

Solutions Manual for Income Tax Fundamentals 2018 36th Whittenburg

CHAPTER 2

GROSS INCOME AND EXCLUSIONS

Group 1 – Multiple Choice Questions

- | | | |
|-----------------------------------|---|-----------------|
| 1. C (LO 2.1) | 10. E (LO 2.4) | 18. C (LO 2.8) |
| 2. C (LO 2.1) | 11. D (LO 2.4) | 19. A (LO 2.9) |
| 3. A (LO 2.1) | 12. B $\$97,500/260 = \$375 \times 4 =$ | 20. E (LO 2.10) |
| 4. D (LO 2.1) | $\$1,500$ (LO 2.5) | 21. D (LO 2.11) |
| 5. B (LO 2.1) | 13. D (LO 2.5) | 22. E (LO 2.12) |
| 6. C $\$500 \times 20\%$ (LO 2.2) | 14. C (LO 2.6) | 23. D (LO 2.13) |
| 7. A (LO 2.2) | 15. A (LO 2.6) | 24. E (LO 2.13) |
| 8. C $\$120 \times 12$ (LO 2.3) | 16. C (LO 2.7) | 25. A (LO 2.14) |
| 9. D (LO 2.3) | 17. D (LO 2.7, 2.8, 2.9, 2.10) | 26. E (LO 2.14) |

Group 2 – Problems

- | | | |
|-------------------------|----------------------|----------------------|
| 1. a. Excluded (LO 2.1) | e. Excluded (LO 2.1) | i. Excluded (LO 2.1) |
| b. Included (LO 2.1) | f. Included (LO 2.1) | j. Excluded (LO 2.1) |
| c. Included (LO 2.1) | g. Included (LO 2.1) | k. Included (LO 2.1) |
| d. Included (LO 2.1) | h. Excluded (LO 2.1) | |
2. The non-cash payment of \$6,000 for services performed is includable income to John. The tax law states that gross income is “all income from whatever source derived.” There is no exception in the law for non-cash items received in exchange for services. (LO 2.1)
3. a. **\$300.** Gross income includes “all income from whatever source derived.” The value of the hair styling is income to Larry for the performance of services. There is no gross income exception in the tax law for “barter” income.
- b. **\$300.** Gross income includes “all income from whatever source derived.” The value of the tax return is income to Sheila for the performance of services. There is no gross income exception in the tax law for “barter” income. (LO 2.1)
4. Illegal income is still taxable since there is no exception excluding it in the tax code. When there is not an explicit exception, gross income is “all income from whatever source derived.” (LO 2.1)
5. Qualified dividends are taxed at either 0%, 15%, or 20%. The 0% rate applies for taxpayers in the ordinary income tax brackets of 10% and 15%. The 15% rate applies for taxpayers in the ordinary income tax brackets of 25% through 35%. The 20% rate applies for taxpayers in the 39.6% bracket. A 3.8% Medicare tax on net investment income will be added to the rates for certain high-income taxpayers. (LO 2.2)
6. If no election is made, the interest is not included in income until the I bond is converted to cash by the taxpayer. If the taxpayer makes an election, however, the income which increases the redemption value but is not paid in cash on the I bond each year is included in the taxpayer’s gross income. (LO 2.2)
7. See Schedule B on Page 40. (LO 2.2)
8. a. (1) **\$450.** b. (1) **\$0.**
(2) **\$450.** (2) **\$425,000.** (LO 2.3)

9. Arlen may deduct the alimony of \$2,000 per month on his tax return. He cannot deduct the child support. Jane must report the alimony as income on her tax return. The child support is not taxable income to her. (LO 2.3)
10. No gain is taxable to Cindy on the transfer of the house since it is part of a property settlement related to a divorce. Allen has a basis of \$90,000 in the house for calculating tax on any future sale of the house. (LO 2.3)
11. a. **\$6,400.**
 b. **\$260.** A non-qualified plan award may only be excluded up to \$400; thus, \$260 is taxable.
 c. **\$1,000,000.**
 d. **\$30,000.** (LO 2.4)
12. a. **\$4,000.**
 b. **\$14,500.**
 c. **\$0.** (LO 2.4, 2.8)

13. SIMPLIFIED METHOD WORKSHEET

- | | |
|---|--------------------|
| 1) Enter total amount received this year. | 1) <u>\$ 7,000</u> |
| 2) Enter cost in the plan at the annuity starting date. | 2) <u>\$48,300</u> |
| 3) Age at annuity starting date | |
| <u>Enter</u> | |
| 55 and under | 360 |
| 56–60 | 310 |
| 61–65 | 260 |
| 66–70 | 210 |
| 71 and older | 160 |
| 4) Divide line 2 by line 3. | 3) <u>210</u> |
| 5) Multiply line 4 by the number of monthly payments this year. If the annuity starting date was before 1987, also enter this amount on line 8; and skip lines 6 and 7. Otherwise go to line 6. | 4) <u>\$ 230</u> |
| 6) Enter the amount, if any, recovered tax free in prior years | 5) <u>\$ 1,610</u> |
| 7) Subtract line 6 from line 2. | 6) <u>\$ 0</u> |
| 8) Enter the smaller of line 5 or 7. | 7) <u>\$48,300</u> |
| 9) Taxable amount this year: Subtract line 8 from line 1. Do not enter less than zero. | 8) <u>\$ 1,610</u> |
| (LO 2.5) | 9) <u>\$ 5,390</u> |
14. **\$61,000** = \$100,000 – \$27,000 – \$12,000. Since the policy was transferred for valuable consideration, the proceeds are taxable to the extent that they exceed the sum of the cash value at the time of transfer plus the premiums paid. (LO 2.6)
15. **\$500.** A beneficiary, who is a surviving spouse, must include the entire amount of interest received with respect to the policy proceeds in gross income. The \$9,000 principal amount may be excluded from gross income. (LO 2.6)
16. David has received an accelerated death benefit or viatical settlement which is excluded from taxable income. (LO 2.6)
17. None of the payment is taxable. Life insurance proceeds are generally considered to be tax-free and specifically excluded from taxable income. (LO 2.6)

18. **\$5,600.** Inheritances are excluded from taxable income; however, subsequent earnings on inherited property must be included in income. (LO 2.7)
19. \$10,000 is taxable. This gift is clearly bonus income in a business setting so it does not qualify for tax-free gift treatment, even if Gwen's client calls the payment a gift. (LO 2.7)
20. None of the gift is taxable. Gifts are excluded from the taxable income of the person receiving the gift. (LO 2.7)
21. \$12,000 is taxable since there is no exclusion for payments made for room and board. \$8,000 is not taxable, since scholarships for tuition are specifically excluded from taxable income. (LO 2.8)
22. None of the cost of the insurance or amounts paid by the insurance company for surgery or treatment are taxable to Skyler. These amounts are specifically excluded from taxable income under the tax law. (LO 2.9)
23. **\$0.** Taxpayers may exclude the total amount received for payment or reimbursement of medical expenses. Premiums for health insurance paid by the taxpayer's employer are also excluded from the taxpayer's gross income. In addition, the \$1,500 (\$3,500 – \$2,000) not paid by the insurance company is deductible as an itemized deduction on Ellen's return, subject to the medical expense deduction limitations. (LO 2.9)
24. a. No. The meals are furnished by the employer on the business premises of the employer during working hours because the employer limits the employee to short meal periods.
b. No. The meals are furnished by the employer on the business premises of the employer during working hours because the taxpayer must be available for emergency calls.
c. Yes. The meals are not furnished for the convenience of the employer. (LO 2.10)
25. **6.00%** = $4.5\% \div (100\% - 25\%)$. (LO 2.11)
26. The tax-exempt municipal bond has the same 5% before and after-tax rate of return. The corporate bond has an after-tax return of 4.55% ($7\% \times (1 - 35\%)$). Karen should invest in the tax-exempt bond due to the higher after-tax rate of return. (LO 2.11)
27. **\$3,250.** Unemployment benefits received are included in gross income. (LO 2.12)
28. **\$4,850** = \$850 + \$4,000. The value of the airline tickets is excluded from gross income under the no additional cost services rule for employees and their families. The \$30 of personal typing is excluded under the de minimis fringe benefits rule. The \$850 worth of employee discount coupons for hotel rooms is included in gross income since the hotel division is a different line of business than that in which Linda is employed. The \$4,000 tuition payment must be included in gross income since Richard is working on a graduate degree and not providing teaching or research activities. (LO 2.13)
29. Yes. Tom will be better off reducing his taxable income by \$2,600 by using the health care flexible spending account. Since his income will be \$2,600 less, he will pay less tax than he would otherwise. (LO 2.13)
30. As calculated on the worksheet on Page 41. (LO 2.14)
31. a. **Yes.** Tax-free municipal bond income is added to AGI in the formula to determine the amount of taxable Social Security.
b. **Zero.** The taxpayer's income is below the threshold amount used in the formula to determine whether Social Security is taxable.
c. **85%.** High-income taxpayers must include 85% of Social Security receipts in taxable income. (LO 2.14)

