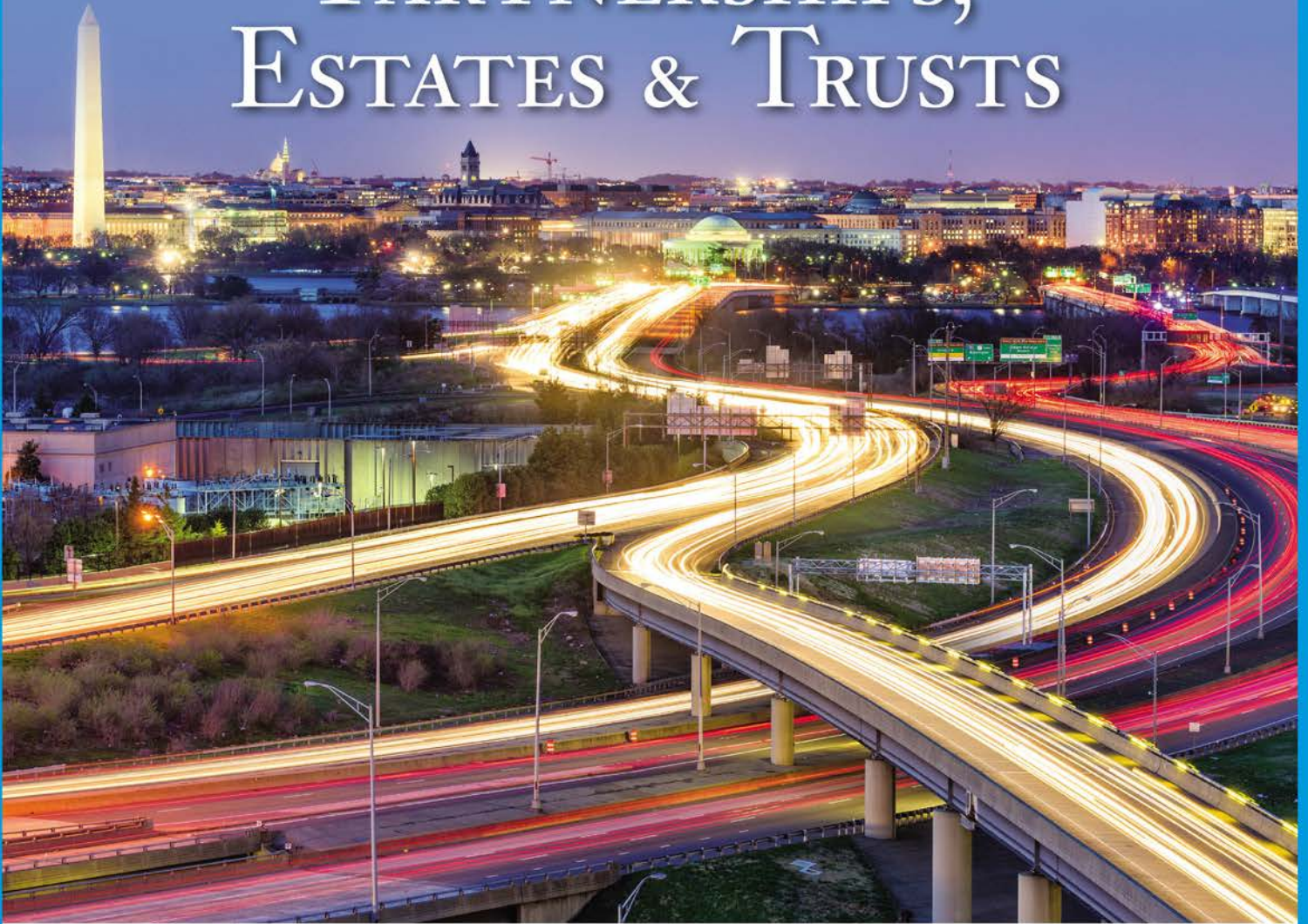




CENGAGE

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

<b>Income</b> (from whatever source) .....	\$ xxx,xxx
Less: Exclusions from gross income. ....	— xx,xxx
<b>Gross Income</b> .....	\$ xxx,xxx
Less: Deductions .....	— xx,xxx
<b>Taxable Income</b> .....	\$ xxx,xxx
Applicable tax rates .....	× xx%
<b>Gross Tax</b> .....	\$ xx,xxx
Less: Tax credits and prepayments .....	— x,xxx
<b>Tax Due</b> (or refund) .....	<u>\$ xx,xxx</u>

## 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.

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

## A legacy of learning for a lifetime of success

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

## Personalized learning

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

**1 million +**  
candidates have  
prepared with Becker

**90% +**  
of Watt Sells award  
winners (2005-2019)  
have prepared  
with Becker

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

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

**GET STARTED AT [BECKER.COM](https://www.becker.com)**

**Becker**+

Copyright 2022 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-322

Copyright 2022 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.



## Make a better grade with CNowv2

Here's how to make every study moment count

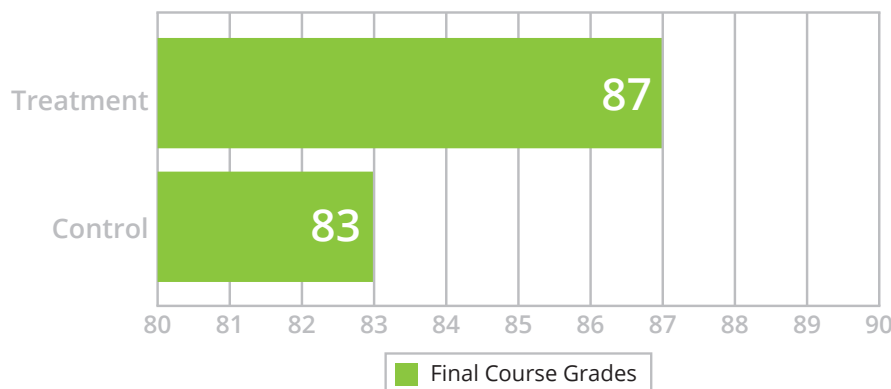
**Multi-media study-tools** such as videos, games, flashcards, crossword puzzles and more allow you to review and check your understanding of key concepts to help you prepare for quizzes and exams.

**The MindTap Reader** is fully optimized for the iPad, provides note-taking and highlighting capabilities and features an online text-to-speech application that vocalizes the content—offering a fun reading experience.

**Flashcards**—use the *MindTap Reader's* pre-made flashcards or make your own. Then print the cards and get to work.

### CNowv2 Users Achieve Higher Grades

(Student Grades, Scale = 0-100; N=246)



Ask your instructor about CNowv2 for this course.  
[cengage.com/cnowv2](https://cengage.com/cnowv2)



"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



# SOUTH-WESTERN FEDERAL TAXATION

# CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS

# 2022

## General Editors

**William A. Raabe**  
Ph.D., CPA

**James C. Young**  
Ph.D., CPA

**Annette Nellen**  
J.D., CPA, CGMA

**William H. Hoffman, Jr.**  
J.D., Ph.D., CPA

## Contributing Authors

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

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

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

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

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

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

**Sharon S. Lassar**  
Ph.D., CPA  
University of Denver

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

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

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

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

**Toby Stock**  
Ph.D., CPA  
Ohio University

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

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



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

Copyright 2022 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. WCN 02-200-322

Copyright 2022 Cengage Learning. All Rights Reserved. May not be copied, scanned, or duplicated, in whole or in part. Due to electronic rights, some third party content may be suppressed from the eBook and/or eChapter(s). Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. Cengage Learning reserves the right to remove additional content at any time if subsequent rights restrictions require it.

This is an electronic version of the print textbook. Due to electronic rights restrictions, some third party content may be suppressed. Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. The publisher reserves the right to remove content from this title at any time if subsequent rights restrictions require it. For valuable information on pricing, previous editions, changes to current editions, and alternate formats, please visit [www.cengage.com/highered](http://www.cengage.com/highered) to search by ISBN#, author, title, or keyword for materials in your areas of interest.

Important Notice: Media content referenced within the product description or the product text may not be available in the eBook version.

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

**William A. Raabe, James C. Young,  
Annette Nellen, William H. Hoffman, Jr.**

SVP, Higher Education & Skills Product: Erin Joyner

VP, Higher Education & Skills Product: Mike  
Schenk

Product Director: Jason Fremder

Assoc. Product Manager: Jonathan Gross

Learning Designer: Emily S. Lehmann

Sr. Content Manager: Nadia Saloom

Sr. Digital Delivery Lead: Tim Richison

IP Analyst: Ashley Maynard

IP Project Manager: Kumaresan  
Chandrakumar, Integra

Marketing Manager: Chris Walz

Marketing Coordinator: Sean D. Messer

Production Service: SPi Global

Designer: Chris A. Doughman

Text Designer: Red Hangar Design

Cover Designer: Bethany Bourgeois

Cover Image: iStock.com/Sean Pavone

Design Images:

Concept Summary:

iStock.com/enot poloskun

Global Tax Issues: enot-poloskun/

E+/Getty Images

Ethics & Equity: iStock.com/LdF

Comprehensive Tax Return Problems:

iStock.com/peepo

Financial Disclosure Insights: Vyaseleva

Elena/Shutterstock.com

Framework 1040: Concept Photo/

Shutterstock.com

© 2022, 2021 Cengage Learning, Inc.

Unless otherwise noted, all content is © Cengage.

ALL RIGHTS RESERVED. No part of this work covered by the copyright herein may be reproduced or distributed in any form or by any means, except as permitted by U.S. copyright law, without the prior written permission of the copyright owner.

For product information and technology assistance, contact us at  
**Cengage Customer & Sales Support, 1-800-354-9706 or  
support.cengage.com.**

For permission to use material from this text or product,  
submit all requests online at **www.cengage.com/permissions.**

All tax forms within the text are: Source: Internal Revenue Service

Tax software: Source: Intuit ProConnect Tax

Becker CPA Review: Source: Becker CPA

Excel screenshots: Source: Used with permissions from Microsoft

Intuit ProConnect Tax, Becker, Microsoft and Checkpoint and all Intuit ProConnect Tax, Becker, Microsoft and Checkpoint-based trademarks and logos are registered trademarks of Intuit ProConnect Tax, Becker, Microsoft and Checkpoint in the United States and other countries.

