Solutions Manual for South-Western Federal Taxation 2025 - Essentials of Taxation - Individuals and Business Entities 28th Nellen

Solution and Answer Guide

NELLEN, CUCCIA, PERSELLIN, YOUNG, SWFT ESSENTIALS OF TAXATION: INDIVIDUALS AND BUSINESS ENTITIES 2025, 9780357989197; CHAPTER 1: INTRODUCTION TO TAXATION

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PROBLEMS

1. (LO 1) Various answers are possible, including using the Key Terms at the end of each chapter, referring to the Glossary (Appendix C), looking up the footnote resources to the Internal Revenue Code in Appendix D, using chapter features (e.g., Global Tax Issues, Ethics & Equity, Tax Planning, and Digging Deeper), examining the tax forms used in the chapters, and completing additional end-of-chapter assignments. All of these resources will help students engage more deeply with the materials and help their understanding.

2. (LO 3, 5, 6) Some tax and nontax considerations James should investigate include the following:

   - State and local income taxes.
   - State and local sales taxes.
   - State and local property taxes.
   - Employee implications of the move (Will James lose current employees? Is the labor market better in the new location? Is cost of living lower or higher in new location?).
   - Logistics/transportation of products to customers (specifically document lower costs).
   - State infrastructure (better in new location?).
   - What is the cost of the move? What is the payback period/ROI for the move?
   - What are real estate prices for new facilities in the new location?
   - Are there any tax incentives from state or local agencies if you relocate?

3. (LO 2) A tax is *regressive* if it represents a larger percentage of the income of a low-income taxpayer relative to the income of a high-income taxpayer. Examples of regressive taxes include sales and excise taxes. A tax is *progressive* if it represents a larger percentage of the income of a high-income taxpayer relative to the income of a low-income taxpayer. The Federal income tax is an example of a progressive tax.

4. (LO 3)

   a. The parsonage probably was not listed on the property tax rolls because it was owned by a tax-exempt church. Apparently the taxing authorities are not aware that ownership has changed.

   b. Ethan should notify the authorities of his purchase. This will force him to pay back taxes but may eliminate *future* interest and penalties.

5. (LO 1, 2, 6) (See Digging Deeper 1.) As to Adam Smith's canon on economy, the Federal income tax yields a mixed result. From the standpoint of the IRS, economy exists as collection costs are nominal (when compared with revenue generated). The government's cost of collecting Federal taxes amounts to less than one-half of 1 percent of the revenue collected. Economy is not present, however, if one looks to the compliance effort and costs expended by taxpayers. According to recent estimates, about 56% of individual taxpayers who file a return pay a preparer, and one-third purchase tax software.

6. (LO 3) Jang probably will be required to pay the Washington use tax if, and when, he applies for Washington license plates. In this case, the use tax probably is the same amount as the Washington sales tax. See the discussion in connection with Example 4 in the textbook.

7. (LO 3) Although the Baker Motors bid is the lowest from a long-term financial standpoint, it is the best. The proposed use of the property by the state and the church probably will make it exempt from the school district's ad valorem tax. This would hardly be the case with a car dealership. In fact, commercial properties (e.g., car dealerships) often are subject to higher tax rates.

8. (LO 3) A possible explanation is that Sophia made capital improvements (e.g., added a swimming pool) to her residence and her parents became retirees (e.g., reached age 65).

9. (LO 5, 6)

SWFT, LLP
5191 Natorp Boulevard
Mason, OH 45040

December 5, 2024

Cynthia Clay
1206 Seventh Avenue
Fort Worth, TX 76101

Dear Cynthia:

I am writing this letter to help you decide on what form of entity to choose for your new food delivery business. In our phone conversation, you indicated that you expect to have losses for the first two years in this business and then make substantial profits in subsequent years. You and Marco also indicated that you are concerned about potential personal liability.

While I can't make a conclusive recommendation based on the information you have given me, I can provide you with some general guidelines that should simplify your decision. First, given your concern about personal liability, a partnership does not appear to be a desirable option (you would both be personally liable for any injuries to customers). Similarly, given your expectation of losses in the first two years, it does not appear that a C corporation would be a desirable choice, at least initially. This is because any losses in the corporation could only be used to offset future corporate profits—you could not use the losses to immediately offset your personal tax liability.

