

McGRAW-HILL'S

# TAXATION

OF INDIVIDUALS

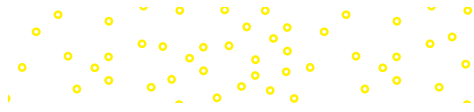


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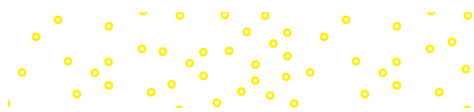


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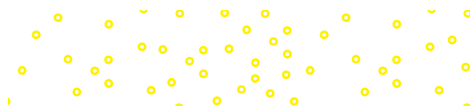


**McGraw-Hill's**

# Taxation of Individuals







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# Taxation of Individuals

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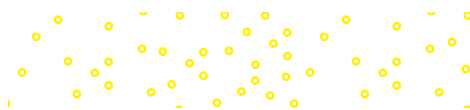
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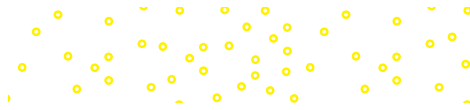
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## McGRAW-HILL'S TAXATION OF INDIVIDUALS, 2020 EDITION, ELEVENTH EDITION

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## Dedications

*We dedicate this book to:*

*My family and to Professor Dave Stewart for his great example and friendship.*

**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, Jeff, and Nicole, and to Professor James E. Wheeler, my mentor and friend.*

**Ed Outsley**

*JES, Tommy, and Laura.*

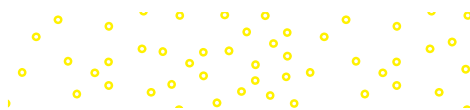
**John Robinson**

*My family: Dan, Travis, Alix, Alan, and Anna.*

**Connie Weaver**

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

**Ron Worsham**



## About the Authors

**Brian C. 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 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. He received the Price Waterhouse Fellowship in Tax Award and the American Taxation Association and Arthur Andersen Teaching Innovation Award for his work in the classroom. Brian 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*.



Courtesy Brian Spilker

**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. 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, the 2003 and 2008 recipient of the American Taxation Association's Outstanding Manuscript Award, and the 2016 recipient of the American Taxation Association's Ray M. Sommerfeld Outstanding Tax Educator Award.



Courtesy Ben Ayers

**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 during 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 tax corporate political activity. 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*.



Courtesy John Barrick



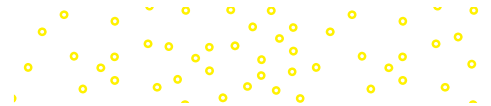
Courtesy Ed Outslay

**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, the Distinguished Faculty Award, the John D. Withrow Teacher-Scholar Award, the Roland H. Salmonson Outstanding Teaching Award, the Senior Class Council Distinguished Faculty Award, the 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. In 2017, Ed received the American Accounting Association / J. Michael and Mary Ann Cook Prize given in "foremost recognition of an individual who consistently demonstrates the attributes of a superior teacher in the discipline of accounting." 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.



Courtesy John Robinson

**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 has been 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) and in 2017 was named the Ernst & Young and ATA Ray Sommerfeld Outstanding Educator. John served as the 2014–2015 president (elect) of the ATA and was 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 2002–2005. Professor Robinson received his J.D. (*Cum Laude*) from the University of Michigan in 1979, and he teaches courses on individual and corporate taxation and advanced accounting.



**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 Professional Program in Accounting and the Executive MBA program 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 award, the David and Denise Baggett Teaching award, and the college and university level Association of Former Students Distinguished Achievement award in teaching. 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*, *National Tax Journal*, *Accounting Horizons*, *Journal of Corporate Finance*, and *Tax Notes*. Connie is the senior editor of *The Journal of the American Taxation Association* and she serves on the editorial board of *Contemporary Accounting Research*.

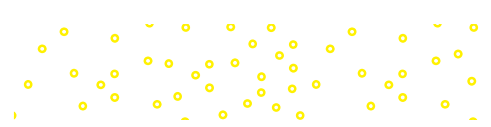


Courtesy Connie Weaver

**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*, *Tax Notes*, *The Journal of Accountancy*, and *Practical Tax Strategies*.