ISSN: 0270-5265

2022 Annual Edition

Student Edition with Intuit ProConnect Tax + RIA Checkpoint

ISBN: 978-0-357-51924-0

Loose Leaf Edition with Intuit ProConnect Tax + RIA Checkpoint

ISBN: 978-0-357-51926-4

**Cengage**

200 Pier 4 Boulevard

Boston, MA 02210

USA

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

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

Printed in the United States of America  
Print Number: 01      Print Year: 2021



# ProConnect™ Tax

intuit®  
Accountants

## Work like a pro.

Get the #1 cloud-based professional tax software for free.<sup>1, 2</sup>

Go beyond the basics and connect with the modern tools you need to work efficiently.

- **Work with confidence.**

Get returns done right the first time with access to all the forms you need, backed by industry-leading calculations and diagnostics.

- **Work smarter.**

Save time with logical data-entry worksheets instead of traditional forms-based methods. Plus, get quick training resources so it's easy to stay up to speed.

- **Work from anywhere.**

It's all online, so there's nothing to install or maintain. And whether you're on your mobile phone or laptop, PC or Mac – you're always good to go.

Visit [TaxEducation.Intuit.com](https://TaxEducation.Intuit.com) to get started.

*Only one sign-up per student. No special code required. If you have trouble accessing or using the software, reach out to us at [taxeducation\\_support@intuit.com](mailto:taxeducation_support@intuit.com) anytime for help.*

<sup>1</sup> Based on Intuit internal data of the number of paid users of ProConnect Tax for Tax Year 2019 compared to publicly available statements from competitors for the same time period.

<sup>2</sup> If you sign-up for the free version of ProConnect Tax for students and educators, you will not have access to certain features, including functionality such as Electronic Filing Services and Intuit Link.

THOMSON REUTERS

# CHECKPOINT

## 3 Simple Ways Checkpoint Helps You Make Sense of All Those Taxes

- 1 Find what you are looking for quickly and easily online with Checkpoint®
- 2 A comprehensive collection of primary tax law, cases and rulings, along with analytical insight you simply can't find anywhere else
- 3 Checkpoint has built-in productivity tools to make research more efficient — a resource more tax pros use than any other

### Titles that include Checkpoint Student Edition:

- Young/Nellen/Raabe/Persellin/Hoffman, *South-Western Federal Taxation: Individual Income Taxes, 2022 Edition*
- 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*
- Nellen/Cuccia/Persellin/Young, *South-Western Federal Taxation: Essentials of Taxation: Individuals and Business Entities, 2022 Edition*
- Murphy/Higgins/Skalberg, *Concepts in Federal Taxation, 2022 Edition*

### Important Information

The purchase of this textbook includes access to Checkpoint Student Edition for a 6-month duration.

To log in, visit **checkpoint.tr.com**, and you will be asked to supply a User ID and Password.

**Instructors:** Please contact your Cengage Account Executive to obtain access for your class.

**Students:** Please work with your instructors to gain access.



**CPA Practice Advisor Rated 5 out of 5 stars**  
**16 consecutive years: 2004-2020**

For technical support, please visit **cengage.com/support**

ISBN-13: 978-0-357-51111-4 • ISBN-10: 0-357-51111-5





# Preface

## COMMITTED TO EDUCATIONAL SUCCESS

**S**outh-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.

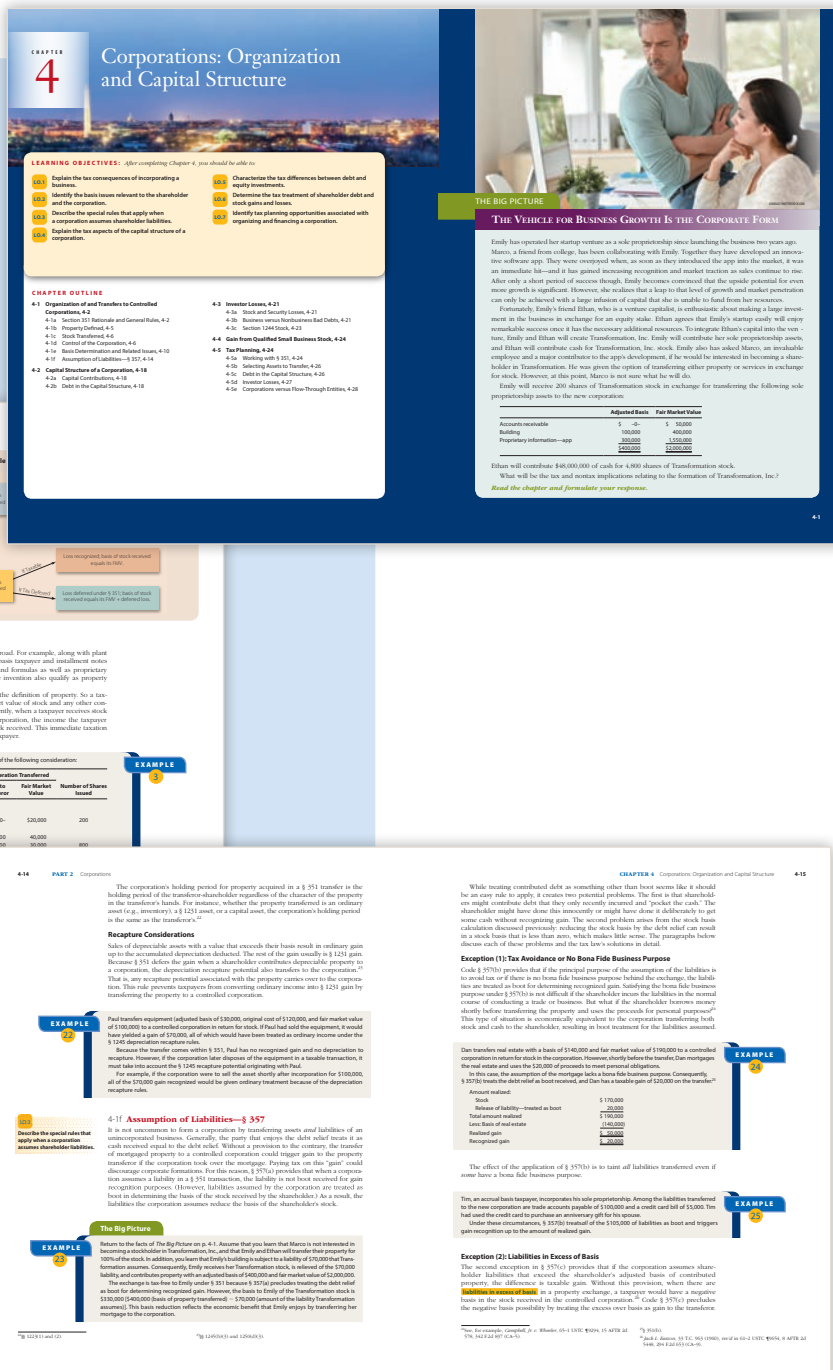
### In revising the 2022 Edition, we focused on:

- **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.





**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

#### 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.

#### Highest Authority

- Financial Accounting Standards and Interpretations of the FASB.
- Pronouncements of bodies that preceded the FASB, such as the Accounting Principles Board (APB).

- FASB Technical Bulletins.
- Audit and Accounting Guides, prepared by the American Institute of CPAs (AICPA) and cleared by the FASB.
- Practice Bulletins, prepared by the AICPA and cleared by the FASB.

- Interpretation Guides of the FASB Staff.
- Accounting Interpretations of the AICPA.
- IASB Accounting Standards.
- FASB Concepts Standards.
- Widely accepted accounting practices, professional journals, accounting textbooks, and treatises.



## 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.

**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.

## 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.<sup>60</sup>
- Realize *deduction* items as *U.S.-source*, to minimize any reduction in net foreign-source income (the numerator of the FTC fraction).



## 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.

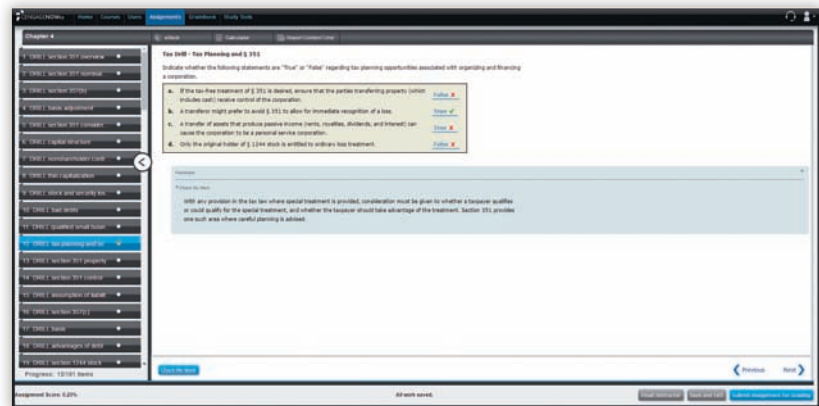


- ☐ **MOTIVATION:** engage students and better prepare them for class
- ☐ **APPLICATION:** help students learn problem-solving behavior and skills to guide them to complete taxation problems on their own
- ☐ **MASTERY:** help students make the leap from memorizing concepts to actual critical thinking

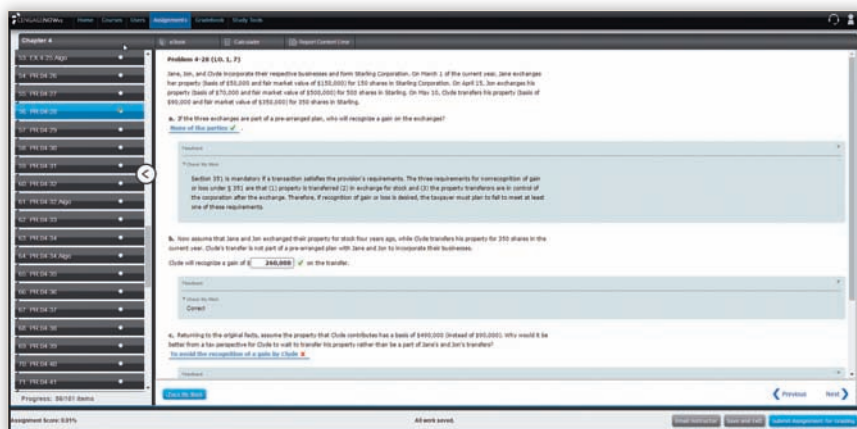
## Motivation —

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.

