2017 Edition

McGraw-Hill's

Taxation of Individuals and Business Entities

SPILKER • AYERS • BARRICK • OUTSLAY • ROBINSON • WEAVER • WORSHAM

Mc Graw Hill Education

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Taxation of Individuals and Business Entities

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Dedications

We dedicate this book to:

My children, Braxton, Cameron, Ethan, and Lauren, and to my parents, Ray and Janet. Last but not least, to my wife, Kim, for allowing me to take up valuable kitchen space while I was working on the project. I love you all.

Brian Spilker

My wife, Marilyn, daughters Margaret Lindley and Georgia, son Benjamin, and parents Bill and Linda.

Ben Ayers

My wife, Jill, and my children Annika, Corinne, Lina, Mitch, and Connor.

John Barrick

My family, Jane, Mark, Sarah, Chloe, Lily, and Jeff, and to Professor James E. Wheeler, my mentor and friend.

Ed Outslay

JES, Tommy, and Laura.

John Robinson

My family, Dan, Travis, Alix, and Alan.

Connie Weaver

My wife, Anne, sons Matthew and Daniel, and daughters Whitney and Hayley.

Ron Worsham

About the Authors

Brian Spilker (PhD, University of Texas at Austin, 1993) is the Robert Call/Deloitte Professor in the School of Accountancy at Brigham Young University. He teaches taxation in the graduate and undergraduate programs at Brigham Young University. He received both BS (Summa Cum Laude) and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Arthur Young & Co. (now Ernst & Young). After his professional work experience, Brian earned his PhD at the University of Texas at Austin. In 1996, he was selected as one of two nationwide recipients of the Price Waterhouse Fellowship in Tax Award. In 1998, he was a winner of the American Taxation Association and Arthur Andersen Teaching Innovation Award for his work in the classroom; he has also been awarded for his use of technology in the classroom at Brigham Young University. Brian researches issues relating to tax information search and professional tax judgment. His research has been published in journals such as *The Accounting Review, Organizational Behavior and Human Decision Processes, Journal of the American Taxation Association, Behavioral Research in Accounting, Journal of Accounting Education, Journal of Corporate Taxation,* and *Journal of Accountancy.*

Ben Ayers (PhD, University of Texas at Austin, 1996) holds the Earl Davis Chair in Taxation and is the dean of the Terry College of Business at the University of Georgia. He received a PhD from the University of Texas at Austin and an MTA and BS from the University of Alabama. Prior to entering the PhD program at the University of Texas, Ben was a tax manager at KPMG in Tampa, Florida, and a contract manager with Complete Health, Inc., in Birmingham, Alabama.

Ben teaches tax planning and research courses in the undergraduate and graduate programs at the University of Georgia. He is the recipient of 11 teaching awards at the school, college, and university levels, including the Richard B. Russell Undergraduate Teaching Award, the highest teaching honor for University of Georgia junior faculty members. His research interests include the effects of taxation on firm structure, mergers and acquisitions, and capital markets and the effects of accounting information on security returns. He has published articles in journals such as the *Accounting Review, Journal of Finance, Journal of Accounting and Economics, Contemporary Accounting Research, Review of Accounting Studies, Journal of Law and Economics, Journal of the American Taxation Association,* and *National Tax Journal*. Ben was the 1997 recipient of the American Accounting Association's Competitive Manuscript Award and the 2003 and 2008 recipient of the American Taxation Association's Outstanding Manuscript Award.

John Barrick (PhD, University of Nebraska at Lincoln, 1998) is currently an associate professor in the Marriott School at Brigham Young University. He served as an accountant at the United States Congress Joint Committee on Taxation for the 110th and 111th Congresses. He teaches taxation in the graduate and undergraduate programs at Brigham Young University. He received both BS and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Price Waterhouse (now PricewaterhouseCoopers). After his professional work experience, John earned his PhD at the University of Nebraska at Lincoln. He was the 1998 recipient of the American Accounting Association, Accounting, Behavior, and Organization Section's Outstanding Dissertation Award. John researches issues relating to professional tax judgment and tax information search. His research has been published in journals such as *Organizational Behavior and Human Decision Processes, Contemporary Accounting Research,* and *Journal of the American Taxation Association*.

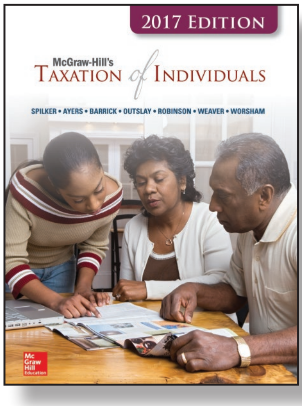
Ed Outslay (PhD, University of Michigan, 1981) is a professor of accounting and the Deloitte/Michael Licata Endowed Professor of Taxation in the Department of Accounting and Information Systems at Michigan State University, where he has taught since 1981. He received a BA from Furman University in 1974 and an MBA and PhD from the University of Michigan in 1977 and 1981. Ed currently teaches graduate classes in corporate taxation, multiunit enterprises, accounting for income taxes, and international taxation. In February 2003, Ed testified before the Senate Finance Committee on the Joint Committee on Taxation's Report on Enron Corporation. MSU has honored Ed with the Presidential Award for Outstanding Community Service, Distinguished Faculty Award, John D. Withrow Teacher-Scholar Award, Roland H. Salmonson Outstanding Teaching Award, Senior Class Council Distinguished Faculty Award, MSU Teacher-Scholar Award, and MSU's 1st Annual Curricular Service-Learning and Civic Engagement Award in 2008. Ed received the Ray M. Sommerfeld Outstanding Tax Educator Award in 2004 and the lifetime Service Award in 2013 from the American Taxation Association. He has also received the ATA Outstanding Manuscript Award twice, the ATA/Deloitte Teaching Innovations Award, and the 2004 Distinguished Achievement in Accounting Education Award from the Michigan Association of CPAs. Ed has been recognized for his community service by the Greater Lansing Chapter of the Association of Government Accountants, the City of East Lansing (Crystal Award), and the East Lansing Education Foundation. He received a National Assistant Coach of the Year Award in 2003 from AFLAC and was named an Assistant High School Baseball Coach of the Year in 2002 by the Michigan High School Baseball Coaches Association.

