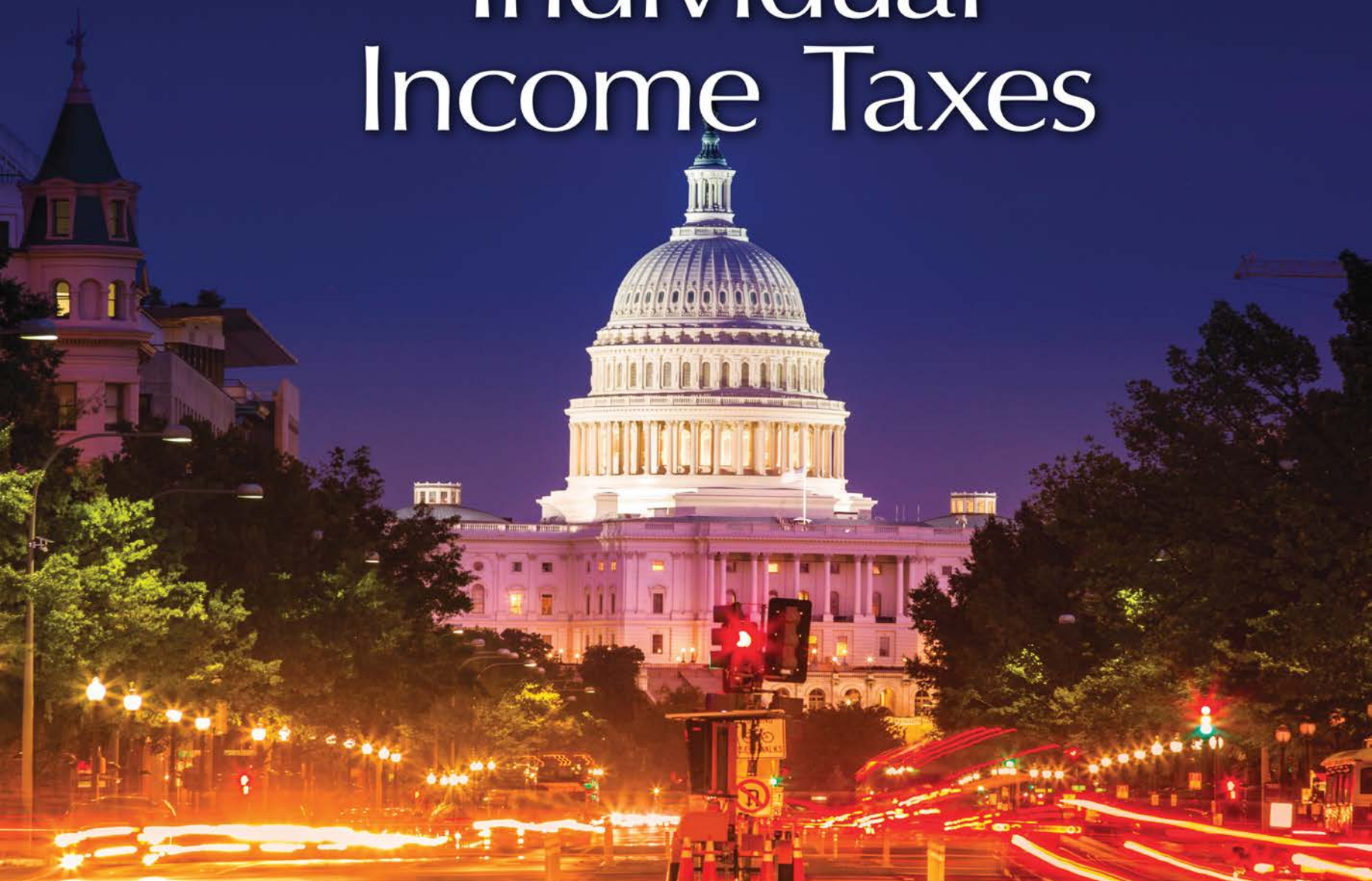




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Individual Income Taxes



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2023

2021 Tax Rate Schedules

Single—Schedule X				Head of household—Schedule Z			
If taxable income is: Over—	But not over—	The tax is:	of the amount over—	If taxable income is: Over—	But not over—	The tax is:	of the amount over—
\$ 0	\$ 9,950	.....10%	\$ 0	\$ 0	\$ 14,200	.....10%	\$ 0
9,950	40,525	\$ 995.00 + 12%	9,950	14,200	54,200	\$ 1,420.00 + 12%	14,200
40,525	86,375	4,664.00 + 22%	40,525	54,200	86,350	6,220.00 + 22%	54,200
86,375	164,925	14,751.00 + 24%	86,375	86,350	164,900	13,293.00 + 24%	86,350
164,925	209,425	33,603.00 + 32%	164,925	164,900	209,400	32,145.00 + 32%	164,900
209,425	523,600	47,843.00 + 35%	209,425	209,400	523,600	46,385.00 + 35%	209,400
523,600	.....	157,804.25 + 37%	523,600	523,600	.....	156,355.00 + 37%	523,600
Married filing jointly or Qualifying widow(er)—Schedule Y-1				Married filing separately—Schedule Y-2			
If taxable income is: Over—	But not over—	The tax is:	of the amount over—	If taxable income is: Over—	But not over—	The tax is:	of the amount over—
\$ 0	\$ 19,900	.....10%	\$ 0	\$ 0	\$ 9,950	.....10%	\$ 0
19,900	81,050	\$ 1,990.00 + 12%	19,900	9,950	40,525	\$ 995.00 + 12%	9,950
81,050	172,750	9,328.00 + 22%	81,050	40,525	86,375	4,664.00 + 22%	40,525
172,750	329,850	29,502.00 + 24%	172,750	86,375	164,925	14,751.00 + 24%	86,375
329,850	418,850	67,206.00 + 32%	329,850	164,925	209,425	33,603.00 + 32%	164,925
418,850	628,300	95,686.00 + 35%	418,850	209,425	314,150	47,843.00 + 35%	209,425
628,300	.....	168,993.50 + 37%	628,300	314,150	.....	84,496.75 + 37%	314,150

2022 Tax Rate Schedules

Single—Schedule X				Head of household—Schedule Z			
If taxable income is: Over—	But not over—	The tax is:	of the amount over—	If taxable income is: Over—	But not over—	The tax is:	of the amount over—
\$ 0	\$ 10,275	.....10%	\$ 0	\$ 0	\$ 14,650	.....10%	\$ 0
10,275	41,775	\$ 1,027.50 + 12%	10,275	14,650	55,900	\$ 1,465.00 + 12%	14,650
41,775	89,075	4,807.50 + 22%	41,775	55,900	89,050	6,415.00 + 22%	55,900
89,075	170,050	15,213.50 + 24%	89,075	89,050	170,050	13,708.00 + 24%	89,050
170,050	215,950	34,647.50 + 32%	170,050	170,050	215,950	33,148.00 + 32%	170,050
215,950	539,900	49,335.50 + 35%	215,950	215,950	539,900	47,836.00 + 35%	215,950
539,900	.....	162,718.00 + 37%	539,900	539,900	.....	161,218.50 + 37%	539,900
Married filing jointly or Qualifying widow(er)—Schedule Y-1				Married filing separately—Schedule Y-2			
If taxable income is: Over—	But not over—	The tax is:	of the amount over—	If taxable income is: Over—	But not over—	The tax is:	of the amount over—
\$ 0	\$ 20,550	.....10%	\$ 0	\$ 0	\$ 10,275	.....10%	\$ 0
20,550	83,550	\$ 2,055.00 + 12%	20,550	10,275	41,775	\$ 1,027.50 + 12%	10,275
83,550	178,150	9,615.00 + 22%	83,550	41,775	89,075	4,807.50 + 22%	41,775
178,150	340,100	30,427.00 + 24%	178,150	89,075	170,050	15,213.50 + 24%	89,075
340,100	431,900	69,295.00 + 32%	340,100	170,050	215,950	34,647.50 + 32%	170,050
431,900	647,850	98,671.00 + 35%	431,900	215,950	323,925	49,335.50 + 35%	215,950
647,850	.....	174,253.50 + 37%	647,850	323,925	.....	87,126.75 + 37%	323,925

Tax Formula for Individuals

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

*Exemption deductions are not allowed from 2018 through 2025.

**Only applies from 2018 through 2025.

Note: For 2021, individuals using the standard deduction may also subtract from adjusted gross income, cash charitable contributions of up to \$300 (\$600 if married, filing jointly).

Basic Standard Deduction Amounts

Filing Status	2021	2022
Single	\$12,550	\$12,950
Married, filing jointly	25,100	25,900
Surviving spouse	25,100	25,900
Head of household	18,800	19,400
Married, filing separately	12,550	12,950

Amount of Each Additional Standard Deduction

Filing Status	2021	2022
Single	\$1,700	\$1,750
Married, filing jointly	1,350	1,400
Surviving spouse	1,350	1,400
Head of household	1,700	1,750
Married, filing separately	1,350	1,400

Personal and Dependency Exemption

2021	2022
\$4,300	\$4,400

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

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SOUTH WESTERN FEDERAL TAXATION

Individual Income Taxes

2023

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Preface

Committed to Educational Success

South-Western Federal Taxation (SWFT) is the most trusted and best-selling taxation series used by colleges and universities. 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.

Individual Income Taxes, 2023 Edition provides a dynamic learning experience inside and outside of the classroom. Built with resources and tools that have been identified as the most important, our complete learning system provides options for students to achieve success.

In addition, *Individual Income Taxes*, 2023 Edition 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.

In revising the 2023 Edition, we focused on:

- **Accessibility. Clarity. Substance.** The authors and editors made this their focus as they revised the 2023 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 (including the upcoming CPA Evolution version of the 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.
- **CNOWv2 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 CNOWv2 to meet evolving student and instructor needs. CNOWv2 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.

Full-Color Design: We understand that students struggle with learning difficult tax law concepts and applying them to real-world scenarios. The 2023 edition uses color to bring the text to life, capture student attention, and present the tax law in an understandable and logical format.

Chapter

14

Property Transactions: Determination of Gain or Loss and Basis Considerations

Learning Objectives: After completing Chapter 14, you should be able to:

- 14-1 Explain the computation of realized gain or loss on property dispositions.
- 14-2 Distinguish between realized and recognized gain or loss.
- 14-3 Illustrate how basis is determined for various methods of asset acquisition.

- 14-4 Describe various loss disallowance provisions.
- 14-5 Identify tax planning opportunities related to selected property transactions.

The Big Picture

Proposed Sale of a House and Other Property Transactions

Alice owns a house that she received from her mother, Paula, seven months ago. Paula paid \$275,000 for the house. Alice is considering selling the house to her favorite nephew, Dan, for \$275,000. Alice anticipates that she will have no gain or loss on the transaction. She comes to you for advice. As Alice's tax adviser, you need answers to the following questions.

- You are aware that Paula died several years ago. Alice received the house from her mother. Did Alice receive the house by gift prior to her mother's death, or did she inherit it after her mother's death? What was Paula's adjusted basis for the house, and when did she buy it? What was the fair market value of the house on the date of Paula's death? Answers to these questions will help you determine Alice's basis in the house.
- To be the house Alice's principal residence (or not), when did it become her principal residence (before or after she received it from Paula)?
- To help determine the tax consequences of Alice's potential sale of the house to Dan, you need answers to these questions: What is the current fair market value of the house? Does Alice intend for the transaction with Dan to be a sale or part-gift and part-gift? What does Alice intend to do with the sale proceeds?

Alice also would like to know the tax consequences of selling her boat, which she purchased for \$22,000 four months ago. She has been using it exclusively for personal use but is disappointed with its layout and capacity. Because it is a new model, there is significant demand for the boat, and based on listings in her area, she anticipates that she can sell it for \$20,000 in 2020.

While you are taking care of Alice's questions that center this year, she sold some stock in Green Corporation at a loss. A few days later, after hearing Green's quarterly earnings report, she decided to buy back the shares. To determine the tax effects of these transactions, you ask her to provide additional information.

Read the chapter and formulate your response.

