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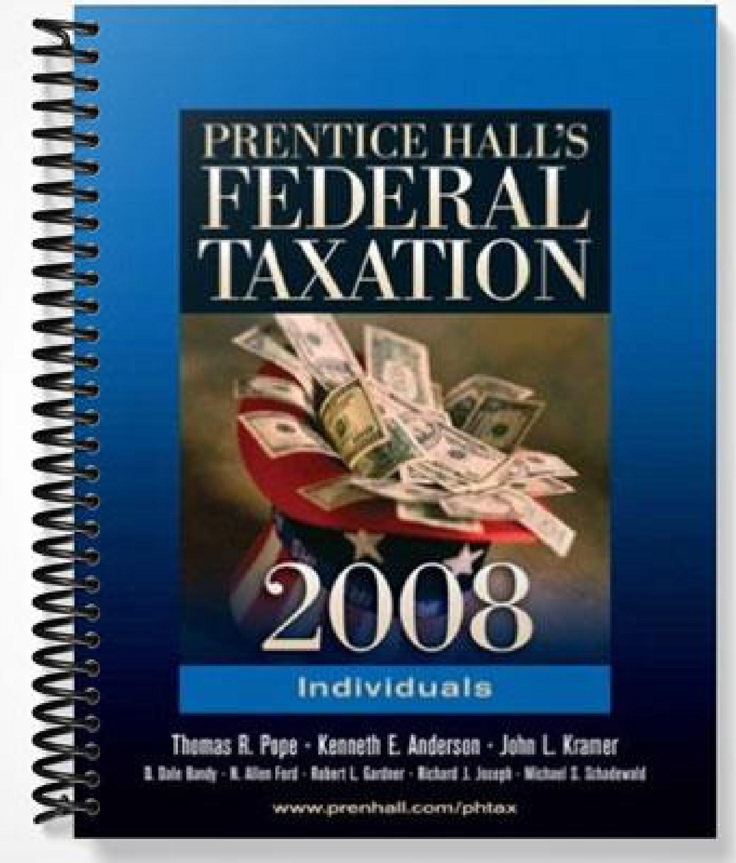
PRENTICE HALL'S
FEDERAL
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Individuals
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Chapter I:2

Determination of Tax

True-False

I:2-1. Gross income is income from whatever source derived less exclusions. T, p. I:2-3.

I:2-2. While exclusions are usually not reported on an individual's income tax return, interest income on state and local government bonds must be reported on the tax return. T, p. I:2-3.

Solution: See Additional Comment.

I:2-3. Generally, deductions for adjusted gross income are personal expenses specifically allowed by tax law. F, p. I:2-4.

Solution: Personal expenses, if deductible, are from AGI deductions.

I:2-4. Generally, itemized deductions are personal expenses specifically allowed by the tax law. T, p. I:2-4.

I:2-5. Taxpayers have the choice of claiming either the personal and dependency exemption or the standard deduction. F, p. I:2-5.

Solution: Taxpayers claim the greater of itemized deductions or the standard deduction.

I:2-6. Refundable tax credits are allowed to reduce or totally eliminate a taxpayer's tax liability but may not reduce the liability below zero. F, p. I:2-6.

Solution: Refundable tax credits may reduce the tax liability to zero and, if some credit still remains, are refundable or paid by the government to the taxpayer.

I:2-7. Nonrefundable tax credits are allowed to reduce or totally eliminate a taxpayer's tax liability but may not reduce the liability below zero. T, p. I:2-6.

I:2-8. The standard deduction is the maximum amount of itemized deductions which may be claimed by a taxpayer, and is based on an individual's filing status, age, and vision. F, p. I:2-10.

Solution: The standard deduction, set by Congress, is not directly related to itemized deductions.

I:2-9. Nonresident aliens are allowed a full standard deduction. F, p. I:2-12.

Solution: The standard deduction is not available to nonresident aliens.

I:2-10. The standard deduction may not be claimed by one married taxpayer filing a separate return if the other spouse itemizes deductions. T, p. I:2-12.

I:2-11. A married taxpayer filing a separate tax return may claim an exemption for the taxpayer's spouse when the spouse has no gross income and is not claimed as a dependent by another. T, p. I:2-12.

I:2-12. The dependency exemption for individuals who die before the end of the year must be prorated. F, p. I:2-13.

I:2-13. A qualifying child of the taxpayer need not meet the gross income test. T, p. I:2-13.

I:2-14. For purposes of the dependency exemption, a qualifying child must be under age 19, a full-time student under age 24, or a permanently and totally disabled child. T, p. I:2-14.

I:2-15. For purposes of the dependency exemption, a qualifying child may not provide more than one-half of his or her own support during the year. T, p. I:2-14.

I:2-16. An individual may not qualify for the dependency exemption as a qualifying child but may still qualify as an other dependent. T, p. I:2-14.

I:2-17. One requirement for claiming a dependent other than a qualifying child is that the taxpayer provides more than 50 percent of the dependent's support. T, p. I:2-15.

I:2-18. The person claiming a dependency exemption under a multiple support declaration must provide more than 10% of the dependent's support. T, p. I:2-17.

I:2-19. Generally, in the case of a divorced couple, the parent who has physical custody of a child for the greater part of the year is entitled to the dependency exemption. T, p. I:2-17.

I:2-20. A married couple need not live together to file a joint return. T, p. I:2-21.

I:2-21. A widow or widower may file a joint tax return and claim an exemption for the deceased spouse in the year of the spouse's death as well as the following two years when certain requirements are met. F, p. I:2-22.

Solution: A joint return may be filed in the year of death with the deceased spouse getting a full personal exemption.

I:2-22. An unmarried taxpayer may file as head of household if he maintains a home for his qualifying child. T, p. I:2-23.

I:2-23. For 2007, unearned income in excess of $1700 of a child under age 18 is generally taxed at the parents' rate. T, p. I:2-25.

I:2-24. If a 13-year-old has earned income of $500 and unearned income of $1,500, all of the income can be reported on the parent's return. F, p. I:2-26.

Solution: To be eligible, the child's income must come solely from interest and dividends.

I:2-25. Generally, when a married couple files a joint return, each spouse is liable for the entire tax and any penalties incurred. T, p. I:2-32.

I:2-26. Regardless of the total amount of gross income, a taxpayer with net self-employment income of $400 or more must file a tax return. T, p. I:2-33.

I:2-27. Taxpayers who can be claimed as a dependent by another must file a return if they have either unearned income over $3,400 in 2007 or total gross income over the standard deduction. F, p. I:2-33.

Solution: They must file if they have unearned income over $850.

Multiple Choice

I:2-28. Taxable income for an individual is defined as:

a. AGI reduced by itemized deductions.
b. AGI reduced by personal and dependency exemptions.
c. total income reduced by deductions for AGI.
d. AGI reduced by deductions from AGI and personal and dependency exemptions.

d, p. I:2-2; Table I:2-1, Tax Formula for Individuals.

I:2-29. All of the following items are generally excluded from income <u>except</u>

a. child support payments.
b. interest on corporate bonds.
c. interest on state and local government bonds.
d. life insurance proceeds paid by reason of death.

b, p. I:2-3. Solution: Interest on corporate bonds is taxable.

I:2-30. All of the following items are included in gross income <u>except</u>

a. alimony received.
b. rent income.
c. dividend income.
d. child support payments received.

d, p. I:2-4. Solution: Child support is not taxable.

I:2-31. All of the following items are deductions for adjusted gross income <u>except</u>

a. alimony.
b. trade or business expenses.
c. rent and royalty expenses.
d. state and local income taxes.

d, p. I:2-5. Solution: State and local income taxes are itemized deductions.

I:2-32. All of the following items are deductions for adjusted gross income <u>except</u>

a. moving expenses.
b. unreimbursed employee business expenses.
c. contributions to medical savings accounts.
d. one-half of self-employment taxes paid.

b, p. I:2-5. Solution: Unreimbursed employee business expenses are miscellaneous itemized deductions.

