

Chapter 4 Summary of End-of Chapter Problem Revisions

2014 Edition Problem Number	2013 Edition Problem Number	2014 Edition Modification
1	1	
2	2	
3	3	Solution updated
4	4	
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13	13	Solution updated
14	14	
15	15	
16	16	
17	17	Problem modified
18	18	
19	19	
20	20	
21	21	Problem modified
22	22	
23	23	
24	24	Problem modified
25	25	
26	26	
27	27	
28	28	
29	29	
30	30	
31	31	Problem modified
32	32	Problem modified
33	33	Solution updated
34	34	Problem updated
35	35	Problem modified
36		New
37		New
38	36	Year updated
39	37	
40	38	Problem modified
41	39	Solution updated

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Solutions to Chapter 4 Problem Assignments

Check Your Understanding

1. *Deferred Compensation*

Solution: (1) Ricardo includes the entire \$3,900,000 ($\$325,000 \times 12$ months) in taxable income this year and his employer deducts the same.

(2) If the contract provides for \$900,000 in deferred compensation, Ricardo includes only \$3,000,000 ($\$250,000 \times 12$ months) in income this year and is taxed on the \$900,000 in the year he receives it. His employer is allowed a deduction of \$3,000,000 in the current year and will deduct the \$900,000 deferred compensation when it is paid.

2. *Excessive Compensation*

Solution: No. Jenny's excess \$8,000 [$(\$15 - \$7) \times 1,000$ hours] salary over what other employees would earn is considered excessive compensation. The \$8,000 would probably be reclassified as a dividend, treated as dividend income to Barbara (Jenny's mother) but no longer deductible by the corporation.

3. *Foreign Earned Income Exclusion*

Solution: John can elect to exclude up to \$97,600 in 2013 under the foreign earned income exclusion. He may also be eligible for the exclusion for excess housing costs.

4. *Employee Fringe Benefits*

Solution: No. Anne has no income from these benefits because they are within the limits for exclusion. Under an educational assistance plan, up to \$5,250 can be excluded; if the education qualifies as a working condition fringe benefit, there is no dollar limit on the exclusion. Parking valued at up to \$230 per month can be excluded and up to \$5,000 per year as a dependent care benefit can also be excluded.

5. *Employee Discount vs. Bargain Purchase*

Solution: A qualified employee discount is a discount within allowable limits provided on a nondiscriminatory basis and is excluded from the employee's income. The excludable discount on merchandise is limited to the gross profit percentage times the price charged to customers. The excludable discount for services cannot exceed 20 percent of the price normally charged to customers. Discounts in excess of the allowable limits are taxed to the employee as compensation. A bargain purchase is a discount that is made available only to select employees and is taxable as additional compensation income to the employee.

6. *De Minimis Benefits*

Solution: Only the \$50 check in part d is taxable. Items a, b, and c are excluded de minimis fringe benefits.

7. *Moving Expenses*

Solution: The employee can either (1) deduct the moving expenses on her year 1 tax return or (2) wait until the time requirement is satisfied and file an amended return for year 1. If the expenses are deducted in year 1 and the time requirement is not met, the employee must either include the amount previously deducted for moving expense as other income in the current year or file an amended return excluding the previously deducted moving expenses.

8. *Stock Options*

Solution: ISOs receive favorable tax treatment from the perspective of the employee because they do not trigger income recognition at either the grant date or at exercise. Instead, the employee recognizes income when the stock is sold and the employee recognizes long-term capital gain rather than ordinary income. A negative feature of ISOs is that the employer receives no compensation deduction at any time for the option. An ISO has certain restrictions imposed on the option price, transferability, and exercise.

A NQSO is more flexible, but the tax treatment is not as favorable for the employee. An employee recognizes income on a NQSO if he or she exercises the option. The amount of income recognized is equal to the difference (called the bargain element) between the strike price and the fair market value of the stock on the exercise date. The employer claims a matching compensation deduction when the employee recognizes income. In addition, if the strike price is below the fair market value at the date the option is issued and the option is exercisable, the employee will have income equal to that difference at that time and the corporation has a corresponding deduction.

9. *Phantom Stock and SARs*

Solution: A phantom stock plan and a stock appreciation right (SAR) plan provide the advantages of stock options without employees owning stock.

10. *Phantom Stock and SARs*

Solution: Both phantom stock plans and stock appreciation right (SAR) plans capture the appreciation of company stock without requiring employees to actually buy the stock. Alternatively, employers could offer NQSOs that employees can exercise under a cashless program. In a cashless program, the employee immediately sells some or all of the shares at the market rate and receives the proceeds from the sale less the strike price, withholding taxes, and brokerage commissions.

11. *Qualified Retirement Plan*

Solution: The employer gets an immediate tax deduction as contributions are paid into a plan while the earnings accumulate tax free and the employee's tax is deferred until the benefits are received in a future year. Employees can make contributions to the retirement plan with before-tax earnings, postponing the tax on both the contributions and the earnings until the funds are withdrawn from the plan.

12. *Qualified vs. Nonqualified Retirement Plans*

Solution: Qualified plans have more advantages (see solution to previous question), but they have contribution limits and must be offered on a nondiscriminatory basis generally to all employees. Under a nonqualified plan, an unlimited amount of compensation for highly compensated executives can be deferred without extending the plan benefits to other employees.

13. *Individual Retirement Accounts.*

Solution: No. Under a traditional IRA, the taxpayer may qualify for a deduction but all contributions and earnings are taxed when withdrawn. If an individual is not covered by another employer retirement plan, then he or she can contribute and deduct up to \$5,500 in 2013 (plus an additional \$1,000 if age 50 or older) to a traditional IRA. If the individual is covered by an employer-sponsored plan, then the contribution deduction may be limited based on the employee's adjusted gross income. In either case, the earnings on the amounts contributed are not taxable until they are withdrawn from the IRA.

Under a Roth IRA, the earnings (as well as all contributions) can be withdrawn tax free, but contributions to a Roth IRA are not deductible.

