Solutions for Pearson's Federal Taxation 2023 Comprehensive 36th Edition by Rupert

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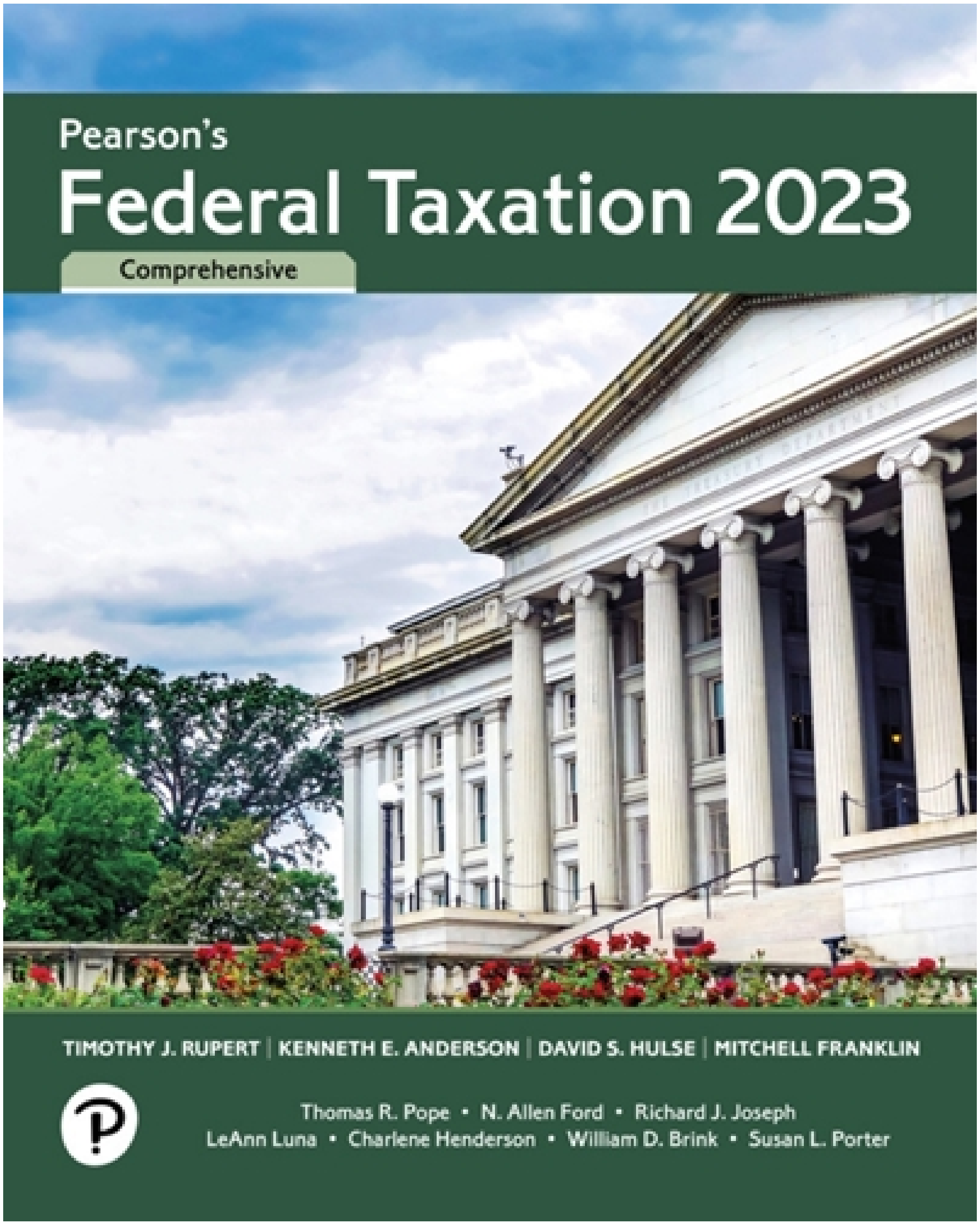

Solutions

Chapter C:2

Corporate Formations and Capital Structure

Learning Objectives

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

1. Discuss the tax advantages and disadvantages of alternative business forms.
2. Apply the check-the-box regulations to partnerships, corporations, and trusts.
3. Recognize the legal requirements and tax considerations related to forming a corporation.
4. Discuss the requirements for deferring gain or loss upon incorporation.
5. Explain the tax implications of alternative capital structures.
6. Determine the tax consequences of worthless stock or debt obligations.
7. Identify tax planning opportunities in corporate formations.
8. Comply with procedural rules for corporate formations.

Areas of Greater Significance

It is important for the student to understand the tax consequences of forming a corporation, including the impact on both corporation and shareholder. The tax advantages and disadvantages of alternative forms of doing business should also be stressed.

Areas of Lesser Significance

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

1. Capital contributions.
2. Compliance and procedural considerations (Reporting requirements under Sec. 351).
3. Choice of capital structure.

Problem Areas for Students

The following areas may prove especially difficult for students:

1. Allocating basis in a partially tax-free incorporation.
2. Characterization of an instrument as debt or equity.
3. Understanding that the tax basis for property contributed to a corporation is different from the basis that is used for financial accounting purposes.

Highlights of Recent Tax Law Changes

The Tax Cuts and Jobs Act of 2017 has significantly changed tax rates. These changed rates alter many traditional decisions often made by individuals when selecting a business entity. Changes can make the C Corporation more useful compared to the S Corporation and increases the complexity of the decision-making process. The deduction for qualified business income, known as the Section 199A deduction, is a significant change that needs to be addressed as part of the decision-making process.

Teaching Tips

Limited liability companies (LLCs) and limited liability partnerships (LLPs) have become more prevalent forms of doing business. Some discussion of LLCs and LLPs should take place here with particular emphasis on (1) the treatment of LLCs in the state where your school is located; and (2) the use of LLPs by the Big 4 accounting firms. More discussion on LLCs and LLPs takes place in Chapters C:9 and C:10.

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Use Examples C:2-11 and C:2-12 to illustrate the rationale behind treating a Sec. 351 transaction as a nontaxable exchange. pp. C:2-12 and C:2-13. Some discussion might be incorporated about the fact that a corporate liquidation is not a tax-free transaction. As a result, it is inexpensive to create a corporation, but may be expensive to liquidate a corporation.

Table C:2-1 may be used as a format for presenting the tax consequences of a Sec. 351 transaction. p. C:2-11.

Use Example C:2-23 as an illustration of a prearranged disposition of stock that disqualifies a Sec. 351 transaction. p. C:2-16.

Tables C:2-2 and C:2-3 can be used as a format for presenting the advantages and disadvantages of issuing equity vs. debt. Point out that cash flow consideration may make equity more attractive than debt. pp. C:2-29 and C:2-30.

Lecture Outline

I. Organization Forms Available.

Businesses can be conducted in one of several forms. A brief summary of these forms will provide the students with an overview of some of the factors that enter into the business form decision.

A. **Sole Proprietorships.** A sole proprietorship is a business owned by one individual and often is selected by individuals who are beginning a new business. The income and expenses are reported on a Schedule C of Form 1040 since a sole proprietorship is not a separate tax entity. All of the business assets are owned by the proprietor. Examples C:2-1 and C:2-2 illustrate the effect this will have on the amount of tax that will be paid on business income. A completed Schedule C and the related facts are included in Appendix B. These facts are used (with minor modifications) to illustrate the similarities and differences in the tax reporting process for a sole proprietorship, C corporation, partnership, and S corporation.

1. **Tax Advantages.** The tax advantages of doing business as a sole proprietorship are listed beginning on p. C:2-3.

   Profits may qualify for the 20% qualified business income deduction (Section 199A Deduction), which is the most significant change under the TCJA of 2017 to be emphasized.

2. **Tax Disadvantages.** The tax disadvantages of operating as a sole proprietorship are listed beginning on p. C:2-3.

B. **Partnerships.** A partnership is an unincorporated business carried on by two or more individuals or other entities. A partnership is a tax reporting, non-taxpaying entity, which acts as a conduit. All items of income, expense, gain, loss, and credit flow through to the partners' tax returns. A partnership must file a Form 1065 annually. Each partner receives a Schedule K-1 (Form 1065), which provides the information that must be reported on the partner's tax return. Examples C:2-3 and C:2-4, p. C:2-4, illustrate the effect of partnership income and loss on an individual partner's tax liability. Only those partnerships maintaining a fiscal year under the Sec. 444 reporting period rules must make tax payments based on the amount of income deferral. A completed Form 1065 and the related facts are included in Appendix B.

A partnership can be either a general partnership or a limited partnership. In a general partnership, each partner has unlimited liability for partnership debts. In a limited partnership, at least one partner must be a general partner, and at least one partner must be a limited partner. Limited partners are liable only to the extent of their investment plus any amount that they commit to contribute to the partnership if called upon.

1. **Tax Advantages.** A partnership is exempt from taxation. Marginal tax rates of the individual partners may be lower than the marginal corporate tax rate on the same income historically, but this may not be the case as of the TCJA of 2017. p. C:2-4.

   Pass through income may qualify for 20% of qualified business income deductions.

   No double taxation is inherent in the use of the partnership form. Profits are taxed only when earned. Generally, additional taxes are not imposed on withdrawals.

   Losses generally can be used to offset income from other sources. A positive basis adjustment is made when income is earned by the partnership and taxed to the partners. This reduces the gain recognized when a sale or exchange of the partnership interest occurs. No such basis adjustment occurs with a C corporation.

2. **Tax Disadvantages.** All profits are taxed when earned even though reinvested in the business. Marginal tax rates of the partners may be greater than the applicable marginal tax rate if the income is taxed to a corporation. Additional disadvantages can be found on p. C:2-4.

   A partner is not an employee. Employment taxes must be paid on a partner's self-employment income from the partnership.

   Some tax-exempt fringe benefits are not available to partners.

   The partnership's taxable year generally must conform to that of its partners or be a calendar year unless a special election is made to use a fiscal year. pp. C:2-4 and C:2-5.

C. **C Corporations.** A C corporation is a separate entity that for tax years beginning after December 31, 2017 is taxed at 21% on taxable income. A C corporation must report all its income and expenses and compute its tax liability on Form 1120 (U.S. Corporation Income tax Return). A completed Form 1120 appears in Appendix B. Shareholders are not taxed on the corporation's earnings unless these earnings are distributed as dividends, and qualified dividends are taxed at the shareholder's tax rate for long-term capital gains can be 0%, 15%, or 20%, depending on the individual's tax status and level of taxable income. In addition, an incremental 3.8% tax rate applies to net investment income for taxpayers whose modified AGI exceeds $200,000 ($250,000 for married filing jointly). Net investment income includes, among other things, interest, dividends, annuities, royalties, rents, and net gains from the disposition of property not used in trade or business, all reduced by deductions allocable to such income or gains. In contrast, a C Corporation's capital gains are taxed at the same 21% tax rate as its other income.

1. **Tax Advantages.** Shareholders employed by the corporation are treated as employees for fringe benefit purposes. As employees they are eligible to receive deductible salary payments. This allows them to adjust their compensation (within limits) to cause the income to be taxed partly on the corporate return and partly on the shareholders' returns, to minimize their overall tax liability.

   A C corporation is allowed to use a fiscal year. There are restrictions on using a fiscal year that apply to personal service corporations unless a special election is made under Sec. 444 by the corporation. p. C:2-6.

2. **Tax Disadvantages.** Double taxation occurs when dividends are paid or the corporation's stock is sold or exchanged.

   Shareholders can generally not withdraw money from the corporation without tax consequences. Distributions are taxable as dividends to the extent of earnings and profits.

   Net operating losses have limited benefit to shareholders. They can be carried back (only if incurred before 2021) or carried over to offset income in future years. This can be a significant disadvantage for start-up companies that may have to wait several years before they can recognize benefit from a loss, and make other business entities much more attractive.

   Capital losses provide no benefit in the year that they are incurred. They can only be used to offset capital gains. p. C:2-6.

D. **S Corporations**. S corporations are corporations that elect to be taxed as a partnership. Generally no tax is paid by the corporation. Instead, all items of income, deduction, gain, loss, and credit flow through to the individual shareholders. Corporate rules apply unless overridden by the Subchapter S provisions. A completed Form 1120S (U.S. Income Tax Return for an S Corporation) is included in Appendix B.

1. **Tax Advantages.** S corporations are generally exempt from taxation. The shareholders pay tax at their marginal tax rates, which are generally lower than the C corporation's marginal tax rate. See the **Tax Strategy Tip** on p. C:2-7.

   Pass through income may qualify for the 20% qualified business income deduction. It is important to note that there are many limitations to this deduction.

Losses pass through to shareholders and generally can be used to offset income earned from other sources. Passive loss rules may limit loss deductions to shareholders. (See Chapter C:11.)

Capital gains are taxed to individual shareholders as though they were earned by the individual. An individual may be able to offset these gains with capital losses from other sources or have them taxed at their own capital gains rates.

Capital losses flow through separately to the shareholders and can be used to offset other capital gains and to a limited extent ordinary income. Shareholders can contribute or withdraw money from the S corporation without adverse tax consequence. Profits are taxed as earned. The earnings are generally not taxed a second time when distributed as dividends.

A positive basis adjustment is made when income is earned by the S corporation and taxed to the shareholders. This reduces the gain recognized when a sale or exchange of the S corporation stock occurs. No such basis adjustment occurs with a C corporation.

2. **Tax Disadvantages.** All the corporation's profits are taxed when earned, whether distributed or not. Distributions generally are made to at least cover the taxes paid by the shareholders on their share of the corporation's earnings.

If the shareholders' marginal tax rates exceed those for a C corporation, the capital that remains for reinvestment may be reduced.

Tax-free fringe benefits are generally not available to shareholders. When provided, they are deductible by the corporation and taxable to the shareholder as compensation. Shareholders are treated as employees for purposes of social security taxes.

An S corporation generally must select a calendar year as its tax year unless a special election is made under Sec. 444 to use a fiscal year.

E. **Limited Liability Company.** A limited liability company (LLC) combines the best features of a partnership and corporation even though it is neither. It is taxed like a partnership while providing the limited liability of a corporation.

F. **Limited Liability Partnership.** Many states also have statutes that allow a business to operate as a limited liability partnership (LLP). This partnership form is particularly attractive to professional service partnerships, such as public accounting firms. Under state LLP laws, partners are liable for their own acts and the acts of individuals under their direction. LLP partners are not liable for the negligence or misconduct of other partners. p. C:2-8.

G. A side-by-side comparison of the tax and nontax attributes of C corporations, partnerships, and S corporations is presented in Appendix F. It might be helpful to periodically refer to this comparison throughout Chapters C:2 through C:11.

II. Check-the-Box Regulations.

Unincorporated businesses are able to choose whether to be taxed as a partnership or corporation. The rules are commonly referred to as "check-the-box" regulations. Treasury Regulations provide that an unincorporated business with two or more owners is taxed as a partnership unless it elects to be taxed as a corporation. An unincorporated business with one owner may elect to be taxed as a corporation or be disregarded as a separate entity and be taxed directly to the owner on a Schedule C. This election is not available to corporations, trusts, or certain special entities such as Real Estate Investment Trusts, Real Estate Mortgage Investment Conduits, or Publicly Traded Partnerships.
An eligible entity may affirmatively elect its classification on Form 8832 [Entity Classification Election]. Examples C:2-8 and C:2-9, p. C:2-8, illustrate the default rules. If an entity makes an election to change its classification, it cannot again change its classification by election during the 60 months following the effective date of the election. There are tax consequences to the changing of classifications. When applying check-the-box regulations, taxpayers must also check whether or not their state will treat an entity in a consistent manner for state tax purposes. p. C:2-8.

III. Legal Requirements and Tax Considerations Related to Forming a Corporation.

The legal requirements for forming a corporation depend on the laws of the state in which the corporation is incorporated. These laws provide for legal capital minimums, incorporation fee, franchise tax, and corporate tax rules. Most corporations are incorporated in the state in which they commence business. Articles of incorporation must be filed. A fee is charged for incorporation and an annual franchise tax is collected. It is important to note that these fees and taxes can be substantial, and should be a consideration prior to formation.

IV. Tax Considerations in Forming a Corporation.

Property, money, or services are transferred to the corporation in exchange for a debt or equity interest. Tax consequences may occur for both the shareholder, debtholder, and the corporation. Example C:2-10 on p. C:2-10 illustrates these tax consequences for the corporation and its shareholders.

At this point you may wish to use Table C:2-1, Overview of Corporate Formation Rules. This summary is found on p. C:2-11 of the text and is a good tool to be used to explain each of the parts of the incorporation transaction. Book-tax accounting issues are discussed later in this chapter.

V. Section 351: Deferring Gain or Loss upon Incorporation.

No gain or loss is recognized when property is transferred to a corporation solely in exchange for stock provided that immediately after the exchange, the transferors are in control. Recognition of gain or loss is deferred through adjustment of the shareholder's basis in the stock. (See Example C:2-11 on p. C:2-12.) The requirements for nonrecognition treatment are discussed below.

A. **The Property Requirement.** Property must be transferred to the corporation in an exchange transaction. Property includes money, and almost any other kind of property including installment obligations, accounts receivable, inventory, equipment, patents, and other intangibles representing "know-how," trademarks, trade names, and computer software.

Excluded from the property definition are services received in exchange for stock in a corporation, indebtedness of the transferee corporation that is not evidenced by a security, and interest on an indebtedness of the transferee corporation that accrued on or after the beginning of the transferor's holding period for the debt.

B. **The Control Requirement.** The transferors as a group must be in control immediately after the exchange. Control is ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. Only stock received for property is counted when determining if control has been received. Stock received for services does not count for purposes of determining control unless property is also contributed.

A transfer of property to an existing corporation will be tax-free only if an 80% interest in the corporation is acquired, or existing shareholders also transfer enough additional property to the corporation to permit the 80% requirement to be satisfied by the transferors as a group.

Transferors must be in control of the corporation immediately after the exchange. The exchanges do not need to be simultaneous, but must be agreed to beforehand and executed in an expeditious and orderly manner.

C. **The Stock Requirement.** No gain or loss is recognized by transferors who exchange property solely for transferee corporation qualifying stock. Voting or nonvoting stock may be received by the transferors. Nonqualified preferred stock is preferred stock that has one of the following characteristics: 1. The shareholder can require the corporation to redeem the stock. 2. The corporation is required to redeem the stock. 3. The corporation has the right to redeem the stock, and is more likely than not to do so, or 4. The dividend rate on the stock varies in relation to interest rates or other such indices. However, nonqualified preferred stock is treated as boot. Stock rights or stock warrants are not considered stock for purposes of Sec. 351. p. C:2-16.

At this point, you may wish to review with the students by referencing Topic Review C:2-1, which provides a concise overview of the requirements of Sec. 351. This review is found on p. C:2-17 in the text.

D. **Effect of Sec. 351 on the Transferors.** If all the requirements of Sec. 351 are met, the transferors do not recognize any gain or loss on contribution of their property to the corporation. The receipt of property other than stock does not completely disqualify the transaction from coming under Sec. 351. However the receipt of property other than stock may cause the exchange to be partly taxable.

Property other than stock that is received is considered **boot**. Gain is recognized to the extent of the lesser of (1) the transferor's realized gain or (2) the amount of money plus FMV of the nonmoney boot property received. A loss is never recognized. The character of the gain depends upon the type of the property transferred. (See Example C:2-24.) Where several properties are transferred, a "separate properties approach" is used. (See Example C:2-25.)

E. **Basis of Stock Received.** The basis of the stock received in a Sec. 351 exchange is the adjusted basis of the property transferred plus any gain recognized by the transferor minus (1) any money received (including liabilities transferred to the corporation that are treated like money) and (2) the FMV of any nonmoney boot property that is received. (See Example C:2-26.)

F. **Tax Consequences to Transferee Corporation.** The transferee corporation needs to determine the amount of gain or loss (if any) it must recognize and the basis of property or services acquired. No gain or loss is recognized by a transferee corporation exchanging stock or debt instruments for property. A transferee corporation must **recognize** gain (but not loss) if it transfers appreciated property to a transferor as part of a Sec. 351 exchange. (See Examples C:2-29 and C:2-30.)

If the transaction is taxable to the transferor, the basis of the property acquired is its acquisition cost.

Topic Review C:2-2 presents a summary of the tax consequences of a tax-free asset transfer to the transferor and the transferee corporation and may be referred to at this point to summarize the more important material relating to partially tax-free in corporations. This review is presented on p. C:2-20.

G. **Assumption of the Transferor's Liabilities.** The assumption of liabilities does not cause the transferor to recognize part or all of his realized gain unless (1) the transfer is made for a tax avoidance purpose or there is no bona fide business purpose for the acquisition and/or assumption of the debt, or (2) the liabilities assumed are in excess of the basis of the properties transferred.

The most important factor in determining whether a tax avoidance purpose is present is the length of time between the incurrence of the liability and the transfer of the liability to the corporation. Liabilities are considered to have a business purpose if the liabilities are incurred in the normal course of business or in the course of acquiring business property. If no business purpose is found, all of the liabilities assumed or acquired are considered boot.

