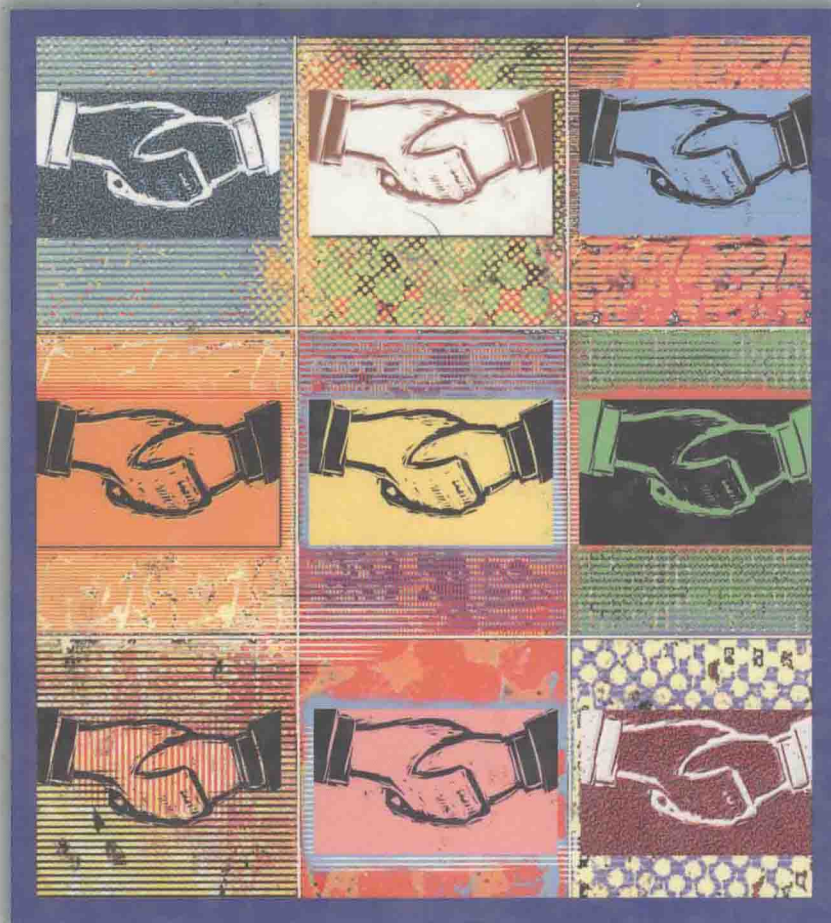


PRENTICE HALL'S

Federal Taxation 2001

INDIVIDUALS



Thomas R. Pope · Kenneth E. Anderson · John L. Kramer

*D. Dale Bandy · N. Allen Ford
Robert L. Gardner · Michael S. Schadewald*

www.prenhall.com/phtax

P R E N T I C E H A L L ' S
F E D E R A L T A X A T I O N

2001

Individuals

EDITORS

THOMAS R. POPE

University of Kentucky

KENNETH E. ANDERSON

University of Tennessee

JOHN L. KRAMER

University of Florida

CONTRIBUTING AUTHORS

D. DALE BANDY

University of Central Florida

N. ALLEN FORD

University of Kansas

ROBERT L. GARDNER

Brigham Young University

MICHAEL S. SCHADEWALD

University of Wisconsin - Milwaukee

ANNOTATIONS

EDMUND D. FENTON

Belmont University



Upper Saddle River, NJ 07458

Acquisitions Editor: Alana Bradley
Editor-in-Chief: PJ Boardman
Editorial Assistant: Jane Avery
Manufacturing Manager: Vincent Scelta
Production Manager: Gail Steier de Acevedo
Production Editor: Lynne Breitfeller
Buyer: Lynne Breitfeller
Design Manager: Patricia Smythe
Interior Design: BB&K Design Inc.
Cover Design: Steven Frim
Composition: Black Dot Graphics
Cover Image: Susan Le Van through Artville

© 2001, 1999, 1998, 1997, 1996 by Prentice-Hall, Inc.
Pearson Education
Upper Saddle River, New Jersey 07458

Statements on Responsibilities in Tax Practice Nos. 1-8 and
SRTP Interpretation 1-1 Copyright © 1988 by American Institute
of Certified Public Accountants, Inc. Reprinted with permission.

All rights reserved. No part of this book may be
reproduced, in any form or by any means,
without written permission from the Publisher.

ISBN 0-13-026017-7
ISBN 0-13-026041-X (IE)
ISBN 0-13-026018-5 (Looseleaf)

Prentice-Hall International (UK) Limited, *London*
Prentice-Hall of Australia Pty. Limited, *Sydney*
Prentice-Hall Canada Inc., *Toronto*
Prentice-Hall Hispanoamericana, S.A., *Mexico*
Prentice-Hall of India Private Limited, *New Delhi*
Prentice-Hall of Japan, Inc., *Tokyo*
Prentice-Hall of Southeast Asia Pte. Ltd., *Singapore*
Editora Prentice-Hall do Brasil, Ltda., *Rio de Janeiro*

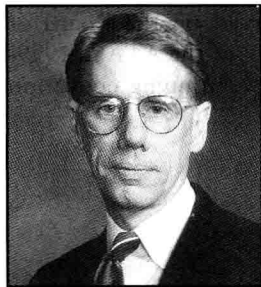
Printed in the United States of America
10 9 8 7 6 5 4 3 2 1

ABOUT THE EDITORS



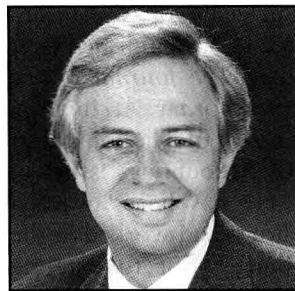
THOMAS R. POPE

Thomas R. Pope is an Associate Professor of Accounting at the University of Kentucky. He received a B.S. from the University of Louisville and an M.S. and D.B.A. in business administration from the University of Kentucky. He teaches partnership and S corporation taxation, tax research and policy, and introductory taxation and has won outstanding teaching awards at the University, College, and School of Accountancy levels. He has published articles in *The Accounting Review*, *The Tax Adviser*, *Taxes*, and a number of other journals. Pope's extensive professional experience includes eight years with Big Five accounting firms. Five of those years were with Ernst & Whinney (now part of Ernst & Young), including two years with their National Tax Department in Washington, D.C. He subsequently held the position of Senior Manager in charge of the Tax Department in Lexington, Kentucky. Pope has also been a leader and speaker at professional tax conferences all over the United States and is active as a tax consultant.



