# *Prentice Halls Federal Taxation 2016 Comprehensive 29th edition Pope Solutions Manual*

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# Chapter I:2

# Determination of Tax

## Discussion Questions

**I:2-1** a. Gross income is income from taxable sources. Form 1040 combines the results of computations made on several separate schedules. For example, income from a proprietorship is reported on Schedule C where gross income from the business is reduced by related expenses. Only the net income or loss computed on Schedule C is carried to Form 1040. This is procedurally convenient but means gross income is not shown on Form 1040.

b. Gross income is relevant to certain tax determinations. For example, whether a person is required to file a tax return is based on the amount of the individual's gross income. As the amount does not necessarily appear on any tax return, it may be necessary to separately make the computation in order to determine whether a dependency exemption is available.

pp. I:2-3 through I:2-5.

**I:2-2** The term "income" includes all income from whatever source derived based either on principles of economics or accounting. Gross income refers only to income from taxable sources. p. I:2-3.

**I:2-3** a. A deduction is an amount that is subtracted from income, while a credit is an amount that is subtracted from the tax itself.

b. In general, a $10 credit is worth more than a $10 deduction because the credit results in a direct dollar for dollar tax savings. The savings from a deduction depends on the tax bracket that applies to the taxpayer.

c. If a refundable credit exceeds the taxpayer's tax liability, the taxpayer will receive a refund equal to the excess. In the case of nonrefundable credits the taxpayer will not receive a refund, but may be entitled to a carryover or carryback. pp. I:2-4 through I:2-6.

**I:2-4** All dependents (1) must have social security numbers reported on the taxpayer's return, (2) must meet a citizenship test, (3) cannot normally file a joint return, and (4) cannot claim others as dependents. Qualifying children must (1) be the taxpayer's child or sibling, (2) be under 19, a full-time student under 24, or disabled, (3) live with the taxpayer, and (4) not be self-supporting. Other dependents must (1) be related to the taxpayer (or reside in the taxpayer's home for the entire year), (2) have gross income less than the amount of the personal exemption, and (3) receive over one-half of their support from the taxpayer. pp. I:2-12 through I:2-17.

**I:2-5** a. Support includes amounts spent for food, clothing, shelter, medical and dental care, education, and the like. Support does not include the value of services rendered by the taxpayer for the dependent nor does it include a scholarship received by a son or daughter of the taxpayer.

b. Yes. When several individuals contribute to the support of another, it is possible for members of the group to sign a multiple support agreement that enables one member of the group to claim the dependency exemption. Also, in the case of divorced couples, the parent with custody for

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over half of the year receives the dependency exemption even if that parent did not provide more than 50% of the child's support. Similarly, in the case of written agreement, the dependency exemption can be given to the noncustodial parent even if that parent provided 50% or less of the child's support.

c. The value of an automobile given to an individual may represent support for that individual. The automobile must be given to the individual and must be used exclusively by the individual. pp. I:2-15 through I:2-18.

**I:2-6** A taxpayer will use a rate schedule instead of a tax table if taxable income exceeds the maximum in the tax table (currently $100,000) or if the taxpayer is using a special tax computation method such as short-year computation. p. I:2-20.

**I:2-7** a. In general, it is the taxpayer's gross income that determines whether the individual must file a return. The specific dollar amounts are listed in the text. Certain individuals must file even if they have less than the specified gross income amounts. These include taxpayers who receive advance payments of the earned income credit and taxpayers with $400 or more of self-employment income. Dependent individuals must file if they have either (1) unearned income over $1,050 or (2) total gross income in excess of the standard deduction.

b. Taxpayers who owe no tax because of deductions or other reasons must still file a return if they have gross income in excess of the filing requirement amounts. p. I:2-35.

**I:2-8** Home mortgage interest and real property taxes are itemized deductions. As a result those expenses alone often exceed the standard deduction enabling a homeowner to itemize. Renters typically do not have these deductions and the standard deduction may be greater than itemized deductions. p. I:2-11.

**I:2-9** If the threshold were "50% or more" two individuals who provided equal amounts of support for another person could both claim a dependency exemption for that individual. By specifying "over 50%" only one individual can meet the requirement. A multiple support agreement could be used by two individuals who provide equal amounts of support to allow one of the two to claim a dependency exemption. p. I:2-15.

**I:2-10** The normal due date for individuals and partnerships is April 15. The normal due date for calendar year corporations is March 15. The normal due date is delayed to the next day that is not a Saturday, Sunday or holiday. p. I:2-35.

**I:2-11** Automatic extensions of six months are available to individuals and corporations. Partnerships are permitted automatic extensions of five months. Any tax that may be owed must be paid with the application for an extension. p. I:2-36.

**I:2-12** Yes. In general, the source of income is not important. It is the use that is important. An exception does exist for a child's scholarship. Parents do not have to consider a child's scholarship when determining whether they provide over half of the child's support. p. I:2-15.

**I:2-13** It can be, but as was noted in the preceding answer, parents may ignore a child's scholarship in deciding whether they provide over half of the child's support.

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**I:2-14** The purpose of the multiple support agreement is to allow one member of a group to claim a dependency exemption when the members together contribute more than 50% of the support of another person and each member of the group contributes over 10%. The multiple support agreement results in an exception to the requirement that the taxpayer alone must provide over one-half of the dependent's support. p. I:2-17.