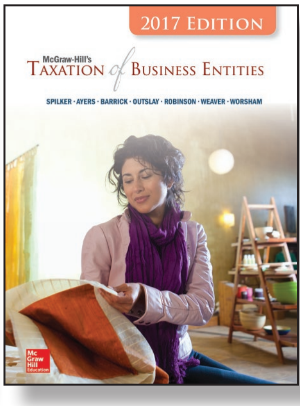
John Robinson (PhD, University of Michigan, 1981) is the Patricia ‘77 and Grant E. Sims ‘77 Eminent Scholar Chair in Business. Prior to joining the faculty at Texas A&M, John was the C. Aubrey Smith Professor of Accounting at the University of Texas at Austin, Texas, and he taught at The University of Kansas where he was The Arthur Young Faculty Scholar. In 2009-2010 John served as the Academic Fellow in the Division of Corporation Finance at the Securities and Exchange Commission. He is the recipient of the Henry A. Bubb Award for outstanding teaching, the Texas Blazer's Faculty Excellence Award, and the MPA Council Outstanding Professor Award. John also received the 2012 Outstanding Service Award from the American Taxation Association (ATA). John served as the 2014-2015 -President (elect) of the ATA and is the ATA's president for 2015-2016. John conducts research in a broad variety of topics involving financial accounting, mergers and acquisitions, and the influence of taxes on financial structures and performance. His scholarly articles have appeared in *The Accounting Review*, *The Journal of Accounting and Economics, Journal of Finance*, *National Tax Journal*, *Journal of Law and Economics*, *Journal of the American Taxation Association*, *The Journal of the American Bar Association*, and *The Journal of Taxation*. John's research was honored with the 2003 and 2008 ATA Outstanding Manuscript Awards. In addition, John was the editor of *The Journal of the American Taxation Association* from 2002 through 2005. Professor Robinson received his J.D. (*Cum Laude*) from The University of Michigan in 1979, and he earned a PhD in accounting from The University of Michigan in 1981. John teaches courses on individual and corporate taxation and advanced accounting.

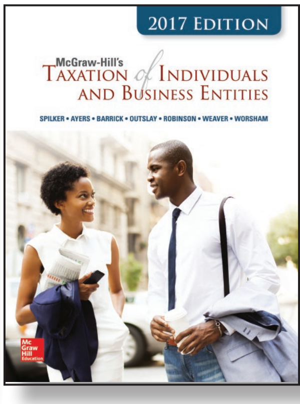
Connie Weaver Connie Weaver (PhD, Arizona State University, 1997) is the KPMG Professor of Accounting at Texas A&M University. She received a PhD from Arizona State University, an MPA from the University of Texas at Arlington, and a BS (chemical engineering) from the University of Texas at Austin. Prior to entering the PhD Program, Connie was a tax manager at Ernst & Young in Dallas, Texas, where she became licensed to practice as a CPA. She teaches taxation in the graduate and undergraduate programs at Texas A&M University. She has also taught undergraduate and graduate students at the University of Wisconsin-Madison and the University of Texas at Austin. She is the recipient of several teaching awards including the 2006 American Taxation Association/Deloitte Teaching Innovations, the David and Denise Baggett Teaching, and Association of Former Students Distinguished Achievement awards recognizing innovation in teaching taxation. Connie's current research interests include the effects of tax and financial incentives on corporate decisions and reporting. She has published articles in journals such as the *Accounting Review, Contemporary Accounting Research, Journal of the American Taxation Association, Accounting Horizons, Journal of Corporate Finance,* and *Tax Notes*. She serves on the editorial board of Contemporary Accounting Research and Issues in Accounting Education and was the 1998 recipient of the American Taxation Association/Price Waterhouse Outstanding Dissertation award.

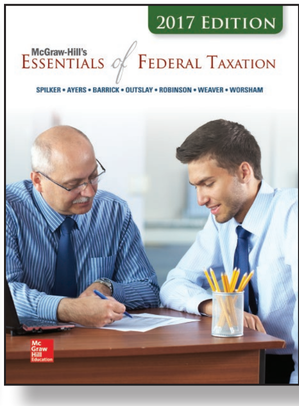
Ron Worsham (PhD, University of Florida, 1994) is an associate professor in the School of Accountancy at Brigham Young University. He teaches taxation in the graduate, undergraduate, MBA, and Executive MBA programs at Brigham Young University. He has also taught as a visiting professor at the University of Chicago. He received both BS and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Arthur Young & Co. (now Ernst & Young) in Dallas, Texas. While in Texas, he became licensed to practice as a CPA. After his professional work experience, Ron earned his PhD at the University of Florida. He has been honored for outstanding innovation in the classroom at Brigham Young University. Ron has published academic research in the areas of taxpayer compliance and professional tax judgment. He has also published legal research in a variety of areas. His work has been published in journals such as *Journal of the American Taxation Association, The Journal of International Taxation, The Tax Executive, Journal of Accountancy,* and *Practical Tax Strategies*.

TEACHING THE CODE IN CONTEXT









The basic approach to teaching taxation hasn't changed in decades. ***Today's student deserves a new approach.*** McGraw-Hill's Taxation of Individuals and Business Entities *is a bold and innovative series that has been adopted by over 300 schools across the country.*

McGraw-Hill's Taxation is designed to provide a unique, innovative, and engaging learning experience for students studying taxation. The breadth of the topical coverage, **the storyline approach to presenting the material,** the emphasis on the tax and nontax consequences of multiple parties involved in transactions, and the integration of financial and tax accounting topics make this book ideal for the modern tax curriculum.

"**This is the best tax book on the market.** It's very readable, student-friendly, and provides great supplements."

– Ann Esarco,
McHenry County College

"A lot of thought and planning went into the structure and content of the text, and a great product was achieved. **One of the most unique and helpful features is the common storyline** throughout each chapter."

– Raymond J. Shaffer,
Youngstown State University

Since the first manuscript was written in 2005, 400 professors have contributed 441 book reviews, in addition to 23 focus groups and symposia. Throughout this preface, their comments on the book's organization, pedagogy, and unique features are a testament to the **market-driven nature of *Taxation*'s development.**

"The Spilker text, in many ways, is a more logical approach than any other tax textbook. **The text makes great use of the latest learning technologies through Connect and LearnSmart.**"

– Ray Rodriguez, Southern Illinois University–Carbondale

A MODERN APPROACH FOR TODAY'S STUDENT

"**This text provides a new approach to the teaching of the technical material.** The style of the text material is easier to read and understand. The examples and storyline are interesting and informative. The arrangement makes more sense in the understanding of related topics."