Thus, two choices exist which provide limited liability and deductibility of losses on your personal income tax return. These are the S corporation and the limited liability company. If you choose an S corporation, we would probably convert the entity to a C corporation when the business becomes profitable. At that point, profits would be taxed at the C corporation rate. A second tax would be levied on your personal income tax return for any dividends paid by the corporation once it achieves C status. In contrast, limited liability companies are taxed like partnerships—all income would be taxed on your personal income tax return in profitable years. The relative desirability of each of these two forms depends on a number of factors. One of the most important factors in your situation is the relationship between your personal tax rate and the tax rate of a C corporation. If you are in a high tax bracket and if the income in the business is sufficiently low, you might be best off choosing the S corporation. Alternatively, if you expect the business to generate a sufficiently large profit each year, it might be best to choose the limited liability company. The qualified business income deduction for income from flow-through entities along with the flat tax rate of 21% that applies to corporations also must be taken into consideration.

If you would like me to give you a clearer recommendation, we should meet at your earliest convenience. If you have any additional questions, please call me.

Best regards,

Julian Jackson, CPA

10. (LO 5, 6)

a.

	Year 1	Year 2	Year 3
Corporate Tax Liability			
Sales revenue	$150,000	$320,000	$600,000
Cash expenses	(30,000)	(58,000)	(95,000)
Depreciation	(25,000)	(20,000)	(40,000)
Taxable income	$ 95,000	$242,000	$465,000
Corporate tax liability	$ 19,950	$ 50,820	$ 97,650
Cash Available for Dividends			
Sales revenue	$150,000	$320,000	$600,000
Tax-free interest income	5,000	8,000	15,000
Cash expenses	(30,000)	(58,000)	(95,000)
Corporate tax liability	(19,950)	(50,820)	(97,650)
Cash available for dividends	$105,050	$219,180	$422,350

	Year 1	Year 2	Year 3
Ashley's After-Tax Cash Flow			
Dividend received	$105,050	$219,180	$422,350
Tax on dividend at 15% rounded	(15,758)	(32,877)	(63,353)
After-tax cash flow	$ 89,292	$186,303	$358,997
PV of cash flow*	$ 79,729	$148,521	$255,534
Total present value	$483,784		

*Present value factors (.8929, .7972, .7118) from Appendix E.

b.

	Year 1	Year 2	Year 3
Individual Tax Liability			
Sales revenue	$150,000	$320,000	$600,000
Cash expenses	(30,000)	(58,000)	(95,000)
Depreciation	(25,000)	(20,000)	(40,000)
Taxable income	$ 95,000	$242,000	$465,000
Individual tax liability**	$ 23,750	$ 60,500	$116,250

**Rate = 25%

	Year 1	Year 2	Year 3
Ashley's After-Tax Cash Flow			
Sales revenue	$150,000	$320,000	$600,000
Tax-free interest income	5,000	8,000	15,000
Cash expenses	(30,000)	(58,000)	(95,000)
Individual tax liability	(23,750)	(60,500)	(116,250)
After-tax cash flow	$101,250	$209,500	$403,750
PV of cash flow*	$ 90,406	$167,013	$287,389
Total present value	$544,808		

*Present value factors (.8929, .7972, .7118) from Appendix E.

c. If Ashley wants to have access to all available cash from the business, then she will have to pay out dividends annually. As seen in the answers to parts a. and b. above, the present value of future cash flows is substantially greater if she does not incorporate under this assumption. Alternatively, if she does not need to pay out dividends, then she may be better off by incorporating, since only the corporate tax will be incurred, which is less than her individual tax. The value of her stock will increase and she then can sell the stock at a later date at favorable capital gains rates.

11. (LO 1) PowerPoint presentations will vary. In favor of high progressivity:

- Ability to pay.
- Fairness of result.
- Benefits of government skew toward those at upper-income levels.

Contrary to high progressivity:

- Discouragement of work and innovation.
- Unfairness of result.
- Civic engagement by those at lower-income levels requires "skin in the game."

