

Chapter 3 Summary of End-of Chapter Problem Revisions

2014 Edition Problem Number	2013 Edition Problem Number	2014 Edition Modification
1	1	
2	2	
3	3	
4	4	
5	5	
6	6	
7	7	
8	8	
9	9	
10	10	
11	11	
12	12	
13	13	
14	14	
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16	16	
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22	22	
23	23	
24	24	
25	25	Problem modified
26	26	Problem modified
27	27	Problem modified
28	28	
29	29	
30	30	
31	31	
32	32	
33	33	
34	34	
35	35	
36	36	
37	37	
38	38	
39	39	Problem modified
40	40	
41	41	

2 Solutions Manual for Taxation for Decision Makers

42	42	
43	43	
44	44	
45	45	
46	46	
47	47	
48	48	
49		New problem
50		New problem
51	49	
52	50	
53	51	
54	52	
55	53	
56	54	Problem modified
57	55	
58	56	
59	57	
60	58	
61	59	
62	60	
63	61	
64	62	
65	63	
66	64	
67	65	
68	66	
69	67	
70	68	
71	69	Problem updated
72	70	
73	71	
74	72	Problem modified
75	73	
76	74	Problem modified

Solutions to Chapter 3 Problem Assignments

Check Your Understanding

1. *Choice of Tax Year*

Solution: The sole proprietorship's operating results will all be reported on Michelle's tax return. As a result, it will have to be on a calendar-year basis unless Michelle applies for and receives permission to change her tax year to October 31.

2. *Accounting Methods*

Solution: Jabba must recognize the fair market value of the computer (assumed to be approximately \$2,000) as income in payment of the bill. Cash-basis taxpayers must recognize income when cash or cash equivalents are received as payment. The computer constitutes a cash equivalent.

3. *Accounting Methods*

Solution: Murphy should recognize the income in year 1. The check was readily available several days before the end of the year and, as a cash-basis taxpayer, Murphy cannot turn its back on the income by failing to pick up the check.

4. *Accounting Methods*

Solution: There are several restrictions on the use of the cash method. If inventory is a material factor in the determination of income, an otherwise cash-basis taxpayer must use the accrual method for determining sales and purchases. They may use the cash method for all other income and expense items, however. Businesses with average annual gross receipts of no more than \$10 million may use a variation of the cash method under which they account for the cost of merchandise inventory as an asset, but their sales on the cash basis. Finally, a C corporation with average annual gross receipts of more than \$5 million (except personal service corporations) is prohibited from using the cash method.

5. *Tax vs. Financial Accounting*

Solution: The government is concerned with collecting its tax revenue when the taxpayer has the "wherewithal" to pay the tax. Thus, the government in general does not permit an accrual taxpayer to postpone the recognition of income not yet earned but for which the taxpayer has received payment. GAAP requires the use of accrual accounting even for prepaid items to properly match income to the periods over which it is earned. This helps to maintain the comparability of financial statements over time that would otherwise be distorted if prepaid items were recognized as income when payment was received.

6. *Assignment of Income*

Solution: Ryan's gross income is \$120,000. He earned the income and he is responsible for including it in his taxable income. He will be treated as making a gift of the \$20,000 to his grandmother.

7. *Income Tax Effects of Gifts*

Solution: Tommy will recognize the \$100 dividend income because he is the legitimate owner of the stock at the time the dividend is paid. Virginia has no income.

8. *Tax-Exempt Bonds*

Solution: The interest exclusion for most state and local bond issues permits state and local governments to finance their governmental activities at much lower interest rates than they would be required to pay if they were competing with corporate bonds.

9. *Original Issue Discount*

Solution: Martha must include the \$840 of accrued interest in her income. The bonds were issued with original issue discount and this must be accrued even by a cash-basis taxpayer.

10. *Gross Income/Treasure Trove*

Solution: Jane should include the \$100 in her gross income. Treasure finds also constitute gross income.

11. *Gross Income/Unemployment Compensation*

Solution: Unemployment compensation is a substitute for the taxable salary or wages a person would receive from his or her employment. A substitute for a form of income that is subject to tax will also be included in gross income and taxed. The American Reinvestment and Recovery Act allowed the first \$2,400 of unemployment compensation received in 2009 to escape taxation, but that provision was never extended beyond the 2009 filing year.

