

# John smith tax issues assignment

[History](#)



Week 4 ??? You Decide John Smith tax issues: a. How is the \$300, 000 treated for purposes of Federal tax income? The \$300, 000 that John received for services rendered from the court case is considered earned income for the year. The \$300, 000 is earned income for John Smith and will be reported as gross income either on Schedule C of the individual return or as gross income on the LLC return. " US code defines gross income in 26 U. S.

C ?? 61 states except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items. " (<http://www.gpo.gov/fdsys/pkg/USCODE-2006-title26/pdf/USCODE-2006-title26-subtitleA-chap1-subchapB-partI-sec61.pdf>) There isn't any other way to treat the \$300, 000 because it is considered gross income and has to be taxed as such b. How is the \$25, 000 treated for purposes of Federal tax income?

John received, in addition to the \$300, 000, \$25, 000 for expenses he incurred during the trial. I would assume that the incurred expenses were deducted and when he was paid the \$25, 000 it would be considered a reimbursement and it would not be considered income. John paid these expenses out of his pocket and was merely reimbursed for what he spent on the case. c. What is your determination regarding reducing the taxable amount of income for both (a) and (b) above? John would like to reduce his taxable income. One way to do so is to take advantage of itemized deductions.

Itemized deductions include expenses for health care, state and local taxes, personal property taxes (such as car registration fees), mortgage interest, gifts to charity, job-related expenses, tax preparation fees, and investment-related expenses. (<http://taxes.about.com/od/taxplanning/a/taxplanning.html>) Another way to reduce his taxable income is to form an LLC. According to IRS " an LLC is an entity created by state statute. The IRS uses tax entity classification, which allows the LLC to be taxed as a corporation, partnership, or sole proprietor, depending on elections made by the LLC and the number of members. (<http://www.irs.gov/businesses/small/article/0,,id=158625,00.html>) An LLC has the ability to be taxed as a corporation. By forming an LLC John can take advantage of deducting certain business expenses. Purchases relating to business can be written-off. By deducting these expenses, John will be able to reduce his taxable income. Another way to reduce John's taxable income is to take advantage of retirement plans such as profit sharing, IRA's, SEP-IRA's, and defined benefit plans. By contributing to these plans John can contribute pre-tax dollars into the plan.

This would lower his taxable income. In regards to buying the building that John is leasing his office in, he could reduce his taxable income by depreciating the building. By depreciating the building John would deduct the amount that would be depreciated and then that amount wouldn't be considered taxable income. The lease payment would be deductible through the LLC. John does have to remember that he will also be receiving payments from the other tenants. I think in this case it would be advantageous to purchase the building with different tax advantages of depreciating the building. 2.

Main Issue #2: Jane Smith tax issues: a. What are the different tax consequences between paying down the mortgage (debt) and assuming a new mortgage (debt) for Federal income tax purposes? Jane would like to pay off their current mortgage, sell the home and purchase a new home. Jane would like to know if it makes better tax sense to pay off the current mortgage, sell the home and purchase the new home or sell the existing home and purchase the new home. I would have to say in this case that it would be better to sell the existing home without paying off the balance and then purchasing the new home.

If the current home was paid off then they couldn't deduct the mortgage interest. If the current home was paid off and they didn't immediately purchase a new home then they would be losing the opportunity to deduct the interest during the time between paying off the current home and purchasing the new home. The one thing that Jane needs to keep in mind is that mortgage interest can be deducted up to \$1,000,000 for couples filing together and \$500,000 for single filers. b. Can John and Jane Smith utilize a 1031 tax exchange to buy a more expensive house using additional money from John's case?

A 1031 exchange is a great way for a tax payer to reduce his/her taxable income. There are a lot of rules when it comes to performing a 1031 exchange. The basic concept is an investor can sell a real estate investment, take the initial investment and the capital gains and purchase another real estate investment within a certain amount of time and not have to pay taxes on the capital gains. The only problem that Jane and John have is that " to qualify for Section 1031 of the Internal Revenue Code, the properties

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exchanged must be held for productive use in a trade or business or for investment. ([http://en. ikipedia.org/wiki/Internal\\_Revenue\\_Code\\_section\\_1031](http://en.ikipedia.org/wiki/Internal_Revenue_Code_section_1031))

c. Does Jane have a business or hobby? Why is this distinction important? According to the tax code Jane has a business and not a hobby. Because Jane made a profit with the jewelry it is then classified as a business. If Jane worked with the jewelry and operated at a loss then it could be classified as a hobby. ([http://en.wikipedia.org/wiki/Internal\\_Revenue\\_Code\\_section\\_183](http://en.wikipedia.org/wiki/Internal_Revenue_Code_section_183)) This distinction is important because if her jewelry was a hobby then it would show that she purchases product and, although she may sell it, she doesn't turn a profit.

Now that the jewelry is considered a business is subject to taxation. d. Would Jane (and John) realize better tax benefits if she had a separate business for her jewelry making activities? Jane has to separate the jewelry business from their personal income. Jane may form an LLC or she could file the schedule C portion of the 1040. In this case she would keep the business income and expenses separate but she would file her taxes jointly with John e. What tax benefits would John realize if he invested \$15, 000 in Jane's jewelry making?

John wouldn't benefit by investing \$15, 000 into Jane's jewelry business. The direct investment would cause no advantage but if Jane used the investment to purchase supplies and upgraded equipment, then, as stated in question d, when Jane files the taxes for her business jointly with John, then he would be able to have tax savings. The supplies for the jewelry business are deductible so John would eventually benefit from the investment. f. Can Jane depreciate her vehicle or jewelry making equipment? How?

Under IRS Topic 510 Jane can use depreciate her vehicle for business use. Topic 510 states that if the vehicle is used totally for business then it can be fully depreciated for the business. If the vehicle is used for both business and personal, then only the percentage used for business can be depreciated. Jane can also keep track of the mileage used for business and depreciate that amount. (<http://www.irs.gov/taxtopics/tc510.html>) The equipment purchased for Jane's jewelry business can also be depreciated.

The law allows for the equipment to be depreciated over one year or over the span of several years. ([http://www.section179.org/section\\_179\\_deduction.html](http://www.section179.org/section_179_deduction.html)) 3. Main Issue # 3: Should John and Jane file separate tax returns or jointly? John and Jane should file joint tax returns. The IRS states that there are more benefits to filing jointly than filing separately. There are certain benefits afforded to individuals filing jointly than to individuals filing separately. (<http://taxes.about.com/od/filingstatus/qt/marriedjointly.htm>) (<http://www.irs.gov/pub/irs-pdf/p501.pdf>)