

CHAPTER 15

CHOICE OF BUSINESS ENTITY -- OTHER CONSIDERATIONS

2017 Edition	Topic	Status
Questions		
1	Explain the difference between a contributory and noncontributory pension plan	Unchanged
2	Explain the tax advantages of using a qualified pension plan	Unchanged
3	Explain the requirements that must be met to establish a qualified pension plan	Unchanged
4	Explain whether all entities are allowed to have a qualified pension plan	Unchanged
5	Explain the difference between a defined benefit plan and a defined contribution plan	Unchanged
6	Determine the maximum amount that can be contributed to a defined contribution	Unchanged
7	Determine the maximum amount that can be contributed to a defined benefit plan	Unchanged
8	Explain the difference between a Keogh plan and other qualified pension plans	Unchanged
9	Define the term owner-partner	Unchanged
10	Explain how being classified as an owner partner affects the amount contributed to a Keogh plan	Unchanged
11	Explain whether all taxpayers can deduct contributions to an IRA account	Unchanged
12	Explain the difference between a simplified employee pension plan, a Keogh plan, and other qualified pension plans	Unchanged
13	Explain the requirements that must be met to establish a simplified employee pension	Unchanged
14	Compare the funding options under a SIMPLE-IRA with a SIMPLE 401(k)	Unchanged
15	Explain how the required distribution amount from a pension plan is determined	Unchanged
16	Discuss when distributions from a pension plan can begin	Unchanged

2017 Edition	Topic	Status
17	Discuss the penalties associated with qualified pension plans, Keoghs, IRAs and SEPs	Unchanged
18	Discuss penalty provisions of Roth IRA	Unchanged
19	Discuss the difference between a nonqualified stock option plan and a qualified stock option plan	Unchanged
20	Explain the difference in the tax treatment if a nonqualified stock option has a readily ascertainable fair market value	Unchanged
21	Discuss the taxation of a nonqualified stock option if it subject to substantial restrictions	Unchanged
22	Explain the advantage of making a Section 83(b) election	Unchanged
23	Explain the requirements that must be met for a stock option to qualify as an incentive stock option	Unchanged
24	Explain the tax treatment of an incentive stock option	Unchanged
25	Contrast a tax credit and a deduction	Unchanged
26	Discuss why a business tax credit can be carried forward)	Unchanged
27	Explain the purpose of tax credits	Unchanged
28	Purpose of the research and development tax credit	Unchanged
29	Expenses that qualify for rehabilitation expenditure tax credit)	Unchanged
30	Restrictions on the rehabilitation expenditure tax credit	Unchanged
31	The purpose of the general business credit	Unchanged
32	Purpose of the alternative minimum tax (AMT)	Unchanged
33	Tax base for the alternative minimum tax	Unchanged
34	Difference between an AMT adjustment and preference	Unchanged
35	Negative AMT adjustments	Unchanged
36	Exemptions with the AMT	Unchanged
37	Tax credits allowed for AMT	Unchanged

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38	Purpose of the AMT credit against regular tax	Unchanged
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40	Rationale for tax treaties	Unchanged
41	Tax treatment of controlled foreign corporation	Unchanged
42	Taxation of Subpart F income	Unchanged
43	Purpose for the foreign tax credit	Unchanged
44	Transfer of appreciated property to foreign subsidiary taxed	Unchanged
45	Purpose of transfer pricing rules	Unchanged
46	Explain taxation of foreign corporations conducting business in U.S.	Unchanged
47	Sale of property by foreign corporation not subject to withholding tax	Unchanged
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48	Compare the amount available for retirement for two taxpayers	Unchanged
49	Determine the amount of a taxpayer's pension contribution with a defined benefit plan - 3 scenarios	Unchanged
50	Determine the amount of a taxpayer's pension contribution with a money purchase plan and profit sharing plan - 4 scenarios)	Unchanged
51	Determine the amount of an owner-partner's and a nonowner-partner's pension contribution with a profit sharing plan- 2 scenarios	Unchanged
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53	Determine the deductible amount that can be contributed to an Individual Retirement Account - three scenarios	Unchanged
54	Determine the deductible amount that can be contributed to an Individual Retirement Account by working spouse	Unchanged
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58-COMM	Tax treatment of excess contribution to a qualified pension plan	Unchanged
59	Determine maximum contribution to Roth IRA	Unchanged
60- COMM	Penalty associated with excess contribution to an IRA	Unchanged
61	Penalty on premature distribution from an IRA	Unchanged
62	Penalty for failing to receive minimum distribution from a qualified pension plan	Unchanged
63-COMM	Determine maximum contribution to Roth IRA by working couple - five scenarios	Unchanged
64	Tax treatment of nonqualified stock option - four scenarios	Unchanged
65	Tax treatment of nonqualified stock option - four scenarios (relates to #64)	Unchanged
66	Tax treatment of nonqualified stock option	Unchanged
67	Tax treatment of nonqualified stock option when a Section 83 (b) election is made (relates to #66)	Unchanged
68	Sale of a nonqualified stock option (relates to #67)	Unchanged
69	Tax treatment of incentive stock option	Unchanged
70	Compare tax treatment of unreasonable compensation paid to an owner-shareholder of a corporation with an owner-shareholder of an S corporation	Unchanged
71	Research and experimental tax credit	Unchanged
72	Rehabilitation tax credits	Unchanged
73	Recapture of rehabilitation tax credits (relates to #72)	Unchanged
74	Child care cost credit	Unchanged
75	General business tax credit	Unchanged
76	Regular tax versus alternative minimum tax - two scenarios)	Unchanged
77	AMT adjustment for 7-year MACRS property	Unchanged
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2017 Edition	Topic	Status
79	Determine the AMT adjustments	Modified
80-COMM	Determine regular tax and AMT tax	Modified
81-COMM	Impact of AMT rules on investing in private activity bonds	Unchanged
82	Determine the AMT exemption - five scenarios	Unchanged
83	Controlled foreign corporation	Unchanged
84	Taxation of controlled foreign corporation	Unchanged
85	Taxation of controlled foreign corporation	Unchanged
86	Taxation of Subpart F income	Unchanged
87-COMM	Nondistribution of Subpart F Income	Unchanged
88	Distribution of Subpart F income	Unchanged
89	Tax treatment of foreign corporation	Unchanged
90	Foreign tax credit	Unchanged
91	Foreign tax credit	Unchanged
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93	Tax treatment of foreign corporation operating in U.S.	Unchanged
94	Tax treatment of dividend from U.S. corporation to nonresident.	Unchanged
95-IID	Choosing the proper retirement plan - individual	Unchanged
96-IID	Choosing the proper retirement plan - corporation	Unchanged
97-IID	Transfer pricing	Unchanged
98-IID	Taxation of foreign corporation doing business in U.S.	Unchanged
99-IID	Taxation of foreign corporation doing business in U.S. with foreign sourced royalty income	Unchanged
100	INTERNET	Unchanged
101	INTERNET	Unchanged
102	Research Problem	Unchanged

2017 Edition	Topic	Status
103	Research Problem	Unchanged
104-DC	Discuss whether a taxpayer with negative taxable income might be liable for tax	Unchanged
105-DC	Discuss the advantages and disadvantages of regular tax and alternative minimum tax	Unchanged
106-DC	Choosing the best pension plan for a unchanged business	Unchanged
107-TPC- COMM	Tax advantages of under different organizational forms of business	Unchanged
108-TPC- COMM	Analyze difference between Roth IRA and regular IRA	Unchanged
109-EDC	Improperly deducting the rehabilitation tax credit - focuses on SSTS #6	Unchanged

CHAPTER 15

CHOICE OF BUSINESS ENTITY -- OTHER CONSIDERATIONS

DISCUSSION QUESTIONS

1. What is the difference between a contributory and a noncontributory pension plan?

A pension plan can be either contributory or noncontributory. A contributory pension plan requires the employee to make a contribution in addition to the contribution made by the employer. In many cases the employee's contribution is a percentage (i.e., 50 percent or 100 percent) of the employer's contribution or a percentage of the employee's salary (e.g., 4% or 8%). A noncontributory pension plan does not require the employee to contribute to the plan but in most cases allows the employee to make a contribution to the plan.

2. What are the tax advantages of using a qualified pension plan instead of a nonqualified pension plan?

The primary advantage of using a qualified pension plan is that neither the employee's nor the employer's contribution to the plan is treated as taxable income to the employee. In addition, the earnings on these contributions are not subject to tax until the employee makes a withdrawal from the pension plan. A nonqualified pension plan produces a tax treatment that is exactly opposite. The employee's contribution to a nonqualified pension plan cannot be deferred, and the employer is not allowed a tax deduction for the contribution unless the taxpayer includes the contribution in taxable income. In addition, the income earned on the contributions is subject to tax. A disadvantage of a qualified pension plan is that it cannot discriminate in favor of highly compensated employees.

3. What requirements must be met for a pension plan to be treated as a qualified pension plan?

For a pension plan to be treated as a qualified pension plan it must meet certain requirements. Generally, the plan must cover all employees who are twenty-one or older and have worked for the company for at least two years. These are commonly referred to as the age and service requirements. Although these requirements cannot be increased, the company can decide to reduce the requirements. A qualified pension plan must also meet the following requirements:

- **The plan must be in writing.**
- **The contributions must be made to a trust.**
- **The plan must be for the exclusive benefit of the employees or their beneficiaries.**
- **The plan cannot discriminate in favor of highly paid employees.**
- **The plan must limit the amount of contributions that can be made to the plan and/or the benefits received from the plan.**

4. Are all entities allowed to establish the same type of qualified pension plan?

Qualified pension plans can be established for employees of corporations, S corporations, and partnerships. An individual who is an owner-partner in a partnership or who is self-employed (sole proprietor), cannot be covered by the same type of qualified pension plan. A taxpayer that owns more than a 10 percent interest in a partnership is considered an owner-partner. These individuals must use another retirement vehicle such as a Keogh plan (HR-10), a simplified employee pension plan (SEP), or an individual retirement account (IRA). An entity with fewer than 100 employees can establish either a SIMPLE-IRA or SIMPLE 401(k) plan.

5. Explain the difference between a defined benefit plan and a defined contribution plan.

A defined benefit plan bases retirement benefits on the number of years an employee has worked for the company and the employee's annual salary. For example, the plan might allow an employee who has reached the plans minimum retirement age and minimum years of service with the company to retire at 50 percent of the average of the employee's three highest years' salary. A defined benefit plan is a backward-looking pension plan that focuses on historical information, that is, years of service and highest salary. Therefore, actuarial assumptions serve as the basis for the amount actually contributed on behalf of an individual. It is important to remember that with a defined benefits plan no direct relationship exists between the amount contributed on behalf of the employee and the benefits paid to the employee. Finally, the employer is not required to maintain a separate account for each employee.

Retirement benefits using a defined contribution plan are based on the total contributions (from both employee and employer) made to the plan along with the gains and losses (net of expenses) earned by the assets in the plan. There are two types of defined contribution plans: a money purchase plan and a profit sharing plan. With a money purchase plan the company and the employee (if it is a contributory plan) contribute a fixed percentage of the employee's salary to the pension plan. This plan requires the corporation to contribute a fixed amount every year, which can be a major drawback for a new and growing business. A profit-sharing plan is more flexible than a money purchase plan because it does not require a fixed annual amount of contribution. However, the plan must specify a formula for allocating contributions among each of the plan's participants.

A defined contribution plan is a forward-looking pension plan that is based on a fixed percentage of each year's salary, with the contributions and income accumulating over time. However, unlike a defined benefit plan, a defined contribution plan requires that the employer maintain a separate account for each employee.

6. What is the maximum amount that can be contributed to a defined contribution pension plan?

The contribution limit for a defined contribution money purchase plan is the lesser of \$53,000 or 25% of the employee's taxable compensation. The limitations for a money purchase plan and a profit sharing plan are the same. Both plans have a limit on the amount of compensation eligible for calculating an employee's maximum contribution. For 2016, the ceiling amount is \$265,000.

7. What is the maximum benefit that can be paid to an individual under a defined benefit plan?

The benefits paid to an employee from a defined benefits plan cannot exceed the lesser of \$210,000 or 100% of the employee's highest 3 consecutive years compensation. In addition, an employee who has 10 years of service with a company must receive a minimum benefit of \$10,000. If an employee has less than 10 years of service with the company, both the minimum benefit and the maximum benefit are reduced proportionately.

8. How does a Keogh plan differ from other qualified pension plans?

Generally, the rules governing a Keogh plan and other qualified pension plans are very similar. However, unlike most other plans, a Keogh plan can have both employees and self-employed individuals as participants. As a result, the contribution limits for an employee and a self-employed individual (e.g., owner-partners) who is covered by a Keogh plan are different.

9. What is meant by the term owner-partner?

A taxpayer who owns more than a 10 percent interest in a partnership is considered an owner-partner. An individual who is considered an owner-partner in a partnership, cannot be covered by the same type of qualified pension plan as the other employees. Instead, these individuals must establish a Keogh or simplified employee pension plan (SEP).

10. How does being an owner-partner affect the amount that can be contributed to a Keogh plan?

Owner-partners use net self-employment income as the basis for determining their Keogh contribution. An individual's net self-employment income is calculated after subtracting the deduction for one-half of self-employment taxes and their Keogh contribution. Therefore, the maximum contribution to a Keogh plan for an individual who is an owner-partner is lower than the amount for employees covered by the same plan in order to account for the individual's deductions for self-employment tax and Keogh plan contribution. The maximum contribution to a Keogh plan is \$53,000 or 20% of net self-employment income.

11. Are all taxpayers (including spouses of active participants) allowed a deduction for a contribution to an individual retirement account? Explain.

All single taxpayers are allowed to contribute and deduct contributions to an individual retirement account if the taxpayer is not a member of an employer provided retirement plan. However, if a single taxpayer is covered by an employer provided retirement plan, the allowable deduction is phased-out over a \$10,000 range beginning when adjusted gross income reaches \$61,000. For married taxpayers, if both taxpayers are covered by an employer provided retirement plan, the deduction is phased-out over a \$20,000 range beginning when adjusted gross income exceeds \$98,000. If only one spouse is covered, the deduction is phased out over a \$10,000 range beginning at an adjusted gross income of \$184,000.

A nonparticipant spouse may make a full \$5,500 deductible contribution to an IRA even if the other spouse is an active participant in an employer-sponsored plan. The maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is a participant is phased out over a \$10,000 range beginning at an adjusted gross income of \$184,000.

12. How does a simplified employee pension plan differ from a Keogh plan? from a qualified pension plan?

A simplified employee pension plan (SEP) is a unique type of pension plan any entity can establish. Like a Keogh plan, a SEP can have both employees and self-employed individuals as participants. The major advantage of a SEP is that it is administratively more convenient and economical than a Keogh or other qualified pension plans. However, unlike a Keogh and other qualified pension plans, only one type of SEP can be established. The maximum SEP contribution that can be on behalf of an employee is the smaller of 25% of the employee's compensation or \$53,000. The maximum contribution for an owner-employee or an owner-partner is 20% of their net self-employment income. These limits are the same as for a Keogh profit sharing plan. Therefore, the amount that can be contributed using a Keogh or other type of qualified pension plan is greater than with a SEP.

13. What requirements must a taxpayer meet to establish a simplified employee pension plan?

A simplified employee pension plan must meet many of the same requirements for other pension plans. The plan must be in writing, it must establish a separate account for each employee, and it cannot discriminate in favor of highly compensated employees. In addition, a SEP must cover all employees who

- Are at least 21 years of age.**
- Have performed services for the business during the year and at least three of the previous five years.**
- Have received at least \$600**

14. Compare the different funding options available to an employer under a SIMPLE-IRA plan and a SIMPLE-401(k) plan. Discuss how these funding options affect the amount the employee and employer can contribute to the plan.

If an employer establishes a SIMPLE-IRA plan eligible employees can choose to have a percentage of their salary, up to a maximum of \$12,500, contributed to the plan. The employer's contribution must be made using one of the following funding formulas:

- 1. The employer must match the employee's contribution up to a maximum of 3 percent of the employee's compensation. However, the employer can elect to match a lower percentage but no less than 1 percent of the employee's compensation. Within a five-year period the employer can only make this election twice. There is no maximum compensation limit for determining the amount the employer can contribute. However, the employer cannot contribute more than \$12,500, (the employee's maximum).**
- 2. The employer can contribute 2 percent of the employee's compensation. If the employer elects this option, the employee is not required to contribute to the plan but can elect to make a contribution. However, the employer's contribution of 2 percent of an employee's compensation is mandatory, even if the employee does not contribute. The maximum employee compensation that can be used in determining the employer's contribution under this option is \$265,000 (i.e., the maximum employer contribution is \$5,300).**

If an employer establishes a SIMPLE-401(k) plan, the maximum amount an employee can contribute to the plan is \$12,500. The employer must contribute to the plan using the two general funding options discussed above. However, the maximum amount of an employee's compensation that can be used in determining the employer's contribution under either funding option is limited to \$265,000. For highly paid employees this reduces the maximum employer contribution under the 3% option from \$12,500 to \$7,950 ($3\% \times \$265,000$). In addition, the employer cannot elect to match the employee's contribution at a rate lower than 3% of the employee's salary.

Finally, both a SIMPLE-IRA and a SIMPLE-401(k) must allow employees to receive cash instead of having the employer make a contribution on their behalf to the SIMPLE plan. If an employee elects the cash option, the cash received is included in the employee's gross income.

15. How is the required minimum distribution (RMD) from a pension plan determined?

Distributions from a qualified pension plan, a Keogh, SEP, IRA, Roth IRA, or SIMPLE plan can begin without penalty after a taxpayer reaches age 59 1/2. The distributions from a pension plan or a Keogh can be a lump sum or an annuity. Distributions from a SEP, IRA, or SIMPLE plan can only be in the form of an annuity. Distributions from a Roth IRA are tax-free, if the distribution occurs more than 5 years after the date the Roth IRA was established. In addition, the distribution does not have to be in the form of a lump-sum or an annuity. Except for a Keogh or Roth IRA, a taxpayer must either withdraw all the assets from the plan (a lump-sum distribution) or begin to receive an annuity no later than April 1 of the tax year after the taxpayer reaches 70 1/2. For a Keogh, the date is the later of April 1 of the year after the taxpayer reaches 70 1/2, or the year the taxpayer retires. The plan account balance on the last day of the preceding calendar year is used as the beginning basis for computing the RMD for a particular year. For succeeding years, the account balance is reduced by the previous year's distribution before determining the next year's RMD. The account balance is divided by the applicable life expectancy to determine the required minimum distribution.

16. Generally, at what age can pension plan distributions begin? When must they begin? Explain any exceptions to these general rules.

Generally, distributions from a qualified pension plan, Keogh, SEP, IRA or SIMPLE plan must begin upon the retirement of an individual. Unless an exception is met, distributions from these plans cannot begin until after the taxpayer reaches age 59 ½. Distributions before age 59 ½ that do not meet an exception are subject to a 10-percent early withdrawal penalty. Except for a Keogh or a Roth IRA, a taxpayer must either withdraw all the assets from the plan (a lump-sum distribution) or begin to receive an annuity the later of April 1 of the tax year after the taxpayer reaches 70 ½, or the year the taxpayer retires. For a Keogh, the date is the later of April 1 of the year after the taxpayer reaches 70 ½, or the year the taxpayer retires. The taxpayer is not required to make withdrawals from a Roth IRA beginning at 70 ½.