Group 2: Problem 30

1. Enter the total amount of social security income	1. \$7,400
2. Enter one-half of line 1	2. 3,700
3. Enter the total of taxable income items on Form 1040 except social security income	3. 14,500
4. Enter the amount of tax exempt interest income	4. 30,000
5. Add lines 2, 3, and 4	5. 48,200
6. Enter all adjustments for AGI except for student loan interest, the domestic production activities deduction and the tuition and fees deduction	6. -0-
7. Subtract line 6 from line 5. If zero or less, stop here, none of the social security benefits are taxable	7. 48,200
8. Enter \$25,000 (\$32,000 if married filing jointly; \$0 if married filing separately and living with spouse at any time during the year)	8. 25,000
9. Subtract line 8 from line 7. If zero or less, enter -0-	9. 23,200
Note: <i>If line 9 is zero or less, stop here; none of your benefits are taxable. Otherwise, go on to line 10.</i>	
10. Enter \$9,000 (\$12,000 if married filing jointly; \$0 if married filing separately and living with spouse at any time during the year)	10. 9,000
11. Subtract line 10 from line 9. If zero or less, enter -0-	11. 14,200
12. Enter the smaller of line 9 or line 10	12. 9,000
13. Enter one-half of line 12	13. 4,500
14. Enter the smaller of line 2 or line 13	14. 3,700
15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-	15. 12,070
16. Add lines 14 and 15	16. 15,770
17. Multiply line 1 by 85% (.85)	17. 6,290
18. Taxable benefits. Enter the smaller of line 16 or line 17	18. \$6,290

32. Worksheet 1. **Recapture of Alimony**Keep for Your Records **Note. Do not enter less than -0- on any line.**

1. Alimony paid in 2nd year	1. <u>\$60,000</u>	
2. Alimony paid in 3rd year	2. <u>\$10,000</u>	
3. Floor	3. <u>\$15,000</u>	
4. Add lines 2 and 3	4. <u>\$25,000</u>	
5. Subtract line 4 from line 1. If zero or less, enter -0-	5. <u>\$35,000</u>	
6. Alimony paid in 1st year	6. <u>\$60,000</u>	
7. Adjusted alimony paid in 2nd year (line 1 minus line 5)	7. <u>\$25,000</u>	
8. Alimony paid in 3rd year	8. <u>\$10,000</u>	
9. Add lines 7 and 8	9. <u>\$35,000</u>	
10. Divide line 9 by 2	10. <u>\$17,500</u>	
11. Floor	11. <u>\$15,000</u>	
12. Add lines 10 and 11	12. <u>\$32,500</u>	
13. Subtract line 12 from line 6	13. <u>\$27,500</u>	
14. Recaptured alimony. Add lines 5 and 13	*14. <u>\$62,500</u>	

* If you deducted alimony paid, report this amount as income on Form 1040, line 11.
If you reported alimony received, deduct this amount on Form 1040, line 31a.

33. See the answer to Problem 7.

Group 3 – Writing Assignment**Research Solution:**

Whittenburg and Gill, CPAs
San Diego, CA
August 3, 20xx

Ms. Vanessa Lazo
1550 Mesa Rosa Drive
San Diego, CA

Dear Professor Lazo,

Thank you for requesting my advice concerning the tax treatment of your free trip to Costa Rica. I have researched your question and am sorry to say that the free tour is taxable.

The fair market value of the tour must be reported on Form 1040, Line 21 "Other Income." In addition, any expenses that you incurred during the trip cannot be deducted.

My conclusion is based upon the facts that you have provided me. I'm sorry that the news was not more favorable. If you have any questions or would like further explanation, please do not hesitate to call.

Sincerely,
Trevor Malcolm
for Whittenburg and Gill, CPAs

Group 4 – Comprehensive Problems

1. See pages 43 through 45.
- 2A. See pages 46 through 47.
- 2B. See pages 48 through 49.

Group 5 – Cumulative Software Problem

The solution to the Cumulative Software Problem is posted on the website for the textbook at www.cengage.com/login.

Comprehensive Problem 1

Form 1040A		Department of the Treasury—Internal Revenue Service		U.S. Individual Income Tax Return (99)		2017		IRS Use Only—Do not write or staple in this space.																																				
Your first name and initial Ken				Last name Hair				OMB No. 1545-0074																																				
If a joint return, spouse's first name and initial Bev				Last name Hair				Your social security number 4 6 5 5 7 9 9 3 4																																				
Home address (number and street). If you have a P.O. box, see instructions. 3567 River Street				Apt. no.				Spouse's social security number 4 6 5 7 4 3 3 2 1																																				
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Springfield, M O 63126				Foreign country name				Foreign province/state/county																																				
Foreign postal code				Foreign postal code				☒ Make sure the SSN(s) above and on line 6c are correct. ☒ You ☒ Spouse																																				
Filing status Check only one box.		1 ☐ Single 2 ☒ Married filing jointly (even if only one had income) 3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶ 4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ 5 ☐ Qualifying widow(er) (see instructions)																																										
Exemptions		6a ☒ Yourself. If someone can claim you as a dependent, do not check box 6a. b ☒ Spouse c Dependents: <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th>(1) First name</th> <th>Last name</th> <th>(2) Dependent's social security number</th> <th>(3) Dependent's relationship to you</th> <th>(4) ☒ if child under age 17 qualifying for child tax credit (see instructions)</th> </tr> </thead> <tbody> <tr><td> </td><td> </td><td> </td><td> </td><td>☐</td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td>☐</td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td>☐</td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td>☐</td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td>☐</td></tr> <tr><td> </td><td> </td><td> </td><td> </td><td>☐</td></tr> </tbody> </table>								(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ☒ if child under age 17 qualifying for child tax credit (see instructions)					☐					☐					☐					☐					☐					☐
(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ☒ if child under age 17 qualifying for child tax credit (see instructions)																																								
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If more than six dependents, see instructions.		Boxes checked on 6a and 6b: 2 No. of children on 6c who: • lived with you: • did not live with you due to divorce or separation (see instructions): Dependents on 6c not entered above: Add numbers on lines above ▶ 2																																										
Income		d Total number of exemptions claimed.																																										
Attach Form(s) W-2 here. Also attach Form(s) 1099-R if tax was withheld. If you did not get a W-2, see instructions.		7 Wages, salaries, tips, etc. Attach Form(s) W-2. 7 53,120 8a Taxable interest. Attach Schedule B if required. 8a 645 b Tax-exempt interest. Do not include on line 8a. 8b 1,000 9a Ordinary dividends. Attach Schedule B if required. 9a 302 b Qualified dividends (see instructions). 9b 302 10 Capital gain distributions (see instructions). 10 11a IRA distributions. 11a 11b Taxable amount (see instructions). 11b 12a Pensions and annuities. 12a 12b Taxable amount (see instructions). 12b 13 Unemployment compensation and Alaska Permanent Fund dividends. 13 1,825 14a Social security benefits. 14a 14b Taxable amount (see instructions). 14b 15 Add lines 7 through 14b (far right column). This is your total income . ▶ 15 55,892																																										
Adjusted gross income		16 Educator expenses (see instructions). 16 17 IRA deduction (see instructions). 17 18 Student loan interest deduction (see instructions). 18 19 Reserved for future use. 19 20 Add lines 16 through 19. These are your total adjustments . 20 21 Subtract line 20 from line 15. This is your adjusted gross income . ▶ 21 55,892																																										
For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11327A Form 1040A (2017)																																												

Go to www.irs.gov/Form1040A for instructions and the latest information.

