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South-Western Federal Taxation

Individual Income Taxes

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

Young • Nellen
Raabe • Persellin
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2023

2021 Tax Rate Schedules

Single—Schedule X

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 9,950	.........10%	**$ 0**
9,950	40,525	**$ 995.00 + 12%**	**9,950**
40,525	86,375	**4,664.00 + 22%**	**40,525**
86,375	164,925	**14,751.00 + 24%**	**86,375**
164,925	209,425	**33,603.00 + 32%**	**164,925**
209,425	523,600	**47,843.00 + 35%**	**209,425**
523,600	....	**157,804.25 + 37%**	**523,600**

Head of household—Schedule Z

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 14,200	.........10%	**$ 0**
14,200	54,200	**$ 1,420.00 + 12%**	**14,200**
54,200	86,350	**6,220.00 + 22%**	**54,200**
86,350	164,900	**13,293.00 + 24%**	**86,350**
164,900	209,400	**32,145.00 + 32%**	**164,900**
209,400	523,600	**46,385.00 + 35%**	**209,400**
523,600	....	**156,355.00 + 37%**	**523,600**

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

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 19,900	.........10%	**$ 0**
19,900	81,050	**$ 1,990.00 + 12%**	**19,900**
81,050	172,750	**9,328.00 + 22%**	**81,050**
172,750	329,850	**29,502.00 + 24%**	**172,750**
329,850	418,850	**67,206.00 + 32%**	**329,850**
418,850	628,300	**95,686.00 + 35%**	**418,850**
628,300	....	**168,993.50 + 37%**	**628,300**

Married filing separately—Schedule Y–2

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 9,950	.........10%	**$ 0**
9,950	40,525	**$ 995.00 + 12%**	**9,950**
40,525	86,375	**4,664.00 + 22%**	**40,525**
86,375	164,925	**14,751.00 + 24%**	**86,375**
164,925	209,425	**33,603.00 + 32%**	**164,925**
209,425	314,150	**47,843.00 + 35%**	**209,425**
314,150	....	**84,496.75 + 37%**	**314,150**

2022 Tax Rate Schedules

Single—Schedule X

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 10,275	.........10%	**$ 0**
10,275	41,775	**$ 1,027.50 + 12%**	**10,275**
41,775	89,075	**4,807.50 + 22%**	**41,775**
89,075	170,050	**15,213.50 + 24%**	**89,075**
170,050	215,950	**34,647.50 + 32%**	**170,050**
215,950	539,900	**49,335.50 + 35%**	**215,950**
539,900	....	**162,718.00 + 37%**	**539,900**

Head of household—Schedule Z

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 14,650	.........10%	**$ 0**
14,650	55,900	**$ 1,465.00 + 12%**	**14,650**
55,900	89,050	**6,415.00 + 22%**	**55,900**
89,050	170,050	**13,708.00 + 24%**	**89,050**
170,050	215,950	**33,148.00 + 32%**	**170,050**
215,950	539,900	**47,836.00 + 35%**	**215,950**
539,900	....	**161,218.50 + 37%**	**539,900**

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

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 20,550	.........10%	**$ 0**
20,550	83,550	**$ 2,055.00 + 12%**	**20,550**
83,550	178,150	**9,615.00 + 22%**	**83,550**
178,150	340,100	**30,427.00 + 24%**	**178,150**
340,100	431,900	**69,295.00 + 32%**	**340,100**
431,900	647,850	**98,671.00 + 35%**	**431,900**
647,850	....	**174,253.50 + 37%**	**647,850**

Married filing separately—Schedule Y–2

If taxable income is: Over—	But not over—	The tax is:	of the amount over—
$ 0	$ 10,275	.........10%	**$ 0**
10,275	41,775	**$ 1,027.50 + 12%**	**10,275**
41,775	89,075	**4,807.50 + 22%**	**41,775**
89,075	170,050	**15,213.50 + 24%**	**89,075**
170,050	215,950	**34,647.50 + 32%**	**170,050**
215,950	323,925	**49,335.50 + 35%**	**215,950**
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).

