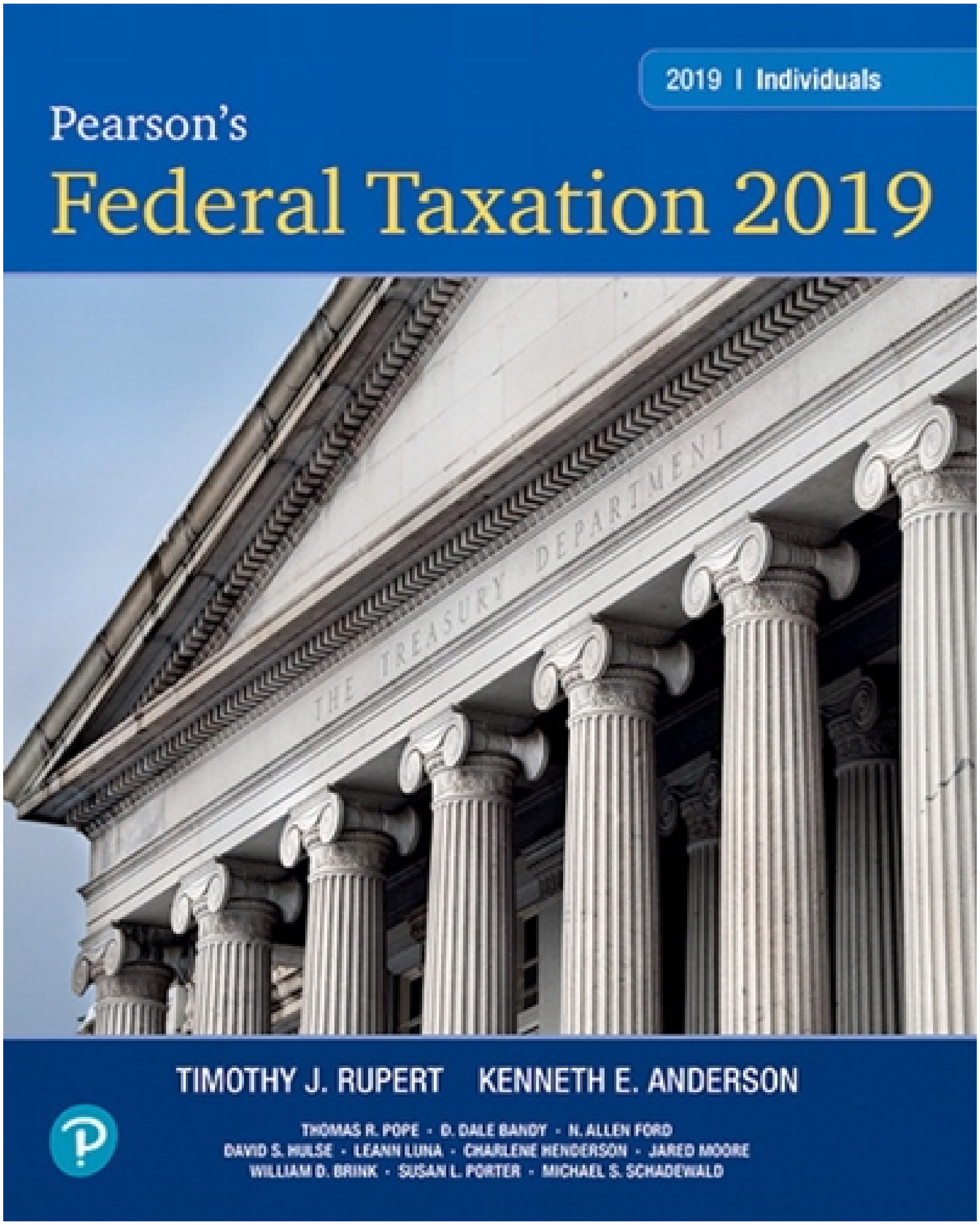
Solutions for Pearsons Federal Taxation 2019 Individuals 32nd Edition by Pope



Solutions

Chapter I:2

Determination of Tax

Discussion Questions

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

b. Gross income is relevant to certain tax determinations. For example, whether a person is required to file a tax return is based on the amount of the individual's gross income. As the amount does not necessarily appear on any tax return, it may be necessary to separately make the computation in order to determine whether a dependent is a qualifying relative. pp. I:2-3.

I:2-2 The term "income" includes all income from whatever source derived, based on principles of economics and/or accounting. Gross income refers only to income from taxable sources; it does not include tax-exempt income. p. I:2-3.

I:2-3 a. A deduction is an amount that is subtracted from gross income (or adjusted gross income), while a credit is an amount that is subtracted from the tax itself.

b. In general, a $10 credit is worth more than a $10 deduction because the credit results in a $10 tax savings. The savings from a deduction is less than 100% of $10, depending on the tax bracket that applies to the taxpayer.

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

I:2-4 A dependent must be a qualifying child or a qualifying relative:

- A qualifying child must (1) be the taxpayer's child or sibling, (2) be under 19, a full-time student under 24, or disabled, (3) live with the taxpayer, and (4) not provide more than half of his or her own support.
- A qualifying relative must (1) be related to the taxpayer (or reside in the taxpayer's home for the entire year), (2) have gross income less than $4,150 (2018), and (3) receive over one-half of his or her support from the taxpayer.

Both types of dependents also must meet several requirements: (1) have a social security number reported on the taxpayer's return, (2) meet a citizenship test, (3) cannot normally file a joint return, and (4) cannot claim others as dependents. pp. I:2-12 through I:2-16.

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

b. Yes. When several individuals contribute to the support of another, it is possible for members of the group to sign a multiple support agreement that enables one member of the group to claim the supported person as a dependent. Also, in the case of divorced couples, the parent with custody for over half of the year may claim their child as a dependent even if that parent did not provide more than 50% of the child's support. Similarly, in the case of a written agreement, the noncustodial parent may claim their child as a dependent even if that parent provided 50% or less of the child's support.

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

I:2-6 A taxpayer will use a rate schedule instead of a tax table if taxable income exceeds the maximum in the tax table (currently $100,000) or if the taxpayer is using a special tax computation method such as short-year computation. p. I:2-19.

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

b. Taxpayers who owe no tax because of deductions or other reasons must still file a return if they have gross income in excess of the filing requirement amounts. p. I:2-33 and I:2-34.

