Solutions Manual for Pearson's Federal Taxation 2026 Individuals 2026 39th Franklin

Chapter I:1

An Introduction to Taxation

Discussion Questions

I:1-1 The Supreme Court held the income tax to be unconstitutional in 1895 because the income tax was considered to be a direct tax. At that time, the U.S. Constitution required that an income tax be apportioned among the states in proportion to their populations. This type of tax system would be extremely difficult to administer because different rates of tax would apply to individual taxpayers depending on their states of residence. p. I:1-2.

I:1-2 The pay-as-you-go withholding was needed in 1943 to avoid significant tax collection problems as the tax base broadened from 6% of the population in 1939 to 74% in 1945. Pay-as-you-go permitted the federal government to deduct taxes directly out of an employee's wages. p. I:1-3.

I:1-3 Under a progressive tax rate structure, the tax rate increases as the taxpayer's income increases. Currently, for 2025, tax rates of 10%, 12%, 22%, 24%, 32%, 35% or 37% apply depending upon the taxpayer's filing status and taxable income levels. Under a proportional tax rate or "flat tax" structure, the same tax rate applies to all taxpayers regardless of their income levels. Under a regressive tax rate structure, the tax rate decreases with an increase in income level. The concept of vertical equity holds that taxpayers with higher income levels should pay a higher proportion of tax and that the tax should be borne by those who have the "ability to pay." Thus, Congressman Patrick's opposition to the flat tax is philosophically correct; under a flat tax system, all taxpayers pay taxes at the same rate, regardless of the ability to pay. pp. I:1-4 and I:1-5.

I:1-4 It is possible for the government to raise taxes without raising tax rates. Because there are two components in computing a taxpayer's tax, the tax base and the tax rate, taxes can be raised by increasing either the rate or the base. Thus, even though the Governor proclaimed that tax rates have remained at the same level, adjustments to the tax base, such as the elimination of deductions, result in tax increases which can be as much, or more, as increases in tax rates. p. I:1-4.

I:1-5 The marginal tax rate is of greater significance in measuring the tax effect for Carmen's decision. The marginal tax rate is the percentage that is applied to an incremental amount of taxable income that is added to or subtracted from the tax base. Through the marginal tax rate, the taxpayer may measure the tax effect of the charitable contribution to her church. If her marginal tax rate is 24%, she will save 24¢ for each $1 contributed to her church. The average tax rate is simply the total tax liability divided by taxable income. pp. I:1-5 and I:1-6.

I:1-6 Gift and estate taxes are levied when a transfer of wealth (property) takes place and are both part of the unified transfer tax system. The tax base for computing the gift tax is the fair market value of all gifts made in the current year minus an annual donee exclusion of $19,000 (2025) per donee, minus a marital deduction for gifts to spouse and a charitable contributions deduction if applicable, plus the value of all taxable gifts in prior years. The tax base for the estate tax is the decedent's gross estate, minus deductions for expenses, and a marital or charitable deduction if applicable, plus taxable gifts made after 1976. pp. I:1-7 through I:1-10.

I:1-7 a. Cathy, the donor, is primarily liable for the gift tax on the two gifts. The children are contingently liable for payment of the gift tax in the event the donor fails to pay.

b. Before considering the unified tax credit equivalent of $13.99 million for 2025, a gift tax results on the two gifts for the current year 2025 computed as follows:

Total gifts	$100,000
Minus: Annual gift tax exclusion ($19,000 x 2 donees)	(38,000)
Gift tax base	$ 62,000

Since Cathy has never made gifts in prior years, no gift tax will be due because of the substantial unified tax credit that is available. pp. I:1-8 and I:1-9.

I:1-8 Carlos would report a taxable gain of $2,000 ($27,000 - $25,000). His tax basis in the stock that he inherited is the fair market value on the date of his father's death. pp. I:1-9 and I:1-10.