12. *Gross Income/Gifts and Inheritances*

Solution: No. The recipients of gifts and inheritances do not include the items received in their gross income. Instead, the giver (donor or decedent) may be subject to a transfer tax (gift or estate tax). Some people consider this transfer tax a second tax because the donor may have been subject to income tax when he or she earned the amounts that were later given as gifts and inheritances.

13. *Life Insurance/Buy-Sell Agreement*

Solution: A buy-sell agreement is an agreement between co-owners of a business that provides for the purchase of one owner's interest by the other (and the other heir's obligation to sell) should the owner die. Life insurance on the deceased payable to the surviving owner(s) provides the funds necessary for the purchase of the deceased owner's interest.

14. *Taxes for a U.S. Citizen vs. Nonresident Alien*

Solution: United States citizens are subject to U.S. tax on their worldwide income. Income earned by nonresident aliens is divided into three categories: U.S. business income (called effectively connected income), non-U.S. business income, and U.S. investment income. Nonresident aliens are taxed similar to U.S. citizens on their effectively connected business income. Business income that is not effectively

connected with the United States is usually not subject to U.S. tax. U.S. investment income includes interest, dividends, and royalties and is usually taxed at a flat 30 percent rate (or treaty rate if lower).

15. *Tax Treaty*

Solution: The objective of a tax treaty with a foreign country is to minimize double taxation of the same income by the United States and the foreign country.

16. *Foreign Tax Credit*

Solution: The purpose of the foreign tax credit is to minimize double taxation of the same income by the two countries. Under the source principle, a country can claim the right to tax income earned within its boundaries. To minimize the double tax, the resident country then allows its citizens and corporations to offset the domestic tax on their foreign income with a foreign tax credit up to the amount of tax paid to the source country. The net tax paid will usually be the greater of the taxes imposed by the two countries claiming jurisdiction over the income.

17. *Nexus*

Solution: Nexus is the type and degree of connection between a taxpayer and a taxing jurisdiction (e.g., a state or city) necessary for that jurisdiction to have the right to impose a tax on the taxpayer.

18. *Installment Method*

Solution: An installment sale is a sale in which the payments are received over a period of time rather than the entire payment being received at the time of sale. For tax purposes a sale of certain qualifying goods is an installment sale if one or more payments are received in a future tax year.

In a qualifying installment sale, the taxpayer recognizes gain (income) and is taxed on this gain only as payments are received. A proportion of each payment is gain; the proportion is the ratio of total gain to the total proceeds on the sale.

The taxpayer must elect out of installment sale treatment if he or she does not want it to apply to a qualifying sale simply by reporting the entire gain on the sale in the year the sale is closed.

19. *Long-Term Construction Contracts*

Solution: A long-term contract is a contract for the manufacture, building, installation or construction of property that will not be completed in the year the contract is entered into. There are two permissible tax treatments: the completed contract method and the percentage-of-completion method. The first allows the contractor to postpone the recognition of income and expenses related to the contract until the year the contract is completed. The percentage-of-completion method allows the taxpayer to recognize income based on the ratio of actual expenses incurred to date to total anticipated expenses for the contract as a whole. The latter method spreads income recognition across the period of time over which the income is earned.

Crunch the Numbers

20. *Short Tax Years*

Solution: \$26,273.

Annualized income = $\$96,000 \times 12/8 = \$144,000$.

Corporate tax on \$144,000 of income is \$39,410 [$(\$50,000 \times 15\% = \$7,500) + (\$25,000 \times 25\% = \$6,250) + (\$25,000 \times 34\% = \$8,500) + (\$44,000 \times 39\% = \$17,160)$]

The tax for 8 months is $\$39,410 \times 8/12 = \$26,273$.

