★ CHAPTER THREE ★

# TAXABLE ENTITIES, TAX FORMULA, INTRODUCTION TO PROPERTY TRANSACTIONS

## INTRODUCTION

The first two chapters dealt with taxation in general and tax reporting. Now it is time to turn to the U.S. individual income tax. This and the following chapter will deal with the basic concepts of that tax. Specifically, Chapter 3 will answer the following questions:

1. In addition to tax rates and a tax base for an income tax, there must be a taxable entity. Three basic entities are subject to the Federal income tax—individuals, corporations, and estates and trusts.

2. The tax base for the income tax is taxable income. The determination starts with income, which is adjusted for several exclusions and deductions.

3. Gains and losses on the sale or other disposition of property affect the taxable income base. A basic understanding of this and related concepts is essential to the effective study of the other topics related to Federal income taxes.

## STUDY SUGGESTIONS

Knowing the taxable entities and understanding the tax formula are essential to mastering the rules related to the Federal income tax. With respect to each of these areas, the following recommendations apply:

1. Taxable Entities. Memorize the three types of taxable entities and try to understand the concepts related to each. Learn which other entities are recognized for tax purposes but not subject to tax on their income.

2. Tax Formula. Two steps are recommended in learning the formulas:

   a. Memorize each of the two tax formulas presented for corporations and individuals. These formulas, once memorized, will become second nature with practice and application.
   b. Review each of the Exhibits in the text containing lists of income, deductions, and so on for general understanding. The details are covered in later chapters and memorization of these lists at this time is inappropriate.

3. Introduction to Property Transactions. Memorize the basic formula for the amount realized and gain or loss realized. Study the other information related to basis determination, capital gains and losses, and trade or business property.

Memorizing formulas is suggested in several instances above. Accomplish this by writing them several times each, in good form, and by solving problems.

## STUDY HIGHLIGHTS

### THE TAXABLE ENTITY

1. There are only *three* types of entities subject to tax under the Federal income tax—individuals, corporations, and estates and trusts (referred to as fiduciaries). Partnerships, for example, pay no tax, but their income or loss flows through to be reported by the partners.

2. **Individuals.** Citizens and residents of the United States are subject to the Federal income tax under § 1 of the Code.

   **a.** Citizens and residents are subject to tax on all forms of taxable income, regardless of source, from throughout the world. Individuals of any age are taxed on their taxable income.
   **b.** The amount of tax paid may be affected if a person is a dependent of another taxpayer or if the person is under age 18.

3. A sole proprietorship is not considered a separate taxable entity.

   **a.** The business transactions are simply those of the owner and are reflected in his or her income and expenses for tax purposes. The income and expenses are treated similarly to other income and deductible expenses for tax purposes and are reported on Schedule C of the individual tax return.
   **b.** The sole proprietor must pay self employment tax on his or her net income. Individuals must also pay self employment tax on any other income from personal services (other than as an employee) even if it does not rise to the level of a business.

4. **International Taxation.** International taxation involves tax treatment of income of citizens and residents earned abroad and of nonresident aliens earned in the U.S.

   **a.** Nonresident alien individuals are taxed on their U.S. source income. Similarly, foreign corporations pay a U.S. income tax on certain portions of their U.S. income.
   **b.** If foreign income taxes are paid on foreign source income by a U.S. citizen or resident, a credit is usually allowed against the U.S. tax on the foreign source income.
   **c.** If a U.S. citizen is a resident of a foreign country or outside the U.S. for eleven months within a twelve month period, he or she may elect to exclude any foreign income earned from personal services (up to $85,700) from U.S. taxation.

   These and other aspects of international taxation are covered in a later chapter.

5. **Corporations.** Domestic corporations are subject to tax on their taxable income under § 11 of the Code. The tax treatment of corporations is similar to that of individuals, although several important differences exist. See the corporate tax formula in the text for examples.

   **a.** Many believe that the earnings of a corporation are subject to double taxation because any part that is distributed as dividends is subject to tax at the shareholder level. This is because the dividends generally are taxable to the shareholders.
   **b.** A shareholder (even one with a controlling interests) can be an employee of the corporation in which he or she holds an interest.
   **c.** The employees of a business, including any employee/owners of a corporation pay payroll duties—FICA, unemployment tax, etc—on the amount of salaries and wages.

6. **Not-for-Profit and Governmental Entities.** Certain entities, such as governments, churches, educational institutions, and other not-for-profit entities, are exempted from U.S. income taxation. These tax-exempt entities are, nonetheless, subject to numerous reporting requirements and restrictions.

7. **Estates and Trusts.** The taxable income of a trust or a decedent's estate is subject to tax by the U.S. government.

   **a.** The person charged with overseeing the activities of an estate or trust is called a fiduciary, since he or she acts in a fiduciary capacity. Accordingly, the tax return that is filed is referred to as the fiduciary return.
   **b.** The fiduciary of the estate or trust calculates the taxable income or loss in a way similar to an individual. When distributions of income are made during a year, however, the taxable income of the trust or estate is taxed to the beneficiary or heir. Since the trust or estate reduces its taxable income by the amount taxed to the beneficiary or heir, it generally only pays tax on the undistributed income. Any distribution from prior years' undistributed profits or from the equity of the trust or estate, which is called *corpus,* are generally tax-free.

8. **Nontaxable Entities.** The partnership entity and a corporation that elects special treatment under Subchapter S of the Code are treated as conduits for tax purposes. Even though they are recognized entities and are treated as separate entities for many purposes under the statute, their income, deductions, gains and losses, and other tax attributes are passed through to their owners.

   **a.** The partners and shareholders, respectively, report the results of the entity's operations, paying tax on any income and deducting any losses.
   **b.** Distributions are generally tax free (but exceptions exist).
   **c.** Salaries and wages of an employee/owner of an S corporation are treated the same as those of a regular corporation. However, for partnerships (and LLCs treated as partnerships) the owners are co-proprietors. For a general partnership, each partner pays self-employment tax on his or her share of net income. For limited partners (and LLC members) only a partner who is able to enter into contracts on behalf of the entity, a partner who spends over 500 hours in the business, or a partner who is practicing one of the professions pays self employment tax.

9. All states allow the formation and operation of limited liability companies (LLCs). These are relatively new entities that are similar to a limited partnership, although there is no equivalent of a general partner. The tax status of this entity depends on the number of corporate characteristics it possesses.

## TAX FORMULA

**10.** The tax formula for individuals illustrates the relationships of the various items of income, deduction, gain, loss, credit, etc., in the determination of the individual income tax. The formula is as follows:

| | | |
|---|---|---|
| Total income (from whatever source) | | $xxx |
| Less: Exclusions from gross income | | − xxx |
| Equals: Gross income | | $xxx |
| Less: Deductions for adjusted gross income | | − xxx |
| Equals: Adjusted gross income | | $xxx |
| Less the following | | |
| The larger of: | | |
| Itemized deductions | $xxx | |
| or | | − xxx |
| Standard deductions | $xxx | |
| Personal and dependency exemption deductions | | − xxx |
| Equals: Taxable income | | $xxx |
| Multiply: Applicable tax rates | | xx% |
| Equals: Gross tax | | $xxx |
| Less: Tax credits and prepayments | | − xxx |
| Equals: Tax due (or refund) | | $xxx |

Each item of income, deduction, gain, loss, etc., must be appropriately classified within this formula. The formula for corporate taxpayers is somewhat simpler and is reproduced in the text.

