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CHAPTER 2 – SOLUTIONS
END OF CHAPTER MATERIAL

Discussion Questions

1. What is a *for* AGI deduction? Give three examples.

Answer:

A deduction for AGI is a deduction permitted under the IRC that is used to calculate AGI. It can also be thought of as a deduction from gross income to arrive at AGI. Examples include deductions for IRAs, Keoghs, or other self-employed qualified pension plans; student loan interest; one-half the self-employment tax; self-employed health insurance deduction; penalty on early withdrawal of savings; and alimony paid.

Learning Objective: 02-01
Topic: Form 1040
Difficulty: 1 Easy
Feedback:
EA: Yes

2. What are the five types of filing status?

Answer:

The five types of filing status are:

- **Single**
- **Married filing a joint return**
- **Married filing separate returns**
- **Head of household**
- **Qualifying widow(er) with dependent child**

Learning Objective: 02-02
Topic: Filing Status
Difficulty: 1 Easy
Feedback:
EA: Yes

3. What qualifications are necessary to file as head of household?

Answer:

To qualify as head of household, the taxpayer must be unmarried at the end of the tax year, be a U.S. citizen or resident throughout the year, not be a qualifying widow(er), and maintain a household that is the principal place of abode of a *qualifying person* for more than half the year or pay more than half the costs of maintaining a separate household for the taxpayer's mother

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or father if the mother or father qualifies as a dependent of the taxpayer. Temporary absences, such as attending school do not disqualify the person under this section.
Learning Objective: 02-02
Topic: Filing Status
Difficulty: 1 Easy
Feedback:
EA: Yes

4. George and Debbie were legally married on December 31, 2018. Can they file their 2018 income tax return using the status of married filing jointly? Why or why not? What other filing status choices do they have, if any?

Answer:

Yes, George and Debbie can file using the filing status of married filing jointly. The requirement for this status is that the couple be legally married on the last day of the tax year. Alternatively, the couple could choose to use the married filing separate status.
Learning Objective: 02-02
Topic: Filing Status
Difficulty: 1 Easy
Feedback:
EA: Yes

5. Why is it important to determine if the taxpayer has dependents to be claimed on the income tax return?

Answer:

The existence and number of dependents affect the determination of total tax liability in areas such as child credits and filing status.
Learning Objective: 02-03
Topic: Dependents
Difficulty: 1 Easy
Feedback:
EA: Yes

6. What are the three general tests that a qualifying person must meet to be a dependent of the taxpayer?

Answer:

To be a dependent of the taxpayer, a qualifying child and a qualifying relative must meet the three general tests: dependent taxpayer test, joint return test and citizen or resident test.

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Learning Objective: 02-03
Topic: Dependents
Difficulty: 1 Easy
Feedback:
EA: Yes

7. What are the five specific tests necessary to be a qualifying child of the taxpayer?

Answer:

A person is a qualifying child if he or she meets all five of the following tests: relationship test, age test, residency test, support test, and special test - for qualifying child of more than one taxpayer.

Learning Objective: 02-03
Topic: Dependents
Difficulty: 1 Easy
Feedback:
EA: Yes

8. What age must a child be at the end of the year to meet the age test under the qualifying child rules?

Answer:

At the end of the year, the child must be: under the age of 19; under the age of 24 and a full-time student; or totally and permanently disabled regardless of age. In addition, the child must be younger than the person claiming the dependency.

Learning Objective: 02-03
Topic: Dependentst
Difficulty: 1 Easy
Feedback:
EA: Yes

9. What are the four specific tests necessary to be a qualifying relative of the taxpayer?

Answer:

A person qualifies as a qualifying relative if he or she meets all four of the following tests: not a qualifying child test, relationship or member of household test, gross income test, and support test.

Learning Objective: 02-03
Topic: Dependents
Difficulty: 1 Easy
Feedback:
EA: Yes

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10. What is a multiple support agreement, and what is its purpose?

Answer:

Normally, in order to claim someone as a dependent a taxpayer must provide more than half the support of the person. At times, an individual may receive support from multiple persons, but no one person has provided more than 50% of the support. In such a case, a multiple support agreement can be signed. If every one of the persons providing support could claim the individual as a dependent (absent the support test) then one person who provided more than 10% of the support can claim him/her as a dependent if all persons sign a written multiple support agreement.

The purpose of the agreement is so someone can claim the dependent rather than no one. Further, the agreement provides a mechanism such that all parties can agree on who that person should be.

Learning Objective: 02-03
Topic: Dependents
Difficulty: 2 Medium
Feedback:
EA: Yes

11. Mimi is 22 years old and is a full-time student at Ocean County Community College. She lives with her parents, who provide all of her support. During the summer, she put her Web design skills to work and earned -$5,000. Can Mimi's parents claim her as a dependent on their joint tax return? Why or why not? Assume that all five tests under qualifying child are met.

Answer:

All of the dependency tests are met by Mimi's parents, so they can claim her as a dependent. The fact that Mimi earned $4,150 does not matter since Mimi is under age 24 and she is a full-time student at a qualifying educational institution. Thus, the gross income test is not necessary for a qualifying child as long as Mimi does not provide more than half of her own support.

Learning Objective: 02-03
Topic: Dependents
Difficulty: 2 Medium
Feedback:
EA: Yes

12. What is the standard deduction for each filing status?

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Answer:

The standard deduction for each filing status for 2018 is:

Single	**$ 12,000**
Married filing jointly	**24,000**
Married filing separately	**12,000**
Head of household	**18,000**
Qualifying widow(er)	**24,000**

Learning Objective: 02-04
Topic: Standard Deduction
Difficulty: 1 Easy
Feedback:
EA: Yes

13. Under what circumstances must a taxpayer use a tax rate schedule rather than using a tax table?

Answer:

If the taxable income of a taxpayer is $100,000 or more, a tax rate schedule must be used. Taxable income of less than $100,000 requires the use of the tax table.

