SWFT 2019 Comprehensive Volume

Chapter 4: Gross Income: Concepts and Inclusions

End-of-Chapter Question, Exercise, and Problem Correlations

Comprehensive 41e (2018)	Comprehensive 42e (2019)	Comprehensive (2019) Learning Objectives	Exact Same	Revised	Brand New	Source Volume: Ind. Income Taxes 42e (2019) OR Corporations 42e (2019)	Source Volume Chapter	Source Volume Question, Problem, or Exercise #
Discussion Questions (DQ)								
DQ.04.01	DQ.04.01	LO1	x			V1	4	DQ1
DQ.04.02	DQ.04.02	LO1	x			V1	4	DQ2
DQ.04.03	DQ.04.03	LO1	x			V1	4	DQ3
DQ.04.04	DQ.04.04	LO1	x			V1	4	DQ4
DQ.04.05	DQ.04.05	LO1	x			V1	4	DQ5
DQ.04.06	DQ.04.06	LO2, 3		x		V1	4	DQ6
DQ.04.07	DQ.04.07	LO2	x			V1	4	DQ7
DQ.04.08	DQ.04.08	LO2	x			V1	4	DQ8
DQ.04.09	DQ.04.09	LO2	x			V1	4	DQ9
DQ.04.10	DQ.04.10	LO3			x	V1	4	DQ10
DQ.04.11	DQ.04.11	LO3, 5	x			V1	4	DQ11
DQ.04.12	DQ.04.12	LO3	x			V1	4	DQ12
DQ.04.13	DQ.04.13	LO3		x		V1	4	DQ13
DQ.04.14	DQ.04.14	LO4		x		V1	4	DQ14
DQ.04.15	DQ.04.15	LO4, 5		x		V1	4	DQ15
DQ.04.16	DQ.04.16	LO4, 5		x		V1	4	DQ16
DQ.04.17	DQ.04.17	LO4	x			V1	4	DQ17
DQ.04.18	DQ.04.18	LO4		x		V1	4	DQ18
DQ.04.19	DQ.04.19	LO4	x			V1	4	DQ19
	DQ.04.20	LO4	x			V1	4	DQ20
Computational Exercises (EX)								
EX.04.20	EX.04.21	LO2		x		V1	4	EX21
EX.04.21	EX.04.22	LO2		x		V1	4	EX22
EX.04.22	EX.04.23	LO3		x		V1	4	EX23
EX.04.23	EX.04.24	LO4		x		V1	4	EX24
EX.04.24	EX.04.25	LO4	x			V1	4	EX25
EX.04.25	EX.04.26	LO4	x			V1	4	EX26
EX.04.26	EX.04.27	LO4	x			V1	4	EX27
Problems (PR)								
PR.04.27	PR.04.28	LO1	x			V1	4	PR28

Comprehensive 41e (2018)	Comprehensive 42e (2019)	Comprehensive (2019) Learning Objectives	Exact Same	Revised	Brand New	Source Volume: Ind. Income Taxes 42e (2019) OR Corporations 42e (2019)	Source Volume Chapter	Source Volume Question, Problem, or Exercise #
PR.04.28	PR.04.29	LO1, 2, 5		x		V1	4	PR29
PR.04.29	PR.04.30	LO2	x			V1	4	PR30
PR.04.30	PR.04.31	LO1, 2	x			V1	4	PR31
PR.04.31	PR.04.32	LO2, 5		x		V1	4	PR32
PR.04.32	PR.04.33	LO2		x		V1	4	PR33
PR.04.33	PR.04.34	LO2, 3, 5	x			V1	4	PR34
PR.04.34	PR.04.35	LO2		x		V1	4	PR35
PR.04.35	PR.04.36	LO2		x		V1	4	PR36
PR.04.36	PR.04.37	LO2		x		V1	4	PR37
PR.04.37	PR.04.38	LO2		x		V1	4	PR38
PR.04.38	PR.04.39	LO2, 5		x		V1	4	PR39
PR.04.39	PR.04.40	LO2, 5	x			V1	4	PR40
PR.04.40	PR.04.41	LO3	x			V1	4	PR41
PR.04.41	PR.04.42	LO2, 3		x		V1	4	PR42
PR.04.42	PR.04.43	LO3, 4	x			V1	4	PR43
PR.04.43	PR.04.44	LO3, 5		x		V1	4	PR44
PR.04.44	PR.04.45	LO3	x			V1	4	PR45
PR.04.45	PR.04.46	LO4		x		V1	4	PR46
PR.04.46	PR.04.47	LO4		x		V1	4	PR47
PR.04.47	PR.04.48	LO4, 5		x		V1	4	PR48
PR.04.48	PR.04.49	LO2, 4	x			V1	4	PR49
PR.04.49	PR.04.50	LO4		x		V1	4	PR50
PR.04.50	PR.04.51	LO4		x		V1	4	PR51
PR.04.51	PR.04.52	LO4		x		V1	4	PR52
PR.04.52	PR.04.53	LO4	x			V1	4	PR53
PR.04.53	PR.04.54	LO4	x			V1	4	PR54
PR.04.54	PR.04.55	LO2, 4		x		V1	4	PR55
PR.04.55	PR.04.56	LO4, 5		x		V1	4	PR56
PR.04.56	PR.04.57	LO4	x			V1	4	PR57
PR.04.57	PR.04.58	LO3, 4	x			V1	4	PR58
Cumulative (Tax Return) Problems (CP)								
CP.04.58	CP.04.59			x		V1	4	CP59
CP.04.59	CP.04.60			x		V1	4	CP60
Research Problems (RP)								
RP.04.01	RP.04.01		x			V1	4	RP1
RP.04.02	RP.04.02		x			V1	4	RP2

Comprehensive 41e (2018)	Comprehensive 42e (2019)	Comprehensive (2019) Learning Objectives	Exact Same	Revised	Brand New	Source Volume: Ind. Income Taxes 42e (2019) OR Corporations 42e (2019)	Source Volume Chapter	Source Volume Question, Problem, or Exercise #
RP.04.03	RP.04.03		x			V1	4	RP3
RP.04.04	RP.04.04		x			V1	4	RP5
RP.04.05	RP.04.05		x			V1	4	RP6
Becker CPA Review Questions (BCPA)								
RCPA	BCPA.04.01				x	V1	4	BCPA1
RCPA	BCPA.04.02				x	V1	4	BCPA2
RCPA	BCPA.04.03				x	V1	4	BCPA3
RCPA	BCPA.04.04				x	V1	4	BCPA4
RCPA	BCPA.04.05				x	V1	4	BCPA5

CHAPTER 4

GROSS INCOME: CONCEPTS AND INCLUSIONS

SOLUTIONS TO PROBLEM MATERIALS

DISCUSSION QUESTIONS

1. (LO 1) According to the Supreme Court in *Thor Power Tool Co. v. Comm.*, "The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major goal of the accountant is to protect these parties from being misled. The primary goal of the tax system, in contrast, is the equitable collection of revenue."

2. (LO 1) The economist's concept of income focuses on changes in the values of assets owned, whereas under tax accounting, realization is required before income is recognized. Generally, realization occurs when there is an exchange of goods and services whose value is capable of objective measurement.

3. (LO 1) Allen received something of value from the casino. Under the broad concept of income, the airfare and hotel accommodations would be considered income. However, Allen could argue that the income should be matched with his $25,000 in gambling losses on the trip, and when the income and losses are combined, the net effect is an economic loss. As will be discussed later in the text, the net loss is not deductible, but at least the gambling losses can be used to offset the income from his gambling activities.

4. (LO 1) Ben must recognize $1,800 of income from the unemployment benefits. His savings from painting his house are not included in gross income—it was not income realized because the savings were not an amount received from another.

5. (LO 1) Because Howard does not know how much he will receive from the sale of automobile parts and it is impractical to determine the cost of individual automobile parts, he could reason that all sales proceeds are a recovery of capital until he receives his cost of $400 and all subsequent proceeds are included in gross income. The IRS may argue that Howard should allocate his cost of the car among the various parts, which may be impractical.

6. (LO 2, 3) The check is a cash equivalent. The employer, as principal, must recognize the income when his agent, the employee, collected it in 2018.

7. (LO 2) According to the constructive receipt doctrine, the taxpayer cannot avoid tax on his or her income by refusing to accept the income at the time it is set aside or made available. The constructive receipt doctrine prevents cash basis taxpayers from deferring their income by intentionally avoiding the receipt of the income in the current tax year.

8. (LO 2) The income from the Series EE bond is deferred until maturity (in three years), but the interest on the bank account is taxed each year under the OID rules. The Series EE savings bonds are exempt from the OID rules, and no interest is included in gross income until the EE bonds' maturity date in three years. Therefore, with the Series EE bonds, the taxpayer is earning interest on his deferred taxes.

