# Solutions to Chapter 3 Problem Assignments

Check Your Understanding

1. [LO 3.1] *Realization Principle*

**Solution:** Income is not recognized (included in gross income) until the taxpayer has realization. Realization usually takes place when an arm’s-length transaction occurs, such as the sale of goods or the rendering of services. Fluctuations in value are not income unless that change is realized through some transaction.

2. [LO 3.1] *GAAP vs. Tax*

**Solution:** (1) The goals of financial accounting and tax reporting are very different. The purpose of financial accounting is to provide information decision makers, such as shareholders and creditors, find useful, while the goal of tax accounting is to collect revenue equitably.

(2) Financial accounting often relies on the principle of conservatism, which tends to understate income when uncertainty exists. In contrast, the income tax system would be greatly hampered in its collection of revenue if taxpayers were allowed the freedom of reporting income conservatively.

(3) Financial accounting often relies on estimates and probabilities. The tax system would not function very efficiently or equitably if taxpayers were allowed to estimate income or base their reported income on probabilities.

3. [LO 3.1] *Book/Tax Differences*

**Solution:** The two major categories are temporary (or timing) differences and permanent differences. For temporary differences, income is taxed in a different period than it is accrued for accounting purposes. Income that is not taxed but is included in financial accounting income would be a permanent difference.

4. [LO 3.1] *Tax-favored Investments*

**Solution:** Tax law favors investments that yield appreciation rather than annual income. The tax on appreciation (gain) is deferred until gain is recognized and then it is frequently taxed at lower long-term capital gains rates. Congress wants to encourage taxpayers to invest for the long-term as it helps the economy.

5. [LO 3.2] *Choice of Tax Year*

**Solution:** The sole proprietorship’s operating results will all be reported on Michelle’s tax return. As a result, it will have to be on a calendar-year basis unless Michelle applies for and receives permission to change her tax-year end to October 31.

6. [LO 3.2] *Accounting Methods*

**Solution:** Jabba must recognize the fair market value of the computer (assumed to be approximately $2,000) as income in payment of the bill. Cash-basis taxpayers must recognize income when cash or cash equivalents are received as payment. The computer constitutes a cash equivalent.

7. [LO 3.2] *Accounting Methods*

**Solution:** Murphy should recognize the income in year 1. The check was readily available several days before the end of the year and, as a cash-basis taxpayer, Murphy cannot turn its back on the income by failing to pick up the check.

8. [LO 3.2] *Accounting Methods*

**Solution:** Congress put several restrictions on the use of the cash method. But all businesses whose average annual gross receipts for the three prior years do not exceed $26 million in 2019 ($25 million in 2018) may use the cash method. Personal service corporations, no matter how large, can always use the cash method.

9. [LO 3.2] *Tax vs. Financial Accounting*

**Solution:** The government is concerned with collecting its tax revenue when the taxpayer has the “wherewithal” to pay the tax. Thus, the government usually does not permit an accrual taxpayer to postpone the recognition of income not yet earned but for which the taxpayer has received payment. GAAP, however, requires the use of accrual accounting even for prepaid items to properly match income to the periods over which it is earned. This helps to maintain the comparability of financial statements over time that would otherwise be distorted if prepaid items were recognized as income when payment was received.

10. [LO 3.2] *Long-Term Construction Contracts*

**Solution:** A long-term contract is a contract for the manufacture, building, installation or construction of property that will not be completed in the year the contract is entered into. There are two permissible tax treatments: the completed contract method and the percentage-of-completion method. The first allows the contractor to postpone the recognition of income and expenses related to the contract until the year the contract is completed. The percentage-of-completion method allows the taxpayer to recognize income based on the ratio of actual expenses incurred to date to total anticipated expenses for the contract as a whole. The latter method spreads income recognition across the period of time over which the income is earned.

11. [LO 3.3] *Assignment of Income*

**Solution:** Ryan’s gross income is $120,000. He earned the income and he is responsible for including it in his taxable income. He will be treated as making a gift of the $20,000 to his grandmother.

12. [LO 3.3] *Community Property Laws*

**Solution:** For tax purposes, community income is split evenly between spouses who file separate returns in community property states. In common law states, income is usually taxed to the individual who earns the income.

