**Chapter I:3**

**Gross Income: Inclusions**

# Discussion Questions

**I:3-1** The phrase "income from whatever source derived" appears in both the 16th Amendment to the Constitution and in Sec. 61(a). This overlapping terminology was adopted to assure the constitutionality of the income tax. p. I:3‑2.

**I:3-2** Economists define income as the amount that an individual could consume during a period and remain as well off at the end of the period as he or she was at the beginning of the period. In accounting, income is measured by a transactions approach. Accountants measure income when it is realized in a completed transaction. pp. I:3‑2 and I:3‑3.

**I:3-3** It is much easier to administer the tax law based on the accounting concept of income instead of the economic concept. Also, wherewithal‑to‑pay is greater when income is taxed as it is realized. pp. I:3‑3 and I:3-4.

**I:3-4** The concept of wherewithal‑to‑pay means that a tax should be imposed when the taxpayer can most easily pay. A taxpayer who owns property that has increased in value does not necessarily have the funds needed to pay any tax. Taxing the gain when it is realized often means that the tax becomes due at the same time the taxpayer collects the sales price. pp. I:3-4 and I:3-5.

**I:3-5** A loan repayment is not consistent with the normal meaning given to the word income. A taxpayer is no better off because a loan is repaid. There has been no economic benefit. As a result the repayment of a loan is not taxable simply because it is not income. p. I:3-3.

**I:3-6** Congress taxes prepaid rental income because of concern that taxpayers who spend the money will be unable to pay the tax when it comes due. Taxing such amounts is to tax income when taxpayers have the greatest wherewithal to pay. The problem created for taxpayers is that they are taxed before they incur related expenses. Repairs, insurance, depreciation, interest and other expenses are incurred as the income is earned. Therefore, there is a mismatching of revenue and expense. pp. I:3-4 and I:3-11 through I:3-12.

**I:3-7** Such arrangements might cause the IRS to question whether the improvements are being made in lieu of rent. If such was the case then the owner of the property may be required to include the value of the improvements in gross income. pp. I:3-15 and I:3-16.

**I:3-8** No. The form of payment (cash, property, or services) is usually unimportant. The important question is whether the taxpayer receives economic benefit. pp. I:3‑4 and I:3-5.

**I:3-9** In the 1930 case of Lucas v. Earl, the Supreme Court held that earnings from labor are taxed to the person who performs the services rather than the person who receives the income. In the 1940 case of Helvering v. Horst, the Supreme Court held that income from property is taxed to the person who owns the property rather than the person who receives the income. One cannot assign income by arranging to have payment made to another person. p. I:3‑6.

**I:3-10** Under community property law, community income is divided equally between a husband and wife. The question of who performed services that produce the income is ignored. In one sense this is contrary to Lucas v. Earl. In another sense the services of both the husband and wife contribute to income production. A spouse who works at home frees the other spouse to work outside the home. pp. I:3‑6 and I:3-7.

**I:3-11** Jane is taxed even if her father is the employer. Jane is taxed even if her wages are paid to one of her parents. If a child under age 18 (and under age 24 in some cases) has unearned income over $2,200, that income is, however, taxed at higher rates (per the kiddie tax rules). Since Jane has earned income, the $3,000 of wages are not subject to the kiddie tax rules. This is true even though Jane is under age 18. p. I:3-8.

**I:3-12** a. Under the concept of constructive receipt, income is taxed when it becomes available to the taxpayer. The taxpayer cannot defer the tax by refusing to accept payment.

b. Income is not constructively received if (1) the receipt is subject to substantial limitations or restrictions, (2) the payor does not have the funds necessary to make payment, or (3) the amount is unavailable to the taxpayer. pp. I:3-9 and I:3-10.

**I:3-13** A territorial system has been adopted, effective 2018. In general, dividends received by U. S. corporations from a 10% or greater foreign subsidiary are eligible for a dividend received deduction. The dividend received deduction is 100% if all of the subsidiary’s accumulated earnings are from foreign sources, effectively exempting the income from the U. S. corporate income tax. The deduction is prorated if a portion of the subsidiary’s earnings are from domestic sources. This recognizes that host countries tax locally earned income. p. I:3-16

**I:3-14** Income is considered to be earned by an accrual basis taxpayer when all the events have occurred which fix the right to receive the income and the amount of income can be determined with reasonable accuracy. p. I:3‑11.

