**CHAPTER 3 - Tax Planning**

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| **Chapter 3. Tax Planning Strategies and Limits****Timing [Present Value] (2)****Shift Income to Another Year (constant tax rates) (4)****Shift Income to Another Year (different tax rates for taxpayer, or in the Code) (8)****Shift to Other Taxpayer (11)****Limits: assignment, loss on sale to related parties (12) Also Pg. 11-35****Shift to Other Taxing Jurisdiction (15)****Conversion (Ordinary income replaced by capital gains, tax-free income, etc.) (16)****Judicial Doctrines, Limits: business purpose, step-transaction-substance, etc. (19)** |

 **[Pg. 3-2]** Planning the timing of revenue recognition can yield benefits because of:

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| --- | --- | --- | --- | --- | --- | --- |
| a.  | Time value of money | b.  | Changing marginal tax rates | c. | Both |  |

 **[Pg. 3-2]** Bill’s after-tax rate of return on investments is 7%.

Bill boughtDell Inc. stock on November 3, 2005 at a cost of $20,000.
The Dell stock has a market value on December 28, 2016 of $100,000.

On December 28, 2016 Bill decides he would like to sell his Dell stock.
Bill's tax rate will be 15% on the gain from sale of this stock.

Bill thinks the stock market may fall and he project the value of the stock will to be $95,000 in early 2017.
He will pay the additional tax with the next federal income tax return filed on April 15, 2017 or 2018.
There will be no penalty for underpayment of income tax. Should bill sell in December or January?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | December. | **b.** | January |  |

 **[Pg. 3-2, 3-8]** Mercedes has decided she needs new equipment for her business.

The new equipment will cost $10,000. Mercedes is considering whether to make the purchase
and claim $10,000 deduction at year-end or next year (2016).
With the new machinery, her business income will rise. Assume her after-tax rate of return is 8 percent.

Her marginal rate will increase from 20 percent this year to 28 percent next year.

She is considering buying the machine (and paying cash) on December 30, 2015, or January 7, 2016.

What is the PV of the after-tax cost of the machine if she buys the machine on January 5, 2016?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $7,407 | **b.** | $7,500  | **c.** | $8,000  | **d.** | $8,100  | **e.** | Other |  |

 **[Pg. 3-2]** Which of the following is an example of the timing strategy?

|  |  |  |
| --- | --- | --- |
| **a.** | A corporation paying its shareholders a $20,000 dividend |  |
| **b.** | A parent employing her child in the family business |
| **c.** | A taxpayer gifting stock to his children |
| **d.** | A cash-basis business delaying billing its customers until after year end |

 **[Pg. 3-2]** Judy has a 25% tax rate and a 6% after-tax rate of return.

A $30,000 tax deduction in four years will save how much tax in today's dollars (rounded)?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $30,000  | **b.** | $7,500  | **c.** | $28,290  | **d.** | $5,940  | **e.** | Other |  |

 **[Pg. 3-2]** Julius has a 30% tax rate and a 10% after-tax rate of return.

A $40,000 tax deduction in two years will save how much tax in today's dollars (rounded)?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $40,000  | **b.** | $9,917  | **c.** | $33,040  | **d.** | $12,000 | **e.** | Other |  |

 **[Pg. 3-12, 11-35]** Jason's employer pays year-end bonuses each year on Dec. 31.

Jason, a cash basis taxpayer, would prefer to not pay tax on his bonus this year.

 (He would actually would prefer his daughter to pay tax on the bonus).

So, he leaves town on December 31, 2015 and has his daughter, Julie, pick
up his check on January 2, 2016. Who reports the income and when?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | Julie in 2015  | **b.** | Julie in 2016 | **c.** | Jason in 2015  | **d.** | Jason in 2016  |  |

 **[Pg. 3-8] Iron Corp.,** a cash basis corporation is in the 15% tax bracket in 2015, and will be in
the 35% bracket in 2016. If certain bills (for operating expenses) are paid in 2015, a current tax
deduction will be allowed for those payments. If Iron’s customers are billed for November
services in early December, many of those customers will make their payments before
December 31, 2015. If billing is delayed a couple of weeks, collections will be in January, 2016.
How should the corporation manage its 2015: **(1)** end-of-year payments of accounts payable
and **(2)** end-of-year billing and collection of accounts receivable?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **(1) Accounts Payable** | **(2) Accounts Receivable** |  |  |
| a. | Accelerate payment | Accelerate Billing and Collection |
| b.  | Defer Payment | Accelerate Billing and Collection |
| c. | Accelerate payment | Defer Billing and Collection |