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

I:2-9 If the support test for a qualifying relative were "50% or more" and two individuals provided equal amounts of support for another person, that person would be a qualifying relative of both individuals (assuming the other requirements for a qualifying relative were met). By specifying that the individual provides "more than 50%" of the person's support, that person cannot be a qualifying relative of more than one individual. If two individuals each provide exactly 50% of another person's support, that person would not be a qualifying relative of anyone because no one provided more than half of his or her support, but the two individuals may be able to use a multiple support agreement to allow one of them to claim that other person as a dependent.

In practice, it is unlikely that an individual provides exactly 50% of another person's support. The distinction between "50% or more" and "more than 50%" is important, however, in other areas of the tax law. For example, consider an individual who owns exactly 50% of a corporation's stock, and that individual sells all of his or her stock to the person who owns the other 50% of the corporation's stock. As Chapter C:7 discusses, the deductibility of a corporation's net operating loss is limited if the corporation's ownership changes by more than

50 percentage points. In this case, that limitation would not be triggered because the corporation's ownership changes by exactly 50 percentage points, not more than 50 percentage points. p. I:2-15.

I:2-10 The normal due date for calendar-year individuals and C corporations is April 15. The normal due date for calendar-year partnerships and S corporations is March 15. If the normal due date is a Saturday, Sunday, or holiday, the normal due date is delayed to the next day that is not a Saturday, Sunday or holiday. p. I:2-34.

I:2-11 Automatic extensions of six months generally are available. For a C corporation, the extension is six or seven months, depending on fiscal year-end. Any tax that may be owed must be paid with the application for an extension. p. I:2-34.

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

I:2-13 It can be, but as was noted in the preceding answer, parents may ignore a child's scholarship in deciding whether they provide over half of the child's support. p.I:2-15.

I:2-14 The purpose of the multiple support agreement is to allow one member of a group to claim a supported person as a dependent when the members together contribute more than 50% of the support of that person and each member of the group contributes over 10%. The multiple support agreement results in an exception to the requirement that the taxpayer alone must provide over one-half of the dependent's support. pp. I:2-16 and I:2-17.

I:2-15 In general, the parent with custody for the greater part of the year may claim the children as dependents. The noncustodial parent may claim them as dependents only if required documentation provides for it. p. I:2-18.

I:2-16 In general, a couple must be married on the last day of the tax year in order to file a joint return. In addition, the spouses must have the same tax year. Also, if one spouse is a nonresident alien, then that spouse must agree to include all of his or her gross income on the return. p. I:2-20.

I:2-17 The phrase "maintain a household" means to pay over one-half of the costs of the household. These costs include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance and food consumed on the premises. Such costs do not include clothing, education, medical treatment, vacations, life insurance and transportation. p. I:2-22.

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

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

b. Some corporations are ineligible for making an S corporation election. Others may choose the C corporation because the 21% corporate tax rate is less than the rate for the higher individual tax brackets (e.g., 32%, 35%, and 37%). Other considerations not discussed in Chapter 2 include fringe benefits, the need to retain earnings in the business and dividend policy. pp. I:2-27 and I:2-28.

I:2-20 The 21% tax rate that applies for C corporations. If an individual with a significant amount of other income operates a new business as a proprietorship, that income is taxed at the owner's marginal tax rate, which may be higher than 21%. Thus, the current tax can be reduced if the corporate form is used and income is retained in the corporation. This advantage may be lost if the corporation distributes the income. New businesses often need to retain income for expansion. p. I:2-27.

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

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

b. Yes. An individual's net long-term capital gain generally is taxed at 0%, 15%, or 20%, depending on the taxable income and filing status. These tax rates are less than the rates that otherwise would apply. Short-term capital gains are taxed much like other income.

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

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

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

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

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

c. The tax on the unearned income of children (i.e., the kiddie tax) was created to reduce the opportunity to reduce taxes by shifting income from parents who are in high tax brackets to children who have little or no other income and would, therefore, normally be in a low tax bracket. pp. I:2-30 and I:2-31.

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

b. In the event of underpayment of taxes on a joint return, the IRS can collect the unpaid tax from either spouse. pp. I:2-32 and I:2-33.

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

Issue Identification Questions

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

I:2-27 The primary tax issue is whether they should file a joint return. Filing jointly could produce a tax savings because more income will be taxed at the low 10% and 12% rates. Carmen, however, should carefully consider whether Carlos is disclosing all of his income. If not, she may be liable for additional taxes, interest, and penalties resulting from the unreported income. The innocent spouse rules may not protect her. She is not required to know with certainty Carlos' income in order to be liable. The fact that Carmen is "surprised" that Carlos' income is so low suggests that she has reason to know that there is unreported income. pp. I:2-32 and I:2-33.

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

Problems

I:2-29

	Smiths	Millers
Salary	$30,000	$95,000
Taxable interest income	20	1,000
Gross Income	$30,020	$96,000
Minus: IRA Contribution	0	(5,500)
Adjusted gross income	$30,020	$90,500
Minus: Greater of standard deduction or itemized deductions	(24,000)	(24,000)
Taxable Income	$ 6,020	$66,500
Gross tax (using Rate Schedule)	$ 602*	$ 7,599*
Minus: Withholding	(1,750)	(8,500)
Tax due (refund)	($ 1,148)	($ 901)

* This answer is based on the 2018 rate schedule. The 2018 tax table was unavailable at the time this solution was prepared. The actual answer using the tax table would be very close to the above answer. pp. I:2-6 and I:2-7.

I:2-30 a.

a.	Salary	$ 1,800
	Taxable interest income	1,600
	Adjusted gross income	$ 3,400
	Minus: Standard deduction	(12,000)
	Taxable income	-0-
b.	Salary	$ 1,800
	Taxable interest income	1,600
	Adjusted gross income	$ 3,400
	Minus: Standard deduction ($1,800 + $350)	(2,150)
	Taxable income	$ 1,250

p. I:2-12.

I:2-31 a.

	Carl	Carol
Adjusted gross income	$60,000	$90,000
Minus: Itemized deductions	(11,000)	(16,200)
Taxable income	$49,000	$73,800

Note: Because Carol claimed itemized deductions on her return, Carl must also itemize. Their total itemized deductions are $27,200 ($11,000 + $16,200). Both could have claimed a standard deduction of $12,000 (total of $24,000), so they gained $3,200 ($27,200 - $24,000) of deductions by itemizing.

b.

Adjusted gross income ($60,000 + $90,000)	$150,000
Minus: Itemized deductions ($11,000 + $16,200)	(27,200)
Taxable income	$122,800

p. I:2-11.

I:2-32 a. Brian may not be claimed as a dependent because his gross income exceeds $4,150 (2018). Brian is not a qualifying child because he is over age 23. He is not a qualifying relative because he fails the gross income test.