If the total amount of liabilities transferred to a controlled corporation by a transferor exceeds the total adjusted basis of all properties transferred by the transferor, the excess liability is a gain that is taxable to the transferor. (See Example C:2-37.)

The term liabilities for a cash or hybrid method of accounting transferor does not include (1) any amount that would give rise to a deduction when paid or (2) any amount that is payable to a retired partner or to liquidate a deceased partner's interest. (See Example C:2-38.)

Topic Review C:2-3 presents a summary of the liability assumption and acquisition rules of Sec. 357 and may now be used to review this material with the students. This review is presented on p. C:2-25.

H. **Other Considerations in a Sec. 351 Exchange.**

1. **Recapture of Depreciation.** If a Sec. 351 exchange is nontaxable, no depreciation recapture is required. The transferor's recapture potential is transferred to the transferee corporation. (See Example C:2-39.)

2. **Computing Depreciation.** When a shareholder transfers depreciable property to a corporation in a Sec. 351 transaction, the corporation must continue to use the same depreciation method and recovery period with respect to the shareholder's basis in the property. An allocation of the depreciation for the year that includes the transfer date must be made between the transferor and transferee. If a basis adjustment occurs because the transferor recognizes a gain, a second depreciable asset is created which is generally depreciated as a new asset under the MACRS rules. (See Example C:2-40.)

3. **Assignment of Income Doctrine.** This doctrine is a judicial requirement that income be taxed to the person who earns it. This doctrine does not apply to a Sec. 351 exchange if the transferor transfers substantially all the business assets and liabilities to the corporation and a business purpose exists for the transfer. Accounts receivable take a zero basis in the corporation's hands and are included in income when collected. (See Example C:2-42.)

VI. Choice of Capital Structure.

A. **Characterization of Obligations as Debt or Equity Capital.** The tax laws provide an incentive for closely held corporations to maximize the amount of allowable interest deductions. Where debt financing resembles equity obligations, the form of the transaction will be ignored and debt will be reclassified as common or preferred stock. No single factor is controlling in determining when reclassification will occur.

B. **Debt Capital.**

1. **Issuance of Debt.** C Corporations with average gross receipts for the previous three years exceeding $27 million (in 2022) are limited in the interest deduction to the sum of (1) businesses interest income; (2) 30% of adjusted taxable income; and (3) floor plan financing interest for corporate tax payers who sell motor vehicles. Interest expense greater than the sum of these three items carries over to the next tax year, subject to the limitation in that year. The carry over period is indefinite. To arrive at adjustable taxable income, a C Corporation calculates taxable income without regard to (1) any item of income, gain, deduction, or loss not properly allocable to a trade or business; (2) any business interest or business interest income; (3) any net operating loss deduction; and (4) any deduction allowable for depreciation, amortization, or depletion taken in years before 2022. C Corporations with average gross receipts of $27 million or less are not limited in their business interest deduction. In contrast to business interest expenses, the corporation cannot deduct dividends paid on equity security.

2. **When Interest Is Paid.** Interest paid on debt is deductible by the payor. Dividends paid on stock are not deductible by the corporation. Noncorporate investors who borrow funds in order to make an investment in a C corporation will find that the interest expense incurred to carry such an investment is generally subject to the investment interest limitation; unless the investment is a passive activity and the interest expense comes under the passive activity limitation rules.

3. **When an Indebtedness Is Satisfied.** Repayment of an indebtedness is not considered an exchange transaction. An obligation that is repaid by a corporation does not result in a gain or loss being recognized by the creditor. The satisfaction of a debt instrument (e.g., note, bond, or a debenture) is an exchange for the holder of a debt instrument and gain or loss will be recognized if the amount received is different from the asset's basis.

Table C:2-2 presents the tax advantages and disadvantages of using debt in the capital structure. This table may be found on p. C:2-29. You may want to discuss the case presented in the box on p. C:2-31 concerning extremely long-term debt issued to raise capital by a corporation.

C. **Equity Capital.** The reasons for use of multiple classes of stock are found on p. C:2-29. Because of the many different types of equity issues that are possible, all tax and nontax advantages of each type cannot be listed. Table C:2-3, Tax Advantages and Disadvantages of Using Stock in the Capital Structure, is found on p. C:2-30.

D. **Capital Contributions by Shareholders.** A corporation does not recognize any income when it receives money or property as a capital contribution from a shareholder. If additional contributions are made without additional stock being issued, the payments are regarded as an additional price paid for the existing stock. (See Example C:2-44.)

E. **Capital Contributions by Nonshareholders.** Nonshareholders sometimes contribute capital to a corporation in the form of cash or other property. For example, a city government might make a "contribution to capital" to a corporation in the form of undeveloped land to induce a corporation to locate within the city and provide jobs for citizens of the municipality. For transfers before December 23, 2017, such "contributions to capital" were excluded from the corporation's gross income if the money or property contributed was neither a payment for goods or services nor a subsidy to induce the corporation to limit production. However, for transfers after December 22, 2017, the term "contribution of capital" no longer includes contributions to the corporation by nonshareholders who are customers, potential customers, governmental entities, or civic groups. In these cases, the transfers will continue to be nontaxable. In this case, the corporation will continue to take a zero basis in the property received, which precludes the corporation from claiming depreciation deductions or other capital recovery offsets with respect to the contributed property.

If a nonshareholder, who is not a customer, potential customer, governmental entity or civic group, contributes cash, the basis of any property acquired with the cash during a 12-month period beginning on the day the corporation received the contribution is reduced by the cash amount used to acquire the property. This basis reduction applies to the corporation's other property in the following order:

1. Depreciable Property
2. Amortizable Property
3. Depletable Property
4. All other property

In the sequence of these downward adjustments, however, a property's basis may not be reduced below zero.

VII. Worthlessness of Stock or Debt Obligations.

A. **Securities.** A debt or equity investment that is evidenced by a security and that becomes worthless results in a capital loss for the investor on the last day of the tax year in which the worthlessness occurs.

Ordinary loss can be reported in some situations. An example of this would be securities that are held by dealers as inventory. A domestic corporation is also permitted to claim an ordinary loss in connection with the worthlessness of a security of an affiliated corporation.

The Sec. 1244 rules permit an ordinary loss to be claimed for qualifying stock issued by a small business corporation that is sold, exchanged, or becomes worthless. Ordinary loss treatment is only allowed an individual who was originally issued the stock, or by a partner in a partnership that was originally issued the stock, and whose distributive share includes the losses for the corporate stock. If a shareholder contributes additional money or property to a corporation after acquiring Sec. 1244 stock, the amount of ordinary loss recognized upon the sale, exchange, or worthlessness of the Sec. 1244 stock is limited to the shareholder's capital contribution at the time the shares were issued. The ordinary loss is limited to $50,000 (or $100,000 if the taxpayer is married and files jointly). Losses in excess of the dollar ceiling are capital losses.

Post-2020 NOLs do not carry back but carry over indefinitely, subject to an 80% of taxable income limitation in the carryover year. This is further discussed in Chapter C:3.

B. **Unsecured Debt Obligations.** Shareholders may make loans to corporations. The type of loss that can be claimed on these advances depends on the nature of the loan. If the advance is treated as paid-in capital, the amount of the loan increases the worthless securities loss on the stock.

A loan made to a corporation that is not evidenced by a security can be deducted under either the business or nonbusiness bad debt rules. Most unsecured advances are considered to be made outside the shareholder's trade or business. If a noncorporate shareholder makes the loan, it will generally be considered a nonbusiness bad debt that is a short-term capital loss, and is limited to a $3,000 deduction per year.

VIII. Tax Planning Considerations.

Sec. 351 treatment is mandatory, not elective, if the provisions are met. In some cases shareholders may wish to recognize gains or losses. In order to accomplish this, one of the provisions necessary for the application of Sec. 351 must be violated. (See Example C:2-50.)

IX. Compliance and Procedural Requirements.

Every person who receives stock, securities, or other property in an exchange qualifying under Sec. 351 must attach a statement to his tax return for the period that includes the date of the exchange. A list of the required information for the transferor is found on p. C:2-36. The transferee corporation must attach a statement to its tax return for the year in which the exchange takes place. A list of the transferee corporation's required information is found on p. C:2-36.

Court Case Briefs

Charles E. Wolfe v. U.S., 612 F. Supp 605 (DC Mont, 1985) aff'd. 798 F.2d 1241 (9th Cir., 1986).

The taxpayer, Charles E. Wolfe, was the sole shareholder and president of Wolfe & Company, a corporation which leased tractor-trailers. Mr. Wolfe also operated an "over-the-road" trucking business as a sole proprietorship. The corporation incurred a large federal tax bill which was paid by Mr. Wolfe personally when the corporation was unable to pay. Mr. Wolfe contended that he should not be held personally liable for the tax liability of the corporation.

The main issue was whether the corporation was the alter ego of Mr. Wolfe. If so, then the Internal Revenue Service could "pierce the corporate veil" and look to Mr. Wolfe's personal assets for satisfaction of the corporate tax liability. The court considered eleven factors, including level of ownership and control of the corporation, commingling of personal and corporate funds, common books and records, distribution of earnings and profits, and representation of corporate-personal relationship. In this case, the facts represented a classic case of a shareholder so dominating corporate affairs such that the corporation and the shareholder did not appear to have separate identities.

Therefore, the Service could pierce the corporate veil and look to the personal assets of the sole shareholder for payment of the taxes. Further, neither economic difficulties nor employee's illness constituted reasonable cause for failure to file or pay tax.

American Bantam Car Company v. CIR, 11 T.C. 397 (1948), aff'd. per curiam 177 F.2d 513 (3rd Cir., 1949).

This is a leading case in the determination of whether a transfer to a corporation is a tax-free transfer to a controlled corporation under the Code Sec. 351. This case is based on Section 112(b)(5) of the Revenue Act of 1936, the precursor of Code Sec. 351.

In this case, property was transferred to the newly formed American Bantam Car Company in exchange for stock of the corporation by three individuals, who immediately after the transfer owned greater than an 80% interest in the corporation. Subsequent to this transfer, the corporation entered into agreements with underwriters for the public offering of stock of the corporation, which if such offering had resulted in sufficient sales, would have reduced the interests of these three initial shareholders, based on the voting rights endowed upon the stock in the articles of incorporation.

The issue before the court was whether these transactions were all part of an integrated plan, thereby eliminating tax-free exchange treatment under Section 112(b)(5) or whether they were actually separate transactions. The court looked at four factors in making their decision: 1) intent of the parties, 2) mutual interdependence of steps, 3) time element, and 4) ultimate result. There is a detailed analysis of each factor and a summary of prior court cases in this case. The court held that the transactions were indeed separate and that the transfer of assets to the corporation should be treated as a tax-free exchange. Therefore, the basis of the assets for the corporation was their basis in the hands of the transferors on the date of the exchange.

Chapter C:2

Corporate Formations and Capital Structure

Discussion Questions

C:2-1 Various. A new business can be conducted as a sole proprietorship, partnership, C corporation, S corporation, LLC, or LLP. Each form has tax and nontax advantages and disadvantages. See pages C:2-2 through C:2-8 for a listing of the tax advantages and disadvantages of each form. A comparison of the C corporation, S corporation, and partnership alternative business forms appears in Appendix F. pp. C:2-2 through C:2-8.

C:2-2 Alice and Bill should consider forming a corporation and making an S corporation election. An S corporation election will permit the losses incurred during the first few years to be passed through to Alice and Bill and be used to offset income from other sources. The corporate form affords them limited liability. As an alternative to incorporating, Alice and Bill might consider setting up a limited liability company that is taxed as a partnership and also has limited liability. pp. C:2-6 through C:2-8.

C:2-3 Yes, several alternative classifications. The only default tax classification for the LLC is a partnership. Because the LLC has two owners, it cannot be taxed as a sole proprietorship. The entity can elect to be taxed as a C corporation or an S corporation. If the entity makes such an election, Sec. 351 applies to the deemed corporate formation. The entity would have to make a separate election to be treated as an S corporation. pp. C:2-8 and C:2-9.

C:2-4 The default tax classification for White Corporation is a C corporation. However, White can be treated as an S corporation if it makes the necessary election. Following an S corporation election, the entity's income will be taxed to its owners, thereby avoiding double taxation. The S corporation election is made by filing Form 2553 within the first 2½ months of the corporation's existence (see Chapter C:11). pp. C:2-6 and C:2-7.

C:2-5 The only default tax classification for the LLC is a sole proprietorship. Because the LLC has only a single owner, it cannot be treated as a partnership. Thus, the default classification is a "disregarded entity" taxed as a sole proprietorship. The entity can elect to be taxed as a C corporation or an S corporation. If the entity makes such an election, Sec. 351 applies to the deemed corporate formation. pp. C:2-8 and C:2-9.

C:2-6 Possible arguments include:

PRO (Corporate formations should be taxable events):

1. A corporate formation is an exchange transaction; therefore, parties to the exchange should recognize gains and losses.
2. Making a corporate formation a taxable event increases tax revenues.
3. Simplification is achieved by eliminating one of the two options - whether a transaction is taxable or not. This change will make administration of the tax laws easier.

4. This change eliminates the need for taxpayers to structure transactions to avoid Sec. 351 to recognize gains and/or losses.

CON (No change should occur to current law):
1. A change in current law would hurt start-up corporations by reducing their capital through the income tax paid by transferors on an asset transfer.
2. No economic gains or losses are realized. Just a change in the form of ownership (direct vs. indirect) has occurred. Therefore, it is not appropriate to recognize gains and losses at this time.
3. With taxation, corporations will have to raise more capital because transferors of noncash property will have less capital to invest and because money must be diverted to pay taxes.
4. Taxpayers are prevented from recognizing losses under the current system, thereby increasing revenues to the government.
5. With taxation, businesses would be deterred from incorporating because of the tax consequences, and therefore economic growth in the U.S. would be adversely affected. pp. C:2-9 and C:2-10.

C:2-7 The following tax consequences, if Sec. 351 applies: Neither the transferor nor the transferee corporation recognizes gain or loss when property is exchanged for stock. Unless boot property (i.e., property other than qualified stock) is received, the transferor's realized gain or loss is deferred until he or she sells or exchanges the stock received. If boot property is received, the recognized gain is the lesser of (1) the amount of money plus the FMV of the non-money boot property received or (2) the realized gain. The transferor recognizes no losses even if boot property is received. The transferor's basis in the stock received references his or her basis in the property transferred and is increased by any gain recognized and is reduced by the amount of money plus the FMV of the non-money boot property received and the amount of any liabilities assumed by the transferee corporation. The basis of the boot property is its FMV. The transferee corporation recognizes no gain on the transfer. The transferee corporation's basis in the property received is the same basis that the transferor had in the property transferred increased by any gain recognized by the transferor. pp. C:2-16 through C:2-21.

C:2-8 For purposes of Sec. 351, the following items are considered to be property: Money and almost any other kind of tangible or intangible property, including installment obligations, accounts receivable, inventory, equipment, patents, trademarks, trade names, and computer software. Property does not include services, an indebtedness of the transferee corporation that is not evidenced by a security, or interest on an indebtedness that accrued on or after the beginning of the transferor's holding period for the debt. pp. C:2-12 and C:2-13.

C:2-9 "Control" is defined as follows: Transferors as a group must own at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. The nonvoting stock ownership is tested on a class-by-class basis. pp. C:2-13 through C:2-16.

C:2-10 The IRS has interpreted the phrase as follows: Sec. 351 requires the transferors to control the transferee corporation immediately after the exchange but does not specify how long this control must be maintained. The transferors, however, must not have a prearranged plan to dispose of their stock outside the control group. If they have such a plan, the IRS may not treat the transferors as in control immediately after the exchange. p. C:2-16.

C:2-11 No. The Sec. 351 requirements are not met because Peter is not considered a transferor of property. Even though he transferred $1,000 of money, this property is of nominal value--less than 10% of the value of the stock he received for services ($49,000). Therefore, only John and Mary are deemed to have transferred property and, since they own only 66-2/3% of the stock of New Corporation, they are not in control. The 10% minimum is specified in Rev. Proc. 77-37 and applies only for advance ruling purposes. The shareholders may choose to engage in the transaction without an advance ruling, report it as nontaxable, and run the risk of being audited, with the result that the IRS treats the transaction as taxable. Alternatively, they might restructure the transaction by having Peter provide a larger amount of cash to the corporation and take more shares of stock. Another option would be for Peter to provide fewer services with the increased amount of cash and still receive 100 shares of stock. p. C:2-14.

C:2-12 No. Section 351 does not require that the shareholders receive stock equal in value to the property transferred. Section 351 would apply to the transfer by Susan and Fred if all other requirements are met. However, Fred probably will be deemed to have made a gift of 25 shares of stock, paid compensation of $25,000, or repaid a $25,000 debt to Susan by transferring the Spade stock. p. C:2-15.

C:2-13 Yes. Section 351 applies to property transfers to an existing corporation. For the exchange to be tax-free, the transferors must be in control of the corporation immediately after the exchange. In this example, Carl is <u>not</u> in control since he owns only 75 out of 125 shares, or 60% of the North stock. Therefore, the Sec. 351 requirements are not met. To qualify under Sec. 351, Carl can transfer enough property to acquire a total of 200 shares out of 250 (200 shares held by Carl and 50 shares held by Lynn) outstanding shares. In this situation, Carl would own exactly 80% of North stock (250 shares x 0.80 = 200 shares). A less expensive alternative would be for Lynn to transfer property equal to or exceeding $10,000 (50 shares owned x $2,000 per share x 10% minimum) to be considered a transferor. pp. C:2-14 and C:2-15.

C:2-14 The transferor's basis in stock received in a Sec. 351 exchange is determined as follows (Sec. 358(a)):

Adjusted basis of property transferred to the corporation	
Plus:	Any gain recognized by the transferor
Minus:	FMV of boot (other than money) received from the corporation
	Money received from the corporation
	The amount of any liabilities assumed by the transferee corporation
Adjusted basis of stock received	

For purposes of calculating stock basis, liabilities assumed by the transferee corporation are considered money and reduce the shareholder's basis in any stock received (Sec. 358(d)).

The shareholder's holding period for the stock includes the holding period of any capital assets or Sec. 1231 assets transferred. If the shareholder transfers any other property (e.g., inventory), the holding period for any stock received begins on the day after the exchange date. This rule can cause some shares of transferee corporation stock to have two different holding periods. The shareholder's basis for any boot property is its FMV, and the holding period begins on the day after the exchange date (Sec. 358(a)(2)). pp. C:2-18 and C:2-19.

C:2-15 Two sets of circumstances may require recognition of gain when liabilities are transferred.

- First, all liabilities assumed by a controlled corporation are considered boot if the principal purpose of the transfer of any portion of such liabilities is tax avoidance or if no bona fide business purpose exists for the transfer (Sec. 357(b)).
- Second, if the total amount of liabilities transferred to a controlled corporation exceeds the total adjusted basis of all property transferred by the transferor, the excess liability amount is treated as a gain taxable to the transferor without regard to whether the transferor had actually realized gain or loss (Sec. 357(c)).

Under the second set of circumstances, the transferor recognizes gain, but the excess liabilities are not considered to be boot. Section 357(c)(3) provides special rules for cash basis transferors who transfer excess liabilities to a corporation. pp. C:2-22 through C:2-25.

C:2-16 The IRS likely would consider the following two factors: (1) The transferor's reason for incurring the liability (e.g., did the liability relate to the transferor's trade or business). (2) The length of time from when the liability was incurred to the transfer date. If the transferor incurred the liability in connection with his or her trade or business, a Sec. 357(b) "problem" probably would not exist even if the transferor incurred the liability shortly before the transfer date. p. C:2-23.

C:2-17 If Mark receives no boot, depreciation is not recaptured (Secs. 1245(b)(3) and 1250(d)(3)). The recapture potential is transferred to Utah Corporation along with the property. If Mark does receive boot and must recognize gain, the recognized gain is treated as ordinary income but not in an amount exceeding the recapture potential. Any remaining recapture potential is transferred to Utah. If Utah sells the property at a gain, it must recapture depreciation deducted by Mark and not recaptured at the time of the transfer, as well as depreciation that it has claimed. Depreciation in the year of transfer must be allocated between the transferor and transferee according to the number of months each party has held the property. The transferee is considered to have held the property for the entire month in which the property was transferred. pp. C:2-25 through C:2-27.

C:2-18 The assignment of income doctrine could apply to a transfer of unearned income. However, the assignment of income doctrine does not apply to a transfer of accounts receivable by a cash method transferor in a Sec. 351 exchange if (1) the transferor transfers substantially all the assets and liabilities of a business and (2) a business purpose exists for the transfer. (See Rev. Rul. 80-198, 1980-2 C.B. 113.) p. C:2-27.

C:2-19 In enacting Sec. 385, Congress mandated that the following factors be taken into account in determining whether an amount advanced to a corporation should be characterized as debt or equity capital:

- Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,
- Whether the debt is subordinate to or preferred over other indebtedness of the corporation,
- The ratio of debt to equity of the corporation,
- Whether the debt is convertible into the stock of the corporation, and
- The relationship between holdings of stock in the corporation and holdings of the interest in question.

