

SOUTH-WESTERN
FEDERAL TAXATION

Hoffman
Raabe
Maloney
Young

CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS

2017

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TAX
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Student Edition



SOUTH-WESTERN
FEDERAL TAXATION

2017 EDITION
CORPORATIONS,
PARTNERSHIPS,
ESTATES & TRUSTS

General Editors

William H. Hoffman, Jr.

J.D., Ph.D., CPA

David M. Maloney

Ph.D., CPA

William A. Raabe

Ph.D., CPA

James C. Young

Ph.D., CPA

Contributing Authors

James H. Boyd

Ph.D., CPA
Arizona State University

Gregory Carnes

Ph.D., CPA
University of North Alabama

D. Larry Crumbley

Ph.D., CPA
Louisiana State University

Steven C. Dilley

J.D., Ph.D., CPA
Michigan State University

William H. Hoffman, Jr.

J.D., Ph.D., CPA
University of Houston

David M. Maloney

Ph.D., CPA
University of Virginia

Annette Nellen

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

Mark B. Persellin

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

William A. Raabe

Ph.D., CPA
Milton, Wisconsin

Debra L. Sanders

Ph.D., CPA
Washington State
University, Vancouver

W. Eugene Seago

J.D., Ph.D., CPA
Virginia Polytechnic
Institute and State University

James C. Young

Ph.D., CPA
Northern Illinois University

Kristina Zvinakis

Ph.D.
The University of Texas
at Austin



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**South-Western Federal Taxation:
Corporations, Partnerships, Estates & Trusts,
2017 Edition**

**William H. Hoffman, Jr., William A. Raabe,
David M. Maloney, James C. Young**

Vice President, General Manager, Science,
Math, and Quantitative Business: Balraj Kalsi

Product Director: Mike Schenk

Sr. Content Developer: Kendra Brown

Production Assistant: Trisha Makley

Associate Marketing Manager: Charisse Darin

Content Project Manager: Nadia Saloom

Manufacturing Planner: Doug Wilke

Marketing Communications Manager:
Sarah Greber

Production Service: Cenveo Publisher Services

Sr. Art Director: Linda May

Cover and Internal Designer: Red Hangar Design

Intellectual Property:

Analyst: Brittani Morgan

Project Manager: Nick Barrows

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Cengage Learning

20 Channel Center Street

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USA

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Preface

COMMITTED TO EDUCATIONAL SUCCESS

South-Western Federal Taxation (SWFT) is the most trusted and best-selling series in college taxation. We are focused exclusively on providing the most useful, comprehensive, and up-to-date tax texts, online study aids, tax preparation tools, and research tools to help instructors and students succeed in their tax courses and beyond.

SWFT is a comprehensive package of teaching and learning materials, significantly enhanced with each edition to meet instructor and student needs and to add overall value to learning taxation.

Corporations, Partnerships, Estates & Trusts, 2017 Edition provides a dynamic learning experience inside and outside of the classroom. Built with resources and tools that have been identified as the most important, our complete learning system provides options for students to achieve success.

Corporations, Partnerships, Estates & Trusts, 2017 Edition covers tax concepts as they affect corporations, partnerships, estates, and trusts. The authors provide accessible, comprehensive, and authoritative coverage of relevant tax code and regulations, as well as all major developments in Federal income taxation. This

market-leading text is intended for students who have had a previous course in taxation.

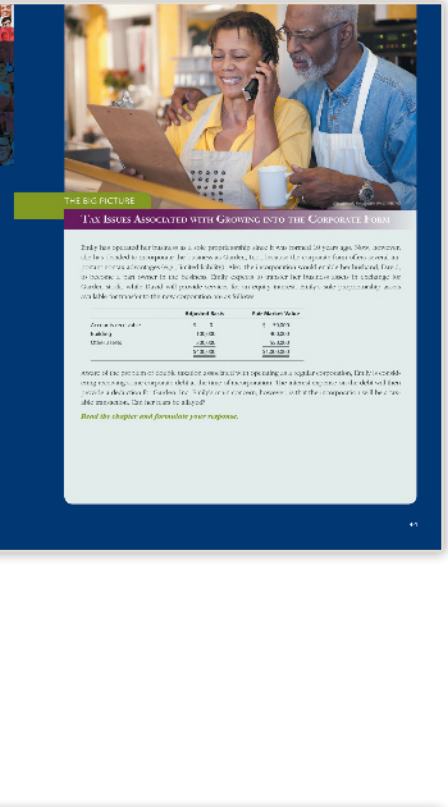
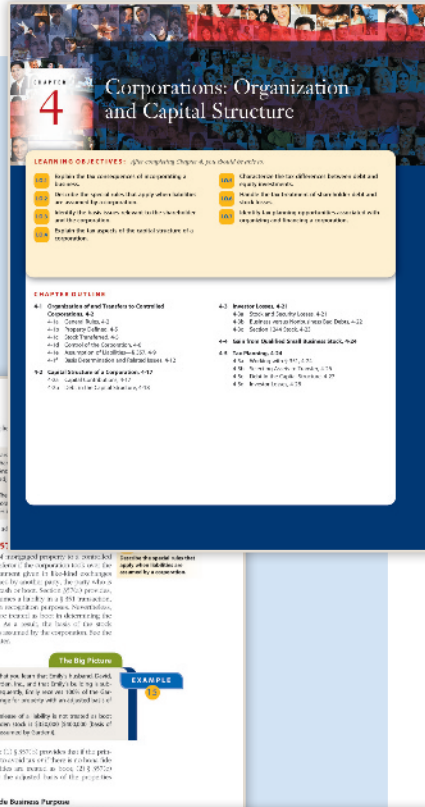
In revising the 2017 Edition, we focused on:

