# Solutions to Chapter 1 Problem Assignments

Check Your Understanding

1. [LO 1.1] *What is a tax?*

**Solution:** A tax is a required payment to a governmental unit to support its operations that is not related to the value of goods or services the person or business receives. A fine is levied as a result of an unlawful act.

2. [LO 1.1] *Constitutional Authority*

**Solution:** The federal income tax system as we know it today did not begin until 1913 when the 16th Amendment to the U.S. Constitution was ratified. The 16th Amendment gave Congress the power to lay and collect taxes “on income, from whatever source derived,” without the previous requirement that all direct taxes be imposed based on population.

3. [LO 1.1] *Current Tax Code*

**Solution:** The Tax Reform Act of 1986 was so extensive, the Code was renamed the *Internal Revenue Code of 1986*. Any current changes to the tax laws are now amendments to the *Internal Revenue Code of 1986.*

4. [LO 1.1] *Tax Expenditures*

**Solution:** Tax expenditures can take the form of special exclusions, deductions, credits or preferential rates for specific activities. These tax expenditures result in a reduction in the revenue that would be collected under a more comprehensive income tax.

5. [LO 1.1] *SALT*

**Solution:** The practice of state and local taxation is commonly referred to as a SALT practice.

6. [LO 1.1] *Nexus*

 **Solution:** Nexus is the necessary type and degree of connection between a business and the state in which it is located for the state to impose a tax on its sales or activities

7. [LO 1.1] *State Income T*ax

 **Solution:** Without physical presence within Arizona, the state cannot assess state income tax on Suntan Corporation’s sales made to persons or businesses located within Arizona.

8. [LO 1.1] *Franchise Tax*

**Solution:** A franchise tax is an excise tax based on the right to do business or own property in a state. It is usually determined based on corporate income, however, so would, in effect, simply be another name for an income tax.

9. [LO 1.1] *State Income Allocation*

**Solution:** The three-factor allocation formula uses a percentage of corporate sales, payroll costs, and tangible property allocated to the state.

10. [LO 1.1] *Employment Taxes*

**Solution:** An employee pays the Social Security and Medicare (FICA) tax; the employer also pays an equivalent Social Security and Medicare (FICA) tax, but the employer also may have to pay an unemployment tax.

11. [LO 1.1] *Wealth Taxes*

**Solution:** The most common wealth tax is the real property tax based on the fair market value of property owned by an individual or a business.

12. [LO 1.1] *Intangible Tax*

 **Solution:** The intangible tax is levied on intangible property such as receivables, stocks, bonds, and other forms of investment instruments owned by businesses and individuals.

13. [LO 1.1] *Estate and Gift Tax*

**Solution:** Property that is given away during a lifetime that exceeds an annual allowance per donee is subject to a gift tax; however, the lifetime exemption prevents most gifts from being subject to this tax. Once, however, taxable gifts exceed the lifetime exemption, gifts are subject to the gift tax. When the person passes away, the remaining property owned at death (not previously given away) is now subject to the estate tax. Any gift tax exemption not used previously by the decedent is then available as an exemption from the estate tax. Thus, a decedent’s estate escapes taxation unless his or her total lifetime taxable gifts plus taxable transfers at death exceed the lifetime exemption.

14. [LO 1.1] *Consumption vs Income Tax*

**Solution:** A consumption tax is levied on purchases of goods or services that are going to be used or consumed. The most common consumption tax is the sales tax, but the value-added tax is another form used in many countries outside the United States. The income tax is based on the value of money or goods that are received, whether it is spent or saved. An income tax will tax money that is going to be saved rather than spent while the consumption tax only taxes money that is spent. The consumption tax is thought to encourage savings.

15. [LO 1.1] *Wealth Taxes*

**Solution:** A wealth tax is based on the value of wealth that a person has at a particular point in time. The real or personal property taxes are wealth taxes. The wealth transfer tax is based on the value of money or property that is passed on to another person. The estate, gift, and inheritance taxes are wealth transfer taxes.

16. [LO 1.1] Use Taxes

**Solution:** A use tax is a companion tax to a sales tax that is imposed on property to be used in one state but which was purchased in another state to which no sales tax was paid on the purchase.

