

Cruz | Deschamps | Niswander | Prendergast | Schisler

Fundamentals of Taxation

2019 EDITION



Mc
Graw
Hill
Education

Surgent
EAreview

TaxACT



Fundamentals of Taxation

2019



Fundamentals of Taxation

2019

Ana Cruz

Miami Dade College

Michael Deschamps

MiraCosta College

Frederick Niswander

East Carolina University

Debra Prendergast

Prairie State College

Dan Schisler

East Carolina University



FUNDAMENTALS OF TAXATION 2019 EDITION, TWELFTH EDITION

Published by McGraw-Hill Education, 2 Penn Plaza, New York, NY 10121. Copyright © 2019 by McGraw-Hill Education. All rights reserved. Printed in the United States of America. Previous editions © 2018, 2017, and 2016. No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written consent of McGraw-Hill Education, including, but not limited to, in any network or other electronic storage or transmission, or broadcast for distance learning.

Some ancillaries, including electronic and print components, may not be available to customers outside the United States.

This book is printed on acid-free paper.

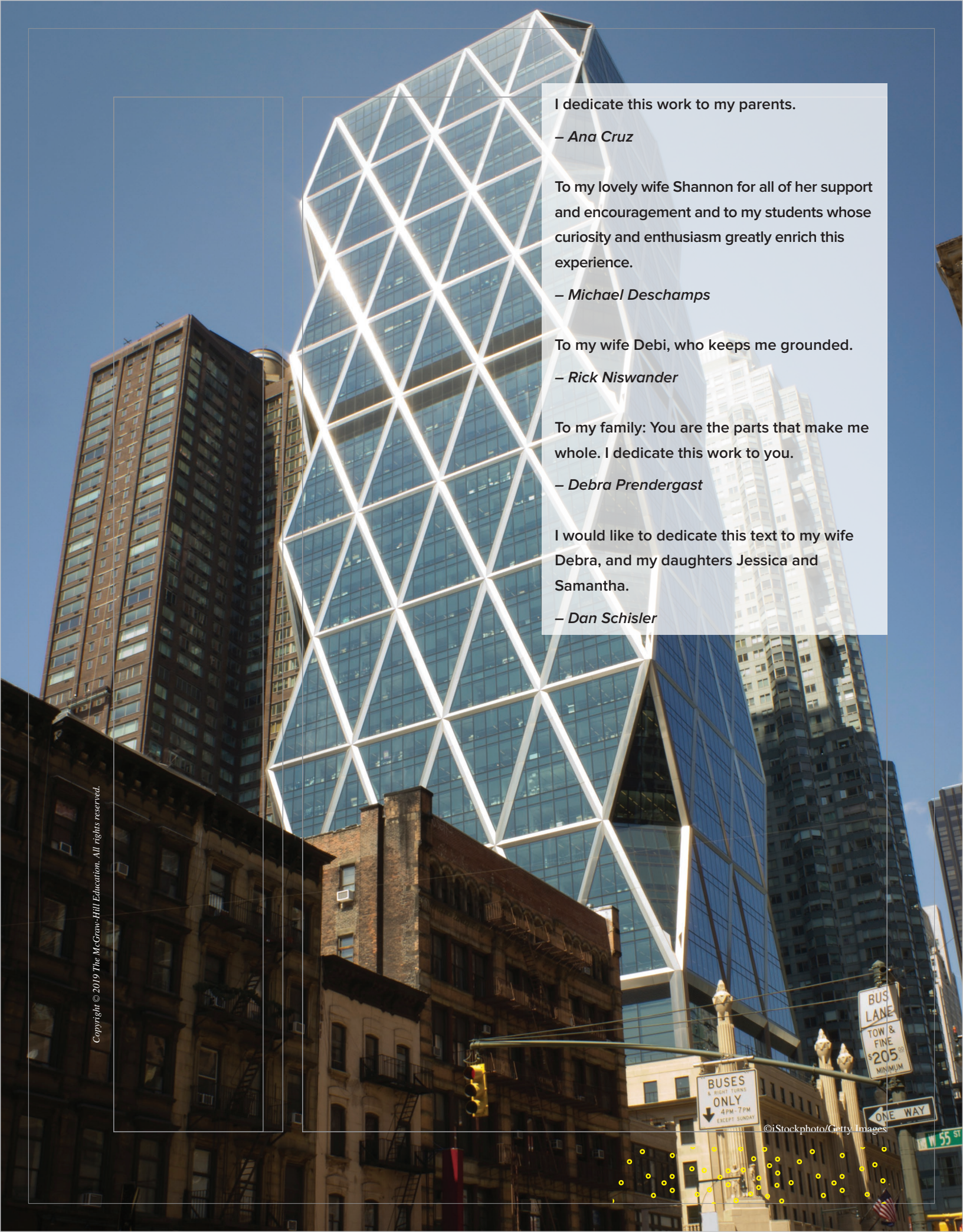
1 2 3 4 5 6 7 8 9 LMN 21 20 19 18

ISBN 978-1-259-91708-0 (bound edition)
MHID 1-259-91708-8 (bound edition)
ISBN 978-1-260-15867-0 (loose-leaf edition)
MHID 1-260-15867-5 (loose-leaf edition)
ISSN 1993-8066

Executive Portfolio Manager: *Kathleen Klehr*
Product Developers: *Jaroslav Szymanski / Katherine Ward*
Marketing Manager: *Zachary Rudin*
Content Project Managers: *Dana M. Pauley / Angela Norris*
Senior Buyer: *Susan K. Culbertson*
Senior Designer: *Matt Backhaus*
Content Licensing Specialist: *Melissa Homer*
Cover Image: ©Purestock/SuperStock (*Young Couple*); ©kristian sekulic/Getty Images (*Family*);
©Getty Images/iStockphoto (*Skyscraper*); ©Robert Nicholas/age fotostock (*Business people*);
©f11photo/Shutterstock (*U.S. Capital building*)
Compositor: *SPi Global*

All credits appearing on page or at the end of the book are considered to be an extension of the copyright page.

The Internet addresses listed in the text were accurate at the time of publication. The inclusion of a website does not indicate an endorsement by the authors or McGraw-Hill Education, and McGraw-Hill Education does not guarantee the accuracy of the information presented at these sites.



I dedicate this work to my parents.

– *Ana Cruz*

To my lovely wife Shannon for all of her support and encouragement and to my students whose curiosity and enthusiasm greatly enrich this experience.

– *Michael Deschamps*

To my wife Debi, who keeps me grounded.

– *Rick Niswander*

To my family: You are the parts that make me whole. I dedicate this work to you.

– *Debra Prendergast*

I would like to dedicate this text to my wife Debra, and my daughters Jessica and Samantha.

– *Dan Schisler*

Updates to the 2019 Edition

©Blend Images/Image Source

Changes to the 2019 edition as a result of the Tax Cuts and Jobs Act of 2017 include the following:



NEW LAW

For 2018 the standard deduction for each filing status has increased.

The New Law marginal boxes in applicable chapters alert students and instructors to key changes in tax law for the current year's textbook.

Chapter 1

- Income tax rates and applicable taxable income ranges will change for all taxpayers.
- The standard deduction increases to \$24,000 for married taxpayers and \$12,000 for single taxpayers.
- The Affordable Care Act penalty for lack of qualifying coverage will expire for tax year 2019 and later.

Chapter 2

- Income tax rates and applicable taxable income ranges will change for all taxpayers.
- The standard deduction increases to \$24,000 for married, \$12,000 for single, and \$18,000 for head of household. The additional standard deduction for elderly and blind remains.
- The personal exemption is eliminated.

Chapter 3

- Income tax rates and applicable taxable income ranges will change for all taxpayers.
- Moving expense reimbursements are no longer excluded from gross income.
- Qualified tuition program withdrawals can be used for tuition at elementary or secondary schools.

Chapter 4

- Income tax rates and applicable taxable income ranges will change for all taxpayers.
- Moving expenses are no longer deductible, except for military personnel moving because of orders related to a permanent change of duty station.
- For divorce agreements executed or modified after December 31, 2018, alimony payments are not deductible, and receipts are not taxable. Existing unmodified agreements will be grandfathered under currently-existing rules.

Chapter 5

- Income tax rates and applicable taxable income ranges will change for all taxpayers.
- Medical expenses are an itemized deduction to the extent they exceed 7.5% of AGI in 2018. The threshold will be 10% in 2019 and later.
- The itemized deduction for state & local taxes is limited to a maximum of \$10,000. This includes state or local income tax, sales tax, and property tax.
- Interest expense on home equity indebtedness is no longer deductible except in limited circumstances.
- Mortgage interest is deductible only on home acquisition indebtedness of \$750,000 or less, down from \$1 million. This change is effective for new indebtedness incurred on or after 12/15/17.
- The itemized deduction for mortgage insurance premiums has been eliminated.
- The AGI limitation for cash contributions to public charities is increased to 60% from 50%.
- An itemized deduction for casualty & theft losses is only permitted if the losses were attributable to a presidentially-declared federal disaster.
- All miscellaneous itemized deductions (those subject to a limitation of 2% of AGI) are no longer permitted.
- The limitation to total itemized deductions for high-income taxpayers (the "Pease" limitation) is eliminated.

Chapter 6

- For businesses with average annual gross receipts (in prior 3 years) over \$25 million, business interest expense is only allowed to the extent it does not exceed 30% of Adjusted Taxable Income (ATI). In general, ATI is taxable income before interest, depreciation, amortization, and depletion.
- For property acquired and placed in service after 9/27/17, the bonus depreciation percentage is increased from 50% to 100%, effectively resulting in full deduction for property so acquired. Applies to new or used property.
- Section 179 depreciation deduction limit increased to \$1 million from \$500,000. This limit is reduced dollar-for-dollar if Section 179 property placed in service in the year exceeds \$2.5 million.
- No deduction is allowed for expenses related to business entertainment, amusement, and recreation. Membership dues are not deductible. 50% limit for food and beverage expenses of trade or business remains. However, meals provided as de minimis fringe or for the convenience of the employer are deductible only at 50%.
- No deduction is allowed for the cost of providing qualified parking and transportation fringe benefits to employees. These items remain a nontaxable fringe benefit to employees.



©Blend Images/Image Source

- Depreciation limits are increased for luxury autos placed in service in 2018 or later.
- Taxpayers are allowed deduction of 20% of income from a partnership, Sub S, or sole proprietorship. The deduction is a “from AGI” deduction, but is not an itemized deduction. Deduction may be limited for taxpayers with income over \$315,000 (married filing jointly) or \$157,500 (all other taxpayers). Deduction does not reduce income subject to self-employment tax.
- Home office expenses of employees are no longer deductible. Previously, these were reported as a miscellaneous itemized deduction. Home office expenses of self-employed taxpayers are still permitted.

Chapter 7

- Income tax rates and applicable taxable income ranges will change for all taxpayers.
- The income breakpoints for taxability of net capital gains and qualified dividends have increased.
 - Capital gains/dividends are taxed at 0% for taxable income less than \$77,200 (MFJ), \$51,700 (HoH), or \$38,600 (all other taxpayers).
 - Then, capital gains/dividends are taxed at 15% for income up to \$479,000 (MFJ), \$239,500 (MFS), \$452,400 (HoH), or \$425,800 (single).
 - Above those amounts, capital gains/dividends are taxed at 20%.

Chapter 8

- Income tax rates and applicable taxable income ranges will change for all taxpayers.
- Taxpayers are allowed deduction of 20% of income from a partnership, Sub S, or sole proprietorship. The deduction is a “from AGI” deduction, but is not an itemized deduction. Deduction may be limited for taxpayers with income over \$315,000 (married filing jointly) or \$157,500 (all other taxpayers). Deduction does not reduce income subject to self-employment tax.

Chapter 9

- Income tax rates and applicable taxable income ranges will change for all taxpayers.
- Child Tax Credit is increased to \$2,000 per child (up from \$1,000), of which \$1,400 is refundable. Adds a \$500 nonrefundable credit for qualifying dependents other than children. Phase out limits increased to \$400,000 for married filing jointly and \$200,000 for single taxpayers.

Chapter 11

- Section 529 plans can now be used for qualified expenses for elementary and secondary schools.

Chapter 12

- Like-kind exchange treatment (Section 1031) is limited only to real property.

Chapter 13

- AMT exemption amounts and phase-out thresholds are increased for all individual taxpayers.

Chapter 14

- For businesses with average annual gross receipts (in prior 3 years) over \$25 million, business interest expense is only allowed to the extent it does not exceed 30% of Adjusted Taxable Income (ATI). In general, ATI is taxable income before interest, depreciation, amortization, and depletion.
- Taxpayers are allowed deduction of 20% of income from a partnership, Sub S, or sole proprietorship. The deduction is a “from AGI” deduction, but is not an itemized deduction. Deduction may be limited for taxpayers with income of \$315,000 (married filing jointly) or \$157,500 (all other taxpayers). Deduction does not reduce income subject to self-employment tax.

Chapter 15

- The corporate tax rate has been reduced to a flat 21%.
- The corporate alternative minimum tax is repealed.
- The 80% dividend received deduction is reduced to 65% and the 70% dividends received deduction is reduced to 50%.
- For businesses with average annual gross receipts (in prior 3 years) over \$25 million, business interest expense is only allowed to the extent it does not exceed 30% of Adjusted Taxable Income (ATI). In general, ATI is taxable income before interest, depreciation, amortization, and depletion.
- For net operating losses (NOLs) created in 2018 and later: (a) loss carryback is not permitted, (b) any loss carryforward is limited to 80% of taxable income in the carryforward year, and (c) unused carryforwards do not expire. NOLs created in tax year 2017 or before are accounted for in accordance with pre-2018 rules. The rules related to capital loss carrybacks and carryforwards are not changed.
- Gross receipt threshold to permit use of cash basis accounting increases from \$5 million to \$25 million. Also, if business has inventories and is under the same \$25 million threshold, it can account for inventories as either non-incidental materials and supplies (thus permitting the cash basis) or the business can use the inventory method used in their financial statements.

Chapter-by-chapter enhancements that have been made in the 2019 edition include the following:

Chapter 1

- Eliminated Form 1040EZ and replaced with new Form 1040 and Schedules.
- Revised line number references for new Forms.
- Updated text for new social security limit.
- Updated text for new household income thresholds for health care tax.

Chapter 2

- Eliminated Form 1040A and replaced with new Form 1040 and Schedules.
- Revised line number references for new Forms.

Chapter 3

- Included updated inflation-adjusted phase out amounts for interest income exclusion for savings bonds.

Chapter 4

- Revised the limits for Health Savings Accounts (HSAs)
- Moving expense mileage rates were revised.

Chapter 5

- Modified coverage of deductible medical expenses to reflect that the 7.5% AGI threshold now applies.
- Medical-related mileage rates were revised.
- The maximum deductible premiums for long-term care were revised.

Chapter 6

- The depreciation expense limits for luxury automobiles were revised.
- Revised the mileage rate for travel expense.

Chapter 7

- Capital gains tax rates and income thresholds were updated.

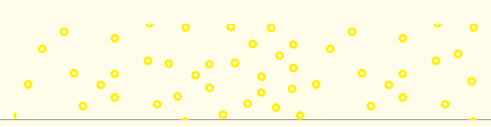
Chapter 9

- Education credit income phase out limitations were revised.
- Revised modified adjusted gross income thresholds for the retirement savings contribution credit.
- Adoption credit amount and income phase out limitations were revised.
- Revised income and phase out limitations for the Earned Income Tax Credit.
- Revised poverty level amounts used to calculate the premium tax credit.

Chapter 10

- Updated withholding allowance amounts and withholding tables.
- Revised the income threshold for filing a Schedule H for household employees.
- Revised penalty amounts for filing incorrect or late Form W-2s.

Chapter 11

- Added detailed coverage of Qualified Tuition Plans, also known as Section 529 plans.
 - Revised contribution limits for defined contribution plans.
 - Updated benefit limits for defined benefit plans.
 - Revised phase out thresholds for traditional IRA and Roth IRA plans.
- 

Four Primary Teaching Advantages of *Fundamentals of Taxation*

©Chris Ryan/age fotostock

1

First, we organize the content of *Fundamentals of Taxation* to **closely follow IRS tax forms**. We introduce students to standard IRS forms early and reinforce their use throughout the text. **Actual tax forms are incorporated throughout** giving students the opportunity to understand the principles behind tax law while they learn how to work with clients to obtain the information they will need to complete tax forms.

2

Second, we **illustrate the proper reporting of tax issues**. We present a tax issue, discuss the legal requirements, illustrate the proper tax form placement, and show the completed form in the text. By effectively leading the student through each issue, we demonstrate how tax form preparation is the result of a careful process that balances legal knowledge with practical experience using tax forms.

