

## CHAPTER 1

### FEDERAL INCOME TAXATION - AN OVERVIEW

2016 Edition	Topic	Status
<b>Questions</b>		
1	Adam Smith's system requirements	Unchanged
2	How well income tax and employment taxes meet Adam Smith's requirements	Unchanged
3	Proportional, regressive, or proportional tax	Unchanged
4	Proportional, regressive, or proportional tax	Unchanged
5	Federal income tax as a revenue producer	Unchanged
6	Collection of income taxes	Unchanged
7	Sales tax versus excise tax	Unchanged
8	Collection of sales and excise taxes	Unchanged
9	Real property versus personal property taxes	Unchanged
10	Gift tax	Unchanged
11	Estate tax	Unchanged
12	Valuation of gift and estate assets	Unchanged
13	Payment of gift and estate taxes	Unchanged
14	Primary sources of tax law	Unchanged
15	Supreme Court cases	Unchanged
16	Federal income tax base	Unchanged
17	Exclusion	Unchanged
18	Deferral versus exclusion	Unchanged
19	Gross income versus income	Unchanged
20	Deductibility of expenses	Unchanged
21	Expense versus loss	Unchanged
22	Transaction loss versus annual loss	Unchanged
23	Legislative grace concept	Unchanged

<b>2016 Edition</b>	<b>Topic</b>	<b>Status</b>
24	Exemptions	Unchanged
25	Inflation effects on taxes	Unchanged
26	Pay-as-you-go collection of taxes	Unchanged
27	Tax credits	Unchanged
28	Tax credit versus deduction	Unchanged
29	Tax credit versus deduction	Unchanged
30	Statute of limitations	Unchanged
31	Auditing returns	Unchanged
32	IRS examinations	Unchanged
33	30-day letters	Unchanged
34	90-day letters	Unchanged
35	Individual versus corporate taxable income	Unchanged
36	Deductions for and from AGI	Unchanged
37	Standard deduction	Unchanged
38	Why study taxes?	Unchanged
39	Goal of tax planning	Unchanged
40	Tax planning-who benefits	Unchanged
<b>Problems</b>		
41	What is a tax?	Unchanged
42	Definition of a tax - five scenarios	Unchanged
43	Calculation of tax and tax rates (marginal, average, effective)	Unchanged
44	Calculation of tax - comparing entities	Unchanged
45	Social Security calculation/tax rate (marginal, average, effective)	Unchanged
46	Progressive, proportional, regressive taxes	Unchanged
47-CT	Progressive, proportional, regressive taxes	Unchanged

<b>2016 Edition</b>	<b>Topic</b>	<b>Status</b>
48	Social Security tax calculation	Unchanged
49	Social Security tax calculation	Unchanged
50	Social Security tax calculation/payment by employer	Unchanged
51	Self-employment tax calculation	Unchanged
52	Social security/self-employment tax	Unchanged
53	Classification of income items	Unchanged
54	Classification of income items	Unchanged
55	What is deductible?	Unchanged
56	Classification of deduction items	Unchanged
57	Calculation of taxable income/tax liability	Unchanged
58	Calculation of taxable income/tax liability	Unchanged
59-COMM	Effect of deduction FOR/FROM adjusted gross income	Unchanged
60-COMM	Tax planning	Unchanged
61	Gift versus Income	Unchanged
62-CT	Tax planning	Unchanged
63	Tax planning	Unchanged
64	Tax planning	Unchanged
65-CT	Tax planning - income splitting	Unchanged
66-CT	Tax planning - income splitting	Unchanged
67	Evasion versus avoidance	Unchanged
68	Evasion versus avoidance	Unchanged
69-IID	Prepaid taxes	Unchanged
70-IID	Student loan interest	Unchanged
71-IID	Gift versus sale of stock	Unchanged
72-IID	Income splitting	Modified

<b>2016 Edition</b>	<b>Topic</b>	<b>Status</b>
73	INTERNET	Unchanged
74	INTERNET	Unchanged
75	Research Problem	Unchanged
76	Research Problem	Unchanged
77	Spreadsheet Problem	Unchanged
<i>78-DC-CT</i>	Value-added Tax	Unchanged
<i>79-DC-CT</i>	How inflation adjustments preserve after tax income	Unchanged
80-TPC-COMM	Actions an owner can take to reduce taxes	Unchanged
81-TPC	Tax effects of financing options	Unchanged
<i>82-EDC-CT</i>	Statements on Standards for Tax Services (SSTS) to situations in problem 67	Unchanged

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## CHAPTER 1

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#### DISCUSSION QUESTIONS

1. Briefly state Adam Smith's four requirements for a good tax system.
  - a. **Equality** - A tax should be imposed based on the taxpayer's ability to pay.
  - b. **Certainty** - The taxpayer should be able to determine the amount of tax and how to make the required payment.
  - c. **Convenience** - The tax should be levied as close as possible to the time the taxpayer receives the amount subject to tax.
  - d. **Economy** - The cost of taxpayer compliance and administering the tax system should be small in relation to the revenue generated.

2. Based on the discussion in the chapter, evaluate how well each of these taxes meets Adam Smith's four requirements:

- a. Income tax

**Adam Smith's four criteria for evaluating a tax are Equality, Certainty, Convenience, and Economy. The aspects of the income tax that promote each of the individual criteria are:**

**Equality** - Progressive tax rates; the use of a standard deduction and exemption amounts have the effect of exempting low-income taxpayers from the tax; indexing of tax rates, standard deduction and exemption amounts are adjusted for inflation.

**Certainty** - The use of an annual accounting period and the consistent use of the same tax return due date.

**Convenience** - The use of a pay as you go system of collecting taxes is more convenient than collecting all taxes at one date. Taxpayer's determine their own tax due in privacy.

**Economy** - The cost of running the IRS is a small percentage of the total tax collected.

**Factors in the tax system that dilute Adam Smith's requirements:**

**Equality** - Income exclusions and special deductions allow taxpayers with high incomes to pay taxes equivalent to those with lower incomes. The use of tax planning by higher income taxpayers also negates some of the equality of the system.

**Certainty** - The complexity of many of the tax law provisions and numerous changes in the tax law from year to year make proper calculation of the tax less certain.

**Convenience** - Some would contend that determining the amount of tax to be withheld is difficult for many people, making the pay as you go system less convenient.

**Economy** - There are significant costs of record-keeping and compliance that are borne by the taxpayers, making the tax less economical.

**b. Employment taxes**

**The aspects of employment taxes that promote compliance with each of the four requirements:**

**Certainty** - The taxes are due as income is earned. The amount of tax is known with little uncertainty in its calculation.

**Convenience** - Taxes are collected by employers and paid by the employer to the government.

**Economy** - No annual reporting is required by the individual; however, the employer must incur the reporting costs. Costs of compliance are minimal.

**Aspects that dilute the requirements:**

**Equality** - The tax is not progressive; the tax consumes more of low income taxpayer's income than a higher income taxpayer's income.

**Economy** - The cost of reporting is proportionately higher for smaller businesses.

3. Based solely on the definitions in the chapter, is the Social Security tax a proportional, regressive, or progressive tax? Explain, and state how the tax might be viewed differently.

**Strictly speaking, the Social Security tax is a proportional tax because it is applied at a constant rate (6.20 % up to \$118,500 and 1.45% on all wages and salaries) to all levels of the tax base. Using the tax base, salaries and wages, the marginal cost is always equal to the average cost, which is indicative of a proportional tax.**

**When viewed as a percentage of the taxpayer's total income, the Social Security tax is a regressive tax. That is, if you compare marginal and average tax rates for taxpayers whose income is greater than the OASDI base amount, the marginal tax rate is 1.45% and the average tax rate decreases as income increases. Thus, higher income taxpayers (those whose income exceeds the base amount subject to tax) pay lower marginal and average rates of tax than those whose income does not exceed the base.**

4. Based solely on the definitions in the chapter, is the sales tax a proportional, regressive, or progressive tax? Explain and state how the tax might be viewed differently.

**Strictly speaking, the sales tax is a proportional tax because it is applied at a constant rate to all levels of the tax base. Using the tax base, goods and services purchased, the marginal tax rate is always equal to the average tax rate, which is indicative of a proportional tax.**

**When another base is used to calculate marginal and average tax rates, the tax appears to be regressive. For example, if total economic income is used as the base, lower income taxpayers will spend a higher percentage of their income on items subject to the sales tax when compared to higher income taxpayers. Thus, the marginal tax rate will be less than the average tax rate, which is indicative of a regressive tax.**

5. As stated in the text, the federal income tax is the largest revenue-producing tax in use in the United States. Why do you think the income tax produces more revenue than any other tax?

**There are two main reasons why the income tax is the largest revenue producer. They evolve around the calculation of a tax as the TAX BASE x TAX RATE. First, the tax rates are generally higher than other most other taxes (10% to 39.6% versus say, a 7% sales tax). Second, the tax base, taxable income, is larger than most other bases. For example, most individuals taxable income is greater than the amount they would spend on items subject to a sales or excise tax. Those taxes with higher rate schedules than the income tax (gift tax, estate tax) have relatively small tax bases. That is, not very many gifts and/or estates are subject to the tax in a given year.**

6. How are federal, state, and local income taxes collected by the government? Consider the cases of an employee and a self-employed taxpayer.

**Employers are required to withhold income taxes on the wages and salaries of their employees. Employers are then responsible for depositing the taxes withheld to the appropriate governmental unit. Self-employed taxpayers are required to estimate their taxes and make quarterly payments to the appropriate governmental unit.**

7. How is a sales tax different from an excise tax?

**Both are taxes on goods and/or services purchased. A sales tax is a percentage of the value of the sales price of the goods or services. It is paid when the goods and/or services are sold. An excise tax is based on either a quantity or volume of the product being sold, such as a gallon of gasoline or per tire. Although it is technically paid when the goods are sold, the excise tax is generally included in the sales price and is typically not shown separately as a tax.**

8. Who is responsible for collecting sales and excise taxes? Who actually pays the tax?

**The seller of the goods and/or services subject to sales and excise taxes are responsible for the collection and payment of the tax. Sales taxes are paid directly by the purchaser as an addition to the sales price of the goods and/or services. The purchaser also pays excise taxes, but they generally are included in the price of the goods and, thus, are not shown as a separate payment by the buyer.**

9. Why is a tax on real property used more often than a tax on personal property?

**A tax on real property is more commonly used because real property is not mobile and is difficult to conceal. Thus, the tax base is more certain and the collection of the tax is easier. Personal property is mobile and easily concealed. Thus, it is more difficult to ascertain the value of personal property owned, making the tax base uncertain and the collection of the tax potentially difficult.**

10. The gift tax is supposed to tax the transfer of wealth from one taxpayer to another. However, the payment of gift tax on a transfer of property is relatively rare. Why is gift tax not paid on most gifts?

**Gift tax payments are rare due to the exclusions from the tax. The basic exclusion is \$14,000 per donee per year. This would allow a married couple to make tax-free gifts of up to \$28,000 per donee per year. Gifts in excess of the annual exclusion can be tax-free if the donor elects to use part of the unified gift and estate tax credit. Under this credit, the equivalent of \$5,430,000 of property transfers may be excluded from gift taxes.**

11. The estate tax is a tax on the value of property transferred at death. Why is payment of the estate tax not a common event?

**Although many people die every year, most pay little or no estate tax. This is due to two factors: the unlimited marital deduction for property passing to a spouse and the unified gift and estate tax credit. The marital deduction exempts from estate tax any property passing to the decedent's spouse. The unified gift and estate tax credit allows up to \$5,430,000 (2015) of tax-free property transfers. Because the majority of people do not have estates exceeding the \$5,430,000 tax-free limit, their estates are not taxed. Proper tax planning for larger estates should result in paying no tax on the death of the first spouse through use of the marital deduction.**

12. What is the basis for valuing assets transferred by gift and at death?

**Gift and estate taxes are based on the fair market value of the property at the date of the gift or at the date of death of the taxpayer.**

13. Who is responsible for reporting and paying gift taxes? estate taxes?

**Gift taxes are assessed on the donor of the gift. It is the donor's obligation to properly report and pay taxes on gifts. Estate taxes are reported and paid by the executor of the estate. The person receiving the property has no obligation to pay either gift or estate taxes.**

14. Identify three primary sources of tax law.

- 1. Legislative - The Internal Revenue Code of 1986.**
- 2. Administrative - The income tax regulations and other IRS documents.**
- 3. Judicial - Trial and appellate court decisions.**



15. Explain why the following statement is not necessarily true: "If the IRS disagrees, I'll take my case all the way to the Supreme Court."

**This statement is false because the Supreme Court chooses the cases it will review. Thus, the court may deny the taxpayer a hearing of his case (a writ of certiorari). Generally, the Supreme Court only considers a few tax cases in a given year.**

16. What is the federal income tax base?

**A tax base is the value that is subject to tax. The federal income tax base is a prescriptive net income amount called federal taxable income. The base is computed by reducing income from all sources by exclusions, deductions, losses, and exemptions.**

17. What is an exclusion?

**An exclusion is an increase in the taxpayer's wealth that Congress has determined should not be subject to tax or it is a recovery of the taxpayer's capital (i.e., investment in an asset).**

18. How is a deferral different from an exclusion?

**An exclusion is income that is never subject to tax. A deferral is income that is not taxed in the current period, but will be taxed in a future period. The future period tax may result from inclusion of the income through either lower depreciation/amortization deductions and/or by the inclusion of a larger gain than would have occurred without the deferral.**

19. How does gross income differ from income?

**Income (broadly defined) includes both taxable and tax-exempt income. This definition of income is closer to an economist's definition of income than is gross income. Gross income is a more restrictive term. Gross income is income (broadly defined) less income not subject to tax (exclusions). Gross income items are the starting point for reporting on a tax return.**

20. What are the three basic tests that an expense must satisfy to be deductible?

- 1. The expense must be ordinary,**
- 2. The expense must be necessary, and**
- 3. The expense must be reasonable in amount.**

21. What is the difference between an expense and a loss?

**Expenses are the ordinary, necessary and reasonable expenditures incurred during a taxable year to earn income. Expenses are normally items that recur each year and whose usefulness does not extend substantially beyond the end of the current year.**

**A loss normally means that an asset has been disposed of (sold, abandoned, etc.) for a price that is less than its tax cost (basis). A loss generally results from a specific transaction as compared to expenses that are usually incurred throughout the year.**

22. How is a transaction loss different from an annual loss?

**A transaction loss results when an asset is sold or otherwise disposed of at a price less than its tax cost (basis). An annual loss results from an excess of total deductions over total income for the year. Thus, a transaction loss is the result of a single event, while an annual loss is the cumulative effect of events for an entire year.**

23. How does the legislative grace concept help identify amounts that qualify for deduction?

**According to the legislative grace concept, an expenditure is not deductible unless a specific provision of the tax law allows the item as a deduction. If an expenditure is identified as an allowable type of deduction by the tax law, it can be subtracted in the taxable income calculation.**

24. What is the purpose of the exemption deduction?

**The exemption deduction is a predetermined amount that certain taxpayers may deduct to compute taxable income. The exemption is an example of the legislative grace concept. Congress has recognized that a certain amount of income is required to pay basic living costs. As a result, an individual is entitled to reduce income by the predetermined basic living cost amount (the exemption) for themselves and those who rely on the taxpayer for support. Estates and trusts are also allowed exemption deductions. However, other tax entities (e.g., corporations) are not allowed exemption deductions.**

25. Based on the example in Exhibit 1--2, explain how inflation can have two effects that result in a hidden tax.

**The hidden tax from inflation can result from two effects:**

- 1. As inflation increases the taxpayer's income, additional tax will be paid even though there is no change in the tax rates or increase in the taxpayer's real income, and**
- 2. In some instances, the increase in income due to inflation may push the taxpayer into a higher marginal tax rate bracket. Thus, the taxpayer will be subject to a higher rate of tax without a corresponding change in real income. The problem of creeping into higher marginal tax brackets is partially cured by indexing the tax rates for inflation.**

26. Explain the pay-as-you-go system.

**Income taxes are paid on income as close to the time it is received by the taxpayer as possible. This is accomplished through income tax withholding on wages and other types of income (e.g., gambling winnings) and through quarterly estimated tax payments on income that is not subject to withholding (e.g., self-employment income, investment income).**

27. What is a tax credit?

**A tax credit is an incentive put into the tax law by Congress to encourage taxpayers to enter into specific types of transactions or to provide relief from double taxation. A tax credit is treated like a prepayment of tax because it reduces the amount due by the full amount of the credit (dollar for dollar reduction in tax liability).**

28. How is a tax credit different from a tax deduction?

**A tax deduction results in a reduction of taxable income (the tax base). Therefore, the tax savings from a deduction are equal to the taxpayer's marginal tax rate multiplied by the amount of the deduction. In contrast, a tax credit is a direct dollar for dollar reduction in the tax liability. Therefore, one dollar of tax credit is worth more than one dollar of tax deduction.**

29. If you were in the 28% marginal tax bracket and you could choose either a \$1,000 tax credit or a \$3,000 tax deduction, which would give you the most tax savings? Why?

**The tax credit is a better choice in this case. The tax credit will reduce the tax due by \$1,000 (i.e., tax credits directly reduce the amount of tax due). The tax deduction will reduce taxable income by \$3,000, resulting in a reduction of the tax due of \$840 ( $\$3,000 \times 28\%$ ). The tax credit gives a \$160 ( $\$1,000 - \$840$ ) tax advantage to a 28% marginal tax rate payer. The \$1,000 tax credit is the equivalent of a \$3,571 tax deduction ( $\$1,000 \div 28\%$ ).**

30. What is the statute of limitations, and what role does it play in the filing of tax returns?

**The statute of limitations is the period of time that the IRS and/or the taxpayer has to correct an error on a return. The general statute of limitations period is three years from the due date of the return. This gives both the IRS and taxpayers time to correct errors on previously filed returns. If a taxpayer discovers an error in a previously filed return, the error is corrected by filing an amended return before the end of the statute of limitations. Thus, the statute of limitations provide an upper end on the amount of time that the taxpayer and the IRS have to correct a return.**

31. Briefly describe the types of programs used by the IRS to select a return for audit.

**The two basic audit programs are the document perfection program and the information matching program. Document perfection involves checking all returns for mathematical, clerical, and tax calculation errors. Information matching uses documents filed by third parties that report various income items to verify that they were properly claimed on the taxpayer's return. These two types of programs do not generate audits per se; rather, taxpayers are notified when errors are found and the tax is recalculated based on the errors.**

**Selection of returns for audit is done using either the Discriminant Function System (DIF) or through special audit programs. The DIF is a computerized return selection program that selects those returns with the highest probability of containing errors. This is done by comparing items on returns with pre-determined standards. The standards are developed based on the audit results of the Taxpayer Compliance Measurement Program (TCMP). The TCMP randomly selects returns from various income levels and each item on the return is comprehensively audited. Special audit programs are designed to select returns based on various parameters that the IRS believes may indicate that the returns are likely to contain errors. Factors that have been used in such audit programs are size of refund and the size of certain deductions in relation to income.**

32. What are the three types of IRS examinations?

**The three types of IRS examinations are correspondence examinations, office examinations, and field examinations. Correspondence examinations are done through the mail and usually involve requests for written documentation of various items on the tax return. Office examinations are conducted at local IRS offices and consist of a meeting between the taxpayer and an IRS representative to resolve factual issues regarding the taxpayer's return. Field examinations are done at the taxpayer's place of business and can involve any item on the taxpayer's return. As such, they are the most in-depth type of examination.**

33. What is included in the 30-day letter, and what options does the taxpayer have after receiving one?

**A 30 day letter includes the revenue agent's report of the results of an IRS examination and a Form 870. If the taxpayer agrees with the results of the examination, the Form 870 is signed. A taxpayer who does not agree with the report may request a meeting with the IRS Appeals Division within 30 days of receiving the revenue agent's report. The appeals division is the last opportunity for the IRS and the taxpayer to work out an agreement on the issues under examination.**

34. What does the 90-day letter represent, and what are the choices the taxpayer has after receiving one?

**The 90-day letter is the formal statutory notice of deficiency that the IRS sends to taxpayers that are unable to reach agreement in the appeals division. After receiving the 90-day letter, taxpayers that do not wish to go to court can wait 90 days and have the IRS formally assess the deficiency and then pay the amount due. Taxpayers who want to litigate must file their litigation action within 90 days of the date of the letter.**

35. How is the calculation of taxable income for an individual different from the calculation of a corporation's taxable income?

**The main difference is in the classification of deductions. Because a corporation is deemed to be in a trade or business, all of its expense are deductible (i.e., a corporation does not engage in personal transactions and, therefore, does not incur nondeductible personal expenditures). Corporations are not allowed standard deductions or exemption amounts in the calculation of taxable income.**

**Deductions of individuals are limited. An individual's deductions must be classified as being either FOR or FROM adjusted gross income. Deductions FOR adjusted gross income are for business related expenses, rental and royalty expenses, self-employment taxes paid, and other specified expenses. Only certain personal expenditures are allowed as deductions. Many of these deductions are subject to a limit based on the taxpayer's adjusted gross income. Allowable personal expenditures are deductible FROM adjusted gross income. An individual has a choice of deducting actual allowable personal expenditures or taking a pre-determined amount as a deduction, called the standard deduction. In addition, individuals are allowed exemption deductions for themselves and their dependents.**

36. How do deductions for adjusted gross income and deductions from adjusted gross income of an individual differ?

**Deductions for adjusted gross income are limited to those related to a trade or business, reimbursed employee expenses, rental and royalty expenses, alimony paid, one-half of self-employment tax paid, contributions to individual retirement accounts, and other specified expenses. Deductions for adjusted gross income are always deductible - there is no minimum allowable amount. In addition, they generally are not limited by the taxpayer's income.**

**Deductions from adjusted gross income are for certain personal expenditures (medical, interest, taxes, charitable contributions, personal casualty losses) and investment related expenses. Many of these deductions are subject to limitations based on the taxpayer's adjusted gross income. In addition, if the taxpayer's adjusted gross income exceeds a pre-specified amount, total itemized deductions are reduced. A minimum deduction from adjusted gross income is allowed to all taxpayers, called the standard deduction.**

37. What is the purpose of the standard deduction for individuals?

**The purpose of the standard deduction is to ensure that all individuals get some minimum deduction for personal expenditures. The provision of the standard deduction also promotes administrative convenience because taxpayers who have very small amounts of the allowable personal deductions do not have to keep records necessary to substantiate deductions and fill out tax forms for very small deduction amounts. In addition, the government does not have to incur costs to audit standard deduction amounts.**

38. Randy is studying finance at State University. To complete the finance major, he has to take a basic income tax course. Because Randy does not intend to be a tax expert, he considers the course a waste of his time. Explain to Randy how he can benefit from the tax course.

**The student's answers may vary, but should contain some of the following points:**

- 1. When a person enters into an economic transaction there will usually be a related income tax effect.**
- 2. Income taxes represent a major expenditure of time and money for most taxpayers. An understanding of basic tax concepts is necessary to avoid overpayment of taxes.**
  - Tax planning helps conserve wealth.**
  - The taxpayer has the primary responsibility for recognizing planning opportunities.**
- 3. Daily business decisions have a tax effect. The taxpayer needs to be familiar with these tax effects to choose between alternative courses of action.**
- 4. The taxpayer is responsible for complying with the tax law even when a tax adviser is hired to prepare returns. Thus, for self-protection, the taxpayer should understand basic tax concepts to be able to identify possible tax related situations.**

39. Evaluate the following statement: "The goal of good tax planning is to pay the minimum amount of tax."

**This statement is partially correct. However, a better statement would be that "good tax planning maximizes the real after-tax return on income." To see why this is correct, consider the decision to recognize income in the current year or defer it to next year. If minimization of tax is the sole criteria, then the income is always deferred. However, deferral is not always the optimal choice. Determining the optimal choice requires the calculation of the real after-tax return from recognizing the income currently versus deferring it to the next year. This involves considering the relative marginal tax rates and the time-value of money.**

40. It has often been said that only the rich can benefit from professional tax planning. Based on the information presented in this chapter, why is this statement at least partially true?

**To take advantage of the two main tax planning techniques - timing income and deductions and income splitting, taxpayers must have income and deductions that can be manipulated to achieve the best tax effect. Taxpayers whose main source of income is from wages and salaries have a very limited set of options available to them for reduction of their taxes. However, such taxpayers can still obtain a limited amount of benefit from tax planning by actions such as purchasing a home to secure an interest deduction (rather than paying non-deductible rent) and investing savings in tax-exempt securities. In addition, taxpayers with higher incomes have more incentive to spend the time, effort, and money necessary to engage in tax planning because the returns from this type of investment are higher (i.e., they are paying higher marginal tax rates). Therefore, each dollar reduction in taxable income is worth more to high income than to low income taxpayers.**

**PROBLEMS**

41. State whether each of the following payments is a tax. Explain your answers.

- a. To incorporate his business, Alex pays the state of Texas a \$2,000 incorporation fee.

**The incorporation fee is not a tax. Alex receives a direct benefit from the payment of the fee - the privilege of operating his business as a corporation**

- b. The city paves a road and assesses each property owner on the road \$4,000 for his or her share of the cost.

**The payment of the assessment is not a tax. The assessment is a property improvement. Only the owners of the property benefit from the assessment. The assessment is a charge to reimburse the county government for the cost of paving the road that provides a direct benefit to each owner's property. Such assessments are added to the basis of the property and are not allowed as a property tax deduction.**

- c. The city of Asheville charges each residence in the city \$10 per month to pick up the trash.

**The fee to collect the trash is not a tax. The \$10 payment provides a specific benefit - the picking up of trash.**

- d. Rory pays \$450 of income tax to the state of California.

**State income taxes meet the definition of a tax. They are required to be paid by law and result from the state's legislative power to tax. State income taxes are general purpose revenues and the payment of the tax does not provide any specific benefits, services, or privileges to the payor.**

- e. Lanny is fined \$45 for exceeding the speed limit.

**Fines are not taxes. They are penalties to discourage behavior and are not designed to produce revenues.**

42. Explain why each of the following payments does or does not meet the IRS definition of a tax:

- a. Jack is a licensed beautician. He pays the state \$45 each year to renew his license to practice as a beautician.

**Not a tax. Jack receives a direct benefit from the payment of the licensing fee - he is allowed to practice as a beautician.**

- b. Polly Corporation pays state income taxes of \$40,000 on its \$500,000 of taxable income.

**State income taxes are a tax under the IRS definition. The taxes are paid to a governmental authority, are paid pursuant to the state's power to tax, are used to provide revenue for the state, and no specific benefit is derived from paying the tax.**

- c. Winona pays \$15 annually for a safety inspection of her automobile that is required by the state.

**Safety inspection fees are not taxes. By paying the fee, Winona is allowed to drive her automobile - a specific benefit is received.**

- d. The Judd Partnership owns land that is valued by the county assessor at \$30,000. Based on this valuation, the partnership pays county property taxes of \$800.

**Ad valorem property taxes meet the IRS definition of a tax. The taxes are paid to a governmental authority, are paid pursuant to the county's power to tax, are used to provide revenue for the county, and no specific benefit is derived from paying the tax.**

- e. Andrea fails to file her income tax return on time. She files the return late, and the IRS assesses her \$25 for the late filing and \$5 for interest on the tax due from the due date of the return until the filing date.

**The late filing fee and interest charge are not taxes. They are penalties for failing to file a timely tax return. As such, they are used to discourage behavior, not produce revenue.**



43. Susan is single with a gross income of \$120,000 and a taxable income of \$98,000. In calculating taxable income, she properly excluded \$10,000 of tax-exempt interest income. Using the tax rate schedules in the chapter, calculate Susan's
- Total tax
  - Marginal tax rate.
  - Average tax rate
  - Effective tax rate

**a. Tax computation: single taxpayer rate schedule for 2015:**

Taxable Income	\$ 98,000	
Tax on	90,750	\$18,481.25
Excess	\$ 7,250	
Taxed at Marginal Rate	x 28%	2,030.00
Total Tax		<u>\$20,511.25</u>

- b. The marginal tax rate is the rate of tax that would be paid on an additional dollar of income. At a taxable income of \$98,000, a single taxpayer would be in the 28% marginal tax rate bracket (from the calculation above).
- c. The average tax rate is the rate of tax paid on the total tax base; the total tax divided by taxable income. In this case, the total tax is \$20,511.25 on a taxable income of \$98,000, which gives an average tax rate of 20.93%:

$$20.93\% = (\$20,511.25 \text{ tax} \div \$98,000 \text{ taxable income})$$

- d. The effective tax rate is the rate of tax paid on all income (taxable and nontaxable). The total tax paid is divided by the taxpayer's economic income (taxable income + nontaxable income). In this case, Susan has \$10,000 of tax-exempt income that increases her economic income to \$108,000 (\$98,000 taxable + \$10,000 nontaxable). This results in an effective tax rate of 18.99%:

$$18.99\% = (\$20,511.25 \text{ tax} \div \$108,000 \text{ economic income})$$

44. A taxpayer has \$95,000 of taxable income for the current year. Determine the total tax, the marginal tax rate, and the average tax rate if the taxpayer is a

- a. Single individual
- b. Married couple
- c. Corporation

a. **Total tax on \$95,000 for a single individual: 2015 single rate schedule**

Taxable Income	\$ 95,000	
Tax on	90,750	\$ 18,481.25
Excess	\$ 4,250	
Taxed at Marginal tax rate	x 28%	1,190.00
Total Tax		<u>\$ 19,671.25</u>

average tax rate = 20.71% = \$19,671.25 tax ÷ \$95,000 taxable income

b. **Total tax on \$95,000 for a married couple: 2015 married, filing jointly rate schedule**

Taxable Income	\$ 95,000	
Tax on	74,900	\$ 10,312.50
Excess	\$ 20,100	
Taxed at Marginal tax rate	x 25%	5,025.00
Total Tax		<u>\$ 15,337.50</u>

average tax rate = 16.14% = \$15,337.50 tax ÷ \$95,000 taxable income

c. **Total tax on \$95,000 for a corporation: 2015 corporate rate schedule**

Taxable Income	\$ 95,000	
Tax on	75,000	\$13,750
Excess	\$ 20,000	
Taxed at Marginal tax rate	x 34%	6,800
Total Tax		<u>\$20,550</u>

average tax rate = 21.63% = \$20,550 tax ÷ \$95,000 taxable income

45. Rory earns 60,000 per year as a college professor. Latesia is a marketing executive with a salary of \$120,000. With respect to the Social Security tax, what are Rory and Latesia's

a. Total taxes?