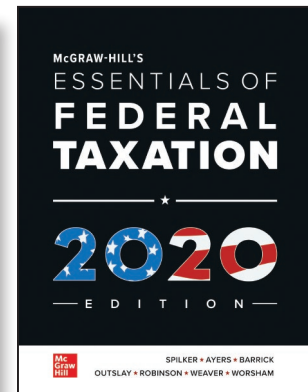
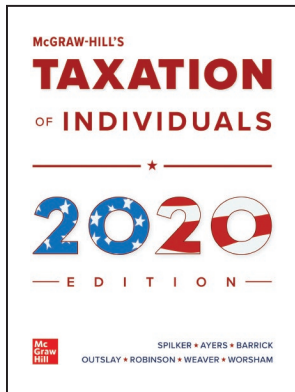
Courtesy Ron Worsham







# TEACHING THE CODE IN CONTEXT



*The bold innovative approach used by McGraw-Hill's Taxation series is quickly becoming the most popular choice of course materials among instructors and students. It's apparent why the clear, organized, and engaging delivery of content, paired with the most current and robust tax code updates, has been adopted by more than 650 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.

"Do you want the best tax text? This is the one to use. It has a storyline in each chapter that can relate to real life issues."

Leslie A. Mostow  
– University of Maryland, College Park

"This text provides broad coverage of important topics and does so in a manner that is easy for students to understand. The material is very accessible for students."

Kyle Post  
– Tarleton State University

Since the first manuscript was written in 2005, 450 professors have contributed 500 book reviews, in addition to 30 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.**

"I think this is the best book available for introductory and intermediate courses in taxation."

Shane Stinson  
– University of Alabama



# A MODERN APPROACH FOR TODAY'S STUDENT

*McGraw-Hill'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 Integrated Examples:** In addition to providing examples in-context, we provide “**What if**” scenarios within many examples to **illustrate how variations in the facts might or might not change the answers**.
- 3 Conversational Writing Style:** The authors took special care to write *McGraw-Hill's Taxation* in a way 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.
- 4 Superior Organization of Related Topics:** *McGraw-Hill's Taxation* provides two alternative topic sequences. In the *McGraw-Hill's Taxation of Individuals and Business Entities* volume, the individual topics generally follow the tax form sequence, with an individual overview chapter and then chapters on income, deductions, investment-related issues, and the tax liability computation. The topics then transition into business-related topics that apply to individuals. This volume then provides a group of specialty chapters dealing with topics of particular interest to individuals (including students), including separate chapters on home ownership, compensation, and retirement savings and deferred compensation. This volume concludes with a chapter covering the taxation of business entities. Alternatively, in the *Essentials of Federal Taxation* volume, the topics follow a more traditional sequence, with topics streamlined (no specialty chapters) and presented in more of a life-cycle approach.
- 5 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.

“The in-text examples of how to complete tax returns (is a strength of this text). These help students improve their overall understanding of the material as it moves from something abstract to something tangible the student can produce.”

Christine Cheng  
– Louisiana State University

# A STORYLINE APPROACH THAT RESONATES WITH STUDENTS



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**Storyline Summary**

**Taxpayers:** Courtney Wilson, age 40, and 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.

**C**ourtney 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 and is worried that she may be subject to the alternative minimum tax this year. 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. Courtney 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 plans to file her tax return and pay her taxes by the looming 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. As their situations evolve, the characters are brought further to life.

“Excellent text! Very readable, easy for students to read and understand. Storyline approach and integrated examples make it easy for students to relate to taxpayers and their tax situations.”

Sandra Owen  
– Indiana State University, Bloomington

## 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 2015 federal tax return on September 6, 2016, after receiving an automatic extension to file their return by October 15, 2016. In 2019, the IRS selects their 2015 tax return for audit. When does the statute of limitations end for Bill and Mercedes's 2015 tax return?

**Answer:** Assuming the six-year and “unlimited” statute of limitation rules do not apply, the statute of limitations ends on September 6, 2019 (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 2015 tax return if the couple filed the return on March 22, 2016 (before the original due date of April 15, 2016)?

