

Chapter 5 Summary of End-of Chapter Problem Revisions

2014 Edition Problem Number	2013 Edition Problem Number	2014 Edition Modification
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19	19	Problem modified
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30	30	Problem updated
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35	35	Solution modified
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45	45	Problem updated
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64	64	Solution updated
65	65	Updated forms
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70	70	
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72	72	Problem modified

Solutions to Chapter 5 Problem Assignments

Check Your Understanding

1. *Trade or Business*

Solution: To be a qualified trade or business, an activity must have a profit motive (to make money) and the taxpayer must spend a sufficient amount of time in the business so that it is not considered simply an investment activity or a hobby. The motivation for the activity cannot be primarily personal pleasure; it must be profit.

2. *Investment Expenses*

Solution: An investment activity is one in which the owner intends to make a profit but does not spend sufficient time to elevate it to a trade or business. Typically, the income from an investment activity comes from owning income-producing assets or from long-term appreciation in assets.

Investment expenses are deductible but the deduction may be limited. Individuals are only permitted to deduct their investment expenses as miscellaneous itemized deductions subject to the 2 percent of AGI limitation.

3. *Timing of Expense Deduction*

Solution: a. Because Marvin's daughters own Marvil Corporation, it is a related entity. Marvil can only deduct the legal expense in the year Marvin recognizes the income. These events both happen in year 1; thus, Marvil can deduct the expense in year 1.

b. Marvil cannot deduct the payment for the legal expense until year 2, the year Marvin recognizes the income.

4. *Substantiation*

Solution: Substantiation may be provided in the form of receipts, canceled checks, and paid bills. If the expense is for travel, entertainment, gifts or automobile expenses, the substantiation could include diaries, trip sheets, travel logs, paid bills, receipts, account books, and expense reports. These should document the amount of the expense, the time and place of the expense, the business purpose for the expense, the date and description of a gift and the business relationship to the person receiving a gift.

5. *Timing of Expense Deduction*

Solution: Businesses are not permitted to use reserves for expenses for tax purposes. Aloha can only deduct the repair expenses in the year the repairs are performed, if it is an accrual-basis taxpayer, or when they are paid, if it is a cash-basis taxpayer.

6. *Business Investigation Expenses*

Solution: Diane can deduct the \$1,900 (\$1,600 + \$300) in the current year as business investigation expenses. Diane can deduct this amount because she is already in the clothing business and expenses for potential expansion are ordinary business expenses whether or not a new store is opened. Her brother, however, is not permitted any deduction for the \$1,900 that he expended. Cameron could only

deduct the \$1,900 (along with start-up expenses not exceeding \$5,000 in total) if the new store was opened.

7. *Organization Costs vs. Business Expenses*

Solution: \$5,000 of the \$6,000 organizational costs are deducted in the first tax year and the remaining \$1,000 are capitalized and amortized over 180 months starting with the month the corporation begins business. The \$700 legal fee is fully deductible in the second year as a business expense.

8. *Business Gifts*

Solution: The deduction for business gifts is limited annually to \$25 per donee.

9. *Domestic vs. Foreign Travel*

Solution: Domestic travel—Actual transportation expenses (plane, train, etc.) as part of travel are fully deductible if the trip is primarily business (more business than nonbusiness days). If the trip is primarily personal, no transportation expenses are deductible. Meals and lodging are deductible only for business days.
Foreign travel—If the travel is purely for business, all transportation costs are deductible. If the travel combines business with some personal days, the transportation costs must be allocated between business and personal time unless the travel time does not exceed one week or less than 25 percent of the time is spent on personal pursuits. In these latter cases, all transportation expenses are deductible. If the travel is primarily personal (personal days exceed business days), no transportation expenses may be deducted. Costs of meals and lodging must be allocated between business and personal days with a deduction only allowed for business days.

10. *Vacation Rental*

Solution: If a vacation home is used by the owner and rented out, the limit on deduction depends upon the relative use by each. If the home is rented for less than 15 days, only those normal expenses of a second home such as mortgage interest and taxes, are deductible as itemized deductions.
If the home is rented for more than 14 days and is used no more than the greater of 14 days or 10 percent of the rental days by the owner, the home is treated as rental property and all rental expenses are deductible against the rental income. Mortgage interest for the personal-use days is not deductible because the dwelling does not qualify as a “home” due to the limited personal use. Real estate taxes, however, are still deductible as itemized deductions.
For rental of more than 14 days, with owner-use more than the greater of 14 days or 10 percent of rental days, the deduction for rental expenses is limited to the rental income, similar to expenses of a hobby. Both mortgage interest and taxes for the personal-use portion are deductible as itemized deductions.

11. *Home Office Deduction*

Solution: For a self-employed person to claim a deduction for a home office, the space must be used exclusively and on a regular basis for the business, and it must be one of the following: the principal place of business for the taxpayer, a place where

clients or customers are met regularly in the normal course of business, or located in a structure separate from the home. In addition to the above requirements, an employee's home office must be for the convenience of the employer (for example, relieving the employer from providing the employee with an office).

12. *Hobby vs. Business*

Solution: Factors that differentiate a hobby from a business include:

- ◆ The manner in which the taxpayer carries on the activity;
- ◆ The expertise of the taxpayer and of the taxpayer's consultants;
- ◆ The time and effort spent by the taxpayer in the activity;
- ◆ The taxpayer's history of profits or losses for this activity;
- ◆ The success of the taxpayer in similar activities;
- ◆ The overall financial status of the taxpayer; and
- ◆ The elements of pleasure or recreation that are part of the activity.

13. *Tax vs. Financial Accounting*

Solution: A permanent difference between tax and financial accounting is one that results from a treatment that does not reverse over time (the difference remains imbedded in their respective net incomes permanently). A temporary or timing difference is one that does reverse in a later period. (Over two or more periods, the income or deductions for financial accounting will equal the income or deductions for tax accounting.) Examples of timing differences include differences in depreciation schedules, bad debt deductions vs. allowances for bad debt, and prepaid expenses. Examples of permanent differences include tax-exempt interest income on municipal bonds, life insurance proceeds, and nondeductible fines.

14. *Schedule M-3*

Solution: Large corporations with assets of \$10 million or more must file a Schedule M-3. This schedule requires large corporations to separately report temporary and permanent differences. The IRS has mandated this disclosure of permanent differences to assist in preventing the use of abusive tax shelters that are structured either to reduce the amount of taxes paid without reporting any corresponding decrease in book income or to increase book income without a corresponding increase in tax liability.