I:2-33. Which of the following credits is considered a refundable credit?

a. child and dependent care credit
b. earned income credit
c. adoption expense credit
d. credit for the elderly

b, p. I:2-6. Solution: The earned income credit is a refundable credit.

I:2-34. A single taxpayer provided the following information for 2007:

Salary	$40,000
Interest on local government bonds (qualifies as a tax exclusion)	4,000
Allowable itemized deductions	8,000

What is taxable income?

a. $28,600
b. $31,600
c. $32,000
d. $32,600

a, p. I:2-6; Example I:2-1. Solution: ($28,700 = $40,000 - $8,000 itemized deductions - $3,400 personal exemption)

I:2-35. Which of the following types of itemized deductions are included in the category of miscellaneous expenses that are deductible only if the aggregate amount of such expenses exceeds 2% of the taxpayer's adjusted gross income?

a. unreimbursed employee business expenses
b. charitable contributions
c. medical expenses
d. home mortgage interest expense

a, p. I:2-10; Table I:2-6.

I:2-36. In 2007 the standard deduction for a married taxpayer filing a joint return and who is 67 years old with a spouse who is 65 years old is

a. $10,700.
b. $11,700.
c. $12,700.
d. $12,800.

d, p. I :2-11. Solution: ($12,800 = $10,700 + $1,050 +$1,050)

I:2-37. In 2007 Bill and Louise (both 50 years old) file a joint tax return claiming as a dependent their son who is blind. Their standard deduction is

a. $10,000.
b. $10,700.
c. $11,300.
d. $11,550.

b, p. I:2-11. Solution: Blindness of a dependent does not increase the standard deduction of the taxpayers.

I:2-38. Anita, who is 28 and single, has adjusted gross income of $50,000 and itemized deductions of $5,000. In 2007, Anita will have taxable income of

a. $41,300.
b. $41,450.
c. $44,850.
d. $45,000.

a, p. I:2-11; Example I:2-4. Solution:

Adjusted gross income	$50,000
Minus: Standard deduction	(5,300)
Exemption	(3,400)
Taxable income	$41,300

I:2-39. On June 1, 2007, Ellen turned 65. Ellen has been a widow for five years and has no dependents. Her standard deduction is

a. $3,400.
b. $5,300.
c. $6,350.
d. $6,650.

d, p. I:2-11. Solution: ($5,350 + $1,300 = $6,650).

I:2-40. The standard deduction is unavailable to all of the following taxpayers <u>except</u>

a. resident aliens.
b. nonresident aliens.
c. an individual filing a return for a period of less than 12 months.
d. a married taxpayer filing a separate return when the other spouse itemizes.

a, p. I:2-12. Solution: There is nothing in the law that precludes resident aliens from taking standard deduction.

I:2-41. The regular standard deduction amount is available to which one of the following taxpayers?

a. Married taxpayer filing a separate return where the other spouse itemizes.
b. A person who has only unearned income and is a dependent of another.
c. An individual filing a return for a period of less than 12 months because of a change in accounting period.
d. An abandoned spouse.

d, p. I:2-12. Solution: A person who is a dependent of another has a limited standard deduction. Married individuals filing separate returns when the other spouse itemizes and an individual filing a short period return may not take the standard deduction. There is nothing in the law that precludes an abandoned spouse from taking the standard deduction.

I:2-42. Husband and wife, who live in a common law state, are eligible to file a joint return for 2007, but elect to file separately. They do not have dependents. Wife has adjusted gross income of $24,000 and has $1,200 of expenditures which qualify as itemized deductions. She is entitled to one exemption. Husband deducts itemized deductions of $8,200. What is the taxable income for the wife?

a. $10,400
b. $15,550
c. $19,400
d. $22,800

c, p. I:2-12; Example I:2-5. Solution: If one spouse on married filing separately returns itemizes deductions, the other spouse must also do so.

Income of wife	$24,000
Minus: Itemized deductions	(1,200)
Personal exemption	(3,400)
Taxable Income	$19,400

I:2-43. Lewis, who is single, is claimed as a dependent on his parents' tax return. He received $1,000 during the year in dividends, which was his only income. What is his standard deduction?

a. $850
b. $1,000
c. $1,300
d. $5,150

a, p. I:2-12; Example I:2-6. Solution: For a dependent, the standard deduction is the greater of earned income plus $300 or $850. Dividends are unearned income.

I:2-44. Charlie is claimed as a dependent on his parents' tax return. He received $750 during the year in dividends, which was his only income. What is his standard deduction?

a. $750
b. $850
c. $1,050
d. $5,150

b, p. I:2-12; Example I:2-6. Solution: For a dependent, the standard deduction is the greater of earned income plus $300 or $850.

I:2-45. Daniel, who is single, is claimed as a dependent on his parents' tax return. He had a small part-time job during 2007 and he earned $700 during the year, which was his only income. What is his standard deduction?

a. $700
b. $850
c. $1,000
d. $5,150

c, p. I:2-12; Example I:2-7. Solution: For a dependent, the standard deduction is the greater of earned income plus $300 ($700 + 300 = $1,000) or $850.

I:2-46. Charlie is claimed as a dependent on his parents' tax return. He had a small part-time job during 2007 and he earned $4,900 during the year, which was his only income. What is his standard deduction?

a. $850
b. $4,900
c. $5,150
d. $5,200

c, p. I:2-12; Example I:2-7. Solution: For a dependent, the standard deduction is the greater of earned income plus $300 or $850, up to a maximum of the regular standard deduction.

I:2-47. A married person who files a separate return can claim a personal exemption for his spouse if the spouse is not the dependent of another and has

a. gross income that is less than the personal exemption.
b. adjusted gross income that is less than the personal exemption.
c. no gross income.
d. no taxable income.

c, p. I:2-12. Solution: A married person who files a separate return can claim a personal exemption for his spouse if the spouse has no gross income during the year and the spouse is not the dependent of another taxpayer.

I:2-48. Bob, age 67, and Karla, age 58, have two children who live with them and for whom they provide total support. Their daughter is 21 years old, blind, is not a full-time student and has no income. Her twin brother is 21 years old, has good sight, is a full-time student and has income of $3,600. Bob and Karla can claim how many personal and dependency exemptions on their tax return?

a. 2
b. 3
c. 4
d. 5

c, pp. I:2-13 and I:2-14. Solution: Bob and Karla get two personal exemptions for themselves. Although their daughter is not their qualifying child, she still qualifies as an other dependent since she meets all of the dependency tests. Their son qualifies as their dependent as he is their qualifying child and need not meet the gross income test. Therefore, they are entitled to two dependency exemptions.

I:2-49. Sarah, who is single, maintains a home in which she, her 15-year old brother, and her 21-year-old niece live. Sarah provides the majority of the support for her brother, her niece, and her cousin, age 18, who is enrolled full-time at the university and lives in an apartment. While the niece and cousin have no income, her brother has a part-time job and earns $4,000 per year. How many personal and dependency exemptions may Sarah claim?

a. 1
b. 2
c. 3
d. 4

c, pp. I:2-13 through I:2-15. Solution: Sarah may claim one personal exemption and two dependency exemptions for her niece and brother. Because her brother qualifies as her qualifying child for purposes of the dependency exemption, he does not have to meet the gross income test. Sarah may not claim her cousin as a dependent since her cousin does not live with her.

I:2-50. Anita, who is divorced, maintains a home in which she and her 16 year old daughter live. Anita provides the majority of the support for her daughter and for a son, age 23, who is enrolled part-time at the university and lives in the dorm. The son also works in the campus bookstore and earns spending money of $3,401. How many personal and dependency exemptions may Anita claim?

a. 1
b. 2
c. 3
d. 4

b, pp. I:2-13 through I:2-15. Solution: (Anita, her daughter). Anita's son does not qualify as her qualifying child (fails age test) nor does he qualify as an other dependent (fails gross income test).