Comprehensive Problem 1, cont.

Qualified Dividends and Capital Gain Tax Worksheet—Line 28

Keep for Your Records



Before you begin: ✓ Be sure you do not have to file Form 1040 (see the Instructions for Form 1040A, line 10).

1. Enter the amount from Form 1040A, line 27	1.	<u>35,092</u>	
2. Enter the amount from Form 1040A, line 9b	2.	<u>302</u>	
3. Enter the amount from Form 1040A, line 10	3.	<u>0</u>	
4. Add lines 2 and 3	4.	<u>302</u>	
5. Subtract line 4 from line 1. If zero or less, enter -0-	5.	<u>34,790</u>	
6. Enter the smaller of:			
• The amount on line 1, or			
• \$37,950 if single or married filing separately,			
\$75,900 if married filing jointly or qualifying widow(er), or			
\$50,800 if head of household.			
7. Enter the smaller of line 5 or line 6	7.	<u>34,790</u>	
8. Subtract line 7 from line 6. This amount is taxed at 0%	8.	<u>302</u>	
9. Enter the smaller of line 1 or line 4	9.	<u>302</u>	
10. Enter the amount from line 8	10.	<u>302</u>	
11. Subtract line 10 from line 9	11.	<u>0</u>	
12. Multiply line 11 by 15% (0.15)	12.	<u>0</u>	
13. Use the Tax Table to figure the tax on the amount on line 5. Enter the tax here	13.	<u>4,284</u>	
14. Add lines 12 and 13	14.	<u>4,284</u>	
15. Use the Tax Table to figure the tax on the amount on line 1. Enter the tax here	15.	<u>4,329</u>	
16. Tax on all taxable income. Enter the smaller of line 14 or line 15 here and on Form 1040A, line 28	16.	<u>4,284</u>	

* Note: This worksheet does not apply for high-income taxpayers under the ACA or ATRA provisions (See LO 1.9).

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Comprehensive Problem 2A, cont.

Form 1040 (2017)		Page 2	
	38 Amount from line 37 (adjusted gross income)	38 61,553	
Tax and Credits	39a Check ☐ You were born before January 2, 1953, ☐ Blind. Total boxes checked ▶ 39a		
	b If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b ☐		
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, \$6,350 Married filing jointly or Qualifying widow(er), \$12,700 Head of household, \$9,350	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40 12,700	
	41 Subtract line 40 from line 38	41 48,853	
	42 Exemptions. If line 38 is \$156,900 or less, multiply \$4,050 by the number on line 6d. Otherwise, see instructions	42 8,100	
	43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43 40,753	
	44 Tax (see instructions). Check if any from: a ☐ Form(s) 8814 b ☐ Form 4972 c ☐	44 5,184	
	45 Alternative minimum tax (see instructions). Attach Form 6251	45	
	46 Excess advance premium tax credit repayment. Attach Form 8962	46	
	47 Add lines 44, 45, and 46	47 5,184	
	48 Foreign tax credit. Attach Form 1116 if required	48	
	49 Credit for child and dependent care expenses. Attach Form 2441	49	
	50 Education credits from Form 8863, line 19	50	
	51 Retirement savings contributions credit. Attach Form 8880	51	
	52 Child tax credit. Attach Schedule 8812, if required	52	
	53 Residential energy credit. Attach Form 5695	53	
	54 Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐	54	
55 Add lines 48 through 54. These are your total credits	55		
56 Subtract line 55 from line 47. If line 55 is more than line 47, enter -0-	56 5,184		
Other Taxes	57 Self-employment tax. Attach Schedule SE	57	
	58 Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	58	
	59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
	60a Household employment taxes from Schedule H	60a	
	b First-time homebuyer credit repayment. Attach Form 5405 if required	60b	
	61 Health care: individual responsibility (see instructions) Full-year coverage ☒	61	
	62 Taxes from: a ☐ Form 8959 b ☐ Form 8960 c ☐ Instructions; enter code(s)	62	
63 Add lines 56 through 62. This is your total tax	63 5,184		
Payments If you have a qualifying child, attach Schedule EIC.	64 Federal income tax withheld from Forms W-2 and 1099	64 9,050	
	65 2017 estimated tax payments and amount applied from 2016 return	65	
	66a Earned income credit (EIC)	66a	
	b Nontaxable combat pay election 66b	66b	
	67 Additional child tax credit. Attach Schedule 8812	67	
	68 American opportunity credit from Form 8863, line 8	68	
	69 Net premium tax credit. Attach Form 8962	69	
	70 Amount paid with request for extension to file	70	
	71 Excess social security and tier 1 RRTA tax withheld	71	
	72 Credit for federal tax on fuels. Attach Form 4136	72	
73 Credits from Form: a ☐ 2439 b ☒ Reserved c ☐ 8885 d ☐	73		
74 Add lines 64, 65, 66a, and 67 through 73. These are your total payments	74 9,050		
Refund	75 If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid	75 3,866	
	76a Amount of line 75 you want refunded to you . If Form 8888 is attached, check here ☐	76a 3,866	
	b Routing number c Type: ☐ Checking ☐ Savings		
	d Account number		
77 Amount of line 75 you want applied to your 2018 estimated tax	77		
Amount You Owe	78 Amount you owe. Subtract line 74 from line 63. For details on how to pay, see instructions	78	
	79 Estimated tax penalty (see instructions)	79	
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ Yes. Complete below. ☐ No		
	Designee's name Phone no. Personal identification number (PIN)		
Sign Here	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.		
	Your signature	Date	Your occupation Salesperson
	Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation Clerk
			Daytime phone number
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date
	Firm's name	Check ☐ if self-employed PTIN	
	Firm's address	Firm's EIN	
			Phone no.

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.

Comprehensive Problem 2B, cont.

