Concepts in Federal Taxation 2019 26th edition Murphy Solutions Manual

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CHAPTER 2

INCOME TAX CONCEPTS

2019 Edition	Topic	Status
Questions		
1	Income tax as a system	Unchanged
2	Ability-to-pay concept	Unchanged
3	Arm's-length transaction concept	Unchanged
4	Relationship of arm's-length concept and related party construct	Unchanged
5	Pay-as-you-go concept	Unchanged
6	Taxable entity versus conduit entity	Unchanged
7	Tax benefit rule	Unchanged
8	Accounting methods	Unchanged
9	Capital recovery concept/income recognition	Unchanged
10	Basis for calculation of gross income	Unchanged
11	Capital gain versus ordinary income	Unchanged
12	Constructive receipt doctrine	Unchanged
13	Wherewithal-to-pay concept versus ability-to-pay concept	Unchanged
14	Application of business purpose concept to determine deductions	Unchanged
15	Capital expenditures	Unchanged
16	Legislative grace concept/difference in application to income and deductions	Unchanged
17	Capital recovery concept/difference in application to income and deductions	Unchanged
Problems		
18	Ability-to-pay concept - four scenarios	Unchanged
19	Ability-to-pay concept - four scenarios	Unchanged
20-CT	Calculation and comparison of tax paid by single versus married taxpayer/discuss ability-to-pay concept	Unchanged

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2019 Edition	Topic	Status
21-CT	Ability-to-pay concept - rationale for difference in tax paid	Unchanged
22	Related parties - individuals, corporations, partnership	Unchanged
23	Related parties - corporations and partnerships	Unchanged
24-COMM	Related party sale - corporations controlled by same individuals	Unchanged
25	Entity concept - segregation of income and expenses	Unchanged
26	Entity concept - segregation of income and expenses	Unchanged
27	Taxation of conduit entities	Unchanged
28	Taxability of corporation versus S corporation	Unchanged
29-COMM	Use of entities	Unchanged
30	Partnership income taxation	Unchanged
31	Assignment of income	Unchanged
32-COMM	Assignment of income	Unchanged
33	Income recognition - cash versus accrual	Unchanged
34	Income recognition - cash versus accrual	Unchanged
35	Tax benefit rule with an application of state tax refund	Unchanged
36	Tax benefit rule	Unchanged
37	Substance-over-form application to a loan	Unchanged
38	Identification of concepts with actual tax treatments	Unchanged
39	Identification of concepts with actual tax treatments	Unchanged
40	Calculation of gain/loss on sale of depreciable assets	Unchanged
41	Long-term capital gains	Unchanged
42	Capital losses - effect of annual limitation	Unchanged
43	Realization concept - four scenarios	Unchanged
44	Realization concept - four scenarios	Unchanged
45-CT	Claim of right	Unchanged

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2019 Edition	Topic	Status
46	Claim of right - four scenarios	Unchanged
47	Claim of right - four scenarios	Unchanged
48	Constructive receipt - contrasting treatments	Unchanged
49	Constructive receipt - three scenarios	Unchanged
50	Realization-provide rationale for five scenarios	Unchanged
51-CT	When should income be recognized	Unchanged
52	Income recognition - provide rationale for four scenarios	Unchanged
53	Mixed-use expenditures -home office	Unchanged
54	Deduction concepts - provide rationale for four scenarios	Unchanged
55	Deduction concepts - provide rationale for four scenarios	Unchanged
56-COMM	Business purpose	Unchanged
57	Differences in treatment of expenses/business versus personal	Unchanged
58-CT	Differences in treatment of personal/ investment/ business loss	Unchanged
59	Calculation of loss on casualty/effect on basis	Unchanged
60	Capital expenditures - four scenarios	Unchanged
61	Basis - four scenarios	Unchanged
62-CT	Timing of deductions - cash versus accrual	Unchanged
IID-63	Related parties - effect of transactions	Unchanged
IID-64	Application of entity concept and related parties to 100% owned corporation	Unchanged
IID-65	Assignment of income/substance-over-form	Unchanged
IID-66	Deductibility of expenses – substance over form	Unchanged
IID-67	Income realization	Unchanged
IID-68	Claim of right	Unchanged
IID-69	Constructive receipt	Unchanged

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2019 Edition	Topic	Status
IID-70	Deductibility of mixed-use expenses	Unchanged
IID-71	Mixed-use expenditures - vacation home	Unchanged
72	RIA Research Exercise	Unchanged
73	RIA Research Exercise	Unchanged
74	INTERNET	Unchanged
75	INTERNET	Unchanged
76	Research Problem	Unchanged
77	Research Problem	Unchanged
78-TFP	Tax Forms Problem – Preparation of 1040EZ	Unchanged
79-DC	Deductibility of oil restoration costs/compare financial accounting with tax accounting	Unchanged
80-TPC	Substance-over-form application to sale of property	Unchanged
81-TPC	A 3-year projection of the tax effect of using a corporation versus a partnership for a new business	Unchanged
82-EDC	Possible under reporting of S corporation income - application of SSTS #3 and SSTS #1	Unchanged

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CHAPTER 2

INCOME TAX CONCEPTS

DISCUSSION QUESTIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

15. What is a capital expenditure?

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

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

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

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

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

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

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

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

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PROBLEMS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

A 10-cent per gallon gasoline tax is a proportional tax. Proportional taxes do not consider the ability-to-pay concept because all taxpayers pay the same tax rate. Giving low-income taxpayers a tax credit lowers their rate making the tax partially based on the ability to pay. However, for the range of taxpayers who do not get credit for the gasoline tax they pay, the tax is not based on ability to pay. Within this range, high-income taxpayers may pay the same tax rate as taxpayers who have incomes that are relatively lower.

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

Sheila's tax is $18,290. Adam and Tanya's tax is $13,879.

Single rate schedule:

Sheila $14,089.50 + [24% x ($100,000 - $82,500)] = $18,290

Married rate schedule:

Adam & Tanya $8,907 + [22% x ($100,000 - $77,400)] = $13,879

The difference in the tax rate schedules for single and married taxpayers reflects the greater ability to pay tax by single taxpayers at the same income level as married taxpayers. However, in this case, the rate schedules do not adjust for the difference in economic incomes. Sheila's economic income is $130,000 ($100,000 taxable income + $30,000 tax-exempt income). Her effective tax rate on this income is 14.06% ($18,290 ÷ $130,000) versus a 13.88% ($13,879 ÷ $100,000) effective tax rate on Adam and Tanya's economic income. Therefore, even though the tax rate structures reflect the ability-to-pay concept, other provisions in the tax law that exclude items from income serve to negate the effect of the tax rate structures.

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

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

1. **Marital Status - If one taxpayer is married and the other is single, the single individual will pay more tax on the same amount of income than a married couple.**

2. **Deductions - If one taxpayer has more allowable deductions, then he or she will pay less tax on the same total income. This could be the result of either one taxpayer having strictly more deductible items, or one taxpayer itemizing their allowable personal deductions and the other taking the standard deduction.**

3. **Tax Credits - If one taxpayer has tax credits that the other does not (or more than the other), then his or her tax will be less.**

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22. Which of the following are related parties?

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

a. Harvey and his sister Janice?

A sister is a related party.

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

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

c. Harvey and his grandfather Maurice?

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

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

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

e. Harvey and his uncle Elmer?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

g. Advertising in the local newspaper, $800

The advertising cost is deductible as a business expense.

h. Interest paid on home furniture loan, $600

Not deductible. Personal interest, other than that on a home mortgage, is not deductible.

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

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

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

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

b. Property taxes, $1,800.

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

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

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

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

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

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

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

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

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

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

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

a. 3-Star Partnership

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

b. Aiko

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

c. Lani

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

d. Charlie

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

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

a. A corporation?

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

b. An S corporation?

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

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

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

One possible way for Binh to take advantage of marginal tax rate differentials is to organize his businesses into a single corporation (not an S corporation) and pay himself a salary. The salary will be income for Binh and deductible by the corporation. This will split the income into two taxable streams - Binh at individual rates and the corporation at the corporate rate of 21%.

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

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30. Christie purchases a one-third interest in the Corporate Capital Partnership (CCP) in 2017 for $40,000. During 2017, CCP earns an income of $90,000, and Christie withdraws $30,000 in cash from the partnership. In 2018, CCP suffers a loss of $30,000, and Christie withdraws $10,000. What are the tax consequences for Christie of this investment in 2017 and 2018?

Christie will include her share of the partnership income, $30,000 ($90,000 x 1/3), on her individual return in 2017 and deduct her share of the partnership loss, $10,000 ($30,000 x 1/3) in 2018. The cash withdrawals do not affect the taxability of the income from the partnership. It should be noted that Christie may not be able to deduct the loss in 2018 if the activity is considered passive. The limitations on passive loss deductions are covered in Chapter 7.

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

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

32. Esmeralda is an attorney. Before 2018, she is employed by the law firm of Ellis and Morgan (E&M). Esmeralda is not a partner in E&M; her compensation consists of a fixed salary and a percentage of any fees generated by clients she brings or refers to the firm. In January 2018, she becomes a partner in the law firm of Thomas, Gooch, and Frankel (TGF). As a partner, Esmeralda agrees to turn over to TGF any income from the practice of law from the date of her admittance to the practice. In leaving E&M, it is agreed that she will continue to receive her percentage of fees from clients she referred to E&M during her employment there. In return, Esmeralda agrees that, upon request she will consult with E&M attorney's regarding these clients. During 2018, she consults with 2 of her former E&M clients and receives $12,000 from E&M per their agreement. The $12,000 consists of $10,000 as a percentage of fees for client referrals after she left E&M and $2,000 as a percentage for work done before she left E&M. Esmeralda turned the $12,000 over to TGF per her partnership agreement. Write a letter to Esmeralda explaining whether she is taxed on the $12,000 she receives from E&M.

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

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

a. Tindle Corporation purchases office supplies costing $600 on December 21, 2018. Tindle pays for the office supplies on January 18, 2019.

The office supplies are not deductible by a cash basis taxpayer until they are paid for in 2019. An accrual basis taxpayer can deduct supplies purchased but not yet paid for in 2018.

b. Raashan pays his employee, Sara, $22,450 in salary up to December 23, 2018. As of December 31, 2018. Raashan owes Sara $560 for the period of December 23 through December 31. The $560 is to be paid on the next pay date, which is January 5, 2019.

A cash basis taxpayer is only allowed to deduct the actual $22,450 paid in 2018. The $560 Sara has earned, but not yet received will be deductible when paid in 2019 by a cash basis taxpayer. An accrual basis taxpayer is allowed to deduct the $22,450 paid plus the $560 that has been incurred through December 31, 2018 but not yet paid.

c. Jerri paints Roland's house in December 2018. Roland pays Jerri's bill in January 2019.

A cash basis taxpayer will not recognize the income from painting the house until it is received in 2019. An accrual basis taxpayer recognizes the painting income in 2018 when it is earned. If the painting cost is deductible, a cash basis taxpayer will deduct the cost when it is paid in 2019. An accrual basis taxpayer deducts the cost when incurred in 2018.

d. Devi sells Aaron a car on August 1, 2018, for $36,000. The terms of the sale call for Aaron to pay Devi $18,000 on August 1, 2018, and $9,000 on August 1 of 2019 and 2020.

A cash basis taxpayer will recognize the income from the sale of the car as the cash is received - one-half of the gain will be recognized in 2018 and one-fourth of the gain in 2019 and 2020. An accrual basis taxpayer will recognize all income from the sale when it is earned in 2018.

e. Barnie's Paint Barn purchases new spray painters on January 15, 2018, at a cost of $3,000. The spray painters have an estimated useful life of 10 years, but the tax life is 5 years.

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

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

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

a. Helen fixes Mark's plumbing in November 2018. Mark receives the bill in December 2018 but does not pay Helen until January 2019.

If Helen uses the cash basis, she will recognize the income when she is paid in January. If she uses the accrual basis, she will recognize the income when it is earned in 2018. If the plumbing expense is deductible by Mark, he will deduct it in 2019 (when paid) if he uses the cash basis and in 2018 (when incurred) if he is an accrual basis taxpayer.

b. The Outback Brewing Company purchases a new delivery van on October 30, 2018. The purchase is financed with a note that will be paid off over 3 years. Outback expects to use the van for 3 years, but the tax life of the van is 5 years.

Because the delivery van has a life that extends substantially beyond the end of 2018, its cost must be capitalized and deducted through depreciation charges over its 5 year tax life. Both cash and accrual basis taxpayers must capitalize such expenditures.

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

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

d. Maury's Computer Consultants, Inc. performs work for Janis in 2018. Maury's bills Janis in 2018, but no payment is received. In 2019, Janis files for bankruptcy, and Maury's determines that it will be able to collect nothing on her account.

If Maury's uses the cash basis, no income will be recognized because it does not receive any payments. Because no income has been recognized, a cash basis taxpayer will not get a deduction for the bad debt. If Maury's is an accrual basis taxpayer, it must recognize the income from the services in 2018. When it is determined that the account is uncollectible in 2019, Maury's will be allowed a deduction for the bad debt to offset the income recognized in 2018.