**Rory's salary is under the OASDI Social Security base limit. Therefore, he pays the combined 7.65% rate on his full salary, resulting in a tax of \$4,590:**

$$\text{\$60,000} \times 7.65\% = \text{\underline{\underline{\$4,590}}}$$

**Latesia's salary is over the OASDI base amount. Therefore, she pays the maximum OASDI tax and the 1.45% MHI tax on all her income, a total Social Security tax of \$9,087:**

OASDI Tax	$\text{\$118,500} \times 6.20\% =$	$\text{\$ 7,347}$
MHI Tax	$\text{\$120,000} \times 1.45\% =$	$\text{1,740}$
Total Tax		$\text{\underline{\underline{\$ 9,087}}}$

b. Marginal tax rates?

**The marginal tax rate is the rate of tax that is paid on the next dollar of income subject to the tax. Because Rory is under the base amount, any subsequent income earned up to the \$118,500 OASDI base amount is subject to tax at 7.65%. Therefore, his marginal tax rate is 7.65%.**

**Latesia has paid the maximum OASDI tax on her salary. Therefore, any additional salary is subject to the MHI portion of the Social Security tax, resulting in a marginal tax rate of 1.45%.**

c. Average tax rates?

**The average tax rate is the total tax divided by the tax base. Rory's average tax rate is 7.65% (\$4,590 tax ÷ \$60,000 tax base).**

**Latesia's average tax rate on the OASDI portion of the tax is 6.20% (\$7,347 tax ÷ \$118,500 tax base). Her MHI average tax rate is 1.45% (\$1,740 tax ÷ \$120,000 tax base). Her combined average tax rate is 7.65% (6.20% + 1.45%).**

d. Effective tax rates?

**The effective tax rate is the total tax divided by the taxpayer's economic income (tax base + income not subject to the tax base). The effective tax rates based only on their salaries are:**

Rory	- 7.65%	( $\text{\$4,590 tax} \div \text{\$ 60,000 salary}$ )
Latesia	- 7.57%	( $\text{\$9,087 tax} \div \text{\$120,000 salary}$ )

46. For each of the following, explain whether the rate structure is progressive, proportional, or regressive:

- a. Plymouth County imposes a 5% tax on all retail sales in the county. Taxpayers with incomes less than \$12,000 receive a refund of the tax they pay.

**Sales taxes are proportional as defined in the text. The average tax rate is equal to the marginal tax rate on all items subject to the tax. When evaluated using income as the tax base, sales taxes are generally regressive - low income taxpayers spend a higher proportion of their income on goods subject to sales tax (their average tax rates are higher). The refund of the sales tax to taxpayers with lower incomes reduces the regressivity of the tax for those taxpayers.**

- b. The country of Zambonia imposes a 10% tax on the taxable income of all individuals.

**The income tax is proportional. The average tax rate is equal to the marginal tax rate at all levels of taxable income. However, the tax becomes regressive if higher income taxpayers have a greater ability to lower their taxable income through exclusions and deductions. This lowers the effective rate of tax for high income taxpayers and induces regressivity into the tax structure.**

- c. Regan County imposes a property tax using the following schedule:

Assessed Value	Tax
\$ -0- to \$10,000	\$ 40
\$10,001 to \$40,000	\$ 40 + 1% of the value in excess of \$10,000
\$40,001 to \$80,000	\$ 340 + 2% of the value in excess of \$40,000
\$80,001 and above	\$1,140 + 3% of the value in excess of \$80,000

**The property tax is progressive. The marginal tax rates are increasing (1%, 2%, 3%) through the rate structure and are higher than the average tax rate.**

- d. The city of Thomasville bases its dog licensing fee on the weight of the dog per the following schedule:

Weight (in pounds)	Tax Rate
0 to 40	\$ 2 + 50% of weight
41 to 80	\$22 + 40% of weight in excess of 40 lbs.
81 and above	\$36 + 30% of weight in excess of 80 lbs.

**The dog licensing fee is regressive - marginal tax rates are increasing as the tax base increases. The marginal tax rate is less than the average tax rate. For example, the tax on a 20 pound dog is \$12 [ $2 + (50\% \times 20)$ ]. The average rate is \$.60 and the marginal rate is \$.50. The tax on a 50 pound dog is \$42 [ $\$22 + (40\% \times 50)$ ], an average rate of \$.84 and a marginal rate of \$.40. Average tax rates are increasing with levels of the tax base while marginal tax rates are decreasing.**

47. The country of Boodang is the leading producer of sausage. Boodang imposes three taxes on its residents and companies to encourage production of sausage and discourage its consumption. Each applies as follows:

- Income tax: Rates apply to each taxpayer's total income:

\$ 0 - \$ 50,000	5% of total income
\$ 50,000 - \$ 200,000	\$ 2,500 + 10% of income in excess of \$50,000
\$200,000 - \$ 500,000	\$17,500 + 20% of income in excess of \$200,000
\$500,000 or more	40% of total income

In calculating total income, sausage workers are allowed to deduct 25% of their salaries. Companies that produce sausage are allowed to deduct 50% of their sales. No other deductions are allowed.

- Sausage tax: All sausage purchases are subject to a 100% of purchase price tax. Residents who consume less than 10 pounds of sausage per year are given a 50% rebate of the sausage tax they paid.
- Property tax: Taxes are based on the distance of a taxpayer's residence from state-owned sausage shops per the following schedule:

0 - 2 miles	\$ 15,000 per mile
2 miles - 5 miles	\$ 5,000 per mile
5 miles or more	\$ 2,000 per mile

Given the definitions in the chapter, are Boodang's taxes progressive, proportional, or regressive? Evaluate and discuss each tax and the aspect(s) of the tax that you considered in making your evaluation.

**Income tax:** The rate schedule is progressive - the marginal tax rate is greater than the average tax rate at all levels. However, the overall tax may be viewed as being regressive due to the deductions allowed to sausage workers and their employers. Because these deductions lower these entities tax base versus non-sausage related entities, their marginal and average tax rates will be lower than comparably paid workers and companies with similar revenues in other businesses.

**Sausage tax:** By definition, the tax rate is proportional - the same tax is paid at all levels of purchases, making the marginal tax rate equal to the average tax rate. The allowance of a credit for small sausage purchasers adds an element of progressivity to the tax. That is, individuals who purchase less than 10 pounds of sausage will have a lower marginal and average tax rate than those who purchase 10 pounds or more. Thus, as the tax base (sausage purchases) increases to 10 pounds, the marginal and average tax rates increase. However, the tax remains proportional for all taxpayers whose purchases are less than 10 pounds, as it does for all taxpayers whose purchases equal or exceed 10 pounds.

**Property tax:** The rate schedule is regressive - as the tax base (miles from a sausage shop) increases, the marginal and average tax rates increase. However, there is an element of proportionality to the tax because it is not cumulative through the base. That is, a different per mile tax is levied at each base level, but the per mile tax does not accumulate as you move through the base. Thus, the marginal and average tax rates are equal through each level - a characteristic of a proportional tax.

48. Joe Bob is an employee of Rollo Corporation who receives a salary of \$12,000 per month. How much Social Security tax will be withheld from Joe Bob's salary in

a. March?

**Joe Bob's salary is under the OASDI Social Security base amount and his entire salary in March will be subject to the 7.65% Social Security tax. Therefore, he will pay \$918 ( $\$12,000 \times 7.65\%$ ) of Social Security tax in March.**

b. November?

**By November, Joe Bob will have earned \$120,000 ( $\$12,000 \times 10$  months) and will have paid in the maximum OASDI tax. Therefore, he will only pay the 1.45% MHI component in November, resulting in a tax of \$174 ( $\$12,000 \times 1.45\%$ ).**

49. Return to the facts of problem 48. Assume that each month, Joe Bob has \$2,800 in federal income tax and \$900 of state income tax withheld from his salary. What is Joe Bob's take-home pay in

a. March?

**Joe Bob's gross salary will be reduced by amounts withheld for federal, state, and local taxes. His March take home pay will be \$7,382 ( $\$12,000 - \$2,800 - \$900 - \$918$ ).**

b. November?

**Joe Bob's take home pay is \$8,126 ( $\$12,000 - \$2,800 - \$900 - \$174$ ) and reflects the lower amount of Social Security withheld due to exceeding the OASDI base amount.**

50. Gosney Corporation has 2 employees. During the current year, Clinton earns \$64,000 and Trahn earns \$120,000. How much Social Security tax does have to Gosney pay on the salaries earned by Clinton and Trahn?

**Gosney must match each employee's Social Security tax payment. The OASDI portion of the Social Security tax is 6.2% of wages and salaries up to a maximum of \$118,500 in 2015. The MHI portion of the tax is 1.45% of all wages and salaries. Clinton is under the OASDI base and pays 7.65% of his entire salary, \$4,896 (\$64,000 x 7.65%). Trahn is over the OASDI base and will pay the maximum OASDI and 1.45% on her entire salary, \$9,087 [(\$118,500 x 6.2%) + (\$120,000 x 1.45%)]. Gosney Corporation must match Clinton and Trahn's payments, a total of \$13,983 (\$4,896 + \$9,087).**

Clinton-	\$ 64,000 x 7.65% =	\$ 4,896
Trahn -	\$118,500 x 6.20% = \$ 7,347	
	\$120,000 x 1.45% = <u>1,740</u>	<u>\$ 9,087</u>
<b>Total Social Security Tax to be Matched</b>		<b><u>\$13,983</u></b>

51. Eric is a self-employed financial consultant. During the current year, Eric's net self-employment income is \$125,000. What is Eric's self-employment tax?

**As a self-employed taxpayer, Eric is required to pay the equivalent of the employee and the employer's Social Security contribution as a self-employment tax. Eric's self-employment income exceeds the OASDI base amount. Therefore, his self-employment tax is calculated as follows:**

OASDI portion of tax:	\$118,500 x (6.20% x 2)=	\$ 14,694
MHI portion of tax:	\$125,000 x (1.45% x 2)=	<u>3,625</u>
<b>Total self-employment tax</b>		<b><u>\$ 18,319</u></b>

52. Darrell is an employee of Whitney's. During the current year, Darrell's salary is \$125,000. Whitney's net self-employment income is also \$125,000. Calculate the Social Security and self-employment taxes paid by Darrell and Whitney. Write a letter to Whitney in which you state how much she will pay in Social Security and self-employment taxes and why she owes these amounts.

**Employees must pay (and the employer must match) the Social Security tax. In 2015, the OASDI portion of the tax is 6.2% on a maximum of \$118,500 of wages and salaries. The 1.45% MHI portion of the tax is paid on all wages and salaries. Because Darrell's income is greater than the OASDI base, he will pay the maximum OASDI and 1.45% MHI on all his income, resulting in a tax of \$9,160:**

<b>OASDI - \$118,500 x 6.20%</b>	<b>\$ 7,347</b>
<b>MHI - \$125,000 x 1.45%</b>	<b>1,813</b>
<b>Total Social Security tax</b>	<b><u>\$ 9,160</u></b>

**Whitney must match Darrell's payment, resulting a total Social Security tax paid on Darrell's salary of \$18,320 (\$9,160 x 2).**

**Self-employed taxpayers must pay both the employee and employer's share of the tax in computing the self-employment tax. Whitney will pay \$18,319 of self-employment tax on her self-employment income:**

<b>OASDI - \$118,500 x (6.2% x 2)</b>	<b>\$ 14,694</b>
<b>MHI - \$125,000 x (1.45% x 2)</b>	<b>3,625</b>
<b>Total self-employment tax</b>	<b><u>\$ 18,319</u></b>

**Thus, the total amount of tax paid is the same. The difference between the two taxes is who pays the tax. Employees pay only half of the tax, while self-employed taxpayers must pay the entire tax. Whitney will pay \$27,479 (her \$18,319 + \$9,160, the employer's share of Darrell's Social Security tax).**



53. Classify the following items as ordinary income, a gain, or an exclusion:

- a. The gross revenues of \$160,000 and deductible expenses of \$65,000 of an individual's consulting business

**Income from a business is ordinary income. In this case, the individual has \$95,000 (\$160,000 - \$65,000) of ordinary income.**

- b. Interest received on a checking account

**Interest received on a checking account is ordinary income.**

- c. Sale for \$8,000 of Kummel Corporation stock that cost \$3,000

**The sale of the stock produces a \$5,000 (\$8,000 - \$3,000) gain.**

- d. Receipt of \$1,000 as a graduation present from grandfather

**The \$1,000 graduation present is a gift. Because gifts are subject to a separate tax on gifts (i.e., the gift tax), the value of a gift is excluded from the income tax.**

- e. Royalty income from an interest in a gold mine

**Royalty income is ordinary income.**

54. Classify the following items as ordinary income, a gain, or an exclusion:

- a. The salary received by an employee

**Salaries received by employees are ordinary income.**

- b. Dividends of \$400 received on 100 shares of corporate stock

**Dividends on stock are ordinary income.**

- c. Sale for \$10,000 of an antique chair that cost \$3,500

**The sale of the chair results in a gain of \$6,500 (\$10,000 - \$3,500).**

- d. Rental income from an apartment building

**Rental income is ordinary income.**

- e. Receipt of an automobile worth \$20,000 as an inheritance from Aunt Ruby's estate

**The value of property received by inheritance is excluded from gross income.**

55. Explain why each of the following expenditures is or is not deductible:

**To be deductible, an expenditure (or loss) must be related to a trade or business or incurred in a production of income (investment) activity. Only specifically authorized personal expenditures (or losses) are deductible.**

- a. Lumbar, Inc., pays \$12,000 as its share of its employees' Social Security tax. The \$12,000 is deductible.

**The employee's Social Security tax is part of Lumbar's salary expense. The salaries are related to Lumbar's business and therefore, are deductible.**

- b. Leroy pays a cleaning service \$250 per month to clean his real estate office. The \$250 is deductible.

**The cleaning costs relate to Leroy's business and are deductible.**

- c. Janice pays a cleaning service \$75 per month to clean her personal residence. The \$75 is not deductible.

**The residence is a personal use asset. The cleaning costs related to a personal use asset are not deductible.**

- d. Leyh Corporation purchases land to use as a parking lot for \$35,000. The \$35,000 is not deductible.

**The land purchase is a capital expenditure. Capital expenditures cannot be deducted in the year of purchase.**

- e. Martin spends \$50 per month on gasoline for the car he uses to drive to his job as a disc jockey. The \$50 is not deductible.

**Commuting is a personal expense. Therefore, the cost of commuting does not relate to a business or investment activity and cannot be deducted.**

56. Classify each of the following transactions as a deductible expense, a nondeductible expense, or a loss:

- a. Nira sells for \$4,300 stock that cost \$6,000.

**The sale of stock costing \$6,000 for \$4,300 results in a loss of \$1,700 (\$4,300 - \$6,000).**

- b. Chiro Medical, Inc., pays \$2,200 for subscriptions to popular magazines that it places in its waiting room.

**Because the magazines are provided to its customers, the subscriptions have a business purpose and are a deductible expense.**

- c. Lawrence pays \$200 for subscriptions to fly-fishing magazines.

**Assuming that Lawrence is not in the fly-fishing business, the use of the magazines is personal and therefore, nondeductible.**

- d. The Mendota Partnership pays \$200,000 to install an elevator in one of its rental properties.

**The installation of the elevator has a business purpose. However, because the usefulness of the elevator extends substantially beyond the end of the current year, it cannot be deducted in total as a business expense in the year of the expenditure. The \$200,000 cost must be capitalized and deducted through depreciation over its tax life.**

- e. Sterling Corporation pays \$6,000 for lawn maintenance at its headquarters.

**The lawn maintenance relates to a business and therefore, it is a deductible business expense.**

57. Based on the following information, what are the taxable income and the tax liability for a single individual?

Total income	\$118,000
Excludable income	2,000
Deductions for adjusted gross income	2,500
Deductions from adjusted gross income	8,000

**The taxable income for a single individual is \$101,500 in 2015:**

<b>Total Income</b>	<b>\$118,000</b>
<b>Excluded Income</b>	<b>(2,000)</b>
<b>Gross Income</b>	<b>\$116,000</b>
<b>Deductions For Adjusted Gross Income</b>	<b>(2,500)</b>
<b>Adjusted Gross Income</b>	<b>\$113,500</b>

**Deductions From Adjusted Gross Income**

the Greater of:		
Itemized Deductions	\$ 8,000	
or		
Standard Deduction	\$ 6,300	(8,000)
<b>Personal Exemption</b>		<b>(4,000)</b>
<b>Taxable Income</b>		<b><u>\$101,500</u></b>

**The tax on \$101,500 in 2015 for a single individual is \$21,491.25:**

<b>Taxable Income</b>	<b>\$101,500</b>		
<b>Tax on</b>	<b>(90,750)</b>		<b>\$ 18,481.25</b>
<b>Tax on excess</b>	<b><u>\$ 10,750</u></b>	<b>x 28%</b>	<b><u>3,010.00</u></b>
<b>Total tax</b>			<b><u>\$ 21,491.25</u></b>

58. Based on the facts of problem 57, calculate the taxable income and the tax liability for a married couple.

**The taxable income for a married couple is \$92,900 in 2015:**

Total Income		\$118,000
Excluded Income		(2,000)
Gross Income		<u>\$116,000</u>
Deductions For Adjusted Gross Income		(2,500)
Adjusted Gross Income		<u>\$113,500</u>
the Greater of:		
Itemized Deductions	\$ 8,000	
or		
Standard Deduction	\$12,600	(12,600)
Personal Exemption (2 x \$ 4,000)		(8,000)
Taxable Income		<u><u>\$ 92,900</u></u>

**The tax on \$92,900 in 2015 for a married couple is \$14,812.50:**

Taxable Income	\$ 92,900		
Tax on	(74,900)		\$ 10,312.50
Tax on excess	<u>\$ 18,000</u>	x 25%	<u>4,500.00</u>
Total tax			<u><u>\$ 14,812.50</u></u>

59. Reba's 2015 income tax calculation is as follows:

Gross income	\$ 120,000
Deductions for adjusted gross income	<u>(3,000)</u>
Adjusted gross income	\$ 117,000
Deductions from adjusted gross income:	
Standard deduction	(6,300)
(Total itemized deductions are \$2,300)	
Personal exemption	<u>(4,000)</u>
Taxable income	<u>\$106,700</u>

Before filing her return, Reba finds an \$8,000 deduction that she omitted from these calculations. Although the item is clearly deductible, she is unsure whether she should deduct it for or from adjusted gross income. Reba doesn't think it matters where she deducts the item, because her taxable income will decrease by \$8,000 regardless of how the item is deducted. Is Reba correct? Calculate her taxable income both ways. Write a letter to Reba explaining any difference in her taxable income arising from whether the \$8,000 is deducted for or from adjusted gross income.

**Because Reba does not currently itemize her deductions, if the item is deductible from adjusted gross income, \$4,000 of the deduction will be "lost" in taking her itemized deductions from \$2,300 to the \$6,300 standard deduction amount. Her taxable income will only decrease by \$4,000 (\$8,000 - \$4,000) if the item is deductible from AGI. Because there is no minimum amount deductible for AGI, the entire \$8,000 deduction will reduce taxable income if the deduction is for AGI. Note: If Reba had already been itemizing (i.e., her itemized deductions had exceeded \$6,300), both deductions would have lowered her taxable income by \$8,000.**

	Deduction For AGI	Deduction From AGI
Gross income	\$ 120,000	\$ 120,000
Deductions For AGI - \$3,000 + \$8,000	<u>(11,000)</u>	<u>(3,000)</u>
Adjusted gross income	\$ 109,000	\$ 117,000
Deduction From AGI		
Greater of:		
Standard deduction -	(6,300)	
Itemized deductions -     \$ 2,300		
		<u>(10,300)</u>
Personal exemption	<u>(4,000)</u>	<u>(4,000)</u>
Taxable income	<u>\$ 98,700</u>	<u>\$ 102,700</u>

60. Since graduating from college, Mabel has used the firm of R&P to prepare her tax returns. Each January, Mabel receives a summary information sheet, which she fills out and sends to R&P along with the appropriate documentation. Because she has always received a refund, Mabel feels that R&P is giving her good tax advice. Write a letter to Mabel explaining why she may not be getting good tax advice from R&P.

**Obtaining a refund does not mean that the taxpayer is obtaining good tax planning advice - it simply means that the taxpayer has prepaid, through withholding and estimated tax payments, more than the actual tax liability. Good tax planning focuses on minimizing the tax liability on the income generated. In fact, having a refund due means that the taxpayer has given the government an interest-free loan for the tax year. Better tax planning would result in the taxpayer actually paying a small amount of tax (generally less than \$1,000 to avoid any penalty for underpayment of estimated taxes), thus receiving an interest-free loan from the government.**

61. Michiko and Saul are planning to attend the same university next year. The university estimates tuition, books, fees, and living costs to be \$12,000 per year. Michiko's father has agreed to give her the \$12,000 she needs to attend the university. Saul has obtained a job at the university that will pay him \$14,000 per year. After discussing their respective arrangements, Michiko figures that Saul will be better off than she will. What, if anything, is wrong with Michiko's thinking?

**Because the \$12,000 she receives from her father is a gift, Michiko will not have to pay tax on the \$12,000. Therefore, the entire \$12,000 she receives is available for her to spend. In contrast, the \$14,000 Saul receives from his job is subject to both the income and Social Security tax, reducing the amount he has to spend. Assuming that Saul has no other sources of income and that he uses the standard deduction, his income tax will be \$370 and he will pay \$1,071 ( $\$14,000 \times 7.65\%$ ) in Social Security tax. This will leave him with only \$12,559 ( $\$14,000 - \$370 - \$1,071$ ). Therefore, Saul is only marginally better off than Michiko under the circumstances.**

**Income Tax Calculation:**

Adjusted Gross Income (equal to gross income)	\$ 14,000
Standard Deduction	(6,300)
Personal Exemption	(4,000)
Taxable Income	<u>\$ 3,700</u>
Tax on \$3,700 - ( $\$3,700 \times 10\%$ )	<u>\$ 370</u>

**Note: Saul would most likely have to pay state income taxes on his salary, further reducing the amount he has to spend. In addition, if Saul is a dependent of his parents, he would not be allowed a dependency exemption (loss of personal exemptions by dependents is discussed in Chapter 8), increasing his federal income tax by \$400 ( $\$4,000 \times 10\%$ ). Under these circumstances it is likely that Saul will have less than \$12,000 of his \$14,000 salary to finance his college education and will not be better off than Michiko.**



62. Inga, an attorney, completed a job for a client in November 2015. If she bills the client immediately, she will receive her \$10,000 fee before the end of the year. By delaying the billing for a month, she will not receive the \$10,000 until 2016. What factors should Inga consider in deciding whether she should delay sending the bill to the client?

**Inga should determine the tax cost of reporting the fee income in 2015 compared to the present value of the tax cost of reporting the income in 2016. Thus, she needs to know the:**

- **2015 Marginal tax rate,**
- **2016 Marginal tax rate, and**
- **The rate of interest (time value of money factor) on investing the deferred tax from 2015 to 2016.**

For example, assume that Inga's 2015 marginal tax rate is 25%, she expects to be in the 33% tax rate bracket in 2016, and the time value of money is 7%. In general, income should be deferred (time value of money factor) and placed in the year with the lowest marginal tax rate (marginal tax rate factor). In this case, the two general rules conflict and Inga must calculate the present value of the tax for each year:

	2015	2016
Tax paid	\$ 2,500	\$ 3,300
Present value factor	1.000	x .935
Present value of tax payment	<u>\$ 2,500</u>	<u>\$ 3,086</u>

In this case, the marginal tax rate effect (put the income in the year with the lowest marginal tax rate) is greater than the present value effect (postpone the recognition of income) resulting in a real tax savings of \$586. By billing the fee now and receiving it in 2015, Inga will minimize her tax liability.

63. Art is in the 28% marginal tax bracket for 2015. He owes a \$10,000 bill for business expenses. Since he reports taxable income on a cash basis, he can deduct the \$10,000 in either 2015 or 2016, depending on when he makes the payment. He can pay the bill at any time before January 31, 2016, without incurring the normal 8% interest charge. If he expects to be in a 33% marginal tax bracket for 2016, should he pay the bill and claim the deduction in 2015 or 2016?

**Art should pay the expense and claim the deduction in 2016. In this case, the marginal tax rate effect (put the deduction in the year with the highest marginal tax rate) is greater than the present value effect (take the deduction as soon as possible) resulting in a real tax savings of \$256 by deducting the expense in 2016:**

	Real Tax Savings	
Claim deduction in 2015	\$ 10,000	
Tax savings at marginal rate	x 28%	\$ 2,800
Claim deduction in 2016	\$ 10,000	
Tax savings at marginal rate	x 33%	
Tax savings	\$ 3,300	
Present value factor	x .926	3,056
Net real savings from 2016 deduction		<u>\$ 256</u>

64. Elki would like to invest \$50,000 in tax-exempt securities. He now has the money invested in a certificate of deposit that pays 5.75% annually. What rate of interest would the tax-exempt security have to pay to result in a greater return on Elki's investment than the certificate of deposit? Work the problem assuming that Elki's marginal tax rate is 15%, 25%, 28%, and 33%.

**The equivalent tax-exempt rate is determined by mathematically equating the after-tax rate of a tax-exempt security (TES) with that of a taxable security (TS). The tax paid on the taxable security is paid at the marginal tax rate (MTR).**

$$\text{TES RATE} = \text{TS} - \text{Tax Paid} = \text{TS} - \text{TS} \times (\text{MTR}) = \text{TS} \times (1 - \text{MTR})$$

**This gives the following tax-exempt equivalent rates for a 5.75% taxable rate:**

<b>Equivalent Tax-Exempt Rate</b>	<b>=</b>	<b>Taxable Rate</b>	<b>x</b>	<b>(1 - MTR)</b>
<u>4.89%</u>	<b>=</b>	<u>5.75%</u>	<b>x</b>	<u>(1 - 15.0%)</u>
4.31%	<b>=</b>	5.75%	<b>x</b>	(1 - 25.0%)
4.14%	<b>=</b>	5.75%	<b>x</b>	(1 - 28.0%)
3.85%	<b>=</b>	5.75%	<b>x</b>	(1 - 33.0%)

65. Leroy and Amanda are married and have 3 dependent children. During the current year, they have the following income and expenses:

Salaries	\$120,000
Interest income	45,000
Royalty income	27,000
Deductions for AGI	3,000
Deductions from AGI	9,000

- a. What is Leroy and Amanda's current year taxable income and income tax liability?

**Leroy and Amanda's 2015 taxable income is \$156,400 and their 2015 tax liability is \$30,844:**

<b>Gross income</b>		
Salaries	\$120,000	
Interest income	45,000	
Dividend income	27,000	\$ 192,000
Deductions for AGI		(3,000)
Adjusted gross income		<u>\$ 189,000</u>
Deductions from AGI		
The greater of:		
Standard deduction	\$12,600	
or		
Itemized deductions	\$ 9,000	(12,600)
Personal and dependency exemptions (5 x \$4,000)		(20,000)
Taxable income		<u><u>\$ 156,400</u></u>
Tax on \$156,400:		
\$29,387.50 + [28% x (\$156,400 - \$151,200)]		<u><u>\$ 30,844</u></u>

**\* Although Leroy and Amanda are eligible for the \$1,000 per child tax credit, the benefit would be phased-out. Because the child tax credit is not discussed until Chapter 8, it is not incorporated into the solution.**

- b. Leroy and Amanda would like to lower their income tax. How much income tax will they save if they validly transfer \$5,000 of the interest income to each of their children? Assume that the children have no other income, and that they are entitled to a \$1,000 standard deduction, but are not allowed a personal exemption deduction.