I:2-51. Amber supports four individuals: Sarah, her stepdaughter, who lives with her; Amy, her cousin, who lives in another state; Anita, her friend, who lives legally in her home all year long; and Charlie, her father, who lives in another state. How many personal and dependency exemptions may Amber claim?

a. 1
b. 2
c. 3
d. 4

d, pp. I:2-13 through I:2-15. Solution: Amber may claim one personal exemption and three (Sarah, Anita, Charlie) dependency exemptions. Amy, her cousin, does not qualify because a cousin is not a related party and can only qualify as a dependent is she lives in the taxpayer's home all year long.

I:2-52. John supports Kevin, his cousin, who lived with him all year. John also supports three other individuals who do not live with him:

Donna who is John's mother
Melissa who John's stepsister
Morris who is Kevin's brother.

How many personal and dependency exemptions may John claim?

a. 2
b. 3
c. 4
d. 5

c, pp. I:2-13 through I:2-15. Solution: John may claim one personal exemption and three dependency exemptions for Kevin, Donna, and Melissa. Morris is John's cousin and does not qualify as a dependent since he doesn't live in John's home. A cousin is not related for tax purposes and would have to live in the taxpayer's home to be claimed as a dependent.

I:2-53. Julia provides more than 50 percent of the support for three individuals: Theresa, an unrelated child who lives with Julia all year long; Margaret, Julia's cousin, who lives in another city; and Emma, Julia's daughter who lives in her own home. How many dependency exemptions can Julia claim on her 2007 tax return?

a. 0
b. 1
c. 2
d. 3

c, pp. I:2-13 and I:2-14; Example I:2-9. Solution: (Theresa, Emma) Assuming all other tests are met, Theresa qualifies as Julia's dependent. A person who lives with the taxpayer all year long need not be related to the taxpayer. Margaret does not qualify as Julia's dependent. She is not related for tax purposes and, therefore, can't be Julia's dependent unless she lives with Julia all year long. Emma qualifies as Julia's dependent. Since Emma is Julia's daughter, she is related for tax purposes and need not live with Julia to be claimed as Julia's dependent. Therefore, Julia has two dependents.

I:2-54. Tony supports the following individuals during 2007: Miranda, his former mother-in-law who lives in her own home and has no gross income; his cousin, Jeff, age 23, who is a full-time student, earns $7,000 during the year, and lives with Tony all year long; and Matt, age 22, who is Tony's brother, is a full-time student who lives on campus and earns $8,000 during the year. How many dependency exemptions may Tony claim in 2007?

a. 0
b. 1
c. 2
d. 3

c, pp. I:2-13 and I:2-15; Examples I:2-10 and I:2-11. Solution: Miranda qualifies as Tony's dependent. She is related to him for tax purposes and does not have to live with him. Jeff earns too much gross income (more than the personal exemption amount of $3,400) and can not qualify as Tony's dependent. Although Matt earns more gross income than the personal exemption amount, he is considered Tony's qualifying child and, therefore, does not have to meet the gross income test. Therefore, Tony can claim two dependents.

I:2-55. David's father is retired and receives $14,000 per year in social security benefits. David's father saves $4,000 of the benefits and spends the remaining $10,000 for his support. How much support must David provide for his father to meet the dependent support requirement?

a. $10,000
b. $10,001
c. $14,000
d. $14,001

b, p. I:2-15; Example I:2-13. Solution: The amount that David's father saves is not counted in the support test. Therefore, David need only provide $1 more than his father ($10,000 + $1) to meet the more than 50 percent test.

I:2-56. Which of the following is not considered support for the dependent support test?

a. food
b. clothing
c. rental value of lodging
d. value of services rendered by the taxpayer for the dependent

d, p. I:2-15. Solution: Food, clothing, and the rental value of the lodging are all considered support.

I:2-57. Anna is supported entirely by her three sons John, James, and Joseph who provide for her support in the following percentages:

John: 10%, James: 40%, Joseph: 50%

Assuming a multiple support declaration exists, which of the brothers may claim his mother as a dependent?

a. any of the sons
b. James or Joseph
c. Joseph only
d. None of them

b, p. I:2-17. Solution: Although no one provides more than 50 percent of Anna's support, a qualifying pool of individuals (John, James, and Joseph) provide over 50 percent of Anna's support. Any one of them who provides more than 10 percent (James or Joseph) may claim Anna assuming a multiple support agreement is filed.

I:2-58.Blaine Greer lives alone. His support comes from the following sources:

Buddy (his son)	$ 600
Ken (his brother)	3,200
Martha (his daughter)	1,300
Natalie (a friend)	1,000
Total support	$6,100

Assuming a multiple support declaration exists, which of the individuals may claim Blaine as a dependent?

a. Ken or Martha
b. Buddy, Ken, or Martha
c. Ken, Martha, or Natalie
d. None of them.

a, p. I:2-17; Example I:2-17. Solution: A qualifying pool of individuals (Buddy, Ken, and Martha) provides more than 50 percent of Blaine's support. Natalie is not part of the qualifying pool as she could not otherwise claim Blaine because he is not related to her and does not live in her home. Of the qualifying pool, any of them that provide more than 10 percent of Blaine's support (Ken or Martha) may claim Blaine under a multiple support agreement.

I:2-59. Rolando, a single taxpayer, has no dependents. Rolando's AGI is $166,400. Rolando's allowable personal exemption in 2007 is

a. $ 272.
b. $3,128.
c. $3,219.
d. $3,400.

c, p. I:2-19; Example I:2-22. Solution:

Adjusted gross income	$166,400
Minus: Threshold	(156,400)
Amount above threshold	$ 10,000
Amount of each layer	2,500
Number of $2,500 layers (rounded to next higher whole number)	4
Percentage disallowed (2% per $2,500 layer)	8%

Amount disallowed: .08 x $3,400 = $272. $272 – 1/3 (272) = $181
Amount allowed: $3,400 - $181 = $3,219.

I:2-60. Husband and wife have one dependent child. On a joint return for 2007, their adjusted gross income is $260,000. What is their deduction for personal and dependency exemptions?

a. $2,244
b. $7,956
c. $8,704
d. $10,200

c, p. I:2-19; Example I:2-22. Solution:

Adjusted gross income	$260,000
Minus: Threshold	(234,600)
Amount above threshold	$ 25,400
Amount of each layer	2,500
Number of $2,500 layers rounded up	11
Percentage disallowed (2% per $2,500 layer)	22%

Amount disallowed: .22 x $10,200 = $2,244. $2,244 – 1/3 (2,244) = $1,496
Amount allowed: $10,200 - $1,496 = $8,704.

I:2-61. The child credit is for taxpayers with dependent children under the age of:

a. 14.
b. 17.
c. 19.
d. 24.

b, p. I:2-20. Solution: Children must be under age 17 to qualify.

I:2-62. Steven and Sarah Tyler have three dependent children ages 13, 15, and 17. Their modified AGI for 2007 is $110,000. What is the amount of the child credit to which they are entitled?

a. $-0-
b. $1,950
c. $2,000
d. $3,000

c, p. I:2-20. Solution: (2 x $1,000 = $2,000).

I:2-63. Steven and Sarah Tyler have three dependent children ages 13, 15, and 17. Their modified AGI for 2007 is $120,000. What is the amount of the child credit to which they are entitled?

a. $-0-
b. $500
c. $1,500
d. $2,000

c, p. I:2-20; Example I:2-24. Solution: The child credit before the phase out is $2,000 (2 x $1,000). They have excess AGI of $10,000 ($120,000 - $110,000). Their credit should be reduced by 10 ($10,000/$1,000) x $50 = $500. Thus, their child credit is $1,500.

