

Chapter 1 Summary of End-of-Chapter Problem Revisions

2014 Edition Problem Number	2013 Edition Problem Number	2014 Edition Modifications
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28	28	Problem updated
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Solutions to Chapter 1 Problem Assignments

Check Your Understanding

1. *Constitutional Authority*

Solution: The 16th amendment to the United States Constitution was passed in 1913.

2. *Type of Tax*

Solution: A tax that is designed to discourage the use of a good or service considered undesirable is called a sin tax.

3. *Objectives of Taxation*

Solution: There are numerous objectives of taxation; some of the more common goals besides raising revenue to support the functions of government are to promote wealth redistribution, price stability, economic growth, full employment, and desirable social goals.

4. *Taxable Persons*

Solution: Only individuals, regular (or C) corporations, and fiduciaries (estates and trusts) pay income taxes.

5. *Gross Revenue vs. Gross Income*

Solution: A business's gross revenue includes all of its receipts from the sale of goods or services; a business's gross income is its gross receipts from sales less the cost of goods sold.

6. *Tax Models*

Solution: The individual tax model includes an intermediate income concept called adjusted gross income. As a result, an individual can have deductions both *for* and *from* adjusted gross income. Deductions from adjusted gross income include personal and dependency exemptions and either a standard deduction or itemized deductions. None of these items appear in the corporate tax model. The corporate and individual tax models both include gross income; they are both permitted deductions from gross income to determine taxable income; they both may have additions to tax and tax credits applied before the final tax liability is determined. Both taxpayers are generally required to make tax prepayments.

7. *Adjusted Gross Income*

Solution: Adjusted gross income is used to provide either a threshold or limitation for most of an individual's itemized deductions. It is also used to determine at what point an individual's exemptions and itemized deductions will begin to be phased out.

8. *Filing Status*

Solution: The four filing statuses are single, married filing jointly, married filing separately, and head of household. (The surviving spouse category included within the married filing jointly category is discussed in Chapter 11.) The standard deduction for a

dependent is subject to limitation although there is no separate filing status for the dependent.

9. *Exemptions*

Solution: The personal exemption is the deduction a self-supporting person takes for him or herself on his or her own tax return. The dependency exemption is the deduction an individual takes for another person, a dependent, whose support is provided by that individual.

10. *Property Dispositions*

Solution: To determine the gain or loss on business or investment property, the taxpayer subtracts the adjusted basis of the property sold from the amount received on the sale. If the result is positive, there is a gain. If the adjusted basis exceeds the amount received, there is a loss.

11. *Deductions vs. Credits*

Solution: A tax credit is a dollar for dollar reduction in a tax liability. A tax deduction only reduces a person's tax in an amount equal to the deduction times the marginal tax rate. Compare a \$1,000 deduction with a \$1,000 credit for a person with a \$20,000 tax liability whose marginal tax rate is 28 percent. The \$1,000 credit reduces the person's tax to \$19,000. The \$1,000 deduction, however, will only reduce the person's tax by \$280 ($\$1,000 \times 28\%$) to \$19,720. The value of a tax deduction is dependent upon the person's marginal tax rate; the value of a tax credit is independent of the marginal tax rate and benefits all taxpayers equally.

12. *Sole Proprietorship*

Solution: Only one taxable person, who must be an individual, can own a sole proprietorship. The sole proprietor is personally liable for all debts of the business. The sole proprietor cannot be an employee of the business. The results of operations of the sole proprietorship are reported on the Schedule C and these are then included in the owner's personal tax return. A partnership must have more than one owner. A general partner is liable for partnership debts but limited partners are only liable for their investment in the partnership. Like sole proprietors, partners cannot be employees of the partnership. Although partnerships do not pay taxes directly, they must file information tax returns. The income/loss from the partnership flows through to the partners and is reported on their own tax returns. If the partners are individuals, these results are reported on Schedule E (included in the personal tax return) and they pay any taxes owing on the income items. Partnerships and limited liability companies differ in a number of ways. Owners of partnerships are partners while owners of limited liability companies are called members. There are no legal requirements to set up a partnership but a limited liability company must be established according to the laws of the state of domicile. Limited liability companies can elect to be taxed as corporations while partnerships do not have that option. In some states, a limited liability company may have only one owner but a partnership must have two or more owners. General partners are normally required to pay self-employment taxes while only the

managing member of a limited liability company may be subject to self-employment taxes. Other items of comparison could be drawn from the table in the text comparing business entity attributes.

13. Corporations

Solution: The principal difference between a C corporation and an S corporation is in the method of taxation. A corporation pays a tax directly on its income. Any net after-tax income that is distributed to its shareholders as dividends is subject to a second level of tax. Thus, these corporate earnings are said to be subject to double taxation. An S corporation's income flows directly through to its shareholders (whether there is an actual distribution of this income in cash or not) undiminished by taxes at the corporate level. The income is then taxed once only at the shareholder level. The corporation can then make actual distributions of this previously-taxed income to the S corporation shareholders without any additional taxes due. There are a number of other differences in that the number and type of S corporation shareholders is limited; it can only have one class of stock outstanding, and its choice of tax year is restricted. None of these restrictions apply to a C corporation. Other items of comparison could be drawn from the table in the text comparing business entity attributes.

14. Consumption Taxes

Solution: Consumption taxes are “spending” taxes. They are taxes that are not levied until a person decides to expend funds (whether from income or from savings) for goods or services. The most common consumption tax is the sales tax. Other consumption taxes include excise taxes, value added taxes, and use taxes.

15. Horizontal vs. Vertical Equity

Solution: Horizontal equity is the concept that argues that persons in the same economic situation should pay equivalent amounts of taxes. The concept of vertical equity states that persons with greater economic wealth should pay a greater amount of taxes and is the foundation for a progressive rate system; conversely, a person with less wealth would pay less tax.

Crunch the Numbers

16. Taxable Income

Solution: Taxable income = \$30,000

	\$40,000	Salary
minus	6,100	Standard deduction
minus	<u>3,900</u>	Personal exemption
equals	\$30,000	Taxable income

17. Taxable Income

Solution: Taxable income = \$47,950

	\$71,000	Salary
plus	1,500	Interest income

minus	8,950	Standard deduction
minus	<u>15,600</u>	Personal and dependency exemptions (\$3,900 x 4)
equals	\$47,950	Taxable income

18. *Taxable Income***Solution:** Taxable income = \$49,000

	\$450,000	Gross receipts
minus	<u>145,000</u>	Cost of goods sold
equals	\$305,000	Gross income
plus	20,000	Gain on sale
minus	<u>276,000</u>	Expenses
equals	\$49,000	Taxable income

The \$500 interest on State of New York bonds is tax-exempt.