**Leroy and Amanda's taxable income will decrease to \$141,400 (\$156,400 - \$15,000) and their tax liability will be \$26,938 [\$10,312.50 + [25% x (\$141,400 - \$74,900)]], a \$3,906 reduction. Each child's taxable income will be \$4,000 (\$5,000 - \$1,000) and the tax will be \$400 (\$4,000 x 10%) per child, a total tax of \$1,200 (\$400 x 3). Leroy and Amanda will save \$2,706 [\$30,844 - \$28,138 (\$26,938 + \$1,200)] if they validly transfer \$5,000 of interest income to each child.**

66. Tina owns and operates Timely Turn Tables (TTT) as a sole proprietorship. TTT's taxable income during the current year is \$80,000. In addition to the TTT income, Tina has the following income and expenses during the current year:

Interest income	\$ 11,000
Royalty income	28,000
Deductions for AGI	2,500
Deductions from AGI	15,000

- a. What is Tina's current year taxable income and income tax liability?

**Tina's taxable income is \$97,500 and her income tax liability is \$20,203:**

**Gross Income:**

Income from TTT	\$ 80,000	
Interest income	11,000	
Royalty income	28,000	\$ 119,000
Deductions for adjusted gross income		(2,500)
Adjusted gross income		\$ 116,500
Deductions from adjusted gross income		
Itemized deductions (greater than standard)		(15,000)
Personal exemption		( 4,000)
Taxable income		<u>\$ 97,500</u>

**Tax on \$97,500, single taxpayer is:**

$$\$18,312.50 + [28\% \times (\$97,500 - \$90,750)] = \$20,203$$

- b. Tina would like to lower her tax by incorporating Timely Turn Tables. How much income tax will she save if she incorporates TTT and pays herself a salary of \$40,000?

**If Tina incorporates, only \$40,000 of TTT's taxable income will be taxed on her return. TTT will pay tax on \$40,000 (\$80,000 - \$40,000 salary paid to Tina). This will lower her taxable income to \$57,500 (\$97,500 - \$40,000 taxed to the corporation). Tina's income tax will be \$10,169 { \$5,156.25 + [25% x (\$57,500 - \$37,450)] } and TTT will pay a tax of \$6,000 (\$40,000 x 15%) on its \$40,000 taxable income. The total tax of \$16,169 (\$10,169 + \$6,000) is \$4,034 (\$20,203 - \$16,169) lower than using a sole proprietorship.**

67. For each of the following situations, state whether the taxpayer's action is tax evasion or tax avoidance:

- a. Tom knows that farm rent received in cash or farm produce is income subject to tax. To avoid showing a cash receipt on his records, he rented 50 acres for his choice of 5 steers to be raised by the tenant. He used 2 of the steers for food for his family and gave 3 to relatives. Because he did not sell the livestock, he did not report taxable income.

**Tom's actions would probably be considered tax evasion. Tom knew that farm produce (5 steers) received as rent is income, but he took steps to conceal and not report the income. As a result, he underpaid his income tax.**

- b. Betty applied for and received a Social Security number for Kate, her pet cat. Surprised by how easy it was to get a Social Security number, she decided to claim a dependent exemption on her tax return for Kate. Other than being a cat, Kate met all the tests for a dependent.

**Betty's actions would probably be considered tax evasion. Claiming fictitious dependent deductions is an act often associated with tax protesters. The tax law allows the exemption deduction only for a qualified "individual" which does not include Kate. Betty intentionally claimed a deduction for an amount she knew was not deductible. As a result, Betty underpaid her tax.**

- c. Glen has put money in savings accounts in 50 banks. He knows a bank is not required to report to the IRS interest it pays him that totals less than \$10. Because the banks do not report the payments to the IRS, Glen does not show the interest he receives as taxable income. Although Glen's accountant has told him all interest he receives is taxable, Glen insists that the IRS will never know the difference.

**Glen's actions would probably be considered tax evasion. All income that is not specifically excluded must be reported as income regardless of the amount. Glen had reason to know the interest income was taxable, he took steps to conceal the income and to omit it from his tax return. As a result, Glen underpaid his tax.**

- d. Bob entered a contract to sell a parcel of land at a \$25,000 gain in 2014. To avoid reporting the gain in 2014, he closed the sale and delivered title to the land to the buyers on January 2, 2015.

**Bob's actions are considered tax avoidance and are an acceptable method of planning the timing of income reporting. A sale of land occurs when title passes to the buyer. Bob properly reported the gain in 2015.**

- e. Asha's taxable income for 2015 puts her in the 33% marginal tax bracket. She has decided to purchase new equipment for her business during 2016. A special election allows Asha to treat the \$25,000 of the cost of the equipment as a current period expense. Because she expects to be in a lower tax bracket next year, Asha buys and begins using \$25,000 worth of the equipment during December 2015. She claims a \$25,000 expense deduction under the special election for 2015.

**Asha's actions would be considered tax avoidance. The \$25,000 expense election is available for property placed in service in a trade or business during the year. Asha's decision to purchase the equipment in 2015 to accelerate the tax deduction is an acceptable tax planning technique.**

68. In each of the following situations, explain why the taxpayer's action is or is not tax evasion:

- a. Jamal owns an electrical appliance repair service. When a client pays him in cash, he gives the cash to his daughter, Tasha. Jamal does not report the cash he gives to Tasha in his business income. Tasha has no other income, and the amount of cash that she receives from Jamal is small enough that she is not required to file a tax return.

**Jamal is engaged in tax evasion. Through his direction of the cash to his daughter, he has willfully caused an underpayment of his tax.**

- b. Roberta and Dudley are married. Roberta usually prepares their tax return. However, in 2014 she was in the hospital and unable to prepare the return, so Dudley did it. In preparing their 2015 return, Roberta notices that Dudley included \$1,000 of tax-exempt municipal bond interest in their 2014 gross income. To correct this mistake, Roberta takes a \$1,000 deduction on the 2015 return.

**This would not constitute tax evasion. Roberta is not making an affirmative action to evade taxation. She has incorrectly taken the deduction in the wrong year. She should file an amended return for 2014 and correct the mistake. Honest mistakes do not constitute tax evasion.**

- c. In 2015, Hearthome Corporation receives notice that the IRS is auditing its 2013 return. In preparing for the audit, Hearthome's controller, Monique, finds a mistake in the total for the 2013 depreciation schedule that resulted in a \$5,000 overstatement of depreciation expense.

**This would not constitute tax evasion. Mistakes are often made in totaling schedules and making other calculations. Hearthome has not made an affirmative action to evade taxation. It should file an amended return for 2013 and correct the depreciation error.**

- d. While preparing his tax return, Will becomes unsure of the treatment of a deduction item. He researches the issue and can find no concrete tax law authority pertaining to the particular item. Will calls up his buddy Dan, an accounting professor, for advice. Dan tells Will that if the law is unclear, he should treat the deduction in the most advantageous manner. Accordingly, Will deducts the full amount of the item, rather than capitalizing and amortizing it over 5 years.

**When the tax law is unclear on the treatment of an item, treating the item to the taxpayer's advantage is not tax evasion. Will's act is intentional, but it is done to avoid tax rather than evade tax.**

- e. Sonja is a free-lance book editor. Most companies for which she works pay her by check. In working out the terms of a job, a new client agrees to pay her by giving her a new computer valued at \$3,600. In preparing her tax return, Sonja notes that the client failed to report to the IRS the value of the computer as income for Sonja. Knowing that her chances of getting caught were small, Sonja does not include the \$3,600 value of the computer in her gross income.

**Sonja has engaged in tax evasion. She has willfully acted to cause an underpayment of tax. Playing the "audit lottery" is not tax avoidance, it is tax evasion.**

**ISSUE IDENTIFICATION PROBLEMS**

In each of the following problems, identify the tax issue(s) posed by the facts presented. Determine the possible tax consequences of each issue that you identify.

69. Marla had \$2,100 in state income taxes withheld from her 2015 salary. When she files her 2015 state income tax return, her actual state tax liability is \$2,300.

**The issue is how much tax Marla owes for 2015. Because she has prepaid \$2,100 through withholding, she only pays \$200 (\$2,100 - \$2,300) with her 2015 tax return.**

70. While reading a State College alumni newsletter, Linh is surprised to learn that interest paid on student loans is deductible. Linh graduated from college 2 years ago and paid \$1,200 in interest during the current year on loans that he took out to pay his college tuition.

**The issue is whether Linh qualifies for the interest deduction. Although student loan interest is deductible, there are limitations on the amount of interest that can be deducted. The requirements for deducting qualified student loan interest are discussed in Chapter 6.**

71. Victoria's son needs \$5,000 for tuition at the Motown School of Dance. Victoria, who is in the 33% marginal tax rate bracket, intends to pay the tuition by selling stock worth \$5,000 that she paid \$2,000 for several years ago.

**The issue is whether Victoria should sell the stock or gift it to her son. Gifts are not taxable to either the donor or the donee. The sale of the stock will produce a \$3,000 capital gain. If the stock has been held for more than one year, Victoria will pay a \$450 (\$3,000 x 15%) tax on the gain. Because her son is a student, his marginal income tax rate is likely lower than Victoria's. If his marginal tax rate is either 10% or 15%, then he will pay no tax on the gain (the capital gain rate for taxpayers in the 10% and 15% brackets is zero).**



72. Joey and Camilla are married and have three children, ages 8, 16, and 18. They own a commercial cleaning business that is organized as a sole proprietorship and makes \$140,000 annually. They have \$30,000 of other taxable income (net of allowable deductions).

The issue is what Joey and Camilla can do to decrease their tax liability. They currently pay \$34,652  $\{ \$29,387.50 + [(\$170,000 - \$151,200) \times 28\%] \}$  of income tax on their \$150,000 of taxable income. One option is to incorporate their cleaning business. A corporation pays a 25% marginal tax rate on up to \$75,000 of taxable income. To minimize their taxes, they could have the corporation pay them \$65,000  $(\$140,000 - \$75,000)$  in salary. The corporation's taxable income would be \$75,000 and Camilla and Joey's taxable income would be \$95,000. The total tax liability under this arrangement would be \$29,088, a savings of \$5,564  $(\$34,652 - \$29,088)$ :

Corporate tax on \$75,000	
$\$7,500 + [(\$75,000 - \$50,000) \times 25\%]$	\$13,750
Married, filing jointly tax on \$95,000:	
$\$10,312.50 + [(\$95,000 - \$74,900) \times 25\%]$	15,338
Total tax liability	<u>\$29,088</u>
Tax without incorporation	34,652
Tax savings from incorporation	<u>\$ 5,564</u>

Another tax savings opportunity would be to employ their 16 and 18 year children in the business. Each child could earn up to \$6,300 (standard deduction amount) tax-free. This would reduce the taxable income of either the sole proprietorship or the corporation, resulting in tax savings at either the parent's 28% marginal tax rate (if they continue to use the sole proprietorship) or the corporation's 25% marginal tax rate. Any income they receive above \$6,300 would be taxed at 10%, resulting in additional tax savings. For example, if Camilla and Joey incorporate their business as suggested above and each of the two children are paid \$6,000, the total tax liability would be \$26,088:

Corporate tax on \$63,000 $(\$75,000 - \$6,000 - \$6,000)$ :	
$\$7,500 + [(\$63,000 - \$50,000) \times 25\%]$	\$10,750
Married, filing jointly tax on \$95,000:	
$\$10,312.50 + [(\$95,000 - \$74,900) \times 25\%]$	15,338
Tax on \$6,000 for each child:	
$(\$6,000 - \$6,300) \times 10\% = \$0 \times 2$	0
Total tax liability	<u>\$26,088</u>

73. **INTERNET ASSIGNMENT** The purpose of this assignment is to introduce you to the tax information provided by the Internal Revenue Service on its World Wide Web site (<http://www.irs.gov/>). Go to this site and look at the various types of information provided and write a short summary of what the IRS offers at its site. Chapter 1 discusses the audit and appeals process. Locate Publication 17, Tax Information for Individuals, and find the discussion of the examination and appeals process. Print out the text of this discussion.

**Clicking on "Individuals" provides a list of items, one of which is Publication 17. Click on Publication 17 and a PDF file will open. Scroll down the "Bookmarks" on the left-hand side and then click on "Your Right as a Taxpayer".**

**INSTRUCTOR'S NOTE:** Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

74. **INTERNET ASSIGNMENT** Many legislative, administrative, and judicial resources are available on the Internet. These can be located using a search engine or a tax directory site on the Internet. This assignment is designed to acquaint you with some of the tax directory sites. Go to one of the tax directory sites provided in Exhibit 16-6 (Chapter 16) and describe the types of information you can access from the site. Use at least three links to other sites and describe the information at each of the sites.

**There are eight possible sites from Exhibit 16-6 that the student may use. Each of the sites contain links to federal and state tax information, the IRS (including tax forms), references to articles (help or tips), and various updating information. In addition, the sites contain other information such as links to discussion groups, CPE providers, tax publishers, tax software, on-line tax preparation.**

**INSTRUCTOR'S NOTE:** Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

75. **RESEARCH PROBLEM.** Audrey opened Hardy Consulting Services during the current year. She has one employee, Deng, who is paid a salary of \$30,000. Audrey is confused about the amount of federal unemployment tax she is required to pay on Deng's salary. The state unemployment tax rate is 4%. Audrey has asked you to determine how much federal unemployment tax she is required to pay on Deng's salary. Write Audrey a letter explaining the amount of federal unemployment tax she must pay.

**Sec. 3301 states that the FUTA rate is 6.2%. Sec. 3306(b)(1) limits the maximum amount of wages subject to the FUTA tax to \$7,000. This sets the tax on Deng's salary at a maximum of \$434 (\$7,000 x 6.2%).**

**Sec. 3302(a)(1) provides credits against the tax for contributions paid into state unemployment compensation funds. Section 3302(c)(2) limits the maximum credit rate to 90% of 6% (as specified in Sec. 3302(d), or 5.4%). However, if the amounts are not paid into the state unemployment fund by the due date of the federal return, Sec. 3302(a)(3) limits the credit to 90% of the amount that would have been allowable had the amounts been paid on or before the due date of the return.**

**Assuming that Audrey pays the state unemployment tax before the due date of her federal return, she will receive a credit of 4% on \$7,000 in salary paid to Deng. Therefore, her federal unemployment tax will be \$154 [\$7,000 x (6.2% - 4%)].**

76. **RESEARCH PROBLEM** Shawna earns \$95,000 as a biologist for Berto Corporation. She also consults with other businesses on compliance with environmental regulations. During the current year, she earns \$25,000 in consulting fees. Determine the amount of self-employment tax Shawna owes on her consulting income.

**The question to be resolved is whether Shawna must pay the 12.4% OASDI rate on all of her consulting income. Sec. 164(f) allows the deduction of one-half of self-employment taxes paid. Sec. 1402(a)(2) provides that self-employment income is reduced by one-half the self-employment tax rate ( $1/2 \times 15.3\% = 7.65\%$ ) multiplied by net earnings from self-employment. Therefore, only 92.35% ( $1 - 7.65\%$ ) of net earnings from self-employment is subject to self-employment tax.**

**Shawna's net self-employment income is \$23,088 (\$25,000 x 92.35%). Reg. Sec. 1.1402(b) - 1(b)(2)(ii) indicates that the maximum self-employment income subject to the OASDI tax is the excess contribution base (\$118,500 in 2015) over the wages received by the individual during the year. In this case, Shawna pays the OASDI portion of the self-employment tax on only \$23,500 (\$118,500 - \$95,000) of her net self-employment income. However, Reg. Sec. 1.1402(b) - 1(b)(2)(iii) requires payment of the 2.9% MHI portion of the tax on all net self-employment income (\$23,088 for Shawna). This results in a self-employment tax of \$3,584**

OASDI on \$23,500	- \$23,500 x 12.4%	\$2,914
MHI on \$23,088	- \$23,088 x 2.9%	670
Total self-employment tax		<u>\$3,584</u>

77. **SPREADSHEET PROBLEM** Using the information below, prepare a spreadsheet that will calculate an individual's taxable income. The spreadsheet should be flexible enough to accommodate single and married taxpayers as well as changes in the information provided below. A template to assist the student in solving this problem can be found at [www.cengagebrain.com](http://www.cengagebrain.com).

Number of dependents	2
Salary	\$75,000
Interest	8,000
Deductions for adjusted gross income	2,800
Deductions from adjusted gross income	14,000

**There are many different ways the students can solve this problem. The goal of the assignment is to expose the student to Excel "If Statements". Set forth below is one possible solution.**

**Input Area:**

Filing Status	M
Dependents	2

Salary		\$75,000
Interest		\$8,000
Other Income		\$-0-
<b>Gross Income</b>		<b>\$83,000</b>
Deductions for AGI		\$2,800
<b>Adjusted Gross Income</b>		<b>\$80,200</b>
Itemized Deductions	\$14,000	
or		
Standard Deductions	\$12,600	\$14,000
Personal and Dependency Exemptions		16,000
<b>Taxable Income</b>		<b>\$50,200</b>

**Input Area:**

Filing Status	S
Dependents	2

Salary		75000
Interest		8000
Other Income		0
<b>Gross Income</b>		<b>=SUM(C5:C7)</b>
Deductions for AGI		2800
<b>Adjusted Gross Income</b>		<b>=C8-C9</b>
Itemized Deductions	14000	
or		
Standard Deduction	=IF(B2="S",6300,IF(B2="M",12600,9250))	=IF(B11>B12,B11,B12)
Personal and Dependency Exemptions		=IF(B2<>"M",((1+B3)*4000),((2+B3)*4000))
<b>Taxable Income</b>		<b>=C10-C13-C14</b>

**DISCUSSION CASES**

78.  
a. What is a value-added tax and how does it work?

**A value-added tax (VAT) is a flat tax rate applied to the value added at each stage of production. Under the credit method discussed in the article, as goods are sold the VAT is added to the sales price. Any VAT paid on purchases is credited against the amount charged on sales, and the net amount is payable to the government. For example, assuming a 10% VAT rate, a firm that purchased raw materials costing \$2,000, processed them and sold the resulting product for \$5,000, would have a VAT payable of \$300:**

VAT charged on sales	\$ 5,000 x 10% =	\$ 500
Less: VAT paid on purchases	\$ 2,000 x 10% =	200
Net VAT due		<u>\$ 300</u>

**The purchaser of the goods would have a \$500 credit for VAT paid to be applied against the VAT it charged on the sale of the product. If the purchaser then sold the goods to a retailer for \$9,000, the gross tax would be \$900 which would be reduced to \$400 by the \$500 credit for purchases:**

VAT charged on sales	\$ 9,000 x 10% =	\$ 900
Less: VAT paid on purchases	\$ 5,000 x 10% =	500
Net VAT due		<u>\$ 400</u>

**Assuming that the retailer then sold the goods for \$16,000 plus the 10% VAT (\$17,600 total selling price including the VAT), it would have a net VAT due of \$700:**

VAT charged on sales	\$ 16,000 x 10% =	\$1,600
Less: VAT paid on purchases	\$ 9,000 x 10% =	900
Net VAT due		<u>\$ 700</u>

**The 10% VAT has produced a total tax of \$1,600 (\$200 + \$300 + \$400 + \$700) throughout the life cycle of the goods. Note that consumers will ultimately bear the burden of the VAT because they will not receive any credit for VAT paid.**

- b. Evaluate the rate structures of the two proposed taxes. Are they proportional, progressive, or regressive?

**Because the VAT is a flat rate applied to the tax base (value added at each stage of production), it meets the definition of a proportional tax. However, because the ultimate tax is borne by the consumer, and consumption, as a percent of income, decreases as income rises (higher income taxpayers spend a lower percentage of their total income on items subject to the VAT), the VAT is regressive when the tax is considered as a percentage of total income. This effect can be somewhat mitigated by such actions as exempting "necessities" from the tax (e.g., food, medical care, and so on) or by providing low-income taxpayers an income tax credit that approximates the amount of VAT they would pay on such necessities. In either case, providing exceptions to the system increases the complexity, and consequently, the cost of administering the tax.**

- c. What, if anything, is wrong with Tom's and/or Joe's point of view? Be sure to explain this part in depth.

**Tom's view of the VAT is off the mark. Although it is appealing to think that the VAT is a good way to get the rich to pay their "fair share" of taxes, the tax is generally more of a burden on lower income taxpayers. At Tom's level of income, it is likely that he is spending all that he makes on consumable items that are subject to the VAT. On the other hand, Joe will spend more on consumable items than Tom, resulting in a higher gross VAT paid. However, it is unlikely that Joe will spend all of his income on items subject to the VAT. Therefore, Tom will be paying a higher percentage of his total income in VAT when compared to Joe. In addition, the VAT will not affect Joe as much as Tom, because most VAT systems exempt medical services from the VAT. Therefore, most of the income Joe receives will not have any VAT charged to it, allowing Joe to escape even more of the tax.**

**The income tax increase proposed by Joe would be more effective in increasing Joe's taxes as compared to the one by Tom. At his current level of income Tom pays no income tax; his taxable income is zero [\$40,000 - \$12,600 standard deduction - \$28,000 (7 exemption deductions at \$4,000 per exemption) < \$0]. Therefore, implementing the increased tax rates will not increase Tom's taxes. Even those taxpayers who have modest incomes would experience an increase in tax if the rates are increased as proposed. However, those in the lowest marginal tax rate bracket would only be subject to one 10 percent increment increase, while the highest bracket taxpayers would experience five 10 percent increases. The result (assuming that no corresponding "loophole" deductions are given that high income taxpayers could use to reduce their taxable income) is to add relatively more tax burden to higher income taxpayers than to lower income taxpayers.**

79. Norman and Vanessa are married and have 2 dependent children. This is a summary of their 2014 tax return:

Adjusted gross income	\$100,700
Deductions from adjusted gross income:	
Standard deduction	(12,400)
Exemptions (\$3,950 x 4)	(15,800)
Taxable income	<u>\$ 72,500</u>
Tax liability	<u>\$ 9,968</u>

- a. Assuming that Norman and Vanessa's 2015 adjusted gross income will increase at the 1.7% rate of inflation and that the standard deduction and exemption amounts do not change, calculate their 2015 taxable income. Calculate the tax liability on this income using the 2014 tax rate schedules (Appendix A).

**Norman and Vanessa's 2015 adjusted gross income will increase to \$102,412. With no increase in the standard deduction or the exemption amount, their taxable income will increase to \$74,212. Their tax liability using 2014 rates would be \$10,266:**

Adjusted gross income - \$100,700 x 1.017%	\$102,412
Deductions from adjusted gross income:	
Standard deduction	(12,400)
Exemptions (\$3,950 x 4)	(15,800)
Taxable income	<u>\$ 74,212</u>
Tax liability - \$10,162.50 + [25% x (\$74,212 - \$73,800)]	<u>\$ 10,266</u>

**In 2014, their after tax adjusted gross income was \$90,732 (\$100,700 - \$9,968). With no adjustment for inflation, their after tax adjusted gross income increases by \$1,414 (\$102,412 - \$10,266 = \$92,146 - \$90,732). This is an increase of 1.56% (\$1,414 ÷ \$90,732), which is less than the rate of inflation.**

- b. Calculate Norman and Vanessa's projected 2015 taxable income and tax liability, assuming that their adjusted gross income will increase by 1.7% and that all other inflation adjustments are made. Compare these calculations with those in part a, and explain how the inflation adjustments preserve Norman and Vanessa's after-tax income.

**In 2015, the standard deduction for a married couple increases to \$12,600 and the personal and dependency exemption amount increases to \$4,000. These inflation adjustments reduce Norman and Vanessa's taxable income to \$73,812. The inflation adjusted 2015 rate schedule results in a tax of \$10,149. These inflation adjustments provide Norman and Vanessa with an after tax adjusted gross income of \$92,263 (\$102,412 - \$10,149). This is a 1.7% [(\$92,263 - \$90,732) ÷ \$90,732] increase, which reflects the rate of inflation and the change in the income tax rate. Thus, by adjusting the standard deduction, exemption amount, and tax rate schedules for inflation, Norman and Vanessa's after-tax income has been preserved.**

Adjusted gross income - \$100,700 x 1.017%	\$102,412
Deductions from adjusted gross income:	
Standard deduction	(12,600)
Exemptions (\$4,000 x 4)	(16,000)
Taxable income	<u>\$ 73,812</u>
Tax liability - \$1,845.00 + [15% x (\$73,812 - \$18,450)]	<u>\$ 10,149</u>



**TAX PLANNING CASE**

80. Bonnie is married and has 1 child. She owns Bonnie's Rib Joint, which produces a taxable income of approximately \$120,000 per year.

- a. Assume that Bonnie's taxable income is \$40,000 without considering the income from the rib joint. How much tax will she pay on the \$120,000 of income from the rib joint?

**Bonnie's 2015 total taxable income is determined by adding the \$120,000 of taxable income from the rib joint to her \$40,000 of other taxable income, resulting in a taxable income of \$160,000. The tax on \$160,000 of taxable income for a married couple in 2015 is \$31,852:**

**From Table 1-3 - Married Taxpayers, Filing Jointly Rate Schedule**

$$\begin{aligned}\text{Tax on \$160,000} &= \$29,387.50 + [28\% \times (\$160,000 - \$151,200)] \\ &= \$31,852\end{aligned}$$

The tax on the \$120,000 rib joint income is the difference in the tax they would have paid on the \$40,000 of other income and the tax paid on the full \$160,000. The tax on \$40,000 of taxable income for a married couple in 2015 (from Table 1-3 - Married Taxpayers, Filing Jointly Rate Schedule) is \$5,078 [ $\$1,845 + 15\% \times (\$40,000 - \$18,450)$ ]. Therefore, the tax on the additional \$120,000 of income generated by the rib joint is \$26,774 ( $\$31,852 - \$5,078$ ).

- b. You work for the firm that prepares Bonnie's tax return. Bonnie has asked the partner for whom you work to advise her on how she might lower her taxes. The partner has assigned you this task. Draft a memorandum to the partner that contains at least two options Bonnie could use to lower her taxes. For each option, explain the calculations that support the tax savings from your recommendation.

**Because Bonnie has a business, she should consider incorporating the business and splitting the income from the business between herself and the corporation. Bonnie is currently in the 28% tax bracket. Corporations are taxed at 15% on the first \$50,000 of taxable income and at 25% on income between \$50,000 and \$75,000 (see Table 1-3). Therefore, Bonnie will be able to significantly lower her taxes if she can leave \$75,000 of income in the corporation and have \$45,000 taxed on her individual tax return. The simplest way to accomplish this is to pay herself a salary of \$45,000, which is deductible by the corporation. This will leave the corporation with a taxable income of \$75,000 ( $\$120,000 - \$45,000$ ) and Bonnie will have a taxable income of \$85,000 ( $\$40,000$  other +  $\$45,000$  salary from the corporation). The total tax paid will be \$26,588:**

**Tax on \$75,000 of corporate income :**

\$50,000 x 15%	\$ 7,500
\$25,000 x 25%	6,250
Total corporate tax	<u>\$ 13,750</u>

**Tax on \$85,000 for a married couple -**

\$10,312.50 + [25% x (\$85,000 - \$74,900)]	12,838
Total tax	<u>\$ 26,588</u>

This strategy results in a tax savings of \$5,264 (\$31,852 - \$26,588). Note that if Bonnie shifts more than \$75,000 of income to the corporation it will be taxed at 34%. Her current marginal tax rate is 25%, so she gains no advantage from taking less than \$45,000 in salary from the corporation.

Another strategy that Bonnie should consider is to hire her child and pay the child a reasonable salary. Of course, the child must be employable - old enough and competent to perform the job. If available, this strategy can be used in conjunction with the incorporation strategy to further lower the overall family tax. For example, if Bonnie's child could be employed in a job that pays \$5,000 per year, one strategy would be to reduce Bonnie's salary by the amount paid to her child. This will retain the full advantage of the 25% corporate tax rate and shift \$5,000 of income taxed at Bonnie's 25% marginal tax rate to her child's 10% marginal tax rate (assuming that the child is in the lowest tax bracket). The result will be a total tax of \$25,838 and an additional tax savings of \$750 (\$26,588 - \$25,838):

**Tax on \$75,000 of corporate income:**

<b>\$50,000 x 15%</b>	<b>\$ 7,500</b>
<b>\$25,000 x 25%</b>	<b>6,250</b>
<b>Total corporate tax</b>	<b>\$ 13,750</b>

**Tax on \$80,000 for a married couple:**

$$\text{\$10,312.50} + [25\% \times (\text{\$80,000} - \text{\$74,900})] \quad 11,588$$

**Tax on \$5,000 for a single individual:**

<b>\$5,000 x 10%</b>	<b>500</b>
<b>Total tax</b>	<b><u>\$ 25,838</u></b>

**NOTE:** The shifting of income from Bonnie to her child can be used even if the business is not incorporated. If Bonnie does not wish to incorporate her business, valid employment of her child will reduce the tax on any income shifted to the child by 18% (28% current marginal tax rate - 10% assumed child's tax rate). Thus, a transfer of \$5,000 of income would result in a tax savings of \$900 (\$5,000 x 18%).