Chapter Outline

14-1 Determination of Gain or Loss, 14-2

14-1a: Realized Gain or Loss, 14-2

14-1b: Recognized Gain or Loss, 14-8

14-1c: Nonrecognition of Gain or Loss, 14-9

14-2 Basis Considerations, 14-9

14-2a: Determination of Cost Basis, 14-9

14-2b: Gift Basis, 14-12

14-2c: Inherited Property, 14-13

14-2d: Disallowed Losses, 14-15

14-3 Tax Planning, 14-22

14-3a: Cost Identification and Documentation Considerations, 14-22

14-3b: Selection of Property for Making Gifts, 14-22

14-3c: Selection of Property to Pass at Death, 14-22

14-3d: Disallowed Losses, 14-23

erty Transactions: Determination of Gain or Loss and Basis Considerations

14-3

osition of property (i.e., transactions in their ownership interest in an asset). A ruling property. The term also designates wide variety of evaluation events including redemptions, and bond redemptions. It also refers to a change in property (or property) the "disposition" (e.g., a casualty, theft, or coming worthless).

is a key factor in determining whether the taxpayer is not sufficiently

14-1

14-1 Determination of Gain or Loss

	<p>The stock has appreciated in value and a charge in value not identifiable event occurred.</p> <p>To \$1,000. Because there was no identifiable event, the result is a realized gain of \$1,000 (\$2,000 - \$1,000).</p>															
	<p>the amount realized from the sale or adjusted basis on the disposition date. In this case, the result is a realized gain, because the amount realized exceeds the amount realized.</p>															
	<p>of \$10,000 for \$3,000. Cain realized gains of \$7,000, he would have had a realized loss.</p>															
	<p>calculation. The various terms used in following pages:</p>															
14.1	<pre> graph TD AB[Adjusted Basis] -- "+" --> RG[Realized Gain] AB -- "-" --> RL[Realized Loss] </pre>															
14.4	<h3>Part 5 Property Transactions</h3> <h4>Amount Realized</h4> <p>The amount realized from a sale or other disposition of property is a measure of the economic value received for property given up. It is the sum of any money received (which includes any debt relief) plus the fair market value of other property received.¹</p> <p>Debt relief includes any liability (e.g., a mortgage) assumed by the buyer when the property is sold. Debt relief also occurs if property is added subject to the mortgage (i.e., the seller remains liable for the debt even though the buyer will be making the payments). In addition, debt relief is not limited by the fair market value of the property.</p> <h4>Example 1</h4> <p>Juan sells a machine used in his landscaping business to Peter for \$30,000, cash plus four acres of property that Peter owns in a nearby town with a fair market value of \$30,000. Juan's amount realized on this sale is \$30,000 (\$20,000 cash + \$10,000 land).</p> <h4>Example 2</h4> <p>Berry owns property on which there is a mortgage of \$30,000. He sells the property to Cal for \$50,000 cash and Cal's agreement to assume the mortgage. Berry's amount realized on this sale is \$70,000 (\$50,000 cash + \$20,000 debt relief).</p>															
	<p>In a property transaction, the fair market value of property received is the price determined by a willing seller and a willing buyer when neither is compelled to sell or buy and both have reasonable knowledge of relevant facts.² All of the relevant facts must be considered,³ and if the fair market value of the property received cannot be determined, the value of the property given up by the taxpayer is assumed to be equitable and may be used.⁴</p>															
	<p>Return to the facts of Example 3. There are several steps one can determine the fair market value of the land Juan is receiving.</p> <ul style="list-style-type: none"> • An appraiser can be paid to provide an appraisal of the land. • One's county property tax assessor's information also may be helpful. The city or county assessor determines the fair market value of property at each property tax rate level applied annually. • If the exchange between a willing seller and buyer, determining the fair market value of Juan's landscaping machine could answer the question (i.e., given the facts of the case, it should be worth \$56,000). 															
	<p>In calculating the amount realized, selling expenses (e.g., advertising, commissions, and legal fees) relating to the sale are deducted. As a result, the amount realized is the net amount the taxpayer received directly or indirectly, in the form of cash or anything else, from the disposition of the property.</p>															
	<p>Related issue see consequences in calculating the amount realized are discussed below.</p> <p>¹ See Reg. 1.1001-1(c)(1). The amount realized also includes any net proceeds from insurance or a condemnation award that the taxpayer receives as a result of the sale.</p> <p>² See Reg. 1.1001-1(c)(2). The fair market value is defined as the price that a willing buyer would pay for the property in its present condition, without any improvement or alteration made by the taxpayer.</p> <p>³ See Reg. 1.1001-1(c)(3). The fair market value is defined as the price that a willing buyer would pay for the property in its present condition, without any improvement or alteration made by the taxpayer.</p> <p>⁴ See Reg. 1.1001-1(c)(4). The fair market value is defined as the price that a willing buyer would pay for the property in its present condition, without any improvement or alteration made by the taxpayer.</p>															
	<h3>Chapter 14 Property Transactions: Determination of Gains or Losses and Basis Consequences</h3> <p>The calculation of the amount realized may appear to be one of the least complex areas associated with property transactions. However, because numerous positive and negative adjustments may be required, this calculation can be complex and confusing. In addition, determining the fair market value of the items received by the taxpayer can be difficult.</p> <p>Ridge acquires an office building and the associated land on October 1, 2022. Under the terms of the sales contract, Ridge is to receive \$600,000 in cash. The purchaser is to assume Ridge's mortgage of \$300,000 on the property. To assist the purchase, Ridge agrees to pay \$15,000 of the purchaser's closing costs (a "selling cost credit"). The broker's commission on the sale is \$45,000. The amount realized for Ridge is determined as follows.</p> <table border="1"> <thead> <tr> <th>Selling price:</th> <th>Cash</th> <th>Mortgage assumed by purchaser</th> <th>Less:</th> <th>Broker's commission</th> <th>Selling cost credit</th> <th>Amount realized</th> </tr> </thead> <tbody> <tr> <td></td> <td>\$600,000</td> <td>\$300,000</td> <td></td> <td>(45,000)</td> <td>(15,000)</td> <td>\$940,000</td> </tr> </tbody> </table> <h4>Example 3</h4> <p>Adjusted basis of property disposed of is the property's original basis adjusted to the date of disposition.⁵ Original basis is the cost or other basis of the property on the date acquired by the taxpayer. Capital additions increase and capital recourses decrease the original basis.⁶ As a result, adjusted basis is the sum of:</p> <ul style="list-style-type: none"> • Cost (or other adjusted basis) on date of acquisition + Capital additions - Capital recourses = Adjusted basis on date of disposition <p>A taxpayer's original basis also includes any liability incurred to acquire the property.</p> <p>Venetta purchased a residence for \$250,000. Whether Venetta uses \$250,000 from her personal assets to pay for the residence or uses \$50,000 from her personal assets and borrows the remaining \$200,000, her basis in the residence is \$250,000. It does not matter whether Venetta borrows from the seller (in a loan contract) or from a local bank or any other lender (in a mortgage).</p> <h4>Example 4</h4> <p>Many assets are acquired without purchasing them (e.g., via gift or inheritance). We'll discuss how to determine basis for these assets later in the chapter.</p> <h4>Capital Additions</h4> <p>Capital additions are the cost of improvements made to the property that differ from useful life or increase its production capacity or efficiency. These costs are different from repair and maintenance expenses, which are neither capitalized nor added to the original basis (see typical Section 6.3). Repair and maintenance expenses are deductible (as ordinary income taxable year) if they are related to business or income-producing property.</p>	Selling price:	Cash	Mortgage assumed by purchaser	Less:	Broker's commission	Selling cost credit	Amount realized		\$600,000	\$300,000		(45,000)	(15,000)	\$940,000	
Selling price:	Cash	Mortgage assumed by purchaser	Less:	Broker's commission	Selling cost credit	Amount realized										
	\$600,000	\$300,000		(45,000)	(15,000)	\$940,000										

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
- ❑ CNOWv2 provides algorithmic versions of these problems

Computational Exercises

17. **LO.1, 2** Sally owns real property for which the annual property taxes are \$9,000. She sells the property to Kate on March 9, 2022, for \$550,000. Kate pays the real property taxes for the entire year on October 1, 2022.
- a. How much of the property taxes can be deducted by Sally and how much by Kate?
 - b. What effect does the property tax apportionment have on Kate's adjusted basis in the property?
 - c. What effect does the apportionment have on Sally's amount realized from the sale?
 - d. How would the answers in parts (b) and (c) differ if Sally paid the taxes?
18. **LO.1** Melba purchases land from Adrian. Melba gives Adrian \$225,000 in cash and agrees to pay Adrian an additional \$400,000 one year later plus interest at 5%.
- a. What is Melba's adjusted basis for the land at the acquisition date?
 - b. What is Melba's adjusted basis for the land one year later?

Research and Data Analytics Problems:

- ❑ Research Problems provide students with vital practice in an increasingly demanded skill area. These end-of-chapter items ask students to find and analyze tax documents, 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 CNOWv2
- ❑ Questions similar to what students would actually find on the CPA Exam

Becker CPA Review Questions

Becker

1. Jasmin purchased 100 shares of Pinkstey Corporation (publicly traded company) on January 1 of year 1 for \$5,000. The FMV of the shares at the end of year 1 was \$6,000. On January 1 of year 4, Pinkstey Corporation declared a 2-for-1 stock split when the fair market value of the stock was \$65 per share. On January 1 of year 5, Jasmin sold all of her Pinkstey Corporation stock when the fair market value was \$40 per share. Which of the following statements is true?
 - a. Jasmin reports \$6,500 in gross income for the 2-for-1 stock split in year 4.
 - b. Jasmin's basis in the Pinkstey Corporation stock at the end of year 4 is \$65 per share.
 - c. Jasmin has no taxable income for the Pinkstey Corporation stock in year 4.
 - d. Jasmin owns 100 shares in Pinkstey Corporation stock at the end of year 4.
2. Alice gifted stock to her son, Bob, in year 5. Alice bought the stock in year 1 for \$8,300. The value of the stock on the date of gift was \$6,400. Bob sold the stock in year 7 for \$15,800. What is Bob's recognized gain or loss on the sale in year 7?
 - a. \$0
 - b. \$7,500 gain
 - c. \$9,400 gain
 - d. \$15,800 gain

Becker

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

The Big Picture

The First Job

After an extensive search, Morgan, a recent college graduate with a major in child development, has accepted a job with Enrichment Child Care Center (ECCC) in a neighboring state. ECCC is located in the western suburbs of a large metropolitan city, roughly 30 miles from the center of the city. Morgan will be moving into a two-bedroom apartment about two miles from ECCC. At ECCC, Morgan will work with preschool children Monday to Friday from 7 A.M. to 5 P.M. One of the reasons she accepted the position at ECCC is the flexibility it provides. Because she is eager to pay off her student loans and save to buy a house, she has decided to freelance in the late afternoons and evenings and on weekends—joining the “gig economy.”

She finds two ways to freelance: (1) transporting people, packages, and meals for a few companies where she finds work through an “app” (like driving for Uber) and (2) tutoring elementary school students in English and math. Her tutoring can take place online or in person (either in her apartment or at the child’s home). She has dedicated the second bedroom in her apartment for freelancing. She has a large table and several chairs in this bedroom that allow her to meet her tutoring students or connect with them via her laptop. She keeps all of her freelancing records in a file cabinet, which she keeps in a closet in the bedroom. She also purchases and keeps various supplies for her tutoring activities in the closet. Although there are some freelance driving options in the suburbs, most often Morgan heads for the city, where there are more passengers and higher fares.

What are some of the income tax issues presented by this situation?

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 taxpayers. Students will follow a family, individual, or other taxpayer throughout the chapter, to discover how the concepts they are learning apply in the real world.

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

Framework 1040:

Fitting It All Together.

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

Framework 1040 Tax Formula for Individuals

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

Income (broadly defined)	\$ xx,xxx
Less: Exclusions	(x,xxx)
Gross income	\$xx,xxx
Less: Deductions for adjusted gross income	(x,xxx)
Adjusted gross income	\$ xx,xxx
Filing Status <input type="checkbox"/> Single <input type="checkbox"/> Married filing jointly <input type="checkbox"/> Married filing separately (SPT) <input type="checkbox"/> Head of household (HCH) <input type="checkbox"/> Qualifying widow(er) (QW)	
Standard Deduction <input type="checkbox"/> Someone can claim: <input type="checkbox"/> You as a dependent <input type="checkbox"/> Your spouse as a dependent	
Dependents (see instructions) <input type="checkbox"/> None <input type="checkbox"/> One <input type="checkbox"/> Two <input type="checkbox"/> Three <input type="checkbox"/> Four <input type="checkbox"/> Five <input type="checkbox"/> Six <input type="checkbox"/> Seven <input type="checkbox"/> Eight <input type="checkbox"/> Nine <input type="checkbox"/> Ten	
12a: Standard deduction or itemized deductions (from Schedule A)	
12b: Charitable contributions if you take the standard deduction*	
13: Qualified business income deduction,** (Attach Form 8995 or Form 8995-A)	
Personal and dependency exemptions** (x,xxx)	
Taxable income	\$ xx,xxx
Tax on taxable income (see Tax Tables or Tax Rate Schedules)	\$ x,xxx
Less: Tax credits (including income taxes withheld and prepaid)	(xxx)
Tax due (or refund)	\$ xxx

* For 2021, married taxpayers may claim up to \$600 of cash charitable donations (\$300 if unmarried).
 ** Exemption deductions are not allowed from 2018 through 2025.
 *** Only applies from 2018 through 2025.

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

Financial Disclosure Insights:

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



Financial Disclosure Insights Tax Deferrals from Reserves

The tax law generally applies the all events and economic performance tests in determining when an expense is deductible. Accordingly, the use of reserves for financial accounting purposes does not carry over to the tax return. When a business creates a reserve, for example, to account for warranty obligations to customers or vacation pay for employees, book expenses are allowed, but the

corresponding tax deduction usually is delayed until an expenditure is actually incurred. The temporary book-tax difference typically creates or adds to a deferred tax asset on the entity's balance sheet.

On a GAAP balance sheet, all deferred tax assets are deemed to be noncurrent.



Ethics & Equity Punching the Time Clock at Year-End

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

- She will document the time she spends "thinking" about her rental activities.
- During the week, Ralph will visit the apartment building to oversee (in a management role) the operations of the rentals.

- On weekends, she and Ralph will visit the same units to further evaluate the operations.
- Also on the weekends, they will be on the lookout for other rental properties to buy and visit open houses of homes they find on the market. Julie plans to count both her and Ralph's weekend hours toward the tally of total participation.