**11. Gross Income.** Gross income is income from whatever source derived, reduced by those items of income that are specifically excluded from income. Income from whatever source derived includes any permanent increase in the taxpayer's net worth.

**a.** Some common examples of income that is taxed (i.e., inclusions) and amounts that escape tax (i.e., exclusions) follow:

| *Inclusions* | *Exclusions* |
|---|---|
| Salaries, wages, etc. | Interest on municipal bonds |
| Commissions | Gifts and inheritances |
| Rents, royalties, etc. | Life insurance proceeds |
| Alimony | Child support |
| Gross income from business | Certain employee benefits |

**b.** The exclusions exist for various social and economic reasons.

**c.** The detailed provisions related to inclusions and exclusions are covered in Chapter 6.

12. **Adjusted Gross Income (A.G.I.) and Deductions for A.G.I.** The deductions for A.G.I. are certain deductions specified in the Code that are allowed regardless of whether the taxpayer itemizes his or her other deductions. Unless a deduction is included in the list in , it is an itemized deduction.

    **a.** The deductions for A.G.I. do not have any particular common element, and generalization is therefore difficult. The most common of these deductions for A.G.I. are the following:

    Trade or business expenses of self-employed individuals
    Trade or business expenses of employees, but only to the extent reimbursed
    Contributions to qualified retirement arrangements
    Deductible expenses to generate rental incomes
    Alimony
    Deductible moving expenses
    Deductible student loan interest
    Qualified education expenses
    Qualified expenses for primary and secondary teachers

    **b.** A.G.I. serves as the basis for the determination of the amount of certain other deductions, such as medical expenses and charitable contributions. Medical expenses, for example, are only deductible to the extent they exceed 7.5 percent of A.G.I.

13. **Itemized Deductions and the Standard Deduction.** Taxable income is reduced by the larger of the standard deduction or the total itemized deductions. Accordingly, a taxpayer does not *itemize* his or her deductions unless his or her itemized deductions exceed the standard deduction. A taxpayer with itemized deductions that are less than the standard deduction calculates taxable income by subtracting the standard deduction and the personal and dependency exemptions from adjusted gross income. A taxpayer who itemizes deducts the itemized deductions and personal and dependency exemptions from adjusted gross income.

14. The *standard deduction amounts* were set by statute for 1988. For each subsequent year, they are adjusted to reflect increases in the consumer price index. The adjusted amounts are announced by the IRS before the beginning of each year. The standard deduction amounts for 1988 and the adjusted amounts for 2007 are as follows:

| | *1988* | *2008* |
|---|---|---|
| Single | $3,000 | $5,450 |
| Unmarried head of household | 4,400 | 8,000 |
| Married filing jointly (and surviving spouse) | 5,450 | 10,900 |
| Married filing separately | 2,500 | 5,450 |

15. *Miscellaneous itemized deductions* are subject to a floor. They are deductible only to the extent their total exceeds 2 percent of A.G.I. Key examples of miscellaneous itemized deductions include tax preparation and planning costs, investment expenses (other than investment interest), and unreimbursed employee business expenses.

16. Most taxpayers simply claim the larger of their itemized deductions or the standard deduction. However, itemized deductions are cut back for taxpayers with A.G.I. in excess of $159,950 (for 2008). The phase-out is calculated as follows:

$$(\text{A.G.I.} - \$159{,}950) \times 0.02$$

The phase-out amount is limited as provided under 17 and 18.

**17.** Certain itemized deductions are not subject to the cut-back. They are the following:

Medical expenses (only those in excess of 7.5% of A.G.I.)
Investment interest (only to the extent of investment income)
Personal casualty and theft losses (only those in excess of 10% of A.G.I.)
Wagering losses (only to the extent of wagering income)

These deductions are allowable, regardless of the amount of the cut-back under 16.

**18.** All other itemized deductions are subject to the cut-back. Some of the more common itemized deductions in this group are the following:

Residence interest
State, local, and foreign income taxes (or sales taxes)
State, local, and foreign real property taxes
State and local personal property taxes
Charitable contributions
Miscellaneous itemized deductions (including tax planning and compliance costs, investment expenses, and unreimbursed employee business expense)

No more than 80 percent of these amounts may be phased out.

**19.** The calculation of allowable itemized deductions is as follows:

| | | |
|---|---|---|
| Itemized deductions subject to the 2% cutback | | \$xxx (a) |
| Minus the lesser of: | | |
| Tentative cutback: [(A.G.I. – \$159,950) × 0.02] | \$xxx | |
| —or— | | – xxx |
| Maximum reduction: (a) × 0.80 | \$xxx | |
| Equals: Allowable amount of deductions subject to the cutback | | \$xxx |
| Plus: Itemized deductions not subject to the cutback | | + xxx |
| Equals: Allowable itemized deductions | | \$xxx |

If the cutback makes the itemized deductions less than the standard deduction, the standard deduction may be claimed, since it is not subject to the cut-back.

**20.** Taxpayers who are either at least 65 years of age or blind at the end of the tax year are entitled to additional standard deduction amounts.

**a.** The amounts are \$1,350 for unmarried persons and \$1,050 for married persons.
**b.** Example, the standard deduction for 2008 for a married couple who are 71 and blind and 69 and of good sight is \$14,050 [\$10,900 + (3 × \$1,050)]. This couple would itemize only if their allowable itemized deductions exceeded \$14,050.

**21.** Married persons filing separately whose spouses itemize, nonresident aliens, and taxpayers filing a return for less than 12 months due to a change of accounting period are not entitled to use the standard deduction. Such taxpayers, therefore, must itemize their deductions from adjusted gross income.

22. **Exemptions.** The personal and dependency exemptions are deductions based on the size and makeup of a taxpayer's family. For the year 2008, the *exemption amount* is $3,500 and it is increased to reflect increases in the consumer price index each year.

    **a.** These deductions are allowable as a personal exemption for the taxpayer and as dependency exemptions for any qualifying persons who are supported by the taxpayer.
    **b.** On a return for married persons filing jointly, there are two taxpayers and, therefore, two personal exemptions.
    **c.** The exemption deduction is subject to a cutback for taxpayers with high A.G.I. These and other rules related to the exemption deduction are covered in Chapter 4.

23. **Taxable Income and Tax Rates.** The income tax is (calculated) based on taxable income and certain specified tax rates. These tax rates for individuals are contained in Code § 1 and differ somewhat depending on the taxpayer's filing status.

    **a.** There are four filing status possibilities as follows:

    Single
    Married filing jointly (and surviving spouse)
    Married filing separately
    Head of household

    The tax rates for each status are contained in the tax rate schedules, which are reproduced inside the cover of the text.
    **b.** These rate *brackets* are adjusted annually for increases in the consumer price index and are published by the IRS late in the fall of the preceding year. The rate schedules for the two most recent years are included in the text (with the most recent included inside the front cover).

24. **Credits and Prepayments.** Credits are amounts provided in the statute that directly reduce the tax. Certain credits are allowed for various economic and social reasons.