I:2-64. Ryan and Edith file a joint return for 2007 showing $130,000 of AGI (with no exclusions under Secs. 911, 931, and 933). They have three dependent children ages 7, 9, and 13. What is the amount of their child credit?

a. $0
b. $1,000
c. $2,000
d. $3,000

c, p. I:2-20; Example I:2-24. Solution: The child credit is $1000 per qualifying child for 2007, with a phase-out for AGI exceeding $110,000 on joint returns. $130,000 - $110,000 = $20,000. There are twenty $1,000 increments (or parts thereof) exceeding the $110,000 phase-out floor, so the child credit will be reduced by 20 x $50 = $1000. Credit before phase-out is 3 children x $1,000 = $3,000. After the phase-out the credit is $2,000 = $3,000 - $1000.

I:2-65. Paul and Sally file a joint return for 2007 showing $87,000 of AGI (with no exclusions under Secs. 911, 931, and 933). They have three dependent children ages 6, 8, and 13. What is the amount of their child credit?

a. $0
b. $1,000
c. $2,000
d. $3,000

d, p. I:2-20. Solution: Three children under the age of 17 and no phase-out. 3 x $1,000 = $3,000.

I:2-66. You may choose married filing jointly as your filing status if you are married and both you and your spouse agree to file a joint return. Which of the following facts would prevent you from being considered married for filing purposes?
a. You were married for several years, but your divorce became final in December.
b. You are married but living apart until some problems can be solved.
c. Your spouse died during the year but the executor of the estate has agreed to the filing of a joint return.
d. None of the above.

a, p. I:2-21. Solution: Marital status is determined as of the last day of the tax year. If the couple is divorced on December 31 (“a”), then they are not married for tax purposes and may not file a joint return.

I:2-67. Tom and Anita were married on December 31 of last year. What is their filing status for last year?
a. They file as single.
b. They file as married joint or married separate.
c. They file as single half the year and married the other half.
d. They file as single for 364 days and married for one day.

b, p. I:2-21. Solution: Marital status is determined as of the last day of the tax year. If the couple was married on December 31, they are considered married for the entire year and may file either married filing jointly or married filing separately (“b”).

I:2-68. When a spouse dies, the surviving spouse for the year of death:
a. may file a married filing jointly return.
b. must file a tax return using the single filing status.
c. must file a tax return using the surviving spouse filing status.
d. may file a married filing jointly return only if the death occurred in the last half of the year.

a, p. I:2-22; Example I:2-28. Solution: In the year of death, a joint return can be filed.

I:2-69. In 2004, Leo’s wife died. Leo has two small children, ages 2 and 4, living at home whom he supports entirely. Leo does not remarry for five years and is not claimed as a dependent on another's return during any of this period. In 2005, 2006, and 2007, Leo's most advantageous filing status is, respectively

a. single for all three years.
b. head of household for all three years.
c. surviving spouse, surviving spouse, head of household
d. surviving spouse, surviving spouse, single.

c, p. I:2-22; Example I:2-28. Solution: In the two years following death (2005 and 2006), Thomas may file as surviving spouse as long as he has at least one dependent child living in the home during the entire year and he provides over half of the expenses of the home. After the two years following the year of death, Thomas qualifies as head of household as he is unmarried and is maintaining a home for a qualifying individual (in this case, his qualifying child).

I:2-70. Carter dies on January 1, 2007. A joint return election is made in 2007 and Marjorie properly qualifies as a surviving spouse for the two following years. Marjorie has one child that she claims as a dependent for this same period. Assuming there is no increase in the amount of personal and dependency exemption from 2007, the amount of personal and dependency exemptions allowed Marjorie in 2007 and in 2008 is, respectively

a. $3,400 and $3,400.
b. $6,800 and $6,800.
c. $10,200 and $6,800.
d. $10,200 and $10,200.

c, p. I:2-22. Solution: Three exemptions for 2007 (joint return) and two for 2008 (surviving spouse).

I:2-71. A surviving spouse is not required to

a. be remarried at the end of the year in which the surviving spouse status is claimed.
b. be a U.S. citizen or resident.
c. be qualified to file a joint return in the year of death.
d. have at least one dependent child living at home the entire year and pay over half of the expenses of the home.

a, p. I:2-22. Solution: An individual claiming surviving spouse status can not have remarried.

I:2-72. Which dependent relative does not have to live in the same household as the taxpayer who is claiming head of household filing status?

a. uncle
b. brother
c. father
d. nephew

c, p. I:2-23. Solution: A taxpayer with a dependent parent qualifies as head of household even if the parent does not live with the taxpayer.

I:2-73. Sally, divorced in 2006, maintains her home in which she and her sixteen-year-old daughter resided for 2006 and 2007. Sally signed the dependency exemption over to her ex-spouse. What is Sally's filing status for 2007 and how many exemptions may she claim?

a. single and one
b. surviving spouse and one
c. head of household and one
d. head of household and two

c, p. I:2-23; Example I:2-29. Solution: Sally qualifies as head of household for 2007. A taxpayer with a qualifying child satisfies the head of household requirement even if the taxpayer releases the dependency exemption to the child's other parent.

I:2-74. David, age 59 and divorced, is the sole support of his mother age 83, who is a resident of a local nursing home for the entire year. David's mother had no income for the year. David's filing status and exemptions claimed are

a. head of household and one exemption.
b. single and one exemption.
c. head of household and two exemptions.
d. single and two exemptions.

c, p. I:2-23. Solution: David's mother qualifies as his dependent; therefore, he gets two exemptions. He qualifies as head of household since a taxpayer with a dependent parent qualifies even if the parent does not live with the taxpayer.

I:2-75. Liz and Bert divorce and Liz receives custody of their child. Bert is ordered by the court to pay child support of $10,000 per year, and Liz agrees in writing to allow Bert to claim the dependency exemption for the child. If Liz maintains the home in which she and her child live, her filing status and exemptions claimed will be

a. single and one exemption.
b. single and two exemptions.
c. head of household and one exemption.
d. head of household and two exemptions.

c, p. I:2-23; Example I:2-29. Solution: Liz gets a personal exemption for herself. A taxpayer with a qualifying child satisfies the head of household requirement even if the taxpayer releases the dependency exemption to the child's other parent.

I:2-76. Edward, a widower whose wife died in 2004 maintains a household for himself and his daughter who qualifies as his dependent. Edward's most favorable filing status for 2007 is

a. single.
b. surviving spouse.
c. head of household.
d. married filing jointly.

c, p. I:2-23. Solution: Surviving spouse status is only available for the two years following the spouse's death, in this case, 2005 and 2006. However, Edward does qualify for head of household.

I:2-77. Erin, a widow for ten years, maintains a household in which she and her mother, for which she gets the dependency exemption through a multiple support agreement, live. Erin's most favorable filing status is

a. single.
b. head of household.
c. surviving spouse.
d. married filing jointly.

a, p. I:2-23. Solution: In order to be head of household, the taxpayer must be unmarried (Erin is widowed) and maintain a home for a dependent relative for more than half the year. However, the dependency exemption for that relative cannot be based on a multiple support agreement. Since it is in this case, Erin does not qualify as head of household.

I:2-78. The filing status in which the rates increase most rapidly is:

a. single.
b. head of household.
c. married filing separately.
d. married filing jointly.

c, p. I:2-23. Solution: The rates on the married filing a separate return schedule increases more rapidly than other individual rate schedules.

I:2-79. A married taxpayer may file as head of household under the abandoned spouse provisions if all of the following are met except:

a. The taxpayer lived apart from his or her spouse for the last six months of the year.
b. The taxpayer is a U.S. citizen or resident.
c. The taxpayer pays over half of the cost of maintaining a household in which the taxpayer and a dependent son or daughter live for over half of the year.
d. The taxpayer must have been married for at least two years.

d, p. I:2-23. Solution: The first three items are all required to meet the abandoned spouse definition.