13. [LO 3.4] *Income Tax Effects of Gifts*

**Solution:** Tommy will recognize the $100 dividend income because he is the legitimate owner of the stock at the time the dividend is paid. Virginia has no income.

14. [LO 3.4] *Tax-Exempt Bonds*

**Solution:** The interest exclusion for most state and local bond issues permits state and local governments to finance their governmental activities at much lower interest rates than they would be required to pay if they were competing with corporate bonds.

15. [LO 3.4] *Original Issue Discount*

**Solution:** Martha must include the $840 of accrued interest in her income. The bonds were issued with original issue discount, so this accrued interest must be included in income even by a cash-basis taxpayer.

16. [LO 3.4] *Gross Income/Treasure Find*

**Solution:** Jane should include the $100 in her gross income. Treasure finds also constitute gross income.

17. [LO 3.4] *Gross Income/Unemployment Compensation*

**Solution:** Unemployment compensation is a substitute for the taxable wages a person would receive from his or her employment. A substitute for a form of income that is subject to tax will also be included in gross income and taxed. (The American Reinvestment and Recovery Act allowed the first $2,400 of unemployment compensation received in 2009 to escape taxation, but that provision was never extended beyond the 2009 filing year.)

18. [LO 3.5] *Gross Income/Gifts and Inheritances*

**Solution:** No.The recipients of gifts and inheritances do not include the items received in their gross income. Instead, the giver (donor or decedent) may be subject to a transfer tax (gift or estate tax). Some people consider this transfer tax a second tax because the donor may have been subject to income tax when he or she earned the amounts that were later given as gifts or inheritances.

19. [LO 3.5] *Life Insurance/Buy-Sell Agreement*

**Solution:** A buy-sell agreement is an agreement between co-owners of a business that provides for the purchase of one owner’s interest by the other (and the other heir’s obligation to sell) should the owner die. Life insurance on the deceased payable to the surviving owner(s) provides the funds necessary for the purchase of the deceased owner’s interest.

20. [LO 3.6] *Taxes for a U.S. Citizen vs. Nonresident Alien*

**Solution:** United States citizens are subject to U.S. tax on their worldwide income. Income earned by nonresident aliens is divided into three categories: U.S. business income (called effectively connected income), non-U.S. business income, and U.S. investment income. Nonresident aliens are taxed similar to U.S. citizens on their effectively connected business income. Business income that is not effectively connected with the United States is usually not subject to U.S. tax. U.S. investment income includes interest, dividends, and royalties and is usually taxed at a flat 30 percent rate (or treaty rate if lower).

21. [LO 3.6] *Tax Treaty*

**Solution:** The objective of a tax treaty with a foreign country is to minimize double taxation of the same income by the United States and the foreign country.

22. [LO 3.6] *Foreign Tax Credit*

**Solution:** The purpose of the foreign tax credit is to minimize double taxation of the same income by two countries. Under the source principle, a country can claim the right to tax income earned within its boundaries. To minimize the double tax, the resident country then allows its citizens and corporations to offset the domestic tax on their foreign income with a foreign tax credit up to the amount of tax paid to the source country. The net tax paid will usually be the greater of the taxes imposed by the two countries claiming jurisdiction over the income.

Crunch the Numbers

23. [LO 3.2] *Cash Method*

**Solution:** $575 is included in 2020 gross income for his sole proprietorship

24. [LO 3.2] *Refunds of Prior Income*

**Solution**: a. Because the refund exceeds $3,000, Specialty Training has two choices: it can deduct the $5,000 in the current year or it can reduce the current year’s tax by the amount of tax paid in the prior year on the $5,000.

b. At 37 percent marginal tax rate in the year of repayment, Specialty would be better off taking a deduction for the amount repaid at that time. It will reduce its taxes by $250 [(37% - 32%) x $5,000] more than taking the deduction for prior year’s taxes paid.

c. With a marginal tax rate of 24 percent, Specialty should reduce the current year’s tax for the $1,600 ($5,000 x 32%) of taxes paid in the prior year. It will be $400 [(32% - 24%) x $5,000] better off.

