

**Answers to Selected PAK Problem Materials:
Unit 01: An Introduction to Taxation (PAK Pages 1-31 to 1-36)**

Discussion Questions

I:1-1 It is possible for the government to raise taxes without raising tax rates. Because there are two components in computing a taxpayer's tax, the tax base and the tax rate, taxes can be raised by increasing either the rate or the base. Thus, even though the Governor proclaimed that tax rates have remained at the same level, adjustments to the tax base, such as the elimination of deductions, result in tax increases as much as increases in tax rates. p. I:1-4.

I:1-2 The marginal tax rate is of greater significance in measuring the tax effect for Carmen's decision. The marginal tax rate is the percentage that is applied to an incremental amount of taxable income that is added to or subtracted from the tax base. Through the marginal tax rate, the taxpayer may measure the tax effect of the charitable contribution to her church. If her marginal tax rate is 25%, she will save 25¢ for each \$1 contributed to her church. The average tax rate is simply the total tax liability divided by taxable income. pp. I:1-5 and I:1-6.

I:1-3 Carlos' tax basis for the stock is \$10,000, the fair market value on the date of death. pp. I:1-9 and I:1-10.

I:1-19 To properly respond to Bruin, tax calculations for both Bruin Corporation and John Bean must be made for the year.

\$400,000 dividend. If the \$400,000 is distributed to John as a dividend, Bruin Corporation would get no deduction for the dividend and would have corporate taxes of \$170,000 (see corporation rate schedule) based on taxable income of \$500,000. John would pay a maximum rate of 15% on the dividend, so the income taxes due by John would be \$60,000. Thus, the total income taxes would be \$230,000 (\$170,000 + \$60,000).

\$400,000 salary. If the \$400,000 is distributed to John as a salary, Bruin Corporation would be allowed a deduction and the corporation's taxable income would be \$100,000. The corporate tax on \$100,000 is \$22,250. John would be required to pay income taxes on the \$400,000 at 35%, so the tax would be \$140,000. The total income taxes for the year would be \$162,250.

As can be seen from the analysis above, the \$400,000 salary would result in considerable smaller taxes. This results even though John is in the top 35% tax bracket. The tax savings would be even higher if John were in a lower tax bracket. Pp. I:1-19 and I:1-20.

I:1-26 Even though the Code is the highest authority of tax law sources, the Code contains general language and does not address the many specific situations and transactions that occur. To resolve tax questions concerning specific situations, administrative rulings and court decisions are an integral part of the income tax law. p. I:1-24.

Problems

I:1-42 a. The amount of Clay's taxable estate is \$4,100,000. This amount is computed as follows:

| | |
|-----------------------------|--------------------|
| Gross estate | \$4,800,000 |
| Minus: Marital deduction | (500,000) |
| Funeral and Admin. Expenses | (125,000) |
| Debts | (75,000) |
| Taxable Estate | <u>\$4,100,000</u> |

b. The tax base for computing Clay's estate tax is \$4,100,000, computed as follows:

| | |
|------------------|--------------------|
| Taxable estate | \$4,100,000 |
| Gifts after 1976 | <u>0</u> |
| Estate tax base | <u>\$4,100,000</u> |

c. If the tentative estate tax is \$1,725,800, estate tax due is computed as follows:

| | |
|----------------------------------|-------------------|
| Estate tax from rate schedule | \$1,725,800 |
| Minus: Unified tax credit (2009) | (1,455,800) |
| Estate tax due | <u>\$ 270,000</u> |

d. Yes, because the aggregate value of the estate decreased during the six-month period following the date of death, the alternate valuation date may be selected by the administrator. The important factors in deciding whether to use the alternate valuation date are (1) the amount of estate taxes to be saved, and (2) the impact on the beneficiaries income tax situation.

Note: There can never be a tax refund even if the unified credit is greater than the tax liability. pp. I:1-9 and I:1-10.

I:1-45 Since Paul's return is filed late and the final balance due on the return is paid late (both due on or before April 15, 2009), Paul is subject to further interest and penalties on his 2008 income tax return. Both interest and penalties are computed on the net tax due or, in this case, \$5,630 (\$32,920 minus \$27,290). The interest and penalties are computed as follows (assuming an 8% interest rate on underpayments on tax and the return is 228 days late):

$$\text{Interest: } \$5,630 \times 6\% \times 228/365 = \$211.01.$$

There are two penalties to which Paul would be subject, a failure to file (timely) penalty and a failure to pay the tax (timely) penalty. The late payment penalty is .5% per month to a maximum of 25%; the late filing penalty is 5% per month to a maximum of 25%. However, both penalties are not assessed together. If both penalties apply, the failure to file penalty is reduced by .5%.