The tax law imposes a 10% early withdrawal penalty on a taxpayer that receives a distribution from a qualified pension plan, Keogh, SEP, IRA or SIMPLE plan before age 59 1/2. This penalty is waived if the distribution is the result of death or disability, is used to cover medical expenses that exceed 7.5 percent of adjusted gross income, is used to pay expenses incurred for first-time home buyers, or qualified higher education expenses. In addition, an individual who is at least 55 can elect to retire early and avoid the penalty.

Roth IRA distributions are not included in the taxpayer's gross income and are not subject to the 10-percent early withdrawal penalty, if the distribution is 5 years after the Roth IRA was established and the distribution is made as a result of death or disability, or is a distribution to pay for "qualified first-time homebuyer expenses". These requirements are similar to those that apply to regular IRA distributions. In addition, unlike deductible IRAs, individuals are allowed to make contributions to a Roth IRA after they reach age 70 1/2.

17. Discuss the penalty provisions associated with qualified pension plans, Keoghs, and IRAs.

The tax law has three major penalty provisions to ensure that the entity and/or individual responsible for the administration of a qualified pension plan, Keogh, SEP, IRA, or SIMPLE complies with the rules and requirements for these plans. The first penalty applies to excess contributions. An excess contribution is a contribution made to a qualified pension plan, Keogh, SEP, or SIMPLE plan in excess of the maximum allowable amount. Excess contributions are subject to a 10 percent penalty. Excess contributions to an IRA are subject to a 6 percent penalty on the smaller of the amount in excess of \$5,000 or the value of the individual's IRA at the close of the tax year. The taxpayer can avoid the penalty by withdrawing the excess contribution from the IRA account before the due date of the tax return.

The second penalty the tax law imposes is a 10% early withdrawal penalty on a taxpayer who receives a distribution from a qualified pension plan, Keogh, SEP, IRA or SIMPLE plan before age 59 1/2. This penalty is waived if the distribution is the result of death or disability or is used to cover allowable medical expense deductions. In addition, an individual who is at least 55 can elect to retire early and avoid the penalty.

The third penalty the tax law imposes is a 50% penalty on the difference between the minimum expected distribution and the actual distribution for a taxpayer who fails to begin receiving a distribution in the year after reaching age 70 1/2. The minimum expected distribution is the amount required to be distributed in the current year so that the pension plan's total assets are distributed over the life expectancy of the taxpayer.

18. Discuss the penalty provisions associated with Roth IRAs.

Excess contributions to an Roth IRA are subject to a 6 percent penalty on the amount in excess of \$5,500 or the value of the of the individual's IRA at the close of the tax year, whichever is smaller. The taxpayer can avoid the penalty by withdrawing the excess contribution from the Roth IRA account before the due date of the tax return. This is the same penalty as for excess contributions to a regular IRA. The tax law also imposes a 10 percent early withdrawal penalty on a taxpayer who receives a distribution from a Roth IRA before reaching age 59 1/2 and who has not met the five-year holding period. The penalty is waived if the holding period is met and the is distribution is the result of death or disability, or is a distribution to pay for "qualified first-time homebuyer expenses. In addition, unlike deductible IRAs, individuals are allowed to make contributions to a Roth IRA even after they reach the age of 70 1/2 without penalty and are not required to take a distribution prior to reaching age 70 1/2.

19. Explain the differences between a nonqualified stock option plan and an incentive stock option plan.

A nonqualified stock option (NQSO) allows the employee to acquire stock of the employer at a specified price beginning on a specified date. The tax consequences for the employee of a nonqualified stock option depend on whether the stock option has a readily ascertainable fair market value. If the option has a readily ascertainable fair market value, the employee recognizes as income an amount equal to the fair market value of the option. Because the employee recognizes income at the date of grant, the employer is entitled to a corresponding deduction.

When an employee is granted the right to a stock option that does not have a readily ascertainable fair market value, the employee does not recognize income until the employee exercises the right to the stock. The amount of income the employee must recognize is the difference between the exercise price and the fair market value of the stock at the date of exercise. Because the employee recognizes income at the date of exercise, the employer is entitled to a corresponding deduction equal to the amount the employee recognizes as income.

Under either scenario, when the stock is sold the employee will recognize a capital gain or loss equal to the difference between the fair market value of the stock at the date of sale and the employee's basis in the stock. The employee's basis in the stock is the amount of income the employee has recognized at the date of grant (if any) plus the amount paid for the shares at the date of exercise.

An incentive stock option is not taxable when the option is granted or when it is exercised. Rather, the taxpayer is allowed capital gain treatment on the difference between the sales price of the stock and the price paid for the option (i.e., exercise price). However, this difference is a tax preference item in computing an individual's alternative minimum tax liability. Because the employee receives special tax treatment, the employer is not entitled to a compensation deduction for the difference between the option price and the fair market value of the stock.

20. Explain the difference in the tax treatment of a nonqualified stock option that has a readily ascertainable fair market value and one that does not have a readily ascertainable fair market value.

If the option has a readily ascertainable fair market value, the employee recognizes as income an amount equal to the fair market value of the option. Because the employee recognizes income at the date of grant, the employer is entitled to a corresponding deduction.

When an employee is granted the right to a stock option that does not have a readily ascertainable fair market value, the employee does not recognize income until the employee exercises the right to the stock. The amount of income the employee must recognize is the difference between the exercise price and the fair market value of the stock at the date of exercise. Because the employee recognizes income at the date of exercise, the employer is entitled to a corresponding deduction equal to the amount the employee recognizes as income.

21. How is a nonqualified stock option taxed if it is subject to substantial risk of forfeiture?

An option is considered subject to substantial risk of forfeiture if the employee must meet certain conditions or requirements before being eligible to receive the option. For example, if an employee must remain with the company for two years after the date of exercise, the stock option is considered subject to substantial risk of forfeiture. Because the employee does not have a claim of right to the stock, the employee is not taxed until the restriction on the option has lapsed. In addition, the corporation does not receive a compensation deduction until this point in time (i.e., when the employee recognizes income).

22. What is the advantage of making a Section 83(b) election?

The tax law allows an employee who receives nonqualified stock options that are nontransferable and subject to substantial restrictions to make a special election (known as a *Section 83(b) election*) at the date of grant. By making this election the taxpayer treats as ordinary income the difference between the exercise price and the fair market value of the stock at the date of exercise. The employer is allowed a deduction for the amount of income recognized by the employee. This election allows the employee to lock in the ordinary income (i.e., compensation) portion of the option. By locking in the ordinary income portion of the option any subsequent appreciation in the value of the stock is treated as capital gain to the taxpayer. However, the taxpayer runs a risk by doing this. If the stock does not increase in value, the taxpayer will have recognized ordinary income but can deduct as a capital loss only the amount paid for the stock option. In addition, even though the taxpayer elects to be taxed at the date of exercise, the holding period of the stock does not begin until the date the restrictions lapse.

23. What requirements must a stock option meet to qualify as an incentive stock option?

For a stock option to be treated as an ISO, the option must be part of a qualified stock plan approved by the shareholders and must meet the following general requirements:

- **The option must be exercised within ten years of the date of grant.**
- **The option price must be equal to or exceed the fair market value of the stock at the date of grant.**
- **The option can be exercised only by the employee to whom the option is granted (i.e., it is nontransferable).**
- **The fair market value of the ISOs granted in a year (number of ISOs granted times the fair market value of the stock) cannot exceed \$100,000.**
- **The stock cannot be sold within one year from the date of exercise or two years from the date granted.**

24. What is the tax treatment of a stock option that qualifies as an incentive stock option? What is the treatment if the requirements are not met?

An incentive stock option is not taxed when the option is granted or when it is exercised. Rather, the taxpayer is allowed capital gain treatment on the difference between the sales price of the stock and the price paid for the option (i.e., exercise price). However, this difference is a tax preference item in computing an individual's alternative minimum tax liability (discussed later). Because the employee receives special tax treatment, the employer is not entitled to a compensation deduction for the difference between the option price and the fair market value of the stock.

If the ISO requirements are not met the tax treatment is similar to a nonqualified stock option. The employee recognizes income when the employee exercises their right to the stock. The amount of income the employee must recognize is the difference between the exercise price and the fair market value of the stock at the date of exercise. Because the employee recognizes income at the date of exercise, the employer is entitled to a corresponding deduction equal to the amount the employee recognizes as income. When the stock is sold the employee will recognize a capital gain or loss equal to the difference between the fair market value of the stock at the date of sale and the employee's basis in the stock. The employee's basis in the stock is the amount of income the employee has recognized at the date of exercise plus the amount paid to exercise the option.

25. Why are tax credits rather than a deduction used to provide tax relief?

A tax credit is a direct reduction in the tax liability of the taxpayer receiving the credit. As such, tax credits are not part of the tax base used to compute the tax liability. Because they are not part of the base and reduce the tax liability dollar for dollar, tax credits are neutral with respect to the marginal tax rate of the taxpayer. That is, in contrast to tax deductions, a \$100 tax credit is worth a \$100 reduction in taxes to taxpayers regardless of their marginal tax rate brackets. In addition, with a credit, tax relief is assured because not all taxpayers can use deductions (i.e., itemize).

26. Why are business credits allowed to be carried forward to future tax years?

Most tax credits are nonrefundable. That is, if the amount of the credit exceeds the tax liability, the taxpayer is not entitled to a refund of the excess. Therefore, to prevent an entity from losing the intended benefit from the tax credit, the tax law generally provides that any amount of credit not used in the current year may be carried forward and used in future years.

27. What is Congress trying to accomplish with the use of tax credits? Provide an example of a tax credit and Congress's purpose for creating it.

The neutrality of tax credits with respect to marginal tax rates allows Congress to target specific activities with the certainty that taxpayers engaging in the activity will receive the expected tax relief. Tax credits are used to encourage investment in specific types of assets or engage in specific activities (research and experimental credit, rehabilitation expenditure credit) and to provide equitable treatment among taxpayers (e.g., foreign tax credit).

28. What is the purpose of the research and experimental tax credit?

The purpose of the research and experimental tax credit is to encourage research and development of new technologies and processes. Two separate credits are allowed.

The first credit is for incremental research expenditures. The incremental credit is equal to 20 percent of the qualified research expenditures in the current year in excess of the base amount.

The second component of the research and experimental credit is the basic research credit. This credit is equal to 20 percent of qualified expenditures for research that is intended to advance scientific knowledge without a specific commercial objective. In order to qualify, two conditions must be met: the payments must be made in cash under a written agreement, and the research must be performed or controlled by a university, college, or other nonprofit scientific research organization. Amounts expended for the basic research cannot be counted in the computing the incremental research credit.

29. What types of expenditures qualify for the rehabilitation tax credit?

Congress felt that some incentive was needed for restoring older buildings in order to preserve decaying inner cities and historic structures; these credits are known as rehabilitation tax credits. A 10-percent older buildings credit is allowed for the expenditures incurred in the rehabilitation of a building placed in service before 1936. Rehabilitation expenditures incurred on a certified historic structure are granted a 20-percent historic structures tax credit.

30. What restrictions are placed on the rehabilitation tax credit?

To qualify for the 10-percent older buildings credit, the rehabilitation expenditures must be incurred to improve or rehabilitate property that is used in the taxpayer's trade or business or that is held for investment purposes. The credit for historic structures is not as restrictive - residential real estate can qualify for the historic structures credit but not for the older building credit. The structure must also be substantially rehabilitated. A substantial rehabilitation means that the rehabilitation expenditures exceed the greater of the property's adjusted basis or \$5,000. In addition, at least 75 percent of the external walls (of which at least 50-percent are used as external walls) and at least 75 percent of the internal structure framework must remain in place. In order to retain the full benefit of the tax credit, the property must be held five full years after completion of the rehabilitation. If a rehabilitated structure is sold before the end of the five-year period, the credit is recaptured (added to the tax liability) in proportion to the number of years (or portions thereof) the actual holding period falls short of the five-year required holding period.

31. What is the purpose of the general business tax credit?

The purpose of the general business credit is to limit the amount of tax credits that can be used to reduce an individual's or a corporation's tax liability. The general business credit applies only to a taxpayer that has a tax credit carryover or can claim more than one general business credit during the year. The following are the major tax credits that comprise the general business credit: the investment tax credit, jobs credit, the alcohol fuels credit, the research credit, the low-income housing credit, the empowerment zone employment credit and the disabled access credit.

32. What is the purpose of the alternative minimum tax?

The purpose of the alternative minimum tax is to ensure that all taxpayers pay some tax. That is, prior to the imposition of the minimum tax, many high income taxpayers were using the allowable incentive provisions in the Internal Revenue Code to reduce their taxes to the extent that they were paying very little (if any) tax in relationship to their income level. Because Congress was hesitant to single out any one incentive by repealing its relief provisions, the politicians decided to impose an additional tax on those taxpayers who take too much advantage of a specified set of tax incentives. The set of tax incentives that became subject to this new tax are called tax preference items.

A new system of taxing preference items was initiated in 1978 called the alternative minimum tax (AMT). This tax is an alternative calculation of the tax liability that results in the minimum amount of tax that the taxpayer must pay. In effect, the AMT is a separate, parallel system. Within this system, many preference items allowed in the calculation of the regular tax liability are either not allowed or the amount of tax relief provided is greatly diminished. This system's goal is to assure that all taxpayers pay their fair share of taxes.

33. What is the tax base for the alternative minimum tax? Explain the general computation of the base.

As a separate tax system, the alternative minimum tax (AMT) is calculated by applying a tax rate to a tax base. The tax base is called alternative minimum taxable income (AMTI). The starting point for the calculation of AMTI is regular taxable income as computed under the general tax system. AMTI is determined by making two separate categories of modifications to the regular taxable income. The first modification is for adjustments and the second is for preferences. Lastly, the applicable exemption amount is subtracted to determine AMTI.

34. What is the basic difference between an AMT adjustment and a preference?

An AMT adjustment is generally for items that are treated differently in the current period but that will reverse themselves in future periods. As such, adjustments may be either positive or negative. The adjustments are generally positive in the first period and negative in future periods as the temporary difference reverses itself.

Preferences are items that are never allowed for AMT purposes. Because they are never allowed, they do not reverse over time and thus, are always positive adjustments in calculating AMT income.

35. Why can AMT adjustments be negative?

In general, the use of the alternative AMT calculation or method results in either acceleration of income items or deferral of deduction items. The net effect of either is a higher taxable income in the initial period(s) of difference. However, alternative minimum tax adjustment items are not disallowed for AMT purposes; they are merely spread out (in the case of deductions) or accelerated (in the case of income items), with the difference in the two calculations being a temporary, not permanent difference. That is, initial differences reverse themselves over time and therefore have the opposite effect on AMTI. Thus, adjustments can be either positive or negative in the calculation of AMTI.

36. What is the AMT exemption amount? Is it available to all taxpayers?

After making all the required adjustments and adding the preference items to taxable income, the result is the tentative alternative minimum taxable income (AMTI). In determining the AMTI tax base, an exemption amount is allowed as a reduction of the tentative AMTI. The exemption amount is designed to eliminate taxpayers with relatively moderate amounts of taxable income who do not have significant amounts of adjustments and/or preferences from the AMT. The exemption amount starts at a tentative amount based on the type of taxpayer and is then reduced by 25 percent of every dollar by which the tentative AMTI exceeds a specified level for each type of taxpayer. For example, a single individual has an initial exemption available of \$53,900, and the phase-out begins at AMTI of \$119,700. A single individual will not be allowed an exemption if AMTI exceeds \$335,300. For a married taxpayer the initial exemption is \$83,800. The phase-out begins at \$159,700 and the exemption is completely phased out if AMTI exceeds \$494,900. Both the exemption amount and the starting point for the exemption phase-out are indexed for inflation.

37. What tax credits are allowed for AMT purposes?

For 2016, the foreign tax credit and non-refundable personal tax credits may be used to offset both the regular tax and the AMT.

38. What is the purpose of the AMT credit against the regular tax?

Most adjustments made in calculating AMTI are merely timing differences. The AMT calculation for these items accelerate income for AMT purposes so that it is reported earlier than it would be for regular tax purposes. The accelerated income is taxed first under AMT and possibly again later, when the timing difference reverses and the regular tax applies.

To avoid double taxation of reversal items, Congress enacted a minimum tax credit that can only be used to reduce the regular tax liability in later years when the regular tax exceeds the AMT. The AMT minimum tax credit is calculated each year in which the AMT applies. The amount of the credit is the difference between the actual AMT for the year and a recomputed AMT. The recomputed AMT is the AMT that would have been paid if the reversal adjustments did not enter into the AMTI calculation. The credit is carried forward and used to reduce the regular tax liability in those years in which the regular tax is greater than the AMT. The credit may be used only to reduce the regular tax to the tentative AMT amount.

39. Compare and contrast how the United States taxes a U.S. citizen, a nonresident alien, a domestic corporation and a foreign corporation.

United States citizens, resident aliens, and domestic corporations are subject to U. S. tax on their worldwide income. Nonresident aliens, and foreign corporations are only subject to tax on income earned in the U.S. and not on their worldwide income. Foreign-owned corporations and nonresident aliens are taxed on business and nonbusiness income that is effectively connected to a U.S. trade or business or is income derived from such activity. U.S. citizens and domestic corporations are generally allowed to reduce gross income by ordinary and reasonable business expenses in arriving at taxable income. In contrast, nonresident aliens receiving interest income sourced in the U.S. are generally subject to a flat 30% withholding rate without any opportunity to reduce such income by similar deductions. U.S. citizens and domestic corporations are generally taxed on gains arising from property transactions whereas nonresident aliens and foreign corporations are generally not taxed.

40. Why does the United States establish a tax treaty with a foreign country?

The primary objective of a tax treaty is to prevent income from being taxed in both countries (i.e., to prevent double taxation). A tax treaty is an agreement between two countries that explains how a citizen or corporation of one country is taxed when working or conducting business in the other country. Another objective of a tax treaty is to promote cooperation and compliance with the tax laws of the treaty nations. Treaties are usually designed to foster economic or social objectives between the countries or to resolve controversial issues. Thus the U.S. would establish a tax treaty with a foreign country in order to accomplish the foregoing objectives.

41. Discuss how a controlled foreign corporation is taxed.

A controlled foreign corporation is a foreign corporation that is more than 50% owned by U.S. shareholders. In general, the U.S. parent corporation is not taxed on the CFC's earnings until the earnings is repatriated in the form of dividends. When the earnings are paid in the form of a dividend, the U.S. parent is allowed a foreign tax credit for the taxes paid by the CFC. An exception to the general rule is when the CFC has Subpart F income. Subpart F income is taxed to the U.S parent when it is earned by the CFC. This treatment is similar to that of a partnership in that the income is taxed whether or not it is actually distributed. Consequently, when the income is paid out by the CFC to the U.S. parent, no tax is due. Consistent with conduit rules, the parent corporation's basis in the CFC stock is increased when Subpart F income is recognized and decreased when a nontaxable dividend is received.

