Test Bank for Pearsons Federal Taxation 2021 Comprehensive 34th Rupert

***Pearson's Federal Taxation 2021: Comp., 34e* (Rupert/Anderson)**
Chapter C1: Tax Research

LO1: Overview of Tax Research

1) Tax planning is not an integral part of open-fact situations.
Answer: FALSE
Explanation: It is integral.
Page Ref.: C:1-2
Objective: 1

2) When a taxpayer contacts a tax advisor requesting advice as to the most advantageous way to dispose of a stock, the tax advisor is faced with
A) a restricted-fact situation.
B) a closed-fact situation.
C) an open-fact situation.
D) a recognized-fact situation.
Answer: C
Explanation: Advice before transaction is open fact situation.
Page Ref.: C:1-2
Objective: 1

3) Investigation of a tax problem that involves a closed-fact situation means that
A) the client's transactions have already occurred and the tax questions must now be resolved.
B) the client's tax return has yet to be filed.
C) future events may be planned and controlled.
D) research is primarily concerned with applying the law to the facts as they exist.
Answer: A
Explanation: After the fact request is a closed fact situation.
Page Ref.: C:1-2
Objective: 1

4) Explain the difference between a closed-fact and open-fact situation.
Answer: In a closed-fact situation, the transaction has occurred and the facts are not subject to change. In an open-fact situation, the transaction is in the formative or projected stage, and the taxpayer is able to structure the facts so that the tax consequences of the transaction can be more favorable.
Page Ref.: C:1-2
Objective: 1

5) In all situations, tax considerations are of primary importance. Do you agree or disagree? Support your answer.
Answer: It is important to consider nontax objectives as well as tax objectives. For instance, if a wealthy client wants to minimize her estate taxes while passing the greatest value possible to her descendants, you would not suggest that she leave the majority of her estate to charity and only a few hundred thousand dollars to her descendants. Although this would reduce her estate tax liability to zero, it would be inconsistent with her objective of allowing her descendants to receive as much after-tax wealth as possible.
Page Ref.: C:1-2; Example C:1-2
Objective: 1

LO2: Steps in the Tax Research Process

1) Identify which of the following statements is true.
A) Tax planning is an integral part of both closed-fact situations and open-fact situations.
B) The first step in conducting tax research is to clearly understand the issues involved.
C) The Statements on Standards for Tax Services recommend that only written tax advice be provided to the client in all situations.
D) All of the above are false.
Answer: C
Explanation: The Statements on Standards for Tax Services recommend that only written tax advice be provided to the client in all situations.
Page Ref.: C:1-3 through C:1-5
Objective: 2

2) Describe the format of a client memo.
Answer: A client memo should include a statement of the facts, a list of issues, a discussion of relevant authority, analysis, and recommendations of appropriate actions to the client based on the research results.
Page Ref.: See Additional Comment page C:1-4
Objective: 2

3) Outline and discuss the tax research process.
Answer:
1) The facts must be determined. However, some facts may not have occurred in an open-fact situation. Where facts have not yet occurred, it is useful to review tax research material to determine which facts would produce the most favorable outcome.
2) The issues must be determined. The issues may not always be clear and may be different than the client believes. Thus, only a thorough understanding of the facts permits an adequate formulation of the issues.
3) Determine which authorities are applicable.
4) Evaluate the authorities. Choose the ones to follow when there are conflicting authorities.
5) Communicate the result to the client. The communication with the client should not result in a misunderstanding. While discussions with the client may be suitable, it is recommended by the AICPA's Statements on Standards for Tax Services that the communication be written where issues are important, unusual or complicated. Many firms require that conclusions be communicated in writing.
Page Ref.: C:1-4
Objective: 2

LO3: Importance of the Facts to the Tax Consequences

1) The tax consultant can give an opinion on a tax fact pattern without all the facts.
Answer: FALSE
Explanation: Tax practitioner should not provide an opinion without all relevant facts.
Page Ref.: C:1-6
Objective: 3

2) Tax compliance is the biggest component of a tax practice.
Answer: FALSE
Explanation: Tax consulting is the biggest component of tax practice.
Page Ref.: C:1-6
Objective: 3

LO4: The Sources of Tax Law

1) The Internal Revenue Code of 1986 contains the current version of the tax law.
Answer: TRUE
Explanation: The last update was 1986.
Page Ref.: C:1-8
Objective: 4

2) Regulations issued prior to the latest tax legislation dealing with a specific Code section are still effective to the extent they do not conflict with the provisions in the new legislation.
Answer: TRUE
Explanation: Per IRC this remains accurate.
Page Ref.: C:1-9
Objective: 4

3) Final regulations have almost the same legislative weight as the IRC.
Answer: TRUE
Explanation: The Courts have followed this concept.
Page Ref.: C:1-10
Objective: 4

4) A revenue ruling is issued by the Internal Revenue Service only in response to a verbal inquiry by a taxpayer.
Answer: FALSE
Explanation: The IRS may voluntarily issue a revenue ruling.
Page Ref.: C:1-12
Objective: 4

5) Taxpayers must pay the disputed tax prior to filing a case with the Tax Court.
Answer: FALSE
Explanation: Tax Court is the only court available in which taxpayer does not have to prepay the tax.
Page Ref.: C:1-14 and C:1-15
Objective: 4

6) Appeals from the U.S. Tax Court are to the Court of Appeals for the Federal Circuit.
Answer: FALSE
Explanation: Appeals from the US Tax Court are to the Court of Appeals for the respective circuit.
Page Ref.: C:1-14 and C:1-15
Objective: 4

7) Appeals from the Court of Appeals go to the Supreme Court under a writ of certiorari. The Supreme Court decides whether or not they will hear the case.
Answer: TRUE
Explanation: USSC reviews requests before acceptance.
Page Ref.: C:1-14 and C:1-15
Objective: 4

8) When the Tax Court follows the opinion of the circuit court of appeals to which the case is appealable, the court is following the
A) Golsen rule.
B) Acquiescence rule.
C) Forum shopping rule.
D) Conformity rule.
Answer: A
Explanation: Since 1970 the Tax Court has followed the Golsen concept.
Page Ref.: C:1-21
Objective: 4

9) Which of the following citations denotes a regular decision of the Tax Court?
A) 41 TCM 1272
B) 35 T.C. 1083 (2003)
C) 39 AFTR 2d 77-640
D) all of the above
Answer: B
Explanation: TC is Tax Court citation.
Page Ref.: C:1-17
Objective: 4

10) The primary citation for a federal circuit court of appeals case would be
A) 40 AFTR 2d 78-1234.
B) 44 F.Supp. 403.
C) 3 F.3d 134.
D) 79-2 USTC & 9693.
Answer: C
Explanation: Citation for federal circuit.
Page Ref.: C:1-20
Objective: 4

11) You have the following citation: Joel Munro, 92 T.C. 71 (1989). Which of the following statements is <u>true</u>?
A) The taxpayer, Joel Munro, won the case because there is no reference to the IRS.
B) The case appears on page 71 in Volume 92 of the official Tax Court of the United States Reports and the case was decided in 1989.
C) This citation refers to a taxpayer conference between the IRS and the taxpayer.
D) The case was tried in 1989 and was appealed in 1992.
Answer: B
Explanation: Citation locator is correct.
Page Ref.: C:1-17
Objective: 4

12) The term "tax law" includes
A) legislation.
B) treasury regulations.
C) judicial decisions.
D) all of the above.
Answer: D
Explanation: Each of these have value of tax law.
Page Ref.: C:1-7
Objective: 4

13) Identify which of the following statements is false.
A) When tax advisors speak of the "tax law," they usually have in mind just the Internal Revenue Code.
B) Members from both the House and the Senate are on the Conference Committee.
C) Records of committee hearings are helpful in determining Congressional intent.
D) All of the above are false.
Answer: A
Explanation: IRC is the main source document.
Page Ref.: C:1-7
Objective: 4

14) The committee that is responsible for holding hearings on tax legislation for the House of Representatives is the
A) Finance Committee.
B) Joint Committee on Taxation.
C) Conference Committee.
D) Ways and Means Committee.
Answer: D
Explanation: The Ways and Means is responsible for holding hearings on tax legislation.
Page Ref.: C:1-7
Objective: 4

15) A tax bill introduced in the House of Representatives is then
A) referred to the House Ways and Means Committee for hearings and approval.
B) referred to the entire House for hearings.
C) voted upon by the entire House.
D) forwarded to the Senate Finance Committee for consideration.
Answer: A
Explanation: Tax bills are referred to the Ways and Means Committee.
Page Ref.: C:1-7
Objective: 4

16) The Senate equivalent of the House Ways and Means Committee is the Senate
A) Finance Committee.
B) Ways and Means Committee.
C) Tax Committee.
D) Joint Conference Committee.
Answer: A
Explanation: Senate committee is Finance Committee.
Page Ref.: C:1-7
Objective: 4

17) Which of the following steps, related to a tax bill, occurs first?
A) signature or veto by the President of the United States
B) consideration by the Senate Finance Committee
C) consideration by the entire Senate
D) consideration by the House Ways and Means Committee
Answer: D
Explanation: Tax bill is considered by House Ways and Means Committee.
Page Ref.: C:1-7
Objective: 4

18) When the House and Senate versions of a tax bill are not in agreement, the disagreements are resolved by the
A) Ways and Means Committee.
B) Mediation Committee.
C) Revenue Committee.
D) Conference Committee.
Answer: D
Explanation: Conference committee resolves disagreements.
Page Ref.: C:1-7
Objective: 4

19) Identify which of the following statements is true.
A) Paragraph references are most commonly used when citing or referring to the tax statutes.
B) Title 26 of the United States Code and the Internal Revenue Code of 1986 are synonymous.
C) Before 1939, tax statutes were codified or compiled into one document.
D) The Internal Revenue Code contains chapters, which are further subdivided into titles.
Answer: B
Explanation: IRC is Title 26 of the USC.
Page Ref.: C:1-8
Objective: 4

20) Title 26 of the U.S. Code includes
A) income tax legislation only.
B) gift tax and estate tax legislation only.
C) alcohol and tobacco tax legislation only.
D) all of the tax legislation mentioned above.
Answer: D
Explanation: Title 26 covers tax legislation.
Page Ref.: C:1-8
Objective: 4

21) The tax statutes with the popular name "The Internal Revenue Code of 1986" are contained in which Title of the Code?
A) 20
B) 25
C) 26
D) 301
Answer: C
Explanation: Title 26 covers tax legislation.
Page Ref.: C:1-8
Objective: 4

22) Which of the following statements regarding proposed regulations is <u>not</u> correct?
A) Proposed regulations expire after three years.
B) Practitioners and other interested parties may comment on proposed regulations.
C) Proposed and temporary regulations are generally issued simultaneously.
D) Proposed regulations do not provide any insight into the IRS's interpretation of the tax law.
Answer: D
Explanation: Proposed regulations provide insight into the IRS's interpretation of the tax law.
Page Ref.: C:1-9
Objective: 4

23) Final regulations can take effect on any of the following dates <u>except</u>
A) the effective date of the statutory language they interpret, provided they are issued within 18 months of the date of the change to the statute.
B) the date on which final regulations were proposed.
C) the date on which related temporary regulations were first published in the Federal Register.
D) the date on which they were issued in final form.
Answer: A
Explanation: Once finalized, regulations can be effective the earliest of (1) the date they were filed with the *Federal Register,* a daily publication that contains federal government pronouncements; (2) the date temporary regulations preceding them were first published in the *Federal Register*; or (3) the date on which a notice describing the expected contents of the regulation was issued to the public. For changes to the IRC enacted after July 29, 1996, the Treasury Department generally cannot issue regulations with retroactive effect.
Page Ref.: C:1-10
Objective: 4

24) When Congress passes a statute with language such as, "The Secretary shall prescribe such regulations as he may deem necessary," the regulations ultimately issued for that statute are
A) congressional regulations.
B) statutory regulations.
C) interpretative regulations.
D) legislative regulations.
Answer: D
Explanation: Whenever the IRC contains language such as "The Secretary shall prescribe such regulations as he may deem necessary" or "under regulations prescribed by the Secretary," the regulations interpreting the IRC provision are legislative.
Page Ref.: C:1-10
Objective: 4

25) Regulations are
A) equal in authority to legislation.
B) equal in authority to legislation if statutory.
C) presumed to be valid and to have almost the same weight as the IRC.
D) equal in authority to legislation if interpretative.
Answer: C
Explanation: Final Treasury Regulations are presumed to be valid and have almost the same authoritative weight as the IRC.
Page Ref.: C:1-10
Objective: 4

26) Identify which of the following statements is <u>true</u>.
A) If regulations are issued prior to the latest tax legislation dealing with a specific Code section, the regulations are no longer effective to the extent they conflict with the provisions in the new legislation.
B) Legislative regulations are more likely to be invalidated by the courts than are interpretative regulations.
C) Regulations have more authoritative weight than tax statutes.
D) All of the above are false.
Answer: A
Explanation: Because of frequent IRC changes, the Treasury Department does not always update the regulations in a timely manner. Consequently, when consulting a regulation, a tax advisor should check its introductory or end note to determine when the regulation was adopted. If the regulation was adopted before the most recent revision of the applicable IRC section, the regulation should be treated as authoritative to the extent consistent with the revision. Thus, for example, if a regulation issued before the passage of an IRC amendment specifies a dollar amount, and the amendment changed the dollar amount, the regulation should be regarded as authoritative in all respects except for the dollar amount.
Page Ref.: C:1-9
Objective: 4

27) Identify which of the following statements is false.
A) The number "5" in the citation Reg. Sec. 1.166-5 refers to the paragraph number.
B) The Cumulative Bulletin is issued semiannually while the Internal Revenue Bulletin is issued weekly.
C) The citation Rev. Rul. 2006-5, I.R.B. 2006-1, 33, indicates that the revenue ruling can be found on page 33 of the 1st I.R.B. for 2006.
D) All of the above are false.
Answer: A
Explanation: -# does not reference the paragraph number.
Page Ref.: C:1-11
Objective: 4

28) The number appearing immediately following the decimal place in a regulation citation refers to the
A) general subject matter of the regulation.
B) Code section being interpreted.
C) sequential number of the regulation.
D) subsection of the Code section being interpreted.
Answer: B
Explanation: # appearing after decimal refers to code section.
Page Ref.: C:1-11
Objective: 4

29) The citation "Reg. Sec. 1.199-2" refers to
A) the first regulation issued in 1999.
B) the second regulation issued in 1999.
C) a regulation that interprets Code Section 199.
D) a regulation that can be found on page 199.
Answer: C
Explanation: # appearing after decimal refers to code section.
Page Ref.: C:1-11
Objective: 4

30) Which regulation deals with Code Section 165?
A) Reg. Sec. 1.165-5
B) Reg. Sec. 165.183-5
C) Reg. Sec. 1.5-165
D) Reg. Sec. 165-5
Answer: A
Explanation: # appearing after decimal refers to code section.
Page Ref.: C:1-11
Objective: 4

31) Which regulation deals with the gift tax?
A) Reg. Sec. 1.165-5
B) Reg. Sec. 20.2014-5
C) Reg. Sec. 25.2518-5
D) Reg. Sec. 301.7002-5
Answer: C
Explanation: Code section 2518 is a gift tax matter.
Page Ref.: C:1-11
Objective: 4

32) Which of the following best describes the weight of a revenue ruling?
A) Revenue rulings carry more weight than regulations.
B) Revenue rulings carry more weight than federal court decisions.
C) Regulations carry more weight than revenue rulings.
D) Revenue rulings should never be used as authority since they only apply to the taxpayer requesting the ruling.
Answer: C
Explanation: Regulations carry more weight than revenue rulings.
Page Ref.: C:1-12
Objective: 4

33) The citation "Rev. Rul. 2006-8, 2006-1 C.B. 541" refers to
A) the eighth ruling of 2006 found on page 541 in Vol. 1 of the 2006 Cumulative Bulletin.
B) the eighth ruling of 2006 found on page 541 in the 2006 volume of the Cumulative Bulletin.
C) the 541st ruling of 2006 found on page eight in Vol. 1 of the 2006 Cumulative Bulletin.
D) the 1st ruling of 2006 found on page 541 in the 2006 volume of the Cumulative Bulletin.
Answer: A
Explanation: Citation log is correct.
Page Ref.: C:1-12
Objective: 4

34) Which of the following documents is issued by the IRS to a specific taxpayer?
A) regulation
B) revenue procedure
C) letter ruling
D) information release
Answer: C
Explanation: Letter rulings are addressed to specific taxpayer.
Page Ref.: C:1-12
Objective: 4

35) Identify which of the following statements is false.
A) A revenue ruling is issued by the Internal Revenue Service only in response to a written inquiry by a taxpayer.
B) Rev. Proc. 2006-19 is a revenue procedure that was published in 2006.
C) The citation Ltr. Rul. 200611075 usually indicates the ruling was made public in the 11th week of 2006.
D) A technical advice memorandum is made available as a letter ruling.
Answer: A
Explanation: Letter rulings are only issued in response to written taxpayer request.
Page Ref.: C:1-11 through C:1-13
Objective: 4

36) Identify which of the following statements is false.
A) Letter rulings are not published by the U.S. Government Printing Office.
B) Technical advice memoranda are issued by the Internal Revenue Service's National Office to provide an answer to a technical question that arises in an audit.
C) The citation Ann. 2006-12, I.R.B. 2006-51, 22 refers to an annotation of an Internal Revenue Service release.
D) Announcements are more technical than information releases.
Answer: C
Explanation: Citation is wrong.
Page Ref.: C:1-13
Objective: 4

37) A Technical Advice Memorandum is usually
A) an internal IRS document describing alternative legislative proposals.
B) part of a Tax Court decision.
C) requested by the taxpayer before entering into a taxable transaction.
D) issued by the national office in response to an audit request.
Answer: D
Explanation: TAMs are usually issued to address request from IRS auditors.
Page Ref.: C:1-13
Objective: 4

38) Which of the following courts is not a trial court for tax cases?
A) U.S. Bankruptcy Court
B) U.S. District Court
C) U.S. Tax Court
D) U.S. Court of Federal Claims
Answer: A
Explanation: Bankruptcy Court does not have jurisdiction for tax matters.
Page Ref.: C:1-14 and C:1-15
Objective: 4

39) The taxpayer need <u>not</u> pay the disputed tax in advance when the suit is initiated in
A) U.S. Court of Federal Claims.
B) U.S. Tax Court.
C) U.S. District Court.
D) both A and B.
Answer: B
Explanation: Tax Court taxpayer does not have to pay disputed amount up front.
Page Ref.: C:1-14 and C:1-15
Objective: 4

40) If the U.S. Supreme Court decides to hear an appeal of a tax case, it will grant a
A) writ of appeal.
B) writ of certiorari.
C) writ of detainer.
D) writ of habeas corpus.
Answer: B
Explanation: Granting review by USSC is done via writ of certiorari.
Page Ref.: C:1-14 and C:1-15
Objective: 4

41) Tax Court memorandum decisions
A) cannot be appealed.
B) are not published.
C) have less precedential value than regular decisions.
D) usually deal with factual variations of issues litigated previously.
Answer: D
Explanation: Tax Court memos usually deal with factual variations of issues litigated previously.
Page Ref.: C:1-15 and C:1-17
Objective: 4

42) George's case was handled under the "small tax case procedure." He does not agree with the findings of the Tax Court. He would like to appeal the decision. Which one of the following is <u>true</u>?
A) There is no appeal.
B) He can appeal the case, but only if the amount of tax involved is greater than $5,000.
C) He would appeal first to the U.S. Court of Appeals for the Federal Circuit.
D) He would appeal first to the U.S. Court of Federal Claims.
Answer: A
Explanation: Small Tax Case do not allow appeal process.
Page Ref.: C:1-17
Objective: 4

43) Identify which of the following statements is false.
A) The acquiescence policy was adopted by the U.S. Tax Court to permit litigating parties to agree on the exact amount of the tax due.
B) Letter rulings are binding only with respect to the taxpayer requesting the ruling.
C) The small cases procedure of the U.S. Tax Court allows a less formal hearing but provides for no appeal.
D) The IRS may retroactively revoke an acquiescence.
Answer: A
Explanation: Acquiescence policy the party states it does not agree but will not appeal the decision.
Page Ref.: C:1-17
Objective: 4

44) The phrase "Entered under Rule 155" indicates that
A) the computation of the exact amount of the tax deficiency has been left to the litigating parties.
B) the court has not reached a decision concerning the appropriate tax treatment of an issue.
C) the parties have agreed not to appeal the decision.
D) only one Tax Court judge reviewed the case.
Answer: A
Explanation: Rule 155 allows computation of exact amount been left to the litigating parties.
Page Ref.: C:1-17
Objective: 4

45) Small case procedures of the U.S. Tax Court requires that the amount in dispute not exceed
A) $5,000.
B) $10,000.
C) $50,000.
D) $100,000.
Answer: C
Explanation: Small tax court cap is 50,000.
Page Ref.: C:1-17
Objective: 4

46) The acquiescence policy of the IRS extends to the
A) U.S. Supreme Court decisions.
B) U.S. Tax Court regular decisions.
C) U.S. District Court decisions.
D) both B and C
Answer: D
Explanation: IRS cannot appeal USSC decisions.
Page Ref.: C:1-17
Objective: 4

47) A tax case <u>cannot</u> be appealed when initiated in the
A) U.S. Court of Federal Claims.
B) U.S. Tax Court.
C) U.S. Tax Court using the small case procedures.
D) none of the above
Answer: C
Explanation: Small tax case does not allow appeal.
Page Ref.: C:1-17
Objective: 4

48) Identify which of the following statements is <u>false</u>.
A) Regular and memorandum decisions of the Tax Court are published by the government in the <u>Tax Court of the United States Reports</u>.
B) The citation <u>Cristofani</u>, 97 T.C. 74 (1991) indicates that the decision is a regular decision of the Tax Court.
C) The citation <u>Estate of Newhouse</u>, 94 T.C. 193 (1990), <u>nonacq.</u> 1991-1 C.B. 1 indicates that the IRS did not formally disagree with this 1990 Tax Court decision until 1991.
D) The Board of Tax Appeals preceded the Tax Court.
Answer: A
Explanation: Tax Court decisions are not published in this reporter.
Page Ref.: C:1-17
Objective: 4

49) You need to locate a recent tax case that was tried in a Federal district court. The decision is an "unreported" decision. This means the decision was
A) not published in the Federal Supplement.
B) not published in American Federal Tax Reports.
C) not published in United States Tax Cases.
D) settled out of court.
Answer: A
Explanation: Unreported means it was not published in the federal supplement.
Page Ref.: C:1-18
Objective: 4

50) A jury trial is permitted in the
A) U.S. District Court.
B) U.S. Tax Court.
C) U.S. Court of Federal Claims.
D) U.S. Tax Court when the small case procedures are used.
Answer: A
Explanation: Tax Court does not permit a jury trial.
Page Ref.: C:1-18
Objective: 4

51) Which of the following citations is the primary citation for a U.S. District Court case?
A) 43 AFTR 2d 79-1023
B) 79-1 USTC &9323
C) 55 F.2d 930
D) 40 F.Supp. 453
Answer: D
Explanation: Federal Supplement is primary citation for US district court.
Page Ref.: C:1-19
Objective: 4

52) Identify which of the following statements is true.
A) The citation, 41 TCM 1272, refers to a Tax Court regular decision published by Commerce Clearing House.
B) The Federal Supplement contains only tax cases.
C) The American Federal Tax Reports contain only tax cases.
D) All of the above are false.
Answer: C
Explanation: American Federal Tax Reports contain only tax cases.
Page Ref.: C:1-19
Objective: 4

53) Identify which of the following statements is true.
A) The U.S. Court of Federal Claims hears cases only in Washington, D.C.
B) Each state has at least one U.S. District Court.
C) Federal district court decisions and federal courts of appeals decisions are not printed by the U.S. Government Printing Office.
D) All of the above are false.
Answer: B
Explanation: Every state has at least one district court.
Page Ref.: C:1-18
Objective: 4

54) Identify which of the following statements is false.
A) Citations to the AFTR and the USTC are referred to as secondary citations.
B) A circuit court of appeals must follow the opinion of another circuit court of appeals if the latter appeals court has previously ruled on the tax issue.
C) A U.S. Supreme Court opinion in a tax matter has the same status as Congressional tax legislation.
D) Circuit Court decisions are reported in the Federal Reporter.
Answer: B
Explanation: Each circuit court is independent of other circuit courts.
Page Ref.: C:1-20
Objective: 4

55) Identify which of the following statements is false.
A) The U.S. Tax Court must follow the previous decisions of the U.S. District Court for the district in which the taxpayer lives.
B) The U.S. Tax Court follows the previous decisions of the U.S. Court of Appeals to which the tax matter is appealable.
C) The opportunity for "forum shopping" occurs when different precedents on the same point exist.
D) The U.S. Tax Court may intentionally issue conflicting decisions.
Answer: A
Explanation: US Tax Court is not bound by US District Court decisions.
Page Ref.: C:1-21
Objective: 4

56) The Tax Court departs from its general policy of ruling uniformly for all taxpayers where
A) a U.S. District Court has ruled differently on the issue in the taxpayer's jurisdiction.
B) the U.S. Court of Federal Claims has ruled differently on the issue in the taxpayer's jurisdiction.
C) the Court of Appeals in the circuit to which the Tax Court decision would be appealed has ruled differently on the issue.
D) the IRS has indicated that it will acquiesce.
Answer: C
Explanation: Tax Court will generally follow the precedent of Court of Appeals for its district.
Page Ref.: C:1-21
Objective: 4

57) Identify which of the following statements is false.
A) When a court opinion discusses facts and issues on which the court does not rule, the comments are called *dicta*.
B) *Dicta* in a court opinion has no influence on other tax proceedings.
C) Published articles and tax services are examples of secondary sources of authority.
D) *Dicta* are not authoritative.
Answer: B
Explanation: Dicta is a court opinion with influence on other court proceedings.
Page Ref.: C:1-23
Objective: 4

58) When a court discusses issues not raised by the facts, the comments
A) are excluded from the formal court opinion.
B) may be referenced by the parties in other cases having the same facts.
C) are not *dicta*.
D) will cause the court's decision to be declared invalid.
Answer: B
Explanation: Court has discretion to reference other cases having same facts.
Page Ref.: C:1-23
Objective: 4

59) Which of the following is a true statement regarding primary authority of tax law?
A) Articles in The Journal of Taxation are viewed as primary authority.
B) Primary authority includes the Code, as well as administrative and judicial interpretations.
C) The Bloomberg BNA Daily Tax Reporter is a source of primary tax authority.
D) Tax services are sources of primary tax authority.
Answer: B
Explanation: Primary authority originates with IRC, administrative and judicial interpretations
Page Ref.: C:1-24
Objective: 4

60) Which of the following is secondary authority?
A) Internal Revenue Code
B) Treasury Regulations
C) RIA and CCH tax services
D) Revenue Ruling
Answer: C
Explanation: Third party sources are secondary authority.
Page Ref.: C:1-24
Objective: 4

61) Explain how committee reports can be used in tax research. What do they indicate?
Answer: Committee reports can help resolve ambiguities in statutory language by revealing Congressional intent. They are indicative of this intent.
Page Ref.: C:1-7
Objective: 4

62) In 1998, Congress passed legislation concerning shifting the burden of proof to the IRS. The taxpayer must introduce "credible evidence" to shift the burden of proof to the IRS. What constitutes "credible evidence"?
Answer: The term is not defined in the IRC. Because the provision is relatively new, few courts have had an opportunity to interpret what "credible evidence" means. In the absence of relevant statutory or judicial authority, you might look to the committee reports to ascertain what Congress intended by the term. Senate Report No. 105-174 states that "credible evidence" means evidence of a quality, which, "after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted."
Page Ref.: C:1-7 and C:1-8; Example C:1-4
Objective: 4

63) Does Title 26 contain statutory provisions dealing only with income taxation? Explain.
Answer: No; Title 26 deals with all taxation matters, not just income taxation. It covers estate tax, gift tax, employment tax, alcohol and tobacco tax, and excise tax matters.
Page Ref.: C:1-8
Objective: 4

64) What is the purpose of Treasury Regulations?
Answer: The Treasury Department issues regulations that expound upon the IRC. Treasury Regulations often contain examples with computations that provide valuable assistance in understanding the statutory language.
Page Ref.: C:1-9
Objective: 4

65) Why should tax researchers take note of the date on which a Treasury Regulation was adopted?
Answer: Researchers should note the date on which a Treasury Regulation was adopted because the IRC may have been revised subsequent to the date of adoption. That is, the regulation may not interpret the current version of the IRC. Discrepancies between the IRC and the regulation occur when the Treasury Department has not updated the regulation to reflect the current statute.
Page Ref.: C:1-9 and C:1-10
Objective: 4

66) Discuss the purposes and scope of temporary regulations.
Answer: Temporary regulations are issued by the Treasury Department after statutory changes have occurred to give guidance with respect to procedural and computational matters. Temporary regulations are also issued as proposed regulations with the same authoritative value as final regulations.
Page Ref.: C:1-9
Objective: 4

67) What are the purposes of citations in tax research?
Answer: Citations serve two purposes. First, they substantiate propositions, and second, they enable the reader to locate underlying authority.
Page Ref.: C:1-11
Objective: 4

68) Are letter rulings of precedential value to third parties?
Answer: Not really. A letter ruling is binding only on the taxpayer to whom the ruling was issued. However, the rulings can be useful in proving insights as to the IRS opinion about the tax consequences of various transactions.
Page Ref.: C:1-12 and C:1-13
Objective: 4

69) What is the difference between a taxpayer-requested letter ruling and a technical advice memorandum issued as a letter ruling?
Answer: A taxpayer-requested letter ruling deals with prospective transactions, whereas a TAM deals with past or consummated transactions.
Page Ref.: C:1-12 and C:1-13
Objective: 4

70) What is an information release?
Answer: The IRS issues information releases when it wants to release information to the general public. They are written in lay terms and are sent to thousands of newspapers throughout the country.
Page Ref.: C:1-13
Objective: 4

71) What are some of the factors to consider when deciding in which court to file a tax-related claim?
Answer: Factors to consider include each court's published precedents pertaining to the issue; the desirability of a jury trial; the tax expertise of each court; the effect on the taxpayer's cash flow.
Page Ref.: C:1-14 and C:1-15
Objective: 4

72) What are some of the consequences of the small cases procedure of the Tax Court?
Answer: The small cases procedure allows a taxpayer the advantage of having a day in court without the expense of an attorney. But if the taxpayer loses, the decision cannot be appealed.
Page Ref.: C:1-17
Objective: 4

73) Where must a tax researcher look to access all Tax Court cases?
Answer: The regular opinions are found in the Tax Court of the United States Reporter, published by the U.S. Government Printing Office, and the memo decisions are published by both RIA and CCH in their own court reporters.
Page Ref.: C:1-17
Objective: 4

74) Is it possible for the Tax Court to intentionally issue conflicting decisions?
Answer: Yes. If the Tax Court is issuing two decisions that are appealable to different circuit courts and these circuit courts have previously reached different conclusions on the issue, the Tax Court follows the respective precedent in each circuit and issues conflicting decisions. This is a result of the Golsen rule.
Page Ref.: C:1-21
Objective: 4

75) The Tax Court decides an expenditure is deductible in the year the issue was first litigated. The government appealed and won a reversal in the Ninth Circuit Court of Appeals. It is the only appellate decision regarding the issue. If and when the Tax Court encounters this issue again, how will it hold?
Answer: The Tax Court will hold that the expenditure is deductible except in the Ninth Circuit. The taxpayers in the Ninth Circuit will be denied the deduction.
Page Ref.: C:1-21; Example C:1-8
Objective: 4

76) Indicate which courts decided the case cited below. Also indicate on which pages and in which publications the authority is reported.