**Answer:** In this scenario the statute of limitations would end on April 15, 2019, because the later of the actual filing date and the original due date is April 15, 2016.

“I enjoy teaching from the McGraw-Hill Spilker taxation textbook. Students too have commented that they prefer it over other texts they have learned taxation from. The ancillaries, LearnSmart and Connect help in my mission to present the material in a logical, reader-friendly manner.”

Cheryl Crespi – Central Connecticut State University

# 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, the 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.

“This is the best text I have found for both my students and myself. Easier to read than other textbooks I have looked at, good examples, and, as mentioned before, I appreciate the instructor resources.”

– Esther Ehrlich, CPA, The University of Texas at El Paso

### TAXES IN THE REAL WORLD Is It a Deductible State Tax Payment, Charitable Contribution, or Neither?

In recent years, it has become popular for state and local governments to provide state or local tax credits for contributions to certain qualified charities (for example, local hospitals, certain scholarship funds, etc.). While there was no “official” IRS guidance on the federal tax treatment of these contributions, in “unofficial” guidance, the IRS Office of Chief Counsel (see Chief Counsel Advice Memorandum 201105010) advised that a payment to a state agency or charitable organization in return for a tax credit might be characterized as either a deductible charitable contribution or a deductible state tax payment. The 2010 CCA advised that taxpayers could take a charitable deduction for the full amount of the contribution without subtracting the value of the state tax credit received. Hence, for federal tax purposes, the taxpayer could take a charitable contribution deduction for an amount that otherwise was used to reduce the taxpayer’s state tax liability. Because individuals deduct both state taxes and charitable contributions as itemized deductions, the IRS was not too concerned with these types of state tax credit programs.

As you might expect, the IRS’s laissez-faire stance changed in 2018 with the enactment of the \$10,000 limit on the itemized deduction for state, local, and foreign taxes. Specifically, the IRS revisited the federal tax consequences of state and local tax credit programs out of concern that taxpayers may use these programs to bypass the \$10,000 limit on the itemized deduction for state, local, and foreign taxes. After further review, the news was not favorable for taxpayers. In Prop. Reg. §1.170A-1(h)(3), the IRS stated that, effective for contributions after August 27, 2018, taxpayers making payments or transferring property to an entity eligible to receive tax-deductible contributions will have to reduce their charitable contribution deductions by the amount of any state or local tax credit received (or expected to be received). Thus, after August 27, 2018, if a taxpayer receives a dollar-for-dollar state tax credit for a contribution to a qualified charity, the charitable contribution deduction is reduced to zero for federal tax purposes (i.e., the contribution is neither a deductible state tax payment or deductible charitable contribution).

Sources: Prop. Reg. §1.170A-1(h)(3); REG-112176-18.

## The Key Facts

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

The **tax base** defines what is actually taxed and is usually expressed in monetary terms, whereas the **tax rate** determines the level of taxes imposed on the tax base and is usually expressed as a percentage. For example, a sales tax rate of 6 percent on a purchase of \$30 yields a tax of \$1.80 ( $\$1.80 = \$30 \times .06$ ).

Federal, state, and local jurisdictions use a large variety of tax bases to collect tax. Some common tax bases (and related taxes) include taxable income (federal and state income taxes), purchases (sales tax), real estate values (real estate tax), and personal property values (personal property tax).

Different portions of a tax base may be taxed at different rates. A single tax applied

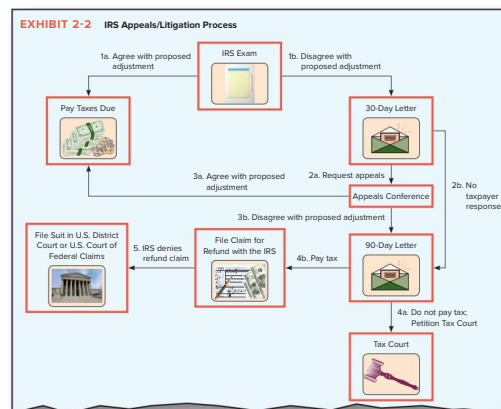
### THE KEY FACTS

#### How to Calculate a Tax

- Tax = Tax base × Tax rate
- The tax base defines what is actually taxed and is usually expressed in monetary terms.
- The tax rate determines the level of taxes imposed

## Exhibits

Today’s students are visual learners, and *McGraw-Hill’s Taxation* understands this student need by making use of clear and engaging charts, diagrams, and tabular demonstrations of key material.



