this erodes the taxpayer's purchasing power. Congress recognized this problem and began to adjust various income tax components through an **indexation** procedure. Indexation, which began in 1985, is based on the rise in the consumer price index over the prior year.

1-1e Political Considerations

A large segment of the Federal tax law is made up of statutory provisions. Because these statutes are enacted by Congress, political considerations often influence tax law. The effect of politics on the tax law includes special interest legislation, political expediency, and state and local influences.

Special Interest Legislation

Certain provisions of the tax law can be explained largely by the political influence some groups have had on Congress. For example, prepaid subscription and dues income is not taxed until earned, but prepaid rents are taxed to the landlord in the year received. The subscription and dues exception was created because certain organizations (e.g., the American Automobile Association) convinced Congress that special tax treatment was needed to cover income received from multiyear dues and subscriptions. Another provision, sponsored by a senator from Georgia, suspended the import duties on ceiling fans. The nation's largest seller of ceiling fans is Atlanta-based Home Depot.

Although some special interest legislation can be justified on economic or social grounds, other special interest legislation cannot. This type of legislation is, however, an inevitable product of our political system.

Political Expediency

Various tax changes can be tied to the shifting moods of the American public. That Congress is sensitive to popular feeling is an accepted fact. As a result, certain provisions of the tax law can be explained by the political climate at the time they were enacted. Measures that deter more affluent taxpayers from obtaining so-called preferential tax treatment have always had popular appeal and, consequently, the support of Congress. Tax provisions like the imputed interest rules, the limitation on the deductibility of interest on investment indebtedness, the alternative minimum tax, and gift and estate taxes can be explained on this basis.

State and Local Government Influences

Political considerations played a major role in providing an exclusion from gross income for interest received on state and local obligations. Somewhat less apparent has been the influence state law has had in shaping our present Federal tax law. Of major importance has been the effect of the community property system used by some states.[21] At one time, the tax position of the residents of these states was so advantageous that a number of common law states planned to adopt the community property system.[22] The political pressure placed on Congress to correct the disparity in tax treatment was considerable. To a large extent, this disparity was eliminated by the Revenue Act of 1948, which extended many of the community property tax advantages to residents of common law jurisdictions.[23] The impact of community property law on the Federal estate and gift taxes is discussed in Chapters 18 and 19.

1-1f Influence of the Internal Revenue Service

LO.3

Explain how the IRS, as the protector of the revenue, has affected tax law.

The IRS has exerted its influence on many areas of the tax law. As the protector of the national revenue, the IRS has been instrumental in securing the passage of legislation designed to curtail aggressive tax avoidance practices (i.e., closing tax loopholes). In addition, the IRS has sought and obtained law changes to make its job easier (administrative feasibility).

The IRS as Protector of the Revenue

There are many provisions in the tax law that have resulted from the direct efforts of the IRS to prevent taxpayers from exploiting a tax loophole. Working within the letter of existing laws, ingenious taxpayers and their advisers devise techniques that accomplish indirectly what cannot be accomplished directly. As a result, Congress passes laws to close the loopholes that taxpayers locate and exploit. Here are some examples (and where they are discussed in the text):

- The use of a fiscal year by personal service corporations, partnerships, S corporations, and trusts to defer income recognition to the owners (see Chapters 3, 10, 12, and 20).
- The use of the cash basis method of accounting by certain large corporations (see Chapter 3).
- The deduction of passive investment losses and expenses against other income (see Chapters 3 and 10).
- The shifting of income to lower-bracket taxpayers through the use of reversionary trusts (see Chapter 20).

