

Chapter 2: Gross Income and Exclusions

Student: _____

1. Noncash items received as income must be included in income at their fair market value.
True False
2. Awards, bonuses, and gifts are all included in gross income.
True False
3. Disability benefits are generally taxable to the individual receiving the amounts.
True False
4. Interest income received by a cash basis taxpayer is generally reported in the tax year it is received.
True False
5. Interest on U.S. Treasury Bonds is not taxable.
True False
6. Taxpayers must report interest income on Series EE savings bonds as the interest accrues.
True False
7. A gift received for opening a bank account is not taxable income to the recipient.
True False
8. Child support payments are deductible by the spouse making the payments.
True False
9. If a divorce agreement executed in 2012 specifies that a portion of the amount of an alimony payment is contingent upon the status of a child, that portion is considered to be a child support payment.
True False
10. Under a divorce agreement executed in 2012, periodic payments of either cash or property must be made at regular intervals to be deductible as alimony.
True False

11. An auto that is received as a prize should be included in the taxpayer's income at its list price rather than its fair market value.

True False

12. Dr. J's outstanding player award is not includible in income, since the award is in recognition of his outstanding performance.

True False

13. If an annuitant, whose annuity starting date was January 1, 2001, dies before recovering his or her investment in the annuity, any unrecovered investment is recognized as a loss on the annuitant's tax return for the year of death.

True False

14. Payments made to a qualified retirement plan by an employer are considered part of the employee's investment in the contract for calculation of the annuity exclusion ratio.

True False

15. When calculating the exclusion ratio for an annuity, the ratio should be revised when there is a significant change in the taxpayer's status or health.

True False

16. If a life insurance policy is transferred to the insured's partnership for valuable consideration, the insurance proceeds are taxable when received by the partnership.

True False

17. To promote business activity, the tax rules generally are very liberal in treating business gifts as tax-free income to the recipient.

True False

18. The receipt of an inheritance is excluded from the taxable income of the recipients.

True False

19. Dividend income arising from stock received as a gift is excluded from gross income since the dividends are considered part of the gift.

True False

20. Amounts received as scholarships for books and tuition may be excluded from the recipient's taxable income.

True False

21. A scholarship for room and board granted in 2012 is fully taxable to the recipient.
- True False
22. Amounts received by an employee as reimbursement for medical expenses under a policy provided by the taxpayer's employer are excluded from gross income.
- True False
23. If an employer claims a business deduction for group health insurance premiums paid on behalf of his employees, the amount must be included in the employees' gross income.
- True False
24. Payments made by an employer for health insurance on behalf of an employee are considered income to the employee at the time the payments are made.
- True False
25. Cash allowances for meals or lodging generally must be included in the employee's income.
- True False
26. The value of lodging provided to a professor to enable him to live near the campus is excluded from gross income.
- True False
27. Interest earned on bonds issued by a state government is fully taxable.
- True False
28. Unemployment compensation is fully taxable to the individual receiving the compensation.
- True False
29. Group term life insurance premiums paid by an employer for insurance amounts less than \$50,000 must be included in the employee's income.
- True False
30. A "no-additional-cost" service includes only those services in the major line of business in which the employee is employed.
- True False
31. In some cases, Social Security benefits may be partially taxable.
- True False

32. Which of the following amounts must be included in the gross income of the recipient?

- A. Child support payments
- B. Welfare payments
- C. Gifts
- D. Royalties
- E. All of the above are included in gross income

33. All of the following amounts must be included in gross income, *except*:

- A. Gambling winnings
- B. Partnership income
- C. Accident insurance proceeds
- D. Dividends
- E. Jury duty fees

34. All of the following amounts are excluded from gross income, *except*:

- A. Tips and gratuities
- B. Child support payments
- C. Scholarship grants for tuition
- D. Gifts
- E. Veterans' benefits

35. Which of the following is generally excluded from gross income?

- A. Dividends
- B. Rewards
- C. Disability benefits
- D. Passive income
- E. None of the above

36. Which of the following is excluded from gross income?

- A. Prizes
- B. Scholarships for tuition
- C. Hobby income
- D. Rental income
- E. All of the above are included in gross income

37. Which of the following is classified as nontaxable income?

- A. Unemployment compensation
- B. Dividend income
- C. Income from real estate rental property
- D. Welfare payments
- E. None of the above

38. In the tax law, the definition of gross income is:

- A. All cash payments received unless excluded by the tax code
- B. All cash payments received for services performed
- C. All income from whatever source derived
- D. All income of any kind unless the income is earned illegally

39. Which of the following is not taxable income?

- A. Dividends
- B. Income from relief of debt
- C. Interest
- D. Royalties
- E. Welfare benefits

40. All of the following amounts are taxable income to the recipient *except*:

- A. Prizes
- B. Unemployment compensation
- C. Salaries
- D. Farm income
- E. Gifts

41. Mary received the following items during 2012:

Christmas bonus from her employer	\$500
Christmas gift from her father	35
Prize won in a radio show contest	100

What is the total amount of the above items that must be included in Mary's 2012 gross income?

- A. \$0
- B. \$100
- C. \$500
- D. \$600
- E. \$635

42. As a Christmas thank-you for being a good employee, Ed's TV Repair gave 62 year-old Edwina three shares of its stock worth \$20 per share. Edwina then received dividends of \$1 per share related to the stock. How much should be included in Edwina's gross income?

- A. \$0
- B. \$3
- C. \$60
- D. \$63
- E. None of the above

43. Which of the following is nontaxable income to the recipient for tax purposes?

- A. Salary income
- B. Income from real estate rental property
- C. Income from tips
- D. Inheritances
- E. None of the above

44. In 2012, Uriah received the following interest payments:

Interest of \$400 on an overpayment of 2010 Federal income taxes

Interest of \$300 from his bank certificate of deposit.

Interest of \$1,500 on municipal bonds

Interest of \$1,000 on United States savings bonds (Series HH)

What amount, if any, should Uriah report as taxable interest income on his 2012 individual income tax return?

- A. \$0
- B. \$700
- C. \$1,700
- D. \$3,200
- E. None of the above

45. Elmer received the following distributions from Virginiana Mutual Fund for the calendar year 2012:

Ordinary dividends	\$250
Capital gain distributions	170
Nontaxable distributions	80

Elsie, Elmer's wife, did not own any of the Virginiana Mutual Fund shares, but she did receive \$175 in interest on a savings account at the Moss National Bank and \$1,475 in interest on California Municipal Bonds. Elmer and Elsie filed a joint income tax return for 2012. What amount is reportable as taxable interest income?

- A. \$0
- B. \$175
- C. \$1,475
- D. \$1,650
- E. None of the above

46. Tim receives \$500 of qualified dividends from Exxon in 2012. He is in the 10 percent ordinary tax bracket. Tim's tax on the dividends will be:

- A. \$50
- B. \$75
- C. \$0
- D. \$25
- E. \$100

47. Elmer received the following distributions from Virginiana Mutual Fund for the calendar year 2012:

Ordinary dividends (nonqualifying)	\$250
Capital gain distributions	170
Nontaxable distributions	80

Elsie, Elmer's wife, did not own any of the Virginiana Mutual Fund shares, but she did receive \$1,600 in interest on a savings account at the Moss National Bank. Elmer and Elsie filed a joint income tax return for 2012. What portion of the distributions from Virginiana Mutual Fund is taxable as ordinary income on their 2012 individual income tax return?

- A. \$0
- B. \$250
- C. \$420
- D. \$500
- E. None of the above

48. Arthur, age 19, is a full-time student at Gordon College and is a candidate for a bachelor's degree. During 2012, he received the following amounts:

Tuition scholarship	\$2,400
Loan from college financial aid office	1,000
Cash support from parents	2,000
Ordinary cash dividend	500
Cash prize awarded in contest	300

What is his adjusted gross income for 2012?

- A. \$700
- B. \$800
- C. \$3,200
- D. \$6,200
- E. None of the above

49. Laura and Leon were granted a divorce in 2004. In accordance with the decree, Leon made the following payments to Laura in 2012:

Child support payments contingent on the age of the child	\$4,000
Indefinite periodic payments terminating on Laura's death	\$6,000

Assuming that Leon does not itemize his deductions, how much of the payments can he deduct as alimony in 2012?