15. *FIN 48*

Solution: Step 1: The business must evaluate each tax position to assess whether it is more likely than not (greater than 50 percent) that the position would be sustained upon examination (including the administrative appeals and litigation process). The business must base its assessment on an analysis of the relevant tax authorities (such as the Code, regulations, rulings, and court cases) and it must assume that the tax authorities have full knowledge of all relevant information (including access to work papers and legal opinions from outside tax advisors). This requirement must be met even if the business believes the possibility of audit or discovery of the matter is remote. Additionally, each tax position must stand on its

own technical merits so that a business may not consider one position as a bargaining chip against another tax position.

Step 2: If a tax position satisfies the first step, the business can then proceed to measure the tax benefit that can be recognized in the financial statements from its uncertain position. If no single amount is more likely than not to be realized, then a cumulative probability analysis of the possible outcomes is required. The business records the largest tax benefit that meets a greater than 50 percent cumulative probability of realization upon ultimate settlement.

16. *UNICAP Rules*

Solution: The uniform capitalization rules require a business to capitalize as part of inventory all the direct costs of manufacturing, purchasing, and storing inventory along with an extensive list of items that are part of overhead, such as factory administration, taxes, pension costs, and service support functions. Businesses whose average annual gross receipts in the three preceding years exceed \$10 million are subject to the UNICAP rules for determining the costs of inventory.

17. *UNICAP Rules*

Solution: a. Factory insurance - Included
b. Advertising – Not included
c. Payroll taxes for factory employees - Included
d. Research and experimentation costs – Not included
e. Repairs to factory equipment – Included

18. *LIFO Inventory*

Solution: In an economy with rising prices, the LIFO inventory method for tax purposes matches the latest and highest costs for goods sold with the selling price of the goods. This reduces the business's taxable income and its taxes payable. The disadvantage is that LIFO must then be used for financial reporting. Thus, financial accounting income reported will also be lower. The business can, however, report an alternative inventory valuation in supplementary material to the financial statements.

Crunch the Numbers

19. *Expenses Related to Tax-Exempt Income*

Solution: Mary is allowed no interest deduction because the loan proceeds were used to invest in tax-exempt securities.

20. *Prepaid Rent*

Solution: a. Bender can only deduct \$1,800 (3 x \$600) rent for the three months remaining in the current year, because the rent payment is for a period extending beyond the end of the succeeding year.
b. Bender can deduct the \$7,200 in each year that it is paid. The contract calls for the advance payments and each payment does not extend beyond the end of the year following the year it is paid.

21. *Prepaid Expenses*

Solution: Simon can only deduct the \$5,000 paid for supplies. The insurance payment must be capitalized and written off one-third in each of the years it covers as if Simon was an accrual-basis taxpayer.

22. *Interest Deduction*

Solution: \$200 for year 1 and \$10,200 for year 2. Foster must amortize the loan discount ($\$100,000 - \$98,000 = \$2,000$ discount) over the 10-year life of the loan at a rate of \$200 per year. Foster can only deduct the \$200 amortized discount in year 1; it can deduct \$10,200 in year 2, consisting of the \$10,000 interest paid on January 1 and the \$200 amortization.

23. *Interest Deduction*

Solution: a. Mike cannot deduct anything because it is not his loan.
 b. Kelley can only deduct the \$5,850 interest expense for the nine monthly payments that she made.
 c. Mike should have given (or loaned) the money to Kelley and let Kelley make the loan payments. That way, Kelley could take a deduction for the \$7,800 interest paid that year.

24. *Business Meals and Club Dues*

Solution: Elisa can deduct \$500 ($50\% \times \$1,000$) of the business lunches only. She has no deduction for any portion of the club dues.

25. *Entertainment Expenses*

Solution: \$70. Entertainment tickets are not only subject to the 50% limit, but the 50% limit applies to the face value of the tickets. Thus, Jim is allowed a deduction for only one-half of the face value of the tickets or \$70 ($50\% \times \140).

26. *Travel Expenses*

Solution: Martha cannot deduct any travel expenses. Her tax home is in San Diego. Her travel to Los Angeles is purely personal and her expenses are nondeductible.

27. *Travel Expenses*

Solution: \$1,100 deductible travel expenses. The airfare of \$420, \$500 for the hotel, \$100 ($50\% \times \200) for meals for the 4 business days, and \$80 ($\20×4) for the cost of 4 days for the rental car = \$1,100 deductible travel expenses. He may also deduct \$25 of the cost of the gift for the customer in Phoenix, but that is not a travel expense.

28. *Temporary Assignments*

Solution: \$8,500. The \$7,000 for lodging and transportation and \$1,500 ($\$3,000 \times 50\%$) for meals during the first seven months are deductible as travel expenses. At that point, the assignment is no longer temporary because the 10-month extension will extend it beyond the one-year limit; the expenses from that point on no longer qualify as travel expenses.

29. *Temporary Assignments*

Solution: Dan cannot deduct any of his expenses incurred for the apartment rent or meals during the 18 months in New York. Because the assignment was for longer than a year, it is not temporary and his tax home shifted to New York.

30. *Transportation Expense*

Solution: \$7,627.50 (90 days x 150 miles x 56.5¢); John is allowed to deduct his mileage only. He has no deduction for meals as he is not “traveling away from home.”

31. *Foreign Travel*

Solution: \$2,730. Luis can deduct \$980 ($7/10 \times \$1,400$) transportation costs, \$1,400 ($7 \times \200) for his hotel, and \$350 ($7 \times \$100 \times 50\%$) for his meals, for a total of \$2,730.

32. *Uncollectible Accounts*

Solution: a. Maria must recognize \$50,000 of income during the current year. She will deduct the \$2,000 as a bad debt in the year she determines it is uncollectible.
b. Maria will recognize only \$48,000 of income in the current year. She has no deduction for the \$2,000 that she cannot collect because it was never recognized as income.

33. *Insurance*

Solution: Melbourne can deduct \$36,000 ($\$16,000 + \$20,000$) in insurance expense. The \$2,000 premium for the president’s life insurance policy is not deductible because the insurance proceeds would be tax exempt.

34. *Legal Expenses*

Solution: Jim may deduct the \$15,000 in legal fees only. The fines for the parking tickets are nondeductible.

35. *Home Office Expenses*

Solution: Maureen’s deductible expenses for her home office are limited to the business income (\$2,300) and she must account for expenses in the following order:

\$1,600 Mortgage interest and property taxes $[(\$5,000 + \$1,400) \times 400/1600]$
450 Utilities and repairs $[(\$1,200 + \$600) \times 400/1600]$
250 Depreciation $(\$6,000 \times 400/1600 = \$1,500)$ limited to \$250 $(\$2,300 - \$1,600 - \$450 = \$250 \text{ remaining})$.