14. *Individual Retirement Accounts*

Solution: a. Sharon should use a Roth IRA because the earnings are tax-free when withdrawn. She avoids tax in the later higher-tax years when the contributions will be withdrawn.

b. Ken should use a traditional IRA because he will get a deduction now for the contribution and he defers taxation on the earnings until he withdraws the funds in retirement when his tax rate will be the same or lower.

c. Susan should use a Roth IRA because there is no minimum distribution requirement during the owner's lifetime. The funds can be left in the account to grow tax free and then passed to beneficiaries.

15. *Fringe Benefits for Self-Employed vs. Employees*

Solution: Owners who are employees of a C corporation are eligible for all the employee fringe benefits discussed in this chapter such as group term life insurance, health insurance, cafeteria plan, and flexible spending arrangements. Partners are considered self-employed individuals and cannot participate in most of the fringe benefits provided on a tax-free basis to employees so they must use after-tax dollars for many of the benefits that employees can obtain with before-tax dollars. Some of the benefits that self-employed individuals cannot receive on a tax-free basis include health and accident insurance, group term life insurance, on-premises lodging, employee achievement awards, moving expenses, transit passes, and parking benefits. To mitigate the difference in this treatment, self-employed individuals may deduct the cost of health insurance premiums for AGI. Although S corporation shareholders can be paid a salary as an employee, if they own more than 2 percent of the S corporation's outstanding stock, they are ineligible for most tax-free fringe benefits and are treated the same as partners for fringe benefit purposes.

16. *Tax Reimbursement Plans*

Solution: A tax protection plan reimburses an individual for any U.S. or foreign taxes paid in excess of the liability he or she would have incurred in U.S. tax if the individual had remained in the United States. If actual taxes are lower than the assumed tax liability, the employee benefits from the foreign assignment because only the actual U.S. and foreign taxes are paid; the employee keeps any tax savings. Thus, under a tax protection plan, an employee may realize significant tax savings in a move to a low-tax country. From an employer's perspective, however, employees may be reluctant to accept assignments in high-tax countries in which actual taxes exceed the assumed U. S. tax.

Under a tax equalization plan, an employee working in a foreign country has the same net tax liability he or she would have paid had the employee remained in the United States. To achieve this balance, the employee's salary is reduced by the hypothetical U.S. tax, but the employee is then reimbursed for the actual U.S. and foreign taxes on the covered income. Under this plan, the employer pays any excess tax but keeps any tax benefit from having employees in low-tax countries. This helps offset the tax costs of having employees in high-tax countries and also prevents employees from preferring one foreign assignment over another merely due to tax differences. Although the objectives of tax protection and equalization plans are similar, a tax equalization plan is usually considered less costly for the employer. Any amounts excluded under foreign earned income or housing cost exclusions reduce the cost of protection or equalization plans to employers because the company does not have to reimburse the employee for U.S. tax on those amounts.

Crunch the Numbers17. *Excessive Compensation*

Solution: There will be an overall increase in taxes of \$29,786.

\$200,000 will not be deductible by Charlie Corporation increasing its tax liability by \$68,000 ($\$200,000 \times 34\%$). Charlie Corporation will save \$2,900 ($\$200,000 \times 1.45\%$) in Medicare taxes but lose the \$986 ($\$2,900 \times 34\%$) tax savings from deducting the Medicare taxes resulting in a net tax increase of \$66,086 ($\$68,000 + \$986 - \$2,900$). There is no change in Social Security taxes because the compensation is above the \$113,700 limit.

Charlie will be taxed on the \$200,000 at the 20% dividend income rate so he will save \$39,200 [$(39.6\% - 20\%) \times \$200,000$] in income taxes in addition to the \$2,900 savings in Medicare taxes. But he will pay a higher NII Medicare surtax of \$5,800 [$(3.8\% \text{ NII surtax} - 0.9\% \text{ surtax}) \times \$200,000$] resulting in a net tax savings to him of \$36,300 ($\$39,200 + \$2,900 - \$5,800$).

The net effect will be an increase in overall taxes of \$29,786 ($\$66,086 - \$36,300$). (Note: Charlie's \$200,000 of salary income would have been subject to the 0.9% medicare surtax on salaries; that is now replaced by the 3.8% Medicare surtax on NII.)

18. *Timing of Compensation*

Solution: Because Amy is a cash-basis taxpayer she includes the salary and bonus in income in the year she receives it.

<u>Year</u>	<u>a. Amy</u>	<u>b. Vargus Corporation</u>
1	\$100,000	\$100,000
2	\$130,000	\$162,000
3	\$132,000	\$100,000

Vargus Corporation must pay the accrued bonus within 2½ months after year-end to deduct it in the year accrued. If paid later than 2½ months after year-end, it is deducted in the year paid.

19. *Group Term Life Insurance*

Solution: a. Tom has \$914 of income. $\$110,000 - \$50,000$ excluded = \$60,000 taxable coverage. $(60 \text{ increments} \times \$1.27 \text{ table rate} \times 12 \text{ months}) = \914.40

b. Same answer as part a.

c. Same answer as part a.

d. \$3,000. Tom is a key employee and the plan is discriminatory so he must include in income the greater of the actual premiums (\$3,000) or the \$1,676.40 computed from the table without excluding the first \$50,000 $(110 \text{ increments} \times \$1.27 \text{ table rate} \times 12 \text{ months}) = \$1,676.40$.

20. *Fringe Benefits under Cafeteria Plan*

Solution: Priscilla includes \$72,700 in income (\$70,000 salary + \$2,700 cash benefits). The group term life insurance and health insurance are tax-free benefits.

21. *Flexible Spending Arrangement*

Solution: a. Zero. It is all excluded.

b. Zero. It is all excluded.

c. It is forfeited. There is no adjustment to Jennifer's income or taxes for the unused amount placed in the FSA.