Learning Objective: 02-05
Topic: Tax Computation
Difficulty: 1 Easy
Feedback:
EA: Yes

14. When and at what rate is interest calculated on amounts owed to the IRS?

Answer:

If the taxpayer still owes tax after April 15th. The rate charged is the federal short-term rate plus 3 percentage points.

Learning Objective: 02-06
Topic: Interest and Penalties
Difficulty: 2 Medium
Feedback:
EA: Yes

15. Prepare a table of the possible IRS penalties listed in the text and give a brief summary of the purpose of each penalty.

Answer:

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Penalty	Reason for Penalty
Interest charged on assessments	**To encourage taxpayers to pay assessments in a timely manner and to compensate the government for the time-value of late payments**
Failure to file a tax return	**To reprimand taxpayers for failing to file a tax return**
Failure to pay tax	**To seek retribution from taxpayers who fail to pay tax**
Failure to pay estimated taxes	**To penalize taxpayers for failing to pay estimated taxes throughout the year**
Accuracy-related penalties	**To seek retribution from taxpayers for underpayments or submitting tax returns with errors**
Fraud penalties	**To penalize taxpayers for providing fraudulent information**
Erroneous claim for refund or credit penalty	**To penalize taxpayers for filing an excessive claim for refund or credit of income tax**

Learning Objective: 02-06
Topic: Interest and Penalties
Difficulty: 2 Medium
Feedback: EA: Yes

Multiple Choice

16. A single taxpayer is 26 years old and has wages of $18,000 and interest income of $450. Which Form 1040 Schedule must the taxpayer use?
a. Schedule 1.
b. Schedule 2.
c. Schedule 3.
d. The taxpayer does not need to use a Schedule.

Answer: d.
Learning Objective: 02-01
Topic: Form 1040 and 1040A
Difficulty: 1 Easy
Feedback: Wages and interest are reported on the basic Form 1040. A schedule is not required.
EA: Yes

17. Payment of alimony by the taxpayer is a *for AGI* deduction. Which Schedule must the taxpayer use to claim this benefit?
a. Schedule 1.
b. Schedule 2.

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c. Schedule 3.
d. The taxpayer does not need to use a Schedule.

Answer: a.
Learning Objective: 02-01
Topic: Form 1040 and 1040A
Difficulty: 1 Easy
Feedback: Alimony deductions can only be claimed on Schedule 1.
EA: Yes

18. A taxpayer is married with a qualifying child (dependent), but she has been living separately from her spouse for the last eight months of the year. However, she paid for more than half of the cost of keeping up the household. Her spouse does not want to file jointly. What filing status must she use when filing her tax return? She wants to obtain the maximum legal benefit.
a. Married filing separately.
b. Single.
c. Qualifying widow(er).
d. Head of household.

Answer: d.
Learning Objective: 02-02
Topic: Filing Status
Difficulty: 1 Easy
Feedback: A taxpayer is considered unmarried for purposes of this section if the spouse was living apart during the last six months of the tax year.
EA: Yes

19. A taxpayer's spouse died on December 31, 2017. He has no qualifying child. Which status should the taxpayer select when filing his 2018 tax return?
a. Qualifying widow(er).
b. Married filing jointly.
c. Single.
d. Married filing separately.

Answer: c.
Learning Objective: 02-02
Topic: Filing Status
Difficulty: 1 Easy
Feedback: The surviving spouse may be eligible to file as a qualifying widow(er) only if certain conditions are met, which include keeping a household as the principal place of abode for the entire year of both the surviving spouse and a child, stepchild, or adopted child who can be claimed as a dependent by the surviving spouse.

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EA: Yes

20. Esmeralda is 20 years of age and a full-time student living with her parents. She had wages of $500 ($50 of income tax withholding) for 2018. Can Esmeralda file a tax return to claim her $50 of income tax withholding even though she is a dependent of her parents?
a. Yes, Esmeralda can file a tax return.
b. No, Esmeralda cannot file a tax return.
c. Esmeralda's parents can report her wages on their tax return.
d. No, Esmeralda is a dependent of her parents.

Answer: a.
Learning Objective: 02-03
Topic: Dependency Exemption
Difficulty: 1 Easy
Feedback: Esmeralda qualifies as a dependent of her parents; however, she can file her own tax return to claim the $50 withheld from her pay.
EA: Yes

21. A taxpayer can claim a dependent if the person is a qualifying child or a qualifying relative and the person meets all of the following tests.
a. Citizen or resident, dependent taxpayer, and age tests.
b. Dependent taxpayer, joint return, and support tests.
c. Joint return, citizen or resident and support tests.
d. Dependent taxpayer, joint return, and citizen or resident tests.

Answer: d.
Learning Objective: 02-03
Topic: Dependent
Difficulty: 1 Easy
Feedback: A qualifying child or a qualifying relative can be claimed as a dependent if the person meets the dependent taxpayer, joint return, and citizen or resident tests.
EA: Yes

22. To be a qualifying child, the taxpayer must meet three general tests and five specific tests. Which of the following is *not* part of the five specific tests?
a. Support test.
b. Age test.
c. Gross income test.
d. Relationship test.

Answer: c.

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Learning Objective: 02-03
Topic: Dependent
Difficulty: 1 Easy
Feedback: The gross income test does not apply to a qualifying child; only to a qualifying relative.
EA: Yes

23. To be a qualifying relative, who has to live in the home of the taxpayer for the entire year?
a. Cousin.
b. Child.
c. Stepchild.
d. Father.

Answer: a.
Learning Objective: 02-03
Topic: Dependent
Difficulty: 2 Medium
Feedback: A cousin does not meet the relationship test under this area. He/she must live in the taxpayer's household for the entire year.
EA: Yes

24. Which amount represents the standard deduction for a taxpayer who is 44 years old and claiming head of household status?
a. $13,600.
b. $19,600.
c. $18,000.
d. $12,000.

Answer: c.
Learning Objective: 02-04
Topic: Standard Deduction
Difficulty: 1 Easy
Feedback: The standard deduction for a taxpayer under age 65 and claiming head of household status is $18,000.
EA: Yes

25. A married couple, both of whom are under 65 years old, decided to file as married filing separately. One of the spouses is going to itemize deductions instead of taking the standard deduction. What is the standard deduction permitted to the other spouse when she files her tax return?
a. $12,000.
b. $13,600.

