

Contents

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Problem 1 – Karl F. and Jeanne S. Wheat**Notes**

[References correspond to the number used in the fact pattern.]

1. Karl is self-employed and all of the business expenses listed should be reported on Schedule C. Use Part I of Form 4562 to apply §179 expensing for the copier (\$300), waiting room furniture (\$3,600), laptop computer (\$2,100), and camera (\$1,200).
2. Depreciation on the Durango under the MACRS method (use Part V of Form 4562) is computed as:

Cost	\$31,000
First year percentage for 5-year property (Table 8.1, Chap. 8)	<u>20%</u>
First year depreciation deduction	\$ 6,200
Business use	<u>92%</u>
Depreciation related to business use	<u>\$ 5,704</u>

However, as the first year recovery limitation is \$3,260, the depreciation claimed cannot exceed \$2,999 (\$3,260 x 92%).

Deductible expenses under the actual expense method total \$8,914, which is the sum of depreciation of \$2,999 + deductible operating costs of \$5,405 [92% x \$5,875, which is the sum of (\$3,100 + \$1,500 + \$820 + \$225 + \$140 + \$90)] + business parking of \$510.

Deductible expenses under the mileage method total \$8,842, which is the sum of \$7,578 of mileage [\$4,392 (8,612 business miles x \$0.51 mileage rate allowed for Jan-June 2011) + \$3,186 (5,740 business miles x \$0.555 mileage rate allowed for July-Dec 2011)] + \$510 of parking + deductible interest on the car loan of \$754 (92% x \$820). Since the actual expense method yields a higher deduction than does the mileage method, the actual expense method is used.

[Note: If *H&R Block At Home* is used, the program will compare the actual cost method to the mileage method over the expected period of use. If the expected period of use is 6 years, the program estimates that the mileage method will result in greater deductions over that time frame. Nevertheless, since the actual cost method results in a greater deduction this year, the actual cost method is chosen in *H&R Block At Home* and the solution reflects that.]

No deduction is allowed for the \$350 in fines caused by the traffic violations.

3. The receptionist is not technically Karl's employee (she is paid by the landlord) but she serves in that capacity. Consequently, the \$28 gift is deductible. [Nominal charges for gift wrapping are disregarded when imposing the \$25 limitation.]

Karl's travel expenses are allowed as a deduction but are subject the limitation for business meals and entertainment. Thus, deductible business meals total \$420 (50% x \$840) and deductible business entertainment totals \$255 (50% x \$510).

The premiums on disability insurance are not deductible. However, the self-employed health insurance premiums are deductible on line 29, page 1 of Form 1040.

4. The IRA contribution is a deduction *for* AGI and is listed on line 32 of page 1 of Form 1040.

Jeanne's other expenses are miscellaneous itemized deductions subject to the 2%-of-AGI floor. In terms of deducting the use of the Chevrolet Malibu in employment-related activities, the automatic (standard) mileage method is permissible. Although the actual cost method is used for the Durango (see item 2), different cars are involved. Under the mileage method, the deduction is \$498 [\$209 (410 business miles x \$0.51 mileage rate allowed for Jan-June 2011) + \$289 (520 business miles x \$0.555 mileage rate allowed for July-Dec 2011)].

Jeanne's total employment-related expenses which are treated as miscellaneous itemized deductions on Schedule A are as follows:

Job hunting expense	\$ 720
Professional journal	120
Professional dues	90
Continuing education	350
Mileage	<u>498</u>
Total employment-related expenses	\$1,778
Less 2% of AGI	<u>(1,418)</u>
Amount deductible on Schedule A	<u>\$ 360</u>

5. Gene Isaacson can be claimed as a dependent by the Wheats for 2011. It does not matter how long he lived during the year as long as he qualified as a dependent at the time of his death. All of Gene's medical expenses (i.e. \$11,800) can be claimed by the Wheats for 2011, as it is the year of payment that controls deductibility.

Funeral expenses are not deductible for Federal income tax purposes.