- **Accessibility. Clarity. Substance.** The text authors and editors made this their mantra as they revised for the 2017 edition. Coverage has been streamlined to make it more accessible to students, and difficult concepts have been clarified, all without losing the substance that makes up the *South-Western Federal Taxation* series.
- **CengageNOWv2 as a complete learning system.** Cengage Learning understands that digital learning solutions are central to the classroom. Through sustained research, we continually refine our learning solutions in CengageNOWv2 to meet evolving student and instructor needs. CengageNOWv2 fulfills learning and course management needs by offering a personalized study plan, video lectures, auto-graded homework, auto-graded tests, and a full eBook with features and advantages that address common challenges.

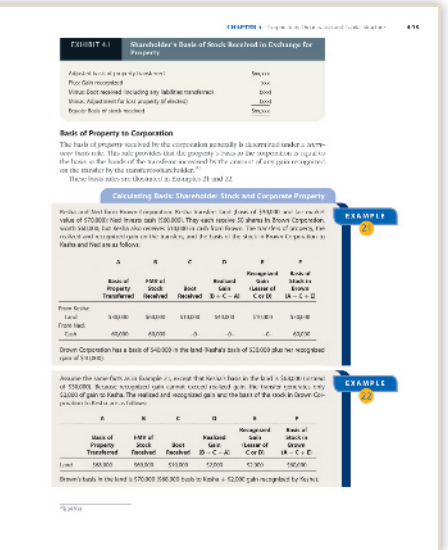
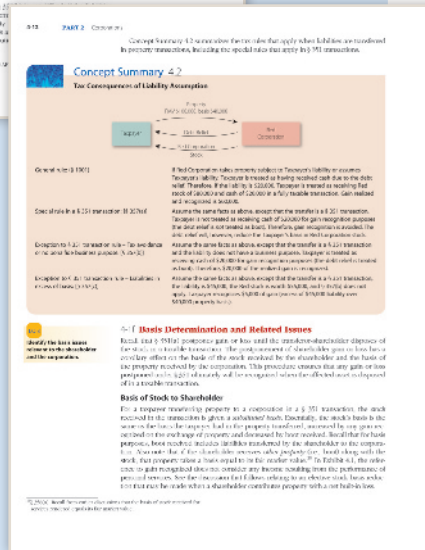
Learning Tools and Features to Help Students Make the Connection

FULL-COLOR DESIGN: We understand that students struggle with learning difficult tax code concepts and applying them to real-world scenarios. The 2017 edition uses color to bring the text to life, capture student attention, and present the tax code in a simple, yet logical format.

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



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



COMPUTATIONAL EXERCISES: Students need lots of practice in areas such as computing tax return problems and adjusting rates. We have developed these exercises to give students practice in calculating the solutions they need to make business decisions.

- Found in end-of-chapter section of the textbook
- CengageNOWv2 provides algorithmic versions of these problems

Computational Exercises

19. **LO.1** Marie and Ethan form Roundtree Corporation with the transfer of the following. Marie performs personal services for the corporation with a fair market value of \$80,000 in exchange for 400 shares of stock. Ethan contributes an installment note receivable (basis \$25,000; fair market value \$30,000), land (basis \$50,000; fair market value \$170,000) and inventory (basis \$100,000; fair market value \$120,000) in exchange for 1,600 shares. Determine Marie and Ethan's current income, gain, or loss; calculate the basis that each takes in the Roundtree stock.
20. **LO.1** Grady exchanges qualified property, basis of \$12,000 and fair market value of \$18,000, for 60% of the stock of Eadie Corporation. The other 40% of the stock is owned by Pedro, who acquired it five years ago. Calculate Grady's current income, gain, or loss and the basis he takes in his shares of Eadie stock as a result of this transaction.
21. **LO.2** Jocelyn contributes land with a basis of \$60,000 and fair market value of \$90,000 and inventory with a basis of \$5,000 and fair market value of \$8,000 in exchange for 100% of Zion Corporation stock. The land is subject to a \$15,000 mortgage. Determine Jocelyn's recognized gain or loss and the basis in the Zion stock received.