**I:3-15** a. Prepaid income is usually taxable when it is received. This is unlike financial accounting where income is reported as it accrues.

b. The concept of wherewithal-to-pay and the desire by the Federal Government to raise tax revenues are the reasons that the tax law does not conform with financial accounting.

c. One problem with this system is that taxpayers must often report income before expenses related to the income are incurred. The result is a mismatching of revenue and expenses. pp. I:3-11 and I:3-12.

**I:3-16** The three conditions that must be met by an accrual basis taxpayer who wishes to defer reporting amounts received in connection with the sale of goods are (1) the goods are not on hand, (2) the amount received is less than the cost of the item, and (3) the income is deferred for financial accounting purposes. pp. I:3-11 and I:3-12.

**I:3-17** An accrual basis taxpayer may defer reporting prepaid service income if the services are to be rendered before the end of the tax year following receipt. p. I:3-12.

**I:3-18** a. Interest on U.S. government obligations (issued after February 29, 1942) and foreign government obligations are taxable. A limited exclusion is available for Series EE savings bonds if the bond proceeds are used for educational purposes. Interest on obligations of states, territories, U.S. possessions and their political subdivisions is tax exempt. There are exceptions for federally insured, arbitrage, and private activity bonds.

b. In general, tax exempt bonds pay a lower interest rate than taxable bonds because investors are willing to accept a lower before-tax return on tax exempt investments.

c. No. In general, investors in lower tax brackets are better off investing in taxable bonds because their after tax return is generally higher. pp. I:3-13, I:3-14, and I:3-29.

**I:3-19** Dividends received by individuals are taxed at lower rates than other income (0% to 20% instead of 10% to 37%). In addition, eligible corporations can elect to be treated much like partnerships. The income of these so-called “S corporations” is reported by shareholders and is not taxed to the corporations. In addition, corporations receiving dividends from other corporations are eligible to claim a dividend-received deduction that varies between 50% and 100% of the dividends received depending on the percentage of stock owned. pp. I:3‑16 and I:3-17.

**I:3-20** Distributions are taxable to shareholders as dividends only to the extent they are made from either current or accumulated earnings and profits. Distributions in excess of earnings and profits are treated as a nontaxable recovery of capital. Distributions in excess of the basis of the stock are treated as capital gain. p. I:3‑17.

**I:3-21** The Supreme Court concluded that stock dividends are not taxable because they are not income. No income is realized from stock dividends because there is no real change in the taxpayer's interest or the risks faced by the taxpayer. p. I:3-18.

**I:3-22** A constructive dividend is a dividend that is given some other label by the parties. For example, a dividend may be called compensation. Such amounts are reclassified as dividends for tax purposes. Thus, the deduction for compensation would be disallowed if a payment were reclassified as a dividend. p. I:3‑18.

**I:3-23** Prior law applies to divorces and separations executed on or before December 31, 2018. Alimony payments covered by prior law are deductible for AGI by the payor and are included in the gross income of the recipient. Alimony payments covered by the new law are neither taxable to the recipient nor deductible by the payor. pp. I:3-19 and I:3-20.

**I:3-24** a. Although Sec. 61 lists several different types of taxable income, it also says any item of income not listed is taxable unless it is specifically excluded. Therefore, a taxpayer must be able to identify a specific exclusion in order to avoid being taxed on an item of income.

b. The Supreme Court has held that unrealized amounts are not income, and therefore are not taxable under the sixteenth amendment to the Constitution.

c. Yes. It makes no difference whether the taxpayer receives cash or some other form of payment. The important question is whether the taxpayer received economic benefit. Otherwise, taxpayers could easily avoid taxes by choosing to receive stock or some other form of payment.

d. The basic question is whether the note has a market value. The receipt of a readily marketable note represents realization. pp. I:3-4 through I:3-6.