I:2-80. To qualify as an abandoned spouse, the taxpayer is not required to

a. be a U.S. citizen or resident.
b. live apart from the spouse for the last six months of the year.
c. pay more than half the cost of maintaining the home.
d. have a son or daughter in the home for the entire year.

d, pp. I:2-23 and I:2-24. Solution: The dependent son or daughter need only live in the taxpayer's home for more than one half year.

I:2-81. In October 2006, Joy and Paul separated and have not lived with each other since. Joy supports their children after the separation and pays the cost of maintaining their home. Joy's filing status in 2006 and 2007 is, respectively,

a. single for both years.
b. head of household and single.
c. married filing separately for both years.
d. married filing separately and head of household.

d, p. I:2-24; Examples I:2-32 and I:2-33. Solution: Joy and Paul are married on the last day of the year so either a joint return or a separate return is required unless Joy qualifies as an abandoned spouse (and thus, head of household). She does not qualify in 2006 since Paul was in the home during the last six months of the year. However, since Paul is gone, a married filing separate return is necessary since he is not around to sign a joint return. In 2007, Joy, though still married, qualifies as an abandoned spouse and, thus, head of household.

I:2-82. For the “Kiddie Tax” to apply, the dependent child must be under age
- a. 14.
- b. 17.
- c. 18.
- d. 24.

c, p. I:2-24. Solution: The child must be under age 14.

I:2-83. For purposes of the “Kiddie Tax,” unearned income includes
- a. wages of the child.
- b. gifts received.
- c. taxable interest & dividends.
- d. more than one of the above are considered unearned income.

c, p. I:2-25. Solution: Interest and dividends are unearned income.

I:2-84. Keith, age 14, is a dependent of his parents. During 2007, Keith's earned income from wages is $2,600 and Keith received $3,000 of interest income. The parent's marginal rate is 28% and Keith's rate is 10%. Keith's tax is
- a. $-0-.
- b. $45.
- c. $230
- d. $270.

d, p. I:2-25; Example I:2-35. Solution:

Wages	$2,600	
Interest	3,000	
AGI	5,600	
Std Ded.	- 2,900	($2,600 wages + $300)
Per. Exmp	-0-	
Taxable Inc.	$2,700	

$2,700 x .10 = $270

I:2-85. Emma, age 20, is a full-time college student with earned income from wages of $4,400 and interest income of $500. Emma's parents provide more than half of Emma's support. Emma's taxable income is

a. $0.
b. $200.
c. $1,300.
d. $4,600.

b, p. I:2-25; Example I:2-35. Solution:

Earned income	$4,400
Plus: Interest income	500
Adjusted gross income	$4,900
Minus: Standard deduction [$4,400 + 300]	(4,700)
Taxable income	$ 200

I:2-86. Michelle, age 20, is a full-time college student with earned income from wages of $5,000 and interest income of $500. Michelle's parents provide more than half of Michelle's support. Michelle's taxable income is

a. $0.
b. $200.
c. $350.
d. $4,650.

c, p. I:2-25; Example I:2-35. Solution:

Earned income	$5,000
Plus: Interest income	500
Adjusted gross income	$5,500
Minus: Standard deduction [$5,000 + 300 but not more than $5,350]	(5,300)
Taxable income	$ 200

I:2-87. Vincent, age 12, is a dependent of his parents. During 2007, Vincent's earned income from wages is $2,600 and Vincent received $3,000 of interest income. The parent's marginal rate is 28% and Vincent's marginal rate is 10%. Vincent's tax is

a. $-0-.
b. $140.
c. $270.
d. $504.

d, p. I:2-25; Example I:2-36. Solution:

Wages	$2,600	
Interest	3,000	
AGI	5,600	
Std Ded.	- 2,900	($2,600 wages + $300)
Per. Exmp	-0-	
Taxable Inc.	$2,700	

Dividends	$3,000
Statutory Ded.	- 850
Portion of Std Ded.	- 850
Net Unearned income	$1,300

Tax on net unearned income $1,300 x 28% =	$364
Tax on taxable income minus net unearned income ($2,700 - $1,300) x 10% =	140
Total Tax	$504

I:2-88. Frank, age 17, received $4,000 of dividends and $1,500 from a part-time job. Frank is a dependent of his parents who are in the 28% percent bracket. Frank's taxable income is

a. $0
b. $350.
c. $400.
d. $3,700.

d, p. I:2-26; Example I:2-37. Solution: ($4,000 + $1,500) - $1,800 std. ded. = $3,700. The standard deduction is the greater of $850 or earned income of $1,500 plus $300 ($1,800).

I:2-89. A corporation has revenue of $350,000 and deductible business expenses of $240,000. What is the federal income tax, before credits?

a. $16,500
b. $22,500
c. $26,150
d. $42,900

c, p. I:2-27. Solution: Net income is $110,000 ($350,000 - $240,000). The tax liability is $22,250 and $3,900 [.39 x 10,000] = $26,150

I:2-90. The following characteristic is not applicable to S corporations or their shareholders:

a. all shareholders must elect S corporation treatment.
b. the corporation must have no foreign shareholders.
c. each shareholder must report a pro rata share of S corporation income on his or her individual return even if the income is not distributed.
d. each shareholder must participate in the operation of the business.

d, p. I:2-28. Solution: There is no requirement that each shareholder participate in the business.

I:2-91. Terri is age 21, single, and cannot be claimed as a dependent by another taxpayer. For 2007 she must file a federal income tax return if she had gross income of at least

a. $ 400.
b. $ 3,400.
c. $ 5,350.
d. $ 8,750.

d, p. I:2-33. Solution:

Personal exemption	$3,400
Standard deduction	5,350
Gross income floor	$8,750

I:2-92. All of the following taxpayers must file a 2007 tax return with the exception of

a. A, age 17 and single, has $6,000 of wages, $400 of interest, and $2,000 of dividends. She is a dependent.
b. B, age 13 and single, is a dependent of his parents and has interest income of $600.
c. C, age 29 and single, has self-employment income of $600.
d. D, age 15 and single, a dependent of his parents, has wages of $1,800 and interest of $900.

b, p. I:2-33. Solution: A and D must file because taxpayers who can be claimed as a dependent by another must file if they have either unearned income of $850 (A and D) or total gross income over the standard deduction (A). C must file because taxpayers with net self-employment income of $400 or more must file regardless of their gross income.

I:2-93. All of the following statements are true except

a. taxpayers who receive advance payments of the earned income credit must file a tax return only if their income exceeds the personal exemption amount.
b. taxpayers with net self-employment income of $400 or more must file regardless of their gross income.
c. taxpayers who can be claimed as a dependent by another must file if they have either unearned income over $850 or total gross income over the standard deduction.
d. in general, taxpayers must file a tax return if their gross income equals or exceeds the sum of the personal exemption and the standard deduction (including the additional standard deduction due to age but not blindness).

a, p. I:2-33. Solution: Taxpayers who receive advance payments of the earned income credit must file regardless of their income levels.

I:2-94. Form 4868, a four-month extension of time to file, allows a taxpayer to

a. avoid interest on underpayment of taxes due.
b. extend the filing date of the return as well as payment of the tax due.
c. extend the filing date of the return but the estimated amount of tax due must still be paid by the original due date of the return.
d. extend the filing date only at the discretion of the IRS.

c, p. I:2-34. Solution: An extension to file a return is not an extension to pay any tax that is owed.

I:2-95. Lester, a widower qualifying as a surviving spouse, has $209,000 of salary, five personal and dependent exemptions and itemizes deductions. Lester must use which form to report his taxable income?

a. form 1040ES
b. form 1040EZ
c. form 1040A
d. form 1040

d, p. I:2-34. Solution: Itemized deductions may be claimed only on Form 1040.