3

Third, we **integrate an individual income tax software package** into the content and refer to its examples. We instruct students how to use the software to complete returns using sample “taxpayers” who appear from chapter to chapter. An important consideration in writing *Fundamentals of Taxation* was to allow instructor flexibility. You can choose to rely heavily on the software, you can incorporate the software only after you cover the law and the reporting, or you can deemphasize the software component. This flexible approach allows you to structure your taxation course the way you want to.

4

Fourth, we supplement the content with **citations of relevant tax authorities** such as the Internal Revenue Code, Treasury Regulations, Revenue Rulings, Revenue Procedures, and court cases. These citations are almost always provided in **footnotes**. Thus, you and your students can easily use, or not use, the footnote material.

Ana Cruz



Courtesy of
Ana Cruz

Dr. Ana Cruz is Chair of the Business Department at Miami Dade College, Wolfson Campus, where she utilizes her extensive experience in the areas of general business, management, accounting, and taxes. She has worked in the service, retailing, and manufacturing industries, as well as in the federal government sector, where she served as a field examiner for the Internal Revenue Service. Dr. Cruz, a certified public accountant, has published several articles in business journals, has participated in several SACS On-Site Committees, and has received the Southeast Banking Corporation Foundation Endowed Teaching Chair (1998) and the Wolfson Senior Foundation Endowed Teaching Chair (2002). She was also named the Professor of the Year for the State of Florida by the Council for Advancement and Support of Education and the Carnegie Foundation (2005).

How Does *Fundamentals of Taxation* Help Students Better Understand Tax?

©Caia Image/Glow Images

Forms-Based Approach

Examples of completed tax forms demonstrate how tax theory covered in the text translates to real returns.

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1040, Washington, DC, 2018.

“The forms-based approach to tax concepts in this text gives students the opportunity to apply concepts by completing actual tax forms both manually and through tax software—not only giving them a valuable skill but ultimately making them more employable in today’s workplace.”

—Angela Deaton Mott, Northeast Mississippi Community College

Appendix B includes comprehensive problems for 1040 Schedules A, C, D, and E. These longer problems include both easy and difficult schedules to test students’ comprehension of a range of topics covered across multiple chapters.

Incorporation of real-world tax returns into the text for electronic as well as manual preparation forces students to learn hands-on skills.

Connect Tax Form Simulations

1040 for a couple Married Filing Jointly with one dependent.

1040 PG 1 1040 PG 2

Page 1 of Form 1040. Use provided information and follow instructions on form.

Form 1040 - U.S. Individual Income Tax Return **2018** OMB No. 1545-0074 IRS Use Only - Do not write in this space.

Filing status: ☐ Single ☐ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Your first name and initial Last name Your social security number (Enter as xxx-xx-xxxx)

Standard deduction: ☐ Someone can claim you as a dependent ☐ You were born before January 2, 1954 ☐ You are blind

Spouse or qualifying person's first name and initial (see inst.) Last name Spouse's social security number (Enter as xxx-xx-xxxx)

Standard deduction: ☐ Someone can claim your spouse as a dependent ☐ Your spouse was born before January 2, 1954
☐ Your spouse is blind ☐ Your spouse itemizes on a separate return or you were dual-status alien

Home address (number and street). If you have a P.O. box, see instructions. Presidential Election Campaign
Check here if you want \$3 to go to this fund (see inst.)

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6. ☐ You ☐ Spouse
☐ Full-year health care coverage (see instructions)

Dependents (see instructions):

(1) First name	Last name	(2) Dependent's social security number (Enter as xxx-xx-xxxx)	(3) Dependent's relationship to you	(4) X if child under age 17 qualifies for (see inst.): Child tax credit	Credit for other dependents
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>

The **Auto-graded Tax Form Simulation**, assignable within *Connect*, provides a much-improved student experience when solving the tax-form based problems. The **Auto-graded Tax Form Simulation** allows students to apply tax concepts by completing the actual tax forms online with automatic feedback and grading for both students and professors.

Michael P. Deschamps



Courtesy of
Michael Deschamps

Michael P. Deschamps received a bachelor of science degree in accounting, graduating magna cum laude from the University of San Diego, where he served as the chapter president for Beta Alpha Psi, the accounting honor society. After working in public accounting and obtaining his CPA license, he returned to San Diego State University, where he earned a master's degree in taxation and a certificate in financial planning. In addition, he earned his Enrolled Agent Certificate in 2004. He is currently the lead accounting instructor at MiraCosta College in Oceanside, CA, where he has developed a highly regarded tax program certified by the State of California. He is an active member of Teachers of Accounting at Two Year Colleges (TACTYC) and has been a frequent presenter on tax topics at the organization's national conventions. He has also given presentations on tax issues to a variety of organizations.

How Does *Fundamentals of Taxation* Provide a Clear Path to Student Success?

©Caiaimage/Glow Images

Clear Objectives for Your Students

or without the footnotes. If you would like to become familiar with the text, the footnotes are a good place to start exploring.

Learning Objectives

When you have completed this chapter, you should understand the following learning objectives (LO):

- LO 1-1** Understand progressive, proportional, and regressive tax structures.
- LO 1-2** Understand the concepts of marginal and average tax rates as well as a simple income tax formula.
- LO 1-3** Understand the components of a Form 1040EZ income tax return.
- LO 1-4** Determine tax liability in instances when a Form 1040EZ return is appropriate.
- LO 1-5** Understand the types of tax authority and how they interrelate (Appendix A).
- LO 1-6** Understand the provisions of IRS Circular 230 for paid tax preparers (Appendix B).

Learning income tax return preparation requires constant reinforcement and practice. The authors have set up *the text* to provide an easy-to-follow format starting with a list of learning objectives, which are then repeated throughout the text where the related material appears.

Concept Checks are mini-quizzes that test students' understanding of each objective.

CONCEPT CHECK 2-2—LO 2-2

1. Even though you are in the process of getting a divorce, you can file as married filing jointly. True or false?
2. The social security number of the taxpayer's spouse must be shown on the taxpayer's tax return when filing as married filing separately. True or false?
3. A surviving spouse who qualified as married filing jointly when the spouse died can file as a qualifying widow(er) for the next two years as long as the surviving spouse pays for more than half the cost of keeping up a household and does not remarry. True or false?

- LO 12-3:** Apply the tax rules to report an installment sale.
- The taxpayer calculates a gross profit percentage based on the basis of the property sold divided by the selling price.
 - As the taxpayer receives cash in installments, the gain is recognized based on the gross profit percentage.
 - The interest income on any note receivable is a separate calculation.
- LO 12-4:** Explain how to exclude a gain on the sale of a personal residence.
- A taxpayer can exclude up to \$500,000 (\$250,000 if single) of gain on the sale of a personal residence.
 - The residence exclusion applies only to the taxpayer's principal residence.
 - The taxpayer must live there two of the last five years.
 - Reduced exclusions are available if a move is the result of employment transfers or health issues.

A summary of the learning objectives appears at the end of each chapter, providing a quick reference chart for students as they prepare for exams.

The same learning objectives are also referenced in the end-of-chapter material next to each discussion question, multiple-choice question, and problem. Additionally, **marginal EA tags** in the end-of-chapter material help instructors and students identify specific questions that will help prepare students for the Enrolled Agent Exam.

Problems connect

All applicable problems are available with **Connect®**

EA **LO 4-1**

43. What are some of the limitations concerning deductibility of student loan interest? Be specific and comprehensive.

Debra Prendergast



Courtesy of
Debra Prendergast

Dr. Debra Prendergast has a doctor of philosophy degree in public policy from the University of Illinois at Chicago, a master's of business administration degree from Governors State University, and a bachelor of arts degree in business administration with a concentration in accounting from Saint Xavier University in Chicago. She is a licensed and practicing certified public accountant in Illinois and a certified management accountant. She began her professional accounting career as a management advisory services consultant with Grant Thornton before taking a position as the controller for a corporation in Chicago. To spend more time with her family, she left her controller position in 1988 and began a 21-year career with Northwestern College. In 2010, Dr. Prendergast became the dean of Business, Mathematics, and Science at Prairie State College. She served as an officer on the board of Teachers of Accounting at Two Year Colleges (TACTYC) and on the Precertification Education Executive committee of the AICPA.

Surgent Enrolled Agent Exam Review Course!

Surgent
EAreview

Surgent has partnered with McGraw Hill Education and is making the Enrolled Agent Exam Review Course available to you. The Enrolled Agent credential is awarded by the Internal Revenue Service to tax preparers who pass the three-part IRS Special Enrollment Examination. By earning the Enrolled Agent credential, tax preparers are awarded the same client representation rights as CPAs and attorneys. In addition, Enrolled Agents historically have a higher lifetime earning potential than tax preparers who do not earn the Enrolled Agent credential.

As a student using Cruz, *Fundamentals of Taxation 2019* edition, you are eligible to receive six months of free access to Part One (Individual Taxation) of the Surgent Enrolled Agent Exam Review. To start your free access, please visit <https://www.Surgent.com/McGrawHill/EA> and complete the registration form. In addition, you are entitled to a discount on the remaining exam sections of our Enrolled Agent Exam Review course. Please see the website above for additional information or to enroll.

McGraw-Hill Customer Experience Group Contact Information

At McGraw-Hill, we understand that getting the most from new technology can be challenging. That's why our services don't stop after you purchase our products. You can contact our Product Specialists 24 hours a day to get product training online. Or you can search the knowledge bank of Frequently Asked Questions on our support Web site. For Customer Support, call **800-331-5094**, or visit www.mhhe.com/support. One of our Technical Support Analysts will be able to assist you in a timely fashion.

Dan Schisler



Courtesy of
Dan Schisler

Dr. Dan Schisler is a Professor and Research Fellow in the Accounting Department at East Carolina University. He holds a doctor of philosophy degree from Memphis State University, a master's degree in accounting—tax concentration from Auburn University, and a bachelor of science degree in accounting from Southeastern Louisiana University. In addition to public accounting experience with Peat Marwick Main & Co, Dr. Schisler has published numerous articles in national academic and practitioner journals such as *Journal of the American Taxation Association*, *Advances in Taxation*, and *Accounting Horizons*. He teaches tax and accounting at the graduate and undergraduate levels at East Carolina, where he has been recognized for teaching excellence by numerous teaching awards at the department, school, and university levels. Dr. Schisler holds CPA certificates in North Carolina and Louisiana.

TaxAct
Professional

“I currently use
TaxAct for my tax
practice, and I like
your choice.”

—Natasha Librizzi,
Milwaukee Area
Technical College

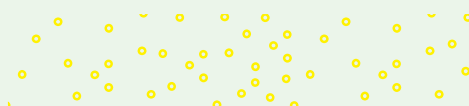
Fundamentals of Taxation features an integrated tax software package from TaxAct, one of the leading tax preparation software companies in the market today. Students are instructed in the practical applications of tax software with exercises that teach how software can be used to prepare all types of tax returns.

Sample “taxpayers” are used throughout the book, in varying situations, to give students full exposure to the many types of tax preparation challenges they will face. This exposure allows students to **make the connection** between the **tax law**, the **software inputs**, and the **tax output** on the appropriate tax forms.

Fundamentals of Taxation also provides the instructor with the flexibility needed in an individual income tax course. Each chapter can be used **with or without the tax software**, depending on the objectives of an individual instructor’s course.

TaxAct features **in-depth form instructions** that supplement the *Fundamentals of Taxation*, making it easier than ever to integrate software into the classroom. Students are provided with the latest tax forms via the **Check for Updates from the Online tab in the program**, so that at the start of the semester, each student will be prepared to work with the most up-to-date information available. With over **120 tax forms, schedules, and worksheets**, TaxAct is sure to have the course materials you will need throughout the semester.

For instructions on how to install the software, please refer to Chapter 1, Appendix C of this text. You can also visit **www.TaxAct.com** today for more information. Please note, at the time of printing, TaxAct is accessible by PC computers only. To ensure all students are able to access TaxAct, a free-of-charge site license is available to schools permitting downloading of the TaxAct software to school lab computers. Please see the online Instructor Resource site for the site license agreement and instructions for submittal.



How Does *Fundamentals of Taxation* Better Prepare My Students?

©NakoPhotography/Shutterstock

From Shoebox to Software

TaxAct
Professional



The From Shoebox to Software examples in each chapter help students understand how they start with a mass of paper provided by a client and proceed to a completed tax return using tax software. The student can actually see the jump from the theoretical tax world to practical application.

“Most importantly, *students learn how to apply what they learned by preparing tax returns at the end of the chapter, and the bonus is they learn how to use tax software. In 16 weeks, students would have prepared over 30 tax returns. This is what attracts students to enroll in the course. It not only meets their requirement for their course of study—they walk away with a life skill.*”

—Lolita M. Lockett,
Florida Community
College at Jacksonville



The simulation of real-world situations in each Shoebox example helps students become professional tax preparers. Their first day of work is far less stressful because it is not the first time they have seen a Form 1040 or a Schedule D. They are far more productive because they know where to start and how to complete the work.

Tax Your Brain



The Tax Your Brain feature is designed to work with the examples in the text to reinforce the understanding of key concepts. Students are given information in an example and then asked to apply what they have learned to a different situation.

TAX YOUR BRAIN

Assume that Janice's year 2019 wage income will be \$50,000 (she worked full-time) and she will have \$8,300 withheld from her wages. Also assume that she expects to sell a large number of paintings and that she estimates her total 2019 tax liability will be \$18,000. To avoid an underpayment penalty, does Janice need to pay estimated payments during 2019 and, if so, how much must she pay?

ANSWER

Janice does not need to make any estimated payments. Her required annual payment is \$8,045, which is the lower of (a) 90% of \$18,000 (the estimate of her 2019 tax liability) or (b) \$8,045 (her tax liability for 2018). Because her estimated tax withholdings are \$8,300, she is not obligated to make estimated payments. She will need to pay the remaining \$9,700 (\$18,000 – \$8,300) no later than April 15, 2020.

By asking students to think critically about theories and concepts while supplying the answer right after the question, the Tax Your Brain examples provide another opportunity for hands-on experience.

New Law

The New Law marginal boxes alert students and instructors to key changes in tax law for the current year's textbook.



NEW LAW

For 2018 the standard deduction for each filing status has increased.

Frederick Niswander



Courtesy of
Frederick Niswander

Dr. Frederick (Rick) Niswander is a Professor of Accounting after serving for over seven years as Vice Chancellor for Administration and Finance at East Carolina University. He holds a doctor of philosophy degree from Texas A&M University and a bachelor of science in business administration degree from Idaho State University. He has taught introductory financial accounting, international accounting, intermediate accounting, and a graduate accounting course that encompasses taxation, financial, and governmental accounting. Prior to obtaining his doctorate and joining the ECU faculty in 1993, he was the chief financial officer of a privately held real estate company in Phoenix, Arizona, for eight years. Dr. Niswander first became a CPA in 1981 and has been a North Carolina CPA since 1994. He is a member of the North Carolina Association of CPAs, the American Institute of Certified Public Accountants, and the American Accounting Association. He has held leadership roles in the American Institute of CPAs including chair of the Board of Examiners and as a member of the AIPCA Board of Directors.

Robust and Relevant End-of-Chapter Material

Fundamentals of Taxation offers a robust selection of end-of-chapter material.

EA LO 3-3 9. Sam owns all of the stock in a newly formed corporation. During 2018, the first year of operation, the corporation realized current earnings and profits of \$10,000. Sam received a \$12,000 distribution from the corporation. How much, if any, of the distribution is taxable to Sam? Why?

Discussion questions test the basic concepts of each chapter. Students supply short answers to a variety of questions covering each of the major concepts in the chapter.

Multiple-choice questions complement the discussion questions as an alternative way to quickly test a variety of learning objectives. They range from easy to more complex computational multiple choices.

Multiple-Choice Questions connect

All applicable multiple-choice questions are available with **Connect**®

- LO 2-1** 16. A single taxpayer is 26 years old and has wages of \$18,000 and interest income of \$450. Which is the simplest tax form this person can file?
- 1040.
 - 1040EZ.
 - 1040A.
 - 1040Z.
- LO 2-1** 17. Payment of alimony by the taxpayer is a *for* AGI deduction. Which form can the taxpayer use to claim this benefit?
- Either 1040 or 1040A.
 - 1040.
 - 1040A.

Tax Return Problems connect

All applicable tax return problems are available with **Connect**®

Use your tax software to complete the following problems. If you are manually preparing the tax returns, you will need to use a Form 1040 or Form 1040A, depending on the complexity of the problem. *Note to instructors and students:* When using software, certain tax credits, such as the Child Tax Credit, may appear on the tax return even though we have not yet discussed those tax credits. This occurs because the taxpayer may be entitled to the credits and the software will automatically include the credit on the final tax return.

