



McGraw-Hill's

Taxation of Individuals and Business Entities

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McGRAW-HILL'S TAXATION OF INDIVIDUALS AND BUSINESS ENTITIES, 2020 EDITION, ELEVENTH EDITION

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Dedications

We dedicate this book to:

My family and to Professor Dave Stewart for his great example and friendship.

Brian Spilker

My wife, Marilyn, daughters Margaret Lindley and Georgia, son Benjamin, and parents Bill and Linda.

Ben Ayers

My wife, Jill, and my children Annika, Corinne, Lina, Mitch, and Connor.

John Barrick

My family, Jane, Mark, Sarah, Chloe, Lily, Jeff, and Nicole, and to Professor James E. Wheeler, my mentor and friend.

Ed Outslay

JES, Tommy, and Laura.

John Robinson

My family: Dan, Travis, Alix, Alan, and Anna.

Connie Weaver

My wife, Anne, sons Matthew and Daniel, and daughters Whitney and Hayley.

Ron Worsham

About the Authors

Brian C. Spilker (PhD, University of Texas at Austin, 1993) is the Robert Call/Deloitte Professor in the School of Accountancy at Brigham Young University. He teaches taxation at Brigham Young University. He received both BS (Summa Cum Laude) and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Arthur Young & Co. (now Ernst & Young). After his professional work experience, Brian earned his PhD at the University of Texas at Austin. He received the Price Waterhouse Fellowship in Tax Award and the American Taxation Association and Arthur Andersen Teaching Innovation Award for his work in the classroom. Brian has also been awarded for his use of technology in the classroom at Brigham Young University. Brian researches issues relating to tax information search and professional tax judgment. His research has been published in journals such as *The Accounting Review*, *Organizational Behavior and Human Decision Processes*, *Journal of the American Taxation Association*, *Behavioral Research in Accounting*, *Journal of Accounting Education*, *Journal of Corporate Taxation*, and *Journal of Accountancy*.



Courtesy Brian Spilker

Ben Ayers (PhD, University of Texas at Austin, 1996) holds the Earl Davis Chair in Taxation and is the dean of the Terry College of Business at the University of Georgia. He received a PhD from the University of Texas at Austin and an MTA and BS from the University of Alabama. Prior to entering the PhD program at the University of Texas, Ben was a tax manager at KPMG in Tampa, Florida, and a contract manager with Complete Health, Inc., in Birmingham, Alabama. He is the recipient of 11 teaching awards at the school, college, and university levels, including the Richard B. Russell Undergraduate Teaching Award, the highest teaching honor for University of Georgia junior faculty members. His research interests include the effects of taxation on firm structure, mergers and acquisitions, and capital markets and the effects of accounting information on security returns. He has published articles in journals such as *The Accounting Review*, *Journal of Finance*, *Journal of Accounting and Economics*, *Contemporary Accounting Research*, *Review of Accounting Studies*, *Journal of Law and Economics*, *Journal of the American Taxation Association*, and *National Tax Journal*. Ben was the 1997 recipient of the American Accounting Association's Competitive Manuscript Award, the 2003 and 2008 recipient of the American Taxation Association's Outstanding Manuscript Award, and the 2016 recipient of the American Taxation Association's Ray M. Sommerfeld Outstanding Tax Educator Award.



Courtesy Ben Ayers

John Barrick (PhD, University of Nebraska at Lincoln, 1998) is currently an associate professor in the Marriott School at Brigham Young University. He served as an accountant at the United States Congress Joint Committee on Taxation during the 110th and 111th Congresses. He teaches taxation in the graduate and undergraduate programs at Brigham Young University. He received both BS and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Price Waterhouse (now PricewaterhouseCoopers). After his professional work experience, John earned his PhD at the University of Nebraska at Lincoln. He was the 1998 recipient of the American Accounting Association, Accounting, Behavior, and Organization Section's Outstanding Dissertation Award. John researches issues relating to tax corporate political activity. His research has been published in journals such as *Organizational Behavior and Human Decision Processes*, *Contemporary Accounting Research*, and *Journal of the American Taxation Association*.



Courtesy John Barrick

iv About the Authors



Courtesy Ed Outslay

Ed Outslay (PhD, University of Michigan, 1981) is a professor of accounting and the Deloitte/Michael Licata Endowed Professor of Taxation in the Department of Accounting and Information Systems at Michigan State University, where he has taught since 1981. He received a BA from Furman University in 1974 and an MBA and PhD from the University of Michigan in 1977 and 1981. Ed currently teaches graduate classes in corporate taxation, multiunit enterprises, accounting for income taxes, and international taxation. In February 2003, Ed testified before the Senate Finance Committee on the Joint Committee on Taxation's Report on Enron Corporation. MSU has honored Ed with the Presidential Award for Outstanding Community Service, the Distinguished Faculty Award, the John D. Withrow Teacher-Scholar Award, the Roland H. Salmonson Outstanding Teaching Award, the Senior Class Council Distinguished Faculty Award, the MSU Teacher-Scholar Award, and MSU's 1st Annual Curricular Service-Learning and Civic Engagement Award in 2008. Ed received the Ray M. Sommerfeld Outstanding Tax Educator Award in 2004 and the Lifetime Service Award in 2013 from the American Taxation Association. He has also received the ATA Outstanding Manuscript Award twice, the ATA/Deloitte Teaching Innovations Award, and the 2004 Distinguished Achievement in Accounting Education Award from the Michigan Association of CPAs. In 2017, Ed received the American Accounting Association / J. Michael and Mary Ann Cook Prize given in "foremost recognition of an individual who consistently demonstrates the attributes of a superior teacher in the discipline of accounting." Ed has been recognized for his community service by the Greater Lansing Chapter of the Association of Government Accountants, the City of East Lansing (Crystal Award), and the East Lansing Education Foundation. He received a National Assistant Coach of the Year Award in 2003 from AFLAC and was named an Assistant High School Baseball Coach of the Year in 2002 by the Michigan High School Baseball Coaches Association.



Courtesy John Robinson

John Robinson (PhD, University of Michigan, 1981) is the Patricia '77 and Grant E. Sims '77 Eminent Scholar Chair in Business. Prior to joining the faculty at Texas A&M, John was the C. Aubrey Smith Professor of Accounting at the University of Texas at Austin, Texas, and he taught at the University of Kansas where he was the Arthur Young Faculty Scholar. In 2009–2010 John served as the Academic Fellow in the Division of Corporation Finance at the Securities and Exchange Commission. He has been the recipient of the Henry A. Bubb Award for outstanding teaching, the Texas Blazer's Faculty Excellence Award, and the MPA Council Outstanding Professor Award. John also received the 2012 Outstanding Service Award from the American Taxation Association (ATA) and in 2017 was named the Ernst & Young and ATA Ray Sommerfeld Outstanding Educator. John served as the 2014–2015 president (elect) of the ATA and was the ATA's president for 2015–2016. John conducts research in a broad variety of topics involving financial accounting, mergers and acquisitions, and the influence of taxes on financial structures and performance. His scholarly articles have appeared in *The Accounting Review*, *The Journal of Accounting and Economics*, *Journal of Finance*, *National Tax Journal*, *Journal of Law and Economics*, *Journal of the American Taxation Association*, *The Journal of the American Bar Association*, and *The Journal of Taxation*. John's research was honored with the 2003 and 2008 ATA Outstanding Manuscript Awards. In addition, John was the editor of *The Journal of the American Taxation Association* from 2002–2005. Professor Robinson received his J.D. (*Cum Laude*) from the University of Michigan in 1979, and he teaches courses on individual and corporate taxation and advanced accounting.

About the Authors ▼

Connie Weaver (PhD, Arizona State University, 1997) is the KPMG Professor of Accounting at Texas A&M University. She received a PhD from Arizona State University, an MPA from the University of Texas at Arlington, and a BS (chemical engineering) from the University of Texas at Austin. Prior to entering the PhD Program, Connie was a tax manager at Ernst & Young in Dallas, Texas, where she became licensed to practice as a CPA. She teaches taxation in the Professional Program in Accounting and the Executive MBA program at Texas A&M University. She has also taught undergraduate and graduate students at the University of Wisconsin–Madison and the University of Texas at Austin. She is the recipient of several teaching awards, including the 2006 American Taxation Association/Deloitte Teaching Innovations award, the David and Denise Baggett Teaching award, and the college and university level Association of Former Students Distinguished Achievement award in teaching. Connie's current research interests include the effects of tax and financial incentives on corporate decisions and reporting. She has published articles in journals such as *The Accounting Review*, *Contemporary Accounting Research*, *Journal of the American Taxation Association*, *National Tax Journal*, *Accounting Horizons*, *Journal of Corporate Finance*, and *Tax Notes*. Connie is the senior editor of *The Journal of the American Taxation Association* and she serves on the editorial board of *Contemporary Accounting Research*.



Courtesy Connie Weaver

Ron Worsham (PhD, University of Florida, 1994) is an associate professor in the School of Accountancy at Brigham Young University. He teaches taxation in the graduate, undergraduate, MBA, and Executive MBA programs at Brigham Young University. He has also taught as a visiting professor at the University of Chicago. He received both BS and MAcc (tax emphasis) degrees from Brigham Young University before working as a tax consultant for Arthur Young & Co. (now Ernst & Young) in Dallas, Texas. While in Texas, he became licensed to practice as a CPA. After his professional work experience, Ron earned his PhD at the University of Florida. He has been honored for outstanding innovation in the classroom at Brigham Young University. Ron has published academic research in the areas of taxpayer compliance and professional tax judgment. He has also published legal research in a variety of areas. His work has been published in journals such as *Journal of the American Taxation Association*, *The Journal of International Taxation*, *The Tax Executive*, *Tax Notes*, *The Journal of Accountancy*, and *Practical Tax Strategies*.



Courtesy Ron Worsham

TEACHING THE CODE IN CONTEXT



The bold innovative approach used by McGraw-Hill's Taxation series is quickly becoming the most popular choice of course materials among instructors and students. It's apparent why the clear, organized, and engaging delivery of content, paired with the most current and robust tax code updates, has been adopted by more than 650 schools across the country.

McGraw-Hill's *Taxation* is designed to provide a unique, innovative, and engaging learning experience for students studying taxation. The breadth of the topical coverage, **the storyline approach to presenting the material**, the emphasis on the tax and nontax consequences of multiple parties involved in transactions, and the integration of financial and tax accounting topics make this book ideal for the modern tax curriculum.

"Do you want the best tax text? This is the one to use. It has a storyline in each chapter that can relate to real life issues."

Leslie A. Mostow
– University of Maryland, College Park

"This text provides broad coverage of important topics and does so in a manner that is easy for students to understand. The material is very accessible for students."

Kyle Post
– Tarleton State University

Since the first manuscript was written in 2005, 450 professors have contributed 500 book reviews, in addition to 30 focus groups and symposia. Throughout this preface, their comments on the book's organization, pedagogy, and unique features are a testament to the **market-driven nature of *Taxation's* development.**

"I think this is the best book available for introductory and intermediate courses in taxation."

Shane Stinson
– University of Alabama



A MODERN APPROACH FOR TODAY'S STUDENT

McGraw-Hill's Taxation series was built around the following five core precepts:

- 1 Storyline Approach:** Each chapter begins with a storyline that introduces a set of characters or a business entity facing specific tax-related situations. Each chapter's examples are related to the storyline, providing students with opportunities to **learn the code in context**.
- 2 Integrated Examples:** In addition to providing examples in-context, we provide “**What if**” scenarios within many examples to **illustrate how variations in the facts might or might not change the answers**.
- 3 Conversational Writing Style:** The authors took special care to write *McGraw-Hill's Taxation* in a way that fosters a friendly dialogue between the content and each individual student. The tone of the presentation is intentionally conversational—creating the impression of **speaking with the student**, as opposed to *lecturing to* the student.
- 4 Superior Organization of Related Topics:** *McGraw-Hill's Taxation* provides two alternative topic sequences. In the *McGraw-Hill's Taxation of Individuals and Business Entities* volume, the individual topics generally follow the tax form sequence, with an individual overview chapter and then chapters on income, deductions, investment-related issues, and the tax liability computation. The topics then transition into business-related topics that apply to individuals. This volume then provides a group of specialty chapters dealing with topics of particular interest to individuals (including students), including separate chapters on home ownership, compensation, and retirement savings and deferred compensation. This volume concludes with a chapter covering the taxation of business entities. Alternatively, in the *Essentials of Federal Taxation* volume, the topics follow a more traditional sequence, with topics streamlined (no specialty chapters) and presented in more of a life-cycle approach.
- 5 Real-World Focus:** Students learn best when they see how concepts are applied in the real world. For that reason, real-world examples and articles are included in “**Taxes in the Real World**” boxes throughout the book. These vignettes demonstrate current issues in taxation and show the relevance of tax issues in all areas of business.

“The in-text examples of how to complete tax returns (is a strength of this text). These help students improve their overall understanding of the material as it moves from something abstract to something tangible the student can produce.”

Christine Cheng
– Louisiana State University

A STORYLINE APPROACH THAT RESONATES WITH STUDENTS



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Storyline Summary

Taxpayers: Courtney Wilson, age 40, and Courtney's mother Dorothy "Gram" Weiss, age 70

Family description: Courtney is divorced with a son, Deron, age 10, and a daughter, Ellen, age 20. Gram is currently residing with Courtney.

Location: Kansas City, Missouri

Employment status: Courtney works as an architect for EWD. Gram is retired.

Filing status: Courtney is head of household. Gram is single.

Current situation: Courtney and Gram have computed their taxable income. Now they are trying to determine their tax liability, tax refund, or additional taxes due and whether they owe any payment-related penalties.

Courtney has already determined her taxable income. Now she's working on computing her tax liability. She knows she owes a significant amount of regular income tax on her employment and business activities. However, she's not sure how to compute the tax on the qualified dividends she received from General Electric and is worried that she may be subject to the alternative minimum tax this year. Finally, Courtney knows she owes some self-employment taxes on her business income. Courtney would like to determine whether she is eligible to claim any tax credits, such as the child tax credit for her two children and education credits, because she paid for a portion of her daughter Ellen's tuition at the University of Missouri–Kansas City this year. Courtney is hoping that she has paid enough in taxes during the year to avoid underpayment penalties.

She's planning on filing her tax return and paying her taxes on time.

Gram's tax situation is much more straightforward. She needs to determine the regular income tax on her taxable income. Her income is so low she knows she need not worry about the alternative minimum tax, and she believes she doesn't owe any self-employment tax. Gram didn't prepay any taxes this year, so she is concerned that she might be required to pay an underpayment penalty. She plans to file her tax return and pay her taxes by the looming due date.

Each chapter begins with a storyline that introduces a set of characters facing specific tax-related situations. This revolutionary approach to teaching tax emphasizes real people facing real tax dilemmas. Students learn to apply practical tax information to specific business and personal situations. As their situations evolve, the characters are brought further to life.

"Excellent text! Very readable, easy for students to read and understand. Storyline approach and integrated examples make it easy for students to relate to taxpayers and their tax situations."

Sandra Owen
– Indiana State University, Bloomington

Examples

Examples are the cornerstone of any textbook covering taxation. For this reason, *McGraw-Hill's Taxation* authors took special care to create clear and helpful examples that relate to the storyline of the chapter. Students learn to refer to the facts presented in the storyline and apply them to other scenarios—in this way, they build a greater base of knowledge through application. Many examples also include "What if?" scenarios that add more complexity to the example or explore related tax concepts.

Example 2-1

Bill and Mercedes file their 2015 federal tax return on September 6, 2016, after receiving an automatic extension to file their return by October 15, 2016. In 2019, the IRS selects their 2015 tax return for audit. When does the statute of limitations end for Bill and Mercedes's 2015 tax return?

Answer: Assuming the six-year and "unlimited" statute of limitation rules do not apply, the statute of limitations ends on September 6, 2019 (three years after the later of the actual filing date and the original due date).

What if: When would the statute of limitations end for Bill and Mercedes for their 2015 tax return if the couple filed the return on March 22, 2016 (before the original due date of April 15, 2016)?

Answer: In this scenario the statute of limitations would end on April 15, 2019, because the later of the actual filing date and the original due date is April 15, 2016.

"I enjoy teaching from the McGraw-Hill Spilker taxation textbook. Students too have commented that they prefer it over other texts they have learned taxation from. The ancillaries, LearnSmart and Connect help in my mission to present the material in a logical, reader-friendly manner."

Cheryl Crespi – Central Connecticut State University

THE PEDAGOGY YOUR STUDENTS NEED TO PUT THE CODE IN CONTEXT

Taxes in the Real World

Taxes in the Real World are short boxes used throughout the book to demonstrate the real-world use of tax concepts. Current articles on tax issues, the real-world application of chapter-specific tax rules, and short vignettes on popular news about tax are some of the issues covered in Taxes in the Real World boxes.

“This is the best text I have found for both my students and myself. Easier to read than other textbooks I have looked at, good examples, and, as mentioned before, I appreciate the instructor resources.”

– Esther Ehrlich, CPA, The University of Texas at El Paso

TAXES IN THE REAL WORLD Is It a Deductible State Tax Payment, Charitable Contribution, or Neither?

In recent years, it has become popular for state and local governments to provide state or local tax credits for contributions to certain qualified charities (for example, local hospitals, certain scholarship funds, etc.). While there was no “official” IRS guidance on the federal tax treatment of these contributions, in “unofficial” guidance, the IRS Office of Chief Counsel (see Chief Counsel Advice Memorandum 201105010) advised that a payment to a state agency or charitable organization in return for a tax credit might be characterized as either a deductible charitable contribution or a deductible state tax payment. The 2010 CCA advised that taxpayers could take a charitable deduction for the full amount of the contribution without subtracting the value of the state tax credit received. Hence, for federal tax purposes, the taxpayer could take a charitable contribution deduction for an amount that otherwise was used to reduce the taxpayer’s state tax liability. Because individuals deduct both state taxes and charitable contributions as itemized deductions, the IRS was not too concerned with these types of state tax credit programs.

As you might expect, the IRS’s laissez-faire stance changed in 2018 with the enactment of the \$10,000 limit on the itemized deduction for state, local, and foreign taxes. Specifically, the IRS revisited the federal tax consequences of state and local tax credit programs out of concern that taxpayers may use these programs to bypass the \$10,000 limit on state, local, and foreign tax deductions. After further review, the news was not favorable for taxpayers. In Prop. Reg. §1.170A-1(h)(3) (3), the IRS stated that, effective for contributions after August 27, 2018, taxpayers making payments or transferring property to an entity eligible to receive tax-deductible contributions will have to reduce their charitable contribution deductions by the amount of any state or local tax credit received (or expected to be received). Thus, after August 27, 2018, if a taxpayer receives a dollar-for-dollar state tax credit for a contribution to a qualified charity, the charitable contribution deduction is reduced to zero for federal tax purposes (i.e., the contribution is neither a deductible state tax payment or deductible charitable contribution).

Sources: Prop. Reg. §1.170A-1(h)(3); REG-112176-18.

The Key Facts

The Key Facts provide quick synopses of the critical pieces of information presented throughout each chapter.

The **tax base** defines what is actually taxed and is usually expressed in monetary terms, whereas the **tax rate** determines the level of taxes imposed on the tax base and is usually expressed as a percentage. For example, a sales tax rate of 6 percent on a purchase of \$30 yields a tax of \$1.80 ($\$1.80 = \$30 \times .06$).

Federal, state, and local jurisdictions use a large variety of tax bases to collect tax. Some common tax bases (and related taxes) include taxable income (federal and state income taxes), purchases (sales tax), real estate values (real estate tax), and personal property values (personal property tax).

Different portions of a tax base may be taxed at different rates. A single tax applied

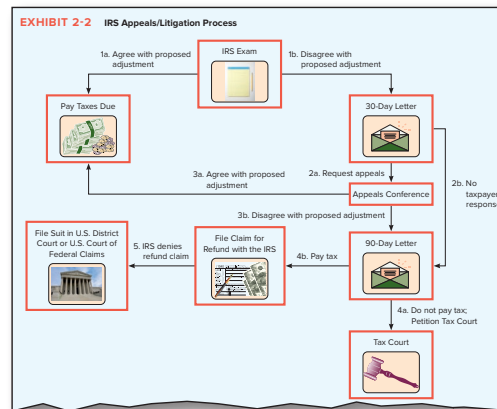
THE KEY FACTS

How to Calculate a Tax

- Tax = Tax base × Tax rate
- The tax base defines what is actually taxed and is usually expressed in monetary terms.
- The tax rate determines the level of taxes imposed

Exhibits

Today’s students are visual learners, and *McGraw-Hill’s Taxation* understands this student need by making use of clear and engaging charts, diagrams, and tabular demonstrations of key material.



“It is easily accessible to students as it is written in easy-to-understand language, and contains sufficient examples to illustrate complicated tax concepts and calculations.”

Machiavelli Chao

– University of California, Irvine: The Paul Merage School of Business

PRACTICE MAKES PERFECT WITH A WIDE

Summary

- LO 2-1** Identify the filing requirements for income tax returns and the statute of limitations for assessment.
- All corporations must file a tax return annually regardless of their taxable income. Estates and trusts are required to file annual income tax returns if their gross income exceeds \$600. The filing requirements for individual taxpayers depend on the taxpayer's filing status, age, and gross income.
 - Individual and C corporation tax returns (except for C corporations with a June 30 year-end) are due on the fifteenth day of the fourth month following year-end. For C corporations with a June 30 year-end, partnerships, and S corporations, tax returns must be filed by the fifteenth day of the third month following the entity's fiscal year-end. Any taxpayer unable to file a tax return by the original due date can request an extension to file.
 - For both amended tax returns filed by a taxpayer and proposed tax assessments by the IRS, the statute of limitations generally ends three years from the *later* of (1) the date the tax return was actually filed or (2) the tax return's original due date.
- LO 2-2** Outline the IRS audit process, how returns are selected, the different types of audits, and what

Summary

A unique feature of *McGraw-Hill's Taxation* is the end-of-chapter summary organized around learning objectives. Each objective has a brief, bullet-point summary that covers the major topics and concepts for that chapter, including references to critical exhibits and examples. All end-of-chapter material is tied to learning objectives.

Learning Objectives

Upon completing this chapter, you should be able to:

- LO 2-1** Identify the filing requirements for income tax returns and the statute of limitations for assessment.
- LO 2-2** Outline the IRS audit process, how returns are selected, the different types of audits, and what happens after the audit.
- LO 2-3** Evaluate the relative weights of the various tax law sources.
- LO 2-4** Describe the legislative process as it pertains to taxation.
- LO 2-5** Perform the basic steps in tax research.
- LO 2-6** Describe tax professional responsibilities in providing tax advice.
- LO 2-7** Identify taxpayer and tax professional penalties.

DISCUSSION QUESTIONS

Discussion Questions are available in Connect®.



- LO 2-1** 1. Name three factors that determine whether a taxpayer is required to file a tax return.
- LO 2-1** 2. Benita is concerned that she will not be able to complete her tax return by April 15. Can she request an extension to file her return? By what date must she do so? Assuming she requests an extension, what is the latest date that she could file her return this year without penalty?
- LO 2-1** 3. Agua Linda Inc. is a calendar-year corporation. What is the original due date for the corporate tax return? What happens if the original due date falls on a Saturday?
- LO 2-2** 4. Approximately what percentage of tax returns does the IRS audit? What are the implications of this number for the IRS's strategy in selecting returns for audit?

Discussion Questions


Discussion questions, now available in *Connect*, are provided for each of the major concepts in each chapter, providing students with an opportunity to review key parts of the chapter and answer evocative questions about what they have learned.

VARIETY OF ASSIGNMENT MATERIAL

Problems

Problems are designed to test the comprehension of more complex topics. Each problem at the end of the chapter is tied to one of that chapter's learning objectives, with multiple problems for critical topics.

PROBLEMS

 connect


Select problems are available in Connect®.

LO 2-1 43. Ahmed does not have enough cash on hand to pay his taxes. He was excited to hear that he can request an extension to file his tax return. Does this solve his problem? What are the ramifications if he doesn't pay his tax liability by April 15?

LO 2-1 44. Molto Stancha Corporation had zero earnings this fiscal year; in fact, it lost money. Must the corporation file a tax return?

Tax Forms Problems

Tax forms problems are a set of requirements included in the end-of-chapter material of the 2020 edition. These problems require students to complete a tax form (or part of a tax form), providing students with valuable experience and practice with filling out these forms. These requirements—and their relevant forms—are also included in *Connect*. Each tax form problem includes an icon to differentiate it from regular problems.


LO 6-1  tax forms

28. Betty operates a beauty salon as a sole proprietorship. Betty also owns and rents an apartment building. This year Betty had the following income and expenses. Determine Betty's AGI and complete page 2 (through line 7) and Schedule 1 of Form 1040 for Betty. You may assume that Betty will owe \$2,502 in self-employment tax on her salon income, with \$1,251 representing the employer portion of the self-employment tax. You may also assume that her divorce from Rocky was finalized in 2016.


Interest income	\$11,255
Salon sales and revenue	86,360

Research Problems

Research problems are special problems throughout the end-of-chapter assignment material. These require students to do both basic and more complex research on topics outside of the scope of the book. Each research problem includes an icon to differentiate it from regular problems.

LO 6-2  research


35. This year Tim is age 45 and is considering enrolling in an insurance program that provides for long-term care insurance. He is curious about whether the insurance premiums are deductible as a medical expense and, if so, what the maximum amount is that can be deducted in any year.

LO 6-2  research

36. Doctor Bones prescribed physical therapy in a pool to treat Jack's broken back. In response to this advice (and for no other reason), Jack built a swimming pool in his backyard and strictly limited use of the pool to physical therapy. Jack paid \$25,000 to build the pool, but he wondered if this amount could be deducted as a medical

Planning Problems

Planning problems are another unique set of problems included in the end-of-chapter assignment material. These require students to test their tax planning skills after covering the chapter topics. Each planning problem includes an icon to differentiate it from regular problems.

LO 2-2  planning


57. The IRS recently completed an audit of Shea's tax return and assessed \$15,000 additional tax. Shea requested an appeals conference but was unable to settle the case at the conference. She is contemplating which trial court to choose to hear her case. Provide a recommendation based on the following alternative facts:

- Shea resides in the 2nd Circuit, and the 2nd Circuit has recently ruled against the position Shea is litigating.
- The Federal Circuit Court of Appeals has recently ruled in favor of Shea's position.
- The issue being litigated involves a question of fact. Shea has a very appealing


Comprehensive and Tax Return Problems

Comprehensive and tax return problems address multiple concepts in a single problem. Comprehensive problems are ideal for cumulative topics; for this reason, they are located at the end of all chapters. In the end-of-book Appendix C, we include tax return problems that cover multiple chapters. **Additional tax return problems are also available in *Connect* and *Instructor Resource Center*. These problems range from simple to complex and cover individual taxation, corporate taxation, partnership taxation, and S corporation taxation.**

COMPREHENSIVE PROBLEMS

 connect

Select problems are available in Connect®.

tax forms 

54. Marc and Michelle are married and earned salaries this year of \$64,000 and \$12,000, respectively. In addition to their salaries, they received interest of \$350 from municipal bonds and \$500 from corporate bonds. Marc contributed \$2,500 to an individual retirement account, and Marc paid alimony to a prior spouse in the amount of \$1,500. Marc and Michelle have a 10-year-old son, Matthew, who lived with them throughout the entire year. Thus, Marc and Michelle are allowed to claim a \$2,000 child tax credit for Matthew. Marc and Michelle paid \$6,000 of expenditures that qualify as itemized deductions and they had a total of \$3,500 in federal income taxes withheld from their paychecks during the course of the year.



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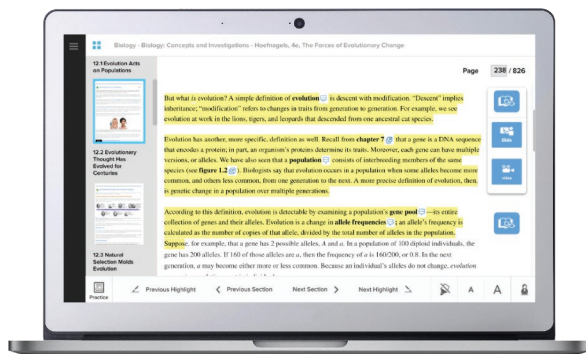
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“I really liked this app—it made it easy to study when you don't have your textbook in front of you.”

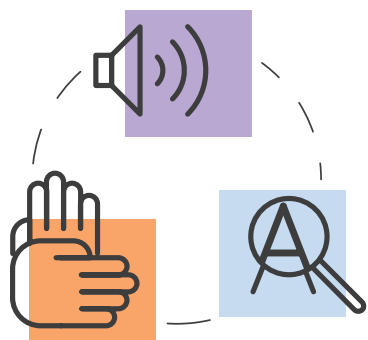
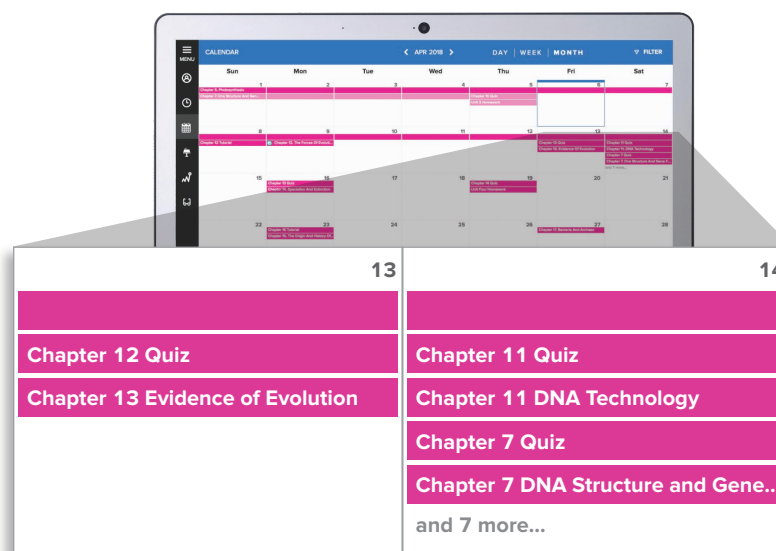
- Jordan Cunningham,
Eastern Washington University

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DIGITAL LEARNING ASSETS TO IMPROVE STUDENT OUTCOMES

“The quality of the online materials in Connect and Learnsmart are market-leading and unmatched in the tax arena.”

Jason W. Stanfield
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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 problems, comprehensive problems (available as auto-graded tax forms), and discussion questions. 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.

Through November, Tex has received gross income of \$120,000. For December, Tex is considering whether to accept one more work engagement for the year. Engagement 1 will generate \$7,000 of revenue at a cost of \$4,000, which is deductible for AGI. In contrast, engagement 2 will generate \$7,000 of revenue at a cost of \$3,000, which is deductible as an itemized deduction. Tex files as a single taxpayer. (use the [tax rate schedules](#).)

- a. Calculate Tex’s taxable income assuming he chooses engagement 1 and assuming he chooses engagement 2. Assume he has no itemized deductions other than those generated by engagement 2.

Description	Engagement 1	Engagement 2
(1) Gross income before new work engagement	\$ 120,000	\$ 120,000
(2) Income from engagement	7,000	7,000
(3) Additional for AGI deduction	(4,000)	
(4) Adjusted gross income	\$ 123,000	\$ 127,000
(5) Greater		
(6) Greater of itemized deductions or standard deduction		

Auto-Graded Tax Forms

The auto-graded **Tax Forms** in Connect provide 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 instructors.