The nondeductible portion of the depreciation (\$1,250) will be carried forward to future years and will be deductible subject to similar limitations.

Alternatively, Maureen could elect the new simplified option that allows her to deduct \$5 per square foot up to 300 square feet = \$1,500 for her home office expenses without requiring an allocation of mortgage interest and taxes. Her business income would then be \$800 $(\$2,300 - \$1,500)$ instead of zero so she would have to pay income tax and any self-employment tax on that income. However, she would be allowed to deduct the full \$6,400 for mortgage interest and property taxes as itemized deductions. She would have no carryover of any expenses to future years.

36. *Business vs. Hobby*

- Solution:** a. If the activity is a business, Teresa may deduct all of the expenses from the revenue; she will report a loss of \$3,000 ($\$24,000 - \$10,000 - \$3,000 - \$8,000 - \$2,000 - \$4,000$).
- b. If the activity is a hobby, Teresa will be able to deduct expenses only to the extent of her income from the activity. So she can deduct only \$24,000 of the expenses.
- c. Some of the factors that should be considered are:
- ◆ The manner in which the taxpayer carries on the activity;
 - ◆ The expertise of the taxpayer and of the taxpayer's consultants;
 - ◆ The time and effort spent by the taxpayer in the activity;
 - ◆ The taxpayer's history of profits or losses for this activity;
 - ◆ The success of the taxpayer in similar activities;
 - ◆ The overall financial status of the taxpayer; and
 - ◆ The elements of pleasure or recreation that are part of the activity.

37. *Vacation Home Rental*

- Solution:** a. Neil does not include the \$1,500 ($\150×10) rent in income. He deducts the mortgage interest and property taxes in full as itemized deductions. He is allowed no deduction for the other expenses.
- b. Neil must recognize \$15,000 ($\150×100) rent as income. He deducts 100/110 of each expense against this income. Thus, the expense deductions are \$21,818 ($\$24,000 \times 100/110$) for mortgage interest; \$10,909 ($\$12,000 \times 100/110$) for property taxes; \$10,909 ($\$12,000 \times 100/110$) for depreciation; and \$4,545 ($\$5,000 \times 100/110$) for the other expenses resulting in a rental loss of \$33,181 ($\$15,000 - \$48,181$). He is not allowed to deduct the balance of the mortgage interest because his personal-use did not meet the threshold to qualify as a "home" but he can deduct the \$1,091 ($\$12,000 - \$10,909$) personal portion of the property taxes as an itemized deduction.
- c. His deductions are now limited to his rental income of \$9,000 ($\150×60 days). He must first deduct the rental portion of mortgage interest and property taxes of \$19,636 ($\$36,000 \times 60/110$); this deduction is limited to \$9,000, however. The \$27,000 ($\$36,000 - \$9,000$) remaining interest and taxes are deductible as itemized deductions. None of the other expenses are deductible.

38. *Book/Tax Differences*

- Solution:** a. \$406,500. ($\$400,000 - \$8,000$ tax-exempt interest income + $\$11,000$ ($50\% \times \$22,000$) meals and entertainment expense + $\$3,300$ life insurance premium + $\$200$ fines).
- b. \$138,210 ($\$406,500 \times 34\%$). Tax expense on the financial statement and taxes payable will be the same because all of the adjustments are for permanent differences between tax and financial accounting income.

39. *Book/Tax Differences*

- Solution:** a. \$3,400 $[(\$80,000 - \$70,000) \times 34\%]$
 b. The \$3,400 is a deferred tax asset as taxes payable are more than book tax expense, resulting in a prepayment of the tax.
 c. It will credit the \$3,400 deferred tax asset created in the prior year for the difference.

40. *Book/Tax Differences*

- Solution:** a. All except two of the items are permanent differences. The \$2,100 (\$3,000 - \$900) excess of the addition to the allowance for bad debts over the direct write-off is a temporary difference and the \$4,000 (\$11,000 - \$7,000) excess of MACRS depreciation over straight-line financial depreciation is also a temporary difference.
 b. Taxable income is \$452,600 and the income tax payable is \$153,883.
 $\$500,000$ book income - $\$3,000$ exempt interest income + $\$200$ nondeductible interest expense + $\$2,100$ excess of addition to allowance for bad debts over the direct write-off + $\$2,000$ ($\$4,000 \times 50\%$) nondeductible portion of meals and entertainment - $\$4,000$ excess of MACRS depreciation over straight-line financial depreciation + $\$2,800$ nondeductible premiums on officer's life insurance - $\$50,000$ tax-exempt life insurance proceeds + $\$2,500$ nondeductible fines = $\$452,600$ taxable income. $\$452,600 \times 34\% = \$153,884$ income tax payable.

41. *Accounting for Deferred Tax Assets and Deferred Tax Liabilities*

- Solution:** a. The \$2,100 (\$3,000 - \$900) excess of the addition to the allowance for bad debts over the direct write-off results in a deferred tax asset of \$714 ($\$2,100 \times 34\%$). The \$4,000 (\$11,000 - \$7,000) excess of MACRS depreciation over straight-line financial depreciation results in a deferred tax liability of \$1,360 ($\$4,000 \times 34\%$).
 b. The journal entry is as follows:
- | | | |
|------------------------|---------|---------|
| Income tax expense | 154,530 | |
| Deferred tax asset | 714 | |
| Deferred tax liability | | 1,360 |
| Income tax payable | | 153,884 |

42. *Accounting for Uncertainty in Income Taxes*

- Solution:** \$600. Makai will recognize a \$600 deduction in its financial statements because it is the largest amount of benefit that is more than 50% likely to be sustained based on the outcome's cumulative probability.

43. *UNICAP Rules*

- Solution:** 70% (14 factory employees / 20 factory & sales staff) of the office costs are allocated to inventory.

44. *FIFO vs. LIFO*

- Solution:** a. No. Inventory costing methods do not have to match the actual flow of inventory.

- b. \$102,000 $[(\$375,000 - \$75,000) \times 34\%]$ could have been saved by using the LIFO inventory method.
- c. If Barley uses LIFO for tax reporting, it will be required to use LIFO in its financial statements; it will, however, be able to supply supplementary data on alternate inventory methods outside the financial statements.

