



# Fundamentals of Taxation

2007

Cruz  
Deschamps  
Niswander  
Prendergast  
Schisler  
Trone



# Fundamentals of Taxation

## 2007

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FUNDAMENTALS OF TAXATION: 2007

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I dedicate this work to my parents.

– Ana Cruz

To my lovely wife Shannon for all of her support and encouragement and to Norma, loving mother and supporter, who was always there for us.

– Michael Deschamps

To my wife Debi, who keeps me grounded.

– Rick Niswander

To my husband, Jim, and to my children Matthew, James, and Genevieve: You are the parts that make me whole. I dedicate this work to you.

– Debra Prendergast

I would like to dedicate this text to my wife, Debra, and my daughters Jessica and Samantha.

– Dan Schisler

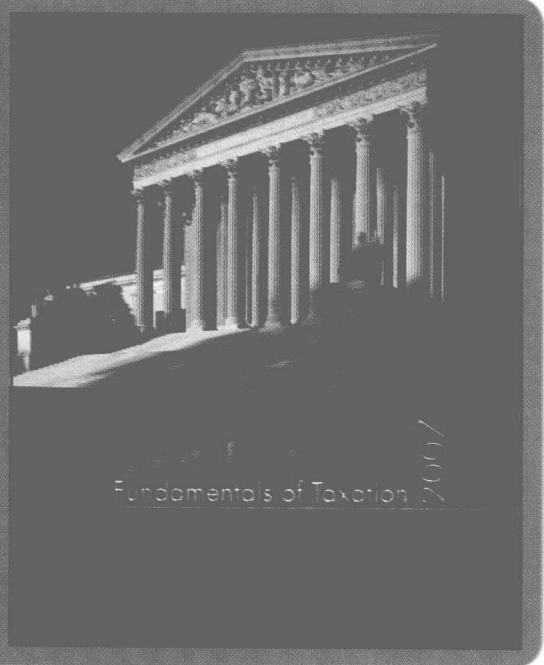
Dedicated to my husband, Darren, and my children, Sean and Nikki, whose life and enthusiasm are the source of my own.

– Jinhee Trone



# A Monumental New Approach to Teaching Tax

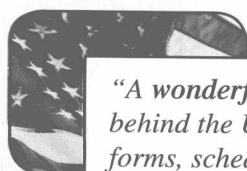
## Fundamentals of Taxation 2007



The majestic Supreme Court Building was built from 1932 to 1935 to stand with the other classical structures occupying the Capitol grounds: the Capitol Building, the White House, and the Library of Congress. The Supreme Court had met previously in various buildings in New York, Philadelphia, and in Washington in the basement of the Capitol Building. With some persuading from William Howard Taft (former President and Chief Justice from 1921 to 1930), Congress allocated \$9,740,000 for a new home for the Court. The building was completed in 1935 after just three years of construction. Remarkably for a government project, the building cost \$94,000 less than budgeted, and the remainder was returned to the U.S. Treasury.


When construction began in 1932, the federal government collected \$1.9 billion in taxes. Faced with the Depression and deepening budget deficits, the government passed the Tax Act of 1932, which raised tax rates significantly and introduced reams of new legislation. Five years later, in 1937, tax receipts were up to \$12,500,000,000, an increase of 663%. By comparison, the Congressional Budget Office projected tax revenues of \$2,370,000,000,000 in 2006!

To train tomorrow's tax preparers to handle the complex U. S. tax law, *Fundamentals of Taxation's* author team has devised **four primary teaching advantages.**



*"A wonderful textbook that will provide you not only the theory that goes behind the US federal tax system, but a wonderful source of information on tax forms, schedules, and related tax documents. It is definitely a book that has a wonderful balance between theory and real-world applications."*

– Jeanine Metzler, Pace Institute



1

First, we organize the text to **closely follow IRS tax forms**. We introduce students to standard IRS forms early and reinforce their use throughout the text. **Actual tax forms are incorporated throughout the text**, giving students the opportunity to understand the principles behind tax law while they learn how to work with clients to obtain the information they will need to complete tax forms.

2

Second, we **illustrate the proper reporting of tax issues**. We present a tax issue, discuss the legal requirements, illustrate the proper tax form placement, and show the completed form in the text. By effectively leading the student through each issue, we demonstrate how tax form preparation is the result of a careful process that balances legal knowledge with practical experience using tax forms.