1040 for a couple Married Filing Jointly.

1040 PG 1 1040 PG 2

Page 1 of Form 1040. Use provided information and follow instructions on form.

Form 1040 U.S. Individual Income Tax Return 2018 OMB No. 1545-0074 IRS Use Only - Do not write 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: _____ (Enter as xxx-xx-xxxx)

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

Spouse or qualifying person's first name and initial (see inst.): _____ Last name: _____

Demarco: _____ Your social security number: 123-45-6789

Spouse standard deduction: Someone can claim your spouse as a dependent Spouse was born before January 2, 1954 Spouse itemizes on a separate return or you were dual-status alien Spouse is blind

Home address (number and street). If you have a P.O. box, see instructions. Apt. no. _____ Your social security number: 234-56-7890

City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule B. _____ Presidential Election Campaign: You Spouse

Dependents (see instructions):

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) <input type="checkbox"/> If more than four dependents, see inst. and <input checked="" type="checkbox"/> here	(4) <input checked="" type="checkbox"/> If child under age 17 qualifies for (see inst.):	Credit for other dependents
				<input type="checkbox"/>	Child tax credit.	<input type="checkbox"/>
				<input type="checkbox"/>		<input type="checkbox"/>
				<input type="checkbox"/>		<input type="checkbox"/>

Guided Examples

The **Guided Examples**, or “hint” videos, in Connect provide a narrated, animated, step-by-step walk-through of select problems similar to those assigned. These short presentations can be turned on or off by instructors and provide reinforcement when students need it most.

TaxACT®

TaxAct Professional *McGraw-Hill's Taxation* can be packaged with tax software from TaxACT, one of the leading preparation software companies in the market today. The 2018 edition includes availability of both *Individuals* and *Business Entities* software, including the 1040 Forms and TaxACT Preparer's Business 3-Pack (with Forms 1065, 1120, and 1120S).

Please note, TaxACT is only compatible with PCs and not Macs. However, we offer easy-to-complete licensing agreement templates that are accessible within Connect and the Instructor Resources Center to enable school computer labs to download the software onto campus hardware for free.

Roger's CPA

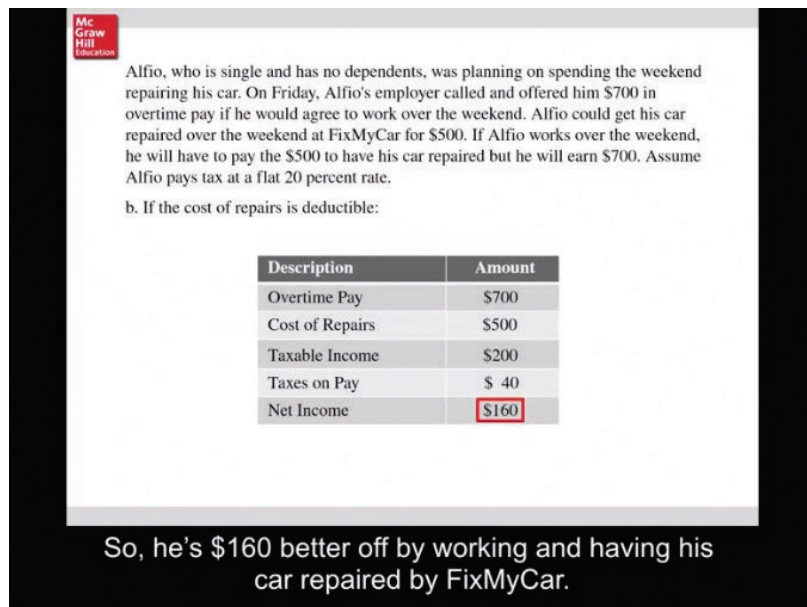
ROGER | CPA Review McGraw-Hill Education has partnered with Roger CPA Review, a global leader in CPA Exam preparation, to provide students a smooth transition from the accounting classroom to successful completion of the CPA Exam. While many aspiring accountants wait until they have completed their academic studies to begin preparing for the CPA Exam, research shows that those who become familiar with exam content earlier in the process have a stronger chance of successfully passing the CPA Exam.

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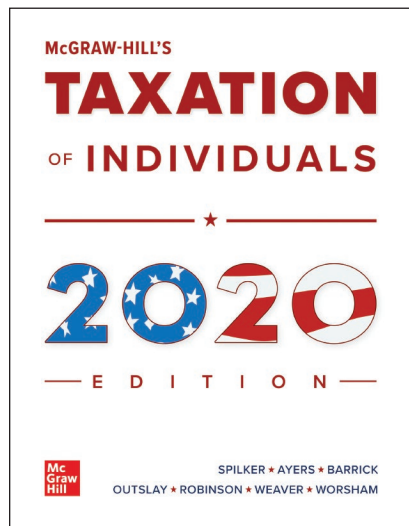
Alfio, who is single and has no dependents, was planning on spending the weekend repairing his car. On Friday, Alfio's employer called and offered him \$700 in overtime pay if he would agree to work over the weekend. Alfio could get his car repaired over the weekend at FixMyCar for \$500. If Alfio works over the weekend, he will have to pay the \$500 to have his car repaired but he will earn \$700. Assume Alfio pays tax at a flat 20 percent rate.

b. If the cost of repairs is deductible:

Description	Amount
Overtime Pay	\$700
Cost of Repairs	\$500
Taxable Income	\$200
Taxes on Pay	\$ 40
Net Income	\$160

So, he's \$160 better off by working and having his car repaired by FixMyCar.

Four Volumes to Fit



McGraw-Hill's Taxation of Individuals is organized to emphasize topics that are most important to undergraduates taking their first tax course. The first three chapters provide an introduction to taxation and then carefully guide students through tax research and tax planning. Part II discusses the fundamental elements of individual income tax, starting with the tax formula in Chapter 4 and then proceeding to more discussion on income, deductions, investments, and computing tax liabilities in Chapters 5–8. Part III then discusses tax issues associated with business-related activities. Specifically, this part addresses business income and deductions, accounting methods, and tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). Part IV is unique among tax textbooks; this section combines related tax issues for compensation, retirement savings, and home ownership.

Part I: Introduction to Taxation

1. An Introduction to Tax
2. Tax Compliance, the IRS, and Tax Authorities
3. Tax Planning Strategies and Related Limitations

Part II: Basic Individual Taxation

4. Individual Income Tax Overview, Dependents, and Filing Status
5. Gross Income and Exclusions
6. Individual Deductions
7. Investments
8. Individual Income Tax Computation and Tax Credits

Part III: Business-Related Transactions

9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

Part IV: Specialized Topics

12. Compensation
13. Retirement Savings and Deferred Compensation
14. Tax Consequences of Home Ownership

McGraw-Hill's Taxation of Business Entities begins with the process for determining gross income and deductions for businesses, and the tax consequences associated with purchasing assets and property dispositions (sales, trades, or other dispositions). Part II provides a comprehensive overview of entities and the formation, reorganization, and liquidation of corporations. Unique to this series is a complete chapter on accounting for income taxes, which provides a primer on the basics of calculating the income tax provision. Included in the narrative is a discussion of temporary and permanent differences and their impact on a company's book "effective tax rate." Part III provides a detailed discussion of partnerships and S corporations. The last part of the book covers state and local taxation, multinational taxation, and transfer taxes and wealth planning.

Part I: Business-Related Transactions

1. Business Income, Deductions, and Accounting Methods
2. Property Acquisition and Cost Recovery
3. Property Dispositions

Part II: Entity Overview and Taxation of C Corporations

4. Entities Overview
5. Corporate Operations
6. Accounting for Income Taxes
7. Corporate Taxation: Nonliquidating Distributions
8. Corporate Formation, Reorganization, and Liquidation

Part III: Taxation of Flow-Through Entities

9. Forming and Operating Partnerships
10. Dispositions of Partnership Interests and Partnership Distributions
11. S Corporations

Part IV: Multijurisdictional Taxation and Transfer Taxes

12. State and Local Taxes
13. The U.S. Taxation of Multinational Transactions
14. Transfer Taxes and Wealth Planning

Four Course Approaches



McGraw-Hill's Taxation of Individuals and Business Entities covers all chapters included in the two split volumes in one convenient volume. See Table of Contents.

Part I: Introduction to Taxation

1. An Introduction to Tax
2. Tax Compliance, the IRS, and Tax Authorities
3. Tax Planning Strategies and Related Limitations

Part II: Basic Individual Taxation

4. Individual Income Tax Overview, Dependents, and Filing Status
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Part III: Business-Related Transactions

9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

Part IV: Specialized Topics

12. Compensation
13. Retirement Savings and Deferred Compensation
14. Tax Consequences of Home Ownership

Part V: Entity Overview and Taxation of C Corporations

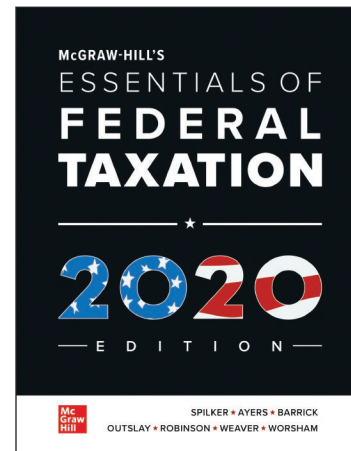
15. Entities Overview
16. Corporate Operations
17. Accounting for Income Taxes
18. Corporate Taxation: Nonliquidating Distributions
19. Corporate Formation, Reorganization, and Liquidation

Part VI: Taxation of Flow-Through Entities

20. Forming and Operating Partnerships
21. Dispositions of Partnership Interests and Partnership Distributions
22. S Corporations

Part VII: Multijurisdictional Taxation and Transfer Taxes

23. State and Local Taxes
24. The U.S. Taxation of Multinational Transactions
25. Transfer Taxes and Wealth Planning



McGraw-Hill's Essentials of Federal Taxation is designed for a one-semester course, covering the basics of taxation of individuals and business entities. To facilitate a one-semester course, *McGraw-Hill's Essentials of Federal Taxation* folds the key topics from the investments, compensation, retirement savings, and home ownership chapters in *Taxation of Individuals* into three individual taxation chapters that discuss gross income and exclusions, *for* AGI deductions, and *from* AGI deductions, respectively. The essentials volume also includes a two-chapter C corporation sequence that uses a life-cycle approach covering corporate formations and then corporate operations in the first chapter and nonliquidating and liquidating corporate distributions in the second chapter. This volume is perfect for those teaching a one-semester course and for those who struggle to get through the 25-chapter comprehensive volume.

Part I: Introduction to Taxation

1. An Introduction to Tax
2. Tax Compliance, the IRS, and Tax Authorities
3. Tax Planning Strategies and Related Limitations

Part II: Individual Taxation

4. Individual Income Tax Overview, Dependents, and Filing Status
5. Gross Income and Exclusions
6. Individual *For* AGI Deductions
7. Individual *From* AGI Deductions
8. Individual Income Tax Computation and Tax Credits

Part III: Business-Related Transactions

9. Business Income, Deductions, and Accounting Methods
10. Property Acquisition and Cost Recovery
11. Property Dispositions

Part IV: Entity Overview and Taxation of C Corporations

12. Entities Overview
13. Corporate Formations and Operations
14. Corporate Nonliquidating and Liquidating Distributions

Part V: Taxation of Flow-Through Entities

15. Forming and Operating Partnerships
16. Dispositions of Partnership Interests and Partnership Distributions
17. S Corporations



SUPPLEMENTS FOR INSTRUCTORS

Assurance of Learning Ready

Many educational institutions today are focused on the notion of *assurance of learning*, an important element of many accreditation standards. *McGraw-Hill's Taxation* is designed specifically to support your assurance of learning initiatives with a simple, yet powerful, solution.

Each chapter in the book begins with a list of numbered learning objectives, which appear throughout the chapter as well as in the end-of-chapter assignments. Every test bank question for *McGraw-Hill's Taxation* maps to a specific chapter learning objective in the textbook. Each test bank question also identifies topic area, level of difficulty, Bloom's Taxonomy level, and AICPA and AACSB skill area.

AACSB Statement

McGraw-Hill Education is a proud corporate member of AACSB International. Understanding the importance and value of AACSB accreditation, *McGraw-Hill's Taxation* recognizes the curricula guidelines detailed in the AACSB standards for business accreditation by connecting selected questions in the text and the test bank to the general knowledge and skill guidelines in the revised AACSB standards.

The statements contained in *McGraw-Hill's Taxation* are provided only as a guide for the users of this textbook. The AACSB leaves content coverage and assessment within the purview of individual schools, the mission of the school, and the faculty. While *McGraw-Hill's Taxation* and the teaching package make no claim of any specific AACSB qualification or evaluation, we have, within the text and test bank, labeled selected questions according to the eight general knowledge and skill areas.

TestGen

TestGen is a complete, state-of-the-art test generator and editing application software that allows instructors to quickly and easily select test items from McGraw Hill's TestGen testbank content and to organize, edit, and customize the questions and answers to rapidly generate paper tests. Questions can include stylized text, symbols, graphics, and equations that are inserted directly into questions using built-in mathematical templates. With both quick-and-simple test creation and flexible and robust editing tools, TestGen is a test generator system for today's educators.

A HEARTFELT THANKS TO THE MANY COLLEAGUES WHO SHAPED THIS BOOK

The version of the book you are reading would not be the same book without the valuable suggestions, keen insights, and constructive criticisms of the list of reviewers below. Each professor listed here contributed in substantive ways to the organization of chapters, coverage of topics, and use of pedagogy. We are grateful to them for taking the time to read chapters or attend reviewer conferences, focus groups, and symposia in support of the development for the book:

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We also appreciate the expert attention given to this project by the staff at McGraw-Hill Education, especially Tim Vertovec, Managing Director; Kathleen Klehr, Executive Portfolio Manager; Danielle McLimore, Assessment Product Developer; Erin Quinones, Core Product Developer; Lori Koetters, Brian Nacik, and Jill Eccher, Content Project Managers; Jessica Cuevas, Designer; Natalie King, Marketing Director; Zach Rudin, Marketing Manager; and Sue Culbertson, Senior Buyer.

Changes in *Taxation of Individuals and Business Entities*, 2020 Edition

For the 2020 edition of McGraw-Hill's *Taxation of Individuals and Business Entities*, many changes were made in response to feedback from reviewers and focus group participants:

- All **tax forms** have been **updated for the latest available tax form as of March 2019**. In addition, **chapter content** throughout the text has been **updated to reflect tax law changes through March 2019**.
- Updated U.S. Series EE Bond interest income exclusion for 2019.
- Updated tax forms from 2017 to 2018.

Other notable changes in the 2019 edition include:

Chapter 1

- Updated tax rates for 2019 and Examples 1-3 through 1-7.
- Updated Social Security Wage base for 2019.
- Updated unified Tax Credit for 2019.
- Updated Taxes in the Real World: National Debt for current debt limit.

Chapter 2

- Updated gross income thresholds by filing status for 2019.
- Enhanced discussion of statute of limitations.
- Updated penalty amounts for failure to file a tax return and failure to pay tax owed.

Chapter 3

- Updated tax rates for 2019.
- Updated Exhibit 3-3 for new tax rates post-TCJA.
- Modified Example 3-4 to clarify the solution.

Chapter 4

- Edited discussion of Form 1040 to match up with revised tax forms.
- Updated Exhibit 4-7 to reflect standard deduction amounts for 2019.
- Updated tax rates for 2019 rates.
- Clarified discussion on tiebreaker rules for qualifying child.
- Revised discussion question 11.
- Updated tax forms from 2017 to 2018.

Chapter 5

- Updated for 2019 amounts for qualified transportation benefits.
- Updated for 2019 flexible spending account contributions.
- Updated for 2019 foreign income exclusion amounts.
- Updated for annual gift tax exclusion and unified tax credit for 2019.

Chapter 6

- Updated excess business loss limitation for 2019.
- Updated discussion of deduction for interest on qualified education loan for 2019.
- Updated AGI floor for medical expense itemized deduction for 2019.
- Updated mileage rate for medical expense itemized deduction for 2019.
- Added a Taxes in the Real World on state and local tax credits and charitable contributions.
- Revised discussion of casualty and theft losses on personal-use assets.
- Updated standard deduction amounts for 2019 amounts.
- Expanded discussion for deduction for qualified business income and updated for 2019.
- Updated tax forms from 2017 to 2018.

Chapter 7

- Updated tax rates in all examples and problems for 2019.
- Updated Exhibit 7-3.
- Updated examples for changes in capital gains tax rate thresholds.
- Revised the discussion of capital gains netting process to illustrate a simpler process for taxpayers that only have 0/15/20 percent long-term capital gains.
- Updated tax forms from 2017 to 2018.

Chapter 8

- Updated tax rate schedules for 2019.
- Moved discussion of net investment income tax to additional tax section.
- Updated discussion of kiddie tax for 2019.
- Updated AMT exemption and tax rate schedule for 2019.
- Updated Social Security tax wage base and self-employment tax base for 2019.
- Updated lifetime learning credit phase-out for 2019.

- Updated earned income credit amounts for 2019.
- Updated tax forms from 2017 to 2018.

Chapter 9

- Updated tax forms from 2017 to 2018.
- Updated definition of interest for the business interest limitation to conform with proposed regulations.
- Added a new Taxes in the Real World on the all-events test for rebate payments.
- Added two new research problems.
- Added a description of the latest IRS position on the deduction of business meals in conjunction with nondeductible entertainment.
- Added example and homework problems on the deduction of business meals.
- Revised examples and text discussion for updated 2018 mileage rates.
- Expanded description of accounting exceptions for small businesses (average annual gross receipts of \$26 million or less in prior three years).

Chapter 10

- Updated Exhibit 10-2 for Weyerhaeuser's 2017 assets.
- Updated tax rates for 2019.
- Revised section on §179 amounts to reflect the inflation adjustments for 2019.
- Updated examples for 2019 §179 amounts.
- Clarified treatment of bonus depreciation for AMT purposes.
- Updated discussion and Exhibit 10-10 relating to automobile depreciation limits.
- Updated §179 amount for SUVs for 2019 inflation amount changes.
- Updated tax forms from 2017 to 2018.
- Updated and revised end-of-chapter problems for §179 amounts and bonus depreciation rules.

Chapter 11

- Updated tax rates for 2019.
- Updated Exhibit 11-6 for changes to recapture.
- Clarified discussion of §1250 recapture as it applies to qualified improvement property placed in service prior to 2018.
- Modified discussion of §1239 gains.
- Modified discussion on like-kind exchanges to clarify purpose of a third-party deferred like-kind exchange.
- Updated discussion of boot given in like-kind exchange.
- Added definition of condemnation.

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- Added clarification of amortization of foreign R&E expenditures post-December 31, 2021.
- Updated tax forms from 2017 to 2018 forms.

Chapter 12

- Substantially revised discussion of salary and wages.
- Substantially revised discussion of equity-based compensation.
- Updated qualified transportation fringe benefit amounts for 2019.
- Updated tax forms to 2018.
- Updated Taxes in the Real World for 2018 proxy statement information.

Chapter 13

- Updated footnote 1 to reflect the 2018 OASDI Trustees report.
- Updated inflation adjusted limits for defined benefit plans, defined contribution plans, and individually managed plans.
- Removed old Exhibit from Coca-Cola proxy statement (old Exhibit 13-6) and integrated a summary description in the text.
- Inserted new footnote providing citation to authority for exceptions to 10 percent early distribution penalty.
- Expanded discussion about making IRA contributions for the prior year after year-end.
- Added discussion to footnote dealing with rollovers from traditional IRAs to Roth IRAs.
- Updated modified AGI phase-out thresholds for deductible contributions to traditional IRAs and contributions to Roth IRAs.
- Updated calculations for limits on self-employed retirement accounts to reflect updated 2019 Social Security wage base limitation.
- Updated saver's credit information for 2019.

Chapter 14

- Updated Taxes in the Real World dealing with online rental communities such as Airbnb.
- Added discussion and an example describing and illustrating when a loan called a "home equity loan" by a bank is considered to be acquisition debt for tax purposes.
- Revised LO 14-3 to emphasize home mortgage interest deduction.
- Revised discussion of the IRS method and the Tax Court method to reflect the circumstances in which each is more favorable given the new tax law.
- Clarified discussion about home office expense requirements.

- Revised discussion questions 12, 14, 25, and 32.
- Revised problems 46, 47, 48, and 68.
- Updated solutions to reflect 2019 inflation-adjusted numbers.
- Updated tax forms from 2017 to 2018.
- Updated settlement statement in Appendix A to reflect 2019 information.

Chapter 15

- Revised section describing the self-employment tax and the additional Medicare tax.
- Updated the discussion on specified service trades or businesses for purposes of the deduction for qualified business income and included reference to new regulation dealing with what constitutes a specified trade or business.
- Updated Social Security wage base limitation for 2019, including related calculations.
- Revised numbers in Example 15-4.
- Eliminated detailed discussion about pre-2018 individual and corporate tax rates.
- Eliminated discussion about pre-2018 dividends received deduction percentages.
- Included more discussion relating to the dividends received deduction.
- Replaced discussion question 5.

Chapter 16

- Updated the discussion on stock option compensation.
- Revised Taxes in the Real World for Facebook stock options.
- Updated the compliance section for new year-end filing.

Chapter 17

- Updated the Taxes in the Real World saga of Weatherford.
- Updated chapter material to incorporate the new FASB rules on disclosures of deferred tax assets and liabilities.
- Updated the Microsoft uncertain tax benefit footnote disclosure.
- Updated the FASB's projects involving accounting for income taxes.

Chapter 18

- Condensed the facts of the story.
- Clarified explanation of the ordering of E&P distributions.
- Introduced a research problem illustrating the calculation of E&P when distributions include both dividends and stock redemptions.

Chapter 19

- Clarified some definitions and terms throughout the chapter.
- Revised explanation of basis calculation when shareholders receive boot in a §351 transaction.
- Revised illustration of a gain or loss calculation for a §351 transaction with boot.
- Added two problems illustrating basis and gain and loss calculation for §351 transactions.

Chapter 20

- Updated discussion on the new rule dealing with the availability of the cash method of accounting for partnerships to reflect inflation adjustment.
- Updated discussion on new excess business loss limitation and how it interacts with other loss limitation rules to reflect inflation adjustments.
- Updated tax forms from 2017 to 2018.
- Revised Taxes in the Real World example.
- Revised end of chapter problems to reflect inflation adjustments.

Chapter 21

- Revised Taxes in the Real World example.
- Added new end of chapter problem on Section 754 basis step-ups.

Chapter 22

- Updated excess business loss limitation for 2019.
- Updated Social Security tax wage base for 2018.
- Updated tax forms from 2017 to 2018.

Chapter 23

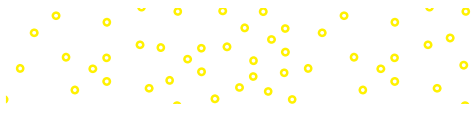
- Substantially revised sales and use tax discussion.
- Updated sales tax nexus for *Wayfair* vs. South Dakota.
- Substantially revised the discussion of income tax nexus.
- Substantially revised the discussion of Public Law 86-272.

Chapter 24

- Updated the discussion on the OECD base erosion and profit-shifting project.
- Updated the proposals for international tax reform.
- Updated the discussion on inversions.

Chapter 25

- Revised text and Exhibit 25-2 for changes in the exemption equivalent.
- Revised calculations, text descriptions, and examples to reflect inflation changes.
- Added new problem illustrating incomplete gifts.
- Replaced Exhibit 25-5 with 2018 Form 709.

- 
- Replaced Exhibit 25-8 with 2019 Form 706.
 - Included a new Taxes in the Real World discussing the role of wills in the estate tax.
 - Added illustration reconciling the gift and estate tax formulas.
 - Clarified the description and illustration of retained estates.

As We Go to Press

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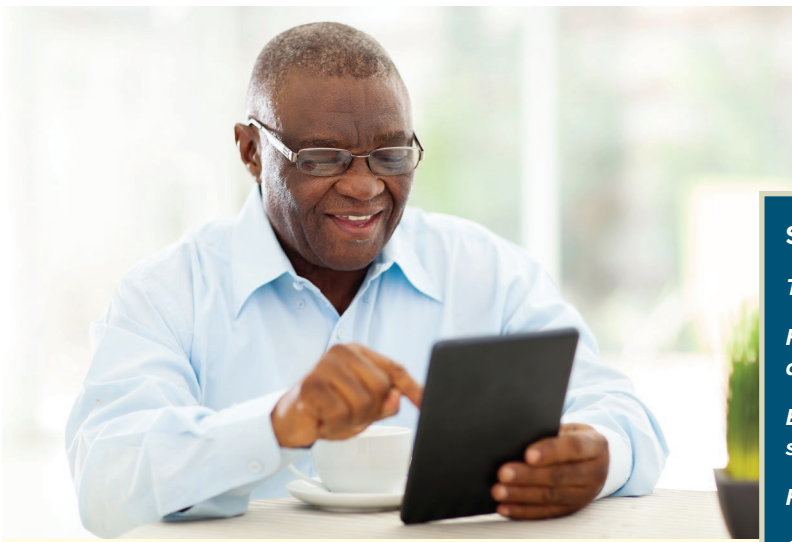
3

Tax Planning Strategies and Related Limitations

Learning Objectives

Upon completing this chapter, you should be able to:

- LO 3-1** Identify the objectives of basic tax planning strategies.
- LO 3-2** Apply the timing strategy.
- LO 3-3** Apply the concept of present value to tax planning.
- LO 3-4** Apply the income-shifting strategy.
- LO 3-5** Apply the conversion strategy.
- LO 3-6** Describe basic judicial doctrines that limit tax planning strategies.
- LO 3-7** Contrast tax avoidance and tax evasion.



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Storyline Summary

Taxpayers:	Bill and Mercedes
Family description:	Bill and Mercedes are married with one daughter, Margaret.
Employment status:	Bill is an economics professor; Mercedes is a small business owner.
Filing status:	Married, filing jointly
Current situation:	Bill and Mercedes want to engage in low-risk tax planning strategies.

While working with their CPA during their audit, Bill and Mercedes decide to inquire about low-risk tax planning opportunities. Specifically, they would like to gain a better understanding of how to maximize their after-tax income without increasing their potential for another audit. (Although it was fun and educational,

one audit is enough!) Mercedes is convinced that, as a small business owner (Lavish Interior Designs Inc.), she pays more than her fair share of taxes. Likewise, Bill, an avid investor, wonders whether he is missing the mark by not considering taxes in his investment decisions. ■

Bill and Mercedes have come to the right place. This chapter describes the basic tax planning concepts that form the basis of the simplest to most complex tax planning transactions. In the process we also discuss the judicial doctrines that serve as basic limits on tax planning.

LO 3-1 BASIC TAX PLANNING OVERVIEW

Effective tax planning requires a basic understanding of the roles that tax and nontax factors play in structuring business, investment, and personal decisions. Although tax factors may not be the sole or even the primary determinant of a transaction or its structure, taxes can significantly affect the costs or benefits associated with business, investment, and personal transactions. Thus, the tax implications of competing transactions warrant careful consideration. Likewise, nontax factors, such as the taxpayer's financial goals or legal constraints, are an integral part of every transaction.

In general terms, effective tax planning maximizes the taxpayer's after-tax wealth while achieving the taxpayer's nontax goals. Maximizing after-tax wealth is not necessarily the same as minimizing taxes. Specifically, maximizing after-tax wealth requires us to consider both the tax and nontax costs and benefits of alternative transactions, whereas tax minimization focuses solely on a single cost—taxes. Indeed, if the goal of tax planning were simply to minimize taxes, the simplest way to achieve it would be to earn no income at all. Obviously, this strategy has potential limitations—most notably, the unattractive nontax consequence of poverty. Thus, it is necessary to consider the nontax ramifications of any planning strategy.

Virtually every transaction includes three parties: the taxpayer, the other transacting party, and the uninvited silent party that specifies the tax consequences of the transaction—the government. Astute tax planning requires an understanding of the tax and nontax costs from the perspectives of both the taxpayer *and* the other parties. For example, as discussed in the Compensation chapter, it would be impossible for an employer to develop an effective compensation plan without considering the tax and nontax costs associated with different compensation arrangements from both the employer's and the employees' perspectives. With sound tax planning, the employer can design a compensation package that generates value for employees while reducing costs for the employer. (One way to achieve this goal is through the use of nontaxable fringe benefits, such as health insurance, which are deductible expenses to the employer but not taxable income to employees.) Throughout the text, we highlight situations where this multilateral approach to tax planning is especially important.

In this chapter we discuss three basic tax planning strategies that represent the building blocks of tax planning:

1. *Timing* (deferring or accelerating taxable income and tax deductions).
2. *Income shifting* (shifting income from high- to low-tax-rate taxpayers).
3. *Conversion* (converting income from high- to low-tax-rate activities).

THE KEY FACTS

The Basics of Tax Planning

- Effective tax planning maximizes the taxpayer's after-tax wealth while achieving the taxpayer's nontax goals.
- Virtually every transaction includes three parties: the taxpayer, the other transacting party, and the uninvited silent party that specifies the tax consequences of the transaction—the government.
- Astute tax planning requires an understanding of the tax and nontax costs from the perspectives of both the taxpayer *and* the other parties.

LO 3-2 LO 3-3

TIMING STRATEGIES

LO 3-6

One of the cornerstones of basic tax planning is the idea of *timing*. When income is taxed or an expense is deducted affects the associated “real” tax costs or savings. This is true for two reasons. First, the time when income is taxed or an expense is deducted affects the *present value* of the taxes paid on income or the tax savings on deductions. Second, the tax costs of income and tax savings of deductions vary as *tax rates* change. The tax costs on income are higher when tax rates are higher and lower when tax rates are lower. Likewise, the tax savings on deductions are higher when tax rates are higher

and lower when tax rates are lower. Let's look at the effects of present value and tax rates on the timing strategy.

Present Value of Money

The concept of **present value**—also known as the time value of money—basically states that \$1 received today is worth *more* than \$1 received in the future. Is this true, or is this some type of new math?

It's true. Assuming an investor can earn a positive **after-tax rate of return** such as 5 percent, \$1 invested today should be worth \$1.05 in one year.¹ Specifically,

Eq. 3-1

$$\begin{aligned} \text{Future Value} &= \text{Present Value} \times (1 + r)^n \\ &= \$1 \times (1 + .05)^1 = \$1.05 \end{aligned}$$

where \$1 is the present value, *r* is the after-tax rate of return (5 percent), and *n* is the investment period (1 year). Hence, \$1 today is equivalent to \$1.05 in one year. The implication of the time value of money for tax planning is that the timing of a cash inflow or a cash outflow affects the present value of the income or expense.

Example 3-1

Bill is given the choice of receiving a \$1,000 nontaxable gift today or a \$1,000 nontaxable gift in one year. Which would Bill prefer? Assume Bill could invest \$1,000 today and earn an 8 percent return after taxes in one year. If he receives the gift today, how much would the \$1,000 be worth in one year?

Answer: The \$1,000 gift today would be worth \$1,080 in one year, and thus Bill should prefer to receive the gift today. Specifically,

$$\begin{aligned} \text{Future Value} &= \text{Present Value} \times (1 + r)^n \\ &= \$1,000 \times (1 + .08)^1 = \$1,080 \end{aligned}$$

In terms of *future value*, the choice in the above example between receiving \$1,000 today and \$1,000 in one year simplifies to a choice between \$1,080 and \$1,000. For even the least materialistic individual, choosing \$1,080—that is, \$1,000 *today*—should be straightforward.