17. [LO 1.1] *Income Taxes*

**Solution:** Two single persons with taxable income of $76,550 each will pay the same total tax as a married couple with taxable income of $153,100. Above $153,100 the married couple’s rate increases to 28% but each of the single persons does not reach that rate until taxable income is over $91,900.

18. [LO 1.2] *Types of Taxes*

**Solution:** The income tax system in the United States is a progressive system; that is, as income increases, the tax rate increases and the person pays a greater percentage of income as a tax. A person who has $9,000 of taxable income will pay $900 in taxes (10%). A person who makes $18,000 will pay $2,233.75 ($932.50 + .15 ($18,000 - $9,325). $2,233.75/$18,000 = 12.41%. A regressive tax system imposes a lower tax rate as income increases; that is, a person pays a decreasing percentage of their income in taxes as income increases. The Social Security portion of the FICA tax is a regressive tax; as the taxpayer’s income on which the tax is based exceeds a maximum, the tax is no longer collected and the rate declines. A proportional tax would collect the same percentage of tax on the tax base, regardless of the size of the base. The sales tax is a proportional tax as the same percent tax is collected regardless of the amount spent.

19. [LO 1.2] *Income Tax Rates*

**Solution:** Individuals have basic tax rates of 10%, 15%, 25%, 28%, 33%, 35%, and 39.6% that apply to their ordinary income and their interest income. The basic tax rates for their dividend income are 0%, 15%, and 20%. Corporations have no tax-favored incomes so they pay tax on all income at rates of 15%, 25%, 34%, and 35%, excluding surtaxes on certain portions of income that ultimately produce a flat tax of 35% on income above $18,333,333.

20. [LO 1.2] *Income Tax Rates*

**Solution:** Individual’s short-term capital gains tax rates are the same as the tax rates on ordinary income. A single individual’s long-term capital gains rates are 0% on long-term capital gains (LTCG) from 0 to $37,950; 15% on LTCG from $37,951 to $418,400, and 20% on LTCG exceeding $418,400.

21. [LO 1.3] *Canons of Taxation*

**Solution:** The basic idea of equity is that persons with similar incomes will face similar taxes. Thus, individuals each with $200,000 in taxable income will pay the same amount of tax. A tax meets the criterion of economy when the amount of revenue it raises is at an optimum level after the costs of administration and compliance are considered. The canon of certainty would dictate that a taxpayer know with reasonable accuracy the tax consequences of a transaction at the time the transaction takes place. The last canon of convenience states that a convenient tax is one that would be readily determined and paid with little effort.

22. [LO 1.3] *Equity Concepts*

**Solution:** Horizontal equity would require persons with equal incomes pay equal amounts of taxes. Vertical equity would require persons with higher incomes to pay a higher percentage of their income than persons with lower incomes. This is the basis of the U.S. tax system.

23. [LO 1.4] *Taxable Persons*

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

24. [LO 1.4] *Gross Income*

**Solution:** The term gross income is an all-inclusive term that includes income from all sources that are not specifically excluded.

25. [LO 1.4] *Basic Tax Model*

**Solution:** The basic elements of the tax model are gross income, less deductions, that equal taxable income or loss. The applicable tax rate is applied to this to determine the gross tax liability. From this tax credits and prepayments are deducted to determine the tax liability owed or the refund due.

26. [LO 1.4] *Capital Losses*

**Solution:** An individual may deduct up to $3,000 of capital losses in excess of capital gains annually; the excess may be carried forward indefinitely to succeeding years. A corporation can only offset capital losses against capital gains; losses are not deductible against other income. Instead the corporation first carries the losses back to the three previous years and then forward for 5 years.

27. [LO 1.4] *Basic Income Tax Rates*

**Solution:** Individuals have basic tax rates of 10%, 15%, 25%, 28%, 33%, 35%, and 39.6% that are applied to their ordinary income. A corporation’s basic tax rates are 15%, 25%, 34%, and 35%, excluding surtaxes.

