

***Fundamentals of Taxation 2018 Edition 11th edition
Cruz Solutions Manual***

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CHAPTER 3 – SOLUTIONS

END OF CHAPTER MATERIAL

Discussion Questions

1. Explain how income is recognized under the cash method of accounting.

Learning Objective: 03-02

Topic: Cash Method of Accounting

Difficulty: 1 Easy

Feedback: Income is recognized under the cash method of accounting when the taxpayer receives or constructively receives cash, property, or services.

EA: Yes

2. Are there circumstances in which income is recognized even when a cash-basis taxpayer does not receive cash? Explain.

Learning Objective: 03-02

Topic: Cash Method of Accounting

Difficulty: 1 Easy

Feedback: Yes. A taxpayer can indirectly receive cash. If a cash-basis taxpayer owes money to a bank and someone else pays the loan to the bank on behalf of the taxpayer, the taxpayer must record income for the amount of debt repaid by the third party. Another example is interest on certain U.S. Savings Bonds. A taxpayer can elect to report the interest on the bonds annually even though no cash is received.

EA: Yes

3. What is meant by the concept of *constructive receipt*?

Learning Objective: 03-02

Topic: Cash Method of Accounting

Difficulty: 1 Easy

Feedback: Constructive receipt of income means that the income is available to or in the control of the taxpayer regardless of whether the taxpayer chooses to utilize the income. For example, income credited to a savings account at year-end is constructively received even if the taxpayer does not withdraw it for use.

EA: Yes

4. Refer to Example 3-4 in the chapter. Explain why Antonio is required to report income even though he did not receive an asset (either cash or property).

Learning Objective: 03-02

Topic: Cash Method of Accounting

Difficulty: 1 Easy

Feedback: Antonio received a benefit (he was better off economically) when Arturo paid Millie on Antonio's behalf. For Antonio, the economic outcome would be exactly the same whether Arturo paid Millie on Antonio's behalf or whether Arturo paid Antonio and then Antonio paid Millie.

EA: Yes

5. Your friend John files his own tax returns. He received a computer as a dividend from a closely held corporation. He says that he does not need to report the computer as dividend income because the dividend was not paid in cash. Is he right? Why?

Learning Objective: 03-03

Topic: Dividend Income

Difficulty: 1 Easy

Feedback: No. The fact that a dividend was paid in cash or property does not matter. Dividends are income to the recipient to the extent of the fair market value of the asset received.

EA: Yes

6. Interest on corporate bonds is taxable to the recipient whereas interest on municipal bonds is tax-free. Would you expect that the interest rate on a corporate bond would be higher or lower than the rate on a municipal bond of comparable quality and term? Why?

Learning Objective: 03-03

Topic: Interest Income

Difficulty: 3 Hard

Feedback: Assuming comparable quality and bond term, we should expect interest rates on corporate bonds to be higher than interest rates on municipal bonds. Interest received on a corporate bond is fully taxable at rates of up to 39.6%. Thus, a taxpayer in the highest tax bracket who receives \$1,000 in interest will pay \$396 in taxes, giving him or her \$604 after tax. If that taxpayer invested in municipal bonds that paid the same rate of interest, the taxpayer would end up with \$1,000 after tax (since the municipal bond interest is not taxed). We would expect individuals to pay more for a bond that gives them \$1,000 after tax than a bond that gives them \$604 after tax. Thus, the price of the municipal bonds will be "bid up" resulting in a lower interest rate for the municipal bond and higher interest rate for the corporate bond. Recall from your Finance class that bond prices and interest rates work in an inverse manner.

EA: Yes

7. What is a *dividend*?

Learning Objective: 03-03

Topic: Dividend Income

Difficulty: 1 Easy

Feedback: A dividend is a distribution of property by a corporation to its shareholders. The dividend must be paid from the earnings and profits of the enterprise.

EA: Yes

8. How are dividends taxed?

Learning Objective: 03-03

Topic: Dividend Income

Difficulty: 1 Easy

Feedback: Dividends are taxed at rates of either 15%, 20%, or 0%. If an individual's marginal ordinary income tax rate is 25% and less than 39.60%, qualified dividends are taxed at a rate of 15% but 20% when the marginal ordinary income tax rate is at 39.60%. If the individual's marginal ordinary income tax rate is less than 25%, qualified dividends are taxed at a rate of 0% (no tax is assessed).

EA: Yes

9. Sam owns all of the stock in a newly formed corporation. During 2017, the first year of operation, the corporation realized current earnings and profits of \$10,000. Sam received a \$12,000 distribution from the corporation. How much, if any, of the distribution is taxable to Sam? Why?

Learning Objective: 03-03

Topic: Dividend Income

Difficulty: 2 Medium

Feedback: Sam will have a taxable dividend of \$10,000 and a nontaxable return of capital of \$2,000. This assumes Sam has some cost basis in his stock. Distributions in excess of earnings and profits are nontaxable and reduce the recipient's basis in the stock of the corporation.

EA: Yes

10. Under what circumstances is a dividend nontaxable to a shareholder recipient?

Learning Objective: 03-03

Topic: Dividend Income

Difficulty: 2 Medium

Feedback: When a distribution is made by a corporation to its shareholders, the distribution is a taxable dividend to the extent of current or accumulated earnings and profits of the corporation. If the distribution exceeds E&P, it is nontaxable return of capital to the extent of the shareholder's basis in the stock. Once the distribution exceeds basis, the excess is treated as a capital gain. Thus, a

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distribution is nontaxable if it is in excess of the E&P of the corporation and the excess is less than the shareholder's basis in the stock.

EA: Yes

11. How do dividends and earnings and profits relate to each other?

Learning Objective: 03-03

Topic: Dividend Income

Difficulty: 1 Easy

Feedback: A dividend is a distribution to a shareholder that is made from the earnings and profits of the corporation. A distribution that is not made from earnings and profits is not a dividend.

EA: Yes

12. Under what circumstances is a state or local income tax refund included in the taxable income of a taxpayer?

Learning Objective: 03-03

Topic: State and Local Tax Refunds

Difficulty: 2 Medium

Feedback: If a taxpayer deducted state or local taxes as an itemized deduction in the prior year, the taxpayer must report income in the year in which the refund was received. The taxable amount is the lesser of (a) the amount received, or (b) the amount deducted in the prior year, or (c) the amount by which the itemized deductions exceed the standard deduction. If the taxpayer did not itemize deductions in the prior year (i.e., took the standard deduction), no amount of the refund is taxable.

EA: Yes

13. Under what circumstances are social security benefits taxable to a single taxpayer?

Learning Objective: 03-03

Topic: Social Security Benefits

Difficulty: 1 Easy

Feedback: If the "provisional income" of a single taxpayer exceeds \$25,000, then a portion of the social security benefits received will be taxable. Provisional income is Adjusted Gross Income plus certain tax-exempt interest plus half of the social security benefits received (some other items are also added, but they are less common).

EA: Yes

14. When determining the taxability of social security benefits, the IRC uses the concept of *provisional income*. How is provisional income calculated?

Learning Objective: 03-03

Topic: Social Security Benefits

Difficulty: 1 Easy

Feedback: Provisional income is equal to Adjusted Gross Income plus the following items:

Excluded interest from qualified U.S. Savings Bonds

Tax-exempt interest

Excluded employer-provided adoption benefits

Excluded foreign income

Deducted interest on educational loans

Deducted tuition and fees

50% of social security benefits

EA: Yes

15. Congress has chosen to exempt certain income from taxation, such as scholarships, gifts, life insurance proceeds, municipal bond interest, and employee fringe benefits. Given that one of the primary purposes of the IRC is to raise revenue for the government, why do you think Congress would provide these and other exemptions?

Learning Objective: 03-04

Topic: Items Excluded from Gross Income

Difficulty: 2 Medium

Feedback: One significant reason is to promote or not discourage certain actions by taxpayers. Scholarships often enable individuals to attend school. Taxing the scholarship would, at least, discourage individuals from seeking more education. Another reason for an exemption is to not burden taxpayers with undue recordkeeping requirements. An example would be certain employee fringe benefits such as a *de minimis* gift.

EA: Yes

16. What is an employer-provided fringe benefit?

Learning Objective: 03-04

Topic: Items Excluded from Gross Income

Difficulty: 1 Easy

Feedback: An employer-provided fringe benefit is an item of economic value provided by an employer to an employee.

EA: Yes

17. Define and give examples of a *de minimis* employee fringe benefit.

Learning Objective: 03-04

Topic: Items Excluded from Gross Income

Difficulty: 1 Easy

Feedback: A *de minimis* fringe benefit is an item of economic value given to employees, the value of which is so small that keeping track of which employees received the benefit is administratively impractical. Examples include: small holiday gifts such as turkeys or hams; holiday parties; birthday gifts; free coffee, etc.

EA: Yes

18. Explain the requirements necessary for a scholarship to be tax-free to the recipient.

Learning Objective: 03-04

Topic: Items Excluded from Gross Income

Difficulty: 2 Medium

Feedback: The individual who receives the scholarship must be a degree-seeking student at an educational institution and must use the proceeds for qualified tuition and related expenses (tuition, fees, books, supplies, and equipment). If the scholarship payment exceeds permitted expenses, the excess is taxable income.

EA: Yes

Multiple Choice

19. Accountants recognize revenue when it is both realized and

- a. Recorded.
- b. Accumulated.
- c. Collected.
- d. Earned.

Answer: d

Learning Objective: 03-01

Topic: When and How to Record Income

Difficulty: 1 Easy

Feedback: This reflects the accrual method of accounting.

EA: Yes

20. For tax purposes, one of the requirements to recognize income is that

- a. There must be an economic benefit.
- b. The income must be tax-exempt.
- c. The transaction must occur but completion of the transaction is not necessary.
- d. There must be a cash transaction.

Answer: a

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Learning Objective: 03-01

Topic: When and How to Record Income

Difficulty: 1 Easy

Feedback: There are three requirements: Economic benefit, the transaction must have reached a conclusion, and the income cannot be tax-exempt.

EA: Yes

21. Income may be realized in the form of

- a. Money or services.
- b. Only money.
- c. Money, services, or property.
- d. None of the above.

Answer: c

Learning Objective: 03-02

Topic: Cash Method of Accounting

Difficulty: 1 Easy

Feedback: Income can be realized in any form, whether in money, property, or services.

EA: Yes

22. When filing their tax returns, almost all individuals use

- a. The cash receipts and disbursements method.
- b. The accrual method.
- c. The recognition method.
- d. The hybrid method.

Answer: a

Learning Objective: 03-02

Topic: Cash Method of Accounting

Difficulty: 1 Easy

Feedback: The cash receipts and disbursement method is the most common method used by individuals, except for some instances where the taxpayers would report income on the accrual basis; an example would be interest income on Series EE and Series I U.S. savings bonds.

EA: Yes

23. An individual must complete Schedule B (Forms 1040A or 1040) if the following situation occurs:

- a. Receives child support payments of \$1,600.
- b. Receives interest income over \$1,500.
- c. Receives qualified dividends of \$1,050.
- d. Receives interest income of \$1,450.

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Answer: b

Learning Objective: 03-03

Topic: Interest Income

Difficulty: 1 Easy

Feedback: Schedule B must be filed if the taxpayer had more than \$1,500 in interest income.

EA: Yes

24. The basis of the property received as a dividend by a shareholder of a corporation is

- a. The book value at the date of distribution.
- b. The original cost at the date of purchase.
- c. The accounting value at the date of distribution.
- d. The fair market value at the date of distribution.

Answer: d

Learning Objective: 03-03

Topic: Dividend Income

Difficulty: 1 Easy

Feedback: The basis of the property received as a dividend in the hands of the shareholder is the property's fair market value at the date of distribution.