19. *Taxable Income***Solution:** Taxable income = \$237,500

	\$560,000	Gross income
plus	2,500	Interest income
minus	<u>325,000</u>	Expenses
equals	\$237,500	Taxable income

The \$20,000 capital loss is not deductible currently.

20. *Taxable Income***Solution:** Taxable income = \$74,400

	George's salary	\$65,000
plus	Mary's salary	<u>45,000</u>
equals	AGI	\$110,000
minus	Itemized deductions	20,000
minus	Standard deduction	0
minus	Personal & dependency exemptions (\$3,900 x 4)	<u>15,600</u>
equals	Taxable income	\$74,400

21. *Determining Tax Liability***Solution:** Taxable income = \$30,000; income tax = \$4,053.75.Income Tax: $(\$8,925 \times 10\%) + (\$21,075 \times 15\%) = \$4,053.75$.22. *Determining Tax Liability***Solution:** Taxable income = \$47,950; income tax = 6,555.Income Tax: $(\$12,750 \times 10\%) + (\$35,200 \times 15\%) = \$6,555$ 23. *Determining Tax Liability***Solution:** Taxable income = \$49,000; income tax = \$7,350.Income Tax: $\$49,000 \times 15\% = \$7,350$.

24. *Determining Tax Liability*

Solution: Taxable income = \$237,500; Income tax = \$75,875

\$50,000 x 15% =	\$7,500
\$25,000 x 25% =	6,250
\$25,000 x 34% =	8,500
\$137,500 x 39% =	<u>53,625</u>
Total tax	\$75,875

25. *Determining Tax Liability*

Solution: They save \$1,950 (\$12,407.50 - \$10,457.50) by itemizing their deductions.

Taxable income with itemizing = \$74,400; Taxable income taking standard deduction = \$82,200 (\$110,000 in salaries - \$12,200 standard deduction - \$15,600 exemptions).

Income Tax Calculation:

<u>Itemizing</u>		<u>Standard Deduction</u>	
\$17,850 x 10% =	\$1,785.00	\$17,850 x 10% =	\$1,785.00
\$54,650 x 15% =	\$8,197.50	\$54,650 x 15% =	\$8,197.50
\$1,900 x 25% =	<u>\$ 475.00</u>	\$ 9,700 x 25% =	<u>\$2,425.00</u>
	\$10,457.50		\$12,407.50

26. *Marriage Penalty*

Solution: They have a marriage penalty of \$408.50 (\$32,265.50 - \$31,857.00).

<u>Tax on \$160,000 (MFJ)</u>		<u>Tax on \$80,000 (Single)</u>	
\$17,850 x 10% =	\$ 1,785.00	\$ 8,925 x 10% =	\$ 892.50
\$54,650 x 15% =	8,197.50	\$27,325 x 15% =	4,098.50
\$73,900 x 25% =	18,475.00	\$43,750 x 25% =	<u>10,937.50</u>
\$13,600 x 28% =	<u>3,808.00</u>	Total =	\$15,928.50
Total =	\$32,265.50	Total x 2 =	\$31,857.00

27. *Joint vs. Single Filing*

Solution: By marrying before the end of 2013 and filing jointly, they save \$5,827.75

(\$43,693.25 - \$37,865.50) in taxes; thus, it will be to their advantage to marry in 2013.

<u>Tax on \$180,000 (MFJ)</u>		<u>Tax on \$180,000 (Single-Conrad)</u>	
\$17,850 x 10% =	\$ 1,785.00	\$8,925 x 10% =	\$ 892.50
\$54,650 x 15% =	8,197.50	\$27,325 x 15% =	4,098.75
\$73,900 x 25% =	18,475.00	\$51,600 x 25% =	12,900.00
\$33,600 x 28% =	<u>9,408.00</u>	\$92,150 x 28% =	<u>25,802.00</u>
Total =	\$37,865.50	Total =	\$43,693.25

If they each have \$90,000 of income, they would each pay \$18,493.25 in taxes and they would then have a marriage penalty of \$879 (\$37,865.50 - \$36,986.50). In this case, they would be slightly better off by postponing their wedding until 2014.

<u>Tax on \$90,000 (Single)</u>	
\$ 8,925 x 10% =	\$ 892.50
\$27,325 x 15% =	4,098.75
\$51,600 x 25% =	12,900.00
\$ 2,150 x 28% =	<u>602.00</u>
Total =	\$18,493.25
Total x 2 =	\$36,986.50

28. *Tax Liability*

Solution: William's income is twice John's, but his taxes are 2.70 (\$10,928.75/\$4,053.75) times John's. This illustrates the progressive nature of the tax system as well as vertical equity.

<u>John's tax on \$30,000</u>		<u>William's tax on \$60,000</u>	
\$8,925 x 10% =	\$ 892.50	\$ 8,925 x 10% =	\$ 892.50
\$21,075 x 15% =	3,161.25	\$27,325 x 15% =	4,098.75
		\$23,750 x 25% =	<u>5,937.50</u>
Total =	<u>\$4,053.75</u>	Total =	<u>\$10,928.75</u>

29. *Tax Liability*

Solution: Lilikoi paid \$6,000 tax for 2011 and \$30,050 tax for 2012. Lilikoi will have a refund of \$9,900 from carrying back \$40,000 of the 2013 loss to 2011 and \$10,000 of the loss to 2012. Note that Lilikoi cannot carry the loss back to only 2012 without first carrying it back to 2011.

Tax paid for 2011 on \$40,000 was $\$40,000 \times 15\% = \$6,000$

Tax paid for 2012 on \$120,000 was $(\$50,000 \times 15\%) + (\$25,000 \times 25\%) + (\$25,000 \times 34\%) + (\$20,000 \times 39\%) = \$30,050$. The loss that is carried back to 2012 reduces the taxable income for that year from \$120,000 to \$110,000 saving tax at the 39% rate that applies to income between \$110,000 and \$120,000.