Short Answer

I:2-96. Tom and Anita Wopat have two children whom they support and who live in their home. Timmy is 17 and has earned income of $5,000 for the year. Tommy is 5. Anita's mother also lives with them and may be claimed as their dependent. She is 75 years old. Their adjusted gross income for 2007 is $130,000.

Required: Compute Tom and Anita's taxable income if they file a joint return and they do not itemize deductions.

Solution:

Adjusted gross income	$130,000
Less: Standard deduction	(10,700)
Allowable exemption ($3,400 x 5)	(17,000)
Taxable income	$102,300

pp. I:2-6 and I:2-7; Example I:2-1.

I:2-97. Hillary is single with no dependents and has a salary of $82,000 for 2007, along with tax exempt interest income of $3,000 from a municipality. Her itemized deductions total $5,500.

Required: Compute her taxable income.

Solution:

Salary	$82,000
Less:	
Itemized deductions	(5,500)
Personal exemption	(3,400)
Taxable income	$73,100

pp. I:2-6 and I:2-7; Example I:2-1.

I:2-98. The following information is available for Tom and Alice Horton, a married couple filing a joint return, for 2007:

Salary (earned by Tom)	$100,000
Interest income	12,000
Deductible IRA contributions	8,000
Itemized deductions	11,000
Exemptions	6,800
Withholding	15,000

a. What is the amount of their gross income?
b. What is the amount of their adjusted gross income?
c. What is the amount of their taxable income?
d. What is the amount of their tax liability (gross tax)?
e. What is the amount of their tax due or (refund due)?

Solution:

	Hortons
Salary	$100,000
Interest	12,000
Gross Income	**$112,000**[a]
Minus: IRA Contribution	8,000
Adjusted gross income	**$104,000**[b]
Minus: Itemized deductions	(11,000)
Exemptions	(6,800)
Taxable Income	**$ 86,200**[c]
Gross tax (using Rate Schedule)	**$14,398***[d]
Minus: Withholding	$ 15,000
Tax due (refund)	(**$602**)[e]
*$8,773 + [.25 (86,200 – 63,700)]	

pp. I:2-6 and I:2-7; Example I:2-1.

I:2-99. Joann and Jules file a joint tax return in 2007 and report AGI of $160,000. Their itemized deductions include $20,000 of medical expenses and home mortgage interest of $15,000. What are the total itemized deductions allowed on their 2007 return?

Solution:
The AGI floor reduces the medical expenses to $8,000 [$20,000 – (.075 x $160,000)]. Total itemized deductions before the reduction is $23,000 ($8,000 + $15,000). This amount must be reduced by $72 [($160,000 - $156,400) x .02] as a result of the overall floor for itemized deductions. Therefore, the total itemized deductions allowed are $22,928 ($23,000 - $72). p. I:2-10; Example I:2-2.

I:2-100. Steve Greene is divorced, age 66, has good eyesight, and lives alone. He claims his son Dylan who is blind as his dependent. Steve had income and expenses as follows for the taxable year 2007:

Gross income from salary	$80,000
Total itemized deductions	5,500

Compute Steve's taxable income for 2007. Show all calculations.

Solution:

Adjusted gross income	$80,000
Less: Standard deduction ($5,300 + $1,300)	(6,600)
Allowable exemption ($3,400 x 2)	(6,800)
Taxable income	$66,600

The additional standard deduction is for Steve's age.

pp. I:2-10 and I:2-11.

I:2-101. Sean and Martha are both over age 65 and Martha is considered blind by tax law standards. Their total income in 2007 from part-time jobs and interest income from a bank savings account is $60,000. Their itemized deductions are $11,000.

Required: Compute their taxable income.

Solution:

Salary & interest	$60,000
Less:	
Standard deduction ($10,700 + 1,050 + 1,050 + 1,050)	(13,850)
Personal exemptions (2 x 3,400)	(6,800)
Taxable income	$39,350

The standard deduction is increased because of age for both and blindness for Martha.

pp. I:2-10 and I:2-11.

I:2-102. In 2007, Kate is single, and a homeowner. She has property taxes on her home of $3,000, makes charitable contributions of $1,500, and pays home mortgage interest of $5,000. Kate's adjusted gross income is $60,000.

Required: Compute her taxable income.

Solution

Adjusted gross income				$60,000
Minus:	Itemized deductions:			
	Property taxes	$3,000		
	Home mortgage interest	5,000		
	Charitable contributions	1,500	(9,500)	
Minus:	Personal exemption			(3,400)
Taxable income			$47,100	

p. I:2-11; Example I:2-3.

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I:2-103. In 2007, Sarah is single. She rents an apartment for which she pays $400 per month and makes charitable contributions of $1,000. Sarah's adjusted gross income is $47,000.

Required: Compute her taxable income. Show all calculations.

Solution:

Adjusted gross income		$47,000
Minus:	Standard deduction	(5,350)
Minus:	Personal exemption	(3,400)
Taxable income		$38,250

p. I:2-11; Example I:2-4.

I:2-104. The following information for 2007 relates to Emma Grace, a single taxpayer, age 18:

Salary	$3,500
Interest income	1,800
Itemized deductions	500

a. Compute Emma Grace's taxable income assuming she is self-supporting.
b. Compute Emma Grace's taxable income assuming she is a dependent of her parents.

Solution:

a.

Salary	$ 3,500
Interest	1,800
Adjusted gross income	$ 5,300
Minus: Standard deduction	(5,350)
Exemptions	(3,400)
Taxable income	-0-

b.

Salary	$ 3,500
Interest	1,800
Adjusted gross income	$ 5,300
Minus: Standard deduction ($3,500 + $300)	(3,800)
Exemption	-0-
Taxable income	$ 1,500

p. I:2-12; Example I:2-7.

I:2-105. Joycelyn, who is 67 years old and single, is claimed as a dependent on her daughter Ellen's tax return. During 2007, she received $1,800 interest on a savings account. She had a part time job that earned $2,000. Her total itemized deductions were $1,200. What is the amount of Joycelyn's taxable income for 2007?

Solution:

Adjusted gross income ($1,800 + $2,000)	$3,800
Less: Standard deduction > ($850 or [(2,000 + 300)]) plus $1,300	(3,600)
Allowable exemption (None—dependent of another)	-0-
Taxable income	$ 200

p. I:2-12.

I:2-106. Maxine, who is 67 years old and single, is claimed as a dependent on her daughter Beth's tax return. During 2007, she received $1,980 interest on a savings account. She had a part time job that earned $950. Her total itemized deductions were $1,300.

Required: Compute Maxine's taxable income for 2007. Show all calculations.

Solution:

Adjusted gross income ($1,980 + $950)	$ 2,930
Less: Standard deduction {[> $850 or (950 + 300)] plus $1,300}	(2,550)
Allowable exemption (None—dependent of another)	-0-
Taxable income	$ 380

p. I:2-12.

I:2-107. Frank attended college for much of 2007, during which time he was supported by his parents. Erin married Frank in December 2007. They live in a common law state. Frank graduated and commenced work in 2008. Erin worked during 2007 and earned $20,000. Frank's only income was interest of $900. Frank's parents are in the 28% tax bracket. Thus, claiming Frank as a dependent would save them $952 ($3,400 x .28).

a. What is Erin and Frank's tax liability if they file a joint return?

b. What is Erin and Frank's total tax liability if they file separate returns and Frank's parents claim him as a dependent?

Solution:

a.

Salary and interest	$20,900
Minus: Standard deduction	(10,700)
Exemption (3400 x 2)	(6,800)
Taxable income	$ 3,400
Gross tax ($3,400 x .10)	$ 340

b.