25. [LO 3.2] *Prepaid Rental Revenue*

**Solution:** a.For tax purposes Realty will recognize $6,000 ($3,000 x 2 months’ rent) income in year 1 because prepaid income is taxed when received for both cash and accrual basis taxpayers. For financial accounting no income will be recognized in year 1.

b. For tax purposes, Realty will recognize $8,500 ($3,000 March rent + $3,000 April rent + $2,500 kept from deposit) income in year 2. For financial accounting, Realty will recognize all $14,500 as income in year 2. (Note that a deduction would be allowed for the costs to repair the damages.)

26. [LO 3.2] *Prepaid Service Revenue*

**Solution:** a.$1,000 (1/24 of $24,000) for both tax and financial accounting.

b. $23,000 for tax accounting and $12,000 for financial accounting. Deferral for tax is not permitted beyond the year following the prepayment.

c. $0 for tax accounting and $11,000 ($24,000 - $1,000 - $12,000) for financial accounting.

27. [LO 3.2] *Long-Term Construction Contract*

**Solution:** (1) Under the completed contract method, Highrise will recognize all $250,000 of gross income and $226,000 of costs in year 2. It will recognize no income or expenses in year 1.

(2) Under the percentage-of-completion method, Highrise will recognize $137,500 of gross income ($121,000/$220,000 x $250,000) and $121,000 of expenses in year 1 for net taxable income of $16,500. In year 2, it will recognize the balance of the revenue of $112,500 ($250,000 - $137,500) and expenses of $105,000 for net taxable income of $7,500.

28. [LO 3.3] *Shifting Income to Children*

**Solution:** a. Alana has $10,970 gross income and Mac has none. Mac includes nothing in his gross income because he gave the stock to Alana and is no longer the owner. Alana is taxed on the dividend income ($170) because she was the owner when the dividend was declared and paid. Alana also includes the $10,800 [600 x ($38 - $20)] gain on the sale of the stock in her gross income. She will use Mac’s purchase price (carryover basis) of the stock to determine her gain on the sale.

b. $1,969.50. Because the gain on the sale of the stock is short-term capital gain, it will be taxed at ordinary income rates. Mac’s 32% marginal tax rate would apply to the short-term capital gain and his rate for dividend income would be 15%. Alana’s 12% marginal tax rate applies to the short-term capital gain and her rate for dividend income is zero. The difference in the tax rates on the STCG between Mac and Alana is 20% (32% - 12%) resulting in a $2,160 ($10,800 x 20%) tax savings. The difference in the tax rates on the dividend income is 15% (15% for Mac – zero for Alana) resulting in a $25.50 ($170 x 15%) tax savings. By having the $10,970 total income taxed to Alana rather than Mac, the family has a total tax savings of $2,185.50 ($2,160 + $25.50).

Note that this solution specifies that Alana is age 24. As discussed in Chapter 12, the kiddie tax provision can cause some unearned income of children under age 24 to be taxed at using the tax rates for estates and trusts.

29. [LO 3.4] *Municipal Bonds*

**Solution:** Carl recognizes gain of $3,000 ($43,000 - $40,000) on the sale of the stock. The interest is nontaxable because these are tax-exempt municipal bonds.

30. [LO 3.4] *Taxable vs. Nontaxable Bonds*

**Solution:** a. Jessica’s after-tax cash flow from the municipal bonds is $550 (5.5% x $10,000) because this interest income is tax exempt. For the corporate bonds, Jessica will receive $700 ($10,000 x 7%) in interest income but will pay $84 ($700 x 12%) in tax on that income resulting in an after-tax cash flow of $616 ($700 - $84).

b. Jessica will now pay $224 ($700 x 32%) in tax on the corporate bond interest income resulting in after-tax cash flow of only $476 ($700 - $224) while her after-tax cash flow from the municipal bonds is still $550.

31. [LO 3.4] *Taxable vs. Nontaxable Bonds*

**Solution:** a. Nick’s after-tax cash flow from the municipal bonds is $1,350 (4.5% x $30,000) because this interest income is tax exempt. For the corporate bonds, Nick will receive $1,800 ($30,000 x 6%) in interest income but will pay $630 ($1,800 x 35%) in tax on that income resulting in an after-tax cash flow of only $1,170 ($1,800 - $630).

b. Nick will now pay $396 ($1,800 x 22%) in tax on the corporate bond interest income resulting in after-tax cash flow of $1,404 ($1,800 - $396) while his after-tax cash flow from the municipal bonds is still $1,350.

