

## CHAPTER 8

### TAXATION OF INDIVIDUALS

2017 Edition	Topic	Status
<b>Questions</b>		
1	Discuss the difference between a personal and dependency exemption	Unchanged
2	What tests must be met to be considered a dependent as a qualifying child or as a qualifying relative	Unchanged
3	Exemption for child when parents are divorced	Unchanged
4	Multiple support agreements	Unchanged
5	What is the importance of filing status	Unchanged
6	Requirements to be a surviving spouse	Unchanged
7	When can a married person file as head of households	Unchanged
8	Difference between deductions FOR adjusted gross income and FROM adjusted gross income	Unchanged
9	Explain the standard deduction	Unchanged
10	Can another taxpayer's expenses be deducted	Unchanged
11	Limitations on medical expenses	Unchanged
12	What is an ad valorem tax	Unchanged
13	Type of interest and limitations on interest deductions	Unchanged
14	When can points be deducted	Unchanged
15	Reason why interest on municipal bonds is not deductible	Unchanged
16	Limitations on the deduction for charitable contributions	Unchanged
17	Charitable contribution - ordinary income property versus long-term capital gain property	Unchanged
18	Limitations on miscellaneous itemized deductions	Unchanged
19	Purpose for the itemized deduction and exemption phase-outs	Unchanged
20	Explain how the itemized deduction phase-out works	Unchanged
21	Standard deduction for a dependent filing a tax return	Unchanged
22	Purpose of the kiddie tax	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
23	Explain who can claim a child tax credit	Unchanged
24	General requirements for the earned income credit	Unchanged
25	Explain if child tax credit is refundable	Unchanged
26	General requirements for the child and dependent care credit	Unchanged
27	Explain whether the child care credit promotes a progressive tax rate structure	Unchanged
28	Compare and contrast the Hope Scholarship Tax Credit and Lifetime Learning Tax Credit	Unchanged
29	Who must file a tax return	Unchanged
<b>Problems</b>		
30	Determine if an individual qualifies as a dependent - four scenarios	Unchanged
31	Determine if an individual qualifies as a dependent - five scenarios	Unchanged
32	Determine the taxpayer's filing status - five scenarios	Unchanged
33	Determine the taxpayer's filing status - five scenarios	Unchanged
34	Comparing total itemized deductions versus standard deduction - four scenarios	Unchanged
35	Comparing total itemized deductions versus standard deduction - six scenarios	Unchanged
36	Determining taxable income and income tax	Unchanged
37	Determining taxable income and income tax	Unchanged
38	Determining deduction for medical expenses	Unchanged
39	Determining deduction for medical expense	Unchanged
<b>40</b>	<b>Determining state income tax deduction</b>	<b>New</b>
41	Determining deduction for state taxes	Unchanged
42	Determining deduction for state taxes	Unchanged
43	Determining deduction for state taxes	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
44	Determining deduction for real estate, impact of real estate taxes on basis of property	Unchanged
45	Determining deduction for home mortgage insurance premiums	Modified
46	Determining deductibility of points paid on refinancing	Unchanged
47	Determining deductibility of home mortgage and home equity interest	Unchanged
48	Determining deduction for home mortgage interest	Unchanged
<b>49-COMM</b>	Determining deduction for interest on a car loan	Unchanged
<i>50-CT</i>	Determining deduction for investment interest	Unchanged
<b>51-COMM</b>	Determining deduction for investment interest	Unchanged
52	Determining deduction for investment interest	Unchanged
53	Determining charitable contribution deduction ordinary income versus capital gain property	Unchanged
54	Determining if an item qualifies as a charitable contribution - four scenarios	Unchanged
<i>55-CT</i>	Determining whether to treat a charitable contribution as ordinary income property or capital gain property	Unchanged
56	Unreimbursed employee business expenses accountable versus nonaccountable plan	Unchanged
57	Determining the amount of miscellaneous itemized deductions	Unchanged
58	Deduction of hobby expenses	Unchanged
59	Personal casualty and theft loss	Unchanged
<b>60-COMM</b>	Business and personal casualty and theft loss	Unchanged
61	Phase-out of itemized deductions and personal exemption	Unchanged
62	Phase-out of itemized deductions and personal exemption	Unchanged
63	Calculating taxable income for a dependent - six scenarios	Unchanged
64	Calculating income tax - six scenarios (Relates to #58).	Unchanged
65	Calculating 2015 income tax liability and tax refund or balance due - four scenarios	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
66	Calculate the maximum child tax credit	Unchanged
67	Calculate the maximum child tax credit	Unchanged
68	Interaction of child tax credit and earned income tax credit	Unchanged
69	2015 Earned income credit - four scenarios	Unchanged
70	2015 Earned income credit - four scenarios	Unchanged
71	Child and dependent care credit - five scenarios	Unchanged
72	Child and dependent care credit - five scenarios	Unchanged
73	Calculate the maximum higher education tax credit	Modified
74	Calculate the maximum higher education tax credit	Modified
75	Determining if a taxpayer must file a return - five scenarios	Unchanged
76	Determining if a taxpayer must file a return - five scenarios	Unchanged
77-IID	Determining whether taxpayer is dependent	Unchanged
78-IID	Determining whether taxpayer is dependent and filing status	Unchanged
79-IID	Filing status	Unchanged
80-IID	Qualified medical expense	Unchanged
81-IID	Deduction of state income tax	Unchanged
82-IID	Interest on a tax deficiency	Unchanged
83-IID	Home mortgage interest	Unchanged
84-IID	Home equity interest	Unchanged
85-IID	Investment interest	Unchanged
86-IID	Charitable contribution of stock	Unchanged
87-IID	Personal casualty loss	Unchanged
88-IID	Education expenses and education credits	Unchanged
89	TAX SIMULATION	Unchanged
90	INTERNET	Unchanged
91	INTERNET	Unchanged

2017 Edition	Topic	Status
92	Research Problem	Unchanged
93	Research Problem	Unchanged
94	Spreadsheet Problem	Unchanged
95	Tax Form Problem	Unchanged
96	Integrative Tax Form Problem	Unchanged
97-INT	Integrative Problem - Can be done as a tax return problem	Unchanged
98-INT	Integrative Problem - Can be done as a tax return problem (Continuation of Chapter 4, #86). <b>Please see Instructor's Note if assigning this problem.</b>	Unchanged
99-DC	Argue why some expenses that are deductions FROM adjusted gross income should be deductions FOR and vice-versa	Unchanged
100-DC -CT	Deductibility of medical insurance premiums - self-employed taxpayer versus employee	Unchanged
101-TPC- COMM	Determining whether to treat a charitable contribution as ordinary income property or capital gain property	Unchanged
102-TPC- COMM	Examines the net after tax cash flow and other benefits of nonworking spouse returning to the workplace	Unchanged
103-TPC- COMM	Evaluating the tax consequences of different funding sources in paying higher education costs	Unchanged
104-EDC- COMM	Responsibility of tax preparer when client alters a return prepared by the taxpayer - scenario utilizes SSTs # 7	Unchanged

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## CHAPTER 8

### TAXATION OF INDIVIDUALS

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#### DISCUSSION QUESTIONS

1. What is the difference between a personal exemption and a dependency exemption? Are all taxpayers allowed a personal exemption?

**Both types of exemptions are worth the same amount in terms of a deduction. Personal exemptions are allowed to the taxpayer(s) filing the return (this can never be greater than two), while dependency exemptions are allowed for those individuals who qualify as a taxpayer's dependent.**

**Not all taxpayers are entitled to a personal exemption. A taxpayer that is claimed as a dependent of another is not allowed a personal exemption deduction. The effect of this provision is to allow only 1 exemption deduction per individual. Note: If there is total tax compliance, then the total number of exemptions taken equals the total U.S. population. However, two factors, administrative convenience and tax evasion, prevent this from happening. For purposes of administrative convenience, the government does not require every taxpayer to file a return. Other taxpayers who are required to file a return choose not to file -- tax evasion.**

2. What are the five tests that must met for an individual to be considered a dependent as a qualifying child? as a qualifying relative? Briefly explain each test.

**The 5 qualifying child tests are:**

1. **Age Test.** To meet the age test, the individual must be under the age of 19 at the end of the year, a full-time student under the age of 24 at the end of the year, or be permanently and totally disabled.
2. **Non-Support Test.** To meet the support test, the individual being claimed as a dependent must not have provided more than one-half of their support.
3. **Relationship Test.** Under the relationship test an individual must be the taxpayer's son, daughter, stepson, stepdaughter, eligible foster child or decedent of such a child, or the taxpayer's brother, sister, stepbrother, stepsister or any descendant of any such relative.
4. **Principal Residence Test.** To meet the principal residence test, the individual must live with the taxpayer for more than one-half of the year. Temporary absences due to illness, vacation, education, military service or other special circumstances are not considered as time living away from the principal residence.
5. **Citizenship or Residency Test.** Under the citizenship or residency test, the child must be a citizen of the United States, or a resident of the United States, Canada or Mexico.

The 5 qualifying relative tests are:

1. **Gross Income Test** - the gross income of a dependent cannot exceed the amount of the exemption deduction.
2. **Support Test** - the taxpayer seeking the exemption must pay more than 1/2 of the amount spent on the dependents support. Only amounts spent on support are considered in this test, not the amounts the dependent may have earned but did not spend on support.
3. **Relationship or Member of Household Test** - the dependent must be either a relative or a member of the taxpayer's household for the entire year. A relative is defined as lineal descendants (ancestor, daughter) and blood relatives (aunt, nephew).
4. **Citizen or Residency Test** - a dependent must be either a U.S. citizen or a resident of the U.S., Canada, or Mexico for at least part of the year.
5. **Joint Return Test** - a dependent cannot file a joint return, unless the only purpose for filing the return is to obtain a refund of taxes paid-in. That is, they are not required to file under the filing requirements.

3. Which parent is entitled to claim the dependency exemption for a child when the parents are divorced? Can the other parent ever claim the dependency exemption?

**The custodial parent is entitled to the deduction, regardless of the level of support the non-custodial parent may provide. There are 2 possible ways that the non-custodial parent can claim the exemption deduction. First, the divorce decree may specify that the non-custodial parent is entitled to the dependency exemption(s). Second, the custodial parent can give the deduction to the non-custodial parent by written agreement. The agreement must be attached to the non-custodial parent's tax return.**

4. What is a multiple support agreement? When is a multiple support agreement necessary?

**A multiple support agreement is an agreement among 2 or more individuals to allow one of the individuals to take a dependency deduction for an individual that meets all of the dependency tests except the support test.**

**A multiple support agreement is necessary when all of the dependency tests are met except the support test. That is, two or more people provide more than 1/2 of the support of another, but no one individual provides more than 1/2 of the support.**

5. Why is a taxpayer's filing status important?

**Filing status is important because it determines which tax rate schedule the taxpayer must use to calculate the tax, the amount of the standard deduction, and the income level at which the phase-out of the exemption deduction begins.**

6. What is a surviving spouse? Explain the tax benefit available to a surviving spouse.

**A surviving spouse is a single taxpayer whose spouse died within the last two years and who has a dependent child living in the home.**

**The tax benefit is that a surviving spouse files using the same tax benefits as a married couple filing jointly receives for two years following the year of death. In the year of the spouse's death, a joint return is filed. This provides a surviving spouse with a larger standard deduction and lower average tax rates than the individual would have received under the head of household filing status.**

7. Under what circumstances can a married person file as a head-of-household?

**The tax law allows an abandoned spouse to file as a head of household. To qualify, the taxpayer must be married at the end of the year, have a dependent child living in the home for more than 1/2 the year, and the taxpayer's spouse has not lived in the home during the last 6 months of the year.**

8. What is(are) the main difference(s) between deductions for AGI and deductions from AGI?

**The primary difference between the two types of deductions is that FOR AGI deductions are closely related to the earning of income, while most deductions FROM AGI are specifically allowable personal expenditures. In addition, there is no minimum deduction amount allowed FOR AGI; only actual expenses are deductible. In contrast, a minimum amount of deduction FROM AGI is allowed through the standard deduction. Some FROM AGI deductions are limited to only the excess of deductible expenses minus a percentage of AGI. For example, medical deductions are limited to the excess of allowable expenses over 10% of AGI. For taxpayers 65 and over, the excess of allowable expenses is 7.5% of AGI.**

9. What is the standard deduction? Explain its relationship to a taxpayer's itemized deductions.

**The standard deduction is the minimum amount of deduction allowed from adjusted gross income for a particular filing status. Therefore, taxpayers will only itemize their deductions when the amount of their allowable itemized deductions exceeds their standard deduction.**

10. One general requirement for deduction is that the expense be the taxpayer's, not that of another. Is this always true? Explain.

**The only exception to the requirement that a deductible expense must be the taxpayer's is for medical expenses of a dependent. This allows a taxpayer to obtain a deduction for the payment of their dependent's medical expenses. To qualify as a dependent for medical expense purposes, the gross income and joint return tests do not have to be met.**



11. Explain the limitations placed on deductions for medical expenses.

**Medical expenses are limited to those costs that directly relate to the diagnosis, cure, mitigation, treatment, or prevention of diseases or which affect the structure or function of the body. Prescription drugs and insulin are the only allowable drugs that can be deducted for medical expenses. The total allowable unreimbursed medical costs are limited to the amount in excess of 10% of the taxpayer's adjusted gross income. Thus, no deduction is allowed until a taxpayer's total qualified unreimbursed expenses exceed the 10% AGI limit. For taxpayers 65 and over, the excess of allowable expenses is 7.5% of AGI.**

12. What is an ad valorem tax? What is the significance of an ad valorem tax?

**An ad valorem tax is a tax based on the value of the property being taxed. The significance is that the itemized deduction for property taxes allows only ad valorem property taxes to be deducted.**

13. Which types of interest are deductible as itemized deductions? What limitations (if any) are imposed on the deduction?

**Itemized deductions for interest are limited to home mortgage interest and investment interest. Home mortgage interest is limited to the interest paid on up to \$1,000,000 dollars in acquisition debt on up to two residences of the taxpayer. In addition, interest on up to \$100,000 of home equity loan debt is deductible mortgage interest. Any interest paid on amounts in excess of the limits is considered to be personal nondeductible interest.**

**Premiums paid or accrued for qualified mortgage insurance in connection with qualified acquisition indebtedness on the taxpayer's residence are deductible as qualified home mortgage interest if the premiums are paid or accrued on or before December 31, 2017. However, the deductible amount is phased out by 10% for each \$1,000 (or portion thereof) that the taxpayer's adjusted gross income (AGI) exceeds \$100,000. For taxpayers that are married filing separately, the phase-out is 10% for each \$500 (or portion thereof) that the taxpayer's adjusted gross income (AGI) exceeds \$100,000.**

**Investment interest is limited to the net investment income of the taxpayer. Any interest in excess of the limit may be carried forward and used in future years. Net investment income is defined as investment income minus investment expenses (other than interest). The amount of investment expense is the amount that is deductible after considering the 2% of AGI limit on miscellaneous itemized deductions.**

14. In what year(s) are points paid to acquire a loan deductible? Explain.

**Points are prepaid interest. As such, they must be allocated over the term of the loan. The only exception to this treatment is for points paid to acquire a home mortgage, which is deductible in the year the points are paid. However, points paid to refinance an existing mortgage must be amortized over the term of the new loan.**

15. Why is interest paid on a loan used to purchase municipal bonds not deductible?

**The interest earned on municipal bonds is excluded from gross income. Because the income is excluded, a deduction is not necessary for the interest expense on these investments to ensure that the taxpayer has the ability to pay the tax on the income. Allowing a deduction for the interest on municipal bonds would provide a double tax benefit to such investments.**

16. What limits are placed on deductions for charitable contributions?

**Charitable contributions are limited to a maximum of 50% of the taxpayer's adjusted gross income. In addition, long-term capital gain property that is valued at fair market value is limited to a maximum of 30% of adjusted gross income. Deductions to certain private non-operating foundations are limited to a maximum of 20% of adjusted gross income. Any amounts in excess of the limits are carried forward for five years and applied to the carryforward years' limitation after the current years' contributions have been applied.**

17. Explain how the deduction allowed for a charitable contribution of ordinary income property is different from the deduction for the donation of long-term capital gain property.

**The contribution for ordinary income property is limited to the lesser of the property's fair market value at the date of the gift or the property's adjusted basis. Therefore, any appreciation in the value of ordinary income property is not allowed as a deduction. Long-term capital gain property may be valued at fair market value. Thus, appreciation in the value of a long-term capital gain property is allowed as a deduction (and is not subject to tax). However, any property valued at fair market value is limited to a maximum deduction of 30% of adjusted gross income. The taxpayer can elect to treat the long-term capital gain property as ordinary income property (i.e., value of the property at its adjusted basis) and be subject to the 50% limitation.**

18. What limitations are placed on miscellaneous itemized deductions?

**Miscellaneous itemized deductions, other than those allowed for gambling losses (limited to gambling winnings), impairment related work expenses of a handicapped person, and the unrecovered investment in an annuity contract, are limited to the amount in excess of 2% of the taxpayer's adjusted gross income.**

19. The itemized deduction and exemption phase-outs are an example of what concepts?

**The purpose of the phase-out is to reduce the itemized and exemption deductions for higher income taxpayers. The theory is that these taxpayers, depending on their filing status, have a greater ability to pay tax and therefore have less need for the itemized and exemption deductions than those taxpayers below the phase-out thresholds.**

20. Explain the operation of the itemized deduction phase-out. What stops a taxpayer from losing all itemized deductions under the phase-out?

**The itemized deduction phase-out reduces the total amount of a taxpayer's itemized deductions when their adjusted gross income reaches a pre-specified level based on their filing status. A taxpayer is single, with an adjusted gross income in excess of \$259,400 must reduce their otherwise-allowable itemized deductions by 3 percent of their adjusted gross income in excess of \$259,400. Two things stop a taxpayer from losing all of their itemized deductions. First, medical expenses, gambling losses, investment interest and casualty losses are exempt from the phase-out. Second, the remaining deductions can only be reduced a maximum of 80% (i.e. at least 20% of other itemized deductions are always allowed).**

21. What is the standard deduction amount for a dependent? Under what conditions can a dependent claim the same standard deduction as a single individual who is not a dependent?

**The standard deduction for a dependent in 2016 is the greater of 1) \$1,050, or 2) the dependents earned income (up to the individual standard deduction amount) + \$350. Under this formula, the standard deduction for a dependent will never be less than \$1,050 or exceed \$6,300 (the 2016 standard deduction).**

22. Why did Congress enact the "kiddie tax"?

**Congress enacted the kiddie tax to prevent high-income taxpayers (parents) from shifting unearned income to low income taxpayers (children). The law prevents this from occurring by taxing the net unearned income of children under 18 and full-time students under the age of 24 at the parents marginal tax rate. Net unearned income is defined as the child's unearned income minus \$1,050 minus the greater of itemized deductions or the standard deduction on unearned income (\$1,050). As a general rule, unearned income in excess of \$2,100 is taxed at the parent's marginal tax rate.**

**Although not specifically stated by Congress, the kiddie tax rules are an extension of the assignment of income doctrine. These rules help to ensure that the progressive tax rate structure and the ability to pay concept are maintained. However, in making the tax system "more" progressive, the kiddie tax adds a level of complexity to the tax system that hinders administrative convenience.**

23. Can all taxpayers who claim a child as a dependent receive a child tax credit for that child? Explain.

**A taxpayer can claim a \$1,000 tax credit for each qualifying child. The definition of a qualifying child is similar to the definition of a child for dependency purposes except that the child must be under age 17 at the end of the tax year and a citizen or resident of U.S.**

**The credit is phased-out at a rate of \$50 for each \$1,000 of income (or fraction thereof) that a married taxpayer's adjusted gross income exceeds \$110,000. The phase-out for taxpayers filing as single or head of household begins at \$75,000.**

24. What are the general criteria for eligibility for the earned income credit?

**The earned income tax credit (EIC) provides tax relief to low-income taxpayers. To qualify for the credit the taxpayer must meet the following four tests:**

- 1. The taxpayer's principal place of abode for more than one-half of the year must be in the United States.**
- 2. The taxpayer or the taxpayer's spouse must be older than 25 but not older than 65.**
- 3. The taxpayer or taxpayer's spouse cannot be a dependent of another taxpayer.**
- 4. The taxpayer cannot have portfolio or passive income in excess of \$3,400 (\$3,400 in 2015).**

25. Is the child credit refundable? Explain.

**For all families, a portion of the child credit may be refundable. The amount of the child credit that is refundable depends on the number of qualifying children in the family. For families with 1 or 2 qualifying children, the refundable credit is calculated as follows:**

**Maximum refundable credit = 15% x (earned income - \$3,000)**

**However, the amount refunded cannot exceed the amount of the credit remaining after reducing the tax liability to zero. For families with 3 or more qualifying children, the maximum credit is the greater of the amount calculated using the formula for 1 or 2 qualifying children or the following formula:**

**Maximum refundable credit = Social Security tax paid - earned income credit**

**Generally, a taxpayer with 3 or more qualifying children will only benefit from the second formula if the taxpayer is ineligible for the earned income credit due to excessive unearned income.**

26. What are the general criteria for eligibility for the child- and dependent-care credit?

**A taxpayer who pays someone to care for any dependent younger than 13 and/or other dependent that is physically or mentally incapacitated so that the taxpayer can work is eligible for a credit based on the amount of their expenses and their earned income level. In addition, a taxpayer can claim the child-and dependent-care credit for a dependent who lives with the taxpayer for more than one-half the year, even if the taxpayer does not provide more than one-half of the cost of maintaining the household. The maximum credit is 35% and is reduced by 1% for each \$2,000 (or portion thereof) of AGI in excess of \$15,000. The maximum reduction is limited to 15 percent, leaving a minimum allowable credit of 20 percent. The minimum credit limit is reached when the taxpayer's AGI exceeds \$43,000. The maximum amount of qualifying expenses is \$3,000 for one qualifying individual and \$6,000 for 2 or more qualifying individuals. The expenditures qualifying for the credit cannot exceed the earned income of the taxpayer. For married taxpayers, the lower earned income is used for the purpose of the limit.**

**To qualify for the credit, two conditions must be met:**

- 1. The taxpayer must incur employment-related expenses**
- 2. The expenses must be for the care of qualified individuals**

27. Does the child-care credit help promote a progressive tax rate structure? Explain.

**A tax credit reduces the tax liability of a taxpayer dollar for dollar and is neutral with respect to the marginal tax rate of the taxpayer. That is, unlike tax deductions, a \$200 tax credit reduces a taxpayer's liability by \$200 regardless of their marginal tax rate bracket.**

**Unlike most credits, the child care credit attempts to foster a progressive tax rate structure by reducing the maximum child-care credit percentage from 35% to a minimum credit of 20%. The credit is multiplied by the taxpayer's child-care expenses to determine the allowable child care credit. The child-care credit reduces the maximum credit by 1% for every dollar of adjusted gross income in excess of \$15,000. However, the credit is never reduced below 20%. Therefore, all taxpayers with adjusted gross income greater than \$43,000 and who have the same amount of child-care expenses receive the same amount of credit.**

**The credit also fosters a progressive tax structure by increasing and capping the amount of qualified expenses depending upon the number of qualifying individuals. The maximum amount of qualifying expenses is \$3,000 for one qualifying individual and \$6,000 for 2 or more qualifying individuals.**

**Some might argue that the child-care credit system could go further by completely phasing out the credit as adjusted gross income increases. However, for social reasons, Congress has decided to maintain the current system.**

28. Compare and contrast the American Opportunity Tax Credit with the Lifetime Learning Tax Credit.

**The American Opportunity Tax Credit and the Lifetime Learning Tax Credit are similar in that:**

- **The expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer.**
- **A taxpayer can claim the American Opportunity Tax Credit or the Lifetime Learning Tax Credit even if the taxpayer receives a tax-free distribution from a Coverdell Education Savings Account. To prevent a taxpayer from receiving a double benefit, the educational expenses that are paid from the Coverdell Education Savings Account cannot be used in determining the total education expenses for purposes of the American Opportunity Tax Credit or the Lifetime Learning Tax Credit. Recall from Chapter 6 that a tax-free distribution from a Coverdell Education Savings Account can be used to pay for up to \$2,500 of room and board expenses. Therefore, a taxpayer can claim an education tax credit for tuition and fees while using a distribution from a Coverdell Education Savings Account to pay for up to \$2,500 of room and board expenses.**

**The credits differ in that:**

- **The American Opportunity Tax Credit provides for a 100% tax credit on the first \$2,000 of expenses and a 25% tax credit on the next \$2,000 of higher education expenses paid during the year for each qualifying student. This is effectively a maximum of \$2,500 per individual. The Lifetime Learning Tax Credit provides a 20%**

credit for up to \$10,000 of qualified higher education expenses per taxpayer (i.e., per family). This is effectively a maximum of \$2,000 per family.

- The American Opportunity Tax Credit can only be claimed for qualified expenses incurred in the first four years of college. Qualified expenses include tuition, fees, and course materials (e.g., textbooks and course supplies). For the Lifetime Learning Tax Credit, qualified expenses do not include course materials but can be claimed for expenses in any year of college or graduate school. Part-time students also can use the credit, if the course(s) help the student acquire or improve their job skills.
- The American Opportunity Tax Credit is phased-out ratably for married taxpayers with adjusted gross incomes between \$160,000 and \$180,000 and for all other taxpayers when adjusted gross income is between \$80,000 and \$90,000.
- The Lifetime Learning Credit is phased-out ratably for married taxpayers with adjusted gross incomes between \$111,000 and \$131,000 and for all other taxpayers when adjusted gross income is between \$55,000 and \$65,000.

29. What determines who must file a tax return?

Taxpayers must file tax returns based on their gross income level in relation to their allowable standard deduction (including the additional deduction for age, but not for blindness) and personal (but not dependency) exemption amounts. When the gross income exceeds this amount, the taxpayer is required to file a return. In addition, self-employed individuals must file when their net earnings from self-employment exceeds \$400, a married individual filing separately must file when their gross income exceeds \$4,050, and a dependent must file when unearned income is greater than \$1,050. Of course, any taxpayer who has had amounts withheld from their earnings will want to file to obtain a refund, even if they are not required to file under the gross income requirements.

**PROBLEMS**

30. Determine whether each of the following individuals can be claimed as a dependent in the current year. Assume that any tests not mentioned have been satisfied.

- a. Nico is 20 and a full-time college student who receives a scholarship for \$11,000. Tuition, books, and fees total \$15,000. His father gives him an additional \$6,000 to pay for room and board and other living expenses.

**Nico meets all the tests as a qualifying child. Even though he used the scholarship for his support, scholarships are not considered support. Therefore, the non-support test is met and Nico is a dependent.**

- b. Lawrence pays \$7,800 of his mother's living expenses. His mother receives \$3,500 in Social Security benefits and \$4,100 from a qualified employer retirement program, all of which is spent on her support.

**Lawrence's mother fails the gross income test. Her gross income for tax purposes is \$4,100 (pension), which is greater than the \$4,050 exemption amount. The Social Security benefits are not included in gross income because her AGI is less than \$25,000.**

- c. Megan's father has no sources of income. During the year, Megan pays all of her father's support. He is a citizen and resident of Australia.