– Robert Bertucelli, Long Island University–Post

Spilker's taxation series was built around the following five core precepts:

1. **Storyline Approach:** Each chapter begins with a storyline that introduces a set of characters or a business entity facing specific tax-related situations. Each chapter's examples are related to the storyline, providing students with opportunities to **learn the code in context.**

2. **Conversational Writing Style:** The authors took special care to write *McGraw-Hill's Taxation* that fosters a friendly dialogue between the content and each individual student. The tone of the presentation is intentionally conversational—creating the impression of ***speaking with*** **the student,** as opposed to *lecturing to* the student.

3. **Superior Organization of Related Topics:** *McGraw-Hill's Taxation* takes a fresh approach to taxation by providing two alternative topic sequences. In the *McGraw-Hill's Taxation of Individuals and Business Entities,* topics are grouped in **theme chapters,** including separate chapters on home ownership, compensation, investments, and retirement savings and deferred compensation. However, in the *Essentials of Federal Taxation,* topics follow a more traditional sequence with topics presented in a life-cycle approach.

"I believe it **breaks down complex topics in a way that's easy to understand.** Definitely easier than other tax textbooks that I've had experience with."

– Jacob Gatlin, Athens State University

4. **Real-World Focus:** Students learn best when they see how concepts are applied in the real world. For that reason, real-world examples and articles are included in **"Taxes in the Real World"** boxes throughout the book. These vignettes demonstrate current issues in taxation and show the relevance of tax issues in all areas of business.

5. **Integrated Examples:** The examples used throughout the chapter relate directly to the storyline presented at the beginning of each chapter, so students become familiar with one set of facts and learn how to apply those facts to different scenarios. In addition to providing in-context examples, we provide **"What if"** scenarios within many examples to **illustrate how variations in the facts might or might not change the answers.**

"**Excellent text; love the story line approach and integrated examples.** It's easy to read and understand explanations. The language of the text is very clear and straightforward."

– Sandra Owen, Indiana University–Bloomington

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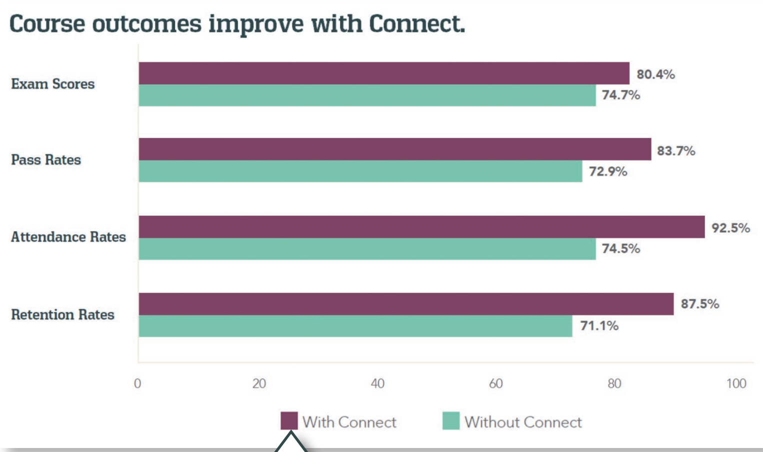

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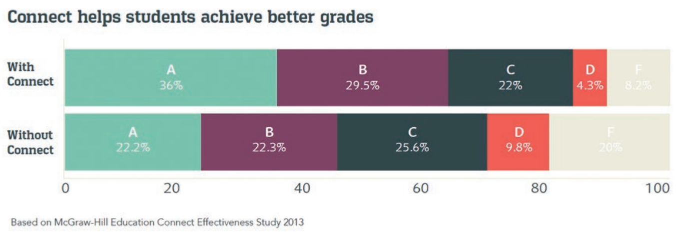

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Mc Graw Hill Education

*Findings based on a 2015 focus group survey at Pellissippi State Community College administered by McGraw-Hill Education

ONLINE ASSIGNMENTS

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. Connect grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes a general journal application that looks and feels more like what you would find in a general ledger software package. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.

Through November, Tex has received gross income of $120,000. For December, Tex is considering whether to accept one more work engagement for the year. Engagement 1 will generate $7,000 of revenue at a cost of $4,000, which is deductible for AGI. In contrast, engagement 2 will generate $7,000 of revenue at a cost of $3,000, which is deductible as an itemized deduction. Tex files as a single taxpayer. (use the tax rate schedules.)

a. Calculate Tex's taxable income assuming he chooses engagement 1 and assuming he chooses engagement 2. Assume he has no itemized deductions other than those generated by engagement 2.

	Description	Engagement 1	Engagement 2
(1)	Gross income before new work engagement	$ 120,000	$ 120,000
(2)	Income from engagement	7,000	7,000
(3)	Additional for AGI deduction	(4,000)	
(4)	Adjusted gross income	$ 123,000	$ 127,000
(5)	Greater		
(6)	Greater of itemized deductions or standard deduction		

End-of-chapter questions in Connect include:

- Discussion Questions
- Problems
- Comprehensive Problems **(Available in the Tax Form Simulation!)**

NEW! Tax Form Simulation

New auto-graded **Tax Form Simulation** provides a much-improved student experience when solving the tax-form based problems. The tax form simulation allows students to apply tax concepts by completing the actual tax forms online with automatic feedback and grading for both students and instructors.

1040 PG1 | 1040 PG2

Form 1040 Department of the Treasury—Internal Revenue Service (99) U.S. Individual Income Tax Retrun **2015** OMB No. 1545-0074 IRS Use Only - Do not write in this space.

For the year Jan. 1–Dec. 31, 2015, or other tax year beginning , 2015, ending , 20 See separate instructions.