22. *Lodging vs. Cash Allowance*

Solution: Clark must include \$34,800 in income [$\$30,000$ salary + $(\$400 \times 12 \text{ months})$]. Lodging must be required as a condition of employment to be excluded.

23. *Employee Discount*

Solution: Yes, \$100 is taxable. The excludable discount for services cannot exceed 20 percent $(20\% \times \$500 = \$100 \text{ maximum tax-free discount})$. Kevin's discount was $\$200 - \$100 \text{ maximum tax-free discount} = \100 excess discount that is taxable.

24. *Tax-Free Fringe Benefits*

Solution: Zero. All of the fringe benefits are tax free. An employer can provide up to \$50,000 in group term life insurance and an unlimited amount of medical insurance tax free. Up to \$5,000 of dependent care benefits can be provided tax free. Employee discounts for merchandise are tax free as long as the employee pays at least the employer's cost.

25. *Moving Expense Qualification*

- Solution:** a. The important distances are the 15 miles from the old home to the old employer and the 70-mile distance the commute would be if she did not move.
b. She exceeds the minimum by 5 miles. (70 miles - 15 miles = 55 miles - 50 mile minimum = 5 miles)

26. *Moving Expense Deduction and Reimbursement*

- Solution:** a. Susan can deduct \$2,500 (\$2,300 transportation for household goods + \$200 airfare).
b. Susan will have \$1,100 in taxable income (\$3,600 reimbursement - \$2,500 qualified expenses = \$1,100).

27. *Restricted Stock*

- Solution:** a. (1) zero; (2) \$75,000; (3) \$25,000. Luis will not recognize any income until the stock vests. Upon vesting, Luis will have ordinary income equal to the fair market value at that time. In this case, Luis will have \$75,000 of ordinary income in the year the stock vests. When he sells the stock, Luis will recognize a capital gain of \$25,000 (\$100,000 - \$75,000 basis).
b. (1) \$20,000; (2) zero; (3) \$80,000. If Luis makes an election to accelerate the recognition of income, he will recognize the fair market value of the stock as income in the year of receipt. His ordinary income in the first year would be \$20,000. There is no recognition of income or gain when the stock vests. Upon sale of the stock, Luis will recognize a long-term capital gain of \$80,000 (\$100,000 - \$20,000 basis).
c. No. If Luis leaves the company before the stock vests, he will not be allowed a deduction for the loss on the stock forfeited, nor will he be allowed a refund of any taxes paid as a result of the prior income recognition.

28. *Nonqualified Stock Options*

- Solution:** a. Zero. No income is recognized when the option is granted because the option price exceeds the fair market value of the stock.
b. \$120,000 bargain element is ordinary income. [(\$50 FMV - \$10 strike price) x 3,000 shares = \$120,000]
c. There are no tax consequences in the year of grant but Cargo deducts the \$120,000 bargain element as compensation paid in the year Mark exercises the options.

29. *Incentive Stock Options*

- Solution:** a. Zero. No income is recognized when the option is granted.
b. Zero. No taxable income when the option is exercised (however, the bargain element is subject to the alternative minimum tax).
c. Zero. No tax consequences for Netcom in the year of grant or exercise.
d. Karen has an \$88,000 capital gain [(\$50 selling price - \$6 cost) x 2,000 shares]. Netcom receives no tax deduction and thus no tax benefit.

30. *Stock Appreciation Rights*

- Solution:** a. Zero. There is no income when the SARs are granted.
 b. \$12,000 income recognized when she exercises the SARs. $[(\$60 - \$20) \times 300 \text{ SARs}]$
 c. \$7,800. Maria will pay a tax of \$4,200 $(\$12,000 \times 35\%)$ on the exercised SARs. Maria's after-tax cash flow from the exercise of the SARs is \$7,800 $(\$12,000 - \$4,200 \text{ tax})$.
 d. Yes. Hancock deducts \$12,000 as compensation expense the same year that Maria exercises the SARs and is taxed on the income.

31. *Employee Benefits*

- Solution:** Larry recognizes \$55,829 in income and Horizon deducts \$66,620. Larry's income includes his net salary of \$55,800; this is the \$60,000 salary reduced for the \$4,200 $(7\% \times \$60,000)$ contributed to the retirement plan. He also must include \$29 in income for the life insurance $(80 - 50 = 30 \text{ increments} \times .08 \times 12 \text{ months} = \$28.80)$.
 Horizon deducts \$60,000 salary + \$120 life insurance + \$3,900 medical insurance + \$2,500 pension contributions + \$100 watch = \$66,620.

32. *Individual Retirement Account*

- Solution:** a. \$5,000. No phase-out when he is not covered by an employer-sponsored plan.
 b. \$4,400 is deductible. $(\$61,000 - \$59,000)/\$10,000 = 20\%$ phased out. \$5,500 maximum – $(\$5,500 \times 20\%) = \$4,400$ deductible amount.

33. *Roth IRA*

- Solution:** a. Zero. Her adjusted gross income exceeds \$127,000.
 b. \$5,000. Her income is below \$112,000 where the phase-out of contributions begins.
 c. \$3,500. She must reduce her maximum allowable Roth contribution deduction of \$5,500 by the \$2,000 she contributes to her traditional IRA.

34. *Self-Employment Tax*

- Solution:** a. \$3,532 $(\$25,000 \times 92.35\% \times 15.3\%)$.
 b. \$1,766, the employer's half of the tax
 c. Zero. No self-employment tax is owed when there is a loss.

35. *Self-Employment Tax*

- Solution:** George pays \$5,553.60 and deducts \$2,776.80. George first multiplies his \$43,000 self-employment income by 92.35% = \$39,710.50. George then reduces the \$113,700 ceiling by the \$78,200 of employee earnings on which social security tax has already been paid. Only \$35,500 $(\$113,700 - \$78,200)$ of his self-employment earnings is subject to the social security tax; however, his entire \$39,710.50 of self-employment earnings is subject to the Medicare tax (because there is no limit on Medicare taxes). George's self-employment taxes are \$5,553.60 $[\$35,500 \times 12.4\% = \$4,402] + (\$39,710.50 \times 2.9\% = \$1,151.60)]$

George deducts one-half of his self-employment taxes of \$2,776.80 $[(\$35,500 \times 6.2\% = \$2,201) + (\$39,710.50 \times 1.45\% = \$575.80)]$ as a deduction for AGI.

