

# Fundamentals of Taxation

**2022**

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Hill**



## FUNDAMENTALS OF TAXATION 2022 EDITION, FIFTEENTH EDITION

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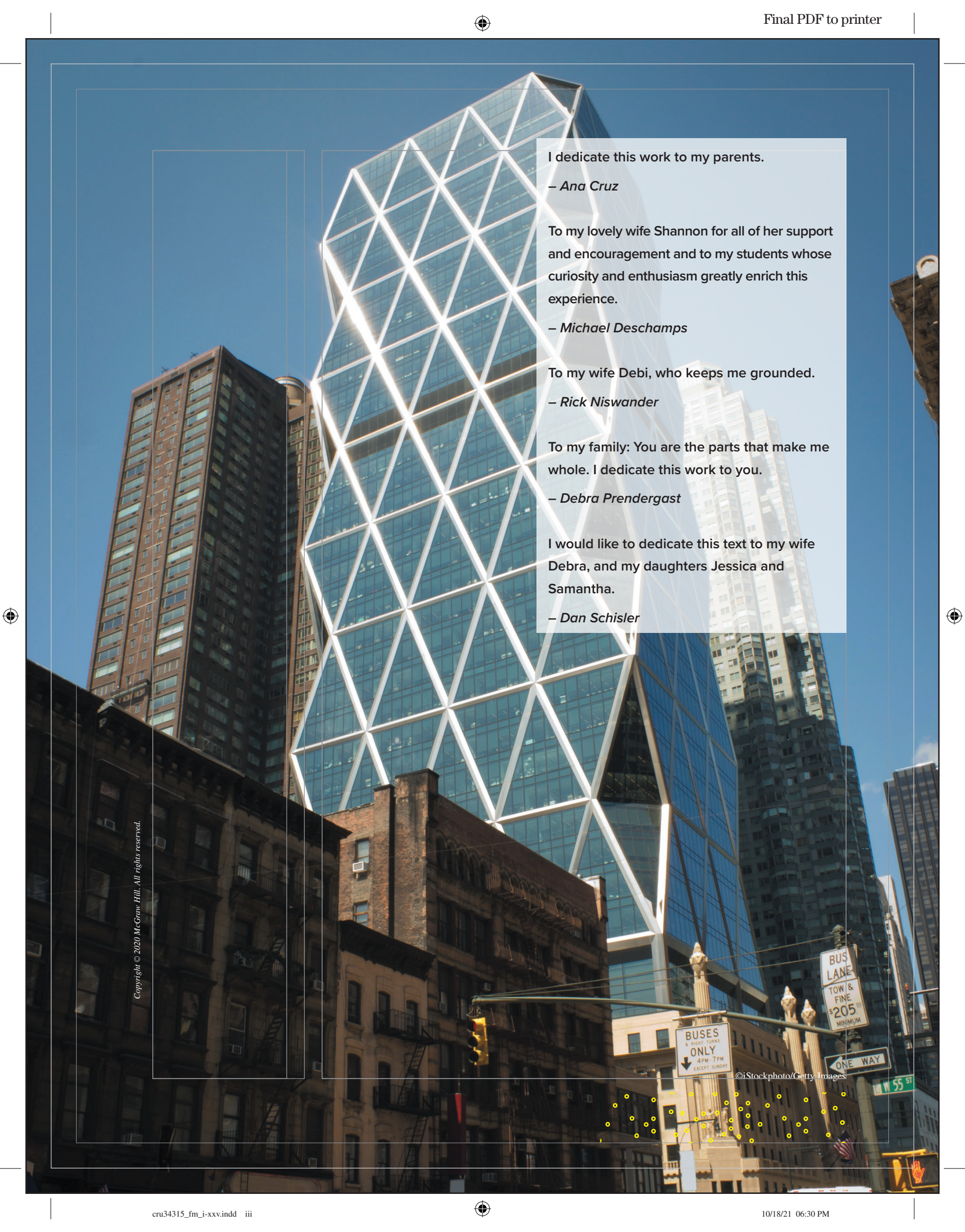
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I dedicate this work to my parents.

– 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

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# Updates to the 2022 Edition

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Chapter-by-chapter enhancements that have been made in the 2022 edition include the following:



**ENROLLED  
AGENT**

New for the 15<sup>th</sup> edition, **Enrolled Agent Fast Facts** are included in every chapter. Each Fast Fact highlights a feature of, or benefit to, becoming an Enrolled Agent (EA), a certification awarded by the US Department of the Treasury. Each Fast Fact will also include a link for students to register for free access to Surgent's EA exam review for Part I of the EA exam at <https://Surgent.com/McGrawHill/EA>. Surgent is a nationwide leader in exam review preparation and a partner with McGraw Hill in promoting the EA certification to students.

## Throughout text

- Updated all tax forms, schedules, and worksheets.

## Chapter 1

- Added text for the \$1,400 Recovery Rebate Credit under provisions of the American Rescue Plan Act (ARPA).
- Updated the standard deduction increases to \$25,100 for married and \$12,550 for single.
- Updated text for new social security limit.
- Revised text for new tax tables and new tax rate schedules.

## Chapter 2

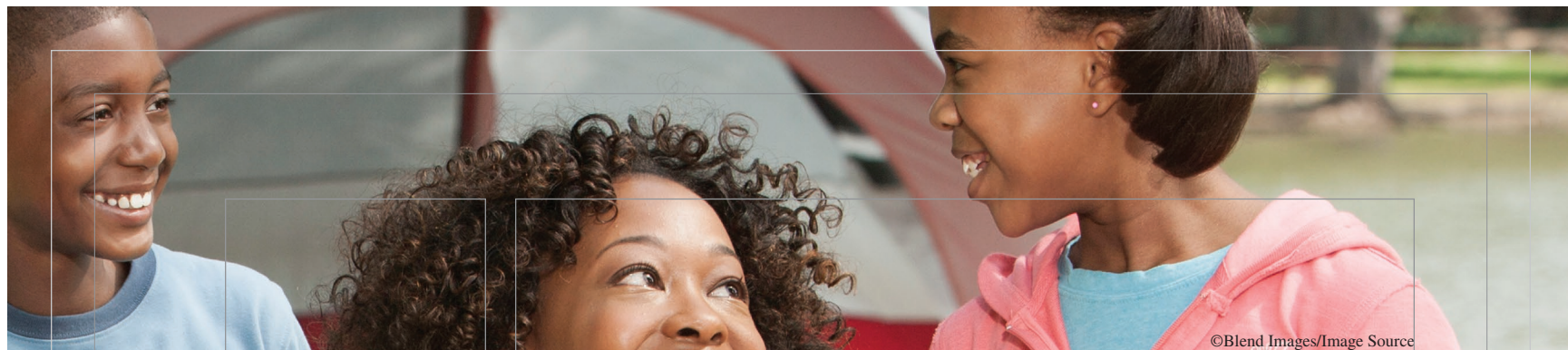
- Updated the standard deduction increases to \$25,100 for married, \$12,550 for single, and \$18,800 for head of household. Additional standard deduction amounts also increase.
- Revised Table 2-1 line-by-line look at Form 1040 and Schedules 1 through 3.
- Revised the introduction to Child Tax Credit to incorporate changes from the ARPA.
- Updated social security wage limit.
- Revised rate of interest on assessments for nonpayment, underpayment, or late payment of tax. Also updated penalty amounts for failure to file.

## Chapter 3

- Updated income thresholds for taxation of dividends and capital gains.
- Updated text related to employer payment of up to \$5,250 of employee student loans for extension of time until 2025.
- Adjusted tax-free exclusion amount under dependent care assistance plans.
- Updated inflation-adjusted phaseout amounts for interest income exclusion for savings bonds.

## Chapter 4

- Revised text to reflect increase to \$600 for charitable contribution deduction for married-filing-jointly taxpayers who do not itemize.
- Added text indicating that discharged student loan debt is not taxable through 2025.
- Updated the limits for Health Savings Accounts (HSAs).
- Added text for COVID-related personal protective equipment (PPE) expenditures that are permitted for HSA disbursements and the educator expense deduction.
- Removed text on the Tuition and Fees Deduction which expired at the end of 2020.



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## Chapter 5

- Adjusted the limitations for long-term care insurance.
- Updated the standard mileage allowance amount for medical expense.
- Added language noting that COVID-related PPE expenses qualify as an itemized deduction for medical expenses.
- Noted that the AGI limitation for itemized charitable contributions from 60% to 100% has been extended through 2021.
- Revised text to reflect increase to \$600 for charitable contribution deduction for married-filing-jointly taxpayers who do not itemize.
- Noted that the mortgage insurance premium deduction was extended through 2021.
- Added text explaining that taxpayers can take a penalty-free distribution of up to \$100,000 from a retirement plan for repair and replacement expenses incurred in a qualified disaster area.