I:1-9 a. Most estates are **not** subject to the federal estate tax because of generous credit and deduction provisions, such as the unified tax credit and the unlimited marital deduction. The unified tax credit equivalent for 2025 is $13.99 million. This means that, at a minimum, for decedents dying in 2025, no estate of $13.99 million or less will be subject to the federal estate tax.

b. This is a controversial question that has proponents on both sides of the issue. Those that believe the estate tax should be reduced or eliminated basically argue that the estate tax is a double tax, that is, the property of the decedent has already been subject to income taxation during his or her lifetime and should not be subjected to further taxation at death. On the other hand, proponents of retaining or increasing the estate tax believe in the ability to pay principle. p. I:1-10.

I:1-10 a. Progressive.

b. Progressive.

c. Proportional.

d. Proportional.

e. Proportional. (However, state and local sales taxes are considered regressive when measured against income).

pp. I:1-4 and I:1-5 and I:1-12.

I:1-11 Decrease. When Carolyn operates her business as a sole proprietor, she is considered to be self-employed. A self-employment tax is imposed at the rate of 15.3% for 2025 (12.4% OASDI + 2.9% Medicare) on all of her business income with a ceiling on the non-hospital insurance (OASDI) portion of the tax base of $176,100 in 2025. Carolyn is also entitled to an income tax deduction equal to 50% of the self-employment tax payments if she is self-employed. If she works as an employee, however, the OASDI and Medicare taxes are imposed at the employee level at a rate of 7.65% for 2025. The OASDI is imposed on earned income up to a maximum of $176,100 in 2025 while Medicare taxes have no ceiling. Her employer would have to match Carolyn's OASDI and Medicare taxes. Thus, Social Security taxes are levied at the same rate of 15.3% (7.65% on the employee and 7.65% on the employer). If the corporation does not pay Carolyn a salary equal to its earnings, the Social Security taxes will be slightly less than under the sole proprietorship. The hospital insurance portion of the FICA premium continues to apply with no ceiling amount for employees, employers, and self-employed individuals. The rate is 2.9% for self-employed individuals and 1.45% each for employees and employers. p. I:1-11.

I:1-12 a. Property taxes are primarily used by local governments and include both real property taxes (real estate) and personal property taxes (tangible and intangible property).

b. Excise taxes are primarily used by the federal government and are imposed on items such as alcohol, tobacco, telephone usage, and many other goods. While not as extensive as the federal government, many state and local governments impose similar types of taxes.

c. Sales taxes are primarily used by state governments and constitute a major revenue source for many states. Local governments are increasingly using sales taxes as well as states. The local governments frequently tack-on 1¢ or 2¢ to the existing state sales tax rather than imposing a separate sales tax.

d. Income taxes are the primary domain of the federal government and constitutes its major source of revenue. However, many state and local governments now use the income tax in their revenue structures.

e. Employment taxes are primarily used by the federal government. Social security (FICA) taxes are a major source of federal revenue. Unemployment taxes are used by states as a compliment to the federal unemployment compensation tax. pp. I:1-10 and I:1-11.

I:1-13 a. The five characteristics of a "good" tax are equity, certainty, convenience, economy, and simplicity. Equity refers to the fairness of the tax to the taxpayers. A certain tax is one that ensures a stable source of government revenue and provides taxpayers with some degree of certainty concerning the amount of their annual tax liability. Convenience refers to the case of assessment, collectability, and administration for the government and reasonable compliance requirements for taxpayers. An economical tax requires minimal compliance costs for taxpayers and minimal administration costs for the government. Simplicity means the tax system is simple to understand and to comply.

b. 1. The federal income tax meets the first four criteria reasonably well, even though many critics would suggest otherwise. The tax is reasonably fair in that the high-income taxpayers pay the most tax, the low-income taxpayers the least tax. While tax laws are constantly changing, most taxpayers have a pretty good idea of what their taxes are going to be for the tax year and the federal income tax does provide the government with a stable source of revenue. The tax is convenient to pay although compliance requirements for taxpayers have risen steadily over the years. The tax is economical for the government to collect; however, the cost of compliance for taxpayers is much too high as approximately 56% of all taxpayers pay a tax preparer to prepare their tax returns. However, virtually no one would suggest that the federal income tax law is simple. In fact, complexity is one of the law's major flaws.