**Megan's father is not a dependent. The citizen or residency requirement is met if the dependent is a citizen or resident of the United States, Canada, or Mexico for any part of the tax year. Therefore, Megan's father does not meet the residency requirement.**

- d. Tawana and Ralph are married and full-time college students. They are both 22 years old. Tawana works as a model and earns \$4,300 and Ralph earns \$2,100 during the year. Tawana and Ralph are not required to file a joint return and do so only to receive a refund of the taxes withheld on their respective incomes. Tawana's parents give them an additional \$10,000 to help them through college.

**Because Tawana and Ralph are not required to file a joint return, Tawana can be claimed as dependent by her parents under the qualifying child rules. Ralph can also be claimed as a dependent under the qualifying relative rules since his gross income is less than \$4,050. If his gross income exceeded \$4,050, he would not have met the gross income test.**

31. Determine whether each of the following individuals can be claimed as a dependent in the current year. Assume that any tests not mentioned have been satisfied.

- a. Victor gives his mother, Maria, \$10,000 a year to help pay for her food, rent, and other household costs. Her only income is \$8,000 in Social Security benefits.

**Victor's mother is his dependent. The Social Security is not taxable because Maria's adjusted gross income is less than \$25,000. The support test is met because Victor pays more than 50%  $\{10,000 > [50\% \times (\$10,000 + \$8,000)]\}$  of his mother's support.**

- b. Manuel is 22 years old and a full-time student. He lives at home with his parents, who pay \$7,000 in college expenses and other costs to support him. During the year, he earns \$5,600 working as a sales clerk in a department store of which he saves \$600 and spends the rest on his support.

**Manuel is a dependent under the qualifying child rules. He is less than 24 years of age and a full-time student and his parents have met the non-support test since he fails to provide more than one-half of his support.**

- c. Assume the same facts as in part b, except that Manuel is 25 years old.

**Manuel is not dependent of his parents. Because he is over 23 years of age, Manuel fails the age test to be considered a qualifying child. Because his gross income of \$5,600 exceeds the \$4,050 personal exemption amount, he fails the gross income test and is not a qualifying relative.**

- d. Michael and Veronica are divorced in the current year. Michael is required to pay \$400 per month in child support. Veronica has custody of their 4-year-old son and pays the other \$200 per month it costs to support him.

**Veronica receives the exemption. The custodial parent receives the dependency exemption unless the noncustodial parent is entitled to the exemption through a separation agreement or divorce decree or Veronica agrees in writing that Michael can take the exemption deduction. The written agreement must be attached to Michael's tax return.**

- e. Bettina pays all of the support for her father, Salvador, who lives in Mexico City.

**Bettina's father is a dependent. The citizen or residency requirement is met if the dependent is a citizen of the United States or a resident of Canada, or Mexico for any part of the tax year. Therefore, Bettina's father meets the residency requirement.**



32. Determine the filing status in each of the following situations:

- a. Angela is single for most of the year. She marries Tim on December 30.

**Filing status is determined on the last day of the tax year. Angela is married, and must either file jointly with Tim or as married, filing separately.**

- b. Earl is divorced during the current year. Their son lives with Earl's former spouse. Earl lives alone.

**Earl is single. Given the facts, he qualifies as a head of household only if his son is either a qualifying child or qualifying relative and he provided more than 50% of the cost of maintaining the household. Note: This assumes that Earl's son lives with him for more than six months during the year.**

- c. Rita is married to Bob, and they have 2 children, ages 2 and 4, at home. Bob and Rita have a fight in March; Bob leaves and never returns. Rita has no idea where Bob is.

**Assuming that Rita provides more than half of the cost of maintaining the home, she can file as a head of household under the abandoned spouse rule. NOTE: If Bob had left the home after June 30, the last half of the year requirement would not be met and Rita would have to file as married, filing separately. She most likely could not file a joint return as both taxpayers must sign the return.**

- d. Joe is single. He provides all the support for his parents, who live in a nursing home. Joe's parents' only source of income is from Social Security.

**Joe's parents qualify as his dependents. Parents who qualify as dependents do not have to live in the household for Joe to qualify as a head of household.**

- e. Sam's wife died in February of last year. Their children are all of legal age and none lives in the household. Sam has not remarried.

**Sam must file as a single individual. He cannot qualify as either a head of household or a surviving spouse because none of his children live in the home.**

- f. Would your answer to part e change if Sam has a dependent child who still lives in the home?

**Sam may file as a surviving spouse (i.e., at joint return rates, deductions, etc.) because he has a dependent child who still lives in the home. This is only allowed for two years after the year of death.**

33. Determine the 2016 filing status in each of the following situations:

- a. Michaela and Harrison decide to separate on October 12, 2016. Before filing their 2016 tax return on February 18, 2017, Michaela files for and is granted a formal separation agreement.

**Marital status is determined on the last day of the tax year. Because Michaela and Harrison are not legally separated on December 31, they are considered married for 2016. If they cannot agree to file a joint return, each must file a return as married filing separately.**

- b. Simon is single and owns a condominium in Florida. His father lives in the condominium, and Simon receives \$1,000 per year from his father as rent. The total expenses of maintaining the condominium are \$15,000. His father receives a pension of \$25,000 and Social Security benefits of \$8,000.

**Simon is single. To obtain head of household status for support of his father, he must qualify as Simon's dependent. He cannot be treated as a qualifying relative because his gross income (\$25,000) exceeds the \$4,050 personal exemption amount, so he fails the gross income test.**

- c. Nick is 32 years old, single, and a successful investment banker. Peter, Nick's cousin and best friend, has fallen on hard times and lives with Nick. Peter works part-time and earns \$3,000 and lives with Nick for the entire year. Nick pays the entire cost of maintaining the household and provides \$5,000 toward Peter's support.

**Nick qualifies as head of household. Peter is considered a dependent because he meets all five requirements under the qualifying relative test. Even though a cousin does not qualify as a relative, because Peter lives the entire year with Nick, he meets the member of household test.**

- d. Jamal's wife died in 2014. He maintains a household for his twin daughters who are seniors in high school.

**Jamal may file as a surviving spouse (i.e., at joint return rates, deductions, etc.) because he has two dependent children who still live in his home. This filing status is only allowed for 2015 and 2016.**

**Instructor's Note: To be a surviving spouse for 2015 and 2016, at least one of his daughters must still live with him and be a qualifying child or qualifying relative. Beginning in 2017, Jamal's filing status will be head of household.**

- e. Kathy and Sven are married with two children, ages 14 and 12. In June, Kathy leaves Sven and their children. Sven has not heard from Kathy, but a former coworker of Kathy's tells Sven that Kathy wanted to move to Ireland.

**Assuming that Sven provides more than half of the cost of maintaining the home, he can file as a head of household under the abandoned spouse rule. NOTE: If Kathy had left the home after June 30, the last half of the year requirement would not be met and Sven would have to file as married filing separately. He most likely could not file a joint tax return as both taxpayers must sign the return.**

34. Determine the maximum deduction from AGI in 2016 for each of the following taxpayers:

- a. Pedro is single and maintains a household for his father. His father is not a dependent of Pedro's. Pedro's itemized deductions are \$6,400, of which \$800 are for real estate taxes.

**He will use his itemized deductions of \$6,400 because it exceeds the standard deduction of \$6,300 for a single taxpayer.**

- b. Jie and Ling are married. Jie is 66 years old, and Ling is 62. They have itemized deductions of \$13,900.

**They will use their itemized deductions of \$13,900 because it exceeds their standard deduction of \$13,850 (\$12,600 regular standard deduction + \$1,250 additional deduction for Jie being over age 65).**

- c. Myron and Samantha are married, and both are 38 years of age. Samantha is legally blind. They have itemized deductions of \$12,500.

**Their standard deduction is \$13,850 (\$12,600 regular standard deduction + \$1,250 additional deduction for blindness). They will deduct the standard deduction because it is greater than their itemized deductions of \$12,500.**

- d. Joelynn is divorced and maintains a home for her 21-year-old son, who is a part-time student at the local university. He pays less than one-half of his support and his earned income for the year is \$3,900. Her itemized deductions are \$9,000.

**She will use the standard deduction for head of household of \$9,300 because it exceeds her itemized deductions of \$9,000. Joelynn qualifies as head of household because her son's gross income is less than \$4,050 (the personal exemption amount). Therefore, Joelynn would meet all the tests for her son to be considered a qualifying relative.**

- e. Frank is 66 years of age. During the year, his wife dies. His itemized deductions are \$13,700.

**For 2016, Frank is considered married. His standard deduction is \$13,850 (\$12,600 regular standard deduction + \$1,250 additional deduction for being over age 65). He will deduct the standard deduction because it is greater than his itemized deductions of \$13,700.**

- f. Assume the same facts as in part e, except that Frank's wife dies in 2015.

**For 2016, Frank is considered single (he doesn't qualify for surviving spouse because he has no dependent children living in the home). His standard deduction is \$7,850 (\$6,300 regular standard deduction + \$1,550 additional deduction for being over age 65). He will deduct his itemized deductions of \$13,700 because it is greater than his standard deduction. Note: Frank does not receive any benefit (i.e., an increase in his itemized deductions) for being over 65. Being over 65 can only increase his standard deduction.**

35. Determine the maximum deduction from AGI in 2016 for each of the following taxpayers:

- a. Selen is single and has itemized deductions for the year of \$6,500. In addition, Selen's mother lives with her, but she does not claim her mother as a dependent.

**Selen is single. For Selen to file as head of household, her mother would have to be her dependent. She will use her itemized deductions of \$6,500 because it is greater than her standard deduction of \$6,300.**

- b. Amanda and Adam are married. Amanda is 67 years old and is legally blind. Adam is 64 years old. They have itemized deductions of \$14,800.

**Their standard deduction is \$15,100 (\$12,600 regular standard deduction + \$1,250 additional deduction for blindness + \$1,250 additional deduction for being over age 65). They will deduct the standard deduction because it is greater than their itemized deductions of \$14,800.**

- c. Micah and Ilana are married and have two children. In April, they have an argument and Micah leaves Ilana. At year-end, Ilana is unaware of Micah's whereabouts, and no formal divorce proceedings have been initiated. Ilana's itemized deductions total \$9,400.

**Ilana cannot file married, filing joint because Micah must sign the tax return. The tax law does allow her to file as head of household since she meets the requirements of an abandoned spouse. She will use her itemized deductions of \$9,400 because it exceeds her standard deduction of \$9,300.**

- d. Constantino is divorced and maintains a home for his 25-year-old daughter who is a graduate student at a local university and earns \$6,500 during the year. His itemized deductions are \$6,500.

**Constantino must file as single because his daughter does not qualify as his dependent (fails gross income test). He will use his itemized deductions of \$6,500 since it exceeds his standard deduction of \$6,300.**

- e. Helen is 69 and a widow. Her 20-year old grandson, who is a full-time student at the local university, lives with her for the entire year. Her husband, Sam, dies in 2015 at the age of 71. Her itemized deductions are \$10,750.

**For 2016, Helen is a head of household. A taxpayer qualifies as a surviving spouse if the dependent is her child, stepchild, foster child or adopted child. Because the dependent child is her grandson, she does not qualify as a surviving spouse. However, she does qualify as head of household and her standard deduction is \$10,850 (\$9,300 regular standard deduction + \$1,550 additional deduction for being over age 65). She will deduct her standard deduction of \$10,850 because it exceeds her itemized deductions of \$10,750.**

- f. Assume the same facts as in part e, except that Sam dies in 2016.

**For 2016, Helen is married. Her standard deduction is \$15,100 (\$12,600 regular standard deduction + \$2,500 additional deduction for both being over age 65). She will deduct the standard deduction because it is greater than her itemized deductions of \$10,600.**

36. Hongtao is single and has a gross income of \$89,000. His allowable deductions for adjusted gross income are \$4,200 and his itemized deductions are \$12,900.
- a. What is Hongtao's taxable income and tax liability for 2016?

**Hongtao's taxable income is \$67,850:**

Gross income		\$ 89,000
Deductions for AGI		(4,200)
Adjusted gross income		<u>\$ 84,800</u>
Deductions from AGI		
The greater of:		
Standard deduction	\$ 6,300	
or		
Itemized deductions	\$12,900	(12,900)
Personal exemption		(4,050)
Taxable income		<u><u>\$ 67,850</u></u>

Hongtao's tax is \$12,734. From the 2016 tax rate schedule, the tax on \$67,850 is:

$$\$5,183.75 + [25\% \times (\$67,850 - \$37,650)] = \$12,734$$

- b. If Hongtao has \$13,500 withheld from his salary during 2016, is he entitled to a refund or does he owe additional taxes?

**Hongtao has a refund of \$766 (\$12,734 - \$13,500).**

- c. Assume the same facts as in parts a and b, except that Hongtao is married. His wife's salary is \$30,000, and she has \$2,000 withheld from her paycheck. What is their taxable income and tax liability for 2016? Are they entitled to a refund, or do they owe additional taxes?

**Their joint taxable income is \$93,800:**

Gross income (\$89,000 + \$30,000)		\$ 119,000
Deductions for AGI		(4,200)
Adjusted gross income		<u>\$ 114,800</u>
Deductions from AGI		
The greater of:		
Standard deduction	\$12,600	
or		
Itemized deductions	\$12,900	(12,900)
Personal exemption (2 x \$4,050)		(8,100)
Taxable income		<u><u>\$ 93,800</u></u>

Their tax liability is \$14,993. From the 2016 tax rate schedule, the tax on \$93,800 is:

$$\$10,367.50 + [25\% \times (\$93,800 - \$75,300)] = \$14,993$$

**They will receive a refund of \$507 [\$14,993 - (\$13,500 + \$2,000)].**

37. Arthur and Cora are married and have 2 dependent children. They have a gross income of \$95,000. Their allowable deductions for adjusted gross income total \$4,000, and they have total allowable itemized deductions of \$14,250.

- a. What is Arthur and Cora's taxable income?

**Arthur and Cora have a taxable income of \$60,550:**

Gross income		\$ 95,000
Deductions for AGI		(4,000)
Adjusted gross income		<u>\$ 91,000</u>
Deductions from AGI:		
The greater of:		
Itemized deductions	\$ 14,250	
or		
Standard deduction	\$ 12,600	(14,250)
Personal and dependency exemptions (4 x \$4,050)		(16,200)
Taxable income		<u><u>\$ 60,550</u></u>

- b. What is Arthur and Cora's income tax?

**The tax on a married couple filing jointly in 2016 is \$8,155. Their net tax liability after the child tax credit is \$6,155.**

$$\begin{array}{rcl}
 \$1,855 + [15\% \times (\$60,550 - \$18,550)] & = & \$ 8,155 \\
 \text{Less: Child tax credit (2 x \$1,000)} & & (2,000) \\
 \text{Net tax liability} & & \underline{\underline{\$ 6,155}}
 \end{array}$$

- c. If Arthur has \$2,900 and Cora has \$3,600 withheld from their paychecks, are they entitled to a refund, or do they owe additional taxes?

**They are entitled to a refund of \$345 [\$6,155 - (\$2,900 + \$3,600)].**

38. Rebecca and Irving incur the following medical expenses during the current year:

Medical insurance premiums	\$4,500
Hospital	950
Doctors	1,925
Dentist	575
Veterinarian	170
Chiropractor	220
Cosmetic surgery	1,450
Over-the-counter drugs	165
Prescription drugs	195
Crutches	105

They receive \$4,050 in reimbursements from their insurance company of which \$300 is for the cosmetic surgery. What is their medical expense deduction if

- a. Their adjusted gross income is \$44,050?

**Rebecca and Irving's allowable medical costs before reimbursement are \$8,470. The cosmetic surgery, veterinarian fees, and the over-the-counter drugs are not allowable medical expenses. Their unreimbursed medical costs are \$4,770 [\$7,470 - \$3,700 (\$4,050 - \$300)]. The \$4,050 reimbursement is reduced by the \$300 reimbursement for the cosmetic surgery. The \$4,770 of medical expenses is subject to the 10% AGI limitation.**

**Their allowable deduction is \$370:**

Medical insurance premiums	\$ 4,500
Hospital	950
Doctors	1,925
Dentist	575
Chiropractor	220
Prescription drugs	195
Crutches	105
Total Allowable medical expenses	<u>\$ 8,470</u>
Less: Insurance reimbursements	(3,700)
Unreimbursed medical expenses	<u>\$ 4,770</u>
Less: AGI limitation (\$44,050 x 10%)	(4,400)
Medical expense deduction	<u><u>\$ 370</u></u>

- b. Their adjusted gross income is \$51,000?

**No deduction is allowed. The AGI limit is \$5,100 (\$51,000 x 10%), which is greater than their \$4,770 of unreimbursed costs.**

39. Lian is 66 years old and is injured in an automobile accident this year. She is hospitalized for 4 weeks and misses 3 months of work after getting out of the hospital. The costs related to her accident are

Hospitalization	\$ 16,100
Prescription drugs	2,050
Doctor's fees	12,225
Wheelchair rental	380
Visits by home nursing service	2,400

Lian's employer-provided insurance policy pays \$23,220 of the costs. She also receives \$4,800 in disability pay from her employer while she is absent from work. By the end of the year, Lian is able to pay \$6,100 of the costs which aren't covered by her medical insurance. What is Lian's allowed itemized deduction for medical expenses if her adjusted gross income is \$39,000 before considering any of the above information?

**All of the costs incurred are qualified medical expenses. Because Lian is over 65 years old, she is allowed to deduct the amount of her unreimbursed medical expenses that exceed 7.5% of her AGI. Lian's unreimbursed medical expenses are \$9,935. However, as a cash basis taxpayer she can only deduct the \$6,100 in unreimbursed costs she paid in the current year. In addition, she must include in her gross income the \$4,800 of disability pay she received from her employer. This increases her adjusted gross income to \$43,800 (\$39,000 + \$4,800), which gives her a medical expense deduction of \$2,815:**

Allowable medical expenses	\$ 33,155
Less: Insurance reimbursements	(23,220)
Unreimbursed medical expenses	<u>\$ 9,935</u>
Unreimbursed medical expenses paid	\$ 6,100
Less: AGI limitation (\$43,800 x 7.5%)	(3,285)
Medical expense deduction	<u>\$ 2,815</u>

**Note: The remainder of Lian's unreimbursed medical expenses \$3,835 (\$9,935 - \$6,100) are eligible for deduction when the expenses are paid.**



40. Paula lives in Arkansas, a state, which imposes a state income tax. During 2015, she pays the following taxes:

Federal tax withheld	5,125
State income tax withheld	1,900
State sales tax – actual receipts	370
Real estate tax	1,740
Property tax on car (ad valorem)	215
Social Security tax	4,324
Gasoline taxes	124
Excise taxes	112

- a. If Paula's adjusted gross income is \$35,000 what is her allowable deduction for taxes?

**Paula is allowed an itemized deduction for the real estate tax and the property taxes she paid on the car during the current year. In addition, she can elect to deduct the greater of the amount she paid in state income taxes or her sales tax deduction. In determining the amount of her sales tax deduction, Paula deducts the greater of the actual amount paid in sales tax, or the IRS table amount. She can also add to the table amount any taxes she paid to acquire motor vehicles, boats, and other vehicles specified by the IRS. Because the table amount of \$554 is greater than the actual amount of \$370, her sales tax deduction is \$554. Since the amount Paul paid in state income taxes (\$1,900) is greater than her sales tax deduction, Paula would deduct her state income taxes. The Social Security, gasoline, and excise taxes are not allowable taxes. The federal income tax withheld is not a deductible tax, but is a prepayment of Paula's federal tax liability. Paula's deduction for taxes is \$3,855.**

State income tax withheld	\$1,900
Real estate tax	1,740
Property tax on car (ad valorem)	215
Total tax deduction	<u>\$3,855</u>

- b. Assume the same facts as in part a, except that Paula pays \$1,600 in sales tax on a motor vehicle she purchased during the year. What is Paula's allowable deduction for taxes?

**As discussed above, Paula can elect to deduct the greater of the amount she paid in state income taxes or the amount of her sales tax deduction. In determining the amount of her sales tax deduction, Paula would take the greater of the actual amount paid in sales tax \$2,154 (\$554 + \$1,600) or the \$1,900 she paid in state income taxes. Since the total sales tax amount of \$2,095 exceeds the amount Paula paid in state income tax \$1,900 she would elect to deduct her state sales taxes. Paula is allowed to deduct \$4,050.**

State sales tax	\$2,154
Real estate tax	1,740
Property tax on car (ad valorem)	215
Total tax deduction	<u>\$4,109</u>

41. Jesse is a resident of New Jersey who works in New York City. He also owns rental property in South Carolina. During 2016, he pays the following taxes:

New Jersey state estimated tax payments	\$ 850
New York City income tax withheld	440
New York State income tax withheld	1,375
Federal Income tax withheld	6,310
Property tax - New Jersey home	2,110
South Carolina income taxes paid when filing 2015 tax return	220
South Carolina estimated tax payments	400
Gasoline taxes	190
Excise taxes	160

During 2016, Jesse's 2014 New York State and New York City tax returns are audited. Based on the audit, he pays an additional \$250 in New York City taxes but receives a refund of \$185 in New York State taxes. He also has to pay a \$40 penalty and interest of \$12 to New York City. However, he receives interest of \$16 from New York State. What is Jesse's allowable deduction for taxes in 2016?

**Jesse is allowed to deduct, as an itemized deduction, all state and local income taxes and property taxes paid in 2016, regardless of which year they relate to. The gasoline and excise taxes, interest and penalties on the audited tax returns are not allowable taxes. He is allowed to deduct \$5,645, as follows:**

2016 New Jersey state estimated tax payments	\$ 850
2016 New York City income tax withheld	440
2016 New York State income tax withheld	1,375
2016 Property tax - New Jersey home	2,110
2016 South Carolina estimated tax payments	400
South Carolina income taxes paid when filing 2015 tax return	220
New York City income tax paid on audit of 2014 tax return	250
<b>Total taxes paid in 2016</b>	<b><u>\$5,645</u></b>

The federal income tax withheld is not a deductible tax but it is a prepayment of Jesse's federal tax liability.

**Note:** The \$185 refund of New York State taxes received in 2016 is included in 2016 gross income under the tax benefit rule. It is not used to offset the previous year's taxes paid deduction. The interest received is also included as income in 2016.

42. Simon is single and a stockbroker for a large investment bank. During 2016, he has withheld from his paycheck \$2,250 for state taxes and \$400 for city taxes. In June 2017, Simon receives a state tax refund of \$145. What is the proper tax treatment of the refund in 2017 if

- a. Simon uses the standard deduction?

**Because Simon uses the standard deduction (\$6,300) in 2016, he does not have to include the income tax refund in his 2017 taxable income. He would only include the refund or a portion of it, if he had itemized his deductions and deducted more state and city taxes than he actually owed (he received a tax benefit).**

- b. Simon has itemized deductions other than state and city income taxes of \$4,850?

**Simon must include the \$145 income tax refund in his 2017 taxable income. He has deducted \$2,650 in state and city taxes in 2016 when his actual state and city taxes should have been \$2,505 [\$400 + (\$2,250 - \$145 refund)]. Therefore, his total itemized deductions were overstated by \$145 [reported as \$7,500 (\$4,850 + \$2,650) instead of \$7,355 (\$4,850 + \$2,505)].**

- c. Simon has itemized deductions other than state and city income taxes of \$3,700?

**Simon must include \$50 of the income tax refund in his 2017 taxable income. As in part b, Simon has deducted \$2,650 in state and city taxes in 2016 when his actual state and city taxes should have been \$2,505 [\$400 + (\$2,250 - \$145 refund)]. However, even though Simon's reported deductions of \$6,350 (\$2,650 + \$3,700) exceed his actual deductions of \$6,205 (\$3,700 + \$2,505) by \$145, Simon has benefited only by the amount his reported deductions exceed the standard deduction of \$6,300. Remember, at a minimum Simon is entitled to the standard deduction. Therefore, Simon only includes \$50 (\$6,350 - \$6,300) of the tax refund in his income for 2017.**

43. Frank and Liz are married. During 2016, Frank has \$2,800 in state income taxes withheld from his paycheck, and Liz makes estimated tax payments totaling \$2,200. In May 2017, they receive a state tax refund of \$465. What is the proper tax treatment of the refund in 2017 if

- a. They use the standard deduction?

**Because they use the standard deduction (\$12,600) in 2016, they do not have to include the income tax refund in their 2017 taxable income. They would only include the refund or a portion of it, if they had itemized their deductions and deducted more state taxes than they actually owed (i.e., received a tax benefit).**

- b. They have itemized deductions other than state income taxes of \$8,100?

**Frank and Liz must include the \$465 income tax refund in their 2017 taxable income. They deducted \$5,000 (\$2,800 + \$2,200) in state taxes in 2016 when their actual state taxes should have been \$4,535 (\$5,000 - \$465 refund). Therefore, their total itemized deductions were overstated by \$465 [reported as \$13,100 (\$8,100 + \$5,000) instead of \$12,635 (\$8,100 + \$4,535)].**

- c. They have itemized deductions other than state income taxes of \$7,700?

**Frank and Liz must include \$100 of the income tax refund in their 2017 taxable income. As in part b, they have deducted \$5,000 in state taxes in 2016 when their actual state should have been \$4,535 (\$5,000 - \$465 refund). However, even though their reported deductions of \$12,700 (\$5,000 + \$7,700) exceed their actual deductions of \$12,235 (\$4,535 + \$7,700) by \$465, Frank and Liz have benefited only by the amount their reported deductions exceed the standard deduction of \$12,600. Remember, at a minimum they are entitled to the standard deduction. Therefore, they only include \$100 (\$12,700 - \$12,600) of the tax refund in income on their 2017 tax return.**

44. Rocco owns a piece of land as investment property. He acquired the land in 1993 for \$18,000. On June 1, 2016, he sells the land for \$80,000. As part of the sale, the buyer agrees to pay all of the property taxes (\$3,600) for the year.
- a. What is Rocco's gain on the sale of the land?

**Because the buyer paid the real estate tax, the sale price is increased by the amount of Rocco's share of the real estate tax liability assumed by the buyer of the land. The allocation of the real estate taxes is based on the number of days Rocco owned the property during the year (151 days from January 1 to May 31), resulting in the buyer effectively paying Rocco an additional \$1,489 [ $\$3,600 \times (151 \div 365)$ ] for the land. The sales price of the land, after adjustment for the real estate tax, is \$81,489 ( $\$80,000 + \$1,489$ ).**

**Rocco has a gain of \$63,489 on the sale of the land:**

Amount realized	$(\$80,000 + \$1,489)$	\$ 81,489
Adjusted basis		(18,000)
Gain on sale		<u>\$ 63,489</u>

- b. What amount of the property taxes can Rocco deduct? What amount can the buyer deduct?