## Chapter 6

- Revised upper limit for Section 179 expense deduction, the standard mileage rate, and self-employment tax income limits.
- Added text related to 100% deductibility for meals provided by a restaurant for 2021 and 2022 under provisions of the Consolidated Appropriations Act of 2021.
- Updated the phaseout ranges for qualified business income deduction limitations.

## Chapter 7

- Modified income thresholds for taxation of dividends and capital gains.

## Chapter 9

- Revised text for the credit for child and dependent care assistance to reflect increased credit amounts, higher expense percentages, modified phaseout limits, and the full refundability of the credit for 2021.
- Modified text to reflect that both education credits now have the same phaseout limits.
- Extensively revised coverage of the child tax credit to reflect changes to the maximum credit amount, creation of multiple phaseout amounts and mechanisms, new provisions for advanced payments, and the full refundability of the credit.
- Updated income limitations for retirement savings contribution credit.
- Changed adoption credit maximum deduction as well as AGI phaseout limits.
- Revised income and phaseout limitations for the Earned Income Tax Credit and noted that 2019 earned income can be used for credit calculation.
- Revised poverty level amounts used to calculate the premium tax credit and noted that the 400% household income upper limit is eliminated for 2021 and 2022.



John Fedele/Blend Images LLC

## Chapter 10

- Revised withholding allowances, withholding tables, calculation of withholding amounts and social security wage limit.
- Revised text for the employee retention tax credit to reflect changes from the Taxpayer Certainty and Disaster Tax Relief Act of 2020.
- Revised penalty amounts for filing incorrect or late Form W-2s.

## Chapter 11

- Changed contribution limits for Keogh and SEP defined contribution plans.
- Updated benefit limits for defined benefit plans.
- Revised phaseout thresholds for contributions to traditional IRA and Roth IRA plans.
- Revised examples for starting IRA Required Minimum Distributions (RMD) to further explain the effect of changing starting age from 70½ to 72.
- Updated list of exemptions to 10% withdrawal penalty of retirement plan distributions.

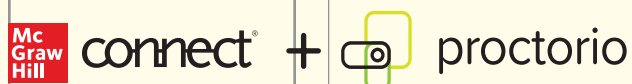
## Chapter 13

- Revised income and exemption thresholds for Alternative Minimum Tax.

## Chapter 15

- Revised text to reflect increase of the limitation on corporate charitable contributions through 2021.
- Noted that business meals provided by a restaurant are fully deductible in 2021 and 2022.

## Remote Proctoring & Browser-Locking Capabilities



Remote proctoring and browser-locking capabilities, hosted by Proctorio within Connect, provide control of the assessment environment by enabling security options and verifying the identity of the student. Seamlessly integrated within Connect, these services allow instructors to control students' assessment experience by restricting browser activity, recording students' activity, and verifying students are doing their own work. Instant and detailed reporting gives instructors an at-a-glance view of potential academic integrity concerns, thereby avoiding personal bias and supporting evidence-based claims.



# Digital Features

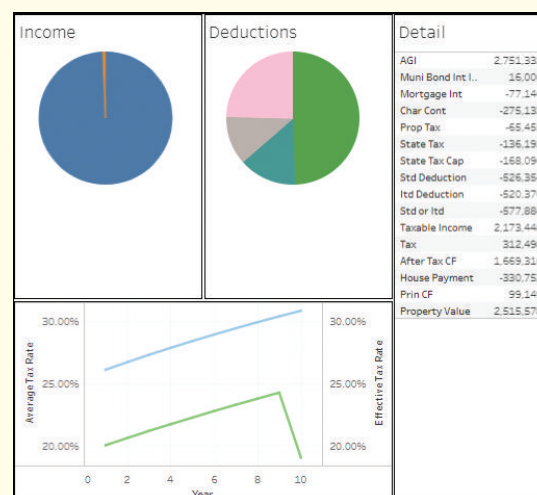
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## Tableau Dashboard Activities

Tableau Dashboard Activities allow students to explore live Tableau dashboards directly integrated into Connect through interactive filters and menus as well as auto-graded questions focused on both calculates and analysis. Students can check their understanding and apply what they are learning within the framework of analytics and critical thinking.

## Writing Assignment

Available within Connect and Connect Master, the Writing Assignment tool delivers a learning experience to help students improve their written communication skills and conceptual understanding. As an instructor you can assign, monitor, grade, and provide feedback on writing more efficiently and effectively.



## Test Builder in Connect

Available within Connect, Test Builder is a cloud-based tool that enables instructors to format tests that can be printed, administered within a Learning Management System, or exported as a Word document of the test bank. Test Builder offers a modern, streamlined interface for easy content configuration that matches course needs, without requiring a download.

Test Builder allows you to

- access all test bank content from a particular title.
- easily pinpoint the most relevant content through robust filtering options.
- manipulate the order of questions or scramble questions and/or answers.
- pin questions to a specific location within a test.
- determine your preferred treatment of algorithmic questions.
- choose the layout and spacing.
- add instructions and configure default settings.

Test Builder provides a secure interface for better protection of content and allows for just-in-time updates to flow directly into assessments.

# Four Primary Teaching Advantages of *Fundamentals of Taxation*

## 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* Provide a Clear Path to Student Success?

## Clear Objectives for Your Students

or without the footnotes. If you would like to become familiar with the text 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).

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 2-1—**  
**LO 2-1**

1. When preparing a tax return, you will seldom use any of the Schedules. True or false?  
2. The concept of Adjusted Gross Income (AGI) is important because many deductions and credits reported on the tax return are computed based on the amount shown as AGI. True or false?

**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 capital gain on the sale of a personal residence.
- The residence exclusion applies only to the taxpayer's principal residence.
- The taxpayer must have lived there two of the last five years.
- Reduced exclusions are available if a move is the reason for the sale.

**LO 12-5:** Apply the rules affecting related parties and wash sales.

- A taxpayer cannot deduct any loss from the sale or exchange of securities between related parties.
- Related parties include family members and controlled entities.
- The wash sale rules disallow a tax loss when the taxpayer sells a security and acquires substantially the same security within 30 days before or after the sale.

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.

**EA LO 4-3** 51. Are the moving expenses of other people besides the service member deductible? If so, what are the requirements for deductibility?

**EA LO 4-4, 4-5** 52. Juan, who is single, is a self-employed carpenter as well as an employee of Frame It, Inc. His self-employment net income is \$43,000, and he received a W-2 from Frame It for wages of \$32,250. He is covered by his employer's pension plan, but his employer does not contribute to it.

## Debra Prendergast



Courtesy of  
Debra Prendergast

Dr. Debra Prendergast holds 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 certified public accountant in Illinois. She began her professional career as a management advisory services consultant with Grant Thornton before taking a controller position for an interior resource corporation in Chicago. In 1988, she left the corporate world and began her academic career. She spent 21 years at Northwestern College and in 2010 she became an administrator at Prairie State College. She recently retired as the dean of Mathematics, Natural Sciences, Curriculum and Cooperatives. She also is an adjunct faculty member in the College of Business at Governors' State University.

## 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 2021, 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?

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**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** 


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

**EA LO 2-1** 16. A single taxpayer is 26 years old and has wages of \$18,350 and interest income of \$1,200. Which Form 1040 Schedule must the taxpayer use?

- Schedule 1.
- Schedule 2.
- Schedule 3.
- The taxpayer does not need to use a Schedule.

**EA LO 2-1** 17. Which Schedule must the taxpayer use to claim a payment made for alimony if the payer was divorced in 2021?

- Schedule 1.
- Schedule 2.

**Tax Return Problems** 

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 and one or more Schedules, depending on the complexity of the problem. *Note to instructors and students:* When using software, certain tax credits 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.

For the following tax return problems, assume the taxpayer does NOT wish to contribute to the Presidential Election Fund, unless otherwise stated in the problem. In addition, the taxpayers did not receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency during the year.

**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:

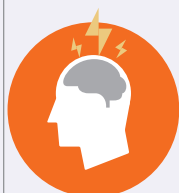
Available in Connect, **Auto-graded Tax Return Problems** incorporate the TaxAct software and encourage students to apply a range of concepts they have learned throughout the chapter. All Auto-graded Tax Return Problems can also be done by hand. The authors indicate which forms are needed for each problem.





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## 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 2022 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 2022 tax liability will be \$18,000. To avoid an underpayment penalty, does Janice need to pay estimated payments during 2022 and, if so, how much must she pay?

#### ANSWER

Janice does not need to make any estimated payments. Her required annual payment is \$7,854, which is the lower of (a) 90% of \$18,000 (the estimate of her 2022 tax liability) or (b) \$7,854 (her tax liability for 2021). 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, 2023.

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 icons in applicable chapters alert students and instructors to key information regarding new tax law that applies to the current year's textbook.