9. (LO 2) The taxpayer can defer income by using the cash method of accounting because customers or clients pay subsequent to the taxpayer performing the services (i.e., defer recognizing income until the receivables are converted to cash).

10. (LO 3)
    a. Sonya must file an FBAR form for 2018 because on at least one day during 2018 she had over $10,000 in a foreign bank account.

    b. Sonya must report the interest income earned from this account on her 2018 income tax form (Form 1040).

11. (LO 3, 5)
    a. If Wade sold the car and gave the proceeds to his daughter, Wade would be taxed on the gain. However, if he gave the property to his daughter, she would own the source of the gain (the "tree"); therefore, she would be taxed on any gain.

    b. Undoubtedly, the IRS would argue that in substance, Wade sold the car and Wade should be taxed on the gain. However, if his daughter did not receive the property with a binding commitment to sell it, she would be the taxpayer on the sale.

12. (LO 3) Anita is not correct in her analysis. Anita and the attorney are not partners. Therefore, her gross income is the full amount of the settlement of $480,000. Anita is entitled to a deduction for $160,000. Because the settlement is associated with a discrimination suit, the deduction is a deduction *for* AGI.

13. (LO 3) Rex must include in his gross income his share of the partnership's income, regardless of whether his share of the profits is actually distributed to him. Therefore, Rex must recognize as gross income from the partnership $120,000 ($400,000 × 30%) in 2018 and $180,000 ($600,000 × 30%) in 2019. The withdrawal of $200,000 merely reduces Rex's basis for his partnership interest.

14. (LO 4) Possible reasons why the payments will not be alimony include: (1) the agreement specified that the payments are not alimony or (2) the payments would continue to the spouse's estate if he died within the 10 years or (3) the payor and payee are members of the same household.

15. (LO 4, 5) The following issues are suggested from the facts presented:

    - Will gains and losses from the sale of property pursuant to the divorce be subject to tax?
    - Would payments with respect to William's contribution toward Abigail's education be taxable to her?
    - What is their filing status until the divorce has been completed?
    - Should the payments be arranged so that they are deductible by William and taxable to Abigail, assuming that the divorce is finalized before 2019? If the payments are taxable to her, what additional amounts should she request in exchange for agreeing to terms that are tax favorable to William?
    - Is the day care that is being provided by the grandparents taxable to either William or Abigail?
    - Who will be able to claim April as a dependent?

16. (LO 4, 5) Patrick and Eva should consider the tax implications of the agreement. The property can be transferred without recognition of gain by Patrick or Eva. However, Eva's cost basis in the stock will be the same as Patrick's. If his basis is less than the fair market value of the stock, Eva will recognize gain when the stock is sold, assuming that the stock maintains its value. The cash payments, as presently structured, will not qualify as alimony deductible by Patrick and income to Eva. The payments are not alimony because they are subject to a contingency related to the daughter, which suggests that the payments are for child support. In addition, to qualify as alimony, the cash payments must cease with the death of the payee, the agreement must not specify that the payments are not alimony, and Patrick and Eva cannot live in the same household when the payments are made. Because the cash payments do not qualify as alimony, Patrick will not be allowed a deduction and Eva will not be required to recognize income.

17. (LO 4) Interest income must be imputed on the loan made by Rose Corporation to John Rose. If the loan is characterized as being made to an employee (i.e., a compensation-related loan), the corporation must recognize imputed interest income, but the corporation will also be allowed to deduct imputed compensation for the same amount as the imputed income. Thus, the imputed interest income and the related imputed compensation expense for Rose Corporation will not affect the amount of the corporation's taxable income. On the other hand, imputed interest income on a loan to a shareholder (i.e., a corporation-shareholder loan) results in taxable interest income for the corporation and an imputed, nondeductible dividend paid to the shareholder.

    John's deduction (if any) for the imputed interest paid is dependent upon how he used the borrowed funds. This is true whether the loan is characterized as an employee loan or a shareholder loan. For example, if the funds were used to buy a personal residence, the interest might be deductible as an itemized deduction. If the funds were invested, the interest might be deductible as investment interest. But if the funds were used for vacations or other personal expenditures, the interest would not be deductible by John.

18. (LO 4) When Connor began receiving payments, he had a life expectancy of 20 years (see Exhibit 4.1), but he collected on the annuity for approximately 16 years (2002–2018). Therefore, he did not recover all of his capital. The unrecovered capital can be deducted as a loss in Connor's final tax return.

19. (LO 4) Melba's insurance coverage of $140,000 is twice her annual salary of $70,000. Because this exceeds $50,000, she is required to include in gross income the premiums on $90,000 of excess insurance coverage. The premiums amount is computed by using a table provided by the IRS. For Melba's age, 42 years, the premium amount is $.10 per month per $1,000 of insurance coverage for her annual insurance coverage in excess of $50,000 (see Exhibit 4.3), which is $108 [($.10)(12)(90)].

20. (LO 4) Under the formula for computing taxable Social Security benefits, an increase in other income increases modified adjusted gross income, which can cause an increase in the taxable benefits, thus causing taxable income to increase by more than the other income.

COMPUTATIONAL EXERCISES

21. (LO 2) The difference between the amount due at maturity is actually interest but is referred to as original issue discount. In such an arrangement, the Code requires the original issue discount to be reported when it is earned, regardless of the taxpayer's accounting method. The interest "earned" is calculated by the effective interest rate method.

    The original issue discount rules do not apply to U.S. savings bonds or to obligations with a maturity date of one year or less from the date of issue.

Kunto's gross income from the certificate is $3,772 ($50,000 − $46,228). Kunto's income earned each year is calculated as follows:

a. 2018: $46,228 × 4% = $1,849.12 rounded to $1,849.

b. 2019: [($46,228 + $1,849) × 4%] = $1,923.08, rounded to $1,923.

22. (LO 2) Rev.Proc. 2004–34 and § 451(c) permit an accrual basis taxpayer to defer recognition of income for advance payments for services, goods, and a few other items to be earned after the end of the tax year of receipt. The portion of the advance payment that relates to services performed in the tax year of receipt is included in gross income in the tax year of receipt, matching what is reported in the taxpayer's financial statements for that year. The portion of the advance payment that relates to services to be performed after the tax year of receipt is included in gross income in the subsequent tax year.

Rev.Proc. 2004–34 does not apply to prepaid rent or prepaid interest. Advance payments for these items are always taxed in the year of receipt.

Length of Contract	**2018 Income**	**2019 Income**
12 months	a. $14,000 × 6/12 = $7,000	c. $14,000 × 6/12 = $7,000
24 months	b. $24,000 × 6/24= $6,000	d. $24,000 × 18/24 = $18,000

Note that for the 24-month contracts, Bigham will only report $12,000 on its 2019 financial statements. The remaining $6,000 is reported on Bigham's 2020 financial statements. Rev.Proc. 2004–34 and § 451(c) do not allow for deferral beyond the year subsequent to the year the advance payment was received.

23. (LO 3) Under a community property system, all property is deemed either to be separately owned by the spouse or to belong to the marital community. Property may be held separately by a spouse if it was acquired before marriage or received by gift or inheritance following marriage. Otherwise, any property is deemed to be community property. For Federal tax purposes, each spouse is taxed on one-half of the income from property belonging to the community. The laws of Texas, Louisiana, Wisconsin, and Idaho distinguish between separate property and the income it produces. In these states, the income from separate property belongs to the community. Accordingly, for Federal income tax purposes, each spouse is taxed on one-half of the income. In the remaining community property states, separate property produces separate income that the owner-spouse must report on his or her Federal income tax return.

In all community property states, income from personal services (e.g., salaries, wages, and income from a professional partnership) is generally treated as if one-half is earned by each spouse.

	Idaho (Community Property State)	**South Carolina (Common Law State)**
Dividends	a. $ 600	d. $ 0
Interest	b. $ 450	e. $900
Salary	c. $40,000	f. $ 0

Note that the stock is a community asset because it was created with community funds (i.e., Simba's salary).

24. (LO 4) For pre-2019 divorces, alimony and separate maintenance payments are deductible by the party making the payments and are includible in the gross income of the party receiving the payments. Thus, income is shifted from the income earner to the income beneficiary, who is better able to pay the tax on the amount received.

A transfer of property other than cash to a former spouse under a divorce decree or agreement is not a taxable event. The transferor is not entitled to a deduction and does not recognize gain or loss on the transfer. The transferee does not recognize income and has a cost basis equal to the transferor's basis.

a. Casper is not required to recognize gain on the transfer of the stock.

b. Yes. Casper may deduct the $7,500 of alimony paid.

c. Cecile has $7,500 of income from the alimony received.

d. Cecile has a realized and recognized capital gain of $15,000 ($40,000 sales price – $25,000 carryover basis) when she sells the stock.