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c. $18,000.
d. $0.

Answer: d
Learning Objective: 02-04
Topic: Standard Deduction
Difficulty: 1 Easy
Feedback: When filing as married filing separately, if one of the spouses itemizes, then the other spouse must itemize or receive a standard deduction of zero.
EA: Yes

26. Employers are required to withhold social security taxes from wages paid to employees. What is the amount of the social security wage limitation for 2018?
a. $128,400.
b. $118,500.
c. $113,700.
d. $127,200.

Answer: a
Learning Objective: 02-05
Topic: Tax Computation
Difficulty: 1 Easy
Feedback: The amount of the social security wage limitation for 2018 is $128,400.
EA: Yes

27. What is the amount of the tax liability for a married couple filing jointly with taxable income of $135,500?
a. $25,418.
b. $28,333.
c. $26,810.
d. $21,689.

Answer: d
Learning Objective: 02-05
Topic: Tax Computation
Difficulty: 2 Hard
Feedback: The amount is $21,689 computed as follows:
($135,500-$77,400) X .22 plus $8,907.00.
EA: Yes

28. What is the percentage of interest the IRS was charging on assessment (amount of unpaid tax liability) during March 2018? You might want to do this research by going to the IRS Web site (www.irs.gov).

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a. 6%.
b. 5%.
c. 3%.
d. 4%.

Answer: d
Learning Objective: 02-06
Topic: Interest and Penalties
Difficulty: 1 Easy
Feedback: The interest rate is 4% for underpayments occurring during March of 2018.
EA: Yes

29. When there is negligence on a return, the IRS charges a penalty of _____of the tax due.
a. 25%.
b. 20%.
c. 18%.
d. 10%.

Answer: b
Learning Objective: 02-06
Topic: Interest and Penalties
Difficulty: 1 Easy
Feedback: The IRS can assess a penalty equal to 20% of the tax due when negligence has occurred.
EA: Yes

30. When there is fraud on a return, the IRS charges a penalty of _____ on any portion of understatement of tax that is attributable to the fraud.
a. 20%.
b. 25%.
c. 75%.
d. 100%.

Answer: c
Learning Objective: 02-06
Topic: Interest and Penalties
Difficulty: 1 Easy
Feedback: The IRS can impose a penalty of 75% on any portion of understatement of tax that is attributable to fraud.
EA: Yes

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Problems

31. The benefits of many deductions, credits, or other benefits are limited to taxpayers with Adjusted Gross Income below certain limits.
   a. Explain how the limitation (phaseout) process works.
   b. Give two examples of deductions, credits, or other benefits that are limited.
   c. Why would Congress wish to limit the benefits of these items?

Answer:

a. Taxpayers with AGI in excess of certain specified amounts are prohibited from utilizing the full amount of many deductions, credits, or other tax benefits. Many tax benefits are structured such that taxpayers with low AGI are not limited, taxpayers with high AGI receive no benefit, and taxpayers in the middle receive a reduced benefit as AGI increases. Sometimes a specified AGI amount represents the dividing line between receiving the full amount of a benefit or not receiving any benefit.

b. Examples of benefits which are subject to limitation include: earned income tax credit, child care credit, child tax credit, and deductibility of IRA contributions.

c. There may be a number of reasons why Congress might restrict benefits. First, reducing benefits results in higher taxable income and tax liability, thus increasing tax revenues. Second, taxpayers with higher AGI are often deemed to be able to financially afford fewer benefits and higher taxes since they have more money to start with. Third, and somewhat ironically, there are fewer high income voters compared to low- and moderate-income voters.

Learning Objective: 02-01
Topic: Form 1040 and 1040A
Difficulty: 2 Medium
Feedback:
EA: Yes

32. List the five types of filing status and briefly explain the requirements for the use of each one.

Answer:

The five types of filing status and requirements are:

***Single*. Taxpayer must be unmarried on the last day of the tax year and must not qualify as either head of household or qualifying widow(er).**

***Married filing a joint return*. Taxpayers must be legally married on the last day of the tax year. Taxpayers in the process of getting a divorce can file**

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with this classification as long as the divorce is not final. Generally, neither taxpayer can be a nonresident alien at any time during the tax year.

***Married filing separate returns*. Taxpayers must meet the requirements for married filing jointly and can then choose to file married filing separately.**

***Head of household*. In order to qualify as head of household, the taxpayer must be unmarried at the end of the tax year, be a U.S. citizen or resident throughout the year, not be a qualifying widow(er), and maintain a household that is the principal place of abode of a *qualifying person* for more than half the year. If the mother or father of the taxpayer qualifies as a dependent of the taxpayer, the taxpayer can be eligible for head of household status by paying more than half the costs of maintaining a separate household that is the principal place of abode for the mother or father.**

***Qualifying widow(er) with dependent child.* During the two years following the year of death of a spouse, a taxpayer can file as a qualifying widow(er) if the taxpayer did not remarry and if the taxpayer maintained a household which was the principal place of abode for the entire year of the taxpayer and a dependent child, stepchild, or adopted child. In addition, the taxpayer must have been eligible to file a joint return in the year the spouse died.**

Learning Objective: 02-02
Topic: Filing Status
Difficulty: 1 Easy
Feedback:
EA: Yes

33. In which of the following cases may the taxpayer claim head of household filing status?

a. The taxpayer is single and maintains a household that is the principal place of abode of her infant son.
b. The taxpayer is single, maintains a household for herself, and maintains a separate household that is the principal place of abode of her dependent widowed mother.
c. The taxpayer was married from January to October and lived with his spouse from January to May. From June 1 to December 31, the taxpayer maintained a household that was the principal place of abode of his married son and daughter-in-law, whom the taxpayer can claim as dependents.
d. Same as (c) except the taxpayer lived with his ex-spouse until August and maintained the household from September 1 to the end of the year.

Answer:

a. The taxpayer can claim head of household status.