ROGER CPA EXAM REVIEW QUESTIONS: While the SWFT series has always provided the most in-depth coverage of tax concepts, Roger CPA Exam Review Questions are included to further prepare students for success on the CPA Exam.

- Located in selected end-of-chapter sections
- Tagged by concept in CengageNOWv2
- Similar questions to what students would actually find on the CPA Exam



Roger CPA Review Questions



1. Kellye and Becky formed Whoop! Shotz Corporation by contributing property with a fair market value of \$50,000 and \$70,000 cash, respectively, each for a 50% ownership in the newly formed company. What is Kellye's taxable gain in this situation if the adjusted basis in the property is \$25,000 and the company is valued at \$120,000?

a. \$0	c. \$25,000
b. \$10,000	d. \$35,000
2. Kellye, Becky, and Emily formed Whoop! Shotz Corporation with the following contributions:

Kellye	\$50,000 cash
Becky	\$50,000 cash
Emily	Legal services

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

THE BIG PICTURE

TAXING CORPORATE DISTRIBUTIONS

Lime Corporation, an ice cream manufacturer, has had a very profitable year. To share its profits with its two shareholders, Orange Corporation and Gustavo, it distributes cash of \$200,000 to Orange and real estate worth \$300,000 (adjusted basis of \$20,000) to Gustavo. The real estate is subject to a mortgage of \$100,000, which Gustavo assumes. The distribution is made on December 31, Lime's year-end.

Lime Corporation has had both good and bad years in the past. More often than not, however, it has lost money. Despite this year's banner profits, the GAAP-based balance sheet for Lime indicates a year-end deficit in retained earnings. Consequently, the distribution of cash and land is treated as a liquidating distribution for financial reporting purposes, resulting in a reduction of Lime's paid-in capital account.

The tax consequences of the distributions to the corporation and its shareholders depend on a variety of factors that are not directly related to the financial reporting treatment. Identify these factors and explain the tax effects of the distributions to both Lime Corporation and its two shareholders.

Read the chapter and formulate your response.

THE BIG PICTURE: Tax Solutions for the Real World. Taxation comes alive at the start of each chapter as The Big Picture Examples give a glimpse into the lives, families, careers, and tax situations of typical filers. Students will follow this one family or individual throughout the chapter showing students how the concept they are learning plays out in the real world.

Finally, to solidify student comprehension, each chapter concludes with a **Refocus on the Big Picture** summary and tax planning scenario. These scenarios apply the concepts and topics from the chapter in a reasonable and professional way.

FINANCIAL DISCLOSURE INSIGHTS:

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



FINANCIAL DISCLOSURE INSIGHTS

Effective Tax Strategies Using Overseas Operations

In a global economy, publicly traded business entities can operate in many taxing jurisdictions. For instance, General Electric reports that it files current-year tax returns with more than 250 countries, amounting to over 7,000 income tax returns at the Federal and local levels worldwide. Note that this tax activity does not take into account the sales, value added, property, and other tax returns that are required by the U.S. states and localities.

The financial reports of profitable U.S. companies indicate that overseas operations can produce tax benefits of their own, not taking into account the effects of

increased market share and financial stability. For instance, the trucking firm Ryder Systems recently reported current tax refunds of about \$235,000 and deferred tax savings of about \$500,000 on non-U.S. profits of about \$11.5 million. In a recent period, Eli Lilly reduced its effective tax rate by about one-third due to overseas operations. And General Electric recently reduced its effective tax rate to a negative amount because of various income deferrals related to overseas earnings. These deferral techniques are addressed later in the chapter.



TAX IN THE NEWS How to Save Taxes and Protect the Environment

What do Ted Turner, Robert Redford, Clint Eastwood, and James Baker (former secretary of state) have in common? Besides being celebrities and financially well-to-do, all have issued **conservation easements** in some or all of the real estate they own. By this means, any "scenic view" that currently exists is preserved. The owner is precluded from obstructing the view by further development of the property. Allegedly, the transfer of the easement is motivated by the owner's desire to "conserve the environment." Realistically, the transfer is largely tax-motivated.

The steps involved in creating a conservation easement and the tax consequences that ensue are as follows.

- After the easement is drafted, the owner transfers it to a conservation trust. Usually, the trust is already in existence, having been created by an environmental group, and operates under the auspices of a local government agency.

- The owner obtains a generous appraisal as to the value of the easement transferred.
- The owner claims the value of the easement as an income tax deduction.
- The value of the property retained (e.g., residence or vacation home) is accordingly reduced by the value of the easement for ad valorem property tax purposes.
- Upon the owner's death, the gross estate includes the property at a discounted value due to the restrictions contained in the easement.