25. (LO 4) If interest is charged on the loan but is less than the Federal rate, the imputed interest is the difference between the amount that would have been charged at the Federal rate and the amount actually charged.

The imputed interest rules apply to the following types of below-market loans:

1. Gift loans (made out of love, affection, or generosity).

2. Compensation-related loans (employer loans to employees).

3. Corporation-shareholder loans (a corporation's loans to its shareholders).

No interest is imputed on total outstanding gift loans of $10,000 or less between individuals, unless the loan proceeds are used to purchase income-producing property. This exemption eliminates immaterial amounts that do not result in apparent shifts of income. However, if the proceeds of such a loan are used to purchase income-producing property, other limitations apply instead.

On loans of $100,000 or less between individuals, the imputed interest cannot exceed the borrower's net investment income for the year (gross income from all investments less the related expenses). Thus, the income imputed to the lender is limited to the borrower's net investment income. In addition, if the borrower's net investment income for the year does not exceed $1,000, no interest is imputed on loans of $100,000 or less. However, these limitations for loans of $100,000 or less do not apply if a principal purpose of a loan is tax avoidance.

As with gift loans, there is a $10,000 exemption for compensation-related loans and corporation-shareholder loans. However, the $10,000 exception does not apply if tax avoidance is one of the principal purposes of a loan. This vague tax avoidance standard makes practically all compensation-related and corporation-shareholder loans suspect. Nevertheless, the $10,000 exception should apply when an employee's borrowing was necessitated by personal needs (e.g., to meet unexpected expenses) rather than tax considerations.

a. In this example, Richard is not subject to the imputed interest rules because the $10,000 exception applies.

b. The $10,000 exception does not apply to the loan to Woody because the proceeds were used to purchase income-producing assets. However, under the $100,000 exception, the imputed interest is limited to Woody's investment income ($600). However, the $1,000 exception also applies to this loan; therefore, no interest is imputed.

c. None of the exceptions apply to the loan to Irene because the loan was for more than \$100,000. Therefore, Elizabeth must recognize \$2,625 as interest income. \$105,000 × 5% × 6/12 = \$2,625.

26. (LO 4) The insurance company invests the amounts received from the annuitant, and the income earned serves to increase the cash value of the annuity. No income is recognized by the annuitant at the time the cash value of the annuity increases because the taxpayer has not actually received any income. The income is not constructively received because, generally, the taxpayer must cancel the policy to receive the increase in value (the increase in value is subject to substantial restrictions).

The tax accounting problem associated with receiving payments under an annuity contract is one of apportioning the amounts received between recovery of capital and income. The annuitant can exclude from income (as a recovery of capital) the proportion of each payment that the investment in the contract bears to the expected return under the contract. The exclusion amount is calculated as follows: (Investment/Expected Return) Annuity Payment = Exclusion.

The expected return is the annual amount to be paid to the annuitant multiplied by the number of years the payments will be received. The payment period may be fixed (a term certain) or may be for the life of one or more individuals. When payments are for life, the taxpayer generally must use the annuity table published by the IRS to determine the expected return. The return of capital is calculated by multiplying the appropriate multiple (life expectancy) by the annual payment.

The exclusion ratio (investment expected/return) applies until the annuitant has recovered his or her investment in the contract. Once the investment is recovered, the entire amount of subsequent payments is taxable. If the annuitant dies before recovering the investment, the unrecovered cost (adjusted basis) is deductible in the year the payments cease (usually the year of death).

The taxpayer's expected return is \$300 × 12 × 20.8 = \$74,880. The exclusion percentage is .667735, rounded to 66.77% (\$50,000 investment/\$74,880). The expected return is \$2,403.72 (66.77% × \$3,600 annual payment). The \$2,403.72 is a nontaxable return of capital, and \$1,196.28, rounded to \$1,196 (\$3,600 − \$2,403.72), is included in gross income.

27. (LO 4) MAGI is, for this purpose, the taxpayer's adjusted gross income from all sources (other than Social Security) plus the foreign earned income exclusion and any tax-exempt interest income. In the formulas, two sets of base amounts are established.

The first set is as follows:

- \$32,000 for married taxpayers who file a joint return.
- \$0 for married taxpayers who do not live apart for the entire year but file separate returns.
- \$25,000 for all other taxpayers.

The second set of base amounts is as follows:

- \$44,000 for married taxpayers who file a joint return.
- \$0 for married taxpayers who do not live apart for the entire year but file separate returns.
- \$34,000 for all other taxpayers.

If MAGI plus one-half of Social Security benefits exceeds the first set of base amounts but not the second set, the taxable amount of Social Security benefits is the lesser of the following:

- .50(Social Security benefits).
- .50[MAGI + .50(Social Security benefits) − first base amount].

If MAGI plus one-half of Social Security benefits exceeds the second set of base amounts, the taxable amount of Social Security benefits is the lesser of 1 or 2 below:

1. .85(Social Security benefits).
2. Sum of:
   a. .85[MAGI + .50(Social Security benefits) − second base amount] and
   b. Lesser of:
      - Amount included through application of the first formula.
      - $4,500 ($6,000 for married filing jointly).

a. Their includible Social Security benefits will be $10,540. Include the lesser of the following:

   1. .85($12,400 Social Security benefits) = $10,540.
   2. Sum of:
      a. .85[$46,000 + .50($12,400) − $44,000 second base amount] = $6,970 and
      b. Lesser of:

         Amount calculated by the first formula, which is the lesser of:
         - .50($12,400 Social Security benefits) = $6,200.
         - .50[$46,000 +.50($12,400) − $32,000] = $10,100.
         - $6,000 for married filing jointly

   The sum equals $12,970 ($6,970 + $6,000). Because 85% of the Social Security benefits received is less than this amount, only $10,540 is included in the couple's gross income.

b. The taxpayers must include $0 of the benefits in gross income. This works out as the lesser of the following:

   1. .50($16,000 Social Security benefits) = $8,000.
   2. .50[$12,000 + .50($16,000) − $32,000] = .50 × −$12,000 = −$6,000. None of the benefits would be taxable because the result is not a positive number.

c. Their includible Social Security benefits will be $12,750. Include the lesser of the following:

   1. .85($15,000 Social Security benefits) = $12,750.
   2. Sum of:
      a. .85[$85,000 + .50($15,000) − $44,000 second base amount] = $41,225 and
      b. Lesser of:

         Amount calculated by the first formula, which is the lesser of:
         - .50($15,000 Social Security benefits) = $7,500.
         - .50[$85,000 +.50($15,000) − $32,000] = $30,250.
         - $6,000 for married filing jointly

The sum equals \$47,225 (\$41,225 + \$6,000). Because 85% of the Social Security benefits received is less than this amount, only \$12,750 is included in the couple's gross income.

PROBLEMS

28. (LO 1)

a. The \$500,000 is economic income and gross income for tax purposes. Sam realized \$500,000 for agreeing not to compete and must include the entire amount in gross income. Pay for not performing is treated the same as pay for performing.

b. The \$5,000 is economic income and gross income for tax purposes.

c. The \$100,000 is an increase in wealth realized, must be included in Valery's gross income, and is economic income.

d. Winn's economic income is \$749,995 (the winnings less the cost of the ticket). For tax purposes, he has \$750,000 of gross income. However, the \$5 may be deductible as an itemized deduction for tax purposes.

e. Larry has economic income of \$1,400 from the production in his garden. However, for tax purposes, no income is realized. The realization requirement is not satisfied because the vegetables are consumed by Larry and his family rather than sold to others.

f. Dawn has economic income of \$2,000. Dawn did not realize gross income at the time of the bargain purchase. She will have realized gain when (and if) she sells the automobile for more than \$1,500, her cost.

29. (LO 1, 2, 5) The taxable bond and reinvested earnings will accumulate at an after-tax rate of 4.0% [(1 − .24) × .05333] to equal \$12,167 at the end of five years [(\$10,000 × 1.2167) = \$12,167].

The income from the Series EE bond will not be taxed until maturity in five years, and the after-tax value will be \$11,672 [\$12,200 − .24(\$12,200 − \$10,000)].

Thus, the after-tax proceeds from the land must exceed \$12,167.

Because the gain on the land will be taxed as a long-term capital gain, the sales proceeds less 15% of the appreciation must exceed \$12,167.

$$\$10,000 + (1 - .15)(X - \$10,000) = \$12,167$$
$$\$10,000 + .85X - \$8,500 = \$12,167$$
$$.85X = \$10,667$$
$$X = \$12,549$$

Thus, the land must increase in value by more than \$2,549 to yield a greater after-tax return than the investment in either of the bonds.