**I:2-15** In general, the parent with custody for the greater part of the year receives the exemption. The noncustodial parent is entitled to the dependency exemption only if required documentation provides that the noncustodial parent is to receive the exemption. p. I:2-17.

**I:2-16** In general, a couple must be married on the last day of the tax year in order to file a joint return. In addition, the spouses must have the same tax year. Also, if one spouse is a nonresident alien then that spouse must agree to include his or her income on the return. p. I:2-21.

**I:2-17** The phrase "maintain a household" means to pay over one-half of the costs of the household. These costs include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance and food consumed on the premises. Such costs do not include clothing, education, medical treatment, vacations, life insurance and transportation. p. I:2-23.

**I:2-18** A married person, if otherwise qualified can claim head-of-household status if he or she is married to a nonresident alien or if he or she qualifies as an abandoned spouse. To be an abandoned spouse, the taxpayer must have lived apart from his or her spouse for the last six months of the year and maintain a household for a qualifying child in which they both live. pp. I:2-22 and I:2-23.

**I:2-19** a. A C Corporation is taxed on its income. In other words, it is taxed as a separate entity. An S Corporation is normally not taxed on its income. Instead, its income flows through and is reported by the shareholders. Each shareholder reports his or her share of the income even if it is not actually distributed.

b. Some corporations are ineligible for making an S corporation election. Others may choose the C corporation because of lower corporate tax rates on taxable income up to $75,000. Other considerations not discussed in Chapter 2 include fringe benefits, the need to retain earnings in the business and dividend policy. pp. I:2-27 and I:2-28.

**I:2-20** Up to $50,000 of income earned by a C corporation is taxed at 15%. If an individual with a significant amount of other income operates a new business as a proprietorship, that income is taxed at the owner’s marginal tax rate, which will be higher than 15%. Thus, the current tax can be reduced if the corporate form is used and income is retained in the corporation. This advantage is lost if the corporation distributes the income. New businesses often need to retain income for expansion. p. I:2-27.

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**I:2-21** a. The major categories of property excluded from capital asset status are:

- Inventory
- Trade receivables
- Certain properties created by the efforts of the taxpayer
- Depreciable business property and business land
- Certain government publications.

b. Yes. A net long-term capital gain is taxed at 15% (0% in the case of an individual taxpayer who is in the 10% or 15% tax bracket and 20% in the case of an individual in the 39.6% tax bracket). Short-term capital gains are taxed much like other income.

c. The availability of favorable tax rates for long-term gains is one implication of capital asset classification. Another is the limitation on the amount of capital loss that can be deducted from other income. At the present time only $3,000 of net capital loss can be deducted from other income by an individual taxpayer in any year. p. I:2-30.

d. Individual taxpayers first deduct (or offset) capital losses from capital gains. If a net capital loss results, only $3,000 of the net capital loss can be deducted from other income. Net capital losses in excess of $3,000 are carried over to future years. p. I:2-30.

**I:2-22** Yes. By waiting the taxpayer can convert the short-term gain to a long-term gain taxed at a maximum rate of 20%. The long-term rate will be available if the taxpayer holds the property over 12 months. The taxpayer should, however, take into consideration other nontax factors such as whether the value of the asset may decline during the extended holding period. p. I:2-30.

**I:2-23** a. Shifting income means moving it from one tax return to another. Splitting income means creating additional taxable entities (such as corporations) so as to spread income between more taxpayers.

b. Different taxpayers are in different tax brackets. As a result, taxes can be saved by shifting income from a taxpayer who is in a high tax bracket to a taxpayer who is in a lower tax bracket.

c. The tax on the unearned income of a minor (i.e., the kiddie tax) was created to reduce the opportunity to reduce taxes by shifting income from parents who are in high tax brackets to children who have little or no other income and would, therefore, normally be in a low tax bracket. pp. I:2-32 and I:2-33.

**I:2-24** a. Both the husband and wife are liable for additional taxes on a joint return. An exception exists for the so-called innocent spouse. To utilize the innocent spouse provision, the tax must be attributable to erroneous items of the other spouse. In addition, the innocent spouse cannot have known or had reason to know of the error, and must elect relief within two years after the IRS begins collection activities. Further, it must be inequitable to hold the innocent spouse liable for the understatement.

b. In the event of underpayment of taxes on a joint return the IRS can look to either spouse to collect the taxes. pp. I:2-33 and I:2-34.

**I:2-25** Couples may change from joint returns to separate returns only prior to the due date for the return. Couples may change from separate returns to a joint return within three years of the due date including extensions. pp. I:2-33 and I:2-34.

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## Issue Identification Questions

**I:2-26** The main issue is whether Yung can claim a dependency exemption for his nephew. The nephew must be a U.S. resident in order to qualify. Normally, this requires that a person have a visa as a permanent resident, but a dependency exemption has been permitted when special circumstances were present. For example, the Tax Court allowed an exemption when it considered the length of the dependent's stay, the individual's intent, and the presence of substantial assets in the U.S. [Carmen R. Escobar, 68 TC 304 (1977)]. The nephew's desire to stay and the desire of other members of the family to move here could all be factors that are considered in determining whether the nephew is a resident. p. I:2-13.

