

2000 EDITION

Principles of Taxation

FOR BUSINESS AND INVESTMENT PLANNING



Sally M. Jones

Principles of Taxation for Business and Investment Planning

2000 Edition

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To Zane, Ward, and Rachael

About the Author



Sally M. Jones is the KPMG Professor of Accounting at the McIntire School of Commerce, University of Virginia, where she teaches both graduate and undergraduate 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 M.P.A. from the University of Texas, and her Ph.D. from the University of Houston. She is also a CPA. Professor Jones is the author of *Federal Taxes and Management Decisions* (Irwin/McGraw-Hill) and was the first editor of *Advances in Taxation* (JAI Press) and the *Price Waterhouse 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 and is a past president of the American Taxation Association.

Preface

P*principles of Taxation for Business and Investment Planning* is a new approach to the subject of taxation. This text is designed for use in introductory tax courses included in either undergraduate or graduate business programs. The objective of this text 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 students with 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 entitled *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 a lifetime of 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, entitled *Objectives of Education for Accountants*. This statement reiterated that an undergraduate business education should provide a base on which lifelong learning can be built.

In spite of these calls for reform, many undergraduate tax courses are taught in a traditional manner based on a paradigm developed four decades ago. In the modern (postwar) 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 newly enacted 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 that has survived to the present day. 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 New 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 twenty-first 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.** Students should be aware

of the role taxes play in financial and managerial decision making and should understand how taxes motivate people and institutions to engage in certain transactions or activities.

- **Postulate 2: Students should comprehend the tax law as an organic whole rather than as a fragmented collection of rules and regulations.** This postulate dictates that students learn to apply the 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 minutia of the law.** The rapid evolution of the tax law results in a very 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 passed by Congress. The student who masters these key elements truly is prepared for a lifetime of learning.

As a teacher with more than 25 years of experience, I know that traditional paradigms die hard and educational reform can be both painful and costly. Nevertheless, I also believe that change in the way college and university professors teach tax is both inevitable and extremely 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. My hope is that *Principles of Taxation for Business and Investment Planning* is a tool that can help us all fulfill that responsibility.

Organization and Content

Principles of Taxation for Business and Investment Planning consists of six parts with a total of 17 chapters. The following summaries of each part describe the sequencing and content of the chapters.

Part One, Exploring the Tax Environment, 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 that businesses routinely encounter 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, concentrates on developing a methodology by which to incorporate tax factors into business decisions. Chapter 3 introduces the pivotal role of net present value of cash flows as the basis for evaluating financial alternatives. Students learn how to compute tax costs and tax savings and how to interpret these numbers as cash flows. Chapter 4 covers the basic 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.

Part Three, The Measurement of Taxable Income, focuses on the quantification of taxable income generated by business operations. Chapter 5 covers the computation

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

Part Four, The Taxation of Business Income, teaches students how to calculate the tax liability on a given amount of business income. Chapter 9 describes the function of sole proprietorships, partnerships, and S corporations as conduits of income, while Chapter 10 discusses corporations as taxable entities in their own right. Chapter 11 builds on the preceding two chapters by exploring the tax planning implications of the choice of business entity. Chapter 12 broadens the discussion by considering the special problems of businesses generating income in more than one tax jurisdiction. This chapter introduces the reader to both multistate and international tax planning strategies.

Part Five, The Individual Taxpayer, concentrates on the tax rules and regulations unique to individuals. Chapter 13 presents the individual tax formula and acquaints students with the complexities of computing individual taxable income and tax liability. Chapter 14 covers compensation and retirement planning. Chapter 15 discusses the tax consequences of investment and rental activities and introduces wealth transfer planning. Finally, Chapter 16 analyzes the tax consequences of personal activities, with particular emphasis on home ownership.

Part Six, The Tax Compliance Process, consists of Chapter 17, which presents the important procedural and administrative issues confronting taxpayers. This chapter covers the basic rules for the payment of tax and the filing of returns, as well as the penalties the Internal Revenue Service may impose on taxpayers who violate the rules. Chapter 17 also describes the judicial process through which taxpayers and the IRS resolve their differences.

The 2000 edition of *Principles of Taxation for Business and Investment Planning* includes a new feature: an appendix entitled **Tax Research**. This appendix provides a succinct overview of the tax research process and is designed to prepare students to solve the research problems included at the end of each chapter. The appendix identifies and explains the six steps in the tax research process and contains a cumulative example of the application of each step to a research case.

Chapter Highlights

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. The chapters contain numerous **examples** and **cases** illustrating the topic or demonstrating the calculation under discussion. End-of-chapter materials begin with a list of **Key Terms** from the chapter. Definitions of the key terms from all the chapters are compiled in a **Glossary** for the text. The end-of-chapter materials also include five types of problems for instructors to assign for class discussion or for homework.