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35. Tim has state income taxes of $4,500 withheld from his salary during 2017. On his 2017 federal income tax return, Tim properly deducts the $4,500 as state taxes paid. Upon filing his 2017 state income tax return, he determines that his actual state income tax for 2017 is only $3,900, and the state sends him a $600 refund. What are the tax consequences of the refund? Explain in terms of the concepts presented in the chapter.

This is a classic example of the tax benefit rule that taxes any amount deducted in a previous year as income in the year of recovery to the extent that a tax benefit was received from the recovered amount. Because Tim took a deduction for the entire $4,500 withheld, any refund of the state taxes must be included in income in the year of the refund. In this case, the $600 refund is taxable in 2018. Note that the annual accounting period concept does not allow Tim to go back and amend his 2017 return for the refund, because the events of each tax year are deemed to stand apart from each other.

In working this problem, you may want to note that if, under the administrative convenience concept, Tim had not itemized his deductions (i.e., he used the standard deduction in 2017) he would not have to claim the $600 refund as income in 2018 because he did not take an actual deduction for the state income taxes. In addition, if Tim's itemized deductions did not exceed his standard deduction by more than $600, then only the excess of Tim's actual deductions over the standard deduction would be income under the tax benefit rule. For example, if Tim's 2017 total itemized deductions were $6,750, then only $400 of the refund would be income. This is the excess of total deductions over the 2017 standard deduction for a single individual ($6,750 - $6,350).

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

Because Tim is a cash basis taxpayer, he must take deductions in the year in which the allowable expense is paid. In this case, the additional $400 in 2017 state tax is paid in 2018. Under the annual accounting period concept, Tim cannot go back and amend his 2017 state tax deduction for taxes paid in 2018. Tim must deduct the taxes in 2018, the year that he pays the taxes.

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36. Jamal Corporation is an accrual basis taxpayer. In 2017, Jamal writes off a $1,000 account receivable from a customer who has died. In 2018, the former customer's estate sends Jamal a check for $600. What are the tax effects of the receipt of the $600 in 2018? Explain.

Because Jamal Corporation took a $1,000 bad debt deduction in 2017, the subsequent recovery of the $600 in 2018 will be included as income in 2018 under the tax benefit rule. This will give Jamal the correct income on the receivable over the tax periods involved. For example, assume that the receivable was generated in 2016. As an accrual basis taxpayer, Jamal would have included the $1,000 as income in 2016. In 2017, when it discovered that the customer had died and Jamal did not expect to collect the receivable, Jamal would deduct the $1,000, canceling out the income recognized in 2016. The $600 receipt in 2018 represents the amount of income actually received from the customer. Because the deduction in 2017 effectively eliminated any income recognition from the customer, the entire $600 is income in 2018 when it is received.

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

If Jamal Corporation is a cash basis taxpayer, it would not have previously recognized any income from the receivable. Therefore, Jamal would not be allowed a bad debt deduction in 2017. Thus, the corporation would include the $600 in income when the cash from the receivable was actually received in 2018.

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

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

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

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

a. Lester purchases some stock for a total cost of $2,500. On December 31, 2017, the stock is worth $2,800. In August 2018, he sells the stock to his brother Rufus for $2,000. Lester has no income from the stock in 2017, and he is not allowed to deduct the $500 loss on the sale of the stock to Rufus in 2018.

The realization concept is responsible for not recognizing the gain in market value in 2017. Lester will not recognize any gain or loss on the stock until it is realized through sale or other disposition. The nonrecognition of loss on the sale to Rufus is due to the related party rules. Because Rufus is a related party, losses on any sales to him would be disallowed. That is, related parties are assumed not to transact at arm's-length when losses are involved.

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

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

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

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

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

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

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

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

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

b. The Parsnip Partnership is an accrual basis taxpayer. During 2017, Parsnip deducted as a bad debt expense a $5,000 account receivable that it determined it could not collect. In 2018, Parsnip receives a $1,000 payment on the account. Parsnip must include the $1,000 in its 2018 gross income.

Under the Tax Benefit Rule, any deduction that is recovered in a subsequent tax year must be included in income to the extent that a tax benefit was received from the deduction in the prior tax year. Because Parsnip deducted the $1,000 as a bad debt in 2017, it must include the $1,000 payment as income in 2018.

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

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

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

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

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40. Postum Partnership purchases a building in 2015 for $250,000. It deducts $5,600 in depreciation on the building in 2015, $6,400 in 2016, $6,400 in 2017, and $3,200 in 2018. It sells the building in 2018 for $260,000. What is the partnership's gain or loss on the sale of the building?

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

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

41. Chelsea, who is single, purchases land for investment purposes in 2013 at a cost of $22,000. In 2018, she sells the land for $38,000. Chelsea's taxable income without considering the land sale is $100,000. What is the effect of the sale of the land on her taxable income, and what is her tax liability?

Land held for investment is a capital asset. The sale of the land results in a $16,000 ($38,000 - $22,000) long-term capital gain. Assuming that she has no other capital gains or losses in 2018, her taxable income increases by the amount of the gain to $116,000 ($16,000 + $100,000). However, net long-term capital gains are taxed at 15%. Therefore, the $16,000 long-term capital gain is taxed separately at the 15% long-term capital gain rate. This results in a total tax of $20,689.50:

Tax on $100,000 - $14,089.50 + [24% x ($100,000 - $82,500)]	**=**	**$18,289.50**
Tax on $16,000 long-term capital gain - $16,000 x 15%	**=**	**2,400.00**
Total tax liability		**$20,689.50**

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42. George purchases stock in Dodo Corporation in 2014 at a cost of $50,000. In 2018, he sells the stock for $32,000. What is the effect of the sale of stock on George's taxable income? Assume that George sells no other assets in 2018.

The sale of stock results in a loss of $18,000 ($32,000 - $50,000). Stock is a capital asset and the loss would be a capital loss. The maximum deduction for a net capital loss of an individual is $3,000 per year. Any excess loss that is not deducted is carried forward and deducted in subsequent years. Therefore, George will only be able to deduct $3,000 of the loss in 2018 with the remaining $15,000 carried forward to 2019. Thus, his taxable income will decrease by $3,000 in 2018.

If George has no capital asset sales in 2019, he will deduct $3,000 of the $12,000 loss carried forward from 2018. The remaining $9,000 of capital loss is then carried forward to 2020.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

b. In 2016, Retro Fit Construction Company purchased equipment by borrowing $100,000 from Fifth State Bank. After paying off $30,000 of the loan, Retro has financial problems in the current year and cannot afford to make its regular payment. Rather than have Retro default on the loan, Fifth State Bank agrees to reduce the debt to $50,000.

When Retro borrowed the $100,000 in 2016, it did not have a claim of right because it was under an obligation to repay the loan. When the loan is reduced to $50,000, Retro acquires a claim of right to the $20,000 ($100,000 - $30,000 - $50,000) that it is no longer obligated to repay.

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

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

d. Alexander Associates does computer consulting for Bertman, Inc., in September. Bertman pays Alexander's $3,000 bill for the work in October 2018. In late November, Bertman's computer system crashes and Bertman sues Alexander, seeking reimbursement of $3,000. The lawsuit is scheduled for court in March 2019.

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

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48. Consider the following two situations. Although they are similar, their treatments are exactly opposite. Identify the concept underlying both treatments, and explain why the concept treats the two situations differently.

    a. Sam is an employee of Dunbar Company. The company regularly mails salary checks to employees to arrive on or before the last day of each month. Sam's regular paycheck arrives at his house on December 31, 2018, but Sam is away on a ski trip and does not return until January 2, 2019. Sam deposits the check in his bank account the following day. The check is included in Sam's 2018 income.

    b. Percy is an employee of Daly Company. In November 2018, Percy's position is eliminated in a "streamlining" of company costs. As part of the cost reduction program, Percy is entitled to severance pay; however, his boss tells him that it will be 3 or 4 months before the severance payments are made. The check arrives by mail on December 31, 2018, while Percy is away on a ski trip. He returns on January 2, 2019, and deposits the check in his bank account the following day. The severance pay check is not taxable until 2019.

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

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

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

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

a. Norman is president of Wright Company. On December 14, 2018, the board of directors votes to give him a $25,000 bonus. Norman receives the bonus on January 4, 2019.

Norman is not in constructive receipt of the bonus in 2018. The bonus is not available for Norman's use until it is received in 2019.

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

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

c. Marnie owns $50,000 par value of 6% coupon bonds. The interest coupons may be clipped and redeemed on May 30 and November 30 each year. Marnie does not redeem the November 30, 2018, coupon interest until January 8, 2019.

Marnie is in constructive receipt of the November 30, 2018, interest payment and must include the $1,500 [$50,000 x 6% x (6 ÷ 12)] interest payment in her 2018 income. The interest payment is available for her use on November 30, 2018 and is taxed at that time, regardless of when she actually receives the payment.

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

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

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

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

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

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

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

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

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

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

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

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

a. List three points at which Nina might recognize income from the improvements made by Downtown Computer Systems.

The 3 possible recognition points are:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

a. Individuals are allowed to deduct medical expenses.

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

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

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

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

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

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

Ray's loss is personal in nature and would not be allowed under the general rule disallowing personal expenditures (legislative grace concept). Congress has provided limited relief in this area, but only to the extent that the loss exceeds $100 and 10% of the taxpayers adjusted gross income. For tax years beginning after December 31, 2017, the personal casualty and theft loss deduction is suspended except for personal casualty losses incurred from a federally-declared disaster. Casualty and theft losses are discussed in Chapter 7.

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

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

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

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

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

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

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

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

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

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56. Sidney lives in Hayes, Kansas. He owns land in Cotulla, Texas, that he inherited from his father several years ago. The land is unimproved and has never produced income. On January 26, 2018, Sidney receives a statement of delinquent taxes on the property for 2015, 2016, and 2017 for $120. On February 10, 2018, Sidney and his wife, Ellen, start to drive to Cotulla; they arrive on February 20 and pay the taxes on the same day. The cost of the trip for Sidney and Ellen is $450. Sidney and Ellen would like to deduct the cost of the trip. Write a letter to Sidney and Ellen in which you explain what they can deduct.

To be deductible, an expenditure must have a business purpose. This is interpreted to mean that the primary motive for the expenditure is to make a profit. The tax law allows the deduction of all ordinary and necessary trade or business expenses. Therefore, the cost of the trip does not have a business purpose and is not deductible, even though it relates to income producing property. Property taxes, even if personal, are deductible as an itemized deduction (subject to a $10,000 limitation discussed in chapter 8).

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

The difference in the three situations is the purpose of the expenditures. All expenditures must be classified as either incurred in a profit making venture or personal expenses. Profit making expenses are generally classified as being either a trade or business expense or an investment related expense. Trade or business expenses are fully deductible. Prior to January 1, 2018, investment related expenses (other than rental or royalty expenses) were deductible miscellaneous itemized deductions subject to a 2% of adjusted gross income limitation. That deduction has been suspended for tax years starting after December 31, 2017 and ending on December 31, 2025. The treatments within each category are illustrated in the problem.

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

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

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

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

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

Melody's legal fees are related to her investment activities and are not deductible.

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

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

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

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

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

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

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

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

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59. A truck owned by Duster Demolition Services is involved in an accident. The truck originally cost $40,000, and $25,000 of depreciation had been taken on the truck as of the date of the accident. The cost of repairing the truck is $10,000, for which the insurance company reimburses Duster $8,000.

a. How much of a loss, if any, is Duster entitled to deduct as a result of the accident?

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

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

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

Basis at time of accident: ($40,000 - $25,000)	**$ 15,000**
Add: Cost of repairs	**10,000**
Deduct: Insurance recovery	**(8,000)**
Loss deduction	**(2,000)**
Basis after accident	**$ 15,000**

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

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

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

The land has a life that extends substantially beyond the end of the tax year and its $8,000 cost must be capitalized. The $2,000 cost of utility and sewer lines must also be capitalized as part of the cost of the land because they provide benefits that extend substantially beyond the end of the current year. The interest on the loan relates only to the current year and is deductible if the land is used in a trade or business or a production of income (investment) activity. The interest also is deductible (as an itemized deduction) if the land is used to construct Zoe's personal residence. The property taxes relate only to the current year and are deductible expenses regardless of the use of the land. However, if the land is not used in a trade or business or a production of income (rental) activity, total deductible property taxes are subject to a $10,000 limitation as discussed in Chapter 8.

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

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

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

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

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

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

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

a. Simone purchases 300 shares of Wilguess Inc., stock in 2016 for $6,300. In 2016 and 2017, Wilguess pays cash dividends of $2 per share. In 2018, Wilguess pays a 40% stock dividend (nontaxable), and Simone receives an additional 120 shares of stock.

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

b. Symbol Corporation purchases a building in 2015 at a cost of $240,000. Annual maintenance costs on the building are $80,000. In 2017, Symbol adds a wing to the building at a cost of $60,000. In 2018, the building is painted at a cost of $25,000. Symbol deducts $4,800 in depreciation in 2015, $7,300 in 2016, and $8,100 in 2017 and 2018.