**I:3-25** a. A taxpayer who recovers an amount deducted in a previous year must report as gross income the recovered amount. The recovered amount need not be included in gross income if the taxpayer received no tax benefit from the previous deduction. There is a tax benefit only if the deduction reduced the tax in the previous year.

b. The reimbursement of a medical expense by insurance would be taxable only if the taxpayer had previously deducted the expense and it resulted in a tax savings. There would have been no tax benefit if either the taxpayer had claimed the standard deduction, or if the floor for the medical deduction exceeded the medical expenses. pp. I:3-26 and I:3-27.

**I:3-26** The chapter outlines requirements found in Reg. Sec. 1.451-5 and Rev. Proc. 2004-34 that, when met, allow taxpayers to defer the recognition of prepayments for goods and services. Further, taxpayers can control the terms of contracts to identify payments as deposits rather than prepaid income. This, of course, assumes that such payments are properly so classified. Moreover, cash basis taxpayers can prepay certain expenses in order to offset prepaid income. p. I:3-28.

**I:3-27** No. Such taxpayers do not receive relief under the tax benefit rule. Therefore, if a taxpayer is in a higher tax bracket when the recovery occurs, the taxpayer will pay more tax as a result of the recovery than was saved from the original deduction. p. I:3-27.

**I:3-28** The main tax factor is whether the difference in interest rates is offset by the amount of tax that must be paid on the taxable interest income. Thus, George should look at the after-tax cash flow from each investment as the principal tax factor to consider. Other nontax factors, of course, influence the decision. These include the term of the two alternative investments, liquidity, marketability and other quality factors influencing risk. p. I:3-29.

**I:3-29** The statement is incorrect. The forgiveness of debt does result in an economic benefit as the debtor is relieved of the obligation to make future payments. pp. I:3-4 and I:3-5.

**I:3-30** One point that they should realize is that if they accept the offer for the automobile that a portion of their social security benefits will be taxable because their provisional income would be greater than the base amount of $32,000 (married filing jointly).

Also, there is some question as to the type of income to be reported from the sale of the automobile. Ordinarily, gains on the sale of investment and personal use assets are capital gains. The fact that the gain is attributable to the work they did themselves could cause the gain to be treated as ordinary. However, if this is the only automobile they have restored, they probably are not considered to be in the automobile restoration business. Should they be in the automobile restoration business, they would also owe self-employment tax.

The automobile probably is not covered by Sec. 1221 which classifies "artistic compositions" and **similar property** as ordinary assets. Reg. Sec. 1.1221-1(c) defines "similar property" to include theatrical productions, radio programs, newspaper cartoon strips, and other property eligible for copyright protection. pp. I:3-24 through I:3-26.

# Issue Identification Questions

**I:3-31** The primary issue is whether Andy has constructively received the delayed payment. Andy apparently earned the salary and was entitled to it. The company had the money to pay him on a timely basis. He agreed to delay payment for what may be a valid business reason. Nevertheless, he decided to delay payment, and that is likely to be construed as constructive payment.

Although not discussed in the text until Chapter 6, there is an issue as to how much State can deduct for Andy's salary. As Andy is not a related party, Sec. 267 will not delay the deduction for his salary until it is included in his income. This assumes that the salary is reasonable. pp. I:3-9 and I:3-10.

**I:3-32** The salary levels raise questions relating to the assignment of income and constructive dividends. The reduction in Lisa's salary and the high level of Jane's salary suggest that there is an effort to remove income from Lisa's return (and estate) and transfer the amounts to Jane without a gift tax. Although students are not expected to be familiar with gift and estate taxes at this point, they should question why the salaries are at the level indicated in the question. In Lucas v. Earl, 8 AFTR 10287, 2 USTC ¶ 496 (USSC, 1930), a husband tried unsuccessfully to assign income from his law practice to his wife. The efforts by Lisa could be compared to the action in Lucas v. Earl. Also the issue of constructive dividends can be raised. The high salary paid to Jane may be viewed as a constructive dividend paid to her. pp. I:3-6 and I:3-18.

