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# INDIVIDUAL INCOME TAXES

2017

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**CHECKPOINT**  
Student Edition

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**SOUTH-WESTERN  
FEDERAL TAXATION**

**2017 EDITION**  
**INDIVIDUAL  
INCOME TAXES**

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# Preface

## COMMITTED TO EDUCATIONAL SUCCESS

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**S**outh-Western Federal Taxation (SWFT) is the most trusted and best-selling series in college taxation. We are focused exclusively on providing the most useful, comprehensive, and up-to-date tax texts, online study aids, tax preparation tools, and research tools to help instructors and students succeed in their tax courses and beyond.

SWFT is a comprehensive package of teaching and learning materials, significantly enhanced with each edition to meet instructor and student needs and to add overall value to learning taxation.

*Individual Income Taxes*, 2017 Edition provides a dynamic learning experience inside and outside of the classroom. Built with resources and tools that have been identified as the most important, our complete learning system provides options for students to achieve success.

*Individual Incomes Taxes*, 2017 Edition provides accessible, comprehensive, and authoritative coverage of the relevant tax code and regulations as they pertain to the individual taxpayer, as well as coverage of all major developments in Federal Taxation.

### In revising the 2017 Edition, we focused on:

- **Accessibility. Clarity. Substance.** The text authors and editors made this their mantra as they revised the 2017 edition. Coverage has been streamlined to make it more accessible to students, and difficult concepts have been clarified, all without losing the substance that makes up the *South-Western Federal Taxation* series.
- **CengageNOWv2 as a complete learning system.** Cengage Learning understands that digital learning solutions are central to the classroom. Through sustained research, we continually refine our learning solutions in CengageNOWv2 to meet evolving student and instructor needs. CengageNOWv2 fulfills learning and course management needs by offering a personalized study plan, video lectures, auto-graded homework, auto-graded tests, and a full eBook with features and advantages that address common challenges.



**COMPUTATIONAL EXERCISES:** Students need lots of practice in areas such as computing tax return problems and adjusting rates. We have developed these exercises to give students practice in calculating the solutions they need to make business decisions.

- Found in end-of-chapter section of the textbook
- CengageNOWv2 provides algorithmic versions of these problems

### Computational Exercises

16. **LO.1** Sally owns real property for which the annual property taxes are \$9,000. She sells the property to Shelley on March 1 for \$550,000. Shelley pays the real property taxes for the entire year on October 1.
  - a. How much of the property taxes can be deducted by Sally and how much by Shelley?
  - b. What effect does the property tax apportionment have on Shelley's adjusted basis in the property?
  - c. What effect does the apportionment have on Sally's amount realized from the sale?
  - d. How would the answers in (b) and (c) differ if the taxes were paid by Sally?
17. **LO.1** Melba purchases land from Adrian. Melba gives Adrian \$225,000 in cash and agrees to pay Adrian an additional \$400,000 one year later plus interest at 5%.
  - a. What is Melba's adjusted basis for the land at the acquisition date?
  - b. What is Melba's adjusted basis for the land one year later?
18. **LO.1** On July 1, 2016, Katrina purchased tax-exempt bonds (face value of \$75,000) for \$82,000. The bonds mature in five years, and the annual interest rate is 6%. The market rate of interest is 2%.
  - a. How much interest income and/or interest expense must Katrina report in 2016?
  - b. What is Katrina's adjusted basis for the bonds on January 1, 2017?

**ROGER CPA EXAM REVIEW QUESTIONS:** While the SWFT series has always provided the most in-depth coverage of tax concepts, Roger CPA Exam Review Questions are included to further prepare students for success on the CPA Exam.

