Gross Income

CHAPTER 3
INCOME SOURCES

CHAPTER 4
INCOME EXCLUSIONS
CHAPTER LEARNING OBJECTIVES

■ Discuss the historical development of what constitutes gross income and how it affects the current view of gross income.

■ Distinguish earned income from unearned income, and discuss the tax problems associated with each type of income.

■ Identify sources of income that result from transfers from others and discuss the tax rules for each type of income.

■ Discuss imputed income and identify the common sources of such income and their tax treatments.

■ Provide an overview of the tax treatment of capital gain income.

■ Describe the primary accounting methods used for tax purposes and how income is recognized under each method: the cash method, the accrual method, and the hybrid method.

■ Discuss the exceptions to the general rules of income recognition for each of the accounting methods.
The first step in calculating the taxable income for any tax entity is determining its gross income. Gross income equals all income received, less exclusions from income. Therefore, all items of income realized during the period under consideration must first be identified. Next, the income items are analyzed and segregated into those that are taxable and those that are excluded from taxation. Finally, the proper tax year for recognition of the income items must be determined. The purpose of this chapter is to introduce the basis for identifying income sources and to discuss those sources that present particular problems. In addition, a brief overview of the tax treatment of capital gains and losses is presented. The chapter also considers the effect of an entity’s accounting method on the recognition of income and exceptions to the general methods of accounting. Exclusions from income tax are discussed in Chapter 4.

The all-inclusive income concept provides the basis for calculating gross income. Under this concept, any income received is assumed to be taxable unless some provision in the tax law allows its exclusion. This concept is the basis of the Internal Revenue Code’s definition of gross income:

SECTION 61 GROSS INCOME DEFINED
(a) General Definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
(1) Compensation for services, including fees, commissions, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
PART II Gross Income

(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

The phrase “all income from whatever source derived” is the statutory equivalent of the all-inclusive income concept’s requirement that any income received is initially considered taxable. This phrase has been part of the income tax law since the Sixteenth Amendment to the Constitution empowered Congress in 1913 to “lay and collect taxes on incomes, from whatever source derived” [emphasis added]. In Section 61 of the Code, the phrase “except as otherwise provided” allows items to be excluded from gross income if the specific exclusion is found in the Internal Revenue Code.

The realization concept requires that income be realized before it is included in gross income. However, nothing in the definition of gross income in the Internal Revenue Code requires that income be realized before it is recognized. Although absent from the Internal Revenue Code, the realization concept was developed primarily by the courts in response to cases requiring an interpretation of the statutory definition of income. As a result, the concept has been adopted by the Internal Revenue Service in the regulation that interprets the definition of gross income:

(a) General Definition. Gross income means all income from whatever source derived unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash.1

Thus, a better working definition would be that gross income includes all income realized from whatever source derived, unless specifically excluded.

At first glance, the statutory and administrative definitions of income appear to be quite simple and straightforward. However, a linguist would no doubt be bothered by the circular nature of the definition: Gross income means all income. In fact, no definition of the term income exists in the Internal Revenue Code. Thus, the threshold question of whether a particular item is income is not answered by these definitions of gross income. Perhaps wisely, Congress has never seen fit to attempt to define the term income. Do you think that drafters of tax legislation in 1913 could have foreseen the complexities of business in the 21st century and been able to draft a precise definition of income to cover such items as incentive stock options and gains from currency translations? By not providing a precise definition, what constitutes income evolves with changes in society. In this regard, the courts have played a major role in guiding taxpayers on the treatment of various transactions in which it is not clear whether the statutory definition of income has been met.

Income Is Derived from Labor and Capital

In 1920, the U.S. Supreme Court considered the first case addressing the concept of income. In determining that specific provisions in the tax law that included stock dividends as taxable income were unconstitutional, the Supreme Court said, “Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through sale or conversion of capital assets.”2

This initial attempt at defining income implies that income could be generated from only two sources: capital and labor. The Court also emphasized the necessity of a realization as a precondition to the existence of income:
Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being “derived”—that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal; that is income derived from property. Nothing else answers the description. [Court’s emphasis]3

In fact, a vast majority of items we commonly think of as income fit nicely into this definition: wages, income from a sole proprietorship (income from labor), interest, dividends, rental income, and royalty income (income from capital). However, this definition did not contemplate sources of income that were not returns from labor or capital, such as windfalls. Consider the following examples:

▲ EXAMPLE 1 Lee is playing golf one day and hits an enormous hook into the woods. While searching for his ball, he finds a tattered sack full of $100 bills. The police are never able to locate the owner, and Lee is allowed to keep the money, which totals $50,000. Does Lee have income from finding this money?

Discussion: Given the Supreme Court’s definition, it would seem that such a windfall would not be considered as “derived from capital, from labor, or from both combined.” However, it would appear that such a “treasure trove,” as it is referred to in income tax jargon, would fit the statutory definition of “income from whatever source derived.” In fact, the courts have said that such treasure troves do constitute income.4

▲ EXAMPLE 2 Johnson, Inc., leases a lot and a building to Wenona Corporation under a 99-year lease that lets Wenona remodel the building at its own cost. The lease provides that all improvements are Johnson’s property upon termination of the lease. Twenty years after remodeling the building, Wenona defaults on the lease payment, and Johnson repossesses the property. The net increase in the value of the property from the remodeling is $50,000. Does Johnson, Inc., have taxable income when it retakes possession of the building?

Discussion: On similar facts, in 1940 the Supreme Court held that Johnson, Inc., was taxable on the increase in the value of the property attributable to the remodeling of the building at the time it repossessed the property.5

Although the Court’s decision on the facts in example 2 would appear to fit the notion of income “derived from capital,” it does not square with the requirement that income be realized by “severing” it from the capital investment and that it be “received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal.” In addressing this issue, the Court said:

While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer’s indebtedness, relief from a liability, or other profit realized from the completion of a transaction. The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does not negative its realization.6

This decision severely weakened the earlier realization requirement by suggesting that any definitive event could be properly considered a realization of income. At this point, there was no requirement that the income be severed from the capital and available for use by the taxpayer. However, in reaction to this decision, in 1942 Congress adopted a provision that excluded from gross income such increases in the value of property upon termination of a lease, to the extent that the lessee’s improvements did not constitute a payment in lieu of rent.7 This exclusion is discussed in Chapter 4.

Income as an Increase in Wealth

As can be seen from the discussion of court cases that define income, the courts increasingly diluted the original judicial requirement that income be derived from capital or labor and that recognition of the income required a realization. In 1955, the
Supreme Court closed the circle on its original definition in a case involving the taxability of punitive damages awarded in an antitrust action. In finding that such windfall profits were taxable income, the Court did not even attempt to reconcile its decision with the earlier “gain derived from capital or labor” requirement. Rather, the Court relegated this concept to minor status in determining that any increase in the wealth of the taxpayer that has been realized is subject to income tax:

But it [income derived from capital or labor] was not meant to provide a touchstone to all future gross income questions. . . . Here we have instances of undeniable accessions to wealth, clearly realized and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients. . . . We find no . . . evidence of intent to exempt these payments. [emphasis added]

Thus, the Court adopted a much broader concept of income, “undeniable accessions to wealth,” as its interpretation of “income from whatever source derived.” The notion of income as an increase in wealth is not new or, for that matter, surprising. Economists have long argued that the true measure of income is the change in wealth for the period under consideration. Using the economist’s definition of income, all gains received during the period, whether realized or not, are considered income. Where the tax law deviates from the economists’ notion of income is in the requirement that the increase in wealth be “clearly realized.” Note also that the tax law definition of income not only requires a realization but also that the taxpayer have “complete dominion” over the realized income. The requirement of complete dominion means that the taxpayer must have a claim of right to the income. Recall that the claim of right doctrine says that any amount received without restriction as to its disposition is income in the period received.

What Constitutes Income: Current View

Given this brief historical account of how the concept of income developed, what is considered income today? Although the courts continue to consider the issue, no significant developments have occurred since the Supreme Court determined that any increase in wealth that has been realized constitutes income. Thus, it is safe to say that the first requirement is that the taxpayer experiences an increase in wealth. An increase in wealth can be through an increase in net worth or through consumption.

▲ EXAMPLE 3 Tran purchases 100 shares of XYZ Company stock during the current year at a cost of $2,000. As of December 31, the shares of stock are worth $2,500. Does Tran experience an increase in wealth during the year as a result of this stock purchase?

Discussion: Tran’s wealth increases as a result of the stock purchase. Her net worth increases by $500 over what it was before she purchased the stock.

▲ EXAMPLE 4 Cara’s car needs new spark plugs. She calls Local Service Station and learns that it will cost $50 to get the job done. Rather than pay the $50, Cara purchases the spark plugs for $15 and installs them herself. Has Cara’s wealth increased as a result of installing the spark plugs herself?

Discussion: Cara’s wealth has increased by the $35 she saved by doing the job herself. Through consumption of the labor and overhead involved in the $50 charged by Local, her net worth has increased by the $35 she saved.

Although an increase in wealth is a necessary condition for the recognition of income, it alone is not sufficient to trigger taxation. Before an increase in wealth becomes taxable (i.e., is recognized income), it must also be realized. As stated previously, realization is not an explicit statutory requirement for the recognition of income; however, over the years, the concept has become so basic to the structure of the tax system that the general premise of the requirement is simply not challenged. What typically is challenged by taxpayers is what constitutes a realization. A reasonable working definition contains the following two elements:
- A change in form and/or substance of the taxpayer’s property (or property rights)
- The involvement of a second party in the income process

The most common forms of income realization involve the receipt of something of value (cash, stock, services) for a service rendered or the sale, exchange, or lease of a property.

▲ EXAMPLE 5 Return to the facts of example 3. Does Tran realize any income from her dealings in XYZ Company’s stock?

Discussion: Although Tran’s wealth increases through the increase in the value of the stock, she has not realized that wealth through sale, exchange, or other disposition of the stock. That is, the form of her property (stock) has not been changed through a transaction with another party.

▲ EXAMPLE 6 Return to the facts of example 4. Has Cara realized the increase in wealth she obtained by repairing the car herself?

Discussion: Cara has had a change in the form of her property through the repairs, but because no second party was involved, she would not be considered to have a realization of income.

In general, any increase in wealth that has been realized by a taxpayer must be recognized (i.e., included in gross income) for tax purposes in the period in which the realization occurs. However, this general rule has several exceptions. As previously stated, some income realizations are excluded by law and therefore are never recognized for tax purposes. The tax laws also provide for deferral of gains on certain types of property transactions in which the wherewithal to pay tax from the transaction is lacking. The recognition of gains from this class of transactions is deferred to a future period when a transaction occurs that provides the cash to pay the tax.

▲ EXAMPLE 7 Duc’s business automobile, which had an adjusted basis of $2,000, was destroyed in a tornado. Duc received a check for $6,000 from his insurance company. He used the $6,000 as a down payment on a new business automobile costing $30,000. Has Duc realized a gain from the destruction of his old automobile? If so, must he recognize the gain in the period of the destruction of the automobile?

Discussion: Duc has realized a gain of $4,000 ($6,000 in insurance proceeds – the adjusted basis of $2,000) on the destruction of his automobile. He realized a gain because he received something of value, $6,000 in cash, for his old automobile in a transaction with another party.

Duc will not have to recognize the gain (include the gain in gross income) on the destruction of his automobile in the current period. When the entire proceeds from the casualty are reinvested in a qualifying replacement asset, the tax law allows the deferral of gains from casualties on business property that has been replaced. In this case, Duc reinvested the entire $6,000 he received for his old automobile and has no cash remaining to pay the tax on the gain. Although Duc does not have to pay tax on the gain in the current period, he will pay tax on the gain when he disposes of the new business automobile in a taxable transaction. Chapter 12 discusses the rules for deferrals of gains and the mechanics of the calculations to ensure that the tax is eventually paid on the gain.

This chapter discusses four categories of income sources to provide a framework for working with income sources. The first two categories are based on the Supreme Court’s early definition of income as being derived from labor, which is referred to as earned income, and income derived from capital, referred to as unearned income. The third category consists of transfers from others. The fourth category considers taxable sources of imputed income.

Earned Income

The most common form of income for individuals is compensation paid for their services. That is, individuals provide their labor for the production of goods and services. In return for their labor, they are compensated by the entity for which they are
performing the work. Providing labor for compensation produces **earned income.** All amounts paid by an employer to or on behalf of an employee are taxable unless specifically excluded by law. In addition, income generated from the operation of a business is considered earned by the owner. Income from illegal activities (gambling, drugs, extortion, etc.) is also considered earned and subject to tax. The most common forms of earned income are

1. Wages, salaries, tips, bonuses, and commissions
2. Income from the active conduct of a trade or business
3. Income from the rendering of services
4. Income from the performance of illegal activities

The taxability of earned income sources is undisputed. However, two problems often arise with this type of income. The first problem stems from a desire to take advantage of the progressive nature of the tax rate schedules by transferring income earned by a high marginal tax rate payer to a family member who is in a lower tax bracket. These attempts are foiled by the assignment-of-income doctrine, which requires the entity earning the income to pay the tax on the income, regardless of who actually receives the income.

▲ **EXAMPLE 8** Thelma has a successful carpet-cleaning business. To lower her taxes, she instructs every fifth client to make the check out to Thelma’s son. Her son is a college student who does not work and uses the checks received from Thelma’s business to pay for his college expenses. Who is taxed on this income?

**Discussion:** Because the payments made to the son were earned by Thelma, she must include the payments in her taxable income. Therefore, this scheme results in no tax savings to Thelma. **Note:** There are legal ways for Thelma to transfer taxability of the income earned from her carpet-cleaning business to her son. The simplest method would be to employ her son in the business and pay him a reasonable salary for his labor. This would lower Thelma’s taxable income through a deduction for compensation and transfer the income to her son for taxation at a lower marginal tax rate.

Taxpayers may also attempt to transfer income to establish a basis for taking business deductions.

▲ **EXAMPLE 9** Michael has a computer in a separate room of his house that he uses to perform work related to his employment as an engineer for Ajax Corporation as well as for personal purposes. Because he is not considered to be in a trade or business, the tax law does not allow a deduction for either the office or the computer. Michael’s wife, Daniela, does the bookkeeping and payroll work for several small businesses. To establish a trade or business for himself, Michael has the payments for Daniela’s bookkeeping services made out to him. Who is taxed on this income?

**Discussion:** No marginal tax rate savings result from the transfer of income from Daniela to Michael, because Michael and Daniela commingle their respective incomes on their joint tax return. The benefit to be derived from such a scheme would be the additional deductions Michael could take for the office and the computer, if he can establish their use in the business of bookkeeping. However, under the assignment-of-income doctrine, Daniela would still be deemed to have earned the payments for her services, and Michael could not claim the checks he receives as income he earned in a trade or business. Thus, he could not take any deductions for the office or the computer.

The second concern with earned income is what constitutes a receipt of income. Typically, earned types of income are received in cash. However, if receipts of cash were the sole source of earned income, clever taxpayers could arrange their affairs to receive significant amounts of their income in other forms, thus avoiding tax. To counter such tax avoidance schemes, a **cash-equivalent approach** is used to measure receipts of income. Under this approach, the receipt of anything with a fair market value will trigger recognition of income. Thus, income can be realized in the form of property, services, meals, lodging, stock, and so on.
EXAMPLE 10  Betty agrees to clean Shiro’s house once a week, in return for which Shiro agrees to mow Betty’s lawn once a week. Betty usually charges $30 to clean a house, which is what Shiro charges to mow a lawn. Do Betty and/or Shiro have taxable income from this arrangement?

Discussion: Yes, both have income of $30 per week from this arrangement. Each receives something of value in return for her or his services. Therefore, they are taxed as if they had paid each other cash.

Under the constructive receipt doctrine, a cash basis taxpayer does not have income until there is an actual or constructive receipt of the income earned. Therefore, a cash basis taxpayer who sells merchandise or performs services on general account does not recognize income until the account is paid with something of value. However, if the customer of such a taxpayer gives the taxpayer a promissory note for the amount due, the fair market value of the note is considered a receipt of property and is taxable when received.

EXAMPLE 11  Farnsworth, a cash basis taxpayer, puts a new roof on EM Corporation’s warehouse in late November and bills it $3,000. EM pays the bill in January. When is Farnsworth taxable on the $3,000 roofing job?

Discussion: Because Farnsworth does not receive something of value until January, the $3,000 is not included in his taxable income until then.

EXAMPLE 12  Assume that in example 11, EM Corporation gives Farnsworth a valid note payable for $3,000 when he completes the roofing job in November. Farnsworth does not discount the note, although local banks typically discount such personal notes by 30%. EM pays the note in full in January. How does this affect Farnsworth’s recognition of income?

Discussion: Because Farnsworth could have converted the note to cash upon receipt, the amount of cash he could have received from discounting the note, its fair market value, is taxable upon receipt. Therefore, $2,100 [$3,000 – (30% × $3,000)] is taxable in the year Farnsworth receives the note. The remaining $900 is taxable when he receives full payment on the note the following January.

Unearned Income

The unearned income category of income includes the earnings from investments and gains from the sale, exchange, or other disposition of investment assets. The distinguishing features of this type of income are that it constitutes a return on an investment and producing the income does not require any labor by the owner of the investment. The most common forms of unearned income are

1. Interest income
2. Dividend income
3. Income from rental and royalty-producing activities
4. Income from annuities
5. Income from conduit entities
6. Gains from the sale of investments producing any of the five forms of unearned income

As with earned sources of income, the inclusion of unearned types of income in the tax base is not controversial. However, a few practical difficulties do arise.

Rental and Royalty Income. The first problem deals with the definition of rental and royalty income. Technically, the tax law defines these two types of income as gross income from the property, less the related expenses to produce the income.

EXAMPLE 13  Ali Corporation owns an apartment building and rents out the units. During the current year, Ali receives total rents of $15,000 and incurs costs of $13,000 related to the apartments. What is Ali Corporation’s rental income for the current year?

Discussion: Ali Corporation has rental income of $2,000 ($15,000 – $13,000).
EXAMPLE 14  Assume that because utility and maintenance costs are higher than expected, Ali’s total expenses related to the apartments are $18,000. What is Ali’s rental income?