2. The state sales tax meets the criteria of certainty, convenience, economy and simplicity quite well. However, the sales tax is criticized as not being equitable as it tends to fall more heavily on lower and middle-income taxpayers.

3. Property taxes do not fare well according to the characteristics of a "good" tax. From equity standpoint, the property tax is imposed on property owners without regard to their income situation. Thus, a farmer may have substantial property but little income to pay the

property tax. Property taxes are certain but clearly not convenient in the sense that they are normally assessed in a lump-sum amount once a year. Property taxes do not meet the economy criteria. Property taxes are rather simple although differences in judgments as to valuation of property are a problem. pp. I:1-12 through I:1-14.

I:1-14 a. Horizontal equity refers to the concept that similarly situated taxpayers should pay approximately the same amount of tax. Vertical equity, on the other hand, refers to the concept that higher income taxpayers should not only pay a higher amount of tax but should pay a higher percentage of tax. Vertical equity is based on the notion that taxpayers who have the "ability to pay" (e.g., higher income taxpayers) should pay more tax than lower income taxpayers.

b. Fairness is an elusive term. Because of widely divergent opinions as to what constitutes fairness, it logically follows that there are also many different and divergent opinions as to what constitutes a "fair" tax structure. p. I:1-13.

I:1-15 Secondary objectives include the following:

a. Economic objectives such as stimulating private investment, reducing unemployment, and mitigating the effects of inflation.
b. Encouraging certain activities such as research and development and small business investment.
c. Social and public policy objectives, (e.g. encouraging charitable contributions and discouraging illegal bribes). pp. I:1-14 and I:1-15.

I:1-16 Probably not. It would be difficult to achieve a simplified tax system and also provide incentives to certain industries as well as achieve social objectives. To achieve a simplified tax system would require the elimination of special purpose provisions, such as with the several consumption tax proposals being forwarded. But consumption taxes generally are considered unfair as they fall disproportionately on the low and middle class. pp. I:1-14 through I:1-16.

I:l-17 Taxpaying entities generally are required to pay income taxes on their taxable income. The major taxpaying entities are individuals and C corporations. Flow-through entities generally do not directly pay income taxes on their taxable income but merely pass the income on to a taxpaying entity. The major flow-through entities are sole proprietorships, partnerships, S corporations, limited liability companies (LLC), limited liability partnerships (LLP), and certain trusts. Some entities do not neatly fall within each category and are actually hybrid entities. S corporations, for example, are subject to income taxes in certain situations, such as taxes on built-in gains, the LIFO recapture tax, etc. Not many S corporations incur these taxes. pp. I:1-16 through I:1-24.

I:1-18 Sally and Tom's taxable income for 2025 would be $110,000, computed as follows:

AGI	$ 140,000
Larger of itemized deductions ($22,000) or standard deduction ($30,000)	(30,000)
Taxable income	$ 110,000

If Sally and Tom had itemized deductions of $32,000 rather than of $22,000, their taxable income would be $108,000, computed as follows:

AGI	$ 140,000
Larger of itemized deductions ($32,000) or standard deduction ($29,200)	(32,000)
Taxable income	$ 108,000

As can be seen previously, the standard deduction of $30,000 is larger than $22,000 of their itemized deductions, so they obviously would claim the standard deduction. Alternatively, if the itemized deductions were $32,000, their taxable income would be 108,000 ($140,000 - $32,000) as the itemized deductions exceed the standard deduction of $30,000. Taxpayers are allowed to deduct the greater of itemized deductions or the standard deduction. pp. I:1-6, I:1-7, and I:1-17.

I:1-19 To properly respond to Bruin, tax calculations for both Bruin Corporation and John Bean must be made for the year.