36. *Medicare Surtax*

Solution: \$1,607, \$803 and \$720.

Andrew pays \$1,606.89 $(\$60,000 \times 92.35\% \times 2.9\%)$ in self-employment tax. He can deduct the \$803.45 employer's half of his self-employment tax. His Medicare surtax of 0.9% is assessed on \$80,000 consisting of \$20,000 salary in excess of the threshold $(\$220,000 - \$200,000 \text{ threshold})$ plus \$60,000 self-employment income. His Medicare surtax is \$720 $(\$80,000 \times 0.9\%)$.

37. *Medicare Surtax*

Solution: \$19,187, \$9,594 and \$1,080.

Marco pays \$19,187.29 $[(\$190,000 \times 92.35\% \times 2.9\%) + (\$113,700 \times 12.4\%)]$ in self-employment tax.

Marco can deduct the \$9,593.65 employer's half of his self-employment tax. The Medicare surtax of 0.9% is assessed on salary and self-employment income in excess of the \$250,000 threshold. Lisa's salary does not exceed the \$250,000 threshold for joint filers, so there is no Medicare surtax on Lisa's salary. Before calculating the Medicare surtax on Marco's self-employment income, the \$250,000 threshold is reduced by Lisa's \$180,000 salary resulting in a remaining threshold for self-employment income of only \$70,000. Marco must pay \$1,080 $(0.9\% \times \$120,000)$ Medicare surtax on self-employment income in excess of the threshold $(\$190,000 - \$70,000)$ (Note: Lisa's, employer would not have withheld any Medicare surtax because her salary did not exceed \$200,000; unless additional taxes were withheld or they made estimated payments, they could be subject to underpayment penalties.)

38. *Self-Employed Health Insurance*

Solution: \$9,200 $(\$2,300 \times 4 \text{ employees})$ for employee insurance premiums is deductible from the business income of the sole proprietorship on Luis's Schedule C. \$2,300 for Luis's own insurance is deductible for AGI on his Form 1040.

39. *IRA Eligibility for Self-Employed*

Solution: \$45,000 earned income. The rental and interest income do not count and the salary is not reduced for the business loss in determining the earned income for his IRA contribution.

40. *Foreign Earned Income Exclusion*

Solution: The exclusion saves \$11,893. If Wendy claims the foreign earned income exclusion, she excludes the \$95,000 salary, leaving only \$10,000 of taxable income on which she will pay a U.S. tax of \$2,800 (using the 28% rate that applies to income from \$95,000 to \$105,000). If she does not claim the foreign earned income exclusion, Wendy's taxable income is \$105,000 $(\$95,000 \text{ foreign salary plus } \$10,000 \text{ other taxable income})$. The U.S. tax on \$105,000 is \$22,693 $[\$17,891 + 28\% (\$105,000 - \$87,850)]$. The U.S. tax on \$105,000 can

also be calculated as: $(\$8,975 \times 10\%) + (\$27,325 \times 15\%) + (\$51,600 \times 25\%) + (\$17,150 \times 28\%) = \$22,693$. Wendy can claim a tax credit for the \$8,000 in foreign tax paid, reducing her U.S. tax to \$14,693 ($\$22,693 - \$8,000$). The income exclusion results in a tax savings of \$11,893 ($\$14,693 - \$2,800$).

41. *Foreign Tax Credit*

Solution: \$3,360. If Mark claims the \$97,600 foreign earned income exclusion, the amount ineligible for the credit is \$14,640 [$\$18,000 \times (\$97,600/\$120,000)$], leaving \$3,360 ($\$18,000 - \$14,640$) in creditable taxes.

Think Outside the Text

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

42. *Business Formation*

Solution: a. (1) If Evan chooses to be a sole proprietorship, his total tax cost will be \$31,910 ($\$14,836 + \$17,074$)
Self-employment tax: $(\$130,000 - \$25,000) \times 92.35\% = \$96,967.50 \times 15.3\% = \$14,836$.

Adjusted gross income: $\$105,000 \text{ income} - (\$105,000 \times .9235 \times 7.65\%) - \$3,000 \text{ insurance premiums} = \$94,582 \text{ AGI}$. $\$94,582 - \$6,100 \text{ standard deduction} - \$3,900 \text{ exemption} = \$84,582 \text{ taxable income}$. Income tax on $\$84,582 = \$17,074$ [$\$4,991 + 25\% (\$84,582 - \$36,250)$]. The income tax on $\$84,582$ can also be calculated as: $(\$8,925 \times 10\%) + (\$27,325 \times 15\%) + (\$48,332 \times 25\%) = \$17,074$.

(2) If Evan chooses to be an S corporation, his total tax cost will be \$23,962 ($\$2,678 + \$420 + \$18,186 + \$2,678$).

The S corporation deducts FICA taxes paid of \$2,678 ($\$35,000 \times 7.65\%$) and FUTA taxes of \$420 ($\$7,000 \times 6\%$). The total amount of income that will pass through to Evan's K-1 will be \$63,902 ($\$130,000 - \$25,000 - \$35,000 - \$2,678 - \$420 - \$3,000$) plus \$3,000 for health insurance. Because Evan owns more than 2% of the S corporation stock, he is taxed on the health insurance and then can deduct the \$3,000 for AGI.

