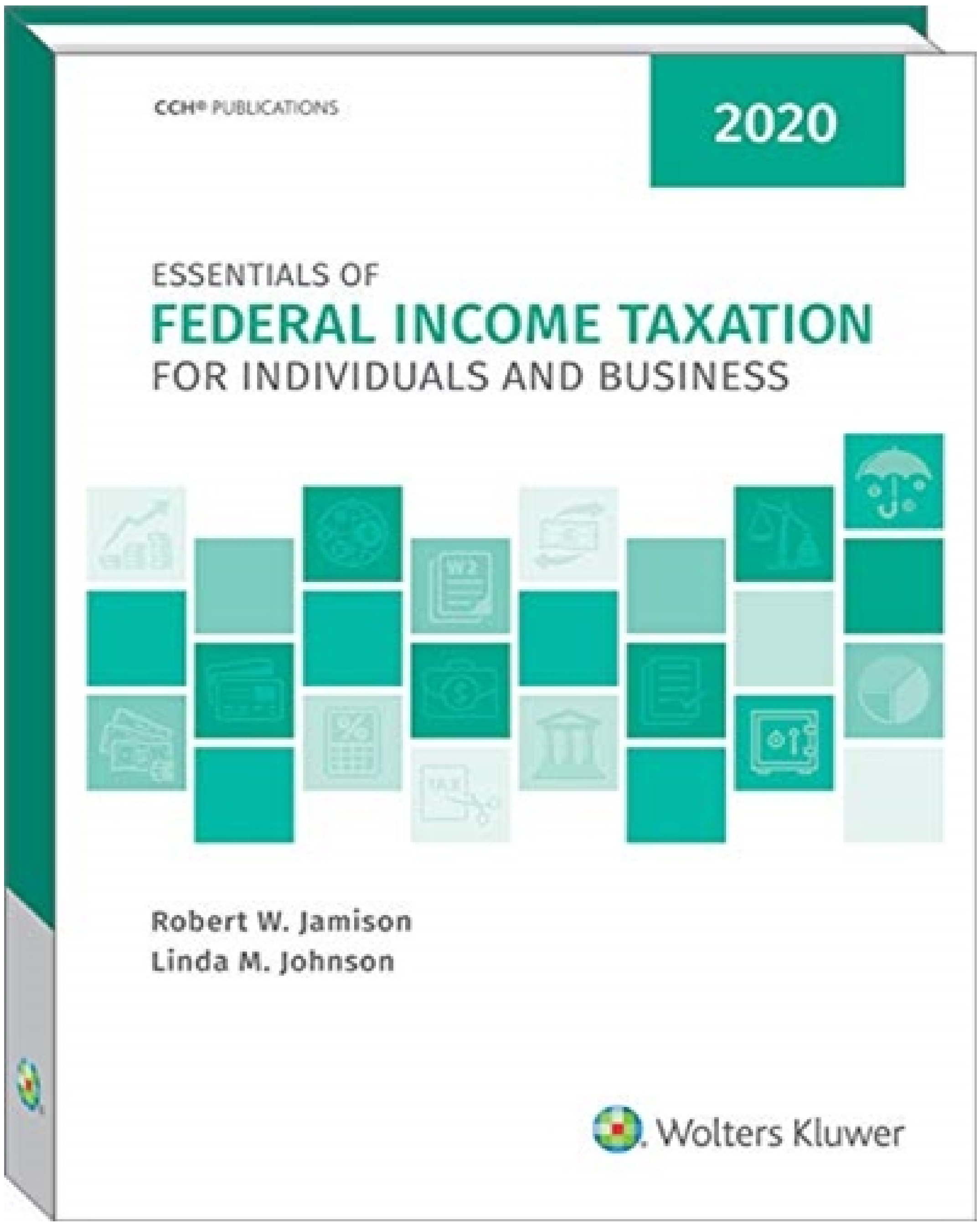
Solutions for Essentials of Federal Income Taxation for Individuals and Business 2020 1st Edition by Johnson



Solutions

Chapter 1
Overview of the Tax Structure

Highlights of 2019 Tax Changes

- The basic standard deduction in 2019:
  - — Single and married filing separately (MFS) taxpayers, $12,200 (up from $12,000 in 2018);
  - — Qualifying widow(er) and married filing jointly (MFJ) taxpayers, $24,400 (up from $24,000 in 2018); and
  - — Head of household (HOH), $18,350 (up from $18,000 in 2018).
- The 2019 additional standard deduction amounts for age/blindness is $1,650 per occurrence for single and head of household taxpayers ($1,550 in 2017) and $1,300 for married and qualifying widow(er) taxpayers ($1,250 in 2018).
- In 2019, the basic standard deduction for dependents is the lesser of (i) $1,100 or (ii) earned income + $350 (same as in 2018).
- The exemption deduction for 2019 is $0 ($0 in 2018).