**Rocco is only allowed to deduct the taxes paid for the portion of the year he owned the land. This allocation is based on the number of days he owned the property during the year (151 days from January 1 to May 31), resulting in a deduction of \$1,489 [ $\$3,600 \times (151 \div 365)$ ].**

**Likewise, the buyer is only allowed to deduct the taxes for the portion of the year (June 1 to December 31) he owned the land. The buyer can deduct \$2,111 ( $\$3,600 - \$1,489$ ) of property taxes.**

- c. What is the buyer's basis in the land?

**The buyer is allowed to increase their basis in the land by the amount of real estate taxes paid on behalf of the seller. Therefore, their basis in the land is \$81,489 ( $\$80,000 + \$1,489$ ).**

**Instructor's Note: Although technically, the allocation is based on the number of days, using 5 months results in approximately the same deduction \$1,500 [ $\$3,600 \times (7 \div 12)$ ]. The \$11 difference ( $\$1,500 - \$1,489$ ) is due to rounding.**

45. Robin purchases a new home costing \$80,000 in the current year. She pays \$8,000 down and borrows the remaining \$72,000 by securing a mortgage on the home. She also pays \$1,750 in closing costs, \$1,600 in points to obtain the mortgage, \$900 in qualified mortgage insurance premiums and pays \$4,440 in interest on the mortgage during the year. Her adjusted gross income is \$78,000.

- a. What is Robin's allowable itemized deduction for interest paid?

**Robin is allowed to deduct the \$4,400 interest paid on the acquisition debt, \$1,600 in points paid to obtain the initial mortgage and the \$900 of qualified mortgage insurance premiums. The total allowable home mortgage interest deduction is \$6,940 (\$4,440 + \$1,600 + \$900). The closing costs are not deductible interest and are added to the basis of the home.**

- b. What is Robin's allowable itemized deduction for interest paid, if her adjusted gross income is \$102,300?

**Robin is allowed to deduct the interest paid on the acquisition debt, \$4,440 and the points paid on the initial mortgage \$1,600. Because her adjusted gross income exceeds \$100,000, Robin must reduce the amount she can deduct for qualified mortgage insurance premiums. Robin must reduce her deduction for qualified mortgage insurance by 10% for each \$1,000 (or fraction thereof) her adjusted gross income exceeds \$100,000. Therefore, she must reduce her deduction by 30%.**

$$\$102,300 - \$100,000 = \frac{\$2,300}{1,000} = 2.3 = 3 \text{ increments}$$

$$\text{Percentage of deduction lost } 3 \times 10\% = 30\%$$

**Her deduction for qualified mortgage insurance premiums is \$630 [\$900 - (\$900 x 30%)]. Her total allowable home mortgage interest deduction is \$6,670 (\$4,440 + \$1,600 + \$630). The closing costs are not deductible interest and are added to the basis of the home.**

46. On March 1, Roxanne acquires a house for \$160,000. She pays \$20,000 down and borrows the remaining \$140,000 by obtaining a 15-year mortgage. Roxanne pays \$3,500 in closing costs and \$2,500 in points in purchasing the house. During the year, she pays \$10,300 of interest on her mortgage.

- a. What is her allowable interest deduction for the year?

**Roxanne is allowed to deduct the interest paid on the acquisition debt, \$10,300, and the points paid to obtain the initial mortgage \$2,500, for a total allowable home mortgage interest deduction of \$12,800. The closing costs are not deductible interest and are added to the basis of the home.**

- b. How would your answer to part a change if Roxanne already owned her home and the points paid on March 1 were for a 15-year mortgage to refinance her existing mortgage?

**Points are only deductible in full in the year paid if they are paid to obtain an initial mortgage. Points paid to refinance an existing mortgage must be amortized over the term of the new loan. In Roxanne's case, the \$2,500 of points are deductible over the 15 year term of the new loan, \$167 ( $\$2,500 \div 15$ ) per year. Because the refinancing occurs in March, she can only amortize 10 months of the points in the current year. Thus, only \$139 [ $\$167 \times (10 \div 12)$ ] is deductible. Her total allowable home mortgage interest deduction is \$10,439 ( $\$10,300 + \$139$ ).**

47. Keith bought his home several years ago for \$110,000. He paid \$10,000 down on the purchase and borrowed the remaining \$100,000. When the home is worth \$230,000 and the balance on his mortgage is \$40,000, Keith borrows \$120,000 using a home equity loan. Keith uses the proceeds of the loan to pay off some gambling debts. During the year, Keith pays \$3,200 in interest on the original home mortgage and \$7,600 in interest on the home equity loan. What is Keith's allowable itemized deduction for interest paid?

**A deduction is allowed for interest paid on acquisition debt of up to \$1,000,000 and on home equity loans secured by the residence up to \$100,000. In addition, the total acquisition debt and home equity debt cannot exceed the fair market value of the property. In this case, the total debt is \$160,000 ( $\$40,000 + \$120,000$ ), which is less than the fair market value. However, only interest on \$100,000 of the home equity loan is deductible, \$6,333 [ $\$7,600 \times (\$100,000 \div \$120,000)$ ]. The remaining \$1,267 of interest is considered personal interest and is not deductible. All of the interest on the original home mortgage, \$3,200, qualifies for deduction. Keith's total interest deduction is \$9,533 ( $\$6,333 + \$3,200$ ).**

**Instructors Note: The proceeds of the home equity loan may be used for any purpose; the only requirement for deductibility of a home equity loan is for the loan to be secured by the residence.**

48. Astrid originally borrowed \$600,000 to acquire her home. When the balance on the original mortgage is \$540,000, she purchases a ski chalet by borrowing \$500,000, which is secured by a mortgage on the chalet. Astrid pays \$45,000 in interest on her home mortgage and \$32,000 in interest on the chalet's mortgage. What is Astrid's allowable itemized deduction for interest paid?

**Interest paid on up to \$1,000,000 of acquisition debt on the taxpayer's principal residence and one other residence may be deducted. In this case, Astrid's total acquisition debt on the two properties is \$1,040,000 (\$540,000 + \$500,000). However, because she has equity in the original home, Astrid's \$500,000 loan on the ski chalet consists of two components \$460,000 of acquisition indebtedness and a \$40,000 home equity loan. Astrid's has an allowable mortgage interest deduction of \$77,000 (\$45,000 + 32,000). Instructor's Note: The solution assumes that the fair market of Astrid's original home is at least \$580,000.**

49. Mandy is interested in purchasing a new automobile for personal use. The dealer is offering a special 1.9% interest rate on new cars. Last fall, she opened a home equity line of credit with her bank. If she uses the line of credit to purchase the car, the interest rate will be 7.95%. Write a letter to Mandy explaining whether she should finance the purchase of her car through the dealer or use her home equity line of credit. Assume Mandy is in the 35% tax bracket.

**Mandy should finance the purchase of her new automobile through the dealer instead of the bank. Even though the interest expense on the home equity loan is tax deductible, while the interest on the loan from the car dealer is nondeductible personal interest, the after-tax cost of the home equity loan is higher. The after-tax interest rate on the home equity loan is 5.17%  $[(1 - .35) \times 7.95\%]$  versus 1.9%  $[(1 - .00) \times 1.90\%]$  if she finances the purchase through the car dealer.**



50. Marjorie is single and has the following investment income:

Interest on savings	\$2,900
Municipal bond interest	1,500
Dividends	7,600

She pays investment interest expense of \$15,000. The interest expense relates to all of the assets in her portfolio.

- a. What is Marjorie's allowable deduction for investment interest?

**Investment interest is limited to net investment income. Marjorie's net investment income is \$2,900 (she has no investment expenses). The \$1,500 of municipal bond interest is excluded from tax and is not investment income for purposes of the investment interest limitation. Dividends receive special tax treatment and are taxed at 15%. Because of the preferential tax treatment, unless Marjorie elects otherwise, the dividends are not included as part of investment income.**

**The \$15,000 of interest is paid to produce \$10,500 of taxable income and \$1,500 of tax-exempt income. The portion of the interest related to the production of the tax-exempt income is not deductible. Therefore, \$1,875 [ $\$15,000 \times (\$1,500 \div \$12,000)$ ] of the interest is not deductible. Marjorie's investment interest expense is \$13,125 ( $\$15,000 - \$1,875$ ). Because this amount exceeds her investment income, Marjorie's investment interest deduction is limited to \$2,900. The remaining \$10,225 ( $\$13,125 - \$2,900$ ) is carried forward to the following year.**

- b. Assume that Marjorie's marginal tax rate is 28%. If she sells stock that produces a long-term capital gain of \$3,000, how will the sale of stock affect her investment interest deduction?

**Marjorie's net investment income remains \$2,900. Long-term capital gain income cannot be counted as investment income if the taxpayer takes advantage of the 15% capital gain rate. Because Marjorie's marginal tax rate is 28%, she will be taking advantage of the favorable 15% tax rate and therefore, cannot include the capital gain income in determining her net investment income.**

**The \$3,000 of capital gain income requires that the amount of deductible interest be recalculated from part a. The \$15,000 of interest now produces \$13,500 ( $\$3,000 + \$10,500$ ) of taxable income and \$1,500 of tax-exempt income. The portion of the interest related to the production of the tax-exempt income is not deductible. Therefore, \$1,500 [ $\$15,000 \times (\$1,500 \div \$15,000)$ ] of the interest is not deductible. Marjorie's investment interest expense is \$13,500 ( $\$15,000 - \$1,500$ ). Because this amount exceeds her investment income, Marjorie's investment interest deduction is limited to \$2,900. The remaining \$10,600 ( $\$13,500 - \$2,900$ ) is carried forward to the following year.**

51. Stoycho and Selen are married. Their marginal tax rate is 28%. They have the following investment income for 2015 and 2016:

	2015	2016
Interest on U.S. Treasury notes	\$ 1,200	\$ 1,400
Cash dividends	3,000	2,200
Interest on savings	2,000	1,500
Interest on State of Montana bonds	800	800
Net long-term capital gain	1,000	500

Their adjusted gross income before considering the investment income is \$84,050 in 2015 and \$73,500 in 2016. Stoycho and Selen pay \$9,000 in investment interest in 2015 and \$5,000 in 2016. The investment interest is incurred to acquire all the investments in their portfolio. Write a letter to Stoycho and Selen explaining how much investment interest they can deduct in 2015 and 2016.

**The investment interest deduction is limited to their net investment income. In 2015, their investment income is \$3,200 (\$1,200 + \$2,000). The interest received on the municipal bonds is tax-exempt and therefore, not allowed for purposes of computing the allowable investment interest deduction. The net long-term capital gain cannot be used in the calculation of gross investment income because it will be taxed at 15%. Dividends receive special tax treatment and are taxed at a maximum rate of 15%. Because of the preferential tax treatment, unless Stoycho and Selen elect otherwise, the dividends are not included as part of investment income.**

**The \$9,000 of interest is paid to produce \$7,200 of taxable income and \$800 of tax-exempt income. The portion of the interest related to the production of the tax-exempt income is not deductible. Therefore, \$900 [ $\$9,000 \times (\$800 \div \$8,000)$ ] of the interest is not deductible. Their investment interest expense is \$8,100 ( $\$9,000 - \$900$ ). Because this amount exceeds their investment income, their investment interest deduction is limited to \$3,200. The remaining \$4,900 ( $\$8,100 - \$3,200$ ) is carried forward to the following year.**

**In 2016, Stoycho and Selen have investment income of \$2,900 (\$1,400 + \$1,500). As in 2015, the interest received on the municipal bonds is tax-exempt and therefore, not allowed for purposes of computing the allowable investment interest deduction. In addition, the dividends and the net long-term capital gain cannot be used in the calculation of gross investment income because it will be taxed at 15%.**

**The \$5,000 of interest is paid to produce \$5,600 of taxable income and \$800 of tax-exempt income. The portion of the interest related to the production of the tax-exempt income is not deductible. Therefore, \$625 [ $\$5,000 \times (\$800 \div \$6,400)$ ] of the interest is not deductible. Their investment interest expense is \$4,375 ( $\$5,000 - \$625$ ). Because \$4,375 exceeds their investment income, their investment interest deduction is limited to \$2,900. The remaining \$1,475 ( $\$4,375 - \$2,900$ ) along with the \$4,900 from 2015 is carried forward to the following year. Their total carryforward to 2017 is \$6,375 ( $\$4,900 + \$1,475$ ).**

52. Liang pays \$12,000 in interest on debt which was used to purchase portfolio investments. He receives \$6,000 in interest from a certificate of deposit, \$4,200 in royalties, and \$2,000 in interest on municipal bonds during the year. His investment-related expenses total \$700. Liang's adjusted gross income is \$75,000.
- a. Assuming that Liang has no other qualifying miscellaneous itemized deductions during the year and that none of the debt is used to acquire the municipal bonds, how much of the \$12,000 in interest paid can he deduct?

**Liang's investment interest deduction is limited to his net investment income. Gross investment income is \$10,200 (\$6,000 + \$4,200). The interest received on the municipal bonds is tax-exempt and therefore, not allowed for purposes of computing the allowable investment interest deduction. Because none of the debt is used to acquire the municipal bonds, none of the investment interest is allocated to the bonds. However, the portion of the investment expenses attributable to tax-exempt income is not deductible. As discussed in Chapter 5, the nondeductible portion of the investment expenses is calculated based on the proportion of tax-exempt income (\$2,000) to total income, \$12,200 (\$2,000 + \$4,200 + \$6,000). Therefore, \$115 [ $\$700 \times (2,000 \div \$12,200)$ ] of the investment expenses are nondeductible. The remaining \$585 ( $\$700 - \$115$ ) of investment expenses are used in the calculation of net investment income. Investment expenses are those allowable after application of the 2% miscellaneous itemized deduction limitation. In this case, the 2% limitation is \$1,500 ( $\$75,000 \times 2\%$ ), leaving no deductible investment expenses. Liang's investment interest deduction is equal to the investment income of \$10,200. The remaining \$1,800 ( $\$12,000 - \$10,200$ ) of investment interest is carried forward to the next year.**

- b. What would Liang's deduction be if he also had \$1,000 in qualifying miscellaneous itemized deductions (employee business expenses)?

**In determining the amount of investment expenses applied against the 2% AGI limit, all other miscellaneous deductions must be applied against the limit first. In this case, the \$1,000 of other miscellaneous expenses is applied to the \$1,500 limit first. This leaves only \$500 of Liang's \$585 deductible investment expenses (as discussed in a) to be used against the limit and an investment expense deduction of \$85. His net investment income is \$10,115 ( $\$10,200 - \$85$ ), resulting in deductible investment interest of \$10,115. The remaining \$1,885 ( $\$12,000 - \$10,115$ ) is carried forward to next year.**

- c. Assume that in part b, the qualifying expenses total \$2,700.

**In this case, none of Liang's investment expenses are applied against the limit (the \$2,700 of other miscellaneous expenses totally uses up the \$1,500 limit), leaving net investment income at \$9,615 ( $\$10,200 - \$585$ ) and deductible investment interest of \$9,615. The remaining \$2,385 ( $\$12,000 - \$9,615$ ) of investment interest is carried forward to next year.**

53. Jana gives property worth \$54,050 to her alma mater during the current year. She purchased the property several years ago for \$32,000.

- a. What is Jana's maximum deduction if the property is ordinary income property?

**The allowable amount of the deduction for ordinary income property is the lower of the adjusted basis or the fair market value of the property. In this case, the allowable deduction amount is \$32,000, the adjusted basis.**

- b. What is Jana's maximum deduction if the property is long-term capital gain property?

**Long-term capital gain property may be deducted at the fair market value of the property, Jana's maximum allowable deduction amount is the \$54,050 fair market value.**

- c. How would your answer change if Jana's adjusted gross income were \$60,000?

**If Jana's AGI is \$60,000, her charitable contribution in both (a) and (b) are limited. In case (a), her maximum charitable deduction is limited to 50% of her adjusted gross income. Because the basis of the property is greater than 50% of her AGI [ $\$32,000 > \$30,000 (\$60,000 \times 50\%)$ ], her charitable contribution deduction is limited to \$30,000. The remaining \$2,000 ( $\$32,000 - \$30,000$ ) can be carried forward for deduction in the succeeding 5 years.**

**In case (b), the maximum charitable contribution deduction for property valued at fair market value is limited to 30% of adjusted gross income. Because the fair market value of the property is greater than 30% of her AGI [ $\$54,050 > \$18,000 (\$60,000 \times 30\%)$ ], her charitable contribution is limited to \$18,000. The remaining \$36,000 ( $\$54,050 - \$18,000$ ) is carried forward for deduction in the succeeding 5 years.**

**NOTE: Jana can elect to reduce the amount of her contribution to the basis of the property, \$32,000 and avoid the 30% limitation. This would allow the same charitable contribution deduction as in case (a).**

54. Determine the allowable charitable contribution in each of the following situations:

- a. Karen attends a charity auction where she pays \$250 for two tickets to a Broadway show. The tickets have a face value of \$150.

**Karen is only allowed to deduct the amount paid in excess of the fair market value of the two tickets, \$100 (\$250 - \$150). She cannot receive a charitable contribution for the \$150 value of the tickets because she received a benefit (i.e., seeing the show) for that portion of her contribution.**

- b. State University holds a raffle to benefit the football team. Each raffle ticket costs \$100, and only 500 tickets are sold, with the winner receiving \$10,000. Gary buys two raffle tickets but does not win the \$10,000 prize.

**The \$100 paid to purchase the raffle tickets is not a charitable contribution.**

- c. Peter is a nurse at a local hospital and earns \$150 per day. One Saturday a month, he volunteers 8 hours of his time at a medical clinic in a neighboring town. The round-trip distance from Peter's home to the clinic is 25 miles.

**No deduction is allowed for the value of a person's time donated to charitable work. However, Peter is allowed to deduct 14 cents a mile for travel to and from the hospital. Peter's charitable contribution is \$42 (14 cents x 25 miles x 12 months).**

- d. Jordan donates stock with a fair market value of \$36,000 to Caulfield College. She acquired the stock in 2000 for \$13,000. Her adjusted gross income is \$60,000.

**Jordan's charitable contribution is \$36,000. Property valued at fair market value is limited to a maximum deduction of 30% of adjusted gross income. Jordan can deduct \$18,000 (\$60,000 x 30%) in the current year. The remaining \$18,000 (\$36,000 - \$18,000) is carried forward for 5 years.**

55. Miguel is a successful businessman who has been approached by St. Kilda University to make a donation to its capital campaign. He agrees to contribute \$75,000, but he is unsure which of the following assets he should contribute:

Asset	Basis	Fair Market Value
Ordinary income property	\$ 41,000	\$ 75,000
Long-term capital gain property	84,050	75,000
Long-term capital gain property	32,000	75,000

Write a letter to Miguel advising him which property he should contribute to St. Kilda's capital campaign.

**The amount of the contribution for ordinary income property is limited to the lesser of the property's fair market value at the date of the gift or the property's adjusted basis. Therefore, any appreciation in the value of ordinary income property is not allowed as a deduction. Long-term capital gain property may be valued at fair market value. Thus, appreciation in the value of a long-term capital gain property is allowed as a deduction (and is not subject to tax). However, any property valued at fair market value is limited to a maximum deduction of 30% of adjusted gross income. The taxpayer can elect to treat the long-term capital gain property as ordinary income property (i.e., value of the property at its adjusted basis) and be subject to the 50% limitation. Any amounts in excess of the limits are carried forward for five years and applied to the carryforward years limitations after the current years' contributions have been applied.**

**Miguel should contribute the long-term capital gain property that has a basis of \$32,000. If Miguel contributes the ordinary income property his charitable contribution is limited to his basis in the property, \$41,000. Contributing either long-term capital gain property results in a charitable contribution deduction of \$75,000. However, if he contributes the property with a basis of \$84,050, Miguel loses the benefit of being able to recognize the \$9,000 (\$75,000 - \$84,050) loss. If he contributes the property with a basis of \$32,000, he does not recognize the \$44,050 (\$75,000 - \$32,000) gain on its appreciation, yet is allowed to increase his charitable contribution by the value of the appreciation.**

**Instructor's Note: If for other reasons Miguel wants to contribute the long-term capital gain property with a basis of \$84,050, he should sell the property and realize the \$9,000 loss. Assuming he does not have any capital gains, he will recognize a \$3,000 capital loss. The amount of his donation to St. Kilda is the same, \$75,000. However, instead of receiving property, St. Kilda would receive cash.**

56. Kweisi incurs the following employment-related expenses during the year:

Airfare	\$2,000
Lodging	1,500
Meals	1,200
Entertainment	800
Incidentals	500

His employer maintains an accountable reimbursement plan and reimburses him \$4,500 for his expenses. He also has \$1,600 of other allowable miscellaneous expenses. What is his allowable deduction if

- a. His adjusted gross income is \$52,000?

**With an accountable plan and a reimbursement less than actual expenses (\$6,000), Kweisi includes the \$4,500 reimbursement in gross income. The \$4,500 of reimbursed costs are a deduction for adjusted gross income. The \$1,500 of unreimbursed expenses are deductible as miscellaneous itemized deductions. The unreimbursed portion of each expense is 25% (\$1,500 ÷ \$6,000). Kweisi is subject to the 50% limit on meals and entertainment for his itemized deductions, leaving him with allowable unreimbursed employee business expenses of \$1,250:**

Airfare (\$2,000 x 25%)	\$ 500
Lodging (\$1,500 x 25%)	375
Meals (\$1,200 x 25% x 50%)	150
Entertainment (\$800 x 25% x 50%)	100
Incidentals (\$500 x 25%)	125
<b>Total unreimbursed employee business expenses</b>	<b><u>\$ 1,250</u></b>

**The \$1,250 of unreimbursed employee business expenses is added to the other allowable miscellaneous itemized deductions of \$1,600 and the total is deductible to the extent it exceeds 2% of Kweisi's adjusted gross income.**

Unreimbursed employee business expenses	\$ 1,250
Other miscellaneous itemized deductions	1,600
<b>Total allowable miscellaneous itemized deductions</b>	<b><u>\$ 2,850</u></b>
<b>Less: 2% x \$52,000</b>	<b><u>(1,040)</u></b>
<b>Allowable itemized deduction</b>	<b><u>\$ 1,810</u></b>

- b. Assume the same facts as in part a, except that Kweisi's employer has a nonaccountable reimbursement plan and Kweisi receives \$4,500 from the plan to pay for his business expenses.

If the plan is nonaccountable, the \$4,500 reimbursement is included in gross income, increasing it to \$56,500 (\$52,000 + \$4,500). Kweisi is not allowed to deduct any of his expenses for adjusted gross income. Kweisi can only deduct the costs as miscellaneous itemized deductions, subject to the 2% of adjusted gross income limitation. The meals and entertainment expenses are subject to the 50% limit, resulting in a \$5,000 of employee business expenses.

Airfare	\$ 2,000
Lodging	1,500
Meals (\$1,200 x 50%)	600
Entertainment (\$800 x 50%)	400
Incidentals	500
Total itemized deduction	<u>\$ 5,000</u>

The \$5,000 of employee business expenses is added to the other allowable miscellaneous itemized deductions of \$1,600 and the total is deductible to the extent it exceeds 2% of Kweisi's adjusted gross income.

Unreimbursed employee business expenses	\$ 5,000
Other miscellaneous itemized deductions	1,600
Total allowable miscellaneous itemized deductions	<u>\$ 6,600</u>
Less: 2% x \$56,500	(1,130)
Allowable itemized deduction	<u>\$ 5,470</u>



57. Trevor is an English professor at Clayton College. His adjusted gross income for the year is \$58,000 including \$5,000 he won at the racetrack. Trevor incurs the following during the year:

Investment advice	\$ 550
Subscriptions to academic journals	240
Dues to academic organizations	275
Attorney fee for tax advice relating to his divorce	325
Parking at the university	100
Safe-deposit box	75
Gambling losses	450
Sport coats worn exclusively at work	750

What is Trevor's allowable miscellaneous itemized deduction?

**Trevor is not allowed to deduct his parking at the university or his sports coats. Trevor's personal decision not to wear the sport coats outside of work does not make the cost of the coats a deductible business expense. The amount of the legal fees paid for tax advice relating to his divorce is deductible assuming the bill specifies how much of the fee is for tax advice. The gambling losses (to the extent of winnings) are a miscellaneous itemized deduction but are not subject to the 2% of AGI limitation. Trevor's total allowable itemized deductions before the 2% AGI limitation are \$1,465. This is reduced by the 2% of adjusted gross income limitation on miscellaneous itemized deductions and his allowable itemized deduction is \$755.**

Investment advice	\$ 550
Subscriptions to academic journals	240
Dues to academic organizations	275
Attorney fee for tax advice relating to his divorce	325
Safe-deposit box	75
<b>Total allowable deductions</b>	<b>\$ 1,465</b>
<b>Less: \$58,000 x 2%</b>	<b>(1,160)</b>
<b>Miscellaneous itemized deduction subject to 2% of AGI</b>	<b>\$ 305</b>
<b>Gambling losses</b>	<b>455</b>
<b>Allowable miscellaneous itemized deductions</b>	<b><u>\$ 755</u></b>

58. Edna works as a marketing consultant. In her spare time, she enjoys painting. Although she sells some of her work at local craft shows, she either displays most of her paintings at home or gives them to family and friends. During the year, she receives \$750 from the sale of her paintings. The cost of producing the sold paintings and the cost of attending the crafts shows is \$1,850. Edna has other allowable miscellaneous deductions of \$1,400, and her adjusted gross income before considering her painting activity is \$48,000. Write a letter to Edna explaining her allowable miscellaneous itemized deduction for the year.

**Edna must include the \$750 from the sale of the paintings in her gross income. Because the activity constitutes a hobby, deductions are limited to the \$750 of income. The hobby expenses are deducted as a miscellaneous itemized deduction, subject to the 2% of AGI limitation.**

**Edna's adjusted gross income after considering the income from her paintings is \$48,750 (\$48,000 + \$750) and her total miscellaneous itemized deductions are \$2,150 (\$1,400 + \$750). This is reduced by the 2% of adjusted gross income limitation on miscellaneous itemized deductions and her allowable itemized deduction is \$1,175.**

Total miscellaneous itemized deductions	\$2,150
Less: \$48,750 x 2%	(975)
Allowable miscellaneous itemized deduction	<u>\$1,175</u>

59. Lee is a college professor with an adjusted gross income of \$32,000. Lee has a lot of bad luck this year. First, a tornado blows the roof off of his house, causing \$4,900 in damage. His insurance company reimburses him only \$1,200 for the roof damage. Later in the year, he is out at a local pub when his \$625 car stereo is stolen. His insurance company does not pay for the stereo because it is worth only \$400 at the time and Lee's policy does not cover losses of less than \$500. What is Lee's allowable casualty and theft loss for the year?