**CengageNOWv2 Instant Access Code ISBN:**  
978-0-357-51929-5

Contact your Cengage Learning Consultant about different bundle options.

The screenshot shows the top portion of the Form 1065, U.S. Return of Partnership Income, for the year 2020. The form is titled "Form 1065 U.S. Return of Partnership Income" and includes the Department of the Treasury Internal Revenue Service logo. The form is for the calendar year 2020, or tax year beginning 2020, ending 2020. The form is for ROCK the Ages LLC, a partnership. The form includes fields for the principal business activity (Musician Agents), principal product or service (Agent Services), business code number (711410), and employer identification number (55-5555556). The form also includes a section for the partner's identifying number (ROCK the Ages LLC) and a section for the partner's share of the partnership's income.

The screenshot shows the bottom portion of the Form 1065, U.S. Return of Partnership Income, for the year 2020. The form includes a section for the partner's identifying number (ROCK the Ages LLC) and a section for the partner's share of the partnership's income. The form also includes a section for the partner's share of the partnership's income, which is divided into three columns: (1) Initial return, (2) Final return, and (3) Name change. The form also includes a section for the partner's share of the partnership's income, which is divided into three columns: (4) Address change, (5) Amended return, and (6) Other (specify).



## EXTENSIVELY REVISED. DEFINITELY 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](http://www.cengage.com/login))
- The Depreciation and the Accelerated Cost Recovery System (ACRS) appendix. (Instructor Companion Website at [www.cengage.com/login](http://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 Residency”).
- 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.

## TAX LAW OUTLOOK

### *From your SWFT Series Editors*

Legislation related to the COVID-19 pandemic was a vehicle for tax changes in 2020. And, a variety of tax changes were incorporated into the American Rescue Plan Act of 2021 (enacted in March 2021). The Biden administration and 117th Congress began to discuss a wide variety of tax law changes, including changes to the Tax Cuts and Jobs Act of 2017 (TCJA). Still others are expected in the Biden administration's Build Back Better plan (with legislation likely to be discussed and possibly enacted before the end of the 117th Congress).

Taxpayers and their advisers will need to evaluate how these changes will affect their short- and long-term planning (adjusting those plans appropriately). The SWFT editors will be monitoring these activities and provide updates to adopters as needed.

## SUPPLEMENTS SUPPORT STUDENTS AND INSTRUCTORS

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

### Online and Digital Resources for Students



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

#### CengageNOWv2 Instant Access Code ISBN:

978-0-357-51929-5

Contact your Cengage Learning Consultant about different bundle options.



#### Thomson Reuters Checkpoint™

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

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

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

### ProConnect™ Tax

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

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

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

### www.cengage.com

Students can use

**www.cengage**

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

### Online Student Resources

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

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



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

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

**www.cengage.com/unlimited**

### Printed Resources for Students

#### Looseleaf Edition (978-0-357-51926-4)

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

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

## Comprehensive Supplements Support Instructors' Needs



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

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

### Solutions Manual

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

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

### PowerPoint® Lectures with Notes

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

### Test Bank

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

Each test item is tagged with its Estimated Time to Complete, Level of Difficulty, and Learning Objective(s), as well as the AACSB's and AICPA's core competencies—for easier instructor planning and test item selection. The 2022 Test Bank is available in Cengage's test generator software, Cognero.

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

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

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

### Other Instructor Resources

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

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

### Custom Solutions

Cengage Learning Custom Solutions develops personalized solutions to meet your taxation education needs. Consider the following for your adoption of *South-Western Federal Taxation 2022 Edition*.

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



## ACKNOWLEDGMENTS

We want to thank all the adopters and others who participated in numerous online surveys as well as the following individuals who provided content reviews and feedback in the development of the ***South-Western Federal Taxation*** 2022 titles.

### William A. Raabe / James C. Young / Annette Nellen / William H. Hoffman, Jr.

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

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

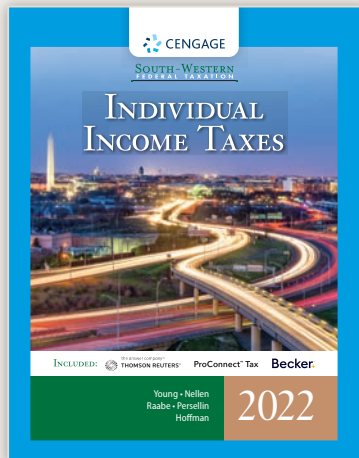
## SPECIAL THANKS

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

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

# The South-Western Federal Taxation Series

To find out more about these books, go to [www.cengage.com](http://www.cengage.com).



## INDIVIDUAL INCOME TAXES, 2022 EDITION

**(YOUNG, NELLEN, RAABE, PERSELLIN, HOFFMAN, Editors)**

provides accessible, comprehensive, and authoritative coverage of the relevant tax code and regulations as they pertain to the individual taxpayer, as well as coverage of all major developments in Federal taxation.

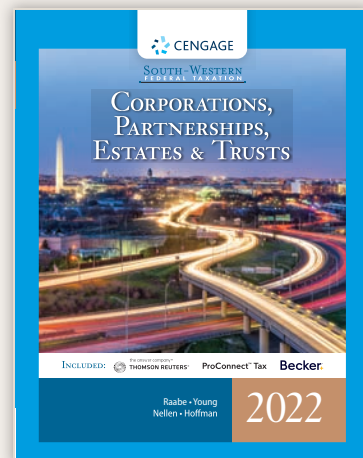
**(ISBN 978-0-357-51907-3)**

## CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS, 2022 EDITION

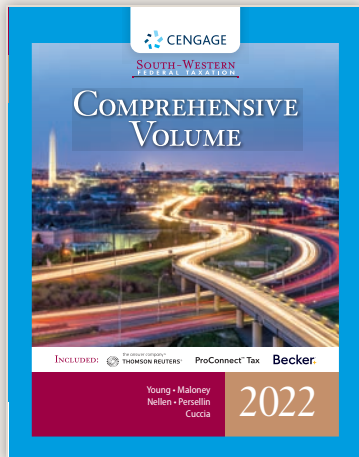
**(RAABE, YOUNG, NELLEN, HOFFMAN, Editors)**

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

**(ISBN 978-0-357-51924-0)**







## COMPREHENSIVE VOLUME, 2022 EDITION

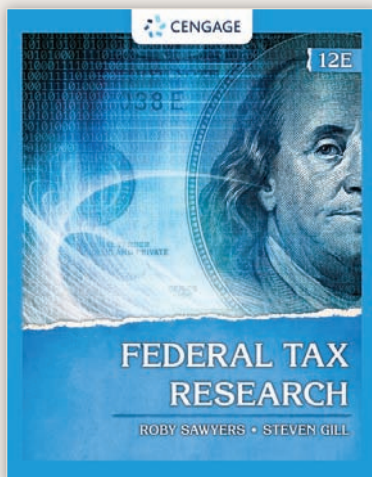
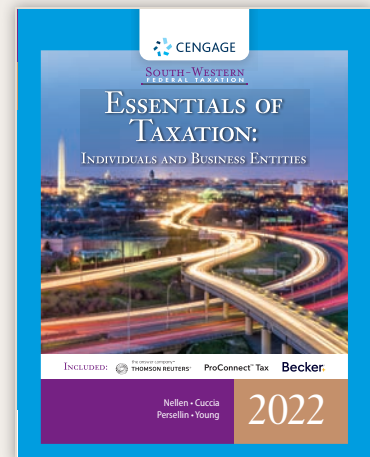
**(YOUNG, MALONEY, NELLEN, PERSELLIN, CUCCIA, Editors)** Combining the number one individual tax text with the number one corporations text, *Comprehensive Volume, 2022 Edition* is a true winner. An edited version of the first two ***South-Western Federal Taxation*** textbooks, this book is ideal for undergraduate or graduate levels. This text works for either a one-semester course in which an instructor wants to integrate coverage of individual and corporate taxation or for a two-semester sequence in which the use of only one book is desired.

**(ISBN 978-0-357-51101-5)**

## 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.

**(ISBN 978-0-357-51943-1)**



## FEDERAL TAX RESEARCH, 12E

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

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

## ABOUT THE EDITORS

---



**William A. Raabe**, Ph.D., CPA, was the Wisconsin Distinguished Professor of Taxation. He taught at Ohio State, Arizona State, the Capital University (OH) Law School, and the Universities of Wisconsin – Milwaukee and Whitewater. A graduate of Carroll University (Wisconsin) and the University of Illinois, Dr. Raabe was

a visiting tax faculty member for a number of public accounting firms, bar associations, and CPA societies. He has received numerous teaching awards, including the Accounting Educator of the Year award from the Wisconsin Institute of CPAs. He was the faculty adviser for student teams in the Deloitte Tax Case Competition (national finalists at three different schools) and the PricewaterhouseCoopers Extreme Tax policy competition (national finalist).



**James C. Young** is the PwC Professor of Accountancy at Northern Illinois University. A graduate of Ferris State University (B.S.) and Michigan State University (M.B.A. and Ph.D.), Jim's research focuses on taxpayer responses to the income tax using archival data. His dissertation received the PricewaterhouseCoopers/

American Taxation Association Dissertation Award, and his subsequent research has received funding from a number of organizations, including the Ernst & Young Foundation Tax Research Grant Program. His work has been published in a variety of academic and professional journals, including the *National Tax Journal*, *The Journal of the American Taxation Association*, and *Tax Notes*. Jim is a Northern Illinois University Distinguished Professor, received the Illinois CPA Society Outstanding Accounting Educator Award in 2012, and has received university teaching awards from Northern Illinois University, George Mason University, and Michigan State University.



**Annette Nellen**, J.D., CPA, CGMA, directs San José State University's graduate tax program (MST) and teaches courses in tax research, tax fundamentals, accounting methods, property transactions, employment tax, ethics, leadership, and tax policy. Professor Nellen is a graduate of CSU Northridge, Pepperdine (MBA),

and Loyola Law School. Prior to joining SJSU in 1990, she was with a Big 4 firm and the IRS. At SJSU, Professor Nellen is a recipient of the Outstanding Professor and Distinguished Service Awards. Professor Nellen is an active member of the tax sections of the AICPA and American Bar Association. In 2013, she received the AICPA Arthur J. Dixon Memorial Award, the highest award given by the accounting profession in the area of taxation. Professor Nellen is the author of BloombergBNA Tax Portfolio, *Amortization of Intangibles*. She has published numerous articles in the *AICPA Tax Insider*, *Tax Adviser*, *Tax Notes State*, and *The Journal of Accountancy*. She has testified before the House Ways & Means and Senate Finance Committees and other committees on Federal and state tax reform. Professor Nellen maintains the 21st Century Taxation Website and blog (21stcenturytaxation.com) as well as Websites on tax policy and reform, virtual currency, and state tax issues (sjsu.edu/people/annette.nellen/).