Tax refund from 2013 loss is $(\$40,000 \times 15\%) + (\$10,000 \times 39\%) = \$9,900$

30. *Tax Liability*

Solution: The net tax liability is \$20,000.

\$250,000 gross income - \$125,000 expenses = \$125,000 taxable income.

The income tax liability is:

\$50,000 x 15% =	\$7,500
\$25,000 x 25% =	6,250
\$25,000 x 34% =	8,500
\$25,000 x 39% =	<u>9,750</u>
Gross tax =	\$32,000
Less tax credit	<u>12,000</u>
Net tax =	<u>\$20,000</u>

31. *Tax Liability*

Solution: Taxable income = \$51,100 and the tax liability = \$6,532.50.

\$76,000 salary and wages - \$13,200 itemized deductions - \$11,700 (\$3,900 x 3) personal and dependency exemptions = \$51,100 taxable income.

Income tax liability is:

\$17,850 x 10% =	\$1,785.00
\$33,250 x 15% =	<u>4,987.50</u>
Tax before credit =	\$6,772.50
Less tax credit	<u>240.00</u>
Net tax =	<u>\$6,532.50</u>

32. *Alternative Minimum Tax*

Solution: The regular tax is \$153,000 and the alternative minimum tax is \$27,400.

Regular tax: $\$450,000 \times 34\% = \$153,000$. Note that this \$153,000 is the same tax that would be computed by going through all of the tax brackets as follows:
 $(\$50,000 \times 15\%) + (\$25,000 \times 25\%) + (\$25,000 \times 34\%) + (\$235,000 \times 39\%) + (\$115,000 \times 34\%) = \$153,000$. This illustrates that for corporations with taxable income between \$335,000 and \$10,000,000, the benefit of the lower tax brackets is completely eliminated by the 5% surtax on income between \$100,000 and \$335,000.

Tentative alternative tax: $\$902,000 \times 20\% = \$180,400$

Alternative minimum tax: $\$180,400 - \$153,000 = \$27,400$

The corporation will pay a total tax of \$180,400 (\$153,000 regular tax + \$27,400 AMT)

33 *Alternative Minimum Tax*

Solution: The alternative minimum tax is \$18,606.75

Regular tax on \$140,000:

\$ 8,925 x 10% =	\$892.50
\$27,325 x 15% =	4,098.75
\$51,600 x 25% =	12,900.00
\$52,150 x 28% =	<u>14,602.00</u>
	\$32,493.25

Tentative alternative minimum tax on \$195,000: $(\$175,000 \times 26\%) + (\$20,000 \times 28\%) = \$45,500 + \$5,600 = \$51,100$.

The alternative minimum tax: $\$51,100 - \$32,493.25 = \$18,606.75$

Betty will pay a total tax of \$51,100 (\$32,493.25 regular tax + \$18,606.75 AMT)

34. *Estate Income Tax*

Solution: The estate will pay \$6,277.80.

\$2,450 x 15% =	\$367.50
\$3,250 x 25% =	812.50
\$3,050 x 28% =	854.00
\$3,200 x 33% =	1,056.00
\$8,050 x 39.6% =	<u>3,187.80</u>
Total tax	\$6,277.80

35. *Tax Liability*

Solution: Taxable income = \$29,000 and the tax liability is \$3,903.75

	\$46,000	Salary		
minus	<u>7,000</u>	Partnership loss (50% x \$14,000)		
equals	\$39,000	Gross income	<u>Tax Calculation</u>	
minus	6,100	Standard deduction	\$8,925 x 10% =	\$892.50
minus	<u>3,900</u>	Personal exemption	\$20,075 x 15% =	<u>3,011.25</u>
equals	\$29,000	Taxable income	Total tax	\$3,903.75

Note that this solution assumes that Carolyn has at least \$7,000 basis in her partnership interest so that she can deduct her full loss this year.

36. *Tax Liability Comparisons*

Solution: Partnership: Pays no tax. June and John are each taxed on the \$32,000 passed through to them at their marginal tax rates.

To determine their marginal tax rates, find the tax bracket in which their other taxable income falls. (Note that their “taxable income” is provided; either the standard or their itemized deductions have already been subtracted.) June’s \$450,000 of taxable income puts her in the 39.6% marginal tax bracket because she is a head of household with taxable income over \$425,000. John is in the 25% marginal tax bracket because his \$100,000 of taxable income is over \$72,500 but not over \$146,400 for a married taxpayer filing a joint return. (If John’s income were to increase by more than \$46,400, he would need to use a higher tax rate for the amount that exceeds \$146,400.)

June’s tax = $\$32,000 \times 39.6\% = \$12,672$.

John’s tax = $\$32,000 \times 25\% = \$8,000$.

Together they pay a total of \$20,672 in taxes.

S Corporation: Pays no tax. June and John are each taxed on the \$32,000 passed through to them at their marginal tax rates.

June’s tax = $\$32,000 \times 39.6\% = \$12,672$.

John’s tax = $\$32,000 \times 25\% = \$8,000$.

Together they pay a total of \$20,672 in taxes.

C Corporation: The corporation pays a tax of \$11,000 [$(\$50,000 \times 15\%) + (\$14,000 \times 25\%)$].

Neither June nor John pay any taxes as they received no distributions from the corporation.

Note: the problem specified only income taxes; Medicare surtaxes and employment taxes are not included in the solution.

37. *Tax Liability Comparisons*

Solution: Partnership: The answer does not change because June and John are taxed fully on their shares of income whether they are distributed or not. Thus, June’s tax is still \$12,672 and John’s tax is \$8,000 for a total of \$20,672 in taxes. They pay no additional tax on the \$28,000 distribution.

S Corporation: The answer does not change because June and John are taxed fully on their shares of income whether they are distributed or not. Thus, June’s tax is still \$12,672 and John’s tax is \$8,000 for a total of \$20,672 in taxes. They pay no additional tax on the \$28,000 distribution.

C Corporation: The corporation pays the same tax of \$11,000 [$(\$50,000 \times 15\%) + (\$14,000 \times 25\%)$]. June and John, however, will now have to recognize \$28,000 of dividend income; John will be taxed at the 15% dividend rate but June will be taxed at 20% (the dividend rate for taxpayers in the 39.6% marginal tax bracket).