Your first name and initial: Mar
Marc

Your social security number: 111-22-3333

Spouse's social security number: 222-33-4444

19010 N.W. 135th Street | Apt. no. | ▲ Make sure the SSN(s) above and on line 6c are correct.

City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below.
Miami, FL 33054

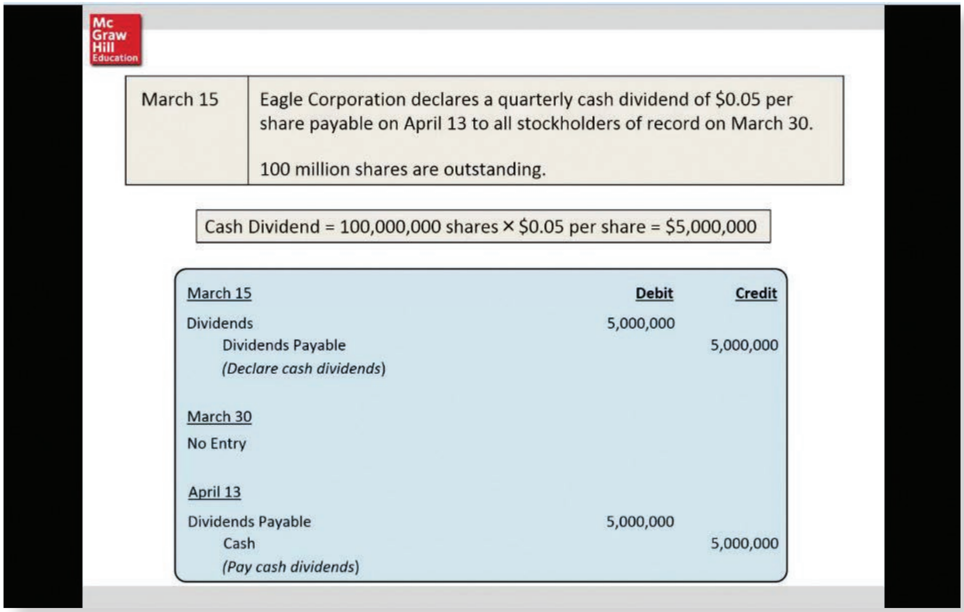
Presidential Election Campaign
Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund.
You Spouse

Foreign country name | Foreign province | Foreign postal code

Filing Status
Check only one box.
1 ☐ Single
2 ☑ Married filing jointly
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

NEW! Guided Examples

The Guided Examples in Connect provide a narrated, animated, step-by-step walk-through of select problems similar to those assigned. These short presentations can be turned on or off by instructors and provide reinforcement when students need it most.



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TaxACT®

McGraw-Hill's Taxation can be packaged with tax software from TaxACT, one of the leading preparation software companies in the market today. The 2016 edition includes availability of both Individuals and Business Entities software, including the 1040 forms and TaxACT Preparer's Business 3-Pack (with Forms 1065, 1120, and 1120S).

A STORYLINE APPROACH THAT WILL RESONATE WITH STUDENTS

© Image Source

Storyline Summary

Taxpayers:	Courtney Wilson, age 40, Courtney's mother Dorothy "Gram" Weiss, age 70
Family description:	Courtney is divorced with a son, Deron, age 10, and a daughter, Ellen, age 20. Gram is currently residing with Courtney.
Location:	Kansas City, Missouri
Employment status:	Courtney works as an architect for EWD. Gram is retired.
Filing status:	Courtney is head of household. Gram is single.
Current situation:	Courtney and Gram have computed their taxable income. Now they are trying to determine their tax liability, tax refund or additional taxes due, and whether they owe any payment-related penalties.

Courtney has already determined her taxable income. Now she's working on computing her tax liability. She knows she owes a significant amount of regular income tax on her employment and business activities. However, she's not sure how to compute the tax on the qualified dividends she received from General Electric. Courtney is worried that she may be subject to the alternative minimum tax this year because she's heard that an increasing number of taxpayers in her income range must pay the tax. Finally, Courtney knows she owes some self-employment taxes on her business income. Courtney would like to determine whether she is eligible to claim any tax credits such as the child tax credit for her two children and education credits because she paid for a portion of her daughter Ellen's tuition at the University of Missouri–Kansas City this year. ... is hoping that she has paid enough in taxes during the year to avoid underpayment penalties. She's planning on filing her tax return and paying her taxes on time.

Gram's tax situation is much more straightforward. She needs to determine the regular income tax on her taxable income. Her income is so low she knows she need not worry about the alternative minimum tax, and she believes she doesn't owe any self-employment tax. Gram didn't prepay any taxes this year, so she is concerned that she might be required to pay an underpayment penalty. She also expects to file her tax return and pay her taxes by the ... due date.

Each chapter begins with a storyline that introduces a set of characters facing specific tax-related situations. This revolutionary approach to teaching tax emphasizes real people facing real tax dilemmas. Students learn to apply practical tax information to specific business and personal situations. The characters are brought further to life.

"The text provides very useful tools that students can read and understand, making it easier to **break the myth that 'tax is hard.'**"

– Daniel Hoops, Walsh College

"**I absolutely love this textbook.** This textbook makes my job of teaching so much easier."

– Chuck Pier, Angelo State University

Examples

Examples are the cornerstone of any textbook covering taxation. For this reason, *McGraw-Hill's Taxation* authors took special care to create clear and helpful examples that relate to the storyline of the chapter. Students learn to refer to the facts presented in the storyline and apply them to other scenarios—in this way, they build a greater base of knowledge through application. Many examples also include "What if?" scenarios that add more complexity to the example or explore related tax concepts.

Example 2-1

Bill and Mercedes file their 2012 federal tax return on September 6, 2013, after receiving an automatic extension to file their return by October 16, 2013 (October 15 was a Sunday). In 2016, the IRS selects their 2012 tax return for audit. When does the statute of limitations end for Bill and Mercedes's 2012 tax return?

Answer: Assuming the six-year and "unlimited" statute of limitation rules do not apply, the statute of limitations ends on September 6, 2016 (three years after the later of the actual filing date and the *original* due date).

What if: When would the statute of limitations end for Bill and Mercedes for their 2012 tax return if the couple filed the return on March 22, 2013 (before the original due date of April 15, 2013)?

Answer: In this scenario the statute of limitations would end on April 15, 2016, because the later of the actual filing date and the original due date is April 15, 2013.

"The **case study approach is excellent** as you follow the taxpayers through the chapters."

– Irwin Uhr, Hunter College

THE PEDAGOGY YOUR STUDENTS NEED TO PUT THE CODE IN CONTEXT

Taxes in the Real World

Taxes in the Real World are short boxes used throughout the book to demonstrate the real-world use of tax concepts. Current articles on tax issues, real-world application of chapter-specific tax rules, and short vignettes on popular news about tax are some of the issues covered in Taxes in the Real World boxes.

TAXES IN THE REAL WORLD Republicans vs. Democrats

We often boil down the tax policy of our major political parties into its simplest form: Democrats raise taxes to fund social programs, and Republicans lower taxes to benefit big businesses and the wealthy. Both ideas simplify the policy of each party, yet both ideas are essentially true.

Whether you agree with more government spending or tax breaks for corporations, each party's agenda will affect your taxes.

Political Ideology: Republican

"We believe government should tax only to raise money for its essential functions." The Republicans state their case plainly on the Republican National Convention website. That is, Republicans believe government should spend money only to enforce contracts, maintain basic infrastructure and national security, and protect citizens against criminals.

