

Principles of Taxation



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for Business and Investment Planning 2020 Edition

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PRINCIPLES OF TAXATION FOR BUSINESS AND INVESTMENT PLANNING, TWENTY THIRD EDITION

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To Zane, Tony, and Tom



About the Authors



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



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



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

A Note from the Authors

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

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

Despite these calls for reform, many undergraduate tax courses are taught in a traditional manner based on a paradigm developed 60 years ago. In the modern era of business education, the first generation of tax teachers were practitioners: accountants or attorneys hired as adjunct faculty to initiate students into the mysteries of the Internal Revenue Code of 1954. These practitioners

taught their students in the same way they trained their employees. In doing so, they created a compliance-oriented paradigm. In today's world, this traditional paradigm is an anachronism. Business students don't need to learn how to generate tax information. Instead, they must learn how to use tax information to make good business and financial decisions.

A Paradigm for the Introductory Tax Course

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

- **Postulate 1: Students should learn the tax law as an integrated component of a complex economic environment.** They should be aware of the role taxes play in financial decision making and should understand how taxes motivate people and institutions to engage in certain transactions.
- **Postulate 2: Students should comprehend the tax law as an organic whole rather than as a fragmented collection of rules and regulations.** They should learn general tax rules rather than the myriad of exceptions that confuse rather than clarify the general rules. They should appreciate how the general rules apply to all taxpaying entities before they learn how specialized rules apply to only certain entities. Finally, they should learn how the law applies to broad categories of transactions rather than to a particular transaction.
- **Postulate 3: Students who learn fundamental concepts have a permanent frame of reference into which they can integrate the constant changes in the technical minutiae of the law.** The rapid evolution of the tax law results in a short shelf life for much of the detailed information contained in undergraduate tax texts. Yet the key elements of the law—the statutory and judicial bedrock—do not change with each new revenue act. Students who master these key elements truly are prepared for a lifetime of learning.

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

Using This Text in a First-Semester Tax Course

Principles of Taxation for Business and Investment Planning is designed for use in a one-semester (15-week) introductory tax course. Instructors can choose which of the 18 chapters deserve a full week's coverage and which can be covered in less than a week. Instructors

may even decide to omit chapters that seem less relevant to the educational needs of their students. Business students who complete a one-semester course based on this text will be well prepared to function in the modern tax environment. If they are required (or may elect) to take a second tax course, they will have a solid, theoretical foundation on which to build.

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

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Changes in *Principles of Taxation*, 2020 edition

Chapter 1

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

Chapter 2

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

Chapter 3

- Added new Business Perspective on page 3-4.
- Updated discussion of tax law uncertainty to include changes to AMT on page 3-12.
- Updated discussion of marginal rate uncertainty to highlight uncertainty associated with Tax Cuts and Jobs Act on page 3-12.

Chapter 4

- Added new Tax Talk on page 4-10.

Chapter 5

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

Chapter 6

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

Chapter 7

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

Chapter 8

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

Chapter 9

- New Tax Talk on page 9-7.

Chapter 10

- Updated Schedule C, Form 1065, Form 1120-S, and Schedule K-1s to 2018 versions.
- Updated discussion of payroll and self-employment taxes for changes to inflation-adjusted Social Security tax threshold on pages 10-11 through 10-14.
- Updated filing statistics in Tax Talks throughout.
- Replaced references to “Section 199A deduction” with “QBI deduction” throughout.
- Added discussion of the taxable income limitation on the QBI deduction and related example on page 10-7.
- Added detailed discussion and example on phase-in of wage limitation on QBI deduction for taxpayers with earnings just above the threshold on page 10-8.
- Updated QBI thresholds for 2019 inflation adjustments.

Chapter 11

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

Chapter 12

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

Chapter 13

- No significant changes in this edition.

Chapter 14

- Updated tax rate tables, standard deductions, and AMT exemption amounts.
- Replaced references to “Section 199A deduction” with “QBI deduction” throughout.
- Updated earned income credit to reflect 2019 inflation adjustments on page 14-20.
- Updated Volpe family examples throughout chapter to reflect 2019 law.
- Updated Form 1040 to reflect revised version of the 1040 and supporting Schedules.

Chapter 15

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

Chapter 16

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

Chapter 17

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

Chapter 18

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

Content Organization

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

PART ONE

Exploring the Tax Environment

- 1 Taxes and Taxing Jurisdictions 1-3
- 2 Policy Standards for a Good Tax 2-1

PART TWO

Fundamentals of Tax Planning

- 3 Taxes as Transaction Costs 3-3
- 4 Maxims of Income Tax Planning 4-1
- 5 Tax Research 5-1

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

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

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

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

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

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

PART THREE

The Measurement of Taxable Income

- 6 Taxable Income from Business Operations 6-3
- 7 Property Acquisitions and Cost Recovery Deductions 7-1
- 8 Property Dispositions 8-1
- 9 Nontaxable Exchanges 9-1

PART FOUR

The Taxation of Business Income

- 10 Sole Proprietorships, Partnerships, LLCs, and S Corporations 10-3
- 11 The Corporate Taxpayer 11-1
- 12 The Choice of Business Entity 12-1
- 13 Jurisdictional Issues in Business Taxation 13-1

PART FIVE

The Individual Taxpayer

- 14 The Individual Tax Formula 14-3
- 15 Compensation and Retirement Planning 15-1
- 16 Investment and Personal Financial Planning 16-1
- 17 Tax Consequences of Personal Activities 17-1

PART SIX

The Tax Compliance Process

- 18 The Tax Compliance Process 18-3
- Appendix A Present Value of \$1 A-2
- Appendix B Present Value of Annuity of \$1 A-3
- Appendix C 2019 Income Tax Rates A-4

Key Learning Tools

Learning Objectives

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

Learning Objectives

After studying this chapter, you should be able to:

- LO 4-1. Describe the difference between tax avoidance and tax evasion.
- LO 4-2. Explain why an income shift or a deduction shift from one entity to another can affect after-tax cash flows.
- LO 4-3. Explain how the assignment of income doctrine constrains income-shifting strategies.
- LO 4-4. Determine the effect on after-tax cash flows of deferral of a tax cost.

LO 4-3
Explain how the assignment of income doctrine constrains income-shifting strategies.

Assignment of Income Doctrine

The federal courts have consistently held that our income tax system prohibits artificial shifts of income from one taxpayer to another. Over 80 years ago, the Supreme Court decided that income must be taxed to the person who earns it, even if that person has a legal right to the wealth represented by the income.⁴ Thus, a business that receives a \$10,000 check in payment for services rendered to a client can't avoid paying tax on the \$10,000 income by simply endorsing the check over to his daughter. In the language of the Court, the tax law must disregard arrangements "by which the income is attributed to a different tree from that on which they grew."

Examples and Cases

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

Conflicting Maxims

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

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

Tax Talk

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

Tax Talk

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

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

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

Key Terms

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

Key Terms			
accrual method of accounting 6-14	all-events test 6-19	allowance method 6-23	business interest limitation 6-9
calendar year 6-5	cash method of accounting 6-10	constructive receipt 6-11	deferred tax asset 6-17
deferred tax liability 6-17	method of accounting 6-23	net operating loss limitation 6-27	fiscal year 6-5
generally accepted accounting principles (GAAP) 6-14	gross income 6-4	hybrid method of accounting 6-13	key-person life insurance policies 6-10
method of accounting 6-23	net operating loss limitation 6-27	permanent personal corporation 6-1	prepaid income 6-1
qualified interest 6-1	realized income 6-1	recognized income 6-1	recurring income 6-1
short-term capital gain 6-1	short-term capital loss 6-1	short-term ordinary income 6-1	short-term ordinary loss 6-1

Sources of Book/Tax Differences

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

Sources of Book/Tax Differences	Permanent	Temporary
	<ul style="list-style-type: none"> Interest on state and local bonds Key-person life insurance proceeds and premiums Fines and penalties Political contributions and lobbying expense Meals and entertainment expenses Sexual harassment settlements subject to nondisclosure agreements 	<ul style="list-style-type: none"> Prepaid income Bad debts Accrued expenses 6-1 all-events test 6-1 Compensation accrued 6-1 Related party accrued 6-1 NOL carryforwards 6-1 Business interest 6-1

Questions and Problems for Discussion

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

Questions and Problems for Discussion	
LO 6-1	1. Firm LK bought a warehouse of used furniture to equip several of its stores. An employee discovered a cache of gold coins in a desk drawer. A local collector offered to buy the coins for \$72,000. Is Firm LK the rightful owner of the coins, which have a \$72,000 fair market value? Does Firm LK recognize income because of this lucky event?
LO 6-2	2. Discuss the choice of a taxable year for the following businesses: <ol style="list-style-type: none"> Retail plant and garden center. French bakery. Chimney cleaning business. Moving and transport business. Software consulting business.
LO 6-3	3. Corporation DB operates three different lines of business. Can the corporation use different overall methods of accounting for each line, or must the corporation use one overall method?

Application Problems

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

Application Problems

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

Issue Recognition Problems

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

Issue Recognition Problems

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

- LO 4-1** 1. Dr. P is a physician with his own medical practice. For the past several years, his marginal income tax rate has been 37 percent. Dr. P's daughter, a student, has no taxable income. During the last two months of the year, Dr. P's patients remit their payments for his services directly to his daughter.
- LO 4-1** 2. Mr. and Mrs. K own rental property that generates \$4,000 more in income than they can deduct. The couple is in the highest marginal tax bracket. For Christmas, Mr. K writes a check for \$1,000 to Mrs. K, and Mrs. K writes a check for \$1,000 to Mr. K.

Research Problems

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

Research Problems

- LO 4-1** 1. Using an electronic library such as Checkpoint, CCH IntelliConnect, find a federal tax case in which the taxpayer is found guilty of tax evasion. In the case, list the behaviors of the taxpayer that convinced the court that the taxpayer was evading (rather than legally avoiding) tax.
- LO 4-9** 2. Using an electronic library such as Checkpoint, CCH IntelliConnect, Nexis, determine how many federal tax cases decided in 2018 involved a step transaction.
- LO 4-9** 3. Using an electronic library such as Checkpoint, CCH IntelliConnect, find a case that discusses the step transaction doctrine in the context of a step transaction. Write a brief (written summary) of the case.

Tax Planning Cases

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

Tax Planning Cases

- LO 4-4** 1. Mrs. O is negotiating to purchase a tract of land from DC Company, a taxpayer. DC bought this land six years ago for \$480,000. According to a recent appraisal, the land is worth \$800,000 in the current real estate market. DC's director of tax, the company's profit on the sale will be taxed at 35%



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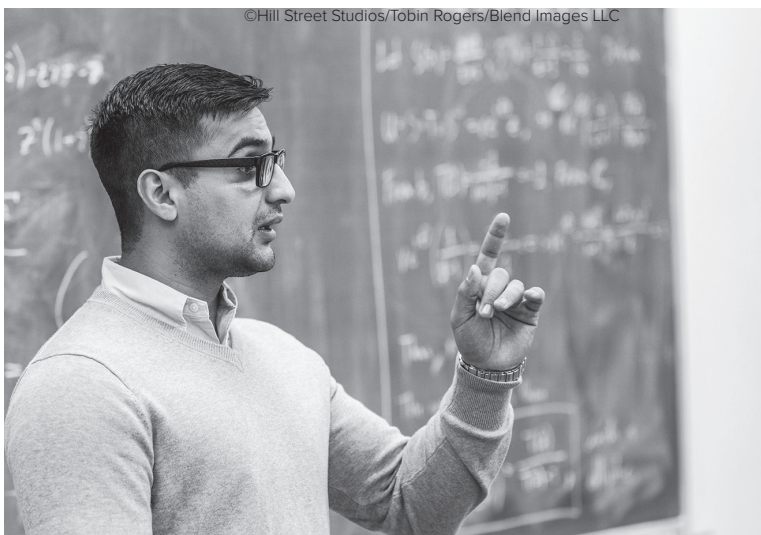


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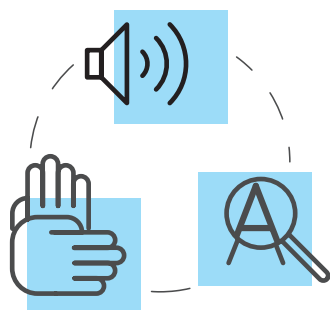
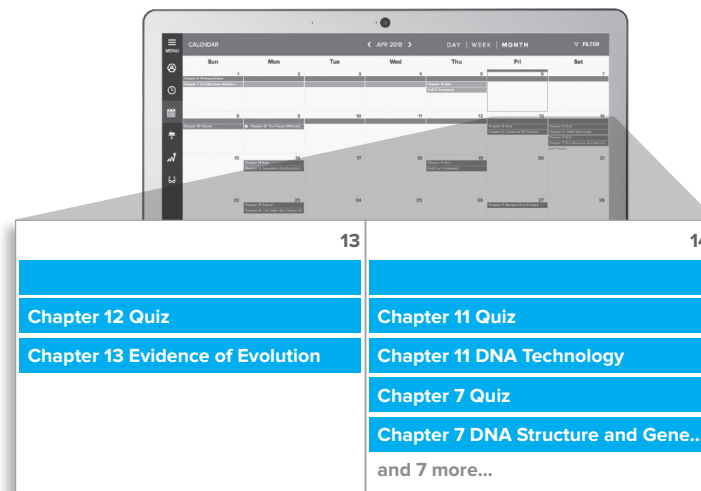
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Online Assignments

1040 Department of the Treasury Internal Revenue Service **2018** U.S. Individual Income Tax Return **2018** OMB No. 1545-0047 IRS Use Only—Do not write or staple in this space.

Filing status: Single Married filing jointly Married filing separately Head of household Qualifying widow(er)

Your first name and initial: _____ Last name: _____ Your social security number: _____

Your standard deduction: Someone can claim you as a dependent You were born before January 2, 1954 You are blind

If joint return, spouse's first name and initial: _____ Last name: _____ Spouse's social security number: _____

Spouse standard deduction: Someone can claim your spouse as a dependent Spouse was born before January 2, 1954 Full-year health care coverage or market-based plan

Spouse is blind Spouse remarried or is dependent upon or you were self-employed

Home address (number and street), if you have a P.O. box, see instructions: _____ Apt. no.: _____ Presidential Election Campaign (see instructions) Yes No

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule B. _____ If you have foreign dependents, list first, last, and date of birth: _____

Dependents (see instructions):

(a) First name	(b) Last name	(c) Social security number	(d) Relationship to you	(e) If you qualify for item 1, check the appropriate box
				<input type="checkbox"/> Child <input type="checkbox"/> Grandchild <input type="checkbox"/> Sister <input type="checkbox"/> Brother <input type="checkbox"/> Nephew <input type="checkbox"/> Niece <input type="checkbox"/> Stepchild <input type="checkbox"/> Adopted child <input type="checkbox"/> Other

Sign Here Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature: _____ Date: _____ Your occupation: _____

Spouse's signature, if a joint return, both must sign: _____ Date: _____ Spouse's occupation: _____

Paid Preparer Use Only

Preparer's name: _____ Preparer's signature: _____ PTIN: _____ Firm's EIN: _____ Check if: See next page Self-employed

Firm's name: _____ Phone no.: _____

Firm's address: _____

For Discussion, Primary Act, and Preparation Reduction Act Notice, see separate instructions. OMB No. 1545-0047 Form 1040 (2018)

Auto-Graded Tax Form Simulations

The auto-graded tax form simulation, assignable within *Connect*, provides a much-improved student experience when solving the tax-form-based problems. The tax form simulation allows students to apply tax concepts by completing the actual tax forms online with automatic feedback and grading for both students and professors.

Auto-Graded Tax Planning Cases and Application Problems

Connect helps students learn more efficiently by providing feedback and practice material when they need it, where they need it. *Connect* grades homework automatically and gives immediate feedback on any questions students may have missed. The extensive assignable, gradable end-of-chapter content includes static and algorithmic versions of tax planning cases (some in the form of auto-graded tax form problems) and application problems. Also, select questions have been redesigned to test students' knowledge more fully. They now include tables for students to work through rather than requiring that all calculations be done offline.



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Introduction to Students

Principles 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 make decisions in which you must evaluate the effect of taxes. At the most fundamental level, all business decisions have the same economic objective: maximization of long-term wealth through cash flow enhancement. The cash flow from any transaction depends on the tax consequences. Therefore, business men and women must appreciate the role of taxes before they can make intelligent decisions, whether on behalf of their firm or on their personal behalf.

Taxes as Business Costs

When businesspeople 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, including taxes, are controlled. 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 preceding paragraph suggests that tax planning means reducing tax costs to maximize the value of the firm. Firms can reduce taxes by any number of strategies. However, tax cost is only one variable that managers must consider in making business decisions. A strategy that reduces taxes may also have undesirable consequences, such as reducing revenues or increasing nontax costs. Because of nontax variables, the 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, 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 doesn't mean that the tax rules applying to individuals are ignored. Quite the contrary. For income tax purposes, individuals and the profit-making activities in which they engage are entwined. As we will observe over and over again, the ultimate taxpayers in every business 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. According to data from the Tax Foundation, Americans devote about 2 hours and 15 minutes of every 8-hour workday to earn enough to pay their local, state, and federal taxes.

People who are clueless about taxes must take a passive role, participating in a tax system they don't understand and over which they exercise no control. In contrast, if you understand how taxes relate to your life, you can take an active role. You can take positive steps to minimize your personal tax 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 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 tax systems by which governments raise revenues. Most of the subject matter of the text pertains to today's tax environment 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 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 the 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. However, these courses give only rudimentary instruction on determining the tax consequences of transactions and overlook the possibilities for controlling tax costs to maximize cash flows. In extreme cases, financial models simply ignore tax consequences by assuming that business decisions are 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 to determine the tax consequences. Correct application of the rule is the learning objective. Students are not required to integrate the tax consequences of transactions into a 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 financial results. Consequently, students often

develop the habit of analyzing transactions from a backward-looking *compliance* perspective rather than a forward-looking *planning* perspective.

The focus of *Principles of Taxation for Business and Investment Planning* is 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 a decision-making framework. Admittedly, these rules and regulations are tough to master. Two observations should give you reassurance. First, while the tax law is extremely technical and complex, the application of its 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 details of the law change every year. Students who learn 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 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 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 appreciate how those strategies can improve cash flows and maximize wealth.