32. [LO 3.4] *Gift Loan*

**Solution:** a. There are no tax consequences to Joshua or Seth because the loan is not in excess of $100,000 and the proceeds are used for personal expenses (rather than investment); the transaction is not subject to the imputed interest rules.

b. The imputed interest rules treat the transaction as if Seth paid $4,000 in interest ($100,000 x 4%) to Joshua each year with Joshua recognizing $4,000 of interest income; Joshua would then be assumed to make a gift of $4,000 annually to Seth. Thus, Joshua must recognize $4,000 in interest income (from the interest imputed at the federal rate) annually and Seth recognizes $8,000 of interest income (from his investment in corporate bonds). If Seth’s net investment income is less than $4,000, the imputed interest will be limited to the lower net investment income.

33. [LO 3.4] *Employee/Shareholder Loans*

**Solution:** Lynn is assumed to pay Sheldon Corporation $3,200 in interest (4% x $80,000) on the loan. Sheldon has $3,200 in interest income. If Lynn is an employee, Sheldon is assumed to then return the $3,200 to Lynn as taxable compensation, deductible by the corporation. If Lynn is a shareholder, the return of the $3,200 is assumed to be taxable dividend income to Lynn but nondeductible by the corporation.

34. [LO 3.4] *Gross Income from Investments*

**Solution:** $11,800.George must include in gross income all except the $1,000 distributed by ABC as a nontaxable distribution. Thus, his gross income must include the $4,000 taxable distribution from ABC and both the $6,500 dividend and the $1,300 capital gain distribution from Brightstar for a total of $11,800.

35. [LO 3.4] *Stock Dividend*

**Solution:** Cheryl recognizes no income from the receipt of the stock dividend. She will spread the basis of the original 100 shares over the new total of 300 shares. Each of the 300 shares will now have a basis of $3.33 [(100 x $10)/300].

36. [LO 3.4] *Annuities*

**Solution:** a. $3,000. If Charles lives for 15 years, he will receive a total of $165,000 (15 x $11,000). $120,000 of this represents a return of his investment; the remaining $45,000 represents income earned on this investment and is taxable. Of each $11,000 payment, $3,000 [($45,000/$165,000) x $11,000] must be included in income. The remaining $8,000 is a tax-free return of his investment.

b. If Charles dies after receiving only $77,000 (7 years at $11,000 per year), he will have recovered only $56,000 (7 x $8,000) of his total $120,000 investment. The remaining $64,000 ($120,000 - $56,000) can be deducted on his final tax return.

37. [LO 3.4] *Annuities*

**Solution:** $13,750.All of the contributions to Barney’s retirement plan except for the $20,000 from after-tax employee contributions will be taxable when received along with the excess received over the total investment. Thus, of the $240,000 in expected payments, $220,000 is taxable. Of each $15,000 payment, $13,750 [$15,000 x ($220,000/$240,000)] must be included in Barney’s gross income.

38. [LO 3.4] *Income from Lottery Winnings*

**Solution:** Julie must include all $500,000 of each payment received in years 1 through 4 in income when received. When she sells her rights to the remaining 26 payments for $8,900,000, the $8,900,000 must be included in income when received.

39. [LO 3.4] *Social Security Benefits*

**Solution:** $31,600.Vera’s modified adjusted gross income is $64,000 [$18,000 + $38,000 + ($16,000 x 50%)]. Because her MAGI exceeds $34,000, she will have to include up to 85 percent of her Social Security benefits in her income determined as the lesser of (1) $13,600 (85% x $16,000) or $30,000 [85% ($64,000 - $34,000) + $4,500] . The inclusion of the tax-exempt interest in MAGI is sufficient to put her in the position of having to include $13,600 of her Social Security benefits in income. Thus, her gross income is $31,600 ($18,000 dividend income + $13,600 Social Security benefit). Although the tax-exempt bond interest must be included in determining modified adjusted gross income, it is not included in determining gross income for tax purposes.