3

Third, we **integrate an individual income tax software package** into the text that is used in examples. We instruct students how to use the software to complete returns using sample “taxpayers” who appear from chapter to chapter. An important consideration in writing the textbook was to allow instructor flexibility. You can choose to rely heavily on the software, you incorporate the software only after you cover the law and the reporting, or you can de-emphasize the software component. This flexible approach allows you to structure your taxation course the way you want to!

4

Fourth, we supplement the text with **citations of relevant tax authorities** such as the Internal Revenue Code, Treasury Regulations, revenue rulings, revenue procedures, and court cases. These citations are almost always provided in **footnotes**. Thus, you and your students can easily use, or not use, the footnote material.

### Ana Cruz



Dr. Ana Cruz is Chair of the Business Department at Miami Dade College, Wolfson Campus, where she utilizes her extensive experience in the areas of general business, management, accounting, and taxes. She has worked in the service, retailing, and manufacturing industries, as well as in the federal government sector, where she served as a field examiner for the Internal Revenue Service. Dr. Cruz has published several articles in business journals and has received the Southeast Banking Corporation Foundation Endowed Teaching Chair (1998) and the Wolfson Senior Foundation Endowed Teaching Chair (2002). Her latest recognition was being named Professor of the Year for the State of Florida by the Council for Advancement and Support of Education and the Carnegie Foundation (2005).

# How Does Cruz Form a Better Understanding of Tax?

## Forms-Based Approach

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

**EXHIBIT 2-1**  
**1040**  
U.S. Individual Income Tax Return  
2006  
Last name, first name, and initial  
Your social security number  
Your filing status  
Your home address (number and street, city, state, and ZIP+4)  
Check box for your filing status:  
1 ☐ Single  
2 ☐ Married filing jointly (separate returns if required)  
3 ☐ Married filing separately  
4 ☐ Head of household  
5 ☐ Qualifying widow(er) with dependent child  
6 ☐ Dependent (check box for dependent)  
7 ☐ Self-employed (check box for self-employed)  
8 ☐ Other (check box for other)  
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*Appendix A includes comprehensive problems for 1040 schedules A, B, C, D, and E. These longer problems include both easy and difficult schedules to test students' comprehension of a range of topics covered across multiple chapters.*

*Incorporation of real-world tax returns into the text for electronic as well as manual preparation forces students to learn hands-on skills.*

*An innovative textbook that emphasizes understanding tax law, tax software and tax forms. Prepares students for the first day on the job.*  
— Howard Godfrey, University of North Carolina-Charlotte

*The forms approach enables the student to see a direct connection among the law, forms and return preparation. This is an important connection and one that many students struggle making [while] utilizing a text written from a theory approach.*

— Karen Kettleson, Western Technical College





*Fundamentals of Taxation* features an integrated tax software package from TaxACT, one of the leading tax preparation software companies in the market today. Students are instructed on the practical applications of tax software, with exercises that teach how software can be used to prepare all types of tax returns.

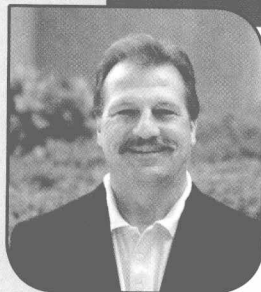
Sample “taxpayers” are used throughout the book, in varying situations, to give students full exposure to the many types of tax preparation challenges they will face. This exposure allows students to **make the connection** between the **tax law**, the **software inputs**, and the **tax output** on the appropriate tax forms.

*Fundamentals of Taxation* also provides the instructor with the flexibility needed in an individual income tax course. Each chapter can be used **with or without the tax software**, depending on the objectives of an individual instructor’s course.

TaxACT features **in-depth form instructions** that supplement the textbook material, making it easier than ever to integrate software into the classroom. Students are provided with the latest tax forms via the **Automatic Update Wizard**, so that at the start of the semester each student will be prepared to work with the most up-to-date information available. With over **120 tax forms, schedules, and worksheets**, TaxACT is sure to have the course materials you will need throughout the semester.

Be sure to visit **[www.TaxACT.com](http://www.TaxACT.com)** today for more information!