KENNETH E. ANDERSON

Kenneth E. Anderson is a Distinguished Professor of Accounting at the University of Tennessee. He earned a B.B.A. from the University of Wisconsin-Milwaukee and subsequently attained the level of tax manager with Arthur Young & Company (now part of Ernst & Young). He then earned a Ph.D. from Indiana University. He teaches introductory taxation, corporate taxation, partnership taxation, and tax policy and has twice won the Beta Alpha Psi Outstanding Educator Award (1994 and 1995). Anderson has published articles in *The Accounting Review*, *The Journal of the American Taxation Association*, *The Journal of Accountancy*, and a number of other journals. In addition, he is on the editorial board of *Advances in Taxation*.



JOHN L. KRAMER

John L. Kramer is the Arthur Andersen Professor of Accounting at the Fisher School of Accounting at the University of Florida. He is a recipient of a Teaching Improvement Program award given by the University of Florida in 1994. He holds a Ph.D. in Business Administration, an M.B.A. from the University of Michigan (Ann Arbor), and a B.B.A. from the University of Michigan (Dearborn). He is a past-president of the American Taxation Association and the Florida Association of Accounting Educators, as well as a past editor of *The Journal of the American Taxation Association*. Kramer has taught for the American Institute of CPAs, American Tax Institute of Europe, and a number of national and regional accounting firms. He is a frequent speaker at academic and professional conferences, as well as having served as an expert witness in a number of court cases. He has published over 50 articles in *The Accounting Review*, *The Journal of the American Taxation Association*, *The Tax Adviser*, *The Journal of Taxation* and other academic and professional journals.

ABOUT THE AUTHORS



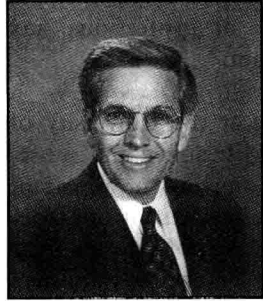
D. DALE BANDY

D. Dale Bandy is the C.G. Avery Professor of Accounting in the School of Accounting at the University of Central Florida. He received a B.S. from the University of Tulsa, an M.B.A. from the University of Arkansas, and a Ph.D. from the University of Texas at Austin. He helped to establish the Master of Science in Taxation programs at the University of Central Florida and California State University, Fullerton, where he previously taught. In 1985, he was selected by the California Society of Certified Public Accountants as the Accounting Educator of the year. Bandy has published 8 books and more than 30 articles in accounting and taxation. His articles have appeared in *Journal of Taxation*, *Journal of Accountancy*, *Advances in Taxation*, *Tax Adviser*, *CPA Journal*, *Management Accounting* and a number of other journals.



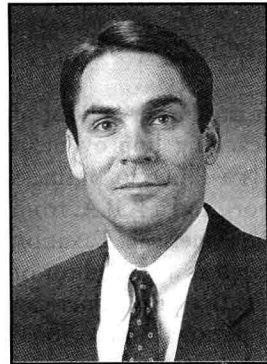
N. ALLEN FORD

N. Allen Ford is the Larry D. Homer/KPMG Peat Marwick Distinguished Teaching Professor of Professional Accounting at the University of Kansas. He received an undergraduate degree from Centenary College in Shreveport, Louisiana, and both the M.B.A. and Ph.D. in Business from the University of Arkansas. He has published over 30 articles related to taxation, financial accounting, and accounting education in journals such as *The Accounting Review*, *The Journal of the American Taxation Association*, and *The Journal of Taxation*. He served as president of the American Taxation Association in 1979-80. Ford has received numerous teaching awards, at the college and university levels. In 1993, he received the Byron T. Shutz Award for Distinguished Teaching in Economics and Business. In 1996 he received the Ray M. Sommerfeld Outstanding Tax Educator Award, which is jointly sponsored by the American Taxation Association and Ernst & Young.



ROBERT L. GARDNER

Robert L. Gardner is the Robert J. Smith Professor of Accounting and the Associate Director of the School of Accountancy and Information Systems at Brigham Young University. He received a B.S. and M.B.A. from the University of Utah and a Ph.D. from the University of Texas at Austin. He has authored or coauthored two books and over 25 articles, and has received several teaching awards. Gardner has served on the Board of Trustees of the American Taxation Association and served as President of the ATA in 1999-2000. He actively consults with several national CPA firms in their continuing education programs.



MICHAEL S. SCHADEWALD

Michael S. Schadewald is an Associate Professor of Accounting and Director of the Deloitte & Touche Center for Multistate Taxation at the University of Wisconsin-Milwaukee. He holds a Ph.D. from the University of Minnesota, an M.S. from the University of Wisconsin-Milwaukee, and a B.B.A. from the University of Wisconsin-Whitewater. He has co-authored a book on international taxation and has published over 25 articles in a number of accounting and tax journals, including *The Journal of the American Taxation Association*, *The Accounting Review*, *Contemporary Accounting Research*, and *The Journal of Taxation*. He serves on the editorial board of *The Journal of the American Taxation Association*, *The International Journal of Accounting*, *Issues in Accounting Education*, and *Journal of Accounting Education*. He has been awarded numerous research grants and fellowships by Big-Five accounting firms, and worked in the Milwaukee office of Arthur Young (now part of Ernst & Young) prior to entering academics.

P R E F A C E

OBJECTIVES AND USE

This text is designed for use in a first course in federal taxation for undergraduate accounting and business students. The text materials have been updated to reflect recent legislative, judicial, and administrative changes in the tax law through January 1, 2000.

A companion volume, *Prentice Hall's Federal Taxation, 2001: Corporations, Partnerships, Estates, and Trusts*, is published for use in the second course in federal taxation. A combined two-semester volume, *Prentice Hall's Federal Taxation, 2001: Comprehensive*, joins 14 chapters of the *Individuals* volume with 14 chapters of the *Corporations, Partnerships, Estates, and Trusts* volume. Either the *Individuals* text or the *Comprehensive* volume may be used with a one-term survey course for undergraduate or graduate students.

Our objective is to provide a readable format with a high level of technical content. We accomplish this through a process of continuous review, improvement, and clarification of the text, examples, and problem material. If you find what you believe is an error, please provide the item to one of the editors along with your comments. We maintain this level of content by focusing on primary topics and relegating minor exceptions to footnotes.