**Instructor's Note:** Assuming the child had no other income, the child would be entitled to a standard deduction of \$6,300 and there would be no tax on the child's income. The total tax liability would be \$25,338 (\$13,750 + \$11,588) and the tax savings would be \$500 (\$25,838 - \$25,338). Because the standard deduction for a dependent is not discussed until Chapter 8, the standard deduction is not incorporated into the original solution.

81. Barbara is going to purchase a car for \$20,000. She has two financing options: She can finance the purchase through the dealer at 1 percent for 48 months, with monthly loan payments of \$425, or she can take a \$2,000 rebate on the purchase price and finance the remaining \$18,000 with a 7.5 percent home equity loan whose monthly payment will be \$435. The interest on the home equity loan is deductible; the interest on the dealer loan is not. Barbara is in the 33% marginal tax rate bracket. Determine her best course of action in financing the purchase of the car.

**If Barbara uses the dealer financing, none of the interest she pays is deductible and she will pay a total of \$20,400 ( $\$425 \times 48$ ) for the car.**

**If Barbara uses the rebate and home equity loan financing, her payments will total \$20,880 ( $\$435 \times 48$ ). However, the \$2,880 ( $\$20,880 - \$18,000$ ) of interest on the loan is deductible, resulting in a \$950 ( $\$2,880 \times 33\%$ ) tax savings. This reduces her net outlay to \$19,930 ( $\$20,880 - \$950$ ).**

**Because of the deductibility of the home equity loan interest, Barbara will pay \$470 ( $\$20,400 - \$19,930$ ) less by using the rebate and home equity loan interest financing than if she uses the nondeductible dealer financing.**

**ETHICS DISCUSSION CASE**

82. Return to the facts of problem 67. Assume that you are the CPA in charge of preparing the tax return for each of the taxpayers in the problem. Based on the Standards for Tax Services (which can be found at [www.cengagebrain.com](http://www.cengagebrain.com)), explain what you should do in each case. Your discussion should indicate which, if any, of the eight statements is applicable and your obligations with regard to each applicable statement. If the facts are not sufficient to determine whether a statement applies to a situation, discuss the circumstances in which the statement would apply.

**Parts a, b, and c of problem 67 involve tax evasion and therefore, present ethical issues for the CPA preparing the returns of the taxpayers. The taxpayers in parts d and e are not evading taxes and the CPA can prepare and sign the returns of the taxpayers in those circumstances.**

**In all 3 evasion cases, if the CPA is aware of the evasion behavior, SSTS #1 would apply. This statement would not allow the CPA to prepare or sign a return if the CPA believes that a position taken on the return does not have a "reasonable possibility" of being sustained if challenged. SSTS Interpretation 1-1 states that in order to meet the "reasonable possibility" standard, the CPA must believe, in good faith, that the position is warranted by existing law or can be supported by a good-faith argument that the existing law is incorrect. Because the taxpayers in parts a, b, and c are taking positions on their returns that would not be sustained if audited by the IRS, a CPA with knowledge of those positions should not prepare or sign the returns. The question in each case is whether the CPA would be expected to have knowledge of the evasion. Each of the 3 situations is discussed in turn.**

- a. Tom knows that farm rent received in cash or farm produce is income subject to tax. To avoid showing a cash receipt on his records, he rented 50 acres for his choice of 5 steers to be raised by the tenant. He used 2 of the steers for food for his family and gave 3 to relatives. Because he did not sell the livestock, he did not report taxable income.

**It is quite likely that the CPA preparing the return in this case would not have knowledge of the evasion behavior. SSTS #3 allows the CPA to rely on information furnished by the client. However, if the CPA has reason to believe that the information provided by the client is incomplete or incorrect, reasonable inquiries should be made by the CPA. In this regard, SSTS #3 indicates that prior year's tax returns be referred to whenever feasible. For example, if the CPA had prepared Tom's return in a previous year and Tom had rented the land for cash that had been properly reported on the prior year's return, the CPA should inquire as to why no income from the farm land is being reported this year. However, if the CPA had not prepared the prior year's returns or if Tom has never reported income from the rental of the land, the CPA would not generally be expected to have knowledge of the rental arrangement. SSTS #3 also requires the CPA to make use of other information known to the CPA. In this regard, the statement indicates that the CPA should consider information known to the CPA from the tax return of another client if it is relevant to the return being prepared. This could occur if the CPA also prepares the return of the person who rented the land from Tom. If that return shows a rental deduction and the CPA is aware that the land was rented from Tom, the CPA should consider this information in**

**determining whether Tom has provided complete and correct information.**

- b. Betty applied for and received a Social Security number for Kate, her pet cat. Surprised by how easy it was to get a Social Security number, she decided to claim a dependent exemption on her tax return for Kate. Other than being a cat, Kate met all the tests for a dependent.

**As in part a, the CPA preparing Betty's return is allowed to rely on the information provided by Betty, unless there is reason to believe that the information on Kate is incorrect. If the CPA had prepared the previous year's return, the additional exemption should cause the CPA to inquire about the circumstances of the new dependent. If the CPA had not prepared the prior year return, it is quite likely that the CPA would not have knowledge of Kate's status as a cat and could, in good faith, prepare and sign the return.**

- c. Glen has put money in savings accounts in 50 different banks. Glen knows a bank is not required to report to the IRS interest it pays him that totals less than \$10. Because the banks do not report the payments to the IRS, Glen does not show the interest he received as taxable income. Although Glen's accountant has told him all interest he receives is taxable, Glen insists that the IRS will never know the difference.

**In this case, it appears from the facts (assuming that the CPA preparing the return is the accountant in the facts) that the CPA does have knowledge that the information that Glen is providing is incorrect and should not prepare or sign the return per SSTs #1 and SSTs #3. That is, if Glen had previously inquired about the taxability of interest and then reports no interest in the information given to the CPA, SSTs #3 would require the CPA to review prior year's returns and make other reasonable inquiries about the omission of the interest income. SSTs #1 also requires that a CPA not recommend a position that exploits the IRS audit selection process. The likelihood of the IRS detecting the omission of income is irrelevant to the CPA's obligations under SSTs #1.**

## Chapter 1

### Check Figures

41. a. not a tax. b. not a tax.  
c. not a tax. d. a tax.  
e. not a tax
42. a. not a tax. b. a tax.  
c. not a tax. d. a tax.  
e. not a tax.
43. a. tax = \$20,511.25 b. 28%  
c. 20.93% d. 18.99%
44. a. tax = \$19,671.25 b. tax = \$15,337.50  
c. tax = \$20,550
45. Rory = \$4,590; Latisha = \$9,087
46. a. proportional b. proportional  
c. progressive d. regressive
47. income tax - progressive  
sausage tax - proportional  
property tax - regressive.
48. a. \$918 b. \$174
49. a. \$7,382 b. \$8,126
50. Clinton-\$4,896; Tranh-\$9,087
51. \$18,319
52. Darrell-\$9,160; Whitney-\$18,319
53. a. ordinary income b. ordinary income  
c. gain d. exclusion  
e. ordinary income
54. a. ordinary income b. ordinary income  
c. gain d. ordinary income  
e. exclusion
55. a. related to a business b. related to a business  
c. personal use asset d. capital expenditure  
e. personal expense

56. a. loss of \$1,700  
c. nondeductible expense  
e. deductible expense.
- b. deductible expense  
d. nondeductible capital expenditure
57. taxable income = \$101,500; tax \$21,491.25
58. taxable income = \$92,906; tax \$14,812.50
59. taxable income (from AGI) is greater by \$4,400
60. N/A
61. Saul's tax = \$370
62. 2015 and 2016 marginal tax rates; time value of money
63. net savings from 2016 deduction = \$256
64. 15.0% = 4.89%  
25.0% = 4.31%  
28.0% = 4.14%  
33.0% = 3.85%
65. a. taxable income = \$156,400  
b. tax savings = \$2,706
66. a. taxable income = \$20,203  
b. tax savings = \$4,034
67. a. evasion  
c. evasion  
e. avoidance
- b. evasion  
d. avoidance
68. a. evasion  
c. not evasion  
e. evasion
- b. not evasion  
d. not evasion

## CHAPTER 2

### INCOME TAX CONCEPTS

2016 Edition	Topic	Status
<b>Questions</b>		
1	Income tax as a system	Unchanged
2	Ability-to-pay concept	Unchanged
3	Arm's-length transaction concept	Unchanged
4	Relationship of arm's-length concept and related party construct	Unchanged
5	Pay-as-you-go concept	Unchanged
6	Taxable entity versus conduit entity	Unchanged
7	Tax benefit rule	Unchanged
8	Accounting methods	Unchanged
9	Capital recovery concept/income recognition	Unchanged
10	Basis for calculation of gross income	Unchanged
11	Capital gain versus ordinary income	Unchanged
12	Constructive receipt doctrine	Unchanged
13	Wherewithal-to-pay concept versus ability-to-pay concept	Unchanged
14	Application of business purpose concept to determine deductions	Unchanged
15	Capital expenditures	Unchanged
16	Legislative grace concept/difference in application to income and deductions	Unchanged
17	Capital recovery concept/difference in application to income and deductions	Unchanged
<b>Problems</b>		
18	Ability-to-pay concept - four scenarios	Unchanged
19	Ability-to-pay concept - four scenarios	Unchanged
20-CT	Calculation and comparison of tax paid by single versus married taxpayer/discuss ability-to-pay concept	Unchanged



<b>2016 Edition</b>	<b>Topic</b>	<b>Status</b>
<i>21-CT</i>	Ability-to-pay concept - rationale for difference in tax paid	Unchanged
22	Related parties - individuals, corporations, partnership	Unchanged
23	Related parties - corporations and partnerships	Unchanged
<b>24-COMM</b>	Related party sale - corporations controlled by same individuals	Unchanged
25	Entity concept - segregation of income and expenses	Unchanged
26	Entity concept - segregation of income and expenses	Unchanged
27	Taxation of conduit entities	Unchanged
28	Taxability of corporation versus S corporation	Unchanged
<b>29-COMM</b>	Use of entities	Unchanged
30	Partnership income taxation	Unchanged
31	Assignment of income	Unchanged
<b>32-COMM</b>	Assignment of income	Unchanged
33	Income recognition - cash versus accrual	Unchanged
34	Income recognition - cash versus accrual	Unchanged
35	Tax benefit rule with an application of state tax refund	Unchanged
36	Tax benefit rule	Unchanged
37	Substance-over-form application to a loan	Unchanged
38	Identification of concepts with actual tax treatments	Unchanged
39	Identification of concepts with actual tax treatments	Unchanged
40	Calculation of gain/loss on sale of depreciable assets	Unchanged
41	Long-term capital gains	Unchanged
42	Capital losses - effect of annual limitation	Unchanged
43	Realization concept - four scenarios	Unchanged
44	Realization concept - four scenarios	Unchanged
<i>45-CT</i>	Claim of right	Unchanged

<b>2016 Edition</b>	<b>Topic</b>	<b>Status</b>
46	Claim of right - four scenarios	Unchanged
47	Claim of right - four scenarios	Unchanged
48	Constructive receipt - contrasting treatments	Unchanged
49	Constructive receipt - three scenarios	Unchanged
50	Realization-provide rationale for five scenarios	Unchanged
51-CT	When should income be recognized	Unchanged
52	Income recognition - provide rationale for four scenarios	Unchanged
53	Mixed-use expenditures -home office	Unchanged
54	Deduction concepts - provide rationale for four scenarios	Unchanged
55	Deduction concepts - provide rationale for four scenarios	Unchanged
<b>56-COMM</b>	Business purpose	Unchanged
57	Differences in treatment of expenses/business versus personal	Unchanged
58-CT	Differences in treatment of personal/ investment/ business loss	Unchanged
59	Calculation of loss on casualty/effect on basis	Unchanged
60	Capital expenditures - four scenarios	Unchanged
61	Basis - four scenarios	Unchanged
62-CT	Timing of deductions - cash versus accrual	Unchanged
IID-63	Related parties - effect of transactions	Unchanged
IID-64	Application of entity concept and related parties to 100% owned corporation	Unchanged
IID-65	Assignment of income/substance-over-form	Unchanged
IID-66	Deductibility of expenses – substance over form	Unchanged
IID-67	Income realization	Unchanged
IID-68	Claim of right	Unchanged
IID-69	Constructive receipt	Unchanged

<b>2016 Edition</b>	<b>Topic</b>	<b>Status</b>
IID-70	Deductibility of mixed-use expenses	Unchanged
IID-71	Mixed-use expenditures - vacation home	Unchanged
72	RIA Research Exercise	Unchanged
73	RIA Research Exercise	Unchanged
74	INTERNET	Unchanged
75	INTERNET	Unchanged
76	Research Problem	Unchanged
77	Research Problem	Unchanged
78-TFP	Tax Forms Problem – Preparation of 1040EZ	Unchanged
79-DC	Deductibility of oil restoration costs/compare financial accounting with tax accounting	Unchanged
80-TPC	Substance-over-form application to sale of property	Unchanged
81-TPC	A 3-year projection of the tax effect of using a corporation versus a partnership for a new business	Unchanged
82-EDC	Possible under reporting of S corporation income - application of SSTs #3 and SSTs #1	Unchanged

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## CHAPTER 2

### INCOME TAX CONCEPTS

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#### DISCUSSION QUESTIONS

1. This chapter compared the operation of the income tax system with the operation of other systems we have devised to govern our everyday lives. Choose an example of a system you deal with in your everyday life, and explain part of its operation in terms of concepts, constructs, and exceptions to the general concepts and constructs.

**There are several possibilities for student response to this problem. The key point is that they identify a system, a concept underlying the system with a related construct, and an exception to the concept. For example, the University Library operates under the general concept that everyone should have access to the materials in the library. A construct related to this concept is that some materials may be checked out for a period of time (two weeks for example), while other types of materials may not be checked out at all (the exception to the construct). Another exception to the check-out rules may be made for faculty: faculty may have longer check-out periods and may be able to check out materials that other users cannot.**

2. The chapter stated that the ability-to-pay concept is fundamental to the operation of the income tax system. What is the ability-to-pay concept, and what two basic aspects of the income tax system are derived from the concept? What might the tax system be like without this concept?

**The ability-to-pay concept states that the tax paid should be related to the amount that the taxpayer has to pay the tax. This concept is implemented by using taxable income (income net of deductions) as the tax base for figuring the tax. This gives recognition to differing levels of income as well as differing levels of deductions by each taxpayer. The second aspect is the use of progressive tax rates in the calculation of the tax. This rate structure imposes lower tax rates on lower income levels while taxing higher levels of income at higher rates.**

**Without this concept, the income tax could be very different. First, a different tax base could be used, such as a tax on all income received. In addition, the tax rate structure might not be progressive. For example, a tax on all income received might be subject to a single tax rate (proportional tax structure).**

3. What is an arm's-length transaction? What is its significance to income taxation?

**An arm's-length transaction is one in which the parties to the transaction bargain in good faith for their individual benefit, not for the mutual benefit of the group. That is, the price of the transaction is a fair market value.**

**The importance for income taxation is that transactions not made at arm's-length are usually not given their intended tax effect. This has led to the related party rules which define situations in which entities do not bargain at arm's-length. Special rules for transactions between related parties have been developed to discourage such transactions.**

4. Explain how the related party construct and the arm's-length transaction concept interact.

**Related parties are defined as certain relatives (children, parents, grandparents) and other relationships in which one party controls the action of the other party (e.g., greater than 50% ownership of a corporation). In such cases, there is an incentive to cooperate to structure transactions that have favorable tax effects for the transaction group (i.e., related parties may enter into transactions that they would not otherwise enter into with an unrelated party). Because of this potential for structuring transactions that could lead to abuse, *related parties are deemed not to transact at arm's-length.***

5. Why is the pay-as-you-go concept important to the successful operation of the income tax system? What other types of taxes are based on this concept?

**Because the U.S. income tax system is based on voluntary compliance, it is important that the system have features that encourage compliance. By having amounts withheld from a taxpayer's income as it is earned and requiring a taxpayer not subject to withholding to make estimated tax payments, the system encourages taxpayers to file returns. That is, without such a requirement, taxpayers would face very large tax payments when filing their annual returns. Many taxpayers could not afford to make such a large lump-sum payment, leading to an incentive either to not file, or to greatly understate their income. The pay-as-you-go system leaves taxpayers with either a relatively small amount of tax due or a refund of a portion of their prepaid taxes. This encourages taxpayers to file their returns and report the correct amount of income.**

**The most familiar type of tax that is based on the same concept is the sales tax. State income taxes and Social Security/Self-Employment taxes are also subject to withholding and estimated payment requirements. In addition, other types of user taxes are typically collected at point of sale. This would include gasoline taxes, taxes on luxury autos, and utility taxes.**

6. What is the difference between a taxable entity and a conduit entity?

**A taxable entity is an entity that must pay tax on its income. The two primary taxable entities are individuals and corporations. The owners of a corporation do not pay the income tax on the corporation's taxable income. However, the owner's are taxed when the corporation distributes income, in the form of dividends, to the owners.**

**A conduit entity is a tax reporting entity that reports its results to the government, but does not pay tax on its income. Rather, the conduit entity's income flows through to its owners, who report their share of the conduit entity income on their returns. Thus, the owners of the conduit entity pay the tax on the conduit's income, not the conduit entity.**

7. Why is the tax benefit rule necessary? That is, which concept drives the need for this construct? Explain.

**The tax benefit rule is necessary because of the annual accounting period concept requirement that the events of each tax year are to stand alone. Because prior year's returns are generally not subject to adjustment under this concept, there is a need for a construct to determine the proper treatment of items previously deducted that are recovered in a subsequent year.**

8. What are the two basic methods of accounting that may be used by taxpayers? How do the two basic methods differ?

**The two basic accounting methods that are acceptable for tax purposes are the cash method and the accrual method. The basic difference between the two methods is the criteria used to determine the timing of the recognition of income and expenses.**

**The cash method recognizes income when cash or its equivalent is received. Expenses are deducted when they are paid. That is, it is basically a cash flow system (although capital expenditures cannot be deducted in total in the period in which they are paid).**

**The accrual method recognizes income when it is earned (the receipt of cash or its equivalent is not a factor). Expenses are deducted when all events have occurred that fix the liability for the payment and the amount of the payment can be reasonably estimated. The payment of the expense is not a factor for accrual basis taxpayers.**

9. What is the effect of the capital recovery concept on income recognition?

**The capital recovery concept states that no income is recognized until all capital invested in an asset has been recovered. Thus, when assets are sold, no income results unless the sales price is greater than the capital invested in the asset. If the sales price is less than the amount of capital invested, then the taxpayer has sustained a loss. The amount of the loss is equal to the capital that was not recovered through the disposition of the asset.**

10. Chapter 1 discussed how gross income is equal to all income received, less exclusions. Which concepts form the basis for this calculation of gross income? Explain.

**The all-inclusive income concept provides that all income received is taxable. The legislative grace concept allows Congress to provide relief from taxes through exclusions and deductions. Thus, the calculation of gross income is a combination of the two concepts.**

11. What is capital gain income? How is it different from ordinary income?

**Capital gain income (loss) results from the sale or other disposition of a capital asset. For individuals, capital assets consist of stocks, bonds, other investment assets, and personal use property.**

**Net long-term capital gains of individuals are given special treatment – generally, the tax rate on a net long-term capital gain is 15%. Net capital loss deductions are limited to \$3,000 per year for individuals. Corporations are only allowed to deduct capital losses against capital gains.**

12. Why does the doctrine of constructive receipt apply only to cash basis taxpayers?

**The constructive receipt doctrine is used to determine when a taxpayer has received income. This is critical for the cash basis taxpayer who recognizes income when it is received.**

**An accrual basis taxpayer recognizes income when the income has been earned. Recognition is not contingent upon receipt of the income. Therefore, the constructive receipt doctrine does not affect income recognition by accrual basis taxpayers.**

13. How is the wherewithal-to-pay concept different from the ability-to-pay concept?

**The ability-to-pay concept is a general concept that states that each taxpayer should pay a tax based on his or her ability to be able to pay the tax. That is, those taxpayers with the most income should pay relatively more tax. This concept leads to such things as progressive rate schedules, exemption deductions, etc., that are system-wide applications.**

**The wherewithal-to-pay concept is an income recognition concept. It states that the tax on an income item should be levied in the period in which the taxpayer has the means to pay the tax. It overrides accounting methods and other concepts (realization) and requires recognition of income items in the period that the taxpayer has resources from the transaction to pay the tax. Thus, the concept is applied to specific transactions and is not a system-wide application.**

14. Explain how the business purpose concept provides the basis for determining which expenses are deductible.

**To deduct an expenditure, the business purpose concept requires that the expenditure have a business or economic purpose that exceeds any tax avoidance motive. A business or economic purpose is one that involves a profit-seeking activity. The tax law embodies this concept by allowing the deduction of trade or business expenses and production of income expenses (i.e., investment expenses), both of which involve profit-seeking activities. Personal expenditures (except those specifically allowed as itemized deductions) and expenditures that are primarily motivated by tax avoidance are not deductible.**

15. What is a capital expenditure?

**A capital expenditure is any expenditure that benefits more than one annual accounting period. That is, the usefulness of the expenditure extends substantially beyond the end of the tax year in which the expenditure is made. Because of the multi-period benefit, capital expenditures generally are not deductible in full in the period they are paid or incurred. Rather, they must be capitalized as an asset and allocated to the periods of benefit. Common capital expenditures include fixed asset purchases (e.g., land, buildings, equipment), prepaid expenses, and purchases of securities.**

16. The legislative grace concept is both an income concept and a deduction concept. Explain how the application of the concept differs for income items and deduction items.

**The legislative grace concept states that any tax relief provided is the result of a specific act of Congress that must be strictly applied and interpreted. Exclusions from income and deduction allowances are both forms of tax relief and therefore, result from the legislative grace concept.**

**The difference in the application of the concept to income and deduction items is the approach taken in analyzing what is included in income and what is deductible. The all-inclusive income concept states that all income received (earned) is taxable absent some specific provision in the tax law exempting it from tax. Thus, the approach to income is to assume that everything is taxable and to look for those provisions that exclude income from tax (i.e., where legislative grace has provided tax relief).**

**Deductions are just the opposite. The business purpose concept states that an expenditure must have a profit motive in order to be deductible. Therefore, when approaching deductions, the assumption is that items are not deductible and specific provisions must be found that allow the deduction (i.e., where legislative grace has provided tax relief).**

17. The capital recovery concept is both an income concept and a deduction concept. Explain how the application of the concept differs for income items and deduction items.

**The capital recovery concept states that there is no income until all capital invested has been recovered. The income side of the concept allows the recovery of capital investment against the selling price of assets in determining the amount of income (loss) from the disposition of assets.**

**The deduction side of the concept is a limit on the amount of the deduction. Because income results from an excess of income over expenses, the maximum amount of any deduction is the amount of capital invested in the deduction. Therefore, expenses are deducted at their cost to the taxpayer, not at some other value (e.g., replacement cost, current market value).**



**PROBLEMS**

18. Which of the following are based on an ability to pay? Explain.

- a. State Y collects a sales tax of 5% on all purchases of goods and services.

**A flat rate tax on the purchase of all goods and services is not a tax that is based on the amount that the taxpayer can afford to pay. It is based on the taxpayer's consumption of goods and services, which is not specifically tied to income levels. That is, there is some minimum level of purchases that all taxpayers incur, regardless of their income level.**

- b. State X collects a sales tax of 5% on all purchases of goods and services but gives low-income families a tax credit for sales taxes.

**The use of a tax credit for low income families would make the sales tax less regressive. Properly constructed, such a tax credit could move the sales tax closer to a tax based on a taxpayer's ability to pay.**

- c. Students at State University are given free parking in designated lots. Faculty and staff members must pay \$125 per year for parking at State University.

**The fee structure is based somewhat on ability to pay regarding students versus faculty and staff. However, within each of these categories various individuals would have greater ability to pay than others. For example, the University President would have a greater ability to pay than a maintenance worker. Thus, the tax is not totally based on ability to pay.**

- d. Barton City charges all customers a flat monthly rate of \$10 for garbage pickup.

**Flat rate charges without regard to income levels are not based on ability to pay. All taxpayers pay the fee without regard to their income level.**

19. Which of the following are based on an ability to pay? Explain.

- a. Local County assesses property taxes at the rate of 1% of assessed value.

**Because the property tax is based on the value of the property and is not related to the taxpayer's income, it is not based on each taxpayer's ability to pay the tax. If it is assumed that there is a correlation between the value of a taxpayer's property and his/her income, then the tax takes on the features of a proportional tax. However, proportional taxes do not consider ability to pay because each taxpayer pays the same rate based on his/her income.**

- b. The university library lets all students, faculty, and staff members check out books free. Students who do not return books by the due date are fined \$1 for each day the book is late. Staff members are fined 50 cents for each day a book is late. Faculty members are not fined when they return books late.

**The book fines are not based on ability to pay. Under this fine structure, those with the least ability to pay, students, pay more than those with the greatest ability to pay, faculty.**

- c. The country of Lacyland assesses an income tax based on the following schedule:

Taxable Income	Income Tax
\$ -0- to \$20,000	20% of taxable income
\$ 20,001 to \$60,000	\$ 4,000 + 15% of taxable income in excess of \$20,000
\$ 60,001 and above	\$10,000 + 10% of taxable income in excess of \$60,000

**This is a regressive tax rate structure - the marginal tax rate is declining as income is increasing (average tax rate is greater than the marginal tax rate). Although higher income taxpayers are paying more tax, they are paying at a lower tax rate. The tax is not based on ability to pay because higher income taxpayers are presumed to be able to pay tax at a higher marginal rate than those with lower incomes.**

- d. State Z imposes a 10-cent-per-gallon tax on gasoline but gives low-income taxpayers a tax credit for gasoline taxes paid.

**A 10-cent per gallon gasoline tax is a proportional tax. Proportional taxes do not consider ability to pay because all taxpayers pay the same tax rate. Giving low income taxpayers a tax credit for the taxes they pay provides a rate differential between high and low income taxpayers and makes the tax at least partially based on ability to pay. However, for the range of taxpayers who do not get credit for the gasoline tax they pay, the tax is not based on ability to pay. Very high income taxpayers will pay the same tax rate as high income taxpayers.**

20. Sheila, a single taxpayer, is a retired computer executive with a taxable income of \$100,000 in the current year. She receives \$30,000 per year in tax-exempt municipal bond interest. Adam and Tanya are married and have no children. Adam and Tanya's \$100,000 taxable income is comprised solely of wages they earn from their jobs. Calculate and compare the amount of tax Sheila pays with Adam and Tanya's tax. How well does the ability-to-pay concept work in this situation?

**Sheila's tax is \$21,071. Adam and Tanya's tax is \$16,588.**

**Single rate schedule:**

**Sheila    \$18,481.25 + [28% x (\$100,000 - \$90,750)] = \$21,071**

**Married rate schedule:**

**Adam & Tanya    \$10,312.50 + [25% x (\$100,000 - \$74,900)] = \$16,588**

**The difference in the tax rate schedules for single and married taxpayers reflects the greater ability to pay tax by single taxpayers at the same income level as married taxpayers. However, in this case, the rate schedules do not adjust for the difference in economic incomes. Sheila's economic income is \$130,000 (\$100,000 taxable income + \$30,000 tax-exempt income). Her effective tax rate on this income is 16.21% (\$21,071 ÷ \$130,000) versus a 16.59% (\$16,588 ÷ \$100,000) effective tax rate on Adam and Tanya's economic income. Therefore, even though the tax rate structures reflect the ability-to-pay concept, other provisions in the tax law that exclude items from income serve to negate the effect of the tax rate structures.**

21. Andrew and Barbara each receive a salary of \$80,000. Neither Andrew nor Barbara has any other source of income. During the current year, Barbara paid \$800 more in tax than Andrew. What might explain why Barbara paid more tax than Andrew when they both have the same income?

**Factors that could cause taxpayers with the same amount of income to pay different amounts of tax are:**

- 1. Marital Status - If one taxpayer is married and the other is single, the single individual will pay more tax on the same amount of income than a married couple.**
- 2. Deductions - If one taxpayer has more allowable deductions, then he or she will pay less tax on the same total income. This could be the result of either one taxpayer having strictly more deductible items, or one taxpayer itemizing their allowable personal deductions and the other taking the standard deduction.**
- 3. Dependents - If one taxpayer has more dependents than the other taxpayer, then his or her taxable income will be less by the amount of the additional exemptions, resulting in less tax paid.**
- 4. Tax Credits - If one taxpayer has tax credits that the other does not (or more than the other), then his or her tax will be less.**

22. Which of the following are related parties:

**Related parties are defined to include members of an individual's family (ancestors, lineal descendants, and brothers and sisters) and entities in which the taxpayer effectively owns more than a 50% interest.**

a. Harvey and his sister Janice?

**A sister is a related party.**

b. Harvey and the Madison Partnership? Harvey owns a 60% interest in the partnership. Three of Harvey's friends own the remaining partnership interest.