The literature of the House Republican Conference goes on to illuminate the role of the government and how tax policies affect individuals: "The money the government spends does not belong to the government; it belongs to the taxpayers who earned it. Republicans believe Americans deserve to keep more of their own money to save and invest for the future, and low tax policies help drive a strong and healthy economy."

Tax relief is the Republican route to growing the economy. A Republican government would reduce taxes for businesses to allow businesses to grow and thus hire more employees. Republicans also seek to limit income taxes for individuals so that people can hold on to more disposable income, which they can then spend, save, or invest.

Political Ideology: Democrat

The tax policy for the Democratic Party calls for raising certain taxes to provide money for government spending, which in turn generates business. The party platform asserts that government spending provides "good jobs and will help the economy today."

Many Democrats are adherents to Keynesian economics, or aggregate demand, which holds that when the government funds programs, those programs pump new money into the economy. Keynesians believe that prices tend to stay relatively stable and therefore any kind of spending, whether by consumers or the government, will grow the economy.

Like the Republicans, Democrats believe the government should subsidize vital services that keep cities, states, and the country running: infrastructure such as road and bridge maintenance and repairs for schools. Democrats also call for tax cuts for the middle class. But who benefits most under each platform? The conventional wisdom is that corporations and the wealthy will benefit more with a Republican tax policy, while small businesses and middle-class households will benefit from a Democratic tax policy.

Source: http://www.investopedia.com/articles/economics/09/us-parties-republican-democrat-taxes.asp

"The Spilker text makes tax easy for students to understand. **It integrates great real-world examples so students can see how topics will be applied in practice.** The integration of the tax form and exhibits of the tax forms in the text are outstanding."

– Kristen Bigbee, Texas Tech University

The Key Facts

Marginal Key Facts provide quick synopses of the critical pieces of information presented throughout each chapter.

		($100,000 – $75,300).
(3) Taxable income before additional $60,000 of tax deductions	$160,000.00	Example 1-3.
(4) Tax on $160,000 taxable income	$ 31,785.50	Example 1-3.
Marginal tax rate on additional $60,000 of tax deductions	25.41%	$\frac{\Delta\text{Tax}}{\Delta\text{Taxable income}} = [(2)-(4)]/[(1)-(3)]$

Bill and Mercedes's marginal tax rate on $60,000 of additional deductions (25.41 percent) differs

THE KEY FACTS

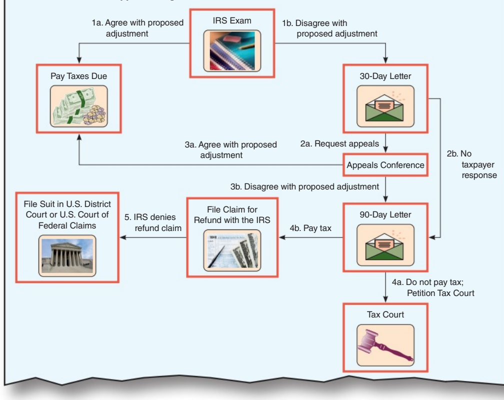
Different Ways to Measure Tax Rates

- Marginal tax rate
  - The tax that applies to next increment of income or deduction.
  - $= \frac{\Delta\text{Tax}}{\Delta\text{Taxable income}}$

Exhibits

Today's students are visual learners, and *McGraw-Hill's Taxation* delivers by making appropriate use of charts, diagrams, and tabular demonstrations of key material.

EXHIBIT 2-2 IRS Appeals/Litigation Process



"A good textbook that uses **great examples throughout the chapters** to give a student an understanding of the tax theory and how it applies to the taxpayers."

– Jennifer Wright, Drexel University

"Spilker's use of examples immediately following the concept is a **great way to reinforce the concepts.**"

– Karen Wisniewski, County College of Morris

PRACTICE MAKES PERFECT WITH A …

Summary

LO 2-1 Identify the filing requirements for income tax returns and the statute of limitations for assessment.

- All corporations must file a tax return annually regardless of their taxable income. Estates and trusts are required to file annual income tax returns if their gross income exceeds $600. The filing requirements for individual taxpayers depend on the taxpayer's filing status, age, and gross income.
- Individual and C corporation tax returns (except for C corporations with a June 30 year-end) are due on the fifteenth day of the fourth month following year-end. For C corporations with a June 30 year-end, partnerships and S corporations, tax returns must be filed by the fifteenth day of the third month following the entity's fiscal year-end. Any taxpayer unable to file a tax return by the original due date can request an extension to file.
- For both amended tax returns filed by a taxpayer and proposed tax assessments by the IRS, the statute of limitations generally ends three years from the *later* of (1) the date the tax return was actually filed or (2) the tax return's original due date.

LO 2-2 Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.

Summary

A unique feature of *McGraw-Hill's Taxation* is the end-of-chapter summary organized around learning objectives. Each objective has a brief, bullet-point summary that covers the major topics and concepts for that chapter, including references to critical exhibits and examples.

All end-of-chapter material is tied to learning objectives:

Learning Objectives

Upon completing this chapter, you should be able to:

LO 2-1 Identify the filing requirements for income tax returns and the statute of limitations for assessment.

LO 2-2 Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.

LO 2-3 Evaluate the relative weights of the various tax law sources.

LO 2-4 Describe the legislative process as it pertains to taxation.

LO 2-5 Perform the basic steps in tax research and evaluate various tax law sources when faced with ambiguous statutes.

LO 2-6 Describe tax professional responsibilities in providing tax advice.

LO 2-7 Identify taxpayer and tax professional penalties.

"You can tell the authors of this textbook are still in the classroom and responsible for the day-to-day education of accounting students. Examples are representative of the end-of-chapter problems, and the end-of-chapter summary is an excellent study tool."

– Debra Petrizzo, Franklin University

DISCUSSION QUESTIONS connect

All applicable Discussion Questions are available with *Connect*®.

LO 2-1 1. Name three factors that determine whether a taxpayer is required to file a tax return.

LO 2-1 2. Benita is concerned that she will not be able to complete her tax return by April 15. Can she request an extension to file her return? By what date must she do so? Assuming she requests an extension, what is the latest date that she could file her return this year without penalty?

LO 2-1 3. Agua Linda Inc. is a calendar-year corporation. What is the original due date for the corporate tax return? What happens if the original due date falls on a Saturday?

Discussion Questions

Discussion questions, now available in *Connect,* are provided for each of the major concepts in each chapter, providing students with an opportunity to review key parts of the chapter and answer evocative questions about what they have learned.

"This is a very readable text. **Students will understand it on their own,** generally, freeing more class time for application, practice, and student questions."