Tax Return Problem 1

Jose and Dora Hernandez are married filing jointly. They are 50 and 45 years old, respectively. Their address is 32010 Lake Street, Atlanta, GA 30294. Additional information about Mr. and Mrs. Hernandez is as follows:

Social security numbers:
Jose: 412-34-5670
Date of birth: 4/23/1968

Dora: 412-34-5671
Date of birth: 7/12/1973

Now available in Connect, **Tax Return Problems** incorporate the TaxAct software and encourage students to apply a range of concepts they have learned throughout the chapter. All Tax Return Problems can also be done by hand. The authors indicate which forms are needed for each problem.

SUCCESSFUL SEMESTERS INCLUDE CONNECT

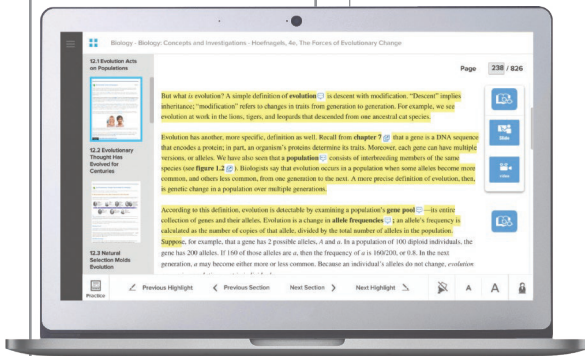
FOR INSTRUCTORS

You're in the driver's seat.

Want to build your own course? No problem. Prefer to use our turnkey, prebuilt course? Easy. Want to make changes throughout the semester? Sure. And you'll save time with Connect's auto-grading too.

65%

Less Time
Grading



They'll thank you for it.

Adaptive study resources like SmartBook® help your students be better prepared in less time. You can transform your class time from dull definitions to dynamic debates. Hear from your peers about the benefits of Connect at www.mheducation.com/highered/connect

Make it simple, make it affordable.

Connect makes it easy with seamless integration using any of the major Learning Management Systems—Blackboard®, Canvas, and D2L, among others—to let you organize your course in one convenient location. Give your students access to digital materials at a discount with our inclusive access program. Ask your McGraw-Hill representative for more information.



©Hill Street Studios/Tobin Rogers/Blend Images LLC



Solutions for your challenges.

A product isn't a solution. Real solutions are affordable, reliable, and come with training and ongoing support when you need it and how you want it. Our Customer Experience Group can also help you troubleshoot tech problems—although Connect's 99% uptime means you might not need to call them. See for yourself at status.mheducation.com

FOR STUDENTS

Effective, efficient studying.

Connect helps you be more productive with your study time and get better grades using tools like SmartBook, which highlights key concepts and creates a personalized study plan. Connect sets you up for success, so you walk into class with confidence and walk out with better grades.

“I really liked this app—it made it easy to study when you don't have your textbook in front of you.”

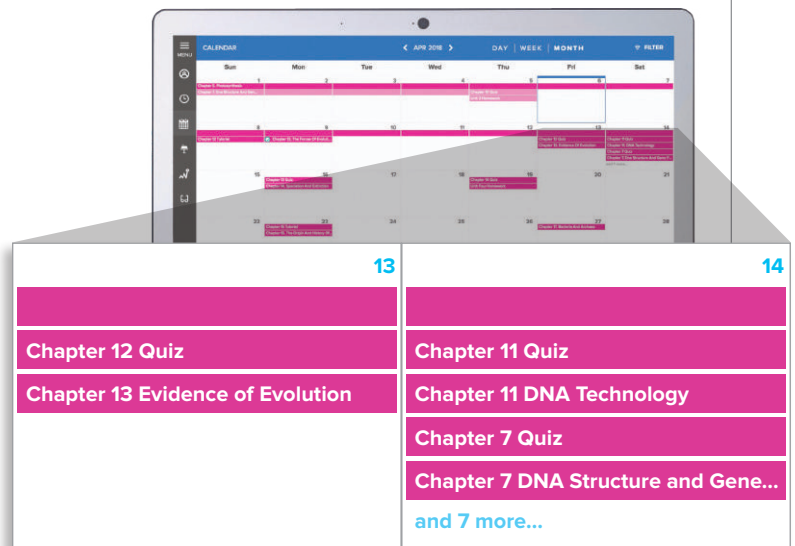
- Jordan Cunningham,
Eastern Washington University

Study anytime, anywhere.

Download the free ReadAnywhere app and access your online eBook when it's convenient, even if you're offline. And since the app automatically syncs with your eBook in Connect, all of your notes are available every time you open it. Find out more at www.mheducation.com/readanywhere

No surprises.

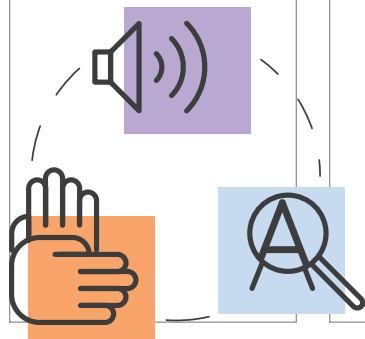
The Connect Calendar and Reports tools keep you on track with the work you need to get done and your assignment scores. Life gets busy; Connect tools help you keep learning through it all.



13	14
Chapter 12 Quiz	Chapter 11 Quiz
Chapter 13 Evidence of Evolution	Chapter 11 DNA Technology
	Chapter 7 Quiz
	Chapter 7 DNA Structure and Gene...
	and 7 more...

Learning for everyone.

McGraw-Hill works directly with Accessibility Services Departments and faculty to meet the learning needs of all students. Please contact your Accessibility Services office and ask them to email accessibility@mheducation.com, or visit www.mheducation.com/about/accessibility.html for more information.



A Monumental Development Effort

©ewgAD/E+/Getty Images

Acknowledgments

Writing a textbook is always a collaborative effort among authors, the publisher, authors' families, and instructors. The professors listed here contributed their time and insight to help this new edition launch successfully. By attending focus groups, reviewing selected chapters, reading through the whole manuscript, and reviewing page proofs, they contributed careful observations that enabled us to make significant improvements. Each person contributed something different—either a well-deserved criticism or a helpful word of encouragement. We sincerely appreciate their help and professionalism:

Nancy Batch, *Mountain View College*

Margaret Black, *San Jacinto College–North*

Joy Bruce, *Gaston College*

Bernard Bugg, *Shaw University*

Marian Canada, *Ivy Tech Community College*

Amy Chataginer, *Mississippi Gulf Coast Community College–Jefferson Davis*

Amy Conley, *Genesee Community College*

Curtis Crocker, *Central Georgia Technical College*

Geoffrey Danzig, *Miami Dade College–North*

John Daugherty, *Pitt Community College*

Patricia Davis, *Keystone College*

Susan Davis, *Green River Community College*

Peggy DeJong, *Kirkwood Community College*

George DeOrio, *Kaplan Career Institute–ICM Campus Technical College*

Scott Edelman, *Dominican College*

Don Furman, *State University of New York–New Paltz*

Kim W. Gatzke, *Delgado Community College*

Michelle Hayes, *Kalamazoo Valley Community College*

Margaret (Peggy) Helms, *Wayne Community College*

Gary Hollingsworth, *Antonelli College*

Carol Hughes, *Asheville Buncombe Tech Community College*

Norma Hunting, *Chabot College*

Kimberly Hurt, *Central Community College–Grand Island*

Karen Kettelson, *Western Technical College*

Mary Lou Kline, *Reading Area Community College*

Becky Knickel, *Brookhaven College*

Natasha Librizzi, *Milwaukee Area Technical College*

William Lloyd, *Lock Haven University of Pennsylvania*

Susan Logorda, *Lehigh Carbon Community College*

Ivan Lowe, *York Technical College*

Ming Lu, *West LA College*

William Lyle, *Georgia Piedmont Technical College*

Ted Lynch, *Hocking College*

Richard Mandau, *Piedmont Technical College*

Stacie Mayes, *Rose State College*

Mike Metzcar, *Indiana Wesleyan University*

Janelle Montgomery, *Rose State College*

Angela Deaton Mott, *Northeast Mississippi Community College*

Michelle Nickla, *Ivy Tech Community College*

Patricia Diane Nipper, *Southside Virginia Community College–Keysville*

Irene Novikov, *Foothill College*

Chris O'Byrne, *Cuyamaca College*

Cynthia Phipps, *Lake Land College*

Betty Pilchard, *Heartland Community College*

Jennifer Robinson, *Trident Technical College*

Patrick Rogan, *Cosumnes River College*

Dennis Sheridan, *Fayetteville Technical Community College*

Amy Shigley, *Edmonds Community College*

Mark Siegel, *South Texas College of Law*

Bonnie Silbernagel, *Lakeshore Technical College*

Barb Squires, *Corning Community College*

Carolyn Strauch, *Crowder College*

Denise Teixeira, *Chemeketa Community College*

Jerri Tittle, *Rose State College*

Alan Viersen, *MiraCosta College*

Shunda Ware, *Atlanta Technical College*

Kenneth Wise, *Wilkes Community College*

Edwin J. Wu, *Norfolk State University*

We greatly appreciate the accuracy-checking work completed by Matt Lowenkron (Glendale Community College). His attention to detail has helped us achieve the accuracy of the 2019 edition.

We also appreciate the expert attention given to this project by the staff at McGraw-Hill Education, especially Tim Vertovec, managing director; Kathleen Klehr, executive portfolio manager; Zach Rudin, marketing manager; Jaroslaw Szymanski and Katie Ward, product developers; Dana Pauley, Angela Norris, and Erika Jordan, content project managers; Matt Backhaus, designer; and Susan Culbertson, buyer.

Ana Cruz

Michael Deschamps

Rick Niswander

Debra Prendergast

Dan Schisler

Assurance of Accuracy

Dear Colleague,

As textbook authors, and more importantly, as instructors of taxation, we recognize the great importance placed on accuracy—not only in the book you are now holding but also in the supplements. With this in mind, we have taken the following steps to ensure that *Fundamentals of Taxation* is error-free:

1. We received detailed feedback from dozens of instructor reviews. Each review contributed in significant ways to the accuracy of the content.
2. Each of us wrote, reviewed, and carefully checked the end-of-chapter material.
3. Multiple accuracy checkers reviewed each chapter and its accompanying end-of-chapter material.
4. A copy editor checked the grammar of the final manuscript.
5. A proofreader reviewed each page to ensure that no errors remained.
6. Our Solutions Manual and Testbank were created by the authors and reviewed by independent accuracy checkers.
7. *Connect* content was verified first by independent accuracy checkers and again by the author team.

Given these steps taken, we have the utmost confidence that you and your students will have a great experience using *Fundamentals of Taxation*.

As We Go To Press

This book is completed in mid-October and printed in early December. We picked that publication date to provide you a book that is as up-to-date as possible. A consequence of using that time frame is that Congress or the IRS may change some aspect of the tax law (especially around year-end or election time) that will affect the material in this book. Thus, it is important that students and instructors utilize *Connect* for information on how tax law changes have affected material in this book.

This book makes liberal use of IRS tax forms to illustrate how the tax law is implemented in practice. In fact, that notion—applying the tax law to practice—is one of the key features of the text.

As noted, we send the book to the printer in late October so we can provide the most up-to-date book as possible to be used for the 2018 tax filing season, which begins in January 2019. When we couple these two notions—using IRS tax forms and an October printing deadline—we must rely on draft tax forms that the IRS releases starting in June and running through the end of the year (see the note about draft tax forms on page 1-8 for more information). Go to the IRS website at www.irs.gov to obtain the final forms.

Sincerely,

Ana Cruz

Mike Deschamps

Rick Niswander

Debra Prendergast

Dan Schisler

Contents

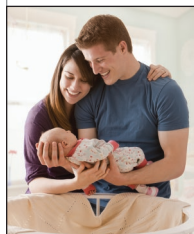


©Purestock/SuperStock

Chapter 1 Introduction to Taxation, the Income Tax Formula, and Form 1040 1-1

Tax Rate Structures 1-2
Marginal Tax Rates and Average Tax
Rates 1-5

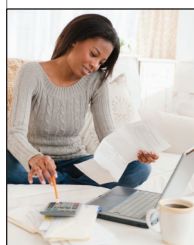
A Simple Income Tax Formula 1-5
The Components of a Basic Form 1040 1-6
Calculation of Income Tax (Form 1040, Line 11) and
Health Care Tax (Schedule 4, Line 61) 1-11
Tax Payments (Form 1040, line 16 and 17) 1-14
Appendix A: Tax Authority 1-19
Appendix B: IRS Rules for Paid Tax
Preparers 1-24
Appendix C: Getting Started with TaxAct 1-25



©Blend Images-Mike Kemp/
Brand X/Getty Images

Chapter 2 Expanded Tax Formula, Form 1040, and Basic Concepts 2-1

The Income Tax Formula and Form
1040 2-2
Filing Status (Form 1040, First Page) 2-9
Dependents (Form 1040, Page 1) 2-11
Standard Deduction (Form 1040, line 8) 2-17
Tax Due to IRS 2-18
Interest and Tax Penalties 2-22



©Blend Images-JGI/Jamie
Grill/Getty Images

Chapter 3 Gross Income: Inclusions and Exclusions 3-1

When and How to Record Income 3-2
Cash Method of Accounting 3-3
Taxability of Components of Gross
Income 3-4
Items Excluded from Gross Income 3-15
Appendix: Tax Accounting for Savings Bond
Interest Used for Education Expenses, Below-Market
Interest Loans, Gift Loans, and Original Issue Discount
Debt 3-24



©NakoPhotography/
Shutterstock

Chapter 4 Adjustments for Adjusted Gross Income 4-1

Student Loan Interest (Schedule 1 of
Form 1040, line 33) 4-2
Health Savings Account Deduction
(Schedule 1, line 25) 4-6
Moving Expenses for Members of the
Armed Forces (Schedule 1, line 26) 4-10
Deduction for Half of Self-Employment Tax (Schedule 1,
line 27) 4-12
Self-Employed Health Insurance Deduction (Schedule 1,
line 29) 4-13
Penalty on Early Withdrawal of Savings (Schedule 1,
line 30) 4-14
Alimony Paid (Schedule 1, line 31a) 4-16
Educator Expenses (Schedule 1, line 23) 4-18



©Blend Images/Image
Source

Chapter 5 Itemized Deductions 5-1

Deductible Medical Expenses
(Schedule A, line 4) 5-3
Deductible State and Local Taxes
(Schedule A, line 7) 5-9
Deductible Interest (Schedule A, line 10) 5-14
Deductible Gifts to Charity (Schedule A, line 14) 5-20
Deductible Casualty and Theft Losses (Schedule A,
line 15) 5-25
Other Itemized Deductions (Schedule A,
line 16) 5-30



©ewg3D/E+/Getty Images

Chapter 6 Self-Employed Business Income (Line 12 of Schedule 1 and Schedule C) 6-1

Income for a Schedule C Trade or Business 6-5
Ordinary and Necessary Trade or Business Expenses 6-7
Depreciation 6-8
Transportation and Travel 6-18
Business Use of the Home and Business
Bad Debts 6-27

Hobby Loss Rules and Education Expenses 6-33
 Self-Employment Tax 6-34
 Appendix: General Depreciation System 6-45



©Caiaimage/Glow Images

Chapter 7

Capital Gains and Other Sales of Property (Schedule D and Form 4797) 7-1

Terms and Tax Forms 7-2
 Classification of Assets 7-4
 Sales of Ordinary Assets 7-7
 Sales of Capital Assets 7-9

Sales of Business Property 7-20
 Tax Issues for Special Types of Sales 7-26



©iStockphoto/Getty Images

Chapter 8

Rental Property, Royalties, and Income from Flow-Through Entities (Line 17, Schedule 1, and Schedule E) 8-1

Rental Property 8-2
 Rental of Vacation Homes 8-9
 Royalty Income 8-16
 Flow-Through Entities 8-17



©kristian sekulic/Getty Images

Chapter 9

Tax Credits (Schedule 3, lines 48 through 54, and Schedule 5, lines 70 through 74) 9-1

Credit for Child and Dependent Care Expenses (Schedule 3, line 49 [Form 2441]) 9-2
 Credit for the Elderly or the Disabled (Schedule 3, Line 54c [Schedule R]) 9-6
 Education Credits (Schedule 3, Line 50 [Form 8863]) 9-7
 Foreign Tax Credit (FTC) (Schedule 3, line 48 [Form 1116]) 9-13
 Child Tax Credit (Schedule 3, line 52) 9-17
 Retirement Savings Contributions Credit (Saver's Credit) (Schedule 3, line 51 [Form 8880]) 9-18
 Adoption Credit (Schedule 3, Line 54c [Form 8839]) 9-19