## 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.



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

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## Forms-Based Approach

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

*“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 Auto-graded Tax Return Problems

**1040 for a Single taxpayer with no dependents.**

1040 PG 1 1040 PG 2

**Form 1040** Department of the Treasury—Internal Revenue Service (99) **2021** 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 (MFS) ☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)  
Check only one box. If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

Your first name and middle initial Last name Your social security number

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

Home address (number and street). If you have a P.O. box, see instructions. Apt. no.

City, town, or post office. If you have a foreign address, also complete spaces below. State ZIP code

Foreign country name Foreign province/state/county Foreign postal code

At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? ☐ Yes ☐ No

**Standard Deduction** **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent ☐ Spouse itemizes on a separate return or you were a dual-status alien

**Age/Blindness** **You:** ☐ Were born before January 2, 1957 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1957 ☐ Is blind

**Dependents** (see instructions):

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

If more than four dependents, see instructions.

The **Auto-graded Tax Return Problems**, assignable within *Connect*, provide a much-improved student experience when solving the tax-form-based problems. The **Auto-graded Tax Return Problems** 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 his BS 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 and a Certificate in Online Education from CSU-East Bay in 2017. He is currently a tenured professor and the tax program coordinator at MiraCosta College in Oceanside, CA, where he has developed a highly regarded tax program that leads to the Enrolled Agent Exam and is certified by the State of California for the California Registered Tax Preparer (CRTP) credential. He is an active member of Teachers of Accounting at Two-Year Colleges (TACTYC) and has been a frequent presenter on tax and accounting topics at the organization's national conventions. He has also given presentations on tax and accounting issues to a variety of organizations.





**TaxAct**  
Professional

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

—Natasha Librizzi,  
Milwaukee Area  
Technical College

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*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 *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?

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## 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.



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## Surgent Enrolled Agent Exam Review Course!

**Surgent**  
*EAreview*

Surgent has partnered with McGraw Hill 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 2022* 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://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.

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### Dan Schisler



Courtesy of  
Dan Schisler

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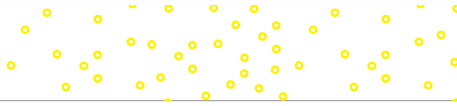
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As noted, we send the book to the printer in late October so we can provide the most up-to-date book as possible to be used for the 2021 tax filing season, which begins in January 2022. When we couple these two notions—using IRS tax forms and an October 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 1-9 for more information). Go to the IRS website at [www.irs.gov](http://www.irs.gov) to obtain the final forms.

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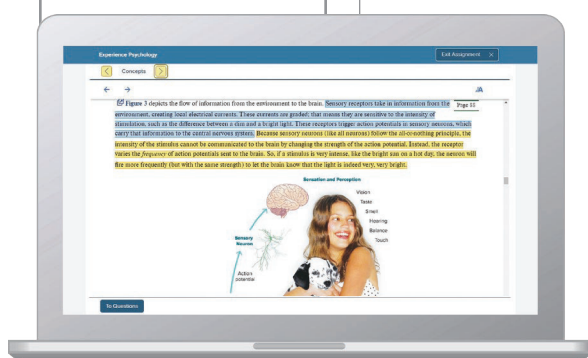
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# A Monumental Development Effort

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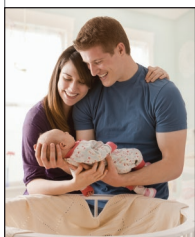


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# **Fundamentals of Taxation**

## **2022**





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# 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).

### 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 Returns**

Source: IRS Statistics of Income Division, Individual Master File Data, IRS Data Warehouse, March 2021, *IRS Publication 1304*, September 2020, and *IRS Statistics of Income Bulletin*, Winter 2019, Spring 2018, Table A.

Type of Tax Return	2019	2018	2017	2016
Total returns	157,682,637	153,774,296	153,095,659	150,315,944
Returns electronically filed (included in above)	148,496,552	137,645,234	135,994,623	132,409,588

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.<sup>1</sup> In tax year 2019, the most current year available, the federal government collected \$1.48 trillion in income tax on \$11.3 trillion of gross income (\$8.7 trillion of taxable income) as reported on 157.7 million individual tax returns.<sup>2</sup> Table 1-1 presents a breakdown of the number of individual tax returns filed for 2016 through 2019.

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.

Taxpayers report their income and expense to the Internal Revenue Service (IRS) on a Form 1040 plus, if appropriate, various Schedules. 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 three Schedules to provide additional information to properly prepare their tax return. The Schedules are all numbered as Schedule 1, Schedule 2, and Schedule 3. In this chapter, we will introduce the basic Form 1040 and a part of Schedule 1. In future chapters, we will discuss the rest of Schedule 1 and the remaining Schedules.

In tax year 2019, the IRS added Form 1040-SR intended for Seniors. It is substantially the same as a Form 1040, but formatted with a larger type size. We do not discuss the Form 1040-SR in this text.

## 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:

1. Progressive rate structure.
2. Proportional rate structure.
3. Regressive rate structure.

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.

<sup>1</sup> The last two chapters are an overview of partnership and corporate taxation.

<sup>2</sup> IRS Statistics of Income Division, Individual Master File Data, IRS Data Warehouse, March 2021.

**TABLE 1-2**  
Individual Income Tax  
Rate Brackets for Married  
Taxpayers for Tax Year  
2021

Taxable Income	Tax Rate
Up to \$19,900	10.0%
\$19,901–\$81,050	12.0%
\$81,051–\$172,750	22.0%
\$172,751–\$329,850	24.0%
\$329,851–\$418,850	32.0%
\$418,851–\$628,300	35.0%
Over \$628,300	37.0%

### 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 \$335,000. Their tax liability is

$\$19,900 \times 10\% =$	\$ 1,990.00
$(\$81,050 - \$19,900) \times 12\% =$	7,338.00
$(\$172,750 - \$81,050) \times 22\% =$	20,174.00
$(\$329,850 - \$172,750) \times 24\% =$	37,704.00
$(\$335,000 - \$329,850) \times 32\% =$	1,648.00
Total tax liability	<u>\$68,854.00</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 about 20.55% calculated as their tax liability of \$68,854 divided by their taxable income of \$335,000. This means that, on average, for each dollar of taxable income, Mary and George paid 20.55 cents to the federal government for income tax.

Table 1-3 provides some additional evidence of the progressivity of the U.S. tax system. Note that although it appears that taxpayers in the under \$15,000 category paid a higher proportion of tax, the group also reported Earned Income Credit much greater than the total tax liability, which means that most taxpayers in this category received a refund greater than they paid in taxes. The Earned Income Credit is a tax credit discussed in Chapter 9 that is intended to support lower income workers to enable them to continue to work. 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 \$251 billion of individual income tax. There were over 29 million taxpayers with income over \$100,000 and they paid tax of almost \$1.3 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 2019, 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 Division, Individual Master File Data, IRS Data Warehouse, March 2021.

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	39,269,402	27,369,909	27,138,637	34,436,449	20,908,838	8,559,402
Taxable income	\$6,938,229	\$192,881,768	\$604,264,808	\$1,753,557,416	\$2,304,350,171	\$3,864,997,623
Total tax liability	\$777,332	\$14,769,011	\$50,115,871	\$186,008,777	\$317,634,367	\$906,217,543
Average tax rate*	11.20%	7.66%	8.29%	10.61%	13.78%	23.45%

\*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 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 \$142,800 of wages in tax year 2021. Once wages exceed the \$142,800 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 a taxpayer 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 \$49,775 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

$\$19,900 \times 10\% =$	\$1,990.00
$(\$49,775 - \$19,900) \times 12\% =$	3,585.00
Total tax liability	<u>\$5,575.00</u>

If you refer to Table 1-2, you will learn that, for a married couple, each dollar of taxable income between \$19,900 and \$81,050 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 \$49,775 on which they had a tax liability of \$5,575. Their average rate is 11.2% ( $\$5,575/\$49,775$ ). 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 11.2%.

### 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 \$19,900 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 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
<u>= Taxable income</u>
× Appropriate tax rates
<u>= Tax liability</u>
– Tax payments and tax credits
<u>= Tax refund or tax due with return</u>

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 \$97,350?
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 a 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.”<sup>3</sup> This category is quite broad and encompasses commissions, bonuses, severance pay, sick pay, meals and lodging,<sup>4</sup> vacation trips or prizes given in lieu of cash, fringe benefits, and similar items.<sup>5</sup>

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.<sup>6</sup> Employees receiving tip income must report the amount of tips to their employers.<sup>7</sup> 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.<sup>8</sup> 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 website at [www.irs.gov](http://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.

<sup>3</sup> IRC § 61(a)(1).

<sup>4</sup> Unless excluded under IRC § 119.

<sup>5</sup> Reg. § 1.61-2 and § 1.61-21.

<sup>6</sup> IRC § 3401(f).

<sup>7</sup> IRC § 6053(a).

<sup>8</sup> IRC § 6053(c).