Evan's gross income is \$101,902 [$\$35,000 \text{ wages} + \$63,902 \text{ S corporation income} + \$3,000 \text{ health insurance}$]. Evan's adjusted gross income is \$98,902 ($\$101,902 - \$3,000 \text{ insurance premiums}$). Evan's taxable income is: \$88,902 ($\$98,902 \text{ AGI} - \$6,100 \text{ standard deduction} - \$3,900 \text{ exemption}$). His income tax is \$18,186 [$\$17,891 + 28\% (\$88,902 - \$87,850)$]. The income tax on \$88,902 can also be calculated as: $(\$8,925 \times 10\%) + (\$27,325 \times 15\%) + (\$51,600 \times 25\%) + (\$1,052 \times 28\%) = \$18,186$. Evan also pays his employee share of FICA tax of \$2,678 ($\$35,000 \times 7.65\%$).

(3) If Evan chooses a C corporation, his total tax cost will be \$20,056 ($\$10,976 \text{ corporation income taxes} + \$2,678 \text{ employer FICA taxes} + \$420 \text{ FUTA taxes} + \$3,304 \text{ personal income taxes} + \$2,678 \text{ employee FICA taxes}$). The C corporation will pay \$2,678 ($\$35,000 \times 7.65\%$) for FICA taxes and \$420 ($\$7,000 \times 6\%$) FUTA taxes. The C corporation will have taxable income of

\$63,902 (\$130,000 - \$25,000 - \$35,000 - \$2,678 - \$420 - \$3,000). The tax liability for the C corporation will be \$10,976 [$\$7,500 + 25\% (\$63,902 - \$50,000)$].

Evan has taxable income of \$25,000 (\$35,000 AGI - \$6,100 standard deduction - \$3,900 exemption). His personal income tax liability is \$3,304 [$\$892.50 + 15\% (\$25,000 - \$8,925)$]. The income tax on \$25,000 can also be calculated as: $(\$8,925 \times 10\%) + (\$16,075 \times 15\%) = \$3,304$. He also pays employee FICA taxes of \$2,678.

b. C corporation. Setting up as a C corporation would result in the lowest amount of taxes for the first year.

c. Some factors to consider when deciding between a C corporation and an S corporation are:

- Shareholders of both C and S corporations can be employees of a corporation, but more than 2% shareholder-employees of S corporations are not eligible for most tax-free fringe benefits and therefore will have to use after-tax dollars for fringe benefits (except health insurance which is deductible for AGI).
- If \$35,000 is considered to be an unreasonably low salary, the IRS might reclassify some of the S corporation's distribution as salary, requiring the payment of additional employment taxes (and possibly penalties).
- An S corporation's income is taxed to the shareholders when earned, even if not distributed.
- What will the expected profits (losses) be in future years? Based on the expectations, the overall marginal tax cost may be higher for a C corporation in future years. If there are losses, the losses flow through to and S corporation owner and are immediately deductible. Losses of a C corporation can only offset profits from other C corporation years.
- Will the C corporation pay dividends? The dividend tax rate is 15%.

43. *Reasonable Compensation*

Solution: Some possible questions include:

- ◆ What is the extent and scope of Cindy's duties for the corporation?
- ◆ What do other executives in comparable positions in comparable companies earn annually?
- ◆ Have other executives been as successful in expanding their business as Cindy has been?
- ◆ How does Cindy's salary compare to the corporation's gross and net income?
- ◆ Was her salary kept unusually low in the beginning with the expectation that it would be increase significantly if she proved to be successful in expanding the company?
- ◆ Does the corporation plan to pay dividends?

44. *Exercising Incentive Stock Options*

Solution: Although the taxpayer pays no regular income tax when an ISO is exercised, the taxpayer must include the bargain element (the difference between the strike price and the fair market value when exercised) in alternative minimum taxable income (AMTI) for the year exercised. The alternative minimum tax (AMT) is assessed at a 26 – 28% rate (refer to Chapter 11 for details). The taxpayer must include the bargain element in AMTI even if the value of the stock declines after exercising the ISO, so tax planning should be done to minimize the AMT. The following four strategies should be considered when exercising ISOs:

1. Exercise sooner rather than later
If the value of the stock is expected to rise steadily, exercising the ISOs soon after they vest will minimize the amount of bargain element that is subject to the AMT.
2. Spread the exercise over several years
If the ISO does not expire before the end of the year, and the stock has already increased substantially in value, a partial exercise in one year, with the balance exercised in a future year or years, will minimize the amount of bargain element subject to the AMT in any one year.
3. Minimize the other elements of AMTI
If a large bargain element cannot be avoided, then try to minimize other elements that increase AMTI. For example, it may be possible to defer a year-end bonus into the next year.
4. Avoid AMT through a disqualifying disposition
The AMT can be completely avoided if the shares acquired with the ISO are sold in the same year as the ISO is exercised. This will be considered a disqualifying disposition (because the stock is not held for more than one year from exercise date) and any gain will be taxed at ordinary income tax rates (instead of favorable long-term capital gains rates). If the stock starts to decline in value, a disqualifying disposition may result in lower tax and increased cash flow compared to holding the stock while it continues to decline.

45. *Stock Option Taxation*

Solution: Under one scenario, an employee receives a significant number of nonqualified stock options (NQSO) at a price slightly above the current market price. After the stock's price increases dramatically, the employee exercises the options and would be required to recognize the bargain element (the difference between the strike price and the fair market value when exercised) as taxable ordinary income. Soon after the exercise, the stock's price drops dramatically. The employee must pay income taxes on the exercise of the option but due to the significant decline in market value cannot sell the stock for enough money to cover the taxes owed. (This happened to many employees in the technology sector.)

46. *Stock Option Terminology*

Solution: a. Backdating is claiming an option was granted earlier than it actually was, to take advantage of a more favorable exercise price, to enhance its potential value.

- b. Repricing involves setting a new, lower exercise price for existing options, because of a decline in the market price of the stock subsequent to the original award.
- c. Reloading is automatically granting new options, at current market prices, to replace some or all of the options that are being exercised.
- d. Spring-loading is awarding options just before the release of positive news that is likely to increase the stock price.
- e. Bullet-dodging involves postponing the award of options until after bad news has driven down the stock price.