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

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

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

e. Granny may not be claimed as a dependent as she fails the gross income test. Her interest from the U.S. bonds exceeds $4,150 and no exception applies. If Granny's interest had been less than $4,150, she would have qualified, as Social Security is not included in her gross income.

pp. I:2-12 through I:2-16.

I:2-33 a. Carole and John can claim David and Kristen as dependents this year. Jack is not a qualifying child (over age 18 and not a full-time student) and is not a qualifying relative because his gross income exceeds $4,150. David can be claimed as a dependent because he is a qualifying child. He meets the four tests of relationship, age, abode, and support. Gross income is not considered for the qualifying child test. Kristen also is a qualifying child and can be claimed as a dependent.

b. Assuming Jack is a full-time student in medical school for at least five months this year, he would be a qualifying child as he now meets the age test (under age 24 and a full-time student). Carole and John can claim Jack as a dependent.

c. In this case, Jack would not be a qualifying child because he fails the age test. However, he is a qualifying relative as he meets the relationship, gross income, and support tests. His gross income is less than $4,150 in 2018.

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

e. David would not be a dependent as he fails the support test for both the qualifying child and qualifying relative tests. pp. I:2-12 through I:2-16.

I:2-34 a. Robert cannot claim Jane as a dependent. Jane is not his qualifying child as she fails the age, abode, and presumably the support test. The facts in the problem do not specify how the $26,000 ($11,000 + $15,000) of support is allocated between Jane and her two children. But this is irrelevant as she fails the age and abode tests. Jane also fails the qualifying relative test because she has too much gross income.

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

c. Jane is entitled to the child credit for each of her two children. Even if Robert were eligible to claim the children as dependents, he would not benefit from the child credit because of his AGI. Robert's $350,000 of AGI exceeds $200,000 by $150,000, so his credit would be reduced, but not below zero, by $7,500 [$50 x (($350,000 - $200,000)/$1,000)]. pp. I:2-12 through I:2-16.

I:2-35 Based on the facts given, Juan cannot claim either Maria or Norma as dependents. He can claim Jose only if written documentation exists.

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

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

Norma is not a "qualifying child" for either her father or Jose as she lives with neither. Further, she is a part-time student. She does not qualify as a "qualifying relative" because she has too much gross income. pp. I:2-12 through I:2-16.

I:2-36 a. Either Mario or Elaine. Caroline cannot because she is unrelated to Anna, and Doug cannot because he provides less than 10% of Anna's support.

b. Elaine must agree in writing to the arrangement.

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

d. No. Old-age allowances are not available for dependents. Old-age allowances increase the amount of the elderly person's standard deduction. pp. I:2-16 and I:2-17.

I:2-37 a. Joan, the custodial spouse, claims the children as dependents and receives the child credit for them.

b. No. p. I:2-18.

I:2-38

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

In part a, Arnie could file a Form 1040 or Form 1040A instead of a Form 1040EZ, but he is not required to do so. In parts b, d, and e, the taxpayer could file a Form 1040 instead of a Form 1040A but is not required to do so. pp. I:2-23 and I:2-35.

I:2-39 a. Not a dependent and no child credit. A cousin must live with the taxpayer in order to qualify as a dependent as a cousin does not automatically meet the relationship test.

b. One dependent and $500 child credit. Because the social security benefits are excluded from gross income, the father meets the gross income test. The father is not required to live with Bob to meet the relationship test. Although the father is not Bob's child, Bob and Ann are allowed a $500 child credit for him because the father is a dependent who is not a qualifying child under age 17.

c. One dependent and one $500 child credit. The daughter is a qualifying child and, because she is a full-time student under age 24, the gross income test is not relevant. Because she is over 16, she does not qualify for the $2,000 child credit.

d. Not a dependent and no child credit. The mother cannot be claimed as a dependent by anyone because she provided over half of her own support. pp. I:2-12 through I:2-17.

I:2-40 a. Juan's AGI exceeds $200,000, but Maria's AGI does not. The child credit thus would be reduced if Juan claims it, but there would be no reduction if Maria claims it. Overall, the tax savings are larger if Maria claims the child credit, so it would be better not to have a written agreement allowing Juan to claim the children as dependents. However, Juan may not be willing to pay as much child support if he foregoes any child credit.

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

I:2-41 a.

Adjusted gross income ($105,000 + $86,000)	$191,000
Minus: Itemized deductions ($19,000 + $8,100)	(27,100)
Taxable income	$163,900
Gross tax	$ 27,937

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

Adjusted gross income	$86,000
Minus: Standard deduction	(12,000)
Taxable income	$74,000
Gross tax	$12,220*

Bill's tax filing as a single taxpayer:

Adjusted gross income	$105,000
Minus: Itemized deductions	(19,000)
Taxable income	$ 86,000
Gross tax	$ 14,930*

Their income taxes total $27,150 ($12,220 + $14,930).

*These amounts are based upon the 2018 tax rate schedule because the 2018 tax table was unavailable when the solution was prepared.

c. Their tax will be $787 ($27,937 - $27,150) higher if they marry before year-end. This is attributable to the fact that their $27,100 of itemized deductions is $3,900 less than the $31,000 ($12,000 + $19,000) of total deductions they would claim if they were not married. The increased taxes due to this is partially offset by the fact that $3,500 ($86,000 - $82,500) of Bill's taxable income is taxed at 22% if they are married rather than 24% if they are not. pp. I:2-20 through I:2-22.

I:2-42 a. Amy need not file because her gross income is less than the threshold of $12,000 and her self-employment income is less than $400.

b. Betty need not file, as her gross income ($9,100) is less than $13,600 ($12,000 + $1,600).

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

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

e. Doug must file because his gross income is over $0 and he is married and not living with his spouse. p. I:2-23 and I:2-24.

I:2-43 a. Yes.

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

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

d. Yes. Because he qualifies as an abandoned spouse he can file as a head-of-household. pp. I:2-22 and I:2-23.

I:2-44 a. 2016: Celia files a joint return even though Wayne died in October.

2017: Celia must file as a single taxpayer. As a part-time student, Wally is not a qualifying child.

2018: Same as 2017.

2019: Same as 2017.

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

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

Note to Instructor: A good exercise is to ask the class how the solution for part a would change if Wally were a full-time student rather than part-time. Celia would qualify as a surviving spouse in 2017 and 2018 and a single taxpayer in 2019.