U.S. v. Maclin P. Davis, 397 U.S. 301, 25 AFTR 2d 70-827, 70-1 USTC & 9289 (1970).
Answer: This case appears in Vol. 397, page 301, of the United States Supreme Court Reports. It is also recorded in Vol. 25, pages 70-827, of the American Federal Tax Reports, Second Series, and in Vol. 1, paragraph 9289 of the 1970 CCH reporter the U.S. Tax Cases.
Page Ref.: C:1-21
Objective: 4

77) If the U.S. District Court for Rhode Island, the Tax Court, and the Eleventh Circuit have all ruled on a particular issue, then what precedents have been set for which courts in the future?
Answer: Any U.S. District court within the Eleventh Circuit must follow that circuit's decision. The U.S. District Court for Rhode Island must rule consistently with its previous ruling. Tax Court decisions are not binding on district courts, thus all district courts other than the one for Rhode Island and those in the Eleventh Circuit are free to decide the issue independently.
Page Ref.: C:1-21; Example C:1-9
Objective: 4

78) What is "forum-shopping"?
Answer: Forum-shopping involves choosing where among the various courts to file a lawsuit. Since courts often disagree as to the appropriate tax treatment of the same item, a taxpayer can file in the jurisdiction that has precedents that favor his circumstances.
Page Ref.: C:1-23
Objective: 4

79) Under what circumstances might a tax advisor find the provisions of a tax treaty useful?
Answer: A tax advisor might consult the provisions of a tax treaty if a U.S. taxpayer engages in transactions in a foreign country. The United States has tax treaties with about 55 countries.
Page Ref.: C:1-24
Objective: 4

80) Compare and contrast proposed, temporary, and final regulations.
Answer: Proposed regulations are not authoritative, but they do provide guidance concerning how the Treasury Department interprets the IRC. Temporary regulations, which have the same effect as final regulations, often are issued after major revisions to the IRC so that taxpayers and tax advisers will have guidance concerning procedural and/or computational matters. Final regulations, which are issued after the public has had time to comment on the proposed regulations, have nearly the same authoritative weight as the IRC.
Page Ref.: C:1-9
Objective: 4

81) Compare and contrast "interpretative" and "statutory" regulations.
Answer: Both types of regulations are issued by the Treasury Department. Interpretative regulations make the statutory language easier to understand and apply. Statutory regulations are issued when Congress delegates its rule-making authority to the Treasury Department. This delegation of authority is made explicitly in the legislation.

The courts are less likely to invalidate a statutory regulation than an interpretative regulation. The reluctance of the court to invalidate a statutory regulation is based on the recognition that Congress has abdicated its rule-making authority to the Treasury Department.
Page Ref.: C:1-10
Objective: 4

82) Explain the legislative reenactment doctrine.
Answer: Under the legislative reenactment doctrine, a Treasury Regulation is deemed to have been endorsed by Congress if the regulation was finalized before a related IRC provision was enacted, and during the interim, Congress did not amend the provision to which the regulation relates.
Page Ref.: C:1-10
Objective: 4

83) In which courts may litigation dealing with tax matters begin? Discuss the factors that might be considered in deciding where to begin litigation.
Answer: The Tax Court, the U.S. Court of Federal Claims, or the U.S. district court for the taxpayer's jurisdiction is where tax-related litigation may begin. The taxpayer would be interested in the precedent, if any, existing within each jurisdiction. The taxpayer might prefer to avoid parting with cash to pay the proposed deficiency. If so, the taxpayer would want to litigate in the Tax Court. If the taxpayer would like to have a jury trial address questions of fact, he or she should opt for the U.S. district court.
Page Ref.: C:1-14 and C:1-15
Objective: 4

84) Describe the appeals process in tax litigation.
Answer: Appeals from Tax Court and U.S. district court decisions are made to the circuit court of appeals for the taxpayer's jurisdiction. U.S. Court of Federal Claims decisions are appealable to the circuit court of appeals for the Federal Circuit. Appeals from any of the circuit courts of appeals may be brought to the U.S. Supreme Court.
Page Ref.: C:1-14 and C:1-15
Objective: 4

85) Discuss the differences and similarities between regular and memorandum decisions issued by the U.S. Tax Court.
Answer: Differences:
1) Regular decisions involve an issue decided for the first time. A memorandum decision frequently involves a variation in the facts for an issue where the law has been previously decided.
2) The IRS's acquiescence policy extends to regular decisions but not to memorandum decisions.
3) Regular decisions are published by the U.S. Government Printing Office in the Tax Court of the United States Reports, while memorandum decisions are published by private companies.

Similarity:
1) Regular and memorandum decisions have the same precedential value.
Page Ref.: C:1-15 and C:1-17
Objective: 4

86) Assume that the Tax Court decided an expenditure in question was deductible. The government appealed to the Fifth Circuit, which reversed the decision and held it was not deductible. No other circuits have ruled on the issue.

A new case has just been filed in the Tax Court. How will the Tax Court rule if this new case is appealable to the Tenth Circuit? Would your answer be different if the case was appealable to the Fifth Circuit?
Answer: The Golsen rule provides that the Tax Court rules consistently with decisions of the circuit court of appeals to which the taxpayer's case is appealable. If the new case is appealable to the Tenth Circuit, the Tax Court will hold the expenditure is deductible, thereby following its own precedent. In a case appealable to the Fifth Circuit, the Tax Court will rule that it is not deductible, thereby following the appellate court's earlier decision.
Page Ref.: C:1-21
Objective: 4

LO5: Tax Services

1) Identify which of the following statements is true.
A) RIA United States Tax Reporter and CCH Standard Federal Tax Reporter are topical tax services.
B) An annotated tax service is organized by broad subject areas.
C) Annotations are summaries of IRS pronouncements and court opinions.
D) All of the above are false.
Answer: A
Explanation: These are third party secondary authority.
Page Ref.: C:1-25
Objective: 5

2) Which tax service is usually deemed to be the most authoritative?
A) United States Tax Reporter
B) Standard Federal Tax Reporter
C) Federal Tax Coordinator 2d
D) All are equally authoritative.
Answer: D
Explanation: All are published federal registers.
Page Ref.: C:1-25
Objective: 5

3) Distinguish between an annotated tax service and a topical tax service.
Answer: An annotated tax service is organized by IRC section. The IRC-arranged subdivisions of this service are likely to encompass several topics. A topical tax service is organized by broad topic. The topically arranged subdivisions of this service are likely to encompass several IRC sections.
Page Ref.: C:1-25
Objective: 5

LO6: The Internet as a Research Tool

1) Internet versions of topical tax services include
A) Code and Regulations.
B) Revenue rulings, letter rulings, and revenue procedures.
C) Court cases involving tax issues.
D) All of the above.
Answer: D
Explanation: Primary and secondary authorities are available online.
Page Ref.: C:1-26
Objective: 6

2) In list form, outline the steps to follow when using a tax service.
Answer: 1) Use a key word search.
2) Read the applicable material.
3) Check the supplementary (current developments) material.
4) Read the cases and rulings referenced in the database.
5) Use a citator to determine the current status of the relevant cases and rulings and if there are any additional cases and rulings.
6) Analyze the information; make analogies and reach a conclusion.
7) Communicate the conclusions to the client.
8) Refine the issues and perhaps return to step 1.
Page Ref.: C:1-27
Objective: 6

LO7: Citators

1) A citator enables tax researchers to locate authorities (e.g., cases and IRS pronouncements) that have cited a particular case.
Answer: TRUE
Explanation: Citators allow quick reference to the material.
Page Ref.: C:1-30
Objective: 7

2) Assume that you want to read a description of a particular area of the law, along with one or more illustrations of how that law is applied. You will not find that type of material in
A) a citator.
B) the Treasury Regulations.
C) the Cumulative Bulletin.
D) the Committee Reports.
Answer: A
Explanation: Citators do not provide explanations.
Page Ref.: C:1-30
Objective: 7

3) Why does a researcher use a citator?
A) to check on authorities issued subsequent to a court decision
B) to determine whether a private letter ruling exists on the subject
C) for examples of the application of a tax provision
D) none of the above
Answer: A
Explanation: Citators allow research determine if case is referenced other places.
Page Ref.: C:1-30
Objective: 7

4) A citator is used to find
A) the judicial history of a case.
B) the cases that have cited a case subsequent to the issuance of the opinion.
C) whether a case has been overturned.
D) all of the above.
Answer: D
Explanation: Citators show history, if cited other places and if still good law.
Page Ref.: C:1-30
Objective: 7

5) What is the minimum information that should be contained in a citation?
Answer: A citation should contain, at a minimum, the name of the case, the reporter that publishes the case, a volume number, a page or paragraph number, the year the case was decided, and the court that decided the case.
Page Ref.: C:1-30
Objective: 7

6) What is the purpose of a citator?
Answer: Citators give a history of the case, and they list other authorities such as other cases or revenue rulings that cite the case in question.
Page Ref.: C:1-30
Objective: 7

LO8: Professional Guidelines for Tax Services

1) According to the Statements on Standards for Tax Services, CPAs must verify all tax return information submitted by reviewing client documentation.
Answer: FALSE
Explanation: The CPA may in good faith rely on information provided by the taxpayer, without verifying the reliability of that information if reasonable inquiries are made where the information furnished appears to be incorrect.
Page Ref.: C:1-31
Objective: 8

2) Which of the following statements about the Statements on Standards for Tax Services is true?
A) A CPA is never allowed to use a taxpayer's estimates when preparing a tax return.
B) The CPA must tell the IRS upon becoming aware that an error has been made on a past tax return.
C) The CPA may in good faith rely on information provided by the taxpayer, without verifying the reliability of that information if reasonable inquiries are made where the information furnished appears to be incorrect.
D) The CPA should not recommend that a taxpayer take a certain position if there is any doubt as to whether the position would be approved by the IRS upon audit.
Answer: C
Explanation: The CPA may in good faith rely on information provided by the taxpayer, without verifying the reliability of that information if reasonable inquiries are made where the information furnished appears to be incorrect.
Page Ref.: C:1-31 through C:1-33
Objective: 8

3) Statements on Standards for Tax Services are issued by
A) the SEC.
B) the IRS.
C) the AICPA.
D) the FASB.
Answer: C
Explanation: The AICPA issues Statements on Standards for Tax Services.
Page Ref.: C:1-31
Objective: 8

4) A client wants to take a tax return position with less than a 10% probability of being upheld in court. The CPA should
A) take the client's desired position, but not sign the tax return.
B) inform the client that the position does not have a realistic possibility of success.
C) ask the client to sign a waiver of his right to sue the CPA in the event the IRS disallows the position.
D) take the client's desired position and sign the return as usual.
Answer: B
Explanation: A CPA should inform a client the position does not have realistic change of success for tax return position with less than a 10% probability of being upheld in court.
Page Ref.: C:1-31
Objective: 8

5) According to the Statements on Standards for Tax Services, if a CPA believes that a client's prior-year tax return contains false information, the CPA should report this to the
A) IRS.
B) SEC.
C) AICPA.
D) None of the above. The CPA does not report the false information to any external agencies, unless required by law.
Answer: D
Explanation: The CPA does not report the false information to any external agencies, unless required by law.
Page Ref.: C:1-32 through C:1-33
Objective: 8

6) Ralph's business records were lost as a result of Hurricane Katrina. CPA Jane prepares Ralph's return using estimates. What do the Statements on Standards for Tax Services state about the use of estimates?
A) Estimates may not be used.
B) Estimates may be used without disclosing their use to the IRS.
C) Estimates may be used, but Jane should disclose their use to the IRS.
D) The Statements on Standards for Tax Services do not address the use of estimates.
Answer: C
Explanation: Estimates may be used but must be disclosed to the IRS.
Page Ref.: C:1-32
Objective: 8

7) During the course of an audit, a CPA discovers an error in a prior return. According to the Statements on Standards for Tax Services, the CPA should
A) ask the client for permission to disclose the error to the IRS.
B) withdraw from the engagement.
C) inform the IRS of the error, regardless of whether the client grants permission.
D) correct the error in the current year's tax return.
Answer: A
Explanation: CPA must get permission.
Page Ref.: C:1-32 through C:1-33
Objective: 8

8) According to the Statements on Standards for Tax Services, what belief should a CPA have before taking a pro-taxpayer position on a tax return?
Answer: The CPA should have a good faith belief that the pro-taxpayer position is warranted in existing law or can be supported by a good-faith argument for an extension, modification, or reversal of existing law. The position should have a realistic possibility of being sustained administratively or judicially on its merits if challenged.
Page Ref.: C:1-31
Objective: 8

9) According to the AICPA's Statements on Standards for Tax Services, what duties does the tax practitioner owe the client?
Answer: The tax practitioner owes the client the following duties: (1) to inform the client of (a) the potential adverse consequences of a tax return position, (b) how the client can avoid a penalty through disclosure, (c) errors in a previously filed tax return, and (d) corrective measures to be taken; (2) to inquire of the client (a) when the client must satisfy conditions to take a deduction and (b) when information provided by him or her appears incorrect, incomplete, or inconsistent on its face, and (3) not to disclose tax-related errors without the client's consent.
Page Ref.: C:1-31 through C:1-33
Objective: 8

10) Your client wants to deduct commuting expenses on his tax return. You explain to the client that there is no legal authority allowing this deduction. The client, however, continues to insist on this action. What guidance do the Statements on Standards for Tax Services provide in this dilemma?
Answer: According to Statement on Tax Standards, the CPA should explain to the client that this action is a violation of the tax law and would trigger IRS penalties. If the client insists on the deduction, the CPA should consider withdrawing from the engagement.
Page Ref.: C:1-31 through C:1-33
Objective: 8

11) Discuss the conflict between advocacy for a client and responsibility to the IRS.
Answer: The CPA's primary duty is to his or her client, not the IRS. The CPA should provide quality advice based on sound legal authority. CPAs do not have to verify client data unless it appears inconsistent, erroneous, or incomplete. CPAs also are not required to report most potential tax law violations to the IRS. If a client refuses to correct a tax-related error, the CPA may terminate the relationship.
Page Ref.: C:1-31 through C:1-33
Objective: 8

LO9: Sample Work Papers and Client Letter

1) There are no questions for this section.

***Pearson's Federal Taxation 2021: Comp., 34e* (Rupert/Anderson)**
Chapter C2: Corporate Formations and Capital Structure

LO1: Organizational Forms Available

1) A sole proprietor is required to use the same reporting period for both business and individual tax information.
Answer: TRUE
Explanation: A sole proprietor is required to use the same reporting period for both business and individual tax information.
Page Ref.: C:2-3
Objective: 1

2) S corporations are flow-through entities in which S income is allocated to shareholders.
Answer: TRUE
Explanation: S corporations are flow-through entities in which S income is allocated to shareholders.
Page Ref.: C:2-6
Objective: 1

3) S corporations must allocate income to shareholders based on their proportionate stock ownership.
Answer: TRUE
Explanation: S corporations must allocate income to shareholders based on their proportionate stock ownership.
Page Ref.: C:2-6
Objective: 1

4) Business assets of a sole proprietorship are owned by
A) a member.
B) an individual.
C) a partner.
D) a stockholder.
Answer: B
Explanation: Sole proprietor is owned by individual owner.
Page Ref.: C:2-2
Objective: 1

5) Identify which of the following statements is <u>false</u>.
A) A solely owned corporation is a sole proprietorship.
B) A sole proprietorship is a separate taxable entity.
C) A sole proprietor is considered to be an employee of the business.
D) All of the above are false.
Answer: D
Explanation: See C2-3
Page Ref.: C:2-3
Objective: 1

6) Which of the following is an advantage of a sole proprietorship over other business forms?
A) tax-exempt treatment of fringe benefits
B) the deduction for compensation paid to the owner
C) low tax rates on dividends
D) ease of formation
Answer: D
Explanation: Advantage - ease of formation
Page Ref.: C:2-3
Objective: 1

7) Which of the following statements about a partnership is true?
A) A partnership is a taxpaying entity.
B) Partners are taxed on distributions from a partnership.
C) Partners are taxed on their allocable share of income whether it is distributed or not.
D) Partners are considered employees of the partnership.
Answer: C
Explanation: Partners are taxed on their allocable share of income whether it is distributed or not.
Page Ref.: C:2-4
Objective: 1

8) Demarcus is a 50% partner in the DJ partnership. DJ has taxable income for the year of $200,000. Demarcus received a $75,000 distribution from the partnership. What amount of income related to DJ must Demarcus recognize?
A) $200,000
B) $75,000
C) $100,000
D) $37,500
Answer: C
Explanation: 200*.5 = 100
Page Ref.: C:2-4; Example C:2-3
Objective: 1

9) Which of the following statements is incorrect?
A) Limited partners' liability for partnership debt is limited to their amount of investment.
B) In a general partnership, all partners have unlimited liability for partnership debts.
C) In a limited partnership, all partners participate in managerial decision making.
D) All of the above are correct.
Answer: C
Explanation: Only the general partner
Page Ref.: C:2-4
Objective: 1

10) Identify which of the following statements is true.
A) Regular corporation and C corporation are synonymous terms.
B) Regular corporation and S corporation are synonymous terms.
C) A partner is generally considered to be an employee of the partnership.
D) All of the above are false.
Answer: A
Explanation: Regular and C Corporation means same thing.
Page Ref.: C:2-5
Objective: 1

11) Which of the following statements is correct?
A) An owner of a C corporation is taxed on his or her proportionate share of earnings.
B) S shareholders are only taxed on distributions.
C) S shareholders are taxed on their proportionate share of earnings that are distributed.
D) S shareholders are taxed on their proportionate share of earnings whether or not distributed.
Answer: D
Explanation: S shareholders are taxed on their proportionate share of earnings whether or not distributed.
Page Ref.: C:2-6 and C:2-7
Objective: 1

12) Identify which of the following statements is true.
A) C corporation operating losses are deductible by the individual shareholders.
B) If a C corporation does not distribute its income to its shareholders annually, double taxation cannot occur.
C) Capital losses incurred by a C corporation can be used to offset the corporation's ordinary income.
D) All of the above are false.
Answer: D
Explanation: See C2-6
Page Ref.: C:2-6
Objective: 1

13) Bread Corporation is a C corporation with earnings of $100,000. It paid $20,000 in dividends to its sole shareholder, Gerald. Gerald also owns 100% of Butter Corporation, an S corporation. Butter had net taxable income of $80,000 and made a $15,000 distribution to Gerald. What income will Gerald report from Bread and Butter's activities?
A) $35,000
B) $95,000
C) $100,000
D) $180,000
Answer: C
Explanation: ($80,000 S corporation income + $20,000 dividends)
Page Ref.: C:2-6
Objective: 1

14) Which of the following statements is <u>incorrect</u>?
A) S corporations must allocate income and expenses to their shareholders based on their proportionate ownership interest.
B) The number of S corporation shareholders is unlimited.
C) S corporation income is taxed to shareholders when earned.
D) S corporation losses can offset shareholder income from other sources.
Answer: B
Explanation: S-Corporation shareholders is limited
Page Ref.: C:2-5; Example C:2-6
Objective: 1

15) Which of the following statements is <u>true</u>?
A) Shareholders in a C corporation can use C corporation losses to offset shareholder income from other sources.
B) C corporation losses remain in the C corporation and can offset capital gain income from other years.
C) C corporation shareholders are taxed based on their proportionate share of income.
D) Distributions of C corporation income are not taxable.
Answer: B
Explanation: C corporation losses remain in the C corporation and can offset capital gain income from other years.
Page Ref.: C:2-5; Example C:2-6
Objective: 1

16) Nathan is single and owns a 54% interest in the new NT Partnership, a calendar-year entity. The NT Partnership reports $100,000 of profits for its first year. Assuming Nathan is taxed at a 35% marginal tax rate on the additional income, how much tax does Nathan owe if the NT Partnership does not distribute any of its profits to him?
Answer: Nathan owes tax on 54% of NT Partnership's profits whether they are distributed or not to him. Thus, he owes 35% of $54,000, or $18,900.
Page Ref.: C:2-4
Objective: 1

17) In January of the current year, Rae purchases 100% of Sun Corporation stock for $30,000. Sun Corporation reports taxable income of $25,000 in the current year, on which it pays tax of $3,750. None of the remaining $21,250 is distributed to Rae. However, on January 1 of the next year, Rae sells her stock to Lee for $51,250. What are the tax consequences to Rae of the sale?
Answer: Rae must report a capital gain of $21,250 ($51,250 - $30,000). Thus, Sun Corporation's profit is taxed twice — once at the corporate level and again at the shareholder level when the stock is sold.
Page Ref.: C:2-5; Example C:2-6
Objective: 1

18) What are the tax consequences to Whitney who owns 50% of Museum Corporation, a qualifying S corporation that is a calendar-year entity, if Museum Corporation reports $60,000 of taxable income? How would your answer change if Museum Corporation reported a $40,000 loss?
Answer: Whitney must pay taxes on $30,000, his 50% share of Museum Corporation's income, whether it is distributed to him or not. Museum Corporation pays no corporate income taxes. If Museum Corporation reports a $40,000 loss, Whitney's $20,000 share of the loss reduces his taxable income.
Page Ref.: C:2-7; Example C:2-7
Objective: 1

19) The tax disadvantages of the C corporation form of doing business include "double taxation." What is meant by the term "double taxation" as used in this context?
Answer: Double taxation occurs when corporate earnings are distributed as dividends to the shareholders. Since the corporate earnings have already been taxed at the corporate level, the shareholders must pay personal income tax as a second tax when the earnings are distributed as dividends. Double taxation can also occur when the stock is sold or exchanged and the portion of the gain attributable to the accumulated earnings is taxed as capital gain.
Page Ref.: C:2-5 and C:2-6
Objective: 1

20) Jane and Joe plan to go into business together. They plan to incorporate the business. What tax issues should they consider when deciding whether or not to elect S corporation status?

- Are their individual marginal tax rates lower or higher than a C corporation's marginal tax rates?
- Do they anticipate profits or losses in the first few years of business?
- Will the corporation generate any capital gains or losses?
- Do they plan to withdraw money from the corporation?
- Will they want or need fringe benefits?
- Do they plan to use a calendar year end or a fiscal year end?

Answer: S corporations generally are exempt from taxation. Income flows through and is taxed to the shareholders. The shareholders' marginal tax rates may be lower than a C corporation's marginal tax rate. Losses flow through to shareholders and can be used to offset income earned from other sources unless limitations apply. This feature is particularly important to corporations just beginning their operations. Passive loss and basis rules may limit loss deductions to shareholders. Because income, loss, and other pass-through items retain their character when they flow through to the shareholders, individual shareholders are taxed on capital gains as though the individual earned the gains. An individual may be able to offset those gains with capital losses from other sources or have them taxed at the appropriate capital gain tax rate. Shareholders generally can contribute money to or withdraw money from an S corporation without gain recognition. Shareholders are taxed only on the annual income of the S corporation. Corporate profits are taxed only at the shareholder level. Shareholders are taxed on all of an S corporation's current year profits whether those profits are distributed or not. Tax-free corporate fringe benefits generally are not available to S corporation shareholders who are employed by the business. Fringe benefits provided by an S corporation are deductible by the corporation and taxable to the shareholder. S corporations generally cannot defer income by choosing a fiscal year for the S corporation other than a calendar year unless the S corporation can establish a business purpose for a fiscal year or unless it makes a special election.
Page Ref.: C:2-6 and C:2-7
Objective: 1

LO2: Check-the-Box Regulations

1) The check-the-box regulations permit an LLC to be taxed as a C corporation.
Answer: TRUE
Explanation: The check-the-box regulations permit an LLC to be taxed as a C corporation.
Page Ref.: C:2-8
Objective: 2

2) Identify which of the following statements is false.
A) The check-the-box regulations permit an LLC to be taxed as a C corporation.
B) Under the check-the-box regulations, an LLC that has only two members (owners) must be taxed as a partnership.
C) A business need not be incorporated under state or federal law to be taxed as a corporation.
D) Once an election is made to change its classification, an entity cannot change again for 60 months.
Answer: B
Explanation: Under the check-the-box regulations, an LLC that has only two members (owners) must choose to be taxed as a partnership or corporation.
Page Ref.: C:2-8
Objective: 2

3) Identify which of the following statements is true.
A) Under the check-the-box regulations, an LLC that has one member (owner) may be disregarded as an entity separate from its owner.
B) An unincorporated business may not be taxed as a corporation.
C) A new LLC that is owned by four members elects to be taxed under its default classification (as a partnership) in its first year of operations. The entity is prohibited from changing its tax classification at any time in the future.
D) All of the above are false.
Answer: A
Explanation: Under the check-the-box regulations, an LLC that has one member (owner) may be disregarded as an entity separate from its owner.
Page Ref.: C:2-8
Objective: 2

4) Three members form an LLC in the current year. Which of the following statements is incorrect?
A) The LLC's default classification under the check-the-box rules is as a partnership.
B) The LLC can elect to have its default classification ignored.
C) The LLC can elect to be taxed as a C corporation with no special tax consequences.
D) If the LLC elects to use its default classification, it can elect to change its status to being taxed as a C corporation beginning with the third tax year after the initial classification.
Answer: D
Explanation: If the LLC elects to use its default classification, it can NOT elect to change its status to being taxed as a C corporation beginning with the third tax year after the initial classification.
Page Ref.: C:2-8 and C:2-9
Objective: 2

5) On January 20 of the current year, a group of ten individuals organize an LLC to conduct an ink-making business in Florida. This year, the LLC is an eligible entity under the check-the-box regulations. How will the LLC be taxed?
Answer: The owners may elect to have the LLC taxed as a corporation. However, if they do not make the election, the LLC will be taxed as a partnership.
Page Ref.: C:2-8; Example C:2-8
Objective: 2

LO3: Legal Requirements and Tax Considerations Related to Forming a Corporation

1) There are no tax consequences of a partnership converting to a C corporation.
Answer: FALSE
Explanation: Partnership conversion to a C Corporation trigger tax implications.
Page Ref.: C:2-9
Objective: 3

LO4: Section 351: Deferring Gain or Loss Upon Incorporation

1) Section 351 applies to an exchange if the contributing shareholders own more than 50% of a corporation's stock after the transfer.
Answer: FALSE
Explanation: 80%
Page Ref.: C:2-12 and C:2-13
Objective: 4

2) The transferor's basis for any noncash boot property received in a Sec. 351 transaction is the boot's FMV reduced by any unrecognized gain.
Answer: FALSE
Explanation: A transferor's basis in any boot property received is the property's FMV.
Page Ref.: C:2-18 and C:2-19
Objective: 4

3) A corporation must recognize a loss when transferring noncash boot property that has declined in value and its stock to a transferor as part of a Sec. 351 exchange.
Answer: FALSE
Explanation: A corporation recognizes gain (but not loss) if it transfers property to a transferor as part of a Sec. 351 exchange.
Page Ref.: C:2-21
Objective: 4

4) If a corporation's total adjusted bases for all properties transferred exceed the total FMV of the properties, the corporation's bases in the property is limited to FMV if no election is made.
Answer: TRUE
Explanation: If a corporation's total adjusted bases for all properties transferred exceed the total FMV of the properties, the corporation's bases in the property is limited to FMV if no election is made.
Page Ref.: C:2-21 and C:2-22
Objective: 4

5) The assignment of income doctrine does not apply if the transferor in a Sec. 351 exchange in which no gain is otherwise recognized transfers substantially all the assets and liabilities of the transferor's trade or business to the controlled corporation.
Answer: TRUE
Explanation: The assignment of income doctrine does not apply if the transferor in a Sec. 351 exchange in which no gain is otherwise recognized transfers substantially all the assets and liabilities of the transferor's trade or business to the controlled corporation.
Page Ref.: C:2-27
Objective: 4

6) Upon formation of a corporation, its assets have the same bases for book and tax purposes.
Answer: FALSE
Explanation: Basis may differ.
Page Ref.: C:2-21 and C:2-22
Objective: 4

7) Identify which of the following statements is true.
A) The exchange of stock for services rendered is not a taxable transaction.
B) The repeal of Sec. 351 would result in more existing businesses being incorporated.
C) Section 351 was enacted to allow taxpayers to incorporate without incurring adverse tax consequences.
D) All of the above are false.
Answer: C
Explanation: Section 351 was enacted to allow taxpayers to incorporate without incurring adverse tax consequences.
Page Ref.: C:2-12
Objective: 4