EA: Yes

25. When an individual's marginal ordinary income tax rate is 25%, the tax rate on qualified dividends is

- a. 0%.
- b. 15%.
- c. 25%.
- d. 5%.

Answer: b

Learning Objective: 03-03

Topic: Dividend Income

Difficulty: 1 Easy

Feedback: When an individual's marginal ordinary income tax rate is less than 25%, the tax rate is 0%. If the individual's marginal ordinary income tax rate is 25% but less than 39.60%, the tax rate on qualified dividends is 15%.

EA: Yes

26. Graciela, who is single, reported itemized deductions of \$6,400 on her 2016 tax return. Her itemized deductions included \$200 of state taxes paid. In 2017, she received a \$150 refund of state taxes paid in 2016. What is the amount that Graciela needs to report on her 2017 tax return? Use the Internet (www.irs.gov) to find out how much the standard deduction was for 2016.

- a. \$200.
- b. \$100
- c. \$0.
- d. She needs to amend her 2016 tax return.

Answer: b

Learning Objective: 03-03

Topic: State and Local Tax Refunds

Difficulty: 3 Hard

Feedback: Itemized deductions of \$6,400 less the standard deduction of \$6,300 for 2016.

EA: Yes

27. Provisional income is calculated by starting with Adjusted Gross Income (AGI) before social security benefits and adding back specific items. One of these items is

- a. Employer-provided adoption benefits.
- b. Taxable interest income.
- c. Wages earned.
- d. Qualified dividends.

Answer: a

Learning Objective: 03-03

Topic: Social Security Benefits

Difficulty: 1 Easy

Feedback: Employer-provided adoption benefits is one of the items that must be added back to AGI to compute provisional income.

EA: Yes

28. Frank, who is single, received \$7,000 of social security benefits. His AGI before the social security benefits was \$15,000. He also had \$100 of tax-exempt interest. What is the amount of taxable social security benefits?

- a. \$18,600.
- b. \$7,000.
- c. \$0.
- d. \$3,500.

Answer: c

Learning Objective: 03-03

Topic: Social Security Benefits

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Difficulty: 2 Medium

Feedback: The provisional income of \$18,600 (\$15,000+\$100+\$3,500) does not exceed the threshold of \$25,000.

EA: Yes

29. Items that must be reported on line 21 (other income) of Form 1040 include

- a. Dividend income.
- b. Capital gains.
- c. Interest income.
- d. Jury duty pay.

Answer: d

Learning Objective: 03-03

Topic: Other Income

Difficulty: 1 Easy

Feedback: Line 21 of the 1040 is where the taxpayer reports other taxable gross income.

EA: Yes

30. Which of the following fringe benefits provided by the employer is *not* taxable to the employee?

- a. Sick pay.
- b. Vacation pay.
- c. Bonus.
- d. 10% discount on products sold by the business; the gross profit percentage for the business is 20%.

Answer: d

Learning Objective: 03-04

Topic: Items Excluded from Gross Income

Difficulty: 1 Easy

Feedback: The discount is not taxable because it does not exceed the gross profit percentage for the business.

EA: Yes

31. Payments to employees under written dependent care assistance plans are tax-free. The exclusion cannot exceed the earned income of the lesser earning spouse and cannot exceed _____ for an individual filing as married filing jointly.

- a. \$2,500.
- b. \$5,000.
- c. \$5,150.
- d. \$5,250.

Answer: b

Learning Objective: 03-04

Topic: Items Excluded from Gross Income

Difficulty: 1 Easy

Feedback: The exclusion cannot exceed \$5,000 for an individual filing as married filing jointly.

EA: Yes

32. Employers can pay (or reimburse) employees for up to _____ per year of educational assistance, whether or not the education is job-related.

- a. \$5,250.
- b. \$5,150.
- c. \$5,000.
- d. \$2,500.

Answer: a

Learning Objective: 03-04

Topic: Items Excluded from Gross Income

Difficulty: 1 Easy

Feedback: Employers can pay up to \$5,250 per year of educational assistance.

EA: Yes

33. An example of nontaxable income is

- a. Wages.
- b. Dividend income.
- c. Alimony payment.
- d. Child support payment.

Answer: d

Learning Objective: 03-04

Topic: Items Excluded from Gross Income

Difficulty: 1 Easy

Feedback: Child support payment is nontaxable to the recipient and not deductible by the payer.

EA: Yes

Problems

34. In 2012, Marie borrowed \$10,000. In 2017, the debt was forgiven. Marie does not believe she should report the forgiveness of debt as income because she received nothing at the time the debt was forgiven in 2017. Do you agree or disagree? Support your position.

Learning Objective: 03-01

Topic: When and How to Record Income

Difficulty: 2 Medium

Feedback: The debt forgiveness must be reported in income in the year it was forgiven. Although it is true that Marie did not receive any cash or property in 2017, she was relieved of the obligation to repay the debt. As a result, she received an economic benefit in 2017 and must report income.

EA: Yes

35. Determine the amount of taxable income that should be reported by a cash-basis taxpayer in 2017 in each of the following independent cases:

- a. A taxpayer completes \$500 of accounting services in December 2017 for a client who pays for the accounting work in January 2018.
- b. A taxpayer is in the business of renting computers on a short-term basis. On December 1, 2017, she rents a computer for a \$200 rental fee and receives a \$500 deposit. The customer returns the computer and is refunded the deposit on December 20, 2017.
- c. Same facts as (b) except that the computer is returned on January 5, 2018.
- d. On December 18, 2017, a landlord rents an apartment for \$700 per month and collects the first and last months' rent up front. It is customary that tenants apply the security deposit to their last month's rent upon moving out.
- e. An accountant agrees to perform \$500 of tax services for an auto mechanic who has agreed to perform repairs on the car of the wife of the accountant. The mechanic repairs the car in December 2017 and the accountant starts and completes the tax work in March 2018.

Learning Objective: 03-02

Topic: Cash Method of Accounting

Difficulty: 2 Medium

Feedback:

- a. No taxable income in 2017. It is taxable in 2018 when received.
- b. Taxable income is \$200 in 2017.
- c. Taxable income is \$200 in 2017.
- d. Taxable income is \$1,400 in 2017. Here, the deposit is actually the equivalent of the last month's rent and is normally applied to rent otherwise due. The landlord is, effectively, collecting two months' rent at the time of move in and must record income in that amount.

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- e. The accountant would have taxable income of \$500 in 2017 and the mechanic would have \$500 of taxable income in 2018.

EA: Yes

36. A taxpayer who purchases a Series EE U.S. Savings Bond must report the interest income (i.e., increase in value) on the bond on the date the bond is redeemed, or the taxpayer can elect to report the interest currently in income. Under what circumstances should a taxpayer report income at maturity? Under what circumstances is it more advantageous to report income currently?

Learning Objective: 03-03

Topic: Interest Income

Difficulty: 3 Hard

Feedback: If the marginal tax rate of the taxpayer will be lower when the bonds mature, it is more advantageous to report the income at maturity (at the lower rates) rather than currently (at the higher rates). Care should be taken, however. If the taxpayer will be receiving social security income when the bonds mature, the taxable interest might cause social security benefits to become taxable, thus eliminating the benefits of the lower future tax rates.

From a record keeping perspective, it is easier to report the income all at once rather than a little bit each year. Alternatively, by paying the tax in small increments, the entire bond proceeds will not be taxed on maturity.

EA: Yes

37. Nancy, who is 59 years old, is the beneficiary of a \$200,000 life insurance policy. What amount of the insurance proceeds is taxable under each of the following scenarios?
- She receives the \$200,000 proceeds as a lump-sum payment
 - She receives the proceeds at the rate of \$4,000 a month for five years.
 - She receives the proceeds in monthly payments of \$1,300 over her remaining life expectancy (assume she will live 25 years).
 - Use the information from (c). If Nancy lives beyond her 25-year life expectancy, what amount of each monthly payment will be taxable in the 26th year?

Learning Objective: 03-03

Topic: Other Income

Difficulty: 3 Hard

Feedback:

- Nancy would have no taxable income to report.
- Nancy would receive \$240,000 over the five year payment term ($\$4,000 \times 5 \text{ years} \times 12 \text{ months}$). Of this amount, \$200,000 is not taxable. She would report interest income of \$40,000 over the five year period at the rate of \$667 per month ($\$40,000 / (5 \times 12)$).

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- c. Based on her life expectancy, Nancy would receive \$390,000 on the insurance contract. Of this amount, \$200,000 is not taxable, so \$190,000 would be taxable interest income. She would report income of \$633 per month ($\$190,000 / (25 \times 12)$).
- d. The entire \$1,300 monthly payment would be reported as taxable income.

EA: Yes

38. Determine the amount of tax liability in the following situations. In all cases, the taxpayer is using the filing status of married filing jointly.

- a. Taxable income of \$62,449 that includes a qualified dividend of \$560.
- b. Taxable income of \$12,932 that includes a qualified dividend of \$322.
- c. Taxable income of \$144,290 that includes a qualified dividend of \$4,384.
- d. Taxable income of \$43,297 that includes a qualified dividend of \$971.
- e. Taxable income of \$262,403 that includes a qualified dividend of \$12,396.

Learning Objective: 03-03

Topic: Dividend Income

Difficulty: 3 Hard

Feedback:

Answers are rounded to the nearest dollar.

- a. tax liability of \$8,351.
- b. tax liability of \$1,263.
- c. tax liability of \$27,112.
- d. tax liability of \$5,416.
- e. tax liability of \$59,579.

EA: Yes

39. Each of the following taxpayers received a state income tax refund in 2017. In all cases, the taxpayer has a filing status of married filing jointly. What amount of the refund is properly included in 2017 income?

- a. Refund of \$729; taxpayer did not itemize deductions in 2016.
- b. Refund of \$591; taxpayer had \$13,220 of itemized deductions in 2016.
- c. Refund of \$927; taxpayer had itemized deductions of \$13,000 in 2016.

Learning Objective: 03-3

Topic: State and Local Tax Refunds

Difficulty: 3 Hard

Feedback:

- a. None of the refund is taxable.
- b. The entire \$591 refund is taxable.
- c. The taxable refund is the lesser of (1) the amount received, (2) the amount of itemized deductions, or (3) the amount that itemized deductions exceeded the standard deduction. The last item is \$400. Thus, the taxable refund is \$400.

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Note that the standard deduction for a married couple in tax year 2016 was \$12,600.

EA: Yes

40. A married couple received \$10,000 of social security benefits. Calculate the taxable amount of those benefits if the couple's provisional income is (a) \$20,000, (b) \$41,000, and (c) \$63,000.

Learning Objective: 03-03

Topic: Social Security Benefits

Difficulty: 3 Hard

Feedback:

- a. Since provisional income is less than the lower limit, none of the benefits are taxable.
- b. The taxable amount is equal to the lesser of 50% of benefits or 50% of the excess of provisional income over \$32,000. The first amount is equal to \$5,000 and the second is equal to \$4,500. Thus, the taxable amount of benefits is \$4,500.
- c. The amount of taxable social security benefits is equal to the lesser of (a) 85% of the benefits or (b) 85% of the excess of provisional income over \$44,000 plus the lesser of (1) \$6,000 or (2) 50% of benefits. Item (a) is \$8,500. Item (b) is \$20,400 (\$68,000 - \$44,000).85 plus the lesser of \$6,000 or \$5,000, for a total of \$25,400. The taxable amount of benefits is \$8,500.

EA: Yes

41. Carl and Karina file a joint return. Karina earned a salary of \$38,000 and received dividends of \$3,000, taxable interest income of \$2,000, and nontaxable interest of \$1,000. Carl received \$9,000 of social security benefits and a gift of \$6,000 from his brother. What amount of social security benefits is taxable to Carl and Karina?