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b. The taxpayer can claim head of household status. It is not necessary that her mother live in the same household as the taxpayer.
c. The taxpayer can claim head of household status.
d. The taxpayer cannot claim head of household status. The son and daughter-in-law must live with the taxpayer for more than half the tax year. And the taxpayer cannot live with his or her spouse during the last 6 months of the year.

Learning Objective: 02-02
Topic: Filing Status
Difficulty: 2 Medium
Feedback:
EA: Yes

34. What are the three tests a qualifying child or qualifying relative must meet to be claimed as a dependent?

Answer:

A qualifying child or qualifying relative must meet the dependent taxpayer, joint return, and citizen or resident tests.

Learning Objective: 02-03
Topic: Dependency Exemptions
Difficulty: 1 Easy
Feedback:
EA: Yes

35. Roberta is widowed and lives in an apartment complex. She receives $8,000 of social security income that she uses to pay for rent and other household expenses. The remainder of her living expenses is paid by relatives and neighbors. The total amount of support paid by Roberta and the others totals $22,000. Amounts paid for support during the year are as follows:

Roberta	$8,000
Ed (neighbor)	4,000
Bill (son)	5,000
Jose (neighbor)	2,000
Alicia (niece)	3,000

a. Which of these persons is entitled to claim Roberta as a dependent absent a multiple support agreement?
b. Under a multiple support agreement, which of these persons is entitled to claim Roberta as a dependent? Explain your answer.
c. If Roberta saved all of her social security income and the other persons paid for the shortfall in the same proportions as shown, which of these persons would be entitled to claim Roberta as a dependent under a multiple support agreement? Explain your answer.

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Answer:

a. **Absent a multiple support agreement, no one is allowed to claim Roberta as a dependent.**

b. **If a multiple support agreement were executed, no one would be able to claim Roberta as a dependent. A person is entitled to claim a dependent under a multiple support agreement if (1) over half the dependent's support was received from a group of people who would each have been entitled to claim the person as a dependent absent the support test, (2) no one person in the group provided over half the support, and (3) the person claiming the exemption paid over 10% of the support. In this instance, the only persons entitled to claim Roberta as a dependent absent the support test are Bill and Alicia since neither Ed and Jose meet the relationship test (this assumes that Roberta is Alicia's aunt by blood and not by marriage). Bill and Alicia contributed only 36% of Roberta's support ([$5,000 + $3,000] / $22,000). Thus, criterion #1 above is not met and no one is entitled to claim Roberta as a dependent.**

c. **Here, the amount paid in support of Roberta is recalculated as follows (percentages are rounded to the nearest full percent):**

	Original Amount Paid	Percentage of Original Total	Revised Amount Paid
Ed (neighbor)	$4,000	29%	$ 6,380
Bill (son)	5,000	36%	7,920
Jose (neighbor)	2,000	14%	3,080
Alicia (niece)	3,000	21%	4,620
	$14,000		$22,000

As in case (b), either Bill or Alicia is entitled to claim Roberta as a dependent absent the support test. Between them, they provided over 50% of the support of Roberta and each one of them provided over 10% of her support. Thus, either Bill or Alicia would be entitled to claim Roberta if a multiple support agreement were executed.

Learning Objective: 02-03
Topic: Dependent
Difficulty: 3 Hard
Feedback:
EA: Yes

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36. Shandra is a U.S. citizen and is the 68-year-old widowed mother of Janet. After retirement, Shandra decided to fulfill a lifelong dream and move to Paris. Shandra receives $1,000 of interest income, but all of her other living expenses (including rent on her Paris apartment with spectacular views of the Eiffel Tower) are paid by Janet. Janet resides in Chicago. Can Janet claim Shandra as a dependent? Explain your answer.

Answer:

Yes, Janet is entitled to claim Shandra as a dependent.

The four specific criteria to be able to claim a qualifying relative as a dependent are:

Not a qualifying child test. **Shandra is not the qualifying child of another taxpayer.**

Relationship test. **Shandra meets the relationship test since she is the mother of Janet.**

Gross income test**. Shandra does not earn equal to or more than the exemption amount.**

Support test**. Janet provides over 50% of Shandra's support.**

In addition, the general tests are also met:

Joint return**. Shandra is widowed and will not file a joint return.**

Citizenship test**. Shandra is a U.S. citizen.**

Dependent taxpayer test**. Janet cannot be claimed as a dependent by another person.**

The fact that Shandra lives in Paris does not matter. It is not important that a dependent live in the U.S., only that he or she is a citizen of the U.S. (or be a certain resident or national).

Learning Objective: 02-03
Topic: Dependency Exemptions
Difficulty: 2 Medium
Feedback:
EA: Yes

37. Donald is a 21-year-old full-time college student. During 2018, he earned $2,550 from a part-time job and $1,150 in interest income. If Donald is a dependent of his parents, what is his standard deduction amount? If Donald supports himself and is not a dependent of someone else, what is his standard deduction amount?

Answer:

Donald's standard deduction amount if he is a dependent of his parents is the greater of $1,050 or his earned income plus $350. Donald's earned income is $2,550 so his standard deduction will be $2,900.

If Donald is self-supporting, his standard deduction amount will be $12,000.

Learning Objective: 02-04
Topic: Standard Deduction
Difficulty: 2 Medium
Feedback:

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EA: Yes

38. Raphael and Martina are engaged and are planning to travel to Las Vegas during the 2018 Christmas season and get married around the end of the year. In 2018, Raphael expects to earn $45,000 and Martina expects to earn $15,000. Their employers have deducted the appropriate amount of withholding from their paychecks throughout the year. Neither Raphael nor Martina has any itemized deductions. They are trying to decide whether they should get married on December 31, 2018, or on January 1, 2019. What do you recommend? Explain your answer.