Often tax planners find it useful to consider sums not in terms of future value, but rather in terms of present value. How would we restate the choice in Example 3-1 in terms of present value? Obviously, the present value of receiving \$1,000 today is \$1,000, but what is the *present value* of \$1,000 received in one year? The answer depends on the **discount factor**, which we derive from the taxpayer's expected after-tax rate of return. The discount factor is very useful for calculating the present value of future inflows or outflows of cash. We can derive the discount factor for a given rate of return simply by rearranging the future value equation (Eq. 3-1) from above:

Eq. 3-2

$$\begin{aligned} \text{Present Value} &= \text{Future Value}/(1 + r)^n \\ &= \$1/(1 + .08)^1 = \$0.926 \end{aligned}$$

Therefore, the discount factor = 0.926

¹Assuming a constant marginal tax rate (*t*), after-tax rate of return (*r*) may be calculated as follows: $r = R \times (1 - t)$, where *R* is the taxpayer's before-tax rate of return.

THE KEY FACTS Present Value of Money

- The concept of present value—also known as the time value of money—states that \$1 received today is worth *more* than \$1 received in the future.
- The implication of the time value of money for tax planning is that the timing of a cash inflow or a cash outflow affects the present value of the income or expense.
- Present Value = Future Value/(1 + *r*)^{*n*}.
- When we are considering cash inflows, higher present values are preferred; when we are considering cash outflows, lower present values are preferred.

EXHIBIT 3-1 Present Value of a Single Payment at Various Annual Rates of Return

Year	4%	5%	6%	7%	8%	9%	10%	11%	12%
1	.962	.952	.943	.935	.926	.917	.909	.901	.893
2	.925	.907	.890	.873	.857	.842	.826	.812	.797
3	.889	.864	.840	.816	.794	.772	.751	.731	.712
4	.855	.823	.792	.763	.735	.708	.683	.659	.636
5	.822	.784	.747	.713	.681	.650	.621	.593	.567
6	.790	.746	.705	.666	.630	.596	.564	.535	.507
7	.760	.711	.665	.623	.583	.547	.513	.482	.452
8	.731	.677	.627	.582	.540	.502	.467	.434	.404
9	.703	.645	.592	.544	.500	.460	.424	.391	.361
10	.676	.614	.558	.508	.463	.422	.386	.352	.322
11	.650	.585	.527	.475	.429	.388	.350	.317	.287
12	.625	.557	.497	.444	.397	.356	.319	.286	.257
13	.601	.530	.469	.415	.368	.326	.290	.258	.229
14	.577	.505	.442	.388	.340	.299	.263	.232	.205
15	.555	.481	.417	.362	.315	.275	.239	.209	.183

Applying the discount factor, we can see that \$1,000 received in one year is worth \$926 in today's dollars. Thus, in terms of present value, Bill's choice in Example 3-1 simplifies to a choice between a cash inflow of \$1,000 today and a cash inflow worth \$926 today. Again, choosing \$1,000 today is pretty straightforward.

Exhibit 3-1 provides the discount factors for a lump sum (single payment) received in n periods using various rates of return. Tax planners frequently utilize such tables for quick reference in calculating present value for sums under consideration.

Example 3-2

At a recent holiday sale, Bill and Mercedes purchased \$1,000 worth of furniture with "no money down and no payments for one year!" How much money is this deal really worth? (Assume their after-tax rate of return on investments is 10 percent.)

Answer: The discount factor of .909 (Exhibit 3-1, 10% Rate of Return column, Year 1 row) means the present value of \$1,000 is \$909 ($\$1,000 \times .909 = \909)—so Bill and Mercedes save \$91 ($\$1,000 - \$909 = \91).

While Example 3-1 considers a \$1,000 cash inflow, Example 3-2 addresses a \$1,000 cash *outflow*. In terms of present value, choosing between paying \$1,000 today and paying \$1,000 in a year simplifies to choosing a cash outflow of either \$1,000 (by paying today) or \$909 (by paying in a year). Most people would prefer to pay \$909. Indeed, financial planners always keep the following general rule of thumb in mind: When considering *cash inflows*, prefer higher present values; when considering *cash outflows*, prefer lower present values.

The Timing Strategy When Tax Rates Are Constant

In terms of tax planning, remember that *taxes paid* represent cash *outflows*, while *tax savings* generated from tax deductions are cash *inflows*. This perspective leads us to two basic tax-related timing strategies when tax rates are constant (not changing):

1. Accelerate tax deductions (deduct in an earlier period).
2. Defer recognizing taxable income (recognize in a later period).

Accelerating tax deductions to an earlier period increases the present value of the tax savings from the deduction. That is, tax savings received now have a higher present value than the same amount received a year from now.

Deferring income to a later period decreases the present value of the tax cost of the income. That is, taxes paid a year from now have a lower present value than taxes paid today. These two strategies are summarized in Exhibit 3-2.

EXHIBIT 3-2 The Timing Tax Strategy When Tax Rates Are Constant

Item	Recommendation	Why?
Tax deductions	Accelerate tax deductions into earlier years.	Maximizes the present value of tax savings from deductions.
Taxable income	Defer taxable income into later tax years.	Minimizes the present value of taxes paid.

Example 3-3

Mercedes, a calendar-year taxpayer, uses the cash method of accounting for her small business.² On December 28, she receives a \$10,000 bill from her accountant for consulting services related to her small business. She can avoid late payment charges by paying the \$10,000 bill before January 10 of next year. Let's assume that Mercedes's marginal tax rate is 32 percent *this year and next* and that she can earn an after-tax rate of return of 10 percent on her investments. When should she pay the \$10,000 bill—this year or next?

Answer: If Mercedes pays the bill this year, she will receive a tax deduction on this year's tax return.³ If she pays the bill in January, she will receive a tax deduction on next year's tax return (one year later). She needs to compare the after-tax costs of the accounting service, using the present value of the tax savings for each scenario:

Present Value Comparison		
Description	Option 1: Pay \$10,000 bill <i>this year</i>	Option 2: Pay \$10,000 bill <i>next year</i>
Tax deduction	\$10,000	\$10,000
Marginal tax rate	<u>× 32%</u>	<u>× 32%</u>
Tax savings	<u>\$ 3,200</u>	<u>\$ 3,200</u>
Discount factor	<u>× 1</u>	<u>× .909</u>
Present value tax savings	<u>\$ 3,200</u>	<u>\$ 2,909</u>
After-tax cost of accounting services:		
Before-tax cost	\$10,000	\$10,000
Less: Present value tax savings	<u>– 3,200</u>	<u>– 2,909</u>
After-tax cost of accounting services	<u>\$ 6,800</u>	<u>\$ 7,091</u>

Since Mercedes would surely rather spend \$6,800 than \$7,091 for accounting services, paying the bill in December is the clear winner.

²In the Business Income, Deductions, and Accounting Methods chapter, we discuss the basic accounting methods (e.g., cash vs. the accrual method), which influence the timing of when income and deductions are recognized for tax purposes.

³Accelerating her payment from January 10 to December 31 will increase the present value of the \$10,000 cash outflow by 10 days. Thus, there is a minor present value cost associated with accelerating her payment.

In terms of accelerating deductions, the intent of the timing strategy is to accelerate the tax deduction significantly *without* accelerating the actual cash outflow that generates the expense. Indeed, if we assume a marginal rate of 32 percent and an after-tax return of 8 percent, accelerating a \$1,000 cash outflow by one year to realize \$320 in tax savings actually *increases* the after-tax *cost* of the expense from \$629.68 to \$680.

Present Value Comparison		
Description	Present value of net cash outflow today	Present value of net cash outflow in one year
Cash outflow	\$1,000	\$1,000.00
Less: Tax savings (outflow × 32% tax rate)	<u>- 320</u>	<u>- 320.00</u>
Net cash outflow	<u>\$ 680</u>	<u>\$ 680.00</u>
Present value factor	<u>× 1</u>	<u>× .926</u>
Present value of net cash outflow today	<u>\$ 680</u>	<u>\$ 629.68</u>

Generally speaking, whenever a taxpayer can accelerate a deduction without also substantially accelerating the cash outflow, the timing strategy will be more beneficial.

Is the accelerating deductions strategy utilized in the real world? Yes. While it is particularly effective for cash-method taxpayers, who can often control the year in which they pay their expenses, all taxpayers have *some* latitude in timing deductions. Common examples of the timing strategy include accelerating depreciation deductions for depreciable assets, using LIFO instead of FIFO for inventory, and accelerating the deduction of certain prepaid expenses.⁴ For large corporations, the benefits associated with this timing strategy can be quite substantial. Thus, tax planners spend considerable time identifying the proper period in which to recognize expenses and evaluating opportunities to accelerate deductions.

Are there certain taxpayer or transaction attributes that enhance the advantages of accelerating deductions? Absolutely. Higher tax rates, higher rates of return, larger transaction amounts, and the ability to accelerate deductions by two or more years all increase the benefits of accelerating deductions. To demonstrate this for yourself, simply rework Example 3-3 and substitute any of the following: 50 percent tax rate, 12 percent after-tax rate of return, \$100,000 expense, or a five-year period difference in the timing of the expense deduction. The benefits of accelerating deductions become much more prominent with these changes.

Deferring income recognition is an equally beneficial timing strategy, especially when the taxpayer can defer the recognition of income significantly without deferring the actual receipt of income very much. Consider the following example.

Example 3-4

In early December, Bill decides he would like to sell \$100,000 of his Dell Inc. stock, which cost \$20,000 10 years ago. Assume Bill's tax rate on the \$80,000 gain will be 15 percent and his typical after-tax rate of return on investments is 7 percent. What effect would deferring the sale to January have on Bill's after-tax cash flow on the sale?

⁴See the discussion of accounting methods in the Business Income, Deductions, and Accounting Methods chapter.

Answer:

Present Value Comparison		
Description	Option 1: Sell the \$100,000 stock in December ⁵	Option 2: Sell the \$100,000 stock in January ⁵
Sales price	\$100,000	\$100,000
Less: Cost of stock	<u>– 20,000</u>	<u>– 20,000</u>
Gain on sale	<u>\$ 80,000</u>	<u>\$ 80,000</u>
Marginal tax rate	<u>× 15%</u>	<u>× 15%</u>
Tax on gain	\$ 12,000	\$ 12,000
Discount factor	<u>× 1</u>	<u>× .935</u>
Present value tax cost	<u>\$ 12,000</u>	<u>\$ 11,220</u>
After-tax cash flow from sale:		
Sales price	\$100,000	\$100,000
Less: Present value tax cost	<u>– 12,000</u>	<u>– 11,220</u>
After-tax cash flow from sale	<u>\$ 88,000</u>	<u>\$ 88,780</u>

Bill would doubtlessly prefer to earn \$88,780 to \$88,000, so from a tax perspective, selling the Dell Inc. stock in January is preferable. An important nontax issue for Bill to consider is the possibility that the stock price may fluctuate between December and January.

Income deferral represents an important aspect of investment planning, retirement planning, and certain property transactions. Income-related timing considerations also affect tax planning for everyday business operations, such as determining the appropriate period in which to recognize income (e.g., cash or accrual accounting method for income and deduction recognition, and depreciation methods).

Do certain taxpayer or transaction attributes enhance the advantages of deferring income? Yes. The list is very similar to that for accelerating deductions: Higher tax rates, higher rates of return, larger transaction amounts, and the ability to defer revenue recognition for longer periods of time increase the benefits of deferral. To demonstrate this for yourself, simply rework Example 3-4 using any of the following: 50 percent tax rate, 12 percent after-tax rate of return on investments, or \$200,000 gain.⁶

The Timing Strategy When Tax Rates Change

When tax rates change, the timing strategy requires a little more consideration because the tax costs of income and the tax savings from deductions will now vary. The higher the tax rate, the higher the tax savings for a tax deduction. The lower the tax rate, the lower

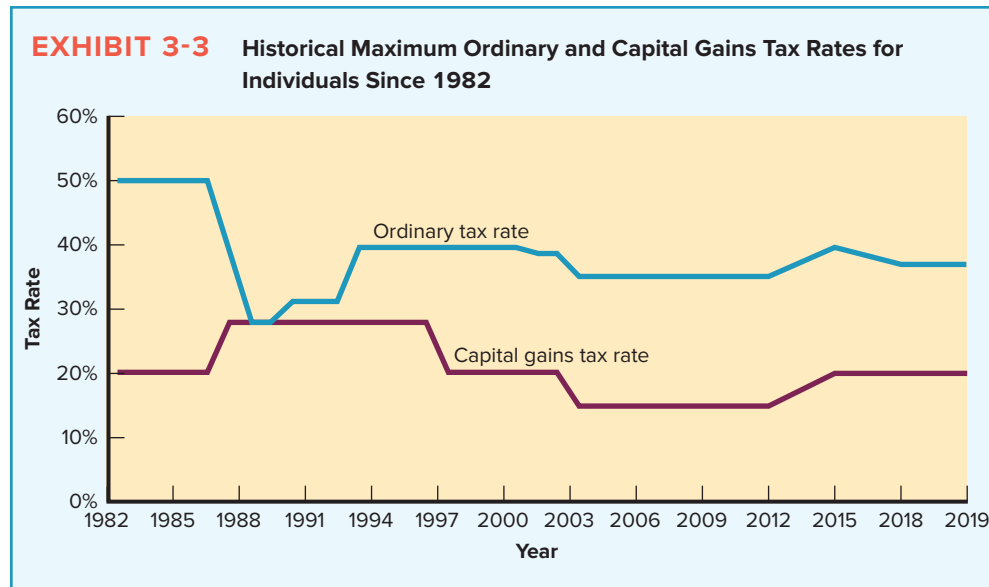
THE KEY FACTS

The Timing Strategy

- The time at which income is taxed or an expense is deducted affects the *present value* of the taxes paid on income or tax savings on deductions.
- The tax costs of income and tax savings of deductions vary as *tax rates* change.
- When tax rates are constant, tax planners prefer to defer income and accelerate deductions.
- When tax rates are increasing, the taxpayer must calculate the optimal tax strategies for deductions and income.
- When tax rates are decreasing, taxpayers should accelerate tax deductions into earlier years and defer taxable income to later years.

⁵This will require Bill to pay the tax on the gain no later than April 15 of the following year (i.e., 3 months after the sale for option 1 and 15 months after the sale for option 2). If Bill and Mercedes's current-year withholding and estimated payments do not equal or exceed 110 percent of their previous year's tax liability, they will have to make an estimated payment by January 15 to avoid the failure to make estimated tax payment penalty (discussed later in the Individual Income Tax Computation and Tax Credits chapter). This example assumes that Bill and Mercedes can avoid the underpayment of estimated tax penalty discussed in the Individual Income Tax Computation and Tax Credits chapter by paying 110 percent of their previous year's tax liability in both options 1 and 2. Thus, they can defer paying the tax on the gain until April 15 of the year following the sale.

⁶In Example 3-4, increasing the deferral period (e.g., from one to five years) also increases the benefits of tax deferral but requires additional assumptions regarding the expected five-year return of the Dell Inc. stock (assuming he does not sell the stock for five years) and his new investment (assuming he sells the Dell Inc. stock and immediately reinvests the after-tax proceeds).



the tax costs for taxable income. *All other things being equal, taxpayers should prefer to recognize deductions during high-tax-rate years and income during low-tax-rate years.* The implication is that before a taxpayer implements the timing strategies suggested above (accelerate deductions, defer income), she should consider whether her tax rates are likely to change. In fact, as we discuss below, increasing tax rates may even suggest the taxpayer should *accelerate* income and *defer* deductions.

What would cause a taxpayer’s marginal tax rate to change? The taxpayer’s taxable income can change for a variety of reasons, such as changing jobs, retiring, or starting a new business. Indeed, in the Introduction to Tax chapter, we demonstrated how a taxpayer’s marginal tax rate changes as income or deductions change. Marginal tax rates can also change because of tax legislation. We discussed the tax legislative process in the Tax Compliance, the IRS, and Tax Authorities chapter and noted that Congress frequently enacts tax legislation because lawmakers use taxes to raise revenue, stimulate the economy, and so on. For example, the Tax Cuts and Jobs Act enacted on December 22, 2017, lowered the top ordinary tax rate from 39.6 percent to 37 percent. In the last 35 years, Congress has changed the maximum statutory tax rates that apply to ordinary income, such as wages and business income, or capital gains, such as gains from the sale of stock, for individual taxpayers no fewer than 11 times (see Exhibit 3-3).

Let’s take a look at how changing tax rates affect the timing strategy recommendations. Exhibit 3-4 presents recommendations for when tax rates are increasing. The taxpayer must actually calculate the optimal tax strategies for deductions and income when tax rates are increasing. Specifically, because accelerating deductions causes them to be

EXHIBIT 3-4 The Timing Tax Strategy When Tax Rates Are Increasing

Item	Recommendation	Why?
Tax deductions	Requires calculation to determine optimal strategy.	The taxpayer must calculate whether the benefit of accelerating deductions outweighs the disadvantage of recognizing deductions in a <i>lower</i> -tax-rate year.
Taxable income	Requires calculation to determine optimal strategy.	The taxpayer must calculate whether the benefit of deferring income outweighs the disadvantage of recognizing income in a <i>higher</i> -tax-rate year.

recognized in a *lower-tax-rate* year, the taxpayer must calculate whether the benefit of accelerating the deduction outweighs the disadvantage. Likewise, because deferring income causes income to be recognized in a *higher-tax-rate* year, the taxpayer must calculate whether the benefit of deferring income outweighs the disadvantage.

Example 3-5

Having decided she needs new equipment for her business, Mercedes is now considering whether to make the purchase and claim a corresponding \$10,000 deduction at year-end or next year. Mercedes anticipates that, with the new machinery, her business income will rise such that her marginal rate will increase from 24 percent this year to 32 percent next year. Assuming her after-tax rate of return is 8 percent, what should Mercedes do?

Answer: Given rising tax rates, Mercedes must calculate the after-tax cost of the equipment for *both* options and compare present values.

Present Value Comparison		
Description	Option 1: Pay \$10,000 bill <i>this year</i>	Option 2: Pay \$10,000 bill <i>next year</i>
Tax deduction	\$10,000	\$10,000
Marginal tax rate	× 24%	× 32%
Tax savings	<u>\$ 2,400</u>	<u>\$ 3,200</u>
Discount factor	× 1	× .926
Present value tax savings	<u>\$ 2,400</u>	<u>\$ 2,963</u>
After-tax cost of equipment:		
Before-tax cost	\$10,000	\$10,000
Less: Present value tax savings	– 2,400	– 2,963
After-tax cost of equipment	<u>\$ 7,600</u>	<u>\$ 7,037</u>

Paying the \$10,000 next year is the clear winner.

In the above example, if the choice were either to recognize \$10,000 of *income* this year or next, the *amounts* would be exactly the same but the conclusion would be different, and Mercedes would prefer to receive \$7,600 of after-tax income this year instead of \$7,037. (Remember, when considering cash *inflows*, we prefer the *higher* present value.) Are these always the answers when tax rates are increasing? No, the answer will depend on both the taxpayer’s after-tax rate of return and the magnitude of the tax rate increase.

Now let’s consider the recommendations when tax rates are *decreasing*—a common scenario when an individual reaches retirement. Exhibit 3-5 presents the timing strategy

EXHIBIT 3-5 The Timing Tax Strategy When Tax Rates Are Decreasing

Item	Recommendation	Why?
Tax deductions	Accelerate tax deductions into earlier years.	Maximizes the present value of tax savings from deductions due to the acceleration of the deductions into earlier years with a <i>higher</i> tax rate.
Taxable income	Defer taxable income into later tax years.	Minimizes the present value of taxes paid due to the deferral of the income to later years with a <i>lower</i> tax rate.

TAXES IN THE REAL WORLD Tax Reform and Tax Planning

How does tax reform affect taxpayers' tax planning? It depends! There is little debate that tax reform affects taxpayers' decisions, but *how* it affects their decisions is a function of the enacted tax laws and taxpayers' circumstances. Provisions to reduce the tax rate, eliminate the interest deduction on corporate debt, and change the tax treatment of capital expenditures affect the after-tax cost of investments, making them more difficult to appropriately value. As a result, it is more difficult for taxpayers to determine the appropriate tax planning strategy.

For companies in the business of investing, such as private equity firms and real estate investment companies, the various tax provisions can have a big and potentially negative impact. For example, it is fairly common for private equity firms to use leveraged buyouts to acquire portfolio companies. Eliminating interest deductions reduces the value of the portfolio companies and, consequently, reduces the profitability

of private equity firms. Therefore, this provision might encourage taxpayers to reduce debt usage on investment purchases (an example of the conversion strategy). Capital intensive businesses will see tax benefits from a tax provision that allows full expensing of capital investments, leading to their use of the timing strategy to purchase assets in the time period when these assets can be immediately expensed rather than depreciated. Similarly, a reduction in tax rates can generate additional tax benefits by encouraging taxpayers to accelerate deductions in a year with higher tax rates or to defer income so it is realized in a year with lower tax rates, a basic tax timing strategy.

With tax reform, it is certain that taxpayers are assessing how their tax strategies might change.

Source: Based on: "Tax reform uncertainty testing alternative investors," <http://www.pionline.com/article/20170417/PRINT/304179983/tax-reform-uncertainty-testing-alternative-investors>, April 17, 2017.

THE KEY FACTS

Limitations to the Timing Strategy

Timing strategies contain several inherent limitations.

- Whenever a taxpayer is unable to accelerate a deduction without also accelerating the cash outflow, the timing strategy will be less beneficial.
- Tax law generally requires taxpayers to continue their investment in an asset in order to defer income recognition for tax purposes.
- A deferral strategy may not be optimal if the taxpayer has severe cash flow needs, if continuing the investment would generate a low rate of return compared to other investments, if the current investment would subject the taxpayer to unnecessary risk, and so on.
- The constructive receipt doctrine, which provides that a taxpayer must recognize income when it is actually or constructively received, also restricts income deferral for cash-method taxpayers.

recommendations in this case. The recommendations are clear. Taxpayers should accelerate tax deductions into earlier years to reap the tax savings from *accelerating* deductions to *higher-tax-rate* years. Likewise, taxpayers should defer taxable income to later years to enjoy the tax benefits of *deferring* taxable income to *lower-tax-rate* years.

Limitations to Timing Strategies Timing strategies contain certain inherent limitations. First, tax laws generally require taxpayers to continue their investment in an asset in order to defer income recognition for tax purposes. In other words, deferral is generally not an option if a taxpayer has "cashed out" of an investment.⁷ For example, Bill could not sell his Dell stock in December and then choose not to recognize the income until January. A deferral strategy may not be optimal if (1) the taxpayer has severe cash flow needs, (2) continuing the investment would generate a low rate of return compared to other investments, or (3) the current investment would subject the taxpayer to unnecessary risk. For example, the risk that the value of Bill's investment in Dell Inc. will decline from December to January in Example 3-4 may lead Bill to forgo deferring his stock sale until January. Again, the astute taxpayer considers both the tax *and* nontax ramifications of deferring income.

A second limitation results from the **constructive receipt doctrine**, which also restricts income deferral for cash-method taxpayers.⁸ Unlike accrual-method taxpayers, cash-method taxpayers report income for tax purposes when the income is *received*, whether it is in the form of cash, property, or services.⁹ The cash method affords taxpayers

⁷See the discussions of like-kind exchanges in the Property Dispositions chapter.

⁸Later in this chapter we discuss other judicial doctrines that apply to all planning strategies.

⁹Accrual-method taxpayers report income when it is earned. In general, income is deemed earned when all events have occurred that fix the taxpayer's right to the income and the income can be estimated with reasonable accuracy. Thus, income recognition for accrual-method taxpayers generally is not tied to payment. The constructive receipt doctrine may apply in situations in which no cash, property, or services have been received but the taxpayer has a right to the income.

some leeway in determining when to recognize income, because such taxpayers can control when they bill their clients. However, the constructive receipt doctrine provides that a taxpayer must recognize income when it is actually *or* constructively received. Constructive receipt is deemed to have occurred if the income has been credited to the taxpayer's account or if the income is unconditionally available to the taxpayer, the taxpayer is aware of the income's availability, and there are no restrictions on the taxpayer's control over the income.

Example 3-6

Mercedes's brother-in-law, Carlos, works for King Acura, which recently instituted a bonus plan that pays year-end bonuses each December to employees rated above average for their customer service. Carlos is expecting a \$10,000 bonus this year that will be paid on December 31. Thinking he'd prefer to defer this income until next year, Carlos plans to take a vacation on December 30 so that he will not receive his bonus check until January. Will Carlos's strategy work?

Answer: No, the constructive receipt doctrine applies here. Because Carlos's check was unconditionally available to him on December 31, he was aware of its availability, and there were no restrictions on his control over the income on that date, Carlos must report the income in the current year.

What could taxpayers do to avoid Carlos's problem in the future? They could request that their employer institute a company policy of paying bonuses on January 1, which would allow all employees to report the bonus income in that year. However, if the employer is a cash-method taxpayer, this creates a potential conflict with its employees. Such an employer would most likely prefer to deduct the bonus in the current year, which requires the bonuses to be paid in December. This conflict would not exist if the employer were an accrual-method taxpayer, because paying the bonuses in January would not affect its ability to deduct the bonuses in the previous year.¹⁰

INCOME-SHIFTING STRATEGIES

LO 3-4 LO 3-6

We've seen that the value of a tax deduction, or the tax cost of income, varies with the marginal tax rate. We've also seen that tax rates can vary across time, which leads to basic tax planning strategies regarding when to recognize deductions and income. Tax rates can also vary across *taxpayers* or *jurisdictions* (states, countries), which leads to still other tax planning strategies—for example, shifting income from high-tax-rate taxpayers to low-tax-rate taxpayers or shifting deductions from low-tax-rate taxpayers to high-tax-rate taxpayers.

The type of taxpayers who benefit most from this strategy are (1) related parties, such as family members or businesses and their owners, who have varying marginal tax rates and are willing to shift income for the benefit of the group; and (2) taxpayers operating in multiple jurisdictions with different marginal tax rates. In any case, tax planners should seek only legitimate methods of shifting income that will withstand IRS scrutiny. In the following section we discuss transactions between family members, followed by a discussion of transactions between owners and their businesses, and finally a discussion of income shifting across jurisdictions.

¹⁰§267(a)(2). When an employee/shareholder and an employer/corporation are related (i.e., the employee/shareholder owns more than 50 percent of the value of the employer corporation), the corporation cannot deduct the compensation expense until the employee/shareholder includes the payment in income.

Transactions between Family Members and Limitations

One of the most common examples of income shifting is high-tax-rate parents shifting income to low-tax-rate children. For example, Bill and Mercedes have a 32 percent marginal tax rate, whereas their daughter, Margaret, has a 10 percent marginal tax rate. Assuming their marginal tax rates remain constant with relatively modest changes in income, every \$1 of income that Bill and Mercedes shift to Margaret reduces the family's tax liability by 22 cents [$\$1 \times (32\% - 10\%)$]. Thus, if Bill and Mercedes shift \$10,000 of taxable income to Margaret, the family's after-tax income will increase by \$2,200. Can taxpayers legally do this? Yes and no. As you might expect, there are limitations on this type of income shifting.

The **assignment of income doctrine** requires income to be taxed to the taxpayer who actually earns it.¹¹ Merely attributing your paycheck or dividend to another taxpayer does not transfer the tax liability associated with the income. The assignment of income doctrine implies that, in order to shift income to a taxpayer, that taxpayer must actually earn the income. For example, if Mercedes would like to shift some of her business income to Margaret, Margaret must actually earn it. One way to accomplish this would be for Mercedes to employ Margaret in her business and pay her a \$10,000 salary. The effects of this transaction are to decrease Mercedes's taxable income by \$10,000 because of tax-deductible salary expense, and to increase Margaret's income by the \$10,000 taxable salary. What if Margaret is paid \$10,000 to answer Mercedes's business phone one Saturday afternoon every month? Does this seem reasonable? Not likely. The IRS frowns upon this type of aggressive strategy.

Indeed, the IRS closely scrutinizes such **related-party transactions**—that is, financial activities among family members (also among owners and their businesses, or among businesses owned by the same owners). Unlike **arm's length transactions**, in which each transacting party negotiates for his or her own benefit, related-party transactions are useful for taxpayers who are much more willing to negotiate for their own common good to the detriment of the IRS. For example, would Mercedes pay an unrelated party \$10,000 to answer the phone once a month? Doubtful.¹²

Are there other ways to shift income to children? For example, could Bill shift some of his investment income to Margaret? Yes, but there's a catch. The assignment of income applies what is referred to as the "fruit and the tree" analogy [*Lucas v. Earl* (S. Ct., 1930), 8 AFTR 10287]. For the owner to avoid being taxed on the fruit from the tree (the income), the owner must transfer the tree. Thus, to shift investment income, Bill would also have to transfer ownership in the underlying investment assets to Margaret.¹³ Is there a problem with this requirement? Not for Margaret. However, Bill would likely prefer to maintain his wealth. The nontax disadvantages of transferring wealth to implement the income-shifting strategy often outweigh the tax benefits of the transfer. For example, most parents either could not afford to or would have serious reservations about transferring significant wealth to their children—a prime example of how nontax costs may override tax considerations.

Transactions between Owners and Their Businesses and Limitations

Income shifting is not limited to transactions within a family unit. One of the most common examples occurs between owners and their businesses. Let's consider Mercedes's interior design business. Currently, Mercedes operates her business as a sole proprietorship. A sole proprietorship (unlike a C corporation) is not a separate reporting entity, and thus, Mercedes reports her business income and deductions on her individual tax return. Shifting

¹¹Later in this chapter we discuss other judicial doctrines that apply to all planning strategies.

¹²The Internal Revenue Code also contains specific provisions to curtail benefits from related-person transactions. For example, §267 disallows a tax deduction for losses on sales to related persons (even if the sale was consummated at the asset's fair market value).

¹³Further, the "kiddie tax" may apply when parents shift too much investment income to children. The kiddie tax restricts the amount of a child's investment income that can be taxed at the child's (lower) tax rate and subjects the rest to trust (higher) tax rates.

income to or from her sole proprietorship offers no benefit because all of her sole proprietorship income is reported on her tax return, regardless of whether it is attributed to her personally or to her business. On the other hand, if Mercedes operated her interior design business as a C corporation, shifting income to or from the C corporation may make good financial sense because the corporation would be a separate entity with tax rates distinct from Mercedes's individual tax rate. Shifting income to herself from the C corporation may allow Mercedes to decrease the tax on her business profits, thereby increasing her after-tax income. This strategy may become more common with the recent significant drop in the corporate tax rates compared to the small decrease in individual tax rates. Example 3-7 illustrates the savings obtainable from this strategy.

Example 3-7

Mercedes is considering incorporating her interior design business. She projects \$200,000 of business profit next year. Excluding this profit, Bill and Mercedes expect \$70,000 of taxable income next year. If Mercedes would like to minimize her current-year tax liability, should she incorporate her business? (Use the married filing jointly tax rate schedule and the corporate tax rate in Appendix D to answer this question.)