$400,000 dividend. If the $400,000 is distributed to John as a dividend, Bruin Corporation would get no deduction for the dividend and would have corporate taxes of $105,000 ($500,000 x 0.21) based on taxable income of $500,000. John would then pay a maximum rate of 20% on the dividend because his taxable income is greater than $533,400 given the tax bracket he is in the 37% bracket starts at taxable income over $626,350 for single taxpayers, so the income taxes due by John on the $400,000 dividend would be $80,000 ($400,000 × 20%). Thus, the total income taxes would be $185,000 ($105,000 + $80,000).

$400,000 salary. If the $400,000 is distributed to John as a salary, Bruin Corporation would be allowed a deduction and the corporation's taxable income now would be $100,000. The corporate tax on $100,000 is $21,000. John would be required to pay income taxes on the $400,000 at 37%, so the tax would be $148,000. The total income taxes for the year would be $169,000 ($21,000 + $148,000).

As can be seen from the analysis above, the $400,000 salary would result in smaller taxes. This results even though John is in the top 37% tax bracket. The tax savings would be even higher if John were in a lower tax bracket. (Note that this solution ignores the incremental 3.8% tax on net investment income for high income taxpayers, which is discussed in later chapters). pp. I:1-19 and I:1-20.

I:1-20 The term "double taxation" refers to the taxing of the same income twice. This type of taxation typically results from a C corporation paying tax on its taxable income and shareholders paying income tax on any dividends received from the C corporation. The impact of double taxation of C corporations has been substantially reduced by the fact that dividends generally are taxed at a 15% rate with a maximum rate of 20%. An example of double taxation can be seen in Example I:1-15 of the textbook. pp. I:1-19 and I:1-20.

I:1-21 Limited liability companies (LLCs) generally are taxed as partnerships. Therefore, the LLC is not subject to income tax on its taxable income but such income is allocated to the members (owners) of the LLC. Thus, only a single-level of taxation is imposed. The same allocation rules that pertain to partnerships also apply to LLCs. Another principle feature of LLCs is limited liability for owners (members) of the LLC. pp. I:1-22 and I:1-23.

I:1-22 To prevent double taxation, the tax law allows partners to increase their basis in the partnership for any income that is allocated to the partner. Since partnership distributions are not subject to taxation if such distributions are less than the partner's basis, double taxation is prevented. Similarly, to prevent double deductions, the tax law requires partners to decrease their basis for any loss or deduction that is allocated to the partner. pp. I:1-21 and I:1-22.

I:1-23 Schedule K-1 is an integral part of both the annual partnership tax return and the S corporation tax return. Partnerships and S corporations use the same allocation system. The K-1 reports a partner's allocable share of partnership ordinary income and separately-stated items, such as dividends, long-term capital gains, etc. A K-1 is prepared for each partner in the partnership and is filed with Form 1065. So, if a partnership has ten partners, there will be ten K-1s that allocate the total partnership income to each partner. A copy of each partner's K-1 is provided to the partners so that they can report the information on their own tax returns. pp. I:1-21 and I:1-22.

I:1-24 Quint's taxable income for 2025 is computed as follows:

Allocable share of PDQ Partnership income ($150,000 x .3333)	$50,000
Other income	15,000
Adjusted gross income (AGI)	$ 65,000
Standard deduction	$(15,000)
Taxable income	$50,000

The $30,000 distribution from the partnership is considered a return of capital and is not taxable to Quint. Since he reports his allocable share of partnership income, if the distribution were taxed again, the result would be double taxation. If the partnership is eligible for the 20% qualified business income (QBI) deduction, Quint would also be allowed a deduction of $10,000 ($50,000 x 0.20) for his share of partnership income. pp. I:1-17 and I:1-21.

I:1-25 Because of the vast volume of tax law sources, it is nearly impossible for any person to have recall knowledge of the entire tax law. Thus, the ability to understand what the relevant sources of tax law are, their relative weight (importance), and where to find the sources are vital to a person working in the tax area. p. I:1-24.

I:1-26 Even though the Code is the highest authority of tax law sources, the Code contains general language and does not address the many specific situations and transactions that occur. To resolve tax questions concerning specific situations, administrative rulings and court decisions are an integral part of the income tax law. p. I:1-24.