Because this text takes 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 tax principles 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 concepts.

The conceptual approach should sensitize you to the tax implications of 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 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 tax concerns or opportunities. Other problems present you with facts suggesting tax issues with no correct solution.

A 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 be the 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 conceptual approach is appropriate for the first tax course because it concentrates on broad issues concerning most taxpayers instead of narrow problems encountered by only a few taxpayers. If you learn these issues, you will be well prepared to expand and deepen your tax knowledge through professional experience. You will understand 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 business advisers.

CPA Exam Preparation

This text provides excellent preparation for the CPA exam. The text covers approximately 90 percent of the specified federal tax content of the Regulation portion of the exam. The 10 percent remaining content consists of advanced topics usually covered in a second-semester undergraduate tax course.

The CPA exam includes a variety of interactive problems designed to test your knowledge of the tax law and your ability to apply the law in realistic situations. Many of the problems are in the form of *simulations*: short cases in which you must demonstrate your tax research and analytic skills. These are the exact skills that you will learn, practice, and refine as you work your way through *Principles of Taxation for Business and Investment Planning*.

If your instructor is using *Connect's* auto-graded homework for this course, he/she has the ability to assign Roger CPA Review multiple choice questions and task-based simulations, providing you with even more opportunities to prepare for the CPA exam.

Conclusion

The authors hope this introduction has conveyed the message that people 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 transactions. Upon 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, a transaction with profound tax consequences. Finally, you will understand that effective tax planning can save more money than the most diligent tax compliance.

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PART SIX

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Part Four

The Taxation of Business Income

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Chapter Ten

Sole Proprietorships, Partnerships, LLCs, and S Corporations

Learning Objectives

After studying this chapter, you should be able to:

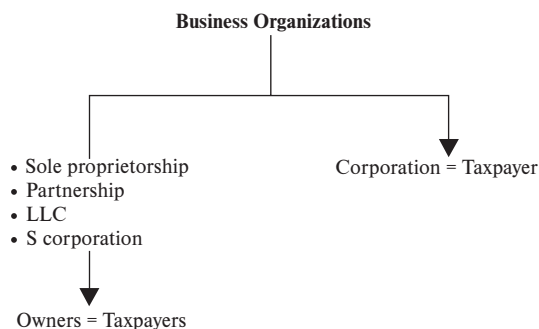
- LO 10-1. Compute net profit or loss from a sole proprietorship.
- LO 10-2. Compute the FICA payroll taxes and the federal SE tax.
- LO 10-3. Explain how limited liability companies (LLCs) are treated for federal tax purposes.
- LO 10-4. Explain the flow-through of partnership items to the partners.
- LO 10-5. Differentiate between a distributive share of partnership income and cash flow.
- LO 10-6. Adjust the tax basis in a partnership interest.
- LO 10-7. Apply the basis limitation on the deduction of partnership losses.
- LO 10-8. Determine if a corporation is eligible to be an S corporation.
- LO 10-9. Identify similarities and differences in the tax treatment of S corporations versus partnerships.
- LO 10-10. Apply the basis limitation on the deduction of S corporation losses.

In Part Three we learned that taxable income from business transactions and activities equals gross income minus allowable deductions.¹ In Part Four, we will learn how to compute the tax on business income. Throughout Part Three, we used the labels *firm* and *company* to refer to business organizations. We could get by with these generic labels because we were concentrating on the *measurement of taxable income*. The measurement process does not depend on the type of legal entity operating the business. As stated in Chapter 4, the tax law is essentially neutral across business entities with respect to the tax base. But to make the actual *tax computation*, we must focus on the specific organizational form of the business.

¹ §63(a).

EXHIBIT 10.1

Categories of Business Organizations



For tax purposes, business organizations fall into one of two categories. The first category consists of organizations that are not taxable entities. The income generated by the organization is taxed directly to the owners. This category includes sole proprietorships, partnerships, limited liability companies (LLCs), and S corporations, all of which are discussed in this chapter. The second category consists of corporations (often referred to as regular or C corporations), which are both persons under the law and taxpayers in their own right. Corporations pay tax on their income at the entity level. If a corporation distributes after-tax earnings to its owners, the distributed income is taxed a second time at the owner level. This potential for double taxation, as well as other characteristics of corporate taxpayers, is examined in detail in Chapter 11. Exhibit 10.1 contrasts the two categories of business organizations in terms of the identity of the taxpayer.

Part Four includes two more chapters that complete our discussion of the taxation of business income. Chapter 12 compares the tax advantages and disadvantages of the various business entities and identifies tax planning strategies unique to each. Finally, Chapter 13 introduces the complexities that develop when business entities operate in more than one taxing jurisdiction.

SOLE PROPRIETORSHIPS

The simplest form of business organization is a **sole proprietorship**, defined as an unincorporated business activity owned by one individual.² A sole proprietor owns the business assets in his or her own name and is personally liable for the business debts. In other words, the business has no legal identity separate from that of its owner. Sole proprietorships are the most common form of business entity in the United States. According to recent Internal Revenue Service data, more than 23 million nonfarm sole proprietorships operate in this country, and nearly three of every four businesses that report to the IRS are operated by sole proprietors.³

Overview of Schedule C

The taxable income from a sole proprietorship is reported on Schedule C (Profit or Loss From Business) of the proprietor's Form 1040 (U.S. Individual Income Tax Return).⁴ This schedule is the proprietorship's income statement for the year. Gross income from the sale of goods to customers or performance of services for clients is accounted for in Part I. The proprietorship's deductible operating expenses and cost recovery deductions are listed in Part II. An excess of gross income over deductions is reported as net profit, while an excess of deductions over gross income is reported as net loss.

LO 10-1

Compute net profit or loss from a sole proprietorship.

² This definition includes businesses in which the owner's spouse has an equity interest in the business under state property law. As discussed later in this chapter, a single-member LLC whose owner is an individual is treated as a sole proprietorship.

³ *IRS Statistics of Income Bulletin*, Spring 2015.

⁴ Agricultural business operations are reported on Schedule F (Profit or Loss From Farming).

*Faux
Antiques—Sole
Proprietorship*

Mr. Tom Owen owns and operates a firm that manufactures reproductions of antique furniture. The business name for this sole proprietorship is Faux Antiques. For 2018, the business records reflect the following items of revenue and expense.

Revenue from furniture sales	\$1,117,300
Sales returns	(21,000)
Expenses: Advertising	6,200
Accounts written off as uncollectible	8,800
Attorney and CPA fees	2,150
Business license tax	2,500
Cost of goods sold	599,700
Interest to credit union	7,300
MACRS depreciation	3,600
Payroll taxes	9,250
Property and liability insurance	5,600
Rent on workroom	23,200
Repairs to tools and equipment	17,900
Supplies	18,000
Utilities	14,000
Wages	73,200

Mr. Owen used this information to prepare the Schedule C included in his Form 1040. Page 1 of this Schedule C is shown as Exhibit 10.2. The \$304,900 net profit reported on Schedule C was included in Mr. Owen's 2018 taxable income.

Note that the tax on net profit is not computed on Schedule C. Instead, the net profit carries to the first page of Form 1040 as ordinary income and is combined with all other income items recognized during the year. Consequently, the individual's business income is just one component of total income on which tax is computed.

QBI Deduction

As mentioned in Chapter 6, the Tax Cuts and Jobs Act of 2017 enacted new Section 199A, creating a new deduction for noncorporate businesses. The goal of this deduction is to lower the effective tax rate on business profit earned by passthrough entities. In general, the tentative deduction equals 20 percent of **qualified business income** earned by an individual taxpayer through a sole proprietorship, partnership, or S corporation. However, various limits and exclusions complicate what is otherwise a simple calculation. Specifically, the deduction is subject to both a wage limitation and a taxable income limitation, described further below.

First, the **QBI deduction** cannot exceed the greater of (1) 50 percent of W-2 wages paid by a qualified trade or business, or (2) the sum of 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis of qualified property used by the business. W-2 wages include most types of taxable compensation paid to business employees. Qualified property is defined as tangible business property subject to depreciation.

***QBI Deduction
after Applying the
Wage Limitation***

Ms. Wilson operates a sole proprietorship with qualified business income of \$1.2 million. Her business paid W-2 wages of \$400,000 and owns depreciable tangible property with an unadjusted basis of \$900,000. Ms. Wilson's QBI deduction (before any taxable income limitation) is computed as follows.

Tentative deduction prior to wage limitation (\$1.2 million × 20%)	\$240,000
Deduction limited to greater of:	
\$400,000 × 50%	\$200,000
\$400,000 × 25% + \$900,000 × 2.5%	122,500
QBI deduction before taxable income limitation	<u>\$200,000</u>

EXHIBIT 10.2

SCHEDULE C (Form 1040) Profit or Loss From Business (Sole Proprietorship)

OMB No. 1545-0074
2018
Attachment Sequence No. **09**

Department of the Treasury Internal Revenue Service (99)
Go to www.irs.gov/ScheduleC for instructions and the latest information.
Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

Name of proprietor: **Tom G. Owen** Social security number (SSN): **497-45-9058**

A Principal business or profession, including product or service (see instructions): **Manufacturing - furniture** **B** Enter code from instructions: **33700**

C Business name, if no separate business name, leave blank: **Faux Antiques** **D** Employer ID number (EIN) (see instr.):

E Business address (including suite or room no.): **1012 East Main**
City, town or post office, state, and ZIP code: **Widener, NY 42714**

F Accounting method: (1) Cash (2) Accrual (3) Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2018? If "No," see instructions for limit on losses Yes No

H If you started or acquired this business during 2018, check here

I Did you make any payments in 2018 that would require you to file Form(s) 1099? (see instructions) Yes No

J If "Yes," did you or will you file required Forms 1099? Yes No

Part I Income

1 Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked <input type="checkbox"/>	1	1,117,300
2 Returns and allowances	2	21,000
3 Subtract line 2 from line 1	3	1,096,300
4 Cost of goods sold (from line 42)	4	599,700
5 Gross profit. Subtract line 4 from line 3	5	496,600
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7 Gross income. Add lines 5 and 6	7	496,600

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8 Advertising	8	6,200	18 Office expense (see instructions)	18	
9 Car and truck expenses (see instructions)	9		19 Pension and profit-sharing plans	19	
10 Commissions and fees	10		20 Rent or lease (see instructions):		
11 Contract labor (see instructions)	11		a Vehicles, machinery, and equipment	20a	
12 Depletion	12		b Other business property	20b	23,200
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	3,600	21 Repairs and maintenance	21	17,900
14 Employee benefit programs (other than on line 19)	14		22 Supplies (not included in Part III)	22	
15 Insurance (other than health)	15	5,600	23 Taxes and licenses	23	11,750
16 Interest (see instructions):			24 Travel and meals:		
a Mortgage (paid to banks, etc.)	16a		a Travel	24a	
b Other	16b	7,300	b Deductible meals (see instructions)	24b	18,000
17 Legal and professional services	17	2,150	25 Utilities	25	14,000
28 Total expenses before expenses for business use of home. Add lines 8 through 27a	28	191,700	26 Wages (less employment credits)	26	73,200
29 Tentative profit or (loss). Subtract line 28 from line 7	29	304,900	27a Other expenses (from line 48)	27a	bad_debts_8,800
30 Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). Simplified method filers only: enter the total square footage of: (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30	30		b Reserved for future use	27b	
31 Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Schedule 1 (Form 1040), line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2. (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32.	31	304,900			
32 If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both Schedule 1 (Form 1040), line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2. (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you must attach Form 6198. Your loss may be limited.			32a <input checked="" type="checkbox"/> All investment is at risk.		
			32b <input type="checkbox"/> Some investment is not at risk.		

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11334P Schedule C (Form 1040) 2018

Second, the final QBI deduction is subject to an overall limitation based on taxable income. The final deduction cannot exceed 20 percent of taxable income computed without regard to (1) the QBI deduction and (2) any net capital gain.

*QBI Deduction
after Applying
the Taxable
Income Limit*

Refer to the preceding example in which Ms. Wilson has qualified business income of \$1.2 million and an allowable QBI deduction after the wage limitation of \$200,000. Consider two alternative scenarios regarding her taxable income and final QBI deduction.

	Scenario A	Scenario B
Taxable income before QBI deduction, excluding net capital gains	\$1,400,000	\$ 900,000
Overall limitation percentage	.20	.20
Taxable income limitation	<u>\$ 280,000</u>	<u>\$ 180,000</u>
Final QBI deduction	<u>\$ 200,000</u>	<u>\$ 180,000</u>

Ms. Wilson's final QBI deduction is the lesser of the taxable income limitation or the \$200,000 QBI deduction after the wage limitation (as computed above). Thus in Scenario B, the taxable income limitation lowers her allowable deduction.

Third, a qualified business does not include service businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management. Qualified business income also excludes investment-related income, gains, losses, and deductions, as well as amounts earned as an employee or received from a partnership by a partner in exchange for services (guaranteed payments).

Finally, an important simplification exempts lower income taxpayers from both the W-2 wage limitation and the exclusion of service businesses. If the taxpayer's 2019 taxable income (prior to the QBI deduction) does not exceed \$321,400 (married filing jointly), \$160,725 (married filing separately), or \$160,700 (all other individuals), the QBI deduction is simply 20 percent of business income, including income from service businesses. For 2018, the related thresholds were \$315,000 (married filing jointly) and \$157,500 (all others).

If taxable income exceeds the \$321,400 (\$160,725 if married filing separately or \$160,700 all others) threshold by not more than \$100,000 (\$50,000 if not married filing jointly), the deduction for service businesses is phased down by 1 percent for every dollar of taxable income over the \$321,400 threshold amount (2 percent if not married filing jointly).

*QBI Deduction
for a Service
Business*

Mr. Krase is a self-employed consultant with 2019 Schedule C profit of \$230,000. His business pays no W-2 wages and has minimal depreciable property. Mr. Krase is married filing a joint return and has taxable income of \$290,000, prior to the QBI deduction.

Mr. Krase's consulting business would be considered a service business, normally not producing qualified business income. In addition, the W-2 wage limitation, if it applied, would reduce any deduction to zero. However, because Mr. Krase's taxable income is below the \$321,400 threshold, he is permitted a QBI deduction of \$46,000 ($\$230,000 \times 20$ percent), reducing his taxable income to \$244,000 ($\$290,000 - \$46,000$). Note that the taxable income limitation would not apply, since the Krases' pre-QBI taxable income of \$290,000 is greater than qualified business income of \$230,000.

What if the Krases' taxable income is \$350,000? Because they exceed the \$321,400 threshold by \$28,600, their allowable QBI deduction is reduced by 28.6 percent to \$32,844 ($\$46,000 - 28.6 \text{ percent} \times \$46,000$).

For nonservice businesses, if taxable income exceeds the \$321,400 (\$160,725 if married filing separately or \$160,700 otherwise) threshold by not more than \$100,000 (\$50,000 if not married filing jointly), the wage limitation is phased in. The phase-in compares the QBI deduction as computed without the wage limitation to the deduction allowed if the full wage limitation applied. This excess deduction amount is then reduced by 1 percent for every dollar of taxable income over the \$321,400 threshold amount (2 percent if not married filing jointly).

Phase-in of Wage Limitation on QBI Deduction

Ms. Jensen is self-employed with 2019 qualified business income of \$140,000. Her business paid \$48,000 of W-2 wages and has no depreciable property. Ms. Jensen is single and has taxable income of \$180,000, prior to the QBI deduction.

Without regard to the wage limitation, Ms. Jensen's QBI deduction would be \$28,000 (\$140,000 QBI × 20 percent). If the wage limitation applied in full, her QBI deduction would be limited to \$24,000 (\$48,000 × 50 percent), a reduction of \$4,000.

Ms. Jensen's taxable income exceeds the threshold by \$19,300 (\$180,000 – \$160,700 threshold), resulting in a reduction percentage of 38.6 percent [$(\$19,300 \times 2)/1000$]. Ms. Jensen's allowable QBI deduction is \$26,456 (\$28,000 – 38.6 percent × \$4,000).

The QBI deduction does not appear on Schedule C, and does not reduce the taxpayer's adjusted gross income. Instead, it is a deduction from adjusted gross income, reducing final taxable income. Chapter 14 discusses this presentation issue in more detail.

Sole Proprietorship Losses

If a sole proprietorship operates at a loss and that loss is deductible, it carries to the first page of Form 1040 to be deducted against other income for the year. However, a current deduction for the loss may be limited. Recall from Chapter 6 that excess business losses of a noncorporate taxpayer are not currently deductible. An excess business loss is an overall net loss from all the taxpayer's business activities in excess of \$510,000 (married filing jointly) or \$255,000 (all other individuals). These thresholds relate to 2019 tax years. For 2018, the excess business loss thresholds were \$500,000 (married filing jointly) or \$250,000 (all other individuals).

Deductible Business Loss

Griffin is a single individual earning salary income of \$300,000. He also conducts business through a sole proprietorship. The following are two alternate scenarios regarding deductibility of a 2019 loss sustained by his business.

	Scenario A	Scenario B
Overall business loss	\$(210,000)	\$(320,000)
Salary income	\$ 300,000	\$ 300,000
Deductible business loss	<u>(210,000)</u>	<u>(255,000)</u>
Net earnings on Form 1040	<u>\$ 90,000</u>	<u>\$ 45,000</u>

Note that in Scenario A, Griffin's business loss is fully deductible. In Scenario B, his business loss exceeds the loss threshold for a single taxpayer. His nondeductible \$(65,000) excess business loss [$(\$320,000 - \$255,000)$] carries forward to the future as a net operating loss (NOL).

If a deductible business loss exceeds other income, the individual can carry the excess loss forward as an NOL deduction. Recall from Chapter 6 that NOLs carry forward indefinitely, but the deduction in future years is limited to 80 percent of taxable income in each carryforward year.

Individual Net Operating Loss

Mr. Zeller reported the following items on his Form 1040 for 2019.