Although Congress enacted Sec. 385 in an attempt to provide statutory guidelines for the debt/equity question, the lack of interpretative regulations (other than those addressing narrow, specific areas) has required taxpayers, the IRS, and the courts to continue to use these statutory factors and other factors identified by the courts in ascertaining whether an instrument is debt or equity. For example, see O.H. Kruse Grain & Milling v. CIR, 5 AFTR 2d 1544, 60-2 USTC ¶9490 (9th Cir., 1960) cited in footnote 47 of the text, which lists additional factors the courts might consider. In addition, the Treasury Department indicated in Notice 94-47, 1994-1 C.B. 357, that it will carefully scrutinize instruments that combine tax treatment for debt with significant equity characteristics. Eight factors were listed that may be considered. pp. C:2-27 and C:2-28.

C:2-20 Advantages of using debt include: Interest is deductible (subject to limitations) by the payor while a dividend payment is not deductible, and the repayment of an indebtedness generally is treated as a return of capital while a stock redemption often is treated as a dividend. Disadvantages of using debt include that dividend payments are eligible for a dividends-received deduction when received by a corporate shareholder; stock can be received tax-free as part of a corporate formation and/or reorganization while the receipt of debt usually is treated as boot; a distribution of stock to shareholders can be a nontaxable stock dividend while a distribution of a debt usually results in dividend income; and worthless stock results in an ordinary loss under Sec. 1244 while a worthless debt instrument generally results in a capital loss. pp. C:2-29 and C:2-30.

C:2-21 Ordinary loss treatment. The principal advantage of satisfying the Sec. 1244 small business stock requirements is the ordinary loss treatment available for individual shareholders and certain partnerships reporting up to $50,000 (or $100,000 if married and filing jointly) of losses incurred on a sale or exchange of the stock. Ordinary loss treatment is available only if the loss is incurred by a qualifying shareholder who acquired the stock from the small business corporation; the corporation was a small business corporation at the time it issued the stock (i.e., a corporation whose aggregate money and other property received for stock is less than $1 million); the corporation issued the stock for money or property (other than stock or securities); and the issuing corporation derived more than 50% of its aggregate gross receipts from active sources during the most recent five tax years ending before the date when the stock was sold or exchanged. pp. C:2-32 and C:2-33.

C:2-22 The two advantages of business bad debt treatment are (1) a business bad debt deduction can be claimed for partial worthlessness and (2) a business bad debt can be deducted as an ordinary loss. A nonbusiness bad debt can be deducted only in the year in which total worthlessness occurs. No partial write-offs of nonbusiness bad debts are permitted. A nonbusiness bad debt can be deducted only as a short-term capital loss. These losses can offset capital gains or be deducted by individuals up to $3,000 in a tax year. No limit exists on business bad debt deductions and, if such losses exceed income, they can be carried over as part of a net operating loss. To claim a business bad debt deduction, the holder must show that the dominant motivation for the loan was related to the taxpayer's business and was not related to the taxpayer's investment activities. pp. C:2-33 and C:2-34.

C:2-23 To recognize gain or loss. Shareholders might avoid Sec. 351 treatment if, in transferring property, they realize a gain or loss that they want to recognize. They may be able to avoid Sec. 351 treatment by violating one or more of its requirements, for example, by selling the property to the corporation for cash, by selling the property to a third party who contributes it to the corporation, or by receiving sufficient boot to recognize the gain. pp. C:2-34 through C:2-36.

C:2-24 The reporting requirements are as follows: Every person who receives stock, securities, or other property in a Sec. 351 exchange must attach a statement to his or her tax return for the period that includes the date of the exchange. The statement must include all the facts pertinent to the exchange (see Reg. Sec. 1.351-3(a)). Similarly, the transferee corporation must attach a statement to its tax return for the year in which the exchange took place (see Reg. Sec. 1.351-3(b)). The transferee's statement requires a description of the property and liabilities received from the transferors and the stock and property transferred to the transferors in exchange for the property. p. C:2-36.

Issue Identification Questions

C:2-25 Mary and Peter should consider the following tax issues:

- Does the property transfer meet the Sec. 351 requirements?
  - Have Peter and Mary transferred property? Does Peter's controlling Trenton Corporation prior to the transfer change the tax result?
  - Are the transferors in control of the corporation immediately after the transfer?
  - Do the transferors receive transferee corporation stock?
- What is each shareholder's recognized gain?
- What is each shareholder's basis in his or her stock?
- What is each shareholder's holding period for his or her stock?
- Does Trenton recognize gain when it issues its stock?
- What is Trenton's basis in the property received from Mary?
- What is Trenton's holding period for the property received from Mary?

The property transfer meets all the Sec. 351 requirements. Peter and Mary are considered to own all 195 of the Trenton shares immediately after the exchange. Peter's contribution of cash for stock is not considered to be a nominal amount according to IRS rules relating to the issuance of private letter rulings (i.e., it equals or exceeds 10% of the value of Peter's prior stock holdings). Thus, his stock is counted towards the 80% minimum stock ownership for control. Mary recognizes no gain on the asset transfer and takes a $50,000 basis in the Trenton shares she receives. The holding period for the Trenton shares includes her holding period for the property transferred. Trenton recognizes no gain when it issues its stock and takes a $50,000 basis in the property. pp. C:2-16 through C:2-21.

C:2-26 Carl and his son should consider the following tax issues:

- Does the property transfer meet the Sec. 351 requirements?
  - Have Carl and his son transferred property?
  - Are the transferors in control of the corporation immediately after the transfer?
  - Do the transferors receive transferee corporation stock?
- Does the property contribution/receipt of stock as described in the facts reflect the true nature of the transaction? Or, has a deemed gift or other event occurred?
- What is each shareholder's recognized gain?
- What is each shareholder's basis in his stock?
- What is each shareholder's holding period in his stock?
- If a deemed gift has been made, is it a taxable gift from Carl to his son? (This question could be rewritten for events other than a gift (e.g., repayment of a loan.))
- What is Cook Corporation's basis in the property received from Carl?
- What is Cook's holding period for the property received from Carl?

The contribution is nontaxable because it meets all the Sec. 351 requirements, and Carl and Carl, Jr. own all the Cook stock. Carl, Jr. receives a disproportionate amount of stock relative to his $20,000 capital contribution. It appears that the transaction should be recast so that Carl is deemed to receive 80 shares of stock, each valued at $1,000. He then gifts 30 shares to Carl, Jr. The deemed gift leaves each shareholder with 50 shares of stock. Neither shareholder recognizes any gain, and Carl takes a $50,000 adjusted basis in the 80 shares he receives. He recognizes no gain on the transfer of 30 shares to Carl, Jr., and $18,750 [(30/80) x $50,000] of his basis accompanies the deemed gifted shares. Carl's basis in his remaining 50 shares is $31,250 ($50,000 - $18,750). Carl, Jr's basis in his 50 shares is $38,750 ($20,000 + $18,750). pp. C:2-9 through C:2-21.

C:2-27 Bill should consider the following tax issues:

- Was the stock sold to a related party (Sam), as defined by Sec. 267(b)? If so, Bill cannot recognize the loss, and the remaining issues need not be examined. If not, then…
- Is the stock a capital asset?
- Is Bold a qualifying small business corporation?
- If so, does the stock qualify for Sec. 1244 stock treatment?
- If Sec. 1244 stock, what is Bill's marital and filing status?
- Has Bill's basis in the stock changed relative to its initial acquisition cost?
- What is the amount and character of Bill's recognized loss?

Bill's stock sale results in the realization of a $65,000 ($100,000 - $35,000) long-term capital loss. If the purchaser is a related party, Sec. 267(a) precludes Bill from recognizing the loss. Because Bill is the original holder of the stock, the loss may be characterized as ordinary under Sec. 1244, assuming the various requirements of that provision are satisfied. pp. C:2-32 and C:2-33.

Problems

C:2-28 With the given facts (and ignoring employment and self-employment taxes), the sole proprietorship and the S corporation with distributions result in the lowest total tax, as determined in the following analysis:

	Sole Proprietorship	C Corporation with Salary	C Corporation with Dividend	S Corporation with Salary	S Corporation with Distribution
Entity Level:					
Income before salary	$50,000	$50,000	$50,000	$50,000	$50,000
Salary deduction	-0-	(20,000)	-0-	(20,000)	-0-
Taxable income	$50,000	$30,000	$50,000	$30,000	$50,000
Entity level tax	$ -0-	$ 6,300	$10,500	$ -0-	$ -0-
Lucia:					
Pass-through income	$50,000	$ -0-	$ -0-	$30,000	$50,000
QBI deduction	(10,000)			(6,000)	(10,000)
Salary income	-0-	20,000	-0-	20,000	-0-
Dividend income	-0-	-0-	20,000	-0-	-0-
Total income to Lucia	$40,000	$20,000	$20,000	$44,000	$40,000
Lucia's tax	$ 8,800[a]	$ 4,400[b]	$ 3,000[c]	$ 9,680[d]	$ 8,800[e]
Total Tax	$ 8,800	$10,700	$13,500	$ 9,680	$ 8,800

[a]$40,000 x 0.22 = $8,800
[b]$20,000 x 0.22 = $4,400
[c]$20,000 x 0.15 = $3,000
[d]$44,000 x 0.22 = $9,680
[e]$40,000 x 0.22 = $8,800

The sole proprietorship and S corporation with distributions organizational forms allow for the qualified business income (QBI) deduction. Also, the corporate tax rate (21%) is close to the individual's tax rate (22%), so the C corporation form along with the double taxation of distributed income in the form of a dividend causes that form to be disadvantageous. The C corporation with salary, while reducing double taxation, does not provide a QBI deduction or a reduced tax rate on salary, so this option also has disadvantages. The S corporation with salary has the disadvantage of reducing the amount of income subject to the QBI deduction. Given different facts, such as a higher individual tax rate, the outcomes of this analysis could change. pp. C:2-2 through C:2-8.

C:2-29 a. None. Dick does not recognize his $10,000 realized loss.

b. $60,000 basis in Triton shares received. Dick's holding period is deemed to begin three years ago when Dick originally purchased the land.

c. None. Evan does not recognize his $15,000 realized loss.

d. $45,000 basis in Triton shares received. Evan's holding period is deemed to begin four years ago when Evan originally purchased the machinery.

e. Fran recognizes $20,000 of ordinary income.

f. $20,000 basis in Triton shares received. Fran's holding period begins the day after the exchange date in the current year.

g. Triton takes a $50,000 basis in the land and a $30,000 basis in the machinery. Because of the loss property limitation rule, the bases of these assets are reduced to their respective FMVs, assuming the parties do not elect to reduce stock basis. Thus, both assets have a holding period that begins the day after the transfer in the current year. The services, if capitalized, would have a $20,000 basis and a holding period starting in the current year. pp. C:2-16 through C:2-22.

C:2-30 a. $20,000 gain. The Sec. 351 requirements have not been met because 30% of the stock is issued for services. Therefore, Ed recognizes $20,000 ($35,000 - $15,000) of capital gain.

b. $35,000 basis in Jet shares received. Ed's holding period begins on the day after the exchange date.

c. Fran recognizes a $10,000 ($35,000 - $45,000) Sec. 1231 loss.

d. $35,000 basis in Jet shares received. Fran's holding period begins on the day after the exchange date.

e. George recognizes $30,000 of ordinary income.

f. $30,000 basis in Jet shares received. George's holding period begins the day after the exchange date.

g. Jet Corporation takes a $35,000 basis in the land and a $35,000 basis in the machinery. Its holding period for each asset begins the day after the exchange date. The services, if capitalized, would have a $30,000 basis.

h. Because the Sec. 351 requirements would now have been met, the answers change as follows:

- a. Ed recognizes no gain or loss.
- b. $15,000 basis in the Jet shares received. Ed's holding period is deemed to begin four years ago when he originally purchased the land.
- c. Fran recognizes no loss.
- d. $45,000 basis in the Jet shares received. Fran's holding period is deemed to begin four years ago when she originally purchased the machinery.
- e. George recognizes $25,000 of ordinary income.
- f. $30,000 ($5,000 cash + $25,000 FMV of services) basis in the Jet shares received. George's holding period begins the day after the exchange date.
- g. Jet's basis in the land and machinery are $15,000 and $35,000, respectively. The loss property limitation rule limits the corporation's basis in the machinery to its FMV. Jet's holding period for the land is deemed to begin four years ago when Dick originally purchased the land. The holding period for the machinery also begins four years ago when Fran purchases it (Reg. Sec. 1.362-4(c)(3)(i)). The services, if capitalized, would have a $25,000 basis. pp. C:2-16 through C:2-22.

C:2-31 a. The control requirement is not met. Transferors of property receive only 75% and thus do not have 80% control.

b. The control requirement is met. Robert transferred more than a nominal amount of property. The 80% control requirement has been met since all of Robert's stock is counted for this purpose.

c. The control requirement is not met. Sam owns only 33-1/3% of the Vast stock immediately after the exchange. No stock ownership is attributed from Sam's parents to Sam.

d. The control requirement is met. Charles and Ruth own 100% of the Tiny stock. The transfers do not have to be simultaneous.

e. The control requirement is not met. Charles had a prearranged plan to sell a sufficient amount of shares to fail the control test. Only if Sam were considered to be a transferor (i.e., the sale took place as part of a public offering) would the transaction meet the requirements of Sec. 351. pp. C:2-13 through C:2-16.

C:2-32 a. The control requirement is met. The property transferred by Fred is not considered to be nominal relative to the value of stock received for services. Therefore, Fred and Greta are considered to own 100% of the New stock.

b. The control requirement is not met. For advance ruling purposes, Maureen's shares are not counted towards determining whether the control requirement has been met because the property she contributed was nominal (i.e., does not meet the 10% property minimum of Rev. Proc. 77-37) compared to the value of the stock received for services. The taxpayer may choose to enter into the transaction without an advance ruling, report it as nontaxable, and run the risk of being audited, with the result that the IRS treats the transaction as taxable. Alternatively, Maureen can contribute additional property so that the amount of property equals or exceeds the 10% minimum. The minimum property contribution is \$4,545 [\$4,545 = 0.10 x (\$50,000 - \$4,545)]. The \$4,545 amount is found by solving the following equation for Property: Property = 0.10 x (\$50,000 - Property), which solves to Property = (0.10 x \$50,000)/1.1. pp. C:2-13 and C:2-14.

C:2-33 Veronica needs to receive 1,000 additional shares in exchange for \$25,000 worth of silver bullion. The 200 shares currently held by Veronica equal 40% of the 500 shares outstanding. To avoid recognizing a gain, Veronica must be "in control" of Poly-Electron immediately after the exchange. Control implies ownership of at least 80% of the total number of Poly-Electron shares outstanding.

The number of additional shares that Veronica must acquire to achieve control can be calculated as follows, where A = additional shares needed:

$$(200 + A) / (500 + A) = 0.80$$
$$200 + A = 0.80 \times (500 + A)$$
$$200 + A = 400 + 0.80\ A$$
$$0.20\ A = 200$$
$$A = 1{,}000 \text{ additional shares}$$

Thus, with the additional 1,000 shares, Veronica will have 80% control after the exchange (i.e., 1,200 / 1,500 = 80%.) If each share is worth \$25, the value of silver bullion that Veronica must contribute is \$25,000 (1,000 shares x \$25). Having achieved control, Veronica's exchange will qualify for nontaxable treatment under Sec. 351. p. C:2-13.

C:2-34 a. No. The exchange does not qualify as nontaxable under Sec. 351 because Al and Bob do not control West Corporation. (Al owns only 1,000/1,300 = 76.9% of the voting common stock while Bob owns 100% of the nonvoting preferred stock). Al recognizes $25,000 of gain on the transfer of the patent. His basis in his West stock is $25,000. Bob recognizes no gain or loss because he contributed cash. His basis in the preferred stock is $25,000. Carl recognizes $7,500 of ordinary income. His basis in his West stock is $7,500. West recognizes no gain or loss on the exchange. Its basis for the assets is: cash, $25,000; patent, $25,000; and services, $7,500.

b. Nontaxable. The exchange now qualifies as nontaxable under Sec. 351 because Al and Bob together own 1,200/1,500 = 80% of the voting common stock and 100% of the nonvoting preferred stock. Al recognizes no gain or loss, and his basis in his West stock is zero. Bob recognizes no gain or loss, and his basis in his West stock is $25,000. The common stock has a $5,000 (200 x $25) FMV, and the preferred stock has a $20,000 (200 x $100) FMV, and those amounts would be allocated to the basis of each type of stock since the stock FMVs equals their bases in this situation. Carl recognizes $7,500 of ordinary income, and his basis in his West stock is $7,500. The consequences to West are the same as in Part a, except the basis for the patent is zero instead of $25,000.

c. Nontaxable. The exchange apparently would qualify under Sec. 351. Assuming the $800 of cash contributed is acceptable under Rev. Proc. 77-37 because it meets the 10% property minimum for advance ruling purposes, Al and Bob would recognize no gain or loss. Carl would recognize $6,700 of ordinary income. The consequences to West are the same as in Part b except the cash contributed by Carl takes an $800 basis and the services generate $6,700 of taxable income. pp. C:2-13 and C:2-14.

C:2-35

	Cash	Equipment	Building	Land	Total
FMV of assets	$ 5,000	$90,000	$40,000	$30,000	$165,000
Fraction of total value	0.030303	0.545455	0.242424	0.181818	1.0000
FMV of stock received	$ 3,788	$68,182	$30,303	$22,727	$125,000
Plus: Boot property	1,212	21,818	9,697	7,273	40,000
Total proceeds	$ 5,000	$90,000	$40,000	$30,000	$165,000
Minus: Adj. basis of assets	(5,000)	(60,000)	(51,000)	(24,000)	(140,000)
Gain (loss) realized	$ -0-	$30,000	($11,000)	$ 6,000	$ 25,000
Allocation of boot	$ 1,212	$21,818	$ 9,697	$ 7,273	$ 40,000
Gain recognized	$ -0-	$21,818	$ -0-	$ 6,000	$ 27,818

a. $27,818 gain recognized:

Gain on equipment, ordinary income (recapture on Sec. 1245 property)	$21,818
Gain on land, Sec. 1231 gain	6,000
Total gain recognized	$27,818

b. $40,000 basis in common stock:

Adj. basis of property transferred	$140,000
Minus: FMV of boot received	(40,000)
Plus: Gain recognized by transferor	27,818
Basis in common stock	$127,818
Basis in nonqualified preferred stock	$ 40,000

c. $165,000 total basis in the property received:

	Tom's Basis	Recog. Gain	Reduction*	Total
Cash	$ 5,000	$ -0-	$ -0-	$ 5,000
Equipment	60,000	21,818	-0-	81,818
Building	51,000	-0-	(2,818)	48,182
Land	24,000	6,000	-0-	30,000
Total	$140,000	$27,818	$(2,818)	$165,000

*Total adjusted basis = $167,818 ($140,000 + $27,818); total FMV = $165,000. Thus, the reduction under Sec. 362(e)(2) = $2,818 ($167,818 - $165,000). Reg. Sec. 1.362-4(g)(2)(ii), adjusted basis includes the increase for gain recognized by the shareholder.

pp. C:2-16 through C:2-22.

C:2-36 $15,000. Ann must recognize $15,000 ($25,000 - $10,000) of gain on the exchange. To comply with the advance ruling requirements of Rev. Proc. 77-37, Fred must receive more than a nominal amount of stock in exchange for his property. If Fred obtained additional stock worth at least 10% of the value of the stock he already owned (i.e., at least five shares of stock in exchange for $5,000), his stock likely would be counted for control purposes, and the Sec. 351 requirements would be met. Ann may choose to enter into the transaction without increasing her property contribution so as to acquire at least 80% of Zero's stock or without having Fred increase his contribution to at least $5,000, proceed without an advance ruling, and report the transaction as being nontaxable. Ann and Fred then run the risk of being audited and the IRS's arguing the transaction is taxable. pp. C:2-14 and C:2-15.

C:2-37 $4,000. Lucy recognizes $4,000 ($12,000 - $8,000) gain on the exchange because she owns less than 80% of the stock immediately after the exchange [(50+10)/110=54.5%]. To qualify under Sec. 351:

(1) Lucy could contribute additional property for enough additional stock to obtain 80% control. To meet the 80% control requirement, she would have to purchase an additional 150 shares to own 200 shares (of the 250 shares outstanding).

(2) Marvin could exchange enough property as part of the same transaction to qualify as a transferor under Sec. 351. For advance ruling purposes under Rev. Proc. 77-37, Marvin would have to contribute at least $6,000 for an additional five shares of stock to be considered a transferor of property. The taxpayers may choose to engage in the transaction without Lucy's and Marvin's increasing their property contributions, proceed without an advance ruling, and report it as being nontaxable. However, they would run the risk of being audited and the IRS's arguing the transaction is taxable. pp. C:2-14 and C:2-15.

C:2-38 a. None. Neither Jerry nor Frank recognizes any gain or loss on the exchange because the Sec. 351 requirements have been met.

b. $44,000. Because the exchange is disproportionate, Frank probably could be deemed to have made a gift of 25 shares of Texas stock to Jerry. Jerry's basis in his 75 shares is $44,000 ($28,000 basis in property transferred by Jerry + $16,000 basis in the 25 shares received from Frank). This calculation presumes that no gift taxes are paid on the transfer. If gift taxes are paid, a second basis adjustment may be needed for the portion of the gift tax attributable to the appreciation.

c. $16,000. Frank's basis in his 25 Texas shares is $16,000 [$32,000 basis in property transferred x (25/50)]. p. C:2-15.