In summary, the conservation easement saves income, property, and estate taxes. The donor receives all of this in addition to the aura of being hailed as an environmentalist.¹⁸

TAX IN THE NEWS: Drawn from today's business and popular press, **Tax in the News** features enliven class discussions by presenting current issues that illustrate the chapter material and applying them to real life. These plentiful and relevant news items make tax law concepts come to life.

In addition, editors offer weekly updates for instructors designed for use in the classroom with links, assignments, and activities included. See the **SWFT** blog at <https://taxintherealworld.wordpress.com>.



ETHICS & EQUITY What Is a Sound Business Purpose?

Natural Recycle, owned and operated by Caleb Liven, wants to expand and would like to acquire Metro Publishing, Inc., owned and operated by Jae Liven, Caleb Liven's sister. Its major assets are large net operating losses (NOLs), unused credits, and antiquated printing equipment. Natural Recycle is very profitable and could benefit from the NOLs and unused credits.

Natural Recycle wants the acquisition to qualify as a tax-free corporate reorganization. Caleb informs his accountant, Mei Xiang, that Natural Recycle is engaged in reclaiming

waterways in the proximity of strip mines, and that Metro Publishing prints tour guide books for major cities. When asked about the business purpose of the merger, Caleb answers, "We need the NOLs and unused credits to offset Natural's high taxable income. I would also like to help my sister get out from under her failing business."

Does Xiang face any ethical problems in structuring the acquisition of Metro Publishing by Natural Recycle as a tax-free reorganization?

ETHICS & EQUITY: Most issues do not have just one correct answer. **Ethics & Equity** features will spark critical thinking and invite classroom discussion, enticing students to evaluate their own value system. Suggested answers to Ethics & Equity scenarios appear in the Solutions Manual.

TAX PLANNING: Most chapters include a separate section, with its own Learning Objective, calling attention to how the tax law can be applied to reach the taxpayer's goals. Tax planning applications and suggestions also appear throughout each chapter.

5-4 TAX PLANNING

5-4a Corporate Distributions

The following points are especially important when planning for corporate distributions.

- Because E & P is the pool of funds from which dividends may be distributed, its periodic determination is essential to corporate planning. As a result, an E & P account should be established and maintained, particularly if the possibility exists that a corporate distribution might be a return of capital.
- Accumulated E & P is the sum of all past years' current E & P. Because there is no statute of limitations on the computation of E & P, the IRS can redetermine a corporation's current E & P for a tax year long since passed. Such a change affects accumulated E & P and has a direct impact on the taxability of current distributions to shareholders.
- Distributions can be planned to avoid or minimize dividend exposure.



GLOBAL TAX ISSUES Consolidated Returns and NOLs

Very few countries outside the United States allow the use of consolidated returns. In the view of most countries, tax deductions for operating losses should be used only by those who generated them, not by some sister or other related corporation. This is as much a social principle (the sanctity of the corporate entity) as a revenue-raising provision (NOL deductions mean lower tax collections).

The way European business is conducted makes this result more understandable, as the tax laws of the various countries must ensure that operating losses generated in Tedesco, for instance, are not shifted to Cadenza and converted to deductions there.

GLOBAL TAX ISSUES: The **Global Tax Issues** feature gives insight into the ways in which taxation is affected by international concerns and illustrates the effects of various events on tax liabilities across the globe.

Take your students from Motivation to Mastery with CengageNOWv2



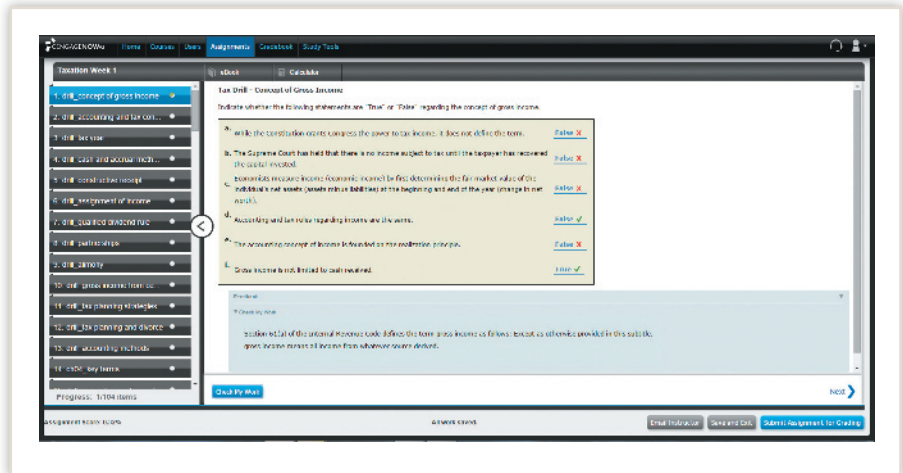
CengageNOWv2 is a powerful course management tool and online homework resource that elevates student thinking by providing superior content designed with the entire student workflow in mind.