I:1-27 a. Ways and Means Committee (House of Representatives), Senate Finance Committee (U.S. Senate) and the Joint Conference Committee.

b. Committee reports are helpful for two major purposes: (1) to explain the new law before the Treasury Department drafts regulations on the tax law changes, and (2) to explain the intent of Congress for passing the new law. pp. I:1-24 through I:1-26.

I:1-28 The National Office of the IRS issues revenue rulings to provide guidance to taxpayers on specific factual situations, processes ruling requests from taxpayers (private letter rulings), and prepares Revenue Procedures that assist taxpayers with compliance matters. Of course, the National Office also provides administrative and human resources functions at the top level of the organization. p. I:1-26.

I:1-29 Individuals most likely to be audited include those that may be involved in any of the following situations:

- Individuals who are sole proprietors and incur significant expenses in connection with the trade or business.
- Itemized deductions in excess of an average amount for the person's income level.
- Filing of a refund claim by a taxpayer who has been previously audited and the audit resulted in a substantial tax deficiency.
- Individuals who are self-employed with substantial business income or income from a profession such as a medical doctor. p. I:1-27.

I:1-30 a. Rarely will the IRS review each line of Anya's return. Audits of individual taxpayers generally focus on selected items on the return. Note: In prior years, the IRS had a Taxpayer Compliance Measurement Program (TCMP) where a small number of taxpayers were selected by a random sample and their returns were audited on a line-by-line basis. These audits were primarily for statistical purposes. Currently, this program has been abandoned. However, the IRS now uses the National Research Program (NRP) to select returns for audit. The NRP will update data compiled in the old TCMP audits and develop new statistical models for identifying returns most likely to contain errors.

b. Generally not all items on a return will be audited. All tax returns are initially checked for mathematical accuracy and items that may be considered clearly erroneous. If differences are noted the IRS sends the taxpayer a bill for the corrected amount. Upon an audit of Anya's return, the IRS generally only examines selected items on the return. These items are those that the IRS believes there is a possibility of error. p. I:1-27.

I:1-31 a. The term "hazards of litigation" refers to the probability of winning or losing a case if it goes to court.

b. Because of the possibility that a case may be lost and the cost of litigation, both the IRS and taxpayers frequently settle a case to avoid such possibilities. The IRS may also decide to settle a case because it does not want to establish an unfavorable precedent of cases in a specific area. A taxpayer may settle a case to avoid substantial legal and professional fees. p. I:1-29.

I:1-32 No, just because the taxpayer has filed a return and received a refund, the IRS may still audit a taxpayer. Tax returns that are selected for audit generally are audited a year or two after the return is received by the IRS. p. I:1-28.

I:1-33 a. The statute of limitations remains open indefinitely if a fraudulent return is filed or if no return is filed at all.

b. The general rule for the disallowance of tax deduction items is that an assessment may be made against the taxpayer within three years from the later of the date the tax return was filed or its due date.

c. A six-year statute of limitations applies if the taxpayer omits an item of gross income that is in excess of 25 percent of the gross income that is reported on the return. p. I:1-28.

I:1-34 The best possible defensibly correct solution is one that is advantageous to the client but is based upon substantial authoritative support (e.g., favorable court cases) even though the position may be challenged upon audit by the IRS. p. I:1-30.

I:1-35 The four principal areas of activity for the profession of tax practice are: tax compliance and procedure, tax research, tax planning and financial planning. Tax compliance and procedure essentially consists of tax return preparation and assisting the taxpayer in dealing with the IRS. Tax research is the process of developing the most defensibly correct solution to a tax problem. Tax planning involves the process of reducing taxes so as to maximize a taxpayer's after-tax return. Financial planning, while not exclusively related to tax, is an area for tax professionals to assist clients with planning for their entire financial affairs. pp. I:1-29 through I:1-31.