Answer:

From a tax perspective, it would be more advantageous for Raphael and Martina to marry in 2018.
The tax liability of Raphael and Martina under each scenario would approximate the following:

	---- Single Returns ----		
	Martina	**Raphael**	**Joint Return**
Adjusted Gross Income…..	**$ 15,000**	**$ 45,000**	**$ 60,000**
Standard deduction ……	**(12,000)**	**(12,000)**	**(24,000)**
Taxable Income……..	**$ 3,000**	**$ 33,000**	**$ 36,000**
Tax liability ……	**$ 303**	**$ 3,773**	**$ 3,942**

If Raphael and Martina get married in 2018 and file a joint return, they will pay $3,942 in federal income tax. If they wait until January 1, 2019, their collective tax liability in 2018 would be $4,076. Thus, for tax purposes, it makes more sense for Raphael and Martina to get married in 2018.

Learning Objective: 02-04
Topic: Standard Deduction
Difficulty: 3 Hard
Feedback:
EA: Yes

39. Determine the amount of the standard deduction for each of the following taxpayers for tax year 2018:

a. Christina, who is single.
b. Adrian and Carol, who are filing a joint return. Their son is blind.
c. Peter and Elizabeth, who are married and file separate tax returns. Elizabeth will itemize her deductions.
d. Karen, who earned $1,100 working a part-time job. She can be claimed as a dependent by her parents.
e. Rodolfo, who is over 65 and is single.
f. Bernard, who is a nonresident alien with U.S. income.

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g. Manuel, who is 70, and Esther, who is 63 and blind, will file a joint return.
h. Herman, who is 75 and a qualifying widower with a dependent child.

Answer:

a. Christina, $12,000.
b. Adrian and Carol, $24,000. They do not get an additional amount for their son.
c. Peter and Elizabeth, $0. Since Elizabeth itemizes, Peter must also itemize so both are entitled to no standard deduction, only an itemized deduction.
d. Karen, $1,450 (her earned income plus $350).
e. Rodolfo, $13,600 ($12,000 + $1,600).
f. Bernard, $0, since he is a nonresident alien.
g. Manuel and Esther, $26,600 ($24,000 + $1,300 + $1,300). Each is entitled to an additional standard deduction; Manuel because he is over 65 and Esther because she is blind.
h. Herman, $25,300 ($24,000 + $1,300).

Learning Objective: 02-04
Topic: Standard Deduction
Difficulty: 2 Medium
Feedback:
EA: Yes

40. Using the appropriate tax tables or tax rate schedules, determine the amount of tax liability in each of the following instances.

a. A married couple filing jointly with taxable income of $32,991.
b. A married couple filing jointly with taxable income of $192,257.
c. A married couple filing separately, one spouse with taxable income of $43,885 and the other with $56,218.
d. A single person with taxable income of $79,436.
e. A single person with taxable income of $297,784.
f. A head of household with taxable income of $96,592.
g. A qualifying widow with taxable income of $14,019.
h. A married couple filing jointly with taxable income of $11,216.

Answer:

All answers rounded to the nearest dollar.

a. $3,576 from the tax table.
b. $34,721 from the tax rate schedule.
c. $5,592 and $8,309 from the tax table.
d. $13,413 from the tax table.
e. $79.914 from the tax rate schedule.
f. $16,076 from the tax table.
g. $1,403 from the tax table.
h. $1,123 from the tax table.

Learning Objective: 02-05

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Topic: Tax Computation
Difficulty: 3 Hard
Feedback:
EA: Yes

41. Determine the average tax rate and the marginal tax rate for each instance in question 40.

Answer:

Answers are rounded to the nearest tenth of a percent. Average rates are determined by dividing the tax liability by the taxable income. Marginal rates are determined by reference to the appropriate tax rate schedule.

a. Average = 10.8% Marginal = 12%
b. Average = 18.1% Marginal = 24%
c. Average = 12.7% and 14.8% Marginal = 22% and 22%
d. Average = 16.9% Marginal = 22%
e. Average = 26.8% Marginal = 35%
f. Average = 16.6% Marginal = 24%
g. Average = 10% Marginal = 10%
h. Average = 10% Marginal = 10%

Learning Objective: 02-05
Topic: Tax Computation
Difficulty: 3 Hard
Feedback:
EA: Yes

42. Using the appropriate tax tables or tax rate schedules, determine the tax liability for tax year 2018 in each of the following instances. In each case, assume the taxpayer can take only the standard deduction.

a. A single taxpayer with AGI of $23,493 and one dependent.
b. A single taxpayer with AGI of $169,783 and no dependents.
c. A married couple filing jointly with AGI of $39,945 and two dependents.
d. A married couple filing jointly with AGI of $162,288 and three dependents.
e. A married couple filing jointly with AGI of $301,947 and one dependent.
f. A taxpayer filing married filing separately with AGI of $68,996 and one dependent.
g. A qualifying widow, age 66, with AGI of $49,240 and one dependent.
h. A head of household with AGI of $14,392 and two dependents.
i. A head of household with AGI of $59,226 and one dependent.

Answer:

a. Taxpayer is entitled to a standard deduction of $12,000. Taxable income is $11,493 and tax liability is $1,187 according to the tax tables.

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b. Taxpayer is entitled to a standard deduction of $12,000. Taxable income is $157,783 and tax liability is $32,180 according to the tax rate schedules.
c. Taxpayer is entitled to a standard deduction of $24,000. Taxable income is $15,945 and tax is $1,593 according to the tax tables.
d. Taxpayer is entitled to a standard deduction of $24,000. Taxable income is $138,288 and tax is $22,302 according to the tax rate schedules.
e. Taxpayer is entitled to a standard deduction of $24,000. Taxable income is $277,947 and tax is $55,286 according to the tax rate schedules.
f. Taxpayer is entitled to a standard deduction of $12,000. Taxable income is $56,996 and tax is $8,474 according to the tax tables.
g. Taxpayer is entitled to a standard deduction of $25,300 ($24,000 + $1,300) Taxable income is $23,940 and tax is $2,490 according to the tax tables.
h. Taxpayer is entitled to a standard deduction of $18,000. Taxable income is zero and tax is zero.
i. Taxpayer is entitled to a standard deduction of $18,000. Taxable income is $41,226 and tax is $4,675 according to the tax tables.