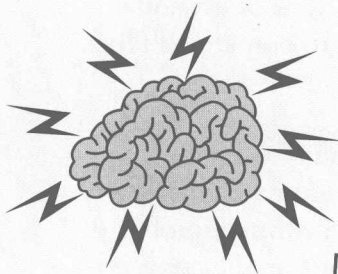
## Michael P. Deschamps



Michael P. Deschamps received a Bachelor of Science degree in Accounting magna cum laude from the University of San Diego, where he served as the chapter president for Beta Alpha Psi, the international accounting honor society. After working in public accounting and obtaining his CPA license, he returned to San Diego State University where he earned a Master’s degree in Taxation and a certificate in Financial Planning. In addition, he earned his Enrolled Agent certificate in 2004. He is currently a tenured professor of accounting and financial services at Chaffey College in Rancho Cucamonga, California; he has also taught a CPA exam review for a number of years. He is an active member of Teachers of Accounting at Two Year Colleges (TACTYC) and was a presenter at the 2006 national convention. He has published articles in both local and national publications and has given presentations on tax issues to a variety of organizations.

# How Does Cruz Better Prepare My Students ?

## Tax Your Brain



*The Tax Your Brain feature is designed to work with the examples in the text to reinforce the understanding of key concepts. Students are given information in an example and then are asked to apply what they have learned to a different situation.*

### TAX YOUR BRAIN

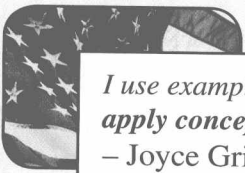


Use the information in Example 2-1 except assume that Mary and Peter each earned \$20,000 from their university employment. Who is entitled to the dependency exemption?

#### ANSWER

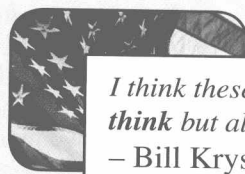
No one. The joint tax return of Mary and Peter would show a tax liability. Thus, the Jeffersons cannot claim the dependency exemption because Mary and Peter do not meet the joint return test. Mary and Peter would not receive the dependency exemption either. The IRS deems that the person or persons filing a tax return are not dependents. Mary and Peter would, however, each be entitled to a personal exemption on their joint tax return. Note that the answer would be the same even if Mary and Peter filed separate returns.

*By asking the student to think critically about theories and concepts, while supplying the answer right after the question, the Tax Your Brain examples provide another opportunity for hands-on experience.*



*I use examples like this all of the time in my classes as a way to help students **apply concepts** learned to various situations.*

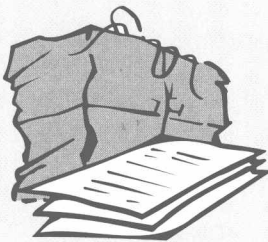
– Joyce Griffin, Kansas City Kansas Community College



*I think these are at a good point in the discussion to not only **make the student think** but also to force the teacher to allow them to digest the topic.*

– Bill Kryshak, University of Wisconsin-Stout

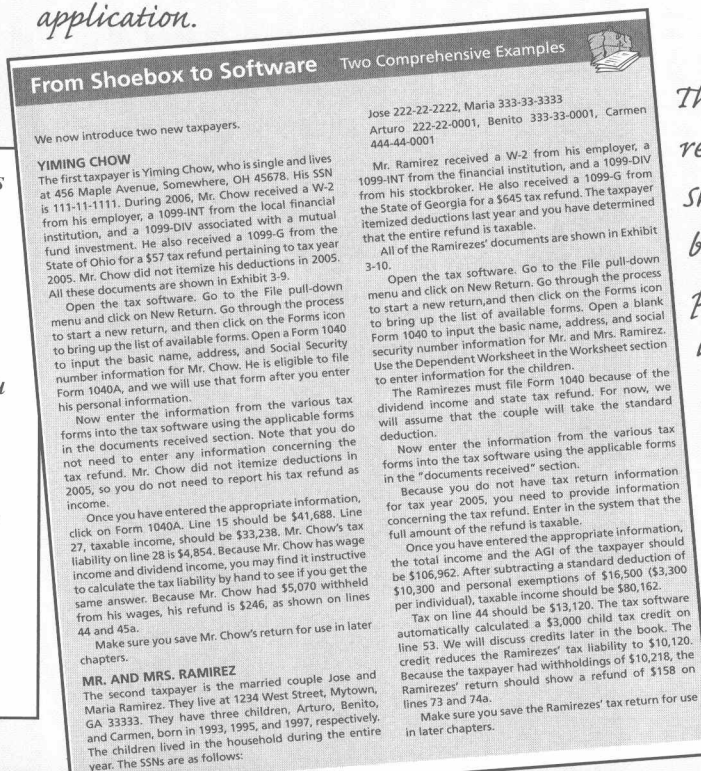
## From Shoebox to Software **TaxACT**



*The From Shoebox to Software examples in each chapter help students understand how they start with a mass of paper provided by a client and proceed to a completed tax return using tax software. The student can actually see the jump from the theoretical tax world to practical application.*