Erin's tax liability:	
Salary	$20,000
Minus: Standard deduction	(5,350)
Exemption	(3,400)
Taxable income	$11,250
Gross tax	$ 1,297*

*$783 + [.15 x ($11,250 - $7,825)]

Frank's tax liability:	
Interest	$ 900
Minus: Standard deduction (> $850 or EI + $300)	(850)
Exemption	(0)
Taxable income	$ 50
Gross tax ($50 x .10)	$ 5

Total tax liability on separate returns: ($1,297 + 5)	$1,302
Total tax liability on joint return	340
Erin and Frank's savings on joint return	$ 962
Parent's savings if Frank claimed as dependent	(952)
Family unit would save if Frank not claimed as dependent	$ 10

p. I:2-12.

I:2-108. Eliza Smith's father, Victor, lives with Eliza who is a single taxpayer. During the year, Eliza purchased clothing for her father costing $600 and provided him with a room that could have been rented for $3,000. In addition, Eliza spent $2,000 for groceries she shared with her father and $1,000 for utilities. Eliza purchased a DVD recorder for $600 which she placed in the living room for both her father and her use.

What is the amount of support provided by Eliza to her father?

Solution:

Clothing	$ 600
Rental value of room	3,000
Groceries (1/2 x $2,000)	1,000
Total support	$4,600

This assumes the utilities are included in the fair rental of the room. If not, one-half of the utilities may also be included. p. I:2-15; Example I:2-14.

I:2-109. For each of the following independent cases, indicate the total number of exemptions that may be claimed by the taxpayer in 2007.

a. Cassie is a single mother. She provides all the support for both her 16-year-old daughter Tammy who lives with her and who earned $15,200 modeling during the Christmas season and her two sons (R.J. and Will) who live with her and have no income.
b. Olivia, 35 years old, provided eighty percent of the support of her grandmother who lived in another state. Her grandmother's only income was from non-taxable social security of $6,500.
c. Vanessa and Matt Reardon are married and under 65 years of age. During 2007, they furnish more than half of the support of their 25 year-old son, Bill, who lives with them. Bill earns $2,000 from a part-time job, most of which he sets aside for future college expenses. Vanessa's father, Henry, who died on January 3, 2007, at age 80, had for many years qualified as their dependent.
d. Douglas and Marjorie are husband and wife and file a joint return. Both are under 65 years of age. They provide more than half of the support of their daughter, Ellen (age 23), who is a full-time medical student. Ellen receives a $3,400 taxable scholarship covering her room and board at college. They furnish all of the support of Henry (Douglas's grandfather), who is age 70 and lives in a nursing home. They also support Meg (age 69), who is a friend of the family who lives with them.
e. Blake Marler, divorced, maintains a home in which she, her twin sons, and her baby daughter live all year. The children's father, Ross, provides over half their support. No special arrangements exist between Blake and Ross.

Solution:

a. 4 (Cassie, Tammy, R.J., and Will)
b. 2 (Olivia, Grandma)
c. 4 (Vanessa, Matt, Bill, Henry)
d. 5 (Douglas, Marjorie, Ellen, Henry, Meg)
e. 4 (Blake, son, son, daughter)

pp. I:2-13 through I:2-17.

I:2-110. Mr. and Mrs. Roberts have three dependent children. They also have adjusted gross income for 2006 of $250,000.

a. What is their taxable income if they file a joint return and they do not itemize deductions? [Show all calculations].

b. What is their total tax liability?

Solution:

a.

Adjusted gross income	$260,000
Less: Standard deduction	(10,700)
Allowable exemption	(14,733)
Taxable income	$234,567

Allowable exemption calculation:

AGI	$260,000
Phase-out floor	(234,600)
Excess	$ 25,400
divide by	2,500
Number of $2,500 layers rounded up	10
Percentage disallowance	20%

Disallowance is .20 x 17,000 = $3,400 – 1/3 (3400) = $2,267

Exemption amount	$ 17,000
Disallowance	(2,267)
Allowable exemption	$ 14,733

b. Tax liability: $43,830.50 + [.33 ($234,567 - $195,850)] = $56,608.

p. I:2-19.

I:2-111. Sam and Diane are married, file a joint tax return, and have taxable income of $110,000. What is the amount of their tax liability?

Solution:

$8,772.50 + [.25 ($110,000 – 63,700] = $20,347.50.

p. I:2-20; Example I:2-25.

I:2-112. Indicate for each of the following, in the appropriate blanks, the most favorable filing status for the 2007 tax year.

a. Kenny died on March 2, 2005. Marge, his wife, and Bart, their son, survive. Marge filed a joint return in 2005. Bart, age 18 in 2007, is a part-time college student and continues to live at home with his mother. He works part-time, earning $5,350. What is Marge's filing status in 2007?

b. Alan Spaulding is single and provides over 50% support of his niece Alicia who lives with him all year long. Alan maintains the household. Alicia makes $3,500 at a part-time job. She is a full-time student, age 18. What is Alan's filing status?

c. Lily, who was divorced on July 27, 2007, provides 100% of the support for her parents who live in a nursing home in Kansas and have no income. What is Lily's filing status?

d. Holly Lindsey was abandoned by her husband Fletcher in September of the current year. She has not seen or communicated with him since then. What is Holly's filing status?

e. Rick Bauer, whose wife died in December 2006 filed a joint tax return for 2006. He did *not* remarry, but has continued to maintain his home in which his two dependent children live. What is Rick's filing status for 2007?

Solution:

a. surviving spouse
b. single
c. head of household
d. married filing separately
e. surviving spouse

pp. I:2-20 through I:2-24.

I:2-113. Gina Lewis, age 12, is claimed as a dependent on her parent's return. During 2007, she earned $2,300 from a summer job. She also earned qualified dividends of $2,750. (Her parents' marginal tax rate is 35 %.)

Required:

a. Compute the amount of Gina's tax liability for 2007.
b. Can Gina's parents take a child tax credit for her?

Solution:

Adjusted gross income ($2,300 + $2,750)	$5,050
Less: Standard deduction [> $850 or ($2,300+ 300)]	(2,600)
Allowable exemption (None—dependent of another)	-0-
Taxable income	$2,450

Tax liability:

Gina's net unearned income:

Unearned income: Dividends	$ 2,750
Less: Statutory deduction of $850	(850)
Less: Greater of	
a. $850 of standard deduction, or Itemized deductions connected with production of income	(850)
Net unearned Income	$1,050

Tax on net unearned income ($1,050 x 15% (dividend rate based on parents)	$158
Tax on taxable income minus net unearned Income ($2,450 - $1,050) x 5% (dividend rate based on child's rate)	70
Total income tax	$228

b. Yes, they can take a credit for Gina on their tax return subject to the phase-out.

p. I:2-26; Example I:2-37.

I:2-114. Oprah is starting Oprah's Poodle Parlor and is considering alternative organizational forms. She anticipates the business will earn $100,000 from operating before compensating her for her services and before charitable contributions. Oprah, who is single, has $3,000 of income from other sources and other itemized deductions of $12,000. Her compensation for services will be $50,000. Charitable contributions to be made by the business are expected to be $5,000. Other distributions (dividends) to her from the business are expected to be $14,000.

Required: Compare her current income tax assuming she operates the business as a proprietorship, an S corporation, and a C corporation. Ignore payroll and other taxes.

Solution:

	Proprietorship	*S Corporation*	*C Corporation*
Business income:			
Operating income	$100,000	$100,000	$100,000
Compensation paid to Oprah		(50,000)	(50,000)
Contributions			(5,000)
Net	$100,000	$ 50,000	$ 45,000
Corporate income tax			$ 6,750
Oprah's income:			
Business income (above)	$100,000	$ 50,000	
Compensation (above)		50,000	$ 50,000
Dividends			14,000
Other income	3,000	3,000	3,000
Adjusted gross income	$103,000	$103,000	$ 67,000
Contributions	5,000	5,000	
Other itemized deductions	12,000	12,000	12,000
Personal exemption	3,400	3,400	3,400
Taxable income	$ 82,600	$ 82,600	$ 51,600
Individual income tax	$ 17,239*	$ 17,239	$ 7,924**
Total tax	$ 17,239	$ 17,239	$ 14,674

*$15,699 + [.28 ($82,600 – 77,100)]

**Tax on dividends: $14,000 x .15 = $2,100 PLUS

Tax on taxable income of $51,600 less $14,000 or $37,600: $4,386 + .25 ($37,600 - $31,850) = $5,824. The total is $7,924.

p. I:2-28; Example I:2-38.