Teaching Suggestions

1. The focus of Chapter 1 should be the tax base formulas. For many students, this course will be their first formal exposure to federal income taxation. To give them an overview, present the tax base formula for all taxpayers. Tell your students that with some computational exceptions, corporations and individual taxpayers all use the same formula to determine their tax base. Then, show how this formula leads to the expanded tax base formula for individual taxpayers.

   When you move from income to gross income (GI), provide an example of an exclusion (such as interest from municipal bonds). When you move from gross income (GI) to adjusted gross income (AGI), provide examples of these deductions. You might mention the IRA deduction and alimony deduction.

   When you get to AGI, you can discuss with your students why AGI is important to individual taxpayers. Mention that a percentage of AGI is an upper limit on some deductions (such as charitable contributions). Also, remind them that a percentage of AGI is a threshold that must be exceeded before some items can be deducted (e.g., medical expenses, casualty and theft losses from personal use property and certain miscellaneous itemized deductions). You might also mention that AGI will become very important throughout the course, as they will later learn that AGI is often used as the threshold to determine whether the taxpayer qualifies for an exclusion, deduction, or credit.

   Let your students know that there are groups of deductions used to get from AGI to taxable income (TI). Indicate that the groups consist of either the standard deduction or itemized deductions. Present the general categories of itemized deductions and indicate why some taxpayers use the standard deduction rather than itemize deductions. Mention that in 2018 the personal exemption deduction is repealed, but the dependency rules are important for determining the taxpayer’s filing status for the standard deduction and certain credits. Conclude your discussion of the taxable income formula with the rules for claiming someone as a dependent.

Continue your discussion with some remarks about applying the proper tax rates to taxable income to arrive at a taxpayer's tax liability. Then, discuss additions to the tax and tax credits. A quick examination of Form 1040 Schedules 2 and 3 will give you ideas for examples. Select items that you feel comfortable in mentioning at this point. Be sure to explain the difference between a deduction and a credit. Finally, mention the bottom line (i.e., the amount due to or owed from the government).

2. Some students may be overwhelmed by discussion of tax forms and schedules early on in a first tax course, while others may find it easier to learn the tax concepts by visualizing the tax forms. Accordingly, the introduction to tax forms is kept to a minimum in Chapter 1. Instructors wanting to introduce their students to tax forms in Chapter 1 can consider incorporating Form 1040, page 1 and Schedules 1 and 2 into their discussion of adjusted gross income. Appendix B (in the back of the textbook) has some of the more commonly-used tax forms and schedules. Although many of the deductions for AGI are listed towards the bottom of Schedule 1 of Form 1040, there are a few that do not appear as separate line items. For example, business deductions are reported as a deduction from business gross income on Schedule C. Also, gains and losses from the sale of business property and from the sale of investment property are netted against one another on Form 4797 and Schedule D, respectively. These topics are discussed later in the textbook in Chapters 7 and 11, respectively.

   Instructors also can decide whether to show students Schedule A when discussing the various types of itemized deductions. This visualization may help some students better recall these deductions when they are discussed in greater detail in Chapters 5 and 6.

Solutions to Questions and Problems

1. Our income tax system has many objectives. Some of them are to:

   (1) Encourage or discourage certain types of behavior.

   (2) Distribute the country's wealth.

   (3) Encourage economic growth and full employment. ¶101.

2. The basic formula for calculating taxable income is the same for all taxpayers. However, individual taxpayers have an expanded formula. The two formulas are compared below. ¶102.

	Basic	Expanded
Total income	$xxx	$xxx
Less: Exempt income	(xxx)	(xxx)
Gross income	$xxx	$xxx
Less: Deductions	(xxx)	
Deductions for AGI		(xxx)
AGI		$xxx
Less: Deductions from AGI:		
Standard deduction or itemized deductions		(xxx)
qualified business income deduction		(xxx)
Taxable income	$xxx	$xxx

3. Not necessarily. The Code's definition of gross income states that it includes all wealth that flows to the taxpayer from whatever source derived, including, but not limited to, the following items. It then goes on to list items that are part of gross income. Items that are not in the list can also be part of gross income. To exclude an item from gross income, a taxpayer must be able to cite some authority. The authority could be the Code, Treasury Regulations, or a court ruling. The IRS can also issue rulings that could exclude major items from reported gross income. ¶104.