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

Ethics & Equity: Ethics & Equity

features will spark critical thinking and invite classroom discussion, enticing students to evaluate their own value system. Suggested reactions 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 also appear throughout each chapter, as pertinent topics are discussed.

LO11

Suggest tax planning strategies to minimize the effect of the passive activity loss and investment interest limitations and recognize the general impact of the additional tax on net investment income.

11-6 Tax Planning

11-6a Minimizing the Impact of the Passive Activity Loss Limits

Perhaps the biggest challenge individuals face with the passive activity loss rules is to recognize the potential impact of the rules and then to structure their affairs to minimize this impact. If a taxpayer does invest in an activity that produces losses subject to the passive activity loss rules, the following discussion describes strategies that may help minimize the loss of current deductions.

Taxpayers who have passive activity losses should adopt a strategy of buying an interest in an activity that is generating passive activity income that can be offset (or sheltered) by the existing passive activity losses. From a tax perspective, it would be foolish to buy a loss-generating passive activity unless (1) the taxpayer has other passive activity income to shelter, (2) the activity is rental real estate that can qualify for the \$25,000 exception, or (3) the activity qualifies for the exception available to real estate professionals.

If money is borrowed to finance the purchase of a passive activity, the associated interest expense is generally treated as part of any passive activity loss. Consequently, by using more available (i.e., not borrowed) cash to purchase the passive investment, the investor will need less debt and will incur less interest expense. By incurring less interest expense, a possible suspended passive activity loss deduction is reduced.



Global Tax Issues From "All Sources" Is a Broad Definition

When § 61 refers to "income from whatever source derived," the law is reaching far beyond the borders of the United States. Although one interpretation of "source" in this context is type of income (e.g., wages and interest), a broader interpretation revolves around the place where the income is generated. In this context, citizens and residents of the United States are subject to taxation on income earned from sources both inside and outside the country. This "world-wide income" tax base can cause potential double taxation problems, with other countries also taxing income earned within their borders. However, mechanisms such as the foreign tax credit can alleviate these tax burdens.

Over the years, a number of individuals have relocated to other countries and renounced their U.S. citizenship to avoid

high U.S. tax rates. Others who have already relocated may renounce their U.S. citizenship to avoid complicated filing and reporting requirements. After hitting a then-record high of 5,411 in 2017, the number of expatriations declined to 2,071 in 2019. However, 6,707 individuals gave up their U.S. citizenship in 2020, a new record. This was in spite of the additional practical challenges in completing the expatriation process caused by the COVID-19 pandemic. Once per quarter, the Department of State publishes the names of U.S. citizens who have renounced their citizenship. Some of these individuals may owe Federal taxes as a result of renouncing. See § 877A.

See "Renouncing American Citizenship Hits All-Time Record" at forbes.com/sites/robertwood/2021/02/07/renouncing-american-citizenship-hits-all-time-record.

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 CNOWv2

CNOWv2 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.

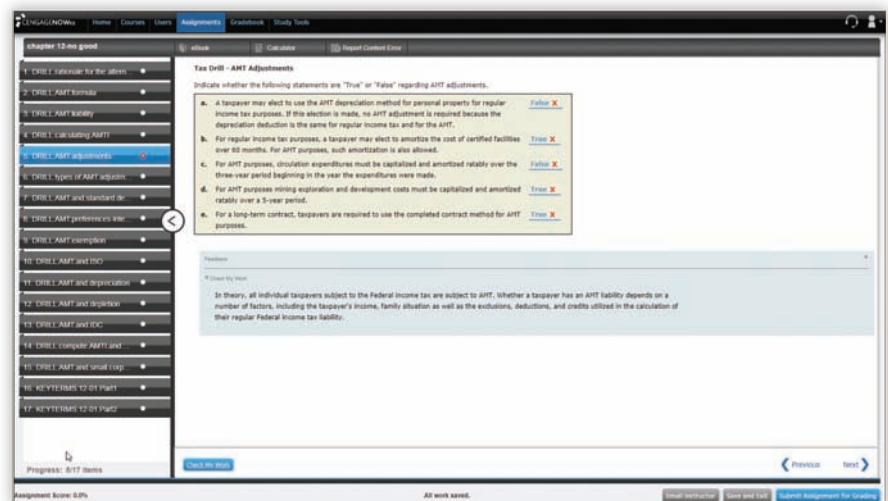


- ❑ **Motivation:** engage students and better prepare them for class
- ❑ **Application:** help students learn problem-solving behavior and skills to guide them to complete taxation problems on their own
- ❑ **Mastery:** help students make the leap from memorizing concepts to actual critical thinking

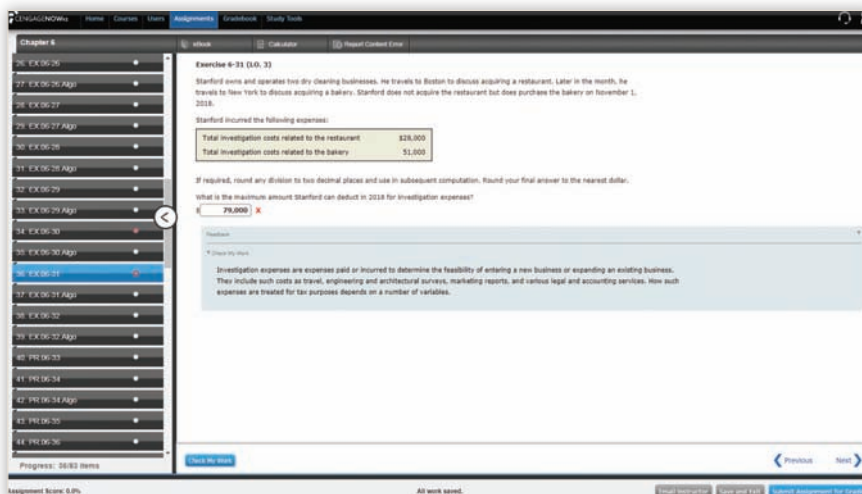
Motivation —

To help with student engagement and preparedness, CNOWv2 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, CNOWv2 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 material manually or in a digital environment.
- ❑ **An Adaptive Study Plan** comes complete with an eBook, practice quizzes, glossary, and flashcards. It is designed to help give students additional support and prepare them for the exam.

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Extensively Revised. Definitively Up to Date.

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

The ***South-Western Federal Taxation*** authors have made every effort to keep all materials up to date and accurate. All chapters contain the following general changes for the 2023 edition:

- Updated materials to reflect changes made through legislative action, new administrative rulings, and court decisions.
- 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* for current developments.
- Added a “Planning” icon to end-of-chapter questions requiring tax planning considerations.

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)
- An appendix that has comprehensive tax return problems for the 2021 tax filing year (Appendix F). (Instructor Companion Website at www.cengage.com/login)
- An appendix that covers depreciation and the Accelerated Cost Recovery System (ACRS). (Instructor Companion Website at www.cengage.com/login)

Chapter 1

- Expanded discussion on the relevance of taxation to accounting and finance professionals to

include the role of a corporate tax director in global growth strategy (added to the planning function), ESG reporting (likely covered in other accounting and business courses and now part of AACSB accreditation standards), and tax advocacy.

- Added information on space travel tax proposals.
- Added information (and a related example) on Preparer Tax Identification Numbers (PTINs).
- Updated figures based on revised IRS data and inflation adjustments.
- Added Research Problem 5 on the data security question tied to the “Safeguards Rule” that is on Form W-12 to obtain or renew a PTIN (ties to the CPA Evolution Model Curriculum).

Chapter 2

- Based on adopter feedback, added 15 basic (simple) research problems involving the legislative sources, administrative sources, and judicial sources of tax law.
- Updated chapter materials (including various references and citations); modified exhibits and concept summaries for new sources (including IRS FAQs).
- Updated end-of-chapter materials as needed.

Chapter 3

- Updated chapter materials to reflect 2021 tax legislation and 2022 inflation adjustments.
- Updated chapter materials to reflect changes in Form 1040 and related schedules; updated various exhibits, including when Form 1040 Schedules 1 through 3 are used and when the 0%, 15%, and 20% break points occur for the alternative tax on net capital gains.
- Revised and clarified materials as needed; updated end-of-chapter materials to reflect 2021 tax legislation and 2022 inflation adjustments.

Chapter 4

- Updated Global Tax Issues feature entitled “From ‘All Sources’ Is a Broad Definition” for the number of recent expatriations.
- Added an Ethics & Equity feature discussing the discrepancy between alimony deducted on tax returns and that reported as income prior to the TCJA of 2017.

- Revised the discussion of the Applicable Financial Statement (AFS) income inclusion rule and related examples for exceptions included in the Regulations issued since last edition.
- Added a new exercise on the AFS income inclusion rule and available exceptions.

Chapter 5

- Reduced coverage of voluntary death benefit payments by employers (employers are more likely to have group term life insurance for employees).
- Added a brief explanation of the foreign housing exclusion or deduction.
- Added a discussion question involving critical thinking and the need to examine the facts to understand why an individual received funds. This determination is necessary in order to determine whether the funds are excludible from gross income.

Chapter 6

- Revised Concept Summary 6.4 (Classification of Expenses) by focusing on activity type (business; personal; investment/production of income).
- Updated and revised chapter materials to reflect changes in tax law and inflation adjustments.
- Deleted discussion question about legal fees incurred in connection with a divorce; created new discussion about the § 162(m) compensation limitation.
- Updated end-of-chapter materials as needed.

Chapter 7

- Updated chapter materials as needed (including end-of-chapter materials).
- Added new research problem, asking students to gather information on whether to repeal or permanently extend the excess business loss limitation provision [§ 461(l)].

Chapter 8

- Updated chapter materials as needed to reflect changes to § 179 limits (including SUVs) and luxury automobile limits, and updated Form 4562 and Schedule C (Form 1040).
- Added a new Excel problem, asking students to build a spreadsheet to calculate MACRS cost recovery and end-of-year adjusted basis for MACRS 3-, 5-, and 7-year assets.
- Updated balance of end-of-chapter materials as needed.

Chapter 9

- Updated chapter materials for revised standard mileage amounts.
- Updated chapter materials for revised QBI deduction limits and the example illustrating the completion of Form 8995-A and Schedule A (Form 8995-A).
- Revised and clarified materials based on feedback from adopters.
- Updated end-of-chapter materials to reflect revised standard mileage amounts, revised QBI deduction limits, the QBI deduction form completion problem (Form 8995), and other questions/problems as needed.

Chapter 10

- Added information about Notice 2020-75 and SALT workarounds some states have enacted for pass-through entities and their owners.
- Revised and clarified text as needed; updated end-of-chapter materials as needed.

Chapter 11

- Updated chapter materials based on feedback from adopters and IRS updates; revised end-of-chapter materials as needed.
- Added a new discussion question on the average period of customer use rental exception.
- Added an additional reference to Research Problem 3 (Reg. § 1.163-15) allowing students to include this expanded tracing rule in their research.

Chapter 12

- Updated chapter materials for AMT exemption inflation adjustments.
- Revised AMT research and experimentation text and problems.
- Added new Global Minimum Tax discussion relative to existing AMT provisions.
- Streamlined text discussion regarding AMT and depreciation.
- Added new planning discussion regarding AMT recordkeeping.
- Added new The Big Picture feature and related examples.

Chapter 13

- Changed Learning Objective 7 (now focused on additional Medicare taxes assessed on high-income individuals).
- Removed Premium Tax Credit discussion, which is covered in online appendix on the Affordable Care Act.
- Updated materials for 2021 legislation (including the American Recovery Plan Act) and inflation adjustments to various items (including the 2022 Social Security base amount). Retained 2021 information when needed (for tax return problems).

Chapter 14

- Updated chapter materials as needed to reflect tax law changes and adopter comments (including revision to the unified estate and gift tax exemption amount).
- Converted a computational exercise dealing with the effective interest rate method for amortizing bond premium (which is not discussed in the chapter) to a discussion question.
- Revised/updated end-of-chapter materials as needed [including the tax form problem related to Form 8949 and a Schedule D (Form 1040)].

Chapter 15

- Revised and updated chapter materials as needed.
- Updated end-of-chapter materials as needed; updated end-of-chapter tax form problem (completion of a Form 8824).

Chapter 16

- Updated Exhibit 16.1 summarizing 2022 and 2021 break points for the 0%/15%/20% alternative tax rates on net capital gains and qualified dividend income.
- Updated the chapter tax return example [including the Form 8949, Schedule D (Form 1040), and the capital gains worksheet].
- Updated text materials based on adopter feedback and tax law changes; updated end-of-chapter materials as needed (including new links to websites for tax research problems).

Chapter 17

- Updated the chapter tax return example [Form 4797 and Schedule D (Form 1040)].
- Updated text materials based on feedback from adopters and various tax law changes [including 2022 alternative tax rate brackets (for net capital gains)].
- Updated end-of-chapter materials (including revised forms); updated data analytics tax research problem for new IRS data.

Chapter 18

- Added an example of the 12-month rule of Reg. § 1.263(a)–1(f).
- Reduced coverage of the installment sale method.
- Reduced Exhibit 18.1 to focus on the most common contract and indirect costs.
- Added new tax planning items.

Chapter 19

- Revised introductory materials.
- Provided context and financial information about § 401(k) and IRA participation.
- New Ethics & Equity item added concerning vesting and plan withdrawals.
- Relocated planning ideas relative to NQDC and NQSO plans.
- Added three new Excel solutions.
- Added one new Excel problem using the XLOOKUP function.
- Timeline analysis added to one problem.