- Located in selected end-of-chapter sections
- Tagged by concept in CengageNOWv2
- Similar questions to what students would actually find on the CPA Exam



### Roger CPA Review Questions

1. Stephen purchased a video game console five years ago for \$500. In order to raise money for the "latest and greatest" console, Stephen sold his console for \$100. Because of advances in technology, Stephen can purchase the new console for \$400. What is the tax treatment of Stephen's sale of his console?
  - a. Stephen recognizes a \$400 loss.
  - b. Stephen does not report the sale.
  - c. Stephen recognizes a \$300 loss.
  - d. Stephen recognizes a \$100 gain.
2. Uncle Ubb gave his nephew, Leroy Lamprey, a gift of stock worth \$10,000. Uncle Ubb's basis in the stock was \$15,000. Leroy sold the stock to an unrelated party for \$11,000. What amount of gain or loss should Leroy report as a result of this sale?
 

a. \$0	c. \$200 gain
b. \$4,000 loss	d. \$1,000 gain



# See how the SWFT series helps students understand the big picture and the relevancy behind what they are learning.

## THE BIG PICTURE

### THE FIRST JOB

After an extensive search, Morgan, a recent college graduate with a major in finance, has accepted a job with Kite Corporation. The job is in sales and will require travel and some entertainment (i.e., business lunches). She will be based in a major metropolitan area in another state. Kite has no available space in the locale, so Morgan will have to maintain her own work facility. In addition to her salary, Morgan will receive a travel allowance. However, Kite has made it clear that the allowance *will not* cover all of her travel expenses. Kite requires all travel expenses to be documented appropriately (e.g., receipts provided, business purpose explained) and submitted in a timely manner.

Morgan is delighted with the new job because it will enable her to maintain a flexible work schedule. Furthermore, working out of her own apartment avoids a time-consuming and costly commute. What are some of the income tax problems presented by this situation?

*Read the chapter and formulate your response.*

## THE BIG PICTURE: Tax Solutions for the Real World.

Taxation comes alive at the start of each chapter as The Big Picture Examples give a glimpse into the lives, families, careers, and tax situations of typical filers. Students will follow this one family or individual throughout the chapter showing students how the concept they are learning plays out in the real world.

Finally, to solidify student comprehension, each chapter concludes with a **Refocus on the Big Picture** summary and tax planning scenario. These scenarios apply the concepts and topics from the chapter in a reasonable and professional way.

## FRAMEWORK 1040:

### Fitting it all Together.

This chapter-opening feature demonstrates how topics within *Individual Income Taxes* fit together, using the Income Tax Formula for Individuals as the framework. The framework helps students organize their understanding of the chapters and topics to see how they relate to the basic tax formula and then identify where these items are reported on Form 1040. Framework 1040 helps students navigate topics by explaining how tax concepts are organized.

FRAMEWORK 1040 Tax Formula for Individuals	
Income (broadly defined).....	\$100,000
Less: Exclusions.....	(0,000)
Gross income.....	\$100,000
Less: Deductions for adjusted gross income.....	(0,000)
FORM 1040 (p. 1)	
12 Business income or (loss). Attach Schedule C or C-EZ.....	
13 Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>	
14 Other gains or (losses). Attach Form 4797.....	
17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E.....	
Adjusted gross income.....	\$100,000
Less: The greater of total itemized deductions or the standard deduction.....	(0,000)
FORM 1040 (p. 2)	
40 Itemized deductions (from Schedule A) or your standard deduction.....	
Personal and dependency exemptions.....	(0,000)
Taxable income.....	\$100,000
Tax on taxable income (see Tax Tables or Tax Rate Schedules).....	\$ 0,000
Less: Tax credits (including income taxes withheld and prepaid).....	(000)
Tax due (or refund).....	\$ 000

Use this chapter-opening **Framework 1040**, which shows the topics as they appear in the individual tax formula, to understand where on Form 1040 these chapter topics would appear.



## FINANCIAL DISCLOSURE INSIGHTS Tax and Book Depreciation

A common book-tax difference relates to the depreciation amounts that are reported for GAAP and Federal income tax purposes. Typically, tax depreciation deductions are accelerated; that is, they are claimed in earlier reporting periods than is the case for financial accounting purposes.