**I:2-27** The primary tax issue is whether they should file a joint return. Filing jointly could produce a tax savings because more income will be taxed at the low 10% and 15% rates. Carmen, however, should carefully consider whether Carlos is disclosing all of his income. If not, she may be liable for additional taxes, interest, and penalties resulting from the unreported income. The innocent spouse rules may not protect her. She is not required to know with certainty Carlos' income in order to be liable. The fact that Carmen is "surprised" that Carlos' income is so low suggests that she has reason to know that there is unreported income. p. I:2-33.

**I:2-28** The primary tax issue is the filing status for both Bill and Jane. Both can file as single taxpayers because they were divorced prior to the end of the tax year. To file as a head of household a taxpayer must pay more than one-half of the costs of maintaining a household (as one's home) in which a dependent relative lives for more than one-half of the year. In the case of divorce, the child need not be a dependent of the custodial spouse. The facts in this question are similar to W.E. Grace v. CIR, 25 AFTR 2d 70-328, 70-1 USTC ¶ 9149 (5th Cir., 1970) and Levon P. Biolchin v. CIR, 26 AFTR 2d 70-5727, 70-2 USTC ¶ 9674 (7th Cir., 1970) where the courts disregarded the fact that the taxpayer owned the house and denied head of household status. Jane should also fail to quality for head of household status because she did not pay more than one-half of the costs of maintaining the household. Secondary issues concern the treatment of child support payments and whether the furnishing of home expenses can be treated as alimony. pp. I:2-22 and I:2-23.

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## Problems

**I:2-29**

| | Lanes | Waynes |
|---|---|---|
| Salary | $32,000 | $115,000 |
| Interest | 1,000 | 10,000 |
| Gross Income | $33,000 | $125,000 |
| Minus: IRA Contribution | ( 5,000) | -0- |
| Adjusted gross income | $28,000 | $125,000 |
| Minus: Itemized deductions | (15,000) | ( 15,000) |
| Exemptions | ( 8,000) | ( 8,000) |
| Taxable Income | $ 5,000 | $102,000 |
| Gross tax (using Rate Schedule) | $ 500* | $ 17,088 |
| Minus: Withholding | ( 700) | ( 18,700) |
| Tax due (refund) | ($ 200) | ($ 1,612) |

* This answer is based on the 2015 rate schedule. The 2015 tax table was unavailable at the time this solution was prepared. The actual answer using the tax table would be very close to the above answer. pp. I:2-6 and I:2-7.

**I:2-30** a.

| | |
|---|---|
| Salary | $ 1,800 |
| Interest | 1,600 |
| Adjusted gross income | $ 3,400 |
| Minus: Standard deduction | ( 6,300) |
| Exemption | ( 4,000) |
| Taxable income | -0- |

b.

| | |
|---|---|
| Salary | $ 1,800 |
| Interest | 1,600 |
| Adjusted gross income | $ 3,400 |
| Minus: Standard deduction ($1,800 + $350) | ( 2,150) |
| Exemption | -0- |
| Taxable income | $ 1,250 |

pp. I:2-11 and I:2-12.

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**I:2-31** a.

| | |
|---|---|
| Adjusted gross income | $36,000 |
| Minus: Standard deduction | (12,600) |
| Exemptions | ( 8,000) |
| Taxable income | $15,400 |

b.

| | |
|---|---|
| Salary (Carl) | $14,000 |
| Minus: Itemized deductions | -0- |
| Exemption | ( 4,000) |
| Taxable income | $10,000 |

| | |
|---|---|
| Salary (Carol) | $22,000 |
| Minus: Itemized deductions | ( 8,500) |
| Exemption | ( 4,000) |
| Taxable income | $ 9,500 |

Note: Because Carol claimed itemized deductions on her return, Carl must also itemize. Both could have claimed a standard deduction of $6,300 (total of $12,600), so combined they lost deductions of $4,100 ($12,600–$8,500) by itemizing.

p. I:2-32.

**I:2-32** a.

| | |
|---|---|
| Salary and interest | $19,100 |
| Minus: Standard deduction | (12,600) |
| Exemptions | ( 8,000) |
| Taxable income | -0- |
| | |
| Gross tax | $ -0- |

b.

| | |
|---|---|
| Salary | $18,000 |
| Minus: Standard deduction | ( 6,300) |
| Exemption | ( 4,000) |
| Taxable income | $ 7,700 |
| | |
| Gross tax | $ 770 |

Note that Hal would also be required to file a separate return and pay a tax of $5 based upon taxable income of $50 ($1,100 interest - $1,050 standard deduction).

c. Hal and Ruth should not file a joint return. The parents will have to pay an additional $1,120 in taxes, while Hal and Ruth only save $775 [($770 + $5) - $0] by filing a joint return.

**I:2-33** a. Brian may not be claimed as a dependent because his gross income exceeds $4,000 (2015). Brian is not a qualifying child because he is over age 23. He is not an other dependent because he fails the gross income test.

b. No effect. Brian's student status is irrelevant because he is over age 23. Thus, Wes and Tina may not claim Brian in this case.