I:1-36 a. Because income taxes may exceed 50% of a taxpayer's income (including federal, state, and local income taxes and Social Security taxes), taxes are an extremely important part of the financial planning process. Any financial plan that does not carefully consider taxes is a flawed plan.

b. Because tax professionals see their clients at least once a year at a minimum (preparation of their income tax returns) and are familiar with the client's financial information, this represents a perfect opportunity to perform financial planning. p. I:1-31.

I:1-37 No, the principal goal of tax planning is to maximize a taxpayer's after-tax cash flow, not just the minimization of taxes due. For example, if a taxable investment generates a better return after taxes are paid than a nontaxable investment, the taxable investment is superior even though taxes must be paid. p. I:1-30.

I:1-38 Tax planning involves the evaluation of alternative courses of action. The evaluation of alternative courses of action can be very time-consuming because of the numerous and complex tax calculations necessary to arrive at an optimal solution. Using tax software has become an essential tool in this process because of the speed and accuracy in which tax calculations can be made as well as data analytic methods to analyze large amounts of tax data. pp. I:1-30 and I:1-31. Tax planning and complex tax calculations, as well as tax research are increasingly performed, or at least assisted, by artificial intelligence (AI).

Problems

I:1-39 a.

Income:		
Salary		$100,000
Business income		25,000
Interest income		10,000
		$135,000
Deductions:		
Business expenses	$9,500	
Itemized deductions	20,000	29,500
Taxable Income		$105,500
Tax		$18,167

Note: Tax-exempt bond interest is not taxable and itemized deductions are greater than the standard deduction amount.

b. Marginal rate = 24% (From tax rate schedule)
Average rate = 17.22% ($18,167/$105,500)
Effective rate = 13.92% ($18,167/($135,000 + $5,000 - $9,500))

c. From a tax planning point of view, the marginal rate is the most important rate because it measures the tax saving from each additional $1 of deduction (or additional tax from each additional $1 of taxable income). pp. I:1-4 through I:1-7 and I:1-17 and I:1-18.

I:1-40. The income tax payable, average tax rate, and marginal tax rate for each amount for 2025 for married couples filing joint income tax returns is as follows:

a. $2,385 + .12($30,000 - $23,850) = $3,123
Average tax rate: $3,123/$30,000. = 10.41%
Marginal tax rate: 12%

b. $11,157 + .22($100,000 - $96,950) = $11,828
Average tax rate: $11,828/$100,000. = 11.83%
Marginal tax rate: 22%

c. $80,398 + .32($425,000 - $394,600) = $90,126
Average tax rate: $90,126/$425,000. = 21.21%
Marginal tax rate: 32%

d. $202,154.50 + .37($800,000 - $751,600) = $220,062.50
Average tax rate: $220,062.50/$800,000 = 27.51%
Marginal tax rate: 37%

Note: This problem clearly demonstrates the progressive nature of the federal income tax. The average tax rate rises from 10.41% to 27.51% in this problem.

I:1-41 a. Their marginal tax rate with $520,000 of taxable income is 35%. However, with an additional $40,000 of deductions, their taxable income drops to $480,000, which would reduce their marginal tax rate to 32% (for 2025, the 35% rate begins when taxable income exceeds $501,050).

b. Their tax savings using the 2025 Tax Rate Schedules and married filing jointly would be computed as follows:

Tax on $520,000	$ 121,094.50
Tax on $480,000	(107,726)
Tax savings	$ 13,368.50

pp. I:1-4 through I:1-7.

I:1-42 Betty's taxable gift for the current year (2025) is $81,000 computed as follows:

Gift to daughter		$100,000
Gift to husband		40,000
Total gifts during year		$140,000
Annual exclusion ($19,000 x 2)	$38,000	
Marital deduction ($40,000 - $19,000)	21,000	(59,000)
Taxable gifts		$81,000

Note: Charitable contributions are not subject to the gift tax. Thus, the contribution to her church is not subject to the gift tax. pp. I:1-8 and I:1-9.