 **[Pg. 3-8] Bonnet Corp.,** is a calendar year cash basis taxpayer,
Bonnet projected its taxable income to be $70,000 for 2015, and $40,000 for 2016.
After making these projections for 2015 and 2016, the company had an advertising campaign
in the winter holidays in 2015.
The cost of this campaign was $10,000, which was not included in the income projections above.
The company may pay the advertising bill in late December or in early January. Ignoring time
value of money, how much is the company’s net savings by paying the bill in December 2015?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $7,500 | **b.** | $1,500 | **c.** | $2,500 | **d.** | $1,000 |  |  |  |

 **[Pg. 3-8, 3-16] Pam** has $100,000 to invest for 5 years.
She is considering a land investment that will appreciate at the rate of 6% per year,
or a savings account paying interest of 6% per year. Both investments involve annual compounding.
After-tax earnings on the savings account would be reinvested in the savings account at 6%.
How do these investments compare in terms of (1) tax deferral and (2) income tax rates?

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Savings Account** | **Land Investment** |  |
| **a.** | More tax deferral | Lower tax rate |
| **b.** | Less tax deferral | Lower tax rate |
| **c.**  | Less tax deferral | Higher tax rate |

 **[Pg. 3-8]** Which of the following decreases the benefits of accelerating deductions?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | Lower tax rates in the future | **b.** | Higher tax rates in the future |  |
| **c.** | Larger after-tax rate of return | **d.** | larger magnitude of transactions  |

 **[Pg. 3-11] Pearl,** a single, wealthy investor earns net rental income of about $400,000 per year.
She does not have significant itemized deductions.
She owns rental property that generates net rental income of $20,000 per year.
She is considering giving the rental property to her elderly mother.
Her mother needs the extra income to pay for her living expenses.
Pearl expects to save federal income taxes with this plan. What planning concept applies here?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | Timing of income. | **b.** | Income shifting |  |
| **c.** | Changing character of income | **d.** | Step transaction doctrine |

 **[Pg. 3-11]** A common income shifting strategy is to:

|  |  |  |
| --- | --- | --- |
| **a.** | shift income from low tax rate taxpayers to high tax rate taxpayers |  |
| **b.** | shift deductions from low tax rate taxpayers to high tax rate taxpayers |
| **c.** | shift deductions from high tax rate taxpayers to low tax rate taxpayers |
| **d.** | accelerate tax deductions |

 **[Pg. 3-12]** Randy pays his 10-year-old daughter $50,000 a year for consulting.
Randy is likely violating which doctrine?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | constructive receipt doctrine  | **b.** | implicit tax doctrine |  |
| **c.** | substance-over-form doctrine  | **d.** | step-transaction doctrine |

 **[Pg. 3-12]** Jenna instructs her son to collect rent checks for the taxpayer's property
and to report this as taxable income on the son's tax return. Jenna is violating which doctrine?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **a.** | constructive receipt doctrine  | **b.** | implicit tax doctrine |  |
| **c.** | assignment of income doctrine | **d.** | step-transaction doctrine |

 **[Pg. 3-16, 1-16]** John's marginal tax rate is 40%. Austin City bond pays 6% interest.
What interest rate would a corporate bond have to offer for John to be indifferent between
the two bonds?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | 30%  | **b.** | 10%  | **c.** | 6%  | **d.** | 3.6% | **e.** | Other |  |

 **[Pg. 3-16, 1-16]** Larry's marginal tax rate is 25%. Corporate bonds pay 10% interest.
What interest rate would a municipal bond have to offer for Larry to be indifferent between
the two bonds?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | 25%  | **b.** | 12.5%  | **c.** | 10%  | **d.** | 7.5%  | **e.** | Other |  |

 **[Pg. 3-17]** Will's marginal tax rate is 32% and his tax rate on dividends is 15%.
A dividend-paying stock (with no growth potential) pays a dividend yield of 8%.