Learning Objective: 03-03

Topic: Social Security Benefits

Difficulty: 3 Hard

Feedback: A portion of social security benefits may be taxable if provisional income exceeds certain limits. The provisional income of Carl and Karina is:

Salary.....	\$ 38,000
Dividend income.....	3,000
Taxable interest income.....	2,000
Tax-exempt interest income.....	1,000
One-half social security benefits.....	4,500

Provisional income.....	\$ 48,500
	=====

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Note that the gift does not enter into the calculations since it is tax-free to Carl and Karina and it is not an item that is required to be added back to provisional income. The amount of taxable social security benefits is equal to the lesser of (a) 85% of the benefits or (b) 85% of the excess of provisional income over \$44,000 plus the lesser of (1) \$6,000 or (2) 50% of benefits.

Item (a) above is equal to \$7,650. Item (b) above is equal to \$3,825 (the excess over \$44,000 times 85%) plus \$4,500 (the lesser of \$6,000 or 50% of benefits) for a total of \$8,325. Thus, the taxable amount of social security benefits for Carl and Karina is \$7,650.

EA: Yes

42. Sean, who is single, received social security benefits of \$8,000, dividend income of \$13,000, and interest income of \$2,000. Except as noted, those income items are reasonably consistent from year to year. At the end of 2017, Sean is considering selling stock that would result in an immediate gain of \$10,000, a reduction in future dividends of \$1,000, and an increase in future interest income of \$1,500. He has asked you for advice. What course of action do you recommend?

Learning Objective: 03-03

Topic: Social Security Benefits

Difficulty: 3 Hard

Feedback: If Sean does not sell the stock, his adjusted gross income will be \$15,000.

Note that none of his social security benefits are taxed.

If Sean sells the stock, a portion of his social security benefits would be taxed in 2017. His provisional income would be:

Dividend income.....	\$ 13,000
Interest income.....	2,000
Gain on sale of stock.....	10,000
One-half social security benefits.....	4,000

Provisional income.....	\$ 29,000
	=====

Because his provisional income exceeds the lower limit, his social security benefits will be taxed to the extent of the lesser of (a) 50% of the benefits or (b) 50% of the excess of provisional income over \$25,000. In this case, the taxable amount would be \$2,000. Thus, because the stock sale would push Sean over the provisional income limitation, a portion of his social security benefits would be taxed. If the sale were not made, none of the social security benefits would be taxed.

Since this sale opportunity is at the end of the year, Sean should consider selling half the stock in 2017 and the other half on the first available trade date in 2018. By doing this, Sean would record a \$5,000 gain in 2017, which would not cause any social security benefits to be taxed because his provisional income would be \$24,000. In 2018, if his social security benefits remain at \$8,000, his dividend income is

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\$12,000 (\$13,000 - \$1,000), and his interest income is \$3,500 (\$2,000 + \$1,500), then the taxable social security benefits would be \$0 (you may find it instructive to perform this calculation yourself). By taking this approach, Sean's taxable income would be lower over the two years compared to taking the entire gain in 2017.

EA: Yes

43. Burger Store is located near many large office buildings, so at lunch it is extremely busy. Burger Store management previously permitted lunchtime employees a half-hour off-premises lunch break. However, employees could not easily return in a timely manner. Thus a new policy was instituted to allow employees a 20-minute break for free lunch (only on the Burger Store premises). The company's accountant believes that the cost of these meals must be allocated to employees as additional compensation because the meals do not qualify as a nontaxable fringe benefit for employee discounts. In your opinion, should the cost of these meals be taxable or tax-free to employees? Support your answer.

Learning Objective: 03-04

Topic: Items Excluded from Gross Income

Difficulty: 2 Medium

Feedback: The cost of the meals is likely to be tax-free to employees. Employer-paid meals are tax-free if they are furnished for the convenience of the employer and are furnished on the business premises. It is obvious that the meals are provided at the Burger Store location. In addition, the arrangement appears to be for the convenience of the employer. Lunch time is a very busy time and, under the old arrangement, employees found it difficult to return on time, thus affecting business operations at a critical time. The new arrangement corrects the problems.

EA: Yes

Discussion Questions Pertaining to Appendix

44. Explain the rules governing the exemption of interest on U.S. savings bonds from taxation if it is used for educational purposes.

Learning Objective: 03-05

Topic: Savings Bond Interest Exclusion

Difficulty: 2 Medium

Feedback: If a taxpayer redeems Series EE or Series I Savings Bonds, the proceeds are not taxable if the proceeds are used to pay qualified higher education expenses of the taxpayer, his or her spouse, or their dependents. Qualified education expenses are tuition and fees at qualified educational institutions. Qualified education expenses must be reduced by tax-exempt scholarships, benefits under state tuition plans, expenses used for educational tax credits, and Coverdell education savings account distributions.

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The exclusion is limited if the taxpayers modified AGI exceeds \$117,250 (\$78,150 for other returns) and is totally eliminated when modified AGI exceeds \$147,250 for joint returns (\$93,150 for other returns).

EA: Yes

45. Define *imputed interest*.

Learning Objective: 03-05

Topic: Below-Market Interest Rate Loans

Difficulty: 1 Easy

Feedback: Some deferred payment contracts may not provide for an interest rate or may contain an interest rate that is materially lower than market rates. Subject to certain limitations, the IRC states that the interest on the contract must be recalculated using a market rate of interest specified in the Code. The difference between the recalculated interest and the face interest is imputed interest.

EA: Yes

46. Why were the interest imputation rules created?

Learning Objective: 03-05

Topic: Below-Market Interest Rate Loans

Difficulty: 1 Easy

Feedback: To prevent taxpayers from shifting income from interest income taxed at a maximum tax rate of 39.6%, to preferential capital gain tax rates.

EA: Yes

47. Briefly explain the application of the imputed interest rules.

Learning Objective: 03-05

Topic: Below-Market Interest Rate Loans

Difficulty: 2 Medium

Feedback: The rules apply to installment loans, term loans, or demand loans where the interest rate is less than the Applicable Federal Rate (AFR).

Imputing interest will reallocate payments such that more of the payment is characterized as interest and less as principal. In effect, the rules restate the sales price as being equal to the PV of the payments using the AFR. Then an amortization schedule is prepared using the AFR as the interest rate.

EA: Yes

48. The interest imputation rules indirectly use a market rate of interest. What is meant by a *market rate of interest*?

Learning Objective: 03-05**Topic: Below-Market Interest Rate Loans****Difficulty: 1 Easy**

Feedback: A market rate of interest is the rate at which a taxpayer could borrow in an arms-length transaction. The market rate of interest is specific to borrower credit risk, loan term, loan amount, and loan collateral.

EA: Yes

49. Define *original issue discount (OID)*. Under what circumstances are the OID rules applied?

Learning Objective: 03-05**Topic: Original Issue Discount****Difficulty: 2 Medium**

Feedback: OID is the difference between the amount for which a debt issue is acquired and the maturity amount of the debt issue. For example, a bond can be purchased from the original issuer in an amount less than face (you might recall from Financial Accounting that the bond is sold/purchased at a discount). The difference between the purchase price and the face amount is OID. The OID rules apply when the amount of OID is equal to or greater than .25% of the maturity value multiplied by the number of years to maturity.

EA: Yes

50. Concerning the exemption for U.S. Savings Bond interest used for education expenses, what are the lower and upper income limitations for married taxpayers, and how is the exemption determined when taxpayer income falls between the limitation amounts?

Learning Objective: 03-05**Topic: Savings Bond Interest Exclusion****Difficulty: 2 Medium**

Feedback: The upper limit for married taxpayers is \$147,250 and the lower limit is \$117,250. If the taxpayer's modified AGI is between these two numbers, the amount of the reduction is equal to:

$$\text{Amount otherwise excludable} \times \frac{\text{Modified AGI} - \text{limitation amount}}{\$30,000}$$

EA: Yes

51. On July 1, 2017, Rene, a cash-basis taxpayer, purchased \$500,000 of the newly issued bonds of Acce Corporation for \$452,260. The 10-year bonds carry an interest rate

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of 8% and were sold to yield 9.5%. What amount of interest income must Rene report in 2017, 2018, and 2019?

Learning Objective: 03-05

Topic: Original Issue Discount

Difficulty: 3 Hard

Feedback: The amortization schedule for the bond investment is

Payment Date	(1) Interest Income	(2) Cash Received	(3) OID	(4) Carrying Amount
				\$452,260
Dec. 31, 2017	\$21,482	\$20,000	\$1,482	453,742
June 30, 2018	21,553	20,000	1,553	455,295
Dec. 31, 2018	21,627	20,000	1,627	456,922
June 30, 2019	21,704	20,000	1,704	458,626
Dec. 31, 2019	21,785	20,000	1,785	460,411

Column (1) is the prior balance in column (4) times 9.5% divided by 2

Column (2) is the \$500,000 face amount multiplied by the 8% face rate divided by 2

Column (3) is column (1) minus column (2)

Column (4) is the prior balance in column (4) plus the OID amount in column (3)

Thus Rene would report interest income of \$21,482 in 2017, \$43,180 in 2018, and \$43,489 in 2019.

EA: Yes

52. In 2017, Joseph and Patricia Jefferson redeemed \$8,000 of Series EE U.S. savings bonds (principal of \$5,500 and interest of \$2,500), the proceeds from which were used to pay for qualified higher education expenses of their dependent daughter who is attending a qualified educational institution. For the year, tuition and fees were \$8,000 and room and board cost \$7,000. The daughter received a \$2,000 tax-exempt scholarship during the year that was used to pay tuition and fees. The Jeffersons' modified AGI was \$96,000 in 2017. They do not participate in any other higher education-related programs. Calculate the amount of savings bond interest that the Jeffersons can exclude from gross income in 2017.

Learning Objective: 03-05

Topic: Savings Bond Interest Exclusion

Difficulty: 3 Hard

Feedback: The Jeffersons can exclude \$1,875 of the Savings Bond Interest in 2017.

Qualified expenses are tuition and fees reduced by scholarships and other items.

The qualified expenses for the Jeffersons are \$6,000 (\$8,000 minus the \$2,000 scholarship). Because the redemption proceeds exceed the qualified higher education expenses, their interest exclusion amount is limited to \$1,875 calculated as [\$2,500 x (\$6,000 / \$8,000)]

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EA: Yes

53. Daniel and Alexis, both 28, are interested in saving for the college education of their twin daughters Alie and Amber. They decide to purchase some Series EE U.S. savings bonds because they know that the interest on the bonds is tax-free in certain circumstances. To easily keep track of the savings for each child, they purchase half of the bonds in the names of Daniel and Alie and the other half in the names of Daniel and Amber. Assuming that current tax law does not change, under what circumstances will Daniel and Alexis be permitted to exclude interest on redemption of these bonds?

Learning Objective: 03-05

Topic: Savings Bond Interest Exclusion

Difficulty: 2 Medium

Feedback: Daniel and Alexis will not be able to exclude interest on the redemption of the bonds. Interest on Series EE U.S. Savings Bonds can be excluded if the proceeds are used to pay qualified higher education expenses for the taxpayer, his or her spouse, or their dependents. However, Daniel and/or Alexis must be the owners of the bonds; the daughters cannot be owners or co-owners. Since the bonds are owned by Daniel and Alie and by Daniel and Amber, the interest cannot be excluded.

EA: Yes

54. A person is selling some property and wishes to obtain payment partially in cash with the remainder in the form of a carryback note receivable.
- Why might the seller wish to increase the sales price and reduce the interest rate on the carryback note? Assume that the cash down payment and the total amount of payments will not change.
 - Would the buyer likely agree to the increased price and decreased interest rate? Why or why not?