**Because Harvey owns more than 50% of partnership, he and the Madison Partnership are related parties.**

c. Harvey and his grandfather Maurice?

**A grandfather is an ancestor; Harvey and Maurice are related parties.**

d. Harvey and Noti Corporation? Harvey owns 40% of Noti Corporation. Three unrelated parties own 20% each.

**Harvey does not own (directly or indirectly) more than 50% of the corporation; Harvey and Noti are not related parties.**

e. Harvey and his uncle Elmer?

**An uncle is not a related party; Harvey and Elmer are not related parties.**

23. In each of the following cases, determine whether Inez is a related party:

- a. Inez owns 500 shares of XYZ Corporation's common stock. XYZ has 50,000 shares of common stock outstanding.

**Inez and XYZ are not related parties. For a corporation to be a related party, the taxpayer must own more than 50% of the stock of the corporation. In this case, Inez owns only 1% ( $500 \div 50,000$ ) of XYZ Corporation.**

- b. Inez owns a 40% interest in the Tetra Partnership. The other 60% interest is owned by 3 of Inez's friends.

**Inez and Tetra are not related parties. For a partnership to be a related party, the taxpayer must own more than a 50% interest in the partnership. In this case, Inez owns 40%. She is not deemed to own the partnership interests of her friends.**

- c. Inez owns 40% of the stock in Alabaster Company. Her husband, Bruce, owns 30% and her brother-in-law, Michael, owns the remaining 30%.

**Inez and Alabaster are related parties. For a corporation to be a related party, the taxpayer must own (directly or indirectly) more than 50% of the stock of the corporation. In this case, Inez owns 40% and her husband owns 30%, for a combined ownership of 70%. Because Inez and her husband are related parties, Inez is deemed to own the stock of her husband for purposes of determining related party relationships.**

- d. Inez is a 100% owner of Nancy Corporation.

**Inez and Nancy are related parties. For a corporation to be a related party, the taxpayer must own more than 50% of the stock of the corporation. In this case, Inez owns 100% of Nancy Corporation.**

24. Doiko Corporation owns 90% of the stock in Nall, Inc. Trebor owns 40% of the stock of Doiko. Trebor's sister owns the remaining 60% of Doiko. During the current year, Trebor purchased land from Nall for \$43,000. Nall had purchased the land for \$62,000. Write a memorandum to the controller of Nall, Inc., explaining the potential tax problem with the sale of the land to Trebor.

**Doiko Corporation and Nall, Inc. are related parties because Doiko owns more than 50% of the stock in Nall. Although Trebor directly owns only 40% of Doiko, he is deemed to own his sister's Doiko shares for purposes of the related party rules. Therefore, Trebor is deemed to control Doiko, which controls Nall. This makes Trebor and Nall related parties. Because the sale to Trebor results in a \$19,000 loss, Nall will not be allowed to deduct the loss because Trebor is a related party. The substance of the transaction is a sale at fair market value (unknown in the facts), with the difference being a dividend payment to Trebor. For example, assume the fair market value of the land is \$72,000. The \$29,000 (\$72,000 - \$43,000) difference in the price Trebor pays for the land is assumed paid to Trebor by Nall. A payment by a corporation to a shareholder is a dividend. Thus, Nall would have a \$10,000 gain on the sale and Trebor would have \$29,000 of dividend income.**

25. Ed runs an auto repair business out of the garage attached to his personal residence. How should he account for each of the following items?

**Under the entity concept, Ed must segregate the income and expenses associated with his auto repair business from those that are personal. The importance of this segregation is that all trade or business expenses are deductible for adjusted gross income, while most personal expenditures are not deductible. Those personal expenditures that are deductible must be deducted from adjusted gross income (itemized deduction).**

- a. Cash received from repair services, \$28,000.

**The \$28,000 is income from his business and is included in gross income from the auto repair business.**

- b. Interest paid on his home mortgage, \$7,300.

**Because the garage is attached to his personal residence, Ed will have to allocate a portion of the interest paid to the garage for deduction as a business expense. The remaining interest is deducted on his individual return as home mortgage interest, provided that he has enough deductions to itemize. The allocation can be made on any reasonable basis; however the use of square footage is probably the best allocation basis for household expenses.**

- c. Power jack hoist purchased at a cost of \$12,000.

**This is a business capital expenditure and must be capitalized and depreciated over its tax life.**

- d. Electricity bills, \$3,600. (Ed does not have separate electricity service to the garage.)

**As with the mortgage interest, Ed will have to make an allocation of the electrical cost attributable to the garage. The personal portion of the electric bill is not deductible on Ed's individual return.**

- e. Checks received from customers that were returned by his bank, \$1,600. The bank charged Ed's account \$35 for processing the bad checks.

**Assuming that Ed is a cash basis taxpayer and the checks all relate to the current year, he would not have to report the \$1,600 of bad checks as income because he does not have control over the income. If any of the \$1,600 had been reported as income in the previous year, Ed would be able to take a deduction for any income recognized that he was unable to collect in the current year. The bank charge would be deductible as a business expense.**



- f. Telephone bill for phone in the garage, \$420. (Ed has a separately listed phone in his house.)

**Fully deductible as a business expense because Ed has a separate personal phone line.**

- g. Advertising in the local newspaper, \$800

**The advertising cost is deductible as a business expense.**

- h. Interest paid on home furniture loan, \$600

**Not deductible. Personal interest, other than that on a home mortgage (or a home equity loan), is not deductible.**

26. Jie owns a lawn mower repair business. Her repair shop is in a building she constructed on the lot on which her personal residence is located. How should Jie account for each of the following?

**Under the entity concept, Jie must segregate the income and expense items related to her repair business from those that are personal. The importance of this segregation is that all trade or business expenses are deductible for adjusted gross income, while most personal expenditures are not deductible. Those personal expenditures that are deductible must be deducted from adjusted gross income (itemized deduction).**

- a. Interest paid on her home mortgage, \$9,200. Interest of \$4,000 is paid on a separate loan that she used to construct the repair shop.

**The \$4,000 is deductible as a business expense. The \$9,200 of home mortgage interest is deductible as an itemized deduction.**

- b. Property taxes, \$1,800.

**Because her repair shop is on the same premises as her personal residence, the property taxes must be allocated between the personal residence and the repair shop. The portion allocated to the repair shop is deductible as a business expense. The remaining property tax is deductible as an itemized deduction. The allocation can be made on any reasonable basis; however, the use of the square footage of the respective properties is a commonly used allocation method.**

- c. Electricity bills, \$3,800. (Jie is not billed separately for electricity service to her repair shop.)

**That portion of the electricity bill that is attributable to the repair shop is a deductible business expense. The personal portion is not deductible. Because she is not billed separately for service to the repair shop, Jie must make a reasonable allocation of the electricity cost between the repair shop and her personal residence.**

- d. Cost of remodeling the kitchen, \$3,200.

**The kitchen is a personal use asset. The cost of the remodeling is not deductible. However, because the remodeling is a capital expenditure, the \$3,200 cost is added to the basis of the house.**

- e. Telephone bills, \$970. Jie uses one telephone number for her residence and her business. The cost of having an extra line to the shop is \$30 per month. The \$970 includes a charge of \$250 for an ad in the business section of the telephone directory.

**Telephone costs related to the repair business are deductible business expenses. Personal telephone costs are not deductible. The \$30 per month line charge to the shop is allocated to her business. The \$250 ad cost is a deductible business expense. Any long-distance calls that are business related are deductible business expenses.**

- f. Cost of operating her van for one year, \$7,800. Jie uses the van in her repair business and for personal use.

**The cost that is attributable to business use is a deductible business expense. The personal use cost is not deductible. Jie must make a reasonable allocation of the \$7,800 between her business and personal use. The most common allocation basis for automobile costs is number of miles driven for each purpose.**

27. Aiko, Lani, and Charlie own the 3-Star Partnership, sharing profits and losses 20:50:30. During the current year, 3-Star has total gross income of \$500,000 and total allowable deductions of \$300,000. How should each of the following taxpayers account for 3-Star's results? Explain.

**Partnerships are conduit entities. The partnership does not pay tax on its income. Each partner is allocated their share of the partnership income for inclusion on their individual tax return.**

- a. 3-Star Partnership

**3-Star will report the \$200,000 ( $\$500,000 - \$300,000$ ) of income to the partners; it will not pay any tax on the \$200,000.**

- b. Aiko

**Aiko must include \$40,000 ( $\$200,000 \times 20\%$ ) of income from the partnership on her personal income tax return.**

- c. Lani

**Lani must include \$100,000 ( $\$200,000 \times 50\%$ ) of income from the partnership on her personal income tax return.**

- d. Charlie

**Charlie must include \$60,000 ( $\$200,000 \times 30\%$ ) of income from the partnership on his personal income tax return.**

28. Wendy owns 20% of the common stock of Britton Company. During the current year, Britton reported a taxable income of \$90,000 and paid \$40,000 in cash dividends. What are the income tax effects for Wendy of her investment in Britton Company if Britton is organized as

a. A corporation?

**A corporation is a taxable entity. Therefore, Britton Company must pay tax on the \$90,000 of taxable income. Amounts paid to shareholders as cash dividends are taxable to the shareholders. Wendy will receive \$8,000 ( $\$40,000 \times 20\%$ ) of taxable dividends that she will report as income on her tax return. Note that the \$40,000 in dividends is taxed twice — once as part of corporate taxable income and a second time when the earnings are distributed to shareholders.**

b. An S corporation?

**An S corporation is a conduit entity. The S corporation does not pay any tax on its income. Each shareholder includes their proportionate share of the S corporation income on their return. In this case, Wendy has \$18,000 ( $\$90,000 \times 20\%$ ) of income that she reports on her tax return. Dividends paid to owners of conduit entities are not taxed to the owners. They are considered to be returns of investment. Therefore, Wendy is not taxed on the \$8,000 of cash dividends received. The \$18,000 of income recognized is added to her basis in the stock and the \$8,000 of dividends received is deducted from her stock basis as a capital recovery.**

29. Binh owns several businesses. The total income generated by all his businesses puts him in the highest marginal tax bracket. Seeking to lower the overall tax on his business income, Binh is thinking of creating two S corporations and putting half his business interests in each. Will this arrangement lower his overall tax? Write a letter to Binh in which you explain the tax effects of organizing his businesses as two S corporations. In your letter, suggest an alternative plan that might lower his tax.

**Splitting his business income into two separate S corporations will not produce any tax savings because S corporations are conduit entities. As such, the income from each S corporation will flow through the corporation and be taxed to Binh. Therefore, Binh's taxable income will remain the same.**

**One possible way for Binh to take advantage of marginal tax rate differentials is to organize his businesses into a single corporation (not an S corporation) and pay himself a salary. The salary will be income for Binh and deductible by the corporation. This will split the income into two taxable streams - Binh at individual rates and the corporation at corporate rates. Because corporations are taxed at lower rates than individuals on up to \$75,000 of income, an optimal planning strategy will set Binh's salary such that the corporate taxable income is \$75,000 with the remaining income taxed to Binh.**

**Another option at this point in the text would be to split the business into two corporations and realize the marginal rate savings as with a single corporation. However, the parent/subsidiary and brother/sister corporation rules which collapse the income of such corporations and tax them as a single entity will operate to negate any additional tax savings over that of using a single corporation. The aspects to be considered in using corporations to split income are covered in Chapter 13 and 14.**

30. Christie purchases a one-third interest in the Corporate Capital Partnership (CCP) in 2014 for \$40,000. During 2014, CCP earns an income of \$90,000, and Christie withdraws \$30,000 in cash from the partnership. In 2015, CCP suffers a loss of \$30,000, and Christie withdraws \$10,000. What are the tax consequences for Christie of this investment in 2014 and 2015?

**Christie will include her share of the partnership income, \$30,000 (\$90,000 x 1/3), on her individual return in 2014 and deduct her share of the partnership loss, \$10,000 (\$30,000 x 1/3) in 2015. The cash withdrawals do not affect the taxability of the income from the partnership. It should be noted that Christie may not be able to deduct the loss in 2015 if the activity is considered passive. The limitations on passive loss deductions are covered in Chapter 7.**

31. Arnie is a self-employed handyman. During the current year, customers pay him \$10,000 in cash for his services. Arnie gives the \$10,000 to his daughter, Ariel, who uses it to pay college expenses. Is Arnie or Ariel taxed on the \$10,000? Explain.

**Under the assignment of income doctrine, Arnie is taxed on all income that he earns, regardless of whether he gives the cash to his daughter. The amounts he gives to his daughter are gifts which are not subject to tax. Arnie is in actual receipt of the cash that he earned and therefore, he is taxed on the cash income.**

32. Esmeralda is an attorney. Before 2015, she is employed by the law firm of Ellis and Morgan (E&M). Esmeralda is not a partner in E&M; her compensation consists of a fixed salary and a percentage of any fees generated by clients she brings or refers to the firm. In January 2015, she becomes a partner in the law firm of Thomas, Gooch, and Frankel (TGF). As a partner, Esmeralda agrees to turn over to TGF any income from the practice of law from the date of her admittance to the practice. In leaving E&M, it is agreed that she will continue to receive her percentage of fees from clients she referred to E&M during her employment there. In return, Esmeralda agrees that, upon request she will consult with E&M attorney's regarding these clients. During 2015, she consults with 2 of her former E&M clients and receives \$12,000 from E&M per their agreement. The \$12,000 consists of \$10,000 as a percentage of fees for client referrals after she left E&M and \$2,000 as a percentage for work done before she left E&M. Esmeralda turned the \$12,000 over to TGF per her partnership agreement. Write a letter to Esmeralda explaining whether she is taxed on the \$12,000 she receives from E&M.

**As a partner of TGF, Esmeralda is entitled to her share of the partnership income per the partnership agreement. Any amounts she earns after entering the TGF partnership are properly considered to be partnership income. The question to be resolved regarding the \$12,000 payment is whether the assignment of income doctrine applies. That is, if the \$12,000 is an amount that she had earned prior to entering the partnership, she cannot escape taxation by assigning the payment to TGF. On similar facts in *Schneer*, 97 T.C. 643 (1991), the Tax Court held that the \$2,000 payment for work done prior to leaving E&M had been earned before entering the TGF partnership and was taxable to Esmeralda per the assignment of income doctrine. The \$10,000 in fees received for client referrals after leaving E&M were held to have not been earned by Esmeralda prior to leaving E&M and were taxable to the TGF partnership.**

33. For each of the following situations determine the proper year for recognition of the income or deduction if the taxpayer is (1) a cash basis taxpayer and (2) an accrual basis taxpayer:

- a. Tindle Corporation purchases office supplies costing \$600 on December 21, 2015. Tindle pays for the office supplies on January 18, 2016.

**The office supplies are not deductible by a cash basis taxpayer until they are paid for in 2016. An accrual basis taxpayer can deduct supplies purchased but not yet paid for in 2015.**

- b. Raashan pays his employee, Sara, \$22,450 in salary up to December 23, 2015. As of December 31, 2015, Raashan owes Sara \$560 for the period of December 23 through December 31. The \$560 is to be paid on the next pay date, which is January 5, 2016.

**A cash basis taxpayer is only allowed to deduct the actual \$22,450 paid in 2015. The \$560 Sara has earned, but not yet received will be deductible when paid in 2016 by a cash basis taxpayer. An accrual basis taxpayer is allowed to deduct the \$22,450 paid plus the \$560 that has been incurred through December 31, 2015 but not yet paid.**

- c. Jerri paints Roland's house in December 2015. Roland pays Jerri's bill in January 2016.

**A cash basis taxpayer will not recognize the income from painting the house until it is received in 2016. An accrual basis taxpayer recognizes the painting income in 2015 when it is earned. If the painting cost is deductible, a cash basis taxpayer will deduct the cost when it is paid in 2016. An accrual basis taxpayer deducts the cost when incurred in 2015.**

- d. Devi sells Aaron a car on August 1, 2015, for \$36,000. The terms of the sale call for Aaron to pay Devi \$18,000 on August 1, 2015, and \$9,000 on August 1 of 2016 and 2017.

**A cash basis taxpayer will recognize the income from the sale of the car as the cash is received - one-half of the gain will be recognized in 2015 and one-fourth of the gain in 2016 and 2017. An accrual basis taxpayer will recognize all income from the sale when it is earned in 2015.**

- e. Bernie's Paint Barn purchases new spray painters on January 15, 2015, at a cost of \$3,000. The spray painters have an estimated useful life of 10 years, but the tax life is 5 years.

**Because the spray painters have a usefulness that extends beyond the current year, the \$3,000 is a capital expenditure that must be capitalized and deducted through depreciation over its tax life (5 years), regardless of the taxpayer's accounting method.**



34. For each of the following situations, determine the proper year for recognition of the income or deduction if the taxpayer is (1) a cash basis taxpayer and (2) an accrual basis taxpayer:

**Cash basis taxpayers recognize income when cash or its equivalent is received and take deductions when the expense is paid in cash or its equivalent. Accrual basis taxpayers recognize income when it is earned and take deductions for expenses when the expenses are incurred.**

- a. Helen fixes Mark's plumbing in November 2015. Mark receives the bill in December 2015 but does not pay Helen until January 2016.

**If Helen uses the cash basis, she will recognize the income when she is paid in January. If she uses the accrual basis, she will recognize the income when it is earned in 2015. If the plumbing expense is deductible by Mark, he will deduct it in 2016 (when paid) if he uses the cash basis and in 2015 (when incurred) if he is an accrual basis taxpayer.**

- b. The Outback Brewing Company purchases a new delivery van on October 30, 2015. The purchase is financed with a note that will be paid off over 3 years. Outback expects to use the van for 3 years, but the tax life of the van is 5 years.

**Because the delivery van has a life that extends substantially beyond the end of 2015, its cost must be capitalized and deducted through depreciation charges over its 5 year tax life. Both cash and accrual basis taxpayers must capitalize such expenditures.**

- c. Morbid Marble Mortuaries, Inc. sells a headstone to Lorissa for \$6,000. The terms of the sale call for Lorissa to pay \$3,000 in the year of sale and \$1,000 in each of the succeeding 3 years.

**Morbid will recognize \$3,000 of income in the current year and \$1,000 in each of the three succeeding years if it uses the cash basis. As an accrual basis taxpayer, Morbid must recognize the \$6,000 sales price in the current year. Because the headstone is a personal expenditure, Lorissa will not be allowed a deduction for its cost regardless of her method of accounting.**

- d. Maury's Computer Consultants, Inc. performs work for Janis in 2015. Maury's bills Janis in 2015, but no payment is received. In 2016, Janis files for bankruptcy, and Maury's determines that it will be able to collect nothing on her account.

**If Maury's uses the cash basis, no income will be recognized because it does not receive any payments. Because no income has been recognized, a cash basis taxpayer will not get a deduction for the bad debt. If Maury's is an accrual basis taxpayer, it must recognize the income from the services in 2015. When it is determined that the account is uncollectible in 2016, Maury's will be allowed a deduction for the bad debt to offset the income recognized in 2015.**

35. Tim has state income taxes of \$4,500 withheld from his salary during 2014. On his 2014 federal income tax return, Tim properly deducts the \$4,500 as state taxes paid. Upon filing his 2014 state income tax return, he determines that his actual state income tax for 2014 is only \$3,900, and the state sends him a \$600 refund. What are the tax consequences of the refund? Explain in terms of the concepts presented in the chapter.

**This is a classic example of the tax benefit rule that taxes any amount deducted in a previous year as income in the year of recovery to the extent that a tax benefit was received from the recovered amount. Because Tim took a deduction for the entire \$4,500 withheld, any refund of the state taxes must be included in income in the year of the refund. In this case, the \$600 refund is taxable in 2015. Note that the annual accounting period concept does not allow Tim to go back and amend his 2014 return for the refund, because the events of each tax year are deemed to stand apart from each other.**

**In working this problem, you may want to note that if, under the administrative convenience concept, Tim had not itemized his deductions (i.e., he used the standard deduction in 2014) he would not have to claim the \$600 refund as income in 2015 because he did not take an actual deduction for the state income taxes. In addition, if Tim's itemized deductions did not exceed his standard deduction by more than \$600, then only the excess of Tim's actual deductions over the standard deduction would be income under the tax benefit rule. For example, if Tim's 2014 total itemized deductions were \$6,300, then only \$100 of the refund would be income. This is the excess of total deductions over the 2014 standard deduction for a single individual (\$6,300 - \$6,200).**

How would your answer change if Tim's actual state income tax is \$4,900 and he has to pay \$400 with his state return?

**Because Tim is a cash basis taxpayer, he must take deductions in the year in which the allowable expense is paid. In this case, the additional \$400 in 2014 state tax is paid in 2015. Under the annual accounting period concept, Tim cannot go back and amend his 2014 state tax deduction for taxes paid in 2015. Tim must deduct the taxes in 2015, the year that he pays the taxes.**

36. Jamal Corporation is an accrual basis taxpayer. In 2014, Jamal writes off a \$1,000 account receivable from a customer who has died. In 2015, the former customer's estate sends Jamal a check for \$600. What are the tax effects of the receipt of the \$600 in 2015? Explain.

**Because Jamal Corporation took a \$1,000 bad debt deduction in 2014, the subsequent recovery of the \$600 in 2015 will be included as income in 2015 under the tax benefit rule. This will give Jamal the correct income on the receivable over the tax periods involved. For example, assume that the receivable was generated in 2013. As an accrual basis taxpayer, Jamal would have included the \$1,000 as income in 2013. In 2014, when it discovered that the customer had died and Jamal did not expect to collect the receivable, Jamal would deduct the \$1,000, canceling out the income recognized in 2013. The \$600 receipt in 2015 represents the amount of income actually received from the customer. Because the deduction in 2014 effectively eliminated any income recognition from the customer, the entire \$600 is income in 2015 when it is received.**

How would your answer be different if Jamal were a cash basis taxpayer?

**If Jamal Corporation is a cash basis taxpayer, it would not have previously recognized any income from the receivable. Therefore, Jamal would not be allowed a bad debt deduction in 2014. Thus, the corporation would include the \$600 in income when the cash from the receivable was actually received in 2015.**

**Note that the effect of the tax benefit rule in this case is to tax the same amount of income (\$600), regardless of the taxpayer's method of accounting.**

37. Angela enrolls as a student at Local College during the current year. Before she starts school, her parents lend Angela \$80,000 with the stipulation that she will lend the entire \$80,000 back to them. The loan is evidenced by a non-interest-bearing note payable in 10 years. Several days later, Angela returns the \$80,000 to her parents in exchange for their \$80,000 note secured by a mortgage on their personal residence. The note has an 8% interest rate and requires monthly interest payments, with the principal due in 10 years. Angela's parents pay her \$6,400 in interest on the loan during the current year. Mortgage interest on a principal residence is deductible as an itemized deduction. Discuss whether Angela's parents should be allowed a deduction for the \$6,400 in interest paid to Angela.

**Only mortgage interest paid on valid debts is deductible. Because Angela's parents loaned her the money with the stipulation that she would return it to them shortly thereafter, there is no economic significance to the debts created. The only purpose of the circular transactions is to attempt to deduct the amounts the parent would pay for Angela's college expenses as interest. Under the substance over form doctrine, transactions are to be taxed according to their true intentions, not some possibly contrived form. In this case, the substance of the transactions is to make a gift of the \$6,400 to Angela. Therefore, her parents would not be allowed to deduct the \$6,400 as interest expense.**

38. For each of the following tax treatments, determine the concept, construct, or doctrine that provides the rationale for the treatment:

- a. Lester purchases some stock for a total cost of \$2,500. On December 31, 2014, the stock is worth \$2,800. In August 2015, he sells the stock to his brother Rufus for \$2,000. Lester has no income from the stock in 2014, and he is not allowed to deduct the \$500 loss on the sale of the stock to Rufus in 2015.

**The realization concept is responsible for not recognizing the gain in market value in 2014. Lester will not recognize any gain or loss on the stock until it is realized through sale or other disposition. The nonrecognition of loss on the sale to Rufus is due to the related party rules. Because Rufus is a related party, losses on any sales to him would be disallowed. That is, related parties are assumed not to transact at arm's-length when losses are involved.**

- b. Kerry is an employee of Ross Company. During the year, Ross withholds federal income taxes of \$3,500 from her salary. Her tax liability for the year is only \$3,200, so she receives a refund of \$300.

**Under the pay-as-you-go concept, amounts withheld from an employee as tax are credited against the tax liability on the tax return. If Kerry has paid in more than her actual liability, she is entitled to a refund of the prepaid taxes.**

- c. Catherine is a city government employee. She often uses the city's photocopier to make personal photocopies and has her secretary type an occasional personal letter. The value of these services for the current year is approximately \$55 but is not included in Catherine's gross income.

**This is an example of administrative convenience. Although the personal use of the photocopier would constitute income under the all-inclusive income concept, the cost of collecting the tax on such benefits would likely exceed the tax collected on such income. In Chapter 4, this is covered as a de minimis fringe benefit exclusion.**

- d. Dante's allowable personal deductions are only \$2,800 this year, so he deducts the standard deduction in computing his taxable income.

**The use of the standard deduction amount in lieu of deducting actual allowable itemized deductions is based on administrative convenience. It also is somewhat based on ability-to-pay in that it provides relief to those taxpayers who do not incur large amounts of itemized deductions; these taxpayers are typically on the low end of the income scale.**

39. For each of the following tax treatments, determine the concept, construct, or doctrine that provides the rationale for the treatment:

- a. During the current year, Trafalger Corporation pays \$475,000 in estimated tax payments. Trafalger determines that its actual tax liability for is \$490,000, so it pays only \$15,000 with its tax return.

**The Pay-As-You-Go Concept requires corporations to make estimated tax payments throughout the tax year. Because the corporation has already paid \$475,000 of its tax bill, it is only required to pay the additional \$15,000 of tax it has not already paid.**

- b. The Parsnip Partnership is an accrual basis taxpayer. During 2014, Parsnip deducted as a bad debt expense a \$5,000 account receivable that it determined it could not collect. In 2015, Parsnip receives a \$1,000 payment on the account. Parsnip must include the \$1,000 in its 2015 gross income.

**Under the Tax Benefit Rule, any deduction that is recovered in a subsequent tax year must be included in income to the extent that a tax benefit was received from the deduction in the prior tax year. Because Parsnip deducted the \$1,000 as a bad debt in 2014, it must include the \$1,000 payment as income in 2015.**

- c. Kuri sells land for \$30,000; its cost was \$20,000. Under the sales agreement, the buyer is to pay Kuri's son \$10,000 of the sales price. Kuri must recognize a gain of \$10,000 on the sale.

**The Assignment of Income Doctrine requires the person or entity that produces income or the owner of property producing income to be taxed on the income from the property regardless of who actually receives the income. Because Kuri owns the land, the entire \$30,000 sales price is attributed to her and she is taxed on the \$10,000 (\$30,000 - \$20,000) gain. Kuri cannot escape taxation on the gain by having proceeds from the sale paid to her son.**

- d. Jevon owns 20% of the stock of Cowdery, Inc., an S corporation. During the current year, Cowdery reports income of \$45,000 and pays no dividends. Jevon must include \$9,000 in gross income.

**S corporations are conduit entities. A Conduit Entity is not taxed on its income - each shareholder of an S corporation is taxed on their proportionate share of the corporation's income. Jevon is taxed on his \$9,000 (\$45,000 x 20%) share of the Cowdery income even though he receives no dividends.**

40. Postum Partnership purchases a building in 2012 for \$250,000. It deducts \$5,600 in depreciation on the building in 2012, \$6,400 in 2013, \$6,400 in 2014, and \$3,200 in 2015. It sells the building in 2015 for \$260,000. What is the partnership's gain or loss on the sale of the building?

**Under the capital recovery concept, Postum Partnership is allowed to recover its \$250,000 investment in the building before it has any income from its disposition. Postum has recovered \$21,600 (\$5,600 + \$6,400 + \$6,400 + \$3,200) of the cost through depreciation deductions. This leaves it with an adjusted basis (i.e., the amount of unrecovered investment) of \$228,400 (\$250,000 - \$21,600) in the year of sale. The amount realized from the sale, \$260,000, is reduced by the \$228,400 adjusted basis, resulting in a gain of \$31,600:**

Sales price		\$260,000
Less: Adjusted basis		
Original cost	\$250,000	
Less: depreciation	<u>(21,600)</u>	<u>(228,400)</u>
Gain on sale		<u>\$ 31,600</u>

41. Chelsea, who is single, purchases land for investment purposes in 2010 at a cost of \$22,000. In 2015, she sells the land for \$38,000. Chelsea's taxable income without considering the land sale is \$100,000. What is the effect of the sale of the land on her taxable income, and what is her tax liability?

**Land held for investment is a capital asset. The sale of the land results in a \$16,000 (\$38,000 - \$22,000) long-term capital gain. Assuming that she has no other capital gains or losses in 2015, her taxable income increases by the amount of the gain to \$116,000 (\$100,000 + \$16,000). However, net long-term capital gains are taxed at 15%. Therefore, the \$16,000 long-term capital gain is taxed separately at the 15% long-term capital gain rate. This results in a total tax of \$23,471:**

Tax on \$100,000 - \$18,481.25 + [28% x (\$100,000 - \$90,750)] =	\$21,071
Tax on \$16,000 long-term capital gain - \$16,000 x 15% =	<u>2,400</u>
Total tax liability	<u>\$23,471</u>

42. George purchases stock in Dodo Corporation in 2011 at a cost of \$50,000. In 2015, he sells the stock for \$32,000. What is the effect of the sale of stock on George's taxable income? Assume that George sells no other assets in 2015.