FEATURES

► The 2001 Edition of *Prentice Hall's Federal Taxation* continues to include an online Multistate Income Taxation chapter. This chapter provides tax instructors with a vehicle to introduce students to a topic of increasing importance among tax practitioners. It provides an overview of state and local tax systems, as well as a more in-depth discussion of state income tax issues such as nexus, corporate filing options, the definition of state taxable income, allocation and apportionment, and state taxation of S Corporations, partnerships and limited liability companies. A complete set of assignment material is available with the chapter in addition to links to related Internet resources. Instructors and students may download the chapter, free of charge, from the web site that accompanies the book www.prenhall.com/phtax.

► Chapter 15: Tax Research. This chapter has been extensively updated to (1) provide more information on the steps in the research process and (2) explain the role of computers in tax research. A special supplement called *How To Do Tax Research* is available from the website at www.prenhall.com/phtax. This downloadable supplement further enhances coverage by explaining how to electronically research a problem based on an actual case.

► A careful choice of topics. Users have found favor with the choice of topics and the extent of detail presented throughout the text. They are particularly pleased with our balance between exhaustive detail and too little detail for topics such as tax research, passive activity losses, and the alternative minimum tax.

► Unique chapter organization. The *Individuals* volume differs from other texts on the market with its early coverage of property transactions, two chapters on the taxation of business entities, and a highly acclaimed chapter on tax planning using the Scholes and Wolfson approach.

► Clear examples. Users regularly praise the clarity and number of examples in this text.

► Margin notes. Students appreciate learning about more than just tax rules so we developed a series of comments in the margin to enrich their learning experience.

Key Points emphasize areas where students require repetition and reinforcement.

Typical Misconceptions identify concepts that students are likely to misunderstand and help them correct their thinking before they take a wrong approach.

Real World Examples provide facts and anecdotes about actual companies and real-life strategies.

Additional Comments elaborate on material presented in the text.

Self-Study Questions provide an in-text study guide. Each question is accompanied by a full solution.

Historical Notes offer a comprehensive understanding of concepts by examining them in their historical context.



Ethical Points focus on ethical questions that confront the tax practitioner, and are designated with an ethics icon.

► **Topic Reviews.** Each chapter contains several topic reviews to help students organize their understanding of the material and aid in preparing for exams. Many of these reviews are in tabular form for easy reference.

► **Tax Planning Considerations.** For the forward-looking part of the tax profession, students need to learn how to offer tax-saving advice for their clients. Our Tax Planning Considerations offer this insight once the basics of the rules have been established.

► **Compliance and Procedural Considerations.** Forms, procedures, and timing are addressed in the Compliance and Procedural Consideration section at the end of each chapter.

► **Footnotes.** An important component of “learning to learn” is knowing where to turn for authoritative information. We collected important references to the tax authorities in the footnotes for students to use as sources.

► **A full complement of assignment material.** The typical format for each chapter includes: discussion questions, issue identification questions, problems, comprehensive problems, tax form/return preparation problems, case study problems, and tax research problems. Tax return problems that can be solved using TaxCut software are marked with an icon.

► **Oral and written communications.** More emphasis is being placed on oral and written communication skills by the various accounting professional organizations (e.g., the American Institute of CPAs and the Accounting Education Change Commission). The case study problems at the end of each chapter are designed to meet this need by requiring students to consider a number of alternatives and present a written or oral solution to the problem. None of these case studies require the student to research the tax law.

► **Expanded coverage of ethics.** Most chapters contain boxes labeled “What Would You Do in This Situation?” and a reprinting of the AICPA’s Statements on Responsibilities in Tax Practice appears in an appendix expands our coverage of ethics. The boxes include many controversies that are as yet unresolved or currently being considered by the courts. They represent choices that may put the practitioner at odds with the client, and are grounded on ethical parameters discussed in various standards, codes of conduct, or Treasury Department circulars. Students are asked to indicate what they would do if they found themselves in the same situation as well as the ethical implications of their actions. The boxes and the Statements on Responsibilities enhance the Ethical Point margin notes and the Case Studies already found in the text.

**TAX
CUT**



► **Stop & Think feature.** These “speedbumps” ask students to stop and think about a business application of tax, or an extension of the basic material, at various points in the chapter. These are not “boxes,” which typically fall outside the running text and can be bypassed. They are part of the text, complete with solutions to show students “how to do it,” and identified by the icon you see here in the margin.

► **Issue identification questions.** Part of the process of learning involves sorting out important information from unimportant details. In an area as detail-oriented as taxation, developing the ability to identify key issues is of paramount importance. We include questions at the end of each chapter that ask students to focus on the important questions that practitioners face on a daily basis.

► **Improvements in the Test Bank.**

SUPPLEMENTAL MATERIALS

The text includes a full complement of supplementary materials. Adopters are encouraged to use these materials to enhance their teaching effectiveness and the students’ learning experience. The following aids are available for instructor and student use:

INSTRUCTOR AIDS

► **Loose-Leaf Edition**—All text versions are available in a three-hole punched, shrink-wrapped format.

► **Instructor’s Guide**—This specially crafted instructor’s guide includes sample syllabi, instructor’s outlines, a series of interesting court cases to teach, a summary of modifications, deletions, and additions to the end-of-chapter problems, and selected teaching assignments. The instructor’s outlines are also available on diskettes and may be downloaded from the faculty resources link at www.prenhall.com/phtax. Faculty password and user i.d. may be obtained from your Prentice Hall Representative.

- ▶ Solutions Manual—This volume includes solutions to the discussion questions, problems, and comprehensive problems. The solutions to the tax form/tax return preparation problems, case studies, and the research problems are included in the instructor’s guide. The solutions manual is also available on disk and new to this edition: the solutions manual may be downloaded from the faculty resource link at www.prenhall.com/phtax. Faculty password and user i.d. may be obtained from your Prentice Hall representative.
- ▶ Test Bank—An extensive array of true-false, multiple choice, essay questions, and calculative problems are included.
- ▶ Prentice Hall Test Manager by ESA, Inc.—This easy-to-use computerized testing program can create exams, evaluate, and track student results. PH Test Manager also provides on-line testing capabilities. Test items are drawn from the test item file. Call-in testing at 1-800-550-1701 is also available on this title Monday-Friday, 8:00 a.m.-8:00 p.m., EST.
- ▶ PowerPoint Transparencies—Approximately 300 full color electronic transparencies are available for each book to enrich the teaching experience. Instructors can make additions or modifications to the transparencies prior to using them in class. The PowerPoint transparencies may also be downloaded from the faculty resource link www.prenhall.com/phtax site. Faculty password and user i.d. may be obtained from your Prentice Hall representative.
- ▶ Web Site—Prentice Hall has created a unique Web site designed to meet the needs of students and faculty. This website www.prenhall.com/phtax contains free student resources, free faculty resources, and premium student resources. These resources are described below:

1. *Free Student Resources* include:

- Current events
- Internet resources
- Tax Law updates
- Inflation adjusted figures
- Student study tips

These tools are not password protected

A free preview of the study guide allows students to try out the study guide for the first two chapters of each text and access to two cases each from the on-line cases for Individual and Corporations.