In addition, Congress has passed laws that enable the IRS to make adjustments based on the substance of a transaction (rather than the form used by the taxpayer). One provision, for example, authorizes the IRS to establish guidelines on “thinly capitalized” corporations. Here, the question is whether corporate debt is recognized as debt for tax purposes or reclassified as equity (see the discussion in Chapter 4). Another provision allows the IRS to make adjustments to a taxpayer’s method of accounting when the method used by the taxpayer does not clearly reflect income. The IRS also has the authority to allocate income and deductions among taxpayers (or businesses owned or

[21]The states with community property systems are Louisiana, Texas, New Mexico, Arizona, California, Washington, Idaho, Nevada, Wisconsin, and (if elected by the spouses) Alaska. The rest of the states are classified as common law jurisdictions. The difference between common law and community property systems centers around the property rights possessed by married persons. In a common law system, each spouse owns whatever they earn. Under a community property system, one-half of the earnings of each spouse is considered owned by the other spouse. For example, assume that Harold and Ruth are married and that their only income is the $80,000 annual salary Harold receives. If they live in Oklahoma (a common law state), the $80,000 salary belongs to Harold. If, however, they live in Texas (a community property state), the $80,000 salary is divided equally, in terms of ownership, between Harold and Ruth.

[22]Such states included Michigan, Oklahoma, and Pennsylvania.

[23]The major advantage extended was the provision allowing married taxpayers to file joint returns and compute the tax liability as if each spouse had earned one-half of the income. This result is automatic in a community property state because half of the income earned by one spouse belongs to the other spouse. The income-splitting benefits of a joint return are now incorporated as part of the tax rates applicable to married taxpayers.

controlled by the same interests) when the allocation is necessary to prevent the evasion of taxes or to correctly reflect the income of each taxpayer.

EXAMPLE 11

Gold Corporation is owned entirely by Justin Gold (a single taxpayer), and both use the calendar year for tax purposes. For the current tax year, Gold Corporation has taxable income of $335,000; Justin has taxable income of $175,000. Not included in Justin's taxable income, however, is $10,000 of rent income usually charged Gold Corporation for the use of some property owned by Justin.

Because the *related parties* have not clearly reflected their taxable income, the IRS can allocate $10,000 of rent income to Justin. After the allocation, Gold Corporation has taxable income of $325,000 and Justin has taxable income of $185,000.[24]

The IRS also has the authority to prevent taxpayers from acquiring corporations to obtain a tax advantage when the principal purpose of the acquisition is the evasion or avoidance of the Federal income tax (this rule is discussed briefly in Chapter 7).

Administrative Feasibility

Some tax laws are created in order to simplify the task of the IRS in collecting the revenue and administering the law. As to collecting revenue, the IRS long ago realized the importance of placing taxpayers on a pay-as-you-go basis. Withholding procedures apply to wages, while the tax on other types of income may have to be paid via quarterly estimated tax payments. The IRS has been instrumental in convincing the courts that accrual basis taxpayers should pay taxes on prepaid income in the year received and not when earned. This approach may be contrary to generally accepted accounting principles, but prepayment is consistent with the wherewithal to pay concept.

To help the IRS collect revenues when due, Congress has passed many provisions that impose interest and penalties on taxpayers if they don't comply with the tax law. These provisions include penalties for failure to pay a tax or to file a return that is due and the negligence penalty for intentional disregard of rules and regulations. Various penalties for civil and criminal fraud are intended to encourage taxpayers to comply with tax laws. This aspect of the tax law is discussed in Chapter 17.

The IRS audit process is essential to an effective administration of our tax system. To carry out this function, the IRS is aided by provisions that reduce the chance of taxpayer error or manipulation, thus simplifying the audit effort. For example, by increasing the individual standard deduction amount, the audit function is simplified because there are fewer returns with itemized deductions needing to be checked.[25] The $15,000 annual gift tax exclusion has the same objective (see Chapter 18). This provision decreases the number of gift tax returns that must be filed (and also reduces the taxes paid), making the job of the IRS easier.[26]

The Big Picture

EXAMPLE 12

Return to the facts of *The Big Picture* on p. 1–1. The advance of $93,000 to her nephew might be considered a taxable gift. If so, Dana would have been allowed a $14,000 gift tax exclusion in 2014. Further, if Dana were married, she and her spouse would have been allowed a $28,000 gift tax exclusion (this is called "gift splitting"). Finally, Dana also could use her lifetime exemption to eliminate any gift tax, depending on her previous gift history (see Chapter 18).