40. [LO 3.4] *Social Security Benefits*

**Solution:** $5,000.Jeff’s modified adjusted gross income does not exceed $25,000 so none of his $18,000 social security benefits are included in his gross income. His gross income consists of only the $5,000 interest income.

41. [LO 3.4] *Damage Payments for Injuries*

**Solution:** $5,000.Mike must include the $2,000 for emotional distress and $3,000 for lost wages in his income. The $12,000 for the physical injuries is excluded from income as a return of his human capital. His gross income is $5,000.

42. [LO 3.4] *Tax Consequences of Divorce*

**Solution:** a. $95,600. Harriet must recognize the $1,300 monthly alimony payment as ordinary income ($15,600 annually). She will also report an $80,000 ($170,000 - $90,000) capital gain on the sale of the vacation home. She has no income from the child support payments.

b. Stu is permitted to deduct the monthly alimony payments of $1,300 ($15,600 annually) in determining his adjusted gross income.

43. [LO 3.4] *Cancellation of Debt*

**Solution:** Markum must recognize a $15,000 ($60,000 - $45,000) taxable gain on the transfer of the property as if it had sold the property for $60,000 and used the proceeds to pay the debt.

44. [LO 3.4] *Recovery of Bad Debt*

**Solution:** a. Sandle would recognize $15,000 of income in year 1. In year 2 it would write off (deduct) the $15,000 as a bad debt as a result of Jim’s bankruptcy. In year 3, it would recognize $12,000 of income on the recovery of that portion of the debt that had been written off in the prior year.

b. If Sandle is a cash-basis taxpayer, it would recognize no income in year 1, would have no deduction in year 2, but would recognize $12,000 of income in year 3.

45. [LO 3.4] *Taxable vs. Nontaxable Bonds*

**Solution:** a. Krystyna’s after-tax cash flow from the municipal bonds is $950 (4.75% x $20,000) because this interest income is tax exempt. For the corporate bonds, Krystyna will receive $1,000 ($20,000 x 5%) in interest income but will pay $120 ($1,000 x 12%) in tax on that income resulting in an after-tax cash flow of $880 ($1,000 - $120).

b. Krystyna will now pay $320 ($1,000 x 32%) in tax on the corporate bond interest income resulting in after-tax cash flow of only $680 ($1,000 - $320) while her after-tax cash flow from the municipal bonds is still $950.

46. [LO 3.3 & 3.4] *Shifting Income to Children*

**Solution:** a. Carlos has $9,200 gross income and Justin has none. Justin includes nothing in his gross income because he gave the stock to Carlos and is no longer the owner. Carlos is taxed on the dividend income ($200) because he was the owner when the dividend was declared and paid. Carlos also includes the $9,000 [450 x ($38 - $18)] gain on the sale of the stock in his gross income. He will use Justin’s purchase price (carryover basis) of the stock to determine his gain on the sale.

b. $2,254. Because the gain on the sale of the stock is short-term capital gain, it will be taxed at ordinary income rates. Justin’s tax rate is 37% for the short-term capital gain and 20% for dividend income. The difference in the tax rates between Justin and Carlos on the short-term capital gain is 25% (37% - 12%) resulting in a $2,250 ($9,000 x 25%) tax savings. The difference in the tax rates on the dividend income is 20% (20% for Justin – zero for Carlos) resulting in a $40 ($200 x 20%) tax savings. By having Carlos taxed on the $9,200 total income rather than Justin, the family has a total tax savings of $2,290 ($2,250 + $40).

c. $1,840. The gain on the sale of the stock is now long-term capital gain (8 months + 5 months = 13 months holding period) because Justin’s holding period tacks on to the period the gift is held by Carlos. Justin’s tax rate is 20% for the long-term capital gain and dividend income while Carlos has a zero rate for the long-term capital gain and dividend income. The difference in the tax rates between Justin and Carlos is 20% (20% for Justin – zero for Carlos) resulting in a $1,840 ($9,200 x 20%) tax savings.

This solution does not include the 3.8% net investment income (NII) Medicare surtax discussed in Chapter 5. Also note that this solution specifies that Carlos is age 24. As discussed in Chapter 12, the kiddie tax provision can cause some unearned income of children under age 24 to be taxed at the tax rate for estates and trusts.

