Introduction to Taxation:
A Decision Making Approach

2001 Edition

Steven J. Rice

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Preface

Introduction to Taxation: A Decision-Making Approach is intended as the primary text for a first course in federal income taxation — either a course at the undergraduate level for accounting majors or a course on tax planning techniques taught at the graduate level, perhaps for MBA students. The book is comprehensive enough to allow its use in a course covering one semester, but chapters may be omitted if the course is only one quarter.

This book *attempts to strike a balance between concepts and details that is different from the majority of textbooks* used in courses on introductory taxation. Too much detail bogs the students down and interferes with their understanding of underlying concepts. This book is geared *to help students learn new concepts rather than to serve as a reference book* for the tax law. The emphasis is on the decision-making aspects of taxation rather than on a rules-oriented approach. This decision-making approach is intended to facilitate the students' motivation to learn.

In order to learn, a certain level of detail is necessary. Thus, there is an example after every new concept. Often students cannot understand a description of a concept that is totally verbal. Numerical examples make understanding much easier. Furthermore, the book uses many *visual* explanations such as line drawings, flow charts, and diagrams to explain new concepts. The adage that "one picture is worth a thousand words" applies very well to learning tax concepts.

The book is not strictly an "individual" text or a "corporate and partnership" text but an overview of the two. In general, the topics covered are those that affect all taxpaying entities. Because of this coverage and because two chapters focus only on individual taxation, the book is suitable for a course devoted only to the subject of individual taxation.

Unique Features

The book has several features that differentiate it from most introductory tax texts. The foremost of these, explanation of the tax law within a decision-making context, has already been mentioned. Other features include the following:

1. **Use of diagrams.** Verbal explanations are supplemented with visual representations of concepts and transactions. For example, interest-free loans are conceptually explained with diagrams to help visualize the transaction and the tax treatment of it. The use of diagrams and the accompanying explanations help students to understand the purpose behind the hypothetical transfers that must be analyzed under the tax laws relating to interest-free loans.

2. **Use of the indirect method versus the direct method for AMT.** The determination of the individual alternative minimum tax (AMT) is presented under both the indirect method (where regular taxable income is adjusted to arrive at AMT) and the direct method (where income and deduction items for this entirely separate system of taxation are shown directly). While the direct method is not the one required by the Code, students are better able to absorb the concept of the AMT when it is presented under the direct method.

3. **Presentation of the rationale for tax laws.** Understanding the *rationale* for a tax law makes it much easier to learn. One example of this is the explanation of the AMT credit. Rather than simply define the individual AMT credit operationally, this book uses an example with diagrams to explain *why* the credit exists. Understanding this credit is important in planning to minimize the general tax acceleration effect of the AMT.

4. **Comprehensive explanation of the tax benefit rule.** Although the doctrine known as the tax benefit rule is easy to state, it can be complicated to apply. This book gives a thorough explanation and a comprehensive example of how to apply the tax benefit rule (including the way that the standard deduction interacts with the application of the rule).

5. **Recognition of interperiod tax allocation for corporations.** For corporations, the tax return (on Schedule M-1 of Form 1120) requires a reconciliation between net income per books and taxable income. This book recognizes that federal tax expense per books *is not the same* as federal tax liability, i.e., the effects of interperiod tax allocation are recognized. Students are exposed to a more realistic situation when the effects of interperiod tax allocation are not assumed away. They will be better able to integrate what they study in their financial accounting courses with what they study in their tax courses.

6. **Conceptual explanation of bond premium and discount.** The subject of bond premium and discount (both original issue discount and market discount) for an investor is conceptually explained, using diagrams of premium and discount amortization. Having this complex subject, which is presented piecemeal in the Internal Revenue Code, presented in a conceptual manner and pulled together in one location helps students to make sense of this important topic.

7. **Conceptual explanation of the at-risk rules.** Consistent with its emphasis on tax planning, this book has a chapter (Chapter 15) on investing in tax shelters. Because an understanding of the at-risk rules is crucial to anyone interested in making decisions about tax-shelter investments, this chapter contains a conceptual explanation of the at-risk rules along with several examples applying these rules.

8. **Explanation of the interaction of certain loss limitation rules.** In addition to an explanation of the passive activity loss (PAL) limitations, this book explains the interaction of the at-risk rules and the PAL limitations. Furthermore, there is an explanation of the interaction of the at-risk rules and the investment interest limitations. Integrating the at-risk rules with (a) the PAL limitations and (b) the investment interest limitations is necessary for a real understanding of tax shelters.

PREFACE

Content and Organization

The first six chapters of the book introduce the concepts of the taxable entity (individual, corporation, trust, or estate) and the nontaxpaying entity (partnership, S corporation), gross income and deductions, capital gain and loss, tax-accounting concepts, and general tax-planning strategies for taxable income such as avoiding it, delaying it, controlling the classification of it, or shifting it to other taxpayers. Chapters 7, 8, and 9 present many of the specific tax differences between individuals and corporations. Chapters 10, 11, 12, 13, and 14 discuss the tax implications of acquiring, using, and disposing of property. Chapter 15 presents the basic concepts involved in investing in activities that might be considered tax shelters. Chapter 16 provides the information necessary for the reader to do his or her own tax research.

Ancillaries

A solutions manual, prepared by the author, is available to adopters. The manual contains solutions to all the even-numbered problems and decision cases that appear at the end of each chapter in the text. Solutions to the odd-numbered problems are contained in the text itself.

Acknowledgments

I am sincerely grateful to Professor James E. Parker of the University of Missouri — Columbia. Professor Parker wrote the first version of this book, which was published before the Tax Reform Act of 1986 came along to make large portions of it obsolete. However, he provided a wonderful framework. It was my desire to preserve his original idea of a decision-making approach that compelled me to take on the task of revising the text and adding new material. I am also grateful to the many University of Washington students who have taken the time to provide thoughtful feedback. Finally, I am forever indebted to the late Professor Ray Sommerfeld of the University of Texas at Austin for inspiring me to teach and write about taxation. Ray, your incredibly bright light still shines in all of us who knew you.

Steven J. Rice

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