21. *Refunds of Prior Income*

Solution: a. Because the refunded amount exceeds \$3,000, Specialty Training has two choices: it can deduct the \$5,000 in the current year or it can reduce the current year's tax by the amount of tax paid in the prior year on the \$5,000.

b. At 39 percent marginal tax rate in the year of repayment, Specialty would be better off taking a deduction for the amount repaid at that time. It will reduce its taxes by \$250 $[(39\% - 34\%) \times \$5,000]$ more than taking the deduction for prior year's taxes paid.

c. With a marginal tax rate of 25 percent, Specialty should reduce the current year's tax for the \$1,700 $(\$5,000 \times 34\%)$ of taxes paid in the prior year. It will be \$450 $[(34\% - 25\%) \times \$5,000]$ better off.

22. *Prepaid Rental Revenue*

Solution: a. For tax purposes Realty will recognize \$6,000 $(\$3,000 \times 2 \text{ months rent})$ income in year 1 because prepaid income is taxed when received for both cash and accrual basis taxpayers. For financial accounting no income will be recognized in year 1.

b. For tax purposes, Realty will recognize \$8,500 $(\$3,000 \text{ March rent} + \$3,000 \text{ April rent} + \$2,500 \text{ kept from deposit})$ income in year 2. For financial accounting, Realty will recognize all \$14,500 as income in year 2. (Note that a deduction would be allowed for the costs to repair the damages.)

23. *Prepaid Service Revenue*

Solution: a. \$1,000 $(1/24 \text{ of } \$24,000)$ for both tax and financial accounting.

b. \$23,000 for tax accounting and \$12,000 for financial accounting. Deferral for tax is not permitted beyond the year following the prepayment.

c. \$0 for tax accounting and \$11,000 $(\$24,000 - \$1,000 - \$12,000)$ for financial accounting.

24. *Municipal Bonds*

Solution: Carl recognizes gain of \$3,000 $(\$43,000 - \$40,000)$ on the sale of the stock. The interest is nontaxable because these are municipal bonds.

25. *Taxable vs. Nontaxable Bonds*

Solution: a. Jessica's after-tax cash flow from the municipal bonds is \$700 $(7\% \times \$10,000)$ because this interest income is tax exempt. For the corporate bonds, Jessica will receive \$700 $(\$10,000 \times 7\%)$ in interest income but will pay \$105 $(\$700 \times 15\%)$ in

tax on that income resulting in an after-tax cash flow of \$595 (\$700 - \$105).

b. Jessica will now pay \$303.80 ($\$700 \times 43.4\%$) in tax on the corporate bond interest income resulting in after-tax cash flow of only \$396.20 ($\$700 - \303.80) while her after-tax cash flow from the municipal bonds is still \$700. Note that she will have to pay the additional 3.8% NII Medicare surtax that increases her tax rate from her 39.6% marginal rate to 43.4% on her investment income (see Table 3.3 on page 121).

26. *Gift Loan*

Solution: a. There are no tax consequences to Joshua or Seth because the loan is not in excess of \$100,000 and the proceeds are used for personal expenses (rather than investment); the transaction is not subject to the imputed interest rules.

b. The imputed interest rules treat the transaction as if Seth paid \$4,000 in interest ($\$100,000 \times 4\%$) to Joshua each year with Joshua recognizing \$4,000 of interest income; Joshua would then be assumed to make a gift of \$4,000 annually to Seth. Thus, Joshua must recognize \$4,000 in interest income (from the interest imputed at the federal rate) annually and Seth recognizes \$8,000 of interest income (from his investment in corporate bonds). If Seth's net investment income is less than \$4,000, the imputed interest will be limited to the lower net investment income.

27. *Employee/Shareholder Loans*

Solution: Lynn is assumed to pay Sheldon Corporation \$3,200 in interest ($4\% \times \$80,000$) on the loan. Sheldon has \$3,200 in interest income. If Lynn is an employee, Sheldon is assumed to then return the \$3,200 to Lynn as taxable compensation, deductible by the corporation. If Lynn is a shareholder, the return of the \$3,200 is assumed to be taxable dividend income to Lynn but nondeductible by the corporation.

28. *Gross Income from Investments*

Solution: \$11,800. George must include in gross income all except the \$1,000 distributed by ABC as a nontaxable distribution. Thus, his gross income must include the \$4,000 taxable distribution from ABC and both the \$6,500 dividend and the \$1,300 capital gain distribution from Brightstar for a total of \$11,800.

