Answers to Selected PAK Problem Materials:
Unit 02. Determination of Tax (PAK Chapter 2)

I:2-1 a. Gross income is income from taxable sources. Form 1040 combines the results of computations made on several separate schedules. For example, income from a proprietorship is reported on Schedule C where gross income from the business is reduced by related expenses. Only the net income or loss computed on Schedule C is carried to Form 1040. This is procedurally convenient, but means gross income is not shown on Form 1040.

b. Gross income is relevant to certain tax determinations. For example, whether a person is required to file a tax return is based on the amount of the individual's gross income. As the amount does not necessarily appear on any tax return, it may be necessary to separately make the computation in order to determine whether a dependency exemption is available.

pp. I:2-2 through I:2-5.

I:2-2 a. A deduction is an amount that is subtracted from income, while a credit is an amount that is subtracted from the tax itself.

b. In general, a $10 credit is worth more than a $10 deduction because the credit results in a direct dollar for dollar tax savings. The savings from a deduction depends on the tax bracket that applies to the taxpayer.

c. If a refundable credit exceeds the taxpayer's tax liability, the taxpayer will receive a refund equal to the excess. In the case of nonrefundable credits the taxpayer will not receive a refund, but may be entitled to a carryover or carryback. pp. I:2-4 through I:2-6.

I:2-3 Yes. In general, the source of income is not important. It is the use that is important. An exception does exist for a child's scholarship. Parents do not have to consider a child's scholarship when determining whether they provide over half of the child's support. p. I:2-15.

I:2-4 It can be, but as was noted in the preceding answer, parents may ignore a child's scholarship in deciding whether they provide over half of the child's support.

a household for a qualifying child in which they both live. pp. I:2-22 and I:2-23.

I:2-5 a. A C Corporation is taxed on its income. In other words, it is taxed as a separate entity. An S Corporation is normally not taxed on its income. Instead, its income flows through and is reported by the shareholders. Each shareholder reports his or her share of the income even if it is not actually distributed.

b. Some corporations are ineligible for making an S corporation election. Others may choose the C corporation because of lower corporate tax rates on taxable income up to $75,000. Other considerations not discussed in Chapter 2 include fringe benefits, the need to retain earnings in the business and dividend policy. pp. I:2-26 and I:2-27.

I:2-32	a.	Salary and interest	$19,100
		Minus: Standard deduction	(11,400)
		Exemption	(7,300)
		Taxable income	$ 400
		Gross tax	$ 40
	b.	Salary	$18,000
		Minus: Standard deduction	(5,700)
		Exemption	(3,650)
		Taxable income	$ 8,650
		Gross tax	$ 880

Note that Hal would also be required to file a separate return and pay a tax of $15 based upon taxable income of $150 ($1,100 interest - $950 standard deduction).

c. Hal and Ruth should not file a joint return. The parents will have to pay an additional $1,022 in taxes, while Hal and Ruth only save $855 [($880 + $15) - $40] by filing a joint return.

I:2-38 a. Joan, the custodial spouse, receives both the dependency exemption and child credit.
b. No. p. I:2-17.

I:2-43 a. Amy must file because her gross income exceeds the limit.
b. Betty need not file, as her gross income ($9,100) is less than $10,750 ($5,700 + $1,400 + $3,650).
c. Chris must file, as his gross income of $2,000 exceeds his standard deduction $1,900 ($1,600 + $300). Chris' standard deduction is limited to the amount of earned income plus $300.
d. Dawn must file because her unearned income is over $950 and her total gross income exceeds her standard deduction.
e. Doug must file because his gross income is over $3,650 and he is married and not living with his spouse. pp. I:2-33 and I:2-34.

I:2-55 a. Maria's adjusted gross income is $48,000.

Salary	$51,000
Capital loss allowable	(3,000)
Adjusted gross income	$48,000

b. Maria's taxable income is $38,650.

Adjusted gross income	$48,000
Standard deduction	(5,700)
Personal exemption	(3,650)
Taxable income	$38,650

c. Maria's tax liability is $5,850.

I:2-64 As Larry and Sue were married at the end of the year, they can file either a joint income tax return or two separate returns. On the surface there is not much difference between the tax liability on a joint return versus separate returns. The important issue here is the fact that Sue believes that Larry may be under-reporting tip income. If they file a joint return, Sue may be liable for the joint tax liability including penalties that may result from under-reporting. There is an innocent spouse provision, but one condition for claiming innocent spouse status is that the taxpayer did not know and had no reason to know that there was under-reporting. As Sue is suspicious of her husband, she should file a separate return to protect herself from possible tax liability associated with unreported income. pp. I:2-29 and I:2-30.