- A. \$0
- B. \$6,000
- C. \$10,000
- D. \$4,000
- E. None of the above

50. Jerry and Sally were divorced under an agreement executed July 1, 2012. The terms of the agreement provide that Jerry will transfer to Sally his interest in a rental house worth \$250,000 with a tax basis to Jerry of \$80,000. What is the amount of the gain that must be recognized by Jerry on the transfer of the property and what is Sally's tax basis in the property after the transfer, respectively?
- A. \$170,000 and \$250,000
 - B. \$0 and \$250,000
 - C. \$170,000 and \$170,000
 - D. \$0 and \$80,000
 - E. None of the above
51. Richard and Alice are divorced and under the terms of their written divorce agreement signed on December 30, 2006, Richard was required to pay Alice \$1,500 per month of which \$600 was designated as child support. He made 12 such payments in 2012. Additionally, Richard voluntarily paid Alice \$1,200 per month for 12 months of 2012, no portion of which was designated as child support. Assuming that Alice has no other income, her tax return for 2012 should show gross income of:
- A. \$0
 - B. \$10,800
 - C. \$18,000
 - D. \$25,200
 - E. None of the above
52. Steve and Laura were divorced in 2007. Laura pays Steve alimony of \$1,200 a month. The payment amount was agreed upon in the decree of divorce. To save money, Steve and Laura still live together. Are the alimony payments that Steve receives in 2012 includable in his income? Can Laura take a deduction for alimony paid?
- A. Yes, the payments meet all alimony payment requirements.
 - B. Yes, alimony is always taxable.
 - C. No, only some of it is tax-exempt because Laura pays Steve too much alimony.
 - D. No, since Steve and Laura still live together, the payments are not considered alimony.
 - E. Yes, alimony payments are not tax-exempt.
53. Roger is required under a 2003 divorce decree to pay \$500 of alimony and \$200 of child support per month for 12 years. In addition, Roger makes a voluntary payment of \$100 per month. How much of the total monthly payment is deductible by Roger?
- A. \$0
 - B. \$200
 - C. \$500
 - D. \$600
 - E. None of the above

54. Laura and Leon were granted a divorce in 2004. In accordance with the decree, Leon made the following payments to Laura in 2012

Child support payments contingent on the age of the child	\$4,000
Annual cash payments, other than child support, specified as alimony in the divorce agreement	\$6,000

How much should Laura include in her 2012 taxable income as alimony?

- A. \$0
 - B. \$6,000
 - C. \$10,000
 - D. \$4,000
 - E. None of the above
55. For divorces after 1984, which of the following statements about alimony payments is not correct?
- A. The payments must be in cash and must be received by the spouse (or former spouse)
 - B. Divorced or legally separated parties can be members of the same household at the time the payments are made
 - C. The payor must have no liability to make payments for any period following the death of the spouse receiving the payments
 - D. The payments must not be designated in the written agreement as anything other than alimony
56. Marie had a good year. She received the following prizes and awards:
- an iPad from The Oprah Show with a fair market value of \$500
 - lottery winnings of \$1,000 received in cash
 - a plaque worth \$25 plus \$100 of Godiva chocolate in recognition for 100 days on the job without an accident
 - a \$10,000 cash prize from American Idol
- How much of her prizes and awards should Marie report on her tax return?
- A. None, they are all excluded from income
 - B. \$11,000; only cash prizes and awards are included
 - C. \$11,500; the award from her job is excluded
 - D. \$11,700; the plaque may be excluded
 - E. \$11,725; everything is included at the highest amount
57. Which of the following gifts would be considered taxable income to the person receiving the gift?
- A. \$5,000 given to the taxpayer from his friend.
 - B. A mobile home given to the taxpayer by his mother.
 - C. A ski boat won by the taxpayer on the Price is Right.
 - D. A Mustang GT given to the taxpayer by his brother.
 - E. None of the above would be considered taxable.

58. Richard, who retired on April 30, 2012, receives a monthly employee annuity benefit of \$1,400 payable for life, beginning May 1, 2012. During his years of employment, Richard contributed \$29,400 to the company's plan. Richard's life expectancy from the IRS tables is 10 years. Using the general rule, how much of the annuity payment amounts received during 2012 (\$11,200) may Richard exclude from gross income?
- A. \$1,960
 - B. \$2,940
 - C. \$9,240
 - D. \$11,200
 - E. None of the above
59. Terry receives \$3,000 annually from an annuity contract which she purchased in 2002 for \$15,000. Her total expected return under the contract is \$45,000 and payments under the contract began in 2003. For the years 2003 through 2012, Terry received \$3,000 per year. Of the \$3,000 received during 2012, what amount must Terry include in her gross income for 2012 under the general rule?
- A. \$3,000
 - B. \$2,062
 - C. \$2,000
 - D. \$1,000
 - E. None of the above
60. Sam, a calendar year taxpayer, purchased an annuity contract for \$3,600 that would pay him \$120 a month beginning on January 1, 2012. His expected return under the contract based on his life expectancy is \$10,800. Assuming Sam received a total of \$1,440 in payments during 2012, how much of this annuity income is included in Sam's gross income for 2012, using the general rule?
- A. \$0
 - B. \$480
 - C. \$960
 - D. \$1,440
 - E. None of the above
61. Sam died on January 15, 2003 and left his wife, Terry, an insurance policy with a face value of \$100,000. Terry elected to receive the proceeds over a 10-year period (\$10,000 plus interest each year). This year Terry receives \$11,500 (\$10,000 proceeds plus \$1,500 interest) from the insurance company. How much income must Terry report from this payment?
- A. \$0
 - B. \$500
 - C. \$1,500
 - D. \$11,500
 - E. None of the above

62. Seymore named his wife, Penelope, the beneficiary of a \$100,000 insurance policy on his life. The policy provided that, upon his death, the proceeds would be paid at a rate of \$4,000 per year plus interest over a 25-year period. Seymore died June 25, 2011, and in 2012 Penelope received a payment of \$5,200 from the insurance company. What amount should she include in her gross income for 2012?
- A. \$200
 - B. \$1,200
 - C. \$4,000
 - D. \$5,200
 - E. None of the above
63. Which of the following would result in life insurance proceeds that are taxable to the recipient?
- A. A life insurance policy transferred to a creditor in payment of a debt
 - B. A life insurance policy in which the insured is the daughter of the taxpayer and the beneficiary is the taxpayer
 - C. A life insurance policy transferred by a shareholder to a corporation
 - D. A life insurance policy purchased by a taxpayer insuring his or her business partner
 - E. A life insurance policy purchased by a corporation insuring an officer.
64. Nicole is a student at USB Law; she receives a \$52,000 scholarship for 2012. Of the \$52,000, \$40,000 is used for tuition, \$5,000 is used for books, and \$7,000 is used for room and board. How much of the scholarship is taxable income for Nicole in 2012?
- A. \$52,000
 - B. \$40,000
 - C. \$45,000
 - D. \$7,000
 - E. \$12,000
65. To pay for college, Henry received the following:
\$1,000 scholarship from the Thespian Club to pay for books
\$5,000 scholarship from the Elks Lodge for tuition
\$4,000 worth of room and board as a dorm supervisor through a work-study program
- How much must Henry claim on his tax return?
- A. \$0
 - B. \$4,000
 - C. \$5,000
 - D. \$6,000
 - E. \$10,000

66. Robert works for American Motors. American Motors pays a \$1,200 premium on Robert's health insurance in 2012. Robert has an operation on his big toe in 2012 that cost \$7,200. The insurance company paid for \$6,800 of it. Which one of the following is true?
- A. Robert has to claim the \$1,200 premium paid by his employer as income in 2012.
 - B. Robert must claim the \$6,800 paid by the insurance company for the operation as income in 2012.
 - C. Robert must claim the \$1,200 premium and the \$6,800 insurance payment as income in 2012.
 - D. None of these events are taxable on his 2012 return.
67. Which of the following may be excluded from income?
- A. Payment for the loss of an arm
 - B. Premiums for health insurance paid by the employer
 - C. Reimbursement from the insurance company for a physical examination
 - D. All of the above are excluded from gross income
 - E. None of the above are excluded from gross income
68. Anthony is a marine biologist who spends months living on a boat in the ocean studying the impact of runoff water a hundred miles off the coast as a part of his job. Which of the following sentences is the most accurate?
- A. Lodging is included in his income.
 - B. He may exclude meals from his income.
 - C. The fuel used to power the boat is excluded from his income.
 - D. b & c are correct, not a.
 - E. All are correct.
69. In which of the following cases may the employee exclude the meals and/or lodging:
- A. A taxpayer lives rent-free at the property she manages even though the owner does not require the manager to live on site.
 - B. A headmaster at a boarding school is required to be on campus all night.
 - C. A president of a major film studio receives a cash allowance to live in Beverly Hills.
 - D. An employee has an option of dining in an employer-sponsored cafeteria or dining out of the office.