	A	B	C	D	E	F	G	H
7	**Corporate Bond**			**EE Bond**			**Land**	
8								
9	Investment amount	10000		Investment amount	10000		Investment amount	10000
10	Number of years	5						
11	Annual pre-tax yield	0.0533		Pre-tax future value	12200		Pre-tax future value	= (H20-H9)/(1-H15)+H9
12								
13	Annual pre-tax return	= (B9*B11)						
14								
15	Tax rate	0.24		Tax rate	0.24		Tax rate	0.15
16								
17	After-tax yield	= (B13*(1-B15))/(B9)		Taxes	= (E11-E9)*E15		Taxes	= (H11-H9)*0.15
18								
19								
20	After-tax future value	= (B9)*(1+B17)^5		After-tax future value	= (E11-E17)		After-tax future value	12167

30. (LO 2)

a. Deb should have recognized $300 interest income and $1,700 gain ($11,700 − $10,000) when she exchanged the bond for stock. Of the value of the corporate stock she received, $300 was for her accrued interest. The remaining $11,700 was in exchange for the bond whose cost was $10,000. The fact that the stock decreased in value after the exchange is not relevant because she still owns the stock and thus has not realized the loss in value.

b. Deb did not realize income when she borrowed on the property. Her net worth did not increase—assets and liabilities increased by an equal amount.

c. Deb must recognize compensation income of $600 ($300 × 2), the fair market value of the tickets at the time she received them.

31. (LO 1, 2)

a. The $1,500 is a reduction in the cost of the automobile and is not income.

b. The $50,000 payment received under the covenant is included in Amos's gross income because the payment is an increase in wealth realized.

c. The change in the zoning rules that causes the property to increase in value is economic gain but is not a realized gain for tax purposes. Amos's wealth increased, but the realization requirement is not satisfied because he did not receive any additional property, nor were any improvements made to his property. Amos will not realize this increase in wealth for tax purposes until he sells the property.

32. (LO 2, 5)

a. Al's gross income for 2018 on the cash basis is $292,000 ($280,000 + $12,000), which is the amount he actually collected in that year.

b. Al's gross income computed by the accrual method is as follows:

Cash received	$292,000
Less: Income received but will not be earned until 2019	(12,000)
Less: Beginning-of-the-year accounts receivable	(40,000)
Plus: End-of-year accounts receivable	60,000
	$300,000

c. Al should use the cash method of accounting so that he will not have to pay income taxes on uncollected accounts receivable. The tax law does not require Al to use the accrual method.

33. (LO 2)

a. Accrual basis gross receipts:

Cash received	$1,400,000
Less: Beginning accounts receivable	(200,000)
Less: Bank loan	(100,000)
Add: Ending accounts receivable	250,000
Gross receipts	$1,350,000

b. Gross income:

Gross receipts		$1,350,000
Cost of goods sold:		
Purchases	$1,300,000	
Beginning inventory	150,000	
Ending inventory	(300,000)	(1,150,000)
Gross income		$ 200,000

34. (LO 2, 3, 5)

Maloney, Raabe, Hoffman, & Young, CPAs
5191 Natorp Boulevard
Mason, OH 45040

October 1, 2018

Ms. Amanda Sims
Managing Partner
ARP Associates
100 James Tower
Denver, CO 80208

Dear Ms. Sims:

I am responding to your suggestion that ARP Associates should change to the accrual method of accounting for tax purposes as a means of reducing accounting fees. Under the accrual method of accounting, receivables must be recognized as income as the services are performed. This is to be contrasted with the cash method of accounting, where no income is recognized until payment is received.

Each year under the accrual method, accelerated tax payments will occur so long as the billing and collection pattern remains the same. Therefore, the partners will pay tax on an additional $75,000 in the first year's income [accrual of billings in first year that would not be collected until second year—one-half of November's billings ($25,000) and all of December's billings ($50,000)], and those payments will not be recovered until the company ceases its operations. Assuming that the partners are in the 35% (combined state and Federal) marginal tax bracket, the deferred taxes under the cash method are $26,250 (.35 × $75,000). If the partners earn a 2.29% ($600 ÷ $26,250) return (or greater) on the deferred taxes, the additional accounting fees will be recovered. Therefore, I recommend that you continue to use the cash method so long as the partners earn a return of 2.29% or greater on the deferred taxes. The partnership is not required to use the accrual method for tax purposes.

Sincerely,

Tara Kelly, CPA
Tax Partner

35. (LO 2)

TO: Susan Apple

FROM: Bill Swan

SUBJECT: Dispute over Recording of Income by Trip Garage, Inc.

DATE: May 1, 2019

I am responding to the questions you raised regarding the timing of the reporting of income by Trip Garage, Inc., for repairing Samuel Mosley's car. The key issue is whether the garage should (1) accrue the $1,000 of income in 2018 and take a $100 loss deduction in 2019 (the IRS view) or (2) report the $900 in 2019 (Trip's preferred approach).

An accrual basis taxpayer is required to recognize income when (1) all the events have occurred to establish the taxpayer's right to receive the income and (2) the amount of the income can be determined with reasonable accuracy. In Trip's case, it does not appear that all the events to fix the rights to the income had occurred in 2018. The customer did not accept the work by the end of the year. Thus, the transaction should be held open in 2018 and no income and related costs should be reported until 2019.

36. (LO 2)

a. The check is a cash equivalent; therefore, the $1,500 must be included in the cash basis taxpayer's 2018 gross income when it was actually received.

b. The check is not a cash equivalent because of the restrictive conditions placed upon it. Therefore, a cash basis taxpayer does not include the $1,500 in gross income until 2019.

c. The fact that the bank was closed is not relevant. The check is a cash equivalent; therefore, the $1,500 must be included in 2018 gross income.

37. (LO 2)

a. The Series EE bonds are not subject to the original issue discount (OID) rules. Therefore, assuming that Marlene did not elect to take the annual increments in value into income each year, her 2018 gross income from the bonds is $2,910 ($10,000 − $7,090).

b. The CD contains $816 ($10,816 − $10,000) of original issue discount (OID), which must be amortized by the effective interest method. Because Marlene owned the CD for six months in 2017, she should have recognized $200 ($10,000 × .04 × 1/2 year) in 2017. In 2018, Marlene earned 4% on the compounded amount of the investment, and her 2018 gross income from the bonds is $408 [.04($10,000 + $200)].

c. The CD is issued for a period of one year; therefore, the OID rules do not apply. Marlene, as a cash basis taxpayer, is not required to recognize any income ($300) until 2019, when the CD matures.

38. (LO 2)

a. The $1,200 is included in the 2018 gross income. The advance payment received in 2017 for goods delivered in 2018 qualifies for deferral because the company satisfied the tax and financial accounting conformity requirement.

b. For the sale of the six-month service contract, $120 is included in 2018 gross income ($240 × 3/6 = $120). The advance payment for services qualifies for proration over the life of the contract because all of the income will be earned by the end of the tax year following the year of receipt.

Drake must include in 2018 gross income $210 ($1,260 × 6/36). Drake would include in 2019 gross income $1,050 ($1,260 − $210), the balance on the contract sold in 2018 for services that would not all be performed by the end of the tax year of receipt. That is, the portion of the advance payment that relates to services to be performed after the tax year of receipt is included in gross income in the tax year following the tax year of receipt of the advance payment.

c. The company must include $1,200 in gross receipts and can deduct the cost of the appliance, $750, in arriving at gross income of $450. The fair market value of the note is not relevant for purposes of determining the accrual method taxpayer's gross income. The interest of $260 will be taxed as it accrues over the 24-month life of the contract.

39. (LO 2, 5)

a. No. Actual receipt applies to the $120,000 ($10,000 × 12 months) she received in 2019. The $132,000 deferred income is not constructively received in 2019 because under the actual contract terms, she did not have the right to receive the income in 2019. The constructive receipt doctrine cannot change actual events to "what might have been done."

b. Freda may have expected to be in a lower marginal tax bracket in 2020. She also benefited by not having to pay the tax on the income shifted into 2020 until she filed her 2020 income tax return or made payments on estimated taxes for 2020.

c. Yes. The $132,000 actually received in 2020 was constructively received in 2019 because it was made available to her in that year.

40. (LO 2, 5)

a.
- The $1,000 damage deposit is not taxed in the year of receipt.
- The damage deposit is not taxable at the time it is collected, but the $500 prepaid rent is taxed in the year of receipt.
- The $1,000 prepaid rent is taxed in the year of receipt.

b. The Bluejay Apartments should use the first option. By doing so, it maximizes deferrals without affecting the cash flows.

41. (LO 3)

Salary	$100,000	Rusty earned $100,000 and used $20,000 to pay his debts.
Interest	6,000	Rusty must include his gross income from all geographic sources.
Loss	–0–	The corporation is the owner of the property; therefore, the rent income and expenses remain in the corporation.
Salary	20,000	Rusty received the salary from the corporation, a separate entity.
Gross income	$126,000	

Rusty is not taxed on the interest and dividends of $5,000 received by Rebecca because she is the owner of the income-producing property.