See Maremont and Forelle, "Bosses' Pay: How Stock Options Became Part of the Problem," *The Wall Street Journal*, December 27, 2006, page A1, for a discussion of these terms and additional information on the stock option backdating problem.

47. *Defined Benefit vs. Defined Contribution Plan*

Solution: An older employee would usually prefer a defined benefit plan because it is based on current earnings. With a shorter period of time over which to make contributions, the defined benefit plan usually permits greater current contributions; the limits on contributions are usually more liberal allowing a faster build-up within the plan. Defined contribution plans are advantageous for younger employees because of the longer time the contributions in the plan earn income.

48. *Retirement Contribution Taxation*

Solution: If Congress changed the law so that contributions to retirement plans could no longer be made with before-tax dollars, the short-term effect would be a reduction in the funds available for retirement savings due to the taxes that would have to be paid. There would be a reduction in the incentive to save for retirement, which would result in even less money being saved. This could result in more people depending on the government during their retirement years. Also, the effect on the economy of decreased saving (these funds will no longer be available for investment by the pension trustees) could also be significant.

Identify the Issues

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

49. *Reasonable Compensation*

Solution: Is Susan's compensation reasonable for her position and responsibilities? How will Sanibel Corporation treat Susan's compensation for tax purpose? Will the deduction be limited to \$1,000,000 or is a portion of the payment incentive based?

50. *Reasonable Compensation*

Solution: Is Virginia now receiving compensation that is unreasonable for her position and responsibilities? Is the reasonable compensation issue mitigated by her having taken no salary from the business for two years?

51. *Employer-Provided Lodging*

Solution: What are the tax consequences of George accepting the rent-free use of the apartment as part of his employment? What could be done to ensure a favorable tax outcome?

52. *Personal-Use of Company-Owned Vehicle*

Solution: How will Victor treat the additional compensation for the lease value of the Jaguar and is he entitled to a deduction for his business use of the vehicle? How will the company treat the Jaguar for depreciation purposes?

53. *Moving Expenses*

Solution: Does Margaret have any income as a result of the reimbursement?

54. *Traditional vs. Roth IRA*

Solution: Is Sarah eligible to make a deductible contribution to a traditional IRA or a nondeductible contribution to a Roth IRA? What are the other personal, family, and business factors that Sarah should consider in deciding whether to invest in a traditional IRA, a Roth IRA, or the preferred stock?

55. *Pension Contribution*

Solution: Will Ken's interest and dividend income be considered along with his salary in determining the maximum amount he can contribute to his company's qualified pension plan? What is the maximum amount that Ken can contribute and are there company matches for all or part of the contributions?

Develop Research Skills

Solutions to research problems are included in a separate file.

Search the Internet

60. *Excess Mileage Allowance*

Solution: The amount that exceeds the standard mileage allowance [number of miles x (60 cents – 56.5 cents in 2013)] is treated as taxable compensation to the employee. No later than the first payroll period following the payroll period in which the business miles of travel are substantiated, the employer must withhold and pay employment taxes on the amount that exceeds the standard mileage allowance.

61. *Flexible Spending Arrangement*

Solution: Beginning in 2011, the definition of medical expenses eligible for payment through an FSA no longer includes over-the-counter medicines. Note that Revenue Ruling 2010-23 made Rev. Rul. 2003-102 obsolete.

62. *Adjusted Gross Income and Self-Employment Tax*

Solution: a. Filled-in tax forms for 2012 are included at the end of this file.

Angelina's self-employment tax is \$9,212 for 2012.

$$\$75,000 \times 92.35\% = \$69,263$$

$$\$69,263 \times 13.3\% = \$9,212$$

$\$75,000 - \$5,298 (\$9,212 \times 57.51\%)$ deduction for employer's portion of self-employment tax = \$69,702 adjusted gross income

b. AGI = \$69,701 ($\$75,000 - \$5,299$ employer's half of SE tax) for 2013.

c. Angelina's self-employment tax is \$10,597 for 2013

$$\$75,000 \times 92.35\% \times 15.3\% = \$10,597.$$

The employer's half of the tax is deductible for AGI.

63. *Conversion to Roth IRA*

Solution: The articles and URLs will vary but here are a few of the main points regarding conversion. Prior to 2010, an individual whose AGI was no more than \$100,000 could convert a traditional IRA to a Roth IRA. When converted from a traditional to a Roth IRA, income tax (but not the 10% early withdrawal penalty) had to be paid on deductible contributions and tax-deferred earnings when they were moved from the traditional to Roth IRA. The entire IRA did not need to be converted at one time. A partial conversion was a way to minimize the tax cost for that year. Generally, it is preferable to contribute to a Roth IRA if the contributions to your traditional IRA are nondeductible. In 2010, the \$100,000 AGI limit was eliminated, allowing high-income taxpayers to convert a traditional IRA to a Roth IRA. To make this conversion more attractive, taxpayers who converted in 2010 could spread the income (and related tax payment) over 2011 and 2012.

Develop Planning Skills64. *Foreign Earned Income*

Solution: If Jorge stays only six months in Saudi Arabia, he must include the entire \$68,400 [(12 months x \$5,000 salary) + (6 months x \$1,400 additional compensation)] in income. His taxable income will be \$58,400 (\$68,400 - \$6,100 standard deduction - \$3,900 personal exemption). His income tax liability will be \$10,529 [\$4,991 + 25% (\$58,400 - \$36,250)]. His income tax can also be calculated as: $(\$8,925 \times 10\%) + (\$27,325 \times 15\%) + (\$22,150 \times 25\%) = \$10,529$. His after-tax compensation is \$57,871 (\$68,400 - \$10,529).

If Jorge extends his assignment for an additional six months, he will be eligible to exclude up to \$97,600 by using the foreign earned income exclusion. Using this provision, he could exclude his entire \$76,800 [12 months x (\$5,000 salary + \$1,400 additional compensation)] compensation. His after-tax income will be the entire \$76,800 resulting in an \$18,929 (\$76,800 - \$57,871) higher after-tax cash flow. From a tax standpoint, Jorge is better off extending his stay at least long enough to meet the 330-day physical presence test.