Earned Income Credit (EIC) (Form 1040, line 17a) 9-21
 Premium Tax Credit (Schedule 2, line 46 or Schedule 5, line 70) 9-28
 Appendix A 9-32
 Appendix B 9-41



©Hill Street Studios/Blend Images LLC

Chapter 10

Payroll Taxes 10-1

Tax Issues Associated with Payroll and Form 1040 10-1
 Federal Income Tax Withholding, Social Security, and Medicare Taxes on Wages and Tips 10-2
 Reporting and Paying Payroll Taxes 10-10

Self-Employment Taxes, Unemployment Taxes, Form 940, Taxes for Household Employees, and Schedule H 10-16
 Employer Payroll Reporting Requirements Including Forms W-2 and W-3 10-25
 Supplemental Wage Payments, Backup Withholding, Form W-9, Estimated Tax Payments, and Form 1040-ES 10-28
 Appendix: Partial Wage Bracket Method Withholding 10-43



©Caia Image/Glow Images

Chapter 11

Retirement and Other Tax-Deferred Plans and Annuities 11-1

Tax-Deferred Plans and Annuities: The Basics 11-1
 Employer-Sponsored Retirement Plans 11-3
 Individual-Sponsored Retirement Plans 11-9
 Tax-Deferred Nonretirement Plans 11-12
 Distributions from Tax-Deferred Pension Plans 11-15
 Tax Treatment of Annuity Contracts 11-23
 Appendix: Life Expectancy Tables 11-27



©Maskot/Image Source

Chapter 12

Special Property Transactions 12-1

Like-Kind Exchanges 12-2
 Involuntary Conversions 12-7
 Installment Sales 12-13
 Sale of a Personal Residence 12-16
 Related-Party Losses and Wash Sales 12-21



©Robert Nicholas/age fotostock

Chapter 13

At-Risk/Passive Activity Loss Rules and the Individual Alternative Minimum Tax 13-1

At-Risk Rules 13-2
 Passive Activity Losses 13-9

At-Risk and PAL Rules in Conjunction 13-16
 Alternative Minimum Tax (AMT) 13-20
 Appendix: Depreciation Tables 13-34



©John Fedele/Blend Images LLC

Chapter 14

Partnership Taxation 14-1

Formation of a Partnership 14-1
 Partnership Ordinary Income or Loss 14-6
 Separately Stated Items 14-13
 Basis of the Partnership Interest 14-16
 Partnership Distributions 14-18

Disposal or Liquidation of a Partnership Interest 14-20



©Chris Ryan/age fotostock

Chapter 15

Corporate Taxation 15-1

Corporate Formation and Filing Requirements 15-2
 Basis 15-9
 Taxable Income and Tax Liability 15-10
 Transactions with Shareholders 15-15
 Schedules L, M-1, and M-3 15-17

Other Corporate Issues 15-18
 Subchapter S Corporations 15-21

Appendix A: Amended Tax Returns (Form 1040X) A-1

Appendix B: Comprehensive Problems B-1

Appendix C: Concept Check Answers C-1

Appendix D: IRS Tax Tables D-1

Appendix E: IRS Tax Forms E-1

Appendix F: 2018 Federal Income Tax Information F-1

Credits CR-1

Index IND-1

Fundamentals of Taxation

2019



©Purestock/SuperStock

Chapter One

Introduction to Taxation, the Income Tax Formula, and Form 1040

This chapter introduces the federal tax system and presents a broad overview of the tax formula. We begin with a wide-angle look at the U.S. tax system and the three types of tax rate structures. We introduce a simplified income tax formula and Form 1040.

Throughout the entire text, the footnotes generally provide citations to the Internal Revenue Code (IRC) and other tax law or regulations. You can read this text either with or without the footnotes. If you would like to become familiar with the IRC and other tax authority, the footnotes are a good place to start exploring.

Learning Objectives

When you have completed this chapter, you should understand the following learning objectives (LO):

- LO 1-1** Understand progressive, proportional, and regressive tax structures.
- LO 1-2** Understand the concepts of marginal and average tax rates as well as a simple income tax formula.
- LO 1-3** Understand the components of a basic Form 1040 income tax return.
- LO 1-4** Determine tax liability in instances when a Form 1040 return is appropriate.
- LO 1-5** Understand the types of tax authority and how they interrelate (Appendix A).
- LO 1-6** Understand the provisions of IRS Circular 230 for paid tax preparers (Appendix B).

Changes to this chapter as a result of the Tax Cuts and Jobs Act of 2017

- Income tax rates and applicable taxable income ranges will change for all taxpayers.
- The standard deduction increases to \$24,000 for married taxpayers and \$12,000 for single taxpayers.

INTRODUCTION

The federal government enacted the first federal income tax in 1861 as a method to finance the Civil War. Prior to that time, federal tax revenues came primarily from excise taxes and duties on imported goods. Once the war was over, Congress repealed the income tax. Congress again passed a federal income tax in 1894 to broaden the types of taxes and to increase federal revenues. However, in 1895 the Supreme Court held that the federal income tax was unconstitutional. That ruling resulted in the Sixteenth Amendment to the Constitution in 1913:

Sixteenth Amendment to the Constitution of the United States of America

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

TABLE 1-1
Type and Number of Individual Tax ReturnsSource: *IRS Statistics of Income Bulletin*, Spring 2018, 2017, 2016, and 2015, Table A.

Type of Tax Return	2016	2015	2014	2013
Form 1040 returns	86,063,674	85,421,307	84,573,730	84,484,712
Form 1040A returns	40,336,292	41,133,634	40,853,006	39,788,033
Form 1040EZ returns	23,915,978	24,010,976	23,259,850	23,463,055
Total returns	150,315,944	150,565,918	148,686,586	147,735,801
Returns electronically filed (included in figures above)	132,409,588	132,251,035	129,076,138	126,531,029

The Sixteenth Amendment provides the underlying legal and statutory authority for the administration and enforcement of individual income taxes. Congress has promulgated tax law that is the primary source of information for what is, and is not, permitted. That tax law is the Internal Revenue Code (IRC). The IRC covers taxation of individuals, corporations, and partnerships, as well as other tax rules. Appendix A in this chapter discusses the types of tax laws, regulations, and court cases that compose what we refer to as *tax authority*. The material in Appendix A is of particular importance to students who want to be involved in tax planning, tax research, and other tax-related activities that require an understanding of taxes beyond a fill-in-the-forms level.

Currently the federal government collects revenue from various types of taxes. The largest revenue generators are the individual income tax, social security tax, corporate income tax, federal gift and estate tax, and various excise taxes. This text focuses on the largest revenue generator for the federal government: the individual income tax.¹ In tax year 2016, most current year available, the federal government collected \$1.45 trillion in income tax on almost \$10.2 trillion of gross income (\$7.3 trillion of taxable income) as reported on 150.3 million individual tax returns.² Table 1-1 presents a breakdown of the number and type of individual tax returns filed for 2013 through 2016.

One major criticism of the current tax system is the complexity of the law and the length of the forms. Complexity in the tax system is not necessarily bad. Taxpayers often do not realize that many provisions that require use of the more complex tax forms are deduction or credit provisions that actually *benefit* the taxpayer. This text will help you understand the tax system's complexity, the rationale behind some of the complexity, and how to complete a tax return effectively.

Until tax year 2018, there were three forms which individual taxpayers could use to report their income and expense to the Internal Revenue Service (IRS)—Form 1040, Form 1040A, and Form 1040EZ. Taxpayers with simple tax returns would use a 1040EZ and, as a return became more complicated, taxpayers used a 1040A or a 1040. As you can see from Table 1-1, over 64 million returns were filed using the two easiest forms—the 1040A and 1040EZ.

In tax year 2018, the IRS revamped the Form 1040. Today, there is one, simplified, Form 1040. For a simple tax return, the taxpayer will use just the Form 1040. As a return gets more complicated, taxpayers can use one or more of six Schedules to provide additional information to properly prepare their tax return. The Schedules are all numbered from 1 to 6 (Schedule 1, Schedule 2, etc.) In this chapter, we will introduce the basic Form 1040 and a part of Schedule 1 and Schedule 4. In future chapters, we will discuss the rest of Schedule 1 and 4 and the remaining Schedules.

TAX RATE STRUCTURES

LO 1-1

The study of taxation must begin with a basic understanding of rate structures and the tax system. We will discuss three different types of tax rate structures:

- Progressive rate structure.
- Proportional rate structure.
- Regressive rate structure.

¹ The last two chapters are an overview of partnership and corporate taxation.

² IRS Statistics of Income Bulletin (Spring 2017), Table A.

TABLE 1-2
Individual Income Tax
Rate Brackets for Married
Taxpayers for Tax Year
2018

Taxable Income	Tax Rate
Up to \$19,050	10%
\$19,051–\$77,400	12%
\$77,401–\$165,000	22%
\$165,001–\$315,000	24%
\$315,001–\$400,000	32%
\$400,001–\$600,000	35%
Over \$600,000	37%

Each of these rate structures is present in the tax collection system at the local, state, or federal level. Taxing authorities use one or more of these structures to assess most taxes.

Progressive Rate Structure

With a *progressive structure*, the tax rate increases as the tax base increases. The tax rate is applied to the tax base to determine the amount of tax. The most obvious progressive tax in the United States, and the focus of this text, is the federal income tax. Table 1-2 illustrates the progressive rate structure of the individual income tax for married taxpayers who file joint returns.

The federal income tax is progressive because the tax rate gets larger as the taxable income (tax base) increases. For very low taxable income, the tax rate is 10% per additional dollar of income, and for very high taxable income, the tax rate is 37% per additional dollar.

EXAMPLE 1-1

Mary and George are married, file a joint federal tax return, and have taxable income of \$325,000. Their tax liability is

$\$19,050 \times 10\% =$	\$ 1,905.00
$(\$77,400 - \$19,050) \times 12\% =$	7,002.00
$(\$165,000 - \$77,400) \times 22\% =$	19,272.00
$(\$315,000 - \$165,000) \times 24\% =$	36,000.00
$(\$325,000 - \$315,000) \times 32\% =$	3,200.00
Total tax liability	<u>\$67,379.00</u>

Note from Example 1-1 that as the tax base (taxable income) increases, the tax rate per dollar of income gets progressively larger, rising from 10% to 32%.

TAX YOUR BRAIN



On average, how much income tax did Mary and George pay on their taxable income, and how do you interpret your answer?

ANSWER

Mary and George had an average tax rate of 20.73% calculated as their tax liability of \$67,379 divided by their taxable income of \$325,000. This means that, on average, for each dollar of taxable income, Mary and George paid 20.73 cents to the federal government for income tax.

Table 1-3 provides some additional evidence of the progressivity of the U.S. tax system. The average tax rates in Table 1-3 confirm that the individual income tax is indeed a progressive tax.

TAX YOUR BRAIN



In Table 1-3, compare those taxpayers with incomes less than \$100,000 to those taxpayers with incomes greater than \$100,000. What does your comparison suggest about income progressivity?

ANSWER

Over 124 million taxpayers had adjusted gross income of less than \$100,000 and this group paid over \$288 billion of individual income tax. There were almost 26 million taxpayers with income over \$100,000 and they paid tax of almost \$1.2 trillion. This is further support for the notion that the U.S. individual income tax system is a progressive system.

TABLE 1-3 Individual Income Tax Returns from 2016, Number of Tax Returns, Taxable Income (in thousands), Total Tax Liability (in thousands), and Average Tax Rate by Ranges of Adjusted Gross Income

Source: IRS Statistics of Income Bulletin, Spring 2018, Table 1.

Item	Ranges of Adjusted Gross Income					
	Under \$15,000	\$15,000 to under \$30,000	\$30,000 to under \$50,000	\$50,000 to under \$100,000	\$100,000 to under \$200,000	\$200,000 or more
Number of returns	34,703,083	29,734,201	26,719,052	33,267,270	18,932,828	6,959,511
Taxable income	\$21,397,029	\$212,001,025	\$564,350,669	\$1,600,848,472	\$1,930,713,847	\$2,994,244,158
Total tax liability	\$1,826,539	\$18,583,289	\$57,988,578	\$210,103,387	\$322,558,340	\$835,714,234
Average tax rate*	8.54%	8.77%	10.28%	13.12%	16.71%	27.91%

*The average tax rate is total tax liability divided by taxable income.

Proportional Rate Structure

With a proportional tax structure, the tax *rate* remains the same regardless of the tax base. The popular name for a proportional tax is a *flat tax*. The most common flat or proportional taxes in existence in the United States are state and local taxes levied on either property or sales. For example, a local sales tax could be 6% on the purchase of a new car. Regardless of whether the price of the car (the tax base) was \$15,000 or \$80,000, the tax rate would still be 6% and the taxpayer would pay either \$900 or \$4,800 in sales tax, depending on the car purchased.

Another proportional tax is the Medicare tax. This tax pays for medical expenses for individuals over age 65. The rate is 2.9% of every dollar of wage income or self-employment income (there is an additional 0.9% tax on income over \$250,000 for married taxpayers and \$200,000 for most others. We discuss this in Chapter 10. We also discuss an additional 3.8% Medicare tax for high income taxpayers in Chapter 7.). Thus a doctor will pay Medicare tax of \$4,350 on the \$150,000 of net income from her medical practice ($2.9\% \times \$150,000$), and a golf professional will pay \$2,900 from his \$100,000 tournament winnings ($2.9\% \times \$100,000$). Although the doctor pays more total tax, the *rate* of tax is the same for both the doctor and the golf professional.

In recent years, there have been numerous political movements to replace the current progressive tax system with a flat tax. One plan called for a 17% flat tax on income. Compared to the current system, the 17% flat tax would result in an increase in tax liability for taxpayers with income of less than \$200,000 and a decrease in tax liability for taxpayers with income of more than \$200,000 (see Table 1-3).

Regressive Rate Structure

With a regressive tax, the rate decreases as the tax base increases. The social security tax is the most common regressive tax. The rate for social security taxes is 6.2% (12.4% for self-employed taxpayers) on the first \$128,400 of wages in tax year 2018. Once wages exceed the \$128,400 ceiling, social security taxes cease. Thus the rate drops (from 6.2% to 0%) as the tax base increases.

CONCEPT CHECK 1-1— LO 1-1



1. The three types of tax rate structures are _____, _____, and _____.
2. The tax rate structure for which the tax rate remains the same for all levels of the tax base is the _____ rate structure.
3. The federal income tax system is an example of a _____ tax structure.

MARGINAL TAX RATES AND AVERAGE TAX RATES

LO 1-2

Newspaper and magazine articles often discuss taxes and use the terms *average tax rate* and *marginal tax rate*. These two terms are not interchangeable; they mean very different things.

The average tax rate is the percentage that a taxpayer pays in tax given a certain amount of taxable income. The marginal tax rate represents the proportion of tax that he or she pays on the last dollar (or more accurately, the *next* dollar) of taxable income.

Let us assume that Ben and Martha have taxable income of \$38,450 and file an income tax return as a married couple. Using the tax rates in Table 1-2, they determine that their tax liability is

$\$19,050 \times 10\% =$	\$1,905.00
$(\$38,450 - \$19,050) \times 12\% =$	2,328.00
Total tax liability	<u>\$4,233.00</u>

If you refer to Table 1-2, you will see that, for a married couple, each dollar of taxable income between \$19,050 and \$77,400 is taxed at a rate of 12%. In other words, if Ben and Martha earned an additional \$100 of taxable income, they would owe the federal government an additional \$12. Thus their marginal tax rate (the rate they would pay for an additional dollar of income) is 12%.

Conversely, the average rate is the percentage of total tax paid on the entire amount of taxable income. Ben and Martha have taxable income of \$38,450 on which they had a tax liability of \$4,233. Their average rate is 11.01% ($\$4,233.00 / \$38,450$). The average rate is, in effect, a blended rate. Ben and Martha paid tax at a 10% rate on some of their taxable income and at a 12% rate on the rest of their income. Their average rate is a mixture of 10% and 12% that, in their case, averages out to 11.01%.

TAX YOUR BRAIN



For Ben and Martha, the marginal rate was larger than the average rate. Is that always the case?

ANSWER

No. When taxable income is zero or is within the lowest tax bracket (from \$0 to \$19,050 for married couples), the marginal rate will be equal to the average rate. When taxable income is more than the lowest tax bracket, the marginal rate will always be larger than the average rate.