29. *Stock Dividend*

Solution: Cheryl recognizes no income from the receipt of the stock dividend. She will spread the basis of the original 100 shares over the new total of 300 shares. Each of the 300 shares will now have a basis of \$3.33 [$(100 \times \$10)/300$].

30. *Annuities*

Solution: a. \$3,000. If Charles lives for 15 years, he will receive a total of \$165,000 ($15 \times \$11,000$). \$120,000 of this represents a return of his investment; the remaining \$45,000 represents income earned on this investment and is taxable. Of each \$11,000 payment, \$3,000 [$(\$45,000/\$165,000) \times \$11,000$] must be included in income. The remaining \$8,000 is a tax-free return of his investment.

b. If Charles dies after receiving only \$77,000 (7 years at \$11,000 per year), he will have recovered only \$56,000 ($7 \times \$8,000$) of his total \$120,000 investment. The remaining \$64,000 ($\$120,000 - \$56,000$) can be deducted on his final tax return.

31. *Annuities*

Solution: \$13,750. All of the contributions to Barney's retirement plan except for the \$20,000 from after-tax employee contributions will be taxable when received along with excess received over the total investment. Thus, of the \$240,000 in expected payments, \$220,000 is taxable. Of each \$15,000 payment, \$13,750 [$\$15,000 \times (\$220,000/\$240,000)$] must be included in Barney's gross income.

32. *Income from Lottery Winnings*

Solution: Julie must include all \$500,000 of each payment received in years 1 through 4 in income when received. When she sells her rights to the remaining 26 payments for \$8,900,000, the \$8,900,000 must be included in income when received.

33. *Social Security Benefits*

Solution: \$31,600. Vera's modified adjusted gross income is \$64,000 [$\$18,000 + \$38,000 + (\$16,000 \times \frac{1}{2})$]. Because her MAGI exceeds \$34,000, she will have to include up to 85 percent of her Social Security benefits in her income determined as the lesser of (1) \$13,600 ($85\% \times \$16,000$) or \$30,000 [$85\% (\$64,000 - \$34,000) + \$4,500$]. The inclusion of the tax-exempt interest in MAGI is sufficient to put her in the position of having to include \$13,600 of her Social Security benefits in income. Thus, her gross income is \$31,600 (\$18,000 dividend income + \$13,600 Social Security benefit). Although the tax-exempt bond interest must be included in determining modified adjusted gross income, it is not included in determining gross income for tax purposes.

34. *Social Security Benefits*

Solution: \$5,000. Jeff's modified adjusted gross income does not exceed \$25,000 so none of his \$18,000 social security benefits are included in his gross income. His gross income consists of only the \$5,000 interest income.

35. *Damage Payments for Injuries*

Solution: \$5,000. Mike must include the \$2,000 for emotional distress and \$3,000 for lost wages in his income. The \$12,000 for the physical injuries is excluded from income as a return of his human capital. His gross income is \$5,000.

36. *Tax Consequences of Divorce*

Solution: a. Harriet must recognize the \$1,300 monthly alimony payment as income (\$15,600 annually). She has no income on the transfer of the home as part of the divorce settlement or for the child support payments.
b. Stu is permitted to deduct the monthly alimony payments of \$1,300 (\$15,600 annually) in determining his adjusted gross income.

37. *Cancellation of Debt*

Solution: Markum must recognize a \$15,000 ($\$60,000 - \$45,000$) taxable gain on the transfer of the property as if it had sold the property for \$60,000 and used the proceeds to pay the debt.

38. *Recovery of Bad Debt*

- Solution:** a. Sandle would recognize \$15,000 of income in year 1. In year 2 it would write off (deduct) the \$15,000 as a bad debt as a result of Jim's bankruptcy. In year 3, it would recognize \$12,000 of income on the recovery of that portion of the debt that had been written off in the prior year.
- b. If Sandle is a cash-basis taxpayer, it would recognize no income in year 1, would have no write off in year 2, but would recognize \$12,000 of income in year 3.