The original basis of the building is the $240,000 cost. Adjustments are made to the basis for any expenditure that cannot be currently deducted and for any capital recoveries of the building investment. The annual maintenance costs and the painting costs are current period expenses that are not capitalized. The addition of the wing to the building is a capital expenditure (its usefulness extends substantially beyond the end of the year of expenditure) and is added to basis. The depreciation deductions are capital recoveries that reduce basis. The adjusted basis at the end of 2018 is $271,700:

Original Basis	**$ 240,000**
Add: Cost of adding wing	**60,000**
Deduct: Depreciation ($4,800 + $7,300 + $8,100 + $8,100)	**(28,300)**
Adjusted basis at end of 2018	**$ 271,700**

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c. Lorissa purchases land as an investment in 2016 for $33,000. Property taxes on the property are $400 per year. In 2017, Lorissa is assessed $2,000 by the county assessor for her share of a sidewalk that the county builds adjacent to the land. Lorissa pays the assessment in 2018.

The original basis in the land is $33,000. Adjustments are made to the basis for any expenditure that cannot be currently deducted and for any capital recoveries of the building investment. The property taxes are deducted in the year paid and do not affect the basis. The assessment for the sidewalk is not a deductible tax. Therefore, it must be added to the basis of the land, resulting in an adjusted basis of $35,000 ($33,000 + $2,000) at the end of 2018.

d. The Barton Brothers Partnership purchases a computer in 2016 for $8,000. The partnership elects to deduct the entire cost of the computer in 2016. In 2018, Barton Brothers spends $300 to repair the computer.

The original basis of the computer is $8,000. Adjustments are made to the basis for any expenditure that cannot be currently deducted and for any capital recoveries of the computer investment. The entire investment in the computer is recovered through the 2016 deduction, reducing the basis to zero (all of the capital investment is recovered). The $300 repair cost is a 2018 expense and does not affect basis.

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

a. Davidson is a cash basis taxpayer.

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

b. Davidson is an accrual basis taxpayer.

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

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ISSUE IDENTIFICATION PROBLEMS

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

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

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

64. Henrietta is the president and sole shareholder of Clutter Corporation. In 2015, Henrietta transferred ownership of her personal residence to the corporation. As part of the transfer, Clutter Corporation assumed Henrietta's mortgage on the house. At the same time, she and the corporation entered into an agreement that lets Henrietta lease the property for as long as she wants at an amount approximating the monthly mortgage payments on the house. During the current year, Clutter paints the house at a cost of $5,000, makes other repairs totaling $3,000, and adds an entertainment room at a cost of $30,000. Current-year property taxes and interest paid by Clutter on the house are $1,400 and $18,000, respectively. Henrietta paid $18,000 in rent to Clutter.

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

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

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

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

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

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

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

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

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

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

69. Aretha is an executive vice president of Franklin, Inc. On December 18, 2018, the Franklin, Inc., board of directors awards her a $20,000 bonus. Aretha asks Franklin's controller to delay processing the bonus check until January. The controller agrees to her request, and she receives the $20,000 bonus check on January 10, 2019.

The issue is what year is the $20,000 bonus taxable? A cash basis taxpayer is in constructive receipt of income when it is credited to their account or otherwise made unconditionally available to them. In this case, Aretha has demonstrated an ability to control the payment by having it paid in January. Therefore, the bonus is made available to her in 2018 and she must include the $20,000 in her 2018 gross income.

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

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

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

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

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

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72. **RIA RESEARCH EXERCISE** Use the RIA Checkpoint research database to answer the following questions. Cut and paste the relevant Internal Revenue Code and Treasury Regulation section(s) into your solution and explain how the authority answers the tax issue in question. Give the most specific citation applicable [e.g., Sec. 168(a)(1)] that answers the question. Note: If the answer can be found in both the code and regulations, you must provide both authorities.

a. Carol went and lobbied before the federal government concerning proposed changes to the new pension regulations. She incurred $2,300 in expenses. What code section and/or regulation disallows a deduction for these expenses?

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

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

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

(e) Denial of deduction for certain lobbying and political expenditures.
(1) In general. No deduction shall be allowed under subsection (a) for any amount paid or incurred in connection with—
(A) influencing legislation,
(B) participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office,
(C) any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums, or
(D) any direct communication with a covered executive branch official in an attempt to influence the official actions or positions of such official.

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

Reg § 1.162-29. Influencing legislation.
(b) Definitions. ***For purposes of this section—***

(1) Influencing legislation. Influencing legislation means—
(i) Any attempt to influence any legislation through a lobbying communication; and

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

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

(3) Lobbying communication. A lobbying communication is any communication (other than any communication compelled by subpoena, or otherwise compelled by Federal or State law) with any member or employee of a legislative body or any other government official or employee who may participate in the formulation of the legislation that—
(i) Refers to specific legislation and reflects a view on that legislation; or
(ii) Clarifies, amplifies, modifies, or provides support for views reflected in a prior lobbying communication.

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

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

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

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

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

§ 164 Taxes

(a) General rule.

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

(1) State and local, and foreign, real property taxes.
(2) State and local personal property taxes.
(3) State and local, and foreign, income, war profits, and excess profits taxes.
(4) The GST tax imposed on income distributions.

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The Tax Cuts and Jobs Act added Sec. 164(b)(6) that restricts the deduction for certain taxes for tax years 2018 through 2025

(6) limitation on individual deductions for taxable years 2018 through 2025.
In the case of an individual and a taxable year beginning after December 31, 2017, and before January 1, 2026-
(A) foreign real property taxes shall not be taken into account under subsection (a)(1) , and

(B) the aggregate amount of taxes taken into account under paragraphs (1) , (2) , and (3) of subsection (a) and paragraph (5) of this subsection for any taxable year shall not exceed $10,000 ($5,000 in the case of a married individual filing a separate return).

The preceding sentence shall not apply to any foreign taxes described in subsection (a)(3) or to any taxes described in paragraph (1) and (2) of subsection (a) which are paid or accrued in carrying on a trade or business or an activity described in section 212 . For purposes of subparagraph (B) , an amount paid in a taxable year beginning before January 1, 2018, with respect to a State or local income tax imposed for a taxable year beginning after December 31, 2017, shall be treated as paid on the last day of the taxable year for which such tax is so imposed.

Reg § 1.164-1. Deduction for taxes.

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

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

(2) State and local personal property taxes.

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

(4) State and local general sales taxes.

Note: Reg. § 1.164-1 has not been updated to reflect the changes of the Tax Cuts and Jobs Act.

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Sec. 164(f)(1) limits the deduction for self-employment taxes to one-half of the tax imposed by Sec. 1401.

(f) Deduction for one-half of self-employment taxes.
(1) In general.

In the case of an individual, in addition to the taxes described in subsection (a) there shall be allowed as a deduction for the taxable year an amount equal to one-half of the taxes imposed by section 1401 for such taxable year.

(2) Deduction treated as attributable to trade or business
For purposes of this chapter, the deduction allowed by paragraph (1) shall be treated as attributable to a trade or business carried on by the taxpayer, which does not consist of the performance of services by the taxpayer as an employee.

c. Hamid dies in an automobile accident. He is covered by a $500,000 life insurance policy which is payable to his wife, Janet. What code section and/or regulation excludes the $500,000 from Janet's gross income?

Sec. 61(a)(10) includes income from life insurance contracts in gross income.

§ 61 Gross income defined.

(a) General definition.

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
(10) ***Income from life insurance and endowment contracts;***

Sec. 101(a)(1) provides the general rule that life insurance proceeds paid on account of death are excluded from gross income.

§ 101 Certain death benefits

(a) Proceeds of life insurance contracts payable by reason of death.
(1) General rule.

Except as otherwise provided in paragraph (2) , subsection (d) , and subsection (f), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.

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Reg. Sec. 1.101-1(a) discusses the exclusion in more depth.

Reg § 1.101-1. Exclusion from gross income of proceeds of life insurance contracts payable by reason of death.

(a) ***(1) In general. Section 101(a)(1) states the general rule that the proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from the gross income of the recipient. Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, are covered by this provision. For provisions relating to death benefits paid by or on behalf of employers, see section 101(b) and §1.101-2. The exclusion from gross income allowed by section 101(a) applies whether payment is made to the estate of the insured or to any beneficiary (individual, corporation, or partnership) and whether it is made directly or in trust. The extent to which this exclusion applies in cases where life insurance policies have been transferred for a valuable consideration is stated in section 101(a)(2) and in paragraph (b) of this section. In cases where the proceeds of a life insurance policy, payable by reason of the death of the insured, are paid other than in a single sum at the time of such death, the amounts to be excluded from gross income may be affected by the provisions of section 101(c) (relating to amounts held under agreements to pay interest) or section 101(d) (relating to amounts payable at a date later than death). See §§1.101-3 and 1.101-4. However, neither section 101(c) nor section 101(d) applies to a single sum payment which does not exceed the amount payable at the time of death even though such amount is actually paid at a date later than death.***

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d. Roy and Deanna are married and have two children, ages 13 and 19. They are aware that they are eligible for a child tax credit, but do not know if their children qualify them for the credit. What code section and/or regulation defines a child for purposes of the child tax credit?

Sec. 24(a) allows a $1,000 tax credit for a qualifying child of the taxpayer.

§ 24 Child tax credit.

(a) Allowance of Credit. —There shall be allowed as a credit against the tax imposed by this chapter for the taxable year with respect to each qualifying child of the taxpayer an amount equal to $1,000.

(h) Special rules for taxable years 2018 through 2025.

(1) In general.

In the case of a taxable year beginning after December 31, 2017, and before January 1, 2026, this section shall be applied as provided in paragraphs (2) through (7) .

(2) Credit amount. Subsection (a) shall be applied by substituting "$2,000" for "$1,000".

Sec. 24(c)(1) defines a qualifying child as a qualifying child under Sec. 152(c) who is less than 17 years of age, and who would not be a dependent if all that follows "resident of the United States" in Sec. 152(b)(3) is disregarded.

(c)(1) Qualifying child -- For purposes of this section --

The term "qualifying child" means a qualifying child of the taxpayer (as defined in section 152(c)) who has not attained age 17.

(2) Exception for certain noncitizens. The term "qualifying child" shall not include any individual who would not be a dependent if subparagraph (A) of section 152(b)(3) were applied without regard to all that follows "resident of the United States".

Sec. 152(c)(1) provides four tests that a qualifying child must meet. The child must meet the relationship test of Sec. 152(c)(2), which requires a qualifying child to be a child of the taxpayer or a descendant of a child of the taxpayer, must have the same principal residence for more than half the taxable year, meet the age requirement of Sec. 152(c)(3) which requires the child to be less than 19 years of age or a student less than 24 years of age, and the child cannot have provided more than one-half of their own support during the year.

152(c) Qualifying Child. —For purposes of this section —

152(c)(1) In general. —The term "qualifying child" means, with respect to any taxpayer for any taxable year, an individual —

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152(c)(1)(A) who bears a relationship to the taxpayer described in paragraph (2),

152(c)(1)(B) who has the same principal place of abode as the taxpayer for more than one-half of such taxable year,

152(c)(1)(C) who meets the age requirements of paragraph (3), and

152(c)(1)(D) who has not provided over one-half of such individual's own support for the calendar year in which the taxable year of the taxpayer begins.

152(c)(2) Relationship. —For purposes of paragraph (1)(A), an individual bears a relationship to the taxpayer described in this paragraph if such individual is —

152(c)(2)(A) a child of the taxpayer or a descendant of such a child, or

152(c)(2)(B) a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative.

152(c)(3) Age requirements. —

152(c)(3)(A) In general. —For purposes of paragraph (1)(C), an individual meets the requirements of this paragraph if such individual —

152(c)(3)(A)(i) has not attained the age of 19 as of the close of the calendar year in which the taxable year of the taxpayer begins, or

152(c)(3)(A)(ii) is a student who has not attained the age of 24 as of the close of such calendar year.

Sec. 152(b)(3)(A) requires a dependent (qualifying child) to be a citizen or resident of the United States or a country contiguous to the United States (Canada and Mexico). However, for purposes of the child tax credit, disregarding all language in Sec. 152(b)(3)(A) after resident means that only citizens or nationals of the United States are qualifying child for purposes of the child tax credit.

152(b)(3) Citizens or nationals of other countries. —

152(b)(3)(A) In general. —The term "dependent" does not include an individual who is not a citizen or national of the United States unless such individual is a resident of the United States or a country contiguous to the United States.

152(b)(3)(B) Exception for adopted child. —Subparagraph (A) shall not exclude any child of a taxpayer (within the meaning of subsection (f)(1)(B)) from the definition of "dependent" if —

152(b)(3)(B)(i) for the taxable year of the taxpayer, the child has the same principal place of abode as the taxpayer and is a member of the taxpayer's household, and

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152(b)(3)(B)(ii) the taxpayer is a citizen or national of the United States.

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73. **RIA RESEARCH EXERCISE** Use the RIA Checkpoint research database to answer the following questions. Cut and paste the relevant Internal Revenue Code and Treasury Regulation section(s) into your solution and explain how the authority answers the tax issue in question. Give the most specific citation applicable [e.g., Sec. 168(a)(1)] that answers the question. Note: If the answer can be found in both the code and regulations, you must provide both authorities.

1. Melinda takes classes costing $3,500 that are paid for by her employer's educational assistance plan.

a. What code section and/or regulation allows the exclusion of payments from an employer's educational assistance plan?