**I:3-33** The question in this case is when should Larry report the payments as income. The transactions do not always meet the precise requirements specified in Reg. Sec. 1.451-5 for advance payments as the payments sometimes exceed Larry's cost. However, the facts indicate that the amounts may qualify as deposits because customers receive refunds and make additional payments when orders are filled. Also, payments are sometimes refunded as Larry is unable to find items that meet customer’s needs. Rev. Rul. 72-519, 1972-2 C. B. 32 explains the difference between deposits and advance payments. In Rev. Rul. 72-519, however, the examples involve situations where the payments are not ordinarily credited toward the price of gasoline, utilities and other items illustrated. As a result, the treatment of payments in this case is not entirely clear. At this level, students should be able to recognize that the issue is when the payments are taxable and question the application of Reg. Sec. 1.451-5. pp. I:3-8 through I:3-10.

# Problems

**I:3-34** a. Paid holidays are taxable.

1. The value of the stock, $1,000, is taxable.
2. The issuance of the old computers does appear to be intended as compensation. Nevertheless, there is a question of what value, if any, they might have. pp. I:3-4 and I:3-5.

**I:3-35** Amounts (a) and (b) have been constructively received. Amount (d) and (e) were unavailable to the taxpayer. Amount (c) was not constructively received because there were no funds available. pp. I:3‑9 and I:3‑10.

**I:3-36** a. and b. Business income is computed below under the accrual and cash methods. Note that there is a significant difference in the amount of income Carmen reports under the two accounting methods.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  | Accrual |  | Cash |
| Sales |  | $ 600,000 |  | $570,000 |
| Purchases | $400,000 |  | $380,000 |  |
| Inventory | 50,000 |  | 30,000\* |  |
| Cost of sales |  | 350,000 |  | 350,000 |
| Gross profit |  | 250,000 |  | 220,000 |
|  |  |  |  |  |
| Expenses |  | 160,000 |  | 145,000 |
| Net income |  | $ 90,000 |  | $ 75,000 |
|  |  |  |  |  |

\*Not deductible because not sold by year-end. The treatment of ending inventory is consistent with Rev. Proc. 2001-10.

c. Paying the $15,000 will not change the net amount of business income Carmen reports if she elects the accrual method. Under the accrual method, the question is whether she incurred the expenses not whether she paid the expenses. However, under the cash method, she would be able to deduct the $15,000 reducing her business income from $75,000 to $60,000. The amount of income Carmen reports varies from $90,000 to $60,000 depending on the accounting method she chooses and whether she prepays the $15,000. This, in turn, will dramatically impact the amount of tax she will have to pay. Carmen might not, however, have the cash to pay the $15,000. The comparison indicates the importance of the choice of accounting methods. p. I:3-11.

**I:3-37** a. Since the proceeds were used to pay qualified college expenses for their dependent daughter and all the other requirements are met, all $500 of interest is excludable.

b. The exclusion is limited to $300 ($500 interest x $1,200 net tuition and fees / $2,000 principal and interest).

c. The excess modified AGI is $6,000 ($129,050 other income + $500 interest -   
$123,550 threshold). The exclusion is reduced by $60 ($300 otherwise available exclusion x $6,000 excess AGI / $30,000). Therefore, the available exclusion is $240 ($300 - $60). pp. I:3-14 and I:3-15.

**I:3-38** a. If the divorce were covered by prior law (i.e., the divorce was complete prior to December 31, 2018) Fred can deduct the $20,000 payments as alimony. Tammy must include the payments in gross income.

b. If covered by new law, alimony payments are not deductible by the payer nor are they taxable to the recipient.

c. The basis of the residence is $100,000.

d. Representatives of individuals involved in a divorce must make sure that the participants understand the after tax implications of alimony payments.