39. *Shifting Income to Children*

- Solution:** a. Alana has \$10,970 gross income and Mac has none. Mac includes nothing in his gross income because he gave the stock to Alana and is no longer the owner. Alana is taxed on the dividend income (\$170) because she was the owner when the dividend was declared and paid. Alana also includes the \$10,800 [$600 \times (\$38 - \$20)$] gain on the sale of the stock in her gross income. She will use Mac's purchase price (carryover basis) of the stock to determine her gain on the sale.
- b. \$3,107. Because the gain on the sale of the stock is short-term capital gain, it will be taxed at ordinary income rates. When the 3.8% NII Medicare surtax is added to Mac's 39.6% marginal tax rate, he will have a combined rate of 43.4% for the short-term capital gain and 23.8% for dividend income (20% dividend rate + 3.8% NII surtax) as shown in Table 3.3 on page 121. The difference in the tax rates on the STCG between Mac and Alana is 28.4% ($43.4\% - 15\%$) resulting in a \$3,067 ($\$10,800 \times 28.4\%$) tax savings. The difference in the tax rates on the dividend income is 23.4% (23.4% for Mac – zero for Alana) resulting in a \$40 ($\$170 \times 23.4\%$) tax savings. By having the \$10,970 total income taxed to Alana rather than Mac, the family has a total tax savings of \$3,107 ($\$3,067 + \40). Note that this solution specifies that Alana is age 24. As discussed in Chapter 12, the kiddie tax provision can cause some unearned income of children under age 24 to be taxed at their parent's marginal tax rate.

40. *Gift Property*

- Solution:** Myra must include only the \$7,000 interest from the bonds in her income. The receipt of a gift or inheritance is not subject to income tax.

41. *Life Insurance Proceeds*

- Solution:** a. Zero. If Linda takes the lump-sum \$500,000 payment, she recognizes no gross income, as life insurance proceeds in general are not taxable.
- b. \$8,000 each year. If she elects to take the insurance proceeds in annual installments, \$80,000 of the total \$580,000 ($10 \times \$58,000$) expected to be received will represent taxable income. Of each annual \$58,000 payment, \$8,000 ($\$80,000 / \$580,000 \times \$58,000$) will be income and \$50,000 ($\$500,000 / \$580,000 \times \$58,000$) will be tax free.

42. *Disability Insurance*

- Solution:** \$16,500. A portion of each payment that represents the premium paid by Mark's employer is taxable income to Mark. Thus, if Mark collects \$30,000 under the

disability policy, \$16,500 ($55\% \times \$30,000$) must be included in gross income and the remaining \$13,500 ($45\% \times \$30,000$) is tax free.

43. *Scholarships*

Solution: \$4,000 is included in income. Sara must include the \$1,000 that was spent for room and board and the \$3,000 from her part-time job on campus in her income. Only the money spent for tuition and required textbooks qualifies as the nontaxable portion of the scholarship.

44. *Scholarships*

Solution: \$400 in year 2. Larry spent only \$6,600 ($\$3,400 + \$3,200$) on qualified expenses from the scholarship money. Thus, he must include the \$400 ($\$7,000 - \$6,600$) not spent on qualified expenses in income. He does not have to include this amount until year 2, however.

45. *Income Recognition from Foreign Subsidiaries*

Solution: Zero. Because Small Corporation does not make any dividend distributions, Small's \$1.5 million is not subject to U.S. taxes. When the earnings are repatriated, Giant Corporation will be able to claim a foreign tax credit for the taxes Small paid to the foreign country on the income it recognizes.

46. *State Income Tax*

Solution: \$282,150. Mango's state income tax will be \$22,500 ($\$450,000 \times 5\%$). Federal income tax will be \$145,350 [$(\$450,000 - \$22,500) \times 34\%$]. Therefore, the after-tax cash flow for Mango Corporation is \$282,150 ($\$450,000 - \$22,500 - \$145,350$).

47. *Installment Sale*

Solution: Randy has a total gain of \$11,500 [$(\$6,000 + \$7,000 + \$7,000) - \$8,500$ basis] on the sale of the land. On an installment sale, Randy must recognize 57.5% ($\$11,500/\$20,000$) of each payment as gain. Thus, his gain in year 1 is \$3,450 ($57.5\% \times \$6,000$); in each of years 2 and 3, he will recognize \$4,025 ($57.5\% \times \$7,000$).

If he elects out of the installment sale method, Randy must recognize the entire \$11,500 of gain in year 1.