Learning Objective: 03-05

Topic: Below-Market Interest Rate Loans

Difficulty: 3 Hard

Feedback:

- The seller is likely interested in maximizing the after-tax benefits of the sale. If the seller increases the sales price (thus increasing the amount of capital gain taxed at 15%, assuming the seller does not have a marginal ordinary income tax rate of 39.60%) and decreases the interest expense (thus decreasing the amount of interest expense taxed at up to 39.60%), the seller will increase the amount of after-tax cash.
- The buyer may agree with the changed purchase structure. If the sales price is increased, the buyer will have a higher cost basis in the property. If the buyer later sells the property, this higher basis will result in a lower gain on the second sale, thus saving taxes later. In this case, the buyer may agree to

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the changed structure. However, if the buyer can fully deduct the interest payments, the buyer may not agree to the change. Lower interest payments will result in lower deductions and a higher current tax liability. In effect, the change would give the buyer higher taxes now in exchange for a lower gain on eventual sale. If the interest payments would not be deductible (for example if they were classified as personal interest), the buyer might agree to the change.

EA: Yes

Multiple Choice Questions Pertaining to Appendix

55. The amount of savings bond interest exempt from tax is limited when an individual is single and his or her AGI reaches

- a. \$117,250.
- b. \$77,550.
- c. \$78,150.
- d. \$76,000.

Answer: c

Learning Objective: 03-05

Topic: Savings Bond Interest Exclusion

Difficulty: 1 Easy

Feedback: The limitation amount for a single individual in 2017 starts at \$78,150.

EA: Yes

56. Original issue discount (OID) is deemed to be zero if it is less than _____ of the maturity value, multiplied by the number of complete years to maturity.

- a. 0.25%.
- b. 5%.
- c. 25%.
- d. 15%.

Answer: a

Learning Objective: 03-05

Topic: Original Issue Discount

Difficulty: 1 Easy

Feedback: OID is deemed to be zero if it is less than .25% of the maturity value, multiplied by the number of complete years to maturity.

EA: Yes

57. An individual with an OID instrument must annually report a portion of the OID as

- a. Dividend income.
- b. Pension income.

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- c. Capital gain income.
- d. Interest income.

Answer: d

Learning Objective: 03-05

Topic: Original Issue Discount

Difficulty: 2 Medium

Feedback: Taxpayers must report a portion of the OID as interest income annually.

EA: Yes

Tax Return Problem #1

The solutions to the chapter tax return problems can be found on the online learning center: www.mhhe.com/cruz2018

Tax Return Problem #2

The solutions to the chapter tax return problems can be found on the online learning center: www.mhhe.com/cruz2018

Tax Return Problem #3

The solutions to the chapter tax return problems can be found on the online learning center: www.mhhe.com/cruz2018

CHAPTER 2

EXPANDED TAX FORMULA, FORMS 1040A AND 1040, AND BASIC CONCEPTS

Learning Objectives

- LO 1. Describe the expanded tax formula and the components of the major sections of Form 1040A and Form 1040.
- LO 2. Determine the proper filing status.
- LO 3. Calculate personal exemptions.
- LO 4. Calculate dependency exemptions.
- LO 5. Determine the standard deduction.
- LO 6. Compute the amount of tax due to the Internal Revenue Service (IRS).
- LO 7. Determine what interest and penalties the IRS can assess and in what instances certain penalties are applicable.

Topics of Primary Importance

- Understanding the significance of choosing the proper filing status;
- Understanding the computation of personal and dependency exemptions.
- Understanding the requirements for a qualifying child and a qualifying relative for purposes of the dependency exemption; and
- Understanding the computation of the tax liability, the tax or refund due, and the interest and penalties assessed by the IRS.

Student Confusion Areas

- Determining the qualifications to claim head of household status;
- Determining the requirements for a qualifying child and a qualifying relative; and
- Determining the failure to file and failure to pay penalties when both apply to the same tax return.

Note to Instructor

- When using software, certain tax credits, such as the Child Tax Credit, may appear on the tax return even though we have not yet discussed tax credits. This occurs because the taxpayer may be entitled to the credits and the software will automatically include the credit on the final tax return.

Notes Outline

I. LO 1 –Major Sections of Forms 1040A and 1040

A. Form 1040A is more complex than Form 1040EZ and Form 1040 is more complex than Form 1040A.

B. A taxpayer must use the form that is right for his or her particular situation. Always keep in mind that the simplest return should be used if the taxpayer's situation can be accommodated to the tax form.

C. By analyzing the Form 1040, the expanded tax formula can better be seen:

Gross Income (GI)
- Permitted deductions from gross income
= Adjusted Gross Income (AGI)
- Standard deduction or itemized deductions
- Personal and dependency exemptions
= Taxable income (TI)
x Appropriate tax rates
= Tax liability
- Tax credits
+ Other taxes
- Tax payments and refundable credits
= Tax refund or tax due with return

D. Adjusted gross income (AGI) is an extremely important concept because many deductions and credits are determined with reference to it.

II. LO 2 – Filing Status

A. There are five filing statuses:

1. Single

- a. Taxpayer is not married and does not qualify for head of household or qualifying widow(er) status.
- b. Divorce or separate maintenance decree must be legally executed on or before December 31st of the tax year.
- c. Marital status is determined on the last day of the tax year.

2. Married filing jointly

- a. Taxpayer must be legally married as of the last day of the tax year.
- b. Joint filing is permitted even though only one spouse earns all the income.
- c. A surviving spouse can file jointly if he or she has not remarried as of December 31st of the tax year when the spouse died.
- d. If one of the spouses is a nonresident alien, generally a joint return cannot be filed.

3. Married filing separately
 - a. Taxpayer must be legally married as of the last day of the tax year to select this filing status.
 - b. Name and social security number of the other spouse must be listed on the taxpayer's tax return.
 - c. Both spouses must take the standard deduction, or must itemize deductions when filing separately; they cannot choose independent from each other.
4. Head of household
 - a. Taxpayer must be unmarried as of the last day of the tax year (there are certain rules for an abandoned spouse), be a U.S. citizen or resident throughout the year, not be a qualifying widow(er), and maintain a household that is the principal place of abode of a qualifying person for more than half of the year.
 - b. A qualifying person can be a qualifying child or a qualifying relative.
 - c. For a qualifying child:
 - i. If the child is single, he or she does not have to be a dependent of the taxpayer.
 - ii. If the child is married, he or she must be a dependent of the taxpayer.
 - d. For a qualifying relative:
 - i. Mother or father must be a dependent of the taxpayer, but there is no requirement for them to live in the taxpayer's home.
 - ii. Other qualifying relatives must be dependents of the taxpayer and live in the taxpayer's home for more than half the year. It is important to understand that a person who is a qualifying relative only because he or she lived with the taxpayer all year as a member of his or her household is not a qualifying person for head of household status, as shown in Exhibit 2-3 of the text; also see IRS Pub 17 for more details.
5. Qualifying widow(er) with dependent child
 - a. Taxpayer was eligible to file a joint return in the tax year the spouse died.
 - b. Taxpayer must be unmarried as of the last day of the tax year.
 - c. Dependent child must live with the taxpayer for the entire year (except for temporary absences).
 - d. Taxpayer must pay more than half the cost of keeping up a household.

In-class Example – A surviving spouse who qualified as married filing jointly when the spouse died and has filed as a qualifying widow(er) for the next year can use the qualifying widow(er) status for the third year even though the child does not live at home and is not a dependent anymore. Is this true?

For the third year, the surviving spouse cannot file as qualifying widow(er) because all the required conditions for this filing status are not met. The surviving spouse must file single.

III. LO 3 – Personal Exemptions

- A. Taxpayer can deduct an exemption for himself or herself and his or her spouse (if married).
- B. The amount of the exemption is \$4,050 in 2017.
- C. If the taxpayer is claimed as a dependent on someone else's return, the taxpayer cannot claim a personal exemption for himself or herself on his or her own return.

IV. LO 4 – Dependency Exemptions

- A. Taxpayer can claim a dependency exemption if the person is a qualifying child or a qualifying relative and meets the following tests:
 - 1. Dependent taxpayer test
 - a. The qualifying child or qualifying relative cannot be claimed as a dependent by someone else.
 - 2. Joint return test
 - a. The qualifying child or qualifying relative cannot file a joint tax return, unless this person files a joint tax return simply to claim a refund and there is no tax liability on the return.
 - 3. Citizen or resident test
 - a. The qualifying child or qualifying relative must be a U.S. citizen, resident, or national; a resident of Canada or Mexico; or an adopted child of the taxpayer if the child is a member of the taxpayer's household all year and the taxpayer is a U.S. citizen or national.
- B. Who is a qualifying child?
 - To be considered a qualifying child, the following tests must be met:
 - 1. Relationship test
 - a. Child or descendant of child (grandchild or great-grandchild), stepchild, eligible foster child, brother, sister, half-brother, half-sister, stepbrother, or stepsister, or a descendant of them.
 - i. A child includes an adopted child and includes a child placed for adoption in the taxpayer's household by an authorized adoption agency even if the adoption is not finalized.
 - 2. Age test

- a. Under the age of 19.
 - b. Under the age of 24 and a full-time student.
 - c. Totally and permanently disabled regardless of age.
- For years after 2008, the child must be younger than the person claiming the dependency.
- 3. Residency test
 - a. Child must live with the taxpayer for more than half the year, except for temporary absences.
- 4. Support test
 - a. Child must not provide more than half of his or her support. Notice that this is different from the requirement under a qualifying relative.
- 5. Special test for qualifying child of more than one taxpayer
 - a. Only one taxpayer can claim the child as a qualifying child. IRS will use the tie-breaker rules, as shown in Exhibit 2-4 of the text, to determine who is entitled to claim the child if the taxpayers involved cannot make a decision by themselves.

C. Who is a qualifying relative?

To be considered a qualifying relative, the following tests must be met:

- 1. Not a qualifying child test
 - a. A qualifying relative cannot be a qualifying child of the taxpayer or someone else.
- 2. Relationship or member of household test
 - a. A qualifying relative must be a member of the taxpayer's household for the entire year, or be related to the taxpayer. Only certain persons are considered related to the taxpayer.
 - i. Child or descendant of child (grandchild or great-grandchild), stepchild, eligible foster child, brother, sister, half-brother, half-sister, or a descendant of them, stepbrother or stepsister, father or mother, brother or sister of parents, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
- Note that if someone is related to the taxpayer (as indicated in the preceding list), it is not necessary that the person live with the taxpayer for the entire year or, actually, any part of the year. But it may be difficult to meet the support test if the individual does not live in the household.
- 3. Gross income test
 - a. A qualifying relative cannot have gross income equal to or greater than the exemption amount (\$4,050 for 2017).
- 4. Support test
 - a. Taxpayer must provide over 50% of the qualifying relative's support.

- b. There are two exceptions: Multiple support agreement and child of divorced or separated parents. For a more detailed explanation, refer to pages 2-14, 2-15 and 2-16 of the text.

Note: Personal and dependency exemptions have remained at \$4,050, phasing out at different adjusted gross income amounts.

V. LO 5 – Standard Deduction

A. The standard deduction is the sum of the basic standard deduction and the additional standard deduction. Both components depend on filing status and are subject to annual adjustment for inflation.