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c. Sherry may be claimed as a dependent by Wes and Tina as she is considered a qualifying child. She meets the four tests of relationship, age, abode, and support. Her gross income is not relevant.

d. Under these facts, Sherry would not be eligible to be claimed as a dependent because she isn't a qualifying child. Under the other dependent test, the gross income test may not be waived, as she is not a full-time student and is over age 18.

e. Granny may not be claimed as a dependent as she fails the gross income test. Her interest from the U.S. bonds exceeds $4,000 and no exception applies. If Granny's interest had been less than $4,000, she would have qualified, as Social Security is not included in her gross income.

pp. I:2-14 through I:2-18.

**I:2-34** a. Carole and John can claim David and Kristen this year. Jack is not a qualifying child (over age 18 and not a full-time student) and is not another relative because his gross income exceeds $4,000. David can be claimed as a dependent because he is considered a qualifying child. He meets the four tests of relationship, age, abode, and support. Gross income is not considered for the qualifying child test. Kristen also is a qualifying child and can be claimed as a dependent.

b. In this case, Jack would be considered a qualifying child as he now meets the age test (under age 24 and a full-time student). Carole and John can claim Jack as a dependent.

c. In this case, Jack would not be a qualifying child because he fails the age test. However, he is a qualifying relative as he meets the relationship, gross income, and support tests. His gross income is less than $4,000 in 2015.

d. If David was a part-time student, he would not be either a qualifying child or qualifying relative. With respect to the qualifying child test, David fails the age test as he is a part-time student. As to the qualifying relative test, David fails the gross income test.

e. David would not be a dependent as he fails the support test for both the qualifying child and qualifying relative tests. pp. I:2-14 through I:2-18.

**I:2-35** a. Robert cannot claim Jane as a dependent. Jane is not his qualifying child as she fails the age, abode, and presumably the support test. The facts in the problem do not specify how the $26,000 ($11,000 + $15,000) of support is allocated between Jane and her two children. But this is irrelevant as she fails the age and abode tests. Jane also fails the qualifying relative test because she has too much gross income.

b. Jane can claim her children as dependents. Robert apparently provides over one-half of their support, but that is irrelevant as they are Jane's "qualifying children." The support requirement only says that the children cannot be self-supporting.

c. Jane is entitled to the child credit for each of her two children. Even if Robert were eligible to claim dependency exemptions for the children, he would not benefit from the child credit because of his income. pp. I:2-14 through I:2-18.

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**I:2-36** Based on the facts given, Juan cannot claim either Maria or Norma as dependents. He can claim Jose only if written documentation exists.

Maria cannot be claimed as a dependent as she provides over one-half of her own support.

Although Juan provides more than one-half of Jose's support, Jose lives with Linda. Absent required documentation, Linda is entitled to the dependency exemption. If Linda signs a completed Form 8332, Juan can claim the exemption.

Norma is not a "qualifying child" for either her father or Jose as she lives with neither. Further, she is a part-time student. She does not qualify as a "qualifying relative" because she has too much gross income. pp. I:2-14 through I:2-18.

**I:2-37** a. Either Mario or Elaine. Caroline cannot because she is unrelated to Anna, and Doug cannot because he provides less than 10% of Anna's support.

b. Elaine must agree in writing to the arrangement.

c. No. Head-of-household status cannot be based on a dependency exemption obtained as the result of a multiple support agreement.

d. No. Old-age allowances are not available for dependents. Old-age allowances increase the amount of the standard deduction. pp. I:2-14 through I:2-18.

**I:2-38** a. Joan, the custodial spouse, receives both the dependency exemption and child credit.

b. No. p. I:2-17.

**I:2-39**

| | Form | Filing Status | Exemptions | Child Credit |
|---|---|---|---|---|
| a. | 1040EZ | Single | 1 | 0 |
| b. | 1040A | Single | 1 | 0 |
| c. | 1040 | Head-of-Household | 1 | 0 |
| d. | 1040A | Single | 1 | 0 |
| e. | 1040A | Head-of-Household | 2 | 1 |

pp. I:2-14 through I:2-24.

**I:2-40** a. No dependency exemption or child credit. A cousin must live with the taxpayers in order to qualify as a dependent as a cousin does not automatically meet the relationship test.

b. One dependency exemption. Because the social security benefits are excluded from gross income, the father meets the gross income test. The father is not required to live with Bob to meet the relationship test.

c. One dependency exemption, no child credit. The daughter is considered a qualifying child and, because she is a full-time student under age 24, the gross income test is not relevant. Because she is over 16, she does not qualify for the child credit.

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d. No dependency exemption or child credit. The mother cannot be claimed as a dependent by anyone because she provided over half of her own support. pp. I:2-14 through I:2-20.

**I:2-41** a. The information provided suggests that Juan will be in a higher tax bracket than Maria. As a result, personal exemptions are worth more to Juan than to Maria.

b. The child credit is phased out for single taxpayers with AGI above $75,000. Because of his high income, Juan will not be entitled to any child credit. Accordingly, it is their combined tax advantage to allow Maria to take the child credit. The credit, however, is only available to taxpayers who claim dependency exemptions for children. Juan would not willingly agree to forego the dependency exemption without some consideration. The tax savings received by Maria from the dependency exemptions and the child credit should be considered when the amount of child support is being determined

c. As the custodial parent, Maria is entitled to file as a head-of-household. This is true even if she does not claim the dependency exemption or child credit. Juan will file as a single taxpayer. pp. I:2-18 and I:2-19.