“It is easily accessible to students as it is written in easy-to-understand language, and contains sufficient examples to illustrate complicated tax concepts and calculations.”

Machiavelli Chao

– University of California, Irvine: The Paul Merage School of Business

# PRACTICE MAKES PERFECT WITH A WIDE

**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

## 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.
- LO 2-6** Describe tax professional responsibilities in providing tax advice.
- LO 2-7** Identify taxpayer and tax professional penalties.

**DISCUSSION QUESTIONS**

Discussion Questions are available in **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?

**LO 2-2** 4. Approximately what percentage of tax returns does the IRS audit? What are the implications of this number for the IRS's strategy in selecting returns for audit?

## 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.



# 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**

Select problems are available in **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, it lost money. Must the corporation file a tax return?

## Tax Forms Problems

Tax forms problems are a set of requirements included in the end-of-chapter material of the 2020 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 form problem includes an icon to differentiate it from regular problems.

**LO 6-1** 28. Betty operates a beauty salon as a sole proprietorship. Betty also owns and rents an apartment building. This year Betty had the following income and expenses. Determine Betty's AGI and complete page 2 (through line 7) and Schedule 1 of Form 1040 for Betty. You may assume that Betty will owe \$2,502 in self-employment tax on her salon income, with \$1,251 representing the employer portion of the self-employment tax. You may also assume that her divorce from Rocky was finalized in 2016.

Interest income	\$11,255
Salon sales and revenue	86,360

## Research Problems

Research problems are special problems throughout the end-of-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 6-2** 35. This year Tim is age 45 and is considering enrolling in an insurance program that provides for long-term care insurance. He is curious about whether the insurance premiums are deductible as a medical expense and, if so, what the maximum amount is that can be deducted in any year.

**LO 6-2** 36. Doctor Bones prescribed physical therapy in a pool to treat Jack's broken back. In response to this advice (and for no other reason), Jack built a swimming pool in his backyard and strictly limited use of the pool to physical therapy. Jack paid \$25,000 to build the pool, but he wondered if this amount could be deducted as a medical

## Planning Problems

Planning problems are another unique set of problems included in the end-of-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.

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 a recommendation based on the following alternative facts:

- Shea resides in the 2nd Circuit, and the 2nd Circuit has recently ruled against the position Shea is litigating.
- The Federal Circuit Court of Appeals has recently ruled in favor of Shea's position.
- The issue being litigated involves a question of fact. Shea has a very appealing

## 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 *Connect* and *Instructor Resource Center*.** These problems range from simple to complex and cover individual taxation, corporate taxation, partnership taxation, and S corporation taxation.

**COMPREHENSIVE PROBLEMS**

Select problems are available in **Connect**®.

**tax forms** 54. 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 contributed \$2,500 to an individual retirement account, 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 \$2,000 child tax credit for Matthew. Marc and Michelle paid \$6,000 of expenditures that qualify as itemized deductions and they had a total of \$3,500 in federal income taxes withheld from their paychecks during the course of the year.