Individual Income Taxes 2023

General Editors

James C. Young
Ph.D., CPA

Annette Nellen
J.D., CPA, CGMA

William A. Raabe
Ph.D., CPA

Mark B. Persellin
Ph.D., CPA, CFP®

Sharon S. Lassar
Ph.D., CPA

Andrew D. Cuccia
Ph.D., CPA

Bradrick M. Cripe
Ph.D., CPA

Contributing Authors

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

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

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

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

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

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

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

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

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

William A. Raabe
Ph.D., CPA
Philadelphia, Pennsylvania

Toby Stock
Ph.D., CPA
Ohio University

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

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

Cengage

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***South-Western Federal Taxation: Individual Income Taxes,* 2023 Edition**

James C. Young, Annette Nellen, William A. Raabe, Mark B. Persellin, Sharon S. Lassar, Andrew D. Cuccia, Bradrick M. Cripe

SVP, Product: Erin Joyner

VP, Product: Thais Alencar

Product Director: Joe Sabatino

Product Manager: Jonathan Gross

Product Assistant: Flannery Cowan

Learning Designer: Kristen Meere

Sr. Content Manager: Nadia Saloom

Digital Project Manager: Steven McMillan

VP, Product Marketing: Jason Sakos

Director, Product Marketing: Danae April

Product Marketing Manager: Colin M. Kramer

IP Analyst: Ashley Maynard

IP Project Manager: Nick Barrows

Production Service: Straive

Designer: Chris Doughman

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Cengage
200 Pier 4 Boulevard
Boston, MA 02210
USA

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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.

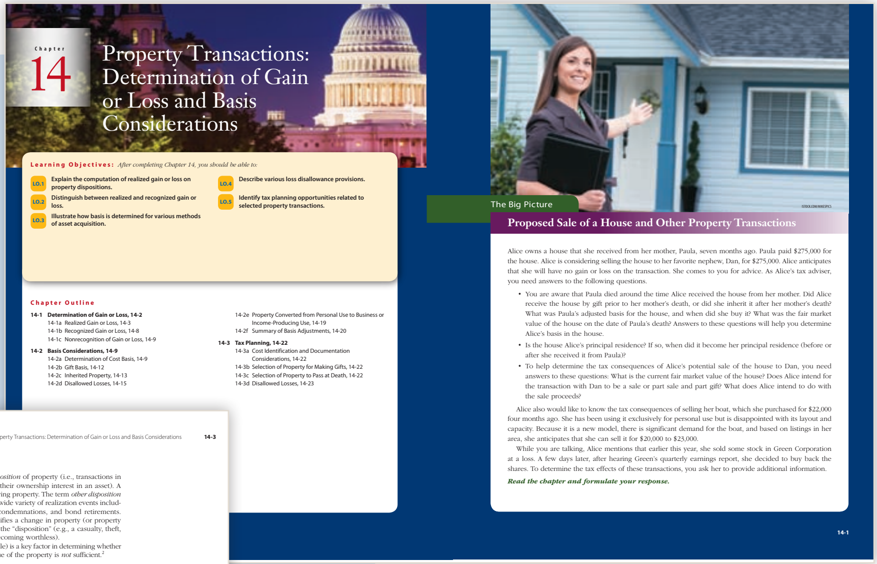
In addition, *Individual Income Taxes*, 2023 Edition provides accessible, comprehensive, and authoritative coverage of the relevant tax code and regulations as they pertain to the individual taxpayer, as well as coverage of all major developments in Federal taxation.

In revising the 2023 Edition, we focused on:

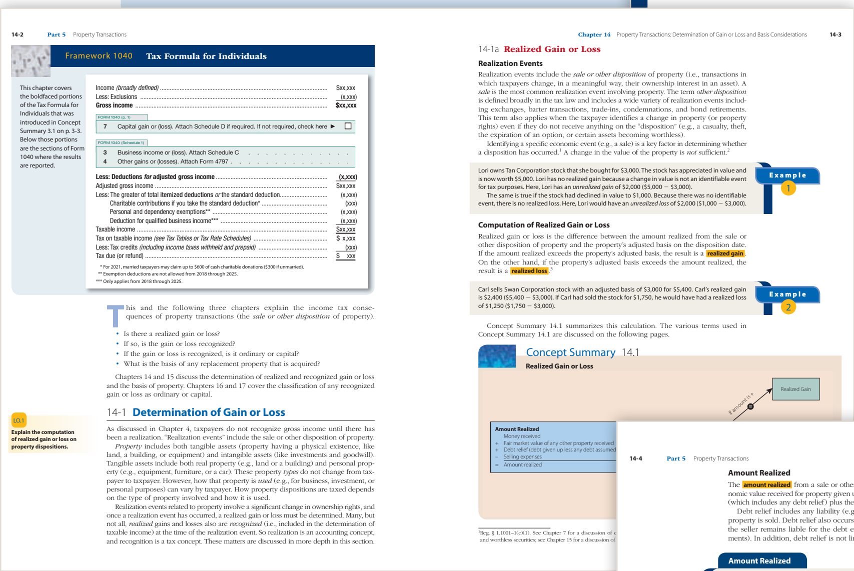
- ***Accessibility. Clarity. Substance.*** The authors and editors made this their focus as they revised the 2023 edition. Coverage has been streamlined to make it more accessible to students, and difficult concepts have been clarified, all without losing the substance that makes up the *South-Western 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.