Discussion: Ali Corporation does not have any rental income. Rather, it has a rental loss of $3,000, the deduction of which is subject to the rules for deducting losses, discussed in Chapter 7.

Annuities. The second item to consider is the taxation of annuities. An annuity is a string of equal payments received over equal time periods for a determinable period. The purchase of annuity contracts has become increasingly popular in recent years as a way to guarantee income during retirement. A typical annuity is illustrated in the top panel of Exhibit 3–1. In the typical annuity situation, an individual pays a certain sum now, in return for which the seller of the annuity promises to make set payments for a period of time in the future. The payments are calculated to provide the purchaser with a predetermined rate of return on the investment. The problem with these arrangements is determining how much of each payment is a return of the original capital investment and how much is a return on the investment. Recall that the capital recovery concept exempts returns of capital from taxation; only returns on capital are taxable sources of income.

EXAMPLE 15  Susan purchased an annuity contract for $30,000. Under the contract, when Susan reaches 62, she is to receive $500 per month for fifteen years. How much income will Susan earn in total from this investment?

Discussion: Susan will receive payments totaling $90,000 ($500 × 12 × 15) from the contract, resulting in a total profit of $60,000 ($90,000 − $30,000).

In example 15, the major tax problem is determining when to recognize the $60,000 earnings from her investment. Although it is clear that she will not realize any income until she begins receiving payments on the contract, taxation once the payments begin is more controversial. A strict application of the capital recovery concept would exempt the first $30,000 as a repayment of capital investment. However, the tax law views the amounts paid out under the contract as being partly a return of her original capital investment (excluded) and partly a return on her capital investment (taxable income).

The annuity exclusion ratio is used to determine the amount of each payment that is excluded from income. The annuity exclusion ratio is the cost of the contract divided by the number of payments expected from the contract. (See the bottom panel of Exhibit 3–1.) When the number of payments on an annuity contract is fixed, the computation is straightforward: The cost of the contract divided by the number of payments to be received gives the excludable portion of each payment.

EXAMPLE 16  Susan begins receiving payments on the contract on January 2, 2003. How much of each $500 payment that she receives from the contract is taxable?

Discussion: Because the contract is based on a fixed number of payments, Susan uses the annuity exclusion ratio based on the actual payments to determine the taxable portion of each payment. The exclusion ratio on the contract is $30,000 ÷ 180 (12 × 15) = $167. Therefore, $167 of each $500 payment is not taxable, because it is considered a return of her $30,000 investment. The remaining $333 is taxed as a return on capital.

Exhibit 3–1

Annuities

<table>
<thead>
<tr>
<th>General Operation of an Annuity</th>
<th>Future Receipts</th>
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</thead>
<tbody>
<tr>
<td>Current Investment ($$)</td>
<td>$ $ $ $ $ $</td>
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<tr>
<td></td>
<td>$ $ $ $ $ $</td>
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<tr>
<td>Annuity Exclusion Ratio</td>
<td></td>
</tr>
<tr>
<td>Cost of the contract</td>
<td>Exclusion per payment</td>
</tr>
<tr>
<td>Number of payments</td>
<td></td>
</tr>
</tbody>
</table>

Amount of each payment taxable = Contract payment − Amount excluded
For annuities making payments until the death of the taxpayer, the calculation becomes more complicated because an estimate of the number of payments that will be made under the annuity contract must be used. The method of estimation to use depends on the date the annuity begins to make payments. If the annuity payments began on or before November 18, 1996, the number of payments under the contract is determined by the taxpayer’s life expectancy at the date the payments began.

If the annuity payments begin after November 18, 1996, the taxpayer must use the “simplified method” to determine the return of capital for each monthly payment. Under this method, the number of anticipated monthly payments is determined based on the age(s) of the taxpayer(s) at the annuity starting date. The simplified method requires the use of a standard set of expected payments for a single taxpayer and a separate table of expected payments when the annuity will continue to be paid to a survivor after the death of the taxpayer. Table 3–1 provides the number of monthly payments to be used by a single taxpayer, and Table 3–2 provides the number of monthly payments when more than one taxpayer will receive payments under the contract.

▲ EXAMPLE 17  Assume the same facts as in example 16, except that the payments are to continue until Susan dies. How much of each $500 payment is taxable?

Discussion:  Susan must use the simplified method to determine the portion of each $500 payment that is excluded. Because Susan is age 62 when she receives her first payment, the number of monthly payments is 260. This gives a monthly exclusion on the contract of $115 ($30,000 ÷ 260). The remaining $385 ($500 – $115) is taxable as a return on investment.

The anticipated monthly payments in the simplified method approximate life expectancies. However, life expectancies are merely averages. As such, few people die at their average life expectancy: Some people die before the average, whereas others outlive their life expectancies. Therefore, in most cases, adjustments are required to ensure that proper capital recovery of the annuity investment is made.

▲ EXAMPLE 18  Using the same facts as in example 17, assume that Susan lives for 25 years and receives payments totaling $150,000 under the contract. How is Susan taxed on these payments?

Discussion:  Because we do not know how long Susan will live when the payments start, we figure the monthly exclusion and income as in example 17. That is, she will exclude $115 per month.

<table>
<thead>
<tr>
<th>Age on Annuity Starting Date</th>
<th>Number of Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>55 and under</td>
<td>360</td>
</tr>
<tr>
<td>56–60</td>
<td>310</td>
</tr>
<tr>
<td>61–65</td>
<td>260</td>
</tr>
<tr>
<td>66–70</td>
<td>210</td>
</tr>
<tr>
<td>71 and over</td>
<td>160</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Combined Age of Taxpayers on Annuity Starting Date</th>
<th>Number of Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>110 and under</td>
<td>410</td>
</tr>
<tr>
<td>111–120</td>
<td>360</td>
</tr>
<tr>
<td>121–130</td>
<td>310</td>
</tr>
<tr>
<td>131–140</td>
<td>260</td>
</tr>
<tr>
<td>141 and over</td>
<td>210</td>
</tr>
</tbody>
</table>
After she receives the 260th payment, Susan will have excluded her entire $30,000 investment. At that time, her capital investment will have been fully recovered. Susan receives 300 (25 years × 12) payments on the contract. Therefore, payments 261 through 300 will be fully taxable.

Note that during the 25 years of payments, Susan will recognize $120,000 ($150,000 received − the $30,000 investment) income.

\[
\begin{align*}
\text{Payments 1–260:} & \quad $100,000 \ ($385 \times 260) \\
\text{Payments 261–300:} & \quad $20,000 \ ($500 \times 40)
\end{align*}
\]

What happens when an annuity owner dies before her life expectancy? In this case, her capital recovery is incomplete; she has not fully recovered her capital investment through an exclusion. To allow full recovery of capital in this situation, the tax law permits a deduction in the year of death for the unrecovered portion of the annuity investment.

▲ EXAMPLE 19 Assume the same facts as in example 17, except that Susan dies on June 15, 2012.

Discussion: Susan receives $3,000 (6 payments × $500) in 2012. She excludes $690 ($115 × 6), and $2,310 ($3,000 − $690) is included in her 2012 gross income.

Up to her death, Susan has received 114 payments (9 years + 6 months in 2012) and excluded $13,110 ($115 × 114) of her $30,000 investment. The remaining $16,890 ($30,000 − $13,110) of her original investment, which was not recovered, is deductible on her 2012 tax return. Therefore, over the period she receives payments on the annuity, she will have recovered her $30,000 investment through $13,110 of excluded income and a deduction of $16,890 in the year of her death.

Note the effect of the annual accounting period concept on the reporting of annuities. This concept requires not only an annual reporting of income but also embodies the notion that the events of each tax year are to stand apart from the events of other years. Thus, we do not go back and adjust the annuity calculations on prior years’ returns when we know the true number of payments. Rather, we apply the capital recovery concept as it applies to the individual year in question.

As a final note on annuities, the exclusion ratio is used when the taxpayer receives amounts that represent both a return of investment in the contract and a return on the investment in the contract. Many pension plans are structured so that amounts paid into the plan by the employee and the employer are excluded from current taxation. Such plans are called qualified plans and allow the deferral of tax on payments into the plan and earnings on the plan’s assets until they are withdrawn. As such, the taxpayer has no previously taxed capital investment in the plan. Therefore, all amounts paid from the plan are subject to tax.

▲ EXAMPLE 20 Agatha worked for Crystal Company for more than 30 years. As part of her employment contract, Crystal matched contributions Agatha made to a qualified plan. None of the payments to the plan or the earnings on the plan investment was subject to tax. Over the years, Agatha accumulated $420,000 in her pension plan. At retirement, she will receive $850 per month from the plan. How much of the monthly payment is subject to tax?

Discussion: Because the $420,000 in the pension plan is income that has not been taxed, the full amount of each payment is subject to tax. Agatha must include all payments she receives from the plan in her gross income in the year she receives the payments.

Calculation of Gain/Loss on Sale of Investments. Another aspect related to unearned income is the calculation of gains or losses from sales, exchanges, or other dispositions of investment property. Again, this is not a particularly perplexing problem. However, you should keep in mind what constitutes a gain. A gain is the
result of a realization in excess of capital investment. The amount of unrecovered capital investment in a property is its adjusted basis. More formally,

\[
\text{Proceeds from sale of property} \\
\text{Less: Selling expenses} \\
\text{Equals: Amount realized from sale of property} \\
\text{Less: Adjusted basis of property sold} \\
\text{Equals: Gain (loss) on sale}
\]

▲ EXAMPLE 21 The Alima Partnership buys a rental property in 2001 for $70,000. In 2003, after deducting depreciation of $5,000, Alima sells the rental property for $90,000 and pays a $6,000 commission on the sale. What is Alima’s gain or loss on the sale of the rental property?

Discussion: The Alima Partnership realizes $84,000 ($90,000 – the $6,000 commission) from the sale. Because Alima has already recovered $5,000 of its investment through depreciation deductions, the adjusted basis for the rental property is $65,000 ($70,000 – $5,000). This results in a gain of $19,000 ($84,000 – $65,000).

Note that property dispositions can also result in losses. A loss results when a property is disposed of at less than its adjusted basis. That is, a loss represents incomplete capital recovery.

▲ EXAMPLE 22 Assume that in example 21, the Alima Partnership is able to sell its rental property for only $60,000 and pays a $3,000 commission on the sale. What is Alima’s gain or loss on the sale of the rental property?

Discussion: In this case, the Alima Partnership realizes only $57,000 ($60,000 – $3,000) on the sale, resulting in a loss on the sale of $8,000 ($57,000 – $65,000). Note that the $8,000 loss represents Alima’s unrecovered investment in the rental property. Letting Alima deduct the $8,000 loss fully recovers its original $70,000 investment:

| Capital deducted as depreciation | $ 5,000 |
| Capital deducted against sales price | 57,000 |
| Capital deducted as a loss | 8,000 |
| Total amount invested | $70,000 |

Income from Conduit Entities. The last consideration related to unearned forms of income is the recognition of income from conduit entities (primarily S corporations and partnerships). Recall that a conduit entity is not taxed on its income; rather, the income from the conduit flows to the owner(s) of the entity for taxation. Thus, taxpayers who own investments in such entities must recognize their share of the conduit’s income on their tax return. Conversely, distributions from a conduit entity are not taxed; they are merely a return of capital investment in the entity.

▲ EXAMPLE 23 Ansel owns a 20% interest in Forrest, Inc. Forrest is organized as an S corporation and has operating income of $80,000 in the current year. Forrest also distributes $20,000 in dividends. What amount of income must Ansel recognize from his ownership in Forrest, Inc.?

Discussion: Ansel must recognize his proportionate share of Forrest’s income, $16,000 (20% × $80,000). Because he is taxed on his share of Forrest’s income, the $4,000 in dividends (20% × $20,000) received is not taxed; it is considered a return of his investment, which reduces the basis of his investment in Forrest.

▲ EXAMPLE 24 Assume that in example 23, Forrest, Inc., is a corporation. What amount of income must Ansel recognize from his ownership in Forrest, Inc.?

Discussion: As a corporation, Forrest is taxed on the $80,000 in income it earned; the income does not flow to the owners. Ansel is taxed on the $4,000 in dividends he receives from Forrest.
PART II  Gross Income

Transfers from Others

As the discussion of what constitutes income indicated, not all income is the result of labor or capital. Tax entities, particularly individuals, sometimes receive amounts that are neither earned nor unearned, yet they constitute realizations of increases in wealth and as such are taxable to the recipient. In this area are five common sources of taxable transfer income:

- Prizes and awards
- Unemployment compensation
- Social Security benefits
- Alimony received
- Death benefit payments

Prizes and Awards. With two exceptions, any prizes or awards received are taxable to the recipient.14 One way to avoid tax on the receipt of a prize or award is to immediately transfer the prize or award to a government body or other qualified charitable organization such as a church, school, or charity. This exclusion is available only for certain awards, such as those for literary, scientific, or charitable achievements for which the taxpayer did not take action to obtain the award and for which no future services must be performed as a condition of receiving the award. Thus, winnings on game shows cannot be excluded, even if they are immediately transferred to a local charity, because the contestant voluntarily entered the contest.

▲ EXAMPLE 25 Letisha receives the outstanding teacher award at State University. The award includes a cash prize of $5,000. Is the $5,000 taxable to Letisha?

Discussion: If Letisha keeps the $5,000, she will have to include it in her gross income. However, if she was chosen from among all teachers at State University and the award does not require her to perform a specific future service, she can avoid taxation by transferring the check to a government body or charitable organization.

The second class of awards that may be excluded is employee achievement awards that are paid in the form of property and are based on length of service or on safety achievements. The maximum dollar exclusion for such awards is $400 per employee per year. However, if the award comes from a qualified plan, the individual limit is raised to $1,600. A qualified plan is a formal written plan or program to award all employees who qualify under the plan’s requirements. The plan must not discriminate in favor of highly compensated employees.

▲ EXAMPLE 26 At her retirement party, Tova receives a Rolex watch worth $1,200 in recognition of her 30 years of service to her employer. Is the receipt of the watch taxable to Tova? If so, how much income must she recognize?

Discussion: Because the watch is an award of property that was given in recognition of length of service, at least $400 of the $1,200 fair market value of the watch may be excluded. If Tova’s watch is given as part of a qualified plan, she may exclude the entire $1,200 from her taxable income, because it is worth less than the $1,600 limit for such plans.

| CONCEPT CHECK | The all-inclusive income concept taxes all income received unless a specific provision in the tax law either excludes the income from taxation or defers its recognition to a later period. The realization concept taxes income when an increase in wealth occurs in an arm’s-length transaction. All earned and unearned income realized by a cash basis taxpayer is taxable in the period in which the income is actually or constructively received. The assignment of income doctrine prevents taxpayers from directing income they have produced to other entities for taxation. The capital recovery concept lets taxpayers recover invested capital tax-free; only returns on invested capital are taxed. |

| Transfers from Others |

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Unemployment Compensation. Amounts received from state unemployment compensation plans are considered substitutes for earned income and are always taxable to the recipient. Unemployment compensation is designed to aid individuals who become unemployed until they can find new employment. A similar type of benefit paid by states to individuals is workers’ compensation. Workers’ compensation is paid to employees who are injured on the job and cannot continue to work as a result of their injuries. A specific exclusion from income is provided for workers’ compensation payments and is discussed in Chapter 4.

Social Security Benefits. Before 1984, Social Security benefits were excluded from taxation. The exclusion was evidently based on administrative convenience because the tax law contained no specific exclusion for such payments. This made some sense, because the payments made by an employee into the fund are not exempt from tax. However, the matching portion paid by the employer is not taxable to the employee. Thus, under the capital recovery concept, it could be said that half of each payment received from Social Security represented a return of the taxpayer’s investment and was therefore excluded, much like the annuities discussed earlier. However, when Congress decided to begin taxing Social Security benefits in 1984, politicians were concerned about taxing those whose main source of income came from Social Security. That is, Congress questioned the ability of lower-income taxpayers to pay the tax. To negate this possibility, Congress used a lesser-of-formula to determine the amount of Social Security to include in gross income; the formula allows lower-income taxpayers to escape taxation on Social Security benefits. Calculation of the taxable portion of Social Security benefits before 1994 is presented in Exhibit 3–2.

Although the second formula seems unduly complex, modified adjusted gross income serves as a “floor” value under which no Social Security benefits are taxed. Note that as long as the taxpayer’s modified adjusted gross income is less than the base amount, none of the Social Security benefits is subject to tax. Thus, people with relatively modest incomes are not taxed on Social Security benefits.

Recall from Chapter 1 that adjusted gross income (AGI) is defined as gross income less deductions for adjusted gross income. Deductions allowable for AGI include trade or business expenses, rental and royalty expenses, reimbursed employee business expenses, payments into pension accounts (e.g., IRAs), and certain other business- and investment-related expenses. As such, adjusted gross income provides a measure of the individual’s ability to pay tax. In the second formula, the two major additions to AGI, for the foreign earned income exclusion and tax-exempt interest (both discussed in Chapter 4), are there to ensure that individuals with large, untaxed economic incomes pay some tax on Social Security benefits.

Exhibit 3–2
Calculation of Taxable Portion of Social Security Benefits Received Before 1994

The taxable portion of Social Security is equal to the lesser of

1. one-half of the Social Security benefits received during the year

OR

2. one-half of the amount by which modified adjusted gross income exceeds the base amount

Where

Modified adjusted gross income = Adjusted gross income + one-half the Social Security benefits received during the year + any foreign earned income exclusion + any tax-exempt interest

And

Base amount = $25,000 for an unmarried individual
$32,000 for a married couple, filing jointly
$-0- for all others
EXAMPLE 27  Judith is a single individual who receives $4,000 in Social Security benefits during 1993. Her adjusted gross income before considering the taxability of the Social Security benefits is $10,000. How much of the $4,000 is taxable?