2. *Free Faculty Resources* include downloadable files for:

- PowerPoint transparencies
- Instructor’s outlines
- Instructor solutions manual
- New problems
- Teaching tips
- Solutions for on-line tax practice problems

These tools are provided at no charge to adopting faculty members and **are** password protected (Faculty password and user i.d. may be obtained from your Prentice Hall representative.)

3. *Premium Student Resources*:

- ▶ On-line “Study Guide”—Students can check their understanding of chapter topics with a variety of multiple-choice and true/false questions, computational problems, case study problems, and tax return preparation problems. Each quiz includes “hints”, immediate scoring, graphical results reporter, explanation of incorrect answers, and the ability to e-mail results to a faculty member or other designated individual.
- ▶ On-line tax cases for Individuals and Corporations
 - a) “*Life of Riley*” tax cases require the student to research specific questions in order to complete the tax return for a given individual. Forms are available in a downloadable format.
 - b) “*Endorphin USA*” tax cases require the student to research specific questions in order to complete the entire tax return for Endorphin USA as a C corporation, S corporation, or partnership. Forms are available in a downloadable format.

Students wishing to purchase the premium student resources can purchase directly through the Web site by clicking the buy subscription link, or they can order the passcode for on-line supplements through their bookstore by using ISBN 0-13-026029-0.

- ▶ **TaxCut Software**—This software allows you to easily prepare your individual tax return by asking you questions just like a tax professional would and filling in the form for you. TaxCut audits your return before you file, allows you to print IRS-approved forms on your own printer and offers context sensitive IRS instructions. The software is free to professors adopting a Prentice Hall tax text and students can purchase copies for \$19.95 directly from Block Financial Corp. by using the coupons found in the book.
- ▶ **Tax Analysts' OneDisc CD-ROM**—Provides all the tools used by tax professionals to do research—Code, regulations, revenue rulings and procedures, court decisions and more! The software is free to professors adopting a Prentice Hall tax text and students can purchase copies for \$19.99 directly from Tax Analysts by using the coupon found in the book.

ACKNOWLEDGMENTS

Our policy is to provide annual editions and to prepare timely updated supplements when major tax revisions occur. We are most appreciative of the suggestions made by outside reviewers for the 2001 Edition because these extensive review procedures have been valuable to the authors and editors during the revision process.

The editors gratefully acknowledge the contributions of W. Peter Salzarulo of Miami University of Ohio. His effort and time over the years helped make the series what it is today.

We wish to acknowledge the following reviewers, whose contributions have helped shape the 2001 Edition:

Ellen D. Cook	University of Southern Louisiana
Alan E. Davis	Community College of Philadelphia
J. Vincent Eagan	Morehouse College
Nancy Foran	Wichita State University
Michelle E. Horning	Goshen College
Gordon Klein	University of California—Los Angeles
Sharon Lassar	Florida Atlantic University
Teresa J. Mack	Loras College
Kaye F. McClung	Troy State University
Duane R. Milano	Southwestern Assemblies of God University
Hector A. Quintanilla	Texas Wesleyan University
Brenda Jill Radcliffe	Ivy Tech State College—Bloomington
Paul Shoemaker	University of Nebraska—Lincoln
Edward H. Simches	Boston University Metropolitan College
John Stancil	Florida Southern College
Michael Sweeney	Hillsdale College
James Yang	Montclair State University

We are also grateful to the various graduate assistants, doctoral students, and colleagues who have reviewed the text and supplementary materials and checked solutions to maintain a high level of technical accuracy. In particular, we would like to acknowledge the following colleagues who assisted in the preparation of supplemental materials for this text:

Priscilla Kenney (Supplements Coordinator)	University of Florida
Sally Baker	DeVry Institute of Technology
Arthur D. Cassill	University of North Carolina at Greensboro
Ann Burstein Cohen	SUNY at Buffalo
Edmund Fenton	Belmont University
Craig J. Langstraat	University of Memphis
Thomas Omer	University of Illinois—Chicago
Michael S. Schadewald	University of Wisconsin—Milwaukee
Caroline Strobel	University of South Carolina
Don Trippeer	East Carolina University

In addition, we want to thank Myron S. Scholes and Mark A. Wolfson for allowing us to use the model discussed in their text, *Taxes and Business Strategy: A Planning Approach*, as the basis for material in Chapter 18.