**William H. Hoffman, Jr.**

earned both his undergraduate (B.A.) and law (J.D.) degrees from the University of Michigan. He completed both an M.B.A. and a Ph.D. at The University of Texas at Austin. Bill began his academic career at Louisiana State University, where he served as a professor of accounting and taxation, before moving to the University of Houston in 1967. Bill's articles appeared in *The Journal of Taxation*, *The Tax Adviser*, *The Journal of Accountancy*, *The Accounting Review*, and *Taxation for Accountants*.







# Brief Contents

## PART 1: INTRODUCTION TO TAXATION AND BUSINESS ENTITIES

---

CHAPTER 1	UNDERSTANDING AND WORKING WITH THE FEDERAL TAX LAW	1-1
CHAPTER 2	THE DEDUCTION FOR QUALIFIED BUSINESS INCOME FOR NONCORPORATE TAXPAYERS	2-1

## PART 2: CORPORATIONS

---

CHAPTER 3	CORPORATIONS: INTRODUCTION AND OPERATING RULES	3-1
CHAPTER 4	CORPORATIONS: ORGANIZATION AND CAPITAL STRUCTURE	4-1
CHAPTER 5	CORPORATIONS: EARNINGS & PROFITS AND DIVIDEND DISTRIBUTIONS	5-1
CHAPTER 6	CORPORATIONS: REDEMPTIONS AND LIQUIDATIONS	6-1
CHAPTER 7	CORPORATIONS: REORGANIZATIONS	7-1
CHAPTER 8	CONSOLIDATED TAX RETURNS	8-1
CHAPTER 9	TAXATION OF INTERNATIONAL TRANSACTIONS	9-1

## PART 3: FLOW-THROUGH ENTITIES

---

CHAPTER 10	PARTNERSHIPS: FORMATION, OPERATION, AND BASIS	10-1
CHAPTER 11	PARTNERSHIPS: DISTRIBUTIONS, TRANSFER OF INTERESTS, AND TERMINATIONS	11-1
CHAPTER 12	S CORPORATIONS	12-1

## **PART 4: ADVANCED TAX PRACTICE CONSIDERATIONS**

---

CHAPTER 13	COMPARATIVE FORMS OF DOING BUSINESS	13-1
CHAPTER 14	TAXES IN THE FINANCIAL STATEMENTS	14-1
CHAPTER 15	EXEMPT ENTITIES	15-1
CHAPTER 16	MULTISTATE CORPORATE TAXATION	16-1
CHAPTER 17	TAX PRACTICE AND ETHICS	17-1

## **PART 5: FAMILY TAX PLANNING**

---

CHAPTER 18	THE FEDERAL GIFT AND ESTATE TAXES	18-1
CHAPTER 19	FAMILY TAX PLANNING	19-1
CHAPTER 20	INCOME TAXATION OF TRUSTS AND ESTATES	20-1



# Contents

## Part 1: INTRODUCTION TO TAXATION AND BUSINESS ENTITIES

### CHAPTER 1

#### UNDERSTANDING AND WORKING WITH THE FEDERAL TAX LAW

**The Big Picture:** *Importance of Tax Research*

#### THE WHYS OF THE TAX LAW

Revenue Needs	1-2
Economic Considerations	1-2
Social Considerations	1-3
Equity Considerations	1-4
Political Considerations	1-8
Influence of the Internal Revenue Service	1-9
Influence of the Courts	1-11

#### SUMMARY

#### RECONCILING ACCOUNTING CONCEPTS

#### WORKING WITH THE TAX LAW—TAX SOURCES

Statutory Sources of the Tax Law	1-14
Administrative Sources of the Tax Law	1-17
Judicial Sources of the Tax Law	1-20
<b>Concept Summary:</b> <i>Federal Judicial System</i>	1-22
<b>Concept Summary:</b> <i>Judicial Sources</i>	1-25
Other Sources of the Tax Law	1-27

#### WORKING WITH THE TAX LAW—LOCATING AND USING TAX SOURCES

Commercial Tax Services	1-28
<b>Financial Disclosure Insights:</b> <i>Where Does GAAP Come From?</i>	1-29
Using Electronic (Online) Tax Services	1-29
Noncommercial Electronic (Online) Tax Sources	1-30

#### WORKING WITH THE TAX LAW—TAX RESEARCH

Identifying the Problem	1-32
Locating the Appropriate Tax Law Sources	1-34
Assessing the Validity of Tax Law Sources	1-34
<b>Ethics &amp; Equity:</b> <i>Choosing Cases for Appeal</i>	1-35
Arriving at the Solution or at Alternative Solutions	1-36
Communicating Tax Research	1-37

#### WORKING WITH THE TAX LAW—TAX PLANNING

Nontax Considerations	1-38
Components of Tax Planning	1-38
Follow-Up Procedures	1-40
Tax Planning—A Practical Application	1-40

#### TAXATION ON THE CPA EXAMINATION

Preparation Blueprints	1-41
Regulation Section	1-41

### CHAPTER 2

#### THE DEDUCTION FOR QUALIFIED BUSINESS INCOME FOR NONCORPORATE TAXPAYERS

**The Big Picture:** *Entrepreneurial Pursuits*

#### TAX TREATMENT OF VARIOUS BUSINESS FORMS

Sole Proprietorships	2-2
Partnerships	2-3
Corporations	2-3
<b>Concept Summary:</b> <i>Tax Treatment of Business Forms Compared</i>	2-6
<b>Global Tax Issues:</b> <i>U.S. Corporate Taxes and International Business Competitiveness</i>	2-7
Limited Liability Companies	2-7

#### THE TAX CUTS AND JOBS ACT (TCJA) OF 2017 AND ENTITY TAX RATES

Challenges of Lowering Tax Rates	2-8
Lowering Tax Rates for Different Business Forms	2-9

#### THE DEDUCTION FOR QUALIFIED BUSINESS INCOME

General Rule	2-10
The Overall Limitation: Modified Taxable Income	2-10
Definition of Qualified Business Income	2-11
Definition of a Qualified Trade or Business	2-11
Limitations on the QBI Deduction	2-13
Limitation Based on Wages and Capital Investment	2-14
<b>Concept Summary:</b> <i>An Overview of the 2021 Qualified Business Income Deduction</i>	2-15
Limitation for “Specified Services” Businesses	2-18
Reporting the Qualified Business Income Deduction	2-26
Aggregation of Qualified Trades and Businesses Under the § 199A Regulations	2-27

Treatment of Losses	2-32
Coordination with Other Rules	2-34
Considerations for Partnerships and S Corporations	2-35
Other Items in the § 199A Regulations	2-35

<b>TAX PLANNING</b>	<b>2-36</b>
Corporate versus Noncorporate Forms of Business Organization	2-36
Optimizing the Deduction for Qualified Business Income	2-37
<b>Refocus on the Big Picture:</b> <i>Entrepreneurial Pursuits</i>	2-37

## Part 2: Corporations

<b>CHAPTER 3</b>	
<b>CORPORATIONS: INTRODUCTION AND OPERATING RULES</b>	<b>3-1</b>
<b>The Big Picture:</b> <i>A Half-Baked Idea?</i>	3-1

<b>AN INTRODUCTION TO THE INCOME TAXATION OF CORPORATIONS</b>	<b>3-2</b>
An Overview of Corporate versus Individual Income Tax Treatment	3-2
Specific Provisions Compared	3-3
Accounting Periods and Methods	3-4
Capital Gains and Losses	3-5
Recapture of Depreciation	3-6
Business Interest Expense Limitation	3-7
Passive Activity Losses	3-9
<b>Concept Summary:</b> <i>Special Rules Applicable to Personal Service Corporations (PSCs)</i>	3-9
Charitable Contributions	3-10
Excessive Executive Compensation	3-12
Net Operating Losses	3-13
Deductions Available Only to Corporations	3-13
<b>Ethics &amp; Equity:</b> <i>Pushing the Envelope on Year-End Planning</i>	3-15
<b>Concept Summary:</b> <i>Income Taxation of Individuals and Corporations Compared</i>	3-17

<b>DETERMINING THE CORPORATE INCOME TAX LIABILITY</b>	<b>3-19</b>
Corporate Income Tax Rates	3-19
Alternative Minimum Tax	3-19
Restrictions on Corporate Accumulations	3-20

<b>PROCEDURAL MATTERS</b>	<b>3-21</b>
Filing Requirements for Corporations	3-21
Estimated Tax Payments	3-21
Schedule M-1—Reconciliation of Income (Loss) per Books with Income per Return	3-22
Schedule M-2—Analysis of Unappropriated Retained Earnings per Books	3-23
Schedule M-3—Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More	3-23
<b>Concept Summary:</b> <i>Conceptual Diagram of Schedule M-1 (Form 1120)</i>	3-24
Effect of Taxes on the Financial Statements	3-26
Form 1120 Illustrated	3-27
Consolidated Returns	3-36

<b>TAX PLANNING</b>	<b>3-36</b>
Corporate versus Noncorporate Forms of Business Organization	3-36
Operating the Corporation	3-37
<b>Refocus on the Big Picture:</b> <i>Cooked to Perfection</i>	3-39

<b>CHAPTER 4</b>	
<b>CORPORATIONS: ORGANIZATION AND CAPITAL STRUCTURE</b>	<b>4-1</b>
<b>The Big Picture:</b> <i>The Vehicle for Business Growth Is the Corporate Form</i>	4-1