    **a.** Perhaps the most common personal credit is the child tax credit.
    **b.** Another is the credit for job-related expenses incurred for the care of a child under age 14, a disabled dependent, or a disabled spouse.
    **c.** Other credits are allowed for such things as education, the use of alcohol fuel and rehabilitation of certain older buildings.
    **d.** Any prepayments by the taxpayer are also subtracted from the gross tax in arriving at the tax due. Prepayments most commonly occur in the form of estimated tax payments required during the year and withholding of Federal income taxes from salaries and wages by employers.

25. The earned income credit (EIC) for low income parents and other very low income individuals is refundable. This means that the taxpayer receives a payment even if they had no prepayments. See the text and the EIC tables for the amount and requirements for the credit.

26. **Other Taxes.** The Federal income tax is only one of a number of taxes imposed on individuals. Some of those taxes are as follows:

    F.I.C.A. (Social Security) taxes paid by an employee and his or her employer on salaries and wages.
    Self-employment taxes on an individual's net earnings from self-employment.
    Certain excise taxes such as those on early withdrawals from individual retirement plans.

    In addition, a taxpayer may have to pay an alternative minimum (income) tax in addition to the regular income tax.

27. **Alternative Minimum Tax.** A taxpayer who is relatively successful in avoiding the regular income tax may be required to pay alternative minimum tax (AMT) if he or she has sufficient AMT adjustments and AMT preferences.

   **a.** The calculation begins with regular taxable income. AMT adjustments (positive and negative) are made and AMT preferences are added. The resulting number is alternative minimum taxable income (AMTI).
   **b.** An exemption amount is subtracted to arrive at the AMT base.
   **c.** The tentative AMT is calculated by applying the tax rate of 26 percent on amounts up to $175,000 and 28 percent on amounts above $175,000.
   **d.** The AMT is the tentative AMT minus the regular income tax.

## INTRODUCTION TO PROPERTY TRANSACTIONS

28. The U.S. income tax system provides that most gains on dispositions of property are taxed and that most losses may be deducted. However, the system requires that several steps be followed. The three following questions are answered:

   **a.** What is the amount of the gain or loss *realized?*
   **b.** How much of the gain or loss that is realized is *recognized?*
   **c.** What is the *character* (i.e., ordinary or capital) of the recognized gain or loss?

29. **Gain or Loss Realized/Recognized.** Gain or loss is realized any time a taxpayer sells or otherwise disposes of property. The formula for determining gain or loss realized is as follows:

| | | |
|---|---|---|
| | Amount of money received (net) | $ xxx |
| + | Fair market value of other property received | + xxx |
| + | Any liabilities discharged (net) | + xxx |
| − | Selling costs | − xxx |
| = | Amount realized | $ xxx |
| − | Adjusted basis of property given up | − xxx |
| = | Gain or loss realized | $ xxx |

30. The adjusted basis of the property transferred is generally its cost, plus and minus certain adjustments. Special rules apply to determining the basis of property acquired by gift, through inheritance, or in certain nontaxable transactions.

31. The gain or loss that is realized is generally recognized in the year of the sale or other disposition. This means that it is currently taken into account for tax purposes, gains being taxed and losses being deducted.

   **a.** Certain types of losses are either disallowed or limited in amount.
   **b.** Other gains or losses may be deferred under specific provisions of the law. When this occurs, the gain or loss that is deferred is recognized at a later date when some replacement property is sold or otherwise disposed of.
   **c.** Examples. When a share of stock is sold for more than its original cost, a gain is realized. The gain is usually recognized since no provision of the law allows a taxpayer to defer the gain. However, if the gain asset had been the taxpayer's primary residence and he or she purchased another qualifying residence, the realized gain is not recognized but is deferred until the replacement residence is sold.

32. **Losses.** The only losses that are deductible for tax purposes by individual taxpayers are as follows:

    a. Losses incurred in carrying on a trade or business
    b. Losses incurred in transactions entered into for profit
    c. Casualty and theft losses

    Losses other than casualties and thefts on the disposition of personal use property are therefore disallowed.

33. **Character of Gain or Loss.** Generally gains and losses are ordinary or capital in nature. Capital gains and losses are those incurred upon the sale or exchange of capital assets. Specifics related to capital gains and losses follow.

34. **Capital Asset Defined.** Capital assets are any assets other than those falling into five specified groups of nonqualifying assets.

    a. The excluded assets are inventory and other property held for sale to customers, productive property used in a trade or business, trade accounts and notes receivable, and others.
    b. Capital assets therefore generally include purely investment properties and personal use properties.

35. **Capital Gains and Losses.** The exact treatment of gains and losses related to sales and exchanges of capital assets can only be determined after an involved process. The process is summarized as follows:

    a. Gains and losses are classified according to holding period. A gain or loss is long-term if the asset was held more than one year, short-term if held one year or less.
    b. Long-term gains are netted against long-term losses to arrive at the net long-term capital gain or loss. Short-term gains are netted against short-term losses to arrive at the net short-term capital gain or loss.
    c. The two results are combined to determine the overall gain or overall loss, and the appropriate treatment is determined.

36. **Tax Treatment of Capital Gains and Losses.** The tax treatment of capital gains and losses depends on the result of the netting process.

    a. If there is a net short-term capital gain only or a net short-term capital gain in excess of a net long-term capital loss, the amount is fully included in A.G.I. and subject to the regular tax rates (i.e., treated like ordinary income).
    b. A net long-term capital gain only or a net long-term capital gain in excess of a net short-term capital loss is referred to as a *net capital gain*. This amount is fully included in A.G.I. and is taxed at a rate of 5%, 10%, 15%, 20%, 25% or 28%, rather than the regular rate, under rules in Chapter 16 and Chapter 17.
    c. If capital losses exceed capital gains for a year, the deduction is limited to $3,000, with any excess carried forward for an indefinite period.

37. **Trade or Business Property.** Depreciable properties and land used in a trade or business are subject to even more complex rules. The complexity is increased because the assets are not capital assets yet a net gain may be treated as a capital gain. A net loss is treated as an ordinary loss.

## STUDY QUESTIONS

**True or False**

______ **1.** A person who is not a U.S. citizen and who temporarily resides in the U.S. will be subject to U.S. taxation on his or her worldwide income.

______ **2.** The sole proprietorship business of an individual taxpayer is treated as a separate entity for tax purposes and subject to the tax rates for corporate taxpayers.

______ **3.** U.S. citizens under the age of 14 are not required to file a Federal tax return or pay a Federal income tax because their income is taxable to their parents.

______ **4.** Interest income earned on a bond issued by a Canadian Corporation (and most other foreign corporations) by a U.S. citizen is subject to U.S. income tax.

______ **5.** In order to qualify for the foreign-earned income exclusion, a U.S. citizen can either be a bona fide resident of a foreign country or simply reside outside the U.S. for 330 days during a twelve-month period.

______ **6.** The results of operations of a sole proprietorship are reported on the partnership income tax return.

______ **7.** Partnerships are taxed at the same rates as corporations for Federal income tax purposes.

______ **8.** The partnership income tax return is appropriately called an information return rather than an income tax return.

______ **9.** An electing small business corporation, or S Corporation, pays a flat tax of 25 percent on its taxable income.