45. *Comprehensive Sole Proprietorship Problem for Chapters 4 and 5*

Solution: a. Net income from the business is \$31,515. The expenses deductible from the \$45,000 of gross income are:

\$ 500	for advertising
2,900	for supplies
500	for taxes and licenses
600	for travel (other than meals)
200	for meals (50% x \$400)
4,746	for auto expense (56.5¢ x 8,400 miles)
100	parking and tolls
<u>3,939</u>	for home office expenses*
\$13,485	total expenses

*Home office expense: $500/2,000 \times \$10,300$ total expense other than depreciation = \$2,575 + \$1,364 depreciation for office = \$3,939

Net income from the business is \$31,515 (\$45,000 - \$13,485).

b. Self-employment income = $\$31,515 \times 92.35\% = \$29,104.10 \times 15.3\% = \$4,453$ self-employment tax.

c. Martin may claim the following additional deductions for AGI: \$2,227 ($\$4,453 \times .5$) for self-employment taxes; \$1,400 health insurance premium; and \$2,500 contribution to his IRA. He would have itemized deductions of \$5,775 ($1500/2000 \times \$7,700$ interest and taxes). The \$120 for speeding tickets is not deductible.

Alternatively, Martin could elect the new simplified option that allows him to deduct \$5 per square foot up to 300 square feet = \$1,500 for his home office expenses without requiring an allocation of mortgage interest and taxes. The net income from his business would then be \$33,954 (\$45,000 - \$11,046).

Self-employment income = $\$33,954 \times 92.35\% = \$31,356.52 \times 15.3\% = \$4,798$ self-employment tax.

Martin may claim the following additional deductions for AGI: \$2,399 ($\$4,798 \times .5$) for self-employment taxes; \$1,400 health insurance premium; and \$2,500 contribution to his IRA. He would have itemized deductions of \$7,700 mortgage interest and taxes. The \$120 for speeding tickets is not deductible.

Think Outside the Text

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

46. *Vacation Rental*

Solution: Yes, but there will be limitations on his deductible expenses similar to other vacation homes. The time-share property meets the definition of a dwelling unit. Prop. Reg. 1-280A-3(f) states that the allocation for the rental expense on a time

share shall be applied on the basis of the taxpayer's expenses for the unit, the number of days during the taxable year that the unit is rented at a fair rental, and the number of days during the taxable year that the unit is used for any purpose.

47. *Presumption Activity Not a Hobby*

Solution: By filing Form 5213 within three years of starting the business, Michael keeps the IRS from questioning the profit motive behind his business for 5 years after he starts it. Filing this form, however, puts the IRS on notice that Michael has a business with anticipated losses and may actually invite the IRS to audit him. In addition, if the activity is still losing money after the first 5 years, the form authorizes the IRS to disallow all 5 years of loss deductions; otherwise it generally can go back only 3 years. A better strategy would be to operate the business with a real profit motive and carry on the business in a professional manner, thus eliminating any need to file Form 5213.

48. *Book/Tax Differences*

Solution: (1) Prepaid rent expense: deductible under certain circumstances for tax purposes but not deductible for financial purposes until the rental term has passed.
 (2) Allowances for repairs: deductible for financial purposes when accrued but not deductible in computing taxable income until the expense is incurred.
 (3) Allowances for bad debts: deductible for financial purposes when accrued but not deductible for tax purposes until the debt is determined uncollectible.
 There are three reasons why financial accounting treatment differs from tax treatment. First, the goals of financial accounting and tax reporting are very different. The former seeks to provide information that decision makers (such as shareholders and creditors) find useful. The latter seeks to collect revenue equitably. Second, financial accounting often relies on the principle of conservatism, which tends to understate income when uncertainty exists. In contrast, the income tax system would be greatly hampered in its collection of revenue if taxpayers were allowed the freedom of reporting income conservatively. Third, financial accounting often relies on estimates and probabilities. The tax system would not function very efficiently or equitably if taxpayers were allowed to estimate expenses that may never actually be incurred.

49. *Book/Tax Differences*

Solution: The provisions that determine taxable income and financial accounting income have many differences. There are two types of differences, permanent and temporary. The permanent differences do not cause any differences in the tax reported for financial purposes than that actually paid. The timing differences, however, result in deferred tax liabilities or deferred tax assets because the differences will reverse in a later period. If there is a deferred tax liability created, the tax expense reported on the financial statement matches financial accounting income; but the taxable income is lower along with the taxes paid; the liability will have to be paid at a later date, however. The deferred tax liability account on the financial statement puts the financial statement users on notice that this tax will have to be paid sometime in the future. The opposite is true for a deferred tax asset; that is, taxes will be lower in the future because of the tax prepayment. In

general, the matching of the tax expense to the financial accounting income is believed to provide better evaluative information for the users of financial statements.

50. *Deferred Tax Assets and Liabilities*

Solution: If corporate income tax rates are reduced, corporations will benefit on their deferred tax liabilities. The amount of tax paid in the future will be lower than if paid today. The opposite is true for deferred tax assets. Deferred tax assets will provide lower future tax savings for the corporation.

51. *Tax vs. Financial Accounting for Travel Vouchers*

Solution: Similar to warranty expenses, a travel voucher expense would be estimated and accrued for book purposes, but it would not be deductible for tax purposes until the vouchers are used. This will result in temporary differences until the vouchers are used or expire.

Identify the Issues

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

52. *Travel Expense*

Solution: How much of Ken's expenses for the four-day conference and the week exploring Gettysburg can he deduct as unreimbursed travel expenses for business purposes?

53. *Bad Debt Deductions*

Solution: Does Christina have a bad debt deduction for the amount she is unable to collect? How much and when is any allowable amount deducted?

54. *Penalties*

Solution: Can Ace deduct the \$3,000 penalty?

55. *Vacation Home*

Solution: What are the tax effects of their exchanging the use of their vacation homes? Does this exchange result in any taxable income and are any rental expenses deductible?

56. *Travel Expenses*

Solution: Are the expenses incurred to testify deductible as business travel or lobbying expenses?

57. *Office in Home*

Solution: What, if any, of the expenses related to the office at the vacation home are deductible by Scott?

58. *Business vs. Hobby*

Solution: Will Anne's business be considered a hobby or a legitimate business given the lack of profits and the manner in which the business has been conducted?

Develop Research Skills

Solutions to research problems are included in a separate file.

Search the Internet

63. *Business Travel*

Solution: Yes. According to Publication 463, Costa Rica qualifies as part of North America.

64. *Employee Business Expenses*

Solution for 2012: \$16,970 total employee business expenses

\$ 13,320	Vehicle expense ($55.5¢ \times 24,000$ miles)
300	Parking and tolls
1,100	Travel expense
250	Other business expenses - business seminar
<u>2,000</u>	Meals & entertainment [$(\$2,800 + \$1,200) \times 50\%$]
\$16,970	Total employee business expenses

Tax forms for 2013 have not yet been released by IRS. A filled-in 2012 tax form is included at the end of this file.