Learning Objective: 02-05
Topic: Tax Computation
Difficulty: 3 Hard
Feedback:
EA: Yes

43. Victoria's 2018 tax return was due on April 15, 2019, but she did not file it until June 12, 2019. Victoria did not file an extension. The tax due on the tax return when filed was $8,500. In 2018, Victoria paid in $12,000 through withholding. Her 2017 tax liability was $11,500. Victoria's AGI for 2018 is less than $150,000. How much penalty will Victoria have to pay (disregard interest)?

Answer:

Victoria must pay a failure to file penalty and failure to pay penalty calculated as follows:

	$12,000	**withholding paid**
+	**$ 8,500**	**tax due**
	$20,500	**total tax for 2018**
	$ 8,500	**underpayment**
	x10%	**2 months late × 5% penalty per month (both penalties are combined)**
	$ 850	**Failure to file and pay penalties**

In order to avoid the underpayment penalty, Victoria must have paid the lesser of 90% of the current year's tax ($18,450) or 100% of the prior year's tax ($11,500). Since she paid $12,000 in withholding, she does not have to pay the underpayment penalty.

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Learning Objective: 02-06
Topic: Interest and Penalties
Difficulty: 3 Hard
Feedback:
EA: Yes

44. Paul has the following information:

AGI for 2018 = $155,000
Withholding for 2018 = $ 24,000
Total tax for 2017= $ 29,000
Total tax for 2018= $ 28,610

a. How much must Paul pay in estimated taxes to avoid a penalty?
b. If Paul paid $1,000 per quarter, would he have avoided the estimated tax penalty?

Answer:

a. In order to avoid the underpayment penalty, Paul must pay the lesser of 90% of the current year tax ($25,749) or 100% of the prior year's tax ($29,000). His withholding for 2018 will be $24,000. Thus, Paul must pay at least $1,749 in estimated payments in 2018.

b. Yes. Assuming Paul's income was earned evenly throughout the year, he would need to pay at least $437.25 (1,749 / 4) per quarter in estimated payments to avoid the estimated income tax penalty.

Learning Objective: 02-06
Topic: Interest and Penalties
Difficulty: 3 Hard
Feedback:
EA: Yes

45. Charles and Joan Thompson file a joint return. In 2017, they had taxable income of $92,370 and paid tax of $14,571. Charles is an advertising executive and Joan is a college professor. During the fall 2018 semester, Joan is planning to take a leave of absence without pay. The Thompsons expect their taxable income to drop to $70,000 in 2018. They expect their 2018 tax liability will be $8,022, which will be the approximate amount of their withholding. Joan anticipates that she will work on academic research during the fall semester.

During September, Joan decides to perform consulting services for some local businesses. Charles and Joan had not anticipated this development. Joan is paid a total of $35,000 during October, November, and December for her work.

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What estimated tax payments are Charles and Joan required to make, if any, for tax year 2018? Do you anticipate that the Thompsons will be required to pay an underpayment penalty when they file their 2018 tax return? Explain your answer.

Answer:

Charles and Joan will be required to make estimated payments for tax year 2018. Estimated payments are required equal to the lesser of 90% of the tax shown on the current year return (which we will calculate below) or 100% of the prior year tax (which was $14,571).

The amount of estimated payments required for tax year 2018 (using the tax rate schedules) is:
Estimated year 2018 taxable income is $105,000 ($70,000 + $35,000)

Tax on $77,400……	**$8,907.00**
Tax on $27,600 ($105,000 – $77,400) x 22%……	**6,072.00**

Estimated 2018 tax liability…..…….	**$14,979.00**
	x 90%

90% of estimated year 2018 tax liability…	**$13,481.10**
	========

Thus, Charles and Joan will need to pay estimated taxes based on $13,481.10 (which is the lesser of $14,571 or $13,481.10). Since they will have paid $8,022 in withholding payments, they will have to pay the difference of $5,459.10 in estimated payments. Because the tax liability shortfall was a result of income earned in the final quarter of the tax year, the estimated payment can be made in one payment on or before January 15, 2019.

If Charles and Joan make the estimated payment determined above, it is unlikely they will have an underpayment penalty on their year 2018 tax return.

Learning Objective: 02-06
Topic: Interest and Penalties
Difficulty: 3 Hard
Feedback:
EA: Yes

Tax Return Problems

Tax Return Problem #1

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The solutions to the chapter tax return problems can be found on the online learning center: www.mhhe.com/cruz2019

Tax Return Problem #2

The solutions to the chapter tax return problems can be found on the online learning center: www.mhhe.com/cruz2019

Tax Return Problem #3

The solutions to the chapter tax return problems can be found on the online learning center: www.mhhe.com/cruz2019

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CHAPTER 2

EXPANDED TAX FORMULA, FORM 1040, AND BASIC CONCEPTS

Learning Objectives

LO 1. Describe the expanded tax formula and the components of the major sections of Form 1040.
LO 2. Determine the proper filing status.
LO 3. Determine dependents.
LO 4. Determine the standard deduction.
LO 5. Compute the amount of tax due to the Internal Revenue Service (IRS).
LO 6. Determine what interest and penalties the IRS can assess and in what instances certain penalties are applicable.

Topics of Primary Importance

- Understanding the significance of choosing the proper filing status;
- Understanding the requirements for a qualifying child and a qualifying relative to be a dependent; and
- Understanding the computation of the tax liability, the tax or refund due, and the interest and penalties assessed by the IRS.

Student Confusion Areas

- Determining the qualifications to claim head of household status;
- Determining the requirements for a qualifying child and a qualifying relative; and
- Determining the failure to file and failure to pay penalties when both apply to the same tax return.

Note to Instructor

When using software, certain tax credits, such as the Child Tax Credit, may appear on the tax return even though we have not yet discussed tax credits. This occurs because the taxpayer may be entitled to the credits and the software will automatically include the credit on the final tax return. In general, tax credits are discussed in Chapter 9.

Notes Outline

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I. LO 1 –Major Sections of Form 1040

A. Chapter one introduced a very simple tax formula that will be expanded in this chapter to address more complex situations.