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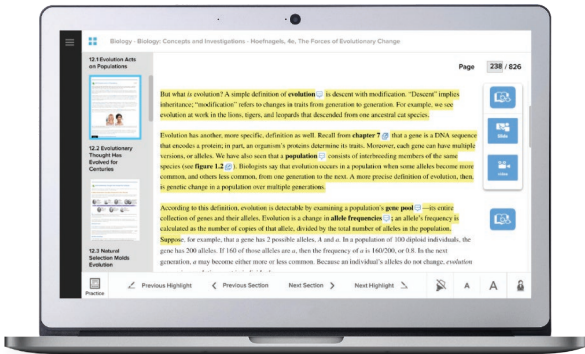
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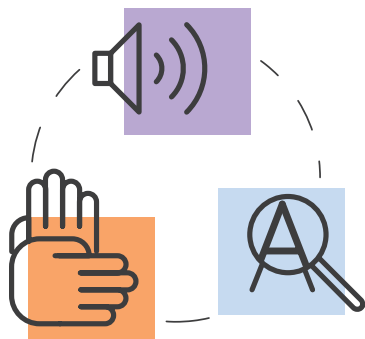
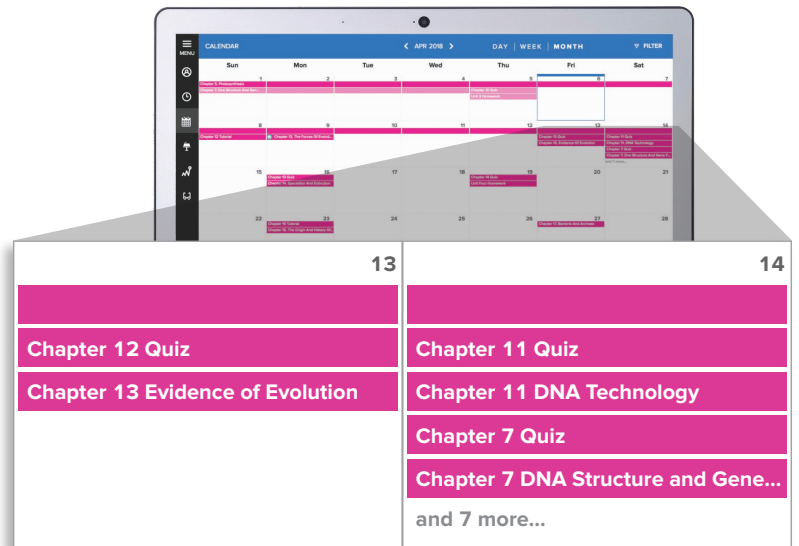
- Jordan Cunningham,  
Eastern Washington University

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# DIGITAL LEARNING ASSETS TO IMPROVE STUDENT OUTCOMES

“The quality of the online materials in Connect and Learnsmart are market-leading and unmatched in the tax arena.”

Jason W. Stanfield  
– Ball State University

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 problems, comprehensive problems (available as auto-graded tax forms), and discussion questions. 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		

## Auto-Graded Tax Forms

The auto-graded **Tax Forms** in Connect provide 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 for a couple Married Filing Jointly.

1040 PG 1 1040 PG 2

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

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

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

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

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

Spouse or qualifying person's first name and initial (see inst.) Last name

Demarco  
123-45-6789  
234-56-7890  
(see inst.)

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

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

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6.

Presidential Election Campaign  
Check here if you want \$3 to go to this fund (see inst.)  
 You  Spouse  
 If more than four dependents, see inst. and ✓ here

Dependents (see instructions):

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if child under age 17 qualifies for (see inst.): Child tax credit	Credit for other dependents
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>

## Guided Examples

The **Guided Examples**, or “hint” videos, 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.

## TaxACT®

**TaxAct** Professional Taxation can be packaged with tax software from TaxACT, one of the leading preparation software companies in the market today. The 2018 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).

Please note, TaxACT is only compatible with PCs and not Macs. However, we offer easy-to-complete licensing agreement templates that are accessible within Connect and the Instructor Resources Center to enable school computer labs to download the software onto campus hardware for free.

## Roger’s CPA



McGraw-Hill Education has partnered with Roger CPA Review, a global leader in CPA Exam preparation, to provide students a smooth transition from the accounting classroom to successful completion of the CPA Exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA Exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing the CPA Exam.

Accordingly, students using these McGraw-Hill materials will have access to sample CPA Exam multiple-choice questions and Task-based Simulations from Roger CPA Review, with expert-written explanations and solutions. All questions are either directly from the AICPA or are modeled on AICPA questions that appear in the exam. Task-based Simulations are delivered via the Roger CPA Review platform, which mirrors the look, feel, and functionality of the actual exam.

McGraw-Hill Education and Roger CPA Review are dedicated to supporting every accounting student along their journey, ultimately helping them achieve career success in the accounting profession. For more information about the full Roger CPA Review program, exam requirements, and exam content, visit [www.rogercpareview.com](http://www.rogercpareview.com).

