

Using source documents to enhance a cumulative tax case study: W-2 example

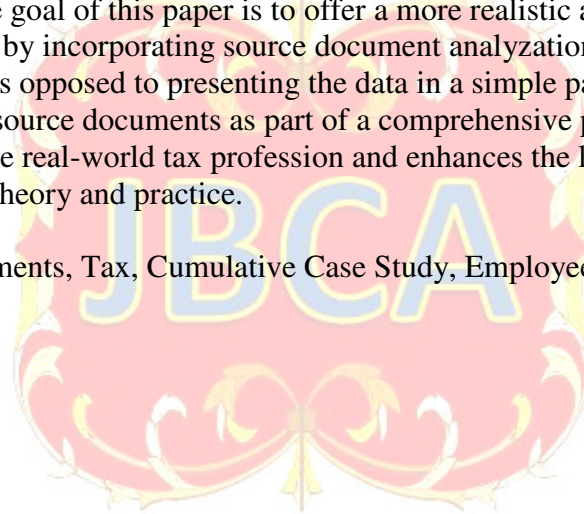
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ABSTRACT

The introduction to federal income taxation of individuals is a course commonly offered as part of most accounting programs. After review of the resources and textbooks available for this course, it is evident that content coverage is similar and most (if not all) textbooks first cover detailed federal tax rules, and later require students to apply those rules to a comprehensive tax calculation problem. The goal of this paper is to offer a more realistic approach to these comprehensive problems by incorporating source document analysis as part of the tax preparation/calculation, as opposed to presenting the data in a simple paragraph. As evidenced in this case study, utilizing source documents as part of a comprehensive problem provides the students with exposure to the real-world tax profession and enhances the learning environment by closing the gap between theory and practice.

Keywords: Source Documents, Tax, Cumulative Case Study, Employee Wage Reporting



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INTRODUCTION

The curriculum of most accounting programs contain an introductory course regarding federal income taxation of individuals. The textbook chapters related to this course explain specific parts of the overall individual income tax formula with the objective of exposing the students to the necessary skills of future taxation professionals. As such, each chapter has problems that help students learn and reinforce their understanding of the specific chapter concepts. (Rupert, Pope, et al., 2019). After a student has been exposed to several chapters discussing specific portions of the individual tax formula, most professors (and textbooks) will assign a cumulative case study where the student is now required to apply the concepts from several chapters and calculate an individual's federal "adjusted gross income," "taxable income," and/or "tax due or refund." (Rupert, Pope, et al., 2019, Prob. 7-60). The goal of this paper is to present an alternative format of the cumulative case study by utilizing actual source document analyzation when solving the comprehensive problem in order to enhance the students' experience in the classroom by mirroring the data that real-world tax professionals receive.

The resources and textbooks available for this particular class are all very similar in content coverage. For example, one chapter usually discusses the relevance of an individual's personal relationships and family for purposes of determining filing status and various tax credits. Another chapter discusses the tax formula, individual marginal tax rates, and the tax calculation for individuals. (e.g. Spliker, Ayers, et al, 2019 Chapter 4). Other chapters discuss items included in a taxpayer's gross income such as wages, capital gains, dividends, interest, and earnings from self-employment. (e.g. Spliker, Ayers, et al, 2019 Chapters 5, 7, & 12). There are also specific chapters regarding deductions such as expenses related to business and itemized deductions. (e.g. Spliker, Ayers, et al, 2019 Chapters 9 & 6). Once the course has covered a sufficient amount of chapters where specific parts of the tax formula are discussed, a cumulative case study is used to aggregate various chapter topics into an "overall" tax return problem. The intent of this cumulative case study problem is to provide a better representation of the actual real life work performed by a tax professional when preparing a tax return for a client. While the value of these cumulative case studies is undisputed, the delivery method of the information could be improved.

It is important for educators to incorporate real-world applications into their course curriculum to close the gap between theory and practice. In a professional practice, the practitioner uses computer tax preparation software to enter client provided information to calculate the client's tax and prepare the individual federal tax return Form 1040 and supporting Schedules. (Bonner, 2019). The value of students completing a cumulative case study in a tax course is to acknowledge that, although using a computer program to enter data is essential, it is not exclusive of a professional review. (Kurinsky, 2019). A cumulative case study helps students appreciate that it is essential that they understand the subject matter so that they are able to perform a professional review/calculation of the computer results to confirm that the data was input correctly and that program output was on the appropriate forms and schedules. Also, in practice, a good tax preparer will suggest planning opportunities to reduce a taxpayer's taxes in the future. (Kurinsky, 2019). As a consequence, the closer the cumulative case study can mirror real life, the better students will be prepared to perform their computer input and review functions as a practicing professional.

