**APPENDIX E**

**PRACTICE SET ASSIGNMENTS—COMPREHENSIVE TAX RETURN PROBLEMS**

**SOLUTIONS TO PROBLEM MATERIALS**

**PROBLEM 1 SOLUTIONS**

1. John is self-employed and all of the business expenses listed should be reported on Schedule C. Use Part I of Form 4562 to apply § 179 expensing for the waiting room furniture ($3,600), copier ($300), laptop computer ($2,100), and camera ($1,200).

2. Depreciation on the Camry under the MACRS method (use Part V of Form 4562) is computed as:

Cost $31,000

First year percentage for 5-year property (Exhibit 8.4, Ch. 8)      20%

First year depreciation deduction $  6,200

Business use      92%

Depreciation related to business use $  5,704

However, as the first year recovery limitation is $3,160, the depreciation claimed cannot exceed $2,907 ($3,160 × 92%).

John’s deductible vehicle expenses other than depreciation are $6,715 [92% × $6,745, which is the sum of ($3,500 gas + $1,700 insurance + $820 interest + $325 auto club dues + $210 oil changes + $190 license/registration)] + business tolls of $510.

The combined deduction for actual vehicle expenses of $9,622 [$2,907 depreciation + $6,715 other] exceeds the $9,301 deductible expenses under the mileage method [$8,037 mileage (14,532 business miles × $0.56 mileage rate) + $510 of tolls + deductible interest on the car loan of $754 (92% × $820)]. Since the actual expense method yields a higher deduction than does the mileage method, John’s choice to use the actual expense method is logical. [Note: *H&R Block Software* compares the actual cost method to the mileage method over the expected period of use. If the expected period of use is 6 years (the number of MACRS recovery periods for depreciating an auto), the program estimates that the mileage method will result in a slightly greater deductions over that time frame. Students will need to choose the ‘actual expenses’ in *H&R Block Software* to honor John’s wishes.]

Finally, regardless of the method for recovering vehicle costs, no deduction is allowed for the $350 in fines associated with John’s traffic violations.

3. John’s travel expenses for lodging are fully deductible. However, his travel meals as well as his in-town business dinners are subject the limitation for business meals and entertainment. Thus, deductible business meals total $875 [($1,140 + 610) × 50%].

John’s contribution to his retirement plan and the medical insurance premiums are deductions *for* AGI, reported on lines 28 and 29 of page 1 of Form 1040, respectively. The medical insurance is “qualifying medical insurance” so that the Millers are not subject to a ‘shared responsibility payment’ under the Affordable Care Act. Unfortunately, the premiums on disability insurance are not deductible.

The receptionist is not technically John’s employee (she is paid by the landlord), but she serves in that capacity. Consequently, the $28 gift is a deductible business expense. [Nominal charges for gift wrapping are disregarded when imposing the $25 limitation on business gifts.]

4. Anne’s contribution to her traditional IRS is a deduction *for* AGI on line 32 of page 1 of Form 1040.

Anne’s other expenses are miscellaneous itemized deductions subject to the 2%-of-AGI floor. In terms of deducting the use of the Chevrolet Malibu in employment-related activities, the automatic (standard) mileage method is permissible. Although the actual cost method is used for the Camry (see item 2), different cars are involved. Under the mileage method, the deduction is $521 [930 business miles × $0.56 mileage rate].

The car expense is combined with Anne’s other employment related expenses. As miscellaneous itemized deductions, the deductible is the excess over 2% of the taxpayers’ AGI as follows:

Job hunting expense $  720

Continuing education 350

Professional dues 120

Professional subscription 90

Mileage     521

Total employment-related expenses $1,801

Less 2% of AGI (1,387)

Amount deductible on Schedule A $  414

5. Gary Simon can be claimed as a dependent by the Millers for 2014. It does not matter how long he lived during the year as long as he qualified as a dependent during the time he was alive. All of Gary’s medical expenses (i.e., $11,800) can be claimed by the Millers for 2014, as it is the year of payment that controls deductibility. Gary’s Medicare insurance is “qualifying medical insurance” so that the Millers are not subject to a ‘shared responsibility payment’ for Gary under the Affordable Care Act. Unfortunately, funeral expenses are not deductible for Federal income tax purposes.