1. The basic standard deduction for tax year 2017 is as follows:

Filing Status	Basic Standard Deduction
Single	\$ 6,350
Married filing jointly	12,700
Married filing separately	6,350
Head of household	9,350
Qualifying widow(erg)	12,700

2. The additional standard deductions for taxpayers who are 65 or older or blind are:

Filing Status	Tax Year 2017
Single	\$ 1,550
Married filing jointly	1,250
Married filing separately	1,250
Head of household	1,550
Qualifying widow(er)	1,250

3. The standard deduction is zero if any of the following situations occur:
 - a. A married couple files separate returns and one spouse itemizes deductions.
 - b. The taxpayer is a nonresident alien.
 - c. A taxpayer files a return for a period of less than 12 months because of a change in accounting period.

VI. LO 6 – Refund or Tax Due

- A. Tax amount (line 28 on Form 1040A or line 44 on Form 1040)
 - 1. Tax tables are used by most taxpayers with taxable income of less than \$100,000.
 - 2. Taxpayers with \$100,000 or more use the tax rate schedules.
- B. Tax liability (line 39 on Form 1040A or line 63 on Form 1040)
 - 1. Represents total amount the taxpayer must pay to the government for the tax year.
- C. Tax payments (lines 40-45 on Form 1040A and lines 64-73 on Form 1040)
 - 1. Most of these payments are submitted in advance to the IRS.
 - a. Examples are: income tax withholdings and quarterly estimated tax payments.
 - b. There is an underpayment penalty for not submitting the appropriate amount to the IRS in a timely manner.
- D. Tax Refund (line 48a on Form 1040A or line 76a on Form 1040) or Tax Due with Return (line 50 on Form 1040A or line 78 on Form 1040)
 - 1. Excess payment results in a refund.
 - 2. Excess remaining tax liability means the taxpayer must pay the additional amount of tax to the IRS.

VII.LO 7 – Interest and Penalties

- A. The following sections show interest charged on assessments and the most common civil and criminal penalties applicable to individual tax returns.
 - 1. Interest charged on assessments

Time Period	Percentage Rate
Jan. 1, 2017 to June 30, 2017	4%
Apr. 1, 2016 to Dec. 31, 2016	4
July 1, 2015 to Mar. 31, 2016	3
Oct. 1, 2011 to June 30, 2015	3
Apr. 1, 2011 to Sept. 30, 2011	4
Jan. 1, 2011 to Mar. 31, 2011	3
Apr. 1, 2009 to Dec. 31, 2010	4
Jan. 1, 2009 to Mar. 31, 2009	5
Oct. 1, 2008 to Dec. 31, 2008	6
July 1, 2008 to Sept. 30, 2008	5
Apr. 1, 2008 to June 30, 2008	6
Jan. 1, 2008 to Mar. 31, 2008	7
July 1, 2007 to Dec. 31, 2007	8
July 1, 2006 to June 30, 2007	8

Oct. 1, 2005 to June 30, 2006	7
Apr 1, 2005 to Sept. 30, 2005	6
Oct. 1, 2004 to Mar. 31, 2005	5

B. Failure to File Tax Penalty and Failure to Pay Tax Penalty

1. Failure to file tax penalty

- a. The 5% penalty is based on the amount of tax due for each month or fraction of a month, up to a maximum of 25%.
- b. Any income tax return not filed within 60 days of its due date is subject to a minimum penalty of the lesser of \$210 or the amount of tax required on the return.

2. Failure to pay penalty

- a. The ½% penalty is based on the amount of tax due for each month or fraction of a month, up to a maximum of 25%.

3. *Caution:* When both penalties apply, the total percentage is 5% per month or fraction of a month, up to a maximum of 25%.

C. Failure to Pay Estimated Income Tax

1. Taxpayer must pay during the year, either through withholding or estimated payments, a minimum of the following:

- a. 90% of the current year's tax liability.
- b. 100% of the prior year's tax liability if the taxpayer's AGI in the prior year is less than \$150,000. If the taxpayer's prior year AGI is more than \$150,000, the percentage for the prior year rule increases to 110%.

2. Estimated payments can be made on a quarterly basis: April 15, June 15, September 15 in the current year, and January 15 of the next calendar year.

3. No estimated tax penalty applies if the tax due after withholding or estimated payments is less than \$1,000.

4. Form 2210 is used to calculate the failure to pay estimated tax penalty.

D. Accuracy-Related Penalties

1. A penalty can be assessed if negligence or any substantial understatement of income occurs.
2. Negligence can be defined as any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code (IRC), including any careless, reckless, or intentional disregard for tax authority.
3. Substantial understatement occurs when the understatement is either more than 10% of the tax required to be shown on the return or \$5,000 or more.
4. IRS can assess a penalty equal to 20% of the tax due when negligence or substantial understatement occurs.

E. Fraud Penalties

1. The Internal Revenue Code (IRC) does not define fraud but one court, as explained on page 2-26 of the text, has defined it as intentional wrongdoing with the purpose of evading tax.
2. IRS can impose a 75% penalty on any portion of understatement of tax that is attributable to fraud.
3. Criminal penalties can be assessed in addition to civil penalties.

F. Erroneous Claim for Refund or Credit Penalty

1. A 20% penalty could be assessed by the IRS on the disallowed amount of the claim if the claim for refund or credit of income filed is found to be excessive. An amount for a claim is classified as “excessive” if the claim amount exceeds the amount of the allowable claim.
2. This penalty does not apply if the fraud or the accuracy-related penalty has been assessed.

For the year Jan. 1–Dec. 31, 2017, or other tax year beginning , 2017, ending , 20 See separate instructions.

Your first name and initial **Margaret** Last name **O'Hara** Your social security number **4 1 2 3 4 5 6 7 0**

If a joint return, spouse's first name and initial Last name Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions. Apt. no. **799 Adams Street**  Make sure the SSN(s) above and on line 6c are correct.

City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). **Jacksonville, FL 32202** Presidential Election Campaign

Foreign country name Foreign province/state/county Foreign postal code Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Filing Status

1 ☒ Single 4 ☐ Head of household (with qualifying person). (See instructions.)

2 ☐ Married filing jointly (even if only one had income) If the qualifying person is a child but not your dependent, enter this child's name here. ▶

3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶ 5 ☐ Qualifying widow(er) (see instructions)

Check only one box.

Exemptions

6a ☒ Yourself. If someone can claim you as a dependent, do not check box 6a } Boxes checked on 6a and 6b **1**

b ☐ Spouse } No. of children on 6c who:

c Dependents: (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) ☒ if child under age 17 qualifying for child tax credit (see instructions)

If more than four dependents, see instructions and check here ▶ ☐

d Total number of exemptions claimed Add numbers on lines above ▶ **1**

Income

7 Wages, salaries, tips, etc. Attach Form(s) W-2 7 **38,000**

8a Taxable interest. Attach Schedule B if required 8a

b Tax-exempt interest. Do not include on line 8a 8b

9a Ordinary dividends. Attach Schedule B if required 9a

b Qualified dividends 9b

10 Taxable refunds, credits, or offsets of state and local income taxes 10

11 Alimony received 11 **24,000**

12 Business income or (loss). Attach Schedule C or C-EZ 12

13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐ 13

14 Other gains or (losses). Attach Form 4797 14

15a IRA distributions 15a b Taxable amount 15b

16a Pensions and annuities 16a b Taxable amount 16b

17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E 17

18 Farm income or (loss). Attach Schedule F 18

19 Unemployment compensation 19

20a Social security benefits 20a b Taxable amount 20b

21 Other income. List type and amount 21

22 Combine the amounts in the far right column for lines 7 through 21. This is your total income ▶ 22 **62,000**

Adjusted Gross Income

23 Educator expenses 23

24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ 24

25 Health savings account deduction. Attach Form 8889 25

26 Moving expenses. Attach Form 3903 26

27 Deductible part of self-employment tax. Attach Schedule SE 27

28 Self-employed SEP, SIMPLE, and qualified plans 28

29 Self-employed health insurance deduction 29

30 Penalty on early withdrawal of savings 30

31a Alimony paid b Recipient's SSN ▶ 31a

32 IRA deduction 32

33 Student loan interest deduction 33

34 Reserved for future use 34

35 Domestic production activities deduction. Attach Form 8903 35

36 Add lines 23 through 35 36

37 Subtract line 36 from line 22. This is your adjusted gross income ▶ 37 **62,000**

Tax and Credits**Standard Deduction for—**

• People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions.

• All others:
Single or Married filing separately, \$6,350
Married filing jointly or Qualifying widow(er), \$12,700
Head of household, \$9,350

38	Amount from line 37 (adjusted gross income)	38	62,000
39a	Check ☐ You were born before January 2, 1953, ☐ Blind. ☐ Spouse was born before January 2, 1953, ☐ Blind. Total boxes checked ▶ 39a ☐		
b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b ☐		
40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	6,350
41	Subtract line 40 from line 38	41	55,650
42	Exemptions. If line 38 is \$156,900 or less, multiply \$4,050 by the number on line 6d. Otherwise, see instructions	42	4,050
43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	51,600
44	Tax (see instructions). Check if any from: a ☐ Form(s) 8814 b ☐ Form 4972 c ☐	44	8,645
45	Alternative minimum tax (see instructions). Attach Form 6251	45	
46	Excess advance premium tax credit repayment. Attach Form 8962	46	
47	Add lines 44, 45, and 46	47	8,645
48	Foreign tax credit. Attach Form 1116 if required	48	
49	Credit for child and dependent care expenses. Attach Form 2441	49	
50	Education credits from Form 8863, line 19	50	
51	Retirement savings contributions credit. Attach Form 8880	51	
52	Child tax credit. Attach Schedule 8812, if required	52	
53	Residential energy credit. Attach Form 5695	53	
54	Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐	54	
55	Add lines 48 through 54. These are your total credits	55	
56	Subtract line 55 from line 47. If line 55 is more than line 47, enter -0-	56	8,645

Other Taxes

57	Self-employment tax. Attach Schedule SE	57	
58	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	58	
59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
60a	Household employment taxes from Schedule H	60a	
b	First-time homebuyer credit repayment. Attach Form 5405 if required	60b	
61	Health care: individual responsibility (see instructions) Full-year coverage ☒	61	0
62	Taxes from: a ☐ Form 8959 b ☐ Form 8960 c ☐ Instructions; enter code(s)	62	
63	Add lines 56 through 62. This is your total tax	63	8,645

Payments

If you have a qualifying child, attach Schedule EIC.

64	Federal income tax withheld from Forms W-2 and 1099	64	9,500
65	2017 estimated tax payments and amount applied from 2016 return	65	
66a	Earned income credit (EIC)	66a	
b	Nontaxable combat pay election 66b		
67	Additional child tax credit. Attach Schedule 8812	67	
68	American opportunity credit from Form 8863, line 8	68	
69	Net premium tax credit. Attach Form 8962	69	
70	Amount paid with request for extension to file	70	
71	Excess social security and tier 1 RRTA tax withheld	71	
72	Credit for federal tax on fuels. Attach Form 4136	72	
73	Credits from Form: a ☐ 2439 b ☐ Reserved c ☐ 8885 d ☐	73	
74	Add lines 64, 65, 66a, and 67 through 73. These are your total payments	74	9,500

Refund

Direct deposit? See instructions.

75	If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid	75	855
76a	Amount of line 75 you want refunded to you . If Form 8888 is attached, check here ☐	76a	855
b	Routing number	c	Type: ☐ Checking ☐ Savings
d	Account number		

Amount You Owe

77	Amount of line 75 you want applied to your 2018 estimated tax	77	
78	Amount you owe. Subtract line 74 from line 63. For details on how to pay, see instructions	78	
79	Estimated tax penalty (see instructions)	79	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete below. ☐ **No**

Designee's name ▶	Phone no. ▶	Personal identification number (PIN) ▶
-------------------	-------------	--

Sign Here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

Your first name and initial Jose		Last name Hernandez		OMB No. 1545-0074	
				Your social security number 4 1 2 3 4 5 6 7 0	
If a joint return, spouse's first name and initial Dora		Last name Hernandez		Spouse's social security number 4 1 2 3 4 5 6 7 1	
Home address (number and street). If you have a P.O. box, see instructions. 32010 Lake Street				Apt. no.	
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Atlanta, GA 30294				Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse	
Foreign country name		Foreign province/state/county			

Filing status Check only one box.