Discussion: None of the $4,000 is included in Judith’s gross income because her modified adjusted gross income falls below the $25,000 floor value for taxation of unmarried taxpayers. Per the formulas in Exhibit 3–2, Judith includes in income the lesser of

\[
\frac{1}{2}(4000) = 2000 \\
\frac{1}{2}(10000 + 2000 - 25000) < 0
\]

EXAMPLE 28  Jack and Bettina receive the following income during 1993:

- Retirement pay $23,000
- Tax-exempt bond interest $10,000
- Social Security benefits $ 6,000

How much of the $6,000 must be included in their gross income?

Discussion: Social Security benefits of $2,000 are taxable per the following formulas:

The lesser of

\[
\frac{1}{2}(6000) = 3000 \\
\frac{1}{2}(23000 + 3000 + 10000 - 32000) = \frac{1}{2}(36000 - 32000) = 2000
\]

Note that if Jack and Bettina were not required to include their tax-exempt interest in the Social Security benefits calculation, their income ($26,000) would have fallen below the base amount for a married couple ($32,000) and no part of their benefits would have been taxed. Thus, the adjustment for tax-exempt interest has made a portion of their benefits taxable in accord with Congress’s intent: to apply the tax to individuals with large economic incomes.

EXAMPLE 29  Ruth is a retired executive whose adjusted gross income for 1993 is $80,000. In addition, she receives $5,000 in Social Security benefits. How much of the $5,000 must be included in Ruth’s gross income?

Discussion: Ruth must include $2,500 in her gross income per the following formula:

The lesser of

\[
\frac{1}{2}(5000) = 2500 \\
\frac{1}{2}(80000 + 2500 - 25000) = 28750
\]

Example 29 illustrates how once a taxpayer’s modified adjusted gross income reaches the level at which formula 2 exceeds one-half of the Social Security benefits, the maximum amount of Social Security subject to tax is one-half of the benefits received, no matter how much the taxpayer’s income increases. Thus, formula 1 establishes a “ceiling” value for the taxation of Social Security benefits received before 1994.

For tax years after 1993, a second-tier inclusion rule applies to higher-income taxpayers. The second tier applies to unmarried individuals with modified adjusted gross incomes greater than $34,000 and married couples filing joint returns with modified adjusted gross incomes exceeding $44,000. The rules discussed earlier (the 50-percent formula) remain in effect for taxpayers with modified adjusted gross incomes that are less than these amounts.

For tax years after 1993, taxpayers with modified adjusted gross incomes above the threshold levels of $34,000 and $44,000 have to make an additional computation to determine the amount of Social Security benefits that they must include in gross income. As outlined in Exhibit 3–3, the new second-tier rule increases the taxable portions in the original Social Security formulas from 50 percent to 85 percent. In addition, formula 2 is increased by the amount of Social Security included under the 50-percent formula or a fixed amount ($4,500 for unmarried individuals, $6,000 for married taxpayers filing joint returns), whichever is less. This change in formula 2 requires taxpayers subject to the second-tier rules to calculate the amount
of Social Security they would have included in their gross income under the 50-percent formula.

▲ **EXAMPLE 30**  Assume the same facts as in example 27, except that the tax year is 2003. How much of the $4,000 in Social Security benefits is included in Judith’s gross income?

**Discussion:** None of the $4,000 is included in Judith’s gross income because her modified adjusted gross income is below the $25,000 floor value for unmarried individuals. Note that the new second-tier rule does not apply to Judith, and her Social Security benefits will not be subject to tax.

▲ **EXAMPLE 31**  Dieter and Luann are a married couple whose adjusted gross income is $42,000. In addition, they receive $10,000 in Social Security benefits. How much of the $10,000 must be included in Dieter and Luann’s gross income?

**Discussion:** Dieter and Luann’s modified adjusted gross income is $47,000 [$42,000 + $5,000 (1/2 × $10,000)]. Because their modified adjusted gross income exceeds the $44,000 base amount, they are subject to the second-tier rule. Under the 50% formula, their taxable Social Security is $5,000:

\[
\frac{1}{2}(\$10,000) = \$5,000
\]

Under the second-tier rule, Dieter and Luann must include $7,550 of the Social Security benefits in gross income:

The lesser of

1. \(85\% \times \$10,000 = \$8,500\)

OR

2. The sum of
   a. \(85\% \times (\$47,000 - \$44,000) = \$2,550\)
   b. The smaller of
      \(\$5,000\) (amount included under the 50% formula)

OR

\(\$6,000\)

Equals

\(\$7,550\)
Alimony Received. In divorce situations, one spouse often makes payments to a former spouse. These payments may be to provide for the support of children (called child support payments), they may be simply a sharing of income between the two parties (called alimony), or they may constitute a division of marital property (property settlement). Child support payments are not taxable to the recipient regardless of how the recipient actually spends the money. However, payments that are a sharing of current income (alimony) are taxable to the recipient and deductible for adjusted gross income by the payer. That is, alimony is an allowable transfer of income from one former spouse to another. To be considered alimony, all the following conditions must be met:

1. The payment must be in cash.
2. The payment must be in a written agreement (either a separation or divorce agreement).
3. The written agreement must not specify that the payments are for some other purpose (i.e., child support).
4. The payer and the payee cannot be members of the same household at the time of the payment.
5. There is no liability to make payments for any period after the death of the payee.

These requirements are intended to ensure that both parties to the agreement concur on the amount of alimony being paid. One controversial tax aspect of divorce involves property settlements. Payments and transfers pursuant to property settlements between spouses do not have any income tax consequences.

▲ EXAMPLE 32 Walt and Janice are divorced during the current year. As part of the divorce settlement, Walt pays Janice $100,000 for her interest in their home (the home has a fair market value of $200,000) and agrees to pay Janice $12,000 per year in alimony. The home has an adjusted basis to Walt and Janice of $120,000. What are the tax effects of the payments Walt makes to Janice?

Discussion: The $100,000 payment to Janice is not a taxable disposition by Janice, and no deduction is allowed to Walt, because it is a property settlement payment. The $12,000 per year of alimony is included in Janice’s gross income and is deductible for adjusted gross income by Walt.

This treatment of property settlements may tempt the spouse making a property settlement to try to disguise the settlement as deductible alimony payments. A complex set of “recapture” rules has been designed to stop this so-called front loading of property settlements disguised as alimony payments during the first three years of separation. The recapture rules require the spouse making the alimony payment (and taking the alimony-paid deduction) to include in income the excess deductions taken when the property settlement has been disguised as alimony. The spouse receiving the disguised payments is allowed a deduction to offset the overstated alimony. These recapture rules have removed the incentive to disguise property settlements as alimony.

The final problem in the alimony area is the attempt to disguise child support payments as alimony. To counter this problem, the tax law requires that any reductions in alimony payments that are the result of a contingency related to a child are classified as child support payments.

▲ EXAMPLE 33 Ben and Diane are divorced in the current year. As part of their divorce agreement, Ben is to pay Diane alimony of $500 per month until their son reaches age 18, at which time the payments will be reduced to $200 per month. What are the tax effects of the payments Ben makes to Diane?

Discussion: Because the payments are to be reduced to $200 when their child reaches age 18 (a contingency related to a child), only $200 per month of all payments made are considered alimony. The remaining $300 is a nondeductible child support payment.
Death Benefit Payments. When an employee dies, the employer often makes payments to surviving dependents to help them adjust to life without the income of the deceased. Until August 19, 1996, the tax law allowed one $5,000 exclusion for death benefits paid to deceased employees’ beneficiaries. Death benefit payments received after August 19, 1996 are no longer allowed the exclusion and are included in the gross income of the beneficiaries.

Imputed Income
Two major sources of income that are untaxed under current law are the goods and services produced by individuals for personal consumption and individuals’ use of their personal residence and other durable goods. To understand why these items constitute income under the principles described earlier in the chapter, consider the following example:

▲ EXAMPLE 34 Jana has a garden in which she grows tomatoes for her personal consumption. The full cost of producing the tomatoes amounts to $40. At current prices, it would have cost $100 to purchase the tomatoes. Does Jana have income from growing and consuming her tomatoes?

Discussion: Although Jana’s wealth has increased by $60 from growing and consuming her own tomatoes rather than purchasing them, she does not have to recognize the $60 as income. The key factor in the nonrecognition of the income is that the $60 increase in wealth was not realized in an arm’s-length transaction with another party. Note that if Jana had sold the tomatoes for $100 and used the money for other purposes, she clearly would have realized the income, and the $60 increase in wealth would be subject to tax.

This example of income from in-kind consumption is but one of many types of imputed income from which taxpayers profit on a daily basis but are not subject to taxation. The primary reason that these kinds of income are not taxed is that there is no realization of the income. In addition, even if in-kind consumption were considered a realization, such income would not be taxed because it would be administratively inconvenient. Imagine the nightmare of having to keep track of all the tasks you perform for yourself rather than hiring someone else to do the work! How could the government audit this type of income?

Although the vast majority of imputed income is not taxed, the tax law does identify several specific items of imputed income that must be taxed. The three most common forms of imputed income subject to tax are

- Below market-rate loans
- Payment of expenses by others
- Bargain purchases

Below Market-Rate Loans. Before 1984, a common tax-planning technique that taxpayers used to shift income from high marginal tax rate taxpayers to low marginal tax rate taxpayers was the use of an interest-free loan, called a below market-rate loan. The savings that could have been realized from such a plan are illustrated in the following example:

▲ EXAMPLE 35 Binh, who is in the 35% marginal tax rate bracket, lends his son Chee $50,000 interest-free. Chee, who is a 15% marginal tax rate payer, puts the money in a savings account earning 10%. How much tax does the family save through this arrangement?

Discussion: If Binh invested the $50,000 at the same earnings rate, the tax savings would be $1,000. That is the difference between the tax Binh would have paid on the $5,000 in interest, $1,750 ($5,000 × 35%), and the tax paid by Chee on the $5,000 in interest, $750 ($5,000 × 15%).
In 1984, Congress curtailed some advantages of interest-free loans by enacting provisions that consider such loans as consisting of two transactions: a normal interest-bearing loan (at the current federal rate of interest) and an exchange of cash between the lender and the borrower to pay the interest on the loan. The imputed exchange of cash is the amount of cash necessary for the borrower to pay the lender the interest on the loan. A conventional interest-bearing loan and an interest-free loan are compared in Figure 3–1.

Under the imputed interest rules, the lender is deemed to have interest income at the federal rate of interest, whereas the borrower is deemed to have made a payment (first imputed cash payment) of the interest (step 2 at the bottom of Figure 3–1). The imputed payment of cash (second imputed cash payment) from the lender to the borrower (step 3 at the bottom of Figure 3–1) may also produce taxable income to the borrower, depending on the type of loan.

**Figure 3–1**

**Imputed Interest Rules**

**CONVENTIONAL LOAN**

1. Amount borrowed (principal) $$

2. Interest is paid over term of loan $

3. Principal is repaid when due $$$

**INTEREST-FREE LOAN**

1. Amount borrowed (principal) $$$

2. A cash payment is imputed from borrower to lender in an amount necessary to pay the interest

3. Interest income imputed to lender is deemed returned to borrower as compensation, a gift, or similar transfer

4. Principal is repaid when due $$$

Results:

Step 2: Lender—interest income
Borrower—interest expense

Step 3: Treatment of imputed cash payment depends on relationship between lender and borrower:
The motive for not requiring interest on the loan determines the tax treatment.

Legend:

--- Actual cash payments
--- Imputed cash payments
The three basic types of loans are

- Gift loans
- Employment-related loans
- Corporation/shareholder loans

A gift loan is one made between family members. The imputed cash exchange on these loans is considered a gift from the lender to the borrower and is not subject to tax. (The exclusion for gifts is covered in Chapter 4.)

▲ EXAMPLE 36 What is the tax treatment of the loan Binh made to Chee in example 35 if the federal rate of interest is 8%?

Discussion: The first step in accounting for an interest-free loan is to determine the amount of imputed interest on the loan using the applicable federal rate of interest. In this case, the amount of imputed interest is $4,000 ($50,000 × 8%). This is the amount of interest income the lender is deemed to have earned (and the borrower is deemed to have paid) from the making of the loan. In this case, interest income of $4,000 is imputed to Binh, and interest expense of $4,000 is imputed to Chee. Binh therefore includes $4,000 of interest in his gross income. Chee has interest expense of $4,000, the deductibility of which depends on how he uses the money. (Interest deductions are discussed in Chapter 5.)

Note: Because this is a gift loan of less than $100,000, the amount of interest imputed may be less than the $4,000 federal rate. See examples 39–41.

The second step is to give effect to the motive for the nonpayment of interest on the loan. This is done by assuming that the lender gave the borrower the cash with which to pay the interest imputed on the loan in the first step. This imputed payment of cash is then taxed as any payment of cash would be taxed. In this case, Binh is deemed to have made a gift to his son of the $4,000 in interest. The receipt of the gift is not taxable to Chee, nor is it deductible by Binh.

When a loan is made to an employee by an employer, the imputed exchange of cash in the second step is deemed to be compensation paid to the employee and thus is taxable to the employee and deductible by the employer.

▲ EXAMPLE 37 In the previous example, assume that Binh lends the $50,000 to Celine, an employee of his roofing business. What is the tax treatment of the loan?

Discussion: As in the gift loan, Binh is assumed to have received (and Celine is assumed to have paid) interest income of $4,000. The imputed payment of cash for the interest is considered a payment for compensation. Therefore, Binh is deemed to have paid Celine $4,000 in compensation, which is taxable to Celine and deductible by Binh.

Note that the net effect of this arrangement for Binh is zero. That is, he has an increase in his income of $4,000 because of the imputation to him of the interest income on the loan, which is counterbalanced by the compensation payment deduction of $4,000. Whether the same is true for Celine depends on whether she can deduct the interest expense imputed on the loan. For example, if Celine uses the $50,000 for a purely personal purpose such as the payment of a personal debt, the interest would not be deductible. In that case, the net effect for Celine would be an increase in taxable income of the $4,000 in imputed compensation.

When an interest-free loan is made to a shareholder of a corporation, the imputed exchange of cash is deemed to be a dividend paid to the shareholder and thus is taxable to the shareholder. A corporation is not allowed a deduction for dividends paid to shareholders.

▲ EXAMPLE 38 In example 37, assume that Celine is a shareholder of Binh’s roofing business, which is organized as a corporation. The loan is made from the corporation to Celine. What is the tax treatment of the loan?

Discussion: The $4,000 in interest is imputed to the corporation and Celine, as in the previous example. The $4,000 imputed exchange of cash to pay the interest is deemed a dividend paid to Celine and is taxable to her as dividend income. Binh’s corporation is deemed to have paid a dividend of $4,000, which is not deductible by the corporation.
A summary of the treatments of the second imputed cash payment for the three types of loans is presented in Table 3–3.

Exceptions to Imputed Interest Rules. There are two exceptions to the rules for interest-free loans. First, any loan of $10,000 or less is exempted from the imputed interest rules. This exception is for administrative convenience; it would be very costly to keep track of all small loans that people make to friends and relatives. Therefore, a small amount of income can still be shifted through the use of $10,000 interest-free loans.

The second exception is for gift loans of $100,000 or less. On such loans, the imputed interest on the loan cannot exceed the borrower’s net investment income (investment income less the costs of producing the income) for the year. Further, if the borrower’s net investment income for the year does not exceed $1,000, the imputed interest is deemed to be zero; the loan has no tax effect. Therefore, gift loans that do not produce much income for the borrower or that are used for in-kind consumption by the borrower escape the imputed interest rules.

▲ EXAMPLE 39 Allegra lends her daughter Elena $50,000, which she uses to purchase a new house. The loan is interest-free, the federal rate of interest is 8%, and Elena has $600 in investment income for the year. What are the tax consequences of the loan?

Discussion: Because this is a gift loan of less than $100,000, the imputed interest is limited to Elena’s net investment income for the year. However, because Elena’s investment income is less than $1,000, no interest is imputed on the loan. Therefore, the loan has no income tax effects for either Allegra or Elena.

▲ EXAMPLE 40 Assume the same facts as in example 39, except that Elena’s investment income is $2,500.

Discussion: In this case, interest on the gift loan would be imputed at $2,500, Elena’s investment income. Allegra would have interest income of $2,500, and Elena would have interest expense of $2,500.

▲ EXAMPLE 41 Assume the same facts as in example 39, except that Elena’s investment income is $6,000.

▲ Table 3–3

<table>
<thead>
<tr>
<th>Type of Loan</th>
<th>Lender</th>
<th>Borrower</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gift loans</td>
<td>Imputed payment is a gift made to the borrower—no income tax effect.</td>
<td>Imputed payment is a gift received from the lender—no income tax effect.</td>
</tr>
<tr>
<td>Employment-related loans</td>
<td>Imputed payment is compensation paid to the borrower—lender gets a deduction for compensation paid.</td>
<td>Imputed payment is compensation received by the borrower—borrower has compensation income.</td>
</tr>
<tr>
<td>Shareholder loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Loan to a shareholder</td>
<td>1. Imputed payment is a dividend paid to the borrower—lender gets no deduction for dividends paid.</td>
<td>1. Imputed payment is a dividend received from the lender—borrower has dividend income.</td>
</tr>
<tr>
<td>2. Loan to the corporation</td>
<td>2. Imputed payment is a contribution to corporate capital—no deduction allowed to lender (added to basis in stock).</td>
<td>2. Imputed payment is receipt of contributed capital—no imputed income to the borrower.</td>
</tr>
</tbody>
</table>
Discussion: In this case, interest at the federal rate of $4,000 ($50,000 \times 8\%) is less than Elena’s investment income of $6,000. Therefore, interest of $4,000 is imputed on the loan. That is, none of the special exceptions for gift loans is applicable. Note: Interest is never imputed at a rate greater than the applicable federal interest rate.

Payment of Expenses by Others. Whenever one taxpayer pays another taxpayer’s expenses, the taxpayer who received the benefit of the payment has realized an increase in wealth and is taxed on the payment, unless the payment constitutes a valid gift. (Gifts are excluded from income.) The more common situations involve payments of expenses of an employee by an employer, taxes of the lessor paid by the lessee of property, and the payment of the personal expenses of the principal shareholder of a closely held corporation. (A closely held corporation is one in which five or fewer shareholders own more than 50 percent of the stock of the corporation.)