**I:2-42** a.

| | |
|---|---|
| Salary ($32,000 + $39,000) | $71,000 |
| Minus: Itemized deductions | ( 13,600) |
| Personal exemptions | ( 8,000) |
| Taxable income | $49,400 |
| Gross tax | $ 6,488* |

b. Mary's tax filing as a single taxpayer:

| | |
|---|---|
| Salary | $39,000 |
| Minus: Standard deduction | ( 6,300) |
| Personal exemption | ( 4,000) |
| Taxable income | $28,700 |
| Gross tax | $ 3,844* |

Bill's tax filing as a single taxpayer:

| | |
|---|---|
| Salary | $32,000 |
| Minus: Itemized deductions | (12,000) |
| Personal exemption | ( 4,000) |
| Taxable income | $16,000 |
| Gross tax | $ 1,939* |

Their income taxes total $5,783 ($3,844 + $1,939).

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*These amounts are based upon the 2015 tax rate schedule because the 2015 tax table was unavailable when the solution was prepared.

c. Their tax will be $705 ($6,488 - $5,783) higher if they marry before year-end. This is attributable to the fact that itemized deduction available to Bill and the standard deduction available to Mary if they are unmarried are greater than the itemized deductions available to them if they are married--$705 [0.15 ($6,300 + $12,000 - $13,600)]. pp. I:2-20 through I:2-23.

**I:2-43** a. Amy need not file because her gross income is less than the threshold of $10,300 and her self-employment income is less than $400.

b. Betty need not file, as her gross income ($9,100) is less than $11,850 ($6,300 + $1,550 + $4,000).

c. Chris must file, as his gross income of $2,300 exceeds his standard deduction $2,250 ($1,900 + $350). Chris' standard deduction is limited to the amount of earned income plus $350.

d. Dawn must file because her unearned income is over $1,050 and her total gross income exceeds her standard deduction.

e. Doug must file because his gross income is over $4,000 and he is married and not living with his spouse. p. I:2-35.

**I:2-44** a. Yes.

b. No. The aunt would have to live with the taxpayer.

c. No. Because she qualifies for the more favorable surviving spouse status, she cannot file as head-of-household.

d. Yes. Because he qualifies as an abandoned spouse he can file as a head-of-household. pp. I:2-20 through I:2-24.

**I:2-45** a. 2013: Celia files a joint return even though Wayne died in October.

2014: Celia must file as a single taxpayer. As a part-time student, Wally is not a qualifying child.

2015: Same as 2014.

2016: Same as 2014.

b. Single. Juanita does not qualify for head-of-household status because Josh is not a "qualifying child." He is over 18 and is not a full-time student.

c. Gertrude may use the head-of-household filing status. Even though she is still legally married, she meets the tests for an abandoned spouse. She lived apart from her spouse for the last six months of the taxable year and paid over one-half the cost of maintaining a household for her dependent son. pp. I:2-21 through I:2-23.

Note to Instructor: A good exercise is to ask the class how this problem would change if Wally were a full-time student rather than part-time. Celia would qualify as a surviving spouse in 2014 and 2015 and a single taxpayer in 2016.

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**I:2-46** a. $95,000 ($46,000 + $49,000).

b.

| | |
|---|---|
| Gross income | 95,000 |
| Minus: Business expenses | (24,000) |
| IRA contributions | (10,000) |
| Adjusted gross income | $61,000 |

c.

| | |
|---|---|
| Adjusted gross income | $61,000 |
| Minus: Itemized deductions | (13,000) |
| Exemptions ($4,000 x 3) | (12,000) |
| Taxable income | $36,000 |

pp. I:2-6 and I:2-7.

**I:2-47** Jan should take the standard deduction. Jan cannot deduct any medical expenses or miscellaneous expenses as they are less than the applicable floors (10% AGI floor for medical and 2% of AGI floor for miscellaneous deductions). She is left with $5,000 of itemized deductions (mortgage interest of $3,000 and property taxes of $2,000) which are less than the $6,300 standard deduction. p. I:2-10.

**I:2-48** $1,850 (salary $4,200 + interest $2,200 - standard deduction ($4,200 + $350)). The taxable income would be the same if she were 16 years of age. However, the tax rate applicable to $100 ($2,200 - $2,100) of the interest income would depend on the parents' tax bracket and not be based on Debbie's income (If she is 23 years old and a full-time student, the parents' tax bracket will be used if her earned income is less than half of her support). pp. I:2-24 through I:2-26.