## EXHIBIT 1-1

Form <b>1040</b>	Department of the Treasury—Internal Revenue Service (99) <b>U.S. Individual Income Tax Return</b>	2021	OMB No. 1545-0074    IRS Use Only—Do not write or staple in this space.
------------------	------------------------------------------------------------------------------------------------------	------	-------------------------------------------------------------------------

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

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

Home address (number and street). If you have a P.O. box, see instructions. Apt. no.

City, town, or post office. If you have a foreign address, also complete spaces below. State ZIP code

Foreign country name Foreign province/state/county Foreign postal code

**Presidential Election Campaign**  
 Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.  
☐ You   ☐ Spouse

At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? ☐ Yes   ☐ No

**Standard Deduction** **Someone can claim:** ☐ You as a dependent   ☐ Your spouse as a dependent  
☐ Spouse itemizes on a separate return or you were a dual-status alien

**Age/Blindness** **You:** ☐ Were born before January 2, 1957   ☐ Are blind   **Spouse:** ☐ Was born before January 2, 1957   ☐ Is blind

Dependents	(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) <input checked="" type="checkbox"/> if qualifies for (see instructions): Child tax credit	Credit for other dependents
If more than four dependents, see instructions and check here ▶ <input type="checkbox"/>					<input type="checkbox"/>	<input type="checkbox"/>
					<input type="checkbox"/>	<input type="checkbox"/>
					<input type="checkbox"/>	<input type="checkbox"/>
					<input type="checkbox"/>	<input type="checkbox"/>

Attach Sch. B if required.  <b>Standard Deduction for—</b> • Single or Married filing separately, \$12,550 • Married filing jointly or Qualifying widow(er), \$25,100 • Head of household, \$18,800 • If you checked any box under <i>Standard Deduction</i> , see instructions.	<table style="width: 100%;"> <tr> <td style="width: 50%;"> <b>1</b> Wages, salaries, tips, etc. Attach Form(s) W-2 . . . . .  <b>2a</b> Tax-exempt interest . . . . .  <b>3a</b> Qualified dividends . . . . .  <b>4a</b> IRA distributions . . . . .  <b>5a</b> Pensions and annuities . . . . .  <b>6a</b> Social security benefits . . . . .  <b>7</b> Capital gain or (loss). Attach Schedule D if required. If not required, check here . . . . .  <b>8</b> Other income from Schedule 1, line 10 . . . . .  <b>9</b> Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your <b>total income</b> . . . . .  <b>10</b> Adjustments to income from Schedule 1, line 26 . . . . .  <b>11</b> Subtract line 10 from line 9. 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## 1-8 Chapter 1 Introduction to Taxation, the Income Tax Formula, and Form 1040

Form 1040 (2021)		Page <b>2</b>															
<b>16</b>	<b>Tax</b> (see instructions). Check if any from Form(s): <b>1</b> <input type="checkbox"/> 8814 <b>2</b> <input type="checkbox"/> 4972 <b>3</b> <input type="checkbox"/> <b>16</b>																
<b>17</b>	Amount from Schedule 2, line 3 <b>17</b>																
<b>18</b>	Add lines 16 and 17 <b>18</b>																
<b>19</b>	Nonrefundable child tax credit or credit for other dependents from Schedule 8812 <b>19</b>																
<b>20</b>	Amount from Schedule 3, line 8 <b>20</b>																
<b>21</b>	Add lines 19 and 20 <b>21</b>																
<b>22</b>	Subtract line 21 from line 18. If zero or less, enter -0- <b>22</b>																
<b>23</b>	Other taxes, including self-employment tax, from Schedule 2, line 21 <b>23</b>																
<b>24</b>	Add lines 22 and 23. This is your <b>total tax</b> <b>24</b>																
<b>25</b>	Federal income tax withheld from:																
<b>a</b>	Form(s) W-2 <b>25a</b>																
<b>b</b>	Form(s) 1099 <b>25b</b>																
<b>c</b>	Other forms (see instructions) <b>25c</b>																
<b>d</b>	Add lines 25a through 25c <b>25d</b>																
<b>26</b>	2021 estimated tax payments and amount applied from 2020 return <b>26</b>																
<b>27a</b>	Earned income credit (EIC) <b>27a</b>																
	Check here if you had not reached the age of 19 by December 31, 2021, and satisfy all other requirements for claiming the EIC. See instructions <input type="checkbox"/>																
<b>b</b>	Nontaxable combat pay election <b>27b</b>																
<b>c</b>	Prior year (2019) earned income <b>27c</b>																
<b>28</b>	Refundable child tax credit or additional child tax credit from Schedule 8812 <b>28</b>																
<b>29</b>	American opportunity credit from Form 8863, line 8 <b>29</b>																
<b>30</b>	Recovery rebate credit. See instructions <b>30</b>																
<b>31</b>	Amount from Schedule 3, line 15 <b>31</b>																
<b>32</b>	Add lines 27a and 28 through 31. These are your <b>total other payments and refundable credits</b> <b>32</b>																
<b>33</b>	Add lines 25d, 26, and 32. These are your <b>total payments</b> <b>33</b>																
<b>Refund</b>	<b>34</b> If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you <b>overpaid</b> <b>34</b>																
<b>35a</b>	Amount of line 34 you want <b>refunded to you</b> . If Form 8888 is attached, check here <input type="checkbox"/> <b>35a</b>																
Direct deposit? See instructions.	<b>b</b> Routing number <input type="text"/> <b>c</b> Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings																
<b>d</b>	Account number <input type="text"/>																
<b>36</b>	Amount of line 34 you want <b>applied to your 2022 estimated tax</b> <b>36</b>																
<b>Amount You Owe</b>	<b>37</b> <b>Amount you owe</b> . Subtract line 33 from line 24. For details on how to pay, see instructions <b>37</b>																
<b>38</b>	Estimated tax penalty (see instructions) <b>38</b>																
<b>Third Party Designee</b>	Do you want to allow another person to discuss this return with the IRS? See instructions <input type="checkbox"/> <b>Yes</b> . Complete below. <input type="checkbox"/> <b>No</b>																
	Designee's name <input type="text"/> Phone no. <input type="text"/> Personal identification number (PIN) <input type="text"/>																
<b>Sign Here</b>	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.	<table border="1"> <tr> <td>Your signature</td> <td>Date</td> <td>Your occupation</td> <td>If the IRS sent you an Identity Protection PIN, enter it here (see inst.) <input type="text"/></td> </tr> <tr> <td>Spouse's signature. If a joint return, <b>both</b> must sign.</td> <td>Date</td> <td>Spouse's occupation</td> <td>If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.) <input type="text"/></td> </tr> <tr> <td>Phone no.</td> <td colspan="3">Email address</td> </tr> </table>	Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.) <input type="text"/>	Spouse's signature. If a joint return, <b>both</b> must sign.	Date	Spouse's occupation	If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.) <input type="text"/>	Phone no.	Email address						
Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.) <input type="text"/>														
Spouse's signature. If a joint return, <b>both</b> must sign.	Date	Spouse's occupation	If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.) <input type="text"/>														
Phone no.	Email address																
<b>Paid Preparer Use Only</b>	<table border="1"> <tr> <td>Preparer's name</td> <td>Preparer's signature</td> <td>Date</td> <td>PTIN</td> <td>Check if: <input type="checkbox"/> Self-employed</td> </tr> <tr> <td>Firm's name <input type="checkbox"/></td> <td colspan="3">Phone no.</td> <td></td> </tr> <tr> <td>Firm's address <input type="checkbox"/></td> <td colspan="3">Firm's EIN <input type="checkbox"/></td> <td></td> </tr> </table>	Preparer's name	Preparer's signature	Date	PTIN	Check if: <input type="checkbox"/> Self-employed	Firm's name <input type="checkbox"/>	Phone no.				Firm's address <input type="checkbox"/>	Firm's EIN <input type="checkbox"/>				
Preparer's name	Preparer's signature	Date	PTIN	Check if: <input type="checkbox"/> Self-employed													
Firm's name <input type="checkbox"/>	Phone no.																
Firm's address <input type="checkbox"/>	Firm's EIN <input type="checkbox"/>																
Go to <a href="http://www.irs.gov/Form1040">www.irs.gov/Form1040</a> for instructions and the latest information.		Form <b>1040</b> (2021)															

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1040. Washington, DC: 2021.



# 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 website ([www.irs.gov](http://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.<sup>9</sup> Interest paid is often deductible.<sup>10</sup> 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 2b.

## Other Income (Form 1040, lines 3 through 6)

The 1040 has lines for dividends (line 3), taxable income from pension and retirement plans (lines 4 and 5), and taxable income from social security (line 6). We discuss these income items in future chapters.

## Additional Income (Form 1040, lines 7 and 8)

The income items listed on lines 1 through 6 are some of the most common. Many other sources of income can be taxable. One type is a capital gain or loss, reported on line 7. We discuss capital gains and losses in Chapter 7. The IRS has placed less-common income items on a separate Schedule, in this case, Schedule 1 (see Exhibit 1-4). Lines 1–9 of Schedule 1 list these additional income items; we will discuss many of these items in future chapters.