6. Under §1014, Jeanne receives Gene's property with a new income tax basis equal to its fair market value at death. For the house and land, this results in a step-up in basis to \$220,000 and \$50,000. For the furniture and appliances, however, a step-down (\$14,000) occurs. In computing depreciation, the new basis under §1014 controls.

Use Table 8.1 in the text for depreciating the personalty (furniture and appliances) and Table 8.6, Column 3, for residential realty (rental home). [For depreciation purposes, the property is deemed placed in service as of March 1—when it was first advertised for rent.] Using Form 4562, the depreciation totals \$9,133 for 2011, comprised of \$2,800 (20% x \$14,000) for the furniture and \$6,333 (2.879% x \$220,000) for the building. The land is not depreciable.

Repairs of \$720 and newspaper advertising of \$360 are deductible in computing net rental income.

7. Rent income is summarized below.

First and last month's rent (2 x \$2,400)	\$ 4,800
May through November (7 x \$2,400)	<u>16,800</u>
	<u>\$21,600</u>

[Note: If you are using *H&R Block At Home*, input 365 in the "days owned" box and in the "days rented" box. Otherwise, the program will apportion the expenses inappropriately.]

The rent for December is not taxed until 2012 since it was not received until then.

The damage deposit is not taxed and becomes income only if and when it is forfeited (i.e., applied towards damages caused by the tenant).

All expenses except the paving assessment are deductible and should be reported on Schedule E. The paving assessment should be added to the cost basis of the land.

8. Karl has a \$10,000 loss from worthless securities. Although it appears that the loss occurs within 12 months (i.e. early December of 2010 to September 2011), under § 165(g)(1) the loss is treated as occurring on the last day of the year of worthlessness. Thus, Karl has a \$10,000 long-term capital loss which he reports on Schedule D of Form 1040.
9. When a taxpayer cannot identify the block of stock that is sold, a FIFO approach is applied. Therefore, the Wheats sold the shares purchased in 2007. Consequently, their gain is \$5,000 [\$17,500 (selling price) – \$12,500 (basis)]. The 500 shares they still own were acquired in 2009.
10. Jeanne's basis in the coin collection is controlled by the gift rules of §1015. Therefore, her basis for gain is her mother's basis of \$9,000. In this case, her basis for loss is also \$9,000 [FMV on the date of the gift (\$18,000) is not lower than basis (\$9,000)]. The measure of a theft loss cannot exceed the lesser of basis (\$9,000) or FMV on date of the theft (\$24,000)—see Concept Summary 7-3 on p. 7-15 in the text. If Jeanne's loss is \$9,000 and the insurance recovery is \$10,000, no loss results. Instead, Jeanne has a \$1,000 long-term capital gain from a collectible—reported on Form 4684 and line 11 of Schedule D. As to the netting process involving gains from collectibles and capital losses, see pp.3-35 and 3-36 in Chapter 3.
11. Under the application of §1014, Jeanne's basis in the lot on Joplin Road is \$19,000—FMV on the date of Violet's death. On the later sale of the property, Jeanne received \$19,700 of consideration since the buyer relieved her of the \$700 in liabilities (back taxes in arrears). Therefore, Jeanne has a long-term capital gain of \$700. Jeanne cannot deduct the taxes because she did not pay them.
12. The presumption is that these "gifts" are compensation for services rendered (i.e., referrals) or to be rendered in the future. It does not matter that there was no obligation or prior agreement to make the payments [see the discussion of the *Duberstein* case on p. 5-5 of the text.] Karl must include \$7,200 in his gross income for 2011—include in Schedule C. The \$900 received on January 4, however, is taxed in 2012.
13. Under the tax benefit rule, the state tax refund is income, reported on line 10, page 1 of Form 1040.

The interest on Missouri bonds is nontaxable, but it must be listed on line 8b, page 1, of Form 1040.

The qualified dividends are subject to the same tax rate as LTCGs—line 44 of Form 1040.

The cash gifts from Karl's parents are nontaxable.

The gambling transactions cannot be netted. The winnings are reported on line 21 of Form 1040 as income. The losses are reported on Schedule A as miscellaneous itemized deductions but are not subject to the 2% of AGI floor.