**I:3-39** a. A substantial portion, perhaps $165,000, would likely be classified as unreasonable and be reclassified as a dividend.

b. The rent is identified as being about the same amount as that paid for similar buildings. It should not be a constructive dividend.

c. Although payments to minor children are often examined closely, it is likely that most, if not all, of the salary is deductible.

d. No reason is given to indicate that the corporation is entitled to deduct the alimony payment. Since the compensation paid to Brad already exceeds the normal limitations, it is likely that this amount is a constructive dividend to Brad. Brad would probably be entitled to a deduction for alimony paid. p. I:3‑18.

**I:3-40** In absence of any alternative explanation, (a), (b), (d), and (e) would likely be classified as constructive dividends. Probably (c) would not be since the sale is at the property's fair market value. p. I:3‑18.

**I:3-41** Stan would report the first and last month's rent, or $6,000, in 2019. In 2020 Stan would report $14,300 of gross income. This consists of February, March, April, and May rent collected from Clay or $12,000; one‑half month's rent withheld from the deposit or $1,500; and the amount withheld for damage or $800. Stan can deduct the cost of repairs. pp. I:3-9 and I:3-15.

**I:3-42** In addition to the regular rental income from the apartment and health club Ed must include $2,600 in gross income. This consists of the lease cancellation payment of $1,000, the first month's rent of $800, and the last month's rent of $800. The security deposit is not taxable. Since there is no reduction in rent, Ed need not include the value of the swimming pool in gross income. pp. I:3-9, I:3-15, and I:3-16.

**I:3-43** Susan’s salary of $44,000, her dividends of $600, her share of the partnership’s income of $4,000, and the lottery winnings of $2,000 are all taxable. Susan is not taxed on the partnership distributions as she has already paid tax on the partnership’s income. To tax the partnership distributions would create double taxation. Although not discussed until a later chapter, she can deduct the cost of lottery tickets up to the amount of her winnings if she itemizes.

**I:3-44** Holly must report $1,300 of gross income determined as follows:

Capital Gain from sale of City of Atlanta Bonds $ 200

Interest on Series EE Bonds 800

Interest on City of Quebec Bonds 300

Gross income $1,300

pp. I:3‑13 and I:3-14.

**I:3-45** a. The exclusion ratio is 25.74 percent computed as follows:

|  |  |
| --- | --- |
| $40,000 25.9 x $500 x 12 | = 25.74% |

The annual exclusion is then determined by multiplying the annual payments times the exclusion ratio.

0.2574 x 12 x $500 = $1,544.40

b. The amount of income that Tim reports will change if he outlives his life expectancy of 25.9 years. Thus, he will be taxed on the entire amount he collects after his total exclusion reaches $40,000. pp. I:3‑20 through I:3‑22.

**I:3-46** a. The simplified method is used because the annuity is related to her employment.

b. Employee contribution $13,000

Divided by the number of anticipated payments ÷ 260

Monthly exclusion $ 50

c. Total pension $ 3,600

Exclusion for 12 months (600)

Taxable pension $ 3,000

pp. I:3-20 through I:3-22.

**I:3-47** a. Dan and Diana will be taxed on $750 of the social security benefits.

Adjusted gross income (excluding social security) $31,000

Plus: 50% of social security 2,500

Provisional income $33,500

The taxable portion is the lesser of $2,500 (0.50 x $5,000 of social security benefits) or $750 [0.50 x ($33,500 of provisional income - $32,000)].

b. Dan and Diana will be taxed on $4,250 of the social security benefits.

Adjusted gross income (excluding social security) $46,000

Plus: 50% of social security 2,500

Provisional income $48,500

The taxable portion is the lesser of $4,250 (0.85 x $5,000 of social security benefits) or $6,325 [the lesser of $6,000 or 0.50 x $5,000 of social security benefits + 0.85 x ($48,500 of provisional income - $44,000)]. pp. I:3-24 through I:3-26.

**I:3-48** a. Assuming she sells all of the stock this year and that she collects the dividends before the sale, one half of the social security benefits are taxable.