I:2-45 a. $190,000 ($92,000 + $98,000).

b.	Gross income	$190,000
	Minus: Business expenses	(48,000)
	IRA contributions	(11,000)
	Adjusted gross income	$131,000
c.	Adjusted gross income	$131,000
	Minus: Itemized deductions	(26,000)
	Taxable income	$105,000
	Gross tax	$14,979*
	Child credit	(2,000)
	Net tax	$12,979

*$8,907 + (22% x ($105,000 - $77,400))

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

I:2-46 Jan should take the standard deduction. Jan cannot deduct any medical expenses as they are less than 7.5% of AGI. She is left with $5,000 of itemized deductions (mortgage interest of $3,000 and property taxes of $2,000) which are less than the $12,000 standard deduction. p. I:2-10.

I:2-47 a.

Earnings	$4,200
Interest	2,200
Adjusted gross income	$6,400
Standard deduction ($4,200 + $350)	(4,550)
Taxable income	$1,850

Debbie is subject to the kiddie tax, assuming her earned income is less than or equal to one-half of her support. Her tax thus is calculated as follows:

Net unearned income = $2,200 - $1,050 - $1,050 = $100

Earned taxable income = $1,850 - $100 = $1,750

A 10% tax rate applies to the first $4,300 ($1,750 + $2,550) of Debbie's taxable income. Her taxable income is only $1,850, so her tax is $185 (10% x $1,850).

b. The answer would not change. If Debbie were age 16, she would be subject to the kiddie tax regardless of her student status and her earned income if her unearned income exceeds $2,100.

pp. I:2-24 through I:2-26.

I:2-48 a. Adjusted gross income:

Salaries	$130,000
Allowable capital loss	(3,000)
Adjusted gross income	$127,000

b. Itemized deductions:

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

c. Taxable income:

Adjusted gross income	$127,000
Standard deduction	(24,000)
Taxable income	$103,000

I:2-49

Karen
Karen's gross tax is $245. At age 21, Karen is subject to the kiddie tax because she is a full-time student whose earned income is less than one-half of her own support and who has unearned income in excess of $2,100.

Taxable income:	
Wages	$3,000
Interest	2,800
Adjusted gross income	$5,800
Standard deduction ($3,000 + $350)	(3,350)
Taxable income	$2,450

Net unearned income = $2,800 - $1,050 - $1,050 = $700

Earned taxable income = $2,450 - $700 = $1,750

A 10% tax rate applies to the first $4,300 ($1,750 + $2,550) of Kim's taxable income. Because her $2,450 taxable income is less than $4,300, Kim's tax is $245 (10% x $2,450).

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

Wages	$11,000
Interest	2,400
Adjusted gross income	$13,400
Standard deduction ($11,000 + $350)	(11,350)
Taxable income	$2,050
Gross tax	$ 205

Amelie

Amelie's gross tax is $185. Amelie is subject to the kiddie tax as she is under age 18 and her unearned income is greater than $2,100.

Taxable income:	
Wages	$5,900
Interest	2,200
Adjusted gross income	$8,100
Standard deduction ($5,900 + $350)	(6,250)
Taxable income	$1,850

Net unearned income = $2,200 - $1,050 - $1,050 = $100

Earned taxable income = $1,850 - $100 = $1,750

A 10% tax rate applies to the first $4,300 ($1,750 + $2,550) of Amelie's taxable income. Because her $1,850 taxable income is less than $4,300, Amelie's tax is $185 (10% x $1,850).

I:2-50 a.

Salary	$ 70,000
S corporation income	30,000
Adjusted gross income	$100,000
Itemized deductions	(18,000)
Taxable income	$ 82,000
Gross tax	$ 13,980

b.

Corporation:	
Taxable income	$ 30,000
Gross tax (0.21 x $30,000)	$ 6,300
Individual:	
Salary	$ 70,000
Dividend ($30,000 - $6,300)	23,700
Adjusted gross income	$ 93,700
Itemized deductions	(18,000)
Taxable income	$ 75,700
Gross tax	$ 10,935*
Total tax ($6,300 + $10,935)	$ 17,235

*The individual's gross tax is the total of the tax on the dividend income and the tax on the remaining income. The tax on the dividend income of $23,700 is $3,555 (0.15 x $23,700). The tax on the remaining income of $52,000 ($75,700 - $23,700) is $7,380 computed using the rate schedule for single taxpayers.

c. The answer to part a is unchanged as the shareholder is taxed on the S corporation's income regardless of whether it is distributed. In part b, the corporation's tax is the same, $6,300, but the shareholder is only taxed on the salary of $70,000.

Adjusted gross income	$ 70,000
Itemized deductions	(18,000)
Taxable income	$ 52,000
Gross tax	$ 7,380
Total tax ($6,300 + $7,380)	$ 13,680

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

pp. I:2-27 through I:2-29.

I:2-51 Lana's child credit is $5,750 [(3 x $2,000) - ($50 x 5)]. pp. I:2-18 and I:2-19.

I:2-52 a. They will save $1,110 ($3,000 x 0.37). Only $3,000 of loss can be offset against other income. The remaining $12,000 of loss can be carried over and offset against future income.

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

c. They will save $1,110 as in part a. The net loss is $5,000 but as in part a, only $3,000 can be offset against other income. The carryover, however, is only $2,000 ($15,000 - $10,000 - $3,000). p. I:2-30.

I:2-53

		2018	2019
a.	Salary	$90,000	$90,000
	Minus: Itemized or standard deduction	(12,000)	(15,600)
	Taxable income	$78,000	$74,400
	Gross Tax	$13,100	$12,308
b.	Salary	$90,000	$90,000
	Minus: Itemized or standard deduction	(12,000)	(12,000)
	Taxable income	$78,000	$78,000
	Gross tax	$13,100	$13,100
c.	Salary	$90,000	$90,000
	Minus: Itemized or standard deduction	(12,000)	(19,600)
	Taxable income	$78,000	$70,400
	Gross tax	$13,100	$11,428

d. By contributing the $8,000 in 2019, Virginia is able to deduct the entire amount. If $4,000 is contributed in each year, only the $4,000 contributed in 2019 is deductible. No tax benefit is received in 2018 because the contribution is less than the standard deduction. If $8,000 is contributed in 2018, then no tax benefit is received. pp. I:2-31 and I:2-32.

I:2-54 a. 1040A
b. 1040
c. 1040A
d. 1040A

In parts a, c, and d, the taxpayer could file a Form 1040 instead of a Form 1040A but is not required to do so. p. I:2-35.

I:2-55 a. Maria's adjusted gross income is $48,000.

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

b. Maria's taxable income is $36,000.