70. An investor is comparing the following two bonds: a bond from ABC Corp which pays an interest rate of 9 percent per year and a municipal bond which pays an interest rate of 7.9 percent per year. The investor is in the 15 percent tax bracket. Which bond will give the investor a higher after-tax interest rate and for which reason?
- A. The ABC bond because it pays a 9 percent interest rate, while the municipal bond only pays 7.9 percent .
 - B. The ABC bond because it pays an equivalent after-tax rate of 10.6 percent, while the municipal bond pays out an equivalent after-tax rate of 9.3 percent.
 - C. The municipal bond because it pays an equivalent after-tax rate of 9.3 percent, while the ABC bond pays out a 9 percent interest rate.
 - D. The municipal bond because it pays an equivalent after-tax rate of 7.9 percent, while the ABC bond pays out an equivalent after-tax rate of 7.65 percent.
 - E. None of the above is correct.
71. Which taxpayer would benefit the most from a tax-free municipal bond compared to a taxable bond?
- A. A taxpayer whose only income is from Social Security
 - B. A taxpayer who won a mega-million-dollar lottery
 - C. The average blue collar worker
 - D. They would all equally benefit from the tax-free municipal bond
72. Steve worked as a tech supervisor for a computer company. In September of 2012, he was laid off. He was paid unemployment compensation for the rest of the year totaling \$7,000. Which of the following is true?
- A. Steve will have to report all \$7,000 of the unemployment compensation as income.
 - B. Steve will have to report \$4,600 of the unemployment compensation as income.
 - C. Unemployment compensation is never taxable.
 - D. As long as the unemployment compensation payments are less than the taxpayer's previous salary, they are not taxable.
 - E. None of the above is true.
73. Susie received unemployment benefits in the current year.
- A. All of the unemployment benefits is taxable.
 - B. All of the unemployment benefits is non-taxable.
 - C. Half of the unemployment benefits is taxable and half is non-taxable.
 - D. The taxability of the unemployment benefits depends upon other income received for the year.
74. Employer-provided spending accounts:
- A. May be set up for tax-free vacation savings
 - B. Are not allowed for dependent care
 - C. Do not require that the employee provide receipts for the expenses incurred
 - D. Allow qualifying expenses to be treated as tax-free reductions in the employees' salaries

75. Indicate which of the following statements is true.
- A. Dependent care plans can only be used to cover the costs of caring for a dependent child.
 - B. Medical flexible spending accounts can be used to cover dentist fees.
 - C. Public transportation may be covered by an employer-provided spending account, but parking can not be covered.
 - D. Dependent care accounts may include day care but not preschool
76. Which of the following is correct?
- A. Employee discounts are always included in gross income.
 - B. Employee discounts of up to 20 percent may be taken on personal property held for investment
 - C. Employee discounts are not tax-free if they exceed the employer's gross markup for merchandise
 - D. Tax-free employee discounts include discounts in lines of business in which the employee does not work.
77. Which of the following fringe benefits is taxable to the employee receiving the benefit?
- A. A subscription to a tax journal provided by the employer to a corporation's tax accountant
 - B. A small discount on toys granted to the salesperson for a toy store
 - C. Incidental use of the company's copier by an office worker
 - D. A 15 percent discount on investment real estate granted to the employee of a real estate developer
 - E. All of the above are tax-free
78. In regards to Social Security benefits:
- A. The Social Security inclusion formula is the same amount for each filing status.
 - B. Social Security benefits are always excluded because wages are subject to Social Security tax when earned.
 - C. Tax-free interest income must be included in the formula used to determine if Social Security is included in taxable income
 - D. Up to 100 percent of Social Security benefits received may be included in taxable income.
79. For 2012, the maximum percentage of Social Security benefits which must be included in a taxpayer's gross income is?
- A. 0%
 - B. 50%
 - C. 65%
 - D. 85%
 - E. 100%

80. Andy landscaped his friend's house in return for a couch set and an HD television worth \$8,000. How much income must Andy report on his tax return for his services?
81. Jack is a lawyer and Jeri is a child psychologist. Jack prepares Jeri's estate planning at no charge and Jeri agrees to counsel Jack's daughter six times at no charge in return for the estate planning. The value of the estate planning is \$1,000 and the value of the therapy sessions is \$1,000.
- a. How much income does Jack have? Why?
 - b. How much income does Jeri have? Why?
82. Barry has a successful methamphetamine laboratory. Producing methamphetamine is illegal under federal law. Is Barry required by law to report the income from his lab on his tax return? Why?

83. Bonnie receives salary income of \$30,000, unemployment compensation of \$5,400, and dividend income of \$1,000 and a gift of \$7,000 in cash from her aunt. How much total income does Bonnie have?

84. Indicate whether each item below would be included in or excluded from the income of the recipient.

<u>Included</u>	<u>Excluded</u>
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- | | |
|--|--|
| a. Payment for laboratory assistant position at UCSD | |
| b. A \$1,000 scholarship for tuition | |
| c. College books paid for by grandma and grandpa | |
| d. A \$1,000 college loan | |
| e. A scholarship for room and board | |
| f. A new car given to recruit a basketball player | |
| g. A scholarship used for supplies and equipment | |

85. Qualified dividends are given special tax treatment. Describe how they are taxed.

86. If a taxpayer holding EE bonds makes an election with respect to the taxation of the bonds, how is the interest which accrues on the bonds, but is not paid, taxed each year?
87. In 2012, what rate would a taxpayer pay on qualified dividend income:
- a. If in the 33 percent bracket?
 - b. If in the 10 percent bracket?
88. Under a divorce agreement executed in 2011, Bob is required to pay his ex-wife, Carol, \$3,000 a month until their youngest daughter is 21 years of age. At that time, the required payments are reduced to \$2,000 per month.
- a. How much of each \$3,000 payment may be deducted as alimony by Bob?
 - b. How much of each \$3,000 payment must be included in Carol's taxable income?

89. Under the terms of a property settlement executed during 2012, Cindy transferred a house worth \$350,000 to her ex-husband, Carl. The property has a tax basis to Cindy of \$300,000.
- How much taxable gain or loss must be recognized by Cindy at the time of the transfer?
 - What is Carl's tax basis in the property he received from Cindy?
90. Peter is required by his divorce agreement to pay alimony of \$6,000 a month and child support of \$4,000 a month to his ex-wife Stella. What is the tax treatment of these two payments?
- To Peter?
- To Stella?
91. As part of the property settlement related to their divorce, Stella must give Peter the house that they have been living in, while she gets 100 percent of their savings accounts. The house was purchased in Texas 15 years ago for \$100,000 and is now worth \$110,000. How much gain must Stella recognize on the transfer of the house to Peter? What is Peter's tax basis in the house for calculating any future sale of the house?

92. Rob is 8 years old and won a sports car valued at \$30,000 in a drawing at Disneyland. How much income, if any, must Rob report on his 2012 tax return? Why?
93. State whether each of the following is taxable or nontaxable.
- a. Susan won a jackpot of \$50,000 gambling at a casino.
 - b. Sarah received a Christmas ham from her employer.
 - c. Jonathan won a car in a supermarket raffle valued at \$25,000.
 - d. Gary received a scholarship for tuition of \$5,000 a year.
 - e. Eric is given lodging valued at \$1,000 a month on the oil rig where he works since it is impossible to go home during the period of time he is assigned to work there.

94. .Martin retired in May, 2012. His pension is \$1,000 per month from a qualified retirement plan to which he contributed \$48,000, and to which his employer contributed \$12,000. Martin's life expectancy from the IRS mortality tables is 10 years, and during 2012 he received total payments of \$8,000 from the plan.

- a. Using the general rule, calculate Martin's taxable income for 2012 from the retirement plan distributions.
- b. If Martin's contributions to the plan had been \$25,000, instead of \$48,000, how much taxable income would he have to report in 2012 from the plan distributions?

95. Cynthia, age 64, retired in June. Starting in July, Cynthia received \$2,000 per month from an annuity. She has contributed \$260,000 to the annuity. Her life expectancy is 20 years.

- a. How much is excluded from income using the simplified method? Per the formula, for ages 61-65, use 260 as the factor to divide by.

1. Enter total amount received this year
2. Enter cost in plan at the annuity starting date
3. Factor at annuity starting date 260
4. Divide line 2 by line 3
5. Multiply line 4 by the number of monthly payments this year
6. Amount, if any, recovered tax free in prior years
7. Subtract line 6 from line 2
8. Enter the smaller of line 5 or 7
9. Taxable amount this year. Subtract line 8 from line 1

- b. Assuming that the annuity is from a nonqualified plan, how much is excluded from income using the general method?

96. Toby transfers to Jim a life insurance policy with a face value of \$25,000 and a cash value of \$5,000 in payment of a personal debt. Jim continues to make premium payments on the policy until Toby's death. At that time, Jim had paid \$1,500 in premiums.

- a. How much income must Jim report when he receives the \$25,000 in proceeds?
- b. Would your answer be different if Toby and Jim were partners in a partnership? Why?

97. Tracy transfers to Glen a life insurance policy with a face value of \$40,000 and a cash value of \$8,000 in payment of a personal debt. Glen continues to make premium payments on the policy until Tracy's death. At that time, Glen had paid \$3,500 in premiums.

- a. How much income must Glen report when he receives the \$40,000 in proceeds?
- b. Would your answer be different if Tracy were a shareholder and CEO of a corporation to which the policy was transferred? Why?

