

Answers to Selected PAK Problem Materials: Unit03

PAK Chapter 3. Gross Income-Inclusions

I:3-5 A loan repayment is not consistent with the normal meaning given to the word income. A taxpayer is no better off because a loan is repaid. There has been no economic benefit. As a result the repayment of a loan is not taxable simply because it is not income. p. I:3-3.

I:3-8 No. The form of payment (cash, property, or services) is usually unimportant. The important question is whether the taxpayer receives economic benefit. p. I:3-4.

I:3-11 Jane is taxed even if her father is the employer. The same result would take place even if her wages were paid to one of her parents. If a child under age 18 (and under age 24 in some cases) has unearned income over \$1,900, that income is, however, taxed at the parents' tax rates. Alternatively, the parents may elect to include the child's unearned income on their tax return. Since Jane has earned income the \$3,000 of wages are not subject to the kiddie tax rules and are not included on the parent's return. This is true even though Jane is under age 18. p. I:3-8.

I:3-18 a. Interest on U.S. government obligations (issued after February 29, 1942) and foreign government obligations are taxable. A limited exclusion is available for Series EE savings bonds if the bond proceeds are used for educational purposes. Interest on obligations of states, territories, U.S. possessions and their political subdivisions is tax exempt. There are exceptions for federally insured, arbitrage, and private activity bonds.

b. In general, tax exempt bonds pay a lower interest rate than taxable bonds because investors are willing to accept a lower return on tax exempt investments.

c. No. In general, investors in lower tax brackets are better off investing in taxable bonds because their after tax return is generally higher. pp. I:3-13, I:3-14, and I:3-29.

I:3-30 One point that they should realize is that if they accept the offer for the automobile that a portion of their social security benefits will be taxable because their provisional income would be greater than the base amount of \$32,000 (married filing jointly).

Also, there is some question as to the type of income to be reported from the sale of the automobile. Ordinarily, gains on the sale of investment and personal use assets are capital gains. The fact that the gain is attributable to the work they did themselves could cause the gain to be treated as ordinary. However, if this is the only automobile they have restored they probably are not considered to be in the automobile restoration business. Should they be in the automobile restoration business, they would also owe self-employment tax.

The automobile probably is not covered by Sec. 1221 which classifies "artistic compositions" and **similar property** as ordinary assets. Reg. Sec. 1.1221-1(c) defines "similar property" to include theatrical productions, radio programs, newspaper cartoon strips, and other property eligible for copyright protection. pp. I:3-24 through I:3-26.

I:3-35 Amounts (a) and (b) have been constructively received. Amount (d) and (e) were unavailable to the taxpayer. Amount (c) was not constructively received because there were no funds available. pp. I:3-9 and I:3-10.

I:3-46 Because this annuity is derived from Beth's employer's retirement plan, the simplified method is used. As Beth is age 65, the number of anticipated payments is 260. She can exclude \$50.40 of each monthly payment ($\$13,104/260$). Assuming that Beth receives 12 monthly payments during the year, the total exclusion is \$604.80. pp. I:3-19 through I:3-22.

I:3-52 a. Although she must subtract the AGI floor of \$2,250, Jan can deduct the remainder of the medical expense payments of \$6,750 ($\$9,000 - \$2,250$) if she pays the balance of \$9,000 in 2009.

b. If she pays and deducts the expenses in 2009, she must include a portion of the reimbursement in her 2010 gross income under the tax benefit rule. She received tax benefit of \$6,750 from the medical expense deduction in 2009. Thus, Jan is required to include \$6,750 in gross income as a result of the reimbursement in 2010. pp. I:3-26 and I:3-27.

I:3-55 a. They would save \$140 ($0.35 \times \400) per year. The daughter would not be subject to tax on any of the interest. ($\$400$ interest - $\$950$ standard deduction).

b. They would save \$140 of taxes per year, but would lose \$100 [$\$400 - (0.06 \times \$5,000)$] of interest. Thus, they would be better off to acquire the tax-exempt bonds.

c. They would save \$350 ($0.35 \times \$1,000$). This assumes no phase-out of itemized deductions.

d. If the salary is reasonable, the full \$10,000 should be deductible as a business expense. Otherwise, the amount deemed unreasonable would be treated as a gift. If other gifts were made during the year it could result in a gift tax. The salary would be taxable to the daughter as income assuming it is not a gift. The parents will save \$3,500 in taxes. pp. I:3-13 and I:3-29.

I:3-62 The memo for the file should include the following points:

1. Child support payments are not included in gross income. As the cash payments were designated as child support by Jim, this characterization is likely to be followed. The transfer of the automobile probably is not taxable as alimony income as the alimony rules require that such payments be made in the form of cash.

2. It follows that Jim is not entitled to deduct any of the payments. If Linda agrees in writing he could receive a dependency exemption and child credit. The fact, however, that he was unemployed much of the year may mean that he owes little if any tax, and that he would not benefit from additional deductions or credits. pp. I:3-18 and I:3-19.

I:3-63 The following points should be discussed in your memo:

1. The main advantage of purchasing Series EE bonds in the parents' names is that they may be able to exclude the interest income they eventually receive. They must meet the basic requirements that the funds be used for educational purposes and meet the income limitation. As the limitation is indexed for inflation and their future income is unknown, the parents cannot be certain whether they will be entitled to the exclusion.

2. If the bonds are purchased in the names of the children and they are under 24 years of age, the interest may be subject to the "kiddie" tax. Nevertheless, if the annual interest is less than

\$1,900 per child and the children elect to report it each year there will be little tax even if the children are under age 24 and no tax if the income is under \$950.

3. The fact that the parents expect high income means that purchasing the bonds in the names of the children may be more desirable. This is true if either the annual income is under \$1,800 per child or the children are over 23 years of age.

4. The fact that the children may have other income in the future means that the children may face significant future taxes if the bonds are purchased in their names. This is particularly a problem if the children are under age 24 because the parents' tax rate may apply to all of the interest income. If that is the case the children would probably benefit from waiting to report the interest when the bonds are redeemed. pp. I:3-14, I:3-16, I:3-30 and I:3-31.

I:3-64 The primary ethical issue relates to how you can adequately advise both clients when their interests may conflict. For example, only one spouse may receive a dependency exemption for a child. Also, whether payments are taxable as alimony or treated as nontaxable property settlements depends on the terms of the divorce. It may well be possible to inform both Lee and Jane as to the relevant tax rules. Nevertheless, one may find it difficult to recommend arrangements that both will find satisfactory. For example, Jane may not want you to advise Lee that there is a rule that enables him to claim children as dependents if she has custody of any children. Similarly, she might not want to tell Lee that labeling payments as property settlements will mean that they cannot be deducted as alimony even though other requirements are met. On the other hand, Lee may not want you to tell Jane that receiving low basis assets could increase the tax she will have to pay when she sells those assets. As a result the information you provide and the advice you give may alienate you from one or both persons. Depending on the situation, it may be desirable to recommend that either Lee or Jane seek advice from another professional tax consultant about relevant tax issues.