Chapter 20

- Added Excel elements to Problem 41.
- Added Research Problem 7 on finding and analyzing IRS data.

Tax Law Outlook

From your SWFT Series Editors:

Legislation related to the COVID-19 pandemic was a vehicle for tax changes in 2021, including a wide variety of tax changes incorporated into the American Rescue Plan Act of 2021. The Biden administration and Congress continue to discuss a wide variety of tax law changes. Although the Build Back Better plan was not enacted, pieces of that proposal are likely to be debated (and possibly adopted) before the end of 2022. In addition, it is likely that Congress will return to its pattern of extending expired and expiring tax provisions sometime in 2022.

Annually, the Joint Committee on Taxation publishes a report of all expired and expiring provisions in the tax law. The report released in January 2022 lists 40 provisions that expired in 2021 ([jct.gov/publications/2022/jcx-1-22/](https://www.jct.gov/publications/2022/jcx-1-22/)). This list does not include the change to § 174 for R&D expenditures to be capitalized and amortized (rather than currently expensed) for tax years beginning after 2021. The Build Back Better Act passed by the House in November 2021 extended that date by four years. If that act does not become law, it is likely that Congress will find another way to extend the effective date of this change that originated with the Tax Cuts and Jobs Act of 2017.

Taxpayers and their advisers will need to evaluate how these changes affect their financial planning strategies and adjust their plans appropriately. The SWFT editors will be monitoring these activities and provide updates to adopters as needed.

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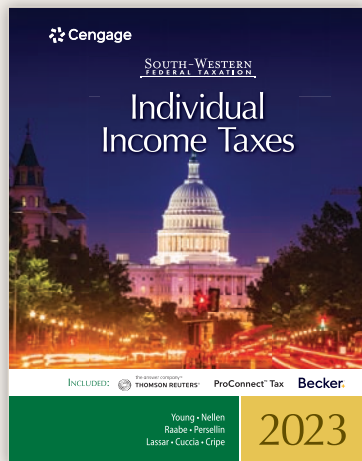
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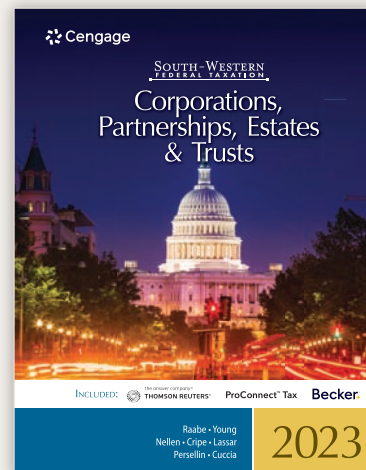
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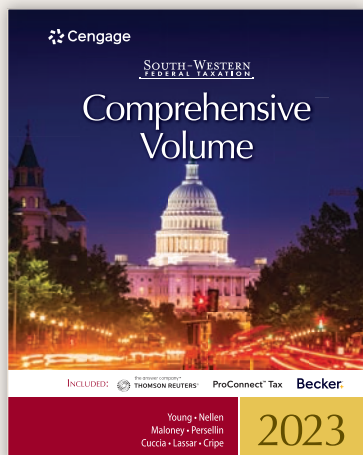
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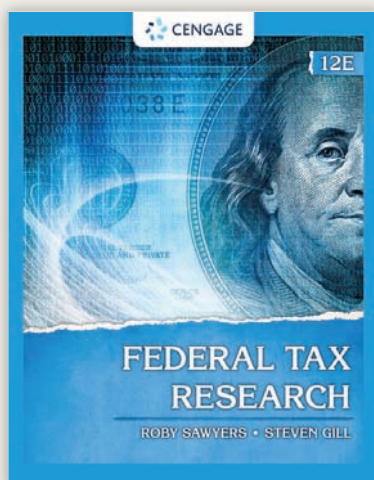
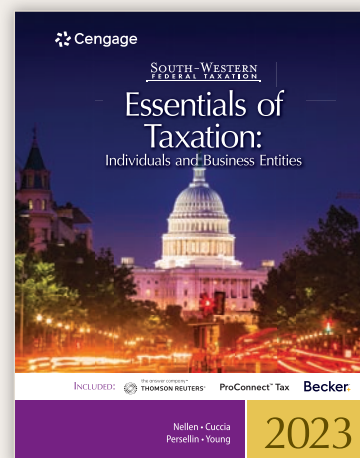
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Brief Contents

Part 1: Introduction and Basic Tax Model

Chapter 1	An Introduction to Taxation and Understanding the Federal Tax Law	1-1
Chapter 2	Working with the Tax Law	2-1
Chapter 3	Tax Formula and Tax Determination; An Overview of Property Transactions	3-1

Part 2: Gross Income

Chapter 4	Gross Income: Concepts and Inclusions	4-1
Chapter 5	Gross Income: Exclusions	5-1

Part 3: Deductions

Chapter 6	Deductions and Losses: In General	6-1
Chapter 7	Deductions and Losses: Certain Business Expenses and Losses	7-1
Chapter 8	Depreciation, Cost Recovery, Amortization, and Depletion	8-1
Chapter 9	Deductions: Employee and Self-Employed-Related Expenses	9-1
Chapter 10	Deductions and Losses: Certain Itemized Deductions	10-1
Chapter 11	Investor Losses	11-1

Part 4: Special Tax Computation Methods, Tax Credits, and Payment Procedures

Chapter 12	Alternative Minimum Tax	12-1
Chapter 13	Tax Credits and Payment Procedures	13-1

Part 5: Property Transactions

Chapter 14	Property Transactions: Determination of Gain or Loss and Basis Considerations	14-1
Chapter 15	Property Transactions: Nontaxable Exchanges	15-1
Chapter 16	Property Transactions: Capital Gains and Losses	16-1
Chapter 17	Property Transactions: § 1231 and Recapture Provisions	17-1

Part 6: Accounting Periods, Accounting Methods, and Deferred Compensation

Chapter 18	Accounting Periods and Methods	18-1
Chapter 19	Deferred Compensation	19-1

Part 7: Corporations and Partnerships

Chapter 20	Corporations and Partnerships	20-1
------------	-------------------------------	------



Contents

Part 1: Introduction and Basic Tax Model

Chapter 1

An Introduction to Taxation and Understanding the Federal Tax Law

1-1

The Big Picture: *Family and Taxes—A Typical Year*

1-1

Approaching the Study of Taxation

1-2

What Is Taxation?

1-2

Taxation in Our Lives

1-2

The Relevance of Taxation to Accounting and Finance Professionals

1-3

How to Study Taxation

1-5

A Brief History of U.S. Taxation

1-5

Early Periods

1-5

Concept Summary: *Individuals and Taxes*

1-6

Revenue Acts

1-6

Trends

1-7

Tax System Design

1-8

Legal Foundation

1-8

The Basic Tax Formula

1-8

Tax Principles

1-9

Major Types of Taxes

1-10

Property Taxes

1-12

Transaction Taxes

1-13

Ethics & Equity: *Making Good Use of Out-of-State Relatives*

1-14

Taxes on Transfers at Death

1-15

Gift Taxes

1-16

Income Taxes

1-17

Employment Taxes

1-19

Other U.S. Taxes

1-20

Concept Summary: *Overview of Taxes in the United States*

1-21

Proposed U.S. Taxes

1-22

Global Tax Issues: *VAT in USA?*

1-23

Tax Administration

1-23

Internal Revenue Service

1-23

The Audit Process

1-24

Statute of Limitations

1-25

Interest and Penalties

1-26

Global Tax Issues: *Outsourcing of Tax Return Preparation*

1-27

Tax Practice

1-27

Understanding the Federal Tax Law

1-29

Revenue Needs

1-29

Economic Considerations

1-29

Social Considerations

1-30

Equity Considerations

1-31

Political Considerations

1-33

Influence of the Internal Revenue Service

1-34

Influence of the Courts

1-35

Summary

1-36

Refocus on The Big Picture: *Family and Taxes—A Typical Year*

1-37

Chapter 2

Working with the Tax Law

2-1

The Big Picture: *Importance of Tax Research*

2-1

Tax Law Sources

2-2

Statutory Sources of the Tax Law

2-2

Administrative Sources of the Tax Law

2-6

Ethics & Equity: *Reporting Tax Fraud*

2-7

Judicial Sources of the Tax Law

2-10

Concept Summary: *Federal Judicial System: Trial Courts*

2-12

Concept Summary: *Judicial Sources*

2-15

Other Sources of the Tax Law

2-17

Working with the Tax Law—Tax Research Tools

2-18

Commercial Tax Services

2-18

Using Electronic (Online) Tax Services

2-19

Noncommercial Electronic (Online) Tax Services

2-19

Working with the Tax Law—Tax Research

2-20

Identifying the Problem

2-21

Refining the Problem

2-22

Locating the Appropriate Tax Law Sources

2-22

Assessing the Validity of Tax Law Sources

2-23

Arriving at the Solution or at Alternative Solutions

2-25

Financial Disclosure Insights: *Where Does GAAP Come From?*

2-26

Communicating Tax Research

2-26

Working with the Tax Law—Tax Planning

Nontax Considerations	2-29
Components of Tax Planning	2-29
Tax Avoidance and Tax Evasion	2-30
Follow-Up Procedures	2-30
Tax Planning	2-31

Taxation on the CPA Examination

Preparation Blueprints	2-31
Regulation Section	2-31

Chapter 3**Tax Formula and Tax Determination; An Overview of Property Transactions**

The Big Picture: A Divided Household	3-1
---	-----

Tax Formula

Concept Summary: Tax Formula for Individuals (Components Integrated into the Text)	3-3
Components of the Tax Formula	3-3
Tax Formula—Correlation with Form 1040	3-8

Standard Deduction

Basic and Additional Standard Deduction	3-17
Individuals Not Eligible for the Standard Deduction	3-18
Special Limitations on the Standard Deduction for Dependents	3-18

Exemptions**Dependents**

Qualifying Child	3-19
Concept Summary: Tiebreaker Rules for Claiming Qualified Child	3-21
Qualifying Relative	3-21
Other Rules for Determining Dependents	3-25
Comparison of Dependent Categories	3-25
Concept Summary: Tests for Dependents	3-26
Ethics & Equity: Whose Qualifying Child Is He?	3-26
Child and Dependent Tax Credits	3-26

Filing Status and Filing Requirements

Filing Status	3-29
Global Tax Issues: Filing a Joint Return	3-30
Ethics & Equity: Abandoned Spouse?	3-33
Filing Requirements	3-33

Tax Determination

Tax Rates	3-35
Computation of Net Taxes Payable or Refund Due	3-36
Kiddie Tax—Unearned Income of Dependent Children	3-37

Tax Return Filing Procedures

Selecting the Proper Form	3-39
---------------------------	------

The E-File Approach	3-40
When and Where to File	3-40
Modes of Payment	3-41

Gains and Losses from Property Transactions—In General**3-41****Gains and Losses from Property Transactions—Capital Gains and Losses****3-42**

Definition of a Capital Asset	3-42
Determination of Net Capital Gain	3-42
Treatment of Net Capital Loss	3-43
Taxation of Net Capital Gain	3-43
Taxation of Virtual Currency	3-44

Tax Planning**3-45**

Maximizing the Use of the Standard Deduction	3-45
Dependents	3-45
Taking Advantage of Tax Rate Differentials	3-46
Income of Certain Children	3-47
Refocus on The Big Picture: A Divided Household	3-47

Part 2: Gross Income**Chapter 4****Gross Income: Concepts and Inclusions****4-1**

The Big Picture: Calculation of Gross Income	4-1
---	-----

Gross Income**4-3**

Definition	4-3
Recovery of Capital Doctrine	4-3
Global Tax Issues: From "All Sources" Is a Broad Definition	4-3
Economic and Accounting Concepts of Income	4-4
Financial Accounting Income versus Taxable Income	4-5
Form of Receipt	4-6

Timing of Income Recognition**4-6**

Taxable Year	4-6
Accounting Methods	4-7
Special Rules Applicable to Cash Basis Taxpayers	4-9
Ethics & Equity: Should the Tax Treatment of Government Bonds and Corporate Bonds Be Different?	4-12
Special Rules Applicable to Accrual Basis Taxpayers	4-13

General Sources of Income and to Whom They Are Taxed**4-14**

Personal Services	4-14
Income from Property	4-15
Income from Partnerships, S Corporations, Trusts, and Estates	4-17

Concept Summary: Taxation of Income and Distributions from Partnerships, S Corporations, Trusts, and Estates

4-18

Income in Community Property States	4-18
-------------------------------------	------

Special Rules Related to Certain Items Included in Gross Income**4-20**

Alimony and Separate Maintenance Payments 4-20

Ethics & Equity: *The Taxation of Alimony and the Alimony Tax Gap* 4-22**Concept Summary:** *Tax Treatment of Payments and Transfers Pursuant to Divorce Agreements and Decrees* 4-23

Imputed Interest on Below-Market Loans 4-23

Concept Summary: *Effect of Certain Below-Market Loans on the Lender and Borrower* 4-24**Concept Summary:** *Exceptions to the Imputed Interest Rules for Below-Market Loans* 4-26**Ethics & Equity:** *Taxing "Made-Up" Income* 4-26