12. (LO 3)

    a. In terms of taxpayer compliance, an ad valorem tax on personalty is less desirable than one on realty. However, a tax on business personalty, such as inventory, is to be preferred over one on personal use (i.e., nonbusiness) personalty.

    b. A tax on stock and bonds would be too easily avoided. The taxing authority would have no means of ascertaining ownership of these assets.

    c. Poor taxpayer compliance is to be expected for any tax on personal use personalty. However, if boats had to be periodically licensed (e.g., safety inspection), this could provide the taxing authority with a means of discovering unreported boat ownership.

13. (LO 2, 8)

    a. Economic justification. The tax law addresses concerns about the use of fossil fuels—in terms of both reliance on foreign oil and the need to ease the problem of climate change.

    b. Economic justification. The tax law addresses concerns about the use of fossil fuels—in terms of both reliance on foreign oil and the need to ease the problem of climate change.

    c. Economic justification. Research and development activities are encouraged by allowing immediate or faster write-off of these expenditures.

    d. Social justification. The charitable deduction helps fund private organizations and causes that are operated in the interest of the general welfare. This relieves government of the need for considerable public funding.

    e. Economic justification. Known as the S election, the provision encourages small businesses to operate in the corporate form without suffering all of the tax disadvantages of the regular (C) corporation.

14. (LO 4, 8)

    a. Social considerations explain the credit. It is socially desirable to encourage parents to provide care for their children while they work.

    b. These deductions raise the issue of preferential tax treatment for homeowners—taxpayers who rent their personal residences do not receive comparable treatment. Even so, the encouragement of home ownership can be justified on economic and social grounds.

    c. The joint return procedure came about to equalize the position of married persons living in common law states with those residing in community property jurisdictions. Political and equity considerations caused this result.

    d. Activities deemed contrary to public policy should not result in tax savings.

    e. The NOL carryforward provision is an equity consideration designed to mitigate the effect of the annual accounting period concept.

    f. The installment method of reporting gain is consistent with the wherewithal to pay concept—the seller is taxed when the payments are made by the purchaser.

g. The exclusion from Federal income taxation of interest from state and local bonds can be justified largely on political considerations. Political goodwill is generated by allowing state and local jurisdictions to secure financing at a lower cost (i.e., interest rate) due to favorable Federal income tax treatment.

h. The treatment of prepaid income is justified under the wherewithal to pay concept. It also eases the task of the IRS as to administration of the tax law.

15. (LO 3) (See Digging Deeper 3.) A value added tax (VAT) taxes the increment in value as goods move through the production and manufacturing stages to the marketplace. Although the tax is paid by the producer, it is reflected in the selling price of the goods. Therefore, a VAT is a tax on consumption.

    A national sales tax taxes numerous transactions and is collected on the final sale of goods and services to the consumer. Consequently, it is collected from the consumer and not the producer of the product as does a VAT.

    In terms of taxpayer compliance, a VAT is preferable to a national sales tax. Without significant collection efforts, a national sales tax could easily be circumvented or avoided in many ways (e.g., resorting to a barter system of doing business).

16. (LO 3) If the tax is imposed on the right to pass property at death, it is classified as an estate tax. If it taxes the right to receive property from a decedent, it is termed an inheritance tax.

    a. Some states impose both an estate tax and an inheritance tax. Some states (e.g., Florida and Texas) levy neither tax.

    b. The Federal government imposes an estate tax.

17. (LO 2, 8) Students' e-mails may vary. Build interaction into the exercise wherever possible, asking the student to send and receive e-mail in a professional and responsible manner.

18. (LO 2, 8)

    a. $24,663 {[($131,750 − $100,525) × 24%] + $17,168.50}.

    b. 10%, 12%, 22%, 24%.

    c. 24%.

    d. 18.7% ($24,663 ÷ $131,750).

    e. 16.9% ($24,663 ÷ $146,350).

19. (LO 3, 4, 6) If Mike is drafted by a team in one of the listed states, he will escape state income tax on income earned within that state (e.g., training camp, home games). He will not, however, escape the income tax (state and local) imposed by jurisdictions where he plays away games. Called the "jock tax," it is applied to out-of-state athletes and entertainers.

20. (LO 2, 8) The checkoff boxes add complexity to the return and mislead taxpayers into presuming that they are not paying for the donation.