Note that this solution does not consider FICA taxes as typically they will be paid even if foreign income is excluded from taxable income.

65. *Planning for Salary Increase*

Solution: Some possible opportunities include:

- ◆ Taking some of the salary in the form of additional tax-exempt fringe benefits
- ◆ Additional deferred compensation options with her employer in qualified and nonqualified plans
- ◆ Investing the money saved in tax-exempt securities.

66. *Lump Sum Distribution vs. Rollover*

Solution: If Maria takes the funds from her retirement plan, the plan trustee is required to withhold 20 percent for income taxes, so she will only receive the remaining \$30,400 [$\$38,000 \times (\$38,000 \times 20\%)$] in cash. The 20 percent withheld for taxes will not pay all of the taxes she will owe on this premature distribution. She will have to pay income taxes at her regular 28 percent marginal tax rate along with a 10 percent premature withdrawal penalty, resulting in an effective tax rate of 38 percent or \$14,440 ($\$38,000 \times 38\%$). Her after-tax funds available will be only \$23,560 ($\$38,000 - \$14,440$ tax). With the auto dealer offering a very low interest rate, she would be better off rolling over the funds in her retirement plan into an IRA, saving the \$14,440 in taxes, and paying for the car from her current income.

67. *401(k) vs. Municipal Bond Investment*

Solution: By investing \$12,000 in a 401(k) plan, William avoids current income taxes of \$3,360 ($\$12,000 \times 28\%$ marginal tax rate). His after-tax cost for this investment is only \$8,640 ($\$12,000 - \$3,360$) while he has \$12,000 invested in the 401(k) plan than can earn income until he withdraws it at retirement. In the meantime, he pays no taxes on all of the investment income, allowing this income to be fully reinvested in the 401(k) plan.

If William invests only \$6,000 in the 401(k), his taxes are reduced by only \$1,680 ($\$6,000 \times 28\%$). He will have to pay income taxes on the \$6,000 he receives to invest in municipal bonds and he will have only \$4,320 ($\$6,000 - \$1,680$ tax) remaining to invest. His net after-tax cost of this investment is \$10,320 ($\$6,000 + \$4,320$). He will then earn annual tax-exempt interest income on this investment of \$259 ($\$4,320 \times 6\%$). Because he has less invested in total, his overall return will be less and the amount available at retirement will be significantly reduced. In addition, he must be able to reinvest the municipal bond interest that is paid annually to continue to earn income on this interest as only the portion invested in the 401(k) provides for automatic reinvestment. Thus, he is better off in the current year investing the entire \$12,000 in a 401(k) plan.

68. *Traditional vs. Roth IRA*

Solution: Contributions to a traditional IRA are made with pre-tax dollars because the contribution is tax deductible. Thus the entire \$3,000 can be contributed to a traditional IRA. After 10 years, Robert will have accumulated \$41,460 ($\$3,000$ annuity $\times 13.82$) in the account. When these funds and their earnings are

withdrawn in retirement, the tax on the withdrawn funds will be levied at Robert's then current 15 percent tax rate. If he wants to take \$3,000 per year after taxes from this account, he will have to withdraw \$3,529 ($\$3,000/.85$) annually. Assuming the same 7 percent interest rate during the withdrawal years, it will take approximately 25 years before the account is depleted ($\$41,460/\$3,529 = 11.748$). This coincides with the present value of an annuity of \$1 that is slightly in excess of 25 years.

Contributions to a Roth IRA are not tax deductible so Robert will be required to pay taxes on the \$3,000 before contributing the funds to a Roth IRA. The \$840 ($\$3,000 \times 28\%$ marginal tax rate) in taxes will reduce the amount available to contribute to only \$2,160 ($\$3,000 - \840 taxes). After 10 years, Robert will have accumulated \$29,851 ($\$2,160 \times 13.82$). When Robert withdraws the funds in retirement, he will pay no taxes on it. It will be almost 18 years before the funds in the Roth IRA are depleted ($\$29,851/\$3,000 = 9.95$). This coincides with the present value of an annuity of \$1 that is slightly less than 18 years.

69. *Net Present Value*

Solution: a. The net present value of the after-tax cash flows for Melinda are \$87,250 from Argus and \$89,394 from Dynamic computed as follows:

After-tax cash flow from Argus salary:

$$\text{Year 1: } \$75,000 - (\$75,000 \times 25\%) - (\$75,000 \times 7.65\%) = \$50,513$$

$$\text{Year 2: } \$75,000 - (\$75,000 \times 33\%) - (\$75,000 \times 7.65\%) = \$44,513$$

NPV of Argus salary:

$$(\$50,513 \times .943) + (\$44,513 \times .890) = \$87,250$$

After-tax cash from Dynamic salary:

$$\text{Year 1: } \$100,000 - (\$100,000 \times 25\%) - (\$100,000 \times 7.65\%) = \$67,350$$

$$\text{Year 2: } \$49,000 - (\$49,000 \times 33\%) - (\$49,000 \times 7.65\%) = \$29,082$$

NPV of Dynamic salary:

$$(\$67,350 \times .943) + (\$29,082 \times .890) = \$89,394$$

The NPV of the after-tax cost for the corporations are \$97,675 for Argus and \$97,984 for Dynamic computed as follows:

After-tax cost for Argus:

$$\text{FICA tax} = \$5,738 (\$75,000 \times 7.65\%)$$

$$\text{Year 1: } [\$75,000 + \$5,738] \times (1-.34) = \$53,287$$

$$\text{Year 2: } [\$75,000 + \$5,738] \times (1-.34) = \$53,287$$

NPV of the cost of Melinda's salary:

$$(\$53,287 \times .943) + (\$53,287 \times .890) = \$97,675$$

After-tax cost for Dynamic:

$$\text{Year 1: } [\$100,000 + (\$100,000 \times 7.65\%)] \times (1-.34) = \$71,049$$

$$\text{Year 2: } [\$49,000 + (\$49,000 \times 7.65\%)] \times (1-.34) = \$34,814$$

NPV of the cost of Melinda's salary:

$$(\$71,049 \times .943) + (\$34,814 \times .890) = \$97,984$$

- b. (1) The best alternative for Melinda would be Dynamic because it results in \$2,144 ($\$89,394 - \$87,250$) higher net present value of after-tax cash flows than offered by Argus.
- (2) From the corporations' perspective, Argus's offer provides a slightly lower after-tax cost but the difference is only \$309 ($\$97,984 - \$97,675$).