I:1-43 a. The amount of Clay's taxable estate is $8,225,000. This amount is computed as follows:

Gross estate	$8,500,000
Minus: Funeral and Admin. Expenses	(125,000)
Debts	(150,000)
Taxable Estate	$8,225,000

b. The tax base for computing Clay's estate tax is $ 8,225,000, computed as follows:

Taxable estate	$8,225,000
Gifts after 1976	0
Estate tax base	$8,225,000

c. If the tentative estate tax is $3,235,800, no estate tax is due, computed as follows:

Estate tax from rate schedule	$3,235,800*
Minus: Unified tax credit (2025) based on an equivalent of $13,990,000	(5,541,800)**
Estate tax due	$0

*[$345,800 + .40 (8,225,000 – 1,000,000)]
**[$345,800 + .40 (13,990,000 – 1,000,000)]

d. Yes, because the aggregate value of the estate decreased during the six-month period following the date of death, the alternate valuation date may be selected by the administrator. The important factors in deciding whether to use the alternate valuation date are (1) the amount of estate taxes to be saved, and (2) the impact on the beneficiaries' income tax situation. However, in this case, the alternate valuation date would not be necessary because the estate tax using date-of-death value is zero.

Note: There can never be a tax refund even if the unified credit is greater than the tax liability.

e. If the gross estate was $18,500,000, the taxable estate and tax base would be $18,225,000 ($18,500,000 - $125,000 - $150,000). The estate tax would be as follows:

Estate tax from rate schedule	$7,235,800
Minus: Unified tax credit (2025)	
based on an equivalent of $13,990,000	(5,541,800)
Estate tax due	$1,694,000

pp. I:1-9 and I:1-10.

I:1-44 a. The corporate tax liability of KT, Inc. for 2025 would be computed as follows:

Gross income	$2,000,000
Expenses: Operating expenses	(800,000)
Taxable income	$ 1,200,000
Corporation tax ($1,200,000 x 0.21)	$ 252,000

The tax liability of Keith and his wife on their individual return for 2025 is as follows:

Dividend from KT, Inc.	$350,000
Other taxable income	130,000
Adjusted Gross Income (AGI)	480,000
Itemized deductions	(40,000)
Taxable income	$440,000
Income tax (joint return rate schedule):	
Taxable income (above)	$440,000
Minus: dividends	(350,000)
Taxable income without dividends	$ 90,000
Tax from rate schedule on $90,000	$ 10,323
Tax on dividends ($350,000 x 15%*)	52,500
	$ 62,823

* See part b solution for explanation.

Thus, the total tax liability for both the corporation (Keith's share of 50%) and Keith and his wife is $188,823 ($126,000 + $62,823).

b. If the consulting business was organized as an LLC, the income taxes would be as follows:

KT, LLC	
Gross income	$2,000,000
Operating expenses	(800,000)
Taxable income	$1,200,000
Income tax	$ 0

LLCs are flow-through entities and are not subject to income taxes on the entity.

The tax liability of Keith and his wife on their individual return for 2025 is as follows:

Pass-through income from KT, LLC ($1,200,000/2)	$600,000
Other taxable income	130,000
Adjusted gross income (AGI)	730,000
Itemized deductions	(40,000)
Taxable income	$690,000
Income tax (joint return rate schedule, rounded)*	$ 180,595

*Keith would also be subject to self-employment taxes on the $600,000 from KT, LLC. This amount is not shown in this problem. Self-employment taxes are covered later in this textbook.

In this case, as seen from the tax calculations above, when the consulting business is organized as an LLC, income taxes are decreased by $8,228, calculated as the difference between their tax as an LLC of $180,595 minus their tax as a C Corporation of $188,823. This results even though the dividends are taxed at a rate of 15%. Also, the $700,000 of LLC distributions ($350,000 each) are not subject to income taxation. pp. I:1-19 through I:1-23.

Note: This extremely simplified problem is intended to illustrate the effect of double taxation of C corporations and shareholders. Prior to 2018, the tax effect was much more significant. The reduction of C corporation tax rates to 21% (from 35%) has substantially reduced the tax advantage of flow-through entities. However, the 20% deduction for flow-through entities would further enhance the viability of flow-through entities.