C:2-39 a. $20,000 capital gain:

Amount realized	$170,000
Minus: Basis in land	(30,000)
Realized gain	$140,000
Boot received (NQPS)	$ 20,000
Gain recognized (capital in character)	$ 20,000

b. $30,000. Basis of common stock and qualified preferred stock: $30,000 + $20,000 - $20,000 = $30,000. This basis must be allocated to the common and qualified preferred stock based on their relative fair market values.

Basis of common stock: $\frac{\$100,000}{\$150,000} \times \$30,000 = \$20,000$

Basis of qualified preferred stock:

$\frac{\$50,000}{\$150,000} \times \$30,000 = \$10,000$

Basis of nonqualified preferred stock: $20,000 (FMV).

c. Basis of land to Temple Corporation: $50,000 = $30,000 + $20,000

pp. C:2-16 through C:2-19.

C:2-40 a. None for Karen and Larry; $7,000 capital gain to Joe. Karen and Larry recognize no gain or loss under Sec. 351 because they receive only stock. Joe recognizes a $7,000 ($15,000 - $8,000) capital gain because he receives only notes and therefore does not qualify for Sec. 351 treatment.

b. Joe's basis in the notes is $15,000. Karen's basis in the stock is $18,000. Larry's basis in the stock is $25,000.

c. Gray Corporation's basis in the land is $15,000. Gray's basis in the equipment is $18,000. The $10,000 of depreciation recapture potential is inherited by Gray because Karen does not recognize a gain on the asset transfer. pp. C:2-16 through C:2-19.

C:2-41 a. $4,000 gain. Nora realizes a $7,000 gain [($18,000 + $4,000) - $15,000] and must recognize a gain of $4,000, the amount of the boot (note) received. Of the $4,000 gain, $3,000 is ordinary income recaptured under Sec. 1245. The remaining $1,000 is a Sec. 1231 gain.

b. $4,000 and $15,000. Nora's basis in the note is $4,000, its FMV. Nora's basis in the stock is $15,000 ($15,000 + $4,000 gain - $4,000 FMV of note).

c. $19,000. Needle Corporation's basis in the machinery is $19,000 ($15,000 + $4,000 gain recognized). pp. C:2-16 through C:2-21 and C:2-25 through C:2-27.

C:2-42 a. $3,000 of ordinary income: Jim realizes a $3,500 [($5,000 + $1,000 + $2,000) - $4,500] gain and recognizes a $3,000 gain. Because the $2,000 education loan assumed by Gold Corporation has no apparent business purpose, all liabilities transferred to Gold are treated as boot under Sec. 357(b). All of Jim's gain is ordinary income recaptured under Sec. 1245.

b. $4,500. Jim's basis in his stock is $4,500 ($4,500 + $3,000 - $3,000).

c. Jim's holding period for the additional shares includes his holding period for the automobile.

d. $7,500. Gold's basis in the automobile is $7,500 ($4,500 + $3,000). pp. C:2-22 and C:2-23.

C:2-43 a. $3,000 of ordinary income, determined as follows:

Stock (FMV) received		$17,000
Release from liability		28,000
Amount realized		$45,000
Minus: Basis of property transferred		
Machinery	$15,000	
Money	10,000	(25,000)
Realized gain		$20,000
Liability assumed		$28,000
Minus: Basis of all property transferred		(25,000)
Recognized gain (Sec. 357(c))		$ 3,000

The gain is treated as ordinary income under Sec. 1245 recapture rules.

b. Zero basis:

Property transferred	$25,000
Minus: Boot received (including liability)	(28,000)
Plus: Gain recognized	3,000
Basis in Moore stock	$ -0-

c. $18,000 basis:

Barbara's basis in the machine	$15,000
Plus: Barbara's recognized gain	3,000
Moore corporation's total basis in machinery	$18,000

d. Sam recognizes no gain or loss.

e. $17,000 basis, the amount of money he contributed to Moore for the stock.

f. Barbara's stock has a split holding period because she received the stock in exchange for Sec. 1231 property and cash, which is neither a capital asset nor Sec. 1231 property. Sam's holding period starts on the day after the exchange date.

g. Sec. 351 would not apply, so the answers would change as follows:

- a. $20,000 ordinary income. Barbara would recognize $20,000 of ordinary income recaptured under Sec. 1245.
- b. $17,000 basis. Barbara's basis in the stock would be $17,000, its FMV.
- c. $35,000 basis. Moore's basis in the machinery would be $35,000, its FMV.
- d. $17,000 ordinary income. Sam would recognize $17,000 of ordinary income from compensation.

e. $17,000 basis. Sam's basis in the Moore stock would be $17,000, its FMV.

f. Both Barbara's and Sam's holding period for their stock would start on the day after the exchange date because the transaction did not qualify under Sec. 351, thereby making Sec. 1223(1) inapplicable.

pp. C:2-23 and C:2-24.

C:2-44 a. $3,000 gain recognized. Jerry realizes an $18,000 [($15,000 + $35,000) - $32,000] gain and recognizes a $3,000 ($35,000 - $32,000) gain because the liabilities exceed the property's basis (Sec. 357(c)).

b. Zero basis. Jerry's basis in his Emerald stock is zero ($32,000 + $3,000 - $35,000).

c. $35,000 basis. Emerald's basis in the property is $35,000 ($32,000 + $3,000).

d. a. No gain or loss. Jerry recognizes no gain or loss because the liabilities are not considered boot and do not exceed the basis of property contributed.

b. $17,000 basis. Jerry's basis in his Emerald stock is $17,000 ($32,000 - $15,000).

c. $32,000 basis. Emerald's basis in the property is $32,000.

pp. C:2-22 through C:2-25.

C:2-45 a. No gain or loss recognized. Ted realizes a $70,000 ([$60,000 + $35,000 + $15,000] - [$5,000 + $35,000]) gain, but Ted recognizes no gain or loss. Section 357(c)(3) precludes Ted from recognizing a gain because of his "excess" liability situation (i.e., liabilities that total $50,000 exceeding the $40,000 total bases of the assets).

b. $25,000 basis. Ted's basis in the stock received is $25,000 ($40,000 - $15,000). No reduction in basis is required for liabilities assumed by the transferee corporation under Sec. 357(c)(3) or under Sec. 358(d)(2).

c. $40,000 basis. The corporation's basis in the assets is the same $40,000 basis that Ted had ($5,000 in the cash, zero in the accounts receivable, and $35,000 in the equipment).

d. The corporation. The corporation must recognize the income from the receivables when it collects on them. The corporation also can deduct the current liabilities when it pays them (Rev. Rul. 80-198, 1980-2 C.B. 13). pp. C:2-24 and C:2-25.

C:2-46 a. $10,000 of ordinary income. Mary realizes a $50,000 ($110,000 - $60,000) gain but recognizes a $10,000 gain (amount of boot received). The gain is treated as ordinary income under the Sec. 1245 recapture rules.

b. $60,000 basis. Mary's basis in the Green common stock is $60,000 ($60,000 + $10,000 - $10,000). Her holding period for the stock is deemed to begin three years ago when she purchased the machine. Mary's basis in the nonqualified preferred stock (boot) is $10,000, its FMV. Her holding period for the NQPS begins on the day after the exchange date.

c. Green recognizes no gain or loss.

d. $70,000 basis. Green's basis in the machine is $70,000 ($60,000 basis to Mary + $10,000 gain recognized by Mary). Green's holding period is deemed to begin three years ago when Mary purchased the machine. pp. C:2-17 through C:2-21, C:2-25, and C:2-26.

C:2-47 a. Since this transfer occurred after December 22, 2017, Ace Corporation recognizes $500,000 of ordinary income because the City of Omaha is a governmental entity.

b. Ace Corporation takes a $500,000 basis in the land.

c. Ace reports $600,000 of ordinary income. When it purchases the equipment, Ace takes a $250,000 basis in the equipment, its cost.

d. Alternative facts:

a. Because the nonshareholder contributor is not a customer, potential customer, governmental entity or civic organization, Ace Corporation recognizes no income.

b. Ace Corporation takes a zero basis in the land.

c. Ace recognizes no income when it receives the cash. The basis of the equipment purchased with the $100,000 contribution is its $250,000 purchase price minus the $100,000 of contributed cash, or $150,000. pp. C:2-31 and C:2-32.

C:2-48 a. Kobe recognizes a $70,000 dividend, which is taxed at the applicable capital gains tax rate, and Bryant Corporation reports taxable income of $110,000. Bryant may not deduct the dividend paid to Kobe.

b. Kobe recognizes interest income of $10,000, which is taxed at his ordinary tax rate. The principal repayment is not taxable to Kobe. Bryant reports taxable income of $100,000 because it gets a $10,000 deduction for the interest paid to Kobe. pp. C:2-27 through C:2-30.
Note: The text erroneously states interest at $20,000. It should have been stated as $10,000 in the text.

C:2-49 a. $100,000 ($75,000 + $25,000) capital loss to each shareholder. The $75,000 loss with respect to the stock investments is capital in character for both Tom and Vicki because they did not purchase the stock from the corporation. Because the $25,000 debts are secured by bonds, the worthless security rules of Sec. 165(g)(1) apply and their losses will be capital in character.

b. STCL to Vicki; ordinary loss to Tom. If the liability were not secured by bonds, Vicki's loan would be related solely to her stock investment and should be treated as a nonbusiness bad debt that is deductible as a short-term capital loss (up to $3,000 a year after netting capital losses against capital gains). An argument can be made that Tom's loss would relate to an attempt to maintain his employment with Guest Corporation and, therefore, has a substantial business purpose. Such a loss would be deductible as an ordinary loss if the dominant motive for making the loan were related to his employment activities.

c. Limited ordinary loss on stock; capital loss on bonds. The loss with respect to the stock investment would be ordinary in character under Sec. 1244 for both Tom and Vicki up to the $100,000 annual limit for the couple because they purchased the stock directly from Guest. The $50,000 loss exceeding the $100,000 Sec. 1244 limit would be capital in character. The worthless security rules of Sec. 165(g)(1) still would apply to the $25,000 losses on the bond investments. These losses would be capital in character. pp. C:2-32 through C:2-34.

C:2-50 Harry: Ordinary loss of $50,000 under Sec. 1244 and LTCL of $75,000.
Susan: LTCL of $175,000.
Big Corporation: $125,000 LTCL. pp. C:2-32 through C:2-34.

C:2-51 a. $50,000 ordinary loss and $2,000 LTCL. Lois's loss is $52,000 ($28,000 - $80,000 basis), of which $50,000 (the limit for a single taxpayer) is ordinary under Sec. 1244. The remaining $2,000 is a long-term capital loss.

b. $42,000 ordinary loss and $10,000 LTCL. Lois's loss still would be $52,000 ($28,000 - $80,000 basis). However, for purposes of computing the Sec. 1244 loss, Lois's basis in the stock would be $70,000. Therefore, the ordinary loss under Sec. 1244 would be $42,000 ($28,000 - $70,000). The remaining $10,000 would be a long-term capital loss. pp. C:2-32 and C:2-33.

C:2-52 $52,000 LTCL. The entire loss is capital in character because Sue was not the original owner of the stock; therefore, the stock is no longer Sec. 1244 stock. pp. C:2-32 and C:2-33.

C:2-53 a. Donna recognizes no gain when she transfers the land to Development Corporation. Development's basis in the land will be $150,000. All gain on the subsequent sale will be ordinary income to Development. This alternative results in the pre-contribution gain that accrued prior to Donna's transfer and the post-contribution profit earned from subdividing the land being taxed at a 21% tax rate.

b. Donna could transfer the land to Development in exchange for stock and $330,000 of debt instruments. In this case, Donna would recognize $330,000 of long-term capital gain and Development's basis in the land would be $480,000. The $330,000 of pre-contribution capital gain (net of any capital losses that Donna has recognized) is taxed at the applicable capital gains tax rate (in this case, 23.8%, including the 3.8% net investment tax). The step-up in basis permits Development to use the additional basis to offset income earned from subdividing the land that otherwise would be taxed at a 21% tax rate. Author's Note: The basic scenario apparently would permit Donna's gain to be reported using the installment method. However, sale of the land by a related person (a corporation controlled by Donna) within two years of the transfer date precludes deferral of the installment gain (Sec. 453(e)). pp. C:2-34 through C:2-36.

Comprehensive Problems

C:2-54 a. Yes. The transaction meets the requirements of Sec. 351. Transferors of property (Alice, Bob, and Carla) own 88.2% (750/850 = 0.882) of the Bear stock.

b. Alice recognizes a $10,000 gain, the amount by which the $60,000 mortgage assumed by Bear Corporation exceeds the $50,000 basis ($12,000 + $38,000) of all the assets transferred by Alice. The character is Sec. 1231 gain, of which some would be Sec. 1250 gain because of depreciation claimed on the building. Bob recognizes $10,000 of gain (the lesser of his realized gain of $15,000 or the boot received of $10,000). The gain is treated as ordinary income recaptured under Sec. 1245. Carla recognizes no gain or loss even though she received cash because she realized a $5,000 loss. Dick recognizes $10,000 of ordinary income as compensation for his services. Bear recognizes no gain or loss on issuing its stock or the note.

c. Alice's basis in her stock is zero ($12,000 + $38,000 - $60,000 liabilities + $10,000 gain). Her holding period for the stock includes her holding period for the land and building. Bob's stock basis is $25,000 ($25,000 + $10,000 gain - $10,000 boot). His holding period for his stock includes his holding period for the equipment. Carla's basis for her stock is $10,000 ($15,000 - $5,000 boot). Her holding period for the stock includes her holding period for the van. Dick's basis in his stock is $10,000. His holding period begins on the day after the exchange date.

d. Bear's basis in the assets received is: land $15,000 [$12,000 + (0.30 x $10,000)] and building $45,000 [$38,000 + (0.70 x $10,000)]. (The gain is allocated between the land and building according to the two assets' relative FMVs as prescribed by the Sec. 357 Treasury Regulations.) The holding period for the land and building includes the time Alice held these properties.

Equipment basis is $35,000 ($25,000 + $10,000). Holding period includes the time that Bob owned the properties. The van's basis is $10,000, limited to its FMV, and the van's holding period includes the time Carla held it (Reg. Sec. 1.362-4(c)(3)(i)). If Bear and Carla elect, Bear can take a $15,000 basis in the van, but Carla's basis in her stock would be limited to $5,000, its FMV. The accounting services are deductible by Bear if incurred after operations have begun. If the expenses are pre-operating expenses, they should be amortizable under Sec. 248.

C:2-55

Transferor shareholders	**----Ed----**	**--------------Fay--------------**	
	For Property	**For Inventory**	**For Land**
FMV common stock received	$40,000	$22,000	$ 11,000
FMV qualified preferred stock received	9,000		
FMV nonqualified preferred stock received	6,000		
Cash received	-0-	16,000	8,000
Liability assumed	-0-	2,000	1,000
Total amount realized	$55,000	$40,000	$ 20,000
Adjusted basis of property transferred	(36,000)	(14,000)	(50,000)
Gain (loss) realized	$19,000	$26,000	$(30,000)
Gain (loss) recognized	$ 6,000	$16,000	$ -0-

Ed's $6,000 gain recognized is ordinary income because of depreciation recapture, and Fay's $16,000 gain recognized is ordinary income because she transferred inventory.

Basis of nonqualified preferred stock:

Ed's basis in the nonqualified preferred stock received is its $6,000 FMV. The holding period of the stock begins the day after the exchange.

Basis of qualified stock:	**Ed**	**Fay**
Basis of property transferred	$36,000	$64,000
Plus: Gain recognized	6,000	16,000
Minus: Boot received:		
Nonqualified preferred stock	(6,000)	
Cash	-0-	(24,000)
Liability assumed	-0-	(3,000)
Total basis of qualified stock	$36,000	$53,000

Check:

FMV qualified stock received	$49,000	$33,000
Minus: Gain deferred	(13,000)	(10,000)
Plus: Loss deferred	-0-	30,000
Total basis of qualified stock	$36,000	$53,000

Allocation of Ed's qualified stock basis (by relative FMV):

Common stock: $40,000/$49,000 x $36,000 = $29,388
Qualified preferred stock: $9,000/$49,000 x $36,000 = $6,612
The basis of each class of qualified stock includes Ed's holding period for the equipment transferred.

Fay's stock:

Each share has a split holding period, with two-thirds considered beginning the day after the exchange, and one-third including Fay's holding period for the land. See Rev. Rul. 85-164, 1985-2 C.B. 117.

Corporation

No gain (loss) recognized

Basis of property received:	**Equipment**	**Inventory**	**Land**
Transferred (carryover) basis	$36,000	$14,000	$50,000
Gain recognized by shareholder	6,000	16,000	-0-
Basis reduction under §362(e)(2)	-0-	-0-	(20,000)*
Total	$42,000	$30,000	$30,000

Holding period: Includes the transferor's holding period for each property.

*Total FMV of property transferred by Fay ($40,000 + $20,000)	$ 60,000
Total adjusted basis of property transferred by Fay ($14,000 + $16,000 + $50,000)**	(80,000)
Reduction under §362(e)(2) [all to loss property, the land]	$(20,000)

**Under Reg. §1.362-4(g)(2)(ii), the transferee corporation's basis for this calculation takes into account all applicable provisions of the tax law and, therefore, includes any gain recognized by the shareholder. Also see Reg. §1.362-4(h) Ex. (6). Thus, the inventory basis for this purpose is $30,000 ($14,000 + $16,000). If the corporation and Fay make a §362(e)(2)(C) election, Fay reduces her stock basis by $20,000 to $33,000, and the corporation takes a $50,000 carryover basis in the land. See Reg. §1.362-4(d)(2).

Tax Strategy and Critical Thinking Problems

C:2-56 a. The circumstances vary for the shareholders, who may or may not be pleased with this result. They have avoided the requirements of Sec. 351, which allows Eric to recognize a $150,000 capital loss. Although Florence has to recognize $25,000 of ordinary income, Wildcat can depreciate the machinery's FMV of $25,000. If Eric can use the $150,000 loss to offset capital gains from other sources, he may be happy with this result. If Florence is in a low tax bracket, she might not mind that she has to recognize $25,000 of ordinary income. However, if Eric has no capital gains and cannot use the $150,000 capital loss, avoiding Sec. 351 may not be a desirable result. This is especially true if Wildcat plans to subdivide the land and sell it, thereby generating ordinary income in the near future. If Sec. 351 applied, Wildcat's basis in the land would be limited under the Sec. 362(e)(2) reduction rules to $50,000, its FMV. However, Eric and Wildcat Corporation could make an election under Sec. 362(e)(2)(C) so that the land would have a $200,000 carryover basis to Wildcat and, therefore, much less income for Wildcat to report in future years. In such case, Eric's basis would be limited to his stock's FMV of $50,000 rather than the $200,000 basis in the property contributed. If he is not planning to sell his stock anytime soon, this reduction might not matter. Also Florence could avoid recognizing $25,000 of ordinary income on the machinery. On the other hand, the machinery would have a zero basis to Wildcat, and therefore Wildcat would not be allowed any depreciation on the machinery. As far as George is concerned, it makes no difference to him whether Sec. 351 applies or not. The result to him is the same either way.

b. If the shareholders decide that meeting the Sec. 351 requirements would produce a greater tax benefit, they can proceed in several ways. For example:

1. The corporation could give George 150 shares of stock worth $15,000 and $10,000 of bonds. In such case Eric and Florence would own more than 80% (750/900 = 0.83) of the stock.
2. Florence and Eric each could contribute an additional $15,000 for 150 shares of stock. In such case, Eric and Florence would own more than 80% (1,050/1,300 = 0.808) of the stock.
3. George could contribute $2,500 of cash in addition to his services for 25 more shares. Thus, he would be a property contributor allowing <u>all</u> his shares to count in the 80% test. In such case, Eric, Florence, and George would own 100% of the stock.

C:2-57 a. Advantages of Alternative a:

1. Simplicity. Each person gets stock equal to her contribution to capital and will share in any appreciation in value in proportion to her contribution.
2. Paula recognizes no gain on the transaction because she received no boot.
3. The stock will be Sec. 1244 stock so, if Paula or Mary sells the stock at a loss or the business becomes bankrupt, at least some of the loss will be an ordinary loss.
4. The corporation, with the shareholders' consent, can elect S corporation status for the first two years, so the losses flow through to the shareholders to offset income from other sources. Later, the corporation, with the shareholders' consent, can revoke the S corporation election to become a regular C corporation.