4. Medical expenses, taxes, interest, and charitable contributions. ¶105.02.

5. Married taxpayers who file married filing separately must claim a standard deduction of $0 if their spouses choose to itemize deductions on their income tax returns. ¶106.

6. Itemized deductions are subtracted from adjusted gross income to determine taxable income. To minimize the tax, taxpayers should claim the greater of their itemized deductions or their total standard deduction. ¶105.02.

7. The additional standard deduction is available to those taxpayers who are at least 65 years old or blind. It applies only to taxpayer (and spouse on a joint return). In 2019, married taxpayers and qualifying widow(er) taxpayers get $1,300 for each occurrence of age and blindness. Single or head of household taxpayers get $1,650 for each occurrence. ¶106.02.

8. a. $4,150. As a dependent, Bryce's standard deduction is the greater of (i) $1,100 or (ii) earned income plus $350. Thus, his standard deduction is $4,150 ($3,800 + $350). ¶106.03.

   b. $6,850. Since Bryce's earned income of did not exceed the maximum standard deduction for taxpayers filing single ($12,200), his standard deduction $6,850 ($6,500 + $350). ¶106.03.

   c. $13,500. The basic standard deduction for married persons filing separately is $12,200. This amount is increased by the additional standard deduction for taxpayers over the age of 64 ($1,300). ¶106.02.

   d. $2,750. A dependent's standard deduction is the greater of (i) $1,100 or (ii) earned income plus $350. This amount is increased by any additional standard deduction for which the dependent qualifies. Juliet has no earned income. Consequently, her standard deduction is the basic deduction ($1,100) plus the additional deduction for blindness ($1,650), for a total of $2,750. ¶106.03.

9. $340,180. ¶103, ¶107.01, ¶107.02, ¶111.

AGI	$365,880
Less: Basic standard deduction for MFJ	(24,400)
Less: Additional standard deduction for age	(1,300)
Less: Exemption deduction (see below)	(0)
Taxable Income	$340,180

10. $306,140. ¶103, ¶107.01, ¶107.02, ¶111.

AGI	$330,540
Less: Basic standard deduction for Qualifying widow(er)	(24,400)
Less: Exemption deduction (see below)	(0)
Taxable Income	$306,140

11. ¶108.01, ¶109.01.

		Qualifying Child?	Qualifying Relative?
a.	Taxpayer's cousin		
b.	Taxpayer's father		X
c.	Taxpayer's foster mother		
d.	Taxpayer's (older) stepsister [1]		X
e.	Taxpayer's (younger) brother-in-law [2]		X
f.	Taxpayer's grandchild	X	X
g.	Taxpayer's (younger) half-brother	X	X
h.	Taxpayer's (younger) nephew related by blood	X	X
i.	Taxpayer's father-in-law (permanent relationship established)		X
j.	Taxpayer's uncle (related by marriage, not blood)		

k.	Taxpayer's son-in-law		X
l.	Taxpayer's grandfather		X
m.	Taxpayer's mother-in-law (permanent relationship established)		X

[1] A qualifying child must be younger than the taxpayer.
[2] This person would be a qualifying child to the taxpayer's spouse, but not the taxpayer.

12. a. Single. ¶112.05.

b. Married filing separately or married filing jointly (but only the latter if the couple filed a joint return to claim a refund of all taxes withheld, and otherwise no return is required). ¶112.02.

c. Married filing jointly or married filing separately. ¶112.01, ¶112.02.

d. Qualifying widow(er). ¶112.03.

e. Single. ¶112.05.

f. Head of household (abandoned spouse). ¶112.04.

g. Head of household. ¶112.04.

h. Married filing separately. ¶112.02.

i. Head of household. ¶112.04.

13. Yes. Grace provides over 50% of her dependent mother's household costs for the year. Parents do not have to live with the taxpayer for the taxpayer to qualify as head of household. ¶112.04.

14. a. Yes. Andy's gross income of $3,590 ($3,190 + $400) exceeds his threshold filing requirement. Since Andy's earned income is $3,190, his threshold for filing is $3,540 (earned income + $350). For dependents who are blind or elderly, the threshold increases by the allowable additional standard deduction. ¶113.02.

b. Yes. Self-employed persons must file a return when they have net earnings from self-employment of at least $400. Marla's net earnings from self-employment are $415. Thus, Marla must file a tax return even though she does not meet the $1,100 gross income threshold to file a return. ¶113.01.

c. No. Since Todd is not a full-time student in the current year, he fails the gross income requirement, and his parents cannot claim him as a dependent. The gross income threshold for nondependents is $12,200 (see Figure 1-2), which is more than Todd's gross income. However, if income taxes were withheld from Todd's wages, he should file for a refund of withheld taxes. Even if no income taxes were withheld from Todd's wages, he could still file a return so that three years after the return's due date (April 15, 2020), Todd's 2019 tax year will close at the normal closing date (April 15, 2023). ¶113.02.