______ **10.** The taxable income of a trust sometimes passes through and is taxed directly to its beneficiaries on their individual income tax return.

______ **11.** Double taxation of corporate income is avoided because a corporation is entitled to a deduction for any dividends that are paid to its shareholders.

______ **12.** Gross income is the amount of income, before subtracting any exclusions, which must be considered in arriving at one's taxable income.

______ **13.** An electing small business corporation (S corporation) is a corporation that may deduct any dividends distributed to its shareholders.

______ **14.** A limited liability company (LLC) is a special type of limited partnership recognized in the tax statutes.

______ **15.** A taxpayer is entitled to deduct the larger of the itemized deductions or the personal and dependency exemptions.

______ **16.** Gross income is income from all sources minus the exclusions from gross income.

______ **17.** Deductions for adjusted gross income are those deductions that a taxpayer is entitled to only if he or she does not itemize.

______ **18.** Lori has adjusted gross income of $75,000 and medical expenses totaling $4,725 for the current year. None of Lori's medical expenses are deductible.

______ **19.** Jim is single and has adjusted gross income of $161,150 and itemized deductions consisting of residence interest of $8,250, property taxes of $800, and charitable contributions of $950 for the current taxable year. Jim may deduct only $9,976 of these deductions.

______ **20.** Miscellaneous itemized deductions in excess of the 2 percent floor are also subject to the phase-out (up to 80 percent) for taxpayers with A.G.I. in excess of $159,950 (for 2008).

______ **21.** A single taxpayer who is 67 years of age and does not itemize is generally entitled to a standard deduction of $6,800 and a personal exemption of $3,500 (for 2008).

______ **22.** The standard deduction for single taxpayers for 2008 is generally $5,450.

______ **23.** A credit, also known as a deduction for A.G.I., is a deduction that a taxpayer is entitled to whether he or she itemized or not.

______ **24.** Federal income tax withheld from one's salary and wages is an example of a prepayment of Federal income taxes.

______ **25.** An individual pays self-employment tax on earnings from a sole proprietorship and a general partnership business.

______ **26.** The personal and dependency exemptions are not allowed in arriving at AMTI (i.e., they must be added to taxable income in arriving at AMTI).

______ **27.** The adjusted basis of a purchased property generally represents its economic cost (plus or minus certain adjustments).

______ **28.** The adjusted basis of property reflects a reduction for depreciation allowed or allowable.

______ **29.** The deduction for capital losses in excess of capital gains for individuals is limited to $5,000 annually.

______ **30.** The holding period required for long-term capital gain or loss treatment is at least one year.

______ **31.** Excess capital losses of individuals may be carried back three years and forward five years.

______ **32.** Land used in a trade or business is a capital asset.

______ **33.** An individual's personal residence is a capital asset.

**Multiple Choice**

**34.** Which of the following entities is subject to the U.S. Federal income tax?

______ **a.** The partnership entity
**b.** The estate of a deceased individual
**c.** An electing small business corporation, or S corporation
**d.** Both a. and c.

**35.** Which of the following is true of the U.S. taxation of alien individuals?

______ **a.** Resident aliens are taxed on their worldwide income.
**b.** Nonresident aliens are taxed only on their income earned in the U.S.
**c.** Nonresident aliens working temporarily in the U.S. as transients escape tax on their income earned outside the U.S.
**d.** All are true.

**36.** Which of the following is a true statement regarding XYZ Corporation, a regular corporation (known as C corporations), for U.S. tax purposes?

______ **a.** The corporation is entitled to a deduction for dividends paid to its shareholders.
**b.** The lowest marginal tax bracket for the corporation is 25 percent.
**c.** The highest marginal tax bracket is 39 percent.
**d.** All of the corporations trade or business deductions are deductions for A.G.I.

**37.** William Wilson paid $500 in tuition for studies related to a new career. William is single and does not itemize his deductions. His marginal tax rate is 28 percent and his average tax rate on his taxable income is 26 percent. Which of the following hypothetical provisions would be to William's greatest benefit?

______ **a.** A new deduction for A.G.I. equal to the amount of the expense.
**b.** A new credit equal to 25 percent of the total expense.
**c.** A new itemized deduction for the total amount of the expense.
**d.** The information provided is insufficient to determine which of the above is most favorable.

**38.** Which of the following is a correct observation related to the comparison between a deduction and a credit?

______ **a.** A deduction of $10 is more valuable than a credit of $10.
**b.** A deduction of $10 is more valuable to a 35 percent bracket taxpayer than is a $4 credit.
**c.** A deduction of $10 is more valuable to a 35 percent bracket taxpayer than it is to a 25 percent bracket taxpayer.
**d.** A credit of $10 is more valuable to a 35 percent bracket taxpayer than it is to a 25 percent bracket taxpayer.

**39.** Which of the following is *not* true regarding itemized deductions for an individual taxpayer?

______ **a.** The itemized deductions are allowed in addition to the deductions for A.G.I.
**b.** The itemized deductions are allowed in lieu of the standard deduction.
**c.** The itemized deductions are phased-out (at least in part) for taxpayers with high A.G.I.
**d.** The itemized deductions are allowed in lieu of the exemption deductions.

**40.** Olivia is forty years old, is single, has no dependents, and has adjusted gross income of $65,300 for 2008. Her itemized deductions consist of residence interest of $8,000, property taxes of $850, charitable contributions of $450 and tax preparation expenses of $175. How much is Olivia's taxable income?

______ **a.** $56,800
**b.** $52,325
**c.** $55,700
**d.** $52,500

**41.** D and E are married and file a joint tax return for 2008. Which of the following is *not* true regarding their standard deduction?

______ **a.** The basic standard deduction is $10,900.
**b.** If D is 67 years of age and blind and E is 62 years of age with good sight, their standard deduction is $13,000.
**c.** In addition to their standard deduction they can claim a deduction for residence interest.
**d.** In addition to their standard deduction, they can claim their personal exemptions.

**42.** Which of the following is *not* true of the individual alternative minimum tax?

______ **a.** Depreciation must be recalculated for AMT purposes if the most rapid methods were used.
**b.** AMT is the excess of the tentative AMT over the regular income tax.
**c.** The tentative AMT is calculated by applying a flat 26 percent tax rate.
**d.** The AMT adjustments may be positive or negative.

**43.** Which of the following is *not* true of the calculation of the amount realized in a completed transaction?

______ **a.** The amount of money and the fair market value of other property received are included.
**b.** The amount of any liabilities discharged, net of those assumed, is included.
**c.** Any selling expenses paid by the seller are subtracted.
**d.** All are true.

**44.** Which of the following is *not* true of adjusted basis?

______ **a.** If a property is sold (i.e., amount realized) for exactly its adjusted basis, no gain or loss is realized.
**b.** It is adjusted upward for improvements.
**c.** It is adjusted downward for depreciation allowed (or allowable).
**d.** It is adjusted for changes in the consumer price index.

**45.** Edwin Dew sold his massive model train set to a friend for gold bullion worth $450 plus $450 cash. Edwin had purchased the train over several years for $375. How much is Edwin's gain or loss realized.