**Personal casualty and theft losses are measured as the lesser of the decline in value due to the casualty or theft or the adjusted basis of the property. Each loss occurring during the year is reduced by any insurance reimbursements and the \$100 statutory floor. The total casualty and theft losses for the year are subject to a 10% of adjusted gross income annual limitation. Due to the two limitations (per occurrence and adjusted gross income), Lee's casualty loss deduction is \$700.**

Amount of loss on roof (Damages)	\$ 4,900	
Less: Insurance reimbursement	(1,200)	
Less: Statutory floor	<u>(100)</u>	
Allowable loss on roof		\$ 3,600
Amount of loss on stereo (FMV)	\$ 400	
Less: Statutory floor	<u>(100)</u>	
Allowable loss on stereo		300
Total casualty and theft losses		<u>\$ 3,900</u>
Less: Annual loss limitation (10% x \$32,000)		<u>(3,200)</u>
Deductible casualty loss		<u><u>\$ 700</u></u>

60. Michael owns a hair salon. During the current year, a tornado severely damages the salon and destroys his personal automobile, which is parked outside. It costs Michael \$12,000 to make the necessary repairs to the salon. He had paid \$21,500 for the automobile, which was worth \$17,100 before the tornado. Michael's business insurance reimburses him for \$7,000 of the salon repair costs. His automobile insurance company pays only \$12,000 for the automobile destruction. Michael's adjusted gross income is \$34,050 before considering the effects of the tornado. Write a letter to Michael explaining his deductible loss from the tornado.

**The damage to the hair salon is a business casualty, which is deductible for adjusted gross income. The deductible loss is \$5,000, the \$12,000 cost of repairing the salon, less the \$7,000 insurance reimbursement.**

**The loss on the automobile is a personal casualty loss, which is deductible as an itemized deduction. The amount of the loss is \$17,100 (the lesser of the \$21,500 basis or the \$17,100 decline in value). The \$5,100 unreimbursed personal casualty loss (\$17,100 - \$12,000 reimbursement) is reduced by the \$100 statutory floor. The total casualty loss for the year is subject to a 10% of adjusted gross income annual limitation. Michael's adjusted gross income is \$29,000 (\$34,050 - \$5,000 business casualty loss). Therefore, the \$5,000 allowable loss is reduced by \$2,900 (\$29,000 x 10%) and his casualty loss deduction is \$2,100.**

Amount of loss	\$ 17,100
Less: Insurance reimbursement	(12,000)
Less: Statutory floor	(100)
Allowable loss on automobile before 10% of AGI limitation	\$ 5,000
Less: Annual loss limitation (10% x \$29,000)	(2,900)
Deductible casualty loss	<u>\$ 2,100</u>

61. Orley is a single individual with no dependents who has an adjusted gross income of \$276,900 in 2016. Orley's itemized deductions total \$19,400, which includes \$1,200 in deductible medical costs and \$5,700 in investment interest.

- a. What is Orley's 2016 taxable income?

**Because Orley's AGI is in excess of \$259,400, his itemized deductions are subject to the 3% phase-out rule. The \$1,200 of medical costs and \$5,700 of investment interest are not subject to the reduction rule, leaving \$12,500 [ $\$19,400 - \$6,900 (\$1,200 + \$5,700)$ ] which can be reduced. The reduction cannot exceed \$10,000 (80% of \$12,500).**

**His AGI in excess of \$259,400 is \$17,500 ( $\$276,900 - \$259,400$ ). The reduction in his itemized deductions is \$525 ( $\$17,500 \times 3\%$ ) and his deductible itemized deductions for the year are \$18,875 ( $\$19,400 - \$525$ ).**

**Orley's \$4,050 exemption is subject to a phase-out because his AGI is over the \$259,400 threshold for a single individual.**

**The \$17,500 of excess AGI gives him 7 ( $\$17,500 \div \$2,500 = 7$ ) phase-out increments at 2% per increment, for a total loss of 14%. Therefore, his exemption is reduced by \$567 ( $\$4,050 \times 14\%$ ) and his personal exemption amount for the year is \$3,483 ( $\$4,050 - \$567$ ).**

**Orley's taxable income is \$254,542 ( $\$276,900 - \$18,875 - \$3,483$ ).**

- b. Assume that Orley's adjusted gross income is \$604,700. What is his 2016 taxable income?

**Because Orley's AGI is in excess of \$259,400, his itemized deductions are subject to the 3% phase-out rule. The \$1,200 of medical costs and \$5,700 of investment interest are not subject to the reduction rule, leaving \$12,500 [ $\$19,400 - \$6,900 (\$1,200 + \$5,700)$ ], which can be reduced. The reduction cannot exceed \$10,000 (80% of \$12,500). His AGI in excess of \$259,400 is \$345,300 ( $\$604,700 - \$259,400$ ) and the calculated reduction in itemized deductions is \$10,359 ( $\$345,300 \times 3\%$ ). However, the calculated amount of \$10,359 exceeds the maximum allowable reduction of \$10,000. Therefore, his deductible itemized deductions for the year are \$9,400 ( $\$19,400 - \$10,000$ ).**

**In addition, Orley will lose his entire exemption deduction because his AGI exceeds \$381,900, which is the AGI level at which all exemptions are lost for a single individual.**

**Orley's taxable income is \$595,300 ( $\$604,700 - \$9,400 - \$0$ ).**

62. Jeff and Marion are married with 3 dependents. Their adjusted gross income in 2016 is \$335,800. Their itemized deductions total \$34,600, including \$4,900 in investment interest.

- a. What is their 2016 taxable income?

**Because Jeff and Marion's AGI is in excess of \$311,300, their itemized deductions are subject to the 3% phase-out rule. The \$4,900 of investment interest is not subject to the reduction rule, leaving \$29,700 (\$34,600 - \$4,900) which can be reduced. The reduction cannot exceed \$23,760 (80% x \$29,700). Their AGI in excess of \$311,300 is \$24,500 (\$335,800 - \$311,300).**

**The reduction in itemized deductions is \$735 (\$24,500 x 3%). Therefore, their deductible itemized deductions for the year are \$33,865 (\$34,600 - \$735).**

**They are allowed two personal and three dependency exemptions for a total exemption deduction of \$20,250 (\$4,050 x 5). They are also subject to the phase-out of their exemptions because their AGI exceeds \$311,300.**

**The \$24,500 of excess AGI gives them 10 (\$24,500 ÷ \$2,500 = 9.8) phase-out increments at 2% per increment, for a total loss of 20%. Therefore, their exemption is reduced by \$4,050 (\$20,250 x 20%) and his personal exemption amount for the year is \$16,200 (\$20,250 - \$4,050).**

**Jeff and Marion's taxable income is \$285,735 (\$335,800 - \$33,865 - \$16,200).**

- b. Assume that their adjusted gross income is \$481,300 and their itemized deductions remain the same. What is their 2016 taxable income?

**Because Jeff and Marion's AGI is in excess of \$311,300, their itemized deductions are subject to the 3% phase-out rule. The \$4,900 of investment interest is not subject to the reduction rule, leaving \$29,700 (\$34,600 - \$4,900) which can be reduced. The reduction cannot exceed \$23,760 (80% x \$29,700). Their AGI in excess of \$311,300 is \$170,000 (\$481,300 - \$311,300). The reduction in itemized deductions is \$5,100 (\$170,000 x 3%). Therefore, their deductible itemized deductions for the year are \$29,500 (\$34,600 - \$5,100).**

**In addition, they will lose their entire deduction for their personal and dependency exemptions because their AGI exceeds \$433,800, which is the AGI level at which all exemptions are lost for a couple filing married filing joint.**

**Jeff and Marion's taxable income is \$451,800 (\$481,300 - \$29,500 - \$0).**

63. Determine the taxable income of each of the following dependents in 2016:

- a. Louis is 12 and receives \$1,250 in interest income.

**Because Louis is a dependent, his standard deduction is limited to \$1,050 and he receives no personal exemption. His taxable income is \$200 (\$1,250 - \$1,050).**

- b. Jackson is 16. He earns \$2,050 from his newspaper route and receives \$700 in dividends on GCM stock.

**Jackson's standard deduction is \$2,400 [(earned income + \$350) > \$1,050]. This leaves him with a taxable income of \$350 (\$2,050 + \$700 - \$2,400).**

- c. Loretta is 18 and a full-time student. She earns \$5,000 as a lifeguard during the summer. In addition, Loretta wins a rescue contest and receives a municipal bond worth \$600. During the year, the bond pays \$20 in interest.

**Loretta's gross income is \$5,600 (\$5,000 + \$600). The \$600 prize she received from the rescue contest is included in her gross income. The municipal bond interest is excluded from gross income. Her standard deduction is \$5,350 (the greater of earned income + \$350 or \$1,050, but limited to the standard deduction for a single individual), leaving her with a taxable income of \$250 (\$5,600 - \$5,350).**

- d. Eva is 15. Her income consists of municipal bond interest of \$750, stock dividends of \$1,300, and interest credited to her savings account of \$900.

**Eva's gross income is \$2,200 (\$1,300 + \$900 -- all unearned) and her standard deduction is \$1,050, leaving her a taxable income of \$1,150.**

- e. Elaine is a college student. Her only income consists of \$3,000 from her part-time job delivering pizzas. Her itemized deductions total \$235.

**Elaine's gross income is \$3,000. Her standard deduction is \$3,000 (earned income + \$350 is greater than \$1,050). The standard deduction is greater than her actual itemized deductions, leaving her with zero taxable income.**

- f. Greg is 2. He has certificates of deposit given to him by his grandparents that pay \$2,500 in interest.

**Greg's taxable income is \$1,450 (\$2,500 - \$1,050 standard deduction).**

64. For each of the dependents in problem 62, calculate the income tax on their taxable income. In each case, assume that their parents' taxable income is \$128,000.

- a. Even though Louis is a minor child, his unearned income is less than \$2,000 and he is not subject to the tax rules on unearned income of a minor child. His \$200 of taxable income is subject to the single taxpayer rates, and his tax liability is \$20 ( $\$200 \times 10\%$ ).
- b. Jackson is a minor child but his unearned income is less than \$2,000, so he is not subject to the tax rules on unearned income of a minor child. Because Jackson is in the 10% tax bracket, his dividend income is taxed at 0%. Therefore, Jackson has no tax liability.
- c. Loretta is a minor child but has no unearned income and pays a tax of \$25 ( $\$250 \times 10\%$ ).
- d. Eva is a minor child with unearned income greater than \$2,100 and is subject to the tax rules on unearned income of a minor child. Her net unearned income is \$100 ( $\$2,200 - \$1,050 - \$1,050$ ), which is taxed at her parent's marginal tax rate. Her remaining taxable income of \$1,050 ( $\$1,150 - \$100$ ) is taxed per the single taxpayer schedule. At a taxable income of \$128,000, the parent's marginal tax rate would be 25%.

Because Eva has dividend income which is taxed at a preferential rate, Eva has to calculate the percentage of her income that will receive the preferential rate. This percentage will also be used by Eva's parent's to determine the amount of Eva's unearned income that will be taxed at their marginal tax rate and the amount that will be taxed at the 15% dividend tax rate. The amount that is taxed at the dividend rate is determined by dividing the amount of dividend income by total income. Therefore, 59.09% ( $\$1,300 \div \$2,200$ ) of Eva's taxable income will be taxed at the preferential rate and 40.91% ( $100\% - 59.09\%$ ) will be taxed at the marginal tax rate.

Tax on dividend income at parent's rate - ( $\$100 \times 59.09\% \times 15\%$ )	\$ 9
Tax on other income at parent's rate - ( $\$100 \times 40.91\% \times 25\%$ )	10
Tax on dividend income at child's rate - ( $\$1,050 \times 59.09\% \times 0\%$ )	-0-
Tax on other income at child's rate - ( $\$1,050 \times 40.91\% \times 10\%$ )	43
Total tax on taxable income	<u>\$ 62</u>

- e. Elaine is not a minor child and has no taxable income. Therefore, she is not liable for any tax.
- f. Greg is a minor child with unearned income greater than \$2,000 and is subject to the tax rules on unearned income of a minor child. His net unearned income is \$400 ( $\$2,500 - \$1,050 - \$1,050$ ), which is taxed at his parent's marginal tax rate. His remaining taxable income of \$1,050 ( $\$1,450 - \$400$ ) is taxed per the single taxpayer schedule. At a taxable income of \$128,000, the parent's marginal tax rate is 25%.

Tax on net unearned income ( $\$400 \times 25\%$ )	\$ 100
Tax on remaining taxable income ( $\$1,050 \times 10\%$ )	105
Total tax on taxable income	<u>\$ 205</u>



**NOTE: Without the "kiddie tax", Greg's tax would have been \$145 ( $\$1,450 \times 10\%$ ).**

65. Calculate the 2016 tax liability and the tax or refund due for each situation:

- a. Mark is single with no dependents and has a taxable income of \$60,000. He has \$10,700 withheld from his salary for the year.

**Mark's 2016 tax is \$10,771  $\{\$5,183.75 + [25\% \times (\$60,000 - \$37,650)]\}$ . He has a tax due of \$71 ( $\$10,771 - \$10,700$ ).**

- b. Harry and Linda are married and have taxable income of \$60,000. Harry has \$5,250 withheld from his salary. Linda makes estimated tax payments totaling \$3,000.

**Harry's and Linda's 2016 tax filing a joint return is \$8,073  $\{\$1,855 + [15\% \times (\$60,000 - \$18,550)]\}$ . They receive a refund of \$177 ( $\$8,073 - \$5,250 - \$3,000$ ).**

- c. Aspra is single. His 20 year old son, Calvin, lives with him throughout the year. Calvin pays for less than one-half of his support and his earned income for the year is \$3,000. Aspra pays all costs of maintaining the household. His taxable income is \$60,000. Aspra's withholdings total \$9,600.

**Aspra qualifies to file as head of household. Aspra's 2016 tax is \$9,298  $\{\$6,897.50 + [25\% \times (\$60,000 - \$50,400)]\}$ . Aspra will receive a refund of \$302 ( $\$9,600 - \$9,298$ ). Note: Calvin qualifies as a dependent as a qualifying relative.**

- d. Randy and Raina are married. Because of marital discord, they are not living together at the end of the year, although they are not legally separated or divorced. Randy's taxable income is \$25,000, and Raina's is \$60,000. Randy makes estimated tax payments of \$3,500, and Raina has \$9,500 in tax withheld from her salary.

**If Randy and Raina can get together and file a joint return, their tax on \$85,000 in 2016 will be \$12,793  $\{\$10,367.50 + [25\% \times (\$85,000 - \$75,300)]\}$ . If they each file separately, Randy's tax will be \$3,286  $\{\$927.50 + [(\$25,000 - \$9,275) \times 15\%]$  and Raina's tax will be \$10,771  $\{\$5,183.75 + [25\% \times (\$60,000 - \$37,650)]\}$ . Their total 2016 tax filing separately is \$14,057 ( $\$10,771 + \$3,286$ ), which is \$1,264 ( $\$12,793 - \$14,057$ ) more tax than they would pay on a joint return.**

**If Randy and Raina file jointly they will receive a \$207 ( $\$12,793 - \$3,500 - \$9,500$ ) tax refund. If they file separately, Randy would receive a refund of \$214 ( $\$3,286 - \$3,500$ ), and Raina would owe additional tax of \$1,271 ( $\$10,771 - \$9,500$ ).**

66. Anika and Jespar are married and have two children ages 16 and 14. Their adjusted gross income for the year is \$98,000.

a. What amount can they claim for the child credit?

**Anika and Jespar can claim a child credit of \$2,000 (\$1,000 x 2). A taxpayer can claim a \$1,000 tax credit for each qualifying child. The definition of a qualifying child is similar to the definition of a qualifying child for dependency purposes except that the child must be under age 17 at the end of the tax year.**

**The credit is phased-out at a rate of \$50 for each \$1,000 of income (or fraction thereof) that a married taxpayer's adjusted gross income exceeds \$110,000.**

b. What amount can they claim for the child credit if their adjusted gross income is \$117,600?

**Anika and Jespar are allowed a child credit of \$1,600 (\$2,000 - \$400). Because their adjusted gross income exceeds \$110,000, the credit must be phased-out at a rate of \$50 for each \$1,000 of adjusted gross income (or fraction thereof) that exceeds \$110,000. Anika and Jespar must reduce their child credit by \$400.**

$$\$117,600 - \$110,000 = \$7,600 \div \$1,000 = 7.6 \text{ (round to 8)}$$

$$\$50 \times 8 = \$400 \text{ reduction in credit.}$$

c. What amount can they claim for the child credit if the children are ages 18 and 16 and their adjusted gross income is \$96,000?

**Anika and Jespar can claim a child tax credit only for the child that is 16 years old. Therefore, their child tax credit is \$1,000.**

67. Neville and Julie are married and have two children ages 19 and 14. Their adjusted gross income for the year is \$85,000.

a. What amount can they claim for the child credit?

**Neville and Julie can claim a child credit of \$1,000 ( $\$1,000 \times 1$ ). A taxpayer can claim a \$1,000 tax credit for each qualifying child. The definition of a qualifying child is similar to the definition of a qualifying child for dependency purposes except that the child must be under age 17 at the end of the tax year.**

b. What amount can they claim for the child credit if their children are ages 16 and 13?

**Because both children are under 17 years of age, Neville and Julie can claim a child credit of \$2,000 ( $\$1,000 \times 2$ ).**

c. Assume the same facts as in part a, except that their adjusted gross income is \$116,400?

**Neville and Julie are allowed a child credit of \$1,650 ( $\$2,000 - \$350$ ). Because their adjusted gross income exceeds \$110,000, the credit must be phased-out at a rate of \$50 for each \$1,000 of adjusted gross income (or fraction thereof) that exceeds \$110,000. Neville and Julie must reduce their child credit by \$350.**

$$\$116,400 - \$110,000 = \$6,400 \div \$1,000 = 6.4 \text{ (round to 7)}$$

$$\$50 \times 7 = \$350 \text{ reduction in credit.}$$

68. Miguel and Katrina have 2 children under age 17, have earned income of \$16,000, and pay \$1,836 in Social Security tax. Their tax liability is \$1,050 before the child credit.
- a. What amount can they claim as a child credit, and what portion of the credit is refundable?

**For all families, a portion of the child credit may be refundable. The amount of the child credit that is refundable depends on the number of qualifying children in the family. For families with 1 or 2 qualifying children, the refundable credit is calculated as follows:**

$$\text{Maximum refundable credit} = 15\% \times (\text{earned income} - \$3,000)$$

**However, the amount refunded cannot exceed the amount of the credit remaining after reducing the tax liability to zero. For families with 3 or more qualifying children, the maximum credit is the greater of the amount calculated using the formula for 1 or 2 qualifying children or the following formula:**

$$\text{Maximum refundable credit} = \text{Social Security tax paid} - \text{earned income credit}$$

**Miguel and Katrina's child credit is \$2,000 (\$1,000 x 2), which is greater than their income tax liability of \$1,050. Although the maximum refundable credit is \$1,950 [15% x (\$16,000 - \$3,000)], the calculated amount can never exceed the available credit of \$2,000. The \$2,000 child credit will reduce their \$1,050 tax liability to zero and they will receive a refund of \$950.**

- b. Assume the same facts as in part a, except that Miguel and Katrina have 3 children under age 17 and are not eligible for the earned income credit. Their tax liability is \$800 before the child credit. What amount can they claim as a child credit, and what portion of the credit is refundable?

**Miguel and Katrina's child credit is \$3,000 (\$1,000 x 3), which is greater than their income tax liability of \$800. The maximum amount of the credit that can be refunded is the greater of:**

$$\$1,950 = 15\% \times (\$16,000 - \$3,000)]$$

**or**

$$\$1,836 = \$1,836 - \$0$$

**The child credit of \$3,000 will reduce their \$800 tax liability to zero and they will receive a refund of \$1,950.**

69. Determine the total allowable 2015 earned income credit in each of the following situations:

- a. Judy is single and earns \$5,500 in salary for the year. In addition, she receives \$2,300 in unemployment compensation during the year.

**The amount of the credit is dependent on the taxpayer's earned income and phases out after income reaches a predetermined level. To qualify for the earned income credit (EIC), a taxpayer must meet the following requirements:**

- 1. The taxpayer's principal place of abode for more than one-half of the year must be in the United States.**
- 2. The taxpayer or the taxpayer's spouse must be 25 years of age but not 65 years of age.**
- 3. The taxpayer or taxpayer's spouse cannot be a dependent of another taxpayer.**

**In addition, the taxpayer cannot qualify for the earned income credit if their portfolio income (e.g., interest, dividends, and tax-exempt interest) exceeds \$3,400 (\$3,400 in 2015).**

**Note that the requirements do not require that the taxpayer have a child. However, the amount of the credit increases if you have one or more qualifying children. Therefore, even though Judy does not have a child, she will qualify for the earned income credit.**

**The \$2,300 that Judy receives in unemployment compensation is taxable. Judy's earned income is \$5,500. However, her adjusted gross income is \$7,800 (greater than earned income) and must be used in the credit phase-out. Using the earned income credit table in the Appendix to Chapter 8, Judy's EIC is \$503.**

- b. Monica is a single parent with 1 dependent child. She earns \$12,500 from her job as a taxicab driver. She also receives \$4,700 in child support from her ex-husband.

**The \$4,700 Monica receives from her ex-husband is not taxable income. Therefore, both Monica's earned income and AGI are \$12,500. Monica's earned income credit (EIC) is \$3,359.**

- c. Paul and Yvonne are married and have 3 dependent children. Their earned income is \$21,300, and they receive \$3,500 in interest income from their savings account.

**Paul and Yvonne do not qualify for the earned income credit because their portfolio income exceeds \$3,400.**

- d. Hattie is married to Herbert, and they have 2 dependent children. During February, Herbert leaves and hasn't been seen or heard from since. Hattie earns \$16,400 from her job. During January and February, Herbert earned \$4,800, but Hattie has no idea how much he earned for the entire year.

**Married taxpayers are required to file a joint return in order to take the EIC. In Hattie's situation, she may elect to file as a Head of Household to alleviate this requirement. An abandoned spouse may file as a Head of Household. An abandoned spouse is one who has a dependent child living in the taxpayer's home for more than half of the year and the taxpayer's spouse does not live in the home at any time during the last half of the year.**

**Hattie would not be responsible for paying taxes on the income Herbert earned for January and February. Therefore, Hattie's earned income and AGI is \$16,400. Hattie has two qualifying children and her EIC is \$5,548.**

**Instructor's Note: A taxpayer who files as married filing separate is not entitled to the earned income credit.**

70. Determine the total allowable 2015 earned income credit in each of the following situations:

- a. Rina is single and earns \$6,300 in salary for the year. In addition, she receives \$1,450 in unemployment compensation during the year.

**The amount of the credit is dependent on the taxpayer's earned income and phases out after income reaches a predetermined level. To qualify for the earned income credit (EIC) a taxpayer must meet the following requirements:**

- 1. The taxpayer's principal place of abode for more than one-half of the year must be in the United States.**
- 2. The taxpayer or the taxpayer's spouse must be 25 years of age but not 65 years of age.**
- 3. The taxpayer or taxpayer's spouse cannot be a dependent of another taxpayer.**

**In addition, the taxpayer cannot qualify for the earned income credit if their portfolio income (e.g., interest, dividends, and tax-exempt interest) exceeds \$3,400 (\$3,400 in 2015).**

**Note that the requirements do not require that the taxpayer have a child. However, the amount of the credit increases if you have one or more qualifying children. Therefore, even though Rina does not have a child, she will qualify for the earned income credit.**

**The \$1,450 that Rina receives in unemployment compensation is taxable. Rina's earned income is \$6,300. However, her adjusted gross income is \$7,750 (greater than earned income) and must be used in the credit phase-out. Using the earned income credit table in the Appendix to Chapter 8, her EIC is \$503.**

- b. Lachlan is single with 1 dependent child. During the year, he earns \$8,000 as a waiter and receives alimony of \$10,000 and child support of \$5,000.

**The \$5,000 Lachlan receives from his ex-wife in child support is not taxable income. However, the \$10,000 of alimony is taxable. Therefore, his earned income (alimony is considered earned income) and AGI are both \$18,000. Lachlan's earned income credit (EIC) is \$3,359.**

- c. Zorica is a single parent with 2 dependent children. She earns \$19,000 from her job as a mechanic. She also receives \$3,000 in child support from her ex-husband.

**Both Zorica's earned income and adjusted gross income are \$19,000. The \$3,000 in child support is not considered taxable income. Zorica's EIC is \$5,355.**

- d. Elliot and Pam are married and have 3 dependent children. Elliot and Pam earn \$12,000 and 9,000 from their jobs, respectively. They receive \$800 in interest and \$1,000 in dividend income.

**Elliot and Pam's earned income is \$21,000 but their adjusted gross income is \$22,800. Their EIC is \$6,242.**



71. Determine the amount of the child and dependent care credit to which each of the following taxpayers is entitled:

- a. Michael and Gladys are married and have a 7-year-old child. Their adjusted gross income is \$44,050, and they pay \$3,300 in qualified child-care expenses during the year. Michael earns \$12,000 and Gladys earns \$30,000 from their jobs.

**Because Michael and Gladys' adjusted gross income (AGI) is in excess of \$15,000, they must reduce the 35% general credit by 1% for each \$2,000 (or portion thereof) of AGI in excess of \$15,000. The maximum reduction is limited to 15 percent, leaving a minimum allowable credit of 20 percent. The minimum credit limit is reached when the taxpayer's AGI exceeds \$43,000, which Michael and Gladys meet. The maximum amount of qualifying expenses is \$3,000 for one qualifying individual and \$6,000 for 2 or more qualifying individuals. For purposes of this credit, a qualifying individual includes any dependent younger than 13 or a dependent or a spouse of the taxpayer who is physically or mentally incapacitated. A taxpayer can claim the child-and dependent-care credit for a spouse or a dependent, if the individual lives with the taxpayer for more than one-half the year, even if the taxpayer does not provide more than one-half of the cost of maintaining the household. The expenditures qualifying for the credit cannot exceed the earned income of the taxpayer. For married taxpayers, the lower earned income of the two is used for the purpose of the limit (\$12,000 in this case, Michael's earnings).**

**Michael and Gladys' child and dependent care credit is \$600 (20% x \$3,000 maximum allowable amount of child care expenditures).**

- b. Jill is a single parent with an 11-year-old daughter. Her adjusted gross income is \$24,500, and she pays \$2,100 in qualified child-care expenses.

**Because Jill's adjusted gross income (AGI) is in excess of \$15,000, she must reduce the 35% general credit by 1% for each \$2,000 (or portion thereof) of AGI in excess of \$15,000. The maximum reduction is limited to 15 percent, leaving the minimum allowable credit of 20 percent. The minimum credit limit is reached when the taxpayer's AGI exceeds \$43,000, which Jill does not meet. The maximum amount of expenses eligible for the credit is limited to \$3,000 (\$6,000 with two or more qualifying individuals). The general credit of 35% must be reduced by 5% [ $(\$24,500 - \$15,000) \div \$2,000 = 4.75\% = 5\%$ ] to 30%. Therefore, Jill's child and dependent care credit is \$630 (30% x \$2,100).**

- c. Cory is a single parent who earns \$9,000 and receives other nontaxable government assistance totaling \$5,700 during the year. She pays \$1,600 in qualified child-care expenses during the year.