Salary from employer	\$ 21,600
Interest and dividend income from investments	1,200
Business loss from sole proprietorship	<u>(26,810)</u>
Net operating loss	<u>\$ (4,010)</u>

Mr. Zeller can use his \$4,010 net operating loss as a carryforward deduction in future years, subject to the 80 percent of taxable income limitation.⁵

Cash Flow Implications

The after-tax cash generated by a sole proprietorship belongs to the individual owner. The individual can retain the cash for use in the business, spend it for personal consumption, or invest it in other income-producing property. In the latter case, earnings from the owner's investments (interest, dividends, rents, etc.) are not considered business income and are not reported on Schedule C.⁶

Faux Antiques Cash to Mr. Owen

Refer to the example in which Mr. Tom Owen owns and operates Faux Antiques. During 2018, Mr. Owen transferred \$261,300 cash from his business bank account to his personal bank account. Mr. Owen and his wife, Claire, pay all their household expenses out of the personal account. The transfer of cash has absolutely no effect on the computation of Faux Antiques's net profit reported on Schedule C.

Tax Talk

The IRS estimates that the annual "tax gap" (taxes that people legally owe but don't pay) equals \$458 billion. About \$125 billion of the gap is attributable to sole proprietors who understate revenue (often received in cash) or overstate deductions.

Dispositions of Business Assets

Only the results of the sole proprietorship's routine operations are reported on Schedule C. If the owner disposes of assets used in the business, recognized gains and losses are reported on Form 4797 (Sales of Business Property). The tax consequences of the disposition are based on the rules discussed in Chapters 8 and 9. For instance, if the owner sells business equipment at a gain, he must report Section 1245 depreciation recapture as ordinary income and any additional gain as Section 1231 gain. If he sells the equipment at a loss, the loss is a Section 1231 loss.

Interest Expense

If an individual borrows money for a business purpose relating to her sole proprietorship, the interest paid on the debt is deductible on Schedule C, subject to the net business interest limitation discussed in Chapter 6. The deductibility of business interest is in sharp contrast to the tax treatment of other types of interest expense. For example, individuals can't deduct the interest paid on debt incurred to purchase consumer goods such as a family car or a new wardrobe. If the sole proprietorship fails to generate enough cash to service the business debt, the individual owner is personally liable for repayment, and the business creditors can look to the owner's nonbusiness assets for satisfaction.

⁵ This example ignores the computational details of the individual NOL deduction. In general, the following items are not allowed when computing the individual NOL: personal exemptions, net capital losses, nonbusiness deductions in excess of nonbusiness income, and the domestic production activities deduction.

⁶ Chapter 16 discusses the taxation of investment income earned by an individual taxpayer.

Home Office Deduction

If an individual uses a portion of his personal residence as an office for his sole proprietorship, the expenses allocable to the home office may qualify as a business deduction.

Home Office Deduction

Mrs. Greer, a self-employed consultant, uses one room of her home as a business office. This room represents 15 percent of the home's square footage. This year, Mrs. Greer incurred the following expenses in connection with her home.

Home mortgage interest	\$18,000
Property tax on residence	4,300
Homeowner's insurance	2,950
Utilities	3,600
House cleaning service	2,400
Repairs	1,900
	<u>\$33,150</u>

If Mrs. Greer's office meets the tax law requirements, she can deduct \$4,973 (15 percent of the total expenses) as a business deduction on her Schedule C.⁷ She can also claim a MACRS depreciation deduction based on 15 percent of the cost of the residence.

The possibility of deducting some percentage of monthly household expenses might prompt the conversion of many a spare bedroom into a home office—even if the use of such office is extraneous to the conduct of the homeowner's business. The tax law limits the potential for abuse through a set of tough requirements for qualifying a portion of a residence as a home office. Essentially, the office must be *exclusively* used on a regular basis as the principal place of any business operated by the homeowner or as a place to meet with patients, clients, or customers.⁸ A home office used exclusively for administrative or management activities qualifies as a principal place of business if the taxpayer has no other fixed location where such activities are conducted.

Principal Place of Business

Dr. Milby is a self-employed obstetrician who treats patients at three different urban hospitals. Although Dr. Milby spends more than 12 hours during an average week at each hospital, he does not maintain an office in any of the hospitals. He does all his medical reading, patient billing and record keeping, and other administrative tasks in his home office where he spends two to three hours each day. Patient treatment is the most significant aspect of Dr. Milby's business, and he spends more hours working at the hospitals than in his home office. Nevertheless, his home office qualifies as Dr. Milby's principal place of business, and he can deduct the expenses allocable to the office.

Even when an individual meets the requirements for a home office, the home office deduction is limited to the taxable income of the business before consideration of the deduction.⁹ In other words, the home office deduction can't create or increase a net loss. A sole proprietor who claims a home office deduction must isolate the deduction on line 30,

⁷ Mrs. Greer can deduct the remainders of her home mortgage interest and property tax as itemized deductions. See Chapters 14 and 17.

⁸ §280A(c)(1).

⁹ §280A(c)(5). *Michael H. Visin*, T.C. Memo 2003-246.

Schedule C, and attach a separate Form 8829 to show the detailed computation of the deduction. Clearly, the IRS is very sensitive about home office deductions. Sole proprietors who are entitled to the deduction should carefully document the underlying expenses and be prepared to justify the necessity of a home office if their tax return is audited.

Employment Taxes

A sole proprietor may be the only person working in the business or the proprietor may have any number of employees. In the latter case, the sole proprietor must obtain an **employer identification number** from the IRS and comply with the state and federal employment tax requirements imposed on every business organization.

Unemployment and FICA Tax

Employers must pay both a state and a federal unemployment tax based on the compensation paid to their employees during the year.¹⁰ As we discussed in Chapter 1, these taxes fund the national unemployment benefits program. Employers must also pay the tax authorized by the Federal Insurance Contribution Act (FICA) that funds our national Social Security and Medicare systems. This **employer payroll tax** has two components: a Social Security tax of 6.2 percent of a base amount of compensation paid to each employee and a Medicare tax of 1.45 percent of the employee's total compensation.¹¹ Congress increases the Social Security base periodically—in 2018, the base was \$128,400; for 2019, the base increased to \$132,900.

LO 10-2

Compute the FICA payroll taxes and the federal SE tax.

Employer Payroll Tax

Mr. Carr has a full-time employee, Mrs. Stroh, who manages Mr. Carr's sole proprietorship. Mrs. Stroh's 2019 salary was \$138,000, and Mr. Carr's employer payroll tax on this salary was \$10,241.

Social Security tax (6.2% × \$132,900)	\$ 8,240
Medicare tax (1.45% × \$138,000)	2,001
Employer payroll tax	<u>\$10,241</u>

In addition to paying unemployment and payroll taxes, employers must collect the FICA tax levied on their employees.¹² For tax years after 2012, this **employee payroll tax** is computed in exactly the same manner as the employer payroll tax.

Employee Payroll Tax Withholding

Based on the facts in the preceding example, Mrs. Stroh's 2019 employee payroll tax was \$10,241.¹³

Social Security tax (6.2% × \$132,900)	\$ 8,240
Medicare tax (1.45% × \$138,000)	2,001
Employee payroll tax	<u>\$10,241</u>

Mr. Carr withheld this tax from Mrs. Stroh's salary and remitted it along with his employer payroll tax to the U.S. Treasury for a total payment of \$20,482 (\$10,241 employer payroll tax + \$10,241 employee payroll tax). Thus, Mr. Carr is the collection agent for the federal government with respect to the employee payroll tax.

¹⁰ §3301.

¹¹ §3111.

¹² §3102.

¹³ §3101. The employee payroll tax is nondeductible for federal income tax purposes.

Employers should take seriously their responsibility to withhold and remit employee payroll tax. If an employer fails to remit the proper FICA tax for an employee, the federal government may collect both halves of the tax (the employer and the employee portions) from the employer.¹⁴

Additional Medicare Tax on Employees

Beginning in 2013, individuals whose wages exceed a threshold amount must pay an extra .9 percent Medicare tax on a portion of their wage income, in addition to the 1.45 percent Medicare tax withheld on all wages. The threshold amount for this additional tax is \$250,000 for married individuals filing jointly (\$125,000 for married filing separately) and \$200,000 for unmarried individuals. The .9 percent tax applies only to employees, not employers. In addition, the tax applies only to wage income above the threshold. For joint filers, the additional tax applies to combined wages above the threshold amount.

Additional Medicare Tax on Wages

In 2019, Mr. Fox earned wage income of \$220,000, and Mrs. Fox earned wage income of \$115,000. On their joint return, they will owe additional Medicare tax on wages of \$765 [.9 percent \times ($\$220,000 + \$115,000 - \$250,000$)].

Employers must withhold the additional Medicare tax only after an employee's wages reach \$200,000 for the year. However, this withholding may not prove sufficient to cover the tax due, if the employee had additional wage income from another job or the employee's spouse has wage income. Any amount due in excess of withholding will be owed on the tax return when filed. Individuals may wish to request extra income tax withholding by their employer to meet this obligation, or consider this tax in calculating estimated tax payments.

Additional Medicare Tax Withholding

As stated previously, in 2019, Mr. Fox earned wage income of \$220,000, and Mrs. Fox earned wage income of \$115,000. Mr. Fox's employer will be required to withhold additional Medicare tax of \$180 [.9 percent \times ($\$220,000 - \$200,000$)] on his wages in excess of \$200,000. Mrs. Fox's employer is not required to withhold this tax because her total wages for the year do not exceed \$200,000. The remaining tax not withheld, \$585 ($\$765 - \180), will be owed on their 2019 joint return.

Income Tax Withholding on Employee Compensation

Employers are required to withhold federal income tax (and possibly state income tax) from the compensation paid to their employees.¹⁵ Employers must remit the withholding to the U.S. Treasury periodically throughout the year. The withholding for each employee is based on the information on the employee's Form W-4 (Employee's Withholding Allowance Certificate) and computed by reference to withholding tables provided by the IRS.

¹⁴ The employer is not technically liable for an employee's payroll tax. However, an employer that fails to "collect, truthfully account for, and pay over" this tax is subject to a penalty equal to 100 percent of such tax. In other words, the penalty on the employer equals the uncollected employee tax. §6672. This penalty has been described as the "iron fist" of the FICA tax system.

¹⁵ §3402.

Gross and Net Compensation

Refer to the examples *Employer Payroll Tax* and *Employee Payroll Tax Withholding* involving Mr. Carr and Mrs. Stroh. During 2019, Mr. Carr also withheld \$22,900 federal income tax from Mrs. Stroh's \$138,000 gross salary. Therefore, Mrs. Stroh received only \$104,859 after-tax (net) compensation.

Gross salary	\$138,000
FICA tax withheld	(10,241)
Federal income tax withheld	(22,900)
Net salary received	<u>\$104,859</u>

At the end of each year, employers are required to provide information concerning the gross wages or salary paid to each employee during the year and the payroll and income tax withheld from that gross income. This information is summarized on the familiar Form W-2 (Wage and Tax Statement).

Income Tax Consequences to the Employer

Business organizations can deduct the gross compensation paid to their employees.¹⁶ They can also deduct state and federal unemployment taxes and the employer payroll tax because these taxes are ordinary and necessary expenses incurred in the conduct of an active business.¹⁷ Let's summarize the relationship between these deductible expenses, the employer's withholding requirements, and the net compensation paid to employees by referring again to Mr. Carr's sole proprietorship.

Compensation and Cash Disbursements

For 2019, Mr. Carr deducted \$138,000 compensation expense and \$10,241 employer payroll tax on that compensation. He withheld \$10,241 employee payroll tax and \$22,900 income tax from Mrs. Stroh's compensation (\$33,141 total) and remitted \$43,382 tax to the U.S. Treasury.

	Deductible Business Expense	Cash Disbursed to:	
		Mrs. Stroh	U.S. Treasury
Salary	\$138,000	\$104,859	\$33,141
Employer FICA tax	10,241		10,241
	<u>\$148,241</u>	<u>\$104,859</u>	<u>\$43,382</u>

Tax Talk

Recent "tax gap" projections estimate that self-employment tax liability is underreported by as much as \$65 billion annually.

Self-Employment Tax

While sole proprietors are responsible for collecting and remitting payroll and income taxes from their employees, sole proprietors themselves are not employees and do not receive a salary from the business. Sole proprietors are self-employed and must pay the federal **self-employment (SE) tax** on their business income.¹⁸ Refer to Schedule C in Exhibit 10.2, and note how line 31 instructs the sole proprietor to carry net profit to Schedule SE.

¹⁶ Unless some or all the compensation must be capitalized to inventory under the uniform capitalization (UNICAP) rules discussed in Chapter 7.

¹⁷ See Rev. Rul. 80-164, 1980-1 C.B. 109.

¹⁸ §1401. Self-employed individuals are not eligible to receive unemployment benefits and, therefore, are not subject to state and federal unemployment taxes.

The self-employment tax is computed on this schedule and paid along with the individual's income tax for the year. Also note that the self-employment tax base is not reduced by any allowable 20 percent deduction for qualified business income reported by a sole proprietorship.

The SE tax has two components: a Social Security tax of 12.4 percent of a base amount of net earnings from self-employment and a Medicare tax of 2.9 percent of total net earnings. For 2017, 2018, and 2019, the Social Security base is \$127,200, \$128,400, and \$132,900, respectively.

Note that the SE tax rates equal the *combined* employer/employee payroll tax rates, and the Social Security base is the same for both taxes. The SE tax was enacted to complement the FICA tax; the federal government collects the same tax on a sole proprietor's self-employment income as it would collect on an identical amount of compensation. To complete the parallel, sole proprietors can claim as an income tax deduction that portion of the SE tax equivalent to the employer payroll tax. For tax years other than 2011 or 2012, the tax deduction is simply one-half of the SE tax.¹⁹

In calculating after-tax business income, sole proprietors must factor in both the income tax and the SE tax levied on that income.

Self-Employment Tax 2019

Mr. Carr's sole proprietorship generated \$225,000 net profit in 2019. If his marginal income tax rate is 37 percent, the after-tax income from the business is \$140,058.

Schedule C net profit		\$225,000
Self-employment tax:		
Self-employment tax base ²⁰	\$207,788	
Social Security tax (12.4% × \$132,900)	16,480	
Medicare tax (2.9% × \$207,788)	6,026	
Total SE tax		(22,506)
Income tax:		
Schedule C net profit	\$225,000	
One-half of self-employment tax	<u>(11,253)</u>	
	\$213,747	
20% deduction for qualified business income (\$225,000 × 20%)*	<u>(45,000)</u>	
Net profit subject to income tax	\$168,747	
	<u>.37</u>	
		<u>(62,436)</u>
After-tax business income		<u>\$140,058</u>

*The 20 percent deduction is computed on Mr. Carr's Schedule C net profit, without reduction for self-employment taxes. Also note that the 20 percent deduction is not a cash out-flow, and therefore does not reduce Mr. Carr's after-tax cash flow.

Note that the SE tax is not a progressive tax because the combined 15.3 percent rate applies to the first dollar of self-employment income. For sole proprietors who earn modest incomes, the SE tax can be a heavier burden than the income tax.

¹⁹ §164(f). For 2011 and 2012, the tax deduction equals 59.6 percent of the Social Security tax and 50 percent of the Medicare tax.

²⁰ The statutory base for the SE tax equals net profit minus a deduction equal to 7.65 percent of such profit. §1402(a)(12). Schedule SE builds this deduction into its computation of net earnings by defining that number as 92.35 percent of Schedule C net profit.

Beginning in 2013, the .9 percent additional Medicare tax also applies to self-employment income when the combination of self-employment income and wages exceeds a threshold amount. The threshold amount for this additional tax is \$250,000 for married individuals filing jointly (\$125,000 for married filing separately) and \$200,000 for unmarried individuals. Unlike the self-employment tax, this additional .9 percent Medicare tax is not deductible for income tax purposes.

Additional Medicare Tax on Self-Employment Income

Recall that Mr. Carr's sole proprietorship generated \$225,000 of net profit in 2019, resulting in net earnings from self-employment of \$207,788. If Mr. Carr is single and has no wage income, he will owe additional Medicare tax of \$70 [.9 percent \times (\$207,788 - \$200,000)]. If Mr. Carr files a joint return with his spouse who has no wage or self-employment income, he owes no additional Medicare tax because his self-employment income is below the \$250,000 threshold for married filing jointly.

PARTNERSHIPS

Entrepreneurs who pool their resources by becoming co-owners of a business can organize the business as a partnership. **Partnerships** are unincorporated entities created by contractual agreement among two or more business associates.²¹ Such associates can be individuals, corporations, and even other partnerships. All 50 states and the District of Columbia have enacted statutes (generally patterned after the Revised Uniform Partnership Act and the Revised Uniform Limited Partnership Act) to define the characteristics and requirements for partnerships operating within their jurisdiction.

Forming a Partnership

The first step in the formation of a partnership is the drafting of an agreement by the prospective partners.²² A partnership agreement is a legal contract stipulating both the rights and the obligations of the partners and the percentage of profits and losses allocable to each. The agreement gives the partners flexibility to customize their business arrangement to suit their unique situation. The partners can agree to share all profits and losses equally, or they can decide on different sharing ratios for special items of income, gain, deduction, or loss. Ideally, a partnership agreement should be drafted by an attorney, should be in writing, and should be signed by all the partners. However, even oral partnership agreements have been respected as binding contracts by the courts.²³

A partnership can be a **general partnership** in which all partners have unlimited personal liability for debts incurred by the partnership. Alternatively, a partnership can be a **limited partnership** in which one or more limited partners are liable for partnership debt only to the extent of their capital contributions to the partnership. Limited partnerships must have at least one general partner. The role of a limited partner in partnership activities must be carefully defined to maintain protection from liability for partnership debts. The Revised Uniform Limited Partnership Act (RULPA), adopted by most states, identifies safe harbor activities in which a limited partner may engage without compromising liability protection. Such activities include (1) working for the limited partnership, (2) advising a

Tax Talk

Recent IRS statistics indicate more than 4 million partnership returns are filed each year.

²¹ The term *partnership* encompasses syndicates, groups, pools, joint ventures, or any other unincorporated business organization. §761(a).

²² See the discussion of organizational and start-up costs in Chapter 7.

²³ See, for example, *Elrod*, 87 T.C. 1046 (1986) and *Kuhl v. Garner*, 894 P.2d 525 (Oregon, 1995).

LO 10-3

Explain how limited liability companies (LLCs) are treated for federal tax purposes.

general partner regarding the partnership business, and (3) voting on partnership matters. Although many limited partners are content to act as passive investors, RULPA permits an expanded role where desired.