[24] § 482. By shifting $10,000 of income to Justin (who is in the 32% bracket), the IRS gains $3,200 in taxes. Allowing the $10,000 deduction to Gold Corporation (which is in the 21% bracket) costs the IRS only $2,100. See Chapter 3 for further discussion of corporate taxable income and taxes.

[25] The IRS gave the same administrative justification when it proposed to Congress the $100 per event limitation on personal casualty and theft losses. Imposition of the limitation eliminated many casualty and theft loss deductions and, as a consequence, saved the IRS considerable audit time. Also, an additional limitation equal to 10% of adjusted gross income applies to the total of nonbusiness losses after reduction by the floor of $100 for each loss.

[26] Particularly in the case of nominal gifts among family members, taxpayer compliance in reporting and paying a tax on such transfers would be questionable. The absence of the $15,000 gift tax exclusion would create a serious enforcement problem for the IRS.

1-1g Influence of the Courts

LO.4

Recognize the role of the courts in interpreting and shaping tax law.

In addition to interpreting statutory provisions and the administrative pronouncements issued by the Treasury Department and the IRS, the Federal courts have influenced tax law in two other ways.[27] First, the courts have developed a number of judicial concepts that help guide how tax provisions are applied. Second, certain key decisions have led to changes in the Internal Revenue Code.

Judicial Concepts Relating to Tax Law

Although ranking the tax concepts developed by the courts in order of importance is difficult, the concept of **substance over form** is certainly near the top of any list. Variously described as the "telescoping" or "collapsing" process or the "step transaction approach," it involves determining the true substance of what happened. In a transaction involving many steps, any one step may be collapsed (or disregarded) as part of determining the substance of the event.

EXAMPLE 13

In 2021, Mrs. Greer, a widow, wants to give $30,000 to Jean without incurring any gift tax liability.[28] She knows that the law permits her to give up to $15,000 each year per person without any tax consequences (the annual exclusion). With this limitation in mind, the following steps are taken: a gift by Mrs. Greer to Jean of $15,000 (nontaxable because of the $15,000 annual exclusion), a gift by Mrs. Greer to Ben of $15,000 (also nontaxable), and a gift by Ben to Jean of $15,000 (nontaxable because of Ben's annual exclusion). Considering only the form of what Mrs. Greer and Ben have done, all appears well from a tax standpoint. In substance, however, what has happened?

By collapsing the steps involving Ben, Mrs. Greer has made a gift of $30,000 to Jean and, therefore, has not avoided the Federal gift tax.

The substance over form concept plays an important role in transactions involving corporations.

Another tax concept developed by the courts deals with the interpretation of statutory tax provisions that operate to benefit taxpayers. The courts have decided that these relief provisions are to be applied narrowly. If a taxpayer wants a relief provision to apply, the taxpayer has the responsibility to meet the provision's requirements (i.e., no exceptions).

The **arm's length** concept is important in the area of corporate-shareholder dealings (see the discussion of constructive dividends in Chapter 5) and in the resolution of valuation problems for estate and gift tax purposes (see Chapters 18 and 19). Particularly in dealings between related parties, transactions can be tested by asking the question: Would unrelated parties have handled the transaction in the same way?

EXAMPLE 14

The sole shareholder of a corporation, Arturo, leases property to the corporation for a monthly rental of $50,000. To test whether the corporation should be allowed a rent deduction for this amount, the IRS and the courts will apply the arm's length concept. Would the corporation have paid $50,000 a month in rent if the same property had been leased from an unrelated party (rather than from the sole shareholder)?

Although the **continuity of interest** concept originated with the courts, it has, in many situations, been incorporated into the Internal Revenue Code. If property is transferred and the taxpayer retains an interest in the property in some form ("continuity of interest"), then the taxpayer should not be subject to tax, since the taxpayer's position has not changed. A like-kind exchange (land for land) is an example of a transaction where this concept applies. This concept also applies to transfers to controlled corporations

[27] A great deal of case law is devoted to ascertaining congressional intent. The courts, in effect, ask: What did Congress have in mind when it enacted a particular tax provision?

[28] The example assumes that Mrs. Greer has exhausted her unified tax credit. See Chapter 18.