PRINCIPLES OF
TAXATION
FOR BUSINESS AND INVESTMENT PLANNING

2020

Sally M. Jones
Shelley C. Rhoades-Catanach
Sandra R. Callaghan

McGraw Hill Education

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for Business and Investment Planning 2020 Edition

Sally M. Jones

Professor Emeritus of Accounting
McIntire School of Commerce
University of Virginia

Shelley C. Rhoades-Catanach

Associate Professor of Accountancy
School of Business
Villanova University

Sandra R. Callaghan

Associate Professor of Accounting
Neeley School of Business
Texas Christian University

McGraw Hill Education

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To Zane, Tony, and Tom

About the Authors

Sally M. Jones is professor emeritus of accounting at the McIntire School of Commerce, University of Virginia, where she taught undergraduate and graduate tax courses. Before joining the Virginia faculty in 1992, Professor Jones spent 14 years on the faculty of the Graduate School of Business, University of Texas at Austin. She received her undergraduate degree from Augusta College, her MPA from the University of Texas, and her PhD from the University of Houston. She is also a CPA. Professor Jones was the first editor of *Advances in Taxation* (JAI Press) and the *PriceWaterhouse Case Studies in Taxation.* She has published numerous articles in the *Journal of Taxation, The Tax Adviser*, and the *Journal of the American Taxation Association.* Professor Jones is a frequent speaker at tax conferences and symposia, a past president of the American Taxation Association, and the 2000 recipient of the Ray M. Sommerfeld Outstanding Tax Educator Award.

Shelley C. Rhoades-Catanach is an associate professor of accountancy at Villanova University. She teaches a variety of tax courses in Villanova's undergraduate, masters of accounting, and graduate tax programs. Before joining the Villanova faculty in 1998, Professor Rhoades-Catanach spent four years on the faculty of Washington University in St. Louis. She has also served as a visiting faculty member at the Darden Graduate School, University of Virginia, and at INSEAD, an international MBA program in Fontainebleau, France. She received her undergraduate degree in accounting from the University of Nebraska at Lincoln and her PhD from the University of Texas at Austin. Professor Rhoades-Catanach has published articles in numerous journals, including the *Journal of the American Taxation Association, Accounting Review, Issues in Accounting Education, Journal of Accounting Education,* and *Review of Accounting Studies.* She has served as president, vice president, and trustee of the American Taxation Association and on the editorial boards of the *Journal of the American Taxation Association* and the *Journal of International Accounting, Auditing and Taxation.* She is the former co-editor of the *Journal of International Accounting, Auditing and Taxation.* Professor Rhoades-Catanach is the 2010 recipient of the Ray M. Sommerfeld Outstanding Tax Educator Award.

Sandra Renfro Callaghan is an associate professor of accounting at the Neeley School of Business at Texas Christian University. She joined the faculty in 1998 after earning her PhD in accounting from Michigan State University. Her current research is primarily focused on topics in taxation, executive compensation, and the Affordable Health Care Act. Professor Callaghan teaches tax and financial accounting courses both at the undergraduate and the graduate level and has earned numerous teaching awards, including the Deans' Teaching Award and Neeley School of Business Alumni Professor of the Year. She has served in various leadership roles, including president of the American Taxation Association and member of the American Accounting Association Council. Professor Callaghan earned a BS from Texas Christian University and an MPA from the University of Texas at Austin. Prior to earning her PhD, she was a tax professional with Ernst & Young.

A Note from the Authors

Principles of Taxation for Business and Investment Planning is a unique approach to the subject of taxation. This text is designed for use in introductory tax courses included in either undergraduate or graduate business programs. Its objective is to teach students to recognize the major tax issues inherent in business and financial transactions. The text focuses on fundamental concepts, the mastery of which provides a permanent frame of reference for future study of advanced tax topics. Unlike traditional introductory texts, *Principles of Taxation for Business and Investment Planning* downplays the technical detail that makes the study of taxation such a nightmare for business students. Traditional texts are heavily compliance oriented and convince many students that the tax law is too complex and specialized to be relevant to their future careers. This text attempts to do just the opposite by convincing students that an understanding of taxation is not only relevant but critical to their success in the business world.