▲ EXAMPLE 42 Ramona is the president of DEF, Inc. Her employment contract states that DEF is to pay Ramona a salary of $100,000 and the federal income tax due on the salary. In the current year, the tax on Ramona’s DEF salary totals $27,000, which is paid by DEF. What is Ramona’s gross income from DEF?

Discussion: The payment of the $27,000 of tax on Ramona’s salary is considered compensation income paid to Ramona. Therefore, her gross income from DEF is $127,000.

▲ EXAMPLE 43 Joe lost his job this year. Because he was having trouble paying all his bills, his grandfather agrees to pay Joe’s home mortgage until he can find a new job. His grandfather makes payments on Joe’s mortgage totaling $10,000 during the current year. What are the tax effects of the payment of Joe’s mortgage by his grandfather?

Discussion: The payment of the mortgage is not meant to be compensation from grandfather to Joe; rather, it is in the nature of a gift from grandfather to Joe to help him through his tough economic times. Therefore, the payments are not taxable to Joe. (Gifts are excluded from income.)

These two examples illustrate the key consideration in determining whether the payment of an expense by another is taxable: intent to compensate. That is, when payments are made on behalf of another in an employment or other business-related context, they are generally taxable. Payments made on behalf of family members that are unrelated to employment or other business matters are generally considered nontaxable gifts.

Bargain Purchases. Ordinarily, when taxpayers astutely purchase property for less than it is worth, they are not taxed immediately on the increased wealth resulting from the purchase. Any such gain will be reflected when the property is sold. However, a true bargain purchase is taxable to the buyer. Such a purchase occurs when the difference between the purchase price and the fair market value represents an effort by the seller to confer an economic advantage to the buyer. That is, the purchase price does not result from an arm’s-length transaction. As such, bargain purchases are typically found in employer/employee purchases and other instances in which the seller perceives some ultimate advantage in selling the property to a particular taxpayer at less than fair market value.

▲ EXAMPLE 44 Sterling is an employee of Shelf Road Development Company. The company recently subdivided some property and offered lots for sale at a price of $50,000. Shelf sells Sterling a lot for $20,000. How much gross income does Sterling have from the purchase of property?

Discussion: The difference between the $50,000 fair market value and the $20,000 purchase price—$30,000—is taxable to Sterling as compensation. The purchase price, an attempt to compensate Sterling, is not the result of an arm’s-length bargain.

▲ EXAMPLE 45 Karolina wants to purchase a new Bugatti roadster. She knows that such cars usually sell for about $50,000. However, she finds a dealer who is having financial difficulties and is able to purchase a Bugatti for only $40,000. Does Karolina have gross income from the purchase of the Bugatti?
PART II  Gross Income

Discussion: Because the dealer gains no long-term benefit from selling the car to Karolina for $40,000, her astute purchase is not considered a bargain purchase for tax purposes. Further, the purchase price is the result of an arm’s-length transaction. Therefore, she is not taxed on the $10,000 below market-value purchase.

Whenever a property is sold, exchanged, or otherwise disposed of, a realization occurs, and the entity owning the property must calculate the gain or loss resulting from the disposition of the property. The income tax provisions governing property transactions are an important part of the income tax system. Chapters 9 through 12 discuss in detail various aspects of income tax accounting for the acquisition, use, and disposition of property. However, because of their importance in the income tax system, we briefly discuss capital gains and losses at this point.

A capital gain or a capital loss results from the sale or other disposition of a capital asset. As discussed in Chapter 2, a capital asset is any asset that is not a receivable, an item of inventory, depreciable property used in a trade or business, or real property used in a trade or business. Thus, the most common capital assets are investment assets (stocks, bonds, rental property held for investment, etc.) and assets used for personal use purposes (home, furniture, clothing, personal automobile, etc.) by individuals.

Since 1921, the tax law has provided some form of preferential tax treatment for capital gains. For example, until 1987, individuals were allowed to deduct 60 percent of any net long-term capital gains. This meant that only 40 percent of net long-term capital gains was subject to tax. During most of this time, the top marginal tax rate was 50 percent, resulting in a maximum tax rate on long-term capital gains of 20 percent (50% x 40%). Although the 60-percent capital gains deduction was repealed in 1986, all the mechanisms for accounting for capital gains and other limitations were left in place. Therefore, although the tax savings may not be as great as they once were, accounting for capital gains and losses remains an important aspect of our tax system. The basic aspects of accounting for capital gains and losses are discussed in the sections that follow. More detailed analysis is provided in Chapter 11.

Capital Gain-and-Loss Netting Procedure

The income tax law determines the treatment of capital gains and losses on an annual basis. That is, all capital gains and losses occurring during a tax year are aggregated through a prescribed netting procedure to determine the net effect of all capital asset transactions for the year. The special tax treatments (if any are applicable) are applied only to the net results for the year, not to individual transactions.

Exhibit 3–4 outlines the procedure for determining the net long-term capital gains or losses for the year. The first step requires identification of the year’s gains and losses by the type of gain. Gains and losses must be identified as long-term or short-term. In addition, collectibles gains and losses, gains on qualified small business stock, and unrecaptured Section 1250 gains must be separately identified at this step. Whether a gain or loss is short term or long term depends on its holding period. As the phrase indicates, the holding period is how long the taxpayer owned the asset that was sold. Assets held for more than 12 months produce long-term capital gains and long-term capital losses. Assets held for one year or less...
produce short-term capital gains and short-term capital losses. Sales of collectibles that are held for more than 12 months produce collectibles gains and collectibles losses. Collectibles include works of art, rugs, antiques, metals, gems, stamps, coins, and alcoholic beverages. Gains on qualified small business stock and unrecaptured Section 1250 gains are defined and discussed in Chapter 11. Distinguishing among the various types of gains and losses is important because each category is accorded different treatment in determining the income tax liability of a taxpayer.

The second step in the netting procedure is to reduce the gains and losses for the year into one net long-term position (either a gain or a loss) and one net short-term position (either a gain or a loss). For purposes of this netting, collectibles gains and losses, gains on qualified small business stock, and unrecaptured Section 1250 gains are treated as being held long-term. Combine all short-term gains and losses to determine a net short-term position for the year.

### EXAMPLE 46

Astrid has the following capital gains and losses for the current year:

<table>
<thead>
<tr>
<th>Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term capital gains</td>
<td>$13,000</td>
</tr>
<tr>
<td>Long-term capital losses</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Short-term capital gains</td>
<td>8,000</td>
</tr>
<tr>
<td>Short-term capital losses</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Collectibles gains</td>
<td>7,000</td>
</tr>
<tr>
<td>Collectibles losses</td>
<td>(3,000)</td>
</tr>
</tbody>
</table>

What are Astrid’s net long-term and net short-term capital gain or loss positions for the year?

**Discussion:** Collectibles gains and losses are treated as long-term gains and losses in the netting procedure. Astrid has a net long-term capital gain of $13,000 and a net short-term capital loss of $2,000 for the current year:

### Long-Term Gain/Loss Netting

<table>
<thead>
<tr>
<th>Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term capital gain</td>
<td>$13,000</td>
</tr>
<tr>
<td>Long-term capital loss</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Collectibles gains</td>
<td>7,000</td>
</tr>
<tr>
<td>Collectibles losses</td>
<td>(3,000)</td>
</tr>
</tbody>
</table>

**Net long-term capital gain** $13,000
After the capital gain-and-loss transactions for the year have been reduced to a long-term and a short-term position for the year, the next step is to reduce the capital gain position for the year to either a gain or a loss on capital asset transactions for the year. Thus, if the short- and long-term positions are opposite (one is a gain and one is a loss), the two positions must be netted together to determine whether a gain or a loss has resulted from the taxpayer’s capital asset transactions for the year.

▲ EXAMPLE 47  Return to the facts of example 46. What is Astrid’s net capital gain or loss for the year?

Discussion:  Astrid has a net long-term capital gain of $11,000 for the year. Because the first netting resulted in a long-term capital gain and a short-term capital loss, one more netting is necessary to determine Astrid’s net capital gain position for the year:

| Net long-term capital gain | $13,000 |
| Net short-term capital loss | (2,000) |
| Net long-term capital gain | $11,000 |

Note that the effect of the netting procedure is to summarize all of Astrid’s capital gains and losses for the year in a net gain position. This is the purpose of the procedure—to reduce all capital gains and losses occurring during the year into either a net gain or a net loss position.

If the first netting produces short- and long-term positions that are the same (both are gains or both are losses), the taxpayer’s gain or loss position for the year is known and no further netting is necessary.

▲ EXAMPLE 48  Milton has the following capital gains and losses for the current year:

| Long-term capital gain | $ 3,000 |
| Long-term capital loss | (1,000) |
| Short-term capital gain | 6,000 |
| Short-term capital loss | (2,000) |

What is Milton’s net capital gain or loss position for the current year?

Discussion:  The first netting results in a net long-term capital gain of $2,000 and a net short-term capital gain of $4,000:

| Net long-term capital gain | $2,000 |
| Net short-term capital gain | $4,000 |

Because both the long- and short-term positions are gains, it is clear that Milton has a gain in his capital asset transactions for the year. Therefore, no further netting is necessary. He will report a long-term capital gain of $2,000 and a short-term capital gain of $4,000 on his current year’s tax return.

After the net capital gain or loss position for the year has been determined, each of the various types of gains and losses is subject to special rules in the calculation of the taxpayer’s taxable income and income tax liability. These rules are outlined in
Table 3–4 and discussed in the next section. One thing you should note is that the tax treatments are applied to the net gain or loss for the entire tax year, not for individual gains and losses occurring during the year.

**Tax Treatment of Capital Gains**

In calculating taxable income, net capital gains are added to gross income. The preferential treatments accorded to the various types of capital gains are applied in the calculation of the income tax liability. Net short-term capital gains receive no preferential tax treatment and are taxed at the taxpayer’s marginal tax rate. Adjusted net capital gains are taxed at 20 percent. The rate is reduced to 10 percent if the taxpayer is in the 15 percent marginal tax rate bracket. Unrecaptured Section 1250 gains are taxed at a maximum rate of 25 percent. Net collectibles gains are taxed at a maximum rate of 28 percent. One-half of the gain on qualified small business stock is excluded from income. The remaining gain is taxed at a maximum rate of 28 percent. Net long-term capital gains are taxed at a maximum rate of 28 percent. Unrecaptured Section 1250 gains are taxed at a maximum rate of 28 percent. One-half of the gain on qualified small business stock is excluded from income. The remaining gain is taxed at a maximum rate of 28 percent.

To calculate the capital gains tax, a series of nettings is done to determine the composition of the net long-term capital gain. Adjusted net capital gain is defined as the net long-term gain from the netting procedure minus the 28 percent rate gain and the unrecaptured Section 1250 gain. The 28 percent rate gain is equal to the sum of the net collectibles gain and gain on qualified small business stock reduced by net short-term capital losses and any long-term capital loss carryovers from previous years. If the 28 percent rate gain is negative, the remaining loss is netted against unrecaptured Section 1250 gains. Any remaining loss is netted against the adjusted
net capital gain. The practical effect of this offsetting of losses is that the long-term capital gain from the netting procedure is accorded the most favorable rates first. That is, the net long-term capital gain from the netting procedure is first allocated to the gain taxed at 20% (adjusted net capital gain), then to the gain taxed at 25% (unrecaptured Section 1250 gain), and last to the gain taxed at 28% (net collectibles gain, and gain on qualified small business stock).

**EXAMPLE 49** In example 47, Astrid had a net long-term capital gain of $11,000, which included a $13,000 long-term gain, a $4,000 long-term loss, a $7,000 collectibles gain, a $3,000 collectibles loss, and a $2,000 net short-term capital loss. Astrid is single and has other taxable income of $92,000. What is her taxable income and income tax liability?

*Discussion:* Astrid adds the $11,000 net long-term capital gain to her gross income, increasing taxable income to $103,000. Astrid’s $11,000 net long-term capital gain consists of three parts: a net long-term capital gain of $9,000 ($13,000 – $4,000), a net collectibles gain of $4,000 ($7,000 – $3,000) and a net short-term capital loss of $2,000. In computing her tax liability, the 28% rate gain is $2,000 ($4,000 collectibles gain – $2,000 short-term capital loss). Her adjusted net capital gain is $9,000 ($11,000 – $2,000). This is equivalent to allocating the $11,000 net long-term capital gain first to the $9,000 adjusted net capital gain, leaving a net collectibles capital gain of $2,000 ($11,000 – $9,000). The adjusted net capital gain is taxed at 20%. In 2003, single individuals begin paying a 30% marginal tax rate at a taxable income of $68,800. Because Astrid’s taxable income is greater than this amount, her marginal rate is 30% and the $2,000 net collectibles gain is taxed at the 28% maximum rate. Her income tax liability is $24,188:

\[
\text{Tax on } $92,000 \text{ ordinary income} - \left(14,190.00 + [30\% \times ($92,000 - $68,800)]\right) = $21,828 \\
\text{Tax on } $2,000 \text{ net collectibles capital gain} - $2,000 \times 28\% = 560 \\
\text{Tax on } $9,000 \text{ net long-term capital gain} - $9,000 \times 20\% = 1,800 \\
\text{Income tax liability} = $24,188
\]

Without the favorable treatment accorded capital gains, Astrid’s income tax liability would have been $25,128. Astrid saves $940 ($25,128 – $24,188) from the capital gain rate provisions.

**EXAMPLE 50** Lane has the following capital gains and losses during the current year:

<table>
<thead>
<tr>
<th>Type of Gain/Loss</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term capital loss</td>
<td>($8,000)</td>
</tr>
<tr>
<td>Collectibles gain</td>
<td>6,000</td>
</tr>
<tr>
<td>Long-term capital gain</td>
<td>12,000</td>
</tr>
</tbody>
</table>

Lane is single and has taxable income from other sources of $42,000. What is her taxable income and her income tax liability?

*Discussion:* Lane has an $8,000 net short-term capital loss and an $18,000 ($6,000 + $12,000) net long-term capital gain. The short-term capital loss and the long-term capital gain are netted, resulting in a $10,000 ($18,000 – $8,000) net long-term capital gain. Because the short-term loss is greater than the collectibles gain, all of the $10,000 net long-term capital gain is adjusted net capital gain. Her taxable income is $52,000 and her income tax liability is $9,632:

\[
\text{Tax on } $42,000 \text{ ordinary income} - \left(3,960.00 + [27\% \times ($42,000 - $28,400)]\right) = $7,632 \\
\text{Tax on } $10,000 \text{ adjusted net capital gain} - $10,000 \times 20\% = 2,000 \\
\text{Total income tax liability} = $9,632
\]

**Tax Treatment of Capital Losses**

Net capital losses of individuals are deductible up to an annual limit of $3,000. Capital losses are deductible as a deduction for adjusted gross income. Any capital loss in excess of the $3,000 limit is carried forward to the next year and is used in the next year’s capital gain-and-loss netting.

**EXAMPLE 51** Chalmer has a net long-term capital gain of $6,000 and a net short-term capital loss of $17,000 in the current year. What is the effect of Chalmer’s capital asset transactions on his taxable income?
**CHAPTER 3  Income Sources**

**Discussion:** Because the long- and short-term positions are opposite, they are netted together, resulting in a net short-term capital loss of $11,000 ($6,000 − $17,000). Chalmer can deduct $3,000 of the loss as a deduction for adjusted gross income in the current year. The remaining $8,000 loss is carried forward to next year as a short-term capital loss and used in next year’s capital gain-and-loss netting.

When an individual has both a net short-term capital loss and a net long-term capital loss in the same year, the short-term loss must be used toward the $3,000 annual limit before any long-term loss is deducted.30

▲ **EXAMPLE 52** During the current year, Zerenda has a $2,000 net short-term capital loss and a $5,000 net long-term capital loss. What is the effect of Zerenda’s capital asset transactions on her taxable income?

**Discussion:** Because the long-term and short-term positions are both losses, no netting is necessary. Zerenda deducts $3,000 of the total loss as a deduction for adjusted gross income. The $3,000 loss deduction is composed of the $2,000 short-term loss and $1,000 of the long-term loss. The remaining $4,000 ($5,000 − $1,000) of the long-term loss is carried forward to the next year as a long-term capital loss and used in next year’s capital gain-and-loss netting.

One thing to remember when dealing with personal use assets (which are capital assets) is that gains on the sale of personal use assets are taxable under the all-inclusive income concept. However, losses on personal use assets are disallowed. Therefore, if a personal use asset is sold at a gain, the gain is a capital gain and subject to the rules for capital gains. A loss on the sale of a personal use asset is not deductible and does not enter into the capital gain netting procedure.

▲ **EXAMPLE 53** Morgan sells for $3,400 a diamond necklace she purchased in 1982 at a cost of $2,000. Larry sells his personal truck, for which he paid $12,000, for $5,000. What are the effects of the sales on Morgan’s and Larry’s incomes?

**Discussion:** Morgan has a long-term capital gain of $1,400 ($3,400 − $2,000) from the sale of her necklace. The $1,400 gain must be combined with her other capital gains and losses in the capital gain-and-loss netting procedure. Larry’s loss of $7,000 ($5,000 − $12,000) on the sale of his truck is a nondeductible personal use loss. Therefore, the loss has no effect on his taxable income.

**Capital Gains and Losses of Conduit Entities**

All items of income—gains, losses, deductions, and credits—of a conduit entity flow through the entity and are reported directly by the owners of the conduit. However, many items realized at the conduit level receive special treatment on the owners’ tax returns. To provide owners with the information necessary to prepare their returns properly, a conduit entity is required to report each owner’s share of the “ordinary” taxable income or loss separately from those items that receive special treatment.31

The ordinary taxable income or loss is the income that results from income, gains, losses, and deductions that receive no special treatment. Because capital gains and losses are aggregated in the netting process on an owner’s return, they must be allocated to each owner.