Solution for 2013: \$17,210 total employee business expenses.

\$13,560	Vehicle expense ($56.5¢ \times 24,000$ miles)
300	Parking and tolls
1,100	Travel expense
250	Other business expenses - business seminar
<u>2,000</u>	Meals & entertainment [$(\$2,800 + \$1,200) \times 50\%$]
\$17,210	Total employee business expenses

65. *Vacation Home Rentals*

Solution: \$60 net rental income

160	Cleaning [$(60/75) \times \$200$]
600	Commissions
320	Insurance [$(60/75 \times \$400)$]
3,200	Mortgage interest [$(60/75) \times \$4,000$]
1,600	Taxes [$(60/75) \times \$2,000$]
400	Utilities [$(60/75) \times \$500$]
<u>560</u>	Depreciation [$(60/75) \times \$700$]
\$6,840	Total rental expense

\$6,900 rents received - \$6,840 rental expenses = \$60 net rental income

A filled-in tax form is included at the end of this file.

66. *Sole Proprietor with Home Office*

Solution for 2012: Net income is \$31,599 and self-employment tax is \$3,881.

\$45,000 Gross income

(500) Advertising
 (4,762) Car and truck expenses [(55.5¢ x 8,400 miles = \$4,662) + \$100 parking & tolls]
 (2,900) Supplies
 (500) Taxes and licenses
 (600) Travel
 (200) Meals (\$400 x 50%)
 \$35,538 Profit before home office expenses
 (3,939) Home office expenses* (from Form 8829)
 \$31,599 Net Profit

*Home office expense: $500/2,000 \times \$10,300$ total expense = \$2,575 + \$1,364 depreciation = \$3,939

Schedule SE Self-employment income: $\$31,599 \times 92.35\% = \$29,181.68 \times 13.3\% = \$3,881.16$.

Tax forms for 2013 have not yet been released by IRS. Filled-in 2012 tax forms are included at the end of this file.

Solution for 2013: Net income from the business is \$31,515 and self-employment tax is \$4,453.

The expenses deductible from the \$45,000 of gross income are:

\$ 500 for advertising
 2,900 for supplies
 500 for taxes and licenses
 600 for travel (other than meals)
 200 for meals (50% x \$400)
 4,746 for auto expense (56.5¢ x 8,400 miles)
 100 parking and tolls
 3,939 for home office expenses*
 \$13,485 total expenses

*Home office expense: $500/2,000 \times \$10,300$ total expense other than depreciation = \$2,575 + \$1,364 depreciation for office = \$3,939

Net income from the business is \$31,515 (\$45,000 - \$13,485).

Schedule SE Self-employment income = $\$31,515 \times 92.35\% = \$29,104.10 \times 15.3\% = \$4,453$ self-employment tax.

Alternatively, Martin could elect the new simplified option that allows him to deduct \$5 per square foot up to 300 square feet = \$1,500 for his home office expenses without requiring an allocation of mortgage interest and taxes. The net income from his business would then be \$33,954 (\$45,000 - \$11,046).

SE Self-employment income = $\$33,954 \times 92.35\% = \$31,356.52 \times 15.3\% = \$4,798$ self-employment tax.

67. *Corporate Schedule M-1***Solution:**

\$4,000,000	Income per books (before tax)
(10,000)	Interest income from tax-exempt municipal bonds
(500,000)	Life insurance proceeds
30,000	Nondeductible portion of meals and entertainment
<u>5,000</u>	Nondeductible premiums on officer's life insurance
\$3,525,000	Income modified for permanent differences
(40,000)	Excess of tax over book depreciation
<u>20,000</u>	Excess of bad debt allowance over direct write off
\$3,505,000	Taxable income

\$3,525,000 book income modified for permanent differences $\times 34\% = \$1,198,500$ income tax expense. $\$4,000,000 - \$1,198,500$ tax = $\$2,801,500$ net income per books.

Note that the income tax liability (the actual amount paid) on its tax return is \$1,191,700 ($\$3,505,000 \times 34\%$). The difference between the book tax expense and the actual tax liability is accounted for on the financial statements as a deferred tax asset and deferred tax liability.

A filled-in Schedule M-1 is included at the end of this file.

68. *Locate Annual Report*

Solution: All of the information needed for this problem can be found under "Note 11. Income Taxes" of Gap's annual report.

- Gap's effective tax rate for the year ended February 2, 2013 was 39.0% and its effective tax rate for the year ended January 28, 2012 was 39.2%.
- Gap's valuation allowance was \$56 million for fiscal 2012 and \$39 million for fiscal 2011.
- At February 2, 2013 Gap had \$50 million state and \$137 million foreign net operating loss carryovers. The state losses expire between fiscal 2022 and fiscal 2023; approximately \$106 million of the foreign losses expire between 2013 and fiscal 2021 and \$31 million of the foreign losses do not expire.

Develop Planning Skills69. *Timing of Payments*

Solution: Kondex should pay the expenses next year.

Pay in current year: $\$50,000 \times 25\% = \$12,500$ tax reduction from expense.

Pay next year: $\$50,000 \times 34\% \times .935 = \$15,895$ present value of tax reduction in the following year.

70. *Combined Business and Pleasure Travel*

Solution: Bob should arrange business meetings on Friday and Monday. His third business day could be either Thursday or Tuesday. By arranging the meetings on both sides of the weekend, he may be able to deduct all of his travel expenses as business expenses even though he spends Saturday and Sunday on personal pleasure. If it is less expensive for him to stay over for the weekend rather than return home after

the meeting on Friday and return for the meeting on Monday, then he will be able to stay over and consider the weekend hotel and meals costs as business expenses.

71. *Temporary Business Assignments*

Solution: Yes. If Ken sends two employees, both will be on temporary assignments of less than one year. Kendrick will be able to deduct all of the expenses for lodging (and 50 percent of meals) for the two employees, but they will have no income from the reimbursement. If he sends only one employee for 18 months, that employee's tax home will change to the new location. Although Kendrick will be able to deduct the reimbursements for meals and lodging as employee compensation, it will be taxable income to the transferred employee, who will have no deduction for any of these expenses.

72. *Vacation Rental*

Solution: If John does not extend the rental, none of the tenant's \$3,500 ($14 \times \250) rent payment is income and John simply deducts the \$6,000 taxes and interest that he pays on the vacation condo as itemized deductions.