8) Identify which of the following statements is true.
A) Section 351 applies exclusively to the formation of a new corporation.
B) Section 351 applies to property transfers in exchange for stock.
C) Section 351 only applies to individual transferors.
D) All of the above are false.
Answer: B
Explanation: Section 351 applies to property transfers in exchange for stock.
Page Ref.: C:2-12
Objective: 4

9) For Sec. 351 purposes, the term "property" does not include
A) cash.
B) accounts receivable.
C) inventory.
D) services rendered.
Answer: D
Explanation: Services does not qualify as property.
Page Ref.: C:2-12
Objective: 4

10) Rose and Wayne form a new corporation. Rose contributes cash for 85% of the stock and Wayne contributes services for 15% of the stock. The tax effect is
A) Rose and Wayne must recognize their realized gains, if any.
B) Wayne must report the FMV of the stock received as capital gain.
C) Rose and Wayne are not required to recognize their realized gains.
D) Wayne must report the FMV of the stock received as ordinary income.
Answer: D
Explanation: Services for stock equals ordinary income.
Page Ref.: C:2-13; Example C:2-12
Objective: 4

11) Identify which of the following statements is true.
A) A transferor's gain or loss that goes unrecognized when Sec. 351 applies is permanently exempt from taxation.
B) If a taxpayer transfers property and services as part of a transaction meeting the Sec. 351 requirements, all of the stock received is counted in determining whether the property transferors have acquired control.
C) If a taxpayer transfers property and services as part of a transaction meeting the Sec. 351 requirements, the nonrecognition of gain or loss will apply to the services.
D) All of the above are false.
Answer: B
Explanation: If a taxpayer transfers property and services as part of a transaction meeting the Sec. 351 requirements, all of the stock received is counted in determining whether the property transferors have acquired control.
Page Ref.: C:2-14
Objective: 4

12) Jermaine owns all 200 shares of Peach Corporation stock valued at $50,000. Kenya, a new shareholder, receives 200 newly issued shares from Peach Corporation in exchange for inventory with an adjusted basis of $40,000 and an FMV of $50,000. Which of the following statements is correct?
A) No gain will be recognized by Kenya.
B) The transaction results in $10,000 of ordinary income for Kenya.
C) The transaction results in $10,000 of capital gain for Kenya.
D) Kenya may defer the recognition of any tax until the stock is sold.
Answer: B
Explanation: 80% test not met
Page Ref.: C:2-15; Example C:2-19
Objective: 4

13) Identify which of the following statements is true.
A) To qualify for Sec. 351 treatment, control is defined as more than 50% ownership of the voting stock, and more than 50% of all other classes of stock.
B) If a shareholder receives stock with an FMV greater than the FMV of the property exchanged in a Sec. 351 transaction, the excess FMV may be considered a gift from one shareholder to another shareholder.
C) Only transfers to newly created corporations qualify for Sec. 351 treatment.
D) All of the above are false.
Answer: B
Explanation: If a shareholder receives stock with an FMV greater than the FMV of the property exchanged in a Sec. 351 transaction, the excess FMV may be considered a gift from one shareholder to another shareholder.
Page Ref.: C:2-15
Objective: 4

14) Barry, Dan, and Edith together form a new corporation; Barry and Dan each contribute property in exchange for stock. Within two weeks after the formation, the corporation issues additional stock to Edith in exchange for property. Barry and Dan each hold 10,000 shares and Edith will receive 9,000 shares. Which transactions will qualify for nonrecognition?
A) Only the first transaction will qualify for nonrecognition.
B) Only the second transaction will qualify for nonrecognition.
C) Because of the step transaction doctrine, neither transaction will qualify.
D) Both transactions will qualify under Sec. 351 if they are part of the same plan of incorporation.
Answer: D
Explanation: See C2-16
Page Ref.: C:2-16; Example C:2-22
Objective: 4

15) In accordance with the rules that apply to corporate formation, which one of the following features does not make an issue of preferred stock "nonqualified"?
A) The shareholder can require the corporation to redeem the stock.
B) The dividend rate on the stock may not vary with interest rates, commodity prices, or other similar indices.
C) The corporation is either required to redeem the stock or is likely to exercise a right to redeem the stock.
D) The stock is limited and preferred as to dividends.
Answer: B
Explanation: The dividend rate on the stock may not vary with interest rates, commodity prices, or other similar indices.
Page Ref.: C:2-16
Objective: 4

16) Under Sec. 351, corporate stock may include all of the following except
A) voting stock.
B) nonvoting stock.
C) stock warrants.
D) qualified preferred stock.
Answer: C
Explanation: Stock warrants are ineligible for Sec. 351.
Page Ref.: C:2-16
Objective: 4

17) Matt and Sheila form Krupp Corporation. Matt contributes property with an FMV of $55,000 and a basis of $35,000. Sheila contributes property with an FMV of $75,000 and a basis of $40,000. Matt sells his stock to Paul shortly after the exchange. The transaction will
A) not qualify under Sec. 351.
B) qualify under Sec. 351 if Matt can show that the sale to Paul was not part of a prearranged plan.
C) qualify with respect to Sheila under Sec. 351 whether Matt qualifies or not.
D) qualify under Sec. 351 only if an advance ruling has been obtained.
Answer: B
Explanation: Prearranged plan violates rules of Sec. 351.
Page Ref.: C:2-16
Objective: 4

18) Brad forms Vott Corporation by contributing equipment, which has a basis of $50,000 and an FMV of $40,000 in exchange for Vott stock. Brad also contributes $5,000 in cash. If the transaction meets the Sec. 351 control and ownership tests, what are the tax consequences to Brad?
A) He recognizes a $5,000 loss.
B) He recognizes a $5,000 gain and a $10,000 loss.
C) He recognizes neither a gain nor a loss.
D) He recognizes a $10,000 loss.
Answer: C
Explanation: Losses are not recognized in a Sec. 351 transaction.
Page Ref.: C:2-16 and C:2-17
Objective: 4

19) If an individual transfers an ongoing business to a corporation in a Sec. 351 exchange, the individual must recognize any realized gain
A) only if the adjusted basis of the property transferred is less than the FMV of the stock received.
B) if the transferor receives property other than stock.
C) if the FMV of the property exchanged exceeds the FMV of the stock received.
D) both A and B above
Answer: B
Explanation: Property triggers boot.
Page Ref.: C:2-17
Objective: 4

20) Carmen and Marc form Apple Corporation. Carmen transfers land that is Sec. 1231 property, with an adjusted basis of $18,000 and an FMV of $20,000 in exchange for one-half of the Apple Corporation stock. Marc transfers equipment that originally costs $28,000 on which he has taken $5,000 in depreciation deductions. The equipment has an FMV of $25,000 and he receives one-half of the stock and a $5,000 short-term note. The transaction meets the requirements of Sec. 351. Which statement below is correct?
A) There is no recognized gain or loss.
B) Carmen recognizes a $2,000 Sec. 1231 gain and Marc recognizes $5,000 as ordinary income.
C) Carmen recognizes a $2,000 Sec. 1231 gain and Marc recognizes a $5,000 Sec. 1231 gain.
D) Carmen recognizes no gain and Marc recognizes $2,000 as ordinary income.
Answer: D
Explanation: Marc has a $2,000 realized gain [($20,000 FMV stock + $5,000 FMV note) - ($28,000 cost - $5,000 depreciation)], all of which is recognized because he received $5,000 of boot in the form of a short-term note. The gain is ordinary income under Sec. 1245.
Page Ref.: C:2-17
Objective: 4

21) Identify which of the following statements is true.
A) The definition of stock under Sec. 351 includes stock rights and warrants.
B) The receipt of property other than stock by the transferor will trigger the recognition of gain or loss under Sec. 351.
C) The character of the gain recognized by the transferor when boot is received in a Sec. 351 transaction depends on the type of boot received.
D) All of the above are false.
Answer: D
Explanation: See C2-16
Page Ref.: C:2-16 and C:2-17
Objective: 4

22) Identify which of the following statements is true.
A) To determine a shareholder's basis in a single class of stock received in a Sec. 351 exchange, the FMV of the stock received must be known.
B) If more than one asset is transferred by the transferor in a Sec. 351 nonrecognition transaction, the transferor is assumed to have received a proportionate share of the stock, cash, and other boot property for each property transferred based upon the assets' relative FMVs.
C) The transferor's basis for any noncash boot property received in a Sec. 351 transaction is the boot's FMV reduced by any unrecognized gain.
D) All of the above are false.
Answer: B
Explanation: If more than one asset is transferred by the transferor in a Sec. 351 nonrecognition transaction, the transferor is assumed to have received a proportionate share of the stock, cash, and other boot property for each property transferred based upon the assets' relative FMVs.
Page Ref.: C:2-17 and C:2-18
Objective: 4

23) Identify which of the following statements is true.
A) If stock and boot property are both received in a Sec. 351 exchange, the transferor must allocate the total basis in the contributed property between the stock and boot property based on the relative FMVs of the stock and the boot property.
B) The adjusted basis of stock received in a Sec. 351 transaction is computed by deducting the deferred loss from the FMV of the stock received.
C) The holding period for stock received in a Sec. 351 transaction in exchange for a capital asset begins on the day after the date of the exchange.
D) All of the above are false.
Answer: D
Explanation: See C2-18
Page Ref.: C:2-18 and C:2-19
Objective: 4

24) Jerry transfers two assets to a corporation as part of a Sec. 351 exchange. The first asset has an adjusted basis of $70,000 and an FMV of $50,000. The second asset has an adjusted basis of $70,000 and an FMV of $150,000. The FMV of the stock received is $180,000, and he also receives $20,000 cash. The realized and recognized gain on the second asset is
A) $80,000 realized; $20,000 recognized.
B) $80,000 realized; $15,000 recognized.
C) $20,000 realized; $10,000 recognized.
D) $10,000 realized; $10,000 recognized.
Answer: B
Explanation:

	1st Asset	2nd Asset	Total
FMV	$50,000	$150,000	= $200,000
Minus: adjusted basis	(70,000)	(70,000)	= (140,000)
Realized gain (loss)	($20,000)	$ 80,000	= $ 60,000
Allocation of boot	$ 5,000[a]	$ 15,000[b]	= $ 20,000
Recognized gain	$ 0	$ 15,000	= $ 15,000

[a] 50/200 × $20,000
[b] 150/200 × $20,000
Page Ref.: C:2-17 and C:2-18
Objective: 4

25) Max transfers the following properties to a newly created corporation for $90,000 of stock and $10,000 cash in a transaction that qualifies under Sec. 351.

	Asset One	**Asset Two**	**Asset Three**
FMV	$30,000	$45,000	$25,000
Basis	35,000	40,000	20,000

Max's recognized gain is
A) $3,000.
B) $5,000.
C) $7,000.
D) $10,000.
Answer: C
Explanation:

	Asset One	**Asset Two**	**Asset Three**	**Total**
FMV	$ 30,000	$ 45,000	$ 25,000	= $100,000
Minus: Adj. Basis	(35,000)	(40,000)	(20,000)	= (95,000)
Realized gain (loss)	($ 5,000)	$ 5,000	$ 5,000	= $ 5,000
Boot	$ 3,000[a]	$ 4,500[b]	$ 2,500[c]	= $10,000
Recognized gain (loss)	0	$ 4,500	$ 2,500	= $ 7,000 gain

a (30/100 × $10,000)
b (45/100 × $10,000)
c (25/100 × $10,000)
Page Ref.: C:2-17 and C:2-18
Objective: 4

26) Cherie transfers two assets to a newly-created corporation. The first asset has an adjusted basis of $40,000 and an FMV of $50,000. The second asset has an adjusted basis of $35,000 and an FMV of $25,000. Cherie receives stock with an FMV of $66,000 and $9,000 cash. Cherie must recognize a gain of
A) $10,000.
B) $6,000.
C) $5,000.
D) $4,000.
Answer: B
Explanation:

	1st Asset	2nd Asset	Total
FMV	$50,000	$ 25,000	= $ 75,000
Minus: Adj. basis	(40,000)	(35,000)	= (75,000)
Realized gain (loss)	($10,000)	$ 10,000	= $ 0
Allocation of boot	$ 6,000[a]	$ 3,000[b]	= $ 9,000
Recognized gain (loss)	$ 6,000	$ 0	= $ 6,000

a (2/3 × $9,000)
b (1/3 × $9,000)
Page Ref.: C:2-17 and C:2-18
Objective: 4

27) Henry transfers property with an adjusted basis of $90,000 and an FMV of $100,000 to a newly-formed corporation in a Sec. 351 exchange. Henry receives stock with an FMV of $80,000 and a short-term note with a $20,000 FMV. Henry's recognized gain is
A) $0.
B) $5,000.
C) $10,000.
D) $20,000.
Answer: C
Explanation: Realized gain is recognized to the extent of boot received. The short-term note is boot, but only $10,000 (the realized gain) is recognized.

FMV	$100,000
Minus: adjusted basis	(90,000)
Gain realized	$ 10,000
Boot	$ 20,000
Gain recognized	$ 10,000

Page Ref.: C:2-17
Objective: 4

28) Henry transfers property with an adjusted basis of $95,000 and an FMV of $100,000 to a newly formed corporation in a Sec. 351 exchange. Henry receives stock with an FMV of $85,000 and a short-term note with a $15,000 FMV. Henry's basis in the stock is
A) $100,000.
B) $95,000.
C) $90,000.
D) $85,000.
Answer: D
Explanation:

Transferor's basis	$95,000
Minus: boot received	(15,000)
Plus: gain recognized	5,000
Stock basis	$85,000

Page Ref.: C:2-18
Objective: 4

29) A shareholder's basis in stock received in a Sec. 351 transaction is
A) increased by the gain recognized by the corporation.
B) decreased by the gain recognized by the transferor.
C) decreased by liabilities assumed by the corporation.
D) increased by the FMV of boot received from the corporation.
Answer: C
Explanation: Assumption of liabilities decrease basis in stock
Page Ref.: C:2-18
Objective: 4

30) Jeremy transfers Sec. 351 property acquired three years earlier having a $100,000 basis and a $160,000 FMV to Jeneva Corporation. Jeremy receives all 200 shares of Jeneva stock having a $140,000 FMV, and a $20,000 90-day Jeneva note. What is Jeremy's recognized gain?
A) $0
B) $60,000
C) $20,000
D) $160,000
Answer: C
Explanation:

FMV of stock received	$140,000
Plus: FMV of 90-day note	20,000
Amount realized	$160,000
Minus: adjusted basis of property transferred	(100,000)
Realized gain	$ 60,000

Jeremy's recognized gain is the lesser of the realized gain or the FMV of the 90-day note (boot property).
Page Ref.: C:2-18
Objective: 4

31) Carolyn transfers property with an adjusted basis of $50,000 and an FMV of $60,000 in exchange for Prime Corporation stock in a Sec. 351 transaction. Carolyn's basis in the stock is
A) $60,000.
B) $50,000.
C) $10,000.
D) $0.
Answer: B
Explanation: Adjusted basis of property transferred ($50,000) minus boot received (0) plus gain recognized (0) equals $50,000.
Page Ref.: C:2-18 and C:2-19
Objective: 4

32) Ralph transfers property with an adjusted basis of $65,000 and an FMV of $70,000 to Lake Corporation in a Sec. 351 transaction. Ralph receives stock worth $60,000 and a short-term note having a $10,000 FMV. Ralph's basis in the stock is
A) $75,000.
B) $70,000.
C) $65,000.
D) $60,000.
Answer: D
Explanation:

Stock and note	$70,000	Transferor's basis	$65,000
Minus: adj. basis	(65,000)	Minus: FMV of boot received	(10,000)
Realized gain	$ 5,000	Plus: gain recognized	5,000
Boot	$10,000	Transferor's stock basis	$60,000
Recognized gain	$ 5,000		

Page Ref.: C:2-18 and C:2-19
Objective: 4

33) Sarah transfers property with an $80,000 adjusted basis and a $100,000 FMV to Super Corporation in a Sec. 351 transaction. Sarah receives stock with an $85,000 FMV and a short-term note with a $15,000 FMV. Sarah's basis in the stock is
A) $100,000.
B) $95,000.
C) $85,000.
D) $80,000.
Answer: D
Explanation:

FMV	$100,000	Transferor's basis	$80,000
Minus: adj. Basis	(80,000)	Minus: FMV of boot received	(15,000)
Realized gain	$ 20,000	Plus: gain recognized	15,000
Boot	$ 15,000	Transferor's stock basis	$80,000
Recognized gain	$ 15,000		

Page Ref.: C:2-18
Objective: 4

34) The transferor's holding period for any stock received in exchange for a capital asset
A) includes the holding period for the property transferred.
B) begins on the day after the exchange.
C) begins on the day of the exchange.
D) none of the above
Answer: A
Explanation: Carry over holding period
Page Ref.: C:2-19
Objective: 4

35) The transferor's holding period for any boot property received in a Sec. 351 stock exchange
A) includes the holding period for the boot transferred.
B) begins on the day after the exchange.
C) begins on the day of the exchange.
D) is the same as the holding period of the stock received in the exchange.
Answer: B
Explanation: Treated as day after the exchange
Page Ref.: C:2-19
Objective: 4

36) Beth transfers an asset having an FMV of $200,000 and an adjusted basis of $150,000 to ABC Corporation in a Sec. 351 transaction. Beth receives in exchange ABC common stock having an FMV of $175,000 and Zeus Corporation common stock (a capital asset) having an FMV of $25,000 and a basis of $10,000 to ABC Corporation. ABC Corporation must recognize
A) no gain.
B) a $15,000 capital gain.
C) a $25,000 capital gain.
D) a $50,000 capital gain.
Answer: B
Explanation: 25-10 = 15
Page Ref.: C:2-20; Example C:2-30
Objective: 4

37) Chris transfers land with a basis of $40,000 to Webb Corporation in exchange for 100% of Webb's stock. At the date of the transfer, the land had a $30,000 fair market value. Absent an election by Chris, Webb's basis in the land is
A) $30,000.
B) $35,000.
C) $40,000.
D) none of the above
Answer: A
Explanation: Carry over of basis
Page Ref.: C:2-21 and C:2-22
Objective: 4

38) Chris transfers land with a basis of $40,000 to Webb Corporation in exchange for 100% of Webb's stock. At the date of the transfer, the land had a $30,000 fair market value. Chris makes an election to reduce his basis in Webb's stock to $30,000, so Webb's basis in the land is
A) $30,000.
B) $35,000.
C) $40,000.
D) none of the above
Answer: C
Explanation: Corporation carries over basis.
Page Ref.: C:2-21 and C:2-22
Objective: 4

39) The transferee corporation's basis in property received in a Sec. 351 exchange is
A) the FMV of the property received.
B) the transferee corporation's basis in the stock exchanged.
C) the transferor's basis for the property plus gain recognized by the transferor.
D) the transferor's basis for the property plus gain recognized by the transferee corporation.
Answer: C
Explanation: See C2-21
Page Ref.: C:2-21
Objective: 4

40) Identify which of the following statements is true.
A) Section 351 provides for nonrecognition of gain for the transferee corporation when it distributes appreciated land that is boot property to a shareholder.
B) A corporation must recognize a loss when transferring noncash boot property that has declined in value and its stock to a transferor as part of a Sec. 351 exchange.
C) The transferee corporation's holding period for assets acquired in an exchange meeting the Sec. 351 requirements includes the transferor's holding period for the property.
D) All of the above are false.
Answer: C
Explanation: The transferee corporation's holding period for assets acquired in an exchange meeting the Sec. 351 requirements includes the transferor's holding period for the property.
Page Ref.: C:2-21
Objective: 4

41) Mario and Lupita form a corporation in a transaction coming under Sec. 351. Lupita transfers property with an adjusted basis of $150,000 and an FMV of $200,000 in exchange for one-half of the stock. The property has an $80,000 mortgage, which the corporation assumes. Lupita has a recognized gain of
A) $0.
B) $50,000.
C) $100,000.
D) $80,000.
Answer: A
Explanation: The mortgage is not in excess of the property's adjusted basis and not indicative of a tax avoidance motive, therefore no gain is recognized.
Page Ref.: C:2-22 and C:2-23
Objective: 4

42) Mario and Lupita form a corporation in a transaction coming under Sec. 351. Lupita transfers property with an adjusted basis of $150,000 and an FMV of $200,000 in exchange for one-half of the stock. The property has an $80,000 mortgage, which the corporation assumes. The corporation's basis in the property is
A) $200,000.
B) $150,000.
C) $80,000.
D) $130,000.
Answer: B
Explanation: The transferor's basis for the property becomes the corporation's basis.
Page Ref.: C:2-23
Objective: 4

43) Lynn transfers land having a $50,000 adjusted basis, an $80,000 FMV, and $10,000 cash to Allied Corporation in exchange for 100% of Allied's stock. The corporation assumes the $70,000 mortgage on the land. Which of the following statements is correct?
A) Lynn recognizes no gain and the stock basis is $60,000.
B) Lynn recognizes a $10,000 gain and the stock basis is $60,000.
C) Lynn recognizes no gain and the stock basis is $50,000.
D) Lynn recognizes a $10,000 gain and the stock basis is zero.
Answer: D
Explanation: Mortgage assumed ($70,000) exceeds total basis of property transferred $60,000 ($50,000 + $10,000) by $10,000. Recognized gain = $10,000. Stock basis = $50,000 + $10,000 + $10,000 gain - $70,000 liability = $0.
Page Ref.: C:2-24 and C:2-25; Example C:2-38
Objective: 4

44) Identify which of the following statements is true.
A) The transferee corporation's acquisition or assumption of liabilities in excess of the total adjusted bases of the properties transferred by a transferor results in a gain recognition by the transferor.
B) When a transferor exchanges a mortgaged property under Sec. 351 and the amount of the mortgage is greater than the transferor's basis in the property, the transferor's basis in the stock received will be equal to the basis the transferor had in the mortgaged property.
C) When forming a corporation, the accounts payable of a transferor's business are not liabilities for gain computation purposes if the transferor's business uses the accrual method of accounting.
D) All of the above are false.
Answer: A
Explanation: The transferee corporation's acquisition or assumption of liabilities in excess of the total adjusted bases of the properties transferred by a transferor results in a gain recognition by the transferor.
Page Ref.: C:2-23
Objective: 4

45) Martin operates a law practice as a sole proprietorship using the cash method of accounting. Martin incorporates the law practice and transfers the following items to a new, solely owned corporation.

	Adjusted Basis	**FMV**
Cash		
Equipment	$10,000	$ 10,000
Accounts receivable	80,000	100,000
Accounts payable (deductible	0	120,000
expenses)	0	60,000
Note payable (on equipment)	50,000	50,000

Martin must recognize a gain of ________ and has a stock basis of ________:
A) $0; $30,000
B) $0; $40,000
C) $20,000; $30,000
D) $20,000; $40,000
Answer: B
Explanation: The accounts payable are not considered liabilities under Sec. 357(c) since the payment of the payables gives rise to a deduction. Stock basis equals: cash basis $10,000 plus equipment basis $80,000, less liability transferred $50,000 = $40,000.
Page Ref.: C:2-24 and C:2-25; Example C:2-38
Objective: 4

46) Silvia transfers to Leaf Corporation a machine she had purchased a year ago for $50,000. The machine has a $40,000 adjusted basis and a $55,000 FMV on the transfer date. $10,000 in depreciation was claimed by Silvia prior to the transfer. Silvia receives all 1,000 shares of Leaf Corporation stock worth $50,000 and a two-year note with a $5,000 FMV. What is the amount and character of the recognized gain or loss?
A) $15,000 ordinary income
B) $15,000 capital gain
C) $5,000 ordinary income
D) $5,000 capital gain
Answer: C
Explanation: Lesser of boot or gain. Boot is $5,000. Depreciation recapture triggers ordinary income.
Page Ref.: C:2-25
Objective: 4

47) Jeremy operates a business as a sole proprietorship. The proprietorship uses the cash method of accounting. He decides to incorporate and transfers the assets and liabilities of the sole proprietorship to the newly formed corporation in exchange for its stock. The assets, which include $10,000 of accounts receivable with a zero basis, have a basis of $20,000 and an FMV of $40,000. The liabilities include accounts payable of $12,000, which will be deductible when paid, and a note payable on medical equipment of $7,000. Jeremy's basis for his stock is
A) $40,000.
B) $20,000.
C) $13,000.
D) $8,000.
Answer: C
Explanation: Reduce basis by amount of the note payable ($20,000 - $7,000). Ignore accounts payable since the corporation will pay and deduct them.
Page Ref.: C:2-24 and C:2-25
Objective: 4

48) Colleen operates a business as a sole proprietorship. She purchased a computer for $10,000 last year. The computer is five-year recovery property for MACRS purposes and is depreciated under the regular MACRS rules. This year, Colleen incorporates the business and transfers the computer to the new corporation on July 20. The depreciation on the computer for this year allocable to the sole proprietorship is
A) $1,868.
B) $1,600.
C) $1,333.
D) $500.
Answer: B
Explanation: MACRS = DDB with half-year convention for first year
Year 1 = $10,000 × 0.20 = $2,000
Year 2 = $10,000 × 0.32 × 0.5 = $1,600 [0.5 = 6 months]
All depreciation for the month of July is allocated to the corporation.
Page Ref.: C:2-26; Example C:2-40
Objective: 4

49) Identify which of the following statements is true.
A) The transferor must recapture depreciation when exchanging Sec. 1245 property in all transactions coming under Sec. 351.
B) A corporation receiving property in a Sec. 351 exchange can select any MACRS depreciation method for the asset.
C) When depreciable property is transferred to a corporation in a Sec. 351 exchange in which no gain is recognized, the corporation must continue to use the transferor's depreciation method and recovery period for the property.
D) All of the above are false.
Answer: C
Explanation: When depreciable property is transferred to a corporation in a Sec. 351 exchange in which no gain is recognized, the corporation must continue to use the transferor's depreciation method and recovery period for the property.
Page Ref.: C:2-26
Objective: 4

50) Identify which of the following statements is true.
A) The assignment of income doctrine requires a cash method of accounting for a transferor/shareholder to recognize income when accounts receivable are transferred by the shareholder to the corporation in a Sec. 351 exchange in which no gain is otherwise recognized.
B) The assignment of income doctrine is a legislative requirement that income be taxed to the person who earns it.
C) The assignment of income doctrine does not apply if the transferor in a Sec. 351 exchange in which no gain is otherwise recognized transfers when a sole proprietor transfers substantially all the assets and liabilities of the transferor's trade or business to a controlled corporation.
D) All of the above are false.
Answer: C
Explanation: The assignment of income doctrine does not apply if the transferor in a Sec. 351 exchange in which no gain is otherwise recognized transfers when a sole proprietor transfers substantially all the assets and liabilities of the transferor's trade or business to a controlled corporation.
Page Ref.: C:2-27
Objective: 4

51) A medical doctor incorporates her medical practice, which is operated as a sole proprietorship. The proprietorship uses the cash method of accounting. Among the assets contributed to the new corporation are unrealized receivables worth $40,000. The receivables are collected by the corporation. Which of the following statements is correct?
A) The $40,000 of receivables is included as ordinary income on the doctor's personal income tax return when collected by the corporation.
B) The doctor must include the $40,000 as ordinary income in her personal income tax return at the time of incorporation.
C) The $40,000 of receivables is included as ordinary income in the corporation's income tax return at the time of incorporation.
D) The $40,000 of receivables is included as ordinary income in the corporation's income tax return when collected.
Answer: D
Explanation: 40,000 of ordinary income upon collection
Page Ref.: C:2-27; Example C:2-42
Objective: 4

52) Maria has been operating a business as a sole proprietorship for several years. She needs additional capital and wants to incorporate her business. The assets of her business (building, land, inventory, and so on) have a $400,000 adjusted basis and a $1.5 million FMV. Maria is willing to exchange the assets for 1,500 shares of Metro Corporation stock, each having a $1,000 FMV. Bill and John are each willing to invest $500,000 in Maria's business and will each receive 500 shares of stock. Why is Sec. 351 important to Maria? Does it matter to Bill and John?
Answer: If not for Sec. 351, Maria would recognize a gain on the incorporation of her business. She has a $1.1 million ($1.5 million - $400,000) realized gain on her contribution of the proprietorship's assets to a new corporation in exchange for 60% of its outstanding shares. However, under Sec. 351, she recognized none of the gain. Section 351 does not affect Bill and John as they are each simply purchasing 20% of the new corporation's stock for $500,000 cash. They do not realize or recognize any gain whether Sec. 351 applies or not.
Page Ref.: C:2-12
Objective: 4

53) Phil and Nick form Philnick Corporation. Phil exchanges cash and other property for 900 shares (90% of the outstanding shares) of Philnick stock. Nick performs accounting services in exchange for 100 shares of Philnick stock worth $10,000. What are the tax consequences from forming the Philnick Corporation to Phil and Nick?
Answer: Phil's exchange of assets for stock qualifies for Sec. 351(a) treatment, thus is tax-free. Nick's exchange of services for stock is not tax-free under Sec. 351. Thus, Nick must recognize $10,000 of ordinary income, the FMV of the Philnick stock received. Nick's basis in the Philnick stock received is $10,000, its FMV.
Page Ref.: C:2-12
Objective: 4