Note that FUTA tax would be the same for both corporations for both years, so it was omitted from this comparative analysis.

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27	Deductible part of self-employment tax. Attach Schedule SE	27	5,298																																																																																					
28	Self-employed SEP, SIMPLE, and qualified plans	28																																																																																						
29	Self-employed health insurance deduction	29																																																																																						
30	Penalty on early withdrawal of savings	30																																																																																						
31a	Alimony paid b Recipient's SSN ▶	31a																																																																																						
32	IRA deduction	32																																																																																						
33	Student loan interest deduction	33																																																																																						
34	Tuition and fees. Attach Form 8917	34																																																																																						
35	Domestic production activities deduction. Attach Form 8903	35																																																																																						
36	Add lines 23 through 35	36	5,298																																																																																					
37	Subtract line 36 from line 22. This is your adjusted gross income ▶	37	69,702																																																																																					

SCHEDULE SE
(Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Chapter 4, Problem 62

Self-Employment Tax

► Information about Schedule SE and its separate instructions is at www.irs.gov/form1040.

► Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2012
Attachment
Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040)

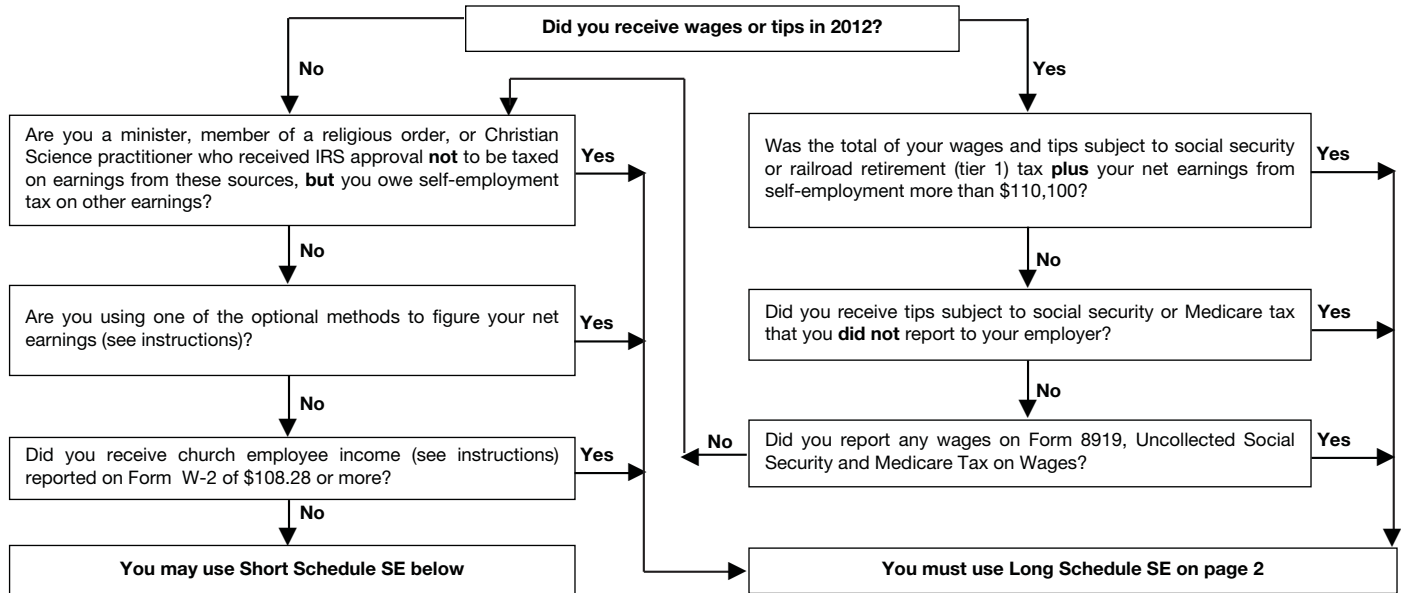
Angelina

Social security number of person
with **self-employment** income ►

Before you begin: To determine if you must file Schedule SE, see the instructions.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only** if you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1a Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a		
b If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code Y	1b	()
2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report	2	75,000	
3 Combine lines 1a, 1b, and 2	3	75,000	
4 Multiply line 3 by 92.35% (.9235). If less than \$400, you do not owe self-employment tax; do not file this schedule unless you have an amount on line 1b ► Note. If line 4 is less than \$400 due to Conservation Reserve Program payments on line 1b, see instructions.	4	69,263	
5 Self-employment tax. If the amount on line 4 is: • \$110,100 or less, multiply line 4 by 13.3% (.133). Enter the result here and on Form 1040, line 56 , or Form 1040NR, line 54 • More than \$110,100, multiply line 4 by 2.9% (.029). Then, add \$11,450.40 to the result. Enter the total here and on Form 1040, line 56 , or Form 1040NR, line 54	5	9,212	
6 Deduction for employer-equivalent portion of self-employment tax. If the amount on line 5 is: • \$14,643.30 or less, multiply line 5 by 57.51% (.5751) • More than \$14,643.30, multiply line 5 by 50% (.50) and add \$1,100 to the result. Enter the result here and on Form 1040, line 27 , or Form 1040NR, line 27	6	5,298	