Thomas R. Pope
Kenneth E. Anderson
John L. Kramer

C O N T E N T S

PREFACE xiii

CHAPTER 1

► AN INTRODUCTION TO TAXATION 1-1

History of Taxation in the United States 1-2

Early Periods 1-2

Revenue Acts From 1913 to the Present 1-3

Revenue Sources 1-3

Types of Tax Rate Structures 1-3

The Structure of Individual Income Tax Rates 1-3

The Structure of Corporate Tax Rates 1-5

Marginal, Average, and Effective Tax Rates for Taxpayers 1-5

Determination of Taxable Income and Tax Due 1-6

Types of Taxes 1-7

State Income and Franchise Taxes 1-7

Wealth Transfer Taxes 1-7

Other Types of Taxes 1-10

Criteria for a Tax Structure 1-11

Equity 1-11

Certainty 1-12

Convenience 1-12

Economy 1-13

Objectives of the Federal Income Tax Law 1-13

Economic Objectives 1-13

Encouragement of Certain Activities and Industries 1-13

Social Objectives 1-14

Tax Law Sources 1-14

Enactment of a Tax Law 1-15

Steps in the Legislative Process 1-15

Administration of the Tax Law and Tax Practice Issues 1-17

Organization of the Internal Revenue Service 1-17

Enforcement Procedures 1-18

Selection of Returns for Audit 1-18

Statute of Limitations 1-19

Interest 1-19

Penalties 1-19

Administrative Appeal Procedures 1-20

Components of a Tax Practice 1-20

Tax Compliance and Procedure 1-20

Tax Research 1-20

Tax Planning and Consulting 1-21

Financial Planning 1-21

Computer Applications in Tax Practice 1-22

Tax Return Preparation 1-22

Tax Planning Applications 1-22

Tax Research Applications 1-22

Problem Materials 1-23

Discussion Questions 1-23

Problems 1-25

Case Study Problem 1-26

Research Problem 1-26

CHAPTER 2

► DETERMINATION OF TAX 2-1

Formula for Individual Income Tax 2-2

Basic Formula 2-2

Definitions 2-3

Tax Formula Illustrated 2-6

Deductions from Adjusted Gross Income 2-7

Itemized Deductions 2-7

Standard Deduction 2-10

Personal Exemptions 2-12

Dependency Exemptions 2-12

Child Credit 2-17

Determining the Amount of Tax 2-18

Filing Status 2-18

Joint Return 2-19

Surviving Spouse 2-20

Head of Household 2-20

Single Taxpayer 2-21

Married Filing a Separate Return 2-21

Abandoned Spouse 2-21

Dependents with Unearned Income 2-22

Corporate Tax Formula and Rates 2-24

Treatment of Capital Gains and Losses 2-25

Definition of Capital Assets 2-25

Tax Treatment of Gains and Losses 2-26

Tax Planning Considerations 2-26

Splitting Income 2-27

Maximizing Itemized Deductions 2-27

Filing Joint or Separate Returns 2-27

Compliance and Procedural Considerations 2-29

Who Must File 2-29

Due Dates for Filing Return 2-29

Use of Forms 1040, 1040EZ, and 1040A 2-30

System for Reporting Income 2-30

Problem Materials 2-30

Discussion Questions 2-30

Issue Identification Questions 2-31

Problems 2-32

Tax Form/Return Preparation Problems 2-36

Case Study Problems 2-36

Tax Research Problems 2-37

CHAPTER 3

► GROSS INCOME: INCLUSIONS 3-1

Economic and Accounting Concepts of Income 3-2

Economic Concept 3-2

Accounting Concept 3-2

Tax Concept of Income 3-3

- Administrative Convenience 3-3
- Wherewithal to Pay 3-4
- Gross Income Defined 3-4

To Whom Is Income Taxable? 3-6

- Assignment of Income 3-6
- Allocating Income Between Married People 3-6
- Income of Minor Children 3-8

When Is Income Taxable? 3-8

- Cash Method 3-8
- Accrual Method 3-11
- Hybrid Method 3-11

Items of Gross Income: Sec. 61(a) 3-12

- Compensation 3-12
- Business Income 3-12
- Gains from Dealings in Property 3-12
- Interest 3-13
- Rents and Royalties 3-14
- Dividends 3-15
- Alimony and Separate Maintenance Payments 3-17
- Pensions and Annuities 3-19
- Income from Life Insurance and Endowment
 - Contracts 3-21
- Income from Discharge Of Indebtedness 3-21
- Income Passed Through to Taxpayer 3-21

Other Items of Gross Income 3-22

- Prizes, Awards, Gambling Winnings, and Treasure Finds 3-22
- Illegal Income 3-22
- Unemployment Compensation 3-23
- Social Security Benefits 3-23
- Insurance Proceeds and Court Awards 3-24
- Recovery of Previously Deducted Amounts 3-25
- Claim of Right 3-26

Tax Planning Considerations 3-26

- Shifting Income 3-26
- Alimony 3-27
- Prepaid Income 3-27
- Taxable, Tax-Exempt, or Tax-Deferred Bonds 3-27
- Reporting Savings Bond Interest 3-28
- Deferred Compensation Arrangements 3-28

Compliance and Procedural Considerations 3-29

Problem Materials 3-30

- Discussion Questions 3-30
- Issue Identification Questions 3-33
- Problems 3-34
- Comprehensive Problems 3-37
- Tax Form/Return Preparation Problems 3-37
- Case Study Problems 3-38
- Tax Research Problem 3-38

CHAPTER 4

► GROSS INCOME: EXCLUSIONS 4-1

Items That Are Not Income 4-2

- Unrealized Income 4-2

Self-Help Income 4-3

Rental Value of Personal-Use Property 4-3

Selling Price of Property 4-3

Major Statutory Exclusions 4-4

- Gifts and Inheritances 4-4
- Life Insurance Proceeds 4-5
- Adoption Expenses 4-6
- Awards for Meritorious Achievement 4-7
- Scholarships and Fellowships 4-7
- Distributions from Qualified State Tuition Programs 4-7
- Payments for Injury and Sickness 4-8
- Employee Fringe Benefits 4-9
- Foreign-Earned Income Exclusion 4-17
- Income from The Discharge of A Debt 4-18
- Exclusion for Gain from Small Business Stock 4-20
- Other Exclusions 4-21

Tax Planning Considerations 4-21

- Employee Fringe Benefits 4-21
- Self-Help and Use of Personally Owned Property 4-22

Compliance and Procedural Considerations 4-22

Problem Materials 4-23

- Discussion Questions 4-23
- Issue Identification Questions 4-24
- Problems 4-24
- Comprehensive Problem 4-28
- Tax Form/Return Preparation Problems 4-29
- Case Study Problems 4-29
- Tax Research Problems 4-30

CHAPTER 5

► PROPERTY TRANSACTIONS: CAPITAL GAINS AND LOSSES 5-1

Determination of Gain Or Loss 5-2

- Realized Gain or Loss 5-2
- Recognized Gain or Loss 5-4

Basis Considerations 5-5

- Cost of Acquired Property 5-5
- Property Received as a Gift: Gifts After 1921 5-6
- Property Received from a Decedent 5-7
- Property Converted From Personal Use to Business Use 5-9
- Allocation of Basis 5-10

Definition of a Capital Asset 5-12

- Influence of the Courts 5-13
- Other IRC Provisions Relevant to Capital Gains and Losses 5-13

Tax Treatment For Capital Gains and Losses of Noncorporate Taxpayers 5-15

- Capital Gains 5-15
- Adjusted Net Capital Gains (ANCG) 5-16
- Capital Losses 5-17

Sale or Exchange 5-20

- Worthless Securities 5-21
- Retirement of Debt Instruments 5-21
- Options 5-24
- Patents 5-24