Individuals who perform professional services for patients or clients, such as doctors, attorneys, and CPAs, often form **limited liability partnerships (LLPs)**. General partners in an LLP are not personally liable for malpractice-related claims arising from the professional negligence of any other partner. However, they are personally liable for other debts of the LLP.²⁴

Limited Liability Partnership

Doctors Jeff Batson, Susan Lloyd, and Cary Carew formed an LLP to conduct their medical practice. The three doctors are general partners. This year, the LLP is the defendant in two lawsuits.

The first lawsuit was initiated by a former LLP employee who claims that she was fired from her job because of age discrimination. Consequently, the ex-employee is suing the LLP for \$600,000 damages. The second lawsuit was initiated by the family of a patient who died shortly after Dr. Carew performed a routine surgical procedure. Because the family believes that Dr. Carew was grossly negligent, it is suing the LLP for \$1.2 million in damages.

If the LLP loses the first lawsuit, the three general partners are personally liable for any portion of the \$600,000 settlement not covered by the LLP's insurance. If the LLP loses the second lawsuit, only Dr. Carew is personally liable for any portion of the \$1.2 million settlement not covered by the LLP's or his own malpractice insurance.

Tax Talk

The Second Circuit Court of Appeals held the owner of a single-member LLC personally liable for the LLC's unpaid payroll tax. The court held that under the check-the-box regulations, the LLC was treated as a "sole proprietorship" for federal tax purposes and "disregarded as an entity separate from its owner." The court rejected the taxpayer's argument that the regulations wrongfully ignored the limited liability provided to LLC owners under state law. McNamee v. U.S., 99 AFTR 2d 2007-2871 (CA-2, 2007).

Limited Liability Companies

Business owners often prefer the partnership form to the corporate form because partnership income is not taxed at the entity level but only at the owner level. The partnership form also provides the greatest flexibility in the manner in which business income can be divided among the co-owners. The major disadvantage of the partnership form is the unlimited personal liability of the general partners for business debt.

Every state (and the District of Columbia) permits business owners to organize as a **limited liability company (LLC)** as an alternative to a general or limited partnership. An LLC is an unincorporated legal entity owned by one or more *members*. In contrast to a partnership, every member has limited liability for the LLC's debts. This limited liability protects even those members who are actively involved in the LLC's business. State laws do not limit the number of members or the type of entity that can be a member in an LLC. Thus, an LLC's membership can include individuals, partnerships, corporations, and even other LLCs.

Under Treasury regulations that classify business entities for federal tax purposes (the check-the-box regulations), an LLC with two or more members is classified as a partnership.²⁵ Consequently, income earned by an LLC is not taxed at the entity level but passes through to the various members. An LLC with only one member (i.e., one owner) is a *disregarded entity* for federal tax purposes. If the single member is an individual, the LLC is treated as a sole proprietorship. If the single member is an entity, the LLC is treated as a division or branch of the entity.

LLCs offer business owners a terrific combination: one owner-level tax on income and limited liability for business debt. Moreover, LLCs are not subject to many of the

²⁴ The Big Four public accounting firms are LLPs.

²⁵ Reg. §301.7701-3(b)(1). Under this regulation, an LLC can elect to be classified as a corporation for federal tax purposes. There is no obvious reason why a domestic LLC would make such an election.

bothersome restrictions that apply to S corporations. As a result, LLCs are an attractive option for business ventures.

One major unresolved issue is the extent to which members are subject to self-employment tax on their LLC income. The self-employment tax statute was written before the advent of LLCs and is silent as to whether distributive shares of LLC business income are net earnings from self-employment. In 1997, the Treasury attempted to resolve this issue through proposed regulations.²⁶ The regulations contain elaborate rules for determining whether an LLC member may be regarded as a limited partner. If so, the member's share of LLC income is not self-employment income. If a member may not be regarded as a limited partner, both guaranteed payments and any share of LLC income are self-employment income. The tax professional community's reaction to these proposed regulations was extremely critical. Congress responded to the criticism by issuing a moratorium that prevented the Treasury from finalizing the 1997 regulations. To date, the Treasury has declined to make a second attempt to resolve this issue.

Self-Employment Income or Not?

Mrs. Miller is a member in Wooster LLC. She does not work for Wooster on a daily basis and does not receive guaranteed payments. However, last year she worked about 175 hours during October and November on a special marketing campaign for Wooster. Mrs. Miller's share of Wooster's ordinary business income last year was \$38,170. Because she is not involved in Wooster's business on a regular basis, Mrs. Miller could argue that she should be regarded as a limited partner and should not pay SE tax on her share of LLC income. However, the IRS could argue that Mrs. Miller did perform substantial personal services for the LLC and therefore should treat her LLC income as earned income subject to SE tax.

Tax Basis in Partnership Interests

Partnerships are both legal entities (title to property can be held and conveyed in the partnership name) and accounting entities (financial books and records are maintained by the partnership). An equity interest in a partnership is an intangible asset, the value of which depends on the underlying value of the partnership business. Partnership interests are considered illiquid assets because partnership agreements usually prevent partners from disposing of their interests without the consent of the other partners. A partner's initial tax basis in a partnership interest equals the cash plus the adjusted basis of any property transferred to the partnership in exchange for the equity interest.²⁷

As legal entities, partnerships can borrow money in their own name. Nonetheless, general partners have unlimited liability for repayment of debt to the partnership's creditors. If the partnership business does not generate enough cash to service its debts, the general partners must contribute funds to satisfy any unpaid liabilities.²⁸ As a result, a partner's economic investment consists of the initial investment of cash or property *plus* the share of partnership debt for which the partner may ultimately be responsible. The tax law acknowledges this responsibility by providing that a partner's share of partnership debt is included in the basis in her partnership interest.²⁹

²⁶ Prop. Reg. §1.1402(a)-2(h).

²⁷ The exchange of property for a partnership interest is nontaxable to both the partner and the partnership (§721). See the discussion of partnership formations in Chapter 9.

²⁸ In this respect, a general partner's risk with respect to the partnership business is equivalent to a sole proprietor's business risk.

²⁹ §752(a).

*Basis in
Partnership
Interest*

Three individuals each contributed \$10,000 cash to a new partnership in which they are equal general partners. The partnership immediately borrowed \$24,000 from a local bank and used the money to purchase equipment and supplies. Each partner's basis in his partnership interest is \$18,000: the initial cash contribution plus an equal share of partnership debt.³⁰

Partnership Reporting Requirements

LO 10-4

Explain the flow-through of partnership items to the partners.

The Internal Revenue Code states that “a partnership as such shall not be subject to the income tax. . . . Persons carrying on a business as partners shall be liable for income tax only in their separate or individual capacities.”³¹ Although partnerships are not taxable entities, they are required to file an annual Form 1065 (U.S. Partnership Return of Income) with the IRS.³²

The taxable income generated by partnership activities is measured and characterized at the entity level. All items of gross income and deduction relating strictly to business operations are reported on page 1 of Form 1065. The net of these items is reported on line 22 as ordinary income or loss. This income or loss is allocated among the partners according to the sharing ratio specified in the partnership agreement. The partners report their share of income or loss on their respective returns and include it in the calculation of taxable income. Accordingly, net profit from a partnership business is taxed directly to the partners; the tax rate depends on whether the partner is an individual or a corporation.³³ Because partnerships serve only as conduits of income, they are described as **passthrough entities**.

*Faux Antiques—
Partnership*

Refer to our earlier example in which Mr. Tom Owen operates a furniture business (Faux Antiques) as a sole proprietorship. Let's change the facts by assuming that Mr. Owen and two co-owners organized Faux Antiques as a partnership. Mr. Owen owns a 60 percent equity interest as a general partner. Faux Antiques generated \$304,900 ordinary business income for 2018. Page 1 of the partnership's Form 1065 is shown as Exhibit 10.3.

Partnerships frequently recognize items of income, gain, expense, or loss that don't relate to business operations. For example, a partnership might invest excess cash in marketable securities that pay dividends and interest. The partnership might recognize gain or loss on the sale of one of these securities. Or the partnership could make a contribution to a local charity. These items are not included in the calculation of ordinary business income or loss.

³⁰ The regulatory rules for calculating a partner's share of partnership debt are extremely complex. The simplest summary of these rules is that recourse debt is shared only by general partners on the basis of their relative loss-sharing ratios and nonrecourse debt is shared by all partners on the basis of their profit-sharing ratios. Reg. §1.752-2 and Reg. §1.752-3.

³¹ 26 U.S. Code §701.

³² As a general rule, partnerships are required to use the same taxable year as that used by their partners. Under this rule, a partnership consisting of individual partners who are calendar year taxpayers files its Form 1065 on a calendar year basis. §706(b).

³³ If partnership income is allocated to a partner that is a passthrough entity (another partnership, LLC, or S corporation), the income is passed through again until it is finally allocated to a taxable entity (an individual or corporation).

EXHIBIT 10.3

Form 1065 Department of the Treasury Internal Revenue Service	U.S. Return of Partnership Income For calendar year 2018, or tax year beginning _____, 2018, ending _____, 20____ Go to www.irs.gov/Form1065 for instructions and the latest information.	OMB No. 1545-0123 2018
A Principal business activity Manufacturing	Type or Print	D Employer identification number 81-1138419
B Principal product or service Furniture		E Date business started February 1, 1990
C Business code number 337000		F Total assets (see instructions) \$ 1,136,460
Name of partnership Faux Antiques		
Number, street, and room or suite no. If a P.O. box, see instructions. 1012 East Main		
City or town, state or province, country, and ZIP or foreign postal code Wldener, NY 42714		

G Check applicable boxes: (1) Initial return (2) Final return (3) Name change (4) Address change (5) Amended return
H Check accounting method: (1) Cash (2) Accrual (3) Other (specify) _____
I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year. **3**
J Check if Schedules C and M-3 are attached.

Caution: Include **only** trade or business income and expenses on lines 1a through 22 below. See instructions for more information.

Income	1a Gross receipts or sales	1,117,300	
	1b Returns and allowances	21,000	
	1c Balance. Subtract line 1b from line 1a		1,096,300
	2 Cost of goods sold (attach Form 1125-A)		599,700
	3 Gross profit. Subtract line 2 from line 1c		496,600
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)		
	5 Net farm profit (loss) (attach Schedule F (Form 1040))		
	6 Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)		
7 Other income (loss) (attach statement)			
8 Total income (loss). Combine lines 3 through 7		496,600	
Deductions <small>(see instructions for limitations)</small>	9 Salaries and wages (other than to partners) (less employment credits)		73,200
	10 Guaranteed payments to partners		
	11 Repairs and maintenance		17,900
	12 Bad debts		8,800
	13 Rent		23,200
	14 Taxes and licenses		11,750
	15 Interest (see instructions)		7,300
	16a Depreciation (if required, attach Form 4562)	3,600	
	16b Less depreciation reported on Form 1125-A and elsewhere on return		3,600
	17 Depletion (Do not deduct oil and gas depletion.)		
	18 Retirement plans, etc.		
	19 Employee benefit programs		
20 Other deductions (attach statement)		45,960	
21 Total deductions. Add the amounts shown in the far right column for lines 9 through 20		191,700	
22 Ordinary business income (loss). Subtract line 21 from line 8		304,900	
Tax and Payment	23 Interest due under the look-back method—completed long-term contracts (attach Form 8697)		
	24 Interest due under the look-back method—income forecast method (attach Form 8866)		
	25 BBA AAR imputed underpayment (see instructions)		
	26 Other taxes (see instructions)		
	27 Total balance due. Add lines 23 through 27		
	28 Payment (see instructions)		
	29 Amount owed. If line 28 is smaller than line 27, enter amount owed		
	30 Overpayment. If line 28 is larger than line 27, enter overpayment		

Sign Here
 Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than partner or limited liability company member) is based on all information of which preparer has any knowledge.

Signature of partner or limited liability company member	Date	May the IRS discuss this return with the preparer shown below? See instructions. <input type="checkbox"/> Yes <input type="checkbox"/> No
Print/Type preparer's name	Preparer's signature	Date
Firm's name	Firm's EIN	Check <input type="checkbox"/> if self-employed
Firm's address	Phone no.	PTIN

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Instead, they are reported on Schedule K of Form 1065 and allocated to the partners for inclusion on the partners' returns.³⁴ These **separately stated items** retain their tax character as they pass through to the partners.³⁵

³⁴ More specifically, Reg. §1.702-1(a)(8)(ii) explains that each partner must be able to take into account separately his or her distributive share of any partnership item that results in an income tax liability different from that which would result if the item were not accounted for separately.

³⁵ §702(b).

Separately Stated Items

For several years, Faux Antiques partnership invested its excess cash in a mutual fund. In 2018, the partnership received a \$1,680 ordinary dividend from the fund and recognized a \$3,710 capital gain on sale of fund shares. During 2018, Faux Antiques made a \$3,000 donation to the United Way and distributed \$250,000 cash to its partners. The dividend, capital gain, donation, and distribution were not included in the computation of ordinary business income. Instead, these items were separately stated on Schedule K of Form 1065, which is shown as Exhibit 10.4.

EXHIBIT 10.4

Form 1065 (2018)		Page 4		
Schedule K		Partners' Distributive Share Items		
		Total amount		
Income (Loss)	1 Ordinary business income (loss) (page 1, line 22)	1	304,900	
	2 Net rental real estate income (loss) (attach Form 8825)	2		
	3a Other gross rental income (loss)	3a		
	3b Expenses from other rental activities (attach statement)	3b		
	3c Other net rental income (loss). Subtract line 3b from line 3a	3c		
	4 Guaranteed payments	4		
	5 Interest income	5		
	6 Dividends and dividend equivalents: a Ordinary dividends	6a	1,680	
	b Qualified dividends	6b	1,680	
	c Dividend equivalents	6c		
	7 Royalties	7		
8 Net short-term capital gain (loss) (attach Schedule D (Form 1065))	8			
9a Net long-term capital gain (loss) (attach Schedule D (Form 1065))	9a	3,710		
b Collectibles (28%) gain (loss)	9b			
c Unrecaptured section 1250 gain (attach statement)	9c			
10 Net section 1231 gain (loss) (attach Form 4797)	10			
11 Other income (loss) (see instructions) Type ▶	11			
Deductions	12 Section 179 deduction (attach Form 4562)	12		
	13a Contributions	13a	3,000	
	b Investment interest expense	13b		
	c Section 59(e)(2) expenditures: (1) Type ▶ (2) Amount ▶	13c(2)		
d Other deductions (see instructions) Type ▶	13d			
Self-Employment	14a Net earnings (loss) from self-employment	14a	304,900	
	b Gross farming or fishing income	14b		
	c Gross nonfarm income	14c		
Credits	15a Low-income housing credit (section 42(j)(5))	15a		
	b Low-income housing credit (other)	15b		
	c Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)	15c		
	d Other rental real estate credits (see instructions) Type ▶	15d		
	e Other rental credits (see instructions) Type ▶	15e		
	f Other credits (see instructions) Type ▶	15f		
Foreign Transactions	16a Name of country or U.S. possession ▶	16a		
	b Gross income from all sources	16b		
	c Gross income sourced at partner level	16c		
	Foreign gross income sourced at partnership level			
	d Section 951A category ▶ e Foreign branch category ▶	16e		
	f Passive category ▶ g General category ▶ h Other (attach statement) ▶	16h		
	Deductions allocated and apportioned at partner level			
	i Interest expense ▶ j Other ▶	16j		
	Deductions allocated and apportioned at partnership level to foreign source income			
	k Section 951A category ▶ l Foreign branch category ▶	16l		
	m Passive category ▶ n General category ▶ o Other (attach statement) ▶	16o		
	p Total foreign taxes (check one): ▶ Paid <input type="checkbox"/> Accrued <input type="checkbox"/>	16p		
q Reduction in taxes available for credit (attach statement)	16q			
r Other foreign tax information (attach statement)				
Alternative Minimum Tax (AMT) Items	17a Post-1986 depreciation adjustment	17a		
	b Adjusted gain or loss	17b		
	c Depletion (other than oil and gas)	17c		
	d Oil, gas, and geothermal properties—gross income	17d		
	e Oil, gas, and geothermal properties—deductions	17e		
	f Other AMT items (attach statement)	17f		
Other Information	18a Tax-exempt interest income	18a		
	b Other tax-exempt income	18b		
	c Nondeductible expenses	18c		
	19a Distributions of cash and marketable securities	19a	250,000	
	b Distributions of other property	19b		
	20a Investment income	20a	1,680	
b Investment expenses	20b			
c Other items and amounts (attach statement)				

Form 1065 (2018)

Tax Consequences to Partners

Distributive Shares and Cash Flows

LO 10-5
Differentiate between a distributive share of partnership income and cash flow.

After the close of its taxable year, a partnership issues a Schedule K-1 (Partner's Share of Income, Credits, Deductions, etc.) to each partner. Schedule K-1 provides detailed information concerning the partner's **distributive share** of the partnership's ordinary business income or loss and any separately stated items. The instructions to the schedule tell individual partners how and where to include each item on their tax return. For instance, a partner's distributive share of ordinary income or loss is reported on Schedule E of Form 1040.

Partners must pay tax on their distributive share of partnership taxable income, regardless of the cash flow from the partnership during the year. In an extreme case, partners may decide to retain all available cash in the partnership. As a result, each partner must find another source of funds to pay the tax on his share of partnership income. Alternatively, partners may decide to withdraw enough cash to pay their taxes. Another possibility is that the partners withdraw all available cash for personal consumption. The important point is that the cash flow is irrelevant in determining the partners' taxable income.

Schedule K-1 for Partner

Each partner in Faux Antiques received a 2018 Schedule K-1 showing a distributive share of ordinary business income, dividend income, capital gain, donation, and cash distribution. Tom Owen's Schedule K-1, which reflects his 60 percent share of each partnership item, is shown as Exhibit 10.5. Mr. Owen reported his \$182,940 share of Faux Antiques's business income as ordinary income on his Form 1040. He reported his \$1,008 share of dividend income as investment income and his \$2,226 share of capital gain as capital gain on his Form 1040. He included his \$1,800 share of Faux Antiques's donation in his total personal charitable contributions for 2018.³⁶ His \$150,000 share of the cash distribution had no effect on his 2018 taxable income.