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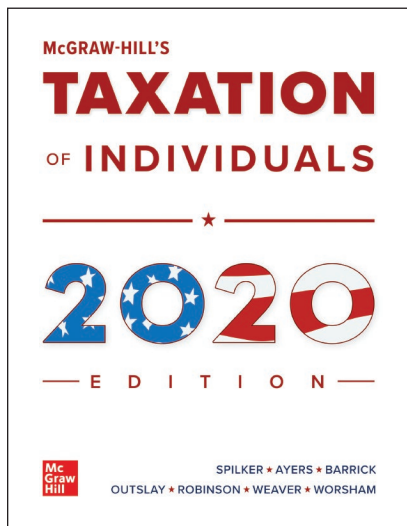
Alfio, who is single and has no dependents, was planning on spending the weekend repairing his car. On Friday, Alfio's employer called and offered him \$700 in overtime pay if he would agree to work over the weekend. Alfio could get his car repaired over the weekend at FixMyCar for \$500. If Alfio works over the weekend, he will have to pay the \$500 to have his car repaired but he will earn \$700. Assume Alfio pays tax at a flat 20 percent rate.

b. If the cost of repairs is deductible:

Description	Amount
Overtime Pay	\$700
Cost of Repairs	\$500
Taxable Income	\$200
Taxes on Pay	\$ 40
Net Income	\$160

So, he's \$160 better off by working and having his car repaired by FixMyCar.

# 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 discussion on income, deductions, investments, and computing tax liabilities in Chapters 5–8. Part III then discusses tax issues associated with business-related activities. Specifically, this part addresses business income and deductions, accounting methods, and tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). 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, Dependents, and Filing Status
5. Gross Income and Exclusions
6. Individual Deductions
7. Investments
8. Individual Income Tax Computation and Tax Credits

#### Part III: Business-Related Transactions

9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

#### 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-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.

## 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, Dependents, and Filing Status
5. Gross Income and Exclusions
6. Individual Deductions
7. Investments
8. Individual Income Tax Computation and Tax Credits

## Part III: Business-Related Transactions

9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

## Part IV: Specialized Topics

12. Compensation
13. Retirement Savings and Deferred Compensation
14. Tax Consequences of Home Ownership

## Part V: Entity Overview and Taxation of C Corporations

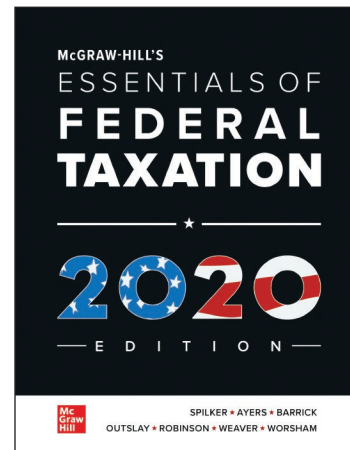
15. Entities Overview
16. Corporate Operations
17. Accounting for Income Taxes
18. Corporate Taxation: Nonliquidating Distributions
19. Corporate Formation, Reorganization, and Liquidation

## Part VI: Taxation of Flow-Through Entities

20. Forming and Operating Partnerships
21. Dispositions of Partnership Interests and Partnership Distributions
22. S Corporations

## Part VII: Multijurisdictional Taxation and Transfer Taxes

23. State and Local Taxes
24. The U.S. Taxation of Multinational Transactions
25. Transfer Taxes and Wealth Planning



*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.

## 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: Individual Taxation

4. Individual Income Tax Overview, Dependents, and Filing Status
5. Gross Income and Exclusions
6. Individual *For* AGI Deductions
7. Individual *From* AGI Deductions
8. Individual Income Tax Computation and Tax Credits

## Part III: Business-Related Transactions

9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

## Part IV: Entity Overview and Taxation of C Corporations

12. Entities Overview
13. Corporate Formations and Operations
14. Corporate Nonliquidating and Liquidating Distributions

## Part V: Taxation of Flow-Through Entities

15. Forming and Operating Partnerships
16. Dispositions of Partnership Interests and Partnership Distributions
17. S Corporations





# 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.

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The statements contained in *McGraw-Hill's Taxation* are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *McGraw-Hill's Taxation* and the teaching package make no claim of any specific AACSB qualification or evaluation, we have, within the text and test bank, labeled selected questions according to the eight general knowledge and skill areas.