**The sale of stock results in a loss of \$18,000 (\$32,000 - \$50,000). Stock is a capital asset and the loss would be a capital loss. The maximum deduction for a net capital loss of an individual is \$3,000 per year. Any excess loss that is not deducted is carried forward and deducted in subsequent years. Therefore, George will only be able to deduct \$3,000 of the loss in 2015 with the remaining \$15,000 carried forward to 2016. Thus, his taxable income will decrease by \$3,000 in 2015.**

**If George has no capital asset sales in 2016, he will deduct \$3,000 of the \$12,000 loss carried forward from 2015. The remaining \$9,000 of capital loss is then carried forward to 2017.**

43. Determine whether the taxpayer in each of the following situations has realized income. Explain why there has or has not been a realization, and determine the amount of income to be reported.

- a. Alfredo owns a one-third interest in Bayou Partnership. During the current year, Bayou's taxable income is \$45,000.

**Alfredo realizes \$15,000 ( $\$45,000 \times 1/3$ ) of income from the partnership. Owners of conduit entities are taxed on their share of the entity's income. Because the partnership has realized income, the partners' have also realized income.**

- b. Janet owns a pest control service. She charges customers \$50 per month for basic pest control. Alternatively, customers can pay a lump sum of \$500 for one year of basic monthly pest control. During the current year, Janet receives \$13,000 in monthly payments and \$26,000 in 1-year prepayments.

**Janet has realized income of \$13,000 from the monthly receipts regardless of her method of accounting because she has a claim of right to the income. Applying the wherewithal-to-pay concept, Janet would also include the \$26,000 of prepayments in income even if she is an accrual basis taxpayer. Note: If Janet is an accrual basis taxpayer, she could use the accrual method to account for the prepayments under the deferral method. This exception is discussed in Chapter 3.**

- c. Monte owns 1,000 shares of Ali, Inc., common stock. During the current year, Ali declares and distributes a 20% stock dividend. As a result, Monte receives an additional 200 shares of stock.

**Monte has not realized any income from the stock dividend because his wealth has not increased. That is, his percentage ownership in the firm remains the same, as does the value of the firm. Therefore, his total wealth remains unchanged and his property interest in the corporation has not changed.**

- d. Rogers Trucking Company owes Big Truck Sales, Inc., \$200,000 for the purchase of 3 trucks. Rogers is having a bad year and is unable to make full payment on the debt to Big Truck. Rather than foreclose on Rogers, Big Truck reduces the debt to \$170,000 so that Rogers can stay in business.

**Rogers wealth has increased by \$30,000 ( $\$200,000 - \$170,000$ ) as a result of a transaction with a second party. Therefore, it has realized income of \$30,000 from the discharge of debt. Rogers has obtained a claim of right to the \$30,000 because it is no longer under an obligation to repay the \$30,000. If Rogers is insolvent before the discharge or if the debt is related to real property, part or all of the forgiveness could be excluded from income (discussed in Chapter 4).**



44. Determine whether the taxpayer in each of the following situations has realized income. Explain why there has or has not been a realization, and determine the amount of income to be reported:

- a. Ramrod Development Company purchases land costing \$230,000. Ramrod subdivides the land into 100 lots, incurring legal fees of \$20,000. It also spends \$50,000 to install utility and sewer connections to each lot. The lots are priced to sell at \$50,000 each, but none sold during the year.

**Income is not realized until the taxpayer's wealth is increased through an Arm's-Length Transaction with another party. Even though Ramrod has subdivided and made improvements to the land, it has not sold any of the lots and therefore, has not realized the increased value of the lots through an arm's-length transaction. Income will be realized when Ramrod sells one or more of the lots.**

- b. Eugene is a computer consultant. Rashid is an accounting professor. Rashid needs help installing some new software on his home computer. Eugene offers to install the software if Rashid will help him set up the books for a new company he is forming. Eugene installs the software in December. Rashid sets up the books in February.

**Income can be realized in any form. Exchanges of services constitute a realization when the services are performed. When Eugene installs the software in December, Rashid has been "paid" for the work he performs in February and the fair market value of the services provided to Rashid are realized at that time. Similarly, Eugene is "paid" for the software installation when Rashid sets up his company's books in February and the fair market value of the services provided to Eugene are realized at that time.**

- c. Sasha is an employee of Chasteen Hair Products. Chasteen provides all employees with free medical coverage. During the current year, the cost of Sasha's coverage is \$1,900.

**Under the All-Inclusive Income Concept, any increase in wealth is taxable unless specifically excluded by the tax law. Sasha's wealth has increased because she has not had to purchase medical coverage due to its provision by Chasteen. The provision of free medical coverage to an employee is part of the employee's compensation package and is realized as the medical coverage is provided. However, there is an exclusion for employer provided medical coverage that is covered in Chapter 4. Therefore, although Sasha realizes income from the provision of medical coverage by her employer, the income is not recognized due to the specific exclusion.**

- d. In November, Ira wins an all-expense-paid trip for two to the Super Bowl in January. He plans to take his best friend to the game. The estimated value of the trip is \$4,300.

**Ira's wealth has increased from the receipt of the prize. Under the All-Inclusive Income Concept, all income is taxable unless specifically excluded by the tax law. Ira must recognize the fair market value of the prize when he wins it in November because the increase in his wealth has occurred through an Arm's-Length Transaction at that time.**

45. Shannon signs a \$100,000 contract to develop a plan for integrating the computer operations of State University in December. Under the contract, she receives a \$30,000 advance against future payments on the contract upon signing the contract. The contract stipulates that if Shannon does not produce an acceptable plan, she must repay any portion of the advance not earned to date. Does Shannon have any income from the receipt of the advance? Explain in terms of the income tax concepts presented in the chapter.

**Shannon has realized income of \$30,000 when she receives the advance royalty. Under the claim of right doctrine, income is realized when the taxpayer has complete dominion and control over the income. In this case, Shannon can use the advance money in any manner which she chooses and is under no absolute obligation to repay the advance. The fact that the income may have to be repaid in a later period does not negate Shannon's right to control the \$30,000 advance payment. If Shannon is required to make a repayment in the future, she would be allowed a deduction at that time under the annual accounting period concept.**

46. Determine whether the taxpayer in each of the following situations has a claim of right to the income received:

- a. Trigger, Inc., receives a \$5,000 stud fee for services rendered by one of its prized horses. Under its standard contract, Trigger will return the fee if a live foal is not born.

**A claim of right exists. Trigger has dominion and control over the \$5,000 stud fee. The fact that the fee may have to be repaid in the future does not limit Trigger's current use of the funds.**

- b. Orville works as a salesman for Brewster Company. He receives a travel allowance of \$1,000 at the beginning of each quarter. At the end of each quarter, he must make a full accounting of his travel expenses and reimburse Brewster for any of the \$1,000 not spent on approved travel.

**Orville does not have a claim of right to the \$1,000 travel advance. The advance is subject to substantial restrictions because a full accounting of the travel expenses must be made and any portion of the advance that is not used for approved travel must be returned.**

- c. Assume that in part b, Orville is not required to account for his actual travel expenses for Brewster and is not required to return unused portions of the travel advance.

**Orville does have a claim of right to the travel advance. He has complete dominion and control over the \$1,000 advance. He is not subject to any restrictions on the use of the money and retains any portion of the \$1,000 he does not spend. NOTE: In this case, Orville would be allowed deductions for his valid travel expenses. The treatment of reimbursed employee business expenses is discussed in Chapter 6.**

- d. Arco Architecture, Inc., receives \$10,000 from a client for work done by a subcontractor on the client's project. Arco, in turn, paid \$10,000 to the subcontractor.

**Arco has a claim of right to the \$10,000. Arco is under no obligation to repay the client. Even though Arco actually paid the \$10,000 over to the subcontractor, it did so under its own control. To understand why this is so, consider what your answer would be if Arco had not paid the subcontractor or more likely, Arco settled the subcontractor's bill for less than \$10,000. Therefore, Arco must include the \$10,000 in income and take a deduction for payments made to the contractor.**

47. Determine whether the taxpayer in each of the following situations has a claim of right to the income received:

**A claim of right exists when amounts are received without restriction on their use and with no clear obligation to repay. The fact that an amount received may have to be repaid due to some future contingency does not negate a taxpayer's claim of right to the income.**

- a. Sulley's Spa Spot sells hot tubs that have a 2-year warranty. The warranty provides for the replacement of all parts and the cost of labor to replace the parts. In addition, Sulley's may replace the hot tub in lieu of repairing it. During the current year, Sulley's hot tub sales total \$250,000. Sulley's estimates that 10% of all hot tubs sold will require warranty work.

**Sulley's has a claim of right to the \$250,000 in hot tub sales. Sulley's is under no obligation to repay any specific hot tub sale. The provision of the warranty is a general obligation that applies to all sales. The fact that it may have to replace or repair some of the hot tubs does not negate its claim of right to the hot tub sales.**

- b. In 2013, Retro Fit Construction Company purchased equipment by borrowing \$100,000 from Fifth State Bank. After paying off \$30,000 of the loan, Retro has financial problems in the current year and cannot afford to make its regular payment. Rather than have Retro default on the loan, Fifth State Bank agrees to reduce the debt to \$50,000.

**When Retro borrowed the \$100,000 in 2013, it did not have a claim of right because it was under an obligation to repay the loan. When the loan is reduced to \$50,000, Retro acquires a claim of right to the \$20,000 (\$100,000 - \$30,000 - \$50,000) that it is no longer obligated to repay.**

- c. Larry's Lawncare Service provides lawn mowing and fertilization services to residential customers. Customers can pay by the month, or they can purchase a one-season contract for \$1,000. The contracts obligate Larry's to provide the necessary mowing and fertilization from April through October. In September, Larry's has a "pre-season" sale that lets current customers purchase next season's contract for \$800. Fourteen customers buy the discounted contract in September.

**Larry's has a claim of right to the \$11,200 (\$800 x 14) in prepaid service contracts that it receives. It is not under a strict obligation to repay the \$800 prepayment price. Larry's obligation is to provide the contracted services, not repay the contract price.**

- d. Alexander Associates does computer consulting for Bertman, Inc., in September. Bertman pays Alexander's \$3,000 bill for the work in October 2015. In late November, Bertman's computer system crashes and Bertman sues Alexander, seeking reimbursement of \$3,000. The lawsuit is scheduled for court in March 2016.

**Alexander Associates has a claim of right to the \$3,000. The lawsuit does not provide a definitive obligation to repay any part of the \$3,000 and does not negate Alexander's claim of right to the income.**

48. Consider the following two situations. Although they are similar, their treatments are exactly opposite. Identify the concept underlying both treatments, and explain why the concept treats the two situations differently.
- a. Sam is an employee of Dunbar Company. The company regularly mails salary checks to employees to arrive on or before the last day of each month. Sam's regular paycheck arrives at his house on December 31, 2015, but Sam is away on a ski trip and does not return until January 2, 2016. Sam deposits the check in his bank account the following day. The check is included in Sam's 2015 income.
  - b. Percy is an employee of Daly Company. In November 2015, Percy's position is eliminated in a "streamlining" of company costs. As part of the cost reduction program, Percy is entitled to severance pay; however, his boss tells him that it will be 3 or 4 months before the severance payments are made. The check arrives by mail on December 31, 2015, while Percy is away on a ski trip. He returns on January 2, 2016, and deposits the check in his bank account the following day. The severance pay check is not taxable until 2016.

**This problem illustrates one of the nuances of the constructive receipt doctrine. In part a, what may be called the general rule for constructive receipt by mail is illustrated. In Rev. Rul. 76-3, 1976-1 CB 114, the service held that an attempted delivery of certified mail constitutes constructive receipt, even in the recipient's absence, as is actual delivery of regular mail. In this case, Sam knew that the check would be arriving on December 31 and could have secured actual physical control of the check if he had so desired.**

**In part b, under similar circumstances, the tax court held, in *Dunbar*, TC Memo 1978-12, that the taxpayer was not in constructive receipt of the severance pay. The court stated that a crucial element in having control of the funds is that the taxpayer be aware that the funds are available to control. Because the funds arrived much sooner than the taxpayer was made aware of, the court held there was no constructive receipt until the taxpayer actually knew the check was available.**

49. Determine whether the taxpayer in each of the following situations is in constructive receipt of income. If not, explain when the income will be constructively received.

**A cash basis taxpayer is in constructive receipt of income when it is credited to their account or otherwise made unconditionally available to them.**

- a. Norman is president of Wright Company. On December 14, 2015, the board of directors votes to give him a \$25,000 bonus. Norman receives the bonus on January 4, 2016.

**Norman is not in constructive receipt of the bonus in 2015. The bonus is not available for Norman's use until it is received in 2016.**

- b. Regan is an employee of BIF Manufacturing, earning \$3,000 per month. She purchases merchandise from BIF costing \$2,000 in January of the current year. To pay for the merchandise, BIF agrees to deduct \$75 per month from her pay, reducing it to \$2,925 per month before other withholdings.

**Regan is in constructive receipt of the \$75 of salary applied to the payment of the debt to her employer. In *Latendresse*, 26 TC 319 (1957), the Tax Court held that where income owed to a taxpayer can offset a debt the taxpayer owes to the same person, the gross amount of the income is taxable. Therefore, Regan must include the \$3,000 she earns each month in her gross income.**

- c. Marnie owns \$50,000 par value of 6% coupon bonds. The interest coupons may be clipped and redeemed on May 30 and November 30 each year. Marnie does not redeem the November 30, 2015, coupon interest until January 8, 2016.

**Marnie is in constructive receipt of the November 30, 2015, interest payment and must include the \$1,500 [ $\$50,000 \times 6\% \times (6 \div 12)$ ] interest payment in her 2015 income. The interest payment is available for her use on November 30, 2015 and is taxed at that time, regardless of when she actually receives the payment.**

50. Using the income concepts presented in this chapter, discuss whether the taxpayer has realized income in each of the following situations:

- a. Adco Corporation pays the health insurance premiums for all its employees. Adrian is an employee of Adco. Health insurance premiums Adco pays for Adrian cost \$1,150 for the current year.

**Under the all-inclusive income concept, Adrian is in receipt of income of \$1,150 from Adco's payment of her personal expenses. She has realized an increase in wealth from the payment, which is a form of compensation. Based solely on the concepts presented in the chapter, she would be in receipt of income from the payment. In Chapter 4, the exclusion for the payment of health insurance premiums by an employer is discussed.**

- b. The Sung Partnership buys a parcel of unimproved land for \$32,000. Sung spends an additional \$22,000 to put in roads and sewerage, and to grade the property for subdividing. The property is subdivided into 15 lots and offered for sale at \$10,000 per lot.

**Sung has not realized the expected increase in wealth by purchasing and subdividing the property for sale. The income from the lots will be realized as they are sold. As an analogy, consider whether Sung would have realized any income if, during the subdividing, oil is discovered on the property.**

- c. Doctors and nurses at Valley View Hospital are allowed to eat free of charge in the hospital cafeteria during their shifts. Sue, a doctor, eats meals valued at \$1,900 during the current year.

**As in part (a), Sue is in receipt of income based on the all-inclusive income and realization concepts discussed in the chapter. However, Sue is able to exclude the value of the meals. This exclusion is discussed in Chapter 4.**

- d. Wayman wins the golf championship at his country club. In addition to a handsome trophy, he receives merchandise worth \$500 for winning the tournament.

**Under the all-inclusive income concept, Wayman is in receipt of \$500 of income from winning the merchandise. There is no exclusion from income for such prizes and awards.**

- e. Rock signs a contract to play football for the Rangers. In addition to a salary of \$1,000,000 per year for 5 years, he is to receive a signing bonus of \$5,000,000 to be paid 10 years from the date the contract was signed.

**Rock only has to recognize the salary he actually receives during the current year as income. The signing bonus is not made available to him in the current year and therefore, he is not in constructive receipt of the income. Taxpayers can defer recognition of income through such contractual arrangements.**

51. Nina leases a building to Downtown Computer Systems for \$5,000 per month under a 5-year lease. The terms of the lease provide that any improvements to the building made by Downtown revert to Nina upon termination of the lease. Downtown remodels the building at a cost of \$40,000. At the end of the lease, the fair market of the remodeling improvements is \$50,000. Nina sells the building one year later for \$250,000.
- a. List three points at which Nina might recognize income from the improvements made by Downtown Computer Systems.

**The 3 possible recognition points are:**

- 1) at the time the improvements are made by Downtown,**
- 2) at the termination of the lease, or**
- 3) when Nina ultimately sells the property.**

- b. According to the income concepts presented in the chapter, when should Nina recognize income from the lease? Explain.

**Although it could be argued that Nina has realized a change in the form of her property upon termination of the lease (meeting the realization concept criteria), the question is whether Nina has the wherewithal-to-pay the tax at that time. Another consideration is whether Nina has to recognize the gain in value of the building at termination of the lease. Most would say that the gain on the building is unrealized at the termination of the lease. Following this line of reasoning, there is no compelling reason why Nina should recognize the income from the improvements at the termination of the lease. This specific exclusion of the value of improvements made by a lessee until the property is sold is covered in Chapter 4.**

- c. Would your answer to part b be different if the lease provides that any improvements made by Downtown Computer Systems can be deducted from the rental payment made to Nina?

**In this case, the improvements are payments in lieu of rent and should be included in income when the improvements are made. Under the cash method of accounting, income can be received in any form. In this case, rents are being received in the form of property.**



52. For each tax treatment described, determine the applicable income tax concept(s), and explain how it forms the basis for the treatment:

- a. Jackson owned coupon bonds with detachable interest coupons. He detached coupons worth \$5,000 and gave them to his son to buy a car. Jackson is taxed on the \$5,000 of interest, even though he never actually received the interest.

**This treatment is prescribed by the assignment of income doctrine. Because Jackson still owns the bonds, he is taxable on the interest, regardless of who actually receives the interest.**

- b. Joan's barn on her ranch was destroyed by a tornado. The barn had an adjusted basis of \$24,000. Joan received insurance proceeds of \$35,000 and built a new barn costing \$40,000. Joan does not have to recognize the gain realized on the barn in the current period.

**This treatment is based on the wherewithal-to-pay concept. Even though the destruction of the barn results in a gain of \$11,000 (\$35,000 - \$24,000), Joan does not have to recognize any gain currently because she has reinvested the entire \$35,000 of insurance proceeds and has nothing remaining to pay tax on the gain. Deferrals of gains on involuntary conversions are discussed in Chapter 12.**

- c. Elvis borrowed \$30,000 from University Credit Union to purchase a new X car. He is not taxed on the receipt of the \$30,000.

**The receipt of the \$30,000 is offset by the \$30,000 obligation to repay the loan, resulting in no increase in wealth to Elvis. The realization concept requires that an increase in wealth occur before income is present. In addition, because of the obligation to repay the loan, Elvis does not have a claim of right to the \$30,000.**

- d. Kelley lost the diamond ring she received from her husband, Ian. The ring had a basis of \$2,000, and she received \$3,000 from her insurance company. Kelley used the money to pay off medical bills. Kelley must recognize a \$1,000 gain on the loss of her ring.

**The all-inclusive income concept requires that all income received be included in gross income, unless a specific provision exempts the income from taxation. There is no exclusion for gains on personal use property. Further, Kelley could not appeal to the wherewithal-to-pay concept in this situation, because she did not replace the diamond ring. NOTE: Even if Kelley had replaced the diamond, the deferral rules for involuntary conversions (discussed in Chapter 12) do not provide for deferrals on personal use property other than the involuntary conversion of a principal residence.**

53. During the current year, Errol starts a management consulting service which he operates from an office in his home. He uses one room of the house as his office. He purchases office furniture for \$6,000 and a computer for \$3,000. He uses the computer primarily in his consulting business but also uses it to track his personal investments and for other personal purposes. What tax problems might Errol face regarding his office, the furniture, and the computer? Explain.

**The major tax problem for Errol is that the assets are used in both his consulting business and for personal use. The office is part of his personal residence - the costs associated with the office are deductible business expenses (see discussion of home office costs in Chapter 5), while the costs associated with his personal use of the residence are not deductible. Therefore, Errol will have to account for the residence as if it were two separate assets - one asset used in his trade or business and one asset as a personal use asset. This leads to a recordkeeping problem in sorting out usage. The most common method is to allocate costs based on the square footage of the office in relation to the total square footage of the house. Then the total costs associated with the house can be allocated to the office by the square footage ratio.**

**The computer presents similar problems - it is used for business, investment, and personal use. The cost of the computer must be allocated to these uses to determine how much of the cost of the computer can be deducted. The business and investment portions of the computer can be deducted, but the personal use of the computer is not deductible.**

**The office furniture is also used for business, investment, and personal use and an allocation of its cost to each use must also be made to determine the deductions for business and investment purposes.**

**All of the assets are depreciable property and the costs allocated for business and investment use must be capitalized and depreciated.**

**Instructor's note: The use of the computer for business, investment, and personal use implies that the other assets are also used for these purposes. As such, Errol would not be able to deduct the costs of the home office, which must be exclusively used in his trade or business (Chapter 5).**

54. For each of the following situations, determine the deduction concepts involved, and explain how they form the basis for the tax treatment described:

- a. Individuals are allowed to deduct medical expenses.

**The general rule is that no personal expenditures are deductible. However, Congress has allowed (i.e., legislative grace concept) certain personal expenditures, including medical expenses to be deducted.**

- b. Happy Burgers, Inc., owns a chain of drive-in restaurants in California. Seeking to expand its operations, Happy spends \$90,000 investigating locations in Oregon. Happy decides that expanding into Oregon is not a wise move, but it is allowed to deduct the \$90,000.

**The business purpose concept allows the ordinary and necessary expenses of a trade or business to be deducted. Since Happy Burgers is in the drive-in restaurant business, expending amounts to investigate expansion opportunities is a normal business practice. The fact they did not ultimately expand into Oregon is irrelevant; businesses normally consider options that, after consideration, are determined not to be good investment opportunities.**

- c. Lage's Licorice Company suffers a fire in one of its warehouses. Equipment that cost \$40,000 and that had been depreciated to an adjusted basis of \$15,000 is destroyed. The equipment, which cost \$50,000 to replace, is uninsured. Lage is allowed to deduct a loss of \$25,000 on the equipment.

**The business purpose concept would allow deduction of the loss, which is limited by the capital recovery concept to the investment in the equipment. In the case of depreciable property, the amount invested is measured by the property's adjusted basis, which is \$25,000 (\$40,000 - \$15,000). Note that the wherewithal-to-pay concept is not applicable in this situation because there is no tax to be paid on a loss.**

- d. While Ray is out to dinner one night, someone breaks into his personal car. The thief steals his stereo and his golf clubs. The fair market value of the items stolen is \$300. Because he has a \$500 deductible on his insurance policy, he receives no reimbursement from his auto insurance. To make matters worse, no tax deduction for his loss is allowed.

**Ray's loss is personal in nature and would not be allowed under the general rule disallowing personal expenditures (legislative grace concept). Congress has provided limited relief in this area, but only to the extent that the loss exceeds \$100 and 10% of the taxpayers adjusted gross income. Casualty and theft losses are discussed in Chapter 7.**

55. For each of the following situations, determine the deduction concepts involved, and explain how they form the basis for the tax treatment described:

- a. Jamie sells her personal residence at a loss of \$9,000. She is not allowed a deduction for the loss.

**Under the Legislative Grace Concept, only those items that Congress specifically allows are deductible. The Business Purpose Concept allows the deduction of expenses and losses incurred in a trade or business or a production of income (investment) activity. Only selected personal expense and losses are deductible. Because the sale of a personal residence does not meet the business purpose concept and is not specifically allowed as a deduction, the loss is not deductible.**

- b. Jamie sells a building used in her business at a loss of \$9,000. She is allowed to deduct a \$9,000 loss on the sale of the building.

**The Business Purpose Concept allows the deduction of expenses and losses incurred in a profit-seeking activity. All expenses and losses incurred in a trade or business are deductible under this concept.**

- c. Last year, Gardner Corporation purchased equipment costing \$10,000. The equipment was eligible for a special expense election, and Gardner deducted the \$10,000 cost in the year of purchase. Gardner is not allowed a depreciation deduction on the equipment in the current year.

**The Capital Recovery Concept allows the deduction of amounts expended in profit-seeking activities. However, you cannot recover more than you have invested in the expenditure. Gardner Corporation is in a trade or business and is allowed to recover the \$10,000 cost of the equipment under the Business Purpose Concept. Because it has deducted the entire \$10,000 under the special expense election, there is no remaining capital to recover and Gardner is not allowed a depreciation deduction on the equipment in the current year (or in future years).**

- d. The Orlando Jams Partnership borrows \$500,000 to use as working capital. During the current year, the partnership pays \$45,000 in interest on the loan and repays \$100,000 of the loan principal. Orlando can deduct the \$45,000 interest payment but cannot deduct the repayment of the loan principal.

**The partnership is a trade or business and is allowed to deduct all ordinary, necessary, and reasonable expenses under the Business Purpose Concept. The \$45,000 interest payment meets the business purpose concept test and is deductible. The repayment of the loan principal is not an expense of the business and is not deductible. The \$500,000 loan proceeds were not taxed when they were received. As the proceeds are used to pay expenses of the business, the expenses are deductible. Allowing a deduction for the repayment of the loan principal would allow the \$500,000 to be deducted twice, a violation of the Capital Recovery Concept. Under the capital recovery concept, deductions cannot exceed the cost of the expenditure.**

56. Sidney lives in Hayes, Kansas. He owns land in Cotulla, Texas, that he inherited from his father several years ago. The land is unimproved and has never produced income. On January 26, 2015, Sidney receives a statement of delinquent taxes on the property for 2012, 2013, and 2014 for \$120. On February 10, 2015, Sidney and his wife, Ellen, start to drive to Cotulla; they arrive on February 20 and pay the taxes on the same day. The cost of the trip for Sidney and Ellen is \$450. Sidney and Ellen would like to deduct the cost of the trip. Write a letter to Sidney and Ellen in which you explain what they can deduct.

**To be deductible, an expenditure must have a business purpose. This is interpreted to mean that the primary motive for the expenditure is to make a profit. The tax law allows the deduction of all ordinary and necessary trade or business expenses and production of income (investment) related expenses. Although the land is held for investment, expenditures on the land must be ordinary and necessary. In this case, the payment of the property taxes is ordinary and necessary and would be deductible. The deductibility of the cost of the trip hinges on whether the trip is ordinary and necessary. First, making such a lengthy trip is not the ordinary means of paying property taxes. In addition, taking 10 days to make the trip indicates that the primary purpose of the trip was personal. Therefore, the cost of the trip does not have a business purpose and is not deductible, even though it relates to income producing property.**

57. Explain why the legal fees paid in the following three situations are treated differently for income tax purposes:

**The difference in the three situations is the purpose of the expenditures. All expenditures must be classified as either incurred in a profit making venture or personal expenses. Personal expenses are generally nondeductible. Expenses incurred in a profit making venture are then classified as being either a trade or business expense or an investment related expense. Trade or business expenses are fully deductible. Investment related expenses (other than rental or royalty expenses) are miscellaneous itemized deductions that are subject to a 2% of adjusted gross income limitation. The treatments within each category are illustrated in the problem.**

- a. Jim pays \$10,000 in legal fees in obtaining a divorce. None of the \$10,000 is deductible.

**Jim's legal fees are personal and no deduction is allowed.**

- b. Camella invents and patents a device that shells nuts. When she learns that another company is selling copies of her device, she pays an attorney \$10,000 to enforce her patent. The \$10,000 is fully deductible.

**Camella's legal fees are related to her trade or business and are fully deductible.**

- c. Melody pays \$10,000 in legal fees for advice relating to investments she owns. Only \$6,000 of the fees is deductible.

**Melody's legal fees are related to her investment activities and are subject to limitation based on her income.**

58. Explain why the loss resulting from the sale of a computer in the following three situations is treated differently for income tax purposes:

**The Business Purpose Concept limits the deductions of losses to those incurred in a trade or business or a production of income (investment) activity. Investment related losses are capital losses that are subject to the capital gain and loss rules. Net capital losses of individuals are deductible up to a maximum of \$3,000 per year. Personal use losses are not deductible.**

- a. Monica sells her personal computer at a loss of \$1,300. None of the loss is deductible.

**The computer is a personal use asset. Losses on personal use assets are not deductible.**

- b. Omar sells a computer used in his carpeting business at a loss of \$4,300. The loss is fully deductible.

**The computer is used in a trade or business. All losses incurred in a trade or business are deductible.**

- c. Jerry sells his computer at a loss of \$3,800. Jerry used the computer to keep track of his investment portfolio. Only \$3,000 of the loss is deductible.