If he extends the rental, John will have to include \$5,250 ($21 \times \250) in income; he will allocate one-half ($3/6$ weeks) of all the expenses to the rental income in the following order: taxes and interest, repairs and insurance, then depreciation. The total deduction is limited to the rental income of \$5,250, however. Thus, he can deduct \$3,000 ($50\% \times \$6,000$) of the taxes and interest and \$1,550 ($50\% \times \$3,100$) of the allocated repairs and insurance. He takes a depreciation deduction of \$500 ($50\% \times \$1,000$) and reduces the basis of the property accordingly. His total deduction for rental expenses is \$5,050 resulting in \$200 ($\$5,250 - \$5,050$) net rental income. The remaining \$3,000 of his interest and taxes may be deducted as itemized deductions.

If he extends the rental he will receive an additional \$1,750 ($7 \times \250) in cash for the rental, but will be taxed on \$3,200 more income (\$3,000 difference in itemized deductions + \$200 net rental income). John would incur \$1,056 ($\$3,200 \times 33\%$) additional taxes to generate \$1,750 additional cash from rent. Therefore, he should extend the rental because he will have a positive after-tax cash flow of \$694 ($\$1,750 - \$1,056$).

Form **2106**Department of the Treasury
Internal Revenue Service (99)**Employee Business Expenses**

▶ Attach to Form 1040 or Form 1040NR.

▶ Information about Form 2106 and its separate instructions is available at www.irs.gov/form2106.

OMB No. 1545-0074

2012Attachment
Sequence No. **129**

Your name

Carl

Occupation in which you incurred expenses

Social security number

Part I Employee Business Expenses and Reimbursements**Step 1 Enter Your Expenses**

	Column A Other Than Meals and Entertainment	Column B Meals and Entertainment
1 Vehicle expense from line 22 or line 29. (Rural mail carriers: See instructions.)	1 13,320	
2 Parking fees, tolls, and transportation, including train, bus, etc., that did not involve overnight travel or commuting to and from work	2 300	
3 Travel expense while away from home overnight, including lodging, airplane, car rental, etc. Do not include meals and entertainment	3 1,100	
4 Business expenses not included on lines 1 through 3. Do not include meals and entertainment	4 250	
5 Meals and entertainment expenses (see instructions)	5	4,000
6 Total expenses. In Column A, add lines 1 through 4 and enter the result. In Column B, enter the amount from line 5	6 14,970	4,000

Note: If you were not reimbursed for any expenses in Step 1, skip line 7 and enter the amount from line 6 on line 8.**Step 2 Enter Reimbursements Received From Your Employer for Expenses Listed in Step 1**

7 Enter reimbursements received from your employer that were not reported to you in box 1 of Form W-2. Include any reimbursements reported under code "L" in box 12 of your Form W-2 (see instructions).	7 0	0
---	-----	---

Step 3 Figure Expenses To Deduct on Schedule A (Form 1040 or Form 1040NR)

8 Subtract line 7 from line 6. If zero or less, enter -0-. However, if line 7 is greater than line 6 in Column A, report the excess as income on Form 1040, line 7 (or on Form 1040NR, line 8)	8 14,970	4,000
Note: If both columns of line 8 are zero, you cannot deduct employee business expenses. Stop here and attach Form 2106 to your return.		
9 In Column A, enter the amount from line 8. In Column B, multiply line 8 by 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 80% (.80) instead of 50%. For details, see instructions.)	9 14,970	2,000
10 Add the amounts on line 9 of both columns and enter the total here. Also, enter the total on Schedule A (Form 1040), line 21 (or on Schedule A (Form 1040NR), line 7). (Armed Forces reservists, qualified performing artists, fee-basis state or local government officials, and individuals with disabilities: See the instructions for special rules on where to enter the total.) ▶	10	16,970

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11700N

Form **2106** (2012)

Part II Vehicle Expenses**Section A—General Information** (You must complete this section if you are claiming vehicle expenses.)

		(a) Vehicle 1	(b) Vehicle 2
11	Enter the date the vehicle was placed in service	11 01 / 01 / 2012	/ /
12	Total miles the vehicle was driven during 2012	12 30,000 miles	miles
13	Business miles included on line 12	13 24,000 miles	miles
14	Percent of business use. Divide line 13 by line 12	14 80 %	%
15	Average daily roundtrip commuting distance	15 miles	miles
16	Commuting miles included on line 12	16 miles	miles
17	Other miles. Add lines 13 and 16 and subtract the total from line 12	17 6,000 miles	miles
18	Was your vehicle available for personal use during off-duty hours?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
19	Do you (or your spouse) have another vehicle available for personal use?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
20	Do you have evidence to support your deduction?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
21	If "Yes," is the evidence written?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	

Section B—Standard Mileage Rate (See the instructions for Part II to find out whether to complete this section or Section C.)

22	Multiply line 13 by 55.5¢ (.555). Enter the result here and on line 1	22 13,320
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Section C—Actual Expenses

		(a) Vehicle 1	(b) Vehicle 2
23	Gasoline, oil, repairs, vehicle insurance, etc.	23	
24a	Vehicle rentals	24a	
b	Inclusion amount (see instructions)	24b	
c	Subtract line 24b from line 24a	24c	
25	Value of employer-provided vehicle (applies only if 100% of annual lease value was included on Form W-2—see instructions)	25	
26	Add lines 23, 24c, and 25.	26	
27	Multiply line 26 by the percentage on line 14	27	
28	Depreciation (see instructions)	28	
29	Add lines 27 and 28. Enter total here and on line 1	29	

Section D—Depreciation of Vehicles (Use this section only if you owned the vehicle and are completing Section C for the vehicle.)

		(a) Vehicle 1	(b) Vehicle 2
30	Enter cost or other basis (see instructions)	30	
31	Enter section 179 deduction and special allowance (see instructions)	31	
32	Multiply line 30 by line 14 (see instructions if you claimed the section 179 deduction or special allowance).	32	
33	Enter depreciation method and percentage (see instructions)	33	
34	Multiply line 32 by the percentage on line 33 (see instructions)	34	
35	Add lines 31 and 34	35	
36	Enter the applicable limit explained in the line 36 instructions	36	
37	Multiply line 36 by the percentage on line 14	37	
38	Enter the smaller of line 35 or line 37. If you skipped lines 36 and 37, enter the amount from line 35. Also enter this amount on line 28 above	38	

**SCHEDULE E
(Form 1040)****Supplemental Income and Loss**

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040, 1040NR, or Form 1041.

▶ Information about Schedule E and its separate instructions is at www.irs.gov/form1040.