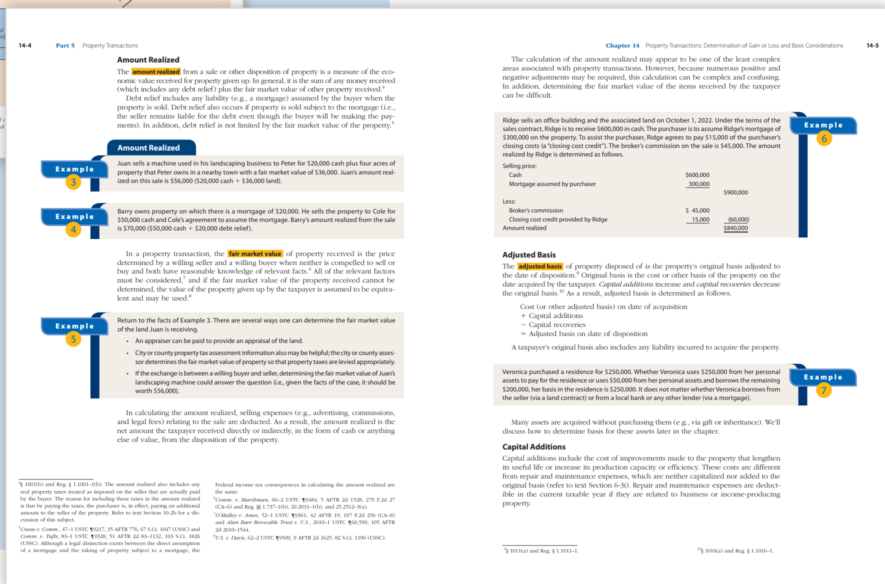
Learning Tools and Features to Help Students Make the Connection

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



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





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

Computational Exercises: Students need to learn to apply the rules and concepts covered in each chapter to truly understand them. These exercises, many of which mirror text examples, allow students to practice and apply what they are learning.

- ❑ Found in the end-of-chapter sections of the textbook
- ❑ 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

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Becker CPA Review Questions

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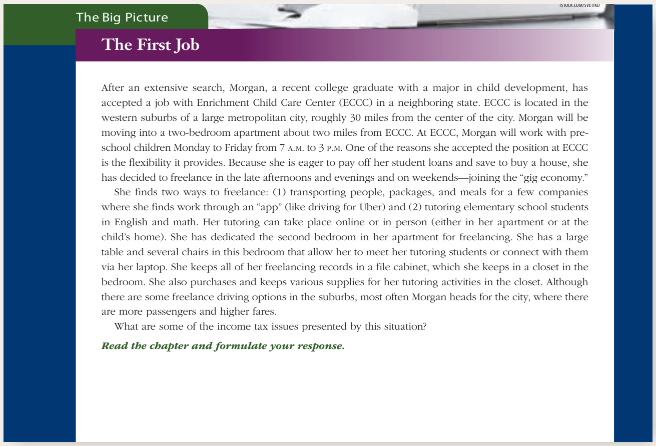
1. Jasmin purchased 100 shares of Pinkstey Corporation (publicly traded company) on January 1 of year 1 for $5,000. The FMV of the shares at the end of year 1 was $6,000. On January 1 of year 4, Pinkstey Corporation declared a 2-for-1 stock split when the fair market value of the stock was $65 per share. 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

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 pre-school children Monday to Friday from 7 A.M. to 3 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.**