June’s tax = $\$28,000 \times 20\% = \$5,600$.

John’s tax = $\$28,000 \times 15\% = \$4,200$.

The total tax for the corporation, June, and John is \$20,800 ($\$11,000 + \$5,600 + \$4,200$).

Note the problem specified only income taxes; Medicare surtaxes and employment taxes are not included in the solution.

38. *Tax Liability Comparisons*

Solution: Partnership: The partnership does not benefit from the loss. June and John are each allocated \$22,000 of loss and can deduct the loss against their other income because they have sufficient basis in the partnership [$\$20,000 \text{ invested} + (\$30,000 \text{ bank loan} \times 50\%) = \$35,000 \text{ basis before loss} - \$22,000 \text{ loss} = \$13,000 \text{ ending basis}$]. June's and John's incomes are high enough for them to remain fully in their respective marginal tax rates of 39.6% and 25%. June benefits from a reduction in taxes of \$8,712 ($\$22,000 \times 39.6\%$) and John saves \$5,500 ($\$22,000 \times 25\%$) in taxes at his marginal tax rate. The total tax savings for both are \$14,212 ($\$8,712 + \$5,500$).

S Corporation: The S corporation does not benefit from the loss. June and John are each allocated \$22,000 of the loss but they can only deduct \$20,000 of this loss against their other income because their deduction is limited to their basis in their S corporation stock. Thus, June benefits from a reduction in taxes of \$7,920 ($\$20,000 \times 39.6\%$) at her marginal tax rate. John reduces his taxes by \$5,000 ($\$20,000 \times 25\%$) at his marginal tax rate. They will each carry their excess \$2,000 loss forward; these losses can be deducted in a future year when they have sufficient basis. The total tax savings for the current year is \$12,920 ($\$7,920 + \$5,000$).

C Corporation: None of the parties have any current tax savings from the \$44,000 loss. As a new corporation, it can only carry its loss forward to offset income (and realize tax savings) in a future year. Losses of a C corporation do not pass through to shareholders.).

Note the problem specified only income taxes; Medicare surtaxes and employment taxes were not included in the solution.

39. *Choice of Business Entity*

Solution: a. (1) The partnership does not pay any tax in years 1 or 2.
 (2) The S corporation does not pay any tax in years 1 or 2.
 (3) The C corporation pays no tax in the year 1 but its year-1 loss can be carried forward to year 2 to offset \$54,000 of its year-2 \$60,000 income; it will pay a tax of \$900 ($\$6,000 \times 15\%$) on this income in year 2.

b. (1) Tax savings for first year of partnership: Clara and Charles are each allocated \$27,000 of loss and each can deduct loss to the extent of his or her basis of \$25,000 [$\$15,000 \text{ investment} + (50\% \times \$20,000 \text{ loan})$]. Clara's tax savings will be \$7,000 ($\$25,000 \text{ deductible loss} \times 28\%$) and Charles's tax savings will be \$6,250 ($\$25,000 \text{ deductible loss} \times 25\%$). The excess loss is carried forward to the next year.

Partner's basis computations:

\$15,000	Partner's original investment
+10,000	Partner's share of liabilities ($\$20,000 \text{ loan} \times 50\%$)
\$25,000	Basis before deducting loss
- 25,000	Deductible loss ($\$54,000 \text{ loss} \times 50\% = \$27,000$ but limited to basis and \$2,000 excess loss carried forward)
0	Basis at end of first year

(2) Tax savings for first year of S corporation: Clara and Charles are each allocated \$27,000 of loss and can deduct loss to the extent of his or her basis of \$15,000 in the S corporation. Clara's tax savings will be \$4,200 (\$15,000 deductible loss x 28%) and Charles's savings will be \$3,750 (\$15,000 deductible loss x 25%).

S corporation shareholder's stock basis computations:

\$15,000	Shareholder's original investment
<u>-15,000</u>	Deductible loss (\$54,000 loss x 50% = \$27,000 but limited to basis and \$12,000 excess loss carried forward)
0	Basis at end of first year

Note that an S corporation shareholder does not increase stock basis for any corporate liabilities.

(3) First year of C corporation: No effect on Clara or Charles. Their basis in stock remains \$15,000 each.

c. (1) Income tax for second year of partnership: Clara pays \$7,840 income tax [(\$30,000 profit - \$2,000 loss carried forward) x 28%] and Charles pays \$7,000 income tax [(\$30,000 profit - \$2,000 loss carried forward) x 25%].

Partner's basis computations:

0	Basis at end of first year
\$30,000	Year 2 profit (\$60,000 x 50%)
<u>- 5,000</u>	Cash distribution
\$25,000	Subtotal
<u>- 2,000</u>	Deduct loss carried forward from previous year
\$23,000	Basis at end of second year

(2) Income tax for second year of S corporation: Clara pays \$5,040 in tax [(\$30,000 profit - \$12,000 loss carried forward) x 28%] and Charles pays \$4,500 tax [(\$30,000 profit - \$12,000 loss carried forward) x 25%].

S corporation shareholder's stock basis computations:

0	Basis at end of first year
\$30,000	Year 2 profit (\$60,000 x 50%)
<u>- 5,000</u>	Cash distribution
\$25,000	Subtotal
<u>- 12,000</u>	Deduct loss carried forward from previous year
\$13,000	Basis at end of second year

(3) Income tax for second year of C corporation: Clara and Charles each pay \$750 tax on their dividend income (\$5,000 dividend income x 15% dividend rate = \$750 tax). Their basis in the corporate stock remains \$15,000.

40. Partnership Basis

Solution: His basis is \$5,200.