Income from Annuities 4-26

Prizes and Awards 4-29

Unemployment Compensation 4-29

Ethics & Equity: *Tax Treatment of Unemployment Compensation* 4-30

Social Security Benefits 4-30

Income Earned from Foreign Bank and Financial Accounts and FBAR Rules 4-31

Tax Planning**4-32**

Minimize Income Included in Gross Income 4-32

Tax Deferral 4-32

Shifting Income to Other Taxpayers 4-34

Refocus on The Big Picture: *Calculation of Gross Income* 4-35**Chapter 5****Gross Income: Exclusions****5-1****The Big Picture:** *Exclusions* 5-1**Income Exclusions****5-2**

Exclusion Defined 5-2

Exclusions versus Non-Income Items 5-3

Gifts and Inheritances**5-3**

Legislative Intent 5-3

Employer Payments to Employees 5-4

Employee Death Benefits 5-4

Life Insurance Proceeds**5-5**

General Rule 5-5

Accelerated Death Benefits 5-5

Ethics & Equity: *Should the Terminally Ill Pay Social Security Taxes?* 5-6

Transfer for Valuable Consideration 5-6

Scholarships**5-7**

General Information 5-7

Timing Issues 5-8

Compensation for Injuries and Sickness**5-8**

Damages 5-8

Ethics & Equity: *Tax Treatment of Damages Not Related to Physical Personal Injury* 5-9**Concept Summary:** *Taxation of Damages* 5-9**Ethics & Equity:** *Classifying the Amount of the Claim* 5-10

Wrongful Incarceration 5-10

Workers' Compensation 5-10

Accident and Health Insurance Benefits 5-10

Employer-Sponsored Accident and Health Plans**5-11**

Medical Reimbursement Plans 5-11

Long-Term Care Insurance Benefits 5-12

Meals and Lodging**5-13**

General Rules for the Exclusion 5-13

Other Housing Exclusions 5-14

Employee Fringe Benefits**5-14**

Specific Benefits 5-15

Cafeteria Plans 5-15

Flexible Spending Plans 5-16

General Classes of Excluded Benefits 5-16

Ethics & Equity: *Fringe Benefits* 5-20

Group Term Life Insurance 5-20

Foreign Earned Income**5-21****Concept Summary:** *Employee Fringe Benefits* 5-22**Global Tax Issues:** *Benefits of the Earned Income Exclusion Are Questioned* 5-22**Interest on Certain State and Local Government Obligations****5-23****Educational Savings Bonds****5-24****Education Savings Programs (§ 529 and § 530 Plans)****5-25**

Qualified Tuition Program 5-26

Coverdell Education Savings Account 5-26

Qualified ABLE Programs (§ 529A Plans)**5-26****Income from Discharge of Indebtedness****5-27****Tax Benefit Rule****5-28****Tax Planning****5-30**

Life Insurance 5-30

Employee Fringe Benefits 5-30

Investment Income 5-31

Refocus on The Big Picture: *Exclusions* 5-32**Part 3: Deductions****Chapter 6****Deductions and Losses: In General****6-1****The Big Picture:** *Calculation of Deductible Expenses* 6-1**Classification of Deductible Expenses****6-2**

Classifying Deductions 6-3

Authority for Deductions	6-3	Concept Summary: The Tax Treatment of Bad Debts Using the Specific Charge-Off Method	7-4
Deduction Criteria for § 162 and § 212	6-5	Business versus Nonbusiness Bad Debts	7-4
Personal Expenses	6-6	Loans between Related Parties	7-5
Business and Nonbusiness Losses	6-6	Concept Summary: Bad Debt Deductions	7-5
Deduction for Qualified Business Income	6-7		
Reporting Procedures	6-9		
Deductions and Losses—Timing of Expense Recognition	6-10	Worthless Securities and Small Business Stock Losses	7-6
Importance of Taxpayer's Method of Accounting	6-10	Worthless Securities	7-6
Cash Method Requirements	6-10	Small Business Stock (§ 1244 Stock) Losses	7-6
Accrual Method Requirements	6-10		
Prepaid Expenses—The “12-Month Rule”	6-12	Losses of Individuals	7-7
Time Value of Tax Deductions	6-12	Events That Are Not Casualties	7-7
		Theft Losses	7-8
		When to Deduct Casualty Losses	7-8
Disallowance Possibilities	6-13	Measuring the Amount of Loss	7-9
Public Policy Limitation	6-13	Ethics & Equity: Is Policy Cancellation an Escape Hatch?	7-10
Global Tax Issues: Overseas Gun Sales Result in Large Fines	6-14	Personal Casualty Gains and Losses	7-12
Ethics & Equity: State Allowed Marijuana Activity: Do Regular Business Deduction Rules Apply (or Those for Drug Dealers)?	6-15	Concept Summary: Casualty Gains and Losses	7-14
Political Contributions and Lobbying Activities	6-15	Statutory Framework for Deducting Losses of Individuals	7-14
Excessive Executive Compensation	6-16	Concept Summary: Statutory Framework for Deducting Losses of Individuals	7-15
Investigation of a Business	6-17		
Concept Summary: Costs of Investigating a Business	6-18	Research and Experimental Expenditures	7-15
Hobby Losses	6-18	Expense Method	7-16
Concept Summary: Common Questions from the IRS Concerning Hobbies/Businesses with Losses	6-20	Deferral and Amortization Method	7-16
Rental of Vacation Homes	6-21		
Concept Summary: Vacation/Rental Home Expenditures Incurred for Taxpayer's Benefit or Taxpayer's Obligation	6-22	Excess Business Losses	7-17
Disallowance of Personal Expenditures	6-25	Excess Business Loss Defined	7-17
Ethics & Equity: Personal or Business Expenses?	6-26	Losses from Partnerships or S Corporations	7-18
Disallowance of Deductions for Capital Expenditures	6-26	Other Rules	7-19
Transactions between Related Parties	6-28		
Substantiation Requirements	6-29	Net Operating Losses	7-19
Expenses and Interest Relating to Tax-Exempt Income	6-29	General Rules	7-20
Other Disallowances	6-30	Computation of the Net Operating Loss	7-20
		Concept Summary: Computation of Net Operating Loss	7-21
Tax Planning	6-30	Computation of Taxable Income for Year to Which Net Operating Loss Is Carried	7-23
Vacation Homes	6-30	Calculation of the Remaining Net Operating Loss	7-24
Concept Summary: Classification of Expenses	6-31		
Hobby Losses	6-32	Tax Planning	7-25
Do Deduction Limits Affect Executive Compensation?	6-33	Small Business Stock (§ 1244 Stock) Losses	7-25
Refocus on The Big Picture: Calculation of Deductible Business Expenses and Tax Planning	6-33	Casualty Losses	7-25
		Refocus on The Big Picture: Losses	7-25
Chapter 7		Chapter 8	
Deductions and Losses: Certain Business Expenses and Losses	7-1	Depreciation, Cost Recovery, Amortization, and Depletion	8-1
The Big Picture: Losses	7-1	The Big Picture: Calculating Cost Recovery Deductions	8-1
Bad Debts	7-2	Depreciation and Cost Recovery	8-2
Specific Charge-Off Method	7-3	Nature of Property	8-2

Placed in Service Requirement	8-3	Travel Expenses	9-9
Cost Recovery Allowed or Allowable	8-3	Definition of Travel Expenses	9-9
Cost Recovery Basis for Personal Use Assets Converted to Business or Income-Producing Use	8-4	Away-from-Home Requirement	9-10
		Restrictions on Travel Expenses	9-11
		Combined Business and Pleasure Travel	9-12
Modified Accelerated Cost Recovery System (MACRS): General Rules	8-4	Education Expenses	9-14
Concept Summary: <i>MACRS: Class Lives, Methods, and Conventions</i>	8-4	General Requirements	9-14
Personalty (and Certain Realty): Recovery Periods and Methods	8-5	Legal Requirements to Keep a Job	9-14
Financial Disclosure Insights: <i>Tax and Book Depreciation</i>	8-6	Maintaining or Improving Existing Skills	9-15
Concept Summary: <i>Straight-Line Cost Recovery under MACRS (Personalty vs. Realty)</i>	8-9	Concept Summary: <i>Conditions for Deducting Regular Education Expenses</i>	9-15
Realty: Recovery Periods and Methods	8-9	What Expenses Are Allowed?	9-15
		Other Provisions Dealing with Education	9-16
Modified Accelerated Cost Recovery System (MACRS): Special Rules	8-10	Concept Summary: <i>Tax Consequences of Provisions Dealing with Education</i>	9-16
Election to Expense Assets (§ 179)	8-10	Other Business Expenses	9-17
Ethics & Equity: <i>Section 179 Limitation</i>	8-14	Office in the Home	9-17
Additional First-Year Depreciation (Bonus Depreciation)	8-14	Moving Expenses	9-21
Using § 179 and Bonus Depreciation Effectively	8-15	Entertainment and Meal Expenses	9-21
Concept Summary: <i>Using § 179 and Bonus Depreciation in 2022</i>	8-17	Ethics & Equity: <i>Your Turn or Mine?</i>	9-23
Business and Personal Use of Automobiles and Other Listed Property	8-18	Miscellaneous Employee Expenses	9-24
Alternative Depreciation System (ADS)	8-23		
Reporting Procedures	8-24	The Deduction for Qualified Business Income	9-25
Amortization	8-25	General Rule	9-25
Depletion	8-28	The Overall Limitation: Modified Taxable Income	9-26
Intangible Drilling and Development Costs (IDCs)	8-29	What Is Qualified Business Income?	9-26
Depletion Methods	8-29	What Is a Qualified Trade or Business?	9-27
		Limitations on the QBI Deduction	9-29
Tax Planning	8-31	Limitation Based on Wages and Capital Investment	9-29
Cost Recovery	8-31	Concept Summary: <i>An Overview of the 2022 Qualified Business Income Deduction</i>	9-30
Amortization	8-32	Limitation for "Specified Services" Businesses	9-33
Cost Recovery Tables	8-32	Reporting the Qualified Business Income Deduction	9-42
Refocus on The Big Picture: <i>Calculating Cost Recovery Deductions</i>	8-36	Aggregation of Qualified Trades or Businesses under the § 199A Regulations	9-43
		Treatment of Losses	9-48
		Other Items in the § 199A Regulations	9-51
Chapter 9		Contributions to Retirement Accounts	9-52
Deductions: Employee and Self-Employed-Related Expenses	9-1	Employee IRAs	9-52
The Big Picture: <i>The First Job</i>	9-1	Self-Employed Keogh (H.R. 10) Plans	9-53
Employee versus Independent Contractor	9-2	Classification of Employee Expenses	9-53
Concept Summary: <i>Employee versus Independent Contractor</i>	9-4	Accountable Plans	9-53
		Nonaccountable Plans	9-54
Self-Employed and Employee-Related Expenses—In General	9-5	Limitations on Itemized Deductions	9-55
Transportation Expenses	9-5	Miscellaneous Itemized Deductions Subject to the 2%-of-AGI Floor	9-55
Qualified Expenses	9-5	Miscellaneous Itemized Deductions Not Subject to the 2%-of-AGI Floor	9-56
Computation of Automobile Expenses	9-6		

Tax Planning	9-56	Maximizing the Medical Deduction	10-29
Employment Status	9-56	Ensuring the Charitable Contribution Deduction	10-29
Implications of Misclassifying Workers	9-56	Planning to Avoid Nondeductible Treatment	10-31
Transportation and Travel Expenses	9-57	Refocus on The Big Picture: <i>Impact of Itemized Deductions on Major Purchases</i>	10-31
Refocus on The Big Picture: <i>The First Job</i>	9-58		
 Chapter 10		 Chapter 11	
Deductions and Losses:		Investor Losses	11-1
Certain Itemized Deductions	10-1	The Big Picture: <i>Investor Loss Limitations Affect the Viability of Certain Investment Opportunities</i>	11-1
The Big Picture: <i>Impact of Itemized Deductions on Major Purchases</i>	10-1	The Tax Shelter Problem	11-2
 Medical Expenses	10-3	At-Risk Limits	11-4
Medical Expenses Defined	10-3	Concept Summary: <i>Calculation of At-Risk Amount</i>	11-5
Capital Expenditures for Medical Purposes	10-4	Passive Activity Loss Limits	11-5
Medical Expenses Incurred for Spouse and Dependents	10-5	Classification and Tax Treatment of Passive Activity Income and Losses	11-5
Transportation, Meal, and Lodging Expenses for Medical Treatment	10-6	Taxpayers Subject to the Passive Activity Loss Rules	11-9
Amounts Paid for Medical Insurance Premiums	10-6	Rules for Determining Passive Activities	11-10
Year of Deduction	10-7	Concept Summary: <i>Tests to Determine Material Participation</i>	11-14
Reimbursements	10-7	Interaction of the At-Risk and Passive Activity Loss Limits	11-15
Health Savings Accounts	10-8	Special Passive Activity Rules for Real Estate Activities	11-16
Affordable Care Act Provisions	10-10	Concept Summary: <i>Treatment of Losses Subject to the At-Risk and Passive Activity Loss Limitations</i>	11-17
 Taxes	10-10	Ethics & Equity: <i>Punching the Time Clock at Year-End Dispositions of Passive Activities</i>	11-20
Deductibility as a Tax	10-10	Investment Interest Limitation	11-21
Property Taxes	10-11	Limitation Imposed	11-21
State and Local Income Taxes and Sales Taxes	10-13	Concept Summary: <i>Passive Activity Loss Rules: Key Issues and Answers</i>	11-22
 Interest	10-14	Computation of Allowable Deduction	11-23
Allowed and Disallowed Items	10-14	Other Investment Losses	11-23
Restrictions on Deductibility and Timing Considerations	10-17	Concept Summary: <i>Common Investment Loss Limitation Rules</i>	11-24
Classification of Interest Expense	10-17	Tax Planning	11-24
Concept Summary: <i>Deductibility of Personal, Student Loan, Mortgage, and Investment Interest</i>	10-18	Minimizing the Impact of Passive Activity Loss Limits	11-24
 Charitable Contributions	10-18	Maximizing the Investment Interest Deduction	11-26
Criteria for a Gift	10-18	Effect of the Additional Tax on Net Investment Income	11-26
Qualified Organizations	10-20	Refocus on The Big Picture: <i>Investor Loss Limitations Can Affect Investment Returns</i>	11-27
Ethics & Equity: <i>An Indirect Route to a Contribution Deduction</i>	10-20		
Time of Deduction	10-20		
Record-Keeping and Valuation Requirements	10-21		
Concept Summary: <i>Documentation and Substantiation Requirements for Charitable Contributions</i>	10-21		
Global Tax Issues: <i>Choose the Charity Wisely</i>	10-22		
Limitations on Charitable Contribution Deduction	10-22		
Concept Summary: <i>Determining the Deduction for Contributions by Individuals</i>	10-25		
 Timing of Payments to Maximize Deductions	10-26		
 Other Itemized Deductions	10-27		
 Comprehensive Example of Schedule A	10-27		
 Tax Planning	10-29		
		Chapter 12	
		Alternative Minimum Tax	12-1
		The Big Picture: <i>The Presence or Absence of the AMT</i>	12-1
		The AMT Calculation Generally	12-2
		AMT Formula: Alternative Minimum Taxable Income (AMTI)	12-3