Penalties: **Late filing penalty** (5% per month to a maximum 25%) $\$5,630 \times 25\% = \$1,407.50$.

*Because the late payment penalty below is assessed, the penalty is 4.5% per month; however, the return was filed 7½ (treated as 8 months under the tax law) months late, the maximum penalty of 25% applies.

Late payment penalty (.5% per month to a maximum 25%) $\$5,630 \times 1.5\%^{**} = \84.45 .

Three months times .5% = 1.5%. The first five months penalty are included in the 5% penalty above.

Thus, Paul must pay an additional \$211.01 of interest and \$1,491.95 (\$1,407.50 + \$84.45) of penalties for filing his return late. Obviously, Paul would be prudent to file his return in a timely manner. pp. I:1-28 and I:1-29.

- I:1-46** a. Of the three individuals, Connie would most likely be audited. Individuals who have unincorporated businesses that produce significant tax losses are likely to get audited by the IRS.
- b. Craig is not likely to be audited.
- c. Dale is not likely to be audited. However, it is likely that the Form 1099 will be checked against the reported amount and the IRS Center will send Dale a bill for the corrected amount of tax. p. I:1-27.

Tax Strategy Problem

I:1-48 Pedro is in a perfect position to begin a gifting program to his children. Since he has such a significant portfolio of stocks and bonds, he could make annual gifts of \$13,000 of stocks and bonds in 2009 and future years to each of his children. The effect of these gifts are to shift the dividends and interest from Pedro (at his high rate) to the children (at their low rates) as well as removing these assets from Pedro's estate upon his death. Since the children have no income, the dividends and interest would be taxed to the older two children at the lowest marginal income tax rates.

As will be discussed in Chapter I:2 of this text, the younger child will be taxed at his parent's rate for much of the income shifted to him per the so-called "kiddie tax." Thus, the shifting of investment income is not effective for children under the age of 18 (or 24 and in college). Also, as will be discussed later, Pedro and his wife can actually gift \$26,000 (\$13,000 x 2) per year and over a few years; a sizeable amount of assets can be transferred to the children. To protect the assets, the gifts can be made to trusts rather than directly to the children to insure that the children do not make bad decisions during their youthful years.

There are many other aspects of this type of tax strategy but this problem is intended to demonstrate both the income and estate tax savings that can be accomplished through the making of annual gifts.

Case Study Problem

I:1-49 a. The deductibility of the loss on the rental of the beach cottage depends upon mechanical rules contained in Sec. 280A dealing with the number of days of personal and rental use. Further limitations may be imposed under the passive activity loss rules contained in Sec. 465. Thus, Mr. Gemstone should be asked to provide documentation as to the rental and personal use of the

cottage. It may also be necessary to determine whether Mr. Gemstone has income from other passive activities if the passive loss rules apply.

Questions need to be raised regarding the valuation of the painting to the local art museum and whether an appraisal was obtained. Under current rules, since the value of the painting is greater than \$5,000, an appraisal from a qualified appraiser is required. In addition, the use of the painting by the art museum determines the amount of the charitable contribution deduction (e.g., the deduction is measured by its fair market value if the painting is used by the museum but is limited to its adjusted basis if the painting is disposed of by the museum).

The deductibility of the \$15,000 loss from the cattle-breeding ranch depends upon whether the activity is a hobby or a business. Therefore, it is necessary to ascertain such factors as whether the activity has been conducted in a business-like manner and whether the taxpayer has expertise and prior experience with cattle breeding operations. It is necessary to review the Treasury Regulations in Reg. Sec. 1.183 dealing with the factors that are considered in making this determination.

b. It is necessary to review the appropriate code sections and Treasury Regulations pertaining to these three issues (i.e., Secs. 280A, 465, 170, and 183). Other authorities such as court cases and IRS rulings should be reviewed to determine the weight of authority for deducting any or all of the losses and deductions and to "build the best possible case" for Mr. Gemstone.