A SIMPLE INCOME TAX FORMULA

LO 1-2

Taxpayers must annually report their taxable income, deductions, and other items to the Internal Revenue Service (IRS). Taxpayers do so by filing an income tax return. In its most simplified form, an individual income tax return has the following components:

Income
– Permitted deductions from income
<hr/>
= Taxable income
× Appropriate tax rates
<hr/>
= Tax liability
– Tax payments and tax credits
<hr/>
= Tax refund or tax due with return

Although many income tax returns are complex, the basic structure of every tax return follows this simplified formula. For many taxpayers, this simplified formula is sufficient.

For example, most individuals who receive all their income from an hourly or salaried job have a tax return that conforms to this basic structure. In later chapters we will expand on this tax formula, and we will provide more information about complexities in our tax laws. However, for this chapter the simplified version is appropriate.

**CONCEPT
CHECK 1-2—
LO 1-2**



1. The marginal tax rate is the rate of tax imposed on the next dollar of taxable income. True or false?
2. What is the marginal tax rate for a married couple with taxable income of \$85,350?
3. Average tax rate and marginal tax rate mean the same thing. True or false?
4. Complex tax returns do not follow the basic (or simplified) income tax formula. True or false?

THE COMPONENTS OF A BASIC FORM 1040

LO 1-3

Taxpayers must annually report their income, deductions, tax liability, and other items to the federal government. They do so by filing a tax return called a Form 1040, shown in Exhibit 1-1.

Let us review the components of the simplified tax formula and how they apply to filing Form 1040. We will refer to the line numbers from the form in much of the discussion.

Filing Status

Taxpayers must determine and declare a filing status. They are: single, married filing a joint return with his or her spouse, married filing separately, head of household, or qualifying widow(er). The filing status is important because income is taxed at different rates depending on the appropriate filing status.

For purposes of this chapter, we will assume the taxpayer is either single or married filing a joint return. We explain the additional categories and expand our discussion of filing status in Chapter 2.

Wages, Salaries, and Tips (Form 1040, line 1)

Wages, salaries, and tips are the major sources of gross income for most taxpayers. In fact, for millions of Americans, these items are their only source of income. Individuals receive wages, salaries, and tips as “compensation for services.”³ This category is quite broad and encompasses commissions, bonuses, severance pay, sick pay, meals and lodging,⁴ vacation trips or prizes given in lieu of cash, fringe benefits, and similar items.⁵

Employees receive wages and related income from their employers. Income received as a self-employed individual (independent contractor) does not meet the definition of wages and is reported on Schedule C. We discuss Schedule C in Chapter 6.

Wages include tips.⁶ Employees receiving tip income must report the amount of tips to their employers.⁷ They use IRS Form 4070 for that purpose. Large food and beverage establishments (those at which tipping is customary and that employ more than 10 employees on a typical business day) must report certain information to the IRS and to employees.⁸ These employers must also allocate tip income to employees who normally receive tips. You can find more information about reporting tip income in IRS Publication 531, available on the IRS Web site at www.irs.gov.

Taxpayers classified as employees who receive compensation will receive a Form W-2 (see Exhibit 1-2) from their employer indicating the amount of wage income in box 1, “Wages, tips, other compensation.” This amount is reported on line 1 of Form 1040.

³ IRC § 61(a)(1).

⁴ Unless excluded under IRC § 119.

⁵ Reg. § 1.61-2 and Reg. § 1.61-21.

⁶ IRC § 3401(f).

⁷ IRC § 6053(a).

⁸ IRC § 6053(c).

EXHIBIT 1-1

Form 1040 Department of the Treasury—Internal Revenue Service (99) **2018** U.S. Individual Income Tax Return OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing status: ☐ Single ☐ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Your first name and initial Last name Your social security number

Your standard deduction: ☐ Someone can claim you as a dependent ☐ You were born before January 2, 1954 ☐ You are blind

If joint return, spouse's first name and initial Last name Spouse's social security number

Spouse standard deduction: ☐ Someone can claim your spouse as a dependent ☐ Spouse was born before January 2, 1954 ☐ Full-year health care coverage or exempt (see inst.)

☐ Spouse is blind Spouse itemizes on a separate return or you were dual-status alien

Home address (number and street). If you have a P.O. box, see instructions. Apt. no. Presidential Election Campaign (see inst.) ☐ You ☐ Spouse

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6. If more than four dependents, see inst. and ✓ here ☐

Dependents (see instructions):

(1) First name Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see inst.): Child tax credit Credit for other dependents
			<input type="checkbox"/> <input type="checkbox"/>
			<input type="checkbox"/> <input type="checkbox"/>
			<input type="checkbox"/> <input type="checkbox"/>
			<input type="checkbox"/> <input type="checkbox"/>

Sign Here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature Date Your occupation If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Spouse's signature. If a joint return, **both** must sign. Date Spouse's occupation If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparers Print/Type preparer's name Preparer's signature PTIN Check if:
See Schedule 6 Firm's name ▶ Firm's EIN ▶ ☐ 3rd Party Designee ☐ Self-employed

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2018)

Form 1040 (2018) Page **2**

1 Wages, salaries, tips, etc. Attach Form(s) W-2

2a Tax-exempt interest 2a Taxable interest

3a Qualified dividends 3a Ordinary dividends

4a IRAs, pensions, and annuities 4a Taxable amount

5a Social security benefits 5a Taxable amount

6 Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22

7 Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 36, from line 6

8 Standard deduction or itemized deductions (from Schedule A)

9 Qualified business income deduction (see instructions)

10 Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-

11 a Tax (see inst.) (check if any from: 1 ☐ Form(s) 8814 2 ☐ Form 4972 3 ☐) b Add any amount from Schedule 2 and check here ☐

12 a Child tax credit/credit for other dependents b Add any amount from Schedule 3 and check here ☐

13 Subtract line 12 from line 11. If zero or less, enter -0-

14 Other taxes. Attach Schedule 4

15 Total tax. Add lines 13 and 14

16 Federal income tax withheld from Forms W-2 and 1099

17 Refundable credits: a EIC (see inst.) b Sch 8812 c Form 8863

Add any amount from Schedule 5

18 Add lines 16 and 17. These are your total payments

Refund 19 If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you **overpaid**

20a Amount of line 19 you want **refunded to you**. If Form 8888 is attached, check here ☐

Direct deposit? See instructions. b Routing number c Type: ☐ Checking ☐ Savings

d Account number

21 Amount of line 19 you want **applied to your 2019 estimated tax** 21

Amount You Owe 22 **Amount you owe**. Subtract line 18 from line 15. For details on how to pay, see instructions 22

23 Estimated tax penalty (see instructions) 23

Go to www.irs.gov/Form1040 for instructions and the latest information. Form **1040** (2018)

A Note about Draft Tax Forms

Many of the IRS tax forms used throughout the text have the word “Draft” and a date printed across the form (see Exhibit 1-1). The IRS creates and modifies tax forms during the tax year. These forms are in draft form until they have obtained final approval within the IRS and by the federal Office of Management and Budget. The IRS distributes the draft forms internally, to tax professionals, and to tax software companies. By doing so, the IRS seeks comments to catch errors or to improve the forms. Final approval usually occurs on a rolling basis between mid-October and mid-December. Once the form has received final approval, the “Draft” label is removed and taxpayers can use the final form as they prepare their tax returns.

This text went to press in late October, when most IRS forms were available only in draft form. By the time you read this, final forms will be available on the IRS Web site (www.irs.gov) and in your tax software after you have updated it.

Taxable Interest (Form 1040, line 2b)

Interest is compensation for the use of money with respect to a bona fide debt or obligation imposed by law (such as loans, judgments, or installment sales). Interest received by or credited to a taxpayer is taxable unless specifically exempt.⁹ Interest paid is often deductible.¹⁰ This section covers interest received.

For individuals, interest income is most often earned in conjunction with savings accounts, certificates of deposit, U.S. savings bonds, corporate bonds owned, seller-financed mortgages, loans made to others, and similar activities.

Generally, interest income is determined based on the interest rate stated in the documents associated with the transaction. Some exceptions exist, and some interest income is nontaxable. These items are discussed in the Appendix to Chapter 3.

Normally, taxpayers will receive a Form 1099-INT that will report the amount of interest earned (see Exhibit 1-3). The amount in box 1 is reported on Form 1040, line 2.

Other Income (Form 1040, lines 3, 4 and 5)

The 1040 has lines for dividends (line 3), taxable income from pension and retirement plans (line 4) and taxable income from social security (line 5). We discuss these income items in future chapters.

Additional Income (Form 1040, line 6)

The income items listed on lines 1 through 5 are some of the most common. Many other sources of income can be taxable. To simplify the basic Form 1040, the IRS has placed less-common income items on a separate Schedule, in this case, Schedule 1 (see Exhibit 1-4). Lines 10-21 of Schedule 1 lists these additional income items and we will discuss many of these items in future chapters. Unemployment Compensation, Schedule 1, line 19, is discussed next.

Unemployment Compensation (Form 1040, Schedule 1, line 19)

Federal and state unemployment compensation benefits are taxable.¹¹ The rationale behind taxing these payments is that they are a substitute for taxable wages. Unemployment benefits are reported to recipients on Form 1099-G in box 1 (see Exhibit 1-5). The amount in box 1 is reported on line 19 of Schedule 1.

Citizens of Alaska also report any Alaska Permanent Fund dividends they receive on line 19 of Schedule 1.

Standard Deduction from Income (Form 1040, line 8)


Taxpayers are permitted a standard deduction from income or they can itemize their deductions, if larger. We discuss itemized deductions in chapter 5. For purposes of this chapter, the line 8 deduction is either \$12,000 if the taxpayer is single or \$24,000 if the taxpayer is filing a return as married. These dollar amounts represent the amount of income that is not taxed.

⁹ IRC § 61(a)(4).

¹⁰ Interest paid in conjunction with a trade or business is covered in Chapter 6. Personal interest paid is in Chapters 4 and 5.

¹¹ IRC § 85(a).

EXHIBIT 1-2

a Employee's social security number		OMB No. 1545-0008		Safe, accurate, FAST! Use				Visit the IRS website at www.irs.gov/efile	
b Employer identification number (EIN)				1 Wages, tips, other compensation		2 Federal income tax withheld			
c Employer's name, address, and ZIP code				3 Social security wages		4 Social security tax withheld			
				5 Medicare wages and tips		6 Medicare tax withheld			
				7 Social security tips		8 Allocated tips			
d Control number				9 Verification code		10 Dependent care benefits			
e Employee's first name and initial Last name Suff.				11 Nonqualified plans		12a See instructions for box 12			
				13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b			
				14 Other		12c			
						12d			
f Employee's address and ZIP code									
15 State Employer's state ID number		16 State wages, tips, etc.		17 State income tax		18 Local wages, tips, etc.		19 Local income tax 20 Locality name	

Form W-2 Wage and Tax Statement 2018 Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Source: U.S. Department of the Treasury, Internal Revenue Service, Form W-2 Wage and Tax Statement. Washington, DC: 2018.

EXHIBIT 1-3

<input type="checkbox"/> CORRECTED (if checked)			OMB No. 1545-0112		2018	Interest Income
PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		Payer's RTN (optional)		Form 1099-INT		
		1 Interest income				Copy B For Recipient This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
		\$				
2 Early withdrawal penalty						
\$						
PAYER'S TIN	RECIPIENT'S TIN	3 Interest on U.S. Savings Bonds and Treas. obligations				
		\$				
RECIPIENT'S name		4 Federal income tax withheld		5 Investment expenses		
		\$		\$		
		6 Foreign tax paid		7 Foreign country or U.S. possession		
Street address (including apt. no.)		\$				
City or town, state or province, country, and ZIP or foreign postal code		8 Tax-exempt interest		9 Specified private activity bond interest		
		\$		\$		
		10 Market discount		11 Bond premium		
		\$		\$		
		12 Bond premium on Treasury obligations		13 Bond premium on tax-exempt bond		
		\$		\$		
Account number (see instructions)		14 Tax-exempt and tax credit bond CUSIP no.		15 State	16 State identification no.	17 State tax withheld
						\$
						\$

Form **1099-INT** (keep for your records) www.irs.gov/Form1099INT Department of the Treasury - Internal Revenue Service

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1099-INT. Washington, DC: 2018.


EXHIBIT 1-4

SCHEDULE 1 (Form 1040) Department of the Treasury Internal Revenue Service	Additional Income and Adjustments to Income ▶ Attach to Form 1040. ▶ Go to www.irs.gov/Form1040 for instructions and the latest information.	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold;">2018</div> Attachment Sequence No. 01
Name(s) shown on Form 1040		Your social security number
<div style="display: flex; justify-content: space-between;"> <div style="width: 65%;"> Additional Income </div> <div style="width: 30%; text-align: right;"> 1-9b </div> </div>		
10 Taxable refunds, credits, or offsets of state and local income taxes		10
11 Alimony received		11
12 Business income or (loss). Attach Schedule C or C-EZ		12
13 Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>		13
14 Other gains or (losses). Attach Form 4797		14
15a Reserved		15b
16a Reserved		16b
17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17
18 Farm income or (loss). Attach Schedule F		18
19 Unemployment compensation		19
20a Reserved		20b
21 Other income. List type and amount ▶		21
22 Combine the amounts in the far right column. If you don't have any adjustments to income, enter here and include on Form 1040, line 6. Otherwise, go to line 23		22
<div style="display: flex; justify-content: space-between;"> <div style="width: 65%;"> Adjustments to Income </div> <div style="width: 30%; text-align: right;"> 23 </div> </div>		
23 Educator expenses		23
24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106		24
25 Health savings account deduction. Attach Form 8889		25
26 Moving expenses for members of the Armed Forces. Attach Form 3903		26
27 Deductible part of self-employment tax. Attach Schedule SE		27
28 Self-employed SEP, SIMPLE, and qualified plans		28
29 Self-employed health insurance deduction		29
30 Penalty on early withdrawal of savings		30
31a Alimony paid b Recipient's SSN ▶		31a
32 IRA deduction		32
33 Student loan interest deduction		33
34 Reserved		34
35 Reserved		35
36 Add lines 23 through 35		36

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F Schedule 1 (Form 1040) 2018

EXHIBIT 1-5

<input type="checkbox"/> CORRECTED (if checked)			
PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		<div style="display: flex; justify-content: space-between;"> <div style="width: 60%;"> 1 Unemployment compensation \$ 2 State or local income tax refunds, credits, or offsets \$ </div> <div style="width: 35%; text-align: center;"> <div style="font-size: 2em; font-weight: bold;">2018</div> Form 1099-G </div> </div>	
PAYER'S TIN	RECIPIENT'S TIN	3 Box 2 amount is for tax year	4 Federal income tax withheld \$
RECIPIENT'S name Street address (including apt. no.) City or town, state or province, country, and ZIP or foreign postal code		<div style="display: flex; justify-content: space-between;"> <div style="width: 60%;"> 5 RTAA payments \$ 7 Agriculture payments \$ 9 Market gain \$ </div> <div style="width: 35%;"> 6 Taxable grants \$ 8 If checked, box 2 is trade or business income <input type="checkbox"/> </div> </div>	
		<div style="display: flex; justify-content: space-between;"> <div style="width: 60%;"> 10a State \$ </div> <div style="width: 35%;"> 10b State identification no. \$ </div> </div>	
		11 State income tax withheld \$	
Account number (see instructions)		<div style="border: 1px solid black; padding: 5px;"> Copy B For Recipient This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported. </div>	
Form 1099-G (keep for your records) www.irs.gov/Form1099G Department of the Treasury - Internal Revenue Service			

	Taxable Income (Form 1040, line 10) <i>Taxable income</i> refers to the wages, interest, and other items on lines 1-6, minus the standard deduction on line 8. ¹² Taxable income is the tax base used to determine the amount of tax.						
CONCEPT CHECK 1-3— LO 1-3 	1. Only certain types of income are reported directly on the face of page 2, Form 1040. They are _____. 2. Unemployment compensation is reported to the taxpayer on a Form _____.						
CALCULATION OF INCOME TAX (FORM 1040, LINE 11) AND HEALTH CARE TAX (SCHEDULE 4, LINE 61) LO 1-4	Income Tax (Form 1040, Line 11) <p>The total amount of tax liability on line 11 of Form 1040 is determined based on the amount of taxable income (line 10). Taxpayers could calculate their tax using the tax rate schedule shown in Table 1-2 (or a similar one if the taxpayer were single). However, that method can be a bit complicated and can result in calculation errors. To make things easier, the IRS has prepared tax tables that predetermine the amount of tax liability for taxable incomes of up to \$100,000.</p> <p>The tax tables applicable for tax year 2018 are printed in Appendix D of this text. Please refer to the 2018 tax tables when reviewing the examples and when working the problems at the end of this chapter unless you are told otherwise.</p>						
EXAMPLE 1-2	Art is a single taxpayer and has taxable income of \$42,787. Referring to the tax table, his income is between \$42,750 and \$42,800. Reading across the table to the Single column gives a tax of \$5,350.						
EXAMPLE 1-3	Joe and Marsha are married and are filing a joint tax return. They have taxable income of \$45,059. In the tax table, their income is between \$45,050 and \$45,100. Their corresponding tax liability is \$5,028.						
	<p>Notice the effect of a differing filing status. Art had lower taxable income than did Joe and Marsha, but Art's tax liability was higher. All other things being equal, for equivalent amounts of taxable income, the highest tax will be paid by married persons filing separately, followed by single persons, then heads of household, and finally by married persons filing jointly. There are two exceptions to this general observation. The first is that, for taxable income up to \$38,700, tax liability will be the same for all groups. The second is that married persons filing separately and single persons will have equal tax liability at taxable income levels up to \$300,000.</p> <p>In the preceding examples, we used the tax tables in Appendix D of this text to determine the amount of tax liability. If we calculated the amount of tax using the tax rate schedules provided in Appendix F of this text (or in Table 1-2 for married taxpayers), we would have computed a slightly different number.</p>						
EXAMPLE 1-4	<p>Bill and Andrea Chappell, a married couple, have taxable income of \$48,305. Using the tax tables in Appendix D, their tax liability is \$5,418. Using the tax rate schedule in Table 1-2 (and printed in Appendix F of this text), their tax liability is</p> <table> <tr> <td>Tax on \$19,050 × 10%</td> <td>\$1,905.00</td> </tr> <tr> <td>Tax on (\$48,305 – \$19,050) × 12%</td> <td>\$3,510.60</td> </tr> <tr> <td>Total tax</td> <td><u>\$5,415.60</u></td> </tr> </table>	Tax on \$19,050 × 10%	\$1,905.00	Tax on (\$48,305 – \$19,050) × 12%	\$3,510.60	Total tax	<u>\$5,415.60</u>
Tax on \$19,050 × 10%	\$1,905.00						
Tax on (\$48,305 – \$19,050) × 12%	\$3,510.60						
Total tax	<u>\$5,415.60</u>						

¹² We discuss the qualified business income deduction in Chapter 6.