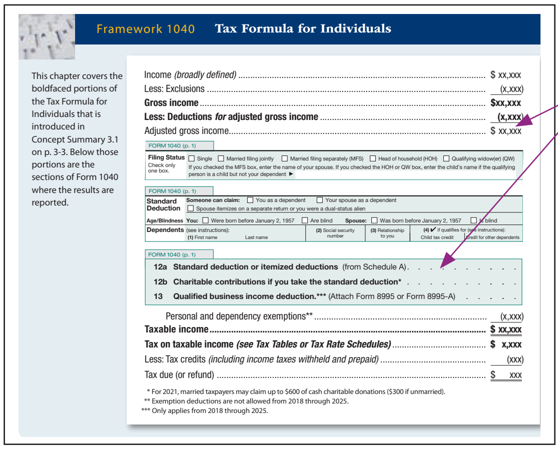
Taxation comes alive at the start of each chapter as The Big Picture examples provide a glimpse into the lives, families, careers, and tax situations of typical taxpayers. Students will follow a family, individual, or other taxpayer throughout the chapter, to discover how the concepts they are learning 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

FORM 1040 (p. 1)

Filing Status Check only one box. ☐ Single ☐ Married filing jointly ☐ Married filing separately (MFS) ☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)
If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

FORM 1040 (p. 1)

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien
Age/Blindness **You:** ☐ Were born before January 2, 1957 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1957 ☐ Is blind
Dependents (see instructions): **(1)** First name Last name | **(2)** Social security number | **(3)** Relationship to you | **(4)** ✔ if qualifies for (see instructions): Child tax credit | Credit for other dependents

FORM 1040 (p. 1)

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.

> LO.11
>
> **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 "worldwide 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.

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APPLICATION
MOTIVATION

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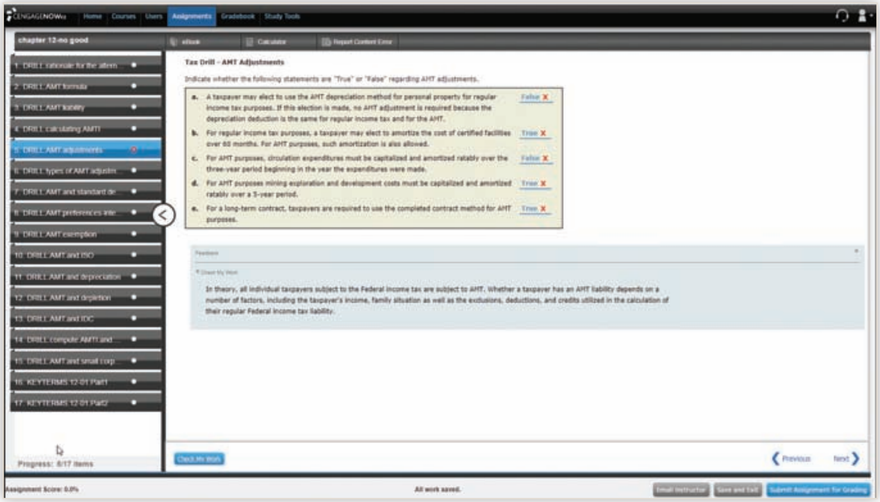

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Students need to learn problem-solving behavior and skills, to guide them to complete taxation problems on their own. However, as students try to work through homework problems, sometimes they become stuck and need extra help. To reinforce concepts and keep students on the right track, CNOWv2 for SWFT offers the following:

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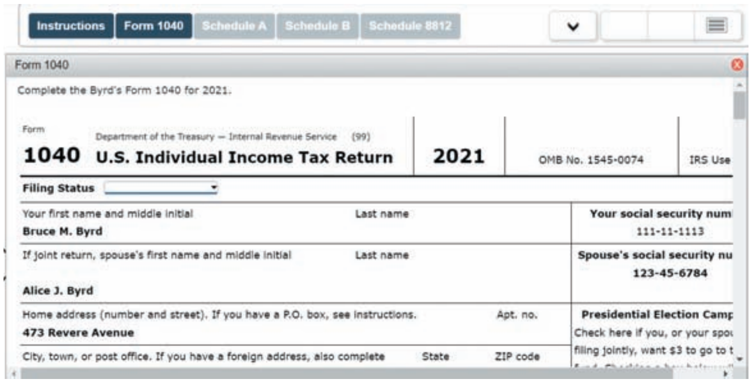

Extensively Revised. Definitively Up to Date.