54) In which of the following independent situations is the Sec. 351 control requirement met?
a) Jane transfers property to Jet Corporation for 75% of Jet Corporation's stock, and Susan provides services to Jet Corporation for the remaining 25% of Jet Corporation stock.
b) Paul transfers property to Pride Corporation for 60% of Pride's stock, and Bob transfers property worth $15,000 and performs services worth $25,000 for the remaining 40% of Pride's stock.
c) Herb and his wife Carolyn each have owned 50% of the 100 outstanding shares of Wykert Corporation stock since it was formed three years ago. In the current year, their daughter, Cindy, transfers property to Wykert Corporation for 50 newly issued shares of Wykert stock.
d) John and Pam develop a plan to form PJ Corporation on May 2 of this year. John transfers property worth $50,000 for 50 shares of PJ Corporation stock. As part of the single plan to incorporate, Pam transfers $50,000 cash for 50 shares of PJ Corporation stock on July 1.
e) Assume the same facts as in Part (d), except that John has a prearranged plan to sell 30 of his shares to Steven on September 1.
Answer:
a) Not met. Transferors of property receive only 75% and they do not have 80% control.
b) Met. Bob transferred more than a nominal amount of property. The 80% control test is met since all of Bob's stock is counted for this purpose.
c) Not met. Cindy owns only one-third of the stock immediately after the exchange. No attribution occurs from Cindy's parents to Cindy.
d) Met. John and Pam own 100% of PJ Corporation. The transfers do not have to be simultaneous.
e) Not met. John had a prearranged plan to sell a sufficient amount of shares to cause the control requirement <u>not</u> to be met.
Page Ref.: C:2-13 and C:2-14
Objective: 4

55) Frans and Arie own 75 shares and 25 shares of Vogel Corporation stock, respectively. There are no other owners. Frans transfers property with a $30,000 adjusted basis and a $50,000 FMV to Vogel Corporation in exchange for an additional 25 shares of Vogel stock. Does this property-for-stock exchange qualify for Sec. 351 treatment?
Answer: Yes. Since Frans owned 80% (100 ÷ 125) of the Vogel stock and is in control of Vogel Corporation, Frans does not recognize any gain on the exchange.
Page Ref.: C:2-14
Objective: 4

56) For the last four years, Bob and Ellen have each owned 100 of the 200 outstanding shares of Racer Corporation's stock. Bob transfers land having a $10,000 basis and a $30,000 FMV to Racer for an additional 30 shares of stock, and Ellen transfers $2,000 for an additional two shares of stock. What is the amount of gain or loss that Bob must recognize on the exchange? If the transaction does not comply with the Sec. 351 requirements, how can it be made to comply?
Answer: Bob must recognize $20,000 ($30,000 - $10,000) of gain on the exchange. Since Ellen only contributed cash, she does not recognize any gain or loss. If Ellen obtained additional stock worth at least 10% of the value of the stock she already owns (i.e., at least 10 shares worth $10,000), her stock would be counted for control purposes and then Sec. 351 would apply. Alternatively, if Bob acquired sufficient stock to own 80% of the outstanding stock after the exchange, Sec. 351 would also apply. If Sec. 351 applies, Bob will recognize no gain on the exchange.
Page Ref.: C:2-14
Objective: 4

57) Dan transfers property with an adjusted basis of $50,000 and an FMV of $100,000 to a newly formed Sun Corporation in exchange for 500 shares of Sun stock, which is one-half of the outstanding Sun stock. His daughter, Sylvia, transfers property with an adjusted basis of $25,000 and an FMV of $50,000 for the other 500 shares at the same time. What are the tax consequences of the two transfers, assuming all the requirements of Sec. 351 are met?
Answer: No gain or loss is recognized by either Dan or Sylvia. However, since the stock was not received in proportion to the relative FMVs of the properties contributed, the IRS may attempt to reconstruct the transaction in the form that Dan has received 667 shares of stock and made a gift of 167 shares to his daughter Sylvia. Dan's basis in his 500 shares of stock is $37,538 [(500/667) × $50,000 basis in property transferred]. Sylvia's basis in her 500 shares is $37,462 [$25,000 basis in property transferred + ($50,000 - $37,538) basis in the shares received as a gift from Dan].
Page Ref.: C:2-15
Objective: 4

58) Tanicia owns all 100 shares of Midwest Corporation's stock, valued at $100,000. Gwen owns property that has a $15,000 adjusted basis and a $100,000 FMV. Gwen contributes the property to Midwest Corporation in exchange for 100 shares of newly issued Midwest stock. Does Sec. 351 apply to Gwen's exchange? What is the amount of her realized gain or loss? How much is recognized?
Answer: Section 351 does not apply because Gwen owns only 50% of the Midwest stock after the exchange and is not in control of Midwest Corporation. Gwen has a realized gain of $85,000 ($100,000 - $15,000), all of which must be recognized.
Page Ref.: C:2-15; Example C:2-19
Objective: 4

59) Abby owns all 100 shares of Rent Corporation's stock, valued at $10,000. Bart owns property that has a $1,500 adjusted basis and a $10,000 FMV. Bart contributes the property to Rent Corporation in exchange for 100 shares of newly issued Rent stock. Abby transfers additional property worth $10,000 for an additional 10 shares of newly issued Rent stock too. Does Sec. 351 apply?
Answer: Both Abby and Bart are transferors, so Sec. 351 does apply. Neither Abby nor Bart recognizes any gain on the exchange.
Page Ref.: C:2-15; Example C:2-20
Objective: 4

60) Anton, Bettina, and Caleb form Cage Corporation. Each contributes appreciated property worth $10,000 for one-third of the Cage stock. Before the exchange, Anton arranges to sell his stock to Darma as soon as he receives it. Does Sec. 351 apply?
Answer: No, this prearranged plan means Anton, Bettina, and Caleb do not have control immediately after the exchange, so Sec. 351 does not apply.
Page Ref.: C:2-16; Example C:2-22
Objective: 4

61) South Corporation acquires 100 shares of treasury stock for $10,000. The next year, South reissues the 100 shares for land having a $15,000 FMV. What is the amount of gain or loss realized by South Corporation, and how much is recognized?
Answer: South realizes a $5,000 ($15,000 - $10,000) gain on the exchange. None of it is recognized.
Page Ref.: C:2-20; Example C:2-29
Objective: 4

62) Azar, who owns 100% of Hat Corporation, transfers land having a $50,000 FMV and a $30,000 adjusted basis to Hat. In return, Azar receives additional shares of Hat common stock having a $40,000 FMV and Cap Corporation common stock having a $10,000 FMV. The Cap Corporation common stock, a capital asset, has a $2,500 basis on Hat's books. What is Azar's realized and recognized gain? Does Hat Corporation recognize a gain on the stock transfer to Azar?
Answer: Azar realizes a $20,000 ($40,000 + $10,000 - $30,000) gain on the land transfer, of which $10,000 must be recognized. Hat Corporation recognizes a $7,500 capital gain ($10,000 - $2,500) when transferring the Cap Corporation stock to Azar.
Page Ref.: C:2-20; Example C:2-30
Objective: 4

63) Yolanda transfers land, a capital asset, having a $70,000 adjusted basis and a $125,000 FMV plus $10,000 cash to Jazz Corporation in exchange for all its stock. Jazz Corporation assumes the $100,000 mortgage on the land. The mortgage assumption has no tax avoidance purpose and has the requisite business purpose. What is the amount of Yolanda's realized gain or loss? How much is recognized and what is its character? What is Yolanda's basis in the Jazz stock?
Answer: Yolanda has a realized gain of $55,000 ($125,000 - $70,000). Even though Yolanda does not receive any boot, she must recognize a $30,000 ($100,000 - $70,000) capital gain, the amount by which the liabilities assumed by Jazz Corporation exceed the basis of the land and the cash transferred by Yolanda. Yolanda's basis in the Jazz stock is $0.

Yolanda's basis in the land transferred	$ 70,000
Plus: Cash transferred	10,000
Gain recognized	20,000
Minus: Boot received (liabilities assumed by Jazz)	($100,000)
Yolanda's basis in the Jazz Stock	$ 0

Page Ref.: C:2-22 and C:2-23; Example C:2-35
Objective: 4

64) Zoe Ann transfers machinery having a $36,000 adjusted basis and a $70,000 FMV for all 100 shares of Zeema Corporation's stock. Before the transfer, Zoe Ann used the machinery in her business. She originally paid $50,000 for the machinery and claimed $14,000 of depreciation before transferring the machinery. Zoe Ann recaptures no depreciation on the transfer and the recapture potential is transferred to Zeema Corporation. Zeema sells the machine for $66,000 after it had depreciated the machine an additional $4,000. What is Zeema's gain on the machine and what is its character?
Answer: Zeema must recognize a $34,000 ($66,000 - $32,000) gain on the sale. Of this gain, $18,000 is ordinary income recaptured under Sec. 1245. The remaining $16,000 is Sec. 1231 gain.
Page Ref.: C:2-25; Example C:2-39
Objective: 4

65) On July 9, 2008, Tom purchased a computer (five-year property for MACRS purposes) for \$6,000, which he used in his sole proprietorship. He claimed \$1,200 (0.20 × \$6,000) of depreciation for 2008. On February 9, 2009, he transfers the computer and other assets of his sole proprietorship to Brewer Corporation in exchange for Brewer stock in a transfer qualifying under Sec. 351. What is the amount of depreciation for 2008 claimed by Tom? What is the amount of depreciation for 2009 claimed by Brewer Corporation? What is Brewer's basis in the computer on the date of transfer?
Answer: Brewer Corporation must use the same MACRS recovery period and method that Tom used. Depreciation for 2009 is \$1,920 (0.32 × \$6,000), which is allocated between Tom and Brewer Corporation. The computer is considered to be held by Tom for one month and by Brewer Corporation for 11 months. Therefore, Tom claims \$160 and Brewer claims \$1,760 in depreciation for 2009. On February 9, 2009, Brewer's basis in the computer is \$4,640.

Original cost of computer	\$6,000
Minus 2008 depreciation taken by Tom	(1,200)
2009 depreciation taken by Tom	(160)
Adjusted basis on transfer date	\$4,640

Page Ref.: C:2-26; Example C:2-40
Objective: 4

66) Reba, a cash basis accountant, transfers all of the assets and liabilities of her practice to Able Corporation in exchange for all of Able Corporation's stock. The assets include \$20,000 of accounts receivable. What is the Corporation's basis in the receivables? Will the corporation be taxed on the receivables, as they are collected?
Answer: Able Corporation's basis in the receivables is zero as the corporation will include the receivables in income as they are collected.
Page Ref.: C:2-27; Example C:2-42
Objective: 4

67) Discuss the impact of the contribution of cash as part of a Sec. 351 exchange.
Answer: Cash is treated as property when it is contributed. No gain or loss is recognized by the transferor when a contribution of cash is made. Stock received by a transferor who contributes cash for the stock has his shares counted for purposes of the 80% control test.
Page Ref.: C:2-12
Objective: 4

68) This year, John, Meg, and Karen form Frost Corporation. John contributes land purchased as an investment four years ago for $15,000 that has a $30,000 FMV in exchange for 30 shares of Frost stock. Meg contributes machinery (Sec. 1231 property) purchased four years ago and used in her business having a $35,000 adjusted basis and a $30,000 FMV in exchange for 30 shares of Frost stock. Karen contributes services worth $20,000 in exchange for 20 shares of Frost stock.

a) What is the amount of John's recognized gain or loss?
b) What is John's basis in his Frost shares? When does his holding period begin?
c) What is the amount of Meg's recognized gain or loss?
d) What is Meg's basis in her Frost shares? When does her holding period begin?
e) How much income, if any, must Karen recognize?
f) What is Karen's basis in her Frost shares? When does her holding period begin?
g) What is Frost Corporation's basis in the land and the machinery? When does its holding period begin? How does Frost Corporation treat the amount paid to Karen for her services?

Answer:

a) Since Sec. 351 does not apply because 25% (20 shares out of 80 total shares) of the stock is issued for services, John must recognize $15,000 of capital gain.
b) John's basis in his shares is $30,000 and his holding period begins on the day after the exchange date.
c) Meg recognizes a $5,000 Sec. 1231 loss.
d) Meg's basis in her shares is $30,000 and her holding period begins on the day after the exchange date.
e) Karen must recognize $20,000 of ordinary income.
f) Karen's basis in her shares is $20,000. Her holding period begins on the day after the exchange date.
g) Frost Corporation has a $30,000 basis in the land and a $30,000 basis in the machinery. Its holding period for each asset begins on the day after the exchange date. The services, if capitalized, would have a $20,000 basis. The services may be amortizable if they are organizational or start-up expenditures.

Page Ref.: C:2-12 through C:2-24
Objective: 4

69) This year, John, Meg, and Karen form Frost Corporation. John contributes land purchased as an investment four years ago for $25,000 that has a $30,000 FMV in exchange for 30 shares of Frost stock. Meg contributes machinery (Sec. 1251 property) purchased four years ago and used in her business having a $50,000 adjusted basis and a $30,000 FMV in exchange for 30 shares of Frost stock. Karen contributes services worth $15,000 and $5,000 cash in exchange for 20 shares of Frost stock.

a) What is the amount of John's recognized gain or loss?
b) What is John's basis in his Frost shares? When does his holding period begin?
c) What is the amount of Meg's recognized gain or loss?
d) What is Meg's basis in her Frost shares? When does her holding period begin?
e) How much income, if any, must Karen recognize?
f) What is Karen's basis in her Frost shares? When does her holding period begin?
g) What is Frost Corporation's basis in the land and the machinery? When does its holding period begin? How does Frost Corporation treat the amount paid to Karen for services?

Answer:

a) Since Sec. 351 would apply to the exchange, John would not recognize any gain or loss.
b) John's basis is $25,000. His holding period begins in his year of purchase four years ago.
c) Meg does not recognize any loss.
d) Meg's basis is $50,000. Her holding period begins in her year of purchase four years ago.
e) Karen must recognize $15,000 of ordinary income.
f) Karen's basis for her shares is $20,000 and her holding period begins on the day after the exchange date.
g) Frost Corporation's basis in the land and machinery are $25,000 and $30,000, respectively. Because Meg contributed loss property, unless an election is made, the basis in the loss property must be reduced to FMV by the corporation. Frost's holding period for the land begins four years ago. Frost's holding period for the machinery begins the day after transfer to Frost Corporation. The services, if capitalized, would have a $15,000 basis. The services may be amortizable if they are organizational or start-up expenditures.

Page Ref.: C:2-12 through C:2-24
Objective: 4

70) On May 1 of the current year, Kiara, Victor, Pam, and Joe form Newco Corporation with the following investments:

Property Transferred

Transferor	Asset	Basis to Transferor	FMV	Number of common shares issued
Kiara	Land	$12,000	$30,000	
	Building	38,000	70,000	400
	Mortgage and the land & building	60,000	60,000	
Victor	Equipment	25,000	40,000	300
Pam	Van	15,000	10,000	50
Joe	Accounting Services	0	10,000	100

Kiara purchased the land and building several years ago for $12,000 and $50,000, respectively. Kiara has claimed straight-line depreciation on the building. Victor also received a Newco Corporation note for $10,000 due in three years. The note bears interest at a rate acceptable to the IRS. Victor purchased the equipment three years ago for $50,000. Pam also receives $5,000 cash. Pam purchased the van two years ago for $20,000.

a) Does the transaction satisfy the requirements of Sec. 351?
b) What are the amounts and character of the reorganized gains or losses to Kiara, Victor, Pam, Joe, and Newco Corporation?
c) What is each shareholder's basis for his or her Newco stock? When does the holding period for the stock begin?
d) What is Newco Corporation's basis for its property and services? When does its holding period begin for each property?
Answer:
a) Yes, the transaction meets the requirements of Sec. 351. Transferors of property (Kiara, Victor, & Pam) own 88.2% (750/850 = 0.882) of the Newco stock.
b) Kiara must recognize a $10,000 gain, the amount by which the $60,000 mortgage assumed by Newco exceeds the $50,000 basis ($12,000 + $38,000) of all the assets transferred by Kiara. The character of the gain is a Sec. 1231 gain. Victor must recognize $10,000 of gain (the lesser of his realized gain of $15,000 on the boot received of $10,000). The gain is ordinary income recaptured under Sec. 1245. Pam realized a $5,000 loss, which is not recognized even though she received cash. Joe must recognize $10,000 ordinary income on compensation for his services. Newco Corporation recognizes neither a gain nor a loss on the issuance of its stock or note.
c) Kiara's basis is zero ($12,000 + $38,000 - $60,000 + $10,000 gain). Her holding period includes her holding period for the land and building. Victor's basis is $25,000 ($25,000 + $10,000 gain - $10,000 boot). His holding period includes his holding period for the equipment. Pam's basis for her stock is $10,000 ($15,000 - $5,000 boot). Her holding period includes the holding period for the van. Joe's basis for his stock is $10,000. His holding period begins on the day after the exchange.

d) Newco Corporation's basis is:

Land	$15,000	[$12,000 + (0.30 × $10,000)]
Building	$45,000	[$38,000 + (0.70 × $10,000)]

The gain is allocated between the two assets based on their relative FMVs. The holding period includes Kiara's holding period.

Equipment: $35,000($25,000 + $10,000).

The holding period includes Victor's holding period.

Van: $15,000.

The holding period includes Pam's holding period.

The $10,000 in accounting services is deductible by Newco Corporation if received subsequent to the start of operations. If they are preoperating expenses, they should be analyzed under Sec. 248.

Page Ref.: C:2-12 through C:2-27

Objective: 4

71) Lynn transfers property with a $56,000 adjusted basis and a $100,000 FMV to Florida Corporation for 75 shares of Florida stock. Fred, Lynn's father, transfers property with a $64,000 adjusted basis and a $100,000 FMV to Florida Corporation for the remaining 25 shares of Florida stock.

a) What is the amount of each transferor's gain or loss?

b) What is Lynn's basis for her Florida stock?

c) What is Fred's basis for his Florida stock?

Answer:

a) Neither Lynn nor Fred recognizes any gain or loss on the exchange since Sec. 351 applies.

b) Since the exchange is disproportionate, it is likely that Fred has made a gift of 25 shares of Florida stock to Lynn. Lynn's basis in her 75 shares is $88,000 ($56,000 basis in property transferred by Lynn + $32,000 basis in the 25 shares received from Fred). (This answer assumes no gift taxes were paid by Fred on the transfer.)

c) Fred's basis in his 25 shares is $32,000 [$64,000 - (0.50 × $64,000)].

Page Ref.: C:2-15

Objective: 4

72) Norman transfers machinery that has a $45,000 basis and a $105,000 FMV and $30,000 in money to Elnor Corporation in exchange for 50 shares of Elnor stock. The machinery, used in Norman's business, originally cost him $150,000 and is subject to an $84,000 liability which Elnor Corporation assumes. Kate exchanges $51,000 cash for the remaining 50 shares of Elnor stock.

a) What is the amount and character of Norman's recognized gain or loss?
b) What is his basis in the Elnor stock?
c) What is Elnor's basis in the machinery?
d) What is the amount and character of Kate's recognized gain or loss?
e) What is Kate's basis in the Elnor stock?
f) When do Norman and Kate's holding periods for their stock begin?

Answer:

a) Norman's realized gain is $60,000 [($51,000 + $84,000) - ($45,000 + $30,000)]. He must recognize $9,000 of gain, the amount by which the liability transferred ($84,000) exceeds the basis of all property transferred by Norman ($45,000 + $30,000).
b) Norman's basis for his Elnor stock is 0 ($45,000 + $30,000 - $84,000 + $9,000 gain).
c) Elnor's basis in the machinery is $54,000 ($45,000 + $9,000).
d) Kate does not recognize any gain or loss.
e) Kate's basis is $51,000.
f) Norman's holding period includes his holding period for the machinery. Kate's holding period starts on the day after the exchange.

Page Ref.: C:2-22 through C:2-24
Objective: 4

73) What is the impact on a transferor if a Sec. 351 exchange involves the assumption of the shareholder's liabilities by the corporation?

Answer: The general rule is that the assumption does not invalidate the Sec. 351 exchange. The liabilities that are assumed are not considered to be boot (Sec. 357(a)). If the assumption or acquisition of any of the liabilities fails to have a business purpose or has a tax avoidance purpose, then all of the liabilities are considered to be money (Sec. 357(b)). Gain is recognized equal to the lesser of the realized gain or money received. If the amount of liabilities assumed or acquired exceeds the adjusted basis of the property transferred, then gain must be recognized in the amount of the excess (Sec. 357(c)).

Page Ref.: C:2-22 and C:2-23; Example C:2-35
Objective: 4

74) Michael contributes equipment with a $25,000 adjusted basis and a $40,000 FMV to Miller Corporation for 25 of its 50 shares of stock. His son, Michael Jr., contributes $10,000 cash for the remaining 25 Miller shares. What tax issues should Michael and his son consider with respect to the stock acquisitions?
Answer:
- Does the property transfer meet the Sec. 351 requirements?
- Have Michael and his son transferred property?
- Are the transferors in control of the corporation following the transfer?
- Do the transferors receive transferee corporation stock?
- Does the property contribution/receipt of stock as outlined in the facts reflect the true nature of the transaction? Or has a gift or other event occurred?
- What is each shareholder's recognized gain?
- What is each shareholder's basis for his stock?
- What is each shareholder's holding period for his stock?
- If a gift has occurred, has Michael made a taxable gift to his son? (This question could be rewritten for events other than a gift — e.g., repayment of a loan.)
- What is Miller Corporation's basis for the property received from Michael?
- What is Miller Corporation's holding period for the property received from Michael?

The contribution is tax-free since it meets all the Sec. 351 requirements, and Michael and Michael Jr. own all the Miller stock. Michael Jr. receives a disproportionate amount of stock compared to his $10,000 capital contribution. It appears that the transaction should be recast so that Michael receives 40 shares of stock, each valued at $1,000. He then gifts 15 shares to Michael Jr. The gift leaves each shareholder with 25 shares of stock. Neither shareholder recognizes any gain, and Michael takes a $25,000 adjusted basis for the 40 shares he receives. He recognizes no gain on the transfer of 15 shares to Michael Jr., and $9.375 [(15/40) × $25,000] of his basis accompanies the gifted shares. Michael's basis for his remaining 25 shares is $15,625 ($25,000 - $9,375). Michael, Jr.'s basis for his 25 shares is $19,375 ($10,000 + $9,375).
Page Ref.: C:2-11 through C:2-22
Objective: 4

75) Stu Walker has owned all 200 shares of Lance Corporation's stock for the past six years. This year, Megan Jones contributes property with a $100,000 basis and a $160,000 FMV for 160 newly issued Lance shares. At the same time, Stu contributes $30,000 in cash for 30 newly issued Lance shares. What tax issues should Megan and Stu consider with respect to the stock acquisitions?

Answer:

- Does the property transfer meet the Sec. 351 requirements?
- Have Stu and Megan transferred property?
- Does the fact that Stu controls Lance Corporation prior to the transfer change the general Sec. 351 rules?
- Are the transferors in control of the corporation following the transfer?
- Do the transferors receive transferee corporation stock?
- What is each shareholder's recognized gain?
- What is each shareholder's basis for his or her stock?
- What is each shareholder's holding period for his or her stock?
- Does Lance Corporation recognize gain when it issues its stock?
- What is Lance Corporation's basis for the property received from Megan?
- What is Lance Corporation's holding period for the property received from Megan?

The property transfer meets all the Sec. 351 requirements. Stu and Megan are considered to own all 390 of the Lance shares immediately after the exchange. Stu's contribution of cash for stock is not considered to be a nominal amount, according to the IRS rules for private letter rulings (i.e., it equals or exceeds 10% of the value of Stu's prior stock holdings) and permits his stock to be counted toward the 80% minimum stock ownership for control. Megan recognizes no gain on the asset transfer and takes a $100,000 basis for the Lance shares she receives. The holding period for the Lance shares includes her holding period for the property transferred. Lance recognizes no gain when it issues its stock and takes a $100,000 basis for the property.

Page Ref.: C:2-11 through C:2-22

Objective: 4

76) On April 2 of the current year, Jana transfers land with a basis of $140,000 and a fair market value of $120,000 to Amish Corporation in exchange for all of its stock. She had originally acquired the land on December 1, 2002. What tax issues arise from the exchange?
Answer:

- Does the property transfer meet the Sec. 351 requirements?
- Has Jana transferred property?
- Is Jana in control of the corporation following the transfer?
- What is Jana's recognized gain?
- What is Jana's basis for her stock?
- Should Jana elect to take a reduced basis in the stock so that Amish will have a $140,000 basis in the land?
- What is Jana's holding period for her stock?
- Does Amish Corporation recognize gain when it issues its stock?
- What is Amish Corporation's basis for the property received from Jana?
- What is Amish Corporation's holding period for the property received from Jana?

The property transfer meets all the Sec. 351 requirements. Neither Jana nor Amish has gain or loss on the exchange. Jana can elect to take a basis of $120,000 in the Amish stock and Amish will have a $140,000 basis in the land. If no election is made, Amish will have a basis of $120,000 in the land and Jana's basis in the stock is $140,000. If Amish has a basis of $120,000 in the land, its holding period for the land will begin on the day after the exchange. If Amish takes Jana's basis of $140,000 and Jana reduces her basis in the stock, Amish's holding period for the land begins on December 2, 2000. Jana's holding period for the stock includes the period for which she held the land.
Page Ref.: C:2-12 through C:2-27
Objective: 4

77) Joan transfers land (a capital asset) having a $20,000 adjusted basis to Jet Corporation in a transaction qualifying under Sec. 351. In exchange, she received 50 shares of Jet Corporation common stock valued at $50,000, a $15,000 Jet Corporation bond due in 10 years, and a $10,000 Jet Corporation note due in 3 years. What tax issues should Joan consider with respect to the transfer?

a) What is the amount of Joan's realized gain or loss? What is the amount of Joan's recognized gain or loss? What is the character of Joan's recognized gain or loss?

b) What is Joan's basis in her stock? What is Joan's basis in the bond? What is Joan's basis in the note?

c) What is Jet Corporation's basis in the land?

Answer:

a) Amount realized ($50,000 + $15,000 + $10,000)	$75,000	
Minus: Basis in land	(20,000)	
Realized gain	$55,000	
Boot received (bond and note)		$25,000
Gain recognized (capital gain)		$25,000

b) Basis of stock and ten-year bond:
Basis of stock: $20,000 + $25,000 - $25,000 = $20,000
Basis of bond: $15,000 (FMV)
Basis of short-term note: $10,000 (FMV)

c) Basis of land to Jet Corporation is: $20,000 + $25,000 = $45,000.

Page Ref.: C:2-17 through C:2-19
Objective: 4

LO5: Choice of Capital Structure

1) The City of Springfield donates land worth $250,000 to Deuce Corporation to induce it to locate in Springfield and provide 1,000 jobs for its citizens. How much gross income must Deuce Corporation recognize because of the land contribution, and what is the land's basis to Deuce Corporation?

A) $250,000 income; $250,000 basis
B) $250,000 income; $0 basis
C) $0 income; $250,000 basis
D) $0 income; $0 basis

Answer: A
Explanation: FMV of property is income, becomes basis.
Page Ref.: C:2-31; Example C:2-45
Objective: 5

2) The City of Portland gives Data Corporation $60,000 cash and land worth $100,000 to induce it to move. The cash was not spent during the 12 months following contribution. The contribution results in
A) income recognition in the amount of $160,000 to the corporation at the time of contribution.
B) income recognition in the amount of $60,000 to the corporation 12 months after the time of contribution.
C) a zero basis in the land and $60,000 ordinary income to the corporation 24 months after the time of contribution if the cash is not used to purchase an asset.
D) a zero basis in the land and a $60,000 basis reduction in other assets.
Answer: A
Explanation: $160,000 upon receipt
Page Ref.: C:2-31; Example C:2-45
Objective: 5

3) Mr. Big, a nonshareholder, who is not a customer, potential customer, governmental entity, or civic group, contributes $60,000 cash and land worth $100,000 to induce Carrie Corporation to relocate to his municipality. Carrie Corporation spent $50,000 of the cash within the first 12 months of his contribution to purchase machinery. The contribution results in
A) Carrie Corporation recognizes no income as a result of the contribution, the land and machinery have a basis of zero.
B) Carrie Corporation recognizes $160,000 of income.
C) Carrie Corporation recognizes no income as a result of the contribution, the land has a basis of zero, and the machinery has a basis of $50,000.
D) Carrie Corporation recognizes no income as a result of the contribution, the land has a basis of $100,000, and the machinery has a basis of $60,000.
Answer: A
Explanation: Nonshareholder contribution
Page Ref.: C:2-31 and C:2-32
Objective: 5

4) Ra Corporation issues a twenty-year obligation at its $1,000 face amount. Rames purchases the obligation for $1,000 on the issue date. Due to a decline in interest rates, Ra calls the obligation by paying $1,010 to each of the holders of the twenty-year obligations. What is the tax treatment of the $1,010 by Ra and Rames?
Answer: Rames will recognize a $10 capital gain on the repayment of the debt instrument. Ra will deduct the $10 premium paid as interest expense.
Page Ref.: C:2-29; Example C:2-43
Objective: 5

5) This year, the City of Seattle gives Dotcom Corporation $120,000 cash and land worth $200,000 to induce it to relocate to Seattle. Dotcom did not spend the cash during the 12 months following the contribution. What are the tax consequences to Dotcom?
Answer: $320,000 income is recognized. Dotcom Corporation's basis in the land is $200,000.
Page Ref.: C:2-31; Example C:2-45
Objective: 5

6) The City of Providence owns 100% of Triple A Baseball Corporation, a minor league baseball team in their community. The City donates land worth $125,000 to Triple A Corporation so the major league team will not revoke the City's minor league franchise. How much gross income must Triple A Corporation recognize because of the land contribution, and what is the land's basis to Triple A Corporation?
Answer: The corporation recognizes no income and the land has a $0 basis because the City is the majority shareholder.
Page Ref.: C:2-30
Objective: 5

7) What is the tax treatment for a contribution of capital to a corporation by a nonshareholder who is not a customer, potential customer, government entity, or civic group?
Answer: The corporation does not recognize income as a result of the capital contribution. The basis of any property contributed by a nonshareholder is zero. The basis of property acquired with a money contribution made by a nonshareholder must be reduced by the amount of the contributed money used toward the purchase. Any money that was contributed and not spent during the 12 months following the contribution reduces the basis of other assets. The order of reduction is: First, depreciable property; then amortizable property; then depletable property; and finally, all other property.
Page Ref.: C:2-31
Objective: 5

8) Sarah has advanced money to her corporation. What tax issues should she consider with respect to this money?
Answer:
- Is it equity capital or debt?
- Is there a written unconditional promise to pay on demand or on a specific date a certain sum of money in return for an adequate consideration in money or money's worth, and to pay a fixed interest rate?
- Is the debt subordinate to or preferred over other indebtedness of the corporation?
- What is the ratio of debt to equity?
- If debt, is the debt convertible into stock?
- What is the relationship between holdings of stock in the corporation and holdings of the interest in question?