\$4,000 beginning basis + (30% x \$7,000 partnership income) - (30% x \$3,000 distribution) = \$4,000 + \$2,100 - \$900 = \$5,200

41. Property Taxes

Solution: He will pay \$750. $\$20,000,000 / \$4,000,000,000 = .005$ or 5 mills per \$1 of valuation. $\$150,000 \times .005 = \750 in tax

42. *Tax Rates*

Solution: $.05 \times (\$335,000 - \$100,000) = \$11,750$
 $\$50,000 (.34 - .15) = \$9,500$
 $(\$75,000 - \$50,000)(.34 - .25) = \$2,250.$
 $\$9,500 + \$2,250 = \$11,750$

43. *Tax Rates*

Solution: $.03 (\$18,333,333 - \$15,000,000) = \$100,000$
 $(.35 - .34)(\$10,000,000) = \$100,000$

44. *Differing Types of Taxes*

Solution: a. Wealth taxes are levied on assets owned by an individual or a business; the most common wealth tax is the property tax which comes in several forms such as real property taxes, inventory taxes, or taxes on plant and equipment. Wealth transfer taxes are only levied when the goods owned by one person are passed gratuitously to another as a gift or a bequest. Estate and inheritance taxes are wealth transfer taxes.

b. The most common consumption tax is the sales tax which is based on the purchase price of goods or services when they are acquired by the spending of one's income or savings. An income tax is levied on the increase in wealth as it is earned regardless of whether that income is actually spent or saved. If a single individual has \$34,500 of taxable income in 2013, he will pay taxes of \$4,729 on this amount even if he saves all or part of the after-tax income. In addition, any income on savings would also be taxed when earned. If this same individual were able to save all of the \$34,500, under a consumption tax he would pay no taxes until he actually spent that income. The money saved would be available for investment and that income would not be taxed until it was spent.

c. The 25% tax bracket for a married couple extends to \$146,400 in 2013. This would be equivalent to two single individuals with equal incomes earning \$73,200 each. Beyond \$146,400, the married filing jointly rate increases to 28% and they begin to be subject to the marriage penalty. Single individuals remain in the 25% tax bracket until their income exceeds \$87,850.

45. *FICA Taxes*

Solution: 2013: $\$40,000 \times 7.65\% = \$3,060$
 2012: $\$40,000 \times 5.65 = \$2,260$. The Social Security tax was reduced on employee salary by 2% in 2011 and 2012.

46. *FICA Taxes*

Solution: 8,934.40 is withheld for FICA taxes in 2013.

$\$113,700 \times 6.2\% =$	\$7,049.40
$\$130,000 \times 1.45\% =$	<u>\$1,885.00</u>
Total	\$8,934.40

\$8,566.20 is withheld for FICA taxes in 2012.

\$110,100 x 4.2% = \$4,624.20

\$130,000 x 1.45% = \$1,885.00

Total \$6,509.20

In 2012, the taxpayer would have paid \$2,425.20 less in Social Security taxes due to the lower base and reduced rate in 2012. The Medicare portion would have remained the same, however.

Think Outside the Text

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

47. *Canons of Taxation*

Solution: The four canons of taxation are equity, economy, certainty, and convenience. In general, with the exception of an evaluation based on equity, many persons believe the sales tax that most states levy is superior to the income tax. The costs to collect and comply with the sales tax are relatively small compared to the amounts collected (although internet sales are a significant problem now); most persons know that when they purchase certain items they are required to pay sales taxes; and they pay at the point of sale without having to file end-of-year returns. Sales taxes are considered regressive, however, and therefore not considered equitable. As a percentage of income, lower income persons pay more sales tax than higher income persons do because they are obliged to spend more of their income. As an absolute amount, however, most wealthy persons spend more overall than poor persons, and, as a result pay more sales taxes (vertical equity). Two persons with equal incomes can pay different amounts of sales taxes, however, if one party chooses to save money while the other spends; this would violate horizontal equity. The income tax has far higher costs of collections and administration but its tax rates are progressive and it contains provisions that exempt low-income taxpayers from paying any taxes. Thus, it is generally seen as more equitable than a sales tax. It fails, however, on convenience and certainty because of the annual filing requirements and constant changing of the laws.

48. *Deductions vs. Credit*

Solution: Taxable income = \$40,000; marginal tax bracket = 25%. Tax savings from the \$4,000 deduction = \$1,000 (25% x \$4,000).

Taxable income = \$200,000; marginal tax bracket = 33%. Tax savings from the \$4,000 deduction = \$1,320 (33% x \$4,000).

A \$4,000 tax credit reduces each taxpayer's tax by \$4,000. The tax savings from a tax credit is independent of the taxpayer's marginal tax rate.

49. *Flat Tax*

Solution: Most students will agree that there will have to be some basic exclusions or deductions to enact a viable flat tax. Comparisons can be drawn, however, to the FICA taxes, which have been flat over incomes up to the Social Security base amount (\$113,700 for 2013), but only the Medicare portion applies above this base amount; an income flat tax, on the contrary, could be structured to exempt a certain

base amount from tax with the tax applying on all income above that minimum excluded base. Discussions of a flat tax can often lead to discussions of higher minimum wages, guaranteed annual incomes and negative income taxes in order to keep the flat tax relatively simple.

50. *Marriage Penalty*

Solution: An evaluation of this proposal at this point usually focuses on the cost to the taxpayer in time and money to determine the tax under the dual system. Other problems arise in the dividing up of dependency exemptions, itemized deductions, and tax credits. If taxpayers are allowed to choose the method that allows them to pay the lower tax, there will also be a decline in total tax revenues.

51. *Tax Fairness*

Solution: No answer is suggested here as the purpose of this question is to require the student to select an alternative and construct an argument to support that position.

52. *After-Tax Cost of Itemized Deductions*

Solution: The after-tax cost of the interest expense and property taxes is \$9,650.

A tax savings only results to the extent the deductible expenses exceed the standard deduction. The taxpayer's total itemized deductions are \$13,500. In 2013, a single taxpayer's standard deduction is \$6,100. The interest and property taxes increase his deduction by \$7,400 (\$13,500 - \$6,100).

Taxable income using itemized deductions = \$62,600 (\$80,000 - \$13,500 - \$3,900 personal exemption).

Taxable income using the standard deduction = \$70,000 (\$80,000 - \$6,100 standard deduction - \$3,900 personal exemption).

<u>Tax on \$62,600</u>		<u>Tax on \$70,000</u>	
\$8,925 x 10% =	\$ 892.50	\$8,925 x 10% =	\$ 892.50
\$27,325 x 15% =	4,098.75	\$26,650 x 15% =	4,098.75
\$26,350 x 25% =	<u>6,587.50</u>	\$33,750 x 25% =	<u>8,437.50</u>
Total	\$11,578.75	Total	\$13,428.75

The reduction in taxes by itemizing is \$1,850.00 (\$13,428.75 - \$11,578.75). The after-tax cost of the \$11,500 interest and property taxes is \$9,650 (\$11,500 - \$1,850).