Adjusted gross income	$48,000
Standard deduction	(12,000)
Taxable income	$36,000

c. Maria's tax liability is $4,130.

I:2-56 a. As no special rules apply and taxable income is $83,000, the gross tax is $10,139.
b. Ralph and Tina are entitled to a child credit for Tina equal to $2,000.
c. Pam's gross tax is computed as follows:

Adjusted gross income (interest)	$3,500
Minus: Standard deduction	(1,050)
Taxable income	$2,450

Net unearned income = $3,500 - $1,050 - $1,050 = $1,400

Earned taxable income = $2,450 - $1,400 = $1,050

A 10% tax rate applies to the first $3,600 ($1,050 + $2,550) of Pam's taxable income. Because her $2,450 taxable income is less than $3,600, Pam's tax is $245 (10% x $2,450).

d. If Pam were age 25, her tax would be computed using the tax rate schedule for a single individual. As her $2,450 taxable income is less than $9,525, Pam's tax is $245 (10% x $2,450). In this case, the kiddie tax does not affect the amount of tax Pam pays.

I-2:57 a. Gail qualifies as a surviving spouse. She is eligible to use the joint return rate schedule.

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

Adjusted gross income	$245,000
Minus: Itemized deductions	(30,000)
Taxable income	$215,000
Gross income tax	$ 40,179

Gail's $245,000 AGI exceeds the $200,000 threshold for reducing the child tax credit for taxpayers who are not married filing jointly, so her credit is reduced (but not below zero) by $2,250 [$50 x (($245,000 – $200,000)/$1,000)]. This reduces Gail's credit to zero. (It is reduced from $2,000 to zero if the daughter is under age 17, and it is reduced from $500 to zero if she is age 17 or older.)

c. Because having a dependent child is required to qualify as a surviving spouse, Gail must file as a single taxpayer. The tax on her $215,000 of taxable income is $50,940.

pp. I:2-18 and I:2-21.

Tax Strategy Problems

I:2-58 The tax liability under the three alternatives is computed as below:

Business income:	**Proprietorship**	**S Corporation**	**C Corporation**
Operating income	$150,000	$150,000	$150,000
Compensation paid to Jack		(100,000)	(100,000)
Net	$150,000	$ 50,000	$ 50,000
Corporate income tax			$ 10,500
Jack's income:			
Business income	$150,000	$ 50,000	
Compensation		100,000	$100,000
Dividends			5,000
Other income	1,000	1,000	1,000
Adjusted Gross Income	$151,000	$151,000	$106,000
Itemized deductions	(14,000)	(14,000)	(14,000)
Taxable income	$137,000	$137,000	$ 92,000
Individual income tax	$ 27,170	$ 27,170	$ 15,920
Total tax	$ 27,170	$ 27,170	$ 26,420

The total tax paid when Jack operates the business as a C corporation is less than the tax paid with the other organizational forms. He does, however, face a potential future individual income tax on the remaining $34,500 ($50,000 - $10,500 - $5,000) of corporate income when the corporation distributes that income. The reason the tax is less now is because higher rates apply to the additional income reported on his personal return when he operates as a proprietor or makes an S election. Dividends are taxed at 15% when received by single individuals whose taxable income is greater than $38,600 but not greater than $425,800.

I:2-59 a. Andrea will save $740 (37% x $2,000) if she makes the contribution.

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

c. Andrea will save $222 (37% x $600) if she makes the gift. Given the amount of her income, the daughter will owe no tax.

d. Andrea will save $222. She however will not be as well off because the exempt interest of $300 is less than the after tax interest of $378 ($600 - $222) from the taxable bonds.

Tax Form/Return Preparation Problems

I:2-60 (See Instructor's Resource Manual)

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

Case Study Problems

I:2-62 This question has some interesting implications. One problem relates to the sale of the loss property. Bala and Ann can only deduct $3,000 of the capital loss from ordinary income each year. As a result, it would take ten years to use up the loss unless they realize a capital gain against which to offset the loss. Although a $3,000 capital loss offsets income that would otherwise be taxed at 37%, it takes a long time to use up the loss. If Bala and Ann sell both of the parcels they own they will realize a net loss of $8,000, which will be used up in the current and next two years even if they realize no additional gains. Further, the $8,000 net loss will offset income that would otherwise be taxed at 37%.

Kim is a dependent of her parents and has no other income, so her taxable income if the land were sold would be $17,950 ($19,000 - $1,050 standard deduction). Because she is age 16, Kim is subject to the kiddie tax. Her net unearned income would be $16,900 ($19,000 - $1,050 - $1,050), and her earned taxable income would be $1,050 ($17,950 - $16,900). Her $17,950 taxable income is comprised entirely of long-term capital gain, so $3,650 ($1,050 + $2,600) would be taxed at 0%, $10,100 (($1,050 + $12,700) - $3,650) would be taxed at 15%, and the remaining $4,200 ($17,950 - $3,650 - $10,100) would be taxed at 20%. The total tax would be $2,355 ((15% x $10,100) + (20% x 4,200)). By waiting to sell her land when she is no longer subject to the kiddie tax, more of the gain may be taxed at 0% or 15%, depending on her income at that time. p. I:2-30.

I:2-63 As Larry and Sue were married at the end of the year, they can file either a joint income tax return or two separate returns. On the surface, there is not much difference between the tax liability on a joint return versus separate returns. The important issue here is the fact that Sue believes that Larry may be under-reporting tip income. If they file a joint return, Sue may be liable for the joint tax liability including penalties that may result from under-reporting. There is an innocent spouse provision, but one condition for claiming innocent spouse status is that the taxpayer did not know and had no reason to know that there was under-reporting. As Sue is suspicious of her husband, she should file a separate return to protect herself from possible tax liability associated with unreported income. pp. I:2-32 and I:2-33.

Tax Research Problems

I:2-64 Since the stepdaughter and her family do not live with Ed, they must be related to him in order to qualify as his dependents. Children meet the relationship tests for a qualifying child (Sec. 152(c)(2)(A)) and for a qualifying relative (Sec. 152(d)(2)(A)), and a child for these purposes includes a stepchild (Sec. 152(f)(1)(A)(i)). Further, Reg. Sec. 1.152-2(d) states that a relationship "once existing will not terminate by divorce or death of a spouse."

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

I:2-65 The baby can be claimed as a dependent even though he or she lived for only a day. In Rev. Rul. 73-156, 1973-1 C.B. 58, the IRS ruled that dependency may be claimed if state or local law treats the child as having been born alive, and this is evidenced by an official document such as a birth or death certificate. If the child had no social security number the IRS instructs taxpayers to enter "Died" in place of the social security number on Form 1040.