Franchises, Trademarks, and Trade Names	5-25
Lease Cancellation Payments	5-26
Holding Period	5-27
Property Received as a Gift	5-27
Property Received from a Decedent	5-28
Nontaxable Exchanges	5-28
Receipt of Nontaxable Stock Dividends and Stock Rights	5-28
Preferential Treatment for Net Capital Gains	5-29
Mobility of Capital	5-29
Mitigation of the Effects of Inflation and the Progressive Tax System	5-29
Lower the Cost of Capital	5-29
Tax Planning Considerations	5-30
Selection of Property to Transfer By Gift	5-30
Selection of Property to Transfer at Time of Death	5-31
Compliance and Procedural Considerations	5-31
Documentation of Basis	5-31
Reporting of Capital Gains and Losses On Schedule D	5-32
Problem Materials	5-32
Discussion Questions	5-32
Issue Identification Questions	5-36
Problems	5-36
Tax Form/Return Preparation Problems	5-40
Case Study Problems	5-41
Tax Research Problems	5-42
CHAPTER 6	
► DEDUCTIONS AND LOSSES	6-1
Business or Investment Requirement	6-5
Ordinary Expense	6-7
Necessary Expense	6-8
Reasonable Expense	6-8
Expenses and Losses Must Be Incurred By the Taxpayer	6-9
General Restrictions on the Deductibility of Expenses	6-9
Capitalization Versus Expense Deduction	6-10
Expenses Related to Exempt Income	6-11
Expenditures That Are Contrary To Public Policy	6-12
Other Expenditures That Are Specifically Disallowed	6-14
Proper Substantiation Requirement	6-17
When an Expense Is Deductible	6-17
Cash Method	6-18
Accrual Method	6-20
Special Disallowance Rules	6-23
Wash Sales	6-23
Transactions Between Related Parties	6-25
Hobby Losses	6-28
Vacation Home	6-30
Expenses of an Office in the Home	6-33
Tax Planning Considerations	6-34
Hobby Losses	6-34
Unreasonable Compensation	6-35
Timing of Deductions	6-35
Compliance and Procedural Considerations	6-36
Proper Classification of Deductions	6-36
Proper Substantiation	6-36
Business Versus Hobby	6-36
Problem Materials	6-37
Discussion Questions	6-37
Issue Identification Questions	6-38
Problems	6-39
Comprehensive Problem	6-44
Tax Form/Return Preparation Problems	6-44
Case Study Problems	6-46
Tax Research Problem	6-47
CHAPTER 7	
► ITEMIZED DEDUCTIONS	7-1
Medical Expenses	7-2
Qualified Individuals	7-2
Qualified Medical Expenses	7-3
Amount and Timing of Deduction	7-6
Taxes	7-8
Definition of a Tax	7-8
Deductible Taxes	7-9
Nondeductible Taxes	7-9
State and Local Income Taxes	7-9
Personal Property Taxes	7-10
Real Estate Taxes	7-10
General Sales Tax	7-11
Self-Employment Tax	7-11
Interest	7-11
Definition of Interest	7-12
Classification of Interest Expense	7-12
Timing of the Interest Deduction	7-19
Charitable Contributions	7-20
Qualifying Organization	7-21
Type of Property Contributed	7-22
Deduction Limitations	7-24
Application of Carryovers	7-25
Special Rules for Charitable Contributions Made By Corporations	7-26
Summary of Deduction Limitations	7-26
Casualty and Theft Losses	7-28
Miscellaneous Itemized Deductions	7-28
Certain Employee Expenses	7-28
Expenses to Produce Income	7-28
Cost of Tax Advice	7-28
Reduction of Certain Itemized Deductions	7-29
Tax Planning Considerations	7-30
Medical Expense Deduction	7-30
Interest Expense Deduction	7-31
Deduction for Charitable Contributions	7-32
Compliance and Procedural Considerations	7-33
Medical Expenses	7-33
Contribution of Property	7-33
Charitable Contributions	7-33
Taxes	7-36

Problem Materials 7-36

- Discussion Questions 7-36
- Issue Identification Questions 7-38
- Problems 7-38
- Tax Form/Return Preparation Problems 7-42
- Case Study Problems 7-43
- Tax Research Problem 7-44

CHAPTER 8

► LOSSES AND BAD DEBTS 8-1

Transactions That May Result in Losses 8-2

- Sale or Exchange of Property 8-2
- Expropriated, Seized, or Confiscated Property 8-3
- Abandoned Property 8-3
- Worthless Securities 8-3
- Demolition of Property 8-4

Classifying the Loss on The Taxpayer's Tax Return 8-4

- Ordinary Versus Capital Loss 8-4
- Disallowance Possibilities 8-6

Passive Losses 8-7

- Computation of Passive Losses and Credits 8-7
- Carryovers 8-7
- Definition of a Passive Activity 8-9
- Taxpayers Subject to Passive Loss Rules 8-11
- Publicly Traded Partnerships 8-13
- Other Rental Real Estate Activities 8-14

Casualty and Theft Losses 8-16

- Casualty Defined 8-16
- Theft Defined 8-18
- Deductible Amount of Casualty Loss 8-18
- Limitations on Personal-Use Property 8-19
- Netting Casualty Gains and Losses on Personal-use Property 8-20
- Casualty Gains and Losses Attributable to Business and Investment Property 8-20
- When Losses Are Deductible 8-21

Bad Debts 8-22

- Bona Fide Debtor-creditor Relationship 8-23
- Taxpayer's Basis in the Debt 8-24
- Debt must be Worthless 8-25
- Nonbusiness Bad Debts 8-25
- Business Bad Debts 8-26
- Accounting for the Business Bad Debt 8-26
- Recovery of Bad Debts 8-27
- Deposits in Insolvent Financial Institutions 8-27

Net Operating Losses 8-28

- Computing the Net Operating Loss 8-28
- Carryback and Carryover Periods 8-31
- Recomputation of Taxable Income in the Carryover Year 8-32

Tax Planning Considerations 8-32

- Bad Debts 8-32
- Casualties 8-33
- Net Operating Losses 8-33

Compliance and Procedural Considerations 8-33

- Casualty Losses 8-33
- Net Operating Losses 8-34
- Worthless Securities 8-34

Problem Materials 8-34

- Discussion Questions 8-34
- Issue Identification Questions 8-36
- Problems 8-36
- Tax Form/Return Preparation Problems 8-40
- Case Study Problems 8-41
- Tax Research Problem 8-42

CHAPTER 9

► EMPLOYEE EXPENSES AND DEFERRED COMPENSATION 9-1

Classification of Employee Expenses 9-2

- Limitations on Unreimbursed Employee Expenses 9-3

Travel Expenses 9-4

- Deductibility of Travel Expenses 9-4
- Definition of Travel Expenses 9-5
- General Qualification Requirements 9-5
- Business Versus Pleasure 9-6
- Foreign Travel 9-7
- Additional Limitations on Travel Expenses 9-8

Transportation Expenses 9-8

- Definition and Classification 9-9
- Treatment of Automobile Expenses 9-10
- Reimbursement of Automobile Expenses 9-11

Entertainment Expenses 9-12

- 50% Disallowance for Meal and Entertainment Expenses 9-12
- Classification of Expenses 9-12
- Business Meals 9-13
- Entertainment Facilities and Club Dues 9-14
- Business Gifts 9-15
- Limitations on Entertainment Tickets 9-15