OMB No. 1545-0074

2012Attachment
Sequence No. **13**Department of the Treasury
Internal Revenue Service (99)

Name(s) shown on return

Your social security number

Gillian

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C or C-EZ** (see instructions). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.**A** Did you make any payments in 2012 that would require you to file Form(s) 1099? (see instructions) ☐ Yes ☒ No**B** If "Yes," did you or will you file required Forms 1099? ☐ Yes ☐ No

1a	Physical address of each property (street, city, state, ZIP code)				
A	Vacation home				
B					
C					
1b	Type of Property (from list below)	2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.	Fair Rental Days	Personal Use Days	QJV
A	3		60	15	
B					
C					

Type of Property:

- | | | | |
|---------------------------|------------------------------|-------------|--------------------|
| 1 Single Family Residence | 3 Vacation/Short-Term Rental | 5 Land | 7 Self-Rental |
| 2 Multi-Family Residence | 4 Commercial | 6 Royalties | 8 Other (describe) |

Income:		Properties:		A	B	C
3	Rents received	3		6,900		
4	Royalties received	4				
Expenses:						
5	Advertising	5				
6	Auto and travel (see instructions)	6				
7	Cleaning and maintenance	7		160		
8	Commissions.	8		600		
9	Insurance	9		320		
10	Legal and other professional fees	10				
11	Management fees	11				
12	Mortgage interest paid to banks, etc. (see instructions)	12		3,200		
13	Other interest.	13				
14	Repairs.	14				
15	Supplies	15				
16	Taxes	16		1,600		
17	Utilities.	17		400		
18	Depreciation expense or depletion	18		560		
19	Other (list) ▶	19				
20	Total expenses. Add lines 5 through 19	20		6,840		
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file Form 6198	21		60		
22	Deductible rental real estate loss after limitation, if any, on Form 8582 (see instructions)	22	()	()
23a	Total of all amounts reported on line 3 for all rental properties	23a				
b	Total of all amounts reported on line 4 for all royalty properties	23b				
c	Total of all amounts reported on line 12 for all properties	23c				
d	Total of all amounts reported on line 18 for all properties	23d				
e	Total of all amounts reported on line 20 for all properties	23e				
24	Income. Add positive amounts shown on line 21. Do not include any losses	24			60	
25	Losses. Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	25	()	
26	Total rental real estate and royalty income or (loss). Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2	26			60	

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Cat. No. 11344L

Schedule E (Form 1040) 2012

**SCHEDULE C
(Form 1040)**Department of the Treasury
Internal Revenue Service (99)**Profit or Loss From Business**
(Sole Proprietorship)**► For information on Schedule C and its instructions, go to www.irs.gov/schedulec.**
► Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2012
Attachment
Sequence No. **09**

Name of proprietor <u>Martin</u>	Social security number (SSN)										
A Principal business or profession, including product or service (see instructions) <u>consulting</u>	B Enter code from instructions <table border="1" style="width:100%; text-align: center;"> <tr> <td> </td><td> </td><td> </td><td> </td><td> </td><td> </td><td> </td><td> </td><td> </td><td> </td> </tr> </table>										
C Business name. If no separate business name, leave blank.	D Employer ID number (EIN), (see instr.) <table border="1" style="width:100%; text-align: center;"> <tr> <td> </td><td> </td><td> </td><td> </td><td> </td><td> </td><td> </td><td> </td><td> </td><td> </td> </tr> </table>										
E Business address (including suite or room no.) ► City, town or post office, state, and ZIP code											
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ►											
G Did you "materially participate" in the operation of this business during 2012? If "No," see instructions for limit on losses . <input type="checkbox"/> Yes <input type="checkbox"/> No											
H If you started or acquired this business during 2012, check here . <input type="checkbox"/>											
I Did you make any payments in 2012 that would require you to file Form(s) 1099? (see instructions) . <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No											
J If "Yes," did you or will you file required Forms 1099? . <input type="checkbox"/> Yes <input type="checkbox"/> No											

Part I Income

1 Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked <input type="checkbox"/>	1	45,000	
2 Returns and allowances (see instructions)	2		
3 Subtract line 2 from line 1	3	45,000	
4 Cost of goods sold (from line 42)	4		
5 Gross profit. Subtract line 4 from line 3	5	45,000	
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6		
7 Gross income. Add lines 5 and 6 <input checked="" type="checkbox"/>	7	45,000	

Part II Expenses**Enter expenses for business use of your home only on line 30.**

8 Advertising	8	500		18 Office expense (see instructions)	18		
9 Car and truck expenses (see instructions).	9	4,762		19 Pension and profit-sharing plans	19		
10 Commissions and fees	10			20 Rent or lease (see instructions):			
11 Contract labor (see instructions)	11			a Vehicles, machinery, and equipment	20a		
12 Depletion	12			b Other business property	20b		
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions).	13			21 Repairs and maintenance	21		
14 Employee benefit programs (other than on line 19)	14			22 Supplies (not included in Part III)	22	2,900	
15 Insurance (other than health)	15			23 Taxes and licenses	23	500	
16 Interest:				24 Travel, meals, and entertainment:			
a Mortgage (paid to banks, etc.)	16a			a Travel	24a	600	
b Other	16b			b Deductible meals and entertainment (see instructions)	24b	200	
17 Legal and professional services	17			25 Utilities	25		
28 Total expenses before expenses for business use of home. Add lines 8 through 27a <input checked="" type="checkbox"/>	28	9,462		26 Wages (less employment credits)	26		
29 Tentative profit or (loss). Subtract line 28 from line 7	29	35,538		27a Other expenses (from line 48)	27a		
30 Expenses for business use of your home. Attach Form 8829 . Do not report such expenses elsewhere	30	3,939		b Reserved for future use	27b		
31 Net profit or (loss). Subtract line 30 from line 29.				31		31,599	
<ul style="list-style-type: none"> • If a profit, enter on both Form 1040, line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2. (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32. 							
32 If you have a loss, check the box that describes your investment in this activity (see instructions).							
<ul style="list-style-type: none"> • If you checked 32a, enter the loss on both Form 1040, line 12, (or Form 1040NR, line 13) and on Schedule SE, line 2. (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you must attach Form 6198. Your loss may be limited. 				32a <input type="checkbox"/> All investment is at risk.			
				32b <input type="checkbox"/> Some investment is not at risk.			

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2012

Part III Cost of Goods Sold (see instructions)

33	Method(s) used to value closing inventory: a <input type="checkbox"/> Cost b <input type="checkbox"/> Lower of cost or market c <input type="checkbox"/> Other (attach explanation)		
34	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation	<input type="checkbox"/> Yes <input type="checkbox"/> No	
35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	
36	Purchases less cost of items withdrawn for personal use	36	
37	Cost of labor. Do not include any amounts paid to yourself	37	
38	Materials and supplies	38	
39	Other costs	39	
40	Add lines 35 through 39	40	
41	Inventory at end of year	41	
42	Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on line 4	42	

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 to find out if you must file Form 4562.