42. What is Subpart F income and how is it taxed?

Subpart F income consists primarily of interest, dividends, rents, royalties, and foreign base company income. Foreign base company income includes foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income. The definitions of the various types of foreign base company income are extremely complex. For example, foreign base company sales income is income derived from the purchase of personal property from or on behalf of a related person, or from the sale of personal property to or on behalf of a related person. The tax treatment of Subpart F income is similar to that of a conduit entity like a partnership or S corporation. Subpart F income is taxed to the parent of a CFC when the CFC earns the income regardless of when it is actually repatriated to the U.S. parent in the form of dividends. When the CFC actually makes a dividend payment to the U.S. parent, no tax is due. Consistent with conduit rules, the parent corporation's basis in the CFC stock is increased when Subpart F income is recognized and decreased when a nontaxable dividend is received.

43. What is the purpose of the foreign tax credit?

The purpose of the foreign tax credit is to provide U.S. taxpayers relief from the double taxation on foreign income that would occur as a result of the foreign country tax and the U.S. taxing the same income. The foreign tax credit applies to individuals and corporations paying foreign taxes on income earned abroad that is included in U. S. taxable income. The amount of the credit is the lesser of (1) the actual foreign taxes paid, or (2) the U.S. tax that would have been paid on the foreign earned income. This limits the amount of the credit to the tax assessed by the U.S. on the foreign income.

44. Why is the transfer of appreciated property to a controlled foreign corporation subject to tax?

A U.S. owner of a controlled foreign corporation is generally not taxed on its foreign income until it is repatriated to the United States. In addition, no gain or loss is reported on the formation of a corporation if, after the formation, the shareholders own 80% of the stock in the new corporation. The combination of these two rules could allow a corporation to transfer appreciated property or securities to a foreign subsidiary tax-free and have the subsidiary sell the property. The gain on the sale of the property would not be taxed until the income is paid as a dividend to the U.S. parent. As a result, a U.S. corporation could avoid paying tax indefinitely on the transfer of appreciated property to a controlled foreign corporation. Consequently, these transactions are treated as a sale of the property to the foreign subsidiary at fair market value with any gain taxed.

45. What is the purpose of the transfer pricing rules?

The purpose of the transfer pricing rules is to prevent income tax avoidance by related entities engaging in exchanges of goods and services to an ultimate buyer. Tax avoidance may occur because of the ability of the related parties to control the timing, amount, and location of the sale price. By manipulating the sales price, a U.S. parent could minimize its U.S. tax liability by selling its product at cost to a CFC located in a country that has a lower marginal tax rate than the U.S. or in a country that does not impose a tax. To prevent this, Congress has established transfer pricing methods that set the sales price between related entities.

46. Explain how foreign corporations conducting business in the United States are taxed on their business and nonbusiness income.

Foreign corporations doing business in the U.S. are subject to U.S. tax on their effectively connected trade or business income at rates that are applicable to any domestic corporation. Effectively connected trade or business income is determined by applying two tests: the asset use test, and the business activities test. Both of these tests are designed to aid in determining if the income should be subject to U.S. tax in the same manner as any other U.S. corporation or if it should be treated as nonbusiness income subject to the flat 30% tax. The asset use test is met if income is derived from assets used in or held for use in the active conduct of a U.S. business. The business activities test is met if the U.S. business activities of the foreign corporation are a material factor in the realization of income or gain and loss. The two tests may be either be applied together or individually to determine if the resulting income or gain or loss is trade or business income or nonbusiness income. Generally, if a nonresident alien or a foreign corporation is conducting a profit-oriented activity within the U.S. that is carried on in a regular, substantial, and continuous manner, then income derived from the activity is deemed to be effectively connected trade or business income.

47. Why is the sale of property by a foreign corporation not subject to the withholding tax on nonbusiness income?

Nonbusiness income received by a foreign person or entity is not taxable unless the income is received from a United States source. Because a foreign taxpayer may not be physically present in the U.S., the payor of the income is required to withhold the tax at the time the income is paid. Therefore, it is referred to as a withholding tax. Generally, these sources of income are subject to a flat withholding tax of 30% and the foreign taxpayer is not allowed any deductions against the tax. The withholding allows for the collection of tax on amounts that may otherwise go untaxed and is administratively convenient for both the taxpayer and the government. Although the tax rate on nonbusiness income is 30%, many tax treaties provide for lower tax withholding rates on certain types of income (e.g., interest).

PROBLEMS

48. Salvadore, 35, is an employee of the Malthouse Corporation. Henrique, 40, is an employee of the Sheedy Corporation. Both belong to a contributory pension plan that requires them to match their employers' contributions of \$70 per month. Each plans to retire at 65. They expect that their \$140 a month (\$70 employee + \$70 employer) contribution will earn 8% interest, compounded annually.

- a. How much will each have available upon retirement?

Salvadore and Henrique will each have \$1,680 per year contributed to the pension plan on their behalf. According to Table 15-1, Salvadore will accumulate \$190,316 [$\$1,680 \times 113.28321$ (30 years at 8%)] in his pension account, whereas Henrique will have only \$122,667 [$\$1,680 \text{ per year} \times 73.01594$ (25 years at 8%)] in his pension account. Because Salvadore begins to provide for his retirement five years earlier than Henrique, he will accumulate \$67,649 ($\$190,316 - \$122,667$) more than Henrique at retirement.

- b. Assume the same facts, except that Salvadore belongs to a nonqualified pension plan and that his marginal tax rate and the pension plan's (i.e., the trust's) marginal tax rate is 25%. How much will Salvadore have in his pension account upon retirement? Assume the actual yield on Salvadore's investment is 6%.

Because Salvadore participates in a nonqualified pension plan, both his contribution and his employer's contribution are subject to tax. Therefore, Salvadore's contribution, less the tax on his retirement fund, will be only \$105 (rounded) per month [$\$140 \times (100\% - 25\%)$] or \$1,260 per year. Salvadore will accumulate \$99,613 [$\$1,260 \times 79.05819$ (30 years at 6%)] in his pension account. Because Salvadore is in a nonqualified pension plan and must pay tax on both his contributions and the income he earns on the contributions, Salvadore's accumulations are \$90,703 ($\$190,316 - \$99,613$) less than with the qualified plan.

49. Manuel is an employee of the Etowah Corporation and has worked for the company for 22 years. Employees are not required to make contributions to the company's defined benefit plan. Based on the plan, Manuel can retire at 40% of the average of his three highest years' salary. Determine the amount Etowah will pay Manuel in pension benefits in each of the following situations:

The benefits paid to an employee from a defined benefits plan cannot exceed the lesser of \$210,000 or 100% of the employee's highest 3 consecutive years compensation. An employee who has 10 years of service with a company must receive a minimum benefit of \$10,000.

- a. His average salary for these three years is \$50,000.

Manuel will receive \$20,000 ($\$50,000 \times 40\%$) per year in retirement income. Because Manuel did not contribute to the pension plan, the \$20,000 he receives each year is taxable. Note: Manuel's highest years' salary do not have to be the three most recent years.

- b. His average salary for these three years is \$580,000.

The maximum amount that Manuel can receive from a defined benefits retirement plan is \$210,000. Since his calculated defined retirement benefit is \$232,000 ($\$580,000 \times 40\%$) he is limited to \$210,000. Because Manuel did not contribute to the pension plan, the 210,000 he receives each year is taxable.

50. Sarah is vice president of production for Fenner Inc., a corporation, which maintains a money purchase pension plan for its employees. She owns 8% of Fenner's stock. Determine the maximum deductible contribution the company can make to the pension plan in each of the following situations:

The maximum amount that can be contributed to a defined contribution money purchase plan is the lesser of \$53,000 or 25% of the employee's taxable compensation. In addition, there is a ceiling on the amount of compensation eligible for calculating an employee's maximum contribution. For 2016, the maximum amount is \$265,000.

- a. Sarah's salary is \$95,000.

The maximum amount Fenner can contribute on behalf of Sarah is \$23,750 ($\$95,000 \times 25\%$), which is less than the \$53,000 maximum.

- b. Sarah's salary is \$320,000.

Because Sarah's salary exceeds the \$265,000 maximum, only \$265,000 of her \$320,000 salary can be used in computing her maximum pension contribution. In addition, because 25% of her salary, \$80,000 ($\$320,000 \times 25\%$) exceeds the \$53,000 maximum, Fenner can only contribute \$53,000 to the pension plan on behalf of Sarah.

51. Warren is a partner in Baines Brothers, a consulting firm specializing in the design of Intranets. Baines maintains a profit-sharing Keogh plan for its partners and employees. Warren owns a 10% partnership interest in Baines Brothers. Determine the maximum deductible contribution the partnership can make to the pension plan in each of the following situations:

The contribution limits for an employee covered by a Keogh plan are the same as for a qualified plan. However, the contribution limits for owners and owner-partners are lower than what is available through a qualified pension plan. A taxpayer that owns more than a 10 percent interest in a partnership is considered an owner-partner. For 2016, the maximum amount of net self-employment income that can be used in calculating the Keogh contribution for an owner-partner is \$265,000.

For a Keogh plan, the maximum amount that can be contributed is limited to the lesser of \$53,000 or 20% of the employee's taxable compensation. As with a money purchase plan, there is a ceiling on the amount of compensation eligible for calculating an employee's maximum contribution. For 2016, the maximum amount is \$265,000.

- a. The partnership's ordinary income is \$1,350,000, and it has no income or deductions that required separate reporting.

Because Warren only owns 10% of Baines Brothers, he is not considered an owner-partner. His contribution is based on his net self-employment income. Warren's share of the partnership income is \$135,000 ($\$1,350,000 \times 10\%$) and his net self-employment income is \$124,673 ($\$135,000 \times 92.35\%$). Warren can contribute \$24,935 ($\$124,673 \times 20\%$) to his Keogh account.

- b. The partnership's ordinary income is \$4,000,000 and it has no income or deductions that required separate reporting.

Warren's share of the partnership income is \$400,000 ($\$4,000,000 \times 10\%$) and his net self-employment income is \$369,400 ($\$400,000 \times 92.35\%$). Warren can only contribute \$53,000 (the maximum allowed) to his Keogh account since it is less than \$73,880 ($\$369,400 \times 20\%$).

52. Ferris and Jody are married and file a joint return. During the current year, Ferris had a salary of \$45,000. Neither Ferris nor Jody is covered by an employer-sponsored pension plan. Determine the maximum IRA contribution and deduction amounts in each of the following cases:

Because neither Ferris nor Jody are covered by a pension plan, any amounts that they are eligible to contribute to an IRA are deductible for adjusted gross income.

- a. Jody earns \$28,000, and their adjusted gross income is \$122,000.

Both taxpayers have earned income. They are both allowed to contribute and deduct \$5,500 of their earned income to their IRA's. Thus, they may contribute and deduct a total of \$11,000 for adjusted gross income.

- b. Jody does not work outside the home and their adjusted gross income is \$65,000.

A married couple's total IRA contribution and deduction is based on the couple's joint earned income. Because their joint earned income is greater than \$11,000, Jody is also allowed to contribute and deduct \$5,500 even though she has no earned income. Thus, they may contribute and deduct a total of \$11,000 for adjusted gross income.

- c. Assume the same facts as in part a, except that Ferris is covered by an employer-sponsored pension plan.

Because only Ferris is covered by an employer sponsored pension plan, the amount that Jody can contribute and deduct is not phased out until their adjusted gross income exceeds \$184,000. Therefore, she can contribute and deduct \$5,500 to her IRA. However, because Ferris is covered by an employer-sponsored pension plan and their adjusted gross income exceeds \$118,000, his contribution is not deductible. They can contribute a total of \$11,000 to their IRA's (\$5,500 each), but they can only deduct \$5,500 of their contribution.

- d. Assume the same facts as in part a, except that Ferris and Jody are covered by an employer-sponsored pension plan.

Because both spouses are covered by an employer sponsored pension plan, the amount of the IRA deduction is reduced when a married couple's adjusted gross income exceeds \$98,000 and is fully phased out when adjusted gross income exceeds \$118,000. Because their adjusted gross income is \$122,000, they can each contribute \$5,500 but cannot take any deduction for their contributions.

53. Zorica and Pierre are married and file a joint return. Zorica earns \$59,500 and Pierre \$35,000. Their adjusted gross income is \$105,000. Determine the maximum IRA contribution and deduction in each of the following cases:

- a. Neither Zorica nor Pierre is covered by an employee-sponsored pension plan.

Because neither Zorica nor Pierre are covered by a pension plan, any amounts that they are eligible to contribute to an IRA are deductible for adjusted gross income. Both taxpayers have earned income, so they are both allowed to contribute and deduct \$5,500 of their earned income to their IRA's. Thus, they may contribute and deduct a total of \$11,000 for adjusted gross income.

- b. Only Zorica is covered by an employee-sponsored pension plan.

Because only Zorica is covered by an employer sponsored pension plan, the amount that Pierre can contribute and deduct is not phased out until their adjusted gross income exceeds \$184,000. Therefore, he can contribute and deduct \$5,500 to his IRA. However, because Zorica is covered by an employer-sponsored pension plan and their adjusted gross income exceeds \$98,000, the amount she can deduct is phased-out ratably over a \$20,000 range until her deduction is fully phased-out when their adjusted gross income exceeds \$118,000. Zorica must reduce the amount of her deduction by 35% $[(\$105,000 - \$98,000) \div \$20,000]$. Her allowable deduction for adjusted gross income is \$3,575 $[\$5,500 - (\$5,500 \times 35\%)]$. They can contribute a total of \$11,000 to their IRA's (\$5,500 each), but they can only deduct \$9,075 $(\$5,500 + \$3,575)$ of their contribution.

- c. Assume the same facts as in part b, except that Pierre has no income and their adjusted gross income is \$124,000.

Because their adjusted gross income is less than \$184,000, Pierre can make a \$5,500 deductible IRA contribution. This is true even though Pierre's spouse (Zorica) is an active participant in an employer-sponsored plan. However, because Zorica is covered by an employer-sponsored pension plan and their adjusted gross income exceeds \$118,000, her contribution is not deductible. They can contribute a total of \$11,000 to their IRA's (\$5,500 each), but they can only deduct \$5,500 of their contribution.

54. Lenore, a single taxpayer with adjusted gross income of \$65,000, is covered by her employer's pension plan. She makes a \$5,500 contribution to her IRA during the current year.

a. How much of the contribution can Lenore deduct?

Lenore's allowable IRA deduction is reduced because her adjusted gross income exceeds \$61,000. The maximum IRA deduction is phased-out proportionately over a \$10,000 range when adjusted gross income exceeds \$61,000. Using the formula below, Lenore's allowable IRA deduction is \$3,300.

$$\text{IRA percentage reduction} = \frac{(\text{Adjusted gross income} - \$61,000)}{\$10,000}$$

$$\text{Maximum IRA Deduction} = \$5,500 \times (100\% - \text{IRA percentage reduction})$$

$$\text{IRA percentage reduction} = \frac{(\$65,000 - \$61,000)}{\$10,000} = 40\%$$

$$\$3,300 = \$5,500 \times 60\% (100\% - 40\%)$$

- b. Assume the same facts as above, except that Lenore's adjusted gross income is \$73,000.

Lenore will be entitled to no deduction because her AGI exceeds the ceiling amount of the phase-out income levels (\$71,000).

- c. Assume that Lenore is married to Lathrop who has no income, and their combined adjusted gross income is \$130,000. Lathrop is not covered by any retirement plan. What are Lenore and Lathrop's maximum deductible IRA contribution?

Because their adjusted gross income is less than \$184,000, Lathrop can make a \$5,500 deductible IRA contribution. The maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is covered by a employer-sponsored pension plan is phased-out proportionately over a \$10,000 range when adjusted gross income exceeds \$184,000. Lenore is not allowed a deduction for any contribution she makes to an IRA because she is an active participant in a retirement plan and their adjusted gross income exceeds \$118,000.

55. In October 2015, the Clark Corporation decides to establish a SIMPLE-401(k) retirement plan for its employees. Clark meets all requirements for establishing a SIMPLE. The company has notified its employees that in 2016, it will fund the SIMPLE-401(k) by contributing 2% of each employee's salary to the plan. Determine the maximum employee and employer contribution for Lei, an employee, in each of the following cases:

- a. Lei's salary is \$62,000.

Lei does not have to contribute to the plan, but she can elect to contribute up to \$12,500 to the plan. The employer's contribution of 2 percent of an employee's compensation is mandatory, even if the employee does not contribute. However, the maximum amount of compensation that Clark can consider in determining its contribution under a SIMPLE 401(k) is \$265,000. Clark must contribute \$1,240 ($\$62,000 \times 2\%$) to the SIMPLE 401(k) on Lei's behalf.

- b. Lei's salary is \$280,000.

As in part a, Lei does not have to contribute to the plan, but she can elect to contribute up to \$12,500 to the plan. Because her salary exceeds \$265,000, the maximum amount that Clark can contribute is \$5,300 ($\$265,000 \times 2\%$). It should be noted that because Clark elected to use this funding option, it must contribute \$5,300, regardless of the amount Lei contributes to the SIMPLE 401(k).

- c. Assume the same facts as in part b, except that Clark funds the plan by matching employees' contributions up to a maximum of 3% of each employee's compensation. Lei contributes the maximum.

As in parts a and b, Lei does not have to contribute to the plan, but she can elect to contribute up to \$12,500 to the plan. Because her salary exceeds \$265,000, the maximum amount that Clark can contribute is \$7,950 ($\$265,000 \times 3\%$).

- d. Assume the same facts as in part b, except that Clark establishes a SIMPLE-IRA and Lei contributes the maximum.

Lei is not required to make a contribution to the SIMPLE-IRA. However, she can elect to contribute up to \$12,500 to the plan and Clark is required to contribute 2% of Lei's salary to the plan. However, unlike with a SIMPLE 401(k), the maximum amount Clark can contribute on Lei's behalf is \$12,500. Because Clark elected to use this funding option, it must contribute \$5,300 ($\$265,000 \times 2\%$) regardless of the amount Lei contributes to the SIMPLE 401(k).

- e. Assume the same facts as in part d, except that Clark funds the plan by matching an employee's contributions up to a maximum of 3% of each employee's compensation. Lei contributes the maximum.

Lei is not required to make a contribution to the SIMPLE-IRA. However, she can elect to contribute up to \$12,500 to the plan and Clark is required to contribute 3% of Lei's salary to the plan. The maximum amount Clark is required to contribute on Lei's behalf is \$7,950 ($\$265,000 \times 3\%$). However, unlike in part d, Clark is only required to match the amount Lei contributes to the SIMPLE-IRA. Therefore, if Lei only contributes \$5,100 to the plan, Clark is only required to match the \$5,100 Lei contributes.

56. Ghon is a married taxpayer who retired from his job at Smithfield Printing in 2015. During 2016, he turns 70 1/2 and begins withdrawing the \$215,000 (balance December 31, 2015) in assets in his pension account. Smithfield maintains a noncontributory pension plan. Determine the required minimum distribution that Ghon must take.