I:2-66 Although Larry may not meet the technical definition of "blind" when he wears the new contact lens, the fact that he can only wear the lens for brief times means that he cannot depend on having the advantage of improved sight. Therefore, the Tax Court in Emanuel Hollman, 38 T.C. 251 (1963) granted an extra personal exemption for blindness permitted under prior law. It seems likely that the same rule would be available to taxpayers today claiming the additional standard deduction amount available to blind taxpayers under current law.

"What Would You Do In This Situation?" Solution

Ch. I:2, p. I:2-29.

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

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

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

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

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

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

Chapter I:2

Determination of Tax

Learning Objectives

After studying this chapter, the student should be able to:

1. Use the tax formula to compute an individual's taxable income.
2. Determine the amount of deductions from Adjusted Gross Income.
3. Calculate the income tax for individuals.
4. Explain the basic income tax rules relating to business entities.
5. Explain the basic income tax rules of capital gains and losses.
6. Describe tax planning considerations for various tax matters.
7. Describe compliance and procedural matters for filing tax returns.

Areas of Greater Significance

It is absolutely vital that students understand the individual formula for calculating the tax or refund due (including standard deduction and filing status). This formula is necessary throughout the balance of the text to work out the problems. Any deficiencies in understanding at this point would be carried over to subsequent materials.

Areas of Lesser Significance

In the interest of time, the instructor may determine that the following area is best covered by student reading, rather than class discussion:

1. Business income and business entities.

Problem Areas for Students

The following areas may prove especially difficult for students:

1. Whether a taxpayer qualifies for head of household filing status.

2. The relationship between the standard deduction and itemized deductions.

3. Whether the qualification (or non-qualification) of a person as a dependent affects the head of household filing status (i.e., the rules for head of household and qualifying dependents overlap, but are not totally consistent).

Highlights of Recent Tax Law Changes

The following items of tax law have changed since the 2018 edition of this chapter:

1. The TCJA changes the treatment of alimony for any divorce or legal separation agreements executed after 2018. Alimony payments will be excluded from the gross income of the recipient and not be deductible by the paying ex-spouse.

2. The TCJA allows flow-through entities to deduct 20% of qualified business income.

3. The TCJA eliminates personal and dependency exemptions.

4. The TCJA provides for new marginal tax rates: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. (See inside front cover for income limits.)

5. The TCJA returns the AGI floor for medical expenses to 7.5% for all taxpayers regardless of age.

6. The TCJA sets a cap of $10,000 ($5,000 if married filing separately) on the deduction of state and local taxes.

7. The TCJA reduces the maximum amount of indebtedness for the home mortgage interest deduction to $750,000 on debt incurred after December 16, 2017 and eliminates mortgage interest deduction for home equity loans.

8. The TCJA increases the maximum amount of the cash charitable contribution deduction to 60% of AGI.

9. The TCJA eliminates deductions for personal casualty and theft losses, except those attributable to a federally declared disaster.

10. The TCJA suspends miscellaneous deductions subject to a 2% of AGI floor.

11. The TCJA significantly increases the standard deduction amount for each filing status.

12. The TCJA separates the “kiddie tax” from the parents’ marginal tax rate. (See Instructor Aid I:2-2.)

13. The TCJA sets a flat tax rate of 21% for ordinary income and capital gains for corporations.

14. The TCJA eliminates the reduction of itemized deductions for high income taxpayers.

15. The floor for filing a tax return for each filing status, except for married filing separately, has increased to match the new standard deduction amounts.

Teaching Tips

1. Due to the annual changes in many of the rules covered in this chapter (e.g., standard deduction), you may wish to inform the students that examinations and/or quizzes will be held on an open-book basis or that you will provide any required statutory amounts for testing purposes. Using this approach allows the students to concentrate on the concepts rather than memorizing numbers.

2. This introductory chapter is a good place to begin emphasizing the difference between deductions for AGI and deductions from AGI. This distinction will increase in importance in subsequent chapters.

Lecture Outline

I. Formula for Individual Income Tax

1. Basic Formula (Table I:2-1, Example I:2-1; Figure I:2-1; Question I:2-1; Problem I:2-29)

   a. The basic formula for calculating individual income tax is:

      i. Gross income – Exclusions - Deductions for AGI = Adjusted gross income

      ii. Adjusted gross income - Deductions from AGI = Taxable income

      iii. Taxable income × Tax rate(s) = Gross tax

      iv. Gross tax - (Credits + Prepayments) = Net tax

2. Definitions (Tables I:2-2 through I:2-5)

   a. Brief definitions of income, exclusions, gross income, deductions for adjusted gross income, adjusted gross income, deductions from adjusted gross income, itemized deductions, standard deduction, taxable income, tax rates, gross tax, and tax credits are presented with references to detailed coverage later in the text.

II. Deductions from Adjusted Gross Income

1. Itemized Deductions (Table I:2-6; Example I:2-2)

   a. The total of qualifying medical expenses, taxes, investment and residential interest, and charitable contributions are claimed only if the total of such items exceeds the standard deduction.

   b. Deductions for medical expenses and charitable contributions are limited by varying percentages of adjusted gross income. Deductions for taxes and residential interest are also capped (generally $10,000 for taxes and interest on $750,000 of indebtedness).

2. Standard Deduction (Examples I:2-3, I:2-4)

   a. The full amount of the standard deduction (which varies with filing status, age, and vision) may be claimed when it exceeds the taxpayer's itemized deductions.

      i. EXAMPLE: A single taxpayer in 2018 has $10,000 of allowable itemized deductions. Since the applicable standard deduction for this taxpayer ($12,000) is greater than his itemized deductions, the taxpayer deducts $12,000 in determining his taxable income.

Filing Status	**Standard Deduction**	
	2017	**2018**
Married couple filing jointly	$12,700	$24,000
Surviving spouse	12,700	24,000
Head of household	9,350	18,000
Single (unmarried individual other than surviving spouse or head of household)	6,350	12,000
Married individual filing separately	6,350	12,000

   b. Additions to the standard deduction are available for taxpayers who are 65 or older and/or blind. The 2018 additions are $1,300 for married taxpayers and $1,600 for single taxpayers.

      i. EXAMPLE: A single taxpayer in 2018 who is 65 and blind would have a standard deduction of $13,600 [$12,000 + $1,600 (age) + $1,600 (blindness)].