53. *After-Tax Interest Rate*

Solution: The interest rate = 4.34%.

The \$7,000 interest (\$100,000 x 7%) would reduce taxes by \$2,660 (\$7,000 x 38%). Thus the net interest paid is \$4,340 (\$7,000 - \$2,660). The after-tax interest rate is 4.34% (\$4,340/\$100,000). Alternatively, this can be calculated directly as 7% (1 - .38) = 4.34%

54. *Property Tax*

Solution: As an ad valorem tax, a property tax is proportional. If you look at any other taxing base except the value of the property, the tax may be progressive for some group of citizens and regressive for others. For example, senior citizens generally have lower

incomes than working persons. They may live in equivalently valued houses because they have lived there a long time and have no mortgage, however. In this case, based on a percentage of income, the property tax would be regressive. Alternatively, a lower income person may spend only 25 percent of his or her income on housing because of other necessities. A high-income person may be able to spend 40 percent of his or her income on housing. The latter's property taxes will be much higher as a percent of income than the former. In this situation, the tax is progressive when based on income. Thus, for a wealth tax such as a property tax, wealth is the only base on which it is practical to evaluate it. It is generally proportional, although a certain base amount may be excluded from the tax (for example, a \$25,000 homestead exemption for persons who own their own home).

55. Tax Liability Comparisons

Solution: Partnership: The partnership pays no taxes, but as general partners, June and John each pay self-employment tax on the total income passed through by the partnership in addition to paying income tax

Self-employment tax = $(\$32,000 \times 92.35\%) \times 15.3\% = \$4,521.46$ each (consisting of \$2,260.73 for the employer's portion of the tax and the same amount for the employee's portion of the tax)

They can deduct the employer's portion of their self-employment tax, however, as a deduction for AGI. Thus, their \$32,000 of income passed through is reduced to \$29,739 $(\$32,000 - \$2,261)$.

June's income tax = $\$29,739 \times 39.6\% = \$11,777$; June's total tax = $\$16,298$ $(\$11,777 + \$4,521)$.

John's income tax = $\$29,739 \times 25\% = \$7,435$; John's total tax = $\$11,956$ $(\$7,435 + \$4,521)$.

Together they pay a total of \$28,254 $(\$16,298 + \$11,956)$ in taxes.

S Corporation: Like the partnership, the S corporation pays no tax. June and John are still each taxed on the \$32,000 passed through to them, but no self-employment taxes are owed.

June's tax = $\$32,000 \times 39.6\% = \$12,672$.

John's tax = $\$32,000 \times 25\% = \$8,000$.

Together they pay a total of \$20,672 in taxes.

C Corporation: The corporation pays a tax of \$11,000 $[(\$50,000 \times 15\%) + (\$14,000 \times 25\%)]$ on its income. Neither the corporation nor June or John pay any employment taxes as neither June nor John received a salary from the corporation. Neither June nor John pay any income taxes as they received no distributions from the corporation.

Note: The problem only specified income and employment taxes; any added Medicare surtaxes were excluded from the solution.

56. Tax Liability Comparisons

Solution: Partnership: The partnership pays no taxes, but as general partners, June and John each pay self-employment tax on the total income passed through by the partnership in addition to the tax on this income.

Self-employment tax = $(\$32,000 \times 92.35\%) \times 15.3\% = \$4,521.46$ each (consisting of \$2,260.73 for the employer's portion of the tax and the same amount for the employee's portion of the tax)

They can deduct the employer's portion of their self-employment tax, however, as a deduction for AGI. Thus, their \$32,000 of income passed through is reduced to \$29,739 $(\$32,000 - \$2,261)$.

June's income tax = $\$29,739 \times 39.6\% = \$11,777$; June's total tax = $\$16,298$ $(\$11,777 + \$4,521)$.

John's income tax = $\$29,739 \times 25\% = \$7,435$ John's total tax = $\$11,956$ $(\$7,435 + \$4,521)$.

Together they pay a total of \$28,254 $(\$16,298 + \$11,956)$ in taxes.

S Corporation: Like the partnership, the S corporation pays no tax. As they are taking the \$28,000 out as a distribution, however, neither the corporation nor June and John pay employment taxes, although they are still each taxed on the \$32,000 passed through to them.

June's tax = $\$32,000 \times 39.6\% = \$12,672$. John's tax = $\$32,000 \times 25\% = \$8,000$.

Together they pay a total of \$20,672 in taxes.

C Corporation: The corporation pays a tax of \$11,000 $[(\$50,000 \times 15\%) + (\$14,000 \times 25\%)]$ on its income. June and John, however, will have to recognize \$28,000 of dividend income each. Because this is a dividend distribution rather than salary, neither the corporation nor June or John pay any employment taxes on the distribution.

June's tax = $\$28,000 \times 20\% = \$5,600$.

John's tax = $\$28,000 \times 15\% = \$4,200$.

The total tax for the corporation, June, and John is \$20,800 $(\$11,000 + \$5,600 + \$4,200)$. (June's dividends are subject to the 20% dividend rate as her other income places her in the 39.6% tax bracket.)

If the distributions were salary payments:

Partnership: Paying a "salary" (technically a guaranteed payment) to the partners does not change the outcome. Total taxes are the same as determined for the distribution above; that is, the partners will pay self-employment taxes on the income as well as income taxes for total taxes of \$28,254.

S Corporation: If the \$28,000 is salary, the corporation will now be required to pay FICA and FUTA taxes on the \$28,000 distributed to June and John, but it will get a deduction for both the taxes and the salary

The corporation will pay a total of \$4,284 in FICA taxes $(\$28,000 \times 7.65\% = \$2,142 \times 2 = \$4,284)$ and FUTA of \$840 $(\$7,000 \times 6.0\% = \$420 \times 2)$. This reduces the corporation's income to \$58,876 $(\$64,000 - \$4,284 - \$840)$. The \$56,000 in total salaries further reduces the S corporation's income to \$2,876.

June and John will each have \$2,142 $(\$28,000 \times 7.65\%)$ in FICA taxes withheld on the \$28,000 salary. In addition, they will each have to pay income taxes on their \$28,000 in salary plus their one-half of the S corporation's residual income $(\$2,876 \times 50\% = \$1,438)$. June will pay an income tax of \$11,657 $[(\$28,000 + \$1,438) \times 39.6\%]$ and John will pay an income tax of \$7,360 $[(\$28,000 + \$1,438) \times 25\%]$ on the income.