Principles of Taxation for Business and Investment Planning has its origin in the 1989 White Paper titled *Perspectives on Education: Capabilities for Success in the Accounting Profession*, published jointly by the Big Eight public accounting firms. The White Paper expressed disenchantment with the narrow technical focus of undergraduate accounting curricula and called for scholastic emphasis on a broad set of business skills necessary for professional success. The Accounting Education Change Commission (AECC), operating under the aegis of the American Accounting Association, embraced the philosophy reflected in the White Paper. In September 1990, the AECC published its Position Statement No. One, titled *Objectives of Education for*

Accountants. This statement reiterated that an undergraduate business education should provide a base for lifelong learning.

Despite these calls for reform, many undergraduate tax courses are taught in a traditional manner based on a paradigm developed 60 years ago. In the modern era of business education, the first generation of tax teachers were practitioners: accountants or attorneys hired as adjunct faculty to initiate students into the mysteries of the Internal Revenue Code of 1954. These practitioners taught their students in the same way they trained their employees. In doing so, they created a compliance-oriented paradigm. In today's world, this traditional paradigm is an anachronism. Business students don't need to learn how to generate tax information. Instead, they must learn how to use tax information to make good business and financial decisions.

A Paradigm for the Introductory Tax Course

Principles of Taxation for Business and Investment Planning provides a paradigm for meeting the educational needs of tax students in the 21st century. This paradigm is based on three postulates:

- **Postulate 1: Students should learn the tax law as an integrated component of a complex economic environment.** They should be aware of the role taxes play in financial decision making and should understand how taxes motivate people and institutions to engage in certain transactions.
- **Postulate 2: Students should comprehend the tax law as an organic whole rather than as a fragmented collection of rules and regulations.** They should learn general tax rules rather than the myriad of exceptions that confuse rather than clarify the general rules. They should appreciate how the general rules apply to all taxpaying entities before they learn how specialized rules apply to only certain entities. Finally, they should learn how the law applies to broad categories of transactions rather than to a particular transaction.
- **Postulate 3: Students who learn fundamental concepts have a permanent frame of reference into which they can integrate the constant changes in the technical minutiae of the law.** The rapid

evolution of the tax law results in a short shelf life for much of the detailed information contained in undergraduate tax texts. Yet the key elements of the law—the statutory and judicial bedrock—do not change with each new revenue act. Students who master these key elements truly are prepared for a lifetime of learning.

We authors know that traditional paradigms die hard and educational reform is difficult. Nevertheless, we believe that change in the way college and university professors teach tax is both inevitable and worthwhile. Our responsibility to our students is to prepare them to cope in a business world with little tolerance for outdated skills or irrelevant knowledge. Our hope is that *Principles of Taxation for Business and Investment Planning* is a tool that can help us fulfill that responsibility.

Using This Text in a First-Semester Tax Course

Principles of Taxation for Business and Investment Planning is designed for use in a one-semester (15-week) introductory tax course. Instructors can choose which of the 18 chapters deserve a full week's coverage and which can be covered in less than a week. Instructors may even decide to omit chapters that seem less relevant to the educational needs of their students. Business students who complete a one-semester course based on this text will be well prepared to function in the modern tax environment. If they are required (or may elect) to take a second tax course, they will have a solid, theoretical foundation on which to build.

This is the 23rd annual edition of *Principles of Taxation for Business and Investment Planning.* Adopters of the text will certainly have many excellent suggestions to improve the next edition. We welcome any and all comments and encourage fellow teachers to e-mail us with their input (smj7q@virginia.edu, shelley.rhoades@villanova.edu, and s.callaghan@tcu.edu).