Almost every tax law change since 1980 has included depreciation provisions that accelerate the related deductions relative to the expenses allowed under GAAP. Accelerated

cost recovery deductions represent a means by which the taxing jurisdiction infuses the business with cash flow created by the reduction in the year's tax liabilities.

For instance, recently, about one-quarter of General Electric's deferred tax liabilities related to depreciation differences. For Toyota's and Ford's depreciation differences, that amount was about one-third. And for the trucking firm Ryder Systems, depreciation differences accounted for all but 1 percent of the deferred tax liabilities.

## FINANCIAL DISCLOSURE INSIGHTS:

Tax professionals need to understand how taxes affect the income statement and balance sheet. **Financial Disclosure Insights**, appearing throughout the text, use current data about existing taxpayers to highlight book-tax reporting differences, effective tax rates, and trends in reporting conventions.



**TAX IN THE NEWS:** Drawn from today's business and popular press, **Tax in the News** features enliven class discussions by presenting current issues that illustrate the chapter material and applying them to real life.

In addition, editors offer weekly updates for instructors designed for use in the classroom with links, assignments, and activities included. See the **SWFT** blog at <https://taxintherealworld.wordpress.com>.

**TAX IN THE NEWS** Medical Expense Deductions Are Now Harder to Come By

For taxpayers under age 65, being in a position to claim a medical expense deduction is more challenging than ever because of an increase a few years ago in the AGI threshold that limits a medical expense's deductibility. Currently, the threshold is 10 percent of AGI for most taxpayers, an increase from 7.5 percent under prior law. For example, if a taxpayer's AGI is \$100,000, only those medical expenses in excess of \$10,000 are deductible ( $\$100,000 \times 10\%$ —an increase of \$2,500 from the prior threshold).

This means that to protect a medical expense deduction, taxpayers must have a better grasp on what qualifies as a medical expense and do a better job of documenting these costs. IRS Publication 502, *Medical and Dental Expenses*, includes a long list of qualifying expenses as well as expenses that do not qualify.

For example, the travel costs to see a doctor or dentist count, as well as fees paid to a chiropractor or psychologist for medical care. Contact lenses, pregnancy test kits, and even doctor-prescribed weight loss programs may qualify. However, the law is not liberal enough to allow for the deductibility of health club dues or for the purchase of substances that are illegal under Federal law, such as medical marijuana.

**ETHICS & EQUITY** Is This the Right Way to Use the Credit for Child and Dependent Care Expenses?

Your friends, Tim and Susan, have hired a child care provider (Rebecca) to come into their home while they are at work to care for their two children. Rebecca charges \$4,500 for her services for the year. Tim and Susan have discovered that up to \$6,000 of qualifying expenditures will generate a credit for child and dependent care expenses and that qualifying expenditures can include payments for housecleaning services.

As a result, they ask Rebecca whether she would be interested in working several hours more per week, after Tim returns from work, for the sole purpose of cleaning the house.

Tim and Susan offer to pay Rebecca \$1,500 for the additional work. For Tim and Susan, the net cost of the additional services would be \$1,200 [ $\$1,500 - (\$1,500 \times 20\%)$ ] due to the availability of the credit for child and dependent care expenses.

You learn of Tim and Susan's opportunity but think it is unfair. If you hired someone to perform similar housecleaning services at the same price, your net cost would be \$1,500, not \$1,200, because you do not qualify for the credit. You are troubled by this inequity. Is your intuition correct?

**ETHICS & EQUITY:** Most issues do not have just one correct answer. **Ethics & Equity** features will spark critical thinking and invite classroom discussion, enticing students to evaluate their own value system. Suggested answers to Ethics & Equity scenarios appear in the Solutions Manual.

**TAX PLANNING:** Most chapters include a separate section, with its own Learning Objective, calling attention to how the tax law can be applied to reach the taxpayer's goals. Tax planning applications and suggestions also appear throughout each chapter.