Answer: If Mercedes does not incorporate her business, the first \$8,950 of her business profits will be taxed at 12 percent (from \$70,000 to \$78,950 of taxable income, the marginal tax rate is 12 percent. The next \$89,450 (from \$78,950 to \$168,400 of taxable income) would be taxed at 22 percent. The remaining \$101,600 (from \$168,400 to \$270,000 of taxable income) would be taxed at 24 percent. Upon reviewing the corporate tax rate schedule, you should note that the corporate tax rate is a flat 21 percent, and is lower than Bill and Mercedes's current marginal tax rate of 24 percent. Thus, there appears to be some opportunity for Mercedes to reduce her current-year tax liability by incorporating her business.¹⁴

In order to shift income from the corporation to the owner, the corporation must create a tax deduction for itself in the process. Compensation paid to employee-owners is the most common method of shifting income from corporations to their owners. Compensation expense is deductible by the corporation and is generally taxable to the employee. (See the Compensation chapter for a broader discussion of nontaxable compensation benefits.) Having the business owner rent property to the corporation or loan money to the corporation are also effective income-shifting methods, because both transactions generate tax deductions for the corporation and income for the shareholder. Because corporations don't get a tax deduction for dividends paid, paying dividends is *not* an effective way to shift income. Having a corporation pay dividends actually results in "double taxation"—the profits generating the dividends are taxed first at the corporate level, and then at the shareholder level. Depending on the taxpayer's tax rate and their dividend tax rate, this strategy may be a good one though under the new tax law it can be quite complicated, and recommending this tax planning strategy without analyzing the taxpayer's situation may not be a good way to keep your job as a tax consultant.

After a taxpayer identifies the opportunity and appropriate method to shift income (compensation paid to a related party), he or she can easily determine the optimal amount to shift depending on the taxpayers' marginal tax rates.

Example 3-8

Assuming Mercedes's goal is to minimize her current-year federal income tax liability, how much of the \$200,000 business income should her corporation report?

Answer: It should report \$191,050. Comparing the two tax rate schedules reveals how to calculate this number.

(continued on page 3-14)

¹⁴Note that this is a simplified discussion of one of many tax issues associated with incorporating a business and assumes Mercedes's business does not qualify for the deduction for qualified business income discussed in the Individual Deductions chapter. In addition, as discussed later in this chapter, Mercedes must consider the judicial doctrines (economic substance, business purpose, etc.) in making this decision. She also needs to consider further tax planning opportunities described in the following example.

Step 1: Would Mercedes rather have income taxed at 21 percent (the corporation's tax rate) or 12 percent (Bill and Mercedes's marginal tax rate before recognizing any profit from Mercedes's business)? The obvious answer is 12 percent. To take advantage of Bill and Mercedes's 12 percent tax bracket, Mercedes should shift \$8,950 of the expected \$200,000 in profits to herself and Bill—via a salary paid to Mercedes.

Step 2: Assuming Bill and Mercedes report \$78,950 of income, their marginal tax rate will now be 22 percent, and thus Mercedes's choice is to have additional income taxed at 22 percent (Bill and Mercedes's marginal tax rate) or at 21 percent (the corporation's tax rate). The clear answer in this case is 21 percent. To take advantage of the 21 percent corporate tax rate, the corporation should retain the remaining \$191,050 of the expected \$200,000 in profits.

How much current federal income tax does this strategy save Bill and Mercedes? The corporation's and Bill and Mercedes's combined federal income tax liability will be \$49,207 (\$40,121 for the corporation plus \$9,086 for Bill and Mercedes) compared to \$53,149 for Bill and Mercedes if the business is operated as a sole proprietorship. Thus, they will save \$3,942.¹⁵

Are there nontax disadvantages of the income-shifting-via-incorporating strategy? Yes. For example, one nontax disadvantage for Mercedes is that her new corporation now has \$150,929 of her after-tax profits (\$191,050 profits less \$40,121 of corporate tax). If Mercedes has personal cash-flow needs that require use of the \$150,929, this is not a viable strategy. Indeed, it's advantageous only if the business owner intends to reinvest the business profits into the business. Furthermore, any subsequent transactions between Mercedes and the corporation would clearly be related-party transactions. Thus, Mercedes should be prepared for IRS scrutiny.¹⁶

As the above example illustrates, tax-avoiding strategies can be quite beneficial and as Bill and Mercedes's personal (nonbusiness) income increases (i.e., their tax bracket increases on personal income), the strategies will produce even greater tax savings. With the decrease in the corporate tax rate from 35 percent to 21 percent due to recent tax law changes, we are likely to see an increasing preference for businesses to operate as corporations. However, tax planning strategies also entail some financial risks if they fail to pass muster with the IRS.

ETHICS

Agnes Meher is the owner of LuPat, a profitable construction company that she operates as a sole proprietorship. As a sole proprietor, Agnes reports the business income from LuPat on her individual tax return. Agnes expects the business to generate \$400,000 of taxable income this year. Combined with her other income, this will put her in the top tax bracket (37 percent). Agnes has two children named Ellie Mae and Spencer,

ages 9 and 11, respectively, who do not currently have any taxable income. Agnes would like to shift some of her income from LuPat to Ellie Mae and Spencer to reduce the overall tax burden from the business income. To shift the income, Agnes hired Ellie Mae and Spencer to perform some janitorial and clerical services for LuPat, paying each child \$20,000. What do you think of Agnes's strategy?

¹⁵This strategy will result in the eventual double taxation of the income retained in Mercedes's corporation. Specifically, Mercedes will eventually have to pay tax on the income retained by the corporation, either in the form of taxable dividends from the corporation or a taxable gain when she sells or liquidates the corporation. The present value of this additional layer of tax reduces the tax savings from this strategy. The longer that the second layer of tax is deferred, the more advantageous this strategy will be. In addition, the example ignores employment-related taxes. These calculations are beyond the scope of this chapter.

¹⁶The taxpayer should maintain documentation for related-party transactions (e.g., notes for related-party loans and contemporaneous documentation of reasonable compensation paid to related parties).

Income Shifting across Jurisdictions and Limitations

Taxpayers that operate in multiple jurisdictions (states, countries) also apply the income-shifting strategy. Specifically, income earned in different jurisdictions—whether in the United States or abroad, and for state income tax purposes, income earned in different states—is often taxed very differently. With a proper understanding of the differences in tax laws across jurisdictions, taxpayers can use these differences to maximize their after-tax wealth.

Example 3-9

Carlos's employer, King Acura, has two locations. Its main location is in South Dakota (a state with no corporate tax), with a secondary location in North Dakota (maximum corporate state tax rate of 4.31 percent). What tax planning strategy may save money for King Acura?

Answer: The most obvious strategy is to shift income from the North Dakota location to the South Dakota location, thereby reducing King Acura's state income tax liability by about 4.31 cents for every dollar of income shifted.¹⁷

A number of possibilities exist to execute a strategy such as King Acura's in Example 3-9. Assuming that the North Dakota and South Dakota locations exchange cars, the firm could shift income via *transfer pricing* (using the price the South Dakota location charges the North Dakota location for cars transferred to North Dakota). Likewise, if the South Dakota location (the corporate headquarters) provides a legitimate support function for the North Dakota location, the firm should allocate a portion of the overhead and administrative expenses from the South Dakota location to the North Dakota location.

What are some of the limitations of income shifting across jurisdictions? First, taxing authorities are fully aware of the tax benefits of strategically structuring transactions across tax borders (across countries or states). Thus, the IRS closely examines transfer pricing on international transactions. Similarly, state tax authorities scrutinize interstate transactions between related taxpayers. Second, when taxpayers locate in low-tax-rate jurisdictions to, in effect, shift income to a tax-advantaged jurisdiction, they may bear **implicit taxes** (i.e., additional costs attributable to the jurisdiction's tax advantage). For example, the demand for workers, services, or property in low-tax-rate jurisdictions, whether a foreign country or a low-tax state, may increase the non-tax costs associated with operating a business there enough to offset the tax advantages. Finally, negative publicity from moving operations (and jobs) from the United States to a lower-tax jurisdiction may more than offset any tax benefits associated with these strategies.

THE KEY FACTS

The Income-Shifting Strategy

- Income shifting exploits the differences in tax rates across taxpayers or jurisdictions.
- Common examples of income shifting include high-tax-rate parents shifting income to low-tax-rate children, businesses shifting income to their owners, and taxpayers shifting income from high-tax jurisdictions to low-tax jurisdictions. The assignment of income doctrine requires income to be taxed to the taxpayer who actually earns the income.
- The IRS closely monitors income-shifting strategies that involve related-party transactions.

LO 3-5

CONVERSION STRATEGIES

We've now seen how tax rates can vary across time and taxpayers. They can also vary across different *activities*. For example, ordinary income such as salary, interest income, and business income received by individual taxpayers is taxed at their ordinary marginal tax rates. Long-term capital gains, which are gains from the sale of investment assets held

¹⁷Because state taxes are deductible for federal tax purposes, every dollar of state taxes reduced with this strategy will increase King Acura's federal income tax liability by its federal marginal tax rate (e.g., 21 percent). Thus, the net tax savings for every dollar of income shifted from North Dakota to South Dakota will be 3.4 percent, which equals the state tax savings (4.31 percent) less the federal tax increase resulting from the lost state tax deduction ($4.31\% \times 21\%$).

THE KEY FACTS**The Conversion Strategy**

- The conversion strategy is based on the understanding that the tax law does not treat all types of income or deductions the same.
- To implement the conversion strategy, taxpayers should be aware of the underlying differences in tax treatment across various types of income, expenses, and activities and have some ability to alter the nature of the income or expense to receive the more advantageous tax treatment.
- The Internal Revenue Code contains specific provisions that prevent the taxpayer from changing the nature of expenses, income, or activities to a more tax-advantaged status.
- Implicit taxes may reduce or eliminate the advantages of conversion strategies.

longer than one year, and dividends are taxed at lower tax rates (currently a maximum of 20 percent), and still other forms of income like nontaxable compensation benefits and municipal bond interest are tax-exempt. Expenses from different types of activities may also be treated very differently for tax purposes. Business expenses are generally fully tax deductible, whereas tax deductions for investments may be limited, and tax deductions for personal expenses may be completely disallowed. In sum, the tax law does not treat all types of income or deductions the same. This understanding forms the basis for the conversion strategy—recasting income and expenses to receive the most favorable tax treatment.

To implement the conversion strategy, the taxpayer must be aware of the underlying differences in tax treatment across various types of income, expenses, and activities and have some ability to alter the nature of the income or expense to receive the more advantageous tax treatment. What are some common examples of the conversion strategy? Income and deductions with differing character, investments generating income subject to differing tax rates, expenses with differing deductibility, and compensation resulting in taxable versus nontaxable income are all examples of items to which the conversion strategy can apply.

To analyze the benefits of the conversion strategy, you often compare the after-tax rates of return of alternative investments rather than the **before-tax rates of return**. Given a stationary marginal tax rate, you can calculate an investment's after-tax rate of return as follows:

Eq. 3-3

$$\text{After-Tax Rate of Return} = \text{Before-Tax Rate of Return} \\ - (\text{Before-Tax Rate of Return} \\ \times \text{Marginal Tax Rate})$$

which simplifies to

Eq. 3-4

$$\text{After-Tax Rate of Return} = \text{Before-Tax Rate of Return} \\ \times (1 - \text{Marginal Tax Rate})$$

Example 3-10

Bill is contemplating three different investments, each with the same amount of risk:

1. A high-dividend stock that pays 8.5 percent dividends annually but has no appreciation potential.
2. Taxable corporate bonds that pay 9.7 percent interest annually.
3. Tax-exempt municipal bonds that pay 6 percent interest annually.

Assuming that dividends are taxed at 20 percent and that Bill's marginal tax rate on ordinary income is 37 percent, which investment should Bill choose?

Answer: To answer this question, we must compute Bill's after-tax rate of return for each investment. The after-tax rates of return for the three investments are

Investment Choice	Computation	After-Tax Rate of Return
High-dividend stock	$8.5\% \times (1 - 20\%) =$	6.8%
Corporate bond	$9.7\% \times (1 - 37\%) =$	6.1
Municipal bond	$6\% \times (1 - 0\%) =$	6.0

Accordingly, Bill should choose the dividend-yielding stock.

What marginal tax rate on ordinary income would make Bill indifferent between the dividend-yielding stock and the corporate bond?

Answer: The dividend-yielding stock has an after-tax rate return of 6.8 percent. For Bill to be indifferent between this stock and the corporate bond, the corporate bond would need a 6.8 percent after-tax rate of return. We can use Equation 3-4 to solve for the marginal tax rate.

$$\begin{aligned} \text{After-Tax Rate of Return} &= \text{Before-Tax Rate of Return} \times (1 - \text{Marginal Tax Rate}) \\ 6.8\% &= 9.7\% \times (1 - \text{Marginal Tax Rate}) \\ \text{Marginal Tax Rate} &= 29.90\% \end{aligned}$$

Let's check this answer:

$$\text{After-Tax Rate of Return} = 9.7\% \times (1 - 29.90\%) = 6.8\%$$

Example 3-10 shows how taxpayers may compare investments when the investment period is one year. However, when taxpayers hold investments for more than a year they potentially receive benefits from combining the timing strategy and the conversion strategy. First, they may be able to defer recognizing gains on the assets until they sell them—the longer the deferral period, the lower the present value of the tax when taxpayers ultimately sell the assets. Second, they may pay taxes on the gains at preferential rates. For example, taxpayers who invest in a corporate stock (capital asset) that does not pay dividends will defer gain on any stock appreciation until they sell the stock, and because it is a capital asset held longer than one year, their gains will be taxed at the lower preferential tax rate for long-term capital gains. These tax advantages provide taxpayers with a greater after-tax rate of return on these investments than they would obtain from less tax-favored assets that earn equivalent before-tax rates of return. Investors who quickly sell investments pay taxes on gains at higher, ordinary rates and incur significantly greater transaction costs. Nevertheless, taxpayers should balance the tax benefits available for holding assets with the risk that the asset values will have declined by the time they want to sell the assets.

To compare investments with differing time horizons, taxpayers use the annualized after-tax rate of return. In general, the after-tax rate of return on any investment is $(FV/I)^{1/n} - 1$ where FV is the future value after taxes, I is the investment (in after-tax dollars), and n is the number of investment periods.¹⁸

Example 3-11

What if: Assume Bill decides to purchase Intel stock for \$50,000 and hold the shares for five years. If the Intel stock grows at a constant 8 percent before-tax rate and does not pay any dividends, how much cash will Bill accumulate after taxes after five years, assuming a long-term capital gains tax rate of 20 percent?

Answer: \$68,773, computed as follows:

Description	Amount	Explanation
(1) Proceeds from sale	\$ 73,466	$[\$50,000 \times (1 + 0.08)^5]$
(2) Basis in shares	<u>50,000</u>	This is the investment in the shares.
(3) Gain realized on sale	\$ 23,466	(1) - (2)
(4) Tax rate on gain	<u>× 20%</u>	Low rate for long-term capital gain*
(5) Tax on gain	<u>\$ 4,693</u>	(3) × (4)
After-tax cash after 5 years	\$68,773	(1) - (5)

*Assumes Bill doesn't have any capital losses.

(continued on page 3-18)

¹⁸Financial calculators designate this calculation as the IRR or internal rate of return.

What annual after-tax rate of return will Bill earn on the money invested?

Answer: 6.58 percent $[(\$68,773/\$50,000)^{1/5} - 1]$.

What if: What would be the after-tax rate of return if Bill held the stock for 18 years?

Answer: 7.03 percent, computed as follows:

Description	Amount	Explanation
(1) Proceeds from sale	\$199,801	$[\$50,000 \times (1 + 0.08)^{18}]$
(2) Basis in shares	50,000	This is the investment in the shares.
(3) Gain realized on sale	\$149,801	(1) – (2)
(4) Tax rate on gain	<u>20%</u>	Low rate for long-term capital gain*
(5) Tax on gain	\$29,960	(3) × (4)
After-tax cash after 18 years	\$169,841	(1) – (5)
After-tax rate of return after 18 years	7.03%	$[(\$169,841/\$50,000)^{1/18} - 1]$

*Assumes Bill doesn't have any capital losses.

What if: How does Bill's rate of return on the Intel stock held for five years compare to a taxable corporate bond that pays 9 percent interest annually and is held for five years?

Answer: The annualized rate of return on the stock held for five years is 6.58 percent, as shown above. Because the interest on the taxable corporate bond is taxed annually, the annual after-tax rate of return does not change with the investment horizon and will equal 6.1 percent, as shown in Example 3-10 $[9.7\% \times (1 - 37\%)]$. In this situation, the combined tax benefits from the timing and conversion strategies cause the stock investment to generate a higher annualized after-tax return than the taxable corporate bond even though its pretax return is lower.

Limitations of Conversion Strategies

Like other tax planning strategies, conversion strategies face potential limitations. The Internal Revenue Code itself also contains several specific provisions that prevent the taxpayer from changing the nature of expenses, income, or activities to a more tax-advantaged status, including (among many others) the depreciation recapture rules discussed in the Property Dispositions chapter and the luxury auto depreciation rules discussed in the Property Acquisition and Cost Recovery chapter. In addition, as discussed in the Introduction to Tax chapter, implicit taxes may reduce or eliminate the advantages of tax-preferred investments (such as municipal bonds or any investment taxed at preferential tax rates) by decreasing their before-tax rate of returns. Thus, implicit taxes may reduce the advantages of the conversion strategy.

LO 3-6

ADDITIONAL LIMITATIONS TO TAX PLANNING STRATEGIES: JUDICIALLY BASED DOCTRINES

The IRS has several other doctrines at its disposal for situations in which it expects taxpayer abuse. These doctrines have developed from court decisions and apply across a wide variety of transactions and planning strategies (timing, income shifting, and conversion). The **business purpose doctrine**, for instance, allows the IRS to challenge and disallow business expenses for transactions with no underlying business motivation, such as the travel cost of a spouse accompanying a taxpayer on a business trip. The **step-transaction doctrine** allows the IRS to collapse a series of related transactions into one transaction to determine the tax consequences of the transaction. The **substance-over-form doctrine** allows the IRS to consider the transaction's substance regardless of its form and, where appropriate, to reclassify the transaction according to its substance. Finally, the

economic substance doctrine requires transactions to meet two criteria to obtain tax benefits. First, a transaction must meaningfully change a taxpayer's economic position (excluding any federal income tax effects). Second, the taxpayer must have a substantial purpose (other than tax avoidance) for the transaction. Economic substance is clearly related to several other doctrines such as the business purpose, step-transaction, and substance-over-form doctrines; however, the economic substance doctrine was incorporated into the Internal Revenue Code as §7701(o). This codification standardizes the requirement for transactions to meet both tests. None of the other doctrines have yet been codified.

The courts have been inconsistent with the application of the tests, with some requiring the transaction to meet either the business purpose or the economic substance requirements and others requiring that it meet both tests. A key part of the codification of the economic substance doctrine is a stiff penalty of 40 percent of the underpayment for failing to meet the requirements—reduced to 20 percent if the taxpayer makes adequate disclosure. In the Tax Compliance, the IRS, and Tax Authorities chapter, we noted that the Internal Revenue Code is the ultimate tax authority. The business purpose, step-transaction, substance-over-form, and economic substance doctrines allow the IRS to state the tax consequences of transactions that follow only the form of the Internal Revenue Code and not the spirit.

You can often assess whether the business purpose, step-transaction, or substance-over-form doctrines apply by using the “smell test.” If the transaction “smells bad,” one of these doctrines likely applies. (Transactions usually “smell bad” when the primary purpose is to avoid taxes and not to accomplish an independent business objective.) For example, using the substance-over-form doctrine, the IRS would likely reclassify most of the \$10,000 paid to Margaret for answering the phone one Saturday afternoon a month as a gift from Mercedes to Margaret (see the earlier discussion of income shifting and transactions between family members), even though the transaction was structured as compensation and Margaret did do some work for her mother. This recharacterization would unwind the income-shifting benefits for the amount considered to be a gift, because gifts to family members are not tax deductible. In sum, the *substance* of the transaction must be justifiable, not just the form.

TAX AVOIDANCE VERSUS TAX EVASION

Each of the general tax planning strategies discussed in this book falls within the confines of legal **tax avoidance**. Tax avoidance has long been endorsed by the courts and even Congress. Recall, for example, that Congress specifically encourages tax avoidance by excluding municipal bond income from taxation, preferentially taxing dividend and capital gain income, and enacting other provisions. Likewise, the courts have often made it quite clear that taxpayers are under no moral obligation to pay more taxes than required by law. As an example, in *Commissioner v. Newman*, 159 F.2d 848 (2 Cir., 1947), which considered a taxpayer's ability to shift income to his children using trusts, Judge Learned Hand included the following statement in his dissenting opinion:

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

In contrast to tax avoidance, **tax evasion**—that is, the willful attempt to defraud the government—falls outside the confines of legal tax avoidance and thus may land the perpetrator within the confines of a federal prison. (Recall from the Tax Compliance, the IRS, and Tax Authorities chapter that the rewards of tax evasion include stiff monetary penalties and imprisonment.) When does tax avoidance become tax evasion? Very good question. In many cases a clear distinction exists between avoidance (such as not paying tax on municipal bond interest) and evasion (not paying tax on a \$1,000,000 game show

THE KEY FACTS

Additional Limitations to Tax Planning Strategies: Judicial Doctrines

- Certain judicial doctrines restrict the common tax planning strategies (timing, income shifting, and conversion).
- The business purpose doctrine allows the IRS to challenge and disallow business expenses for transactions with no underlying business motivation.
- The step-transaction doctrine allows the IRS to collapse a series of related transactions into one transaction to determine the tax consequences of the transaction.
- The substance-over-form doctrine allows the IRS to reclassify a transaction according to its substance.
- The economic substance doctrine requires transactions to have both an economic effect (aside from the tax effect) and a substantial purpose (aside from reduction of tax liability).

LO 3-7

THE KEY FACTS

Tax Evasion versus Tax Avoidance

- Tax avoidance is the legal act of arranging your transactions to minimize taxes paid.
- Tax evasion is the willful attempt to defraud the government by not paying taxes legally owed.
- Tax evasion falls outside the confines of legal tax avoidance.

prize). In other cases, the line is less clear. In these situations, professional judgment, the use of a smell test, and consideration of the business purpose, step-transaction, substance-over-form, and economic substance doctrines may prove useful.

TAXES IN THE REAL WORLD Cheating the IRS

Few people like to pay taxes, but most of us do so. Some, however, try to cheat the IRS, including the rich and famous (among them, Mike “The Situation” Sorrentino, Chris Tucker, and rapper DMX). Folks who are trying to escape the reach of the IRS may fail to file tax returns, claim deductions to which they’re not entitled, make up fake business expenses, or otherwise try to disguise how much money they really made. These tax evaders cost the government a lot of money. The average annual “tax gap” for 2008–2010, the most recent period for which the IRS has estimated the amount of owed taxes that weren’t paid on time, is \$458 billion (see <https://www.irs.gov/newsroom/the-tax-gap>).

The main cause of the tax gap is underreporting income, accounting for \$376 billion of the IRS’s missing money. Not filing returns and underpaying taxes owed were two other causes. Some of that money fails to make it into the hands of the government through innocent accounting

mistakes or the inability of taxpayers to pay even though they want to. But some of it goes missing due to deliberate fraud.

In fiscal year (FY) 2016, the IRS initiated 3,395 criminal investigations related to tax code violations (these aren’t the same as audits, which are much more common—1.03 million individuals were audited in FY 2016). The number of criminal investigations is relatively small, especially considering the millions of taxpayers in the United States. But once the IRS starts an investigation, there’s a good chance it will lead to a conviction and prison time for the offender. The IRS boasts of a 79.5 percent conviction rate (2,699 sentenced/3,395 investigations) on these criminal tax cases.

Source: “Avoid an Audit: 6 Tax Lessons from Celebrities,” <http://www.cheatsheet.com/personal-finance/5-lessons-from-celebrity-tax-cheats.html?a=viewall> April 4, 2016; and the IRS Criminal Divisions 2016 Annual Report, https://www.irs.gov/pub/foia/ig/ci/2016_annual_report_02092017.pdf.

As you might expect, tax evasion is a major problem for the IRS that vigorous prosecution alone has not been able to solve. Is tax evasion a victimless crime? No. Because the federal government must replace lost tax revenues by imposing higher taxes on others, honest taxpayers are the true victims of tax evasion. Currently, the most recent federal government estimates indicate that tax evasion costs the federal government more than \$450 billion annually in lost tax revenues. As citizens and residents of the United States, each of us must recognize our obligation to support our country. As future accountants and business professionals, we also must recognize the inherent value of high ethical standards, which call for us to do the right thing in *all* situations. Business professionals have learned over and over that the costs of doing otherwise far exceed any short-term gains.

CONCLUSION

In this chapter we discussed three basic tax planning strategies—timing, income shifting, and conversion—and their related limitations. Each of these strategies exploits the variation in taxation across different dimensions. The timing strategy exploits the variation in taxation across time: The real tax costs of income decrease as taxation is deferred; the real tax savings associated with tax deductions increase as tax deductions are accelerated. However, because tax rates may change over time and the tax costs of income and tax savings of deductions vary with tax rates, tax planning should consider the effects of such changes on the timing strategy. The income-shifting strategy exploits the variation in taxation across taxpayers or jurisdictions. The assignment of income doctrine limits aggressive attempts to shift income across taxpayers. In addition, related-party transactions

receive close IRS attention given the increased likelihood of taxpayer abuses in these transactions. Finally, the conversion strategy exploits the variation in taxation rates across activities, although implicit taxes may reduce the advantages of this strategy. In addition to limitations specific to each planning strategy, the judicial doctrines of business purpose, step-transaction, and substance-over-form broadly apply to a wide range of transactions and planning strategies.

The timing, income-shifting, and conversion strategies represent the building blocks for the more sophisticated tax strategies that tax professionals employ on a daily basis. Combining an understanding of these basic tax planning strategies with knowledge of our tax law will provide you with the tools necessary to identify, evaluate, and implement tax planning strategies. Throughout the remainder of the text, we will discuss how these strategies can be applied to different transactions.

Summary

Identify the objectives of basic tax planning strategies.

LO 3-1

- Effective tax planning maximizes the taxpayer's after-tax wealth while achieving the taxpayer's nontax goals. Maximizing after-tax wealth is not necessarily the same as tax minimization. Maximizing after-tax wealth requires one to consider both the tax and nontax costs and benefits of alternative transactions, whereas tax minimization focuses solely on a single cost (i.e., taxes).
- Virtually every transaction involves three parties: the taxpayer, the other transacting party, and the uninvited silent party that specifies the tax consequences of the transaction (i.e., the government). Astute tax planning requires an understanding of the tax and nontax costs from the taxpayer's *and* the other parties' perspectives.

Apply the timing strategy.

LO 3-2

- One of the cornerstones of basic tax planning involves the idea of *timing*—that is, *when* income is taxed or an expense is deducted affects the associated “real” tax costs or savings. This is true for two reasons. First, the timing of when income is taxed or an expense is deducted affects the *present value* of the taxes paid on income or the tax savings on deductions. Second, the tax costs of income and the tax savings from deductions vary as *tax rates* change.
- When tax rates are constant, tax planners prefer to defer income (i.e., to reduce the present value of taxes paid) and accelerate deductions (i.e., to increase the present value of tax savings). Higher tax rates, higher rates of return, larger transaction amounts, and the ability to accelerate deductions or defer income by two or more years increase the benefits of the timing strategy.
- When tax rates change, the timing strategy requires a little more consideration because the tax costs of income and the tax savings from deductions vary as *tax rates* change. When tax rates are increasing, the taxpayer must calculate the optimal tax strategies for deductions and income. When tax rates are decreasing, the recommendations are clear. Taxpayers should accelerate tax deductions into earlier years and defer taxable income to later years.
- Timing strategies contain several inherent limitations. Generally speaking, whenever a taxpayer must accelerate a cash outflow to accelerate a deduction, the timing strategy will be less beneficial. Tax law generally requires taxpayers to continue their investment in an asset in order to defer income recognition for tax purposes. A deferral strategy may not be optimal if the taxpayer has severe cash flow needs, if continuing the investment would generate a low rate of return compared to other investments, if the current investment would subject the taxpayer to unnecessary risk, and so on. The constructive receipt doctrine, which provides that a taxpayer must recognize income when it is actually or constructively received, also restricts income deferral for cash-method taxpayers.

3-22 CHAPTER 3 Tax Planning Strategies and Related Limitations

LO 3-3 Apply the concept of present value to tax planning.

- The concept of present value—also known as the time value of money—basically states that \$1 today is worth *more* than \$1 in the future. For example, assuming an investor can earn a positive return (e.g., 5 percent after taxes), \$1 invested today should be worth \$1.05 in one year. Hence, \$1 today is equivalent to \$1.05 in one year.
- The implication of the time value of money for tax planning is that the timing of a cash inflow or a cash outflow affects the present value of the income or expense.

LO 3-4 Apply the income-shifting strategy.

- The income-shifting strategy exploits the differences in tax rates across taxpayers or jurisdictions. Three of the most common examples of income shifting are high-tax-rate parents shifting income to low-tax-rate children, businesses shifting income to their owners, and taxpayers shifting income from high-tax jurisdictions to low-tax jurisdictions.
- The assignment of income doctrine requires income to be taxed to the taxpayer who actually earns the income. In addition, the IRS closely monitors such related-party transactions—that is, financial activities among family members, among owners and their businesses, or among businesses owned by the same owners. Implicit taxes may also limit the benefits of income shifting via locating in tax-advantaged jurisdictions.

LO 3-5 Apply the conversion strategy.

- Tax law does not treat all types of income or deductions the same. This understanding forms the basis for the conversion strategy—recasting income and expenses to receive the most favorable tax treatment. To implement the conversion strategy, one must be aware of the underlying differences in tax treatment across various types of income, expenses, and activities and have some ability to alter the nature of the income or expense to receive the more advantageous tax treatment.
- Common examples of the conversion strategy include investment planning to invest in assets that generate preferentially taxed income; compensation planning to restructure employee compensation from currently taxable compensation to nontaxable or tax-deferred forms of compensation; and corporate distribution planning to structure corporate distributions to receive the most advantageous tax treatment.
- The Internal Revenue Code contains specific provisions that prevent the taxpayer from changing the nature of expenses, income, or activities to a more tax-advantaged status. Implicit taxes may also reduce or eliminate the advantages of conversion strategies.

LO 3-6 Describe basic judicial doctrines that limit tax planning strategies.

- The constructive receipt doctrine, which may limit the timing strategy, provides that a taxpayer must recognize income when it is actually *or* constructively received. Constructive receipt is deemed to have occurred if the income has been credited to the taxpayer's account or if the income is unconditionally available to the taxpayer, the taxpayer is aware of the income's availability, and there are no restrictions on the taxpayer's control over the income.
- The assignment of income doctrine requires income to be taxed to the taxpayer who actually earns the income. The assignment of income doctrine implies that, in order to shift income to a taxpayer, that taxpayer must actually earn the income.
- The business purpose, step-transaction, and substance-over-form doctrines apply across a wide variety of transactions and planning strategies (timing, income shifting, and conversion).
- The business purpose doctrine allows the IRS to challenge and disallow business expenses for transactions with no underlying business motivation, such as the travel cost of a spouse accompanying a taxpayer on a business trip.
- The step-transaction doctrine allows the IRS to collapse a series of related transactions into one transaction to determine the tax consequences of the transaction.
- The substance-over-form doctrine allows the IRS to consider the transaction's substance regardless of its form and, where appropriate, reclassify the transaction according to its substance.