It is important to distinguish between capital and debt. Interest paid with respect to a debt instrument is deductible by the payor corporation, whereas dividends paid are not.
Page Ref.: C:2-29 and C:2-30
Objective: 5

LO6: Worthlessness of Stock or Debt Obligations

1) Any losses on the sale of Section 1244 stock are ordinary.
Answer: FALSE
Explanation: Ordinary losses subject to Sec. 1244 stock losses are capped at $100,000 for MFJ taxpayers
Page Ref.: C:2-32 and C:2-33
Objective: 6

2) Ralph and Yolanda purchased 20% of the initial offering of Major Corporation common stock for $150,000. Major Corporation is a qualifying small business corporation and the stock qualifies as Sec. 1244 stock. Ten months later, Major Corporation files for bankruptcy and the shareholders are notified that the stock is worthless. Ralph and Yolanda, who are married and file a joint return, have a
A) $150,000 ordinary loss.
B) $150,000 capital loss.
C) $100,000 ordinary loss; $50,000 capital loss.
D) $100,000 ordinary loss; $50,000 ordinary loss carryforward.
Answer: C
Explanation: MFJ 1244 stock loss is capped at $100,000 ordinary loss
Page Ref.: C:2-32; Example C:2-46
Objective: 6

3) Yenhung, who is single, forms a corporation using a tax-free asset transfer, which qualifies under Sec. 351. She contributes property having an adjusted basis of $50,000 and an FMV of $40,000. The stock received from the corporation is Sec. 1244 stock. When Yenhung sells the stock for $30,000, her loss is

A)

Ordinary loss	**Capital loss**
$ 0	$20,000

B)

Ordinary loss	**Capital loss**
$10,000	$10,000

C)

Ordinary loss	**Capital loss**
$20,000	$ 0

D)

Ordinary loss	**Capital loss**
$10,000	$ 0

Answer: B
Explanation: The loss on formation of the corporation ($10,000) is postponed until the stock is sold and retains its character as capital. $10,000 of the loss ($30,000 sales proceeds - $40,000 Sec. 1244 basis) qualifies as an ordinary loss on the sale of Sec. 1244 stock.
Page Ref.: C:2-33; Example C:2-47
Objective: 6

4) Nikki exchanges property having a $20,000 adjusted basis and a $16,000 FMV for 100 shares of Niftik stock in a transaction qualifying under Sec. 351. The stock qualifies as Sec. 1244 stock. Nikki's basis in her Niftik stock is $20,000. If Nikki sells her stock for $5,000, what is the amount and character of her loss?
Answer: Nikki has a $15,000 ($5,000 - $20,000) recognized loss. Her ordinary loss under Sec. 1244 is $11,000 ($5000 - $16,000 Sec. 1244 basis). The remaining $4,000 loss is a capital loss.
Page Ref.: C:2-32; Example C:2-46
Objective: 6

5) Darnell, who is single, exchanges property having a $60,000 adjusted basis and a $50,000 FMV for 1,000 shares of Fox Corporation stock in a transaction qualifying under Sec. 351. The stock qualifies as Sec. 1244 stock. If Darnell sells his stock for $30,000, what is the amount and character of his recognized gain or loss?
Answer: Darnell has a $20,000 ordinary loss and a $10,000 capital loss.

Proceeds	$30,000
Adjusted basis in the stock	$60,000
Realized loss	$30,000

For Sec. 1244 purposes, his basis is $50,000. Therefore only $20,000 ($30,000 - $50,000) qualifies as an ordinary loss. The remaining $10,000 is a capital loss.
Page Ref.: C:2-32; Example C:2-46
Objective: 6

6) Will, a shareholder in Wiley Corporation, lent money to the corporation. The corporation is unable to repay him. What tax issues should Will consider with respect to the loan?
Answer:
- Was the loan evidenced by a security?
- Was there a business purpose for making the loan?
- Is the shareholder an employee of the corporation?
- If so, was the loan made in his capacity as an employee or as a shareholder?
- What are the relative dollar amounts of his stock investment and his compensation?

The type of loss allowed if a shareholder lends money to a corporation that is not repaid depends on the nature of the loan. If the unpaid loan was not evidenced by a security, it is either a business or nonbusiness bad debt. Nonbusiness bad debts are deductible only as short-term capital losses when the debt is determined to be totally worthless. Business bad debts are deductible as ordinary deductions without limit when they are either partially or totally worthless. The IRS generally treats a loan made by a shareholder to a corporation in connection with his stock investment as a nonbusiness activity. If the loan is made to protect the shareholder's employment with the corporation, it may be treated as an ordinary loss under the business bad debt rules.
Page Ref.: C:2-33 and C:2-34
Objective: 6

7) Severs Corporation employs Susan as an Advertising Director. Her annual compensation from Severs Corporation is $100,000. Severs Corporation is experiencing financial problems, and Susan lends the corporation $50,000 in 2008 in an attempt to help it through its financial difficulties. Severs Corporation subsequently declares bankruptcy, and in 2010 Susan and the other creditors receive 10 cents on each dollar they are owed. What is the amount and character of Susan's loss?
Answer: Since Susan is not a shareholder in Severs Corporation, her loss of $45,000 ($50,000 × .90) is an ordinary loss and is fully deductible in the year she incurs the loss.
Page Ref.: C:2-33 and C:2-34; Example C:2-48
Objective: 6

LO7: Tax Planning Considerations

1) Gene purchased land five years ago as an investment. The land cost him $200,000 and is now worth $530,000. Gene plans to transfer the land to Dee Corporation, which will subdivide the land and sell individual parcels. Dee Corporation's profits on the land will be ordinary income. What are the tax consequences of the asset transfer and land sales if Gene contributes the land to Dee Corporation in exchange for all of its stock? What alternative methods can be used to structure the transaction to achieve better tax consequences?
Answer: Gene recognizes no gain when he transfers the land to Dee Corporation. Dee Corporation's basis in the land will be $200,000. All gain on the subsequent sale will be ordinary income to Dee Corporation. This alternative results in the precontribution gain that accrued prior to Gene's transfer and the postcontribution profit originating from subdividing the land being taxed at Dee Corporation's marginal tax rate. Gene could transfer the land to Dee Corporation in exchange for stock and $330,000 of debt instruments. In this case, Gene would recognize $330,000 of long-term capital gain and Dee Corporation's basis in the land would be $530,000. The $330,000 of precontribution capital gain (net of any capital losses that Gene has recognized) is taxed at a 15% capital gains tax rate.
Page Ref.: C:2-35 through C:2-36
Objective: 7

2) Why would a transferor want to avoid the nonrecognition of gain under Sec. 351? How can the nonrecognition provision of Sec. 351 be avoided?
Answer: A transferor may want the corporation to have a higher basis in the property transferred. A higher basis would allow greater depreciation deductions and reduce the gain recognized if the corporation sells the property. The increased depreciation and/or reduced gain may be an advantage because the corporation may be in a higher tax bracket than the transferor. A transferor's gain also may be a capital gain that is reduced by a capital loss so as to be tax-free. Nonrecognition can be avoided by selling the property to the corporation for cash or cash and debt. The 80% control test may be intentionally avoided by issuing property for services. Also, by using debt in an amount that exceeds the transferor's basis or by having debt assumed or acquired without a business purpose, the transferor can be required to recognize gain.
Page Ref.: C:2-35
Objective: 7

3) Discuss the tax planning opportunities that are available in forming a corporation when one of the parties owns property that has a high basis and a low FMV.
Answer: The plan should be formulated to allow the contributor to avoid Sec. 351 and be able to recognize the loss. This can be done by having the transferor sell the property to an unrelated party and then have the transferor contribute cash. The transferor must be careful to avoid the related party rules of Sec. 267, which could prevent the loss from being recognized if the property is sold directly to the corporation. Several other suggestions are explored on pages C:2-34 and C:2-35.
Page Ref.: C:2-33 and C:2-34; Example C:2-48
Objective: 7

4) Several years ago, John acquired 200 shares of Jersey Corporation stock directly from the corporation for $150,000 in cash. This year, he sold the stock to Bill for $85,000. What tax issues should John consider with respect to the stock sale?

Answer:

• Was the stock sold to a related party (Bill) as defined by Sec. 267(b)? If so, John cannot recognize the loss, and the remaining issues do not have to be examined.

• Is the stock a capital asset?

• Is Jersey Corporation a qualifying small business corporation?

• If a qualifying small business corporation, does the stock qualify for Sec. 1244 stock treatment?

• If Sec. 1244 stock, what is John's marital and filing status?

• Has John's basis for the stock changed from its initial acquisition cost?

• What is the amount and character of John's recognized loss?

John's stock sale results in a $65,000 ($150,000 - $85,000) long-term capital loss, provided the purchaser was not a related party. If the purchaser is a related party, Sec. 267(a) prevents John from recognizing any loss. Since John is the original holder of the stock, the loss may be characterized as ordinary under Sec. 1244 if the various requirements of Sec. 1244 are satisfied.

Page Ref.: C:2-34 and C:2-35

Objective: 7

LO8: Compliance and Procedural Considerations

1) Discuss the IRS reporting requirements under Sec. 351.
Answer: Both the transferor-shareholders and the transferee corporation must attach a statement to their tax returns for the period that includes all the facts pertinent to the exchange and discloses the date of the exchange.

The transferor-shareholder statement would include:

- a description of the property transferred and its adjusted basis to the transferor.
- a description of the stock received in the exchange, including its kind, number of shares, and FMV.
- a description of the securities received in the exchange, including the principal amount, terms, and FMV.
- the amount of money received.
- a description of any other property received, including its FMV.
- a statement of the liabilities transferred to the corporation, including the nature of the liabilities, when and why they were created, and the corporate business reason for their transfer.

The transferee corporation statement would include:

- a complete description of all property received from the transferors.
- the adjusted basis of the property to the transferors.
- a description of the stock issued to the transferors.
- a description of the securities issued to the transferors.
- the amount of money distributed to the transferors.
- a description of any other property distributed to the transferors.
- information regarding the transferor's liabilities that are assumed by the corporation.

Page Ref.: C:2-36
Objective: 8

***Pearson's Federal Taxation 2021: Comp., 34e* (Rupert/Anderson)**
Chapter I1: An Introduction to Taxation

LO1: History of Taxation in the United States

1) The federal income tax is the dominant form of taxation by the federal government.
Answer: TRUE
Explanation: The federal income tax provides more revenues than any other tax.
Page Ref.: I:1-2
Objective: 1

2) The Sixteenth Amendment to the U.S. Constitution permits the passage of a federal income tax law.
Answer: TRUE
Explanation: The Sixteenth Amendment amended the Constitution to permit the imposition of an income tax.
Page Ref.: I:1-2
Objective: 1

3) When a change in the tax law is deemed necessary by Congress, the entire Internal Revenue Code must be revised.
Answer: FALSE
Explanation: The federal income tax law is changed on an incremental basis.
Page Ref.: I:1-3
Objective: 1

4) The largest source of federal revenues is the corporate income tax.
Answer: FALSE
Explanation: The largest source is the individual income tax.
Page Ref.: I:1-3
Objective: 1

5) Until about 100 years ago, attempts to impose a federal income tax were ruled unconstitutional. The amendment to the U.S. Constitution allowing the imposition of a federal income tax is the
A) Second Amendment.
B) Thirteenth Amendment.
C) Sixteenth Amendment.
D) Nineteenth Amendment.
Answer: C
Explanation: The Sixteenth Amendment, ratified in 1913, gave Congress the power to impose a federal income tax.
Page Ref.: I:1-2
Objective: 1

6) The largest source of revenues for the federal government comes from
A) individual income taxes.
B) corporate income taxes.
C) Social Security and Medicare taxes (FICA).
D) estate and gift taxes.
Answer: A
Explanation: The individual income tax has provided the largest source of revenues for many years.
Page Ref.: I:1-3
Objective: 1

LO2: Types of Tax Rate Structures

1) A progressive tax rate structure is one where the rate of tax increases as the tax base increases.
Answer: TRUE
Explanation: Under a progressive tax system, the rate increases as the tax base increases.
Page Ref.: I:1-4
Objective: 2

2) The terms "progressive tax" and "flat tax" are synonymous.
Answer: FALSE
Explanation: A proportional, not progressive, tax and flat tax are synonymous.
Page Ref.: I:1-4
Objective: 2

3) A proportional tax rate is one where the rate of the tax is the same for all taxpayers, regardless of income levels.
Answer: TRUE
Explanation: A proportional tax is essentially a flat tax.
Page Ref.: I:1-4
Objective: 2

4) Regressive tax rates decrease as the tax base increases.
Answer: TRUE
Explanation: Regressive rates increase as the base decreases.
Page Ref.: I:1-5
Objective: 2

5) The marginal tax rate is useful in tax planning because it measures the tax effect of a proposed transaction.
Answer: TRUE
Explanation: The marginal rate applies to the planned addition to income or reduction to income.
Page Ref.: I:1-5
Objective: 2

6) A taxpayer's average tax rate is the tax rate applied to an incremental amount of taxable income that is added to the tax base.
Answer: FALSE
Explanation: The marginal tax rate is the tax rate applied to an incremental amount of taxable income.
Page Ref.: I:1-5
Objective: 2

7) If a taxpayer's total tax liability is $30,000, taxable income is $100,000, and economic income is $120,000, the average tax rate is 30 percent.
Answer: TRUE
Explanation: The average rate equals the tax liability divided by the taxable income.
Page Ref.: I:1-5
Objective: 2

8) If a taxpayer's total tax liability is $4,000, taxable income is $20,000, and total economic income is $40,000, then the effective tax rate is 20 percent.
Answer: FALSE
Explanation: The effective rate would be $4,000/$40,000 = 10 percent.
Page Ref.: I:1-6
Objective: 2

9) Arthur pays tax of $5,000 on taxable income of $50,000 while taxpayer Barbara pays tax of $12,000 on $120,000. The tax is a
A) progressive tax.
B) proportional tax.
C) regressive tax.
D) None of the above.
Answer: B
Explanation: The tax rate is proportional because the 10% tax rate applies to both taxpayers regardless of their income level.
Page Ref.: I:1-4; Example I:1-3
Objective: 2

10) Which of the following taxes is progressive?
A) sales tax
B) excise tax
C) property tax
D) federal income tax
Answer: D
Explanation: Federal income tax rates increase as a taxpayer's taxable income rises.
Page Ref.: I:1-4; Topic Review I:1-1
Objective: 2

11) Which of the following taxes is proportional?
A) gift tax
B) income tax
C) sales tax
D) Federal Insurance Contributions Act (FICA)
Answer: C
Explanation: A sales tax is assessed at a fixed rate of the purchase amount, based on state and local law.
Page Ref.: I:1-4; Topic Review I:1-1
Objective: 2

12) Which of the following taxes is regressive?
A) Federal Insurance Contributions Act (FICA)
B) excise tax
C) property tax
D) gift tax
Answer: A
Explanation: For upper income wage earners, the Social Security tax ceases at a maximum wage base. For 2020, wages over $137,700 are not subject to the Social Security tax.
Page Ref.: I:1-5; Topic Review I:1-1
Objective: 2

13) The corporate tax rate is
A) progressive.
B) regressive.
C) proportional.
D) none of the above.
Answer: C
Explanation: The corporate tax rate is a flat 21 percent.
Page Ref.: I:1-5
Objective: 2

14) Sarah contributes $25,000 to a church. Sarah's marginal tax rate is 35% while her average tax rate is 25%. After considering her tax savings, Sarah's contribution costs
A) $6,250.
B) $8,750.
C) $16,250.
D) $18,750.
Answer: C
Explanation: [$25,000 × (100% - 35%)] = $16,250
Page Ref.: I:1-5; Example I:1-4
Objective: 2

15) Helen, who is single, is considering purchasing a residence that will provide an $18,000 tax deduction for property taxes and mortgage interest. If her marginal tax rate is 24% and her effective tax rate is 20%, what is the amount of Helen's tax savings from purchasing the residence?
A) $3,600
B) $4,320
C) $3,200
D) $18,000
Answer: B
Explanation: $18,000 × .24 marginal rate = $4,320 tax savings.
Page Ref.: I:1-5; Example I:1-4
Objective: 2

16) Charlotte pays $8,000 in tax deductible property taxes. Charlotte's marginal tax rate is 24%, effective tax rate is 20% and average rate is 22%. Charlotte's tax savings from paying the property tax is
A) $1,600.
B) $1,760.
C) $1,920.
D) $8,000.
Answer: C
Explanation: $8,000 × 0.24 = $1,920
Page Ref.: I:1-5; Example I:1-4
Objective: 2

17) Briana, who is single, has taxable income for 2020 of $90,000, resulting in a total tax of $15,680. Her total economic income is $100,000. Briana's average tax rate and effective tax rate are, respectively,
A) 17.42% and 15.68%.
B) 17.42% and 24%.
C) 15.68% and 24%.
D) 15.68% and 17.42%.
Answer: A
Explanation: Average tax rate: $15,680 ÷ $90,000 = 17.42%
Effective tax rate: $15,680 ÷ $100,000 = 15.68%
Page Ref.: I:1-5 and I:1-6; Example I:1-5
Objective: 2

18) Larry and Ally are married and file a joint return. They are considering purchasing a personal residence that will generate two deductions: $10,000 in home mortgage interest and $8,000 in real estate taxes. Their marginal tax rate is 24%. What is the total tax savings if Larry and Ally purchase the residence?
Answer: ($10,000 + $8,000) × .24 = $4,320
Page Ref.: I:1-5; Example I:1-4
Objective: 2

19) Larry and Ally are married and file a joint return. They are considering purchasing a personal residence that will generate two deductions: $10,000 in home mortgage interest and $8,000 in real estate taxes. Their marginal tax rate is 24%. If Larry and Ally purchase the residence, what will be the after-tax cost of this additional $18,000 in expenditures?
Answer: Tax savings of expenditures: ($10,000 + $8,000) × .24 = $4,320
After-tax cost:: $18,000 - $4,320 = $13,680.
Page Ref.: I:1-5; Example I:1-4
Objective: 2

LO3: Other Types of Taxes

1) All states impose a state income tax which is generally based on an individual's federal adjusted gross income (AGI) with minor adjustments.
Answer: FALSE
Explanation: While many states impose a state income tax, not all states do. In those states that do impose tax, the taxes vary greatly in both form and rates.
Page Ref.: I:1-7
Objective: 3

2) The unified transfer tax system, comprised of the gift and estate taxes, is based upon the total property transfers an individual makes during lifetime and at death.
Answer: TRUE
Explanation: Gift and estate taxes, which comprise a unified transfer tax system, are based on cumulative transfers.
Page Ref.: I:1-7
Objective: 3

3) Gifts between spouses are generally exempt from transfer taxes.
Answer: TRUE
Explanation: The tax law allows for unlimited transfers between spouses.
Page Ref.: I:1-8
Objective: 3

4) The primary liability for payment of the gift tax is imposed upon the donee.
Answer: FALSE
Explanation: The gift tax is imposed on the donor.
Page Ref.: I:1-8
Objective: 3

5) For gift tax purposes, a $15,000 annual exclusion per donee is permitted.
Answer: TRUE
Explanation: Donors are allowed to exclude $15,000 per donee per year for gift tax purposes.
Page Ref.: I:1-8
Objective: 3

6) An individual will be subject to gift tax on gifts made to a charity greater than $15,000.
Answer: FALSE
Explanation: Contributions to charity are not limited by the $15,000 gift tax exclusion.
Page Ref.: I:1-8
Objective: 3

7) Property is generally included on an estate tax return at its historical cost basis.
Answer: FALSE
Explanation: Property is generally valued at fair market value at date of death or the alternate valuation date.
Page Ref.: I:1-10
Objective: 3

8) Property transferred to the decedent's spouse is exempt from the estate tax because of the estate tax marital deduction provision.
Answer: TRUE
Explanation: The estate and gift tax law allows tax exempt transfers to spouses.
Page Ref.: I:1-10
Objective: 3

9) Gifts made during a taxpayer's lifetime may affect the amount of estate tax paid by the taxpayer's estate.
Answer: TRUE
Explanation: Gift and estate taxes are applied to cumulative transfers under the uniform tax system.
Page Ref.: I:1-10
Objective: 3

10) While federal and state income taxes, as well as the federal gift and estate taxes, are generally progressive in nature, property taxes are proportional.
Answer: TRUE
Explanation: Property taxes are assessed on the value of property.
Page Ref.: I:1-11
Objective: 3

11) The unified transfer tax system
A) imposes a single tax upon transfers of property during an individual's lifetime only.
B) imposes a single tax upon transfers of property during an individual's life and at death.
C) imposes a single tax upon transfers of property only at an individual's death.
D) none of above.
Answer: B
Explanation: The gift (transfers during life) tax and estate (transfers after death) tax systems are unified.
Page Ref.: I:1-7
Objective: 3

12) When property is transferred, the gift tax is based on
A) replacement cost of the transferred property.
B) fair market value on the date of transfer.
C) the transferor's original cost of the transferred property.
D) the transferor's depreciated cost of the transferred property.
Answer: B
Explanation: The gift tax is based on the property's fair market value on the date of transfer.
Page Ref.: I:1-8
Objective: 3

13) Paul makes the following property transfers in the current year:

- $22,000 cash to his wife
- $34,000 cash to a qualified charity
- $220,000 house to his son
- $3,000 computer to an unrelated friend

The total of Paul's taxable gifts, assuming he does not elect gift splitting with his spouse, subject to the unified transfer tax is
A) $205,000.
B) $212,000.
C) $245,000.
D) $279,000.
Answer: A
Explanation: $220,000 - $15,000 = $205,000. The gift to the unrelated friend is below the $15,000 annual gift tax exclusion. The gifts to his wife and to the charity are not subject to gift tax.
Page Ref.: I:1-8; Example I:1-6
Objective: 3

14) Charlie makes the following gifts in the current year: $40,000 to his spouse, $30,000 to his church, $18,000 to his nephew, and $25,000 to a friend. Assuming Charlie does not elect gift splitting with his wife, his taxable gifts in the current year will be
A) $28,000.
B) $13,000.
C) $25,000.
D) $43,000.
Answer: B
Explanation: ($18,000 - $15,000) + (25,000 - $15,000) = $13,000. The gift to his spouse and the charitable gift are not subject to gift taxes.
Page Ref.: I:1-8; Example I:1-6
Objective: 3

15) Shaquille buys new cars for five of his friends. Each car cost $70,000. What is the amount of Shaquille's taxable gifts?
A) $0
B) $275,000
C) $335,000
D) $350,000
Answer: B
Explanation: 5 × ($70,000 - $15,000) = $275,000
Page Ref.: I:1-8; Example I:1-6
Objective: 3

16) In 2020, an estate is not taxable unless the sum of the taxable estate and taxable gifts made after 1976 exceeds
A) $4,577,800.
B) $10,000,000.
C) $5,000,000.
D) $11,580,000.
Answer: D
Explanation: The unified credit equivalent for estate and gift taxes is $ 11,580,000 for 2020. This exclusion amount equates to a unified credit of $4,577,800.
Page Ref.: I:1-9; Example I:1-7
Objective: 3

17) Eric dies in the current year and has a gross estate valued at $16,500,000. The estate incurs funeral and administrative expenses of $100,000 and also pays off Eric's debts which amount to $250,000. Eric bequeaths $600,000 to his wife. Eric made no taxable transfers during his life. Eric's taxable estate will be
A) $4,250,000.
B) $15,550,000.
C) $4,150,000.
D) $16,500,000.
Answer: B
Explanation: ($16,500,000 - $100,000 - $250,000 - $600,000) = $15,550,000
Page Ref.: I:1-10; Example I:1-8
Objective: 3

18) Jose dies in the current year and has a gross estate valued at $13,000,000 in 2020. Over the past ten years, Jose had made taxable gifts of $400,000. The estate incurs funeral and administrative expenses of $100,000 and also pays off Jose's debts which amount to $300,000. Jose bequeaths $500,000 to his wife. What is the amount of Jose's tax base, the amount on which the estate tax is computed?
A) $12,100,000
B) $12,500,000
C) $700,000
D) $1,100,000
Answer: B
Explanation: $13,000,000 - $100,000 funeral/administrative expense - $300,000 liabilities - $500,000 marital transfers = $12,100,000 taxable estate + $400,000 gifts = $12,500,000 tax base
Page Ref.: I:1-10; Example I:1-8
Objective: 3

19) Which of the following statements is <u>incorrect</u>?
A) Property taxes are levied on real estate.
B) Excise taxes are assessed on items such as gasoline and telephone use.
C) Gift taxes are imposed on the recipient of a gift.
D) The estate tax is based on the fair market value of property at death or the alternate valuation date.
Answer: C
Explanation: Gift taxes are imposed on the donor of a gift, not the recipient.
Page Ref.: I:1-8 through I:1-11
Objective: 3

20) Kole earns $140,000 in 2020 in his job as a sales manager. What is his FICA tax?
A) $10,567
B) $8,680
C) $10,710
D) $10,534
Answer: A
Explanation: (137,700 × .062) + (140,000 × .0145) = $10,567
Page Ref.: I:1-11
Objective: 3

21) Jillian, a single individual, earns $230,000 in 2020 through her job as an accounting manager. What is her FICA tax?
A) $12,142
B) $11,872
C) $17,595
D) $10,534
Answer: A
Explanation: (137,700 × .062) + (230,000 × .0145) + ((230,000 - 200,000) × .009) = $12,142
Page Ref.: I:1-11
Objective: 3

22) Martha is self-employed in 2020. Her self employment income is $140,000. What is her self-employment tax?
A) $21,068
B) $21,135
C) $21,420
D) None of the above
Answer: B
Explanation: (137,700 × .124) + (140,000 × .029) = $21,135
Page Ref.: I:1-11
Objective: 3

23) Vincent makes the following gifts during 2020:

$15,000 cash gift to wife
Gift of automobile valued at $35,000 to his adult son
Gift of golf clubs valued at $5,000 to a friend
$10,000 contribution to church

Although he is married, none of the gifts are considered joint gifts with his wife. What are the total taxable gifts subject to the unified transfer tax?
Answer:

	Gift Value	Adjustment	Taxable Gift
Cash to wife	$15,000	spousal gifts excluded	$ 0
Auto to son	35,000	less $15,000 exclusion	20,000
Clubs to friend	5,000	less $15,000 exclusion	0
Church donation	10,000	charity gifts excluded	0
Taxable gifts			$20,000

Page Ref.: I:1-8; Example I:1-6
Objective: 3

24) Jeffery died in 2020 leaving a $16,000,000 gross estate. Six months after his death, the gross assets are valued at $16,100,000. In years prior to 2020 (but after 1976), Jeffery had made taxable gifts of $300,000. Of the $16,000,000 gross estate, estate assets valued at $3 million were transferred to his wife and $100,000 was used to pay administrative and funeral expenses. Jeffery had debts of $200,000 which were paid by the estate, and the remainder of the estate was transferred to his children.

a. What is the amount of Jeffery's taxable estate?

b. What is the tax base for computing Jeffery's estate?

c. What is the amount of estate tax owed if the unified credit is $4,577,800?

d. Alternatively, if six months after his death, the gross assets in Jeffery's estate declined in value to $15,000,000, can the administrator of Jeffery's estate elect the alternate valuation date?

Answer:

Gross Estate	$16,000,000
Minus: Funeral and administrative expenses	(100,000)
Minus: Debts	(200,000)
Minus: Marital deduction	(3,000,000)
Taxable estate (a)	**$12,700,000**
Plus: Taxable gifts made after 1976	300,000
Tax base (b)	**$13,000,000**
Tentative tax on estate tax base $345,800 + [.4 × (13,000,000 - $1,000,000)]	$ 5,145,800
Minus: Tax credits (unified tax credit)	4,577,800
Unified transfer tax due (c)	**$ 568,000**

d. The alternate valuation date (six months after the date of death) may be elected only if the aggregate value of the gross estate decreases during the six-month period following the date of death and the election results in a lower estate tax liability. In this case, the alternate valuation date can be elected.

Page Ref.: I:1-10; Example I:1-8

Objective: 3

25) Mia is self-employed as a consultant. During 2020, Mia earned $180,000 in self-employment income. What is Mia's self-employment tax?