47. [LO 3.5] *Property from Gift or Inheritance*

**Solution:** Myra must include only the $7,000 interest from the bonds in her income. The receipt of a gift or inheritance is not subject to income tax.

48. [LO 3.5] *Life* *Insurance Proceeds*

**Solution:** a. Zero. If Linda takes the lump-sum $500,000 payment, she recognizes no gross income, as life insurance proceeds are usually are not taxable.

b. $8,000 each year. If she elects to take the insurance proceeds in annual installments, $80,000 of the total $580,000 (10 x $58,000) expected to be received will represent taxable interest. Of each annual $58,000 payment, $8,000 ($80,000/$580,000 x $58,000) will be income and $50,000 ($500,000/$580,000 x $58,000) will be tax free.

49. [LO 3.5] *Disability Insurance*

**Solution:** $16,500.A portion of each payment that represents the premium paid by Mark’s employer is taxable income to Mark. Thus, if Mark collects $30,000 under the disability policy, $16,500 (55% x $30,000) must be included in gross income and the remaining $13,500 (45% x $30,000) is tax free.

50. [LO 3.5] *Scholarships*

**Solution:** $4,000 is included in income. Sara must include the $1,000 that was spent for room and board and the $3,000 from her part-time job on campus in her income. Only the money spent for tuition and required textbooks qualifies as the nontaxable portion of the scholarship.

51. [LO 3.5] *Scholarships*

**Solution:** $400 in year 2.Larry spent only $6,600 ($3,200 + $3,400) on qualified expenses from the scholarship money. Thus, he must include the $400 ($7,000 - $6,600) not spent on qualified expenses in income. He does not have to include this amount until year 2, however.

Develop Planning Skills

52. [LO 3.2] *Accounting Methods*

**Solution:** The cash method of recognizing income and expenses, if available, usually provides the higher net present value for the company’s cash flow. Income is not recognized until payment is received. This is usually later than when income would be recognized under the accrual method. By delaying the recognition of income, the payment of taxes on this income can be delayed. In addition, cash-basis taxpayers may have the ability to make early payments for expenses at year-end, accelerating their deductions. A deduction in the current year may be worth more than the same deduction in the next year due to the time value of money

53. [LO 3.2] *Prepaid Rent*

**Solution:** If $4,000 is designated as the last two months’ rent, $4,000 must be included in income when received. If only $2,000 is designated as rent, then only $2,000 must be included in income when received. Thus, the designation of $4,000 as security deposit is better for Palace Company from a tax standpoint (although they might lose prospective tenants with a high security deposit).

54. [LO 3.4] *Investment Alternatives*

**Solution:** With a marginal tax rate of 37 percent, her after-tax return on the corporate bonds is only 5.67 percent [9% x (1-.37)]. She would be better off investing in the tax exempt bonds that pay 6 percent. With a marginal tax rate of only 22 percent, her after-tax return on the corporate bonds improves to 7.02 percent [9% x (1- .22)], and she would be better off investing in the corporate bonds.

Think Outside the Text

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

55. [LO 3.2] *Doctrine of Constructive Receipt*

**Solution:** Based on the doctrine of constructive receipt, the tax court judge would rule in favor of the IRS. The doctrine of constructive receipt requires Walter to recognize the income when the funds were made available to him. The $77,000 should be included as income in the year the original check was received. The fact that a tear slip exists, indicates that the check was received. If the check was detached and not received with the tear slip, Walter should have contacted the customer and requested another check to be sent immediately. This was the decision of the court in *Walter v. U.S.*, 92 AFTR 2d. 98-5115, 148 F. 3d 1027, 98-2 USTC ¶50546.

56. [LO 3.4] *Social Security Benefits*

**Solution:** The student should present a logical argument for or against the 100 percent tax rate on Social Security benefits of high-income individuals so answers will vary. They may consider the following points.

The Social Security Act states that every individual who meets program eligibility requirements is entitled to benefits so it is referred to as an entitlement program. Social Security was originally designed as social insurance meant to ensure that, regardless of which might happen with their personal finances and retirement savings over the course of their lifetime, elderly Americans would be protected by a government-based safety net that would prevent destitution in old age. The concept of Social Security as an earned right has helped ensure its high level of public support.