48. *Long-Term Construction Contract*

Solution: (1) Under the completed contract method, Highrise will recognize all \$250,000 of gross income and \$226,000 of costs in year 2. It will recognize no income or expenses in year 1.

(2) Under the percentage-of-completion method, Highrise will recognize \$137,500 of gross income ($\$121,000/\$220,000 \times \$250,000$) and \$121,000 of expenses in year 1 for net taxable income of \$16,500. In year 2, it will recognize the balance of the revenue of \$112,500 ($\$250,000 - \$137,500$) and expenses of \$105,000 for net taxable income of \$7,500.

49. NII Medicare Surtax

Solution: \$2,812. The NII Medicare surtax is 3.8% times the lesser of NII or modified AGI in excess of the threshold. NII is \$74,000 (\$60,000 LTCG + \$8,000 dividend + \$6,000 interest). Modified AGI in excess of the threshold is \$484,000 (\$660,000 salaries + \$74,000 NII - \$250,000 threshold). Note that tax-exempt income is excluded. $\$74,000 \text{ NII} \times 3.8\% = \$2,812$.

50. NII Medicare Surtax

Solution: \$1,824. The NII Medicare surtax is 3.8% times the lesser of NII or modified AGI in excess of the threshold. NII is \$52,000 (\$40,000 STCG + \$7,000 dividend + \$5,000 interest). Modified AGI in excess of the threshold is \$48,000 (\$196,000 salary + \$52,000 NII - \$200,000 threshold). Note that tax-exempt income is excluded. $\$48,000 \text{ NII} \times 3.8\% = \$1,824$.

Think Outside the Text

These questions require answers that are beyond the material that is covered in this chapter.

51. Social Security Benefits

Solution: The student should present a logical argument for or against the 100 percent tax rate on Social Security benefits of high-income individuals so answers will vary.

52. Income from Inheritance

Solution: The student should try to present logical arguments why the retroactive inclusion of certain items in income should not be permitted by laws passed at year-end. For a long time, however, it has been understood that there is no particular reason why interest on tax-exempt bonds has been excluded from income. This is simply a matter of timing of inclusion. For a number of years now, Congress has retroactively reinstated deductions so there is a significant precedence for Congress to be allowed to act at any time during the year and have those actions apply from the first of the tax year. The primary argument against allowing this type of retroactive law is that it does not allow taxpayers to plan adequately. However, it is hard to argue that the law that states Congress can tax income from whatever source would not apply to income earned during the year the law is passed. It would be a different matter if Congress were to act retroactively to tax items received in prior tax years as there has always been the concept of tax years to provide closure for the taxpayer for prior years.

53. Alimony Recapture

Solution: Part of any payments structured as alimony payments that decrease by more than \$15,000 per year from year 1 to year 2 and then again from year 2 to year 3 can be recharacterized as property settlements. The portion so recharacterized must be recaptured (taken into income) by the payor and can be deducted by the recipient in the third year.

54. *Insurance Transfer*

Solution: Joe will have income for the \$800 (\$5,000 - \$4,200) portion of the debt that Willy forgives as part of accepting the cash surrender value of the policy to cancel the debt. When Joe is killed, Willy's basis in the insurance policy is \$5,050 (\$5,000 debt + \$50 premium payment). He will have income of \$19,950 on the collection of the \$25,000 from the insurance policy. When a policy is transferred to a third party for money or moneys worth, the receipt of the face value of the policy is no longer tax free. Income must be recognized based on the proceeds received and the purchaser's investment in the policy at the time of the decedent's death.

55. *Doctrine of Constructive Receipt*

Solution: Based on the doctrine of constructive receipt, the tax court judge would rule in favor of the IRS. The doctrine of constructive receipt requires Walter to recognize the income when the funds were made available to him. The \$77,000 should be included as income in the year the original check was received. The fact that a tear slip exists, indicates that the check was received. If the check was detached and not received with the tear slip, Walter should have contacted the customer and requested another check to be sent immediately. This was the decision of the court in *Walter v. U.S.*, 92 AFTR 2d. 98-5115, 148 F. 3d 1027, 98-2 USTC ¶50546.