**16-7 TAX PLANNING**

**16-7a Importance of Capital Asset Status**

Why is capital asset status important? Capital asset status enables the taxpayer to be eligible for the alternative tax on net capital gain. Individuals who receive income in the form of long-term capital gains or qualified dividend income have an advantage over taxpayers who cannot receive income in these forms.

Capital asset status is also important because capital gains must be offset by capital losses. If a net capital loss results, the maximum deduction is \$3,000 per year.

Consequently, capital gains and losses must be segregated from other types of gains and losses and must be reported separately on Schedule D of Form 1040.

**GLOBAL TAX ISSUES** Outsourcing of Tax Return Preparation

The use of foreign nationals to carry out certain job assignments for U.S. businesses is an increasingly popular practice. Outsourcing such activities as telemarketing to India, for example, usually produces the same satisfactory result as having the work done in the United States but at a much lower cost.

Outsourcing is also being applied to the preparation of tax returns. Not only can this practice be expected to continue, but it probably will increase in volume. Outsourcing tax return preparation does not violate Federal law and is compatible with accounting ethical guidelines as long as three safeguards are followed: First, the practitioner must make sure client confidentiality is maintained. Second, the practitioner must verify the accuracy of the work that has been outsourced. Third, the practitioner must inform clients, preferably in writing, when any third-party contractor is used to provide professional services.

Practitioners justify outsourcing as a means of conserving time and effort that can be applied toward more meaningful tax planning on behalf of their clients.

**GLOBAL TAX ISSUES:** The **Global Tax Issues** feature gives insight into the ways in which taxation is affected by international concerns and illustrates the effects of various events on tax liabilities across the globe.

# Take your students from Motivation to Mastery with CengageNOWv2

CengageNOWv2 is a powerful course management tool and online homework resource that elevates student thinking by providing superior content designed with the entire student workflow in mind.

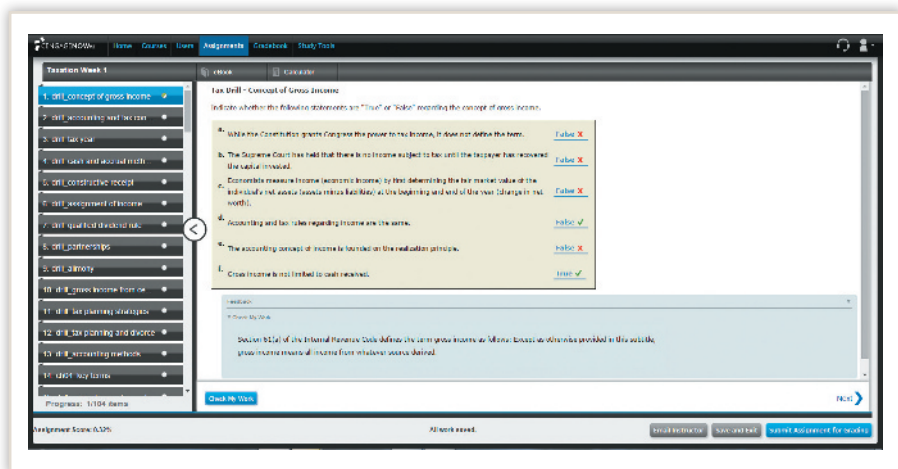


- **MOTIVATION:** engage students and better prepare them for class
- **APPLICATION:** help students learn problem-solving behavior and skills in order to complete taxation problems on their own
- **MASTERY:** help students make the leap from memorizing concepts to actual critical thinking