6. Under § 1014, Anne receives Gary’s property with a new income tax basis equal to its fair market value at death. For the house and land, this results in a step-up in basis to $220,000 and $50,000, respectively. For the furniture and appliances, however, a step-down ($14,000) occurs. In computing depreciation, the new basis under § 1014 controls.

Use Exhibit 8.4 in the text for depreciating the personalty (furniture and appliances) and Exhibit 8.9, Column 3, for residential realty (rental home). [For depreciation purposes, the property is deemed placed in service as of March 1—when it was first advertised and available for rent.] Using Form 4562, the depreciation totals $9,133 for 2014, comprised of $2,800 (20% × $14,000) for the furniture and $6,333 (2.879% × $220,000) for the building. Land is never depreciable.

Repairs of $720 and newspaper advertising of $360 are deductible in computing net rental income on Schedule E (see item 7).

7. Net rental income is reported on Schedule E. The 2014 rent receipts are summarized below.

First and last month’s rent (2 × $2,400) $  4,800

May through November (7 × $2,400)   16,800

$21,600

[Note: If you are using *H&R Block Software*, input 365 in the “days owned” box and in the “days rented” box. Otherwise, the program will apportion the expenses inappropriately.]

The rent for December is not taxed until 2015 since it was not received until then.

The damage deposit is not taxed and becomes income only if and when it is forfeited (i.e., applied towards damages caused by the tenant).

All expenses except the paving assessment are deductible and should be reported on Schedule E. The paving assessment should be added to the cost basis of the land.

8. John has a $10,000 loss from his investment in Pioneer Aviation (worthless securities). Although it appears that the loss occurs within 12 months (i.e., early December of 2013 to September 2014), under § 165(g)(1) the loss is treated as occurring on the last day of the year of worthlessness. Thus, John has a $10,000 long-term capital loss which he reports on Form 8949 as well as Schedule D of Form 1040.

9. When a taxpayer owns different blocks of the same stock, sells some of that stock, and does not specifically identify the block of stock that is sold, a FIFO approach is applied. The broker was correct in quantifying the basis of the shares sold. Therefore, the Millers sold the shares purchased in November 2013 for a short-term capital gain of $5,000 [$17,500 (selling price) – $12,500 (basis)]. The 700 shares they still own were acquired in April 2014.

10. Anne’s basis in the coin collection is controlled by the gift rules of § 1015. Therefore, her basis for gain is her mother’s basis of $9,000. In this case, her basis for loss is also $9,000 [FMV on the date of the gift ($18,000) is not lower than basis ($9,000)]. The measure of a theft loss cannot exceed the lesser of basis ($9,000) or FMV on date of the theft ($24,000)—see Concept Summary 7.3 on p. 7-15 in the text. If Anne’s loss is $9,000 and the insurance recovery is $10,000, no loss results. Instead, Anne has a $1,000 long-term capital gain from a collectible. The gain from this theft is computed on Form 4684 and reported on line 11 of Schedule D. [Note: *H&R Block Software* requires a manual entry to carry the gain computed on Form 4684 to line 11 of Schedule D.]

See Chapters 3 and 16 for a discussion of the netting process involving capital gains and losses. Since the taxpayers’ long-term capital losses exceed their short-term capital gains, the Millers are permitted to deduct ($3,000) of the net loss against their other income. The remaining ($300) will be a long-term capital loss carryforward to their 2015 tax year.