Answer: .124 × $137,700 = $17,075

.029 × $180,000 = 5,220

Self-employment tax $22,295

Page Ref.: I:1-11

Objective: 4

LO4: Criteria for a Tax Structure

1) Adam Smith's canons of taxation are equity, certainty, convenience, and economy.
Answer: TRUE
Explanation: Adam Smith's canons of taxation include equity, certainty, convenience and economy.
Page Ref.: I:1-12
Objective: 4

2) The primary objective of the federal income tax law is to achieve various economic and social policy objectives.
Answer: FALSE
Explanation: The primary objective of the federal income tax law is to raise revenues for government operations.
Page Ref.: I:1-14
Objective: 4

3) Which of the following is not one of Adam Smith's canons of taxation?
A) equity
B) convenience
C) certainty
D) economic stimulation
Answer: D
Explanation: Smith's canons of taxation are equity, certainty, convenience and economy (in terms of administration of the tax system).
Page Ref.: I:1-12
Objective: 4

4) Horizontal equity means that
A) taxpayers with the same amount of income should pay the same amount of tax.
B) taxpayers with larger amounts of income should pay more tax than taxpayers with lower amounts of income.
C) all taxpayers should pay the same tax.
D) None of the above.
Answer: A
Explanation: Horizontal equity means that taxpayers with the same amount of income should pay the same amount of tax.
Page Ref.: I:1-13
Objective: 4

5) Vertical equity means that
A) taxpayers with the same amount of income should pay the same amount of tax.
B) taxpayers with larger amounts of income should pay more tax than taxpayers with lower amounts of income.
C) all taxpayers should pay the same tax.
D) None of the above.
Answer: B
Explanation: Vertical equity means that taxpayers with larger amounts of income should pay more tax than taxpayer's with lower amounts of income.
Page Ref.: I:1-13
Objective: 4

6) Which of the following is not an objective of the federal income tax law?
A) Stimulate private investment.
B) Redistribution of wealth.
C) Encourage research and development activities.
D) Prevent taxpayers from paying a higher percentage of their income in personal income taxes due to inflation.
Answer: B
Explanation: Redistribution of wealth is not an objective of the federal income tax law.
Page Ref.: I:1-14 and I:1-15
Objective: 4

7) Which of the following is not a social objective of the tax law?
A) prohibition of a deduction for illegal bribes, fines and penalties
B) a deduction for charitable contributions
C) an exclusion for interest earned by large businesses
D) creation of tax-favored pension plans
Answer: C
Explanation: There is no exclusion for interest income earned by large businesses.
Page Ref.: I:1-15
Objective: 4

8) A presidential candidate proposes replacing the income tax with a national sales tax. The sales tax would have a flat rate. Describe the impact of this change in terms of tax structure and equity.
Answer: The change would replace a progressive tax with a proportional tax. The national sales tax decreases vertical equity since taxpayers with higher income would not necessarily pay more in taxes. The sales tax would be based on consumption, not income. The impact of the sales tax is regressive since taxpayers with lower levels of income would pay a greater percentage of their income.
Page Ref.: I:1-3, I:1-4 and I:1-14; Topic Review I:1-1
Objective: 4

LO5: Entities in the Federal Income Tax System

1) Individuals are the principal taxpaying entities in the federal income tax system.
Answer: TRUE
Explanation: Revenues from income taxation of individuals far exceed those of other taxpayers.
Page Ref.: I:1-17
Objective: 5

2) The various entities in the federal income tax system may be classified into two general categories, *taxpaying entities* (such as individuals and C [regular] corporations) and *flow-through entities* such as sole proprietorships, partnerships, S corporations, and limited liability companies.
Answer: TRUE
Explanation: Certain business entities do not pay tax; the income is passed through to the business owners. The business owners pay the tax on the taxable income earned by the entity as part of their tax liability.
Page Ref.: I:1-17
Objective: 5

3) Dividends paid from most U.S. corporations are taxed at the same rate as the recipients' salaries and wages.
Answer: FALSE
Explanation: Qualifying dividends are taxed at a preferential rate.
Page Ref.: I:1-20
Objective: 5

4) Flow-through entities do not have to file tax returns since they are not taxable entities.
Answer: FALSE
Explanation: S Corporations, partnerships and limited liability companies have to file an informational tax return each year.
Page Ref.: I:1-20
Objective: 5

5) Organizing a corporation as an S Corporation results in a single level of taxation.
Answer: TRUE
Explanation: S Corporations do not pay tax. Owners of the corporation pay tax on their share of the corporation's taxable income, but do not pay tax on the distributions received.
Page Ref.: I:1-22
Objective: 5

6) In a limited liability partnership, a partner is not liable for his partner's acts of negligence or misconduct.
Answer: TRUE
Explanation: A partner in an LLP is liable for his own acts of negligence or misconduct, but not those of his partners.
Page Ref.: I:1-23
Objective: 5

7) Limited liability companies may elect to be taxed as corporations.
Answer: TRUE
Explanation: An LLC can affirmatively elect to be taxed as a corporation.
Page Ref.: I:1-23
Objective: 5

8) Limited liability company members (owners) are responsible for the liabilities of their limited liability company.
Answer: FALSE
Explanation: Limited liability company members have protection from entity-level liability in a manner similar to that of shareholders of corporations.
Page Ref.: I:1-23
Objective: 5

9) Which of the following is not a taxpaying entity?
A) C corporation
B) partnership
C) individual
D) All of the above are taxpayers.
Answer: B
Explanation: A partnership is a flow-through entity.
Page Ref.: I:1-16
Objective: 5

10) All of the following are classified as flow-through entities for tax purposes except
A) partnerships.
B) C corporations.
C) S corporations.
D) limited liability companies.
Answer: B
Explanation: A C corporation is a taxpaying entity.
Page Ref.: I:1-16
Objective: 5

11) Firefly Corporation is a C corporation. Freya owns all of the stock. During the current year Firefly earned taxable income of $500,000 and paid a $300,000 dividend to Freya. Which of the following statements is correct?
A) Firefly will pay corporate income tax on its earnings, and Freya will pay individual income tax on the dividends.
B) Only Firefly will pay taxes. Freya will not pay any taxes due to her holdings in Firefly.
C) Firefly's income will flow through to Freya's tax return, and she will pay the taxes on the $500,000 of corporate income.
D) Firefly will not pay any taxes, but Freya will pay taxes on the dividend received.
Answer: A
Explanation: The C corporation pays tax on its own taxable income, and then a second layer of tax is paid by the shareholders when dividends are paid to them.
Page Ref.: I:1-19 and I:1-20; Example I:1-15
Objective: 5

12) Rocky and Charlie form RC Partnership as equal partners. Rocky contributes $100,000 into RC while Charlie contributes real estate with a cost and fair market value of $100,000. During the current year, RC earned net income of $600,000. The partnership distributes $200,000 to each partner. The amount that Rocky should report on his individual tax return is
A) $0.
B) $100,000.
C) $200,000.
D) $300,000.
Answer: D
Explanation: Rocky must report 50% × $600,000 or $300,000, his share of partnership net income. The distribution of $200,000 is not taxable but rather a nontaxable return of capital reducing Rocky's basis ($100,000 original investment + $300,000 share of income) by $200,000 to $200,000.
Page Ref.: I:1-21; Example I:1-18
Objective: 5

13) AB Partnership earns $500,000 in the current year. Partners A and B are equal partners who do not receive any distributions during the year. How much income does partner A report from the partnership?
A) $0
B) $250,000
C) $500,000
D) None of the above
Answer: B
Explanation: Partners are taxed on their share of partnership income, regardless of whether they receive a distribution. $500,000 × .5 = $250,000
Page Ref.: I:1-21; Example I:1-18
Objective: 5

14) In an S corporation, shareholders
A) are taxed on their proportionate share of earnings.
B) are taxed only on dividends.
C) may allocate income among themselves in order to consider special contributions.
D) are only taxed on salaries.
Answer: A
Explanation: Similar to partners in a partnership, S corporation shareholders are taxed on their proportionate share of the income earned by the corporation, regardless of distribution payments.
Page Ref.: I:1-22
Objective: 5

15) Fireball Corporation is an S corporation. Leyla owns all of the stock. During the current year, Fireball earned taxable income of $500,000 and paid a $300,000 distribution to Leyla. Which of the following statements is correct?
A) Fireball will pay corporate income tax on its earnings, and Leyla will pay individual income tax on the distribution.
B) Only Fireball will pay taxes. Leyla will not pay any taxes due to her holdings in Fireball.
C) Fireball's income will flow through to Leyla's tax return, and she will pay the taxes on the $500,000 of corporate income.
D) Fireball will not pay any taxes, but Leyla will pay taxes on the distribution received.
Answer: C
Explanation: Similar to partners in a partnership, S corporation shareholders are taxed on their proportionate share of the income earned by the corporation, regardless of distribution payments.
Page Ref.: I:1-22; Example I:1-19
Objective: 5

16) All of the following statements are true except
A) the net income earned by a sole proprietorship is reported on the owner's individual income tax return.
B) the net income of an S corporation is subject to double taxation because it is taxed at the entity level and dividends paid from the S corporation to individual shareholders are also taxed.
C) the net income of C corporation is subject to double taxation because it is taxed at the entity level and dividends paid from the C corporation to individual shareholders is also taxed.
D) LLCs are generally taxed as partnerships.
Answer: B
Explanation: An S corporation is a flow-through entity, not a taxable entity. The items of income/loss are allocated to each shareholder who pays tax on the items on his or her individual income tax return.
Page Ref.: I:1-17 through I:1-23
Objective: 5

17) Tercot Partnership reported $1,000,000 of business receipts, $700,000 of business deductions, and $100,000 of interest income. Terry is a 50% partner in Tercot Partnership. On Terry's return, she will be entitled to a deduction for qualified business income of
A) $60,000.
B) $80,000.
C) $40,000.
D) $30,000.
Answer: D
Explanation: Tercot's business income is $300,000 ($1,000,000 business receipts - $700,000 business deductions; interest income is not included). Terry's share of the business income is $150,000. The qualified business income deduction is 20% of the $150,000.
Page Ref.: I:1-20; Example I:1-16
Objective: 5

18) Signal Corporation is an S corporation owned equally by Serena and three other shareholders. The corporation reported $900,000 of business receipts, $500,000 of business deductions and $40,000 of dividend income. On Serena's return, she will be entitled to a deduction for qualified business income of
A) $20,000.
B) $22,000.
C) $80,000.
D) $88,000.
Answer: A
Explanation: Signal's business income is $400,000 ($900,000 business receipts - $500,000 business deductions; investment income is not included). Serena's share of the business income is $100,000. The qualified business income deduction is 20% of the $100,000.
Page Ref.: I:1-20; Example I:1-16
Objective: 5

19) Which of the following is not an advantage of a limited liability company (LLC)?
A) limited liability for all members of a LLC
B) ability to choose between taxation as a partnership or corporation
C) default tax treatment as a corporation, unless otherwise elected
D) All of the above are advantages of an LLC.
Answer: C
Explanation: A business operated as an LLC is treated as a flow-through entity unless the LLC elects to be taxed as a corporation.
Page Ref.: I:1-22 and I:1-23
Objective: 5

20) What is an important aspect of a limited liability partnership?
A) It is the same as a limited partnership where the general partner has unlimited liability.
B) A partner has unlimited liability arising from his or her own acts of negligence or misconduct or similar acts of any person under his or her direct supervision, but does not have unlimited liability in other matters.
C) All partners have limited liability regarding all partnership activities.
D) All partners have unlimited liability.
Answer: B
Explanation: A partner in an LLP remains responsible for his or her own actions, or those under his supervision, but is not liable for the actions of other partners.
Page Ref.: I:1-23
Objective: 5

21) Brad and Angie had the following income and deductions during 2020:

Salaries	$110,000
Interest income	10,000
Itemized deductions	26,000
Taxes withheld during year	12,000

Calculate Brad and Angie's tax liability due or refund. They file a joint tax return.
Answer:

Salaries	$110,000
Interest income	10,000
Gross income	120,000
Deduction for AGI	0
AGI	120,000
Itemized deductions	(26,000)
Taxable income	$94,000

Tax = $9,235 + .22(94,000 - 80,250) = $12,260
$12,260 - 12,000 taxes withheld = $260 taxes due
Page Ref.: I:1-17 and I:1-18; Example I:1-13
Objective: 5

22) Chris, a single taxpayer, had the following income and deductions during 2020:

Salary	$65,000
Interest on bank account	300
Tax-exempt interest	200
Deduction for AGI	3,500
Itemized deductions	13,000
Taxes withheld	7,500

Calculate Chris's tax liability due or refund.

Answer: Salary	$65,000
Interest on bank account	300
Gross income	65,300
Deduction for AGI	(3,500)
Adjusted gross income	61,800
Itemized deductions	(13,000)
Taxable income	$48,800

Tax $4,617.50 + .22(48,800 - 40,125) = $6,526
$7,500 taxes withheld -6,526 = $974 tax refund
Page Ref.: I:1-17 and I:1-18; Example I:1-13
Objective: 5

23) During the current tax year, Frank Corporation generated gross income of $1,900,000 and had ordinary and necessary deductions of $1,400,000. What is the amount of Frank Corporation's corporate income tax for the year?
Answer: Taxable income is $1,900,000 - $1,400,000 = $500,000. The tax is $105,000 ($500,000 × .21).
Page Ref.: I:1-19; Example I:1-14
Objective: 5

24) During the current tax year, Charlie Corporation generated gross income of $1,800,000 and had ordinary and necessary deductions of $1,300,000, resulting in taxable income of $500,000. If Charlie Corporation paid qualifying dividends of $200,000 to shareholders, all of whom subject to a 15% marginal tax rate on qualifying dividend income, what is the total tax paid on both corporate income and the corporate dividends?
Answer: Corporate taxable income is $1,800,000 - $1,300,000 = $500,000. Dividends are not tax deductible.
Corporate tax: ($500,000 × .21) = $105,000
Shareholder tax on qualifying dividends: ($200,000 × .15 maximum rate on qualifying dividends for taxpayers in 24% marginal tax bracket) = $30,000
Total Tax: $105,000 + $30,000 = $135,000
Page Ref.: I:1-19 and I:1-20; Example I:1-15
Objective: 5

25) Doug and Frank form a partnership, D and F Advertising, each contributing $50,000 to start the business. During the first year of operations, D and F earns $80,000, which is allocated $40,000 each to Doug and Frank. At the beginning of the second year, Doug sells his interest to Marcus for $90,000. What is the amount of Doug's taxable gain on the sale?
Answer: There is no gain on the sale.

Amount realized	$90,000
Adjusted basis *	-90,000
Gain or loss on sale.	0

*Adjusted basis as of date of sale is the $50,000 contributed basis plus the $40,000 income allocated to basis.
Page Ref.: I:1-21; Example I:1-17
Objective: 5

26) Leonard established a trust for the benefit of his son. The principal amount of the trust is $400,000. The trust is projected to earn approximately 5% per year. In the current year, the trust earned $20,000. Expenses of $4,000 were incurred. Assume that $14,000 is distributed to Leonard's son.
a. How much income is taxed to the trust?
b. How much income is taxed to Leonard's son?
Answer:
a. $20,000 income - $4,000 expenses - $14,000 distribution = $2,000 taxed to trust
b. $14,000 is included in Leonard's son's taxable income for the year.
Page Ref.: I:1-23
Objective: 5

LO6: Tax Law Sources

1) The tax law encompasses administrative and judicial interpretations, such as Treasury regulations, revenue rulings, revenue procedures, and court decisions, as well as statutes.
Answer: TRUE
Explanation: Sources of tax law extend beyond the Internal Revenue Code itself.
Page Ref.: I:1-24
Objective: 6

2) The term "tax law" includes
A) Internal Revenue Code.
B) Treasury Regulations.
C) Judicial decisions.
D) All of the above.
Answer: D
Explanation: The Code is a legislative source; the Regulations are an administrative source, and judicial decisions are judicial sources of tax law.
Page Ref.: I:1-24
Objective: 6

3) Which of the following serves as the highest authority for tax research, planning, and compliance activities?
A) Internal Revenue Code
B) Income Tax Regulations
C) Revenue Rulings
D) Revenue Procedures
Answer: A
Explanation: The Internal Revenue Code is the law passed by Congress. The other documents provide guidance in applying the law.
Page Ref.: I:1-24
Objective: 6

4) All of the following are executive (administrative) sources of tax law <u>except</u>
A) Internal Revenue Code.
B) Income Tax Regulations.
C) Revenue Rulings.
D) Revenue Procedures.
Answer: A
Explanation: The Internal Revenue Code is a legislative source.
Page Ref.: I:1-24 and Topic Review I:1-3
Objective: 6

LO7: Enactment of a Tax Law

1) Generally, tax legislation is introduced first in the Senate and referred to the Senate Finance Committee.
Answer: FALSE
Explanation: A tax bill is first introduced in the House and referred to the Ways and Means Committee.
Page Ref.: I:1-24
Objective: 7

2) Which of the following steps, related to a tax bill, occurs first?
A) signature or veto by the President of the United States
B) consideration by the Senate
C) consideration by the House Ways and Means Committee
D) consideration by the Joint Conference Committee
Answer: C
Explanation: Most tax legislation originates in the House of Representatives and is then referred to the House Ways and Means Committee.
Page Ref.: I:1-24
Objective: 7

3) A tax bill introduced in the House of Representatives is then
A) referred to the House Ways and Means Committee for hearings and approval.
B) referred to the full House for hearings.
C) forwarded to the Senate Finance Committee for consideration.
D) voted upon by the full House.
Answer: A
Explanation: Most tax legislation originates in the House of Representatives and is then referred to the House Ways and Means Committee.
Page Ref.: I:1-24
Objective: 7

4) When new tax legislation is being considered by Congress
A) the tax bill will usually originate in the Senate.
B) different versions of the House and Senate bills are reconciled by the Speaker of the House and the President of the Senate.
C) different versions of the House and Senate bills are reconciled by a Joint Conference Committee.
D) after the President of the United States approves a tax bill, the Joint Conference Committee must then vote on passage of the bill.
Answer: C
Explanation: The Joint Conference Committee reconciles the House and Senate bills.
Page Ref.: I:1-25
Objective: 7

5) The Senate equivalent of the House Ways and Means Committee is the Senate
A) Joint Committee on Taxation.
B) Ways and Means Committee.
C) Finance Committee.
D) Joint Conference Committee.
Answer: C
Explanation: The Senate Finance Committee considers tax legislation.
Page Ref.: I:1-25
Objective: 7

6) List the steps in the legislative process for major tax reform.
Answer:
1. Tax bill is introduced by member(s) of House of Representatives and referred to House Ways and Means Committee.
2. House Ways and Means Committee considers and studies House bill.
3. House Ways and Means Committee votes and approved bill is forwarded to full House.
4. Approval of House bill by the House of Representatives.
5. Senate Finance Committee modifies and amends House bill into separate Senate bill.
6. Approval of Senate bill by the Senate.
7. Both bills sent to Joint Conference Committee
8. Reconciled bill issued by a Joint Conference Committee and sent to House and Senate for approval.
9. Approval or veto of legislation by the President.
10. New tax law and amendments incorporated into the Code.

Page Ref.: I:1-24 and I:1-25; Table I:1-2
Objective: 7

LO8: Administration of the Tax Law and Tax Practice Issues

1) The Internal Revenue Service is the branch of the Treasury Department responsible for administering the federal tax law.
Answer: TRUE
Explanation: The IRS is the branch of the Treasury Department that is responsible for administration of the Internal Revenue Code.
Page Ref.: I:1-26
Objective: 8

2) Generally, the statute of limitations is three years from the later of the date the tax return is filed or the due date.
Answer: TRUE
Explanation: While there are exceptions that extend the statute of limitations, the general limit is three years from the later of the filing date or the due date of a return.
Page Ref.: I:1-28
Objective: 8

3) When returns are processed, they are scored to determine their potential for yielding additional tax revenues. This program is called
A) Taxpayer Compliance Measurement Program.
B) Discriminant Function System.
C) Standard Audit Program.
D) Field Audit Program.
Answer: B
Explanation: The scoring system of risk measurement by the IRS is called the Discriminant Function System.
Page Ref.: I:1-27
Objective: 8

4) Which of the following individuals is most likely to be audited?
A) Lola has AGI of $35,000 from wages and uses the standard deduction.
B) Marvella has a $145,000 net loss from her unincorporated business (a horse farm). She also received $950,000 salary as a CEO of a corporation.
C) Melvin is retired and receives Social Security benefits.
D) Jerry is a school teacher with two children earning $55,000 a year. He also receives $200 in interest income on a bank account.
Answer: B
Explanation: Of those listed, the taxpayer with investments or trade or business expenses that produce significant losses, Marvella, is most likely to be audited.
Page Ref.: I:1-27
Objective: 8

5) Alan files his 2019 tax return on April 1, 2020, shortly before the April 15 due date. His return contains no misstatements or omissions of income. The statute of limitations for changes to the return expires
A) April 1, 2024.
B) April 15, 2023.
C) April 15, 2024.
D) The statute of limitations never expires.
Answer: B
Explanation: The three-year statute applies, beginning with the April 15 due date of the return.
Page Ref.: I:1-28
Objective: 8

6) Peyton has adjusted gross income of $2,000,000 on his 2019 tax return, filed April 15, 2020, the due date. He accidentally failed to include $200,000 that he received for a television advertisement. How long does the IRS have to audit Peyton's federal tax return?
A) until April 17, 2022
B) until April 17, 2023
C) until April 17, 2026
D) The IRS can audit Peyton's return at any future date.
Answer: B
Explanation: The omission does not exceed 25% of reported gross income, so the three-year statute still applies. Since the omission was accidental, the rules for fraud do not apply.
Page Ref.: I:1-28
Objective: 8

7) Latashia reports $100,000 of gross income on her 2019 tax return, filed on the April 15, 2020 due date. She omits $30,000 of income, but the error was not fraudulent. When does the statute of limitations for examining her tax return expire?
A) April 15, 2022
B) April 15, 2023
C) April 15, 2026
D) It never expires.
Answer: C
Explanation: The six-year statute applies since the omitted income exceeds 25% of the gross income reported.
Page Ref.: I:1-28
Objective: 8

8) The IRS must pay interest on
A) all tax refunds.
B) tax refunds paid later than 30 days after the due date.
C) tax refunds paid later than 45 days after the due date.
D) The IRS never pays interest on tax refunds.
Answer: C
Explanation: The IRS does not have to pay interest if the refund is paid within 45 days after the due date (or filing date, if later).
Page Ref.: I:1-28; Example I:1-27
Objective: 8

9) Kate files her tax return 36 days after the due date. When she files the return, she sends a check for $2,000 which is the balance of the tax owed by her. Kate's penalty for failure to file a return will be
A) 0.5% per month (or factor thereof) up to a maximum of 25%.
B) 5% per month (or factor thereof) up to a maximum of 25%.
C) 20% per month (or factor thereof).
D) 25%.
Answer: B
Explanation: The penalty for failure to file is 5% per month up to 25%.
Page Ref.: I:1-28
Objective: 8

10) What are the correct monthly rates for calculating failure to file and failure to pay penalties?

A)

Failure to file	**Failure to pay**
5.0%	5.0%

B)

Failure to file	**Failure to pay**
0.5%	0.5%

C)

Failure to file	**Failure to pay**
5.0%	0.5%

D)

Failure to file	**Failure to pay**
0.5%	5.0%

Answer: C

Explanation: The penalty for failure to file is 5% per month up to 25%. The failure to pay penalty is 0.5% per month up to 25%.

Page Ref.: I:1-28 and I:1-29

Objective: 8

11) Frederick failed to file his 2019 tax return on a timely basis. In fact, he filed his 2019 income tax return on October 31, 2020, (the due date was April 15, 2020) and paid the amount due at that time. He failed to make timely extensions. Below are amounts from his 2019 return:

Taxable income	$120,000
Total tax liability on taxable income	22,974
Total tax withheld from his salary	22,000

Frederick sent a check for $974 in payment of his liability. He thinks that he has met all of his financial obligations to the government for 2019. For what additional amounts may Frederick be liable assuming any applicable interest rate is 6%?

Answer: Since Frederick's return is filed late and the final balance due on the return is paid late (both due on or before April 15, 2020), Frederick is subject to further interest and penalties on his 2019 income tax return. Both interest and penalties are computed on the net tax due.

There are two penalties to which Frederick would be subject, a failure to file (timely) penalty and a failure to pay the tax (timely) penalty. The late payment penalty is .5% per month to a maximum of 25%; the late filing penalty is 5% per month to a maximum of 25%. However, both penalties are not assessed together.

Page Ref.: I:1-28 and I:1-29

Objective: 8

12) Explain how returns are selected for audit.
Answer: The IRS uses both computers and experienced personnel to select returns for examination. The Discriminant Function System (DIF) is used to select returns for examination. The DIF system generates a score for a return based on the potential for the return to generate additional tax revenue. After returns are scored based on the DIF system, the returns are manually screened by experienced IRS personnel who decide which returns warrant further examination.
Page Ref.: I:1-27
Objective: 8

13) Describe the types of audits that the IRS conducts.
Answer: In an office audit, the taxpayer goes to the IRS office and brings substantiation for a particular deduction, credit or income item. An office audit does not involve a complete audit for all items on the return. A field audit is used for corporations engaged in a trade or business. A field audit generally is broader in scope than an office audit. A field audit usually is conducted at the taxpayer's place of business or the office of his or her tax advisor. Most large corporations are subject to annual audits.
Page Ref.: I:1-27
Objective: 8

14) What does the statute of limitations mean? Describe the different statutes of limitations that apply to tax returns.
Answer: The statute of limitations is the period of time in which the taxpayer and/or the IRS can revise a tax return. Typically the statute of limitations is three years from the later of the filing date or due date of the return. If 25% or more of income is omitted from the return, the statute of limitations is six years from the later of the date filed or return's due date. For a return that has not been filed or involves fraud, the statute of limitations is never closed.
Page Ref.: I:1-28
Objective: 8

15) Describe the nondeductible penalties imposed upon taxpayers for failure to comply.
Answer:
a. A penalty of 5% per month subject to a maximum of 25% is imposed for failure to file a tax return.
b. A penalty of 0.5% per month subject to a maximum of 25% is imposed for failure to pay a tax that is due.
c. An accuracy related penalty of 20% for underpayment due to negligence or disregard of the rules or regulations.
d. A 75% penalty is imposed for fraud.
e. A penalty based upon the current interest rate is imposed for underpayment of estimated taxes.
Page Ref.: I:1-28 and I:1-29
Objective: 8

LO9: Components of a Tax Practice

1) Which is not a component of tax practice?
A) providing clients tax refund advance loans
B) tax research
C) tax planning and consulting
D) compliance
Answer: A
Explanation: Tax research, tax planning and consulting and tax compliance are all regular aspects of tax practice. Providing tax refund loans is not acceptable practice.
Page Ref.: I:1-29
Objective: 9

2) Describe the components of tax practice.
Answer:
a. Tax compliance and procedure.
b. Tax research.
c. Tax planning and consulting.
d. Financial planning.
Page Ref.: I:1-29
Objective: 9

L10: Computer Applications in Tax Practice

1) The computer is the primary tool of the tax professional. The tax professional uses the computer for all of the following client services except
A) tax planning for clients.
B) tax research for client questions.
C) investment purchases on behalf of clients.
D) tax return preparation.
Answer: C
Explanation: Tax planning, tax research and tax return preparation are routine services by tax professionals on behalf of their clients utilizing software. Making investments is not.
Page Ref.: I:1-31 and I:1-32
Objective: 10

Pearson's Federal Taxation 2021: Comp., 34e **(Rupert/Anderson)**
Chapter I2: Determination of Tax

LO1: Formula for Individual Income Tax

1) The term "gross income" means the total of all income from any source, but after reduction for exclusions.
Answer: TRUE
Explanation: The tax law includes all sources of income in gross income unless specifically excluded.
Page Ref.: I:2-3
Objective: 1

2) Although exclusions are usually not reported on an individual's income tax return, interest income on state and local government bonds must be reported on the tax return.
Answer: TRUE
Explanation: See Additional Comment, p. I:2-3.
Page Ref.: I:2-3
Objective: 1

3) Generally, deductions for (not from) adjusted gross income are personal expenses specifically allowed by tax law.
Answer: FALSE
Explanation: Personal expenses, if deductible, are generally from AGI deductions.
Page Ref.: I:2-4
Objective: 1

4) Generally, itemized deductions are personal expenses specifically allowed by the tax law.
Answer: TRUE
Explanation: Personal expenses are not allowed as deductions unless specifically provided in the tax law.
Page Ref.: I:2-4
Objective: 1

5) Taxpayers have the choice of claiming either deductions for AGI or the standard deduction.
Answer: FALSE
Explanation: All taxpayers are allowed to deduct their qualifying deductions for AGI. In addition, taxpayers have the choice of claiming either itemized deductions or the standard deduction as deductions from AGI.
Page Ref.: I:2-4
Objective: 1

6) A sole proprietor is tentatively eligible for the 20% qualified business income deduction. The taxpayer will only be able to deduct the amount if she claims itemized deductions.
Answer: FALSE
Explanation: Individuals who are otherwise eligible for the deduction may claim it whether they claim itemized deductions or the standard deduction.
Page Ref.: I:2-5
Objective: 1

7) Refundable tax credits are allowed to reduce or totally eliminate a taxpayer's tax liability but any credits in excess of the tax liability are lost.
Answer: FALSE
Explanation: Refundable tax credits may reduce the tax liability to zero and, if some credit still remains, are refundable or paid by the government to the taxpayer.
Page Ref.: I:2-6
Objective: 1

8) Nonrefundable tax credits are allowed to reduce or totally eliminate a taxpayer's tax liability but any credits in excess of the tax liability are lost.
Answer: TRUE
Explanation: Nonrefundable credits can only reduce the tax liability to zero. The excess is lost.
Page Ref.: I:2-6
Objective: 1

9) Taxable income for an individual is generally defined as
A) AGI reduced by itemized deductions and tax credits.
B) gross income reduced by itemized deductions.
C) AGI reduced by tax credits.
D) AGI reduced by the greater of the standard deduction or itemized deductions.
Answer: D
Explanation: Taxable income is AGI reduced by either the standard deduction or itemized deductions.
Page Ref.: I:2-2; Table I:2-1
Objective: 1

10) All of the following items are generally excluded from income <u>except</u>
A) child support payments.
B) interest on corporate bonds.
C) interest on state and local government bonds.
D) life insurance proceeds paid by reason of death.
Answer: B
Explanation: Interest on corporate bonds is taxable.
Page Ref.: I:2-3; Table I:2-2
Objective: 1

11) All of the following items are included in gross income except
A) pension benefits received.
B) rent income.
C) interest earned on a bank account.
D) child support payments received.
Answer: D
Explanation: Child support is not taxable.
Page Ref.: I:2-3 and I:2-4, Tables I:2-2 and I:2-3
Objective: 1

12) All of the following items are deductions for adjusted gross income except
A) contributions to health savings accounts.
B) trade or business expenses.
C) rent and royalty expenses.
D) state and local income taxes.
Answer: D
Explanation: State and local income taxes are itemized deductions.
Page Ref.: I:2-5; Table I:2-4
Objective: 1

13) All of the following items are deductions for adjusted gross income except
A) interest on student loans.
B) unreimbursed employee business expenses.
C) qualifying contributions to individual retirement accounts.
D) one-half of self-employment taxes on year's earnings.
Answer: B
Explanation: Unreimbursed employee business expenses are not allowed as a deduction.
Page Ref.: I:2-5; Table I:2-4
Objective: 1

14) Which of the following credits is considered a refundable credit?
A) credit for elderly and disabled
B) earned income credit
C) adoption expense credit
D) lifetime learning credit
Answer: B
Explanation: The earned income credit is a refundable credit.
Page Ref.: I:2-6; Table I:2-5
Objective: 1

15) A single taxpayer provided the following information for 2020:

Salary	$80,000
Interest on local government bonds (qualifies as a tax exclusion)	4,000
Allowable itemized deductions	13,000

What is taxable income?
A) $71,000
B) $67,600
C) $80,000
D) $67,000
Answer: D
Explanation: $80,000 - $13,000 itemized deductions = $67,000
Page Ref.: I:2-6; Example I:2-1
Objective: 1

16) Hannah is single with no dependents and has a salary of $102,000 for 2020, along with tax exempt interest income of $3,000 from a municipality. Her itemized deductions total $12,600.