In determining the required minimum distribution Ghon must receive, the starting point is the account balance in his pension plan on the last day of the preceding calendar year. This amount is then divided by the appropriate factor from Table 15-2 in the text. Therefore, Ghon's required minimum distribution for 2016 is \$8,113 [$\$215,000 \div 26.5$ (factor for 71 years of age)]. For subsequent years, the account balance is always reduced by the amount of the minimum distribution.

57. Felicia is a single taxpayer who retired from her job as a sales executive with Waynesville Associates, LLC. During 2015, she turns 70 1/2 and decides to begin withdrawing the \$320,000 in assets (balance as of December 31, 2014) in her pension account. Her pension plan is a qualified noncontributory plan.

- a. What is the required minimum distribution that Felicia must take?

Felicia must contribute an amount that is calculated by finding the appropriate factor from Table 15-2 in the text and dividing this into the plan account balance at the end of the previous year. The plan account balance on the last day of the preceding calendar year is used as the beginning basis for computing the RMD for a particular year. For succeeding years, the account balance is first reduced by the amount distributed during the year before determining the next year's RMD. For Felicia, this means her required minimum distribution is \$12,075 [$\$320,000 \div 26.5$ (table factor for a taxpayer age 71)].

- b. Assume the same facts as in a above except that the pension plan account balance on December 31, 2015 is \$301,000. What is Felicia's minimum required distribution for 2016?

The required minimum distribution for Felicia in the subsequent year will be computed by first reducing the pension plan balance by the RMD computed for the first year. This amount is \$288,925 ($\$301,000 - \$12,075$). The next step is divide this amount by 25.6, the factor from the table for someone 72 years old. The RMD is \$11,286 ($\$288,925$ divided by 25.6).

58. Suresh is sales representative for Swinley Manufacturing. The corporation maintains a defined contribution profit sharing plan on behalf of its employees. The company contributes 15% of each employee's salary. Suresh's salary for the year is \$200,000. Because of his record sales achievement during the year, the company decides to pay Suresh a bonus of \$75,000. Suresh is aware of the tax benefits associated with pension plans and has asked the controller of the company to pay him \$35,000 of the bonus in cash and to contribute the remaining \$40,000 (\$75,000 - \$35,000) to his pension. Prepare a letter to Suresh explaining the tax consequences of his proposal.

The maximum amount that can be contributed to a profit sharing plan is limited to the smaller of \$53,000 or 25% of the employee's taxable compensation. In addition, there is a ceiling on the amount of compensation eligible for calculating an employee's maximum contribution. For 2016, the maximum amount is \$265,000. Because, Suresh's total compensation of \$275,000 (\$200,000 + \$75,000), exceeds \$265,000, the maximum amount Swinley can contribute on behalf of Suresh is the lesser of \$53,000 or 25% of \$265,000.

If Swinley contributes \$40,000 in addition to the \$22,500 (\$150,000 x 15%) based on Suresh's salary, the \$9,500 [(\$22,500 + \$40,000) - \$53,000] excess contribution to the pension plan is subject to a 10 percent penalty. The penalty would be \$950 (\$9,500 x 10%).

59. Hector is a single taxpayer with adjusted gross income of \$122,000. What is the maximum contribution that he can make to a Roth IRA for the current year?

Hector may make a \$5,500 contribution to a Roth IRA but it will not be deductible. The benefit of the Roth IRA is that it is "back-loaded", meaning the favorable tax aspects of the Roth IRA occur when withdrawals are made after meeting a five-year holding period. No taxes are due on any of the distributions or the earnings on the contributions if the holding period is met. Additionally, the early withdrawal penalty associated with pension plans is not applicable to the Roth IRA if the withdrawal is made after the holding period condition is met and is a result of death or disability, or a distribution to pay for qualified first-time homebuyer expenses. As with other pension plans, if the distribution occurs after the taxpayer reaches age 59 1/2, then no penalty is due. Eligible Roth IRA contributions are subject to income phase-out rules. The maximum yearly contribution that can be made to a Roth IRA is phased-out for single taxpayers with AGI between \$117,000 and \$132,000 and joint filers with AGI between \$184,000 and \$194,000. Therefore Hector must reduce his contribution by \$1,833 $\{ \$5,500 \times [(\$122,000 - \$117,000) \div \$15,000] \}$. His maximum contribution is \$3,667 ($\$5,500 - \$1,833$).

60. Ross is single and maintains an IRA. During a trip to Las Vegas in 2016, he wins \$14,000 at the roulette wheel. He decides to put half his earnings in his IRA account and spend the other half on a trip to Europe. At the end of 2016, the total assets in his IRA account are \$29,000. Because he is covered by his employer's pension plan, Ross did not deduct any portion of his \$7,500 IRA contribution. His salary for the year is \$70,000. Write a letter to Ross advising him on the tax consequences of his actions.

Excess contributions to an IRA are subject to a 6 percent penalty on the amount in excess of \$5,500 or the value of the individual's IRA at the close of the tax year, whichever is smaller. Ross can avoid the penalty by withdrawing the excess contribution from the IRA account before the due date of the tax return. Even if Ross is not allowed to take a deduction for his contribution, his maximum contribution is limited to \$5,500.

Assuming Ross does not withdraw the \$2,000 excess contribution ($\$7,500 - \$5,500$) from his account before April 15, 2017 (the due date of his return), he must pay a penalty of \$120. This is the lesser of \$1,740 ($\$29,000 \times 6\%$) or \$120 [$6\% \times \$2,000 (\$7,500 - \$5,500)$]

In addition, even though Ross is covered by an employer-sponsored pension plan he is not allowed to deduct the "adjusted" \$5,500 contribution because his adjusted gross income of \$84,000 ($\$70,000$ of salary + $\$14,000$ gambling) is greater than the phase-out limit of \$71,000.

61. During the current year, Kyung purchases a boat for \$70,000. Because she has only \$7,000 of the necessary \$14,000 down payment, Kyung makes a \$7,000 withdrawal from her IRA account. Immediately before the withdrawal, the balance in her account consists of \$9,000 in deductible contributions, \$13,000 in nondeductible contributions, and \$3,000 in earnings on the plan's assets.
- a. What are the tax consequences of Kyung's making the \$7,000 withdrawal from her IRA account?

The taxable amount of the distribution depends on whether the taxpayer has a basis in the IRA account. Individuals can have a basis in their IRA account only if their contributions to the account were not deductible. That is, the contributions were made with after-tax dollars. Under the capital recovery concept, the taxpayer includes as income only the portion of the distribution that exceeds the basis.

The value of Kyung's IRA account before the withdrawal is \$25,000 (\$9,000 + \$13,000 + \$3,000). Of that amount, \$13,000 or 52% ($\$13,000 \div \$25,000$) consists of nondeductible contributions. Therefore, 52% of the amount she withdraws from her IRA is not subject to tax. The taxable portion of Kyung's distribution is \$3,360 [$(\$7,000 \times (100\% - 52\%))$].

In addition to the income tax, she is also subject to an early withdrawal penalty on the amounts distributed from her IRA. Assuming Kyung withdrew funds from her IRA before reaching age 59 1/2, she is subject to 10% penalty on the amount she receives. This penalty only can be waived if the distribution is the result of death or disability, is used to pay expenses incurred by qualified first-time homebuyers (\$10,000 maximum), is used to pay qualified higher education expenses, or is used to cover medical expenses that exceed 7.5 percent of adjusted gross income. In addition, an individual who is at least 55 can elect to retire early and avoid the penalty. None of these provisions are applicable to Kyung.

Only \$3,360 of the withdrawal is subject to income tax. The entire \$3,360 that is included in her gross income is subject to the 10% penalty. Kyung will have to pay an early withdrawal penalty of \$336 ($\$3,360 \times 10\%$). However, she can take a deduction for AGI for the early withdrawal penalty of \$336.

- b. Assume that the withdrawal was made for a down payment on Kyung's first home. What are the tax consequences of Kyung's making the \$7,000 withdrawal from her IRA account?

The tax consequences are identical to the outcomes discussed above except that the early withdrawal penalty would not be applicable. The early withdrawal penalty is waived if the proceeds are used by a first-time homebuyer to pay for expenses in acquiring a home. The maximum amount that can be withdrawn is \$10,000. In this case, Kyung includes \$3,360 of the withdrawal in income. However, this amount is not subject to the 10% penalty.

62. Glenna is retired from the Cherry Hills Corporation. When she retired at 68, she decided to take her pension as a lump-sum distribution and roll over the proceeds tax free into her IRA. On January 1, 2014, she began to receive the required \$22,000 distribution from her IRA account. During the current year she has a \$40,000 gain on the sale of land that she inherits from her brother. Because of this gain she decides to reduce her withdrawal from her IRA from the required \$22,000 to \$6,000. Explain to Glenna the tax consequences of her decision.

The tax law imposes a 50% penalty on the difference between the minimum expected distribution and the actual distribution for a taxpayer who fails to begin receiving a distribution in the year after reaching age 70 1/2. The minimum expected distribution is the amount required to be distributed in the current year so that the pension plan's total assets are distributed over the life expectancy of the taxpayer.

Glenna is required to receive a distribution from her IRA account of \$22,000. Because she chooses to receive only \$6,000, she is subject to a penalty of \$8,000 $[(\$22,000 - \$6,000) \times 50\%]$ on the difference between the required distribution and her actual distribution.

Instructor's Note: Because the penalty rate of 50% is greater than the highest marginal tax rate (39.6%), only in unique situations should the taxpayer choose not to receive the minimum required distribution.

63. Juan and Angel, ages 56 and 54, respectively, decide to establish Roth IRAs. Juan and Angel are married, and both are covered by pension plans where they work. Their adjusted gross income is \$125,000. They want to make the maximum contribution to the Roth IRAs.

- a. What is the maximum amount they may contribute to a Roth IRA?

Juan and Angel may make a maximum contribution of \$13,000 (\$6,500 each) to a Roth IRA since they are both older than 50 they are each allowed to make a catch-up contribution of \$1,000. The contributions are not deductible and the earnings will accumulate tax-deferred until withdrawn. If they make a qualified distribution from the Roth IRA, the tax-deferred earnings are not subject to tax. A distribution is qualified if at the time of the distribution, the taxpayer is age 59 1/2 and the contributions were in the Roth IRA for at least five years.

- b. Assume that Juan and Angel's adjusted gross income for the year is \$190,000. What is the maximum contribution they may make?

Contributions to a Roth IRA are limited to certain adjusted gross income limitations and are phased-out for married couples filing jointly when AGI reaches \$184,000. Because Juan and Angel's AGI is greater than \$184,000, their maximum contribution is phased-out ratably over a \$10,000 range until the amount they can contribute is fully phased-out when their adjusted gross income exceeds \$194,000. Juan and Angel must reduce the amount of their contribution by 60% $[(\$190,000 - \$184,000) \div \$10,000]$. They each can contribute \$2,600 $[\$6,500 - (\$6,500 \times 60\%)]$ to their Roth IRA.

- c. Assume that Juan and Angel are now ages 62 and 60, respectively, and want to withdraw \$10,000 to purchase a new car. What are the tax implications of the withdrawal from the Roth IRA?

Because Juan and Angel are over age 59 1/2 and contributions from the Roth IRA have been held in the account for more than five years, the distribution, including the untaxed earnings, is tax-free.

- b. Assume the same facts in part c, except Juan is 60 and Angel is 58?

Because Angel has not reached age 59 1/2 prior to the distribution date, the amount associated with her withdrawal is not a qualified distribution. However, there is no income tax due on the amount distributed to the extent the distribution represents prior year contributions and not earnings on the contributions. The ordering rules require that amounts distributed from a Roth IRA first come from contributions and then from the earnings on the contributions. However, the early withdrawal penalty would apply to the entire amount attributable to Angel's share of the withdrawal.

- e. Assume the same facts in part a, except that Juan and Angel have a regular IRA they want to rollover to a Roth IRA. The balance in the IRA is \$20,000. Write a memo describing the tax factors that Juan and Angel should consider before deciding to roll over the IRA to a Roth IRA.

Several tax factors need to be considered when deciding whether to rollover an IRA into a Roth IRA. In general, a rollover or conversion of an existing IRA to a Roth IRA is a taxable event requiring the taxpayer to pay tax on the distribution. It is treated as any other distribution. However, the rollover distribution is not subject to the 10% early withdrawal penalty.

As a practical matter, the rollover is a good idea if the present value of the taxes paid on the rollover is less than the tax savings on the distributions taken in later years. Because Juan and Angel are close to retirement, it is questionable whether they will have enough time to build up the Roth IRA with tax-free earnings to replace the taxes paid on the rollover. Again, this will depend on when they plan on retiring and their marginal tax rate at retirement. In addition, they must also consider the rate of return on the investment and the state tax effects of the rollover. Finally, the question of whether to make nondeductible contributions to any type of IRA must be evaluated in light of the lower capital gains rates that might be applicable for similar investments.

64. On September 1, 2016, Beaconsfield Corporation grants Albert a nonqualified stock option to acquire 500 shares of the company's stock for \$8 per share. The fair market value of the stock on the date of grant is \$14. Determine the tax consequences to both Albert and the Beaconsfield Corporation in each of the following situations:
- a. The option has a readily ascertainable fair market value of \$3 per share, and Albert exercises the option on February 15, 2017, when the fair market value of the stock is \$16.

An employee who receives a nonqualified stock option that has a readily ascertainable fair market value recognizes as income the amount equal to the fair market value of the option. Because the employee recognizes income at the date of grant, the employer is entitled to a corresponding deduction.

Albert must recognize \$1,500 ($\3×500 shares) as income and the Beaconsfield Corporation can deduct \$1,500 as compensation expense.

An employee who exercises a stock option with a readily ascertainable fair market value, does not recognize income at the date of exercise. However, the exercise of the option does affect the employee's basis in the stock. The employee's basis is equal to the amount of income recognized at the date of the grant plus the cash paid to exercise the option. The holding period for the stock begins at the exercise date.

Albert's basis in the stock is \$5,500 [$(\$8 + \$3) \times 500$]. This represents the \$1,500 ($\$3 \times 500$) in ordinary income he recognized on the date of grant plus the \$4,000 ($\8×500) he paid to exercise the option. His holding period for determining whether the gain or loss is short term or long term begins on February 15, 2017.

Instructor's Note: It is important to note that because the option has a readily ascertainable fair market value, the employee has a basis in the option, not in the stock of the company.

- b. The option does not have readily ascertainable fair market value and Albert exercises the option on February 15, 2017, when the fair market value of the stock is \$16.

An employee who receives an option that does not have a readily ascertainable fair market value does not recognize income at the date of grant, but rather at the date of exercise. The amount of income the employee must recognize is the difference between the option price and the fair market value of the stock at the date of exercise. Because the employee does not recognize income at the date of grant, the employer is not entitled to a corresponding deduction.

At the date of the grant Albert does not recognize any income and the Beaconsfield Corporation receives no deduction.

Because the stock did not have a readily ascertainable fair market value at the date of grant, Albert must recognize income at the date of exercise. At the date of exercise he must report the difference between the exercise price and the fair market value of the stock as income. His basis is equal to the amount of income recognized at the date of the exercise plus the cash paid to exercise the option. The holding period for the stock begins at the exercise date.

Albert has compensation income of \$4,000 $[(\$16 - \$8) \times 500]$ and his basis in the stock is \$8,000 $[(\$8 + \$8) \times 500]$. This represents the \$4,000 $(\$8 \times 500)$ he paid to exercise the option price plus the \$4,000 $(\$8 \times 500)$ in ordinary income he recognized on the date of exercise.

Because Albert recognized ordinary income at the date of exercise, the Beaconsfield Corporation is entitled to a compensation deduction of \$4,000.

- c. The option has a readily ascertainable fair market value of \$3 per share but is subject to a substantial risk of forfeiture and Albert does not make a Section 83(b) election. When the restrictions lapse on September 30, 2017, the fair market value of the stock is \$20 per share.

An employee who receives a stock option that is subject to a substantial risk of forfeiture is not taxed until the restriction on the option has lapsed. The employee is not considered to have a claim of right to the stock option until the restrictions lapse. This is true even if the stock option has a readily ascertainable fair market value. Because the employee does not recognize income at the date of grant, the employer is not entitled to a corresponding deduction.

At the date of the grant Albert does not recognize any income and the Beaconsfield Corporation receives no deduction.

On September 30 when the restrictions lapse, Albert must recognize income of \$6,000 $[(\$20 - \$8) \times 500]$. His basis in the stock is now \$10,000 $(\$4,000 + \$6,000)$. The corporation is entitled to a compensation deduction of \$6,000.

- d. The option has a readily ascertainable fair market value of \$3 per share but is subject to substantial risk of forfeiture and Albert makes a Section 83(b) election.

The tax law allows an employee who receives nonqualified stock options that are nontransferable and subject to substantial restrictions to make a special election (known as a *Section 83(b) election*) at the date of exercise. By making this election, the taxpayer treats as ordinary income the difference between the exercise price and the fair market value of the stock at the date of exercise. Because the employee does not recognize income at the date of grant, the employer is not entitled to a corresponding deduction.

By making a Section 83(b) election at the date of exercise, Albert will treat as ordinary income the difference between the exercise price and the fair market value of the stock at the date of exercise. His basis is equal to the amount of income recognized at the date of the exercise plus the cash paid to exercise the option. This represents the \$4,000 ($\8×500) he paid to exercise the option price plus the \$4,000 ($\8×500) in ordinary income he recognized on the date of exercise. The holding period for the stock begins at the exercise date.

Albert has compensation income of \$4,000 [$(\$16 - \$8) \times 500$] and his basis in the stock is \$8,000 [$(\$8 + \$8) \times 500$]. The corporation is entitled to a compensation deduction of \$4,000.

65. Return to the facts of problem 64. On November 30, 2017, when the fair market value of the stock is \$30 he sells the stock. Determine the tax consequences to both Albert and the Beaconsfield Corporation in each situation presented in problem 64.

Part a

Albert's basis in the stock is \$5,500 $[(\$8 + \$3) \times 500]$. This represents the \$1,500 $(\$3 \times 500)$ in ordinary income he recognized on the date of grant plus the \$4,000 $(\$8 \times 500)$ he paid to exercise the option. His holding period for determining whether the gain or loss is short term or long term begins on February 15, 2016.

When Albert sells the stock on November 30, 2017 for \$15,000 $(\$30 \times 500)$ shares), he recognizes a short-term capital gain of \$9,500 $(\$15,000 - \$5,500)$. The gain is short-term because he held the stock for less than 12 months.

Because Albert did not recognize ordinary income at the date of sale, the Beaconsfield Corporation is not entitled to an additional compensation deduction.

Part b

His basis is equal to the amount of income recognized at the date of the exercise plus the cash paid to exercise the option. The holding period for the stock begins at the exercise date.

When Albert sells the stock on November 30, 2017 for \$15,000 $(\$30 \times 500)$ shares) he recognizes a short-term capital gain of \$7,000 $(\$15,000 - \$8,000)$. The gain is short-term because he held the stock less than 12 months.