21. (LO 7) The SSTSs are available at: **aicpa-cima.com/resources/download/revised-statements-on-standards-for-tax-services-no-1-4-1-1-2024**.

    a. While it is fine and usually beneficial to use tax preparation software, the preparer should be sure they understand how the software works and verify at least a sampling of items on returns and review all returns for completeness and accuracy. For a new tax calculation such as the renter's credit, the preparer should be sure they understand how the credit is computed and then apply the provision to a variety of fact patterns (e.g., single taxpayers versus married taxpayers) without tax software and compare it to the software's calculation of the credit to ensure that the software is computing the credit correctly.

    b. As noted in SSTS 1.4, members are responsible for their work product and should take "reasonable steps" to be sure any tools they use "are appropriate for the intended purpose." A preparer should not rely on artificial intelligence (AI) to produce a tax answer for a client. If appropriate in terms of security and privacy, AI can be used, similar to conducting research, but as with any other research tool or resource, the preparer must still fully analyze and review the results for accuracy, completeness, and whether current tax law is appropriately applied.

BRIDGE DISCIPLINE PROBLEMS

1. Solutions may vary among students.
2. Solutions may vary among students.
3. Solutions may vary among students.
4. When taxes become "too high," the rate of tax cheating increases, because the payoff from misconduct increases. Property and transaction taxes are difficult to cheat on, as the tax base is easily detectible, while cheating on taxes on income and asset transfers may be more easily accomplished, and enforcement activities by the taxing agency become more expensive. High rates of tax cheating can lead to several undesirable consequences.

    - A "conspicuous consumption" society, wherein taxpayers use their tax underpayments to increase their lifestyles in a public fashion.
    - A loss of confidence in the self-assessment system, such that certain levels of cheating are assumed to occur, and the number of cheaters increases.
    - The "missing revenue" keeps the government from delivering the goods and services that the taxes are supposed to pay for.
    - Political gridlock can occur when it becomes impossible to raise tax rates high enough, or broaden the tax base enough, to offset the cheaters' "missing revenue."

5. a. To encourage pension plans is to stimulate saving (economic consideration). Also, it provides security from the private sector for retirement to supplement public programs which tend to provide lesser benefits (social considerations). An opposing consideration is that only higher income individuals are able to fully fund their pension plans and thus gain the greater tax benefit from the favorable rules for retirement savings.

b. To make education more widely available is to promote a socially desirable objective. A better educated workforce also serves to improve the country's economic capabilities. As a result, education tax incentives can be justified on both social and economic grounds. A weakness in the current incentives is that they are only for college education, rather than also in preparation for other careers including health care, personal care, construction, and skilled trades (e.g., mechanics, electricians, and plumbers).

c. The encouragement of home ownership can be justified on both social and economic grounds. For example, if a person owns a home and has no mortgage by the time they retire, their monthly living expenses will be lower. An opposing consideration to the tax breaks for home ownership is that the mortgage interest deduction applies to debt up to $750,000, thus providing a greater tax break to higher income individuals who can qualify for this large of a mortgage. Also, renters indirectly pay property taxes through their rent, but receive no tax deduction for that indirect payment. Finally, the home ownership tax breaks today apply once the home is acquired; there are no tax incentives to help an individual buy a home (such as a first-time homebuyer tax credit).

Research Problems

These research problems require that students utilize online resources to research and answer the questions. As a result, solutions may vary among students and courses. You should determine the skill and experience levels of the students before assigning these problems, coaching where necessary. Encourage students to use reliable websites and blogs of the IRS and other government agencies, media outlets, businesses, tax professionals, academics, think tanks, and political outlets to research their answers.

1. An example of a sweetened beverage tax proposal is H.R. 2772 (117th Congress), the SWEET Act. Proposals also exist in a number of states and cities. Some cities, including Berkeley, California, Philadelphia, Pennsylvania, and Boulder, Colorado, have already enacted soda taxes. Considerations in analyzing these proposals include issues of regressivity (an equity and fairness issue), complexity of definitions, burden of enforcement, and neutrality in affecting decision making. Cook County, Illinois (Chicago) passed and then repealed a sweetened beverage tax due to a number of these issues.