- **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.
- **Application Problems** give students practice in applying the technical material covered in the chapter. Most of the problems are quantitative and

students must perform a calculation (or a series of calculations) to derive a numeric solution to the problem.

- **Issue Recognition Problems** are designed to 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, the 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 to respond to these problems.
- **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, students need access to either a traditional or an electronic tax library. Instructors who assign the research problems can refer their students to **Appendix C**, which provides an overview of the tax research process.
- **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 advisor by analyzing the case and recommending a course of action to maximize the after-tax value of the transaction.

Supplemental Materials

An **Instructor's Manual** includes a course outline, topics for class discussion, and teaching hints for a one-semester introductory tax course. The Instructor's Manual also provides suggested solutions to all end-of-chapter problems and cases.

A **Web Page**, prepared by Thomas C. Omer (University of Illinois at Chicago), provides relevant links for each chapter and a series of interactive tutorials.

A **Test Bank**, prepared by Roxanne Spindle (Virginia Commonwealth University), contains multiple-choice, true-false, and short problems requiring analysis and written answers.

Computest is a computerized version of the manual test bank for more efficient use, available in a Windows platform.

Teletest allows users to call a toll-free number, specify the content of desired exams, and have a laser-printed copy of the exams mailed to them.

A **Study Guide**, prepared by Bill Duncan (Arizona State University–West), enables students to review text material and test their understanding. The guide includes a summary of each chapter's highlights, study suggestions, and self-test questions.

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 17 chapters in the book 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 particular educational needs of their students. I believe that business students who complete a one-semester course based on this text will be well prepared to function in the current 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. The second tax course typically involves an in-depth study of the taxation of business entities: C corporations, partnerships, and S corporations. Because *Principles of Taxation for Business and Investment Planning* puts so much emphasis on the essential tax consequences of business transactions, students who learn from this text should easily make the transition to an advanced tax course.

The content and organization of this text are highly compatible with the Model Tax Curriculum proposed by the American Institute of Certified Public Accountants in 1996. 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 generated by business and property transactions. They are then introduced to the different types of business entity and the tax considerations unique to each type. Individual taxation should be one of the last topics covered in the course, 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.

This is the third annual edition of *Principles of Taxation for Business and Investment Planning*. I've been a student of the tax law far too long to believe that this edition is free from technical error or includes every relevant topic. I'm certain that adopters of the text will have many excellent suggestions as to how I can improve the next edition. I welcome any and all comments and encourage my fellow teachers to call me (804-924-3483) or e-mail me (smj7q@virginia.edu) with their input.

Acknowledgments

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Introduction to Students

P*inciples of Taxation for Business and Investment Planning* explores the role that taxes play in modern life. The book is written for business students who have completed introductory courses in accounting and finance and are familiar with basic business concepts. Those of you who fit this description, regardless of your future career path, will be called on to make decisions in which you must evaluate the impact of taxes. At the most fundamental level, all business decisions have the same economic objective: the maximization of long-term wealth through cash flow enhancement. The cash flow generated by any transaction depends on the tax consequences. Business men and women must appreciate the role of taxes before they can make intelligent economic decisions, whether on behalf of their firm or on their personal behalf.

Taxes as Business Costs

When business professionals are asked to identify the common goal of all business decisions, their immediate response tends to be that the goal is to increase profits. When prompted to think past the current year, most eventually conclude that the long-term goal of business decisions is to maximize the value of the firm. In this text, a **firm** is a generic business organization. Firms include sole proprietorships, partnerships, limited liability companies, subchapter S and regular corporations, and any other arrangement through which people carry on a profit-motivated activity. Firm managers know that short-term profits and long-term value are enhanced when operating costs are controlled. The taxes that firms pay with respect to any facet of their business operations represent out-of-pocket costs. Experienced managers never regard taxes as fixed or unavoidable costs. As you will soon discover, opportunities abound for controlling the tax cost of doing business.