14. The garage sale netted a realized loss of \$16,300 [\$9,200 proceeds – \$25,500 cumulative bases]. This realized loss is personal and therefore not tax deductible. The \$9,200 proceeds are essentially a nontaxable return of capital.

The medical expenses eligible for deduction total \$14,357 [\$1,300 medical expenses + \$1,200 dental expenses + \$11,800 of Gene's medical expenses + \$57 for medical mileage [\$29 (150 business miles x \$0.19 mileage rate allowed for Jan-June 2011) + \$28 (120 business miles x \$0.235 mileage rate allowed for July-Dec 2011)]]].

The charitable deduction is based on the amount paid and not on the pledge year involved. Thus, the full \$3,600 is deductible in 2011. Plus, the Wheats can deduct \$45 (320 miles x \$0.14) for the use of the Malibu for charitable purposes.

15. The Wheats should claim two personal exemptions for themselves and dependency exemptions for Gene, Trace and Trevor. Since Trace saves his earnings for future college expenses and is not providing any of his support, he meets the definition of a qualifying child. The income he earned does not matter since there is no gross income test for a dependent who meets the definition of a qualifying child.

Form 1040 Department of the Treasury—Internal Revenue Service (99) 2011		OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.
For the year Jan. 1–Dec. 31, 2011, or other tax year beginning		, 2011, ending , 20	
Your first name and initial Karl F		Last name Wheat	
If a joint return, spouse's first name and initial Jeanne S		Last name Wheat	
Home address (number and street). If you have a P.O. box, see instructions. 13071 Forestview Drive		Apt. no.	
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Columbia MO 65201		Foreign country name Foreign province/country Foreign postal code	
Filing Status 1 <input type="checkbox"/> Single 2 <input checked="" type="checkbox"/> Married filing jointly (even if only one had income) 3 <input type="checkbox"/> Married filing separately. Enter spouse's SSN above and full name here. 4 <input type="checkbox"/> Head of household (with qualifying person). (See instr.) If the qualifying person is a child but not your dependent, enter this child's name here. 5 <input type="checkbox"/> Qualifying widow(er) with dependent child		Your social security number 111-11-1111 Spouse's social security number 123-45-6781 Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. <input type="checkbox"/> You <input type="checkbox"/> Spouse	
Exemptions 6a <input checked="" type="checkbox"/> Yourself. If someone can claim you as a dependent, do not check box 6a b <input checked="" type="checkbox"/> Spouse c Dependents: (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) <input checked="" type="checkbox"/> if child under age 17 qualifying for child tax credit (see instructions) Gene Isaacson 123-45-6784 Parent Trace Wheat 123-45-6788 Son Trevor Wheat 123-45-6789 Son d Total number of exemptions claimed		Boxes checked on 6a and 6b: 2 No. of children on 6c who: • lived with you: 2 • did not live with you due to divorce or separation (see instructions): Dependents on 6c not entered above: 1 Add numbers on lines above: 5	
Income 7 Wages, salaries, tips, etc. Attach Form(s) W-2 8a Taxable interest. Attach Schedule B if required b Tax-exempt interest. Do not include on line 8a 9a Ordinary dividends. Attach Schedule B if required b Qualified dividends 10 Taxable refunds, credits, or offsets of state and local income taxes 11 Alimony received 12 Business income or (loss). Attach Schedule C or C-EZ 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here 14 Other gains or (losses). Attach Form 4797 15a IRA distributions 15a Taxable amount 16a Pensions and annuities 16a Taxable amount 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 18 Farm income or (loss). Attach Schedule F 19 Unemployment compensation 20a Social security benefits 20a Taxable amount 21 Other income. List type and amount: GAMBLING 22 Combine the amounts in the far right column for lines 7 through 21. This is your total income		7 32,000 8a 2,000 8b 1,400 9a 600 9b 600 10 90 11 12 52,393 13 -3,000 14 15b 0 16b 0 17 6,127 18 0 19 20b 21 1,000 22 91,210	
Adjusted Gross Income 23 Educator expenses 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 25 Health savings account deduction. Attach Form 8889 26 Moving expenses. Attach Form 3903 27 Deductible part of self-employment tax. Attach Schedule SE 28 Self-employed SEP, SIMPLE, and qualified plans 29 Self-employed health insurance deduction 30 Penalty on early withdrawal of savings 31a Alimony paid b Recipient's SSN 32 IRA deduction 33 Student loan interest deduction 34 Tuition and fees. Attach Form 8917 35 Domestic production activities deduction. Attach Form 8903 36 Add lines 23 through 35 37 Subtract line 36 from line 22. This is your adjusted gross income		23 0 24 0 25 0 26 0 27 3,701 28 8,000 29 4,600 30 0 31a 32 4,000 33 34 35 0 36 20,301 37 70,909	
KIA For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Form 1040 (2011)			