Sally M. Jones

Shelley C. Rhoades-Catanach

Sandra R. Callaghan

Changes in *Principles of Taxation*, 2020 edition

Chapter 1

- Updated all Tax Talks, examples, and end-of-chapter problems.
- Updated all references to state income tax, sales tax, and excise tax rates.
- Updated Exhibit 1.1 to include fiscal year 2017 federal tax revenue data.
- Added new Tax Talk on page 1–8.
- Added new Tax Talk on page 1–11.
- Updated discussion of the physical presence test on page 1–15.
- Updated discussion of cumulative bulletins on page 1–17.

Chapter 2

- Updated federal deficit and national debt data on page 2–3.
- Updated discussion of payroll and self-employment taxes for changes to inflation-adjusted Social Security tax threshold on page 2–3.
- Added Notable Quote on page 2–8.
- Updated discussion of tax expenditures budget to consider impact of Tax Cuts and Jobs Act on page 2–11.
- Updated Tax Talk on page 2–17.

Chapter 3

- Added new Business Perspective on page 3–4.

- Updated discussion of tax law uncertainty to include changes to AMT on page 3–12.
- Updated discussion of marginal rate uncertainty to highlight uncertainty associated with Tax Cuts and Jobs Act on page 3–12.

Chapter 4

- Added new Tax Talk on page 4–10.

Chapter 5

- Updated Tax Talk on page 5–8.
- Added new Tax Talk on page 5–11.

Chapter 6

- Replaced references to "Section 199A deduction" with "QBI deduction."
- Updated excess business loss limitation for 2019 thresholds on page 6–27.

Chapter 7

- Updated law changes related to the Section 179 deduction on pages 7–19 and 7–20.

Chapter 8

- New Tax Talk on page 8–10.
- New Tax Talk on page 8–24.

Chapter 9

- New Tax Talk on page 9–7.

Chapter 10

- Updated Schedule C, Form 1065, Form 1120-S, and Schedule K-1s to 2018 versions.
- Updated discussion of payroll and self-employment taxes for changes to

inflation-adjusted Social Security tax threshold on pages 10–11 through 10–14.

- Updated filing statistics in Tax Talks throughout.
- Replaced references to "Section 199A deduction" with "QBI deduction" throughout.
- Added discussion of the taxable income limitation on the QBI deduction and related example on page 10–7.
- Added detailed discussion and example on phase-in of wage limitation on QBI deduction for taxpayers with earnings just above the threshold on page 10–8.
- Updated QBI thresholds for 2019 inflation adjustments.

Chapter 11

- Updated filing statistics in Tax Talks throughout.
- Updated Form 1120 and Schedule M-3 to 2018 versions.
- Revised discussion of Tax Freedom Day on page 11–16 to reflect current statistics.

Chapter 12

- Updated filing statistics in Tax Talk on page 12–8.
- Revised discussion of preferential rates on dividend income on page 12–12.
- Replaced references to "Section 199A deduction" with "QBI deduction" throughout.

Chapter 13

- No significant changes in this edition.

Chapter 14

- Updated tax rate tables, standard deductions, and AMT exemption amounts.
- Replaced references to "Section 199A deduction" with "QBI deduction" throughout.

- Updated earned income credit to reflect 2019 inflation adjustments on page 14–20.
- Updated Volpe family examples throughout chapter to reflect 2019 law.
- Updated Form 1040 to reflect revised version of the 1040 and suppporting Schedules.

Chapter 15

- Updated all Tax Talks, examples, and end-of-chapter problems.
- Updated examples on pages 15–3 and 15–4 to include 2018 Form W-2 and Form 1099-MISC.
- Added new Tax Talk on page 15–15.
- Added new Tax Talk on page 15–24.
- Added new Tax Talk on page 15–27.
- Updated coverage of Employer-Provided Plans to reflect 2019 inflation adjustments.
- Updated coverage of Individual Retirement Accounts to reflect 2019 inflation adjustments.
- Added two new examples on page 15–32.
- Revised Application Problems 15–34, 15–35, and 15–36.