3. Dependency Requirements (Examples I:2-8, I:2-12, I:2-16, I:2-17; Topic Review I:2-1; Problem I:2-32)

   a. Qualification of dependents can affect a taxpayer's filing status and access to deductions and credits. Dependents must meet the following requirements:

      i. Have a Social Security number reported on return;

      ii. Be a U.S. Citizen, U.S. Resident, or reside in Canada or Mexico; and

      iii. Not have filed a joint return (unless filed for the sole purpose of obtaining a refund).

   b. Additional requirements for "qualifying children"

      i. Be a natural, adopted, foster child, or stepchild of the taxpayer, a sibling of the taxpayer, or descendants of any of the previous;

      ii. Be under 19, a full-time student under age 24, or a permanently and totally disabled child;

      iii. Have the same principal abode as taxpayer, and

      iv. Dependent may not provide more than one half of his or her own support.

   c. Additional requirements for "qualifying relatives"

      i. Be related to the taxpayer or reside in the taxpayer's household for the entire year;

      ii. Have gross income less than $4,150; and

      iii. The taxpayer must normally provide more than one half of the dependent's support. (Receipts of the potential dependent are counted as support only if the receipts are spent for support, i.e., if the dependent puts all his social security payments in a savings account, the payments do not count in the support test.)

      iv. Exceptions may exist under multiple support agreements and parental releases.

4. Child Credit (Example I:2-21; Problem I:2-51)

   a. Individual taxpayers may claim a $2,000 credit for each qualifying child (U.S. citizen/national/resident under 17 who qualifies as the taxpayer's dependent descendent, stepchild, or foster child) under age 17 plus a $500 credit for each other dependent.

b. The total credit for all children is reduced by $50 for each $1,000 (or fraction thereof) of AGI over $200,000 ($400,000 for married filing jointly).

c. Under certain circumstances, the credit is refundable.

III. Determining the Amount of Tax (Examples I:2-26, I:2-27; Topic Review I:2-2; Problem I:2-48; Instructor Aid I:2-1)

Gross tax is determined by applying the tax table (Appendix A) or tax rate schedule inside the front cover to the taxpayer's taxable income.

In 2018, tax brackets of 10%, 12%, 22%, 24%, 32%, 35%, and 37% are applicable to individual taxpayers. The income level covered by the six brackets varies with filing status.

1. Joint Return

   a. A joint return may be filed by a man and woman if they are considered married for tax purposes on the last day of the tax year. Common law marriages and same-sex marriages are recognized. Annulled marriages are viewed as having never occurred.

   b. Taxpayers legally divorced at the end of the year may be treated as married for tax purposes, if the divorce is considered a sham.

      i. EXAMPLE: Taxpayers obtain a foreign divorce effective 12-30-2016 and remarry 1-2-2017. The only reason for the procedure was to improve tax filing status. The taxpayers will be treated as married for the tax year ending 12-31-2016.

2. Surviving Spouse (Example I:2-28)

   a. A widow or widower may file as a surviving spouse in the two years after the year the decedent spouse died if the surviving spouse:

      i. Has not remarried;

      ii. Is a U.S. citizen or resident;

      iii. Was qualified to file a joint return in the year of death; and

iv. Paid over half the costs of maintaining a household in which a dependent child, adopted child, or stepchild lives during the entire tax year.

b. The widow or widower may file jointly in the year of the spouse's death with the cooperation of the executor of the estate. Both the surviving spouse and the executor must sign any joint return. If either party does not agree to file a joint return, then they must file as married filing separately.

c. The widow or widower may qualify as head of household in the years after the expiration of the surviving spouse status, assuming the surviving spouse meets the qualifications outlined below.

3. Head of Household (Example I:2-29)

a. An individual may file as head of household if the individual:

i. Is considered single for tax purposes (see abandoned spouse, below);

ii. Is not a surviving spouse;

iii. Is a U.S. citizen or resident; and

iv. Pays over half the costs of maintaining a household in which a qualifying child or dependent relative lives for more than half of the tax year. Dependent parents may reside in a separate household, and children do not have to be tax dependents to qualify.

4. Single Taxpayer

a. A taxpayer who does not qualify for any other filing status must file under the single status.

5. Married Filing Separately

a. Married individuals may choose to file separate returns rather than one joint return. Separate returns will seldom provide the best overall tax results due to the higher rates. However, every married couple's tax should be computed using both the joint return rules and the separate return rules to insure the lowest overall tax.

6. Abandoned Spouse (Examples I:2-32, I:2-33; Question I:2-18)

a. A legally married individual may file as head-of-household if the individual:

i. Lived apart from the spouse for the last 6 months of the year;

ii. Pays over half of the cost of maintaining a household in which the taxpayer and a dependent child lived for over half the year; and

iii. Is a U.S. citizen or resident.

b. Without the abandoned spouse rule, the only alternative for the taxpayer would be to file married-separately (due to the unavailability of the absent spouse to prepare and sign a joint return). Head-of-household tax rates are significantly better than married-filing separately rates.

7. Children with Unearned Income (Example I:2-37; Problem I:2-56; Instructor Aid I:2-2)

a. A dependent's standard deduction is the greater of $1,050 or the dependent's earned income plus $350.

b. For children under 18, unearned income in excess of $2,100 is taxed in a special way. Between the ages of 18 and 23, this "kiddie tax" only applies under certain circumstances (e.g., the child's earned income represents less than half of his or her support).

IV. Business Income and Business Entities

Unlike for individuals, the tax rate schedule for C corporations is not progressive. Instead, a flat 21% tax rate applies.

V. Treatment of Capital Gains and Losses (Question I:2-21; Instructor Aid I:2-3)

1. Definition of Capital Assets

a. Capital assets are assets other than inventory; depreciable property used in a trade or business; real property used in a trade or business; patents; copyrights or literary, musical, or artistic compositions in the hands of the creator or a donee of the creator; letters or memoranda; accounts or notes receivable from the ordinary course of a trade or business; or certain U.S. Government publications.

b. The tax definition of capital assets is significantly different from the financial accounting definition of capital assets (i.e., property, plant, & equipment).

2. Tax Treatment of Gains and Losses

a. Net long-term capital gains (with a holding period greater than one year) are generally taxed at 0% if taxable income is not over $38,600, 15% if taxable income is between $38,600 and $425,800, and 20% if taxable income is over

$425,800. Different thresholds apply to other filings statuses ($77,200 and $479,000 for married filing jointly; $51,700 and $425,400 for head of household). Net short-term capital gains are taxed at ordinary income. Net capital losses offset a maximum of $3,000 of other income, with an unlimited carryforward for individuals.

b. A net investment income tax of 3.8% applies to certain high-income taxpayers.