- **MOTIVATION:** engage students and better prepare them for class
- **APPLICATION:** help students learn problem-solving behavior and skills in order to complete taxation problems on their own
- **MASTERY:** help students make the leap from memorizing concepts to actual critical thinking

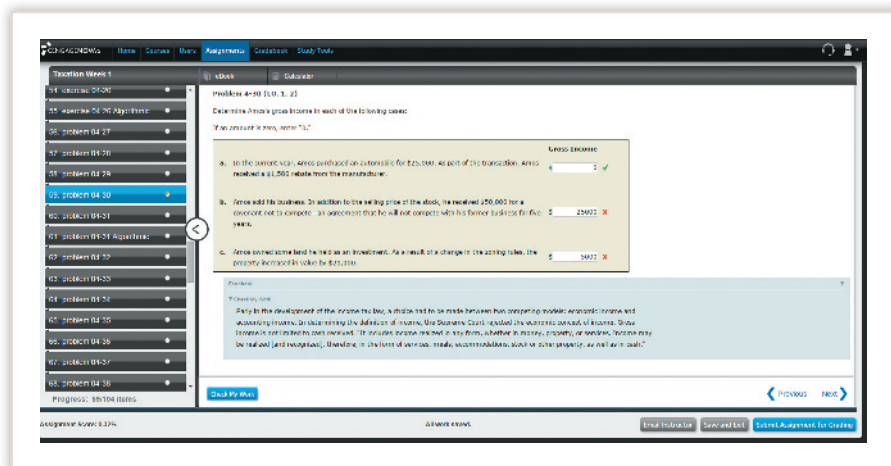
Motivation —

Many instructors find that students come to class unmotivated and unprepared. To help with engagement and preparedness, CengageNOWv2 for SWFT offers the following features:

- **“Tax Drills” test students on key concepts and applications.** With three to five questions per learning objective, these “quick-hit” questions help students prepare for class lectures or review prior to an exam.



Application —



Students need to learn problem-solving behavior and skills in order to complete taxation problems on their own. However, as students try to work through homework problems, sometimes they become stuck and need guidance. To help reinforce concepts and keep students on the right track, CengageNOWv2 for SWFT offers the following:

- **End-of-chapter homework from the text** is expanded and enhanced to follow the workflow a professional would use to solve various client scenarios. These enhancements better engage students and encourage them to think like a tax professional.

- **Algorithmic versions** of end-of-chapter homework are available for computational exercises and at least 15 problems per chapter.
- **“Check My Work” Feedback.** Homework questions include immediate feedback so students can learn as they go. Levels of feedback include an option for “check my work” prior to submission of an assignment.
- **Post-Submission Feedback.** After submitting an assignment, students receive even more extensive feedback explaining why their answers were incorrect. Instructors can decide how much feedback their students receive and when, including the full solution.
- **Built-in Test Bank** for online assessment.

Mastery —

- **NEW! Tax Form Problems** are **NEW** to CengageNOWv2. Students can now complete the Cumulative H&R Block Problems found in the end-of-chapter manually in a digital environment.
- **“What-If” Questions** allow students to develop a deeper understanding of the material as they are challenged to use their prior knowledge of the tax situations and critically think through new attributes to determine how the outcome will change.
- **An Adaptive Study Plan** comes complete with an eBook, practice quizzes, crossword puzzle, glossary, and flashcards. It is designed to help give students additional support and prepare them for the exam.

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EXTENSIVELY REVISED. DEFINITELY UP TO DATE.

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

The ***South-Western Federal Taxation*** authors have made every effort to keep all materials up to date and accurate. All chapters contain the following general changes for the 2017 Edition.

- Updated materials to reflect changes made by the Protecting Americans from Tax Hikes (PATH) Act of 2015 and other Public Laws of 2015
- Streamlined chapter content (where applicable) to clarify material and make it easier for students to understand.
- Revised numerous materials as the result of changes caused by indexing of statutory amounts.
- Revised Problem Materials, Computational Exercises, and CPA Exam problems.
- Updated *Tax in the News* items in each chapter with coverage of recent events.
- Updated Chapter Outlines to provide an overview of the material and to make it easier to locate specific topics.
- Revised *Financial Disclosure Insights* and *Global Tax Issues* as to current developments.

In addition, the following materials are available online.

- An appendix that helps instructors broaden and customize coverage of important tax provisions of the Affordable Care Act. (Instructor Companion Website at www.cengage.com/login)
- The Depreciation and the Accelerated Cost Recovery System (ACRS) appendix (formerly Appendix G in *SWFT Individual Income Taxes*). (Instructor Companion Website at www.cengage.com/login)
- The Taxation in the Real World weekly blog posts for instructors. (<https://taxintherealworld.wordpress.com>)

Chapter 1

- Updated references and citations throughout the chapter.
- Revised and clarified text and examples throughout the chapter.

- Updated materials on administrative tax law sources and commercial tax services.