THE ENHANCED LEARNING ASSOCIATED WITH USE OF SOURCE DOCUMENTS IN A CUMULATIVE TAX CASE STUDY

As stated earlier, the cumulative case studies in textbooks usually provide the student with various types of taxpayer data and then require the student to use the data to calculate the taxpayer's federal "adjusted gross income," "taxable income," and/or "tax due or refund." In addition, some cumulative case studies also require the student to complete the appropriate tax forms and schedules (i.e. fill in the Form 1040 and Schedules A, B, C, D, etc.). These case studies are very good at providing students with an experience similar to what they may encounter in a professional tax practice. However, the format in which the data for the underlying case study is communicated creates unrealistic expectations for the student when it comes to real-world practices. This paper illustrates how the use of taxpayer "source documents" in a cumulative case study enhances the student learning experience and provides a more accurate representation of what they will experience as a practicing tax preparer.

When preparing a tax return in practice, the taxpayer meets with the tax professional and brings various source documents and other information. These documents and information are used by the tax professional to prepare the taxpayer's tax return. (Bahrey, 2019). Examples of the source documents may include the taxpayer's W-2 Wage Statement, Forms: 1099 Misc (for rent & royalty income, and non-employee compensation), 1099 Div (dividend and distribution income), 1099 B (stock sales broker transactions), 1098 (Mortgage interest expense) ... etc. (IRS Guide to Information Returns, 2019). The textbook cumulative case studies, however, do not use these source documents. Rather they merely provide students with the relevant information from these documents.

For example, a textbook cumulative case study usually directly provides the amount of the taxpayer's taxable salary, federal taxes withheld, state income taxes paid, dividend income, long-term capital gain from stock sales, charitable contributions, real and personal property taxes paid, etc. in the form of a paragraph, simple table or list (as illustrated in the next section of this paper). The problem with this approach is that the case study has already performed for the student one of the most important functions of a tax preparer: understanding the source document information to determine which information is relevant and how it is reported. Additionally, knowing the names of the forms and what information they are reporting is basic knowledge expected of tax professionals, and students could benefit from being exposed to them first-hand in the classroom. A much more realistic and valuable learning experience is a cumulative case study that provides the underlying data to students in the form of the source documents and then requires the students to determine the relevant information and prepare the tax return.

USING A "W-2" SOURCE DOCUMENT TO ILLUSTRATE ENHANCED LEARNING OF A CUMULATIVE CASE STUDY

Case Study #1: Textbook Example

As part of a cumulative tax case, assume a textbook provides the following facts regarding the taxpayer, Mr. Pup: "Mr. Pup is an employee of Bulldog Inc. For the year, Mr. Pup has taxable wages of \$251,287.85, withholding of federal income tax of \$44,531.45, paid payroll taxes (Social Security and Medicare) totaling \$12,500.80, and paid state income taxes of

\$20,962.33. In addition, Bulldog Inc. paid \$6,240.48 of annual health insurance premiums for Mr. Pup.”

The student would be required to use the above data, along with other data provided in the cumulative case study, to calculate Mr. Pup’s tax liability and/or prepare the tax return on appropriate forms and schedules.

Case Study #2: W-2 Source Document Example

Compare the above problem to the following: “Mr. Pup is an employee of Bulldog Inc. At the end of the year, Mr. Pup received a W-2 as indicated in Form 1 (Appendix).”

In this example, the student would be required to analyze Mr. Pup’s W-2 and determine how the information affects the taxpayer’s tax return, calculate Mr. Pup’s tax liability and/or prepare the tax return on appropriate forms and schedules. Additionally, the case study example would ask the following questions regarding the W-2:

1. What is the taxpayer’s taxable wages for federal income tax? (Box 1, 3, or 5)
2. What is the amount of state income tax paid? (To assess its possibility as an itemized deduction.)
3. What is the amount of federal income tax withheld? (To assess the possibility of a refundable tax credit.)
4. Why are the wages in boxes 3 and 5 different from box 1? (In order to begin a discussion of non-deductible payroll taxes - Social Security and Medicare.)
5. What are the items in box 12? (In order to begin a discussion of excluded employee 401(k) contributions, excluded employer paid health coverage, and excluded employee/employer paid section 125 cafeteria plan).

To fully illustrate how this method can be utilized in the classroom, the solutions to the above questions are as follows:

1. What is the taxpayer’s taxable wages for federal income tax?

Taxable wages for federal income tax are \$251,287.85 as indicated in Box 1 of the W-2. (IRS General Instructions, 2019, page 16). The employee’s total wages were \$269,787.85 (Box 5), however, a 401(k) pre-tax contribution of \$18,500 (Box 12a D) is not currently taxable. Boxes 3, 5, and 16 indicate wages for purposes other than federal income tax. (See solution to question 4 for further explanation.)

2. What is the amount of state income tax paid?

State income tax paid is \$19,812.66 as indicated in Box 17. However, for federal itemized deduction purposes, the \$1,149.67 CA SDI tax (Box 14) is also considered a state income tax and is combined with state income tax paid for a total federal itemized deduction of \$21,262.33. (IRS Sch. A Instructions, 2018, pages A-3 & A-4).

3. What is the amount of federal income tax withheld?

The federal income tax withheld is \$44,531.45 as indicated in Box 2.

4. Why are the wages in boxes 3 and 5 different from box 1?

The wages in Boxes 3 and 5 generate the employee paid payroll taxes (Boxes 4 & 6). The employee paid portion of payroll taxes and is not deductible by the employee taxpayer on a federal income tax return. (IRS Sch. A Instructions, 2018, page A-3).