1 ☐ Single 2 ☒ Married filing jointly (even if only one had income) 3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶	4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ 5 ☐ Qualifying widow(er) (see instructions)
--	--

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a.

b ☒ **Spouse**

c Dependents:

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ☒ if child under age 17 qualifying for child tax credit (see instructions)
Adela Hernandez		412-34-5672	Daughter	☒
				☐
				☐
				☐
				☐
				☐

d Total number of exemptions claimed. **3**

Income

7 Wages, salaries, tips, etc. Attach Form(s) W-2. **76,800**

8a Taxable interest. Attach Schedule B if required. **300**

b Tax-exempt interest. **Do not** include on line 8a. **8b**

9a Ordinary dividends. Attach Schedule B if required. **9a**

b Qualified dividends (see instructions). **9b**

10 Capital gain distributions (see instructions). **10**

11a IRA distributions. 11a	11b Taxable amount (see instructions). 11b
12a Pensions and annuities. 12a	12b Taxable amount (see instructions). 12b

13 Unemployment compensation and Alaska Permanent Fund dividends. **13**

14a Social security benefits. 14a	14b Taxable amount (see instructions). 14b
---	--

15 Add lines 7 through 14b (far right column). This is your **total income.** ▶ **77,100**

Adjusted gross income

16 Educator expenses (see instructions). 16	
17 IRA deduction (see instructions). 17	
18 Student loan interest deduction (see instructions). 18	
19 Reserved for future use. 19	
20 Add lines 16 through 19. These are your total adjustments. 20	
21 Subtract line 20 from line 15. This is your adjusted gross income. ▶ 77,100	

Tax, credits, and payments**Standard Deduction for—**

• People who check any box on line 23a or 23b or who can be claimed as a dependent, see instructions.

• All others:
Single or Married filing separately, \$6,350
Married filing jointly or Qualifying widow(er), \$12,700
Head of household, \$9,350

If you have a qualifying child, attach Schedule EIC.

22	Enter the amount from line 21 (adjusted gross income).	22	77,100
23a	Check ☐ You were born before January 2, 1953, ☐ Blind if: ☐ Spouse was born before January 2, 1953, ☐ Blind } Total boxes checked ▶ 23a ☐		
b	If you are married filing separately and your spouse itemizes deductions, check here ▶ 23b ☐		
24	Enter your standard deduction .	24	12,700
25	Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-.	25	64,400
26	Exemptions. Multiply \$4,050 by the number on line 6d.	26	12,150
27	Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-. This is your taxable income .	27	52,250
28	Tax , including any alternative minimum tax (see instructions).	28	6,909
29	Excess advance premium tax credit repayment. Attach Form 8962.	29	
30	Add lines 28 and 29.	30	6,909
31	Credit for child and dependent care expenses. Attach Form 2441.	31	
32	Credit for the elderly or the disabled. Attach Schedule R.	32	
33	Education credits from Form 8863, line 19.	33	
34	Retirement savings contributions credit. Attach Form 8880.	34	
35	Child tax credit. Attach Schedule 8812, if required.	35	1,000
36	Add lines 31 through 35. These are your total credits .	36	1,000
37	Subtract line 36 from line 30. If line 36 is more than line 30, enter -0-.	37	5,909
38	Health care: individual responsibility (see instructions). Full-year coverage ☒	38	
39	Add line 37 and line 38. This is your total tax .	39	5,909
40	Federal income tax withheld from Forms W-2 and 1099.	40	9,810
41	2017 estimated tax payments and amount applied from 2016 return.	41	
42a	Earned income credit (EIC).	42a	
b	Nontaxable combat pay election. 42b		
43	Additional child tax credit. Attach Schedule 8812.	43	
44	American opportunity credit from Form 8863, line 8.	44	
45	Net premium tax credit. Attach Form 8962.	45	
46	Add lines 40, 41, 42a, 43, 44, and 45. These are your total payments .	46	9,810

Refund

Direct deposit? See instructions and fill in 48b, 48c, and 48d or Form 8888.

47	If line 46 is more than line 39, subtract line 39 from line 46. This is the amount you overpaid .	47	3,901
48a	Amount of line 47 you want refunded to you . If Form 8888 is attached, check here ▶ ☐	48a	3,901
b	Routing number ▶ c Type: ☐ Checking ☐ Savings		
d	Account number		
49	Amount of line 47 you want applied to your 2018 estimated tax .	49	

Amount you owe

50	Amount you owe. Subtract line 46 from line 39. For details on how to pay, see instructions.	50	
51	Estimated tax penalty (see instructions).	51	

Third party designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes**. Complete the following. ☐ **No**

Designee's name ▶	Phone no. ▶	Personal identification number (PIN) ▶
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Sign here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid preparer use only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For the year Jan. 1–Dec. 31, 2017, or other tax year beginning

, 2017, ending

, 20

See separate instructions.

Your first name and initial

Last name

Your social security number**Jose****Hernandez****4 1 2 3 4 5 6 7 0**

If a joint return, spouse's first name and initial

Last name

Spouse's social security number**Dora****Hernandez****4 1 2 3 4 5 6 7 1**

Home address (number and street). If you have a P.O. box, see instructions.

Apt. no.

32010 Lake Street

▲ Make sure the SSN(s) above and on line 6c are correct.

City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).

Atlanta, GA 30294**Presidential Election Campaign**Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Foreign country name

Foreign province/state/county

Foreign postal code

Filing Status1 ☐ Single2 ☒ Married filing jointly (even if only one had income)3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶4 ☐ Head of household (with qualifying person). (See instructions.)

If the qualifying person is a child but not your dependent, enter this child's name here. ▶

5 ☐ Qualifying widow(er) (see instructions)

Check only one box.

Exemptions6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6ab ☒ **Spouse**c **Dependents:**

(1) First name Last name

(2) Dependent's social security number

(3) Dependent's relationship to you

(4) ☒ if child under age 17 qualifying for child tax credit (see instructions)**Adela Hernandez****4 1 2 3 4 5 6 7 2****Daughter**☒If more than four dependents, see instructions and check here ▶ ☐

d Total number of exemptions claimed

Boxes checked on 6a and 6b

2

No. of children on 6c who:

• lived with you
• did not live with you due to divorce or separation (see instructions)**1**

Dependents on 6c not entered above

Add numbers on lines above ▶

3**Income**

7 Wages, salaries, tips, etc. Attach Form(s) W-2

7**76,800**8a **Taxable** interest. Attach Schedule B if required**8a****300**b **Tax-exempt** interest. **Do not** include on line 8a**8b**

9a Ordinary dividends. Attach Schedule B if required

9a

b Qualified dividends

9b

10 Taxable refunds, credits, or offsets of state and local income taxes

10

11 Alimony received

11

12 Business income or (loss). Attach Schedule C or C-EZ

1213 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐**13**

14 Other gains or (losses). Attach Form 4797

14

15a IRA distributions

15a

b Taxable amount

15b

16a Pensions and annuities

16a

b Taxable amount

16b

17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E

17

18 Farm income or (loss). Attach Schedule F

18

19 Unemployment compensation

19

20a Social security benefits

20a

b Taxable amount

20b

21 Other income. List type and amount

2122 Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶**22****77,100****Adjusted Gross Income**

23 Educator expenses

23

24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ

24

25 Health savings account deduction. Attach Form 8889

25

26 Moving expenses. Attach Form 3903

26

27 Deductible part of self-employment tax. Attach Schedule SE

27

28 Self-employed SEP, SIMPLE, and qualified plans

28

29 Self-employed health insurance deduction

29

30 Penalty on early withdrawal of savings

30

31a Alimony paid b Recipient's SSN ▶

31a

32 IRA deduction

32

33 Student loan interest deduction

33

34 Reserved for future use

34

35 Domestic production activities deduction. Attach Form 8903

35

36 Add lines 23 through 35

3637 Subtract line 36 from line 22. This is your **adjusted gross income** ▶**37****77,100**

Tax and Credits**Standard Deduction for—**

• People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions.

• All others:
Single or Married filing separately, \$6,350
Married filing jointly or Qualifying widow(er), \$12,700
Head of household, \$9,350

38	Amount from line 37 (adjusted gross income)	38	77,100
39a	Check ☐ You were born before January 2, 1953, ☐ Blind. ☐ Spouse was born before January 2, 1953, ☐ Blind. Total boxes checked ▶ 39a ☐		
b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b ☐		
40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	12,700
41	Subtract line 40 from line 38	41	64,400
42	Exemptions. If line 38 is \$156,900 or less, multiply \$4,050 by the number on line 6d. Otherwise, see instructions	42	12,150
43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	52,250
44	Tax (see instructions). Check if any from: a ☐ Form(s) 8814 b ☐ Form 4972 c ☐	44	6,909
45	Alternative minimum tax (see instructions). Attach Form 6251	45	
46	Excess advance premium tax credit repayment. Attach Form 8962	46	
47	Add lines 44, 45, and 46	47	6,909
48	Foreign tax credit. Attach Form 1116 if required	48	
49	Credit for child and dependent care expenses. Attach Form 2441	49	
50	Education credits from Form 8863, line 19	50	
51	Retirement savings contributions credit. Attach Form 8880	51	
52	Child tax credit. Attach Schedule 8812, if required	52	1,000
53	Residential energy credit. Attach Form 5695	53	
54	Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐	54	
55	Add lines 48 through 54. These are your total credits	55	1,000
56	Subtract line 55 from line 47. If line 55 is more than line 47, enter -0-	56	5,909

Other Taxes

57	Self-employment tax. Attach Schedule SE	57	
58	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	58	
59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
60a	Household employment taxes from Schedule H	60a	
b	First-time homebuyer credit repayment. Attach Form 5405 if required	60b	
61	Health care: individual responsibility (see instructions) Full-year coverage ☒	61	0
62	Taxes from: a ☐ Form 8959 b ☐ Form 8960 c ☐ Instructions; enter code(s)	62	
63	Add lines 56 through 62. This is your total tax	63	5,909

Payments

If you have a qualifying child, attach Schedule EIC.

64	Federal income tax withheld from Forms W-2 and 1099	64	9,810
65	2017 estimated tax payments and amount applied from 2016 return	65	
66a	Earned income credit (EIC)	66a	
b	Nontaxable combat pay election 66b		
67	Additional child tax credit. Attach Schedule 8812	67	
68	American opportunity credit from Form 8863, line 8	68	
69	Net premium tax credit. Attach Form 8962	69	
70	Amount paid with request for extension to file	70	
71	Excess social security and tier 1 RRTA tax withheld	71	
72	Credit for federal tax on fuels. Attach Form 4136	72	
73	Credits from Form: a ☐ 2439 b ☐ Reserved c ☐ 8885 d ☐	73	
74	Add lines 64, 65, 66a, and 67 through 73. These are your total payments	74	9,810

Refund

Direct deposit? See instructions.