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

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

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- Add your own material to cover additional topics or information.
- Add relevance by including sections from Sawyers/Gill's *Federal Tax Research* or your state's tax laws and regulations.

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Mark P. Altieri, *Kent State University*
Susan E. Anderson, *Elon University*
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Candace Witherspoon, *Valdosta State University*
Sheila Woods, *DeVry University, Houston, TX*
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Thomas Young, *Lone Star College – Tomball*

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Robyn Dawn Jarnagin, *University of Arkansas*
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George R. Starbuck, *McMurry University*
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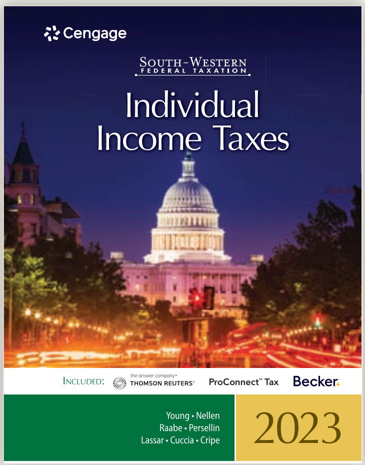

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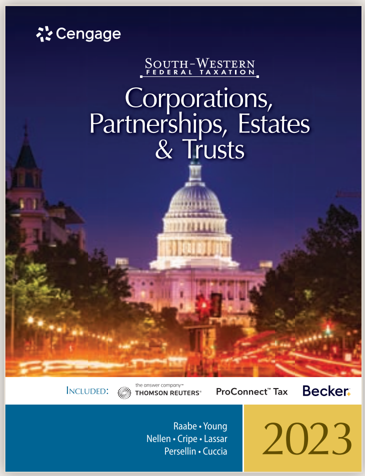

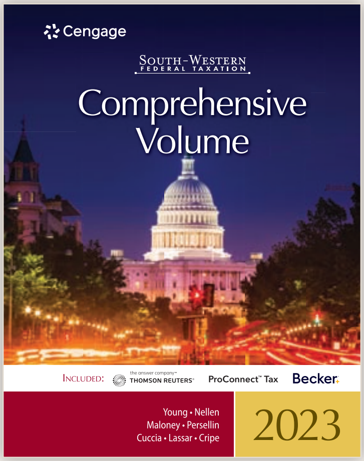

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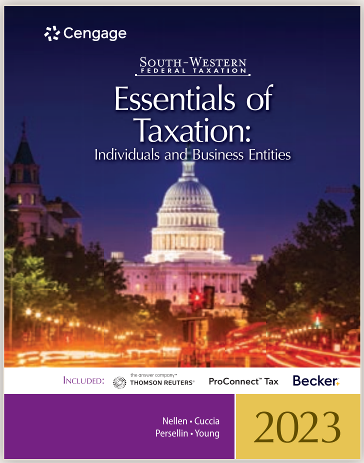

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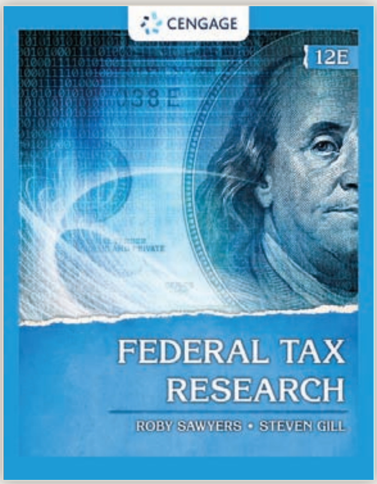

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About the Editors

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

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

William A. Raabe, Ph.D., CPA, was the Wisconsin Distinguished Professor of Taxation. He taught at Ohio State, Arizona State, the Capital University (OH) Law School, and the Universities of Wisconsin – Milwaukee and Whitewater. A graduate of Carroll University (Wisconsin) and the University of Illinois, Dr. Raabe has been a visiting tax faculty member for a number of public accounting firms, bar associations, and CPA societies. He has received numerous teaching awards, including the Accounting Educator of the Year award from the Wisconsin Institute of CPAs.