Pension $10,000

Social Security (50%) 3,500

Dividends 1,000

Gain on the sale of stock 20,000

Provisional income $34,500

The taxable portion is the lesser of $5,950 (0.85 x $7,000 of social security benefits) or $3,925 [the lesser of $4,500 or 0.50 x $7,000 of social security benefits + 0.85 x ($34,500 of provisional income - $34,000)]. Thus, her AGI of $34,925 is computed as follows:

Pension $10,000

Social security benefits 3,925

Dividends 1,000

Gain 20,000

AGI $34,925

b. On the other hand, if she only sells half of the stock this year, none of the social security benefits are taxable. That is because the provisional (income computed) below is less than the $25,000 threshold for single social security recipients.

Pension $10,000

Social security benefits (50%) 3,500

Dividends 1,000

Gain 10,000

Provisional income $24,500

The result is that her AGI (computed below) is $13,925 lower than in part (a) because the capital gain is only $10,000 and none of the social security benefits are taxable. Of course, the other half of the gain will be taxable next year. She, however, has avoided paying tax on any of her social security benefits by selling half of the stock this year and half next year.

Pension $10,000

Dividends 1,000

Gain 10,000

AGI $21,000

pp. I:3-24 through I:3-26.

**I:3-49** a. Provisional income is $28,500 which is computed as follows:

Salary $27,000

Plus: 50% of social security (0.50 x $3,000) 1,500

Provisional income $28,500

The taxable portion of the social security benefits is equal to $1,500, which is equal to the lesser of

* 1. 50% of social security benefits, $1,500 (50% x $3,000), or
  2. 50% of provisional income in excess of $25,000, $1,750 [50% ($28,500 - $25,000)].

b. The answer would not change. Bob’s provisional income would increase to $29,500 if he also had $1,000 of tax exempt interest income as 50% of the excess provisional income is $2,250. Nevertheless, the taxable portion of the Social Security benefits remains at 50% or $1,500.

1. In this instance, having tax exempt interest income will result in $2,550 of Bob’s Social Security benefits being taxed. Bob’s provisional income increases to $38,500. As his provisional income exceeds $34,000, Bob is subject to an alternative computation. The taxable portion of the social security benefits is equal to $2,550, which is equal to the lesser of
   1. 85% of the Social Security benefit, $2,550 (0.85 x $3,000), or
   2. 85% of provisional income over $34,000, plus the lesser of (1) $4,500 or (2) 0.50 x Social Security benefits {$5,325 = [0.85 x ($38,500 - $34,000) + 0.50 x $3,000]}.

pp. I:3-24 through I:3-26.

**I:3-50** Salary $25,000

Dividends 2,700

Pension 2,400

Rent ( 5,000)

Social Security 1,200

Adjusted gross income $26,300

The taxable portion of the pension is $2,400 (4 x $1,000 x 0.60). The rental activity results in a net loss of $5,000 which is subtracted in computing adjusted gross income. One‑half of the social security benefits of $1,200 (0.50 x $600 x 4) is taxable. The formula amount is $2,150 (see below) but since that is over one‑half of the benefit, the formula is not applicable.

### Adjusted gross income (excluding social security benefits) $25,100

#### Plus: 50% of social security benefits 1,200

Tax exempt interest 3,000

### Provisional income $29,300

Minus: Base amount (25,000)

### Total $ 4,300

x 0.50

Formula amount $ 2,150

pp. I:3-24 through I:3-26.

**I:3-51** a. None. The amount received is a recovery of capital.

1. None. The repayment of a loan is nontaxable. The fact that the taxpayer had to initiate a lawsuit is irrelevant.
2. Accounting fees are taxable. The fact that she had to sue is not relevant. A cash basis taxpayer would report the fee when it is collected. An accrual basis taxpayer would report the fee when the services are rendered. An accrual basis taxpayer would not have to report the fee a second time when collected unless it had been written off as a bad debt.
3. None of the amounts represent income. There is a possibility that forgiveness of debt could become an issue, but that does not yet appear to be the case. p. I:3-26.