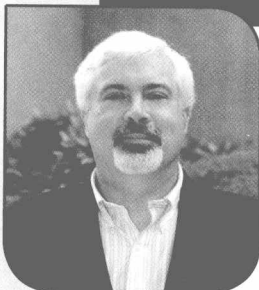
*The main benefit of this text is the **practitioner approach** of including real world "shoe box" exercise examples and the use of tax software. I really believe that you have a great product and you could actually develop some continuing education products from it.*

— Richard White,  
Florida Metropolitan  
University



*The simulation of real-world situations in each Shoebox example helps students become professional tax preparers. Their first day of work is far less stressful because it is not the first time they have seen a Form 1040 or a Schedule D. They are far more productive because they know where to start and how to complete the work.*

### Frederick Niswander



Dr. Frederick (Rick) Niswander is Dean of the College of Business and the W. Howard Rooks Distinguished Professor at East Carolina University. He holds a Doctor of Philosophy degree from Texas A&M University and a Bachelor of Science in Business Administration degree from Idaho State University. He has taught introductory financial accounting, international accounting, intermediate accounting, and a graduate accounting course that encompasses taxation, financial, and governmental accounting. Prior to obtaining his doctorate and joining the ECU faculty in 1993, he was the Chief Financial Officer of a privately held real estate company in Phoenix, Arizona, for eight years. Dr. Niswander has been a CPA in North Carolina since 1994 and in Arizona since 1981. He is a member of the North Carolina Association of CPAs, the American Institute of Certified Public Accountants, and the American Accounting Association. He is also the chairman of the NCACPA, an 11,000-member statewide CPA organization.



# How Does Cruz Provide a Clear Path to Student Success?

## Clear Objectives for Your Students

or without the footnotes. If you would like to become familiar with tax authority, the footnotes are a very good place to start exploring the intricacies of the tax code and the

### Learning Objectives

When you have completed this chapter, you should be able to master the following Learning Objectives (LO):

- LO 1. Understand progressive, proportional, and regressive tax structures
- LO 2. Understand the concepts of average and marginal tax rates as well as a simple income tax formula.
- LO 3. Understand the components of a 1040EZ income tax return.
- LO 4. Determine tax liability in instances when a 1040EZ return is appropriate.
- LO 5. Understand the types of tax authority and how they interrelate (Appendix A).

*Learning income tax return preparation requires constant reinforcement and practice. The authors have set up Fundamentals of Taxation to provide an easy-to-follow format starting with a list of learning objectives, which are then repeated throughout the book where the related material appears.*

*Concept Checks are mini-quizzes that test understanding of each objective.*

### CONCEPT CHECK 2-2—LO 2



1. Even though you are in the process of getting a divorce, you can file as married filing jointly. True or False?
2. The social security number of the taxpayer's spouse must be shown on the taxpayer's tax return when filing married filing separately. True or False?
3. A surviving spouse who qualified as married filing jointly when the spouse died can file as a qualifying widow(er) for the next two years as long as the surviving spouse pays for more than half the cost of keeping up a household and does not remarry. True or False?

### Chapter 4 Adjustments for Adjusted Gross Income 4-19

LO 2: Be able to calculate the health savings account deduction.

- A health savings account (HSA) is a tax-exempt savings account used to pay for qualified medical expenses.
- To be eligible for an HSA, the taxpayer must be self-employed or an employee (or spouse) of an employer with a high deductible health plan.
- Distributions from an HSA are tax free as long as they are used to pay for qualified medical expenses.

LO 3: Determine the deduction for moving expenses.

- If someone moves due to a change in employment, certain expenses related to moving may be deducted.
- The costs of moving goods and people from the old residence to the new residence are considered suitable expenses.
- The deductibility of moving expense is subject to both time and distance tests.