Chapter 2

- Added a Concept Summary comparing the tax attributes of various forms of business entities.
- Added a Concept Summary on Schedule M-1 (Form 1120).
- Added a new *Tax in the News* feature and a new *Global Tax Issues* feature.
- Updated text to reflect new filing due dates for corporations.
- Updated text and examples throughout the chapter.

Chapter 3

- Added a *Tax in the News* feature on the Tax Court's decision in *Advo, Inc.*, highlighting the factors used to determine whether a taxpayer has ownership of property for purposes of the DPAD.
- Added a *Tax in the News* feature on revenues raised by the corporate AMT.
- Revised and clarified text and examples throughout the chapter.
- Updated the chapter example related to Form 8903 (Domestic Production Activities Deduction).
- Updated the chapter example related to Form 4626 (Alternative Minimum Tax—Corporations).

Chapter 4

- Revised several sections of the chapter, including a Concept Summary, to improve readability and clarity.
- Provided a new *Tax in the News* feature that describes ways in which local and state jurisdictions compete to attract new businesses and employers in exchange for tax breaks.
- Revised the facts in an example that illustrates the tax effects of debt versus equity to be more realistic with current market interest rates.

Chapter 5

- Enhanced and expanded the chapter examples on determining corporate E & P and allocating E & P to distributions.
- Added examples on constructive dividends when a corporation pays a shareholder's obligations.
- Revised and clarified text and examples throughout the chapter.

Chapter 6

- Added two new *Tax in the News* features, entitled “Value of Corporate Stock Buybacks Questioned” and “State Dissolution of Corporate Status Not Determinative of Liquidation Status under Federal Tax Law.”

Chapter 7

- Deleted *Ethics & Equity* feature “Possible Sour Notes.”
- Modified Concept Summary 7.2 and Concept Summary 7.4.
- Clarified Exhibit 7.1, Exhibit 7.5, and Exhibit 7.6.
- Reduced discussion of acquisitive “Type D” reorganizations and removed exhibit illustrating it.
- Replaced *Tax in the News* feature “Want a Doughnut with That Burger?” with “Google Adopts a Parent.”
- Modified *Ethics & Equity* feature “What Is a Sound Business Purpose?”
- Modified *Global Tax Issues* feature “Acquisition Is the Prescription to Lower Taxes.”
- Modified *Financial Disclosure Insights* feature “When an Acquisition Fails.”
- Enhanced problem materials concerning present value computations.

Chapter 8

- Expanded discussion of non-tax motivations to consolidate.
- Noted that IRS permission typically is granted automatically when changing from one common tax-sharing method to another.
- Updated filing data for Federal consolidated returns.
- Updated material concerning the due dates for Federal consolidated tax returns.
- Streamlined the listing of consolidated group items.
- Added a present value computation to a problem about an intercompany transaction.

Chapter 9

- Added a Concept Summary regarding the income and deduction sourcing rules.
- Streamlined the discussion of § 367 asset transfers.
- Revised the materials for Subpart F income, stock basis, and application of E & P on flow-throughs.
- Added a Concept Summary illustrating the transactions involved when Subpart F flow-throughs apply.
- Updated information about the international economy and location of multinationals’ income and assets, and corporate income tax nominal rates and withholding for various countries.

- Added a *Tax in the News* feature about the location of U.S. companies’ overseas profits.
- Expanded Tax Planning materials that highlight the optimization of the foreign tax credit computations by use of the income sourcing rules.

Chapter 10

- Modified and relocated the discussion of guaranteed payments to clarify their effect on partnership operations.
- Incorporated a Form 1065 as part of the Big Picture example.
- Placed added emphasis on the proper use of Form 1065 as a means of reporting partnership operations.

Chapter 11

- Updated for indexation adjustments.

Chapter 12

- Added *Tax in the News* feature “Distribution of Loss Property.”
- Enhanced and updated material concerning recognition period for built-in gains tax.
- Revised discussion concerning material participation by S shareholders.
- Expanded discussion of self-rental income as part of § 1411 Medicare tax.

Chapter 13

- Updated data and statistics on number of business entities.
- Added return due dates to Concept Summary 13.1, updated for 2015 law changes.
- Added Research Problem on Federal tax reform and business entities.

Chapter 14

- Updated the discussion of Schedule UTP and current filing statistics for Schedule UTP.
- Revised the computational templates for annual changes in deferred tax assets and liabilities.
- Expanded the discussion of the FASB and IASB convergence projects.
- Added citations to certain GAAP rules in accounting for income taxes.
- Added example for ASC 740–10 (FIN 48).

Chapter 15

- Updated statistics related to the charitable sector and the donor base, private foundations, and filing deadlines.

- Added *Tax in the News* feature “NFL Gives Up Exempt Status.”
- Updated tax rates and ceilings for the excise taxes on private foundations.
- Clarified materials concerning UBTI adjustments and debt-financed income.
- Revised materials concerning the application process for exempt entities, filing due dates, and public disclosure of Forms 990.