Because Albert did not recognize ordinary income at the date of sale, the Beaconsfield Corporation is not entitled to an additional compensation deduction.

Part c

Albert's basis in the stock is \$10,000 $(\$4,000 + \$6,000)$.

When Albert sells the stock on November 30, 2017 for \$15,000 $(\$30 \times 500)$ shares), he recognizes a short-term capital gain of \$5,000 $(\$15,000 - \$10,000)$. The gain is short-term because he held the stock for less than 12 months.

Because Albert does not recognize any ordinary income and therefore, the corporation is not entitled to a compensation deduction.

Part d

By making a Section 83(b) election at the date of exercise, Albert will treat as ordinary income the difference between the exercise price and the fair market value of the stock at the date of exercise. His basis is equal to the amount of income recognized at the date of the exercise plus the cash paid to exercise the option. This represents the \$4,000 ($\8×500) he paid to exercise the option price plus the \$4,000 ($\8×500) in ordinary income he recognized on the date of exercise. The holding period for the stock begins at the exercise date.

When Albert sells the stock on November 30, 2017 for \$15,000 ($\30×500 shares) he recognizes a short-term capital gain of \$7,000 ($\$15,000 - \$8,000$). The gain is short-term because he held the stock for less than 1 year.

At the date of the sale, Albert did not recognize any ordinary income and therefore, the corporation is not entitled to a compensation deduction.

66. On May 10, 2016, Somerton Inc., grants Louise a nonqualified stock option to acquire 700 shares of the company's stock for \$11 per share. The fair market value of the stock on the date of grant is \$13. The option does not have a readily ascertainable fair market value. On June 1, 2016, when the fair market value of the stock is \$15, Louise exercises the stock option. Determine the tax consequences for Louise and Somerton on the grant date of the option and the exercise date.

An employee who receives an option that does not have a readily ascertainable fair market value will not recognize income at the date of grant but rather at the date of exercise. The amount of income the employee must recognize is the difference between the option price and the fair market value of the stock at the date of exercise. Her basis is equal to the amount of income recognized at the date of the exercise plus the cash paid to exercise the option. The holding period for the stock begins at the exercise date. Because the employee does not recognize income at the date of grant, the employer is not entitled to a corresponding deduction.

At the date of the grant Louise does not recognize any income and the Somerton Corporation is not entitled to a deduction.

Louise has compensation income of \$2,800 $[(\$15 - \$11) \times 700]$ and her basis in the stock is \$10,500 $[(\$4 + \$11) \times 700]$. This represents the \$2,800 $(\$4 \times 700)$ in ordinary income she recognized on the date of exercise, plus the \$7,700 $(\$11 \times 700)$ she paid to exercise the option.

Because Louise recognized ordinary income at the date of exercise, the Somerton Corporation is entitled to a compensation deduction of \$2,800.

67. Return to the facts of problem 66. If the stock is subject to substantial restrictions, what are the tax consequences for both Louise and Somerton on the date Louise is granted the stock option and the date she exercises the stock assuming she does not make a Section 83(b) election? How would your answer change if she makes a Section 83(b) election and the fair market value of the stock when the restrictions lapse on March 31, 2016 is \$22?

An employee who receives a stock option that is subject to substantial risk of forfeiture is not taxed until the restriction on the option has lapsed. The employee is not considered to have a claim of right to the stock option until the restrictions lapse at that time the employee will recognize income. Because the employee does not recognize income at the date of grant or the date of exercise, the employer is not entitled to a corresponding deduction at either date.

At the date of the grant, Louise does not recognize any income and the Somerton Corporation is not entitled to a deduction.

Louise does not recognize any income at the date of exercise. Her basis in the stock is the \$7,700 ($\11×700), she paid to exercise the option. When the restrictions lapse on March 31, 2017, Louise must recognize income of \$7,700 [$(\$22 - \$11) \times 700$]. Her basis in the stock \$15,400 ($\$7,700 + \$7,700$). The Somerton Corporation is entitled to a compensation deduction of \$7,700, the amount Louise recognizes as income, on the date the restrictions lapse.

By making a Section 83(b) election at the date of exercise, Louise will treat as ordinary income the difference between the exercise price and the fair market value of the stock at the date of exercise. Her basis is equal to the amount of income recognized at the date of the exercise plus the cash paid to exercise the option. The holding period for the stock begins at the exercise date.

Louise has compensation income of \$2,800 [$(\$15 - \$11) \times 700$] and her basis in the stock is \$10,500 [$(\$4 + \$11) \times 700$]. This represents the \$2,800 ($\$4 \times 700$) in ordinary income she recognized on the date of exercise, plus the \$7,700 ($\11×700) she paid to exercise the option. Because Louise recognized ordinary income at the date of exercise, the Somerton Corporation is entitled to a compensation deduction of \$2,800.

Instructors Note: By making a Section 83(b) election Louise will recognize a lower amount of ordinary income as long as the stock price continues to increase. This is especially important if the stock is held for more than one year.

68. Return to the facts of problem 67. Assume that Louise sells the stock on October 31, 2017 for \$35 per share. Determine the tax consequences for Louise and Somerton on the date of sale.

If Louise did not make a Section 83(b) election, when she sells the stock on October 31, 2017 for \$24,500 ($\35×700 shares) she recognizes a short-term capital gain of \$9,100 ($\$24,500 - \$15,400$). The gain is short-term because she held the stock for less than 12 months.

If Louise makes a Section 83(b) election, when she sells the stock on October 31, 2017 for \$24,500 ($\35×700 shares) she recognizes a short-term capital gain of \$14,000 ($\$24,500 - \$10,500$). The gain is short-term because she held the stock for less than 12 months.

Instructors Note: By making a Section 83(b) election Louise recognizes a higher amount of capital gain income. This is important if she has net capital losses in excess of \$3,000.

69. On July 1, 2016, Howard is granted the right to acquire 500 shares of the Matoney Corporation for \$15 per share. The option qualifies under the company's incentive stock option plan. The current fair market value of the stock is \$12. On August 18, 2017 when the stock is selling for \$18 per share, Howard exercises his option to purchase the stock. He sells the shares on September 15, 2018, for \$29 per share. Determine the tax consequences for Howard and the Matoney Corporation on the

An incentive stock option is not taxable when the option is granted or when it is exercised. Rather, the taxpayer is allowed capital gain treatment on the difference between the sales price of the stock and the price paid for the option (i.e., exercise price). However, this difference is a tax adjustment in computing an individual's alternative minimum tax liability. Because the employee receives special tax treatment, the employer is not entitled to a compensation deduction for the difference between the option price and the fair market value of the stock.

a. Date of grant

At the date of grant Howard does not recognize any income. Because he does not recognize any ordinary income, Matoney is not entitled to a compensation deduction.

b. Date of exercise

Howard does not recognize any income on the date of exercise, and Matoney is not entitled to a compensation deduction. However, the difference between the fair market value of the shares at the date of exercise (\$18) and the exercise price (\$15) is a tax adjustment in computing his alternative minimum tax liability. Howard's tax preference is \$1,500 $[(\$18 - \$15) \times 500]$. Howard's basis in the stock is \$7,500 $(\$15 \times 500)$. His holding period begins on the date of exercise. His basis for AMT purposes is \$9,000 $(\$7,500 + \$1,500)$ or \$18 per share $(\$9,000 \div 500)$.

c. Date of sale

Howard will recognize a long-term capital gain of \$7,000 $[(\$29 - \$15) \times 500]$ on the sale of the stock. The gain is long-term because he has held the stock more than 12 months from the date of exercise. Matoney is not entitled to a compensation deduction. His gain for AMT purposes is \$5,500 $[(\$29 - \$18) \times 500]$

Assume that Howard sells the stock on August 15, 2018 for \$27 per share. What are the tax consequences to Howard and the Matoney Corporation.

Because Howard did not hold the stock for one year after the date of exercise (August 18, 2017, until August 15, 2018), the stock does not receive the favorable tax treatment of an ISO. For tax purposes the stock is treated as a nonqualified stock option. Howard must recognize \$1,500 $[(\$18 - \$15) \times 500]$ in ordinary income. Because he recognizes \$1,500 as income, his basis in the stock is \$9,000 $(\$1,500 + \$7,500)$.

When Howard sells the stock on August 15, 2018 for \$13,500 ($\27×500 shares) he recognizes a short-term capital gain of \$4,500 ($\$13,500 - \$9,000$). The gain is short term because he did not hold the stock more than 12 months from the date of exercise. Because Howard recognizes ordinary income on the stock option, Matoney is entitled to a compensation deduction of \$1,500. For regular tax purposes, Howard will get a tax credit to the extent the \$1,500 caused Howard to pay an AMT tax in the year of exercise.

70. Sonya owns 60% and her sister Karen owns 40% of the Tanglewood Group. They inherited their ownership from their mother who died in 2015. Sonya is the president and CFO of the corporation and receives a salary of \$140,000, which is reasonable given her duties and responsibilities. Karen, who is vice president, is paid a salary of \$61,000. She is not actively involved in the business and views her ownership as an investment. Discuss how the payments to Sonya and Karen are treated for tax purposes if

- a. Tanglewood is a corporation.

The \$140,000 salary to Sonya should be deductible. The amount she is paid is similar to the pay received by other individuals functioning in the same capacity. However, the \$61,000 paid to Karen is not a deductible expense of the corporation because it lacks a business purpose. The payment to Karen is treated as a dividend and included as income on his tax return. The payment of a dividend is not deductible by the corporation.

- b. Tanglewood is an S corporation.

The \$140,000 salary to Sonya should be deductible. The amount she is paid is similar to the pay received by other individuals functioning in the same capacity. However, the \$61,000 paid to Karen is not a deductible expense of the corporation because it lacks a business purpose. Because Tanglewood is a flow-through entity, Karen's income from the S corporation increases by \$24,000 ($\$61,000 \times 40\%$). Because Karen does not materially participate in the business, the income from the entity is passive. Sonya's income increases by \$36,000 ($\$61,000 - \$24,000$).

71. Clinton Corporation spent \$800,000 on qualified research activities during the current year. Clinton's fixed base percentage is 10%, and its annual average gross receipts for the four preceding years is \$2,000,000.

a. What is Clinton's allowable incremental research and experimental tax credit?

The incremental research expenditure credit is equal to 20% of the excess of the current year's expenditures minus the base amount. The base amount is the fixed base percentage multiplied by the average annual gross receipts for the 4 previous years. Clinton's calculated base amount for the current year is \$200,000 (\$2,000,000 x 10%). However, the base amount cannot be less than 50% of current-year expenditures, \$400,000 (\$800,000 x 50%). Therefore, for purposes of the incremental credit, Clinton's base amount is \$400,000, the minimum amount allowable.

Clinton's credit is \$80,000:

$$20\% \times (\$800,000 \text{ of qualified expenditures} - \$400,000 \text{ base amount})$$

- b. Assume that the average of Clinton's annual gross receipts for the preceding four years is \$10,000,000. What is Clinton's allowable incremental research tax credit?

Clinton's calculated base amount for the current year is \$1,000,000 (\$10,000,000 x 10%) which exceeds the minimum base amount of \$400,000. Therefore, for purposes of the incremental credit, Clinton's base amount is \$1,000,000. Clinton's does not receive an incremental research expenditure credit because the expenditures are less than the base amount [20% x (\$800,000 - \$1,000,000)].

72. Lavinia owns an advertising agency. In February 2016, Lavinia purchases for \$32,000 a building that was originally placed in service in 1922. Lavinia spends \$65,000 rehabilitating the building for use as her advertising agency office. The rehabilitation is completed in November 2016.

- a. What criteria must Lavinia meet to qualify for the older buildings rehabilitation tax credit?

To qualify for the 10-percent rehabilitation credit, the rehabilitation expenditures must be incurred to improve or rehabilitate property placed in service before 1936 that is used in the taxpayer's trade or business or that is held for investment purposes. The structure must also be substantially rehabilitated in that the rehabilitation expenditures exceed the greater of the property's adjusted basis or \$5,000. In addition, at least 75 percent of the external walls (of which at least 50-percent must be used as external walls) and at least 75 percent of the internal structural framework must remain in place.

- b. Assuming that she meets all qualifying criteria, what are the amounts for Lavinia's older buildings rehabilitation tax credit and the basis of the building?

Lavinia's tax credit is \$6,500 ($\$65,000 \times 10\%$). Lavinia's adjusted basis in the building is \$90,500 ($\$32,000 + \$65,000 - \$6,500$).

- c. What criteria must Lavinia meet to qualify for the historic structures credit?

In addition to the criteria set forth in part a, to qualify for the historic structures credit a building must be certified as historic by the Department of Treasury and must be located in a registered historic district or listed on the National Register of Historic Place. However, unlike the older building credit, the historic structures credit can be taken on residential real estate.

- d. Assume Lavinia meets the criteria in part c and that the building qualifies for both credits. What is the total of the rehabilitation credits for 2016? What is the basis of the building?

Lavinia's tax credit is \$19,500 [$(\$65,000 \times 10\%) + (\$65,000 \times 20\%)$]. Lavinia's adjusted basis in the building is \$77,500 ($\$32,000 + \$65,000 - \$19,500$).

73. Return to the facts of problem 72. Assume that Lavinia sells the building in April 2019.
- a. How much of the older buildings tax credit must Lavinia recapture?

To retain the full benefit of the tax credit, the property must be held five full years after the date of completion of the rehabilitation. If a rehabilitated structure is sold before the end of the five-year period, the credit is recaptured (added to the tax liability) in proportion to the number of years (or portions thereof) the actual holding period falls short of the five-year required holding period.

Lavinia held the building, after the rehabilitation was completed, for two full years (from November 2016 to April 2019). Therefore, the recaptured amount of the credit is \$3,900:

$$(3 \text{ years not held} \div 5 \text{ years required}) \times \$6,500 \text{ tax credit} = \$3,900$$

- b. Assuming the building qualified for both credits, how much of the historic structures credit must Lavinia recapture?

Lavinia held the building, after the rehabilitation was completed, for two full years (from November 2016 to April 2019). Therefore, the recaptured amount of the credit is \$11,700:

$$(3 \text{ years not held} \div 5 \text{ years required}) \times \$19,500 \text{ tax credit} = \$11,700$$

74. Hurst Corporation wants to provide child care for its employees. Because Hurst does not have a suitable facility on its own premises, it rents a building for the center. The rent for the year totals \$61,000. In addition, Hurst hires a qualified director to run the facility and spends an additional \$5,000 in training costs for the director. Hurst incurs \$20,000 in referral expenditures. What is Hurst Corporation's child care costs credit?

The child care cost credit is the sum of 25 percent of the qualified child care expenses incurred plus 10 percent of qualified child care resources and referral expenditures associated with providing such services. The credit is limited to a maximum of \$150,000 in any year. Qualified child care expenditures includes items used to acquire, construct, or expand property and any costs associated with training, compensating, and educating employees of the facility. The costs of contracting with an outside qualified child care facility is included in qualified child care expenses. Referral expenditures are covered for those that are incurred by an employer in contracting for qualified child care for its employees. Hurst can claim a child care cost credit of \$18,250 {[25% x (\$61,000 + \$5,000)] + [\$20,000 x 10%]}.

75. Willtem Corporation has total general business credits of \$25,000. It has a net regular tax liability of \$17,000 and its tentative alternative minimum tax is \$13,000. What can Willtem deduct as its general business credit?

Willtem's general business tax credit is \$4,000. The credit is limited to the net regular tax of \$17,000 minus the larger of the tentative minimum tax or 25% of the excess of its net regular tax liability over \$25,000. It should be noted that the calculation cannot result in a negative number.

Net regular tax		\$ 17,000
Less: the greater of		
Tentative minimum tax	\$13,000	
or		
[25% x (\$17,000 - \$25,000)]	-0-	(13,000)
General business credit		<u>\$ 4,000</u>

Willtem will have a general business credit carryover of \$21,000 (\$25,000 - \$4,000) that maybe carried back 1 year or forward 20 years to offset Willtem's future tax liability.

76. Determine the total amount of tax due and the amount of the alternative minimum tax in each of the following situations:
- a. Wilbur Corporation's regular tax liability is \$180,000, and its tentative alternative minimum tax is \$150,000.

Because Wilbur's regular tax liability exceeds the tentative minimum tax, it must pay the \$180,000 regular tax liability. No AMT is due (AMT cannot be negative). The purpose of the AMT is to ensure that taxpayers pay a certain minimum amount of tax, not to reduce the regular tax liability.

- b. Gene's regular tax liability is \$27,000, and her tentative alternative minimum tax is \$44,000.

Because Gene's tentative minimum tax is greater than her regular tax liability, she is subject to the AMT and must pay the \$44,000 tax calculated using the AMT rules. Gene is deemed to pay \$27,000 in regular tax liability and an AMT of \$15,000 (\$44,000 - \$27,000).

77. Stan purchases machinery costing \$100,000 for use in his business in 2016. The machinery is 7-year MACRS property and has an ADS life of 12 years. Prepare a depreciation schedule using the regular MACRS method and ADS depreciation assuming that Stan does not make a Section 179 election. Determine the amount of the adjustment Stan must make in computing his alternative minimum tax each year.

The depreciable basis for regular tax and AMT purposes is the \$100,000 cost of the machinery. Machinery is tangible personal property with a MACRS class life of 7 years and is depreciated using 200% declining balance method. For AMT purposes, Stan must depreciate it using the 150% declining balance method over the 7-year MACRS life (Table 10-7). In computing AMTI, Stan must add the excess of MACRS depreciation over the allowable ADS amount. When depreciation under ADS exceeds MACRS, the difference is subtracted in computing AMTI. The MACRS, ADS depreciation and AMT adjustment is calculated as follows:

Year	Basis	Percentage	Depreciation		ADS	AMT Adjust.
			MACRS	Percentage		
2016	\$100,000	14.29%	\$ 14,290	10.71%	\$ 10,710	\$ 3,580
2017	\$100,000	24.49%	24,490	19.13%	19,130	5,360
2018	\$100,000	17.49%	17,490	15.03%	15,030	2,460
2019	\$100,000	12.49%	12,490	12.25%	12,250	240
2020	\$100,000	8.93%	8,930	12.25%	12,250	(3,320)
2021	\$100,000	8.92%	8,920	12.25%	12,250	(3,330)
2022	\$100,000	8.93%	8,930	12.25%	12,250	(3,320)
2023	\$100,000	4.46%	4,460	6.13%	6,130	(1,670)
Total			<u>\$100,000</u>		<u>\$100,000</u>	<u>\$ -0-</u>

Instructor's Note: For property placed in service after December 31, 1998, a taxpayer that elects to use straight-line MACRS for Section 1245 property will no longer need to compute an AMT adjustment. Under the new law, the ADS useful life will be the same as the useful life using the straight-line method. This is also true for Section 1250 property.

This problem is an extension of problem 51 in Chapter 10.

78. Assume that in problem 77, Stan sells the machinery in 2022 for \$28,500. Determine the effect of the sale on Stan's regular taxable income and his alternative minimum taxable income in 2022.