Disadvantages of Alternative a:

1. All distributions to Paula and Mary (above reasonable salaries) will be taxed as dividends to the shareholders and are not deductible by the corporation, although the dividends are subject to preferential tax rates.
2. Mary may want additional assurance that she will have preference in getting her investment back before the corporation pays any dividends. Since Paula has a majority ownership, she can decide when and if the corporation pays any dividends.
3. Paula may not want to share ownership with Mary. She might prefer that Mary's investment be treated as a loan so that all future appreciation accrues to her (Paula).

b. Advantages of Alternative b:

1. Paula recognizes no gain on the transaction.
2. Mary is assured of a return of her investment on whatever terms are specified in the debt instrument, plus interest income at the stated market rate for ten years (provided the corporation does not go bankrupt).
3. Even if the corporation becomes bankrupt, Mary will have first call on any assets before Paula since Mary is a creditor.
4. Paula owns all the stock and benefits from the company's appreciation in value.
5. Paula's stock is Sec. 1244 stock.
6. The corporation, with Paula's consent, can elect S corporation status for the first two years, which allows Paula to use losses to offset income from other sources.
7. The corporation gets a deduction for the interest paid to Mary, subject to limitations.
8. Mary's income is limited to the note interest. She is not taxed on the return of her principal.

Disadvantages of Alternative b:

1. Mary may want to participate in the anticipated growth of the company. She might prefer some stock in addition to some notes.
2. All distributions to Paula (above salary) are taxed as dividends and are not deductible by the corporation, although the dividends are subject to a preferential tax rate.
3. In the event of bankruptcy, Mary's loss is capital in character.

c. Advantages of Alternative c:

1. Both Paula and Mary share in any stock appreciation.
2. The interest paid to Paula and Mary is deductible by the corporation, subject to limitations. Their income does not include any principal payments.
3. The stock is Sec. 1244 stock, so Mary and Paula each would have an ordinary loss for at least part of their investment.
4. The corporation, with the shareholders' consent, can elect S corporation status and pass through losses during the first two years. Later, the corporation, with the shareholders' consent, can revoke the S corporation election.

Disadvantages of Alternative c:
1. For Paula, receipt of the note would be considered the receipt of boot, and she would have to recognize gain to the extent of $100,000 FMV of the note received, possibly over the ten-year period under the installment method.
2. Paula might not want to share ownership with Mary.
3. Mary might prefer a more secure return of her investment as in Alternative b even if she cannot participate in future growth of the corporation.
4. The IRS might try to reclassify the debt as equity, thereby changing its tax characteristics and possibly jeopardizing the S corporation election, if one has been made.

d. Advantages of Alternative d:
1. Paula recognizes no gain on the exchange.
2. All stock is Sec. 1244 stock.
3. Paula owns all the common stock and is entitled to the company's appreciation in value. If she is willing to share some of this appreciation, the preferred stock could be made participating preferred stock.

Disadvantages of Alternative d:
1. Mary has no assured return because the corporation might not pay dividends. However, she is more assured of payment than with common stock since the stock is cumulative.
2. Mary does not participate in the growth of the corporation. However, if they agree, the preferred stock can be participating.
3. The corporation cannot elect S corporation status because it has issued more than one class of stock.
4. All distributions to Paula and Mary (above any salaries) are taxable to them as dividends and not deductible by the corporation, although the dividends are subject to a preferential tax rate.

In general, no one plan is ideal. Paula and Mary must take into consideration the following factors:
1. How much of the future appreciation in growth is Paula willing to share with Mary?
2. How much assurance does Mary want that she will have first claim on assets to repay her investment? How willing is she to be a minority shareholder or would she rather be a creditor?
3. How large a risk exists that the corporation will go bankrupt so that Paula and Mary want their ownership stakes to be Sec. 1244 stock?
4. How willing is Paula to recognize gain on the corporate formation?

C:2-58 a. A pass-through entity. In light of the nursery's projected losses over the next two years, Paula and Mary might consider organizing the business as an S corporation, a general partnership, a limited partnership, or a limited liability company. With respect to all these forms, losses generated at the entity level would pass through to Paula's and Mary's separate returns. As a result, Paula and Mary could use a pro rata share of the entity's loss to offset income they earn over the next two years. In the case of a C corporation, losses generated at the entity level would carry over to offset the corporation's income in other years. Paula and Mary could not use C corporation losses to offset income they earn individually over the next two years. In either case, any NOL carryover to a post-2020 year would be subject to the 80% of taxable income limitation in the carryover years. Regarding the pass-through entity, this form would have the added advantage of providing the owners a qualified business income deduction should the entity become profitable in the future.

b. As a type of partnership. To achieve their various business and investment objectives, and in light of their proposed use of debt and equity, Paula and Mary might structure the partnership as either a limited partnership or as a general partnership that makes a special allocation. A limited partnership would give either investor the opportunity to trade her general partnership right to manage the business (analogous to common stock ownership) for a limited partnership right to a fixed rate of return (analogous to preferred stock ownership). A limited partnership also would give either investor the opportunity to become a general creditor of the partnership (analogous to a corporate bondholder).

In the case of a general partnership, so long as the special allocation has substantial economic effect (see Chapter C:9) this business form would give either investor the opportunity to trade her general partnership right to residual profits (analogous to common stock ownership) for a more limited right to a fixed rate of return (analogous to preferred stock ownership). It also would give either investor the opportunity to become a general creditor of the partnership (analogous to a corporate bondholder).

Although the general partner in either partnership form would have unlimited liability, a limited liability company taxed by default as a general partnership would afford all its members limited liability.

Case Study Problems

C:2-59 Listed below are the major points that should be covered in the memorandum to Bob. The student should incorporate those points into a properly structured memorandum using good form with proper grammar and punctuation.

In the client memorandum, before discussing the tax advantages and disadvantages of incorporating, the student might discuss the nontax advantages of incorporating (e.g., limited liability, ease of transferring ownership interest, etc.).

With the popularity of limited liability companies (LLCs), some consideration should be given to this business form. All states have adopted LLC legislation. Because most of Bob's business will be done within a single state, interstate activities and the lack of a common body of LLC rules among states will not be an issue.

The adoption of the final check-the-box regulations means that C corporation tax treatment is not limited to incorporated entities. Some discussion of the tax implications of the check-the-box regulations for an existing entity (a proprietorship) should be mentioned in the memorandum.

<u>Incorporation</u>

1. A corporate formation in which Bob receives only stock is nontaxable. Bob will recognize no gain or loss on the asset transfer. The transfer of property by either of the new investors should be properly timed since nontaxable transfers to existing corporations are difficult to

accomplish because of the 80% control requirement. Timing is less important if the new investors are contributing cash and their contributions are to be made after Bob's contribution.

2. Bob likely will desire to continue to use the calendar year as the corporation's tax year because there appears to be little advantage of changing to a fiscal year.

3. Bob likely will desire to continue the cash method of accounting as the corporation's overall method of accounting because of its simplicity, assuming the small business exception under Sec. 448 applies if he operates the business as a C corporation.

4. Bob will continue to use the same depreciation method and convention once he transfers the building and equipment to the corporation. The depreciation recapture potential carries over from the proprietorship to the corporation. Depreciation for the year of transfer should be divided between Bob and the corporation.

5. The income from collecting the accounts receivable and accounts payable items that represent deductible expenses are reported by the corporation. The income is recognized when the corporation collects the receivables. The expenses are deducted when the corporation pays the liability.

6. Consideration should be given to an S corporation election. A C corporation may trigger double taxation if the earnings are distributed as a dividend, although the dividends will be taxed at the applicable capital gains rate. The S corporation election will permit all the earnings to be taxed at the individual tax rates and avoid the possibility of double taxation. The qualified business income deduction also may apply.

7. By retaining C corporation status, Bob would be permitted to exclude 100% of the gain recognized on the sale or exchange of qualified small business corporation stock that has been held for more than five years. Even if the stock were held less than five years, but more than one year, Bob's gain would be taxed at the applicable capital gains rate. This advantage is not available to an S corporation whose shareholders instead increase the basis of their stock by the amount of any earnings retained in the business.

8. The salary paid to Bob should be reviewed to make sure it is reasonable. The employment taxes paid on the salary are about the same as the self-employment tax liability incurred with the sole proprietorship.

9. Consideration should be given to the availability of fringe benefits for Bob from either the C or S corporation business form. In general, the treatment of these fringe benefits—accident and health benefit premiums, etc.—are treated like guaranteed payments or salary for partners and 2%-or-more-shareholders of an S corporation. (See Chapter C:11.)

10. Consideration should be given to a retirement plan for Bob. He can make deductible contributions to an IRA, or perhaps establish a qualified plan if he makes the S corporation election.

Capital Structure

1. The simplest capital structure is to have solely common stock issued to Bob and/or either of the other individuals who are interested in investing in the business. Common stock may be attractive to the individual who desires to be active in the business. Bob may prefer to issue preferred stock or debt to the individual who is interested only in investing in the business. The preferred stock could provide a guaranteed dividend payment for the investor. Preferred stock, however, may prevent an S corporation election.

2. The preferred or common stock should qualify for Sec. 1244 treatment. Section 1244 permits an ordinary loss to be claimed on the sale, exchange, or worthlessness of the stock.

3. The use of debt will permit the payment of a deductible interest payment to the debt holder, subject to limitations. The receipt of debt as part of the incorporation transaction will trigger the recognition of part or all of the transferor's realized gain.

4. The use of debt will permit the repayment to be partially or totally nontaxable. Unlike stock, which need not be retired, debt usually is retired at a designated maturity date.

5. Bob should consider whether he should transfer the building and equipment to the corporation as part of the incorporation transaction. Some tax advantages may exist with Bob retaining title to the property and leasing it to the corporation. Keeping the property outside the business and leasing it to the corporation also prevents the possible taking of the property by the corporation's creditors if financial difficulties arise.

Although the above discussion has been couched in terms of using a corporation or an LLC primarily to obtain tax advantages, one probably also should explain that LLCs and partnerships can be taxed as a C corporation under the check-the-box regulations. This change will provide greater flexibility for selecting the business entity form.

Depending on the length of the assignment, the student might compare the partnership, corporation, and LLC forms of doing business because it is not entirely obvious from the facts that the corporate form is superior to the partnership form.

C:2-60 Among the information that the transferor must provide the IRS are statements about the property transferred and its adjusted basis to the transferor. In addition, a statement about the liabilities transferred to the corporation including the nature of the liabilities, when and why they were created, and the corporate business reason for the transfer must be attached to the transferor's return for the year of the transfer (see Reg. Sec. 1.351-3(a). Similar information must be attached to the transferee corporation's tax return for the year of transfer (see Reg. Sec. 1.351-3(b).

From the facts of the problem, the funds obtained from placing the mortgage on the building and land apparently has been used for personal purposes. Withdrawals from a sole proprietorship, however, are not a taxable event for Eric Wright. The transfer of the mortgage to the corporation, however, may be a taxable event if the IRS can prove that the acquisition or assumption of the liability by the corporation had a tax avoidance motive or lacked the necessary business purpose. In such a situation, all the liabilities assumed and acquired by the corporation would be boot property. On the other hand, a factor in favor of the taxpayer not being subject to Sec. 357(b) is that one year has passed between the time the mortgage was taken out and the time it was transferred to the corporation.

The tax practitioner should thoroughly research the issue before reaching a conclusion. Should he or she find Sec. 357(b) is applicable, he or she should not agree to the client's position since the AICPA's Statements on Standards for Tax Services (SSTS) No. 1, Tax Return Positions, Para. 5a (reproduced in Appendix E) holds that a CPA should not recommend to a client that a position be taken with respect to the tax treatment of any item on a return unless the CPA has a good faith belief that the position has a realistic possibility of being sustained administratively or judicially on its merits if challenged. Eric's situation may lie in a gray area but, if sufficient authority exists for saying the necessary business purpose is present, the CPA may prepare Eric's return and not report any gain under Sec. 357(b). If the position does not have a reasonable basis, SSTS No. 1, Paragraph 5b, also would prevent the CPA from signing either Eric's personal return or the corporate return unless the liability is appropriately disclosed on the two returns. Thus, even if the position is disclosed, the CPA may not sign the return if the position does not have a reasonable basis.

Tax Research Problems

C:2-61 The memorandum should explain why the transaction meets the requirements of Sec. 351. Under Reg. Sec. 1.351-1(a)(3), stock underwriters may be disregarded for purposes of Sec. 351 if the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory. If a person acquires stock from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires the stock is treated as transferring cash directly to the corporation in exchange for the stock and the underwriter is disregarded.

C:2-62 The memorandum should point out that the transfers of property to a controlled corporation are nontaxable only if the transferors control the transferee corporation immediately after the exchange (Sec. 351(a)). Section 368(c) defines control in terms of two 80% tests. Regulation Sec. 1.351-1(a) outlines some of the requirements of the control test but does not directly address the question of a prearranged binding agreement whereby one transferor sells one-half of his stock to someone who is not a transferor. Example (1) of Reg. Sec. 1.351-1(b) permits a transfer to qualify under Sec. 351 where transferee corporation stock is transferred by gift from a controlling transferor to his son, who also is a transferor, immediately after the exchange. Regulation Sec. 1.351-1(a)(1)(ii) permits a shareholder to be ignored as a transferor when the amount of stock issued directly for property is of relatively small value in comparison to the value of the stock already owned or to be received by the person who transferred the property.

Under Rev. Rul. 79-194, 1979-1 C.B. 145, the control requirement of Sec. 351(a) is to be determined after any sales or transfers occur. In Situation 1 of this ruling, the control requirement is satisfied when part of the 80% stock interest in a newly created corporation that was acquired by a transferor corporation was sold to a group of investors who had acquired the other 20% stock interest in the original transaction. In this situation, the shift in ownership occurred among individuals who were transferors, and the recipients owned a substantial amount of the corporation's stock.

In a second situation, described in Rev. Rul. 79-194, the control requirement was not met upon completion of a sale under a similar agreement, whereby a transferor who originally had acquired 99% of the stock sold one-half the stock of the new corporation to a second transferor who had originally acquired only 1% of the stock. The IRS held that the control requirement was not met because the 1% shareholder received stock of small value in the original transfer relative to the amount received in total and, therefore, was not considered to be a transferor.

In the current case, it must be determined whether Bob has received a substantial part of the Stone Corporation stock or not. Revenue Procedure 77-37, 1977-2 C.B. 568, Sec. 3.07, indicates that ownership of 10% of the stock to be owned is not "of small value" and therefore should be considered a substantial part of the stock. Under this authority, the control requirement should be met and the transaction should be permitted to qualify under Sec. 351.

C:2-63 The memorandum should explain that, as long as the additional 25 shares to be received by Greta do not have any other rights attaching to them, they are considered to be stock for purposes of Sec. 351. Thus, Greta will not have to recognize any income when she receives her contingent shares.

Revenue Ruling 57-586, 1957-2 C.B. 249, addressed negotiable certificates issued to a shareholder in connection with a nontaxable reorganization representing a contingent interest in additional shares of the acquiring corporation's stock that would be issued along with cash dividends if certain occurrences took place. The ruling held that the certificates were "other" property and fell under the boot rules.

Two later court cases and several revenue rulings have changed this position substantially. First, in June M. Carlberg v. U.S., 6 AFTR 2d 5316, 60-2 USTC ¶9647 (8th Cir., 1960), the Eighth Circuit Court of Appeals held that certificates of contingent interest issued to the taxpayer-stockholder in a corporate reorganization permitting her to obtain reserved shares, which were not to be issued pending the determination of liabilities of one of the merging corporations, were stock rather than other property.

In James C. Hamrick, 43 T.C. 21 (1964), the Tax Court held that a taxpayer's contractual right to receive additional stock, contingent upon the earnings of the corporation exceeding a specified amount, is the equivalent of stock within the meaning of Sec. 351. The receipt of additional shares in later years pursuant to the original incorporation agreement was held not to result in the recognition of gain by the transferor.

The IRS held in Rev. Rul. 66-112, 1966-2 C.B. 68, that, because the contingent contractual rights were not specifically marketable and could give rise only to the receipt of additional stock by a transferor, both the stock and the control tests of Sec. 351 were satisfied. The IRS has acquiesced to the Hamrick decision (1966-2 C.B. 2). Revenue Ruling 66-112 also distinguished the facts at hand from those in Rev. Rul. 57-586.

Revenue Ruling 67-90, 1967-1 C.B. 79, provides that a contingent contractual right to receive only additional voting stock provided for in a plan of reorganization satisfies the "solely for voting stock" requirement for a Type B reorganization where the number of additional shares of stock to be issued is determined by a formula based upon the future market price of the shares of the acquiring corporation.

Revenue Procedure 77-37, 1977-2 C.B. 568, places certain restrictions on contingent stock that will be issued as part of a reorganization when a taxpayer is requesting a private letter ruling on the transaction. These restrictions do not apply to a Sec. 351 transaction. Revenue Procedure 83-59, 1983-2 C.B. 575, as modified by subsequent "no rule" area revenue procedures, requires a representation be made about contingent shares that are to be issued as part of a request for a private letter ruling on a Sec. 351 transaction, but it does not place any limit on the portion of the stock that can be considered to be contingent.

C:2-64 Yes. John can avoid recognizing the $175,000 gain according to Ninth Circuit and Second Circuit holdings. In Peracchi v. CIR, 81 AFTR 2d 98-1754, 98-1 USTC ¶50, 150 (9th Cir., 1998), the Ninth Circuit reversed the decision of the Tax Court and held that an unsecured promissory note contributed to a corporation by its sole shareholder had a basis equal to its face amount. A similar result was reached in Lessinger v. CIR, 63 AFTR 2d 89-1055, 89-1 USTC ¶9254 (2nd Cir., 1989).

Therefore, if John contributes a $175,000 promissory note to Newco in addition to the assets, the basis of assets contributed includes the face value of the note and is $475,000 ($250,000 + $175,000). Because the liabilities do not exceed the basis of assets contributed, John recognizes no gain.

C:2-65 The client letter should address two questions. First, if Leticia, Monica, and Nathaniel advance funds to Lemona Corporation, will the advance be recharacterized as equity instead of debt? Second, will the unavailability of alternative financing at "reasonable rates" be significant in any decision to recharacterize?

If the IRS and/or the courts recharacterize the advance as equity, the IRS and/or the courts would treat any "interest" paid to the three investors as "dividends," nondeductible by Lemona. Furthermore, the IRS and/or the courts might treat the advance as nonbusiness related, i.e., as intended to safeguard the investors' initial equity investment. In the latter event, if Lemona later became insolvent, and the three investors were unable to recoup the full amount of the advance, their loss would be treated as nonbusiness bad debt. Because the loss would be capital in character, it would be deductible only to the extent of $3,000 (per year) in excess of any capital gains. No relief for partial losses would be afforded the investors.

The key statutory authority that governs the characterization of an investor advance to a corporation is Sec. 385. Under Sec. 385, the Treasury Secretary is authorized to issue regulations for determining whether an interest in a corporation should be treated as equity or indebtedness. Factors to be considered in the determination include,

- Whether there is a written, unconditional promise to pay a sum certain in money
- Whether the interest is subordinate to any corporate indebtedness
- The corporation's debt to equity ratio
- Convertibility of the interest into corporate stock
- The relationship between stockholdings and the interest in question

Based on Factors 2, 3, and 5, the three investors' interest in Lemona resembles equity more than debt. The interest is subordinate to other Lemona obligations; the corporation's debt to equity ratio is extraordinarily high (25:1 before the note issuance); and the relationship between the interest in question and the investors' pre-existing stockholdings is proportionate.

On the other hand, based on Factors 1 and 4, the three investors' interest resembles debt more than equity. The interest is evidenced by a note (i.e., a written, unconditional promise to pay a sum certain in money), and it is not convertible into Lemona stock.

In Rudolph A. Hardman, 60AFTR 2d 87-5651, 82-7 USTC ¶9523 (9th Cir., 1987), the Ninth Circuit Court of Appeals cited 11 factors for distinguishing debt from equity for purposes of Sec. 385:

- The names given to certificates evidencing indebtedness
- The presence or absence of a maturity date
- The source of repayments
- The right to enforce payment of principal and interest
- Participation in management
- The investor's status relative to corporate creditors
- The intent of the parties
- Thin capitalization
- Identity of interest between creditor and stockholder
- Payment of interest out of "dividend" funds
- The ability of the corporation to obtain funds from outside lenders

In the client letter, and to the extent possible, the student should evaluate the three investors' corporate interest in terms of each of these factors.

In Tomlinson v. The 1661 Corporation, 19 AFTR 2d 1413, 67-1 USTC ¶9438 (5th Cir., 1967), a closely held corporation attempted to procure financing from outside lenders, but because of prohibitive interest rates, instead issued 7%, 15-year notes to its existing shareholders in exchange for cash advances of $138,400. The debt was subordinate to other corporate obligations. The corporation was not entitled to pay dividends on its stock until it had paid all past accrued interest on the notes. The corporation issued the notes on a pro rata basis and was thinly capitalized. On its tax return, the corporation deducted "interest" payments on the notes, but the IRS disputed this tax treatment. The IRS argued that based on all the facts and circumstances, the capital advanced by the shareholders was equity, not debt. Therefore, payments on the securities were dividends and nondeductible.

In the client letter, the student should draw an analogy between the facts and issues of the Tomlinson case and those of the case in question. The student also should cite factual dissimilarities that might undermine application of the Tomlinson holding to the present case. From the analysis, he or she should derive a cogent conclusion that addresses the two central issues.

"What Would You Do In This Situation?" Solution

Ch. C:2, p. C:2-31.

The IRS is likely to carefully scrutinize any issuance of debt to determine whether it should be treated as debt or equity or some combination of each.