▲ **EXAMPLE 54** Parnell and Isis are equal partners in the Steiner Partnership. Steiner has total income of $70,000, consisting of the following items in the current year:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income from sales</td>
<td>$120,000</td>
</tr>
<tr>
<td>Trade or business expenses</td>
<td>90,000</td>
</tr>
<tr>
<td>Operating income</td>
<td>$30,000</td>
</tr>
<tr>
<td>Long-term gain on investment property</td>
<td>50,000</td>
</tr>
<tr>
<td>Short-term loss on Webto stock</td>
<td>(10,000)</td>
</tr>
<tr>
<td>Total income</td>
<td>$70,000</td>
</tr>
</tbody>
</table>

How do Steiner’s results affect Parnell and Isis?

**Discussion:** As equal partners, Parnell and Isis share the partnership items equally. Each reports $15,000 (50% × $30,000) in ordinary income from the partnership. In addition,
each will have a long-term capital gain of $25,000 and a short-term capital loss of $5,000 that each must include in his or her capital gain-and-loss netting.

▲ EXAMPLE 55 Assume that in addition to the items reported to her in example 54, Isis has the following income items:

- Salary from Webto Corporation $64,000
- Dividend income 4,000
- Long-term capital loss (14,000)

What is Isis’s adjusted gross income?

Discussion: Isis’s adjusted gross income is $89,000:

- Salary from Webto Corporation $64,000
- Dividend income 4,000
- Ordinary income from Steiner Partnership 15,000
- Net long-term capital gain $(25,000 – $14,000 – $5,000) 6,000
- Adjusted gross income $89,000

Note that if the Steiner Partnership were not required to report its capital gains and losses separately, Isis’s adjusted gross income would be $100,000 \(((1/2 \times 70,000) + 64,000 + 4,000 – 3,000)\) because of the limitation on capital loss deductions. Because capital gains and losses are reported separately from the partnership’s ordinary income, Isis’s $14,000 long-term capital loss is deducted against the $25,000 long-term capital gain from the partnership and is not subject to the capital loss limitations.

Once an income item has been identified as taxable, the tax year for recognition must be determined. In general, the taxpayer’s accounting method dictates the proper period for inclusion. The two basic accounting methods allowed for tax purposes are the cash method and the accrual method. We will discuss each method and its general income-recognition criteria in turn. Within each of the two basic accounting methods are exceptions to the treatments prescribed by the methods. These exceptions are generally designed to either discourage tax avoidance schemes or are based on the wherewithal-to-pay concept, which states that income should be taxed when the taxpayer has the means to pay the tax.

Cash Method

Taxpayers using this method of accounting recognize income when it is actually or constructively received. Recall that reduction to cash is not necessary to trigger income recognition because of the cash-equivalent approach to income recognition under the cash method of accounting. All that is required is that something with a fair market value (property, services, etc.) be received. Under the constructive receipt doctrine, income is received when it is made unconditionally available to the taxpayer and is subject to the taxpayer’s complete control.

Because of its simplicity (a checkbook is all the record keeping that is required), most individuals use the cash method. In addition, this method gives taxpayers a somewhat limited ability to determine the year of taxation by accelerating or deferring cash receipts.

▲ EXAMPLE 56 Harold is a cash basis taxpayer who repairs and maintains air conditioners and heating units in his spare time. The current year has been a good one for Harold, and he expects to be in the top marginal tax bracket. Next year, he plans to expand his business with a resulting increase in expenses and a drop in his marginal tax rate. What can Harold do to lower his tax bill?

Discussion: To lower his taxes, Harold should defer receipt of some of his repair and maintenance income until next year, when his marginal tax rate will be lower. This can be accomplished by delaying billings to customers until next year or by easing any credit terms he extends to customers.
Because of this ability to determine the year of taxation using the cash method, several restrictions are placed on the use of the method by certain types of taxpayers. These restrictions are discussed more fully in Chapter 13. The most basic restriction on the use of the cash method is that taxpayers who sell inventories must account for sales, purchases, and inventories using the accrual basis.\footnote{33}

Exceptions Applicable to the Cash Method. The major income-recognition exception for cash basis taxpayers is for investments in original issue discount (OID) securities. An OID security is a debt instrument that has interest payable at maturity rather than throughout the life of the debt. Before the OID rules were codified, cash basis taxpayers could defer interest income by purchasing OID instruments.

\begin{example}
First Financial, Inc., loans Heywood $10,000 on an interest-only basis, with interest payable annually at 10% for 3 years. Under the agreement, Heywood pays $1,000 in interest at the end of each year for 3 years. The $10,000 loan balance is repaid at the end of the third year. How much income does First Financial recognize each year?

\textit{Discussion:} This is a conventional debt situation wherein interest is received throughout the term of the loan and is recognized accordingly. The $1,000 in interest received each year would be included in First Financial's gross income.
\end{example}

\begin{example}
As an alternative, First Financial could lend the money on a discount basis. As an OID debt, the face amount of the debt would be $13,310, payable at the end of 3 years, and Heywood would still receive the $10,000 at the inception of the loan. If First Financial is a cash basis taxpayer, how would it recognize the interest under the general rules for the cash method?

\textit{Discussion:} Under the cash method, First Financial would recognize no income until it receives payment at the end of the third year. At that time, First Financial would recognize the difference between the amount received at maturity and the amount Heywood actually received as income, $3,310 ($13,310 − $10,000). Note that First Financial receives slightly more interest under this arrangement, because interest is being earned on the annual interest payment that is not being made throughout the 3 years.

Current tax law requires that all OID securities with a maturity of more than one year be accounted for on the accrual basis, using the effective interest method.\footnote{34} The intent of this provision is to discourage cash basis investors from deferring income using OID instruments.

\begin{example}
What is the proper income recognition for First Financial in example 58?

\textit{Discussion:} Because the loan is made on an OID basis and has a term of more than one year, First Financial must recognize the interest annually, using the effective interest method. Under this method, the book value of the debt is increased each year for the prior year’s interest, which was accrued but not paid. Interest is calculated as the product of the book value outstanding throughout the year and the rate of interest charged on the loan.

\begin{align*}
\text{Year 1} & \quad 10,000 \times 10\% = 1,000 \\
\text{Year 2} & \quad (10,000 + 1,000) \times 10\% = 1,100 \\
\text{Year 3} & \quad (10,000 + 1,000 + 1,100) \times 10\% = 1,210 \\
\text{Total income recognized} & \quad 3,310
\end{align*}

Series E and EE savings bonds issued by the U.S. government are OID securities that are exempt from the OID rules.\footnote{35} Taxpayers purchasing these bonds are not required to amortize interest income during the life of the bonds, although they may elect to amortize all such bonds they hold currently. If such an election is made, they must amortize interest on any bonds they purchase in the future.

\begin{example}
Henry purchases for $650 a Series EE savings bond with a face value of $1,000 in the current year. The savings bond matures in 10 years and is priced to yield a 6% annual return. How should Henry account for the interest income related to the savings bond?
\end{example}
Discussion: Because Series EE savings bonds are exempted from the OID rules, Henry will not have to recognize interest on the bond until he cashes it in. If Henry cashes in the bond at maturity, he will receive the $1,000 face value of the bond. At that time, he would recognize $350 ($1,000 – $650) in interest income. Note: Henry may elect to amortize the interest earned on the bond each year, using the effective interest method. However, if he makes this election, any other Series EE bonds he owns, as well as any others he may purchase in the future, must also be amortized. That is, you must use the same accounting method for all such bonds.

Accrual Method
Taxpayers using this method recognize income when it is earned, regardless of the actual period of receipt. Income is considered earned when (1) all events have occurred that fix the right to receive the income, and (2) the amount of income earned can be determined with reasonable accuracy. In most cases, these recognition criteria parallel the recognition rules for financial accounting. Some significant differences between the two are discussed later.

Two important aspects of the accrual method should be noted at this point. First, the checkbook approach commonly used by cash basis taxpayers is not sufficient to account for the many accruals and deferrals of income required by the accrual method. Thus, this is a more costly method. Second, accrual basis taxpayers have little control over the timing of their income, because the earning of the income, not the receipt of payment, is the critical recognition event.

▲ EXAMPLE 61 Assume the same facts as in example 56, except that Harold has elected to be an accrual basis taxpayer.

Discussion: Harold must recognize the income from the performance of his repair and maintenance services in the year in which they are performed, not when he receives payment for them. Therefore, he has little ability to control the timing of his income recognition to take advantage of marginal rate differences between tax years.

Exceptions Applicable to the Accrual Method. The receipt of prepaid income by accrual basis taxpayers is generally taxable in the tax year in which payment is received (under the wherewithal-to-pay concept). Thus, advance receipts of rent, interest, royalties, payments for goods, and payments for services are taxable when the cash payment is received, even for accrual basis taxpayers.

There are two exceptions to the general rule for prepayments received for goods and services. For service prepayments, the accrual method may still be used if the services will be performed before the end of the tax year following the year of receipt. This is referred to as the one-year rule for services.

▲ EXAMPLE 62 On July 1, 2003, Toy’s Termite Service, Inc., receives $1,200 on a one-year service contract. Under the contract, Toy’s is to perform pest control once per month. Assuming that Toy’s uses the accrual method of accounting, when should the $1,200 be recognized for tax purposes?

Discussion: The services are to be performed before December 31, 2004 (the end of the tax year following the year of receipt). Therefore, under the one-year rule for services, Toy’s may use the accrual method to recognize income from the contract. Six months of services are to be performed in 2003 and 2004, resulting in the recognition of $600 in income in each year. Note: If Toy’s uses the cash method of accounting, the entire $1,200 is taxable in the year of receipt. The one-year rule is an exception for accrual basis taxpayers.

▲ EXAMPLE 63 Assume the same facts as in example 62, except that the $1,200 advance receipt is for a two-year service contract. When should Toy’s recognize the income from the contract?

Discussion: Because the contract continues past December 31, 2004 (the end of the tax year following the year of receipt), the one-year rule for services does not apply. Toy’s must recognize the entire $1,200 in 2003. Note: A one-year prepayment contract always meets the one-year rule requirement, but a two-year prepayment contract never meets the one-year rule requirement.
It should be noted that the one-year rule applies only to advance receipts for services. Advance receipts for rents and interest are never deferred under the one-year rule for services; they are always taxable in the year of receipt.

The second exception to the general rule for prepayments is for prepaid receipts received for goods. To use the accrual method to account for advance receipts for goods, the prepayment must be less than the cost of the goods and must be deferred for financial accounting purposes.39

**EXAMPLE 64** Anne wants to buy a new car, but none of the dealers in her area has the car she wants. Local Car Sales, Inc., agrees to order the car she wants from the factory. The agreed-upon price for the car is $17,500, and Anne agrees to give Local a $500 deposit on the order, the balance to be paid upon delivery. Local receives the deposit on December 27, 2003. The car arrives the following February, and Anne pays Local the $17,000 balance due on the car. How should Local Car Sales, Inc., account for the $500 deposit received in 2003?

**Discussion:** Assuming that the $500 deposit is less than the cost of the car to Local, Local may defer recognition of the deposit until 2004, provided that it also defers recognition for financial accounting purposes.

**Hybrid Method**

The hybrid method of accounting allows the taxpayer to account for sales of merchandise and the related cost of goods sold on the accrual basis and all other items of income and expense on the cash basis. Thus, the hybrid method is a mixture of the accrual and cash methods. This method is most commonly used by taxpayers who have inventories and therefore must use the accrual method to account for sales and the cost of goods sold from inventories. Such taxpayers must still use the cash method to account for other revenues and must use the cash method for all other expenses.

**EXAMPLE 65** Sunshine is a cash basis taxpayer who repairs and maintains hot tubs in her spare time. She also sells hot tubs. How must Sunshine account for sales of the hot tubs?

**Discussion:** Sunshine must use the accrual method to account for sales and calculate cost of goods sold for the hot tubs. However, she may elect to use the hybrid method of accounting, which would let her use the cash method for her service income and for all other expenses.

**Exceptions Applicable to All Methods**

Certain taxpayers must use two major income-recognition methods, regardless of their accounting methods. These methods relate to installment sales of property and accounting for long-term construction contracts.

**Installment Sales.** An installment sale occurs whenever property is sold and at least one payment is received in a tax year subsequent to the year of sale. Taxpayers who are not dealers in the particular type of property but who make casual sales of property must recognize income from the sale by using the installment method, unless they elect to recognize the entire gain in the year of the sale. The installment method is based on the wherewithal-to-pay concept and recognizes income proportionally as the selling price is received.

**EXAMPLE 66** Lene purchases a tract of land in 1999 at a cost of $20,000 as a speculative investment. In 2003, she sells the land for $50,000. The terms of the sale require the buyer to pay Lene $10,000 in 2003, $20,000 in 2004, and $20,000 in 2005 with interest at 8% on the outstanding balance. How much income must Lene recognize in 2003 through 2005?

**Discussion:** Because Lene is not a dealer in property, she must use the installment method, unless she elects to recognize the entire $30,000 ($10,000 + $20,000 + $20,000 – $20,000) gain in 2003. Under the installment method, the gain is recognized proportionally as the $50,000 selling price is received.

<table>
<thead>
<tr>
<th>Year</th>
<th>Calculation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$10,000 \times (30,000 \div 50,000) = $ 6,000</td>
<td>$ 6,000</td>
</tr>
<tr>
<td>2004 &amp; 2005</td>
<td>$20,000 \times (30,000 \div 50,000) = $12,000</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

In addition, Lene has interest income of $3,200 ($40,000 \times 8\% ) on the outstanding balance in 2004 and $1,600 ($20,000 \times 8\% ) in 2005.
The use of the installment method by other taxpayers has been severely restricted in recent years (i.e., dealers in property generally cannot use the installment sales method).

**Long-Term Construction Contracts.** Taxpayers in the construction industry typically undertake projects that span a number of years. In the past, the income recognition on contracts spanning more than one tax year could be deferred until the completion of the contract. Although this method is still allowable in greatly restricted circumstances, most long-term construction contracts must be accounted for by using the **percentage-of-completed-contract method**. As the name of the method implies, income is recognized according to the amount of work completed on the contract each year. The work completed must be based on costs incurred during the year in relation to the estimated total costs of the project.

▲ **EXAMPLE 67** Acme Construction Corporation enters into a contract in 2003 to construct a bridge for Garden City. The contract price for the bridge is $10,000,000, and Acme estimates its total cost of building the bridge to be $8,000,000. In 2003, Acme’s actual costs were $2,000,000. How much gross income from the contract must Acme report in 2003?

**Discussion:** Using the percentage-of-completion method, Acme reports gross income from the contract of $2,500,000 in 2003.

\[
\begin{align*}
\text{Work completed} & = \left( \frac{2,000,000}{8,000,000} \right) \\
\text{Gross income} & = 25\% \times 10,000,000 = 2,500,000
\end{align*}
\]

To ensure that contractors do not manipulate their income by inaccurately estimating contract costs, a look-back rule is applied at the completion of the contract, and interest is charged on any deficient income reporting.

**Concept Challenge**

Reinforce the concepts covered in this chapter by completing the on-line tutorials located at the Concepts in Federal Taxation website.

**Summary**

This chapter focused on the determination of taxable income sources. In general, a taxpayer is in receipt of income when an increase in wealth is realized. Realization requires a change in the form or substance of a taxpayer’s property or property rights and the involvement of a second party in an arm’s-length transaction.

The four primary sources of income are earned income (income from labor), unearned income (income from investments), transfers from others (increases in wealth that are not the result of either labor or investment), and imputed income (increases in wealth realized because another party confers an economic advantage). Within each of these categories are various problems of realization and recognition. In most instances, application of the income tax concepts provides a solution to the problem. In other cases, the treatment is prescribed by law and must be learned through study and experience. To aid you in reviewing these sources of income, Table 3–5 classifies the income items discussed in this chapter and summarizes the major problems within each category of income.

Capital gains and losses are subject to special reporting rules. All capital gains and losses for a tax year are segregated from other forms of income and subjected to the capital gain-and-loss netting procedure. The purpose of the capital gain-and-loss netting procedure is to reduce a taxpayer’s capital gain and loss transactions for the tax year to a net figure that represents the gain or loss for the year. Net long-term capital gains of individuals are taxed at a rate of 20 percent. Up to $3,000 of net capital losses of individuals are deductible for adjusted gross income. Any excess losses are carried forward to the next year’s netting.