June's total tax is \$13,799 (\$2,142 + \$11,657); John's total tax is \$9,502 (\$2,142 + \$7,360); the total for the corporation, June, and John is \$28,425 (\$4,284 + \$840 + \$13,799 + \$9,502).

C Corporation: The corporation will pay \$4,284 ($\$28,000 \times 7.65\% = \$2,142 \times 2$) in total FICA taxes and \$840 ($\420×2) in FUTA. This reduces the corporation's taxable income to \$58,876. The \$56,000 in salaries further reduces the corporation's income to \$2,876. Its income tax is \$431 ($\$2,876 \times 15\%$). Thus, its total tax is \$5,555 (\$4,284 + \$840 + \$431).

John and June will now pay income and FICA taxes on the \$28,000 of salaries. June's income tax is \$11,088 ($\$28,000 \times 39.6\%$) and her total tax is \$13,230 (\$11,088 + \$2,142); John's income tax is \$7,000 ($\$28,000 \times 25\%$) and his total tax is \$9,142 (\$7,000 + \$2,142). Together, the corporation June and John pay a total of \$27,927 (\$5,555 + \$13,230 + \$9,142).

Identify the Issues

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

57. Filing Status

Solution: What is John and Mary's filing status for the current year?

58. Dependent Status

Solution: Does William qualify as a dependent of his parents?

59. S Corporation Requirements

Solution: Is the S corporate restriction of no more than 100 shareholders violated when John gives half of his shares to his wife? Will its S election terminate?

60. Disguised Dividend

Solution: Will all of Clifford's salary be deductible by the corporation as salary or is it possible that a portion of it will be declared a disguised dividend?

Search the Internet

For the following four problems, consult the IRS Web site (www.irs.gov).

61. Statistical Information

Solution: On the home page for tax statistics (www.irs.gov/uac/TaxStats-2) accessed under Tax Stats, Facts and Figures at www.IRS.gov are links to a wide range of tables, articles, and data that describe and measure elements of the U.S. tax system. These include statistics and other information about returns filed with the IRS. Headings under this section include: Business Tax Statistics; Individual Tax Statistics; IRS Operations & Budget; Statistics of Income (SOI); Charitable & Exempt Org. Statistics; Products, Publications, & Papers; Statistics by Form; Other IRS Data and Research, Additional Information; and What's New.

62. *Asking Questions or Making Comments to the IRS*

Solution: Under “Additional Information” found on the home page for Tax Statistics, there is a direct link under Questions on Tax Statistics? that accesses a page on which you can send an email to the IRS with general questions or comments regarding these statistics. Links are also provided for accessing other information.

63. *Statistics of Income*

Solution: About SOI, Dissemination Policy, SOI Products and Services, SOI Studies, Statistical Methodology, and All Topics

64. *Information about the IRS*

Solution: At the bottom of the IRS home page, click on "more" under Learn about the IRS. “Organization, Its Mission and Statutory Authority” and “Brief History of IRS” appear along with other links including The Commissioner’s Section, The Agency, its Mission and Statutory Authority, Strategic Plan and Other References, Open Government Initiative, Contracting Opportunities, and Contact Us.

65. *Tax Freedom Day*

Solution: (a) Tax Freedom Day is the specific day in the year that, on average, Americans stop working to pay the government; that is, income to that date all goes to pay taxes; income for the rest of the year belongs to the taxpayer to do with as he or she chooses.

(b) Tax Freedom Day was April 11 in 2011 and April 13 in 2012. Thus, 101 of the 365 days in 2011 and 103 days in 2012 were worked to pay taxes. It has been estimated that the tax freedom day will be April 18 in 2013; however, this date varies greatly when done on a state-by-state basis.

Develop Planning Skills66. *Single vs. Married Filing Status*

Solution:

	<u>MFS</u>	<u>MFJ</u>	<u>Single</u>
Gross Income/ Filing Status	\$100,000	\$200,000	\$100,000
Personal exemption(s)	3,900	7,800	3,900
Standard deduction	6,100	12,200	6,100
= Taxable income	\$90,000	\$180,000	\$90,000
<u>Tax Rate</u>	<u>Tax—MFS</u>	<u>Tax—MFJ</u>	<u>Tax—Single</u>
10% x	\$ 8,925 = \$ 892.50	\$17,850 = \$1,785.00	\$ 8,925 = \$ 892.50
15% x	\$27,325 = \$4,098.75	\$54,650 = \$8,197.50	\$27,325 = \$4,098.75
25% x	36,950 = \$9,237.50	\$73,900 = \$18,475.00	\$51,600 = \$12,900.00
28% x	\$16,800 = \$4,704.00	\$33,600 = <u>\$9,408.00</u>	\$ 2,150 = \$ 602.00
Total Tax	<u>\$18,932.75</u>	\$37,865.50	<u>\$18,493.25</u>
x 2	\$37,865.50		\$36,986.50

It makes no difference if they marry this year and file either as married filing jointly or separately. If they postpone the wedding until next year, they will save \$879 (\$37,865.50 - \$36,986.50) in taxes filing as single individuals this year.

67. Total Tax Comparisons

Solution: (a) Sole Proprietorship: Jeremy will be taxed on the entire net income from the sole proprietorship of \$48,000 (\$60,000 - \$12,000) regardless of the "salary." \$48,000 - \$3,900 personal exemption - \$6,100 standard deduction = \$38,000 taxable income; $(10\% \times \$8,925) + (15\% \times \$27,325) + (\$1,750 \times 25\%) = \$892.50 + \$4,098.75 + \$437.50 = \$5,428.75$ income tax.

Corporation: \$60,000 - \$12,000 - \$30,000 = \$18,000 taxable income; $\$18,000 \times 15\% = \$2,700$ income tax. Income tax on Jeremy's \$30,000 salary: Jeremy's taxable income = \$30,000 - \$6,100 standard deduction - \$3,900 personal exemption = \$20,000. Tax on \$20,000 = $(\$8,925 \times 10\%) + (\$11,075 \times 15\%) = \$892.50 + \$1,661.25 = \$2,553.75$. Total taxes as a corporation = \$2,700 + \$2,553.75 = \$5,253.75

Based solely on income taxes, Jeremy should incorporate because his taxes will be \$175 (\$5,428.75 - \$5,253.75) less than operating as a sole proprietorship.