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

Sharon S. Lassar, Ph.D., CPA (Florida), is the John J. Gilbert Professor and Director of the School of Accountancy at The University of Denver. Dr. Lassar earned her Ph.D. at the University of Southern California, her Master of Taxation at Bentley University, and her Bachelor's in Accounting from West Virginia University. Prior to joining the University of Denver, Dr. Lassar was the Director of the School of Accounting at Florida International University and previously served on the faculties of Florida Atlantic University and the University of Arizona. She began her career with a Big 4 firm. Dr. Lassar has served the profession in many ways, most recently as a member of the AICPA Council. Dr. Lassar is a past president of the Accounting Programs Leadership Group and Past Chair of the Colorado Society of CPAs. Dr. Lassar also served on the Accounting Accreditation Task Force of AACSB International whose work resulted in new standards for accreditation, the hallmark of them being fully engaging practitioners in the accreditation process.

Andrew D. Cuccia, Ph.D., CPA, is the Steed Professor of Accounting at the University of Oklahoma. He is a graduate of Loyola University, New Orleans (B.B.A.) and the University of Florida (Ph.D.). Prior to entering academia, Andy practiced as a CPA with a Big 4 accounting firm. Before joining the University of Oklahoma, he was on the faculty at Louisiana State University and the University of Illinois. His research focusses on taxpayer and tax professional judgment and decision making and has been published in several journals including *The Accounting Review,* the *Journal of Accounting Research,* the *Journal of the American Taxation Association,* and *Tax Notes*. He has taught undergraduate and graduate courses in income tax fundamentals as well as graduate courses in corporate tax, tax policy, and tax research. Andy is a past president of the American Taxation Association and a member of the American Accounting Association, the National Taxation Association, and the AICPA.

Bradrick M. Cripe, Ph.D., CPA, is a Presidential Teaching Professor and the Donald E. Kieso Endowed Chair of Accountancy at Northern Illinois University. He is a graduate of New Mexico State University (B.A., B.C.J., and M.Acc.) and the University of Nebraska-Lincoln (Ph.D.). Prior to receiving his Ph.D. in 2006, he worked on the tax staff of a Big 4 accounting firm. Professor Cripe teaches courses in taxation and business strategy, corporate taxation, international taxation, and advanced issues in taxation. He has published in *The Accounting Review, Issues in Accounting Education, Journal of Accountancy, Tax Notes*, and other academic and practitioner journals.