The Treasury Department has been given the authority under Sec. 385 to write regulations to distinguish between debt and equity, and also to allow an issue to be treated partly as debt and partly as equity. Thus far, the Treasury Department has not issued final Sec. 385 regulations, except for some specific situations not germane here. As a result, taxpayers must rely on judicial decisions as an indication of how a particular issue will be treated.

Section 385 suggests factors that should be considered in determining whether an amount advanced to a corporation should be treated as debt or equity. In addition, O.H. Kruse Grain and Milling v. CIR, 5 AFTR 2d 1544, 60-2 USTC ¶9490 (9th Cir., 1960), lists additional factors the courts might consider. The Treasury Department indicated in Notice 94-47, 1994-1 C.B. 357, that it will carefully scrutinize instruments that combine tax treatment for debt with significant equity characteristics. Eight factors were listed that may be considered.

As a CPA, you should inform your client of the risk that the proposed debt issue may be challenged by the IRS and partly or totally reclassified as equity. The fact that many large corporations already have issued debt instruments with extremely long maturities is a point in your client's favor. If the corporation decides to go ahead with the issue, you would be justified in recommending the interest deductions if there exists a realistic possibility of the deductions being sustained upon examination. You also may recommend the deductions if a reasonable basis exists, and the taxpayer makes adequate disclosures. See Statement on Standards for Tax Services No. 1, Tax Return Positions in Appendix E.

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 2022 edition of this chapter:

1. The standard deduction for each filing status has increased. (See page I:2-10.)

2. The increase in standard deduction for elderly or blind when filing as single or head of household has increased to $1,750 ($1,700 in 2021) and when married filing jointly to $1,400 ($1,350 in 2021).

3. The limit for the gross income test for a qualifying relative has increased to $4,400 ($4,300 in 2021).

4. The income levels for tax rates for ordinary income, long-term capital gains, dividend income, and the kiddie tax have increased. (See Quick Reference.)

5. The deduction amounts for the kiddie tax have increased to $1,150 ($1,100 in 2021) for the statutory deduction and the greater of $1,150 ($1,100 in 2021) and earned income plus $400 ($350 in 2021).

6. The floor for filing a tax return for each filing status has increased. (See page I:2-34.)

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; Figures I:2-1, 1:2-2; 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 2022 has $10,000 of allowable itemized deductions. Since the applicable standard deduction for this taxpayer ($12,950) is greater than his itemized deductions, the taxpayer deducts $12,950 in determining his taxable income.

Filing Status	**Standard Deduction**	
	2021	**2022**
Married couple filing jointly	$25,100	$25,900
Surviving spouse	25,100	25,900
Head of household	18,800	19,400
Single (unmarried individual other than surviving spouse or head of household)	12,550	12,950
Married individual filing separately	12,550	12,950

b. Additions to the standard deduction are available for taxpayers who are 65 or older and/or blind. The 2022 additions are $1,400 for married taxpayers and $1,750 for single taxpayers.

i. EXAMPLE: A single taxpayer in 2022 who is 65 and blind would have a standard deduction of $16,450 [$12,950 + $1,750 (age) + $1,750 (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 $4,400; 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.

d. The American Rescue Plan Act revises this credit as part of additional COVID relief legislation.

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 (see Tables appendix) to the taxpayer's taxable income.

In 2022, 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. Married Filing Jointly

   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 12-30-2021 and remarry 1-2-2022. The only reason for the procedure was to improve tax filing status. The taxpayers will be treated as married for the tax year ending 12-31-2021.

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 statutory deduction is $1,150, and a dependent's standard deduction is the greater of $1,150 or the dependent's earned income plus $400.

   b. For a child under 18, unearned income in excess of $2,300 is taxed in a special way. Between the ages of 18 and 23, this "kiddie tax" only applies if the child is a full-time student and the child's earned income represents less than half of his or her total 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. Flow-through entities, such as S corporations and partnerships, may be eligible for a 20% qualified business income (QBI) deduction, depending on the nature of the business activity, to bring flow-through tax rates in line with the flat C corporation tax rate.

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 $41,675, 15% if taxable income is between $41,675 and $459,750, and 20% if taxable income is over $459,750. Different thresholds apply to other filing statuses ($83,350 and $517,200 for married filing jointly; $55,800 and $488,500 for head of household). Net short-term capital gains are taxed at ordinary income rates. 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:2-34 for the gross income filing levels.)

i. EXAMPLE: For 2022, a single taxpayer (under 65, not blind, not a dependent on another return) must file a return when gross income exceeds $12,950.

2. Due Dates and Extensions

a. Tax returns for calendar-year individual taxpayers (Form 1040) are generally 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. Starting in 2018, the IRS has discontinued Forms 1040EZ and 1040A in favor of a simplified Form 1040 and additional schedules:

i. Schedule 1 reports sources of income that are not reported on Form 1040.

ii. Schedule 2 reports AMT, various other taxes, and excess advance premium tax credit repayment. (See Chapter I:14.)

iii. Schedule 3 reports various nonrefundable tax credits and estimated tax payments.

c. Partnerships must file Form 1065 and S corporations must file Form 1120-S 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 $1,150

   Less: Greater of

   a. $1,150 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 tax as net unearned income times parents' marginal tax rate plus taxable income exceeding net unearned income times child's tax rate.

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

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2021** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing Status Check only one box.
☐ Single ☑ Married filing jointly ☐ Married filing separately (MFS) ☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)
If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

Your first name and middle initial	Last name	Your social security number
Zachary L.	Mao	123 45 6789
If joint return, spouse's first name and middle initial	Last name	Spouse's social security number
Cici K.	Mao	987 65 4321

Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.		
520 Chestnut St.			
City, town, or post office. If you have a foreign address, also complete spaces below.	State	ZIP code	
Philadelphia	PA	19106	
Foreign country name	Foreign province/state/county	Foreign postal code	

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? ☐ Yes ☑ No

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** ☐ Were born before January 2, 1957 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1957 ☐ Is blind

Dependents (see instructions): If more than four dependents, see instructions and check here ▶ ☐

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) ✔ if qualifies for (see instructions): Child tax credit	Credit for other dependents
Oliver	Mao	111 22 3333	Son	☑	☐
				☐	☐
				☐	☐
				☐	☐

Attach Sch. B if required.

Standard Deduction for—
- Single or Married filing separately, $12,550
- Married filing jointly or Qualifying widow(er), $25,100
- Head of household, $18,800
- If you checked any box under *Standard Deduction*, see instructions.

1	Wages, salaries, tips, etc. Attach Form(s) W-2			1	85,000
2a	Tax-exempt interest	2a			
b	Taxable interest			2b	200
3a	Qualified dividends	3a			
b	Ordinary dividends			3b	
4a	IRA distributions	4a			
b	Taxable amount			4b	
5a	Pensions and annuities	5a			
b	Taxable amount			5b	
6a	Social security benefits	6a			
b	Taxable amount			6b	
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			7	
8	Other income from Schedule 1, line 10			8	
9	Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income** ▶			9	85,200
10	Adjustments to income from Schedule 1, line 26			10	
11	Subtract line 10 from line 9. This is your **adjusted gross income** ▶			11	85,200
12a	**Standard deduction or itemized deductions** (from Schedule A)	12a	25,100		
b	Charitable contributions if you take the standard deduction (see instructions)	12b			
c	Add lines 12a and 12b			12c	25,100
13	Qualified business income deduction from Form 8995 or Form 8995-A			13	
14	Add lines 12c and 13			14	25,100
15	**Taxable income.** Subtract line 14 from line 11. If zero or less, enter -0-			15	60,100

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2021)

Notes to Instructor:
For 2021, many taxpayers received advance payments for a portion of their child tax credit. This problem specifies that the taxpayers did not receive any such payments. Although advance payments applied only for 2021 (and not for 2022), some instructors may want to specify its amount (e.g., $1,800), which would reduce the amount on line 28.
The American Rescue Plan Act of 2021 provided for rebate payments that typically were $1,400 for each taxpayer and each dependent. Most taxpayers received these payments directly from the government. An eligible taxpayer who did not receive a rebate payment from the government can claim it as a credit on the 2021 tax return.
This problem does not specify whether the taxpayers received a rebate payment. The solution here assumes that they received the full amount to which they were entitled, so they cannot claim a credit. If they received less than such full amount, they could claim the unreceived amount as a credit on line 30.

16	**Tax** (see instructions). Check if any from Form(s): 1 ☐ 8814 2 ☐ 4972 3 ☐	16	6,817*
17	Amount from Schedule 2, line 3	17	
18	Add lines 16 and 17	18	6,817
19	Nonrefundable child tax credit or credit for other dependents from Schedule 8812	19	
20	Amount from Schedule 3, line 8	20	
21	Add lines 19 and 20	21	
22	Subtract line 21 from line 18. If zero or less, enter -0-	22	6,817
23	Other taxes, including self-employment tax, from Schedule 2, line 21	23	
24	Add lines 22 and 23. This is your **total tax** ▶	24	6,817
25	Federal income tax withheld from:		
a	Form(s) W-2 — 25a: 5,600		
b	Form(s) 1099 — 25b		
c	Other forms (see instructions) — 25c		
d	Add lines 25a through 25c	25d	5,600
26	2021 estimated tax payments and amount applied from 2020 return	26	
27a	Earned income credit (EIC) — 27a		
	Check here if you were born after January 1, 1998, and before January 2, 2004, and you satisfy all the other requirements for taxpayers who are at least age 18, to claim the EIC. See instructions ▶ ☐		
b	Nontaxable combat pay election — 27b		
c	Prior year (2019) earned income — 27c		
28	Refundable child tax credit or additional child tax credit from Schedule 8812 — 28: 3,600		
29	American opportunity credit from Form 8863, line 8 — 29		
30	Recovery rebate credit. See instructions — 30		
31	Amount from Schedule 3, line 15 — 31		
32	Add lines 27a and 28 through 31. These are your **total other payments and refundable credits** ▶	32	3,600
33	Add lines 25d, 26, and 32. These are your **total payments** ▶	33	9,200

If you have a qualifying child, attach Sch. EIC.

Refund

34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you **overpaid**	34	2,383
35a	Amount of line 34 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐	35a	2,383
▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings		
▶ d	Account number		
36	Amount of line 34 you want **applied to your 2022 estimated tax** ▶ 36		

Direct deposit? See instructions.

Amount You Owe

37	**Amount you owe.** Subtract line 33 from line 24. For details on how to pay, see instructions ▶	37	
38	Estimated tax penalty (see instructions) ▶ 38		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS? See instructions ▶ ☐ **Yes.** Complete below. ☐ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.) ▶
		Manager	
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.) ▶
		Teacher	
Phone no.	Email address		

Joint return? See instructions. Keep a copy for your records.

Paid Preparer Use Only

Preparer's name	Preparer's signature	Date	PTIN	Check if: ☐ Self-employed
Firm's name ▶			Phone no.	
Firm's address ▶			Firm's EIN ▶	

Go to *www.irs.gov/Form1040* for instructions and the latest information. Form **1040** (2021)

*From 2021 Tax Table.

Form **1040-SR** Department of the Treasury—Internal Revenue Service (99) **U.S. Tax Return for Seniors** **2021** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing Status* Check only one box.
☑ Single ☐ Married filing jointly ☐ Married filing separately (MFS)
☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)
If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

Your first name and middle initial	Last name	Your social security number
John R.	Lane	111 44 6666
If joint return, spouse's first name and middle initial	Last name	Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	
1010 Ipsen St.		

City, town, or post office. If you have a foreign address, also complete spaces below.	State	ZIP code
Yorba Linda	CA	90102

Foreign country name	Foreign province/state/county	Foreign postal code

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☑ **You** ☐ **Spouse**

At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? ▶ ☐ Yes ☑ No

Standard Deduction
Someone can claim: ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness
You: ☑ Were born before January 2, 1957 ☐ Are blind
Spouse: ☐ Was born before January 2, 1957 ☐ Is blind

Dependents* (see instructions):
If more than four dependents, see instructions and check here ▶ ☐

(1) First name Last name	(2) Social security number	(3) Relationship to you	(4) ✔ if qualifies for (see instructions): Child tax credit	Credit for other dependents
			☐	☐
			☐	☐
			☐	☐
			☐	☐

Attach Schedule B if required.

1	Wages, salaries, tips, etc. Attach Form(s) W-2				1	50,000
2a	Tax-exempt interest	2a		b Taxable interest	2b	240
3a	Qualified dividends	3a		b Ordinary dividends	3b	
4a	IRA distributions	4a		b Taxable amount	4b	
5a	Pensions and annuities	5a	41,000	b Taxable amount	5b	41,000
6a	Social security benefits	6a		b Taxable amount	6b	
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐				7	
8	Other income from Schedule 1, line 10				8	
9	Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income** ▶				9	91,240
10	Adjustments to income from Schedule 1, line 26 ▶				10	6,000
11	Subtract line 10 from line 9. This is your **adjusted gross income** ▶				11	85,240

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 71930F Form **1040-SR** (2021)

*John does not qualify as a head of household because his cousin is not his dependent (his cousin fails the relationship test for a qualifying child, as well as the relationship test for a qualifying individual).

Standard Deduction
See Standard Deduction Chart on the last page of this form.

12a	**Standard deduction or itemized deductions** (from Schedule A)	12a	14,250*		
b	Charitable contributions if you take the standard deduction (see instructions)	12b			
c	Add lines 12a and 12b			12c	14,250
13	Qualified business income deduction from Form 8995 or Form 8995-A			13	
14	Add lines 12c and 13			14	14,250
15	**Taxable income.** Subtract line 14 from line 11. If zero or less, enter -0-			15	70,990
16	**Tax** (see instructions). Check if any from: 1 ☐ Form(s) 8814 2 ☐ Form 4972 3 ☐ ________			16	11,363**
17	Amount from Schedule 2, line 3			17	
18	Add lines 16 and 17			18	11,363
19	Nonrefundable child tax credit or credit for other dependants from Schedule 8812			19	
20	Amount from Schedule 3, line 8			20	
21	Add lines 19 and 20			21	
22	Subtract line 21 from line 18. If zero or less, enter -0-			22	11,363
23	Other taxes, including self-employment tax, from Schedule 2, line 21			23	
24	Add lines 22 and 23. This is your **total tax** ▶			24	11,363
25	Federal income tax withheld from:				
a	Form(s) W-2	25a	12,100		
b	Form(s) 1099	25b			
c	Other forms (see instructions)	25c			
d	Add lines 25a through 25c			25d	12,100
26	2021 estimated tax payments and amount applied from 2020 return			26	
27a	Earned income credit (EIC)			27a	
	Check here if you were born after January 1, 1998, and before January 2, 2004, and you satisfy all the other requirements for taxpayers who are at least age 18 to claim the EIC. See instructions ▶ ☐				
b	Nontaxable combat pay election	27b			
c	Prior year (2019) earned income	27c			
28	Refundable child tax credit or additional child tax credit from Schedule 8812	28			
29	American opportunity credit from Form 8863, line 8	29			
30	Recovery rebate credit. See instructions	30			
31	Amount from Schedule 3, line 15	31			
32	Add line 27a and 28 through 31. These are your **total other payments and refundable credits** ▶			32	
33	Add lines 25d, 26, and 32. These are your **total payments** ▶			33	12,100

If you have a qualifying child, attach Sch. EIC.

* From Standard Deduction Chart on page 4 of Form 1040-SR.

** From 2021 Tax Table.

Form 1040-SR (2021) Page 3

Refund

34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you **overpaid**	34	737
35a	Amount of line 34 you want **refunded to you.** If Form 8888 is attached, check here ☐	35a	737
▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings		
▶ d	Account number		
36	Amount of line 34 you want **applied to your 2022 estimated tax** ▶ 36		

Direct deposit? See instructions.

Amount You Owe

37	**Amount you owe.** Subtract line 33 from line 24. For details on how to pay, see instructions ▶	37	
38	Estimated tax penalty (see instructions) ▶ 38		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS? See instructions ▶ ☐ **Yes.** Complete below. ☐ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
		Retired	
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.)
Phone no.	Email address		

Paid Preparer Use Only

Preparer's name	Preparer's signature	Date	PTIN	Check if: ☐ Self-employed
Firm's name ▶			Phone no.	
Firm's address ▶			Firm's EIN ▶	

Go to *www.irs.gov/Form1040SR* for instructions and the latest information. Form **1040-SR** (2021)

Standard Deduction Chart*

Add the number of boxes checked in the "Age/Blindness" section of *Standard Deduction* on page 1 . . . . . ▶ 1

IF your filing status is. . .	AND the number of boxes checked is. . .	THEN your standard deduction is. . .
Single	1	$14,250
	2	15,950
Married filing jointly	1	$26,450
	2	27,800
	3	29,150
	4	30,500
Qualifying widow(er)	1	$26,450
	2	27,800
Head of household	1	$20,500
	2	22,200
Married filing separately**	1	$13,900
	2	15,250
	3	16,600
	4	17,950

* Don't use this chart if someone can claim you (or your spouse if filing jointly) as a dependent, your spouse itemizes on a separate return, or you were a dual-status alien. Instead, see instructions.

** You can check the boxes for your spouse if your filing status is married filing separately and your spouse had no income, isn't filing a return, and can't be claimed as a dependent on another person's return.

SCHEDULE 1 (Form 1040)

Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

▶ Attach to Form 1040, 1040-SR, or 1040-NR.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2021
Attachment Sequence No. 01

Name(s) shown on Form 1040, 1040-SR, or 1040-NR: John R. Lane

Your social security number: 111-44-6666

Part I Additional Income

1	Taxable refunds, credits, or offsets of state and local income taxes	1	
2a	Alimony received	2a	
b	Date of original divorce or separation agreement (see instructions) ▶		
3	Business income or (loss). Attach Schedule C	3	
4	Other gains or (losses). Attach Form 4797	4	
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	5	
6	Farm income or (loss). Attach Schedule F	6	
7	Unemployment compensation	7	
8	Other income:		
a	Net operating loss	8a	( )
b	Gambling income	8b	
c	Cancellation of debt	8c	
d	Foreign earned income exclusion from Form 2555	8d	( )
e	Taxable Health Savings Account distribution	8e	
f	Alaska Permanent Fund dividends	8f	
g	Jury duty pay	8g	
h	Prizes and awards	8h	
i	Activity not engaged in for profit income	8i	
j	Stock options	8j	
k	Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property	8k	
l	Olympic and Paralympic medals and USOC prize money (see instructions)	8l	
m	Section 951(a) inclusion (see instructions)	8m	
n	Section 951A(a) inclusion (see instructions)	8n	
o	Section 461(l) excess business loss adjustment	8o	
p	Taxable distributions from an ABLE account (see instructions)	8p	
z	Other income. List type and amount ▶	8z	
9	Total other income. Add lines 8a through 8z	9	
10	Combine lines 1 through 7 and 9. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8	10	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2021**

Part II Adjustments to Income

11	Educator expenses			11	
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106			12	
13	Health savings account deduction. Attach Form 8889			13	
14	Moving expenses for members of the Armed Forces. Attach Form 3903			14	
15	Deductible part of self-employment tax. Attach Schedule SE			15	
16	Self-employed SEP, SIMPLE, and qualified plans			16	
17	Self-employed health insurance deduction			17	
18	Penalty on early withdrawal of savings			18	
19a	Alimony paid			19a	
b	Recipient's SSN ▶				
c	Date of original divorce or separation agreement (see instructions) ▶				
20	IRA deduction			20	6,000
21	Student loan interest deduction			21	
22	Reserved for future use			22	
23	Archer MSA deduction			23	
24	Other adjustments:				
a	Jury duty pay (see instructions)	24a			
b	Deductible expenses related to income reported on line 8k from the rental of personal property engaged in for profit	24b			
c	Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8l	24c			
d	Reforestation amortization and expenses	24d			
e	Repayment of supplemental unemployment benefits under the Trade Act of 1974	24e			
f	Contributions to section 501(c)(18)(D) pension plans	24f			
g	Contributions by certain chaplains to section 403(b) plans	24g			
h	Attorney fees and court costs for actions involving certain unlawful discrimination claims (see instructions)	24h			
i	Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations	24i			
j	Housing deduction from Form 2555	24j			
k	Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041)	24k			
z	Other adjustments. List type and amount ▶	24z			
25	Total other adjustments. Add lines 24a through 24z			25	
26	Add lines 11 through 23 and 25. These are your **adjustments to income.** Enter here and on Form 1040 or 1040-SR, line 10, or Form 1040-NR, line 10a			26	6,000

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return **2021** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing Status Check only one box.
☑ Single ☐ Married filing jointly ☐ Married filing separately (MFS) ☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)
If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

Your first name and middle initial	Last name	Your social security number
Tracy M.	Kidwell	433 33 3333
If joint return, spouse's first name and middle initial	Last name	Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions.		Apt. no.
600 S. Maestri Place		
City, town, or post office. If you have a foreign address, also complete spaces below.	State	ZIP code
New Orleans	LA	70130
Foreign country name	Foreign province/state/county	Foreign postal code

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? ☐ Yes ☑ No

Standard Deduction **Someone can claim:** ☑ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** ☐ Were born before January 2, 1957 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1957 ☐ Is blind

Dependents (see instructions): If more than four dependents, see instructions and check here ▶ ☐

(1) First name Last name	(2) Social security number	(3) Relationship to you	(4) ✔ if qualifies for (see instructions): Child tax credit	Credit for other dependents
			☐	☐
			☐	☐
			☐	☐
			☐	☐

Attach Sch. B if required.