75	If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid	75	3,901
76a	Amount of line 75 you want refunded to you . If Form 8888 is attached, check here ☐	76a	3,901
b	Routing number	c	Type: ☐ Checking ☐ Savings
d	Account number		
77	Amount of line 75 you want applied to your 2018 estimated tax	77	
78	Amount you owe. Subtract line 74 from line 63. For details on how to pay, see instructions	78	
79	Estimated tax penalty (see instructions)	79	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete below. ☐ **No**

Designee's name ▶	Phone no. ▶	Personal identification number (PIN) ▶
-------------------	-------------	--

Sign Here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

Your first name and initial Marie	Last name Lincoln	OMB No. 1545-0074 Your social security number 4 1 2 3 4 5 6 7 0
If a joint return, spouse's first name and initial	Last name	Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions. 4110 N.E. 13th Street		Apt. no.	▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions). Miami, FL 33127			Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
Foreign country name	Foreign province/state/county	Foreign postal code	

Filing status Check only one box.

1 ☐ Single 2 ☐ Married filing jointly (even if only one had income) 3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶	4 ☒ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶ 5 ☐ Qualifying widow(er) (see instructions)
---	---

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a.

b ☐ **Spouse**

c Dependents:

(1) First name	Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ☒ if child under age 17 qualifying for child tax credit (see instructions)
Steven Lincoln		412-34-5672	Son	☒
				☐
				☐
				☐
				☐
				☐

d Total number of exemptions claimed. **2**

Income

7 Wages, salaries, tips, etc. Attach Form(s) W-2. **43,600**

8a Taxable interest. Attach Schedule B if required. **500**

b Tax-exempt interest. **Do not** include on line 8a. **8b**

9a Ordinary dividends. Attach Schedule B if required. **9a**

b Qualified dividends (see instructions). **9b**

10 Capital gain distributions (see instructions). **10**

11a IRA distributions. 11a	11b Taxable amount (see instructions). 11b
12a Pensions and annuities. 12a	12b Taxable amount (see instructions). 12b

13 Unemployment compensation and Alaska Permanent Fund dividends. **13**

14a Social security benefits. 14a	14b Taxable amount (see instructions). 14b
--	---

15 Add lines 7 through 14b (far right column). This is your **total income.** ▶ **44,100**

Adjusted gross income

16 Educator expenses (see instructions). 16	
17 IRA deduction (see instructions). 17	
18 Student loan interest deduction (see instructions). 18	
19 Reserved for future use. 19	
20 Add lines 16 through 19. These are your total adjustments. 20	
21 Subtract line 20 from line 15. This is your adjusted gross income. ▶ 44,100	

Tax, credits, and payments**Standard Deduction for—**

• People who check any box on line 23a or 23b or who can be claimed as a dependent, see instructions.

• All others:
Single or Married filing separately, \$6,350

Married filing jointly or Qualifying widow(er), \$12,700

Head of household, \$9,350

If you have a qualifying child, attach Schedule EIC.

22	Enter the amount from line 21 (adjusted gross income).	22	44,100
23a	Check ☐ You were born before January 2, 1953, ☐ Blind if: ☐ Spouse was born before January 2, 1953, ☐ Blind } Total boxes checked ▶ 23a ☐		
b	If you are married filing separately and your spouse itemizes deductions, check here ▶ 23b ☐		
24	Enter your standard deduction .	24	9,350
25	Subtract line 24 from line 22. If line 24 is more than line 22, enter -0-.	25	34,750
26	Exemptions. Multiply \$4,050 by the number on line 6d.	26	8,100
27	Subtract line 26 from line 25. If line 26 is more than line 25, enter -0-. This is your taxable income .	27	26,650
28	Tax , including any alternative minimum tax (see instructions).	28	3,334
29	Excess advance premium tax credit repayment. Attach Form 8962.	29	
30	Add lines 28 and 29.	30	3,334
31	Credit for child and dependent care expenses. Attach Form 2441.	31	
32	Credit for the elderly or the disabled. Attach Schedule R.	32	
33	Education credits from Form 8863, line 19.	33	
34	Retirement savings contributions credit. Attach Form 8880.	34	
35	Child tax credit. Attach Schedule 8812, if required.	35	1,000
36	Add lines 31 through 35. These are your total credits .	36	1,000
37	Subtract line 36 from line 30. If line 36 is more than line 30, enter -0-.	37	2,334
38	Health care: individual responsibility (see instructions). Full-year coverage ☒	38	
39	Add line 37 and line 38. This is your total tax .	39	2,334
40	Federal income tax withheld from Forms W-2 and 1099.	40	4,540
41	2017 estimated tax payments and amount applied from 2016 return.	41	
42a	Earned income credit (EIC).	42a	
b	Nontaxable combat pay election. 42b		
43	Additional child tax credit. Attach Schedule 8812.	43	
44	American opportunity credit from Form 8863, line 8.	44	
45	Net premium tax credit. Attach Form 8962.	45	
46	Add lines 40, 41, 42a, 43, 44, and 45. These are your total payments .	46	4,540

Refund

Direct deposit? See instructions and fill in 48b, 48c, and 48d or Form 8888.

47	If line 46 is more than line 39, subtract line 39 from line 46. This is the amount you overpaid .	47	2,206
48a	Amount of line 47 you want refunded to you . If Form 8888 is attached, check here ▶ ☐	48a	2,206
b	Routing number ▶ c Type: ☐ Checking ☐ Savings		
d	Account number		
49	Amount of line 47 you want applied to your 2018 estimated tax .	49	

Amount you owe

50	Amount you owe. Subtract line 46 from line 39. For details on how to pay, see instructions.	50	
51	Estimated tax penalty (see instructions).	51	

Third party designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes**. Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid preparer use only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For the year Jan. 1–Dec. 31, 2017, or other tax year beginning

, 2017, ending

, 20

See separate instructions.

Your first name and initial

Last name

Your social security number**Marie****Lincoln****4 1 2 3 4 5 6 7 0**

If a joint return, spouse's first name and initial

Last name

Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions.

Apt. no.

4110 N.E. 13th Street

▲ Make sure the SSN(s) above and on line 6c are correct.

City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).

Miami, FL 33127**Presidential Election Campaign**Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Foreign country name

Foreign province/state/county

Foreign postal code

Filing Status1 ☐ Single2 ☐ Married filing jointly (even if only one had income)3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶4 ☒ Head of household (with qualifying person). (See instructions.)

If the qualifying person is a child but not your dependent, enter this child's name here. ▶

5 ☐ Qualifying widow(er) (see instructions)

Check only one box.

Exemptions6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6ab ☐ **Spouse**c **Dependents:**

(1) First name Last name

(2) Dependent's social security number

(3) Dependent's relationship to you

(4) ☒ if child under age 17 qualifying for child tax credit (see instructions)**Steven Lincoln****4 1 2 3 4 5 6 7 2****Son**☒If more than four dependents, see instructions and check here ▶ ☐**Boxes checked on 6a and 6b****1****No. of children on 6c who:**• lived with you
• did not live with you due to divorce or separation (see instructions)**1****Dependents on 6c not entered above****Add numbers on lines above ▶****2**

d Total number of exemptions claimed

Income

7 Wages, salaries, tips, etc. Attach Form(s) W-2

7 **43,600**8a **Taxable** interest. Attach Schedule B if required8a **500**b **Tax-exempt** interest. **Do not** include on line 8a

8b

9a Ordinary dividends. Attach Schedule B if required

9a

b Qualified dividends

9b

10 Taxable refunds, credits, or offsets of state and local income taxes

10

11 Alimony received

11

12 Business income or (loss). Attach Schedule C or C-EZ

12

13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐

13

14 Other gains or (losses). Attach Form 4797

14

15a IRA distributions

15a

b Taxable amount

15b

16a Pensions and annuities

16a

b Taxable amount

16b

17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E

17

18 Farm income or (loss). Attach Schedule F

18

19 Unemployment compensation

19

20a Social security benefits

20a

b Taxable amount

20b

21 Other income. List type and amount

21

22 Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶22 **44,100****Adjusted Gross Income**

23 Educator expenses

23

24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ

24

25 Health savings account deduction. Attach Form 8889

25

26 Moving expenses. Attach Form 3903

26

27 Deductible part of self-employment tax. Attach Schedule SE

27

28 Self-employed SEP, SIMPLE, and qualified plans

28

29 Self-employed health insurance deduction

29

30 Penalty on early withdrawal of savings

30

31a Alimony paid b Recipient's SSN ▶

31a

32 IRA deduction

32

33 Student loan interest deduction

33

34 Reserved for future use

34

35 Domestic production activities deduction. Attach Form 8903

35

36 Add lines 23 through 35

36

37 Subtract line 36 from line 22. This is your **adjusted gross income** ▶37 **44,100**

Tax and Credits**Standard Deduction for—**

• People who check any box on line 39a or 39b or who can be claimed as a dependent, see instructions.

• All others:
Single or Married filing separately, \$6,350
Married filing jointly or Qualifying widow(er), \$12,700
Head of household, \$9,350

38	Amount from line 37 (adjusted gross income)	38	44,100
39a	Check ☐ You were born before January 2, 1953, ☐ Blind. ☐ Spouse was born before January 2, 1953, ☐ Blind. Total boxes checked ▶ 39a ☐		
b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b ☐		
40	Itemized deductions (from Schedule A) or your standard deduction (see left margin)	40	9,350
41	Subtract line 40 from line 38	41	34,750
42	Exemptions. If line 38 is \$156,900 or less, multiply \$4,050 by the number on line 6d. Otherwise, see instructions	42	8,100
43	Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	26,650
44	Tax (see instructions). Check if any from: a ☐ Form(s) 8814 b ☐ Form 4972 c ☐	44	3,334
45	Alternative minimum tax (see instructions). Attach Form 6251	45	
46	Excess advance premium tax credit repayment. Attach Form 8962	46	
47	Add lines 44, 45, and 46	47	3,334
48	Foreign tax credit. Attach Form 1116 if required	48	
49	Credit for child and dependent care expenses. Attach Form 2441	49	
50	Education credits from Form 8863, line 19	50	
51	Retirement savings contributions credit. Attach Form 8880	51	
52	Child tax credit. Attach Schedule 8812, if required	52	1,000
53	Residential energy credit. Attach Form 5695	53	
54	Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐	54	
55	Add lines 48 through 54. These are your total credits	55	1,000
56	Subtract line 55 from line 47. If line 55 is more than line 47, enter -0-	56	2,334

Other Taxes

57	Self-employment tax. Attach Schedule SE	57	
58	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	58	
59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	59	
60a	Household employment taxes from Schedule H	60a	
b	First-time homebuyer credit repayment. Attach Form 5405 if required	60b	
61	Health care: individual responsibility (see instructions) Full-year coverage ☒	61	0
62	Taxes from: a ☐ Form 8959 b ☐ Form 8960 c ☐ Instructions; enter code(s)	62	
63	Add lines 56 through 62. This is your total tax	63	2,334

Payments

If you have a qualifying child, attach Schedule EIC.

64	Federal income tax withheld from Forms W-2 and 1099	64	4,540
65	2017 estimated tax payments and amount applied from 2016 return	65	
66a	Earned income credit (EIC)	66a	
b	Nontaxable combat pay election 66b		
67	Additional child tax credit. Attach Schedule 8812	67	
68	American opportunity credit from Form 8863, line 8	68	
69	Net premium tax credit. Attach Form 8962	69	
70	Amount paid with request for extension to file	70	
71	Excess social security and tier 1 RRTA tax withheld	71	
72	Credit for federal tax on fuels. Attach Form 4136	72	
73	Credits from Form: a ☐ 2439 b ☐ Reserved c ☐ 8885 d ☐	73	
74	Add lines 64, 65, 66a, and 67 through 73. These are your total payments	74	4,540

Refund

Direct deposit? See instructions.