Part 4: Special Tax Computation Methods, Tax Credits, and Payment Procedures

Ethics & Equity: Who Will Pay the AMT?	12-4
AMT Formula: Other Components	12-4
AMT Adjustments and Preferences	12-6
Adjustments	12-6
Global Tax Issues: A Global Minimum Tax	12-15
Concept Summary: Summary of AMT Adjustment Provisions	12-18
Preferences	12-18
Ethics & Equity: Incentive Stock Options and the AMT	12-20
Illustration of the AMT Computation	12-21
AMT Credit	12-21
Concept Summary: Summary of AMT Preference Provisions	12-22
Tax Planning	12-22
Avoiding Preferences and Adjustments	12-22
Concept Summary: AMT Adjustments and Preferences for Individuals	12-23
Controlling the Timing of Preferences and Adjustments	12-24
Other AMT Tax Planning Strategies	12-24
Refocus on The Big Picture: The Presence or Absence of the AMT	12-24
Chapter 13	
Tax Credits and Payment Procedures	13-1
The Big Picture: Education Tax Credits	13-1
Tax Policy Considerations	13-3
Overview and Priority of Credits	13-4
Refundable versus Nonrefundable Credits	13-4
General Business Credit	13-5
Treatment of Unused General Business Credits	13-5
Specific Business-Related Tax Credits	13-6
Tax Credit for Rehabilitation Expenditures	13-6
Work Opportunity Tax Credit	13-7
Research Activities Credit	13-7
Low-Income Housing Credit	13-9
Disabled Access Credit	13-10
Credit for Small Employer Pension Plan Startup Costs	13-11
Credit for Employer-Provided Child Care	13-11
Credit for Employer-Provided Family and Medical Leave	13-12
Other Tax Credits	13-12
Earned Income Credit	13-12
Foreign Tax Credit	13-14
Child and Dependent Tax Credits	13-15
Credit for Child and Dependent Care Expenses	13-15
Ethics & Equity: Is This the Right Way to Use the Credit for Child and Dependent Care Expenses?	13-17

Education Tax Credits	13-18
Energy Credits	13-19
Credit for Certain Retirement Plan Contributions	13-19
Concept Summary: Tax Credits	13-21
Payment Procedures	13-23
Employers	13-23
Self-Employed Taxpayers	13-25
Additional Medicare Taxes on High-Income Individuals	13-29
Tax Planning	13-31
Credit for Child and Dependent Care Expenses	13-31
Adjustments to Increase Withholding	13-32
Adjustments to Avoid Overwithholding	13-33
Refocus on The Big Picture: Education Tax Credits	13-33

Part 5: Property Transactions

Chapter 14	
Property Transactions: Determination of Gain or Loss and Basis Considerations	14-1
The Big Picture: Proposed Sale of a House and Other Property Transactions	14-1
Determination of Gain or Loss	14-2
Realized Gain or Loss	14-3
Concept Summary: Realized Gain or Loss	14-3
Recognized Gain or Loss	14-8
Concept Summary: Realized and Recognized Gain or Loss	14-8
Nonrecognition of Gain or Loss	14-9
Basis Considerations	14-9
Determination of Cost Basis	14-9
Gift Basis	14-12
Inherited Property	14-13
Disallowed Losses	14-15
Concept Summary: Wash Sale Rules	14-17
Ethics & Equity: Washing a Loss Using an IRA	14-19
Property Converted from Personal Use to Business or Income-Producing Use	14-19
Summary of Basis Adjustments	14-20
Concept Summary: Adjustments to Basis	14-21
Tax Planning	14-22
Cost Identification and Documentation Considerations	14-22
Selection of Property for Making Gifts	14-22
Selection of Property to Pass at Death	14-22
Disallowed Losses	14-23
Refocus on The Big Picture: Proposed Sale of a House and Other Property Transactions	14-23

Chapter 15

**Property Transactions:
Nontaxable Exchanges****The Big Picture:** *Alternative Uses of Property***15-1****Nontaxable Exchanges****15-2****Like-Kind Exchanges—§ 1031****15-3**

Like-Kind Property

15-4

Exchange Requirement

15-4

Concept Summary: *Delayed § 1031 Exchange*

15-5

Boot

15-6

Basis and Holding Period of Property Received

15-7

Reporting Considerations

15-10

Involuntary Conversions—§ 1033**15-10**

Involuntary Conversion Defined

15-12

Computing the Amount Realized

15-12

Replacement Property

15-13

Concept Summary: *Involuntary Conversions: Replacement Property Tests*

15-14

Time Limitation on Replacement

15-14

Nonrecognition of Gain

15-15

Reporting Considerations

15-16

Sale of a Residence—§ 121**15-16**

Principal Residence

15-17

Requirements for Exclusion Treatment

15-17

Calculating the Exclusion

15-19

Exceptions to the Two-Year Rules

15-20

Tax Planning**15-22**

Like-Kind Exchanges

15-22

Involuntary Conversions

15-23

Sale of a Principal Residence

15-23

Refocus on The Big Picture: *Alternative Uses of Property*

15-24

Chapter 16

**Property Transactions: Capital
Gains and Losses****The Big Picture:** *Managing Capital Asset Transactions***16-1****General Scheme of Taxation****16-3****Capital Assets****16-3**

Definition of a Capital Asset (§ 1221)

16-4

Ethics & Equity: *Sculpture as a Capital Asset*

16-6

Effect of Judicial Action

16-6

Statutory Expansions

16-7

Sale or Exchange**16-8**

Worthless Securities and § 1244 Stock

16-8

Retirement of Corporate Obligations

16-9

Options

16-9

Concept Summary: *Options: Consequences to the Grantor and Grantee*

16-11

Patents

16-11

Franchises, Trademarks, and Trade Names (§ 1253)

16-12

Concept Summary: *Franchises: Consequences to the Franchisor and Franchisee*

16-14

Lease Cancellation Payments

16-14

Holding Period**16-15**

General Rules

16-15

Special Holding Period Rules

16-15

Special Rules for Short Sales

16-16

Concept Summary: *Short Sales of Securities*

16-17

**Tax Treatment of Capital Gains and Losses
of Noncorporate Taxpayers****16-19**

Capital Gain and Loss Netting Process

16-19

Qualified Dividend Income

16-23

Alternative Tax on Net Capital Gain and Qualified Dividend Income

16-24

Concept Summary: *Income Layers for Alternative Tax on Capital Gain Computation*

16-25

Treatment of Net Capital Losses

16-27

Concept Summary: *Final Results of the Capital Gain and Loss Netting Process and How They Are Taxed*

16-28

Reporting Procedures

16-28

**Tax Treatment of Capital Gains and Losses
of Corporate Taxpayers****16-29****Global Tax Issues:** *Capital Gain Treatment in the United States and Other Countries*

16-35

Tax Planning**16-35**

Importance of Capital Asset Status

16-35

Planning for Capital Asset Status

16-35

Effect of Capital Asset Status in Transactions Other Than Sales

16-36

Stock Sales

16-37

Maximizing Benefits

16-37

Year-End Planning

16-37

Refocus on The Big Picture: *Managing Capital Asset Transactions*

16-38

Chapter 17

**Property Transactions: § 1231
and Recapture Provisions****17-1****The Big Picture:** *Depreciation Recapture*

17-1

Section 1231 Assets**17-3**

Relationship to Capital Assets

17-3

Property Included

17-4

Property Excluded

17-4

Special Rules for Certain § 1231 Assets

17-4

General Procedure for § 1231 Computation

17-6

Concept Summary: *Section 1231 Netting Procedure*

17-7

Section 1245 Recapture**17-10**

Section 1245 Property

17-12

Observations on § 1245

17-12

Section 1250 Recapture**17-13**

Section 1250 Recapture Situations

17-13

Concept Summary: Comparison of § 1245 and § 1250 Depreciation Recapture	17-14
Unrecaptured § 1250 Gain (Real Estate 25% Gain)	17-14
Ethics & Equity: The Sale of a “Cost-Segregated” Building	17-15
Considerations Common to §§ 1245 and 1250	17-16
Exceptions	17-16
Other Applications	17-17
Concept Summary: Depreciation Recapture and § 1231 Netting Procedure	17-18
Global Tax Issues: Depreciation Recapture in Other Countries	17-19
Special Recapture Provisions	17-19
Special Recapture for Corporations	17-19
Gain from Sale of Depreciable Property between Certain Related Parties	17-19
Intangible Drilling Costs	17-19
Reporting Procedures	17-20
Ethics & Equity: Incorrect Depreciation and Recognized Gain	17-22
Tax Planning	17-27
Timing of § 1231 Gain	17-27
Timing of Recapture	17-27
Postponing and Shifting Recapture	17-28
Avoiding Recapture	17-28
Refocus on The Big Picture: Depreciation Recapture	17-28

Part 6: Accounting Periods, Accounting Methods, and Deferred Compensation

Chapter 18	
Accounting Periods and Methods	18-1
The Big Picture: Accounting Period and Method	18-1
Accounting Periods	18-2
Specific Provisions for Partnerships, S Corporations, and Personal Service Corporations	18-3
Ethics & Equity: Who Benefits from the Change in Tax Year?	18-5
Selecting the Tax Year	18-6
Changes in the Accounting Period	18-6
Taxable Periods of Less Than One Year	18-7
Mitigation of the Annual Accounting Period Concept	18-8
Ethics & Equity: Special Tax Relief	18-10
Accounting Methods	18-10
Permissible Methods	18-10
Cash Receipts and Disbursements Method	18-11
Accrual Method	18-13
Concept Summary: Accruals Under the Economic Performance Test (Reg. § 1.461-4)	18-14
Financial Disclosure Insights: Tax Deferrals from Reserves	18-16
Hybrid Method	18-16
Change of Method	18-17

Ethics & Equity: Change in Accounting Method	18-19
Special Accounting Methods	18-19
Installment Method	18-19
Long-Term Contracts	18-25
Inventories	18-28
Determining Inventory Cost	18-29
Ethics & Equity: Preserving the LIFO Reserve	18-33
The LIFO Election	18-33
Special Inventory Methods Relating to Farming and Ranching	18-34
Inventory of Small Taxpayers	18-34
Tax Planning	18-35
Taxable Year	18-35
Cash Method of Accounting	18-35
Installment Method	18-35
Inventories	18-36
Refocus on The Big Picture: Accounting Period and Method	18-36
Chapter 19	
Deferred Compensation	19-1
The Big Picture: A Taxpayer Who Saves	19-1
Qualified Pension, Profit Sharing, Stock Bonus, and Cash Balance Plans	19-2
Types of Plans	19-2
Concept Summary: Defined Benefit Plan and Defined Contribution Plan Compared	19-3
Ethics & Equity: Switching from Defined Benefit to Defined Contribution Pension Plans	19-4
Qualification Requirements	19-4
Ethics & Equity: Vesting and Withdrawal Rules	19-8
Tax Consequences to the Employee and Employer	19-8
Limitations on Contributions to and Benefits from Qualified Plans	19-9
Section 401(k) Plans	19-10
Retirement Plans for Self-Employed Individuals	19-11
Keogh (H.R. 10) Plans	19-11
Solo § 401(k) Plans	19-12
Savings Incentive Match Plan for Employees (SIMPLE Plans)	19-12
Simplified Employee Pension Plans (SEPs)	19-12
Concept Summary: Keogh Plan and SEP Compared	19-13
Individual Retirement Accounts (IRAs)	19-13
General Rules	19-13
Taxation of Benefits	19-16
Rollovers and Conversions	19-17
Concept Summary: Comparison of IRAs	19-17
Nonqualified Deferred Compensation Plans	19-18
Underlying Rationale for Tax Treatment	19-18
Tax Treatment to the Employer and Employee	19-18
Ethics & Equity: The Ethics of Sustainable Investing	19-19