The period in which an item of income is recognized is determined by the taxpayer’s method of accounting. The two basic accounting methods are the cash method and the accrual method, although some taxpayers may use a combination of the two methods called the hybrid method. Exceptions to the general recognition rules exist for certain installment sales and long-term construction contracts. Other specific recognition exceptions exist for both the cash and the accrual methods.
### Income Sources by Class of Income

<table>
<thead>
<tr>
<th>Income Sources</th>
<th>Major Problems</th>
</tr>
</thead>
</table>
| **Earned Income** | Assignment of income  
Wages and salaries  
Tips, commissions, bonuses  
Income from sole proprietorship—either the active conduct of a trade or business or the rendering of services  
Income from illegal activities—gambling, drug dealing, racketeering, etc.  
Earned income (p. 90)  
Holding period (p. 106)  
Hybrid method of accounting (p. 115)  
Imputed income (p. 101)  
Installment sale (p. 115)  
Long-term capital gain (p. 106)  
Long-term capital loss (p. 106)  
Net capital loss (p. 110)  
Net collectibles gain (p. 109)  
Net short-term capital gain (p. 109) | What is a receipt?  
Definition of income from rents and royalties  
Capital recovery on annuities  
Calculation of gain (loss)  
Income from conduit entity |
| **Unearned Income** | Definition of income from rents and royalties  
Wages and salaries  
Tips, commissions, bonuses  
Income from sole proprietorship—either the active conduct of a trade or business or the rendering of services  
Income from illegal activities—gambling, drug dealing, racketeering, etc.  
Earned income (p. 90)  
Holding period (p. 106)  
Hybrid method of accounting (p. 115)  
Imputed income (p. 101)  
Installment sale (p. 115)  
Long-term capital gain (p. 106)  
Long-term capital loss (p. 106)  
Net capital loss (p. 110)  
Net collectibles gain (p. 109)  
Net short-term capital gain (p. 109) | Definition of income from rents and royalties  
Capital recovery on annuities  
Calculation of gain (loss)  
Income from conduit entity |
| **Transfers from Others** | Exception for prizes and awards given to charity  
Unemployment compensation  
Social Security benefits  
Alimony received  
Death benefit payments  
Prizes and awards  
Unemployment compensation  
Social Security benefits  
Alimony received  
Death benefit payments | Exception for prizes and awards given to charity  
Exception for employee awards for length of service or safety  
Calculation of taxable portion of Social Security benefits  
Front loading of alimony payments to disguise a property settlement  
Child support payments disguised as alimony |
| **Imputed Income** | Below market-rate loans  
Payment of expense by others  
Bargain purchases  | Below market-rate loans  
Gift vs. compensation for payment of expenses by others  
Compensatory nature of bargain purchase |

**Key Terms**

- Adjusted net capital gain (p. 109)
- Alimony (p. 100)
- Annuity (p. 92)
- Annuity exclusion ratio (p. 92)
- Bargain purchase (p. 105)
- Below market-rate loan (p. 101)
- Capital asset (p. 106)
- Cash-equivalent approach (p. 90)
- Child support payment (p. 100)
- Collectibles gains (p. 107)
- Collectibles losses (p. 107)
- Death benefit payments (p. 101)
- Earned income (p. 90)
- Holding period (p. 106)
- Hybrid method of accounting (p. 115)
- Imputed income (p. 101)
- Installment sale (p. 115)
- Long-term capital gain (p. 106)
- Long-term capital loss (p. 106)
- Net capital loss (p. 110)
- Net collectibles gain (p. 109)
- Net short-term capital gain (p. 109)
- One-year rule for services (p. 114)
- Original issue discount security (OID) (p. 113)
- Percentage-of-completed-contract method (p. 116)
- Property settlement (p. 100)
- Savings bond (U.S. government-issued) (p. 113)
- Short-term capital gain (p. 107)
- Short-term capital loss (p. 107)
- Unearned income (p. 91)
1 Reg. Sec. 1.61-1—States that income can be realized in any form, including cash, services, and property received.
2 Eisner v. Macomber, 252 U.S. 189 at 207 (1920)—In holding that a stock dividend did not constitute gross income, determined that income is derived from labor and capital.
3 Eisner v. Macomber at 207.
4 Cesarini v. Comm., 428 F.2d 812 (6th Cir. 1970)—In determining that cash found in a purchased piano was included in gross income, established that “treasure troves” constitute gross income.
5 Helvering v. Bruun, 303 U.S. 461 (1940)—Held that a landlord realized gain on the forfeiture of a leasehold for the non-payment of rent and that the increase in the value of the property was taxable even though the gain was not severed from the property. (Subsequently overturned by enactment of Sec. 109).
6 Helvering v. Bruun at 469.
7 Sec. 109—States that gross income does not result from increases in the value of a property at the termination of a lease.
8 Glenshaw Glass v. Comm., 348 U.S. 426 at 430–431 (1955)—Determined that income consists of undeniable accessions to wealth that are completely controlled by the taxpayer.
9 Reg. Sec. 1.61-15—States that income from illegal activities is included in gross income.
10 Sec. 72—Describes the general rules for the taxation of annuities and presents the formula for determining the amount of each payment that is taxable.
11 Sec. 1001—Prescribes the calculation of gains and losses on dispositions of property; defines amount realized for purposes of determining gain or loss on dispositions.
12 Sec. 1016—Provides the general rules for adjustments to basis of property for capital expenditures and recoveries of capital subsequent to purchase.
13 Reg. Sec. 1.61-13—States that a partner’s share of the partnership’s income is included in the gross income of the partner.
14 Sec. 74—States that prizes and awards are taxable; details situations under which a qualified prize or award may be excluded from income.
15 Sec. 85—States that unemployment compensation payments received are taxable.
16 Sec. 86—States that Social Security payments received are taxable for high-income taxpayers; provides the formula for determining the taxable portion of Social Security payments.
17 Reg. Sec. 1.71-1—States that child support payments are not taxable.
18 Sec. 71—States that alimony received is taxable; defines alimony and presents the required recapture for front loading of alimony payments.
19 Reg. Sec. 1.71-IT—Discusses what constitutes a contingency related to a child.
20 Sec. 7872—Prescribes the treatment of below market-rate (interest-free) loans and the exceptions to the below market-rate rules.
21 Old Colony Trust Co. v. CIR, 279 U.S. 716 (1929)—Determined that the payment of a corporate officer’s state and federal taxes by the corporation constituted gross income to the officer; established that payment of another’s expense in an employment-related setting is compensation that is included in gross income.
22 CIR v. Smith, 324 U.S. 695 (1945)—Held that selling stock to an employee at less than its fair market value constituted compensation received by the employee; established that a “bargain purchase” in an employment-related setting is included in gross income.
23 Sec. 1221—Defines capital assets.
24 Sec. 1222—Defines short-term and long-term capital gains and losses; prescribes the netting procedure used for capital gains and losses.
25 Sec. 1223—Defines holding period for purposes of determining short-term and long-term classification of capital gains and losses.
26 Sec. 1(h)—Defines collectibles gains and losses and unrecaptured Section 1250 gains. Prescribes the tax rates to be paid on capital gains.
27 IRS Restructuring and Reform Act of 1998, Sec. 5000—Provides the netting rules for capital gains and losses in calculating the tax on capital gains.
28 Sec. 1211—Sets forth the limit on deductions of capital losses of corporations and individuals.
29 Sec. 1212—Allows the carryforward of disallowed capital losses by individuals.
30 Reg. Sec. 1.1211-1—Requires the deduction of short-term capital losses before long-term capital losses in determining the current year’s capital loss deduction.
31 Sec. 703—Requires a partnership to state separately the items of income, gain, losses, deductions, and credits provided in Sec. 702 in computing its taxable income. Sec. 702 requires partners to separately account for their share of capital gains and losses, gains and losses on the sale of certain types of business property, charitable contributions, foreign taxes, and other items as prescribed by the secretary of the Treasury. Sec. 1366 contains similar provisions for S corporations.
32 Sec. 446—States general rules for methods of accounting, including the allowance of the cash and accrual methods.
33 Reg. Sec. 1.446-1—Requires the use of the accrual method for sales and cost of goods sold for sales of inventories; allows accounting of other income and expenses with the cash basis. (The hybrid method is an acceptable accounting method.)
34 Sec. 1273—Prescribes the methods for determining the amount of original issue discount to include in gross income.
35 Sec. 1272—Provides for the inclusion of original issue discount on debt instruments in gross income. Allows the exclusion of U.S. savings bonds from the OID rules.
36 Sec. 451—Sets forth general rules for taxable year of inclusion of gross income items.
37 Reg. Sec. 1.61-8—States that gross income includes rental and royalty income and that advance receipts of rent are included in gross income in the year of receipt, regardless of the taxpayer’s accounting method.
38 Rev. Proc. 71-21—Prescribes the conditions under which an accrual basis taxpayer may defer an advance receipt for services (one-year rule for services).
39 Reg. Sec. 1.451-5—Specifies the conditions under which an accrual basis taxpayer can defer recognition of income from an advance receipt for goods.
40 Sec. 453—Prescribes the required treatment of installment sales of property.
41 Temp. Reg. Sec. 15a.453-1—Provides the calculations for determining the amount of income to be recognized under the installment method of accounting.
42 Sec. 460—Requires the use of the percentage-of-completed-contract method of accounting for long-term construction contracts.

1. How is the definition of income for income tax purposes different from the definition used by economists to measure income?
2. One of Adam Smith’s four criteria for evaluating a tax is certainty. Does the income tax definition of gross income promote certainty in the U.S. tax system? Explain.
3. What is the difference between realized income and recognized income?
4. Buford purchased a new automobile in March for $23,000. In April, he receives a $500 rebate check from the manufacturer. The rebate was paid to all customers who purchased one of the manufacturer’s automobiles in March. Should Buford include the $500 rebate in his gross income? Explain.
5. What is a cash equivalent? How does a cash equivalent affect the reporting of income?
6. What type of income does a sole proprietor of a business receive?
7. What is the difference between earned income and unearned income?
8. How is the gross income from a rental property or a royalty property determined?
9. Explain how the capital recovery concept applies to the taxation of annuities. Consider both purchased annuities and pension payments in your answer.
10. Explain the difference in determining the amount of income recognized from a conduit entity versus a taxable entity.
11. What effect does an asset’s adjusted basis have in determining the gain or loss realized upon its sale?
12. This chapter noted that returns on investment are taxable, whereas returns of investment are not taxable. What is the conceptual basis for this treatment? Cite examples of each type of return, and explain why they are or are not taxable.
13. Prizes and awards are generally taxable. Under what conditions is the receipt of a prize or award not taxable?
15. How is the taxation of an alimony payment different from the taxation of a child support payment?
16. What incentive does a taxpayer have to disguise a property settlement as an alimony payment?
17. Does the tax treatment of below market-rate loans violate any income tax concepts? If so, how? Explain.
18. Evaluate the following statement: Whenever another person pays an expense for you, you are in receipt of taxable income.
19. What is a bargain purchase?
20. How is capital gain income treated differently from other forms of income?
21. What is the purpose of the capital gain-and-loss netting procedure?
22. Are all losses realized on the sale of capital assets deductible?
23. Why is it important that a conduit entity separate the reporting of its capital gains and losses from its report of other forms of income?
24. Detail any significant differences in the recognition of income using the cash method and using the accrual method of accounting.
25. Explain the hybrid method of accounting.
26. How does the wherewithal-to-pay concept affect the tax treatment of prepaid income?
27. Under what circumstances can the following taxpayers defer recognition of prepaid income beyond the year of receipt?
   a. A cash basis taxpayer
   b. An accrual basis taxpayer
28. What is an installment sale?
29. How is the degree of completion of a long-term construction contract determined?
30. Mitch travels extensively in his job as an executive vice president of Arthur Consulting Company. During the current year, he used frequent flier miles that he had obtained during his business travel to take his family on a vacation to Europe. The normal airfare for the trip would have been $6,000.
   a. Discuss whether Mitch has realized income from the use of the frequent flier miles for personal purposes.
   b. Will Mitch have to recognize any income from the use of the frequent flier miles? Explain.
31. Two Sisters is a partnership that owns and operates a farm. During the current year, the partnership raised and harvested hay at a cost of $20,000. It then traded half the hay for quarter horse breeding stock—young horses worth $30,000. Two Sisters fed the remainder of the hay to the horses, which were worth $50,000 at the end of the year. How much income does the partnership have from these transactions during the current year?
32. Darcy borrowed $4,000 in 2000 from her employer to purchase a new computer. She repays $1,000 of the loan plus 6% interest on the unpaid balance in 2000, 2001, and 2002. After closing a big deal in 2003, she receives the original loan agreement stamped “paid in full” across the face. Does Darcy have to pay any income from the cancellation of the loan in 2003? Explain.
33. In December, Hilga sells her German language translation business to Chia-Ching. The sales agreement includes a provision that for an extra $6,000, Hilga will not open another German language translation business in the area for two years. Chia-Ching pays Hilga the $6,000 in January. In June, Hilga opens a European language translation business in a neighboring state and advertises it in Chia-Ching’s locality. Has Hilga realized income? If so, when does she realize the income?
34. How much taxable income should each of the following taxpayers report?
   a. Kimo builds custom surfboards. During the current year, his total revenues are $90,000, and he incurs $30,000 in expenses. Included in the $30,000 is a $10,000 payment to Kimo’s five-year-old son for services as an assistant.
   b. Manu gives hula lessons at a local bar. During the current year, she receives $9,000 in salary and $8,000 in tips. In addition, she engages in illegal behavior, for which she receives $10,000.
35. In each of the following cases, determine who is taxed on the income:
   a. For $200, Lee purchases an old car that is badly in need of repair. He works on the car for 3 months and spends $300 on parts to restore it. Lee’s son Jason needs $2,000 to pay his college tuition. Lee gives the car to Jason, who sells it for $2,000 and uses the money to pay his tuition.
   b. Erica loans a friend $20,000. The terms of the loan require the payment of $2,000 in interest each year to Erica’s daughter. At the end of 4 years, the $20,000 loan principal is to be repaid to Erica. Erica’s daughter will use the $2,000 to pay her college tuition.

36. Determine whether Frank or Dorothy, Frank’s friend, is taxed on the income in each of the following situations:
   a. Frank owns 8% bonds with a $10,000 face value. The bonds pay interest annually on June 30. On September 30, Frank makes a bona fide gift of the bonds to Dorothy.
   b. A few years ago, Frank wrote a best-selling book about computers. On August 1, he instructs the publisher to pay all future royalties to Dorothy.
   c. Frank owns 1,000 shares of Pujan stock. On May 1, Pujan declares a $12-per-share dividend to shareholders of record as of June 1. On May 15, Frank gives the Pujan stock to Dorothy. She receives the $12,000 dividend on June 30.

37. In each of the following cases, determine who is taxed on the income:
   a. Camille owns several rental properties that produce $3,000 in income each month. Because of the age of the properties, Camille is concerned about her potential liability from accidents on the property. On June 1, she forms the CAM Rental Corporation and transfers ownership of the rental properties to the corporation. The tenants continue to pay Camille the monthly rent, which she deposits in her personal checking account.
   b. Jimbob owns royalty interests in several oil wells. On March 1, Jimbob instructs the payers of the royalties to pay half of each royalty payment to his son Joebob.
   c. Assume the same facts as in part b, except that on March 1, Jimbob gifts a half interest in each royalty contract to Joebob.

38. Determine whether any income must be recognized in each of the following situations, as well as who must report income, how much that taxpayer should report, and when that taxpayer will report the income:
   a. Patz Corporation owns a gourmet restaurant. The restaurant needs to remodel its kitchen but is short of cash. Dennis owns Tucky’s Accessories, a restaurant supply store. The manager of Patz makes a deal with Dennis to have Tucky’s do the kitchen remodeling, in exchange for which Patz will cater Tucky’s company picnic. Tucky’s does the remodeling and Patz caters the picnic. It costs Patz $800 to cater the picnic, a job for which it would have charged $1,500.
   b. Geraldo is a sales manager who enjoys collecting antique guns. Geraldo attends various shows around the country at which collectors and dealers sell and trade guns. During the current year, Geraldo sells 3 guns for a total of $6,200 (the cost of the guns to Geraldo was $4,000) and purchases 2 guns at a total cost of $2,400. In addition, he exchanges a gun for which he had paid $700 for another gun worth $800.

39. Partha owns a qualified annuity that cost $52,000. Under the contract, when he reaches age 65, he will receive $500 per month until he dies. Partha turns 65 on June 1, 2003, and receives his first payment on June 3, 2003. How much gross income will Partha report from the annuity payments in 2003?

40. Minnie owns a qualified annuity that cost $78,000. The annuity is to pay Minnie $650 per month for life after she reaches age 65. Minnie turns 65 on September 28, 2003, and receives her first payment on Nov. 1, 2003.
   a. How much gross income does Minnie have from the annuity payments she receives in 2003?
   b. Shortly after receiving her payment on October 1, 2018, Minnie is killed in an automobile accident. How does the executor of Minnie’s estate account for the annuity on her return for the year 2018?
   c. Assume that the accident does not occur until November 1, 2027. How does the executor of Minnie’s estate account for the annuity on her 2027 return?
41. Duc has been employed by Longbow Corporation for 25 years. During that time, he bought an annuity at a cost of $50 per month ($15,000 total cost). The annuity will pay him $200 per month after he reaches age 65. When Duc dies, his wife, Annika, will continue to receive the annuity until her death. Duc turns 65 in April 2003 and receives 8 payments on the contract. Annika is age 60 when the annuity payments begin.
   a. How much gross income does Duc have from the contract in the current year?
   b. Assume that Duc dies on April 2, 2013. How does Annika account for the contract in 2013?
   c. Assume the same facts as in part b and that Annika dies on August 4, 2020. How does the executor of Annika’s estate account for the contract in the year of her death?

42. Hank retires this year after working 30 years for Local Company. Per the terms of his employment contract, Hank is to receive a pension of $600 per month for the rest of his life. During the current year, he receives 7 pension payments from Local. At the time of his retirement, Hank is single and 67 years old.
   a. How much taxable income does Hank have if his employer’s plan was noncontributory (i.e., Local Company paid the entire cost of the plan; Hank made no contributions to it)?
   b. How would your answer change if Hank had contributed $42,000 to the pension plan? Assume that the $42,000 had been included in Hank’s income (i.e., he has already paid tax on the $42,000).
   c. What if Hank had contributed $42,000 to the plan and none of the $42,000 were taxed (i.e., the tax law allows certain pension contributions to go untaxed during the contribution period)?

43. Ratliff Development Corporation purchases a tract of land in 2002 at a cost of $120,000 and subdivides the land into 30 building lots. The cost of subdividing is $6,000. In 2002, Ratliff installs roads and utilities at a cost of $36,000 and pays property taxes totaling $2,000 in 2002 and 2003. Interest paid on the loan used to purchase the land is $10,000 in 2002 and $6,000 in 2003. In 2003, Ratliff sells 10 lots for a total of $350,000. What is the corporation’s gain or loss on the sale of the lots?

44. The Rosco Partnership purchases a rental property in 1998 at a cost of $150,000. From 1998 through 2003, Rosco deducts $14,000 in depreciation on the rental. The partnership sells the rental property in 2003 for $160,000 and pays $9,000 in expenses related to the sale. What is Rosco’s gain or loss on the sale of the rental property?

45. Reddy owns common stock with a market value of $30,000. The stock pays a cash dividend of $2,400 per year (an 8% annual yield). Reddy is considering selling the stock, which she purchased 13 years ago for $10,000, and using the proceeds to purchase stock in another company with a 10% annual dividend yield. If Reddy’s goal is to maximize future dividends on her common stock investments, should she make the sale and purchase the new shares? Assume that Reddy is in a 30% marginal tax rate bracket.

