Answers to Selected PAK Problem Materials: Unit04
PAK Chapter 4. Gross Income – Exclusions

- PAK, Chapter 4 ***Discussion Questions***: 4-5, 4-6, 4-10, 4-17, 4-24
- PAK, Chapter 4 ***Problems***: 4-37, 4-41, 4-44, 4-53
- PAK, Chapter 4 ***Case Study:*** 4-61

Discussion Questions

I:0-1 a. Income earned prior to the gift is taxable to the donor while income earned after the gift is taxable to the donee.

b. The total tax liability can be reduced if the donee is in a lower income tax bracket than the donor. pp. I:4-4 and I:4-5.

I:0-2 a. Motive plays an important role. For a transfer to be a gift, it must be made for reasons such as love, affection, kindness, sympathy, generosity, or admiration.

b. Tips are considered to be compensation for services. This is true even though generosity or other motives may be present. pp. I:4-4 and I:4-5.

I:0-3 a. A scholarship is an amount paid or allowed to, or for the benefit of, a degree candidate to aid the individual in pursuing his or her studies.

b. The exclusion is limited to amounts awarded for tuition, books, fees, supplies, and equipment. As a result, if a scholarship either exceeds the total amount of qualifying expenses or, alternatively, the scholarship is specified as being for nonqualifying expenses, the scholarship will be at least partially taxable.

c. It is likely that such a scholarship will be viewed as compensation for future services, and will, therefore, be taxable. The expenses incurred by the employee may be deductible education expenses.

d. No. The amounts will normally be taxable compensation. p. I:4-7.

I:0-4 As there is no exclusion for premiums paid on a whole life policy, the officers must include the amount of the premiums in gross income. Because of the discriminatory practices relative to discounts on products, the officers must include the discounts in gross income. Whether the payment of social club expenses is taxable depends on the use of the club. The officers may exclude payments from gross income to the extent they are business related. The payment of any personal portion of social club expenses is taxable income to the officers. The free parking provided by the employer is not taxable even if it is only provided to the officers. This is true even if the benefit is provided to the officer on a discriminatory basis. pp. I:4-10 through I:4-14.

I:0-5 a. There are four instances where a discharge of indebtedness is not a taxable event. They are discharges that occur in bankruptcy, discharges relating to business real property, certain discharges relating to student loans, and discharges that occur when the taxpayer is insolvent.

b. A father's forgiveness of a daughter's debt may be motivated by reasons such as love and affection. As a result the forgiveness may be a gift and excluded from gross income. pp. I:4-20 and I:4-21.

Issue Identification Questions

I:0-6 a. Although Sue has a very serious health problem she is not terminally ill. As a result, no special exclusion is available for the lump sum payment received. If she accepts the lump sum settlement, she would be required to include in gross income the amount she receives in excess of the premiums she has paid $145,000 ($225,000 -$80,000).

b. Sue does not have to report any gross income from the annuity, as the benefits are less than the cost of her long-term health care.

c. She may exclude the full amount, as the benefits are less than $280 per day.

pp. I:4-8 through I:4-10.

I:0-7 Otto must include his salary of $50,000 and the grant of $2,000. Although not specifically asked, it is noted that the expenses related to the grant are deductible. Because the expenses are reimbursed, the deduction is for AGI. Although the other employment related expenses totaling $1,000 would qualify as itemized deductions, they are less than the 2% of AGI floor. p. I:4-7.

I:0-8 a. $5,600 ($4,000 + $700 + $600 + $300). Data Corp. can deduct the premiums paid on the group term policy.

b. Neither Bob nor Damitria is required to report any premiums as income as the group coverage is less than $50,000. Andy must report $1,188 of gross income which is computed as follows: $.66 per thousand x 12 months x $150,000 of excess coverage/$1,000. Cindy must report $28.80 computed as follows: $.08 per thousand x 12 months x $30,000 of excess coverage/$1,000. pp. I:4-9 through I:4-12.

I:0-9 a. Under Sec. 104 taxpayer will have to include the entire $40,000 award in gross income as there is no indication of physical injury nor are there any medical expenses.

b. Libel has been held to be personal injury. However, as it is not a physical injury no exclusion is available under Sec. 104.

c. The $10,000 she received from the employer sponsored disability policy is taxable. If her injury was deemed permanent, she may possibly qualify for the disability credit. As the $15,000 is a reimbursement for medical expenses she does not have to include the reimbursement in gross income. pp. I:4-8 through I:4-10.

Case Study Problems

I:4-61 The following points should be made in the client memo:

1. The economics from the receipt of a nontaxable fringe benefit compared with the receipt of an equivalent amount of taxable compensation should be stressed. For example, an employee who is unable to deduct medical expenses because of the 7.5% of AGI limitation would be economically better off if his employer paid his medical and health insurance premiums instead of receiving the same amount as a salary increase.

2. As a minimum the company should consider providing medical and health insurance and group-term life insurance coverage up to $50,000 per employee because the premium payments are deductible by the employer and are not taxable to employees.

3. Free parking might be provided on a discriminatory basis to executives or to all employees if the vacant building can be easily converted. This fringe benefit is nontaxable as a "working condition" fringe.

4. Employee discounts on automotive parts can be provided (limited to the employer's gross profit percent) on a tax-free basis.

5. The company should consider establishing a dependent care assistance program because it can then provide an exclusion up to $5,000 of dependent care assistance for each employee provided that the benefits are offered under a plan that does not discriminate in favor of highly compensated employees. It should be noted, however, that the employee's childcare credit may be reduced to the extent that dependent care assistance payments are received.

6. It may be useful to suggest that the benefit program should be integrated with the process of determining annual salary adjustments. Otherwise, a significant program may be prohibitive in terms of its cost to the company.