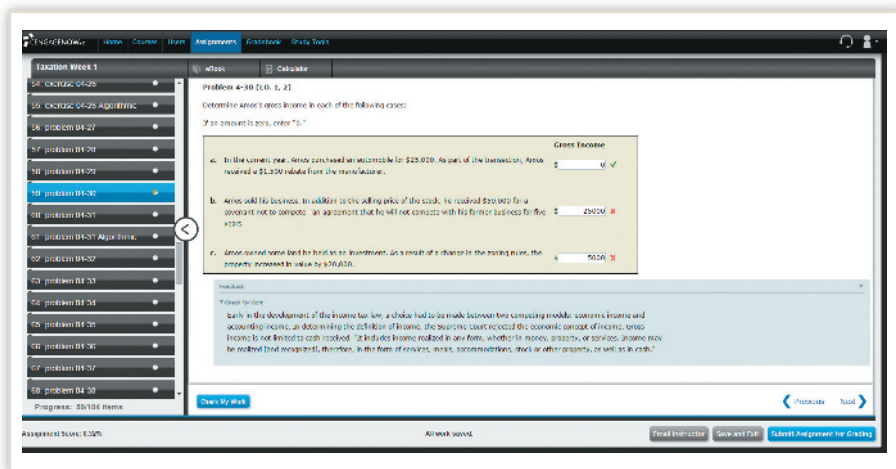
## Motivation —

Many instructors find that students come to class unmotivated and unprepared. To help with engagement and preparedness, CengageNOWv2 for SWFT offers the following features:

- **“Tax Drills” test students on key concepts and applications.** With three to five questions per learning objective, these “quick-hit” questions help students prepare for class lectures or review prior to an exam.



## Application —



Students need to learn problem-solving behavior and skills in order to complete taxation problems on their own. However, as students try to work through homework problems, sometimes they become stuck and need guidance. To help reinforce concepts and keep students on the right track, CengageNOWv2 for SWFT offers the following:

- **End-of-chapter homework from the text** is expanded and enhanced to follow the workflow a professional would use to solve various client scenarios. These enhancements better engage students and encourage them to think like a tax professional.

- **Algorithmic versions** of end-of-chapter homework are available for computational exercises and at least 15 problems per chapter.
- **“Check My Work” Feedback.** Homework questions include immediate feedback so students can learn as they go. Levels of feedback include an option for “check my work” prior to submission of an assignment.
- **Post-Submission Feedback.** After submitting an assignment, students receive even more extensive feedback explaining why their answers were incorrect. Instructors can decide how much feedback their students receive and when, including the full solution.
- **Built-in Test Bank** for online assessment.

## Mastery —

- **NEW! Tax Form Problems** are **NEW** to CengageNOWv2. Students can now complete the Cumulative H&R Block Problems found in the end-of-chapter manually in a digital environment.
- **“What-If” Questions** allow students to develop a deeper understanding of the material as they are challenged to use their prior knowledge of the tax situations and critically think through new attributes to determine how the outcome will change.
- **An Adaptive Study Plan** comes complete with an eBook, practice quizzes, crossword puzzle, glossary, and flashcards. It is designed to help give students additional support and prepare them for the exam.

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## EXTENSIVELY REVISED. DEFINITELY UP TO DATE.

Each year the *South-Western Federal Taxation* series is updated with thousands of changes to each text. Some of these changes result from the feedback we receive from instructors and students in the form of reviews, focus groups, web surveys, and personal e-mail correspondence to our authors and team members. Other changes come from our careful analysis of the evolving tax environment. **We make sure that every tax law change relevant to the introductory taxation course was considered, summarized, and fully integrated into the revision of text and supplementary materials.**

The *South-Western Federal Taxation* authors have made every effort to keep all materials up to date and accurate. All chapters contain the following general changes for the 2017 Edition.

- Updated materials to reflect changes made by the Protecting Americans from Tax Hikes (PATH) Act of 2015 and other Public Laws of 2015.
- Streamlined chapter content (where applicable) to clarify material and make it easier for students to understand.
- Revised numerous materials as the result of changes caused by indexing of statutory amounts.
- Revised Problem Materials, Computational Exercises, and CPA Exam problems.
- Updated *Tax in the News* items with coverage of recent events.
- Updated Chapter Outlines to provide an overview of the material and to make it easier to locate specific topics.
- Revised *Financial Disclosure Insights* and *Global Tax Issues* as to current developments.