Guaranteed Payments

The personal involvement of individual partners in the partnership business can vary greatly across partners. Limited partners, by definition, do not actively participate in the day-to-day operation of the business and, at most, may take part in major management decisions. General partners may have different levels of participation; some may be sporadically involved, while others may devote 100 percent of their workweek to the business.

Partners who work for the partnership on a continual basis expect to be compensated. These partners typically receive **guaranteed payments** from the partnership based on the value of their work. Guaranteed payments to partners are analogous to the salaries paid to partnership employees. The partnership deducts guaranteed payments in computing ordinary income, and partners report guaranteed payments as ordinary income.³⁷ However, partners can't be employees of their partnerships any more than individuals can be employees of their sole proprietorships. Because a guaranteed payment is not a salary, neither the partnership nor the partner pays FICA payroll tax. Nor does the partnership withhold any federal income tax from the guaranteed payment. If a partner earns a \$10,000 monthly guaranteed payment, that partner receives \$10,000 cash each month. At the end of the year, the partnership does not issue a Form W-2 to the partner. Instead, the total guaranteed payments are reported as an ordinary income item on the partner's Schedule K-1.

³⁶ The tax consequences of personal charitable contributions are discussed in Chapter 17.

³⁷ §707(c).

Self-Employment Income

Individual general partners are considered to be self-employed. Consequently, any guaranteed payments plus their distributive share of ordinary business income are net earnings from self-employment subject to SE tax and the .9 percent additional Medicare tax.³⁸ Limited partners are not considered self-employed and are not required to pay self-employment tax on their distributive share of ordinary income.³⁹

Self-Employment Income

Refer to Mr. Owen's Schedule K-1 from the Faux Antiques partnership (Exhibit 10.5). Line 14 shows that Mr. Owen's \$182,940 distributive share of business income represents net earnings from self-employment. Mr. Owen must report these earnings on a Schedule SE and compute his SE tax accordingly.

QBI Deduction and Excess Business Loss Limitation

Partners who are not corporations may be eligible for the QBI deduction with respect to qualified business income earned through a partnership. This deduction is computed by the partner, not by the partnership. However, the partnership is required to report to its partners the information needed to make the computation. Specifically, each partner will need his or her share of qualified business income, W-2 wages, and the unadjusted basis of qualified property held by the partnership.

Noncorporate partners must also apply the excess business loss limitation to their share of any business losses flowing through from a partnership. As discussed in Chapter 6 and earlier in this chapter in connection with sole proprietorships, aggregate 2019 business losses in excess of \$510,000 (married filing jointly) or \$255,000 (all other individuals) are not currently deductible. Instead, such excess losses carry forward as part of the taxpayer's NOL carryforward. The limitation is applied by each noncorporate partner, not by the partnership.

We should emphasize that the QBI deduction and the excess business loss limitation are partner-level computations, not partnership allocations. As such, these items do not affect the partner's basis in their partnership interest.

Partnership Losses and Excess Business Loss Limitation

Amelia is a partner in two partnerships. This year, Amelia's share of Partnership N's ordinary business income is \$193,000. Partnership Q allocated Amelia \$(460,000) of ordinary business loss. If Amelia is single, her excess business loss of \$(12,000) ($\$193,000 - \$460,000 + \$255,000$ single threshold) is not currently deductible. If Amelia is married and files a joint return, her loss deduction is not limited. Her net partnership loss of \$(267,000) is fully deductible against other sources of income.

Comprehensive Example

To summarize our discussion of the tax consequences of partnerships, consider the case of ABC Partnership. This business is owned by three individual partners. Ms. Alton and Mr. Bach are general partners who work in the business, and Ms. Cole is a limited partner. The partnership agreement provides that Ms. Alton and Mr. Bach are each allocated 40 percent

³⁸ §1402(a).

³⁹ §1402(a)(13).

EXHIBIT 10.5

651118
OMB No. 1545-0123

2018

Schedule K-1 (Form 1065)
Department of the Treasury
Internal Revenue Service

For calendar year 2018, or tax year beginning / / 2018 ending / /

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	182,940	15	Credits
2	Net rental real estate income (loss)			
3	Other net rental income (loss)		16	Foreign transactions
4	Guaranteed payments			
5	Interest income			
6a	Ordinary dividends	1,008		
6b	Qualified dividends	1,008		
6c	Dividend equivalents			
7	Royalties			
8	Net short-term capital gain (loss)		17	Alternative minimum tax (AMT) items
9a	Net long-term capital gain (loss)	2,226		
9b	Collectibles (28%) gain (loss)			
9c	Unrecaptured section 1250 gain		18	Tax-exempt income and nondeductible expenses
10	Net section 1231 gain (loss)			
11	Other income (loss)			
12	Section 179 deduction		19	Distributions
13	Other deductions	1,800	A	150,000
14	Self-employment earnings (loss)	182,940	A	Investment_Inc_1,008

*See attached statement for additional information.

For IRS Use Only

Part I Information About the Partnership

A Partnership's employer identification number
81-1138419

B Partnership's name, address, city, state, and ZIP code
Faux Antiques
1012 East Main
Widener, NY 42714

C IRS Center where partnership filed return
Cincinnati

D Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number
498-45-9058

F Partner's name, address, city, state, and ZIP code
Tom G. Owen
330 Aspen Lane
Widener, NY 42714

G General partner or LLC member-manager Limited partner or other LLC member

H Domestic partner Foreign partner

I1 What type of entity is this partner? Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	60 %	60 %
Loss	60 %	60 %
Capital	60 %	60 %

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse	\$	\$
Qualified nonrecourse financing	\$ 13,612	\$ 13,612
Recourse	\$ 21,050	\$ 21,050

L Partner's capital account analysis:

Beginning capital account	\$ 25,000
Capital contributed during the year	\$
Current year increase (decrease)	\$ 184,374
Withdrawals & distributions	\$(150,000)
Ending capital account	\$ 59,374

Tax basis GAAP Section 704(b) book
 Other (explain)

M Did the partner contribute property with a built-in gain or loss?
 Yes No
If "Yes," attach statement (see instructions)

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of income or loss, while Ms. Cole is allocated the remaining 20 percent. ABC pays a \$3,000 monthly guaranteed payment to Ms. Alton and a \$1,100 monthly guaranteed payment to Mr. Bach. For 2017, ABC's ordinary business income (after deducting the guaranteed payments) was \$90,800. ABC also earned \$3,300 interest income from a mutual bond fund investment. On December 24, ABC distributed \$20,000 cash to its partners (\$8,000 to Ms. Alton and Mr. Bach and \$4,000 to Ms. Cole). ABC reported the following information on each partner's 2017 Schedule K-1.

ABC Partnership 2017 Schedule K-1s			
	Ms. Alton	Mr. Bach	Ms. Cole
Guaranteed payments	\$36,000	\$13,200	–0–
Distributive shares:			
Ordinary business income	36,320	36,320	\$18,160
Interest income	1,320	1,320	660
Net earnings from self-employment	72,320	49,520	–0–
Cash distribution	8,000	8,000	4,000

The partners included their guaranteed payments and their share of business and interest income in taxable income, and Ms. Alton and Mr. Bach paid SE tax on their net earnings from self-employment. Assuming that Ms. Alton was in a 28 percent marginal tax bracket and both Mr. Bach and Ms. Cole were in a 31 percent marginal tax bracket, each partner's after-tax cash flow from ABC is computed as follows (note that in 2017, the QBI deduction was not available).

ABC Partner Cash Flows			
	Ms. Alton	Mr. Bach	Ms. Cole
Guaranteed payments	\$36,000	\$13,200	–0–
Cash distribution	8,000	8,000	\$ 4,000
SE tax*	(10,218)	(6,997)	–0–
Income tax	<u>(19,189)</u>	<u>(14,676)</u>	<u>(5,834)</u>
After-tax cash flow	<u>\$14,593</u>	<u>\$ (473)</u>	<u>\$ (1,834)</u>
Income tax calculation:			
Guaranteed payments	\$36,000	\$13,200	–0–
Ordinary business income	36,320	36,320	\$18,160
Interest income	1,320	1,320	660
One-half SE tax	<u>(5,109)</u>	<u>(3,499)</u>	<u>–0–</u>
Taxable income	\$68,531	\$47,341	\$18,820
	.28	.31	.31
Income tax	<u>\$19,189</u>	<u>\$14,676</u>	<u>\$ 5,834</u>

* Self-employment tax based on 92.35 percent of net earnings from self-employment. See footnote 20. Net earnings from self-employment as reported on Schedule K-1 are computed without regard to this reduction.

Ms. Alton had positive cash flow from the partnership, but both Mr. Bach and Ms. Cole had negative cash flows. This cash flow information reflects the fact that the three partners paid tax on partnership profits that they did not withdraw as cash from the business.

Adjusting the Basis of a Partnership Interest

LO 10-6

Adjust the tax basis in a partnership interest.

When a partner is allocated a share of partnership income but does not receive a cash distribution of that income, the partner is making an additional investment in the partnership. The partner should be entitled to recover this investment tax-free at some future date. When a partner receives a cash distribution, the distribution is treated as a nontaxable return of investment.⁴⁰ These investment increases and decreases are captured as positive and

⁴⁰ §731(a) and §733. If a partner receives a cash distribution that exceeds the partner's basis, the excess distribution is recognized as capital gain.

negative year-end adjustments to the tax basis in the partner's interest in the partnership.⁴¹ Let's continue the comprehensive example by computing the ABC partners' basis adjustments for 2017. The partner's initial basis on January 1, 2017, carries forward from 2016 and is assumed as follows.

ABC Partner Basis Adjustments for 2017*			
	Ms. Alton	Mr. Bach	Ms. Cole
Adjusted basis on January 1	\$35,000	\$60,000	\$100,000
Increased by:			
Ordinary business income	36,320	36,320	18,160
Interest income	1,320	1,320	660
Decreased by:			
Cash distribution	<u>(8,000)</u>	<u>(8,000)</u>	<u>(4,000)</u>
Adjusted basis on December 31	<u>\$64,640</u>	<u>\$89,640</u>	<u>\$114,820</u>

* This comprehensive example ignores any changes in partnership liabilities that would affect the partners' basis.

When a partnership generates an ordinary business loss or a separately stated loss, each partner's share of the loss represents a decrease in the partner's investment that is captured as a negative basis adjustment. Year-end basis adjustments for losses are made after any adjustments for income items or cash distributions.⁴²

To illustrate the negative basis adjustment for losses, assume that ABC Partnership generated a \$99,200 operating loss (after deducting Ms. Alton's and Mr. Bach's guaranteed payments) in 2018. ABC earned \$2,400 interest income and recognized a \$19,600 capital loss on the sale of mutual fund shares. The partnership made no cash distributions to its partners. ABC reported the following information on each partner's 2018 Schedule K-1.

ABC Partnership 2018 Schedule K-1s			
	Ms. Alton	Mr. Bach	Ms. Cole
Guaranteed payments	\$36,000	\$13,200	—0—
Distributive shares:			
Ordinary business loss	(39,680)	(39,680)	\$(19,840)
Interest income	960	960	480
Capital loss	(7,840)	(7,840)	(3,920)
Net earnings from self-employment	(3,680)	(26,480)	—0—
Cash distribution	—0—	—0—	—0—

The partners included their guaranteed payments and their share of interest income in taxable income. They also deducted their share of ordinary business loss and included their share of ABC's capital loss in their net capital gain or loss for 2018.⁴³ Because Ms. Alton and Mr. Bach had negative earnings from self-employment, they paid no SE tax for the year.

⁴¹ §705(a). Basis is also increased for a partner's distributive share of tax-exempt income.

⁴² Reg. §1.705-1(a). Basis is also decreased by a partner's distributive share of nondeductible expenses.

⁴³ This example assumes that the §465 at-risk limitation and the §469 passive activity loss limitation are inapplicable for all three partners. These limitations are discussed in Chapter 16. Each partner would also include their allocable loss from ABC in applying the excess business loss limitation discussed earlier in this chapter.

ABC Partner Basis Adjustments for 2018			
	Ms. Alton	Mr. Bach	Ms. Cole
Adjusted basis on January 1	\$64,640	\$89,640	\$114,820
Increased by:			
Interest income	960	960	480
Decreased by:			
Ordinary business loss	(39,680)	(39,680)	(19,840)
Capital loss	(7,840)	(7,840)	(3,920)
Adjusted basis on December 31	<u>\$18,080</u>	<u>\$43,080</u>	<u>\$ 91,540</u>

Basis Limitation on Loss Deductions

LO 10-7

Apply the basis limitation on the deduction of partnership losses.

As a general rule, partners may deduct their distributive share of partnership losses for the year. However, they must reduce the basis in their partnership interest by their share of losses, and the basis cannot be reduced below zero. If a partner's share of losses exceeds basis, the excess is not deductible in the current year.⁴⁴ The partner can carry the nondeductible loss forward indefinitely and can deduct it in a future year in which basis in the partnership interest is restored.

Suppose that ABC Partnership had another bad year in 2019. The partnership did not make any guaranteed payments to Ms. Alton or Mr. Bach. Even with this frugality, ABC's business generated a \$160,000 operating loss. ABC did earn \$3,000 interest income from its mutual fund and reported the following information on each partner's 2019 Schedule K-1.

ABC Partnership 2019 Schedule K-1s			
	Ms. Alton	Mr. Bach	Ms. Cole
Guaranteed payments	-0-	-0-	-0-
Distributive shares:			
Ordinary business loss	\$(64,000)	\$(64,000)	\$(32,000)
Interest income	1,200	1,200	600
Net earnings from self-employment	(64,000)	(64,000)	-0-
Cash distribution	-0-	-0-	-0-

Ms. Alton's and Mr. Bach's deduction for their share of loss is limited to the adjusted basis in their partnership interest immediately before the negative basis adjustment for the loss.

ABC Partner Basis Adjustments for 2019			
	Ms. Alton	Mr. Bach	Ms. Cole
Adjusted basis on January 1	\$ 18,080	\$ 43,080	\$91,540
Increased by:			
Interest income	1,200	1,200	600
Decreased by:			
Deductible loss	(19,280)	(44,280)	(32,000)
Adjusted basis on December 31	-0-	-0-	<u>\$60,140</u>
Nondeductible loss carryforward	\$(44,720)	\$(19,720)	-0-

⁴⁴ §704(d).

In 2019, all three partners must include their share of ABC's interest income in taxable income. Ms. Cole can deduct her entire \$32,000 share of ABC's ordinary business loss. Ms. Alton can deduct only \$19,280, and Mr. Bach can deduct only \$44,280 of their share of loss. Ms. Alton and Mr. Bach can carry their nondeductible loss into future taxable years, but they must restore basis in their partnership interests to deduct the carryforward. These partners could easily create basis by investing more money in ABC Partnership. But if the partnership's business is failing (as the 2018 and 2019 losses suggest), Ms. Alton and Mr. Bach could lose their additional investment. In such a case, they would have made the mistake of throwing good money after bad to secure a tax deduction. Of course, if ABC's business becomes profitable again, the partners' shares of future income will create basis against which Ms. Alton and Mr. Bach can deduct their loss carryforwards.

Let's complete our comprehensive example with one more year of ABC Partnership's operations. In 2020, the partnership generated \$64,400 ordinary business income after deducting an \$18,000 guaranteed payment to Ms. Alton and a \$6,600 guaranteed payment to Mr. Bach. ABC earned \$3,400 interest income and recognized an \$11,000 capital gain on the sale of mutual fund shares. ABC reported the following information on each partner's 2020 Schedule K-1.

ABC Partnership 2020 Schedule K-1s			
	Ms. Alton	Mr. Bach	Ms. Cole
Guaranteed payments	\$18,000	\$ 6,600	-0-
Distributive shares:			
Ordinary business income	25,760	25,760	\$12,880
Interest income	1,360	1,360	680
Capital gain	4,400	4,400	2,200
Net earnings from self-employment	43,760	32,360	-0-
Cash distribution	-0-	-0-	-0-

The partners included their guaranteed payments and their share of business, interest, and capital gain in taxable income, and Ms. Alton and Mr. Bach paid SE tax on their net earnings from self-employment. The partners increased the basis in their partnership interests by their share of income, and, as a result, Ms. Alton could deduct \$31,520 and Mr. Bach could deduct \$19,720 of their 2019 loss carryforwards in the computation of 2020 taxable income. Ms. Alton has a \$13,200 remaining loss carryforward that she can deduct to the extent of future increases in the basis in her ABC interest.

ABC Partner Basis Adjustments for 2020			
	Ms. Alton	Mr. Bach	Ms. Cole
Adjusted basis on January 1	-0-	-0-	\$60,140
Increased by:			
Ordinary business income	\$25,760	\$25,760	12,880
Interest income	1,360	1,360	680
Capital gain	4,400	4,400	2,200
	<u>\$31,520</u>	<u>\$31,520</u>	<u>\$75,900</u>
Decreased by:			
Deductible loss carryforward	(31,520)	(19,720)	-0-
Adjusted basis on December 31	-0-	<u>\$11,800</u>	<u>\$75,900</u>
Remaining loss carryforward	(13,200)	-0-	-0-

SUBCHAPTER S CORPORATIONS

Tax Talk

Recent IRS statistics indicate that more than 4.8 million S corporation returns are filed each year.

Before the advent of LLCs, business owners who wanted to avoid both the corporate income tax and the risk of unlimited personal liability had only one choice: the **subchapter S corporation**. This form of business organization is a corporate entity, organized as such under state law.⁴⁵ A predominant characteristic of corporations is the limited liability of their shareholders. If a corporation gets into financial trouble and can't pay its debts, the corporate creditors have no claim against the personal assets of the shareholders. Thus, the shareholders' risk is limited to their investment in the corporation.

For federal tax purposes, a subchapter S corporation is a passthrough entity; its business income is allocated and taxed directly to the corporation's shareholders.⁴⁶ The statutory rules providing for this passthrough are almost identical to the partnership rules. The ordinary income or loss generated by an S corporation's business is reported on page 1 of Form 1120S (U.S. Income Tax Return for an S Corporation). This income or loss is allocated among the shareholders based on their percentage ownership of the corporation's outstanding stock.⁴⁷ Recall from our discussion of partnerships that considerable flexibility is allowed in the allocation of income and loss items to partners. This flexibility is not permitted to S corporations and their shareholders. All S corporation allocations are strictly based on percentage ownership of stock.