## Unemployment Compensation (Form 1040, Schedule 1, line 7)

Federal and state unemployment compensation benefits are taxable.<sup>11</sup> 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 7 of Schedule 1.

Citizens of Alaska also report any Alaska Permanent Fund dividends they receive on line 8f of Schedule 1.

## Standard deduction or itemized deductions (Form 1040, line 12a)

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 12a deduction is either \$12,550 if the taxpayer is single or \$25,100 if the taxpayer is filing a return as married. These dollar amounts represent the amount of income that is not taxed.


<sup>9</sup> IRC § 61(a)(4).

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

<sup>11</sup> IRC § 85(a).

## 1-10 Chapter 1 Introduction to Taxation, the Income Tax Formula, and Form 1040

## EXHIBIT 1-2

<b>a</b> Employee's social security number		Safe, accurate, FAST! Use				Visit the IRS website at www.irs.gov/efile	
<b>b</b> Employer identification number (EIN)		<b>1</b> Wages, tips, other compensation		<b>2</b> Federal income tax withheld			
<b>c</b> Employer's name, address, and ZIP code		<b>3</b> Social security wages		<b>4</b> Social security tax withheld			
		<b>5</b> Medicare wages and tips		<b>6</b> Medicare tax withheld			
		<b>7</b> Social security tips		<b>8</b> Allocated tips			
<b>d</b> Control number		<b>9</b>		<b>10</b> Dependent care benefits			
<b>e</b> Employee's first name and initial      Last name      Suff.		<b>11</b> Nonqualified plans		<b>12a</b> See instructions for box 12			
		<b>13</b> Statutory employee      Retirement plan      Third-party sick pay		<b>12b</b>			
		<b>14</b> Other		<b>12c</b>			
				<b>12d</b>			
<b>f</b> Employee's address and ZIP code							
<b>15</b> State      Employer's state ID number	<b>16</b> State wages, tips, etc.	<b>17</b> State income tax	<b>18</b> Local wages, tips, etc.	<b>19</b> Local income tax	<b>20</b> Locality name		

**Form W-2 Wage and Tax Statement**      **2021**      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: 2021.

## EXHIBIT 1-3

<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.		Payer's RTN (optional)		OMB No. 1545-0112		<b>2021</b>		<b>Interest Income</b>	
		<b>1</b> Interest income		\$		Form <b>1099-INT</b>					
		<b>2</b> Early withdrawal penalty		\$						<b>Copy B</b>	
<b>PAYER'S TIN</b>		<b>RECIPIENT'S TIN</b>		<b>3</b> Interest on U.S. Savings Bonds and Treas. obligations		\$				<b>For Recipient</b>	
<b>RECIPIENT'S name</b>		<b>4 Federal income tax withheld</b>		<b>5</b> Investment expenses		\$				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.	
<b>Street address (including apt. no.)</b>		<b>6</b> Foreign tax paid		<b>7</b> Foreign country or U.S. possession		\$					
<b>City or town, state or province, country, and ZIP or foreign postal code</b>		<b>8</b> Tax-exempt interest		<b>9</b> Specified private activity bond interest		\$					
		<b>10</b> Market discount		<b>11</b> Bond premium		\$					
		<b>12</b> Bond premium on Treasury obligations		<b>13</b> Bond premium on tax-exempt bond		\$					
		<b>FATCA filing requirement</b> <input type="checkbox"/>		<b>14</b> Tax-exempt and tax credit bond CUSIP no.		<b>15</b> State		<b>16</b> State identification no.		<b>17</b> State tax withheld	
<b>Account number (see instructions)</b>										\$	

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: 2021.

**EXHIBIT 1-4**

<b>SCHEDULE 1</b> <b>(Form 1040)</b> <small>Department of the Treasury Internal Revenue Service</small>	<b>Additional Income and Adjustments to Income</b> ▶ Attach to Form 1040, 1040-SR, or 1040-NR. ▶ Go to <a href="http://www.irs.gov/Form1040">www.irs.gov/Form1040</a> for instructions and the latest information.	<small>OMB No. 1545-0074</small> <div style="font-size: 2em; font-weight: bold;">2021</div> <small>Attachment Sequence No. 01</small>
Name(s) shown on Form 1040, 1040-SR, or 1040-NR		Your social security number
<b>Part I Additional Income</b>		
1 Taxable refunds, credits, or offsets of state and local income taxes . . . . .		<b>1</b>
2a Alimony received . . . . .		<b>2a</b>
b Date of original divorce or separation agreement (see instructions) ▶		
3 Business income or (loss). Attach Schedule C . . . . .		<b>3</b>
4 Other gains or (losses). Attach Form 4797 . . . . .		<b>4</b>
5 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E . . . . .		<b>5</b>
6 Farm income or (loss). Attach Schedule F . . . . .		<b>6</b>
7 Unemployment compensation . . . . .		<b>7</b>
8 Other income:		
a Net operating loss . . . . .	<b>8a</b> ( )	
b Gambling income . . . . .	<b>8b</b>	
c Cancellation of debt . . . . .	<b>8c</b>	
d Foreign earned income exclusion from Form 2555 . . . . .	<b>8d</b> ( )	
e Taxable Health Savings Account distribution . . . . .	<b>8e</b>	
f Alaska Permanent Fund dividends . . . . .	<b>8f</b>	
g Jury duty pay . . . . .	<b>8g</b>	
h Prizes and awards . . . . .	<b>8h</b>	
i Activity not engaged in for profit income . . . . .	<b>8i</b>	
j Stock options . . . . .	<b>8j</b>	
k Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property . . . . .	<b>8k</b>	
l Olympic and Paralympic medals and USOC prize money (see instructions) . . . . .	<b>8l</b>	
m Section 951(a) inclusion (see instructions) . . . . .	<b>8m</b>	
n Section 951A(a) inclusion (see instructions) . . . . .	<b>8n</b>	
o Section 461(l) excess business loss adjustment . . . . .	<b>8o</b>	
p Taxable distributions from an ABLE account (see instructions) . . . . .	<b>8p</b>	
z Other income. List type and amount ▶	<b>8z</b>	
9 Total other income. Add lines 8a through 8z . . . . .		<b>9</b>
10 Combine lines 1 through 7 and 9. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8 . . . . .		<b>10</b>
For Paperwork Reduction Act Notice, see your tax return instructions. <span style="float: right;">Cat. No. 71479F Schedule 1 (Form 1040) 2021</span>		

Source: U.S. Department of the Treasury, Internal Revenue Service, Schedule 1. Washington, DC: 2021.

Schedule 1 (Form 1040) 2021

Page **2****Part II Adjustments to Income**

<b>11</b>	Educator expenses . . . . .	<b>11</b>	
<b>12</b>	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 . . . . .	<b>12</b>	
<b>13</b>	Health savings account deduction. Attach Form 8889 . . . . .	<b>13</b>	
<b>14</b>	Moving expenses for members of the Armed Forces. Attach Form 3903 . . . . .	<b>14</b>	
<b>15</b>	Deductible part of self-employment tax. Attach Schedule SE . . . . .	<b>15</b>	
<b>16</b>	Self-employed SEP, SIMPLE, and qualified plans . . . . .	<b>16</b>	
<b>17</b>	Self-employed health insurance deduction . . . . .	<b>17</b>	
<b>18</b>	Penalty on early withdrawal of savings . . . . .	<b>18</b>	
<b>19a</b>	Alimony paid . . . . .	<b>19a</b>	
<b>b</b>	Recipient's SSN . . . . .		
<b>c</b>	Date of original divorce or separation agreement (see instructions) ▶ . . . . .		
<b>20</b>	IRA deduction . . . . .	<b>20</b>	
<b>21</b>	Student loan interest deduction . . . . .	<b>21</b>	
<b>22</b>	Reserved for future use . . . . .	<b>22</b>	
<b>23</b>	Archer MSA deduction . . . . .	<b>23</b>	
<b>24</b>	Other adjustments:		
<b>a</b>	Jury duty pay (see instructions) . . . . .	<b>24a</b>	
<b>b</b>	Deductible expenses related to income reported on line 8k from the rental of personal property engaged in for profit . . . . .	<b>24b</b>	
<b>c</b>	Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8l . . . . .	<b>24c</b>	
<b>d</b>	Reforestation amortization and expenses . . . . .	<b>24d</b>	
<b>e</b>	Repayment of supplemental unemployment benefits under the Trade Act of 1974 . . . . .	<b>24e</b>	
<b>f</b>	Contributions to section 501(c)(18)(D) pension plans . . . . .	<b>24f</b>	
<b>g</b>	Contributions by certain chaplains to section 403(b) plans . . . . .	<b>24g</b>	
<b>h</b>	Attorney fees and court costs for actions involving certain unlawful discrimination claims (see instructions) . . . . .	<b>24h</b>	
<b>i</b>	Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations . . . . .	<b>24i</b>	
<b>j</b>	Housing deduction from Form 2555 . . . . .	<b>24j</b>	
<b>k</b>	Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041) . . . . .	<b>24k</b>	
<b>z</b>	Other adjustments. List type and amount ▶ . . . . .	<b>24z</b>	
<b>25</b>	Total other adjustments. Add lines 24a through 24z . . . . .	<b>25</b>	
<b>26</b>	Add lines 11 through 23 and 25. These are your <b>adjustments to income</b> . Enter here and on Form 1040 or 1040-SR, line 10, or Form 1040-NR, line 10a . . . . .	<b>26</b>	