**I:2-49** a. Adjusted gross income:

| | |
|---|---|
| Salary | $130,000 |
| Allowable capital loss | (3,000) |
| Adjusted gross income | $127,000 |

b. Itemized deductions:

| | |
|---|---|
| Home mortgage interest | $ 10,000 |
| State income taxes | 4,000 |
| Charitable contributions | 5,000 |
| Itemized deductions | $ 19,000 |

c. Personal exemptions ($4,000 x 4) $ 16,000

d. Taxable income

| | |
|---|---|
| Adjusted gross income | $127,000 |
| Itemized deductions | (19,000) |
| Personal exemptions | (16,000) |
| Taxable income | $ 92,000 |

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**I:2-50**

**Karen**
Karen's gross tax is $371. At age 21, Karen is subject to the kiddie tax because she is a full-time student who earned less than one-half of her own support and who has unearned income in excess of $2,100.

| | |
|---|---|
| Taxable income: | |
| Wages | $3,000 |
| Interest | 2,800 |
| Adjusted gross income | $5,800 |
| Standard deduction ($3,000 + $350) | ( 3,350) |
| Taxable income | $2,450 |
| | |
| Net unearned income: | |
| Unearned income | $2,800 |
| Statutory deduction | ( 1,050) |
| Portion of standard deduction | ( 1,050) |
| Net unearned income | $ 700 |
| | |
| Gross tax: | |
| Tax on net unearned income ($700 X 0.28) | $ 196 |
| Tax on taxable income less net unearned income ($1,750 X 10%) | 175 |
| Gross tax | $ 371 |

**Susan**
Susan's gross tax is $205. Susan does not owe the kiddie tax as she is age 18 and her earned income is greater than one-half of her support.

| | |
|---|---|
| Wages | $4,500 |
| Interest | 2,400 |
| Adjusted gross income | $6,900 |
| Standard deduction ($4,500 + $350) | (4,850) |
| Taxable income | $2,050 |
| Gross tax | $ 205 |

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**Amelie**
Amelie's gross tax is $203. Amelie is subject to the kiddie tax as she is under age 18 and her unearned income is greater than $2,100.

| | |
|---|---|
| Taxable income: | |
| Wages | $5,900 |
| Interest | 2,200 |
| Adjusted gross income | $8,100 |
| Standard deduction | ( 6,250) |
| Taxable income | $1,850 |

| | |
|---|---|
| Net unearned income: | |
| Unearned income | $2,200 |
| Statutory deduction | ( 1,050) |
| Portion of standard deduction | ( 1,050) |
| Net unearned income | $ 100 |

| | |
|---|---|
| Gross tax: | |
| Tax on net unearned income ($100 X 0.28) | $ 28 |
| Tax on taxable income less net unearned income ($1,750 X 0.10) | 175 |
| Gross tax | $ 203 |

**I:2-51** a.

| | |
|---|---|
| Salary | $ 60,000 |
| S corporation income | 40,000 |
| Adjusted gross income | $100,000 |
| Itemized deductions | ( 18,000) |
| Personal exemption | ( 4,000) |
| Taxable income | $ 78,000 |
| Gross tax | $ 15,294 |

b. Corporation:

| | |
|---|---|
| Taxable income | $ 40,000 |
| Gross tax (0.15 x $40,000) | $ 6,000 |

Individual:

| | |
|---|---|
| Salary | $ 60,000 |
| Dividend ($40,000 - $6,000) | 34,000 |
| Adjusted gross income | $ 94,000 |
| Itemized deductions | ( 18,000) |
| Personal exemption | ( 4,000) |
| Taxable income | $ 72,000 |
| Gross tax | $ 10,394* |
| Total tax ($6,000 + $10,394) | $ 16,394 |

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*The individual's gross tax is the total of the tax on the dividend income and the tax on the remaining income. The tax on the dividend income of $34,000 is $5,100 (0.15 x $34,000). The tax on the remaining income of $38,000 ($72,000 - $34,000) is $5,294 computed using the rate schedule for single taxpayers.

c. The answer to part a is unchanged as the shareholder is taxed on the S corporation's income regardless of whether it is distributed. In part b, the corporation's tax is the same, $6,000, but the shareholder is only taxed on the salary of $60,000.

| | |
|---|---|
| Adjusted gross income | $ 60,000 |
| Itemized deductions | ( 18,000) |
| Personal exemption | ( 4,000) |
| Taxable income | $ 38,000 |
| Gross tax | $ 5,294 |
| Total tax ($6,000 + $5,294) | $ 11,294 |

The shareholder will be taxed on the corporation's undistributed income if it is paid out as a dividend in a future year.

pp. I:2-27 through I:2-30.

**I:2-52** Lana's child credit is $2,450 [(3 x $1,000) - ($50 x 11)]. p. I:2-19.

**I:2-53** a. They will save $1,188 ($3,000 x 0.396). Only $3,000 of loss can be offset against other income. The remaining $12,000 of loss can be carried over and offset against future income.

b. The additional tax is $2,000 ($10,000 x 0.20).

c. They will save $1,188 as in part a. The net loss is $5,000 but as in part a, only $3,000 can be offset against other income. The carryover, however, is only $2,000 ($15,000 - $10,000 - $3,000). p. I:2-30.