**I:3-52** a. Yes. The payment is taxable as there are no restrictions on Jesse's use of the money. As Jesse is in the 24% tax bracket his additional tax from including the $8,000 in gross income is $1,920 (0.24 x $8,000).

b. Jesse can simply deduct the $8,000, which will reduce his tax by $960 (0.12 x $8,000). Alternatively, he can compute the tax that he would otherwise pay and then reduce that tax by the additional $1,920 tax he paid the previous year when he reported the lump-sum payment. Obviously, the second alternative is preferred.

c. As the amount is less than $3,000, Jesse has only the option of deducting the repayment. pp. I:3-26 and I:3-27.

**I:3-53** a. They would save $148 (0.37 x $400) per year. The daughter would not be subject to tax on any of the interest. ($400 interest ‑ $1,100 standard deduction).

b. They would save $148 of taxes per year, but forego $100 [$400 ‑ (0.06 x $5,000)] of interest. Thus, they would be better off to acquire the tax-exempt bonds.

c. They would save $370 (0.37 x $1,000). This assumes no phase-out of itemized deductions.

d. If the salary is reasonable, the full $10,000 should be deductible as a business expense. Otherwise, the amount deemed unreasonable would be treated as a gift. If other gifts were made during the year it could result in a gift tax. The salary would be taxable to the daughter as income assuming it is not a gift. The parents will save $3,700 in income taxes. pp. I:3-13 and I:3-29.

**I:3-54** a. Even though an 11 year old is subject to the kiddie tax, there will be no tax liability as long as the son's income is less than $1,100 per year.

b. The son should file a return and elect to report interest annually. If interest is reported annually there will be little if any tax. If all interest is reported when the bonds mature there will be a large income reported in a single year and a significant tax liability.

c. Each gift potentially increases the child's income. If a dependent child's unearned income increases above $1,100, there is a potential tax and the tax on income over $2,200 will be at higher rates as long as the child is under age 18 (24 in some instances). Therefore, it may be desirable to either elect out of the annual reporting of Series EE interest or choose to make gifts of other types of assets. Growth stocks might be desirable as they produce little current income. Also, dividend income is taxed at lower rates. pp. I:3-13 through I:3-15 and I:3-27 through I:3-28.

# Comprehensive Problems

**I:3-55** a. No. She would be protected by the innocent spouse provision of Sec. 66.

b. Head-of-household (see Chapter I:2).

c. $1,500. One half of her husband's earnings prior to the time he left home.

d. No. The amount of income is less than her personal exemption (see Chapter I:2).

pp. I:3-17 through I:3-19.

**I:3-56** Salary $97,000

### Interest on money market account 200

### Interest on loan to brother 2,100

### Fee for jury duty 50

### State income tax refund 140

### Dividend on Ace stock 1,000

Dividend on Tray stock 1,400

### Adjusted gross income $101,890

Minus: Itemized deductions ( 19,000)

Taxable income $82,890

### Gross tax $ 13,858\*

### Minus: Credit for dependent ( 500)

Minus: Withholding ( 14,000)

Net refund due $ 642

# \*The dividend income of $2,400 is taxed at 15% ($2,400 x 0.15 = $360). The tax on the remaining income of $80,490 ($82,890 - $2,400) is computed using the rate schedule for single taxpayers and amounts to $13,498. The total tax is $13,858 ($360 + $13,498).

# Tax Strategy and Critical Thinking Problems

**I:3-57** a. If the divorce settlement is reached before the end of 2018, payments can be structured so that they qualify as alimony which means Kamal can deduct future payments on his tax return. Padma would be taxed on the alimony she receives. If he is in a higher tax bracket than Padma, there would be a net tax savings. If the divorce settlement is reached after 2018, payments would not be deductible by Kamal or taxable to Padma. Tax advisors should inform their clients of the tax implications of divorce settlements so the clients can weigh tax payments when agreeing to a specific arrangement.

b. Transferring the stock to Padma means she would become a co-owner in the restaurant. As a co- owner she would be taxed on her 30% share of restaurant profits and Kamal would be taxed on his salary and on his 70% share of the profits. This would produce a net tax savings if Padma is in a lower tax bracket than Kamal. In some ways, the plan produces a tax result that is similar to alimony under old law. Obviously, there are other issues that would determine whether Kamal and Padma would choose this option. For example, Padma’s future income is tied to future profits of the restaurant. She could choose to sell her interest in the business bringing in an unfamiliar investor. pp. I:3-18 to I:3-20.