*A summary of the learning objectives appears at the end of each chapter, providing a quick reference chart for students as they prepare for exams.*

*The same learning objectives are also referenced in the end-of-chapter material next to each discussion question, multiple choice question, and problem.*

### Problems

- LO 1 34. In 2002, Marie borrowed \$10,000. In 2006, the debt was forgiven. Marie does not believe she should report the forgiveness of debt as income because she received nothing at the time the debt was forgiven in 2006. Do you agree or disagree? Support your position.
- LO 1 35. Determine the amount of taxable income that should be reported by a cash-basis taxpayer in 2006 in each of the following independent cases.
- a. A taxpayer completes \$500 of accounting services in December 2006 for a client who pays for the accounting work in January 2007.
  - b. A taxpayer is in the business of renting computers on a short-term basis. On December 1, 2006, she rents a computer for a \$200 rental fee and receives a \$500 deposit. The customer returns the computer and is refunded the deposit on December 20, 2006.
  - c. Same facts as (b) except that the computer is returned on January 5, 2007.
  - d. On December 18, 2006, a landlord rents an apartment for \$700 per month and collects the first and last month's rent up front. It is customary that tenants apply the deposit to their last month's rent upon moving out.
  - e. An accountant agrees to perform \$500 of tax services for an auto mechanic who has agreed to perform repairs on the car of the wife of the accountant. The mechanic repairs the car in December 2006 and the accountant starts and completes the tax work in March 2007.

## Robust & Relevant End-of-Chapter Material

*Fundamentals of Taxation* offers a robust selection of end-of-chapter material.

**LO 3** 14. In January 2004, Jeff incurred \$1,200 of moving expenses when he moved from Des Moines to Detroit. When he moved, he had no job but found one a week after moving. He stayed on that job for two months, changed to another job for four months, and changed again to a long-term position that he held for the remainder of the year. What is the amount of moving expense deduction Jeff can report in 2004, if any?

*Discussion Questions test the basic concepts of each chapter. Students supply short answers to a variety of questions covering each of the major concepts in the chapter.*

### Multiple Choice

21. (Introduction) For AGI, or above the line, deductions:
- a. Are determined by the taxpayer.
  - b. Are set by statute.
  - c. Increase tax liability.
  - d. Are reported in Schedule A.
22. (Introduction) For AGI, or above the line, deductions:
- a. Increase AGI.
  - b. Reduce tax credits.
  - c. Are only available for MFJ.
  - d. Can reduce overall tax liability.

### Tax Return Problems

#### Tax Return Problem 1

Use your tax software to complete the following problems. If you are manually preparing tax returns, you will need a Form 1040 for each problem.

Brenda attended Kansas State University during 2002–2006. She incurred educational expenses of \$10,000 of which \$2,000 was paid for by scholarships. To finance her education, she borrowed \$7,000 through a federal student loan program and borrowed another \$3,000 position with the Houston Deloitte & Touche office for educational purposes. After graduation, she accepted a job at 4560 Apple Blossom Lane with her cat, Misty. Her Form W-2 contained information in the following boxes:

Box 1 = \$56,533.05  
Box 2 = \$ 8,452.12  
Box 3 = \$56,533.05

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

*Multiple Choice questions complement the discussion questions as an alternative way to quickly test a variety of learning objectives. The questions range from easy to more complex computational multiple choices.*

## Debra Prendergast



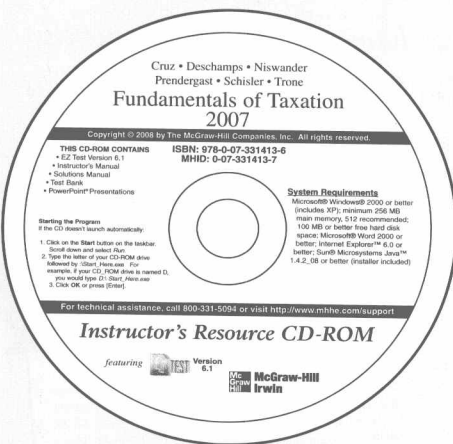
Dr. Debra Prendergast has a Doctor of Philosophy degree in Public Policy from the University of Illinois at Chicago, a Master's of Business Administration degree from Governors State University, and a Bachelor of Arts degree in Business Administration with a concentration in Accounting from Saint Xavier University in Chicago. She is a licensed and practicing Certified Public Accountant in Illinois and a Certified Management Accountant. She began her professional accounting career as a management advisory services consultant with Grant Thornton before taking a position as the controller for a corporation in Chicago. To spend more time with her family, she left her controller position in 1988 and began teaching accounting at Northwestern Business College, a private two-year college. In 2000, Dr. Prendergast became the Program Coordinator in the School of Commerce at Northwestern Business College. She serves as an officer on the board of Teachers of Accounting at Two Year Colleges (TACTYC) and is on the executive board of a Chicago non-profit corporation.