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**I:2-54**

| | | 2015 | 2016 |
|---|---|---|---|
| a. | Salary | $20,000 | $20,000 |
| | Minus: Itemized or standard deduction | ( 6,300) | ( 9,000) |
| | Exemption | ( 4,000) | ( 4,000) |
| | Taxable income | $ 9,700 | $ 7,000 |
| | Gross Tax | $ 994 | $ 700 |
| b. | Salary | $20,000 | $20,000 |
| | Minus: Itemized or standard deduction | ( 6,300) | ( 8,000) |
| | Exemption | ( 4,000) | ( 4,000) |
| | Taxable income | $ 9,700 | $ 8,000 |
| | Gross tax | $ 994 | $ 800 |
| c. | Salary | $20,000 | $20,000 |
| | Minus: Itemized or standard deduction | ( 6,300) | (10,000) |
| | Exemption | ( 4,000) | ( 4,000) |
| | Taxable income | $ 9,700 | $ 6,000 |
| | Gross tax | $ 994 | $ 600 |

d. By contributing the $2,000 in 2016, Virginia is able to deduct the entire amount. If $1,000 is contributed in each year, only the $1,000 contributed in 2016 is deductible. No tax benefit is received in 2015 because the contribution is less than the standard deduction. If $2,000 is contributed in 2015, then no tax benefit is received. pp. I:2-32 and I:2-33.

**I:2-55** a. 1040A
b. 1040
c. 1040A
d. 1040A

p. I:2-36.

**I:2-56** a. Maria's adjusted gross income is $48,000.

| | |
|---|---|
| Salary | $51,000 |
| Capital loss allowable | ( 3,000) |
| Adjusted gross income | $48,000 |

b. Maria's taxable income is $37,700.

| | |
|---|---|
| Adjusted gross income | $48,000 |
| Standard deduction | ( 6,300) |
| Personal exemption | ( 4,000) |
| Taxable income | $37,700 |

c. Maria's tax liability is $5,219.

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**I:2-57** a. As no special rules apply and taxable income is $83,000, the gross tax is $12,338.

b. Ralph and Tina are entitled to a child credit for Tina equal to $1,000.

c. Pam's gross tax is computed as follows:

| | |
|---|---|
| Gross income (interest) | $3,500 |
| Minus: Standard deduction | ( 1,050) |
| Taxable income | $2,450 |
| | |
| Tax on first $1,050 (0.10 x $1,050) | $ 105 |
| Tax on remaining $1,400 (0.25 x $1,400) | 350 |
| Gross tax | $ 455 |

d. If Pam were age 25, her tax would be computed without reference to the parents' tax rate. Thus, her tax would be $245 (0.10 x $2,450) assuming she is still a dependent.

**I-2:58** a. Gail qualifies as a surviving spouse. She is eligible to use the joint return rate schedule.

b. Her taxable income and gross income tax are computed as follows:

| | |
|---|---|
| Adjusted gross income | $379,900 |
| Minus: Itemized deductions | (17,900)* |
| Personal and dependency exemptions | ( 3,520)** |
| Taxable income | $358,480 |
| Gross income tax | $ 93,827 |

*$20,000 - [0.03 x ($379,900 - $309,900)]
**$8,000 - [$8,000 x (0.02 x ($379,900 - $309,900)/$2,500)]

Because of her high income, Gail's child credit is fully phased-out and she also owes a 3.8% tax on her investment income over $250,000 or $4,936 (0.038 x [$379,900 - $250,000]).

c. Because having a dependent child is required to qualify as a surviving spouse, Gail must file as a single taxpayer.

pp. I:2-10, I:2-18, and I:2-31.

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## Tax Strategy Problems

**I:2-59** The tax liability under the three alternatives is computed as below:

| **Business income** | **Proprietorship** | **S Corporation** | **C Corporation** |
|---|---|---|---|
| Operating income | $ 60,000 | $60,000 | $60,000 |
| Compensation paid to Jack | | ( 40,000) | ( 40,000) |
| Net | $ 60,000 | $20,000 | $20,000 |
| Corporate income tax | | | $ 3,000 |
| | | | |
| **Jack's income** | | | |
| Business income | $ 60,000 | $20,000 | |
| Compensation | | 40,000 | $40,000 |
| Dividends | | | 5,000 |
| Other income | 1,000 | 1,000 | 1,000 |
| Adjusted Gross Income | $ 61,000 | $61,000 | $46,000 |
| | | | |
| Other itemized deductions | (10,000) | (10,000) | (10,000) |
| Personal exemption | ( 4,000) | ( 4,000) | ( 4,000) |
| Taxable income | $ 47,000 | $47,000 | $32,000 |
| Individual income tax | $ 7,544 | $ 7,544 | $ 3,589 |
| Total tax | $ 7,544 | $ 7,544 | $ 6,589 |

The total tax paid when Jack operates the business as a C corporation is less than the tax paid with the other organizational forms. He, however, does face a potential future individual income tax on the remaining $12,000 ($20,000 - $3,000 - $5,000) of corporate income in the year he distributes that income. The reason the tax is less now is because higher rates apply to the additional income reported on his personal return when he operates as a proprietor or when he makes an S election. Dividends received by individuals in the 10% and 15% tax brackets are exempt from income tax. Jack's taxable income is $32,000 which is below the top-end of the 15% tax bracket. As a result, the current year's dividends do not result in a tax. Nevertheless, there may be a tax on future dividend distributions if Jack has more income. pp. I:2-27 through I:2-30.

**I:2-60** a. Andrea will save $792 (39.6% x $2,000) if she makes the contribution.

b. Andrea's taxes will not change because the contribution is not deductible.

c. Andrea will save $238 (39.6% x $600) if she makes the gift. Given the amount of her income the daughter will owe no tax.

d. Andrea will save $238. She however will not be as well off because the exempt interest of $300 is less than the after tax interest of $362 ($600 - $238) from the taxable bonds.