(b) Sole proprietorship: \$48,000 net income (\$60,000 - \$12,000).

Jeremy's self-employment tax on \$48,000 = $\$48,000 \times 92.35\% \times 15.3\% = \$6,782.18$ (consisting of \$3,391.09 for the employer's and an equal amount for the employee's portion of the tax)

Jeremy's income tax on \$48,000 income from proprietorship:

Taxable income = \$48,000 - \$3,391.09 (employer's amount) - \$3,900 - \$6,100 = \$34,608.91

Tax on \$34,608.91 = $(\$8,925 \times 10\%) + (\$25,683.91 \times 15\%) = \$892.50 + \$3,852.59 = \$4,745.09$

Total taxes as a sole proprietorship = \$6,782.18 + \$4,745.09 = \$11,527.27

Corporation: The corporation will pay \$2,295 (\$30,000 x 7.65%) FICA tax on \$30,000 salary and \$420 (\$7,000 x 6%) FUTA (Federal unemployment tax)

Corporate net income = \$60,000 - \$12,000 - \$2,295 FICA - \$420 FUTA - \$30,000 salary = \$15,285

Corporate income tax = $\$15,285 \times 15\% = \$2,292.75$

Income tax on Jeremy's \$30,000 salary: Jeremy's taxable income = \$30,000 - \$6,100 standard deduction - \$3,900 personal exemption = \$20,000. Tax on \$20,000 = $(\$8,925 \times 10\%) + (\$11,075 \times 15\%) = \$892.50 + \$1,661.75 = \$2,553.75$. Jeremy also pays \$2,295 (\$30,000 x 7.65%) in FICA in 2013.

Total taxes as a corporation = \$2,295 + \$420 + \$2,292.75 + \$2,295 + \$2,553.75 = \$9,856.50

Based solely on 2013 taxes, Jeremy should incorporate because his taxes will be \$1,670.77 (\$9,856.50 - \$11,527.27) less than operating as a sole proprietorship.

68. Charitable Deduction

Solution: As a married couple, their standard deduction is \$12,200 in 2013 (the same assumed in 2014). The 10 percent they plan to give to charity each year does not

exceed their standard deduction in 2013 or 2014 (as assumed) so there would be no tax savings in either year by contributing 10 percent of income each year. Their total planned contribution is \$20,500 (\$10,000 + \$10,500) over the two years and they have saved sufficient funds to contribute the entire amount in one year. If they contribute the entire \$20,500 in 2013, their taxable income would be \$71,700 (\$100,000 - \$7,800 personal exemptions - \$20,500 contribution) which is \$8,300 less than their \$80,000 taxable income if they claim the standard deduction (\$100,000 - \$7,800 personal exemptions - \$12,200 standard deduction). This \$8,300 savings in taxable income is split between two tax brackets with \$7,500 (\$80,000 - \$72,500) in the 25% bracket and \$800 ((\$72,500 - \$71,700) in the 15% bracket. Their tax savings for 2013 is \$1,995 [(\$7,500 x 25%) + (\$800 x 15%)] by doubling up their donations this year.

Under the assumption of no change in tax rates or standard deduction, however, they would have the same tax savings in 2014, but one year later; in the meantime they could benefit from any income earned on the contribution until made in 2014. As rate brackets and standard deductions generally increase annually, their tax savings would be slightly smaller by taking the double deduction in 2014. This would have to be compared to the additional income on their savings, however, if the contribution were postponed.

69. After-Tax Return

Solution: The after-tax interest on the taxable bonds equals 6% $(1 - .34) = 3.96\%$. The 4.5 percent interest rate on the tax-exempt bonds provides the better return.

70. Tax Liability Comparison

Solution: Regular C Corporation: FICA tax on Carol's \$60,000 salary is \$4,590 (\$60,000 x 7.65%). FUTA = \$420 (\$7,000 x 6%)
 Corporate taxable income = \$200,000 - \$75,000 - \$60,000 salary - \$4,590 FICA - \$420 FUTA = \$59,990.
 Income tax on \$59,990 = $(\$50,000 \times 15\%) + (\$9,990 \times 25\%) = \$7,500 + \$2,497.50 = \$9,997.50$.
 Total corporate taxes = $\$4,590 + \$420 + \$9,997.50 = \$15,007.50$.
 Carol's taxes: Carol also pays \$4,590 (\$60,000 x 7.65%) in FICA taxes on her salary but she cannot deduct these taxes.
 Carol's taxable income = \$60,000 - \$6,100 standard deduction - \$3,900 personal exemption = \$50,000.
 Income tax on \$50,000 = $(8,925 \times 10\%) + (\$27,325 \times 15\%) + (\$13,750 \times 25\%) = \$892.50 + \$4,098.75 + \$3,437.50 = \$8,428.75$.
 Carol's total taxes = $\$8,428.75 + \$4,590 = \$13,018.75$.
 Total taxes = $\$15,007.50 + \$13,018.75 = \$28,026.25$

S Corporation: FICA tax on Carol's \$60,000 salary is \$4,590 (\$60,000 x 7.65%). FUTA = \$420 (\$7,000 x 6%).

The net S corporation income of \$59,990 (same as the regular corporation) is passed through to Carol for taxation along with her salary income.

Carol's taxable income = \$60,000 salary + \$59,990 corporation income - \$6,100 standard deduction - \$3,900 exemption = \$109,990.

Tax on Carol's \$109,990 taxable income = $(\$8,925 \times 10\%) + (\$27,325 \times 15\%) + (\$51,600 \times 25\%) + (\$22,140 \times 28\%) = \$892.50 + \$4,098.75 + \$12,900 + \$6,199.20 = \$24,090.45$

Carol's total tax = $\$24,090.45 + \$4,590 = \$28,680.45$

Total taxes = $\$28,680.45 + \$4,590 + \$420 = \$33,690.45$

Based on 2013 total taxes only, Carol should not make the S corporation election because the total taxes will be \$5,664.20 ($\$33,690.45 - \$28,026.25$) less operating as a regular C corporation.