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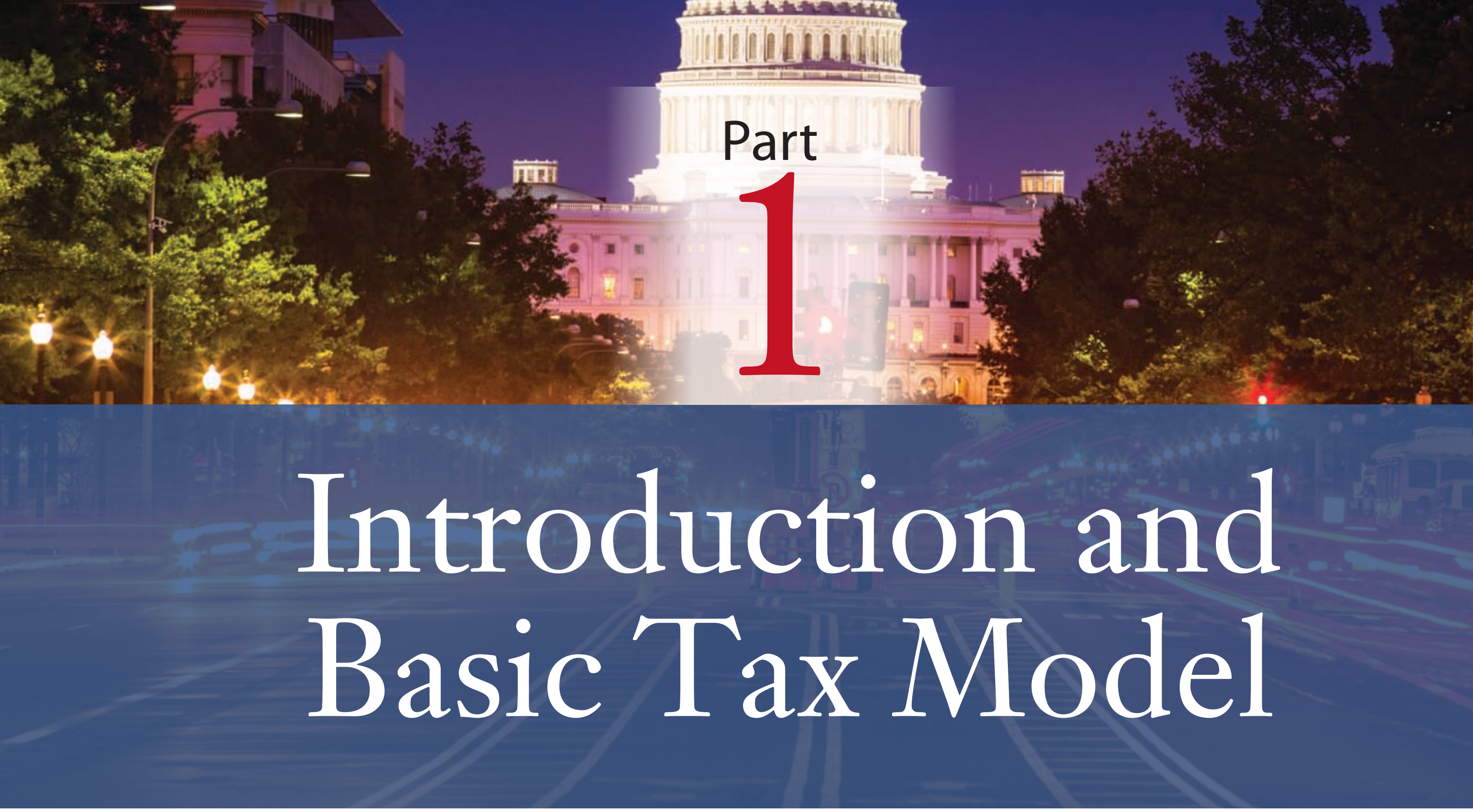