In addition, the following materials are available online.

- An appendix that helps instructors broaden and customize coverage of important tax provisions of the Affordable Care Act. (Instructor Companion Website at [www.cengage.com/login](http://www.cengage.com/login))
- The Depreciation and the Accelerated Cost Recovery System (ACRS) appendix (formerly Appendix G in *SWFT Individual Income Taxes*). (Instructor Companion Website at [www.cengage.com/login](http://www.cengage.com/login))
- The Taxation in the Real World weekly blog posts for instructors. (<https://taxintherealworld.wordpress.com>)

### Chapter 1

- Updated materials to reflect inflation indexation including the unified transfer tax credit and exemption amount, annual gift tax exclusion amount, and FICA base amount.

- Updated information related to interest on assessments and refunds.

### Chapter 2

- Updated references and citations throughout the chapter.
- Added a new *Ethics & Equity* feature on tax fraud.
- Updated materials on administrative tax law sources and commercial tax services.

### Chapter 3

- Updated materials to reflect inflation indexation.
- Reorganized materials on filing status and related filing requirements.
- Revised and expanded the Concept Summary related to dependency exemption tests.

### Chapter 4

- Added Concept Summary comparing taxation of income and distributions from partnerships, S corporations, and estates/trusts.
- Modified exercises, where appropriate, to have students look up present values in appendix rather than be given the present and future value amounts.

### Chapter 5

- Updated scholarship examples to illustrate tax effect of cost of attendance scholarships that many student-athletes receive today. Also added a *Tax in the News* feature on this NCAA development and the effect of taxable scholarships on the kiddie tax.
- Added a *Tax in the News* feature on a 2015 tax court decision as to whether compensation received for donating eggs was excludable damages.
- Added an *Ethics & Equity* feature on employee meals offered by some high-tech companies.
- Revised foreign earned income exclusion examples to reflect that 2016 is a leap year.
- Expanded coverage of Education Savings Programs to include not only § 529 plans but also § 530 Coverdell Education Savings Accounts.
- Modified coverage on income from discharge of indebtedness to highlight differences between recourse and non-recourse debt.
- Updated amounts for inflation and 2015 law changes, such as the parity for the qualified transit pass fringe benefit.

## Chapter 6

- Updated the exhibit on the more common deductions *for* AGI and provided links to text coverage.
- Revised and relocated the time value of money discussion to an earlier part of the chapter.
- Revised the *Tax in the News* feature on executive compensation.
- Added a Concept Summary related to common questions posed by the IRS related to hobby losses.
- Revised the discussion of the materials regarding when repairs and maintenance must be capitalized or can be expensed and added several examples.

## Chapter 7

- Added a Concept Summary on casualty losses.
- Revised bad debt deduction Concept Summary.
- Updated the discussion of worthless securities and small business stock losses.
- Revised and clarified text and examples throughout the chapter, including modifications for annual inflation indexation.

## Chapter 8

- Added a Concept Summary on MACRS (class lives, methods, and conventions), enhanced the exhibit on cost recovery periods for personalty, and revised and updated text and examples throughout the chapter.
- Streamlined material on MACRS special rules.
- Updated materials to reflect tax extender legislation involving additional first-year depreciation and § 179 expense election.

## Chapter 9

- Added a Concept Summary on employee vs. independent contractor, including the IRS categories of behavioral control, financial control, and the relationship of the parties.
- Updated the standard mileage allowance for 2016.
- Expanded the discussion of the record-keeping and substantiation requirements for entertainment expenses.
- Updated the summary dealing with the many tax provisions involving education.
- Updated various retirement contribution amounts for inflation.