98. Van is sick and tired of his job. His doctor certifies that his health may be compromised if he continues to work at his current job. He sells his life insurance policy to Life Settlements, Inc. for \$50,000 so he can take a break from work. He has paid \$10,000 so far for the policy. How much of the \$50,000 must Van include in his taxable income?
99. Helga receives a \$300,000 life insurance payment when her boyfriend Andy dies. How much of the payment is taxable to Helga?
100. In June of 2012, Rob's wealthy stepmother died and left him a stock portfolio worth \$600,000. Before she died, she gave him a gift of \$20,000 in cash. How much of these amounts, if any, are taxable to Rob? Why?

101. In June of 2012, a wealthy aunt gave Janie a stock portfolio worth \$150,000. During the year, she collects \$4,000 in dividends. How much of these amounts, if any, should Janie include in gross income for 2012? Why?
102. Geoff is a company president who has had a very good year at work. The owner of the company is pleased and gives him a gift of \$50,000 at the end of the year. The owner writes "gift" in the memo section of the check. How much of the gift is taxable to Geoff?
103. Tim receives a \$25,000 gift from his parents for a down payment on a house. They know he can not buy a house without their help. They write "gift" in the memo line of the check. How much of the gift is taxable to Tim?

104. Elmore receives a rental property as an inheritance from his grandmother. The rental is worth \$500,000 and Elmore collected rental income of \$24,000 during the year.

For the year, what is Elmore's gross income from the inheritance?

105. Karina receives a scholarship of \$10,000 to a college. She is also given a job which pays \$5,000 a year to help with her expenses. \$7,000 of the scholarship is earmarked for tuition and \$3,000 is for room and board. How much of the money from the scholarship and the job are taxable to Karina?

106. Kim earned \$30,000 from Pfizer before she was laid off. She then collected \$7,000 unemployment benefits. Finally, Kim received a \$12,500 scholarship for college tuition so she could return to college to earn a microbiology degree. How much does Kim need to report as income on her tax return?

107. Joey is a single taxpayer. Joey's employer pays \$1,800 per year for his health insurance. During the year, Joey had medical expenses of \$2,500 and the insurance company reimbursed him for the full \$2,500. How much of the above amounts, if any, must be included in Joey's gross income? Why?
108. Marco and his family are covered by his company's health insurance plan. The health insurance costs his company \$2,500 a year. During the year, Marco's daughter is diagnosed with a serious illness and the health insurance pays \$25,000 for treatment. How much of the insurance cost and the treatment are taxable to Marco?
109. Bob is a machinist in a remote Alaskan crab-freezing plant. The plant is accessible only by boat or airplane and has no available lodging for rent. Bob's employer provides him with lodging at the plant and pays for all of his electricity, gas, and other utilities, valued at \$700 per month. Is the value of the lodging taxable to Bob? Explain.

110. As a new benefit to employees, the Acme Company is providing a dining allowance every Tuesday for use in one of the twenty restaurants that they own around town. Should this benefit be included in the employees' wages?
111. A taxpayer in the 33 percent tax bracket invests in a New York City Bond paying 5 percent interest. What taxable interest rate would provide the same after-tax return?
112. Mable is a wealthy widow who has come to you for tax advice. She is in the 35 percent tax bracket. She has a choice between investing in a high-quality municipal bond paying 3.5 percent or a high-quality corporate bond paying 7 percent. From a tax standpoint, which investment would you advise her to make and why?

113. A taxpayer in the 28 percent tax bracket invests in a City of San Diego bond paying 8 percent interest. What taxable interest rate would provide the same after-tax return?

114. Jim, a single individual, was unemployed for a few months during 2012. During the year, he received \$3,600 in unemployment compensation payments. How much of his unemployment compensation payments must be included in gross income?

115. William, a single taxpayer, works for the men's clothing division of a large corporation. During 2012, William received the following fringe benefits:

	<u>Value</u>
20 percent discount on men's clothing (the usual markup is 40 percent)	\$350
15 percent discount on toys from the toy division of the company (the usual markup is 25 percent)	100
Personal copies on the company's copier	15
A subscription to <i>Men's Clothing Weekly</i>	35
Use of the company's athletic facilities	50

As a result of receiving the above fringe benefits, what amount must William include in his 2012 gross income?

116. Curt's tax client is employed at a large company that offers medical flexible spending accounts to its employees. Terry, the client, must decide at the beginning of the year whether he wants to put as much as \$5,000 of his salary into the medical spending account. Terry has excellent insurance through the company and is very healthy. He does not expect to have any medical expenses during the year. Terry does not itemize deductions. Should Curt recommend that Terry put the maximum in his medical flexible spending account? Why or why not?

117. Answer the following questions regarding the taxability of Social Security payments.

- a. Will a taxpayer with no income other than Social Security have to include the Social Security in taxable income?
- b. Will a taxpayer with a large amount of municipal bond income, but no taxable income, likely have to pay tax on part of his or her Social Security?
- c. What is the maximum amount of Social Security which may be subject to tax on an individual's tax return?

118. During the 2012 tax year, Thomas and Yolanda received \$24,000 in Social Security benefits. The amount of their adjusted gross income for the year was \$2,000 and they received no tax-exempt interest income.

Calculate the amount of the Social Security benefits that Thomas and Yolanda must include in their gross income for 2012.

119. Ordinarily life insurance proceeds are excluded from gross income. Why would they be taxable if earlier the policy had been transferred for valuable consideration?

120. During 2012, Margaret and John received \$24,000 in Social Security benefits. The amount of their adjusted gross income for the year before any Social Security income was \$140,000 and they received \$19,000 in tax-exempt income.

Explain the treatment of their Social Security income for tax purposes and the likely percentage of the Social Security income that will be taxable to Margaret and John.

Chapter 2: Gross Income and Exclusions **Key**

1. Noncash items received as income must be included in income at their fair market value.
TRUE
2. Awards, bonuses, and gifts are all included in gross income.
FALSE
3. Disability benefits are generally taxable to the individual receiving the amounts.
FALSE
4. Interest income received by a cash basis taxpayer is generally reported in the tax year it is received.
TRUE
5. Interest on U.S. Treasury Bonds is not taxable.
FALSE
6. Taxpayers must report interest income on Series EE savings bonds as the interest accrues.
FALSE
7. A gift received for opening a bank account is not taxable income to the recipient.
FALSE
8. Child support payments are deductible by the spouse making the payments.
FALSE
9. If a divorce agreement executed in 2012 specifies that a portion of the amount of an alimony payment is contingent upon the status of a child, that portion is considered to be a child support payment.
TRUE
10. Under a divorce agreement executed in 2012, periodic payments of either cash or property must be made at regular intervals to be deductible as alimony.
FALSE

11. An auto that is received as a prize should be included in the taxpayer's income at its list price rather than its fair market value.

FALSE

12. Dr. J's outstanding player award is not includible in income, since the award is in recognition of his outstanding performance.

FALSE

13. If an annuitant, whose annuity starting date was January 1, 2001, dies before recovering his or her investment in the annuity, any unrecovered investment is recognized as a loss on the annuitant's tax return for the year of death.

TRUE

14. Payments made to a qualified retirement plan by an employer are considered part of the employee's investment in the contract for calculation of the annuity exclusion ratio.

FALSE

15. When calculating the exclusion ratio for an annuity, the ratio should be revised when there is a significant change in the taxpayer's status or health.

FALSE

16. If a life insurance policy is transferred to the insured's partnership for valuable consideration, the insurance proceeds are taxable when received by the partnership.

FALSE

17. To promote business activity, the tax rules generally are very liberal in treating business gifts as tax-free income to the recipient.

FALSE

18. The receipt of an inheritance is excluded from the taxable income of the recipients.

TRUE

19. Dividend income arising from stock received as a gift is excluded from gross income since the dividends are considered part of the gift.

FALSE

20. Amounts received as scholarships for books and tuition may be excluded from the recipient's taxable income.

TRUE

21. A scholarship for room and board granted in 2012 is fully taxable to the recipient.

TRUE

22. Amounts received by an employee as reimbursement for medical expenses under a policy provided by the taxpayer's employer are excluded from gross income.

TRUE

23. If an employer claims a business deduction for group health insurance premiums paid on behalf of his employees, the amount must be included in the employees' gross income.

FALSE

24. Payments made by an employer for health insurance on behalf of an employee are considered income to the employee at the time the payments are made.

FALSE

25. Cash allowances for meals or lodging generally must be included in the employee's income.

TRUE

26. The value of lodging provided to a professor to enable him to live near the campus is excluded from gross income.

FALSE

27. Interest earned on bonds issued by a state government is fully taxable.

FALSE

28. Unemployment compensation is fully taxable to the individual receiving the compensation.

TRUE

29. Group term life insurance premiums paid by an employer for insurance amounts less than \$50,000 must be included in the employee's income.

FALSE

30. A "no-additional-cost" service includes only those services in the major line of business in which the employee is employed.