28. [LO 1.4] *Fiduciaries*

**Solution:** Trusts and estates are two fiduciary entities; a trust is established by a grantor who appoints a trustee to manage the assets for the benefit of the trust’s beneficiaries. An estate is an entity that is created on the death of a person that provides management for the assets in the decedent’s estate until they can be distributed to the beneficiaries. A grantor is the person who creates the trust when assets are placed in the trust for the benefit of the beneficiaries. The trustee is the person selected by the grantor to oversee the assets and ensure the trust functions as specified by the grantor. The beneficiary of the trust is the person for whom the trust was established and who is to benefit from the income from the trust (an income beneficiary) or receive the assets when the trust is closed (the remainderman).

29. [LO 1.5] *Sole Proprietorships*

**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 and must pay self-employment tax. 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 and general partners are required to pay self-employment tax. 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. Partners pay any taxes owing on the income items but loss is deductible only if a partner has sufficient basis. A partner’s basis begins with his or her investment in the partnership and is increased for the partner’s share of partnership liabilities.

 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. Only the managing members of a limited liability company may be subject to self-employment taxes.

30. [LO 1.5] *Corporations*

**Solution:** The principal difference between a C corporation and an S corporation is in the method of taxation. A C 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.

Crunch the Numbers

31. [LO 1.1] *Property Taxes*

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

32. [LO 1.1] *FICA Tax*

**Solution:** $40,000 x 7.65% = $3,060

33. [LO 1.1] *FICA Taxes*

**Solution:** 9,377is withheld for FICA taxes in 2017.

|  |  |
| --- | --- |
| $127,200 x 6.2% = | $7,886 |
| $140,000 x 1.45% = | 2,030 |
| Total | $9,916 |

34. [LO 1.4] *Taxable Income*

**Solution:** Taxable income = $29,600

 $40,000 Salary

 Less 6,350 Standard deduction

 Less 4,050 Personal exemption

 $29,600

35. [LO 1.4] *Taxable Income*

**Solution:** Taxable income = $49,400

|  |  |  |
| --- | --- | --- |
|  | $71,000  |  Salary  |

 Plus 1,500 Interest income

 Less 15,000 Itemized deductions

 Less 8,100 Personal and dependency deductions

 $49,400

36. [LO 1.4] *Taxable Income*

**Solution:** Taxable income = $49,000

|  |  |  |
| --- | --- | --- |
|  | $450,000 | Gross receipts |
| minus |  145,000 | Cost of goods sold |
| equals | $305,000 | Gross income |
| plus |  20,000 | Gain on sale |
| minus |  276,000 | Expenses |
| equals |  $49,000 | Taxable income |

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

37. [LO 1.4] *Taxable Income*

**Solution:** Taxable income = $237,500

|  |  |  |  |
| --- | --- | --- | --- |
|  | $560,000 | Gross income |  |
| plus | 2,500 | Interest income |  |
| minus | 325,000 | Expenses |  |
| equals | $237,500 | Taxable income |  |
|  |  |  |  |

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

38. [LO 1.4] *Taxable Income*

**Solution:** Taxable income = $77,900

|  |  |  |
| --- | --- | --- |
|  | George's salary | $65,000 |
| plus | Mary's salary | 45,000 |
| equals | Gross income | $110,000 |

 minus Itemized deductions 24,000

 minus Personal exemptions 8,100

 equals $ 77,900

39. [LO 1.4] *Determining Tax Liability*

**Solution:** Taxable income = $29,600; income tax = $3,973.75.

 Income Tax: ($9,325 x 10%) + ($20,275 x 15%) = $3,973.75.

40. [LO 1.4] *Determining Tax Liability*

**Solution:** Taxable income = $49,400; income tax = 6,742.50.

Income Tax: [($49,400 - $13,350) x 15%] + $1,335 = $6,742.50

41. [LO 1.4] *Determining Tax Liability*

**Solution:** Taxable income = $49,000; income tax = $7,350.

Income Tax: $49,000 x 15% = $7,350.