1	Wages, salaries, tips, etc. Attach Form(s) W-2			1	
2a	Tax-exempt interest	2a		2b	9,000
	b Taxable interest				
3a	Qualified dividends	3a		3b	
	b Ordinary dividends				
4a	IRA distributions	4a		4b	
	b Taxable amount				
5a	Pensions and annuities	5a		5b	
	b Taxable amount				
6a	Social security benefits	6a		6b	
	b Taxable amount				
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			7	
8	Other income from Schedule 1, line 10			8	
9	Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income** ▶			9	9,000
10	Adjustments to income from Schedule 1, line 26			10	
11	Subtract line 10 from line 9. This is your **adjusted gross income** ▶			11	9,000
12a	**Standard deduction or itemized deductions** (from Schedule A)	12a	1,100*		
b	Charitable contributions if you take the standard deduction (see instructions)	12b			
c	Add lines 12a and 12b			12c	1,100
13	Qualified business income deduction from Form 8995 or Form 8995-A			13	
14	Add lines 12c and 13			14	1,100
15	**Taxable income.** Subtract line 14 from line 11. If zero or less, enter -0-			15	7,900

Standard Deduction for—
- Single or Married filing separately, $12,550
- Married filing jointly or Qualifying widow(er), $25,100
- Head of household, $18,800
- If you checked any box under *Standard Deduction,* see instructions.

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2021)

*For 2021, a dependent's standard deduction is limited to the greater of $350 ($0 earned income plus $350) or $1,100.

Form 1040 (2021) Page 2

16	**Tax** (see instructions). Check if any from Form(s): 1 ☐ 8814 2 ☐ 4972 3 ☐	16	1,607*
17	Amount from Schedule 2, line 3	17	
18	Add lines 16 and 17	18	1,607
19	Nonrefundable child tax credit or credit for other dependents from Schedule 8812	19	
20	Amount from Schedule 3, line 8	20	
21	Add lines 19 and 20	21	
22	Subtract line 21 from line 18. If zero or less, enter -0-	22	1,607
23	Other taxes, including self-employment tax, from Schedule 2, line 21	23	
24	Add lines 22 and 23. This is your **total tax** ▶	24	1,607
25	Federal income tax withheld from:		
a	Form(s) W-2 — 25a		
b	Form(s) 1099 — 25b		
c	Other forms (see instructions) — 25c		
d	Add lines 25a through 25c	25d	
26	2021 estimated tax payments and amount applied from 2020 return	26	
27a	Earned income credit (EIC) — 27a		
	Check here if you were born after January 1, 1998, and before January 2, 2004, and you satisfy all the other requirements for taxpayers who are at least age 18, to claim the EIC. See instructions ▶ ☐		
b	Nontaxable combat pay election — 27b		
c	Prior year (2019) earned income — 27c		
28	Refundable child tax credit or additional child tax credit from Schedule 8812 — 28		
29	American opportunity credit from Form 8863, line 8 — 29		
30	Recovery rebate credit. See instructions — 30		
31	Amount from Schedule 3, line 15 — 31		
32	Add lines 27a and 28 through 31. These are your **total other payments and refundable credits** ▶	32	
33	Add lines 25d, 26, and 32. These are your **total payments** ▶	33	-0-

If you have a qualifying child, attach Sch. EIC.

Refund

34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you **overpaid**	34	
35a	Amount of line 34 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐	35a	
▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings		
▶ d	Account number		
36	Amount of line 34 you want **applied to your 2022 estimated tax** ▶ — 36		

Direct deposit? See instructions.

Amount You Owe

37	**Amount you owe.** Subtract line 33 from line 24. For details on how to pay, see instructions ▶	37	1,607
38	Estimated tax penalty (see instructions) ▶ — 38		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS? See instructions ▶ ☐ **Yes.** Complete below. ☐ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.) ▶
		Student	
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.) ▶
Phone no.	Email address		

Joint return? See instructions. Keep a copy for your records.

Paid Preparer Use Only

Preparer's name	Preparer's signature	Date	PTIN	Check if: ☐ Self-employed
Firm's name ▶			Phone no.	
Firm's address ▶			Firm's EIN ▶	

Go to *www.irs.gov/Form1040* for instructions and the latest information. Form **1040** (2021)

* From Line 18 of Form 8615.

Form **8615**

Department of the Treasury
Internal Revenue Service (99)

Tax for Certain Children Who Have Unearned Income

▶ Attach only to the child's Form 1040 or Form 1040-NR.
▶ Go to *www.irs.gov/Form8615* for instructions and the latest information.

OMB No. 1545-0074
2021
Attachment Sequence No. 33

Child's name shown on return	Child's social security number
Tracy M. Kidwell	433-33-3333

Before you begin: If the child, the parent, or any of the parent's other children for whom Form 8615 must be filed must use the Schedule D Tax Worksheet or has income from farming or fishing, see **Pub. 929,** Tax Rules for Children and Dependents. It explains how to figure the child's tax using the **Schedule D Tax Worksheet** or **Schedule J** (Form 1040).

A Parent's name (first, initial, and last). **Caution:** See instructions before completing.	B Parent's social security number
Kelly S. Kidwell	433-33-1111

C Parent's filing status (check one):
☐ Single ☑ Married filing jointly ☐ Married filing separately ☐ Head of household ☐ Qualifying widow(er)

Part I Child's Net Unearned Income

1	Enter the child's unearned income. See instructions	1	9,000
2	If the child **did not** itemize deductions on **Schedule A** (Form 1040) or **Schedule A** (Form 1040-NR), enter $2,200. Otherwise, see instructions	2	2,200
3	Subtract line 2 from line 1. If zero or less, **stop;** do not complete the rest of this form but **do** attach it to the child's return	3	6,800
4	Enter the child's **taxable income** from Form 1040 or 1040-NR, line 15. If the child files Form 2555, see the instructions	4	7,900
5	Enter the **smaller** of line 3 or line 4. If zero, **stop;** do not complete the rest of this form but **do** attach it to the child's return	5	6,800

Part II Tentative Tax Based on the Tax Rate of the Parent

6	Enter the parent's **taxable income** from Form 1040 or 1040-NR, line 15. If zero or less, enter -0-. If the parent files Form 2555, see the instructions	6	132,000
7	Enter the total, if any, from Forms 8615, line 5, of **all other** children of the parent named above. **Do not** include the amount from line 5 above	7	
8	Add lines 5, 6, and 7. See instructions	8	138,800
9	Enter the tax on the amount on line 8 based on the **parent's** filing status above. See instructions. If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ ☐	9	22,033[a]
10	Enter the parent's tax from Form 1040 or 1040-NR, line 16, minus any alternative minimum tax. **Do not** include any tax from **Form 4972, 8814,** or **8885** or any tax from recapture of an education credit. If the parent files Form 2555, see the instructions. If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) was used to figure the tax, check here ▶ ☐	10	20,537[b]
11	Subtract line 10 from line 9 and enter the result. If line 7 is blank, also enter this amount on line 13 and go to **Part III**	11	1,496
12a	Add lines 5 and 7 — 12a: 6,800		
b	Divide line 5 by line 12a. Enter the result as a decimal (rounded to at least three places)	12b	x 1.000
13	Multiply line 11 by line 12b	13	1,496

Part III Child's Tax—If lines 4 and 5 above are the same, enter -0- on line 15 and go to line 16.

14	Subtract line 5 from line 4 — 14: 1,100		
15	Enter the tax on the amount on line 14 based on the **child's** filing status. See instructions. If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ ☐	15	111[c]
16	Add lines 13 and 15	16	1,607
17	Enter the tax on the amount on line 4 based on the **child's** filing status. See instructions. If the Qualified Dividends and Capital Gain Tax Worksheet, Schedule D Tax Worksheet, or Schedule J (Form 1040) is used to figure the tax, check here ▶ ☐	17	793[d]
18	Enter the **larger** of line 16 or line 17 here and on the **child's** Form 1040 or 1040-NR, line 16. If the child files Form 2555, see the instructions	18	1,607

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 64113U Form **8615** (2021)

[a] $9,328.00 + .22($138,800 - $81,050)

[b] $9,328.00 + .22($132,000 - $81,050)

[c] From 2021 Tax Table. The amount on Line 15 would be $110 ($1,100 × 0.10) if the tax rate schedule were used instead.

[d] From 2021 Tax Table. The amount on Line 17 would be $790 ($7,900 × 0.10) if the tax rate schedule were used instead.

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 sole 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 Schedule 1 (and from there 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 an individual is required to file a tax return is based on his or her 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:2-15, and I:2-35.

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 $200 credit is worth more than a $200 deduction because the credit results in a $200 tax savings. The savings from a deduction is less than 100% of $200, 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:
  - Be the taxpayer's (a) child, (b) sibling, or (c) descendent of (a) or (b)
  - Be under 19, a full-time student under 24, or disabled
  - Live with the taxpayer for more than half the year, and
  - Not provide more than half of his or her own support.

- A qualifying relative must:
  - Be related to the taxpayer (or reside in the taxpayer's home for the entire year)
  - Have gross income less than $4,400 (2022),
  - Receive more than half of his or her support from the taxpayer, and
  - Not be a qualifying child.

Both qualifying children and qualifying relatives must also meet several other requirements:

- Meet a citizenship test
- Cannot normally file a joint return, and
- Cannot claim others as dependents.

pp. I:2-13 through I:2-17.

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. Maybe. There are several situations where a taxpayer provides 50% or less of another person's support and can claim that person as a dependent:

- If the other person does not provide more than half of his or her own support, that person is the taxpayer's qualifying child (if the other tests for a qualifying child are met).
- 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 qualifying relative.
- In the case of divorced couples, the parent with custody for over half of the year may claim their child as a dependent. Similarly, in the case of a written agreement, the noncustodial parent may claim their child as a dependent.

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:2-14 through I:2-16.

I:2-6 A taxpayer will use a tax 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:2-20.

I:2-7 a. In general, it is an individual's gross income that determines whether he or she 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: (1) dependent individuals whose unearned income exceeds $1,150 or whose total gross income exceeds the standard deduction, (2) taxpayers who owe the 0.9% Additional Medicare Tax or the 3.8% Net Investment Income Tax, and (3) taxpayers with $400 or more of net self-employment income.

b. Individuals 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:2-35.

I:2-8 Home mortgage interest and real property taxes are itemized deductions. As a result, a homeowner's itemized deductions often exceed the standard deduction, making it beneficial to itemize. Renters typically do not have these deductions, so the standard deduction often is greater than itemized deductions. p. I:2-12.

I:2-9 If the support test for a qualifying relative were "50% or more" and two individuals each provided exactly 50% of another person's support, 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:2-16.

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:2-35.

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. pp. I:2-35 and I:2-36.

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 (or whether the child provided more than half of his or her own support). p. I:2-16.

I:2-13 Scholarships generally do qualify as support, but an exception exists for a scholarship received by the taxpayer's child. Parents may ignore a child's scholarship in determining whether they provide over half of the child's support (or whether the child provided more than half of his or her own support). p. I:2-16.

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 qualifying relative when the members together contribute more than 50% of the support of that person and each member of the group contributes over 10% (the group includes only those individuals contributing over 10% of the supported person's support and who meet the relationship test for a qualifying relative with respect to the supported person). The multiple support agreement results in an exception to the requirement that the taxpayer alone must provide over one-half of the qualifying relative's support. pp. I:2-17 and I:2-18.

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:2-19.

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:2-21.

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:2-24.

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. pp. I:2-24 and I:2-25.

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 shareholders report the S corporation's income on their own income tax returns. That is, the shareholders (not the corporation) are taxed on the corporation's income. This flow-through treatment occurs even if the income 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 that were not discussed in Chapter I:2 include fringe benefits, the need to retain earnings in the business, and dividend policy. pp. I:2-28 and I:2-29.

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 sole 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 will be reduced (and possibly reversed) if the corporation distributes the income. New businesses often need to retain income for expansion. p. I:2-29.

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

- Inventory
- Trade receivables, such as accounts receivable
- 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 net 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. pp. I:2-31 and I:2-32.

I:2-22 Yes. By waiting, the taxpayer can convert the short-term capital gain to a long-term capital gain that is potentially taxed at a lower rate. The long-term rate will not be available if the taxpayer holds the property for 12 months or less. 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. pp. I:2-31 and I:2-32.

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

b. Different taxpayers are in different tax brackets. Thus, 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:2-32 and I:2-33.

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:2-33 and I:2-34.

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:2-34.

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. citizen or U.S. resident in order to qualify. The nephew is not a U.S. citizen, so he must be a U.S. resident to qualify as a Yung's dependent. 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:2-14.

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 a 10% rather than 12% rate. 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:2-33 and I:2-34.

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, assuming neither one has remarried. 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 alimony and child support payments. p. I:2-23.

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	(6,000)
Adjusted gross income	$30,020	$90,000
Minus: Greater of standard deduction or itemized deductions	(25,900)	(26,400)
Taxable Income	$ 4,120	$63,600
Gross tax (using Rate Schedule)	$ 412*	$ 7,221*
Minus: Withholding	(750)	(8,500)
Tax due (refund)	($ 338)	($ 1,279)

* This answer is based on the 2022 rate schedule. The 2022 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, I:2-7, and I:2-12.

I:2-30 a.

Wages	$ 7,000
Taxable interest income	425
Adjusted gross income	$ 7,425
Minus: Standard deduction	(12,950)
Taxable income	-0-

b.

Wages	$ 7,000
Taxable interest income	425
Adjusted gross income	$ 7,425
Minus: Standard deduction	(7,400)*
Taxable income	$ 25

*$12,950 standard deduction is limited to the greater of $7,400 ($7,000 earned income plus $400) or $1,150.

p. I:2-13.

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: Carl cannot claim the standard deduction because his spouse (Carol) claimed itemized deductions. Their total itemized deductions are $27,200 ($11,000 + $16,200). Each could have claimed a standard deduction of $12,950 (total of $25,900), so they gained $1,300 ($27,200 - $25,900) 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

Note that this $122,800 taxable income equals the sum of their $49,000 and $73,800 taxable incomes if they file separately.

p. I:2-13.

I:2-32 The person is not Wes and Tina's dependent in parts a, b, and d but is their dependent in parts c and e.

a. Brian is not a qualifying child because he fails the age test (he is over age 23). Brian is not a qualifying relative because he fails the gross income test (his gross income of $5,200 is not less than $4,400 for 2022).

b. No effect. Brian's student status is irrelevant because he is over age 23. Thus, Brian is not a qualifying child or a qualifying relative.

c. Sherry meets the four requirements to be a qualifying child: (1) she meets the relationship test because she is Wes and Tina's child, (2) she meets the age test because she is under age 24 and a full-time student, (3) she meets the abode test because her principal place of abode is with her parents for more than half the year; her temporary presence in the dormitory for her college education is treated as time living with her parents, and (4) she does not provide more than half of her own support because her parents provide more than half of it. Sherry's gross income is relevant for determining if she is her parent's qualifying relative, but she meets the criteria to be a qualifying child.

d. Sherry is not a qualifying child because she fails the age test (she is not under 24 *and* a full-time student). Sherry is not a qualifying relative because she fails the gross income test (her gross income of $5,000 is not less than $4,400 for 2022). Although the parents meet the relationship test and support test with respect to Sherry, they must meet all of the tests for her to be their qualifying relative.

e. Granny is not a qualifying child because she fails the age test (she also fails the relationship test for a qualifying child). However, Granny meets all the requirements to be a qualifying relative of Wes and Tina: (1) she meets the relationship test because she is an ancestor of Tina, (2) she meets the gross income test because her gross income is zero (her only income, the Social Security, is wholly tax-exempt), (3) she meets the support test because Wes and Tina provide 60% of her support, and (4) she is not a qualifying child.

pp. I:2-13 through I:2-17.

I:2-33 a. Carole and John can claim David and Kristen as dependents this year (David and Kristen are their qualifying children). 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 is not less than $4,400. David meets the requirements to be a qualifying child: (1) he meets the relationship test because he is Carole and John's child, (2) he meets the age test because he is under age 24 and a full-time student, (3) he meets the abode test because he lives with Carole and John for more than half the year, and (4) he meets the support test because he does not provide more than half of his own support. The fact that David's $6,400 gross income is not less than $4,400 is irrelevant; it is relevant for determining whether he is a qualifying relative. Kristen also meets the requirements to be a qualifying child.

b. Jack is Carole and John's qualifying child because he meets the age test (Jack is under age 24 and a full-time student for at least five months this year). Carole and John can claim Jack, David, and Kristen as dependents. Note that Jack will not be Carole and John's qualifying child next year because he will be age 24, not under age 24 (although Jack may be their qualifying relative next year).

c. As in part a, Jack is not a qualifying child because he fails the age test. However, he meets the requirements to be Carole and David's qualifying relative: (1) he meets the relationship test because he is their child, (2) he meets the gross income test because his $3,000 gross income is less than $4,400, (3) he meets the support test because John and Carole provide more than half of Jack's support, and (4) he is not a qualifying child.

d. David would not be a qualifying child because he would fail the age test (he is not under age 24 *and* a full-time student). David also would not be a qualifying relative because he fails the gross income test (his $6,400 gross income is not less than $4,400).

e. David would not be a qualifying child because he would fail the support test (he would provide more than half of his own support). David also would not be a qualifying relative because he would fail the support test for a qualifying relative (John and Carole would not provide more than half of David's support). pp. I:2-13 through I:2-17.

I:2-34 a. No. Jane is not a qualifying child because she fails the age test (she is not under age 19 and is not a full-time student under age 24). Jane also fails the abode test because she does not live with Robert for more than half the year. Jane is not a qualifying relative because her $20,000 gross income is not less than $4,400.

b. Yes. The children meet the requirements to be Jane's qualifying children: (1) they meet the relationship test because they are Jane's children, (2) they meet the age test because they are under age 19, (3) they meet the abode test because they live with Jane for more than half the year, and (4) they each meet the support test because Robert, not themselves, provides more than half of their support. The children are not Robert's qualifying relatives because they are Jane's qualifying children.

c. Jane is entitled to the $2,000 child tax credit for each of her two children because they are her qualifying children and are under age 17. Jane does not qualify as a head of household because she does not pay over half of the costs of maintaining her household (Robert does), so her filing status is single. Assuming Jane claims the standard deduction, her taxable income is $7,050 ($20,000 - $12,950) and her tax before credits is $705 ($7,050 x 0.10). The refundability of Jane's child tax credit is limited to the lesser of $2,625 ((0.15 x ($20,000 - $2,500)) or $2,800 ($1,400 x 2), so she can use $705 of the $4,000 ($2,000 x 2) credit to offset her $705 tax before credits and another $2,625 as a refundable credit. Jane will be unable to use the last $670 ($4,000 - $705 - $2,625) of the credit. pp. I:2-13 through I:2-24.

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

Maria provides $12,000 of her own support, and Juan provides $9,000 ($5,000 + $4,000) of it. Juan thus does not provide more than half of Maria's support, so the support test for a qualifying relative is failed. The support test for a qualifying child is also failed, as well as the age test for a qualifying child.

Jose generally would be Linda's qualifying child because she is Jose's custodial parent. If Linda signs a completed Form 8332, Juan can claim Jose as a dependent.

Norma is not a qualifying child because she fails the age test (she is not under age 24 *and* a full-time student). Norma also fails the abode test with respect to Juan because she does not live with him for more than half the year (she also fails the abode test with respect to her father). Norma is not a qualifying relative because her $6,000 gross income is not less than $4,400. pp. I:2-13 through I:2-16 and p. I:2-19.

I:2-36 a. Mario and Elaine. To be eligible to claim Anna as a qualifying relative under a multiple support agreement, an individual must:

- Provide more than 10% of the supported person's support. In Anna's case, Mario, Caroline, and Elaine provide more than $700 (0.10 x $7,000) of Anna's support.
- Meet all requirements, other than the support requirement, for claiming Anna as a qualifying relative. Anna meets the relationship test for a qualifying relative with respect to Mario, Doug, and Elaine, and she meets the gross income test because her zero gross income is less than $4,400.

Only Mario and Elaine meet both criteria, so only they are eligible to claim Anna as a qualifying relative under a multiple support agreement.

b. Elaine. That is, all other individuals who are eligible to claim Anna as a qualifying relative under a multiple support agreement.

c. $12,950. Mario is not married and presumably is not a surviving spouse. Head of household status cannot be based on dependency obtained as the result of a multiple support agreement. Mario is not eligible for an additional standard deduction due to age. Although his dependent mother is age 65 or older, Mario is not. pp. I:2-13 through I:2-18.

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

b. No. p. I:2-19.