Form 1040 (2017)		Page 2
38 Amount from line 37 (adjusted gross income)		38 71,753
Tax and Credits	39a Check ☐ You were born before January 2, 1953, ☐ Blind. } Total boxes ☐ if: ☐ Spouse was born before January 2, 1953, ☐ Blind. } checked ▶ 39a	
	b If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b ☐	
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, \$6,350 Married filing jointly or Qualifying widow(er), \$12,700 Head of household, \$9,350	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40 12,700
	41 Subtract line 40 from line 38	41 59,053
	42 Exemptions. If line 38 is \$156,900 or less, multiply \$4,050 by the number on line 6d. Otherwise, see instructions	42 8,100
	43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43 50,953
	44 Tax (see instructions). Check if any from: a ☐ Form(s) 8814 b ☐ Form 4972 c ☐	44 6,714
	45 Alternative minimum tax (see instructions). Attach Form 6251	45
	46 Excess advance premium tax credit repayment. Attach Form 8962	46
	47 Add lines 44, 45, and 46	47 6,714
	48 Foreign tax credit. Attach Form 1116 if required	48
	49 Credit for child and dependent care expenses. Attach Form 2441	49
50 Education credits from Form 8863, line 19	50	
51 Retirement savings contributions credit. Attach Form 8880	51	
52 Child tax credit. Attach Schedule 8812, if required	52	
53 Residential energy credit. Attach Form 5695	53	
54 Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐	54	
55 Add lines 48 through 54. These are your total credits	55	
56 Subtract line 55 from line 47. If line 55 is more than line 47, enter -0-	56 6,714	
Other Taxes	57 Self-employment tax. Attach Schedule SE	57
	58 Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	58
	59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59
	60a Household employment taxes from Schedule H	60a
	b First-time homebuyer credit repayment. Attach Form 5405 if required	60b
61 Health care: individual responsibility (see instructions) Full-year coverage ☒	61	
62 Taxes from: a ☐ Form 8959 b ☐ Form 8960 c ☐ Instructions; enter code(s)	62	
63 Add lines 56 through 62. This is your total tax	63 6,714	
Payments	64 Federal income tax withheld from Forms W-2 and 1099	64 7,864
	65 2017 estimated tax payments and amount applied from 2016 return	65
	66a Earned income credit (EIC)	66a
	b Nontaxable combat pay election 66b	66b
	67 Additional child tax credit. Attach Schedule 8812	67
	68 American opportunity credit from Form 8863, line 8	68
	69 Net premium tax credit. Attach Form 8962	69
	70 Amount paid with request for extension to file	70
	71 Excess social security and tier 1 RRTA tax withheld	71
	72 Credit for federal tax on fuels. Attach Form 4136	72
73 Credits from Form: a ☐ 2439 b ☒ Reserved c ☐ 8885 d ☐	73	
74 Add lines 64, 65, 66a, and 67 through 73. These are your total payments	74 7,864	
Refund	75 If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid	75 1,150
	76a Amount of line 75 you want refunded to you . If Form 8888 is attached, check here ▶ ☐	76a 1,150
Direct deposit? See instructions.	b Routing number	c Type: ☐ Checking ☐ Savings
d Account number		
77 Amount of line 75 you want applied to your 2018 estimated tax ▶	77	
Amount You Owe	78 Amount you owe. Subtract line 74 from line 63. For details on how to pay, see instructions ▶	78
79 Estimated tax penalty (see instructions)	79	
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ Yes. Complete below. ☐ No	
	Designee's name ▶	Phone no. ▶
	Personal identification number (PIN) ▶	
Sign Here	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.	
	Your signature	Date
	Spouse's signature. If a joint return, both must sign.	Date
Joint return? See instructions. Keep a copy for your records.	Your occupation	Daytime phone number
	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature
	Firm's name ▶	Firm's EIN ▶
	Firm's address ▶	Phone no.
	Check ☐ if self-employed	PTIN

Key Number Tax Return Summary**Chapter 2****Comprehensive Problem 1**

Adjusted Gross Income (Line 21)	<u>55,892</u>
Taxable Income (Line 27)	<u>35,092</u>
Total Tax (Line 39)	<u>4,284</u>
Amount Overpaid (Line 47)	<u>721</u>

Comprehensive Problem 2A

Adjusted Gross Income (Line 37)	<u>61,553</u>
Taxable Income (Line 43)	<u>40,753</u>
Total Tax (Line 63)	<u>5,184</u>
Amount Overpaid (Line 75)	<u>3,866</u>

Comprehensive Problem 2B

Adjusted Gross Income (Line 37)	<u>71,753</u>
Taxable Income (Line 43)	<u>50,953</u>
Total Tax (Line 63)	<u>6,714</u>
Amount Overpaid (Line 75)	<u>1,150</u>

Chapter Two

Gross Income and Exclusions

Learning Objective 2.1 The Nature of Gross Income

Gross income is the initial point of tax computation and is composed of the following items:

1. Compensation for services, including fees, commissions, fringe benefits, and similar items
2. Gross income derived from business
3. Gains derived from dealings in property
4. Interest
5. Rents
6. Royalties
7. Dividends
8. Alimony and separate maintenance payments
9. Annuities
10. Income from life insurance and endowment contracts
11. Pensions
12. Income from discharge of indebtedness
13. Distributive share of partnership gross income
14. Income in respect of a decedent
15. Income from an interest in an estate or trust

The general rule is that “*all income from whatever source derived*” must be included in gross income unless specifically excluded.

- Noncash items should be reported at a fair market value.
- Specific exclusions can be found in Table 2.2.

Learning Objective 2.2 Interest and Dividend Income

Interest and dividend income is part of gross income.

- If a taxpayer earns \$1,500 or more in interest and dividends, must file a Schedule B
- Interest and dividends from cooperative banks, credit unions, domestic building and loan associations, domestic savings and loan associations, federal savings and loan associations and mutual savings banks are included.

Savings bonds come in three different forms:

- Series EE, Series HH and Series I.
 - Series EE bonds are issued at a discount.
 - Series HH bonds are bonds that have interest paid semi-annually.
 - Series I bonds do not pay interest until maturity, but earnings are adjusted for inflation on a semi-annual basis.
 - *Note:* Cash basis taxpayers report the increase in redemption value on a Series EE or Series I bonds

- Dividends are one type of distribution paid to a taxpayer by a corporation - types of dividends are:
 - Ordinary dividends, nontaxable distributions and capital gain distributions.
 - There are special lower tax rates for qualifying dividends.
 - *Note:* Dividends that do not qualify are taxed at ordinary rates.

<i>Ordinary Tax Bracket</i>	<i>Qualifying Dividend Tax Rate for 2016</i>
10% and 15%	0%
25% through 35%	15%
39.6%	20%*
*An additional 3.8% Medicare surtax on Net Investment Income including qualifying dividends applies to high-income taxpayers. (LO 1.9)	

Learning Objective 2.3 Alimony

Alimony payments are deductible by the individual making the payments and taxable income to the person receiving the payments.

- The term "alimony," for income tax purposes, includes separate *or periodic maintenance payments* made to a spouse or former spouse.
- Payments must meet certain requirements to be considered alimony.
 - Rules for divorces prior to 1985 were different than they are now so consult the tax rules for that time period if reference to those particular rules are needed.

To qualify as alimony, payments must:

- ...be in cash and be received by spouse.
- ...be made under a decree of divorce/separation or associated written agreement
- ...cease upon the death of the spouse
- ...not be designated as anything other than alimony in the written agreement
- ...not be made to members of the same household
- ...not be child support payments

Payments contingent on age or marital status of child are not alimony and therefore nondeductible.

- *Note: Alimony paid by high-income spouse to low-income spouse will result in tax savings to high-income spouse.*
- Payments contingent on age or marital status of child are not alimony.
 - May be an important factor in determining which spouse is entitled to claim the dependency exemption for the child.

- Child support payments must be up to date before any amounts paid may be treated as alimony.

Learning Objective 2.4 Prizes and Awards

Prizes and awards are taxable income to the recipient.

- Other awards are also generally taxable, even if they are awards given for accomplishments and without solicitation by the taxpayer.
- Certain employee achievement awards made in recognition of length of service or safety achievement can be excluded from income.
 - As a rule, the maximum excludable amount is \$400
 - But if the award is given through a "qualified plan" the maximum exclusion increases to \$1,600.

Learning Objective 2.5 Annuities

- An annuity is an investment that pays periodic payments to the purchaser for the remainder of his/her life.
- Standard mortality tables, based on the current age of the annuitant, are used to calculate
- Each annuity payment received contains an element of taxable income and an element of tax-free return of the original purchase price.
- To calculate the taxable portion of the payment, the tax law provides two methods
 - the Simplified Method or the general rule.