Reimbursed Employee Business Expenses 9-15

Moving Expenses 9-18

- Expense Classification 9-18
- Definition of Moving Expenses 9-18
- Treatment of Employer Reimbursements 9-19

Education Expenses 9-20

- Classification of Education Expenses 9-20
- General Requirements for a Deduction 9-21

Office in Home Expenses 9-22

- General Requirements for a Deduction 9-22
- Deduction and Limitations 9-24

Deferred Compensation 9-25

- Qualified Pension and Profit-Sharing Plans 9-26
- Qualification Requirements for a Qualified Plan 9-27
- Tax Treatment to Employees and Employers 9-28
- Nonqualified Plans 9-29
- Employee Stock Options 9-32
- Plans for Self-Employed Individuals 9-33
- Individual Retirement Accounts (IRAs) 9-35
- Traditional IRA 9-35

- Roth IRA 9-37
- Education IRA 9-39
- Simplified Employee Pensions 9-39

Tax Planning Considerations 9-40

- Moving Expenses 9-40
- Providing Nontaxable Compensation To Employees 9-41

Compliance and Procedural Considerations 9-42

- Substantiating Travel and Entertainment Expenses 9-42
- Reporting Employee Business Expenses 9-42
- Reporting Moving Expenses 9-45
- Reporting Office in Home Expenses 9-45
- Qualification of Pension and Profit-Sharing Plans 9-45

Problem Materials 9-46

- Discussion Questions 9-46
- Issue Identification Questions 9-49
- Problems 9-49
- Tax Form/Return Preparation Problems 9-56
- Case Study Problems 9-57
- Tax Research Problem 9-58

CHAPTER 10**► DEPRECIATION, COST RECOVERY, AMORTIZATION, AND DEPLETION 10-1**

- General Considerations 10-2
- Pre-ACRS Depreciation (Years Before 1981) 10-4
- ACRS (1981 Through 1986) 10-4
- MACRS (1987 and Later Years) 10-6
- Section 179 Expensing Election 10-10
- Macrs Restrictions 10-11

Amortization 10-14

- Sec. 197 Intangibles 10-15
- Depletion Methods 10-18
- Treatment of Intangible Drilling and Development Costs 10-20

Tax Planning Considerations 10-20

- Alternative Depreciation System Under MACRS 10-20
- IDCs: Capitalization Versus Expensing Election 10-20
- Structuring a Business Combination 10-22

Compliance and Procedural Considerations 10-22

- IDC Election Procedures 10-22
- Reporting Cost Recovery, Depreciation, Depletion, and Amortization Deductions 10-22

Problem Materials 10-23

- Discussion Questions 10-23
- Issue Identification Questions 10-28
- Problems 10-29
- Tax Form/Return Preparation Problems 10-32
- Case Study Problems 10-34
- Tax Research Problem 10-34

CHAPTER 11**► ACCOUNTING PERIODS AND METHODS 11-1****Accounting Periods 11-2**

- Required Payments and Fiscal Years 11-3

- Changes in the Accounting Period 11-4
- Returns for Periods of Less Than 12 Months 11-5

Overall Accounting Methods 11-7

- Cash Receipts and Disbursements Method 11-7
- Accrual Method 11-8
- Hybrid Method 11-9

Inventories 11-10

- Determination of Inventory Cost 11-11

Special Accounting Methods 11-14

- Long-Term Contracts 11-14
- Installment Sales Method 11-17
- Deferred Payment Sales 11-20

Imputed Interest 11-21

- Imputed Interest Computation 11-22
- Accrual of Interest 11-23
- Gift, Shareholder, and Other Loans 11-23

Change in Accounting Methods 11-24

- Amount of Change 11-25
- Reporting the Amount of the Change 11-26
- Obtaining IRS Consent 11-26

Tax Planning Considerations 11-27

- Accounting Periods 11-27
- Accounting Methods 11-27
- Installment Sales 11-27

Compliance and Procedural Considerations 11-27

- Reporting Installment Sales on Form 6252 11-27
- Procedures for Changing to LIFO 11-29

Problem Materials 11-29

- Discussion Questions 11-29
- Issue Identification Questions 11-30
- Problems 11-30
- Tax Form/Return Preparation Problem 11-33
- Case Study Problems 11-33
- Tax Research Problems 11-34

CHAPTER 12**► PROPERTY TRANSACTIONS: NONTAXABLE EXCHANGES 12-1****Like-Kind Exchanges 12-2**

- Like-Kind Property Defined 12-2
- A Direct Exchange Must Occur 12-5
- Three-Party Exchanges 12-5
- Receipt of Boot 12-6
- Basis of Property Received 12-7
- Exchanges Between Related Parties 12-8
- Transfer of Non-Like-Kind Property 12-9
- Holding Period for Property Received 12-9

Involuntary Conversions 12-10

- Involuntary Conversion Defined 12-11
- Tax Treatment of Gain Due to Involuntary Conversion Into Boot 12-12
- Tax Treatment of Gain Due to An Involuntary Conversion Directly Into Similar Property 12-13
- Replacement Property 12-13
- Obtaining Replacement Property 12-15
- Time Requirements for Replacement 12-15

Charitable Contributions 16-33
Dividends-Received Deduction 16-33

Compliance and Procedural Considerations 16-34

Filing Requirements 16-34
Schedule M-1 and M-2 Reconciliations 16-34
Maintenance of Records for E&P 16-35

Problem Materials 16-36

Discussion Questions 16-36
Issue Identification Questions 16-37
Problems 16-38
Tax Form/Return Preparation Problems 16-44
Case Study Problems 16-45
Tax Research Problem 16-46

CHAPTER 17

► PARTNERSHIPS AND S CORPORATIONS 17-1

Types of Flow-Through Entities 17-2

Partnerships 17-2
S Corporations 17-3
Limited Liability Companies 17-3
Limited Liability Partnerships 17-3

Taxation of Partnerships 17-4

Formation of A Partnership 17-4
Partnership Operations 17-7
Special Allocations 17-8
Allocation of Partnership Income, Deductions, Losses,
and Credits to Partners 17-9
Basis Adjustments for Operating Items 17-9
Limitations on Losses and Restoration of Basis 17-10
Transactions Between a Partner and the Partnership 17-11
Partnership Distributions 17-13
Sale of a Partnership Interest 17-14
Optional Basis Adjustments 17-15
Electing Large Partnerships 17-16