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Chapter 16

- Updated all Tax Talks, examples, and end-of-chapter problems.
- Updated Exhibits 16.1, 16.2, and 16.3 to include 2018 Form 1040, Schedule B, Schedule D, and Schedule E.
- Updated coverage of the gift and estate taxes to reflect 2019 inflation adjustments.
- Revised Appendix 16–A to include 2018 Form 8949, Form 1040, Schedule D, and Qualified Dividends and Capital Gain Tax Worksheet.

Chapter 17

- Updated all Tax Talks, examples, and end-of-chapter problems.
- Expanded example of Payments Pursuant to a Divorce on page 17–5.
- Added new Tax Talk on page 17–6.
- Updated Exhibit 17.1 page 17–9.
- Added new Tax Talk on page 17–10.
- Expanded Application Problem 17–5.
- Modified Application Problem 17–12.

Chapter 18

- Updated all Tax Talks, examples, and end-of-chapter problems.
- Added new Tax Talk on page 18–5.
- Expanded audit coverage discussion in example on page 18–8.
- Revised discussion of Accuracy-Related Penalty on page 18–11.
- Added discussion and example of the penalty for Substantial Understatement of Income Tax on page 18–11.
- Added **accuracy–related penalty** and **substantial understatement of income tax** to Key Terms.
- Added new Application Problems 18–16 and 18–17.

Content Organization

The content and organization of this text are highly compatible with the Model Tax Curriculum proposed by the American Institute of Certified Public Accountants. According to the AICPA, the introductory tax course should expose students to a broad range of tax concepts and emphasize the role of taxation in the business decision-making process. Under the model curriculum, students first learn to measure the taxable income from business and property transactions. They are then introduced to the different types of business entities and the tax considerations unique to each type. Individual taxation should be one of the last topics covered, rather than the primary focus of the course. Because *Principles of Taxation for Business and Investment Planning* reflects this recommended pedagogical approach, the text is ideal for courses based on the AICPA Model Tax Curriculum.

PART ONE

Exploring the Tax Environment

Part One consists of two chapters that familiarize students with the global tax environment. Chapter 1 describes the environment in terms of the legal relationship between taxes, taxpayers, and governments. Definitions of key terms are developed, and the major taxes are identified. Chapter 2 considers the tax environment from a normative perspective by asking the question: “What are the characteristics of a good tax?” Students are introduced to the notions of tax efficiency and tax equity and learn how contrasting political beliefs about efficiency and equity continue to shape the tax environment.

PART TWO

Fundamentals of Tax Planning

Part Two concentrates on developing a methodology for incorporating tax factors into business decisions. Chapter 3 introduces the pivotal role of net present value of cash flows in evaluating financial alternatives. Students learn how to compute tax costs and tax savings and how to interpret them as cash flows. Chapter 4 covers the maxims of income tax planning. The characteristics of the tax law that create planning opportunities are explained, and the generic techniques for taking advantage of those opportunities are analyzed. Chapter 5 provides a succinct overview of the tax research process and prepares students to solve the research problems included at the end of each chapter. The chapter explains the six steps in the tax research process and contains a cumulative example of the application of each step to a research case.

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PART THREE

The Measurement of Taxable Income

Part Three focuses on the quantification of business taxable income. Chapter 6 covers the computation of income or loss from ongoing commercial activities, with special emphasis on differences between taxable income and net income for financial statement purposes. Chapters 7 and 8 explore the tax implications of acquisitions and dispositions of business property, while Chapter 9 is devoted to nontaxable exchanges.

PART FOUR

The Taxation of Business Income

Part Four teaches students how to calculate the tax on business income. Chapter 10 describes the function of sole proprietorships, partnerships, LLCs, and S corporations as conduits of income, while Chapter 11 discusses corporations as taxable entities in their own right. Chapter 12 builds on the preceding two chapters by exploring the tax planning implications of the choice of business entity. Chapter 13 broadens the discussion by considering the special problems of businesses operating in more than one tax jurisdiction. This chapter introduces both multistate and international tax planning strategies.