Because the allowable depreciation is different under the 2 systems, the basis of the property at the date of sale is also different. For regular tax purposes, the property has an adjusted basis of \$8,930, while the AMT basis of the property is \$12,255:

Year	Basis	Percentage	Depreciation		AMT Adjust
			MACRS	Percentage ADS	
2016	\$100,000	14.29%	\$ 14,290	10.71%	\$ 3,580
2017	\$100,000	24.49%	24,490	19.13%	5,360
2018	\$100,000	17.49%	17,490	15.03%	2,460
2019	\$100,000	12.49%	12,490	12.25%	240
2020	\$100,000	8.93%	8,930	12.25%	(3,320)
2021	\$100,000	8.92%	8,920	12.25%	(3,330)
2022	\$100,000	4.46%*	4,460	6.13%**	(1,665)
Total			<u>\$ 91,070</u>	<u>\$ 87,745</u>	<u>\$ 3,325</u>

* Depreciation in year of sale 4.46% (8.93% x 50%)

** Depreciation in year of sale 6.13% (12.25% x 50%)

Original basis	\$ 100,000	\$ 100,000
Depreciation to date of sale	(91,070)	(87,745)
Adjusted basis at date of sale	<u>\$ 8,930</u>	<u>\$ 12,255</u>

The difference in adjusted basis between the two systems causes the gain on the sale of the property to be different. Because the gain is included in regular taxable income, an adjustment must be made to get the correct gain for AMT purposes. The sale of the machinery results in a negative AMT adjustment of \$3,325:

	MACRS	ADS
Amount realized	\$ 28,500	\$ 28,500
Adjusted basis	(8,930)	(12,255)
Gain on sale	19,570	\$ 16,245
AMT adjustment	(3,325)	-0-
Difference	<u>\$ 16,245</u>	<u>\$ 16,245</u>

The \$3,325 AMT adjustment is the amount of gain that is included in regular taxable income that should not be included in AMTI because of the reduced depreciation deductions for AMT purposes.

79. Alice and Frank had the following items on their current-year tax return:

Adjusted gross income			\$140,000
Less: Deductions from adjusted gross income			
Medical expenses	\$14,450		
Less: 10% x \$140,000	<u>(14,000)</u>	\$ 450	
Home mortgage interest		6,300	
Home equity loan interest		1,200	
State income taxes		3,525	
Property taxes		950	
Charitable contributions (cash)		575	
Miscellaneous itemized deductions	\$ 3,000		
Less: 2% x \$140,000	<u>(2,800)</u>	200	(13,200)
Less: Exemptions (2 x \$4,050)			(8,100)

Determine the amount of the adjustments that Alice and Frank will have to make in computing their alternative minimum tax.

The primary adjustments that are required of individual taxpayers are for deductions from adjusted gross income that are either modified or not allowed for AMT purposes. The only itemized deductions allowed from AGI for AMT purposes are

1. Medical expenses in excess of 10% of AGI
2. Charitable contributions
3. Casualty and theft losses
4. Qualified housing interest
5. Investment interest
6. Miscellaneous itemized deductions not subject to the 2 percent of AGI reduction (gambling losses, premature cessation of annuities)

Personal and dependency exemption amounts are not deducted in arriving at AMTI.

Home equity loan interest is deductible only if the proceeds of the loan were used to improve the residence.

Alice and Frank will not be able to deduct the following expenses that are deductible for regular taxable income:

- (1) State taxes (\$3,525) and property taxes (\$950) are not deductible for AMTI.
- (2) Assuming that the home equity loan is not used to improve the house, the home equity interest (\$1,200) is not deductible.
- (3) The miscellaneous itemized deductions (\$200) are not deductible because only miscellaneous itemized deductions that are not required to be reduced by 2% of adjusted gross income are permitted.

(4) The exemptions of \$8,100 are not deductible for AMT purposes.

Regular taxable income:

Adjusted gross income (AGI)	\$140,000
Less: Total deductions from AGI	(13,200)
Less: Exemptions	(8,100)
Taxable income	<u>\$118,700</u>

AMT adjustments for itemized deductions and exemptions:

Add:		
Home equity loan interest	1,200	
State income taxes	3,525	
Property taxes	950	
Miscellaneous itemized deductions	200	
Exemptions	<u>8,100</u>	<u>13,975</u>
		\$ 132,675
Less: AMT exemption (married filing jointly)		(83,800)
Equals: AMTI		<u>\$ 48,875</u>
Tax Rate		x 26%
Tax		<u>\$ 12,708</u>

A married couple filing a joint return on \$118,700 of taxable income would have a regular tax liability of \$21,218:

$$\text{\$10,367.50} + [25\% \times (\text{\$118,700} - \text{\$75,300})] = \text{\$21,218}$$

Because their regular tax (\$21,218) is greater than their alternative minimum tax (12,708), they are not subject to the alternative minimum tax and their tax liability is \$21,218.

80. Joan and Matthew are married, have two children, and report the following items on their current year's tax return:

Adjusted gross income			\$178,000
Less: Deductions from adjusted gross income			
Medical expenses	\$19,950		
Less: 10% x \$178,000	<u>(17,800)</u>	\$ 2,150	
Home mortgage interest		13,500	
Home equity loan (for college education)		9,000	
State income taxes		12,500	
Property taxes		9,700	
Charitable contributions		7,000	
Miscellaneous itemized deduction	\$ 5,300		
Less: 2% x \$178,000	<u>(3,560)</u>	<u>1,640</u>	
Total Itemized deductions			(54,990)
Less: Exemptions (4 x \$4,050)			(16,200)

Determine Joan and Matthew's regular tax liability and, if applicable, the amount of their alternative minimum tax. Write a memo to Joan and Matthew explaining the adjustments they will have to make in computing their alternative minimum tax.

The primary adjustments that are required of individual taxpayers are for deductions from adjusted gross income that are either modified or not allowed for AMT purposes. The only itemized deductions allowed from AGI for AMT purposes are

1. Medical expenses in excess of 10% of AGI
 2. Charitable contributions
 3. Casualty and theft losses
 4. Qualified housing interest
 5. Investment interest
 6. Miscellaneous itemized deductions not subject to the 2 percent of AGI reduction (gambling losses, premature cessation of annuities)
- Personal and dependency exemption amounts are not deducted in arriving at AMTI.
 - Home equity loan interest is deductible only if the proceeds of the loan were used to improve the residence.
 - Joan and Matthew will not be able to deduct the following expenses that were deductible for regular taxable income:
 - (1) State taxes (\$12,500) and property taxes (\$9,700) are not deductible for AMTI.
 - (2) If the home equity loan is used for college education expenses, the home equity interest (\$9,000) is not deductible.

- (3) The miscellaneous itemized deductions (\$1,640) are not deductible because only miscellaneous itemized deductions that are not required to be reduced by 2% of adjusted gross income are permitted.
- (4) The exemptions of \$16,200 are not deductible for AMT purposes.

Based on the above information Joan and Matthew would calculate their regular taxable income and their alternative minimum taxable income as follows:

Regular taxable income:

Adjusted gross income (AGI)	\$ 178,000
Less: Total deductions from AGI	(54,990)
Less: Exemptions	(16,200)
Taxable income	<u>\$ 106,810</u>

The AMT adjustments (itemized deductions and exemptions):

Add:

State income taxes	12,500	
Property taxes	9,700	
Home equity loan interest	9,000	
Miscellaneous itemized deductions	1,640	
Exemptions	<u>16,200</u>	<u>49,040</u>
Tentative AMTI		\$ 155,850
Less: AMT exemption (married filing jointly)		(83,800)
Equals: AMTI		<u>\$ 72,050</u>
Tax rate		x 26%
Tax		<u><u>\$ 18,733</u></u>

A married couple filing a joint return on \$106,810 of taxable income would have a regular tax liability of \$18,245:

$$\$10,367.50 + [25\% \times (\$106,810 - \$75,300)] = \$18,245$$

Therefore, Joan and Matthew have a total tax liability for 2016 of \$18,733. This would consist of a regular tax liability of \$18,245 and an alternative minimum tax liability of \$488 (\$18,733 - \$18,245).

81. Pauline is considering investing in bonds. Her broker has given her several options to consider. The first option is to invest in city bonds with an interest rate of 6%. The second option involves the purchase of private activity bonds (subject to the AMT) that yield 7.5% interest. A third option is the purchase of High-Flier Utility bonds yielding 9% interest. Assuming that Pauline's marginal tax rate is 33%, write a letter to her explaining which option she should choose. In your letter be sure to consider all circumstances that could affect the after-tax return on the bond.

Individuals are subject to an AMT rate of 26 percent on the first \$186,300 of AMTI and 28 percent on AMTI in excess of \$186,300.

Any interest earned on tax-exempt securities that are not private activity bonds is excluded for regular tax and AMT purposes. Therefore, Pauline's after tax rate of return is 6% on the tax-exempt city bonds for regular tax and AMT purposes.

Private activity bond interest is not taxable for regular tax purposes, retaining the 7.5% after tax rate of return. Certain private activity bond interest is subject to the AMT through its inclusion as a preference item. Therefore, if Pauline is subject to the AMT, the after tax rate of return for AMT purposes is either 5.55% [$7.5\% \times (1 - 26\%)$] or 5.4% [$7.5\% \times (1 - 28\%)$] depending on the level of AMTI.

The High-Flier Utility bonds are taxable for regular and AMT tax purposes. The after tax rate of return depends on her marginal tax rate. The after tax return will vary from 6.03% [$9\% \times (1 - 33\%)$] if she is in the 33% marginal tax rate bracket to 5.44% [$9\% \times (1 - 39.6\%)$] if she is in the highest tax rate bracket for regular tax purposes. The potential after tax returns for AMT purposes are 6.66% [$9\% \times (1 - 26\%)$] and 6.48% [$9\% \times (1 - 28\%)$].

The High-Flier Utility bonds give the largest after tax return for AMT purposes. The private activity bonds give Pauline the largest after tax return if she is not subject to the AMT (i.e., for regular tax purposes). Therefore, her optimal choice is dependent on whether or not she is subject to the AMT.

82. Determine the AMT exemption amount for each of the following taxpayers:

The exemption amount starts at a tentative amount based on the type of taxpayer and is reduced by 25 percent of every dollar by which the tentative AMTI exceeds a specified level based on type of taxpayer (corporation or individual) and the filing status for individual taxpayers (See Table 15-14).

- a. Nominal Corporation has an alternative minimum taxable income of \$140,000.

The exemption is the initial exemption of \$40,000 for a corporation because Nominal's AMTI is less than \$150,000 (the phase-out floor).

- b. Janine is a single individual with an alternative minimum taxable income of \$165,000.

Janine's exemption is \$42,575:

Initial exemption for single individual		\$ 53,900
Less Phase-out:		
AMTI	\$ 165,000	
Less phase-out floor	(119,700)	
Excess	\$ 45,300	
Reduction percentage	x 25%	(11,325)
AMT Exemption		<u>\$ 42,575</u>

- c. Jagged Corporation has an alternative minimum taxable income of \$220,000.

Jagged's exemption is \$22,500:

Initial exemption for a corporation		\$ 40,000
Less Phase-out:		
AMTI	\$ 220,000	
Less phase-out floor	(150,000)	
Excess	\$ 70,000	
Reduction percentage	x 25%	(17,500)
AMT Exemption		<u>\$ 22,500</u>

- d. Peter and Wendy have an alternative minimum taxable income of \$144,000.

Peter and Wendy's exemption is the initial exemption of \$83,800. There is no phase-out, because their AMTI is less than the \$159,700 married couple filing jointly phase-out floor (see Table 15-14).

- e. Popup Corporation has an alternative minimum taxable income of \$900,000.

Because Popup Corporation's AMTI is above \$310,000, the exemption amount is fully phased-out and Popup's exemption amount is zero.

83. Bivona Corporation forms Jarvis Corporation in the country of Simants. Bivona owns 90% of Jarvis' voting stock and 30% of its preferred stock. The remaining Jarvis stock is owned by citizens of Simants. The preferred shares represent 20% of the fair market value of the company. All Bivona shareholders are U.S. citizens. Is Jarvis a controlled foreign corporation? Explain.

A controlled foreign corporation (CFC) is a foreign corporation that is more than 50% owned by U.S. shareholders. The 50% ownership test is met if, on any day during the year, U.S. shareholders own more than 50% of the voting stock or more than 50% of the total value of the corporate stock. Jarvis is considered a controlled foreign corporation. Although Bivona only needs to meet one of these tests for Jarvis to be treated as a CFC, it meets both of the tests. Because Bivona owns more than 50% of the stock, it meets the ownership test. By owning 78% $[(90\% \times 80\%) + (30\% \times 20\%)]$ of Jarvis, it also meets the fair market value test. Earnings of a CFC are generally not taxed the parent corporation until they are repatriated in the form of dividends.

84. Stanton Technology owns 100% of Goldman Corporation, a controlled foreign corporation. Goldman's taxable income from its manufacturing operations is \$3.0 million and it does not pay a dividend during the year. Goldman pays foreign taxes on its income at a marginal tax rate of 27%, while Stanton's marginal tax rate is 34%. What is the tax treatment of Goldman's income?

Goldman will pay \$810,000 $(\$3,000,000 \times 27\%)$ in foreign taxes for the year. Because Goldman is a CFC, Stanton will pay no U.S. federal income tax on Goldman's earnings until all or a portion of the earnings are remitted (paid) in dividends to Stanton. The earnings from manufacturing operations are not considered Subpart F income. If Goldman subsequently pays a dividend to Stanton for the full amount, Stanton will include the dividend in its income but will be allowed a foreign tax credit for \$810,000 because the foreign taxes paid by Goldman is less than the foreign tax credit limit $[\$1,020,000 (\$3,000,000 \times 34\% \text{ U.S. rate})]$.

85. Smile Corporation invests \$2.0 million for a 49% interest in Irehoe Inc., a newly formed Irish corporation that manufactures farm equipment. Jim, a U. S. resident, owns 10% of Irehoe. Jim owns no stock in Smile Corporation. An Irish corporation owns the remaining Irehoe shares. Irehoe reports a profit for the current year of \$150,000 and pays no dividends. Irehoe pays no income tax in Ireland because of a tax holiday for newly formed corporations that have a significant foreign ownership. Discuss the tax implications for Smile, Irehoe, and Jim.

Because Smile Corporation and Jim are U.S. shareholders who own more than 50% of the voting stock of Irehoe, a foreign corporation, Irehoe is a CFC for U.S. tax purposes. Owners of CFCs are taxed depending on whether the CFC has Subpart F earnings and whether any distributions are made during the year. Subpart F income consists of interest, dividends, royalties, and foreign base company income. From the facts, it appears that Irehoe does not have any Subpart F income. As a result, its income will be not subject to tax in Ireland (i.e., tax holiday) and not currently subject to U.S. tax Smile and Jim will not be taxed on any portion of the income until it is paid to them as a dividend.

86. Assume the same facts as in problem 85, except that Irehoe's income consists solely of commissions from selling farm equipment manufactured and distributed by Smile Corporation to foreign buyers.

Irehoe's income is foreign base company sales income which is a category of Subpart F income. U. S. shareholders will have to include their ratable share of Irehoe's Subpart F income in their tax return as a constructive distribution whether any amount is actually distributed. Therefore Smile must include \$73,500 ($\$150,000 \times 49\%$) in income for the current year while Jim must report \$15,000 ($\$150,000 \times 10\%$). This treatment is similar to how owners of a flow-through entity are taxed. Smile Corporation and Jim will be entitled to a foreign tax credit for their ratable share of the CFC's foreign taxes paid. In this case, no Irish taxes are paid, so Smile will not be entitled to any foreign tax credit.

87. Logo Corporation, a domestic corporation, owns 100% of TAG, a foreign corporation. TAG is Logo's only source of income. During the current year, TAG receives \$80,000 of dividends and interest from its foreign investments. TAG pays \$6,000 in foreign taxes and does not distribute any income to Logo during the year. Write a memo to Logo discussing the implications of its ownership of TAG.

Tag is a CFC because Logo, a U.S. shareholder, owns more than 50% of the voting stock of TAG. The \$80,000 dividend and interest income that TAG receives is Subpart F income and must be included in Logo's income even though no actual distribution is made to Logo. Logo is allowed a \$6,000 foreign tax credit for the foreign taxes that TAG pays on its investment income.

88. Assume the same facts as in problem 87. In the next year, TAG distributes \$5,000 to Logo. What are the tax effects of the distribution?

Because the \$5,000 is from earnings previously taxed under the Subpart F rules, Logo is not taxed on the distribution. Logo's basis in TAG stock will be reduced by the amount of the distribution. This treatment is similar to the treatment of owners of conduit entities.

89. Norman, a U.S. corporation, owns 100% of Monterio, a foreign corporation operating in Barbados, which has no income tax. Norman ships goods directly to its foreign customers from its Atlanta manufacturing operations. Monterio processes all sales invoices and receipts in its Barbados office. Monterio reports \$1.4 million of income during the year and does not pay any foreign taxes. Norman's marginal tax rate is 34%, and Monterio did not pay a dividend during the year.

- a. How is Monterio's income taxed in the U.S.?

Monterio is a CFC and has Subpart F income. The tax treatment is similar to a conduit entity. Therefore, the earnings will be subject to tax and Norman's basis in Monterio's stock is increased. Even though Monterio does not pay any dividends, Norman must include 100% of Monterio's income (\$1,400,000) in its income for the year. This will result in Norman paying \$476,000 ($\$1,400,000 \times 34\%$) in taxes.

- b. What are the tax consequences if Norman receives a \$300,000 dividend from Monterio?

As with a conduit entity, because the income has already been included in income, the distribution is not taxable. The distribution decreases Norman's basis in the Monterio stock by the amount of the distribution.

90. Petro Corporation is a U. S. corporation with operations in several foreign countries as well as in the United States. During the current year, Petro's worldwide taxable income is \$600,000. Petro's foreign source income is \$180,000, on which it pays \$45,000 in foreign taxes.

- a. What is Petro's foreign tax credit?

To provide U.S. taxpayers relief from the double taxation of its foreign income, the tax law allows a foreign tax credit for foreign taxes paid. The foreign tax credit applies to individuals and corporations paying foreign taxes on income earned abroad that is included in U. S. taxable income. The amount of the credit is the lesser of (1) the actual foreign taxes paid, or (2) the U.S. tax that would have been paid on the foreign earned income. This limits the credit to the tax that is assessed by the United States on the foreign income. The limit is calculated using the following formula:

$$\text{Limit} = \frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income}} \times \text{U. S. income tax before tax credits}$$

If the actual foreign taxes paid are less than the limit, the actual foreign tax is the amount of the allowable credit. When the foreign taxes paid exceed the limit, the unused portion can be carried back one year and forward for ten years, subject to each year's foreign tax credit limit. Petro's foreign tax credit limit would be \$61,200 = [(\$180,000/\$600,000) x \$204,000] assuming Petro's marginal tax rate is 34%. Because Petro paid \$45,000 in foreign taxes and the amount is less than the foreign tax credit limit, all of the foreign taxes paid may be credited against the U.S. tax.

- b. What is Petro's foreign tax credit if it pays \$75,000 in foreign taxes?