Here the difference between the two tax numbers is \$2.40. There will usually be a slight difference between the amount of tax calculated using the tax tables and the amount calculated using the tax rate schedules. The reason is that the tax rate schedules are precise, whereas the tax tables in Appendix D determine tax liability in \$50 increments. In fact, the amount of tax liability shown in the tax tables represents the tax due on taxable income exactly in the middle of the \$50 increment. The tax tables calculated Bill and Andrea's tax based on taxable income of \$48,325 (the middle of the range of \$48,300 to \$48,350). So, the tax tables added \$20 to their taxable income. $\$20 \times 12\%$ marginal rate = \$2.40 difference. Thus a taxpayer with taxable income in the lower half of the increment (like Bill and Andrea in the example) will pay a little extra in tax while someone in the upper half of the increment will pay a little less.

Again, unless instructed otherwise, for taxable income under \$100,000 use the tax tables in Appendix D when you calculate tax liability.

TAX YOUR BRAIN



Determine the precise tax liability using the tax rate schedules in Appendix F for Art in Example 1-2 and for Joe and Marsha in Example 1-3.

ANSWER

Using the tax rate schedules, Art's tax liability is \$5,352.64. The tax liability of Joe and Marsha is \$5,026.08.

Health Care Tax (Schedule 4, line 61)

The Affordable Care Act requires all individuals to either have health care coverage, or qualify for a health coverage exemption, or make a shared responsibility payment with their tax return. The shared responsibility payment is reported on Schedule 4, line 61 (see Exhibit 1-6).

Most health care coverage that people have is qualifying health care coverage (also called *minimum essential coverage*). Common examples of qualifying coverage are:

- Health coverage provided by the taxpayer's employer,
- Health coverage obtained through the Health Insurance Marketplace (also known as an "Exchange"), and
- Most government-sponsored coverage including Medicare, most Medicaid, and coverage for veterans and active duty service members.

EXHIBIT 1-6

SCHEDULE 4 (Form 1040) <small>Department of the Treasury Internal Revenue Service</small>		Other Taxes ► Attach to Form 1040. ► Go to www.irs.gov/Form1040 for instructions and the latest information.		<small>OMB No. 1545-0074</small> 2018 <small>Attachment Sequence No. 04</small>	
Name(s) shown on Form 1040				Your social security number	
Other Taxes	57	Self-employment tax. Attach Schedule SE	57		
	58	Unreported social security and Medicare tax from: Form a <input type="checkbox"/> 4137 b <input type="checkbox"/> 8919	58		
	59	Additional tax on IRAs, other qualified retirement plans, and other tax-favored accounts. Attach Form 5329 if required	59		
	60a	Household employment taxes. Attach Schedule H	60a		
	b	Repayment of first-time homebuyer credit from Form 5405. Attach Form 5405 if required	60b		
	61	Health care: individual responsibility (see instructions)	61		
	62	Taxes from: a <input type="checkbox"/> Form 8959 b <input type="checkbox"/> Form 8960 c <input type="checkbox"/> Instructions; enter code(s)	62		
	63	Section 965 net tax liability installment from Form 965-A 63			
64	Add the amounts in the far right column. These are your total other taxes . Enter here and on Form 1040, line 14	64			

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71481R **Schedule 4 (Form 1040) 2018**

If a taxpayer or a taxpayer and spouse (if filing jointly) had qualifying health care coverage for every month of 2018, then no additional tax due. In this case, the taxpayer checks the box on the first page of Form 1040 (just to the right of the entry for City and State). Most taxpayers will have qualifying coverage.

If a taxpayer did not have qualifying coverage, the taxpayer may be eligible for an exemption from health care coverage. Some of the exemptions include:

- Cost of the lowest-cost qualifying coverage exceeds 8% of household income.
- Taxpayer income is below the minimum level required to file a return. Generally, for single taxpayers this amount is gross income less than \$12,000 and for married taxpayers it is gross income less than \$24,000. These amounts are increased if the taxpayer or spouse is over age 65.
- If a taxpayer went without coverage for less than three consecutive months during the year.

For a complete list of exemptions, refer to the instructions for Form 8965, available on the IRS Web site.

Taxpayers who qualify for an exemption must file a Form 8965 and no additional tax is due on Schedule 4, line 61.

If a taxpayer does not have qualifying coverage and is not eligible for an exemption, the taxpayer will be required to report a shared responsibility payment on Schedule 4, line 61.

In general, the annual shared responsibility payment is the greater of:

- 2.5% of household income that is greater than the tax return filing threshold (see on the following page), or
- A flat dollar amount, which is \$695 per adult and \$347.50 per child under age 18, limited to a family maximum of \$2,085.

Taxpayers owe 1/12 of the calculated annual shared responsibility payment for each month they do not have coverage and do not qualify for an exemption.

The annual shared responsibility payment cannot exceed the national average premium for a bronze-level qualified health plan available through the Marketplace. Practically, this limitation is unlikely to apply.

The tax return filing threshold amounts are shown in the following chart.

Filing Status	Household Income Threshold
Single, under age 65	\$12,000
Single, age 65 or older	\$13,600
Married, filing jointly, both spouses under age 65	\$24,000
Married, filing jointly, one spouse age 65 or older	\$25,300
Married, filing jointly, both spouses age 65 or older	\$26,600
Married filing separately	\$12,000
Head of household, under age 65	\$18,000
Head of household, age 65 or older	\$19,600

We discuss married filing separately and head of household filing statuses in Chapter 2.

EXAMPLE 1-5

Debra is age 37 and single. During all of 2018, she did not have qualifying health care coverage, nor was she eligible for an exemption. The national average premium limitation does not apply. Her household income was \$50,000. Her annual shared responsibility payment is the greater of:

- 2.5% of household income that is greater than the threshold. This is $(\$50,000 - \$12,000) \times 2.5\% = \$950$.
- \$695.

Thus, her annual shared responsibility payment, shown on Schedule 4, line 61, is \$950.

EXAMPLE 1-6

George and Deloris are both under age 65 and file as married, filing jointly. During all of 2018, they did not have qualifying health care coverage, nor were they eligible for an exemption. The national average premium limitation does not apply. Their household income was \$35,000. Their annual shared responsibility payment is the greater of:

- 2.5% of household income that is greater than the threshold. This is $(\$35,000 - \$24,000) \times 2.5\% = \$275$.
- $\$695 \times 2 = \$1,390$.

Thus, their annual shared responsibility payment, shown on Schedule 4, line 61, is \$1,390.

Certain taxpayers are eligible for a premium tax credit. In general, eligible taxpayers have income that is 400% or less than the federal poverty line for the taxpayer's family size. We discuss the premium tax credit in Chapter 9, Tax Credits.

The IRS issues publications which provide additional details related to application of the Affordable Care Act. These include Publication 5187, Publication 5201, and the instructions to Form 8965. All are available on the IRS Web site at www.irs.gov.

Total Tax (Form 1040, line 15)

Line 15 is the tax from line 11, minus tax credits from Schedule 3 (we discuss these credits in Chapter 9), plus other taxes from Schedule 4 (we discuss these in Chapters 6, 9, and 10). The amount represents the total amount the taxpayer must pay to the government for the tax year. As we will see the taxpayer has likely already paid all or most of this liability.

**CONCEPT
CHECK 1-4—
LO 1-4**


1. Taxpayers with taxable income under \$100,000 *must* calculate their tax liability using the tax tables. True or false?
2. Refer to the tax tables. What is the tax liability of a married couple with taxable income of \$93,262? _____
3. Using the tax rate schedule in Table 1-2 (or Appendix F), determine the tax liability (to the nearest penny) for a married couple with taxable income of \$93,262. _____
4. Taxpayers who do *not* have qualifying health care coverage must pay a shared responsibility payment of 2.5% of household income. True or False?

TAX PAYMENTS (FORM 1040, LINE 16 AND 17)**LO 1-3**

Usually, taxpayers pay most of their tax liability prior to the due date of the tax return. Commonly, taxpayers pay through income tax withholding or quarterly estimated tax payments.

When certain taxable payments are made to individuals, the law requires the payer to retain (withhold) a portion of the payment otherwise due and to remit the amount withheld to the Treasury.¹³ The withheld amount represents an approximation of the amount of income tax that would be due for the year on the taxable payment. Withholding, credited to the account of the taxpayer, reduces the amount of tax otherwise due to the government on the due date of the return.

Taxpayers have taxes withheld from their wages. When an employer pays a salary or wages to an employee, the employer is required to retain part of the amount otherwise due the employee. The amount retained is payroll tax withholding and is a part of virtually every pay stub in the country. The total amount of individual income tax withheld from the earnings of an employee is shown in box 2 of the Form W-2 given to each employee shortly after the end of the calendar year. The amount in box 2 is transferred to line 16 of Form 1040.

Earned Income Credit (Form 1040, line 17a)

An Earned Income Credit (EIC) is available for certain low-income taxpayers. The EIC is a percentage of earned income with a phaseout of the credit at higher earned income amounts. For purposes of this chapter, we will assume the EIC is zero. We discuss the EIC in more detail in Chapter 9.

¹³ See Chapter 10 for discussion of the rules associated with withholding and remitting payroll taxes.

From Shoebox to Software An Introduction



Throughout this text, we provide a series of features called From Shoebox to Software. These sections explain how a tax preparer goes about putting together all or part of a tax return. Because this is the first time we have presented a From Shoebox to Software feature, let's explain what it is and how it works.

The majority of the information that appears on a tax return comes from some sort of source document. The most common document is an IRS form. Almost all taxpayers receive source documents provided on standardized IRS forms. These documents include a W-2 for wages, a 1099-INT for interest payments, a 1099-B for stock brokerage transactions, and many others. These documents serve a dual purpose. First, they provide taxpayers information necessary to prepare a portion of their tax returns in a standardized and easy-to-use format. Second, the IRS receives a copy of each document and uses the information to check whether individual taxpayers have properly reported items on their tax returns.

The second type of document used for tax return preparation is a nonstandardized, free-form document. It could be a charge card receipt from a restaurant meal with a business customer, a bill from a hospital for medical care, or a written record (such as a journal) of business car expenses.

Taxpayers accumulate documents during the tax year and then use them when the tax return is prepared. Tax return preparers have a standard joke about clients coming to their office with a pile of documents—some useful, some not. This pile of documents is often called a “shoebox” because many times that's what the documents are kept in during the year. Virtually every tax preparer has a story (often many) about a client who drops a shoebox full of documents on the preparer's desk—often on April 14, the day before the individual income tax return filing deadline.

The tax return preparer must then make sense of the shoebox full of documents. One challenge is to separate the documents useful in the preparation of the return (W-2s,

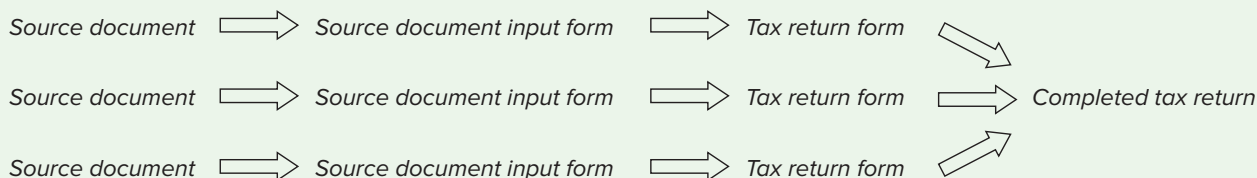
medical receipts, etc.) from documents that do not matter (the receipt for a new gas grill used by the taxpayer at home). The series of From Shoebox to Software explanations (and your future understanding of tax rules and regulations) will help you extract the valuable documents from the rest of the papers.

From Shoebox to Software explanations will also help you determine how the information from the document is “put into” tax software so the completed return is accurate. It is one thing to have the correct data and quite another to be able to efficiently, effectively, and correctly use them in the software. Many tax software products are available for use. Some are very simple, and others are extremely complex. In this book we use TaxAct software, produced by 2nd Story Software. However, it doesn't matter what software product you use because almost all tax software has a similar structure: Source document information is entered into a series of input forms that then feed into a tax return form that is then assembled with other tax return forms into a final completed tax return. The drawing below illustrates the process.

When you use the tax software, you initially record the information from the source document on a source document input form. For example, you record information from a W-2 source document on a W-2 input form in the tax software. You record most tax information in a similar manner.

Sometimes you record source document data directly on a tax return form. This occurs if the item is unusual or does not “flow” to another form.

The From Shoebox to Software text boxes will show you how to take raw data and enter them correctly on the tax forms. Before you start to use the software, you should take a few minutes to read Appendix C of this chapter, where we provide some basic information and guidelines concerning the TaxAct software that is included with this text.



Total Payments (Form 1040, line 18)

Line 18 is the sum of the tax withholding from line 16 and the credits on line 17.

Tax Refund (line 20a) or Tax Due with Return (line 22)

Compare the amount owed (line 15) with the total amount already paid (line 18). Excess payment results in a refund; remaining tax liability means the taxpayer must pay the remaining amount owed when filing the return.

(text continues on page 1-19)

From Shoebox to Software A Comprehensive Example



This comprehensive example allows you to use what you have learned. Use your tax software and follow along as we explain the procedure. When you have finished, you will have prepared a 1040 using the information in the example.

Your clients are Ed and Betty Davidson, a married couple. They live at 456 Main Street, Anywhere, NC 27890. Ed's social security number is 412-34-5670 and Betty's is 412-34-5671.¹⁴

Betty worked at Brenden Manufacturing and received a W-2 from the company. Ed performed volunteer work during the year and received no compensation. They received \$372.33 in interest income from First Savings Bank during the year.

You received the following documents (see below and the next page) from the Davidsons.

Open TaxAct. Click on Forms on the toolbar at the top of the page. This will open the Forms Explorer and allow you to select the form you wish to work on. You will use the Forms method to input information into the TaxAct software. We realize that the software has a mode, called Q&A, that will ask the user a series of questions and will create a tax return based on the answers. Tax practitioners seldom use this mode. If you plan to become a tax practitioner (or even if you just want to do your own return yourself), you will need to get in the habit of using the Forms mode to become more

familiar with the various IRS forms used when filing a return.

The Forms Explorer has three primary categories of forms from which to choose:

Forms and schedules: This section includes all of the IRS forms that you need to complete a tax return. At this point, we care about only one form—the 1040.