TRUE

31. In some cases, Social Security benefits may be partially taxable.

TRUE

32. Which of the following amounts must be included in the gross income of the recipient?
- A. Child support payments
 - B. Welfare payments
 - C. Gifts
 - D.** Royalties
 - E. All of the above are included in gross income
33. All of the following amounts must be included in gross income, *except*:
- A. Gambling winnings
 - B. Partnership income
 - C.** Accident insurance proceeds
 - D. Dividends
 - E. Jury duty fees
34. All of the following amounts are excluded from gross income, *except*:
- A.** Tips and gratuities
 - B. Child support payments
 - C. Scholarship grants for tuition
 - D. Gifts
 - E. Veterans' benefits
35. Which of the following is generally excluded from gross income?
- A. Dividends
 - B. Rewards
 - C.** Disability benefits
 - D. Passive income
 - E. None of the above
36. Which of the following is excluded from gross income?
- A. Prizes
 - B.** Scholarships for tuition
 - C. Hobby income
 - D. Rental income
 - E. All of the above are included in gross income
37. Which of the following is classified as nontaxable income?
- A. Unemployment compensation
 - B. Dividend income
 - C. Income from real estate rental property
 - D.** Welfare payments
 - E. None of the above

38. In the tax law, the definition of gross income is:
- A. All cash payments received unless excluded by the tax code
 - B. All cash payments received for services performed
 - C. All income from whatever source derived**
 - D. All income of any kind unless the income is earned illegally
39. Which of the following is not taxable income?
- A. Dividends
 - B. Income from relief of debt
 - C. Interest
 - D. Royalties
 - E. Welfare benefits**
40. All of the following amounts are taxable income to the recipient *except*:
- A. Prizes
 - B. Unemployment compensation
 - C. Salaries
 - D. Farm income
 - E. Gifts**

41. Mary received the following items during 2012:

Christmas bonus from her employer	\$500
Christmas gift from her father	35
Prize won in a radio show contest	100

What is the total amount of the above items that must be included in Mary's 2012 gross income?

- A. \$0
 - B. \$100
 - C. \$500
 - D. \$600**
 - E. \$635
42. As a Christmas thank-you for being a good employee, Ed's TV Repair gave 62 year-old Edwina three shares of its stock worth \$20 per share. Edwina then received dividends of \$1 per share related to the stock. How much should be included in Edwina's gross income?
- A. \$0
 - B. \$3
 - C. \$60
 - D. \$63**
 - E. None of the above

43. Which of the following is nontaxable income to the recipient for tax purposes?

- A. Salary income
- B. Income from real estate rental property
- C. Income from tips
- D.** Inheritances
- E. None of the above

44. In 2012, Uriah received the following interest payments:

Interest of \$400 on an overpayment of 2010 Federal income taxes

Interest of \$300 from his bank certificate of deposit.

Interest of \$1,500 on municipal bonds

Interest of \$1,000 on United States savings bonds (Series HH)

What amount, if any, should Uriah report as taxable interest income on his 2012 individual income tax return?

- A. \$0
- B. \$700
- C.** \$1,700
- D. \$3,200
- E. None of the above

45. Elmer received the following distributions from Virginiana Mutual Fund for the calendar year 2012:

Ordinary dividends	\$250
Capital gain distributions	170
Nontaxable distributions	80

Elsie, Elmer's wife, did not own any of the Virginiana Mutual Fund shares, but she did receive \$175 in interest on a savings account at the Moss National Bank and \$1,475 in interest on California Municipal Bonds. Elmer and Elsie filed a joint income tax return for 2012. What amount is reportable as taxable interest income?

- A. \$0
- B.** \$175
- C. \$1,475
- D. \$1,650
- E. None of the above

46. Tim receives \$500 of qualified dividends from Exxon in 2012. He is in the 10 percent ordinary tax bracket. Tim's tax on the dividends will be:

- A. \$50
- B. \$75
- C.** \$0
- D. \$25
- E. \$100

47. Elmer received the following distributions from Virginiana Mutual Fund for the calendar year 2012:

Ordinary dividends (nonqualifying)	\$250
Capital gain distributions	170
Nontaxable distributions	80

Elsie, Elmer's wife, did not own any of the Virginiana Mutual Fund shares, but she did receive \$1,600 in interest on a savings account at the Moss National Bank. Elmer and Elsie filed a joint income tax return for 2012. What portion of the distributions from Virginiana Mutual Fund is taxable as ordinary income on their 2012 individual income tax return?

- A. \$0
B. \$250
C. \$420
D. \$500
E. None of the above
48. Arthur, age 19, is a full-time student at Gordon College and is a candidate for a bachelor's degree. During 2012, he received the following amounts:

Tuition scholarship	\$2,400
Loan from college financial aid office	1,000
Cash support from parents	2,000
Ordinary cash dividend	500
Cash prize awarded in contest	300

What is his adjusted gross income for 2012?

- A. \$700
B. \$800
C. \$3,200
D. \$6,200
E. None of the above
49. Laura and Leon were granted a divorce in 2004. In accordance with the decree, Leon made the following payments to Laura in 2012:

Child support payments contingent on the age of the child	\$4,000
Indefinite periodic payments terminating on Laura's death	\$6,000

Assuming that Leon does not itemize his deductions, how much of the payments can he deduct as alimony in 2012?

- A. \$0
B. \$6,000
C. \$10,000
D. \$4,000
E. None of the above

50. Jerry and Sally were divorced under an agreement executed July 1, 2012. The terms of the agreement provide that Jerry will transfer to Sally his interest in a rental house worth \$250,000 with a tax basis to Jerry of \$80,000. What is the amount of the gain that must be recognized by Jerry on the transfer of the property and what is Sally's tax basis in the property after the transfer, respectively?
- A. \$170,000 and \$250,000
 - B. \$0 and \$250,000
 - C. \$170,000 and \$170,000
 - D.** \$0 and \$80,000
 - E. None of the above
51. Richard and Alice are divorced and under the terms of their written divorce agreement signed on December 30, 2006, Richard was required to pay Alice \$1,500 per month of which \$600 was designated as child support. He made 12 such payments in 2012. Additionally, Richard voluntarily paid Alice \$1,200 per month for 12 months of 2012, no portion of which was designated as child support. Assuming that Alice has no other income, her tax return for 2012 should show gross income of:
- A. \$0
 - B.** \$10,800
 - C. \$18,000
 - D. \$25,200
 - E. None of the above
52. Steve and Laura were divorced in 2007. Laura pays Steve alimony of \$1,200 a month. The payment amount was agreed upon in the decree of divorce. To save money, Steve and Laura still live together. Are the alimony payments that Steve receives in 2012 includable in his income? Can Laura take a deduction for alimony paid?
- A. Yes, the payments meet all alimony payment requirements.
 - B. Yes, alimony is always taxable.
 - C. No, only some of it is tax-exempt because Laura pays Steve too much alimony.
 - D.** No, since Steve and Laura still live together, the payments are not considered alimony.
 - E. Yes, alimony payments are not tax-exempt.
53. Roger is required under a 2003 divorce decree to pay \$500 of alimony and \$200 of child support per month for 12 years. In addition, Roger makes a voluntary payment of \$100 per month. How much of the total monthly payment is deductible by Roger?
- A. \$0
 - B. \$200
 - C.** \$500
 - D. \$600
 - E. None of the above

54. Laura and Leon were granted a divorce in 2004. In accordance with the decree, Leon made the following payments to Laura in 2012

Child support payments contingent on the age of the child	\$4,000
Annual cash payments, other than child support, specified as alimony in the divorce agreement	\$6,000

How much should Laura include in her 2012 taxable income as alimony?

- A. \$0
B. \$6,000
C. \$10,000
D. \$4,000
E. None of the above
55. For divorces after 1984, which of the following statements about alimony payments is not correct?
- A. The payments must be in cash and must be received by the spouse (or former spouse)
B. Divorced or legally separated parties can be members of the same household at the time the payments are made
C. The payor must have no liability to make payments for any period following the death of the spouse receiving the payments
D. The payments must not be designated in the written agreement as anything other than alimony
56. Marie had a good year. She received the following prizes and awards:
- an iPad from The Oprah Show with a fair market value of \$500
 - lottery winnings of \$1,000 received in cash
 - a plaque worth \$25 plus \$100 of Godiva chocolate in recognition for 100 days on the job without an accident
 - a \$10,000 cash prize from Americal Idol
- How much of her prizes and awards should Marie report on her tax return?
- A. None, they are all excluded from income
B. \$11,000; only cash prizes and awards are included
C. \$11,500; the award from her job is excluded
D. \$11,700; the plaque may be excluded
E. \$11,725; everything is included at the highest amount
57. Which of the following gifts would be considered taxable income to the person receiving the gift?
- A. \$5,000 given to the taxpayer from his friend.
B. A mobile home given to the taxpayer by his mother.
C. A ski boat won by the taxpayer on the Price is Right.
D. A Mustang GT given to the taxpayer by his brother.
E. None of the above would be considered taxable.