Sec. 127(a)(1) allows the exclusion of amounts paid or expenses incurred by an employer for employee educational assistance if it is provided according to a program described in Sec. 127(b).

SEC. 127. EDUCATIONAL ASSISTANCE PROGRAMS.

127(a) Exclusion From Gross Income.—

127(a)(1) In general.—Gross income of an employee does not include amounts paid or expenses incurred by the employer for educational assistance to the employee if the assistance is furnished pursuant to a program which is described in subsection (b).

Reg. Sec. 1.127-1(a)(1) and (a)(2) reiterate the exclusion of amounts paid or provided to an employee under a qualified educational assistance program.

§1.127-1. Amounts received under a qualified educational assistance program

(a) Exclusion from gross income.—The gross income of an employee does not include—

(1) Amounts paid to, or on behalf of the employee under a qualified educational assistance program described in §1.127-2, or

(2) The value of education provided to the employee under such a program.

Reg. Sec. 1.127-1(b) adds that any amount excluded under this provision is not eligible to be treated as a credit or deduction for the employee.

(b) Disallowance of excluded amounts as credit or deduction.—Any amount excluded from the gross income of an employee under paragraph (a) of this section shall not be allowed as a credit or deduction to such employee under any other provision of this part.

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Reg. Sec. 1.127-1(c) states that if an amount is received from a program that is not qualified, the amount must be included in gross income.

(c) Amounts received under a nonqualified program.—Any amount received under an educational assistance program that is not a "qualified program" described in §1.127-2 will not be excluded from gross income under paragraph (a) of this section. All or part of the amounts received under such a non-qualified program may, however, be excluded under section 117 or deducted under section 162 or section 212 (as the case may be), if the requirements of such section are satisfied.

b. What code section and/or regulation limits the amount that can be excluded?

Sec. 127(a)(2) limits the annual excludible amount to $5,250.

127(a)(2) $5,250 maximum exclusion.—If, but for this paragraph, this section would exclude from gross income more than $5,250 of educational assistance furnished to an individual during a calendar year, this section shall apply only to the first $5,250 of such assistance so furnished.

c. What code section and/or regulation defines the elements of an employer's educational assistance plan that must be met for employee's to be allowed an exclusion for payments received from the plan?

Sec. 127(b)(1) requires a separate written plan for the exclusive benefit of employees to provide them with educational assistance. The plan must meet the five requirements of Sec. 127(b)(2) through Sec. 127(b)(6).

127(b) Educational Assistance Program.—

127(b)(1) In general.—For purposes of this section, an educational assistance program is a separate written plan of an employer for the exclusive benefit of his employees to provide such employees with educational assistance. The program must meet the requirements of paragraphs (2) through (6) of this subsection.

127(b)(2) Eligibility.—

127(b)(3) Principal shareholders or owners.—

127(b)(4) Other benefits as an alternative.—

127(b)(5) No funding required.—A program referred to in paragraph (1) is not required to be funded.

127(b)(6) Notification of employees.—

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The requirements of an educational assistance program are reiterated and expanded on in Reg. Sec. 1.127-2(a) – (b).

§1.127-2., Qualified educational assistance program

(a) In general.—A qualified educational assistance program is a plan established and maintained by an employer under which the employer provides educational assistance to employees. To be a qualified program, the requirements described in paragraphs (b) through (g) of this section must be satisfied. It is not required that a program be funded or that the employer apply to the Internal Revenue Service for a determination that the plan is a qualified program. However, under §601.201 (relating to rulings and determination letters), an employer may request that the Service determine whether a plan is a qualified program.

(b) Separate written plan.—

d. What code section and/or regulation defines what types of expense payments from an employer's educational assistance plan can be excluded from the employee's gross income?

Sec. 127(c)(1)(A) defines educational assistance as payments for the education of the employee, including, but not limited to, tuition, fees, books, supplies, and equipment or the provision of courses of instruction, including books, supplies, and equipment (Sec. 127(c)(1)(B). Educational assistance does not include tools or supplies that can be retained by the employee or amounts paid for meals, lodging, or transportation. Payments for sports, game, or hobby courses are not educational assistance.

127(c)(1) Educational assistance.—The term "educational assistance" means—

127(c)(1)(A) the payment, by an employer, of expenses incurred by or on behalf of an employee for education of the employee (including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment), and

127(c)(1)(B) the provision, by an employer, of courses of instruction for such employee (including books, supplies, and equipment), but does not include payment for, or the provision of, tools or supplies which may be retained by the employee after completion of a course of instruction, or meals, lodging, or transportation. The term "educational assistance" also does not include any payment for, or the provision of any benefits with respect to, any course or other education involving sports, games, or hobbies.

Reg. Sec. 1.127-2(c)(1) –(4) reiterates and expands on the Sec. 127(c)(1) definition.

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(c) Educational assistance

(1) In general.—The benefits provided under the program must consist solely of educational assistance. The term "educational assistance" means—

(i) The employer's payment of expenses incurred by or on behalf of an employee for education, or

(ii) The employer's provision of education to an employee.

(2) Alternative benefits.—Benefits will not be considered to consist solely of educational assistance if the program, in form or in actual operation, provides employees with a choice between educational assistance and other remuneration includible in the employee's gross income.

(3) Certain benefits not considered educational assistance.—The term "educational assistance" does not include the employer's payment for, or provision of—

(i) Tools or supplies (other than textbooks) that the employee may retain after completing a course of instruction,

(ii) Meals, lodging, or transportation, or

(iii) Education involving sports, games, or hobbies, unless such education involves the business of the employer or is required as part of a degree program. The phrase "sports, games, or hobbies" does not include education that instructs employees how to maintain and improve health so long as such education does not involve the use of athletic facilities or equipment and is not recreational in nature.

(4) Education defined.—As used in section 127, §1.127-1, and this section, the term "education" includes any form of instruction or training that improves or develops the capabilities of an individual. Education paid for or provided under a qualified program may be furnished directly by the employer, either alone or in conjunction with other employers, or through a third party such as an educational institution. Education is not limited to courses that are job related or part of a degree program.

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2. Billy's Barbeque has assets of $60,000 and liabilities of $100,000. To assist Billy's, its bank agrees to reduce the amount due on a loan from $65,000 to $50,000.

a. What code section and/or regulation specifically includes discharges of debt in gross income?

Sec. 61(a)(12) specifically includes income from discharge of indebtedness in gross income. This general rule is also found in Reg. Sec. 1.61-12(a).

§61 Gross income defined.

(a) General definition. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(12) Income from discharge of indebtedness;

Reg § 1.61-12. Income from discharge of indebtedness.

(a) In general. ***The discharge of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.***

b. What code section and/or regulation allows certain discharges of debt to be excluded from gross income?

Sec. 108(a)(1)(B) allows an exclusion from gross income for discharges of debt that occur when the taxpayer is insolvent.

SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS.

108(a) Exclusion From Gross Income.—

108(a)(1) In general.—Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

108(a)(1)(A) the discharge occurs in a title 11 case,

108(a)(1)(B) the discharge occurs when the taxpayer is insolvent,

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c. What code section and/or regulation defines the condition that must be met to exclude a discharge of debt from gross income?

Sec. 108(d)(3) defines insolvent as the excess of liabilities over the fair market value of assets.

108(d)(3) Insolvent.—For purposes of this section, the term "insolvent" means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

d. What code section and/or regulation limits the amount of debt discharge that can be excluded?

Sec. 108(a)(3) limits the amount of the exclusion to the amount the taxpayer is insolvent before the discharge.

108(a)(3) Insolvency exclusion limited to amount of insolvency.—In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

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74. **INTERNET ASSIGNMENT** Many legislative, administrative, and judicial resources are available on the Internet. They can be located using search engines provided by your browser or a tax directory site located on the Internet. The purpose of this assignment is to practice searching the Internet to locate tax materials. Using a search engine or one of the tax directory sites provided in Exhibit 16-6 (Chapter 16), find the Treasury Regulation that provides the treatment of advance receipts of rental income. Trace the process you used to find this regulation (search engine or tax directory used and key words). Print the text of the regulation.

The National Archives and Records Administration provides the Code of Federal Regulations (which includes income tax regulations) in a searchable database (http://www.gpoaccess.gov/cfr/index.html). This site can be accessed from the tax directories listed in Exhibit 16-6 of Chapter 16. The appropriate regulation is Reg. Sec. 1.61-8. It can be found with the search "rent and advance" in the CFR database.

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

75. **INTERNET ASSIGNMENT** Many legislative, administrative, and judicial resources are available on the Internet. They can be located using a search engine provided by your browser or a tax directory site located on the Internet. The purpose of this assignment is to practice searching the Internet to locate tax materials. Using a search engine or one of the tax directory sites provided in Exhibit 16-6 (Chapter 16), find the U.S. Supreme Court decision that established the claim of right doctrine. Provide the citation to the case and explain the facts that led to the creation of the claim of right doctrine.

The easiest way to find this case is to use one of the tax directory sites to locate a site that has Supreme Court cases. One site that has a complete set of Supreme Court cases is FINDLAW (http://www.findlaw.com/casecode.supreme.html). Searching this site with "claim of right" yields a number of cases, many of which are not tax cases. The tax cases found all refer to *North American Oil Consolidated v Burnet*, 286 U.S. 417 (1932).

Income from the sale of oil and gas produced during 1916, impounded in the hands of a receiver to await the outcome of litigation, is taxable to the oil company when paid to it by the receiver in 1917, whether it was on the cash or the accrual basis, and regardless of the fact that the litigation was not finally settled, in favor of the oil company, until 1922. The oil company was not taxable in 1916 on an amount it might never receive.

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

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76. **RESEARCH PROBLEM.** The assignment of income doctrine states that income is taxed to the entity owning the income, regardless of who actually receives the income. That is, income taxation cannot be escaped by assigning the payment of income to another entity. Find the court case that led to this doctrine and explain the facts surrounding the court's decision.

***Lucas v. Earl*, 281 US 111 (S.Ct. 1930) established the assignment of income doctrine. The case involved Guy Earl's attempt to transfer one-half of the salary and attorney's fees he earned in 1920 and 1921 to his wife (each spouse was taxed separately on their income in these years; there was no married, filing joint status available to split the income). Mr. Earl had executed a contract that each party would be entitled to one-half of any income or any other property that either might receive.**

77. **RESEARCH PROBLEM** Under a reimbursement plan that has been in effect for 5 years, Simmons Corporation advances travel expenses to its sales employees. The advances are deducted from the employees' commissions as they are earned. The employees have an unconditional obligation to repay any advances not repaid through the commission offset. Up to the current year, the sales employees' commissions have never been sufficient to fully offset the advances made under the plan. To boost morale, Simmons charges off the balance of the advances. What are the tax effects of the reimbursement plan and the subsequent write-off of the advance balances?

The primary issue is whether the write-off of the advance balances is taxable to the employees. Rev. Rul. 69-465, 1969-2 CB 27, held that debts from travel advances owed to a company that were charged off represent additional compensation to the employee and were deductible by the company in the year of the charge-off.

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78. **TAX FORM PROBLEM** Kimberly Cerny is a graduate student. She is 22 years old and works part-time as a graduate assistant in the biology department. She had health insurance for the full year under her parents' insurance. In the summer, Kimberly was an intern at Neutrobio, Inc. Details regarding her salary and withholdings from her employment follows.

	Biology Department	Neutrobio, Inc.
Salary	$2,600	$3,600
Federal withholding	260	302
State withholding	97	114
Social Security	168	275

Kimberly also received $1,200 in interest from a savings account that was set up by her grandparents to help pay her college expenses. Kimberly lives at 499 Hillside Drive, Portland, Oregon, 97208. She is a dependent of her parents, her Social Security number is 324-99-8020, and does not wish to contribute to the Presidential Campaign Election Fund. She has asked you to help her with her federal income tax return. Prepare Form 1040EZ for Kimberly. Forms and instructions can be downloaded from the IRS web site (http://www.irs.gov).

Instructor's Note: The solution to the tax form problem is included separately in the file SM_Ch_02 Problem_78.pdf on the companion website, www.cengage.com.

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DISCUSSION CASES

79. The controller of Newform Oil Company has come to you for advice. Newform recently cleared a forested area and began drilling an oil well on the site. The well is a gusher, and Newform's geologists estimate that it will produce for at least 10 years. Environmental restoration laws will require Newform to completely reforest and restore the oil well site when the well is taken out of production. An engineering firm hired by Newform estimates that the cost of complying with the environmental requirements to be $8,000,000. For financial accounting purposes, Newform intends to amortize the estimated cost over the 10-year expected life. In addition, it plans to put $500,000 per year into an account that should provide the $8,000,000 necessary to perform the restoration.

    The controller would like your advice on the deductibility of the costs of restoration. That is, when can Newform deduct the costs and how much can it deduct? Based on the concepts discussed in this chapter, explain what you think is the proper treatment of the restoration costs for tax purposes.