Required: Compute her taxable income.

Answer: Salary	$102,000
(Interest income is excluded)	
Less:	
Itemized deductions	(12,600)
Taxable income	$ 89,400

Page Ref.: I:2-3 through I:2-7; Example I:2-1
Objective: 1

17) Kadeisha is single with no dependents and has a salary of $102,000 for 2020, along with tax exempt interest income of $3,000 from a municipality. Her itemized deductions total $11,600.

Required: Compute her taxable income.

Answer: Salary	$102,000
(Interest income is excluded)	
Less:	
Standard deduction	(12,400)
Taxable income	$ 89,600

Page Ref.: I:2-3 through I:2-7; Example I:2-1
Objective: 1

18) The following information is available for Bob and Brenda Horton, a married couple filing a joint return, for 2020. Both Bob and Brenda are age 32 and have no dependents.

Salaries	$200,000
Interest income	12,000
Deductible IRA contributions	11,000
Itemized deductions	25,600
Withholding	31,000

a. What is the amount of their gross income?
b. What is the amount of their adjusted gross income?
c. What is the amount of their taxable income?
d. What is the amount of their tax liability (gross tax), rounded to the nearest dollar?
e. What is the amount of their tax due or (refund due)?

Answer:	**Hortons**	
Salary	$200,000	
Interest	12,000	
Gross Income	**$212,000**	**a.**
Minus: IRA Contributions	11,000	
Adjusted gross income	**$201,000**	**b.**
Minus: Itemized deductions	(25,600)	
Taxable Income	**$175,400**	**c.**
Tax liability (using Rate Schedule) *	**$30,255**	**d.**
Minus: Withholding	- 31,000	
Tax due (refund)	**($ 745)**	**e.**

*$29,211 + [.24 (175,400 - 171,050)]
Page Ref.: I:2-3 through I:2-7; Example I:2-1
Objective: 1

LO2: Deductions from Adjusted Gross Income

1) The standard deduction is the maximum amount of itemized deductions which may be claimed by a taxpayer and is based on an individual's filing status, age, and vision.
Answer: FALSE
Explanation: The standard deduction, set by Congress, is not directly related to itemized deductions. It is the alternative to itemized deductions.
Page Ref.: I:2-9
Objective: 2

2) Nonresident aliens are allowed a full standard deduction.
Answer: FALSE
Explanation: The standard deduction is not available to nonresident aliens.
Page Ref.: I:2-11
Objective: 2

3) The standard deduction may not be claimed by one married taxpayer filing a separate return if the other spouse itemizes deductions.
Answer: TRUE
Explanation: If a married couple files separately and one spouse itemized deductions, the other spouse must also itemize.
Page Ref.: I:2-11
Objective: 2

4) A qualifying child of the taxpayer must meet the gross income test.
Answer: FALSE
Explanation: The gross income test only applies to potential dependents who are not a qualifying child of the taxpayer.
Page Ref.: I:2-13
Objective: 2

5) For purposes of the dependency exemption, a qualifying child must be under age 19, a full-time student under age 24, or a permanently and totally disabled child.
Answer: TRUE
Explanation: Two primary considerations for qualifying child status are age and full-time student status. In addition, an otherwise eligible individual may qualify.
Page Ref.: I:2-13
Objective: 2

6) For purposes of the dependency criteria, a qualifying child may not provide more than one-half of his or her own support during the year.
Answer: TRUE
Explanation: An otherwise qualifying child will no longer qualify if he provides more than half of his own support.
Page Ref.: I:2-13
Objective: 2

7) Parents must provide more than half the support of their child under the age of 19 in order for the child to be considered as a dependent *qualifying child*.
Answer: FALSE
Explanation: The key support criteria for *qualifying child* status is that the child cannot provide more than half of her own support.
Page Ref.: I:2-13
Objective: 2

8) A daughter or son may not satisfy the criteria to be considered a qualifying child but may still qualify as a dependent.
Answer: TRUE
Explanation: A son or daughter, or certain other family members, may exceed the age 19 or age 24 and full-time student status but may still be a dependent based on the qualifying relative criteria.
Page Ref.: I:2-13 and I:12-14
Objective: 2

9) One requirement for claiming a dependent as a qualifying relative is that the taxpayer provides more than 50 percent of the dependent's support (assuming it is not a multiple support agreement situation).
Answer: TRUE
Explanation: If an individual does not qualify as a child, a key test is whether the taxpayer provides more than half of the individual's support.
Page Ref.: I:2-14 and I:2-15
Objective: 2

10) When two or more people qualify to claim the same person as a dependent, a taxpayer who is entitled to claim the dependent through the qualified child rules has priority over a taxpayer who meets the requirements for other relatives.
Answer: TRUE
Explanation: Tie-breaker rules favor the taxpayer who can claim the dependent under the qualifying child rules.
Page Ref.: I:2-16
Objective: 2

11) The person claiming a dependent under a multiple support declaration must provide more than 25% of the dependent's support.
Answer: FALSE
Explanation: The minimum support percentage for a person claiming the dependent under the multiple support agreement is 10%.
Page Ref.: I:2-16 and I:2-17
Objective: 2

12) Generally, in the case of a divorced couple, the parent who has physical custody of a child for the greater part of the year is entitled to claim the child as a dependent.
Answer: TRUE
Explanation: The custodial parent will claim the child as a dependent unless a parental release is signed.
Page Ref.: I:2-18
Objective: 2

13) The child tax credit is a partially refundable credit.
Answer: TRUE
Explanation: Generally, the refundable credit is limited to the lesser of (1) 15% of the taxpayer's earned income in excess of $2,500 or (2) $1,400 (if the taxpayer has one or two qualifying children).
Page Ref.: I:2-19
Objective: 2

14) In 2020, the standard deduction for a married taxpayer filing a joint return and who is 67 years old with a spouse who is 65 years old is
A) $26,100.
B) $28,100.
C) $27,400.
D) $24,800.
Answer: C
Explanation: ($27,400 = $24,800 + $1,300 + $1,300)
Page Ref.: I:2-9 and I:2-10
Objective: 2

15) In 2020, Brett and Lashana (both 50 years old) file a joint tax return claiming as a dependent their son who is blind. Their standard deduction is
A) $24,800.
B) $26,100.
C) $26,450.
D) $14,150.
Answer: A
Explanation: Blindness of a dependent does not increase the standard deduction of the taxpayers.
Page Ref.: I:2-9 and I:2-10
Objective: 2

16) Annisa, who is 28 and single, has adjusted gross income of $55,000, itemized deductions of $5,000 and a lifetime learning credit of $1,000. In 2020, Annisa will have taxable income of
A) $42,600.
B) $49,000.
C) $50,000.
D) $41,600.
Answer: A
Explanation:

Adjusted gross income	$55,000
Minus: Standard deduction	(12,400)
Taxable income	$42,600

Page Ref.: I:2-9 through I:2-11; Example I:2-4
Objective: 2

17) On June 1, 2020, Ellen turned 65. Ellen has been a widow for five years and has no dependents. Her standard deduction is
A) $26,100.
B) $24,800.
C) $14,050.
D) $12,400.
Answer: C
Explanation: $12,400 + $1,650 = $14,050
Page Ref.: I:2-9 and I:2-10
Objective: 2

18) Taquin, age 67 and single, paid home mortgage interest of $6,000, charitable contributions of $5,000 and property taxes of $4,000 in 2020. He has no dependents. Taquin will claim a deduction from AGI of
A) $14,050.
B) $16,650.
C) $16,100.
D) $15,000.
Answer: D
Explanation: The $1,650 deduction supplement for age or blindness only increases the standard deduction amount, not the itemized deductions allowed. In this case the increased standard deduction of $14,050 ($12,400 + $1,650) is less than the total itemized deductions of $15,000.
Page Ref.: I:2-9 and I:2-10
Objective: 2

19) The regular standard deduction is available to which one of the following taxpayers?
A) a married taxpayer filing a separate return where the other spouse itemizes
B) a person who has only unearned income and is a dependent of another
C) a nonresident alien
D) None of the above.
Answer: D
Explanation: Responses A through C are all examples of taxpayers who do not have the privilege of deducting the full standard deduction.
Page Ref.: I:2-11 and I:2-12
Objective: 2

20) Husband and wife, who live in a common law state, are eligible to file a joint return for 2020, but elect to file separately. Wife has adjusted gross income of $25,000 and has $2,200 of expenditures which qualify as itemized deductions. Husband deducts itemized deductions of $14,200. What is the taxable income for the wife?
A) $12,600
B) $22,800
C) $25,000
D) None of the above
Answer: B
Explanation: If one spouse on married filing separately returns itemizes deductions, the other spouse must also do so.

Income of wife	$25,000
Minus: Itemized deductions	(2,200)
Taxable Income	$22,800

Page Ref.: I:2-12; Example I:2-5
Objective: 2

21) Lewis, who is single, is claimed as a dependent by his parents. He received $2,000 during the year in dividends, which was his only income. What is his standard deduction for 2020?
A) $1,100
B) $2,000
C) $2,350
D) $12,400
Answer: A
Explanation: For a dependent, the standard deduction is the greater of earned income plus $350 or $1,100. Dividends are unearned income.
Page Ref.: I:2-12; Example I:2-6
Objective: 2

22) Charlie is claimed as a dependent by his parents in 2020. He received $8,000 during the year from a part-time acting job, which was his only income. What is his standard deduction?
A) $1,100
B) $12,400
C) $8,000
D) $8,350
Answer: D
Explanation: For a dependent, the standard deduction is the greater of earned income plus $350 or $1,100, but no more than the current year regular standard deduction amount.
Page Ref.: I:2-12; Example I:2-7
Objective: 2

23) Deborah is claimed as a dependent by her parents. She had a part-time acting job during 2020 and earned $13,000 during the year, which was her only income. What is her standard deduction?
A) $13,000
B) $1,100
C) $12,400
D) $13,350
Answer: C
Explanation: For a dependent, the standard deduction is the greater of earned income plus $350 or $1,100, but no more than the current year regular standard deduction amount.
Page Ref.: I:2-12; Example I:2-7
Objective: 2

24) Cheryl is claimed as a dependent by her parents. She had a part-time job during 2020 and earned $4,900 during the year, in addition to $600 of interest income. What is her standard deduction?
A) $1,100
B) $4,900
C) $5,250
D) $12,400
Answer: C
Explanation: For a dependent, the standard deduction is the greater of earned income plus $350 or $1,100, but no more than the current year regular standard deduction amount.
Page Ref.: I:2-12; Example I:2-7
Objective: 2

25) Ben, age 67, and Karla, age 58, have two children who live with them and for whom they provide total support. Their daughter is 21 years old, blind, is not a full-time student and has no income. Her twin brother is 21 years old, has good sight, is a full-time student and has income of $4,800. Which of the following statements is correct regarding Ben and Karla's ability to claim the twins as dependents?
A) The couple can claim both twins as dependents.
B) The couple cannot claim either twin as a dependent.
C) The couple can only claim the daughter as a dependent.
D) The couple can only claim the son as a dependent.
Answer: A
Explanation: Although their daughter is not their qualifying child, she still qualifies as a dependent since she meets all of the dependency tests for a qualifying relative. Their son qualifies as their dependent as he is their qualifying child and need not meet the gross income test. Therefore, they are entitled to both twins as dependents.
Page Ref.: I:2-13 and I:12-14
Objective: 2

26) Sarah, who is single, maintains a home in which she, her 15-year-old brother, and her 21-year-old niece live. Sarah provides the majority of the support for her brother, her niece, and her cousin, age 18, who is enrolled full-time at the university and lives in an apartment. While the niece and cousin have no income, her brother has a part-time job and earns $4,500 per year. How many dependents may Sarah claim?
A) 1
B) 2
C) 3
D) None
Answer: B
Explanation: Sarah may claim her niece and brother as dependents. Because her brother qualifies as her qualifying child for purposes of the dependency exemption, he does not have to meet the gross income test. Sarah may not claim her cousin as a dependent since her cousin does not live with her.
Page Ref.: I:2-13 and I:12-14
Objective: 2

27) Anita, who is divorced, maintains a home in which she and her 16-year-old daughter live. Anita provides the majority of the support for her daughter and for a son, age 23, who is enrolled part-time at the university and lives in the dorm. The son also works in the campus bookstore and earns spending money of $4,500. Which of the following statements is <u>correct</u> regarding the number of dependents Anita can claim?
A) Anita can claim her daughter, but not her son, as a dependent.
B) Anita can claim her son, but not her daughter, as a dependent.
C) Both the son and daughter qualify as Anita's dependents.
D) Neither the daughter nor the son qualify as Anita's dependent.
Answer: A
Explanation: Anita will claim her daughter who is a qualifying child. Anita's son does not qualify as her qualifying child because he fails the age test. He cannot qualify as her dependent under the general provisions because he fails the gross income test.
Page Ref.: I:2-13 and I:12-14
Objective: 2

28) John supports Kevin, his cousin, who lived with him throughout 2020. John also supports three other individuals who do not live with him:

Donna, who is John's mother
Melissa, who John's stepsister
Morris, who is John's cousin

Assume that Donna, Melissa, Morris, and Kevin each earn less than $4,300. How many dependents can John claim?
A) 1
B) 2
C) 3
D) 4
Answer: C
Explanation: John can claim three dependents—Kevin, Donna, and Melissa. Morris is John's cousin and does not qualify as a dependent since he doesn't live in John's home. A cousin is not related for tax purposes and would have to live in the taxpayer's home to be claimed as a dependent.
Page Ref.: I:2-13 and I:12-14
Objective: 2

29) Julia provides more than 50 percent of the support for three individuals throughout 2020: Theresa, an unrelated child who lives with Julia all year long; Margaret, Julia's cousin, who lives in another city; and Emma, Julia's daughter, who lives in her own home. Each of the potential dependents earned less than $4,300. How many dependents can Julia claim?
A) 0
B) 1
C) 2
D) 3
Answer: C
Explanation: (Theresa, Emma) Assuming all other tests are met, Theresa qualifies as Julia's dependent. A person who lives with the taxpayer all year long need not be related to the taxpayer. Margaret does not qualify as Julia's dependent. She is not related for tax purposes and, therefore, can't be Julia's dependent unless she lives with Julia all year long. Emma qualifies as Julia's dependent. Since Emma is Julia's daughter, she is related for tax purposes and need not live with Julia to be claimed as Julia's dependent. Therefore, Julia has two dependents.
Page Ref.: I:2-13 and I:2-14; Example I:2-9
Objective: 2

30) David's father is retired and receives $14,000 per year in Social Security benefits. David's father saves $4,000 of the benefits and spends the remaining $10,000 for his support. How much support must David provide for his father to meet the dependent support requirement?
A) $10,000
B) $10,001
C) $14,000
D) $14,001
Answer: B
Explanation: The amount that David's father saves is not counted in the support test. Therefore, David need only provide $1 more than his father ($10,000 + $1) to meet the more than 50 percent test.
Page Ref.: I:2-14 and I:2-15; Example I:2-13
Objective: 2

31) Which of the following is <u>not</u> considered support for the dependent support test?
A) food
B) clothing
C) rental value of lodging
D) value of services rendered by the taxpayer for the dependent
Answer: D
Explanation: Food, clothing, and the rental value of the lodging are all considered support.
Page Ref.: I:2-15
Objective: 2

32) Juanita's mother lives with her. Juanita purchased clothing for her mother costing $1,000 and provided her with a room that Juanita estimates she could have rented for $4,000. Juanita spent $5,000 on groceries she shared with her mother. Juanita also paid $700 for her mother's health insurance coverage. How much of these costs is considered support?
A) $5,000
B) $8,200
C) $10,000
D) $10,700
Answer: B
Explanation: $1,000 + 4,000 + 700 + .5(5,000) = $8,200
Page Ref.: I:2-15; Example I:2-14
Objective: 2

33) Anna is supported entirely by her three sons John, James, and Joseph who provide for her support in the following percentages:

John: 10%, James: 40%, Joseph: 50%

Assuming a multiple support declaration exists, which of the brothers may claim his mother as a dependent?
A) any of the sons
B) James or Joseph
C) Joseph only
D) none of them
Answer: B
Explanation: Although no one provides more than 50 percent of Anna's support, a qualifying pool of individuals (John, James, and Joseph) provide over 50 percent of Anna's support. Any one of them who provides more than 10 percent (James or Joseph) may claim Anna, assuming a multiple support agreement is filed.
Page Ref.: I:2-16 and I:2-17; Example I:2-17
Objective: 2

34) Blaine Greer lives alone. His support comes from the following sources:

Buddy (his son)	$2,600
Ken (his brother)	4,200
Martha (his daughter)	2,300
Natalie (a friend)	1,000
Total support	$10,100

Assuming a multiple support declaration exists, which of the individuals may claim Blaine as a dependent?
A) Ken or Martha
B) Buddy, Ken, or Martha
C) Ken, Martha, or Natalie
D) none of them
Answer: B
Explanation: A qualifying pool of individuals (Buddy, Ken, and Martha) provides more than 50 percent of Blaine's support. Natalie is not part of the qualifying pool as she could not otherwise claim Blaine because he is not related to her and does not live in her home. Of the qualifying pool, any individual who provides more than 10 percent of Blaine's support (Buddy, Ken, or Martha) may claim Blaine under a multiple support agreement.
Page Ref.: I:2-16 and I:2-17; Example I:2-17
Objective: 2

35) The child tax credit is for taxpayers with dependent children under the age of
A) 14.
B) 17.
C) 19.
D) 24.
Answer: B
Explanation: Children must be under age 17 to qualify.
Page Ref.: I:2-18
Objective: 2

36) Steven and Susie Tyler have three children ages 13, 15, and 19. The 19-year-old is in the military and not a dependent. Their modified AGI is $108,000. What is the total amount of the child tax credit and credit for other dependents to which they are entitled?
A) $0
B) $2,000
C) $4,000
D) $6,000
Answer: C
Explanation: 2 × $2,000 = $2,000. The 19-year-old will not qualify for the child credit, and as he is not a dependent, he will not qualify for the $500 credit for other dependents either.
Page Ref.: I:2-18 and I:2-19
Objective: 2

37) Nate and Nikki have two dependent children ages 12 and 15. Their modified AGI is $410,000. What is the amount of the child tax credit to which they are entitled?
A) $0
B) $500
C) $3,500
D) $4,000
Answer: C
Explanation: The child tax credit before the phase-out is $4,000 (2 × $2,000). They have excess AGI of $10,000 ($410,000 - $400,000). Their credit should be reduced by 10 ($10,000/$1,000) × $50 = $500. Thus, their child credit is $3,500.
Page Ref.: I:2-18 and I:2-19; Example I:2-22
Objective: 2

38) Ryan and Edith file a joint return showing $420,000 of AGI. They have three dependent children ages 7, 9, and 13. What is the amount of their child tax credit?
A) $0
B) $2,000
C) $5,000
D) $6,000
Answer: C
Explanation: The child tax credit is $2,000 per qualifying child, with a phase-out for AGI exceeding $400,000 on joint returns. $420,000 - 400,000 = $20,000. There are twenty $1,000 increments (or parts thereof) exceeding the $400,000 phase-out floor, so the child credit will be reduced by 20 × $50 = $1,000. Credit before phase-out is 3 children × $2,000 = $6,000. After the phase-out the credit is $5,000 = $6,000 - $1,000.
Page Ref.: I:2-18 and I:2-19; Example I:2-22
Objective: 2

39) Rose and Steve are a married couple with two qualifying children. Lily is a 15-year-old high school student, and Sam is a 21-year-old college student. The couple reports AGI of $165,000. The couple is entitled to child and other dependent tax credits of
A) $2,000.
B) $4,000.
C) $1,000.
D) $2,500.
Answer: D
Explanation: The couple is entitled to a $2,000 child tax credit for Lily because she is under 17. Sam's status as a dependent over age 17 entitles the couple to a $500 credit for other dependents.
Page Ref.: I:2-18 and I:2-19; Example I:2-24
Objective: 2

40) Amanda has two dependent children, ages 10 and 12. She earned $30,000 from her job, and her income tax before credits is $1,200. How much of her child tax credit is refundable?
A) $1,200
B) $1,400
C) $2,800
D) $4,000
Answer: B
Explanation: The child tax credit earned is $4,000 ($2,000 per child), of which $1,200 will offset the income tax liability. The refundable component of the $2,800 balance is limited to $1,400: the lesser of (1) 15% of the taxpayer's earned income in excess of $2,500 (which is $4,125) or (2) $1,400.
Page Ref.: I:2-18 and I:2-19; Example I:2-25
Objective: 2

41) Steve Greene, age 66, is divorced with no dependents. In 2020, Steve had income and expenses as follows:

Gross income from salary	$80,000
Total itemized deductions	5,500

Compute Steve's taxable income for 2020 Show all calculations.

Answer: Adjusted gross income	$80,000
Less: Standard deduction ($12,400 + $1,650)	(14,050)
Taxable income	$65,950

The additional standard deduction is for Steve's age.
Page Ref.: I:2-9 and I:2-10
Objective: 2

42) Sean and Martha are both over age 65 and Martha is considered blind by tax law standards. Their total income in 2020 from part-time jobs and interest income from a bank savings account is $80,000. Their itemized deductions are $25,000.

Required: Compute their taxable income.

Answer: Salary & interest	$60,000
Less:	
Standard deduction [$24,800 + (3 × 1,300)]	(28,700)
Taxable income	$31,300

The standard deduction is increased because of age for both and blindness for Martha.
Page Ref.: I:2-9 and I:2-10
Objective: 2

43) Kate is single and a homeowner. In 2020, she has property taxes on her home of $4,000, pays state income taxes of $5,000, makes charitable contributions of $3,000, and pays home mortgage interest of $6,000. Kate's adjusted gross income for 2020 is $77,000.

Required: Compute her taxable income for 2020.

Answer:	Adjusted gross income		$77,000
Minus:	Itemized deductions:		
	Property taxes	$4,000	
	State income taxes	5,000	
	Home mortgage interest	6,000	
	Charitable contributions	3,000	(18,000)
Taxable income			$59,000

Page Ref.: I:2-11; Example I:2-3
Objective: 2

44) In 2020, Sam is single and rents an apartment for which he pays $800 per month, pays state income taxes of $2,000 and makes charitable contributions of $1,000. Sam's adjusted gross income is $47,000.

Required: Compute his taxable income. Show all calculations.

Answer:	Adjusted gross income	$47,000
Minus:	Standard deduction	(12,400)
Taxable income		$34,600

Page Ref.: I:2-9 through I:2-11; Example I:2-4
Objective: 2

45) Eliza Smith's father, Victor, lives with Eliza who is a single taxpayer. During the year, Eliza purchased clothing for her father costing $1,200 and provided him with a room that could have been rented for $6,000. In addition, Eliza spent $4,000 for groceries she shared with her father. Eliza purchased a new computer for $900 which she placed in the living room for both her father and her use.

What is the amount of support provided by Eliza to her father?

Answer: Clothing	$1,200
Rental value of room	6,000
Groceries (1/2 × $4,000)	2,000
Total support	$9,200

Page Ref.: I:2-15; Example I:2-14
Objective: 2

46) Paul and Hannah, who are married and file a joint return, are in the process of adopting a child who is born in December 2020. The child, a son, comes to live with them a week after his birth on December 12. The adoption is not finalized until February of 2021. What tax issues are present in this situation?
Answer: Are Paul and Hannah able to claim the baby as a dependent in 2020, allowing them to claim a child tax credit?
Page Ref.: I:2-12 and I:2-13
Objective: 2

LO3: Determining the Amount of Tax

1) A married couple need not live together to file a joint return.
Answer: TRUE
Explanation: A couple legally married at year-end can filed a joint return.
Page Ref.: I:2-20
Objective: 3

2) A widow or widower whose spouse passed away in the current year may file a joint tax return as long as the widow or widower does not remarry before the end of the year.
Answer: TRUE
Explanation: A joint return may be filed in the year of death.
Page Ref.: I:2-22
Objective: 3

3) An unmarried taxpayer may file as head of household if he maintains a home for his qualifying child.
Answer: TRUE
Explanation: A divorced, legally separated or never married parent can file as head of household if he maintains a home for his qualifying child.
Page Ref.: I:2-22
Objective: 3

4) Theo's wife moved overseas in April, and they have not been in touch, although they are still legally married. Theo pays all the costs of the household which includes his 12-year-old son. Because Theo is still married, his only option is to file his tax return as married filing separately.
Answer: FALSE
Explanation: A married individual can claim head of household status if the taxpayer lived apart from the spouse for the last six months of the year, and the taxpayer paid over half the cost of maintaining the household with a dependent child.
Page Ref.: I:2-23 and I:2-24
Objective: 3

5) Kelly is age 23 and a full-time student with interest and dividend income of $2,600 in the current year. The total cost of her support for the year is $19,000. She is not subject to the kiddie tax.
Answer: FALSE
Explanation: She meets the age and student status to be subject to kiddie tax, and her unearned income exceeds the $2,200 threshold.
Page Ref.: I:2-25
Objective: 3

6) Divya is age 22 and a full-time student with $8,000 of income from part-time and summer jobs and $2,600 of interest and dividend income. The total cost of her support for the year is $15,000. Divya is not subject to the kiddie tax.
Answer: TRUE
Explanation: For children between ages 19 and 23 with unearned income exceeding $2,200 in 2020, the kiddie tax will apply unless earned income exceeds half of the cost of support. Divya's earned income is more than half of the cost of her support so kiddie tax will not apply.
Page Ref.: I:2-25
Objective: 3

7) If a 13-year-old has earned income of $500 and interest and dividends of $2,500, all of the income can be reported on the parent's return.
Answer: FALSE
Explanation: To be eligible, the child's income must come solely from interest and dividends.
Page Ref.: I:2-27
Objective: 3

8) Suri, age 8, is a dependent of her parents and has unearned income of $6,000. She must file her own tax return.
Answer: FALSE
Explanation: A dependent earning solely unearned income not exceeding $11,000 may report unearned income on the parents' return.
Page Ref.: I:2-27
Objective: 3

9) You may choose married filing jointly as your filing status if you are married and both you and your spouse agree to file a joint return. Which of the following facts would prevent you from being considered married for filing purposes?
A) You were married for several years, but your divorce became final in December.
B) You are married but living apart until some problems can be solved.
C) Your spouse died during the year.
D) None of the above
Answer: A
Explanation: Except in the year of the death of a spouse, marital status is determined as of the last day of the tax year. If the couple is divorced in December, then they are not married for tax purposes and may not file a joint return.
Page Ref.: I:2-20
Objective: 3

10) Tom and Alice were married on December 31 of last year. What is their filing status for last year?
A) They file as single.
B) They file as married filing jointly or married filing separately.
C) They file as single for half the year and married filing jointly for the other half.
D) They file as single for 364 days and married filing jointly for one day.
Answer: B
Explanation: Marital status is determined as of the last day of the tax year. If the couple was married on December 31, they are considered married for the entire year and may file either married filing jointly or married filing separately.
Page Ref.: I:2-20
Objective: 3

11) When a spouse dies, the surviving spouse for the year of death
A) may file a married filing jointly return.
B) must file a tax return using the single filing status.
C) must file a tax return using the head of household filing status.
D) may file a married filing jointly return only if the death occurred in the last half of the year.
Answer: A
Explanation: In the year of death, a joint return can be filed.
Page Ref.: I:2-22
Objective: 3

12) In 2017, Leo's wife died. Leo has two small children, ages 2 and 4, living at home whom he supports entirely. Leo does not remarry and is not claimed as a dependent on another's return during any of this period. In 2018, 2019, and 2020, Leo's most advantageous filing status is, respectively
A) single for all three years.
B) head of household for all three years.
C) surviving spouse, surviving spouse, head of household.
D) surviving spouse, surviving spouse, single.
Answer: C
Explanation: In the two years following year of death (2018 and 2019), Leo may file as surviving spouse as long as he has at least one dependent child living in the home during the entire year and he provides over half of the expenses of the home. After the two years following the year of death, Leo qualifies as head of household as he is unmarried and is maintaining a home for a qualifying individual (in this case, his qualifying child).
Page Ref.: I:2-22
Objective: 3

13) Edward, a widower whose wife died in 2017, maintains a household for himself and his 10-year-old daughter. Edward's most favorable filing status for 2020 is
A) single.
B) surviving spouse.
C) head of household.
D) married filing jointly.
Answer: C
Explanation: Surviving spouse status is only available for the two years following the spouse's death, in this case, 2018 and 2019. However, Edward does qualify for head of household in 2020.
Page Ref.: I:2-22
Objective: 3

14) In order to qualify to file as surviving spouse, all of the following criteria must be met by the widow or widower except
A) he or she and the decedent must have shared the same household as of date of death.
B) he or she must be a U.S. citizen or resident.
C) he or she must be qualified to file a joint return in the year of death.
D) he or she must have at least one dependent child living at home the entire year and pay over half of the expenses of the home.
Answer: A
Explanation: There is no requirement that the surviving spouse and the deceased spouse were living in the same household as of date of death.
Page Ref.: I:2-22
Objective: 3