58. Richard, who retired on April 30, 2012, receives a monthly employee annuity benefit of \$1,400 payable for life, beginning May 1, 2012. During his years of employment, Richard contributed \$29,400 to the company's plan. Richard's life expectancy from the IRS tables is 10 years. Using the general rule, how much of the annuity payment amounts received during 2012 (\$11,200) may Richard exclude from gross income?
- A. \$1,960
 - B. \$2,940
 - C. \$9,240
 - D. \$11,200
 - E. None of the above
59. Terry receives \$3,000 annually from an annuity contract which she purchased in 2002 for \$15,000. Her total expected return under the contract is \$45,000 and payments under the contract began in 2003. For the years 2003 through 2012, Terry received \$3,000 per year. Of the \$3,000 received during 2012, what amount must Terry include in her gross income for 2012 under the general rule?
- A. \$3,000
 - B. \$2,062
 - C. \$2,000
 - D. \$1,000
 - E. None of the above
60. Sam, a calendar year taxpayer, purchased an annuity contract for \$3,600 that would pay him \$120 a month beginning on January 1, 2012. His expected return under the contract based on his life expectancy is \$10,800. Assuming Sam received a total of \$1,440 in payments during 2012, how much of this annuity income is included in Sam's gross income for 2012, using the general rule?
- A. \$0
 - B. \$480
 - C. \$960
 - D. \$1,440
 - E. None of the above
61. Sam died on January 15, 2003 and left his wife, Terry, an insurance policy with a face value of \$100,000. Terry elected to receive the proceeds over a 10-year period (\$10,000 plus interest each year). This year Terry receives \$11,500 (\$10,000 proceeds plus \$1,500 interest) from the insurance company. How much income must Terry report from this payment?
- A. \$0
 - B. \$500
 - C. \$1,500
 - D. \$11,500
 - E. None of the above

62. Seymore named his wife, Penelope, the beneficiary of a \$100,000 insurance policy on his life. The policy provided that, upon his death, the proceeds would be paid at a rate of \$4,000 per year plus interest over a 25-year period. Seymore died June 25, 2011, and in 2012 Penelope received a payment of \$5,200 from the insurance company. What amount should she include in her gross income for 2012?
- A. \$200
 - B. \$1,200**
 - C. \$4,000
 - D. \$5,200
 - E. None of the above
63. Which of the following would result in life insurance proceeds that are taxable to the recipient?
- A. A life insurance policy transferred to a creditor in payment of a debt**
 - B. A life insurance policy in which the insured is the daughter of the taxpayer and the beneficiary is the taxpayer
 - C. A life insurance policy transferred by a shareholder to a corporation
 - D. A life insurance policy purchased by a taxpayer insuring his or her business partner
 - E. A life insurance policy purchased by a corporation insuring an officer.
64. Nicole is a student at USB Law; she receives a \$52,000 scholarship for 2012. Of the \$52,000, \$40,000 is used for tuition, \$5,000 is used for books, and \$7,000 is used for room and board. How much of the scholarship is taxable income for Nicole in 2012?
- A. \$52,000
 - B. \$40,000
 - C. \$45,000
 - D. \$7,000**
 - E. \$12,000
65. To pay for college, Henry received the following:
\$1,000 scholarship from the Thespian Club to pay for books
\$5,000 scholarship from the Elks Lodge for tuition
\$4,000 worth of room and board as a dorm supervisor through a work-study program
- How much must Henry claim on his tax return?
- A. \$0
 - B. \$4,000**
 - C. \$5,000
 - D. \$6,000
 - E. \$10,000

66. Robert works for American Motors. American Motors pays a \$1,200 premium on Robert's health insurance in 2012. Robert has an operation on his big toe in 2012 that cost \$7,200. The insurance company paid for \$6,800 of it. Which one of the following is true?
- A. Robert has to claim the \$1,200 premium paid by his employer as income in 2012.
 - B. Robert must claim the \$6,800 paid by the insurance company for the operation as income in 2012.
 - C. Robert must claim the \$1,200 premium and the \$6,800 insurance payment as income in 2012.
 - D.** None of these events are taxable on his 2012 return.
67. Which of the following may be excluded from income?
- A. Payment for the loss of an arm
 - B. Premiums for health insurance paid by the employer
 - C. Reimbursement from the insurance company for a physical examination
 - D.** All of the above are excluded from gross income
 - E. None of the above are excluded from gross income
68. Anthony is a marine biologist who spends months living on a boat in the ocean studying the impact of runoff water a hundred miles off the coast as a part of his job. Which of the following sentences is the most accurate?
- A. Lodging is included in his income.
 - B. He may exclude meals from his income.
 - C. The fuel used to power the boat is excluded from his income.
 - D.** b & c are correct, not a.
 - E. All are correct.
69. In which of the following cases may the employee exclude the meals and/or lodging:
- A. A taxpayer lives rent-free at the property she manages even though the owner does not require the manager to live on site.
 - B.** A headmaster at a boarding school is required to be on campus all night.
 - C. A president of a major film studio receives a cash allowance to live in Beverly Hills.
 - D. An employee has an option of dining in an employer-sponsored cafeteria or dining out of the office.

70. An investor is comparing the following two bonds: a bond from ABC Corp which pays an interest rate of 9 percent per year and a municipal bond which pays an interest rate of 7.9 percent per year. The investor is in the 15 percent tax bracket. Which bond will give the investor a higher after-tax interest rate and for which reason?
- A. The ABC bond because it pays a 9 percent interest rate, while the municipal bond only pays 7.9 percent .
 - B. The ABC bond because it pays an equivalent after-tax rate of 10.6 percent, while the municipal bond pays out an equivalent after-tax rate of 9.3 percent.
 - C.** The municipal bond because it pays an equivalent after-tax rate of 9.3 percent, while the ABC bond pays out a 9 percent interest rate.
 - D. The municipal bond because it pays an equivalent after-tax rate of 7.9 percent, while the ABC bond pays out an equivalent after-tax rate of 7.65 percent.
 - E. None of the above is correct.
71. Which taxpayer would benefit the most from a tax-free municipal bond compared to a taxable bond?
- A. A taxpayer whose only income is from Social Security
 - B.** A taxpayer who won a mega-million-dollar lottery
 - C. The average blue collar worker
 - D. They would all equally benefit from the tax-free municipal bond
72. Steve worked as a tech supervisor for a computer company. In September of 2012, he was laid off. He was paid unemployment compensation for the rest of the year totaling \$7,000. Which of the following is true?
- A.** Steve will have to report all \$7,000 of the unemployment compensation as income.
 - B. Steve will have to report \$4,600 of the unemployment compensation as income.
 - C. Unemployment compensation is never taxable.
 - D. As long as the unemployment compensation payments are less than the taxpayer's previous salary, they are not taxable.
 - E. None of the above is true.
73. Susie received unemployment benefits in the current year.
- A.** All of the unemployment benefits is taxable.
 - B. All of the unemployment benefits is non-taxable.
 - C. Half of the unemployment benefits is taxable and half is non-taxable.
 - D. The taxability of the unemployment benefits depends upon other income received for the year.
74. Employer-provided spending accounts:
- A. May be set up for tax-free vacation savings
 - B. Are not allowed for dependent care
 - C. Do not require that the employee provide receipts for the expenses incurred
 - D.** Allow qualifying expenses to be treated as tax-free reductions in the employees' salaries

75. Indicate which of the following statements is true.
- A. Dependent care plans can only be used to cover the costs of caring for a dependent child.
 - B.** Medical flexible spending accounts can be used to cover dentist fees.
 - C. Public transportation may be covered by an employer-provided spending account, but parking can not be covered.
 - D. Dependent care accounts may include day care but not preschool
76. Which of the following is correct?
- A. Employee discounts are always included in gross income.
 - B. Employee discounts of up to 20 percent may be taken on personal property held for investment
 - C.** Employee discounts are not tax-free if they exceed the employer's gross markup for merchandise
 - D. Tax-free employee discounts include discounts in lines of business in which the employee does not work.
77. Which of the following fringe benefits is taxable to the employee receiving the benefit?
- A. A subscription to a tax journal provided by the employer to a corporation's tax accountant
 - B. A small discount on toys granted to the salesperson for a toy store
 - C. Incidental use of the company's copier by an office worker
 - D.** A 15 percent discount on investment real estate granted to the employee of a real estate developer
 - E. All of the above are tax-free
78. In regards to Social Security benefits:
- A. The Social Security inclusion formula is the same amount for each filing status.
 - B. Social Security benefits are always excluded because wages are subject to Social Security tax when earned.
 - C.** Tax-free interest income must be included in the formula used to determine if Social Security is included in taxable income
 - D. Up to 100 percent of Social Security benefits received may be included in taxable income.
79. For 2012, the maximum percentage of Social Security benefits which must be included in a taxpayer's gross income is?
- A. 0%
 - B. 50%
 - C. 65%
 - D.** 85%
 - E. 100%

80. Andy landscaped his friend's house in return for a couch set and an HD television worth \$8,000. How much income must Andy report on his tax return for his services?