Schedule 1 (Form 1040) 2021

**EXHIBIT 1-5**

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Unemployment compensation \$		OMB No. 1545-0120	
		2 State or local income tax refunds, credits, or offsets \$		<b>2021</b> Form <b>1099-G</b>	
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		5 RTAA payments \$		6 Taxable grants \$	
		7 Agriculture payments \$		8 If checked, box 2 is trade or business income <input type="checkbox"/>	
		9 Market gain \$			
Account number (see instructions)		10a State	10b State identification no.	11 State income tax withheld \$	
				\$	

Form **1099-G** (keep for your records) [www.irs.gov/Form1099G](http://www.irs.gov/Form1099G) Department of the Treasury - Internal Revenue Service

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1099-G. Washington, DC: 2021.

**Taxable Income (Form 1040, line 15)**

*Taxable income* refers to the wages, interest, and other items on lines 1–8, minus the adjustments to income on line 10, the standard deduction on line 12a, the charitable contribution for those who do not itemize on line 12b, and the Qualified Business Income deduction on line 13.<sup>12</sup> Taxable income is the tax base used to determine the amount of tax.

**CONCEPT  
CHECK 1-3—**  
**LO 1-3**


- Only certain types of income are reported directly on the face of Form 1040. They are \_\_\_\_\_.
- Unemployment compensation is reported to the taxpayer on a Form \_\_\_\_\_.

**CALCULATION OF INCOME TAX (FORM 1040, LINE 16) AND HEALTH CARE TAX**
**LO 1-4****Income Tax (Form 1040, Line 16)**

The total amount of tax liability on line 16 of Form 1040 is determined based on the amount of taxable income (line 15). 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.

The tax tables applicable for tax year 2021 are printed in Appendix D of this text. Please refer to the 2021 tax tables when reviewing the examples and when working the problems at the end of this chapter unless you are told otherwise.

<sup>12</sup> We discuss the qualified business income deduction in Chapter 6.

## 1-14 Chapter 1 Introduction to Taxation, the Income Tax Formula, and Form 1040

**EXAMPLE 1-2**

Dembe 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 \$5,159.

**EXAMPLE 1-3**

Jie and Min 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 \$5,011.

Notice the effect of a differing filing status. Dembe had lower taxable income than did Jie and Min, but Dembe'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 \$9,950, 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 \$314,150.

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.

**EXAMPLE 1-4**

Bill and Andrea Chappell, a married couple, have taxable income of \$48,305. Using the tax tables in Appendix D, their tax liability is \$5,401. Using the tax rate schedule in Table 1-2 (and printed in Appendix F of this text), their tax liability is

Tax on \$19,900 $\times$ 10%	\$1,990.00
Tax on (\$48,305 – \$19,900) $\times$ 12%	\$3,408.60
Total tax	<u>\$5,398.60</u>

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 (except for taxable income less than \$3,000 where the increments are \$25). 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 more 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 Dembe in Example 1-2 and for Jie and Min in Example 1-3.

**ANSWER**

Using the tax rate schedules, Dembe's tax liability is \$5,161.64. The tax liability of Jie and Min is \$5,009.08.

**Health Care Tax**

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. Effective January 1, 2019, the shared responsibility payment is zero. Thus, unlike past tax years, there are no additional calculations and no additional tax in 2021.

**Total Tax (Form 1040, line 24)**

Line 24 is the tax from line 16, minus tax credits from Schedule 3 (we discuss these credits in Chapters 2 and 9), plus other taxes from Schedule 2 (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 learn, 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 \$91,262? \_\_\_\_\_
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 \$91,262. \_\_\_\_\_

**TAX PAYMENTS (FORM 1040, LINES 25d, 26, AND 32)****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.<sup>13</sup> 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 25a of Form 1040.

**Earned Income Credit (Form 1040, line 27a)**

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.

**Total Payments (Form 1040, line 33)**

Line 33 is the sum of the tax withholding from line 25d, estimated payments on line 26, and the credits summarized on line 32.

<sup>13</sup> 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, we will 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,

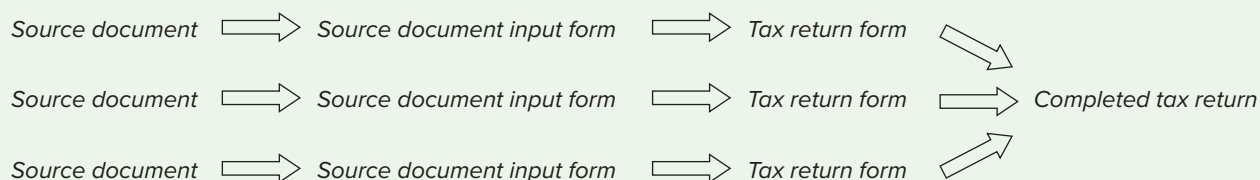
medical receipts, etc.) from documents that do not matter (the receipt for a new gas grill used by the taxpayer at home). The series of From Shoebox to Software explanations (and your future understanding of tax rules and regulations) will help you extract the valuable documents from the rest of the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



### Tax Refund (line 35a) or Tax Due with Return (line 37)

Compare the amount owed (line 24) with the total amount already paid (line 33). 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 1-18)

## 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, both age 52. They live at 456 Main Street, Greenville, NC 27858. Ed's social security number is 412-34-5670 and Betty's is 412-34-5671.<sup>14</sup>

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 <b>412-34-5671</b>		Safe, accurate, <b>FAST! Use</b>		Visit the IRS website at <a href="http://www.irs.gov/efile">www.irs.gov/efile</a>	
b Employer identification number (EIN)		1 Wages, tips, other compensation <b>52,766.00</b>		2 Federal income tax withheld <b>3,191.12</b>	
c Employer's name, address, and ZIP code  <b>Brenden Manufacturing 6789 Main Street Greenville, NC 27858</b>		3 Social security wages <b>52,766.00</b>		4 Social security tax withheld <b>3,271.49</b>	
d Control number		5 Medicare wages and tips <b>52,766.00</b>		6 Medicare tax withheld <b>765.11</b>	
e Employee's first name and initial  <b>Betty Davidson 456 Main Street Greenville, NC 27858</b>		7 Social security tips		8 Allocated tips	
f Employee's address and ZIP code		9		10 Dependent care benefits	
15 State Employer's state ID number <b>NC</b>		16 State wages, tips, etc. <b>52,766.00</b>		17 State income tax <b>1,005.91</b>	
		18 Local wages, tips, etc.		19 Local income tax	
				20 Locality name	

**Form W-2 Wage and Tax Statement 2021** 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: 2021.

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

<input type="checkbox"/> CORRECTED (if checked)				OMB No. 1545-0112		<b>Interest Income</b>
PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.  <b>First Savings Bank</b> <b>123 Main Street</b> <b>Greenville, NC 27858</b>		Payer's RTN (optional)		<b>2021</b>  Form <b>1099-INT</b>		
		1 Interest income  \$ <b>372.33</b>				
PAYER'S TIN  <b>33-1234500</b>		RECIPIENT'S TIN  <b>412-34-5670</b>		2 Early withdrawal penalty  \$		<b>Copy B</b>  <b>For Recipient</b>
RECIPIENT'S name  <b>Ed Davidson</b> Street address (including apt. no.)  <b>456 Main Street</b> City or town, state or province, country, and ZIP or foreign postal code  <b>Greenville, NC 27858</b>		3 Interest on U.S. Savings Bonds and Treas. obligations  \$		4 Federal income tax withheld \$		
FATCA filing requirement <input type="checkbox"/>		6 Foreign tax paid \$		5 Investment expenses \$		
		8 Tax-exempt interest \$		7 Foreign country or U.S. possession \$		
Account number (see instructions)		10 Market discount \$		9 Specified private activity bond interest \$		
		12 Bond premium on Treasury obligations \$		11 Bond premium \$		
		14 Tax-exempt and tax credit bond CUSIP no.		13 Bond premium on tax-exempt bond \$		
		15 State		16 State identification no.		
				17 State tax withheld \$		

Form **1099-INT** (keep for your records) [www.irs.gov/Form1099INT](http://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: 2021.