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Pearson

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PREFACE

General

The text materials from Pearson's Federal Taxation 2026: Individuals (Franklin/Richardson) are principally designed for use in a first course in federal taxation for undergraduate or graduate accounting and business students.

With the inclusion of chapters on partnerships, S corporations, C corporations, and tax considerations for investors, the text also can be used in a survey federal taxation course for undergraduate or graduate students.

The text also could be used in an introductory federal taxation course in law school to the extent the instructor prefers a more direct approach than the case method.

The text includes a full complement of supplementary and ancillary materials. We recommend that all adopters refer to the Preface to the text for the supplementary and ancillary materials provided to adopters. Many of these items are available to faculty and students at no cost. Adopters are encouraged to use these materials to enhance their teaching effectiveness and their students' learning experience.

Sample Syllabi

This guide contains sample syllabi for a one-semester and a one-quarter introductory tax course. It contains suggested reading and problem assignments that can be turned into a complete assignment sheet with only minimal work.

Instructor Outlines

The instructor outline for each chapter consists of: learning objectives, areas of greater and lesser significance, problem areas for students, highlights of recent tax law changes, teaching tips, lecture outline, a set of references to court cases that are designed to be interesting and informative to the student, and instructor aids. A summary description of each area is presented below.

Learning Objectives

The materials for each chapter include the learning objectives for that chapter. This focus will be useful to the instructor and may be communicated to students to assist their study.

Areas of Greater Significance

The materials for each chapter point out the areas of greater significance. This feature permits the instructor to allocate a greater share of class time and homework assignments to these areas.

Areas of Lesser Significance

The materials for each chapter point out the areas of lesser significance. This feature permits the instructor to reduce the amount of class time and homework assignments devoted to these areas.

Problem Areas for Students

The materials for each chapter detail areas in which students are likely to experience difficulty in learning and in retaining. Instructors may allocate more class time to these topics, while letting the student learn other topics directly from the text and problems.

Highlights of Recent Tax Law Changes

Recent tax law changes are highlighted, including amendments to the Internal Revenue Code, administrative pronouncements, and judicial decisions. These changes are cross-referenced to the text materials.

Teaching Tips

Each lecture outline contains a series of teaching tips designed to improve an instructor's coverage or presentation of the materials in the chapter. Some of the teaching tips concern issues that might be added to the lecture outline at a particular point. Others focus upon the method of presentation of a topical item. All of these teaching tips have been provided by the authors or instructors who are currently using the book.

Lecture Outline

The lecture outlines for each chapter are organizational tools centered on the topics that could be covered in lecture discussions. Textual examples, tables, figures, and problems are referenced to the applicable topic. Faculty members can use the outlines provided to develop their own lecture outlines.

The Instructor's Resource Manual, including lecture outlines, is available on the Instructor's Resource Center (IRC) online at:

http://www.pearsonhighered.com/pearsontax

Registration/login is required on the IRC online. For assistance, you may contact your Pearson representative. If you do not know your Pearson representative, you may visit:

www.pearsonhighered.com/replocator

The lecture outlines are designed so the instructor can share them with students to assist in taking notes and subsequent study.

Court Case Briefs

Each chapter contains references to and a brief annotation of a series of selected court cases. These cases are recommended as a way for faculty members to incorporate interesting illustrations into their lectures.

Instructor Aid

An additional instructor figure is provided for nearly every chapter.

Solutions to Tax Form/Return Preparation Problems

The authors have prepared solutions to the Tax Form/Return Preparation Problems, provided as a separate zip file download on the IRC online, under both the Instructor's Manual and Solutions Manual, for convenience of faculty.

Final Remarks

We hope these materials are helpful when teaching with the Pearson's Federal Taxation 2026: Individuals text. We would appreciate receiving any suggestions that you have for improving these or any other supplemental materials. To report any error corrections or suggestions, or if you would like to obtain an immediate solution to your question or problem, please do not hesitate to contact the editor at:

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