42. (LO 2, 3)

a. The cash basis corporation must recognize the income of $10,000 in 2018, when its agent, Troy, received the check, which is a cash equivalent. Troy will not recognize any bonus until it is actually or constructively received. The fact that the employer received the fees in 2019 does not affect the time Troy recognizes the bonus.

b. The corporation must recognize the income in 2018, when the agent, Troy, performed the services. Troy will recognize the 10% bonus in 2019 because neither actual nor constructive receipt of the bonus occurs in 2018.

c. The fact that the customer admits that the check will not be honored if presented at the end of the year means that the check is not a "cash equivalent." Furthermore, the restriction on when the check can be presented for payment is "substantial." Thus, income is not recognized in 2018.

43. (LO 3, 4) Each partner's share of the partnership income is one-third of the taxable income earned by the partnership. The premiums on the partner's group term life insurance are included in each partner's gross income. The limited exclusion for group term life insurance premiums is available only to employees (not partners). Therefore, each partner's gross income is $90,800 [($270,000 + $2,400)/3]. The contributions and distributions in this case do not affect any of the partners' gross income. They merely increase or decrease the partner's basis account.

44. (LO 3, 5)

a.

Amur dividends (Note 1)	$ 60,000
Blaze dividends (Note 2)	40,000
Grape dividends	22,000
Total dividend income	$122,000

Note 1: Even though Amur is a foreign corporation, the dividend is a qualified dividend because its stock is traded on an established U.S. securities market.

Note 2: The dividend paid by Blaze is not a qualified dividend because the holding period requirement is not satisfied (i.e., must be held more than 60 days during the 121-day period beginning 60 days before the ex-dividend date).

Qualified dividends	
Amur dividend	$60,000
Grape dividend	22,000
	$82,000
Applicable rate	× 15%
Tax on qualified dividends	$12,300
Non-qualifying dividends	
Blaze dividend	$40,000
Applicable rate	× 32%
Tax on non-qualified dividends	$12,800
Total tax on dividends	$25,100

b. The daughter is in the 10% marginal tax bracket. She has $1,000 of qualified dividends that are eligible for the alternative tax rate of 0% (rather than the usual 15%). So the daughter's tax liability on the dividends is $0 ($1,000 × 0%).

c. Alva's after-tax return on the bond is 3.06% [(1 − .32)(.045)]. Her after-tax return on the stock is 3.4% [(1 − .15)(.04)]. Therefore, the stock yields the greater after-tax return because any appreciation in value is the same.

d. The daughter is in the 10% marginal tax bracket. Therefore, her after-tax return on the bond is 4.05% [(1 − .10)(.045)]. Her after-tax return on the stock is 4.0% [(1 − .00)(.04)]. Therefore, the bond yields the greater after-tax return.

45. (LO 3)

	a. California		b. Texas	
	Doug	Liz	Doug	Liz
Salary	$48,000	$48,000	$48,000	$48,000
Rent		8,000	4,000	4,000
Dividends	1,900		950	950
Interest	1,200	1,200	1,200	1,200
	$51,100	$57,200	$54,150	$54,150

Under Texas law, the rents and dividends belong to the community even though this income is derived from separate property. Under California law, the income is community or separate depending on the state law classification of the underlying assets. In this case, the interest is community income because the savings account was funded with community property.

46. (LO 4) Assuming the divorce is finalized before 2019, the following answers apply.

a. The transfers of the stock and residence pursuant to the divorce are nontaxable to Nell and Kirby. Nell assumes Kirby's basis in the stock of $150,000, and Kirby's basis in the house is $300,000. However, the $50,000 cash paid by Kirby will be alimony unless the agreement specifies that the payment is "not alimony."

b. The cash payments of $1,000 per month do not qualify as alimony because they will not cease upon Nell's death. The payments are excluded from Nell's gross income as they are received by her, and Kirby may not deduct the payments (would be a deduction *for* AGI if the payments had been classified as alimony).

c. The monthly payments of $1,200 are in part child support and in part alimony. The monthly amount that will continue after the occurrence of the contingency related to the child is considered alimony. Therefore, $300 per month is alimony that must be included in Nell's gross income, and the other $900 received each month is child support. Kirby can deduct the alimony payments of $300 as a deduction *for* AGI.

47. (LO 4) Under these facts, it would seem that a fair division would mean that each spouse received equal value as calculated on an after-tax basis. Under the proposal, each spouse will receive equal value as calculated on a before-tax basis, but Rafel will receive less than Alicia after taxes are considered.

Under the plan, Rafel and Alicia would receive an equal before tax amount of $280,000. Rafel will receive assets with a fair market value of $410,000, but would incur a $130,000 liability to Alicia. As Rafel pays Alicia the $17,600 each year, the payments will not be deductible by Rafel as alimony (or included in Alicia's gross income), unless they would cease upon Alicia's death. Moreover, the interest on the obligation will not be deductible because it is not incurred in a trade or business or a transaction entered into for profit. Therefore, the after-tax interest rate on the loan is the same as the stated rate of 6%. The other property transactions will have substantial tax implications. Rafel's basis in the investment assets will be $160,000. Therefore, if the investments were sold for their current value, Rafel would have a $250,000 ($410,000 − $160,000) taxable gain. Rafel would incur a $37,500 ($250,000 × 15%) tax liability. However, Alicia will not have any tax liability as a result of the proposed transactions because she does not intend to sell the appreciated asset she received, the personal residence. Even if she did sell the residence, the realized gain would be exempt from tax under the § 121 exclusion (see Chapter 13).

48. (LO 4, 5) The family's after-tax cash flow will decrease by less if Roy borrows from Hal rather than the bank. Interest is imputed on the loan from Hal (at 3%) because the interest rate charged by Hal (2%) is less than the Federal rate (3%). With the loan from Hal, all of the interest stays in the family rather than being paid to and received from the bank, Hal's tax on his interest income decreases, and Roy's tax benefit from deducting the interest decreases by a lesser amount.

	Borrow from Bank	Borrow from Hal
Hal's interest on CD, $150,000 × .035	$5,250	
Less: Tax on the interest income, $5,250 × .32	(1,680)	
Hal's interest on loan to Roy, $150,000 × .03 = $4,500		
Less: Hal's tax on imputed interest, ($150,000 × .03) × .32		($1,440)
Roy's bank interest expense, $150,000 × .04	(6,000)	
Roy's tax benefit from deducting interest, $6,000 × .12	720	
Roy's tax benefit from interest to Hal, ($150,000 × .03) × .12		540
After-tax cash flow to family	($1,710)	($ 900)

49. (LO 2, 4)

a. The imputed interest amount for six months is $180 ($12,000 × .03 × .5). However, the imputed interest rules do not apply because the loan was less than $100,000 and Jim does not have any investment income.

b. The imputed interest rules do not apply because this gift loan was for less than $10,000 and it was not used to purchase income-producing property.

c. The imputed interest for four months is $250 ($25,000 × .03 × 4/12). Because the amount of the loan exceeds $10,000 and the borrower had net investment income that is less than the imputed interest amount, the imputed interest is limited to an amount equal to Al's net investment income of $220. This amount would be reported as interest income for Ridge and as interest expense for Al. However, because this amount does not exceed $1,000, no interest is imputed.

d. The imputed amount for three months is $1,125 ($150,000 × .03 × 3/12). This amount is reported as interest income by Ridge and as interest expense by his mother. The investment income limitation does not apply to this loan because the loan exceeded $100,000.

50. (LO 4)

a. This loan is a gift loan between individuals that is eligible for the $100,000 exception. Although Mike's sister has $900 of investment income, interest is not imputed under this exception if the borrower's net investment income is not greater than $1,000. So the imputed amount is $0.

b. This loan is an employer-employee loan for not greater than $10,000. Sam did not use the funds to buy investments, and there appears to be no tax avoidance motive. Thus, no interest is imputed.

c. Interest is imputed on this loan. The $100,000 exception is not available on corporation-shareholder loans. The imputed interest would be calculated as follows:

$$\$25,000 \times (5\% - 4\%) \times 1/2 = \$125$$

d. The loan from Kait to Jake is classified as a gift loan between individuals that is eligible for the $100,000 exception. So the imputed interest income for the six months is calculated as follows:

$60,000 × 5% × 1/2 = $1,500

Under the $100,000 exception, the imputed interest is limited to Jake's net investment income of $2,100. So in this case, the limit has no effect on the amount of imputed interest.