15. A fiscal year is any 12-month period ending on the last day of a calendar month other than December. Although individual taxpayers can elect to use the fiscal year, most use the calendar year. Corporations and partnerships are the largest users of a fiscal year end. ¶114.

16. a. A tax year normally closes three years after the later of the due date of a tax return or its filing date. Since the taxpayer's return was filed before its due date, the 2019 tax year closes at midnight on April 15, 2023. Although a revenue agent can examine records for 2019 and prior years to determine the basis of property, a revenue agent normally cannot adjust the tax for 2019 after April 15, 2023. However, if the agent discovers a substantial amount of gross income has been omitted from the taxpayer's filed return, the three-year closing rule is extended to six years. See the answer to part (b) below. ¶115.01.

    b. If more than 25% of the gross income as reported on a taxpayer's return is inadvertently omitted from the return, three years are added to the normal closing date. To apply this test, total all gross income reported on a taxpayer's filed tax return. Multiply this amount by 25%. If the omitted gross income is more than this amount, the six-year closing rule applies. ¶115.01.

17. ¶113.02.

    a. (1) Standard deduction = $12,200 (for single taxpayers). (2) Gross income threshold = $12,200 ($12,200 standard deduction).

    b. (1) Standard deduction = $4,400 ($1,100 limited basic standard deduction + $1,650 additional standard deduction for age + $1,650 additional standard deduction for blindness). (2) Since Maggie is claimed as a dependent, she must file a tax return in 2019 if either her gross income or unearned income exceeds $4,400 ($1,100 + $1,650 + $1,650). When a taxpayer is claimed as a dependent, both the age and blindness additional standard deductions are taken into consideration when determining the dependent's gross income threshold.

    c. (1) Standard deduction = $15,500 ($12,200 basic standard deduction + $1,650 for age + $1,650 for blindness). (2) Gross income threshold = $13,600 ($12,200 basic standard deduction + $1,650 additional standard deduction for age). Because Maggie is not claimed as a dependent, the additional standard deduction for blindness is not taken into consideration when determining her gross income threshold.

    d. (1) Standard deduction = $27,000 ($24,400 basic standard deduction for MFJ + $2,600 additional deduction for age). For tax purposes, Jeannie turns 65 on December 31, 2019. (2) Gross income threshold = $27,000 ($27,000 standard deduction).

    e. (1) Standard deduction = $13,500($12,200 basic standard deduction for MFS + $1,300 additional standard deduction for blindness). (2) If Sally is not a dependent on another person's tax return, her gross income threshold is $0. However, if Sally is claimed as a dependent and her husband itemizes, Sally's gross income threshold is $0.

    f. (1) Standard deduction = $25,700 ($24,400 basic standard deduction for MFJ + $1,300 additional standard deduction for Joe's age). (2) Gross income threshold = $25,300 ($25,250 standard deduction). When filing a joint return in the year of his spouse's death, Joe files a joint return with his deceased spouse.

18. Although Wendy does not prepare her own return, a knowledge of the tax laws could prove beneficial. In addition to helping her identify data needed by her preparer each year, her additional knowledge may help in understanding the completed return. It will also mean that she can review the completed return for omissions or errors. Probably the most important reason for acquiring more tax knowledge is to improve her tax problem recognition skills. Recognizing a potential tax problem before a transaction takes place means tax planning may be possible to minimize the tax bite. ¶116.01.

19. a. Tax planning is the process of analyzing in advance the tax consequences of taxable transactions that affect a taxpayer and the taxpayer's family. The planning should be done far enough in advance to enable the taxpayer to take actions that will affect the amount and timing of tax liabilities (current year and future years). Short-term tax planning usually covers one to three years. Long-term tax planning may involve an extended period of time. ¶116.

    b. The primary reason for tax planning is to minimize the income tax liability. The objective should be to pay the least legal amount of income tax at the latest possible time. ¶116.

    c. Three tax planning principles that will help a taxpayer to minimize the tax liability are:

       (1) Having a working knowledge of the tax laws (or seek tax advice from a tax expert).

       (2) Planning taxable transactions in advance to benefit from their timing and tax impact.

       (3) Keeping good records. ¶116.

    d. If total itemized deductions are about equal to the taxpayer's standard deduction, it is possible to minimize the tax liability by alternating from year to year between itemized deductions and the standard deduction. This process involves bunching controllable deductions in one year, such as charitable contributions, medical expenses, and quarterly state income tax payments, and then using the standard deduction the next year. ¶116.