## TestGen

TestGen is a complete, state-of-the-art test generator and editing application software that allows instructors to quickly and easily select test items from McGraw Hill's TestGen testbank content and to organize, edit, and customize the questions and answers to rapidly generate paper tests. Questions can include stylized text, symbols, graphics, and equations that are inserted directly into questions using built-in mathematical templates. With both quick-and-simple test creation and flexible and robust editing tools, TestGen is a test generator system for today's educators.

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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 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:

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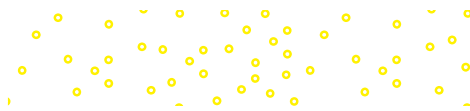
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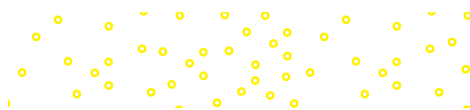
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# Changes in *Taxation of Individuals*, 2020 Edition

For the 2020 edition of McGraw-Hill's *Taxation of Individuals*, 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 March 2019**. In addition, **chapter content** throughout the text has been **updated to reflect tax law changes through March 2019**.
- Updated U.S. Series EE Bond interest income exclusion for 2019.
- Updated tax forms from 2017 to 2018.

Other notable changes in the 2019 edition include:

## Chapter 1

- Updated tax rates for 2019 and Examples 1-3 through 1-7.
- Updated Social Security Wage base for 2019.
- Updated unified Tax Credit for 2019.
- Updated Taxes in the Real World: National Debt for current debt limit.

## Chapter 2

- Updated gross income thresholds by filing status for 2019.
- Enhanced discussion of statute of limitations.
- Updated penalty amounts for failure to file a tax return and failure to pay tax owed.

## Chapter 3

- Updated tax rates for 2019.
- Updated Exhibit 3-3 for new tax rates post-TCJA.
- Modified Example 3-4 to clarify the solution.

## Chapter 4

- Edited discussion of Form 1040 to match up with revised tax forms.
- Updated Exhibit 4-7 to reflect standard deduction amounts for 2019.
- Updated tax rates for 2019 rates.
- Clarified discussion on tiebreaker rules for qualifying child.
- Revised discussion question 11.
- Updated tax forms from 2017 to 2018.

## Chapter 5

- Updated for 2019 amounts for qualified transportation benefits.
- Updated for 2019 flexible spending account contributions.
- Updated for 2019 foreign income exclusion amounts.
- Updated for annual gift tax exclusion and unified tax credit for 2019.

## Chapter 6

- Updated excess business loss limitation for 2019.
- Updated discussion of deduction for interest on qualified education loan for 2019.
- Updated AGI floor for medical expense itemized deduction for 2019.
- Updated mileage rate for medical expense itemized deduction for 2019.
- Added a Taxes in the Real World on state and local tax credits and charitable contributions.
- Revised discussion of casualty and theft losses on personal-use assets.
- Updated standard deduction amounts for 2019 amounts.
- Expanded discussion for deduction for qualified business income and updated for 2019.
- Updated tax forms from 2017 to 2018.

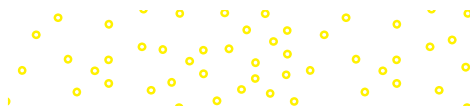
## Chapter 7

- Updated tax rates in all examples and problems for 2019.
- Updated Exhibit 7-3.
- Updated examples for changes in capital gains tax rate thresholds.
- Revised the discussion of capital gains netting process to illustrate a simpler process for taxpayers that only have 0/15/20 percent long-term capital gains.
- Updated tax forms from 2017 to 2018.

## Chapter 8

- Updated tax rate schedules for 2019.
- Moved discussion of net investment income tax to additional tax section.
- Updated discussion of kiddie tax for 2019.
- Updated AMT exemption and tax rate schedule for 2019.
- Updated Social Security tax wage base and self-employment tax base for 2019.
- Updated lifetime learning credit phase-out for 2019.





- Updated earned income credit amounts for 2019.
- Updated tax forms from 2017 to 2018.