Documents received: Earlier we mentioned that the Shoebox contains two types of source documents. One type of source document is an IRS form. In the Documents Received section, you will find input screens for many IRS forms received by taxpayers. When you properly input the IRS form information on the appropriate screen, the data will automatically flow to all other applicable forms. For the Davidsons, we are interested in the input forms for their W-2 and the 1099-INT.

Worksheets: This section contains worksheets for you to input information that the software will summarize and then show on the appropriate tax form. These worksheets are helpful to collect supporting information in one place. The software worksheets also help the tax practitioner have consistent work paper files and procedures. For this example, we will not use any of the worksheets.

a Employee's social security number 412-34-5671		OMB No. 1545-0008		Safe, accurate, FAST! Use				Visit the IRS website at www.irs.gov/efile	
b Employer identification number (EIN)				1 Wages, tips, other compensation 53,766.00		2 Federal income tax withheld 3,379.12			
c Employer's name, address, and ZIP code Brenden Manufacturing 6789 Main Street Anywhere, NC 27890				3 Social security wages 53,766.00		4 Social security tax withheld 3,333.49			
				5 Medicare wages and tips 53,766.00		6 Medicare tax withheld 779.61			
				7 Social security tips		8 Allocated tips			
d Control number				9 Verification code		10 Dependent care benefits			
e Employee's first name and initial Last name Suff.				11 Nonqualified plans		12a See instructions for box 12			
Betty Davidson 456 Main Street Anywhere, NC 27890				13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b			
				14 Other		12c			
						12d			
f Employee's address and ZIP code									
15 State Employer's state ID number NC		16 State wages, tips, etc. 53,766.00		17 State income tax 1,201.22		18 Local wages, tips, etc.		19 Local income tax 20 Locality name	

Form **W-2** Wage and Tax Statement

2018

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Source: U.S. Department of the Treasury, Internal Revenue Service, Form W-2 Wage and Tax Statement. Washington, DC: 2018.

¹⁴ Throughout the text we use common fictional social security numbers for all our fictional taxpayers.

<input type="checkbox"/> CORRECTED (if checked)				
PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. First Savings Bank 123 Main Street Anywhere, NC 27890		Payer's RTN (optional) 1 Interest income \$ 372.33	OMB No. 1545-0112 2018 Form 1099-INT	Interest Income Copy B For Recipient This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
PAYER'S TIN 33-1234500	RECIPIENT'S TIN 412-34-5670	2 Early withdrawal penalty \$		
RECIPIENT'S name Ed Davidson Street address (including apt. no.) 456 Main Street City or town, state or province, country, and ZIP or foreign postal code Anywhere, NC 27890		3 Interest on U.S. Savings Bonds and Treas. obligations \$	4 Federal income tax withheld \$	
RECIPIENT'S name Ed Davidson Street address (including apt. no.) 456 Main Street City or town, state or province, country, and ZIP or foreign postal code Anywhere, NC 27890		5 Investment expenses \$	6 Foreign tax paid \$	
RECIPIENT'S name Ed Davidson Street address (including apt. no.) 456 Main Street City or town, state or province, country, and ZIP or foreign postal code Anywhere, NC 27890		7 Foreign country or U.S. possession \$	8 Tax-exempt interest \$	9 Specified private activity bond interest \$
RECIPIENT'S name Ed Davidson Street address (including apt. no.) 456 Main Street City or town, state or province, country, and ZIP or foreign postal code Anywhere, NC 27890		10 Market discount \$	11 Bond premium \$	12 Bond premium on Treasury obligations \$
RECIPIENT'S name Ed Davidson Street address (including apt. no.) 456 Main Street City or town, state or province, country, and ZIP or foreign postal code Anywhere, NC 27890		13 Bond premium on tax-exempt bond \$	14 Tax-exempt and tax credit bond CUSIP no. 	15 State
RECIPIENT'S name Ed Davidson Street address (including apt. no.) 456 Main Street City or town, state or province, country, and ZIP or foreign postal code Anywhere, NC 27890		16 State identification no. 	17 State tax withheld \$	
RECIPIENT'S name Ed Davidson Street address (including apt. no.) 456 Main Street City or town, state or province, country, and ZIP or foreign postal code Anywhere, NC 27890		18 State tax withheld \$	19 State tax withheld \$	

Form **1099-INT** (keep for your records) www.irs.gov/Form1099INT Department of the Treasury - Internal Revenue Service

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1099-INT. Washington, DC: 2018.

To start, you must input the basic information about the Davidsons. Go to the File menu (upper left) and click on New Return. The system will then give you the opportunity to import data from a prior year's tax return. For all examples in this text, there is no prior year information.

You will now be at the main TaxAct screen in the Q&A mode. Click on the Forms icon on the taskbar. This will take you to the Forms Explorer. Click on Forms and Schedules and then double-click on Federal Form 1040. TaxAct will print out the appropriate return and schedules depending on the data provided. Information related to the taxpayer is recorded on Form 1040.

You now need to input the basic name and address information for the Davidsons. Click on the appropriate boxes in the white area on the upper portion of the 1040 form. You also need to input their social security numbers in the appropriate boxes. When you have entered the information, click the Forms icon and then double-click on Federal Form 1040. You should now be looking at Form 1040 with the Davidsons' information at the top of the form. Check to see that the information is correct. If not, go back to Form 1040 and correct it.

We now need to input the W-2 and 1099-INT information. Click on the Forms icon and then click on Documents Received toward the bottom of the left column. Input the W-2 first. Double-click on Federal Form W-2. This will bring up a W-2 input form. You now need to input the information from Betty's W-2 from Brenden Manufacturing. Fill in all appropriate boxes, including the employer name and address. Make sure you input the correct social security number and name for Betty. When you have completed the W-2 for Brenden Manufacturing, click the Back button at the bottom. You will be

back at the Forms Explorer.

Now input the information from the 1099-INT.

You have now input the tax information for the Davidsons. Let's look at the result. Go to the Forms Explorer, click on Forms and Schedules, and double-click on Federal Form 1040. This will bring up the completed 1040 of the Davidsons.

Your completed 1040 should look like the form shown on the next page.

Line 1, wages, salaries, and tips, is \$53,766. This is the wage information from the W-2 of Betty.

Line 2b, taxable interest, shows the \$372 of interest income from First Savings Bank. When you typed in the information, you put in \$372.33, yet line 2b only shows \$372. What happened to the 33 cents? When you input information, you use dollars and cents. When the software completes the forms, it will round all numbers to the nearest dollar (the IRS says we need to round down amounts below 50 cents and round up amounts of 50 cents or more).

Line 7, Adjusted Gross Income, is the summation of lines 1 and 2. Line 8 is the \$24,000 deduction for a married couple. Taxable income, line 10, is \$30,138 and represents line 7 minus line 8.

Line 15 is the total tax liability of \$3,234. You can check this figure with reference to the 2018 tax tables.

Line 16, federal income tax withheld, is the amount from box 2 from Betty's W-2.

When you compare the Davidsons' total liability of \$3,234 to the \$3,379 they have already paid in withholding and credits, you see that the Davidsons will receive a refund of \$145. This amount is on line 20a.

Form 1040 Department of the Treasury—Internal Revenue Service (99) **2018** U.S. Individual Income Tax Return OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing status: ☐ Single ☒ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Your first name and initial **Ed** Last name **Davidson** Your social security number **4 1 2 3 4 5 6 7 0**

Your standard deduction: ☐ Someone can claim you as a dependent ☐ You were born before January 2, 1954 ☐ You are blind

If joint return, spouse's first name and initial **Betty** Last name **Davidson** Spouse's social security number **4 1 2 3 4 5 6 7 1**

Spouse standard deduction: ☐ Someone can claim your spouse as a dependent ☐ Spouse was born before January 2, 1954 ☒ Full-year health care coverage or exempt (see inst.)

☐ Spouse is blind ☐ Spouse itemizes on a separate return or you were dual-status alien

Home address (number and street). If you have a P.O. box, see instructions. **456 Main Street** Apt. no. **Presidential Election Campaign** (see inst.) ☐ You ☐ Spouse

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6. **Anywhere, NC 27890** If more than four dependents, see inst. and ☒ here ☐

Dependents (see instructions):

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) <input checked="" type="checkbox"/> if qualifies for (see inst.):	Child tax credit	Credit for other dependents
					<input type="checkbox"/>	<input type="checkbox"/>
					<input type="checkbox"/>	<input type="checkbox"/>
					<input type="checkbox"/>	<input type="checkbox"/>

Sign Here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature _____ Date _____ Your occupation _____ If the IRS sent you an Identity Protection PIN, enter it here (see inst.) _____

Spouse's signature. If a joint return, **both** must sign. _____ Date _____ Spouse's occupation _____ If the IRS sent you an Identity Protection PIN, enter it here (see inst.) _____

Paid Preparers Print/Type preparer's name _____ Preparer's signature _____ PTIN _____ Check if: ☐ 3rd Party Designee ☐ Self-employed

See Schedule 6 Firm's name _____ Firm's EIN _____

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2018)

Form 1040 (2018) Page **2**

1 Wages, salaries, tips, etc. Attach Form(s) W-2 **53,766**

2a Tax-exempt interest **372**

3a Qualified dividends

4a IRAs, pensions, and annuities

5a Social security benefits

6 Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22 **54,138**

7 Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 36, from line 6 **54,138**

8 Standard deduction or itemized deductions (from Schedule A) **24,000**

9 Qualified business income deduction (see instructions)

10 Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0- **30,138**

11 a Tax (see inst.) **3,234** (check if any from: 1 ☐ Form(s) 8814 2 ☐ Form 4972 3 ☐) b Add any amount from Schedule 2 and check here ☐

12 a Child tax credit/credit for other dependents b Add any amount from Schedule 3 and check here ☐

13 Subtract line 12 from line 11. If zero or less, enter -0- **3,234**

14 Other taxes. Attach Schedule 4

15 Total tax. Add lines 13 and 14 **3,234**

16 Federal income tax withheld from Forms W-2 and 1099 **3,379**

17 Refundable credits: a EIC (see inst.) b Sch 8812 c Form 8863

Add any amount from Schedule 5

18 Add lines 16 and 17. These are your total payments **3,379**

19 If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you **overpaid** **145**

20a Amount of line 19 you want **refunded to you**. If Form 8888 is attached, check here ☐

20b Routing number ☐ Type: ☐ Checking ☐ Savings

20d Account number

21 Amount of line 19 you want **applied to your 2019 estimated tax** **21**

Amount You Owe Amount you owe. Subtract line 18 from line 15. For details on how to pay, see instructions **22**

23 Estimated tax penalty (see instructions) **23**

Go to www.irs.gov/Form1040 for instructions and the latest information. Form **1040** (2018)

Standard Deduction for—

- Single or married filing separately, \$12,000
- Married filing jointly or Qualifying widow(er), \$24,000
- Head of household, \$18,000
- If you checked any box under Standard deduction, see instructions.

Attach Form(s) W-2. Also attach Form(s) W-2G and 1099-R if tax was withheld.

	<p>A taxpayer who is entitled to a refund can elect to (a) receive a check or (b) have the refund deposited directly in the taxpayer's bank account by supplying account information on lines 20b, c, and d.</p> <p>In many ways, a tax return is the document a taxpayer uses to “settle up” with the IRS after a tax year is over. On it, the taxpayer reports income and deductions, the amount of tax, and the tax already paid. The refund (line 20a) or tax due (line 22) is simply the balancing figure required to make total net payments equal to the amount of total tax liability.</p> <p>Individual income tax returns must be filed with the IRS no later than April 15 of the following year. Thus tax returns for calendar year 2018 must be filed (postmarked) no later than April 15, 2019. If April 15 falls on a weekend, taxpayers must file by the following Monday. Taxpayers can receive a six-month extension to file their returns if they file Form 4868 no later than April 15. Any remaining tax liability is still due by April 15—the extension of time pertains only to the tax return, not the tax due.</p>
EXAMPLE 1-7	Nora, who is single, has determined that her total tax liability for 2018 is \$4,486. In 2018 her employer withheld \$4,392 from Nora's paychecks. When Nora files her return, she will need to enclose a check for \$94. Thus Nora's total payment for tax year 2018 is \$4,486 (\$4,392 withholdings plus \$94 paid with her return), which is equal to her total liability for 2018.
EXAMPLE 1-8	Todd and Ellen, a married couple, determined that their total tax liability for 2018 is \$8,859. In 2018 Ellen's employer withheld \$5,278 from her paycheck and Todd's employer withheld \$3,691. Todd and Ellen will receive a refund of \$110 (\$5,278 + \$3,691 – \$8,859). Thus Ellen and Todd's total payment for tax year 2018 is \$8,859 (\$5,278 and \$3,691 of withholdings minus the \$110 refund), which is equal to their total liability for 2018.

**CONCEPT
CHECK 1-5—
LO 1-3**



1. Taxpayers pay all of their tax liability when they file their tax returns. True or false?
2. Bret's tax liability is \$15,759. His employer withheld \$15,367 from his wages. When Bret files his tax return, will he be required to pay or will he get a refund? _____. What will be the amount of payment or refund? _____
3. An Earned Income Credit will increase the amount of tax liability. True or false?

Appendix A

**TAX AUTHORITY
LO 1-5**

Throughout this text, there are many references to “tax authority.” As a beginning tax student, you need to understand what tax authority is. The best definition of *tax authority* is that the term refers to the guidelines that give the taxpayer not only guidance to report taxable income correctly but also guidelines and precedent for judicial decisions concerning conflicts between the IRS and the taxpayer. There are three types of primary tax authority:

- Statutory sources
- Administrative sources
- Judicial sources

TABLE 1-4
Legislative Process
of U.S. Tax Laws

- U.S. House of Representatives Ways and Means Committee.
- Voted on by the House of Representatives.
- U.S. Senate Finance Committee.
- Voted on by the Senate.
- Joint Conference Committee (if differences between the House and Senate versions).
- Joint Conference bill voted on by the House of Representatives and the Senate.
- If the bill passes the House and Senate—signed or vetoed by the president of the United States.
- If signed—incorporated into the Internal Revenue Code.

Statutory Sources of Tax Authority

The ultimate statutory tax authority is the Sixteenth Amendment to the U.S. Constitution. By far the most commonly relied-upon statutory authority is the IRC. Congress writes the IRC. Changes to it must pass through the entire legislative process to become law. Table 1-4 shows the legislative process for tax laws.

Typically federal tax legislation begins in the Ways and Means Committee of the House of Representatives (although bills can start in the Senate Finance Committee). A tax bill passed by the House is sent to the Senate for consideration. If the Senate agrees to the bill with no changes, it sends the bill to the president for a signature or veto. If, as is more likely, the Senate passes a bill different from the House version, both houses of Congress select some of their members to be on a Joint Conference Committee. The committee's goal is to resolve the conflict(s) between the House and Senate versions of the bill. Once conflicts are resolved in the Conference Committee, both the House and the Senate vote on the common bill. If passed by both bodies, the bill goes to the president and, if signed, becomes law and part of the IRC.

Each enacted law receives a public law number. For example, Public Law 99-272 means the enacted legislation was the 272nd bill of the 99th Congress (the January 2019 to January 2021 legislative years of the Congress will be the 116th Congress).

Throughout the legislative process, each taxation committee (Ways and Means, Senate Finance, and the Joint Conference Committee) generates one or more committee reports that note the "intent of Congress" in developing legislation. These committee reports can provide courts, the IRS, and tax professionals guidance as to the proper application of enacted tax law. The public law number of the bill is used to reference committee reports. Public Law 99-272 would have a House Ways and Means Committee report, a Senate Finance Committee report, and possibly a Joint Conference Committee report.¹⁴

The IRS publishes the congressional reports in the *IRS Cumulative Bulletin*. *Cumulative Bulletins* are in most libraries in the government documents section. The reports are also on various governmental Internet sites. Use an Internet search engine to help you find these sites. *Cumulative Bulletins* for the last five years are available on the IRS Web site (www.irs.gov).

The IRC is organized by subtitle, as shown in Table 1-5.

TABLE 1-5
Subtitles of the Internal
Revenue Code

Subtitle	Subject
A	Income taxes
B	Estate and gift taxes
C	Employment taxes
D	Excise taxes
E	Alcohol and tobacco taxes
F	Procedure and administration
G	Joint Committee on Taxation
H	Presidential election campaign financing
I	Trust funds

¹⁴ Not all bills have committee reports from each house of Congress. If there are no conflicts between the House and Senate, additional committee reports are not necessary. Such an outcome is unusual.