The Simplified Method

Taxpayers are generally required to use the simplified method to calculate the taxable amount of annuities started *after November 18, 1996*.

- *Note:* Non-qualified plan annuitants and some annuitants age 75 and over still have to use the general rule rather than the simplified method.
- To calculate the taxable amount, the IRS provides a Simplified Method Worksheet. The exclusion ratio is calculated at the start of the annuity and remains constant.

The General Rule

Prior to implementing the simplified method, the general rule ratio used to calculate the amount excluded for most annuities. The calculation is as follows:

$$\frac{\text{Investment in the Contract}}{\text{Annual Payment} \times \text{Life Expectancy}} \times \text{Amount Received} = \text{Excluded Amount}$$

Employee Annuities

If an employer makes periodic payments to a retirement annuity on behalf of an employee and the payments are made to a qualified retirement plan, *the contributions by the employer are not taxable to the employee*.

- Because the contributions are not taxable when they are made, they are not considered part of the employee's investment in the contract when calculating the exclusion ratio.

Learning Objective 2.6 Life Insurance

Life insurance proceeds are excluded from gross income.

- To be excluded, proceeds must be paid to the beneficiary by reason of the death of the insured.
 - If the proceeds are taken over several years instead of in a lump sum, the insurance company pays interest on the unpaid proceeds. The interest is generally taxable income
- Early payouts of life insurance are excludable
- Payouts from viatical settlements can be excluded from gross income:
 - For terminally ill taxpayers and
 - For a chronically ill taxpayer to extent proceeds pay for long-term care.
 - These exclusions require certification by an M.D.

Learning Objective 2.7 Gifts and Inheritances

The fair market value of gifts and inheritances may be excluded from taxable income

- But income received from property after the transfer is taxable.
- Gifts given in the business setting are considered taxable income
 - If gift recipient provides service in return for gift, presumed that gift is income for the service performed.

Learning Objective 2.8 Scholarships

Scholarship dollars awarded that are used to *pay room and board are taxable*

- Scholarship dollars spent for tuition, fees, books, and course-required supplies and equipment are *exempt*.
- Payments received by students for part-time employment including work-study are taxable as compensation.

Learning Objective 2.9 Accident and Health Insurance

Taxpayers may exclude from income the entire amount received from accident or health insurance plans for payment of medical care.

- Taxpayers may also exclude any premiums paid by a taxpayer's employer from income.
- If the employer pays premiums on behalf of the employee for health, accident, or long-term care insurance, the employer may deduct them.

Learning Objective 2.10 Meals and Lodging

Meals and lodging provided by employers to employees for the convenience of the employer are generally not considered part of compensation and *so are not included in employee's taxable income*.

- Taxpayers may exclude from income the value of lodging provided by an employer if the lodging is located on the business premises and must be accepted as a requirement of employment.

Learning Objective 2.11 Municipal Bond Interest

- Interest income earned on state or local government bonds is exempt from federal tax.

Note: The interest exclusion encourages high-income taxpayers to lend money to state and local governments at lower interest rates.

$$\text{After-tax return} = \text{Tax-free interest rate} / (1.00 - \text{tax rate})$$

Learning Objective 2.12 Unemployment Compensation

Unemployment compensation is fully taxable and must be included in the taxpayer's gross income.

Learning Objective 2.13 Employee Fringe Benefits

All fringe benefits must be included in an employee's gross income unless specifically excluded by law as follows.

Flexible Spending Accounts

Employers may form plans which allow employees to set aside money from their salary before it is taxed to pay for one or more expenses.

- These expenses, in 2017, include
 - Dependent care accounts (maximum of \$5,000)
 - Medical flexible spending accounts (up to \$2,600 per year)
 - Public transportation and parking at work (up to \$255/month).

Group Term Life-Insurance

Employers may pay for up to \$50,000 of group term life-insurance for employees.

No-Additional-Cost Services

Employees may receive tax-free services from their employer, if it's in major line of business in which employed.

- For example - airline employee's free standby airplane ticket (employee is flying at no additional cost to the employee).

Education Assistance Programs

Employer may provide up to \$5,250 of excludable tuition assistance.

- Requires existence of a written plan.

Qualified Employee Discounts

Employees may receive tax-free discounts from their employer

- On services, limited to 20% of typical customer price
- On merchandise, limited to mark up on product

Working Condition Fringe Benefits

Employees may exclude from income any property or services provided by the employer that would be excluded from income anyway.

- For example: use of company car for business or subscription to an appropriate professional journal (for example, a tax journal for a CPA firm).

De Minimis Fringe Benefits

Some benefits are so minimal that accounting for them is impractical.

- For example: occasional use of office equipment for personal use, Christmas turkeys, picnics, etc.

Tuition Reduction

Employees of educational institutions can exclude the value of a tuition reduction from their income if it was for undergraduate work and is available to all employees.

- Exclusion applies to employees, spouses, and dependents if a tuition reduction plan exists for them.
- Graduate students can only exclude tuition reductions if they work at the same school where they are teaching or doing research.

Athletic Facilities

Employees may exclude from gross income the value of the use of an athletic facility located onsite

Retirement Planning Fringe Benefit

Qualified retirement planning services are any retirement planning services provided to an employee and his/her spouse by an employer maintaining a “qualified employer plan.”

- The exclusion *does not apply* to services that may be related to tax preparation, accounting, legal or brokerage services.

Learning Objective 2.14 Social Security Benefits

- Many taxpayers may exclude all of their Social Security earnings from gross income. Middle and upper income Social Security recipients may have to include *up to 85%* of their benefits in taxable income.
- The amount of benefits taxable is based on the taxpayer’s MAGI (Modified Adjusted Gross Income).

Base Amounts Table

Base	Applies to
\$32,000	Married filing jointly
\$0	Married filing separately but did not live apart for the entire year
\$25,000	All other taxpayers