– Valrie Chambers,
Texas A&M University–Corpus Christi

. . . WIDE VARIETY OF ASSIGNMENT MATERIAL

Problems Problems are designed to test the comprehension of more complex topics. Each problem at the end of the chapter is tied to one of that chapter's learning objectives, with multiple problems for critical topics.

> **PROBLEMS** connect
>
> **All applicable problems are available with *Connect*®.**
>
> LO 2-1 43. Ahmed does not have enough cash on hand to pay his taxes. He was excited to hear that he can request an extension to file his tax return. Does this solve his problem? What are the ramifications if he doesn't pay his tax liability by April 15?
>
> LO 2-1 44. Molto Stancha Corporation had zero earnings this fiscal year; in fact, they lost money. Must they file a tax return?

Tax Forms Problems Tax forms problems are a set of requirements included in the end-of-chapter material of the 2017 edition. These problems require students to complete a tax form (or part of a tax form), providing students with valuable experience and practice with filling out these forms. These requirements—and their relevant forms—are also included in *Connect*. Each tax forms problem includes an icon to differentiate it from regular problems.

> tax forms 70. Shauna Coleman is single. She works as an architectural designer for Streamline Design (SD). Shauna wanted to determine her taxable income for this year. She correctly calculated her AGI. However, she wasn't sure how to compute the rest of her taxable income. She provided the following information with hopes that you could use it to determine her taxable income.
>
> a) Shauna paid $4,675 for medical expenses and Blake, Shauna's boyfriend, drove Shauna (in her car) a total of 115 miles so that she could receive care for a broken ankle she sustained in a biking accident.
>
> b) Shauna paid a total of $3,400 in health insurance premiums during the year

Research Problems Research problems are special problems throughout the end of the chapter assignment material. These require students to do both basic and more complex research on topics outside of the scope of the book. Each research problem includes an icon to differentiate it from regular problems.

> LO 2-5 research 72. Matt and Lori recently were divorced. Although grief stricken, Matt was at least partially comforted by his monthly receipt of $10,000 alimony. He was particularly excited to learn from his friend, Denzel, that the alimony was not taxable. Use an available tax service to determine if Denzel is correct. Would your answer change if Matt and Lori continued to live together?
>
> LO 2-5 research 73. Shaun is a huge college football fan. In the past, he has always bought football tickets on the street from ticket scalpers. This year, he decided to join the university's ticket program, which requires a $2,000 contribution to the university

"The textbook is comprehensive, uses an integrated approach to taxation, contains clear illustrations and examples in each chapter, and has a **wealth of end-of-chapter assignment material.**"

– James P. Trebby, Marquette University

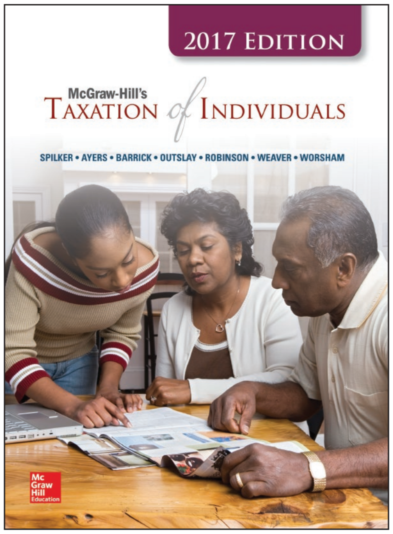
Planning Problems Planning problems are another unique set of problems, also located at the end of the chapter assignment material. These require students to test their tax planning skills after covering the chapter topics. Each planning problem includes an icon to differentiate it from regular problems.

> 56. Jackie has a corporate client that has recently received a 30-day notice from the IRS with a $100,000 tax assessment. Her client is considering requesting an appeals conference to contest the assessment. What factors should Jackie advise her client to consider before requesting an appeals conference? LO 2-2 planning
>
> 57. The IRS recently completed an audit of Shea's tax return and assessed $15,000 additional tax. Shea requested an appeals conference but was unable to settle the case at the conference. She is contemplating which trial court to choose to hear her case. Provide her a recommendation based on the following alternative facts: LO 2-2 planning
>
> a) Shea resides in the 2nd Circuit, and the 2nd Circuit has recently ruled against

Comprehensive and Tax Return Problems Comprehensive and tax return problems address multiple concepts in a single problem. Comprehensive problems are ideal for cumulative topics; for this reason, they are located at the end of all chapters. In the end-of-book Appendix C, we include tax return problems that cover multiple chapters. **Additional tax return problems are also available in the *Connect Library*.**

> **COMPREHENSIVE PROBLEMS**
>
> **Select problems are available in *Connect*®.** connect
>
> tax forms 53. Marc and Michelle are married and earned salaries this year of $64,000 and $12,000, respectively. In addition to their salaries, they received interest of $350 from municipal bonds and $500 from corporate bonds. Marc and Michelle also paid $2,500 of qualifying moving expenses, and Marc paid alimony to a prior spouse in the amount of $1,500. Marc and Michelle have a 10-year-old son, Matthew, who lived with them throughout the entire year. Thus, Marc and Michelle are allowed to claim a $1,000 child tax credit for Matthew. Marc and

Four Volumes to Fit…



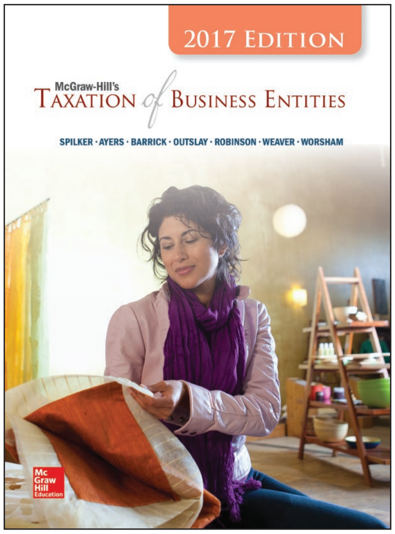
McGraw-Hill's Taxation of Individuals is organized to emphasize topics that are most important to undergraduates taking their first tax course. The first three chapters provide an introduction to taxation and then carefully guide students through tax research and tax planning. Part II discusses the fundamental elements of individual income tax, starting with the tax formula in Chapter 4 and then proceeding to more depth on individual topics in Chapters 5–7. Part III then discusses tax issues associated with business and investment activities. On the business side, it addresses business income and deductions, accounting methods, and tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). For investments it covers portfolio-type investments such as stocks and bonds and business investments including loss limitations associated with these investments. Part IV is unique among tax textbooks; this section combines related tax issues for compensation, retirement savings, and home ownership.