<b>ORGANIZATION OF AND TRANSFERS TO CONTROLLED CORPORATIONS</b>	<b>4-2</b>
Section 351 Rationale and General Rules	4-2
<b>Global Tax Issues:</b> <i>Tax Reform Adds a New Wrinkle to the Choice of Organizational Form When Operating Overseas</i>	4-3
<b>Concept Summary:</b> <i>Shareholder Consequences: Taxable Corporate Formation versus Tax-Deferred § 351 Transaction</i>	4-5
Property Defined	4-5
Stock Transferred	4-6
Control of the Corporation	4-6
Basis Determination and Related Issues	4-10
<b>Concept Summary:</b> <i>Tax Consequences to the Shareholders and Corporation: With and Without the Application of § 351 (Based on the Facts of Example 16)</i>	4-11
Assumption of Liabilities—§ 357	4-14
<b>Concept Summary:</b> <i>Tax Consequences of Liability Assumption</i>	4-17

<b>CAPITAL STRUCTURE OF A CORPORATION</b>	<b>4-18</b>
Capital Contributions	4-18
Debt in the Capital Structure	4-18

<b>INVESTOR LOSSES</b>	<b>4-21</b>
Stock and Security Losses	4-21
Business versus Nonbusiness Bad Debts	4-21
<b>Ethics &amp; Equity:</b> <i>Can a Loss Produce a Double Benefit?</i>	4-21
Section 1244 Stock	4-23

<b>GAIN FROM QUALIFIED SMALL BUSINESS STOCK</b>	<b>4-24</b>
---	-------------

<b>TAX PLANNING</b>	<b>4-24</b>
Working with § 351	4-24
Selecting Assets to Transfer	4-26
Debt in the Capital Structure	4-26
Investor Losses	4-27
Corporations versus Flow-Through Entities	4-28
<b>Refocus on the Big Picture:</b> <i>The Vehicle for Business Growth Is the Corporate Form</i>	4-29

<b>CHAPTER 5</b>	
<b>CORPORATIONS: EARNINGS &amp; PROFITS AND DIVIDEND DISTRIBUTIONS</b>	<b>5-1</b>
<b>The Big Picture:</b> <i>Taxing Corporate Distributions</i>	5-1

<b>CORPORATE DISTRIBUTIONS—OVERVIEW</b>	<b>5-2</b>
---	------------

<b>EARNINGS AND PROFITS (E &amp; P)—§ 312</b>	<b>5-3</b>
Computation of E & P	5-3

Summary of E & P Adjustments	5-6
<b>Concept Summary:</b> <i>E &amp; P Adjustments</i>	5-7
Current versus Accumulated E & P	5-8
Allocating E & P to Distributions	5-8
<b>Concept Summary:</b> <i>Allocating E &amp; P to Distributions</i>	5-9
<b>Ethics &amp; Equity:</b> <i>Shifting E &amp; P</i>	5-12

<b>DIVIDENDS</b>	<b>5-12</b>
Rationale for Reduced Tax Rates on Dividends	5-12
Qualified Dividends	5-13
Property Dividends	5-14
<b>Concept Summary:</b> <i>Noncash Property Distributions</i>	5-16
Constructive Dividends	5-16
Stock Dividends and Stock Rights	5-19

<b>TAX PLANNING</b>	<b>5-21</b>
Corporate Distributions	5-21
Planning for Qualified Dividends	5-23
Constructive Dividends	5-24
<b>Refocus on the Big Picture:</b> <i>Taxing Corporate Distributions</i>	5-26

<b>CHAPTER 6</b>	
<b>CORPORATIONS: REDEMPTIONS AND LIQUIDATIONS</b>	<b>6-1</b>
<b>The Big Picture:</b> <i>Family Corporations and Stock Redemptions</i>	6-1

<b>STOCK REDEMPTIONS—IN GENERAL</b>	<b>6-2</b>
-------------------------------------	------------

<b>STOCK REDEMPTIONS—SALE OR EXCHANGE TREATMENT</b>	<b>6-3</b>
<b>Global Tax Issues:</b> <i>Foreign Shareholders Prefer Sale or Exchange Treatment in Stock Redemptions</i>	6-4
Historical Background and Overview	6-4
<b>Concept Summary:</b> <i>Summary of the Qualifying Stock Redemption Rules</i>	6-5
Stock Attribution Rules	6-5
<b>Concept Summary:</b> <i>Tax Consequences of Stock Redemptions to Shareholders</i>	6-7
Not Essentially Equivalent Redemptions	6-7
Disproportionate Redemptions	6-8
Complete Termination Redemptions	6-9
Partial Liquidations	6-9
Redemptions to Pay Death Taxes	6-11

<b>STOCK REDEMPTIONS—EFFECT ON THE CORPORATION</b>	<b>6-11</b>
Recognition of Gain or Loss	6-12
Effect on Earnings and Profits	6-12
Redemption Expenditures	6-12

<b>STOCK REDEMPTIONS—PREFERRED STOCK BAILOUTS</b>	<b>6-12</b>
Background	6-13
Tax Consequences	6-13
Section 306 Stock	6-13

<b>LIQUIDATIONS—IN GENERAL</b>	<b>6-14</b>
The Liquidation Process	6-14
Liquidating and Nonliquidating Distributions Compared	6-14

<b>LIQUIDATIONS—EFFECT ON THE DISTRIBUTING CORPORATION</b>	<b>6-15</b>
The General Rule	6-15
Antistuffing Rules	6-16
<b>Concept Summary:</b> <i>Summary of Antistuffing Loss Disallowance Rules</i>	6-19

<b>LIQUIDATIONS—EFFECT ON THE SHAREHOLDER</b>	<b>6-20</b>
<b>Ethics &amp; Equity:</b> <i>Transferee Liability for Tax Deficiency of Liquidated Corporation</i>	6-20

<b>LIQUIDATIONS—PARENT-SUBSIDIARY SITUATIONS</b>	<b>6-21</b>
Minority Shareholder Interests	6-21
<b>Global Tax Issues:</b> <i>Basis Rules for Liquidations of Foreign Subsidiaries</i>	6-21
Indebtedness of the Subsidiary to the Parent	6-22
Basis of Property Received by the Parent Corporation—The General Rule	6-22
Basis of Property Received by the Parent Corporation—§ 338 Election	6-23
<b>Concept Summary:</b> <i>Summary of Liquidation Rules</i>	6-23

<b>TAX PLANNING</b>	<b>6-25</b>
Stock Redemptions	6-25
Corporate Liquidations	6-26
Parent-Subsidiary Liquidations	6-27
Asset Purchase versus Stock Purchase	6-27
<b>Refocus on the Big Picture:</b> <i>A Family Attribution Waiver Is a Valuable Tool in Succession Planning</i>	6-28

<b>CHAPTER 7</b>	
<b>CORPORATIONS: REORGANIZATIONS</b>	<b>7-1</b>
<b>The Big Picture:</b> <i>Structuring Acquisitions</i>	7-1

<b>CORPORATE REORGANIZATIONS</b>	<b>7-2</b>
Different Types of Reorganizations	7-2
Tax Consequences in a Tax-Free Reorganization	7-3
<b>Concept Summary:</b> <i>Gain and Basis Rules for Nontaxable Exchanges</i>	7-3
<b>Concept Summary:</b> <i>Basis to Acquiring Corporation of Property Received</i>	7-5

<b>TYPES OF TAX-FREE REORGANIZATIONS</b>	<b>7-6</b>
Type A	7-6
Type B	7-8
Type C	7-10
Type D	7-12
Type E	7-15
<b>Concept Summary:</b> <i>Summary of Type A Through Type D Reorganizations: Advantages and Disadvantages</i>	7-16
Type F	7-17
Type G	7-17

<b>JUDICIAL DOCTRINES</b>	<b>7-18</b>
Sound Business Purpose	7-18
Continuity of Interest	7-18
Continuity of Business Enterprise	7-19

Continuity of Business Enterprise	7-19	Excess Loss Accounts	8-27
Step Transaction	7-19	<b>Refocus on the Big Picture:</b> <i>Should the Affiliated Group File a Consolidated Return?</i>	8-28
<b>Ethics &amp; Equity:</b> <i>Poison Pills</i>	7-19		
<b>TAX ATTRIBUTE CARRYOVERS</b>	<b>7-19</b>	<b>CHAPTER 9</b>	
<b>Financial Disclosure Insights:</b> <i>Acquisitions Can Have Negative Consequences</i>	7-20	<b>TAXATION OF INTERNATIONAL TRANSACTIONS</b>	<b>9-1</b>
Allowance of Carryovers	7-20	<b>The Big Picture:</b> <i>Going International</i>	9-1
Net Operating Loss Carryovers	7-20	<b>OVERVIEW OF INTERNATIONAL TAXATION</b>	<b>9-3</b>
Earnings and Profits	7-22	<b>TAX TREATIES</b>	<b>9-5</b>
<b>Concept Summary:</b> <i>Treatment of E &amp; P Carried to Successor</i>	7-23	<b>Global Tax Issues:</b> <i>COVID-19 and Permanent Establishment</i>	9-6
Other Carryovers	7-23		
<b>Concept Summary:</b> <i>Summary of Carryover Rules</i>	7-24	<b>SOURCING OF INCOME AND DEDUCTIONS</b>	<b>9-6</b>
<b>TAX PLANNING</b>	<b>7-24</b>	Income Sourcing Rules	9-7
<b>Concept Summary:</b> <i>Comprehensive Summary of Corporate Reorganizations</i>	7-25	Allocation and Apportionment of Deductions	9-9
Target Liabilities	7-25	<b>Concept Summary:</b> <i>The Sourcing Rules</i>	9-10
Assessing Restructuring Options	7-25	Transfer Pricing	9-10
<b>Refocus on the Big Picture:</b> <i>Structuring Acquisitions</i>	7-27	<b>Ethics &amp; Equity:</b> <i>The Costs of Good Tax Planning</i>	9-11
		<b>FOREIGN CURRENCY GAIN/LOSS</b>	<b>9-14</b>
<b>CHAPTER 8</b>		<b>U.S. PERSONS WITH OFFSHORE INCOME</b>	<b>9-15</b>
<b>CONSOLIDATED TAX RETURNS</b>	<b>8-1</b>	Export Property, Licenses, Foreign Branches	9-15
<b>The Big Picture:</b> <i>A Corporation Contemplates a Merger</i>	8-1	<b>Financial Disclosure Insights:</b> <i>Overseas Operations and Book-Tax Differences</i>	9-17
<b>THE CONSOLIDATED RETURN RULES</b>	<b>8-2</b>	<b>Concept Summary:</b> <i>The Foreign Tax Credit</i>	9-17
Motivations to Consolidate	8-2	Tax Havens	9-18
Source and Philosophy of Consolidated Return Rules	8-3	Offshore (Foreign) Corporations Controlled by U.S. Persons	9-19
<b>Ethics &amp; Equity:</b> <i>Delegating Authority to the Nonelected</i>	8-4	<b>Concept Summary:</b> <i>Subpart F Income and a CFC</i>	9-21
<b>ASSESSING CONSOLIDATED RETURN STATUS</b>	<b>8-4</b>	<b>Concept Summary:</b> <i>Components of Subpart F Income</i>	9-23
<b>Financial Disclosure Insights:</b> <i>GAAP and Tax Treatment of Consolidations</i>	8-5	Movement Toward a More Territorial System	9-23
<b>ELECTING CONSOLIDATED RETURN STATUS</b>	<b>8-6</b>	<b>U.S. TAXATION OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS</b>	<b>9-25</b>
<b>Concept Summary:</b> <i>The Consolidated Return Election</i>	8-6	Nonresident Alien Individuals	9-25
Affiliated Group	8-7	Foreign Corporations	9-27
Affiliated versus Controlled Group	8-7	Foreign Investment in Real Property Tax Act	9-28
Eligibility for the Consolidation Election	8-9	Expatriation to Avoid U.S. Taxation	9-28
Compliance Requirements	8-10	<b>REPORTING REQUIREMENTS</b>	<b>9-29</b>
State Tax Effects	8-14	<b>TAX PLANNING</b>	<b>9-29</b>
<b>Concept Summary:</b> <i>The Consolidated Tax Return</i>	8-14	The Foreign Tax Credit Limitation and Sourcing Provisions	9-29
<b>STOCK BASIS OF SUBSIDIARY</b>	<b>8-14</b>	Transfer Pricing	9-30
<b>CONSOLIDATED TAXABLE INCOME</b>	<b>8-15</b>	<b>Refocus on the Big Picture:</b> <i>Going International</i>	9-31
Computational Procedure	8-16		
Typical Intercompany Transactions	8-17	<b>Part 3: Flow-Through Entities</b>	
<b>Global Tax Issues:</b> <i>Consolidated Returns and NOLs</i>	8-19		
Group Items	8-23	<b>CHAPTER 10</b>	
The Matching Rule	8-25	<b>PARTNERSHIPS: FORMATION, OPERATION, AND BASIS</b>	<b>10-1</b>
<b>Concept Summary:</b> <i>Consolidated Taxable Income</i>	8-26	<b>The Big Picture:</b> <i>Why Use a Partnership, Anyway?</i>	10-1
<b>TAX PLANNING</b>	<b>8-27</b>		
Choosing Consolidated Return Partners	8-27		
Consolidation versus 100 Percent Dividends Received Deduction	8-27		
Protecting the Group Members' Liability for Tax Payments	8-27		