# How Does the Cruz Package Provide Complete Support?

## Instructor Resources

*Fundamentals of Taxation* authors Cruz, Deschamps, Niswander, Prendergast, Schisler, and Trone know that every component of the learning package must be integrated and supported by strong ancillaries. Critical to any successful ancillary package is author involvement. For this reason, the author team writes all instructor resources that accompany *Fundamentals of Taxation*.



### Instructor's CD-ROM

ISBN 0073314137

This all-in-one resource contains the Instructor's Resource Manual, Solutions Manual, Testbank Word files, and PowerPoint® slides, as detailed here.

### Instructor's Resource Manual

This manual provides for each chapter (1) a chapter summary that highlights the key points of each learning objective, (2) a brief topical and lecture outline, (3) ethics cases, (4) suggestions for group, Internet, and other class exercises to supplement the material in the book.

### Solutions Manual

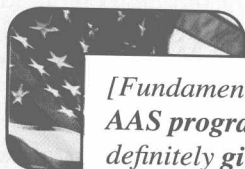
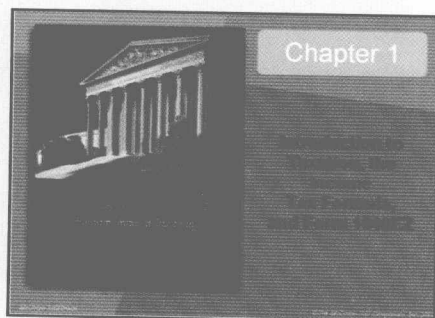
The Solutions Manual includes detailed solutions for every discussion question, exercise, problem, and case in the text.

### Testbank

*Fundamentals of Taxation's* comprehensive Testbank contains more than 900 multiple-choice, problems, and essay questions.

### PowerPoint Slides

The PowerPoint presentations serve as a visual representation of the learning objectives and key points in each chapter. The slides are available on the Online Learning Center (OLC) and on the Instructor's CD-ROM.



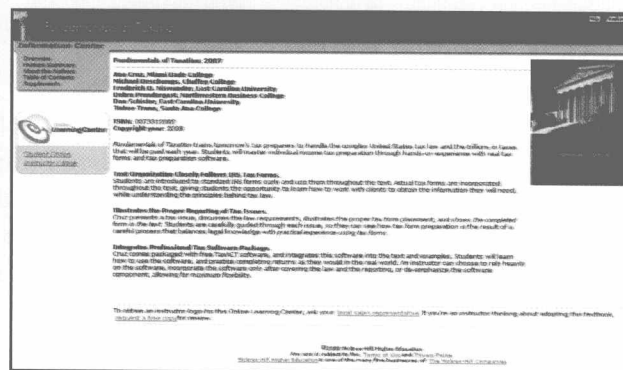
*[Fundamentals of Taxation] is very suited toward training students in an AAS program in accounting for a career in accounting. This approach will definitely give the students a skill that they can carry out in to the workforce.*

– Wayne Lewis, Fulton Montgomery Community College



## Online Learning Center (OLC) [www.mhhe.com/cruz2007](http://www.mhhe.com/cruz2007)

The Online Learning Center (OLC) that accompanies *Fundamentals of Taxation* provides a wealth of extra material for both instructors and students. With content specific to each chapter of the book, the Cruz OLC is available to help students tackle a wide range of topics. It does not require any building or maintenance on your part and is ready to go the moment you and your students type in the URL.

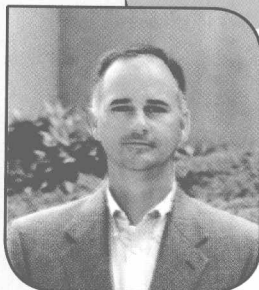


As students study, they can refer to the OLC for such benefits as:

Self-grading multiple choice quizzes	Links to professional resources
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