### Chapter 9

- Updated tax forms from 2017 to 2018.
- Updated definition of interest for the business interest limitation to conform with proposed regulations.
- Added a new Taxes in the Real World on the all-events test for rebate payments.
- Added two new research problems.
- Added a description of the latest IRS position on the deduction of business meals in conjunction with nondeductible entertainment.
- Added example and homework problems on the deduction of business meals.
- Revised examples and text discussion for updated 2018 mileage rates.
- Expanded description of accounting exceptions for small businesses (average annual gross receipts of \$26 million or less in prior three years).

### Chapter 10

- Updated Exhibit 10-2 for Weyerhaeuser's 2017 assets.
- Updated tax rates for 2019.
- Revised section on §179 amounts to reflect the inflation adjustments for 2019.
- Updated examples for 2019 §179 amounts.
- Clarified treatment of bonus depreciation for AMT purposes.
- Updated discussion and Exhibit 10-10 relating to automobile depreciation limits.
- Updated §179 amount for SUVs for 2019 inflation amount changes.
- Updated tax forms from 2017 to 2018.
- Updated and revised end-of-chapter problems for §179 amounts and bonus depreciation rules.

### Chapter 11

- Updated tax rates for 2019.
- Updated Exhibit 11-6 for changes to recapture.
- Clarified discussion of §1250 recapture as it applies to qualified improvement property placed in service prior to 2018.
- Modified discussion of §1239 gains.
- Modified discussion on like-kind exchanges to clarify purpose of a third-party deferred like-kind exchange.
- Updated discussion of boot given in like-kind exchange.

- Added definition of condemnation.
- Added clarification of amortization of foreign R&E expenditures post-December 31, 2021.
- Updated tax forms from 2017 to 2018 forms.

### Chapter 12

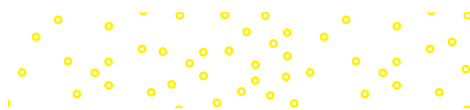
- Substantially revised discussion of salary and wages.
- Substantially revised discussion of equity-based compensation.
- Updated qualified transportation fringe benefit amounts for 2019.
- Updated tax forms to 2018.
- Updated Taxes in the Real World for 2018 proxy statement information.

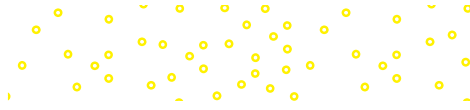
### Chapter 13

- Updated footnote 1 to reflect the 2018 OASDI Trustees report.
- Updated inflation adjusted limits for defined benefit plans, defined contribution plans, and individually managed plans.
- Removed old Exhibit from Coca-Cola proxy statement (old Exhibit 13-6) and integrated a summary description in the text.
- Inserted new footnote providing citation to authority for exceptions to 10 percent early distribution penalty.
- Expanded discussion about making IRA contributions for the prior year after year-end.
- Added discussion to footnote dealing with rollovers from traditional IRAs to Roth IRAs.
- Updated modified AGI phase-out thresholds for deductible contributions to traditional IRAs and contributions to Roth IRAs.
- Updated calculations for limits on self-employed retirement accounts to reflect updated 2019 Social Security wage base limitation.
- Updated saver's credit information for 2019.

### Chapter 14

- Updated Taxes in the Real World dealing with online rental communities such as Airbnb.
- Added discussion and an example describing and illustrating when a loan called a "home equity loan" by a bank is considered to be acquisition debt for tax purposes.
- Revised LO 14-3 to emphasize home mortgage interest deduction.
- Revised discussion of the IRS method and the Tax Court method to reflect the circumstances in which each is more favorable given the new tax law.

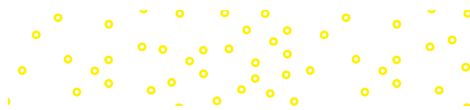




- Clarified discussion about home office expense requirements.
- Revised discussion questions 12, 14, 25, and 32.
- Revised problems 46, 47, 48, and 68.
- Updated solutions to reflect 2019 inflation-adjusted numbers.
- Updated tax forms from 2017 to 2018.
- Updated settlement statement in Appendix A to reflect 2019 information.

## As We Go to Press

The 2020 Edition is current through March, 2019. You can visit the *Connect Library* for updates that occur after this date.





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