**Because the government assistance of \$5,700 is nontaxable, Cory does not include the amount in adjusted gross income (AGI). Therefore, Cory's AGI is \$9,000, which is below \$15,000 base and she is allowed the full 35% credit. Cory's child and dependent care credit is \$560 (35% x \$1,600). Note: Since Cory's taxable is zero [ $(\$9,000 - \$8,350 - \$7,300) < 0$ ], she would not benefit from the child and dependent care credit because the credit is nonrefundable**

- d. Roosevelt and Myrtle are married and have 2 children. Roosevelt earns \$94,050, and Myrtle has a part-time job from which she earns \$4,400 during the year. They pay \$4,700 in qualified child-care expenses during the year.

**The expenditures qualifying for the credit cannot exceed the earned income of the taxpayer. For married taxpayers, the lower earned income of the two is used for the purpose of the limit. Therefore, Roosevelt and Myrtle's qualifying expenses are limited to \$4,400 (Myrtle's earned income). Because their adjusted gross income is in excess of \$43,000, they are allowed the minimum 20% credit. This results in a child and dependent care credit of \$880 ( $\$4,400 \times 20\%$ ).**

- e. Randy is single and earns \$80,000 per year. He maintains a home for his father, who has been confined to a wheelchair since he had a stroke several years ago. Randy's father receives \$6,000 in Social Security but has no other income. Because his father requires constant attention, Randy hires a helper to take care of his father while he is at work. Randy pays the helper \$13,000 during the current year.

**To qualify for the credit, two conditions must be met: (1) the taxpayer must incur employment-related expenses, and (2) the expenses must be for the care of qualified individuals.**

**An employment expense is one that must be paid to enable the taxpayer to work and must be paid for either household services or for the care of a qualified individual. Generally, the expenses must be incurred within the taxpayer's home, although out-of-the-home expenses for dependents younger than 13 and for a disabled dependent or spouse also qualify. A taxpayer can claim the child-and dependent-care credit for a spouse or a dependent, if the individual lives with the taxpayer for more than one-half the year, even if the taxpayer does not provide more than one-half of the cost of maintaining the household. By hiring a helper, Randy is able to maintain employment. Because Randy's father is disabled and meets the dependency tests he is a qualified individual.**

**Randy's adjusted gross income (AGI) is greater than \$43,000, so Randy receives the minimum credit of 20%. Therefore, Randy's child and dependent care credit is \$600 [ $20\% \times \$3,000$  (the \$13,000 is limited to the \$3,000 maximum expense for 1 qualifying individual)].**

72. Determine the amount of the child-and-dependent care credit to which each of the following taxpayers is entitled:

- a. Caryle and Philip are married and have a 4-year-old daughter. Their adjusted gross income is \$48,000, and they pay \$2,100 in qualified child-care expenses during the year. Caryle earns \$18,000, and Philip earns \$30,000 in salary.

**Because Philip and Caryle's adjusted gross income (AGI) is in excess of \$15,000, they must reduce the 35% general credit by 1% for each \$2,000 (or portion thereof) of AGI in excess of \$15,000. The maximum reduction is limited to 15 percent, leaving a minimum allowable credit of 20 percent. The minimum credit limit is reached when the taxpayer's AGI exceeds \$43,000, which Philip and Caryle meet. The maximum amount of qualifying expenses is \$3,000 for one qualifying individual and \$6,000 for 2 or more qualifying individuals. A taxpayer can claim the child-and dependent-care credit for a spouse or a dependent, if the individual lives with the taxpayer for more than one-half the year, even if the taxpayer does not provide more than one-half of the cost of maintaining the household. For purposes of this credit, a qualifying individual includes any dependent younger than 13 or a dependent or a spouse of the taxpayer who is physically or mentally incapacitated. The expenditures qualifying for the credit cannot exceed the earned income of the taxpayer. For married taxpayers, the lower earned income of the two is used for the purpose of the limit (\$18,000 in this case, Caryle's earnings).**

**Philip and Caryle's child and dependent care credit is \$420 (20% x \$2,100 child care expenditures).**

- b. Natalie is a single parent with an 8-year-old son. Her adjusted gross income is \$27,000, and she pays \$3,100 in qualified child-care expenses.

**Because Natalie's adjusted gross income (AGI) is in excess of \$15,000, she must reduce the 35% general credit by 1% for each \$2,000 (or portion thereof) of AGI in excess of \$15,000. The maximum reduction is limited to 15 percent, leaving the minimum allowable credit of 20 percent. The minimum credit limit is reached when the taxpayer's AGI exceeds \$43,000, which Natalie does not meet. The maximum amount of expenses eligible for the credit is limited to \$3,000 (\$6,000 with two or more qualifying individuals). The general credit of 35% must be reduced by 6% [ $(\$27,000 - \$15,000) \div \$2,000 = 6.00\% = 6\%$ ] to 29%. Therefore, Natalie's child and dependent care credit is \$870 (29% x \$3,000 maximum allowable amount of child care expenses).**

- c. Leanne and Ross are married and have 3 children, ages 6, 4, and 1. Their adjusted gross income is \$78,000, and they pay \$6,500 in qualified child-care expenses during the year. Leanne earns \$48,000, and Philip earns \$30,000 in salary.

**Because their adjusted gross income is in excess of \$43,000, they are allowed the minimum 20% credit. For 2 or more qualifying individuals the maximum amount of expenses eligible for the credit is \$6,000. This results in a child and dependent care credit of \$1,200 (\$6,000 x 20%).**

- d. Malcolm and Mirella are married and have 2 children. Mirella earns \$55,000, and Malcolm has a part-time job from which he earns \$4,050 during the year. They pay \$4,800 in qualified child-care expenses during the year.

**The expenditures qualifying for the credit cannot exceed the earned income of the taxpayer. For married taxpayers, the lower earned income of the two is used for the purpose of the limit. Therefore, Malcolm and Mirella's qualifying expenses are limited to \$4,050 (Malcolm's earned income). Because their adjusted gross income is in excess of \$43,000, they are allowed the minimum 20% credit. This results in a child and dependent care credit of \$800 ( $\$4,050 \times 20\%$ ).**

- e. Andrew is a single parent with a 14-year-old son. Because he does not arrive home from work until 7 p.m., Andrew has hired someone to take care of his son after school and cook him supper. Andrew's adjusted gross income is \$59,000, and he pays \$3,400 in child-care expenses.

**Andrew does not qualify for the child care credit because his son is not a qualifying individual. For purposes of this credit, a qualifying individual includes any dependent younger than 13 or a dependent or a spouse of the taxpayer who is physically or mentally incapacitated.**

- f. Assume the same facts as in part e, except that Andrew's son is 12 years old.

**Because his son is a qualifying individual, Andrew is eligible for the child care credit. Because his adjusted gross income is in excess of \$43,000, he is allowed the minimum 20% credit. For 1 qualifying individual, the maximum amount of expenses eligible for the credit is \$3,000. This results in a child and dependent care credit of \$600 ( $\$3,000 \times 20\%$ ).**

73. Martina is single and has two children in college. Matthew is a sophomore and Christine is in her fifth year of college. Martina pays \$3,600 in tuition and fees for Matthew, \$700 for textbooks, and \$2,000 for his room and board. Christine's tuition and fees are \$4,800, her textbooks are \$550, and her room and board expenses are \$1,800. Martina's adjusted gross income is \$56,000.

**Eligible taxpayers who incur expenses for higher education can elect to claim one of two tax credits, the American Opportunity Tax Credit (AOTC) or the Lifetime Learning Tax Credit (LLTC). Only one credit can be claimed for each qualifying student. Qualifying expenses for the American Opportunity Tax Credit (AOTC) include tuition, related fees, and course materials (i.e., textbooks) required for enrollment at an eligible institution. Unlike the AOTC, course materials are not a qualifying expense in calculating the Lifetime Learning Tax Credit.**

**The AOTC and the LLTC are both phased out ratably over the same base, \$20,000 for married taxpayers and \$10,000 for all other taxpayers. However, the credits over phased out at different levels of adjusted gross income. The AOTC is phased out ratably for married taxpayers with adjusted gross income between \$160,000 and \$180,000 and for all other taxpayers with adjusted gross income between \$80,000 and \$90,000. The LLTC is phased out ratably for married taxpayers with adjusted gross income between \$111,000 and \$131,000 and for all other taxpayers with adjusted gross income between \$55,000 and \$65,000.**

**The American Opportunity Tax Credit provides for a 100% tax credit on the first \$2,000 of qualified expenses and a 25% tax credit on the next \$2,000 of higher education expenses paid during the year for each qualifying student. Therefore, the maximum credit a taxpayer may claim per year for each qualifying student is \$2,500  $[(\$2,000 \times 100\%) + (\$2,000 \times 25\%)]$ . The AOTC can only be claimed for the first four years of undergraduate study.**

**The Lifetime Learning Tax Credit provides a 20% credit for up to \$10,000 of qualified higher education expenses. The LLTC is limited to a maximum amount of \$2,000  $(\$10,000 \times 20\%)$ , regardless of the number of qualifying individuals incurring higher education expenses.**

- a. What amount can Martina claim as a tax credit for the higher education expenses she pays?

**Martina can claim an American Opportunity Tax Credit (AOTC) for Matthew and the Lifetime Learning Tax Credit for Christine. Only the expenses incurred for tuition and fees and textbooks are eligible for the AOTC. Because Matthew's qualifying expenses of \$4,300  $(\$3,600 + \$700)$  exceed \$4,050, Martina can claim the maximum AOTC of \$2,500  $[(\$2,000 \times 100\%) + (\$2,000 \times 25\%)]$ .**

Christine is not eligible for the AOTC because she is in her fifth year of study. Only tuition and fees are qualifying expenses in calculating the LLTC. Martina can claim a LLTC of \$960 (\$4,800 x 20%). Because Martina's adjusted gross income exceeds \$54,050, her LLTC must be reduced using the following formula:

$$\text{Tax credit percentage} = \frac{\text{Adjusted gross income} - \$55,000}{\$10,000}$$

$$\text{Tax credit allowed} = \text{Calculated tax credit} \times (1 - \text{tax credit percentage})$$

$$10\% = \frac{\$56,000 - \$55,000}{\$10,000}$$

$$\$864 = \$960 \times (1 - 10\%)$$

Martina's higher education tax credit is \$3,364 (\$2,500 AOTC for Matthew + \$864 LLTC for Christine).

- b. Assume that Martina's adjusted gross income is \$83,000. What amount can she claim as a tax credit for the higher education expenses she pays?

Because Martina's adjusted gross income exceeds \$65,000, she is not eligible to claim the LLTC and must reduce the amount of her AOTC using the following formula:

$$\text{Tax credit percentage} = \frac{\text{Adjusted gross income} - \$80,000}{\$10,000}$$

$$\text{Tax credit allowed} = \text{Calculated tax credit} \times (1 - \text{tax credit percentage})$$

$$30\% = \frac{\$83,000 - \$80,000}{\$10,000}$$

$$\$1,750 = \$2,500 \times (1 - 30\%)$$

Martina's higher education tax credit is \$1,750 (\$1,750 AOTC for Matthew + \$0 LLTC for Christine).

74. Brendan and Theresa are married and have three children in college. Their twin daughters, Christine and Katlyn, are freshmen and attend the same university. Their son, Kevin, is a graduate student. Brendan and Theresa pay \$12,000 in tuition and fees (\$6,000 each) and \$1,100 in textbooks (\$500 and \$600 respectively) for their daughters and \$4,200 in tuition and fees for Kevin and \$400 in textbooks. The twins' room and board is \$2,600, while Kevin's room and board is \$1,400. Brendan and Theresa have an adjusted gross income of \$77,000.

**Eligible taxpayers who incur expenses for higher education can elect to claim one of two tax credits, the American Opportunity Tax Credit (AOTC) or the Lifetime Learning Tax Credit (LLTC). Only one credit can be claimed for each qualifying student. Qualifying expenses for the American Opportunity Tax Credit (AOTC) include tuition, related fees, and course materials (i.e., textbooks) required for enrollment at an eligible institution. Unlike the AOTC, course materials are not a qualifying expense in calculating the Lifetime Learning Tax Credit.**

**The AOTC and the LLTC are both phased out ratably over the same base, \$20,000 for married taxpayers and \$10,000 for all other taxpayers. However, the credits over phased out at different levels of adjusted gross income. The AOTC is phased out ratably for married taxpayers with adjusted gross income between \$160,000 and \$180,000 and for all other taxpayers with adjusted gross income between \$80,000 and \$90,000. The LLTC is phased out ratably for married taxpayers with adjusted gross income between \$111,000 and \$131,000 and for all other taxpayers with adjusted gross income between \$55,000 and \$65,000.**

**The American Opportunity Tax Credit provides for a 100% tax credit on the first \$2,000 of qualified expenses and a 25% tax credit on the next \$2,000 of higher education expenses paid during the year for each qualifying student. Therefore, the maximum credit a taxpayer may claim per year for each qualifying student is \$2,500  $[(\$2,000 \times 100\%) + (\$2,000 \times 25\%)]$ . The AOTC can only be claimed for the first four years of undergraduate study.**

**The Lifetime Learning Tax Credit provides a 20% credit for up to \$10,000 of qualified higher education expenses. The LLTC is limited to a maximum amount of \$2,000  $(\$10,000 \times 20\%)$ , regardless of the number of qualifying individuals incurring higher education expenses.**

- a. What amount can they claim as a tax credit for the higher education expenses they pay?

**Brendan and Theresa can claim an American Opportunity Tax Credit (AOTC) for each of their daughters and the Lifetime Learning Tax Credit for Kevin. Only the expenses incurred for tuition and fees and textbooks are eligible for the AOTC. Because each of their qualifying expenses exceed \$4,050  $(\$6,600 = \$6,000 + \$600)$  and  $(\$6,500 = \$6,000 + \$500)$ , Brendan and Theresa can claim the maximum AOTC of \$2,500  $[(\$2,000 \times 100\%) + (\$2,000 \times 25\%)]$  for each daughter.**

**Kevin is not eligible for the AOTC because he is a graduate student, but is eligible for the LLTC. Only tuition and fees are qualifying expenses in calculating the LLTC. Brendan and Theresa can claim a LLTC of \$840 (\$4,200 x 20%).**

**Brendan and Theresa's total higher education tax credit is \$5,840 (\$5,000 AOTC for the twins + \$840 LLTC for Kevin).**

- b. Assume that their adjusted gross income is \$116,000. What amount can they claim as a tax credit for the higher education expenses they pay?

**Brendan and Theresa can claim a total tax credit for higher education expenses of \$5,630. Because Brendan and Theresa's adjusted gross income is less than \$160,000, they do not have to reduce their AOTC. However, since their adjusted gross income exceeds \$111,000, they must reduce the amount of the LLTC using the following formula:**

$$\text{Tax credit percentage} = \frac{\text{Adjusted gross income} - \$111,000}{\$20,000}$$

$$\text{Tax credit allowed} = \text{Calculated tax credit} \times (1 - \text{tax credit percentage})$$

$$25\% = \frac{\$116,000 - \$111,000}{\$20,000}$$

$$\$630 = \$840 \times (1 - 25\%)$$

**Brendan and Theresa can claim a higher education tax credit of \$5,630 (\$5,000 AOTC for the twins + \$630 LLTC for Kevin).**

- c. Assume the same facts as in part a, except that Kevin is a freshman and the twins are graduate students. What amount can Brendan and Theresa claim as a tax credit for the higher education expenses they pay?

**If Kevin is a freshman, they would claim an AOTC of \$2,500. Kevin's qualifying expenses of \$4,600 (\$4,200 + \$400) exceed \$4,050, so they will be able to claim the maximum allowable credit.**

**If the twins are graduate students, they would not be eligible for the AOTC, but their expenses qualify for the LLTC. In addition, the LLTC is not a per person tax credit but a per taxpayer (i.e., Brendan and Theresa) tax credit. Therefore, the maximum LLTC for the twins is \$2,000 (\$10,000 x 20%).**

**Brendan and Theresa can claim a total tax credit for higher education expenses of \$4,500 (\$2,500 + \$2,000).**



75. Determine whether each of the following taxpayers must file a return in 2016:

- a. Jamie is a dependent who has wages of \$4,050.

**Jamie's standard deduction is equal to her wages, so she does not have to file.**

- b. Joel is a dependent who has interest income of \$1,200.

**Joel's unearned income is greater than \$1,000, so he has to file a return.**

- c. Martin is self-employed. His gross business receipts are \$24,050, and business expenses are \$24,300. His only other income is \$2,600 in dividends from stock he owns.

**Although Martin's net income from self-employment is less than \$400, his total gross income is \$26,600, which is greater than \$10,450 (\$6,300 + \$4,050). He must file a return.**

- d. Valerie is 68 and unmarried. Her income consists of \$6,500 in Social Security benefits and \$11,500 from a qualified employer-provided pension plan.

**Valerie's gross income is \$11,500 which is less than \$11,900 (\$6,300 + \$4,050 + \$1,550 exemption for age) and she is not required to file a return.**

- e. Raul and Yvonne are married and have 2 dependent children. Their only income is Raul's \$21,000 salary.

**Raul and Yvonne's gross income of \$21,000 is more than \$20,700 [\$12,600 + (2 x \$4,050)], so they must file a tax return. Note: The dependency exemptions are not included in determining whether Raul and Yvonne have to file a return. Therefore, even though their taxable income will be zero [\$21,000 - \$20,700 - \$8,100 (\$4,050 x 2)], they still must file a tax return. In fact, they should receive a refund because of his tax withholdings, the child tax credit, and the earned income tax credit.**

76. Determine whether each of the following taxpayers must file a return in 2016:

- a. Felicia is a dependent who has wages of \$6,100 and interest income of \$225.

**Because Felicia's gross income of \$6,325 is more than her standard deduction of \$6,300, she must file a return.**

- b. Jason is a dependent who has interest income of \$800.

**Jason's unearned income is less than \$1,000, so he does not have to file a return.**

- c. Jerry is self-employed. His gross business receipts are \$43,000, and business expenses are \$40,300. His only other income is \$1,200 in interest from municipal bonds.

**Because Jerry's gross income of \$43,000 is greater than \$10,350 (\$6,300 + \$4,050), he must file a return. In addition, Jerry must file because his self-employment income is greater than \$400.**

- d. Magnus is 69, unmarried and legally blind. His income consists of \$10,500 in Social Security benefits and \$11,200 from a qualified employer-provided pension plan.

**Magnus's gross income is \$11,200, which is less than \$11,900 (\$6,300 + \$4,050 + \$1,550 age exemption) and he is not required to file a return.**

- e. Wayne and Florencia are married and have 1 dependent child. Wayne stays home and takes care of their child. Florencia's salary is \$23,000.

**Wayne and Florencia's gross income of \$23,000 is more than \$20,700 [\$12,600 + (2 x \$4,050)], so they must file a tax return. Note: The dependency exemptions are not included in determining whether they have to file a return. Therefore, even though their taxable income will be zero [\$23,000 - \$20,700 - \$4,050 (\$4,050 x 1)], they still must file a tax return. In fact, they should receive a refund because of her tax withholdings, the child tax credit, and the earned income tax credit.**

**ISSUE IDENTIFICATION PROBLEMS**

In each of the following problems, identify the tax issue(s) posed by the facts presented. Determine the possible tax consequences of each issue that you identify.

77. Kahn is 21 years old and a full-time student. He lives at home with his parents and pays less than half of his support. During the year, he earns \$6,400 working as a sales clerk in a department store.

**The first issue is whether Kahn is a dependent of his parents. Kahn would be dependent under the qualifying child rules. He meets the age test (full-time student under 24 years of age), principal residence test, non-support test (he does not pay for than one-half of his support), relationship test and citizenship test. The second issue is whether Kahn has to file a tax return. Since his income is more than the standard deduction amount of \$6,300, he must file a tax return.**

78. Lois is single. She provides more than 50% of the support for her mother who lives in a nursing home. Her mother receives \$4,050 from Social Security and \$7,000 in dividends.

**There are two issues. The first is whether Lois's mother qualifies as her dependent. The second is whether Lois can file as head of household. Lois's mother can only qualify as a dependent under the qualifying relative rules. Under these rules, her mother will not qualify as a dependent because her gross income (\$7,000) exceeds the personal exemption amount of \$4,050. Since her mother does not qualify as her dependent, Lois cannot file as head of household.**

79. Hector is 66 years of age. During the year, his wife dies.

**The issue is to determine Hector's filing status for the current year. Hector is considered married for the current year and would file using the married filing joint tax rates. Based on the information provided, Hector would file as single in the subsequent year.**

80. Myrth is 67, single, and has poor hearing. She pays \$300 for special equipment attached to her phones to amplify a caller's voice.

**The issue is whether the special equipment qualifies as a medical expense deduction. The cost of the special equipment is a deductible medical expense because it was purchased by the taxpayer primarily to mitigate his condition of deafness.**

**Instructor's Note: This issue identification problem is based on Rev. Rul. 71-48, 1971-1, CB 99.**

81. Jacqueline is single. In June 2016, she receives a refund of \$250 from her 2015 state tax return. Her 2015 itemized deductions were \$8,000. In October 2016, her 2014 state tax return is audited, and she has to pay an additional \$340 in state taxes. During 2016, Jacqueline has \$2,450 withheld from her paycheck for state income taxes.

**The issue is to determine the tax treatment for the various state income tax transactions during the year. Under the tax benefit rule, the \$250 refund she receives is included as income on her 2016 tax return. The \$250 does not reduce her 2016 itemized deduction for state taxes. Even though the audit relates to the 2014 tax year, the additional \$340 in state tax is deductible as an itemized deduction on her 2016 tax return. Jacqueline can also deduct as an itemized deduction the \$2,450 in state taxes she had withheld in 2016. She will report \$250 as income and her total itemized deduction for state taxes is \$2,790 (\$2,450 + \$340).**

82. Troy's 2014 tax return is audited. The auditor determines that Troy inadvertently understated his ending inventory in calculating his business income. The error creates an additional tax liability of \$5,000. The IRS charges interest on the additional tax liability of \$600.

**The issue is whether the interest is personal interest or interest incurred in a trade or business. If the interest is considered personal it is not deductible. The facts of this case indicate that Troy is being assessed an additional tax liability and interest on that liability as a result of understating the ending inventory in his business. The general rule is that interest on a personal tax return is considered personal interest. Because the interest expense can be directly traced to a mistake made in computing his business income, an argument could be made that the interest is business interest and deductible.**

**Instructors Note:** The problem is designed to point out to the student that the logical and conceptually intuitive answer is not always correct. The facts of the problem are based on *Miller* 65 F. 3d 687, (1995), [reversing the District Court *Miller et ux. v. US* 841 F. Supp. 305 ND, (1993)]. In this case, the 8<sup>th</sup> Circuit Court ruled that a taxpayer who incurs interest expense on an additional tax liability as a result of the IRS disallowing farm expenses is not allowed to deduct the interest paid on the additional tax liability as a business expense.

83. Dwight purchases a new home costing \$100,000 in the current year. He pays \$15,000 down and borrows the remaining \$85,000 by securing a mortgage on the home. He also pays \$2,000 in closing costs, and \$1,700 in points to obtain the mortgage. He pays \$7,500 in interest on the mortgage during the year.

**The issue is to determine which of Dwight's expenses in acquiring his new home are deductible. Dwight is allowed to deduct the \$7,500 of interest paid on the acquisition debt and the \$1,700 of points paid to obtain the initial mortgage. His total allowable home mortgage interest deduction is \$9,200. The closing costs of \$2,000 are not deductible and are added to the basis of the home.**

84. Donna bought her home several years ago for \$200,000. She paid \$20,000 down on the purchase and borrowed the remaining \$180,000. When the home is worth \$280,000 and the balance on the mortgage is \$120,000, she borrows \$110,000 using a home equity loan. She uses the proceeds of the loan to acquire a new car, pay off some credit card debt, and pay her children's tuition at a private school. She pays \$12,600 in interest on the home equity loan.

**The issue is to determine the deductible amount of interest. A deduction is allowed for interest paid on acquisition debt of up to \$1,000,000 and on home equity loans secured by the residence up to \$100,000. In addition, the total acquisition debt and home equity debt cannot exceed the fair market value of the property. In this case, the total debt is \$230,000 (\$110,000 + \$120,000), which is less than the fair market value. However, only interest on \$100,000 of the home equity loan is deductible, \$11,455 [ $\$12,600 \times (\$100,000 \div \$110,000)$ ]. The remaining \$1,145 of interest is considered personal interest and is not deductible.**

**Note that the proceeds of the home equity loan may be used for any purpose; the only requirement for deductibility of a home equity loan is that the loan be secured by the residence.**

85. Diedre is single and has dividend income of \$7,500 and a \$6,000 long-term capital gain. She pays \$9,000 of investment interest. The interest expense relates to all of the assets in her portfolio. Diedre has no tax-exempt income, her marginal tax rate is 33% and her adjusted gross income is \$195,000.

**The issue is to determine Deidre's investment interest expense deduction. Investment interest is limited to net investment income. Dividends receive special tax treatment and are taxed at 15% and 20% for taxpayers in the 39.6% marginal tax rate bracket. Because of the preferential tax treatment, unless Marjorie elects otherwise, the dividends are not included as part of investment income. Long-term capital gain income cannot be counted as investment income if the taxpayer takes advantage of the 15% capital gain rate. Unless Deidre elects to forego the preferential rates for dividends and long-term capital gains gain her net investment income for purposes of determining the amount of deductible interest is zero.**

**Because Diedre's marginal tax rate is 33%, she saves \$540 (\$2,025 - \$1,485) by electing to include the dividends and capital gain income in investment income and not taking advantage of the favorable 15% tax rate. Her investment interest deduction is \$9,000.**

**Using Preferential Rates:**

Tax on dividends and capital gains (\$13,500 x 15%)	\$2,025
Less: Tax benefit from investment interest	-0-
Net Tax Cost	\$2,025

**Not Using Preferential Rates:**

Tax on dividends and capital gains (\$13,500 x 33%)	\$4,455
Less: Tax benefit from investment interest (\$9,000 x 33%)	(2,970)
Net Tax Cost	\$1,485

**Instructors Note: It is not always in the best interest of the taxpayer to forego the preferential rates. It is dependent on the taxpayer's marginal tax rate, time value of money (since investment interest can be carried forward) and the amount the taxpayer's investment interest expense. For example, if the taxpayer only incurred \$5,000 of investment interest expense, the \$1,650 (\$5,000 x 33%) of tax savings from the deduction would result in a net tax cost of \$2,805 (\$4,455 - \$1,650) and the preferential rate treatment would be preferred.**

86. Jose donates stock worth \$20,000 to the United Way. He purchased the stock several years ago for \$8,000. His adjusted gross income is \$60,000.

**The issue is what amount can Jose deduct as a charitable contribution. Although contributions of long-term capital gain property may be valued at the fair market value of the property (\$20,000), the maximum allowable deduction cannot exceed 30% of the taxpayer's adjusted gross income. Therefore, unless he elects to value the contribution at its adjusted basis, the maximum amount he can deduct in the current year is \$18,000. The remaining \$2,000 (\$20,000 - \$18,000) can be carried forward and deducted in the following year, subject to the 30% limit.**

87. Royce received an antique watch as a gift from his grandfather. The fair market value of the watch is \$12,500. The watch has been missing all year and is not covered by insurance.