Faux Antiques—S Corporation

Refer to our earlier example involving Mr. Tom Owen and his antique furniture restoration business. Let's change the facts again by assuming that Mr. Owen and his two co-owners incorporated the business as Faux Antiques Inc., which is an S corporation for federal tax purposes. Tom Owen owns 60 percent of the outstanding stock. Faux Antiques Inc. generated \$304,900 ordinary business income in 2018. Page 1 of the S corporation's Form 1120S is shown as Exhibit 10.6.

If an S corporation recognizes items of income, gain, deduction, or loss that don't relate to ordinary business operations, these items are separately stated on Schedule K of Form 1120S and retain their tax character as they flow through to the shareholders.

Separately Stated Items

In 2018, Faux Antiques Inc. received a \$1,680 ordinary dividend from a mutual fund and recognized a \$3,710 capital gain on sale of fund shares. During 2018, the corporation made a \$3,000 donation to the United Way and distributed \$250,000 cash to its shareholders. The dividend, capital gain, donation, and distribution were not included in the computation of ordinary business income. Instead, these items were separately stated on Schedule K of Form 1120S, which is shown as Exhibit 10.7.

Eligible Corporations

LO 10-8

Determine if a corporation is eligible to be an S corporation.

Only domestic corporations formed under the law of one of the 50 states or the District of Columbia are eligible to be S corporations for federal tax purposes. Eligibility is based on three statutory requirements.⁴⁸

⁴⁵ While a partnership must have at least two co-owners as partners, a corporation may be owned by one shareholder.

⁴⁶ §1363(a) and §1366.

⁴⁷ §1377(a).

⁴⁸ §1361. Corporations that have been operating as regular corporations and that meet the eligibility requirements can be converted to S corporations. Converted S corporations are subject to several troublesome corporate-level taxes that don't apply to original S corporations. See §1374 and §1375. In addition, an LLC that has "checked the box" to be treated as a corporation could also elect S status.

EXHIBIT 10.6

Form **1120S** U.S. Income Tax Return for an S Corporation

Department of the Treasury Internal Revenue Service

OMB No. 1545-0123

2018

Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation. Go to www.irs.gov/Form1120S for instructions and the latest information.

For calendar year 2018 or tax year beginning , 2018, ending , 20

A S election effective date **February 1, 1990**

B Business activity code number (see instructions) **337000**

C Check if Sch. M-3 attached

D Employer identification number **81-1138419**

E Date incorporated **February 1, 1990**

F Total assets (see instructions) \$ **1,136,640**

G Is the corporation electing to be an S corporation beginning with this tax year? Yes No If "Yes," attach Form 2553 if not already filed

H Check if: (1) Final return (2) Name change (3) Address change (4) Amended return (5) S election termination or revocation

I Enter the number of shareholders who were shareholders during any part of the tax year **3**

Caution: Include **only** trade or business income and expenses on lines 1a through 21. See the instructions for more information.

Income	1a Gross receipts or sales	1a	1,117,300
	b Returns and allowances	1b	21,000
	c Balance. Subtract line 1b from line 1a	1c	1,096,300
	2 Cost of goods sold (attach Form 1125-A)	2	599,700
	3 Gross profit. Subtract line 2 from line 1c	3	496,600
	4 Net gain (loss) from Form 4797, line 17 (attach Form 4797)	4	
5 Other income (loss) (see instructions—attach statement)	5		
6 Total income (loss). Add lines 3 through 5	6	496,600	
Deductions (see instructions for limitations)	7 Compensation of officers (see instructions—attach Form 1125-E)	7	
	8 Salaries and wages (less employment credits)	8	73,200
	9 Repairs and maintenance	9	17,900
	10 Bad debts	10	8,800
	11 Rents	11	23,200
	12 Taxes and licenses	12	11,750
	13 Interest (see instructions)	13	7,300
	14 Depreciation not claimed on Form 1125-A or elsewhere on return (attach Form 4562)	14	3,600
	15 Depletion (Do not deduct oil and gas depletion.)	15	
	16 Advertising	16	6,200
	17 Pension, profit-sharing, etc., plans	17	
18 Employee benefit programs	18		
19 Other deductions (attach statement)	19	39,750	
20 Total deductions. Add lines 7 through 19	20	191,700	
21 Ordinary business income (loss). Subtract line 20 from line 6	21	304,900	
Tax and Payments	22a Excess net passive income or LIFO recapture tax (see instructions)	22a	
	b Tax from Schedule D (Form 1120S)	22b	
	c Add lines 22a and 22b (see instructions for additional taxes)	22c	
	23a 2018 estimated tax payments and 2017 overpayment credited to 2018	23a	
	b Tax deposited with Form 7004	23b	
	c Credit for federal tax paid on fuels (attach Form 4136)	23c	
	d Refundable credit from Form 8827, line 8c	23d	
	e Add lines 23a through 23d	23e	
	24 Estimated tax penalty (see instructions). Check if Form 2220 is attached <input type="checkbox"/>	24	
	25 Amount owed. If line 23e is smaller than the total of lines 22c and 24, enter amount owed	25	
26 Overpayment. If line 23e is larger than the total of lines 22c and 24, enter amount overpaid	26		
27 Enter amount from line 26: Credited to 2019 estimated tax Refunded	27		

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer _____ Date _____ Title _____

May the IRS discuss this return with the preparer shown below (see instructions)? Yes No

Paid Preparer Use Only

Print/Type preparer's name _____ Preparer's signature _____ Date _____ Check if self-employed PTIN _____

Firm's name _____ Firm's EIN _____

Firm's address _____ Phone no. _____

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1. Only individuals, estates, certain trusts, and tax-exempt organizations may be shareholders, and nonresident aliens (persons who are neither citizens nor permanent residents of the United States) cannot be shareholders. This requirement ensures that the S corporation's income is taxed at the individual rates.
2. The number of shareholders is limited to 100. A family may elect for all family members to be treated as one shareholder.
3. The corporation can have only a single class of outstanding common stock; an S corporation cannot include preferred stock in its capital structure. Because of this requirement, shares of stock in an S corporation carry identical rights to corporate profits and assets. This requirement is not violated if the outstanding shares have different voting rights.

EXHIBIT 10.7

Schedule K Shareholders' Pro Rata Share Items		Total amount	
Income (Loss)	1 Ordinary business income (loss) (page 1, line 21)	1	304,900
	2 Net rental real estate income (loss) (attach Form 8825)	2	
	3a Other gross rental income (loss)	3a	
	b Expenses from other rental activities (attach statement)	3b	
	c Other net rental income (loss). Subtract line 3b from line 3a	3c	
	4 Interest income	4	1,680
	5 Dividends: a Ordinary dividends	5a	
	b Qualified dividends	5b	
	6 Royalties	6	
	7 Net short-term capital gain (loss) (attach Schedule D (Form 1120S))	7	
8a Net long-term capital gain (loss) (attach Schedule D (Form 1120S))	8a	3,710	
b Collectibles (28%) gain (loss)	8b		
c Unrecaptured section 1250 gain (attach statement)	8c		
9 Net section 1231 gain (loss) (attach Form 4797)	9		
10 Other income (loss) (see instructions) Type ▶	10		
Deductions	11 Section 179 deduction (attach Form 4562)	11	
	12a Charitable contributions	12a	3,000
	b Investment interest expense	12b	
	c Section 59(e)(2) expenditures (1) Type ▶ (2) Amount ▶	12c(2)	
d Other deductions (see instructions) Type ▶	12d		
Credits	13a Low-income housing credit (section 42(j)(5))	13a	
	b Low-income housing credit (other)	13b	
	c Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)	13c	
	d Other rental real estate credits (see instructions) Type ▶	13d	
	e Other rental credits (see instructions) Type ▶	13e	
	f Biofuel producer credit (attach Form 6478)	13f	
	g Other credits (see instructions) Type ▶	13g	
Foreign Transactions	14a Name of country or U.S. possession ▶	14a	
	b Gross income from all sources	14b	
	c Gross income sourced at shareholder level	14c	
	Foreign gross income sourced at corporate level		
	d Section 951A category	14d	
	e Foreign branch category	14e	
	f Passive category	14f	
	g General category	14g	
	h Other (attach statement)	14h	
	Deductions allocated and apportioned at shareholder level		
	i Interest expense	14i	
	j Other	14j	
	Deductions allocated and apportioned at corporate level to foreign source income		
	k Section 951A category	14k	
	l Foreign branch category	14l	
	m Passive category	14m	
	n General category	14n	
o Other (attach statement)	14o		
Other information			
p Total foreign taxes (check one): <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	14p		
q Reduction in taxes available for credit (attach statement)	14q		
r Other foreign tax information (attach statement)			
Alternative Minimum Tax (AMT) Items	15a Post-1986 depreciation adjustment	15a	
	b Adjusted gain or loss	15b	
	c Depletion (other than oil and gas)	15c	
	d Oil, gas, and geothermal properties—gross income	15d	
	e Oil, gas, and geothermal properties—deductions	15e	
	f Other AMT items (attach statement)	15f	
Items Affecting Shareholder Basis	16a Tax-exempt interest income	16a	
	b Other tax-exempt income	16b	
	c Nondeductible expenses	16c	
	d Distributions (attach statement if required) (see instructions)	16d	150,000
	e Repayment of loans from shareholders	16e	
Other Information	17a Investment income	17a	1,680
	b Investment expenses	17b	
	c Dividend distributions paid from accumulated earnings and profits	17c	
	d Other items and amounts (attach statement)		
Reconciliation	18 Income/loss reconciliation. Combine the amounts on lines 1 through 10 in the far right column. From the result, subtract the sum of the amounts on lines 11 through 12d and 14p	18	307,290

There are no statutory limits on an S corporation's invested capital, volume of sales, or number of employees. Consequently, S corporations can be very large corporate enterprises.

Subchapter S Election

An eligible corporation becomes an S corporation by the unanimous election of its shareholders.⁴⁹ The election is permanent for the life of the corporation unless shareholders owning a majority of the stock revoke the election.⁵⁰ The election is immediately terminated if the corporation loses its eligibility. For example, if a shareholder sells shares to a partnership (an ineligible shareholder), the election terminates as of the date of sale.⁵¹ The corporation is no longer a passthrough entity and is subject to the corporate income tax.

The inadvertent termination of an S election can be a tax planning disaster for the shareholders. Moreover, they generally cannot make a new election for five years.⁵² Because of the potential severity of the problem, the tax law provides a relief measure. If shareholders discover that an inadvertent termination has occurred and take immediate steps to correct the situation (repurchase the corporate stock from the partnership in our example), the IRS may allow the original S election to remain in effect.⁵³

Shareholders of closely held corporations, including S corporations, often enter into shareholder agreements to prevent negative consequences associated with undesirable transfers of stock. Shareholder agreements may provide that the corporation, or other shareholders, has a right of first refusal if one shareholder wants to dispose of his or her stock. Such an agreement could prevent a transfer to an ineligible shareholder, avoiding an inadvertent termination of the S corporation election.

Tax Basis in S Corporation Stock

A shareholder's initial tax basis in stock issued by an S corporation equals the cash plus the adjusted basis of any property transferred to the corporation in exchange for the stock.⁵⁴ When an S corporation incurs a debt, no shareholder has any personal liability. Accordingly, no S corporation debt is included in a shareholder's stock basis, even if the shareholder has guaranteed the debt.

LO 10-9

Identify similarities and differences in the tax treatment of S corporations versus partnerships.

Basis in S Corporation Stock

Three individuals each contributed \$10,000 cash to form a new S corporation. Each individual received 100 shares of the 300 shares of outstanding stock. The S corporation immediately borrowed \$24,000 from a local bank and used the money to purchase equipment and supplies. The bank required the shareholders to personally guarantee repayment of the loan. Each shareholder's basis in her S corporation stock is \$10,000: the initial cash contribution to the corporation.

Tax Consequences to Shareholders

After the close of its taxable year, an S corporation issues a Schedule K-1 (Shareholder's Share of Income, Credits, Deductions, etc.) to each shareholder. The Schedule K-1 has the

⁴⁹ §1362(a). To document consent to the election, each shareholder must file a signed Form 2553 with the IRS.

⁵⁰ §1362(d)(1).

⁵¹ §1362(e)(1).

⁵² §1362(g).

⁵³ §1362(f).

⁵⁴ The transfer of property to a corporation in exchange for stock is nontaxable to the transferors if they have at least 80 percent control of the corporation immediately after the transfer. §351. See the discussion of corporate formations in Chapter 9.

same function as a partnership Schedule K-1; it informs the owners of their **pro rata share** of business income or loss and any separately stated items.⁵⁵

The S corporation shareholders must incorporate the information on Schedule K-1 into their individual tax returns. Thus, the corporate income is taxed at the individual rates, and the shareholders pay the tax. The cash (if any) that the shareholders received from the corporation is irrelevant in determining their taxable income.

Schedule K-1 for Shareholder

Each shareholder in Faux Antiques received a 2018 Schedule K-1 showing a pro rata share of ordinary business income, dividend income, capital gain, donation, and cash distribution. Tom Owen's Schedule K-1, which reflects his 60 percent share of each corporate item, is shown as Exhibit 10.8. Mr. Owen reported his \$182,940 share of Faux Antiques's business income as ordinary income on his Form 1040. He reported his \$1,008 share of dividend income as investment income and his \$2,226 share of capital gain as capital gain on his Form 1040. He included his \$1,800 share of Faux Antiques's donation in his total personal charitable contributions for 2018. His \$150,000 share of the cash distribution had no effect on his 2018 taxable income.

QBI Deduction and Excess Business Loss Limitation

S corporation shareholders may be eligible for the Section QBI deduction with respect to qualified business income earned through an S corporation. The deduction is computed by the shareholder, not the S corporation. In addition, S corporation shareholders must also apply the excess business loss limitation to their share of any business losses flowing through from an S corporation. This limitation is applied by each shareholder, not by the S corporation.

Salary Payments

A significant difference between partnerships and S corporations is that an owner (shareholder) can be an employee of the corporation. Shareholders who work in the corporate business receive salaries as compensation for their services. Both the corporation and the employee pay the FICA payroll tax on the salary, and the corporation withholds federal income tax. At the end of the year, the corporation issues a Schedule K-1 and a Form W-2 to any shareholder/employee. S corporation shareholders are not considered to be self-employed. Therefore, their share of corporate business income is not subject to self-employment tax.⁵⁶

Payments to Shareholder/Employees

Milo Todd owns 20 percent of the stock in Sussex Inc., a calendar year S corporation, and is employed as the corporation's CEO. This year, Milo's salary from Sussex was \$75,000, from which Sussex withheld both employee FICA tax and state and local income tax. Sussex's ordinary business income (after deduction of all employee compensation) was \$984,000, and Milo's share of this income was \$196,800. Milo received a \$160,000 cash distribution from Sussex with respect to his stock. Milo must include \$271,800 (\$75,000 salary + \$196,800 share of corporate income) in taxable income. The \$160,000 cash distribution has no effect on Milo's taxable income.

⁵⁵ As previously discussed, partners are taxed on their distributive share of partnership income. In contrast, S corporation shareholders are taxed on their pro rata share of S corporation income. This difference in terminology is not simply semantics. The partnership allocation rules provide for considerably more flexibility in determining income allocations than the S corporation rules.

⁵⁶ Rev. Rul. 59-221, 1959-1 C.B. 225.

EXHIBIT 10.8

671117
OMB No. 1545-0123

Final K-1 Amended K-1

Schedule K-1 (Form 1120S) **2018**

Department of the Treasury For calendar year 2018, or tax year
Internal Revenue Service

beginning / / 2018 ending / /

Shareholder's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Corporation		Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items	
A Corporation's employer identification number 81-1138419		1 Ordinary business income (loss)	13 Credits
B Corporation's name, address, city, state, and ZIP code Faux Antiques 1012 East Main Widener, NY 42714	2 Net rental real estate income (loss)	182,940	
C IRS Center where corporation filed return Cincinnati	3 Other net rental income (loss)		
Part II Information About the Shareholder	4 Interest income		
D Shareholder's identifying number 487-45-9058	5a Ordinary dividends	1,008	
E Shareholder's name, address, city, state, and ZIP code Tom G. Owen 330 Aspen Lane Widener, NY 42714	5b Qualified dividends	1,008	14 Foreign transactions
F Shareholder's percentage of stock ownership for tax year 60 %	6 Royalties		
	7 Net short-term capital gain (loss)		
	8a Net long-term capital gain (loss)		
	8b Collectibles (28%) gain (loss)	2,226	
	8c Unrecaptured section 1250 gain		
	9 Net section 1231 gain (loss)		
	10 Other income (loss)		15 Alternative minimum tax (AMT) items
	11 Section 179 deduction		16 Items affecting shareholder basis
	12 Other deductions		
	A Charitable_contr_1,800		
			17 Other information
			D Distribution_150,000
* See attached statement for additional information.			

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Note that salary payments to S corporation shareholders are generally deductible in computing ordinary income from the business. Thus, a shareholder receiving a salary payment will report greater salary income and less ordinary income. While the net impact on the shareholder's taxable income may be zero, the payroll tax cost of the salary payment creates an incentive for S corporations to understate salary payable to shareholders. As a result, the IRS tends to carefully scrutinize salary payments to S corporation shareholders to ensure that adequate compensation (and adequate payroll tax) is paid given the shareholder's efforts.

Adequate Salary Payments to Shareholder/Employees

Maxwell owns 100 percent of the stock of Golden Inc., a calendar year S corporation. Maxwell spends 60 hours a week working for the corporation. During the current year, Golden earned \$200,000 of ordinary income, before any salary payments to Maxwell. If Maxwell is paid \$100,000 of salary, the corporation will owe \$7,650 employer payroll taxes on this income. Remaining corporate ordinary income, allocated and taxable to Maxwell, will be \$92,350. Maxwell will pay \$7,650 employee payroll tax on his salary income, and personal income tax on \$192,350, his salary and income allocated from the S corporation. If Maxwell's marginal tax rate is 37 percent, his income tax on his salary and S corporation earnings is \$71,170, and his total tax burden (payroll and income tax) related to his S corporation is \$78,820.

If Maxwell does not take a salary from Golden, he will report and pay tax on \$200,000 total S corporation earnings, resulting in additional tax liability of only \$74,000. However, if the IRS audits either Maxwell or Golden, it will likely assert that Maxwell should be reasonably compensated for his work on behalf of the corporation, and assess additional payroll tax liability on both the corporation and the shareholder.