<b>OVERVIEW OF PARTNERSHIP TAXATION</b>	<b>10-2</b>	<b>DISTRIBUTIONS FROM A PARTNERSHIP</b>	<b>11-2</b>
What Is a Partnership?	10-2	Distributions in General	11-2
<b>Concept Summary:</b> <i>Comparison of Partnership Types</i>	10-4	<b>Concept Summary:</b> <i>Hot Assets</i>	11-4
Key Concepts in Taxation of Partnership Income	10-4	Proportionate Current Distributions	11-4
		<b>Ethics &amp; Equity:</b> <i>Arranging Tax-Advantaged Distributions</i>	11-7
<b>FORMATION OF A PARTNERSHIP: TAX EFFECTS</b>	<b>10-6</b>	<b>Concept Summary:</b> <i>Proportionate Current Distributions (General Rules)</i>	11-8
Contributions to the Partnership	10-6	Proportionate Liquidating Distributions	11-8
Exceptions to the General Rule of § 721	10-7	Property Distributions with Special Tax Treatment	11-11
Other Issues Related to Contributed Property	10-9	<b>Concept Summary:</b> <i>Proportionate Liquidating Distributions When the Partnership Also Liquidates (General Rules)</i>	11-12
<b>Concept Summary:</b> <i>Partnership Formation and Initial Basis Computation</i>	10-11	Disproportionate Distributions	11-13
Tax Accounting Elections	10-11		
Initial Costs of a Partnership	10-12	<b>SECTION 736—LIQUIDATING DISTRIBUTIONS TO RETIRING OR DECEASED PARTNERS</b>	<b>11-14</b>
Method of Accounting	10-12	General Partners in Service-Providing Partnerships	11-14
Taxable Year of the Partnership	10-13	Limited Partners or Capital-Intensive Partnerships	11-16
		Tax Treatment of § 736 Payments	11-16
<b>PARTNERSHIP OPERATIONS AND REPORTING</b>	<b>10-14</b>	<b>Concept Summary:</b> <i>Liquidating Distributions of Cash When the Partnership Continues</i>	11-19
Partnership Reporting, In General	10-14		
Measuring Partnership Income	10-15	<b>SALE OF A PARTNERSHIP INTEREST</b>	<b>11-19</b>
Form 1065 Example	10-18	General Rules	11-19
<b>Financial Disclosure Insights:</b> <i>Financial Reporting for Partnerships</i>	10-23	Hot Assets and Carried Interests	11-21
		<b>Concept Summary:</b> <i>Sale of a Partnership Interest</i>	11-23
<b>PARTNER CALCULATIONS AND REPORTING</b>	<b>10-24</b>	<b>Global Tax Issues:</b> <i>A Partnership Isn't Always a Partnership—Complications in the Global Arena</i>	11-23
Partner Reporting of Partnership Income	10-24		
Partner Allocations	10-26	<b>OTHER DISPOSITIONS OF PARTNERSHIP INTERESTS</b>	<b>11-24</b>
Schedule K-1 Example	10-28	Transfers to a Corporation	11-24
<b>Concept Summary:</b> <i>Tax Reporting of Partnership Items</i>	10-30	Death of a Partner	11-24
<b>Ethics &amp; Equity:</b> <i>Built-In Appreciation on Contributed Property</i>	10-30	Gifts	11-24
Partner's Basis	10-31		
Effect of Partnership Liabilities on Partner's Basis	10-32	<b>SECTION 754—OPTIONAL ADJUSTMENTS TO PROPERTY BASIS</b>	<b>11-25</b>
Partner's Capital Account	10-35	Adjustment: Sale or Exchange of an Interest	11-26
<b>Concept Summary:</b> <i>Comparing a Partner's Tax Basis and Capital Account</i>	10-36	Adjustment: Partnership Distributions	11-27
Loss Limitations	10-36	<b>Concept Summary:</b> <i>Basis Adjustments under § 754</i>	11-29
<b>OTHER TAXES ON PARTNERSHIP INCOME</b>	<b>10-38</b>	<b>OTHER ISSUES</b>	<b>11-29</b>
<b>Global Tax Issues:</b> <i>Withholding Requirements for non-U.S. Partners</i>	10-38	Termination of a Partnership	11-29
Self-Employment Tax	10-39	Family Partnerships	11-30
Net Investment Income Tax	10-39	<b>Global Tax Issues:</b> <i>Sale of Global Partnership Interests</i>	11-31
		Limited Liability Companies	11-31
<b>TAX PLANNING</b>	<b>10-40</b>	Limited Liability Partnerships	11-32
Choosing Partnership Taxation	10-40	Partnership Administration and Anti-Abuse	11-32
Formation and Operation of a Partnership	10-41		
Basis Considerations and Loss Deduction Limitations	10-41	<b>TAX PLANNING</b>	<b>11-32</b>
<b>Concept Summary:</b> <i>Major Advantages and Disadvantages of the Partnership Form</i>	10-41	Planning Partnership Distributions	11-32
Partnership Reporting Requirements	10-42	Sales and Exchanges of Partnership Interests	11-33
Transactions between Partners and Partnerships	10-42	Comparing Sales to Liquidations	11-33
Drafting the Partnership Agreement	10-42	Other Partnership Issues	11-34
<b>Refocus on the Big Picture:</b> <i>Why Use a Partnership, Anyway?</i>	10-43	<b>Refocus on the Big Picture:</b> <i>The Life Cycle of a Partnership</i>	11-35
<b>CHAPTER 11</b>			
<b>PARTNERSHIPS: DISTRIBUTIONS, TRANSFER OF INTERESTS, AND TERMINATIONS</b>	<b>11-1</b>		
<b>The Big Picture:</b> <i>The Life Cycle of a Partnership</i>	11-1		

## CHAPTER 12 S CORPORATIONS

**The Big Picture:** *Deductibility of Losses and the Choice of Business Entity*

12-1

### CHOICE OF BUSINESS ENTITY

12-2

An Overview of S Corporations

12-2

### QUALIFYING FOR S CORPORATION STATUS

12-3

Defining an S Corporation

12-3

Making the Election

12-5

Shareholder Consent

12-6

Loss of the Election

12-7

### OPERATIONAL RULES

12-9

Taxable Income

12-9

Qualified Business Income Deduction

12-12

Allocation of Income and Loss

12-12

Distributions to Shareholders

12-13

**Concept Summary:** *Classification Procedures for Distributions from an S Corporation*

12-14

Noncash Property Distributions

12-18

**Concept Summary:** *Consequences of Noncash Distributions*

12-18

Shareholder's Basis in S Stock

12-19

Treatment of Losses

12-21

Tax on Pre-Election Built-In Gain

12-22

LIFO Recapture Tax

12-23

Passive Investment Income Penalty Tax

12-23

Other Operational Rules

12-24

### TAX PLANNING

12-25

When the Election Is Advisable

12-25

**Concept Summary:** *Making an S Election*

12-25

Making a Proper Election

12-26

Operation of the S Corporation

12-26

**Refocus on the Big Picture:** *Using a Pass-Through Entity to Achieve Deductibility of Losses*

12-27

## Part 4: Advanced Tax Practice Considerations

## CHAPTER 13 COMPARATIVE FORMS OF DOING BUSINESS

13-1

**The Big Picture:** *Selection of a Tax Entity Form*

13-1

### FORMS OF DOING BUSINESS

13-2

### NONTAX FACTORS

13-3

Capital Formation

13-3

Limited Liability

13-4

Other Factors

13-4

### SINGLE VERSUS DOUBLE TAXATION

13-4

Overall Effect on Entity and Owners

13-4

Alternative Minimum Tax

13-6

State Taxation

13-6

**Global Tax Issues:** *Tax Rates and Economic Activity*

13-7

### CONTROLLING THE ENTITY TAX

13-7

Favorable Treatment of Certain Fringe Benefits

13-8

Minimizing Double Taxation

13-8

Considering the Qualified Business Income Deduction

13-11

### CONDUIT VERSUS ENTITY TREATMENT

13-11

Effect on Recognition at Time of Contribution to the Entity

13-11

Effect on Basis of Ownership Interest

13-12

**Ethics & Equity:** *Income Tax Basis That Does Not Change?*

13-13

Effect on Results of Operations

13-13

Effect on Recognition at Time of Distribution

13-14

Effect on Passive Activity Losses

13-15

Effect of At-Risk Rules

13-15

Effect of Special Allocations

13-16

### FICA, SELF-EMPLOYMENT TAXES, AND NIIT

13-17

FICA

13-17

Self-Employment Tax

13-17

Net Investment Income Tax (NIIT)