The basic Form 1040 in Exhibit 2-1 of the text contains lines for items most commonly used by taxpayers. Some individuals will be able to file a return using only the basic 1040. However, many taxpayers have a more-complex tax situation. The basic Form 1040 is supplemented by six Schedules (Schedule 1, Schedule 2, etc.). These Schedules provide much more detail to cover almost any tax situation. We provide copies of Schedule 1 through Schedule 6 in Exhibit 2-2 of the text.

The more commonly used Schedules are 1, 3, and 4 although particularly complex tax returns could require the use all the Schedules.

B. By analyzing the Form 1040, the expanded tax formula can better be seen:

Gross Income (GI)
- Permitted deductions from gross income
= Adjusted Gross Income (AGI)
- Standard deduction or itemized deductions
= Taxable income (TI)
x Appropriate tax rates
= Tax liability
- Tax credits
+ Other taxes
- Tax payments and refundable credits
= Tax refund or tax due with return

C. Adjusted gross income (AGI) is an extremely important concept because many deductions and credits are determined with reference to it.

II. LO 2 – Filing Status

A. There are five filing statuses:

1. Single
    a. Taxpayer is not married and does not qualify for head of household or qualifying widow(er) status.
    b. Divorce or separate maintenance decree must be legally executed on or before December 31st of the tax year.
    c. Marital status is determined on the last day of the tax year.
2. Married filing jointly
    a. Taxpayer must be legally married as of the last day of the tax year.

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b. Joint filing is permitted even though only one spouse earns all the income.
c. A surviving spouse can file jointly if he or she has not remarried as of December31st of the tax year when the spouse died.
d. If one of the spouses is a nonresident alien, generally a joint return cannot be filed.

3. Married filing separately
   a. Taxpayer must be legally married as of the last day of the tax year to select this filing status.
   b. Name and social security number of the other spouse must be listed on the taxpayer's tax return.
   c. Both spouses must take the standard deduction, or must itemize deductions when filing separately; they cannot choose independent from each other.
4. Head of household
   a. Taxpayer must be unmarried as of the last day of the tax year (there are certain rules for an abandoned spouse), be a U.S. citizen or resident throughout the year, not be a qualifying widow(er), and maintain a household that is the principal place of abode of a qualifying person for more than half of the year.
   b. A qualifying person can be a qualifying child or a qualifying relative.
   c. For a qualifying child:
      i. If the child is single, he or she does not have to be a dependent of the taxpayer.
      ii. If the child is married, he or she must be a dependent of the taxpayer.
   d. For a qualifying relative:
      i. Mother or father must be a dependent of the taxpayer, but there is no requirement for them to live in the taxpayer's home.
      ii. Other qualifying relatives must be dependents of the taxpayer and live in the taxpayer's home for more than half the year. It is important to understand that a person who is a qualifying relative only because he or she lived with the taxpayer all year as a member of his or her household is not a qualifying person for head of household status, as shown in Exhibit 2-3 of the text; also see IRS Pub 17 for more details.
5. Qualifying widow(er) with dependent child
   a. Taxpayer was eligible to file a joint return in the tax year the spouse died.
   b. Taxpayer must be unmarried as of the last day of the tax year.
   c. Dependent child must live with the taxpayer for the entire year (except for temporary absences).

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d. Taxpayer must pay more than half the cost of keeping up a household.
e. Status is only available for two years (the year the spouse died and the following year).

In-class Example – A surviving spouse who qualified as married filing jointly when the spouse died and has filed as a qualifying widow(er) for the next year can use the qualifying widow(er) status for the third year even though the child does not live at home and is not a dependent anymore. Is this true?
For the third year, the surviving spouse cannot file as qualifying widow(er) because all the required conditions for this filing status are not met. The surviving spouse must file single.

III. **LO 3 – Dependents**

A. Taxpayer can claim a dependent if the person is a qualifying child or a qualifying relative and meets the following tests:
1. Dependent taxpayer test
    a. The qualifying child or qualifying relative cannot be claimed as a dependent by someone else.
2. Joint return test
    a. The qualifying child or qualifying relative cannot file a joint tax return, unless this person files a joint tax return simply to claim a refund and there is no tax liability on the return.
3. Citizen or resident test
    a. The qualifying child or qualifying relative must be a U.S. citizen, resident, or national; a resident of Canada or Mexico; or an adopted child of the taxpayer if the child is a member of the taxpayer's household all year and the taxpayer is a U.S. citizen or national.

B. Who is a qualifying child?
To be considered a qualifying child, the following tests must be met:
1. Relationship test
    a. Child or descendant of child (grandchild or great-grandchild), stepchild, eligible foster child, brother, sister, half-brother, half-sister, stepbrother, or stepsister, or a descendant of them.
        i. A child includes an adopted child and includes a child placed for adoption in the taxpayer's household by an authorized adoption agency even if the adoption is not finalized.
2. Age test
    a. Under the age of 19.
    b. Under the age of 24 and a full-time student.
    c. Totally and permanently disabled regardless of age.

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For years after 2008, the child must be younger than the person claiming the dependency.

3. Residency test
    a. Child must live with the taxpayer for more than half the year, except for temporary absences.
4. Support test
    a. Child must not provide more than half of his or her support. Notice that this is different from the requirement under a qualifying relative.
5. Special test for qualifying child of more than one taxpayer
    a. Only one taxpayer can claim the child as a qualifying child. IRS will use the tie-breaker rules, as shown in Exhibit 2-4 of the text, to determine who is entitled to claim the child if the taxpayers involved cannot make a decision by themselves.