Form	1040	Department of the Treasury—Internal Revenue Service (99)	2017	OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.																				
U.S. Individual Income Tax Return																									
For the year Jan. 1–Dec. 31, 2017, or other tax year beginning , 2017, ending , 20																									
Your first name and initial		Last name		See separate instructions.																					
Albert T.		Gaytor		Your social security number																					
If a joint return, spouse's first name and initial		Last name		266 51 1966																					
Allison A.		Gaytor		Spouse's social security number																					
Home address (number and street). If you have a P.O. box, see instructions.		Apt. no.		266 34 1967																					
12340 Cocoshell Road				▲ Make sure the SSN(s) above and on line 6c are correct.																					
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).																									
Coral Gables, FL 33134		Presidential Election Campaign																							
Foreign country name		Foreign province/state/county		Foreign postal code																					
				Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. ☒ You ☒ Spouse																					
Filing Status																									
1 ☐ Single 2 ☒ Married filing jointly (even if only one had income) 3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶ 4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ 5 ☐ Qualifying widow(er) (see instructions)																									
Exemptions																									
6a ☒ Yourself. If someone can claim you as a dependent, do not check box 6a. b ☒ Spouse c Dependents: (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) ☒ if child under age 17 qualifying for child tax credit (see instructions)																									
<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 20%;">Crocker</td> <td style="width: 20%;">Gaytor</td> <td style="width: 20%;">261 55 1212</td> <td style="width: 20%;">Son</td> <td style="width: 20%; text-align: center;">☐</td> </tr> <tr> <td> </td> <td> </td> <td> </td> <td> </td> <td style="text-align: center;">☐</td> </tr> <tr> <td> </td> <td> </td> <td> </td> <td> </td> <td style="text-align: center;">☐</td> </tr> <tr> <td> </td> <td> </td> <td> </td> <td> </td> <td style="text-align: center;">☐</td> </tr> </table>						Crocker	Gaytor	261 55 1212	Son	☐					☐					☐					☐
Crocker	Gaytor	261 55 1212	Son	☐																					
				☐																					
				☐																					
				☐																					
Boxes checked on 6a and 6b: 2 No. of children on 6c who: • lived with you: 1 • did not live with you due to divorce or separation (see instructions): Dependents on 6c not entered above: Add numbers on lines above ▶ 3																									
d Total number of exemptions claimed																									
Income																									
7 Wages, salaries, tips, etc. Attach Form(s) W-2 7 65,420 8a Taxable interest. Attach Schedule B if required 8a 992 b Tax-exempt interest. Do not include on line 8a 8b 745 9a Ordinary dividends. Attach Schedule B if required 9a 1,585 b Qualified dividends 9b 1,425 10 Taxable refunds, credits, or offsets of state and local income taxes 10 11 Alimony received 11 12 Business income or (loss). Attach Schedule C or C-EZ 12 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐ 13 14 Other gains or (losses). Attach Form 4797 14 15a IRA distributions 15a b Taxable amount 15b 16a Pensions and annuities 16a b Taxable amount 16b 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 17 18 Farm income or (loss). Attach Schedule F 18 19 Unemployment compensation 19 3,900 20a Social security benefits 20a b Taxable amount 20b 21 Other income. List type and amount 21 Gambling winnings 5,900 22 Combine the amounts in the far right column for lines 7 through 21. This is your total income ▶ 22 77,797																									
Adjusted Gross Income																									
23 Educator expenses 23 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 24 25 Health savings account deduction. Attach Form 8889 25 26 Moving expenses. Attach Form 3903 26 27 Deductible part of self-employment tax. Attach Schedule SE 27 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 ▶ 667 34 9224 31a 11,500 32 IRA deduction 32 33 Student loan interest deduction 33 34 Reserved for future use 34 35 Domestic production activities deduction. Attach Form 8903 35 36 Add lines 23 through 35 36 11,500 37 Subtract line 36 from line 22. This is your adjusted gross income ▶ 37 66,297																									
For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form 1040 (2017)																									

Form 1040 (2017)		Page 2	
Tax and Credits	38 Amount from line 37 (adjusted gross income)	38	66,297
	39a Check ☐ You were born before January 2, 1953, ☐ Blind. ☐ Spouse was born before January 2, 1953, ☐ Blind. Total boxes checked ☐ 39a		
	b If your spouse itemizes on a separate return or you were a dual-status alien, check here ☐ 39b		
Standard Deduction for— • People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions. • All others: Single or Married filing separately, \$6,350 Married filing jointly or Qualifying widow(er), \$12,700 Head of household, \$9,350	40 Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	12,700
	41 Subtract line 40 from line 38	41	53,597
	42 Exemptions. If line 38 is \$156,900 or less, multiply \$4,050 by the number on line 6d. Otherwise, see instructions	42	12,150
	43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	41,447
	44 Tax (see instructions). Check if any from: a ☐ Form(s) 8814 b ☐ Form 4972 c ☐	44	5,071
	45 Alternative minimum tax (see instructions). Attach Form 6251	45	
	46 Excess advance premium tax credit repayment. Attach Form 8962	46	
	47 Add lines 44, 45, and 46	47	5,071
	48 Foreign tax credit. Attach Form 1116 if required	48	
	49 Credit for child and dependent care expenses. Attach Form 2441	49	
	50 Education credits from Form 8863, line 19	50	
	51 Retirement savings contributions credit. Attach Form 8880	51	
	52 Child tax credit. Attach Schedule 8812, if required	52	
	53 Residential energy credit. Attach Form 5695	53	
	54 Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐	54	
	55 Add lines 48 through 54. These are your total credits	55	
	56 Subtract line 55 from line 47. If line 55 is more than line 47, enter -0-	56	5,071
Other Taxes	57 Self-employment tax. Attach Schedule SE	57	
	58 Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	58	
	59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
	60a Household employment taxes from Schedule H	60a	
	b First-time homebuyer credit repayment. Attach Form 5405 if required	60b	
	61 Health care: individual responsibility (see instructions) Full-year coverage ☒	61	
	62 Taxes from: a ☐ Form 8959 b ☐ Form 8960 c ☐ Instructions; enter code(s)	62	
	63 Add lines 56 through 62. This is your total tax	63	5,071
Payments	64 Federal income tax withheld from Forms W-2 and 1099	64	7,907
	65 2017 estimated tax payments and amount applied from 2016 return	65	
	66a Earned income credit (EIC)	66a	
	b Nontaxable combat pay election 66b	66b	
	67 Additional child tax credit. Attach Schedule 8812	67	
	68 American opportunity credit from Form 8863, line 8	68	
	69 Net premium tax credit. Attach Form 8962	69	
	70 Amount paid with request for extension to file	70	
	71 Excess social security and tier 1 RRTA tax withheld	71	
	72 Credit for federal tax on fuels. Attach Form 4136	72	
	73 Credits from Form: a ☐ 2439 b ☐ Reserved c ☐ 8885 d ☐	73	
	74 Add lines 64, 65, 66a, and 67 through 73. These are your total payments	74	7,907
Refund	75 If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid	75	2,836
	76a Amount of line 75 you want refunded to you . If Form 8888 is attached, check here ☐	76a	2,836
	b Routing number c Type: ☐ Checking ☐ Savings		
	d Account number		
	77 Amount of line 75 you want applied to your 2018 estimated tax	77	
Amount You Owe	78 Amount you owe. Subtract line 74 from line 63. For details on how to pay, see instructions	78	
	79 Estimated tax penalty (see instructions)	79	
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ Yes. Complete below. ☐ No		
	Designee's name	Phone no.	Personal identification number (PIN)
Sign Here	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.		
	Your signature	Date	Your occupation
	Boat Captain		Daytime phone number
	Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation
	Homemaker		If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date
	Firm's name	Firm's EIN	Phone no.
	Firm's address	Check ☐ if self-employed	PTIN

Go to www.irs.gov/Form1040 for instructions and the latest information.

Form **1040** (2017)

Qualified Dividends and Capital Gain Tax Worksheet—Line 44

Keep for Your Records



Before you begin: ✓ See the earlier instructions for line 44 to see if you can use this worksheet to figure your tax.
 ✓ Before completing this worksheet, complete Form 1040 through line 43.
 ✓ If you do not have to file Schedule D and you received capital gain distributions, be sure you checked the box on line 13 of Form 1040.