Stock Options	19-19	S Corporations	20-23
Incentive Stock Options	19-19	Qualification for S Status	20-23
Financial Disclosure Insights: <i>Share-Based Compensation</i>	19-20	Operational Rules	20-25
Financial Disclosure Insights: <i>Executive Compensation</i>	19-22	Ethics & Equity: <i>Income Tax Basis That Does Not Change?</i>	20-28
Nonqualified Stock Options	19-22		
Tax Planning	19-23	Partnerships	20-28
Qualified Plans	19-23	Nature of Partnership Taxation	20-28
Self-Employed Retirement Plans	19-23	Concept Summary: <i>A Comparison of Some of the Tax Attributes of S and C Corporations</i>	20-29
Individual Retirement Accounts	19-23	Partnership Formation and Basis	20-29
Comparison of § 401(k) Plan with IRA	19-24	Partnership Operations	20-31
Nonqualified Deferred Compensation (NQDC) Plans	19-24		
Concept Summary: <i>Section 401(k) Plan and IRA Compared</i>	19-25	Tax Planning	20-33
Stock Options	19-25	Corporate versus Noncorporate Forms of Business Organization	20-33
Concept Summary: <i>Incentive Stock Options and Nonqualified Stock Options Compared</i>	19-25	C Corporation versus S Status	20-35
Liquidating Retirement Assets	19-26	Income Shifting to Reduce the Family Income Tax Burden	20-35
Refocus on The Big Picture: <i>A Taxpayer Who Saves</i>	19-26	Refocus on The Big Picture: <i>Choice of Business Entity</i>	20-36

Part 7: Corporations and Partnerships

Chapter 20	
Corporations and Partnerships	20-1
The Big Picture: <i>Choice of Business Entity</i>	20-1
Choice of Entity	20-2
Nontax Considerations	20-2
Concept Summary: <i>Nontax Characteristics of Business Entities</i>	20-4
General Tax Consequences of Different Forms of Business Entities	20-4
Check-the-Box Election	20-5
Corporations	20-6
Legal Status	20-6
Individuals and Corporations Compared—An Overview	20-6
Specific Provisions Compared	20-8
Deductions Available Only to C Corporations	20-12
Determination of Corporate Tax Liability	20-14
Corporate Filing Requirements	20-15
Reconciliation of Corporate Taxable Income and Accounting Income	20-15
Concept Summary: <i>Summary of Income Tax Consequences: Individuals Compared with C Corporations</i>	20-17
Forming the Corporation	20-18
Transfers to Controlled Corporations	20-18
Capital Contributions	20-20
Ethics & Equity: <i>Selective Incorporation</i>	20-21
Distributions to Shareholders	20-21
Dividend Distributions	20-21
Constructive Dividends	20-22

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
Practice Set Assignments—Comprehensive Tax Return Problems	F-1
Index	I-1

Online Appendices

Depreciation and the Accelerated Cost Recovery System (ACRS)
Affordable Care Act Provisions



Part

1

Introduction and Basic Tax Model

Chapter **1**

An Introduction to Taxation and Understanding the Federal Tax Law

Chapter **2**

Working with the Tax Law

Chapter **3**

Tax Formula and Tax Determination; An Overview of Property Transactions

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

An Introduction to Taxation and Understanding the Federal Tax Law

Learning Objectives: After completing Chapter 1, you should be able to:

- | | |
|---|--|
| <p>LO.1 Explain the importance of taxation and apply methods for studying this topic.</p> <p>LO.2 Describe some of the history and trends of the Federal income tax.</p> <p>LO.3 Describe and apply principles and terminology relevant to the design of a tax system.</p> <p>LO.4 Identify the different taxes imposed in the United States at the Federal, state, and local levels.</p> | <p>LO.5 Explain the administration of the tax law, including the audit process utilized by the IRS.</p> <p>LO.6 Evaluate some of the ethical guidelines involved in tax practice.</p> <p>LO.7 Classify tax rules based on their possible economic, social, equity, and political reasons for inclusion in a particular tax system.</p> <p>LO.8 Explain the role played by the IRS and the courts in the evolution of the Federal tax system.</p> |
|---|--|

Chapter Outline

1-1 Approaching the Study of Taxation, 1-2

- 1-1a What Is Taxation? 1-2
- 1-1b Taxation in Our Lives, 1-2
- 1-1c The Relevance of Taxation to Accounting and Finance Professionals, 1-3
- 1-1d How to Study Taxation, 1-5

1-2 A Brief History of U.S. Taxation, 1-5

- 1-2a Early Periods, 1-5
- 1-2b Revenue Acts, 1-6
- 1-2c Trends, 1-7

1-3 Tax System Design, 1-8

- 1-3a Legal Foundation, 1-8
- 1-3b The Basic Tax Formula, 1-8
- 1-3c Tax Principles, 1-9

1-4 Major Types of Taxes, 1-10

- 1-4a Property Taxes, 1-12
- 1-4b Transaction Taxes, 1-13
- 1-4c Taxes on Transfers at Death, 1-15
- 1-4d Gift Taxes, 1-16

1-4e Income Taxes, 1-17

1-4f Employment Taxes, 1-19

1-4g Other U.S. Taxes, 1-20

1-4h Proposed U.S. Taxes, 1-22

1-5 Tax Administration, 1-23

- 1-5a Internal Revenue Service, 1-23
- 1-5b The Audit Process, 1-24
- 1-5c Statute of Limitations, 1-25
- 1-5d Interest and Penalties, 1-26
- 1-5e Tax Practice, 1-27

1-6 Understanding the Federal Tax Law, 1-29

- 1-6a Revenue Needs, 1-29
- 1-6b Economic Considerations, 1-29
- 1-6c Social Considerations, 1-30
- 1-6d Equity Considerations, 1-31
- 1-6e Political Considerations, 1-33
- 1-6f Influence of the Internal Revenue Service, 1-34
- 1-6g Influence of the Courts, 1-35
- 1-6h Summary, 1-36



The Big Picture

Family and Taxes—A Typical Year

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

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

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

Explain these developments, and resolve the issues raised.

Read the chapter and formulate your response.

This chapter provides an introduction to our Federal tax system to set a foundation for what you'll learn in subsequent chapters. Among the topics discussed are:

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

LO.1

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

1-1 Approaching the Study of Taxation

1-1a What Is Taxation?

"Taxes are what we pay for civilized society."

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

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

1-1b Taxation in Our Lives

"Nothing is certain, except death and taxes."

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

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

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

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

Taxes also affect the lives of individuals via the ballot box. Federal, state, and local elections often include initiatives that deal with taxation, such as whether state income taxes should be raised (or lowered), whether a new tax should be imposed on soda, or whether the sales tax rate should be changed. Candidates running for office often have positions on tax changes they would like to make if elected.

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

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

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

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

- *Compliance:* Ensure that the business files all tax returns and makes all tax payments on time. Mistakes and missed due dates will lead to penalties and interest expense.
- *Planning:* Help a business apply favorable tax rules, such as income deferral and tax credits, to minimize tax liability (and maximize owner wealth). The time value of money concept is also important here, as is coordinating tax planning with other business goals to maximize earnings per share.²
- *Financial reporting:* Financial statements include a variety of tax information, including income tax expense on the income statement and deferred tax assets and liabilities on the balance sheet. Footnotes to the financial statements report various tax details, including the company's effective tax rate. Computation and proper reporting of this information require knowledge of both tax and financial reporting rules [including the Financial Accounting Standards Board's Accounting Standards Codification (ASC) 740, *Income Taxes*].
- *Environmental, Social, and Governance (ESG) reporting:* A growing trend in corporate reporting is to address various business sustainability and responsibility matters and to report environmental, social, and governance activities and impact. Standard frameworks might be used that include tax metrics such as the Global Reporting Initiative (GRI) Standards or ones generated by the World Economic Forum.³ This reporting can include taxes paid in each country (part of "country-by-country reporting"), reconciliation between taxes paid and the statutory tax

²A corporate tax director or vice president of tax is typically involved in the strategic planning and growth of the company due to the significance of tax liabilities and planning opportunities to the business. For example, a 2021 position announcement for a Tax Director at Roblox stated that the director would lead initiatives to support global growth of the company.

³For example, see World Economic Forum, *Toward Common Metrics and Consistent Reporting of Sustainable Value Creation*, Jan. 2020; www3.weforum.org/docs/WEF_IBC_ESG_Metrics_Discussion_Paper.pdf.

rate on financial statement profits, financial assistance received from governments via tax deductions and credits, and an explanation of the corporation's tax policy and strategy.⁴

- *Controversy*: This term refers to interaction a taxpayer may have with a tax agency such as the IRS. The IRS and state and local tax agencies regularly audit tax returns that have been filed to verify that taxes were properly computed and paid.
- *Cash management*: Taxes must be paid on time to avoid penalties and interest. Income and self-employment taxes must be estimated and paid quarterly and reconciled on the annual return. Other taxes may be due weekly, monthly, or semiannually. Businesses must be sure they have the funds ready when the taxes are due and have procedures to track due dates.
- *Data analysis*: With a majority, if not all, of a company's records maintained in digital form, there are opportunities to use this information to enhance profits, better understand the customer base, and improve and understand the information from a tax perspective. Tax practitioners often need skills in data analysis and visualization to identify samples for both internal and external audits, find ways to identify the products and services subject to sales tax in different states, and extract tax data to help inform other business functions such as where to locate a new sales office.
- *Tax advocacy*: Taxpayers and tax practitioners can add tremendous value to the improvement and evolution of our tax laws by sharing their knowledge, experiences, and ideas with lawmakers and tax agencies. Some of this work is performed by professional organizations such as the American Institute of CPAs (AICPA), industry associations, and various policy organizations. This input might take the form of comment letters, testimony before legislative committees (delivered in person or submitted for the record), or individual correspondence and meetings.⁵

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

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

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

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

⁴For examples, see Intel's 2020–21 Corporate Responsibility Report; csrreportbuilder.intel.com/pdfbuilder/pdfs/CSR-2020-21-Full-Report.pdf; and The Walt Disney Company's 2020 Corporate Social Responsibility Report; thewaltdisneycompany.com/app/uploads/2021/02/2020-CSR-Report.pdf.

⁵For examples of such advocacy, see formal letters submitted by the AICPA (aicpa.org/advocacy/tax.html); testimony delivered at tax reform hearings in Congress (sjsu.edu/people/annette.nellen/website/

[117th-hearings.htm](https://www.117th-hearings.htm)); and tax policy activities and reports of various industry and policy organizations such as the U.S. Chamber of Commerce (uschamber.com/taxes) and the Center on Budget and Policy Priorities (cbpp.org/research/topics/federal-tax).

1-1d How to Study Taxation

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

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

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

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

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

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

1-2 A Brief History of U.S. Taxation

1-2a Early Periods

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

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

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

LO.2

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

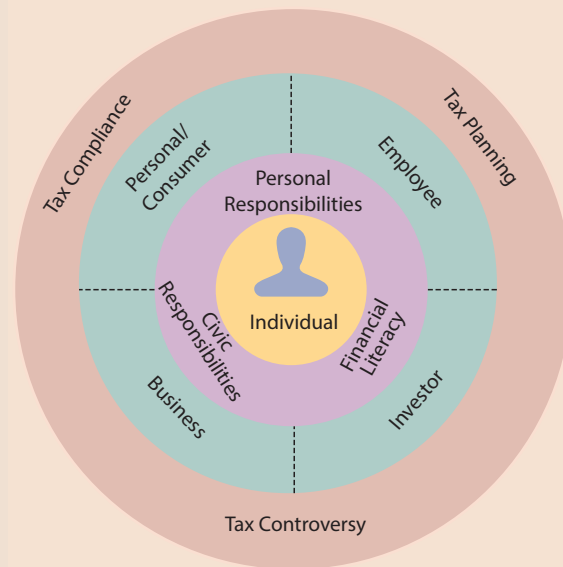


Concept Summary 1.1

Individuals and Taxes

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

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



and Trust Co., the U.S. Supreme Court found that taxes on the income of real and personal property were the legal equivalent of a tax on the property involved and, therefore, required apportionment based on the population of the United States, as required by Article I, Section 8 of the Constitution.⁶

A Federal corporate income tax, enacted by Congress in 1909, fared better in the judicial system. The U.S. Supreme Court found this tax to be constitutional because it was treated as an excise tax.⁷ In essence, it was a tax on the right to do business in the corporate form. So it was viewed as a form of the franchise tax.⁸ Since the corporate form of doing business had been developed in the late nineteenth century, it was unknown to the framers of the U.S. Constitution. Because a corporation is an entity created under law, jurisdictions possess the right to tax its creation and operation. Using this rationale, many states still impose franchise taxes on corporations.