VI. Tax Planning Considerations

1. Shifting Income Between Family Members (Examples I:2-42 through I:2-44)

   a. Shifting taxable income to family members to lower tax brackets will reduce the overall family tax burden.

   b. Restrictions apply to transactions that only involve assignment, and not shifting, of income, as well as transactions that trigger the kiddie tax.

2. Splitting Income (Example I:2-45)

   a. Creating additional taxpayers can reduce the overall tax burden, but administrative costs, especially of additional corporations, reduce the overall savings.

3. Maximizing Itemized Deductions (Examples I:2-46, I:2-47)

   a. Itemized deductions only provide value to the extent that they exceed the standard deduction. Timing expenses and charitable contributions so that they fall in a single tax year can increase the value of the resulting deductions.

4. Filing Joint or Separate Returns (Example I:2-50)

   a. Both tax and non-tax issues determine whether married couples should file jointly or separately.

   b. Spouses who file jointly are jointly liable for income tax, including the tax on disallowed deductions or unreported income. The innocent spouse provision protects spouses who were not aware of the magnitude of the understated tax liability, and the separate liability election allows spouses or former spouses to elect to be separately liable for the tax.

VII. Compliance and Procedural Considerations

1. Who Must File (Example I:2-51)

a. Generally, the income limitation for filing is the standard deduction for a particular status. The limitation is zero for married filing separately. (See page I:2-35 for the gross income filing levels.)

i. EXAMPLE: For 2018, a single taxpayer (under 65, not blind, not a dependent on another return) must file a return when gross income exceeds $12,000.

2. Due Dates and Extensions

a. Tax returns for calendar-year individual taxpayers (Forms 1040, 1040EZ, 1040A) are due April 15 (or first business day thereafter if April 15 is not a business day) following the end of the taxable year, with an automatic six-month extension if Form 4868 is filed by the due date for the return.

b. Forms 1040EZ and 1040A are used for taxpayers that have few complications in the tax year. Taxpayers with only salary, wages, and no more than $1,500 of interest may file using Form 1040EZ. Taxpayers with only salary, wages, dividends, interest, pensions and annuities, and unemployment income can file using Form 1040A. Both forms also have restrictions on deductions and credits allowed. All taxpayers may file using Form 1040.

c. Partnerships must file Form 1065 and S corporations must file Form 1120S by the fifteenth day of the third month following year end (i.e., March 15 for calendar-year-end taxpayers). C corporations must file Form 1120 and have the same due date as individual taxpayers. Any of these organizations can file Form 7004 to obtain a six-month extension.

d. An extension to file is not an extension on paying taxes. Interest and penalties apply for underpayment even when filing an extension.

3. Systems for Reporting Income

a. Payments made by certain entities are reported to the IRS for computer cross-checking that all income has been reported.

b. Items reported include pensions, annuities, wages, dividends, interest, sales of securities, unemployment compensation, rents, royalties, and lump-sum distributions from retirement plans.

Court Case Briefs

Kenneth Royce Boykin v. CIR, 1984 PH T.C. Memo & 84,297, 48 TCM 267.

The taxpayer and his wife were divorced in February of 1979, but he continued to live with his former wife and their children after the divorce in 1979 and 1980. IRC Sec.143 provides that the "determination of whether an individual is married shall be made as of the close of his taxable year." IRC Sec.143 further provides that an individual legally separated by divorce or a separate maintenance decree is not considered married. The taxpayer was denied the filing status of married, filing jointly because he was not married at the close of the tax years at issue. Texas (state of residence) recognizes common law marriages that have the elements of mutual agreement, cohabitation, and the holding out of themselves as married to the public. Their cohabitation did not qualify because they had not mutually agreed to be remarried. However, he was permitted "head of household" filing status because he met the requirements of Sec. 2(b). He was not married at the close of the tax year and he maintained a household for over half of the tax year for his dependent children.

Haynes, 119 AFTR 2d 2017-865.

Mr. and Mrs. Haynes hired Mr. Dunbar, a CPA, to prepare and file their 2010 individual tax return. In 2011, Dunbar filed for an extension to submit the Haynes's 2010 income tax return, which was granted by IRS. On Oct. 17, 2011, Dunbar attempted to use the Lacerte software program to electronically file the Haynes's 2010 tax return. The IRS rejected the filing because the return listed Mrs. Haynes's social security number on the line designated for the employer identification number. Dunbar advised Mr. Haynes that the return had been filed, but eleven months later, the IRS notified the Haynes that it had not received their 2010 return. In December 2012, Dunbar filed the Haynes's 2010 tax return on paper. IRS assessed a late-filing penalty, which the Haynes paid. They subsequently filed a refund suit in district court, but the court rejected their claim. The court stated that relying on a CPA's erroneous word that the return had been filed was not reasonable cause for failing to file a tax return in a timely fashion.

Instructor Aid I:2-1

Relative Tax by Filing Status*

Lowest	Married Filing Jointly/Surviving Spouse
	Head of Household
	Single
Highest	Married Filing Separately**

*Assuming the same amount of taxable income.

**In the few cases where the married couple both has income and only one has substantial amounts of itemized deductions, the result may vary.

Instructor Aid I:2-2

Kiddie Tax

1. Compute the child's taxable income in the normal fashion for dependents.

2. Compute the child's net unearned income (investment income, including dividends, taxable interest, capital gains, rents, and royalties):

   Unearned income

   Less: Statutory deduction of $1,050

   Less: Greater of

   a. $1,050 of standard deduction, or

   b. Itemized deductions directly connected with the production of the unearned income

   Equals:Net unearned income (not less than zero)

3. Compute the child's earned taxable income (ETI) by subtracting net unearned income (Step 2) from taxable income (Step 1). ETI is not less than zero.

4. Determine tax rate:

   10%: Portion of taxable income not over ETI + $2,550

   24%: Portion of taxable income over ETI + $2,550

   35%: Portion of taxable income over ETI + $9,150

   37%: Portion of taxable income over ETI + $12,500

Instructor Aid I:2-3

Capital Assets

Capital assets are defined in a negative manner under the Internal Revenue Code. Capital assets are assets that are <u>not</u>:

- Inventory
- Depreciable property used in a trade or business
- Real Property used in a trade or business
- Patents
- Copyrights
- Literary, musical, or artistic compositions

  In the hands of the creator or a donee of the creator

- Letters or memorandums
- Accounts or notes receivable from the ordinary course of a trade or business
- Certain U.S. Government publications