1. Enter the amount from Form 1040, line 43. However, if you are filing Form 2555 or 2555-EZ (relating to foreign earned income), enter the amount from line 3 of the Foreign Earned Income Tax Worksheet	1.	41,447
2. Enter the amount from Form 1040, line 9b*	2.	1,425
3. Are you filing Schedule D?*		
☐ Yes. Enter the smaller of line 15 or 16 of Schedule D. If either line 15 or line 16 is blank or a loss, enter -0-.	3.	0
☒ No. Enter the amount from Form 1040, line 13.		
4. Add lines 2 and 3	4.	1,425
5. If filing Form 4952 (used to figure investment interest expense deduction), enter any amount from line 4g of that form. Otherwise, enter -0-	5.	0
6. Subtract line 5 from line 4. If zero or less, enter -0-	6.	1,425
7. Subtract line 6 from line 1. If zero or less, enter -0-	7.	40,022
8. Enter: \$37,950 if single or married filing separately, \$75,900 if married filing jointly or qualifying widow(er), \$50,800 if head of household.	8.	75,900
9. Enter the smaller of line 1 or line 8	9.	41,447
10. Enter the smaller of line 7 or line 9	10.	40,022
11. Subtract line 10 from line 9. This amount is taxed at 0%	11.	1,425
12. Enter the smaller of line 1 or line 6	12.	1,425
13. Enter the amount from line 11	13.	1,425
14. Subtract line 13 from line 12	14.	0
15. Enter: \$418,400 if single, \$233,350 if married filing separately, \$470,700 if married filing jointly or qualifying widow(er), \$444,550 if head of household.	15.	470,700
16. Enter the smaller of line 1 or line 15	16.	41,447
17. Add lines 7 and 11	17.	41,447
18. Subtract line 17 from line 16. If zero or less, enter -0-	18.	0
19. Enter the smaller of line 14 or line 18	19.	0
20. Multiply line 19 by 15% (0.15)	20.	0
21. Add lines 11 and 19	21.	1,425
22. Subtract line 21 from line 12	22.	0
23. Multiply line 22 by 20% (0.20)	23.	0
24. Figure the tax on the amount on line 7. If the amount on line 7 is less than \$100,000, use the Tax Table to figure the tax. If the amount on line 7 is \$100,000 or more, use the Tax Computation Worksheet	24.	5,071
25. Add lines 20, 23, and 24	25.	5,071
26. Figure the tax on the amount on line 1. If the amount on line 1 is less than \$100,000, use the Tax Table to figure the tax. If the amount on line 1 is \$100,000 or more, use the Tax Computation Worksheet	26.	5,281
27. Tax on all taxable income. Enter the smaller of line 25 or line 26. Also include this amount on Form 1040, line 44. If you are filing Form 2555 or 2555-EZ, do not enter this amount on Form 1040, line 44. Instead, enter it on line 4 of the Foreign Earned Income Tax Worksheet	27.	5,071

*If you are filing Form 2555 or 2555-EZ, see the footnote in the Foreign Earned Income Tax Worksheet before completing this line.

Income Tax Fundamentals 2018

Chapter 2 Gross Income & Exclusions

Learning Objectives, Part 1

- Understand and apply definition of gross income
- Determine tax treatment of income categories such as interest, dividends, alimony, unemployment, etc.
- Calculate taxable portion of annuities
- Identify exclusions from gross income such as life insurance proceeds, fringe benefits, scholarships, inheritances and gifts, etc.

Learning Objectives, Part 2

- Explain tax treatment of health insurance
- Identify common employee fringe benefit income exclusion
- Determine municipal bond interest tax treatment
- Apply rules governing inclusion of Social Security payments as income

Defining Gross Income

- Tax code defines gross income as “All income from whatever source derived”
- This means all sources of income are included **unless specifically excluded**
 - See Table 2.1 on page 2-3 for inclusions
 - See Table 2.2 on page 2-3 for exclusions
 - Non-cash items included at fair market value
 - Barter transactions are includable

Interest Income

- If total interest income $> \$1,500$, must report on Schedule B of Form 1040
- Interest is reported in year received for cash basis taxpayers
 - Fair market value of gifts/services a taxpayer receives for making long-term deposits or opening an account are taxable interest

U.S. Government Bonds, Part 1

- Series EE bonds
 - Purchase at discount and then redeem
 - Interest is generally taxed year bonds are redeemed
- Series HH bonds
 - Issued at face value
 - Pay interest semiannually and interest is taxed each year
 - Treasury stopped issuing 8/04, but there are still outstanding HH bonds paying interest

U.S. Government Bonds, Part 2

- Series I bonds
 - Purchase for face value
 - Earnings are adjusted semiannually for inflation
 - Interest taxed each year or at maturity

Dividend Income

- 3 kinds of dividends
 - Ordinary dividends are most common
 - Return of net income to shareholders
 - Schedule B when total dividend income > \$1,500
 - Nontaxable distributions are return of original investment - not paid from corporation's earnings and profits
 - Not included in taxpayer's income and reduces basis in stock
 - Capital gain distributions (CGD)
 - When stock reaches zero basis, further distributions are CGD
 - Report on page 1 of Form 1040 or Schedule D of Form 1040

Tax Rates for Dividends

- “Qualifying dividends” are classified by corporations issuing dividends and brokerage firms holding stock investments

<i>Regular tax bracket</i>	<i>Qualifying Dividend Rate</i>
10-15%	0%
25-35%	15%
39.6%	20%
High Income Taxpayers Medicare Surtax	3.8%

- If not “qualifying,” dividends taxed at ordinary rates

Alimony

- Alimony is deductible to payer and taxable to payee
- Alimony payments must meet *five requirements* as follows (if subject to divorce agreement after 1984)
 - Must be in cash and received by ex-spouse
 - Must be made in connection with written instrument
 - Can't continue after death of ex-spouse
 - Can't be designated as anything other than alimony
 - Parties may not be members of the same household

Other Issues with Alimony

- Recapture provisions prevent front-end loading of alimony payments
- Property transfer is not alimony because it's not cash
 - Transferor doesn't have to recognize any gain on transaction
 - Transferee's basis in property is same as transferor's

Alimony Example

Example

Complying with a 2017 written divorce decree, Frederik pays Shanna \$1,800/month. The decree specifies that the payments will be reduced 40% when their daughter, in Shanna's custody, becomes eighteen. How much can Frederik deduct per year as alimony?

Solution, Part 1

Example

Complying with a 2017 written divorce decree, Frederik pays Shanna \$1,800/month. The decree specifies that the payments will be reduced 40% when their daughter, in Shanna's custody, becomes eighteen. How much can Frederik deduct per year as alimony?

Solution

40% of each payment is considered nondeductible child support; therefore, $\$1,800 \times 12 \text{ months} \times 60\% = \$12,960/\text{year deductible alimony}$.

Child Support

- Child support is not deductible to payer and not taxable to payee
- If payer falls behind on child support, he/she must bring this current before any portion of payments can be considered alimony
- Rules differ for divorce agreements executed pre- and post-1985

Prizes/Awards

- Taxable amount equal to cash prize or fair market value of property

Exception: Employee awards of tangible personal property (up to \$400) received for recognition of length of service or safety achievement are excludable. Up to \$1,600 may be excluded, if it is granted under a “qualified plan award.”

- Game show and reality TV show winners should be aware that prizes/awards are taxable

Prize/Award Example

Example

Josef, an employee of Vesuvius Statuaries LLC, receives a clock for 20 years of service valued at \$1,500 and the award is not considered a “qualified plan award;” how much is excludable from Josef’s gross income?

Solution, Part 2

Example

Josef, an employee of Vesuvius Statuaries LLC, receives a clock for 20 years of service valued at \$1,500 and the award is not considered a “qualified plan award;” how much is excludable from Josef’s gross income?

Solution

\$400 is excluded and \$1,100 would have to be included in Josef’s gross income calculation

Annuities/Pensions, Part 1

- An annuity is an instrument that a taxpayer buys (usually at retirement) in return for periodic payments for the remainder of his/her life
- The taxable portion of these periodic payments is calculated based on
Mortality tables provided by IRS *and* The annuity purchase price

Annuities/Pensions – Simplified Method

- Individuals generally required to use this method to calculate taxable amount from an annuity - if annuity payments commenced after 11/18/96
- Taxpayer must fill in simplified method worksheet provided by IRS
 - See pp. 2-12 through 2-14 for example of simplified method worksheet

Annuities/Pensions, Part 2

- General Rule
 - Payments received are both taxable (income) and nontaxable (return of capital)
 - Must calculate amount to exclude from income
 1. First, calculate exclusion ratio
$$\text{Investment in Contract} / (\text{Annual payment} \times \text{Life expectancy})$$
 2. Secondly, find the amount to exclude
$$\text{Exclusion Ratio (from step 1)} \times \text{Annual Amount of Annuity Received}$$

Annuities/Pensions Example

Example

Din has saved \$750,000 in his retirement account and uses it to purchase an annuity. His annuity equals \$4,800/month and the IRS tables show he is expected to live 19 years. How much is excludable from tax each year of Din's retirement? Assume that Din is required to use the general rule.