75	If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid	75	2,206
76a	Amount of line 75 you want refunded to you . If Form 8888 is attached, check here ☐	76a	2,206
b	Routing number	c Type: ☐ Checking ☐ Savings	
d	Account number		

Amount You Owe

77	Amount of line 75 you want applied to your 2018 estimated tax	77	
78	Amount you owe. Subtract line 74 from line 63. For details on how to pay, see instructions	78	
79	Estimated tax penalty (see instructions)	79	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete below. ☐ **No**

Designee's name ▶	Phone no. ▶	Personal identification number (PIN) ▶
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Sign Here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately list all amounts and sources of income I received during the tax year. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, both must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

Cruz | Deschamps | Niswander | Prendergast | Schisler

Fundamentals of Taxation

2018 EDITION



Chapter 2

Expanded Tax
Formula, Forms
1040 and 1040A,
and Basic
Concepts

Learning Objective #1: The Expanded Tax Formula and the Major Sections of Form 1040A and Form 1040 (1 of 2)

- The Tax Return
 - Forms 1040A and 1040 are more complex than the 1040EZ
 - A taxpayer must always use the proper form
- Adjusted Gross Income (AGI)
 - Gross income minus a list of permitted deductions
 - Many deductions and credits are based on AGI

Learning Objective #1: The Expanded Tax Formula and the Major Sections of Form 1040A and Form 1040 (2 of 2)

The Expanded Tax Formula

Gross Income (GI)

– Permitted Deductions from Gross Income

= Adjusted Gross Income (AGI)

– Standard Deduction or Itemized Deductions

– Personal and Dependency Exemptions

= Taxable Income (TI)

× by Appropriate Tax Rates

= Tax Liability

– Tax Credits

+ Other Taxes

– Tax Payments and Refundable Credits

= Tax Refund or Tax Due with Return

Learning Objective #1: The Expanded Tax Formula and the Major Sections of Form 1040A and Form 1040- Concept Check 2-1

1. When preparing a tax return, you should always use Form 1040. True or False?

False

2. The concept of Adjusted Gross Income (AGI) is important because many deductions and credits reported on the tax return are computed based on the amount shown as AGI? True or False?

True

Learning Objective #2: How to Determine the Proper Filing Status (1 of 4)

- There are five filing statuses:
 - Single
 - Not married as of the last day of the year
 - Married Filing Jointly (MFJ)
 - Must be legally married on the last day of the year
 - The marital status of a couple is determined under the laws of the state in which they reside
 - It does not matter if only one has earned income

Learning Objective #2: How to Determine the Proper Filing Status (2 of 4)

- Married Filing Separately (MFS)
 - Must be married but elect to file separately
 - The standard deduction can be taken only if both make the same selection
 - Must show the social security number of the other spouse on the taxpayer's return
 - Only in unusual circumstances is it advantageous for a married couple to file MFS

Learning Objective #2: How to Determine the Proper Filing Status (3 of 4)

- Head of Household
 - Must be unmarried at the end of the year
 - A married taxpayer living apart from the spouse during the last six months of the year might qualify as unmarried
 - Must be a U.S. citizen or resident
 - Must maintain a household for a qualifying person for more than half the year
 - Exception: Parents can live in a separate household

Learning Objective #2: How to Determine the Proper Filing Status (4 of 4)

- Qualifying Widow(er) with Dependent Child
 - Must be eligible to file a joint return the year the spouse died
 - Must be unmarried
 - Must pay for more than half the costs of a household that is the principal place of residence of the taxpayer and child for the entire year
 - Exception: temporary absences are permitted

Learning Objective #2: How to Determine the Proper Filing Status-

Concept Check 2-2 (1 of 2)

- 1. Even though you are in the process of getting a divorce, you can file as married filing jointly. True or False?*

True

- 2. The social security of the taxpayer's spouse must be shown on the taxpayer's tax return when filing as married filing separately. True or False?*

True

Learning Objective #2: How to Determine the Proper Filing Status-

Concept Check 2-2 (2 of 2)

3. A surviving spouse who qualified as married filing jointly when the spouse died can file as a qualifying widow(er) for the next two years as long as the surviving spouse pays for more than half the cost of keeping up a household and does not remarry. True or False?

False

Learning Objective #3: The Calculation of Personal Exemptions

- Personal Exemptions
 - Are for the taxpayer and spouse
 - Are subject to annual adjustment for inflation
 - Are not allowed on a taxpayer's return if he or she can be claimed as a dependent on another return
- Personal Exemption Amount for 2017
 - \$4,050
 - For 2017, the exemption amount phases out when taxpayers reach a certain level of AGI

Learning Objective #3: The Calculation of Personal Exemptions- Concept Check 2-3

1. If you file a tax return with your spouse, you can claim a total of \$8,100 for personal exemptions. True or False?

True

Learning Objective #4: The Calculation of Dependency Exemptions (1 of 3)

- The Dependent must be a qualifying child or relative and meet three general tests:
 - Dependent taxpayer test
 - If the dependent can be claimed by someone else, then the taxpayer cannot claim this person as a dependent
 - Joint return test
 - The person claimed as a dependent cannot file a joint return with his or her spouse, unless a return is filed only to claim a refund and there is no tax liability on the return

Learning Objective #4: The Calculation of Dependency Exemptions (2 of 3)

- Citizen or resident test
 - The dependent must meet one of the following:
 - be a U.S. citizen, resident, or national
 - be resident of Canada or Mexico
 - be an adopted child of the taxpayer if the child is a member of the taxpayer's household all year and the taxpayer is a U.S. citizen or national

Learning Objective #4: The Calculation of Dependency Exemptions (3 of 3)

- A Qualifying Child must meet five specific tests:
 - Relationship test
 - Age test
 - Residency test
 - Support test
 - Special test for qualifying child of more than one taxpayer

Learning Objective #4: The Calculation of Dependency Exemptions - Concept Check 2-4 (1 of 2)

1. What are the five specific tests you need to meet to claim someone as a qualifying child?

Relationship test

Age test

Residency test

Support test

Special test for qualifying child of more than one

taxpayer

Learning Objective #4: The Calculation of Dependency Exemptions - Concept Check 2-4 (2 of 2)

2. *To meet the age test, a child who is not disabled must be _____, or _____ if a full time student*

Under 19 years of age, or under 24 years of age and a full time student.

Also, for years after 2008, the child must be younger than the person claiming the dependency.

Learning Objective #4: The Calculation of Dependency Exemptions

- A Qualifying Relative must meet four specific tests:
 - Not a qualifying child test
 - Relationship or member of household test
 - Gross income test
 - Support test
- The Dependency Exemption
 - \$4,050 per dependent

Learning Objective #4: The Calculation of Dependency Exemptions-Concept Check 2-5

- 1. You must meet one of these four tests to be a qualifying relative: Not a qualifying child test, relationship or member of household test, gross income test and support test. True or False?*

False

- 2. A qualifying relative can earn up to \$6,350 for the year 2017. True or False?*

False

Learning Objective #5: How to Determine the Standard Deduction (1 of 3)

- The Standard Deduction for 2017 is:

Single	\$ 6,350
Married Filing Jointly	\$12,700
Married Filing Separately	\$ 6,350
Head of Household	\$ 9,350
Qualifying Widow(er)	\$12,700

Learning Objective #5: How to Determine the Standard Deduction (2 of 3)

- The Standard Deduction:
 - Increases for people who are age 65 or older or blind
 - Is limited for dependent taxpayers to the higher of \$1,050, or the taxpayer's earned income plus \$350 but cannot be over the basic standard deduction

Learning Objective #5: How to Determine the Standard Deduction (3 of 3)

- Additional Standard Deductions for Taxpayers who are 65 or older or blind

Single	\$ 1,550
Married Filing Jointly	\$ 1,250
Married Filing Separately	\$ 1,250
Head of Household	\$ 1,550
Qualifying Widow(er)	\$ 1,250

Learning Objective #5: How to Determine the Standard Deduction- Concept Check 2-6

1. What is the amount of the standard deduction in each of the following cases:

- Taxpayer is single, 42 years of age, and blind*

\$7,900 (\$6,350 + \$1,550)

- Taxpayer is head of household, 37 years of age, and not blind*

\$9,350

- Taxpayers are married filing jointly, the husband is 67 and the wife is 61 years of age, and neither is blind*

\$13,950 (\$12,700 + \$1,250)

Learning Objective #6: The Amount of Tax Due to the Internal Revenue Service (IRS) (1 of 2)

- Amount of Tax Liability
 - The tax liability is computed by using the tax tables or the tax rate schedules
- Tax Payments and Credits Reduce the Tax Liability
 - Withholding by the employer and estimated payments sent to IRS
 - Tax credits
 - Nonrefundable
 - Refundable

Learning Objective #6: The Amount of Tax Due to the Internal Revenue Service (IRS) (2 of 2)

- Tax Refund or Amount Due with Return
 - Excess payment results in a refund
 - Excess remaining tax liability means an amount is owed to IRS

Learning Objective #6: The Amount of Tax Due to the Internal Revenue Service (IRS)-Concept Check 2-7

1. *Use the tables in the back of the text to determine the tax amount for the following situations*

- Single taxpayer with a taxable income of \$34,640*

\$4,728

- Married taxpayers filing jointly with a taxable income of \$67,706* _____

\$9,226

2. *What is the limit on the FICA (social security) amount for 2017?* _____

\$127,200

Learning Objective #7: Interest and Penalties the IRS Can Assess (1 of 4)

- Interest Charged on Assessments
 - The rate charged is the federal short-term rate plus 3 percentage points
 - Examples of some rates for different periods

Jan. 1, 2017 to June 30, 2017	4%
Apr. 1, 2016 to Dec. 31, 2016	4%
July 1, 2015 to Mar. 31, 2016	3%
Oct. 1, 2011 to June 30, 2015	3%
Apr. 1, 2011 to Sept. 30, 2011	4%

Learning Objective #7: Interest and Penalties the IRS Can Assess (2 of 4)

- Penalties
 - Failure to file a tax return
 - 5 percent per month or fraction of a month, not to exceed 25 percent
 - Any income tax return not filed within 60 days of its due date is subject to a minimum penalty of the lesser of \$210 or the amount of tax required on the return
 - Failure to pay tax penalty
 - .5 percent per month or fraction of a month, not to exceed 25 percent

Learning Objective #7: Interest and Penalties the IRS Can Assess (3 of 4)

- Maximum amount is 5 percent per month or fraction of a month, not to exceed 25 percent when both penalties apply to the same situation
- Failure to pay estimated income tax penalty
 - Applies if taxpayer fails to pay during the year a minimum of: 90 percent of the current year tax liability, or 100 percent of the prior year's tax liability if the taxpayer's AGI in the prior year is less than \$150,000.
- Accuracy-related penalty
 - Applies when there is negligence or any substantial understatement
 - The rate is 20 percent of the tax due

Learning Objective #7: Interest and Penalties the IRS Can Assess (4 of 4)

- Fraud penalty
 - Applies to the understatement of tax that is attributable to fraud
 - The rate is 75 percent
- Erroneous claim for refund or credit
 - The rate is 20 percent on the disallowed amount of the claim if the claim for refund or credit of income filed is found to be excessive.
 - Not applicable if the fraud or the accuracy-related penalty has been assessed

Learning Objective #7: Interest and Penalties the IRS Can Assess-Concept

Check 2-8 (1 of 2)

- 1. A taxpayer filed an automatic extension before April 15 but sent no money to the IRS. He then filed his return by June 2 and paid the amount due of \$3,000. What are the amounts for the failure to file a tax return penalty and the failure to pay penalty?*

Failure to file does not apply but failure to pay is

$$\mathbf{\$30 = (\$3,000 \times .5\%)2}$$

Learning Objective #7: Interest and Penalties the IRS Can Assess-Concept Check 2-8 (2 of 2)

2. Fraud on a tax return can also lead to criminal charges. True or False

True