Form 1040 (2011)		Karl	F Wheat	111-11-1111	Page 2
Tax and Credits		38 Amount from line 37 (adjusted gross income)		38	70,909
39a Check <input type="checkbox"/> You were born before January 2, 1947, <input type="checkbox"/> Blind. <input type="checkbox"/> Spouse was born before January 2, 1947, <input type="checkbox"/> Blind. Total boxes checked ▶ 39a		b If your spouse itemizes on a separate return, or you were a dual-status alien, check here ▶ 39b		0	
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, \$5,800 Married filing jointly or Qualifying widow(er), \$11,600 Head of household, \$8,500	40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)		40	25,400
	41	Subtract line 40 from line 38		41	45,509
	42	Exemptions. Multiply \$3,700 by the number on line 6d		42	18,500
	43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43	27,009
	44	Tax (see instructions). Check if any from: a <input type="checkbox"/> Form(s) 8814 b <input type="checkbox"/> Form 4972 c <input type="checkbox"/> 962 election		44	3,114
	45	Alternative minimum tax (see instructions). Attach Form 6251 ▶		45	0
	46	Add lines 44 and 45		46	3,114
	47	Foreign tax credit. Attach Form 1116 if required		47	0
	48	Credit for child and dependent care expenses. Attach Form 2441		48	
	49	Education credits from Form 8863, line 23		49	
50	Retirement savings contributions credit. Attach Form 8880		50	0	
51	Child tax credit (see instructions)		51		
52	Residential energy credits. Attach Form 5695		52		
53	Other credits from Form: a <input type="checkbox"/> 3800 b <input type="checkbox"/> 8801 c <input type="checkbox"/>		53	0	
54	Add lines 47 through 53. These are your total credits		54	0	
55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶		55	3,114	
Other Taxes		56 Self-employment tax. Attach Schedule SE		56	6,435
57 Unreported social security and Medicare tax from Form: a <input type="checkbox"/> 4137 b <input type="checkbox"/> 8919		57		0	
58 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required		58		0	
59a Household employment taxes from Schedule H		59a		0	
b First-time homebuyer credit repayment. Attach Form 5405 if required		59b		0	
60 Other taxes Enter code(s) from instructions		60			
61 Add lines 55 through 60. This is your total tax ▶		61		9,549	
Payments		62 Federal income tax withheld from Forms W-2 and 1099		62	1,320
63 2011 estimated tax payments and amount applied from 2010 return		63		8,800	
If you have a qualifying child, attach Schedule EIC.	64a	Earned income credit (EIC)		64a	
	b	Nontaxable combat pay election 64b			
	65	Additional child tax credit. Attach Form 8812		65	
	66	American opportunity credit from Form 8863, line 14		66	
	67	First-time homebuyer credit from Form 5405, line 10		67	0
	68	Amount paid with request for extension to file		68	
	69	Excess social security and tier 1 RRTA tax withheld		69	0
	70	Credit for federal tax on fuels. Attach Form 4136		70	
	71	Credits from Form: a <input type="checkbox"/> 2439 b <input type="checkbox"/> 8839 c <input type="checkbox"/> 8801 d <input type="checkbox"/> 8885		71	0
	72	Add lines 62, 63, 64a, and 65 through 71. These are your total payments ▶		72	10,120
Refund		73 If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you overpaid ▶		73	571
74a Amount of line 73 you want refunded to you. If Form 8888 is attached, check here		74a		409	
Direct deposit? See instructions.	b Routing number XXXXXXXXXX ▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings				
	d Account number XXXXXXXXXXXXXXXXXXXX				
75 Amount of line 73 you want applied to your 2012 estimated tax ▶		75		0	
Amount You Owe		76 Amount you owe. Subtract line 72 from line 61. For details on how to pay, see instructions ▶		76	
77 Estimated tax penalty (see instructions)		77		162	
Third Party Designee		Do you want to allow another person to discuss this return with the IRS (see instructions)? <input type="checkbox"/> Yes. Complete below <input checked="" type="checkbox"/> No			
Designee's name ▶		Phone no. ▶		Personal identification number (PIN) ▶	
Sign Here		Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.			
Joint return? See instructions. Keep a copy for your records.	Your signature		Date	Your occupation	
	Spouse's signature. If a joint return, both must sign.		Date	Ins Claims Adjustor	
				Daytime phone number 555-555-5555	
				If the IRS sent you an Identity Protection PIN, enter it here (see inst.)	
Paid Preparer Use Only		Print/Type preparer's name		Preparer's signature	
		Firm's name ▶		Firm's EIN ▶	
		Firm's address ▶		Phone no.	
				Check <input type="checkbox"/> if self-employed PTIN	