13-18

Effect on the Entity and Its Owners

13-18

### DISPOSITION OF A BUSINESS OR AN OWNERSHIP INTEREST

13-19

Sole Proprietorship

13-19

Partnership and Limited Liability Company

13-20

C Corporation

13-21

S Corporation

13-22

### CONVERTING TO OTHER ENTITY TYPES

13-23

Sole Proprietorship

13-23

C Corporation

13-23

Partnership or LLC

13-23

### OVERALL COMPARISON OF FORMS OF DOING BUSINESS

13-24

**Concept Summary:** *Tax Attributes of Different Forms of Business (Assume That Partners and Shareholders Are All Individuals)*

13-24

### TAX PLANNING

13-28

**Refocus on the Big Picture:** *Selection of a Tax Entity Form*

13-29

## CHAPTER 14 TAXES IN THE FINANCIAL STATEMENTS

14-1

**The Big Picture:** *Taxes in the Financial Statements*

14-1

### ACCOUNTING FOR INCOME TAXES—BASIC PRINCIPLES

14-2

Book-Tax Differences

14-2

**Concept Summary:** *Common Book-Tax Differences*

14-5

Generally Accepted Accounting Principles and ASC 740

14-5

**CAPTURING, MEASURING, AND RECORDING TAX EXPENSE—THE PROVISION PROCESS****14-7**

Current Tax Expense 14-8

**Global Tax Issues:** *Accounting for Income Taxes under International Standards* 14-9

Deferred Tax Expense 14-9

**Financial Disclosure Insights:** *The Book-Tax Income Gap* 14-9

The Valuation Allowance 14-14

**Global Tax Issues:** *Tax Losses and the Deferred Tax Asset* 14-15**TAX DISCLOSURES IN THE FINANCIAL STATEMENTS** **14-17**

Presentation of Amounts Recognized in the Financial Statements 14-17

The Financial Statement Footnotes 14-18

The Effective Tax Rate Reconciliation 14-18

**SPECIAL ISSUES** **14-20**

The Financial Accounting for Tax Uncertainties 14-20

**Concept Summary:** *Recognizing the Tax Benefits of Uncertain Tax Positions Under ASC 740–10* 14-21**Ethics & Equity:** *Disclosing Aggressive Tax Positions* 14-24

Effects of Statutory Tax Rate Changes 14-24

Repeal of the Corporate Alternative Minimum Tax 14-25

The Corporate Tax Department 14-25

**Concept Summary:** *The Income Tax Provision Process* 14-26**BENCHMARKING** **14-26**

Methods of Analysis 14-27

Tax Rate Sustainability 14-28

Uses of Benchmarking Analysis 14-28

**Concept Summary:** *Benchmarking Analysis* 14-29**TAX PLANNING** **14-29**

Releasing Valuation Allowances 14-29

Comparing Tax Savings 14-30

**Refocus on the Big Picture:** *Taxes in the Financial Statements* 14-31**CHAPTER 15  
EXEMPT ENTITIES** **15-1****The Big Picture:** *Effect of a For-Profit Business on a Tax-Exempt Entity* 15-1**TYPES OF EXEMPT ORGANIZATIONS** **15-3****CHARACTERISTICS OF EXEMPT ENTITIES** **15-3**

Serving the Common Good 15-3

Not-for-Profit Entity 15-3

Use of Net Earnings 15-3

**Concept Summary:** *Consequences of Exempt Status* 15-5**TAXES ON EXEMPT ENTITIES** **15-5**

Taxable Transactions 15-5

Feeder Organizations 15-8

**PRIVATE FOUNDATIONS** **15-8**

Tax Consequences of Private Foundation Status 15-8

**Concept Summary:** *Exempt Organizations: Classification* 15-10

Taxes Imposed on Private Foundations 15-11

**UNRELATED BUSINESS INCOME TAX** **15-12**

Unrelated Trade or Business 15-13

Unrelated Business Taxable Income 15-16

**Concept Summary:** *Unrelated Business Income Tax* 15-18**REPORTING REQUIREMENTS** **15-19**

Obtaining Exempt Organization Status 15-19

Annual Filing Requirements 15-19

Disclosure Requirements 15-20

**TAX PLANNING** **15-21**

Choosing an Exempt Classification 15-21

Maintaining Exempt Status 15-21

Private Foundation 15-22

Unrelated Business Income Tax 15-22

**Refocus on the Big Picture:** *Effect of a For-Profit Business on a Tax-Exempt Entity* 15-23**CHAPTER 16  
MULTISTATE CORPORATE TAXATION** **16-1****The Big Picture:** *Making a Multistate Location Decision* 16-1**CORPORATE STATE INCOME TAXATION** **16-2**

Computing State Income Tax 16-2

State Modifications 16-3

The UDITPA and the Multistate Tax Commission 16-3

Jurisdiction to Impose Tax:  
Nexus and Public Law 86–272 16-6

Nexus in Today's Economy 16-7

**Concept Summary:** *Multistate Taxation* 16-8**APPORTIONMENT AND ALLOCATION OF INCOME** **16-8**

The Apportionment Procedure 16-9

Apportionable Income 16-9

Apportionment Factors: Elements and Planning 16-11

**Concept Summary:** *Apportionable Income* 16-12

The Sales Factor 16-13

The Payroll Factor 16-14

The Property Factor 16-16

**Financial Disclosure Insights:** *State/Local Taxes and the Tax Expense* 16-17**THE UNITARY THEORY** **16-18**

What Is a Unitary Business? 16-19

Tax Effects of the Unitary Theory 16-19

Consolidated and Combined Returns 16-21

**Global Tax Issues:** *Water's Edge Is Not a Day at the Beach* 16-21**Concept Summary:** *Using Apportionment Formulas* 16-22**TAXATION OF S CORPORATIONS** **16-22**

Eligibility 16-22

State Tax Filing Requirements 16-22

**TAXATION OF PARTNERSHIPS AND LLCs****16-23****OTHER STATE AND LOCAL TAXES****16-23**

State and Local Sales and Use Taxes

16-23

Local Property Taxes

16-25

Other Taxes

16-26

**Ethics & Equity:** *Encouraging Economic Development through Tax Concessions*

16-27

**TAX PLANNING****16-28**

Selecting the Optimal State in Which to Operate

16-28

Restructuring Corporate Entities

16-29

Subjecting the Corporation's Income to Apportionment

16-31

**Ethics & Equity:** *Can You Be a Nowhere Adviser?*

16-32

Planning with Apportionment Factors

16-32

Sales/Use Tax Compliance

16-33

Capital Stock Taxation

16-33

**Refocus on the Big Picture:** *Making a Multistate Location Decision*

16-33

**CHAPTER 17****TAX PRACTICE AND ETHICS****17-1****The Big Picture:** *A Tax Adviser's Dilemma*

17-1

**TAX ADMINISTRATION****17-2**

Organizational Structure of the IRS

17-3

IRS Procedure—Letter Rulings

17-4

IRS Procedure—Other Issuances

17-4

**Ethics & Equity:** *Tax Compliance Costs*

17-5

Administrative Powers of the IRS

17-5

The Audit Process

17-6

**Ethics & Equity:** *Can the IRS Pretend to Be Your Friend?*

17-7

The Taxpayer Appeal Process

17-9

Offers in Compromise and Closing Agreements

17-10

**Ethics & Equity:** *Our Taxing System of Self-Assessment*

17-11

Interest

17-12

**Concept Summary:** *Working with the IRS*

17-13

Taxpayer Penalties

17-13

**Ethics & Equity:** *First-Time Tax Violators Can Get Off with Just a Warning*

17-18

Statute of Limitations

17-21

**THE TAX PROFESSION AND TAX ETHICS****17-22**

The Tax Professional

17-22

Regulating Tax Preparers

17-23

IRS Rules Governing Tax Practice

17-23

Preparer Penalties

17-24

Privileged Communications

17-26

AICPA Statements on Standards for Tax Services

17-27

**Concept Summary:** *Tax Profession and Ethics*

17-30

**TAX PLANNING****17-30**

Strategies in Seeking a Letter Ruling

17-30

Considerations in Handling an IRS Audit

17-30

Statute of Limitations

17-31

Litigation Considerations

17-32

Penalties

17-32

Ethics in the Tax Practice

17-32

Privileged Communications

17-33

**Refocus on the Big Picture:** *A Tax Adviser's Dilemma*

17-33

**Part 5: Family Tax Planning****CHAPTER 18****THE FEDERAL GIFT AND ESTATE TAXES****18-1****The Big Picture:** *An Eventful and Final Year*