**The computer is used in an investment activity. The \$3,800 loss is a capital loss. If Jerry has no capital gains for the year, his capital loss deduction is limited to \$3,000. The remaining \$800 is carried forward for deduction in the next year.**

59. A truck owned by Duster Demolition Services is involved in an accident. The truck originally cost \$40,000, and \$25,000 of depreciation had been taken on the truck as of the date of the accident. The cost of repairing the truck is \$10,000, for which the insurance company reimburses Duster \$8,000.
- a. How much of a loss, if any, is Duster entitled to deduct as a result of the accident?

**Gains and losses on property are measured as the difference between the amount realized and the adjusted basis of the property. In this case, Duster realized \$8,000 from the insurance company. However, since the truck was not totally destroyed in the accident, the entire adjusted basis was not lost and some other measure of the investment lost due to the accident is necessary. In these types of situations, the cost of repairing the truck is typically used to estimate the lost investment. Therefore, Duster's loss is \$2,000 (\$8,000 - \$10,000).**

- b. What is the adjusted basis of the truck after the accident?

**The basis of property must be adjusted for investments in and recoveries of investment. Prior to the accident, the adjusted basis is \$15,000. Duster receives a net deduction of \$2,000 (a capital recovery) for the accident. Therefore, the basis is not reduced by the \$2,000 deduction and remains at \$15,000. Alternatively, the basis can be calculated by adjusting for lost investment and recoveries of investment:**

<b>Basis at time of accident: (\$40,000 - \$25,000)</b>	<b>\$ 15,000</b>
<b>Add: Cost of repairs</b>	<b>10,000</b>
<b>Deduct: Insurance recovery</b>	<b>(8,000)</b>
<b>Loss deduction</b>	<b>(2,000)</b>
<b>Basis after accident</b>	<b><u>\$ 15,000</u></b>



60. Determine the proper treatment of each of the following expenditures:

**Expenditures that have a useful life that extends substantially beyond the end of the current tax year must be capitalized; they cannot be deducted in total in the year they are incurred. Trade or business and production of income (investment) expenditures can be deducted in the current year if they do not meet the criteria for capitalization.**

- a. Zoe purchases land costing \$8,000. During the current year, she pays \$2,000 to have utilities and sewer lines installed on the property. Zoe also pays \$600 in interest on the loan used to obtain the land and \$300 in property taxes on the land.

**The land has a life that extends substantially beyond the end of the tax year and its \$8,000 cost must be capitalized. The \$2,000 cost of utility and sewer lines must also be capitalized as part of the cost of the land because they provide benefits that extend substantially beyond the end of the current year. The interest on the loan relates only to the current year and is deductible if the land is used in a trade or business or a production of income (investment) activity. The interest also is deductible (as an itemized deduction) if the land is used to construct Zoe's personal residence. The property taxes relate only to the current year and are deductible expenses regardless of the use of the land.**

- b. On August 2, Carruth Corporation pays \$11,000 for a 2-year fire insurance policy on its manufacturing facility.

**The fire insurance policy is a capital expenditure because its usefulness extends substantially beyond the end of the current year. Carruth can deduct \$2,292  $[(\$11,000 \div 24 \text{ months}) \times 5 \text{ months}]$  of the cost of the policy in the current year.**

- c. The Freeborn Partnership purchases a rental property costing \$125,000. Before it rents out the building, Freeborn repaints it at a cost of \$2,000 and spends \$1,200 on minor repairs. After the property is rented, a pipe bursts, requiring \$2,000 in repairs.

**Freeborn must capitalize the \$125,000 purchase price of the property, the \$2,000 painting cost, and the \$1,200 repair cost as the cost of getting the rental property ready for its intended use. The repair of the burst pipe is a current period rental expense.**

- d. Aqua Robotics, Inc., purchases and pays for supplies costing \$1,400 on December 26. As of December 31, the company has not used \$1,200 worth of the supplies.

**Aqua can deduct the \$1,400 of supplies in the year of purchase. Although not all the supplies have been used by year-end, the supplies are not deemed to have a life that extends substantially beyond the end of the current year and may be deducted when purchased (accrual basis) or paid for (cash basis), regardless of when they are actually used.**

61. Determine the taxpayer's adjusted basis in each of the following situations. If any changes are made in the original basis of the asset, explain why they are necessary.

- a. Simone purchases 300 shares of Wilguess Inc., stock in 2013 for \$6,300. In 2013 and 2014, Wilguess pays cash dividends of \$2 per share. In 2015, Wilguess pays a 40% stock dividend (nontaxable), and Simone receives an additional 120 shares of stock.

**The original basis of the 300 shares of stock is \$6,300. The receipt of the cash dividend is taxable income and does not affect the amount of investment in the stock. The stock dividend is nontaxable. Therefore, Simone has 420 shares of stock that have a total basis of \$6,300 after the dividend. Each of the 420 shares of stock has a basis of \$15 ( $\$6,300 \div 420$ ).**

- b. Symbol Corporation purchases a building in 2012 at a cost of \$240,000. Annual maintenance costs on the building are \$80,000. In 2014, Symbol adds a wing to the building at a cost of \$60,000. In 2015, the building is painted at a cost of \$25,000. Symbol deducts \$4,800 in depreciation in 2012, \$7,300 in 2013, and \$8,100 in 2014 and 2015.

**The original basis of the building is the \$240,000 cost. Adjustments are made to the basis for any expenditure that cannot be currently deducted and for any capital recoveries of the building investment. The annual maintenance costs and the painting costs are current period expenses that are not capitalized. The addition of the wing to the building is a capital expenditure (its usefulness extends substantially beyond the end of the year of expenditure) and is added to basis. The depreciation deductions are capital recoveries that reduce basis. The adjusted basis at the end of 2015 is \$271,700:**

Original Basis	\$ 240,000
Add: Cost of adding wing	60,000
Deduct: Depreciation	
( $\$4,800 + \$7,300 + \$8,100 + \$8,100$ )	(28,300)
Adjusted basis at end of 2015	<u>\$ 271,700</u>

- c. Lorissa purchases land as an investment in 2013 for \$33,000. Property taxes on the property are \$400 per year. In 2014, Lorissa is assessed \$2,000 by the county assessor for her share of a sidewalk that the county builds adjacent to the land. Lorissa pays the assessment in 2015.

**The original basis in the land is \$33,000. Adjustments are made to the basis for any expenditure that cannot be currently deducted and for any capital recoveries of the building investment. The property taxes are deducted in the year paid and do not affect the basis. The assessment for the sidewalk is not a deductible tax. Therefore, it must be added to the basis of the land, resulting in an adjusted basis of \$35,000 (\$33,000 + \$2,000) at the end of 2015.**

- d. The Barton Brothers Partnership purchases a computer in 2013 for \$8,000. The partnership elects to deduct the entire cost of the computer in 2013. In 2015, Barton Brothers spends \$300 to repair the computer.

**The original basis of the computer is \$8,000. Adjustments are made to the basis for any expenditure that cannot be currently deducted and for any capital recoveries of the computer investment. The entire investment in the computer is recovered through the 2013 deduction, reducing the basis to zero (all of the capital investment is recovered). The \$300 repair cost is a 2015 expense and does not affect basis.**

62. Davidson Industries manufactures golf course maintenance equipment. The equipment comes with a 4-year warranty. Davidson's engineers estimate that approximately 10% of the equipment will be defective and require payment under the warranty. Discuss the propriety of allowing Davidson a deduction for warranty costs in the current year if

a. Davidson is a cash basis taxpayer.

**Under the cash basis, Davidson would not be able to deduct any expenses until they were actually paid. Therefore, the only deduction in the current year for a cash basis taxpayer would be for actual expenditures on defects during the current year.**

b. Davidson is an accrual basis taxpayer.

**An accrual basis taxpayer deducts expenses when the liability for the expense has occurred and the amount of the expense can be estimated with reasonable accuracy. In the case of contingent liabilities, such as warranties, the question is whether or not the amount of the liability can be fixed with reasonable accuracy. The IRS has taken the position that estimated expenses cannot be accrued. Their reasoning is based on the interpretation that because the payee on the warranty is unknown until an actual warranty payment is made, the amount of the liability cannot be reasonably estimated. Therefore, the only deduction allowed in the current year for an accrual basis taxpayer is for actual expenditures on defects during the current year. This accounting treatment for contingent liabilities is discussed in Chapter 5.**

**ISSUE IDENTIFICATION PROBLEMS**

In each of the following problems, identify the tax issue(s) posed by the facts presented. Determine the possible tax consequences of each issue that you identify.

63. Junior bought some stock several years ago for \$8,000. He is thinking of selling and has 2 offers. His broker told him he could sell the stock for \$8,300 and would have to pay a \$600 commission, for a net realization of \$7,700. His sister Bonnie offered to pay Junior \$7,700 with no commissions paid on the transaction.

**The issue is whether Junior will be able to deduct the \$300 (\$7,700 - \$8,000) loss if he sells the stock to his sister. Bonnie is a related party. Transactions between related parties are given close scrutiny and a set of rules have been constructed to prevent manipulations between related parties. Even though Junior would be selling the stock to Bonnie at fair market value net of commissions (what he would have received from an unrelated party), the tax law disallows the deduction of any loss on a sale between related parties.**

64. Henrietta is the president and sole shareholder of Clutter Corporation. In 2012, Henrietta transferred ownership of her personal residence to the corporation. As part of the transfer, Clutter Corporation assumed Henrietta's mortgage on the house. At the same time, she and the corporation entered into an agreement that lets Henrietta lease the property for as long as she wants at an amount approximating the monthly mortgage payments on the house. During the current year, Clutter paints the house at a cost of \$5,000, makes other repairs totaling \$3,000, and adds an entertainment room at a cost of \$30,000. Current-year property taxes and interest paid by Clutter on the house are \$1,400 and \$18,000, respectively. Henrietta paid \$18,000 in rent to Clutter.

**The issue is whether Clutter Corporation can deduct the loss on the rental of the house to Henrietta. The entity concept requires taxpayers to keep their business and personal affairs separate and apart so that the transactions of each can be treated properly according to rules for each type of transaction. Through this arrangement, Henrietta is attempting to create a deductible loss from her use of her personal residence. The entity concept requires that she keep her personal transactions separate from her corporate business, thus disallowing the loss in this case. In addition, Henrietta and Clutter Corporation are related parties. As such, transactions between Henrietta and Clutter are given careful scrutiny for tax avoidance motives. In this case, the amount of rent that Henrietta pays is based on the mortgage payment (which includes deductible interest). This arrangement creates a rental loss for Clutter. Because of Henrietta's ability to control Clutter's actions, losses on transactions between the two are not allowed. Therefore, Clutter will not be able to deduct a loss on the rental.**

65. Milton is an inventor who has also written several successful mystery novels. Because he didn't really need the income from the novels, Milton wrote them under an assumed name and had the royalties paid to Hammer Corporation. When Milton incorporated Hammer, he gave all the stock to his three sons. The sons are employed by the corporation, with salaries approximately equal to the royalties earned each year from the novels.

**The issue to be resolved is who is taxed on the royalty income. This arrangement is an attempt to transfer taxation of Milton's royalties to his sons through Hammer Corporation. Because the income was earned by Milton, the assignment of income doctrine requires that he be taxed on the royalties. The royalties received by Hammer would not be income for the corporation.**

**A secondary issue is the deductibility of the salary payments to the sons. The amounts paid to Milton's sons would not be deductible expenses because they lack a business purpose. The substance of this arrangement is a gift of the royalties from Milton to his sons. As gifts, the sons would recognize no income and Milton (or the corporation) would not receive a deduction.**

66. Jerry and his wife, Joanie, own a successful concrete company that is organized as a corporation. Jerry spends all his time running the company, whereas Joanie has a full-time job as a legal secretary. The corporation pays Joanie a salary of \$45,000 a year as vice president.

**The issue is whether Joanie's salary is deductible. To be deductible, the expenditure must have a business purpose. This means that the primary motive for making the expenditure is profit related. In addition, a business expense must be ordinary, necessary, and reasonable in amount. The problem in this arrangement is that the payment is made to a related party. Payments made to related parties are assumed to not be made at arm's-length and, therefore, are given special scrutiny. In this case, because Joanie has a full-time job, the salary paid to her is likely to be excessive in light of her duties to the corporation and, therefore, unreasonable. In such a case, the substance over form doctrine would characterize the excess payment as a dividend payment (which is not deductible by the corporation) rather than as a deductible salary expense.**

67. The Perry Development Partnership purchases 40 acres of land for \$30,000. It spends \$8,000 subdividing the land into 2-acre parcels and \$17,000 to install a sewer line and utilities to each parcel. Perry intends to sell the 2-acre parcels for \$12,000, but none of them are sold by the end of the current year.

**The issue is whether Perry has realized income by subdividing the parcels. A realization requires a change in the form and/or the substance of the taxpayer's property or property rights in an arm's length-transaction. Although there has been a change in the form of the property through the subdividing, this did not occur in an arm's-length transaction. Therefore, Perry has not realized any income from subdividing the property into 2-acre parcels.**

68. Ayah signs a contract to write a book for East Publishing Company in the current year. Under its terms, she receives a \$5,000 advance against future royalty payments upon signing the contract. The contract provides that if Ayah does not write a suitable book or if the book's royalties are insufficient to cover the advance, she must repay any portion not earned.

**The issue is whether Ayah has realized income from the receipt of the \$5,000. Under the claim of right doctrine, income is realized when the taxpayer has complete dominion and control over the income. That is, she can use the money in any manner in which she chooses and is under no absolute obligation to repay the advance. The fact that the income may have to be repaid in a later period does not negate Ayah's right to control the \$5,000 advance payment. If Ayah is required to make a repayment in the future, she would be allowed a deduction at that time. Ayah has realized income of \$5,000 when she receives the advance royalty.**

69. Aretha is an executive vice president of Franklin, Inc. On December 18, 2015, the Franklin, Inc., board of directors awards her a \$20,000 bonus. Aretha asks Franklin's controller to delay processing the bonus check until January. The controller agrees to her request, and she receives the \$20,000 bonus check on January 10, 2016.

**The issue is what year is the \$20,000 bonus taxable? A cash basis taxpayer is in constructive receipt of income when it is credited to their account or otherwise made unconditionally available to them. In this case, Aretha has demonstrated an ability to control the payment by having it paid in January. Therefore, the bonus is made available to her in 2015 and she must include the \$20,000 in her 2015 gross income.**

70. Arnold is a college professor specializing in robotics. During the current year, he attends a meeting on robotics in San Diego. Because of the desirable location of the meeting, he takes along his wife, Hortense, and their 2 children. The meeting lasts for 3 days, but Arnold and his family stay for 2 weeks.

**The tax issue posed is whether Arnold can deduct the costs of the attending the meeting (including those of his family). To be deductible, the expenditure must have a business purpose. This is interpreted to mean that the primary motive for making the expenditure is related to making a profit. Purely personal expenditures are disallowed. Thus, the issue is whether Arnold's expenditures were made primarily out of a profit motive or were they primarily personal. If the trip is found to be primarily personal in nature, a further issue to be resolved is whether any of Arnold's costs are deductible as a business expense. The rules for determining travel expense deductions are discussed in Chapter 6.**

71. Doris purchases a ski cabin in Montana during the current year. She hires a real estate management company to rent out the cabin on a daily basis. The real estate management company tells Doris to expect an average of 70 rental days per year. Doris intends to use the cabin for her vacation 3 weeks during the year.

**The primary issue is the deductibility of the expenses Doris incurs related to the ski cabin. To be deductible, an expenditure must have a business purpose. This means that the primary motive for the expenditure must be profit related. In this case, the cabin is used for both investment purposes (the production of rents) and for personal purposes (Doris' vacation). Therefore, the cabin is a mixed-use asset that will have to be accounted for as two assets - the investment portion and the personal use portion. Expenditures related to personal use are not deductible (other than allowable itemized deductions for interest and taxes). The expenditures related to the production of rental income are deductible, but may be limited.**

**A primary problem in such a circumstance is whether the primary purpose of purchasing the cabin is investment related or personal. In Chapter 5, the tax law definitions for making this determination are discussed.**



72. **RIA RESEARCH EXERCISE** Use the RIA Checkpoint research database to answer the following questions. Cut and paste the relevant Internal Revenue Code and Treasury Regulation section(s) into your solution and explain how the authority answers the tax issue in question. Give the most specific citation applicable [e.g., Sec. 168(a)(1)] that answers the question. Note: If the answer can be found in both the code and regulations, you must provide both authorities.
- a. Carol went and lobbied before the federal government concerning proposed changes to the new pension regulations. She incurred \$2,300 in expenses. What code section and/or regulation disallows a deduction for these expenses?

**Sec. 162(a) allows the deduction of ordinary and necessary business expenses.**

**§ 162 Trade or business expenses.**

**(a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—**

**Sec. 162(e)(1) disallows any deduction for certain lobbying expenses as defined in Sec. 162(e)(1).**

**(e) Denial of deduction for certain lobbying and political expenditures.**

**(1) In general. No deduction shall be allowed under subsection (a) for any amount paid or incurred in connection with—**

**(A) influencing legislation,**

**(B) participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office,**

**(C) any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums, or**

**(D) any direct communication with a covered executive branch official in an attempt to influence the official actions or positions of such official.**

**Reg. Sec. 1.162-29(b) defines influencing legislation for purposes of determining whether an activity is lobbying.**

**Reg § 1.162-29. Influencing legislation.**

**(b) Definitions. For purposes of this section—**

**(1) Influencing legislation. Influencing legislation means—**

**(i) Any attempt to influence any legislation through a lobbying communication; and**

**(ii) All activities, such as research, preparation, planning, and coordination, including deciding whether to make a lobbying communication, engaged in for a purpose of making or supporting a lobbying communication, even if not yet made. See paragraph (c) of this section for rules for determining the purposes for engaging in an activity.**

**(2) Attempt to influence legislation.** *An attempt to influence any legislation through a lobbying communication is making the lobbying communication.*

**(3) Lobbying communication.** *A lobbying communication is any communication (other than any communication compelled by subpoena, or otherwise compelled by Federal or State law) with any member or employee of a legislative body or any other government official or employee who may participate in the formulation of the legislation that—*

*(i) Refers to specific legislation and reflects a view on that legislation; or*

*(ii) Clarifies, amplifies, modifies, or provides support for views reflected in a prior lobbying communication.*

**(4) Legislation.** *Legislation includes any action with respect to Acts, bills, resolutions, or other similar items by a legislative body. Legislation includes a proposed treaty required to be submitted by the President to the Senate for its advice and consent from the time the President's representative begins to negotiate its position with the prospective parties to the proposed treaty.*

**(5) Specific legislation.** *Specific legislation includes a specific legislative proposal that has not been introduced in a legislative body.*

**(6) Legislative bodies.** *Legislative bodies are Congress, state legislatures, and other similar governing bodies, excluding local councils (and similar governing bodies), and executive, judicial, or administrative bodies. For this purpose, administrative bodies include school boards, housing authorities, sewer and water districts, zoning boards, and other similar Federal, State, or local special purpose bodies, whether elective or appointive.*

- b. Marsha is self-employed and paid \$4,000 in self-employment taxes during the year. What code section and/or regulation lets her deduct 50% of these taxes as a deduction for adjusted gross income?

**Sec. 164(a) allows a deduction for taxes paid or accrued. Reg. Sec. 1.164-1(a) also allows the deduction for taxes paid or accrued.**

## **§ 164 Taxes**

**(a) General rule.**

***Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:***

**(1) State and local, and foreign, real property taxes.**

**(2) State and local personal property taxes.**

**(3) State and local, and foreign, income, war profits, and excess profits taxes.**

**(4) The GST tax imposed on income distributions.**

**(5) The environmental tax imposed by section 59A.**  
**Reg § 1.164-1. Deduction for taxes.**

**(a) In general. Only the following taxes shall be allowed as a deduction under this section for the taxable year within which paid or accrued, according to the method of accounting used in computing taxable income:**

**(1) State and local, and foreign, real property taxes.**

**(2) State and local personal property taxes.**

**(3) State and local, and foreign, income, war profits, and excess profits taxes.**

**(4) State and local general sales taxes.**

**Sec. 164(f)(1) limits the deduction for self-employment taxes to one-half of the tax imposed by Sec. 1401.**

**(f) Deduction for one-half of self-employment taxes.**  
**(1) In general.**

**In the case of an individual, in addition to the taxes described in subsection (a) there shall be allowed as a deduction for the taxable year an amount equal to one-half of the taxes imposed by section 1401 for such taxable year.**

**(2) Deduction treated as attributable to trade or business**  
**For purposes of this chapter, the deduction allowed by paragraph (1) shall be treated as attributable to a trade or business carried on by the taxpayer which does not consist of the performance of services by the taxpayer as an employee.**

- c. Hamid dies in an automobile accident. He is covered by a \$500,000 life insurance policy which is payable to his wife, Janet. What code section and/or regulation excludes the \$500,000 from Janet's gross income?

**Sec. 61(a)(10) includes income from life insurance contracts in gross income.**

**§ 61 Gross income defined.**

**(a) General definition.**

**Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:**

**(10) Income from life insurance and endowment contracts;**

**Sec. 101(a)(1) provides the general rule that life insurance proceeds paid on account of death are excluded from gross income.**

**§ 101 Certain death benefits**

- (a) Proceeds of life insurance contracts payable by reason of death.*  
*(1) General rule.*

***Except as otherwise provided in paragraph (2) , subsection (d) , and subsection (f), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.***

**Reg. Sec. 1.101-1(a)** discusses the exclusion in more depth.

***Reg § 1.101-1. Exclusion from gross income of proceeds of life insurance contracts payable by reason of death.***

***(a) (1) In general. Section 101(a)(1) states the general rule that the proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from the gross income of the recipient. Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, are covered by this provision. For provisions relating to death benefits paid by or on behalf of employers, see section 101(b) and §1.101-2. The exclusion from gross income allowed by section 101(a) applies whether payment is made to the estate of the insured or to any beneficiary (individual, corporation, or partnership) and whether it is made directly or in trust. The extent to which this exclusion applies in cases where life insurance policies have been transferred for a valuable consideration is stated in section 101(a)(2) and in paragraph (b) of this section. In cases where the proceeds of a life insurance policy, payable by reason of the death of the insured, are paid other than in a single sum at the time of such death, the amounts to be excluded from gross income may be affected by the provisions of section 101(c) (relating to amounts held under agreements to pay interest) or section 101(d) (relating to amounts payable at a date later than death). See §§1.101-3 and 1.101-4. However, neither section 101(c) nor section 101(d) applies to a single sum payment which does not exceed the amount payable at the time of death even though such amount is actually paid at a date later than death.***

- d. Roy and Deanna are married and have two children, ages 13 and 19. They are aware that they are eligible for a child tax credit, but do not know if their children qualify them for the credit. What code section and/or regulation defines a child for purposes of the child tax credit?

**Sec. 24(a) allows a \$1,000 tax credit for a qualifying child of the taxpayer.**

**§ 24 Child tax credit.**

**(a) Allowance of Credit. —***There shall be allowed as a credit against the tax imposed by this chapter for the taxable year with respect to each qualifying child of the taxpayer an amount equal to \$1,000.*

**Sec. 24(c)(1) defines a qualifying child as a qualifying child under Sec. 152(c) who is less than 17 years of age, and who would not be a dependent if all that follows “resident of the United States” in Sec. 152(b)(3) is disregarded.**

**(c)(1) Qualifying child --** *For purposes of this section --*

*The term “qualifying child” means a qualifying child of the taxpayer (as defined in section 152(c)) who has not attained age 17.*

**(2) Exception for certain noncitizens.** *The term “qualifying child” shall not include any individual who would not be a dependent if subparagraph (A) of section 152(b)(3) were applied without regard to all that follows “resident of the United States”.*

**Sec. 152(c)(1) provides four tests that a qualifying child must meet. The child must meet the relationship test of Sec. 152(c)(2), which requires a qualifying child to be a child of the taxpayer or a descendant of a child of the taxpayer, must have the same principal residence for more than half the taxable year, meet the age requirement of Sec. 152(c)(3) which requires the child to be less than 19 years of age or a student less than 24 years of age, and the child cannot have provided more than one-half of their own support during the year.**

**152(c) Qualifying Child. —***For purposes of this section —*

**152(c)(1) In general. —***The term “qualifying child” means, with respect to any taxpayer for any taxable year, an individual —*

**152(c)(1)(A) who bears a relationship to the taxpayer described in paragraph (2),**

**152(c)(1)(B) who has the same principal place of abode as the taxpayer for more than one-half of such taxable year,**

**152(c)(1)(C) who meets the age requirements of paragraph (3), and**

**152(c)(1)(D) who has not provided over one-half of such individual's own support for the calendar year in which the taxable year of the taxpayer begins.**

**152(c)(2) Relationship.** —*For purposes of paragraph (1)(A), an individual bears a relationship to the taxpayer described in this paragraph if such individual is —*

**152(c)(2)(A)** *a child of the taxpayer or a descendant of such a child, or*

**152(c)(2)(B)** *a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative.*

**152(c)(3) Age requirements.** —

**152(c)(3)(A) In general.** —*For purposes of paragraph (1)(C), an individual meets the requirements of this paragraph if such individual —*

**152(c)(3)(A)(i)** *has not attained the age of 19 as of the close of the calendar year in which the taxable year of the taxpayer begins, or*

**152(c)(3)(A)(ii)** *is a student who has not attained the age of 24 as of the close of such calendar year.*

**Sec. 152(b)(3)(A)** requires a dependent (qualifying child) to be a citizen or resident of the United States or a country contiguous to the United States (Canada and Mexico). However, for purposes of the child tax credit, disregarding all language in Sec. 152(b)(3)(A) after resident means that only citizens or nationals of the United States are qualifying child for purposes of the child tax credit.

**152(b)(3) Citizens or nationals of other countries.** —

**152(b)(3)(A) In general.** —*The term “dependent” does not include an individual who is not a citizen or national of the United States unless such individual is a resident of the United States or a country contiguous to the United States.*

**152(b)(3)(B) Exception for adopted child.** —*Subparagraph (A) shall not exclude any child of a taxpayer (within the meaning of subsection (f)(1)(B)) from the definition of “dependent” if —*

**152(b)(3)(B)(i)** *for the taxable year of the taxpayer, the child has the same principal place of abode as the taxpayer and is a member of the taxpayer's household, and*

**152(b)(3)(B)(ii)** *the taxpayer is a citizen or national of the United States.*

73. **RIA RESEARCH EXERCISE** Use the RIA Checkpoint research database to answer the following questions. Cut and paste the relevant Internal Revenue Code and Treasury Regulation section(s) into your solution and explain how the authority answers the tax issue in question. Give the most specific citation applicable [e.g., Sec. 168(a)(1)] that answers the question. Note: If the answer can be found in both the code and regulations, you must provide both authorities.

1. Melinda takes classes costing \$3,500 that are paid for by her employer's educational assistance plan.
- a. What code section and/or regulation allows the exclusion of payments from an employer's educational assistance plan?

**Sec. 127(a)(1) allows the exclusion of amounts paid or expenses incurred by an employer for employee educational assistance if it is provided according to a program described in Sec. 127(b).**

### **SEC. 127. EDUCATIONAL ASSISTANCE PROGRAMS.**

#### **127(a) Exclusion From Gross Income.—**

**127(a)(1) In general.—Gross income of an employee does not include amounts paid or expenses incurred by the employer for educational assistance to the employee if the assistance is furnished pursuant to a program which is described in subsection (b).**

**Reg. Sec. 1.127-1(a)(1) and (a)(2) reiterate the exclusion of amounts paid or provided to an employee under a qualified educational assistance program.**

#### **§1.127-1. Amounts received under a qualified educational assistance program**

**(a) Exclusion from gross income.—The gross income of an employee does not include—**

**(1) Amounts paid to, or on behalf of the employee under a qualified educational assistance program described in §1.127-2, or**

**(2) The value of education provided to the employee under such a program.**

Reg. Sec. 1.127-1(b) adds that any amount excluded under this provision is not eligible to be treated as a credit or deduction for the employee.

**(b) Disallowance of excluded amounts as credit or deduction.—Any amount excluded from the gross income of an employee under paragraph (a) of this section shall not be allowed as a credit or deduction to such employee under any other provision of this part.**

**Reg. Sec. 1.127-1(c)** states that if an amount is received from a program that is not qualified, the amount must be included in gross income.

***(c) Amounts received under a nonqualified program.—Any amount received under an educational assistance program that is not a “qualified program” described in §1.127-2 will not be excluded from gross income under paragraph (a) of this section. All or part of the amounts received under such a non-qualified program may, however, be excluded under section 117 or deducted under section 162 or section 212 (as the case may be), if the requirements of such section are satisfied.***

- b. What code section and/or regulation limits the amount that can be excluded?

**Sec. 127(a)(2)** limits the annual excludible amount to \$5,250.

***127(a)(2) \$5,250 maximum exclusion.—If, but for this paragraph, this section would exclude from gross income more than \$5,250 of educational assistance furnished to an individual during a calendar year, this section shall apply only to the first \$5,250 of such assistance so furnished.***

- c. What code section and/or regulation defines the elements of an employer's educational assistance plan that must be met for employee's to be allowed an exclusion for payments received from the plan?