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## Tax Form/Return Preparation Problems

**I:2-61** (See Instructor's Resource Manual)

**I:2-62** (See Instructor's Resource Manual)

**I:2-63** (See Instructor's Resource Manual)

## Case Study Problems

**I:2-64** This question has some interesting implications. One problem relates to the sale of the loss property. Bala and Ann can only deduct $3,000 of the capital loss from ordinary income each year. As a result, it would take ten years to use up the loss unless they realize a capital gain against which to offset the loss. Although a $3,000 capital loss offsets income that would otherwise be taxed at 39.6% it takes a long time to use up the loss. If Bala and Ann sell both of the parcels they own they will realize a net loss of $8,000 which will be used up in the current and next two years even if they realize no additional gains. Further, the $8,000 net loss will offset income that would otherwise be taxed at 39.6%.

Because of her age, Kim is currently subject to the "kiddie tax", which means that most of her capital gain will be taxed at her parents' rate (20% for capital gains). By waiting to sell her land when she is no longer subject to the kiddie tax, she will be able to use her standard deduction to offset part of the gain and the remainder may be taxed at a low rate (perhaps zero). p. I:2-30.

**I:2-65** As Larry and Sue were married at the end of the year, they can file either a joint income tax return or two separate returns. On the surface there is not much difference between the tax liability on a joint return versus separate returns. The important issue here is the fact that Sue believes that Larry may be under-reporting tip income. If they file a joint return, Sue may be liable for the joint tax liability including penalties that may result from under-reporting. There is an innocent spouse provision, but one condition for claiming innocent spouse status is that the taxpayer did not know and had no reason to know that there was under-reporting. As Sue is suspicious of her husband, she should file a separate return to protect herself from possible tax liability associated with unreported income. pp. I:2-33 and I:2-34.

## Tax Research Problems

**I:2-66** Since the stepdaughter and her family do not live with Ed, they must be related to him in order to qualify as his dependents. Clearly, the stepdaughter meets this test. Stepdaughters are specifically listed in Sec. 152(a)(2) as relatives. Further, Reg. Sec. 1.152-2(d) states that a relationship "once existing will not terminate by divorce or death of a spouse."

On the other hand, Ed is not related to the stepdaughter's husband. Stepson-in-laws are not listed in Sec. 152(a). The Tax Court in Desio Barbetti [9 T.C. 1097 (1947)] held that the term "grandchildren" does not include step-grandchildren, and that neither stepchild nor son-in-law covers stepson-in-laws. Current law refers to step-children and their descendants which suggests that the child is eligible to be claimed as a dependent.

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**I:2-67** The full exemption deduction for a dependent is available even though the dependent is born or dies during the year. In Rev. Rul. 73-156, 1973-1 C.B. 58 the IRS ruled that an exemption may be claimed if state or local law treats the child as having been born alive, and this is evidenced by an official document such as a birth or death certificate. If the child had no social security number the IRS instructs taxpayers to enter "DIED" in place of the social security number on Form 1040.

**I:2-68** Although Larry may not meet the technical definition of "blind" when he wears the new contact lens, the fact that he can only wear the lens for brief times means that he cannot depend on having the advantage of improved sight. Therefore, the Tax Court in Emanuel Hollman, 38 T.C. 251 (1963) granted an extra personal exemption for blindness permitted under prior law. It seems likely that the same rule would be available to taxpayers today claiming the additional standard deduction amount available to blind taxpayers under current law.

## "What Would You Do In This Situation?" Solution

**Ch. I:2, p. I:2-28.**

A married person has the option of filing a joint return or as a married person filing separately. Whether a person is married depends on the laws of the state of residence. The abandoned spouse rules provide an exception, but the rules only apply if the taxpayer maintains a household for a dependent child. This case does not indicate that Jane has a child.

State laws establish conditions that must be met for a missing person to be declared legally dead. Typically, a missing person cannot be declared legally dead for seven years. During the interim, a guardian can be appointed to handle the affairs of the missing person. This all taken together indicates that Jane is still classified as a married person for tax purposes.

The IRS has ruled that a spouse who is appointed guardian may elect to file a joint return with his or her missing spouse (Rev. Rul. 55-387, 1955-1 CB 131). The joint return would enable Jane to take advantage of the lower rate schedule, claim an additional personal exemption, and utilize a larger standard deduction. Before she could file a joint return, Jane would have to be appointed as Jim's guardian.

Choosing to file a joint return does have some risks. Jane does not know how much income Jim has or whether he is even alive. Should she file a joint return, the innocent spouse provision probably would protect Jane from tax on any income that Jim may be earning.

One unusual aspect of the situation is that the IRS may know of her husband's status. This is because the IRS would have any return that Jim is filing and have information on any income that is being reported under his social security number on 1099's and W-2's. The IRS is prohibited from giving out information on taxpayers including where they live. As a result, it is unclear what the IRS would do with the information should Jane file a joint return.

Jane could file for a divorce. If the divorce were granted before year end, Jane would file as a single taxpayer. Also, if Jim is declared legally dead Jane will file as a single taxpayer.

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