## Chapter 10

- Revised and clarified examples throughout the chapter.
- Updated chapter materials for 2016 inflation adjustments and legislative changes.
- Revised three *Tax in the News* features: one relating to the current cost of tax expenditures, another covering the maximum HSA contribution amounts, and one regarding the impact of the overall limitation on itemized deductions on President and Mrs. Obama's 2014 tax return.
- Rewrote a *Global Tax Issues* feature with a focus on the recent Nepal earthquake.

## Chapter 11

- Changed the term “passive loss/income” to “passive activity loss/income” to be consistent with the statutory language.
- Clarified language at several points in the chapter to eliminate ambiguity.
- Noted judicial authority that held a trust also could qualify for the real estate professional rule.

## Chapter 12

- Updated statistics as to filing patterns for the AMT and AMT liabilities by state residents.
- Revised *Ethics & Equity* feature about accelerating AMT preferences and adjustments.
- Augmented materials concerning adjustments for incentive stock options.
- Revised materials as to AMT preference for sales of § 1202 stock.
- Added problems featuring Excel commands and present value computations.

## Chapter 13

- Revised and clarified text and examples throughout the chapter, including changes made by the PATH Act of 2015.
- Updated chapter materials for inflation adjustments and for various computational formulas and amounts.
- Streamlined coverage of payment procedures.
- Updated material summarizing key tax provisions of the Affordable Care Act.

## Chapter 14

- Added a Concept Summary (and related examples) on the wash sale rules.
- Added opening overviews to multiple sections of the chapter.
- Clarified the discussion of the tax implications of easements.
- Revised and clarified text and examples throughout the chapter.

## Chapter 15

- Updated the discussion and examples related to like-kind exchanges.
- Added a Concept Summary on delayed like-kind exchanges.
- Updated the Form 8824 illustration.
- Revised and clarified text and examples throughout the chapter.

## Chapter 16

- Updated qualified small business stock materials to reflect changes made by the PATH Act of 2015.
- Updated Concept Summary 16.4 (the alternative tax on capital gain computation).
- Updated the chapter tax return example [including the Form 8949, Schedule D (Form 1040), and the capital gains worksheet].
- Revised and clarified text and examples throughout the chapter.

## Chapter 17

- Revised and clarified text and examples throughout the chapter.

- Updated the chapter tax return example, clearly linking the example computations to placement on the various tax forms. Updated the Form 4797 and Schedule D (Form 1040).

## Chapter 18

- Updated information on due date for Form 1128.
- Clarified examples involving changes from cash to accrual method to reflect that inventory is treated as non-incidentals supplies while on the cash method.
- Added a *Tax in the News* feature on FASB revenue recognition standards and tax relevance.
- Added new exercise (49) on computing and reporting a § 481(a) adjustment.

## Chapter 19

- Updated for inflation adjustments and PATH change to make the IRA distribution to charity rule permanent.
- Updated *Tax in the News* feature on professional athletes.
- Added a new *Tax in the News* feature on non-cash compensation.
- Removed example on NQSO where option traded on exchange (transaction is uncommon).

## Chapter 20

- Noted qualified joint ventures as another business filing option for married couples.
- Updated to reflect new due dates for partnership and C corporation returns starting in 2016.

## TAX LAW OUTLOOK

### *From your SWFT Series Editors:*

Concerns about income inequity and job creation will keep income tax issues at the forefront of tax-related discussions throughout 2016 and 2017. Candidates and office holders will focus tax proposals on middle-class tax relief and tax increases for the wealthy. Federal tax treatments of income from overseas sources also may be reviewed. While a comprehensive “tax reform” bill is not likely, there will be serious consideration of various proposals, especially involving college tuition relief and the taxation of capital gains.