46. How much income should the taxpayer recognize in each of the following situations? Explain.
   a. Julius owns a 25% interest in the Flyer Company, which is organized as a partnership. During the current year, he is paid $14,000 by Flyer as a distribution of earnings. Flyer’s taxable income for the year (calculated without any payments made to partners) is $60,000.
   b. Felix owns 1,000 shares of Furr Company, which is a publicly traded corporation. Furr has 1,000,000 shares of stock outstanding during the current year. The company has a net income of $2,500,000 and pays out a $3 per share dividend during the current year.
   c. Andrea is the sole proprietor of Andrea’s Art Shop. During the current year, Andrea’s has total revenue of $157,000 and total expenses of $110,000. Andrea draws a monthly salary of $2,600 from the shop that is not included in the $110,000 in expenses.
   d. Maryanne owns 50% of the stock of Sterling Safe Company, an S corporation. During the current year, Sterling has a taxable income of $300,000 and pays out dividends of $120,000 to its shareholders.
   e. Assume the same facts as in part d, except that Sterling incurs a loss of $60,000 during the current year.

47. Devi is the chief executive officer of Nishida Limited. Devi owns 20% of the common stock of Nishida. During the current year, Devi’s salary is $60,000 and he receives a $30,000 bonus. Nishida has taxable income of $200,000 and pays $80,000 in cash dividends. How much gross income does Devi have if
   a. Nishida is a corporation?
   b. Nishida is an S corporation?
48. Pablo wins a new automobile on a television game show. The car has a listed sticker price of $31,500. A dealer advertises the same car for $30,000. How much income does Pablo have from the receipt of the car? Explain.

49. Determine the amount of income that must be recognized in each of the following cases:
   a. Ramona is a production supervisor for White Company. During the current year, her division had no accidents, and White rewarded the achievement with a $200 cash award to each employee in the division.
   b. Lenny retires from the Brice Company this year. At his retirement reception, the company gives him a set of golf clubs valued at $600 in appreciation of his years of loyal service.
   c. Fatima is named Humanitarian of the Year by Local City for her volunteer service. She receives a plaque and an all-expense-paid trip to Washington, D.C., where she will meet the president. The value of the trip is $1,400.
   d. Sook is a college professor specializing in computer chip development. During the current year, she publishes a paper that explains the design of a revolutionary new chip. Softmicro, Inc., awards him $10,000 for the best breakthrough idea of the year. Sook uses the money to purchase a computer workstation to use in his research.

50. Has the taxpayer in each of the following situations received taxable income? If so, when should the income be recognized? Explain.
   a. Charlotte is a lawyer who specializes in drafting wills. She wants to give her husband a new gazebo for Christmas. In November, she makes a deal with Joe, a local handyman, to build a gazebo. In return, Charlotte is to draft a will for Joe’s father. The gazebo normally would cost $3,000, which is approximately what Charlotte would charge for drafting the will. Joe builds the gazebo in time for Christmas, Charlotte drafts the will and delivers it to Joe the following January.
   c. Dayo is the director of marketing for Obo, Inc. In December, the board of directors of Obo votes to give Dayo a $10,000 bonus for her excellent work throughout the year. The check is ordered and written on December 15 but is misplaced in the mail room and is not delivered to Dayo until January 5.
   d. John is unemployed. During the current year, he receives $4,000 in unemployment benefits. Because the unemployment is not enough to live on, John sells drugs to support himself. His total revenue for the year is $120,000. The cost of the drugs is $60,000.

51. Elwood had to retire early because of a job-related injury. During the current year, he receives $10,000 in Social Security benefits. In addition, he receives $6,000 in cash dividends on stocks that he owns and $8,000 in interest on tax-exempt bonds. Assuming that Elwood is single, what is his gross income if
   a. He receives no other income?
   b. He also receives $11,000 in unemployment compensation?
   c. He sells some land for $80,000? He paid $45,000 for the land.

52. Hermano and Rosetta are a retired couple who receive $10,000 in Social Security benefits during the current year. They also receive $3,000 in interest on their savings account and taxable pension payments of $28,000. What is their gross income if
   a. They receive no other income?
   b. They receive $13,000 in interest from tax-exempt bonds they own?

53. Upon returning from lunch, you find the following message on your voice mail:
   This is Jarrett Ogilvie. I’m not one of your clients, but I need some advice. I received a statement in the mail from the Social Security Administration reporting the $8,500 I received from them last year. It says that a portion of my Social Security may be taxable. Last year was the first year I ever received Social Security and I’m confused. I thought Social Security wasn’t taxable. Could you call me and explain this?
   What facts will you need from Jarrett to determine what portion, if any, of the $8,500 of Social Security benefits is taxable? In your answer, explain how different facts may lead to different taxable amounts.

54. Albert and Patricia are divorced during the current year. As part of their divorce agreement, Patricia agrees to pay Albert alimony of $85,000 in the current year and $5,000 per year in subsequent years. What tax problem is presented by this agreement? What will be the ultimate tax treatment of the alimony payments?
55. Will and Janine are divorced during the current year. Will is to have custody of their two children and will receive their house as part of the divorce settlement. The house, which Will and Janine bought for $60,000, is worth $100,000. Janine is to receive one of their automobiles, for which they paid $21,000 and which is now worth $9,000. Will will get the other automobile, which cost $6,000 and is worth $2,000. Janine is to pay Will alimony of $900 per month. However, the alimony payment is to be reduced by $200 per month as each child reaches age 18 or if a child should die or marry before reaching age 18. What are the tax effects of the divorce settlement for Will and Janine?

56. Erica and Raphael are divorced during the current year. Because Erica made millions in the record industry while Raphael served as the homemaker and primary caretaker of baby Dexter, Erica agrees to give Raphael 20% of the stock in her record business. The fair market value of the stock is $1,200,000. Instead of paying alimony to Raphael, Erica agrees to hire him as a handyman for five years at a salary of $190,000 per year. Raphael’s position has no stated responsibilities. Raphael has custody of baby Dexter. Discuss the tax implications of these arrangements.

57. Which of the following interest-free loans are subject to the imputed interest rules?
   a. Alamor Corporation loans Sandy, an employee, $8,000. The loan is to be repaid over 4 years. Sandy uses the proceeds to buy a used automobile. She has $1,100 in investment income during the current year.
   b. Trinh loans her son Jimmy $80,000. The loan is to be repaid over 20 years. Jimmy uses the loan to purchase a cabin in the mountains. He has $300 in investment income during the current year.
   c. Abdula Corporation loans Augie, an employee, $80,000. The loan is to be repaid over 20 years. Augie uses the loan to purchase a new house. He has $300 in investment income during the current year.
   d. Isabel owns 10% of Marcos Corporation. Isabel loans Marcos $20,000 to use for working capital. The loan is to be repaid over 5 years. Marcos has no investment income during the current year.
   e. Stuart loans his sister Sima $120,000. The loan is to be repaid over 20 years. Sima uses the loan to purchase a new home. She has no investment income during the current year.

58. Laura makes the following interest-free loans during the current year. Discuss the income tax implications of each loan for both Laura and the borrower. In all cases, the applicable federal interest rate is 8%.
   a. On April 15, Laura loans $30,000 to her brother Hyun to pay his income taxes. Hyun is financially insolvent and has no sources of investment income.
   b. On March 1, Laura loans $12,000 to her secretary, George. He uses the money as a down payment on a new house.
   c. On July 1, Laura loans her father $150,000. He uses the money to buy a franchise to open a yogurt store. He makes $5,000 on the yogurt store during the current year.
   d. On January 1, Laura loans $70,000 to Lotta, Inc. She is the sole shareholder of Lotta, Inc., which is organized as a corporation.

59. On January 1, Wilton loans Andy $90,000. The loan is to be repaid in 5 years with no interest charged. The applicable federal rate is 5%. Discuss the treatment of the loan for both Wilton and Andy in each of the following independent situations:
   a. Andy is Wilton’s son, and he uses the loan to purchase a new home. Andy has investment income of $600 during the year.
   b. Andy is Wilton’s son, and he uses the loan to purchase investment property. Andy’s net income from all investments for the year is $1,800.
   c. Assume the same facts as in part b, except that Andy is an employee of Wilton’s.
   d. Assume the same facts as in part b, except that Andy is a shareholder in Wilton’s corporation, which makes the loan to Andy.

60. Determine whether the following taxpayers have gross income from the payment of their expenses:
   a. Julia’s mother, Henrietta, is short of cash when it comes time to pay her property taxes. Julia pays Henrietta’s property taxes of $350.
   b. Kurt fell asleep at the wheel one night and crashed his car into a telephone pole. Repairs to the car cost $600. Kurt isn’t covered by insurance and doesn’t have the cash to pay the repair shop. Because he needs his car in his job as a salesman, his employer pays the repair bill.
c. Leonard leases a building from the PLC Partnership for $800 per month. The lease agreement requires Leonard to pay the property taxes of $1,100 on the building.

d. On July 1, Gino bought some land from Harco Corporation for $14,000. As part of the sales agreement, Gino agrees to pay the property taxes of $700 for the year. Harco had paid $10,000 for the land.

61. Reggie works during the summer for Dan the Screenman. Dan pays Reggie $4,300 in salary, saves Reggie $200 on free screens for Reggie’s father’s house, and agrees to pay Reggie’s fall college tuition of $2,100. How much gross income does Reggie have from this arrangement?

62. Aziza is the sole owner of Azi’s Fast Pizza. During the current year, Azi’s replaces its fleet of delivery vehicles. Aziza’s son purchases one of the old vehicles for $500, its tax basis to Azi’s. Similar vehicles are sold for $4,000. What tax problem is posed by this situation? Explain who, if anyone, should report income from the transaction.

63. Determine whether the taxpayer has income that is subject to taxation in each of the following situations:
   a. Capital Motor Company is going out of business. As a result, June is able to purchase a car for $12,000; its original sticker price was $25,000.
   b. Chuck is the sole owner of Ransom, Inc., a corporation. He purchases a machine from Ransom for $10,000. Ransom had paid $50,000 for the machine, which was worth $30,000 at the time of the sale to Chuck.
   c. Gerry is an elementary school teacher. She receives the Teacher of the Month Award for February. As part of the award, she gets to drive a new car supplied by a local dealer for a month. The rental value of the car is $400 per month.
   d. Payne has worked for Stewart Company for the last 25 years. On the 25th anniversary of his employment with Stewart, he receives a set of golf clubs worth $1,200 as a reward for his years of loyal service to the company.
   e. Anna enters a sweepstakes contest that was advertised on the back of a cereal box, and wins $30,000. The prize will be paid out in 30 annual installments of $1,000. She receives her first check this year.
   f. Terry buys an antique vase at an estate auction for $780. Upon returning home, she accidentally drops the vase and finds that a $100 bill had been taped inside it.

64. Pedro purchases 50 shares of Piper Company stock on February 19, 2000, at a cost of $4,300. He sells the 50 shares on July 2, 2003, for $9,000. On March 14, 2003, Pedro purchases 100 shares of Troxel stock for $9,700. He sells the Troxel shares on December 18, 2003, for $6,600. What is the effect of the stock sales on Pedro’s 2003 income?

65. Rikki has the following capital gains and losses for 2003:
   - Short-term capital gain: $1,000
   - Long-term capital gain: $11,000
   - Long-term capital loss: $3,000
   - Collectibles gain: $8,000
   - Collectibles loss: $2,000

   What is the effect of the capital gains and losses on Rikki’s taxable income and her income tax liability? Assume that Rikki is in the 35% marginal tax rate bracket.

66. Polly has the following capital gains and losses for 2003:
   - Short-term capital gain: $1,000
   - Short-term capital loss: $8,000
   - Long-term capital gain: $5,000
   - Collectibles gain: $16,000
   - Collectibles loss: $3,000

   What is the effect of the capital gains and losses on Polly’s taxable income and her income tax liability? Assume that Polly is in the 30% marginal tax rate bracket.
67. Erin, a single taxpayer, has a taxable income of $103,000 in the current year before considering the following capital gains and losses:

- Short-term capital gain: $3,000
- Long-term capital gain: $22,000
- Unrecaptured Section 1250 gain: $14,000

In addition, Erin has an $8,000 long-term capital loss carryover from last year. What are the effects of these transactions on Erin’s taxable income and her income tax liability?

68. Jason and Jill are married and have a six-year-old daughter. During the year, they sell one acre of land for $80,000. Three years ago, they paid $70,000 for two acres of land. Their other income and deductions are as follows:

- Jill’s commissions: $82,000
- Jason’s salary: $46,000
- Interest income: $8,000
- Short-term loss on sale of stock in Nippon Inc.: $(15,000)
- Deductions for adjusted gross income: $28,000

Calculate Jason and Jill’s taxable income and income tax liability for the current year.

69. Herbert and Geraldine have a taxable income of $28,000 in 2003, before considering the gain they realize on the sale of 500 shares of Olebolla Corporation common stock for $26 per share. Herbert had acquired the shares for $3 per share while he worked for Olebolla through the company’s employee incentive program. He retired from the company in 1999. What is the effect of the sale on Herbert and Geraldine’s taxable income and their income tax liability?

70. Jawan has the following capital gains and losses in the current year:

- Short-term capital gain: $500
- Short-term capital loss: $3,000
- Long-term capital gain: $6,000
- Long-term capital loss: $12,000
- Collectibles gain: $2,000

What is the effect of the capital gains and losses on Jawan’s taxable income?

71. Refer to problem 70. In the following year, Jawan has the following capital gains and losses:

- Short-term capital loss: $(1,300)
- Long-term capital gain: $8,600
- Long-term capital loss: $4,100

What is the effect of the capital gains and losses on his taxable income?

72. During the current year, Inge sells stock purchased in 1999 at a loss of $9,000. She also owns a 10% interest in Chatham, Inc., which is organized as an S corporation. Chatham reports ordinary income of $80,000 and a short-term capital gain of $30,000 during the current year. What are the effects of these two investments on Inge’s taxable income?

73. Ozzello Property Management is organized as a partnership. The owners, Lorenzo, Erwin, and Michelle, share profits and losses 30:30:40. Ozzello has the following results for the current year:

- Management fees: $230,000
- Long-term gain on sale of investments: $22,000
- Short-term loss on sale of investments: $(4,000)
- Salaries paid to employees: $67,000
- Office rent: $43,000
- Office expenses: $19,000

Determine each partner’s share of Ozzello’s taxable income for the current year.

74. Ramona owns 20% of the stock of Miller, Inc. Miller reports the following items for the current year:

- Sales: $3,400,000
- Gain on sale of stock held for 2 years: $250,000
- Cost of goods sold: $1,800,000
- Operating expenses: $900,000
- Dividends paid to stockholders: $180,000
What are the effects on Ramona’s taxable income if Miller, Inc., is organized as
a. A corporation?
b. An S corporation?

75. Chloe and Emma start a new business, Cement Sidewalks and Accessories (CSA), during
the current year. CSA is organized as a partnership. Chloe owns 40% of CSA; Emma owns
the remaining 60%. Chloe and Emma come to your firm for advice on the tax conse-
quences of their business. Your supervisor gives you the following information, as pre-
pared by Chloe and Emma for their first year of operation:

<table>
<thead>
<tr>
<th>Sales</th>
<th>$210,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of materials</td>
<td>(95,000)</td>
</tr>
<tr>
<td>Labor costs</td>
<td>(90,000)</td>
</tr>
<tr>
<td>Other expenses</td>
<td>(55,000)</td>
</tr>
<tr>
<td>Loss on sale of stock</td>
<td>(18,000)</td>
</tr>
<tr>
<td>Cash withdrawals by partners</td>
<td>(70,000)</td>
</tr>
<tr>
<td>Loss</td>
<td>$(118,000)</td>
</tr>
</tbody>
</table>

Prepare a memo for your supervisor explaining the ramifications of CSA’s first-year re-
sults for Chloe’s and Emma’s tax liabilities.

76. During the last five months of the year, Dwana opens a new Internet telecommunications
business called Dwan-Com. Dwan-Com bills $50,000 of revenues, but only receives
$40,000 cash. Dwan-Com incurs $3,000 of supply expenses, and $41,000 of labor costs.
Dwan-Com pays for $2,200 of the supplies and $38,000 of the labor costs in the current year.
a. What is Dwan-Com’s taxable income if it elects the cash method of accounting?
b. What is Dwan-Com’s taxable income if it elects the accrual method of accounting?
c. What method of accounting do you recommend that Dwan-Com elect?

77. Bonnie opens a computer sales and repair service during the current year. Her records for
the year show:

<table>
<thead>
<tr>
<th>Sales Made</th>
<th>Cash Received</th>
<th>Liability Incurred</th>
<th>Cash Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repair revenue</td>
<td>$30,000</td>
<td>$22,000</td>
<td></td>
</tr>
<tr>
<td>Computer sales</td>
<td>26,000</td>
<td>18,000</td>
<td></td>
</tr>
<tr>
<td>Computer purchases</td>
<td>$55,000</td>
<td>$27,500</td>
<td></td>
</tr>
<tr>
<td>Employee wages</td>
<td>12,000</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Supplies, utilities, etc.</td>
<td>9,000</td>
<td>6,000</td>
<td></td>
</tr>
</tbody>
</table>

Bonnie has computers on hand on December 31 that cost $40,000 and have a retail selling
price of $65,000.

Bonnie needs help figuring her taxable income. Is more than one income figure pos-
sible? If so, explain why, and compute taxable income under the various methods.

78. Arlene is a lawyer. She begins the current year with $8,000 in accounts receivable from
customers. During the year, she bills customers $210,000 in fees and receives $180,000 in
payments on account. She writes off $12,000 of the receivables as uncollectable, leaving
her a year-end receivable balance of $26,000. What is Arlene’s gross income if
a. She uses the cash basis of accounting?
b. She uses the accrual basis of accounting?

79. Determine how much interest income Later Federal Loan Company, a cash basis taxpayer,
must recognize on each of the following loans in 2003:
a. A $10,000, 8.5%, 6-month loan made on October 1, 2003. The principal and interest are
due on April 1, 2004.
b. A $10,000, 6-month loan, discounted at 8% on October 1, 2003. Later gives the borrower
$9,615, and the borrower must repay the $10,000 face amount on April 1, 2004.
c. A $10,000, 2-year loan, discounted at 6% on October 1, 2003. Later gives the borrower
$8,900; the $10,000 face amount is to be repaid on October 1, 2005.