Most of this text pertains to subtitle A of the IRC (income taxes). The IRC is hundreds of pages in length. An excerpt from the IRC follows:

IRC § 61. Gross Income Defined

General Definition—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

- Compensation for services, including fees, commissions, fringe benefits, and similar items;
- Gross income derived from business;
- Gains derived from dealings in property;
- Interest;
- Rents;
- Royalties;
- Dividends;
- Alimony and separate maintenance payments;
- Annuities;
- Income from life insurance and endowment contracts;
- Pensions;
- Income from discharge of indebtedness;
- Distributive share of partnership gross income;
- Income in respect of a decedent; and
- Income from an interest in an estate or trust.

The major national tax publishers such as Research Institute of America (RIA) and Commerce Clearing House (CCH) publish the IRC in bound versions and on their respective Web sites. The IRC can also be located on numerous tax Internet sites, although students are cautioned that the content of most generic Web sites is often not up to date (RIA and CCH are current).

**CONCEPT
CHECK 1-6—**

LO 1-5



1. The committee charged with considering tax legislation in the House of Representatives is called the _____ Committee.
2. The most commonly relied-on statutory authority is _____.
3. All tax legislation must pass both the House of Representatives and the Senate and be signed by the president of the United States in order to become law. True or false?

As authorized by Congress, the president of the United States enters into tax treaties. Thus treaties between the United States and other countries are also statutory tax authority.

A problem with the IRC is that it is usually extremely broad and sometimes difficult to apply to specific tax situations. Because of this limitation, administrative and judicial tax authorities have evolved.

Administrative Tax Authority

The IRS, a division of the U.S. Treasury Department, develops administrative tax authority. The tax authority created by the IRS is, in effect, the IRS's interpretation of the IRC. Table 1-6 presents a list of the major IRS administrative authorities. These are the rulings or interpretations of the IRS at the national level. Each region of the IRS also publishes several authoritative guidelines.

TABLE 1-6
**Examples of Administrative
Authority (in order of
strength of authority, from
highest to lowest)**

Type of Administrative Authority

IRS Regulations (Treasury Regulations)
Revenue Rulings
Revenue Procedures
Private Letter Rulings
IRS Notices

Example of Typical Research Citation

Reg. § 1.351-1
Rev. Rul. 80-198, 1980-2 CB 113
Rev. Proc. 87-32, 1987-2 CB 396
PLR 8922063
Notice 97-69, 1997-2 CB 331

Treasury Regulations

IRS Regulations are by far the strongest administrative authority. Regulations are the IRS's direct interpretation of the IRC. There are four types of IRS Regulations (listed in order of strength of authority, high to low):

Legislative Regulations: The IRS writes these regulations under a direct mandate by Congress. Legislative Regulations actually take the place of the IRC and have the full effect of law.

General or Final Regulations: The IRS writes these regulations under its general legislative authority to interpret the IRC. Most sections of the IRC have General Regulations to help interpret the law.

Temporary Regulations: These regulations have the same authority as General Regulations until they expire three years after issuance. The IRS issues Temporary Regulations to give taxpayers immediate guidance related to a new law. Temporary Regulations are noted with a "T" in the citation (for example, Reg. § 1.671-2T).

Proposed Regulations: These regulations do not have the effect of law. The IRS writes Proposed Regulations during the hearing process leading up to the promulgation of General Regulations. The purpose of the Proposed Regulations is to generate discussion and critical evaluation of the IRS's interpretation of the IRC.

Regulations are referred to (or cited) by using an IRC subtitle prefix, the referring code section, and the regulation number. For example, Reg. § 1.162-5 refers to the prefix (1) denoting the income tax subtitle, IRC section 162, and regulation number 5. Here are some examples of regulation subtitle prefixes:

1. Income Taxes (Reg. § 1.162-5).
20. Estate Tax (Reg. § 20.2032-1).
25. Gift Tax (Reg. § 25.2503-4).
31. Employment Taxes (Reg. § 31.3301-1).
301. Procedural Matters (Reg. § 301.7701-1).¹⁵

Like the IRS, the national publishers (RIA and CCH) publish and sell paperback and hard-bound versions of IRS Regulations. You can also find regulations on a number of tax Internet sites including the IRS Web site (www.irs.gov).

Revenue Rulings and Revenue Procedures

Revenue Rulings (Rev. Rul.) and Revenue Procedures (Rev. Proc.) are excellent sources of information for taxpayers and tax preparers. When issuing a Revenue Ruling, the IRS is reacting to an area of the tax law that is confusing to many taxpayers or that has substantive tax implications for numerous taxpayers. After many taxpayers have requested additional guidance on a given situation, the IRS may issue a Rev. Rul. The Rev. Rul. lists a factual situation, the relevant tax authority, and the IRS's conclusion as to the manner in which taxpayers should treat the issue.

Revenue Procedures (Rev. Proc.), on the other hand, are primarily proactive. Through a Rev. Proc., the IRS illustrates how it wants something reported. Often the IRS provides guidelines or safe harbors to help taxpayers follow the law as interpreted by the IRS. For example, after the Tax Reform Act of 1986, the allowable depreciation methods were drastically changed. The IRS issued Rev. Proc. 87-56 and 87-57 to help taxpayers and preparers properly calculate and report depreciation expense under the new rules.

¹⁵ Various other prefixes are used in specific situations. When dealing with income taxes, however, the first (1) is used most often.

The citations for Revenue Rulings and Revenue Procedures indicate the year of the ruling or procedure and a consecutive number (reset to 1 each year). For example, Rev. Proc. 87-56 was the 56th Revenue Procedure issued in 1987. Revenue Rulings and Procedures are in the *Cumulative Bulletins* published by the IRS and available on its Web site.

Other IRS Pronouncements

Other pronouncements issued by the IRS include Private Letter Rulings (PLRs) and IRS Notices. Each of these has limited authority. The IRS issues PLRs when a taxpayer requests a ruling on a certain tax situation. The PLR is tax authority only to the taxpayer to whom it is issued, although it does indicate the thinking of the IRS.

When there is a change in a rate or allowance, the IRS issues an IRS Notice. For example, if there is a change to the standard mileage rate for business travel from 55 cents a mile to 50 cents a mile, the IRS will issue an IRS Notice to publicize the change.

In addition to the administrative authority discussed in this section, the IRS also publishes various other sources of information that can benefit taxpayers, such as Technical Advice Memorandums and Determination Letters.

CONCEPT CHECK 1-7— LO 1-5



1. Administrative tax authority takes precedence over statutory tax authority. True or false?
2. IRS Revenue Procedures are applicable only to the taxpayer to whom issued. True or false?
3. The administrative tax authority with the most strength of authority is _____.

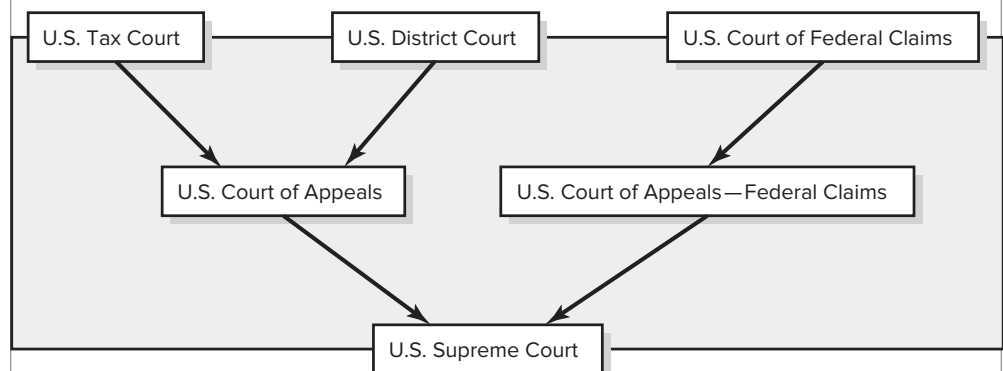
Judicial Tax Authority

The tax laws and regulations are complex. There can be differences of opinion as to how a taxpayer should report certain income or whether an item is a permitted deduction on a tax return. When conflict occurs between the IRS and taxpayers, it is the job of the court system to settle the dispute. The rulings of the various courts that hear tax cases are the third primary tax authority.

Figure 1-1 depicts the court system with regard to tax disputes. Three different trial courts hear tax cases: (1) the U.S. Tax Court, (2) the U.S. District Court, and (3) the U.S. Court of Federal Claims. Decisions by the Tax Court and the district courts may be appealed to the U.S. Court of Appeals and then to the Supreme Court. U.S. Court of Federal Claims cases are appealed to the U.S. Court of Appeals—Federal Claims, and then to the Supreme Court.

The Tax Court hears most litigated tax disputes between the IRS and taxpayers. The Tax Court is a national court with judges who travel throughout the nation to hear cases. Judges are tax law specialists and hear tax cases in major cities several times a year.

FIGURE 1-1
Court System for Tax
Disputes



	<p>The court system becomes involved when a taxpayer and the IRS do not agree. Typically the IRS assesses the taxpayer for the tax the IRS believes is due. The taxpayer then needs to decide whether to go to court to contest the IRS's position and, if so, determine a court venue. One major advantage the taxpayer has when filing a petition with the Tax Court is that the taxpayer does not need to pay the IRS's proposed tax assessment prior to trial. With the other two judicial outlets (the district court and the Court of Federal Claims), the taxpayer must pay the government and then sue for a refund.</p>
--	--

CONCEPT
CHECK 1-8—
LO 1-5



1. The U.S. Supreme Court does not accept appeals of tax cases. True or false?
2. A taxpayer who does not agree with an assessment of tax by the IRS has no recourse. True or false?
3. A taxpayer who does not want to pay the tax assessed by the IRS prior to filing a legal proceeding must use the _____ Court.

Appendix B

IRS RULES FOR PAID TAX PREPARERS
LO 1-6

Anyone can prepare a tax return; in fact each year, millions of Americans do so. It is also the case that millions benefit from the services of a paid tax preparer. The IRS has established rules that must be followed by any person who receives compensation to prepare a tax return or provide tax advice. These rules are found in Circular 230. You can download Circular 230 from the IRS Web site at www.irs.gov.

The provisions of Circular 230 apply to Certified Public Accountants (CPAs), attorneys, enrolled agents, registered tax return preparers, or any other person who, for compensation, prepares a tax return, provides tax advice, or practices before the IRS. Practicing before the IRS includes all communications with the IRS with respect to a client. If a practitioner fails to comply with the provisions, he or she can be suspended or disbarred from practice before the IRS, receive a public censure, be fined, or be subject to civil or criminal penalties.

The rules are far reaching and complex. They affect not only tax return preparation but also tax opinions, marketing and advertising, client records, fees, tax preparer registration, and other matters.

A paid preparer is someone who, for compensation, prepares all or substantially all of a tax return or tax form submitted to the IRS or a claim for refund. There is an exemption for individuals who do not sign the tax return and who are supervised by a CPA, attorney, or enrolled agent.

Paid preparers must register with the IRS and obtain a preparer tax identification number (PTIN). Preparers who are not CPAs, attorneys, or enrolled agents must also pass a competency examination and fulfill continuing education requirements of at least 15 hours annually (including 2 hours of ethics or professional conduct). Enrolled agents must obtain 72 hours of continuing education every three years (including 2 hours of ethics or professional conduct). CPAs and attorneys are subject to continuing education requirements under the rules of each state. Paid preparers must renew their PTIN annually.

Under the provisions of Circular 230, paid preparers or individuals giving tax advice must:

- Sign all tax returns they prepare.
- Provide a copy of the returns to clients.
- Return records to clients.
- Exercise due diligence.

- Exercise best practices in preparing submissions to the IRS.
- Disclose all nonfrivolous tax positions when such disclosure is required to avoid penalties.
- Promptly notify clients of any error or omission on a client tax return.
- Provide records and information requested by the IRS unless the records or information are privileged.
- Inform a client if the client has made an error or omission in a document submitted to the IRS.

Paid preparers or individuals giving tax advice must *not*:

- Take a tax position on a return unless there is a “realistic possibility” of the position being sustained.
- Charge a fee contingent on the outcome of the return or any position, except in certain limited situations.
- Charge an “unconscionable fee.”
- Unreasonably delay the prompt disposition of any matter before the IRS.
- Cash an IRS check for a client for whom the return was prepared.
- Represent a client before the IRS if the representation involves a conflict of interest.
- Make false, fraudulent, or coercive statements or claims or make misleading or deceptive statements or claims. In part, this item pertains to claims made with respect to advertising or marketing.

Circular 230 contains detailed requirements associated with providing clients with a tax opinion that the client can rely upon to avoid a potential penalty related to a tax position. These opinions are called “covered opinions.”

Paid preparers who are in willful violation of the provisions of Circular 230 may be censured, suspended, or disbarred. They may also be subject to monetary penalty or to civil or criminal penalties.

Appendix C

GETTING STARTED WITH TAXACT

This text includes an online version of the TaxAct tax preparation software for individual income tax returns. Throughout this text, we provide examples and end-of-chapter questions and problems that you can solve using tax software.

The tax return problems can be completed either by hand using the tax forms available in this text and on the IRS Web site or by using the TaxAct software. Your instructor will tell you how to prepare the problems. If you are using the tax software, this section will help you get started.

Many tax software products are on the market. They are all similar. Because of that, except for this chapter, we have purposefully written the text in a “software-neutral” manner. What we discuss for TaxAct will generally apply to any individual income tax product you would be likely to use.

The following information will help you get started using the TaxAct software:

- Visit the *Connect* Library and select TaxAct Program under Course-wide content.
- Select each TaxAct program you wish to download and follow the prompts to complete installation.
- Once download is complete, TaxAct will automatically open. The program may ask you a number of questions that you will skip or respond with “Cancel.” Subsequent times you start the software, it may ask about state tax software. Respond with “Cancel.”
- You will eventually arrive at the Home screen.

The TaxAct software allows the user to input tax information in two formats. One is the Interview Method (called Q&A). With this method, the computer asks a series of questions that guides the user through the issues pertaining to his or her tax return. This method is active when the program starts and is sometimes helpful for individuals preparing a tax return who know very little about taxes.

The second method is the Forms Method. With it, the user selects the appropriate tax form or input form and types the correct information onto the appropriate line or lines. This method is suited to those who have some familiarity with the tax forms and how they interact. Using this text, you will quickly reach the necessary level of familiarity.

We will exclusively use the Forms Method throughout the text. We do this for three reasons. First, we strongly believe that when preparing taxes, the user needs to understand the forms that are needed, how they interact, and where the numbers come from and go to. Otherwise it is like memorizing only one way to get to work—if something changes, the individual is totally lost. Second, in the text, we often focus on one or two forms at a time, not an entire tax return (except for the comprehensive examples). The Q&A method is not designed to zero in on a form or two—instead it guides a user through an entire return. Third, the Q&A method makes assumptions that are sometimes difficult to change.

Other tax software uses similar Q&A (interview) or Forms approaches. No matter what software you end up using after you graduate from school, the basic approach and input methodology found in TaxAct will be the same from program to program.

To get the program into the proper input method and to get it ready to accept data, you need to click on the Forms icon on the toolbar, toward the top of the page in the middle.

When you want to start a new “client,” perform the following steps:

1. Click on the File pull-down menu at the upper left.
2. Click on New Return.
3. The system may ask you whether you want to order a state tax product. Click Continue.

Now click on the Forms icon to get to the Forms Method.

The TaxAct program is a highly complex computer program. The software recognizes that information “starts” on a certain form or schedule and then is carried forward to other forms or schedules. For example, the name and address of the taxpayer are initially entered on Form 1040. TaxAct automatically transfers these data to other forms that require that information.

As you use the TaxAct software, you will notice that most numerical information is in either a green or blue color. Green numbers are numbers that you can enter directly on the form you are working on. Blue numbers are calculated on (or derived from) another form or worksheet. If you click on a blue number, you can then click on the Folder icon and go to the supporting form or worksheet.

If you click on a blue number and try to enter a figure, the software will warn you that you are trying to alter a calculated value. You can then choose to go to the supporting schedule, or you can choose to override the value. The software strongly advises you *not* to enter information directly but to go to the appropriate supporting form. We concur. Until you have a much better understanding of how tax software works (or unless we specifically tell you otherwise), you should use the supporting schedules. If you fail to do so, you can get unanticipated results that may create an erroneous return. This can occur, for example, when the software transfers a number to two or more follow-up forms. If you change the number on one of the follow-up forms but not on the other(s), you will have an erroneous return.

Important note: Preliminary versions of tax software are generally issued in October with final versions coming out around January. Software vendors want to make sure you are using the most up-to-date versions of their software and tax forms. This text comes with a preliminary version of the software, and the vendors require you to get an updated version before you can print any tax forms. **Before TaxAct will allow you to print out a tax return, you need to**