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 a split screen with a Basic Information Worksheet on the right and a list of worksheets, forms, and documents received on the left. As you work through preparation of a tax return, TaxAct will create the appropriate return and schedules depending on the data provided.

You now need to input basic name and address information for the Davidsons. You do so on the Basic Information Worksheet. After you have filled in name, address, and SSN, click the plus sign beside Forms and Schedules on the left side of the split screen. This will allow you to select and view a 1040 for the Davidsons. 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 Forms, 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 \$52,766. 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 11, Adjusted Gross Income, is the summation of lines 1 and 2. Line 12a is the \$25,100 deduction for a married couple. Taxable income, line 15, is \$28,038.

Line 24 is the total tax liability of \$2,965. You can check this figure with reference to the 2021 tax tables.

Line 25a, federal income tax withheld, is the amount from box 2 from Betty's W-2.

When you compare the Davidsons' total liability of \$2,965 to the \$3,191 they have already paid in withholding and credits, you see that the Davidsons will receive a refund of \$226. This amount is on line 35a.



<b>Form 1040</b> Department of the Treasury—Internal Revenue Service (99)	<b>U.S. Individual Income Tax Return</b> <b>2021</b>	OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.
------------------------------------------------------------------------------	---------------------------------------------------------	-------------------	----------------------------------------------------

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

Your first name and middle initial <b>Davidson</b>	Last name <b>Ed</b>	Your social security number <b>4 1 2 3 4 5 6 7 0</b>
If joint return, spouse's first name and middle initial <b>Betty</b>	Last name <b>Davidson</b>	Spouse's social security number <b>4 1 2 3 4 5 6 7 1</b>

Home address (number and street). If you have a P.O. box, see instructions.  
**456 Main Street**

City, town, or post office. If you have a foreign address, also complete spaces below.  
**Greenville**

State  
**NC**

ZIP code  
**27858**

Foreign country name Foreign province/state/county Foreign postal code

**Presidential Election Campaign**  
 Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.  
☐ You ☐ Spouse

At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? ☐ Yes ☒ No

**Standard Deduction** **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent  
☐ Spouse itemizes on a separate return or you were a dual-status alien

**Age/Blindness** **You:** ☐ Were born before January 2, 1957 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1957 ☐ Is blind

**Dependents** (see instructions):

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) <input checked="" type="checkbox"/> if qualifies for (see instructions): 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"/>

If more than four dependents, see instructions and check here ▶ ☐

<b>Attach Sch. B if required.</b>	<b>1</b> Wages, salaries, tips, etc. Attach Form(s) W-2 . . . . . <b>2a</b> Tax-exempt interest . . . . . <b>3a</b> Qualified dividends . . . . . <b>4a</b> IRA distributions . . . . . <b>5a</b> Pensions and annuities . . . . . <b>6a</b> Social security benefits . . . . . <b>7</b> Capital gain or (loss). Attach Schedule D if required. If not required, check here . . . . . <b>8</b> Other income from Schedule 1, line 10 . . . . . <b>9</b> Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your <b>total income</b> . . . . . <b>10</b> Adjustments to income from Schedule 1, line 26 . . . . . <b>11</b> Subtract line 10 from line 9. This is your <b>adjusted gross income</b> . . . . . <b>12a</b> <b>Standard deduction or itemized deductions</b> (from Schedule A) . . . . . <b>b</b> Charitable contributions if you take the standard deduction (see instructions) . . . . . <b>c</b> Add lines 12a and 12b . . . . . <b>13</b> Qualified business income deduction from Form 8995 or Form 8995-A . . . . . <b>14</b> Add lines 12c and 13 . . . . . <b>15</b> <b>Taxable income.</b> Subtract line 14 from line 11. If zero or less, enter -0- . . . . .	<b>1</b> <b>52,766</b> <b>2b</b> <b>372</b> <b>3b</b> <b> </b> <b>4b</b> <b> </b> <b>5b</b> <b> </b> <b>6b</b> <b> </b> <b>7</b> <b> </b> <b>8</b> <b> </b> <b>9</b> <b>53,138</b> <b>10</b> <b> </b> <b>11</b> <b>53,138</b> <b>12a</b> <b>25,100</b> <b>12b</b> <b> </b> <b>12c</b> <b>25,100</b> <b>13</b> <b> </b> <b>14</b> <b>25,100</b> <b>15</b> <b>28,038</b>
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**Standard Deduction for—**  
 • Single or Married filing separately, \$12,550  
 • Married filing jointly or Qualifying widow(er), \$25,100  
 • Head of household, \$18,800  
 • If you checked any box under **Standard Deduction**, see instructions.

**For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.** Cat. No. 11320B Form **1040** (2021)

## 1-20 Chapter 1 Introduction to Taxation, the Income Tax Formula, and Form 1040

Form 1040 (2021)		Page <b>2</b>	
<b>16</b>	<b>Tax</b> (see instructions). Check if any from Form(s): <b>1</b> <input type="checkbox"/> 8814 <b>2</b> <input type="checkbox"/> 4972 <b>3</b> <input type="checkbox"/> _____	<b>16</b>	<b>2,965</b>
<b>17</b>	Amount from Schedule 2, line 3	<b>17</b>	
<b>18</b>	Add lines 16 and 17	<b>18</b>	<b>2,965</b>
<b>19</b>	Nonrefundable child tax credit or credit for other dependents from Schedule 8812	<b>19</b>	
<b>20</b>	Amount from Schedule 3, line 8	<b>20</b>	
<b>21</b>	Add lines 19 and 20	<b>21</b>	<b>0</b>
<b>22</b>	Subtract line 21 from line 18. If zero or less, enter -0-	<b>22</b>	<b>2,965</b>
<b>23</b>	Other taxes, including self-employment tax, from Schedule 2, line 21	<b>23</b>	
<b>24</b>	Add lines 22 and 23. This is your <b>total tax</b>	<b>24</b>	<b>2,965</b>
<b>25</b>	Federal income tax withheld from:		
<b>a</b>	Form(s) W-2	<b>25a</b>	<b>3,191</b>
<b>b</b>	Form(s) 1099	<b>25b</b>	
<b>c</b>	Other forms (see instructions)	<b>25c</b>	
<b>d</b>	Add lines 25a through 25c	<b>25d</b>	<b>3,191</b>
<b>26</b>	2021 estimated tax payments and amount applied from 2020 return	<b>26</b>	
<b>27a</b>	Earned income credit (EIC) Check here if you had not reached the age of 19 by December 31, 2021, and satisfy all other requirements for claiming the EIC. See instructions <input type="checkbox"/>	<b>27a</b>	
<b>b</b>	Nontaxable combat pay election	<b>27b</b>	
<b>c</b>	Prior year (2019) earned income	<b>27c</b>	
<b>28</b>	Refundable child tax credit or additional child tax credit from Schedule 8812	<b>28</b>	
<b>29</b>	American opportunity credit from Form 8863, line 8	<b>29</b>	
<b>30</b>	Recovery rebate credit. See instructions	<b>30</b>	
<b>31</b>	Amount from Schedule 3, line 15	<b>31</b>	
<b>32</b>	Add lines 27a and 28 through 31. These are your <b>total other payments and refundable credits</b>	<b>32</b>	<b>0</b>
<b>33</b>	Add lines 25d, 26, and 32. These are your <b>total payments</b>	<b>33</b>	<b>3,191</b>
<b>Refund</b>	<b>34</b> If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you <b>overpaid</b>	<b>34</b>	<b>226</b>
<b>35a</b>	Amount of line 34 you want <b>refunded to you</b> . If Form 8888 is attached, check here <input type="checkbox"/>	<b>35a</b>	<b>226</b>
Direct deposit? See instructions.	<b>b</b> Routing number _____ <b>c</b> Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings		
	<b>d</b> Account number _____		
	<b>36</b> Amount of line 34 you want <b>applied to your 2022 estimated tax</b>	<b>36</b>	
<b>Amount You Owe</b>	<b>37</b> <b>Amount you owe</b> . Subtract line 33 from line 24. For details on how to pay, see instructions	<b>37</b>	
	<b>38</b> Estimated tax penalty (see instructions)	<b>38</b>	
<b>Third Party Designee</b>	Do you want to allow another person to discuss this return with the IRS? See instructions <input type="checkbox"/> <b>Yes</b> . Complete below. <input type="checkbox"/> <b>No</b>		
	Designee's name _____	Phone no. _____	Personal identification number (PIN) _____
<b>Sign Here</b>	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.		
	Your signature _____	Date _____	Your occupation _____
Joint return? See instructions. Keep a copy for your records.	Spouse's signature. If a joint return, <b>both</b> must sign. _____	Date _____	Spouse's occupation _____
	Phone no. _____	Email address _____	
<b>Paid Preparer Use Only</b>	Preparer's name _____	Preparer's signature _____	Date _____
	Firm's name _____	PTIN _____	Check if: <input type="checkbox"/> Self-employed
	Firm's address _____	Phone no. _____	Firm's EIN _____

Go to [www.irs.gov/Form1040](http://www.irs.gov/Form1040) for instructions and the latest information.