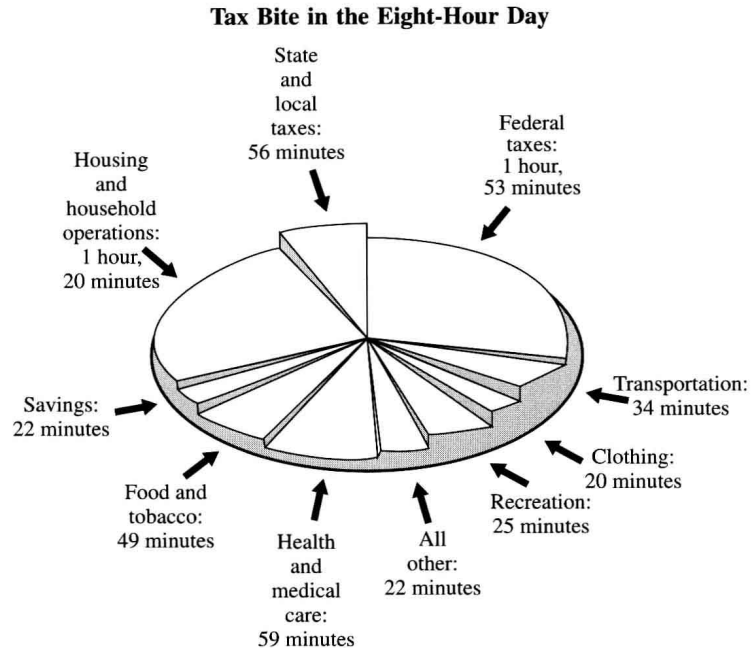
The above observations suggest that tax planning means reducing the tax cost of business operations to maximize the value of the firm. Firms can reduce taxes by implementing any number of strategies. However, tax cost is only one variable that managers must consider in making business decisions. Few strategies affect just one isolated aspect of a firm's overall operation. A strategy that reduces taxes may also have undesirable consequences, such as reducing revenues or increasing nontax costs. Because of nontax variables, the business strategy with the least tax cost may not be the best strategy. Therefore, tax minimization in and of itself may be a short-sighted objective. This point is so elementary yet so important: *effective tax planning must take into account both tax and nontax factors*. When faced with competing strategies, business managers should implement the strategy that maximizes firm value, even when that strategy has a higher tax cost than the alternatives. In other words, managers should never let the tax tail wag the business dog.

Taxes as Household Expenditures

Principles of Taxation for Business and Investment Planning concentrates on the income taxation of business activities and organizations. This concentration does not mean that the tax rules applying to individuals are ignored. Quite to the contrary. For

income tax purposes, individuals and the profit-making activities in which they engage are inextricably entwined. As we will observe over and over again, the ultimate taxpayers in every business situation are the people who own and operate that business.

As you study this text, consider your own role as a lifelong taxpayer. Regardless of who you are, where you live, or how you earn and spend your money, you will pay taxes on a regular basis to any number of governments. In fact, in the United States, taxes are the single largest household expenditure. The following pie chart shows that a person working an eight-hour day spends almost three hours working to pay local, state, and federal taxes.



Source: Tax Foundation.

People who are clueless as to how taxes work are in a passive role, required by law to participate in a tax system they don't understand and over which they exercise no control. In contrast, if you comprehend how taxes relate to your life, you can assume an active role. You can take positive steps to minimize your personal tax liability to the fullest extent allowed by law. You can make informed financial decisions to take advantage of tax-saving opportunities. You can draw rational conclusions about the efficiency and fairness of existing tax laws and can assess the merit of competing tax reform proposals. Finally, you can change the tax system by participating as a voter in the democratic process.

The Text's Objectives

Principles of Taxation for Business and Investment Planning has three main objectives that motivate the overall design of the text, the selection and ordering of topics, and the development of each topic.

Introducing Tax Policy Issues

The first objective is to acquaint you with the economic and social policy implications of the various tax systems used by governments to raise revenues. Most of the subject matter of the text pertains to the tax environment as it exists today and how successful businesses adapt to and take advantage of that environment. But the text also raises normative issues concerning the efficiency and equity of many features of the tax environment. You will learn how certain provisions of the tax law are intended to further the government's fiscal policy goals. You are invited to evaluate these goals and to question whether the tax system is an effective or appropriate mechanism for accomplishing the goals.

The text identifies potentially negative aspects of the tax environment. It explains how taxes may adversely affect individual behavior or cause unintended and undesirable outcomes. You will be asked to consider whether certain provisions of the tax law favor one group of taxpayers over another and whether such favoritism is justifiable on any ethical grounds. After probing both the strengths and weaknesses of the current tax system, you can draw your own conclusions as to how the system can be improved.

Bridging the Gap between Finance and Tax

The second objective of the text is to bridge the academic gap between the study of financial theory and the study of tax law. Finance courses teach students how to make decisions on the basis of after-tax cash flows generated by the management or investment strategy under consideration. However, these courses give students only rudimentary instruction on determining the tax consequences of transactions and overlook the possibilities for controlling tax consequences to maximize cash flows. In extreme cases, financial models simply ignore tax consequences by assuming that business decisions can be made in a tax-free environment.