    The environmental restoration costs incurred by Newform have a Business Purpose and are fully deductible as a trade or business expense. The Capital Recovery Concept limits the amount of the deduction to the amount expended on the restoration. Therefore, the key issue to be determined is the timing of the deduction. There are several possibilities that should be considered. First, can Newform amortize the $8,000,000 estimated cost over the 10-year life of the project (as in financial accounting)? Alternatively, can the $500,000 paid into the fund account form the basis for a deduction? A third possibility is that no deduction would be allowed until actual restoration costs are incurred. The memorandum should discuss these possibilities in terms of the income tax concepts. More specifically, the following issues should be addressed:

    1. **Financial accounting versus income tax accounting - the purpose of financial accounting is to determine the "true income" for each reporting period. The matching concept in financial accounting requires the accrual of the estimated restoration expenses against current period income in order to show the full cost of producing the income. The purpose of income tax accounting is to generate and collect revenue. One of the main concepts of the income tax system is that the tax should be based on the taxpayer's Ability to Pay. This concept requires that the taxable income number reflect the actual results of each annual accounting period. That is, does the taxpayer have the Wherewithal-to-Pay the tax on the income being generated? In this regard, deductions reduce taxable income, which in turn reduce the required tax payment. The question the student should address is whether the reduction in taxable income should take place during the earnings period or when amounts are actually being expended for restoration costs.**

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2. Accounting Method - the facts indicate that Newform uses the accrual method for financial accounting and presumably, would use the same accounting method in calculating taxable income. For tax purposes, accrual basis taxpayers deduct expenses when they are incurred. The question that the student should address is when are the restoration expenditures "incurred"? Is an estimate of the expenses to be paid in the future sufficient? Is the $500,000 that is paid into the fund account "incurred"?

The student may also consider deductibility under the cash method. The cash method allows deductions when they are paid. The question that the student should address for a cash basis taxpayer is whether payments made into a fund to provide for the future expenses is a "payment" of the expenses. In this regard, they may discuss whether the fund payment reduces Newform's Wherewithal-to-Pay each period.

3. Capital Recovery Concept - This concept limits the amount of a deduction to its cost. The question to be resolved is whether estimates of future costs can be recovered currently. That is, Newform has no basis in the restoration costs until it expends amounts related to the costs. Therefore, this concept would not allow the 10-year amortization of expected future costs because no capital investment in the restoration has been made. However, the student should address whether the annual $500,000 payments made into the fund account constitute a capital investment that can be recovered currently.

INSTRUCTOR'S NOTE: **At this stage in the course, there is no hard and fast answer to the deduction of the costs. This is covered in Chapter 5 in the discussion of the all-events test and the economic performance test requirements for deductions by accrual basis taxpayers. The purpose of this case is to stimulate student thinking about how the expenses should be treated based on their application and interpretation of the income tax concepts. As such, it is reasonable to assume that they will come to different conclusions on the application of the concepts.**

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80. The Prevetti Partnership is engaged in the purchase and management of apartment complexes. The partnership entered into an agreement with Parsnip Development Company on July 1 of the current year to purchase the Perry Apartments. The sales agreement stated the purchase price of $5,000,000. It also provided for "other payments to seller," composed of a $500,000 payment for a covenant not to compete, $50,000 for the seller's management advice during the ownership transition, and a financing fee of $100,000. In addition, the seller is to receive the first $400,000 of the rent collected by Prevetti. The purchase was completed on August 5. Monthly rentals on the property are $90,000. Prevetti paid Parsnip the first $400,000 of rent it collected per the purchase agreement. How much rental income does the Prevetti Partnership have for the current year? Explain.

The question to be resolved on these facts is whether Prevetti or Parsnip is taxed on the $400,000 rent payment Prevetti paid to Parsnip. Following the strict language of the sales contract leads to the conclusion that Parsnip is taxed on the rents that it received. However, a closer analysis of the contract indicates that the rental payment that Prevetti makes to Parsnip is part of the sales price of the property. That is, the sales price is effectively $5,400,000. In effect, Prevetti is using the rents as security for payment of the additional $400,000. This is an application of the substance over form doctrine which taxes transactions according to their true intent, rather than their strict form. On similar facts in *Ellison*, 80 T.C. 378 (1983), the Tax Court held that rent paid to the seller is nothing more than a financing arrangement and that, in substance, the rents are earned by the purchaser and are part of the purchase price of the property.

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TAX PLANNING CASE

81. Biko owns a snowmobile manufacturing business, and Miles owns a mountain bike manufacturing business. Because each business is seasonal, their manufacturing plants are idle during their respective off-seasons. Biko and Miles have decided to consolidate their businesses as one operation. In so doing, they expect to increase their sales by 15% and cut their costs by 30%. Biko and Miles own their businesses as sole proprietors and provide the following summary of their 2017 taxable incomes:

	Biko	Miles
Business income		
Sales	$ 600,000	$ 450,000
Cost of goods sold	(400,000)	(300,000)
Other expenses	(100,000)	(75,000)
Business taxable income	$ 100,000	$ 75,000
Other taxable income (net of allowable deductions)	20,000	35,000
2017 Taxable income	$ 120,000	$ 110,000

Biko and Miles don't know what type of entity they should use for their combined business. They would like to know the tax implications of forming a partnership versus a corporation. Under either form, Biko will own 55% of the business and Miles will own 45%. They each require $60,000 from the business and would like to increase that by $5,000 per year.

Based on the information provided, do a three-year projection of the income of the business and the total taxes for a partnership and for a corporation. In doing the projections, assume that after the initial 30% decrease in total costs, their annual costs will increase in proportion to sales. Also, assume that their nonbusiness taxable income remains unchanged. Use the 2018 tax rate schedules to compute the tax for each year of the analysis.

The first step in the analysis is to calculate the taxable income of the business entity under the assumptions given. Partnerships are conduit entities, so the partnership is not subject to tax on its income. Biko and Miles will include their share of the partnership's income in their individual tax calculation.

Partnership Income Calculation:

	2017	**2018**	**2019**	**2020**
Sales	**$1,050,000**	**$1,207,500**	**$1,388,625**	**$1,596,919**
COGS	**(700,000)**	**(490,000)**	**(563,500)**	**(648,025)**
Other expenses	**(175,000)**	**(122,500)**	**(140,875)**	**(162,006)**
Taxable income	**$ 175,000**	**$ 595,000**	**$ 684,250**	**$ 786,888**

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Taxable Income Computation:

Biko will be taxed on 55% of the income from the partnership; Miles will be taxed on the remaining 45% of partnership income. Because they are taxed on the partnership income, the yearly cash withdrawals are not taxed again in the partnership entity form. The total tax paid under this option is the sum of the tax Biko and Miles pay as individuals.

Biko's Tax: (2018 Single rate schedule)

	2018	2019	2020
Business taxable income	$ 327,250	$ 376,338	$ 432,788
Other taxable income	20,000	20,000	20,000
Taxable income	$ 347,250	$ 396,338	$ 452,788
Tax	$ 97,227	$ 114,408	$ 134,165

Miles Tax: (2018 Single rate schedule)

	2018	2019	2020
Business taxable income	$ 267,750	$ 307,912	$ 354,100
Other taxable income	35,000	35,000	35,000
Taxable income	$ 302,750	$ 342,912	$ 389,100
Tax	$ 81,652	$ 95,709	$ 111,875
Total tax (Biko & Miles)	$ 178,879	$ 210,117	$ 246,040

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Corporation Tax Calculation:

A corporation is a taxable entity. The corporation will pay tax on its income. The withdrawals by Biko and Miles take the form of salaries, which are deductible by the corporation and included in Biko and Miles individual income tax calculation. The tax under this option is the sum of the tax paid by the corporation, Biko, and Miles.

	2017	2018	2019	2020
Sales	$1,050,000	$1,207,500	$1,388,625	$1,596,919
COGS	(700,000)	(490,000)	(563,500)	(648,025)
Other expenses	(175,000)	(122,500)	(140,875)	(162,006)
Salaries	-0-	(120,000)	(130,000)	(140,000)
Taxable income	$ 175,000	$ 475,000	$ 554,250	$ 646,888
Corporate Tax		$ 99,750	$ 116,393	$ 135,846
Biko's Tax:				
Salary from corporation		$ 60,000	$ 65,000	$ 70,000
Other taxable income		20,000	20,000	20,000
Taxable income		$ 80,000	$ 85,000	$ 90,000
Tax		$ 13,540	$ 14,690	$ 15,890
Miles Tax:				
Salary from corporation		$ 60,000	$ 65,000	$ 70,000
Other taxable income		35,000	35,000	35,000
Taxable income		$ 95,000	$ 100,000	$ 105,000
Tax		$ 17,090	$ 18,290	$ 19,490
Total tax		$ 130,380	$ 149,373	$ 171,226

Summary of Total Tax:	2018	2019	2020
Partnership	$ 178,879	$ 210,117	$ 246,040
Corporation	130,380	149,373	171,226
Tax savings with partnership	$ 48,499	$ 60,744	$ 74,814

Based on the assumptions given in the case, the partnership offers greater tax savings over the three-year period than the corporate form. However, this analysis is only one factor in the decision to use a corporation versus a partnership. Other non-tax factors, such as limited liability should also be considered. In addition, other tax factors such as employment taxes and the availability of nontaxable fringe benefits should also be considered. These factors are discussed in Chapter 13.

Instructor's Note: The solution ignores the impact of the Qualified Business Income (QBI) deduction available to both Biko and Miles under the partnership option. This deduction is discussed in Chapter 6 and would reduce the taxable income of Biko and Miles and reduce their total taxes under the partnership option.

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ETHICS DISCUSSION CASE

82. You are a CPA who has been preparing tax returns for Sign, Seal, and Deliver, a mid-size CPA Firm for the last 5 years. During the current year, you are assigned the individual return of a new client, Guadalupe Piaz. Guadalupe has completed and returned the tax return questionnaire that the firm sent to her.

    In reviewing the questionnaire, you notice that Guadalupe has included an entry for $10,000 in cash dividends received from Quinn Corporation. However, there is no supporting documentation for the dividend payment in the information Guadalupe provided.

    What concerns you is that until this year, you had prepared the tax return for Quinn Corporation. (It was reassigned to another firm member when you were promoted late last year.) You know that Quinn Corporation was organized as an S corporation during the years that you prepared the return. During that period, Quinn was equally owned by 3 shareholders, and Guadalupe was not among them. In addition, the Corporation was highly profitable, averaging approximately $6,000,000 per year in taxable income. Given this information, what are your obligations under the Statements on Standards for Tax Services (which can be found at www.cengage.com)? Write a memorandum to your supervisor explaining your concerns and what actions, if any, you will need to take before you can prepare Guadalupe's return.

    SSTS #3 allows a CPA to rely on information provided by a client. However, if the information appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the CPA, SSTS #3 requires the CPA to make reasonable inquiries about the information provided. Paragraph .06 of SSTS #3 discusses the CPA's obligation in regard to unsupported lists of tax information. Although there is no absolute obligation to examine underlying documentation (paragraph .07), SSTS #3 advises the CPA to encourage the client to provide supporting data where necessary. That is, if the CPA has reason to believe, based on other information known to the CPA, that the amounts reported may be incorrect, the CPA should ask the client to provide the supporting documentation to avoid misunderstandings, inadvertent errors, and possible administrative actions (i.e., audits) in the future. The CPA should also consider relevant information from the returns of other clients if the information is necessary to properly prepare a return and the use of the other information does not violate any law or rule relating to confidentiality.

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Applying these requirements to Guadalupe, the CPA's knowledge of Quinn Corporation would require the CPA to examine Quinn Corporation's return (assuming that Sign, Seal, and Deliver still prepares the return). Because Quinn is an S corporation, Guadalupe should report her share of Quinn's income on her return. Cash dividends received from an S corporation are not taxable. It is quite likely that Guadalupe does not understand the conduit nature of an S corporation and has incorrectly reported the amount of cash dividends that she received in the tax return information questionnaire. There is also the possibility that Quinn is no longer an S corporation and that the cash dividends that Guadalupe received is the correct amount of income that should be reported. An examination of Quinn's return will show the correct of amount of income that Guadalupe should report from her investment in Quinn. If the $10,000 is not the correct amount of income to be reported, the CPA should discuss the problem with Guadalupe and advise her that the amount is incorrect.

Under SSTS #1, the CPA cannot prepare or sign a return if the CPA does not have "a good faith belief" that a position being taken on a return does not have a "realistic possibility" of being sustained upon audit. Therefore, if Guadalupe does not consent to the reporting of the correct amount of income from Quinn Corporation, the CPA should not prepare or sign the return.

If the Quinn Corporation tax return information is not available, the CPA should ask Guadalupe to provide the supporting documentation she received from Quinn. If Guadalupe will not provide (or does not have) the reporting information, she should be advised of the possible tax consequences (additional tax, penalties, etc.) of incorrectly reporting the income from the S corporation. Under these circumstances, the CPA should consider the effect of SSTS #1. As stated above, the CPA would have to determine whether Guadalupe's non-cooperation in providing the required information would cause him or her to be unable to prepare or sign the return.