Note: The social security tax rate (6.2%) applies only to the first \$128,400 (2018) of wages (Box 3). The Medicare tax rate (1.45%) applies to the entire amount considered employee wages \$269,787.85 (Box 5). (Note that the Medicare tax amount of \$4,540.01 (Box 6) also includes the extra Medicare payroll tax of .9% of wages exceeding \$200,000. [$\$4,540.01 = (\$269,787.85 \times 1.45\%) + (.9\% \times (\$69,787.85))$]). (IRS Pub. 15, 2018, Pages 25 & 25).

5. What are the items in box 12?

The items in Box 12 indicate additional employer reporting to the employee. The \$18,500 (Code D) discussed in solution 1 above is the employee's pre-tax 401(k) contribution. The \$6,240.48 (Code DD) is employer paid health insurance coverage and is excluded from employee gross income. The \$3,350 (Code W) are non-taxable employer contributions (including employee non-taxable section 125 contributions) to the employee's Health Savings Account. (IRS Pub 15-B, page 15).

Note: The \$3,350 difference in state taxable wages (Box 16) and federal taxable wages (Box 1) represents the employee contributions to an HSA account as they are not excluded from wages in the state of California. (California Franchise Tax Board, 2018).

DISCUSSION

When comparing the two case study presentation methods above, it becomes clear that Case Study #1 does not provide the depth or relevance as Case Study #2. Additionally, Case Study #2 engages the students by providing realistic examples of what to expect as future tax professionals and promotes discussions in the classroom about real-world scenarios. Utilizing this approach for the cumulative case study enhances the learning environment by closing the gap between theory and practice by requiring the student to use the taxpayer's actual W-2 to determine the relevant (and non-relevant) federal income tax information.

As illustrated by Case Study #2, an entire cumulative case study related to individual federal income tax can be based upon the source document approach. Instead of directly providing the student with an amount of dividends, or an amount of long-term/short-term capital gains/losses (which would be consistent with the example illustrated in Case Study #1 above), a federal form 1099 B and/or 1099 Div could be provided to the student for analysis (similar to Case Study #2). This approach could also be extended for business or self-employment income. For example, the student could be provided with a taxpayer's year-end business income statement where the student must evaluate it for both deductible and non-deductible expenses, tax depreciation, various business meals, travel, and transportation deductions and limitations,

self-employment tax, and the 20% qualified business income deduction. As discussed above, this method would generate a more realistic setting and highlight the difficulties and issues tax professionals face when dealing with tax preparation.

The value of utilizing this approach also extends beyond the tax preparation aspect. By incorporating these important forms into the case study, it is exposing students (who are current or future taxpayers) to the reporting requirements of the federal government to help them better understand their own income tax scenarios. This would benefit all students in the classroom and engage even those whose career objectives are outside of the taxation side of the accounting profession.

CONCLUSION

In the undergraduate accounting curriculum, the introduction to federal income taxation of individuals is a very difficult course. It requires students to become familiar with many intricate rules and then apply those rules using taxpayer information to prepare a tax return using appropriate federal forms and schedules. Textbooks address the learning of these rules in various chapters and then, in later chapters, use one or more cumulative case studies requiring students to use rules from various chapters to prepare an entire individual tax return. The cumulative case studies are helpful, but lack a critical element.

The cumulative case studies provide the students with relevant tax information, but unlike the real life tax profession, students are not provided with the source documents. As such, students are not exposed to a critical element (source documents) of what they will constantly encounter in the real life tax profession. This article provides an example of how source documents can be the substance of a cumulative case study. By introducing students to source documents, they will experience a more realistic example of what they will encounter if they prepare tax returns as a tax professional.

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APPENDIX

Form 1

22222		Void <input type="checkbox"/>	a Employee's social security number 111-11-1111	For Official Use Only ▶ OMB No. 1545-0008	
b Employer identification number (EIN) 94-2000001			1 Wages, tips, other compensation 251,287.85	2 Federal income tax withheld 44,531.45	
c Employer's name, address, and ZIP code BULLDOG INC. 1 BULLDOG ST. FRESNO CA 93740			3 Social security wages 128,400.00	4 Social security tax withheld 7,960.80	
			5 Medicare wages and tips 269,787.85	6 Medicare tax withheld 4,540.01	
			7 Social security tips	8 Allocated tips	
d Control number			9 Verification code	10 Dependent care benefits	
e Employee's first name and initial MR.		Last name PUP	Suff.	11 Nonqualified plans	12 a See instructions for box 12 D 18,500.00
222 DOG LANE FRESNO CA 93740			13 Statutory employee Retirement plan Third-party sick pay X	12 b DD 6,240.48	
			14 Other CASDI 1,149.67	12 c W 3,350.00	
			12 d		
f Employee's address and ZIP code			15 State Employer's state ID number CA 002-0000-1	16 State wages, tips, etc 254,637.85	17 State income tax 19,812.66
			18 Local wages, tips, etc	19 Local income tax	20 Locality name

Form **W-2 Wage and Tax Statement**
 Copy A for Social Security Administration — Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.

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