- The codified economic substance doctrine requires transactions to have a substantial purpose and to meaningfully change a taxpayer's economic position in order for a taxpayer to obtain tax benefits.

Contrast tax avoidance and tax evasion.

LO 3-7

- Tax avoidance is the legal act of arranging one's transactions, and so on, to minimize taxes paid. Tax evasion is the willful attempt to defraud the government (i.e., by not paying taxes legally owed). Tax evasion falls outside the confines of legal tax avoidance.
- In many cases a clear distinction exists between avoidance (e.g., not paying tax on municipal bond interest) and evasion (e.g., not paying tax on a \$1,000,000 game show prize). In other cases, the line between tax avoidance and evasion is less clear. In these situations, professional judgment, the use of a "smell test," and consideration of the business purpose, step-transaction, and substance-over-form doctrines may prove useful.

KEY TERMS

after-tax rate of return (3-3)

arm's length transactions (3-12)

assignment of income doctrine (3-12)

before-tax rate of return (3-16)

business purpose doctrine (3-18)

constructive receipt doctrine (3-10)

discount factor (3-3)

economic substance doctrine (3-19)

implicit tax (3-15)

present value (3-3)

related-party transaction (3-12)

step-transaction doctrine (3-18)

substance-over-form doctrine (3-18)

tax avoidance (3-19)

tax evasion (3-19)

DISCUSSION QUESTIONS

Discussion Questions are available in Connect®.



1. "The goal of tax planning is to minimize taxes." Explain why this statement is not true. LO 3-1
2. Describe the three parties engaged in every business transaction and how understanding taxes may aid in structuring transactions. LO 3-1
3. In this chapter we discussed three basic tax planning strategies. What different features of taxation does each of these strategies exploit? LO 3-1
4. What are the two basic timing strategies? What is the intent of each? LO 3-2
5. Why is the timing strategy particularly effective for cash-method taxpayers? LO 3-2
6. What are some common examples of the timing strategy? LO 3-2
7. What factors increase the benefits of accelerating deductions or deferring income? LO 3-2
8. How do changing tax rates affect the timing strategy? What information do you need to determine the appropriate timing strategy when tax rates change? LO 3-2 LO 3-3
9. Describe the ways in which the timing strategy has limitations. LO 3-2 LO 3-6
10. The concept of the time value of money suggests that \$1 today is not equal to \$1 in the future. Explain why this is true. LO 3-3
11. Why is understanding the time value of money important for tax planning? LO 3-3
12. What two factors increase the difference between present and future values? LO 3-3
13. What factors have to be present for income shifting to be a viable strategy? LO 3-4
14. Name three common types of income shifting. LO 3-4
15. What are some ways that a parent could effectively shift income to a child? What are some of the disadvantages of these methods? LO 3-4
16. What is the key factor in shifting income from a business to its owners? What are some methods of shifting income in this context? LO 3-4
17. Explain why paying dividends is not an effective way to shift income from a corporation to its owners. LO 3-4

3-24 CHAPTER 3 Tax Planning Strategies and Related Limitations

LO 3-5 18. What are some of the common examples of the conversion strategy?

LO 3-5 19. What is needed to implement the conversion strategy?

LO 3-5 20. Explain how implicit taxes may limit the benefits of the conversion strategy.

LO 3-5 **LO 3-6**

21. Clark owns stock in BCS Corporation that he purchased in January of the current year. The stock has appreciated significantly during the year. It is now December of the current year, and Clark is deciding whether or not he should sell the stock. What tax and nontax factors should Clark consider before making the decision on whether to sell the stock now?

planning

LO 3-5 22. Do after-tax rates of return for investments in either interest- or dividend-paying securities increase with the length of the investment? Why or why not?

LO 3-5 23. Cameron purchases stock in both Corporation X and Corporation Y. Neither corporation pays dividends. The stocks both earn an identical before-tax rate of return. Cameron sells stock in Corporation X after three years and he sells the stock in Corporation Y after five years. Which investment likely earned a greater after-tax return? Why?

LO 3-5 24. Under what circumstances would you expect the after-tax return from an investment in a capital asset to approach that of tax-exempt assets (assuming equal before-tax rates of return)?

LO 3-5 25. Laurie is thinking about investing in one or several of the following investment options:

planning

Corporate bonds (ordinary interest paid annually)

Dividend-paying stock (qualified dividends)

Life insurance (tax-exempt)

Savings account

Growth stock

a) Assuming all of the options earn similar returns before taxes, rank Laurie's investment options from highest to lowest according to their after-tax returns.

b) Which of the investments employ the deferral and/or conversion tax planning strategies?

c) How does the time period of the investment affect the returns from these alternatives?

d) How do these alternative investments differ in terms of their nontax characteristics?

LO 3-5 26. What is an "implicit tax" and how does it affect a taxpayer's decision to purchase municipal bonds?

LO 3-6 27. Several judicial doctrines limit basic tax planning strategies. What are they? Which planning strategies do they limit?

LO 3-6 28. What is the constructive receipt doctrine? What types of taxpayers does this doctrine generally affect? For what tax planning strategy is the constructive receipt doctrine a potential limitation?

LO 3-6 29. Explain the assignment of income doctrine. In what situations would this doctrine potentially apply?

LO 3-6 30. Relative to arm's length transactions, why do related-party transactions receive more IRS scrutiny?

LO 3-6 31. Describe the business purpose, step-transaction, and substance-over-form doctrines. What types of tax planning strategies may these doctrines inhibit?

LO 3-7 32. What is the difference between tax avoidance and tax evasion?

LO 3-7 33. What are the rewards of tax avoidance? What are the rewards of tax evasion?

LO 3-7 34. "Tax avoidance is discouraged by the courts and Congress." Is this statement true or false? Please explain.

PROBLEMS

Select problems are available in Connect®.



- 35. Yong recently paid his accountant \$10,000 for elaborate tax planning strategies that exploit the timing strategy. Assuming this is an election year and there could be a power shift in the White House and Congress, what is a potential risk associated with Yong’s strategies?

LO 3-2
planning

- 36. Billups, a physician and cash-method taxpayer, is new to the concept of tax planning and recently learned of the timing strategy. To implement the timing strategy, Billups plans to establish a new policy that allows all his clients to wait two years to pay their co-pays. Assume that Billups does not expect his marginal tax rates to change. What is wrong with his strategy?

LO 3-2 LO 3-3
planning

- 37. Tesha works for a company that pays a year-end bonus in January of each year (instead of December of the preceding year) to allow employees to defer the bonus income. Assume Congress recently passed tax legislation that decreases individual tax rates as of next year. Does this increase or decrease the benefits of the bonus deferral this year? What if Congress passed legislation that increased tax rates next year? Should Tesha ask the company to change its policy this year? What additional information do you need to answer this question?

LO 3-2 LO 3-3
planning

- 38. Isabel, a calendar-year taxpayer, uses the cash method of accounting for her sole proprietorship. In late December she received a \$20,000 bill from her accountant for consulting services related to her small business. Isabel can pay the \$20,000 bill anytime before January 30 of next year without penalty. Assume her marginal tax rate is 37 percent this year and next year, and that she can earn an after-tax rate of return of 12 percent on her investments. When should she pay the \$20,000 bill—this year or next?

LO 3-2 LO 3-3
planning

- 39. Using the facts from the previous problem, how would your answer change if Isabel’s after-tax rate of return were 8 percent?

LO 3-2 LO 3-3
planning

- 40. Manny, a calendar-year taxpayer, uses the cash method of accounting for his sole proprietorship. In late December he performed \$20,000 of legal services for a client. Manny typically requires his clients to pay his bills immediately upon receipt. Assume Manny’s marginal tax rate is 37 percent this year and next year, and that he can earn an after-tax rate of return of 12 percent on his investments. Should Manny send his client the bill in December or January?

LO 3-2 LO 3-3
planning

- 41. Using the facts from the previous problem, how would your answer change if Manny’s after-tax rate of return were 8 percent?

LO 3-2 LO 3-3
planning

- 42. Reese, a calendar-year taxpayer, uses the cash method of accounting for her sole proprietorship. In late December, she received a \$20,000 bill from her accountant for consulting services related to her small business. Reese can pay the \$20,000 bill anytime before January 30 of next year without penalty. Assume Reese’s marginal tax rate is 32 percent this year and will be 37 percent next year, and that she can earn an after-tax rate of return of 12 percent on her investments. When should she pay the \$20,000 bill—this year or next?

LO 3-2 LO 3-3
planning

- 43. Using the facts from the previous problem, when should Reese pay the bill if she expects her marginal tax rate to be 35 percent next year? 24 percent next year?







LO 3-2 LO 3-3
planning

- 44. Hank, a calendar-year taxpayer, uses the cash method of accounting for his sole proprietorship. In late December, he performed \$20,000 of legal services for a client. Hank typically requires his clients to pay his bills immediately upon receipt. Assume his marginal tax rate is 32 percent this year and will be 37 percent next year, and that he can earn an after-tax rate of return of 12 percent on his investments. Should Hank send his client the bill in December or January?

LO 3-2 LO 3-3
planning

3-26 CHAPTER 3 Tax Planning Strategies and Related Limitations

- LO 3-2** **LO 3-3**
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- LO 3-4**
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- LO 3-4**
planning
- LO 3-4** **LO 3-6**
planning
45. Using the facts from the previous problem, when should Hank send the bill if he expects his marginal tax rate to be 35 percent next year? 24 percent next year?
46. Geraldo recently won a lottery and chose to receive \$100,000 today instead of an equivalent amount in 10 years, computed using an 8 percent rate of return. Today, he learned that interest rates are expected to increase in the future. Is this good news for Geraldo given his decision?
47. Assume Rafael can earn an 8 percent after-tax rate of return. Would he prefer \$1,000 today or \$1,500 in five years?
48. Assume Ellina earns a 10 percent after-tax rate of return and that she owes a friend \$1,200. Would she prefer to pay the friend \$1,200 today or \$1,750 in four years?
49. Jonah has the choice of paying Rita \$10,000 today or \$40,000 in 10 years. Assume Jonah can earn a 12 percent after-tax rate of return. Which should he choose?
50. Bob's Lottery Inc. has decided to offer winners a choice of \$100,000 in 10 years or some amount currently. Assume that Bob's Lottery Inc. earns a 10 percent after-tax rate of return. What amount should Bob's offer lottery winners currently, in order to be indifferent between the two choices?
51. Tawana owns and operates a sole proprietorship and has a 37 percent marginal tax rate. She provides her son, Jonathon, \$8,000 a year for college expenses. Jonathon works as a pizza delivery person every fall and has a marginal tax rate of 15 percent.
- What could Tawana do to reduce her family tax burden?
 - How much pretax income does it currently take Tawana to generate the \$8,000 (after taxes) given to Jonathon?
 - If Jonathon worked for his mother's sole proprietorship, what salary would she have to pay him to generate \$8,000 after taxes (ignoring any Social Security, Medicare, or self-employment tax issues)?
 - How much money would the strategy in part (c) save?
52. Moana is a single taxpayer who operates a sole proprietorship. She expects her taxable income next year to be \$250,000, of which \$200,000 is attributed to her sole proprietorship. Moana is contemplating incorporating her sole proprietorship. Using the single individual tax brackets and the corporate tax rate in Tax Rates at the end of the book, find out how much current tax this strategy could save Moana (ignore any Social Security, Medicare, or self-employment tax issues). How much income should be left in the corporation?
53. Ori and Jane, husband and wife, operate a sole proprietorship. They expect their taxable income next year to be \$450,000, of which \$250,000 is attributed to the sole proprietorship. Ori and Jane are contemplating incorporating their sole proprietorship. Using the married-joint tax brackets and the corporate tax rate in Tax Rates at the end of the book, find out how much current tax this strategy could save Ori and Jane. How much income should be left in the corporation?
54. Hyundai is considering opening a plant in two neighboring states. One state has a corporate tax rate of 10 percent. If operated in this state, the plant is expected to generate \$1,000,000 pretax profit. The other state has a corporate tax rate of 2 percent. If operated in this state, the plant is expected to generate \$930,000 of pretax profit. Which state should Hyundai choose? Why do you think the plant in the state with a lower tax rate would produce a lower before-tax income?
55. Bendetta, a high-tax-rate taxpayer, owns several rental properties and would like to shift some income to her daughter, Jenine. Bendetta instructs her tenants to send their rent checks to Jenine so Jenine can report the rental income. Will this shift the income from Bendetta to Jenine? Why, or why not?

56. Using the facts in the previous problem, what are some ways that Bendetta could shift some of the rental income to Jenine? What are the disadvantages associated with these income-shifting strategies? **LO 3-4 LO 3-6**

57. Daniel is considering selling two stocks that have not fared well over recent years. A friend recently informed Daniel that one of his stocks has a special designation, which allows him to treat a loss up to \$50,000 on this stock as an ordinary loss rather than the typical capital loss. Daniel figures that he has a loss of \$60,000 on each stock. If Daniel's marginal tax rate is 35 percent and he has \$120,000 of other capital gains (taxed at 15 percent), what is the tax savings from the special tax treatment? **LO 3-5**

58. Dennis is currently considering investing in municipal bonds that earn 6 percent interest, or in taxable bonds issued by the Coca-Cola Company that pay 8 percent. If Dennis's tax rate is 22 percent, which bond should he choose? Which bond should he choose if his tax rate is 32 percent? At what tax rate would he be indifferent between the bonds? What strategy is this decision based upon? **LO 3-5**

59. Helen holds 1,000 shares of Fizbo Inc. stock that she purchased 11 months ago. The stock has done very well and has appreciated \$20/share since Helen bought the stock. When sold, the stock will be taxed at capital gains rates (the long-term rate is 15 percent and the short-term rate is the taxpayer's marginal tax rate). If Helen's marginal tax rate is 35 percent, how much would she save by holding the stock an additional month before selling? What might prevent Helen from waiting to sell? **LO 3-5**

60. Anne's marginal income tax rate is 32 percent. She purchases a corporate bond for \$10,000 and the maturity, or face value, of the bond is \$10,000. If the bond pays 5 percent per year before taxes, what is Anne's annual after-tax rate of return from the bond if the bond matures in 1 year? What is her annual after-tax rate of return if the bond matures in 10 years? **LO 3-5**
61. Irene is saving for a new car she hopes to purchase either four or six years from now. Irene invests \$10,000 in a growth stock that does not pay dividends and expects a 6 percent annual before-tax return (the investment is tax deferred). When she cashes in the investment after either four or six years, she expects the applicable marginal tax rate on long-term capital gains to be 25 percent. **LO 3-5**

 - What will be the value of this investment four years from now? Six years from now?
 - When Irene sells the investment, how much cash will she have after taxes to purchase the new car (four and six years from now)?
62. Komiko Tanaka invests \$12,000 in LymaBean, Inc. LymaBean does not pay any dividends. Komiko projects that her investment will generate a 10 percent before-tax rate of return. She plans to invest for the long term. **LO 3-5**

 - How much cash will Komiko retain, after taxes, if she holds the investment for five years and then sells it when the long-term capital gains rate is 15 percent?
 - What is Komiko's after-tax rate of return on her investment in part (a)?
 - How much cash will Komiko retain, after taxes, if she holds the investment for five years and then sells when the long-term capital gains rate is 25 percent?
 - What is Komiko's after-tax rate of return on her investment in part (c)?
 - How much cash will Komiko retain, after taxes, if she holds the investment for 15 years and then sells when the long-term capital gains rate is 15 percent?
 - What is Komiko's after-tax rate of return on her investment in part (e)?

3-28 CHAPTER 3 Tax Planning Strategies and Related Limitations

LO 3-5

planning

63. Alan inherited \$100,000 with the stipulation that he “invest it to financially benefit his family.” Alan and his wife Alice decided they would invest the inheritance to help them accomplish two financial goals: purchasing a Park City vacation home and saving for their son Cooper’s education.

	Vacation Home	Cooper’s Education
Initial investment	\$50,000	\$50,000
Investment horizon	5 years	18 years

Alan and Alice have a marginal income tax rate of 32 percent (capital gains rate of 15 percent) and have decided to investigate the following investment opportunities.

	5 Years	Annual After-Tax Rate of Return	18 Years	Annual After-Tax Rate of Return
Corporate bonds (ordinary interest taxed annually)	5.75%		4.75%	
Dividend-paying stock (no appreciation and dividends are taxed at 15%)	3.50%		3.50%	
Growth stock	FV = \$65,000		FV = \$140,000	
Municipal bond (tax-exempt)	3.20%		3.10%	

Complete the two annual after-tax rate of return columns for each investment and provide investment recommendations for Alan and Alice.

LO 3-7

64. Duff is really interested in decreasing his tax liability, and by his very nature he is somewhat aggressive. A friend of a friend told him that cash transactions are more difficult for the IRS to identify and, thus, tax. Duff is contemplating using this “strategy” of not reporting cash collected in his business to minimize his tax liability. Is this tax planning? What are the risks with this strategy?

LO 3-7

65. Using the facts from the previous problem, how would your answer change if, instead, Duff adopted the cash method of accounting to allow him to better control the timing of his cash receipts and disbursements?

LO 3-2

LO 3-4

LO 3-5

planning

research

LO 3-7

research

66. Using an available tax service or the Internet, identify three basic tax planning ideas or tax tips suggested for year-end tax planning. Which basic tax strategy from this chapter does each planning idea employ?

67. Jayanna, an advertising consultant, is contemplating instructing some of her clients to pay her in cash so that she does not have to report the income on her tax return. Use an available tax service to identify the three basic elements of tax evasion and penalties associated with tax evasion. Write a memo to Jayanna explaining tax evasion and the risks associated with her actions.

LO 3-7

research

68. Using the IRS website (<https://www.irs.gov/uac/The-Tax-Gap>), how large is the current estimated “tax gap” (i.e., the amount of tax underpaid by taxpayers annually)? What group of taxpayers represents the largest “contributors” to the tax gap?

 **ROGER** | CPA Review

Source: Roger CPA Review

Sample CPA Exam questions from Roger CPA Review are available in Connect as support for the topics in this text. 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.





chapter
15 Entities Overview

Learning Objectives

Upon completing this chapter, you should be able to:

- LO15-1** Discuss the legal and nontax characteristics of different types of legal entities.
- LO 15-2** Describe the different types of entities for tax purposes.
- LO 15-3** Identify fundamental differences in tax characteristics across entity types.



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Storyline Summary

Taxpayer:	Nicole Johnson
Location:	Salt Lake City, Utah
Employment status:	State government employee with entrepreneurial ambitions

Nicole Johnson is currently employed by the Utah Chamber of Commerce in Salt Lake City, Utah. While she enjoys the relatively short workweeks, she eventually would like to work for herself. In her current position, she deals with a lot of successful entrepreneurs who have become role models for her. Nicole has also developed an extensive list of contacts that should serve her well when she starts her own business. It has taken a while, but Nicole believes she has finally developed a viable new business idea. Her idea is to design and manufacture bed sheets that have various colored patterns and are made of unique fabric blends. The sheets look great and are extremely comfortable whether the bedroom is warm or cool. She has had several friends try out her prototype sheets and they have consistently given the sheets rave reviews. With this encouragement, Nicole started giving serious thought to making “Color Comfort Sheets” a moneymaking enterprise.

Nicole has enough business background to realize that she is embarking on a risky path, but one, she hopes, with significant potential rewards. After creating some initial income projections, Nicole realized that it will take a few years for the business to become profitable.

While Nicole’s original plan was to start the business by herself, she is considering seeking out another equity owner so that she can add financial resources and business experience to the venture. Nicole feels like she has a grasp on her business plan, but she still needs to determine how to organize the business for tax purposes. After doing some research, Nicole learned that she should consider many factors in order to determine the “best” entity type for her business. Each type of entity has advantages and disadvantages from both tax and nontax perspectives, and the best entity for a business depends on the goals, outlook, and strategy for that particular business and its owners. She understands that she has more work to do to make an informed decision.

to be continued . . .

This chapter explores various types of legal entities and then discusses entities available for tax purposes. We outline some of the pros and cons of each entity type from both nontax and tax perspectives, as we help Nicole determine how she will organize her business to best accomplish her goals. Subsequent chapters provide additional detail concerning the tax characteristics of each entity type.

LO 15-1

ENTITY LEGAL CLASSIFICATION AND NONTAX CHARACTERISTICS

When forming new business ventures, entrepreneurs can choose to house their operations under one of several basic entity types. These entities differ in terms of their legal and tax considerations. In fact, as we discuss in more depth below, the legal classification of a business may be different from its tax classification. These entities differ in terms of the formalities that entrepreneurs must follow to create them, the legal rights and responsibilities conferred on the entities and their owners, and the tax rules that determine how the entities and owners will be taxed on income generated by the entities. CPAs are frequently asked to help clients choose the best entity choice for their businesses. CPAs can help clients navigate recent tax legislation that has significantly changed the tax landscape for entity choice.

Legal Classification

Generally, a business entity legally may be classified as a **corporation**, a **limited liability company (LLC)**, a **general partnership (GP)**, a **limited partnership (LP)**, or a **sole proprietorship** (not formed as an LLC).¹ Under state law, corporations are recognized as legal entities separate from their owners (shareholders). Business owners legally form corporations by filing **articles of incorporation** with the state in which they organize the business. State laws also recognize limited liability companies (LLCs) as legal entities separate from their owners (members). Business owners create limited liability companies by filing either a **certificate of organization** or **articles of organization** with the state in which they are organizing the business (depending on the state).

Partnerships are formed under state partnership statutes and the degree of formality required depends on the type of partnership being formed. General partnerships may be formed by written agreement among the partners, called a **partnership agreement**, or they may be formed informally without a written agreement when two or more owners join together in an activity to generate profits. Although general partners are not required to file partnership agreements with the state, general partnerships are still considered to be legal entities separate from their owners under state laws. Unlike general partnerships, limited partnerships are usually organized by written agreement and typically must file a **certificate of limited partnership** to be recognized by the state.²

Finally, for state law purposes, sole proprietorships (not formed as single member LLCs) are *not* treated as legal entities separate from their individual owners. As a result, sole proprietors are not required to formally organize their businesses with the state, and they hold title to business assets in their own names rather than in the name of their businesses.

Nontax Characteristics

Rather than identify and discuss all possible nontax entity characteristics, we compare and contrast several prominent characteristics across the different legal entity types.

¹Variations of these entities include limited liability partnerships (LLPs), limited liability limited partnerships (LLLLPs), professional limited liability companies (PLLCs), and professional corporations (PCs).

²Similar to limited partnerships, LLPs, LLLPs, PLLCs, and PCs must register with the state to receive formal recognition.

Responsibility for Liabilities Whether the entity or the owner(s) is ultimately responsible for paying the liabilities of the business depends on the type of entity. Under state law, a corporation is solely responsible for its liabilities.³ Similarly, LLCs and not their members are responsible for the liabilities of the business.⁴ For entities formed as partnerships, all general partners are ultimately responsible for the liabilities of the partnership. In contrast, limited partners are not responsible for the partnership's liabilities.⁵ However, limited partners are not allowed to actively participate in the activities of the business.

Finally, if a business is conducted as a sole proprietorship, the individual owner is responsible for the liabilities of the business. However, individual business owners may organize their businesses as single-member LLCs. In exchange for observing the formalities of organizing as an LLC, they receive the liability protection afforded LLC members.⁶

Rights, Responsibilities, and Legal Arrangements among Owners State corporation laws specify the rights and responsibilities of corporations and their shareholders. For example, to retain limited liability protection for shareholders, corporations must create, regularly update, and comply with a set of bylaws (internal rules governing how the corporation is run). They must have a board of directors. They must have regular board meetings and regular (at least annual) shareholder meetings, and they must keep minutes of these meetings. They must also issue shares of stock to owners (shareholders) and maintain a stock ledger reflecting stock ownership. They must comply with annual filing requirements specified by the state of incorporation, pay required filing fees, and pay required corporate taxes, if any. Consequently, shareholders have no flexibility to alter their legal treatment with respect to one another (rights are determined solely by stock ownership not by agreements), with respect to the corporation, or with respect to outsiders. In contrast, while state laws provide default provisions specifying rights and responsibilities of LLCs and their members, members have the flexibility to alter their arrangement by spelling out, through an operating agreement, the management practices of the entity and the rights and responsibilities of the members consistent with their wishes. Thus, LLCs allow more flexible business arrangements than do corporations.

Like LLC statutes, state partnership laws provide default provisions specifying the partners' legal rights and responsibilities for dealing with each other absent an agreement to the contrary. Because partners have the flexibility to depart from the default provisions, they frequently craft partnership agreements that are consistent with their preferences.

Although in many instances having the flexibility to customize business arrangements is desirable, sometimes inflexible governance rules mandated by state statute are needed to limit the participation of owners in management when their participation becomes impractical. For example, when businesses decide to "go public" with an **initial public offering (IPO)** on one of the public securities exchanges, they usually solicit a

THE KEY FACTS

Legal Classification and Nontax Characteristics of Entities

- State law generally classifies entities as either corporations, limited liability companies, general partnerships, limited partnerships, or sole proprietorships.
- Corporations and limited liability companies shield all their owners against the entity's liabilities.
- Corporations are less flexible than other entities but are generally better suited to going public.

³Payroll tax liabilities are an important exception to this general rule. Shareholders of closely held corporations may be held responsible for these liabilities.

⁴When closely held corporations and LLCs borrow from banks or other lenders, shareholders or members are commonly asked to personally guarantee the debt. To the extent they do this, they become personally liable to repay the loan in the event the corporation or LLC is unable to repay it.

⁵Limited liability limited partnerships (LLLPs) are limited partnerships in which general and limited partners are protected from the liabilities of the entity. Also, professional service businesses such as accounting firms and law firms are generally not allowed to operate as corporations, LLCs, or limited partnerships. These businesses are frequently organized as limited liability partnerships (LLPs), professional limited liability companies (PLLCs), or professional corporations (PCs). Owners of a PLLC or a PC are protected from liabilities of the entity other than liabilities stemming from their own negligence. LLPs do not provide protection against liabilities stemming from a partner's own negligence or from the LLP's contractual liabilities.

⁶Shareholders of corporations and LLC members are responsible for liabilities stemming from their own negligence.

vast pool of potential investors to become corporate shareholders.⁷ State corporation laws prohibit shareholders from directly amending corporate governance rules and from directly participating in management—they have only the right to vote for corporate directors or officers. In comparison, LLC members generally have the right to amend the LLC operating agreement, provide input, and manage LLCs. Obviously, managing a publicly traded business would be next to impossible if thousands of owners had the legal right to change operating rules and directly participate in managing the enterprise.

Exhibit 15-1 summarizes several nontax characteristics of different types of legal entities.

EXHIBIT 15-1 Business Types: Legal Entities and Nontax Characteristics

Nontax Characteristics	Corporation	LLC	General Partnership	Limited Partnership	Sole Proprietorship
Must formally organize with state	Yes	Yes	No	Yes	No*
Responsibility for liabilities of business	Entity	Entity	General partner(s)	General partner(s)	Owner [†]
Legal arrangement among owners	Not flexible	Flexible	Flexible	Flexible	Not applicable
Suitable for initial public offering	Yes	No	No	No [^]	No

*A sole proprietor must organize with the state if she forms a single-member LLC.

[†]The owner is not responsible for the liabilities of the business if the sole proprietorship is organized as an LLC. However, the owner is responsible for liabilities stemming from her own negligence and for any liabilities the owner personally guarantees.

[^]While it is uncommon, certain limited partnerships are eligible for IPOs.

As summarized in Exhibit 15-1, corporations and LLCs have the advantage in liability protection, LLCs and partnerships have an advantage over other entities in terms of legal flexibility, and corporations have the advantage when owners want to take a business public.

continued from page 15-1 . . .

As an initial step in the process of selecting the type of legal entity to house Color Comfort Sheets (CCS), Nicole began to research nontax issues that might be relevant to her decision. Early in her research she realized that the nontax benefits unique to traditional corporations were relevant primarily to large, publicly traded corporations. Although Nicole was very optimistic about CCS’s prospects, she knew it would likely be a long time, if ever, before it went public. However, she remained interested in limiting her own and other potential investors’ liability in the new venture, so she began to dig a little deeper. As she perused the state of Utah website, she learned that corporations and LLCs are the only legal entities that can completely shield investors from liabilities. Although Nicole doesn’t anticipate any trouble from her future creditors, she decides to limit her choice of legal entity to either a corporation or LLC.

At this point in her information-gathering process, Nicole is leaning toward the LLC option because she is not sure she wants to deal with board meetings and all the other formalities of operating a corporation; however, she decides to assemble a five-year forecast of CCS’s expected operating results and to learn a little more about the way corporations and LLCs are taxed before making a final decision.

to be continued . . .

⁷The vast majority of IPOs involve corporate shares; however, limited partnership interests are occasionally sold in IPOs. Like shareholders, limited partners are typically not allowed to participate in management. Limited partnerships are used for public offerings in lieu of corporations when they qualify for favorable partnership tax treatment available to some publicly traded partnerships.

ENTITY TAX CLASSIFICATION

A business's legal form may be different from its tax form. We discussed the legal form of business entities above. We now discuss the tax form of business entities. In general terms, for tax purposes business entities can be classified as either separate taxpaying entities or **flow-through entities**. Separate taxpaying entities pay tax on their own income. In contrast, flow-through entities generally don't pay taxes because income from these entities flows through to their business owners, who are responsible for paying tax on the income.

How do we determine whether a particular business entity is treated as a separate taxpaying entity or as a flow-through entity for tax purposes? According to Treasury Regulations, commonly referred to as the "check-the-box" regulations, entities that are legal corporations under state law are, by default, treated as **C corporations** for tax purposes. These corporations and their shareholders are subject to tax provisions in Subchapter C (and not Subchapter S) of the Internal Revenue Code.⁸ C corporations report their taxable income to the IRS on Form 1120. However, shareholders of *legal* corporations may qualify to make a special tax election known as an "S" election, thus permitting the corporation to be taxed as a flow-through entity called an **S corporation**.⁹ S corporations and their shareholders are subject to tax provisions in Subchapter S of the Internal Revenue Code. S corporations report the results of their operations to the IRS on Form 1120S.

Also under the check-the-box regulations, unincorporated entities are, by default, treated as flow-through entities.¹⁰ However, owners of an unincorporated entity can still elect to have their business taxed as a C corporation instead of as the default flow-through entity.¹¹ In fact, the owner(s) of an unincorporated entity could elect to have the business taxed as a C corporation and then make a second election to have the "C corporation" taxed as an S corporation (provided that it meets the S corporation eligibility requirements).¹² Before making such elections, however, the business owner(s) would need to be convinced that the move makes sense from a tax perspective.¹³ The nontax considerations do not change because these elections do not affect the legal classification of the entity.

Finally, unincorporated flow-through entities (all flow-through entities except S corporations) are treated for tax purposes as either partnerships, sole proprietorships, or **disregarded entities** (considered to be the same entity as the owner).¹⁴ Unincorporated entities (including LLCs) with more than one owner are treated as partnerships.¹⁵ Partnerships report their operating results to the IRS on Form 1065. Unincorporated entities (including LLCs) with only one *individual* owner such as sole proprietorships and **single-member LLCs** are treated as sole proprietorships.¹⁶ Income from businesses taxed as sole proprietorships is reported on Schedule C of Form 1040. Similarly, unincorporated entities with only one *corporate* owner, typically a single-member LLC, are disregarded for tax purposes. Thus, income and losses from this single, corporate-member LLC is reported as if it had originated from a division of the corporation and is reported directly on the single-member corporation's return. Exhibit 15-2 provides a flowchart for determining the tax form of a business entity under the check-the-box regulations. Taxpayers check the box by filing Form 8832.