Public attention has recently focused on Social Security’s long-range financial problems with policy reformers suggesting that Social Security should be subject to some form of means testing. People in favor of means testing argue that this would save a large amount of money by reclaiming benefits from wealthy Americans who can get along fine without them while still allowing Social Security to serve its basic purpose of providing a safety net to the elderly. Higher-income individuals would be guaranteed that if their income level declined, they would be able to keep a greater share of their benefits.

People against means testing argue that Social Security would be fundamentally changed from social insurance to a redistributive welfare program. They argue that means testing would create a disincentive for people to save, buy other insurance, or work part-time in retirement. They also argue that such a system would create pressure for younger workers to be able to opt out of Social Security, threatening to undermine its political viability in the long term.

57. [LO 3.4] *Retroactive Changes*

**Solution:** The student should try to present logical arguments why the retroactive inclusion of certain items in income should or should not be permitted by laws passed late in the year. For a long time it has been understood that interest on tax-exempt bonds has been excluded from income because Congress has continued the exclusion; it could change the law whenever it votes to do so. For a number of years now, Congress has retroactively reinstated deductions so there is significant precedence for Congress to be allowed to act at any time during the year and have those actions apply retroactively to the beginning of the tax year. The primary argument against allowing this type of retroactive law is that it does not allow taxpayers to plan adequately. However, it is hard to argue that the law that states Congress can tax income from whatever source would not apply to income earned during the year the law is passed. It would be a different matter if Congress were to act retroactively to tax items received in prior tax years as there has always been the concept of tax years to provide closure for the taxpayer for prior years.

58*.* [LO 3.4] *Alimony Recapture*

**Solution:** Part of any payments structured as alimony payments that decrease by more than $15,000 per year from year 1 to year 2 and then again from year 2 to year 3 can be recharacterized as property settlements. The portion so recharacterized must be recaptured (taken into income) by the payor and can be deducted by the recipient in the third year. To prevent this reclassification as nondeductible property settlement, alimony payments during the first three years should not decrease by more than $15,000 between years.

59. [LO 3.5] *Insurance Transfer*

**Solution:** Joe will have income for the $800 ($5,000 - $4,200) portion of the debt that Willy forgives as part of accepting the cash surrender value of the policy to cancel the debt. When Joe is killed, Willy’s basis in the insurance policy is $5,050 ($5,000 debt + $50 premium payment). He will have income of $19,950 on the collection of the $25,000 from the insurance policy. When a policy is transferred to a third party for money or money’s worth, the receipt of the face value of the policy is no longer tax free. Income must be recognized based on the proceeds received and the purchaser’s investment in the policy at the time of the decedent’s death.

60. [LO 3.2, 3.4 & 3.5] *Doctrine of Constructive Receipt*

**Solution:** This question is based on an Oprah Winfrey show. The only significant difference is that Oprah gave more than 300 audience members debit cards for only $1,000 each.

1. Does the receipt of the debit card (“prize”) result in $16,000 taxable income to the recipient even if the recipient does nothing further with the card? Even though the prize is not supposed to be used for one’s own use, would the recipient’s control over the disbursement of the proceeds from the debit card be sufficient to cause the recipient to have taxable income under Section 61? Do constructive receipt principles apply? Reg. Sec. 1.451-2 states “...income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions.” Will the stipulation that the use of the card be for a charitable cause amount to a “substantial limitation or restriction”? There does not appear to be a way for the show to effectively enforce this so it is doubtful that this stipulation will qualify as a substantial restriction but there is no authority directly on point.

2. If the receipt of the card is not itself a taxable event, what about the actual usage of the card? What are the ramifications for the audience participants who transfer the $16,000 to their selected person or cause? The drawing down of cash (regardless of the intent for so doing) is actual (not merely constructive) receipt of the money. This will substantially increase the risk that the recipient of the debit card has gross income under Section 61 at the moment of cash withdrawal. Again, there is no authority directly on point.

3. If the audience members give the money to a qualified charitable organization, the individuals can claim a charitable contribution deduction only if they itemize their deductions. If they have no other itemized deductions, their tax benefit from the contribution will be limited to the amount it exceeds their standard deduction (thus, not completely offsetting their $16,000 gross income).