Solution, Part 3

Example

Din has saved \$750,000 in his retirement account and uses it to purchase an annuity. His annuity pays \$4,800/month and the IRS tables show he is expected to live 19 years. How much is excludable from tax each year of Din's retirement? Assume that Din is required to use the general rule.

Solution

$$\$750,000 / (\$4,800 \times 12 \text{ months} \times 19 \text{ years}) = .685$$

.685 = 68.5% of amount is excluded from tax

$$.685 \times (\$4,800 \times 12 \text{ months}) = \$39,456 \text{ annual exclusion}$$

Employee Annuities

- Employers may make periodic payments to retirement plans on behalf of their employees
- These payments are not taxable to employee in current year
- They are not considered part of investment when calculating exclusion ratio

Life Insurance Proceeds

- Life insurance proceeds are excluded from gross income if:
 - Proceeds paid to beneficiary by reason of death of the insured *and*
 - Beneficiary has an insurable interest

Life Insurance Proceeds Example

Example

Karina dies on 6/15/17, leaving her husband, Dann, a \$500,000 life insurance policy. The proceeds will be paid out to Dann \$100,000 per year plus interest for 5 years.

In the current year, Dann receives \$105,000 (\$100,000 + \$5,000 interest). How much is taxable to Dann in the current year?

Solution, Part 4

Example

Karina dies on 6/15/17, leaving her husband, Dann, a \$500,000 life insurance policy. The proceeds will be paid out to Dann \$100,000 per year plus interest for 5 years. In the current year, Dann receives \$105,000 (\$100,000 + \$5,000 interest). How much is taxable to Dann in the current year?

Solution

Dann must include the \$5,000 of interest income in his gross income calculation; the face value of \$100,000 is not taxable.

Viatical Settlements

- Also known as accelerated death benefits
- Viatical settlements are excludable from gross income in certain situations
 - Chronically or terminally ill taxpayer collects early payout from insurance company or sells/assigns policy to a viatical settlement provider
 - Terminally ill patient must have certification from MD stating that he/she reasonably expected to die within 24 months
 - Chronically ill must have certification from MD stating the he/she is unable to perform daily living activities unassisted

Life Insurance Policy Transferred for Value

- If policy is transferred for value, then all or part of the proceeds may be taxable to recipient

Taxable amount = Proceeds from death of insured - Cash surrender value at time of transfer + Premiums paid by purchaser

- Exception: if policy is transferred for value to partner of insured, a partnership in which insured is a partner or a corporation in which insured is an officer, then policy proceeds are *not* taxable

Life Policy Transfer Example

Example

Bianca transfers a life insurance policy with a face value of \$25,000 and cash surrender value of \$4,000 to Yvette as payment for services rendered. Yvette pays premiums of \$500 per year for a total of \$1,500 in the ensuing 3 years; Bianca dies and Yvette collects the \$25,000. How much must Yvette include in her gross income?

How would this answer differ if Yvette and Bianca were partners in a partnership?

Solution, Part 5

Example

Bianca transfers a life insurance policy with a face value of \$25,000 and cash surrender value of \$4,000 to Yvette as payment for services rendered. Yvette pays premiums of \$500 per year for a total of \$1,500 in the ensuing three years; Bianca dies and Yvette collects the \$25,000. How much must Yvette include in her gross income? How would this answer differ if Yvette and Bianca were partners in a partnership?

Solution

Yvette must include \$19,500 in income [$\$25,000 - \$4,000 + \$1,500$].

If Yvette and Bianca were partners in a partnership, the entire proceeds (\$25,000) would be tax-free.

Gifts & Inheritances

- Inheritances are excluded from income
 - Any income generated from property received after transfer is taxable
 - Estate may incur taxes
- Gifts received are excluded from income
 - A gift is defined by the courts as a voluntary transfer of property without adequate consideration
 - Gifts in business settings usually considered taxable income
 - If recipient renders services for the gift, amount is taxable

Scholarships

- Scholarships received for fees, books, tuition, course-required supplies or equipment are excluded from income
- Must include scholarship amounts in income for:
 - Any amounts applied to room and board
 - Any amounts received as compensation for required work (including work study)

Employer Paid Accident & Health Insurance Premiums

- Taxpayers may exclude from income the total amount received for
 - Payment of medical care
 - Payment for loss of a body member or function (called accidental death and dismemberment)
- Premiums paid by employer on employee's behalf are excluded from income
 - For medical insurance
 - For accidental death and dismemberment insurance

Meals and Lodging

- Meals and lodging provided by employer are generally excluded from income (if following tests are met)
 - (1) Meals provided by employer on premises during working hours *solely for the benefit of the employer* because employee must be available for emergency calls or is limited to short meal periods
 - (2) Lodging provided by employer on premises and must be accepted as a requirement for employment

Municipal Bond Interest

- Taxpayer may exclude interest on state and local government obligations (called “muni bonds”) from federal taxation
- After-tax return for tax-free bond calculated as follows
After-tax return = Tax-free interest rate / (1.00 – taxpayer’s tax rate)

Municipal Bond Interest Example

Example

Gopal is in the 33% federal income tax bracket and invests in a Nashville City Bond paying 6%. What taxable interest rate will yield the same after-tax return as the municipal bond?

Solution, Part 6

Example

Gopal is in the 33% federal income tax bracket and invests in a Nashville City Bond paying 6%. What taxable interest rate will yield the same after-tax return as the municipal bond?

Solution

Taxable interest rate equivalent = 8.96%

$$(.06) / (1.00 - .33) = .0896$$

Unemployment Compensation

- Unemployment compensation payments are fully taxable in 2017
- These payments are deductible on some state's income tax returns

Employee Fringe Benefits: Employer-Provided Spending Accounts, Part 1

- Employer-sponsored plan allowing employees to set aside pretax dollars for:
 - Dependent Care flexible spending accounts (FSAs) up to \$5,000/year
 - Health Care FSAs up to \$2,600/year
 - Health insurance co-pays, medical care
 - Dental work, optical care, prescription costs
 - Public transport/parking/commuter biking costs up to certain limits

Can result in significant tax savings for employee

Employee Fringe Benefits: Employer-Provided Spending Accounts, Part 2

- “Use-it-or-lose-it” provision
 - If amounts are left in FSAs after certain date, employee loses them
 - Can carryover up to \$500 of unused amounts into a 3-month grace period into the next year

Employee Fringe Benefits, Part 1

- May exclude certain fringe benefits from gross income, such as:
 - Employer-paid premiums for group term life insurance (face value up to \$50,000)
 - Education assistance plans (up to \$5,250/year)
 - Qualified employee discounts (with exceptions)
 - Working condition fringe benefits - excludable if you could deduct item on your own as an employee

Employee Fringe Benefits, Part 2

- De minimis fringe benefits (immaterial - not worth tracking)
- Tuition reduction for undergraduate and available to all employees
- Value of membership to onsite athletic facilities
- Retirement planning services
- Other excludable fringes (see Table 2.3 on page 2-24)

Social Security Benefits

- Part of Social Security benefits may be included in gross income
 - Maximum inclusion amount = 85%
- Inclusion based on taxpayer's Modified AGI (MAGI)
 - $\text{MAGI} = \text{AGI} + \text{tax-exempt interest (and other items)}$
- If $[\text{MAGI} + (50\%)(\text{SS benefits})] < \text{base amount}^*$ then benefits are not includable

Calculating Taxable Amount of SS Benefits

If $[\text{MAGI} + (50\%)(\text{SS benefits})]$ exceeds base amount as follows:

Base Amount	Filing Status
\$32,000	MFJ
\$25,000	All others

...then, the taxable amount is calculated by completing the Simplified Taxable Social Security Worksheet (pages 2-25 – 2-26)