80. In January 2003, Conan, a cash basis taxpayer, purchases for $4,000 a Series EE savings
bond with a maturity value of $4,800 (a 6% annual yield). At the same time, he also pur-
chases for $5,000 a 3-year bank certificate of deposit with a maturity value of $6,650 (a 10% 
How much income must Conan recognize in 2005?
81. Lorene, Inc., owns an apartment complex. The terms of Lorene’s lease agreement require new tenants to pay the first and last month’s rent and a cleaning deposit at the inception of the lease. The cleaning deposit is returned when tenants move out and leave their apartment in good condition. If the apartment is not in good condition, Lorene hires a cleaning company and uses the tenant’s deposit to pay the cleaning bill, with any excess deposit returned.

During the current year, Lorene receives monthly rents totaling $28,000, last month’s rent deposits from new tenants of $8,000, and cleaning deposits of $7,000. Lorene keeps $5,000 in cleaning deposits to pay the cleaning company bill on apartments that are not left in good shape (the $5,000 is the actual cost that is paid in cash to the cleaning company) and returns $4,000 in deposits. Lorene’s expenses related to the rental property (other than the cleaning costs) are $14,000. What is Lorene, Inc.’s gross income from the rental property if Lorene is a cash basis taxpayer? an accrual basis taxpayer?

82. Last year Miklos Enterprises built a warehouse for $480,000 and rented it to Big-Burger Company for 30 years for $10,000 per year for the first five years and $15,000 per year thereafter. During the current year, Big-Burger makes $44,000 of permanent lighting improvements to the warehouse. The leasehold agreement specifies that at the end of the lease, any permanent improvements to the warehouse will belong to Miklos Enterprises. How much gross income does Miklos Enterprises recognize from its arrangements with Big-Burger?

83. Determine the proper year(s) for reporting the income in each of the following cases:
   a. Lagoon Inc., an accrual basis taxpayer, owns an amusement park. The park is open April through September. In October, Lagoon begins selling discounted season passes for the upcoming season. By the end of the year, Lagoon has received $40,000 from the advance sale of the discounted passes.
   b. Arnie sells and repairs televisions. In December of the current year, a customer special-orders a television that retails for $2,600 (Arnie’s cost is $1,300). Arnie requires the customer to prepay $1,500 as a condition of placing the order.
   c. Quick Systems, Inc., an accrual basis taxpayer, leases out computer equipment. During December, Quick receives $22,000 from customers as advance rent for January.
   d. Trinh is a service representative for Harrington Corporation. Trinh and Harrington are cash basis taxpayers. In addition to her salary, Trinh receives a bonus equal to 5% of all receipts collected from her customers during the year. On December 30, a customer gives her a $5,000 check payable to Harrington for Trinh’s work during the current year. Trinh returns to her office on January 3 and promptly gives the check to the company’s controller.

84. How much income would an accrual basis taxpayer report in 2003 in each of the following situations?
   a. Toby’s Termite Services, Inc., provides monthly pest control on a contract basis. Toby sells a 1-year contract for $600 and a 2-year contract for $1,100. In October, Toby sells 10 one-year contracts and 5 two-year contracts.
   b. John’s Tractor Sales receives a $150 deposit from a customer for a new tractor that the customer orders in December. The tractor arrives the following February, at which time the customer pays the remaining $9,800 of the agreed-upon sales price.
   c. A customer of First Financial Lending sends First Financial two $600 checks in December in payment of December and January interest on a loan.
   d. First Financial Lending receives interest payments totaling $8,400 in January 2004 in payment of December 2003 interest on loans.

85. Daryl purchases land in 1999 at a cost of $65,000. In 2003, he sells the land for $100,000.
   a. How much gain or loss does Daryl realize on the sale of the land?
   b. Assume that the sales contract on the land calls for the buyer to pay Daryl $40,000 at the time of sale and $15,000 per year for the next 4 years with interest on the unpaid balance at 8%. How much income must Daryl recognize in 2003? In 2004?

86. Sonya and Sven got married two years ago. They purchased their honeymoon villa on Romantic Lake for $600,000. During the next two years, they rented the villa to others and took $30,000 of depreciation. This year Sonya and Sven were divorced. They sold the villa for $500,000 and agreed to split the proceeds in half.
   a. How much gain or loss will Sonya recognize on the sale of the villa?
   b. Given the weak real estate market at Romantic Lake, Sonya and Sven agreed to the buyer’s proposal to pay $300,000 this year and $50,000 per year for each of the next four years. How much gain or loss will Sonya recognize?
87. In 2000, Patricia purchases a rental property as an investment at a cost of $60,000. From 2000 through 2003, she takes $7,000 in depreciation on the property. In 2003, Patricia sells the rental property for $80,000, payable at $20,000 per year for 4 years with interest on the unpaid balance at 10%. How much income or loss must Patricia recognize in 2003? Assume that in addition to the sale of the rental property, Patricia sells other capital assets that result in a loss of $28,000. What would you recommend that Patricia do regarding the gain on the sale of the rental property?

88. WCM Builders enters into a contract to build a shopping mall in 2003 for $6,000,000. Completion of the mall is expected to take 2 years and cost WCM $3,600,000. Upon signing the contract, WCM receives $600,000. During 2003, WCM incurs costs of $1,200,000 and receives a $1,000,000 progress payment. WCM’s forewoman estimates that the job is 50% complete at the end of 2003. How much income must WCM recognize in 2003 from the work done on the mall?

89. Quapaw Construction Company enters into an agreement with Paine County to resurface 30 miles of highway. The contract is for $600,000. Quapaw estimates its total cost of the project to be $500,000. During the current year, Quapaw completes 18 miles of resurfacing, incurs $250,000 in actual costs, and receives $300,000 in advance payments on the project. How much income will Quapaw have to recognize during the current year?

In each of the following problems, identify the tax issue(s) posed by the facts presented. Determine the possible tax consequences of each issue that you identify.

90. During her vacation, Janita found a gold bar from a sunken ship while she was scuba diving off Texas.

91. Herman sells his carpet-cleaning business to Elki. As part of the sales agreement, Elki pays Herman $3,000 for his agreement not to open another carpet-cleaning business in the area for 3 years.

92. In 1997, Awnings, Inc., issues $200,000 of 15%, 20-year bonds payable at par. During 2003, when Awnings’ bonds are trading at 93, the company purchases and retires $100,000 par value of the bonds.

93. Merlene owns a bookstore. The store needs repainting, but she is short of cash to hire a painter. Fred is a painter who enjoys fine mystery novels. Merlene makes a deal with Fred to have him paint the bookstore for any 30 mystery novels Merlene has in stock. Fred paints the store and selects novels that cost Merlene $250 and had a retail selling price of $480.

94. Simon and Sherry divorce during the current year. As part of their property settlement, Simon gives Sherry 25% of the stock in his 100%-owned corporation, Hobday, Inc. The stock has a fair market value of $80,000. Rather than pay Sherry any alimony, Simon agrees to make her a vice president of Hobday with an annual salary of $70,000. In her position, Sherry has no responsibilities or involvement with the company.

95. Gilbert got married this year. Because he couldn’t afford a wedding reception, his employer gave him the $5,000 he needed to pay for it.

96. Meek, Inc., remodeled its offices this year. Renee, the executive vice president, bought the desk, couch, and lamp set that had been in her office for $200.

97. RealTime Rentals leases space on its Internet server. Its standard one-year lease agreement requires new customers to pay the first and last months’ rent upon signing the lease and a $500 deposit that is returned after the customer has been with RealTime for one year.

98. Tonya purchased land for investment purposes in 2000 for $21,000. In 2003, she sells the land for $36,000. The terms of the sale require the purchaser to pay Tonya $12,000 per year for three years with interest of 6% on the unpaid balance. Tonya also sells stock that she paid $28,000 for in 2001 for $16,000.
99. **INTERNET ASSIGNMENT**  Capital gains of individuals are taxed at a 20% rate (10% for 15%-marginal tax rate taxpayers). Capital gains of corporations are taxed at the corporation’s marginal tax rate. In reducing the individual capital gains rates, one argument that proponents advanced is that other countries have lower capital gains rates, which discourages capital investment in the United States. Use the Internet to find information on the capital gains rates in other countries. In your search, try to determine how many countries have capital gains rates that are lower than those in the United States. Also, select one country and compare its capital gains taxation with the capital gains taxation in the United States.

100. **INTERNET ASSIGNMENT**  In the United States, dividends received from corporations are taxable. Because the corporation paying the dividend does not get a deduction for dividends paid, the dividends are subject to double taxation. Other countries may provide tax relief for dividends received to eliminate the double taxation problem. Use the Internet to find information on the taxation of dividends in another country. Trace the process you used to obtain the information (search engine or tax directory and key words used) and summarize the treatment of dividends received in that country.

101. **RESEARCH PROBLEM**  Nathan and Maranda agree to divorce in the current year. In structuring the divorce agreement, Maranda proposes that Nathan assign a $200,000 life insurance policy on himself to her as part of the divorce agreement. Under Maranda’s proposal, Nathan would continue paying the premiums on the life insurance policy. Nathan’s attorney, Horace, has asked you to determine whether the insurance premium payments would be considered an alimony payment made by Nathan. Determine the tax treatment of the proposed premium payments and write a memorandum to Horace summarizing your results.

102. **RESEARCH PROBLEM**  A stock appreciation right (SAR) entitles the holder of the right to a cash payment equal to the difference between the fair market value of the stock on the date the SAR is exercised and the fair market value of a share on the date the SAR is granted. In 2001, L&M Corporation grants 1,000 SARs to Jasmine, an employee of SAR. On the date of the grant, the L&M stock sells for $30 per share. On December 31, 2001, the stock sells for $40; it sells for $50 on December 31, 2002, and for $55 on December 31, 2003. Jasmine exercises the SARs on December 31, 2003. When does she recognize income from the SARs, and what is the character of the income recognized?

103. **SPREADSHEET PROBLEM**  Julio and Rosetta are retired and receive $12,000 in Social Security benefits during the current year. They also receive $10,000 in interest and taxable pension payments of $30,000. Prepare a spreadsheet calculating the amount of Social Security income that is included in their gross income and their adjusted gross income. The spreadsheet should be able to handle changes in their marital status (e.g., if Julio dies) or their income.

104. **TAX FORM PROBLEM**  Marvin and Tracy Peery’s 2002 taxable income is $67,970 before considering the effect of their investment activities. Details of their 2002 sales of investment assets follows:

<table>
<thead>
<tr>
<th>Security</th>
<th>Sale Date</th>
<th>Purchase Date</th>
<th>Sales Price</th>
<th>Commissions Paid</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jobe Tool Inc.</td>
<td>02/19/02</td>
<td>11/15/01</td>
<td>$14,500</td>
<td>$400</td>
<td>$11,000</td>
</tr>
<tr>
<td>Gilly Corporation</td>
<td>04/30/02</td>
<td>03/02/99</td>
<td>$8,800</td>
<td>$300</td>
<td>$2,900</td>
</tr>
<tr>
<td>Skyleab Inc.</td>
<td>12/14/02</td>
<td>04/30/02</td>
<td>$8,000</td>
<td>$275</td>
<td>$8,525</td>
</tr>
</tbody>
</table>

The Form 1099 Marvin and Tracy received from their broker indicated total sales of $30,325 (i.e., sales were reported net of commissions). In addition, on July 19, Marvin sells a Barry Sanders football card for $600. He paid $20 for the card in June 1990.

Marvin and Tracy ask you to prepare their 2002 Schedule D. Their 2001 tax return indicates that they had a $4,500 net long-term capital loss in 2001. Marvin’s Social Security number is 567-22-3495 and Tracy’s is 654-33-8790. Forms and instructions can be downloaded from the IRS web site (http://www.irs.ustreas.gov/formspubs/index.html).
105. Yung is the sole owner of Southern Hills Insurance Agency. His primary business is the sale of fire and casualty policies. He has recently expanded his business by selling life insurance policies. Under his agreement with Heart Life Insurance Company, he receives a basic commission on each policy he sells. The basic commission is equal to the cost of the insurance minus the first year’s premium. Under the agreement, Yung collects the cost of the insurance policy and remits the first-year premium to the company. He is also entitled to an override commission, which is paid on subsequent years’ premiums. To build up his life insurance business, Yung enters into separate contracts with clients in which he agrees to act as an insurance consultant for a fee that is equal to the first-year premium. The client pays Yung the fee, which he remits to Heart Life. This contract effectively waives Yung’s basic commission and offers the insurance at a discounted price, a practice that is illegal under state law. During the current year, Yung sold policies that had a cost of $50,000 and first-year premiums of $18,000 (which were remitted to Heart Life). He also received $11,000 in override commissions from policies sold in previous years. How much income must Yung report from the life insurance policies in the current year? Explain.

106. Kerry is employed as a ticket vendor at an off-track betting parlor in New York. No credit is extended to customers, and employees are not allowed to bet on races. Kerry is a compulsive gambler and occasionally places bets without paying for them. In the past, she has always managed to cover her bets without being detected by her employer. Earlier this year, Kerry ran up $80,000 in bets that she did not pay for and won only $33,000. She was unable to cover this large loss and turned herself in to her employer. Kerry was convicted of grand larceny and sentenced to five years of probation, required to perform 200 hours of community service, and pay a $500 fine. Her employer was liable to the racetrack for the bets she had made and obtained a judgment against her for the $47,000 shortfall it had to pay because of her indiscretions. How much, if any, gross income must Kerry recognize from her illegal betting?

107. Nick and Jolene are married. Nick is 61 and retired in 2002 from his job with Amalgamated Company. Jolene is 56 and works part-time as a special education teacher. Nick and Jolene have a substantial amount of investment savings and would like to reorganize it to achieve the best after-tax return on their investments. They give you the following list of projected cash receipts for 2003:

- Jolene’s salary: $13,000
- Nick’s pension—fully taxable: $12,500
- Interest income: $4,000
- Dividend income: $4,000
- Social Security benefits: $7,000
- Farmer’s Fund annuity: $6,000

In addition, Nick tells you that he owns a duplex that he rents out. The duplex rents for 2003 are $18,000, and Nick estimates expenses of $22,000 related to the duplex. The annuity was purchased 18 years ago for $20,000, and pays $500 per month for 10 years.

Nick and Jolene’s investments consist of the following:

- 6-month certificates of deposit (CDs): $100,000
- 1,000 shares of Lardee’s common stock (current market value = $7 per share, projected 2003 dividend = $1 per share)—cost: $10,000
- 2,000 shares of Corb Company common stock (current market value = $20 per share, projected 2003 dividend = $7.50 per share)—cost: $20,000

a. Assuming that Nick and Jolene have total allowable itemized deductions of $12,350 in 2003 and that they have no dependents, determine their 2003 taxable income and tax liability based on the projections they gave you.
b. The 6-month CDs consist of two $50,000 certificates, both of which yield 4% interest. One CD matures on January 3, 2003. Nick’s banker tells him that he can renew the CD for one year at 4%. Nick’s stockbroker tells him that he can purchase tax-exempt bonds with a yield of 3%. Nick would like you to determine whether the tax-exempt bonds provide him a better after-tax return than the CD.

c. Jolene is concerned that they are not getting the best return on their Corb Company stock. When they purchased the stock in 1992, the $.50 per share dividend was yielding 10% before taxes. However, the rise in market value has far outpaced the dividend growth, and it is yielding only 3.75%, based on the current market value. Jolene thinks they should sell the stock and purchase either the 3% tax-exempt securities or the 4% CD if it would be a better deal from an income tax viewpoint. Calculate the tax effect on their 2003 income of selling the shares, and determine whether they should sell the shares and invest the after-tax proceeds in tax-exempt securities or the 4% CD. Do this calculation after you have determined the best option regarding the CD that matures in January.

108. Peter is a professor of mathematics at State University. His lifetime avocation has been sailing, and he owns an ongoing sailing vessel. He plans to retire in five years and spend the remainder of his life “plying” the South Pacific, visiting exotic ports of call. Accordingly, in five years, he plans to convert all his assets into a single-life annuity that is payable monthly into a bank account which he can access from anywhere in the world.

He currently owns four residential lots in Miller Beach that he purchased as an investment in 1971 for $6,000. Peter has received an offer of $140,000 for the lots. He estimates that the lots will appreciate during the next five years at an 11% annual rate.

If he sells the lots, Peter will invest the proceeds in his portfolio of stocks. He invests in growth securities paying negligible dividends that provide their return through appreciation. Peter expects his security portfolio to increase an average of 12% per annum. The risk of real estate in Miller Beach is approximately equal to that of growth stocks.

Peter asks you to evaluate each of the following alternatives and make a recommendation on which course of action he should pursue.

Alternative 1. Sell the beach property now, reinvest the net proceeds in stock, sell the stock in five years, and retire.

Alternative 2. Continue to hold the beach property for another five years, sell the lots, and retire.

109. The Gallery is an indoor recreational facility. It employs 95 minimum-wage employees and 7 management-level staffers. During the past month, all employees participated in a promotion to enhance sales by distributing discount coupons to potential customers. The employee who had the most coupons redeemed was to receive a $150 credit toward the purchase of a mountain bike. The general manager won the coupon promotion. After accepting the $150 credit, he instructed the controller, Aretha, not to include the $150 on his pay stub or on his Form W-2. Aretha is a CPA and a member of the AICPA. You prepare the tax return for the gallery. Aretha has advised you of the situation regarding the general manager; she is concerned about the effect on her career of following the general manager’s instructions. Prepare a letter to Aretha explaining the potential ramifications of following the general manager’s instructions and what actions, if any, she should take to avoid adverse career effects.

110. Mei has asked you to prepare her tax returns. She estimates that the weekly revenues from her carpet-repair business were $1,000 for 40 weeks. She mentions that she works for five of the remaining weeks for $7,000 but tells you not to include that in her gross income because it came from a good friend of her godfather. Mei gives you a dividend statement for $3,565. When you inquire about interest from her bank accounts, she says that it was $716. Consult the discussion in Appendix D, Statements on Standards for Tax Services, on the use of estimates. State what standards may be applicable to this situation and what should result from applying the standards. Mei is willing to pay you $275 to prepare her tax return. Can you determine Mei’s gross income? If not, what will you tell Mei?