LO 15-2

THE KEY FACTS

Tax Classification of Legal Entities

- Corporations are C corporations unless they make a valid S election.
- Unincorporated entities are taxed as partnerships if they have more than one owner.
- Unincorporated entities are taxed as sole proprietorships if held by a single individual or as disregarded entities if held by a single entity.
- Unincorporated entities may elect to be treated as C corporations. They then may make an S election if eligible.

⁸Reg. §301.7701-3(a).

⁹§1362(a). Because §1361 limits the number and type of shareholders of corporations qualifying to make an S election, some corporations are ineligible to become S corporations.

¹⁰Reg. §301.7701-3(b). However, §7704 mandates that unincorporated publicly traded entities be taxed as corporations unless their income predominately consists of certain types of passive income.

¹¹Reg. §301.7701-3(a).

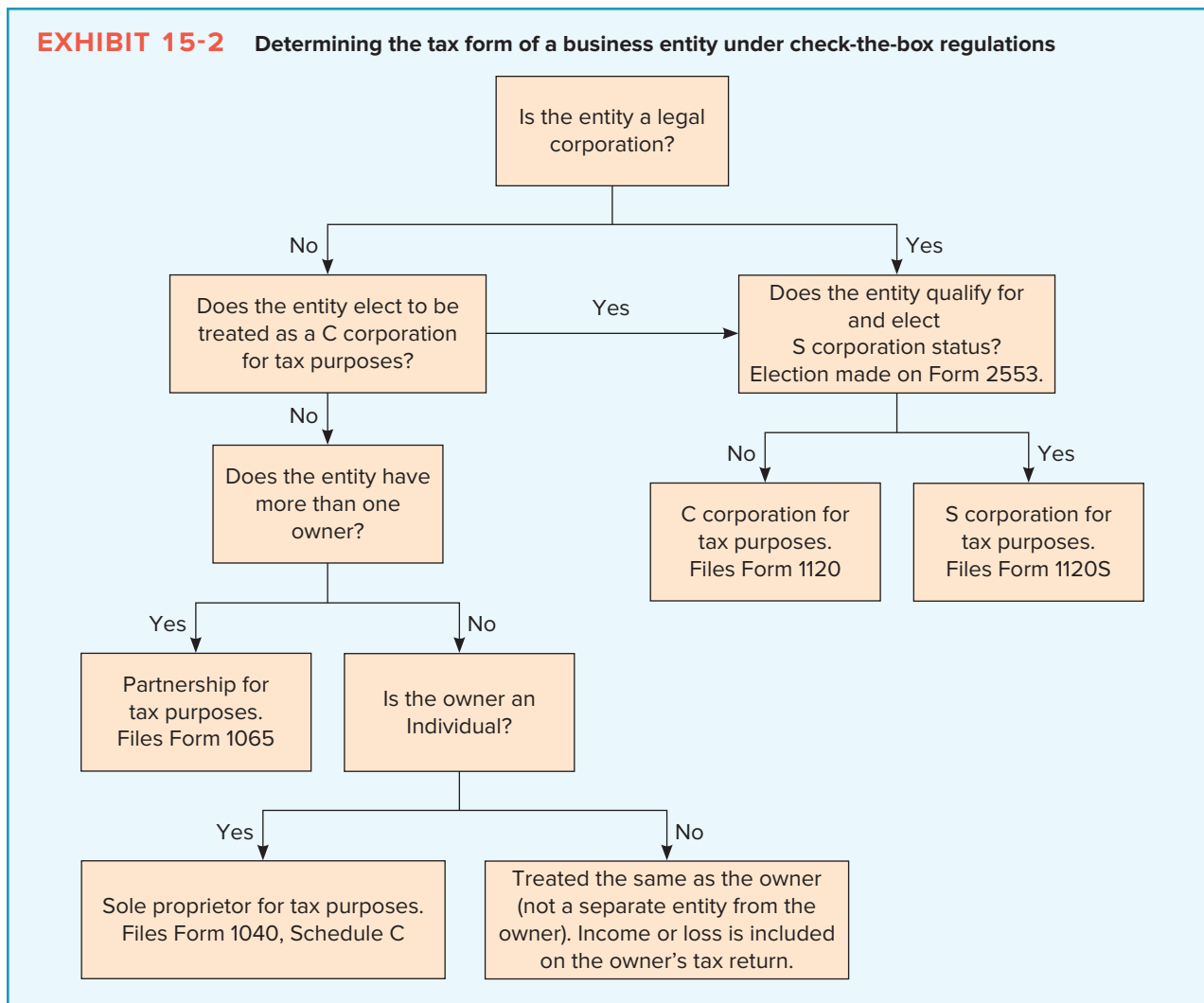
¹²In general, a noncorporate entity that is eligible to elect to be treated as a corporation can elect to be treated as a corporation for tax purposes and as an S corporation in one step by filing a timely S corporation election.

¹³As presented in Exhibit 15-3, compared to corporations, unincorporated entities taxed as partnerships have more favorable ownership requirements and more favorable tax treatment on nonliquidating and liquidating distributions of noncash property.

¹⁴Reg. §301.7701-3(a).

¹⁵Reg. §301.7701-3(b)(i).

¹⁶Reg. §301.7701-3(b)(ii).

EXHIBIT 15-2 Determining the tax form of a business entity under check-the-box regulations

To summarize, although there are other types of legal entities, there are really only four categories of business entities recognized by the U.S. tax system, as follows:

1. C corporation (separate taxpaying entity; income reported on Form 1120).
2. S corporation (flow-through entity; income reported on Form 1120S).
3. Partnership (flow-through entity; income reported on Form 1065).
4. Sole proprietorship (flow-through entity; income reported on Form 1040, Schedule C).

Example 15-1

What if: Assume Nicole legally forms CCS as a corporation (with only common stock) by filing articles of incorporation with the state. What are her options for classifying CCS for tax purposes if she is the only shareholder of CCS?

Answer: Nicole may treat CCS as either a C corporation or an S corporation. The default tax classification is a C corporation for tax purposes. However, given the facts provided, CCS is eligible to make an election to be taxed as an S corporation.¹⁷

¹⁷§1361(b).

What if: Assume Nicole legally forms CCS as an LLC (with only one class of ownership rights) by filing articles of organization with the state. What are her options for classifying CCS for tax purposes if she is the only member of CCS?

Answer: The default classification for CCS is a sole proprietorship because CCS is unincorporated with one individual member. However, Nicole may elect to have CCS taxed as a C corporation or as an S corporation. CCS can be treated as a C corporation because unincorporated entities may elect to be taxed as corporations. Further, eligible entities taxed as corporations can elect to be treated as S corporations.

What if: Assume Nicole legally forms CCS as an LLC and allows other individuals or business entities to become members in return for contributing their cash, property, or services to CCS. What is the default tax classification of CCS under these assumptions?

Answer: Partnership. The default tax classification for unincorporated entities with more than one owner is a partnership.

It might seem at this point that owners of businesses classified as flow-through entities would be treated the same for tax purposes; however, that is true only in a general sense. We see in this and other chapters that there are subtle and not-so-subtle differences in ways the owners of ventures classified as S corporations, partnerships, and sole proprietorships are taxed.¹⁸

ENTITY TAX CHARACTERISTICS

LO 15-3

In choosing among the available options for the tax form of business entities, owners and their advisers must carefully consider whether tax rules that apply to a particular tax classification would be either more or less favorable than tax rules under alternative tax classifications. The specific tax rules they must compare and contrast are unique to their situations; however, certain key differences in the tax rules tend to be relevant in many scenarios. We turn our attention to the taxation of business entity income, owner compensation, and the tax treatment of entity losses, because these are a few of the most important tax characteristics to consider when selecting the tax form of the entity. Later in the chapter we preview other tax factors that differ between entities, and we identify the chapter where each factor is discussed in more detail.

Taxation of Business Entity Income

The taxation of a business entity's income depends on whether the entity is a flow-through entity or a C corporation. Flow-through entity income is taxed once to the owner when the income "flows through" or is allocated (on paper) to entity owners at the end of the year, whether or not the income is distributed to them. The income is included on the owners' tax returns as if they had earned the income themselves. Flow-through entity owners are not, however, taxed when the income is actually distributed to them. C corporation income is taxed twice. The income is first taxed to the corporation at the corporate tax rate. A C corporation's income is taxed again to the shareholders when the corporation distributes the income as a dividend or when shareholders sell their stock.¹⁹

The Taxation of Flow-Through Entity Business Income The tax that flow-through entity owners pay on the entity's business income depends in large part on the owner's marginal income tax rate. For 2019, the top marginal individual tax rate is 37 percent. Nevertheless, flow-through entity owners' tax burden on the flow-through

¹⁸The Business Income, Deductions, and Accounting Methods chapter explains how sole proprietors are taxed, and the Forming and Operating Partnerships, Dispositions of Partnership Interests and Partnership Distributions, and the S Corporations chapters explain how partners and S corporation shareholders are taxed.

¹⁹Distributions to C corporation shareholders are taxed as dividends to the extent they come from the "earnings and profits" (similar to economic income) of corporations.

income also depends on whether the income is eligible for the deduction for qualified business income, whether it is subject to the net investment income tax, whether it is subject to self-employment tax and/or it is subject to the additional Medicare tax. Below, we discuss the deduction for qualified business income, the net investment income tax, the self-employment tax, the additional Medicare tax, and the overall tax rate on flow-through entity income (assuming the owners are individuals).

Deduction for qualified business income. This deduction applies to individuals with **qualified business income (QBI)** from flow-through entities, including partnerships, S corporations, or sole proprietorships.²⁰ That is, this is a deduction for individuals and not for business entities. The deduction is a *from* AGI deduction but is not an itemized deduction. Therefore, individuals can claim the deduction even though they claim the standard deduction instead of itemized deductions. In general, a taxpayer can deduct 20 percent of the amount of qualified business income allocated to them from the entity, subject to certain limitations.²¹ Qualified business income is the net business income from a qualified trade or business conducted in the United States. To qualify, the business income must be from a business other than a **specified service trade or business**. In general, a specified service trade or business includes certain service businesses such as services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or which involves the performance of services that consist of investing and investment management trading or dealing in securities, partnership interests, or commodities.²² Business income does not include income earned as an employee or investment type income such as capital gains, dividends, and investment interest income.

Net investment income tax. When an owner of an entity taxed as a partnership or a shareholder of an S corporation does not work for the entity (that is, the owner is a passive owner or investor in the entity), the business income allocated to the taxpayer is considered to be “passive” income.²³ Because passive income is considered to be investment income for purposes of the net investment income tax, passive owners of flow-through entities may be required to pay net investment income tax on income allocated to them from the business. The net investment income tax rate is 3.8 percent and it applies only when a taxpayer’s (modified) AGI exceeds the threshold amount. The threshold amount is \$250,000 for married taxpayers filing jointly and surviving spouses, \$125,000 for married taxpayers filing separately, and \$200,000 for all other taxpayers.²⁴

Self-employment tax. Business owners who receive and/or are allocated self-employment income from their business are subject to self-employment tax on the income. Whether a flow-through entity’s business income allocated to an owner is considered to be self-employment income to the owner depends on the type of entity and the owner’s involvement in the entity’s business activities. An S corporation’s business income allocated to a shareholder is not self-employment income to the shareholder. In contrast, a sole proprietorship’s income is self-employment income to the sole proprietor. The determination isn’t as clear for the business income allocated to owners of entities taxed as a partnership.

²⁰§199A.

²¹Under §199A(b)(2)(B), the deduction cannot exceed the greater of 50 percent of the wages paid with respect to the qualified trade or business, or the sum of 25 percent of the wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property in the qualified trade or business. This limit does not apply to taxpayers with taxable income (before the deduction) below a certain threshold and the limitation phases in over a range of taxable income above the threshold [see §199A(b)(3)]. The limit is applied at the individual owner level and is beyond the scope of this chapter.

²²§199A(d)(2). See Reg. §1.199A-5 for discussion of what constitutes a specified trade or business in each of the fields referenced in §199A(d)(2). The specified service trade or business requirement does not apply to taxpayers with taxable income (before the deduction) below a certain threshold and the requirement phases in over a range of taxable income above the threshold [see §199A(d)(3)].

²³See §469. We discuss specific tests for determining when an owner is a passive investor in the Forming and Operating Partnerships chapter.

²⁴See §1411.

For these entities, whether business income is self-employment income to an owner depends on the owner's involvement in the entity's business activities.²⁵

The tax base for the self-employment tax is the taxpayer's **net earnings from self-employment**. Net earnings from self-employment is 92.35 percent of the taxpayer's self-employment income (from all sources).²⁶ For 2019, the first \$132,900 of net earnings from self-employment is taxed at 15.3 percent and net earnings from self-employment above \$132,900 is taxed at 2.9 percent. The \$132,900 cutoff is reduced by the amount of the employee compensation the taxpayer received during the year. Thus, for example, a taxpayer who was allocated \$170,000 of self-employment income (assuming no other self-employment income and no employee compensation) would report \$156,995 of net earnings from self-employment ($\$170,000 \times .9235$) and owe \$21,032 of self-employment tax ($\$132,900 \times .153 + (\$156,995 \text{ minus } \$132,900) \times .029$). Taxpayers can deduct 50 percent of the self-employment tax they pay as a *for* AGI deduction. Consequently, a taxpayer who paid \$21,032 of self-employment tax would deduct \$10,516 of the tax as a *for* AGI deduction ($\$21,032 \times .50$). Finally, it is important to note that the self-employment tax is computed separately for each spouse even if a married couple files a joint return (the computation of the self-employment tax is not a joint computation).

Additional Medicare tax. In addition to the self-employment tax, business owners who receive or are allocated self-employment income from their business potentially must pay the additional Medicare tax on the income. The tax rate for the additional Medicare tax is .9 percent and the tax base is the sum of the taxpayer's net earnings from self-employment (from all sources) plus compensation earned as an employee in excess of a threshold amount. The threshold amount is \$250,000 for married taxpayers filing jointly and surviving spouses, \$125,000 for married taxpayers filing separately, and \$200,000 for all other taxpayers.²⁷ Thus, for example, a single taxpayer who was allocated \$240,000 of self-employment income (assuming no other self-employment income and no employee compensation) and who reported \$270,000 of AGI would have \$221,640 of net earnings from self-employment ($\$240,000 \times .9235$) and would owe \$195 of additional Medicare tax [$(\$221,640 \text{ minus } \$200,000) \times .009$].

The additional Medicare tax is computed jointly for married couples filing a joint return. Thus, net earnings from self-employment from both spouses (and compensation earned as employees, if any) is combined to determine the excess of net earnings from self-employment over the \$250,000 threshold amount for married taxpayers filing a joint tax return. Taxpayers are not allowed to deduct any of the additional Medicare tax they pay.

Example 15-2

What if: Assume that Nicole chooses to form CCS as an S corporation. She makes the following assumptions:

- CCS's taxable income is \$500,000 and all of the income is business income.
- Her marginal ordinary tax rate is 37 percent.
- Nicole is eligible for the full deduction for qualified business income on the flow-through income from CCS.
- The income is not passive income and is therefore not subject to the net investment income tax.
- Because CCS is an S corporation, the flow-through business income from CCS is not self-employment income to Nicole.

What is the overall tax rate on CCS's business income?

(continued on page 15-10)

²⁵We discuss more details of determining whether business income allocated to partners is self-employment income in the Forming and Operating Partnerships chapter.

²⁶See §1402. Taxing 92.35 percent of self-employment income for self-employment tax and additional Medicare tax purposes provides the taxpayer with an implicit 7.65 percent deduction for the employer's portion of the 15.3 percent self-employment tax.

²⁷The additional Medicare tax applies to combined earned income of both spouses if married filing jointly.

Answer: 29.6 percent, computed as follows:

Description	Amount	Explanation
(1) Business income allocated to Nicole	\$ 500,000	
(2) Deduction for qualified business income	(100,000)	(1) × 20 percent
(3) Net taxable income to Nicole from CCS	400,000	(1) + (2)
(4) Earnings after entity-level tax	37%	Marginal tax rate
(5) Owner-level income tax	148,000	(3) × (4)
Overall tax rate on business income allocation	29.6%	(5)/(1)

What if: Assume the original facts except that the income from CCS is not eligible for the deduction for qualified business income. What is the overall tax rate on CCS's business income?

Answer: 37 percent. The entire \$500,000 business income is taxed to Nicole at her marginal ordinary tax rate of 37 percent.

What if: Assume the original facts except the income from CCS is not eligible for the deduction for qualified business income and Nicole is a passive investor in CCS and must pay the 3.8 percent net investment income tax on the income. What is the overall tax rate on the income of CCS?

Answer: 40.8 percent. The full \$500,000 of business income is taxed to Nicole at her marginal ordinary tax rate of 37 percent plus the net investment income tax rate of 3.8 percent.

Example 15-3

What if: Assume that Nicole forms CCS as an LLC with another investor so that CCS is taxed as a partnership. Nicole makes the following assumptions:

- CCS earns business income of \$1,000,000 and Nicole's share of the business income is \$500,000.
- Nicole's marginal ordinary tax rate is 37 percent.
- Nicole is entitled to the full deduction for qualified business income on the flow-through income from CCS.
- Because Nicole works full-time for the entity, the business income allocated to her is self-employment income.
- Nicole's marginal self-employment tax rate is 2.9 percent (she has other sources of self-employment income that put her net earnings from self-employment over the \$132,900 cutoff for the 15.3 percent rate).
- The entire net earnings from self-employment from the income allocation is subject to the .9 percent additional Medicare tax (her AGI and her net earnings from self-employment are over the threshold amount before considering the the CCS business income allocation).

What is the overall tax rate on the CCS business income allocated to Nicole?

Answer: 32.61 percent, computed as follows:

Description	Amount	Explanation
(1) Business income allocated to Nicole	\$ 500,000	
(2) Deduction for 50 percent of self-employment tax (for AGI deduction)	(6,695)	(1) × .9235 × .029 × .5
(3) Deduction for qualified business income (from AGI deduction)	(100,000)	(1) × 20 percent
(4) Income net of Nicole's deductions	393,305	(1) – (2) – (3)
(5) Owner-level income tax	145,523	(4) × 37%
(6) Self-employment tax	13,391	(1) × .9235 × .029
(7) Additional Medicare tax	4,156	(1) × .9235 × .009
(8) Total tax paid on CCS business income allocations	\$ 163,070	(5) + (6) + (7)
Overall tax rate on business income allocation	32.61%	(8)/(1)

What if: Assume the original facts except that the business income allocation is not qualified business income (QBI). What is the overall tax rate on the CCS business income allocated to Nicole?

Answer: 40.01 percent. The only difference between the original and new facts in this what-if example is that Nicole would pay an additional \$37,000 in income tax (\$100,000 QBI deduction × 37 percent tax rate). Consequently, the overall taxes due on the business income allocation would be \$200,070 (\$163,070 + \$37,000) and the overall tax rate would be 40.01 percent (\$200,070/\$500,000).

What if: Assume the original facts except that the business income allocation is Nicole’s only source of self-employment income for the year. Further, assume that Nicole’s husband received \$800,000 of salary. What is the overall tax rate on the CCS business income allocated to Nicole?

Answer: 35.30 percent, computed as follows:

Description	Amount	Explanation
(1) Business income allocated to Nicole	\$ 500,000	
(2) Net earnings from self-employment	461,750	(1) × .9235
(3) Deduction for 50 percent of self-employment tax (for AGI deduction)	(14,935)	(7) × .5
(4) Deduction for qualified business income (from AGI deduction)	(100,000)	(1) × 20%
(5) Income net of Nicole’s deductions	385,065	(1) – (3) – (4)
(6) Owner-level income tax	142,474	(5) × 37%
(7) Self-employment tax	29,870	\$132,900 × .153 + [(2) – \$132,900] × .029
(8) Additional Medicare tax	4,156	(2) × .009 [couple’s AGI and employee compensation income exceeds \$250,000 threshold amount before including (2)]
(9) Total tax paid on CCS business income allocations	\$ 176,500	(6) + (7) + (8)
Overall tax rate on business income allocation	35.30%	(9)/(1)

What if: Assume the original facts except the income from CCS is not eligible for the QBI deduction and Nicole is a passive investor in CCS. Consequently, she must pay the net investment income tax on the entire income allocation but not the self-employment tax or the additional Medicare tax. What is the overall tax rate on the CCS business income allocated to Nicole?

Answer: 40.8 percent. The entire \$500,000 business income allocation is taxed to Nicole at her marginal ordinary tax rate of 37 percent plus the net investment income tax rate of 3.8 percent.

In summary, while income from a flow-through entity is taxed only once, the overall tax rate on the entity’s business income depends on whether the income (and the owner) qualifies for the deduction for qualified business income and whether the income is subject to the net investment tax or is considered to be self-employment income.

Overall Tax Rate of C Corporation Income C corporations are taxed on their taxable income at a flat 21 percent rate. The tax rate on the second level of tax on a C corporation’s income depends on whether the shareholder is an individual, a C corporation, an **institutional shareholder**, a tax-exempt entity, or a foreign entity.

Individual shareholders. The tax rate on dividends to individual taxpayers depends on the individual’s taxable income. High-income taxpayers are taxed on dividends at a 20 percent rate, low-income taxpayers are taxed at a 0 percent rate, and others are taxed on dividends at

a 15 percent rate.²⁸ Also, as discussed above, taxpayers with (modified) AGI in excess of a threshold amount pay an additional 3.8 percent net investment income tax on dividends.

Example 15-4

What if: Assume that Nicole forms CCS as a C corporation and she makes the following assumptions:

- CCS earns taxable income of \$500,000.
- CCS will distribute all of its after-tax earnings annually as a dividend.
- Nicole's marginal ordinary tax rate is 37 percent and her dividend tax rate is 23.8 percent (including the net investment income tax).

What is the overall tax rate on CCS's taxable income?

Answer: 39.8 percent, computed as follows:

Description	Amount	Explanation
(1) Taxable income	\$500,000	
(2) Corporate tax rate	21%	Flat corporate tax rate
(3) Corporate-level tax	\$105,000	(1) × (2) [first level of tax]
(4) Income remaining after taxes and amount distributed as a dividend	\$395,000	(1) – (3)
(5) Dividend tax rate	23.8%	20% dividend rate + 3.8% net investment income tax rate
(6) Shareholder-level tax on dividend	\$ 94,010	(4) × (5) [second level of tax]
(7) Total tax paid on corporate taxable income	\$199,010	(3) + (6)
Overall tax rate on corporate taxable income	39.8%	(7)/(1)

Note that the overall rate is not 44.8 percent (21 percent corporate rate + 23.8 percent shareholder rate) because the amount of corporate-level tax (\$105,000) is income that is not taxed twice (it is paid to the government, not to the shareholders).

What if: Assume that Nicole forms CCS as a C corporation and she makes the following assumptions:

- CCS earns taxable income of \$500,000.
- CCS distributes 25 percent of its after-tax earnings as a dividend and retains the rest to grow the business.
- Nicole's marginal ordinary tax rate is 37 percent and her dividend tax rate is 23.8 percent (including the net investment income tax).

What is the overall tax rate on CCS's taxable income?

Answer: 25.7 percent, computed as follows:

Description	Amount	Explanation
(1) Taxable income	\$500,000	
(2) Corporate tax rate	21%	Flat corporate tax rate
(3) Corporate-level tax	\$105,000	(1) × (2) [first level of tax]
(4) Income remaining after taxes and amount distributed as a dividend	\$395,000	(1) – (3)
(5) Dividend	\$ 98,750	(4) × 25% distributed
(6) Tax rate on dividend	23.8%	20% dividend rate + 3.8% net investment income tax rate
(7) Shareholder-level tax on dividend	\$ 23,503	(5) × (6) [second level of tax]
(8) Total tax paid on corporate taxable income	\$128,503	(3) + (7)
Overall tax rate on corporate taxable income	25.7%	(8)/(1)

²⁸To the extent the dividend income increases a taxpayer's taxable income beyond specific "breakpoints" the dividend is taxed at a higher rate. For 2019, the breakpoint between the 0 and 15 percent rate is \$78,750 for married taxpayers filing jointly, \$52,750 for head of household filers, and \$39,375 for all other taxpayers. The breakpoint between the 15 percent and 20 percent rate is \$488,850 for married taxpayers filing jointly, \$244,425 for married taxpayers filing separately, \$434,500 for single taxpayers, and \$461,700 for head of household filers.

The overall tax rate is lower in this situation because CCS retains most of its after-tax income and thus protects that portion of its income from immediate double taxation. If CCS retained all of its after-tax earnings, the current overall tax rate on its income would have been 21 percent (the corporate tax rate). Also, note that while the overall tax rate is lower when CCS distributes less of its income, Nicole also receives less cash from the business.

Shareholders that are C corporations. Shareholders that are C corporations are taxed on dividends at 21 percent, the same rate as they are taxed on ordinary income. In addition, dividends received by a corporation are potentially subject to another (third) level of tax when the corporation receiving the dividend distributes its earnings as dividends to its shareholders. This potential for more than two levels of tax on the same before-tax earnings prompted Congress to allow corporations to claim the **dividends received deduction (DRD)**. In the next chapter, we discuss the DRD in detail, but the underlying concept is that a corporation receiving a dividend is allowed to deduct a certain percentage of the dividend from its taxable income to offset the potential for additional layers of taxation on the dividend when it distributes the dividend to its shareholders. The dividends-received deduction percentage is 50, 65, or 100 percent of the dividend received, depending on the level of the recipient corporation's ownership in the dividend-paying corporation's stock. The DRD is 50 percent if the shareholder corporation owns less than 20 percent of the distributing corporation; 65 percent if it owns at least 20 percent but less than 80 percent of the distributing corporation; and 100 percent if the shareholder corporation owns at least 80 percent of the distributing corporation. Thus, a corporation's net tax rate on a dividend received is 10.5 percent if it claims a 50 percent DRD [$.21 \text{ tax rate} \times (1 - .5 \text{ DRD})$], 7.35 percent if it claims a 65 percent DRD [$.21 \text{ tax rate} \times (1 - .65 \text{ DRD})$], and 0 percent if it claims a 100 percent DRD [$.21 \times (1 - 1.0 \text{ DRD})$].

Example 15-5

What if: Assume that Nicole invites a corporation to invest in CCS in exchange for a 10 percent share in the company. Nicole makes the following assumptions as part of her calculations:

- CCS is a C corporation.
- CCS earns taxable income of \$500,000.
- CCS will pay out all of its after-tax earnings annually as a dividend.

Given these assumptions, what would be the overall tax rate on the corporate investor's share of CCS's income given that the shareholder corporation would be eligible for the 50 percent dividends received deduction?

Answer: 29.3 percent, computed as follows:

Description	Amount	Explanation
(1) Taxable income	\$500,000	
(2) Corporate tax rate	21%	\$105,000
(3) Entity-level tax		(1) × (2) [first level of tax]
(4) After-tax income	\$395,000	(1) – (3)
(5) Corporate investor's dividend	\$ 39,500	(4) × 10%
(6) Taxable dividend	\$ 19,750	(5) × (1 – 50% DRD)
(7) Corporate investor's share of entity-level tax	\$ 10,500	(3) × 10% investor's share
(8) Corporate investor's tax on dividend	\$ 4,148	(6) × 21% corporate tax rate
(9) Total tax paid on corporate taxable income	\$ 14,648	(7) + (8)
Overall tax rate on corporate taxable income	29.3%	(9)/[(1) × 10% investor's share]

Note: The income of the corporate shareholder will be taxed again when the corporate shareholder distributes it to its own shareholders.

Institutional shareholders. Pension and retirement funds are some of the largest institutional shareholders of corporations. However, these entities do not pay shareholder-level tax on the dividends they receive. Ultimately, retirees pay the second tax on this income when they receive retirement distributions from these funds. While retirees pay the second tax at ordinary rates, not the reduced dividend rates, they are able to defer the tax until they receive fund distributions.

Tax-exempt and foreign shareholders. Tax-exempt organizations such as churches and universities are exempt from tax on their investment income, including dividend income from investments in corporate stock. Similarly, foreign investors may be eligible for reduced rates on dividend income depending on the tax treaty, if any, their country of residence has signed with the United States.

As we discuss and illustrate above, C corporation income is subject to **double taxation**. The first tax is paid by the corporation when it earns the income and the second tax is paid by the shareholders when the shareholders receive distributions of the corporation's earnings in the form of dividends. Can C corporations avoid the second level of tax entirely by not paying dividends? The answer is generally no. Even when corporations retain after-tax income, their shareholders pay the second level of tax at capital gains rates on the undistributed income when they sell their stock because the undistributed income indirectly increases the value of their stock and thus increases shareholders' gains when they sell the stock. Assuming the shareholder is an individual and the shareholder owns stock in a corporation for more than a year, the gain is taxed at the same rates as the tax rates on qualified dividends discussed above (0, 15, or 20 percent plus 3.8 percent net investment income tax for higher income taxpayers). Because this second level of tax is deferred until taxpayers sell their stock, the longer they hold the stock, the less the tax cost is on a present value basis. In the extreme, taxpayers can avoid the second level of income tax completely on their stock appreciation by holding the stock until death. At death, gain built into the stock is eliminated because the stock takes basis equal to the value of the stock on the date of death.²⁹

Shareholders other than individuals face different tax consequences when they sell their shares. When shareholders that are C corporations eventually sell the stock, they are taxed on capital gains at a flat 21 percent tax rate. Consequently, income from stock appreciation may expose income to *more* than two levels of taxation because capital gains from selling stock do not qualify for the dividends received deduction. Also, institutional shareholders don't pay tax when they sell their stock and recognize capital gains. However, retirees generally pay tax on the gains at ordinary rates when they receive distributions from their retirement accounts. Finally, tax-exempt shareholders do not pay tax on capital gains from selling stock, and foreign investors are generally not subject to U.S. tax on their capital gains from selling corporate stock.

Finally, the tax law provides incentives for C corporations to distribute income rather than to retain it for the purpose of avoiding the second level of tax. First, **personal holding companies** (closely held corporations generating primarily investment income) are subject to a 20 percent **personal holding company tax** on their undistributed income.³⁰ Second, corporations that retain earnings for the purpose of avoiding the second level of tax are subject to a 20 percent **accumulated earnings tax** on the retained earnings.³¹ Corporations are not considered to be retaining earnings for tax avoidance purposes and are not subject to the accumulated earnings tax to the extent they (1) reinvest the earnings in assets necessary for their business or (2) retain liquid assets for reasonable planned needs of the business.

Under the tax rate system prior to 2018, flow-through entities were generally considered to be superior to corporations for tax purposes because they generated income that was taxed only once while corporations produced income that was taxed twice, with the

²⁹See §1014.

³⁰§541.