If Petro pays \$75,000 in foreign taxes, its foreign tax credit is still limited to a total of \$61,200 for the year. When the foreign taxes paid exceed the limit, the unused portion can be carried back one year and forward for ten years, subject to each year's foreign tax credit limit. The excess amount \$13,800 (\$75,000 - \$61,200) may be carried back one year or forward ten years and applied against U. S. taxes during that time period.

91. Flagler Corporation paid \$75,000 in foreign taxes on \$250,000 in foreign income during the current year. Flagler's total taxable income is \$800,000.
- a. What is Flagler's foreign tax credit?

The foreign tax credit on Flagler's foreign source income is limited to the lesser of the actual foreign taxes paid (\$75,000) or the U.S. tax that would have been paid on foreign source income. Flagler's U.S. tax on \$800,000 of taxable income is \$272,000 (\$800,000 x 34% corporate marginal tax rate). This produces a limit of \$85,000:

$$\text{Limit} = [(\$250,000 \div \$800,000) \times \$272,000] = \$85,000$$

Because the actual taxes paid are less than the limit, Flagler's foreign tax credit is the \$75,000 in actual foreign taxes paid.

- b. Assume that Flagler paid \$112,500 on its foreign income. What is Flagler's foreign tax credit?

Flagler's foreign tax credit is limited to \$85,000 as calculated above. The \$27,500 (\$112,500 - \$85,000) excess may be carried back one year and used to offset tax paid, subject to each year's foreign tax credit limit. If the entire credit is not used in the carryback period, any unused portion may be carried forward for 10 years and used, subject to each year's individual limit on foreign taxes paid.

92. Readyhough Industries, a U.S. corporation with a 34% marginal tax rate, forms Brandon, Inc., a wholly-owned foreign corporation that operates in Ireland. In exchange for 100% of Brandon's stock, Readyhough transfers \$250,000 cash and property with a basis of \$400,000 and a fair market value of \$2.0 million. Write a memo to Readyhough explaining the tax consequences of this transaction.

Because a U.S. corporation could avoid paying tax indefinitely on the transfer of appreciated property to a controlled foreign corporation, Congress decided not to exempt these types of transactions from taxation. Instead, such transfers of appreciated property to a controlled foreign corporation are treated as a sale of the property to the foreign subsidiary at fair market value. Readyhough is treated as having sold the property to Brandon in a taxable transaction. Readyhough would recognize a \$1,600,000 (\$2,000,000 - \$400,000) of gain on the formation of Brandon. Because Readyhough recognizes gain on the transfer of the securities, its basis in the property is \$2,000,000. Readyhough will have to pay \$544,000 (\$1,600,000 x .34) of tax on the exchange.

93. Taverex is a foreign corporation that operates a manufacturing plant in Lubbock, Texas. Taverex sells its products to customers outside the U. S. In the current year, Taverex's gross revenue is \$4.0 million. Cost of goods sold and other operating expenses total \$2.8 million. Is Taverex taxed on the income? Explain.

Taverex will be taxed on the net income of its manufacturing and sales activity in the U.S. Foreign corporations doing business in the U. S. are subject to U.S. tax on their effectively connected trade or business income at rates that are applicable to any domestic corporation. Effectively connected trade or business income is determined by applying two tests: the asset use test, and the business activities test. The tests are designed to determine whether the income from the Lubbock operation should be taxed similar to a U.S. Corporation or if the income should be treated as nonbusiness income and taxed a 30%. The distinction is important because trade or business income is reported net of expenses, while no deductions are allowed against nonbusiness income.

The asset use test is met if income is derived from assets used in or held for use in the active conduct of a U.S. business. The business activities test is met if the U. S. business activities of the foreign corporation are a material factor in the realization of income or gain and loss. Generally, if a nonresident alien or a foreign corporation is conducting a profit-oriented activity within the U.S. that is carried on in a regular, substantial, and continuous manner, then income derived from the activity is deemed to be effectively connected trade or business income. In this case, it appears that Taverex meets both the asset use test and the business activities test and it will be taxed similar to a U.S. corporation.

Taverex's taxable income is \$1,200,000 (\$4,000,000 - \$2,800,000) and its tax liability is \$408,000 { $\$113,900 [(\$1,200,000 - \$335,000) \times 34\%]$ }.

94. Conrad is a citizen and resident of Trinidad. He receives an \$8,000 dividend from Sturino Industries, a U. S. domestic corporation.
- a. What is the tax treatment of the dividend?

Nonbusiness income sourced in the U.S. is subject to a flat 30% withholding rate. Therefore, Sturino should withhold U.S. taxes of \$2,400 ($\$8,000 \times 30\%$) on the dividend.

- b. Under what circumstances would the dividend not be taxable?

The dividend would not be taxable to Conrad if the dividend is subject to a joint treaty provision between the U.S. and Trinidad that specifically exempts dividends from withholding. In addition, it is possible that a provision in the treaty while not exempting the income from tax could tax it at a lower rate.

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.

95. John is single and has \$74,000 income from his job at Lawndale Ice Cream Company. He wants to invest \$150 a month in an IRA but is not sure which type he qualifies for and whether this would be a better investment than putting the money in a money market account earning 3% interest per year.

The major issues can be divided into tax and nontax issues. John must decide whether he should invest in a deductible IRA, (assuming he qualifies) or some other tax-favored investment. Non-tax factors John must consider is the risk he is willing to assume and whether the after-tax rate of return on a money market fund will yield a higher return than the tax-favored IRAs. Tax factors John should consider is his marginal tax rate and whether he is an active participant in an employer-sponsored retirement plan. As a participant this can affect whether John can deduct his IRA contribution. If he is a participant he might still be entitled to a deduction depending on his adjusted gross income. Finally, John should consider the benefits of a Roth IRA.

It appears that John's adjusted gross income will be greater than the \$71,000 phase-out limit for an active participant in an employer-sponsored plan, so if he is an active participant in a qualified retirement plan, a deductible IRA is not possible. If that is the case, he should consider opening a Roth IRA. The contribution is not deductible but the distributions upon retirement are tax-free.

If he is not an active participant, John could make a deductible IRA contribution of \$5,500. If John is in the 25% tax bracket, his tax deduction is worth \$1,375 ($\$5,500 \times .25$). If John puts his money in a money market earning 3% before tax, his after-tax yield will be 2.25% [$3\% \times (1 - 25\%)$].

96. Lisa works full time at the Snowden Corporation as a manager in quality control. She is trying to get her employer to initiate a retirement program for all Snowden employees who make more than \$80,000 a year.

The issue is determining what type of pension plan Snowden should establish for its employees. Pension plans may be either qualified or nonqualified. Qualified plans may be further classified as either a defined benefit plan or a defined contribution plan. Qualified plans allow the employer and the employee to make contributions to the plan. Both contributions are taxed deferred (i.e., taxed to the employee when withdrawn). In addition, the employer is entitled to a current deduction for its contribution. Nonqualified plans have the opposite effect. Current contributions to the plan are subject to tax by the employee, and the employer cannot take a deduction until the employee recognizes income from the contribution.

A defined benefit plan sets retirement benefits based on the number of years an employee has worked for the company and the employee's annual salary. A defined contribution plan bases the benefits on the total contributions made to the plan from both the employer and employee along with the gains and losses earned by the assets of the plan.

The defined contribution plan has limitations on the amount that can be contributed to the plan. The contribution limits are the lesser of \$53,000 or 25% of the employee's taxable compensation limited to \$265,000. Therefore, the maximum contribution is limited to \$53,000. The most commonly used pension plan is a defined contribution plan. If Snowden adopts this type of retirement plan, it will be able to contribute up to 25% of Lisa's salary or \$20,000 (\$80,000 x 25%).

97. The Schwarzbach Corporation manufactures metal fasteners at a cost of 55 cents per fastener and sells them to wholesalers for 60 cents each. During the year, it establishes a 100% owned CFC in Portugal to sell the fasteners in Europe. Schwarzbach sells the fasteners to its CFC for 58 cents each.

At issue is whether Schwarzbach is dealing with its CFC at arm's length or whether Schwarzbach is arbitrarily setting prices to avoid taxation on the sale of the fasteners. Because Schwarzbach charges \$.60 cents per fastener to arm's length customers and only \$.58 cents to its wholly-owned CFC, the IRS may question whether the transfer price is clearly reflects income. Based on the facts, it appears that Schwarzbach will have a difficult time justifying the price it charges to its CFC.

98. Jingling Corporation is wholly owned by Jing and Ling, who are residents of Japan. Jingling is located in Nebraska and produces home furniture. Jingling sells its furniture directly to final customers in the U. S. and Japan. Jingling earns \$250,000 from sales during the current year. It also receives \$20,000 of royalty income from patents it owns on furniture inventions, and processes. No dividends are paid during the current year.

The first issue is whether the \$250,000 Jingling earns is income that is effectively connected U.S. trade or business income. Two tests, the asset use test and the business activities test, are used to determine whether the income from the Nebraska operation should be taxed similar to a U.S. Corporation or if the income should be treated as nonbusiness income and taxed at 30%. The distinction is important because trade or business income is reported net of expenses, while no deductions are allowed against nonbusiness income.

The asset use test is met if income is derived from assets used in or held for use in the active conduct of a U.S. business. The business activities test is met if the U. S. business activities of the foreign corporation are a material factor in the realization of income or gain and loss. Generally, if a nonresident alien or a foreign corporation is conducting a profit-oriented activity within the U.S. that is carried on in a regular, substantial, and continuous manner, then income derived from the activity is deemed to be effectively connected trade or business income. In this case, it appears that Jingling meets both the asset use test and the business activities test and it will be taxed similar to a U.S. corporation.

The second issue is whether the royalties from the patents also are subject to U.S. tax. Sourcing rules are important in that Jingling will be able to reduce gross receipts by any expenses associated with defending the patents and other expenses associated with generating operating income. The royalty income meets the business activities test and is subject to U.S. tax. Jinling will have a U.S. tax liability of \$91,800 ($\$270,000 \times 34\%$).

99. Assume the same facts as in problem 98, except that Jingling's royalty income is from investments located in Japan.

Because the royalties originate from investments in a foreign country, the issue arises as to which tax jurisdiction is entitled to tax the royalties, the country in which the royalties originate, or the country in which the taxpayer resides. The taxpayers must establish if a current treaty is in effect that resolves such matters even if sourcing rules in both countries claim income inclusion. Since a tax treaty exists between Japan and the U.S., Jingling probably will not include the \$25,000 in U.S. taxable income. However, the income will be subject to Japanese tax.

100. **INTERNET ASSIGNMENT** Use the Internet to find articles or discussions about planning aspects of Roth IRAs and regular IRAs. Trace the steps you use to find additional information (search engine or tax directory used and key words). Write a summary of the information you find. Include the URL of the World Wide Web site that contains the information you use for your summary.

One possible starting point is Google's homepage and search engine (www.google.com). Starting at the Google homepage use the search engine provided and type in the key words "Roth IRA". This search will result in several "hits" on Web sites and articles that may be linked to by clicking on the one that interests you. Using the search engine, an article was located that would assist the user in determining whether or not to rollover an existing IRA to a Roth IRA based on user input online. The site was www.rothira.com. This site provides a wealth of knowledge and links to other information concerning Roth IRAs

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.

101. **INTERNET ASSIGNMENT** The Alternative Minimum Tax remains a very controversial item that affects a greater number of taxpayers each year. Go to http://en.wikipedia.org/wiki/Alternative_Minimum_Tax and read through the wiki that discusses the Alternative Minimum Tax (AMT) and write a one-page summary either supporting the current AMT requirements (i.e. rates, exemption amounts, etc.) or detailing why the AMT should be reformed or repealed.

The Alternative Minimum Tax (AMT) is an [income tax](#) imposed by the [United States federal government](#) on individuals, [corporations](#), [estates](#), and [trusts](#). AMT is imposed at a nearly flat rate on an adjusted amount of taxable income above a certain threshold (also known as exemption). This exemption is substantially higher than the exemption from regular income tax.

Regular taxable income is adjusted for certain items computed differently for AMT, such as depreciation and medical expenses. No deduction is allowed for state taxes or miscellaneous itemized deductions in computing AMT income. Taxpayers with incomes above the exemption whose regular Federal income tax is below the amount of AMT must pay the higher AMT amount.

A predecessor Minimum Tax, enacted in 1969, imposed an additional tax on certain tax benefits for certain taxpayers. The present AMT was enacted in 1982 and limits tax benefits from a variety of deductions. President Obama signed "[fiscal cliff](#)" legislation on January 2, 2013 to ensure that the Alternative Minimum Tax is permanently adjusted for inflation.

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102. **RESEARCH PROBLEM** Genco Company is a small manufacturing company that makes metal presses for larger manufacturing companies. Genco is located in a large city and desires to expand its operations, which will require it to hire more workers. Some of the workers need to be highly skilled machinists, while others need little prior training or experience. Genco would like to hire employees from the economically depressed neighborhoods near its plant. The plant manager has heard that there are income tax credits available for providing work opportunities for certain targeted groups of individuals. He comes to you for information about who he could hire that would qualify for this credit. Prepare a memo for the plant manager that identifies the qualifying targeted groups and explain the tax benefits associated with employing individuals in these targeted groups.

Under Sec. 51, the work opportunity tax credit provides an incentive for businesses to hire individuals who are members of a qualifying targeted group. The tax benefit comes in the form of a tax credit and is part of the general business credit. The maximum credit is 35% of the qualifying first-year wages. The credit is available for individuals who are hired that are qualifying members of one of eight targeted groups. The eight groups are:

- A qualified IV- recipient
- A qualified veteran
- A qualified ex-con
- A high-risk youth
- A vocational rehabilitation referral
- A qualified summer youth employee
- A qualified food stamp recipient, or,
- A qualified SSI recipient

Reg. Sec. 1.51-1(c)(1)-(3) provides guidance in determining who are eligible members of these targeted groups and how eligibility is established and maintained.

103. **RESEARCH PROBLEM** The United States and the country of Bersia are about to enter into a tax treaty. The U. S. is especially interested in establishing a treaty because many U. S. students attend medical school in Bersia and work while getting their medical degrees. In addition, many U. S. citizens are moving to Bersia to retire. Find the Model Income Tax Treaty. How many articles are included in the Model Treaty? Which article deals with the income tax treatment of students? List at least three other articles and the topics they cover.

Once the student has located the Model Income Tax Treaty, the student can scan the document to see that there are currently 29 articles dealing with a variety of topics such as residence, students, and capital gains and losses. Article 20 discusses "Students and Trainees" while Articles 6, 7, 12, 17, 23 explain the following topics, "Income from Real Property", "Business Profits", "Royalties", "Artists and Sportsmen", and "Relief from Double Taxation" respectively.

DISCUSSION CASES

104. Harry and Matilda are married and have the following tax return data for 2016:

Income:		
Salaries		\$ 120,000
Cash dividends		4,000
Tax-exempt bond interest		<u>8,000</u>
Total income		\$ 132,000
Exclusions:		
Tax-exempt bond interest		<u>(8,000)</u>
Gross income		\$ 124,000
Deductions for adjusted gross income:		
Loss on rental property	\$ 14,000	
NOL carryforward	<u>50,000</u>	<u>(64,000)</u>
Adjusted gross income		\$ 61,000
Deductions from adjusted gross income (after limitations):		
Medical expenses	\$ 3,000	
Taxes	14,500	
Home mortgage interest	15,300	
Home equity loan interest	9,000	
Charitable contributions	6,200	
Miscellaneous itemized deductions	<u>3,500</u>	<u>(51,400)</u>
Personal and dependency exemptions		<u>(16,200)</u>
Taxable income		\$ <u>(6,600)</u>

Do Harry and Matilda owe any income tax for 2016? Explain why they might owe tax in 2016 and discuss the items on their tax return that could cause them to pay income tax in 2016. Be sure to adequately explain each item. Calculations are not required.

Harry and Matilda may owe income tax for 2016 if they are subject to the Alternative Minimum Tax (AMT). The following discussion details the possible adjustments that have to be made in order to arrive at their Alternative Minimum Taxable Income (AMTI).

POSSIBLE ADJUSTMENTS FOR AMTI:

Interest paid on debt by state and local governments is excluded from gross income. Congress has disallowed the exclusion of interest on private activity bonds for AMT purposes. A private activity bond is one in which the proceeds are used by anyone other than a governmental unit (i.e., industrial development bonds, mortgage subsidy bonds, and student loan bonds). Therefore, Harry and Matilda may have to include some or all of the \$8,000 in tax-exempt interest for AMTI purposes.

A possible depreciation adjustment may be needed for AMT purposes for depreciation on the rental property. For property placed in service after December 31, 1986 (i.e., property subject to the MACRS depreciation system), the AMT requires depreciation to be computed using the alternative depreciation system (discussed in Chapter 10). For tangible personal property (Class lives of 3, 5, 7 and 10 years), the ADS system uses the 150% method that converts to the straight-line method. This results in longer depreciation lives than MACRS. The use of ADS in calculating depreciation causes AMT depreciation to initially be lower, resulting in a positive adjustment. However, in later years, the ADS

depreciation will exceed the MACRS depreciation, and the effect of the adjustment will reverse itself in the AMTI calculation. If the rental property was purchased before 1986, the excess depreciation (over straight-line) is a tax preference item that is always added for AMT purposes.

The primary AMT adjustments that are required of individual taxpayers are for deductions from adjusted gross income that are either modified or not allowed for AMT purposes. The only itemized deductions allowed from AGI for AMT purposes are

1. Medical expenses in excess of 10% of adjusted gross income
2. Charitable contributions
3. Casualty and theft losses
4. Qualified housing interest
5. Investment interest
6. Miscellaneous itemized deductions not subject to the 2 percent of AGI reduction (gambling losses, premature cessation of annuities)

Harry and Matilda's taxes of \$14,500 are not deductible for AMTI.

Home equity loan interest is deductible only if the proceeds of the loan are used to improve the residence. If Harry and Matilda's home equity loan is not used to improve the residence, no deduction may be taken in calculating AMTI.

Harry and Matilda's miscellaneous itemized deductions might not be deducted for AMTI if the deductions are subject to the 2% limitation.

Personal and dependency exemption amounts are not deducted in arriving at AMTI. Therefore, the \$16,200 of personal and dependency exemptions are not deducted.

The NOL carryforward of \$50,000, for AMT purposes, is 90% of AMTI (after all other adjustments and preferences).

105. Alex and Jeff have differing views on the current tax system. Alex believes that any tax system that has two tax structures, a regular tax and an alternative minimum tax, is inefficient and inequitable. In fact, the system violates all canons of taxation espoused by Adam Smith. Jeff, however, feels that Congress should use the tax code as a vehicle for encouraging taxpayers to engage in various social and economic transactions. Therefore, he argues that the alternative minimum tax is necessary to ensure that each taxpayer pays some amount of tax. With whom do you agree? Why?