# I:3-58 The $1,000 deduction on this year’s return will save taxes of $370 (0.37 x $1,000) compared to $240 (0.24 x $1,000) on next year’s return. Also, making the contribution today (December 31) instead of tomorrow (January 1) enables Jake to benefit from the deduction on this year’s tax return instead of next year’s return. Delaying the contribution one day results in a one year delay in the tax savings from the deduction and a reduction in the benefit of $130.

# Tax Form/Return Preparation Problems

**I:3-59** (See Instructor’s Resource Manual)

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# Case Study Problems

**I:3-61** The memo for the file should include the following points:

1. Child support payments are not included in gross income. As the cash payments were designated as child support by Jim, this characterization is likely to be followed. The transfer of the automobile probably is not taxable as alimony income as the alimony rules require that such payments be made in the form of cash.

2. It follows that Jim is not entitled to deduct any of the payments. If Linda agrees in writing he could receive a dependency exemption and child credit. The fact, however, that he was unemployed much of the year may mean that he owes little if any tax, and that he would not benefit from additional deductions or credits. pp. I:3-18 and I:3-19.

**I:3-62** The following points should be discussed in your memo:

1. The main advantage of purchasing Series EE bonds in the parents' names is that they may be able to exclude the interest income they eventually receive. They must meet the requirements that the funds be used for educational purposes and meet the income limitation. As the limitation is indexed for inflation and their future income is unknown, the parents cannot be certain whether they will be entitled to the exclusion.

2. If the bonds are purchased in the names of the children and they are under 24 years of age, the interest may be subject to the "kiddie" tax. Nevertheless, if the annual interest is less than $2,200 per child and the children elect to report it each year there will be little tax even if the children are under age 24 and no tax if the income is under $1,100.

3. The fact that the parents expect high income means that purchasing the bonds in the names of the children may be more desirable. This is true if either the annual income is under $2,200 per child or the children are over 23 years of age.

4. The fact that the children may have other income in the future means that the children may face significant future taxes if the bonds are purchased in their names. This is particularly a problem if the children are under age 24 because the parents’ tax rate may apply to all of the interest income. If that is the case the children would probably benefit from waiting to report the interest when the bonds are redeemed. pp. I:3-14, I:3-16, I:3-30 and I:3-31.

**I:3-63** The primary ethical issue relates to how you can adequately advise both clients when their interests may conflict. For example, only one spouse may receive a dependency exemption for a child. Also, whether payments are taxable as alimony or treated as nontaxable property settlements depends on the terms of the divorce. It may well be possible to inform both Lee and Jane as to the relevant tax rules. Nevertheless, one may find it difficult to recommend arrangements that both will find satisfactory. For example, Jane may not want you to advise Lee that there is a rule that enables him to claim children as dependents if she has custody of any children. Similarly, she might not want to tell Lee that labeling payments as property settlements will mean that they cannot be deducted as alimony even though other requirements are met. On the other hand, Lee may not want you to tell Jane that receiving low basis assets could increase the tax she will have to pay when she sells those assets. As a result the information you provide and the advice you give may alienate you from one or both persons. Depending on the situation, it may be desirable to recommend that either Lee or Jane seek advice from another professional tax consultant about relevant tax issues.

# Tax Research Problem

**I:3-64** Under Reg. Sec. 1.109-1 the value of improvements to real estate must be included in gross income if the lessee makes the improvements in lieu of rent. In this case, it is given that the taxpayer did forego one month's rent (which amounted to $1,000) and that the improvements cost $4,000. In CIR v. G. H. Cunningham [2 AFTR 2d 5511, 58-2 USTC ¶ 9771 (9th Cir., 1958)], the court concluded that there was no income to the lessor because the improvements did not increase the value of the property. Though the wiring in this instance cost $4,000, its specialized use did not increase the value of the property.