______ **a.** $850
**b.** $525
**c.** $75
**d.** $25

**46.** Which of the following types of losses are not deductible (at least in part) by individual taxpayers?

______ **a.** Losses incurred in trade or business
**b.** Losses incurred in transactions entered into for profit
**c.** Losses on the sale of personal residences
**d.** Casualty and theft losses

**47.** Which of the following is a capital asset?

______ **a.** Residence held for personal use
**b.** Inventory held for resale to customers
**c.** Accounts receivable from clients
**d.** Computer held for use in business

**48.** Which of the following is a capital asset?

______ **a.** An automobile held for sale to customers
**b.** An automobile used for deliveries in a business
**c.** An automobile driven by the taxpayer's teenage children to school
**d.** More than one of the above

**49.** Which of the following statements is *not* true of capital gains and losses?

______ **a.** An asset must generally be held more than one year to qualify for long-term treatment.
**b.** Short-term capital gains in excess of long-term capital losses are provided favorable treatment.
**c.** Capital losses in excess of the annual limit may be carried forward indefinitely by an individual.
**d.** Deductions for long-term capital losses in excess of gains are generally subject to an annual dollar limit.

**50.** Jane Wills sold the following properties during the current year:

| | | |
|---|---|---|
| 100 shares of Fault Inc., held 14 months | $600 | loss |
| 50 shares of Fine Corp., held 5 months | 240 | gain |
| Jewelry held 7 years for speculation | 700 | gain |

What is the total amount of gain or loss included in calculating Jane's adjusted gross income?

______ **a.** $340
**b.** $170
**c.** $940
**d.** $0

**51.** Based on information in the previous question, how much is Jane's net long-term capital gain (or loss)?

______ **a.** $940
**b.** $700
**c.** $340
**d.** $100

**52.** Fritz recognized a long-term capital loss of $2,000 and a short-term capital loss of $3,000 for the current year. What is Fritz's deduction for capital losses in the current year?

______ **a.** $4,000
**b.** $5,000
**c.** $3,000
**d.** $2,500

### Completion

**53.** Three legal entities that pay U.S. income tax on their net taxable income are ________ , ________ , and ________ . Two legal entities that generally escape tax are the ________ , and the ________ .

**54.** Deductions that are allowed regardless of whether a taxpayer itemizes his or her deductions are the ________ adjusted gross income. Those allowed only to taxpayers who have deductions in excess of their ________ are the itemized deductions.

**55.** The calculated gain or loss that is the mathematical difference between the ________ and the adjusted basis is the gain or loss ________ . The gain or loss that is actually taken into account in determining the taxable income for the year is the gain or loss ________ .

**56.** The excess of long-term capital gains over long-term capital losses is the ________ . The excess of short-term capital losses over short-term capital gains is ________ . The net capital gain is the excess of the ________ over the ________ .

### Problems

**A.** Write the tax formula for individual taxpayers in good form.

**B.** List the differences between the tax formula for individuals and that for corporations.

### Tax Return Problems

**C.** Harold O. Reese is unmarried and has no dependents. Harold is a staff accountant with a local corporation and earned a salary for the current year of $28,470. Federal income taxes of $3,025 were withheld. Harold's only other income was interest of $350 on his savings account, and since he does not have significant itemized deductions, he claims the standard deduction. Complete a Form 1040EZ for Harold for 2007 (use 2008 forms and rates if the forms and the tax tables are available).

**D.** Bronwen Waring is a successful teacher and an unmarried head of household with two dependents, Max and Lew. Bronwen's salary for the year was $40,000. Federal income taxes of $4,117 were withheld from her salary. Bronwen has accumulated significant savings, which generated interest of $4,750 and dividends of $1,340. On October 30, Bronwen sold 100 shares of Rachael's Animal Products, Inc. for $3,800. The shares originally cost $5,200 exactly two years earlier. Complete a Form 1040 and appropriate schedules for Bronwen in for 2007 (use 2008 forms and rates if the forms and the tax tables are available).

Form **1040EZ**

Department of the Treasury—Internal Revenue Service

**Income Tax Return for Single and Joint Filers With No Dependents** **2007**

OMB No. 1545-0074

**Label** (See page 8.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

| | | | |
|---|---|---|---|
| Your first name and initial | Last name | | **Your social security number** |
| 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 page 9. | | Apt. no. | ▲ You **must** enter your SSN(s) above. ▲ |
| City, town or post office, state, and ZIP code. If you have a foreign address, see page 9. | | | Checking a box below will not change your tax or refund. |

**Presidential Election Campaign** (page 9) ▶ Check here if you, or your spouse if a joint return, want $3 to go to this fund . . . ▶ ☐ **You** ☐ **Spouse**

**Income**

**Attach Form(s) W-2 here.**

Enclose, but do not attach, any payment.

1 Wages, salaries, and tips. This should be shown in box 1 of your Form(s) W-2. Attach your Form(s) W-2. — 1

2 Taxable interest. If the total is over $1,500, you cannot use Form 1040EZ. — 2

3 Unemployment compensation and Alaska Permanent Fund dividends (see page 10). — 3

4 Add lines 1, 2, and 3. This is your **adjusted gross income.** — 4

5 If someone can claim you (or your spouse if a joint return) as a dependent, check the applicable box(es) below and enter the amount from the worksheet on back.

☐ **You** ☐ **Spouse**

If no one can claim you (or your spouse if a joint return), enter $8,750 if **single;** $17,500 if **married filing jointly.** See back for explanation. — 5

6 Subtract line 5 from line 4. If line 5 is larger than line 4, enter -0-. This is your **taxable income.** ▶ — 6

**Payments and tax**

7 Federal income tax withheld from box 2 of your Form(s) W-2. — 7

8a **Earned income credit (EIC).** — 8a

b Nontaxable combat pay election. — 8b

9 Add lines 7 and 8a. These are your **total payments.** ▶ — 9

10 **Tax.** Use the amount **on line 6 above** to find your tax in the tax table on pages 18–26 of the booklet. Then, enter the tax from the table on this line. — 10

**Refund**

Have it directly deposited! See page 15 and fill in 11b, 11c, and 11d or Form 8888.

11a If line 9 is larger than line 10, subtract line 10 from line 9. This is your **refund.** If Form 8888 is attached, check here ▶ ☐ — 11a

▶ b Routing number ▶ c Type: ☐ Checking ☐ Savings

▶ d Account number

**Amount you owe**

12 If line 10 is larger than line 9, subtract line 9 from line 10. This is the **amount you owe.** For details on how to pay, see page 16. ▶ — 12

**Third party designee**

Do you want to allow another person to discuss this return with the IRS (see page 16)? ☐ **Yes.** Complete the following. ☐ **No**

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

**Sign here**

Joint return? See page 6. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return, and to the best of my knowledge and belief, it is true, correct, and accurately lists 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 | |

**Paid preparer's use only**

| | | | |
|---|---|---|---|
| Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN |
| Firm's name (or yours if self-employed), address, and ZIP code | | EIN | |
| | | Phone no. | ( ) |

**For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 32.** Cat. No. 11329W Form **1040EZ** (2007)

Form **1040** Department of the Treasury—Internal Revenue Service
**U.S. Individual Income Tax Return 2007** IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2007, or other tax year beginning , 2007, ending , 20 OMB No. 1545-0074

**Label**
(See instructions on page 12.)
**Use the IRS label.** Otherwise, please print or type.

LABEL HERE

| | | |
|---|---|---|
| Your first name and initial | Last name | **Your social security number** |
| 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 page 12. | Apt. no. | You **must** enter your SSN(s) above. |
| City, town or post office, state, and ZIP code. If you have a foreign address, see page 12. | | Checking a box below will not change your tax or refund. |

**Presidential Election Campaign** ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 12) ▶ ☐ **You** ☐ **Spouse**

**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 page 13.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 14)

**Exemptions**

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

c **Dependents:**

| (1) First name Last name | (2) Dependent's social security number | (3) Dependent's relationship to you | (4) ✓ if qualifying child for child tax credit (see page 15) |
|---|---|---|---|
| | | | ☐ |
| | | | ☐ |
| | | | ☐ |
| | | | ☐ |

If more than four dependents, see page 15.