2. Each of the Big Four firms has information on data analytics and how it can be used for tax purposes:

   - **pwc.com/us/en/services/consulting/cloud-digital/data-analytics.html**
   - **home.kpmg.com/xx/en/home/services/tax/global-indirect-tax/data-and-analytics.html**
   - **ey.com/en_us/big-data-analytics**
   - **www2.deloitte.com/us/en/pages/deloitte-analytics/solutions/deloitte-analytics.html**

Students should also find how the IRS and state tax agencies are using big data to improve audit selection and enforcement. For example, see IRS information in the Internal Revenue Manual (IRM) 1.1.18, Research, Applied Analytics and Statistics Division at:

- **irs.gov/irm/part1/irm_01-001-018**

3. The Safeguards Rule was created as part of the Gramm-Leach-Bliley Act in 1999 (P.L. 106–102). The FTC summarizes this rule as follows: “The Safeguards Rule requires financial institutions under FTC jurisdiction to have measures in place to keep customer information secure. In addition to developing their own safeguards, companies covered by the Rule are responsible for taking steps to ensure that their affiliates and service providers safeguard customer information in their care.” This rule applies to all paid return preparers.

   - **ftc.gov/business-guidance/resources/ftc-safeguards-rule-what-your-business-needs-know**

   IRS Publication 4557 includes several actions preparers should take to protect client data and meet the Safeguards Rule. In reviewing student answers, confirm that they understand the Safeguards Rule and why a preparer obtaining or renewing a PTIN is asked to confirm that they have a data security plan. The publication lists numerous actions, consider whether the three plan elements the student describes are among the most important.

   In August 2022, the IRS Security Summit released a document with explanation and templates to help practitioners update or create a security plan. See IR–2022–147 (August 9. 2022) at **irs.gov/newsroom/security-summit-releases-new-data-security-plan-to-help-tax-professionals-new-wisp-simplifies-complex-area**.

4. Circular 230 § 10.35 on competence states that a practitioner may become competent for an engagement matter in a variety of ways, including by consulting with experts or studying the law. As a result, if someone at the firm gains a better understanding of virtual currency transactions, the record keeping needed to determine the tax consequences of over 2,500 trades and also consider other rules (e.g., the trader versus investor status of the client), they can accept this client. If the firm is not able to become competent, they may not accept this potential new client.

SOLUTIONS TO BECKER CPA REVIEW QUESTIONS

1. **Choice “a” is correct.** Treasury Department Circular 230 is the IRS publication that addresses the practice before the IRS of practitioners with regard to the rules governing the authority to practice before the IRS, the duties and restrictions relating to practice before the IRS, the sanctions for violations of the regulations, and the rules applicable to disciplinary proceedings.

   Choice “b” is incorrect. Treasury Department Circular 230 does not provide guidance for practicing before the U.S. Tax Court but provides guidance for practicing before the IRS.

Choice “c” is incorrect. Treasury Department Circular 230 does not address presenting before state boards of accountancy but provides guidance to practitioners on practicing before the IRS.

Choice “d” is incorrect. The standards for the financial reporting of income taxes are found in Accounting Standards Codification (ASC) Section 740, not Treasury Department Circular 230.

2. **Choice “b” is correct.** All of the other choices are required conduct by a preparer of an income tax return. A preparer must make a reasonable attempt to obtain the necessary information from the taxpayer and make inquiries if the information appears to be incorrect or incomplete. The preparer is not responsible for verifying taxpayer-provided information. The taxpayer is actually responsible for providing the preparer with accurate information.

   Choices “a,” “c,” and “d” are incorrect, as they are all required conduct by a preparer of an income tax return. A preparer must:

   - Legally minimize the taxpayer’s tax liability and abide by the tax code.
   - Make a reasonable effort to obtain the necessary information from the taxpayer and make inquiries if the information appears to be incorrect or incomplete.
   - Recommend a tax return position only if the preparer has a good faith belief that the position has a realistic possibility of being sustained if challenged.
   - Notify the taxpayer if he or she becomes aware of a tax return error.
   - Inform the taxpayer on how to correct the situation of the taxpayer having failed to file a tax return.
   - Consider withdrawing from the engagement if the taxpayer does not correct the error or file the return the preparer advised him or her about.
   - Not inform the IRS without the taxpayer’s permission.