42. [LO 1.4] *Determining Tax Liability*

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

 [($237,500 - $100,000) x 39%] + $22,250 = $75,875

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

43. [LO 1.4] *Marriage Penalty*

**Solution:** They have a marriage penalty of $207 ($31,684.50 - $31, 477.50).

MFJ: [($160,000 - $153,100) x 28%] + $29,752.50 = $31,684.50

Single: [($80,000 - $37,950) x 25%] + $5,226.25 = $15,738.75 x 2 = $31,477.50

44. [LO 1.4] *Joint vs. Single Filing*

**Solution:** a.It will be to their advantage to marry in 2017.

b.By marrying before the end of 2017 and filing jointly, they save $6,097.25 ($43,381.75 - $37,284.50) in taxes.

 MFJ: [($180,000 - $153,100) x 28%] + $29,752.50 = $37,284.50

 Single: [($180,000 - $91,900) x 28%] + $18,713.75 = $43,381.75

c. If they each have $90,000 of income, they would each pay $18,238.75 in taxes and they would then have a marriage penalty of $807 ($37,284.50 - $36,477.50). In this case, they would be slightly better off by postponing their wedding until 2018.

 Tax on $90,000 (Single): [($90,000 - $37,950) x 25%] + $5,226.25 = $18,238.75

 $18,238.75 x 2 = $36,477.50

45. [LO 1.4] *Income Tax Liability*

**Solution:** Taxable income = $48,850 and the net tax liability = $6,155.

 $76,000 salary and wages - $15,000 of itemized deductions and $12,150 in personal exemptions = $48,850 taxable income.

Income tax liability is: $1,865 + .15 x [$48,850 - $18,650] = $6,395

 $6,395 - $240 credit = $6,155

46. [LO 1.4] *Tax Liability*

**Solution:** The estate will pay $6,215.60.

|  |  |
| --- | --- |
| $2,550 x 15% =  | $382.50 |
| $3,450 x 25% =  | 862.50 |
| $3,150 x 28% =  | 882.00 |
| $3,350 x 33% = | 1,105.50 |
| $7,500 x 39.6 = | 2,970.00 |
| Total tax | $6,202.50 |

47. [LO 1.4] *Tax Rates*

**Solution**: .05 x ($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

48. [LO 1.4] *Tax Rates*

**Solution: .**03 x ($18,333,333 - $15,000,000) = $100,000

 (.35 - .34)($10,000,000) = $100,000

49. [LO 1.5] *Tax Liability*

**Solution:** William’s income is twice John’s, but his taxes are 2.67 ($10,771.25/$4,036.25) times John’s. This illustrates the progressive nature of the tax system as well as vertical equity.

 [($30,000 - $9,325) x 15%] + $932.50 = $4,033.75

 [($60,000 - $37,950) x 25%] + $5,226.25 = $10,738.75

50. [LO 1.5] *Net Operating Loss*

**Solution:** Lilikoi paid $6,000 tax for 2015 and $30,050 tax for 2016. Lilikoi will have a refund of $9,900 from carrying back $40,000 of the 2017 loss to 2015 and $10,000 of the loss to 2016. (Note that Lilikoi cannot carry the loss back to only 2016 without first carrying it back to 2015.)

 Tax paid for 2015 on $40,000 was $40,000 x 15% = $6,000

Tax paid for 2016 on $120,000 was [($20,000 x 39%) + $22,250] = $30,050.

The $10,000 loss that is carried back to 2016 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 2017 loss is ($40,000 x 15%) + ($10,000 x 39%) = $9,900

51. [LO 1.5] *Determining 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: [($25,000 x 39%) + $22,250] = $32,000 gross tax

 $32,000 - $12,000 tax credit = $20,000 net tax

52. [LO 1.5] *Determining Tax Liability*

**Solution:** Taxable income = $28,650 and the tax liability is $3,833.75

|  |  |  |
| --- | --- | --- |
|  | $46,000 | Salary |
| minus | 7,000 | Partnership loss (50% x $14,000) |
| equals | $39,000 | Gross income |
| minus | 10,400 | Deduction |
| equals | $28,600 | Taxable income |

 Tax: [($28,600 - $9,325) x 15%] + $932.50 = $3,823.75

53. [LO 1.4 & 1.5] *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 the “other ordinary taxable income” is provided; either the standard or their itemized deductions and the personal exemptions have already been subtracted.) June’s $475,000 of other ordinary taxable income puts her in the 39.6% marginal tax bracket because she is a head of household with taxable income over $444,550. John’s $32,000 falls within the 25% marginal tax bracket ($110,000 of taxable income plus the additional $32,000 does not exceed $153,100 – the 25% tax bracket). His $32,000 is taxed at 25% for a married taxpayer filing a joint return.