PART FIVE

The Individual Taxpayer

Part Five concentrates on the tax rules and regulations unique to individuals. Chapter 14 presents the individual tax formula and acquaints students with the complexities of computing individual taxable income. Chapter 15 covers compensation and retirement planning. Chapter 16 covers investment and rental activities and introduces wealth transfer planning. Finally, Chapter 17 analyzes the tax consequences of personal activities, with particular emphasis on home ownership.

PART SIX

The Tax Compliance Process

Part Six consists of Chapter 18, which presents the important procedural and administrative issues confronting taxpayers. It covers the basic rules for paying tax and filing returns, as well as the penalties on taxpayers who violate the rules. Chapter 18 also describes the judicial process through which taxpayers and the IRS resolve their differences.

Key Learning Tools

Learning Objectives

The chapters begin with learning objectives that preview the technical content and alert students to the important concepts to be mastered. These objectives appear again as marginal notations marking the place in the chapter where each learning objective is addressed.

> **Learning Objectives**
>
> After studying this chapter, you should be able to:
>
> LO 4-1. Describe the difference between tax avoidance and tax evasion.
>
> LO 4-2. Explain why an income shift or a deduction shift from one entity to another can affect after-tax cash flows.
>
> LO 4-3. Explain how the assignment of income doctrine constrains income-shifting strategies.
>
> LO 4-4. Determine the effect on after-tax cash flows of deferral of a tax cost.

> **LO 4-3**
> Explain how the assignment of income doctrine constrains income-shifting strategies.
>
> *Assignment of Income Doctrine*
>
> The federal courts have consistently held that our income tax system artificial shifts of income from one taxpayer to another. Over 80 years ag Court decided that income must be taxed to the person who earns it, even if has a legal right to the wealth represented by the income.[4] Thus, a busin receives a $10,000 check in payment for services rendered to a client can't $10,000 income by simply endorsing the check over to his daughter. In language of the Court, the tax law must disregard arrangements "by whic attributed to a different tree from that on which they grew."

Examples and Cases

The chapters contain numerous examples and cases illustrating or demonstrating the topic under discussion.

Conflicting Maxims

Firm MN operates as two separate taxable entities, Entity M and Entity N. The firm
tiating a transaction that will generate $25,000 cash in year 0 and $60,000 cash
If Entity M undertakes the transaction, taxable income will correspond to c
(i.e., Entity M will report $25,000 and $60,000 taxable income in years 0 and 1). If
undertakes the transaction, it must report the entire $85,000 taxable income in
Entity M has a 32 percent marginal tax rate, while Entity N has a 21 percent marginal
Firm MN uses a 5 percent discount rate to compute NPV.

	Entity M		Entity N	
Year 0:				
Before-tax cash flow		$25,000		$2
Taxable income	$25,000		$85,000	
	.32			

Tax Talk

Each chapter includes items of "Tax Talk." These items highlight new tax planning strategies, tax facts, legislative proposals, or innovative transactions with interesting tax implications reported in the business press.

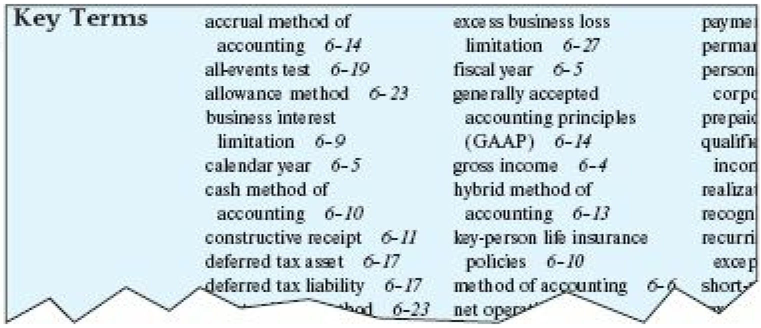
Tax Talk
Several of Europe's smallest countries, such as Luxembourg, Switzerland, and Ireland, offer very low corporate tax rates to attract multinational corporations. Case in point: Amazon.com channels the profits earned across the 28-nation European Union through its Luxembourg subsidiary.