I:2-38 a. Schedule 3 because of the child care credit Abby and Bert claim.

b. None. Form 1040 reports all of the information Celeste needs to report.

c. None. Donna and Ernie report on Form 1040 the salary, pension benefits, qualified dividends, net capital gain, and federal income taxes withheld (the long-term capital gain carries to Form 1040 from Schedule D, and it may carry to Schedule D from Form 8949). They also file Schedule A to claim their itemized deductions. Donna and Ernie can file Form 1040-SR instead of Form 1040 because Ernie is age 65 or older, but they are not required to do so.

d. None. Fiona also files Schedule B to report the taxable interest income and Form 8615 for her kiddie tax. p. I:2-36.

I:2-39 a. Zero dependents and zero credit. A cousin does not meet the relationship test for a qualifying child and meets the relationship test for a qualifying relative only if the cousin lives with the taxpayer for the entire year.

b. One dependent and $500 credit. Bob's father is a qualifying relative. The gross income test is met because the father's gross income of $800 is less than $4,400. The abode test must be met for a qualifying child but not for a qualifying relative. Bob and Ann are allowed a $500 credit for the father because he is their dependent but is not a qualifying child under age 17.

c. One dependent and $500 credit. The daughter is a qualifying child. Although the gross income test must be met for a qualifying relative, it does not have to be met for a qualifying child. Clay is allowed a $500 credit; although the daughter is a qualifying child, she is not under age 17.

d. Zero dependents and zero credit. The multiple support agreement is irrelevant because the mother provided over half of her own support.

e. Two dependents and $2,500 credit. The daughter is a qualifying child; the gross income test need not be met. The son is also a qualifying child. Zoe and Walt are allowed a $2,000 child tax credit for their son because he is a qualifying child under age 17, but they are allowed only a $500 credit for their daughter because she is not under age 17. pp. I:2-13 through I:2-20.

I:2-40 a. Juan's AGI exceeds $200,000, but Maria's AGI does not. The child tax 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 tax 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 tax 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:2-19 and I:2-20.

I:2-41 a.

Adjusted gross income ($112,000 + $94,000)	$206,000
Minus: Itemized deductions ($21,700 + $11,800)	(33,500)
Taxable income	$172,500
Gross tax	$ 29,184

b.

Mary's tax filing as a single taxpayer:	
Adjusted gross income	$94,000
Minus: Standard deduction	(12,950)
Taxable income	$81,050
Gross tax	$13,448*

Bill's tax filing as a single taxpayer:	
Adjusted gross income	$112,000
Minus: Itemized deductions	(21,700)
Taxable income	$ 90,300
Gross tax	$ 15,508*

Their income taxes total $28,956 ($13,448 + $15,508).

*These amounts are based upon the 2022 tax rate schedule because the 2022 tax table was unavailable when the solution was prepared.

c. Their tax will be $228 ($29,184 - $28,956) higher if they marry before year-end. This is attributable to the fact that their $33,500 of itemized deductions is $1,150 less than the $34,650 ($12,950 + $21,700) of total deductions they would claim if they were not married. The increased taxes due to this is partially offset by the fact that $1,225 ($90,300 - $89,075) of Bill's taxable income is taxed at 22% if they are married rather than 24% if they are not. pp. I:2-21 and I:2-22.

I:2-42 a. Amy need not file because her gross income is less than the threshold of $12,950 and her self-employment income is less than $400.

b. Betty need not file, as her gross income ($9,100) is less than $14,700 ($12,950 + $1,750).

c. Chris must file, as his gross income of $2,300 exceeds his standard deduction of $2,300 ($1,900 + $400). Chris' standard deduction is limited to the amount of earned income plus $400 (or $1,150, if greater).

d. Dawn must file because her unearned income is over $1,150 and her total gross income exceeds her standard deduction.

e. Doug must file because his gross income is over $5 and he is married and not living with his spouse. p. I:2-35.

I:2-43 a. Yes.

b. No. The aunt does not live with the taxpayer for more than half the year.

c. No. Cindy qualifies as a surviving spouse, so she does not qualify as a head of household. This is beneficial for Cindy because, as a surviving spouse, she is allowed a larger standard deduction than as a head of household, and the tax rate schedule is also more favorable.

d. Yes. Because Dick qualifies as an abandoned spouse, he can file as a head of household. pp. I:2-23 and I:2-24.

I:2-44 a. 2020: Celia files a joint return even though Wayne died in October.

2021: Celia must file as a single taxpayer. As a part-time student, Wally is not a qualifying child. Celia thus does not qualify as a head of household because she does not maintain a household in which a dependent lives for more than half the year.

2022: Same as 2021.

2023: Same as 2021.

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:2-24.

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 2021 and 2022 and a single taxpayer in 2023. Wally would not be Celia's qualifying child in 2023 because he would no longer be under age 24, and he would not be her qualifying relative because he would fail the gross income test (assuming that test's threshold for 2023 is less than $5,000).

I:2-45

Jim's salary	$ 92,000
Revenues for Pat's sole proprietorship	98,000
Gross income	$190,000
Minus: Expenses for Pat's sole proprietorship	(48,000)
IRA contributions (2 x $6,000)	(12,000)
Adjusted gross income	$130,000
Minus: Itemized deductions	(26,000)
Qualified business income deduction	(10,000)[a]
Taxable income	$ 94,000
Gross tax	$ 11,914[b]
Minus: Child tax credit	(2,000)
Net tax	$ 9,914
Minus: Withholdings	(7,000)
Estimated tax payments	(3,000)
Additional tax due (refund)	$ (86)

[a] 0.20 x ($98,000 - $48,000).

[b] $9,615 + [0.22 x ($94,000 – $83,550)]. This is based on the 2022 tax rate schedule because the 2022 tax table was unavailable when the solution was prepared.

pp. I:2-2 through I:2-7 and I:2-19.

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 $12,950 standard deduction. p. I:2-12.

I:2-47

Wages	$ 9,000
Interest	10,400
Adjusted gross income	$19,400
Standard deduction	(9,400)*
Taxable income	$10,000

*Because she is a dependent, Lucy's standard deduction is limited to the greater of $9,400 ($9,000 earned income plus $400) or $1,150.

Lucy is under age 18, so she is subject to the kiddie tax. Her net unearned income is $8,100 ($10,400 - $1,150 - $1,150), and it is taxed at 24% because her parents' $240,000 taxable income is in the 24% tax bracket. Lucy's tax is calculated as follows:

Tax on net unearned income ($8,100 x 24%)	$1,944
Tax on taxable income exceeding net unearned income (($10,000 - $8,100) x 10%)	190
Total income tax	$2,134

pp. I:2-25 through I:2-27.

I:2-48

Salaries	$130,000
Allowable capital loss	(3,000)
Adjusted gross income	$127,000
Standard deduction	(25,900)[a]
Taxable income	$101,100
Gross tax	$13,476[b]
Child tax credit and credit for other dependents ((2 x $2,000) + (1 x $500))	(4,500)
Net tax	$ 8,976
Withholdings	(11,000)
Additional tax due (refund)	$(2,024)

[a] John and Georgia claim the standard deduction because it is greater than their itemized deductions of $21,800 ($10,000 + $4,000 + $2,800 + $5,000). None of the medical expenses are deductible because they are less than $9,525 (0.075 x $127,000).

[b] $9,615 + [0.22 x ($101,100 - $83,550)]

I:2-49

Karen

Karen's gross tax is $300. 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 $2,300.

Taxable income:	
Wages	$3,000
Interest	2,800
Adjusted gross income	$5,800
Standard deduction ($3,000 + $400)	(3,400)
Taxable income	$2,400

Net unearned income = $2,800 - $1,150 - $1,150 = $500

Mike and Linda's $100,000 taxable income is in the 22% tax bracket, so Karen's net unearned income is taxed at 22%. The other $1,900 ($2,400 - $500) of Karen's taxable income is taxed at her 10% rate. Karen's total income tax is $300 (($500 x 0.22) + ($1,900 x 0.10)).

Susan

Susan's gross tax is $200. 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 + $400)	(11,400)
Taxable income	$ 2,000
Gross tax	$ 200

Amelie

Amelie's gross tax is $190. Amelie is not subject to the kiddie tax. Although she is under age 18, her unearned income ($2,300 of interest) is not greater than $2,300.

Taxable income:	
Wages	$5,900
Interest	2,300
Adjusted gross income	$8,200
Standard deduction ($5,900 + $400)	(6,300)
Taxable income	$1,900
Gross tax	$ 190

pp. I:2-25 through I:2-27.

I:2-50 a.

Salaries ($70,000 + $90,000)	$160,000
S corporation income	30,000
Adjusted gross income	$190,000
Itemized deductions	(31,000)
Qualified business income deduction	(6,000)*
Taxable income	$153,000
Gross tax	$ 24,894

*0.20 x $30,000.

b.

Peach Corporation:	
Taxable income	$ 30,000
Gross tax (0.21 x $30,000)	$ 6,300
Individuals:	
Salaries ($70,000 + $90,000)	$160,000
Dividend ($30,000 - $6,300)	23,700
Adjusted gross income	$183,700
Itemized deductions	(31,000)
Qualified business income deduction	-0-
Taxable income	$152,700
Gross tax	$ 23,169*
Total tax ($6,300 + $23,169)	$ 29,469

*The 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 $129,000 ($152,700 - $23,700) is $19,614, computed using the rate schedule for married couples filing jointly.

c. The answer to part a is unchanged as the shareholder (Georgia) 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:

Salaries (also adjusted gross income)	$160,000
Itemized deductions	(31,000)
Qualified business income deduction	-0-
Taxable income	$129,000
Gross tax	$ 19,614
Total tax ($6,300 + $19,614)	$ 25,914

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:2-28 through I:2-31.

I:2-51 Before considering any reduction due to her AGI, Lana's child tax credit is $6,000 (3 x $2,000). For unmarried individuals, the threshold for reducing the credit is $200,000. Lana's AGI is $204,400, so there are five $50 reductions in her credit (($204,400 - $200,000) / $1,000 = 4.4, which is four $1,000s of AGI exceeding $200,000 plus a fraction thereof). Lana's child tax credit is $5,750 [$6,000 - ($50 x 5)]. pp. I:2-19 and I:2-20.

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 carries over and can offset 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). They also will not have to pay any tax in the future on the $10,000 gain because they reported the gain in the current year. pp. I:2-31 and I:2-32.

I:2-53

		2022	2023
a.	Salary	$90,000	$90,000
	Minus: Itemized or standard deduction	(12,950)	(16,550)
	Taxable income	$77,050	$73,450
	Gross Tax	$12,568	$11,776
b.	Salary	$90,000	$90,000
	Minus: Itemized or standard deduction	(12,950)	(12,950)
	Taxable income	$77,050	$77,050
	Gross tax	$12,568	$12,568
c.	Salary	$90,000	$90,000
	Minus: Itemized or standard deduction	(12,950)	(20,550)
	Taxable income	$77,050	$69,450
	Gross tax	$12,568	$10,896

d. By contributing the $8,000 in 2023, Virginia is able to deduct the entire amount. If $4,000 is contributed in each year, only the $4,000 contributed in 2023 is deductible. No tax benefit is received in 2022 because Virginia does not itemize deductions that year. If $8,000 is contributed in 2022, then no tax benefit is received. p. I:2-33.

I:2-54 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 $35,050.

Adjusted gross income	$48,000
Standard deduction	(12,950)
Taxable income	$35,050

c. Maria's tax liability is $4,001 [$1,027.50 + (0.12 x ($35,050 - $10,275))].

I:2-55 a. $690 tax savings. As a dependent, Pam's standard deduction is limited to the greater of $400 ($0 earned income plus $400) or $1,150. Her standard deduction thus is $1,150, and her taxable income is $12,850 ($14,000 AGI minus $1,150). Pam is under age 18, so the kiddie tax applies to her. Pam's tax is calculated as follows:

Net unearned income = $14,000 - $1,150 - $1,150 = $11,700

Ralph and Tina's $500,000 taxable income is in the 35% tax bracket, so this net unearned income is taxed at 35%. Pam's tax is:

Tax on net unearned income ($11,700 x 0.35)	$4,095
Tax on taxable income exceeding net unearned income (($12,850 - $11,700) x 0.10)	115
Total income tax	$4,210

If Ralph and Tina had not transferred the bonds to Pam, they would have received the interest and incurred $4,900 (0.35 x $14,000) of tax on it. By transferring the bonds to Pam, the family saves $690 ($4,900 - $4,210) of tax in the current year.

b. $3,220 tax savings. The kiddie tax does not apply because Pam is not under age 24. Pam's tax on the $14,000 of interest can be determined by calculating her tax with and without the $14,000:

With $14,000: Taxable income = $35,000 + $14,000 - $12,950 = $36,050
Tax = $4,121

Without $14,000: Taxable income = $35,000 - $12,950 = $22,050
Tax = $2,441

Pam's tax increases by $1,680 ($4,121 - $2,441) when she receives the interest in addition to her wages. Because her last dollar of taxable income is in the 12% tax bracket with and without the $14,000, the $1,680 increased tax can also be calculated by multiplying $14,000 by 12%. If Ralph and Tina had not transferred the bonds to Pam, the tax on the $14,000 of interest would have been $4,900 (see part a). By transferring the bonds to Pam, the family saves $3,220 ($4,900 - $1,680) of tax in the current year. This tax savings can also be calculated by multiplying $14,000 by 23% (0.35 – 0.12).

I:2-56 a. Gail's 2022 filing status is married filing jointly because she and her husband were married when he died (assuming Gail does not choose to file separately from her deceased husband). Gail qualifies as a surviving spouse for 2023 and 2024 and as a head of household for 2025 and 2026. Gail's son attains age 17 in 2026, so she can claim a $2,000 child tax credit for him in 2022 through 2025 and a $500 credit for other dependents for him in 2026. Gail's tax each year is calculated as follows:

	2022	***2023***	***2024***	***2025***	***2026***
Adjusted gross income	$150,000	$150,000	$150,000	$150,000	$150,000
Greater of standard deduction or itemized deductions	(25,900)[a]	(25,900)[a]	(25,900)[a]	(24,000)[b]	(24,000)[b]
Taxable income	$124,100	$124,100	$124,100	$126,000	$126,000
Gross tax	$18,536	$18,536	$18,536	$22,576	$22,576
Credit for child or other dependent	(2,000)	(2,000)	(2,000)	(2,000)	(500)
Net tax	$16,536	$16,536	$16,536	$20,576	$22,076

[a] Greater of $24,000 itemized deductions or $25,900 standard deduction allowed for a married couple filing jointly and for a surviving spouse.
[b] Greater of $24,000 itemized deductions or $19,400 standard deduction allowed for a head of household.

b. As in part a, Gail's 2022 filing status is married filing jointly. Gail does not qualify as a surviving spouse or head of household in any of the subsequent years because the son who lives with her is not her dependent. Her filing status those years is single, and she is not allowed any credit for a child or other dependent. Gail's tax each year is calculated as follows:

2022: Gross tax is $18,536 (see part a). Net tax also is $18,536.

2023: Gail claims itemized deductions because their $24,000 amount exceeds the $12,950 standard deduction she is allowed. Her taxable income is $126,000 ($150,000 - $24,000), and her gross tax is $24,076. Her net tax also is $24,076.

2024: $24,076 (see 2023).

2025: $24,076 (see 2023).

2026: $24,076 (see 2023).

Tax Strategy and Critical Thinking Problems

I:2-57 The tax liability under the three alternatives is computed as below:

Business income:	**Proprietorship**	**S Corporation**	**C Corporation**
Income before Jack's compensation	$190,000	$190,000	$190,000
Salary paid to Jack		(100,000)	(100,000)
Net	$190,000	$ 90,000	$ 90,000
Corporate income tax (21%)			$ 18,900
Jack's income:			
Business income	$190,000	$ 90,000	
Salary		100,000	$100,000
Dividends			7,500
Other income	22,000	22,000	22,000
Adjusted gross income	$212,000	$212,000	$129,500
Itemized deductions	(20,000)	(20,000)	(20,000)
Qualified business income deduction	(38,000)[a]	(18,000)[b]	-0-
Taxable income	$154,000	$174,000	$109,500
Individual income tax	$ 30,796	$ 35,912	$ 19,441
Total tax	$ 30,796	$ 35,912	$ 38,341

[a]20% x $190,000 = $38,000.
[b]20% x $90,000 = $18,000.

The total tax paid when Jack operates the business as a sole proprietorship is less than when he operates it as an S corporation because the qualified business income (QBI) deduction is greater with a sole proprietorship than with an S corporation. This difference occurs because the QBI deduction is allowed for flow-through income but not salary income. Jack could increase his QBI deduction with the S corporation organizational form by decreasing the salary, but the IRS might challenge this reduced amount as being unreasonably low.

In this case, the total tax for the current year is highest with the C corporation organizational form, and the analysis does not consider the potential future individual income tax on the remaining $63,600 ($90,000 - $18,900 - $7,500) of corporate income when the corporation distributes that income. An important reason the tax is higher is that Jack obtains no QBI deduction with the C corporation. This detriment, however, could be mitigated or reversed if the business becomes more profitable. With a C corporation, the additional profits would be taxed at 21% (plus a 15% or 20% tax when distributed to Jack as a dividend, depending on the extent to which it is more profitable). With a sole proprietorship or S corporation, the additional profits could be taxed to Jack in the 24% or a higher tax bracket.

I:2-58 a. Andrea will save $740 (37% x $2,000) of tax if she makes the contribution.

b. Andrea's taxes will not change. She does not deduct the contribution if she does not claim itemized deductions.

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 because the $600 will be offset by a $1,150 standard deduction.

d. Andrea will save $222 (37% x $600), assuming there is no gain or loss on the sale. She however will not be as well off because the tax-exempt interest of $300 is less than the after-tax interest of $378 ($600 - $222) from the taxable bonds.

I:2-59 The tax law does not limit the amount of income Nell and Nick can shift to Toni, but the tax savings the family can realize is limited because of the kiddie tax. Some of Toni's interest would be offset by her standard deduction and thus be tax-free. The interest exceeding her standard deduction would be taxed, and the portion of this excess that is net unearned income would be taxed to Toni at Nell and Nick's 35% marginal tax rate. To the extent Toni is taxed on the interest at a rate of less than 35%, the family's total taxes will be reduced. However, if Nell and Nick transfer too many corporate bonds to Toni, the kiddie tax will cause some of the interest to be taxed at 35%, resulting in no tax savings.

The maximum amount of the corporate bonds Nell and Nick can transfer to Toni so the interest from them is taxed to Toni at less than a 35% rate can be determined algebraically. Let z be the amount of bonds transferred:

Interest generated by z bonds = 0.048z (all of this is unearned income)

To avoid the kiddie tax, Nell and Nick need to ensure that the transferred bonds do not generate more than $2,300 of interest. This will be the case if:

$$0.048z \leq 2{,}300$$
$$z \leq 47{,}917$$

If Nell and Nick transfer $47,917 (or less) of the corporate bonds to Toni, all the interest on those bonds will be taxed to Toni at less than a 35% rate.

The $47,917 is larger than the $16,000 annual exclusion for the gift tax for 2022 (Chapter I:1), although Nell and Nick can each use the $16,000 amount. To avoid gift tax implications, Nell and Nick could transfer the bonds to Toni over several years, limiting the amount transferred each year to double the annual exclusion. Nell and Nick should also consider nontax implications of these transfers. For example, upon reaching the age of majority (e.g., 18 or 21), Toni would be free to sell the bonds and use the proceeds for whatever purposes she desires, regardless of Nell and Nick's approval or disapproval.

An alternative way of determining the $47,917 is to use an Excel worksheet. Set a cell to an arbitrary value for z (the cell is A1 for this explanation). Another cell (A2 here) contains the formula for Toni's net unearned income [=(0.048*a1)-2300]. Excel's Goal Seek feature can then be used, setting cell A2 to zero by changing cell A1.

Tax Form/Return Preparation Problems

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

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

I:2-62 (See Instructor's Resource Manual)

Case Study Problems

I:2-63 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 $17,850 ($19,000 - $1,150 standard deduction). Because she is age 16, Kim is subject to the kiddie tax, under which her net unearned income would be $16,700 ($19,000 - $1,150 - $1,150). Her $17,850 taxable income is comprised entirely of long-term capital gain, so $16,700 would be taxed at 20% (Bala and Ann's tax rate for net capital gain) and the remainder would be tax-free (Kim's 0% tax rate for net capital gain). Kim's tax would be $3,340 ($16,700 x 0.20). 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. pp. I:2-13, I:2-25 through I:2-28, and I:2-32.

I:2-64 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:2-33 and I:2-34.

Tax Research Problems

I:2-65 None of the three individuals qualify as Ed's qualifying children; they do not live with him and thus fail the abode test. A child meets the relationship test for a qualifying relative (Sec. 152(d)(2)(A)), and a child for this purpose 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(d)(2). The Tax Court in Desio Barbetti [9 T.C. 1097 (1947)] held that grandchildren do not include step-grandchildren, and that neither stepchildren nor children-in-law covers stepchildren-in-law. Current law refers to children and their descendants, which suggests that the step-grandchild meets the relationship test for a qualifying relative.

Ed's stepdaughter and her child meet all the tests for a qualifying relative, so Ed can claim them as dependents (the problem's facts are such that they meet the gross income and support tests). Ed cannot claim his stepdaughter's husband as a dependent.

I:2-66 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:2-67 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:2-25.

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 1099s and W-2s. 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.