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

1-2b Revenue Acts

After the Sixteenth Amendment was ratified by the states, Congress enacted the Revenue Act of 1913. Under this Act, the first Form 1040 was due on March 1, 1914. The law allowed various deductions and personal exemptions of \$3,000 for a single individual and \$4,000 for married taxpayers. These large exemptions excluded all but the more wealthy taxpayers from the new income tax.⁹ Rates ranged from a low of 1 percent to a high of 6 percent. The 6 percent rate applied only to taxable income in excess of \$500,000.¹⁰

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

⁷*Flint v. Stone Tracy Co.*, 3 AFTR 2834, 31 S.Ct. 342 (USSC, 1911).

⁸See the discussion of state franchise taxes later in text Section 1-4g.

⁹A \$3,000 exemption in 1913 would be about \$82,000 today, while a \$4,000 exemption would be about \$109,000.

¹⁰This should be contrasted with the highest 2022 tax rate of 37%, which applies once taxable income exceeds \$539,900 for single taxpayers and \$647,850 for married taxpayers filing a joint return.

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

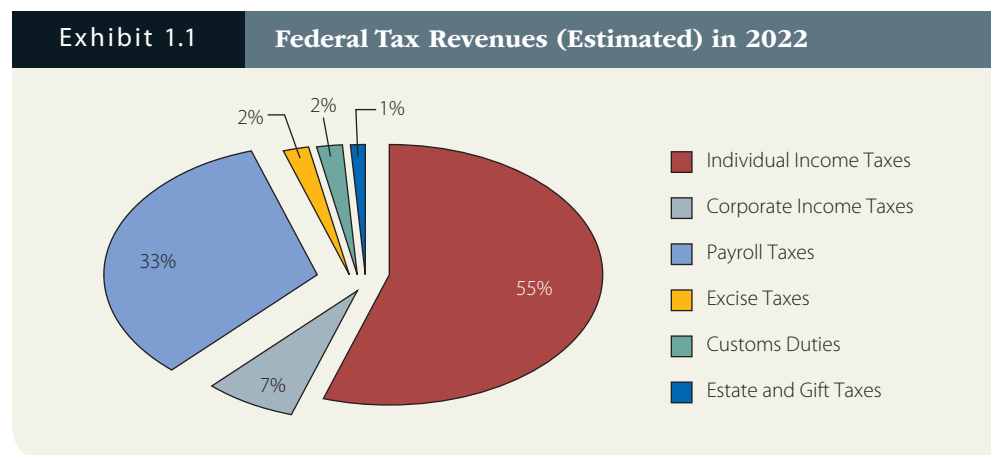
1-2c Trends

The income tax is a major source of revenue for the Federal government. Exhibit 1.1 shows the tax revenue sources¹¹ and the importance of the income tax. Income tax collections from individuals and corporations amount to 61 percent of the total receipts. One revenue source missing from the Exhibit 1.1 pie chart is borrowing to cover the deficit, which in recent years has represented between 10 to 40 percent of total government revenues.

The need for revenues to finance the war effort during World War II converted the income tax from one that applied mostly to high-income individuals to a *mass tax*. In 1939, less than 6 percent of the U.S. population was subject to the Federal income tax. By 1945, more than 74 percent of the population was subject to the Federal income tax.¹²

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

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



¹¹Revenue data can be found at [irs.gov/statistics](https://www.irs.gov/statistics), [cbo.gov](https://www.cbo.gov), and [whitehouse.gov/omb](https://www.whitehouse.gov/omb). The instruction booklet for Form 1040 includes a revenue pie chart that includes borrowing to cover the deficit, as well as a pie chart that shows government spending in broad categories.

¹²Richard Goode, *The Individual Income Tax* (Washington, D.C.: The Brookings Institution, 1964), pp. 2–4.

tax software.¹³ The IRS estimates that the average time spent by individuals to prepare and file their tax return and engage in necessary recordkeeping is 12 hours

New ways of doing business and living often require changes and/or clarifications to the tax law. For example, increased longevity requires a need for more revenues from Social Security taxes (and/or an increase in retirement age). Increased global business activity means modifying a country's tax system to be more in line with other countries to make sure businesses are not impeded when entering the global marketplace. New types of digital assets [e.g., virtual currency (or cryptocurrency) and non-fungible tokens (NFTs)] often require lawmakers or the IRS to clarify how existing tax rules apply to the new assets and related transactions. Ideally, lawmakers should review tax systems periodically to ensure that they continue to be efficient in light of changes in how businesses and individuals function.

LO.3

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

1-3 Tax System Design

1-3a Legal Foundation

Article I, Section 8 of the U.S. Constitution states in part: "The Congress shall have power to lay and collect taxes." The Constitution also provided some limits on this taxing power, which led to the enactment of the Sixteenth Amendment to allow for an income tax (discussed in text Section 1-2a). This history lesson is important for a legislature or an electorate that wants to change a tax system. The jurisdiction's underlying governing documents (whether a country, state, or city) must be reviewed to determine whether they impose any restrictions relevant to taxation.

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

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

1-3b The Basic Tax Formula

The basic formula for any tax is:

$$\text{Tax base} \times \text{Tax rate} = \text{Tax liability}$$

Tax Base

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

Tax Rates

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

¹³Most IRS instructions for forms and schedules include an estimate of the time needed to prepare the form or schedule.

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

Example

1

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

Bill and Chris, a married couple filing jointly, have taxable income of \$15,000. Their Federal income tax rate for 2022 is 10%, which is the rate that applies to the first \$20,550 of taxable income for a married couple filing jointly. Their tax liability is \$1,500.

If, however, their taxable income is \$85,000, their Federal income tax rates progress from 10% to 12% to 22% as their taxable income increases. In this case, their 2022 Federal income tax liability is \$9,934. The Federal income tax uses a *progressive* rate structure that applies higher rates to taxable income (the tax base) as that income increases (see Appendix A to confirm these calculations, and note how progressivity is built into the rate structure of the Federal income tax).

Example

2

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

1-3c Tax Principles

In the late 1700s, Adam Smith identified the following *canons (or principles) of taxation*, which are still considered today when evaluating a particular tax structure:¹⁴

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

¹⁴*The Wealth of Nations* (New York: Dutton, 1910), Book V, Chapter II, Part II.

The American Institute of Certified Public Accountants (AICPA) has issued suggestions to guide tax reform and policy activities. Titled *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, the monograph identifies 12 principles that are commonly used as indicators of desirable tax policy. The first four principles are adapted from Adam Smith's *The Wealth of Nations*. The complete list follows:¹⁵

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

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

LO.4

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

1-4 Major Types of Taxes

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

Example

3

Rick is employed by Flamingo Corporation in San Antonio, Texas, at a salary of \$74,000. Rick's employer offers him a chance to transfer to its New York City office at a salary of \$94,000.

Although Rick must consider many nontax factors before he decides on a job change, he should also evaluate the tax climate. How do state and local taxes compare? For example, neither Texas nor San Antonio imposes an income tax, but New York State and New York City do. A quick computation indicates that the additional income taxes (Federal, state, and local) involve approximately \$12,000.

continued

¹⁵AICPA, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, 2017. Similarly, see GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, 2005. As "long-standing

criteria," the GAO lists "equity; economic efficiency; and a combination of simplicity, transparency, and administrability."

Consequently, what appears to be a \$20,000 pay increase is actually only about \$8,000 when the additional \$12,000 of income taxes are taken into account. Other taxes and costs (e.g., sales taxes, property taxes, food, utilities, transportation) will also have to be factored into a decision.

Exhibit 1.2

Application of the *Guiding Principles of Good Tax Policy*

The *Guiding Principles of Good Tax Policy* can be applied to evaluate an existing tax rule or a proposed change. Here is an example of how the principles apply to a state's proposal to exempt college textbooks from sales tax.

Principle	Application	Result
Equity and fairness	Although all college students would pay no sales tax on their textbooks, the effect varies among students based on their ability to pay. This proposal provides tax savings not only to lower-income students but also to higher-income students who may not need the tax break to cover school costs. Also, higher-income students might buy full-price new books rather than lower-cost used books, resulting in larger tax savings.	Not fully met
Certainty	College textbooks can be identified, such as by looking at what is listed on a course syllabus.	Met
Convenience of payment	A sales tax exemption generally means that the tax is not owed at the time of purchase. If, instead, the exemption is structured for the student to pay the sales tax and apply for a refund later, convenience of payment would not be met.	Met
Effective tax administration	Sellers will have additional record keeping and reporting requirements to separate tax-exempt textbook sales from taxable sales. Some type of system is needed to prove that the buyer is a student purchasing a book for a college class. The state tax agency will incur additional time and costs in writing rules, modifying tax forms, and auditing compliance with the new rule.	Not met
Information security	If obtaining the exemption requires that students show proof to retailers that they are a student, there should be no need to provide a Social Security number. If students are required to claim the exemption with the state tax agency after purchasing the textbooks, the agency might request a student's Social Security number, which could increase the risk of identity theft.	Likely met
Simplicity	"Textbook" needs to be defined. The intent of the exemption is to benefit students. The seller needs to verify that the book is for use by a student for a class. For example, both students and nonstudents might buy a copy of <i>Romeo and Juliet</i> . Only the student purchasing it for a college class is entitled to the sales tax exemption. Complexity exists in the procedures needed to ensure that the exemption is used properly.	Not met
Neutrality	Students purchase textbooks because they are needed for class. The exemption is unlikely to change a student's behavior.	Met
Economic growth and efficiency	The exemption will reduce costs of attending college by a small amount. As a result, the change is unlikely to result in a greater number of college graduates (which might benefit the economy). Savings from not paying sales tax might be spent on other consumables. The impact on the economy is likely minor.	Met
Transparency and visibility	Students and textbook sellers are likely to be aware of the exemption because colleges will promote it as a reduction in the cost of attending college.	Met
Minimum tax gap	Students may abuse the rule by using the exemption for books that are not for class use. Nonstudents may abuse this rule by claiming they are college students.	Not met
Accountability to taxpayers	Were students and universities, particularly those funded by the state, aware of the textbook sales tax exemption proposal? Students and universities could provide information to legislators on whether there is a need for a sales tax exemption or if other financial support would be more helpful. Bookstores would want an opportunity to provide information on the compliance costs and challenges of the exemption.	More information needed
Appropriate government revenue	Existing data on how many textbooks are purchased enable the government to estimate how much tax revenues will decrease due to the new exemption.	Met

Conclusion: Although the majority of the principles are met, the ones that are not met (effective tax administration, simplicity, and minimum tax gap) are significant. If lawmakers believe this tax exemption is necessary to help lower costs for college students, they should consider alternative means of achieving the goal that are less complex. For example, grants could be offered or increased for college students in need of financial assistance.

1-4a **Property Taxes**

Correctly referred to as **ad valorem taxes** because they are based on value, property taxes are a tax on wealth, or capital. As a result, they have much in common with estate taxes and gift taxes discussed later in the chapter. Although property taxes do not tax income, the income actually derived from the property (or the potential for any income) may be relevant if it affects the value of the property being taxed.

Property taxes fall into *two* categories: those imposed on real property (land and buildings) and those imposed on personal property (assets other than land and buildings). Both have added importance because they often generate a deduction for Federal income tax purposes (see Chapter 10).

Ad Valorem Taxes on Real Property

Property taxes on real property are used exclusively by states and their local subdivisions (such as cities, counties, and school districts). They represent a major source of revenue for *local* governments (and school districts).

How real property is defined can have an important bearing on which assets are subject to tax. This is especially true in jurisdictions that do not impose ad valorem taxes on personal property. Real property, or **realty**, generally includes real estate and any fixtures. A *fixture* is something so permanently attached to the real estate that its removal will cause irreparable damage. A built-in bookcase is likely a fixture, whereas a movable bookcase is not. Electrical wiring and plumbing become realty when they are installed in a building.

Here are some of the characteristics of ad valorem taxes on real property:

- Property owned by the Federal government is exempt from tax. In general, the same is true for property owned by state and local governments and by charitable organizations.
- Some states provide for lower valuations on property used for agriculture or other special uses (e.g., wildlife sanctuaries).
- States may have a homestead exemption, which makes some portion of the value of a personal residence exempt from tax.
- Lower taxes may apply to a residence owned by a taxpayer aged 65 or older.
- When non-income-producing property (e.g., a personal residence) is converted to income-producing property (e.g., a rental house), the appraised value may be increased.

The Big Picture

Example

4

Return to the facts of *The Big Picture* on p. 1-1. Why did the Walkers' property taxes decrease but those of the Carters increase?

A likely explanation is that one (or both) of the Walkers achieved senior citizen status, leading to a reduction of their property taxes. In the case of the Carters, the assessed value of their property might have increased due to property values increasing in their location. Or perhaps they made significant home improvements (e.g., kitchen/bathroom renovation or addition of a deck) that increased the value (tax base) of the home.

Ad Valorem Taxes on Personal Property

Personal property, or **personalty**, can be defined as all property that is not realty. There is a difference between how property is *classified* (realty or personalty) and how it is *used*. Both realty and personalty can be either business use or personal use property. Examples include a residence (realty that is personal use), an office building (realty that is business use), surgical instruments (personalty that is business use), and home furniture (personalty that is personal use).¹⁶

¹⁶The distinction, important for ad valorem and for Federal income tax purposes, often becomes confusing when personalty is referred to as "personal" property to distinguish it from "real" property. This designation does not

give a complete picture of what is involved. The description "personal" residence, however, is clearer, because a residence can be identified as being realty. What is meant in this case is realty that is personal use property.