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Chapter 2
Check Figures

18. a. not ability to pay
b. possibly based on ability to pay
c. not ability to pay
d. not ability to pay

19. a. not ability to pay
b. not ability to pay
c. not ability to pay
d. not ability to pay

20. Single tax = $20,982; Married tax = $16,478

21. marital status, deductions, dependents, tax credits

22. a. related party
b. related party
c. related party
d. not related parties
e. not related parties

23. a. not related parties
b. not related parties
c. related party
d. related party

24. Related parties, Nall cannot deduct the loss.

25. a. business income
b. interest must be allocated
c. capital expenditure
d. electricity must be allocated
e. bad checks not income
f. fully deductible
g. fully deductible
h. not deductible

26. a. $4,000 business expense; $9,200 itemized deduction
b. property tax must be allocated
c. electricity must be allocated
d. not deductible; add to basis of house
e. $30 per month deductible; $250 ad deductible
f. cost of operating van must be allocated

27. a. no tax paid
b. $ 40,000 taxable income
c. $100,000 taxable income
d. $ 60,000 taxable income

28. a. Wendy's taxable income = $8,000
b. Wendy's taxable income = $18,000

29. Using 2 separate S corporations will not reduce tax

30. 2017 taxable income = $30,000; 2018 taxable loss = $10,000

31. Arnie is taxed on the $10,000

32. $2,000 taxable to Esmeralda

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33. a. cash basis in 2019 — accrual basis in 2018
b. cash basis = $22,450 — accrual basis = $23,010
c. cash basis in 2019 — accrual basis in 2018
d. cash basis - as payments received — accrual basis in 2018
e. capital expenditure

34. a. cash basis in 2019 — accrual basis in 2018
b. capital expenditure
c. cash basis - as payments received — accrual basis - in year of sale
d. cash basis - no income recognized — accrual basis - in 2018

35 $600 income in 2018

36. $600 income in 2018 no deduction; $600 income in 2018

37. Parents cannot deduct interest paid

38. a. realization concept — b. pay-as-you-go concept
c. administrative convenience concept — d. administrative convenience concept

39. a. pay-as-you-go concept — b. tax benefit rule
c. assignment of income doctrine — d. entity concept; conduit entity

40. $31,600 gain on sale

41. Tax liability = $20,689.50

42. $18,000 realized loss; $3,000 deductible loss

43 a. $15,000 realization — b. $39,000 realization
c. no realization — d. $30,000 realization

44. a. no realization — b. realization
c. realization — d. realization

45. $30,000 of income

46. a. claim of right — b. no claim of right
c. claim of right — d. claim of right

47. a. claim of right — b. claim of right to $20,000
c. claim of right — d. claim of right

48. constructive receipt doctrine

49. a. no constructive receipt — b. $75 per month constructive receipt
c. $1,500 constructive receipt

50. a. realization — b. no realization
c. realization — d. realization
e. $1,000,000 realization

51. N/A

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52. a. assignment of income doctrine
b. wherewithal-to-pay concept
c. claim of right doctrine
d. all-inclusive income concept

53. allocation of costs between different uses

54. a. legislative grace
b. business purpose concept
c. business purpose concept
d. legislative grace concept

55. a. legislative grace concept
b. business purpose concept
c. capital recovery concept
d. business purpose concept; capital recovery

56. cost of trip not deductible

57. a. personal expense
b. trade or business expense
c. production of income (investment) expense

58. a. personal loss not deductible
b. trade or business loss deductible
c. investment loss maximum deductible loss $3,000

59. a. $2,000
b. $15,000

60. a. capitalize land, utility, sewer line
b. capital expenditure; $2,292 deductible
c. capitalize purchase price
painting and repair
d. deduct supplies cost

61. a. basis per share=$15
b. $271,700
c. $35,000
d. zero basis

62. a. deduct actual expenditures
b. deduct actual expenditures

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CHAPTER 2
Income Tax Concepts

This chapter is the foundation for this text.

The concepts established here are fundamental to understanding the topics in subsequent chapters. ***Chapters 3 through 16*** incorporate a "look back" approach that discusses the operation of the U.S. tax system through the conceptual framework developed in this chapter. You may want to spend as many as five 50-minute class periods on this chapter's content. Emphasize to students the importance of reading the ***Concept Review*** at the beginning of each subsequent ***chapter*** (***3 through 16***). Also, point out the "***concept checks***" located throughout the chapters.

Teaching Tip #1: A drill approach during class time reinforces the concepts presented in the chapter. When students come to class, hand out a list of scenarios that demonstrate the concepts to be discussed that day. Go around the classroom and have students discuss the concept that explains the answer to the inherent question. The problems at the end of the chapter fit this approach very well.

Teaching Tip #2: The next several pages contain examples I use as in-class exercises or additional homework problems. (I have included the answers for you.) Students need as much practice as we can give them on understanding the concepts. The efforts made now will pay off later.

Teaching Tip #3: Suggest to students they rely on ***Table 2-1*** to gain a familiarity with the Concepts and related Constructs and Doctrines. This table gives students a map to follow and a resource to look back on later.

Writing assignments: ***Problems 24, 29, 32, and 56; and Ethics Discussion Case 82*** are suggested. ***Problem 21*** can be presented in modified writing assignment form.

21A. Andrew Evans and his sister, Barbara Evans-DeCarlo, each receive a salary of $80,000. Neither Andrew nor Barbara has any other source of income. During the current year, Barbara paid $800 more in tax than Andrew. Barbara has come to you to receive help in understanding why her tax bill is higher than Andrew's. Write a letter to Barbara explaining the possible source(s) of the difference.

Chapter 2, Class Exercises #1

General and Accounting Concepts (and Constructs)

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1. Jeromy receives a $480 tax credit for childcare. The credit was earned because of Jeromy's expenditures for day care for his daughter while Jeromy worked. What concept explains why Jeromy receives this tax credit?
   Ans: Ability To Pay

2. Bowow Company allows its employees to make personal Xerox copies without charge on the company copy machines. What concept helps explain why the benefit received is not taxable to Bowow employees?
   Ans: Administrative Convenience Concept

3. Glenda sells 100 shares of ICBM stock to her brother for $10,000. The shares originally cost Glenda a total of $12,000. Glenda is not allowed to deduct the loss realized on the sale of the stock shares. What concept applies to this event?
   Ans: Arms-Length Transaction Concept

4. Doria sells a van to a corporation in which she is a 40% stockholder. She realizes a loss of $2,500 on the sale. She is not allowed to deduct the loss for tax purposes, because in addition to her ownership percentage, her spouse owns 30%. Which concepts apply?
   Ans: Arms-Length Transaction & Related Party Rules

5. The State of Utah collects sales tax of 6.25% at the point of sale on purchases of most goods. What concept dictates the point of sale collection?
   Ans: Pay As You Go

6. Hugh, a self-employed contractor, is scrambling around to refigure his estimated 2018 income tax liability, because he needs to mail his fourth quarter estimated tax payment January 15, 2019. What concept is causing Hugh to scramble?
   Ans: Pay As You Go

7. Sharon is the sole shareholder of Grimsley Corporation. During the year, Sharon received $44 of cash dividends from Grimsley. The dividends are included in Sharon's gross income. She has a current-year income tax liability of $5,905. Grimsley Corporation has a current-year income tax liability of $156,700. What concept dictates that both Sharon and the corporation pay tax on their separate incomes?
   Ans: Entity Concept

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8. Francis "hired" her four-year-old son to be the office manager of her real estate firm. She deducted his $20,000 annual salary as a business expense. The IRS disallowed the deduction upon examination of Francis' tax return. Why?
   Ans: Substance Over Form Doctrine

9. Pat is a partner in Oil Exploration Limited Partnership. For the current year the partnership reported net income of $130,000. Pat's share of the income is $1,300. Pat reports that amount in her gross income. The partnership pays no income tax on its earnings. What concept applies here?
   Ans: Entity Concept (Partnerships are Conduits)

10. Alicia is a self-employed electrician. All cash payments she receives from customers are deposited into a bank account held in the name of her son. Alicia does not have use of the funds. Therefore, she does not think she needs to include the cash receipts in her gross income. What corollary of the Entity Concept dictates that Alicia needs to include the receipts in her income?
    Ans: Assignment of Income Doctrine

11. Terri files her tax return on April 15, 2019, reporting only her 2018 income, gains, deductions, and losses. She did not include the $2,000 bonus received from her employer on January 10, 2019, relating to her work performance during 2018. What concept will indicate that Terri's actions are correct?
    Ans: Annual Accounting Period Concept

12. Angelo had $4,000 of State Income Taxes withheld from his salary during 2017. On his 2017 federal income tax return, Angelo properly deducted the $4,000 as State Taxes Paid. Upon filing his 2017 State Tax Return on April 15, 2018, he determined that his actual State Income Tax for 2017 was only $3,300. He received a refund of $700 on May 25, 2018, from the amounts withheld by the State. What rule dictates that the $700 is included in Angelo's 2018 income?
    Ans: Tax Benefit Rule following the Annual Accounting Period Concept

Chapter 2, Class Exercises #2

General Concepts

1. One proposal before Congress is to establish a flat tax. Is a flat rate structure based on the ability-to-pay concept?
   Ans: No. The tax levied on a taxpayer is based on the amount that the taxpayer can afford to pay. A taxpayer who has more income than a second taxpayer will pay more tax than the second taxpayer.

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2. Opponents to the current progressive tax rate structure of the U.S. system claim it is unfair because the highest individual tax rate is 39.6%. Discuss the "unfairness" of this system using the ability-to-pay concept.

   Ans: Since taxpayers with the highest incomes pay income tax at a rate higher than taxpayers with lower incomes, the ability-to-pay concept is appropriately applied with the current tax system.

3. Discuss how certain exclusions from income undermine the ability-to-pay concept. For purposes of this analysis, use the exclusion for the receipt of gifts.

   Ans: To the extent that a taxpayer has income that is not subject to tax because of an allowable exclusion like gifts, the taxpayer is being taxed at less than her or his ability to pay.

4. Discuss why employees of Lone Pig Brewing Company are not taxed on the free beer they drink during breaks and lunch hours.

   Ans: Although employees are in receipt of income from the free beer provided by the employers, this form of compensation is not taxable because the cost of each employee's tracking his or her consumption, as well as the cost of the government's ensuring that all employees include the cost of the free beer in the income, exceeds the additional tax that would be collected. Thus, under the administrative convenience concept, employees are not taxed on the free beer.

5. All of Justina's tax-related records were destroyed when the moving van transporting her belongings to Colorado Springs rolled off Wolf Creek Pass. Because she did not want to reconstruct the records, Justina used the standard deduction amount when she filed her income tax return. Why is Justina allowed to use the standard deduction amount instead of actual expense amounts?

   Ans: This approach saves the taxpayer time in reconstructing the information and also saves the government time in ensuring the accuracy of the information reported (i.e., the standard deduction is not audited).

6. Henry wants his daughter, Amy, to have his acreage near Moose Crossing. Amy is able to pay up to $75,000 for the property. Henry paid $95,000 for it several years ago. Recently, an appraiser told Henry he could sell it for $200,000. Henry plans to accept the $75,000 from Amy. He thinks that the $75,000 is fair, in part, because he hopes to be able to deduct the loss realized on the sale. Why will Henry be disappointed about his plans to recognize the loss?

   Ans: The sale will not be at arm's-length. This transaction is a form of self-dealing. Amy and Henry are related parties. The realized loss cannot be recognized because of this relationship.

7. Antonio, Renee, and Manuel are the only shareholders of Undula Corporation owning 52%, 44%, and 4%, respectively.

   a. Undula Corporation plans to sell Renee a car purchased for $20,000 two years ago and a current adjusted basis of $15,000 because of depreciation. The agreed purchase price is $8,000. Will Undula be allowed to recognize a loss on the sale?

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Explain.
Ans: This transaction is at arm's-length. Because Renee does not own more than 50% of the corporation, she is not deemed to be a related party. Therefore, there is no constructive ownership and no self-dealing.

b. Antonio is going to sell manufactured goods from his sole proprietorship to Undula for $40,000. The cost of the goods is $50,000. Will Antonio be allowed to deduct the realized loss on the sale? Explain.
Ans: Antonio is involved with self-dealing in this scenario. Since he owns more than 50% of Undula Corporation, he is deemed to be in control of the entity. He is a related party, and the transaction is not at arm's length. No loss recognition is allowed for Antonio (or his sole proprietorship).

8. Reynaldo is self-employed. Because he does not receive a salary, he has no payroll withholding for income taxes. Reynaldo thinks he is exempt from the pay-as-you-go concept. Explain why he is incorrect in this assumption.
Ans: Voluntary compliance is essential to the operation of the U.S. tax system. Part of the voluntary compliance component is the pay-as-you-go system. It requires all taxpayers to pay tax as income is generated. For taxpayers without withholding from employers, estimated tax payments must be made. Quarterly estimated tax payments are required when estimated tax for a year is at least $500.

Chapter 2, Class Exercises #3

Income Concepts

1. After buying books at the beginning of the semester, Lucy finds a $100 bill outside the door of the bookstore. The $100 is considered gross income. Why?
Ans: All-inclusive Income Concept and no legislative grace to exclude

2. Ed's spouse, Trixie, died in 2018. Ed received $1,000,000 from a life insurance policy in which he was the beneficiary. Ed invested the funds in Micro-Bionics, Inc., common stock, and received $30,000 in cash dividends in 2018. The $1,000,000 is excluded from gross income and the $30,000 is included. Why?
Ans: Legislative grace provides for the exclusion from gross income of life insurance proceeds; and dividend income has received no legislative grace.