Partnership Elections 17-17

Tax Year Restrictions 17-17
Cash Method of Accounting Restrictions 17-18

Taxation of S Corporations 17-19

Qualification Requirements 17-19
Election Requirements 17-20
Termination Conditions 17-21
S Corporation Operations 17-23
Basis Adjustments to S Corporation Stock 17-24
S Corporation Losses and Limitations 17-25
Other S Corporation Considerations 17-26

Tax Planning Considerations 17-29

Use of Operating Losses 17-29
Income Shifting Among Family Members 17-30
Optional Basis Adjustment Election Under Sec. 754 17-30

Compliance and Procedural Considerations 17-31

Partnership Filing Requirements and Elections 17-31
Reporting Partnership Items on Form 1065 17-31
S Corporation Filing Requirements and Accounting
Method Elections 17-32
Reporting S Corporation Items on Form 1120S 17-32

Comparison of Alternative Forms of Business
Organizations 17-32

Problem Materials 17-34

Discussion Questions 17-34
Issue Identification Questions 17-36
Problems 17-37
Comprehensive Problem 17-42
Tax Form/Return Preparation Problems 17-42
Case Study Problems 17-43
Tax Research Problems 17-44

CHAPTER 18

► TAXES AND INVESTMENT PLANNING 18-1

Investment Models 18-2

The Current Model 18-2
The Deferred Model 18-5
The Exempt Model 18-9
The Pension Model 18-10
Multiperiod Strategies 18-14
Summary and Comparison of Basic Investment Models
18-14

Other Applications of Investment Models 18-16

Flow-Through Entity Versus C Corporation 18-16
Current Salary Versus Deferred Compensation 18-20

Implicit Taxes and Clienteles 18-25

Problem Materials 18-29

Discussion Questions 18-29
Problems 18-29

TABLES

1996 Tax Tables and Rate Schedules T-1

APPENDICES

► APPENDIX A

Tax Research Working Paper File A-1

► APPENDIX B

Tax Forms B-1

► APPENDIX C

MACRS and ACRS Tables C-1

► APPENDIX D

Glossary D-1

► APPENDIX E

Statements on Responsibilities in Tax Practice (SRTPs) E-1

► APPENDIX F

Index of Code Sections F-1

► APPENDIX G

Index of Treasury Regulations G-1

► APPENDIX H

Index of Government Promulgations H-1

► APPENDIX I

Index of Court Cases I-1

► APPENDIX J

Subject Index J-1

1

CHAPTER

AN
INTRODUCTION
TO TAXATION**LEARNING OBJECTIVES**

After studying this chapter, you should be able to

- ▶ 1 Discuss the history of taxation in the United States
- ▶ 2 Differentiate between the three types of tax rate structures
- ▶ 3 Describe the various types of taxes
- ▶ 4 Discuss what constitutes a "good" tax structure and the objectives of the federal income tax law
- ▶ 5 Identify the various tax law sources and understand their implications for tax practice
- ▶ 6 Describe the legislative process for the enactment of the tax law
- ▶ 7 Describe the administrative procedures under the tax law
- ▶ 8 Describe the components of a tax practice and understand the importance of computer applications in taxation

CHAPTER OUTLINE

History of Taxation in the United States...1-2
 Types of Tax Rate Structures...1-3
 Types of Taxes...1-7
 Criteria for a Tax Structure...1-11
 Objectives of the Federal Income Tax Law...1-13
 Tax Law Sources...1-14
 Enactment of a Tax Law...1-15
 Administration of the Tax Law and Tax Practice Issues...1-17
 Components of a Tax Practice...1-20
 Computer Applications in Tax Practice...1-22

KEY POINT

In many situations, the use of the tax laws to influence human behavior is deliberate. As will be seen later in this chapter, tax laws are often used to achieve social and economic objectives.

The federal tax system has a substantial effect on investor, business, and personal decisions in the United States. The following examples illustrate the impact of the tax law on various decisions in our society:

- ▶ A business decision about whether to invest in a new plant or equipment may depend, in part, on the existence of favorable tax provisions.
- ▶ An employee may decide to accept a new job because the prospective employer offers favorable tax-free fringe benefits or an attractive deferred compensation plan.
- ▶ An individual may decide to buy a principal residence rather than rent comparable property because of the availability of tax deductions for mortgage interest and real estate taxes.
- ▶ The terms of a property settlement agreement pursuant to a divorce decree may be structured to take into account the tax laws governing alimony and property settlements.

The purpose of this text is to provide an introduction to the study of federal income taxation as applicable to individuals. However, before discussing the specifics of the U.S. federal income tax law, it is helpful to have a broad conceptual understanding of the taxation process. This chapter provides an overview of the following topics:

- ▶ Historical developments of the federal tax system
- ▶ Types of taxes levied and structural considerations
- ▶ Objectives of the tax law
- ▶ Tax law sources and the legislative process
- ▶ Internal Revenue Service (IRS) collection, examination, and appeals processes
- ▶ The nature of tax practice, including computer applications and tax research

HISTORY OF TAXATION IN THE UNITED STATES

OBJECTIVE 1

Discuss the history of taxation in the United States

HISTORICAL NOTE

The reinstatement of the income tax in 1894 was the subject of heated political controversy. In general, the representatives in Congress from the agricultural South and West favored the income tax in lieu of customs duties. Representatives from the industrial eastern states were against the income tax and favored protective tariff legislation.

EARLY PERIODS

The federal income tax is the dominant form of taxation in the United States. In addition, most states and some cities and counties also impose an income tax. Both corporations and individuals are subject to such taxes.

Before 1913 (the date of enactment of the modern-day federal income tax), the federal government relied predominantly on customs duties and excise taxes to finance its operations. The first federal income tax on individuals was enacted in 1861 to finance the Civil War but was repealed after the war. The federal income tax was reinstated in 1894, however, that tax was challenged in the courts because the U.S. Constitution required that an income tax be apportioned among the states in proportion to their populations. This type of tax system, which would be both impractical and difficult to administer, would mean that different tax rates would apply to individual taxpayers depending on their states of residence.

In 1895, the Supreme Court ruled that the tax was in violation of the U.S. Constitution.¹ Therefore, it was necessary to amend the U.S. Constitution to permit the passage of a federal income tax law. This was accomplished by the Sixteenth Amendment, which was ratified in 1913. The Sixteenth Amendment, while being an extraordinarily important amendment, consists of one sentence.

Sixteenth Amendment to the Constitution of the United States

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

¹ *Pollock v. Farmers' Loan & Trust Co.*, 3 AFTR 2602, (USSC, 1895). Note, however, that a federal income tax on corporations that was enacted in 1909

was held to be constitutional because it was treated as an excise tax. See *Flint v. Stone Tracy Co.*, 3 AFTR 2834, (USSC, 1911).