**The issue is whether missing property qualifies as a casualty loss. For the property to qualify as a casualty loss, the property must be missing due to a robbery, larceny or embezzlement. Missing items do not constitute a theft. Therefore, Royce will not be able to deduct the missing watch as a casualty loss.**

88. Casandra and Gene are married and have a daughter who is a junior at State University. Their adjusted gross income for the year is \$78,000, and they are in the 25% marginal tax bracket. They paid their daughter's \$3,500 tuition, \$450 for textbooks, and \$3,200 in room and board with \$4,750 in savings and by withdrawing \$2,400 from a Coverdell Education Savings Account.

**The first issue is whether Casandra and Gene should claim the American Opportunity Tax Credit or The Lifetime Learning Tax Credit (LLTC).**

**The American Opportunity Tax Credit provides for a 100% tax credit on the first \$2,000 of qualified expenses and a 25% tax credit on the next \$2,000 of higher education expenses paid during the year for each qualifying student. Therefore, the maximum credit a taxpayer may claim per year for each qualifying student is \$2,500  $[(\$2,000 \times 100\%) + (\$2,000 \times 25\%)]$ . The Lifetime Learning Tax Credit provides a 20% credit for up to \$10,000 of qualified higher education expenses. The LLTC is limited to a maximum amount of \$2,000  $(\$10,000 \times 20\%)$ , regardless of the number of qualifying individuals incurring higher education expenses. Assuming the student is eligible for the AOTC, the AOTC will always result in the highest tax credit.**

**The second issue is what expenses qualify for the higher education tax credits. Qualifying expenses for the American Opportunity Tax Credit (AOTC) include tuition, related fees, and course materials (i.e., textbooks) required for enrollment at an eligible institution. Unlike the AOTC, course materials are not a qualifying expense in calculating the Lifetime Learning Tax Credit. Their qualifying AOTC expenses total \$3,950  $(\$3,500 + \$450)$  and their allowable credit is \$2,488  $[(\$2,000 \times 100\%) + (\$1,950 \times 25\%)]$ . If they elect the LLTC, only the \$3,500 tuition is eligible for the credit and their LLTC is \$700  $(\$3,500 \times 20\%)$ .**

**The third issue is the tax treatment of the proceeds from the Coverdell Education Savings Account. The proceeds are tax-free and do not impact the amount of the deduction since the proceeds from the Coverdell Education Savings Account can be used to pay up to \$2,500 of room and board expenses.**

**They should claim the AOTC.**



89. **TAX SIMULATION.** Ross and Jessica are married and have one child, Joy, who is two years old. Ross is a recent college graduate and works as a software engineer. Jessica is a full-time student at Hendrick College, and attends classes in the Fall and Spring semesters. Ross earns \$32,000 during the year and the couple incurred \$2,200 in child care expenses so that Jessica could attend class.

Required: Determine the income tax treatment of the child care expenses. Search a tax research database and find the relevant authority (ies) that forms the basis for your answer. Your answer should include the exact text of the authority (ies) and an explanation of the application of the authority to Ross and Jessica's facts. If there is any uncertainty about the validity of your answer, indicate the cause for the uncertainty.

**Sec. 21(a)(1) allows a taxpayer who maintains a household for a qualifying individual to take a tax credit for a percentage of employment related expenses incurred to take care of the child.**

*(a) Allowance of credit. (1) In general. In the case of an individual who maintains a household which includes as a member one or more qualifying individuals (as defined in subsection (b)(1) ), there shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the applicable percentage of the employment-related expenses (as defined in subsection (b)(2) ) paid by such individual during the taxable year*

**Sec. 21(b)(1)(A) defines a qualified individual as a dependent of the taxpayer who is under 13 years of age.**

*(b) Definitions of qualifying individual and employment-related expenses. For purposes of this section — (1) Qualifying individual. The term “qualifying individual” means— (A) a dependent of the taxpayer (as defined in [section 152\(a\)\(1\)](#) ), (B) a dependent of the taxpayer (as defined in [section 152](#) , determined without regard to [subsections \(b\)\(1\)](#) , [\(b\)\(2\)](#) , and [\(d\)\(1\)\(B\)](#) ) who is physically or mentally incapable of caring for himself or herself and who has the same principal place of abode as the taxpayer for more than one-half of such taxable year, or (C) the spouse of the taxpayer, if the spouse is physically or mentally incapable of caring for himself or herself and who has the same principal place of abode as the taxpayer for more than one-half of such taxable year*

**Sec. 21(b)(2)(A)(ii) defines employment related expenses as those expenses incurred to care for a qualifying individual.**

*(2) Employment-related expenses. (A) In general. The term “employment-related expenses” means amounts paid for the following expenses, but only if such expenses are incurred to enable the taxpayer to be gainfully employed for any period for which there are 1 or more qualifying individuals with respect to the taxpayer: (i) expenses for household services, and (ii) expenses for the care of a qualifying individual*

**Sec. 21(c)(1) sets forth the maximum amount of employment related expenses that can be used in calculating the amount of the child care tax credit.**

*(c) Dollar limit on amount creditable. The amount of the employment-related expenses incurred during any taxable year which may be taken into account under [subsection \(a\)](#) shall not exceed— (1) \$3,000 if there*

*is 1 qualifying individual with respect to the taxpayer for such taxable year, or (2) \$6,000 if there are 2 or more qualifying individuals with respect to the taxpayer for such taxable year. The amount determined under [paragraph \(1\)](#) or [\(2\)](#) (whichever is applicable) shall be reduced by the aggregate amount excludable from gross income under [section 129](#) for the taxable year.*

However, Sec. 21(d)(1) limits the amount of employment related expenses that can be used to calculate the child care credit for a married taxpayer to the lesser of the two spouses earned income.

*(d) Earned income limitation. (1) In general. Except as otherwise provided in this subsection, the amount of the employment-related expenses incurred during any taxable year which may be taken into account under subsection (a) shall not exceed— (A) in the case of an individual who is not married at the close of such year, such individual's earned income for such year, or (B) in the case of an individual who is married at the close of such year, the lesser of such individual's earned income or the earned income of his spouse for such year.*

While this would appear to not allow Ross and Jessica a child tax credit, Sec. 21(d)(2)(A) allows a spouse who is a full-time student to have earned income for purposes of meeting this test of \$250 for each month the spouse is a full-time student.

*(2) Special rule for spouse who is a student or incapable of caring for himself. In the case of a spouse who is a student or a qualifying individual described in subsection (b)(1)(C) , for purposes of paragraph (1) , such spouse shall be deemed for each month during which such spouse is a full-time student at an educational institution, or is such a qualifying individual, to be gainfully employed and to have earned income of not less than— (A) \$250 if [subsection \(c\)\(1\)](#) applies for the taxable year, or (B) \$500 if [subsection \(c\)\(2\)](#) applies for the taxable year. In the case of any husband and wife, [this paragraph](#) shall apply with respect to only one spouse for any one month.*

In conclusion, Jessica is assumed to have \$2,250 [ $\$250 \times 9$  months (September through May)] of earned income for purposes of determining the amount of employment related expenses that can be used in the calculation of their child care tax credit. Since their child care expenses (\$2,200) are less than \$2,250, they are limited to \$2,200 of expenses.

Because their adjusted gross income (AGI) is in excess of \$15,000, they must reduce the 35% general credit by 1% for each \$2,000 (or portion thereof) of AGI in excess of \$15,000. The maximum reduction is limited to 15 percent, leaving the minimum allowable credit of 20 percent. The general credit of 35% must be reduced by 9% [ $(\$32,000 - \$15,000) \div \$2,000 = 8.50 = 9\%$ ] to 26%. Therefore, their child and dependent care credit is \$572 (26% x \$2,200).

90. **INTERNET ASSIGNMENT** With the recent changes in the tax law definition of a dependent, it is interesting to compare how the United States definition of a dependent differs throughout the world. Go to the Australian Government Tax webpage at <http://www.ato.gov.au/>. Type the word dependant (Australian spelling) in the search box. Then click on the term “Adjusted taxable income ATI) for you and your dependants”. Read through the information provide on this page and determine how the Australian definition of a dependent is similar to and different from that of a qualifying child or a qualifying relative.

**Note: The Australian spelling of dependant is “ant” instead of the American spelling “ent”**

The Australian definition of a dependent is similar to our definition in that it includes the taxpayer’s children and parents. It is different in that the age of children who are not students is under 16 years of age as opposed to our age limit of under 19 years of age. In addition, for children who are attending school, the Australian age limit is under 25 years of age as opposed to our limit of under 24 years of age. Unlike the US definition of a dependent that defines the amount of support required to be provided (i.e, more than 50%), the Australian definition does not specifically define the percentage (Note: The amount might be defined in their regulations). Finally, the taxpayer’s spouse is considered a dependent for Australian tax purposes while for U.S. tax purposes, the terminology is different and both spouses are treated as personal exemptions.

#### Who is a dependant?

A dependant can be:

- your spouse—married or de facto
- a student who is under 25 years and is a full-time student at school, college or university
- a child—including your spouse's child, adopted child, step-child or ex-nuptial child who is under 16 years and is not a student
- a child-housekeeper—your child of any age who works full-time keeping house for you
- an invalid relative—your child, brother or sister who is 16 years or over, who
- receives a disability support pension or a special needs disability support pension, or
- has a certificate from a Commonwealth-approved doctor certifying a continuing inability to work
- your parents or spouse's parents.

A dependant needs to be an Australian resident for tax purposes (see Residency). For a spouse, student or child only, they will be treated as a resident if you have always lived in Australia or you came to live in Australia permanently—unless they have set up a permanent home outside Australia.

#### Overseas dependants

Your spouse and dependent children who are waiting to migrate to Australia are considered to be your dependants for tax offset purposes but they must migrate within 5 years from when you came to live in Australia permanently. We may ask you to provide evidence.

**What is maintaining a dependant?**

**This means:**

- You and the dependant resided together, or
- You gave the dependant food, clothing and lodging, or
- You helped them to pay for their living, medical and educational costs.
- If you had a spouse for the whole year and your spouse worked for part of the year, you are still considered to have maintained your spouse—as a dependant—for the whole year.
- You are considered to have maintained a dependant even if you were temporarily separated—for example, due to holidays. You are still considered to have maintained dependants who were overseas if they were away from Australia only for a short time.
- If you maintained a dependant for only part of the year, you may need to adjust your claim.

**INSTRUCTOR'S NOTE:** Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

91. **INTERNET ASSIGNMENT** The Internet is a useful resource for tax planning. One useful tax planning tool can be found at the Turbo Tax web site (<http://www.turbotax.com>). At this site, by clicking on the tax Taxcalculator and Tips and then clicking on TaxCaster you can estimate your tax liability by clicking on the various buttons to input your income tax data. Go to the Turbotax web site and supply your personal information. Provide the information you used in filling out the tax estimator and the results it gave to you.

**There is no set solution for this problem. The following information was submitted to the tax estimator:**

Salary	\$41,000
Qualifying dividends	1,000
Other Income	1,500
Short-term capital gains	1,100
Long-term capital gains	3,000
IRA contribution	4,050
State and local taxes	1,100
Other state tax payments	300
Federal taxes withheld	4,500

**INSTRUCTOR'S NOTE:** Obviously, the solution will vary based on the information submitted. The instructor might consider providing the students with the above information. The purpose of the exercise is to expose the students to the vast resources available on the Internet. At the time the solution went to press the tax planner was computing 2015 tax liability. This will probably be changed to calculate a taxpayer's 2016 tax liability. Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

**SOLUTION:**

For 2015, with a filing status of single and age 25 it is estimated that you will receive a refund of \$130.

Federal	
Adjusted Gross Income	43,600
Itemized or Standard Deductions	6,300
Exemption Deduction	4,000
Taxable Income	33,300
Total Tax	3,938
Total Withholding and Payments	4,500
Your Refund	562

**Details**

Income	Wages	41,000
	Qualifying Dividends	1,000
	Capital gains	4,100
	Other income	1,500
	Total income	47,600
Adjusted Gross Income	Other	4,050
	Total adjustments	4,050
	Adjusted gross income	43,600
Deductions	Taxes	1,400
	Total itemized deductions	1,400
	Larger of itemized or standard deductions	6,300
	Exemption deduction	4,000
	Taxable income	33,300
	Regular income tax	3,938
AMT and Credits	Tax after credits	3,938
Other Taxes	Total tax	3,938
Payments	Total payments	4,500
Refund / Amount You Owe	Refund	562
	Marginal tax rate	15 %
	Average tax rate (\$3,938/\$47,600)	8.3%

92. **RESEARCH PROBLEM** Ben is single and works as a lawyer. His mother lives in a nursing home which costs \$30,000 per year. Ben pays \$10,000, his mother pays \$6,000, and her health insurance policy pays the remaining \$14,050. His mother's only income for the year is \$9,000 from Social Security. Can Ben claim his mother as a dependent on his tax return? Explain. Would your answer change if the \$14,050 were not from a health insurance policy but from Medicare? Explain.

**Based on the facts of the problem, Ben's mother meets the gross income test since her only income is from Social Security which is not included in gross income. In addition, she meets the relationship, residency and joint return test. The only test that is questionable is the support test. Because he provides more of his mother's support (\$10,000) than she does (\$9,000), the key question is whether the health insurance policy ( or Medicare) is considered support.**

**In Rev. Rul. 64-223, 1964-2 CB 50, the IRS concluded that the proceeds received by an individual from a health insurance policy are not considered support when determining who is entitled to a dependency exemption. In Rev. Rul. 70-341, 1970-2 CB 31, the IRS reached the same conclusion for Medicare payments. Therefore, Ben will be allowed to claim his mother as a dependent.**

**The IRS and the courts are split over the receipt of Medicaid payments. The courts have generally found that Medicaid is not included in determining support, while the IRS has taken the position that the payment is a form of welfare and should be included in determining support.**

**The IRS agrees with the Second Circuit in *Alfred Turecamo*, 39 AFTR 2d 77-1487 (1977, CA2) that not only Part A benefits covering hospital care but also Part B benefits covering doctor care are entirely excluded from the dependent's total support. However, the IRS contends that Medicaid payments are part of support just like any other welfare payments. The Tax Court, in *Mary Archer*, 73 TC 963 (1980), has held that because of the interlocking nature of Medicare and Medicaid, there is no distinction between the two and that Medicaid payments are excluded from the support calculation.**

93. **RESEARCH PROBLEM** Amanda graduated summa cum laude in marketing from State University. As an honor student, she was a member of Beta Gamma Sigma, an honorary business fraternity. She has agreed to donate \$250,000 to State if the university uses the proceeds to build a fraternity house for Beta Gamma Sigma. In addition, she has agreed to donate the money only if it is deductible as a charitable contribution. Determine whether Amanda's donation qualifies as a charitable contribution.

**The question of whether a gift to a college fraternity is deductible depends on the purpose and function of the fraternity. If the fraternity is "social", donations to it are not deductible. This is the case where the fraternity house is used as a meeting place and for entertainment. However, where its purposes and functions are exclusively for scientific, literary, or educational purposes, donations are deductible. The fact that students live and eat in the fraternity housing will not by itself deny deductibility. In one case, the fraternity's charter clearly limited it to educational, literary, and charitable purposes.**

**The problem is based on the Board of Tax Appeals case *Milton Smith Jr.*, (1933) 28 BTA 422, nonacquiescence and Rev. Rul. 60-367, 1960-2 CB 73. As a result, Amanda will be allowed a charitable contribution for her gift to Beta Gamma Sigma.**



94. **SPREADSHEET PROBLEM** Using the information below, prepare a spreadsheet calculating a taxpayer's taxable income and tax liability for all taxpayers with adjusted gross income below \$100,000. The spreadsheet should be flexible enough to calculate the taxable income if the taxpayer's filing status is single or married and if the taxpayer has additional dependents. A template to assist the student in solving the problem can be found at [www.cengagebrain.com](http://www.cengagebrain.com).

Number of dependents	2
Salary	\$80,000
Interest	10,000
Deductions for adjusted gross income	2,500
Deductions from adjusted gross income	14,050

**Input Area:**

Filing Status	M
Dependency Exemptions	2

Wages		\$	80,000
Interest		\$	10,000
Deduction for Adjusted gross income		\$	(2,500)
Adjusted Gross Income		\$	87,500
Itemized Deductions	\$	14,050	
Standard Deduction	\$	12,600	\$ (14,050)
Exemptions			\$ (16,200)
<b>Taxable Income</b>		<b>\$</b>	<b>57,300</b>
<b>Tax</b>		<b>\$</b>	<b>7,668</b>

**Input Area:**

Filing Status	M
Dependency Exemptions	2

Wages

Interest

Deduction for Adjusted gross income

Adjusted Gross Income

Itemized Deductions 14000

Standard Deduction =IF((B2="s"),6300,IF((B2="M"),12600,IF((B2="HH"),9300,6300)))

Exemptions

**Taxable Income****Tax**

80000

10000

-2500

=SUM(C6:C8)

=IF(B10&gt;B11,-B10,-B11)

=IF(OR((B2="s"),(B2="h")),(-4000+(-B3\*4050)),(-8000+(-B3\*4050)))

**=SUM(C9:C12)**

=IF(B2="S",VLOOKUP(\$C\$13,D13:E18,2,TRUE),VLOOKUP(\$C\$13,D20:E25,2,TRUE))

0

0.1

9275

=927.5+((C13-D14)\*0.15)

37650

=5183.75+((C13-D15)\*0.25)

91150

=18558.75+((C13-D16)\*0.28)

190150

=46278.75+((C13-D17)\*0.33)

413350

=119934.75+((C13-D18)\*0.35)

415050

=120529.75+((C13-D19)\*.396)

0

0.1

18550

=1855+((C13-D21)\*0.15)

75300

=10367.50+((C13-D22)\*0.25)

151900

=29517.50+((C13-D23)\*0.28)

231450

=51791.50+((C13-D24)\*0.33)

413350

=111818.50+((C13-D25)\*0.35)

=130578.50+((C13-D26)\*.396)

466950

95. **TAX FORM PROBLEM** Joe and Sharon Racca are married and have two children. Joe works as a sales manager for a national pharmaceutical company and Sharon is a nurse. They own a vacation home in New Hampshire that is used 30% for personal purposes. During the year they receive \$800 in reimbursements from their medical plan and report \$2,200 of investment income. They contributed stock, with a fair market value of \$4,050, which they acquired in 2005 at a cost of \$1,700 to Stanton College. The Racca's gambling winnings for the year were \$1,000 and are included in their adjusted gross income. Their adjusted gross income for the year is \$88,000 and they provide you with the following data:

Automobile insurance	\$ 1,450
Homeowners insurance	625
Life insurance	980
Disability insurance	375
Health insurance premiums	1,420
Country club dues	1,800
Health club dues	750
Hospital	4,700
Doctor	1,275
Chiropractor	650
Dentists	3,750
Prescription drugs	275
Over-the-counter drugs	460
State taxes withheld	3,475
Property taxes (ad valorem)	320
Investment interest	1,600
Mortgage interest (primary residence)	6,850
Real estate taxes (primary residence)	2,240
Mortgage interest (vacation residence - unallocated)	3,000
Real estate taxes (vacation residence - unallocated)	1,350
Charitable contributions (cash)	8,435
Charitable contribution (clothes at FMV)	100
Investment advice	425
Subscriptions to investment journals	225
Dues to professional organizations	375
Attorney fee for tax advice on dispute with IRS	525
Parking at work	190
Safe-deposit box	75
Tax return preparation	400
Gambling losses	650
Union dues	310
Nurses uniform	225

Unreimbursed employee business expenses (after allocation but before limitations)

Airfare	600
Lodging	450
Meals	390
Entertainment	280
Incidentals	150

Complete Form 1040 Schedule A. Joe's Social Security number is 063-79-4185 and Sharon's Social Security number is 530-22-6584. Forms and instructions can be downloaded from the IRS web site (<http://www.irs.ustreas.gov/formspubs/index.html>).

The following sets forth how the information is presented on the Schedule A:

**Medical**

Health insurance premiums	\$ 1,420	
Hospital	4,700	
Doctor	1,275	
Chiropractor	650	
Dentists	3,750	
Prescription drugs	275	
Reimbursement	(800)	
Total Line 1	<u>\$ 11,270</u>	
Less: \$88,000 x 10%	<u>(8,800)</u>	
Line 4		\$ 2,470

**State and Local Taxes**

State taxes withheld - Line 5	\$ 3,475	
Real estate taxes (primary residence)	\$ 2,240	
Real estate taxes (vacation residence) \$1,350 x 30%	405	
Total Line 6	<u>2,645</u>	
Property taxes (ad valorem) - Line 7	<u>320</u>	
Total Line 9		\$ 6,440

**Interest**

Mortgage interest (primary residence)	\$ 6,850	
Mortgage interest (vacation residence) (3,000 x 30%)	900	
Total Line 10	<u>\$ 7,750</u>	
Investment interest Line 14	<u>1,600</u>	
Total Line 14		\$ 9,350

**Charitable Contributions**

Charitable contributions (cash) Line 15	8,435	
Charitable contribution (stock - FMV)	4,050	
Charitable contribution (clothes at FMV) Line 16	100	
Total Line 18		\$ 12,535

**Miscellaneous Itemized Deductions**

Employee business expenses (see below)	\$ 1,535	
Dues to professional organizations	375	
Nurses uniform	225	
Union dues	310	
Attorney fee for tax advice on dispute with IRS	525	
Total Line 21	<u>\$ 2,970</u>	
Tax return preparation Line 22	\$ 400	
Investment advice	\$ 425	
Subscriptions to investment journals	225	
Safe-deposit box	75	
Total Line 23	<u>\$ 725</u>	

Sum of Lines 21, 22 and 23	\$ 4,095	
Less: \$88,000 x 2%	<u>(1,760)</u>	
Line 26		\$ 2,335

Gambling losses Line 28	\$ 650
Total Itemized Deductions	<u>\$33,780</u>

Unreimbursed employee business expenses (after allocation but before limitations)

Airfare	\$ 600
Lodging	450
Meals (390 x 50%)	195
Entertainment (280 x 50%)	140
Incidentals	150
Total unreimbursed employee expenses	<u>\$1,535</u>

**Not Deductible:**

Automobile insurance	\$1,450
Homeowners insurance	625
Life insurance	980
Disability insurance	375
Health club dues	750
Country club dues	1,800
Parking at work	190
Over-the-counter drugs	460

Instructor's Note: The full tax form solution is included separately in file SM\_Ch\_08\_Problem\_95.pdf located on the Instructor's Resource CD within the folder 'Solutions Manual' and also on the companion website, [www.cengagebrain.com](http://www.cengagebrain.com).

96. **Integrative Tax Return Problem** This is the final part of a six part problem that allows you to prepare the 2015 tax return for Laurie and Lynn Norris. As with the previous parts, this part of the problem will ask you to prepare a portion of their tax return. You should then complete the Norris' tax return for 2015. The following information is provided for preparing their 2015 tax return:

- Recall from Chapter 3 that Lynn and Laurie are married and have two children, Josh (15 years old) and Julie (19 years old). Julie is a sophomore at Baynard University and the Norris' pay the following education expenses on behalf of Julie:

Tuition and fees	\$4,300
Textbooks	475
Room and board	2,800

- The Norris' make timely federal quarterly estimated tax payments of \$2,000.
- They contribute stock with a fair market value of \$5,000 to Alamoso Tech. The stock was acquired in 2005 at a cost of \$1,400.
- The Norris' gambling winnings for the year were \$1,000 while their losses were \$1,750.
- In 2014, they refinanced their home and incurred \$2,250 in points to secure a 15 year mortgage.
- The Norris' receive \$2,000 in reimbursements from their medical plan.
- In addition they provide you with the following expenses:

Automobile insurance	\$ 2,950
Homeowners insurance	1,140
Life insurance	870
Disability insurance	465
Health insurance premiums	1,650
Country club dues	2,100
Health club dues	500
Hospital	1,400
Doctor	675
Chiropractor	650
Dentists	1,930
Prescription drugs	340
Over-the-counter drugs	140
State taxes withheld	2,775
Property taxes (ad valorem)	190
Mortgage interest	7,000
Real estate taxes	2,200
Charitable contributions (cash)	3,120
Charitable contribution (clothes at FMV)	100
Investment advice	320
Subscriptions to investment journals	240
Dues to professional organizations	415
Attorney fee for tax advice on dispute with IRS	585
Safe-deposit box	45
Tax return preparation	460

**Required:** Based on the information provided above, complete Form 1040 Schedule A, Form 8283, Form 8863 and finish the 2015 tax return for Laurie and Lynn Norris.

The following sets forth how the information is presented on the Schedule A:

**Medical**

Health insurance premiums	\$ 1,650	
Hospital	1,400	
Doctor	675	
Chiropractor	650	
Dentists	1,930	
Prescription drugs	340	
Reimbursement	(2,000)	
Total Line 1	<u>\$ 4,645</u>	
Less: \$150,656 x 10%	<u>(15,066)</u>	
Line 4		\$ 0

**State and Local Taxes**

State taxes withheld - Line 5	\$ 2,775	
Real estate taxes (\$2,200 x 87.5%) - Line 6	\$ 1,925	
Property taxes (ad valorem) - Line 7	<u>190</u>	
Total Line 9		\$ 4,890

**Interest**

Mortgage interest (\$7,000 x 87.5%)	\$ 6,125	
Points (\$2,250 ÷ 15 years)	<u>150</u>	
Total Line 10	<u>\$ 6,275</u>	
Total Line 14		\$ 6,275

**Charitable Contributions**

Charitable contributions (cash) Line 16	\$ 3,120	
Charitable contribution (stock – FMV)	5,000	
Charitable contribution (clothes at FMV) Line 17	<u>100</u>	
Total Line 17	<u>5,100</u>	
Total Line 19		\$ 8,220

**Miscellaneous Itemized Deductions**

Dues to professional organizations	415	
Attorney fee for tax advice on dispute with IRS	<u>585</u>	
Total Line 21	<u>\$ 1,000</u>	
Tax return preparation Line 22	\$ 460	
Investment advice	\$ 320	
Subscriptions to investment journals	240	
Safe-deposit box	<u>45</u>	
Total Line 23	<u>\$ 605</u>	
Sum of Lines 21, 22 and 23	<u>\$ 2,065</u>	
Less: \$150,656 x 2%	<u>(3,013)</u>	
Line 26		\$ 0

<b>Gambling losses Line 27</b>	<b><u>\$ 1,000</u></b>
<b>Total Itemized Deductions</b>	<b><u>\$20,385</u></b>

**Instructor's Note:** The complete tax form solution is included separately in files SM\_Ch\_08\_Problem\_96A.pdf, SM\_Ch\_08\_Problem\_96B.pdf, SM\_Ch\_08\_Problem\_96C.pdf, SM\_Ch\_08\_Problem\_96D.pdf located on the Instructor's Resource CD within the folder 'Solutions Manual' and also on the companion website, [www.cengagebrain.com](http://www.cengagebrain.com).