What interest rate must the corporate bond offer for Will to be indifferent between the two investments?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | 12%  | **b.** | 11%  | **c.** | 10%  | **d.** | 8%  | **e.** | Other |  |

 **[Pg. 3-10, 5-7]** The Constructive Receipt Doctrine modifies the application of the:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **a.** | Cash basis | **b.** | Accrual Basis | **c.** | Both Cash Basis and Accrual Basis |  |

 **[Pg. 3-12]** Sue owns land that she rents to a farmer for $500 per month.
She received the monthly rental of $500 for each of the first ten months of the year.
She assigned the income for the last two months to her mother.

Sue instructed the farmer to send the last two month's rent to her mother.
How much rental income should Sue report for the year?

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $5,000 | **b.** | $6,000 | **c.** | Other |  |  |  |  |

 **[Pg. 3-11, 5-21]** Bum is single and earns a salary from Big Corporation of $100,000 per year.
On January 1 of the current year, he invested $250,000 in a new corporation [“Local Corp.”] that sells toys. Bum owns 100% of the stock of Local Corporation. Bum does not receive a salary from Local Corporation. The company does not elect S status. In 2016, Local Corporation had these transactions:

|  |  |
| --- | --- |
| **Transactions of “Local Corporation”** | **C Corporation** |
| Gross revenue from business operations | $200,000 |
| Cost of sales and other routine business operating expenses | 140,000 |
| Dividends paid by Local Corporation to Bum | 10,000 |

What is the tax liability for Local Corporation for 2016?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $10,000 | **b.** | $12,500 | **c.** | $15,000 | **d.** | $16,667 |  |

 **[Pg. 3-11, 5-21]** Repeat the preceding question. Bum has no other income generating activities.
What is Bum’s gross income for 2016?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $160,000 | **b.** | $150,000 | **c.** | $110,000 | **d.** | $100,000 |  |

 **[Pg. 3-11, 5-21]** Repeat the preceding question, except assume the corporation did elect
S status on January 1. Bum has no income other than the income identified in the information above. What is Bum’s gross income for 2016?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $160,000 | **b.** | $150,000 | **c.** | $120,000 | **d.** | $110,000 |  |

A corporation is in the 39% marginal tax bracket. The corporation can pay a marketing
consultant $10,000 to develop a campaign that will generate $50,000 in new revenue.

Alternatively, the corporation can pay 10,000 to a tax consultant to develop a tax plan that
will save $50,000 in taxes. Which project provides the highest net after-tax cash flow?

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| a.  | Marketing | b.  | Tax planning |  |

**The following questions deal with Dividends (cash dividends, stock dividends, stock splits)**

**Let’s reach into the other chapters identified, and go ahead and get a full picture of dividend rules.**

 **[Pg. 3-13, 14-3]** On 1-1-2015, Ernie started Local Corp. (a C corp.) with an investment of $100,000.

Ernie received 100% of the stock of the corporation. Earnings and profits equal after-tax income for Local.
In 2015, Local had after-tax income of $40,000 and paid no dividend.
In 2016, Local had after-tax income of $40,000, and distributed $90,000 to Ernie on December 31, 2016.
How much dividend income does Ernie report for 2016?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $0.00 | **b.** | $40,000 | **c.** | $80,000 | **d.** | $90,000 |  |

 **[Pg. 3-13, 14-17]** On 1-5-2004 Harris purchased 100 shares of Campbell Corporation common stock.

He paid $6,000 for the stock. On 7-8-2015, he received a nontaxable stock dividend of 20 shares of Campbell Corporation common stock. In the current year, Harris sold ten shares of the common stock
for $700. What is his gain or loss on the sale?

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $700  | **b.**  | $500  | **c.** | $200  | **d.** | $100  | **e.** | Other |  |  |

 **[Pg. 3-13, 14-17]** CYZ Corp. issues two shares of stock for each share held, as a stock dividend
to shareholders. Before the dividend, Cheryl owns 100 shares of CYZ Corp. stock that she purchased
 for $12 per share. She receives 200 new shares as a result of the dividend.
What is the basis of each share of her stock after the dividend?

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $12.00 | **b.** | $8.00 | **c.** | $4.00 | **d.** | None of these |  |

 **[Pg. 3-16] On September 17, 2015,** Arthur bought IBM stock for $32,000.
On September 2, **2016**,Arthur sold stock for $3,700. He has no other capital asset sales in **2016**.
Arthur is in the 25% marginal tax rate bracket for ordinary income. What is his tax on the stock sale?

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **a.** | $ - 0 - | **b.** | $ 500 | **c.** | $ 750 | **d.**  | $1,000 | **e.** | $1,250 |  |