C. Who is a qualifying relative?

To be considered a qualifying relative, the following tests must be met:

1. Not a qualifying child test
    a. A qualifying relative cannot be a qualifying child of the taxpayer or someone else.
2. Relationship or member of household test
    a. A qualifying relative must be a member of the taxpayer's household for the entire year, or be related to the taxpayer. Only certain persons are considered related to the taxpayer.
        i. Child or descendant of child (grandchild or great-grandchild), stepchild, eligible foster child, brother, sister, half-brother, half-sister, or a descendant of them, stepbrother or stepsister, father or mother, brother or sister of parents, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
        Note that if someone is related to the taxpayer (as indicated in the preceding list), it is not necessary that the person live with the taxpayer for the entire year or, actually, any part of the year. But it may be difficult to meet the support test if the individual does not live in the household.
3. Gross income test
    a. A qualifying relative cannot have gross income equal to or greater than $4,050.
4. Support test
    a. Taxpayer must provide over 50% of the qualifying relative's support.
    b. There are two exceptions: Multiple support agreement and child of divorced or separated parents. For a more detailed explanation, refer to pages 2-14, 2-15 and 2-16 of the text.

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IV. **LO 4 – Standard Deduction**

A. The standard deduction is the sum of the basic standard deduction and the additional standard deduction. Both components depend on filing status and are subject to annual adjustment for inflation.

1. The basic standard deduction for tax year 2018 is as follows:

Filing Status	Basic Standard Deduction
Single	$12,000
Married filing jointly	24,000
Married filing separately	12,000
Head of household	18,000
Qualifying widow(erg)	24,000

2. The additional standard deductions for taxpayers who are 65 or older or blind are:

Filing Status	Tax Year 2018
Single	$ 1,600
Married filing jointly	1,300
Married filing separately	1,300
Head of household	1,600
Qualifying widow(er)	1,300

3. The standard deduction is zero if any of the following situations occur:
   a. A married couple files separate returns and one spouse itemizes deductions.
   b. The taxpayer is a nonresident alien.
   c. A taxpayer files a return for a period of less than 12 months because of a change in accounting period.

V. **LO 5 – Refund or Tax Due**

A. Tax amount (line 11 on Form 1040)
   1. Tax tables are used by most taxpayers with taxable income of less than $100,000.
   2. Taxpayers with $100,000 or more use the tax rate schedules.

B. Tax liability (line 15 on Form 1040)

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1. Represents total amount the taxpayer must pay to the government for the tax year.

C. Tax payments (lines 16-17 on Form 1040)
1. Most of these payments are submitted in advance to the IRS.
a. Examples are: income tax withholdings and quarterly estimated tax payments.
b. There is an underpayment penalty for not submitting the appropriate amount to the IRS in a timely manner.

D. Tax Refund (line 20a on Form 1040) or Tax Due with Return (line 22 on Form 1040)
1. Excess payment results in a refund.
2. Excess remaining tax liability means the taxpayer must pay the additional amount of tax to the IRS.

VI. **LO 6 – Interest and Penalties**

A. The following sections show interest charged on assessments and the most common civil and criminal penalties applicable to individual tax returns.
1. Interest charged on assessments

Time Period	Percentage Rate
Apr. 1, 2018 to June 30, 2018	5%
Jan. 1, 2017 to Mar. 31, 2018	4
Apr. 1, 2016 to Dec. 31, 2016	4
July 1, 2015 to Mar. 31, 2016	3
Oct. 1, 2011 to June 30, 2015	3
Apr. 1, 2011 to Sept. 30, 2011	4
Jan.1, 2011 to Mar. 31, 2011	3
Apr. 1, 2009 to Dec. 31, 2010	4
Jan. 1, 2009 to Mar. 31, 2009	5
Oct. 1, 2008 to Dec. 31, 2008	6
July 1, 2008 to Sept. 30, 2008	5
Apr. 1, 2008 to June 30, 2008	6
Jan. 1, 2008 to Mar. 31, 2008	7
July 1, 2007 to Dec. 31, 2007	8
July 1, 2006 to June 30, 2007	8
Oct. 1, 2005 to June 30, 2006	7
Apr 1, 2005 to Sept. 30, 2005	6

B. Failure to File Tax Penalty and Failure to Pay Tax Penalty
1. Failure to file tax penalty

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a. The 5% penalty is based on the amount of tax due for each month or fraction of a month, up to a maximum of 25%.
b. Any income tax return not filed within 60 days of its due date is subject to a minimum penalty of the lesser of $210 or the amount of tax required on the return.

2. Failure to pay penalty
   a. The ½% penalty is based on the amount of tax due for each month or fraction of a month, up to a maximum of 25%.
3. *Caution:* When both penalties apply, the total percentage is 5% per month or fraction of a month, up to a maximum of 25%.

C. Failure to Pay Estimated Income Tax
1. Taxpayer must pay during the year, either through withholding or estimated payments, a minimum of the following:
   a. 90% of the current year's tax liability.
   b. 100% of the prior year's tax liability if the taxpayer's AGI in the prior year is less than $150,000. If the taxpayer's prior year AGI is more than $150,000, the percentage for the prior year rule increases to 110%.
2. Estimated payments can be made on a quarterly basis: April 15, June 15, September 15 in the current year, and January 15 of the next calendar year.
3. No estimated tax penalty applies if the tax due after withholding or estimated payments is less than $1,000.
4. Form 2210 is used to calculate the failure to pay estimated tax penalty.

D. Accuracy-Related Penalties
1. A penalty can be assessed if negligence or any substantial understatement of income occurs.
2. Negligence can be defined as any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code (IRC), including any careless, reckless, or intentional disregard for tax authority.
3. Substantial understatement occurs when the understatement is either more than 10% of the tax required to be shown on the return or $5,000 or more.
4. IRS can assess a penalty equal to 20% of the tax due when negligence or substantial understatement occurs.

E. Fraud Penalties
1. The Internal Revenue Code (IRC) does not define fraud but one court, as explained on page 2-26 of the text, has defined it as intentional wrongdoing with the purpose of evading tax.
2. IRS can impose a 75% penalty on any portion of understatement of tax that is attributable to fraud.
3. Criminal penalties can be assessed in addition to civil penalties.

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F. Erroneous Claim for Refund or Credit Penalty

1. A 20% penalty could be assessed by the IRS on the disallowed amount of the claim if the claim for refund or credit of income filed is found to be excessive. An amount for a claim is classified as "excessive" if the claim amount exceeds the amount of the allowable claim.
2. This penalty does not apply if the fraud or the accuracy-related penalty has been assessed.

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