Part I: Introduction to Taxation
1. An Introduction to Tax
2. Tax Compliance, the IRS, and Tax Authorities
3. Tax Planning Strategies and Related Limitations

Part II: Basic Individual Taxation
4. Individual Income Tax Overview
5. Gross Income and Exclusions
6. Individual Deductions
7. Individual Income Tax Computation and Tax Credits

Part III: Business- and Investment-Related Transactions
8. Business Income, Deductions, and Accounting Methods
9. Property Acquisition and Cost Recovery
10. Property Dispositions
11. Investments

Part IV: Specialized Topics
12. Compensation
13. Retirement Savings and Deferred Compensation
14. Tax Consequences of Home Ownership



McGraw-Hill's Taxation of Business Entities begins with the process for determining gross income and deductions for businesses, and the tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). Part II provides a comprehensive overview of entities, and the formation, reorganization, and liquidation of corporations. Unique to this series is a complete chapter on accounting for income taxes, which provides a primer on the basics of calculating the income tax provision. Included in the narrative is a discussion of temporary and permanent differences and their impact on a company's book "effective tax rate." Part III provides a detailed discussion of partnerships and S corporations. The last part of the book covers state and local taxation, multinational taxation, and transfer taxes and wealth planning.

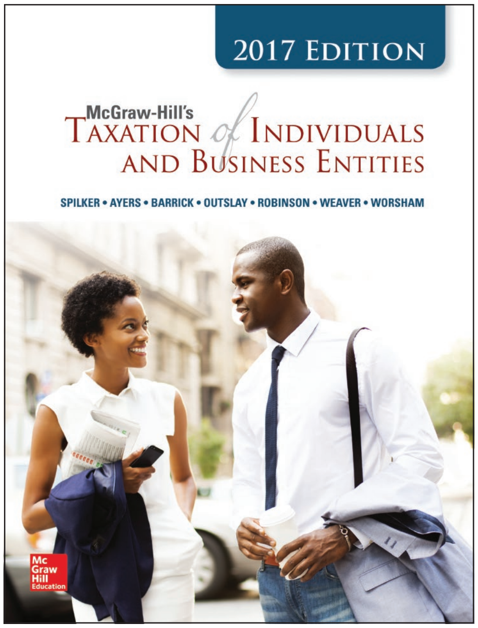
Part I: Business- and Investment-Related Transactions
1. Business Income, Deductions, and Accounting Methods
2. Property Acquisition and Cost Recovery
3. Property Dispositions

Part II: Entity Overview and Taxation of C Corporations
4. Entities Overview
5. Corporate Operations
6. Accounting for Income Taxes
7. Corporate Taxation: Nonliquidating Distributions
8. Corporate Formation, Reorganization, and Liquidation

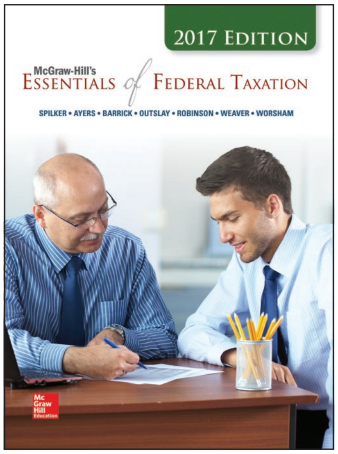
Part III: Taxation of Flow-Through Entities
9. Forming and Operating Partnerships
10. Dispositions of Partnership Interests and Partnership Distributions
11. S Corporations

Part IV: Multijurisdictional Taxation and Transfer Taxes
12. State and Local Taxes
13. The U.S. Taxation of Multinational Transactions
14. Transfer Taxes and Wealth Planning

…Four Course Approaches



McGraw-Hill's Taxation of Individuals and Business Entities covers all chapters included in the two split volumes in one convenient volume. See Table of Contents.



McGraw-Hill's Essentials of Federal Taxation is designed for a one-semester course, covering the basics of taxation of individuals and business entities. To facilitate a one-semester course, *McGraw-Hill's Essentials of Federal Taxation* folds the key topics from the investments, compensation, retirement savings, and home ownership chapters in *Taxation of Individuals* into three individual taxation chapters that discuss gross income and exclusions, for AGI deductions, and from AGI deductions, respectively. The essentials volume also includes a two-chapter C corporation sequence that uses a life-cycle approach covering corporate formations and then corporate operations in the first chapter and nonliquidating and liquidating corporate distributions in the second chapter. This volume is perfect for those teaching a one-semester course and for those who struggle to get through the 25-chapter comprehensive volume.

SUPPLEMENTS FOR INSTRUCTORS

Assurance of Learning Ready

Many educational institutions today are focused on the notion of *assurance of learning*, an important element of many accreditation standards. *McGraw-Hill's Taxation* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful, solution.

Each chapter in the book begins with a list of numbered learning objectives, which appear throughout the chapter as well as in the end-of-chapter assignments. Every test bank question for *McGraw-Hill's Taxation* maps to a specific chapter learning objective in the textbook. Each test bank question also identifies topic area, level of difficulty, Bloom's Taxonomy level, and AICPA and AACSB skill area. You can use our test bank software, *EZ Test Online*, or Connect to easily search for learning objectives that directly relate to the learning objectives for your course. You can then use the reporting features of *EZ Test* to aggregate student results in similar fashion, making the collection and presentation of Assurance of Learning data simple and easy.

AACSB Statement

McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *McGraw-Hill's Taxation* recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the text and the test bank to the general knowledge and skill guidelines in the revised AACSB standards.

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McGraw-Hill Education's Connect

Mc Graw Hill Education connect®

Connect offers a number of powerful tools and features to make managing your classroom easier. Connect with *McGraw-Hill's Taxation* offers enhanced features and technology to help both you and your students make the most of your time inside and outside the classroom.

EZ Test Online

This test bank in Word™ format contains multiple-choice questions, essay questions, and short problems. Each test item is coded for level of difficulty, learning objective, AACSB and AICPA skill area, and Bloom's Taxonomy level.

McGraw-Hill's EZ Test Online is a flexible and easy-to-use electronic testing program that allows instructors to create tests from book-specific items. EZ Test Online accommodates a wide range of question types and allows instructors to add their own questions. Multiple versions of the test can be created and any test can be exported for use with course management systems such as BlackBoard/WebCT. EZ Test Online gives instructors a place to easily administer exams and quizzes online. The program is available for Windows and Macintosh environments.