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

 John’s tax = $32,000 x 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 as shown above for the partnership and together they pay $20, 672 in taxes.

 C Corporation: The corporation pays a tax of $11,000

[$7,500 + ($64,000 - $50,000) x 25%] = $11,000

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

 Note the problem specified only income taxes; employment taxes are not included in the solution to this problem.

54. [LO 1.4 & 1.5] *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 and the partnership pays no tax. 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 and the S corporation pays no tax. 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 x 15%) + ($14,000 x 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 x 20% = $5,600.

 John’s tax = $28,000 x 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 to this problem.

55. [LO 1.4 & 1.5] *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 invested + ($30,000 bank loan x 50%) = $35,000 basis before loss - $22,000 loss = $8,000 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 x 39.6%) and John saves $5,500 ($22,000 x 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 (which does not include any of the corporation’s liabilities). Thus, June benefits from a reduction in taxes of $7,920 ($20,000 x 39.6%) at her marginal tax rate. John reduces his taxes by $5,000 ($20,000 x 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: Neither June nor John 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.

56. [LO 1.4 & 1.5 *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 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 x 15%) on this remaining $6,000 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 $25,000 of the loss (the extent of basis [$15,000 investment + (50% x $20,000 loan)]. Clara’s tax savings will be $7,000 ($25,000 deductible loss x 28%) and Charles’s tax savings will be $6,250 ($25,000 deductible loss x 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 loan x 50%) |
| $25,000 | Basis before deducting loss |
|  - 25,000 | Deductible loss ($54,000 loss x 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 the basis in the S corporation stock. 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 |
| -15,000 | 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%]. The cash distribution is not taxed but is a reduction of basis.

Partner’s basis computations:

|  |  |
| --- | --- |
| 0  | Basis at end of first year |
| $30,000 | Year 2 profit ($60,000 x 50%) |
| - 5,000 | Cash distribution |
| $25,000 | Subtotal |
| - 2,000 | 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%]. The cash distribution is not taxed but is a reduction of basis.

S corporation shareholder’s stock basis computations:

|  |  |
| --- | --- |
| 0 | Basis at end of first year |
| $30,000 | Year 2 profit ($60,000 x 50%) |
| - 5,000 | Cash distribution |
| $25,000 | Subtotal |
| - 12,000 | 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.

57. [LO 1.5] *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

Develop Planning Skills

58. [LO 1.4] *Single vs. Married Filing Status*

 **Solution:**

Married Filing Separately: [($89,700 - $75,950) x 28%] + $14,758.75 = $18,608.75

$18,608.75 x 2 = $37,217.50

Married Filing Jointly: [($179,400 - $151,900) x 28%] + $29,517.50 = $37,217.50

Single: [($89,700 - $37,650) x 25%] + $5,183.75 = $18,196.25 x 2 = $36,392.50

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 $825 ($37,217.50 - $36,392.50) in taxes filing as single individuals this year.

59. [LO 1.4 & 1.5] *Total Tax Comparison*

**Solution:** Sole Proprietorship: Jeremy will be taxed on the entire net income from the sole proprietorship of $68,000 ($80,000 – $12,000) regardless of the “salary.” $68,000 - $10,350 allowable deduction = $57,650 taxable income; [25% x ($57,650 - $37,650)] + $5,183.75 = $10,183.75 income tax.

Corporation: $80,000 - $12,000 - $30,000 = $38,000 taxable income; $38,000 x 15% = $5,700 corporate income tax. Income tax on Jeremy’s $30,000 salary: Jeremy’s taxable income = $30,000 - $10,350 allowable deduction = $19,650. Tax on $19,650 = $927.50 + [($19,650 - $9,275) x 15%] = $2,438.75. Total taxes as a corporation = $5,700 + $2,438.75 = $8,183.75

Based solely on income taxes, Jeremy should incorporate because his taxes will be $2,000 ($10,183.75 - $8,183.75) less than operating as a sole proprietorship.