Chapter 16

- Updated data and statistics about state and local tax revenues.
- Revised Exhibit 16.1 to emphasize data flows.
- Updated *Tax in the News* feature about state tax credits for filmmakers.
- Revised discussion of application of P.L. 86–272 in today’s economy.
- Modified introductory discussion of allocation and apportionment of income.
- Revised material involving the sales factor and the throwback rule.
- Modified material discussing combined versus consolidated returns.
- Reorganized material listing sales/use tax exemptions.
- Added materials about the sales/use taxation of online transactions.

Chapter 17

- Updated various amounts and statistics as to audits, refunds, fees, and filing practices.
- Updated citations to various annual documents.
- Added discussion of the role of the National Taxpayer Advocate.
- Revised material concerning IRS regulation of tax return preparers.
- Updated and augmented material involving Circular 230 and tax preparer penalties.
- Added problems featuring Excel commands and present value computations.

Chapter 18

- Condensed the material on the historical background of the Federal estate and gift taxes.
- Simplified the tax treatment of gifts made within three years of death (§ 2035).
- Updated examples that compute the Federal estate and gift tax to reflect the new 2016 unified transfer tax credit and exclusion amount.
- Added Exhibit 18.2 that illustrates the use of the QTIP election in avoiding the terminable interest prohibition to obtaining the marital deduction.

Chapter 19

- Included new inflation limitations on the adjustment for electing current use valuation as to farms and other small businesses of a decedent.
- Reflected the inflation increase on the amount of estate tax subject to the 2 percent interest rate that can be deferred under § 6166.
- Restructured the discussion of the role of the probate estate in estate planning.

Chapter 20

- Updated amounts concerning fiduciary tax rates and exemptions.
- Clarified that a trust is created and defined under state law, not Federal income tax law.
- Updated statistics about fiduciary returns, gross and taxable income, and tax liability generated.
- Added rules concerning the NIIT to Concept Summary 20.1.
- Updated amounts related to the NIIT for fiduciaries.
- Clarified the availability of the DPAD when a fiduciary operates a trade or business.
- Deleted material relating to beneficiaries’ treatment of losses in the year of the entity’s termination.

TAX LAW OUTLOOK

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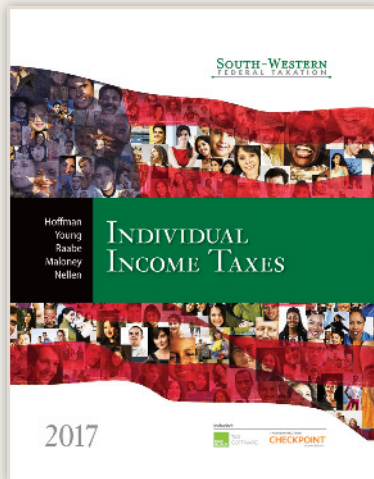
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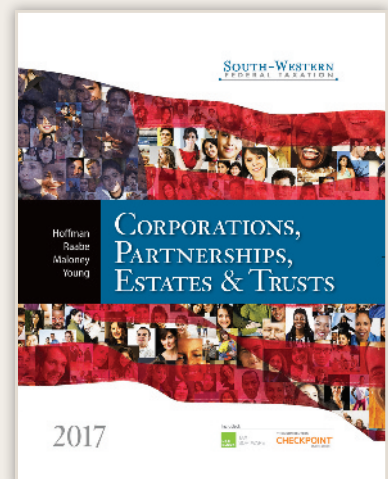
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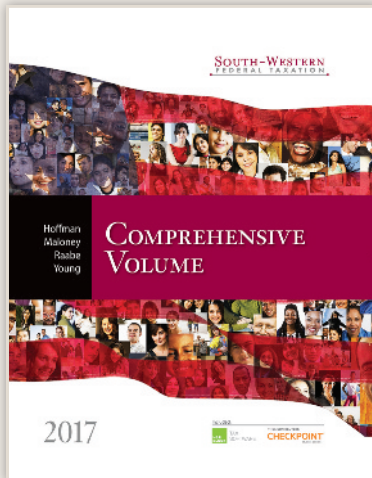
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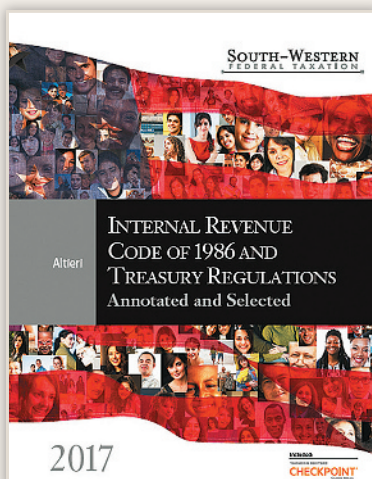
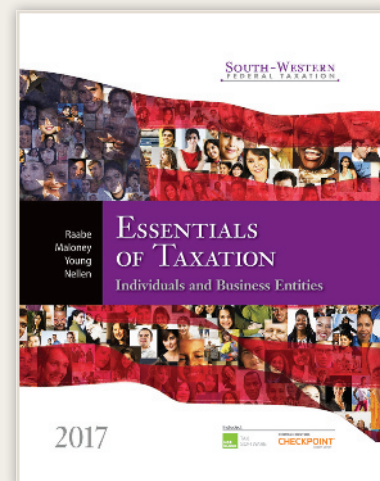
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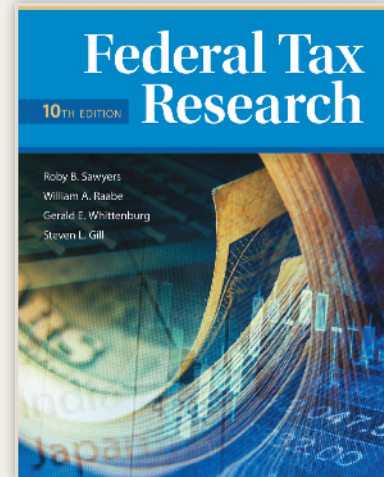
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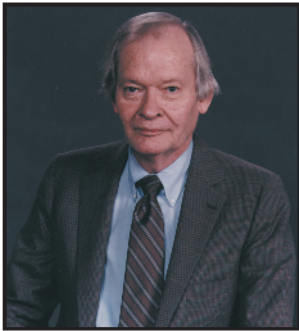
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ABOUT THE EDITORS