**No. of children on 6c who:**
• lived with you
• did not live with you due to divorce or separation (see page 16)
**Dependents on 6c not entered above**

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

**Income**

**Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.**

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

| | | | | |
|---|---|---|---|---|
| 7 | Wages, salaries, tips, etc. Attach Form(s) W-2 | | 7 | |
| 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 (see page 19) | 9b | | |
| 10 | Taxable refunds, credits, or offsets of state and local income taxes (see page 20) | | 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 (see page 21) | 15b | |
| 16a | Pensions and annuities 16a | b Taxable amount (see page 22) | 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 (see page 24) | 20b | |
| 21 | Other income. List type and amount (see page 24) | | 21 | |
| 22 | Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶ | | 22 | |

**Adjusted Gross Income**

| | | | | |
|---|---|---|---|---|
| 23 | Educator expenses (see page 26) | 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 | One-half of self-employment tax. Attach Schedule SE | 27 | | |
| 28 | Self-employed SEP, SIMPLE, and qualified plans | 28 | | |
| 29 | Self-employed health insurance deduction (see page 26) | 29 | | |
| 30 | Penalty on early withdrawal of savings | 30 | | |
| 31a | Alimony paid b Recipient's SSN ▶ | 31a | | |
| 32 | IRA deduction (see page 27) | 32 | | |
| 33 | Student loan interest deduction (see page 30) | 33 | | |
| 34 | Tuition and fees deduction. Attach Form 8917 | 34 | | |
| 35 | Domestic production activities deduction. Attach Form 8903 | 35 | | |
| 36 | Add lines 23 through 31a and 32 through 35 | | 36 | |
| 37 | Subtract line 36 from line 22. This is your **adjusted gross income** ▶ | | 37 | |

**For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 83.** Cat. No. 11320B Form **1040** (2007)

Form 1040 (2007) Page 2

**Tax and Credits**

Standard Deduction for—
- People who checked any box on line 39a or 39b **or** who can be claimed as a dependent, see page 31.
- All others:

Single or Married filing separately, $5,350

Married filing jointly or Qualifying widow(er), $10,700

Head of household, $7,850

| | | |
|---|---|---|
| 38 | Amount from line 37 (adjusted gross income) | 38 |
| 39a | Check if: ☐ **You** were born before January 2, 1943, ☐ Blind. ☐ **Spouse** was born before January 2, 1943, ☐ Blind. Total boxes checked ▶ 39a ☐ | |
| b | If your spouse itemizes on a separate return or you were a dual-status alien, see page 31 and check here ▶39b ☐ | |
| 40 | **Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin) | 40 |
| 41 | Subtract line 40 from line 38 | 41 |
| 42 | If line 38 is $117,300 or less, multiply $3,400 by the total number of exemptions claimed on line 6d. If line 38 is over $117,300, see the worksheet on page 33 | 42 |
| 43 | **Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0- | 43 |
| 44 | **Tax** (see page 33). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ Form(s) 8889 | 44 |
| 45 | **Alternative minimum tax** (see page 36). Attach Form 6251 | 45 |
| 46 | Add lines 44 and 45 ▶ | 46 |
| 47 | Credit for child and dependent care expenses. Attach Form 2441 — 47 | |
| 48 | Credit for the elderly or the disabled. Attach Schedule R — 48 | |
| 49 | Education credits. Attach Form 8863 — 49 | |
| 50 | Residential energy credits. Attach Form 5695 — 50 | |
| 51 | Foreign tax credit. Attach Form 1116 if required — 51 | |
| 52 | Child tax credit (see page 39). Attach Form 8901 if required — 52 | |
| 53 | Retirement savings contributions credit. Attach Form 8880 — 53 | |
| 54 | Credits from: **a** ☐ Form 8396 **b** ☐ Form 8859 **c** ☐ Form 8839 — 54 | |
| 55 | Other credits: **a** ☐ Form 3800 **b** ☐ Form 8801 **c** ☐ Form ____ — 55 | |
| 56 | Add lines 47 through 55. These are your **total credits** | 56 |
| 57 | Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- ▶ | 57 |

**Other Taxes**

| | | |
|---|---|---|
| 58 | Self-employment tax. Attach Schedule SE | 58 |
| 59 | Unreported social security and Medicare tax from: **a** ☐ Form 4137 **b** ☐ Form 8919 | 59 |
| 60 | Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required | 60 |
| 61 | Advance earned income credit payments from Form(s) W-2, box 9 | 61 |
| 62 | Household employment taxes. Attach Schedule H | 62 |
| 63 | Add lines 57 through 62. This is your **total tax** ▶ | 63 |

**Payments**

If you have a qualifying child, attach Schedule EIC.

| | | |
|---|---|---|
| 64 | Federal income tax withheld from Forms W-2 and 1099 — 64 | |
| 65 | 2007 estimated tax payments and amount applied from 2006 return — 65 | |
| 66a | **Earned income credit (EIC)** — 66a | |
| b | Nontaxable combat pay election ▶ 66b | |
| 67 | Excess social security and tier 1 RRTA tax withheld (see page 59) — 67 | |
| 68 | Additional child tax credit. Attach Form 8812 — 68 | |
| 69 | Amount paid with request for extension to file (see page 59) — 69 | |
| 70 | Payments from: **a** ☐ Form 2439 **b** ☐ Form 4136 **c** ☐ Form 8885 — 70 | |
| 71 | Refundable credit for prior year minimum tax from Form 8801, line 27 — 71 | |
| 72 | Add lines 64, 65, 66a, and 67 through 71. These are your **total payments** ▶ | 72 |

**Refund**

Direct deposit? See page 59 and fill in 74b, 74c, and 74d, or Form 8888.

| | | |
|---|---|---|
| 73 | If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you **overpaid** | 73 |
| 74a | Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐ | 74a |
| ▶ b | Routing number ▶ **c** Type: ☐ Checking ☐ Savings | |
| ▶ d | Account number | |
| 75 | Amount of line 73 you want **applied to your 2008 estimated tax** ▶ 75 | |

**Amount You Owe**

| | | |
|---|---|---|
| 76 | **Amount you owe.** Subtract line 72 from line 63. For details on how to pay, see page 60 ▶ | 76 |
| 77 | Estimated tax penalty (see page 61) — 77 | |

**Third Party Designee**

Do you want to allow another person to discuss this return with the IRS (see page 61)? ☐ **Yes.** Complete the following. ☐ **No**

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

**Sign Here**

Joint return? See page 13. 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 complete. 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

**Paid Preparer's Use Only**

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

Form **1040** (2007)

Schedules A&B (Form 1040) 2007 OMB No. 1545-0074 Page **2**

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side. **Your social security number**

# Schedule B—Interest and Ordinary Dividends

Attachment Sequence No. **08**

## Part I Interest

(See page B-1 and the instructions for Form 1040, line 8a.)