I:2-115. Sly and Jennifer are in the 33% tax bracket for ordinary income and the 15% bracket for capital gains. They have owned several blocks of stock for many years. They are considering the sale of two blocks of stock. The sale of one would produce a gain of $12,000 while the sale of the other would produce a loss of $18,000. For purposes of this problem, ignore personal exemptions, itemized deductions, and other phase-outs. They have no other gains and losses this year.

a. How much tax will they save if they sell the block of stock that produces a loss?
b. How much additional tax will they pay if they sell the block of stock that produces a gain?
c. What will be the impact on their taxes if they sell both blocks of stock?

Solution:

a. $3,000 (A net capital loss is limited to $3,000 per year) x .33 = $990. They can carryover the remaining $15,000 loss to next year.
b. $12,000 x .15 (maximum rate on long-term capital gains) = $1,800.
c. $12,000 gain - $18,000 loss = Net capital loss of $6,000 of which $3,000 is currently deductible to save taxes of $3,000 x .33 = $990. They should sell both so that they totally escape taxation of the gain this year. They can carryover the remaining $3,000 loss to next year.

p. I:2-30.

I:2-116. Alicia is a cash-basis, calendar-year taxpayer. Her salary is $30,000, and she is single. She plans to purchase a residence in 2007. She anticipates her property taxes and interest will total $8,000. Each year, Alicia contributes approximately $1,500 to charity. Her other itemized deductions total $1,000. For purposes of this problem, assume 2008 tax rates, exemptions, and standard deductions are the same as 2007.

a. What will her gross tax be in 2007 and 2008 if she contributes $1,500 to charity in each year?
b. What will her gross tax be in 2007 and 2008 if she contributes $3,000 to charity in 2007 but makes no contribution in 2008?
c. What will her gross tax be in 2007 and 2008 if she makes no contribution in 2007 but contributes $3,000 to charity in 2008?
d. Why does alternative "c" yield the lowest tax?

		2007	**2008**
a.	Salary	$30,000	$30,000
	Minus: Itemized or standard deduction	(5,350)	(10,700)
	Exemption	(3,400)	(3,400)
	Taxable income	$21,250	$ 15,900
	Gross Tax	$ 2,798*	$ 1,994**
b.	Salary	$30,000	$30,000
	Minus: Itemized or standard deduction	(5,350)	(9,000)
	Exemption	(3,400)	(3,400)
	Taxable income	$21,250	$17,600
	Gross tax	$ 2,798*	$ 2,249***
c.	Salary	$30,000	$30,000
	Minus: Itemized or standard deduction	(5,350)	(12,000)
	Exemption	(3,400)	(3,400)
	Taxable income	$21,250	$14,600
	Gross tax	$ 2,798*	$ 1,799****

*$782.50 + [.15 ($21,250 - $7,825)] = $2,798
**$782.50 + [.15($15,900 - $7,825)] = $1,994
***$782.50 + [.15 ($17,600 - $7,825)] = $2,249
****$782.50 + [.15 ($14,600 - $7,550)] = $1,799

d. The contributions have no tax benefit in 2007 because the standard deduction is taken and charitable contributions are itemized deductions.

p. I:2-31.

I:2-117. Carol and Robert have salaries of $35,000 and $27,000, respectively. Their itemized deductions total $6,000. They are married, under 65, and live in a common law state.

a. Compute their taxable income assuming that they file a joint return.

b. Compute their taxable income assuming that they file separate returns and that Robert claims all of the itemized deductions.

Solution:

a.

Adjusted gross income	$62,000
Minus: Standard deduction	(10,700)
Exemptions	(6,800)
Taxable income	$44,500

b.

Salary (Carol)	$35,000
Minus: Itemized deductions	-0-
Exemption	(3,400)
Taxable income	$31,600
Salary (Robert)	$27,000
Minus: Itemized deductions	(6,000)
Exemption	(3,400)
Taxable income	$17,600

pp. I:2-31 and I:2-32.

I:2-118. For each of the following taxpayers indicate which tax form should be used, the applicable filing status, the number of personal and dependency exemptions available, and the number of children who qualify for the child credit.

a. Jeffrey is a widow, age 71, who receives a pension of $10,000, nontaxable social security benefits of $12,000, and interest of $2,000. He has no dependents.
b. Selma is a single college student who earned $6,800 working part-time. She has $1,700 of interest income and received $1,000 support from her parents.
c. Olivia is married, but her husband left her three years ago and she has not seen or heard from him since. She supports herself and her six-year-old daughter. She paid all the household expenses. Her income consists of salary of $18,500 and interest of $800.
d. Ruben is a single college student who earned $6,800 working part-time. He has $250 of interest income and received $1,000 support from his parents.
e. Carol is divorced and received $12,000 alimony from her former husband and earned $15,000 working full-time as a secretary. She also received $2,500 of child support for her daughter who lives with her. According to a written agreement, she gave up the dependency exemption to her former husband.

Solution:

	Form	**Filing Status**	**Exemptions**	**Child Credit**
a.	1040A	Single	1	0
b.	1040A	Single	1	0
c.	1040A	Head-of-Household	2	1
d.	1040EZ	Single	1	0
e.	1040	Head-of-Household	1	0

pp. I:2-12 through I:2-24 and I:2-34.

Essay

I:2-119. What options are available for reporting and paying tax on the unearned income of a child under age 18?

Solution:
One option allows the child to report the unearned income on his or her own tax return while calculating the tax by reference to the parents' tax rate. Only unearned income in excess of $1,700 is taxed at the parents' rates.

A second option allows the parents to elect to include the child's unearned income on their own return. To be eligible for this election, the child's gross income must be entirely from dividends and interest and must not exceed $8,000. Also, there must be no withholding or estimated payments using the child's social security number. p. I:2-25.

I:2-120. Discuss reasons why a married couple may choose not to file a joint return.

Solution:
1. One spouse incurs most of medical expenses and itemized deductions can be maximized.
2. They may not want joint tax liability.
3. Casualty losses may be deductible on a separate return but not on a joint return because of the 10% floor. p. I:2-31.

I:2-121. Discuss why Congress passed the innocent spouse provision and give requirements to be met in order to qualify as an innocent spouse and be relieved of liability for tax on unreported income.

Solution:
The provision was passed because each spouse is liable for the entire tax on a joint return as well as penalties imposed. This would not be fair if one spouse concealed information regarding income or deductions from the other spouse.

An innocent spouse is relieved of liability when
1. The amount is attributable to grossly erroneous items of the other spouse.
2. The innocent spouse did not know of and had no reason to know that there was such an understatement of tax.
3. To hold the innocent spouse liable for the understatement would be inequitable.
4. The innocent spouse elects relief within two years after the IRS begins collection activities. p. I:2-32.

Issue Identification

I:2-122. Sam and Diane separated in June of this year although they continue to live in the same town. They have twin sons, Norm and Cliff, who remain in the family home with Diane. Sam's income this year was $45,000 while Diane worked only part-time and made $15,000. Sam also gambles heavily but told Diane that he had no winnings this year. What tax issues should they consider?

Solution: Sam and Diane have several choices for filing status. Since they are still married on December 31, the last day of the tax year, they could file jointly. That will probably result in the lowest overall tax liability. However, they should consider joint and several liabilities, especially if Diane fears that Sam may be hiding income. If Diane is maintaining the home in which at least one dependent child lives, she may be able to file as head of household. Of course, they could file separately which would result in the highest overall tax liability.

pp. I:2-29 and I:2-30.