³¹See §§531–533.

first level of tax imposed at a rate comparable to the individual tax rate. However, for years after 2017, the corporate tax rate is significantly lower than the maximum individual tax rate. Further, as described above, tax law effective beginning in 2018 provides a deduction for qualified business income (QBI) for individuals who are owners of flow-through entities. This tax legislation makes the optimal choice of entity based on overall tax rates of the entity's business income less clear than it was under prior law. It is important to note, however, that the corporate tax rate reduction is a permanent change, while the QBI deduction is scheduled to expire in 2026. The overall tax rate on a flow-through entity's business income depends on whether the flow-through entity's business income is eligible for the QBI deduction and whether the income is subject to the net investment income tax or the self-employment tax and the additional Medicare tax. For C corporations, the overall tax rate depends in large part on the extent to which the corporation distributes its after-tax earnings as a dividend to its shareholders. As we saw in Example 15-2, the overall tax rate on CCS's taxable income as a flow-through entity ranged from 29.6 percent to 40.8 percent, depending on whether the QBI deduction and the net investment income tax applied. In Example 15-4, the overall tax rate on CCS's taxable income as a C corporation ranged from 21 percent, when CCS retained all of its after-tax income, to 39.8 percent, when it distributed all of its after-tax income.

Owner Compensation Entity owners who work for the entity are compensated in different ways, depending on the entity type. Owners of S corporations and C corporations receive compensation as employees. Owners of flow-through entities taxed as partnerships receive compensation in the form of guaranteed payments. Sole proprietors don't receive a separate compensation payment because a sole proprietorship is the same taxable entity as the individual sole proprietor.

S corporations and C corporations deduct the wages paid to employees (including shareholders who are employees) to calculate the entity's business income. They also pay (and deduct) the employer's portion of the FICA tax (Social Security tax plus Medicare tax) on the employee's behalf. The employer's portion of the tax is 7.65 percent of the employee's first \$132,900 of employee compensation plus 1.45 percent of employee compensation above \$132,900. The shareholder-employee is taxed on the wages received at ordinary rates and is required to pay the employee's portion of the FICA tax, which is generally the same as the employer's portion. When considering both the employer's and the employee's portions of the FICA tax, the overall FICA rate is 15.3 percent of the first \$132,900 of wages and 2.9 percent of the rest. This is the same rate as the self-employment tax rate. Also, similar to self-employment income, employee compensation is subject to the additional Medicare tax when the taxpayer's AGI is over the threshold amount (discussed above).

Entities taxed as partnerships deduct guaranteed payments made to owners working for the entity. However, the entity is not required to pay FICA tax on the owner-worker's behalf because guaranteed payments are self-employment income and self-employment taxes are the sole responsibility of the owner-worker.³² The owner-worker is taxed on the amount of the guaranteed payment at ordinary rates and is required to pay self-employment tax and potentially additional Medicare tax on the income, depending on their income level (see prior discussion on computing the self-employment and additional Medicare tax). A sole proprietorship does not pay deductible compensation to the sole proprietor. All of the income of a sole proprietorship is self-employment income and, consequently, is subject to self-employment tax and the additional Medicare tax.

Owner compensation provides potential tax planning opportunities, depending on the type of entity. For S corporations, business income allocations to owners are not subject to FICA or self-employment tax. However, wages paid to owner-employees are subject to FICA tax. (Recall that the combined employer/employee FICA rate is the same as the self-employment tax rate.) Consequently, as we discuss in the S Corporations chapter,

³²Taxpayers pay self-employment tax on self-employment income and FICA taxes on employee compensation.

S corporations have a tax incentive to pay lower salary/wages to shareholder-employees that is subject to FICA tax so there is more business income to allocate to shareholder-employees that is not subject to FICA tax (lower deductible wages means higher business income allocations). Further, S corporations have an incentive to reduce wages to shareholder-employees in order to increase business income because employee compensation is not eligible for the deduction for qualified business income, but business income allocations to shareholders are eligible. In the extreme, S corporations may prefer to pay zero wages to shareholder-employees in order to maximize business income allocations to them. However, to the extent an S corporation shareholder receives an unreasonably low salary for services provided, the IRS may reclassify some of the shareholder's business income allocation as salary.

In contrast to S corporations, entities taxed as partnerships don't have an incentive to decrease guaranteed payments in order to increase business income allocations in an attempt to save self-employment taxes to owners. This is because both guaranteed payments and business income allocations are self-employment income to the owner-worker. However, similar to S corporations, entities taxed as partnerships have an incentive to reduce guaranteed payments to owner-workers in order to increase business income allocations to them because guaranteed payments are not eligible for the qualified business income but allocations of business income are eligible. Finally, relative to both S corporations and entities taxed as partnerships, sole proprietorships may be the most advantageous for purposes of maximizing the qualified business income deduction in certain situations. This is because the sole proprietorship's qualifying business income is not reduced by a deduction for compensation paid to the owner/sole proprietor.

For C corporations, tax planning opportunities have potentially shifted with the steep reduction in the corporate tax rate relative to individual rates, effective beginning in 2018. Prior to the rate reduction, corporations could avoid double taxation of their income by paying deductible salaries to shareholder-employees. This income would be taxed once to the employee at ordinary rates similar to the corporate rate. The IRS could evaluate compensation to an employee-shareholder to determine if the compensation was unreasonably high for the work the employee-shareholder was doing and, to the extent it was, reclassify the excess compensation as nondeductible dividends. Currently, however, with the corporate rate significantly lower than the maximum individual rate, corporations have an incentive to pay lower salaries to shareholder-employees in order to have more of their income taxed at the lower corporate rate. By reducing deductible salaries, more of the corporate income is subject to tax at the lower 21 percent tax rate. If the income is paid in the form of salaries, it is subject to the individual rate (the top rate is 37 percent) and subject to both the employer's and the employee's portion of the FICA tax. This type of strategy is more likely to be useful for closely held corporations where all of the owners work for the corporation. It remains to be seen how the IRS will respond to such strategies.

While the overall tax rate of an entity's income and the tax treatment of owner compensation are important entity choice factors, it is also important to consider the tax treatment of the entity's losses and other tax characteristics when choosing a tax entity for a new business.

Deductibility of Entity Losses When a C corporation's tax deductions exceed its income for the year, the excess is called a **net operating loss (NOL)**. While NOLs provide no tax benefit to C corporations for the year they incur them, corporations may use NOLs to offset corporate taxable income and reduce corporate taxes in other years. The specific tax treatment for an NOL depends on when the NOL was generated. For NOLs generated in tax years ending before 2018, corporations could carry NOLs back and offset up to 100 percent of taxable income (before the NOL deduction) reported in the two preceding years and carry NOLs forward to offset up to 100 percent of taxable income for up to 20 years. However, for NOLs generated in tax years ending after 2017, corporations can carry NOLs forward indefinitely but they are not allowed to carry them back. Further, the

deduction for post 2017 NOLs is limited to 80 percent of taxable income (before the NOL deduction) for a given year.³³ In any event, losses from C corporations are *not* available to offset shareholders' personal income.

In contrast to losses generated by C corporations, losses generated by sole proprietorships and other flow-through entities are generally available to offset the owners' personal income, subject to certain restrictions. For example, the owner of an entity taxed as a partnership or an S corporation shareholder may deduct losses from the entity only to the extent of the owner's basis in her ownership interest in the flow-through entity. In addition, deductibility of losses from flow-through entities may be further limited by the at-risk limitation and/or the passive activity loss limitation. The at-risk limitation is similar to the basis limitation but is slightly more restrictive. The passive activity loss limitation typically applies to individual investors who are passive investors in the flow-through entity. For passive investors, the business activities of the entity are called passive activities. In these circumstances, taxpayers can deduct losses from passive activities only to the extent they have income from other passive activities (or when they sell their interest in the activity). Due to the complex nature of these limitations, we defer a detailed discussion of these limitations until the Forming and Operating Partnerships chapter.

Individual taxpayers are also not allowed to deduct an "excess business loss" for the year. An **excess business loss** is the excess of aggregate business deductions for the year over the sum of aggregate business gross income or gain of the taxpayer plus a threshold amount. The threshold amount for 2019 is \$510,000 for married taxpayers filing jointly and \$255,000 for other taxpayers. The amounts are indexed for inflation. Excess business losses include business losses from sole proprietorships, entities taxed as partnerships, and S corporations. In the case of an S corporation or an entity taxed as a partnership, the provision applies at the owner level. Excess business losses are carried forward and used in subsequent years. The excess business loss limitation applies to losses that are otherwise deductible after applying the basis, at-risk, and passive loss rules. See the Forming and Operating Partnerships chapter for more details.

The ability to deduct flow-through losses against other sources of income can be a significant issue for owners of new businesses because new businesses tend to report losses early on as the businesses get established. If owners form a new business as a C corporation, the corporate-level losses provide no current tax benefit to the shareholders. The fact that C corporation losses are trapped at the corporate level can impose a higher tax cost for shareholders initially doing business as a C corporation relative to a flow-through entity such as an S corporation or an entity taxed as a partnership.

TAXES IN THE REAL WORLD Will Entity Selection Be Affected by the Recent Tax Law Changes?

In its Statistics of Income Tax Report, the Internal Revenue Service reported the following information relating to tax entity selection by business owners as of 2013 (the most recent year reported). Sole proprietorships were the most common, followed by S corporations, entities taxed as partnerships, and then C corporations. Nevertheless, C corporations by far generated the most business entity receipts and net income.

Under recent tax legislation, the C corporation tax rate has been reduced from 35 percent to 21 percent and owners of flow-through entities are allowed a new deduction for qualified business income generated by the entity. Going forward, how do you expect the percentage of each entity type to change, if at all, under the new tax system? Is it likely we will see a shift toward C corporations as the entity of choice?

(continued)

THE KEY FACTS

Taxation of Entity Income

- Flow-through entity income is taxed at the owner's tax rate. Individuals are taxed at a top marginal income rate of 37 percent on business income allocated to them from a flow-through entity.
- Flow-through entity owners who receive qualified business income from a flow-through entity are allowed to claim a qualified business income deduction equal to 20 percent of the qualified business income allocated to them (subject to certain limitations).
- Business income allocations to passive owners of flow-through entities may be subject to the 3.8 percent net investment income tax.
- Business income allocated to S corporation shareholders is not subject to self-employment tax.
- Owners of entities taxed as a partnership may be subject to self-employment tax on business income allocations, depending on the owner's involvement in the business activities.
- Sole proprietors are subject to self-employment tax on the sole proprietorship's income.
- C corporation taxable income is subject to a flat 21 percent tax rate.
- Individuals who are C corporation shareholders are generally taxed at a maximum rate of 20 percent on dividends received. Further, certain taxpayers may be charged a 3.8 percent net investment income tax on dividends and capital gains.
- C corporation shareholders that are themselves C corporations are generally eligible to receive a 50 percent or greater dividends received deduction (DRD).

(continued)

³³We discuss the net operating loss deduction in more detail in the Corporate Operations chapter.

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- C corporation shareholders who are individuals generally pay capital gains taxes when shares are sold at a gain.
- S corporation and C corporation shareholders receive employee compensation for work they do for the entity.
- Owner-workers for entities taxed as a partnership receive compensation in the form of guaranteed payments. Guaranteed payments are self-employment income.

	Number of Entities	Business Receipts	Net Income (including deficits)
Totals for all entities	33,423,187	\$33,260,092,484	\$3,065,208,464
Entity Type	Percentage	Percentage	Percentage
C corporations	4.82	61.24	46.64
S corporations	12.74	20.55	17.93
General partnerships	1.69	1.22	3.56
Limited partnerships	1.25	3.89	10.00
LLCs (taxed as partnerships)	6.84	9.02	9.72
Sole proprietorships (nonfarm)	72.03	4.09	12.15
Other*	.63	0	0

*Other includes Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs). Neither type of entity has business receipts or net income.

Source: <https://www.irs.gov/statistics/soi-tax-stats-integrated-business-data>, Tax Year 2013.

ETHICS

Troy is the sole shareholder and CEO of BQT. BQT is a very profitable S corporation. Until recently, Troy's salary was in line with the salaries of comparable CEOs. However, Troy recently learned that he could reduce his tax burden if he were to reduce his salary. In particular, by lowering his salary, Troy would receive less employee compensation that is subject to FICA tax

and is not eligible for the qualified business income deduction, and he would be allocated more business income that is not subject to FICA tax and qualifies for the qualified business income deduction. After considering the potential benefits, Troy decided to cut his salary in half. Do you think Troy's decision is ethical? Why or why not?

Example 15-6

What if: Assume that Nicole organizes CCS as a C corporation and that, in spite of her best efforts as CEO of the company, CCS reports a tax loss of \$50,000 in its first year of operation (year 1). Also assume that Nicole's marginal tax rate is 37 percent and her husband's salary for year 1 is \$500,000. Nicole files a joint tax return with her husband. How much tax will CCS pay in year 1 and how much tax will Nicole (and her husband) pay on the \$500,000 of other taxable income if CCS is organized as a C corporation?

Answer: CCS will pay \$0 in taxes because it reports a loss for tax purposes. However, CCS can carry the loss forward to future years and can use the loss to offset up to 80 percent of its taxable income in a given year. Because Nicole may not use the CCS loss to offset her husband's salary, she (and her husband) must pay \$185,000 in taxes. See the computations in the table below.

What if: Suppose CCS is organized as an S corporation and Nicole's stock basis in CCS before the year 1 loss is \$100,000. How much tax will CCS pay in year 1, and how much tax will Nicole (and her husband) pay on the \$500,000 salary?

Answer: CCS will pay \$0 taxes (S corporations are not tax-paying entities) and Nicole will pay \$166,500 in taxes. See the computations in the table below.

Description	C Corporation	S Corporation (flow-through)	Explanation
(1) Taxable income (loss)	\$ (50,000)	\$ (50,000)	
(2) CCS corporate-level tax	\$ 0	\$ 0	No taxable income
(3) Nicole's other income	\$ 500,000	\$ 500,000	
(4) CCS loss available to offset Nicole's other income	\$ 0	\$ (50,000)	\$0 if C corporation; (1) if S corporation (flow-through entity)
(5) Nicole's other income reduced by entity loss	\$ 500,000	\$ 450,000	(3) + (4)
(6) Nicole's marginal ordinary tax rate	37%	37%	
Nicole's tax on other income	\$185,000	\$166,500	(5) × (6)

What if: Suppose CCS is organized as an S corporation and Nicole's stock basis before the \$50,000 year 1 loss is \$100,000. Further, assume that Nicole does not participate in CCS's business activities; that is, assume she is a passive investor in the business entity. How much tax will Nicole (and her husband) pay on the \$500,000 of other income?

Answer: \$185,000. Because Nicole is a passive investor, she is not allowed to deduct the loss allocated to her this year. She must carry it over and use it in future years (this assumes neither Nicole nor her husband have income from other investments in which they are passive investors).

As the example above illustrates, owners' ability to immediately use start-up losses from flow-through entities to offset income from other sources is a tax advantage of flow-through entities over C corporations.

OTHER TAX CHARACTERISTICS

There are many tax factors that differ across entities and can influence the entity selection decision. Exhibit 15-3 provides an overview of these tax characteristics. The exhibit describes the general rules for each tax characteristic as it relates to C corporations, S corporations, entities taxed as partnerships, and sole proprietorships, and it ranks the entities on each characteristic (1 is most tax favorable). Finally, it identifies the chapters where detail on these tax characteristics can be found.

Converting to Other Entity Types

With the significant reduction in corporate tax rates from tax legislation effective beginning in 2018, owners of existing flow-through entities may reevaluate their entity status and determine whether they prefer to have their entity taxed as a C corporation rather than as a flow-through entity. Fortunately for flow-through entity owners wanting to change entity type, it is easy and inexpensive to convert flow-through entities, including sole proprietorships, into C corporations. Owners of S corporations can revoke their election to be taxed as an S corporation and be taxed as a C corporation (see the S Corporations chapter for details on this process). As we discussed in the Entity Tax Classification section of this chapter, owners of entities taxed as partnerships and sole proprietors doing business as an LLC can retain the same legal entity type but make a check-the-box election to be taxed as a C corporation. Alternatively, owners of partnerships and sole proprietors can contribute the assets of the business entity to a newly formed corporation in a tax-deferred transaction without any special tax elections.³⁴ However, because this alternative involves creating a new legal entity, nontax factors (e.g., the cost of creating a new entity, changing the asset title to a new entity, etc.) may make this option less desirable than the check-the-box election to be taxed as a C corporation.

Conversely, with recent tax law changes providing a deduction for qualified business income and slightly lower individual tax rates, C corporation shareholders may prefer to have their business taxed as a flow-through entity rather than as a C corporation. Shareholders of existing corporations really have only two options for converting into flow-through entities. First, shareholders of C corporations could make an election to treat the corporation as an S corporation (flow-through entity), if they are eligible to do so. This option is not available for many corporations due to the tax rule restrictions prohibiting certain corporations from operating as S corporations.³⁵ The only other option is for the shareholders to liquidate the corporation and form the business as an entity taxed as a partnership or sole proprietorship for tax purposes. This may not be a viable option, however, because the taxes imposed on liquidating corporations with appreciated assets can be punitive, even with the significantly lower corporate tax rate provided by recent tax

³⁴§351 and Rev. Rul. 84-111 1984-2 CB 88.

³⁵See the S Corporations chapter for details on making the S corporation election.

EXHIBIT 15-3 Comparison of Tax Characteristics across Entities

15-20

Tax Characteristic	C Corporation	Entity Taxed as Partnership	S Corporation	Sole Proprietorship	Summary
Owner limits	At least one shareholder.	At least two owners.	Not more than 100; no corporations, partnerships, nonresident aliens, or certain trusts.	N/A	Limitations are least strict for C corporations and most strict for S corporations. S corporations are the only entity with significant owner limitations. More detail for this factor is discussed in the S Corporations chapter.
Rank ¹	1	2	3	N/A	
Owner contributions of appreciated property to entity	Tax deferred to shareholder if certain requirements are met.	Tax deferred to owner.	Tax deferred to shareholder if certain requirements are met.	N/A	This factor favors entities taxed as partnerships because partners are not required to meet special requirements in order to avoid recognizing gain on the contribution of appreciated property to the partnership, but shareholders of both C and S corporations are required to meet certain requirements to avoid recognizing gain on such contributions to the corporation. More detail for this factor is provided in the Corporate Formation, Reorganization, and Liquidation, the Forming and Operating Partnerships, and the S Corporations chapters.
Rank	2	1	2	N/A	
Accounting periods	Generally, any tax year that ends on the last day of any month. ²	Generally, must use tax year that matches tax year of owners (special rules when not all owners have same tax year-end).	Calendar year.	Generally a calendar year.	C corporations generally have the most flexibility to select their year-end. But because C corporations are not flow-through entities, this is not a real advantage or disadvantage from a tax perspective. Partnerships generally are not free to choose their year-end but they can have a year-end that is a different year-end from some of the owners. Because this allows some partners to defer reporting income, this factor favors partnerships over S corporations. S corporations generally have the same calendar year-end as their shareholders. More detail for this factor is provided in the Business Income, Deductions, and Accounting Methods, the Forming and Operating Partnerships, and the S Corporations chapters.
Rank	N/A	1	2	N/A	
Overall accounting method	Must use accrual method unless average annual gross receipts are \$26 million or less. ^{3,4}	Generally, allowed to use cash or accrual method.	Generally, allowed to use cash or accrual method.	Cash or accrual method.	Entities taxed as partnerships, S corporations, and sole proprietorships generally have more flexibility to choose their overall accounting method than do C corporations with average annual gross receipts over \$26 million. The cash method makes it easier for these entities to plan the timing of income and expenses than does the accrual method. More detail for this factor is provided in the Business Income, Deductions, and Accounting Methods, the Corporate Operations, the Forming and Operating Partnerships, and the S Corporations chapters.
Rank	4	1	1	1	
Allocation of income or loss items to owners	N/A	Allocations based on partnership agreement (can differ from ownership percentages).	Allocations based on stock ownership percentages.	N/A	This factor applies to partnerships and S corporations only. Partnerships have more flexibility than S corporations to determine how to allocate income and loss items to entity owners. More detail for this factor is provided in the Forming and Operating Partnerships and the S Corporations chapters.
Rank	N/A	1	2	N/A	

Tax Characteristic	C Corporation	Entity Taxed as Partnership	S Corporation	Sole Proprietorship	Summary
Share of flow-through entity debt included in basis of owner's equity interest	N/A	Increase basis in ownership interest by owner's share of entity's debt.	No increase in stock basis for debt of entity (special rules if shareholder lends money to S corporation).	N/A	Partners are allowed to increase the basis in their ownership interest by their share of the partnership's debt; S corporation shareholders generally are not. This factor favors partnerships over S corporations. More detail for this factor is provided in the the Forming and Operating Partnerships and the S Corporations chapters.
Rank	N/A	1	2	N/A	
Nonliquidating distributions of noncash property	Gains recognized on distributed appreciated property and losses disallowed on distributions of depreciated property.	Generally no gain or loss recognized on noncash property distributions.	Same as C corporation.	N/A	This factor favors partnerships for distributions of appreciated and depreciated property. More detail for this factor is provided in the Corporate Taxation: Nonliquidating Distributions, the Dispositions of Partnership Interests and Partnership Distributions, and the S Corporations chapters.
Rank	2	1	1	N/A	
Liquidating distributions	Gain and loss recognized (certain losses disallowed).	Generally no gain or loss recognized.	Gain and loss recognized (certain losses disallowed).	N/A	This factor tends to favor partnerships if the liquidating entities have gain assets, and it tends to favor corporations if the entities have loss assets. More detail for this factor is provided in the Corporate Formation, Reorganization, and Liquidation, the Dispositions of Partnership Interests and Partnership Distributions, and the S Corporations chapters.
Rank	1	1	1	N/A	

¹-"Rank" orders the entities based on the particular characteristic (1 is most favorable).

²C corporations that qualify as personal service corporations (PSCs) are generally required to use a calendar year. In general, a personal service corporation is a corporation whose shareholders perform professional services such as law, engineering, and accounting. See §448(d)(2) for more detail.

³The \$26 million threshold applies for tax years beginning in 2019. For tax years beginning in 2018, the threshold was \$25 million.

⁴C corporations that are qualified personal service corporations are required to use the cash method.

law changes. As described in Exhibit 15-3, liquidating corporations are taxed on the appreciation in the assets they distribute to their shareholders in liquidation. Further, shareholders of liquidating corporations are also taxed on the difference between the fair market value of the assets they receive from the liquidating corporation and the tax basis in their stock. Effectively, the total double-tax cost of liquidating a corporation can swamp expected tax savings from operating as a flow-through entity. The tax cost of liquidating an entity is a factor to consider when making the tax entity choice for a business.

Example 15-7

What if: Assume we are years down the road and that Nicole is the sole shareholder of CCS (a C corporation). CCS's assets have a fair market value of \$10 million and adjusted tax basis of \$6 million (\$4 million built-in gain). Further assume that the corporate tax rate is 21 percent, Nicole's stock basis in CCS is \$2 million, and her marginal tax rate on long-term capital gains is 23.8 percent (20 percent capital gains rate + 3.8 percent net investment income tax). How much tax would CCS and Nicole be required to pay if CCS were to liquidate in order to form an LLC?

Answer: \$2,544,080. This would be a steep tax price to pay for changing from a C corporation to an LLC.

Description	Amount	Explanation
(1) FMV of CCS assets	\$10,000,000	
(2) Adjusted basis of CCS assets	6,000,000	
(3) CCS taxable income on liquidation	4,000,000	(1) – (2)
(4) Corporate tax rate	21%	
(5) Entity-level tax	840,000	(3) × (4)
(6) After-tax assets distributed to Nicole	9,160,000	(1) – (5)
(7) Nicole's stock basis	2,000,000	
(8) Nicole's long-term capital gain on distribution	7,160,000	(6) – (7)
(9) Nicole's marginal tax rate on gain	23.8%	
(10) Shareholder-level tax	1,704,080	(8) × (9)
Total entity and shareholder-level tax on liquidation	\$ 2,544,080	(5) + (10)

continued from page 15-4. . .

Nicole quickly determined she would legally form CCS as an LLC in Utah. This would provide her with limited liability and allow her complete flexibility for determining the tax entity type of CCS. If at some point she wanted to convert CCS into a corporation in Utah, she was advised that she could make the conversion simply by filing some paperwork.

Nicole's five-year forecast of CCS's expected operating results showed that CCS would generate losses for the first three years and then become very profitable thereafter. With these projections in hand, Nicole first considered forming CCS as a partnership for tax purposes (she was planning on bringing in another investor) or electing to become an S corporation. Nicole determined that income allocated to her from CCS would be eligible for the deduction for qualified business income whether she operated CCS as a partnership or an S corporation. She then compared the specific tax rules applicable to partnerships and S corporations before deciding her preference between the two tax entity types. She identified some differences that could sway her decision one way or the other. Supporting a decision to select a partnership, Nicole learned she would likely be able to deduct the projected start-up losses from CCS more quickly with a partnership compared with an S corporation because she could include a share of the partnership's debt in her

tax basis in her ownership interest (whereas she would not be able to include a share of the S corporation's debt in the tax basis of her ownership interest). Nicole also hoped to attract corporate investors, and she discovered that a partnership can have corporate partners but that S corporations are not permitted to have corporate shareholders. Supporting a decision to select an S corporation, Nicole learned that S corporations appear to have a compelling advantage over partnerships in reducing the self-employment tax of owners active in managing their businesses. Nicole decided that she preferred a partnership over an S corporation because she would be willing to potentially incur additional self-employment taxes with a partnership in exchange for the ability to deduct her losses sooner and for the freedom to solicit corporate investors.

Nicole then turned her attention to whether she preferred to operate CCS as a C corporation or a partnership for tax purposes. Favoring the partnership tax entity choice was the fact that Nicole would be able to immediately deduct initial losses of the business against her personal income. Favoring the C corporation choice was the overall tax rate on the CCS income when it becomes profitable. She reasoned that the corporate tax rate is significantly lower than her marginal individual tax rate and she planned to grow CCS by having CCS retain rather than distribute its income and subject it to a second level of tax. Consequently, Nicole determined that the overall tax rate to CCS income would be significantly lower if she operated CCS as a C corporation. Further, as a C corporation she would be able to solicit corporate owners and eventually take CCS public if the opportunity were to present itself (to do this she would have to convert to a legal corporation). After much thought and analysis, Nicole chose to make the election necessary to have CCS taxed as a C corporation. With this big decision out of the way, Nicole could focus on applying for a small business loan from her local bank and on having her attorney take the necessary steps to formally organize CCS as a limited liability company. ■

CONCLUSION

Any time a new business is formed, and periodically thereafter as circumstances change (such as relevant tax law), business owners must carefully evaluate what type of business entity will maximize the after-tax profits from their business ventures. Many of the key factors to consider in the entity selection decision-making process are outlined in this chapter. When making the entity selection decision, owners must carefully balance the tax and nontax characteristics unique to the entities available to them. This chapter explains how various legal entities are treated for tax purposes and how certain tax characteristics differ between entity types. Moreover, it also identifies some of the more important nontax issues that come to bear on the choice of entity decision. With this understanding, taxpayers and their advisers will be better prepared to face this frequently encountered business decision. In the Forming and Operating Partnerships chapter, we return to Nicole and Color Comfort Sheets LLC to examine the tax rules that apply to Nicole and other members in CCS as they form the entity for tax purposes and begin business operations.

Summary

Discuss the legal and nontax characteristics of different types of legal entities.

LO 15-1

- Entities that differ in terms of their legal characteristics include corporations, limited liability companies, general partnerships, limited partnerships, and sole proprietorships.
- Corporations are formally organized by filing articles of incorporation with the state. They are legally separate entities and protect their shareholders from the liabilities of the corporation. State corporation laws dictate interactions between corporations and shareholders.

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As a result, shareholders have limited flexibility to customize their business arrangements with the corporation and other shareholders. State corporate governance rules do, however, facilitate initial public offerings.

- Limited liability companies are formally organized by filing articles of organization with the state. Like corporations, they are separate legal entities that shield their members from liabilities. In contrast to corporations, state LLC statutes give members a great deal of latitude in customizing their business arrangements with the LLC and other members.
- General partnerships may be organized informally without state approval, but limited partnerships must file a certificate of limited partnership with the state to organize. Although they are considered to be legally separate entities, they provide either limited or no liability protection for partners. While limited partners in limited partnerships have liability protection, general partners are fully exposed to the liabilities of the partnership. General and limited partnerships are given a great deal of latitude in customizing their partnership agreements.
- Sole proprietorships are businesses legally indistinguishable from their sole individual owners. As such, they are very flexible but provide no liability protection. Sole proprietors can obtain liability protection by converting to a single-member LLC.

LO 15-2 Describe the different types of entities for tax purposes.

- The four categories of business entities recognized by our tax system include: C corporations, S corporations, partnerships, and sole proprietorships.
- Legal corporations that don't make the S election are treated as C corporations and therefore pay taxes. All other entities recognized for tax purposes are flow-through entities.
- Legal corporations that qualify for and make the S election are treated as S corporations.
- Unincorporated entities with more than one owner are treated as partnerships unless they elect to be taxed as a corporation. If the entity elects to be taxed as a corporation, it can further elect to be taxed as an S corporation if it meets the S corporation requirements.
- Unincorporated entities with one owner are treated as sole proprietorships, where the sole owner is an individual, or as disregarded entities otherwise. If a sole proprietor converts to a single member LLC, the LLC can elect to be taxed as a corporation. It can further elect to be taxed as an S corporation.

LO 15-3 Identify fundamental differences in tax characteristics across entity types.

- Flow-through entity income is taxed once at the owner level. For individual owners, the top rate is 37 percent. Flow-through income may also be subject to the net investment income tax for passive investors or the self-employment tax for those involved in the business activities of a partnership or sole proprietorship.
- Flow-through business owners are eligible to deduct 20 percent of their qualified business income as a *from* AGI deduction that is not an itemized deduction. The deduction is subject to certain limitations determined at the individual level.
- Qualified business income is generally nonservice business income generated in the United States.
- Flow-through entity business income allocated to passive owners is subject to the 3.8 percent net investment income tax for taxpayers with AGI over a threshold dependent on filing status.
- Self-employment income is subject to self-employment tax and additional Medicare tax.
- S corporation business income allocated to shareholders is not self-employment income.
- Sole proprietorship income is self-employment income to the sole proprietor.
- Whether business income of entities taxed as a partnership is self-employment income to an owner depends on the owner's involvement in the entity's business activities.
- Corporate taxable income is taxed at the corporate level and again at the shareholder level. The corporate tax rate is a flat 21 percent. The second level of tax is paid at the shareholder level when the corporation distributes after-tax earnings as a dividend or when the shareholder sells the stock. The tax rate for the second level of tax depends on the type of shareholder.
- Dividends and long-term capital gains are taxed at a top rate of 23.8 percent (20 percent dividend plus 3.8 percent net investment income tax). Corporate shareholders are taxed on

dividends and capital gains at the corporate tax rate. However, corporations are entitled to deduct 50, 65, or 100 percent of dividends received based on the extent of their ownership in the distributing corporation.