3. Ned sold 200 shares of common stock, received $2,000, and had a gain of $1,000 on the sale. Red sold 200 items of inventory from his shop and earned $1,000 from the sales. For tax purposes Ned and Red may have different results, even though their income amounts are the same. Why?
Ans: Capital Recovery Concept. Stock is a capital asset and capital gains are taxed at a maximum rate of 15%; the inventory is an ordinary income item and the income could be taxed at a marginal rate as high as 35%.

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4. Alice sold 100 shares of common stock and incurred a loss of $3,500 on the sale. Candice sold 100 items of inventory from her shop and a loss of $3,500 resulted. For tax purposes Alice and Candice have different results. Why?
   Ans: Net capital losses are limited to $3,000 annually; losses on inventory sales are ordinary and have no deduction limits.

5. Sally bought a plot of raw land for $2,000 two years ago. She subdivided the land into four equal sized parcels. This year Sally sold one parcel for $800 and another for $400. What are the tax ramifications?
   Ans: Capital Recovery Concept; Allocate the basis of $2,000 into four equal parts of $500. Gain of $300 on the first parcel and a loss of $100 on the second. These two sales are considered separately.

6. Billy Bob bought a small ranch for $200,000 three years ago. This year, oil was discovered on neighboring property; therefore, the county assessor re-valued Billy's property at $350,000. Is there any income tax effect?
   Ans: No realization has occurred.

7. Radio station WLLK received $100,000 from Comfort Elixirs, Inc., to air Comfort's commercials during a local talk show in December 2012. December's ratings dropped sharply when the show's star quit. Shortly thereafter, Comfort contacted WLLK, indicating that it wanted to discontinue its sponsorship and requesting return of $75,000 of the payment. The station continued to air the commercials and kept the $100,000. Comfort brought suit to recover the $75,000. Is the $100,000 included in WLLK's gross income?
   Ans: Yes. Claim of Right Doctrine -- no clear obligation to repay and unrestricted use of the money

8. Sammie is an employee of Mavis Company. The company regularly mails salary checks to employees to arrive on or before the last day of each month. Sammie's regular paycheck arrived at his house on Dec. 31, 2017, but Sammie was on vacation and didn't return until January 2, 2018. Sammie deposited the check in his bank account the following day. The gross amount of the check is included in Sammie's 2017 income. Why?
   Ans: Constructive Receipt Doctrine

9. Rasheed sold a parcel of investment real estate to Opal for $500,000 in 2017. Rasheed will receive $100,000 annually, plus interest at 9%, from 2018 through 2022. Rasheed will recognize no gross income on this sale in 2017. Why?
   Ans: Wherewithal-To-Pay Concept from which the installment sale rules emanate.

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Chapter 2, Class Exercises #4

Deduction Concepts

1. Helen is allowed to deduct the $5,000 cash and the Roberta-Glidden painting valued at $1,000 she donated to Catholic Charities Foundation. Why?
   Ans: Legislative Grace permits the deduction of charitable contributions

2. Forby Corporation had its expenditure of $340,000 for salary to its president and sole shareholder disallowed as a deduction by the IRS. Comparable salaries for presidents of similarly sized firms in the same industry average $95,900. The $340,000 was reclassified as a nondeductible cash dividend. What was the reason the IRS used for the disallowance?
   Ans: Lack of Business Purpose for the unreasonable compensation

3. Randi is a self-employed plumber. She spent $12,000 of her personal savings to buy 120 shares of Kryptogenics, Inc., common stock. She also sold several shares of Xenon Corp. stock and incurred $260 of deductible expenditures. Why is the first expenditure not deductible when the second one is deductible?
   Ans: The first is a capital expenditure where the usefulness extends substantially beyond the end of the tax year. The second is directly related to the sale of an investment asset.

4. Michael sold a personal-use car that had cost $5,000 for $2,000. Why is the loss realized on this transaction disallowed as a deduction?
   Ans: Personal losses are disallowed

5. Craig bought a business-use vehicle for $20,000. He used the vehicle for three years and properly deducted $4,000 annually as depreciation expense. At the beginning of year 4, Craig sold the vehicle for $7,500. Why is Craig's deductible loss only $500?
   Ans: Craig deducted capital recovery amounts of $4,000 annually for three years. Therefore, the adjusted basis was $8,000 at the date of sale. Only $7,500 of the adjusted basis was recovered. The realized loss is recognized because it was incurred with business-use property.

Lecture Outline

I. Federal income taxation is based on a system of rules
   A. Understanding the basic system gives the student the
      1. Ability to determine treatment of transactions
      2. Foundation for understanding the exceptions

B. Exceptions stem from alternative goals
    1. Social
    2. Economic
    3. Political
C. A *Concept* is a broad principle
    1. *Constructs* and *Doctrines* are interpretive devices to apply concepts
        a. Construct is a mechanism developed to implement a concept
        b. Doctrine is a construct developed via the courts
D. ***Discussion Question #1*** is good for creating understanding of artificial systems
    1. **Hint:** Divide your class into small groups and have each solve ***Discussion Question #1***

II. General Concepts apply to almost all aspects of the income tax system
A. Ability to Pay Concept (***Problems 18 to 21***)
    1. Tax levied based on an amount that taxpayer can afford to pay
    2. Taxable income reflects deductions and exclusions due to Ability to Pay (***Examples 1 and 2***)
    3. Tax credits also follow Ability to Pay
    4. Progressive tax rate structure
B. Administrative Convenience Concept
    1. Cost vs. benefit
        a. Taxpayer considerations
        b. Government considerations
    2. Examples of Administrative Convenience
        a. Fringe benefit exclusions (***Example 3***)
        b. Standard deduction amounts (***Example 4***)
C. Arm's-Length Transaction Concept requires economic reality (***Problems 22 and 23***)
    1. Self-dealing via related party transactions (***Figure 2-1***)
        a. Family members
        b. More than 50%-owned corporations (***Example 5***)
        c. Corporations and partnerships if same person owns over 50% of both
D. Pay As You Go Concept
    1. Encourages voluntary compliance through withholding (***Example 6***) and estimated tax payments

III. Accounting Concepts give directions for properly reporting transactions
    A. Entity Concept provides for determination of the proper taxpaying unit
        1. Taxable Entities (***Problems 25 and 26***)
            a. Individuals
            b. Corporations
            c. Estates
            d. Certain Trusts
        2. Conduit Entities are nontaxable (***Problem 27***)
            a. Income, losses, etc. pass through to Taxable Entities
            b. S Corporations (***Example 8; Problem 28***)
                1. ***Examples 7 and 8*** discuss the differences between C and S Corporations
            c. Partnerships (***Problem 30***)
            d. Trusts have both Conduit and Taxable characteristics
        3. Sole Proprietorships (***Examples 9 to 11***)
            a. Business items are segregated from personal items
            b. Report business net income on Individual tax return
            c. **Hint:** Bring a Form 1040 and Schedule C to class (or use the copies provided in ***Appendix C*** of the textbook). You can easily demonstrate the concept of pass-through to the tax return of the taxable entity (the individual).
    B. Assignment of Income Doctrine (***Problems 31 and 32***)
        1. A prohibitive provision
        2. "Whoever provides services reports the income derived from the efforts" (***Example 12***)
        3. **Hint:** Bring a copy of *Lucas v. Earl*, 281 US 111 (1930) to class. Read the prose containing the "fruit and tree" analogy.
        4. Transfer of title of property is valid way to assign income (***Example 13***)
    C. Annual Accounting Period Concept
        1. Each tax year stands apart from all others
        2. Calendar years are most common
        3. Fiscal years may fit a natural business year better
            a. Retailers with FYE January 31, after the holiday busy season
            b. CPA firms with FYE of September or October
        4. Cash or Accrual Accounting Method (***Problems 33 and 34***)
            a. **Hint:** Emphasize that "cash" really means cash-equivalent
            b. ***Examples 14 and 15***

D. Tax Benefit Rule (***Examples 16 and 17; Problems 35 and 36***)
    1. Recovery of prior year deduction reported as income when recovered
    2. Only applies if tax benefit received previously
E. Substance-Over-Form Doctrine (***Problem 37; Examples 18 to 21***)
    1. Reality of a transaction determines taxability
    2. **Hint:** This is the "Duck Rule: 'If it walks like.., and quacks like.., it is...' "

IV. Income Concepts determine what constitutes taxable income
A. All-Inclusive Income Concept
    1. **Hint:** Read (or have a student read) *IRC* §61 to reinforce - taxable income determination begins with "everything"
    2. All economic benefits received are income (***Example 22)***
B. Legislative Grace Concept (***Example 23***)
    1. Exclusions, deductions, and credits
        a. Reductions in income
        b. Only due to Congressional action
    2. These provisions are narrowly and strictly applied and interpreted
    3. Special tax treatment for certain types of income
        a. Capital Assets are *not* receivables, inventory, real or depreciable property used in a trade or business, and certain intangibles (most business assets are not capital)
            1. **Hint:** Go over examples of Capital Assets. Students tend to focus on the GAAP concept of capital assets and are confused about the tax definition.
            2. A net (aggregate) capital gain is taxed at a maximum rate of 15% for individuals (***Problem 41***) (0% for taxpayers with AGI below $77,200 if married filing jointly and 20% for taxpayers with AGI over $479,000 if married filing jointly)
            3. A net (aggregate) capital loss is limited to $3,000 per year for individuals (***Problem 42***)
C. Capital Recovery Concept (***Problems 40 to 42; Example 24***)
    1. No gain is taxed until all capital invested in an asset is recovered
    2. If full amount of investment is not recovered on disposition, a loss is realized
D. Realization Concept (***Problems 43 and 44***)
    1. No recognition until realization (***Example 25***)

2. Arms-length transaction & wealth increases
3. Claim of Right Doctrine
    a. Amounts received without restriction are included in year of receipt
    b. ***Examples 26 to 28; Problems 45 to 47***
4. Constructive Receipt Doctrine
    a. Concerns cash basis taxpayers only
    b. Income is deemed realized
        1. When unconditionally available without physical possession
        2. Taxpayer must be aware of availability (***Example 32***)
        3. No restrictions or limitations over taxpayer's control
        4. ***Examples 29 to 32; Problems 48 and 49***
        5. **Hint:** Use ***Figure 2-2*** to help students understand the differences in constructive receipt and claim of right. Notice the timing: claim of right applies when payment is received -- constructive receipt applies prior to actual receipt

E. Wherewithal-To-Pay Concept provides reasoning for certain deferral provisions
    1. Taxation should occur when taxpayer has resources to pay
        a. Like-kind exchanges (***Example 33***)
        b. Installment sales provisions
    2. Affects certain accrual basis taxpayers too (***Example 34***)
        a. Advance payments for goods and services are income
    3. **Hint:** Students tend to confuse wherewithal-to-pay and ability-to-pay. Stress that wherewithal-to-pay is a transaction concept. Ability-to-pay is a system-wide concept.
F. ***Problem 52*** is an overall Income Concepts problem

V. Deduction Concepts provide the basis for determining the what, how much and when of deductions.
    A. Legislative Grace: nothing is deductible without a provision of tax law
    B. Business Purpose Concept: *Business purpose* must be > *Tax avoidance* motives
        1. Expenses incurred in trade or business (***Examples 35 and 36***)

2. Expenses related to production of income (Investment Expenses) (***Examples 37 and 38***)
3. Personal expenses are disallowed (***Problem 57; Examples 39 and 40***)
    a. Itemized deduction exception (***Example 41***)

C. Capital Recovery Concept
1. Basis is the amount invested (the cost) in an asset (***Example 42; Problem 61***)
2. Capital expenditures establish long-term assets (***Examples 43 to 47***)
    a. Capital is recovered via depreciation
    b. Adjusted basis is the amount of unrecovered investment

D. ***Problems 54 and 55*** are good overall Deduction Concept problems

Concept Challenge. ***Have students complete the on-line quizzes available at the textbook's website (www.cengagebrain.com)***

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Appendix A
Tax Return Problem - Part II
Detailed Explanation

1. Joyce will report $10,648 of income from her business.

   a. Joyce will report $26,620 of income, of which $22,620 is from the 1099-MISC (see Exhibits A-10 to A-12) and $4,000 is an advance from the publisher. The advance is taxable to Joyce because she has a claim or right to the advance. The royalties are from Joyce's trade or business and do not have to be reported on Schedule E.

   b. Because this is the first year she has owned the Volster, Joyce must decide whether to use the standard mileage rate or her actual expenses. If Joyce uses the standard mileage rate, 4,860 (10,800 x 45%) of her miles are eligible for the deduction. The standard mileage rate provides a deduction of $2,600 (53.5 cents x 4,860 miles). As a self-employed taxpayer, Joyce can add to the standard mileage rate the business portion of the personal property taxes on the car $234 ($520 x 45%) and the business portion of the interest expense on her car loan $114 ($254 x 45%). The standard mileage rate method and her total deduction for car expenses is $2,948 ($2,600 + $234 + $114). Joyce should use the standard deduction because it yields a greater deduction than using actual expenses ($2,948 versus $2,436).

   c. Joyce can claim a home office deduction because the room is used exclusively for her business.