51. (LO 4)

a. The employer-employee loan would be eligible for the $10,000 exemption through June 30, 2019. However, in July 2019, the total outstanding loans exceed $10,000. The $100,000 exemption does not apply to these loans. Therefore, interest is imputed on the $18,000 amount of the loans for the period July through December 2019. Vito, Inc., has interest income, and Vito has compensation income of $360 [.04($18,000 × 6/12)]. Vito also has interest expense of $360, and Vito, Inc., has compensation expense of the same amount. Note that employer-employee loans are not eligible for the $100,000 exemption.

b. A corporation-shareholder loan is not eligible for the $100,000 exemption and usually does not qualify for the $10,000 exemption (i.e., cannot satisfy the requirement that tax avoidance is not a principal purpose of the loan). Therefore, for 2018 and 2019, the corporation has interest income and dividends paid (not deductible) as follows:

2018 ($8,000 × 4% × 6/12)		$160
2019 ($8,160 × 4% × 6/12)	$163	
($8,160 + $163 + $10,000)(.04)(6/12)	366	$529

Vito has dividend income and interest expense of equal amounts.

52. (LO 4)

a. Cost (her investment) = $42,000

$$\frac{\text{Employee's investment}}{\text{Number of anticipated payments [Exhibit 4.2]}} = \frac{\$42{,}000}{210} = \$200 \text{ exclusion per payment}$$

Collections in 2017 (6 payments × $3,000)	$18,000
Exclusion for capital recovery ($200 × 6 payments)	(1,200)
Include in gross income	$16,800

The simplified method is used to calculate the annuity exclusion percentage because this is a qualified retirement plan distribution.

b. Pam will have recovered her investment as a return of capital prior to the twenty-fourth year (i.e., 17 years and 6 months). Thus, all annuity payments received in the twenty-fourth year ($36,000) are includible in her gross income.

$3,000 × 12 payments = $36,000

c.

Investment in the contract	$42,000
Less: Capital recovered ($200 exclusion × 160 payments)	(32,000)
Unrecovered cost (loss in the final year return)	$10,000
Income from collections in final year: [$24,000 collected − (8 × $200 = $1,600 exclusion)]	$22,400

53. (LO 4)

a. Peyton is required to include $60,000 in gross income, the value of the automobile. The award does not satisfy the right type of achievement requirement to qualify for exclusion from gross income. In addition, the provision that requires the recipient to contribute the award to a qualified governmental unit or nonprofit organization is not satisfied.

b. Jacob can exclude from his gross income the $1.4 million Nobel Peace Prize received and then given to the United Nations, assuming that the United Nations is a qualified nonprofit organization.

c. The $10,000 Linda received cannot be excluded as a prize because it was not received in recognition of a qualifying achievement (e.g., scientific, artistic). Moreover, she entered the contest. However, the $6,000 tuition award (but not the $4,000 received for meals and housing) can qualify as a scholarship.

54. (LO 4)

a. Alice's gross income from the excess coverage is computed as follows:

Uniform premiums for $1,000 of protection for 1 month	$ .08
Coverage for 12 months (age 32)	× 12
	$ .96
Excess coverage: $\frac{\$90{,}000 - \$50{,}000}{\$1{,}000}$	× 40
Includible amount for Alice	$38.40

Kay is a partner (not an employee); therefore, the exclusion for group term life insurance premiums is not applicable for her. The partnership will deduct the actual premiums paid. The premiums attributable to the partners (based on the uniform table) are included in the partner's gross income. Therefore, Kay includes $270 in her gross income.

Uniform premiums for $1,000 of protection for 1 month	$ .15
Coverage for 12 months	× 12
	$ 1.80
Excess coverage: $\frac{\$150{,}000 - \$0}{\$1{,}000}$	× 150
Includible amount for Kay	$270.00

b. As an employee of the incorporated business, Kay is eligible for the group term life insurance exclusion.

Uniform premiums for $1,000 of protection for 1 month	$ .15
Coverage for 12 months	× 12
	$ 1.80
Excess coverage: $\frac{\$150{,}000 - \$50{,}000}{\$1{,}000}$	× 100
Includible amount for Kay	$180.00

The availability of the life insurance premiums and other benefits available to employees that are discussed in Chapter 5 are considerations in deciding whether to incorporate a business.

55. (LO 2, 4)

Salary	$ 90,000
Unemployment compensation	8,800
Interest income	60
Dividend income	550
Lottery winnings	1,500*
Gross income	$100,910

*The $5 cost of the lottery ticket is deductible as a miscellaneous itemized deduction, not subject to the 2%-of-AGI reduction.

Note: Neither the $12,000 loan nor the principal of $1,940 from the savings account withdrawal are included in gross income.

56. (LO 4, 5)

a.

Taxable Social Security benefits =	
.5[$35,000 + .5($12,000) − $32,000] = .5($9,000)	$ 4,500
Pension benefits, etc.	35,000
AGI	$39,500

b.

Other income ($35,000 − $8,000)	$27,000
Taxable Social Security benefits =	
.5[$27,000 + $6,000 + .5($12,000) − $32,000]	3,500
AGI	$30,500
AGI in part a. above	(39,500)
Decrease in AGI	($ 9,000)

Note: The taxpayers' economic income decreased by $2,000 ($8,000 − $6,000), but taxable income decreased by $9,000. However, with a 12% marginal tax rate, their after-tax economic income will decrease by only $920.

Decrease in interest income	$2,000
Decrease in tax liability (12% × $9,000)	(1,080)
Decrease in economic income	$ 920

c. Lesser of:

(1)	.85[$65,000 + .5($12,000) − $44,000] = .85($27,000)	$22,950
	Plus smaller of:	
	Amount calculated by the first formula, which is the lesser of	
	.5($12,000) = $6,000	
	.5[$65,000 + .5($12,000) − $32,000] = $19,500	
	or	
	$6,000	6,000
		$28,950

or

(2)	.85($12,000)	$10,200

Therefore, Linda and Don would be required to include 85% of the Social Security benefits ($10,200) in their gross income.

Includible Social Security benefits	$10,200
Other income ($35,000 + $30,000)	65,000
AGI	$75,200
AGI in part a. above	(39,500)
Increase in AGI	$35,700

Note: The increase in AGI exceeds the increase in earnings because more of the Social Security benefits became taxable.

57. (LO 4)

a.

Charles E. and Bernice B. Bennett

Worksheet 1. **Figuring Your Taxable Benefits** *Keep for Your Records*

Before you begin:
- If you are married filing separately and you **lived apart** from your spouse for all of 2017, enter "D" to the right of the word "benefits" on Form 1040, line 20a; or Form 1040A, line 14a.
- Do not use this worksheet if you repaid benefits in 2017 and your total repayments (box 4 of Forms SSA-1099 and RRB-1099) were more than your gross benefits for 2017 (box 3 of Forms SSA-1099 and RRB-1099). None of your benefits are taxable for 2017. For more information, see Repayments More Than Gross Benefits.
- If you are filing Form 8815, Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989, do not include the amount from line 8a of Form 1040 or Form 1040A on line 3 of this worksheet. Instead, include the amount from Schedule B (Form 1040A or 1040), line 2.

1. Enter the total amount from box 5 of ALL your Forms SSA-1099 and RRB-1099. Also enter this amount on Form 1040, line 20a; or Form 1040A, line 14a . . . **1.** 12,000		
2. Enter one-half of line 1	**2.**	6,000
3. Combine the amounts from: *Form 1040:* Lines 7, 8a, 9a, 10 through 14, 15b, 16b, 17 through 19, and 21 *Form 1040A:* Lines 7, 8a, 9a, 10, 11b, 12b, and 13	**3.**	46,000
4. Enter the amount, if any, from Form 1040 or 1040A, line 8b	**4.**	
5. Enter the total of any exclusions/adjustments for: • Adoption benefits (Form 8839, line 28), • Foreign earned income or housing (Form 2555, lines 45 and 50; or Form 2555-EZ, line 18), and • Certain income of bona fide residents of American Samoa (Form 4563, line 15) or Puerto Rico	**5.**	
6. Combine lines 2, 3, 4, and 5	**6.**	52,000
7. *Form 1040 filers:* Enter the amounts from Form 1040, lines 23 through 32, and any write-in adjustments you entered on the dotted line next to line 36. *Form 1040A filers:* Enter the amounts from Form 1040A, lines 16 and 17	**7.**	--
8. Is the amount on line 7 less than the amount on line 6? **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040, line 20b; or Form 1040A, line 14b. **Yes.** Subtract line 7 from line 6	**8.**	52,000
9. If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2017, enter $25,000	**9.**	32,000
Note. If you are married filing separately and you lived with your spouse at any time in 2017, skip lines 9 through 16; multiply line 8 by 85% (0.85) and enter the result on line 17. Then go to line 18.		
10. Is the amount on line 9 less than the amount on line 8? **No.** STOP None of your benefits are taxable. Enter -0- on Form 1040, line 20b; or on Form 1040A, line 14b. If you are married filing separately and you **lived apart** from your spouse for all of 2017, be sure you entered "D" to the right of the word "benefits" on Form 1040, line 20a; or on Form 1040A, line 14a. **Yes.** Subtract line 9 from line 8	**10.**	20,000
11. Enter $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2017	**11.**	12,000
12. Subtract line 11 from line 10. If zero or less, enter -0-	**12.**	8,000
13. Enter the **smaller** of line 10 or line 11	**13.**	12,000
14. Enter one-half of line 13	**14.**	6,000
15. Enter the **smaller** of line 2 or line 14	**15.**	6,000
16. Multiply line 12 by 85% (0.85). If line 12 is zero, enter -0-	**16.**	6,800
17. Add lines 15 and 16	**17.**	12,800
18. Multiply line 1 by 85% (0.85)	**18.**	10,200
19. **Taxable benefits.** Enter the **smaller** of line 17 or line 18. Also enter this amount on Form 1040, line 20b; or Form 1040A, line 14b	**19.**	10,200

TIP *If you received a lump-sum payment in 2017 that was for an earlier year, also complete Worksheet 2 or 3 and Worksheet 4 to see if you can report a lower taxable benefit.*

b. $10,200.