William H. Hoffman, Jr. earned B.A. and J.D. degrees from the University of Michigan and M.B.A. and Ph.D. degrees from The University of Texas. He is a licensed CPA and attorney in Texas. Recognized for his teaching excellence, Dr. Hoffman's academic experience includes The University

of Texas (1957–1961), Louisiana State University (1961–1967), and the University of Houston (1967–1999). A frequently requested professional speaker, Dr. Hoffman has addressed many tax institutes and conferences and has published extensively in academic and professional journals. His articles appear in *The Journal of Taxation*, *The Tax Adviser*, *Taxes—The Tax Magazine*, *The Journal of Accountancy*, *The Accounting Review*, and *Taxation for Accountants*.



William A. Raabe, Ph.D., CPA, was the Wisconsin Distinguished Professor of Taxation. He taught at Ohio State, Arizona State, the Capital University (OH) Law School, and the Universities of Wisconsin – Milwaukee and Whitewater. A graduate of Carroll University (Wisconsin) and

the University of Illinois, Dr. Raabe's teaching and research interests include international and multistate taxation, technology in tax education, personal financial planning, and the economic impact of sports teams and fine arts groups. Dr. Raabe also writes the PricewaterhouseCoopers Tax Case Studies. He has written extensively about book-tax differences in financial reporting. Dr. Raabe has been a visiting tax faculty member for a number of public accounting firms, bar associations, and CPA societies. He has received numerous teaching awards, including the Accounting Educator of the Year award from the Wisconsin Institute of CPAs. He has been the faculty adviser for student teams in the Deloitte Tax Case Competition (national finalists at three different schools) and the PricewaterhouseCoopers Extreme Tax policy competition (national finalist). For more information about Dr. Raabe, visit BillRaabeTax.com and BillRaabeTax on YouTube and Twitter.



David M. Maloney, Ph.D., CPA, is the Carman G. Blough Professor of Accounting Emeritus at the University of Virginia's McIntire School of Commerce. He completed his undergraduate work at the University of Richmond and his graduate work at the University of Illinois at Urbana-Champaign. Upon

joining the Virginia faculty in January 1984, Dr. Maloney taught Federal taxation in the graduate and undergraduate programs and was a recipient of major research grants from the Ernst & Young and KPMG Foundations. Dr. Maloney has published work in numerous professional journals, including *Journal of Taxation*, *The Tax Adviser*, *Tax Notes*, *Corporate Taxation*, *Accounting Horizons*, *Journal of Taxation of Investments*, and *Journal of Accountancy*.



James C. Young is the Crowe Horwath Professor of Accountancy at Northern Illinois University. A graduate of Ferris State University (B.S.) and Michigan State University (M.B.A. and Ph.D.), Jim's research focuses on taxpayer responses to the income tax using archival data. His dissertation

received the PricewaterhouseCoopers/American Taxation Association Dissertation Award and his subsequent research has received funding from a number of organizations, including the Ernst & Young Foundation Tax Research Grant Program. His work has been published in a variety of academic and professional journals, including the *National Tax Journal*, *The Journal of the American Taxation Association*, and *Tax Notes*. Jim is a Northern Illinois University Distinguished Professor, received the Illinois CPA Society Outstanding Accounting Educator Award in 2012, and has received university teaching awards from Northern Illinois University, George Mason University, and Michigan State University.



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