Consider two domestic firms that each receive $5,000 cash, all of
income. Firm Y operates in State Y, which imposes a flat 4 percent tax on
Firm Z operates in State Z, which imposes a flat 10 percent tax on
For federal purposes, state income tax payments are deductible in the
taxable income.[7] Both firms face a 21 percent federal tax rate. Under the
and Z have the following after-tax cash flows:

	Firm Y	Firm Z
Before-tax cash/income	$ 5,000	$ 5,000
State income tax cost	(200)	(500)
Federal taxable income	$ 4,800	$ 4,500
Federal tax cost		
(Taxable income × 21%)	(1,008)	(945)
After-tax cash flow	$ 3,792	$ 3,555

Key Terms

Key terms are indicated in boldface in the text. A list of key terms is also supplieD At the end of the chapter with page references for easy review. Definitions of key terms from all the chapters are compiled in a Glossary for the text.



Key Terms

accrual method of accounting 6-14
all-events test 6-19
allowance method 6-23
business interest limitation 6-9
calendar year 6-5
cash method of accounting 6-10
constructive receipt 6-11
deferred tax asset 6-17
deferred tax liability 6-17

excess business loss limitation 6-27
fiscal year 6-5
generally accepted accounting principles (GAAP) 6-14
gross income 6-4
hybrid method of accounting 6-13
key-person life insurance policies 6-10
method of accounting 6-6

Sources of Book/Tax Differences

Chapters 6, 7, 8, 9, 11, 13, and 15 provide a list of the sources of book/tax differences introduced in the chapter.

Sources of Book/Tax Differences

Permanent
- Interest on state and local bonds
- Key-person life insurance proceeds and premiums
- Fines and penalties
- Political contributions and lobbying expense
- Meals and entertainment expenses
- Sexual harassment settlements subject to nondisclosure agreements

Temporary
- Prepaid income
- Bad debts
- all-events test
- NOL carryforwards

Questions and Problems for Discussion

Challenge students to think critically about conceptual and technical issues covered in the chapter. These problems tend to be open-ended and are designed to engage students in debate. Many problems require students to integrate material from previous chapters in formulating their responses.

Questions and Problems for Discussion

LO 6-1 1. Firm LK bought a warehouse of used furniture to equip several of it
An employee discovered a cache of gold coins in a desk drawer. A loc
Firm LK the rightful owner of the coins, which have a $72,000 fair mar
Does Firm LK recognize income because of this lucky event?

LO 6-2 2. Discuss the choice of a taxable year for the following businesses:
a. Retail plant and garden center.
b. French bakery.
c. Chimney cleaning business.
d. Moving and transport business.
e. Software consulting business.

LO 6-3 3. Corporation DB operates three different lines of business. Can the co
different overall method of accounting for each line, or must the corpo
overall method?

Application Problems

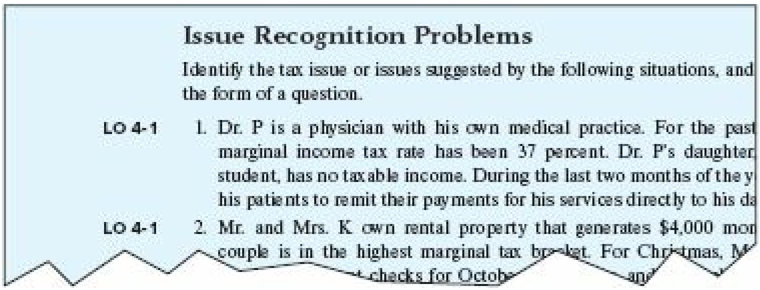
Give students practice in applying the technical material covered in the chapter. Most of the problems are quantitative and require calculations to derive a numeric solution.