4. If the audience members donate the money to a needy person instead of a qualifying charitable organization, they would have $15,000 of gross income and would have made a taxable gift of $1,000 ($16,000 gift less $15,000 annual exclusion) assuming they had not given other amounts that year to the same donee.

5. Will the Bank of America be able to deduct the payouts on the debit cards as a business expense (possibly as marketing)? Most likely it will get some deduction. The bank would not, however, qualify for any charitable contribution deductions because it has no control over which donees are selected by the audience members.

6. Must the value of the DVD recorders be included as taxable income as a prize? Alternatively were the DVD recorders merely “loaned” to the audience members, to be returned when the future show is taped? Will only those audience members who return for the future show (with a recorded story for use on the show) be permitted to keep the recorder? Will they have taxable compensation income from providing their video recording services in exchange for being permitted to keep the DVD recorders? It certainly seems likely they would have taxable income.

Search the Internet

61. [LO 3.4] *Locate IRS Publication and Calculate Income*

**Solution:** $2,500.Add one-half of $10,000 social security benefits to the $20,000 dividend income and the $5,000 of tax-exempt bond interest, resulting in a total of $30,000. Subtract the $25,000 base amount for a single individual from the $30,000 total yielding $5,000 in excess of the base amount. Because the excess beyond the base amount ($5,000 excess) is less than $9,000, no more than half the benefits will be taxed. Compare $2,500 (half of the $5,000 excess beyond the base amount) to $5,000 (half of the Social Security benefits of $10,000). The smaller of these two ($2,500) is included in the taxpayer’s gross income. Thus, the taxpayer’s gross income is $22,500 ($20,000 dividend income + $2,500 taxable Social Security income).

62. [LO 3.4] Locate IRS Publication and Determine Countries Where Exempt

**Solution:** U.S. citizens who are residents of the following countries are exempt from U.S. tax on their benefits: Canada, Egypt, Germany, Ireland, Israel, Romania, and the United Kingdom. A resident of Italy is exempt but only if also a citizen of Italy.

63. [LO 3.4] *Dividend Income from Foreign Corporations*

**Solution:** Dividend income received from foreign corporations located in China or Jamaica will be treated as qualified dividends eligible for the reduced tax rate. However, dividend income from Bermuda and the Netherland Antilles is not eligible for the reduced dividend tax rate.

64. [LO 3.5] *Consequences of Frequent Flyer Miles*

**Solution:** The IRS policy for now is that it will not assert that a taxpayer has understated his or her federal tax liability because of the receipt or personal use of frequent flyer miles attributable to business or official travel. Any future guidance on the taxability of these benefits will be applied prospectively only.

Identify the Issues

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

65. [LO 3.2] *Barter Transactions*

**Solution:** Will Jason or Bob’s Auto Repairs be required to recognize any income as a result of this barter arrangement? Will they be entitled to a deduction for repair expenses?

66. [LO 3.2] *Prepaid Rent*

**Solution:** How should the landlord treat the prepayment of 3 months’ rent that is characterized as part rent and part security deposit? In which year(s) is income recognized and does the answer change if the landlord is an accrual basis taxpayer rather than cash basis?

67. [LO 3.2] *Timing and Amount of Income*

**Solution:** When should Sid’s Body Shop recognize the income for the repair work? How should it handle the reduction in expected payment from $2,000 to $1,700?

68. [LO 3.4] *Treasure Find*

**Solution:** Does Gillian have any taxable income as a result of her treasure find? If yes, how would the amount of income be determined?

69. [LO 3.4] *Treasure Find*

**Solution:** Does Nelson have any taxable income as a result of find the money?

70. [LO 3.4] *Cancellation of Debt*

**Solution:** Does Sharp Corporation have income or other tax consequences as a result of the creditor writing off $20,000 of its debt?

71. [LO 3.6] *Bond Interest*

**Solution:** Is interest income on bonds issued by a foreign governmental entity taxable or tax-exempt?

Develop Research Skills

Solutions to research problems 72 – 76 are included in the Instructor’s Manual.

Fill-in the Forms

The solution to tax form problem 77 is included in the Instructor’s Manual.