Traditional tax law courses err in the opposite direction. These courses teach students to apply statutory rules to well-defined, closed-fact situations and to determine the resulting tax consequences. Correct application of the rule is the learning objective. Students are not required to integrate the tax consequences of transactions into a broad business decision-making framework. In other words, they don't translate tax outcomes into cash flows. Traditional law courses may fail to encourage students to consider how closed-fact situations can be restructured to change the tax outcome and improve the overall financial results. Consequently, students often develop the habit of analyzing transactions from a backward-looking *compliance* perspective rather than from a forward-looking *planning* perspective.

The primary focus of *Principles of Taxation for Business and Investment Planning* is on the common ground shared by financial theory and tax law. The connecting links between the two disciplines are stressed throughout the text. You will learn how effective business planning depends on an accurate assessment of relevant tax factors. Tax rules and regulations are presented and illustrated in the context of an economic decision-making framework. Admittedly, these rules and regulations are tough to master. Two observations should give you reassurance. First, while the detailed structure of the tax law is both extremely technical and complex, the application of the law's underlying principles to business decision making is relatively straightforward. Second, you can learn to appreciate tax planning strategies without becoming a tax-compliance expert.

Teaching the Framework of the Income Tax

The third objective of *Principles of Taxation for Business and Investment Planning* is to teach the framework of the federal income tax, the dominant feature of the modern tax environment. This framework has been remarkably stable over time, even though the particulars of the law change every year. Students who devote their time and energy to understanding the framework needn't worry that their knowledge will be outdated when Congress enacts its next revenue bill.

The federal income tax system has a bad reputation as an impenetrable, intractable body of law. While the whole fabric of the income tax law is every bit as complicated as its critics suggest, its framework consists of a manageable number of basic principles. The principles are internally consistent and underlie many seemingly disparate technical provisions. By concentrating on these principles, you can attain a sufficient level of tax knowledge in a single introductory course. You will not be a tax expert, but you will be tax literate. You may not be capable of implementing sophisticated tax planning strategies, but you will know how those strategies can improve cash flows and maximize wealth.

Because this text adopts a conceptual approach to the tax law, narrowly drawn provisions, exceptions, limitations, and special cases are deemphasized. Details with the potential to confuse rather than clarify the tax principle under discussion are usually relegated to footnotes. When we do examine a detailed provision of the law, the detail should illuminate an underlying concept. Or we may discuss a thorny technical rule just to emphasize the practical difficulties encountered by tax professionals who don't have the luxury of dealing with abstractions.

The conceptual approach should sensitize you to the tax implications of business transactions and cultivate your ability to ask good tax questions. This approach downplays the importance of the answers to these questions. Knowing the answers, or more precisely, finding the answers to tax questions is the job of tax accountants and attorneys who devote long hours in their research libraries to that end. A tax-sensitive business manager knows when to consult these experts and can help formulate the tax issues for the expert to resolve. The text's emphasis on issue recognition rather than issue resolution is reflected in the problems at the end of each chapter. Many of these problems ask you to analyze a fact situation and simply identify any tax concerns or opportunities suggested by the facts. Other problems present you with facts suggesting tax issues with no correct solution.

A Reassuring Word to Accounting Majors. *Principles of Taxation for Business and Investment Planning* is an ideal introductory text for those of you who are concentrating in accounting and who may even plan to specialize in taxation. You will benefit enormously from mastering the framework of the income tax as the first step in your professional education; this mastery will serve as a foundation for the future study of advanced topics. You will gain a command of basic principles on which to rely as you develop an instinct for your subject—a facility for diagnosing the tax issues suggested by unfamiliar and unusual transactions.

The text's conceptual approach is appropriate for the first tax course because it concentrates on broad themes concerning most taxpayers instead of narrow problems encountered by an isolated few. If you learn these themes, you will be well prepared to expand and deepen your tax knowledge through professional experience. You will understand from the beginning that taxes are only one aspect of the economic decision-making process. Because of this understanding, those of you who become tax

professionals will be equipped to serve your clients not just as tax specialists but as valued business advisors.

Conclusion

Hopefully, this introduction has conveyed the message that business men and women who decide on a particular course of action without considering the tax outcomes are making an uninformed, and possibly incorrect, decision. By proceeding with the course of study contained in this text, you will learn to recognize the tax implications of a whole spectrum of business transactions. On entering the business world, you will be prepared to make decisions incorporating this knowledge. You will spot tax problems as they arise and will call in a tax professional before, rather than after, initiating a transaction with profound tax consequences. And finally, you will understand that effective tax planning can save more money than the most diligent tax compliance.

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