15) Which of the following dependent relatives does not have to live in the same household as the taxpayer who is claiming head of household filing status?
A) uncle
B) brother
C) father
D) nephew
Answer: C
Explanation: A taxpayer with a dependent parent qualifies as head of household even if the parent does not live with the taxpayer.
Page Ref.: I:2-22 and I:2-23
Objective: 3

16) Sally divorced her husband three years ago and has not remarried. Since the divorce she has maintained her home in which she and her now sixteen-year-old daughter reside. The daughter is a qualified child. Sally signed the daughter's dependent status over to her ex-spouse by filing the appropriate IRS form. What is Sally's filing status for the current year?
A) single
B) surviving spouse
C) head of household
D) married filing separately
Answer: C
Explanation: Sally qualifies as head of household for the current year. A taxpayer with a qualifying child satisfies the head of household requirement even if the taxpayer releases the dependent status to the child's other parent.
Page Ref.: I:2-22 and I:2-23; Example I:2-29
Objective: 3

17) Dave, age 59 and divorced, is the sole support of his mother age 83, who is a resident of a local nursing home for the entire year. Dave's mother had no income for the year. Dave's filing status is
A) married filing separately.
B) single.
C) head of household.
D) married filing jointly.
Answer: C
Explanation: Dave's mother qualifies as his dependent. He qualifies as head of household since a taxpayer with a dependent parent qualifies even if the parent does not live with the taxpayer.
Page Ref.: I:2-22 and I:2-23
Objective: 3

18) Which filing status reaches the 37% marginal rate at the lowest level of taxable income?
A) surviving spouse
B) head of household
C) married filing separately
D) married filing jointly
Answer: C
Explanation: While the tax rates are the same for all filing statuses, a taxpayer filing as married filing separately will reach the 37% tax bracket at the lowest taxable income threshold of the the four filing statuses.
Page Ref.: I:2-23
Objective: 3

19) A married taxpayer may file as head of household under the abandoned spouse provisions if all of the following are met except
A) the taxpayer lived apart from his or her spouse for the last six months of the year.
B) the taxpayer is a U.S. citizen or resident.
C) the taxpayer pays over half of the cost of maintaining a household in which the taxpayer and a dependent son or daughter live for over half of the year.
D) the taxpayer must have been married for at least two years.
Answer: D
Explanation: The first three items are all required to meet the abandoned spouse definition. The requirements do not specify a minimum length of marriage.
Page Ref.: I:2-23 and I:2-24
Objective: 3

20) To qualify as an abandoned spouse, the taxpayer is not required to
A) be a U.S. citizen or resident.
B) live apart from the spouse for the last six months of the year.
C) pay more than half the cost of maintaining the home.
D) have a son or daughter in the home for the entire year.
Answer: D
Explanation: The dependent son or daughter need only live in the taxpayer's home for more than one-half of the year.
Page Ref.: I:2-23 and I:2-24
Objective: 3

21) In October 2020, Joy and Paul separated and have not lived with each other since, but they are still legally married. Due to some legal concerns, they will not file a joint return. Joy supports their children after the separation and pays the cost of maintaining their home. Joy's filing status in 2020 and 2021 is, respectively
A) single for both years.
B) head of household and single.
C) married filing separately for both years.
D) married filing separately and head of household.
Answer: D
Explanation: Joy and Paul are married on the last day of the year so either a joint return or a separate return is required unless Joy qualifies as an abandoned spouse (and thus, head of household). She does not qualify in 2020 since Paul was in the home during the last six months of the year. However, since Paul is gone, a married filing separate return is necessary since he is not around to sign a joint return. In 2021, Joy, though still married, qualifies as an abandoned spouse and, thus, head of household.
Page Ref.: I:2-23 and I:2-24; Examples I:2-32 and I:2-33
Objective: 3

22) The oldest age at which the "Kiddie Tax" could apply to a dependent child is
A) 17.
B) 18.
C) 20.
D) 23.
Answer: D
Explanation: The child must be under age 24.
Page Ref.: I:2-25
Objective: 3

23) Tobe is a 22-year-old college student with $5,000 of interest income and $6,000 of earned income. Kiddie tax will apply to him if
A) he is a part-time student and the cost of his support exceeds $12,000.
B) he is a part-time student and the cost of his support is $12,000 or less.
C) he is a full-time student and the cost of his support exceeds $12,000.
D) he is a full-time student and the cost of his support is $12,000 or less.
Answer: C
Explanation: Kiddie tax will apply to a full-time student between the ages of 19 through 23 with unearned income exceeding $2,200 in 2020 and whose earned income is less than or equal to one-half of his support.
Page Ref.: I:2-25
Objective: 3

24) Elise, age 20, is a full-time college student with earned income from wages of $4,400 and interest income of $500. Elise's parents provide more than half of her support. Elise's 2020 taxable income is
A) $0.
B) $150.
C) $500.
D) $3,850.
Answer: B
Explanation:

Earned income	$4,400
Plus: Interest income	500
Adjusted gross income	$4,900
Minus: Standard deduction [$4,400 + 350 but not more than $12,400]	(4,750)
Taxable income	$ 150

Page Ref.: I:2-25 and I:2-26; Example I:2-37
Objective: 3

25) Michelle, age 20, is a full-time college student with earned income from wages of $5,200 and interest income of $700. Michelle's parents provide more than half of Michelle's support. Michelle's 2020 taxable income is
A) $0.
B) $700.
C) $350.
D) $4,850.
Answer: C
Explanation:

Earned income	$5,200
Plus: Interest income	700
Adjusted gross income	$5,900
Minus: Standard deduction [$5,200 + 350 but not more than $12,400]	(5,550)
Taxable income	$ 350

Page Ref.: I:2-25; Example I:2-36
Objective: 3

26) Satish, age 11, is a dependent of his parents. His only source of income in 2020 is $8,000 of interest income on bonds given him by his grandparents, resulting in taxable income of $6,900. Under kiddie tax rules, calculation of tax requires dividing taxable income between net unearned income and other taxable income taxable at his own rate. Satish's taxable income will be divided as follows:
A) net unearned income -$6,900 and other taxable income -$0.
B) net unearned income -$5,800 and other taxable income -$1,100.
C) net unearned income -$0 and other taxable income -$6,900.
D) net unearned income -$8,000 and other taxable income -$1,100.
Answer: B
Explanation:

Unearned income	$8,000
Less: Statutory deduction	-1,100
Standard deduction	-1,100
Net unearned income	$5,800
Taxable income	$6,900
Less net unearned income	-5,900
Other taxable income	$1,100

Page Ref.: I:2-25 and I:2-26; Example I:2-37
Objective: 3

27) Yusef, age 15, is a dependent of his parents. In 2020 he earned $5,000 from a part-time job and $8,000 of interest income on bonds given him by his grandparents, resulting in taxable income of $7,650. Under kiddie tax rules, calculation of tax requires dividing taxable income between net unearned income and other taxable income taxed at his own rate. Yusef's taxable income will be divided as follows

A) net unearned income -$5,800 and earned taxable income -$1,850.
B) net unearned income -$7,650 and earned taxable income -$0.
C) net unearned income -$0 and earned taxable income -$7,650.
D) net unearned income -$1,850 and earned taxable income -$5,800.

Answer: A

Explanation:

Unearned income	$8,000
Less: Statutory deduction	-1,100
Standard deduction	-1,100
Net unearned income	$5,800
Taxable income	$7,650
Less net unearned income	-5,800
Earned taxable income	$1,850

Page Ref.: I:2-25 and I:2-26; Example I:2-37

Objective: 3

28) Evie is six years old, and the daughter of parents in the 37% tax bracket. Her only source of taxable income comes from a corporate bond fund received as a gift from her grandparents last year. For 2020, Evie earned $9,000 of interest income from this fund. What is Evie's federal income tax liability?
A) $680
B) $2,923
C) $2,626
D) $790
Answer: C
Explanation:

Earned income	$ 0
Plus: Interest income	9,000
Adjusted gross income	$9,000
Minus: Standard deduction	(1,100)
Taxable income	$7,900
Unearned income	$9,000
- Standard deduction	(1,100)
- Statutory deduction	(1,100)
Net unearned income	$6,800
Tax computation:	
$6,800 net unearned income x 37% (parents' tax rate)	$2,516
$1,100 remaining taxable income x 10%	110
Total income tax	$2,626

Page Ref.: I:2-25 and I:2-26; Example I:2-38
Objective: 3

29) The following information for 2020 relates to Emma Grace, a single taxpayer, age 18:

Salary	$6,500
Interest income	1,200
Itemized deductions	500

a. Compute Emma Grace's taxable income assuming she is self-supporting.
b. Compute Emma Grace's taxable income assuming she is a dependent of her parents.

Answer:

a.

Salary	$ 6,500	
Interest	1,200	
Adjusted gross income	$7,700	
Minus:	Standard deduction	(12,400)
Taxable income	0	

b.

Salary	$ 6,500	
Interest	1,200	
Adjusted gross income	$ 7,700	
Minus:	Standard deduction ($6,500 + 350)	(6,850)
Taxable income	$ 850	

Page Ref.: I:2-24 through I:2-26; Examples I:2-35 and I:2-36
Objective: 3

30) Indicate for each of the following the most favorable filing status for the 2020 tax year.

a. Kenny died on March 2, 2019. Marge, his wife, and Bart, their son, survive. Marge filed a joint return in 2019. Bart, age 18 in 2020, is a full-time college student and continues to live at home with his mother. He works part-time, earning $3,200. What is Marge's filing status in 2020?

b. Alan Spaulding is single and provides over 50% support of his niece Alicia who lives with him all year long. Alan maintains the household and claims Alicia as a dependent. Alicia makes $3,600 at a part-time job. She is a full-time student, age 18. What is Alan's filing status?

c. Lily, who was divorced on July 27, 2020, provides 100% of the support for her parents who live in a nursing home in Kansas and have no income. What is Lily's filing status?

d. Holly was abandoned by her husband Fletcher in September of the current year. She has not seen or communicated with him since then. What is Holly's filing status?

e. Rick, whose wife died in December 2017, filed a joint tax return for 2017. He did not remarry, but has continued to maintain his home in which his two dependent children live. What is Rick's filing status for 2020?

Answer:

a. surviving spouse

b. head of household

c. head of household

d. married filing separately

e. head of household

Page Ref.: I:2-20 through I:2-23

Objective: 3

31) Gina Lewis, age 16, is claimed as a dependent on her parent's return. She is their only child. She earned $4,300 from a summer job. She also earned interest of $3,850. Her parents' marginal tax rate is 37 percent.

Required:
a. Compute the amount of Gina's tax liability for 2020. The following schedule of tax brackets will be helpful.

b. Can Gina's parents take a child tax credit for her?
Answer:

a. Adjusted gross income ($4,300 + $3,850)	$8,150
Less: Standard deduction [greater of $1,100 or ($4,300 + 350)]	(4,650)
Allowable exemption (None-dependent of another)	0
Taxable income	$3,500

Gina's net unearned income:	
Unearned income: Interest	$ 3,850
Less: Statutory deduction of $1,100	(1,100)
Less: Standard deduction	(1,100)
Net unearned income	$ 1,650
Gina's taxable income in excess of net unearned income	$ 1,850

Tax calculation:		
Tax on net unearned income (parents' 37% marginal rate)	$ 611	
Tax on income in excess of net unearned income (10%)		185
Total income tax		$ 796

b. She is under age 17 and their qualifying child so she qualifies for the child credit. The credit will be phased out because the parents' marginal tax rate is 37% so their AGI will be beyond the phaseout range.
Page Ref.: I:2-25 and I:2-26; Example I:2-37
Objective: 3

32) For each of the following taxpayers, indicate the applicable filing status and the number of children who qualify for the child credit.
a. Jeffrey is a widower, age 71, who receives a pension of $10,000, nontaxable social security benefits of $12,000, and interest of $2,000. He has no dependents.
b. Selma is a single, full-time college student, age 20, who earned $6,800 working part-time. She has $1,700 of interest income and received $1,000 support from her parents.
c. Olivia is married, but her husband left her three years ago and she has not seen or heard from him since. She supports herself and her six-year-old daughter. She paid all the household expenses. Her income consists of salary of $18,500 and interest of $800.
d. Ruben is a single, full-time college student, age 20, who earned $6,800 working part-time. He has $250 of interest income and received $10,000 support from his parents.
e. Cathy is divorced and received $12,000 alimony from her former husband and earned $35,000 working as an administrative assistant. She also received $2,500 of child support for her daughter who lives with her. Cathy filed the appropriate IRS form and gave up the dependency exemption to her former husband.
Answer:

	Filing Status	**Child Credit**
a.	Single	0
b.	Single	0
c.	Head-of-Household	1
d.	Single	0
e.	Head-of-Household	0

Page Ref.: I:2-12 through I:2-24
Objective: 3

33) Mary Ann pays the costs for her Aunt Hazel to live in a nursing home. Aunt Hazel receives Social Security benefits of $7,000 a year which are turned over to the nursing home. Mary Ann pays the remaining cost of $33,000. Hazel has no other income. Mary Ann visits Hazel twice a week and meets with doctors and nurses regarding Hazel's medical care. What tax issues should Mary Ann consider?
Answer: Can Mary Ann file as head of household? Would Mary Ann be able to claim Hazel as a dependent?
Page Ref.: I:2-22 and I:2-23
Objective: 3

LO4: Business Income and Business Entities

1) The only business entity that pays federal income taxes is the C corporation.
Answer: TRUE
Explanation: S corporations and partnerships are both flow-through entities. Sole proprietors report the sole proprietorship income directly on their individual income tax return.
Page Ref.: I:2-27 through I:2-29
Objective: 4

2) The annual tax reporting form filed with the IRS by C corporations is the Schedule C.
Answer: FALSE
Explanation: C corporations file Form 1120. Sole proprietors report business income on Schedule C, which is included with individual's Form 1040.
Page Ref.: I:2-28
Objective: 4

3) A corporation has revenue of $350,000 and deductible business expenses of $240,000. What is the federal income tax, before credits?
A) $26,400
B) $22,000
C) $23,100
D) $38,500
Answer: C
Explanation: Taxable income is $110,000 ($350,000 - $240,000). The tax liability is $23,100 [.21 × 110,000].
Page Ref.: I:2-29
Objective: 4

4) Ray is starting a new business with a friend and trying to decide between a C corporation, S corporation, and partnership. Which of the following statements regarding his decision is correct?
A) An S corporation owner must pay income taxes only on the salary received.
B) A partner in a partnership is taxed on his or her share of partnership income.
C) A shareholder in a C corporation is taxed on his or her share of corporate income.
D) S corporations pay taxes on their current year income.
Answer: B
Explanation: The partnership form is a flow-through entity.
Page Ref.: I:2-27 through I:2-29
Objective: 4

5) Artco Inc. is a C corporation. This year it earned $50,000 of taxable income and paid a $10,000 distribution (dividend) to Lily, its sole shareholder. Lily has a marginal tax rate of 24%. Due to the corporation's results and the distribution paid, the IRS will receive total taxes of
A) $12,000.
B) $12,900.
C) $13,500.
D) $10,500.
Answer: A
Explanation:

Corporate tax	$50,000 × 21% corporate tax rate on $50,000	$10,500
Lily's tax on dividend	$10,000 × 15% dividend rate	1,500
Total tax		$12,000

Page Ref.: I:2-28 and I:2-29; Example I:2-40
Objective: 4

6) Silver Inc. is an S corporation. This year it earned $60,000 of taxable income and paid a $10,000 distribution to Daisy, its sole shareholder. Daisy has a marginal tax rate of 24%. Due to the corporation's results and the distribution paid, the IRS will receive total taxes of
A) $12,600.
B) $14,400.
C) $14,100.
D) $11,520.
Answer: D
Explanation:

Corporate tax		$ 0
Daisy's tax on flow-through income	$60,000 - 12,000 (20% qualified bus. ded.) × 24% marginal tax rate	11,520
Daisy's tax on distribution		0
Total tax		$11,520

Page Ref.: I:2-28 and I:2-29; Example I:2-40
Objective: 4

7) Paige is starting Paige's Poodle Parlor and is considering alternative organizational forms. She anticipates the business will earn $100,000 from operating before compensating her for her services and before charitable contributions. Page, who is single, has $6,000 of income from other sources and other itemized deductions of $13,000. Her compensation for services will be $50,000. Charitable contributions to be made by the business are expected to be $5,000. Other distributions (dividends) to her from the business are expected to be $14,000.

Required: Compare her 2020 income tax assuming she operates the business as a proprietorship, an S corporation, and a C corporation. Ignore payroll and other taxes.
Answer:

	Sole Proprietorship	*S Corporation*	*C Corporation*
Business income:			
Operating income	$100,000	$100,000	$100,000
Compensation paid to Paige		(50,000)	(50,000)
Charitable contributions			(5,000)
Net business income	$100,000	$ 50,000	$ 45,000
Corporate income tax (21%)			$ 9,450
Paige's income:			
Business income (above)	$100,000	$ 50,000	
Compensation (above)		50,000	$ 50,000
Dividends			14,000
Other income	6,000	6,000	6,000
Adjusted gross income	$106,000	$106,000	$ 70,000
Charitable contributions	5,000	5,000	
Other itemized deductions	13,000	13,000	13,000
Itemized deductions	18,000	18,000	13,000
Qualified business income ded.*	20,000	10,000	
Taxable income	$ 68,000	$ 78,000	$ 57,000
Individual income tax	$ 10,750	$ 12,950	$ 7,350
Total tax	$ 10,750	$ 12,950	$ 16,800

*Sole proprietorship: 20% × $100,000; S corporation: 20% × $50,000
Individual tax computations:
Sole proprietorship form
$4,617.50 + [.22 × ($68,000 - 40,125)] = $10,750
S corporation form
$4,617.50 + [.22 × ($78,000 - 40,125)] = $12,950
C corporation form
-tax on dividends $14,000 × .15 = $2,100, plus
-tax on taxable income of $57,000 - 14,000 or $43,000: $4,617.50 + [.22 × ($43,000 - 40,125)] = $5,250
Total individual tax = $7,350

Page Ref.: I:2-28 and I:2-29; Example I:2-40
Objective: 4

LO5: Treatment of Capital Gains and Losses

1) A $10,000 gain earned on stock held 13 months is taxed in a more favorable manner than a $10,000 gain earned on stock held 11 months.
Answer: TRUE
Explanation: Lower tax rates apply to long-term capital gains.
Page Ref.: I:2-31
Objective: 5

2) A building used in a business is sold after five years of use for a gain. The gain will be treated as a long-term capital gain.
Answer: FALSE
Explanation: Depreciable business property is excluded from the definition of a capital asset.
Page Ref.: I:2-31
Objective: 5

3) If an individual with a taxable income of $15,000 has a long-term capital gain in 2020, it is taxed at
A) 0%.
B) 20%.
C) 10%.
D) 15%.
Answer: A
Explanation: Taxpayers with taxable income of $40,000 or less will have a 0% tax rate on long-term capital gains.
Page Ref.: I:2-31
Objective: 5

4) If a single taxpayer with a marginal tax rate of 37% has a long-term capital gain in 2020, it is taxed at
A) 0%.
B) 20%.
C) 10%.
D) 15%.
Answer: B
Explanation: Single taxpayers with a marginal tax rate of 37% will have a 20% tax rate on long-term capital gains. The 37% marginal tax rate starts at $518,400 for a single individual, and the 20% long-term capital gain rate starts at taxable income of $441,450 for a single taxpayer.
Page Ref.: I:2-31
Objective: 5

5) If a single taxpayer with a marginal tax rate of 24% has a long-term capital gain in 2020, it is taxed at
A) 0%.
B) 20%.
C) 25%.
D) 15%.
Answer: D
Explanation: Single taxpayers with taxable income exceeding $40,000 but less than $441,450 will have a 15% tax rate on long-term capital gains. The 24% marginal tax rate for single taxpayers ranges from $85,525 to $163,300.
Page Ref.: I:2-31
Objective: 5

6) Steve and Jennifer are in the 32% tax bracket for ordinary income and the 15% bracket for capital gains. They have owned several blocks of stock for many years. They are considering the sale of two blocks of stock. The sale of one would produce a gain of $12,000 while the sale of the other would produce a loss of $18,000. For purposes of this problem, ignore itemized deductions and additional investment taxes. They have no other gains and losses this year.
a. How much tax will they save if they sell the block of stock that produces a loss?
b. How much additional tax will they pay if they sell the block of stock that produces a gain?
c. What will be the impact on their taxes if they sell both blocks of stock?
Answer:
a. $990. A net capital loss is limited to $3,000 per year × .32 = $960. They can carry over the remaining $15,000 loss to next year.
b. $12,000 × .15 (maximum rate on long-term capital gains) = $1,800.
c. $12,000 gain - $18,000 loss = Net capital loss of $6,000 of which $3,000 is currently deductible to save taxes of $3,000 × .32 = $960. They should sell both so that they totally escape taxation of the gain this year. They can carry over the remaining $3,000 loss to next year.
Page Ref.: I:2-31
Objective: 5

LO6: Tax Planning Considerations

1) Mr. and Mrs. Kusra are in the top tax bracket. They have just had a baby. The Kusras plan to gift a corporate bond they currently own to the baby. The bond pays $2,100 of interest income per year. The Kusra family overall will save taxes if the bond is transferred to the child.
Answer: TRUE
Explanation: Kiddie tax ramifications do not apply until the child has earned more than $2,200 of investment income.
Page Ref.: I:2-31
Objective: 6

2) Ivan Trent, age five, receive $2,900 of dividends per year from a mutual fund he owns; it is his only source of taxable income. Ivan's parents plan to gift a corporate bond they currently own to him. The bond pays $4,100 of interest income per year. Ivan's parents are in the 37% tax bracket. The individual income tax rate schedule that generally applies to a single taxpayer indicates a 10% tax rate until taxable income of $9,875. Ivan's family will save tax at the rate of 27% (37% - 10% tax rates) on the bond interest income if the parents transfer the bond to Ivan.
Answer: FALSE
Explanation: The child is subject to kiddie tax because he already receives investment income in excess of the $2,200 threshold. The tax on the interest income from the bond owned by the child will be taxed at the parents' marginal rate (37%).
Page Ref.: I:2-31
Objective: 6

3) Generally, when a married couple files a joint return, each spouse is liable for one-half of the entire tax and any penalties incurred.
Answer: FALSE
Explanation: Joint liability applies for the full tax.
Page Ref.: I:2-32
Objective: 6

4) A taxpayer is able to change his filing status from married filing jointly to married filing separately by filing an amended return.
Answer: FALSE
Explanation: Taxpayers are not able to change their status from filing a joint return to separate returns, although they can change their status from separate returns to a joint return by filing an amended return.
Page Ref.: I:2-33
Objective: 6

5) In order to shift the taxation of dividend income from a parent to a child
A) the parent must direct the corporation to pay the dividend to the child.
B) the parent must transfer ownership of the stock to the child.
C) the parent can deposit the dividend in the child's bank account.
D) all of the above will result in shifting the taxation to the child.
Answer: B
Explanation: Actual ownership of the asset must transfer to the child.
Page Ref.: I:2-31; Examples I:2-43 and I:2-44
Objective: 6

6) Married couples will normally file jointly. Identify a situation where a married couple may prefer to file separately.
A) The spouse with lower income has substantial medical expenses.
B) A couple is separated and contemplating divorce.
C) One spouse can be held responsible for the entire tax liability.
D) All of the above
Answer: D
Explanation: Responses A, B and C all provide situations where married filing separately may be preferential.
Page Ref.: I:2-32
Objective: 6

7) A taxpayer can receive innocent spouse relief if
A) the understated tax is attributable to erroneous items of the other spouse.
B) the innocent spouse did not know and had no reason to know that there was an understatement of tax.
C) under the circumstances, it would be inequitable to hold the innocent spouse liable for the understated tax.
D) All of the above conditions apply.
Answer: D
Explanation: All of the items are required for innocent spouse relief.
Page Ref.: I:2-33
Objective: 6

8) Kelsey is a cash-basis, calendar-year taxpayer. Her salary is $60,000, and she is single. She plans to purchase a residence in 2021. She anticipates her property taxes and interest will total $11,000 in 2021. Each year, Kelsey contributes approximately $1,500 to charity. Her other itemized deductions total $2,000. For purposes of this problem, assume the 2020 standard deduction amount remains in effect for 2021.

a. What will be her deductions from AGI in 2020 and 2021 if she contributes $1,500 to charity in each year?

b. What will be her deductions from AGI in 2020 and 2021 if she contributes $3,000 to charity in 2020 but makes no contribution in 2021?

c. What will be her deductions from AGI in 2020 and 2021 if she makes no contribution in 2020 but contributes $3,000 to charity in 2021?

d. Why does option C yield the largest deductions over time?

Answer:

		2020	**2021**
a.	Potential itemized deduction	$ 3,500	$14,500
	Standard deduction	12,400	12,400
	Deduction from AGI (larger of above)	$12,400	$ 14,500
	Deductions across two years		$ 26,700
b.	Potential itemized deduction	$ 5,000	$13,000
	Standard deduction	12,400	12,400
	Deduction from AGI (larger of above)	$12,400	$ 13,000
	Deductions across two years		$ 25,200
c.	Potential itemized deduction	$ 2,000	$16,000
	Standard deduction	12,400	12,400
	Deduction from AGI (larger of above)	$12,400	$ 16,000
	Deductions across two years		$ 28,200

d. The contributions have no tax benefit in 2020 because the standard deduction is taken and charitable contributions are itemized deductions.

Page Ref.: I:2-32

Objective: 6

9) Discuss reasons why a married couple may choose not to file a joint return.
Answer:
1. One spouse incurs most of medical expenses and itemized deductions can be maximized.
2. They may not want joint tax liability.
3. Casualty losses may be deductible on a separate return but not on a joint return because of the 10% floor.
Page Ref.: I:2-32 and I:2-33
Objective: 6

10) Discuss why Congress passed the innocent spouse provision and detail the requirements to be met in order to qualify as an innocent spouse and be relieved of liability for tax on unreported income.
Answer: The provision was passed because each spouse is liable for the entire tax on a joint return as well as penalties imposed. This would not be fair if one spouse concealed information regarding income or deductions from the other spouse.

An innocent spouse is relieved of liability when
1. The amount is attributable to grossly erroneous items of the other spouse.
2. The innocent spouse did not know of and had no reason to know that there was such an understatement of tax.
3. To hold the innocent spouse liable for the understatement would be inequitable.
4. The innocent spouse elects relief within two years after the IRS begins collection activities.
Page Ref.: I:2-33
Objective: 6

11) Oscar and Diane separated in June of this year although they continue to live in the same town. They have twin sons, Blake and Cliff, who remain in the family home with Diane. Oscar's income this year was $45,000 while Diane worked only part-time and made $15,000. Oscar also gambles heavily but told Diane that he had no winnings this year. What tax issues should they consider?
Answer: Oscar and Diane have several choices for filing status. Since they are still married on December 31, the last day of the tax year, they could file jointly. That will probably result in the lowest overall tax liability. However, they should consider joint and several liabilities, especially if Diane fears that Oscar may be hiding income. If Diane is maintaining the home in which at least one dependent child lives, she may be able to file as head of household. Of course, they could file separately which would result in the highest overall tax liability.
Page Ref.: I:2-32 and I:2-33
Objective: 6

12) Alexis and Terry have been married five years and file joint tax returns. Alexis began embezzling funds from her employer during the third year of their marriage. Last year, Alexis suddenly left the country and Terry does not know where she is. In the current year, Terry learned that the IRS had assessed him $27,000 in unpaid taxes due to Alexis's embezzlement. What tax issue(s) are present in Terry's situation? What questions would you ask Terry to determine his appropriate response to the IRS?
Answer: Is Terry eligible for innocent spouse relief? Did Terry benefit financially from Alexis's embezzlement? Did Terry have reason to know of the embezzlement?
Page Ref.: I:2-32 and I:2-33
Objective: 6

LO7: Compliance and Procedural Considerations

1) The requirement to file a tax return is based on the individual's adjusted gross income.
Answer: FALSE
Explanation: The requirement to file is based on the individual's gross income.
Page Ref.: I:2-34
Objective: 7

2) Tax returns from individual and C corporate taxpayers are due on the 15th day of the third month following the close of the tax year.
Answer: FALSE
Explanation: Individual returns and C corporation returns are both due on the 15th day of the fourth month following the close of the tax year.
Page Ref.: I:2-34 and I:2-35
Objective: 7

3) Tax returns from individual taxpayers and partnerships are due on the 15th day of the fourth month following the close of the tax year.
Answer: FALSE
Explanation: Individual returns are due on the 15th day of the fourth month following the close of the tax year, but partnership tax returns are due the 15th day of the third month.
Page Ref.: I:2-34 and I:2-35
Objective: 7

4) Assuming a calendar tax year and the conventional 15th of the month due date, all of the following business entities must file their 2020 tax returns by the March 15, 2021 except
A) the C corporation.
B) the S corporation.
C) the partnership.
D) All of the above entities must file their 2020 tax returns by March 15, 2021.
Answer: A
Explanation: A calendar-year C corporation 2020 tax return deadline is April 15, 2021.
Page Ref.: I:2-34 and I:2-35
Objective: 7

5) Form 4868, a six-month extension of time to file, allows a taxpayer to
A) avoid interest on underpayment of taxes due.
B) extend the filing date of the return as well as payment of the tax due.
C) extend the filing date of the return but the estimated amount of tax due must still be paid by the original due date of the return.
D) extend the filing date only at the discretion of the IRS.
Answer: C
Explanation: An extension to file a return is not an extension to pay any tax that is owed.
Page Ref.: I:2-34 and I:2-35
Objective: 7

6) Ava reports income from a sole proprietorship and interest earned on savings accounts. In addition to the Form 1040, she will need to file
A) Form 1099.
B) Schedule 1.
C) Schedule 2.
D) none of the above.
Answer: B
Explanation: Income from sole proprietorships is reported on Schedule 1.
Page Ref.: I:2-35
Objective: 7