      1. Her business use of the house is 15% (375 office square ft. ÷ 2,500 total square ft.). The first step in determining the basis of Joyce's home office is to determine the basis of the home. This is obtained by reducing the purchase price of the property ($70,000) by the value of the land $7,000 ($70,000 x 10%). The portion of the basis attributable to her home office ($9,450) is determined by multiplying the basis of the house $63,000 ($70,000 - $7,000) by Joyce's business use percentage of 15%. Joyce's depreciation deduction is $242 ($9,450 x .02564).

      2. Joyce can deduct the business use percentage (15%) of the indirect expenses. Her indirect expenses include home mortgage interest ($8,140), real estate taxes ($11,200), heat ($2,170), insurance ($1,480), cleaning ($1,560) and electricity ($740). Because the kitchen repairs do not relate to her home office, no portion of the expense is deductible. She can deduct $1,221 ($8,140 x 15%) of the home mortgage, $1,680 ($11,200 x 15%) of the real estate taxes and $893 ($5,950 x 15%) of the other indirect expenses. Note: The personal portion of interest and real estate expenses are deducted on Schedule A [see # 3 (b) (1) and 3 (c) below].

   d. All of Joyce's other business expenses are deductible in full except for meals, which must be reduced by 50%. Her deduction for meals is $305 ($610 x 50%). Her travel of $4,445 consists of train tickets ($535), airfare ($1,670), and lodging ($2,240).

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e. Note: The students might place some of the expenses listed on Schedule C of the tax return solution on different lines. For example, the postage on line 27a, other expense, could be listed as part of office expense on line 18. Therefore, this should be viewed as one acceptable method for preparing Schedule C.

2. Joyce is self-employed and must pay self-employment tax on her net earnings from self-employment. She is allowed to deduct 1/2 of the self-employment tax paid as a deduction for adjusted gross income. This results in only 92.35% of the self-employment income subject to the tax. Joyce's self-employment tax is $1,504 [($10,648 x 92.35%) x 15.3%] and her deduction on line 27 of the 1040 is $752 ($1,504 x 50%).

3. The Schnappaufs' total itemized deductions for the year are $43,513. The following is an explanation of each component of their itemized deductions.

a. *Medical Expenses*
The Schnappaufs can use all of their medical expenses except for the $175 for over-the-counter medicine and the vet fees of $350 for their dog Sandy in computing their medical expense deduction. Because their medical expenses of $7,890 (net of the $700 reimbursement) are less than $12,616 (7.5% x $168,214), they cannot deduct any of their medical expenses.

Instructor's Note: Some students might argue that the cost of the Exsoaligner is a deductible expense, because it was recommended by Bill's chiropractor to help strengthen his back. That argument has some merit. However, including the Exsoaligner as a deductible medical expense will not increase their medical expenses over the 7.5% of AGI threshold.

b. *Taxes*
Bill and Joyce can deduct a total of $16,463 in taxes for the year. The deductible amount of the taxes is described below.

1. The state income taxes of $5,577 withheld from Bill's salary and Joyce's quarterly estimated tax payments of $600 ($150 x 4 quarter) to the State of Rhode Island are deductible. Their state tax deduction is $6,177. The Schnappaufs can deduct only 85% of their real estate taxes on Schedule A because the other 15% relates to Joyce's home office [see # 1(c)(2) above]. Their deduction for real estate taxes is $9,520 ($11,200 x 85%).

2. The personal property tax paid on their cars is deductible, because the tax is based on the value (ad valorem) of the car. Because Joyce uses the car 45% for business, only $286 ($520 x 55%) of the tax is deductible on Schedule A [see # 1(b) above]. The Schnappaufs can deduct $766 ($480 + $286) in personal property taxes.

c. *Interest*
The Schnappaufs can deduct a total of $12,019 of interest for the year. The Schnappaufs can deduct only 85% of their home mortgage interest of $8,140 on Schedule A, because the other 15% relates to Joyce's home office [see # 1(c)(2) above]. Their deduction is $6,919 ($8,140 x 85%). They also can deduct the interest on the home equity loan of $5,100 (see Exhibit A-14).

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d. *Charitable Contributions*
The Schnappaufs gave a total of $8,980 to charitable organizations during the year. The cash contributions of $8,210 were given to Christ the King ($3,100), United Fund ($2,700), the University of Adelaide ($510) and Tremon University ($1,900) and are assumed to be made throughout the course of the year and are not subject to the special reporting rules for individual cash contributions in excess of $250. The antique table donated to the United Way is considered capital gain property and is valued at its fair market value ($410). The other property donated to the United Way would produce a personal loss if sold and are valued at the lower of fair market value or adjusted basis. Form 8283 is required because the total value of the property exceeds $500.

e. *Miscellaneous Deductions*
The Schnappaufs are entitled to a deduction for their miscellaneous itemized deductions of $2,911. This is the amount that is greater than 2% of their adjusted gross income [$6,275 - $3,364 ($168,214 x .02)]. They also can deduct their $3,450 of gambling losses. The miscellaneous deductions include Bill's education expenses of $3,310 that could not be deducted for AGI or qualify for an education tax credit. The breakdown of their miscellaneous itemized deductions is found on statements accompanying the tax return solution.

4. Both Bill and Joyce can make contributions to their IRA accounts, but only Joyce can deduct her contribution for adjusted gross income. The amount Bill contributed to the individual retirement accounts is not deductible, because Bill participates in USC's pension plan and their adjusted gross income exceeds $119,000. Joyce's contribution is deductible because she is self-employed, does not have another pension plan, and their adjusted gross income is less than $186,000. Bill must file a Form 8606 for the amount contributed to his IRA account.

5. They are eligible for an American Opportunity Tax Credit of $2,945 for Will and Dan's education expenses. The $5,000 tax credit is phased out by 10% since their AGI exceeds $160,000 and appears as a tax credit of $1,767 on line 50 and as a tax payment of $1,178 (the refundable amount) on line 68. Bill is not entitled to a Lifetime Learning Tax Credit and cannot be deducted for AGI since their AGI exceeds $160,000. The expenses can be deducted from AGI as a miscellaneous deduction and are included above in #3f.

6. Their total federal withholdings from Phase I is $25,302. This represents Bill's federal withholding of $23,871, the $1,240 withheld on Bill's blackjack winnings, the $47 withheld on the income from the Collingwood Capital Fund and the $144 withheld on the interest from the Ford Motor Bonds. In addition, Joyce's made quarterly estimated tax payments of $840 ($210 x 4 quarters) and is shown on line 65. For reporting purposes, 40% of the $2,945 American Opportunity Tax Credit is refundable, so $1,178 ($2,945 x 40%) of the credit is considered a federal tax payment. Their total federal tax payments are $27,320 ($25,302 + $840 + $1,178).

7. The Schnappaufs' income tax liability is $17,365 but is reduced to $15,598 by the non-refundable portion ($1,767) of the $2,945 American Opportunity Tax Credit. Although Tom is eligible for the child tax credit, Bill and Joyce cannot claim the credit because their adjusted gross income exceeds $130,000. Their tax liability is increased by Joyce's self-employment tax of $1,504, and their total tax liability for the year is $17,102. If Part III is not done, the Schnappaufs will receive a refund of $10,218.

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Chapter 2

Income Tax Concepts

Murphy & Higgins

Concepts in Federal Taxation, 2019 edition

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Federal Income Taxation

- Based on a system of rules
  - Developed around general *concepts* and specific *exceptions*

Once you understand the unifying concepts, you can apply them to almost every aspect of the system.

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Four Major Groupings of Concepts

- General concepts
- Accounting concepts
- Income concepts
- Deduction concepts

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Terminology

- Concept: A broad principle
  - Construct: A means to implement a concept
  - Doctrine: A construct developed by the courts

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General Concepts:
Ability to Pay

- Tax should be based on an amount that a taxpayer can afford to pay.
- Constructs used
  - Deductions
  - Exclusions
  - Credits
  - Progressive tax rates

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General Concepts
Administrative Convenience

- The benefit derived from a concept, construct, or doctrine should always exceed the cost of implementation.
- Constructs used
  - Standard deduction amounts
  - Fringe benefit exclusions
- Example
  - Bow Company allows its employees to make copies for personal reasons without charge on the company copy machine. The employees are not required to include the value of the copies in taxable income.

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General Concepts:
Arms-Length Transaction

- A transaction between related parties must reflect economic reality.
- Constructs used
  - Related-party provisions
  - Constructive ownership rules
- Example
  - Gaby sells 100 shares of IBM stock to her brother for $10,000. The shares had originally cost Gaby $12,000. Because this is not an arms-length transaction Gaby is not allowed to use the $2,000 loss from the sale to reduce her taxable income.

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General Concepts:
Pay as You Go

- Taxpayers are required to pay tax as they generate income.
- Constructs used
  - Withholding
  - Estimated tax payments

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Accounting Concepts: Entity

- Each tax entity must keep separate records and report operations separately
- Constructs used:
  - Taxable entities
  - Conduit entities
  - Sole Proprietorships
- Doctrine used:
  - Assignment of Income

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Accounting Concepts
Assignment of Income

- All income earned from services provided by an entity or property owned by an entity are to be taxed to that entity

- Example
  - Sage is a self-employed electrician. She deposits all cash payments she receives in a bank account in her son's name. Sage does not have use of the funds; however, she is required to include the amount of the cash payments in her gross income.

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Accounting Concepts: Annual Accounting Period

- Each taxpayer must select
  - A tax year
    - Calendar
    - Fiscal
  - An accounting method
    - Cash
    - Accrual
    - Hybrid

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Accounting Concepts:
Annual Accounting Period Constructs & Doctrines

- Tax Benefit Rule
  - If a tax benefit is derived from a deduction in one year, any refund received in a subsequent year must be reported as income
  - Example
    - Abner had $4,000 of state income taxes withheld from his salary during 2017. He deducted the $4,000 as part of his itemized deductions on his 2017 federal return. On May 15, 2018, he received a refund of $1,000 from the state. When he files his 2018 federal return, Abner will be required to report the $1,000 as income.

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Accounting Concepts:
Annual Accounting Period Constructs & Doctrines

- Substance-Over-Form Doctrine
  - A transaction must be realistic in an ordinary sense and not contrived merely to avoid tax
  - Example
    - Jacee “hired” her 4-year old son as office manager for her real estate firm. When she filed her federal tax return she deducted $20,000 as Salary Expense for him. The IRS disallowed the deduction when they examined her return.

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Income Concepts:
All-Inclusive Income

- All income received is taxable unless a provision of the law specifically excludes it

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Income Concepts
Legislative Grace

- Any tax relief provided is the result of specific acts of Congress which are applied and interpreted strictly.

- Constructs used:
  - Exclusions, deductions and credits
  - Special classifications such as capital assets

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Income Concepts:
Capital Recovery

- A taxpayer may recover all invested capital before income is taxed.
- Constructs used:
  - Basis
  - Gains and Losses
- Example
  - Nash sold 200 shares of common stock for $2,000. Because he had paid $800 for the shares, he is required to report only $1,200 as income.

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Income Concepts
Realization

- No income is recognized as taxable income until it has been realized by the taxpayer.

- Doctrines used:
  - Claim of Right Doctrine
    - Applies to both accrual and cash basis taxpayers
  - Constructive Receipt Doctrine
    - Applies only to cash basis taxpayers

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Income Concepts:

Realization and its Constructs and Doctrines – Claim of Right

- Realization does not occur until an amount has been *received without restriction*
- Applies when the taxpayer received payment but there is a restriction the taxpayer's right to keep some or all of it
- Example
  - Pamela rented her garage apartment to Mahlon and collected $450, the first-month's rent, in advance. She also collected $500 as a security deposit that she will return to Mahlon if he doesn't damage the apartment. She must report only $450 as income because she has no *claim of right* to the $500.

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Income Concepts:

Realization and its Constructs and Doctrines – Constructive Receipt

- A modification that prevents cash basis taxpayers from “turning their backs” on income.

- Realization is *deemed* to have occurred if
  - A taxpayer is aware an amount is available,
  - The amount is unconditionally available (even without physical possession), and
  - Receipt of the amount is within the taxpayer’s control.

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Income Concepts:

Realization and its Constructs and Doctrines – Constructive Receipt

- Example
  - Gale is a self-employed handyman. Tracy, one of his customers, brought a check for $250 on December 30, 2016, to pay for work Gale had finished. Gale asked her to mail the check instead, so he could check "delivery time." Gale must report the $250 as income in 2016 even if the check isn't delivered until 2017.

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Income Concepts: Wherewithal-to-Pay

- Tax should be recognized and paid when the taxpayer has the resources to pay.
- Constructs used:
  - Deferrals
  - Recognition of unearned income

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Deduction Concepts:
Legislative Grace, Again

- Any deduction allowed is the result of specific acts of Congress which are applied and interpreted strictly

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Deduction Concepts
Business purpose

- Only expenditures made in order to generate income and for a purpose other than tax avoidance will be deductible.
- Examples:
  - Trade or business expenses
  - Investment expenses
  - Michael may not deduct depreciation on his personal-use automobile because he does not use it in his business.

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Deduction Concepts:
Capital Recovery

- A taxpayer may deduct the amount of capital invested before income is reported.

- Constructs used:
  - Basis
  - Capital expenditures

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