- Corporations can defer the second level of tax by not distributing their after-tax income. However, corporations that retain earnings for tax avoidance rather than business purposes may be subject to the accumulated earnings tax or the personal holding company tax. These taxes reduce the incentive for corporations to retain earnings in order to avoid the second level of tax. Corporations are allowed to retain earnings to invest in their business.
- Business entity owners who work for the entity are compensated in different ways, depending on the type of entity.
- S corporation and C corporation shareholders who work for the entity receive employee compensation.
- Owners who work for entities taxed as partnerships receive guaranteed payments that are self-employment income to the owner-worker.
- Sole proprietors don't receive compensation from the business because the sole proprietorship and the sole proprietor are the same entity for tax purposes.
- Operating losses from S corporations and entities taxed as partnerships flow through to the owners. Owners may deduct these losses only to the extent of the basis in their ownership interest. The losses must also clear "at-risk" limitations and passive activity loss limitations in order for the owners to deduct the loss.
- The at-risk limitation is similar to the basis limitation. The passive activity loss limitations typically apply to individual investors who do little, if any, work relating to the business activities of the flow-through entity (referred to as *passive* activities to the individual investors). In these circumstances, taxpayers can deduct such losses only to the extent they have income from other passive activities.
- Flow-through entity individual owners are not allowed to deduct an excess business loss for the year (\$510,000 for married couples filing jointly; \$255,000 for other taxpayers). This provision potentially limits losses that would otherwise be deductible after applying the at-risk and passive activity loss limitations.
- Shareholders can mitigate the double tax by increasing the time they hold shares before selling.
- C corporation losses are referred to as net operating losses (NOLs).
- C corporations incurring NOLs before 2018 can carry the losses back two years and forward up to 20 years to offset up to 100 percent of taxable income in those years. C corporations incurring losses after 2017 can carry the losses forward indefinitely but may not carry the losses back. Further, the NOL deduction is limited to 80 percent of taxable income without the deduction in those years.
- C corporations may have one or many shareholders. S corporations may have one shareholder and as many as 100 unrelated shareholders; but corporations, nonresident aliens, partnerships, and certain trusts may not be S corporation shareholders. Partnerships must have at least two partners but are not restricted to a maximum number of partners. Sole proprietorships may have only one owner.
- Gains and income from contributing appreciated property to business entities are more easily deferred with partnerships compared to C and S corporations.
- S corporations, partnerships, and sole proprietorships are generally required to use tax year-ends conforming to the tax year-ends of their owners. C corporations may use any tax year-end.
- C corporations generally must use the accrual method unless they are a smaller corporation (average gross receipts of \$26 million or less in the prior three years). S corporations may use either the cash or accrual method of accounting. Partnerships generally may use either the cash or accrual method. Sole proprietorships may use either the cash or accrual method.
- Income and losses may be specially allocated to partners based on the partnership agreement. This gives partnerships a great deal of flexibility in determining how the risks and rewards of the enterprise are shared among partners. In contrast, income and losses must be allocated pro rata to S corporation shareholders consistent with their ownership percentages.

15-26 CHAPTER 15 Entities Overview

- Partners, but not S corporation shareholders, may add their share of entity debt to the basis in their ownership interest.
- Generally, distributions of appreciated property trigger gain at both the corporate and shareholder level when made to shareholders of C corporations; trigger gain at the corporate level when made to S corporation shareholders; and don't trigger any gain at all when made to partners.
- On liquidation, C and S corporations will generally recognize gains and losses on distributed assets. In contrast, partnerships and their partners generally do not recognize gains or losses on liquidating distributions.
- Converting a flow-through entity into a C corporation for tax purposes is generally fairly easy and inexpensive to do. S corporation shareholders can revoke the S corporation election; partnerships (and sole proprietorships formed as LLCs) can check the box to be taxed as a corporation; and partnerships and sole proprietors can contribute assets to a corporate entity in tax-deferred transactions.
- C corporations wanting to convert to a flow-through entity have two options. They may elect to become an S corporation if eligible, or they may liquidate the corporation and organize as a new entity. Taxes from liquidating C corporations can be significant when C corporations have appreciated assets.

KEY TERMS

accumulated earnings tax (15-14)**articles of incorporation (15-2)****articles of organization (15-2)****C corporation (15-5)****certificate of limited partnership (15-2)****certificate of organization (15-2)****corporation (15-2)****disregarded entities (15-5)****dividends received deduction (DRD) (15-13)****double taxation (15-14)****excess business loss (15-17)****flow-through entities (15-5)****general partnership (GP) (15-2)****initial public offering (IPO) (15-3)****institutional shareholders (15-11)****limited liability company (LLC) (15-2)****limited partnership (LP) (15-2)****net earnings from self-employment (15-9)****net operating loss (NOL) (15-16)****partnership agreement (15-2)****personal holding companies (15-14)****personal holding company tax (15-14)****qualified business income (QBI) (15-8)****S corporation (15-5)****single-member LLCs (15-5)****sole proprietorship (15-2)****specified service trade or business (15-8)**

DISCUSSION QUESTIONS

Discussion Questions are available in Connect®.



- LO 15-1** 1. What are the most common legal entities used for operating a business? How are these entities treated similarly and differently for state law purposes?
- LO 15-1** 2. How do business owners create legal entities? Is the process the same for all entities? If not, what are the differences?
- LO 15-1** 3. What is an operating agreement for an LLC? Are operating agreements required for limited liability companies? If not, why might it be important to have one?
- LO 15-1** 4. Explain how legal entities differ in terms of the liability protection they afford their owners.
- LO 15-1** 5. Have recent tax law changes increased or decreased the double tax on C corporation income? Explain.
- LO 15-1** 6. Why is it a nontax advantage for corporations to be able to trade their stock on the stock market?
- LO 15-1** 7. How do legal corporations protect shareholders from liability? If you formed a small corporation, would you be able to avoid repaying a bank loan from your community bank if the corporation went bankrupt? Explain.

8. Other than corporations, are there other legal entities that offer liability protection? Are any of them taxed as flow-through entities? Explain. **LO 15-1 LO 15-2**
9. In general, how are unincorporated entities classified for tax purposes? **LO 15-2**
10. Can unincorporated legal entities ever be treated as corporations for tax purposes? Can legal corporations ever be treated as flow-through entities for tax purposes? Explain. **LO 15-2**
11. What are the differences, if any, between the legal and tax classifications of business entities? **LO 15-2**
12. What types of business entities does the U.S. tax system recognize? **LO 15-2**
13. For flow-through entities with individual owners, how many times is flow-through entity income taxed, who pays the tax, and what is the tax rate? **LO 15-3**
14. What is the qualified business income deduction and how does it affect the tax rate on flow-through entity income? **LO 15-3**
15. Doug is considering investing in one of two partnerships that will build, own, and operate a hotel. One is located in Canada and one is located in Arizona. Assuming both investments will generate the same before-tax rate of return, which entity should Doug invest in when considering the after-tax consequences of the investment? Assume Doug's marginal rate is 37 percent, he will be a passive investor in the business, and he will report the flow-through income from either entity on his tax return. Explain (ignore any foreign tax credit issues). **LO 15-3**
16. Is business income allocated from a flow-through entity to its owner's self-employment income? Explain. **LO 15-3**
17. Who pays the first level of tax on a C corporation's income? What is the tax rate applicable to the first level of tax? **LO 15-3**
18. Who pays the second level of tax on a C corporation's income? What is the tax rate applicable to the second level of tax and when is it levied? **LO 15-3**
19. Is it possible for shareholders to defer or avoid the second level of tax on corporate income? Briefly explain. **LO 15-3**
20. How does a corporation's decision to pay dividends affect its overall tax rate? **LO 15-3**
21. Is it possible for the overall tax rate on corporate taxable income to be lower than the tax rate on flow-through entity taxable income? If so, under what conditions would you expect the overall corporate tax rate to be lower? **LO 15-3**
22. Assume Congress increases individual tax rates on ordinary income while leaving all other tax rates unchanged. How would this change affect the overall tax rate on corporate taxable income? How would this change affect overall tax rates for owners of flow-through entities? **LO 15-3**
23. Assume Congress increases the dividend tax rate to the ordinary tax rate while leaving all other tax rates unchanged. How would this change affect the overall tax rate on corporate taxable income? **LO 15-3**
24. Evaluate the following statement: "When dividends and long-term capital gains are taxed at the same rate, the overall tax rate on corporate income is the same whether the corporation distributes its after-tax earnings as a dividend or whether it reinvests the after-tax earnings to increase the value of the corporation." **LO 15-3**
25. If XYZ Corporation is a shareholder of BCD Corporation, how many levels of tax is BCD's before-tax income potentially subject to? Has Congress provided any tax relief for this result? Explain. **LO 15-3**
26. How many times is income from a C corporation taxed if a retirement fund is the owner of the corporation's stock? Explain. **LO 15-3**
27. For tax purposes, how is the compensation paid to an S corporation shareholder similar to compensation paid to an owner of an entity taxed as a partnership? How is it different? **LO 15-3**

15-28 CHAPTER 15 Entities Overview

- LO 15-3** 28. Why might it be a good tax planning strategy for an S corporation with one shareholder to pay a salary to the shareholder on the low end of what the services are potentially worth?
- LO 15-3** 29. When a C corporation reports a loss for the year, can shareholders use the loss to offset their personal income? Why or why not?
- LO 15-3** 30. Is a current-year net operating loss of a C corporation available to offset income from the corporation in other years? Explain.
- LO 15-3** 31. Would a corporation with a small amount of current-year taxable income (before the net operating loss deduction) and a large net operating loss carryover have a tax liability for the current year? Explain.
- LO 15-3** 32. In its first year of existence, SMS, an S corporation, reported a business loss of \$10,000. Michelle, SMS's sole shareholder, reports \$50,000 of taxable income from sources other than SMS. What must you know to determine whether she can deduct the \$10,000 loss against her other income? Explain.
- LO 15-3** 33. ELS, an S corporation, reported a business loss of \$1,000,000. Ethan, ELS's sole shareholder, is involved in ELS's daily business activities and he reports \$1,200,000 of taxable income from sources other than ELS. What must you know in order to determine how much, if any, of the \$1,000,000 loss Ethan may deduct in the current year? Explain.
- LO 15-3** 34. Why are S corporations less favorable than C corporations and entities taxed as partnerships in terms of owner-related limitations?
- LO 15-3** 35. Are C corporations or flow-through entities (S corporations and entities taxed as partnerships) more flexible in terms of selecting a tax year-end? Why are the tax rules in this area different for C corporations and flow-through entities?
- LO 15-3** 36. Which tax entity types are generally allowed to use the cash method of accounting?
- LO 15-3** 37. According to the tax rules, how are profits and losses allocated to owners of entities taxed as partnerships (partners or LLC members)? How are they allocated to S corporation shareholders? Which entity permits greater flexibility in allocating profits and losses?
- LO 15-3** 38. Compare and contrast the FICA tax burden of S corporation shareholder-employees and LLC members (assume the LLC is taxed as a partnership) receiving compensation for working for the entity (guaranteed payments) and business income allocations to S corporation shareholders and LLC members assuming the owners are actively involved in the entity's business activities. How does your analysis change if the owners are not actively involved in the entity's business activities?
- LO 15-3** 39. Explain how liabilities of an LLC (taxed as a partnership) or an S corporation affect the amount of tax losses from the entity that limited liability company members and S corporation shareholders may deduct. Do the tax rules favor LLCs or S corporations?
- LO 15-3** 40. Compare the entity-level tax consequences for C corporations, S corporations, and entities taxed as partnerships for both nonliquidating and liquidating distributions of noncash property. Do the tax rules tend to favor one entity type more than the others? Explain.
- LO 15-3** 41. If entities taxed as partnerships and S corporations are both flow-through entities for tax purposes, why might an owner prefer one form over the other for tax purposes? List separately the tax factors supporting the decision to operate as either an entity taxed as a partnership or as an S corporation.
- LO 15-3** 42. What are the tax advantages and disadvantages of converting a C corporation into an LLC taxed as a partnership?

PROBLEMS

Select problems are available in Connect®.



43. Visit your state's official website and review the information there related to forming and operating business entities in your state. Write a short report explaining the steps for organizing a business in your state and summarizing any tax-related information you found.
44. Andrea would like to organize SHO as either an LLC (taxed as a sole proprietorship) or a C corporation. In either form, the entity is expected to generate an 11 percent annual before-tax return on a \$200,000 investment. Andrea's marginal income tax rate is 35 percent and her tax rate on dividends and capital gains is 15 percent. Andrea will also pay a 3.8 percent net investment income tax on dividends and capital gains she recognizes. If Andrea organizes SHO as an LLC, Andrea will be required to pay an additional 2.9 percent for self-employment tax and an additional .9 percent for the additional Medicare tax. Further, she is eligible to claim the full deduction for qualified business income. Assume that SHO will pay out all of its after-tax earnings every year as a dividend if it is formed as a C corporation.
- How much cash after taxes would Andrea receive from her investment in the first year if SHO is organized as either an LLC or a C corporation?
 - What is the overall tax rate on SHO's income in the first year if SHO is organized as an LLC or as a C corporation?
45. Jacob is a member of WCC (an LLC taxed as a partnership). Jacob was allocated \$100,000 of business income from WCC for the year. Jacob's marginal income tax rate is 37 percent. The business allocation is subject to 2.9 percent of self-employment tax and .9 percent additional Medicare tax.
- What is the amount of tax Jacob will owe on the income allocation if the income is not qualified business income?
 - What is the amount of tax Jacob will owe on the income allocation if the income is qualified business income (QBI) and Jacob qualifies for the full QBI deduction?
46. Amanda would like to organize BAL as either an LLC (taxed as a sole proprietorship) or a C corporation. In either form, the entity is expected to generate an 8 percent annual before-tax return on a \$500,000 investment. Amanda's marginal income tax rate is 37 percent and her tax rate on dividends and capital gains is 23.8 percent (including the 3.8 percent net investment income tax). If Amanda organizes BAL as an LLC, she will be required to pay an additional 2.9 percent for self-employment tax and an additional .9 percent for the additional Medicare tax. Also, she is eligible to claim a full deduction for qualified business income on BAL's income. Assume that BAL will distribute half of its after-tax earnings every year as a dividend if it is formed as a C corporation.
- How much cash after taxes would Amanda receive from her investment in the first year if BAL is organized as either an LLC or a C corporation?
 - What is the overall tax rate on BAL's income in the first year if BAL is organized as an LLC or as a C corporation?
47. Sandra would like to organize BAL as either an LLC (taxed as a sole proprietorship) or a C corporation. In either form, the entity is expected to generate an 8 percent annual before-tax return on a \$500,000 investment. Sandra's marginal income tax rate is 37 percent and her tax rate on dividends and capital gains is 23.8 percent (including the 3.8 percent net investment income tax). If Sandra organizes BAL as an LLC, she will be required to pay an additional 2.9 percent for self-employment tax and an additional .9 percent for the additional Medicare tax. BAL's income is not qualified business income (QBI) so Sandra is not allowed to claim the QBI

LO 15-1



LO 15-3

LO 15-3

LO 15-3

LO 15-3

deduction. Assume that BAL will distribute all of its after-tax earnings every year as a dividend if it is formed as a C corporation.

- a) How much cash after taxes would Sandra receive from her investment in the first year if BAL is organized as either an LLC or a C corporation?
- b) What is the overall tax rate on BAL's income in the first year if BAL is organized as an LLC or as a C corporation?

LO 15-3



48. Tremaine would like to organize UTA as either an S Corporation or a C corporation. In either form, the entity will generate a 9 percent annual before-tax return on a \$1,000,000 investment. Tremaine's marginal income tax rate is 37 percent and his tax rate on dividends and capital gains is 23.8 percent (including the net investment income tax). If Tremaine organizes UTA as an S corporation he will be allowed to claim the deduction for qualified business income. Also, because Tremaine will participate in UTA's business activities, the income from UTA will not be subject to the net investment income tax. Assume that UTA will pay out 25 percent of its after-tax earnings every year as a dividend if it is formed as a C corporation.

- a) How much cash after taxes would Tremaine receive from his investment in the first year if UTA is organized as either an S corporation or a C corporation?
- b) What is the overall tax rate on UTA's income in the first year if UTA is organized as an S corporation or as a C corporation?
- c) What is the overall tax rate on UTA's income in the first year if it is organized as an S corporation but UTA's income is not qualified business income?
- d) What is the overall tax rate on UTA's income if UTA's income is not qualified business income and Tremaine is a passive investor in UTA?

LO 15-3



49. Marathon Inc. (a C corporation) reported \$1,000,000 of taxable income in the current year. During the year, it distributed \$100,000 as dividends to its shareholders as follows:

- \$5,000 to Guy, a 5 percent individual shareholder.
- \$15,000 to Little Rock Corp., a 15 percent shareholder (C corporation).
- \$80,000 to other shareholders.

- a) How much of the dividend payment did Marathon deduct in determining its taxable income?
- b) Assuming Guy's marginal ordinary tax rate is 37 percent, how much tax will he pay on the \$5,000 dividend he received from Marathon Inc. (including the net investment income tax)?
- c) What amount of tax will Little Rock Corp. pay on the \$15,000 dividend it received from Marathon Inc. (50 percent dividends received deduction)?
- d) Complete Form 1120 Schedule C for Little Rock Corp. to reflect its dividends received deduction (use the most recent Form 1120, Schedule C available).
- e) On what line on page 1 of Little Rock Corp.'s Form 1120 is the dividend from Marathon Inc. reported, and on what line of Little Rock Corp.'s Form 1120 is its dividends received deduction reported?

LO 15-3



50. After several years of profitable operations, Javell, the sole shareholder of JBD Inc., a C corporation, sold 22 percent of her JBD stock to ZNO Inc., a C corporation in a similar industry. During the current year JBD reports \$1,000,000 of after-tax income. JBD distributes all of its after-tax earnings to its two shareholders in proportion to their shareholdings. How much tax will ZNO pay on the dividend it receives from JBD? What is ZNO's tax rate on the dividend income (after considering the DRD)? [Hint: See IRC §243.]

LO 15-3

51. Mackenzie is considering conducting her business, Mac561, as either a single-member LLC or as an S corporation. Assume her marginal ordinary income tax rate is 37 percent, her marginal FICA rate on employee compensation is 1.45 percent, her marginal self-employment tax rate is 2.9 percent, and any employee compensation or

self-employment income she receives is subject to the .9 percent additional Medicare tax. Also assume Mac561 generated \$200,000 of business income before considering the deduction for compensation Mac561 pays to Mackenzie and Mackenzie can claim the full qualified business income deduction on Mac561's business income. Determine Mackenzie's after-tax cash flow from the entity's business income and any compensation she receives from the business under the following assumptions:

- a) Mackenzie conducted Mac561 as a single-member LLC.
 - b) Mackenzie conducted Mac561 as an S corporation and she received a salary of \$100,000. All business income allocated to her is also distributed to her.
 - c) Mackenzie conducted Mac561 as an S corporation and she received a salary of \$20,000. All business income allocated to her is also distributed to her.
 - d) Which entity/compensation combination generated the most after-cash flow for Mackenzie? What are the primary contributing factors favoring this combination?
52. In its first year of existence (year 1), SCC corporation (a C corporation) reported a loss for tax purposes of \$30,000. How much tax will SCC pay in year 2 if it reports taxable income from operations of \$20,000 before considering loss carryovers under the following assumptions?
- a) Year 1 is 2017.
 - b) Year 1 is 2018.
53. In its first year of existence (year 1), Willow Corp. (a C corporation) reports a loss for tax purposes of \$50,000. In year 2 it reports a \$40,000 loss. For year 3, it reports taxable income from operations of \$100,000 before any loss carryovers. How much tax will Willow Corp. pay in year 3, what is its NOL carryover to year 4, and when will the NOL expire under the following assumptions?
- a) Year 1 is 2017.
 - b) Year 1 is 2018.
54. Damarcus is a 50 percent owner of Hoop (a business entity). In the current year, Hoop reported a \$100,000 business loss. Answer the following questions associated with each of the following alternative scenarios.
- a) Hoop is organized as a C corporation and Damarcus works full-time as an employee for Hoop. Damarcus has a \$20,000 basis in his Hoop stock. How much of Hoop's loss is Damarcus allowed to deduct against his other income?
 - b) Hoop is organized as an LLC taxed as a partnership. Fifty percent of Hoop's loss is allocated to Damarcus. Damarcus works full-time for Hoop (he is not considered to be a passive investor in Hoop). Damarcus has a \$20,000 basis in his Hoop ownership interest and he also has a \$20,000 at-risk amount in his investment in Hoop. Damarcus does not report income or loss from any other business activity investments. How much of the \$50,000 loss allocated to him by Hoop is Damarcus allowed to deduct this year?
 - c) Hoop is organized as an LLC taxed as a partnership. Fifty percent of Hoop's loss is allocated to Damarcus. Damarcus does not work for Hoop at all (he is a passive investor in Hoop). Damarcus has a \$20,000 basis in his Hoop ownership interest and he also has a \$20,000 at-risk amount in his investment in Hoop. Damarcus does not report income or loss from any other business activity investments. How much of the \$50,000 loss allocated to him by Hoop is Damarcus allowed to deduct this year?
 - d) Hoop is organized as an LLC taxed as a partnership. Fifty percent of Hoop's loss is allocated to Damarcus. Damarcus works full-time for Hoop (he is not considered to be a passive investor in Hoop). Damarcus has a \$70,000 basis in his Hoop ownership interest and he also has a \$70,000 at-risk amount in his investment in Hoop. Damarcus does not report income or loss from any other business activity investments. How much of the \$50,000 loss allocated to him by Hoop is Damarcus allowed to deduct this year?

LO 15-3

LO 15-3

LO 15-3

e) Hoop is organized as an LLC taxed as a partnership. Fifty percent of Hoop's loss is allocated to Damarcus. Damarcus does not work for Hoop at all (he is a passive investor in Hoop). Damarcus has a \$20,000 basis in his Hoop ownership interest and he also has a \$20,000 at-risk amount in his investment in Hoop. Damarcus reports \$10,000 of income from a business activity in which he is a passive investor. How much of the \$50,000 loss allocated to him by Hoop is Damarcus allowed to deduct this year?

LO 15-3

55. Danni is a single 30 percent owner of Kolt (a business entity). In the current year, Kolt reported a \$1,000,000 business loss. Answer the following questions associated with each of the following alternative scenarios:
- Kolt is organized as a C corporation and Danni works 20 hours a week as an employee for Kolt. Danni has a \$200,000 basis in her Kolt stock. How much of Kolt's loss is Danni allowed to deduct this year against her other income?
 - Kolt is organized as an LLC taxed as a partnership. Thirty percent of Kolt's loss is allocated to Danni. Danni works 20 hours a week on Kolt business activities (she is not considered to be a passive investor in Kolt). Danni has a \$400,000 basis in her Kolt ownership interest and she also has a \$400,000 at-risk amount in her investment in Kolt. Danni does not report income or loss from any other business activity investments. How much of the \$300,000 loss allocated to her from Kolt is Danni allowed to deduct this year?
 - Kolt is organized as an LLC taxed as a partnership. Thirty percent of Kolt's loss is allocated to Danni. Danni is not involved in Kolt business activities. Consequently, she is considered to be a passive investor in Kolt. Danni has a \$400,000 basis in her Kolt ownership interest and she also has a \$400,000 at-risk amount in her investment in Kolt. Danni does not report income or loss from any other business activity investments. How much of the \$300,000 loss allocated to her from Kolt is Danni allowed to deduct this year?

LO 15-3**research**

56. Mickey, Mickayla, and Taylor are starting a new business (MMT). To get the business started, Mickey is contributing \$200,000 for a 40 percent ownership interest, Mickayla is contributing a building with a value of \$200,000 and a tax basis of \$150,000 for a 40 percent ownership interest, and Taylor is contributing legal services for a 20 percent ownership interest. What amount of gain is each owner required to recognize under each of the following alternative situations?
[Hint: Look at §351 and §721.]
- MMT is formed as a C corporation.
 - MMT is formed as an S corporation.
 - MMT is formed as an LLC.

LO 15-3**research**

57. Dave and his friend Stewart each own 50 percent of KBS. During the year, Dave receives \$75,000 compensation for services he performs for KBS during the year. He performed a significant amount of work for the entity and he was heavily involved in management decisions for the entity (he was not a passive investor in KBS). After deducting Dave's compensation, KBS reports taxable income of \$30,000. How much FICA and/or self-employment tax is Dave required to pay on his compensation and his share of the KBS income if KBS is formed as a C corporation, an S corporation, or a limited liability company (ignore the .9 percent additional Medicare tax)?

LO 15-3**research**

58. Rondo and his business associate, Larry, are considering forming a business entity called R&L but they are unsure about whether to form it as a C corporation, an S corporation, or an LLC taxed as a partnership. Rondo and Larry would each invest \$50,000 in the business. Thus, each owner would take an initial basis in his ownership interest of \$50,000 no matter which entity type is formed. Shortly after the formation of the entity, the business borrowed \$30,000 from the bank. If applicable, this debt will be shared equally between the two owners.

- a) After taking the loan into account, what is Rondo’s tax basis in his R&L stock if R&L is formed as a C corporation?
 - b) After taking the loan into account, what is Rondo’s tax basis in his R&L stock if R&L is formed as an S corporation?
 - c) After taking the loan into account, what is Rondo’s tax basis in his R&L ownership interest if R&L is formed as an LLC and taxed as a partnership?
59. Kevin and Bob have owned and operated SOA as a C corporation for a number of years. When they formed the entity, Kevin and Bob each contributed \$100,000 to SOA. They each have a current basis of \$100,000 in their SOA ownership interest. Information on SOA’s assets at the end of year 5 is as follows (SOA does not have any liabilities):

LO 15-3


Assets	FMV	Adjusted Basis	Built-in Gain
Cash	\$200,000	\$200,000	\$ 0
Inventory	80,000	40,000	40,000
Land and building	220,000	170,000	50,000
Total	\$500,000		

At the end of year 5, SOA liquidated and distributed half of the land, half of the inventory, and half of the cash remaining after paying taxes (if any) to each owner. Assume that, excluding the effects of the liquidating distribution, SOA’s taxable income for year 5 is \$0.

- a) What is the amount and character of gain or loss SOA will recognize on the liquidating distribution?
- b) What is the amount and character of gain or loss Kevin will recognize when he receives the liquidating distribution of cash and property? Recall that his stock basis is \$100,000 and he is treated as having sold his stock for the liquidation proceeds.

COMPREHENSIVE PROBLEMS

Select problems are available with Connect®.



60. Daisy Taylor has developed a viable new business idea. Her idea is to design and manufacture cookware that remains cool to the touch when in use. She has had several friends try out her prototype cookware and they have consistently given the cookware rave reviews. With this encouragement, Daisy started giving serious thought to starting up a business called “Cool Touch Cookware” (CTC).




Daisy understands that it will take a few years for the business to become profitable. She would like to grow her business and perhaps at some point “go public” or sell the business to a large retailer.

Daisy, who is single, decided to quit her full-time job so that she could focus all of her efforts on the new business. Daisy had some savings to support her for a while but she did not have any other source of income. She was able to recruit Kesha and Aryan to join her as initial equity investors in CTC. Kesha has an MBA and a law degree. Kesha was employed as a business consultant when she decided to leave that job and work with Daisy and Aryan. Kesha’s husband earns close to \$300,000 a year as an engineer (employee). Aryan owns a *very* profitable used car business. Because buying and selling used cars takes all his time, he is interested in becoming only a passive investor in CTC. He wanted to get in on the ground floor because he really likes the product and believes CTC will be wildly successful. While CTC originally has three investors, Daisy and Kesha have plans to grow the business and seek more owners and capital in the future.

The three owners agreed that Daisy would contribute land and cash for a 30 percent interest in CTC, Kesha would contribute services (legal and business advisory) for the first two years for a 30 percent interest, and Aryan would contribute cash for a 40 percent interest. The plan called for Daisy and Kesha to be actively involved in managing the business while Aryan would not be. The three equity owners' contributions are summarized as follows:

Daisy Contributed	FMV	Adjusted Basis	Ownership Interest
Land (held as investment)	\$120,000	\$70,000	30%
Cash	30,000		
Kesha Contributed			
Services	150,000		30
Aryan Contributed			
Cash	200,000		40

Working together, Daisy and Kesha made the following five-year income and loss projections for CTC. They anticipate the business will be profitable and that it will continue to grow after the first five years.

Cool Touch Cookware 5-Year Income and Loss Projections	
Year	Income (Loss)
1	\$(200,000)
2	(80,000)
3	(20,000)
4	60,000
5	180,000

With plans for Daisy and Kesha to spend a considerable amount of their time working for and managing CTC, the owners would like to develop a compensation plan that works for all parties. Down the road, they plan to have two business locations (in different cities). Daisy would take responsibility for the activities of one location and Kesha would take responsibility for the other. Finally, they would like to arrange for some performance-based financial incentives for each location.

To get the business activities started, Daisy and Kesha determined CTC would need to borrow \$800,000 to purchase a building to house its manufacturing facilities and its administrative offices (at least for now). Also, in need of additional cash, Daisy and Kesha arranged to have CTC borrow \$300,000 from a local bank and to borrow \$200,000 cash from Aryan. CTC would pay Aryan a market rate of interest on the loan but there was no fixed date for principal repayment.

Required:

Identify significant tax and nontax issues or concerns that may differ across entity types and discuss how they are relevant to the choice of entity decision for CTC.



61. Cool Touch Cookware (CTC) has been in business for about 10 years now. Daisy and Kesha are each 50 percent owners of the business. They initially established the business with cash contributions. CTC manufactures unique cookware that remains cool to the touch when in use. CTC has been fairly profitable over the years. Daisy and Kesha have both been actively involved in managing the business. They have developed very good personal relationships with many customers (both wholesale and retail) that, Daisy and Kesha believe, keep the customers coming back.

On September 30 of the current year, CTC had all of its assets appraised. Below is CTC's balance sheet, as of September 30, with the corresponding appraisals of the fair market value of all of its assets. Note that CTC has several depreciated assets. CTC uses the hybrid method of accounting. It accounts for its

gross margin-related items under the accrual method and it accounts for everything else using the cash method of accounting.

Assets	Adjusted Tax Basis	FMV
Cash	\$150,000	\$150,000
Accounts receivable	20,000	15,000
Inventory*	90,000	300,000
Equipment	120,000	100,000
Investment in XYZ stock	40,000	120,000
Land (used in the business)	80,000	70,000
Building	200,000	180,000
Total assets	<u>\$700,000</u>	<u>\$935,000[†]</u>
Liabilities		
Accounts payable	\$ 40,000	
Bank loan	60,000	
Mortgage on building	100,000	
Equity	500,000	
Total liabilities and equity	<u>\$700,000</u>	

*CTC uses the LIFO method for determining the adjusted basis of its inventory. Its basis in the inventory under the FIFO method would have been \$110,000.

[†]In addition, Daisy and Kesha had the entire business appraised at \$1,135,000, which is \$200,000 more than the value of the identifiable assets.

From January 1 of the current year through September 30, CTC reported the following income:

Ordinary business income	\$530,000
Dividends from XYZ stock	12,000
Long-term capital losses	15,000
Interest income	3,000

Daisy and Kesha are considering changing the business form of CTC.

Required:

- a) Assume CTC is organized as a C corporation. Identify significant tax and nontax issues associated with converting CTC from a C corporation to an S corporation. [Hint: See IRC §1374 and §1363(d).]
- b) Assume CTC is organized as a C corporation. Identify significant tax and nontax issues associated with converting CTC from a C corporation to an LLC. Assume CTC converts to an LLC (taxed as a partnership) by distributing its assets to its shareholders, who then contribute the assets to a new LLC. [Hint: See IRC §§331, 336, and 721(a).]
- c) Assume that CTC is a C corporation with a net operating loss carryforward as of the beginning of the year in the amount of \$2,000,000. Identify significant tax and nontax issues associated with converting CTC from a C corporation to an LLC (taxed as a partnership). Assume CTC converts to an LLC by distributing its assets to its shareholders, who then contribute the assets to a new LLC. [Hint: See IRC §§172(a), 331, 336, and 721(a).]



Source: Roger CPA Review

Sample CPA Exam questions from Roger CPA Review are available in Connect as support for the topics in this text. 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.