58. (LO 3, 4) Donna has substantial tax problems:

a. Donna's share of the partnership income of $150,000 will be taxable to Donna even though the income was not distributed. Therefore, she will need to come up with the cash required to pay the taxes.

b. A portion of the Social Security benefits will be taxable because Donna has other income. If Donna and her husband file separate returns, she must include $7,140 ($8,400 × 85%) of the Social Security benefits in her gross income (i.e., the base amount is $0 in this case). Even with a joint return, Donna and her husband would include $7,140 of the Social Security benefits in their gross income (i.e., in this case, the base amount would be $44,000).

c. Donna must report the $1,200 of interest income even though the creditor received the money. She owned the property that earned the income. Also, she benefited from the income in that the money was used to satisfy her liability.

d. Donna will be required to include in gross income one-half of her husband's income because they are residents of a community property state.

CUMULATIVE PROBLEMS

59. *Part 1—Tax Computation*

Gross income:	
Salary and commissions ($74,000 + $86,000) (Note 1)	$160,000
Interest income on certificate of deposit	382
Interest income on Second Bank savings account (Note 2)	1,600
Dividends on CSX stock (Note 3)	4,200
Income from partnership (Note 4)	7,000
Deductions *for* adjusted gross income	(–0–)
Adjusted gross income	$173,182
Standard deduction (greater than itemized deductions)	(24,000)
Taxable income	$149,182
Tax liability (Note 5)	$ 24,405
Dependent credit (Note 6)	(1,000)
Less: Tax withheld by employers ($12,400 + $11,000)	(23,400)
Estimated tax payments	(8,000)
Net tax payable (or refund due) for 2018	($ 7,995)

(1) The $3,100 commission for Freida is not included in her gross income until it is received in 2019.

(2) The $900 of interest on the City of Corbin bonds is excluded from gross income.

(3) The dividends of $4,200 on the CSX stock are included in Dan and Freida's gross income.

(4) Dan's share of the partnership profits is $7,000 (per the Schedule K–1 received). Therefore, he must include this amount in his gross income.

(5) The Butler's tax liability is $24,405:

Tax on dividend income ($4,200 × 15%)	$ 630
Tax on other taxable income ($144,982) (from tax schedule)	23,775
	$24,405

(6) Gina qualifies as a dependent. Under the qualifying child requirements, she does not have to satisfy the gross income test. In any event, this is not a problem because Gina has $0 gross income. Gina does not file a joint return with her husband. Therefore, because all of the requirements are satisfied for a qualifying child, Dan and Freida can claim a dependent credit for Gina. Ben, their son, fails to qualify as a dependent because of the age requirement for a qualifying child and because of the gross income test for a qualifying relative. Sam, their son, does qualify as a dependent as a qualifying child. It appears he has too much gross income ($6,300). However, there is no gross income test under the qualifying child requirements. He does satisfy the qualifying child age requirement by being a full-time student during five calendar months. Because Sam is not under age 17, Dan and Frieda cannot claim the $2,000 child credit for Sam but can claim the $500 dependent credit.

Part 2—Tax Planning

Maloney, Raabe, Hoffman, & Young, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 29, 2018

Dan and Freida Butler
625 Oak Street
Corbin, KY 40701

Dear Dan and Freida:

You asked me to estimate your after-tax income under the assumption that Dan will work only half-time next year. The $37,000 reduction in Dan's pay will be partially offset by a $4,000 estimated increase in the amount Freida will earn. This net $33,000 reduction in salary and wages will also result in a decrease in your Kentucky income tax, Social Security tax, and Medicare tax. The net reduction in your after-tax cash flow will be approximately $21,000. The calculations are presented below:

	Taxable Income	Cash Flow
Decrease in salary and other earned income	($33,000)	($33,000)
Decrease in Social Security and Medicare tax (.0765 × $33,000)		2,525
Decrease in Kentucky income tax (.04)	1,320	1,320
Decrease in Federal taxable income	($31,680)	
Decrease in Federal income tax (.22)		6,970
After-tax decrease in cash flow		($22,185)

If you have any further questions, please call me.

Sincerely,
John Jones, CPA

TAX FILE MEMORANDUM

DATE: December 27, 2018

FROM: John Jones

SUBJECT: Dan and Freida Butler, Change in Taxes for 2018

Dan plans to work only half-time in 2018, but Frieda anticipates an increase in her income. Dan's income will decrease by $37,000, and Frieda's income is expected to increase by $4,000 and a $400 increase in the personal and dependency exemptions deduction. This net $33,000 reduction in salary and wages will also result in a decrease in their Kentucky income tax, Social Security tax, and Medicare tax. The net reduction in their after-tax cash flow will be approximately $21,000. The calculations are presented below:

	Taxable Income	Cash Flow
Decrease in salary and other earned income	($33,000)	($33,000)
Decrease in Social Security and Medicare tax (.0765 × $33,000)		2,525
Decrease in Kentucky income tax (.04)	1,320	1,320
Decrease in Federal taxable income	($31,680)	
Decrease in Federal income tax (.22)		6,970
After-tax decrease in cash flow		($22,185)

My assumptions for the analysis were as follows:

1. The $3,100 commission received on January 10, 2018, is included in the $90,000 income to be earned by Freida in 2018.
2. The 22% 2018 marginal tax rate remains the same in 2019.
3. Interest income, dividend income, partnership income, and the standard deduction are the same for 2018 and 2019.
4. Gina and Sam will continue to qualify as dependents.

60. Gross income:

Pension	$39,850
Interest income (Note 1)	5,500
Dividend income	2,000
Annuity income (Note 2)	3,240
Social Security benefits (Note 3)	11,900
Imputed interest on gift loan (Note 4)	1,600
Net rent income (Note 5)	1,750
Gross income	$65,840
Deductions *for* AGI	(–0–)
AGI	$65,840
Less: Itemized deductions (Note 6)	(13,000)
Taxable income	$52,840
Tax liability (Note 7)	$ 7,424
Less: Estimated tax payments	(5,900)
Net tax payable (or refund due) for 2018	$ 1,524

Notes

(1) The $4,500 of interest on the City of Alto bonds is excludible from gross income.

(2) The exclusion percentage and the related annual exclusion on the annuity contract Cecil purchased are calculated as follows:

$$\frac{\$46{,}800}{\$450 \times 260 \text{ payments}} = 40\% \times \$5{,}400 = \$2{,}160$$

Cecil received $5,400 of annuity payments from the insurance company this year. Thus, Cecil must include $3,240 ($5,400 − $2,160) in his gross income this year.

(3) The amount of the Social Security benefits that Cecil must include in his gross income is the lesser of the following two amounts:

a. 85%($14,000) = $11,900

b. Sum of:

(1) .85[$65,840 − $11,900 + $4,500 + 50%($14,000) − $34,000] = $26,724 and

(2) Lesser of:
(a) 50%($14,000) = $7,000
50%[$65,840 − $11,900 + $4,500 + 50%($14,000) − $25,000] = $20,220
(b) $4,500

Thus, $26,724 + $4,500 = $31,224.

Because the amount calculated under part a. of $11,900 is less than the amount calculated under part b. of $31,224, the $11,900 is included in Cecil's gross income.

(4) Because Cecil made a below-market gift loan to Sarah, he needs to determine whether any imputed interest should be included in his gross income. The loan qualifies under the $100,000 exemption. Because Sarah's net investment income is only $1,600, Cecil must include only $1,600 in his gross income rather than $3,600 ($60,000 × 6%).

(5) The net rental income from the townhouse is as follows:

Rent income		$9,000
Less: Expenses		
Utilities	$2,800	
Maintenance	1,000	
Real estate taxes	750	
Insurance	700	
Depreciation	2,000	(7,250)
Net rent income		$1,750

(6) Cecil's itemized deductions are as follows:

Personal property taxes	$ 2,100
State income taxes	3,500
Charitable contributions	7,400
	$13,000

Cecil's state income taxes paid of $3,500 exceeded the sales taxes he paid of $912. Cecil's standard deduction would be $12,000 (the basic standard). Thus, Cecil will itemize deductions.