From Alex's perspective, the alternative minimum tax (AMT) violates Adam Smith's four cannons of taxation. Recall from Chapter 1 that the four cannons are equality, certainty, convenience, and economy. From an equity point of view, in having an alternative minimum tax, Congress is admitting that the regular tax system might not be either vertically or horizontally equal. In essence, the goal of the alternative minimum tax is to ensure that all taxpayers pay a minimum amount of taxes. Therefore, if high income taxpayers are only paying a minimum amount of taxes (at a maximum rate of 25%), then vertical equity doesn't exist. Likewise, from a horizontal equity point of view, by creating tax preferences, the code allows similarly situated taxpayers who invest an equal amount of money in different investments to be taxed differently, (some taxed at 28% by the AMT, others at 28%, 33%, 35% or 39.6% by the regular tax).

The alternative minimum tax also fails the criteria of certainty. If the regular tax system fails to meet this test, due to the constant changes in the tax law, it should not be surprising that adding a parallel tax system to the equation will only result in a taxpayer being less certain of the tax consequences of a transaction.

At first thought, the ATM tax system would seem to meet the test of convenience. However, embodied in the concept of convenience is that the U.S. tax system is based on voluntary compliance. The more complex and convoluted the tax system becomes, the greater the likelihood that individuals will not honestly comply.

Finally, from the perspective of economy, a system that includes the AMT cannot be economical from either the taxpayer's or the government's perspective. The AMT requires taxpayers to maintain two sets of tax records or for taxpayers who are not tax inclined, to incur an additional cost for an expert to prepare their return. The government's compliance costs would also increase because the government must ensure that taxpayers are complying with both tax systems.

From Jeff's perspective, the AMT tax system is the most efficient and effective means for Congress to encourage taxpayers to engage in socially or economically desirable transactions while ensuring that all taxpayer's pay a minimum amount of tax. To achieve similar results without using the alternative minimum tax would require Congress to make each section of the tax code in which they want to provide preferential treatment unduly complex. Therefore, instead of a few taxpayers being subject to a second tax system (i.e., the AMT) a greater number of taxpayers would be subject to complex provisions. To ensure that all taxpayers are not subject to the alternative minimum tax, an individual's tentative alternative minimum taxable income must exceed an exemption level.

For Congress to achieve a result similar to the exemption amount without a separate tax system, would require a threshold limit based on the taxpayer's adjusted gross income (or some other criteria) for each provision that Congress determined it did not want to provide tax relief. For example, state taxes are deductible for regular tax purposes, but are not deductible for AMT purposes. Therefore, without an alternative minimum tax system, a threshold limit would be needed for state taxes.

Finally, Jeff might argue that because the tax law is a result of the political process, the two parallel tax systems ensure what the regular tax system by itself does not - that all taxpayers pay a minimum amount of taxes.

106. Lynn and Alicia are equal partners in a local bookstore. They have operated the bookstore for two years but have reported only a small profit. This year they anticipate that the bookstore will generate a large enough profit so that each will be able to contribute to a pension plan. They sought the advice of two local accountants on the type of pension plan they should adopt but received conflicting advice. They have come to your firm to help resolve the conflict. Explain the type of pension plans available to Lynn and Alicia and advise them on which type of plan they should adopt.

A partnership cannot establish for its partner the same type of qualified pension plans that is available to a corporation. Instead, the partnership or the individual partner must establish either a Keogh or simplified employee pension plan (SEP). The major advantage of a SEP is that it is administratively more convenient and economical than a Keogh plan. However, unlike a Keogh, only one type of SEP can be established. As an owner-partner, if Lynn or Alicia decides to establish a SEP, the maximum contribution they can contribute is limited to the lesser of 20% of their net self-employment income or \$53,000. The maximum compensation limit is \$265,000. These limits are the same if they decide to establish a Keogh profit sharing plan or a money purchase plan.

There are two disadvantages associated with establishing a Keogh money purchase plan. First, by establishing a Keogh money purchase plan, Lynn and Alicia are required to contribute a fixed amount to the plan every year. This is not a requirement for either a SEP or a Keogh profit sharing plan. Second, having to make a contribution to a pension plan every year can be a strain on the cash-flow of a new and growing business.

Another option they have is to establish a defined benefits plan. The benefits paid to an employee or a partner from a defined benefits plan cannot exceed the lesser of \$210,000 or 100% of the employee's highest 3 consecutive years' compensation. A defined benefit plan is a backward-looking pension plan that focuses on historical information, that is, years of service and highest salary. It is important to remember that with a defined benefits plan no direct relationship exists between the amount contributed on behalf of the employee and the benefits paid to the employee. Overall, the most prudent course of action for a growing business is to establish a simplified employee pension plan.

TAX PLANNING CASES

107. William, Daniel, and Thomas are brothers who have decided to form an engineering firm. Although Thomas has an MBA degree and will function primarily as the firm's financial expert, he has no formal tax knowledge. William and Daniel are bringing clients from their former firm, but Thomas anticipates that the new firm's client base will not be large enough to avoid a tax loss for three years. After year 3, the firm's profits should increase rapidly. By year 6, he anticipates, that the firm will generate a substantial profit and employ 25 people. Because Thomas is unsure whether the firm should operate as an S corporation, partnership, or corporation he has hired your accounting firm to guide him. Thomas is particularly concerned with how the form of organization would affect the:

- Pension plan the firm will adopt
- Firm's ability to compensate current owners and employees and attract new owners or employees
- Total tax liability of the owners
- Firm's ability to distribute cash and/or property

Write a letter to Thomas explaining how the organizational form of the business affects each of the items he has mentioned.

The entity established cannot be a sole proprietorship because there is more than one individual involved. The brothers can choose to establish a partnership, corporation or an S corporation. Each of the types of entities is discussed in turn.

Partnership

If they choose to establish a partnership they will be considered self-employed and can only establish either a Keogh or simplified employee pension plan (SEP). The major advantage of a SEP is that it is administratively more convenient and economical than a Keogh plan. However, unlike a Keogh, only one type of SEP can be established. As an owner-partner, if they decide to establish a SEP, the maximum contribution they can contribute is limited to the lesser of 20% of their net self-employment income or \$53,000. The maximum compensation limit is \$265,000. These limits are the same if they decide to establish a Keogh profit sharing plan or a money purchase plan.

Finally they could choose to establish a defined benefits plan. The benefits paid to an employee or a partner from a defined benefits plan cannot exceed the lesser of \$210,000 or 100% of the employee's highest 3 consecutive years' compensation. A defined benefit plan is a backward-looking pension plan that focuses on historical information, that is, years of service and highest salary. It is important to remember that with a defined benefits plan no direct relationship exists between the amount contributed on behalf of the employee and the benefits paid to the employee.

The partnership form will probably detract from the entity's ability to attract new owner-employees. Because owner-employees will want an ownership interest in the entity, attracting these individuals on a constant basis will require the entity to constantly revise the partnership agreement. In addition, a partner's share of the profits is generally based on their partnership interest in the business. Therefore, it is critical that the partner's ownership interest properly reflects his or her contribution to the entity. Although the use of guaranteed payments might mitigate the effect of this problem, it makes compensating each partner a difficult task.

A partnership is not a separate taxable entity but rather a conduit. Therefore, absent guaranteed payments each partner is taxed on his or her pro rata share of the partnership income. In addition, the income that flows through to the partner is subject to self-employment tax. Each partner must pay self-employment tax on the first \$118,500 of their net self-employment income at a rate of 15.3%. The amount in excess of \$118,500 is taxed at 2.9%. The partner is allowed a deduction for AGI for one-half of the amount of self-employment tax paid. Therefore, the partner must pay both income tax and self-employment tax on all the income earned during the year.

Unlike pension plans, which require that a partner own 10 percent interest in the partnership to be considered an owner-partner, all partners are treated as owner-partners for fringe benefit purposes. The partnership is allowed to deduct the cost of certain fringe benefits as a guaranteed payment and the partners are required to include the guaranteed payment as income on their tax return. Only employer-provided group term life insurance coverage, employer-sponsored accident and health-care plans, cafeteria plans, and meals and lodging furnished for the convenience of the employer are subject to this treatment. Because the tax law mentions only these fringe benefits, all other fringe benefits appear to be deductible by the partnership as an ordinary business expense and are not income to the partner. As a self-employed taxpayer, a partner can deduct the cost of health-care premiums as a deduction for adjusted gross income.

If a partner receives a non-liquidating distribution of cash and property, the partner's basis in the partnership is first reduced by the cash distributed and then, by the adjusted basis of the property distributed. However, the partner's basis cannot be reduced below zero. If the basis of the property distributed is greater than the partners' basis in the partnership, the partner must reduce their basis in the distributed property by the excess.

A distribution of cash and/or property in complete liquidation of the partnership can result in the partners recognizing a gain or loss. A gain is recognized only to the extent that the amount of cash distributed exceeds the partner's basis in the partnership. A loss can be recognized on the complete liquidation of a partner's interest but only if cash is the only asset distributed.

Corporation

A corporation is not restricted in the type of qualified pension plan it establishes. Because the rules and requirements applicable to employees of defined contribution money purchase plan, profit sharing plan, and a defined benefit plan are the same as discussed above for a Keogh and SEP the discussion is not repeated here.

A major advantage of forming a corporation is the ease in which it can attract and retain new employees. The salary paid to an individual is deductible as long as it is reasonable. In addition, the employee is only required to pay 7.65% in Social Security taxes on the first \$118,500 of their salary and 1.45% on any salary in excess of that amount. The corporation is required to match the amount of Social Security paid by the employee. The corporation is allowed to deduct this amount, while the employee cannot deduct the amount he/she contributes to Social Security. Unlike a partnership, fringe benefits paid to an employee are deductible and are not treated as income to the employee.

For an employee-shareholder of a corporation, the major disadvantage associated with this form of organization is that the income earned by the corporation (and later paid to the shareholder as a dividend) is subject to double taxation.

Cash or other property distributed to a shareholder is generally taxable to the shareholder based on the all-inclusive income concept. The distribution (fair market value for property) is classified as a dividend coming from the corporation's earnings and profits. Earnings and profits (E&P) generally represent undistributed, previously taxed corporate profits. If a corporate distribution exceeds both the current and accumulated E&P, the capital recovery concept dictates that the distribution is tax-free to shareholders. Therefore, the basis in the stock held by shareholders is reduced by the amount of the tax-free return of capital. If a shareholder receives a distribution in excess of the basis of the stock (recovery in excess of capital), the shareholder recognizes a capital gain.

A corporation making a non-liquidating distribution of property will recognize gain to the extent the fair market value of the property distributed exceeds its basis. However, if the fair market value of the property distributed is less than the property's basis, the corporation cannot recognize a loss.

The tax law treats a shareholder that receives a distribution of cash or property in complete liquidation as having sold their stock to the corporation for the amount of cash distributed. Therefore, to the extent that the distribution is greater than the shareholder's basis in the stock, the stockholder recognizes gain. Conversely, if the shareholder's basis is less than the amount received, the shareholder recognizes a loss. The corporation does not recognize income on the distribution of cash in a complete liquidation. Unlike with a non-liquidating distribution of property, the corporation is allowed to recognize loss if the fair market value of the property is less than its basis.

S Corporation

Like a corporation, an S corporation is not restricted in the type of qualified pension plan it establishes. Because the rules and requirements are the same as discussed previously, the discussion is not repeated here.

The ability to attract owner-employees is somewhat limited with an S corporation because the number of shareholders is limited to 75. In addition, similar to a partnership, fringe benefits paid to an individual who owns more than 2% of the S corporation is treated as compensation to the individual.

A major advantage of an S corporation is that because it is a conduit entity, it can employ shareholders and deduct the salary or wages paid to them in determining the corporation's ordinary income. Unlike a partnership, the income that flows through to the owner of an S corporation is not subject to Self-employment tax. Only the wages received by an owner-employee of an S corporation are subject to Social Security tax. As with a corporation, an S corporation is required to match the amount contributed by the employee and receives a deduction for the amount paid.

Non-liquidating cash distributions from an S corporation to its shareholders are generally tax-free and reduce the shareholders' basis in the corporate stock. If the distributions exceed a shareholder's basis, the excess amount is treated as a capital gain. The cash distribution has no tax consequences to the S corporation. A non-liquidating distribution of property to shareholders of an S corporation is treated the same as a cash dividend. The S corporation will recognize a gain only if the fair market value of the property distributed exceeds its basis. An S corporation cannot recognize a loss on the distribution of property.

A shareholder who receives a cash or property distribution in complete liquidation of their interest in an S corporation will recognize a gain or loss depending on whether the distribution is more or less than their basis in the stock. The tax treatment for the S corporation is identical to that for a corporation.

108. Fred, age 50, plans to retire when he reaches age 65. He is considering investing in either an IRA or a Roth IRA. He plans to contribute \$6,500 per year until he retires. He expects his marginal tax rate to be 28% until he retires, when he expects the marginal rate to drop to 15%. He anticipates that the rate of return on either IRA to be 8% before considering any tax effects. Prepare a memo analyzing the tax effects of investing in a regular IRA versus a Roth IRA. Discuss factors that might have an influence on Fred's decision to choose either an IRA or a Roth IRA. Assume that Fred meets the income limits for making the maximum contribution per year.

If Fred contributes \$6,500 per year to an Individual Retirement Account (IRA) for 15 years, the account will grow to \$176,489 ($\$6,500 \times 27.15211$; see Table 15-1 in the text). In addition, if each year Fred reinvests the annual tax savings of \$1,820 ($\$6,500 \times 28\%$) in a tax-free investment (i.e., municipal bonds), this amount will accumulate to \$49,417 ($\$1,820 \times 27.15211$) for a combined pre-tax accumulation of \$225,906 ($\$176,489 + \$49,417$).

If Fred contributes 6,500 to a Roth IRA, the accumulation at retirement will be \$176,489 ($\$6,500 \times 27.15211$). However, the IRA is subject to tax at withdrawal whereas the Roth IRA is not. For Fred to remain in the 15% marginal tax rate bracket, he will have to make sure that the distribution does not push him into the next marginal tax bracket. Assuming that Fred remains in the 15% marginal tax bracket and receives the proceeds over a ten-year period, Fred receives \$22,591 ($\$225,906 \div 10$ years) each year. His tax liability on the distribution is \$3,389 ($\$22,591 \times 15\%$) and his after-tax proceeds are \$19,202 ($\$22,591 - \$3,389$). Fred's annual distribution from the Roth IRA is \$17,649 ($\$176,489 \div 10$ years). Because the Roth IRA distribution is not subject to tax, the after-tax distribution is \$17,649. The investment in the IRA provides \$1,553 ($\$19,202 - \$17,649$) more per year than the Roth IRA.

Whether the IRA or the Roth IRA is a better investment depends on how much is withdrawn each year, the rate of return earned each year, and the taxpayer's marginal tax bracket at retirement. In addition, Fred needs to consider that Roth IRAs do not require mandatory distributions after reaching 70 $\frac{1}{2}$ as with an IRA and that Roth IRAs, unlike conventional IRAs, allow a taxpayer to make contributions after reaching 70 $\frac{1}{2}$.

ETHICS DISCUSSION CASE

109. Nina is the auditor for Geiger Construction, a local builder. Geiger recently renovated a historic building in downtown Kingston. The building, which consists of 5 shops, is owned by the Restoring Historic Kingston Partnership (RHKP). Nina is also the tax accountant for Merlin, a limited partner in RHKP. In preparing Merlin's 2016 tax return the K-1 of RHKP (which Nina did not prepare) shows that Merlin is entitled to both an older buildings credit and an historic structures credit. Nina properly deducts both credits. Later that year, Nina is conducting the audit of Geiger Construction, and she compliments the owner on the wonderful job the company did in restoring the building while meeting the requirements necessary for the building to qualify for the historic rehabilitation credits. Marshall, the owner of Geiger Construction, informs Nina that because of an unforeseen structural problem, the company was not able to meet the historic rehabilitation requirements. The company could preserve only 50%, not the required 75%, of the external walls. What is Nina's obligation (refer to Statement on Standards for Tax Services which can be found at www.cengagebrain.com), if any, with respect to Merlin's filed tax return? Does she have any obligation to Merlin's other partners? to the preparer of the partnership return?

Because Nina has become aware of an error on one of her client's tax returns, under Statement on Standards for Tax Services (SSTS) No. 6 she should inform her client of the error on his tax return. It is not her responsibility to file an amended tax return, but Merlin who is responsible for filing an amended return. In all likelihood, Merlin will ask Nina to prepare the return. If Nina is asked to file Merlin's 2016 tax return and she has not prepared Merlin's 2015 amended return, she must determine whether Merlin has filed the amended return. If he has not, paragraph .06 of SSTS # 6 requires that Nina consider withdrawing from the professional relationship. If she does decide to terminate her relationship with Merlin, she should probably consult her lawyer to make sure that she is not in violation of Rule 301 (relating to the CPA's confidential client relationship) or state laws concerning privileged communication.

Based on the standards, Nina's only responsibility is to her client Merlin. Her responsibilities under the standards do not extend to Merlin's other limited partners or even to the preparer of the partnership return. Although she is not required to notify the preparer, as a courtesy Nina probably should inform the preparer that she has become aware of information that affects the tax liability of the limited partners in the Restoring Historic Kingston Partnership (RHKP). It is possible that the individual who prepared the return is unaware of the information. If Nina does notify the individual who prepared the RHKP partnership return, it is their responsibility to inform all the limited partners. The notification would probably be done through a cover letter with a revised K-1 that did not include the rehabilitation tax credit.

Chapter 15

Check Figures

- | | |
|---|--|
| 48. a. \$190,316 (S) | b. \$99,613 |
| 49. a. \$20,000 | b. \$210,000 |
| 50. a. \$23,750 | b. \$53,000 |
| 51. a. \$24,935 | b. \$53,000 |
| 52. a. \$11,000 | b. \$11,000 |
| c. \$5,500 | d. \$11,000 contribution
\$ 0 deduction |
| 53. a. \$11,000 | b. \$9,075 |
| c. \$5,500 | |
| 54. a. \$3,300 | b. \$0 |
| c. \$5,500 | |
| 55. a. \$12,500 Lei; \$1,240 Clark | b. \$12,500 Lei; \$5,300 Clark |
| c. \$12,500 Lei; \$7,950 Clark | d. \$12,500 Lei; \$5,300 Clark |
| e. \$12,500 Lei; \$7,950 Clark | |
| 56. a. \$8,113 is RMD | |
| 57. a. \$12,075 is RMD | b. \$11,286 is RMD |
| 58. \$950 penalty | |
| 59. \$3,667 | |
| 60. \$120 penalty | |
| 61. a. \$3,360 income; \$336 penalty | b. a. \$3,360 income; No penalty |
| 62. \$8,000 penalty | |
| 63. a. \$13,000 | b. \$2,600 each |
| c. If held for 5 years then tax-free | d. Angel's withdrawal subject to penalty |
| e. N/A | |
| 64. a. \$1,500 income and deduction | b. \$4,000 income and deduction |
| c. \$6,000 income and deduction | d. \$4,000 income and deduction |
| 65. a. \$9,500 STCG | b. \$7,000 STCG |
| c. \$5,000 STCG | d. \$7,000 STCG |
| 66. Option date: \$0 income and deduction; Exercise date \$2,800 income and deduction | |
| 67. Without election: \$7,700 income and deduction; With election: \$2,800 income and deduction | |
| 68. Without election: \$9,100 STCG; With election: \$14,000 | |

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