Adjusting the Basis of S Corporation Stock

Shareholders make positive and negative adjustments to the basis in their S corporation stock in much the same way as partners adjust the basis in their partnership interests.⁵⁷ Specifically, shareholders increase the basis in their stock by their share of the corporation's income and gain for the year. Conversely, shareholders reduce the basis by their share of any corporate losses. Cash distributed by an S corporation to a shareholder is a nontaxable return of investment that reduces stock basis.⁵⁸ Recall, however, that the basis of S corporation stock does not reflect changes in entity debt.

Basis Limitation on Loss Deductions

LO 10-10

Apply the basis limitation on the deduction of S corporation losses.

The tax law imposes the same limitation on S corporation losses as it does on partnership losses: Such losses are currently deductible only to the extent of the owner's investment. Under the limitation rule for S corporations, a shareholder can deduct an amount of loss that reduces his stock basis to zero.⁵⁹ If a shareholder also has basis in any debt obligation from the S corporation, the shareholder may deduct additional loss to reduce the debt basis to zero.⁶⁰ In other words, a shareholder's investment that can be recovered through tax deductions includes both his equity investment and his investment as a corporate creditor.

Nondeductible S Corporation Loss

Ms. Jentz owns 25 percent of the outstanding stock of SGM, a calendar year S corporation. At the beginning of 2018, Ms. Jentz's basis in her stock was \$81,000. Several years ago, Ms. Jentz loaned \$30,000 to SGM in return for its interest-bearing note. For 2018, SGM incurred a \$500,000 operating loss. Although Ms. Jentz's Schedule K-1 reflects a \$125,000 loss, Ms. Jentz can deduct only \$111,000 of the loss on her Form 1040.

	Stock Basis	Note Basis
Beginning of year	\$ 81,000	\$30,000
Deductible loss	(81,000)	(30,000)
End of year	-0-	-0-
Nondeductible loss	\$(14,000)	

⁵⁷ §1367(a).

⁵⁸ Salary payments to shareholder/employees have no effect on stock basis. If a shareholder receives a cash distribution that exceeds stock basis, the excess distribution is recognized as a capital gain. §1368.

⁵⁹ §1366(d)(1)(A).

⁶⁰ §1366(d)(1)(B).

Ms. Jentz's \$14,000 nondeductible loss is carried forward into future years. If she creates basis by making an additional investment in SGM as either a shareholder or a creditor, she can deduct the loss to the extent of the additional basis. Alternatively, if SGM generates future income, Ms. Jentz's share of *undistributed* income will first increase the basis in her note to its \$30,000 face amount and will then increase her stock basis.⁶¹ Ms. Jentz can deduct her loss carryforward to the extent of her restored basis.

Basis Restoration

Ms. Jentz's 25 percent share of SGM's 2019 income is \$50,000. The corporation made no cash distributions during the year. The undistributed income increases Ms. Jentz's investment basis and allows her to deduct the \$14,000 loss carryforward from 2018 on her 2019 return.

	<i>Stock Basis</i>	<i>Note Basis</i>
Beginning of year	–0–	–0–
Share of income:		
Increase to note basis		\$30,000
Increase to stock basis	<u>\$20,000</u>	
	\$20,000	\$30,000
Loss carryforward	<u>(14,000)</u>	
End of year	<u>\$ 6,000</u>	<u>\$30,000</u>

Because of the deduction for her loss carryforward, Ms. Jentz's 2019 taxable income includes only \$36,000 SGM income.

If SGM were to repay the \$30,000 loan from Ms. Jentz before her basis in the note was restored to its face amount, the repayment would be treated as an amount realized on sale of the note. Because the note is a capital asset to Ms. Jentz, she would recognize a capital gain equal to the excess of the repayment over her basis.⁶²

Gain on Repayment of Debt

Change the facts in the previous example by assuming that SGM retired its debt to Ms. Jentz by paying her \$30,000 (plus accrued interest) on June 30, 2019. Assume also that SGM distributed \$50,000 cash to Ms. Jentz to match her \$50,000 share of 2019 income. In this case, Ms. Jentz had no 2019 *undistributed* income to restore basis in either her SGM note or her SGM stock. Consequently, she must recognize a \$30,000 long-term capital gain on repayment of the note and cannot deduct any of her 2018 loss carryforward.

Conclusion

In this chapter, we've examined the tax consequences of operating a business as a sole proprietorship or as a passthrough entity. In the case of a sole proprietorship, the business income is included in the owner's taxable income and taxed at the individual rates. In the case of a general or limited partnership, LLC, or S corporation, the business income is allocated to the owners of the entity. The income is taxed directly to the partners, members, or shareholders at their marginal rate. Many owners deliberately use these organizational forms to avoid paying an entity-level tax on business income. This tax strategy is one of the topics covered in Chapter 11. Before we can evaluate this strategy, we must examine the tax consequences of operating a business as a regular corporation.

⁶¹ §1367(b)(2).

⁶² §1271(a)(1) and Rev. Rul. 64-162, 1964-1 C.B. 304.

Key Terms

distributive share	10-21	limited liability company (LLC)	10-16	qualified business income	10-5
employee payroll tax	10-11	limited liability partnership (LLP)	10-16	self-employment (SE) tax	10-13
employer identification number	10-11	limited partnership	10-15	separately stated item	10-19
employer payroll tax	10-11	partnership	10-15	sole proprietorship	10-4
general partnership	10-15	passthrough entity	10-18	subchapter S corporation	10-28
guaranteed payment	10-21	pro rata share	10-32		
		QBI deduction	10-5		

Questions and Problems for Discussion

- LO 10-1** 1. Can a sole proprietorship be described as a passthrough entity?
- LO 10-1, 10-2** 2. Mrs. Liu owns a business as a sole proprietor. Near the end of her taxable year, she is evaluating a new opportunity that would generate \$25,000 additional income for her business. What marginal tax rate should Mrs. Liu use to compute the tax cost of this opportunity?
- LO 10-1** 3. This year, Mr. Pitt's sole proprietorship generated a \$17,000 net loss. Can Mr. Pitt use this loss as a net operating loss carryforward deduction?
- LO 10-2** 4. This year, Firm Q, a cash basis taxpayer, remitted \$26,800 FICA payroll tax to the federal government. However, the firm deducted only \$13,400 FICA tax on its income tax return. Can you explain this apparent inconsistency?
- LO 10-2** 5. Critique the employee payroll tax on the normative standards of convenience to the taxpayer and vertical equity.
- LO 10-2** 6. Define the tax base for the self-employment tax. When do sole proprietors pay the self-employment tax to the federal government?
- LO 10-1, 10-2** 7. Why is only half of a sole proprietor's self-employment tax deductible in the computation of taxable income?
- LO 10-3** 8. Tom, Angela, and Peter want to become co-owners of a business enterprise. Compare their personal liability for the debts incurred by the enterprise if they organize as:
- A general partnership.
 - A limited partnership.
 - An LLC.
 - An S corporation.
- LO 10-4** 9. Why are certain items of income, gain, deduction, or loss separately stated on a partnership or an S corporation tax return?
- LO 10-4** 10. This year, Soya Partnership disposed of only one operating asset and recognized a \$22,000 loss on the disposition. Why must Soya report this net Section 1231 loss as a separately stated item rather than deducting the loss in the computation of ordinary business income?
- LO 10-1** 11. Both Mr. A and Mr. Z are sole proprietors. This year, each proprietorship generated \$85,000 net cash flow from business operations. Mr. A used the cash to expand his business, while Mr. Z used the cash to make the down payment on a new home for his family. Discuss how the different uses of cash affect each man's federal income tax for the year.

- LO 10-3, 10-4** 12. Four years ago, Mr. Bates purchased 1,000 shares of UPF Inc. for \$10,000. These shares represent a 30 percent equity interest in UPF, which is an S corporation. This year, UPF defaulted on a \$120,000 unsecured debt to a major creditor.
- To what extent can the creditor demand repayment of the debt from Mr. Bates?
 - Would your answer change if UPF is a partnership in which Mr. Bates is a 30 percent general partner?
 - Would your answer change if UPF is a partnership in which Mr. Bates is a 30 percent limited partner?
 - Would your answer change if UPF is an LLC in which Mr. Bates is a 30 percent member?
- LO 10-6, 10-9** 13. Mr. Yang sold his interest in a business to an unrelated purchaser for \$500,000 cash. How does Mr. Yang determine his adjusted basis for purposes of computing gain or loss realized on the sale if the business is:
- A sole proprietorship?
 - A partnership?
 - An S corporation?
- LO 10-4, 10-5** 14. Corporation ABC sold its interest in KK Partnership on October 9 for \$150,000. KK Partnership uses a calendar year for tax purposes. Explain the reason why Corporation ABC cannot compute gain or loss realized on the date that the sale occurs.



All applicable Application Problems are available with *Connect*.

Application Problems

- LO 10-1, 10-2** 1. James Jones is the owner of a small retail business operated as a sole proprietorship. During 2018, his business recorded the following items of income and expense.

Revenue from inventory sales	\$147,000
Cost of goods sold	33,500
Business license tax	2,400
Rent on retail space	42,000
Supplies	15,000
Wages paid to employees	22,000
Payroll taxes	1,700
Utilities	3,600

- Compute taxable income attributable to the sole proprietorship by completing Schedule C to be included in James's 2018 Form 1040.
 - Compute self-employment tax payable on the earnings of James's sole proprietorship by completing a 2018 Schedule SE, Form 1040.
 - Assume that James's business is not a service business, and that it has \$155,000 unadjusted basis in tangible depreciable property. Calculate James's 2018 QBI deduction, before any overall taxable income limitation.
- LO 10-1** 2. Rhea is a self-employed professional singer. She resides in a rented apartment and uses one room exclusively as a business office. This room includes 225 of the 1,500 square feet of living space in the apartment. Rhea performs in recording studios and concert halls, but she conducts all of the administrative duties with respect to the business in her home office. This year, Rhea's apartment rent was \$48,000. She paid \$5,200 to a

housekeeping service that cleaned the entire apartment once a week and \$2,000 for renter's insurance on the apartment furnishings. Compute Rhea's home office deduction assuming that:

- a. Her net profit before the deduction was \$300,000.
 - b. Her net profit before the deduction was \$4,000.
- LO 10-1** 3. Marcia, a single individual, has qualified trade or business income of \$240,000. Her business paid \$80,000 of W-2 wages this year and has \$50,000 of tangible business property.
- a. Compute Marcia's QBI deduction, assuming her overall taxable income before QBI is \$300,000.
 - b. Compute Marcia's QBI deduction, assuming her overall taxable income before QBI is \$180,000.
- LO 10-1** 4. Evan, a single individual, operates a service business that earned \$110,000 in 2018. The business has no tangible property and paid no W-2 wages.
- a. Compute Evan's QBI deduction, assuming his overall taxable income before QBI is \$125,000.
 - b. Compute Evan's QBI deduction, assuming his overall taxable income before QBI is \$165,000.
- LO 10-1** 5. Colin, a self-employed consultant, uses a room of his home as a business office. This room represents 10 percent of the home's square footage. This year, Colin incurred the following expenses in connection with his home.

Home mortgage interest	\$12,980
Property tax on residence	2,200
Homeowner's insurance	1,475
Utilities	2,100
Furnace repairs	300

Colin purchased the home in 2000 for \$225,000. For MACRS depreciation purposes, he allocated \$185,000 to the building and \$40,000 to the land.

- a. If Colin's gross business income exceeded his operating expenses by \$75,000, compute his net profit for the year.
 - b. If Colin's gross business income exceeded his operating expenses by \$1,800, compute his net profit for the year.
- LO 10-2** 6. Mr. Williams is employed by BDF Inc. Compute BDF's 2019 employer payroll tax with respect to Mr. Williams assuming that:
- a. His annual compensation is \$60,000.
 - b. His annual compensation is \$200,000.
- LO 10-2** 7. Refer to the facts in the preceding problem. Assume that in the year 2020, the Social Security base amount increases to \$135,000. Compute BDF's 2020 employer payroll tax with respect to Mr. Williams assuming that:
- a. His annual compensation is \$60,000.
 - b. His annual compensation is \$200,000.
- LO 10-2** 8. For 2019, Ms. Deming earned wages totaling \$225,000. Calculate any .9 percent additional Medicare tax owed, assuming that:
- a. Ms. Deming is single.
 - b. Ms. Deming files a joint return with her husband who earned \$100,000 of wages for 2019.

- LO 10-2** 9. Calculate the total Social Security and Medicare tax burden on a sole proprietorship earning 2019 profit of \$300,000, assuming a single sole proprietor with no other earned income.
- LO 10-2** 10. Mrs. Singer owns a profitable sole proprietorship. For each of the following cases, use a Schedule SE, Form 1040, to compute her 2018 self-employment tax and her income tax deduction for such tax.
- Mrs. Singer's net profit from Schedule C was \$51,458. She had no other earned income.
 - Mrs. Singer's net profit from Schedule C was \$51,458, and she received a \$100,000 salary from an employer.
 - Mrs. Singer's net profit from Schedule C was \$51,458, and she received a \$137,000 salary from an employer.
- LO 10-1, 10-2** 11. In 2019, Wilma Way's sole proprietorship, WW Bookstore, generated \$120,000 net profit. In addition, Wilma recognized a \$17,000 gain on the sale of business furniture and shelving, all of which was recaptured as ordinary income. The business checking account earned \$960 interest income.
- Which of these income items are subject to self-employment tax?
 - Compute Wilma's 2019 self-employment tax.
 - Compute Wilma's allowable QBI deduction, assuming \$43,000 of W-2 wages and \$90,000 unadjusted basis of tangible depreciable property. Further assume the overall taxable income limitation on QBI does not apply.
 - Compute Wilma's 2019 taxable income from her bookstore activity.
- LO 10-1, 10-2** 12. JC recently graduated from veterinary school and opened her own professional practice. This year, her net profit was \$32,000. Assume JC does not qualify for the QBI deduction. Compute JC's after-tax income from her practice assuming:
- Her self-employment tax is \$4,522, and her marginal income tax rate is 22 percent.
 - What percentage of the federal tax burden on JC's business income is represented by the self-employment tax?
- LO 10-2** 13. Jane is a self-employed attorney. This year, her net profit exceeded \$350,000, which put her in the 37 percent tax bracket. Early in the year, Jane hired Ben as a paralegal and paid him a \$33,000 salary.
- Compute the employer payroll tax on Ben's salary.
 - In addition to the employer payroll tax, Jane paid \$400 unemployment tax on Ben's salary. The salary and tax expense reduced Jane's net earnings from self-employment, thereby saving \$962 in self-employment tax. Compute Jane's after-tax cost of hiring Ben.
- LO 10-6** 14. AB Corporation and YZ Corporation formed a partnership to construct a shopping mall. AB contributed \$500,000 cash, and YZ contributed land (\$500,000 FMV and \$430,000 basis) in exchange for a 50 percent interest in ABYZ Partnership. Immediately after its formation, ABYZ borrowed \$250,000 from a local bank. The debt is recourse (unsecured by any specific partnership asset). Compute each partner's initial basis in its partnership interest, assuming that:
- Both AB and YZ are general partners.
 - AB is a general partner, and YZ is a limited partner.
- LO 10-4** 15. This year, FGH Partnership generated \$600,000 ordinary business income. FGH has two equal partners: Triad LLC and Beta, an S corporation. Triad LLC has three members: Mr. T, who owns a 40 percent interest; Mrs. U, who owns a 35 percent interest; and V Inc., which owns a 25 percent interest. Beta has 100 shares of outstanding stock,

all of which are owned by Ms. B. Identify the taxpayers who must pay tax on the partnership income, and determine how much income must be reported by each.

- LO 10-5** 16. Amit is a limited partner in Reynolds Partnership. This year, Amit's Schedule K-1 from Reynolds reflected \$50,000 of ordinary income, \$1,000 of interest income, and a cash distribution of \$35,000. Amit's marginal tax rate is 37 percent. Amit qualifies for the QBI deduction, without regard to the wage or taxable income limitations.
- Calculate the tax cost of Amit's partnership earnings this year.
 - Calculate Amit's after-tax cash flow from his partnership activity this year.
- LO 10-5, 10-6** 17. Kari is a limited partner in Lizard Partnership. This year, Kari's share of partnership ordinary income is \$20,000, and she received a cash distribution of \$30,000. Kari's tax basis in her partnership interest at the beginning of the year was \$50,000. Her marginal tax rate is 22 percent. Kari qualifies for the QBI deduction, without regard to the wage or taxable income limitations.
- Calculate the tax cost of Kari's partnership earnings this year.
 - Compute Kari's after-tax cash flow from her partnership activity this year.
 - Compute Kari's tax basis in her partnership interest at the ending of the year. Assume no change in her share of partnership liabilities during the year.
- LO 10-4, 10-5** 18. Rochelle is a limited partner in Megawatt Partnership. For 2019, her schedule K-1 from the partnership reported the following share of partnership items.

Ordinary income	\$25,000
Section 1231 loss	(3,000)
Nondeductible expense	1,000
Cash distribution	5,000

- Calculate the net impact of the given items on Rochelle's 2019 taxable income. Assume that Rochelle does not qualify for the QBI deduction.
 - Assume that Rochelle's marginal tax rate is 35 percent. Calculate her 2019 after-tax cash flow as a result of her interest in Megawatt.
- LO 10-4** 19. KLMN Partnership's financial records show the following.

Gross receipts from sales	\$670,000
Cost of goods sold	(460,000)
Operating expenses	(96,800)
Business meals	(6,240)
Section 1231 loss on equipment sale	(13,500)
Charitable contribution	(1,500)
Distributions to partners	(10,000)

Compute KLMN's ordinary business income for the year.

- LO 10-4, 10-6** 20. Refer to the facts in the preceding problem. Mr. T is a 10 percent general partner in KLMN. During the year, he received a \$1,000 cash distribution from KLMN.
- Compute Mr. T's share of partnership ordinary income and separately stated items.
 - If Mr. T's adjusted basis in his KLMN interest was \$45,000 at the beginning of the year, compute his adjusted basis at the end of the year. Assume that KLMN's debt did not change during the year.
 - How would your basis computation change if KLMN's debt at the end of the year was \$28,000 more than its debt at the beginning of the year?