Application Problems

LO 6-1 1. Nello Company owed $23,400 overdue rent to its landlord, Bonview
is a desirable tenant, Bonview agreed to settle the overdue account
payment from Nello. Both Nello and Bonview are accrual basis tax
a. What is the tax consequence to Nello of the settlement of it
payable to Bonview? Compute Nello's net cash outflow from th
ing its tax rate is 35 percent.
b. What is the tax consequence to Bonview of the settlement of i
receivable from Nello? Compute Bonview's net cash inflow fr
assuming its tax rate is 21 percent.

Issue Recognition Problems

Develop students' ability to recognize the tax issues suggested by a set of facts and to state those issues as questions. The technical issues buried in these problems typically are *not* discussed in the chapter. Consequently, students must rely on their understanding of basic principles to analyze the problem, spot the tax concern or opportunity, and formulate the question to be resolved. In short, students must take the first steps in the tax research process.


Issue Recognition Problems

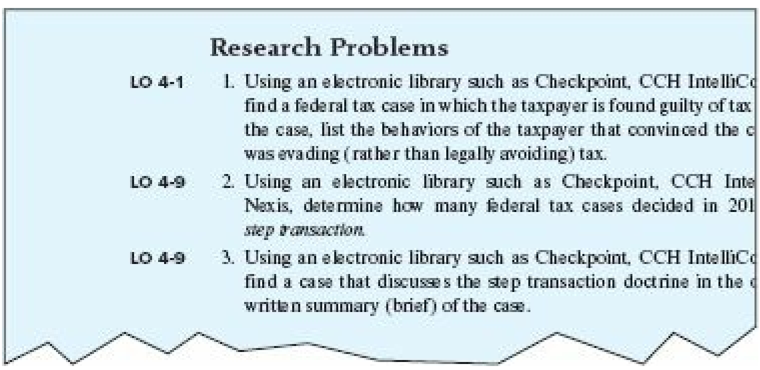
Identify the tax issue or issues suggested by the following situations, and
the form of a question.

LO 4-1 1. Dr. P is a physician with his own medical practice. For the past
marginal income tax rate has been 37 percent. Dr. P's daughter
student, has no taxable income. During the last two months of the y
his patients to remit their payments for his services directly to his da

LO 4-1 2. Mr. and Mrs. K own rental property that generates $4,000 mon
couple is in the highest marginal tax bracket. For Christmas, M
checks for Octob... an...

Research Problems

Provide further opportunity for students to develop their analytic skills. These problems consist of short scenarios that suggest one or more tax issues. The scenarios conclude with explicit research questions for the students to answer. To find the answers, they need access to either a traditional or an electronic tax library.


Research Problems

LO 4-1 1. Using an electronic library such as Checkpoint, CCH IntelliC
find a federal tax case in which the taxpayer is found guilty of tax
the case, list the behaviors of the taxpayer that convinced the c
was evading (rather than legally avoiding) tax.

LO 4-9 2. Using an electronic library such as Checkpoint, CCH Inte
Nexis, determine how many federal tax cases decided in 201
step transaction.

LO 4-9 3. Using an electronic library such as Checkpoint, CCH IntelliC
find a case that discusses the step transaction doctrine in the
written summary (brief) of the case.

Tax Planning Cases

Give students an opportunity to integrate their tax knowledge into a business planning framework. Most cases involve taxpayers who must decide whether to undertake a certain transaction or who must choose between alternative transactions. Students must assume the role of tax adviser by recommending a course of action to maximize the after-tax value of the transaction.

Tax Planning Cases

LO 4-4

1. Mrs. O is negotiating to purchase a tract of land from DC Company, a taxpayer. DC bought this land six years ago for $480,000. Accordin appraisal, the land is worth $800,000 in the current real estate market. DC's director of tax, the company's profit on the sale will be taxed at 35

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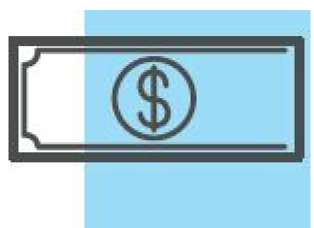

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