43	When did you place your vehicle in service for business purposes? (month, day, year) ▶ / /	
44	Of the total number of miles you drove your vehicle during 2012, enter the number of miles you used your vehicle for:	
a	Business 8,400 b Commuting (see instructions) c Other 6,600	
45	Was your vehicle available for personal use during off-duty hours?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
46	Do you (or your spouse) have another vehicle available for personal use?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
47a	Do you have evidence to support your deduction?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
b	If "Yes," is the evidence written?	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.

48	Total other expenses. Enter here and on line 27a	48

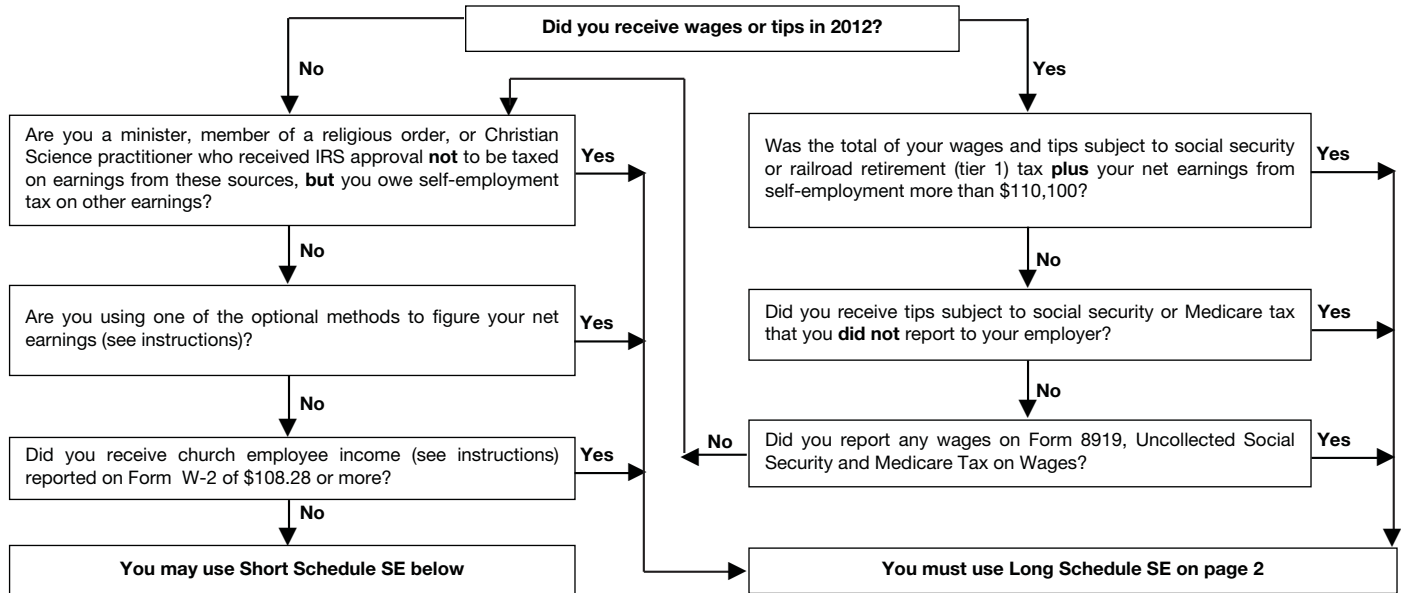
SCHEDULE SE
(Form 1040)Department of the Treasury
Internal Revenue Service (99)**Self-Employment Tax**► Information about Schedule SE and its separate instructions is at www.irs.gov/form1040.

► 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)

Martin

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		31,599
3 Combine lines 1a, 1b, and 2	3		31,599
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		29,182
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		3,881
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		2,232

Schedule L Balance Sheets per Books		Beginning of tax year		End of tax year	
Assets		(a)	(b)	(c)	(d)
1	Cash				
2a	Trade notes and accounts receivable				
b	Less allowance for bad debts	()		()	
3	Inventories				
4	U.S. government obligations				
5	Tax-exempt securities (see instructions)				
6	Other current assets (attach statement)				
7	Loans to shareholders				
8	Mortgage and real estate loans				
9	Other investments (attach statement)				
10a	Buildings and other depreciable assets				
b	Less accumulated depreciation	()		()	
11a	Depletable assets				
b	Less accumulated depletion	()		()	
12	Land (net of any amortization)				
13a	Intangible assets (amortizable only)				
b	Less accumulated amortization	()		()	
14	Other assets (attach statement)				
15	Total assets				
Liabilities and Shareholders' Equity					
16	Accounts payable				
17	Mortgages, notes, bonds payable in less than 1 year				
18	Other current liabilities (attach statement)				
19	Loans from shareholders				
20	Mortgages, notes, bonds payable in 1 year or more				
21	Other liabilities (attach statement)				
22	Capital stock: a Preferred stock				
	b Common stock				
23	Additional paid-in capital				
24	Retained earnings—Appropriated (attach statement)				
25	Retained earnings—Unappropriated				
26	Adjustments to shareholders' equity (attach statement)				
27	Less cost of treasury stock		()		()
28	Total liabilities and shareholders' equity				

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return**Note:** Schedule M-3 required instead of Schedule M-1 if total assets are \$10 million or more—see instructions

1	Net income (loss) per books	2,801,500	7	Income recorded on books this year not included on this return (itemize):	
2	Federal income tax per books	1,198,500		Tax-exempt interest \$ 10,000	
3	Excess of capital losses over capital gains			Insurance proceeds 500,000	
4	Income subject to tax not recorded on books this year (itemize):				510,000
5	Expenses recorded on books this year not deducted on this return (itemize):		8	Deductions on this return not charged against book income this year (itemize):	
a	Depreciation \$		a	Depreciation . . . \$ 40,000	
b	Charitable contributions . . \$		b	Charitable contributions \$	
c	Travel and entertainment . . \$ 30,000				40,000
	Life Ins. Prem. 5,000; Bad Debt Allow. 20,000	55,000	9	Add lines 7 and 8	
6	Add lines 1 through 5	4,055,000	10	Income (page 1, line 28)—line 6 less line 9	3,505,000

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1	Balance at beginning of year		5	Distributions: a Cash	
2	Net income (loss) per books			b Stock	
3	Other increases (itemize):			c Property	
			6	Other decreases (itemize):	
			7	Add lines 5 and 6	
4	Add lines 1, 2, and 3		8	Balance at end of year (line 4 less line 7)	