**Note.** If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

| | | | Amount |
|---|---|---|---|
| **1** | List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶ | 1 | |
| **2** | Add the amounts on line 1 | 2 | |
| **3** | Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815 | 3 | |
| **4** | Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶ | 4 | |

**Note.** If line 4 is over $1,500, you must complete Part III.

## Part II Ordinary Dividends

(See page B-1 and the instructions for Form 1040, line 9a.)

**Note.** If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

| | | | Amount |
|---|---|---|---|
| **5** | List name of payer ▶ | 5 | |
| **6** | Add the amounts on line 5. Enter the total here and on Form 1040, line 9a ▶ | 6 | |

**Note.** If line 6 is over $1,500, you must complete Part III.

## Part III Foreign Accounts and Trusts

(See page B-2.)

You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; or **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

| | | Yes | No |
|---|---|---|---|
| **7a** | At any time during 2007, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1 | | |
| **b** | If "Yes," enter the name of the foreign country ▶ | | |
| **8** | During 2007, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See page B-2 | | |

**For Paperwork Reduction Act Notice, see Form 1040 instructions.** **Schedule B (Form 1040) 2007**

**SCHEDULE D (Form 1040)**

Department of the Treasury
Internal Revenue Service

# Capital Gains and Losses

► Attach to Form 1040 or Form 1040NR. ► See Instructions for Schedule D (Form 1040).
► Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074
**2007**
Attachment Sequence No. **12**

Name(s) shown on return | **Your social security number**



## Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

| **(a)** Description of property (Example: 100 sh. XYZ Co.) | **(b)** Date acquired (Mo., day, yr.) | **(c)** Date sold (Mo., day, yr.) | **(d)** Sales price (see page D-7 of the instructions) | **(e)** Cost or other basis (see page D-7 of the instructions) | **(f) Gain or (loss)** Subtract (e) from (d) |
|---|---|---|---|---|---|
| 1 | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |

2 Enter your short-term totals, if any, from Schedule D-1, line 2 . . . . . **2**

3 **Total short-term sales price amounts.** Add lines 1 and 2 in column (d) . . . . . **3**

4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 **4**

5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . . **5**

6 Short-term capital loss carryover. Enter the amount, if any, from line 10 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions . . . . . **6** ( )

7 **Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f) . . . . . **7**

## Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

| **(a)** Description of property (Example: 100 sh. XYZ Co.) | **(b)** Date acquired (Mo., day, yr.) | **(c)** Date sold (Mo., day, yr.) | **(d)** Sales price (see page D-7 of the instructions) | **(e)** Cost or other basis (see page D-7 of the instructions) | **(f) Gain or (loss)** Subtract (e) from (d) |
|---|---|---|---|---|---|
| 8 | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |
| | | | | | |

9 Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . . **9**

10 **Total long-term sales price amounts.** Add lines 8 and 9 in column (d) . . . . . **10**

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . . **11**

12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . . **12**

13 Capital gain distributions. See page D-2 of the instructions . . . . . **13**

14 Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions . . . . . **14** ( )

15 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back . . . . . **15**

**For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions.** Cat. No. 11338H **Schedule D (Form 1040) 2007**

Schedule D (Form 1040) 2007 Page **2**

## Part III Summary

| | | | |
|---|---|---|---|
| **16** Combine lines 7 and 15 and enter the result . . . . . . . . . . . . . . . . | 16 | | |
| If line 16 is:<br>• A **gain**, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below.<br>• A **loss**, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22.<br>• **Zero**, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22. | | | |
| **17** Are lines 15 and 16 **both** gains?<br>☐ **Yes.** Go to line 18.<br>☐ **No.** Skip lines 18 through 21, and go to line 22. | | | |
| **18** Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** on page D-8 of the instructions . . . . . . . . . . . . . . . . . . . . . . . ▶ | 18 | | |
| **19** Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** on page D-9 of the instructions . . . . . . . . . . . . . . . . . . ▶ | 19 | | |
| **20** Are lines 18 and 19 **both** zero or blank?<br>☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 35 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR). **Do not** complete lines 21 and 22 below.<br>☐ **No.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Schedule D Tax Worksheet** on page D-10 of the instructions. **Do not** complete lines 21 and 22 below. | | | |
| **21** If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the **smaller** of:<br>• The loss on line 16 or<br>• ($3,000), or if married filing separately, ($1,500) } . . . . . . . . . . . . .<br>**Note.** When figuring which amount is smaller, treat both amounts as positive numbers. | 21 | ( | ) |
| **22** Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b?<br>☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 35 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR).<br>☐ **No.** Complete the rest of Form 1040 or Form 1040NR. | | | |

Schedule D (Form 1040) 2007

## SOLUTIONS TO STUDY QUESTIONS

### True or False

1. True. U.S. citizens and residents are taxed on their worldwide income. Unless a person is a visitor or transient, he or she is likely to become resident for income tax purposes. (See p. 3-4.)

2. False. The income and deductions related to the sole proprietorship are included on the return of the proprietor along with any other income and allowable deductions. (See p. 3-3.)

3. False. Any individual with gross income above specified levels, regardless of his or her age, must file a return and pay any tax due. For simplicity, some parents may elect to include the income of a child under age 14 on their own return but the child's income is still taxed. (See p. 3-3.)

4. True. A U.S. citizen is taxed on his/her worldwide income unless some special provision allows exclusion. No such exception exists for Canadian interest. (See p. 3-4.)

5. True. Either is sufficient to qualify an individual to exclude up to $80,000 per year of foreign source earned income. (See p. 3-4.)

6. False. The results of operations for a sole proprietorship are reported on the Form 1040, more specifically on Schedule C. (See p. 3-3.)

7. False. The partnership generally pays no Federal income tax. Its net income and other tax attributes pass through to the partners. (See p. 3-6.)

8. True. The entity pays no tax, and the return details the amounts of income, loss, deduction, and credit to be taxed to the partners. (See pp. 3-6 and 3-7.)

9. False. An electing S Corporation generally pays no tax. Its income, deductions, gains, losses, etc., pass through to the shareholders. (See p. 3-7.)

10. True. Income passes through to the beneficiaries to the extent of amounts distributed currently. (See pp. 3-5 and 3-6.)

11. False. No such deduction is allowed to a corporation. (See p. 3-5.)

12. False. Gross income is income from whatever source, net of any exclusions from gross income. (See p. 3-13.)

13. False. The S corporation avoids double taxation, but the mechanism is that the shareholders pay tax on the corporation's income. (See p. 3-7.)

14. False. The LLC is a new type of entity recognized in most of the states. Its owners are referred to as members. (See p. 3-7.)

15. False. A taxpayer who itemizes may deduct both the itemized deductions and the personal and dependency exemptions. One whose itemized deductions do not exceed the standard deduction may claim the standard deduction. (See pp. 3-14 through 3-18.)