(7) Cecil does not qualify for the Tax Rate Schedule for a head of household. He maintains a home for his unmarried daughter, Sarah. She is not his dependent. Even though she is unmarried, Sarah must be his dependent for head-of-household purposes.

Tax on $50,840 ($52,840 − $2,000) (from tax schedule)	$7,124
15% × $2,000 dividend income	300
	$7,424

RESEARCH PROBLEMS

1. CLIENT LETTER

Maloney, Raabe, Hoffman, & Young, CPAs
5191 Natorp Boulevard
Mason, OH 45040

December 29, 2018

President, Tranquility Funeral Home, Inc.
400 Rock Street
Memphis, TN 38152

Dear Sir:

You asked me to address the question of when the income from preneed funeral contracts should be included in gross income. Based on my research, I have concluded that the amounts collected are customer deposits, rather than the receipt of prepaid income. Therefore, the prepaid amounts are not included in gross income until Tranquility performs the services.

In a case involving a situation much the same as yours, *Perry Funeral Home, Inc.*, (86 TCM 713, T.C.Memo. 2003–340), the Tax Court concluded that the prepayments were refundable deposits under the control of the customer and, therefore, were not prepaid income. The payments were not prepaid income because the customer was not required to use the service—the customer could demand a refund anytime prior to the time the goods and services were provided. The Tax Court cites as authority *Comm. v. Indianapolis Power & Light Co.*, [65 AFTR 2d 90–394, 110 S.Ct. 589, 493 U.S. 203 (1990)], which held that refundable utility deposits were not prepaid income.

Please call me if you have any further questions.

Sincerely,

Jane J. Jones, CPA
Partner

2. Your client received the proceeds and had the free and unrestricted use of the funds. As a result, she must include the $50,000 in her gross income. To balance her taxable income with her economic income, your client may be permitted a tax loss. The fraud she claims was committed against her gave rise to a claim against her father. If the father is convicted but she cannot recover from him, she may be entitled to claim a loss on her tax return.
The facts of your client's situation are similar to those found in *Reinaldo Moracen*, T.C. Summary Opinion 2007–69.

3. The cancellation of the policy in payment of the debt is a taxable event, the same as if he received $30,000. The premiums paid, $6,800, are considered a recovery of capital, and the balance, $23,200, must be included in the client's gross income. See, for example, *Ledger v. Comm.*, T.C.Memo. 2011–183.

Research Problems 4 and 5

These research problems require that students utilize online resources to research and answer the questions. As a result, solutions may vary among students and courses. You should determine the skill and experience levels of the students before assigning these problems, coaching where necessary. Encourage students to use reliable websites and blogs of the IRS and other government agencies, media outlets, businesses, tax professionals, academics, think tanks, and political outlets to research their answers.

4. Search on the question "Are lottery winnings taxable in California?" The Tax Foundation website (http://taxfoundation.org/article/lottery-tax-rates-vary-greatly-state) and the California State Lottery Winner's Handbook (www.calottery.com/win/winners-handbook) indicate that the state of California does not tax lottery winnings. However, more searching reveals that although the state does not tax California lottery winnings, winnings of other states' lotteries are taxable by the state [see the instructions for the California Schedule CA (540)].

5. Search using the following terms: *divorce terms negotiation tax*. A multitude of sources will result.

   The firm might offer a service in which it proposes that the spouses' attorneys work together to ensure that the divorce results in payment of the lowest possible amount of taxes. The firm might provide a service that offers to help spouses share the resulting tax savings.

CHECK FIGURES

21.a. $1,849.
21.b. $1,923.
22.a. $7,000.
22.b. $6,000.
22.c. $7,000.
22.d. $18,000.
23.a. $600.
23.b. $450.
23.c. $40,000.
23.d. $0.
23.e. $900.
23.f. $0.
24.a. No gain or loss.
24.b. Deduction.
24.c. $7,500 income.
24.d. $15,000 gain.
25.a. $0.
25.b. $0.
25.c. $2,625.
26. 66.77%; $1,196.
27.a. $10,540.
27.b. $0.
27.c. $12,750.
28.a. $500,000.
28.b. $5,000.
28.c. $100,000.
28.d. $749,995 and $750,000.
28.e. $0 for tax purposes.
28.f. $0 for tax purposes.
29. Land needs to increase in value by more than $2,549.
30.a. $300 interest income and $1,700 gain.
30.b. Gross income $0.
30.c. Gross income $600.
31.a. Gross income $0.
31.b. Gross income $50,000.
31.c. Gross income $0.
32.a. Cash basis income $292,000.
32.b. Accrual basis income $300,000.
32.c. Cash method.
33.a. Gross receipts $1,350,000.
33.b. Gross income $200,000.
34. Accrual method increases gross income by $75,000.
35. Trip should report in 2019.
36.a. Include $1,500 in 2018.
36.b. Include $1,500 in 2019.
36.c. Include $1,500 in 2018.
37.a. $2,910.
37.b. 2017 $200; 2018 $408.
37.c. $0 in 2018, $300 in 2019.
38.a. Gross income of $1,200 may be deferred until 2018.
38.b. Gross income of $120 ($240 × 3/6) in 2018 for 6-month contract. For 36-month contract, include $210 in 2018 gross income.
38.c. Gross income $450 ($1,200 − $750).
39.a. Constructively received $0.
39.b. She may be in a lower tax bracket in 2020.
39.c. Constructively received in 2019.
40.a. Report in the year of receipt $0 under option 1, $500 under option 2, and $1,000 under option 3.
40.b. First option.
41. $126,000 for Rusty.
42.a. Corporation recognizes $10,000 in 2018; Troy recognizes $0.
42.b. Same as part a.
42.c. Corporation recognizes $0 in 2018; Troy recognizes $0 in 2018.
43. $90,800 for each partner.
44.a. $25,100 ($12,300 + $12,800).
44.b. $0 tax liability.
44.c. Stock is better.
44.d. Bond is better.
45.a. Doug $51,100; Liz $57,200.
45.b. Doug $54,150; Liz $54,150.
46.a. No recognition tax consequences; $50,000 cash might be alimony.
46.b. $0 alimony.
46.c. $300 is alimony.
47. Goal is to receive equal value on an after-tax basis.
48. Roy should borrow from Hal.
49.a. $0.
49.b. $0.
49.c. $220.
49.d. $1,125.
50.a. $0 imputed interest.
50.b. $0 imputed interest.
50.c. Imputed interest $125.
50.d. Imputed interest $1,500.
51.a. Compensation income and interest expense to Vito $360; compensation expense and interest income to Vito, Inc., $360.
51.b. Interest income and dividends paid to the corporation in 2018 $160; interest expense and dividend income to Vito in 2018 $160; amount in 2019 is $529.
52.a. Gross income $16,800.

52.b. Gross income $36,000.
52.c. $22,400.
53.a. $60,000.
53.b. $0.
53.c. $4,000.
54.a. Alice $38.40; Kay $270.
54.b. $180.
55. $100,910.
56.a. $39,500.
56.b. No.
56.c. $35,700.
57.b. $10,200.
58.a. The $150,000 is taxable.
58.b. $7,140 is taxable.
58.c. $1,200 is taxable.
58.d. Donna must include one-half of husband's winnings.
59. Refund due $7,995.
60. Net tax payable (or refund due) $1,524.

SOLUTIONS TO ETHICS & EQUITY FEATURES

Should the Tax Treatment of Government Bonds and Corporate Bonds Be Different? (p. 4-11). The difference in the tax treatment of U.S. government bonds and corporate bonds appears to be a situation where the law lacks horizontal equity: similar investments are taxed differently. The law can be justified as tax simplification for small investors. Moreover, these types of government bonds are generally purchased by middle-income taxpayers who will not exploit the rules. On the other hand, corporate bonds are largely purchased by wealthy individuals and financial institutions to whom complexity in the law is not a major problem and who would likely find means to exploit the income deferral.

Taxing "Made-Up" Income (p. 4-24). The use of interest-free loans can easily be used to avoid income taxes within the family unit. Suppose, for example, that Christian is in the 39.6% income tax bracket and Mia's bracket is 15%. If the $200,000 loan yields income of $20,000, the parties have saved $4,920 ($7,920 − $3,000) annually by channeling the investment through a lower-bracket family member. The imputed interest rules preclude this kind of income shifting.

SOLUTIONS TO BECKER CPA REVIEW QUESTIONS

Detailed answer feedback for Becker CPA Review questions is available on the instructor companion site (www.cengage.com/login).

1.	a	4.	b
2.	b	5.	b
3.	d		