Form **1040** (2021)

Source: U.S. Department of the Treasury, Internal Revenue Service, Form 1040. Washington, DC: 2021.

	<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 35b, 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 35a) or tax due (line 37) 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 2021 must be filed (postmarked) no later than April 15, 2022. 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>
<b>EXAMPLE 1-5</b>	Nora, who is single, has determined that her total tax liability is \$4,486. 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 is \$4,486 (\$4,392 withholdings plus \$94 paid with her return), which is equal to her total liability.
<b>EXAMPLE 1-6</b>	Hector and Juanita, a married couple, determined that their total tax liability is \$8,859. Juanita's employer withheld \$5,278 from her paycheck and Hector's employer withheld \$3,691. Hector and Juanita will receive a refund of \$110 (\$5,278 + \$3,691 – \$8,859). Thus, Hector and Juanita's total payment is \$8,859 (\$5,278 and \$3,691 of withholdings minus the \$110 refund), which is equal to their total liability.

**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?



**NEW LAW**

### Recovery Rebate Credit

In response to the COVID-19 pandemic, Congress passed three Acts which were signed into law. Each of these Acts provided assistance to individuals and businesses to address the economic impact of the pandemic. A provision in each Act that affected a significant majority of taxpayers was payment of a Recovery Rebate Credit (RRC) to individuals.

The first Act was the CARES Act passed in March 2020. It provided an RRC of \$1,200 per qualified person. The second Act was the Consolidated Appropriations Act passed in December 2020 which provided an RRC of \$600 per qualified person. These two credits were reported on tax returns for tax year 2020 and are not considered here.

In March 2021, the American Rescue Plan Act (ARPA) was passed and signed into law. It provided an additional RRC for tax year 2021. The 2021 RRC is an advance refundable tax credit of \$1,400 per qualified person. A qualified person is the taxpayer, spouse, and any eligible dependent. Unlike the 2020 RRC payments, any dependent, regardless of age, is deemed to be a qualified person (see Chapter 2 for details as to how a dependent is determined). Generally, recipients must have a social security number.

The credit amount may be limited based on the Adjusted Gross Income (AGI) of the taxpayer as noted on Form 1040, line 11. The full credit is allowed for AGI up to \$75,000 (single), \$150,000 (married filing jointly), or \$112,500 (head of household). Above those levels, the

	<p>credit amount is reduced proportionally and is completely eliminated at AGI of \$80,000 for single (\$5,000 phaseout range), \$160,000 MFJ (\$10,000 phaseout range), or \$120,000 for HoH (\$7,500 phaseout range). For AGI in the phaseout range, the credit is phased out proportionately. For example, if AGI for a married couple was \$164,000, they would have “used up” 40% of the phaseout range (\$4,000 of a \$10,000 range). Thus, the total credit would be reduced by 40%.</p>
<b>EXAMPLE 1-7</b>	<p>Consider the following independent cases:</p> <p>Carla is single with AGI of \$52,000. She would be entitled to an RRC of \$1,400.</p> <p>Tomas and Gizelle have one dependent child and AGI of \$118,290. They are entitled to an RRC of \$1,400 per person, or \$4,200 in total. If their AGI were \$167,000, they would be 70% into their \$10,000 phaseout range and their credit would be reduced by 70% to \$1,260 [<math>\\$4,200 - (\\$4,200 \times 70\%)</math>].</p> <p>Antonio is single with AGI of \$82,000. His regular RRC would be \$1,400, but his AGI exceeds \$80,000 so he would not be eligible for any RRC.</p>
	<p>As was the case with the first two RRC bills, Congress wanted to get funds into the hands of taxpayers quickly, so the IRS sent checks or electronic payments to eligible taxpayers starting in March 2020. To determine the proper RRC amount, the IRS used the AGI and dependent information reported on the most recent tax return filed by the taxpayer. Normally, the most recent tax return would have been for tax year 2019 (although by mid-March some taxpayers would have filed their returns for tax year 2020).</p> <p>The credit will be reconciled on the 2021 tax return. On that return, taxpayers eligible for a larger rebate will receive the additional credit as part of the return process. Taxpayers who should have received less will NOT have to pay back the excess.</p>
<b>EXAMPLE 1-8</b>	<p>Consider the following independent cases. Assume the taxpayers have filed a 2019 tax return but not a 2020 tax return.</p> <p>A single taxpayer had 2019 AGI of \$89,000. The taxpayer would not have received an RRC in early 2021. However, if the actual AGI of the taxpayer for 2021 was \$68,000 the taxpayer would be entitled to the full \$1,400 credit and would report the credit on line 30 of Form 1040.</p> <p>A single taxpayer has 2019 AGI of \$60,000 so the taxpayer would have received a RRC of \$1,400. If that taxpayer actually had 2021 AGI of \$110,000 the taxpayer would not be otherwise qualified to receive a rebate check. However, the taxpayer is not required to pay back the excess when the 2021 return is filed.</p>
	<p><b><i>In this textbook, unless otherwise noted, we assume that example taxpayers (such as the Davidson’s in the comprehensive example) received the correct amount of RRC. Thus, they will not be entitled to any additional credit.</i></b></p>

## 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  
for U.S. Tax Laws

### 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.

- 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.

**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

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 2021 to January 2023 legislative years of the Congress will be the 117th Congress).

Throughout the legislative process, each taxation committee (House 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.<sup>15</sup>

<sup>15</sup> 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.

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 website (www.irs.gov).

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

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**

(a) 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:

- (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
- (2) Gross income derived from business;
- (3) Gains derived from dealings in property;
- (4) Interest;
- (5) Rents;
- (6) Royalties;
- (7) Dividends;
- (8) Annuities;
- (9) Income from life insurance and endowment contracts;
- (10) Pensions;
- (11) Income from discharge of indebtedness;
- (12) Distributive share of partnership gross income;
- (13) Income in respect of a decedent; and
- (14) 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 websites. The IRC can also be located on numerous tax Internet sites, although students are cautioned that the content of most generic websites 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	Example of Typical Research Citation
IRS Regulations (Treasury Regulations)	Reg. § 1.351-1
Revenue Rulings	Rev. Rul. 80-198, 1980-2 CB 113
Revenue Procedures	Rev. Proc. 87-32, 1987-2 CB 396
Private Letter Rulings	PLR 8922063
IRS Notices	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).<sup>16</sup>

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 website ([www.irs.gov](http://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.

<sup>16</sup> Various other prefixes are used in specific situations. When dealing with income taxes, however, the first (1) is used most often.

Revenue Procedures, 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.

The citations for Revenue Rulings and Revenue Procedures indicate the year of the ruling or procedure and a consecutive number (reset to 1 at the beginning of 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 website.

### 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



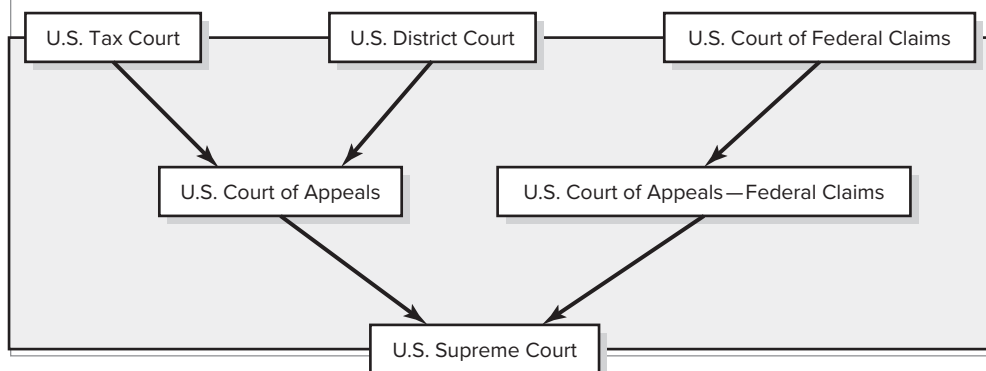
1. Administrative tax authority takes precedence over statutory tax authority. True or false?
2. IRS Revenue Procedures are applicable only to the taxpayer to whom issued. True or false?
3. The administrative tax authority with the most strength of authority is \_\_\_\_\_.

### 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

**FIGURE 1-1**  
Court System for Tax  
Disputes





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.

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.

**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 website at [www.irs.gov](http://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. Failure to comply with the provisions can subject the practitioner to suspension, disbarment from practice before the IRS, a public censure, fines, and 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 is 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 website 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 guide users through the issues pertaining to their tax returns. 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 left of the page.

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 a Basic Information Worksheet and then transferred to Form 1040. TaxAct automatically transfers these data to other forms that require the 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