**SCHEDULE A
(Form 1040)**Department of the Treasury
Internal Revenue Service (99)

Name(s) shown on Form 1040

Karl F Wheat

Itemized Deductions▶ **Attach to Form 1040.**▶ **See Instructions for Schedule A (Form 1040).**

OMB No. 1545-0074

2011Attachment
Sequence No. **07**Your social security number
111-11-1111

Medical and Dental Expenses	Caution. Do not include expenses reimbursed or paid by others.			
	1	Medical and dental expenses (see instructions)	1	14,357
	2	Enter amount from Form 1040, line 38 . . . 2 70,909		
	3	Multiply line 2 by 7.5% (.075)	3	5,318
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4	9,039
Taxes You Paid	5 State and local (check only one box):			
	a. <input checked="" type="checkbox"/> Income taxes, or		5	3,456
	b. <input type="checkbox"/> General sales taxes			
	6	Real estate taxes (see instructions)	6	3,800
	7	Personal property taxes	7	0
	8	Other taxes. List type and amount ▶	8	0
	9	Add lines 5 through 8	9	7,256
Interest You Paid	10	Home mortgage interest and points reported to you on Form 1098	10	4,200
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address ▶		
			11	0
	12	Points not reported to you on Form 1098. See instructions for special rules	12	0
	13	Mortgage insurance premiums (see instructions)	13	0
	14	Investment interest. Attach Form 4952 if required. (See instructions)	14	
	15	Add lines 10 through 14	15	4,200
Gifts to Charity	16	Gifts by cash or check. If you made any gift of \$250 or more, see instructions	16	3,645
	17	Other than by cash or check. If any gift of \$250 or more, see instructions. You must attach Form 8283 if over \$500	17	0
	18	Carryover from prior year	18	0
	19	Add lines 16 through 18	19	3,645
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. (See instructions.)	20	0
Job Expenses and Certain Miscellaneous Deductions	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See instructions.) ▶ Form 2106		
			21	1,778
	22	Tax preparation fees	22	
	23	Other expenses—investment, safe deposit box, etc. List type and amount ▶	23	0
	24	Add lines 21 through 23	24	1,778
	25	Enter amount from Form 1040, line 38 . . . 25 70,909		
	26	Multiply line 25 by 2% (.02)	26	1,418
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-	27	360
Other Miscellaneous Deductions	28	Other—from list in the instructions. List type and amount ▶		
		Gambling Losses 900	28	900
Total Itemized Deductions	29	Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40	29	25,400
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here		

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Schedule A (Form 1040) 2011