56. *Doctrine of Constructive Receipt*

Solution: This question is based on an Oprah Winfrey show (See "'Giving Back' Is Oprah's 'Favorite Giveaway Ever,'" *Chicago Sun-Times*, 10/31/06, page 5). The only real difference is that Oprah gave more than 300 audience members debit cards for only \$1,000 each.

1. Does the receipt of the card ("prize") result in \$15,000 taxable income to the recipient even if the recipient does nothing further with the card? Even though the prize is not supposed to be used for one's own use, would the recipient's control over the disbursement of the proceeds from the debit card be sufficient to cause the recipient to have taxable income under Section 61? Do constructive receipt principles apply? Reg. Sec. 1.451-2 states "...income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions." Will the stipulation that the use of the card be for a charitable cause amount to a "substantial limitation or restriction"? There does not appear to be a way for the show to effectively enforce this so it is doubtful that this stipulation will qualify as a substantial restriction but there is no authority directly on point.

2. If the receipt of the card is not itself a taxable event, what about the actual usage of the card? What are the ramifications for the audience participants who transfer the \$15,000 to their selected person or cause? The drawing down of cash (regardless of the intent for so doing) is actual (not merely constructive) receipt of the money. This will substantially increase the risk that the recipient of the debit card has gross income under Section 61 at the moment of cash withdrawal. Again, there is no authority directly on point.

3. If the audience members give the money to a qualified charitable organization, the individuals can claim a charitable contribution deduction only if they itemize their deductions. If they have no other itemized deductions, their tax benefit from

the contribution will be limited to the amount it exceeds their standard deduction (thus not completely offsetting their \$15,000 gross income).

4. If the audience members donate the money to a needy person instead of a qualifying charitable organization, they would have \$15,000 of gross income and would have made a taxable gift of \$1,000 (\$15,000 gift less \$14,000 annual exclusion) assuming they had not given other amounts that year to the same donee.

5. Will the Bank of America be able to deduct the payouts on the debit cards as a business expense (possibly as marketing)? Most likely it will get some deduction. The bank would not, however, qualify for any charitable contribution deductions because it has no control over which donees are selected by the audience members.

6. Must the value of the DVD recorders be included as taxable income as a prize? Alternatively were the DVD recorders merely “loaned” to the audience members, to be returned when the future show is taped? Will only those audience members who return for the future show (with a recorded story for use on the show) be permitted to keep the recorder? Will they have taxable compensation income from providing their video recording services in exchange for being permitted to keep the DVD recorders? It certainly seems likely they would have taxable income.

Identify the Issues

Identify the issues or problems suggested by the following situations. State each issue as a question.

57. Barter Transactions

Solution: Will Jason or Bob’s Auto Repairs be required to recognize any income as a result of this barter arrangement? Will they be entitled to a deduction for repair expenses?

58. Prepaid Rent

Solution: How should the landlord treat the prepayment of 3 months rent that is characterized as part rent and part security deposit?

59. Timing and Amount of Income

Solution: When should Sid’s Body Shop recognize the income for the repair work? How should it handle the reduction in expected payment from \$2,000 to \$1,700?

60. Bond Interest

Solution: Is interest income on bonds issued by a foreign governmental entity taxable or tax-exempt?

61. Treasure Find

Solution: Does Gillian have any taxable income as a result of her treasure find?

62. Tax Effects of Divorce

Solution: How will the \$1,000 payment be treated for tax purposes, as alimony, child support, or a combination of the two?

63. *Cancellation of Debt*

Solution: Does Sharp Corporation have income or other tax consequences as a result of the creditor writing off \$20,000 of its debt?

Develop Research Skills

Solutions to research problems are included in a separate file.

Search the Internet

68. *Locate IRS Form*

Solution: Form 6252: *Installment Sale Income*

69. *Locate IRS Publication and Calculate Income*

Solution: \$2,500. Add $\frac{1}{2}$ of \$10,000 social security benefits to the \$20,000 dividend income and the \$5,000 of tax-exempt bond interest, resulting in a total of \$30,000. Subtract the \$25,000 base amount for a single individual from the \$30,000 total yielding \$5,000 in excess of the base amount. Because the excess beyond the base amount (\$5,000 excess) is less than \$9,000, no more than half the benefits will be taxed. Compare \$2,500 ($\frac{1}{2}$ of the \$5,000 excess beyond the base amount) to \$5,000 ($\frac{1}{2}$ of the Social Security benefits of \$10,000). The smaller of these two (\$2,500) is included in the taxpayer's gross income. Thus, the taxpayer's gross income is \$22,500 (\$20,000 dividend income + \$2,500 taxable Social Security income).