**INTEGRATIVE PROBLEMS****97. Robert & Susan - 2016 Tax Calculation****Gross income:**

Susan's salary	\$ 85,000
Susan's cafeteria plan cash - (\$8,500 - \$6,600)	1,900
Susan's employee business expense reimbursement	8,500
Susan's life insurance - [(170 - 50) x \$1.08]	130
Robert's salary - (\$45,000 - \$2,250)	42,750
Robert's business income	19,300
Racetrack winnings	2,600
Interest - (\$1,900 + \$400)	2,300
Cash dividends	1,750

**Total gross income****\$ 164,230****Deductions for adjusted gross income:**

Reimbursed employee business expenses	\$ 8,500	
Capital loss	3,000	
Loss on small business stock	20,200	
IRA deduction (Susan)	5,500	
Self-employment tax (\$2,727 x 50%)	1,364	
Rental property	-0-	(38,564)

**Adjusted gross income****\$ 125,666****Deductions from adjusted gross income:**

Medical expenses	\$-0-	
<b>Taxes:</b>		
State income tax	\$ 8,810	
Property taxes - car	260	
Property taxes - residence	1,720	
Property taxes - rental	320	11,110

**Interest:**

Home mortgage - residence	\$ 14,700	
Home mortgage - rental	890	
Home equity loan	1,950	
Investment interest	550	18,090

Charitable contributions 1,830

Automobile casualty -0-

**Miscellaneous itemized:**

Tax return preparation	\$ 375
Employee business expenses	1,290
Total miscellaneous	\$ 1,665
Less: (\$125,666 x 2%)	2,513
	\$ -0-

Plus: Gambling losses 170

Total itemized deductions (31,200)

Exemptions (4 x \$4,050) (16,200)

**Taxable income \$ 78,266****Tax on ordinary income of \$76,516 (\$78,266 - \$1,750)**

\$76,516 = [\$10,367.50 + [25% x (\$76,516 - \$75,300)]] \$ 10,672

Tax on dividends (\$1,750 x 15%) 263

Add: Self-employment tax 2,727

Less: Withholdings = (\$6,500 + \$6,100 + \$780) (13,380)

Child Credit (1,200)

**Tax refund \$ (918)**

**Discussion:****Gross Income:**

Susan is taxed on the \$1,900 of cash  $[(\$85,000 \times .10) - \$6,600]$  that she took in lieu of the cafeteria plan benefits. She also must include the premiums on the excess group-term life insurance coverage of \$130  $[\$170 - \$50] \times \$1.08$ . All other benefits chosen by Susan are excluded from income. Robert is allowed to reduce his salary by his contribution to the pension plan. Therefore, the amount included in gross income is \$42,750  $[\$45,000 \times 95\% (100\% - 5\%)]$ . He can exclude both the required contribution of 3% and his 2% voluntary contribution. In addition, he is not taxed currently on his employer's contribution to his retirement plan.

Susan must include the reimbursement of her employee expenses in her gross income because the reimbursement is less than her actual costs. The reimbursed portion is deductible for AGI. As a practical matter, the \$8,500 reimbursement and related deduction could have been left off the final summary computation. The unreimbursed portion of Susan's employee business expenses is deductible from AGI, subject to all applicable limitations. Susan is reimbursed for 85%  $(\$8,500 \div \$10,000)$  of her expenses, leaving 15% unreimbursed.

The racetrack winnings of \$2,600 are taxable. The amount withheld for payment of state income taxes (\$260) is deductible as state income taxes paid; the amount withheld for federal taxes (\$780) is included in determining the refund or tax due for 2016. The \$170 Susan and Robert lost on the races prior to winning (i.e., gambling losses) are deductible as a miscellaneous itemized deduction, but is not subject to the 2% AGI limitation.

Interest on the City of Buffalo bonds and the Puerto Rico government bonds are tax-exempt. The interest from the savings account (\$1,900), the U.S. Treasury bills (\$400) and the cash dividends (\$1,750) are all taxable. However, the dividends are taxed at 15%.

The disability pay Robert received from the policy he purchased is excluded. None of the medical expense reimbursements are included in gross income because the employer provided policy paid less than actual costs.

All of the facts indicate that Robert's activities constitute a trade or business. Therefore, all ordinary and necessary business expenses are deductible For AGI. As a matter of practice, the allowable expenses are netted against the gross income from the business and reported as a net figure.

Revenues		\$112,000
Paint	\$ 33,100	
Other material	6,100	
Insurance	5,100	
Payment to students	48,400	(92,700)
Business income		<u>\$ 19,300</u>

**Deductions For AGI:**

Susan is allowed to deduct her reimbursed employee business expenses for AGI. However, as discussed above, in the final summary calculation the reimbursement and the deduction could be left off.

Married individuals are allowed to deduct as an ordinary loss up to \$100,000 of losses on the sale of small business stock. Robert and Susan can deduct \$20,200 (\$6,800 - \$27,000) as an ordinary loss.

Robert and Susan had a short-term capital gain of \$3,500 on the sale of Sobey Corporation stock and a long-term capital loss of \$7,250 on the sale of Bristol Corporation stock. The long-term loss is netted with the long-term capital gain from the limited partnership for a net long-term capital of loss of \$6,650 (\$600 - \$7,250). Netting the \$6,650 long-term loss with the \$3,500 short-term capital gain results in a net long-term capital loss for the year of \$3,150. Only \$3,000 of the loss is deductible in 2016. The remaining \$150 (\$3,150 - \$3,000) is carried forward to 2017.

The limited partnership is considered a passive activity. Losses from passive activities, with certain exceptions for real estate, can only offset income from other passive activities. Therefore, Robert and Susan cannot deduct the \$2,100 ordinary loss. The cash distribution of \$2,400 is not taxable but is considered a return of their investment.

Robert and Susan must treat their summer house as a vacation home. The number of days the rental property is used for personal purposes (30) exceeds 14 days, and is greater than 10% of the number of days the property is rented. Because the vacation home is considered a second residence, rental expenses cannot exceed rental income. Expenses must be deducted in a specific order: interest and taxes, then other expenses and finally depreciation. The rental expenses are allocated based on the number days the property is rented (80) to the total number of days used 100 (80 + 20). As a result, 80% ( $80 \div 100$ ) of the expenses, with the exception of the management fee (100% rental), are rental use and 20% ( $20 \div 100$ ) of the expenses are personal use and are not deductible.

The following summarizes the income and expenses for the summer home

	<u>Rental</u>	<u>Deductible Personal</u>
Rental income	\$ 6,500	
<b>Category 1:</b>		
Interest on mortgage (\$4,450 x 80%)	3,560	\$ 890
Property taxes (\$1,600 x 80%)	1,280	320
Balance of income	\$ 1,660	
<b>Category 2:</b>		
Management fee	380	
Repairs (\$320 x 80%)	256	
Utilities (\$650 x 80%)	520	
Insurance (\$420 x 80%)	336	
Balance of income	\$ 168	
<b>Category 3:</b>		
Depreciation (\$7,000 x 80% = \$5,600)	168	
Balance of income	<u>\$ - 0-</u>	

The allocated depreciation is \$5,600 (\$7,000 x 80%) but is limited to \$168, the balance of income after category 2 expenses. The remaining \$5,432 can be carried forward and used to offset income in future years.

Robert is self-employed and must pay self-employment tax on his net earnings from self-employment. He is allowed to deduct 1/2 of the self-employment tax paid as a deduction for adjusted gross income. This results in only 92.35% of the self-employment income subject to tax. Robert's self-employment tax is \$2,727 [(\$19,300 x 92.35%) x 15.3%] and his deduction for AGI is \$1,364. Note: Robert must pay self-employment taxes using the 15.3% tax rate, because his total income of \$61,650 (\$42,750 of salary + \$18,900 self-employment) is less than the Social Security maximum of \$118,500.

Susan is entitled to a deduction for her IRA contributions, because their adjusted gross income is less than \$184,000. Robert cannot deduct his IRA contribution because he is covered by a qualified employer-sponsored pension plan and their adjusted gross income exceeds \$118,000.

### Deductions From AGI:

They can deduct the cost of the medical insurance policy of \$1,500 (\$125 x 12), optometrist costs of \$285, prescription drugs of \$175, and the unreimbursed medical expenses associated with Robert's accident of \$2,200 (\$14,050 - \$11,800). Their total allowable medical expenses are \$4,160. The life and disability insurance policies are not medical policies and are not deductible. Similarly, veterinarian fees, health club dues, and non-prescription medicines are not deductible medical expenses. Robert & Susan receive no medical expense deduction because the medical expenses do not exceed 10% of AGI \$12,567 (\$125,666 x 10%).

Robert & Susan are allowed to deduct state income taxes paid through withholding and the amount withheld on the racetrack winnings for a total of \$8,810 (\$5,400 + \$3,150 + \$260). They can deduct the property taxes on their principal residence (\$1,720) and the portion of the taxes allocated to their personal use of the summer home (\$320). The auto registration fee is deductible as a property tax to the extent it is based on the value of the automobile, \$260 (\$390 - \$130). The \$130 license fee is not deductible. No deductions are allowed for federal income taxes paid; they are credited against the income tax liability.

Interest on their personal residence mortgage (\$14,700), the home equity loan (\$1,950), and the investment interest of \$550 are deductible in full. The home mortgage is under the \$1,000,000 limit and the home equity loan is under the \$100,000 limit. In addition, the fair market value of their home exceeds the total of both debts. Investment interest is deductible to the extent of investment income. Robert and Susan's investment income exceeds \$600. They also can deduct the mortgage interest expense on their summer home that is allocated to personal use (\$890). Interest paid on personal credit cards is not deductible. Their total interest expense is \$18,090.

They are allowed to deduct charitable contributions of \$1,830. The amounts paid to the United Way (\$260), Randolph University (\$520), St. Philip's Church (\$750), along with the charitable contribution allocated to them from the limited partnership (\$300) are all deductible. Chamber of Commerce dues and political contributions are not charitable contributions.

The automobile and homeowner's insurance are personal expenditures and are not deductible under any allowable personal expenditure category. This is also true for the country club dues.

Robert suffered a gross casualty loss of \$8,000 (the lessor of \$19,500 or \$8,000) on his automobile accident. This is reduced by the \$6,700 of insurance proceeds and the \$100 per event statutory floor, resulting in a loss from the accident of \$1,200. For the loss to be deductible it must be greater than 10% of AGI. Since the loss of \$8,000 is less than \$12,567 ( $125,666 \times 10\%$ ), Robert and Susan cannot claim a casualty loss for the year.

Robert and Susan can deduct, not subject to the 2% AGI limitation, their unsuccessful wagers (\$170) at the racetrack. Because Susan is reimbursed for only 85% ( $\$8,500 \div \$10,000$ ) of her business expenses, they can deduct the remaining 15% of the expenses as unreimbursed business expenses. The unreimbursed meal and entertainment expenses are subject to the 50% limitation on meals and entertainment (see summary below).

The tax return preparation fee (\$375) is deductible and subject to the 2% limit.

Transportation (\$4,100 x 15%)	\$ 615
Lodging (\$2,700 x 15%)	405
Incidentals (\$400 x 15%)	60
Meals (\$1,800 x 15% x 50%)	135
Entertainment (\$1,000 x 15% x 50%)	75
Total unreimbursed employee expenses	<u>\$ 1,290</u>

Robert and Susan are entitled to two personal exemptions and two dependency exemptions, a total of \$16,200 (\$4,050 x 4).

Their taxable income for the year is \$78,266. However, the \$1,750 of dividend income is taxed at 15%. The remaining \$76,516 (\$78,266 - \$1,750) of taxable income is calculated using the 2016 married filing joint tax rate schedule. Robert's self-employment tax of \$2,727 is added to the \$10,935 (\$10,672 + \$263) income tax liability resulting in a 2016 tax liability of \$13,662 and is reduced by their child tax credit of \$1,200. The \$2,000 (\$1,000 x 2) credit must be reduced by \$50 for each \$1,000 or fraction thereof of adjusted gross income in excess of \$110,000. Therefore, they must reduce their child credit by \$800 (see calculation below). Robert and Susan's tax liability after the child tax credit is 12,462 (\$13,662 - \$1,200).

The tax liability is reduced by the amounts withheld on their salaries and their gambling winnings during 2016. The \$13,380 (\$6,500 + \$6,100 + \$780) of withholding results in a tax refund of \$918 (\$12,462 - \$13,380).

#### Child Credit Phase-out:

$$(\$125,666 - \$110,000) \div \$1,000 = 15.67 \text{ (rounded to 16)}$$

$$\$50 \times 16 = \$800 \text{ reduction in credit}$$

$$\$2,000 - \$800 = \$1,200 \text{ allowable child tax credit}$$

## 98. Carmin's 2016 Tax Calculation.

**Gross Income:**

Gross income from phase 1	\$ 79,116
Additional ordinary income from S corporation	5,400
State tax refund	60
Carmin's business income	<u>10,966</u>
Total gross income	<u>\$ 95,542</u>

**Deductions for adjusted gross income:**

Alimony from phase 1 (\$100 x 12)	\$ 1,200	
Net rental loss	1,660	
Self-employment tax deduction	775	
Capital loss deduction	<u>3,000</u>	(6,635)
Adjusted gross income		<u>\$ 88,907</u>

**Deductions from adjusted gross income:**

Unreimbursed medical expenses	\$ 2,845	
Less: AGI limit (\$88,907 x 10%)	<u>(8,891)</u>	\$ -0-
Taxes		
State income tax	\$ 4,768	
Estimated state taxes (\$150 x 4)	600	
2015 state tax paid in 2016	245	
Property taxes on residence	1,584	
Fire tax	136	
Property taxes on personal auto	<u>168</u>	7,501
Interest		
Home mortgage interest	\$ 5,200	
Home equity loan interest	850	
Refinancing points amortization	<u>80</u>	6,130
Charitable contributions		
Paid in cash	\$ 2,465	
Contribution of property	<u>360</u>	2,825
Casualty loss		
Unreimbursed loss	\$ 5,700	
Less: Statutory floor	(100)	
Less: Limit (\$88,907 x 10%)	<u>(8,891)</u>	-0-
Miscellaneous deductions		
Employee business expenses	1,055	
Other miscellaneous deductions	520	
Less: Limit (\$88,907 x 2%)	<u>(1,778)</u>	-0-
Total itemized deductions		(16,456)
Personal and dependency exemptions (2 x \$4,050)		<u>(8,100)</u>
Taxable income		<u>\$ 64,351</u>

Tax on ordinary income of \$64,051 (\$64,351 - \$300)	
{ \$6,897.50 + [25% x (\$64,051 - \$50,400)] }	\$ 10,310
Tax on dividend income from phase 1 (\$300 x 15%)	45
Add: Carmin's self-employment tax	<u>1,549</u>
Total tax liability	\$ 11,904
Less: Child tax credit	(300)
Less: Estimated tax payments (\$400 x 4)	(1,600)
Less: Withholdings	<u>(9,723)</u>
Tax Due	<u>\$ 281</u>

**Additional Gross Income Sources:**

Carmin must include her state income tax refund of \$60 in gross income.

**Carmin's Business**

In Phase 1 of the tax return Carmin reported income from Grubstake Mining and Development of \$2,000. However, because some of the items reported by Grubstake receive special tax treatment she cannot report the net amount of \$2,000 (\$7,400 + \$300 - \$5,200 - \$500) as ordinary income. Therefore, she must include an additional \$5,400 (\$7,400 - \$2,000 reported in Phase 1) as ordinary income. The tax treatment of the short-term capital gain, long-term capital loss and the charitable contribution are discussed below.

All of the facts indicate that Carmin's activities constitute a trade or business. Therefore, all ordinary and necessary business expenses are deductible For AGI. As a matter of practice, the allowable expenses are netted against the gross income from the business and reported as a net figure.

Commissions		\$ 24,230
Deductible expenses:		
Advertising	\$ 4,300	
Telephone	550	
Real estate license	160	
Automobile expenses	4,630	
Interest on car	140	
Property tax on car	112	
Tax preparation	550	
Home office expenses	<u>2,822</u>	<u>\$(13,264)</u>
Business income		<u><u>\$ 10,966</u></u>

Carmin's car is used 40% ( $8,000 \div 20,000$ ) of the time in her business. Because she does not keep track of her actual expenses she must use the standard mileage rate of 54 cents per mile. Carmin can deduct her parking and tolls. Because she is self-employed, she can also deduct 40% of the interest on her car loan and personal property taxes on the car.

Mileage (8,000 miles x 54 cents)	\$ 4,320
Tolls	85
Parking	225
Allowable automobile costs	<u><u>\$ 4,630</u></u>
Property tax (\$280 x 40%)	<u><u>112</u></u>
Interest (\$350 x 40%)	<u><u>140</u></u>

Because Carmin uses a portion of her home (i.e., the basement) for her business, a portion of the expenses she incurs in maintaining the home are deductible as a business expense. The most common method for allocating the expenses is square footage. The total square footage of Carmin's house is 3,000 (2,400 square foot living area + 600 square foot basement). Therefore, 20% ( $600 \text{ square feet} \div 3,000 \text{ square feet}$ ) of the expenses in maintaining the home are deductible. In addition, Carmin can



depreciate 20% of her home. Therefore, Carmin's depreciation deduction is \$415 ( $\$2,077 \times 20\%$ ).

The following summarizes Carmin's allowable home office deduction.

Interest ( $\$6,500 \times 20\%$ )	\$1,300
Real estate taxes ( $\$1,980 \times 20\%$ )	396
Fire tax ( $\$170 \times 20\%$ )	34
Water ( $\$205 \times 20\%$ )	41
Electric ( $\$980 \times 20\%$ )	196
Gas ( $\$630 \times 20\%$ )	126
Insurance ( $\$1,470 \times 20\%$ )	294
Interest refinancing ( $\$100 \times 20\%$ )	20
Depreciation (see above)	415*
Total home office deduction	<u>\$2,822</u>

\* The depreciation of \$2,077 provided in the book is before the allocation discussed above

### ***Deductions For Adjusted Gross Income***

The \$300 short-term capital gain and the \$1,220 short-term capital loss from Phase I must be netted together giving her a \$920 short-term capital loss. In addition she has a \$5,200 long-term capital loss reported to her by Grubstake Mining and Development and a long-term capital gain of \$110 for a net long-term capital loss of \$5,090 (\$110 gain - \$5,200 loss). Because the loss is greater than \$3,000, she can deduct only \$3,000 and the short-term capital loss of \$920 must be used first. Her long-term capital loss is reduced by \$2,080 (\$3,000 - \$920) and the remaining loss of \$3,010 (\$5,090 - \$2,080) is carried forward to 2017.

Carmin is self-employed and must pay the self-employment tax on her net earnings from self-employment. She is allowed to deduct 1/2 of the self-employment tax paid as a deduction for adjusted gross income. This results in only 92.35% of the self-employment income subject to the tax. Because Carmin's \$80,000 salary from her job at ASCI leaves her \$38,500 (\$118,500 - \$80,000) under the Social Security maximum of \$118,500, she has to pay Social Security tax on all of her self-employment income. Her self-employment tax is \$1,549 [ $(\$10,966 \times 92.35\%) \times 15.3\%$ ] and her deduction is \$775 ( $\$1,549 \times 50\%$ ).

Alimony paid is deductible for adjusted gross income. Alimony payments that are reduced based on a contingency related to a child are reduced to the amount that will be paid after the contingency. Carmin's alimony payment will be reduced to \$100 per month when Julius reaches age 18. Therefore, Carmin can only deduct \$1,200 ( $\$100 \times 12$ ) of the payments made to Ray as alimony.

### ***Deductions From Adjusted Gross Income***

Individuals are allowed to deduct the greater of their allowable itemized deductions or their standard deduction. Carmin's allowable itemized deductions exceed the standard deduction for filing as head of household.

**Medical Expenses:** Unreimbursed medical expenses in excess of 10% of AGI are allowed as an itemized deduction. Carmin's allowable medical costs total \$2,845. The allowable costs include those for doctors (\$390), dentists (\$310), chiropractor (\$265), optometrist (\$125), emergency room charges (\$440), prescription drugs (\$215) and the unreimbursed expenses (\$1,100 = \$1,900 - \$800) from ASCI's flexible benefits plan (see Phase I information). Over-the-counter drugs are not deductible. The health club dues paid on her behalf by ASCI are not deductible medical expenses because they are not a treatment for a specific medical condition. The \$2,845 of allowable medical expenses must be reduced the 10% of AGI limitation leaving Carmin with no deduction for medical expenses.

**Taxes:** State and local income taxes paid during 2016 are allowed as a deduction. This includes the amounts withheld from her salary (\$4,768), \$600 ( $\$150 \times 4$ ) in quarterly estimated tax payments and the additional 2015 state tax that is paid in 2016 (\$245). Real and personal property taxes are also deductible. Because Carmin uses part of her home for her business she must allocate a portion (20% - see calculation above) of the real estate tax and fire tax to her business. Therefore, she can only deduct \$1,584 ( $\$1,980 \times 80\%$  ( $100\% - 20\%$ )) of her real estate taxes and \$136 ( $\$170 \times 80\%$  ( $100\% - 20\%$ )) of her fire tax as an itemized deduction.

Carmin can deduct the \$280 in property taxes paid to the town because the taxes are based on the value of the car. However, 40% (see calculation above) of the property tax is business related. Therefore, she only can deduct \$168 ( $\$280 \times 60\%$  ( $100\% - 40\%$ )) as an itemized deduction.

**Interest:** Only qualified home mortgage interest is deductible. Interest paid on up to \$100,000 of home equity loan debt is qualified mortgage interest. As with the real estate and fire taxes, because Carmin uses part of her home for her business she must allocate 20% (see calculation above) of the mortgage interest to her business. Therefore, she can only deduct \$5,200 ( $\$6,500 \times 80\%$  ( $100\% - 20\%$ )) of the home mortgage interest as an itemized deduction. Carmin should not allocate a portion of the home equity interest to her business because the loan proceeds were used to renovate the kitchen and bathroom and to pay off credit card debt. She should deduct the full amount, \$850, of the home equity interest as an itemized deduction.

**Points** paid to obtain an initial mortgage are deductible in the year paid. However, points paid to refinance an existing mortgage must be amortized over the term of the new loan. The \$1,800 of points paid on the refinancing must be amortized over the 15 year term of the new mortgage ( $\$1,800 \div 15 = \$120$  per year). Because the refinancing was done on March 1, only ten months \$100 ( $\$120 \times (10 \div 12)$ ) of the current year's amortization is deductible. However, since \$20 ( $\$100 \times 20\%$ ) was allocated to the home office, only \$80 ( $\$100 - \$20$ ) is deductible.

**Charitable Contributions:** Contributions to qualified charitable organizations are deductible. Larkin College (\$850), the First Methodist Church (\$790), the United Way (\$125), and the homeless shelter (\$200) are qualified charitable organizations. The \$500 allocated from Grubstake Mining and Development is considered a cash contribution. The \$360 property contribution to the Salvation Army is deductible.

**Casualty Loss:** The theft of cash and the jewelry is an allowable personal casualty loss. The loss is measured as the lesser of the decline in value, or the basis of the item. The measured loss for the jewelry is \$6,000 and \$300 for the cash. Carmin's basis in the jewelry is the fair market value when her grandmother died. The total measured loss is \$6,300 (\$6,000 + \$300) and is reduced by the \$600 (\$500 + \$100) of insurance proceeds for an unreimbursed loss of \$5,700. The \$100 statutory floor reduces the loss to \$5,600. The \$5,600 loss is subject to an annual limitation of 10% of adjusted gross income. Subtracting the 10% limitation of \$8,891 (\$88,907 x 10%) results in no casualty loss deduction on the theft.

**Miscellaneous Itemized Deductions:** Because Carmin is reimbursed for only 90% (\$10,800 ÷ \$12,000) of her business expenses, she can deduct the remaining 10% of the expenses as unreimbursed business expenses. However, the meal and entertainment expenses allocated to Carmin must be reduced by 50%.

Airfare (\$4,700 x 10%)	\$ 470
Hotel (\$3,400 x 10%)	340
Car rental (\$600 x 10%)	60
Incidentals (\$400 x 10%)	40
Meals (\$2,000 x 10% x 50%)	100
Entertainment (\$900 x 10% x 50%)	45
Total unreimbursed employee expenses	<u>\$ 1,055</u>

Carmin also can deduct the \$295 for business publications and the \$225 (\$775 - \$500 business related) in tax preparation fees. Her total allowable miscellaneous deductions of \$1,575 (\$1,055 + 295 + \$225) are reduced by \$1,778 (2% x \$88,907), resulting in no miscellaneous itemized deduction.

### ***Exemption Deductions***

Carmin is allowed one personal and one dependency deduction (Anika). Carmin is the custodial parent of Anika but not her son, Julius. This gives her a total deduction of \$8,100 (\$4,050 x 2).

### ***Calculation of Tax Due (Refund)***

Carmen's taxable income for the year is \$64,351. However, the \$300 of dividend income is taxed at 15%. The remaining \$64,051 (\$64,351 - \$300) of taxable income is calculated using the 2016 head of household tax rate schedule. Her self-employment tax of \$1,549 is added to the \$10,355 (\$10,310 + \$45) income tax liability resulting in a 2016 tax liability of \$11,904. The tax liability is reduced by her \$300 child tax credit. The \$1,000 credit must be reduced by \$50 for each \$1,000 dollars or fraction thereof of adjusted gross income in excess of \$75,000. Therefore, she must reduce the child credit by \$700 (see calculation below). Carmen's tax liability after the child tax credit is 11,604 (\$11,904 - \$300).

The tax liability of \$11,604 is reduced by the amount withheld on her salary of \$9,723 and \$1,600 (\$400 x 4) of federal quarterly estimated tax payments resulting in tax due of \$281 (\$11,604 - \$9,723 + \$1,600).

### **Child Credit Phase-out:**

$$(\$88,907 - \$75,000) \div \$1,000 = 13.91 \text{ (rounded to 14)}$$

$$\$50 \times 14 = \$700 \text{ reduction in credit}$$

$$\$1,000 - \$700 = \$300 \text{ allowable child tax credit}$$

***Items that are not deductible:***

The loss on the \$10,000 loan to Ray is a nonbusiness bad debt. Nonbusiness bad debts are deductible as short-term capital losses in the year the debt becomes worthless. Therefore, Carmin does not receive benefit for the \$10,000 capital loss until 2017.

The contributions to the sorority and the local chamber of commerce are not deductible charitable contributions.

Carmin's \$70 car registration cannot be deducted.

Federal income taxes and Social Security taxes cannot be deducted.

The interest on the credit card debt and the interest on the car loan attributable to her personal use of the car are both considered personal interest and not deductible.

## DISCUSSION CASES

99. Chapter 6 discusses expenditures of individuals that are deductible for adjusted gross income (e.g., alimony) and explains the advantage of having an expenditure classified as a deduction for adjusted gross income. Chapter 8 discusses expenditures that are deductible from adjusted gross income (e.g., medical expenses). Select an example of each type of deduction (i.e., for and from) and present an argument as to why that deduction is incorrectly classified. That is, why the expenditure that is a deduction for adjusted gross income should be reclassified as a deduction from adjusted gross income, and why the expenditure that is a deduction from adjusted gross income should be reclassified as a deduction for adjusted gross income.