60. [LO 1.1, 1.4 & 1.5] *Form of Business Operations: C Corporation vs. S Corporation*

**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 = [($59,990 - $50,000) x 25%] + $7,500 = $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 - $6,350 standard deduction and $4,050 personal exemption= $49,600.

 Income tax: ($49,600 - $37,950) x 25%] + $5,226.25 = $8,138.75.

 Carol’s total taxes = $8,138.75 + $4,590 = $12,728.75.

 Total taxes = $15,007.50 + $12,728.75 = $27,736.25

 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 - $6,350 standard deduction and $4,050 personal exemption = $109,590.

 Tax on Carol’s $109,640 taxable income = [($109,590 - $91,900) x 28%] + $18,713.75 = $23,666.95

 Carol’s total tax = $23,666.95 + $4,590 = $28,256.95

 Total taxes = $28,256.95 + $4,590 +$420 = $33,266.95

 Based on 2017 total taxes only, Carol should not make the S corporation election because the total taxes will be $5,530.70 ($33,266.95 - $27,736.25) less operating as a regular C corporation.

Think Outside the Text

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

61. [LO 1.2] *Tax Rates*

**Solution:**

|  |  |  |
| --- | --- | --- |
| Income Tax Rate on salary | Employment Tax Rate | Capital Gains Tax Rate |
| 15% | 7.65% | 0% |
| 28% | 6.2% up to $127,200 and 1.45% on $132,000 | 15% |
| 28% | 6.2% up to $127,200 and 1.45% on $176,000 salary | 15% on $139,000\* |
| 33% | 6.2% up to $127,200; 1.45% on $285,000\* | 15% on the first $133,400 (up to AGI of $418,400) and 20% on remaining $114,650\* |

 \*excluding Medicare surtaxes

62. [LO 1.2] *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.

63. [LO 1.2] *Property Tax*

 **Solution:** As an ad valorem tax, a property tax is proportional. If you use another tax 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 have lived in their home a long time and paid off the mortgage. If it had significantly appreciated (with property tax increases), based on a percentage of their 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 would make it somewhat progressive).

64. [LO 1.2] *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 ($127,200 for 2017), 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.

65. [LO 1.3] *Tax Evaluation Using the 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.

66. [LO 1.4] *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. To some degree taxpayers have a choice now – but the difference in tax rates from single to married filing separately and the requirement that both must either choose the standard deduction or itemize deductions limits their “gaming the system.”

67. [LO 1.4] *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%

68. [LO 1.4] *Deductions vs. Credits*

 **Solution:** Taxable income = $50,000; 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.

Search the Internet

*For the following four problems, consult the IRS Web site (*[*www.irs.gov*](http://www.irs.gov)*)*.

*Check solutions*

69. [LO 1.1] *Statistical Information*

**Solution:** On the IRS.gov home page search for tax statistics or click on Tax Stats, Facts and Figures at the bottom of the page to access *www.irs.gov/uac/Tax-Stats*-2. There 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.

70. [LO 1.1] *Asking Questions or Making Comments to the IRS*

**Solution:** On www.irs.gov/uac/TaxStats-2page under “Additional Information,” 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**.**

71. [LO 1.1] *Statistics of Income*

**Solution:** About SOI, Dissemination Policy, SOI Products and Services, SOI Data Releases, Statistical Methodology, and All Topics

72. [LO 1.1] *Information about the IRS*

**Solution:** At the bottom of the IRS home page, click on "About Us." A list of topics pop up including “The Commissioner’s Section,” “The Agency, Its Mission and Statutory Authority” and “Brief History of IRS” along with other links including Today’s IRS Organization, Equity, Diversity and Inclusion of IRS, Strategic Plan and Other References, Open Government Initiative, Contracting Opportunities, and Contact Us.

73. [LO 1.1] *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 24 in both 2015 and 2016. Thus, 111 days in each year were worked to pay taxes. This date varies greatly when done on a state-by-state basis.

Identify the Issues

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

74. [LO 1.4] *Filing Status*

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

75. [LO 1.5] *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?

76. [LO 1.5] *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?