The noncash payment of \$8,000 for services performed is taxable income to Andy. The tax law states that taxable income is "all income from whatever source derived." There is no exception in the law for noncash items received in exchange for services.

81. Jack is a lawyer and Jeri is a child psychologist. Jack prepares Jeri's estate planning at no charge and Jeri agrees to counsel Jack's daughter six times at no charge in return for the estate planning. The value of the estate planning is \$1,000 and the value of the therapy sessions is \$1,000.

- a. How much income does Jack have? Why?
- b. How much income does Jeri have? Why?

a. \$1,000. Taxable income includes "all income from whatever source derived." The value of the therapy for his child is income to him for the performances of services. There is no taxable income exception in the tax law for "barter income."

b. \$1,000. Taxable income includes "all income from whatever source derived." The value of the estate planning is income to her for the performances of services. There is no taxable income exception in the tax law for "barter income."

82. Barry has a successful methamphetamine laboratory. Producing methamphetamine is illegal under federal law. Is Barry required by law to report the income from his lab on his tax return? Why?

Yes. Illegal income is still taxable income since there is no exception excluding it in the tax code. When there is no explicit exception, taxable income is "all income from whatever source derived."

83. Bonnie receives salary income of \$30,000, unemployment compensation of \$5,400, and dividend income of \$1,000 and a gift of \$7,000 in cash from her aunt. How much total income does Bonnie have?

$$\$36,400 = \$30,000 + \$1,000 + \$5,400$$

84. Indicate whether each item below would be included in or excluded from the income of the recipient.

Included Excluded

- a. Payment for laboratory assistant position at UCSD
- b. A \$1,000 scholarship for tuition
- c. College books paid for by grandma and grandpa
- d. A \$1,000 college loan
- e. A scholarship for room and board
- f. A new car given to recruit a basketball player
- g. A scholarship used for supplies and equipment

- a. Included
- b. Excluded
- c. Excluded
- d. Excluded
- e. Included
- f. Included
- g. Excluded

85. Qualified dividends are given special tax treatment. Describe how they are taxed.

Qualified dividends are taxed at either 0 percent or 15 percent. The 0 percent rate applies to taxpayers in the ordinary income tax brackets of 10 percent and 15 percent. The 15 percent rate applies to taxpayers in the ordinary income tax brackets of 25 percent and above.

86. If a taxpayer holding EE bonds makes an election with respect to the taxation of the bonds, how is the interest which accrues on the bonds, but is not paid, taxed each year?

If an election is made, the increase in the redemption value of the bond (or interest accrual as it is commonly called) is included in current taxable income each year.

87. In 2012, what rate would a taxpayer pay on qualified dividend income:

- a. If in the 33 percent bracket?
- b. If in the 10 percent bracket?

- a. 15 percent
- b. 0 percent

88. Under a divorce agreement executed in 2011, Bob is required to pay his ex-wife, Carol, \$3,000 a month until their youngest daughter is 21 years of age. At that time, the required payments are reduced to \$2,000 per month.

- a. How much of each \$3,000 payment may be deducted as alimony by Bob?
- b. How much of each \$3,000 payment must be included in Carol's taxable income?

- a. \$2,000
- b. \$2,000

89. Under the terms of a property settlement executed during 2012, Cindy transferred a house worth \$350,000 to her ex-husband, Carl. The property has a tax basis to Cindy of \$300,000.

- a. How much taxable gain or loss must be recognized by Cindy at the time of the transfer?
- b. What is Carl's tax basis in the property he received from Cindy?

- a. \$-0-
- b. \$300,000

90. Peter is required by his divorce agreement to pay alimony of \$6,000 a month and child support of \$4,000 a month to his ex-wife Stella. What is the tax treatment of these two payments?
To Peter?
To Stella?

Peter may deduct the alimony of \$6,000 per month on his tax return. He cannot deduct the child support.

Stella must report the alimony of \$6,000 per month as income on her tax return. The child support is not income to Stella.

91. As part of the property settlement related to their divorce, Stella must give Peter the house that they have been living in, while she gets 100 percent of their savings accounts. The house was purchased in Texas 15 years ago for \$100,000 and is now worth \$110,000. How much gain must Stella recognize on the transfer of the house to Peter? What is Peter's tax basis in the house for calculating any future sale of the house?

No gain is taxable to Stella on the transfer of the house since it is part of a property settlement related to a divorce. Peter has a basis of \$100,000 in the house for calculating tax on any future sale of the house.

92. Rob is 8 years old and won a sports car valued at \$30,000 in a drawing at Disneyland. How much income, if any, must Rob report on his 2012 tax return? Why?

\$30,000. Prizes are taxable income, valued at fair market value

93. State whether each of the following is taxable or nontaxable.

- a. Susan won a jackpot of \$50,000 gambling at a casino.
- b. Sarah received a Christmas ham from her employer.
- c. Jonathan won a car in a supermarket raffle valued at \$25,000.
- d. Gary received a scholarship for tuition of \$5,000 a year.
- e. Eric is given lodging valued at \$1,000 a month on the oil rig where he works since it is impossible to go home during the period of time he is assigned to work there.

- a. Taxable
- b. Nontaxable
- c. Taxable
- d. Nontaxable
- e. Nontaxable

94. Martin retired in May, 2012. His pension is \$1,000 per month from a qualified retirement plan to which he contributed \$48,000, and to which his employer contributed \$12,000. Martin's life expectancy from the IRS mortality tables is 10 years, and during 2012 he received total payments of \$8,000 from the plan.

- a. Using the general rule, calculate Martin's taxable income for 2012 from the retirement plan distributions.
- b. If Martin's contributions to the plan had been \$25,000, instead of \$48,000, how much taxable income would he have to report in 2012 from the plan distributions?

- a. $\$4,800 = \$8,000 - \$3,200$ exclusion, calculated as $\$48,000/\$120,000 \times \$8,000$.
- b. $\$6,333 = \$8,000 - \$1,667$ exclusion, calculated as $\$25,000/\$120,000 \times \$8,000$.

95. Cynthia, age 64, retired in June. Starting in July, Cynthia received \$2,000 per month from an annuity. She has contributed \$260,000 to the annuity. Her life expectancy is 20 years.

a. How much is excluded from income using the simplified method? Per the formula, for ages 61-65, use 260 as the factor to divide by.

1. Enter total amount received this year
2. Enter cost in plan at the annuity starting date
3. Factor at annuity starting date 260
4. Divide line 2 by line 3
5. Multiply line 4 by the number of monthly payments this year
6. Amount, if any, recovered tax free in prior years
7. Subtract line 6 from line 2
8. Enter the smaller of line 5 or 7
9. Taxable amount this year. Subtract line 8 from line 1

b. Assuming that the annuity is from a nonqualified plan, how much is excluded from income using the general method?

a. \$6,000 is excluded from income. See calculation below.

1. Enter total amount received this year \$12,000
2. Enter cost in plan at the annuity starting date 260,000
3. Factor at annuity starting date 260
4. Divide line 2 by line 3 1,000
5. Multiply line 4 by the number of monthly payments this year 6,000
6. Amount, if any, recovered tax free in prior years 0
7. Subtract line 6 from line 2 6,000
8. Enter the smaller of line 5 or 7 6,000
9. Taxable amount this year. Subtract line 8 from line 1 6,000

b. Amount excluded = $\frac{\$260,000}{\$24,000 \times 20 \text{ years}} \times \$12,000 = \underline{\$6,500}$

96. Toby transfers to Jim a life insurance policy with a face value of \$25,000 and a cash value of \$5,000 in payment of a personal debt. Jim continues to make premium payments on the policy until Toby's death. At that time, Jim had paid \$1,500 in premiums.
- a. How much income must Jim report when he receives the \$25,000 in proceeds?
 - b. Would your answer be different if Toby and Jim were partners in a partnership? Why?

- a. $\$18,500 = \$25,000 - \$5,000 - \$1,500$.
- b. Yes. Transfers to a partner, even for valuable consideration, result in nontaxable proceeds.

97. Tracy transfers to Glen a life insurance policy with a face value of \$40,000 and a cash value of \$8,000 in payment of a personal debt. Glen continues to make premium payments on the policy until Tracy's death. At that time, Glen had paid \$3,500 in premiums.

- a. How much income must Glen report when he receives the \$40,000 in proceeds?
- b. Would your answer be different if Tracy were a shareholder and CEO of a corporation to which the policy was transferred? Why?

- a. $\$28,500 = \$40,000 - \$8,000 - \$3,500$.
- b. Yes. Transfers to corporation by a shareholder and officer of a corporation, even if for valuable consideration, result in nontaxable proceeds.

98. Van is sick and tired of his job. His doctor certifies that his health may be compromised if he continues to work at his current job. He sells his life insurance policy to Life Settlements, Inc. for \$50,000 so he can take a break from work. He has paid \$10,000 so far for the policy. How much of the \$50,000 must Van include in his taxable income?