## SUPPLEMENTS SUPPORT STUDENTS AND INSTRUCTORS

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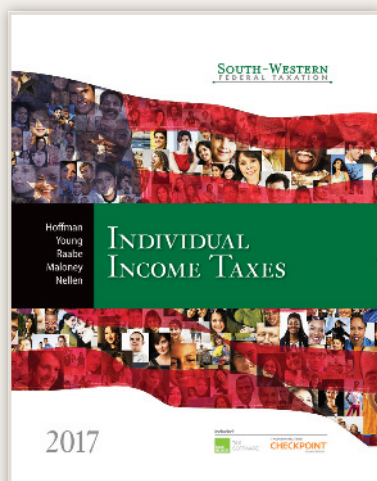
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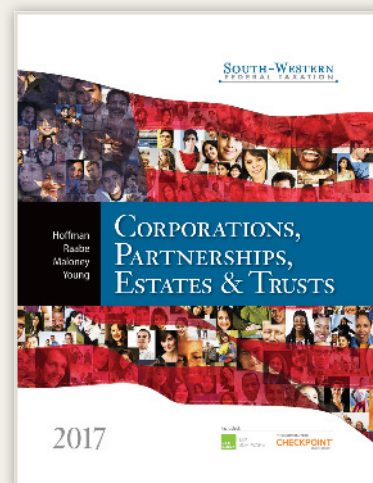
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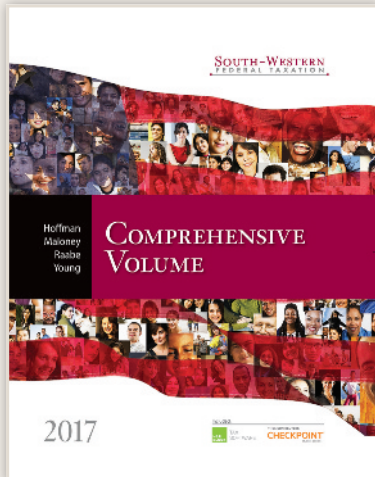
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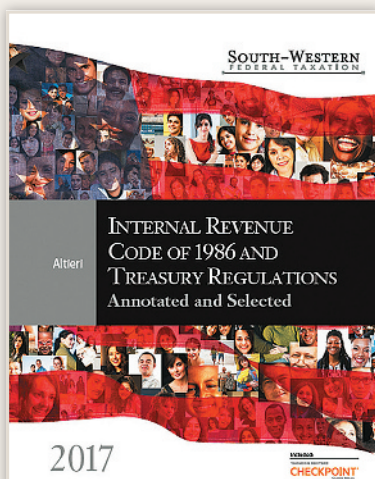
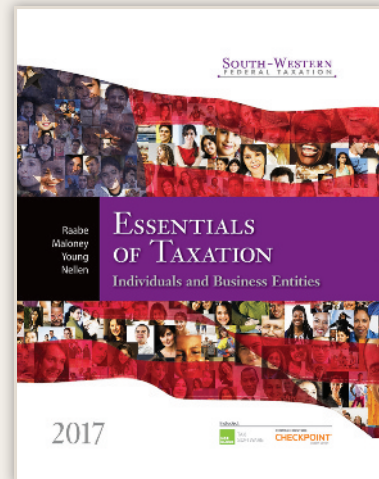
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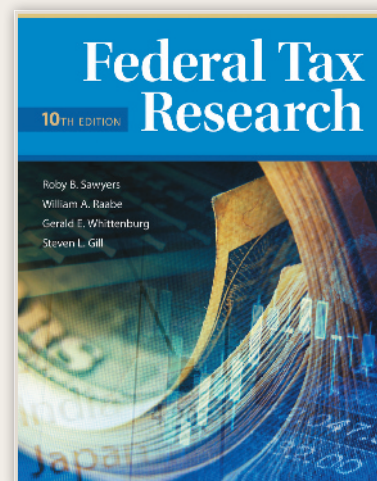
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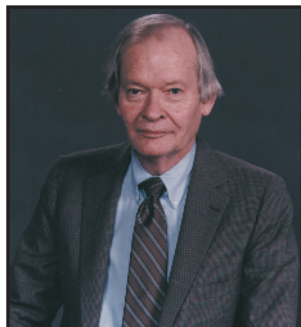
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