**16.** True. Gross income includes income from all sources except that specifically excluded by statute. (See p. 3-13.)

**17.** False. These deductions are allowable whether the taxpayer itemizes or not. (See p. 3-16.)

**18.** True. Lori's medical expenses are not deductible because they do not exceed the 7.5% floor. (See p. 3-17.)

**19.** True. Jim's deductions of $10,000 are reduced by 2% of A.G.I. in excess of $159,950 [($161,150 − $159,950) × 2% = $24]. (See p. 3-19.)

**20.** True. These deductions are not one of the four classes that are not subject to the phase-out. (See pp. 3-15 and 3-19.)

**21.** True. The basic standard deduction for single taxpayers is $5,450 and the additional amount for the elderly is $1,350 for 2008. The exemption amount is $3,500. (See p. 3-18.)

**22.** True. For years after 1988 it is adjusted to reflect price level increases. (See p. 3-18.)

**23.** False. A credit is a direct reduction in one's tax, as opposed to a deduction, which reduces one's taxable income. (See p. 3-22).

**24.** True. Prepayment refers to an amount that is paid prior to the filing of the tax return. (See p. 3-22.)

**25.** True. The self-employment tax is the Social Security levy equivalent to F.I.C.A. for employees and employers. (See p. 3-22.)

**26.** True. There is a separate exemption that is allowed for AMT purposes. (See p. 3-23.)

**27.** False. Adjusted basis of purchased property includes historical cost, which is not economic cost in inflationary times. It is also adjusted for subsequent events. (See p. 3-28.)

**28.** True. The adjusted basis is reduced by depreciation and other capital recoveries. (See  and p. 3-28.)

**29.** False. The annual limit on excess capital losses is $3,000. (See p. 3-32.)

**30.** False. The holding period requirement is more than one year. (See p. 3-31.)

**31.** False. Excess capital losses of individuals are not carried back. They are instead carried forward indefinitely to be deducted within the limit. (See p. 3-32.)

**32.** False. Such assets fall into the special category, § 1231 assets. (See p. 3-30.)

**33.** True. Personal use assets are not excluded from the definition of a capital asset. (See p. 3-30.)

### Multiple Choice

**34.** **b.** Estates and trusts are subject to the Federal income tax. Both the partnership and the S Corporation are generally treated as a conduit. (See pp. 3-5 through 3-9.)

**35.** **d.** All of the statements are true. Residents are taxed on their worldwide income, whereas nonresident aliens are taxed only on income earned in the U.S. (See pp. 3-3 and 3-4.)

**36.** **c.** Each of the other statements is flawed. No deduction is allowed for dividends paid, the lowest marginal tax bracket is 15 percent, and there is no such thing as A.G.I. for a corporation. (See pp. 3-4 and 3-5.)

**37.** **a.** The new deduction for A.G.I. is of the greater value, $140 ($500 × 28 percent marginal tax bracket). A new itemized deduction would provide no benefit since William does not itemize. (See pp. 3-11 through 3-24.)

**38.** **c.** A deduction of $10 is worth $3.50 to a 35 percent bracket taxpayer and $2.50 to a 25 percent bracket taxpayer. (See pp. 3-11 through 3-24.)

**39.** **d.** The itemized deductions or the standard deduction are allowed along with the personal and dependency exemptions. (See pp. 3-17 through 3-20.)

**40.** **d.** The tax preparation expense is not deductible due to the 2 percent floor. The other items, plus an exemption deduction, are deductible [$65,300 − ($8,000 + $850 + $450) − $3,500 = $52,500]. (See pp. 3-17 through 3-20.)

**41.** **c.** Residence interest is an itemized deduction that is not allowed if D and E claim the standard deduction. Their standard deduction is $10,700, increased by $1,050 each for age 65 (1) or older and blindness (1). (See pp. 3-17 through 3-20.)

**42.** **c.** These statements are true, except for the fact that the tax rate is 28 percent for AMT base in excess of $175,000. (See p. 3-23.)

**43.** **d.** Each of these statements is true. (See  and p. 3-27.)

**44.** **d.** Basis is not adjusted for changes in price levels under current law. (See  and p. 3-27.)

**45.** **b.** The gain realized equals the amount realized of $900 less the adjusted basis of $375. (See  and p. 3-27.)

**46.** **c.** A loss on the sale of a personal residence is not deductible. The other three categories of losses are allowed under § 165(c). (See p. 3-30.)

**47.** **a.** Assets held for personal use are not excluded from the definition of capital assets. All of the others are specifically excluded by § 1221. (See p. 3-30.)

**48.** **c.** An automobile driven by a taxpayer's son or daughter for personal use is a capital asset. (See p. 3-30.)

**49.** **b.** No favorable treatment is allowed, but long-term capital gains in excess of short-term capital losses are taxed at a rate not exceeding 28 percent. (See p. 3-30.)

**50.** **a.** Both the short-term gain of $240 and the net long-term capital gain [i.e., long-term gains − long-term losses] of $100 are fully included in adjusted gross income. (See p. 3-31.)

**51.** **d.** The net long-term capital gain is the excess of the long-term capital gain ($700) over the long-term capital loss ($600). (See p. 3-31.)

**52.** **c.** Fritz's deduction would be $3,000 and the rest would be carried forward indefinitely. (See p. 3-32.)

## Completion

**53.** individuals; corporations; estates and trusts
partnership; S corporation

**54.** deductions for; standard deduction

**55.** amount realized; realized; recognized

**56.** net long-term capital gain; net short-term capital loss
net long-term capital gains; net short-term capital losses

## Problems

**A.** See Exhibit 3-2 in the text and the Study Notes on the preceding pages.

**B.** The differences are all between gross income and taxable income since the corporation does not calculate A.G.I. or deduct personal and dependency exemptions. The corporation simply deducts deductions from gross income to determine taxable income. The individual deducts all of the following: deductions for A.G.I. to determine A.G.I., itemized deductions (or the standard deduction if larger), and personal and dependency exemptions.

**C.** Harold O. Reese's return and tax calculation are summarized as follows:

| | *2008* | *2007* |
|---|---|---|
| Salaries and wages | $28,470 | $28,470 |
| Interest income | 350 | 350 |
| A.G.I. | $28,820 | $28,820 |
| Standard deduction | − 5,450 | − 5,350 |
| Personal exemption | − 3,500 | − 3,400 |
| Taxable income | $19,870 | $20,170 |
| | | |
| Tax from tax tables | $ 2,579 | $ 2,635 |
| Withholding | − 3,025 | − 3,025 |
| Tax due (or refund) | $ (446) | $ (390) |

**D.** Bronwen Waring's return and tax calculation are summarized as follows:

| | *2008* | *2007* |
|---|---|---|
| Salaries and wages | $ 40,000 | $ 40,000 |
| Interest and dividends | + 6,090 | + 6,090 |
| Loss on sale of stock | – 1,400 | – 1,400 |
| A.G.I. | $ 44,690 | $ 44,690 |
| Standard deduction | – 8,000 | – 7,850 |
| Personal exemption | – 10,500 | – 10,200 |
| Taxable income | $ 26,190 | $ 26,640 |
| Tax from tax tables | $ 3,356 | $ 3,436 |
| Withholding | – 4,117 | – 4,117 |
| Tax due (or refund) | $ (761) | $ (681) |