He must pay tax on the \$40,000 gain on the sale of the policy. Van has not met the requirement for an accelerated death benefit or a viatical settlement.

99. Helga receives a \$300,000 life insurance payment when her boyfriend Andy dies. How much of the payment is taxable to Helga?

None of the payment is taxable. Life insurance proceeds received upon the death of the insured are generally considered to be tax-free and specifically excluded from taxable income.

100. In June of 2012, Rob's wealthy stepmother died and left him a stock portfolio worth \$600,000. Before she died, she gave him a gift of \$20,000 in cash. How much of these amounts, if any, are taxable to Rob? Why?

\$0

Inheritances and gifts are not taxable to the recipient.

101. In June of 2012, a wealthy aunt gave Janie a stock portfolio worth \$150,000. During the year, she collects \$4,000 in dividends. How much of these amounts, if any, should Janie include in gross income for 2012? Why?

\$4,000. The gift of stock is not classified as income, but earnings on the stock are income.

102. Geoff is a company president who has had a very good year at work. The owner of the company is pleased and gives him a gift of \$50,000 at the end of the year. The owner writes "gift" in the memo section of the check. How much of the gift is taxable to Geoff?

The full \$50,000 is taxable. The gift is clearly bonus income in a business setting so does not qualify for tax-free gift treatment, even if Geoff's employer calls the payment a gift.

103. Tim receives a \$25,000 gift from his parents for a down payment on a house. They know he can not buy a house without their help. They write "gift" in the memo line of the check. How much of the gift is taxable to Tim?

None of the gift is taxable. Gifts are excluded from the taxable income of the person receiving the gift.

104. Elmore receives a rental property as an inheritance from his grandmother. The rental is worth \$500,000 and Elmore collected rental income of \$24,000 during the year.

For the year, what is Elmore's gross income from the inheritance?

\$24,000, the amount of the rental income.

105. Karina receives a scholarship of \$10,000 to a college. She is also given a job which pays \$5,000 a year to help with her expenses. \$7,000 of the scholarship is earmarked for tuition and \$3,000 is for room and board. How much of the money from the scholarship and the job are taxable to Karina?

The \$5,000 earnings from the job are taxable, as is \$3,000 of the scholarship. There is no exclusion for payments made for room and board. \$7,000 is not taxable, since scholarships for tuition are specifically excluded from taxable income.

106. Kim earned \$30,000 from Pfizer before she was laid off. She then collected \$7,000 unemployment benefits. Finally, Kim received a \$12,500 scholarship for college tuition so she could return to college to earn a microbiology degree. How much does Kim need to report as income on her tax return?

Kim needs to report \$37,000 on her tax return: \$30,000 from her employment at Pfizer and \$7,000 from unemployment benefits received. The \$12,500 scholarship is excluded from income.

107. Joey is a single taxpayer. Joey's employer pays \$1,800 per year for his health insurance. During the year, Joey had medical expenses of \$2,500 and the insurance company reimbursed him for the full \$2,500. How much of the above amounts, if any, must be included in Joey's gross income? Why?

None. The health insurance premiums paid by the employer are not income to Joey and the reimbursement of medical expense by the insurance company is not income to Joey.

108. Marco and his family are covered by his company's health insurance plan. The health insurance costs his company \$2,500 a year. During the year, Marco's daughter is diagnosed with a serious illness and the health insurance pays \$25,000 for treatment. How much of the insurance cost and the treatment are taxable to Marco?

None of the cost of the family insurance or amounts paid by the insurance company for treatments are taxable to Marco. These amounts are specifically excluded from taxable income under the tax law.

109. Bob is a machinist in a remote Alaskan crab-freezing plant. The plant is accessible only by boat or airplane and has no available lodging for rent. Bob's employer provides him with lodging at the plant and pays for all of his electricity, gas, and other utilities, valued at \$700 per month. Is the value of the lodging taxable to Bob? Explain.

No. The lodging costs paid by the employer are not taxable to the employee because the lodging is on the business premises and must be accepted as a requirement for employment.

110. As a new benefit to employees, the Acme Company is providing a dining allowance every Tuesday for use in one of the twenty restaurants that they own around town. Should this benefit be included in the employees' wages?

Yes. The meals are not being provided for the convenience of the employer. Therefore, the cost of the meals should be included in the employees' wages.

111. A taxpayer in the 33 percent tax bracket invests in a New York City Bond paying 5 percent interest. What taxable interest rate would provide the same after-tax return?

$$7.46\% = 5\% / (1 - .33)$$

112. Mable is a wealthy widow who has come to you for tax advice. She is in the 35 percent tax bracket. She has a choice between investing in a high-quality municipal bond paying 3.5 percent or a high-quality corporate bond paying 7 percent. From a tax standpoint, which investment would you advise her to make and why?

She should invest in the corporate bond. At the 35 percent tax bracket, the equivalent rate on the tax-free bond is 5.38 percent or 3.5 percent divided by $(1 - .35)$, which is lower than the 7 percent rate of return on the corporate bond.

113. A taxpayer in the 28 percent tax bracket invests in a City of San Diego bond paying 8 percent interest. What taxable interest rate would provide the same after-tax return?

$$11.11 \text{ percent} = 8 \text{ percent} / (1 - .28)$$

114. Jim, a single individual, was unemployed for a few months during 2012. During the year, he received \$3,600 in unemployment compensation payments. How much of his unemployment compensation payments must be included in gross income?

\$3,600. Unemployment compensation is included in gross income.

115. William, a single taxpayer, works for the men's clothing division of a large corporation. During 2012, William received the following fringe benefits:

	<u>Value</u>
20 percent discount on men's clothing (the usual markup is 40 percent)	\$350
15 percent discount on toys from the toy division of the company (the usual markup is 25 percent)	100
Personal copies on the company's copier	15
A subscription to <i>Men's Clothing Weekly</i>	35
Use of the company's athletic facilities	50

As a result of receiving the above fringe benefits, what amount must William include in his 2012 gross income?

\$100, the discount on toys from the toy division.

116. Curt's tax client is employed at a large company that offers medical flexible spending accounts to its employees. Terry, the client, must decide at the beginning of the year whether he wants to put as much as \$5,000 of his salary into the medical spending account. Terry has excellent insurance through the company and is very healthy. He does not expect to have any medical expenses during the year. Terry does not itemize deductions. Should Curt recommend that Terry put the maximum in his medical flexible spending account? Why or why not?

No. Terry will be better off keeping his salary \$5,000 higher and paying tax on the salary, since he will likely have no medical costs to reimburse from a medical spending account during the year. If Terry has no medical expenses, he will lose the \$5,000 in the account after the end of the year.

117. Answer the following questions regarding the taxability of Social Security payments.
- a. Will a taxpayer with no income other than Social Security have to include the Social Security in taxable income?
 - b. Will a taxpayer with a large amount of municipal bond income, but no taxable income, likely have to pay tax on part of his or her Social Security?
 - c. What is the maximum amount of Social Security which may be subject to tax on an individual's tax return?
- a. No. The taxpayer's income is below the threshold amount used in the formula to determine whether Social Security is taxable.
 - b. Yes. Tax-free municipal bond income is added to AGI in the formula to determine the amount of taxable Social Security.
 - c. 85 percent. High-income taxpayers must include 85 percent of Social Security receipts in taxable income.

118. During the 2012 tax year, Thomas and Yolanda received \$24,000 in Social Security benefits. The amount of their adjusted gross income for the year was \$2,000 and they received no tax-exempt interest income.

Calculate the amount of the Social Security benefits that Thomas and Yolanda must include in their gross income for 2012.

\$0. Their modified adjusted gross income is less than the base amount required to have taxable Social Security.

119. Ordinarily life insurance proceeds are excluded from gross income. Why would they be taxable if earlier the policy had been transferred for valuable consideration?

If a policy is transferred for valuable consideration, it takes on the nature of an investment for the new owner. Generally, the excess of the amount realized on disposal of an investment over the cost of the investment is subject to taxation.

120. During 2012, Margaret and John received \$24,000 in Social Security benefits. The amount of their adjusted gross income for the year before any Social Security income was \$140,000 and they received \$19,000 in tax-exempt income.

Explain the treatment of their Social Security income for tax purposes and the likely percentage of the Social Security income that will be taxable to Margaret and John.

Social Security income is partially taxed based on the taxpayer's modified adjusted gross income. Modified adjusted gross income includes adjusted gross income plus tax exempt interest plus half of the Social Security received. For low income taxpayers, no Social Security income is taxable. Higher income taxpayers must include 50 percent to 85 percent of the Social Security receipts in income. Given the high level of income reported by Margaret and John, it is safe to say they would have to include 85 percent of the Social Security payments in taxable income. To be certain, the IRS Social Security worksheet should be used to calculate the taxable amount.