A HEARTFELT THANKS TO THE MANY COLLEAGUES WHO SHAPED THIS BOOK

The version of the book you are reading would not be the same book without the valuable suggestions, keen insights, and constructive criticisms of the list of reviewers below. Each professor listed here contributed in substantive ways to the organization of chapters, coverage of topics, and the use of pedagogy. We are grateful to them for taking the time to read chapters or attend reviewer conferences, focus groups, and symposia in support of the development for the book:

Previous Edition Reviewers

Kevin Baugess, *ICDC College*
Christopher Becker, *Coastal Carolina University*
Jeanne Bedell, *Keiser University*
Lisa Blum, *University of Louisville*
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We also appreciate the expert attention given to this project by the staff at McGraw-Hill Education, especially Tim Vertovec, Managing Director; Kathleen Klehr, Senior Brand Manager; Danielle Andries, Product Developer; Lori Koetters, Brian Nacik, and Jill Eccher, Content Project Managers; Matthew Diamond, Designer; and Sue Culbertson, Senior Buyer.

Changes in *Taxation of Individuals and Business Entities,* 2017 Edition

For the 2017 edition of McGraw Hill's *Taxation of Individuals and Business Entities,* many changes were made in response to feedback from reviewers and focus group participants:

- All **tax forms** have been **updated for the latest available tax form as of January 2016.** In addition, **chapter content** throughout the text has been **updated to reflect tax law changes through January 2016.**

Other notable changes in the 2017 edition include:

Chapter 2

- Updated for 2016 inflation adjustments and legislative changes.
- Updated discussion of tax return due dates.

Chapter 3

- Updated tax rates for 2016.
- Updated Exhibit 3-3 for new tax rates.
- Added new Taxes in the Real World.
- Added new Ethics box.

Chapter 4

- Updated personal exemption amounts for 2016.
- Updated standard deduction amounts for 2016.
- Updated tax rates for 2016.
- Moved rates from back cover of text to new appendix near end of the book.
- Updated tax forms from 2014 to 2015 forms.
- Revised the discussion relating to character of income.
- Revised the opening paragraph in the Personal and Dependency Exemptions section.
- Updated the taxes in the real world on "Tax status for same-sex married couples" to reflect recent developments in the area.

Chapter 5

- Updated for legislative changes.
- Updated for 2016 inflation adjustments.
- Updated for new tax forms.

Chapter 6

- Updated for legislative changes.
- Updated for 2016 inflation adjustments.
- Updated for new tax forms.

Chapter 7

- Updated tax rates for 2016.
- Updated tax forms from 2014 to 2015.
- Revised and streamlined the discussion of capital gains netting process.
- Revised the step-by-step capital gains netting process.
- Revised capital gains examples.
- Clarified Example 7-14 on investment interest expense.

Chapter 8

- Updated for legislative changes.
- Updated for 2016 inflation adjustments.
- Revised Kiddie Tax discussion.
- Updated for new tax forms.

Chapter 9

- Added new standard business mileage.
- Updated for new tax forms.

Chapter 10

- Updated tax rates for 2016.
- Updated tax forms from 2014 to 2015.
- Added new discussion for repair regulations.
- Added example on repair regulations.
- Added new end-of-chapter problems for repair regulations.

Chapter 11

- Updated tax rates for 2016.
- Updated tax forms from 2014 to 2015.
- Added discussion about holding period for dual basis rules.
- Added discussion about holding period for related party losses.
- Updated end-of-chapter problems.

Chapter 13

- Updated inflation adjusted limits for defined benefit plans, defined contribution plans, and individually managed plans.
- Added new taxes in the real world about Jeb Bush's defined benefit plan.
- Updated AGI phase-out thresholds for deductible contributions to traditional IRAs and contributions to Roth IRAs.

- Clarified the tax consequences of nonqualified distributions from Roth type retirement accounts.
- Clarified how the earned income limit applies to nondeductible contributions to IRAs.
- Clarified the contribution limits for Individual 401(k) retirement plans.
- Added a problem comparing the tax consequences of potential early distributions from traditional 401(k) and a Roth 401(k) retirement accounts.
- Updated Saver's credit information.

Chapter 14

- Updated URL in footnote 4.
- Added mortgage insurance deduction to Exhibit 14-1.
- Added new taxes in the real world called "Double take on home-related interest deductions."
- Removed taxes in the real world called "Extreme tax savings strategy" that dealt with how contestants on "Extreme makeover: Home Edition" treated their benefit for tax purposes.
- Updated Example 14-15 dealing with the IRS method vs. Tax court method of allocating rent expense to reflect leap year in 2016.
- Updated tax forms from 2014 forms to 2015 forms.
- Updated settlement statement in Appendix A.

Chapter 15

- Added a footnote highlighting the idea that unincorporated entities taxed as partnerships have more favorable ownership requirements and more favorable tax treatment on nonliquidating and liquidating distributions of noncash property than C or S corporations.
- Edited a footnote to point out that when a shareholder receives interest from a loan to the corporation, the interest income is investment income that could be subject to the 3.8% Net Investment Income Tax.
- Edited footnote to point out that shareholders who hold stock until death may avoid while shareholders may escape the shareholder level of the double tax. However, these shareholders may pay estate tax on the value of the stock held at death.
- Added a row to the entity comparison chart in Exhibit 15-3 that compares across entities the tax consequences of nonliquidating distributions of noncash property.

Chapter 18

- Added new Taxes in the Real World.

Chapter 19

Revised and clarified explanations of merger forms.

Chapter 22

- Updated chapter for tax law changes.
- Updated for new tax forms.

Chapter 25

- Revised explanation and computations based on updated exemption equivalent (unified credit).
- Updated tax forms.

As We Go to Press

The 2017 Edition is current through March 4, 2016. You can visit the *Connect Library* for updates that occur after this date.

Table of Contents

4 Individual Income Tax Overview, Exemptions, and Filing Status

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15 Entities Overview

16 Corporate Operations

17 Accounting for Income Taxes

McGraw-Hill's

Taxation of Individuals and Business Entities

chapter

1 An Introduction to Tax

Learning Objectives

Upon completing this chapter, you should be able to:

- **LO 1-1** Demonstrate how taxes influence basic business, investment, personal, and political decisions.
- **LO 1-2** Discuss what constitutes a tax and the general objectives of taxes.
- **LO 1-3** Describe the different tax rate structures and calculate a tax.
- **LO 1-4** Identify the various federal, state, and local taxes.
- **LO 1-5** Apply appropriate criteria to evaluate alternate tax systems.