**Sec. 127(b)(1)** requires a separate written plan for the exclusive benefit of employees to provide them with educational assistance. The plan must meet the five requirements of Sec. 127(b)(2) through Sec. 127(b)(6).

***127(b) Educational Assistance Program.—***

***127(b)(1) In general.—For purposes of this section, an educational assistance program is a separate written plan of an employer for the exclusive benefit of his employees to provide such employees with educational assistance. The program must meet the requirements of paragraphs (2) through (6) of this subsection.***

***127(b)(2) Eligibility.—***

***127(b)(3) Principal shareholders or owners.—***

***127(b)(4) Other benefits as an alternative.—***

***127(b)(5) No funding required.—A program referred to in paragraph (1) is not required to be funded.***

***127(b)(6) Notification of employees.—***



The requirements of an educational assistance program are reiterated and expanded on in Reg. Sec. 1.127-2(a) – (b).

**§1.127-2., Qualified educational assistance program**

**(a) In general.**—A qualified educational assistance program is a plan established and maintained by an employer under which the employer provides educational assistance to employees. To be a qualified program, the requirements described in paragraphs (b) through (g) of this section must be satisfied. It is not required that a program be funded or that the employer apply to the Internal Revenue Service for a determination that the plan is a qualified program. However, under §601.201 (relating to rulings and determination letters), an employer may request that the Service determine whether a plan is a qualified program.

**(b) Separate written plan.**—

- d. What code section and/or regulation defines what types of expense payments from an employer's educational assistance plan can be excluded from the employee's gross income?

Sec. 127(c)(1)(A) defines educational assistance as payments for the education of the employee, including, but not limited to, tuition, fees, books, supplies, and equipment or the provision of courses of instruction, including books, supplies, and equipment (Sec. 127(c)(1)(B)). Educational assistance does not include tools or supplies that can be retained by the employee or amounts paid for meals, lodging, or transportation. Payments for sports, game, or hobby courses are not educational assistance.

**127(c)(1) Educational assistance.**—The term “educational assistance” means—

**127(c)(1)(A)** the payment, by an employer, of expenses incurred by or on behalf of an employee for education of the employee (including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment), and

**127(c)(1)(B)** the provision, by an employer, of courses of instruction for such employee (including books, supplies, and equipment), but does not include payment for, or the provision of, tools or supplies which may be retained by the employee after completion of a course of instruction, or meals, lodging, or transportation. The term “educational assistance” also does not include any payment for, or the provision of any benefits with respect to, any course or other education involving sports, games, or hobbies.

Reg. Sec. 1.127-2(c)(1) –(4) reiterates and expands on the Sec. 127(c)(1) definition.

**(c) Educational assistance**

- (1) In general.—The benefits provided under the program must consist solely of educational assistance. The term “educational assistance” means—**
  - (i) The employer's payment of expenses incurred by or on behalf of an employee for education, or**
  - (ii) The employer's provision of education to an employee.**
- (2) Alternative benefits.—Benefits will not be considered to consist solely of educational assistance if the program, in form or in actual operation, provides employees with a choice between educational assistance and other remuneration includible in the employee's gross income.**
- (3) Certain benefits not considered educational assistance.—The term “educational assistance” does not include the employer's payment for, or provision of—**
  - (i) Tools or supplies (other than textbooks) that the employee may retain after completing a course of instruction,**
  - (ii) Meals, lodging, or transportation, or**
  - (iii) Education involving sports, games, or hobbies, unless such education involves the business of the employer or is required as part of a degree program. The phrase “sports, games, or hobbies” does not include education that instructs employees how to maintain and improve health so long as such education does not involve the use of athletic facilities or equipment and is not recreational in nature.**
- (4) Education defined.—As used in section 127, §1.127-1, and this section, the term “education” includes any form of instruction or training that improves or develops the capabilities of an individual. Education paid for or provided under a qualified program may be furnished directly by the employer, either alone or in conjunction with other employers, or through a third party such as an educational institution. Education is not limited to courses that are job related or part of a degree program.**

2. Billy's Barbeque has assets of \$60,000 and liabilities of \$100,000. To assist Billy's, its bank agrees to reduce the amount due on a loan from \$65,000 to \$50,000.
- a. What code section and/or regulation specifically includes discharges of debt in gross income?

**Sec. 61(a)(12) specifically includes income from discharge of indebtedness in gross income. This general rule is also found in Reg. Sec. 1.61-12(a).**

**§61 Gross income defined.**

**(a) General definition. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:**

**(12) Income from discharge of indebtedness;**

**Reg § 1.61-12. Income from discharge of indebtedness.**

**(a) In general. The discharge of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.**

- b. What code section and/or regulation allows certain discharges of debt to be excluded from gross income?

**Sec. 108(a)(1)(B) allows an exclusion from gross income for discharges of debt that occur when the taxpayer is insolvent.**

**SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS.**

**108(a) Exclusion From Gross Income.—**

**108(a)(1) In general.—Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—**

**108(a)(1)(A) the discharge occurs in a title 11 case,**

**108(a)(1)(B) the discharge occurs when the taxpayer is insolvent,**

- c. What code section and/or regulation defines the condition that must be met to exclude a discharge of debt from gross income?

**Sec. 108(d)(3) defines insolvent as the excess of liabilities over the fair market value of assets.**

***108(d)(3) Insolvent.—For purposes of this section, the term “insolvent” means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer’s assets and liabilities immediately before the discharge.***

- d. What code section and/or regulation limits the amount of debt discharge that can be excluded?

**Sec. 108(a)(3) limits the amount of the exclusion to the amount the taxpayer is insolvent before the discharge.**

***108(a)(3) Insolvency exclusion limited to amount of insolvency.—In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.***

74. **INTERNET ASSIGNMENT** Many legislative, administrative, and judicial resources are available on the Internet. They can be located using search engines provided by your browser or a tax directory site located on the Internet. The purpose of this assignment is to practice searching the Internet to locate tax materials. Using a search engine or one of the tax directory sites provided in Exhibit 16-6 (Chapter 16), find the Treasury Regulation that provides the treatment of advance receipts of rental income. Trace the process you used to find this regulation (search engine or tax directory used and key words). Print the text of the regulation.

**The National Archives and Records Administration provides the Code of Federal Regulations (which includes income tax regulations) in a searchable database (<http://www.gpoaccess.gov/cfr/index.html>). This site can be accessed from the tax directories listed in Exhibit 16-6 of Chapter 16. The appropriate regulation is Reg. Sec. 1.61-8. It can be found with the search "rent and advance" in the CFR database.**

**INSTRUCTOR'S NOTE:** Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

75. **INTERNET ASSIGNMENT** Many legislative, administrative, and judicial resources are available on the Internet. They can be located using a search engine provided by your browser or a tax directory site located on the Internet. The purpose of this assignment is to practice searching the Internet to locate tax materials. Using a search engine or one of the tax directory sites provided in Exhibit 16-6 (Chapter 16), find the U.S. Supreme Court decision that established the claim of right doctrine. Provide the citation to the case and explain the facts that led to the creation of the claim of right doctrine.

**The easiest way to find this case is to use one of the tax directory sites to locate a site that has Supreme Court cases. One site that has a complete set of Supreme Court cases is FINDLAW (<http://www.findlaw.com/casecode.supreme.html>). Searching this site with "claim of right" yields a number of cases, many of which are not tax cases. The tax cases found all refer to *North American Oil Consolidated v Burnet*, 286 U.S. 417 (1932).**

**Income from the sale of oil and gas produced during 1916, impounded in the hands of a receiver to await the outcome of litigation, is taxable to the oil company when paid to it by the receiver in 1917, whether it was on the cash or the accrual basis, and regardless of the fact that the litigation was not finally settled, in favor of the oil company, until 1922. The oil company was not taxable in 1916 on an amount it might never receive.**

**INSTRUCTOR'S NOTE:** Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

76. **RESEARCH PROBLEM.** The assignment of income doctrine states that income is taxed to the entity owning the income, regardless of who actually receives the income. That is, income taxation cannot be escaped by assigning the payment of income to another entity. Find the court case that led to this doctrine and explain the facts surrounding the court's decision.

***Lucas v. Earl*, 281 US 111 (S.Ct. 1930) established the assignment of income doctrine. The case involved Guy Earl's attempt to transfer one-half of the salary and attorney's fees he earned in 1920 and 1921 to his wife (each spouse was taxed separately on their income in these years; there was no married, filing joint status available to split the income). Mr. Earl had executed a contract that each party would be entitled to one-half of any income or any other property that either might receive.**

77. **RESEARCH PROBLEM** Under a reimbursement plan that has been in effect for 5 years, Simmons Corporation advances travel expenses to its sales employees. The advances are deducted from the employees' commissions as they are earned. The employees have an unconditional obligation to repay any advances not repaid through the commission offset. Up to the current year, the sales employees' commissions have never been sufficient to fully offset the advances made under the plan. To boost morale, Simmons charges off the balance of the advances. What are the tax effects of the reimbursement plan and the subsequent write-off of the advance balances?

**The primary issue is whether the write-off of the advance balances is taxable to the employees. Rev. Rul. 69-465, 1969-2 CB 27, held that debts from travel advances owed to a company that were charged off represent additional compensation to the employee and were deductible by the company in the year of the charge-off.**

78. **TAX FORM PROBLEM** Kimberly Cerny is a graduate student. She is 22 years old and works part-time as a graduate assistant in the biology department. She had health insurance for the full year under her parents' insurance. In the summer, Kimberly was an intern at Neutobio, Inc. Details regarding her salary and withholdings from her employment follows.

	<u>Biology Department</u>	<u>Neutobio, Inc.</u>
Salary	\$2,600	\$3,600
Federal withholding	260	302
State withholding	97	114
Social Security	168	275

Kimberly also received \$1,200 in interest from a savings account that was set up by her grandparents to help pay her college expenses. Kimberly lives at 499 Hillside Drive, Portland, Oregon, 97208. She is a dependent of her parents, her Social Security number is 324-99-8020, and does not wish to contribute to the Presidential Campaign Election Fund. She has asked you to help her with her federal income tax return. Prepare Form 1040EZ for Kimberly. Forms and instructions can be downloaded from the IRS web site (<http://www.irs.gov>).

**Instructor's Note:** The solution to the tax form problem is included separately in the file **SM\_Ch\_02 Problem\_78.pdf** on the companion website, [www.cengagebrain.com](http://www.cengagebrain.com).

**DISCUSSION CASES**

79. The controller of Newform Oil Company has come to you for advice. Newform recently cleared a forested area and began drilling an oil well on the site. The well is a gusher, and Newform's geologists estimate that it will produce for at least 10 years. Environmental restoration laws will require Newform to completely reforest and restore the oil well site when the well is taken out of production. An engineering firm hired by Newform estimates that the cost of complying with the environmental requirements to be \$8,000,000. For financial accounting purposes, Newform intends to amortize the estimated cost over the 10-year expected life. In addition, it plans to put \$500,000 per year into an account that should provide the \$8,000,000 necessary to perform the restoration.

The controller would like your advice on the deductibility of the costs of restoration. That is, when can Newform deduct the costs and how much can it deduct? Based on the concepts discussed in this chapter, explain what you think is the proper treatment of the restoration costs for tax purposes.

**The environmental restoration costs incurred by Newform have a Business Purpose and are fully deductible as a trade or business expense. The Capital Recovery Concept limits the amount of the deduction to the amount expended on the restoration. Therefore, the key issue to be determined is the timing of the deduction. There are several possibilities that should be considered. First, can Newform amortize the \$8,000,000 estimated cost over the 10-year life of the project (as in financial accounting)? Alternatively, can the \$500,000 paid into the fund account form the basis for a deduction? A third possibility is that no deduction would be allowed until actual restoration costs are incurred. The memorandum should discuss these possibilities in terms of the income tax concepts. More specifically, the following issues should be addressed:**

1. **Financial accounting versus income tax accounting - the purpose of financial accounting is to determine the "true income" for each reporting period. The matching concept in financial accounting requires the accrual of the estimated restoration expenses against current period income in order to show the full cost of producing the income. The purpose of income tax accounting is to generate and collect revenue. One of the main concepts of the income tax system is that the tax should be based on the taxpayer's Ability to Pay. This concept requires that the taxable income number reflect the actual results of each annual accounting period. That is, does the taxpayer have the Wherewithal-to-Pay the tax on the income being generated? In this regard, deductions reduce taxable income which in turn reduce the required tax payment. The question the student should address is whether the reduction in taxable income should take place during the earnings period or when amounts are actually being expended for restoration costs.**



2. **Accounting Method** - the facts indicate that Newform uses the accrual method for financial accounting and presumably, would use the same accounting method in calculating taxable income. For tax purposes, accrual basis taxpayers deduct expenses when they are incurred. The question that the student should address is when are the restoration expenditures "incurred"? Is an estimate of the expenses to be paid in the future sufficient? Is the \$500,000 that is paid into the fund account "incurred"?

The student may also consider deductibility under the cash method. The cash method allows deductions when they are paid. The question that the student should address for a cash basis taxpayer is whether payments made into a fund to provide for the future expenses is a "payment" of the expenses. In this regard, they may discuss whether the fund payment reduces Newform's Wherewithal-to-Pay each period.

3. **Capital Recovery Concept** - This concept limits the amount of a deduction to its cost. The question to be resolved is whether estimates of future costs can be recovered currently. That is, Newform has no basis in the restoration costs until it expends amounts related to the costs. Therefore, this concept would not allow the 10-year amortization of expected future costs because no capital investment in the restoration has been made. However, the student should address whether the annual \$500,000 payments made into the fund account constitute a capital investment that can be recovered currently.

**INSTRUCTOR'S NOTE:** At this stage in the course, there is no hard and fast answer to the deduction of the costs. This is covered in Chapter 5 in the discussion of the all-events test and the economic performance test requirements for deductions by accrual basis taxpayers. The purpose of this case is to stimulate student thinking about how the expenses should be treated based on their application and interpretation of the income tax concepts. As such, it is reasonable to assume that they will come to different conclusions on the application of the concepts.

80. The Prevetti Partnership is engaged in the purchase and management of apartment complexes. The partnership entered into an agreement with Parsnip Development Company on July 1 of the current year to purchase the Perry Apartments. The sales agreement stated the purchase price of \$5,000,000. It also provided for "other payments to seller," composed of a \$500,000 payment for a covenant not to compete, \$50,000 for the seller's management advice during the ownership transition, and a financing fee of \$100,000. In addition, the seller is to receive the first \$400,000 of the rent collected by Prevetti. The purchase was completed on August 5. Monthly rentals on the property are \$90,000. Prevetti paid Parsnip the first \$400,000 of rent it collected per the purchase agreement. How much rental income does the Prevetti Partnership have for the current year? Explain.

**The question to be resolved on these facts is whether Prevetti or Parsnip is taxed on the \$400,000 rent payment Prevetti paid to Parsnip. Following the strict language of the sales contract leads to the conclusion that Parsnip is taxed on the rents that it received. However, a closer analysis of the contract indicates that the rental payment that Prevetti makes to Parsnip is part of the sales price of the property. That is, the sales price is effectively \$5,400,000. In effect, Prevetti is using the rents as security for payment of the additional \$400,000. This is an application of the substance over form doctrine which taxes transactions according to their true intent, rather than their strict form. On similar facts in *Ellison*, 80 T.C. 378 (1983), the Tax Court held that rent paid to the seller is nothing more than a financing arrangement and that, in substance, the rents are earned by the purchaser and are part of the purchase price of the property.**

**TAX PLANNING CASE**

81. Biko owns a snowmobile manufacturing business, and Miles owns a mountain bike manufacturing business. Because each business is seasonal, their manufacturing plants are idle during their respective off-seasons. Biko and Miles have decided to consolidate their businesses as one operation. In so doing, they expect to increase their sales by 15% and cut their costs by 30%. Biko and Miles own their businesses as sole proprietors and provide the following summary of their 2014 taxable incomes:

	<u>Biko</u>	<u>Miles</u>
Business income		
Sales	\$ 600,000	\$ 450,000
Cost of goods sold	(400,000)	(300,000)
Other expenses	(100,000)	( 75,000)
Business taxable income	\$ 100,000	\$ 75,000
Other taxable income		
(net of allowable deductions)	20,000	35,000
2014 Taxable income	<u>\$ 120,000</u>	<u>\$ 110,000</u>

Biko and Miles don't know what type of entity they should use for their combined business. They would like to know the tax implications of forming a partnership versus a corporation. Under either form, Biko will own 55% of the business and Miles will own 45%. They each require \$60,000 from the business and would like to increase that by \$5,000 per year.

Based on the information provided, do a three-year projection of the income of the business and the total taxes for a partnership and for a corporation. In doing the projections, assume that after the initial 30% decrease in total costs, their annual costs will increase in proportion to sales. Also, assume that their nonbusiness taxable income remains unchanged. Use the 2015 tax rate schedules to compute the tax for each year of the analysis.

**The first step in the analysis is to calculate the taxable income of the business entity under the assumptions given. Partnerships are conduit entities, so the partnership is not subject to tax on its income. Biko and Miles will include their share of the partnership's income in their individual tax calculation.**

**Partnership Income Calculation:**

	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>
Sales	\$1,050,000	\$1,207,500	\$1,388,625	\$1,596,919
COGS	(700,000)	(490,000)	(563,500)	(648,025)
Other expenses	(175,000)	(122,500)	(140,875)	(162,006)
Taxable income	<u>\$ 175,000</u>	<u>\$ 595,000</u>	<u>\$ 684,250</u>	<u>\$ 786,888</u>

***Taxable Income Computation:***

Biko will be taxed on 55% of the income from the partnership; Miles will be taxed on the remaining 45% of partnership income. Because they are taxed on the partnership income, the yearly cash withdrawals are not taxed again in the partnership entity form. The total tax paid under this option is the sum of the tax Biko and Miles pay as individuals.

**Biko's Tax: (2015 Single rate schedule)**

	<b>2015</b>	<b>2016</b>	<b>2017</b>
Business taxable income	<b>\$ 327,250</b>	<b>\$ 376,338</b>	<b>\$ 432,788</b>
Other taxable income	<b>20,000</b>	<b>20,000</b>	<b>20,000</b>
Taxable income	<b><u>\$ 347,250</u></b>	<b><u>\$ 396,338</u></b>	<b><u>\$ 452,788</u></b>
Tax	<b>\$ 98,199</b>	<b>\$ 114,398</b>	<b>\$ 133,852</b>

**Miles Tax: (2015 Single rate schedule)**

	<b>2015</b>	<b>2016</b>	<b>2017</b>
Business taxable income	<b>\$ 267,750</b>	<b>\$ 307,912</b>	<b>\$ 354,100</b>
Other taxable income	<b>35,000</b>	<b>35,000</b>	<b>35,000</b>
Taxable income	<b><u>\$ 302,750</u></b>	<b><u>\$ 342,912</u></b>	<b><u>\$ 389,100</u></b>
Tax	<b>\$ 83,514</b>	<b>\$ 96,767</b>	<b>\$ 112,009</b>
Total tax (Biko & Miles)	<b><u>\$ 181,713</u></b>	<b><u>\$ 211,165</u></b>	<b><u>\$ 245,861</u></b>

**Corporation Tax Calculation:**

A corporation is a taxable entity. The corporation will pay tax on its income. The withdrawals by Biko and Miles take the form of salaries, which are deductible by the corporation and included in Biko and Miles individual income tax calculation. The tax under this option is the sum of the tax paid by the corporation, Biko, and Miles.

	2014	2015	2016	2017
Sales	\$1,050,000	\$1,207,500	\$1,388,625	\$1,596,919
COGS	(700,000)	(490,000)	(563,500)	(648,025)
Other expenses	(175,000)	(122,500)	(140,875)	(162,006)
Salaries	-0-	(120,000)	(130,000)	(140,000)
Taxable income	<u>\$ 175,000</u>	<u>\$ 475,000</u>	<u>\$ 554,250</u>	<u>\$ 646,888</u>
Corporate Tax		\$ 161,500	\$ 188,445	\$ 219,942

**Biko's Tax:**

Salary from corporation	\$ 60,000	\$ 65,000	\$ 70,000
Other taxable income	20,000	20,000	20,000
Taxable income	<u>\$ 80,000</u>	<u>\$ 85,000</u>	<u>\$ 90,000</u>
Tax	\$ 15,794	\$ 17,044	\$ 18,294

**Miles Tax:**

Salary from corporation	\$ 60,000	\$ 65,000	\$ 70,000
Other taxable income	35,000	35,000	35,000
Taxable income	<u>\$ 95,000</u>	<u>\$ 100,000</u>	<u>\$ 105,000</u>
Tax	\$ 19,671	\$ 21,071	\$ 22,471
Total tax	<u>\$ 196,965</u>	<u>\$ 226,560</u>	<u>\$ 260,707</u>

**Summary of Total Tax:**

	2015	2016	2017
Partnership	\$ 181,713	\$ 211,165	\$ 245,861
Corporation	196,965	226,560	260,707
Tax savings with partnership	<u>\$ 15,252</u>	<u>\$ 15,395</u>	<u>\$ 14,846</u>

Based on the assumptions given in the case, the partnership offers greater tax savings over the three-year period than the corporate form. However, this analysis is only one factor in the decision to use a corporation versus a partnership. Other non-tax factors, such as limited liability should also be considered. In addition, other tax factors such as employment taxes and the availability of nontaxable fringe benefits should also be considered. These factors are discussed in Chapter 13.

**ETHICS DISCUSSION CASE**

82. You are a CPA who has been preparing tax returns for Sign, Seal, and Deliver, a mid-size CPA Firm for the last 5 years. During the current year, you are assigned the individual return of a new client, Guadalupe Piaz. Guadalupe has completed and returned the tax return questionnaire that the firm sent to her.

In reviewing the questionnaire, you notice that Guadalupe has included an entry for \$10,000 in cash dividends received from Quinn Corporation. However, there is no supporting documentation for the dividend payment in the information Guadalupe provided.

What concerns you is that until this year, you had prepared the tax return for Quinn Corporation. (It was reassigned to another firm member when you were promoted late last year.) You know that Quinn Corporation was organized as an S corporation during the years that you prepared the return. During that period, Quinn was equally owned by 3 shareholders, and Guadalupe was not among them. In addition, the Corporation was highly profitable, averaging approximately \$6,000,000 per year in taxable income. Given this information, what are your obligations under the Statements on Standards for Tax Services (which can be found at [www.cengagebrain.com](http://www.cengagebrain.com))? Write a memorandum to your supervisor explaining your concerns and what actions, if any, you will need to take before you can prepare Guadalupe's return.

**SSTS #3 allows a CPA to rely on information provided by a client. However, if the information appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the CPA, SSTS #3 requires the CPA to make reasonable inquiries about the information provided. Paragraph .06 of SSTS #3 discusses the CPA's obligation in regard to unsupported lists of tax information. Although there is no absolute obligation to examine underlying documentation (paragraph .07), SSTS #3 advises the CPA to encourage the client to provide supporting data where necessary. That is, if the CPA has reason to believe, based on other information known to the CPA, that the amounts reported may be incorrect, the CPA should ask the client to provide the supporting documentation to avoid misunderstandings, inadvertent errors, and possible administrative actions (i.e., audits) in the future. The CPA should also consider relevant information from the returns of other clients if the information is necessary to properly prepare a return and the use of the other information does not violate any law or rule relating to confidentiality.**

Applying these requirements to Guadalupe, the CPA's knowledge of Quinn Corporation would require the CPA to examine Quinn Corporation's return (assuming that Sign, Seal, and Deliver still prepares the return). Because Quinn is an S corporation, Guadalupe should report her share of Quinn's income on her return. Cash dividends received from an S corporation are not taxable. It is quite likely that Guadalupe does not understand the conduit nature of an S corporation and has incorrectly reported the amount of cash dividends that she received in the tax return information questionnaire. There is also the possibility that Quinn is no longer an S corporation and that the cash dividends that Guadalupe received is the correct amount of income that should be reported. An examination of Quinn's return will show the correct amount of income that Guadalupe should report from her investment in Quinn. If the \$10,000 is not the correct amount of income to be reported, the CPA should discuss the problem with Guadalupe and advise her that the amount is incorrect.

Under SSTS #1, the CPA cannot prepare or sign a return if the CPA does not have "a good faith belief" that a position being taken on a return does not have a "realistic possibility" of being sustained upon audit. Therefore, if Guadalupe does not consent to the reporting of the correct amount of income from Quinn Corporation, the CPA should not prepare or sign the return.

If the Quinn Corporation tax return information is not available, the CPA should ask Guadalupe to provide the supporting documentation she received from Quinn. If Guadalupe will not provide (or does not have) the reporting information, she should be advised of the possible tax consequences (additional tax, penalties, etc.) of incorrectly reporting the income from the S corporation. Under these circumstances, the CPA should consider the effect of SSTS #1. As stated above, the CPA would have to determine whether Guadalupe's non-cooperation in providing the required information would cause him or her to be unable to prepare or sign the return.

## Chapter 2

### Check Figures

18. a. not ability to pay  
c. not ability to pay  
b. possibly based on ability to pay  
d. not ability to pay
19. a. not ability to pay  
c. not ability to pay  
b. not ability to pay  
d. not ability to pay
20. Single tax = \$21,071; Married tax = \$16,588
21. marital status, deductions, dependents, tax credits
22. a. related party  
c. related party  
e. not related parties  
b. related party  
d. not related parties
23. a. not related parties  
c. related party  
b. not related parties  
d. related party
24. Related parties, Nall cannot deduct the loss.
25. a. business income  
c. capital expenditure  
e. bad checks not income  
g. fully deductible  
b. interest must be allocated  
d. electricity must be allocated  
f. fully deductible  
h. not deductible
26. a. \$4,000 business expense; \$9,200 itemized deduction  
b. property tax must be allocated  
c. electricity must be allocated  
d. not deductible; add to basis of house  
e. \$30 per month deductible; \$250 ad deductible  
f. cost of operating van must be allocated
27. a. no tax paid  
c. \$100,000 taxable income  
b. \$ 40,000 taxable income  
d. \$ 60,000 taxable income
28. a. Wendy's taxable income = \$8,000  
b. Wendy's taxable income = \$18,000
29. Using 2 separate S corporations will not reduce tax
30. 2014 taxable income = \$30,000; 2015 taxable loss = \$10,000
31. Arnie is taxed on the \$10,000
32. \$2,000 taxable to Esmeralda



33. a. cash basis in 2016  
b. cash basis = \$22,450  
c. cash basis in 2016  
d. cash basis - as payments received  
e. capital expenditure
- accrual basis in 2015  
accrual basis = \$23,010  
accrual basis in 2015  
accrual basis in 2015
34. a. cash basis in 2016  
b. capital expenditure  
c. cash basis - as payments received  
d. cash basis - no income recognized
- accrual basis in 2015  
accrual basis - in year of sale  
accrual basis - in 2015
35. \$600 income in 2015
36. \$600 income in 2015 no deduction; \$600 income in 2015
37. Parents cannot deduct interest paid
38. a. realization concept  
c. administrative convenience concept
- b. pay-as-you-go concept  
d. administrative convenience concept
39. a. pay-as-you-go concept  
c. assignment of income doctrine
- b. tax benefit rule  
d. entity concept; conduit entity
40. \$31,600 gain on sale
41. 2015 tax liability = \$23,471
42. \$18,000 realized loss; \$3,000 deductible loss
43. a. \$15,000 realization  
c. no realization
- b. \$39,000 realization  
d. \$30,000 realization
44. a. no realization  
c. realization
- b. realization  
d. realization
45. \$30,000 of income
46. a. claim of right  
c. claim of right
- b. no claim of right  
d. claim of right
47. a. claim of right  
c. claim of right
- b. claim of right to \$20,000  
d. claim of right
48. constructive receipt doctrine
49. a. no constructive receipt  
c. \$1,500 constructive receipt
- b. \$75 per month constructive receipt
50. a. realization  
c. realization  
e. \$1,000,000 realization
- b. no realization  
d. realization
51. N/A

52. a. assignment of income doctrine  
c. claim of right doctrine
- b. wherewithal-to-pay concept  
d. all-inclusive income concept
53. allocation of costs between different uses
54. a. legislative grace  
c. business purpose concept
- b. business purpose concept  
d. legislative grace concept
55. a. legislative grace concept  
c. capital recovery concept
- b. business purpose concept  
d. business purpose concept; capital recovery
56. cost of trip not deductible
57. a. personal expense  
c. production of income (investment) expense
- b. trade or business expense
58. a. personal loss not deductible  
c. investment loss maximum deductible loss \$3,000
- b. trade or business loss deductible
59. a. \$2,000
- b. \$15,000
60. a. capitalize land, utility, sewer line  
c. capitalize purchase price painting and repair
- b. capital expenditure; \$2,292 deductible  
d. deduct supplies cost
61. a. basis per share=\$15  
c. \$35,000
- b. \$271,700  
d. zero basis
62. a. deduct actual expenditures
- b. deduct actual expenditures