70. *Calculate AGI on Form 1040*

Solution: \$87,000. A filled-in Form 1040 is included in at the end of this file. The amounts to be included in calculating the AGI are: \$60,000 Pierre's salary + \$10,000 Jeanie's wages + \$3,000 corporate bond interest + \$5,000 dividend income + \$10,000 S corporation income + \$4,000 capital gains - \$5,000 alimony paid = \$87,000. The municipal bond interest is tax-exempt and, therefore, not included in calculating AGI. No deduction is permitted for child support payments. Note that Jeanie Lappin's \$10,000 from her part-time job for the year must be included in the joint tax return (even though they were not married until the end of the year).

71. *Dividend Income from Foreign Corporations*

Solution: Dividend income received from foreign corporations located in China or Jamaica will be treated as qualified dividends eligible for the reduced tax rate. However, dividend income from Bermuda and the Netherland Antilles is not eligible for the reduced dividend tax rate.

72. *Consequences of Frequent Flyer Miles*

Solution: The IRS policy for now is that it will not assert that a taxpayer has understated his or her federal tax liability because of the receipt or personal use of frequent flyer miles attributable to business or official travel. Any future guidance on the taxability of these benefits will be applied prospectively only.

Develop Planning Skills

73. *Accounting Methods*

Solution: The cash method of recognizing income and expenses, if available, usually provides the higher net present value for the company's cash flow. Income is not recognized until payment is received. This is usually later than when income would be recognized under the accrual method. By delaying the recognition of income, the payment of taxes on this income can be delayed. In addition, cash-basis taxpayers may have the ability to make early payments for expenses at year-end, accelerating their deductions. A deduction in the current year may be worth more than the same deduction in the next year due to the time value of money.

74. *Investment Alternatives*

Solution: With a marginal tax rate of 39.6 percent, her effective rate is 43.4% when combined with the NII Medicare surtax of 3.8%. Her after tax return on the corporate bonds is only 5.09 percent [$9\% \times (1 - .434)$]. She would be better off investing in the tax exempt bonds paying 6 percent. With a marginal tax rate of only 28 percent, she is not subject to the NII surtax so her after tax return on the corporate bonds improves to 6.48 percent [$9\% \times (1 - .28)$], and she would be better off investing in the corporate bonds.

75. *Prepaid Rent*

Solution: If \$4,000 is designated as the last two months rent, \$4,000 must be included in income when received. If only \$2,000 is designated as rent, then only \$2,000 must be included in income when received. Thus, the designation of \$4,000 as security deposit is better for Palace Company from a tax standpoint (although they might lose prospective tenants with a high a security deposit).

76. *Tax Effects of Divorce*

Solution: a. To receive \$15,000 after tax at a 15 percent marginal tax rate, Elizabeth would have to receive \$17,647. If Kevin pays Elizabeth \$17,647 as alimony, she will have a net after-tax cash flow \$15,000 after she pays the tax of \$2,647 ($\$17,647 \times .15$). [The \$15,000 after-tax is "grossed-up" to the \$17,647 before-tax amount by dividing \$15,000 by .85 (100% - 15%)]

b. If Kevin can deduct the \$18,500 as alimony, he can reduce his taxes by \$6,105 ($\$18,500 \times 33\%$). His net after-tax cash out flow is \$12,395 ($\$18,500 - \$6,105$). His cash flow improves by \$2,605 ($\$15,000$ nondeductible payment - $\$12,395$ net after-tax alimony payment) over the \$15,000 alternative. Elizabeth must pay \$2,775 ($\$18,500 \times 15\%$) tax on the alimony resulting in a net after-tax cash inflow of \$15,725 ($\$18,500 - \$2,775$). Elizabeth's cash position improves by \$725 ($\$15,725 - \$15,000$).