**Presently, the majority of expenses that are deductions for adjusted gross income are expenses that have a business purpose. Likewise, the majority of expenses which are deducted from adjusted gross income (i.e., itemized deductions) are for personal expenses. Expenses from AGI are deductible only through legislative grace. Two expenses that are classified as deductions for adjusted gross income which do not meet the business purpose requirement are alimony and contributions to individual retirement accounts (IRA). The payment of alimony is a result of a change in marital status and is personal in nature. If legal expenses related to a divorce are non-deductible because the expense is personal in nature, the transfer payment between the two individuals should also be considered personal.**

**The government, in allowing individuals to deduct IRA contributions is trying to encourage savings, and reduce its burden to provide for the taxpayer (i.e., through higher social security benefits) at retirement. By allowing an IRA deduction, the government is mirroring the tax treatment it provides to taxpayers who have employer provided pension plans. Nevertheless, the payment is personal in nature and should be treated as are other personal deductions -- as a deduction from adjusted gross income.**

**On the other side, medical and investment expenses are two expenditures that are considered as personal expenses and deducted from adjusted gross income. An argument could be made to treat these costs as deductions for adjusted gross income. If Congress continues to allow IRA contributions as deductions for adjusted gross income, then medical expenses should be afforded similar treatment. That is, a large number of taxpayers receive employer paid medical coverage that is an excludable fringe benefit. Therefore, if Congress is going to allow IRA contributions as a deduction for adjusted gross income, medical expenses should also be allowed as a deduction for adjusted gross income.**

**Recall from Chapter 5 (See Figure 5-1), that for an expense to be deductible, the expense (in addition to being ordinary, necessary and reasonable) must be incurred in a profit motivated activity. However, while trade and business expenses that meet this criteria are allowed to be deducted for adjusted gross income, investment expenses that meet the very same criteria are only allowed as a deduction from adjusted gross income. Investment expenses are limited further, because the expenses must exceed 2% of adjusted gross income to be deductible.**

**Teaching Note: There is no correct or incorrect answer to this question. Rather, the purpose of the question is for the students to question and evaluate how consistent Congress is in applying the concepts discussed throughout the course. The question clearly demonstrates that in creating and passing tax legislation there are many factors that influence Congress.**

100. Harold works for the Zanten Corporation. Ken is self-employed. Zanten pays all of Harold's medical insurance premiums, whereas Ken purchases medical insurance from his insurance agent. Explain how the payments of Ken's and Harold's medical insurance are treated for tax purposes. Does this treatment meet Adam Smith's equity criterion?

**The payment of Harold's medical premiums by Zanten is a nontaxable fringe benefit and is not taxable to Harold. This assumes that Harold is not a highly compensated employee and that Zanten's medical plan does not discriminate in favor of highly compensated employees. If so, the premiums would be taxable to Harold.**

**The premiums Ken pays as a self-employed taxpayer are considered unreimbursed medical expenses that can be deducted from adjusted gross income. For Ken to receive any benefit from the payment of the medical premiums his total medical expenses must exceed 7.5% of adjusted gross income and Ken must be able to itemize. Ken is allowed to deduct his health insurance premiums as a deduction from adjusted gross income. Ken is allowed this treatment only if he and/or his spouse is not covered or eligible to be covered by another medical plan.**

**The effect of these differing treatments is inconsistent with Adam Smith's notion of horizontal equity. Under this concept, two similarly situated taxpayers should be taxed the same. For example, assume that both Harold and Ken are married with 2 children; both have adjusted gross income of \$70,000; both have a taxable income of \$50,000 before considering the medical premiums; and have a medical policy that costs \$450 per month. Harold will receive a tax free benefit of \$5,400 ( $\$450 \times 12$ ) on the company's payment of the premiums. This will not affect his adjusted gross income or his taxable income. Ken must pay out \$5,400 in medical insurance premiums. The deduction for AGI will allow Ken to save \$1,350 ( $\$5,400 \times 25\%$ ) more in taxes than Harold. However, from a cash-flow or disposable income point of view, Ken is worse off by \$4,050 ( $\$5,400 - \$1,350$ ).**

**TAX PLANNING CASE**

101. Lauren owns stock for which she paid \$70,000 several years ago. She is considering donating the stock to the United Way. The fair market value of the stock is \$80,000. Her adjusted gross income is \$90,000. Lauren has \$5,000 worth of other itemized deductions. She expects that her adjusted gross income will decrease by \$10,000 a year and her itemized deductions will remain constant over the next 4 years. Assume a present value factor of 10%. Write a letter to Lauren explaining whether she should deduct the fair market value of the stock or reduce the amount of her contribution to the adjusted basis of the property.

**Lauren has contributed long-term capital gain property to the United Way and is allowed to value the charitable contribution at \$80,000 (the fair market value of the property). However, because the stock is long-term capital gain property, the maximum amount she can deduct as a charitable contribution for the year is limited to 30% of her adjusted gross income, \$27,000 (\$90,000 x 30%). The remaining \$53,000 (\$80,000 - \$27,000) is carried forward and deducted over the next 3 years. Alternatively, she has the option of treating the property as ordinary income property and reducing her contribution to the basis of the stock (\$70,000). In doing so, her charitable contribution is limited to 50% of her adjusted gross income. For the current year this is \$45,000 (\$90,000 x 50%), leaving her with \$25,000 (\$70,000 - \$45,000) to be carried forward and deducted in year 2.**

**Given the facts, Lauren should treat the property as long-term capital gain property. Although in the current year, Lauren's charitable contribution is limited to \$27,000 and her tax liability is greater by \$4,355 (\$9,294 - \$4,939), over the four-year period she will save \$2,020 (\$31,056 - \$29,036) in taxes. However, when the present value of the tax payments is considered, Lauren is only better off by \$798 (\$26,491 - \$25,693).**

**Treat as Ordinary Income Property: Year 1**

Adjusted gross income		\$90,000
Itemized deductions before contributions	\$ 5,000	
Charitable contribution	<u>45,000*</u>	(50,000)
Personal exemption		(4,050)
Taxable income		<u>\$35,950</u>
Tax { \$927.50 + [15% x (\$35,950 - \$9,275)] }		<u>\$ 4,929</u>

**\* Her charitable contribution is limited to \$45,000 (\$90,000 x 50%) and she has a charitable contribution carryforward of \$25,000 (\$70,000 - \$45,000).**



**Treat as Ordinary Income Property: Year 2**

Adjusted gross income		\$80,000
Itemized deductions before contributions	\$ 5,000	
Charitable contribution	<u>25,000*</u>	(30,000)
Personal exemption		(4,050)
Taxable income		<u>\$45,950</u>

Tax  $\{\$5,183.75 + [25\% \times (\$45,950 - \$37,650)]\}$  \$ 7,259

\* She has a charitable contribution carryforward of \$25,000 (\$70,000 - \$45,000). The amount of the charitable contribution is less than 50% of her AGI.

**Treat as Ordinary Income Property: Year 3**

Adjusted gross income		\$70,000
Itemized deductions before contributions	\$ 6,300**	
Charitable contribution	<u>-0-</u>	(6,300)
Personal exemption		(4,050)
Taxable income		<u>\$59,650</u>

Tax  $\{\$5,183.75 + [25\% \times (\$59,650 - \$37,650)]\}$  \$10,684

**Treat as Ordinary Income Property: Year 4**

Adjusted gross income		\$60,000
Itemized deductions before contributions	\$ 6,300**	
Charitable contribution	<u>-0-</u>	(6,300)
Personal exemption		(4,050)
Taxable income		<u>\$49,650</u>

Tax  $\{\$5,183.75 + [25\% \times (\$49,650 - \$37,650)]\}$  \$ 8,184

**Long-term Capital Property: Year 1**

Adjusted gross income		\$90,000
Itemized deductions before contributions	\$ 5,000	
Charitable contribution	<u>27,000*</u>	(32,000)
Personal exemption		(4,050)
Taxable income		<u>\$53,950</u>

Tax  $\{\$5,183.75 + [25\% \times (\$53,950 - \$37,650)]\}$  \$ 9,259

\* Her charitable contribution is limited to \$27,000 (\$90,000 x 30%) and she has a charitable contribution carryforward of \$53,000 (\$80,000 - \$27,000).

\*\* Standard Deduction

**Long-term Capital Property: Year 2**

Adjusted gross income		\$80,000
Itemized deductions before contributions	\$ 5,000	
Charitable contribution	<u>24,050*</u>	(29,000)
Personal exemption		<u>(4,050)</u>
Taxable income		<u>\$46,950</u>

Tax  $\{ \$5,183.75 + [25\% \times (\$46,950 - \$37,650)] \}$  \$ 7,509

\* Her charitable contribution is limited to \$24,050 ( $\$80,000 \times 30\%$ ) and she has a charitable contribution carryforward of \$29,000 ( $\$53,000 - \$24,050$ ).

**Long-term Capital Property: Year 3**

Adjusted gross income		\$70,000
Itemized deductions before contributions	\$ 5,000	
Charitable contribution	<u>21,000*</u>	(26,000)
Personal exemption		<u>(4,050)</u>
Taxable income		<u>\$39,950</u>

Tax  $\{ \$5,183.75 + [25\% \times (\$39,950 - \$37,650)] \}$  \$ 5,759

\* Her charitable contribution is limited to \$21,000 ( $\$70,000 \times 30\%$ ) and she has a charitable contribution carryforward of \$8,000 ( $\$29,000 - \$21,000$ ).

**Long-term Capital Property: Year 4**

Adjusted gross income		\$60,000
Itemized deductions before contributions	\$ 5,000	
Charitable contribution	<u>8,000*</u>	(13,000)
Personal exemption		<u>(4,050)</u>
Taxable income		<u>\$42,950</u>

Tax  $\{ \$5,183.75 + [25\% \times (\$42,950 - \$37,650)] \}$  \$ 6,509

\* Her charitable contribution of \$8,000 is less than the \$18,000 ( $\$60,000 \times 30\%$ ) maximum.

***Tax Recap*****Ordinary Income:**

	Year 1	Year 2	Year 3	Year 4	Total
Tax	\$ 4,929	\$ 7,259	\$10,684	\$ 8,184	<u>\$ 31,056</u>
PV Factor	x 1.000	x .917	x .842	x .722	
Net Tax	<u>\$ 4,929</u>	<u>\$ 6,657</u>	<u>\$ 8,996</u>	<u>\$ 5,909</u>	<u>\$ 26,491</u>

**Long-term Capital Gain:**

Tax	\$ 9,259	\$ 7,509	\$ 5,759	\$ 6,509	<u>\$ 29,036</u>
PV Factor	x 1.000	x .917	x .842	x .722	
Net Tax	<u>\$ 9,259</u>	<u>\$ 6,886</u>	<u>\$ 4,849</u>	<u>\$ 4,699</u>	<u>\$ 25,693</u>

102. Reg and Rhonda are married and have 2 children, ages 5 and 3. Rhonda has not worked outside the home since the birth of their first child. Now that the children are older, she would like to return to work and has a job offer that would pay her \$27,000 per year. For her to take the job, the children will have to be put into a day-care center. The day-care center will cost \$500 per month. Given the high cost of the day-care center, Reg and Rhonda are wondering whether it is worth it for Rhonda to take the job. They project their current-year taxable income (without considering Rhonda's job) as \$50,000. Write a letter to Rhonda explaining how much additional cash (after taxes) she will earn if she accepts the job. You should include in your letter the nontax factors Rhonda should consider before taking the job.

**From Rhonda's salary of \$27,000, she will have to pay federal taxes, state taxes (which are unknown) and Social Security taxes on her earnings, reducing her after tax cash flow. In addition, she will incur \$6,000 (\$500 x 12) of day care costs, for which she will receive a child and dependent care tax credit. The tax credit serves as a reduction of the cash outflow on the regular income taxes she will pay on her \$27,000 of salary.**

**To qualify for the child and dependent care credit, two conditions must be met: (1) the taxpayer must incur employment-related expenses, and (2) the expenses must be for the care of qualified individuals. Reg and Rhonda meet both of the conditions and qualify for the credit.**

**Because Reg and Rhonda's AGI is in excess of \$15,000, they must reduce the 35% general credit by 1% for each \$2,000 (or portion thereof) of AGI in excess of \$15,000. The maximum reduction is limited to 15 percent, leaving the minimum allowable credit of 20 percent. The minimum credit limit is reached when the taxpayer's AGI exceeds \$43,000. Reg and Rhonda's AGI exceeds the \$43,000 minimum credit threshold and they will receive the minimum 20% credit. The maximum amount of expenses that qualify for the credit is limited to \$3,000 (\$6,000 with two or more qualifying individuals).**

**Reg and Rhonda's child and dependent care credit is \$1,200 (20% x \$6,000). The net expenditure on day-care becomes \$4,800 (\$6,000 - \$1,200 tax savings). If Rhonda accepts the position, Reg and Rhonda's taxable income will be \$77,000 (\$50,000 + \$27,000). This will keep Reg and Rhonda in the 25% marginal tax bracket (taxable income from \$75,300 to \$151,900).**

**Rhonda will receive \$13,384 in net cash payments from her new job:**

Rhonda's gross salary	\$ 27,000
Less:	
Child and dependent care expenditure	(6,000)
Incremental tax liability (25% x \$27,000 salary)	(6,750)
Social Security (7.65% x \$27,000)	(2,066)
Plus:	
Child and dependent care credit	1,200
Net cash flow due to Rhonda's new job *	<u>\$ 13,384</u>

**Other Factors to Consider:**

If Rhonda accepts the position, not only will she benefit by receiving \$13,384 per year, but she will be building Social Security credits for retirement (the employer also contributes 7.65% of Rhonda's salary). If the employer offers any pension benefits, Rhonda will be eligible to earn years of service toward vesting or joining the plan. Rhonda might also receive other non-taxable employee fringes [e.g., medical insurance, group-term life insurance, health club (if in the building), employee discounts, business periodicals, membership dues]. Some non-pecuniary benefits are self-satisfaction of holding a paying job, interaction with colleagues, possible advancement with more challenging duties, possible on-site health facilities, and potentially better or cheaper medical benefits.

On the other hand, Rhonda would have limited contact with her children, potentially missing out on future school activities. Rhonda's free or personal time will also be limited. Rhonda's vacation time will be drastically reduced (probably two weeks per year after the first full year of employment). In essence, Rhonda is foregoing her freedom of choice.

**\*Note:** The solution does not include the reduction in cash flow for state and local income taxes.

103. Beverly and Charlie are married and have one child, Carla, who is 8 years old. With all the changes in the tax law concerning higher education expenses, Beverly and Charlie realize they need to plan for their daughter's college education. They intend to contribute \$2,000 per year for the next 10 years to a Coverdell Education Savings Account. Their broker has advised them that the \$20,000 they contribute to the Coverdell Education Savings Account will generate total income of \$8,900. The total cost of tuition and fees for Carla's four years at the local university is expected to be \$80,000. Beverly and Charlie expect to have \$11,600 in savings and \$28,900 from the Coverdell Education Savings Account available to pay for Carla's tuition costs. They plan on obtaining \$14,500 in qualified student loans and selling stock for \$25,000 to provide the additional money they need to pay Carla's tuition and fees. The amount of the savings is based on annual growth of 6%, and the gain on the stock is based on a growth rate of 8% per year. The payments on the student loans will not start until 6 months after Carla's graduation. The sale of the stock is expected to generate a gain of \$12,000. The broker also estimates that when Carla starts college, the phase-out range for married taxpayers for the American Opportunity Tax Credit and the Lifetime Learning Tax Credit will be \$180,000 to \$200,000 and that the phase-out for student loan interest will be \$85,000 to \$100,000. The phase-outs will increase by \$1,000 per year. The American Opportunity Tax Credit limits are expected to be 100% of the first \$3,000 of expenses and 25% of the next \$3,000 of expenses in 10 years. The Lifetime Learning Tax Credit will be limited to 20% of the first \$15,000 of expenses. Beverly and Charlie's adjusted gross income when Carla starts school is expected to \$84,050 and will increase 5% per year. The tuition is constant over the four years (\$20,000 per year), and Carla's \$80,000 tuition can be paid using any combination of the funding sources. Write a letter to Beverly and Charlie suggesting one combination of the funding sources to pay for Carla's tuition. Your letter should also explain the tax savings from your proposed funding strategy and why other possible funding source combinations will not produce greater savings.

**The first step in solving this problem is to analyze the tax consequences associated with each of the funding sources. In addition, it is important to understand the inter-relationship between the funding sources and the different tax credits and the limitations associated with the tax credits.**

**The sale of the stock will generate a long-term capital gain and be taxed at 15%. Therefore, Beverly and Charlie will pay a tax of \$1,800 (\$12,000 gain x 15%) on the gain. Without considering the consequences of using the other funding sources, they should wait to sell the stock as long as possible.**

**The interest on the student loan will not begin accruing until 6 months after Carla graduates. Therefore, without considering the consequences of using the other funding sources, they should use the student loan to pay for higher education expenses as early as possible.**

**The savings will grow at 6% each year and will yield an after tax return (assuming a marginal tax rate of 25%) of 4.50% [ $6\% \times (1 - 25\%)$ ]. Therefore, without considering the consequences of using the other funding sources, they should wait as long as possible to use their savings.**

Beverly and Charlie are eligible to claim one of two tax credits, the American Opportunity Tax Credit (AOTC) or the Lifetime Learning Tax Credit (LLTC). Only one credit can be claimed for each qualifying student and only tuition and fees are qualified higher education expenses. Although the credit can be claimed in a year that the taxpayer pays for higher education costs using proceeds from an Coverdell Education Savings Account, expenses paid for with distributions from an Coverdell Education Savings Account are not considered qualified higher education expenses in computing either education tax credit. Both credits are phased-out ratably for married taxpayers with adjusted gross incomes between \$180,000 and \$200,000 (when Carla is in college).

The American Opportunity Tax Credit provides for a 100% tax credit on the first \$3,000 of expenses and a 25% tax credit on the next \$3,000 of higher education expenses paid during the year for each qualifying student. Therefore, the maximum credit a taxpayer may claim per year for each qualifying student is \$3,750  $[(\$3,000 \times 100\%) + (\$3,000 \times 25\%)]$ . The AOTC can only be claimed for the first two years of undergraduate study.

The Lifetime Learning Tax Credit provides a 20% credit for up to \$15,000 of qualified higher education expenses. The LLTC credit is limited to a maximum amount of \$3,000  $(\$15,000 \times 20\%)$ , regardless of the number of qualifying individuals incurring higher education expenses

Beverly and Charlie expect their adjusted gross income to be \$84,050, the first year that Carla is in college and that it will grow at 5% each year. Therefore, their adjusted gross income for each year she is in college is

<u>Year</u>	<u>Adjusted gross income</u>
1	\$ 84,050
2	\$ 88,200 $(\$84,050 \times 5\%)$
3	\$ 92,610 $(\$88,200 \times 5\%)$
4	\$ 97,241 $(\$92,610 \times 5\%)$

Based on the above calculation, their higher education tax credits will not be subject to the phase-out.

The proceeds from a Coverdell Education Savings Account, including the income earned on the contributions to the IRA, are tax-free if the proceeds are used to pay for higher education costs. Therefore, the \$8,900 received from the Coverdell Education Savings Account is not subject to tax.

Using the information discussed above, one possible funding strategy is:

<u>Year</u>	<u>Source of funds</u>	<u>Tax benefit (cost)</u>
1	\$14,500 Student loan \$ 5,500 Coverdell ESA	\$ 3,750 AOTC
2	\$ 6,000 Stock sale \$14,050 Coverdell ESA	(\$432) LTCG tax \$ 3,750 AOTC
3	\$11,600 Savings 1,000 Stock sale 5,400 Coverdell ESA	\$ (522) after-tax income (\$72) LTCG tax \$ 3,750 AOTC
4	\$20,000 Stock sale Lost income on savings from year 3	(\$1,440) LTCG tax (\$522) after-tax income \$ 3,750 AOTC

The student loan should be the first funding source for the first year. Because the interest does not accrue until Carla graduates, the loan is effectively a tax-free use of the funds. The remaining \$5,500 funds should come from the Coverdell Education Savings Account. Because at least \$6,000 of the tuition is paid from sources other than the Coverdell Education Savings Account, Beverly and Charlie can claim an AOTC of \$3,000  $[(\$3,000 \times 100\%) + (\$3,000 \times 25\%)]$ . In the second year, the sale of the stock needs to be at least \$6,000 so that they can minimize their tax liability yet still claim the maximum AOTC of \$3,750. The remaining funds (\$14,050) should come from the Coverdell Education Savings Account. The entire sale of stock will generate a \$12,000 gain that will result in a capital gain tax of \$1,800  $(15\% \times \$12,000)$ . Assuming that the \$12,000 gain on the sale of the stock is equally distributed over all the stock sales, the tax on the sale of the stock in year two will be \$432  $[\$1,800 \times (\$6,000 \div \$25,000)]$ . In year 3, Beverly and Charlie should use their savings of \$11,600. However, by utilizing their savings, they will lose \$522  $[(\$11,600 \times 6\%) \times (1 - 25\%)]$  of income in the third and fourth year. The remaining funding for year 3 should be with \$6,400 of the Coverdell Education Savings Account and through the sale of \$1,000 in stock. The tax on the sale of the stock in year three will be \$72  $[\$1,800 \times (\$1,000 \div \$25,000)]$ . They will be able to claim a \$3,750 AOTC in year 3. The fourth year will be funded entirely by the sale of stock. The tax on the sale of the stock in year two will be \$1,440  $[\$1,800 \times (\$20,000 \div \$25,000)]$ . As in the previous years they will be able to claim an AOTC of \$3,750.

**Instructor's Note:** For simplicity and to avoid confusing the students, the funding options do not consider the income earned on the investments during the four years. The impact on the earnings does not change the conclusions reached in the problem. While intuitively it might not make sense to sell stock which will be taxed at 15% while keeping money in a savings account that is taxed at 25%, this occurs because the stock has not appreciated over the four year period. By changing this variable, the solution could change.

**ETHICS DISCUSSION CASE**

104. Tom, an executive for a large corporation, enjoys the challenge of preparing his tax return. He is aggressive in preparing his return and searches through all the available publications to reduce his tax liability. In all the years Tom has completed his return, he has never been audited. However, in preparing his 2015 tax return, Tom misinterpreted a complex change in the law and is being audited. Aware that he probably should have an expert represent him before the IRS, Tom has hired Josephine, a local CPA. During the audit process, Josephine finds expenses that Tom had failed to deduct. However, the IRS also disallowed some of Tom's other deductions. During a meeting, Josephine and the IRS agent agree on Tom's revised taxable income. When Josephine receives the auditor's change letter, she checks the agent's calculation and finds that the agent has miscalculated the new tax liability by \$750 in Tom's favor. In fact, Tom will now receive a refund. When Tom receives his copy of the letter, he leaves a message on Josephine's voice mail congratulating her on her work. You are Josephine's assistant. Josephine asks you to write a letter to Tom explaining the course of action she must take.

**Although the Statements on Standards for Tax Services (SSTS) do not directly address this question, SSTS #7 does address what a CPA should do when the CPA is aware of an error during an administrative procedure. Paragraph .01 of SSTS #7 defines an error as any position, omission or method of accounting, which at the time the return is filed, fails to meet the standards set out in SSTS #1. Because the error in this case does not meet the definition of an error as set forth by SSTS #7, then technically, if Josephine chooses to ignore the error, she is not in violation of this standard. However, while the mistake does not meet the definition of an error set forth in the standard, informing her client of the error is in the spirit of the standard. Further, if she informs the client of the error and the client refuses to disclose the error to the IRS, paragraph .04 of the standard requires Josephine to reassess whether she should continue a professional relationship with the client. It is important to remember that if the client refuses to disclose the error, Josephine cannot disclose this information to the Internal Revenue Service without potentially violating Rule 301 of the Code of Professional Conduct, dealing with a CPA's confidential client relationship.**



## Chapter 8

### Check Figures

30. a. Dependent  
c. Not a dependent  
b. Not a dependent  
d. Dependent
31. a. Dependent  
c. Not a dependent  
e. Dependent  
b. Dependent  
d. Dependent
32. a. Married filing jointly or filing separately  
c. Head of household  
e. Single  
b. Single  
d. Head of household  
f. Surviving spouse
33. a. Married  
c. Head of household  
e. Head of household  
b. Single  
d. Surviving spouse
34. a. \$6,400  
c. \$13,850  
e. \$13,850  
b. \$13,900  
d. \$9,300  
f. \$13,700
35. a. \$6,500  
c. \$9,400  
e. \$10,850  
b. \$15,100  
d. \$ 6,500  
f. \$15,100
36. a. \$67,850; \$12,734 tax  
c. \$93,800 taxable income; \$14,993 tax; \$507 refund  
b. \$766 refund
37. a. \$60,550  
c. \$345 refund  
b. \$8,155; \$6,155 after credit
38. a. \$370  
b. \$0
39. \$2,815
40. a. \$3,855  
b. \$4,180
41. \$5,645
42. a. No effect  
c. \$50 income  
b. \$145 income
43. a. No effect  
c. \$100 income  
b. \$465 income
44. a. \$63,489  
c. \$81,489  
b. \$1,489 - Rocco
45. a. \$6,940  
b. 6,670
46. a. \$12,800  
b. \$10,439

47. \$9,533
48. \$77,000
49. Car loan from dealer
50. a. \$2,900; \$10,225 carryforward                      b. \$2,900; \$10,225 carryforward
51. 2015 - \$3,200; \$4,900 carryforward                      2016 - \$2,900; \$6,375 carryforward
52. a. \$10,200    b. \$10,000  
c. \$9,500
53. a. \$32,000    b. \$54,050 if long-term gain property  
c. \$30,000; \$18,000
54. a. \$100    b. \$0  
c. \$42    d. \$18,000
55. Property with basis of \$32,000
56. a. \$1,810    b. \$5,470
57. \$755
58. \$1,175
59. \$700
60. \$2,100
61. a. \$254,542    b. \$595,300
62. a. \$285,735    b. \$451,800
63. a. \$200    b. \$400  
c. \$250    d. \$1,150  
e. \$0    f. \$1,450
64. a. \$20    b. \$20  
c. \$25    d. \$62  
e. \$0    f. \$205
65. a. \$10,771; \$71 due    b. \$8,073; \$177 refund  
c. \$9,298; \$302 tax refund    d. Joint: \$12,793; \$214 refund
66. a. \$2,000    b. \$1,600    c. \$1,000
67. a. \$1,000    b. \$2,000    c. \$1,650
68. \$950 refund; \$1,950 refund
69. a. \$503    b. \$3,359  
c. \$0    d. \$5,548

70. a. \$503  
c. \$5,355
- b. \$3,359  
d. \$6,242
71. a. \$600  
c. \$560  
e. \$600
- b. \$630  
d. \$880
72. a. \$420  
c. \$1,200  
e. \$0
- b. \$870  
d. \$800  
f. \$600
73. a. \$3,364
- b. \$1,750
74. a. \$5,840  
c. \$4,500
- b. \$5,630
75. a. Does not need to file  
c. Must file  
e. Must file
- b. Must file  
d. Does not need to file
76. a. Must file  
c. Must file  
e. Must file
- b. Does not need to file  
d. Must file