- LO 10-4, 10-6** 21. Jayanthi and Krish each own a 50 percent general partner interest in the JK Partnership. The following information is available regarding the partnership's 2018 activities.

Sales revenue	\$500,000
Selling expenses	200,000
Depreciation expense	30,000
Long-term capital gain	9,000
Nondeductible expenses	2,000
Partnership debts, beginning of the year	100,000
Partnership debts, end of the year	120,000
Partnership distributions	
Jayanthi	50,000
Krish	50,000

- a.* Calculate the partnership's ordinary (nonseparately stated) income, and indicate which items must be separately stated.
- b.* Calculate Jayanthi's allocable share of partnership items.
- c.* If Jayanthi has no other sources of taxable income, what is her total gross income for 2018?
- d.* At the beginning of the year, Jayanthi's adjusted tax basis in her partnership interest was \$25,000. Calculate her ending adjusted tax basis in her partnership interest.
- LO 10-4** 22. Refer to the facts in the preceding problem.
- a.* Complete Schedule K, Form 1065, for the partnership.
- b.* Complete Schedule K-1, Form 1065, for Jayanthi.
- LO 10-6, 10-7** 23. This year, individual X and individual Y formed XY Partnership. X contributed \$50,000 cash, and Y contributed business assets with a \$50,000 FMV. Y's adjusted basis in these assets was only \$10,000. The partnership agreement provides that income and loss will be divided equally between the two partners. Partnership operations for the year generated a \$42,000 loss. How much loss may each partner deduct currently, and what basis will each partner have in her interest at the beginning of next year? Assume the excess business loss limitation does not apply to either X or Y.
- LO 10-7** 24. AV Inc. is a member of an LLC. This year, AV received a Schedule K-1 reporting a \$1,200 share of capital loss and a \$4,000 share of Section 1231 gain. During the year, AV recognized a \$5,000 capital loss on the sale of marketable securities and a \$17,000 Section 1231 loss on the sale of business equipment. What effect do the LLC losses have on AV's taxable income?
- LO 10-4** 25. Bonnie and George are equal general partners in BG Partnership. Bonnie receives a \$4,000 monthly guaranteed payment for services. This year, BG generated \$95,000 profit (before consideration of Bonnie's guaranteed payments).
- a.* Compute each partner's distributive share of ordinary business income.
- b.* Compute each partner's self-employment income.
- c.* How would your answers change if BG's profit was only \$32,000 instead of \$95,000?
- LO 10-6, 10-7** 26. Zelda owns a 60 percent general interest in YZ Partnership. At the beginning of 2018, the adjusted basis in her YZ interest was \$95,000. For 2018, YZ generated a \$210,000 business loss, earned \$14,600 dividend and interest income on its investments, and recognized a \$6,200 capital gain. YZ made no distributions to its partners and had no debt.
- a.* How much of her share of YZ's loss can Zelda deduct on her 2018 return? Assume the excess business loss limitation does not apply.

- b. Compute Zelda's adjusted basis in her YZ interest at the end of 2018.
- c. Would your answers change if Zelda received a \$5,000 cash distribution from YZ during 2018?
- LO 10-6, 10-7** 27. Refer to the facts in the preceding problem. In 2019, YZ generated \$7,000 ordinary business income and \$18,000 dividend and interest income. The partnership made no distributions. At the end of the year, YZ had \$21,000 debt.
- a. How much partnership income will Zelda report on her 2019 return? Assume the excess business loss limitation does not apply.
- b. Compute Zelda's adjusted basis in her YZ interest at the end of 2019.
- LO 10-6, 10-7, 10-9** 28. At the beginning of 2019, Ms. P purchased a 20 percent interest in PPY Partnership for \$20,000. Ms. P's Schedule K-1 reported that her share of PPY's debt at year-end was \$12,000, and her share of ordinary loss was \$28,000. On January 1, 2020, Ms. P sold her interest to another partner for \$2,000 cash.
- a. How much of her share of PPY's loss can Ms. P deduct on her 2019 return?
- b. Compute Ms. P's recognized gain on sale of her PPY interest.
- c. How would your answers to parts (a) and (b) change if PPY were an S corporation instead of a partnership?
- LO 10-6, 10-7** 29. On January 1, 2018, Leo paid \$15,000 for 5 percent of the stock in BLS, an S corporation. In November, he loaned \$8,000 to BLS in return for a promissory note. BLS generated a \$600,000 operating loss in 2018.
- a. How much of his share of the loss can Leo deduct on his 2018 return? Assume the excess business loss limitation does not apply.
- b. Compute Leo's basis in his BLS stock and his BLS note at the end of 2018.
- LO 10-6, 10-7** 30. Refer to the facts in the preceding problem. BLS generated \$408,000 ordinary business income in 2019.
- a. How much of Leo's share of this income is included in his 2019 taxable income?
- b. Compute Leo's basis in his BLS stock and his BLS note at the end of 2019.
- c. How would your answers change if BLS's ordinary business income was only \$220,000?
- LO 10-6** 31. Refer to the facts in part (c) of the preceding problem. In 2020, BLS repaid its \$8,000 debt to Leo before he restored any basis in the debt. How much gain or loss, if any, will Leo recognize as a result of the debt repayment?
- LO 10-9** 32. For each of the following situations, indicate whether the corporation is eligible to elect S corporation status.
- a. Carman Corporation has two shareholders, Carla and Manuel. Carla is a United States citizen permanently residing in Mexico. Manuel is a Mexican citizen permanently residing in the United States.
- b. Same given info as in part (a), except that Manuel resides in Mexico.
- c. Devin Corporation has 110 individual shareholders, of which 12 are members of the same family.
- d. Evans Corporation has two shareholders, Mark and Joan, who are both United States citizens and residents. Mark owns all of the 100 shares of Evans common stock outstanding, and Joan owns all of the 100 shares of Evans preferred stock outstanding.
- e. Grant Corporation has two shareholders: William, a United States citizen and resident, and ABC Partnership. ABC is a domestic partnership with six individual partners, all of whom are United States citizens and residents.

- LO 10-9** 33. Wanda is a 20 percent owner of Video Associates, which is treated as a passthrough entity for federal income tax purposes. This year, Wanda was allocated \$45,000 of ordinary income from Video Associates, \$1,000 of tax-exempt interest income, and \$2,000 of nondeductible expenses. Wanda also received a \$10,000 distribution from Video Associates this year. At the beginning of the year, Video Associates had outstanding debt of \$100,000. At the end of the year, the entity's outstanding debts increased to \$130,000.
- If Video Associates is a partnership, and her basis in her partnership interest at the beginning of the year is \$30,000, determine Wanda's tax basis in her partnership interest at year-end.
 - If Video Associates is an S corporation, and her basis in her S corporation stock at the beginning of the year is \$10,000, determine Wanda's tax basis in her corporate stock at year-end.
- LO 10-9** 34. Evan is the sole shareholder of Magic Roofing Company, a calendar year S corporation. Although Evan spends at least 30 hours per week supervising Magic's employees, he has never drawn a salary from Magic. Magic has been in existence for five years and has earned a profit every year. Evan withdraws \$50,000 of cash from the S corporation each year.
- Explain the tax consequences of Evan's cash withdrawals from the S corporation and their impact on Evan's taxable income and Magic's ordinary income.
 - An IRS agent has just begun examining the last three years of tax returns filed by Evan and Magic. He has questioned whether the \$50,000 withdrawals should be characterized as salary payments to Evan instead of shareholder distributions. What are the income tax consequences to Evan and Magic if these distributions are characterized as salary payments?
 - What are the payroll tax consequences to Evan and Magic if the distributions are characterized as salary payments? Calculate the total potential underpayment of both employee and employer payroll tax that could result from this audit.

Issue Recognition Problems

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

- LO 10-4** 1. Ellie has operated a sole proprietorship for six years during which net profit has been stable and Ellie's marginal tax rate has been a constant 24 percent. Ellie projects that her profit next year will be the same as this year. Consequently, she estimates her tax cost for next year based on a 24 percent rate. Late in the year, Ellie's husband graduated from law school and accepted an excellent offer of employment from a local firm.
- LO 10-2** 2. Javier is a full-time employee of B Inc. and operates a sole proprietorship. This year, his salary was \$70,000, and his net earnings from self-employment were \$60,000.
- LO 10-2** 3. Mr. and Mrs. Chou file a joint income tax return. Mr. Chou reports the income from his full-time landscaping business on a Schedule C, which lists him as the sole proprietor. He also reports 100 percent of the net profit as his self-employment income and pays SE tax accordingly. During the last several years, Mrs. Chou has worked at least 20 hours per week in her husband's business. However, Mr. Chou does not pay her a salary or wage for her services.
- LO 10-1** 4. Travis is a professional writer who maintains his business office in one room of his personal residence. The office contains Travis's desk, filing cabinets, personal computer

and printer, copying machine, phone system, and fax machine. It also contains his family's library of videotapes, music CDs, popular novels, and the set of encyclopedias used by his three children for their schoolwork.

- LO 10-4** 5. Lola owns a 15 percent limited interest in AF Partnership, which uses a calendar year for tax purposes. On April 12, Lola sold her entire interest to the R Corporation; consequently, she was a partner for only 102 days during the year. AF generated \$845,000 ordinary business income this year and recognized a \$70,000 capital gain on the November 13 sale of marketable securities.
- LO 10-6** 6. Nine years ago, Fred paid \$20,000 cash for a 2 percent limited interest in a very profitable partnership. Every year Fred has properly included his distributive share of partnership income in taxable income. This year, Fred sold his interest to an unrelated party for \$80,000 and computed a \$60,000 gain recognized on sale.
- LO 10-3** 7. The 18 partners in KT Limited Partnership unanimously voted to convert their partnership to an LLC. To make the conversion, each partner will exchange his interest in KT for a membership interest in the newly formed LLC.
- LO 10-9** 8. Four individuals are evaluating the tax cost of operating their business as an S corporation. They assume that the corporation will pay no tax on its annual business income. They plan to incorporate the business in a state with a 7 percent corporate income tax.
- LO 10-7** 9. Mr. Yang just sold his entire 20 percent interest in DK Partnership to an unrelated purchaser for \$7,500. Mr. Yang's adjusted basis in the interest was zero, and he had a \$12,000 carryforward of DK loss.
- LO 10-7** 10. Paula's Schedule K-1 from an LLC reported a \$12,000 share of ordinary loss and a \$1,900 share of capital loss. Paula's adjusted basis in her LLC interest before consideration of these losses was \$6,200.
- LO 10-4** 11. Marcus, a cash basis individual, is a general partner in MNOP Partnership. Both Marcus and MNOP use a calendar year for tax purposes. According to the partnership agreement, MNOP pays a \$10,000 guaranteed payment to Marcus on the last day of every calendar month. However, because of a bookkeeping error, the partnership did not pay (and Marcus did not receive) his final guaranteed payment for 2018 until January 10, 2019.
- LO 10-6, 10-7** 12. David's Schedule K-1 from DES, an S corporation, reported \$8,900 tax-exempt interest and \$4,700 ordinary loss. David's adjusted basis in his stock before consideration of these items was \$2,000.
- LO 10-9** 13. Mr. and Mrs. West are the only shareholders in WW, an S corporation. This year, WW paid \$21,000 to the caterers who provided food for the couple's silver wedding anniversary celebration.
- LO 10-8** 14. The 100 shares of NS's outstanding stock are owned by seven unrelated individuals. NS has an S corporation election in effect. Late in the year, one individual announces to his fellow shareholders that he intends to give his NS shares to his son-in-law, who is a citizen and resident of Canada.
- LO 10-4** 15. BR Inc. owns a 20 percent interest in a limited partnership. All the other partners are individual shareholders in BR. This year, BR sold land to the partnership for use in the partnership's business activity. BR's basis in the land was \$400,000, and the selling price was \$275,000. This price was determined by an independent appraiser.
- LO 10-4** 16. JKL Partnership uses the calendar year for tax purposes. For the current calendar year, the partnership generated \$1 million ordinary business income. Corporation L, a 10 percent limited partner in JKL, uses a fiscal year ending June 30 as its tax year.

- LO 10-6, 10-7** 17. FG Inc. owned a 3 percent limited interest in a partnership that has been unprofitable for several years. The partnership recently informed its partners that they must contribute additional capital if the partnership is to survive. FG decided not to contribute any more money and sent written notification to the general partner relinquishing its equity interest. On the date of notification, FG's adjusted basis in the interest was \$15,500.

Research Problems

- LO 10-4** 1. Don Ferris and Lou Lindberg are the two partners in F&L Partnership. The partnership agreement provides that all income is allocated equally between Don and Lou but in no case shall the allocation to Don be less than \$75,000 per year. (In other words, Don has a minimum guarantee of \$75,000.) This year, F&L generated \$107,200 net profit. Compute F&L's taxable income for the year and each partner's distributive share of that income.
- LO 10-2** 2. Max Coen is employed as a full-time police officer by the Memphis Police Department. He is required to abide by the department's rules of conduct, which apply whether he is on-duty or off-duty. With the department's permission, Max "moonlights" as a security guard for several public school districts. While serving as a security guard, he is required to wear his police uniform and to carry police equipment (gun, handcuffs, etc.). The school districts pay security guards on an hourly basis and do not withhold income tax or payroll tax. This year, Max earned a \$32,000 salary from the city of Memphis and \$8,100 wages from the school districts. Do Max's wages constitute net earnings from self-employment on which he must pay SE tax?
- LO 10-8** 3. Herold had been a calendar year S corporation since 1990. On October 10, 2019, Mrs. Hughes sold 18 shares of Herold stock to a foreign partnership, thereby terminating Herold's S election. Herold's taxable income for the entire 2019 calendar year was \$592,030. Describe the federal tax returns that Herold must file for 2019, determine how much income must be reported on each, and compute any corporate income tax that Herold must pay.
- LO 10-10** 4. At the beginning of the current year, Sandy Brewer had a zero basis in her 38 shares of stock in Lindlee, an S corporation, a zero basis in a \$5,000 note from Lindlee, and a \$7,400 carryforward of a prior year ordinary loss from Lindlee that she was unable to deduct because of the basis limitation. Early in February of the current year, Sandy was notified by Lindlee's attorney that the corporation was bankrupt. Consequently, Lindlee was defaulting on its \$5,000 debt to Sandy, and Sandy's 38 shares of stock were worthless. Describe the consequences to Sandy of the worthlessness of her Lindlee investments.



All applicable Tax Planning Cases are available with *Connect*.

Tax Planning Cases

- LO 10-1** 1. Mr. and Mrs. Janus operate a restaurant business as a sole proprietorship. The couple has decided to purchase \$85,000 of new kitchen equipment for the restaurant. They also want to buy two new automobiles—one for their personal use and one for their 19-year-old son's personal use. The two automobiles will cost \$65,000. Mr. and Mrs. Janus have \$70,000 in a savings account that they can use to partially fund these purchases. They intend to borrow the additional \$80,000 from a local bank at 7 percent annual interest. What steps should the couple take to minimize the after-tax cost of the borrowed funds?

- LO 10-4, 10-6, 10-7** 2. On March 1, 2019, Eve and Frank each contributed \$30,000 cash to the newly formed EF Partnership in exchange for a 50 percent general interest. The partnership immediately borrowed \$50,000 from an unrelated creditor, a debt that it does not have to repay for two years. In November, the partners estimate with reasonable certainty that EF's 2019 operating loss will be \$100,000. However, EF's business has started to generate positive cash flow, and the partners estimate that EF will be profitable in 2020, perhaps generating as much as \$125,000 ordinary income. In anticipation of these future profits, Eve and Frank are considering withdrawing their initial cash contributions from EF before Christmas. Eve and Frank are both in the 35 percent tax bracket. What tax planning advice can you offer the partners?
- LO 10-9, 10-10** 3. In the current year (year 0), Amisha became a shareholder in Sultan Inc., a calendar year S corporation, by contributing \$15,000 cash in exchange for stock. Shortly before the end of the year, Sultan's CFO notified Amisha that her pro rata share of ordinary loss for the year would be \$55,000. Amisha immediately loaned \$40,000 to Sultan in exchange for a two-year, interest-bearing corporate note. Consequently, she had enough stock and debt basis to allow her to deduct the \$55,000 loss on her current year return. Compute the NPV of Amisha's cash flow *associated with her loan* in the following three cases. In each case, assume she has a 35 percent marginal tax rate on ordinary income, a 15 percent rate on capital gains, and a 6 percent discount rate.
- For the next two years (years 1 and 2), Amisha's share of Sultan's ordinary income totaled \$49,000, and Sultan did not distribute cash to its shareholders. However, it did repay the \$40,000 loan plus \$3,800 interest in year 2.
 - For the next two years (years 1 and 2), Amisha's share of Sultan's ordinary income totaled \$19,100, and Sultan did not distribute any cash to its shareholders. However, it did repay the \$40,000 loan plus \$3,800 interest in year 2.
 - For the next two years (years 1 and 2), Amisha's share of Sultan's ordinary loss totaled \$11,400. In year 2, the corporation declared bankruptcy and defaulted on all its debts, including the loan from Amisha.
- LO 10-9** 4. Marla recently inherited \$50,000 and is considering two alternatives for investing these funds. Investment A is stock of a C corporation, expected to pay annual dividends of 8 percent. Investment B is stock of an S corporation. Based on income projections, Marla's share of the S corporation's ordinary income would be approximately \$10,000 per year. However, the S corporation does not expect to make cash distributions for the foreseeable future. Marla would hold either investment for three years, at which time she believes the C corporation stock could be sold for \$60,000 and the S corporation stock could be sold for \$90,000.
- Assume that the initial investment would be made in year 0, dividends on the C corporation stock would be received in years 1, 2, and 3; S corporation earnings would be allocated in years 1, 2, and 3; and either investment would be sold in year 3. Assume that Marla's S corporation income would not qualify for the QBI deduction. Also assume that Marla's marginal tax rate on ordinary income is 35 percent. Using a 4 percent discount rate, calculate the net present value of after-tax cash flows attributable to either investment, and make a recommendation to Marla regarding which investment she should choose.



Sample CPA Exam questions from Roger CPA Review are available in *Connect* as support for the topics in this chapter. These Multiple Choice Questions and Task-Based Simulations include expert-written explanations and solutions, and provide a starting point for students to become familiar with the content and functionality of the actual CPA Exam.