18-1

**TRANSFER TAXES—IN GENERAL****18-2**

Nature of the Taxes

18-2

**Global Tax Issues:** *U.S. Transfer Taxes and NRAs*

18-3

**Concept Summary:** *Formula for the Federal Gift Tax*

18-4

**Concept Summary:** *Formula for the Federal Estate Tax*

18-4

Valuation Issues

18-5

Key Property Concepts

18-6

**THE FEDERAL GIFT TAX****18-7**

General Considerations

18-7

**Ethics & Equity:** *It's the Thought That Counts*

18-7

Transfers Subject to the Gift Tax

18-9

Annual Gift Tax Exclusion

18-10

Deductions

18-11

Computing the Federal Gift Tax

18-11

Procedural Matters

18-12

**Concept Summary:** *Federal Gift Tax Provisions*

18-13

**THE FEDERAL ESTATE TAX****18-13**

Gross Estate

18-14

**Concept Summary:** *Federal Estate Tax Provisions—Gross Estate*

18-19

Taxable Estate

18-19

Estate Tax Credits

18-23

**Global Tax Issues:** *Treaty Relief Is Not Abundant!*

18-24

Procedural Matters

18-25

**Concept Summary:** *Federal Estate Tax Provisions—Taxable Estate and Procedural Matters*

18-25

**THE GENERATION-SKIPPING TRANSFER TAX****18-25**

Inter-Generational Transfers

18-25

The Tax on Generation-Skipping Transfers

18-26

**TAX PLANNING****18-26****Refocus on the Big Picture:** *An Eventful and Final Year*

18-27

**CHAPTER 19****FAMILY TAX PLANNING****19-1****The Big Picture:** *Lifetime Giving—the Good and the Bad*

19-1

**VALUATION CONCEPTS****19-2**

Valuation Issues

19-2

Valuation of Specific Assets

19-3



<b>Ethics &amp; Equity:</b> <i>One Way to Handle Loans to Troublesome In-Laws</i>	19-4
<b>Ethics &amp; Equity:</b> <i>Can IRS Valuation Tables Be Disregarded?</i>	19-5
Real Estate and the Special Use Valuation Method	19-5
Valuation Problems with a Closely Held Business	19-6
<b>Concept Summary:</b> <i>Valuation of Transferred Assets</i>	19-10

<b>INCOME TAX CONCEPTS</b>	<b>19-10</b>
Basis of Property Acquired by Gift	19-10
Basis of Property Acquired by Death	19-11
<b>Concept Summary:</b> <i>Income Tax Basis of Transferred Assets</i>	19-13

<b>GIFT PLANNING</b>	<b>19-13</b>
Minimizing Gift Taxes	19-14
Minimizing Estate Taxes	19-14
Income Tax Considerations	19-15

<b>ESTATE PLANNING</b>	<b>19-17</b>
Probate Costs	19-17
Transfer Tax Deductions	19-17
Providing Estate Liquidity	19-20
Nontax Estate Planning Issues	19-22
<b>Concept Summary:</b> <i>Estate and Gift Tax Planning</i>	19-22
<b>Refocus on the Big Picture:</b> <i>Lifetime Giving—the Good and the Bad</i>	19-23

<b>CHAPTER 20</b>	
<b>INCOME TAXATION OF TRUSTS AND ESTATES</b>	<b>20-1</b>
<b>The Big Picture:</b> <i>Setting Up a Trust to Protect a Family</i>	20-1

<b>FIDUCIARY INCOME TAXATION</b>	<b>20-2</b>
What Is a Trust?	20-2
What Is an Estate?	20-5

<b>NATURE OF TRUST AND ESTATE TAXATION</b>	<b>20-5</b>
<b>Concept Summary:</b> <i>Tax Characteristics of Major Pass-Through Entities</i>	20-6
Tax Accounting Periods and Methods	20-6
Tax Rates and Personal Exemption	20-6
Alternative Minimum Tax	20-7
Additional Tax on Net Investment Income	20-8

<b>TAXABLE INCOME OF TRUSTS AND ESTATES</b>	<b>20-8</b>
Entity Accounting Income	20-8
Gross Income	20-11
<b>Ethics &amp; Equity:</b> <i>To Whom Can I Trust My Pet?</i>	20-13
Ordinary Deductions	20-13
Deductions for Losses	20-15
Charitable Contributions	20-15
Deduction for Distributions to Beneficiaries	20-16
<b>Concept Summary:</b> <i>Uses of the DNI Amount</i>	20-17
Tax Credits	20-19
<b>Concept Summary:</b> <i>Principles of Fiduciary Income Taxation</i>	20-20

<b>TAXATION OF BENEFICIARIES</b>	<b>20-20</b>
Distributions by Simple Trusts	20-20
Distributions by Estates and Complex Trusts	20-20
Character of Income	20-22

<b>GRANTOR TRUSTS</b>	<b>20-23</b>
-----------------------	--------------

<b>PROCEDURAL MATTERS</b>	<b>20-25</b>
---------------------------	--------------

<b>TAX PLANNING</b>	<b>20-25</b>
A Trust or an Estate as an Income-Shifting Device	20-25
Income Tax Planning for Estates	20-26
Distributions of In-Kind Property	20-27
<b>Ethics &amp; Equity:</b> <i>Who Should Be a Trustee?</i>	20-27
Deductibility of Administrative Expenses	20-27
Duties of an Executor	20-28
Additional Taxes on Capital Gains and Net Investment Income	20-28
<b>Refocus on the Big Picture:</b> <i>Setting Up a Trust to Protect a Family</i>	20-29

## APPENDICES

TAX FORMULAS, TAX RATE SCHEDULES, AND TABLES	A-1
TAX FORMS	B-1
GLOSSARY	C-1
TABLE OF CODE SECTIONS CITED	D-1
PRESENT VALUE AND FUTURE VALUE TABLES	E-1
INDEX	I-1

## Online Appendices

DEPRECIATION AND THE ACCELERATED COST RECOVERY SYSTEM (ACRS)

AFFORDABLE CARE ACT PROVISIONS





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.

# Understanding and Working with the Federal Tax Law

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

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

## CHAPTER OUTLINE

### 1-1 The Whys of the Tax Law, 1-2

- 1-1a Revenue Needs, 1-2
- 1-1b Economic Considerations, 1-2
- 1-1c Social Considerations, 1-3
- 1-1d Equity Considerations, 1-4
- 1-1e Political Considerations, 1-8
- 1-1f Influence of the Internal Revenue Service, 1-9
- 1-1g Influence of the Courts, 1-11

### 1-2 Summary, 1-13

### 1-3 Reconciling Accounting Concepts, 1-13

### 1-4 Working with the Tax Law—Tax Sources, 1-13

- 1-4a Statutory Sources of the Tax Law, 1-14
- 1-4b Administrative Sources of the Tax Law, 1-17
- 1-4c Judicial Sources of the Tax Law, 1-20
- 1-4d Other Sources of the Tax Law, 1-27

### 1-5 Working with the Tax Law—Locating and Using Tax Sources, 1-28

- 1-5a Commercial Tax Services, 1-28
- 1-5b Using Electronic (Online) Tax Services, 1-29
- 1-5c Noncommercial Electronic (Online) Tax Sources, 1-30

### 1-6 Working with the Tax Law—Tax Research, 1-32

- 1-6a Identifying the Problem, 1-32
- 1-6b Locating the Appropriate Tax Law Sources, 1-34
- 1-6c Assessing the Validity of Tax Law Sources, 1-34
- 1-6d Arriving at the Solution or at Alternative Solutions, 1-36
- 1-6e Communicating Tax Research, 1-37

### 1-7 Working with the Tax Law—Tax Planning, 1-38

- 1-7a Nontax Considerations, 1-38
- 1-7b Components of Tax Planning, 1-38
- 1-7c Follow-Up Procedures, 1-40
- 1-7d Tax Planning—A Practical Application, 1-40

### 1-8 Taxation on the CPA Examination, 1-40

- 1-8a Preparation Blueprints, 1-41
- 1-8b Regulation Section, 1-41



## THE BIG PICTURE

STOCKLITE/SHUTTERSTOCK.COM

### 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<sup>1</sup> 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.

<sup>1</sup>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.<sup>2</sup>

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.<sup>3</sup>

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.<sup>4</sup> 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).<sup>5</sup>

### 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.

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

<sup>3</sup>A long-term capital gain has a favorable tax advantage for individuals.

<sup>4</sup>Known as § 1244 stock (and subject to specific annual limitations), this subject is covered in Chapter 4.

<sup>5</sup>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.<sup>6</sup> 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.<sup>7</sup>

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.<sup>8</sup>

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).<sup>9</sup>

<sup>6</sup>These provisions also can be justified under the category of economic considerations since a better educated workforce carries a positive economic impact.

<sup>7</sup>A tax credit rather than a deduction would eliminate the effects of multiple taxation on the same income.

<sup>8</sup>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.

<sup>9</sup>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.<sup>10</sup>

### 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

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.<sup>11</sup>

#### EXAMPLE

2

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.<sup>12</sup>

#### EXAMPLE

3

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.<sup>13</sup> The Azure stock is worth \$100,000.

#### EXAMPLE

4

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.<sup>14</sup>

#### EXAMPLE

5

Amber Corporation and Crimson Corporation decide to consolidate to form Aqua Corporation.<sup>15</sup> 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.

#### EXAMPLE

6

<sup>10</sup>See Chapter 18.

<sup>11</sup>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).

<sup>12</sup>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.

<sup>13</sup>Transfers of property to controlled corporations (§ 351) are discussed in Chapter 4.

<sup>14</sup>The formation of a partnership is discussed in Chapter 10.

<sup>15</sup>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)].<sup>16</sup> 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).<sup>17</sup> 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.<sup>18</sup>

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.<sup>19</sup> 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.

<sup>16</sup>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.

<sup>17</sup>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.

<sup>18</sup>The exchange of stock does not qualify for nontaxable treatment as a like-kind exchange (refer to Example 2).

<sup>19</sup>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.

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

Year	Profit (or Loss)	
	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.

### EXAMPLE

8

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.<sup>20</sup> 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.

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.

### EXAMPLE

9

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.

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*

### EXAMPLE

10

<sup>20</sup>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 ( $20\% \times \$80,000$ ) 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.<sup>21</sup> 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.<sup>22</sup> 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.<sup>23</sup> 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

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).

#### LO.3

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

## 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

<sup>21</sup>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.

<sup>22</sup>Such states included Michigan, Oklahoma, and Pennsylvania.

<sup>23</sup>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.<sup>24</sup>

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.<sup>25</sup> 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.<sup>26</sup>

### 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).

<sup>24</sup>§ 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.

<sup>25</sup>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.

<sup>26</sup>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

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.<sup>27</sup> 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. Various 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.

In 2021, Mrs. Greer, a widow, wants to give \$30,000 to Jean without incurring any gift tax liability.<sup>28</sup> 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.

LO.4

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

#### EXAMPLE

13

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?

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)?

#### EXAMPLE

14

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

<sup>27</sup>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?

<sup>28</sup>The example assumes that Mrs. Greer has exhausted her unified tax credit. See Chapter 18.