Part 1

Introduction and Basic Tax Model

Chapter **1**

An Introduction to Taxation and Understanding the Federal Tax Law

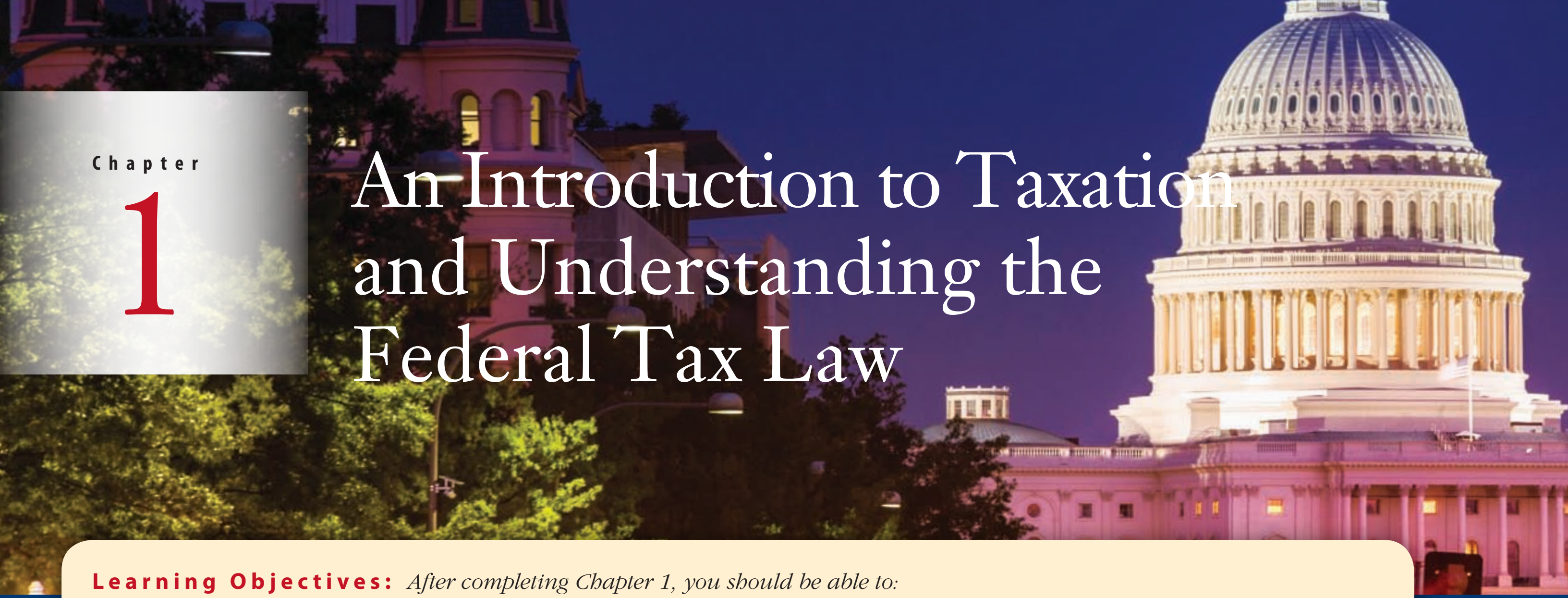
Chapter **2**

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.



Chapter 1

An Introduction to Taxation and Understanding the Federal Tax Law

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

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

Chapter Outline

The Big Picture

Family and Taxes—A Typical Year

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

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

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

Explain these developments, and resolve the issues raised.

Read the chapter and formulate your response.

This chapter provides an 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.

1-1 Approaching the Study of Taxation

LO.1

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

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

[2] A 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.

[3] For 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).

[4]For 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**.

[5]For 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**); 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

LO.2

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

1-2a Early Periods

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

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

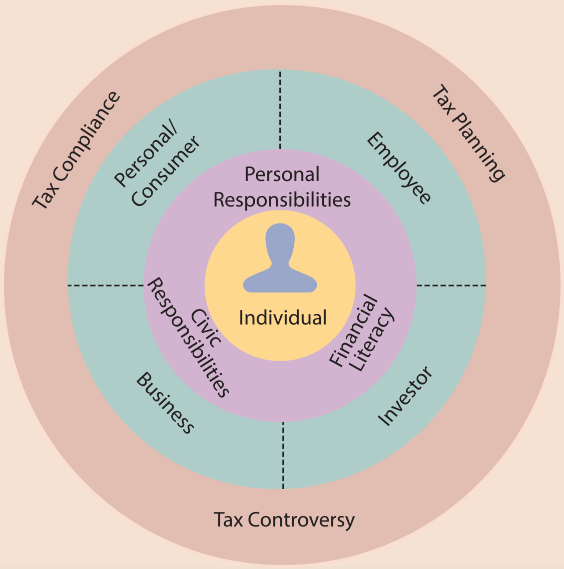
When a new Federal income tax on individuals was enacted in 1894, its opponents were prepared to successfully challenge its constitutionality. In *Pollock v. Farmers' Loan*

Concept Summary 1.1

Individuals and Taxes

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

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



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

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[6] 3 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).

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

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

[10] This 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

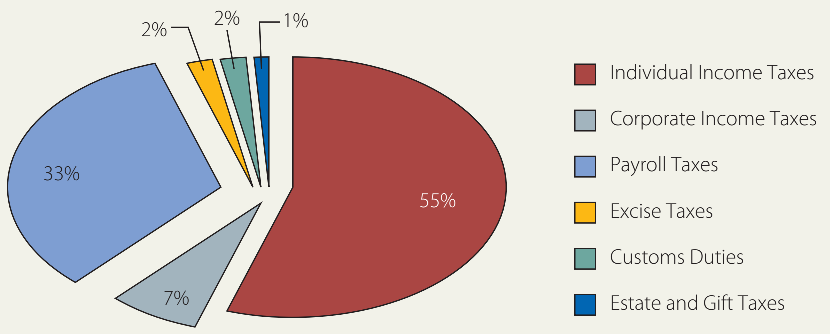
The income tax is a major source of revenue for the Federal government. Exhibit 1.1 shows the tax revenue sources[11] and the importance of the income tax. Income tax collections from individuals and corporations amount to 61 percent of the total receipts. One revenue source missing from the Exhibit 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

Exhibit 1.1 **Federal Tax Revenues (Estimated) in 2022**



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

[12] Richard 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:

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

Tax Base

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

Tax Rates

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

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

Example 1

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

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

Example 2

Bill and 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).

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

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

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 *Romeo and Juliet*. 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]

[16]The 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.