11. Under the application of § 1014, Anne’s basis in the lot on Mississippi Road is $19,000—FMV on the date of Violet’s death. On the later sale of the property, Anne received $19,700 of consideration since the buyer relieved her of the $700 in liabilities by paying the unpaid taxes (back taxes in arrears) on the property. Therefore, Anne has a long-term capital gain of $700. Further, because Anne did not pay the property taxes associated with this land, she cannot deduct them.

12. The presumption is that these “gifts” are compensation for services rendered (i.e., referrals) or to be rendered in the future. It does not matter that there was no obligation or prior agreement to make the payments [see the discussion of the *Duberstein* case on p. 5-3 of the text.] John must include $7,200 as Other Income in his Schedule C for the year. The $900 received on January 4, however, is taxed in 2015—the year of receipt.

13. John’s $82,000 received for services performed as an insurance claims adjuster is included in Schedule C.

Under the tax benefit rule, the state tax refund is income, reported on line 10, page 1 of Form 1040. Refunds of federal income tax are never taxable income.

The interest on Minnesota bonds is nontaxable. Nevertheless, it must still be reported on line 8b, page 1, of Form 1040 and it should also be reported on Schedule B.

The qualified dividends are subject to the same tax rate as LTCGs.

The cash gifts from John’s parents are nontaxable.

The gambling transactions cannot be netted. The winnings are reported on line 21 of Form 1040 as other income. The losses are reported on Schedule A as Other Miscellaneous Deductions, but the deduction is limited to John’s gambling winnings of $1,000.

14. The garage sale netted a realized loss of $16,300 [$9,200 proceeds – $25,500 cumulative bases]. This realized loss is personal and therefore not tax deductible. The $9,200 proceeds are essentially a nontaxable return of capital.

15. The medical expenses eligible for deduction total $14,363 [$1,300 medical expenses + $1,200 dental expenses + $11,800 of Gene’s medical expenses + $63 for medical mileage (270 medical miles × $0.235 mileage rate)]. The deduction is the excess of such expenses over 10% of AGI.

The charitable deduction is based on the amount paid and not on the pledge year involved. Thus, the full $3,600 is deductible in 2014. Plus, the Millers can deduct $45 (320 miles × $0.14) for the use of the Malibu for charitable purposes.

16. The Millers should claim personal exemptions for themselves and dependency exemptions for Gary, Trace, and Trevor. Since Trace saves his earnings for future college expenses and is not providing any of his support, he meets the definition of a qualifying child. The income he earned does not matter since there is no gross income test for a dependent who meets the definition of a qualifying child. Also, the Millers can claim the child tax credit for Trevor since he is less than 17 years old.

17. Anne’s wages are reported as such on Form 1040 line 7. Her federal income tax withholding is reported on Form 1040 line 64, and the sum of the couple’s quarterly estimated taxes is reported on Form 1040 line 65. Anne’s state income tax withheld is combined with the other state taxes paid by the Millers and entered on Schedule A line 5 (the Income Taxes box should also be checked].

18. A brief summary of the Millers’ tax return for 2014 appears below.

Gross income—

Salary $32,000

Schedule B 3,200

Taxable state tax refund 90

Schedule C 51,685

Schedule D (3,000)

Schedule E 6,127

Other (Gambling) 1,000

Total Income $91,102

Deductions *for* AGI—

Deductible self-employment tax (3,652)

Deduction for contribution to retirement plan (8,000)

Deduction for health insurance (4,600)

IRA Deduction    (5,500)

AGI $69,350

Schedule A—Itemized deductions (deductions *from* AGI) (23,943)

Personal and dependency exemptions (19,750)

Taxable income $25,657

Computing tax using the *Schedule D Tax Worksheet* yields an income tax liability of $2,764. The child tax credit of $1,000 reduces this to $1,764. To this is added the self-employment tax of $7,303 (see Schedule SE) for a total amount due of $9,067. Since the Millers paid in a total of $9,320, the resultant overpayment of $253 will be refunded to them.

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